Business / Technical Brief

Smarter Pricing Strategies

February, 2022, Version 2.1

Public

Purpose statement

This document analyses the advantages of moving away from product centric pricing to customer centric pricing for retail and institutional banking products and how Price Creation and Discovery helps achieve the goal.

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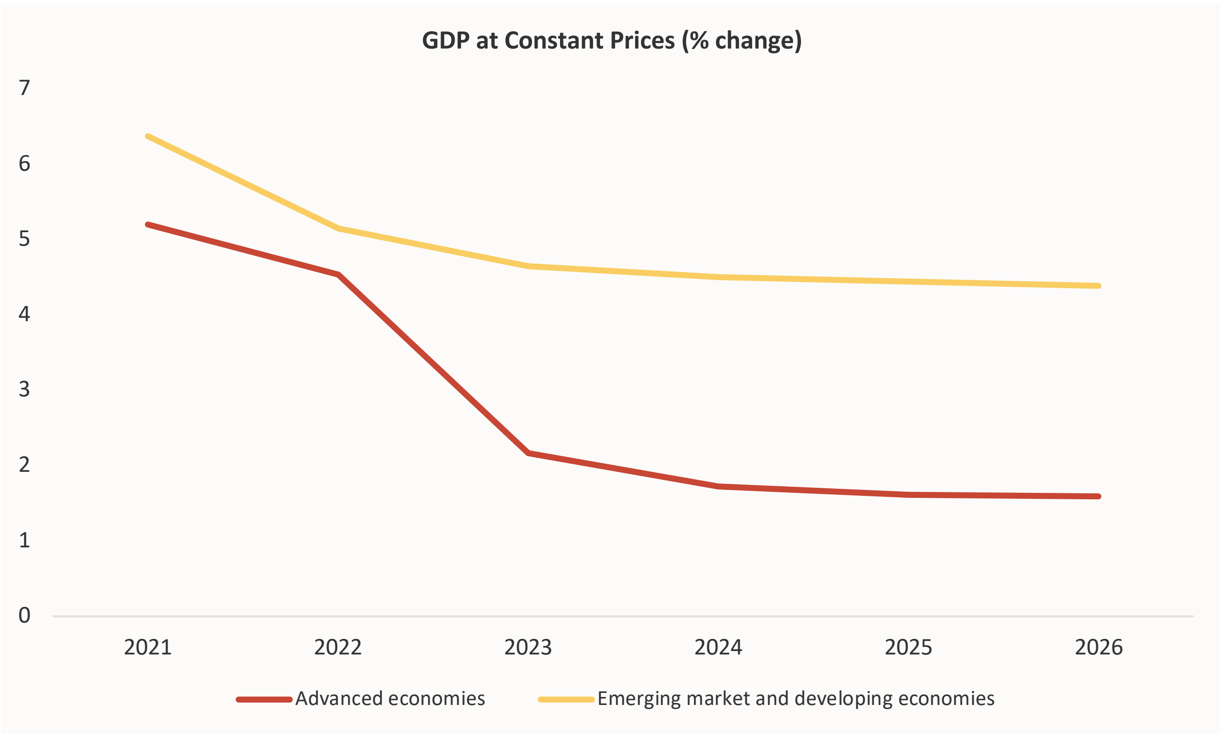
Smarter pricing buffer bottom lines in uncertain times

With unforeseen, unprecedented stress events, earnings of banks have started to get impacted due to margin pressures and increased credit exposure to hard-hit industries as businesses close and layoffs rise. The world economy may witness a muted growth as forecasted by IMF.



Source IMF

More than half of the banks are operating with an RoE below the cost of equity.

Concessions to borrowers such as zero-percent credit lines, loan relief, and fee waivers have further depressed revenue on top of the downward pressure on margins from central banks' rate reductions.

