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Where is lease pricing going, and what factors are driving it? I've been fortunate enough over the last 12 years to be a part of lease pricing discussions with dozens of lessors large and small, captive, bank and independent, while working with some of the premier lease pricing experts in the industry. The following is a brief high-level summary of where I see lease pricing going over the next few years.

In finance classes, the phrases "efficient markets" and "risk premium" get tossed around rather casually, but we in the equipment finance world live them. Constant pressure on margins makes the equipment finance market as a whole more efficient. You get creative and cut costs, or you're out of the market, probably sooner rather than later. And risk, especially credit and residual risk, are the daily stuff of our lives.

Sophisticated lease pricing is the child of margin pressure and risk. When pricing a competitive deal, one where the customer is shopping for lease rate factor, creative structure or present value of future payments, it's critical to be able to properly reflect risk to keep the margin healthy, or at least tolerable.

25 years ago, personal computers were still a new and largely untested technology. Sophisticated lease pricing meant pulling out the trusty HP 12c, tacking enough basis points onto the borrowing rate to cover costs, and punching in the numbers. Experienced pricing people had a hard-earned feel for how many basis points were 'enough' – they rarely had all the expense data by line, credit rating, equipment type, etc., it any form that they could easily apply to individual deals. Instead, they used fairly broad classifications of risk and their personal knowledge of their customers to reach a mutually acceptable price. It worked, and still does in many segments.

Pricing based on broad classifications and heuristic expense loading provides opportunities for both you and your competitors, however. Customer A and customer B both fall into the same broad pricing category – say, medium-sized businesses with 'A' credit - and so get the same price – but are the risks and costs associated with them really the same? Would your company be better off in the long run if you offered a better price to A or demand a higher price from B, based on a better understanding of the risks involved?

Eventually, someone in the market will do a better job at pricing in risk. Then, in addition to being less competitive in the deals you really want, you are put in the awkward position of wondering if the deal you just won was worth winning – if the competitor with the better pricing model demanded a higher price than you did, maybe he knows something you don't. Maybe that wasn't really a deal you wanted to win at your price.

And thus, it a nutshell, the pricing arms race begins. All other things being close to equal, the first company with a better pricing methodology will win more of the business it wants to win, and lose deals it really doesn't want. Competitors will then be motivated to improve their pricing methods, which, in turn, motivates the first company to launch another round of improvements. And on and on it goes, with every company getting more and more sophisticated just to keep up.

The pricing arms race I just described is by no means theoretical. Real companies, names known by everyone in the industry, are engaged in pricing arms races right now. But it's a stealth battle, easy to miss unless you know where to look. On the front end, in fact, improved pricing may be painful in some areas – you may lose deals you used to win. It's easy to overlook the positive effects of more sophisticated pricing, because the additional profits are realized over the course of years – if I refine my pricing today and win deals that runs 5 years, it's only after 5 years that the improved results are fully realized. Further, the improvement is only fully realized across a portfolio – better pricing just improves your odds of making money on any particular deal, but, across many deals, those better odds become almost a certainty.

Today, the majority of large, sophisticated lessors use some flavor of risk-based pricing, with RAROC – Risk Adjusted Return on Capital – being perhaps the most common. They also use more than one metric – they will look at, for example, RAROC, a fully-loaded spread over an index, and a simple after-tax yield. All three measures must lie within targeted ranges for the deal to be acceptable. This 'belts and suspenders' approach safeguards against making poor decisions based on the occasional odd behavior of one type of metric in unusual deals – for example, RAROC tends to heavily favor excellent credits, to the point where a deal shedding almost no cash may look wonderful – great yield, but no cash. The other yields act as a reality check in such cases.

The growth in the use of these sophisticated yields is largely due to good, cheap technology. A decent laptop with network access, good integration and the right software make it possible to put very sophisticated pricing in the hands of everyone in the company who needs it. Sophisticated pricing can stand alone, or can be integrated into CRM software or origination systems, or put out on the web. Inputs such as cost of funds indexes, expense loads and residual values can be updated as often as desired. Any degree of centralized control can be exercised.

There's no sign the pricing arms race will let up any time soon. Lessors will continue to add more and more sophistication and flexibility to their pricing, and push more and more functionality out to their sales force. Back-end 'post mortem' analysis, which ultimately feeds the pricing logic, will continue to gain in importance and vigor. More and better integration will enable a view of the data and the customer that is both more broad and incisive. It's an exciting time in lease pricing technology.

By Joseph Moore (Published Fall 2008 in the UAEL Newsletter)