Risk-based pricing, in the simplest terms, is alignment of loan pricing with the expected loan risk. Typically, a borrower’s credit risk is used to determine if a loan application will be accepted or declined. That same risk level may also be used to drive pricing. This means charging a higher interest rate for a higher risk transaction and a lower rate for a lower risk transaction. While all large banks have some form of risk-based pricing, small to medium-sized banks are now investigating how to formally leverage this pricing strategy.

A balanced pricing strategy is comprised of three critical elements. First, the bank must have solid credit quality. A seasoned bank executive recently commented, “Regardless of the pricing, a bad loan is a bad loan is a bad loan.” If the borrower defaults, the net result is a charge-off that negatively impacts credit reserves and bank earnings. The second important component is profitability. Pricing for closed loans must result in the net spread required for the portfolio to cover expenses and generate desired return. Many banks have found that pricing more aggressively will generate more loans – but are they profitable loans? The final component of a balanced pricing strategy is portfolio growth. There is a constant challenge to grow the portfolio to increase earnings year-over-year. A balanced pricing strategy should support portfolio growth generated by profitable, quality loans. The result is a balanced pricing strategy that can be best summarized as the proverbial three-legged stool of quality, profitability, and growth. Each is important, but if one is missing, the stool will tip over.

Risk of Flat-Rate Pricing

While most large banks already have risk-based pricing strategies in place, this is often a new venture for small or medium-sized banks. Even if they “know” to price risky loans higher, implementing a formal strategy is a way to create a process that drives consistent results. Banks without a formal risk-based pricing approach typically use a flat-rate pricing model where all customers receive the same rate. The use of the flat-rate pricing model may be the result of a lack of technology to support a more sophisticated pricing strategy – or just an approach to “keep it simple.”

The inherent problem with a flat-rate pricing strategy is that the bank will typically close a disproportionate share of lower credit quality loans since the higher credit quality borrowers can
obtain better pricing through other avenues (i.e. banks offering risk-based pricing). Even if the higher credit quality borrowers apply for a flat-rate priced loan, these borrowers will often have a lower closing rate as they find better pricing elsewhere. Banks can see this for themselves by tracking the percentage of loans approved but not booked divided by total loans approved by credit score band.

Lower credit quality borrowers see the flat-rate pricing model as more attractive than a risk-based pricing model and typically will have a higher closing rate. When a bank sets a flat-rate price based on a certain mixture of credit risk customers – and then closes a higher percentage of lower credit quality loans - the bank is not adequately compensated for the risk level of the portfolio.

**Zions Model**

One bank who recently moved from flat-rate pricing to a risk-based pricing strategy is Zions Bancorporation. The bank leveraged clearly defined credit acceptance criteria and used that information to establish risk-based pricing. The result was a matrix that outlined the pricing criteria and the associated pricing premium for various risk grades. For example, Zions indicated that for the direct unsecured product, the loss distribution is more than 12 times greater for borrowers with a bankruptcy score higher than 580 or a credit score of less than 670. Zions used this information to classify these loans as ‘auto-decline’.

In an interesting twist, the better credit score did not always generate the lower rate. While the credit score of 730 and above did generate the lowest pricing as expected; the credit score of 671 – 699 generated a 22% lower loss distribution than the credit score of 700 – 729. This would result in a lower risk-based price for the 671 – 699 credit score borrowers versus the 700 – 729 credit score borrowers. While this example is uncommon, the due diligence and tracking of actual loan performance is critical when establishing a credible pricing model based on a bank’s actual portfolio results.

Zions’ risk-based pricing strategy also analyzes loan originator or sales lender overrides that occur outside the standard acceptance range. Based on the historical performance of overrides, Zions was able to determine the premium for certain score ranges that is required to drive an acceptable level of return for these credit overrides. This process allows lenders to request an “extension” and enables the bank to make these overrides on an as-needed basis with the appropriate pricing required to maintain profitability.1

**Pricing Model Basics**

While the Zions example used bankruptcy score and credit score, some of the other variables that may be included in a risk-based pricing matrix are collateral, loan-to-value, debt-to-income, and origination channel. Additional variables that impact the overall pricing model are expected loss, pre-payment rate, anticipated fee income, as well as origination cost, servicing cost, capital requirements, and cost of funds.

Risk-based pricing is especially valuable when dealing with near-prime (credit score of 630 to 680) or sub-prime lending (credit score below 630). The cost of capital can be appropriately applied by credit grade - which can be calculated as part of a RAROC (risk-adjusted return on capital) pricing model. Ultimately, the bank can modify the pricing based on the amount of increased or decreased risk and associated capital required as part of the risk-based pricing strategy.

Generally, pricing models are dynamic and continually updated based on the bank’s experience as well as external factors such as cost of funds. It is important that a bank have the availability of data at the individual loan level over the life of the loan. The bank must be able to assess how they predicted the loan would perform against how the loan actually performed.

There are other types of pricing models available. Relationship pricing models evaluate the overall value of the customer to the organization across all products. Marketing models compute competitor offerings and pricing to determine the available pricing ranges for certain products in

specific markets. Pricing optimization models determine the price elasticity for each borrower. Regardless of the type of pricing model, an element of risk-based pricing must be included to make sure that the risk taken by the bank is aligned with the rate and fees paid by the borrower.

Near-prime & Sub-prime Lending

Historically, many banks had a policy of offering lending products only to “prime” borrowers (generally defined as a credit bureau score of 680 to 700 or higher). Many banks now offer loans to near-prime credit borrowers with credit scores of 630 – 680. Some banks have expanded into the sub-prime lending market in an effort to drive more loan volume and recover some of the costs spent on applications already taken or processed.

