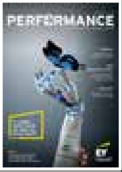

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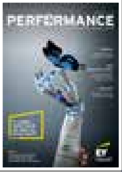
Pricing management: a tool for building differential capabilities and rapidly growing profits

The explosion of computing has delivered increasing amounts of data and information to financial institutions, but knowledge of what to do with it has not kept pace. This situation occurs in many fields, and pricing management in banking is no exception. Having the right pricing strategy and execution are well known for helping to achieve short-term profitability and differentiation, but many financial institutions are struggling to make this work.



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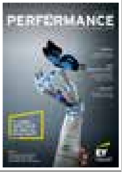
Authors

Paulo Pantigoso
Country Managing Partner, Ernst & Young Asesores Sociedad Civil de Responsabilidad Limitada (EY Peru)

José Carlos Bellina
Partner, FSO Advisory Leader, EY Peru

Alejandro Carranza
Senior Manager, FSO Advisory, EY Peru

Christian Nue
Senior Manager, FSO Advisory, EY Peru



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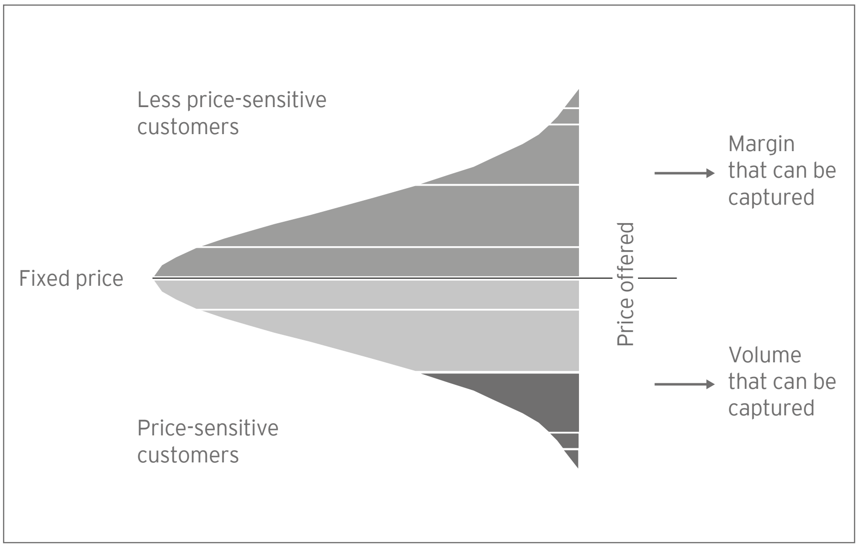
In the short term, determining the right price for the customer leads to capturing the most profitability (see Figure 1).

Yet today, the pricing strategy process poses many challenges:

- The bank's priorities are not always aligned to customer-level pricing. Banks are commonly oriented toward managing the product and not the customer (where prices are usually set by the product manager rather than the segment or pricing strategy manager).
- A cultural bias can exist, with the result that pricing is managed on a discretionary basis rather than as the result of a structured or analytical process.
- A centralized function to design and control the pricing strategy is lacking.
- There is an absence of processes that permit a pricing strategy to be implemented and followed as decisions are being taken on a customer level.
- There is a shortage of available data and the processes to capture it in the future.
- There is a lack of internal capabilities in advanced analytics to help understand the data.
- The current IT infrastructure does not support a dynamic pricing process architecture, and developing the necessary tools is expensive and complicated.

Figure 1. The relationship between price sensitivity and profitability



- The effect of market dynamism and changing circumstances in regulation can shift prices.

Having a dynamic pricing strategy based on advanced analytics can be a source of differentiation. In fact, it is likely that, in the not-too-distant future, it will become a necessary part of remaining competitive: more accessible technologies are emerging, and more flexible and nimble organizations will take advantage of them.

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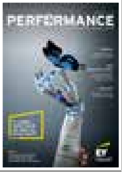

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The essence of pricing management

These challenges can be managed with a structured process, a pricing management function and by implementing a new culture in the bank.

Our framework for developing a pricing management strategy and managing its execution has three levels (see Figure 2):

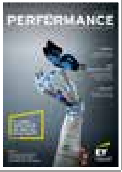
1. Pricing strategy
2. Customer-level pricing capabilities
3. Foundational capabilities

The first level defines the guidelines and business rules on how pricing is going to be managed. It is mainly focused at a segment and product level, defining a strategy for each customer segment depending on industry dynamics, regulation and the competitive environment.

The second level (into which we will dive deeper in this article) is focused on the processes and capabilities to bring the pricing strategy to a per-customer execution. The goal is to offer the optimal price for the right client, for the right product at the right moment, subject to business goals, customer relationship, willingness to pay, competition, regulation and associated risks.

