LOAN PRICING

4 Minute Read

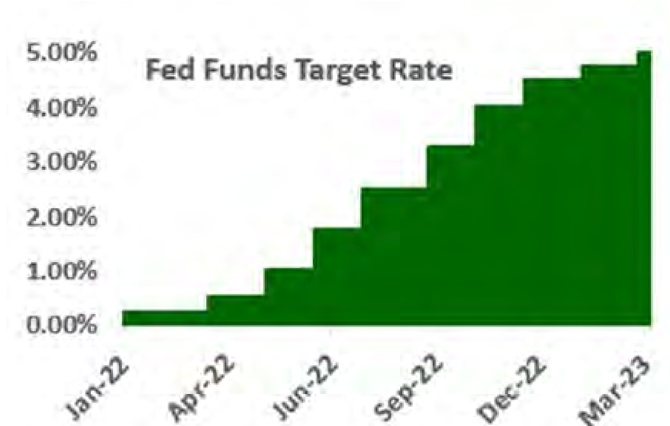
McQueen
Financial Advisors

Loan Pricing

As the Fed Funds & U.S. Treasury rates recently increased sharply, we have noted that loan yields have not kept pace. We will first review the recent benchmark rate changes, then turn to loan yields.

Loan yields have not kept pace

Fed Rate Hikes
At the start of 2022, the Fed Funds rate stood at 0.25% and was increased to 5.00% by early 2023. The magnitude of rate increase is unprecedented. The Fed has not increased the Fed Funds rate by more than 4 full percentage points in any 12-month period since the 1980s.



U.S. Treasury Rates Sharply Higher
1-year U.S. Treasuries yielded 0.40% in January 2022 and now stand at 4.60%, up over 4 full percentage points. Long term yields are up as well, but not nearly as much. 10-year U.S. Treasury yields are up approximately 2 full percentage points and now yield just over 3.50%.

Loan Yields
There is a strong relationship between 10-year U.S. Treasury rates and mortgage rates. As such, when 10-year U.S. Treasury yields trend higher, mortgage rates quickly follow. This same relationship doesn't exist for other loan types. Setting the rate on mortgage loans is straightforward enough. There is ample public information about competition, national averages and the rate at which U.S. Agencies will purchase loans. This same information doesn't exist for other loan types. We need alternative loan pricing methods for retail and commercial loans.

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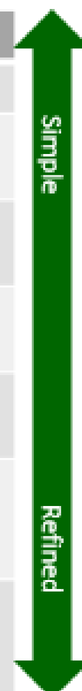
Loan Pricing Methods
Loan pricing methods may be simple or more refined. There are several methods available, and lenders may utilize different methods for each loan type. In our experience, the Market-Based method is most common.

Pricing Method	Description
One-Price	One size fits all (rarely used today)
Cost-Plus	Sum of cost of funds, operating expenses, risk and desired profit, expressed in basis points
Market-Based	Loan yields set on what the market will bear, based on a competitive survey
Index-Based	Yield tied to an index plus a spread, common for variable rate loans
Risk-Based	Variation of the cost-plus method with individual risk premium added based on credit score
Adjusted-Risk-Based	Variation of the risk-based method, considering factors other than credit score (debt-to-income, loan-to-value)
Profit-Based	Profit maximization is the primary driver, with consideration given to costs, risk, competition and growth opportunities



Market-based yield may be too low

Build-Up Method	Yield
Risk-Free U.S. Treasury	4.00%
CECL Allowance	1.25%
Credit Tier Spread	1.50%
Total	**6.75%**

A market-based yield of 5.00% is too low!

Build-Up Approach
This is simply a second look at loan yields from a different angle. The build-up method starts with a risk-free U.S. Treasury yield. Next, add the CECL allowance and risk-based premium, then compare the results to the market-based yield. Let's assume that loan yields in our competitive market are 5.00% and we'd like to know if this looks reasonable. A comparison using the build-up method looks like this:

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> Many lenders have not reset loan rates high enough

Supply & Demand

Traditional economic theory explains how price is determined: where supply meets demand. If lenders could raise rates indefinitely to increase profits, competition would quickly follow, and yields would fall. On the other hand, if high competition resulted in very low yields, some competitors would exit the market. The long-term result is an equilibrium position where growth is both possible and profitable. This balance will often (but temporarily) get out of whack. This is happening now because many lenders have not reset loan rates high enough in relation to the change in Fed Funds and U.S. Treasury rates. Mispriced lending can't last forever, but it may last longer than we would like.

Lend or Invest?

We know with near certainty that funding costs are likely trend higher. If ample liquidity exists, should we lend or invest? A comparison using the build-up method might reveal inadequate loan yields compared to market-based loan pricing. Sometimes, investment returns will look very attractive and should be considered. This is especially true if we expect economic stress, which may result in higher loan delinquency and charge-offs.

We suggest the following

- Raise loan rates to maintain a positive risk-based spread.
- Review offering rates and competitive pricing now and more often.
- If competitors have not increased rates yet, maybe they are waiting for the market to reset higher. Someone needs to move first. Why not you?
- Consider the change in the Fed Funds rate and U.S. Treasury rates when making pricing decisions.
- Review and update risk-based pricing grids.
- Reduce indirect dealer reserves to slow growth of low yielding programs.
- Internally discuss growth opportunities versus yield opportunities. Growth at low yields is never a good option.
- **Talk to your MFA Advisor about investment portfolio options in the current rate environment. Often, bond yields are a very attractive option.**