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Internal Consulting Group

Knowledge Area Review (KAR 023)

Pricing in Commercial Banking – Product Brochure

April 2015

KAR 023: Pricing in Commercial Banking (a review of global best practice)
Report overview and sample pages

What is this report?

- ICG's 23rd Knowledge Area Review (KAR), covering global best practice in commercial banking pricing.
- Over 130 pages (samples attached) of in-depth information, drawing on the best public-domain thinking and practice globally from consulting firms, banks, academics and others.
- Created by a global team with over 100 years of collective experience in pricing and financial services.
- Priced at US$7,500 (plus any applicable taxes) per organisation for an unlimited global license.
- Published in April 2015.

What questions does it answer?

- How does commercial pricing need to support banks' underlying strategic priorities in the current context?
- What are the foundations of pricing for risk and how do they need to evolve?
- What are the key best practice principles in pricing for relationship?
- How should banks approach implementation and address the major challenges they will encounter?
- What might be around the corner for commercial banking pricing over the next few years?

Why buy it?

- Get smart quickly and in depth on pricing for commercial banking.
- Bring yourself up-to-date and be ahead of major emerging developments.
- Align your team with the best up-to-date thinking and practice worldwide.
- Benchmark your risk and relationship pricing approaches against global best practice principles.
- Save time and money in kicking off major pricing improvement efforts.

Where can I buy it?

- From your local ICG affiliate or office
- From the co-authors, Gerry Purcell (Toronto, Canada - gerry.purcell@internalconsulting.com) or Moti Shahani (London, UK - moti.shahani@internalconsulting.com)
- From ICG's web store.

Pricing in Commercial Banking: Contents

Section	Component	Description
1	**Executive Summary**	Overview of our research and findings
2	**Pricing in Commercial Banking**	A global review of customer relationship pricing from small businesses to larger corporates
2a	**Setting the Context**: How does commercial banking pricing need to support banks' underlying strategic priorities?	
2b	**Pricing for Risk**: What are the foundations and how do they need to evolve?	For each different dimension: • The key thinking from consulting firms, journals and academia as to what constitutes best practice • Examples of this best practice across different firms and industries.
2c	**Pricing for Relationship**: What are the key best practice principles for relationship pricing?	
2d	**Implementation Considerations & Challenges:** How should banks approach implementation and address the major challenges they will encounter?	
2e	**What's Next?** What could be around the corner for commercial banking pricing over the next few years?	
3	**Knowledge Sources**	Relevant published materials for further reading

Executive Summary

As banks emerge from post-crisis fragility and refocus on value creation, commercial banking pricing has once again been moving up the agenda.

Improving pricing capabilities is seen both as an economic necessity and as a bright spot of underleveraged opportunity, with the tangible prospect of substantial, direct, immediate and sustainable impact on the bottom line.

So how can banks go about seizing the opportunity?

Management of risk remains central and must respond to ongoing and mounting regulatory pressures, but pricing has already moved on to the point where it is driven more by relationship rather by than risk. Banks are attempting to become more customer-centric and more sophisticated in their pricing approaches. At the same time, major new developments – many of them digital-led – promise to disrupt 'business as usual' with a tidal wave of innovation.

This report draws together the best global thinking and practice from consulting firms, banks, academics, and others to answer five key questions:

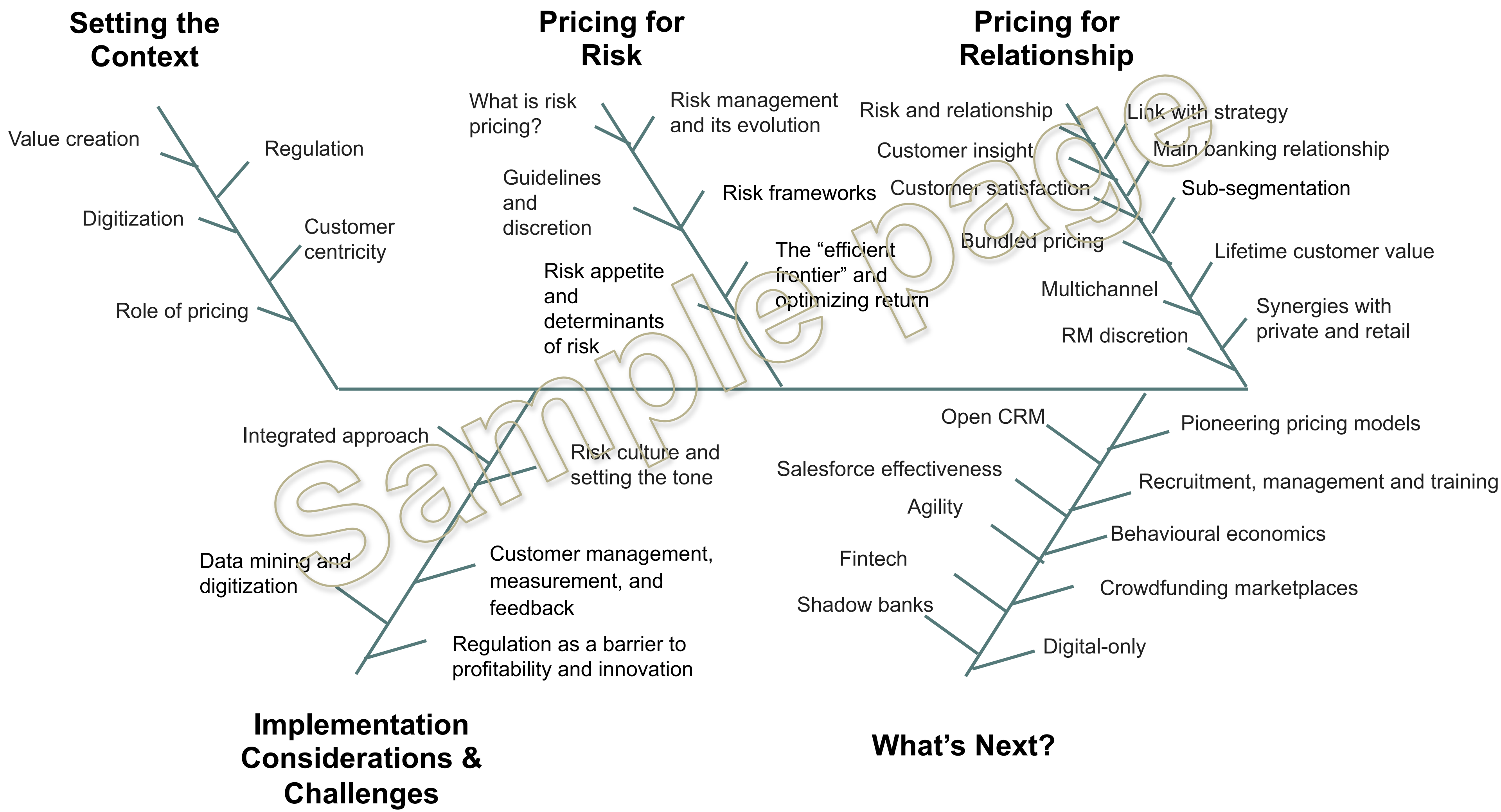
- How does commercial pricing need to support banks' underlying strategic priorities in the current context?
- What are the foundations of pricing for risk and how do they need to evolve?
- What are the key best practice principles in pricing for relationship?
- How should banks approach implementation and address the major challenges they will encounter?
- What might be around the corner for commercial banking pricing over the next few years?