The third level is the bedrock for the strategy and pricing techniques to work in an organization. The principle elements are as follows:

- Organizational alignment: governance organizational design and incentives need to be aligned to the strategy, and accountability and resources need to be clearly apportioned. This usually engages three key groups in the organization:
  - Pricing command center: a group that is usually new in organizations implementing a pricing strategy. It is the heart of the strategy and needs two types of team – advanced analytics (i.e., big data architects, data scientists and data visualizers) and pricing strategists who will manage the incentives related to the right pricing and set discount management limits for the approval workflow.
  - Product management: the group that has historically managed prices, and should be the main input for the business rules on discount management.
  - Front line: the group facing customers and that takes decisions with them. It is very important to establish the type of decisions they can take, the limits to which they can handle them and the extent to which they can ask for approval to make changes.



- Tools and technology: organizational design only holds when a technology tool handles the process and definitions. Usually, a dynamic pricing strategy needs extended capabilities in managing big sets of data, having real-time processing, advanced analytics modeling and deep integration with banking core systems, as well as friendly multichannel reporting tools that allow decisions to be made on the go.

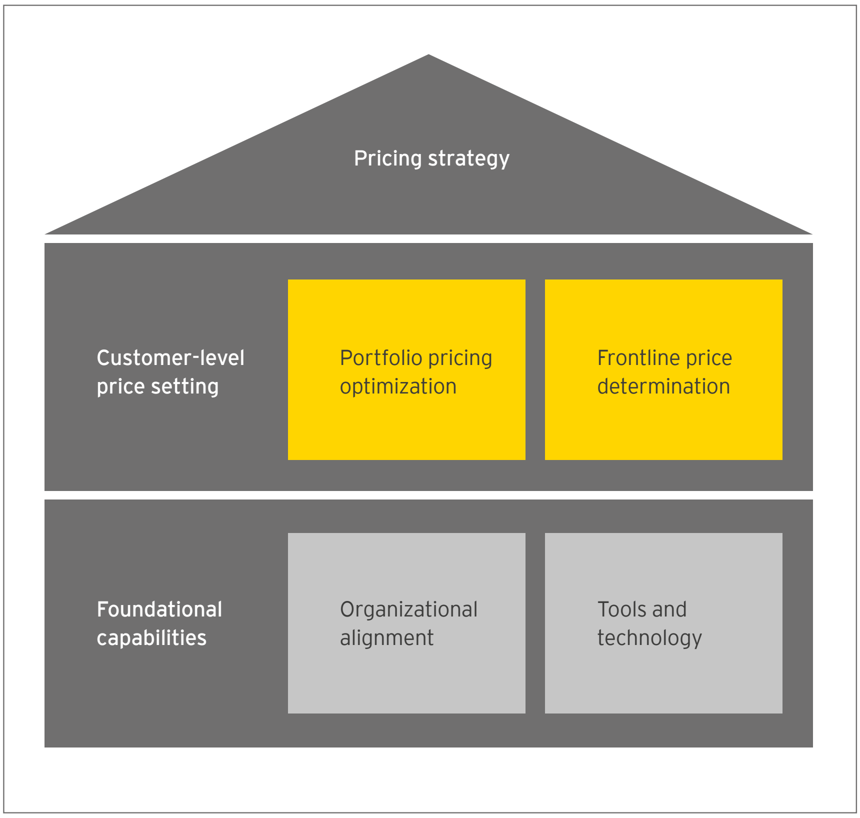
Customer-level pricing capabilities

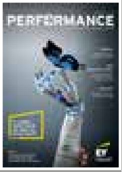
The core behind pricing management transformation in banking lies in developing the right capabilities to enable the right price for every customer.

This has two key parts:

1. Portfolio pricing optimization: determining the right price per customer segment and improving the results based on available information and the bank's goals
2. Frontline price determination: improving value by adapting to each customer at each moment

Figure 2. Pricing management framework





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The goal is to offer the optimal price for the right client, for the right product at the right moment, subject to business goals, customer relationship, willingness to pay, competition, regulation and associated risks.

1. **Portfolio pricing optimization**

   Setting the most appropriate price for a product portfolio for many clusters of customers is done in two cyclical steps: the first is advanced analytics for determining the price, and the second is experimentation through A/B testing:

   - **Advanced analytics for determining the price**
     In advanced analytics, many factors have to be taken into account and modeled in complex algorithms to segment clients, determine elasticity, improve the portfolio and, finally, determine the best prices aligned to business goals.

     Furthermore, the algorithms used have different maturity levels, from statistical reporting and human-led decisions to real-time machine-learning automated decisions and the speed to execute the analytics.

