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Internal Consulting Group

Knowledge Area Review (KAR 024)

Pricing in Retail Banking – Product Brochure

July 2015

KAR 024: Pricing in Retail Banking
Report overview and sample pages

What is this report?

- ICG's 24th Knowledge Area Review (KAR), covering global best practice in retail banking pricing.
- Over 164 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 August 2015.

What questions does it answer?

- What is the history and evolution of pricing in Retail Banking?
- What is the structure and range of delivery approaches for pricing capabilities?
- What are the core tactics for the pricing decision?
- How is pricing managed and monitored?
- What is the current "state of the art" in pricing?
- What could be around the corner for retail banking pricing over the next few years?

Why buy it?

- Get smart quickly and in depth on pricing for retail 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 pricing approaches and develop a roadmap for change against global best practice principles using key takeaways for each chapter and a simple evaluation matrix and pricing trend radar included in the material
- Save time and money in kicking off major pricing improvement efforts.

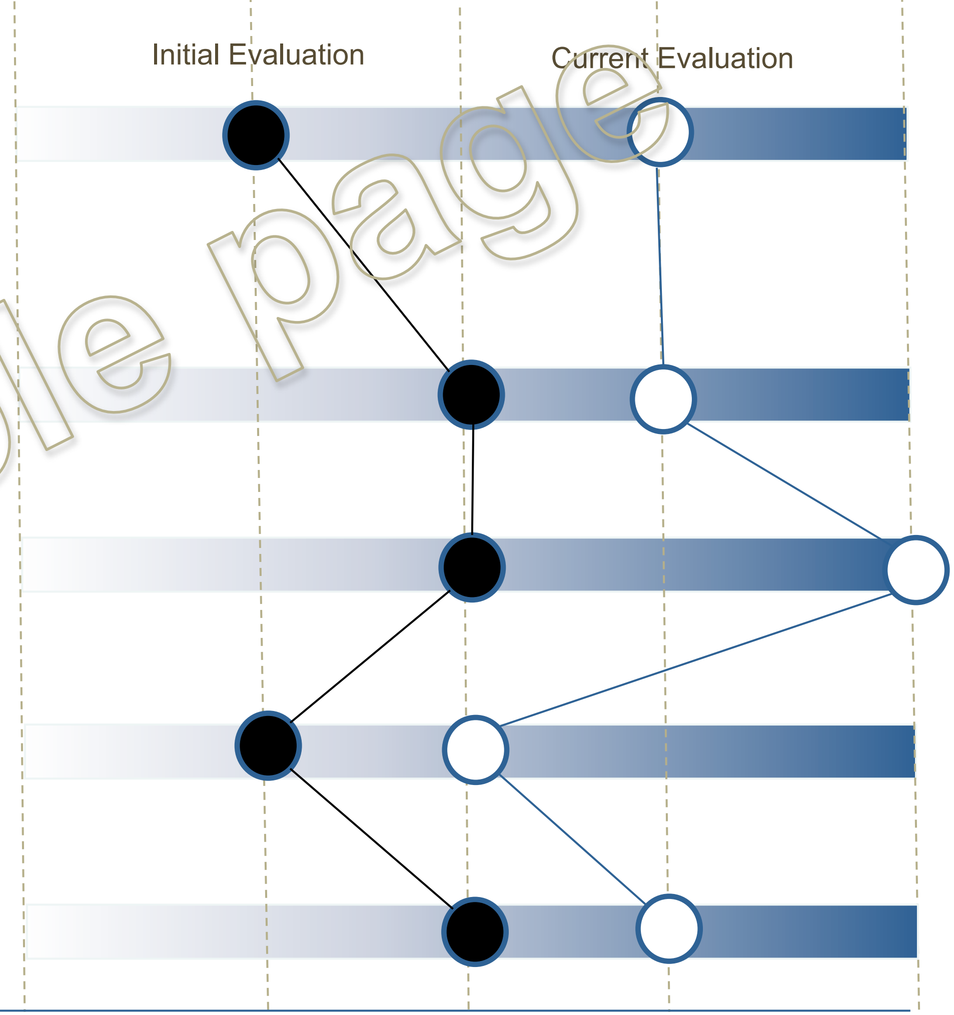
Where can I buy it?

