Commercial Loan Pricing
Variables for Consideration

OFN Small Business Finance Forum
June 18, 2012

HOPE
Colorado Enterprise Fund
Commercial Loan Pricing
Variables for Consideration

HOPE
The Primary Driver for Loan Pricing: (#1) The Borrower’s DSCR

- **DSCR**
  - If the Borrower cannot afford the proposed pricing of the loan, nothing else really matters.
    - The pricing must be changed or the loan should be declined or converted to an investment or grant.
  - Depending on the type of business minimum DSCRs expectations should be set.
    - HOPE generally will look for a sustainable minimum of 1.25, unless the project is a residential income producing property which is 1.15. Credit enhancements or special funds are generally required for financings below these thresholds.
Primary Pricing Drivers:
(#2) Market Competition and (#3) Cost of Funds

• Assuming access to and the desire for loan capital by a business: Lenders are competing for business and are all engaged in the selling of a commodity good (money). Financial institutions must differentiate themselves on the following:
  – Service
  – Loan structure
  – Pricing (which is heavily influenced by each lender’s own funding costs and risks)
Primary Pricing Drivers:
(#4) Loan Program Restrictions and (#5) Social Impact

• Loan Program Requirements/Limitations:
  – Funder Restrictions: funders (private and public) may sometimes dictate what the pricing of a loan will be (very common with disaster response or other special purpose programs)
  – Credit Enhancement Program Guidelines: Loan pricing guidance as with some federal (USDA and SBA) and state programs

• Social Impact:
  – Economically distressed communities, MWOB, special industries (childcare, housing, medical, etc.), disaster response, other
(#6) Loan Type -
Delivery Costs, Revenue Duration, and Transaction Risk

- Term Loans
  - Commercial R/E
  - FF&E
  - Permanent Working Capital
- Bridge or Mini-perms
- Construction
- ABLs
- Letters of Credit (Standby)

Notes:
In addition to cost of funds and potential loan losses, loan pricing must cover overhead (prospecting, underwriting, and loan servicing).
To help offset income duration risk – can charge prepayment penalties.
Participations: Pricing by lender consensus.
(7) Interest Rate Risk - Fixed or Variable Rate

- HOPE’s preference is for Variable (adjusting quarterly)
  - carefully use/select pricing floors/ceilings
- Fixed Rates will carry a premium (the longer the rate is fixed the higher the premium and must be balanced with appropriate funding source)
  - Premium is calculated on current and perceived future rate environments

**Note:**
Charge for fixed rate forward commitments (lock-in fees).
(8) Term / Amortization Duration

• Term Length – the longer the term of the loan, the higher the premium (time value of money)

• Amortization – the longer the amortization period of the loan, the higher the premium (credit/collateral risk)
(#9) Credit Risk-Based Adjustment

- Loan Grade (HOPE uses a Scale of 1-8; grade definitions are included in the handouts).
- Grade is determined jointly by loan officer and underwriter (all of our business loans are centrally underwritten).
- Loan Committee has final say on initial loan grade and pricing.
- A subjective assessment made by objective analysis.
Major Credit Risk Considerations

- Business Condition/Performance – F/Ss
- Management – résumé
- Industry - NAICC
- Competition – Market
- Potential Exposure – Collateral, Guarantors, and other secondary repayment sources

[Individual risk assessments are calculated for each of the above loan characteristics then aggregated to assign the loan grade.]
Other Loan Pricing Considerations

- Application Fees
- Packaging Fees
- Commitment Fees: Make sure commitment letters cover expenses incurred in the closing process, including legal, if the borrower does not close the loan.
- Origination Fees
- Documentation Fees
- Third-Party Closing Costs – Legal, Title, Survey, Environmental, Flood, Credit, Filing Fees, etc.
Commercial Loan Pricing

Variables for Consideration

Colorado Enterprise Fund
Drivers for Loan Pricing:

Risk Level
Size of Loan
Type of Loan
Drivers for Loan Pricing:

1. Risk Level
   - *Credit profile* of business owner(s) – credit score and bankruptcy score
   - *Global income capacity* measured by cash flow ratios (DTI and DSCR)*
   - *Secondary sources of repayment* (collateral, guarantors, etc.)

