



OLIVER WYMAN |



*EMEA Survey*

# PRICING AT EUROPEAN RETAIL BANKS



MARSH & MCLENNAN  
COMPANIES

# EXECUTIVE SUMMARY

- Price setting is an important driver of profit in retail and SME banking. Getting it right depends on a combination of analytic techniques and management processes. Improving pricing is thus a relatively low cost way of increasing revenue, requiring no major “infrastructure” investment
- What can European retail banks do to improve their price setting? That depends on how far their current pricing fall short of best practice. This Oliver Wyman report summarizes the findings of a survey of pricing practices across European banks, compares them with best practice and recommends priorities for improvement
- Our survey found that:
  - Reference prices are usually set by staff responsible for a Product (e.g. mortgage or credit card) rather than staff responsible for a Segment (e.g. affluent or small business)
  - Most banks apply few and unsophisticated techniques for setting reference prices, with most depending on “benchmarks”: i.e. following competitors
  - Price discretion varies by country (e.g. more in Spain, less in the UK) and by product (e.g. more for mortgages, less for credit cards)
  - The pricing discretion of sales staff is rarely guided by customer analytics or disciplined by price-based incentives
- These generally unsophisticated practices mean that European banks have much to gain from upgrading their pricing. We recommend they focus on:
  - Developing price setting techniques that take account of not only product features but customer (or segment) characteristics that influence risk, usage, cross-sell and price-elasticity
  - Creating pricing teams that possess the required analytical skills, capture and analyse the relevant data and act as expert advisers to those responsible for setting prices, such as product or segment managers or pricing committees
  - Extending the pricing discretion of sales staff in the products where ticket size and price elasticity warrant it, while also supporting them with pricing guidance and disciplining them with incentive payments that vary with price realisation

# 1. INTRODUCTION

John Smith opened his current account at your bank when he was a student. He is now 35 years old and employed as an accountant. He has a €400,000 mortgage with you, on which you are making a 100 basis point risk-adjusted margin. His annual bonus, €25,000 this year, has just been paid into his current account. You want him to place this money in a term deposit with you rather than at a competitor. What price should you offer him?

Banks face such pricing questions thousands of times every day, even if they go unnoticed. The right answer depends on a range of factors, such as the cost of serving the customer and his price elasticity – which itself depends on many factors, including the price he can get from your competitors and the cost of switching.

Gathering such information, and basing prices on it, is not cost free. Yet the benefits from superior pricing – in higher average margins, increased sales and reduced attrition of valuable customers – far exceed these costs. In fact, much of the required information will already be collected by the bank for other purposes, such as basic account management. And much is known to distribution staff but goes to waste because of simple deficiencies in sales processes and incentive schemes. Upgrading pricing techniques promises a better return on investment than most other strategic initiatives available to retail banks. Especially now.

The easy profit growth of the pre-2007 credit bubble has disappeared. Economic uncertainty is constraining household and business sector demand for borrowing, and near-zero interest rates make deposit margins hard to find – a problem compounded by the price war for deposits engendered by Basel III's new liquidity requirements. At the same time, customers are becoming more price-sensitive and less loyal, encouraged by the price transparency provided by the internet. In short, retail banking profits are a shrinking pie, of which each bank must therefore fight for a larger share. Clever pricing is a cheap and effective weapon in this battle.

Yet Oliver Wyman's experience working with clients has made us suspect that, with a few exceptions, European retail banks take a rudimentary approach to pricing. To test this suspicion, we collaborated with Efma to conduct a survey of 107 European retail banks and their approach to pricing. This report states the main findings of the survey, places European banks on a scale of pricing sophistication and recommends pricing initiatives that will yield the best return on investment.

## 2. SURVEY FINDINGS

## 2.1 CONTEXT

We asked respondents about the external forces that most affect their pricing. Unsurprisingly, the challenges of the post-crisis environment are the most significant. The net stable funding ratio (NSFR) requirements of Basel III mean that many European banks will be required to replace short-term wholesale funding with more stable retail deposits. This is creating a price war for deposits which, as shown in Exhibit 1, is considered the greatest external pressure on pricing. Similarly, increased capital requirements put upward pressure on asset pricing, as banks will need to pass on the increased cost of lending to borrowers.

### EXHIBIT 1: TOP EXTERNAL CHALLENGE

% OF BANKS RECORDING CHALLENGE AS 1

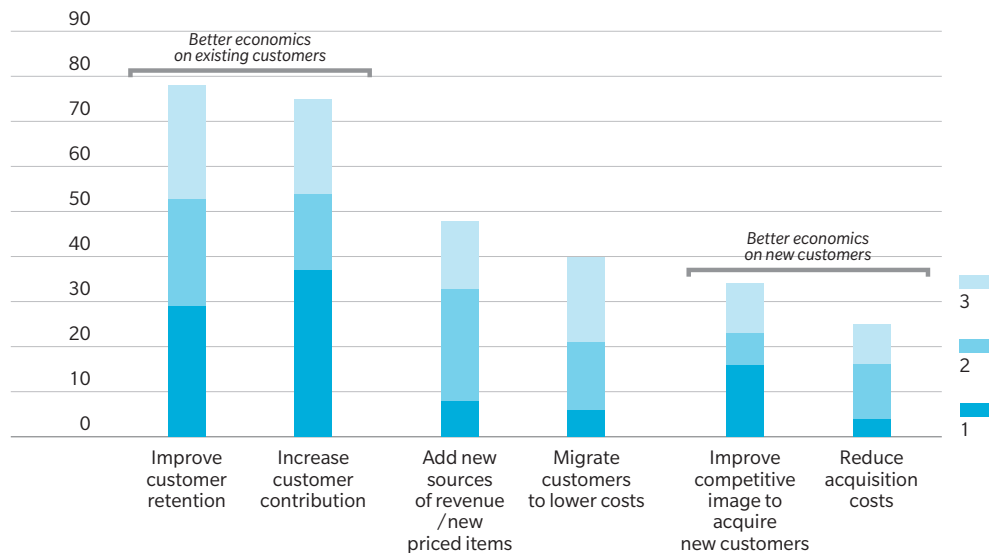


Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis

As shown in Exhibit 1, European bankers believe customer loyalty has decreased. This is feeding through to the goals of pricing, of which retaining customers and increasing their contribution are considered the most important. Bankers are more concerned with pricing to extract value from existing customers than pricing to win new ones (Exhibit 2).

