

Pricing with Confidence

13 Reasons You Need
Competitive Rate Intelligence

A Research Paper

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Preface

The solutions and strategies identified in this research paper are based on nearly fifteen years of experience and research conducted by Datatrac. With thousands of credit union and bank customers nationwide, Datatrac is the leading resource for financial product research and competitive rate intelligence in the industry.

Introduction

Setting retail pricing is the financial equivalent of using a navigational system to “get a fix” on your destination. The Global Positioning System, or GPS, consists of twenty-four satellites orbiting our earth constantly transmitting data to pinpoint any location worldwide. At the touch of a button, GPS can tell you exactly where you are on the map by plotting your position against multiple satellites.

Likewise, your goal in making pricing decisions is to pinpoint proper rates and price points for your credit union in your market. While developing sound pricing strategies is not as simple as pushing a button on a GPS unit, the process does share certain characteristics with GPS methodology. In a process known as *triangulation*, the calculation of an unknown point (the pricing decision) is based on its relationship to other known points (benchmarks). In terms of pricing management, these benchmarks fall into three primary categories:

- Competitive rate intelligence
- Asset/liability management (ALM) balance sheet modeling
- Asset/liability committee (ALCO) policies and guidelines

Competitive rate intelligence provides the *external* benchmark to ensure your strategies are as sound in the marketplace as they are in the minds of your executives. ALM balance sheet modeling is the *internal* benchmark for evaluating the impact of your pricing decisions on your balance sheet given various interest rate and liquidity scenarios. ALCO policies and guidelines represent the fundamentals that enable you to navigate a consistent course in both calm and turbulent economic conditions.

The purpose of this research paper is to focus on the use of competitive rate intelligence as a benchmarking tool for making sensible product pricing decisions and justifying those decisions to executives and examiners. Used in conjunction with sound asset/liability management and ALCO policies and guidelines, competitive rate intelligence enables management to make better, more marketable pricing decisions resulting in greater value to members, a better bottom line, reduced risk and satisfied regulatory requirements.

Just as GPS requires multiple satellite inputs to compute and pinpoint your location, effective decisions cannot be made in a vacuum. The accuracy and effectiveness of your pricing decisions increase exponentially when “*triangulated*” with multiple, real-life inputs. Pricing confidently requires competitive rate intelligence to provide a reality check on your assumptions and decisions. After all, every basis point counts.

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Section I

13 Reasons You Need Competitive Rate Intelligence

Main Street: Pick up the *Wall Street Journal* and you can find today's treasury rates, the LIBOR index, swap curves, FHLB advance rates, etc. Most credit unions use these indices as a benchmark, if not foundation, for their pricing strategies. One problem: Credit unions don't compete on Wall Street. Your members are on Main Street. Even if your field of membership is nationwide, you still compete in local markets. As competition and market volatility increase, it seems the cost of funds is different from one corner to the next. This is as good a reason as any to use local competitive intelligence in your pricing decisions.

Regulators: Examiners look for consistent, documented and well-grounded decisions. Grow too fast and regulators worry that your rates are too good, attracting more "hot" money than may be appropriate.¹ Price too conservatively and your bottom line may suffer. Credit union regulations are replete with requirements to document and validate assumptions, including a long list of guidelines such as:

- "The credit union should evaluate the external and internal factors influencing its business; including economic and regulatory issues, its member base, its competition, and its competitive opportunities. The credit union should also plan for . . . high/low interest rate environments."²
- "Are recent decisions (dividend rates, loan terms and rates) consistent with keeping the gap within acceptable levels?"³
- "Are management's conclusions reached from the gap analysis consistent with past performance during changes in interest rates?"⁴
- "Credit unions should document basis risk, which is the difference in movement between RSAs [rate sensitive assets] and RSLs [rate sensitive liabilities]"⁵
- "Are the underlying assumptions (interest rate changes, membership behavior) documented and do they appear reasonable? Are assumptions reevaluated periodically?"⁶
- "Are rate sensitivity assumptions for nonmaturity share accounts reasonable and supportable?"⁷
- "Maturity and repricing structures should include mechanisms to monitor and control the risk taken by credit unions."⁸

The above list is only a sampling of the conditions you need to substantiate. Competitive rate intelligence arms you with ammunition for justifying your pricing decisions to examiners based on *your* market, not just a national index. Assuming you can provide reasonable, well-documented justification for your decisions, examiners typically do not go any further with that part of the analysis.

