Cover story

Costs count: Control of operating expenses is central to loan profitability

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At first glance, it would appear that it has gotten easier to price loans for a profit in the past few years. Banks have seen their cost of funds plummet as interest rates fall and reckless competitors are swept away. At the same time, in response to pressure from regulators to boost capital, rates paid by consumers have not been cut nearly as much. Interest margins have been healthy — for a change.

The only problem has been finding people to lend to. Skittish about a faltering economy, consumers spent 1991 and 1992 paying down debt, not taking it on. Figures from the Federal Reserve indicate that consumer instalment debt (excluding mortgages) fell from 16.5 percent of national income in 1990 to 15.3 percent in the second quarter of 1992. There was a decrease in absolute terms as well, from $735 billion to $723 billion.

As the nation restructured its household balance sheets, banks found themselves flush with deposits. No wonder the deficit-laden U.S. government was able to sell its debt securities at fire-sale rates.

Signs of life in lending volume have returned, however. As noted, a significant amount of debt has been paid down, and 1992 saw the first increase in domestic auto sales in four years — a good sign for lenders. So are we ready to cash in on a new spread bonanza? Not necessarily.

The cost problem: Expenses exposed

Each year, the Fed releases a set of numbers that are less well-known than its figures on interest rates and personal saving, but which carry equally important implications for bankers. The *Functional Cost Analysis* (FCA) surveys banks, savings institutions, and credit unions to see how much it costs them to provide various services.

One should be cautious about using the FCA for year-to-year comparisons; results can be skewed somewhat by variations in the sampling. Still, one theme emerges clearly and consistently: Operating costs are becoming an ever-greater factor in loan profitability.

Data for the commercial banks participating in the FCAs for 1988 through 1991 (the most recent year for which data is available) offer three indications of this trend:

• Net asset yields for mortgages, consumer instalment loans, and

(continued on page 24)

Some tried-and-true methods to cut your loan costs

The Moebs $ervices suggestions below have been tried and found effective in cutting loan costs:

Insist on electronic payment. Payments via direct debit should be an assumed condition of any rate advertised or quoted. If a borrower wants to write paper checks, let him or her pay for the privilege by paying a higher rate. But don't put yourself into the position of trying to convince him or her to take direct debit after the loan has been all but closed.

Do away with reminder notices. Save on postage and processing by doing away with reminder notices on late payments. They only condition borrowers to rely on a mid-month "wake-up call." In place of reminder notices, send only late-charge notices, and make the late charge steep enough to cover lost interest and the cost of preparing and mailing the notice.

File bankruptcy claims yourself. Sure, you need an experienced bankruptcy lawyer to fight cases in bankruptcy court, but you don't need one to file a routine claim to "get in line" for your share of a debtor's assets. Bankruptcy courts have forms for filing claims which can be filled out by clerical staff. You don't need to pay a law firm $50 an hour or more to do it.

When a bank files its own bankruptcy claims, it becomes cost-efficient to make at least a token claim in Chapter 7 liquidations, where debtors often have no assets left to disburse. Banks often ignore Chapter 7 filings, figuring they are not worth the cost of contesting them.

Have loan service personnel collect on accounts 30 days or fewer past due. Most loan delinquencies result from tardy payments, lost payments, or service problems, not from an inability or unwillingness to pay. Therefore, it makes sense to have clerical personnel follow up on routine delinquencies, since personnel are far less expensive than professional collectors and fully trained to handle such problems.

Take loan applications through automated phone systems. Banks can build loan volume without adding staff if they allow customers to make loan applications over the phone through an audio response system. The procedure takes far less time than a face-to-face meeting, and consumers have warmed to the idea of being able to make an application any time of the day or night.

Charge the full late charge allowed under state law. Most banks do so, but some do not. Charging the highest permissible late fee has virtually no impact on volume, because borrowers, when they take out a loan, believe they can manage the payments and are not concerned about late fees.