## EXHIBIT 2: PRICING OBJECTIVES RANKED AS TOP 3

% OF BANKS RECORDING OBJECTIVE AS 1, 2 OR 3



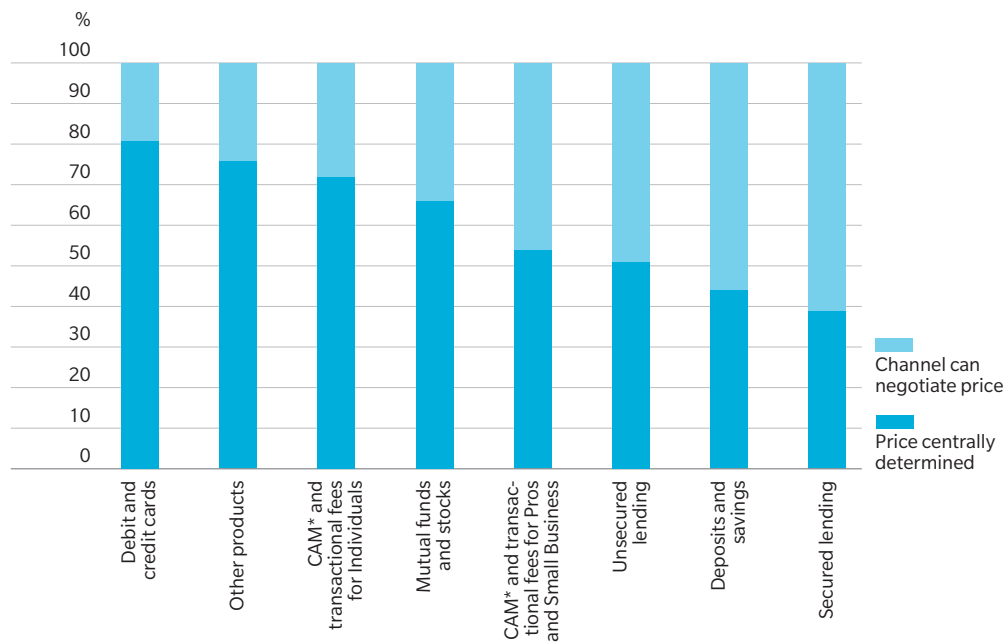
Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis

## 2.2 WHO SETS PRICES?

Who sets prices at European banks? The first question is whether they are set centrally – for example, by the product or segment group – or whether distribution staff have discretion to set prices or, at least, to vary them within specified bounds.

We found out that pricing is most centralised for transactional products, such as current accounts and credit cards. These products are typically sticky and have small balances, which means there is little to be gained from sales-force price discretion. More discretion is allowed for larger balance products, such as deposits and secured loans (Exhibit 3). This allows distribution staff to respond to customers' increased but variable price sensitivity concerning "big ticket" purchases.

EXHIBIT 3: LEVEL OF PRICE CENTRALISATION ACROSS PRODUCTS

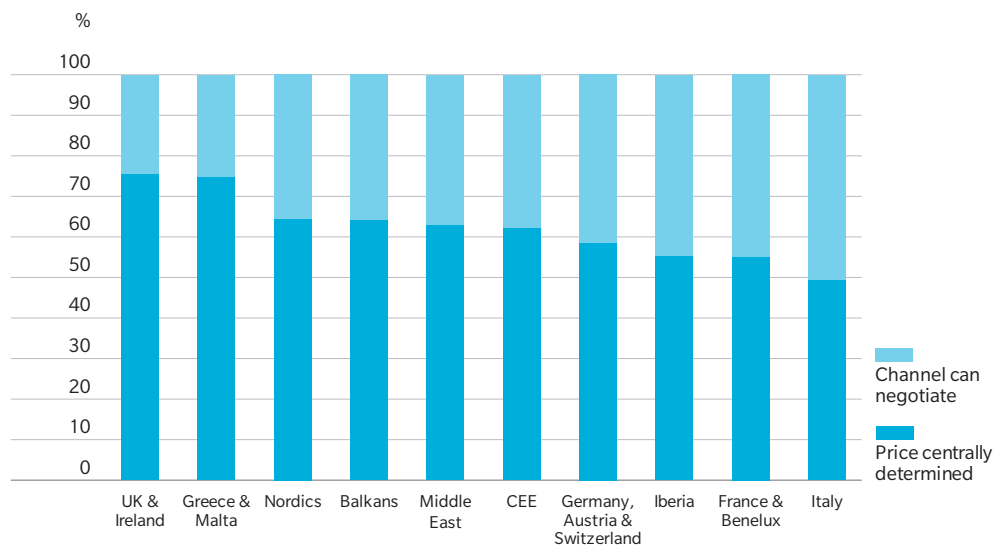


\* Current account management

Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis

The degree of price setting centralisation also varies across countries (see Exhibit 4). This roughly correlates with branch density – that is, it correlates inversely with population per branch – and so may reflect the broader “balance of power” between the centre and the regions or branches in different countries.

**EXHIBIT 4: LEVEL OF CENTRALISATION IN THE ORGANISATION BY GEOGRAPHIC LOCATION**

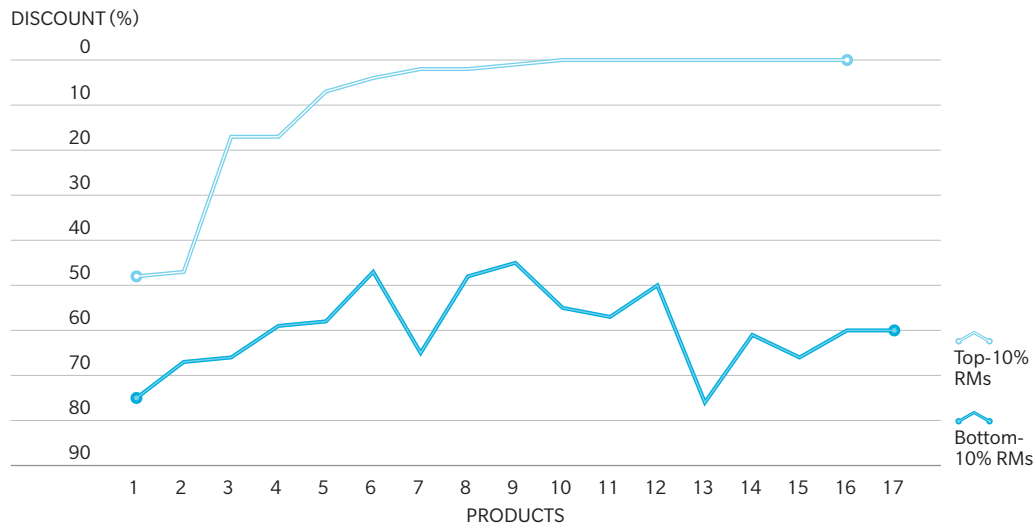


Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis



Giving price discretion to distribution staff can improve pricing because they have information about customers that is not available to central price setters. However, if price discretion is not accompanied by incentives that take account of price realisation or by supporting analytics (such as customer value simulation), distribution staff are likely to destroy value through excessive discounting. Exhibit 5 shows the different rates of discounting among RMs at a single bank with no relevant difference in customer portfolios.

