eBook: Auto Lending Pricing

Innovative Approaches to Pricing in Auto Lending

A Smooth Ride Ahead



earnix

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Executive Summary

Banks, credit unions, and automotive captive finance companies—any organization providing auto lending—stand to **gain a lot from new, smarter pricing strategies** and approaches.

It's a real opportunity, but only for auto lenders willing to shake up the status quo and implement new strategies that combine technology with innovative new ways of thinking. By **improving pricing approaches with modern technology**, these organizations can grow their customer bases, improve overall profitability, and deploy highly tailored, personalized offers that create meaningful customer experiences.

This eBook dives into the following issues:

- Challenges caused by traditional pricing methodologies
- Benefits of smarter, more intelligent dynamic pricing solutions
- What to look for in new technology
- Best practices for auto lenders ready to take the next step

"Smarter pricing helps to optimize yields, manage the cost of funding, gain market share, do right by the customer, and manage risks."

BAIN & COMPANY

New Times Call for New Digital Strategies

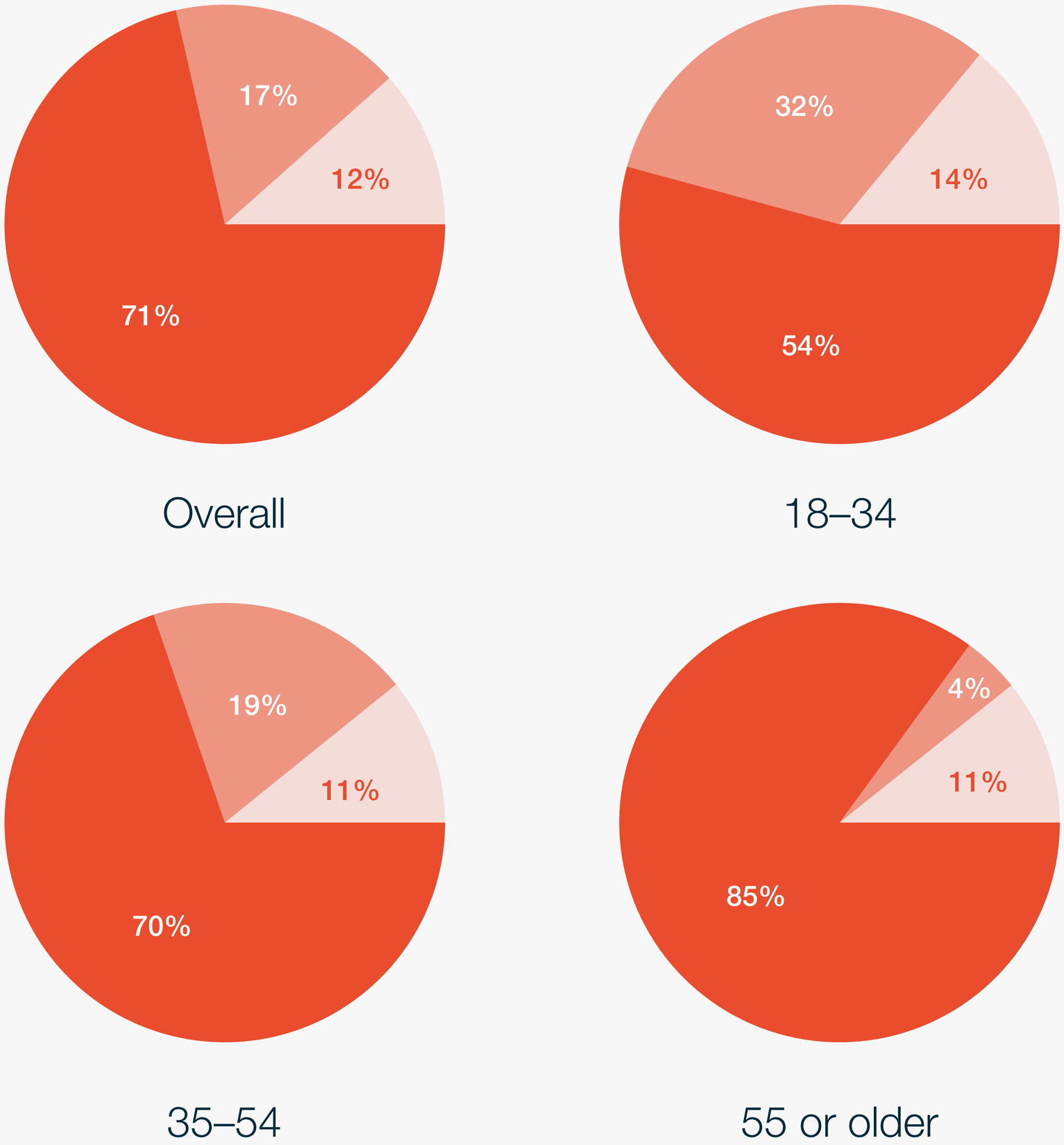
Amid inventory shortage, skyrocketing prices, and outdated sales practices, the car-buying experience continues to be a miserable one for many consumers. Today, most people dislike—even dread—the **antiquated back-and-forth negotiations** related to the price of a car, the interest rate, and other details.

