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## RISK-BASED PRICING RECONSIDERED, PART 2

Second of a two-part look at Loan Risk Pricing

When the dust of today's cleanup clears, what will risk-based pricing look like?

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To read part 1 of this "Talking Credit" series first, [click here](#).

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Last week we discussed the need to consider the cost of loan servicing in the pricing of credit. Collateral surveillance and credit monitoring take staff time and attention and the bank can—and should—charge for these activities.

This week we're going to talk about considering the bank's equity capital in loan pricing. There are multiple ways that this can be approached. My overall point is that equity is a scarce resource and should be treated with considerable deference. It should be employed not only tactically (to make the balance sheet balance, so to speak) but also be deployed to earn a disciplined, consistent return commensurate with risk in the borrowing enterprise's business.

Give capital its due

Recognize, first, that equity capital is a source of funds. There are many regulatory definitions of capital adequacy and the point here is not to specify one over the other, but rather to explicitly consider equity as a source of funding.

If you do so, then it's a straightforward enough process to calculate what a minimum return on that capital, dedicated to lending, should be.

If your bank's equity-to-assets ratio is, say 6%, (12.5% of sources of funds are in the form of equity capital) then you should ask yourself if this is the appropriate funding mix for each individual loan.

Most probably, you've thought about this over time, and recognize that a portfolio of troubled credit requires a higher equity allocation than a portfolio of low-risk, efficiently performing loans appropriately diversified, risk rated, and monitored.

## Renewing a forgotten methodology: account analysis

In my work teaching on-line classes for ABA, I've been surprised to note in recent years how many community bankers have not been exposed to the concept of "account analysis."

This technique consists of the tracking of all costs and all income sources associated with an account relationship. In this way, each account can be valued objectively by the same criteria applied in a consistent way. It's really a simple process of calculating revenues and subtracting costs and noting whether there's a net profit on that particular piece of business.

Granted, there are several assumptions to be made in the allocation process. But the imprecision of a particular calculation is more than compensated for by the value and consistency of the result.

Some banks, generally larger ones rather than smaller ones, often take an additional step of requiring each account to produce a minimum return on equity. This makes sense in that it produces an analytical result that is inclusive of an ROE on an account-by-account basis.

## Capital's role in account analysis

There are two capital-related inputs to the process.

The first is indirect.

It comes in the form of a "risk premium" for each loan. The risk premium is driven by the bank's risk rating system. Most banks allocate the reserve to each "pass graded" loan, with a higher allocation for criticized loans. Often, these allocations approximate 1% or so for Pass, 1.75% for Special Mention, and 6% for Substandard. In addition, there is a specific ratio, credit by credit, for any portion of any Doubtful credit that is determined to be uncollectible.

In each category, the specific allocation is driven by the bank's historical loss experience, combined with any specific judgments on the overall condition of the economy or other special circumstances.

These allocations are called "indirect allocations" of capital, because the loan loss reserve is built by periodic charges to income (with the result being lower retained earnings).

The second methodology is the direct charge.

A direct charge is allocated to each loan, typically in the proportion of equity capital to total sources of funds. If this calculation works out to be, say 6%, then 6% of each loan is deemed to be funded by equity, with the balance of 94% by debt.

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Some banks create a "hurdle" rate that each loan is expected to generate.

If the bank chooses to price by a minimum-desired return on equity on each loan, the arithmetic is as follows: desired minimum ROE x .06 x average amount of the loan outstanding .

You can mix and match

Pricing loans to include cost of servicing and demanding a minimum return on equity are not mutually exclusive concepts. Bank analytical models usually can do both and should consider both. Reasonableness of the assumptions and consistency of the model's methodology are the keys to long term success.

Remember that our goal is to be accurate over time, rather than precise.

One problem that we have all experienced, particularly in times of robust economic growth and strong loan demand, has been the "category killer" bank that will underprice to get the business.

How many of us have sat around in loan committees shaking our heads in wonder about how some of our competitors are pricing loans?

We may or may not decide to match the price or try to beat it. That's a business decision related more to marketing, than to loan pricing.

We as an industry have an opportunity to reinstate a pricing environment that makes sense from a risk reward point of view. Our current situation is marked by a general caution and an aversion to risk. It's time to give capital the respect it deserves in the loan pricing process.

How many of your banks are using "science" in your loan pricing?

Are you satisfied with the result?

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear interviews with Ed about workouts here. You can e-mail him at [etoleary@att.net](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).

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