This pressure cannot necessarily be countered with loan growth in the near future. How do banks then gauge the effects of these measures on profitability? How do banks estimate their own risk while acknowledging the customer's long-term relationship with the bank? This is especially hard when the current external environment is remarkably different than the forecasted scenario at the time of customer acquisition.

These uncertain times make it even more important for banks to extract efficiencies from their current operations and revisit pricing as a profitability lever. Even from before, pricing has four times more impact on profitability than other improvements.

While top-tier banks have started to look at pricing as a profitability strategy since the last financial crisis, for most banks it remains a "cost-plus" or "risk-based" exercise.

This paper looks at how banks can boost their profitability with smarter pricing.

A tale of two customers

Banks initially approached pricing on a cost-plus basis where "cost of funds + margin = price." This places the product at the forefront instead of the customer. As a result, customers tend to have relationships across multiple banks as they go after the next best product offer.

Many banks have since embarked on a pricing optimization journey from product-based pricing to risk-based pricing where the customer's credit score and credit history determine their interest rate.

But this does not take into account the cost of servicing each customer. One customer may have a great credit record but may use the bank for a high volume of low-margin transactions, eroding the profitability of servicing that client. Another customer may have low servicing costs but is price insensitive and will be able to absorb a rate increase easily.

An effective pricing strategy goes beyond simply tracking performance at an enterprise level. It involves understanding the economic profitability of each customer and product tied to that customer relationship.

Granular customer-level profitability also offers an additional unlocked profitability tool – understanding which customers are unaffected by slight price increases and which ones are given unwarranted discounts.

Manual processes

Through primitive pricing practices, banks are leaving millions on the table. Pricing data which is usually stored in Excel-based models and siloed systems limit the 360-degree enterprise customer view.

Manual integration between pricing applications and other core systems, including funds transfer pricing, Basel regulatory capital, and profitability applications make it difficult to calculate each customer's lifetime value or profitability.

At the same time, there are different conflicting motives across each product life cycle –

Relationship Manager is focused on revenue and commissions	*Credit Underwriter* is focused on minimizing risk exposure	*Marketing* is focused on devising the next discount campaign

Evaluating profitability is also a different process depending on who is doing the evaluation. Sales may be focused on the size of the customer account, but the bank may be barely breaking even after servicing costs are taken into consideration.

In the recent past, there has been a tectonic shift towards digital banking as it accelerated post the pandemic induced global lockdowns. This change in customer behavior, which also provides the opportunity to condense operational costs by rationalizing the branch network, requires the banks to adapt an integrated agile framework for quick decisioning. The manual and siloed processes limit banks' ability to respond fast to customer needs.

Plugging revenue leaks

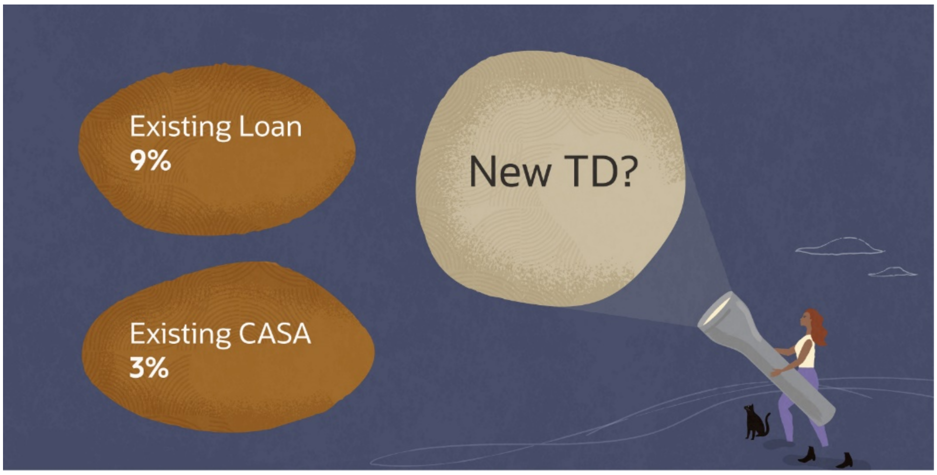
Pricing strategies go beyond the stated rates. Banks will need to understand off-rate leakages, including the cost of running promotions, the cost of offering customized products, the impact of bundling products and services or the cost of providing unique forms of post-sales support. Fee waivers on low-margin transactions may affect the bottom line at the product-level, but what is the impact on the customer overall relationship and potential profitability?