Yet the pain is not one-sided. Auto lenders may find themselves in an unfavorable position as well if they overlook consumer demands for a **seamless, transparent, digital experience** that includes shopping, purchasing, and financing a new car. Data from the Deloitte 2021 Global Automotive Consumer Study found that while older segments of consumers still value an in-person shopping experience, a growing number of younger consumers wants a virtual buying experience (see next page).[1]

Unfortunately, many auto finance companies are not ready to provide these digital experiences. Outdated technology stacks and a lack of effective analytical engines prevent them from delivering the personalized offers consumers crave, performing detailed “what-if” simulations, and taking full advantage of large volumes of consumer data. All of this leads to:

- Clunky origination processes
- Poorly managed portfolio risk
- Ineffectual governance and compliance processes
- Low profitability

Figure 1: Most preferred method for US consumers to acquire their next vehicle



- Fully virtual process (i.e., online shopping, digital document signing, vehicle drop-off)
- Partially vitural process (i.e., online shopping, physical test drive, digital docment signing)
- In-person (i.e., face-to-face at the dealership)

[1]Deloitte: “Digital by Design: Transforming the Auto Finance Sector in the Wake of the Global Pandemic.”

Challenges Posed by Pricing Models of the Past

Risk-based pricing has been in wide use in auto captive finance for decades, where lending decisions have been driven by two factors: credit scoring for the individual borrower or statistical models based on the behavior of large numbers of consumers over time.

While risk-based pricing once served its purpose, today it leads to potential issues and concerns. First, credit scoring relies on parameters that have notoriously long time lags, such as incomes, repayments on other loans, demographics, and more. More often than not, lenders' **pricing models can't keep up** with changes to this data, causing them to misprice their loans or mismanage risk.

Think of it this way: As an integral part of the pricing process, credit scoring looks to the past as a way to predict the future. But without modern technologies —such as data modeling, advanced data analytics, and machine learning and artificial intelligence models—this approach falls short. For example, past pricing approaches simply can't deliver personalized offers and services in real time and in the way that consumers have come to expect.

The Need to Get Pricing Right

According to Bain and Company, auto lenders, and financial institutions in general must **focus on pricing in five different dimensions**:

- Making prices fair and rewarding customer loyalty
- Optimizing yields
- Managing the cost of funding
- Gaining (and retaining) market share
- Managing risk

Bain and Company, "Smarter Pricing to Balance Profits and Risk"

Adding Up to Real Complications

When credit decisions seem arbitrary, consumers who may have legitimate reasons to feel they deserve better terms must plead their cases to loan officers, which can be a time-consuming, inefficient, and even expensive process.

Auto finance lenders could also inadvertently make offers to riskier segments of borrowers whose credit histories may not have caught up with their changing circumstances, subjecting lenders to unnecessary risk.

Similarly, statistical modeling attempts to use behaviors exhibited by large segments of the population and apply these findings to make single decisions for a specific borrower. It's a **rules-based approach that can't detect nuances** in individual circumstances.

This approach still suffers from time-related issues faced by credit scoring. Additionally, rules-based statistical models can't predict or account for large, unexpected economic conditions, like recessions, global pandemics, inflation, and other disruptions.

As a result, **rules-based systems "run out of gas"** when decision-making variables become complex and when there are large volumes of data to be considered. This is especially true in situations where it's difficult to define the rules in advance or when an auto lender's requirements—and pricing models—change constantly.

It all becomes a real disadvantage in an already complex and volatile auto market. Auto finance companies need to do all they can to improve their pricing strategies.

