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Pricing for Competitive Advantage in U.S. Auto Finance

A ground shift in the business of auto financing in the U.S. is creating significant opportunities for retail banks seeking new revenue growth. However, the auto finance market has unique characteristics, particularly in pricing and distribution, that sets it apart from other consumer finance asset classes. Banks must fully understand these differences to make a successful play for market share.

The U.S. auto financing market was once dominated by captive lenders, but the financial crisis and its aftermath led to the decline and disappearance of a number of these players, and caused others to scale back. While the U.S. economy was still on shaky ground, and new car sales were declining, auto finance volumes fell. Now, however, new car sales are up and auto-lending is the fastest-growing asset class in retail banking. For banks, this is an opportunity to expand their share in a market that has additional attractions: auto finance's prevailing third-party approach to distribution means that revenue-hungry lenders can grow assets and revenues without a substantial increase in their distribution costs.

The opportunity is real, but reaping the rewards will not be as easy as it might appear at first glance. Auto financing differs in fundamental ways from most other forms of consumer finance, particularly in pricing. Clearly understanding how pricing works in this atypical market is critical to a lender's success or failure.

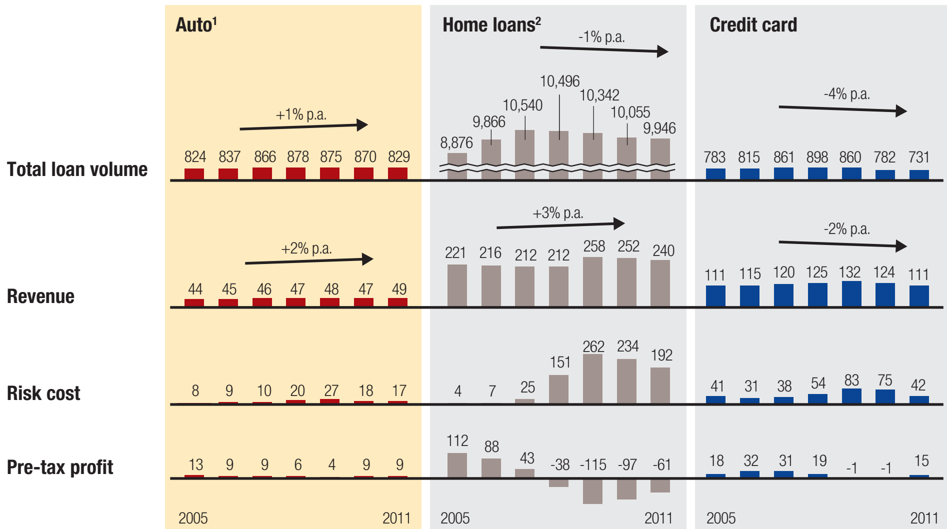
A timely opportunity for U.S. banks

Auto loans were the only major asset class in retail banking to avoid significant losses (on an annualized basis) during the financial crisis (Exhibit 1, page 2). This performance can be attributed in large part to the countercyclical dynamics of new and used car markets: when sales in the former decline, asset values in the latter typically rise. This balance helps buffer lenders from growing losses by increasing the value of repos-

Exhibit 1

Auto loans weathered the crisis better than other retail bank asset classes

Total loan volumes, revenue, risk cost and pre-tax profits, U.S., 2005-2011



[1] Includes non-bank lenders

[2] Includes mortgages, home equity lending and lines of credit, with mortgages comprising ~80%

Source: McKinsey Global Banking Profit Pools

sessed collateral as higher numbers of car borrowers default on their loans. However, during the financial crisis, this traditional balance was not enough to protect several captive lenders, who relied largely on the securitization markets to fund their loans. Banks, by contrast, continued lending to auto buyers and gained share during and since the financial crisis. McKinsey expects banks to continue to remain dominant lenders in auto finance.