The focus is on pricing for the core commercial banking business, from the smallest SMEs to larger corporates, but excluding very large companies, where the pricing dynamics can be different.

Our aim is to provide a comprehensive, strategic, and action-focused synthesis of material, starting with the macro environment and drilling down to the nuts and bolts of how to do it. We also provide a central navigation point for a large quantity of publicly-available thinking, evidence and experience, with clear and detailed references for further reading.

Pricing in Commercial Banking: Content Overview

A review of global best practice



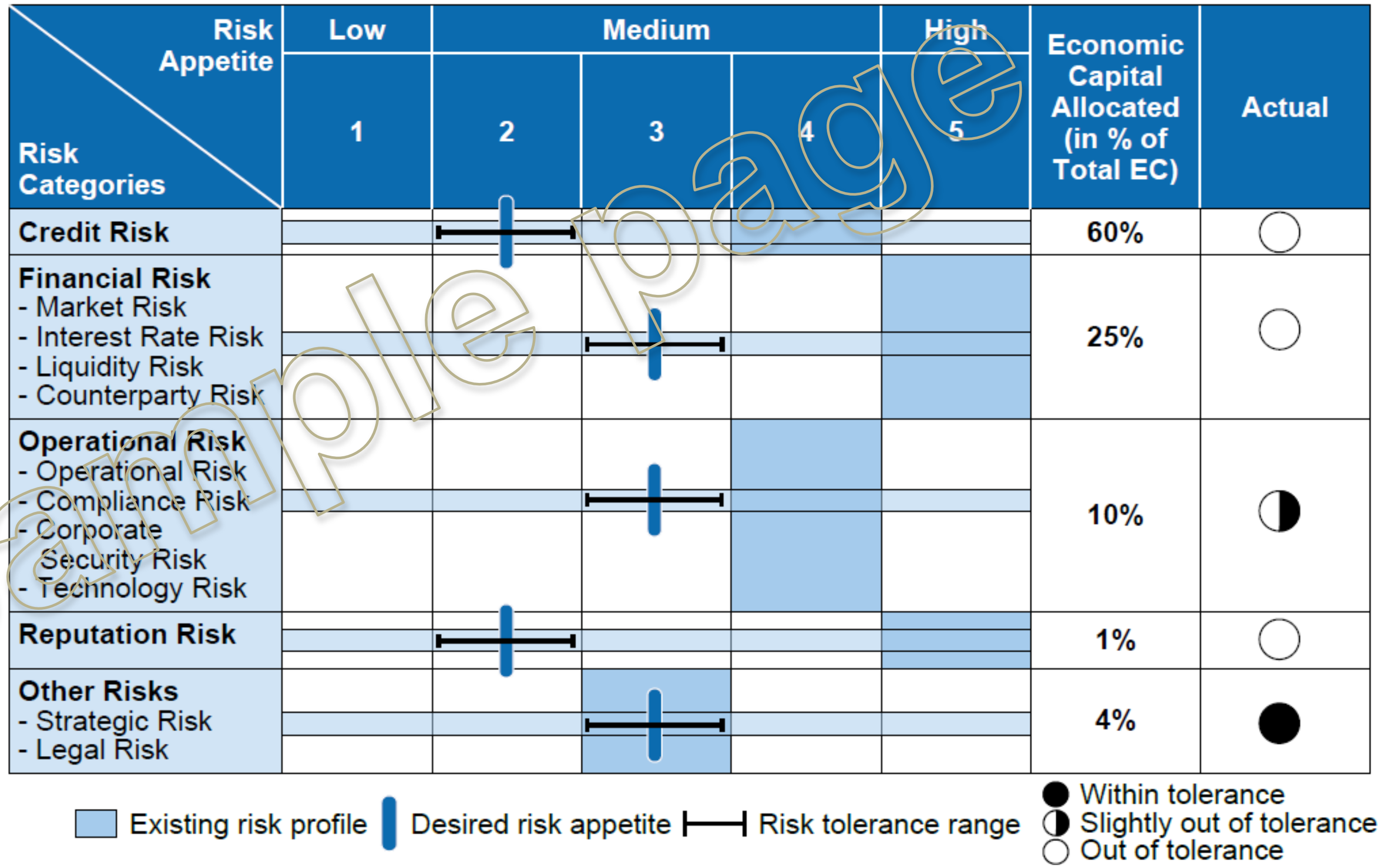
For specific risk management purposes, risk appetite and tolerances are defined for all major risk categories