Auto finance companies face:

- Supply chain issues
- High demand for used and new vehicles
- Increasing interest rates and regulations

A Modern Technology Approach to Risk-Based Pricing

As captives and auto finance companies face all of these challenges—and the risk of falling behind early adopter competitors who may be a step ahead—it's no wonder that they are looking for **a better way to price loans** and other product offers and manage risk.

Today, more agile, composable, and intelligent solutions are helping auto lending companies **reimagine internal pricing operations**. These proven technologies help them evolve their best practices and innovate their operations to better serve modern customers.

For example, machine learning (ML) and artificial intelligence (AI) can provide much deeper insights into data. These models can identify complex, nonlinear patterns in large data sets and improve the overall accuracy of risk modeling.

They can also improve pricing models and outcomes. Systems based on AI and ML are essentially infinitely expandable, and their accuracy grows with time and with the growth of applicable data sets. In fact, the combination allows decisioning systems to learn, becoming more accurate over time.

Even with large data sets, AI and ML make it possible to identify patterns and apply judgment to decision-making, leading to **greater personalization and quicker turnaround time**, both of which are critical to the customer experience.

Customers and prospects feel offers are **crafted just for them**, while the auto finance company avoids the costs and risks inherent in traditional pricing and decisioning approaches.

Fast Time to Value and ROI

While ML and AI technologies and other investments can deliver impressive results, they suffer from the misconception that implementing seemingly sophisticated solutions must be a long, expensive, and time-consuming process.

Many auto captive finance companies may have attempted to implement risk-based pricing in the past, only to be disappointed in the poor results. These include:

- ✓ High development costs
- ✓ Ongoing expenses for model refreshes
- ✓ Software updates and maintenance
- ✓ Unpredictable integration issues with existing systems

Today, modern pricing solutions eliminate these issues. For example, pricing software integrates with existing systems, adding the layer of intelligence auto lenders and other financial services firms need to create fully connected systems.

They also provide powerful automation, advanced analytics, and autonomous monitoring. By combining these **best-in-class pricing technologies with dynamic decisioning capabilities**, auto finance companies can easily scale experiences, reduce their time to market, and continuously innovate their offerings.

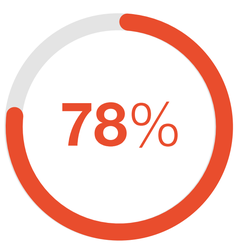
They can also be implemented extremely quickly to provide fast time to value and return on investment. Many implementations can be completed in mere weeks, not months (or even years!) required for traditional on-premises systems.

Real-World Success: ML-Based Risk Modeling

A leading global auto finance company used a hybrid approach to combine its proven financial risk modeling with the ML-based predictions. This market leader is **now able to predict consumer acceptance** of various price points and loan terms–and stay ahead of the competition.

The Need to Go Digital: Pricing Challenges in Auto Lending

With auto sales booming, **it's never been more critical to embrace digitization**. The Wolters Kluwer Digital Auto Finance Index reports:



growth in **digital financing transactions** 2020-2021, up from 38% growth in the prior year



increase in **digital transactions** comparing Q4 2021 with Q4 2020

Even with so many aspects of dealerships becoming much more modern—especially with mobile and new digital offerings—the financing process still feels like it did 10-20 years ago. Yet by not going digital, especially with pricing solutions, **auto loan providers remain stuck** using old, outdated processes.

Many rely on disparate, siloed systems or legacy technology to manage and model data, run pricing simulations, attempt to create personalized offers, and deploy these offers in various channels.

Not only is this type of approach time-consuming and error-prone, but it also makes it extremely difficult for the financing company to deploy compelling offers in time to beat the competition.

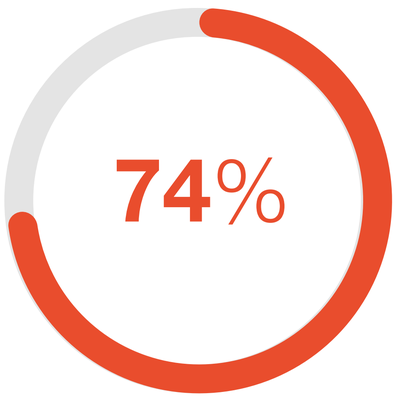
"Wolters Kluwer Digital Auto Finance Index reports a **144% growth** in digital financing transactions over the last 12 months, including a 282% growth rate when comparing Q2 2022 with Q2 2021."