* Based on loan payment amount which is determined by structure, rate, term, etc.
Drivers for Loan Pricing:

2. Size of Loan

- *Determined by borrower’s income capacity* and overall risk profile of loan
- *The larger the loan, the lower the pricing*
- Other size considerations on portfolio level:
  - Capital at risk
  - Capital available
  - Capital deployed into earning asset (ROA)
Other Loan Pricing Considerations

- Structure of loan (amortization, type of loan, use of funds, payment amount, covenants, rate, fees, terms, guarantees, etc.)
- Source and cost of funds
- Mission considerations
- Market factors
- TA needs of borrower
- Administrative burden of loan structure
QUESTIONS?

• Greg Wineland, HOPE
  Gwineland@hope-ec.org

• Ceyl Prinster, Colorado Enterprise Fund
  ceyl@coloradoenterprisefund.org
Credit Ratings – Commercial Loans

Each loan will be given a risk rating code (1 through 8) that will reflect the risk potential involved. The initial rating will be assigned by the approval authority (Credit Committee) after having been recommended by the underwriters.

Many loans will have characteristics that are applicable to more than one rating category; therefore, final risk assignment may be dependent upon the personal judgment of the servicing officer, approval authority, and/or the Loan Review Committee.

Definitions of Risk Rating Categories

Risk Rating #1 - Pass/Excellent

Assets that are virtually free of credit risk. Obligors in this category represent the highest credit quality and greatest financial strength. Generally this category might include companies with “AAA” credit ratings and/or companies with access to national credit markets.

Assets can also be rated under this category based upon perfected collateral coverage. These assets should be fully secured by cash or equivalent, governmental guaranty, or other marketable instruments if the market value $\geq 120\%$ of the outstanding balance.

A rating of 1 – “Pass/Excellent” must be earned through the demonstration of a minimum of 2 years of satisfactory payment history with HFCU.

Risk Rating #2 - Pass/Good

Assets under this category possess a nominal risk of default. This category includes obligors with strong financial strength and superior financial ratios and trends, and/or companies with “AA” credit ratings.

Other credits may fall under this category based upon perfected collateral; for example, credits secured by marketable issues that do not meet the 120% margin coverage required for an "Excellent" rating.

Risk Rating #3 - Pass/Acceptable Average

Assets in this category are considered to possess a normal level of risk. Obligors in this category have satisfactory financial strength and adequate cash flow coverage to service debt, with established operations and satisfactory repayment history, and/or companies with "A" credit ratings. If secured, the perfected collateral should be of acceptable quality and within established borrowing parameters.
Risk Rating #4 - Pass/Monitor

Assets in this category possess an overall acceptable level of risk, but that risk may be increased by certain conditions that represent "Red Flags." These "Red Flags" require a higher level of supervision or monitoring. The obligor may be experiencing these conditions for the first time or it may be recovering from weakness that at one time justified a harsher rating.

These conditions may include: weaknesses in financial trends; marginal cash flow; one-time negative operating results; non-compliance with policy or borrowing agreements; poor diversity in operations; lack of adequate monitoring information; questionable management stability/ability; etc.

This rating may also be assigned solely in the type of business or industry in that the obligor may be involved if such is less than stable and/or is highly sensitive to market place influences.

This also includes companies with a "BBB" credit rating. Collateral may be of questionable quality, lacking of adequate margins, have values outside borrowing parameters, or exhibit perfection flaws.

Risk Rating #5 - Criticized/Other Loans Especially Mentioned

A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Risk Rating #6 - Substandard

A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged. Current sound worth implies unpledged assets of adequate liquidating values that can be used to repay debt or augment cash flow. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt.

