

## PRICING FOR RISK DEBATE GETS A REBOOT

Improving business renews a long-standing question

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When bankers start talking about pricing for risk, it's a sure sign that business is improving. Why?

My own theory is that bankers either are unsure of what the rate really should be, as loan demand begins to pick up. Or they are fussing about losing a deal or two to the competition, which has suddenly made certain deals less attractive, due to a lower contractual rate of interest.

There's also the possibility that this is a cop-out, and that banks have begun to price against the competition without much analysis of what the risks really are.

Has the mantra of "pricing for risk" become a verbal smoke screen?

Defining the terminology

Since this is such a durable topic among bankers, maybe we should be sure that we all mean the same thing when we talk about "pricing for risk."

One stark way of thinking about this question is to postulate that the only way to completely cover the risk inherent in any deal is to charge a rate that reimburses 100% of principal. Any loss is therefore completely covered.

So, this logic goes, anything less than that is in fact pricing in some degree of risk. Make sense? Probably not, as what borrower would ever agree to this?

Another narrow way of looking at this question is to view any spread above the lender's cost of funds as the risk premium and more rate is always better. Note that this form of pricing for risk is largely, if not completely, subjective.

I perceive that the risk in a particular deal is "X" and I therefore rationalize a contract rate of interest to meet the competition while at the same time calculating that it is sufficient to meet my subjective assessment of the risk.

This sort of thinking is inherently delusional and will not lead to sustainable returns net of provisions to the loan loss reserve. What banker would willingly and freely admit that he is not pricing for anticipated risk?

Yet how effective was pricing for risk over the last credit cycle?

## A commercial finance mindset

A sort of middle road between these mutually exclusive approaches is to view any credit risk in any deal as unwelcome and so pricing for risk means covering the full cost of administration and supervision of the credit to effectively reduce credit risk to near zero.

The mindset is that review, monitoring, and close supervision of collateral as well as operating results will substantially reduce credit risk.

This is the implicit pricing model of commercial finance loans. These are loans for the purpose of carrying inventory and receivables and are characteristically made to highly leveraged borrowers who pledge their working assets to secure the credit.

I've worked with lenders who specialize in commercial finance credits. Their techniques are thorough and effective and generally result in portfolios with low delinquencies and losses. These results come with a cost of administration that is often considerably higher than most other types of loans.

These lenders seem to know as much about the receivables and inventory securing their credits as the borrower himself does. Thinking about credit risk this way--understanding the business virtually as well as the borrower--is a credit risk model that makes sense in terms of understanding how to minimize loss. It is also instructive in the way it focuses on those activities that all experienced credit people acknowledge as significant risk minimizers.

Unfortunately, this usually implies a labor-intensive process. How expensive would this be to consistently maintain over a diversified portfolio of loans at most independent banks?

Loan risk management: always a subjective discipline

The traditional approach to loan pricing contemplates a thorough analysis of the bank's costs, and being that these costs are all recognized and allocated into every loan transaction.

Most banks accomplish this with varying degrees of formality. Any contractual rate of interest should be the sum of cost of funds plus cost of credit administration activities plus an allocation for the allowance (based on historical experience degree of credit quality criticism) plus a general overhead charge and the like.

Any system will ultimately produce results no better than the quality of the activity for servicing credit and the provisions to the allowance for loan losses based on anticipated risk. What is often missing is an honest assessment of what it really should cost the bank to monitor the activities of the borrower. We are often short-sighted in this process.

There will always be a degree of subjectivity in the process and our judgments in hindsight can be seen to be excessively optimistic or pessimistic, especially about economic conditions. This is where so many banks, large and small, were caught unawares four years ago. They simply had no idea that market conditions would be as negative and as protracted as they were. It's also true that loan managements were not always rigorous in measuring or anticipating concentrations of credit.

Two prerequisites for hitting the mark

Ultimately, our perceptions must be data driven. This means both an internal organization to troll for and capture this information and the "wisdom" to recognize what the inputs are really telling us.

How many of us could have priced most credit in 2007 for the risks that were only evident in hindsight, such as concentrations of credit?

The answer is that we probably couldn't have although we might have recognized the froth and turned down the loan spigot a bit.

To some, this suggests that no matter how much "science" is applied to rate setting, the job of properly pricing for risk is an imprecise process. Do you agree with that? If you really do, then ask yourselves how much of your loan pricing policy has been turned over to the competition.

What's the alternative?

There's a better way. How about being realistic about the skill sets and manpower necessary to properly oversee a portfolio of loans? How about making it your business to know what the competition is doing?

Get your "spies" working in the community so that you really understand who is doing what in terms of rate.

If you and your colleagues develop a consensus that the competition is pricing irresponsibly, then back off. Let them get some deals but make it costly in terms of their net interest margins.

Would you rather have the biggest bank in town or the most profitable?

You won't get the ultimate process exactly right. But at least you will calibrate a lot better.

Unfortunately, that's a difficult competitive posture as your best customers are susceptible to being picked off and rate is a very potent weapon.

How do you counter this?

Experience tells me that it's how you tell your story and present your value proposition to your borrowers. We'll get into that topic in detail next column. Independent banks must learn to tell their stories more effectively. Loan growth doesn't have to be 100% rate driven and you don't have to price your note case according to the competition's value proposition. Stay tuned.

#### 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 has been a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio 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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