Commercial Loan Pricing Strategies

September 30, 2014
Webinar
Jeff Morris - joined Austin Associates’ Financial Management Division in 1998. He is responsible for profitability analysis services and works with clients who utilize the firm’s innovative software products, including its proprietary organization/product/customer profitability software and its loan and deposit pricing software, with over 35 years experience in various financial management roles.

Andy Morgan - joined the firm in 2001. He is responsible for development and support of the firm’s proprietary software offered through the Financial Management Division. He has designed software applications for loan pricing, deposit pricing, customer information systems, organization/customer/product profitability, and other financial reporting systems designed exclusively for the community banking industry.

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AUSTIN ASSOCIATES, LLC

Financial Management Consultants for Community Bankers

- Community bank advisors for more than 40 years
- Specialized consulting and advisory services
  - Asset / Liability Management
  - Profitability Analysis & Improvement
  - Loan & Relationship Pricing Systems
  - Balance Sheet Structuring
  - Regulatory Compliance
- Current owners are consultants/managers
- Over 200 bank/thrift clients in 2013 in 26 states
AGENDA

Loan Pricing Webinar
September 30, 2014

- Trends
  - Community Banks(<$3B) vs. Regionals($20B-$100B)
  - Loan Yields vs. Market Rates
- Attendee Submitted Loan Pricing Case Studies
- Community Bank ROE and Loan ROE Trends
- Loan Pricing in a Rising Rate Environment
YIELD TRENDS

Loan Yields

- Community Bank Loan Yields
- 5 YR FHLB
- 1 YR FHLB
- Prime

<table>
<thead>
<tr>
<th>Year</th>
<th>Community Bank</th>
<th>5 YR FHLB</th>
<th>1 YR FHLB</th>
<th>Prime</th>
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<tr>
<td>2008Q4</td>
<td>6.44</td>
<td>2.63</td>
<td>1.72</td>
<td>3.52</td>
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<td>2009Q4</td>
<td>6.08</td>
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<td>1.78</td>
<td>2.67</td>
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<td>2010Q4</td>
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<td>1.47</td>
<td>2.08</td>
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<td>5.73</td>
<td>1.47</td>
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<td>2012Q2</td>
<td>5.67</td>
<td>1.45</td>
<td>1.35</td>
<td>2.30</td>
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<td>2012Q3</td>
<td>5.63</td>
<td>1.45</td>
<td>1.45</td>
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<td>2012Q4</td>
<td>5.57</td>
<td>1.45</td>
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<td>2013Q1</td>
<td>5.38</td>
<td>2.08</td>
<td>2.04</td>
<td>2.30</td>
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<td>2013Q2</td>
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<td>5.09</td>
<td>2.08</td>
<td>2.04</td>
<td>2.30</td>
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<tr>
<td>2014Q2</td>
<td>5.11</td>
<td>2.08</td>
<td>2.04</td>
<td>2.30</td>
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## CASE STUDIES – SUMMARY OF LOANS SUBMITTED FOR EVALUATION

<table>
<thead>
<tr>
<th>Case Num</th>
<th>Bank State</th>
<th>Bank Size</th>
<th>Loan Request</th>
<th>Term</th>
<th>Rate</th>
<th>Fees</th>
<th>Other Accounts</th>
<th>Loan ROE</th>
<th>Relationship ROE</th>
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<tr>
<td>1</td>
<td>IN</td>
<td>$775 M</td>
<td>$3.0 M</td>
<td>120 Mo.</td>
<td>4.5%</td>
<td>$30 K</td>
<td>None</td>
<td>9.43%</td>
<td>9.43%</td>
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<tr>
<td>1a</td>
<td>IL</td>
<td>$250 M</td>
<td>$1.5 M</td>
<td>120 Mo.</td>
<td>4.5%</td>
<td>$3,000</td>
<td>None</td>
<td>8.38%</td>
<td>8.38%</td>
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<tr>
<td>2</td>
<td>IN</td>
<td>$300 M</td>
<td>$100 K</td>
<td>60 Mo.</td>
<td>6.00%</td>
<td>$ -0-</td>
<td>None</td>
<td>13.90%</td>
<td>13.90%</td>
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<tr>
<td>3</td>
<td>FL</td>
<td>$350 M</td>
<td>$250 K</td>
<td>60 Mo.</td>
<td>5.50%</td>
<td>$ -0-</td>
<td>None</td>
<td>20.00%</td>
<td>20.00%</td>
</tr>
<tr>
<td>4</td>
<td>MN</td>
<td>$240 M</td>
<td>$2.4 M</td>
<td>60 Mo.</td>
<td>4.45%</td>
<td>$12 K</td>
<td>$1 M DDA</td>
<td>24.00%</td>
<td>29.35%</td>
</tr>
<tr>
<td>5</td>
<td>NY</td>
<td>$465 M</td>
<td>$1.1 M</td>
<td>60 Mo.</td>
<td>4.75%</td>
<td>$6,000</td>
<td>None</td>
<td>16.50%</td>
<td>16.50%</td>
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<tr>
<td>6</td>
<td>IN</td>
<td>$330 M</td>
<td>$500 K</td>
<td>12 Mo.</td>
<td>3.75%</td>
<td>$1,000</td>
<td>$200 K</td>
<td>19.00%</td>
<td>23.00%</td>
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<tr>
<td>6a</td>
<td>TX</td>
<td>$900 M</td>
<td>$1.2 M</td>
<td>12 Mo.</td>
<td>6.65%</td>
<td>$12 K</td>
<td>$150 K</td>
<td>57.00%</td>
<td>57.00%</td>
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</tbody>
</table>
CASE STUDY #1