3 B

Illustrative

CORPORATE LEVEL RISK APPETITE AND TOLERANCES

- Risk appetite is usually expressed in risk measures (e.g. value at risk), nominal measures (e.g. $ amount of credit outstanding), or outcomes (e.g. capital level).
- Efforts to manage risk appetite and risk tolerance will necessarily focus on those risk categories that have the highest percentage of total economic capital allocated to them.
- Aggregation of risk tolerances ensures that the bank operates in line with its desired overall risk appetite.



Source: A Comprehensive Risk Appetite Framework for Banks, Booz & co., 2009.

Banks often establish an overall price positioning or approach

EXAMPLES OF PRICE POSITIONINGS FOR BANKS

POSITION	REQUIRED CAPABILITY	CHARACTERISTICS	EXAMPLE (MORTGAGES – AUSTRALIA)
"Best"	• Active monitoring of competition, staying in top quartile for all selected products	Attractive to customers Requires low-cost business model	• NAB Mortgages
"Promotional"	• Create perception of good prices through cycling, promotions or aggressive headline rates	Better economics Requires customer insight	• HSBC Mortgages
""Fair"	• Pricing justifiable with reference to competition or costs. Limited of any use of 'hidden' fees	Satisfied customers Clear policy	• CUA
"Premium"	• Better products and services. Requires strong proposition and a recognised position.	Higher margins if costs managed Superior business model	• Macquarie Bank
"Personal"	• Customers get their own prices, based on individual characteristics, loyalty, etc.	Greater loyalty, share of wallet Requires customer pricing model	• CBA Mortgages
"Discretionary"	• Negotiation at point of sale, locally determined price targets	Achieves discrimination Requires control, incentives, tracking, compliance	• Brokered Mortgage Sales (Large Loans)
None	• None required	Easy to implement	• Many

Source: ICG – taken from work on mortgages strategy in Australia

Examine transaction data using established analytical tools to identify sources of revenue and margin leakages

ANALYSIS TOOLS

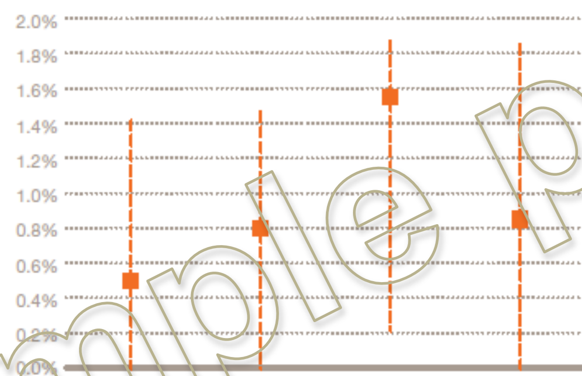
Price band analysis and price waterfall analysis tools have proven valuable in:

- providing a foundation to capture opportunity at the transaction level,
- allowing organizations to identify areas of price erosion, and
- achieving the best net realized price for each customer or transaction.

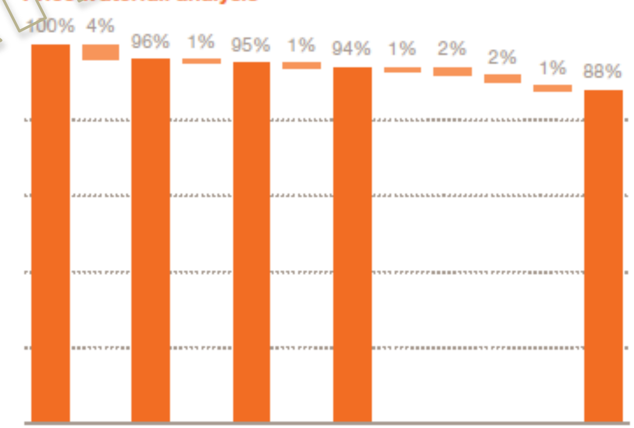
Margin leakages and unwarranted price concessions can be analyzed for a given product or business unit across geographies or customer segments.

IDENTIFYING REVENUE & MARGIN LEAKAGES

Analytical tools	Benefits
Price band analysis	• Identifies distribution and variability between the invoice price and the actual transaction price (margin bands) among customers within and across different customer segments, products, geographies, and channels. • Helps control the variation of prices by product, channel, and customer value for setting prices.



