PRICING: THE 'VALUE MEAL' APPROACH

Now more than ever banks need to consider a new pricing paradigm—multiproduct and bundling pricing or relationship pricing—to boost customer relationships and offset fee-revenue declines.

BY JENS BAUMGARTEN, OLIVER BUSHNELL AND DAVID VIDAL

BANKS CURRENTLY FIND THEMSELVES under double pressure: from consumer groups that challenge bank fees and from falling revenue stemming in part from regulations restricting the use of overdraft fees.

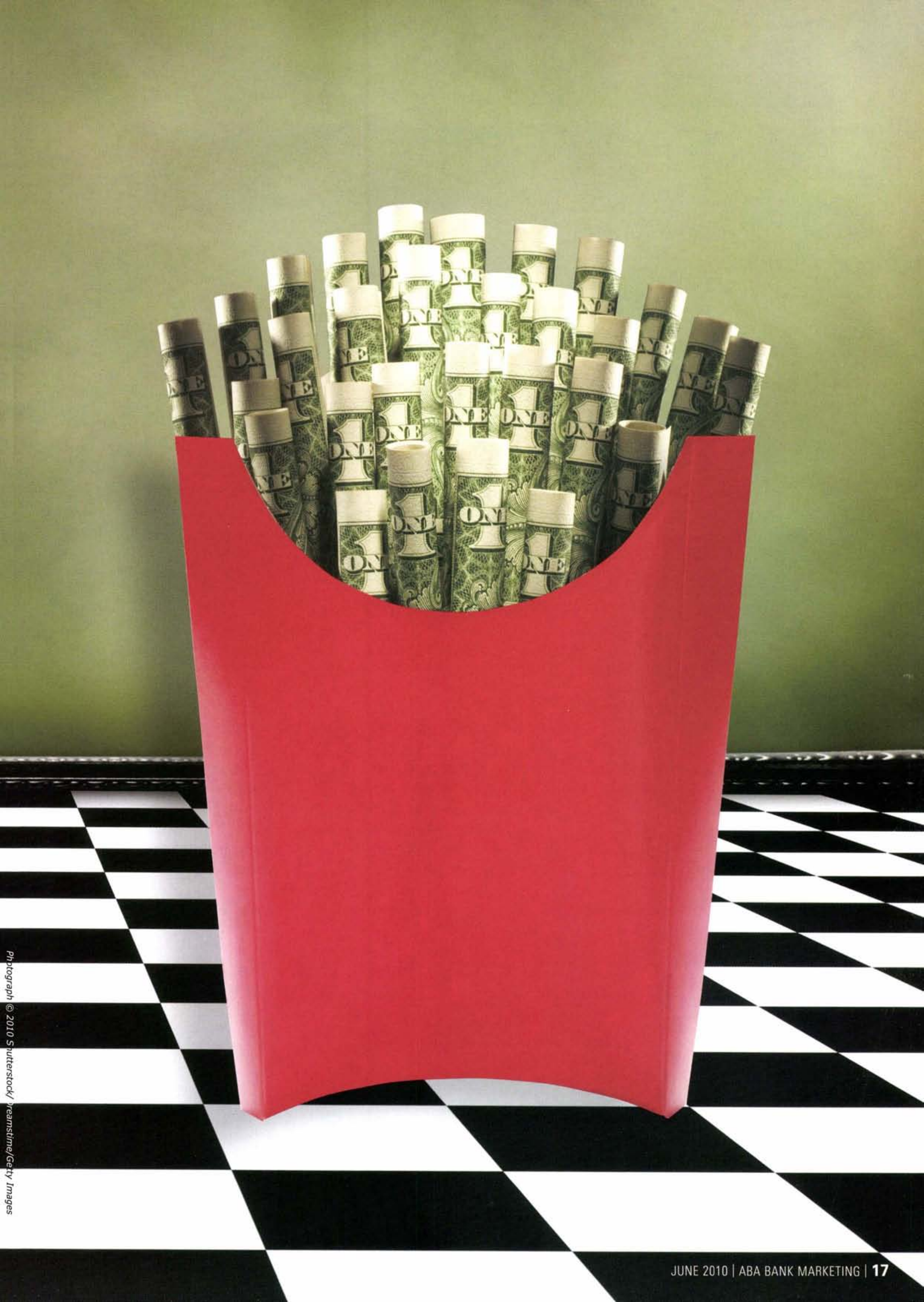
While it will be tempting for banks to simply raise unregulated fees (bounced check fees, for example) or implement basic annual fees for currently free services (checking and savings accounts), this is sure to draw greater ire from customers and will do nothing to rebuild consumer confidence and increase needed volumes. In order to increase volumes through deeper and broader customer relationships, banks must develop product offers and pricing schemes that foster their customer relationships and increase customer loyalty.

