What's on the minds of Your Colleagues and Competitors?

Loan Growth & Profitability

Thank you for your interest in our recent webinar ***Loan Growth Strategies for Highly-Competitive Markets*** on Wednesday, February 24. We received overwhelming feedback to the webinar and are responding to questions submitted by participants. Because of your interest, we wanted to include you in this brief follow-up to the webinar. Please see the questions and answers below:

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1) We currently use a single ROE threshold for all loans. Specifically, I'm curious about your rationale for accepting a lower threshold for smaller balance loans and how you would rebut the criticism of "if we know smaller balance loans are inherently less profitable, why would we further lower the threshold and do additional, less profitable loans?"

This is an excellent question. We see financial institutions struggle with this issue all the time. We find that the response that any one particular institution has to the small-sized borrower is highly dependent upon:

- Your institution's current Loan/Asset ratio;
- Your liquidity position; and
- The strength of your loan pipeline.

If your institution is positioned in a vibrant economic marketplace and your loan pipeline is strong, your loan-to-asset ratio is high, and you do not have a lot of excess liquidity waiting to be deployed, you may very well be able to lessen the amount of smaller loans you accept.

However, we find that this is not the case for many institutions. For a financial institution with a low loan/asset ratio, high liquidity, and a weak loan pipeline, they really must consider accommodating some (perhaps larger) portion of their total loan portfolio with smaller loans.

If handled properly, it enhances both the absolute dollar amount of bank profitability, and increases bank-wide ROE. We have worked with many clients to help them achieve that outcome by properly setting ROE targets for the smaller loans.

This needs to take into account the existing portfolio ROE by product and by loan size, and the exiting ROE of the bank as a whole. Some banks view this as a part of their community bank mission and they need the volume to grow their portfolios. They also use it as a means of staying in touch with growing companies which might become larger borrowers in the future.

Click here to watch this segment (2 minutes, 11 seconds) of the webinar.

https://www.youtube.com/watch?v=vU5ZOyjI2YU#t=34m10s

2) What are you seeing from regulatory exams regarding acceptable levels of purchased participations?

While there are no bright line tests, or upper limit thresholds, as far as a percentage of total loans are concerned, regulators simply want to see evidence that your overall risk management program indicates that your institution can adequately manage risks inherent with participation loans. General guidelines that apply to participation loans include:

- Board approved policies and procedures,
- Underwriting standards, policy limits, and monitoring guidelines,
- Diversification in the bank's loan portfolio (concentration limits),
- Being cautious in lending outside of the bank's areas of expertise,
- Avoid entering into a relationship that is too complicated to understand,
- Know the agreement details, including details for the lead bank and all participants, and
- Understand how the participation may be sold or repurchased.

Click here to watch this segment (1 minute, 45 seconds) of the webinar.

https://www.youtube.com/watch?v=vU5ZOyjI2YU#t=25m05s

3) Our lenders have a mentality to grow loans without considering the impact of the full potential relationship. How can we "re-wire" them to recognize the increased value of gathering the whole relationship?

It is our experience that a formal pricing model is the best way to approach relationship pricing.
A model that is configured and calibrated correctly for your institution will give your lenders a quantitative view of the profitability of each relationship. Many times, this allows for lower loan pricing in competitive situations which can make the difference between losing the loan to a competitor or closing the deal for your institution. Tracking the percentage of commercial loan customers without (primary) deposit relationships will help, as will assuring that each loan officer receives periodic reports summarizing their personal portfolio's ROE trend.

Also, develop and implement well-structured incentive compensation systems that will encourage lenders to act in the best interests of the bank. Relevant performance measures must include more than just volume and rate considerations. Measures must incorporate ROE level and trends, as well as credit quality and other qualitative factors, like documentation completeness and referrals to retail lending, wealth management, deposit growth and new customer acquisition.

Click here to watch this segment (1 minute, 19 seconds) of the webinar.

https://www.youtube.com/watch?v=vU5ZOyjI2YU#t=30m56s

4) **Our bank doesn't have a loan pricing or profitability system, so is there any other way for us to determine low ROE relationships?**

Not having either of those systems puts your bank at a competitive disadvantage when it comes to identifying low return customer relationships in need of cultivation. You can use proxies for attempting to identify low return relationships, but those are relatively inaccurate and could cause you to spend time and energy moving in the wrong direction. Proxies for low return relationships might include things like smaller average account sizes, lower yields, longer fixed-rate terms, weaker credit scores, a lack of fee income and no or very small deposit balances. Obtaining either a loan pricing system, when implemented with an interface to your core data, or a customer profitability system, greatly facilitates the efficiency with which you can identify existing customers with large potential for profitability improvement.

Click here to watch this segment (4 minutes, 38 seconds) of the webinar.

https://www.youtube.com/watch?v=vU5ZOyjI2YU#t=20m22s

5) **In your presentation's first example, you talked about adding $30 M of loans – did you assume increased costs for staffing, etc.?**

No, we didn't. When we talk with clients, typically CEOs, CFOs, and CLOs, about their organizations' capacity for bringing on new loan volume, and servicing those relationships, they almost always tell us that they feel they have significant excess capacity with existing staff to grow fairly considerably. We think that this is true for most institutions today. For that reason, we didn't increase operating expenses in our example.

Click here to watch this segment (3 minutes, 8 seconds) of the webinar.

https://www.youtube.com/watch?v=vU5ZOyjI2YU#t=16m12s

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http://www.loanpricingpro.com/category/resources/webinars/ ***or***

http://www.austinassociates.com/news/webinars/

If you would like to discuss specific loan growth and/or profitability questions directly with our loan pricing and profitability experts, please contact us:

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