Analytical tools	Benefits
Price waterfall analysis	• Captures, quantifies, and visually displays each element (revenue leak) of the price structure, cascading down from list price to invoice price to pocket price which occurs after price is set with the customer. • Flags outlier customers whose cost to serve in certain areas is disproportionately high or whose margin across transactions is consistently lower than average. • Identifies which cost elements have the greatest impact on margins. • Highlights which cost-to-serve elements can be reduced in order to keep a larger portion of the list price. • Links cost to serve with pricing levels and customer segmentation. • Used in conjunction with price band to target potential customer groups for price increases.



Source: PWC FS Viewpoint, 2012

Granular sub-segmentation around intelligent groupings of customer need can be a highly effective strategy

KEY POINTS

- Garanti Bank is Turkey's second largest private bank, but is recognized as the leading SME bank and has a SME market share three times its share of other segments.
- SME loans grew 76% in USD terms between 2007 and 2011.
- One of the keys to its success has been very granular sub-segmentation to cater for the needs of Turkey's typically very small SMEs.
- 5 segment examples are shown here and there were 17 such 'support packages' on Garanti Bank's website as at April 2015

EXAMPLES OF GARANTI BANK SEGMENTS AND PROPOSITIONS

SEGMENT	PROPOSITION	LOANS	SERVICES
WOMEN	• Improve company's production capacity or improve its service • Brand new package for women	• Women entrepreneur loan • Business premises loan • Auto loan • Cash loan • SME project finance loan	• Checking account, OD ACC, POS, credit card, LG's foreign trade services, SME pension plan, insurance factoring
TOURISM	• Flexible cashflow and FX support for agencies, suppliers, cafés, and restaurants	• Tourism support loan • Business premises loan • Commercial vehicle loan • Fuel management system	• Checking account, OD ACC, POS, credit card, LG's
MANUFACTURING	• Support for those that want to grow and expand abroad	• Machinery loan • Cash loans • Expo participation loan • Certificate acquisition loan • Business premises loan • SME support loan	• Checking account, OD ACC, POS, credit card, LG's foreign trade services, SME pension plan, export insurance
AGRICULTURE	• Investment and production financing on terms that suit the harvest period	• Tractor and harvester loan • ST production loan • M and LT support loan • Greenhouse loan • Warehouse receipt loan	• Ekin card, agriculture insurance, SME pension for farmers
TRADESMEN	• Use loans at discounted rates • Meet client's financing needs as well as collections and payments	• Tradesmen support loan • Loan via POS • Commercial vehicle loan	• Checking account, SME insurance, tax collection

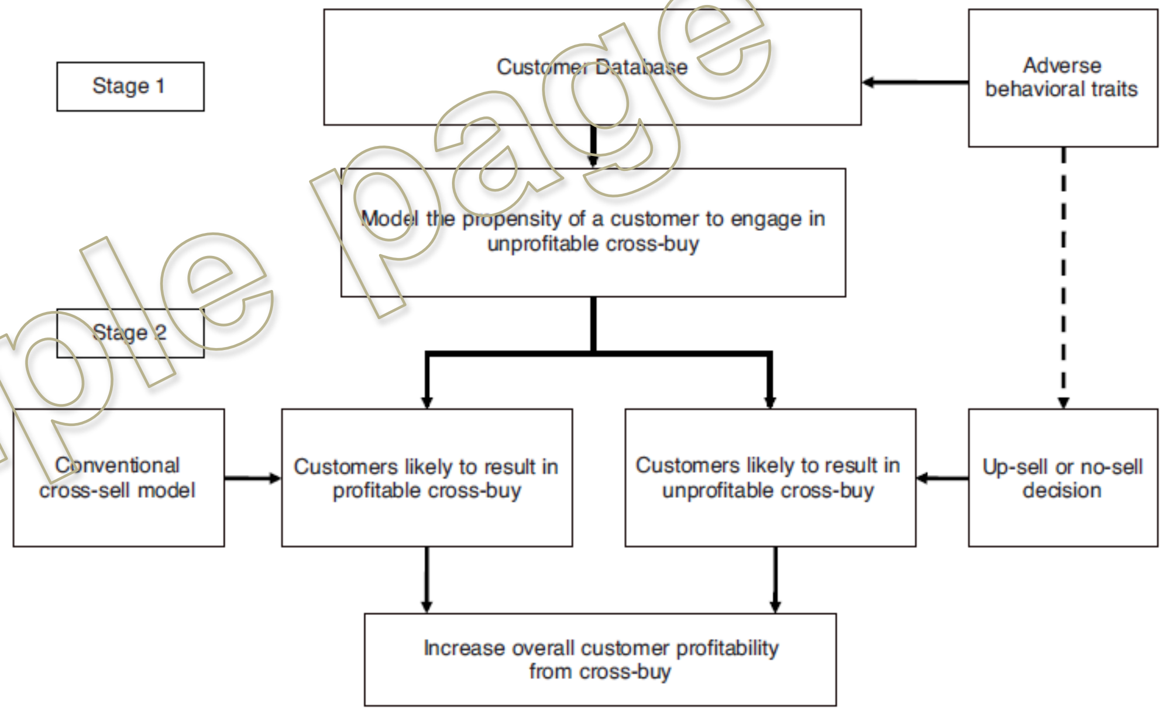
Source: Customer Management in SME Banking: a best-in-class guide, International Finance Corporation, 2012; Garanti Bank website