Thus now is a good time to review the pricing schemes and introduce innovative ones such as multiproduct pricing, bundling or relationship pricing.

Reward for increased use of bank products

While simple price cuts make customers happy in the short term, they are profit killers; the added volume they spur rarely compensates for the lower unit-contribution margins. Innovative pricing schemes are the only means through which profits can be increased and customer loyalty simultaneously strengthened. The common philosophy of these pricing approaches is to reward customers more as they increase their use of the bank's products and services, creating a win-win situation for both the customer and the bank.

One key requirement for such schemes is to be simple and transparent so that the customer clearly recognizes the monetary advantage of a stronger relationship with the bank. This transparency will also make significant headway towards complying with new regulations requiring the simplification of bank product fee and rate structures. When appropriate, multiple schemes can be combined.



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Here is a review of some of the innovative pricing approaches that can help to reach the goal of better differentiated prices, thus better matching customers' willingness-to-pay:

While simple price cuts make customers happy in the short term, they are profit killers.

1. Multiproduct pricing/bundling

In multiproduct pricing, customers are presented with monetary incentives that promote product consumption. A typical example from outside fincancial services comes from telecommunications, where consumers receive a substantial discount on the price of a cell phone if they sign a contract with a network provider. In banking, bundling is becoming more common in the category of mortgages. HSBC Canada, for example, offers decreased annual mortgage rates for customers who add a banking product (for example, a checking account) or a deposit of at least a certain amount in new funds to an HSBC investment or deposit account. The more products customers purchase, the further the rate on their mortgage falls.

The bundling of product or service components into a package is a special form of multiproduct pricing. Among typical examples of bundling, McDonald's combines a hamburger, french fries and soda to make an "Extra Value Meal." Microsoft sells Windows together with countless other applications, and your local coffee shop most likely sells a cup of coffee and a donut for one bundled price.

Bundling could be an especially useful tactic to encourage customers to opt in to overdraft protection services. The bank might offer customers the option of overdraft protection at a fixed fee—with even lower fees if the customer also signs up for certain other accounts (such as savings, brokerage, CDs and so forth). This way, cross-selling and certain product bundles would be promoted while simultaneously limiting the number of clients who opt out of full overdraft protection.

Many banks have made considerable progress to better understand the products or features that should be represented in a package or bundle. However, they usually have

Implementing a New Pricing Approach: A Bank Case Study

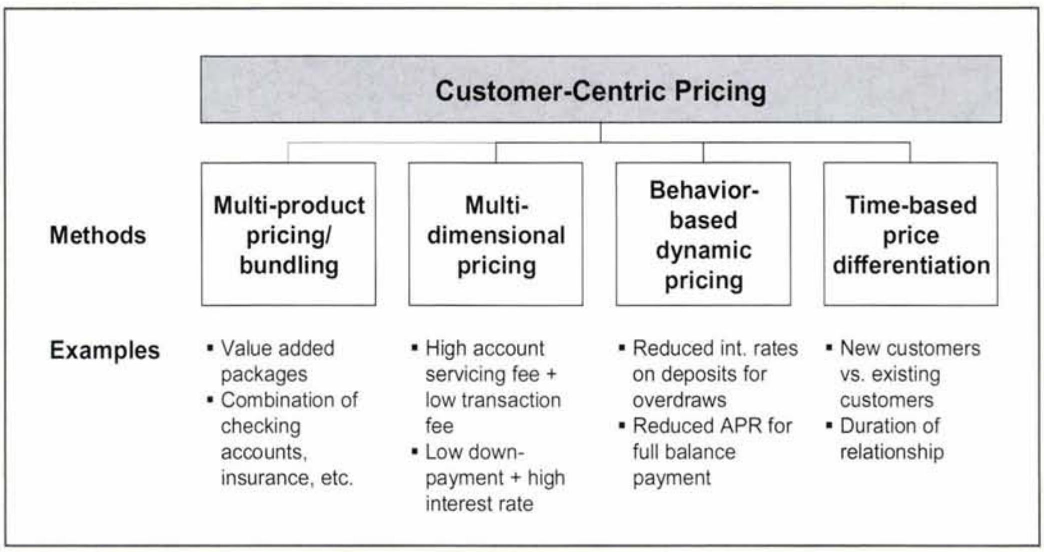
The following case study, a result of a recent project, illustrates how a customer-centric pricing scheme that combines several of the pricing approaches mentioned in the main article was conceived and implemented.

