

January 5, 2009

## Price Optimization Is Registering With Financial Services Industry

By AMY REEVES

Two years ago, the truth dawned on Kelly Mankin and his cohorts at Chrysler Financial.

"The simplest way to put it is that we realized one day that our pricing was effectively all art and very little science," said Mankin, the auto financing company's vice president for marketing. "There were multiple examples in the company where we employed demand models in other areas, so why not pricing?"

So, managers kicked around the idea of using pricing optimization — using specialized software to crunch all relevant data points and come up with the most profitable price for a given transaction.

Pricing optimization isn't new. It's been a staple of some other fields, especially the travel industry — hence the many different prices paid for airline tickets. It is also used in other wholesale and retail markets. Chrysler's core car business uses pricing optimization to help price its vehicles for maximum sales.

But it had seldom been used in finance, and never in auto financing, so Mankin admits he was skeptical. After all, auto prices come from a complex interaction of the retail price, the wholesale price and whatever chargebacks, advances and other incentives get thrown into the sale.

### Can See Potential Return

Yet Mankin was impressed with the results of his pricing optimization contractor.

"They were able to prove to us that those demand elasticities could indeed be modeled, and they were able to quantify the value of modeling for us," Mankin said. "We could really identify, on a dollars-and-cents basis, the potential return of moving forward with the project."

Chrysler employed privately held Nomis Solutions to provide the software, which had to handle 24 pricing territories and up to 14 levels of consumer credit. Chrysler has used the system for two pricing cycles so far, Mankin says.

How much this move might help the company remains to be seen. Chrysler Financial finds itself entangled in two industries in deep crisis — automotive and financial — and has lately asked the government for a \$4 billion loan.

But at a time when financial companies are looking for anything to help save business, pricing optimization might be an important part of the tool kit.

"No one (in the financial sector) was looking at this before 2001 or 2002," said Bobbie Britting, an analyst at Tower Group. "It was really auto financing and home equity that first picked up on pricing optimization."

Europe and Canada have embraced the idea more enthusiastically than the U.S., with Lloyd's of London, the Royal Bank of Canada (RY) and the Bank of Montreal (BMO) making use of pricing optimization systems. German business software giant SAP (SAP) embeds price-optimization abilities in some of its products.

Richard De Lotto, an analyst at research firm Gartner, says he's been expecting the trend to hit U.S. banks for several years but he hasn't heard much about any actual institutions using it. He says banks are probably using aspects of price optimization but keeping quiet about it.

"This is their usual pattern of doing stuff in very deep secrecy," De Lotto said. "I think(they're) using various forms of price optimization but calling it other things."

Britting says financial firms often aren't sure if what they're doing really counts as price optimization. Full-blown optimization tends to come at the end of a long process of gathering more data about clients and creating more complicated pricing schemes.

Eric Lindeen, marketing director for privately held enterprise software firm Zoot Enterprises, says he has been watching this process unfold in the financial sector. Most institutions are using information about customers to create credit risk pools, where firms can tailor their offerings based on expected behavior patterns of certain demographic groups.

### **Higher Profit, Lower Risk**

"We've seen that the larger institutions are increasingly interested in making their pricing optimization decisions more accurate and more effective," Lindeen said. "We've still seen very, very few that have done anything to the degree that you might see in the airline industry. But we have seen institutions become much more aggressive to make sure that the people who have either higher profitability or lower risk are paying a lower price, and the folks that either are a higher risk or a lower profitability are in fact paying their own way."

De Lotto says that banks' silence about pricing optimization might also be a nod to public relations. Customers don't always see the difference between price optimization and price gouging.

Those in the industry say this is a misperception, since optimization sometimes means a lower rate for a stronger customer.

"The reality is that it creates more price points," said Tower's Britting. "Some people will get a lower rate than they would otherwise have gotten, some will get the same, some higher."

The recent banking crisis has only made PR more difficult for banks. And their reduced funds have threatened tech spending and the vendors who provide things like pricing optimization.

Zoot's Lindeen says some financial customers are cutting back on their capital spending but others are looking for an edge.

"We've seen a fair number of institutions that have been pretty cautious in the past starting to see this as an opportunity for investment," he said. "In one or two years, if they can position themselves now they will be in a fantastic position in the future."