While individual banks have varying thresholds, many define sub-prime lending as a credit bureau score of 630 or lower. The avoidance of sub-prime lending by banks has been shifting. The 2005 BenchMark Home Equity Study found that half of the participants had a sub-prime lending strategy of either a pass-through program whereby they forward declined applications to a third-party for consideration or a portfolio strategy of retaining sub-prime loans on the bank’s books.

While the majority of banks have historically avoided sub-prime borrowers “on the books”, virtually all banks have sub-prime home equity loans and lines within their portfolio. How does this happen? Generally, it is exceptions, overrides, and one-time credit policy violations that create additional risk exposure over time. The result is that virtually all banks have some sub-prime loans in their portfolio and those loans may not be priced according to their risk-level. While certain overrides and exceptions are needed based on competitive factors or the value of the bank’s relationship with the customer, it is important to note whether the bank is making a credit underwriting exception or a pricing exception or both.

The ability for banks to reach deeper into the credit spectrum provides a way to lift the booked loan volume without necessarily increasing the applications. Because of the costs already incurred in processing the application, the bank’s ability to close more loans also helps to immediately recover those costs. In the 2005 CBA Home Equity Lending Study conducted by BenchMark Consulting International, 11% of home equity loans and 6% of home equity lines of credit booked during the 12-month study period were sub-prime credit. This was approximately a 20% increase in the amount of sub-prime borrowers within the new home equity products booked, year-over-year.
The credit decision, alone, is challenging for near-prime loans that are between the 630 - 680 credit bureau score range, or even the sub-prime home equity – which is defined as a credit bureau score of less than 630. For banks that choose to lend within these credit score bands, it is essential that an appropriate rate is received in return for the increased risk of default. In addition, the servicing and default management for near-prime and sub-prime require different processes and policies. Banks who extend into this space must be fully aware of the risk associated with these loans and adjust underwriting criteria and loan pricing, as required, to mitigate the risk.

**Lender Overrides and Exceptions**

While banks may develop sophisticated pricing models and even pursue opportunities in the near-prime and sub-prime areas with confidence, there is one challenge that seems to continue – loan originator (LO) overrides and exceptions. Many banks put such a high emphasis on the LO and their judgment and evaluation of a borrower that many loans are made which ignore the risk-based pricing models.

In some cases, the LO may either approve a loan that the automated underwriting system declines, or the LO may offer a lower than suggested interest rate. In some cases, the LO may do both by approving a lower credit score borrower and providing a lower-than-expected rate and fee. Evidence across multiple banks suggest that while, anecdotally, we would like to believe the LO knows best, these overrides and exceptions perform worse than the loans made within bank guidelines. From BenchMark’s work at 39 of the top 50 US Banks, we have found that credit policy and underwriting overrides and exceptions typically perform at least twice as bad as those loans made within policy. The ability to restrict the LOs from making overrides and exceptions is difficult in a sales-focused environment without completely removing their autonomy and empowerment. By tracking these exceptions and adding a risk-based price premium based on the increased risk, LOs can make fact-based decisions and control behavior that may be negatively impacting future portfolio performance.

**Risk-Based Pricing to Increase Loan Growth**

While some banks find credit officers tightening the credit policies in today’s tough economic times, anticipating the coming storm of increased delinquency and degraded portfolio performance, others are looking to risked-based pricing as a way to drive more volume. One leading industry bank executive recently commented the challenge at his bank is shifting from a risk-avoidance mindset to a risk-return mindset. This particular bank has an average credit bureau score of 730 and a very low charge-off rate but is challenged to continue to grow the home equity portfolio. This bank sees significant pricing competition in the “A” paper where margins have been compressed by heated competition.

In this example, one option may be buying slightly deeper with the appropriate credit-risk underwriting and the associated risk-based pricing applied. The bank will generate more loan volume and capture borrowers with a 680 - 700 credit bureau score that are priced according to the risk-level. Another option is to avoid holding these loans in portfolio and pursuing a strategy to refer these applications to a third party or sell the closed loans.

If a decision is made to put these loans on the books, it is critical that the bank determine the increased probability of default, increased cost of capital, and other loan pricing variables to calculate the appropriate pricing for these near-prime loans. By appropriately leveraging risk-based pricing, this firm will be positioned to generate more loan volume with interest rates tied to the associated loan risk.

**FACT Act**

Recent consumer protection was created by the Fair and Accurate Credit Transactions Act of 2003 (FACT Act). Lenders will likely face additional challenges with the risk-based pricing provisions under Section 311 of the FACT Act of 2003 that will require banks to provide risk-based pricing notices. This means that lenders must issue risk-based pricing notices whenever information in the borrower credit file causes them to pay an interest
rate or fee that is “materially less favorable.” This could create some additional steps for risk-based pricing institutions, but will not substantially curb the appeal or practice of pricing for risk.

Conclusion

The Federal Reserve has reported a declining trend in delinquency over the past 10 years, which has been further validated by BenchMark’s CBA studies and direct work with bank clients. However, many key leading indicators point to difficult times ahead. With expected increases in delinquencies, interest rates, and expected losses – some lenders are tightening credit standards because of concern of loan quality. Other banks are extending the reach into near-prime and sub-prime credit as a way to keep the loan volume at prior record levels.

There are many variables to consider when evaluating a risk-based pricing strategy. For a balanced strategy, the firm must have an appropriate level of focus on quality, profitability, and growth. Now may be the time to evaluate your firm’s pricing strategy and determine corrective actions that are needed.

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