RELATIONSHIP SUMMARY

**Bank**

$775 M Asset Savings Bank in IN  
Currently earning 11% ROE (E/A = 9.31%)  
Loan / Asset Ratio = 63%

**New Loan**

$3.0 M 10 year fixed @ 4.5% w/ $30,000 fee

**Existing Relationship**

Customer has:
- No deposits – loan only relationship

Existing Relationship = None (new request)

PRICING CONSIDERATIONS

- 10 year fixed rate carries high cost of funding, thus hurting ROE (9.43%)
- Increases bank’s interest rate risk
- New loan needs to be priced at 5.25% in order to return 15% Loan Target
- New loan needs to be priced at 4.75% in order to return 11% ROE (bank’s current ROE level)

**Strategy**

Negotiate rate up or term down. If either is not possible due to competitive influences, it might be best to walk away unless there is potential to add significant ($1M+) compensating deposit balances.
### CASE STUDY #1

#### Relationship Pricing System

**Loan Parameters**
- **Loan Structure**: Fixed Rate
- **Loan Amount**: $3,000,000.00
- **Fixed Rate** (%): 4.500%
- **Fixed Term**: 120
- **Amort/Commit Term**: 240
- **Balloon**: 360 months
- **Participation**: 0.000 % Rate Holdback: 0.000 %

**Credit Quality**
- **Provision Expense**: 0.800
- **Credit Quality**: Average
- **Funding Curve**: FHLM Borrowings

**Product Costs**
- **Payment Structure**
  - **Principal and Interest**
  - **Interest Only**
  - **Fixed Principal**
  - **Non-Linear** Schedule

**Loan Fees**
- **Commit Fee Calc**
  - **Fees**: 0.000
  - **Points**: 1.000
  - **Commission**: 0.000
  - **Pre-Pay Penalty**: 0.000

**Loan Input Report**
- **Total**: $2,466,756
  - **Profit**: $216,342
  - **ROE**: 9.43%
  - **Target**: 15.00%

**Monthly $**
- **Provision Expense**: $24,000.00
- **Interest Only**: $0.00
- **Fixed Principal**: $0.00
- **Non-Linear**: $0.00

**Payment Frequency**: Monthly
RELATIONSHIP SUMMARY

**Bank**

$250M Asset Commercial Bank in IL  
Currently earning 12.20% ROE (E/A = 10%)  
Loan / Asset Ratio = 72%

**New Loan**

$1.5M Loan @ 4.5% w/ $3,000 fees – requested for 120 Months

**Existing Relationship**

Prospective New Customer (none)

PRICING CONSIDERATIONS

- 10 year fixed rate carries high cost of funding, thus hurting ROE (8.38%)
- Increases bank’s interest rate risk
- New loan needs to be priced at 5.50% in order to return 15% Loan Target
- New loan needs to be priced at 5.00% in order to return 12% ROE (bank’s current ROE level)

**Strategy**

Negotiate rate up or term down. If either is not possible due to competitive influences, it might be best to walk away unless there is potential to add significant ($700k) compensating deposit balances
CASE STUDY #2

RELATIONSHIP SUMMARY

Bank

$ 300 M Asset Commercial Bank in IN
  Currently earning 12.50% ROE (E/A = 9.90%)
  Loan / Asset Ratio = 53%

New Loan

$100 K Loan @ 6.00% FR – 60 Months
  No Fees
  Credit Grade 4

Existing Relationship

Prospective New Customer (none)

