



Smart Use of Pricing Can Help Banks in the Battle for Deposits

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"Unprecedented turmoil" is among the phrases most commonly used to describe the current state of banking. And, indeed the last few months have seen an historic rate of failures, near-failures, and acquisitions combined with a rapid tightening of credit. Amid all this turmoil, it is easy to forget that the basic business of gathering deposits and making loans is not going to disappear. In fact, as banks look for ways to survive the current environment, more careful management of the core businesses of lending and deposits will have a high priority. In this article, I'll explain how pricing and profitability management can help bank executives break through the current market conditions and prepare themselves for the future

The Impact of Scarcity and Cost of Capital on Lending

Banks and finance companies are grappling with the perfect storm: a volatile funding environment, a lack of liquidity in the marketplace and extremely high inter-bank lending rates. This combination of factors is leading to a need to rethink the fundamentals of the business. In particular, it has generated three urgent needs:

1. The Need to Originate to Order

Historically, a robust secondary market with a seemingly insatiable appetite for credit products meant that the supply of credit was essentially unconstrained. A home could be found for almost any type of reasonable (and often unreasonable) loan. Now, funding and balance sheet needs are dictating the types of loans that can be funded. Lenders need to be able to use intelligent pricing to stimulate customer demand for the types of products they want to put into the market.

2. The Need to Understand Customer Price-Response

Our research has shown that the constrained supply of credit means that consumers' responsiveness to price is at an all time low. Savvy executives can use pricing to capitalize on this opportunity to improve net interest margins and better position themselves in the market. However, the price-responsiveness of borrowers is changing more rapidly than we have seen before—often on a week-by-week basis. To the extent that it was ever any good, much of the received wisdom about customer price-response is now out of date and changing by the week. To fully capture the opportunity, targeted analytics and careful market tracking will be required.

3. The Need to Mitigate Adverse Selection

Consumers willing to accept higher rates are typically those that have the most burning need for credit and may have higher default probabilities. Unless this is clearly analyzed and managed, adverse selection will translate into higher losses for lenders in the future. Traditional risk measures based on bureau or custom scoring have been established based on historic market conditions and do not fully account for this. To manage and avoid adverse selection, lenders need to understand how higher APRs will change the loss behavior in different customer segments.

The Impact of Scarcity and Cost of Capital on Deposits

The collapse of the wholesale credit market has led to a new focus on deposits worldwide.

Racing for Deposits

Deposits are getting more competitive and difficult to secure as the "land grab" for deposits drives down margins. While acquisition is one way to building the deposit balance, most banks are going to need to rely on organic growth. As the economy moves into recession, the savings rate is likely to increase, creating new opportunities.

Understanding Changing Customer Response to Pricing

Consumers are considering brand and financial stability when making decisions about savings and deposits—there is a definite and discernible "flight to quality". Banks with a strong reputation and an extensive retail network in a certain market will be able to compete most effectively. Those with a weaker reputation and/or less extensive retail branch network will need to price their deposits more aggressively to compete. Understanding where and how to target prices to attract the most deposit balances at the lowest rates will be a complex challenge. Most banks use an ad hoc and judgmental pricing process, which lacks an understanding of customer response, to address an incredibly complex problem with potentially tens or hundreds of thousands of price points. Many banks are moving to a more analytical approach that enables them to meet their targets in the most profitable fashion.

Using Best-in-Class Pricing and Profitability Management

Through a combination of advanced analytics, innovative technology and tailored business processes, a best-in-class pricing and profitability management approach can improve financial and operational performance on both sides of the balance sheet. With the ability to quantify customer response to pricing, executives can develop pricing goals and a pricing strategy that are aligned with business objectives and financial performance targets. Because they are able to forecast what they can expect to acquire as a result of a pricing action before putting prices into the market, this approach supports an intelligent debate on the inevitable tradeoffs such as volume versus profit and risk goals, tier/term mix, credit score distribution, and loan-to-value (LTV).

Once performance goals are set, prices can be optimized to achieve profit, volume and balance targets from the portfolio level

down to the micro-segment level. Executives can measure the impact of a competitor's price changes or recent exit on their business. Additional benefits include: increased profits and/or market share, higher returns on assets, improved deposits balances, more control over risk, a cohesive view of key performance indicators at a portfolio and micro-segment level, and the use of a more structured, repeatable and efficient pricing process.

For lenders, the ability to predict the impact of price on consumer response enables them to optimize their credit and term mix within the context of their risk and ABS conduit tolerances. For deposits executives, an understanding of customer response to deposit rates at the point of sale and renewal helps drive incremental margin improvements. By optimizing deposits pricing and understanding the impact of price on take up of all of their products, banks can efficiently find the most profitable way to both attract funds and lend them.

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