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FINANCIAL SERVICES

Relationship-based Pricing:

Build a Sound Foundation for New Paradigm Success

ORACLE STRATEGY BRIEF | SEPTEMBER 2015

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Introduction

For four decades, the promise of “have it your way,” was the foundation of an iconic ad campaign for a U.S. restaurant chain – an omni-present reminder of the importance of the individual in the business relationship. This wasn’t exactly the case, however, in the highly regulated and tradition-laced financial services industry – especially when it came to product pricing.

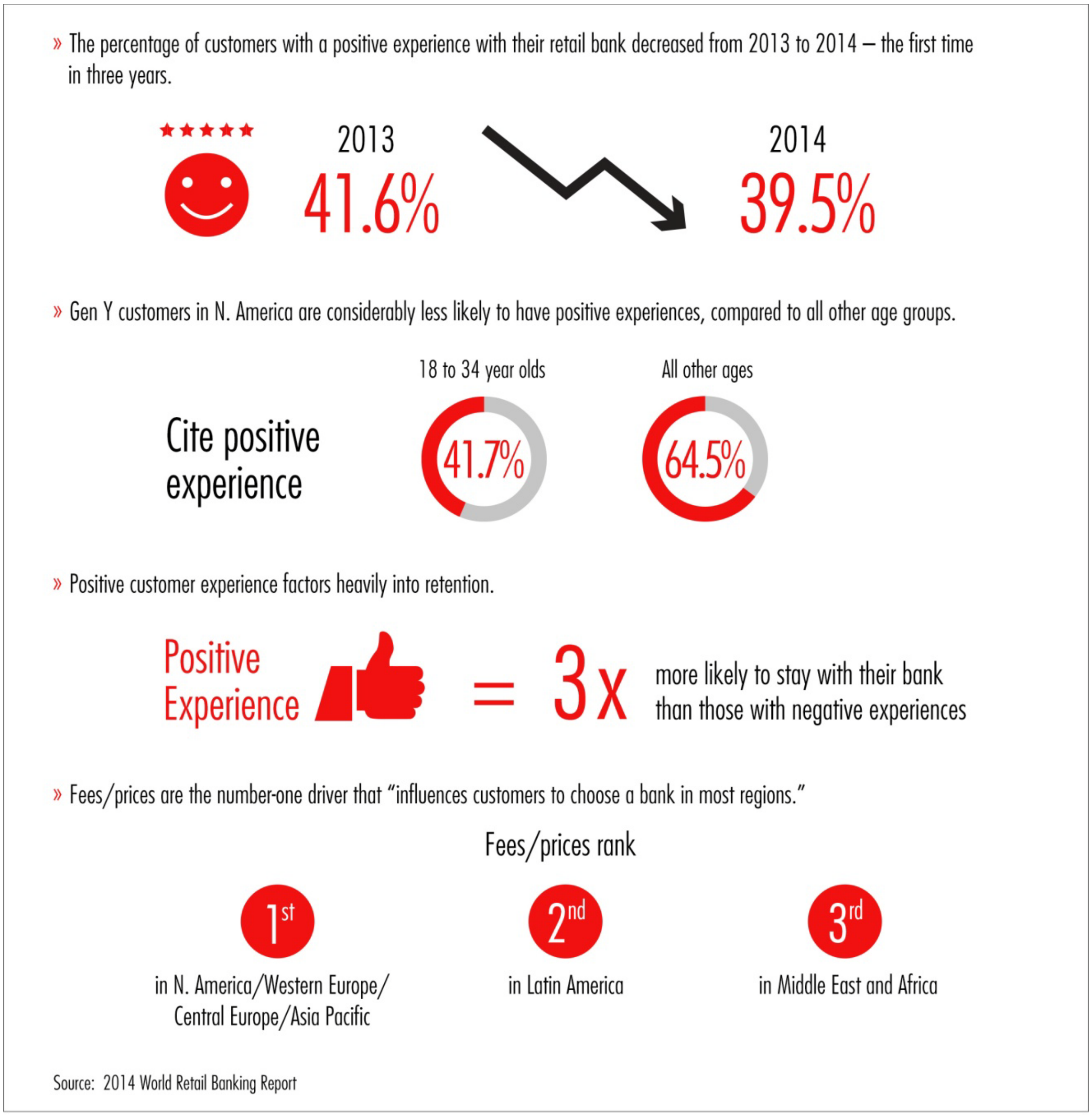
With the emergence of challenger banks and non-traditional market entrants – such as discount retailer Wal-Mart and warehouse club Costco – as well as the need to capture the increasingly affluent, yet elusive, Gen Y audience, financial institutions are doubling down on putting the customer at the center of the business, including when determining pricing strategies.