Encourage loan prepayments. Lenders lose money on the last six months of a loan, because the income is less than the processing cost over that period. Establish incentives for paying off loans early — such as cash bonuses — and encourage borrowers to roll small remaining balances into new loans.

Install a telephone rate line. It may sound basic, but loan personnel spend much of their valuable time quoting rates to people over the phone. A phone line to an answering machine is much less expensive, and many customers actually prefer to get basic information from a machine. It also saves you the embarrassment of having loan staffers quote different rates to people.

Costs count

(continued from page 22)

credit cards generally have fallen during the period;

- Operating expenses generally have risen as a *percentage of assets* for each of those three product lines; and
- The dollar cost of making a loan and collecting payments has continued the rise it has shown since the FCA was instituted in the 1970s.

Data from Moebs $ervices' annual *Expense Control* survey also gives reason to believe that lending costs are rising, even as the overall cost levels reported by commercial banks have declined. The survey reports expense levels by categories (such as personnel, occupancy, data processing, etc.) and does not indicate definitively how much is spent on loans or deposits. But there are two indications that cost control on the lending side lags behind that on the deposit side:

- From 1988 to 1991, when the overall expense level reported by commercial banks fell from an average 3.53 percent of assets to 3.22 percent, the level reported for loan collection *rose* from 1 basis point to 3.
- The two most notable improvements — in employee salaries and computer expenses — have been driven largely by deposit-side automation. Expense levels in these areas declined by 11 basis points between the 1990 and 1991 studies, whereas overall reported expenses fell by only 7 basis points — an indication that loan side costs may have risen.

If loan costs have been rising for so long, why are they a problem now? Because falling interest rates have exposed them.

Back in the "old days," interest-rate controls and branching restrictions hid operating costs by guaranteeing spreads and by limiting competition. Deregulation put an end to that practice, but again, operating costs were hidden in the first flush of the new age — this time by soaring interest rates that remained at historically high levels throughout the 1980s. Even as non-interest expenses rose, their relative impact on asset yields diminished because of the huge returns money was supposed to be earning.

Today, as rates fall and industry consolidation continues apace, every basis point of operational fat looms ever larger on the bottom line and is a drag on an institution's competitiveness. In response, banks must do thorough cost analyses of their lending operations, must eliminate whatever costs they can, and must integrate the rest into their calculations for pricing loans.

Calculating loan costs

Banks need a systematic approach to calculate their loan costs. Moebs $ervices has developed a formula for doing just that. Figure 1 shows how to calculate both origination and maintenance costs.

The formulas need the following basic data:

1. The number of loans originated over the past year or over an appropriate period of time;
2. The number of payments received over the same period;
3. A total figure for all loan department costs;
4. A figure for the loan department's share of the institution's overall data processing, occupancy and administrative costs (the "burden rate"); and
5. Estimates of the time spent originating and maintaining loans.

The formula in figure 2 on page 26 calculates the cost to originate. Multiply the loan department costs by the burden rate, add the loan department costs, multiply that total by the percent of the department's time spent originating, and divide by the number of loans originated. The result is the cost to originate a single loan.

The example shows that it costs $100 to originate a loan, assuming that an institution originates 1,350 loans a year, taking up 45 percent of the loan department's time.

The formula in figure 3 on page 26 calculates maintenance costs in the same manner, only you multiply the department costs and burden costs by the time spent maintaining. Assuming 26,400 payments that take 55 percent of the department's time to process, the cost is $6.25 per payment.

Readers may recoil at the assumption that the burden rate would be 200 percent, meaning that the loan department's share of institutional overhead is twice as great as its own direct costs. In fact, this assumption is not unreasonable. Burden rates of 150 percent to 300 percent of department line costs are common in financial institutions.

The cost factor in ROAs

Once you've determined your costs, you either must reduce them or must price your loans to recover those costs. By analyzing a typical auto loan under different scenarios, we'll see that realistically attainable cost-cutting can produce returns that exceed those produced by price hikes.