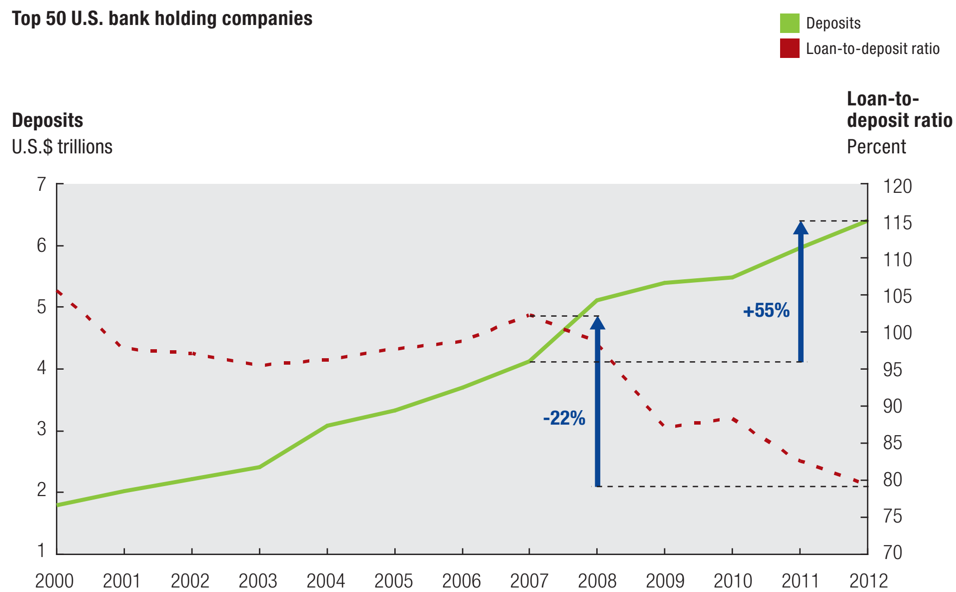
The positive outlook for auto sales, coupled with a weaker position for captive lenders, presents a compelling opportunity for retail banks, at a moment when most are deposit-rich but relatively asset-poor. Between 2007 and 2012, bank deposits grew by 55 percent, while average loan-to-deposit ratios fell by 22 percent (Exhibit 2, page 3). Because lending did not keep pace with the influx of deposits, many banks now find themselves with excess liquidity. Reeling from losses in their mortgage lending businesses and unable to significantly boost lending elsewhere, banks large and small are turning to auto financing, an asset class to which most had previously devoted limited attention. While the opportunity is compelling, it is essential to note that auto financing differs in major ways from the types of lending with which most retail bankers are familiar.

The road less travelled

The salient difference between auto financing and other forms of consumer lending is its reliance on business-to-business relationships. Dealers—not lenders directly—originate the vast majority of U.S. auto loans, which means that during the sales process lenders have minimal direct contact with the consumers who will ultimately become their customers. Lenders therefore must depend heavily on dealers to direct customers to them. This model is different than the standard distribution model in retail banks. On the other hand, dealers work within an interaction model driven primarily by their reliance on manufacturers' captive lenders. Therefore, the shift in auto financing to banks will require a learning curve on two sides of what effectively is a three-party deal between the lender, dealer and consumer.

Exhibit 2

Bank deposits have grown more rapidly than lending, compelling banks to find new opportunities to rebuild their assets