Unprofitable cross-selling may be less of an issue than in other sectors but, if necessary, a two-stage management framework can be applied

UNPROFITABLE CROSS-BUYING ANALYSIS

Number	Firm	Proportion of Cross-Buy Customers Who Are Unprofitable
1	B2B financial service firm	9.57%
2	B2B IT firm	18.50%
3	B2C retail bank	19.13%
4	B2C catalog retailer	35.10%
5	B2C fashion retailer	31.61%

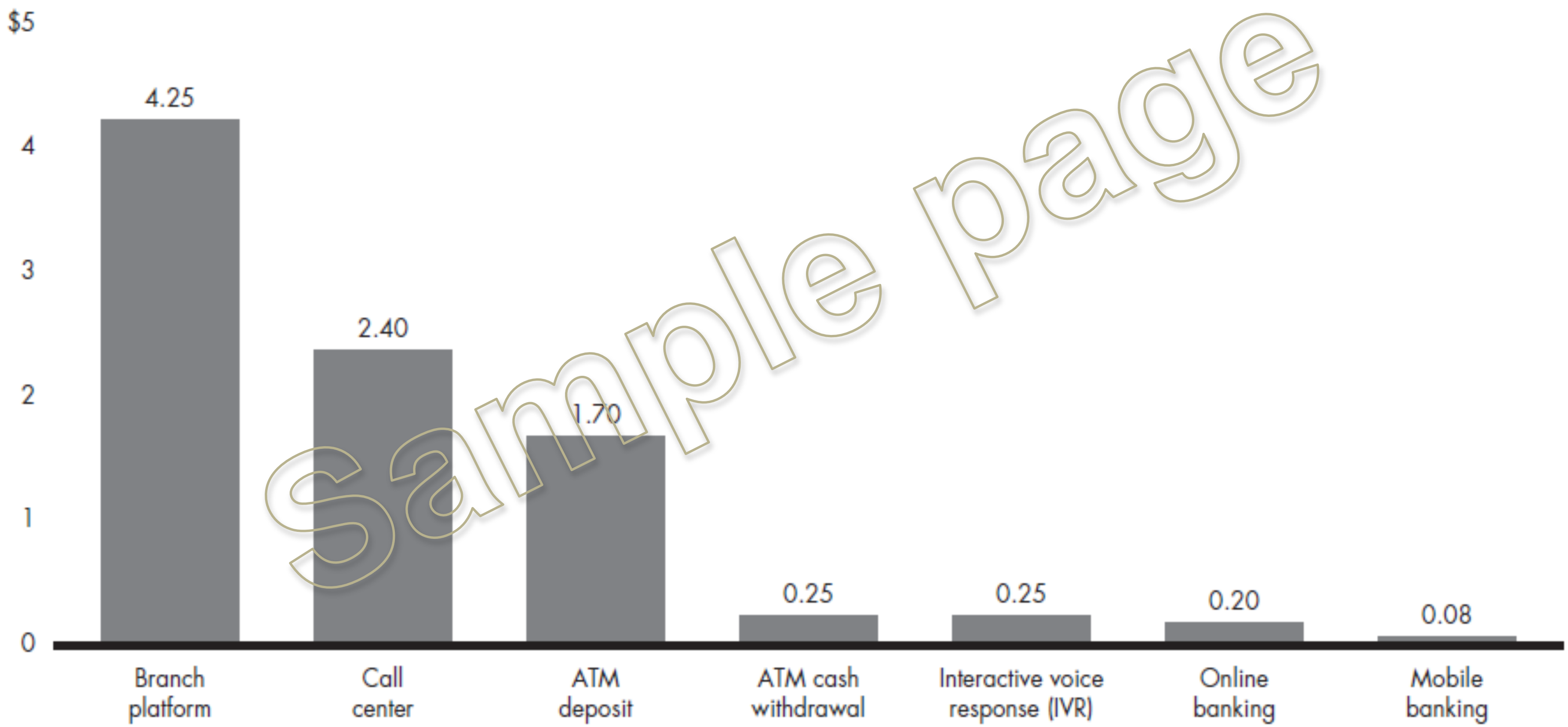
A TWO-STAGE FRAMEWORK FOR PROFITABLE CROSS-SELLING



Source: Unprofitable Cross-Buying – Evidence from Consumer and Business Markets, by Shah, Kumar, Qu and Chen, in American Marketing Association Journal of Marketing, Vol 76, May 2012

Digitization is completely changing the economics of customer servicing, leading to differential pricing by channel

COST PER TRANSACTION – BY CHANNEL



Source: Diebold Inc. analyst day presentation, 2010

Source: Customer Loyalty in Retail Banking, Global Edition 2012, Bain and Company

BASEL III implementation is ramping up, focusing on Capital, Liquidity, and Leverage

