Opportunities for Action in Financial Services

The Untapped Power of Pricing

THE BOSTON CONSULTING GROUP

The Untapped Power of Pricing

How many prices and fees does your institution have for its products and services? Hundreds? Thousands? By how much could you raise prices in some areas without hurting volume, or lower them in other areas and lure customers from your competitors? Most important, do you have a process in place to help you answer these questions and then move quickly and strategically to capture value?

The truth is, prices in most financial-services companies evolve reactively on the basis of management hunches, competitors' moves, and the pressures of sales targets. They are not usually determined through deep knowledge of different customer segments and their price sensitivity toward various products. The result is often a fragmented set of price mechanisms and price levels that either leave money on the table or drive customers to lower-cost providers.

The Boston Consulting Group's view is that most financial-services institutions could better utilize pricing as a tool to increase earnings and market share. Indeed, of all the ways managers can affect the bottom line, pricing can be the most powerful. A recent BCG analysis of retail banks, for example, revealed that if aggregate prices were increased by just 1 percent, with volume and costs remaining constant, the result would be a 6.8 percent increase in return on equity. By contrast, a 1 percent increase in volume or a 1 percent decrease in costs would raise ROE by just 1.8 percent and 2.3 percent, respectively. The dynamics are similar in the fund-management and insurance industries. (See the exhibit "Pricing Is a Bigger Profit Driver Than Volume or Cost.") Unfortunately, financial institutions' information systems are rarely set up to assemble and analyze the type of customer-

Pricing Is a Bigger Profit Driver Than Volume or Cost

Impact on Return on Equity of a 1% Improvement in Profit Driver

Profit

	Banking	Fund manage-ment	Insurance (nonlife)	Insurance (life)
Price	6.8%	3.5%	12.0%	15.0%
Volume	1.8%	1.7%	5.2%	7.7%
Cost	2.3%	1.8%	2.6%	1.3%

SOURCE: BCG analysis.

response and competitive-positioning information required to make good pricing decisions.

The penalties for poor pricing can be severe. Losing just a small percentage of your best customers—or failing to capture fully their willingness to pay—can hurt profits dramatically. What is more, efforts to improve pricing usually pay off handsomely. Companies that have made pricing a strategic priority have seen profits on certain products increase by up to 25 percent. The key is to recognize that the power of pricing often goes untapped and to figure out how to make it work better for you.

The Seven Pillars of Improved Pricing

Improving your pricing amid the current climate of intensified competition in financial services—more providers, greater similarity of prices and products, lower switching costs—is a multifaceted task. BCG has identified seven pillars that can help you build a powerful pricing capability.

Align pricing strategy with business strategy. Begin by clarifying the strategic positioning of your institution for various products. Are you a premium, value, or mainstream provider? Does your pricing strategy help or hinder your business strategy? How can you use pricing to differentiate yourself?

Halifax Bank of Scotland, for example, has adopted a "consumer champion" strategy. Using reduced lending rates and low fees to drive volume, HBOS is gaining scale, lowering unit costs, and clearly differentiating itself to U.K. consumers seeking mortgages and deposit accounts. Its use of pricing to strengthen and accelerate its overall strategy has helped the bank claim a significant share of the U.K. retail mortgage market. What is more, such a strategy can be difficult for rivals to keep pace with, because higher business volumes can drive costs down, in turn allowing for even more competitive pricing.

Price to customer value. Different customers often value identical products and services—as well as the specific elements they are composed of—differently. By understanding those differences and pricing accordingly, banks can capture untapped value. The key is to create more effective methods of customer segmentation and to identify innovative pricing structures that elicit customers' full willingness to pay.

One approach is to unbundle product offerings and place the price focus on separate components. For example, Washington Mutual, a regional bank in the United States, determined that most of its checking-account customers were fed up with per-transaction costs, minimum-balance requirements, and monthly fees. So it offered an account free of those charges and restrictions that paid no interest but charged "acceptable" penalties for bouncing checks and other actions within the customer's control. The result was a large increase in checking-account customers and a significant rise in the income they generated.

Discrete charges such as those for bounced checks—and for late payments and credit-limit violations on credit cards—can often be repriced to an institution's advantage because customers expect not to incur those charges. When they do incur them, they tend to blame themselves, not the bank. Moreover, many retail-banking customers are relatively unaware of how these discrete fees compare with equivalent ones at other banks. Their lack of awareness creates many opportunities for raising prices and enhancing revenues. Such opportunities, of course, must be weighed against the possibility of customers seeking alternative offerings elsewhere.

Price to manage risk. In most financial institutions, a great deal of effort is expended on measuring and managing risk. But risk is often surprisingly mispriced, hurting profitability.

Take the case of a global bank that held a large corporate-loan book whose risk profile was altered by the Asian financial crisis of the mid- to late 1990s. For a period, the prices of the loans continued to reflect the older, lower risk level. The bank finally conducted a risk-pricing analysis, which helped it see the discrepancies. It then recategorized the loans into four types—exit, reprice, regrade, and retain—and established a regular review process. The bank later estimated that the repricing exercise increased income from the loans by more than $5 million per year.