Federal Reserve data indicate that the average bank rate for a 48-month new car loan in 1989 was 12.07 percent, and that the average amount financed was $12,000. Given that the loan's duration was approximately 20 months, we use the two-year Treasury bill rate for the funding cost of the loan. Figures for the loan-loss ratio, origination cost, and maintenance cost come from the FCA.

We see that the expense level for the 1989 loan is 1.66 percent of its value, and the return on assets is 1.23 percent. Running the same loan with 1991 interest rates and cost factors, we see that the expense level rises to 2.08 percent, but the ROA increases to 1.92 percent — thanks to an improved interest margin.

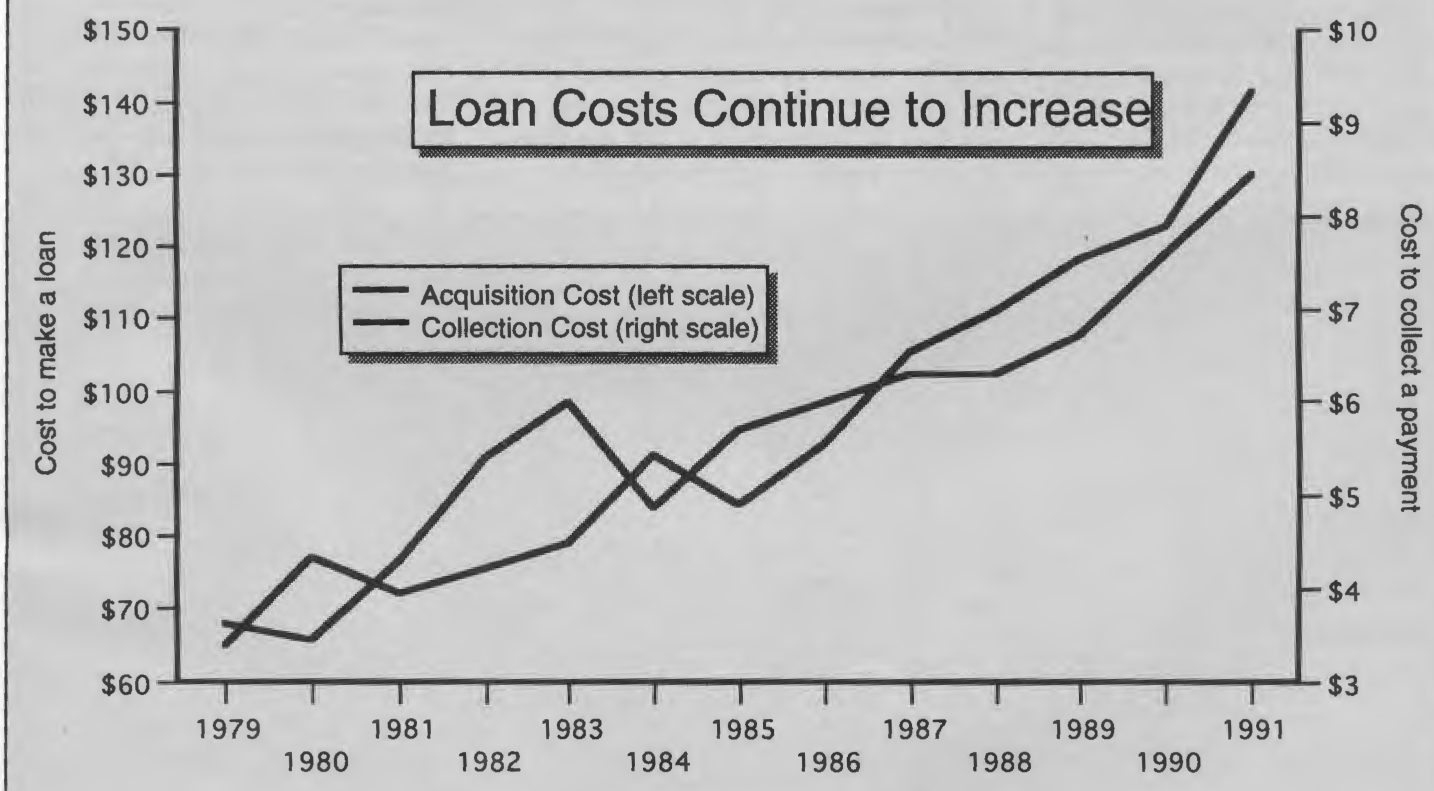
Now, what if we try to improve the ROA by charging an application fee? The ROA improves to 2.19 percent when we add a $42 application fee, the average amount reported in a Moebs $ervices 1991 survey of auto loans.