Is unwarranted discounting being used across the board or is it strategically offered for the best customer? Does your relationship manager have the tools to understand who the best customer is?

As banks move from risk-based to relationship-based pricing, siloed systems of record, fragmented data, product-driven pricing, and complex spreadsheet models remain real hurdles.

Achieving true relationship-based pricing

We expect customers to be increasingly price-driven as the majority continue to feel the impacts of the economy and markets. This will be the new normal until consumers, businesses, and the surrounding ecosystem can adapt for the better– and even then, positive effects towards the economy will take months to kick in.



As you engage with your customers on price, consider if you can offer optimized relationship-based pricing based on the following factors:

1. Existing relationship
2. Engagement and performance with current products
3. New product(s) the customer is considering
4. Key customer attributes

With this granular understanding of the customer, you can better tailor offers based on strength or potential of each individual customer relationship, historical profitability, and estimate the effect of these offers on overall bottom-line profitability. For new customers, pricing is based on expected customer behavior which can be inferred via customer segmentation.

Profitability calculations should include other revenues, expenses associated with the transactions over time, and expected engagement levels based on the customer segment they belong to.

Optimized relationship pricing is not a one-off tactic with each new product launch. Strategic pricing monitors the customer performance so that corrective measures can be taken to improve profitability or drive retention.

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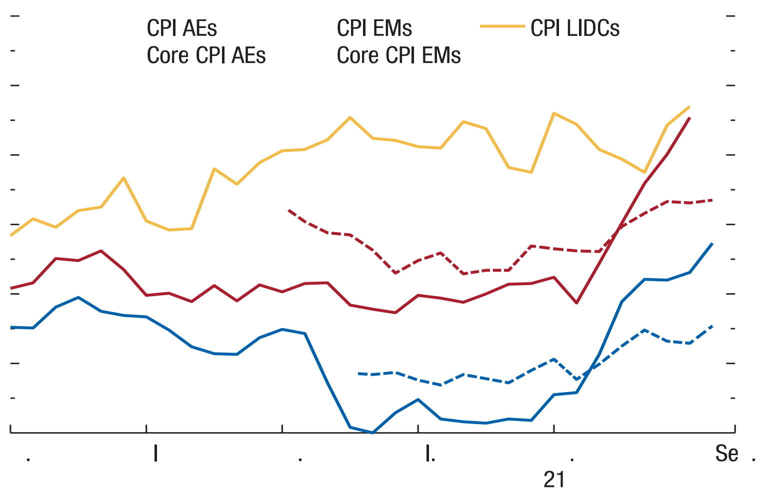