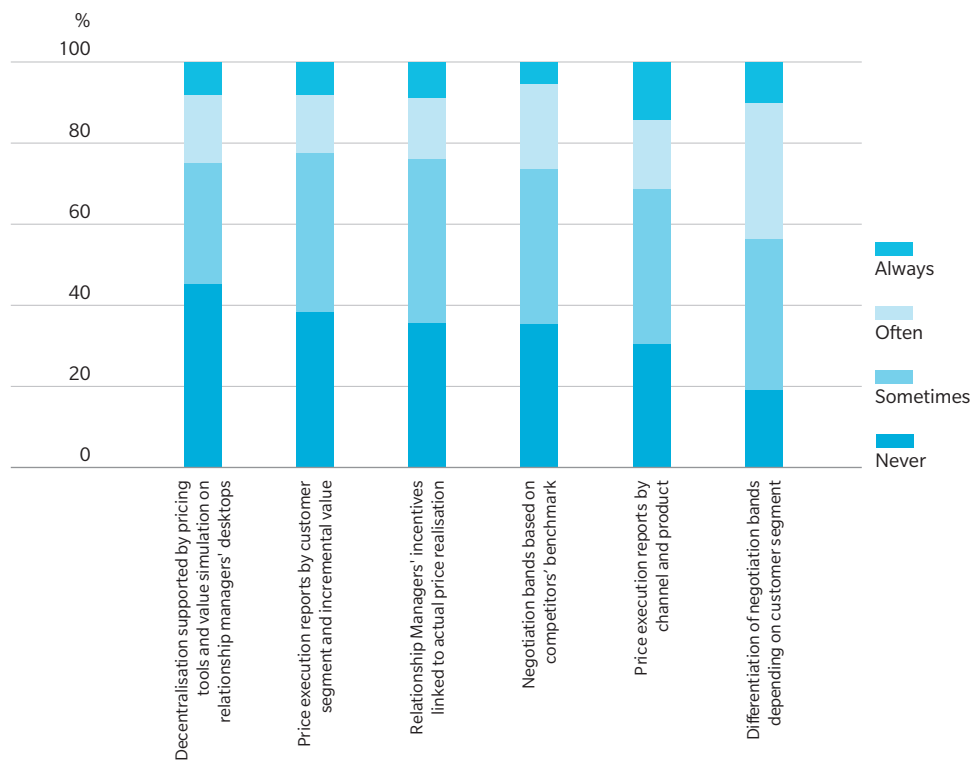
## EXHIBIT 5: PRICES



Source: Oliver Wyman analysis

Our survey showed that, with a few notable exceptions, European retail banks fail to discipline price discretion with properly designed incentive schemes or pricing tools (Exhibit 6).

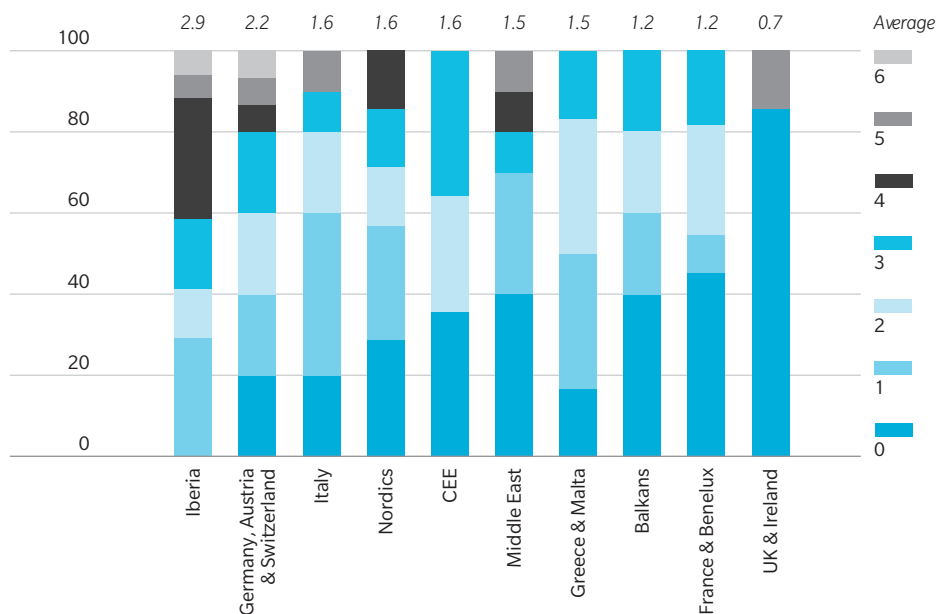
EXHIBIT 6: USAGE OF TOOLS AND REPORTS FOR PRICE DECENTRALISATION



Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis

However, our survey revealed a healthy, if imperfect, correlation between the degree of pricing de-centralisation and the number of tools used to discipline discretionary pricing (compare Exhibit 4 and Exhibit 7).

**EXHIBIT 7: NUMBER OF TOOLS TO MANAGE PRICING DECENTRALISATION**



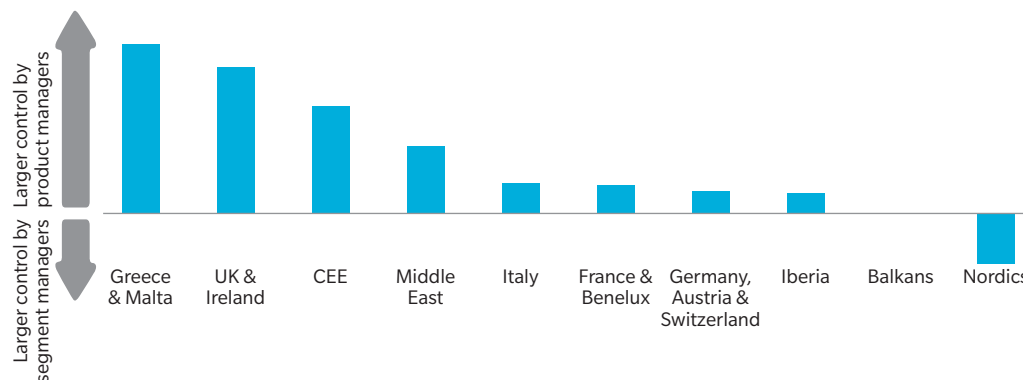
**Note:** Tools included in survey: Price execution reports by customer segment and incremental value, Relationship Managers' incentives linked to price realisation, pricing tools and value simulation on relationship managers' desktops, negotiation bands based on competitors benchmark, price execution reports by channel and product and differentiation of negotiation bands depending on customer segment.

Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis

Even where distribution staff have price discretion, “headline” or reference prices are specified by central staff. This will typically be either Product managers or Segment managers. Our survey revealed that Product managers are dominant across Europe, with the exception of the Nordic and Balkan banks (see Exhibit 8). Product managers can take segment characteristics into account when setting prices. Nevertheless, they may have an incentive to set prices in a way that maximizes returns to their product but that does not necessarily maximize the customers’ overall return to the bank.

Central price-setting, whether owned by Product or by Segment, can be the responsibility of a specialist pricing unit or of a committee of interested parties. At one of our clients, pricing teams located in product groups make recommendations that are reviewed and voted on by a committee of interested parties, including representatives of Risk, Segment, Distribution and Strategic Marketing.

#### EXHIBIT 8: METRIC OF PRODUCT VS. SEGMENT RESPONSIBILITY



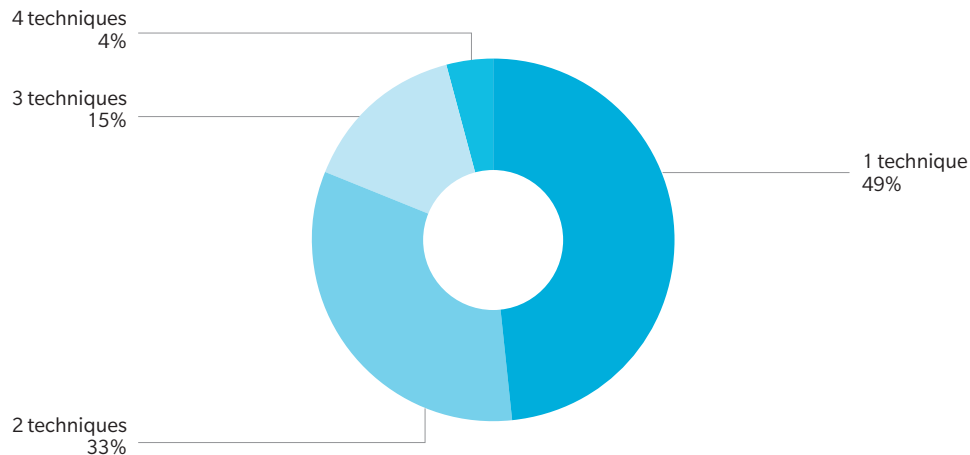
Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis

## 2.3 PRICE SETTING TECHNIQUES

There are many ways to set prices. For example, prices can be set to yield a target margin above costs, or they can be set to optimise the trade-off between unit profit and volume based on estimates of customers' price elasticity, or they can simply follow competitors' prices. We discuss European banks' use of various approaches below. First, however, it is interesting to consider how many approaches or techniques banks employ when setting prices. As Exhibit 9 shows, the answer is few.

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**EXHIBIT 9: NUMBER OF TECHNIQUES UTILISED PER PRODUCT ACROSS ALL SURVEYED BANKS**



Note: Techniques included in the survey were Competitive benchmarks, Customer price sensitivity, Customer value or risk and Price tactics

Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis

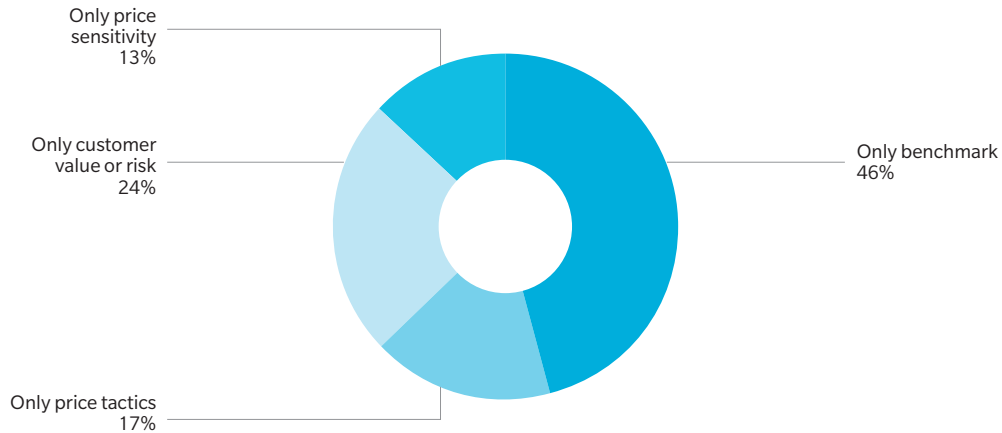
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Not only do banks employ few pricing techniques, but by far the most popular technique is the simplest. European banks mainly set their prices by competitor benchmarking (see Exhibit 10). This means that in each market, prices are effectively set by a small number of leading institutions.

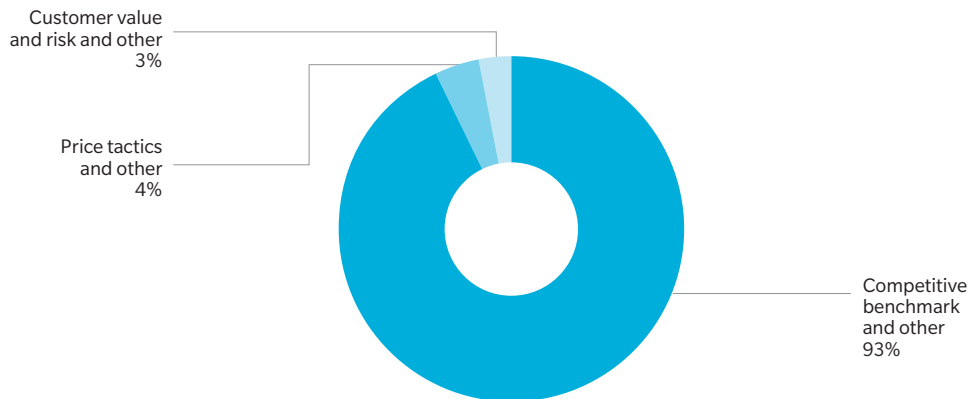
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#### EXHIBIT 10: PRICING TECHNIQUES USED