The same survey, however, found that only 43 percent of banks charge fees on auto loans, and that even smaller percentages of savings institutions and credit unions charge them. What will happen to your competitive position if you start charging fees?

Suppose instead that we seek to increase ROA by cutting costs. We'll adopt one of the techniques listed in figure 3 (page 26) by making automatic payments an assumed condition of every loan; a customer will have to pay a premium if he or she wants to pay by check. We can estimate the savings from this technique by substituting an FCA figure for credit union processing costs, $5.49, for the bank figure, $8.44.

(continued on page 26)

Figure 1: Loan costs continue to increase



Source: Federal Reserve functional cost analysis

Costs count

(continued from page 25)

The authors

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Credit unions, we know, make extensive use of direct debit.

Under this scenario, the ROA soars to 2.46 percent — and the consumer doesn't have to pay a penny more. To get that ROA through pricing alone, the lender would have to either add 50 basis points to the rate or charge a $100 fee. Either approach would make his or her products uncompetitive.

Moreover, by cutting costs, we have widened the gap between the asset's ROA and its expense level. Now an ROA is an ROA whether it exceeds expenses or not. But when projected ROA exceeds expenses, the lender is well-protected if consumer prices fall.

Some lenders, believing they must "spend money to make money," run expense levels substantially higher than the projected ROAs on their base loan products. To maintain ROAs, they count on price increases for cars and other consumer durables to produce additional volume. This practice leaves them vulnerable, because they cannot reorganize their lending operations as quickly as salesmen can cut prices.

Figure 2: How to calculate your loan costs

Basic Data

A.	Number of Loans Originated in the Past Year =	1,350
B.	Number of Payments in the Past Year =	26,400
C.	Loan Department Costs =	$100,000
D.	Overhead or Burden Percent =	200%
E.	Percent Time Spent on:	
1.	Originating =	45%
2.	Maintaining =	55%

Unit Cost Formulas

#1. Cost to originate

$$= \frac{[(C \times D) + C] \times E1}{A}$$

$$= \frac{[(\$100{,}000 \times 200\%) + \$100{,}000] \times 45\%}{1{,}350}$$

$$= \$100$$

#2. Mo. maint. cost

$$= \frac{[(C \times D) + C] \times E2}{B}$$

$$= \frac{[(\$100{,}000 \times 200\%) + \$100{,}000] \times 55\%}{26{,}400}$$

$$= \$6.25$$

Figure 3: Cost control boosts auto loan ROA

Loan	*Amount*	*APR*	*COF*	*Loss Ratio*	*Orig. Cost*	*Main. Cost/mo.*	*App. Fee*	*Exp. Level*	*ROA*
"Typical" 1989 loan	$12,000	12.07%	8.55%	0.61%	$118	$6.70	0	1.66%	1.25%
Same loan, 1991	$12,000	11.14%	6.49%	0.65%	$141	$8.44	0	2.08%	1.96%
1991 loan + avg. fee	$12,000	11.14%	6.49%	0.65%	$141	$8.44	$42	2.08%	2.19%
1991 loan + direct debit	$12,000	11.14%	6.49%	0.65%	$141	$5.49	0	1.54%	2.46%

Source: LOAN software, Moebs $ervices