Financial institutions are looking to embrace relationship-based pricing, which allows them to tailor rates based on a customer’s current or potential value to the bank. While the objective is clear, many institutions face formidable hurdles in executing effectively on this next-gen strategy. These are obstacles, however, that they can and must overcome to continue to compete profitability.

Reality Check

The 2014 World Retail Banking Report, developed by Capgemini and the European Financial Management Association (EFMA), provides instructive, yet sobering, insight into the state of customer experience in the retail banking sector and the importance of pricing in influencing banking decisions.

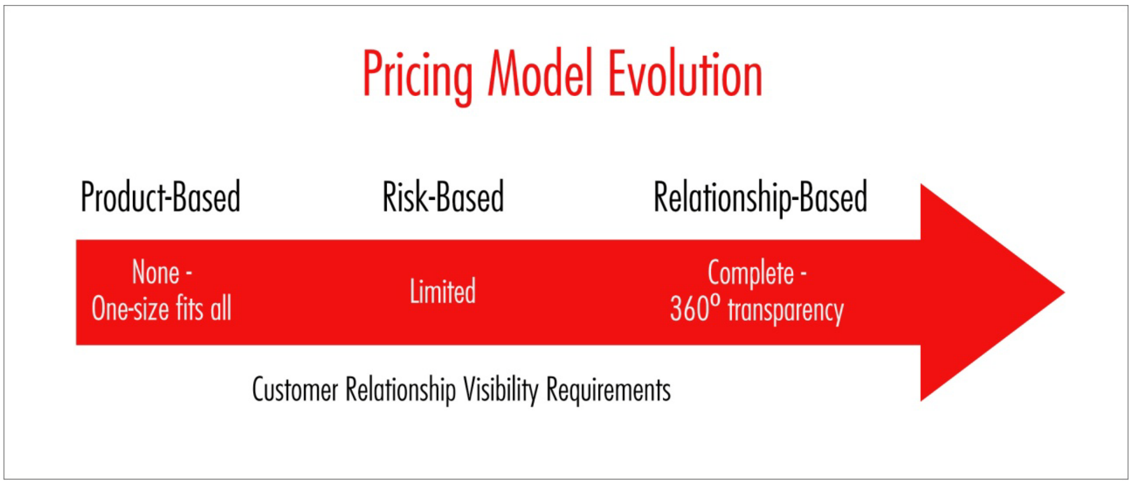
Specifically, the most recent study finds:



The 2014 report reinforces the long-held belief that pricing factors heavily into the customer relationship equation – including retention – and cannot be ignored.

Seeking: A More Evolved Pricing Strategy

While financial services products have grown more sophisticated over the years, pricing strategies, as a rule, have not kept pace. Several factors, however, are driving the need for change. Elevated customer expectations, as noted previously, is a major driver, but not the only one. In the U.S. retail banking sector, for example, the Credit Card Accountability Responsibility and Disclosure Act of 2009 as well as Dodd-Frank provisions have introduced new restrictions and requirements, which drive up the cost of capital while introducing new rate limitations. At the same time, the cost of attracting new customers has risen exponentially in recent years. The institutional banking sector faces similar regulatory and capital requirement pressures, which increase costs and drive the need for innovative pricing strategies.



For decades, banks relied almost exclusively on a standard rate-card pricing model for most products – a "one-size-fits-all approach" that does not take the relative strength of the customer relationship into account. Further, this rigid model cannot factor in account risk and does not enable banks to optimize pricing or incentives. In short, it places the product, not the customer, at the center of the banking experience.

Today, most banks use a combination of rate-card and risk-based pricing, the latter of which looks to provide differentiation based on risk associated with a specific customer. While this approach enables greater flexibility and opportunity to individualize the customer experience, it still falls short in enabling banks to evaluate and incorporate the complete relationship when determining pricing.

To meet changing customer expectations and market challenges, banks seek new ways to recognize and capitalize on customer individuality – understanding that no two customers have exactly the same needs or potential. In addition, customers will no longer stand for new, and often unproven customers, getting more attractive introductory rates.

Banks want to extend the concept of individualized service to pricing with relationship-based pricing, which enables them to provide tailored offers based on the strength or potential of the complete customer relationship with the institution. This approach also enables firms to capitalize on the new relationship paradigm in which customers expect reciprocal loyalty – including the best-possible pricing – from their long-time financial partners.

Ready, Set….Not So Fast

Relationship-based pricing requires enterprise-wide, 360-degree visibility into each customer. This is where adoption comes to a screeching halt for many organizations as siloed systems and manual processes continue to proliferate.

Legacy pricing solutions are largely manual and based on spreadsheet models, which do not contain information about existing customer relationships and prohibit banks from managing pricing from an enterprise level. In addition, most banks cannot readily calculate a customer's lifetime value, potential, or profitability – key requirements for relationship-based pricing – using their legacy pricing solutions.