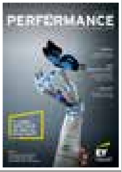
     The initial state (less mature) is that banks act intuitively with fixed prices that can only be changed through multiple approval processes. This matures into integrating more data and making risks and costs part of the pricing equation.

     The next evolution has been toward value-based pricing, taking into account the price elasticity of customers and the value they get from the bank.

     Looking ahead, the trend in pricing is toward advanced analytics and artificial intelligence that predicts and adjusts prices in real time.

   - **Experimentation through A/B testing**
     The information used for determining the optimum price is restricted to data points that have been collected in the past. Experimenting is a way of discovering what nobody else knows; creating data about customer behavior that no other organization has. This is what makes it such a powerful tool.

Figure 3. Price-setting analytics dimensions



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Looking ahead, the trend in pricing is toward advanced analytics and artificial intelligence that predicts and adjusts prices in real time.

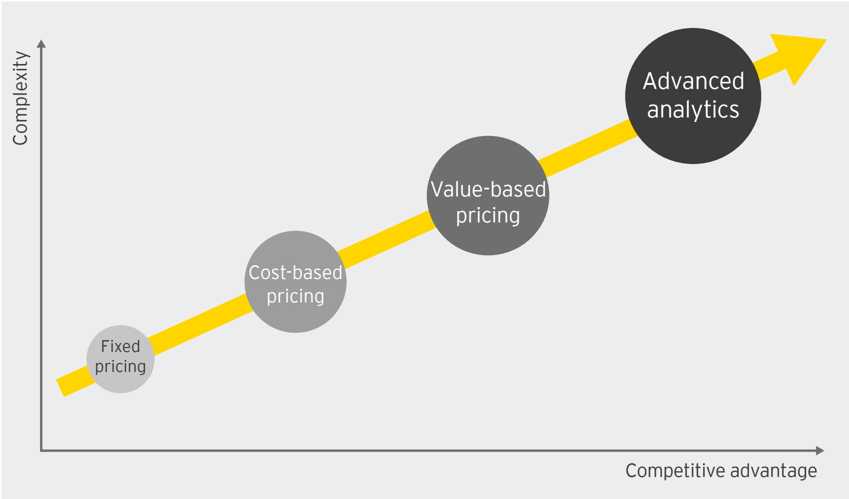
2. **Frontline price determination**

   Even though the appropriate pricing has been identified for the cluster, the best price for each client and each moment will be improved at the front line. The front line knows the customer and can evaluate if the customer has another quote, or values speed alone and is less sensitive to price.

   EY's framework supports a number of tools that can be implemented in pricing systems to improve negotiation and speed up the disbursement process. Examples include: a better process for discount management; having a centralized office that manages negotiation parameters and performance reporting on the front line; offering special promotions and bundling for customers; and allowing special autonomies for some client representatives.

   Usually, frontline price determination is critical to improving results and outperforming competitors.

Figure 4. Pricing optimization maturity model



Positive results

We have seen the implementation of pricing management projects achieve some great results in banking. For example:

1. An increase in profitability by 3% to 7% as a result of moving direct variables, such as price and quantity, when they weren't being optimized, and indirect variables, such as having a faster process for better customer satisfaction.
2. Improved capabilities for handling competitive changes in the future: after the projects are implemented, the banks have an organization that actively manages pricing and data around market behavior to help react and test initiatives proactively to drive the market.

This suggests great potential for this management tool to increase knowledge within financial institutions, and help create an important competitive advantage and rapid and impactful profit growth.

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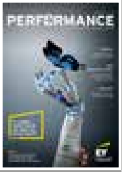

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Pricing management in action

EY has helped financial institutions develop capabilities in pricing management, with measurable results and impacts on the bottom line.

We assisted a global institution in designing its new pricing management model. Having defined and decided on its new organization, pricing governance and the first tools to manage and execute the pricing strategy, the bank launched a pilot to help it:

1. Understand and adapt to the customer decision-making process
2. Understand the organizational challenges of having a more structured pricing model

During the pilot, as these concerns were being addressed, an important outcome began to emerge: the profitability of the product started growing very quickly. Having a better controlled process helped to enable better negotiations and determine the right price for each customer. Not only did the average interest rate and spread grow, but credit allocation (as shown in Figure 5) did too.

The organization learned new capabilities along the way and was able to react better to market pricing moves; the gathering of past data also helped to inform better decisions for future pricing strategy, completing the cycle.

A few months after the pilot had been launched, the new pricing process was already working in every branch in the country, and a formal and more robust tool was being developed to integrate with the bank's legacy systems. ■

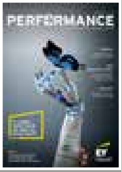

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Figure 5. Improvements in average interest rate and credit allocation