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"Small potato" borrowers can benefit from big-business practices

Building and maintaining a quality board of directors

BANK *Wire*

Risk and reward

Consider these factors when pricing commercial loans

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Is your institution one of the many community banks that take a "seat of your pants" approach to pricing commercial loans? In other words, you look at what your competitors are charging and set your rates accordingly.

If this is your M.O., be aware that it can be a dangerous approach — it's no way to judge whether the pricing is sufficient to cover your costs and risks. A better approach is to use loan-pricing models: financial models that calculate interest rates based on your desired returns, costs, risks and other assumptions.

A loan-pricing model can help you make informed decisions about whether it makes sense for your bank to match competitive rates. And if you incorporate risk-based pricing into the model, you can more effectively customize prices based on a borrower's credit profile, relationship with your bank and the loan's terms.

What are the risks?

Your model should consider a variety of risks; generally, the higher the risk, the higher the interest rate:

Credit risk. This refers to the risk that borrowers will default, causing the bank to lose principal or interest, or both, and to incur higher collection costs. To develop accurate pricing information, banks should track their actual loss experience by loan type, loan-to-value tier, and credit score or grade. This data allows you to better match pricing to the risks associated with particular types of loans or borrowers.

Interest rate risk. There are types of interest rate risk but, in general, the term refers to the risk that a loan's profitability will change as interest rates fluctuate. If, for example, a bank funds long-term fixed-rate loans with short-term deposits, a flattening yield curve will cause the bank's margins to shrink. Its pricing should reflect this risk by charging higher rates for longer-term fixed-rate loans.

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Option risk. Many bank products contain options that can affect a loan's profitability if exercised, such as the right to prepay a loan or withdraw deposits early with little or no penalty. Option risk, a form of interest rate risk, exists because, when interest rates go *up*, deposit holders tend to move their funds into higher-yielding investments. And when rates go *down*, borrowers see an incentive to refinance. Either way, the bank's margins decline.

How can a loan-pricing model help?

A detailed discussion of specific loan-pricing models is beyond this article's scope. But it's critical for your bank to select a model that's appropriate in light of its circumstances. Many models, for example, focus on maximizing risk-adjusted return on capital. This approach may be appropriate when funding is in short supply and capital is scarce. But if your bank is highly liquid, it may make more sense to evaluate loan

How does cost factor in?

To develop an accurate picture of a loan's profitability, it's critical to account for all associated fees, origination costs and servicing costs. Do these costs vary by loan type? Are they fixed or do they vary by loan size? If your bank doesn't track cost data by loan type and size, it may be able to consult industry data for pricing purposes.

prices in comparison to alternative investments in which it would otherwise park its cash.

Despite their name, loan-pricing models aren't necessarily used to price loans, since banks are usually constrained by what the market will bear. But a well-designed model can help you determine whether your bank should offer certain types of loans at competitive rates. Or you may choose not to compete, if those rates won't cover your costs and risks.

You may find that your funds are better invested elsewhere. For instance, you might consider making loans for which demand is high, but supply is low — such as long-term, fixed-rate fully amortizing commercial real estate loans. Many banks are reluctant to make these loans because of concerns about interest rate risk. But with the right loan-pricing model you can charge an appropriate risk premium that allows your bank to hedge that risk. And the market will likely bear the premium because of the high demand compared to supply.

Whichever model you choose, it's only as good as the data and assumptions you plug into it. Review your information systems, processes and procedures to be sure you're tracking the data you need to price loans effectively.

Benefits of risk-based pricing

Incorporating risk-based pricing into their models enables banks to align loan prices with expected risk, charging higher interest rates for higher-risk loans and lower interest rates for lower-risk loans. This helps a bank attract and retain customers with the highest credit quality. Flat-rate pricing, on the other hand, often results in a disproportionate number of low-credit-quality loans because it drives the best customers to look elsewhere for better rates.

Consider the whole relationship

One thing that distinguishes community banks from other banks is the relationships they form with customers. Rather than setting prices based solely on the profitability of a loan, you should price loans based on the value of the entire relationship. This approach can ultimately allow your bank to maintain profitability long-term by helping you to retain valued customers. ▲

"Small potato" borrowers can benefit from big-business practices

You're the kind of banker who likes lending to small business owners. You typically develop a face-to-face relationship with the principal, wrap your arms around the company's financial condition quite easily, and like helping the "little guy." But part of you knows that small businesses often carry more risk than their beefier, more established, counterparts.