##### FOR SINGLE-TECHNIQUE PRODUCTS



##### FOR TWO-TECHNIQUE PRODUCTS

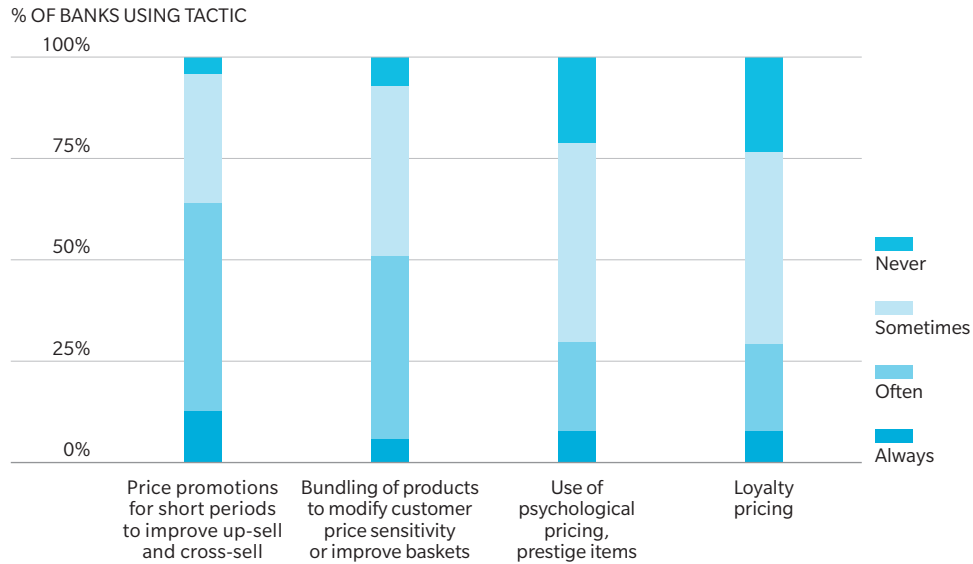


Note: Techniques included in the survey were Competitive benchmarks, Customer price sensitivity, Customer value or risk and Price tactics

Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis

As shown in Exhibit 10, 17% of surveyed banks use what we call “price tactics” (where they use only one technique). By price tactics we mean making conditional price offers to customers, such as a discount for buying now or for buying several products or for staying loyal (Exhibit 11).

#### EXHIBIT 11: USAGE OF PRICING TACTICS

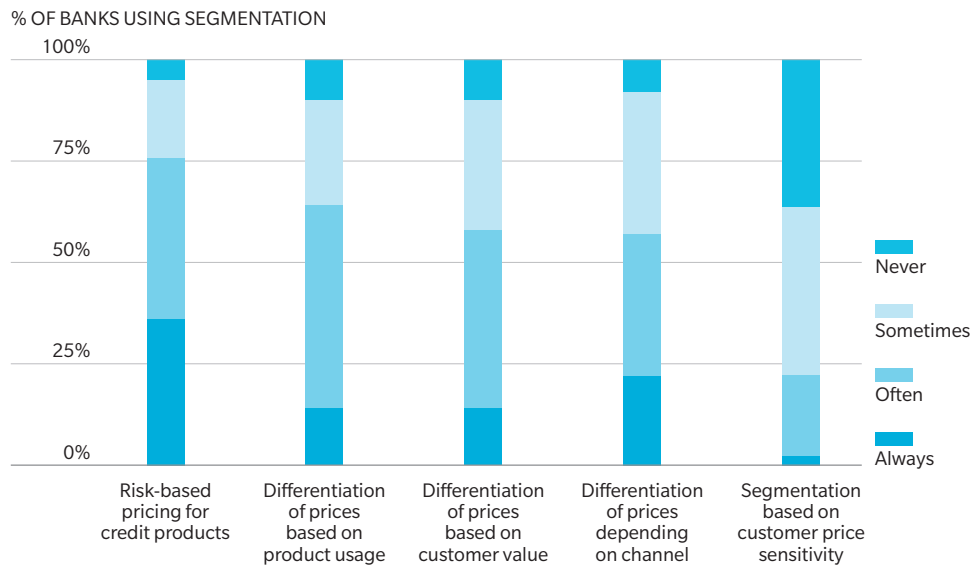


Note: 10% of respondents also submitted an alternative pricing tactic. These alternatives are not displayed on the chart

Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis

All banks segment their pricing: that is, they vary prices according to features of the transaction or customer. However, they tend to vary prices according to the most easily observed features – such as channel, ticket size or risk bucket – rather than the most relevant to optimal pricing, such as customer price elasticity (Exhibit 12 and Box 1).

## EXHIBIT 12: USAGE OF PRICING SEGMENTATION



Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis



## BOX 1: THE ECONOMIC AND POLITICS OF ELASTICITY-BASED PRICING

Customers are more price sensitive for some product than others. Size of balance, transparency of pricing and ease of switching are obvious factors. They explain why customers are more price sensitive for term deposits than for current accounts. However, price sensitivity also differs with less obviously relevant factors, such as whether the product is being purchased for the first time (more sensitive) or held after a re-pricing (less sensitive). This fact provides the rationale for products with initial discount periods.

Price sensitivity also varies with characteristics of the customer. For example, lower credit quality and less educated customers are generally less price sensitive than other customers. And characteristics that are not evident in data contained in any computer but may be apparent to a salesman can also indicate differences in price sensitivity. A customer may be obviously casual, negligent or in a hurry.

If banks develop the correct pricing models, pricing discretion and pricing incentive schemes, they can take advantage of such varying price sensitivities to significantly increase their average margins. Yet such pricing tactics are often considered improper. Customers can usually understand and accept differences in price that are explained by differences in cost to the bank, such as higher prices for higher risk or for smaller balances. But charging a higher price simply because a customer is of a less price

sensitive disposition strikes many consumers, commentators and regulators as exploitative.

Even bankers who seek only profit, and who themselves have no moral qualms about such pricing tactics, may be well advised to avoid the reputational and regulatory risks that they entail. Yet this does not mean that understanding customers' price elasticity is of no use to banks. It can still be employed for products where there is no headline price, such as unsecured loans to SMEs, provided that prices are capped so that they do not rise to levels considered usurious. And where there are headline prices, price-elasticity can be used to make decisions about discounting. For most retail banking products, this is already the relevant consideration. As with most big ticket retail products, the question is rarely who will be charged a premium to the headline price but only who will be offered how large a discount.

