

You may have seen the recent article in SmartMoney magazine about Pricing Optimization in banking entitled “Price Profiling.” This is the first time that Profit-based Pricing has been addressed in a consumer-oriented publication with a wide circulation (SmartMoney Magazine reaches about 3.5MM consumers). While the coverage was balanced and well-researched, the article also highlighted a fairly negative experience that a consumer had with Bank of America mortgage.

The adoption of pricing optimization technology in banking and finance is accelerating, especially with the recent pressure on volumes in consumer lending and the most recent influx of private equity capital. Adopters have achieved significant business benefits. Consumers are seeing less irrational pricing in the market. Regulators have endorsed the focus on transparency and process rather than judgmental margin setting. In the U.S. alone, the volume of lending optimized through the Nomis Price Optimizer™ solution has increased to more than \$4bn per month, and will reach over \$10bn per month by end of 2008.

Profit-based Pricing today is where risk-based pricing was about 8-10 years ago and where credit scoring was about 12-15 years ago. Both of these innovations were initially regarded skeptically by banks and finance companies as well as consumers. Today, they are industry standards and have resulted in wider availability of credit (with the obvious downsides we’re seeing now), lower prices to consumers overall, and increased ability to securitize assets.

Some of the benefits to consumers, especially in the current “down” market, when most lenders are making sweeping decisions to tighten credit policy and limit their lending include:

- **Better Segmentation** - a more sophisticated approach to segmentation and pricing enables lenders to make less dramatic cuts when tightening credit policies. Banks can apply better models for varying costs according to channel, geography, and risk categories and understand where they can selectively provide loans to meet consumer needs while meeting the bank’s goals.
- **Better Negotiation Capabilities** - most banks’ pricing policies and processes prevent consumers from negotiating price regardless of their value to the bank. Pricing optimization helps identify smart ranges that banks can use in specific circumstances to negotiate with consumers in a way that makes sense for the consumer and the bank.
- **Consumer Access to Loans** - pricing optimization enables banks to understand their potential for increasing profits and market share. This means that they can more easily identify un-served or under-served markets, which provides consumers with more access to loan products.

But there is a risk that pricing optimization will receive negative publicity if it is not managed correctly. Some of the key learnings we’ve observed over the last few years are:

- 1) **Pricing optimization is not about raising prices:** Pricing optimization generates prices that more accurately reflect the business goals of the bank and the preferences of consumers in the market - and that means both lower and higher prices. Compared to traditional risk-based pricing, pricing optimization reduces the judgmental variability in pricing and replaces it with empirical, data-driven evidence to support each and every pricing decision. It does not use prohibited categories (such as income, age, gender, race, or zip code) to determine rates for individuals. It produces more consistent pricing over time and may result in more attractive rates for consumers across all risk categories.

- 2) **Balancing goals and constraints to avoid price gouging:** Pricing optimization needs to be able to balance macro-level goals like volume, profit, risk, and capital but also respect micro-level constraints based on risk scores, relative price ladders, time-bound price changes, cross-cannibalization, utilization, prepayment, etc. These rules constrain price changes such that you will never have a scenario where a consumer is priced out of the market by 70 basis points, as quoted in the SmartMoney Magazine article. Pricing rule management is a critical component of pricing optimization software, and experienced managers will know how to leverage technology to ensure that pricing is consistent with consumer expectations. Additionally, most use competitor rates to create pricing rules related to maintaining competitive parity - as such, these rules ensure that pricing is not out of sync with the market.
- 3) **Manage branding:** The industry uses “Profit-based Pricing” to describe the next generation of pricing beyond traditional risk-based pricing. Most of our customers have kept their investment in pricing optimization technology quiet. The few that have publicly spoken about it have referred to it as “Customer-Centric pricing”, “Pricing and Profitability Management”, or “Revenue Optimization.” Profit-based Pricing is NOT about charging what the consumer is willing to pay - it is about setting prices that fulfill corporate goals and objectives with an understanding of market demand and response.
- 4) **Provide transparency and training:** Profit-based Pricing is not a black box - it is absolutely critical that front-line employees understand the reasons why prices are what they are. Transparency to the front-line employee and ultimately to the consumer enables customer-facing employees to credibly discuss and sell a product. This means that pricing optimization software needs to be able to provide deep insight, reason codes, and justification for pricing changes.
- 5) **Align intuition and science:** Most price changes suggested by pricing optimization technology should align with the intuition of the pricing manager and business executives (of course they are likely to be more granular). Recommended changes that are counter-intuitive should be logically consistent. If intuition and science do not align, prices should not be put into the market.
- 6) **Focus on process and execution in addition to the science:** Profit-based Pricing is a process enabled by software and analytics. It is not a modeling or science project. While optimization technology and math is important to the success of a Profit-based Pricing effort, it is even more important to focus on alignment of strategic goals, pricing processes, pricing execution, incentives, and training. This requires clear focus on a vision for how pricing drives overall business performance and alignment of the key stakeholders to that vision.

Profit-based Pricing is following a similar adoption pattern to credit scoring and risk-based pricing across the industry and will ultimately result in:

- More consistent and less irrational pricing
- Better alignment of company goals and pricing strategy
- Increased profits and volume for the industry
- Better deals for the majority of consumers

Frank Rohde
Chief Marketing Officer & VP, Product Management
Nomis Solutions

About Nomis Solutions

Nomis Solutions is the recognized leader in Profit-based Pricing for banking and finance. Profit-based Pricing is an advanced approach to pricing, powered by pricing optimization technology that provides the insights, automation and capabilities necessary to use pricing as a strategic lever to achieve performance objectives and implement price changes more dynamically and frequently. The award-winning Nomis Price Optimizer™ Suite is a set of business solutions that combines pricing analytics, optimization, and execution into a comprehensive pricing strategy and process.

The suite includes specific solutions for auto finance, home equity lending, personal lending, mortgage, and deposits. Each solution delivers quick time-to-benefit, increases profits and market share by 10-20%, and provides valuable insights about how customer preferences impact product and portfolio performance through a consistent, repeatable and efficient pricing process that supports compliance. Select customers include Abbey, AmeriCredit, Ford Motor Credit Company, GE Money, HBOS plc, Royal Bank of Canada, and Washington Mutual Bank. Headquartered in San Bruno, CA, Nomis Solutions also has offices in London, United Kingdom. Visit www.nomissolutions.com or contact us at info@nomissolutions.com or 650-588-9800.