Small businesses can learn from bigger businesses — there are reasons why the latter grew and why they endure. So, assess whether your "small potato" customers are benefiting from some of the best practices of the "big enchiladas."

Operating lean

Public companies answer to investors who consider earnings per share and stock price to be key

gauge whether each employee is meeting or exceeding management's expectations — or whether his or her goals require revision. Reviews also give employees feedback on their performance and the opportunity to improve weaknesses.

Penetrating the market

Most large corporations have well-known brands and strong online presences. Likewise, successful small businesses know their target market and are recognized by buyers on the local level.

indicators of their return on investment. Maximizing earnings is a short-term goal, but building value requires a long-term focus.

Many small businesses operate lean — with limited staff and overhead — but, in doing so, they may sacrifice value-building opportunities. Sometimes you need to spend money to grow or protect your assets.

For example, if your small-business borrower is hiring its managers based solely on minimizing expenses (rather than professional expertise), it could be on a road to failure. Likewise, if, reluctant to make the financial investment, the borrower passes up opportunities to pursue new markets, it might be squandering its potential for growth.

Formalizing a vision

Startups can successfully be run on gut instinct for a short while. But eventually every business needs a long-term strategic plan. Formal planning allows owners to communicate their visions down the organizational chart, as well as to lenders and private investors. Business plans give outsiders the opportunity to play devil's advocate, which can help pinpoint potential flaws and weaknesses.

Planning should extend to employees. What's each worker's expected role in the owner's strategic vision? Annual performance reviews help employers

Social media campaigns — such as Facebook posts and Groupon offers — are fairly inexpensive ways small borrowers can penetrate their local market and build brands.

Leveraging assets

Borrowing enables businesses to grow quickly. Unfortunately, many private business owners are debt averse, preferring to grow slowly using personal or company funds. But a little leverage can go a long way.

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The theory behind the concept of leverage is that the business can generally earn a higher return from its operations than the cost of its debt. Today's low interest rates make debt a particularly attractive form of financing. To sweeten the deal, interest on the debt is tax-deductible.

Balancing work and life

People, they say, are a company's biggest asset. And people at large corporations work hard. But there are usually specific work and vacation hours. Small businesses tend to blur the lines between home and office, especially if they're one and the same.

No one can be productive or innovative when they're overtired and overworked. A sign of a successful entrepreneur is the ability to take time off and relax. A true vacation allows the owner to recharge — and proves that the company is a viable going concern.

Shared concerns

Small businesses share many of the same concerns as large businesses, including operating and health care costs, regulatory intervention and uncertainty over economic conditions. It makes sense then that your small-business customers can benefit from employing some of the same best practices as do the big ones. ▲

Building and maintaining a quality board of directors

Today's regulatory environment applies increasing pressure on banks to beef up their compliance and risk management functions. In examining these functions, federal banking regulators are emphasizing the critical oversight role played by a bank's board of directors.

All community banks should review the composition of their boards and develop strategies for recruiting and retaining quality directors and evaluating their effectiveness.

Regulatory expectations

OCC guidelines issued last fall establish risk management standards for large banks under its supervision. Although community banks aren't required to comply with these standards, they provide valuable insight into regulators' heightened expectations for banks of all sizes.

According to the guidelines, a bank's board should 1) require management to establish and implement an effective risk governance framework, 2) actively oversee the bank's risk-taking activities and 3) hold management accountable for adherence to the framework. In addition, the board should have at least two independent directors. And all directors should exercise sound, independent judgment.

The guidelines also state that banks should provide ongoing training to directors, proportionate to their knowledge and experience, on subjects such as complex products and services, significant risks, and banking laws and regulations. And boards should conduct annual self-assessments to evaluate their effectiveness.

What to look for in a director

There's no single profile of the quintessential director. But all good bank directors share certain characteristics.

According to the OCC's *Director's Book*, the principal qualities of an effective director are strength of character, an inquiring and independent mind, practical wisdom and sound judgment.