- From your local ICG affiliate or office
- From the lead author Gerry Purcell (Toronto, Canada - gerry.purcell@internalconsulting.com)
- From ICG's web store.

Pricing Trend Radar: Where do you stand on the continuum and how are you advancing?

Illustrative

	Trend	No evidence	Some evidence	Below parity	Parity	Competitively advantaged
Setting the Context	You see pricing playing a role in optimizing customer satisfaction (e.g. price-quality ratio and relative price, and price reliability, fairness, and transparency)					
	You see the role of pricing in mitigating conduct risk					
	You integrate hard analytics with discovering customer elasticity through conversation					
Business Model	You complete periodic pricing strategy reviews, p19					
	You model capability to include voice of customer, conjoint, and price elasticity					



Source: ICG Analysis

Leading Pricing Practices Applied to Retail Banking: Contents

Section	Component	Description
1	**Executive Summary**	Overview of our research and findings
2	**Pricing in Retail Banking**	A global review of pricing in Retail Banking including views on practices in non-financial industries
2a	**Setting the Context**: What is the history and evolution of pricing in Retail Banking?	**In This Section:** • Overview of key themes to set the context for pricing: regulation, digitization, and customer centricity **Key Chapter Takeaways:** • Pricing is now seen as an important part of optimizing customer satisfaction • Pricing management is critical for managing conduct risk • Winners integrate hard analytics with customer elasticity and other "soft" techniques
2b	**Business Model**: What is the structure and range of delivery approaches for pricing capabilities?	
2c	**Pricing Tactics**: What are the core tactics for the pricing decision?	
2d	**Governance and Regulation:** How is pricing managed and monitored?	
2e	**Current State of the Art:** What is the current "state-of-the-art" in pricing?	
2f	**What's Next?** What could be around the corner for retail 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, pricing is once again 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.

The banks continue to have a number of complex, interconnected issues on their plate. Experts have different ways of articulating and summarising the key themes, but three stand out with particular prominence: regulation, digitization, and customer centricity.

Regulators are flexing their muscles and consumers' attitudes towards banks are perhaps more cynical than ever. They have their eyes set on applying behavioural economics to financial product marketing to make up for the shortcomings to the "*homo economicus*" paradigm (i.e. people are not necessarily rational in their decision-making). With all this attention, banks would do well to ensure that their pricing strategy – and its effect on operations, client and agent behaviour – limits exposure to financial or reputational risk.

Digitization is having a huge effect on the nature of retail and commercial customers' interaction with banks and on the economics of serving them, with important implications for pricing strategy. It is also enabling a whole new level of 'Big Data' capture and analytics, with pricing amongst the top areas of opportunity.

Increasing customer centricity is being forced by regulation and the need to restore customer trust. For retail bank pricing, this means a need to focus on longer-term customer satisfaction as well as short-term gain, but it is also a value creation opportunity to tailor pricing more closely to individual customers.

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.

Executive Summary (2)

So how can banks go about addressing these and other issues?

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

- What is the history and evolution of pricing in Retail Banking?
- What is the structure and range of delivery approaches for pricing capabilities?
- What are the core tactics for the pricing decision?
- How is pricing managed and monitored ?
- What is the current “state-of-the-art” in pricing?
- What could be around the corner for retail banking pricing over the next few years?

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.

