

**Banking Industry Group**

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Member of the  
Wolf Financial Group

# community Banking

Better Ways ▲ Better Results

A NEWSLETTER FOR THE BANKING INDUSTRY

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## Pricing Agreements

### Winning the War Against Margin Compression

In today's challenging economic environment, many community banks are fighting an uphill battle to maintain acceptable margins on their small business loans — you might call it the "war against margin compression."

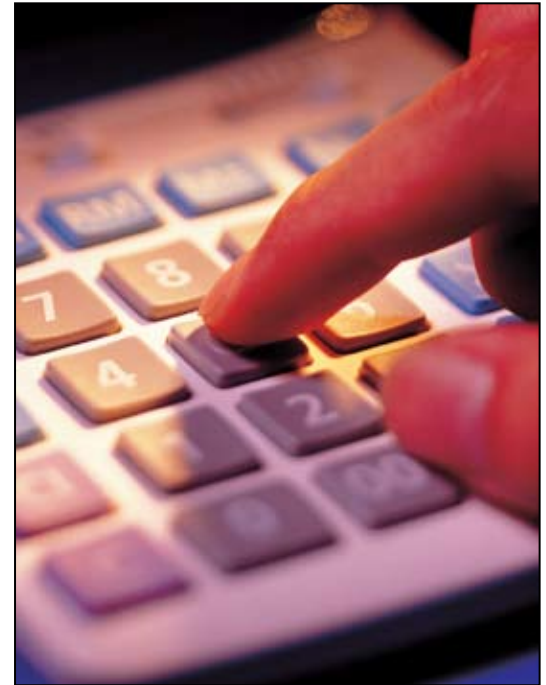
Winning this war requires a comprehensive loan pricing strategy. The first step: use a pricing model to determine exactly what you need to earn on each loan to cover your costs and meet your profit objectives. You can then create pricing agreements that communicate these expectations to borrowers and give you recourse to exercise remedies for non-compliance if they don't meet their obligations.

#### The Importance of Pricing Agreements

When lending to small businesses, most banks give borrowers various pricing options that include different combinations of interest rates charged, fees assessed and balances maintained. The bank, in turn, must weigh these against its primary expenses — cost of funds, direct product costs, administrative overhead and risk premium — to determine the profitability of each loan.

To ensure adequate margins, it's critical that pricing models accurately integrate each of these variables. The fact is, it's usually difficult to impossible to earn an acceptable rate of return on a small business loan without a corresponding deposit relationship (a scenario sometimes referred to as a "hire of the dollar" loan).

Similarly, usage on a credit facility is a key determinant of loan profitability. For example, if a pricing agreement estimates



50 percent usage of a line of credit, but a customer uses 75 percent, this will effectively lower the yield on the loan. To project usage more accurately, look at a borrower's historical performance — or if none is available, work with the borrower to come up with a realistic estimate.

A typical scenario faced by many community bankers might look something like this: ABC Bank and XYZ customer agree to a loan in which the interest rate will be 5.25 percent, the balance maintained will be no less than \$50,000 and the average percentage of line usage will be 60 percent. However, one year into the agreement, usage is 80 percent and balances on deposit are only half.

Without a formal pricing agreement, the banker's only recourse is to try to re-price

# How Cross-Selling Boosts Customer Loyalty

There's no question that community banks face unique challenges in today's tough credit environment. In times like these, it often pays to go back to the basics and refocus on what gives community banks a competitive advantage: specifically, adding value to relationships with small business borrowers.

Doing so will likely allow you to broaden and deepen your relationships with borrowers by recommending additional products and services that can help them at the appropriate stages of development. But here's the best news: The more entrenched a customer is with your bank, the less likely it is that they will leave.

Slipping such "golden handcuffs" onto your customers is the best way to engender their loyalty and increase customer retention.

## It's All About the Relationship

When considering the value of the overall relationship with each of your small business customers, it's important to think in terms of income, not rate. As our feature article in this issue details, the profitability of each customer is determined by a combination of interest rate, fees and balances across the entire relationship, not just a single loan.

Therefore, the key to maximizing the value of each small business relationship is cross-selling and up-selling customers so that they are using as many of your bank's products and services as possible. If customers are using five or more products or services, the chances of them leaving your bank for a quarter-point lower rate decrease drastically.