Management: Examiners aren't the only people who question your decisions. Competitive rate intelligence helps you make sound decisions and support those decisions to other executives and board members. Many credit unions use competitive data to establish pricing guidelines. These guidelines (often set at a number of basis points above or below the local competitive market depending on objectives) may now be delegated from the board to a senior management pricing committee.

On May 15, 2001, the NCUA issued a Legal Opinion Letter which expanded a 1993 ruling allowing federal credit union boards to delegate limited authority to set dividend rates. The letter states, "We recognize that a quickly changing interest rate environment may require an FCU to adjust dividend rates quickly to remain competitive and operate in a safe and sound manner."⁹

The letter further states that, "The board may set a range of dividend rates for each kind of share account and delegate to the committee the authority to adjust rates within those limits." Competitive rate intelligence provides a sound, market-sensitive basis for delegating this "range." For example, if the board's objective is to secure more long-term funding, a guideline or range might be issued to management to reprice the following products on a weekly basis based on local market competition: Short-term CDs priced at 25 basis points below the market and a special offering a 25 basis point premium on new CDs with a maturity of one year or more. The same index strategy works for share draft dividends, lending rates, etc. Guidelines like the above are simple, effective and easy to follow.

If you wait for your board meetings to change rates, you may want to consider delegating this authority to management or an ALM committee based on guidelines set by the board. Competitive rates don't wait for the next board meeting.

CAMEL Ratings: The "M" in CAMEL (Management) specifically asks, "Are rates competitive?"¹⁰ Further requirements state that a credit union must be "responsive to changing economic conditions."¹¹ The "L" for Asset/Liability Management requires examiners to "review a credit union's maturity and repricing of its assets in conjunction with the type of deposit base used to finance those assets."¹² Additional guidelines specify that "attention should be directed to the credit union's liability funding costs relative to its yield on assets and its market environment."¹³ In fact, many of the ratios used in a CAMEL analysis require you to substantiate how you compete with real-market conditions. How else would you document these issues if not with comparative analysis of rates from your peers? To the extent that competitive rate intelligence justifies and documents your decisions, the result can help you improve and/or sustain your rating.

Sales: Your frontline sales people, tellers and lenders, need competitive intelligence so they know more about your competitors' rates and specials than your members do. Don't let your member relations staff be caught by surprise when a new special is launched in your market. Your competitive intelligence system should alert you immediately to the latest changes in competitor rates and special offers.

- Marketing:** Make intelligent, fact-based marketing decisions. Combine current and historical local market rate trends with other demographic data, MCIF (Marketing Customer Information Files) and economic data to enable you to better understand your market and design your next product or marketing campaign.
- Spot Opportunities:** Presumably due to disparate supply and demand in the need for raising deposits and funding loans at various positions along the yield curve, the retail cost of funds varies greatly within markets and between markets. Even in low rate environments, variances of 200-400 basis points *per product* for deposit and lending products alike routinely occur in each market. Nationwide, it's even more.¹⁴ If you are not paying attention to competitive rates in your market, at any given time you are probably either paying too much, charging too little or missing market-share opportunities. Furthermore, "core shares," which make up the majority of most credit unions' deposits, are typically much less sensitive to interest rate swings than time deposits because members with share accounts are buyers of your services whereas time deposits are often money shoppers out for the best rate. Understanding your members' needs and pricing accordingly is essential to the future of your business.
- Benchmarks:** Treasuries are falling out of favor with Wall Street as a pricing index and a discount rate due, in part, to supply/demand imbalances and the government's reduced need for funds. This causes the treasury yield curve to be less responsive to market conditions. LIBOR, swap curves, Freddie Mac as well as a few others are jostling to become the new benchmark, although the market appears to be far from settling on a replacement any time soon.¹⁵ In any case, none of these "new" benchmarks offer the local litmus test needed to make competitive pricing decisions in your market. With market-by-market variances often reaching hundreds of basis points,¹⁶ you will neither maximize your competitiveness nor your spread if you use only a national benchmark. Rates from your peers and competitors, however, are a superior resource as they are a reflection of the aggregate decisions of your peers as they react to the stimuli of your local markets.
- ALCO/ALM:** Gap analysis, core analysis, rate-shocking, income simulations, forecasting, funds transfer pricing. All require well-documented, reasonable and regularly updated interest rate assumptions and analysis. In fact, an ALM CAMEL rating of one (1) requires that "Interest rate risk management is integrated into the credit union's organization and planning to promote sound decisions."¹⁷ According to an ALM expert, "Risk Management models have evolved into extremely complex tools, yet often providing imprecise output . . . The potential for error in risk management modeling has obviously come to the forefront in the regulator's mind."¹⁸ Comprehensive modeling, of course, requires much more than simply projecting interest rates and rate-shocking your portfolio. However, after credit worthiness, rate assumptions and interest rate risk are the next most important inputs to the model. The best sources for rate assumptions are actual rates from the markets in which you compete.