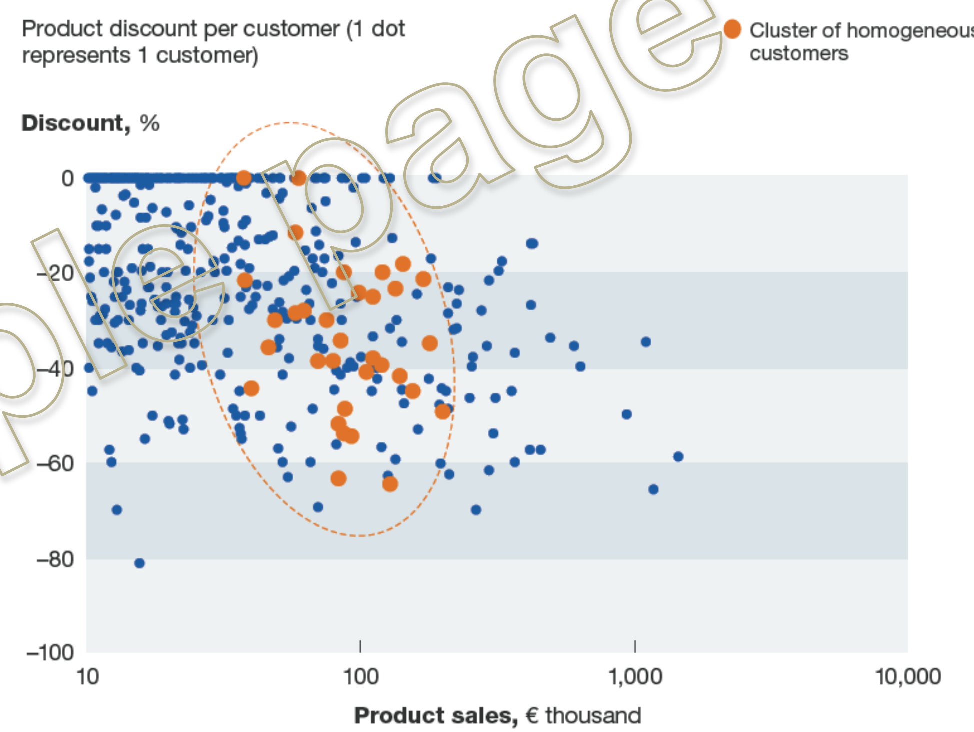
Should you require more information, do not hesitate to contact one of the authors. Their contact information is included at the end of this report.

Understanding how customers value each product remains a critical capability

AND I.T. IS KEY TO UNDERSTANDING WHAT CUSTOMERS REALLY WANT

- Even with all the intricacies of today's analytics and pricing complexities, the price of a product or service ultimately comes down to what the customer thinks it's worth – or value pricing.
- Best practice companies augment analytics with detailed customer insights to ensure they identify and understand all the key buying factors that determine how much a product is worth to a given customer; understand how those factors compare with competitors offers, and quantify the value created for the customer.
- While analytics can certainly help in determining value, developing insights often requires "softer" and more traditional skills, such as talking with customers and observing their operations

ANALYSIS CAN IDENTIFY OPPORTUNITIES FOR DIFFERENTIATED PRICING BASED ON A CUSTOMER'S WILLINGNESS-TO-PAY



Source: Turning pricing power into profit, McKinsey, 2015.

Successful businesses can clearly articulate what kind of business they want to be in, the clients they need, and align pricing to ensure that they achieve this

PRICING STRATEGY

- Many companies lose revenue and margins due to having a poor understanding of their customers, the positioning of their products in the marketplace, not knowing what drives value for their customers, or what drives cost-to-serve.
- Pricing is an integral part of a bank's go-to-market strategy. The pricing approach that a bank takes should be aligned with how it wants to be positioned in the market. As financial institutions mature their pricing capabilities, they will be better able to respond to external forces while building upon their brand and value proposition.
- Setting a pricing strategy is part of a recurring process and should be periodically re-assessed based on changes in internal and external strategic drivers.

INTERNAL & EXTERNAL STRATEGIC DRIVERS

Source: PWC FS Viewpoint, 2012

Implementing a successful customer segmentation program requires careful planning and strategic decision making

SAMPLE OF CUSTOMER SEGMENTATION MODEL TO ANALYSE CUSTOMER LIKELIHOOD TO ADOPT DISTRIBUTION CHANNELS

Customer segments	Expected Lifetime Value	Mobile Adopt	Branch	Phone	Online
Couples without dependents: Financial up-and-comers, strong users of technology	Very High	Very High	Moderate	High	Very High
Empty nesters: Wealthy, high touch, low interest in technology	Moderate	Low	High	High	Very High
Established families: Growing assets, developing interest in technology	Very High	High	High	Very High	Very High
Single adults: Young spenders, low savings, high interest in technology	Low	Very High	Low	Moderate	High

