

WHITE PAPER



Seizing the Opportunity to Reverse the Long-Term Trend in Margin Compression

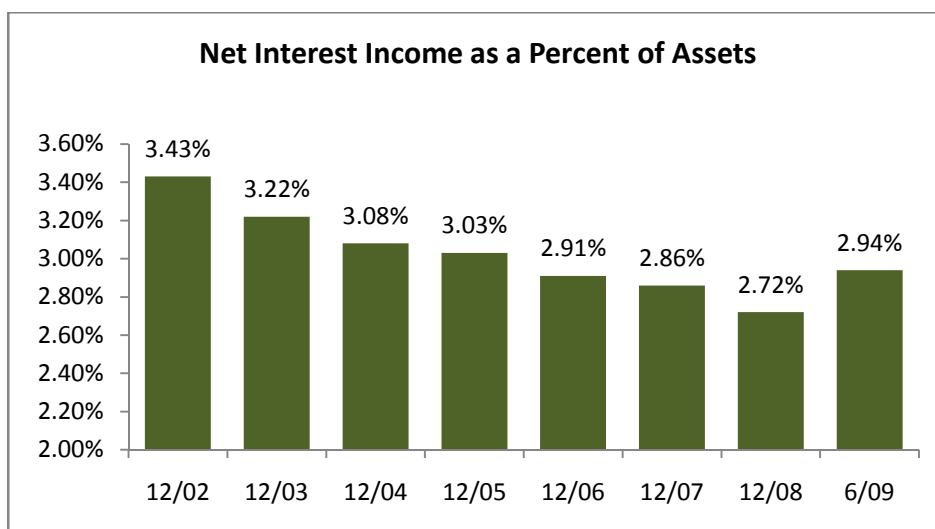
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Recent increase in net interest income sustainable?

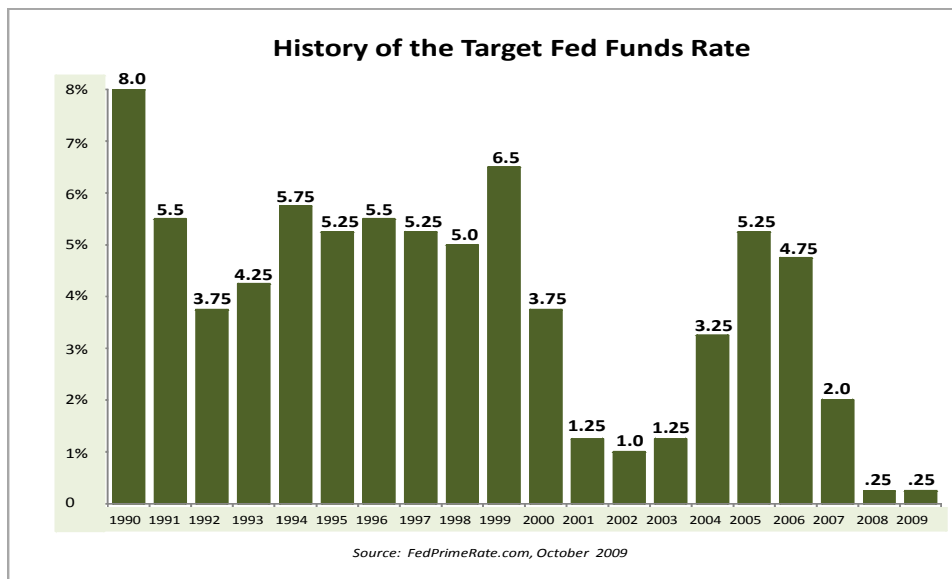
After seven straight years of decline, during the first six months of 2009, net interest income as a percent of assets increased. The improvement was not insignificant, a 22 basis point gain occurred when comparing the industry result for all of 2008. It hit the highest level since 2006.



While we would like to think there is a renewed, widespread discipline in the pricing of credits, more likely the root cause of the gain is something less permanent. Sooner or later, pressure to again grow assets (as a means of leveraging capital and enhancing return on equity) will slowly creep back into the industry’s behavior. Less risk-averse banks will once again start rationalizing looser credit standards with creative new explanations that “it is different this time.”

In the short-term – say the next few years while the industry continues to work out of this down credit quality cycle and the regulators are determined to demonstrate that they are cracking down on irresponsible bankers – sanity may well prevail. Long-term the same trends noted above will happen again.

The first proof point will be the inevitable increase in the Fed Funds rate that must occur soon. The graphic on the next page shows the downward movement of the Fed Funds rate from 1990 to recent times. The banking industry also will likely show a willingness and ability to sustain current margins by increasing the price of credit.



It does not have to be this way. However, a profound commitment to rational credit pricing is required by banks' Boards of Directors and executive teams to avoid another round of cyclicity in asset quality brought about by lax standards and irrational pricing that ignores risks.

