

# A POSITIVE CHARGE

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**P**ricing is clearly an essential task in financial services institutions, with varying levels of sophistication across institutions. No two institutions follow the exact same set of processes or analyses in setting pricing for consumer asset and liability products, with the continuum spanning from almost exclusively manual to highly automated processes. These processes are complex, and ‘breakages’ frequently occur in the process chain.

The one element missing from most pricing processes is an understanding of consumers’ price elasticity of demand. Most often institutions ask “At what price are we willing to sell our money to borrowers or buy money from depositors?” instead of “At what price are borrowers willing to buy and depositors willing to sell money?”

As the value of product portfolios reaches into the billions, minute differences in interest rates can have a material impact on overall bank profitability. Pricing and revenue optimization, also referred to as profit-based pricing, represents a movement toward greater precision in the pricing process. The methodologies utilize complex analytics to provide far more specific pricing recommendations based on a customer segment’s characteristics and attitudes toward price and the elasticity of demand. Fixing some or all of the ‘breakages’ in the current pricing process can significantly improve portfolio profitability.

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Gathering competitive rates and fee information requires multiple sources of data and is often manual and prone to error; cash flow projections by market are often inaccurate; pricing recommendations are based on intuition; recommendations are made with a one-size-fits-all claim; manual posting of rates to core systems results in transposition omissions; dissemination of rates internally and externally is error prone; rate overrides are not tracked or monitored; fee waivers are not tracked or only on a limited basis after a substantial time has passed, resulting in lost revenue.

Price optimization solutions present an outstanding opportunity, especially for lenders, to optimize their profits as well as their application pull-through rates while still managing the various risks associated with particular loans in a particularly difficult lending market. It is important to note that price optimization does not recommend increasing all loan prices or decreasing all deposit prices; it requires a financial institution to understand customers’ demand for products and services and their sensitivity to price. It establishes both the price the customer is willing to pay for a loan and the acceptable rate of return for the lender.

Profit-based pricing strategies incorporating consumer price elasticity of demand are gaining momentum with top institutions in North America and Europe, but moving up the continuum to an ad-



vanced pricing methodology, financial institutions need to establish an overall pricing strategy and focus on three key areas related to people, process, and technology to achieve a successful price optimization implementation.

## Keys to success related to people

For any price optimization project to succeed, proponents must gain buy-in and support from senior management. Funding, staffing, technical development initiatives, and ultimately the project implementation itself may hinge directly on top-down support. Co-operation of all key stakeholders including members of the pricing committee as well as resources for analytics and technology support is essential. Shared goals build a strong team. Project leaders must address potential issues, such as the need for local market pricing discretion in overrides and exceptions and must track them carefully. Typically, a 'root cause' analysis will reveal that 80 percent of the overrides come from 20 percent of the sales force.

Employee incentives should be in the project implementation plan. With pricing optimization, the ultimate goal is to find an efficient pricing frontier that most profitably balances customers' demand and volume, thereby maximizing the financial returns for the institution.

Identify the skills required to build and use highly analytical tools. A number of vendors provide profit-based pricing model development as well as implementation guidance. Institutions can follow a variety of paths and have external resources available to assist where needed.

## Keys to process success

Implementing an effective price optimization strategy requires ongoing management and oversight of the entire pricing process. Include careful development and monitoring of the demand and cash-flow models, adherence to rate recommendations at the point of sale or in back-office renegotiations, tracking of pricing exceptions, and the ongoing adjustments and validation of the model's price recommendations.

Incorporate business rules and constraints into the pricing process; this may include financial, operational, market, and interest rate risk constraints. The bank may set a minimum loan volume threshold to ensure that increasing loan rates for a specific segment, while leading to higher profitability per loan, will not stifle overall loan volume. An institution may also set market constraints to ensure that rates never exceed a certain percentage, or that loan rates never exceed those of a strategic competitor.

Guidelines for exceptions and overrides need to be established to ensure the bank complies with its stated policies. This is essential to understanding the performance of the model. Price optimization tools solve for the most efficient pricing strategy for an institution once the particular business constraints have been factored in. Overriding the model's recommendations can be counterproductive at best and symptomatic of malfeasance at worst.

Financial institutions should introduce as much automation to the pricing process as possible. Reliance on manual processes for posting interest rates to loan origination or deposit systems is often subject to process errors. Fortunately,

automated price optimization technology typically interfaces with these systems enforcing adherence to pricing policy as accounts are established.

As part of a price optimization implementation project, financial institutions should benchmark historic performance at the outset of the program. Benchmarking financial performance against competitors' performance or industry performance can allay concerns about the efficacy of the pricing strategy.

## Keys to technology success

The most pressing technology requirement is a substantial quantity of historical data. Model development typically requires 24 months of historical data. Data must be cleansed of unusual activities that could skew the output of the model. Don't mistake seasonality for pricing improvements. The key deliverable of price optimization is a calculation of the efficient frontier of pricing, volume, and profitability. Without data, a demand model cannot be constructed.

Institutions face a variety of data issues, including complete lack of data, data accuracy, and challenges to data access. Both internal and external data is necessary for model building such as application, credit bureau, property appraisal and information on other products owned by the customer, transaction history, channel preferences and banking habits.

Technology offers institutions the opportunity to automate the myriad of manual processes that make up the pricing process. Implementation of price optimization relies on interfaces with existing bank processing systems. As the interfaces are created, the manual aspects of the pricing

process can be reviewed for automation or elimination.

A systemic implementation of price optimization provides clear documentation on the way prices are set and wards off potential compliance problems. Increased transparency and objectivity provide accountability and defensible pricing methodology. Moreover, employees who dedicate hours of time to manual processes can realign their activities to focus on the analysis of pricing trends, data, and markets.

Price optimization involves a philosophical change from a product-based to a customer-based orientation, changing the focus from the price at which the institution will sell the product to the price the customer is willing to pay to buy the product. The introduction of advanced analytics and use of data in demand modeling is a fundamental principle. Other project success factors include introducing and formalizing business rules and constraints into the pricing process, automating manual processes wherever possible for operational transparency and accuracy, and rigorous exception pricing oversight and governance. Working within these basic principles, institutions have the opportunity to move to a higher level of pricing sophistication with the customer as the focal point and to position themselves for a move toward a holistic customer approach. ■

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