



RECOVERY TIPS - By BRIAN KING

Price Optimization

Many U.S. banks are eliminating or reducing high-risk assets that require more capital in preparation for the new Basel III recommendations that phase into effect by 2019. This shift is generating pressure on pricing policies and procedures. Net interest margin is critical to financial services providers. They are experiencing competition for high quality loans, increased regulatory compliance expense, and recent legislation impacting fee income.

Lenders are eager to originate quality loans and lines of credit with solid interest margins. Pricing includes both interest rates and fees that impact the Annual Percentage Rate (APR) and can consist of flat rate pricing, loan balance and relationship pricing, risk-based pricing, and price optimization. Often, a hybrid or combination of the strategies may be most effective.

Ideally, loan pricing software provides a consistent pricing process that is both rational and analytical. Price Optimization helps provide a balance between customer demand, the market environment, and lender profitability. Since customer price sensitivity is not necessarily correlated with credit risk, a data driven decision process allows the lender to maximize the loan close rate and net interest margin simultaneously.

Individual price sensitivity determines the customers that seek the lowest possible price versus those that value other factors instead such as brand, convenience, rewards, or relationship. Price optimization can also protect the lender with a logical and scientific pricing methodology that reduces or

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eliminates any unnecessary bias.

Loan price optimization borrows from the success found in airline industry pricing: to match the best possible price with each individual customer offer. Without price optimization, higher loan pricing generally results in fewer loans. With price optimization, lenders can present custom-tailored pricing to each potential borrower. The result can be more loan volume, higher quality loans, or both.

Unfortunately, price optimization can be complicated. Imagine the task of accurately predicting consumer level price sensitivity across various loan products, channels, and credit spectrums for each individual applicant. This requires innovative behavioral scoring, predictive insights about the price-sensitivity of the customer, and lots and lots of data.

Some larger lenders have implanted internal price optimization models into their organizations. This can be effective if the firm has the time and money to continually monitor, enhance, and upgrade the systems as appropriate. Many lenders instead select an industry vendor partner that specializes in price optimization. And industry vendors providing price optimization solutions have shown impressive results for their clients.

Some of the advantages of a price optimization tool are the ability to provide real-time pricing, dashboard reports on production and profitability, and compliance adherence. Ideal pricing is beyond a simple risk-based credit decision, loan balance, or relationship focus. Price optimization is the culmination of all these factors and more into a rules based decision engine that provides “the right price for the right customer at the right time.” Clients may also use price optimization software for credit capi-

tal allocation. The calculation of the full credit profile of each borrower includes factors that drive the capital allocation and product profitability.

Price optimization solutions may also be able to reduce management time in administering the pricing process. Instead of a pricing committee meeting to review pricing on a daily, weekly, or monthly basis – this committee can instead establish rules, alerts, and triggers that manage and monitor pricing automatically. This frees the group to focus on more strategic decisions and rule modifications versus day-to-day pricing decisions.

Many offerings have the ability to generate consumer deposit and loan rates sheets by lender, region, or state. This allows lenders to recognize key market differences while also calculating the profitability for each scenario.

Most price optimization solutions, whether in-house or provided by a third party, provide multiple benefits. These solutions are based on advanced analytics, historical data, and price sensitivity. The key functionality of these systems may be prepackaged or available a la cart. Below are the most commonly requested features:

Rate Sheets. Preparing rate sheets and fee schedules including necessary credit capital allocation criteria.

Existing Portfolio Pricing. Analysis and re-pricing of existing customer portfolio to reduce attrition and manage credit risk.

Point of Sale Tools. Frontline employees can leverage real-time transaction-level price optimization to sell more products at a higher profit margin. These tools may include relationship components and scenario capabilities for guidance on various options that achieve desired margin.

Pricing Process Improvement. By providing a highly structured application process, pricing recommendations are seamless and overrides are minimized. Multiple industry studies have proven that loans booked as credit overrides perform significantly worse, so an improved pricing process can help minimize this risk. Some solutions can also provide alerts when ROE (return on equity) thresholds are not met.

Reporting and Tracking. Dashboard reporting provides insights into pricing compliance, price sensitivity, competitor pricing,

attrition risk, and opportunities for improvement. Ideally the reporting will provide drill-down functionality by division, region, branch, and employee.

Implementation and Training. The proper installation and setup of the price optimization solution is critical. Depending on the level of integration, ongoing support may also be required from various internal and external resources. It is important to consider this a dynamic solution with continuous process improvement versus a “once and done” mentality.

Professional Services. Consulting and professional services can often be helpful in optimizing the solution. A vendor partner’s industry pricing expertise can help lending executives properly benchmark industry standards, conduct price sensitivity analysis, and define negotiation guidelines for front-line employees. An external partner can also assist with ongoing strategies, improving pricing processes and systems, and continually monitoring pricing operations.

In conclusion, price optimization determines the price-elasticity for a specific client in a particular transaction. The customer’s willingness to pay is essential to pricing. Financial services institutions leveraging this data will outperform their competition. As you consider price optimization there are several natural applications.

Direct marketing campaigns can leverage price optimization data to enhance response rates. By promoting the “right product to the right customer at the right time” lenders can increase both application and close rates across multiple channels. Price optimization can also be used for origination decisions in both a centralized or decentralized environment. By using a rules based engine, front-line personnel or distribution channel partners can be provided with recommended pricing and also have defined pricing discretion levels.

Finally, price optimization can be used for managing existing portfolios and particularly lines of credit. Pricing decisions can include changes that increase yield, decrease attrition, or improve utilization. As you consider the merits of price optimization for lending within your organization, recognize that any improvements you are able to achieve will result in a direct negative impact to your competitors. ❖

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