Price elasticity can also be used to design products aimed at well-defined customer segments. In such cases the bank is not selling the same product at various prices but various products which, like different cars, naturally have different prices. Such product and price differentiation can be genuinely beneficial to customers and to banks – just as offering different products at different prices is beneficial to car producers and consumers.

# 3. EVALUATION

Before making recommendations about where and how to improve pricing at European banks, it is important to understand how close they are to best practice. Of course, there are many facets to pricing and any given bank will be better in some than others. To make discussion manageable, we have divided pricing into three broad elements:

- Price setting method
- Organisation and processes
- Price execution

For each we have defined a “staircase”, stepping from the most basic approach to best practice (Exhibit 13).

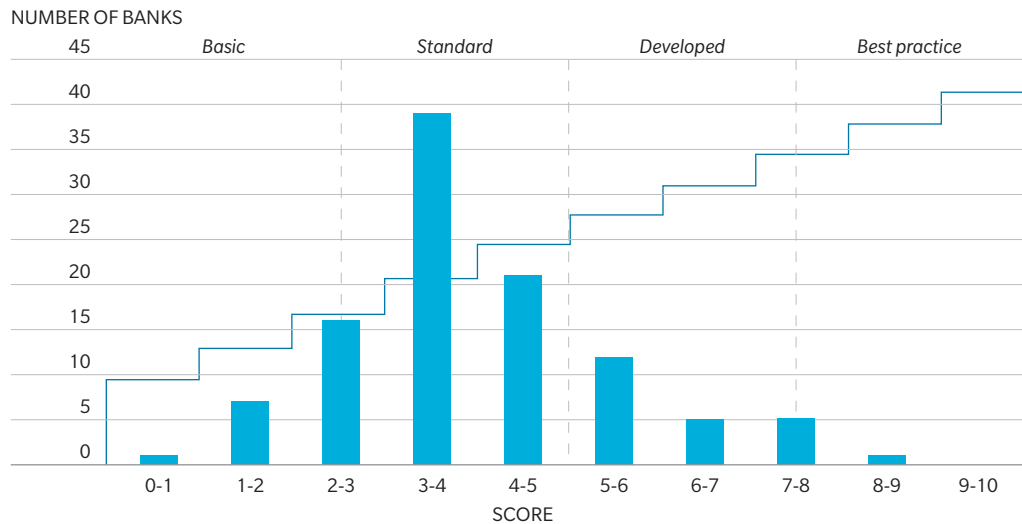
EXHIBIT 13

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From banks' staircase location in these various categories we constructed an overall score reflecting their pricing sophistication. Few achieved a "best practice" score (Exhibit 14).

Variation between individual banks is much greater than variation between national averages.

#### EXHIBIT 14: PERCEIVED DEVELOPMENT LEVEL



Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis



# 4. RECOMMENDATIONS

Most European banks can make significant progress in the three areas of pricing sketched in section 3. Although priorities will vary according to starting points, in this section we describe the developments that will be most valuable for a typical European bank.

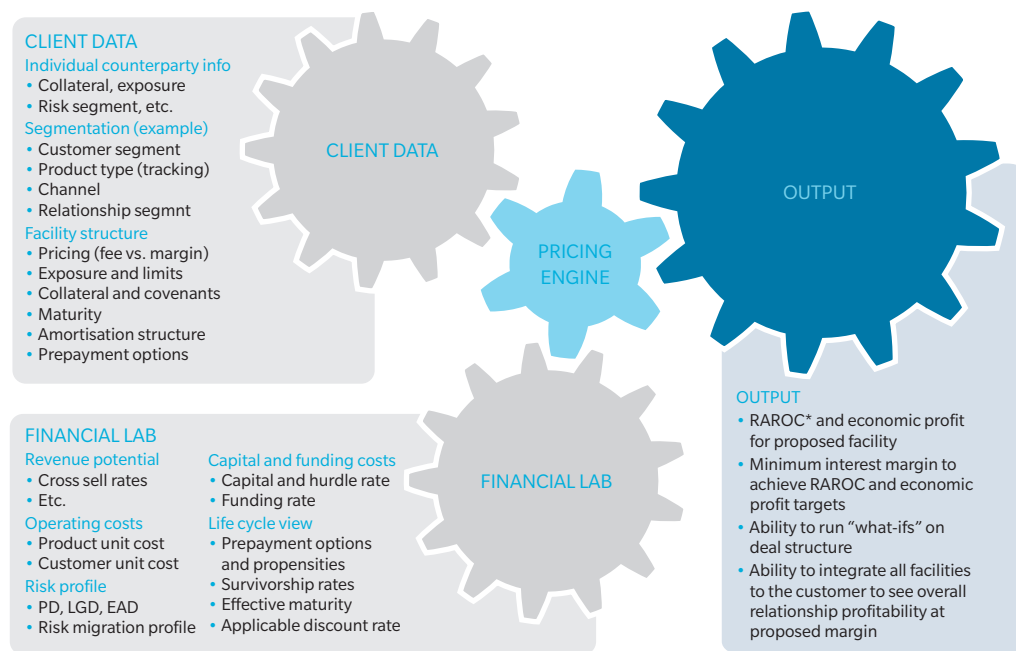
## 4.1 PRICE SETTING METHOD

Most European banks now set prices using methods that are unlikely to result in optimal prices. Ideally, prices would be set on the basis of each individual customer's price sensitivity with regard to the product in question, taking account also of the probability of cross-sales and retention, and constrained by a supply-side analysis of the risk-adjusted breakeven (Exhibit 15).

This ideal is difficult to achieve, not only because banks lack information about all the relevant dispositions of individual customers but also because regulations and reputational issues often constrain banks' ability to set prices on such a basis (Box 1).

Nevertheless, European banks could make valuable steps in this direction. Many still fail to segment customers by risk or need, and most use price elasticity curves for few if any products. Yet the data to do so is readily available, and the skills already exist at most European banks or could be acquired at relatively low cost. A pricing unit with relatively few "quants" can progressively extend advanced statistical techniques across a bank's range of retail products and customer segments (4.2 and 4.4).

## EXHIBIT 15: ILLUSTRATIVE SUPPLY-SIDE PRICING MODEL



\* Risk-adjusted return on capital



## 4.2 ORGANISATION AND PROCESS

On the basic or traditional approach, headline prices are set by product managers. Yet they have typically lacked the incentives to price for maximum return to the bank (as opposed to their own product) and lack the information and analytic support to set optimal prices even considering their product in isolation.

