The PRICING ADVISOR
A Professional Pricing Society Publication
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Structuring Loan Pricing to Enhance Asset/Liability Management

In many banks, pricing is an ad hoc function. Managed holistically, it can become a source of competitive advantage. Banks need to evolve beyond risk- and cost-based pricing, as the authors explain. This article presents numerous pricing strategies that, although explained in the banking industry context, can be applied in pricing practices across multiple industries. *David Vidal is a director at Simon - Kucher & Partners and can be reached at David.Vidal@simon-kucher.com. Jens Baumgarten is a managing partner at Simon - Kucher & Partners and can be reached at jens.baumgarten@simon-kucher.com.*

Despite their important impact on loan volume, deposit balances, revenues and profits, banks rarely implement pricing strategies that integrate cost, risk and market factors. Instead, pricing is often handled by a separate pricing team or even by the individual business lines that do not have the capacity to consider the big picture when setting rates for specific types of loans or deposits.

In fact, when disparate committees or managers set prices, they are engaging in asset/liability management (A/LM). And while the A/LM committee may be monitoring the balance sheet, examining interest-rate risk and measuring liquidity etc., in many banks, pricing is much more of an ad hoc function.

This article outlines steps to manage pricing across business lines and to formally connect pricing with the overall A/LM effort:

- Develop a clear understanding of pricing trade-offs.
- Define specific goals for pricing.
- Establish formal pricing guidelines.
- Develop a holistic pricing process.
- Define pricing governance rules and organizational accountability.

Pricing that meshes with A/LM goals and is aligned with the bank's strategy requires not only more executive attention but also more professional pricing processes, as well as a clear pricing organization with governance rules.

Develop a Clear Understanding of Pricing Trade-Offs

Loan volume growth and profit growth can be achieved at the same time, as many banks found during the years preceding the recent collapse. But maximizing both at the same time is simply not possible, and that's what many bank executives fail to recognize when making pricing decisions.

When there is a (negative) elasticity of demand to rate changes, profits will increase when loan rates go up so long as the effect of decreasing demand and resulting loan volume loss is less than the incremental margin generated by the higher rates. The specific profit-maximizing rate depends very much on the cost of funds and risk level for specific market segments, but it will always be different than the revenue-maximizing rate.

As a first step, management teams and asset/liability committees (ALCOs) must understand these trade-offs and identify which rate strategies generate more loans while balancing these goals with the effect on profits and other metrics. Currently, ALCO members in many banks lack measurement tools to obtain a holistic view of the interrelated effects of pricing decisions. Specifically, an elasticity-based quantification of the effects of pricing changes on key metrics for the bank (return on capital, liquidity ratios, profits, loan volume growth) is essential to guarantee intelligent arbitrages. For example, given the current importance of accumulating deposits for lending, establishing A/LM strategies based on an understanding of depositors' sensitivity to interest rates is extremely valuable and requires close monitoring and testing.

The increased sophistication of products and services offered by most banks and credit unions makes the clarification of trade-offs more and more challenging but worthwhile, given the tremendous influence of pricing on the bank's overall spread between total interest income and expense.

Define Specific Goals for Pricing

Once tools are in place to precisely determine the effects of pricing decisions, the second stage in changing the management of pricing is clarifying your specific pricing goals. Executives frequently disagree on pricing strategies. Typically, some executives are motivated to make pricing decisions that support sales growth (sales/operations, marketing); others aim for profit (finance, credit risk).

Given the sophistication of strategic pricing decisions bankers must make, it is important to uncover differences in opinions in a structured way and then to create strategic alignment.

For example, a regional U.S. lender recently endeavored to define their pricing strategy. First and foremost, that meant solving internal philosophical conflicts around pricing. To achieve that, managers completed a computer-based questionnaire where they made a series of trade-offs among several potential outcomes of their pricing decisions. In one of the trade-offs offered, for example, managers had to choose between higher revenue for the given year with a lower gross margin compared to higher revenue over a five-year period with a

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higher return on capital over the same period. The dynamic trade-offs became more and more difficult as the respondent moved through the questionnaire in order to further clarify his or her strategic vision for pricing based on his or her previous answers. For this lender, the approach revealed and explained differences both in the perception of what the current strategy was and in what managers believed the optimal pricing strategy should be. The pricing implications of various market pressures and risks for the bank were perceived very differently across the management team. Presenting the results of this exercise and sharing the reasoning of each manager helped to structure the discussion on loan pricing goals and create consensus. Ultimately, by achieving strategic agreement on the pricing goals, managers were able to establish formal pricing strategies in the ALCO. For example, the bank established a set of predetermined competitive reactions for each loan term in order to avoid impulsive decision making.

Establish Formal Pricing Guidelines

Given the sophistication and multitude of products and services offered by most banks, ALCO or top management should obviously not be involved with all pricing decisions the bank makes. That's why, after defining and ranking its goals for pricing as described above, every bank should derive general pricing principles or guidelines and communicate them to product managers and salespeople (Figure 1).

A manager of a large U.S. bank noted how vital it is to develop pricing guidelines: "It was extremely important for us to draw up a set of pricing principles for our future price and product policies. We then had a clearly defined framework. We can now refer to these pricing guidelines in all of our pricing discussions. Having our seven commandments of pricing was extremely helpful in creating a more efficient pricing process."

