Module LL06:
Technology, Alliances in Marketing and Loan Pricing

Learning Objectives

The objectives of this module are to:

- Discuss the role of technology and automation in credit and marketing strategies for ag lending institutions.
- Examine which individuals and organizations are important in influencing decisions on lifestyle businesses and how influences change depending upon customer and business lifecycle.
- Provide practical examples of how alliances have been effective in marketing and business development and identify key characteristics of effective alliance building.
- Have a basic understanding of pricing of credit from an institution’s competitive standpoint and understand how the local environment influences pricing strategy.

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Introduction

Technology, automation and information management are methods that institutions and individuals are using to differentiate themselves in the marketplace, by becoming more efficient and productive. Being able to apply the latest technology to provide benefits to the customer is essential in providing value-added in customer relationships.

Strategic alliances are becoming more important in a world that is increasingly interdependent and collaborative. Working with other businesses to expand the range of knowledge and expertise customers receive from your institution helps provide a competitive edge in the marketplace. Maintaining positive relationships with alliance partners can reap benefits for all parties involved.

A basic understanding of how loans are priced can provide insight on how rates, terms and fees are determined to help book profitable business for the institution.

Technology

The ownership of computers and use of the Internet play an important role in the agrilending industry. The percentage of agricultural producers and rural homeowners owning computers and using the Internet has increased dramatically, and most every lending institution uses computers. However, this creates challenges because people are drowning in data and information, while they are starved for knowledge and solutions.

To illustrate this point, from the beginning of time to 1900, all the knowledge and information was equal to one inch on a yardstick. From 1900 to 1945, information and knowledge tripled to three inches. After World War II until today information and knowledge equates to the height of the Washington Monument. In today’s world of laptops, cell phones and instant messages, systems to organize information are critical in the time management function.

The challenge is to take data, either gathered by a person or computer, and turn it into organized information that has use to the institution and customer. As one moves up the information value chain (Figure 1) the key is to turn information to knowledge, which can provide financial solutions to the customer as you motivate them to action.

Streamlining & Automation

The rural lifestyle segment lends itself to a very automated, streamlined analysis system because of its homogeneous structure. A majority of rural lifestyle customers are dependent on non-farm earnings and wealth, and they desire standardized products. In the future, one lending officer and administrative assistant may be asked to manage
and supervise 600 to 1000 lifestyle accounts per full time employee. Marketing will require the same type of efficiency. While there is a tendency to think of these accounts as transactional relationships, value-added can be provided through the use of alliances with realtors, efficiency in paperwork and documentation, technology in the form of websites and financial software, and outside-the-box advertising and promotion.

Kiosk lending or online credit applications and marketing documentation will not be an option, but a requirement, that will challenge the logistics and operational procedures used for these loans. Applications will be streamlined to gather pertinent repayment and income data along with balance sheet information, such as assets and liabilities from the personal balance sheet. Data such as years of employment at a particular job, years at current residence, and quality of credit history will be used in the analysis process.

Data verification and analysis will play an increasing role in extending credit to lifestyle customers, along with the internal staff’s ability to work together as a team to expedite the credit process. This teamwork can be compared to an efficient convenience store at which a change in staff is transparent to the customer.

**Creative Marketing Strategies**

Lending institutions play an important role in the increasing technology environment. The Internet allows ag lenders to market their products, services and information 24 hours a day, seven days a week. The key is to keep the website updated and fresh with new information. Providing hyperlinks to the institution’s products and services and to alliances such as realtors, surveyors, and appraisers can be a window to reach new and existing customers in the portfolio.

Other lending institutions offer web sites that feature articles by leading authorities in the agriculture industry, which increases the number of people who visit the site on a regular basis. Some websites allow customers to check loan balances and interest rates, while others offer tools that assist customers with savings, investments and retirement planning.

An international ag lending institution offers a web-based program that allows a customer to conduct a lifestyle, business and personal analysis for the lifestyle segment. This interactive website has been an extremely useful marketing tool to address the uncertainties customers have concerning financial, business, and lifestyle issues.

While the use of technology is increasing, these are examples of how one can personalize and customize the information and data to enhance relationships and increase customer loyalty. Recent academic research found that as custom technology increased, particularly when it was combined with creative and outside the box activities, borrowers were less interest rate sensitive, which is contrary to popular thought.
Alliances in Ag and Rural Lending

In today’s information-based society where information is doubling every five years, the use of networking is a critical element in agribusinesses’ and agrilenders’ marketing programs. It is critical to determine the priority of influencers in the marketing mix. Recent research found some intriguing results regarding the spheres of influence for borrowers.