Creating Mutually Beneficial Outcomes

Going digital can solve these challenges and deliver real benefits for both parties. Customers can make the purchases that meet their needs and walk away highly satisfied that they found the ideal vehicle at the best price and loan rate.

Not only does this lead to higher revenues for the dealer, but they also improve internal efficiencies. "Going digital" helps **foster, maintain, and grow relationships** between dealers and their customers.

Consumers are increasingly willing to embrace digital solutions as a way to secure auto loans. A recent *Forbes* article reviewed the Deloitte 2021 Global Automotive Consumer study and found:



of consumers would prefer to conduct credit checks and **complete financing online** instead of in person[2]

A win-win is possible. Accenture described how a global bank **reinvented its entire auto loans process**, digitally transforming its automotive and consumer loans businesses.

The result?

↑ 50%

A 50% increase in car loans sales, a double-digit drop in total costs, and a jump to the #1 spot in market share (up from #4).[3]

While many dealers simply aren't ready to deliver yet, they can meet these expectations with the right digital capabilities and overall approaches.

[2] Forbes Wheels, "Car Buyers Want a Hybrid of Online and Offline Shopping Experiences, Surveys Say." [ITALICIZE "FORBES WHEELS"]

[3] Accenture, "The Future of Auto Finance: A Smoother Ride."

Four Recommendations for Auto Lenders

Accenture recommends four best practices for auto finance organizations looking to improve the lending process:[4]

1. **Start new and imagine** what a frictionless experience could look like from every point of view

2. **Go digital** to minimize or eliminate manual paper processing, e.g., with a mobile app that provides real-time status updates

3. **Employ data and insights** to reduce the number of questions asked of the buyer and remove duplicated effort

4. **Use automation** to streamline internal processes and accelerate approvals

[4] Accenture, “Fresh Auto Finance Approach Boosts Market Share.”

Fast Adopters Stand to Gain the Most

Fortunately, new advances in digital and cloud technology have created **valuable new innovations and trends** in lending and auto financing.

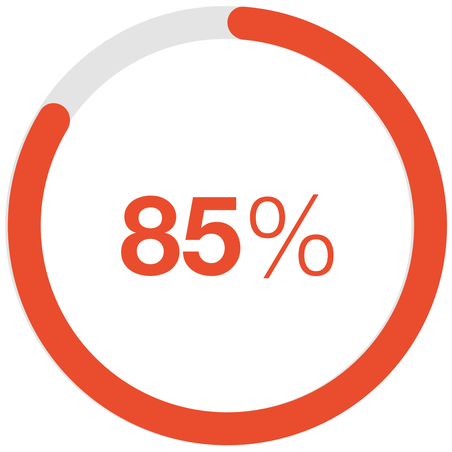
Powerful pricing solutions now use next-generation technologies such as advanced data analytics, ML and AI, and autonomous monitoring to enable auto dealers and captives to manage all aspects of their lending program.

Pricing teams can now access and model large volumes of data, run detailed “what-if” scenarios, and use machine learning and AI-driven insights to create and deploy highly personalized offers.

The most effective solutions also help financial services firms meet stringent governance and compliance requirements, thanks to built-in reporting that provides a complete audit trail detailing every action. Dealers can now improve communications and even explain pricing using personalized offers and information.

While there are many benefits to this new approach, one of the biggest is speed. Auto finance companies can **develop and change pricing models in mere minutes**, which means that they can often deliver highly compelling offers in real time. This goes a long way to providing a new experience to customers—and helping win the deal, retain profitable customers, and grow market share.

A Significant Opportunity for Innovative Auto Lenders



Today more than 85% of automobile purchases are **financed**, and in just the United States alone.[5]

$1T

There are >$1 trillion in **outstanding auto loans**. It's a real opportunity for lenders who get it right—and get started before the competition.[5]

To gain the most market share, auto finance companies use smarter pricing strategies to **target different segments of customers and maximize profitability**. To do this, Experian recommends eight best practices:[6]

- ✓ Make decisions at a finer level of granularity
- ✓ Take more factors into consideration when making decisions
- ✓ Predict and respond to different economic, operational, or competitive environments
- ✓ Consider factors other than profit
- ✓ Take a holistic view of customer's decision process
- ✓ Improve the management of key internal business groups
- ✓ Integrate pricing decisions and the operational process
- ✓ Develop strategies that address different economic variables and outcomes

[5]TurnKey Lender, "Why Auto Lenders Should Consider Digitizing Their In-House Lending Programs."

