PERFORMANCE MATTERS

The Crisis of Losing Money on Every Deal and Making It Up in Volume

By Dennis Child, Marketing Director, Thompson Consulting and Training (TCT)

September 2013

Despite the recent run up in interest rates and signs of an improved economy, financial institutions are still experiencing squeezes on interest margins and profitability. Making lending a profitable venture is still the central challenge facing financial institution managers. The problem could well get worse unless loan portfolios experience growth, see increasing yields, and are managed using stochastically derived methods.

Most credit unions and community banks have been reluctant to make loans to any but the most credit-worthy borrowers. But, there are only so many prime borrowers to go around. In fact, consumers with means, and usually the highest FICOs, are still in the process of reducing their debt. To increase loan portfolios, CEOs resort to price wars hoping to bring in what few prime borrowers there are. Studies performed by TCT indicate that many CEOs are making prime loans at prices below their costs. Sadly, these credit unions are losing money on every loan they make and trying “to make it up in volume”. TCT ALM* models confirm that many credit unions are spiraling into a self-imposed “down-shock” scenario and their equity projections are dire at best.

Breaking the spiral into extinction and improving interest margins requires steps that for many CEOs pushes them outside their comfort levels and beyond their present skills. They must “reach deeper” into the pool of prospective borrowers. Reaching deeper and making loans to less-than-prime borrowers is not for the faint of heart, nor for the novice lender. Without the proper management tools and guidance, making loans to the less-than-prime borrower is every bit as disastrous as making loans to high FICO borrowers at rates below cost.

Studies and models performed by TCT, show that interest margins improve when credit unions implement two basic processes: (1) establish a statistically substantiated, well thought out Concentration Risk policy; and (2) utilize a statistically derived and validated Risk Based Loan pricing-model.

Concentration Risk Policy

CEOs need to establish Concentration Risk polices that at the very least set maximum equity-at-risk levels for FICO pools as well as for loans by type and term. TCT provides a very effective modeling tool to aid CEOs in determining what their equity at risk levels should be for each of their FICO pools.

Risk Based Loan Pricing

Almost all CEOs realize that individual borrowers pose different risk depending on their credit history, circumstances and habits. Many use some form of tiered loan pricing. However, few CEOs are really pricing their loans using a statistically derived and validated model that takes into account all expenses unique to each FICO tier. TCT's Risk Based Loan pricing tool determines interest rates that need to be assessed to borrowers in each FICO tier to assure they are priced profitably. This Risk Based Loan pricing model takes into account, by FICO tier, a credit union's unique: (1) cost of funds; (2) processing costs (direct and indirect); (3) collection costs; and (4) charge-offs.

Once a credit union CEO has an effective Concentration Risk policy and an accurate Risk Based Loan pricing model, they can confidently "reach deeper" into the pool of potential borrowers and enjoy better interest margins and profitability.

For more information on TCT's Risk Based Loan pricing tools or TCT's assistance in drafting a Concentration Risk Policy, please contact the author at dennis@tctconsult.com.

For a copy of Dr. Randy Thompson's white paper, Risk Based Pricing, A Model for Credit Unions, please send an email address and contact information to dennis@tctconsult.com.

*For a copy of Dr. Randy Thompson's white paper on TCT's Asset/Liability Modeling tool, send contact information including email address to dennis@tctconsult.com.