Spheres of Influence
Strategically, there appears to be an inner core, middle, and outer-layer of influencers in the decision making process of obtaining loans and financial services in the lifestyle segment.

The inner core starts, of course, with the spouse or partner. Nearly 70 percent of investment decisions and 63 percent of credit decisions are made or influenced by the spouse. If you attempt to market related services such as insurance or investment products, this can increase to well above 80 percent influence by the spouse. A huge mistake many lenders make is failure to bring the spouse in the negotiations when marketing related services such as insurance and risk management products. In many cases, they are the major decision maker. However, realize that in some regions of the country this can vary dramatically because of cultural customs.

In the lifestyle segment the inner core of influencers also includes current customers, real estate agents, family, employers and lenders. The middle layer of influencers in the lifestyle segment finds the extended network of people and associates. Teachers,
daycare workers, attorneys, accountants and church members have been found to be
important in building the sphere of influence. Developing relationships with doctors,
travel agents, title companies, extension offices, and appraisers along with various
community associations such as Rotary, etc. can be very valuable tools in developing
the spheres of influence. Depending on the region, culture, and personal preferences
any influencer could move among layers.

Some institutions have discovered that a person who is a lifestyle rural resident
frequently makes a very effective marketer. They can demonstrate empathy concerning
the excitement and trials and tribulations of being a rural resident. This includes the
process one must go through to obtain the property to the day-to-day responsibilities of
managing the household and small farmette.

The sphere of influencers can change depending on the lifecycle of the customer or
business. In the preservation and transfer of wealth stages, the inner core influencers
may become the lawyer, financial planner and insurance specialist along with the
accountant. Some agrilending institutions have divisions that actually organize and
facilitate these meetings to solidify relationships or gain the trust or confidence of new
customers.

A critical element in alliances is relationships with appraisers and surveyors. These
individuals often not only have face-to-face time with the customer, but also insight into
properties and assets being financed. Strong communications skills must be executed
with this group to ensure that time sensitive projects are expedited so as not to hinder
customer service. In the preservation of wealth stage, especially if there is a death,
divorce or business transfer, these surveys and appraisals can be critical and timely
documents in the mediation process. Thus, while the initial fee from these services can
be high, the value added may come years later if organized files are maintained.

Lifestyle Segment Alliances

Concerning the lifestyle segment, real estate purchases are a large component of
business for an institution. Where does the real estate agent play a part? Recent
data from the National Association of Realtors provides information that sheds
light on this segment.

The median age of a U.S. homebuyer is 39, with a median income if $67,100 in
today’s dollars. Sixty-two percent are married couples, while 26 percent are single. Forty percent are first time
homebuyers, purchasing a median size

home of slightly less than 2000 square feet.
The homebuyers’ race/ethnicity was 84 percent white, 6 percent African American, 5 percent Hispanic, 3 percent Asian and 2 percent others. The minority and immigrant groups are expected to increase to 30 percent in the decades ahead.

This backdrop provides us a landscape of how important the realtor is in forming strategic alliances. Where did these homebuyers get their information? Over 90 percent received information from the real estate agent, while 74 percent used the internet or a yard sign, 53 percent used the newspaper, 51 percent open houses, 40 percent magazines or books, 37 percent builders, 26 percent radio or television, 21 percent billboards, and 16 percent used relocation firms.

The real estate agent is going to become a very important conduit in agrilending marketing as more potential customers seeking credit and financial services come from outside the area. The study also finds the real estate agent’s ability to assist homebuyers in seeking financing was one of the top five attributes they seek in an agent. High on the attributes in an agent was assistance in finding the home, appraisal, knowledge of what sells, and assistance in all the paperwork and negotiations. If an agrilender strategically positions him or herself, he or she can provide assistance in each of these areas such as appraisals, streamlined paperwork, benchmarking on sales, and negotiations as a method of value added.

Insight on methods used by real estate agents to advertise helps determine how alliances should be positioned. Seventy-three percent utilize yard signs, 72 percent utilize Internet, open houses, newspapers and magazines are used 49%, 46% and 34%, respectively. Direct mail was the method of promotion 18 percent of the time, while TV and radio were used 5 percent or less.

Insight on why people purchased homes provides underlying information when meeting with the customer. Proximity to schools, family and friends ranked high, followed by quality of school district, shopping, recreation and entertainment. Quality of neighborhood was the number one attribute.

It is particularly important for lifestyle lenders to form alliances and relationships with real estate agents. Keep them informed of products and services your institution offers. Having a link on each other’s website is a method of marketing sometimes overlooked.
Next, analyze the sales of your realtors. Do they deal with single-family homes, country estates, or farm properties? This can assist in developing focus when targeting products and services.