Pricing optimization, a core component of the relationship-based model, also remains elusive. It is complicated by lack of integration between pricing applications and other core systems, such as funds transfer pricing, Basel regulatory capital, and profitability applications. Banks also require the need to gauge the effect of offers and variations in metrics on bottom-line profitability. Further, they seek insight into pricing elasticity and optimal bundling options to meet specific objectives – whether that is maximizing product sales and profitability or minimizing risk.

As important, many banks struggle with ongoing monitoring of customer and deal performance, which is essential to empowering timely corrective action to improve profitability, as needed.

New Era/New Requirements

Banks considering the move to relationship-based pricing are taking a critical look at their legacy infrastructures to determine what is needed to confidently and successfully roll out this new model. In assessing requirements, firms should consider the following:

- **Do we have an enterprise view of the customer that enables us to understand their current performance?** Complete visibility into each customer is the cornerstone of an effective relationship pricing initiative.
- **Do we currently have – or could we support – an enterprise approach to pricing or is it handled inconsistently across lines of business?** An enterprise-wide approach is critical to the success of a relationship pricing initiative. If only one part of the organization adopts relationship pricing, it still does not guarantee loyalty if other parts of the bank negatively impact customer experience through outdated pricing approaches. Having an enterprise-wide application gives the bank an opportunity to enforce consistent approaches to pricing. As an example, one part of the business might only look at profitability without considering allocated expenses while other groups might consider both factors. This difference can lead to inconsistent application of strategies across the bank.
- **Does our current pricing solution provide the flexibility needed to support both rate-card and negotiated approaches?** One size does not fit all when it comes to pricing models. As such, firms need the ability to select and manage different pricing methodologies, specific to certain products or unique retail and institutional scenarios. They also must be able to pre-define offers and associated eligibility criteria that can be linked to the deal price for better differentiation.
- **Is our pricing solution fully automated or does it require bankers to manually predict the profitability of a deal or the profitability of existing customer relationships?** Automation accelerates processes and reduces costs while improving consistency, bolstering compliance, and reducing overall risk. Integration to other core systems, such as funds transfer pricing, regulatory capital, and customer relationship management applications, is essential to the automation equation as firms must have a clear understanding of these costs and factors and their implications for a specific deal and the overall customer relationship.
- **Can we effectively optimize pricing?** Modeling and scenario analysis are critical to pricing optimization. To support this goal, firms require the ability to incorporate a fully loaded profit and loss (P&L) prediction for the deal based on various rates and then conduct automated scenario analysis to determine the best path forward.

- **Can we readily support offers, such as rate cuts and fee waivers, that we can apply on top of the interest rate offered against a product?** These capabilities provide the flexibility necessary for delivering a truly individualized customer experience, especially while creating and selling bundles.
- **Do we have ongoing visibility into the performance of the deal or customer at a granular level – enabling us to address issues proactively and quickly?** Continuous performance monitoring capabilities – at the customer and account level – empower management to take timely corrective action when profitability falls below anticipated targets.

A Holistic Approach

Oracle Financial Services Price Creation and Discovery helps financial services organizations address these challenges and introduce effective relationship-based pricing strategies into their organizations. The solution enables retail and institutional banks to optimize pricing and profitability of asset and liability products while providing the highly individualized experience that customers demand.

Oracle's highly flexible and configurable enterprise-wide pricing optimization solution delivers several unique benefits to the market:

- Accelerates time to value and reduces IT complexity. The solution is built on the common Oracle Financial Services Analytical Applications (OFSAA) platform and the unified, financial services-specific data model. It is pre-integrated with other OFSAA products, including Oracle Financial Services Funds Transfer Pricing, Oracle Financial Services Basel Regulatory Capital, Oracle Financial Services Institutional Performance Analytics, and Oracle Financial Services Retail Performance Analytics.
- Supports both rate-card and negotiable methods for greater flexibility across retail and institutional scenarios
- Provides end-to-end visibility into myriad factors and parameters influencing each deal, such as payment rates, revenue, expenses, potential losses, and net income
- Delivers sophisticated scenario analysis that enables firms to predict the profitability of existing deals and optimize the price against customer profitability
- Features automated triggers that force price reviews for non-performing instruments to optimize profitability – enabling continuous monitoring and empowering management

Conclusion

Clearly, the financial services landscape is changing significantly, and the primary change drivers – enhanced customer expectations, increased regulatory requirements, and new pressures from untraditional players – will not cease. For financial institutions to maintain a critical competitive edge in this dynamic environment, they must focus their efforts on placing the customer at the center of the business to provide the bespoke service experience that today's banking customer not only requires, but actively demands. And, modern banking requires modern technology. To successfully introduce and execute relationship-based pricing strategies, banks must leverage innovative technology solutions that optimize pricing while empowering management to continually monitor performance and strengthen overall customer relationships.

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