- History:** If you don't know history, you're doomed to repeat it. Maintaining a competitive corporate memory offers profound insight into how you got ahead or behind your competition over the years. Have your pricing strategies been historically leading or lagging the indices and/or your competition? Did this result in a gain or loss of business? If interest rates go up or down, will it have the same impact on your portfolio as it did historically? Why or why not? Although your rates and your competitors' rates are only one piece of the puzzle, historically plotting them against other data is an invaluable exercise. Tracking your competitive history provides a before, during and after snapshot of your pricing strategies compared to your peers and other indices. You gain a priceless advantage by analyzing, understanding and deploying this knowledge.
- Increased Spreads:** Need more capital? What if you could increase your lending rates and/or decrease your deposit rates decisively without losing market share? Competitive rate intelligence enables you to evaluate your pricing strategies in terms of the competition and focus on "spread management" instead of "cost management." The impact can be substantial. For example, a \$250 million credit union would realize almost \$200,000 a year in savings with a five-basis-point increase in spread.¹⁹ Competitive rate intelligence will allow you to consistently balance your spreads while sustaining marketable rates.
- Product:** In today's competitive market, plain-vanilla products don't capture your members' wallet-share. Teaser rates, relationship pricing, tiering, specials . . . if your products do not have either an outstanding rate or unique salable features, it's very difficult to bring in new business. Examiners also require "Appropriateness of the products and services offered in relation to the credit union's size and management experience."²⁰ Keeping abreast of what other financial institutions are doing in your market and across the country not only helps you compete, it's fuel for new product ideas and assists you in garnering "buy-in" for your product concepts internally.
- Avoid Groupthink:** We all tend to think that our products are the best. That's the team spirit. But our true strengths and weaknesses aren't unveiled until we play another team. Pricing decisions are not reality until they hit the streets. Competitive analyses bring a bit of the street into the boardroom or ALCO meeting.

Section II

How To Obtain Competitive Rate Intelligence In-House vs. Outsourcing Alternatives

No credit union is a pricing island. You need competitive intelligence, both to be marketable and to ensure you are not pricing too expensively. The next question is how should you go about obtaining consistent, reliable and meaningful information? Do you conduct your own internal research or outsource to a third party?

Sound business practice promotes sticking to core competencies (i.e. activities that increase your credit union's unique value to your members) and outsourcing supporting roles. Therefore, as credit unions are not typically in the business of market research, the obvious choice is to outsource. Here are a few specific reasons why:

Consistency: According to NCUA guidelines, "Consistent measurement between periods is essential to understanding the changing risk structure of the balance sheet and to identify underlying causes."²¹ Best-of-breed research/database firms set standards to ensure your data is collected the same way every time and that your reports will always be on time for your pricing, ALCO and/or board meetings. They will also archive your information so that you will have an audit trail when an examiner asks you to document your competitive history.

Succession Planning: In today's transient world, knowledge sharing is a must for corporate continuity. Outsourcing not only provides a corporate memory for consistent historical analysis, it ensures continuity in your succession planning so that job transitions and corporate transitions can be executed smoothly and without disturbance in your historical audit trail.