It is particularly important to develop relationships with the local Chamber of Commerce, Rotary groups, and be an active member in school and community activities. In some cases, demonstrating through work and effort is an indication that you as an agrilender “walk the talk” rather than just “talk the talk.”

**Key Points in Alliance Relationships**

An often overlooked, but very important, component in alliance relationships is the attributes to look for in strategic alliances.

- First, determine if your organization and you as an individual have common value systems and core values as the potential alliance partner.

- Realize that alliance relationships are not forever and are often not bound by contractual arrangements. For example, an alliance with an accountant or lawyer may be formed to assist a customer through a transition plan. Once the problem has been solved, the alliance may be dissolved.

- Be sure to discuss common ground and differences you may have with a customer or segment of customers. In some cases a “one plus one” relationship can escalate to three because of the resources and expertise brought to the situation to add value.

- In some cases, the sharing of key information and data, with customers’ permission, can be a valuable resource that can make both organizations stronger.

- Examine the track record and execution of the strategic partners involved. Who did they deal with and were the results positive? Has the organization or individual been involved in collaborative efforts in the past?

- What has been the institution’s longevity and stability in the area? In rural communities, word of mouth and cultures that are slow to change can be an impediment in forming alliances.

- What is the name recognition and enhancement to branding? Is the strategic alliance building upon or degrading the brand recognition of your business?

Having current technology and positive alliance relationships in place helps position your institution for success in a competitive ag lending marketplace.
Challenges and Marketing Strategies

Lifestyle lenders who are focusing on the rural community lending segment have unique insight in the marketplace.

Competitors they identify generally include community banks, credit unions, and national and international banks such as Wells Fargo and Bank of America along with Canadian, Mexican and European banks. Others include non-traditional lenders such as sub-prime lenders who carve out a market niche, and competition from owner financing.

How do these lenders market their services? They use the Internet, simple application and qualification procedures, and they target areas with high population growth and turnover of properties. Others are utilizing interest-only payments and in some cases negative amortization loans.

For an institution to be successful, the following are recommendations made by various focus groups of lifestyle lenders. First, lifestyle lending must be part of the vision, mission and core values of the institution. Failure to do so does not provide the scale and commitment necessary to be successful.

Second, build a referral network. This includes professionals that are part of the spheres of influence discussed previously. Target the groups or organizations that will yield significant business in your target market.

Utilize the uniqueness of the Farm Credit System to your advantage as an opportunity to differentiate the organization. In many cases Farm Credit can make loans on properties that have unique characteristics that are outside the policy guidelines of competitors.

Ensure that you have a marketing program that allows you to customize to meet the unique requests of the lifestyle segment. Of course having a team of knowledgeable staff members with a consistent message and a strong technology platform will accelerate the program in the marketplace. Community involvement is not an option but a requirement. Keeping abreast of changes in the community, new business, competitors’ events and opportunities to gain name recognition and branding of the institution and yourself is essential. Finally execution and follow through and a customer relationship management program are very critical for exceptional customer service.

Loan Pricing

The value of pricing loans according to the risk associated with the customer has been validated by many financial institutions that have found profit margins squeezed in recent years by fluctuating interest rates, rising cost of administering credit, and problem loans. Competition in the lifestyle segment has been intense. This requires a keen eye and understanding of whether the institution can meet competitors’ rates and still remain profitable. Loan pricing determines the compensation paid to an institution for its role as a risk intermediary. Loan pricing is no different than product pricing for any business. The institution must recover its raw material cost (cost of funds), its overhead, and meet
predetermined profit objectives within the constraints imposed by the competition in a risky environment.

The pricing environment of today is characterized by interest rate volatility, disinflation and inflation, all of which have an impact on loan pricing. Institutions are facing a profit squeeze because of deteriorating interest rate spreads, an incredible shrinking marketplace with fewer profitable lending opportunities, rising operating costs, loan losses, competition, increased customer sophistication and reduced loyalty. Effective loan pricing can enhance institutions' profits, which can in turn increase capital. This capital or profit is the lender's cheapest source of credit. This in turn enhances capital position, which is looked upon favorably by regulators and investors.

Impact of Local Environment on Pricing

The pricing of agricultural credit can be influenced by local market conditions. For example, an area that includes bottom-lined, globally competitive customers may have to adjust pricing procedures to meet the customs of the region. Instead of a total portfolio being 70 percent relationship-based and 30 percent pricing-based, the opposite may be true.