[6]Experian, "Price Optimization in Retail Consumer Lending."

What to Look for in a Risk-Based Pricing Solution

As banks and auto finance companies evaluate new technology for risk-based pricing, they should look for the following functionality and capabilities:

Comprehensive Pricing Functionality

Banks and auto finance companies need proven solutions that can improve the way they develop precise, personalized pricing offers and products, including integrated simulation and ML and AI capabilities that allow for faster, automated pricing processes.

Governance and Compliance

The ideal solution should also provide functionality to automate and improve governance, risk management, and compliance. For example, the solution should include complete audit trails, detailed records, and comprehensive reports, giving the pricing team and compliance officers fast, easy access to all activity, a critical edge in complying with even the most stringent regulations.

Proven Integration Capabilities

In most cases, banks should avoid any technology that requires a full rip-and-replace implementation. Instead, the ideal solution should seamlessly integrate with existing applications, databases, and systems. It should also be composable, critical to taking advantage of microservices and overcoming the challenges caused by monolithic architectures.

A Fast ROI

Many banks still rely on a patchwork of legacy pricing systems and on-premises hosting, an infrastructure that is overly complex, time-consuming, and expensive. Yet by avoiding a full rip and replace and enjoying fast implementation, banks and auto finance companies can gain a real ROI measured in months–not years.

All of these capabilities can help financial services firms overcome the limitations caused by past approaches to pricing, especially based on credit scoring and statistical modeling, and position them to achieve their specific business goals.

The Earnix Advantage



While banks clearly face a number of real challenges, there is a way to overcome them. At Earnix, we create agile, composable, and intelligent solutions that enable the world to reimagine banking operations.

We help leaders evolve best practices and incrementally innovate their operations to better serve modern consumers. By creating more agile and resilient infrastructure, our customers can confidently take on large-scale transformation while instantly unlocking more value from every engagement. We connect existing systems, new technologies, and diverse teams to not only improve what exists, but to accelerate "what's next."

The Earnix Price-It platform delivers **all the tools needed** to model customer demand, run complex “what-if” scenarios, quickly deploy the optimum pricing strategy, and comply with stringent regulatory requirements. Earnix also enables lenders to combine AI-driven scenario analysis and pricing science with real-time deployment strategies.

If lenders' goals change, **Earnix helps users pivot instantly** by updating yield curves and competitor data, recalculating sophisticated pricing strategies and deploying to the market before the competition can even schedule a meeting between their data scientists and the pricing team.

With the Earnix Price-It platform, banks and auto lenders can ensure prices are quoted in line with customers' behavior and risk. They can also develop and deploy the right pricing to achieve specific goals, such as:

- ✓ Portfolio profitability and size
- ✓ Customer lifetime value
- ✓ Regulatory requirements
- ✓ Revenue growth
- ✓ Profitability

All of this helps auto finance companies combat today's lending challenges. Increasing agility and speed to market helps captives address changing market conditions, interest rate volatility, changes in vehicle demand, shifts in consumer buying behavior and other market factors.

Summary & Conclusion

Auto financing and lending are going to continue to become more competitive. Now is the time for auto loan providers to **take the first step** toward implementing a comprehensive digital strategy, and it may be easier than they think to reap the many benefits of a modern pricing software approach.

With a pricing platform, auto lenders and financial services firms can now use world-class analytics and advanced automation capabilities to develop and deploy much more compelling auto loans, faster than ever. This provides a valuable advantage in beating the competition, generating new sales, and creating long-term, profitable connections with customers and prospects.

Next Steps

To learn more about Earnix, including how we can help your organization **overcome existing challenges and capitalize on new opportunities** with agile, dynamic, intelligent solutions, visit earnix.com.

Reimagine auto financing today →

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Earnix is the premier provider of composable intelligent solutions designed to transform how global insurers and banks are run. Earnix solutions unlock value across all facets of the business, connecting with customers, and breaking away from the status quo imposed by legacy single systems.

Earnix's solutions offer systemized, enterprise-wide value with ultra-fast ROI. It has been innovating for Insurers and Banks since 2001 with offices in the Americas, Europe, Asia Pacific, and Israel. For more information visit: earnix.com.