

# Why banks must fix their pricing process

The last nine months have been difficult for US banks and finance companies, with market conditions causing executives to significantly lower future performance expectations. *FST* spoke with **Frank Rohde** of Nomis Solutions about what banks can do to weather this crisis.



**Frank Rohde** is Chief Marketing Officer and Vice President of Product Management at Nomis Solutions. He has 15 years of experience in financial services, working with a range of clients on product development, marketing and pricing problems.

**FST.** Why does pricing represent an area of opportunity for banks?

**FR.** The pricing of deposits and loans is at the core of managing the performance of a bank. Yet in our work with a number of the large money-center banks, we have found that the pricing process is fundamentally broken. While executives understand that they have some pricing power in their respective markets, they lack the tools to translate business strategy and corporate goals into the tactical pricing of products.

The lack of focus on pricing is surprising. Most banks still manage their pricing strategy with Excel spreadsheets, and the ratio of risk analysts to pricing analysts in the typical bank is probably five-to-one or higher. Similarly, banks have invested significantly in risk-management technology but have completely neglected pricing technology.

**FST.** You're saying the pricing process is fundamentally broken – that's a strong statement. What do you mean?

**FR.** Let's take a look at the typical pricing process in a large US bank. First, the Executive Pricing Committee comes up with the pricing strategy. However, there is no clear understanding of the profit and volume tradeoffs when defining objectives for product and segment performance.

Next, the Pricing and Profitability team manually translates that pricing strategy into pricing tactics by using a combination of a risk- and market-based approach to pricing, to come up with rates for each product, channel, market and customer segment. Despite their best efforts, 80 percent of the rates are too

high or too low. One of the key reasons for this problem area is that customer response to pricing is poorly understood and often judgmental. Most pricing managers do not have the tools or the insight to understand how many more deals are generated or how much profit is lost by decreasing a rate by 25 basis points in a specific segment of the market. And, those that do have the luxury of having access to price response models have no infrastructure in place to optimize thousands of rates simultaneously across products, markets and customer segments.

In a recent survey of pricing managers across the top 30 banks and finance companies in the US and Canada, 90 percent admitted that their pricing process was in dire need of improvement. Executives in the top 10 banks in the US admit privately that their ability to use pricing to drive business results is limited.

Then because the Pricing Operations team manually types those rates into the pricing execution system, three to five percent of these rates are miscoded. Now the rates are available to the Credit and Funding Operations. This group works directly with customers to negotiate the best rate for each individual transaction. However, often times the front-line negotiation rules are overly simplistic. For example, the front-line staff is empowered to give customers with a checking account a 50 basis point discount on loans and an additional 25 basis points of pricing discretion on all CDs,

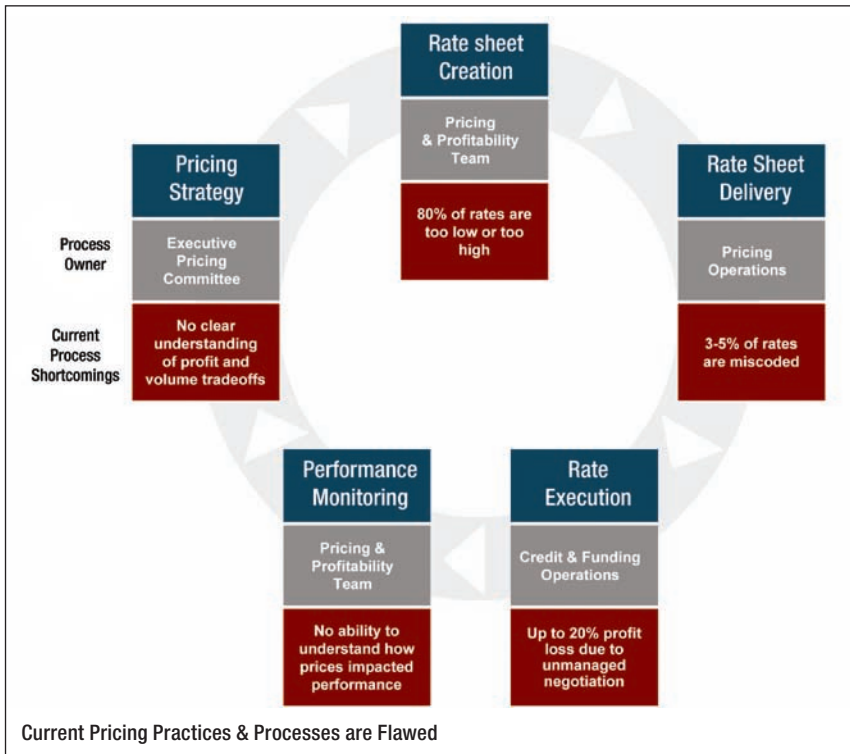
regardless of the customer's value to the bank. Up to 20 percent of profits are lost during this poorly managed negotiation process.

