

## PRICING TECHNOLOGY

# It's all in the margin for both dealer and lender

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## The challenge

Point-of-Sale (POS) finance is in rapid and structural decline. It can be argued that pricing is the principal cause of this decline. There are two problems with current pricing. The first lies in the structure of dealer incentives paid by finance companies. The second lies in the (absence of) technology deployed to help business managers at dealers set prices to end-customers.

## Dealer incentives

The major source of dealer income from POS finance is difference-in-charges (DIC) commission. Under these arrangements, the finance company sets a minimum rate (base rate) at which it agrees to finance a customer's vehicle purchase, subject to satisfactory credit underwriting. The dealer typically receives 80 to 100 per cent of the DIC between the rate he can negotiate with the end customer and the base rate.

This structure rewards dealers' business managers to secure the absolute highest rates possible from end customers. However, while the dealer wants high prices, once the finance company has set its base rate, it wants maximum volume and, therefore, lower prices.

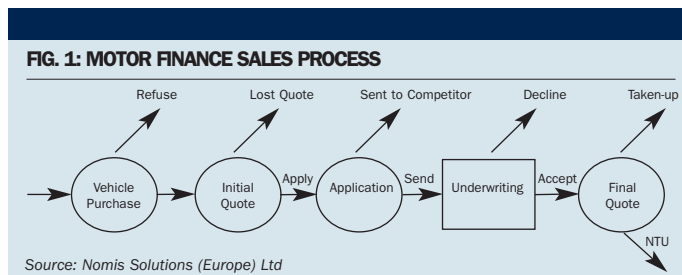
Consider the simplified

finance sales process outlined in Figure 1.

There are five steps in the process where the customer may drop out: three controlled by the customer, one by the dealer and one by the finance company. The customer may refuse to receive a quote, reject the terms quoted, or not take up the quote after offer because the terms are not attractive. The dealer may send the customer's application to a competitor. The finance company may decline the customer's application for bad credit. This is more likely to happen with high prices owing to the phenomenon known as "adverse selection", where higher prices attract poorer credit risks. The likelihood of customer fall-out increases with price quoted at each stage (except, perhaps, where the dealer decides where to send the application).

As higher prices result in lower credit quality, the proportion of applications that fall within the parameters for automatic underwriting declines, again because of adverse selection. This results in higher processing expense for the finance company, as it must manually underwrite more applications. Finally, there is also strong evidence that higher prices result in more early settlement.

So there are six distinct reasons why the finance company wants low prices to maximise volume.



In contrast, the dealer wants high prices to maximise DIC commissions. If only the dealer and finance company would co-operate more effectively, lower end-customer prices could increase "system-wide" profits by five to ten per cent.

## Pricing technology

As described above, pricing influences the quote-to-conversion rate at five distinct steps of the finance sales process. Pricing also drives converted loan profitability, underwriting expense and early settlement. In addition, not all customers are equally sensitive to rates. As is now widely accepted in credit scoring, human judgment just cannot compete with technology in assessing such a complex environment.

Some banks are now deploying a technology known as profit-based pricing (also known as price optimisation) to help set end-customer prices. These systems use automated, quantitative techniques to

improve the effectiveness of current pricing methods and have increased profitability by the equivalent of 15 to 35bp.

Specifically, they measure the influence of price on quote-to-loan conversion rates (customer price sensitivity), and use it to set prices by micro-segment (defined in terms of product, dealer, customer and channel characteristics) that optimise the trade-off between the volume and margins of deals done.

## Tweaking the profit split

Taken together, profit-based-pricing technology and changes to the structure of dealer incentives can help solve the pricing problem in motor finance, reverse the decline in penetration and increase profitability.

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