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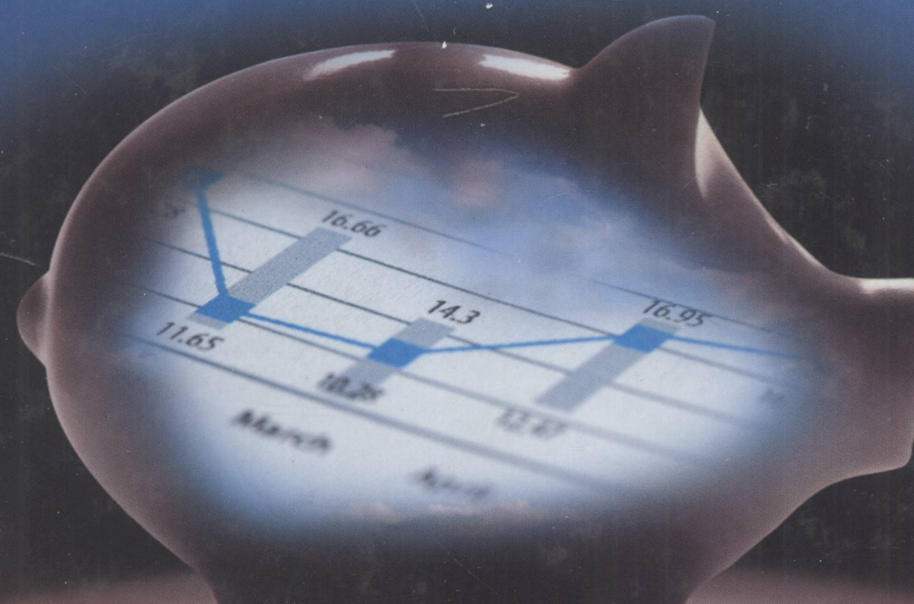
Price Management in Financial Services

Smart Strategies for Growth



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Introduction

CHAPTER 1

The term "price management" was coined by Simon and Dolan in their 1997 book *Power Pricing*. Two of the most globally recognized thought leaders in pricing research and advice, the authors described their approach to pricing as follows: "Progressive businesses proactively use pricing as a tool for achieving their goals. These advocates of 'price management' recognize the importance of pricing in determining profit and develop deep pricing competencies to consistently deliver improved profits for their companies."

This book is about applying these principles to the financial services industry. We lay out the fundamentals of pricing in a concise and practical format, show how managers can successfully apply them in practice, and explain why pricing is capable of giving businesses a competitive edge. The book is, to a large extent, based on hundreds of strategic pricing projects conducted by the authors at Simon-Kucher & Partners, the most recognized pricing consultancy in the world. Throughout the book, we provide concrete recommendations for optimal price management.

The reader will be provided with recommendations on: price wars, strategic aspects of pricing, effect of price on sales volume, price optimization, intelligent forms of price differentiation, as well as pricing process and pricing organization. Overall, the aim of the book is to provide an understanding of the effects of price on sales and profits and to demonstrate ways for pricing professionals to use pricing to increase profits.

The book will answer a variety of key management questions, including:

- What are the reasons for the increased importance of pricing in financial services institutions, and how can pricing be used to increase profits?
- Why are pricing principles needed, and how can these be developed?

- How should financial services institutions position themselves in the market with regard to pricing, and what is an appropriate price and product strategy?
- What are the reasons for price wars in the financial services industry, and what strategies can be deployed to avoid price wars?
- What is a price-response function and how can this function be reliably determined to optimize prices for financial services products?
- What is a pricing process and how can a systematic pricing process be developed?
- What effect does brand have on pricing, and vice-versa?
- What intelligent forms of price differentiation exist (e.g. interest rate tiers, added-value account packages, and family prices)?
- What psychological aspects should be taken into account in pricing (e.g. customer perception of interest rates and discounts) and what are their implications for price communication?
- What effect does pricing have on the organization and is there a need for a "Head of Pricing" position in financial services institutions?
- What aspects of price implementation should be considered (e.g. enforcing prices in sales negotiations)?
- How should pricing be monitored by financial services institutions?
- How can the challenges of pricing in different business areas (e.g. B2B, B2C or fund business) and segments (retail, private banking and commercial customers) be solved?

Throughout the book, answers to the above questions are revealed with the help of numerous case study examples.

The book consists of nine chapters.

Setting the scene in Chapter 2, we explore the fundamentals of pricing and why pricing is growing in relevance. We point out the key drivers raising the importance of pricing throughout the financial services industry, and draw particular attention to the damage caused by price wars – common in today's fiercely competitive markets.

- In Chapter 3, we provide the reader with an overview of the fundamental building blocks of pricing and examine how pricing and strategy interact.
- In Chapter 4, we explore price optimization methodologies and use case studies to show how optimization methods have been successfully implemented by financial services organizations around the world.
- In Chapter 5, we go beyond the basic methodologies of price optimization and get to the heart of pricing. Using various case studies, we show how to apply key pricing strategies in the financial services industry, including price differentiation, price bundling, non-linear pricing and multi-person pricing.
- Chapter 6 describes the key psychological aspects of pricing (price awareness, price perception, price image and price thresholds) and shows how financial services organizations can make use of them.
- In Chapter 7, we show how to confront the various obstacles encountered when putting pricing decisions into action. We explore the important question of what a manager should consider when implementing pricing strategies (pricing organization, pricing information systems, price enforcement).
- The case studies in Chapter 8 provide a step-by-step account of pricing in action. We demonstrate how financial services companies have implemented pricing. The pricing methodologies described in the book are at the center of each example.
- The book's final chapter provides managers with an overview of the key learnings from the book.