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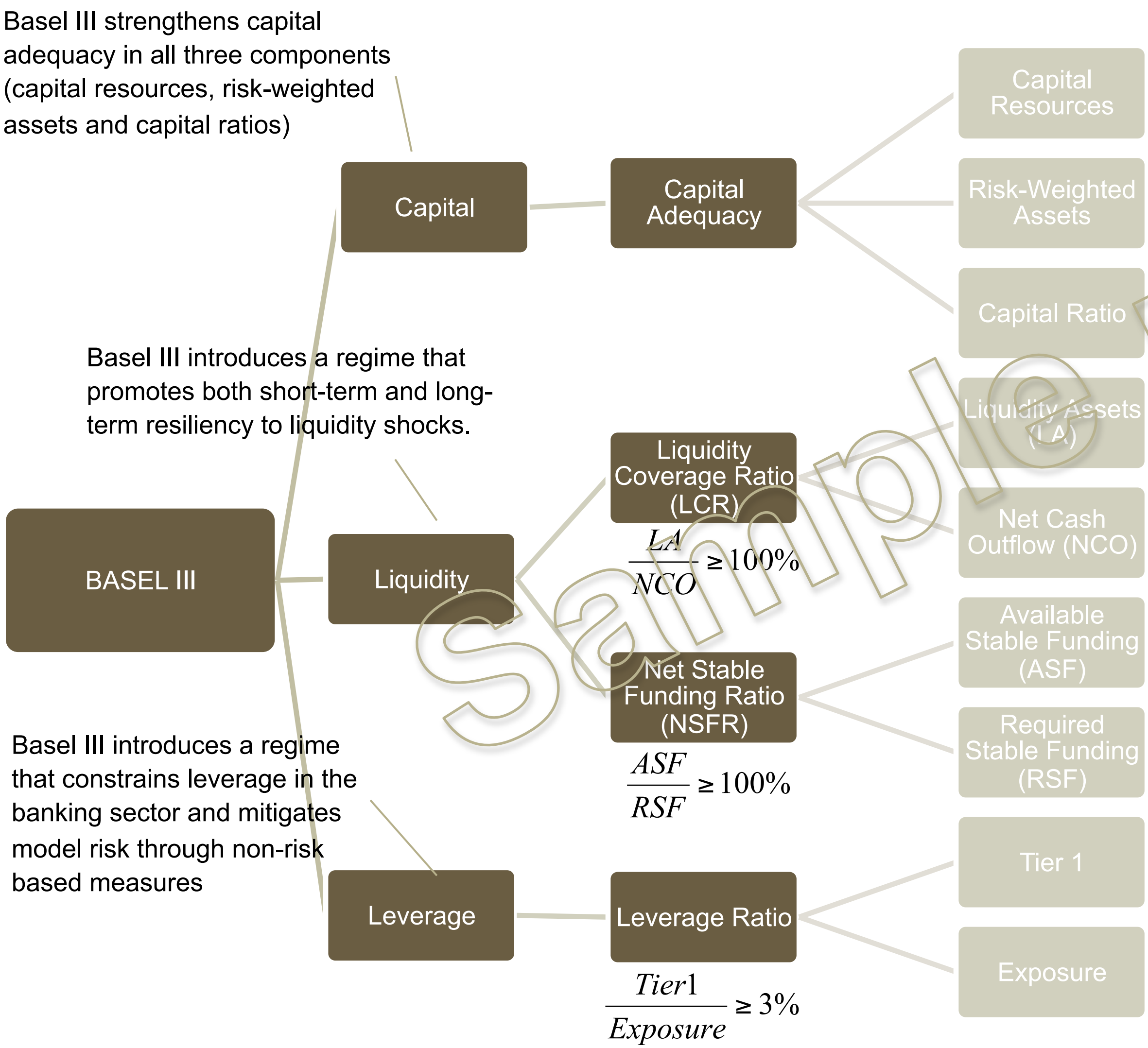


Description	Timeline
Increase to common equity Tier 1 (CET1) and total Tier 1 capital ratios including new capital conservation and countercyclical capital buffers. CET1 capital ratio increases from 2% to 7% (including the capital conservation buffer)	Increasing 2013 –2019
More robust standards and criteria to determine eligibility of instruments as capital.	Increasing 2013-2019
Strengthening of counterparty credit risk capital including new credit valuation adjustment capital charge (CVA), changes to capital treatment of collateral.	2013
Stocks of high quality liquid assets in stressed conditions; must be unencumbered and ideally central bank eligible	2015
Net cash outflow over a 30 calendar-day period under a prescribed stress scenario	2015
Equity and liability funding expected to be a reliable sources of funds over a one year time horizon	2018
Assets and exposures requiring stable funding over a one year time horizon	2018
Tier 1 capital is consistent with the measure used for capital adequacy	2018
Exposure is determined on a non-risk basis, generally following the accounting measure.	2018

Source: Banking on Basel III, Institutional Cash Distributors, 2014.

Bank of America is focusing on "Big Data" with an emphasis on an integrated approach to customers and internal operations

Bank of America.

2

NEEDS OR EVENTS-BASED MARKETING

- **The key objective of its big data efforts is understanding the customer across all channels and interactions, and presenting consistent, appealing offers to well-defined customer segments.**
- For example, the bank utilizes transaction and propensity models to determine which of its primary relationship customers may have a credit card, or a mortgage loan that could benefit from refinancing.
    - When the customer accesses the bank's online channel, calls a call centre, or visits a branch, that information is available to the online app, or the sales associate to present the offer.
    - The bank has launched a program called "BankAmeriDeals," which provides cash-back offers to holders of the bank's credit and debit cards based on analyses of where they have made payments in the past.

RISK MANAGEMENT

- The bank moved from a shared-services data modeling environment to a dedicated "Grid Computing" platform to drive operation efficiency by early detection of high-risk accounts.
- The initiative is benefiting the bank in several ways, for instance, it has reduced their loan default calculation time for a mortgage book of more than 10 million loans from 96 hours to just four.
    - The bank is also able to process ad hoc jobs at three times the speed of the previous environment.