Last, but certainly not least, without a rigorous actual performance tracking process, the Pricing and Profitability team have a difficult time determining whether or not performance targets were met. And, if they were not met, the pricing team is often unable to identify the reasons why performance varied from plans, which could help them make better pricing decisions in the future.

These shortcomings in the pricing process can result in profit and volume losses of as much as 10-20 percent. However, there is an even bigger issue that I believe was a root cause of the credit crisis we have seen over the last three quarters: banks and finance companies have not managed to connect pricing strategy to a balanced understanding of profitability and market demand.

**FST.** So you believe that pricing is a root cause of the credit crisis?

**FR.** Yes. What we saw from 2003 through the summer of 2007 was a very aggressive expansion of consumer credit – specifically mortgages – without adequate risk premiums to cover



expected and unexpected losses. Because banks didn't have a comprehensive pricing optimization platform in place, they were unable to adequately assess the cost of the adverse selection that was invariably occurring in the near- and subprime markets.

**“I believe that if banks and finance companies implement a comprehensive pricing and profitability management platform, this will prevent a repeat of the irrational pricing and excesses we have seen in the last three years”**

In addition, most banks were basing their pricing strategy on what the competition was doing, and the current pricing models that banks had in place were not accounting for the changing customer behavior down the line. No one was running simulations or optimizations to determine how a portfolio of 620-FICO customers with 90 percent LTV loans would perform under these changing conditions.

Since October 2007, the pendulum has swung the other way. Rather than adequately price loans for near- and subprime customers,

the market has shut down completely. This is an overreaction, out of fear that every new mortgage to a 620-FICO customer will default.

During the good times, loans were significantly underpriced compared to their level of risk, and now because banks don't know how to price them, these loans are simply not offered. Of course there is an optimal price for the 620-FICO 90 percent LTV customer, but banks do not have the systems in place to determine that price, so they miss out on the opportunity.

**FST.** Shouldn't risk-based pricing have prevented the excesses you're describing?

**FR.** Sure. The problem is that pricing strategy is often the result of a negotiation between various stakeholders in the bank without the benefit of a common information layer. While the times were good, the marketing and sales instinct of the bank took over and loans were priced the same as everyone else in the market, in order to grow volume and gain market share. Now fear has taken over and banks are overreacting in the other direction.

What is missing in this process is a pricing and profitability management platform that provides a common depth of pricing insight to all stakeholders in the organization. Such a platform would translate strategic goals and constraints into the thousands of price points a bank has in the market across deposit and

credit products. It should also accurately balance risk and profitability forecasts with an understanding of demand and competitive prices, and allow for rapid recalibration of a strategy as the market and consumers change.

**FST.** So how can banks fix their pricing process and platform?

**FR.** Pricing optimization enables executives to leverage pricing as a core strategic driver of performance. Pricing should not be treated as a support function. Instead it should be a core competency, because it is the quickest and highest leverage strategy that a bank can deploy to impact results this year.

During the third quarter of 2007, net interest margins for US banks were the lowest since 1991. Competition for deposit funds is heating up and we're starting to see some irrational pricing, and credit charge-offs continue to increase. In this environment, pricing optimization is one of the few ways in which executives can improve net interest margins and keep volume propped up. Pricing optimization starts to show results within months rather than years, and as such is one of the few tools that executives have at their

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disposal to weather the next 12-24 months.

Forward-looking organizations have realized this potential and made pricing optimization a strategic initiative, with high levels of executive visibility. In addition to executive sponsorship, choosing the right technology partner is critical, as is ensuring the right level of change management and communication internally.

But most importantly, I believe that if banks and finance companies implement a comprehensive pricing and profitability management platform, this will prevent a repeat of the irrational pricing and excesses we have seen in the last three years. ■

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