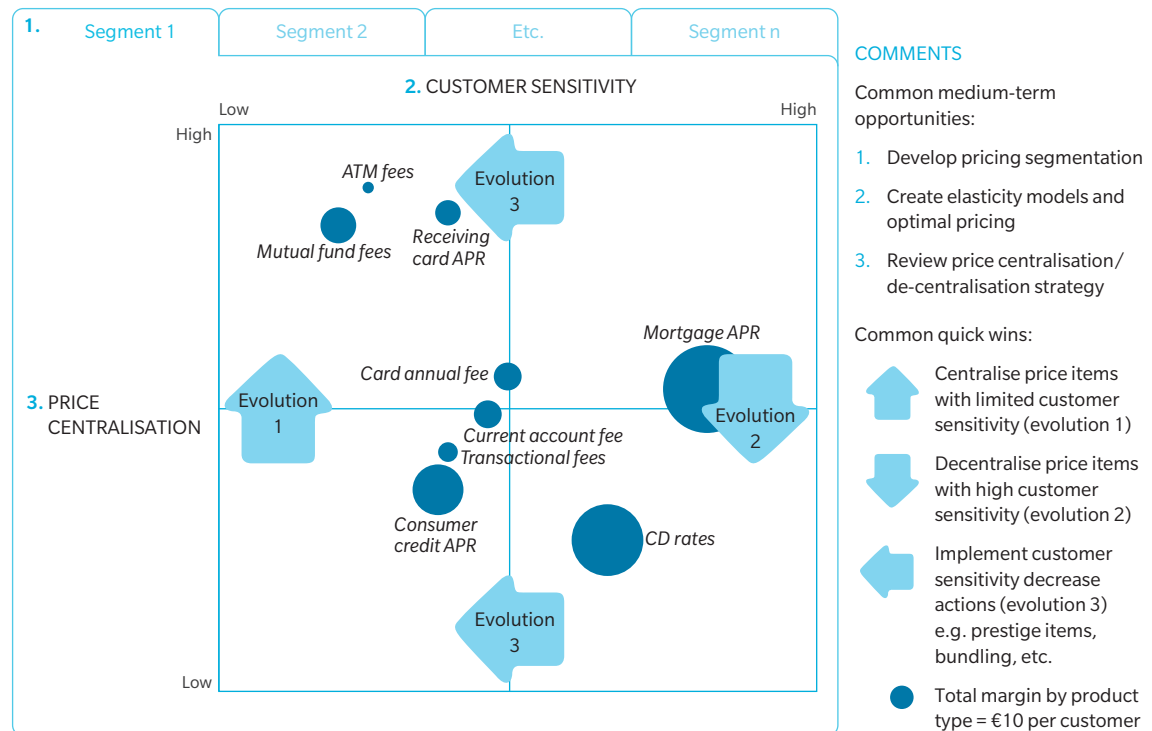
Banks should aim to shift responsibility for headline prices to committees of interested parties – Product, Segment, Risk, Marketing, etc. – guided by recommendations from dedicated pricing teams using the best data and analytic techniques available. Such organisational structure will help to ensure that pricing does not become an ill-informed internal competition whose net effect is damaging to the bank.

Under such a structure, the frequency with which headline prices change would usually increase. The specialized pricing teams would continuously monitor customer behaviour, competitor behaviour, prices realized by the network and shifting economic conditions. And they would recommend price fine-tuning that does not occur at most banks today.

As noted in section 3, the degree of price discretion for sales or distribution staff varies across Europe. Many banks would benefit from increasing the discretion they allow on some products and from decreasing it on others. The extra complication, expense and risk of allowing price discretion are generally worthwhile where product balances can be large and when customers are price sensitive, especially when this price sensitivity is more readily observed by a face-to-face encounter than on the basis of data stored in computer systems. Exhibit 16 illustrates the logic of when to extend and when to reduce pricing discretion.

## EXHIBIT 16: DIFFERENT PRODUCT PRICING STRATEGIES CAN BE DEFINED ACCORDING TO CUSTOMER PRICE SENSITIVITY AND LEVEL OF PRICE CENTRALISATION

### FRAMEWORK FOR MIGRATING PRICE DISCRETION

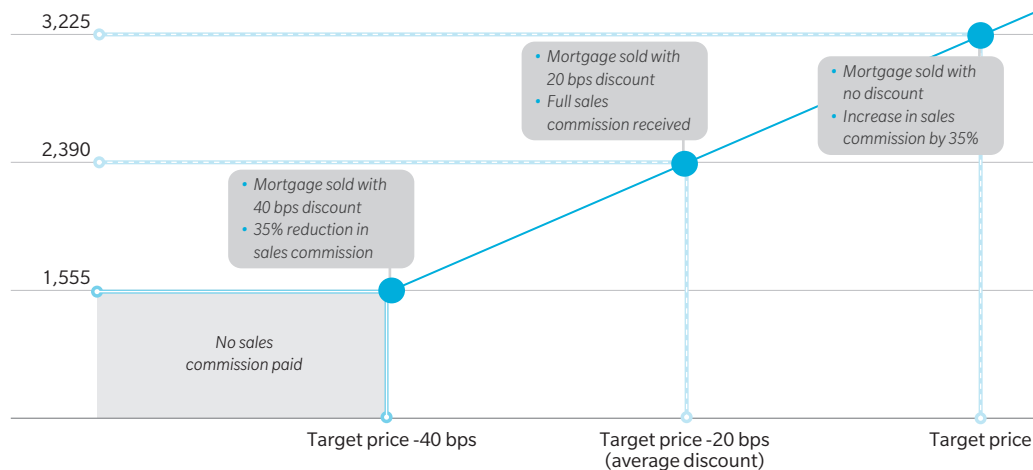


## 4.3 PRICE EXECUTION

Price discretion is valuable only when it is disciplined by the correct incentives. If a relationship manager's variable pay is based on volume alone, then he will be inclined to discount excessively. The low prices he offers will increase his sales and, hence, his bonus but lose the bank money.

To avoid such behaviour, price discretion must be accompanied by price-adjusted compensation. A seller's pricing must be judged against some pricing standards and his performance measure and variable pay adjusted accordingly. Exhibit 17 illustrates one way in which this could be achieved.