GOVERNANCE STRUCTURE

- The bank modified its organizational structure in line with big data initiatives. The bank historically employed several quantitative analysts, but in order to support its big data initiatives, the bank consolidated dispersed analytics talent.
- BoA also set up matrix reporting lines from its analytics teams to a central analytics group as well as business units.
    - The result is improved visibility and reusability of initiatives along with providing customized services specific to a function or a business unit.

Big Data Alchemy: How Can Banks Maximize the Value of their Customer Data? Capgemini, 2014; Big Data in Big Companies, International Institute for Analytics and SAS, 2013.

Newer players, often digital-led, are providing new types of competition in multiple areas of commercial banking

1

EXAMPLES OF DIGITAL-LED PLAYERS RELEVANT TO AREAS OF COMMERCIAL/ CORPORATE BANKING

"Roughly 25% of US middle market lending is now being provided by various shadow banking players"

PayPal
Alibaba Group
Square

Payments

OnDeck
Kabbage
amazon

Digital financing

ARIBA
An SAP Company
PR PrimeRevenue

End-to-end financial supply chains

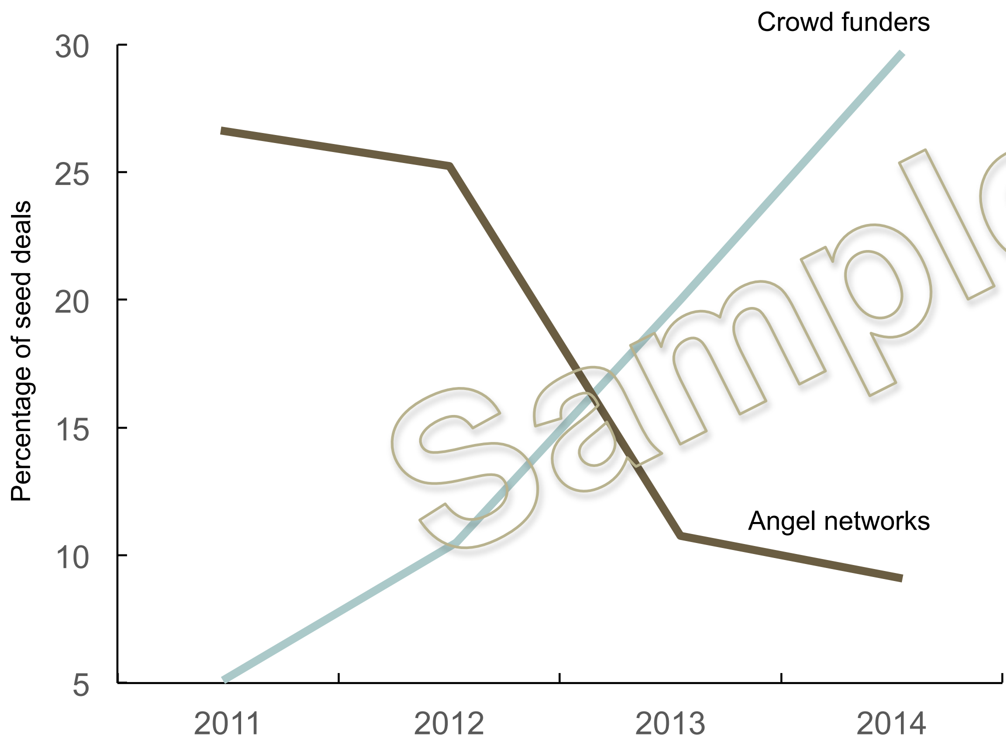
OZFOREX
Foreign Exchange Services

Monolines

Source: BCG Global Corporate Banking 2015: The Look of a Winner

In UK seed equity investment, crowdfunding has already overtaken angel investment to become the largest funding source

SEED CROWD FUNDERS VS. ANGEL NETWORKS



CROWD FUNDERS CROWD OUT ANGEL NETWORKS

"2014's biggest story was the rise of crowd funding platforms, particularly their appropriation of a significant number of seed-stage deals at the expense of traditional angel networks. More than 30% of investments into fledgling companies were completed through these platforms in 2014 and we foresee that number reaching 50% in the year ahead. Of course, the argument can be made that crowd funding platforms are really just angel networks in disguise (or even that much of their success is down to pre-syndicated angel rounds topping up on the platforms). Nevertheless, we think there's a seismic shift occurring towards more investment rounds backed by the public"

Source: Beauhurst (UK)

Behavioural economics can lead to simple but highly impactful opportunities to reframe pricing