The assets are characterized by the distinct possibility that the credit union will sustain some loss if the deficiencies are not corrected. This does not imply ultimate loss of the principal, but may involve burdensome administrative expenses and the accompanying cost to carry the asset.

Examples of substandard assets include those to obligors with insufficient or negative cash flow, negative net worth coupled with inadequate guarantor support, inadequate working capital, and/or significantly past due loans and overdrafts. Substandard assets
might also include foreclosed Other Real Estate Owned or repossessed personal property carried in Other Assets.

**Risk Rating #7 - Doubtful**

Assets classified doubtful have all the weaknesses inherent in a substandard asset except that the weaknesses make collection or liquidation in full (on the basis of currently existing facts, conditions, and values) highly questionable and improbable.

The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until its more exact status may be determined.

Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral, and refinancing plans. The doubtful classification should only be applied to that portion of the asset that is of questionable collectability.

For example, if the collateral coverage is inadequate on a substandard asset (when looking to the collateral to repay the debt), the uncollateralized portion could be considered doubtful if one of the pending factors noted above are involved. Assets classified as doubtful must be placed on non-accrual status.

**Risk Rating #8 - Loss**

Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather, it is not practical or desirable to defer writing off this basically worthless asset, even though partial recovery may be affected in the future.

This classification is based upon current facts, not probabilities. Assets should be classified as loss and charged-off in the period in which they became uncollectible.
Loan Pricing

Section 107(5) of the Act provides that interest rates may not exceed 15 percent per year on unpaid balances inclusive of all finance charges. The NCUA board may lift this ceiling requirement from time-to-time for periods not to exceed 18 months.

If HOPE knowingly takes, receives, reserves, or charges a rate of interest greater than the allowed rate, this action may result in a forfeiture of the entire interest the note or other evidence of debt carries with it.

Variable and fixed rate loan pricing will be made available by the credit union. Pricing will be sufficient to cover the cost of funds that are loaned, cost of loan servicing, the provision for anticipated loss from the loan, and a reasonable margin of income.

In no case will the pricing of loans exceed the maximum rate allowed by state law on the unpaid balance inclusive of all finance charges. Rate determination will be affected by such factors as risk, how liquid the collateral is, and the repayment schedule, while continuing to maintain fair standards for all members.

Interest rates for members’ business loans will be indexed to the Wall Street Journal Prime Rate (WSJ Prime) or other such nationally recognized lending base rate. The chosen index and applicable margin will be fully disclosed to the borrower.

It shall be the responsibility of HOPE management to develop guidelines for the pricing of loans, lines of credit, commitment fees, and other credit arrangements to be made by HOPE.

Consideration will be made of those issues most frequently associated with pricing:

- Account relationship
- Special servicing costs
- Frequency of usage under a line
- Appropriate premium for risk might arise because of the nature of the credit or the term
- Commitment fees
- And any other issues related to the activities of the lending areas

Generally, the credit union will charge commitment fees on loans except where not permitted [SBA or other].

All HOPE business customers will be required to pay HOPE’s legal expenses associated with the review and extension of the loan. The purpose of this flexible policy is to provide basic consideration guidelines for the pricing of loans, lines of credit, and other loan commitments.
## LOAN RATE DETERMINATION WORKSHEET