Price to create efficiencies. Not truly understanding costs, and therefore pricing inefficiently, is a trap some institutions fall into. Given the complex cost structure of many financial-services products and their multi-channel delivery, this aspect of pricing offers fertile territory for improvements.

For example, we know a broker whose transactions on behalf of clients contained varying units of volume. At one point, with prices based on units of volume handled but costs based on the number of transactions executed, the company was losing money on customers that traded often but in small volumes. To make matters worse, competitors that understood their costs better began to “cherry pick” the company’s most profitable customers—those that traded infrequently but in large volumes. Over a period of years, the broker saw a steady decline in income and return on equity.

To correct the problem, BCG talked to 50 of the broker’s customers worldwide to gauge their price thresholds, then redesigned the company’s pricing model and helped it enact a plan both to win back profitable customers and to reprice offerings to unprofitable ones. The result was that profits and return on equity rose for the first time in a decade.

Optimize the price-volume tradeoff. For any product or service, a theoretical optimum exists at which increases or reductions in price levels are offset by volume impacts. But because identifying the optimum is extremely difficult, many organizations forsake analysis in favor of gut feeling. In fact, it is possible to build a rich picture of price-volume tradeoffs by examining historical data and conducting rigorous experiments.

The U.S. credit-card company Capital One, for example, has adopted what it calls an “information-based strategy” to help it grapple with the tradeoff. It conducts thousands of price and product tests every year, and utilizes transaction data to refine customer profiles continually. These initiatives have given Capital One keen insight into how much volume would be lost or gained by price changes on various offerings, and have helped it determine the most profitable interest rates, credit limits, and payment terms for highly segmented customer groups. The company, which has developed thousands of diverse card offerings, has attained a customer base of nearly 50 million accounts since its inception in 1995, and has seen its market share appreciate substantially.

Sometimes price thresholds become clearly evident to the market. For example, research in the Australian banking industry has shown that between 1994 and 2000, lenders started losing customers to competitors when the interest-rate differential reached 25 basis points.

Improve price realization. It's difficult enough to find the right price for a given product or service. That makes it doubly frustrating for CEOs when established prices are undercut by their own people, or when systems and routine procedures fail to identify and charge the prices that customers are willing to pay. This sort of price "leakage" is all too common in financial services.

We know of a global investment company, for example, that wanted to improve the productivity of its private-banking activities but was hampered by the fact that its account managers had grown accustomed to having price discretion—especially to close a sale. An analysis showed that the discounts being offered were not related to volume or profitability.

To combat the problem, the company reestablished specific pricing guidelines and added strict exemption policies. It also introduced price communication techniques and price monitoring. The company subsequently estimated that those changes increased its private-banking revenue by nearly 15 percent in the short term.

Leakage also occurs when data are inaccurately captured or used. We have seen many examples of misclassified transactions and services, causing significant undercharging, and large differences between agreed pricing terms and prices actually billed. Identifying leakage is rarely easy but usually has a swift and sizable payback.

Organize to capture pricing opportunities. Although considerable gains can be made through one-time pricing-improvement exercises, the true goal is to embed in your institution the capability to optimize prices continually. It is this capacity that rivals will find difficult to emulate. Attaining it requires a strict focus on organization and supporting processes.

Companies must clearly outline responsibilities for pricing decisions and establish strict accountability for overall pricing performance. Specific roles must be assigned and a structure put in place that not only facilitates coordinated pricing decisions across the organization but also analyzes them and feeds the learning back into the system to aid future pricing decisions.

In addition, institutions can greatly improve their pricing capabilities by rethinking their pricing metrics. Information systems should be able to track and break down revenue and profitability movements at a line-item level, and be linked to incentives that encourage the sales force to pursue optimal price realization. Pricing models should take into account such issues as lifetime profitability, avoidable costs, and acquisition costs. And information systems must be able to capture and use data that are vital to making pricing decisions in a given business.

Make Pricing Work for You

Financial services providers have more means today than ever before to collect pricing information, analyze it, and use it as part of their strategic arsenal. Those that take action will position themselves to develop long-term pricing capabilities that can lead to sustained competitive advantage. Those that linger may find themselves struggling to catch up.

As you think about how to strengthen your own company's pricing performance, we encourage you to ask yourself a few questions:

- Could you raise the prices of your top five products by 10 percent without losing 10 percent in volume? Would lowering the same prices bring a better result? How confident are you of your responses?

- Would any form of unbundling or rebundling of your products and services allow you to better extract the full value that customers are willing to pay?

- Do your prices encourage the use of low-cost channels? Do you know whether migration between channels is building or eroding profits?

- Is price leakage a problem in your company? How do you know?

Companies that are serious about improving pricing should rigorously evaluate how their current models are performing against the seven pillars. Such an examination will likely result in a set of immediate steps that can sharpen pricing strategy. It will also help establish a focused, long-term pricing agenda. Finally, it will clarify priorities for building the capabilities in personnel, organization, and infrastructure—such as IT systems—that are needed to create a durable, nimble, and optimal pricing model.

Precision pricing, at its best, is a unique combination of science and art. Your competitors may already be on the road toward achieving it. Are you?

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