QUESTIONS TO CONSIDER

- Have we gathered data that will enable us to understand where customers are in the financial life cycle and to forecast their money management needs?
- What is the lifetime value (current and expected future profit) of each customer segment?
- What financial development objectives have we established for each customer segment, and how are we differentiating product, pricing, and communication strategies for each segment?
- Do we understand the drivers of customer loyalty and attrition for each segment?

Source: When the growing gets tough, PWC, 2011.

Contingent Pricing: Arrangement to sell a product at a low price if the seller does not succeed in obtaining a higher price offer during a specified period.

2

KEY POINTS

- The optimal contingent pricing structure depends on the buyer's risk attitude – a deep discount is most profitable if buyers are risk-prone.
- A consolation reward is most profitable if buyers are risk averse.
- To motivate buyers to participate in a contingent pricing arrangement, the seller must provide sufficient incentives.
- Consequently, buyers also benefit from contingent pricing.
- In addition, because the buyers with the highest willingness-to-pay get the product, contingent pricing increases the efficiency of resource allocation.

PRICING IMPLICATIONS

- The price for a product may be set too low, causing the seller to leave money on the table, or too high, driving away potential buyers.
- Contingent pricing can be useful in mitigating these problems.
- In contingent pricing arrangements, price is contingent on whether the seller succeeds in obtaining a higher price within a specified period.
- If probability of obtaining the high price is not too high, sellers profit from using contingent pricing while economic efficiency increases.

Case Example: CAT

- Caterpillar sells its spare parts to dealers with the option to repurchase the item at a 10% price premium in case another dealer or customer runs out of stock and has an urgent need for the product in question.

Source: Eyal Biyalogorsky & Eitan Gerstner, Contingent Pricing to Reduce Price Risks, University of California, Davis, Graduate School of Management

Psychological pricing: Research examining psychological aspects of pricing seeks to understand how customers form perceptions of value and how companies can favorably influence this

KEY POINTS

- Psychological pricing uses the customer's emotional response to encourage sales. By pricing products strategically, a company may increase sales without significantly reducing prices. For example, a higher price is actually more likely to increase sales.
- Use psychological pricing to choose an appealing price based on the needs and wants of the target audience.
- Builds an impression of the brand without making significant changes to the product. Simply revising your pricing structure can make the product suddenly seem like the best bargain on the market or elevate a luxury product to the top of the available options.
- When using psychological pricing, the target audience for the product determines the way to price products or services.

PRICING TECHNIQUES

- **Charm Pricing** – takes advantage of relative and anchor prices to make a product more appealing solely because of its listed price.
- **Price lining** – involves distinct lines of products, each in a distinct price range, such as budget, mid-range and high-end. Additional features on the upgraded lines don't typically cost much but allow you to increase the price significantly.
- **Advertised reference prices** (e.g. manufacturer-suggested retail price $299, now only $99) influence customer choice towards higher margin products, even if customers themselves know that these reference prices are inflated.
- **The compromise effect** is a phenomenon whereby brands gain market share when they become intermediate, rather than extreme, options in a choice set. Customers are averse to extreme options. Pricing managers thus have the option to increase the likelihood that customers buy a premium product by adding a super-premium product to their product lines. Examples: Starbucks, Dell, FedEx, and Amazon.

Source: Hinterhuber A. and Liozu, S.M. (2014) Is Innovation in pricing your next source of competitive advantage? Business Horizon, 57: 413-423

Regulatory pressure continues to mount post crisis, with four challenges of particular concern

	DRIVERS	IN SUMMARY
1	**Structure**	Regulatory requirements will force major structural change, including the split of global entities into a patchwork of smaller locally or separately regulated subsidiaries
2	**Conduct, Markets & Culture**	It is critical that change is underpinned by a dramatic shift in culture, through tone from the top, policies, hiring practices, incentive structures, embedding values and demonstrating consequences for behaviours which are no longer acceptable.
3	**Data & Reporting**	A key challenge is the increasing maturity of data analytics capabilities
4	**Governance & Risk**	Much work is already underway on this, but much more needs to be done. As banks get to grips with their business strategy, risk appetite, risk culture, and management, they will need quite different management information which only significant investments in core and critical systems, as well as emerging analytic technologies, will provide.

