

PROFIT-BASED PRICING

A new approach to pricing in motor finance

Lawrence Whittle

In the shrinking UK point of sale market, balancing the objectives of the consumer, the dealer and the lender is a challenge. On top of the complexity, executives are dealing with margin and cost pressure, increased competition for market share from both traditional and non-traditional lenders, an aggressive regulatory environment, an increase in consumer credit risk, and few innovative ideas on how to gain a competitive advantage or gain new customers.

Despite this highly charged environment, the most recent innovation in loan pricing was the introduction of risk-based pricing – also known as cost-based pricing – in the early 80s. While it was pioneering at the time, the factoring of “risk to price” is now standard practice.

A new approach

In order to compete effectively, motor finance executives need a good understanding of demand elasticity and how a change in price could impact key performance indicators such as profitability, volume, conversion rates, retention and default. This needs to be viewed along side a dynamically changing mix of manufacturer-led promotions for new cars and a plethora of lending options in the used car sector. Because of previous investments in CRM and data warehouse systems, the data about booked deals, as well as those deals that were applied for but not booked, is now available to be analysed and manipulated to set more effective pricing strategies.

A profit-based pricing approach is enabled by pricing optimisation technology, which is being used successfully in industries such as airlines, hospitality, manufacturing and retail. Designed specifically for the unique profitability dynamics of the finance market, profit-based pricing integrates

sophisticated analytics and an understanding of demand elasticity to enable more tailored and profitable pricing decisions within a transparent and objective framework required by regulators.

Profit-based pricing provides a more strategic way for lenders to manage their business by better understanding how price impacts performance, and helps motor finance executives increase profits without sacrificing market share.

Understand the incremental profitability of every potential transaction

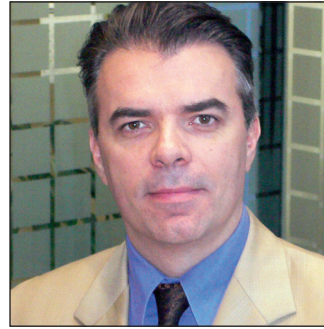
Using a profit-based pricing approach, motor financiers will be keenly attuned with the incremental profitability implications of each applicant. It is important to break out the sunk costs (such as marketing and advertising costs) of programmes and only incorporate the variable costs for each transaction.

For example, a £300,000 national marketing programme to promote the rollout of a used car motor lending programme should not automatically be included in the pricing decision. However, the variable costs of the potential transaction should be factored into the overall incremental profitability. The costs associated with processing the lending applications, approval, and overall origination process per transaction would be incorporated into the final price of the loan.

Understanding the incremental profitability of each transaction will give funders the most flexibility and strategic insight into how much negotiating power they can give the dealer.

Give your competition the unprofitable risks

Adverse selection is a market process that occurs from information asymmetries between buyers (customers) and



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and are less likely to shop around. Because this phenomenon can have a significant impact on financing credit mix, being aware of it and being armed with the right information will provide funders with a strategic advantage in setting prices.

Evaluate trade-offs in your pricing

A profit-based pricing approach is geared towards maximising profit without sacrificing market share. By using a profit-based approach to better understand demand elasticity, we can systematically move customer segments closer to the efficient frontier (see figure 2).

Summary

Rather than simply pricing for the inherent risk in selling the product, motor financiers need to price for the brand value in which their company is heavily investing. Past industry experience has illustrated that the early adopters of profit-based pricing tend to reap the greatest rewards.

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sellers (lenders). For example, Company A provides one buy rate for its “pre-owned” vehicles at 9 per cent and Company B has a multi-tiered risk-based price structure with five tiers based on credit score. The following adverse selection could occur.

All of the high risk customers would select Company A because of the better rate than available from Company B (9 per cent versus 9.5 per cent and 10 per cent). Company B would get the lower risk customers because of the better rates (8 per cent and 8.5 per cent versus 9 per cent).

Adverse selection needs to be incorporated when setting prices, especially in sub-prime markets. Lower credit quality customers tend to have fewer options than prime borrowers

FIGURE 1

	Risk Score Band				
	>550	550-599	600-649	650-700	700<
Company A rate	9%	9%	9%	9%	9%
Company B rate	10%	9.50%	9%	8.50%	8%
Key:	Customers select A	Customers select B	Either		

Figure 1: Bank A offers one rate across all risk scores, Bank B offers various rates by risk score.

FIGURE 2

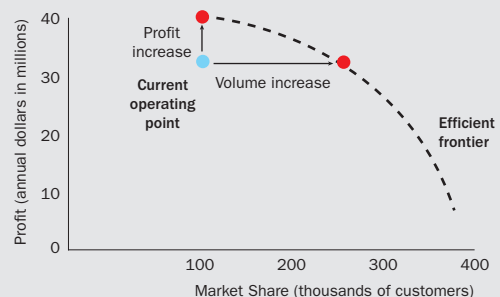


Figure 2: Motor financiers have the opportunity to use a profit-based pricing approach to optimise profitability and market share goals by moving customer segments closer to the efficient frontier.