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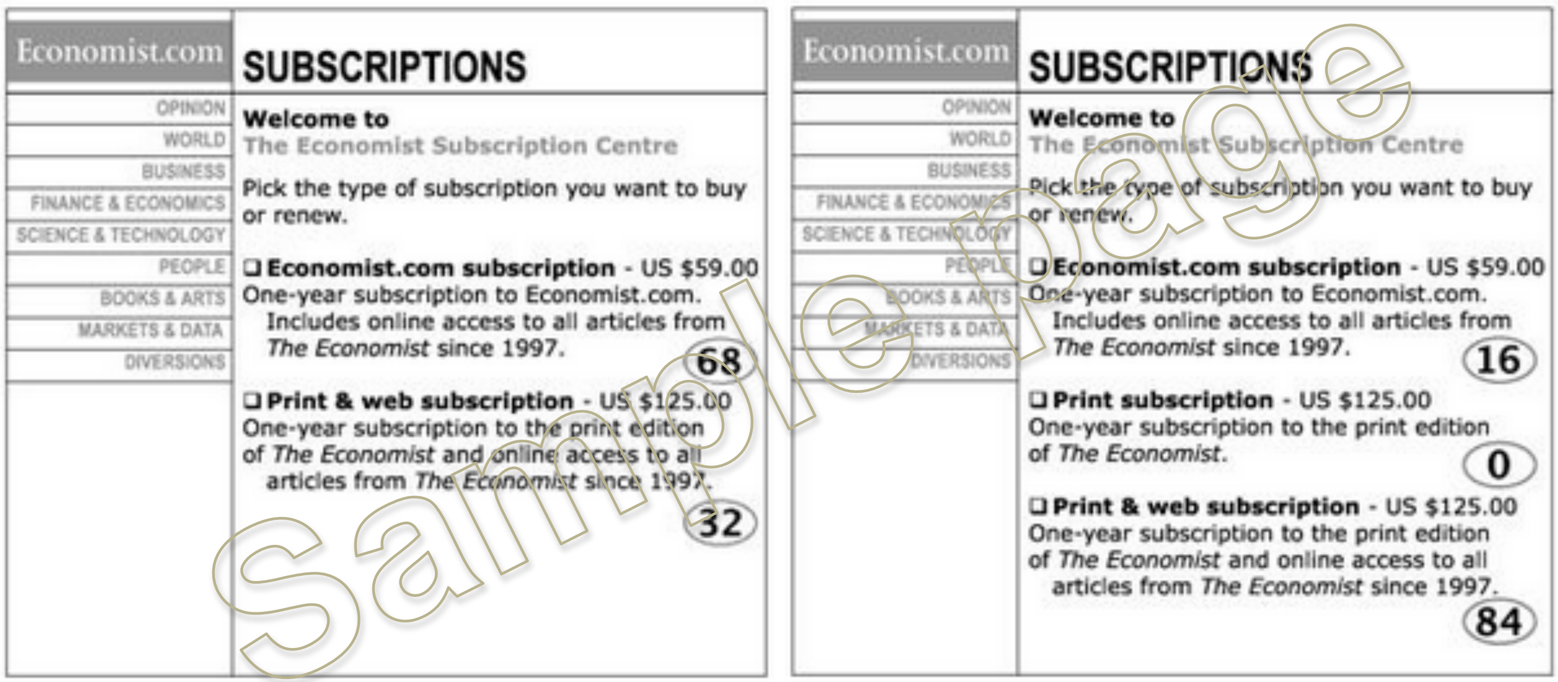
BEHAVIORAL ECONOMICS EXAMPLE – ECONOMIST SUBSCRIPTIONS



- Behavioural economics has a number of interesting and potentially powerful applications in pricing.
- In this example, MIT students were shown two different sets of offers for an Economist subscription and asked to say which they would choose.
- When offered two options – digital or print + digital, most chose the cheaper digital-only offer.
- When a third option was added, of print only at the same price as print + digital, no-one chose the new option, but most people chose the more expensive print + digital offer, which now seemed better value.

Source: *Predictably Irrational by Dan Ariely*

Relevant Articles: *The Insights Review* (an ICG publication)

Title	Source	Description
Accelerating Growth and Profits in North American Commercial Banking	McKinsey, 2014	A compact (18 page) article by McKinsey that zooms in on the commercial banking sector in North America, but also has insight that is relevant for this sector globally in terms of the five identified levers to boost performance. The article also defines three distinct business models in existence in commercial banking, which organizations and their advisors may recognize when holding themselves up to this looking glass. The performance in the sector is lumpy with top performers almost twice as productive as those at the bottom, and the three models are proxy across this performance spectrum. This spread of performance is a clear indication that there is likely room to improve. Those with only a light interest in this sector will be satisfied with an overview of the recommended initiatives to boost growth and profits, namely: • Optimize pricing; • Find new sources of growth; • Improve customer experience; • Transform the sales model; and • Build the digital commercial bank. For those that are committed to the sector, they will enjoy a deeper reading which will bring into focus the winning strategies for today and tomorrow. Excellent work by McKinsey.
Achieving Near-Real-Time Risk Monitoring	Towers Watson, 2013	An excellent how-to guide for addressing typical shortcomings in insurance risk appetite statements. Uses a combination of educational tools, conceptual frameworks and a consolidated case study to demonstrate possible improvements.
Assessing Risk Culture — Questions Firms Should Be Asking	EY, 2014	An interesting summary of the FSB's approach to assessing risk culture. Supervisors will now be assessing culture using an outcomes approach to avoid measurement issues with the various 'hows'. EY report that supervisors will be looking for four key outcomes: tone from the top; accountability; effective challenge; and incentives. Helpfully, they then provide comprehensive tables around each question using the FSB's own consultative guidelines for supervisors and sample questions. Plenty of helpful content for internal consultants charged with helping preparations.

Source: *The Insights Review (various editions) http://internalconsulting.com/store/the-insights-review/*

Acknowledgements

This report is the 23rd in ICG's series of Knowledge Area Reviews, each of which provides a comprehensive perspective on global best practice in a different business area and/or function.

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