Source: Evolving Banking Regulation ASPAC Edition, KPMG, 2014 (we look at 4 of the 5, with the fifth being OTC changes)

There is great concern among UK bankers that industry standard practices will be retroactively deemed unacceptable by regulators

REGULATION LACKS CLARITY, UNCERTAINTY ABOUNDS

- **Clarifying the principles that guide "good" conduct.** While an "outcome-based" approach does not rely on explicit rules, greater clarity on the principles of "good" conduct, that recognize that industry practices may not have aligned with principles for acceptable conduct, could help build some shared understanding between regulators and banks.
- One participant stated, "Principles are important to help define acceptable behaviors. Outcomes test to see if the principles are effective. The concern is that a small number of outcomes can be used retrospectively to say that we've got it all wrong."
- Clarity regarding which customers require which level of protection would help banks tailor their conduct practices.

- **Defining effective conduct governance.** Several directors expressed uncertainty regarding the board's role in the issue of conduct. One asked, "For directors, do we have to look at processes or outcomes?" Another stated that some banks' practice of having the board review products may not be helping conduct and asked, "Is it appropriate for boards to review products? How do you determine if product governance is working?"
- Furthermore, boards struggle with indicators to determine whether or how far their banks are moving in the right direction and the relative tradeoffs as they seek to reduce risk, but hopefully improve the quality of customers and revenue.

- **Simplifying products and pricing.** Banks continue to worry that historical practices on pricing that remain industry standards may one day be deemed unacceptable retroactively by regulators. One participant stated, "Front-book/back-book pricing is something that regulators are clearly exploring and reviewing… There is an industry practice that is exploiting inertia in long-tenured customers to subsidize attractive offers for new customers… There could be potential for regulatory intervention by establishing some ground rules: it's OK to have an introductory offer, where prices go up in year two or three, so long as you're transparent about it, [but] practices built upon consistently raising the price the longer you remain with a product or bank are not fair customer treatment."

"What is good? Is it [a bank that is] 95% free of conduct breaches? 100%?" – Participant

"Conduct is not a risk to be managed – that will lead to [it becoming] a compliance exercise – it is more a culture and business model question." – Participant

Source: A new era of conduct supervision: consequences, challenges, and opportunities, EY/Tapestry Networks, 2014; Responses taken from a meeting of the Bank Governance Leadership Network (BGLN) participants, including non-executive directors and executives from global banks, met with senior regulators in London on 18 February 2014.

Today, companies employ a range of advanced pricing strategies to address individual client situations (2)

Strategy	Brand	Case Example
Pricing to drive market expansion	IKEA	**IKEA** does not allow costs to dictate prices; rather, it determines prices based on what key customer segments are willing to pay.
Displacement pricing	RYANAIR skype	**Ryanair** barely breaks even on its flight operations. Yet it is Europe's most profitable airline, largely as a result of the profitability of its ancillary revenues: income from third parties, early boarding fees, baggage fees, and on-board sales. **Skype** (Internet calls are free, fixed-line calls are sold at regular prices), **Google** (search is free, advertisement is sold), **fast-consumption newspapers** (given away for free, advertisement is sold), **and open-source software** (standard models are free, customized versions are sold) compete very successfully by using similar pricing strategies.
Participative pricing	priceline.com Wikipedia The Free Encyclopedia	**Priceline** is a prime example of NYOP (Name Your Own Price) or PWYW (Pay What You Want). Examples of PWYW pricing can be found in information services (e.g. **Wikipedia**), in **museums** (voluntary contributions), in the **music industry** (e.g. **Radiohead**), and the hotel and restaurant industry. Fairness considerations, social norms, and credible threats by the seller to switch back to fixed prices seem to motivate customers to pay non-zero prices. In three experimental studies involving restaurants and cinemas, PWYW pricing led to lower average prices than previously posted fixed prices but higher revenues due to new demand. Thus, participative pricing can be beneficial for sellers as well as for customers

