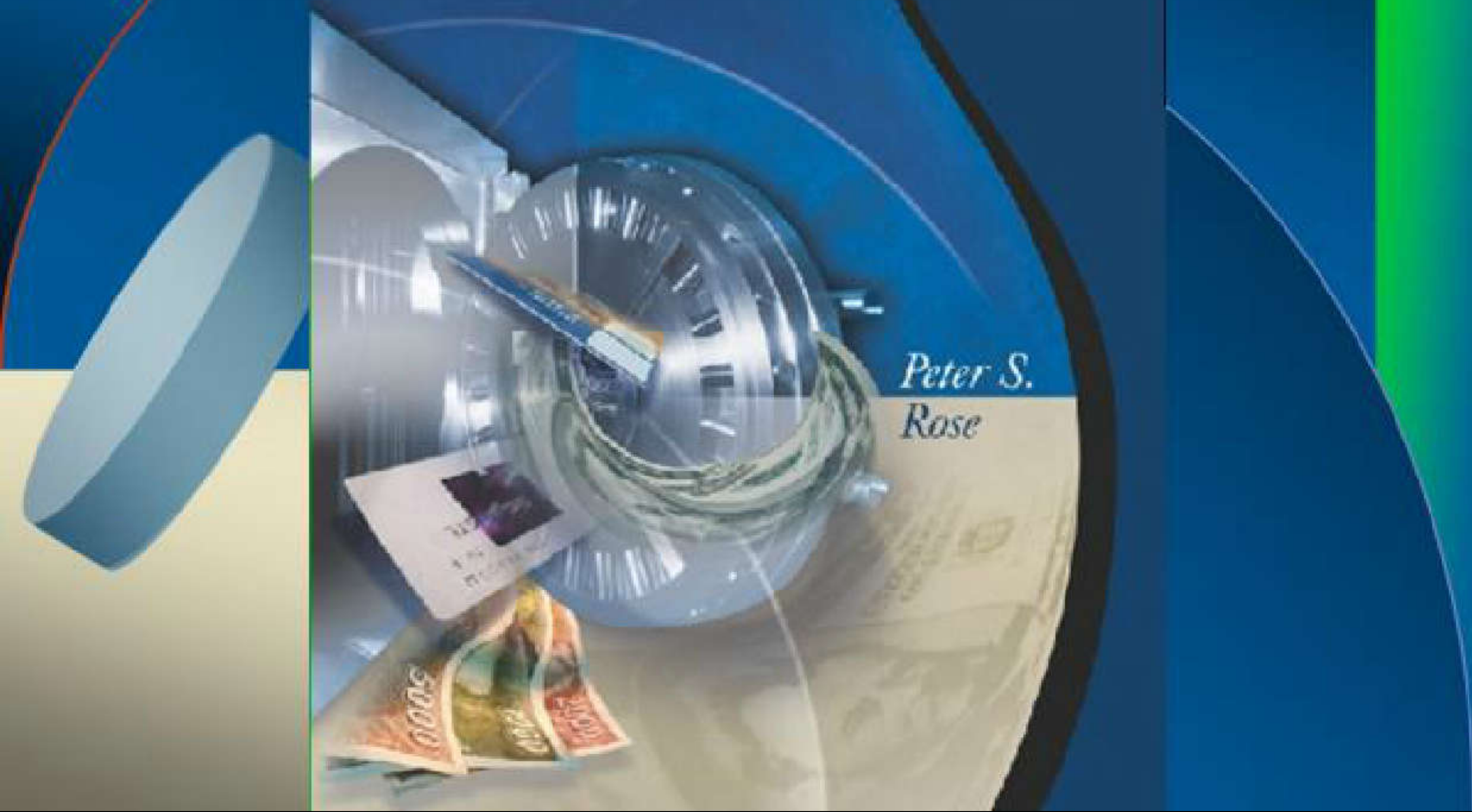
Commercial Bank *Management*



Peter S. Rose

Pricing Consumer and Real Estate Loans

Chapter 21

The purpose of this chapter is to learn how consumer and real estate loan rates may be determined and to see the options a bank loan officer has today in pricing loans extended to individuals and families.

Cost-Plus Model of Pricing Loans

Loan Rate Paid by Consumer	=	Bank's Cost of Raising Loanable Funds	+	Nonfunding Operating Costs	+	Risk Premium for Customer Default	+	Risk Premium for Time to Maturity	+	Desired Profit Margin

Annual Percentage Rate (APR)

The APR is the Internal Rate of Return that Equates Total Payments With the Amount of the Loan. The Truth in Lending Act Requires That This Rate Be Told to Consumer On All Loans

Simple Interest

In Simple Interest the Customer Only Pays Interest On the Amount of the Principal Left. First the Declining Loan Balance is Calculated and That Reduced Balance is Used to Calculate the Amount of Interest Owed

Discount Rate Method

The Discount Rate Method Requires the Customer to Pay the Interest in Advance. Interest is Deducted First and the Customer Receives the Loan Amount Less Any Interest Owed

Add-On Loan Rate Method

Interest Owed is Added to the Principal Amount, Then the Loan Payments are Calculated By Dividing This Sum By the Number of Loan Payments

Rule of 78s

A Rule of Thumb to Determine Exactly How Much Interest Income a Bank is Entitled to Accrue at Any Point in Time From an Installment Loan Being Paid in Monthly Installments.

Compensating Balance Requirements

Some Banks Require Customers to Keep a Certain Percentage of the Loan Amount in a Deposit Account in the Bank. This Raises the Effective Cost of a Consumer Loan.

Variable Rate Consumer Loan

Floating Prime Based Consumer Loan Rate	=	Prime or Base Rate	+	Risk Premium

Interest Rates on Home Mortgages

- Fixed Rate Mortgage (FRM) – 1930s to 1970s Most Mortgages Were Fixed-Rate Mortgages. They Had a Fixed Interest Rate That Did Not Change Over the Life of the Loan
- Adjustable Rate Mortgage (ARM) – in the Early 1970s Adjustable Rate Mortgages Were Allowed. These Mortgages Have an Interest Rate That Changes Over the Life of the Mortgage. Roughly One Quarter of All Mortgages are Adjustable Today

Mortgage Points

This is an Additional Up Front Charge Often Required on Home Mortgages. It is a Percentage of the Loan Amount and Reduces the Amount of the Loan Available