

# Pricing for Opportunity in Home Equity Lending

Advanced pricing skills will be critical as home equity lenders compete for selective growth opportunities going into next year.

BY GAURAV GUPTA

As retail bankers prepare for a challenging 2012, home equity lending will be a critical engine for revenue and asset growth in an overall tight market. But many lenders will forfeit opportunity if they confine themselves to traditional pricing practices.

Following the U.S. credit crisis, home equity lenders initially worked to fortify underwriting, realizing that they had not adequately protected themselves during the heady expansion years. This is certainly appropriate given the outlook for continued high unemployment, flat or falling housing prices and a towering consumer debt load.

Defensive measures only go so far, however, at a time when the pool of eligible customers is significantly reduced and banks are hungry for profitable assets. The larger question is how to generate profitable growth under more prudent lending standards.

The answer, in most cases, lies with improved pricing skills that go far beyond the basics of risk-adjusted pricing, the de facto industry standard. Risk basics fail to consider important variables such as customer relationship profitability and segment variations in customer demand.

For example, there is a large group of credit-worthy customers who don't have time for price-shopping and just want convenient access to a rainy-day line of credit. In other cases, judicious rate offers can attract many substantial new borrowers, materially

improving profits — by more than 20% in one recent case study — without disturbing underwriting standards.

Such opportunities typically are overlooked among most banks. Beyond risk, lenders largely confine their frame of reference to competitor actions, internal cost estimates and executive interpretations of recent results. This omits, for example, customer's sensitivity to price; the extent to which account holders actually will use their lines of credit; likely balance duration; shopping attitudes (price versus convenience); and the extent of consolidated business done with customers across all areas of the bank.

In many cases, lenders have yet to compile the source information needed to analyze such variations in customer demand and performance. We have seen instances where lenders either do not ask applicants to state the intended purpose of their home equity loans or record such information erratically. Even in cases where such information is available, it is not routinely analyzed and consistently incorporated into pricing decisions.

## THREE-PART APPROACH

To address home equity pricing questions more systematically, leading institutions are adopting a three-part approach:

**Product economics.** Banks generally need a more precise workup on how various customer factors (i.e., expected funds usage and cost to serve) influence profitability.

And many could improve decision-making by using more robust metrics to assess value, such as economic profit, net present value, and risk-adjusted return on capital.

As to why expected usage matters, the potential for home equity lending profitability often is quite different between, for example, a borrower getting ready to add a room to the house; or someone who simply wants a backup line of credit to assure household liquidity; or parents who are looking to fund a child's education. Most pricing policies do not take such variations into account today.

Also, our research continues to show significant opportunities for improvement in cost calculations. More work needs to be done on funds transfer pricing methodologies, for example, to accurately calculate the cost of funding loans. Expenses for marketing, sales and supporting operations need to be accurately allocated as well.

**Segmentation.** Often today in home equity lending, customer segment dimensions are limited to risk basics, transaction characteristics and local geographies and housing markets. While these are important factors, they are not the complete answer in targeted marketing and pricing.

Additional perspectives, such as purpose of the loan, nature of relationship with the bank and overall household cash management needs, help to uncover pockets of opportunity

**Fig. 1: Insights about behavioral differences can help make better targeting, pricing and portfolio management decisions**



that are otherwise are not visible. With established customers, for example, the bank can augment basic risk scores with salient account and transaction information, which can help to clarify, and in many cases expand, the pool of qualified borrowers.

**Elasticity of demand.** Most banks routinely track competitor prices, which are then used as an input for subjective pricing decisions. For one thing, this approach fails to recognize that various groups of customers look in different places to get a sense of market prices. It also overlooks differences in consumer attitudes and responses to similar price signals. By contrast, advanced lenders carefully study and quantify how consumer demand varies in accordance with

changes in lending rates, and they use that knowledge to refine pricing strategies within customer segments.

Such in-depth preparation sets the stage for precision marketing and pricing strategies in home equity lending. Goals for various customer groups may vary markedly, everything from special offers to bring rate-sensitive customers off the sidelines to judicious adjustments that will improve margins in areas of stronger customer demand.

Together, consumer loan cross-sell and account consolidation represent one of the strongest opportunities in retail banking going into next year. Nationally, we estimate that there is a potential \$2 trillion opportunity for consumer credit consolidation, based on Novantas research indicating

that many consumers have scattered borrowing wallets but are attitudinally receptive to consolidating business with their primary bank.

Advanced pricing skills are critical in making the most of this opportunity, and indeed will provide the most immediate performance boost for well-prepared banks.

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