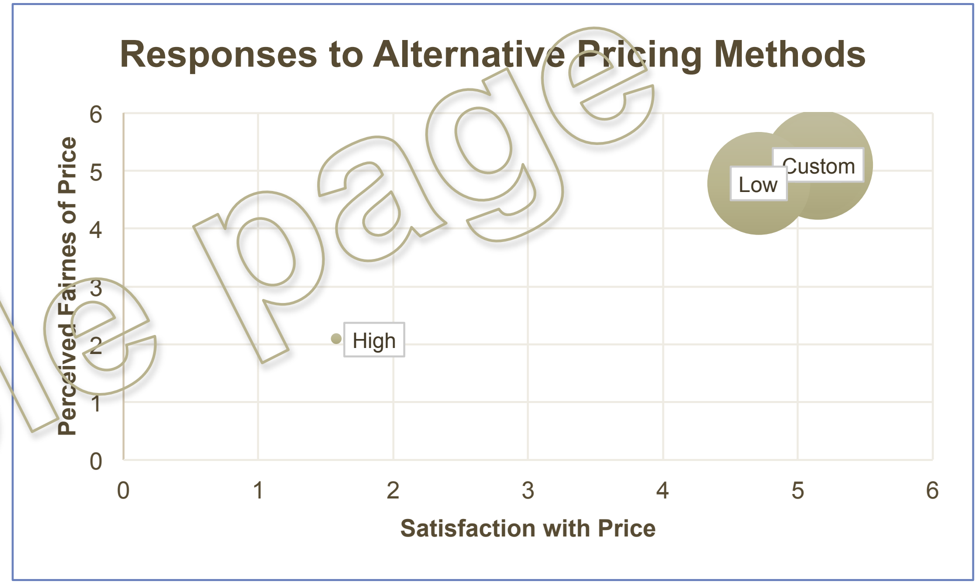
Source: Hinterhuber A. and Liozu, S.M. (2014) Is Innovation in pricing your next source of competitive advantage? Business Horizon, 57: 413-423

Technology is evolving to enable the most challenging of data manipulations, this will enable much broader customized pricing

THE CONTEXT OF CUSTOMIZED PRICING

- The core of marketing concepts is profitability through the satisfaction of consumers' wants and needs
- Each consumer is unique, and maximum satisfaction would be achieved if firms could address those wants and needs individually rather than treating everyone the same
- Historically, all transactions were conducted between individuals and all products were customized
- Advances in technology over the years brought standardization, mass communication, and widespread distribution
- As demands grew, capacity and technology constraints required organizations to look for efficiencies to be able to offer product within the constraints of what can be done
- Segmentation and other market mechanisms to estimate demand, pricing, etc. developed – with the inherent weakness that these are really just estimates.

CUSTOMERS REGARD THEIR "RESERVATION PRICE" AS THE FAIREST AND MOST SATISFYING



The above chart summarizes the results of a survey of pizza consumers:

- Custom refers to selling to the consumer at their "reservation price" (both above and below cost)
- Low price refers to the lowest price that they will pay
- High reflects the highest price that a consumer in the study would pay.

Source: Customized pricing: win:win or end run? Drake Management Review, Volume 1, April 2012

Acknowledgements

This report is the 24rd in ICG's series of Knowledge Area Reviews or KARs®, each of which provides a comprehensive perspective on global best practice in a different business area and/or function.

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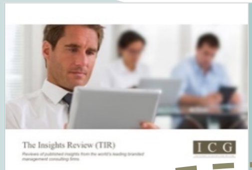

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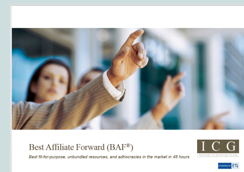
Focused collation of expert insights and opinions on a subject matter of interest. Can be convened with local and or global experts.



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