You can go a long way toward achieving the dual goals of adding value and cross-selling/up-selling by making strategic recommendations that will help

customers move from one stage of development to the next. Many business owners don't have experience in navigating the potential minefields that exist here, so you can play a valuable consultative role.

For example, there are a number of different products and services that can help companies in a fast-growth stage. These include treasury management services to help improve cash management, capital markets services to provide a capital boost to sustain growth, and asset-based loans to purchase additional materials and equipment.

Also, don't forget about cross-selling personal banking services to your small business customers. Personal checking accounts and loans, IRAs, auto and student loans, and online banking are all products that can help further entrench customers with your bank.

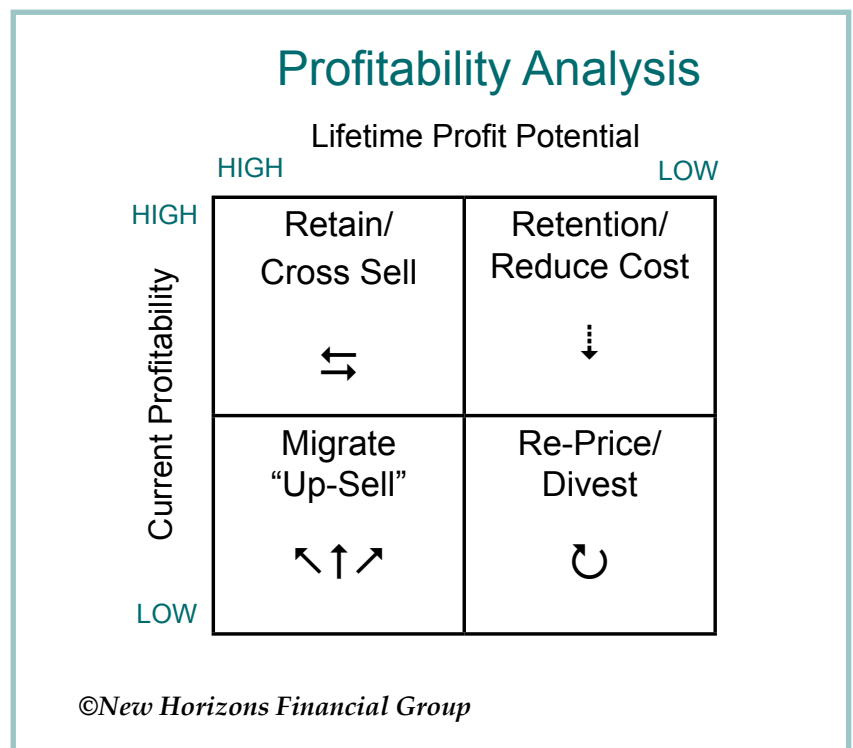
Online banking and bill-pay are especially valuable when it comes to holding onto customer relationships. Once customers have established these services (on both the business

and personal sides), they are more likely to remain with you, even if it's just out of convenience.

## But How Profitable Are They?

Of course, the degree to which you will want to suggest additional services depends primarily on how profitable customers are to the bank. To determine this, you should gauge each customer's current and lifetime profit potential. The chart on this page illustrates strategies for retaining, cross-selling, up-selling or divesting customers based on their profit potential.

For example, if a business is highly profitable now and has the potential to remain so over its lifetime, you would want to pull out all the stops to retain this customer and cross-sell them as many products and services as possible. However, if a customer is marginally profitable or unprofitable now and will likely remain so in the future, you should try to re-price the loan and/or move the business out of the bank. ■



the loan at maturity and make up the difference over the next year. However, the bank will always be playing catch-up, and this approach may severely damage the customer relationship.

## Higher Loan Spreads

Using sound loan pricing models and implementing formal pricing agreements can lift loan spreads by as much as 30 to 50 basis points. In addition to helping ensure profitability, pricing agreements offer several other benefits to the bank, such as:

- Enabling the bank to price for risk, performance and/or relationship (more details below).
- Giving the bank recourse to exercise remedies for non-compliance with loan terms and covenants, including re-pricing the loan before it matures and billing the customer for the value ascribed to deposit balances that do not materialize.
- Helping the lender define a walk-away point at which making a loan is not in the best interest of the bank.