Beyond that, the strongest boards have a diversity of skills, experiences, education and views. And it's important to ensure that your board's composition and technical skills align with your bank's strategies and business lines.

The *Director's Book* also suggests that director candidates should possess:

- Basic knowledge of the banking industry and regulatory framework,
- A willingness to put the bank's interests ahead of personal ones,
- A willingness to avoid conflicts of interest, and
- Knowledge of the communities the bank serves.

Additionally, candidates should, of course, have appropriate business experience and knowledge. And their willingness and ability to make the necessary time commitment is essential.

Perhaps the most powerful incentive for recruiting and retaining quality directors is a culture that allows them to do their jobs effectively.

Attracting and retaining directors

There was a time when the honor of being asked to join a community bank's board was the only incentive a prospective director needed. But in the current environment, the honor of serving is counterbalanced by concerns about the challenges of the director's job and potential legal liability.

So how do you attract quality directors and get them to stay? Compensation, benefits and liability insurance are important, of course. But perhaps the most powerful incentive is to create a culture that allows directors to do their jobs effectively.

Among other things, you should ensure that management is transparent regarding the bank's finances and operations, that the board is empowered to make decisions, that the board receives all the information it needs to make those decisions on a timely basis, and that management treats board members with respect, seeking their input on relevant matters.

Also important are ongoing training and educational opportunities and recognition of the directors' contributions.

Culture matters

As directors retire or move on to other endeavors, it's critical to replace them with a diverse group of talented business leaders. The right culture can help you recruit and retain the best people. ▲

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FED EASES CAPITAL REQUIREMENTS FOR COMMUNITY BANKS

A new Federal Reserve Board rule, now in effect, expands the availability of "small bank holding company" status. Small bank holding companies are exempt from the requirement to maintain consolidated regulatory capital ratios, which allows them to use traditional debt and other nonequity funding to finance growth or provide liquidity to shareholders (subject to certain limits). Regulatory capital ratios continue to apply at the subsidiary bank level.

The Fed increased the asset threshold of its "Small Bank Holding Company Policy Statement" from $500 million to $1 billion and expanded the policy statement to include certain savings and loan holding companies with consolidated assets of less than $1 billion. As before, small bank holding companies must meet qualitative requirements, including restrictions on nonbanking activities, off-balance-sheet activities and publicly registered securities. ▲

WHAT COMMUNITY BANKS DO TO MANAGE RISK

According to *Bank Director*'s 2015 *Risk Practices Survey*, 27% of banks with less than $1 billion in assets handle risk governance through a separate risk committee of the board, while 30% use a combined audit-risk committee, 21% use an audit committee, and 21% manage risk through the entire board.

Smaller banks also are following the lead of the largest banks by hiring chief risk officers or others officially designated with responsibility for overseeing the bank's risk management program. Among banks with less than $1 billion in assets, 71% have designated such an officer. Also, 75% of these banks have completed a formal enterprise risk assessment, 57% have prepared a "risk appetite statement," and 44% have a full-time information security officer. For more information, go to bankdirector.com and click on "Research." ▲

SHOULD YOU POST PRIVACY NOTICES ONLINE?

A new rule finalized by the Consumer Financial Protection Bureau allows banks to publish privacy notices on their websites rather than mail paper copies to customers once a year. But before you take advantage of this cost-saving opportunity, be sure you understand the rule's conditions. Among other things, your bank mustn't share nonpublic personal information in ways that would trigger customers' opt-out rights. And you must use the model privacy notice developed by federal banking regulators in 2009, without modification.

A bank that posts privacy notices online also must inform customers, at least annually, that privacy notices are available on its website and that it will mail paper copies upon request. Your bank can satisfy this requirement by including a "clear and conspicuous" statement on other regular consumer communications, such as account statements. ▲

P&G Associates

P&G Associates ("P&G") has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to national firms, P&G provides internal audit, regulatory compliance, BSA/AML, information technology and enterprise risk management review services and software. P&G is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

P&G's uniqueness is characterized by its experienced staff and partners. Their hands-on involvement on each engagement provides our clients with a wide range of skills, experience and industry expertise. We employ the use of Subject Matter Experts — designated individuals performing audits in their specific field of expertise. The use of such professionals provides a unique value-added approach that is both efficient and productive.

We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

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