Fundamentals of Modern Pricing

CHAPTER

2

Increasing relevance of pricing

Many businesses set prices using a combination of instinct, rule of thumb ("we base our prices on our main rival or competitors") and subjective opinion. Financial institutions are no different. This approach to pricing all too often results in lost revenues and strategic mistakes. Headlines describing the consequences of such pricing mishaps are becoming more prevalent: "Direct banks are putting margins under pressure"; "... in times of increasing price sensitivity"; "Bartering at the bank counter"; "Disastrous price wars ...". In a research study conducted by Simon and Dolan (1997), 187 executives in Europe and USA, including financial services managers, were asked about the areas of marketing in which they experienced the most competitive pressure and faced the greatest problems. The results placed pricing at the top of the list.

Price is not only important from the competitor perspective. A wide variety of market studies support the notion that price is increasingly becoming a key customer requirement in financial services. The depersonalization of financial services through online and tele-banking channels partially explains this trend. Customers require fewer of the institution's resources and expect prices to reflect this fact. This presents significant challenges in the pricing of financial services products. The key drivers that have led to a change in the landscape of the financial services industry and a greater reliance on price management are set out in the following section.

INTERNET-ENABLED PRICE TRANSPARENCY AND COMPARABILITY

In 2008, the percentage of US households with Internet access hit 70 percent. This percentage will continue to rise as will the level of mobile phone penetration. Recent studies report that around two thirds of all Internet users compare prices online. The importance of online banking is similarly increasing, and this trend is occurring around the world. Approximately 47 percent of EU citizens use the Internet regularly (at least once a week at home or at work). In Germany, the number of online accounts has increased from 3.8 million in 1998 to over 35 million today.

The proliferation of Internet usage across the world has allowed suppliers to reduce costs and pass savings onto customers. Checking accounts that actually pay customers a monthly incentive to use online services have sprung up in the market. In the US, the aggressive pricing of online brokerages such as Charles Schwab and TD Ameritrade has forced traditional banks such as Bank of America to continuously decrease prices and to even offer selected customer segments free trades.

INCREASING REGULATORY REQUIREMENTS

Around the globe, regulatory authorities are increasing their influence on the pricing of financial services products. Since 2003, the Swiss Investment Fund Association (SFA) has required its members to include a "Total Expense Ratio" (TER) in any investment fund price quote. In doing so, the SFA, together with the Swiss Stock Exchange, has attempted to bring transparency to the fund market. As a result, more than 90 percent of all authorized investment funds now provide a TER. Providers like e-fundresearch.com regularly calculate the average TER for various fund types in Switzerland. This level of transparency clearly increases price pressure for those providers whose services are more expensive than the published benchmark.

In the UK, the Office of Fair Trading (OFT) has increased its level of intervention in the UK financial services market. In order to limit the penalty that credit card issuers can charge customers on late payment of monthly interest charges, it has placed a ceiling on late payment fees. Similar intervention is expected for unauthorized overdraft penalties for checking accounts.

CHANGE IN CUSTOMER BEHAVIOUR

The needs of banking customers change significantly over time. Whereas once customers expected personal service at a bank branch, they now demand high quality electronic banking services. As a consequence, the need for banks to develop personal relationships with customers has become less important. Direct banks and insurers are at the forefront of this market development. In 2008, the number of US households using online banking reached more than 40 million (80 million in Europe). From a customer perspective, the cost savings from a "self-service" online bank far outweigh any lack of personal service. Research suggests that only one in 20 direct customer interactions with a bank employee are for a personal financial consultation. Indeed, around 40 percent of customers surveyed indicated that they would prefer to visit their local bank less often in the future – an alarming trend for incumbent banks with significant branch networks. While this points in the direction of the continued growth of direct banks, incumbent banks must respond by developing value-added products and services supported by innovative pricing (see Chapter 5 for more detail).

UNCERTAIN ECONOMIES LEADING TO HIGHER PRICE AWARENESS

In many developed economies, declining real income and employment market uncertainties have created a culture of increased price awareness. For example, ING Direct has grown in the US from a virtual unknown to a powerhouse with more than 5 million customers and more than $62 billion in assets by positioning its products as "Simple, Quick and Cheap". In Germany, ING DiBa has brought in more than 6.5 million customers and more than €76 billion in total assets with this strategy. ING Direct is currently the world's leading direct savings bank with over 18 million customers worldwide.

NEW COMPETITORS WITH AGGRESSIVE PRICING AND INNOVATIVE OFFERINGS

The range of competition in the market has widened through the advent of new products, innovative and differentiated pricing, as well as more aggressive communication strategies. An ever increasing variety of businesses are competing for the same customers. This growing list includes financial services arms of retail businesses, such as BMW Financial Services (Germany), Marks & Spencer Money and Tesco Personal Finance (UK). Through more aggressive marketing, sales campaigns, and low prices, these new entrants have built up sizable customer bases, winning market share from incumbents.

There has also been an emergence of rewards and loyalty programs. More and more businesses, from retail companies to airlines, have started issuing credit cards with the aim of reducing customer churn and increasing cross-selling opportunities. MBNA Europe Bank (UK) issues credit cards on behalf of popular English football clubs: Chelsea's Rewards Credit Card, the official 5 star Liverpool FC Rewards Credit Card, and the Manchester United Credit Card are all tailored to the clubs' fans and can be linked to customized benefits (e.g. discounted ticket prices).

INCREASING GLOBALIZATION OF BANKS

Globalization has changed the role of international price management in financial services. Merging customer habits and industry standards, lower trade barriers and IT costs, and increasing transparency of information