

Open banking

Potential pricing implications

March 2018

Information about a customer's financial position and transactions has been a key source of competitive advantage for established financial institutions. The move to open banking will result in the ownership of this customer information moving from financial institutions to customers, enabling them to share their transaction and other data with third parties.

The combination of more information on customers' credit profiles, and the ability for customers to share this information with a broader range of suppliers, reduces barriers to entry and potentially places additional competitive pressure on bank profitability.

In Australia a component of open banking, [Comprehensive Credit Reporting \(CCR\)](#), also referred to as positive credit reporting, was scheduled to become mandatory on 1 July 2018. In June 2018 the Australian Senate proposed delaying the implementation of CCR for 12 months with concerns about the impact on vulnerable customers. When it is introduced CCR is specifically intended to increase competition in the Australian financial services market.

Put this together with the fact that these changes are occurring in a market which is experiencing increased regulatory capital requirements, slower growth, and margin compression, and you have transformative change.

As customers increasingly use online price comparison websites, as well as mortgage brokers, 'shopping around' for the best offer and the best price has become easier and more effective. This increased demand for price transparency and price matching could also fuel a growing willingness by customers to switch banks. The exchange of customer data under open banking and CCR looks set to accelerate these trends and level the playing field between incumbents and new entrants, increasing competition¹.

The result?

Any traditional competitive advantage the banks had from owning customer data will disappear. Their advantage will now come from being able to use this data to own the customer relationship, so they can better understand customers' needs and make more refined credit assessments. In this environment banks will need to ensure they have an integrated and innovative framework to pricing.

Notes

¹ Deloitte, Open Banking: How to flourish in an uncertain future, June 2017. See also: <https://www2.deloitte.com/uk/en/pages/financial-services/articles/future-banking-open-bankingpsd2-flourish-in-uncertainty.html>.

The action? Adopt a more holistic approach to pricing

Traditionally, financial institutions have used actuarial methods to price lending. These methods reflect the cost of serving a customer, based on their current characteristics. They don't account for the total lifetime of the customer relationship, any likely changes in a customer's risk profile, or the perceived value being provided to the customer. As open banking uncouples products from distribution, financial institutions will need to become more strategic about customer pricing.

This requires financial institutions to look at three customer characteristics:

1. Customer profitability: risk, cost-to-serve and cost-to-acquire
2. Customer price elasticity: how will price drive the likelihood of purchase or renewal
3. Customer life time value.

When combined, these elements price a service from a customer rather than a product perspective. A variation on any one of these dimensions can have a significant impact on a lender's profitability and market share.

By adopting strategic pricing financial institutions are:

- better placed to understand what customers value, and so review the product portfolio
- able to match the right price with the right customer by segmenting their pricing more effectively across different customer segments based on a combination of varying risk and varying degrees of perceived value in products or service
- sure of the cost drivers across customer and product segments.

Price optimisation analytical framework



Greater competition delivers better consumer results

The Productivity Commission's draft report into competition in financial services has noted that: "Rivalry through price competition is rarely evident" in Australian bankingⁱⁱ.

As consumers get greater transparency and clarity around credit reporting, lower-risk consumers are likely to demand more competitive rates. At the same time smaller lenders and new entrants will have an improved ability to assess risk as a result of the additional credit and repayment information to which they will now have access. This is likely to result in increased competition for lower risk customers.

The introduction of open banking and CCR are likely to mean that financial institutions will face competitive pressure to reduce interest rates and fees across all of the credit facilities they provide to customers. In response financial institutions will need to consider implementing strategic pricing, such as risk based pricing, at an individual customer level.

Banks with more advanced analytic skills which adopt this method will be able to offer more sophisticated approaches to their customers. Though slower to develop in retail lending, individual risk-based pricing is more prevalent in the insurance industry where global players are embedding advanced machine learning approaches into their pricing operations.

Individual credit scoring will ensure financial institutions can assess, price, and manage the risk associated with each customer individually. This can occur at origination and throughout the life of a loan. It also lets a financial institution adjust the price according to the depth of the relationship, on whether the customer wants a single product or multiple products and their loyalty. When these factors are correlated with customer risk and customer lifetime value, you have risk-based pricing.

As well as the additional credit information available under CCR, these risk based pricing models could also include:

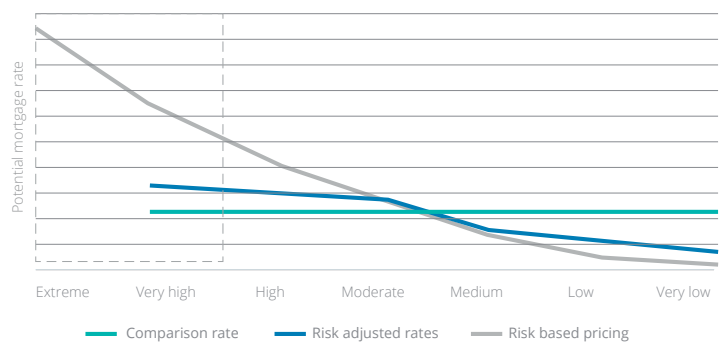
- financial information such as income, expenses, credit history, other periodic payment commitments
- demographic information including age, education, family status, location, and occupation
- behavioural information like loyalty and payment history, as well as social media data.

Risk based pricing is an example of price innovation at play

By varying pricing to more accurately reflect a customer's risk, rather than their bargaining power, risk based pricing lowers the cost of credit for lower risk customers, while higher risk borrowers are provided credit, albeit at a higher price.