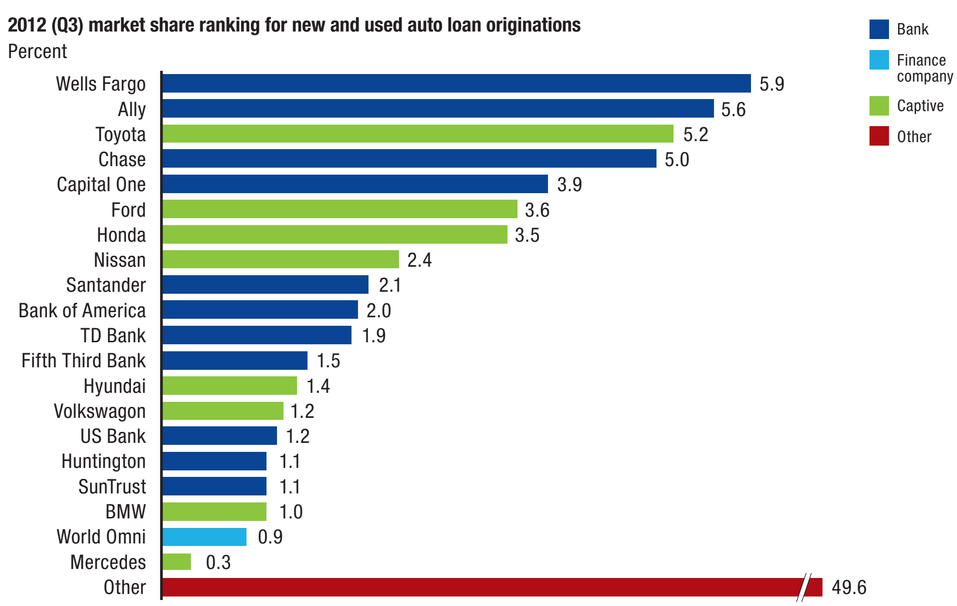


Source: SNL; McKinsey analysis

Another significant challenge for banks is the auto finance market's high level of fragmentation (Exhibit 3). Some 50,000 U.S. auto dealers have access to approximately 900 lenders nationwide, each offering a unique mix of financial terms, service levels and dealer incentives. In 2012, the top 20 lenders accounted for only 51 percent of total originations. Although each dealer typically works with just a handful of lenders, replacing any one of them is relatively easy for a dealer.

Exhibit 3

The U.S. auto finance market is highly fragmented



Source: Experian Auto

There are additional ways in which auto financing differs from the kinds of lending that retail banks are accustomed to:

- **Lenders have no direct interaction with borrowers in the negotiation process.** Only dealers interact directly with auto buyers when structuring transactions, so banks must rely heavily on dealer insight when assessing customer credit profiles, negotiating loan terms and making other lending decisions.
- **No standard product.** Unlike other retail banking asset classes, such as mortgages, there is no "standard" auto loan product, which makes it much harder to compare the loan offering and, often, the pricing. Lenders have different preferences on dimensions such as credit profile, loan-to-value limitations, loan term offered, and age of used cars they buy, leading to essentially different types of products.
- **Pricing is highly regional.** Substantial regional variability in pricing presents a significant challenge for banks with nationwide operations, because they have to compete with rival lenders and adapt to dealer business preferences, both of which often vary substantially by state (and often by major metropolitan regions).
- **Auto loan rates change frequently.** Unlike rates for most retail banking products, auto loans rates are subject to rapid fluctuation. For banks, responding to frequent price changes across a multitude of markets and competitors can be a major challenge.
- **Overall complexity of the pricing construct.** The many dimensions on which auto loans are priced means that the general level of complexity is very high (e.g., lenders have "pricing sheets" with up to 60,000 price points in each state). Not only does this complexity require a large amount of data analysis, it also means that managing the frequent changes and fostering understanding and alignment within the organization becomes a significant challenge.

Getting into higher gear: Six steps to successful pricing

The complications that make pricing in auto finance a challenge also create opportunities for banks that can excel in this area. Based on work with a number of auto lenders, McKinsey believes there are six fundamental steps lenders can take that will help them to price competitively.

1. Build a pricing model based on actual costs and returns

True profitability can be determined only when true costs are known. Therefore, identifying actual costs—both direct and indirect—is the necessary starting point for price development. Such costs will include the bank's cost of capital (including regulatory capital), as well as any operating expenses related to sales and marketing, dealer types, service levels, seasonality and loan servicing. Costs associated with different customer risk levels need to be determined on a granular basis. McKinsey has found that many banks struggle to accurately define their auto financing costs because auto lending occurs in more than one part of the institution or because they use a complex allocation method that does not reflect reality. Inaccurate cost data generates inaccurate profit forecasts and, ultimately, sub-optimal pricing decisions. By taking a full accounting of its true costs and returns, one lender found that its profits were understated in the types of loans where it wanted to increase lending. It was then able to reduce prices and grow volume while maintaining its profit level for those types of loans.

2. Align pricing to strategy and use the full pricing spectrum

Pricing is a strategy enabler, but it must align with the organization's overall strategy. The first step in achieving this is to develop a common set of success metrics for the entire organization (e.g., sales, risk and finance). The use of different measures for these functional areas leads to sub-optimal pricing, as the pricing team attempts to optimize a non-aligned set of objectives. Next, the pricing strategy should use the full pricing spectrum with differing results in different parts of the pricing "sheet," and optimize across the entire grid. Optimizing across different price points can be challenging, but it is much more rewarding than taking simplistic common hurdles across the entire spectrum. Pricing discussions and decisions can become core tactics for testing and supporting overall strategy and for providing frequent checks and measures.