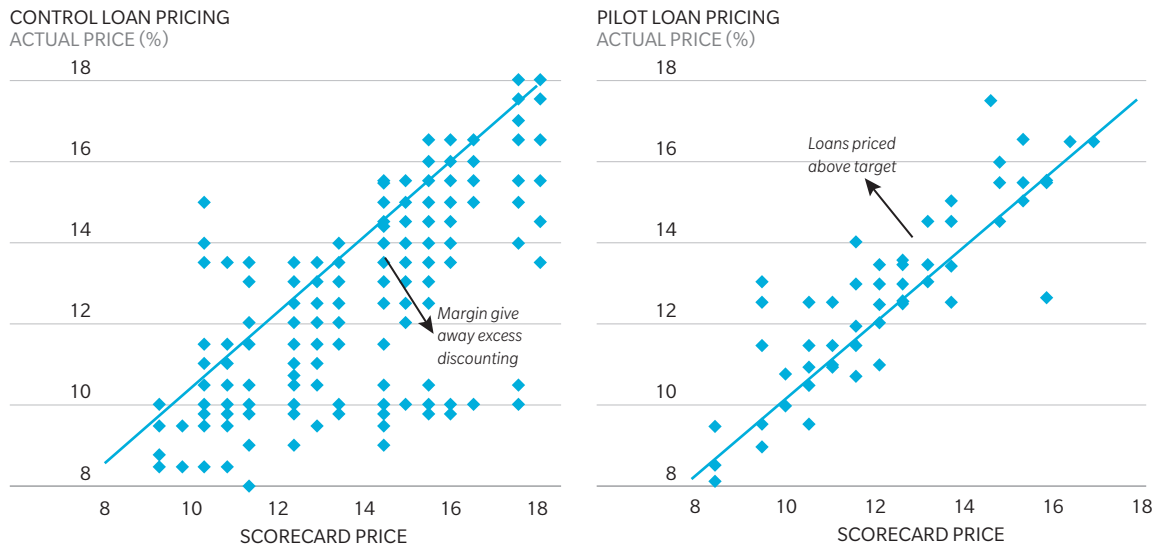
EXHIBIT 17: SALES COMMISSION RECEIVED IN THE INCENTIVE SYSTEM



Source: Oliver Wyman analysis; client example of incentive system

The results of price discretion can be further enhanced by providing sales staff with pricing support tools. These provide them with recommended prices or price ranges for products and customers with various characteristics, such as income, age, education, occupation and so on (Exhibit 15). Such tools should be developed by the teams of specialists sitting in Pricing Units, as mentioned in 4.2. When Oliver Wyman has helped clients to introduce price-adjusted compensation and pricing support tools, we have observed impressive uplifts in average pricing (Exhibit 18).

#### EXHIBIT 18: PILOT RESULTS FOR PRICING DISCRETION DISCIPLINE SCHEME (IBERIAN CLIENT)

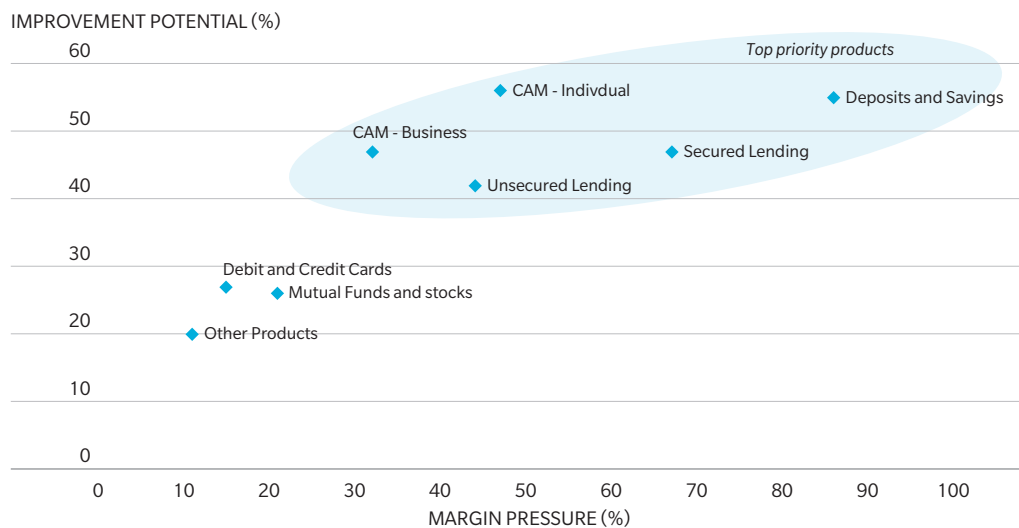


Source: Oliver Wyman analysis

## 4.4 IMPLEMENTATION

Banks cannot move to best practice pricing in all areas, all at once. They should apply their efforts to the products where improving pricing will have the greatest value. The prioritised products should be those that are under the greatest external margin pressure and that are currently priced in an unsophisticated way. As Exhibit 19 shows, this approach identifies deposits, lending and current accounts as the priority products for the surveyed European banks as a whole but this will vary by market and institution.

EXHIBIT 19: PRODUCTS IDENTIFIED AS TOP PRIORITY



Source: Oliver Wyman – Efma pricing survey; Oliver Wyman analysis

To price better banks must improve their decision making processes across a number of dimensions:

- Determine pricing strategy in line with the bank's overall customer, product and market strategy:
  - Price segmentation (at what level will you price?)
  - Competitive positioning by segment (product and customer)
  - Determination of pricing approaches and techniques in line with brand positioning and regulation
- Align price setting governance, organisation and processes to deliver pricing strategy:
  - Set up pricing units to develop insights and analysis around pricing
  - Ensure relevant stakeholders are involved in price setting, e.g. segment owners for a segment driven strategy
  - Establish a pricing timetable for price review and setting
- Develop analytics to support and challenge the pricing strategy:
  - Product and customer value models
  - Price elasticity models for the most critical product groups
  - Optimisation and what-if tools to evaluate alternative strategies and scenarios
  - Customer research and test and learn
- For products where it is relevant, develop or improve tools and processes to manage price discretion. This includes setting price discretion limits, monitoring price realisation and aligning of incentives with price realisation

In the absence of such improvements, European banks will miss out on one of the few opportunities for profit enhancement and risk being left behind by their most sophisticated competitors

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For more information please contact the marketing department by email at [info-FS@oliverwyman.com](mailto:info-FS@oliverwyman.com) or by phone at one of the following locations:

EMEA

+44 20 7333 8333

AMERICAS

+1 212 541 8100

ASIA PACIFIC

+65 6510 9700

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