Develop a Holistic Pricing Process

Bank executives today generally agree that there are opportunities to improve pricing strategy, analysis and deployment processes. More than ever, economic and regulatory conditions dictate that banks become more sophisticated and transparent with their pricing: regulatory pressures on fees are mounting, consumers are more price sensitive, and price wars have intensified on products such as deposit accounts. Many banks, however, have yet to lay the groundwork for intelligent pricing management by employing a professional pricing process, pricing organization and pricing governance rules.

Experience shows that these three inefficiencies in pricing processes are most prevalent:

- **The absence of key pricing process steps and, thus, of key inputs for pricing decisions.** As stated above, many banks fail to derive clear pricing goals from their A/LM strategy (for example, which type and term of loans are needed most from an A/LM perspective).

- **The multitude of conflicting and uncoordinated information flows.** In many banks, there is no structured process to balance conflicting goals and manage various optimization metrics (return on capital, profit, liquidity, charge-offs, prepayment levels, etc.). Also, a lot of banks fail to integrate supply-and demand-side analytics for pricing. Typically, the risk management, marketing, treasury and finance teams provide different inputs, but there is no team designated to compile and reconcile these reports.

- **The lack of clear timing and sequencing of specific pricing sub-processes**. Typically, banks do not differentiate strategic/cyclical and tactical/ongoing pricing decisions, as well as the related process steps. The absence of a systematic pricing process ultimately results in a lack of transparency on current pricing practices and in suboptimal pricing decisions.

A four-stage plan that starts with defining strategic pricing goals all the way through implementing and monitoring pricing measures (Figure 2) is recommended. Price monitoring is especially important in lending and commercial banking, where final prices are mostly determined through negotiations. Most banks generate improvements of 2 percent to 5 percent in cost/income ratio when they improve their pricing processes.

Figure 1: Banks Should Define Pricing Guidelines

Pricing Guidelines	Design
Profit first	Bank A's main goal is profitable growth. The products of department X have to be profitable as a whole. The customer's utility value and willingness to pay, costs and competitive prices all determine future product pricing structures.
Competitive/price positioning	Bank Y aims to position itself as a premium provider in the market. Accordingly, it charges higher prices for quality products and services. Hence, customers should view the products as having a consistent relationship in price and performance. The products' prices must be in the upper quarter of the market's price corridor.
Price elasticities	In the future, Bank Z will gather and analyze the most appropriate information to identify and track the most relevant revenue drivers for the business. As well as preferences, customers' values and competitors' prices, Bank Z will assess customers' willingness to pay and product price elasticities.
Self-selection	Customers have the freedom to choose which products or services they want. Customers choose products to meet their individual needs.

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Define Pricing Governance Rules and Organizational Accountability

In most industries, pricing has been established as a key function and clear pricing governance rules have been defined (airlines, hospitality, retail, telecommunications etc.). For banks, however, pricing is still rarely governed by transparent rules, nor does it have an organizational home or management role dedicated to it, such as a "Head of Pricing."

When establishing a pricing organization and governance organization, banks need to answer, among others, the following questions:

- Who is responsible for determining prices for banking products?
- Who awards discounts (for example, for large loans), in what form and to what extent? What are the escalation points for discount authorization?
- How do different organizational functions (marketing, credit risk, finance, sales, analytics, information technology) interact and coordinate when it comes to pricing? Is there a dedicated pricing committee?
- Where should the price management function be located within the organization?
- What information is needed to make educated pricing decisions? How should the necessary data be managed? By which function?

Research in the financial services sector has shown that in the vast majority of institutions, pricing is still managed independently within the diverse business lines. As a result, pricing managers of different lending and deposit products do not interact or are not equipped with all relevant information, which results in suboptimal pricing decisions.

Senior management must be involved to clarify pricing goals and to bring together necessary resources, but that is not enough. Pricing needs an organizational home with a dedicated manager coordinating the pricing process. Two types of pricing organizational structures exist: dedicated pricing departments and cross-functional pricing committees that coordinate individual pricing responsibilities.

The first approach—a dedicated pricing department—makes it possible to clearly assign roles that usually have no ownership and allows for more functional pricing expertise. This enables the bank to build up pricing as a core competency and use it as a strategic instrument (more resources available to develop tools, best practices, methodologies, etc.). Dedicated pricing departments, however, come at a higher cost and offer less flexibility than using resources and combining them in cross-functional teams.

The most appropriate form of pricing function depends on each bank's respective strategy, structure and resources. In any case, it is essential that the roles and responsibilities of each function are clearly defined, that there is adequate staffing and that there are clear lines of cooperation and authority to ensure maximum efficiency in coordinating the role of the various pricing stakeholders.

Pricing for Competitive Advantage

Given the increased attention of customers and regulators to banks' pricing practices, the management of these practices must quickly evolve and go beyond the industry's current norm of risk- and cost-based pricing. Establishing pricing as a core competency and competitive advantage requires executive leadership and the integration of A/LM requirements, as well as a clear pricing process, organization and governance. With the recent industry disruptions and the resulting increase of government oversight, the time has come to focus on these topics. Banks that develop pricing into a core managerial competency will find the recovery smoother and more profitable than banks that fail to seize this opportunity.

Figure 2: A Four-Stage Pricing Process Pricing Strategy/Pricing Analytics and Optimization Models/Pricing Systems/Pricing Implementation