**Pricing for risk.** Accurately pricing loans for risk is a potential source of competitive advantage for community banks. To do this effectively, banks must accurately assign Asset Quality Ratings (or AQRs) to each loan.

The first step is to create an AQR framework with sufficient levels of granularity in place — or in other words, one that includes more than just one broad “pass” category for minimal and acceptable risk loans. Typically, such a framework will include up to six different “pass” categories ranging between “substantially risk-free” and “marginally acceptable.”

Next, you must create a mechanism for assigning appropriate risk premiums to each loan, and for

tracking the AQR migration of loans over time. Performance benchmarks should be established that, if crossed, would trigger a change in AQR. If loans move down the AQR scale toward a higher probability of default, this will impact the profitability of the credit, and the pricing agreement should stipulate what recourse is available to the bank — a rate adjustment, additional fees or a bill — to help preserve its profit.

### Pricing for performance.

Performance-based pricing is based on providing incentives to borrowers to provide financial statements to the bank on a periodic basis. Such statements enable the lender to monitor key metrics and ratios that will help him or her gauge the financial health of the business, including some key performance indicators that may be in the loan covenants (such as leverage, liquidity and cash flow coverage ratios).

If covenants are not met, or if the borrower fails to provide the statements within the time period allotted, the pricing agreement should stipulate what recourse is available to compensate the bank for the potentially higher credit risk and increased administrative costs that will be incurred. On the flip side, the agreement may be structured to enable the business to receive a lower interest rate if it maintains the proper ratios and metrics.

### Pricing for relationship.

Relationship pricing is based on the idea of “bundling” products and services for customers. This can be a true win-win: Your customer may benefit from a lower overall cost of banking, while you benefit from a broader, deeper relationship with each customer. See the article on page 2 for more details on the benefits of these customer “golden handcuffs.”

## Facing Competitive Realities

Of course, all of these steps must be viewed in light of the competitive realities of your marketplace. Strictly enforcing the terms of a pricing agreement without considering the circumstances involved in each relationship may be akin to throwing the baby out with the bathwater. The last thing you want to do is chase off a good customer into the arms of a competitor, so consider each relationship on a case-by-case basis.

If your competitive environment doesn't allow you to be as aggressive as you'd like with regard to drafting and enforcing strict pricing agreements, you should at least let customers know you will be monitoring their credit usage, deposit balance and other variables, and that you expect them to abide by the terms of the agreement. Such awareness is often half the battle. ■

*For more information please contact Tim Johnson at 630-545-4594.*

## What Determines Profitability?

The primary determinants to profitability that a pricing model must incorporate are:

- Interest margin
- Non-interest margin
- Asset utilization
- Financial leverage
- Credit quality

We can help you determine which factors should be incorporated into your pricing model. For assistance, please give us a call.

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# BANKING BRIEFS

## Breaking the Fraud Triangle

In a slowing economy like we're facing today, instances of fraud and embezzlement often rise at small companies. Such fraud can literally wipe out a small business that doesn't have the financial means to recover, which makes it imperative that you help your customers guard against it.

Internal fraud is illustrated by what's known as the fraud triangle, which identifies three elements that must be present for fraud to occur: pressure, rationalization and opportunity. Pressures are personal circumstances that convince employees of the need to steal from their employer, such as large medical bills, gambling losses, substance abuse and an extravagant lifestyle. With enough financial pressure, some employees are able

to rationalize their fraud. "I deserve more money," "I'll eventually pay it back," and "The boss makes plenty of money anyway" are a few examples.

Business owners have no control over these two elements, but they do control whether employees have the opportunity to commit fraud. The two biggest mistakes owners make that can lead to employee fraud are failure to implement basic internal controls and failure to segregate financial duties.

Maintaining some level of personal financial oversight is the easiest internal control that business owners can implement. Some owners delegate all financial matters to a controller or bookkeeper — who may be a longtime, trusted employee —

and don't even so much as look at the bank statements. Taking this simple step is often enough to nip fraud opportunities in the bud.

The biggest opportunity for fraud occurs when there is little or no segregation of financial duties among employees. At least two separate people should make deposits, write checks and balance the bank statement to provide an appropriate level of financial checks and balances in the business.

We can help your clients implement appropriate internal controls to guard against fraud. Contact us for more details. ■



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