Source : ly ic · IMF, CPI databas · IMF staff calcula ion
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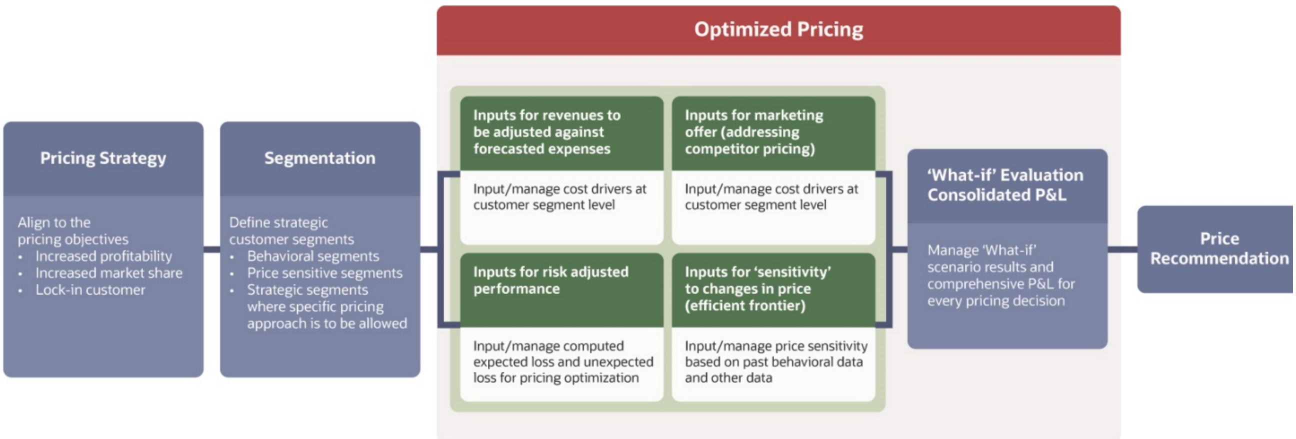
Consumer and wholesale prices worldwide are witnessing a major northward movement.

Strategic pricing is becoming more important in this stagflation like era as customers are more rate sensitive throughout their banking product life-cycle from onboarding till maturity. A complete workflow allows users to identify accounts that need repricing and take corrective measures.

A successful pricing approach is fully integrated and flexible enough to work across retail or wholesale scenarios, enabling you to optimize and strengthen customer profitability in the long run.

Managing Profitability in Times of Crisis

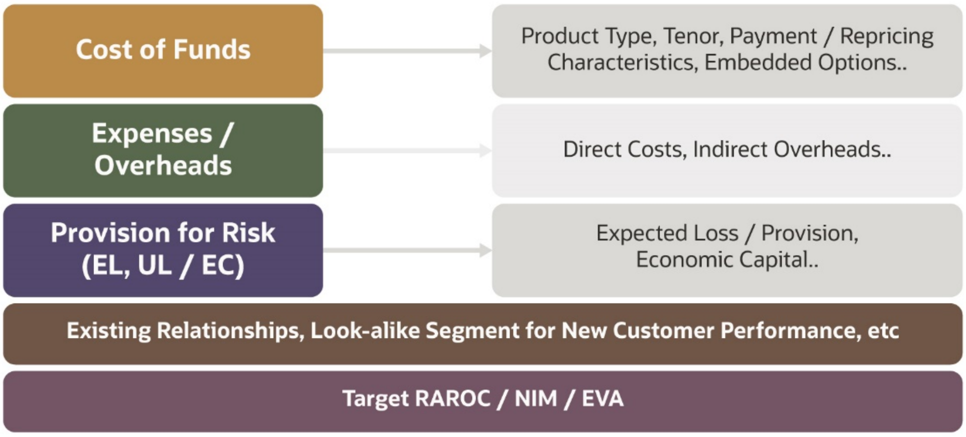
Oracle Financial Services Price Creation and Discovery offers a fully integrated and unified system for retail and institutional banks to price asset and liability products profitably.



With a fully integrated solution, banks are empowered with the right tools to

- Leverage a unified and highly scalable system that is fully integrated with other systems that build out a complete risk adjusted P&L including FTP, Basel, PFT cost allocations and Performance Analytics
- Predict the profitability of existing and new deals, with ability to optimize price against customer profitability
- Trigger a price-review for non-performing customers or retaining strong performing customers
- Support ongoing visibility of deals and customers

- Handle pricing consistently across line of business
- Support both rate-card and negotiated approaches to pricing
- Monitor customer performance with an enterprise-wide view



The pricing war is won in the thousands of decisions made by relationship managers across your bank in any single day. Unleash your bottom-line potential by getting pricing right – one customer at a time.

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