PRICING CONSIDERATIONS

- Represents opportunity for new business / customer relationship
- Loan as specified is approximately equal to 13.9% ROE
- Given current low Loan/Asset ratio, work with customer to bring new business to bank

Strategy

Negotiate rate with customer as follows:
  If loan only relationship, rate = 6.25%
  With operating checking account (estimated average balances at $30,000), rate = 6.00%

Inquire about other profitable new relationship accounts available to be added? Rate could be even lower with these.
RELATIONSHIP SUMMARY

Bank
$350M Asset Commercial Bank in FL
- Currently earning 5.5% ROE (E/A = 7.4%)
- Loan / Asset Ratio = 74%

New Loan
$250 k CRE Loan @ 5.5% w/ no fees – requested for 60 Months

Existing Relationship
Prospective New Customer (none)

PRICING CONSIDERATIONS

- Represents opportunity for new business / customer relationship
- Loan as specified is approximately equal to 20% ROE
- Given current low Bank-wide ROE, it makes sense to do this deal as quoted

Strategy
If this is a competitive situation, the rate could go as low as 4.90% and still maintain a 15% ROE.

With operating checking account (estimated average balances at $30,000), rate could go to 4.75%
## RELATIONSHIP SUMMARY

**Bank**

$240M Asset Commercial Bank in MN  
Currently earning 8.0% ROE (E/A = 6.2%)  
Loan / Asset Ratio = 71%

**New Loan**

$2.4M Loan @ 4.45% w $12,000 fees – requested for 60 Months

**Existing Relationship**

$1M non-interest bearing checking account

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## PRICING CONSIDERATIONS

- This customer is highly self-funding
- Hi reported ROE (29%) is partly due to low capital level of bank
- Defensive pricing will apply due to self-funding (no rate is too low) and existing customer profitability level

**Strategy**

Rate could be lowered significantly to keep customer in the bank, as long as checking account stays
CASE STUDY #5

RELATIONSHIP SUMMARY

Bank

$465M Asset Commercial Bank in NY
   Currently earning 11% ROE (E/A = 9.8%)
   Loan / Asset Ratio = 54%

New Loan

$1.1M Loan @ 4.75% w/ $6,000 fees – requested for 60 Months

Existing Relationship

Prospective New Customer (none)

PRICING CONSIDERATIONS

✓ At these terms, loan is highly desirable (16% ROE)
✓ New loan could be priced as low as 4.0% and still exceed bank wide average ROE
✓ Given low Loan/Asset ratio, remain very competitive in order to win this deal

Strategy
Negotiate for rate at or near 4.75%
If client seeks rate concession, prospect for operating checking account, cash management, or other investment accounts
RELATIONSHIP SUMMARY

**Bank**

$330M Asset Commercial Bank in IN
- Currently earning 11.5% ROE (E/A = 9.3%)
- Loan / Asset Ratio = 70%

**New Loan**

$500k Loan @ prime + 50 w/ $1,000 fees – requested for 12 months

**Deposit Balances**

$200 K DDA balances

PRICING CONSIDERATIONS

- Floating rate loans carry a lower cost of funds than term loans (short end of the curve)
- Full usage ROE is 19% while 50% usage yields 17.8% ROE
- With $200 K deposit balance, the ROE of the customer is 24%

**Strategy**

Given bank’s current ROE, target for this customer should be around an 18% ROE. Pricing is adequate to achieve this return level
### CASE STUDY #6

**Relationship Pricing System**

<table>
<thead>
<tr>
<th>Loan 1</th>
<th>Loan 2</th>
<th>Loan 3</th>
<th>Loan 4</th>
<th>Loan 5</th>
<th>Loan 6</th>
<th>Loan 7</th>
<th>Loan 8</th>
<th>Loan 9</th>
<th>Loan 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit: $500,000</td>
<td>ROE: 9.06%</td>
<td>Target: 19.37%</td>
<td>Profit: $200,000</td>
<td>ROE: 6.83%</td>
<td>Relationship: Webinar8 - Webinar Cust 8</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total**
- Profit: $700,000
- ROE: 22.78%
- Target: 15.00%

**12 Months Benchmark Calc**

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**Credit Quality**
- Provision Expense: 0.90%
- Credit Quality: Average
- Funding Curve: FHLM Borrowings

**Product Costs**
- Origination Expense: 0.12%
- Servicing Expense: 0.06%
- Fixed Expense: 0.24%
- Tax Rate: 14.00%
- Capital Allocation: 9.00%
- Risk Adjustment: Default