Cost: The cost of obtaining research is nominal compared to the cost of making an uninformed decision or the friction of debating "gut" decisions with regulators or executives. Typically, the cost of outsourcing competitive research is significantly less than conducting in-house research since you can access pooled data – that is, other financial institutions may already monitor many of the same institutions and products you require. The cost to gather the data is collectively shared among many institutions; you are only paying a premium to customize the data to your particular needs. Furthermore, there is no up-front cost in software design or labor for gathering, archiving and/or disseminating the information, not to mention the cost and distraction of managing it.

- Arms-length:** Unbiased documentation from a qualified third party provides substantially better justification to executives, board members and examiners than internally generated research. In regards to ALM, NCUA guidelines state, "Someone other than the person who runs the model should conduct the review."²² Third-party research, documentation and analysis not only assists others in understanding your decisions, it provides you with knowledge for making better decisions.
- Collective Knowledge:** When you buy research from a well-respected firm that specializes in competitive intelligence, you are gaining their experience in solving the needs of many other clients with objectives similar to your own. Immediate access to a database of nationwide, current and historical financial product information would be impractical, if not impossible, for any single institution to maintain.
- Scalability and Ramp-Up Time:** Time to market is a required consideration for all projects. Since we all have to do more with less, we need to count on our partners and vendors to deliver as needed, when needed. The advantage of using a qualified research firm specializing in competitive analysis is that their resources are dedicated to your project to facilitate timely delivery. Research can be customized and scaled up or down upon demand.
- Simplicity:** Market research/database management companies make the onerous, internally unreliable process of compiling, archiving and disseminating the information you need very simple. You and your management team simply access your customized reports when you need them. Your time is more valuable in determining how you can use the information to better manage your business or increase value to your members, not gathering and managing data.
- Data Warehousing, Mining and Mapping:** A competitive research firm that specializes in database management is able to store your current and historical data for fast and flexible retrieval. By archiving with industry standard retrieval codes, data can be layered with other demographic, economic and/or internal data such as MCIF (Marketing Customer Information File) data for further analysis.
- Quality Controls:** Best-of-breed market research/database management firms will consistently interrogate their database in search of errors and inconsistencies. Staff will be regularly trained on best practices for gathering and maintaining data. Procedures and audit trails will be maintained. Such controls go far beyond any standards that would be maintained in-house.
- Assurances:** Choose your vendors carefully. If they don't stand behind their product, don't do business with them. You and your executives are making critical decisions based on the data, you deserve to know that it's timely, accurate and unbiased.

Conclusion

With margins thinning, competition increasing and software models and forecasting methods becoming more complex, we can expect executives and regulators to become more particular in the future. The marketplace is even less forgiving. Setting rates is a highly public decision. Your board, executives, examiners, members . . . everyone sees the end results. Most do not see the thought process behind pricing decisions. And even if they do, they may not understand it.

Competitive rate intelligence is a simple concept that everyone can understand. It establishes an objective benchmark to build consensus and streamline the decision making process. Rate setting is no place for guesswork. You need accurate, up-to-date, consistent intelligence to make the most informed pricing decisions.

Competitive rate intelligence will not replace balance sheet management. It will keep your pricing on course and help you balance your bottom line while building market share. If you're not keeping a pulse on the marketplace in which you compete, you're missing valuable opportunities.

According to one expert, "The availability of peer group data and the capability to easily report and compare results can provide, perhaps, the most significant benefit to understanding and managing a financial institution."²³ Said another way: Information is knowledge. Knowledge is an advantage. Like any competitive weapon, those who have it and know how to use it will be strong, those who do not may fall prey to those who do.

About Datatrac



Datatrac is an information company specializing in the financial services industry. Since 1988 the company has combined technology, research and strategic services to enable thousands of financial institutions to make timely, competitive pricing decisions. With over 3 million retail deposit and lending interest rates and products updated annually, Datatrac manages the most comprehensive financial products database in the industry. For more information, visit www.datatrac.net. For a free two-week trial, visit www.datatrac.net/cuna.

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