The following solutions represent keys to effective loan pricing and the approaches discussed below have proven to work across myriad loan portfolio types. Success depends, quite simply, on effectively aligning profit objectives with lender goals and compensation. These new goals and objectives must then be supported with robust continuing education and training. There is no substitute for discipline and hard work.

Solutions to Improve Lending Profit Contribution

There are several important drivers of lending performance that affect the ultimate outcome of lending businesses. We address each of these opportunities for bankers to strengthen the profit contribution of myriad lines of lending business with more effective business processes in four controllable areas:

- Pricing discipline
- Sales and negotiating skills
- Operating efficiency/credit decision timeliness
- Management reporting and incentives

Pricing Discipline

Our client analyses have found that many bankers have a credible tool to help them determine pricing based on the overall relationship of the customer and the bank's requirements for profitability and tolerance for credit risk. However, pricing loans to match the competition has not stopped the erosion of margins.

In short, without a sound starting point and an understanding of the price needed to reach the bank's objectives, there is little hope of resisting pushback from any client.



An effective pricing discipline can yield substantial improvements, including:

- Increasing net interest margins in the loan portfolio.
- Rating borrowers on risk-adjusted profitability, ensuring that the bank is being paid for credit risk associated with different grade loans.
- Encouraging officers to cross-sell other bank services and secure core deposits to improve relationship profitability.
- Promoting profit-oriented relationship management and value-added selling.
- Ensuring the bank is being paid for its customer service.
- Measuring officers on risk-adjusted profitability and supporting risk-adjusted performance measures for incentive programs.

Sales and Negotiating Skills

Perhaps not surprisingly, those who complain the loudest about their competitors giving away credit to undercut their pricing, frequently have the worst loan yields.

Building strong relationships in business is the key to success in a competitive marketplace. Knowing this, most relationship managers rely on developing high-impact sales skills as a way to expand their customer relationships.

But an equally important skill in maintaining strong, professional relationships has often been overlooked. This is the ability to successfully negotiate the terms of the sale after the customer signals that he or she is ready to commit. This is when the stakes are highest in a relationship – when there is the most to gain and the most at risk. The goals of effective negotiation include:

- Uncovering and prioritizing the needs that lie beneath negotiation points for the customer and the bank.
- Conducting meetings that build solutions in a way that enhances the relationship.
- Using a creative process to break through seemingly insurmountable impasses.
- Responding to tactics and keeping negotiations centered.
- Using principled negotiation to get better outcomes for the bank.

Operating Efficiency

Pricing discipline and sales savvy will not compensate for poor underwriting and closing processes. While the elapsed time to make and fund a loan varies significantly by credit product, it is clear that borrowers expect and value timely decisions and error-free processing in funding the credit. Our experience with all lending products has found common themes in business processes that should be addressed to optimize the loan experience:

- Poorly deployed technology and/or inadequate use of available systems that support all aspects of loan processing and servicing, ranging from imaging and workflow management, to underwriting tools, to document preparation systems.
- Misaligned duties and responsibilities are found across an organization, most typically with experienced senior staff engaged in low-value-added tasks. This is particularly common in commercial lending.
- Under-utilized staff deployed in markets with low business potential and/or portfolio assignments overload certain lenders while under-utilizing the full capacity of the lending staff.
- Redundant checks and controls that do little or nothing to actually improve the quality control function, but instead slow processing.



Management Reporting and Incentive Systems

The old saying that “you get what you measure” couldn’t be truer than with lending. Commercial lender production and relationship reporting tends to be heavy on new business and asset quality, and somewhere between low-key and silent on other matters of profitability and the components of profit, including fees and rates.

There are typically meaningful opportunities to improve overall results by improving reporting and reward systems, including:

- Production goal-setting to include not just metrics for sales and credit quality, but also metrics for profitability, including specific goals for margin income.
- Periodic reporting of, and management follow-up to, performance against the goals, including coaching and other corrective actions to ensure focus on the desired results.
- Incentive rewards designed to ensure the collection of fees and achievement of margin goals to augment production and asset quality metrics.

Summary

Pressure on margins is not going to diminish. The goal that bankers can realistically expect to accomplish in the lending arena is to slow the inevitable pace. The level of information available to borrowers will continue to increase, and as a macroeconomic reality, profit margins will continue to shrink.

Bankers can be more effective at pricing and delivering loans of all types by systematically improving their business processes, including pricing, workload allocation, technology use, and incentive rewards.

For More Information

The FIS team of specialists comprises practitioners in financial services, operations, technology, risk management, and retail and commercial banking. Our operational expertise covers the many facets of deposit growth and branch network effectiveness. We deliver measurable results that aim to increase efficiency, grow revenue and improve profitability. We welcome the opportunity to discuss your specific areas of interest and learn how our consulting group may be able to help your organization move forward with key opportunities.