<table>
<thead>
<tr>
<th>Interest Rate Computation</th>
<th>Rate Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product Type</strong></td>
<td></td>
</tr>
<tr>
<td>- Life Style = 2.00%</td>
<td></td>
</tr>
<tr>
<td>- Small Contractors = 1.50%</td>
<td></td>
</tr>
<tr>
<td>- Small/Emerging = 1.00%</td>
<td></td>
</tr>
<tr>
<td>- Mezzanine = 0.50%</td>
<td></td>
</tr>
<tr>
<td>- Non-Profits = 1.00%</td>
<td></td>
</tr>
<tr>
<td><strong>Loan Type</strong></td>
<td></td>
</tr>
<tr>
<td>- Short-Term Loan = 2.00%</td>
<td></td>
</tr>
<tr>
<td>- Amortized Loan = 1.00%</td>
<td></td>
</tr>
<tr>
<td><strong>Collateral</strong></td>
<td></td>
</tr>
<tr>
<td>- Unsecured Loans = 2.00%</td>
<td></td>
</tr>
<tr>
<td>- UCC Secured Loans = 1.50%</td>
<td></td>
</tr>
<tr>
<td>- Real Estate Loans = 1.00%</td>
<td></td>
</tr>
<tr>
<td><strong>Credit Score</strong></td>
<td></td>
</tr>
<tr>
<td>- less than 600 = 2.00%</td>
<td></td>
</tr>
<tr>
<td>- 600 to 650 = 1.50%</td>
<td></td>
</tr>
<tr>
<td>- 650+ = 1.00%</td>
<td></td>
</tr>
<tr>
<td><strong>Debt Coverage Ratio (choose only one)</strong></td>
<td></td>
</tr>
<tr>
<td>- Business Debt Coverage</td>
<td></td>
</tr>
<tr>
<td>- less than 1.00-to-1.00 = 2.00%</td>
<td></td>
</tr>
<tr>
<td>- more than 1.00-to-1.00 = 1.00%</td>
<td></td>
</tr>
<tr>
<td>- Personal Debt Coverage</td>
<td></td>
</tr>
<tr>
<td>- more than 60% = 2.00%</td>
<td></td>
</tr>
<tr>
<td>- less than 60% = 1.00%</td>
<td></td>
</tr>
</tbody>
</table>

### Total Risk-based Interest Rate

+ Base (Minimum) Interest Rate 2.50%

### Total Risk and Base Interest Rate

<table>
<thead>
<tr>
<th>Loan Fees</th>
<th>Amount</th>
<th>Waived?</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Unsecured Loans</td>
<td>$100</td>
<td></td>
</tr>
<tr>
<td>- UCC Secured Loans</td>
<td>$150</td>
<td></td>
</tr>
<tr>
<td>- Real Estate Secured Loans</td>
<td>Based on Attorney Fees</td>
<td></td>
</tr>
<tr>
<td>- Mezzanine Loans</td>
<td>1% of Loan Amount</td>
<td></td>
</tr>
</tbody>
</table>
CFF Small Business Loan Rates  
*As of 08/11/11*

The rates below are for internal use only!  
Final rate, term & fees will be determined by risk & economic impact.  
Exceptions are to be noted on the Loan Presentation.

<table>
<thead>
<tr>
<th>General and other Funds</th>
<th>“Term Loans up to 36 Months”</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount: $1,000 to $4,999</td>
</tr>
<tr>
<td>“Term Loans 37 to 60 Months”</td>
<td></td>
</tr>
<tr>
<td>Amount: $1,000 to $4,999</td>
<td>$5,000 to $25,000</td>
</tr>
<tr>
<td>Unsecured 11.49% 10.99% 10.49%</td>
<td>Bus Assets/Auto 10.99% 10.49% 9.49%</td>
</tr>
<tr>
<td>“Lines of Credit”</td>
<td></td>
</tr>
<tr>
<td>(Approved as an exception; 6% floor rate)</td>
<td></td>
</tr>
<tr>
<td>Amount: $1,000 to $4,999</td>
<td>$5,000 to $25,000</td>
</tr>
<tr>
<td>Prime + Prime + Prime +</td>
<td></td>
</tr>
<tr>
<td>Unsecured n/a 3.00% 2.50%</td>
<td>Bus Assets/Auto n/a 2.25% 1.75%</td>
</tr>
</tbody>
</table>

See attached fee schedule.