**Payment Structure**
- Principal and Interest: Yes
- Interest Only: Yes
- Fixed Principal: No
- Non-Linear Schedule: No
- Interest Only after P&I: 0 months
- Payment Frequency: Monthly

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### Loan Parameters
- **Loan Structure**: Adjustable/Floating
- **Loan Amount ($)**: $500,000.00
- **Adjustable Rate (%)**: 3.750
- **Reprice Frequency**: 0
- **Amort/Commit Term**: 12 months
- **Balloons**: 0 months
- **Participation**: 0.00%
- **Rate Holdback**: 0.00%

### Loan Fees
- **Commit Fee Calc**: 0.20%
- **Points**: 0.00%
- **Commission**: 0.00%
- **Pre-Pay Penalty**: 0.00%
- **Monthly $**: 0.00
### RELATIONSHIP SUMMARY

**Bank**

$900M Asset Commercial Bank in TX  
Currently earning 11.0% ROE (E/A = 9.3%)  
Loan / Asset Ratio = 46%

**New Loan**

$1.2M RLOC @ 6.65% w/ $12,000 fees – requested for 12 months

**Existing Relationship**

$150k Deposit Relationship  
Credit Grade 2

### PRICING CONSIDERATIONS

- This is a slam dunk, no brainer!
- ROE is above 50%
- With a Loan/Asset Ratio <50%, this is a deal the bank needs.
- 1 Point fee also has a huge impact on ROE

**Strategy**

If this becomes a competitive negotiation, there is a lot of room on pricing. ROE target can be met at every pricing level.
### Community Bank ROE by Product

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage Loans</td>
<td>32.5%</td>
<td>31.9%</td>
</tr>
<tr>
<td>Commercial Loans</td>
<td>19.2%</td>
<td>12.6%</td>
</tr>
<tr>
<td>Treasury Products</td>
<td>20.4%</td>
<td>8.8%</td>
</tr>
<tr>
<td>Deposit Products</td>
<td>6.5%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Bank</td>
<td>14.5%</td>
<td>8.9%</td>
</tr>
</tbody>
</table>

Community Bank ROE by Product

<table>
<thead>
<tr>
<th>CLIENT</th>
<th>COMMERCIAL LOANS</th>
<th>BANK AS WHOLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>CLIENT A</td>
<td>17.3%</td>
<td>11.8%</td>
</tr>
<tr>
<td>CLIENT B</td>
<td>14.9%</td>
<td>10.4%</td>
</tr>
<tr>
<td>CLIENT C</td>
<td>23.1%</td>
<td>9.5%</td>
</tr>
<tr>
<td>CLIENT D</td>
<td>13.9%</td>
<td>8.6%</td>
</tr>
<tr>
<td>CLIENT E</td>
<td>12.0%</td>
<td>7.7%</td>
</tr>
<tr>
<td>CLIENT F</td>
<td>5.7%</td>
<td>6.1%</td>
</tr>
<tr>
<td>CLIENT G</td>
<td>7.5%</td>
<td>6.0%</td>
</tr>
<tr>
<td>CLIENT H</td>
<td>7.2%</td>
<td>2.7%</td>
</tr>
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</table>

Prior Historical Averages:
- Commercial Loans: 18.5%
- Bank as Whole: 11.4%

Commercial Loans versus Bank-wide ROE
CONSIDERATIONS WHEN SETTING PRICING TARGETS

- Avoid Single Numeric Targets
- Current Bank-wide ROE
- ROE of Existing Commercial Loan Portfolios
  - Make Apples to Apples Comparisons
- Appetite for New Loan Balances
- What is the competition doing?
- Capital Availability
- The ROE of the Customer’s Existing Relationship
- Incremental Improvement
KEY STRATEGIES FOR 2014 - 2015

- Prepare for rising interest rate environment
  - Raise ROE targets going forward
  - New loans must cover future cost of funding
- Focus sales strategy on relationship instead of loan price
- Always give the customer alternatives and options – avoid ever saying “NO”
- Avoid pricing down to the competition, or to as low as the pricing model says you can go
- Be disciplined and objective – walk away from deals if the bank’s objectives are not being met
CONTACTS

We appreciate hearing from you.

If you have questions or comments, regarding today’s Webinar, or if you would like to see any of your bank’s current loan or customer relationships modeled, please feel free to contact us at any time.

We would also be pleased to provide your lending team with a customized demonstration of the Austin Associates Commercial Loan Pricing System - simply contact Andy or Jeff to arrange a date and time for your demo.

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