Second, a locale may have a community bank or agricultural loan officer that is aggressive in building an agricultural portfolio and a low price image. If the bank is family or community owned, they may forgo short-term profits to attract a producer's business through lower rates. Lending institutions may temporarily reduce rates to assist producers experiencing financial trauma due to natural disasters or other misfortune as well.

Thus, in pricing strategy, competition can come from practices established outside the region in corporate headquarters; however, market research into the sociological and psychological customs and practices of the area is critical to include in the assessment.

Overview of Customer Profitability Systems

The role of the lender is one of identifying areas of uncertainty, quantifying risk and pricing for risk. If the risk is acceptable, the lender must negotiate a loan pricing agreement that covers the institution's cost, compensates for risk assumed, and meets profit objectives. The role of a customer profitability system is to define the institution's costs, to rate risk, and develop pricing guidelines within the profit objective of the individual customer. All of these increase the effectiveness of loan negotiation position. However, after determining the cost and pricing objective with associated risk, the overall price may not be realistic in the face of competition. As a result, the institution may be forced to change competitive strategy, offer different products or services, cut costs or accept lower returns. While competition may dictate loan pricing, it does not dictate the institution's pricing strategy or eliminate the necessity for a good customer profitability system.

Sources and Uses of Funds
The following illustration provides one with a methodology of how loans are priced. Some institutions may have sophisticated systems with many rate scenarios while others may be more simplified. This illustration provides an overview and understanding of the process of pricing loans. The loan officer must first determine the actual average loan balance over the period the debt is held. The next step is to determine the usage for each of the institution's sources of funds. This could be customer's average deposit balance at a bank, the institution's equity capital, or the purchase of funds from other sources. This is usually the largest cost to most institutions, and management generally has a target figure depending upon the cost of capital external to operations.

Revenues or Income

There are four sources of loan income: interest on loans, service charges, fees paid by borrowers, and earnings from compensating balances maintained if the borrower maintains deposits at a bank.

The largest source of income is interest. Fee income is growing in importance. Examples of fee income include inspection, origination fees, prepayment penalty, commitment fees, and servicing.

Expenses

Documenting all expenses can be a cumbersome task but it must be done to evaluate the situation accurately. Direct costs include credit given for balances, i.e., interest paid on interest bearing accounts at a bank. Also, if fee income is charged, associated costs for these aspects must be considered. Also, the institution's overhead costs must be calculated. Management defines the mechanism for allocating overhead cost. Overhead includes the direct cost of the lending function, as well as the cost of support, such as support staff, tellers, receptionists, credit and loan administration, senior management, and other fixed costs, such as buildings and facilities.

Risk

There are two types of risk involved in lending: rate and credit. Credit has two components: the risk of default, and transactional risk associated with maturity and collateral.

Rate risk is associated with the fact that the lender's cost of funds could rise faster than the rate of the loan. Institutions can shift this risk to the borrower through variable rate pricing. The cost of credit risk is reflected in the institution's provisions for loan losses. This cost is allocated across the portfolio. This allocation may be made on the basis of percentage outstanding or a simple risk-pricing matrix.

Interest rate risk is affected by loan structure. A 20-year fixed rate loan will have much more opportunity for adverse interest rate cyclical risk to the lender than a shorter-term loan. That is because rates become much more uncertain as the term of the loan is extended.
Contrast this to a short term operating loan with a variable rate. This loan represents very little interest rate risk to the institution because either positive or negative adjustments can be made to protect the lender.

As credit quality decreases, the rate increases. Too often good quality borrowers are overcharged, so it is important to equate rate with risk. Also, as the terms of repayment are extended, rate risk increases. Changes in cost of funds are more uncertain over a longer-term loan. Thus, a short term revolving liquidity line of credit for a low risk borrower would be 25 to 50 basis points (one hundred basis points equates to one percent), whereas it would be 125 to 350 basis points for a higher risk long-term borrower.

**Profit Objective**

Finally, a lender must choose a profit objective that supports institutional goals for growth and leverage dividend payout or returns to capital. Management ascertains the overall profit objective, and this can be applied to individual loans. The institution's goals are translated to an individual loan by converting before- or after-tax returns on earning assets, or return on assets (ROA) and return on equity (ROE).

**Five Components of Pricing**

Thus, based upon the lender's cost of funds, inside equity capital and outside funding, administrative and interest cost, the risk associated with the loan, and the profit objectives provided by management, a rate would be offered. The rate could be raised or lowered, depending upon profit objectives, cost of funds, interest paid on deposits and administrative costs. Also, any fees could influence the rate offered.

Thus, one can observe how a risk can be incorporated into a pricing system to allow an institution to profitably price individual loans and logically meet competitive pressures.