New Basel III Standards Lead to Higher Rates or Lower ROE's

Beginning January 1, 2015, larger banks are required to allocate additional capital to cover their unfunded commitments, amounts most commonly associated with unused draws on lines of credit, letters of credit, or undrawn portions of construction loans. While smaller banks may not be required to simultaneously comply with these standards, their regulators may communicate either a formal or informal expectation that they comply even when not legally required to do so.

Regulators, banking industry analysts, and bank CEO's and CFO's all seem to agree that these new rules will have a major impact on the profitability of existing customer relationships and on commercial loan portfolios, to the point that banking organizations will need to reassess investment strategies and the allocation of capital to the products impacted by these rules.

To assess the significance of these changes, let's consider the impact on a few example loans, commonly originated by banks on either side of the Basel III threshold. This typically includes the undrawn portion of construction loans and lines of credit. Additionally, there may be another layer of capital requirements for loans meeting the Basel Commission's definition of Highly Volatile CRE, which adds either pricing or return pressures to these loan types. We will analyze each of these types in the following examples.

Lines of Credit

Using the example of a commonly utilized line of credit loan for $5 M, but where the average line use over time is only 50% of that amount or $2.5 M, we discovered that by pricing this loan at prime prior to Basel III, we could attain our targeted ROE of 20%. However, after imposition of the new guidelines requiring us to set aside additional capital for the unfunded portion of the loan, and assuming that our non-cancellable commitment was for one year or less, we had to accept either a lower ROE of 16.7%, or charge the customer approximately 50 basis points more on this loan, raising the rate to 3.73%.

If our non-cancellable commitment was longer than one year, the higher level of capital required to satisfy Basel III caused our ROE to fall further, to 14.61%. Otherwise, we would need to charge the customer an additional 50 basis points, bringing the rate on the loan up to 4.23%.

Acquisition, Construction & Development Loans

We encountered similar findings when we performed this same exercise on a typical construction loan. Our full commitment amount was $4.0 M and the construction period was projected to be approximately 12 months. Given the assumed draw schedule, the estimated outstanding balance over the construction period was $2.4 M.

We were previously able to price this loan at prime and, together with our normal applicable fees, we attained our target ROE of 22%. After applying the new Basel III rules for the additional capital to cover the unfunded commitment, we found that the ROE fell to 19.41%, unless we raised the customer's rate to 3.61%, in which case we were still able to earn our 22% ROE.

The situation deteriorates quickly if the underlying loan meets the Basel III definitions of a highly volatile commercial real estate loan. The total combined capital required to cover the extended portion of the loan, plus the unfunded commitment increases significantly (the HVCRE designation raises the necessary capital set-aside by 150%), and the ROE on the loan falls to 12.94%. Otherwise, the loan rate would need to be increased to 5.12% to meet our internal ROE target of 22%.

Commercial Real Estate Loans

Finally, let's consider the common example of a $2.5 M, five-year fixed rate commercial real estate loan (amortized over 20 years) with normal fees and expenses. In the past, we were able to price this loan at 4.25% and earn a very acceptable 18% ROE.

If, for the sake of our example, this loan now qualifies as a Highly Volatile Commercial Real Estate Loan, either due to high LTV ratios, or low investor cash in the deal, the resulting ROE falls to 12%. To attain our target ROE of 18%, the rate would need to be increased to 5.35%.

Conclusion

Clearly, none of these changes will be welcomed by customers, lenders or shareholders, and application of the standards will reduce the bank's ability to grow commercial loans. Managers of commercial lending departments will increasingly need to focus on the following:

1. The amount of capital required for each loan type;
2. The potential loss of ROE to the bank; and
3. The pricing adjustment required to meet internal ROE targets.

With the availability of this information, you and your lending team will be able to identify the best alternative to meet the needs of your customers, bank, and shareholders.

As an endnote, if you'd like to see the details of the loan pricing analysis that supports the calculations of both the ROE's and the resulting loan prices referred to in this article, email us at Info@LoanPricingPRO.com and we will send you the full whitepaper upon which this article is based.

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