3. Develop and communicate a unique value proposition

How will an offering differ from those of competitors in a bank's target markets? What services and service levels will be offered to dealers and consumers? What dealer incentive programs will be provided? Which types of loans does a bank want, and why? Creating a value proposition that clearly answers these questions will help dealers quickly understand a bank's objectives. Dealers have access to some 900 lenders nationwide, but routinely work with only a small number. Given these odds, banks seeking to build relationships cannot afford overly complex or poorly communicated offerings. Dealers play a key role in loan distribution in this market and should clearly understand not only the bank's needs, but also how the bank can help them succeed.

4. Monitor the competitive environment

Knowing who the competitors are in each local market is important because it is at this level that most lenders actually price. National lenders often find themselves competing against regional and local institutions, as well as against national rivals who might also employ pricing strategies that vary by region.

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A bank needs to understand each of the dealerships that comprise the core of its business. The axiom that a majority of business derives from a relatively small number of customers (in this case, from *dealers*) prevails in auto finance. A bank must therefore know who its prime competitors are at each of its core dealerships. For instance, a bank might compete with one lender for super-prime loans and another for prime loans. Having a strategy that reflects the actual competition at each core dealer in each market can generate superior results, while more generic approaches usually produce mediocre outcomes. A further complicating factor is that dealer expectations and responses can vary from one market to another, so generic approaches will result in only scattershot success.

5. Treat dealers as a key constituency

The marketing principle of thoroughly understanding customer needs applies to auto finance in force. A price structure, guidelines and messaging that reflect the dealer perspective will significantly improve the odds for success. Dealers, for instance, need a clear sense of a lender's pricing structure so they can quickly determine which lender offers the most suitable loan for a particular customer. When a lender's pricing structure is complex and difficult to grasp, dealers tend to divert borrowers toward lenders with simpler pricing schemes. Banks should remain alert for signs of dealer confusion, and promptly clarify as needed. Keeping dealers well informed about any upcoming changes signals that a bank considers them a valued constituency.

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Furthermore, because pricing in auto finance changes frequently, banks should reevaluate and adjust pricing often. Failure to do so is a sign to dealers that the lender is out of touch with the local market.

Finally, incentive programs for dealers are, in essence, an indirect form of communication. Dealers infer what a lender's objectives are from the way banks structure their incentive programs. So when a bank revises its pricing structure in any significant way, it is imperative to revise the incentive plan accordingly to avoid dealer confusion.

6. Involve all stakeholders in pricing decisions

Many bank functions, including sales and marketing, finance, risk and loan servicing, are closely linked to pricing, and should therefore play a role in establishing, monitoring or revising pricing structures. Over time, these participants gain fresh insight as markets, competitors, dealers and auto buyers adapt to an ever-changing sales, lending and regulatory environment. Including them on an ongoing basis enables pricing decisions that reflect the latest conditions that the bank and its target markets are facing.

To determine how well a pricing strategy, incentive plans and other marketing elements are performing, banks should establish tracking and analytical capabilities. Monitoring competitors' offerings is crucial to understanding each target market. These steps are particularly important in auto finance, where pricing changes frequently. If a bank's pricing in a given market is out of line with the competition, swift corrective action can often restore dealer interest before too much ground is lost.

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A growing number of banks are coming to view auto financing—previously a low priority for most—as a promising source of revenue and asset diversification. The relative decline of the auto industry's captive lenders and an improving economic outlook suggest that the opportunity is a significant one. To be successful, banks have to adopt a pricing process and discipline that reflects the peculiarities of pricing in auto finance.

While the opportunities in auto finance are attractive, they differ in important ways from those with which most retail bankers are accustomed. They require a solid understanding of a business model that centers on third parties and allows minimal contact with borrowers. Moreover, pricing in this environment varies locally and changes frequently, a significant difference from the pricing environments with which most banks are familiar. Banks that approach this opportunity in ways that clearly acknowledge the differences outlined above can lock in the best customers and reap meaningful performance gains as auto sales continue to rebound.

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