The price of most lending in Australia is currently based on a standard variable rate (SVR) or benchmark rate for a product.ⁱⁱⁱ

Variable interest rates



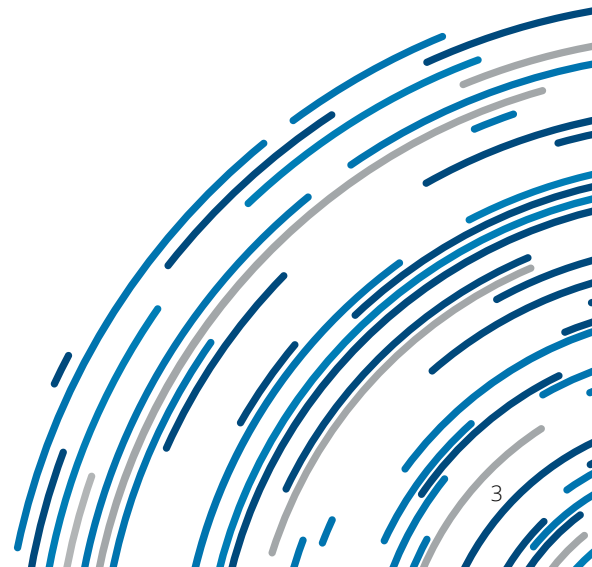
Although discounts are provided to some customers and fees, such as mortgage insurance, are charged to others, these price adjustments often reflect customers' bargaining power, or an institution's desire to win new business or retain existing business, rather than the underlying risk of the customer.

Non-price risk adjustments, such as minimum deposit levels, and maximum loan amounts are also used to differentiate risk. However, where they do occur, risk adjustments are typically only applied to an individual product, such as a mortgage, rather than to all of the credit exposures of a customer.

Notes

ⁱ Productivity Commission, Draft Report, "Competition in the Australian Financial System", January 2018. See also: <http://www.pc.gov.au/inquiries/current/financial-system/draft>

ⁱⁱ Productivity Commission (2018) op. cit.



Transitioning to strategic pricing

Financial institutions need to look at all three components of their pricing framework: profitability, price elasticity and customer lifetime value.

By focusing only on current profitability organisations may exclude customers whose risk profile, and profitability, will improve over their lifetime.

If organisations focus just on risk, they could see a significant reduction in business, as people who are higher risk also tend to be more price elastic. In addition, there is a higher risk of adverse conduct outcomes.

Financial institutions should increase their pricing sophistication across each dimension – profitability, price elasticity and customer lifetime value – in order to mitigate the risk of unintended consequences.

An example of unintended consequences is redlining^v – denying services to certain ethnic groups through selective price discrimination^v. In the United States banks and insurers have been accused of defining zones in which minorities are unable to access financial services at reasonable rates (or at all) through an over-reliance on a risk-based view of the world^{vi}. If credit is provided based only on a customer's current credit scores organisations risk ignoring an individual's propensity to improve their credit risk profile over their lifetime.

Implementing strategic pricing

Lenders will need to be able to answer the following questions:

1. Is our pricing framework strategic or tactical?
2. Are our pricing decisions made on the basis of customer risk or product risk?
3. Does our current pricing reflect the risk of a customer or their bargaining power?
4. Can we adequately explain to a customer why their pricing differs from a base-rate price, and what actions they could take to improve the pricing by improving their credit worthiness?
5. Is our review of customer pricing active and based on specific events experienced by a customer?
6. Do we review customer pricing over the lifetime of the customer?
7. Are our pricing decisions consistent with our conduct obligations on fairness and transparency?
8. Do we have the right data and analytic capability to implement strategic pricing?
9. Have our risk assessment models and pricing algorithms been robustly developed and tested?

Notes

^v Badger, Emily, "Redlining: Still a thing", Washington Post, 28 May 2015. The word has particular roots in the 1930s when the government-sponsored Home Owner's Loan Corporation first drafted maps of American communities to sort through which ones were worthy of mortgage lending. Neighborhoods were ranked and color-coded, and the D-rated ones — shunned for their "inharmonious" racial groups — were typically outlined in red. See also: https://www.washingtonpost.com/news/wnk/wp/2015/05/28/evidence-that-banks-still-deny-black-borrowers-just-as-they-did-50-years-ago/?utm_term=.20347640bf58

^{vi} Human Relations Commission, Pennsylvania (2017-09-27). "Unlawful Discriminatory Predatory and Reverse Redlining Guidelines in Housing and Commercial Property". See also: <http://www.phrc.pa.gov/Resources/Law-and-Legal/Documents/Policies%20and%20Guidelines/Predatory%20Lending%20Guidelines.pdf>

^{vii} Glantz, Aaron and Marintez, Emmanuel, "For people of color, banks are shutting the door to homeownership", Reveal News, 15 February 2018. See also: <https://www.revealnews.org/article/for-people-of-color-banks-are-shutting-the-door-to-homeownership/>

The last word

Retail banking globally is about to undergo what has the potential to be a seismic shift driven by changing consumer preferences, regulatory changes opening up bank data, and technology-enabled innovation. Opening up banking data carries an inherent threat of commoditisation for incumbent banks and presents growth opportunities for challenger banks, fintechs and others.^{vii} Access to high quality credit information as a result of comprehensive credit reporting should lead to better credit decisions and an improved credit environment for customers.

As competitive pressures increase, financial institutions are adopting more sophisticated pricing strategies. Strategic pricing has been enabled by advances in data availability and analytics and is supported by algorithmic pricing, machine learning tools and open APIs.

As financial institutions transition to value-based strategic pricing, it is critical that they take into account the three critical pricing dimensions of customer profitability, customer price elasticity and customer lifetime value, as well as the implications around conduct and fairness in pricing.

Notes

^{vii} Deloitte, Open Banking, (2017) op. cit.

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