A retail bank was suffering from growing competitive pressure and had already lost many customers to no-frills offers from price-aggressive banks. Management decided to explore and introduce a new pricing scheme that aimed to:

- Strengthen customer loyalty.
- Increase cross-selling.
- Recover funds from existing customers that moved to other banks.
- Utilize existing customers as multipliers in attracting new customers.

After an analysis of the current price structures and product usages, the checking account was deemed the core product of customer loyalty. There were no packages or bundles with other products offered and multiproduct utilization was consequently low compared to competition. The analysis resulted in the design of three new checking account packages as value-added accounts. The first package was a no-frills, free online account with pure online payment functionality. The second package included a standard credit card and an automated cash management service based on a related savings account. The third package, an all-in account, included unlimited online and paper-based transactions as well as a platinum credit card and a number of insurance options.

Most importantly, through a multidimensional discount structure, the



This chart is a summary of selected forms of customer-centric pricing strategies, listing each strategy and the key components of the strategy.

limited knowledge of customers' value perception for different products or features, which provide the best insight into the optimal pricing of the bundle. Many banks only consider costs when setting bundle prices and ignore the decision a customer makes between buying the individual components independently and buying the bundle.

In order to set these prices effectively, companies must understand the distribution of customers' willingness-to-pay (reservation prices) across the bundle features. A reliable and valid measurement of individual reservation prices can be obtained with conjoint measurement, a survey method which relies on indirect questioning and trade-off analysis.

2. Multidimensional pricing

Multidimensional pricing is a combination of several price components, usually an up-front or recurring fixed fee and a variable component (based for example on the number of transactions a client makes). Such a multipart scheme results in automatic discounts on additional units purchased. This strategy aims to encourage product consumption as well as to develop loyal customers. The lending industry commonly uses this practice, where a loan structuring or set-up fee is the up-front component, and the interest rate is the variable component. However, the setup of such multidimensional pricing schemes rarely takes into account the preferences and willingness-to-pay of the customer. A thorough understanding of consumer preferences and willingness-to-pay for different loan attributes (up-front structuring fee, downpayment, interest rate, contract length and so forth) is important to decide on the optimal price and rate levels.

Furthermore, the multidimensional pricing structures that a bank can implement vary significantly depending on the type of loan considered (home mortgages, car loans) and the customer segment considered. Affluents and households with income below $30,000 do not have the same preferences, and even within these segments, different needs must be considered.

Among typical examples of bundling, McDonald's combines a hamburger, french fries and Coke to make an "Extra Value Meal."

bank gave its customers a discount on the account fee depending on total balances held at the bank and the number of banking products a customer used (see chart). There were two types of discounts:

- *Discounts on multiproduct use*: the account fee is lowered by one dollar per additional product or service used.
- *Volume-based discounts*: the account price is reduced depending on the total investment volume held with the bank.

The introduction of the new accounts went smoothly. The concept attracted many first-time customers, but more importantly and due to smart loyalty incentives mentioned above, the number of products purchased per customer increased dramatically and the average balance held rose significantly as well—the result of customers transferring money from other banks. The additional revenue generated covered the costs of the model transition in only 12 months.

Services Used	Monthly discount ($)
Use of checking account as primary direct deposit account for paychecks	1.00
Credit card revenue of at least $500/month	1.00
Funds savings plan available at retail bank investment company	1.00
Use of IRA retirement account	1.00

Investment volume ($)	Monthly discount ($)
0 to 25,000	0.00
25,001 to 50,000	1.00
50,001 to 100,000	2.00
100,001 to 500,000	5.00
Over 500,001	10.00

Monthly basic price dependent on investment volume and number of used services

Number of services used Investment volume ($)	0	1	2	3	4
0 to 25,000	10.00	9.00	8.00	7.00	6.00
25,001 to 50,000	9.00	8.00	7.00	6.00	5.00
50,001 to 100,000	8.00	7.00	6.00	5.00	4.00
100,001 to 500,000	5.00	4.00	3.00	2.00	1.00
Over 500,001	0.00	0.00	0.00	0.00	0.00

*Data altered to protect client confidentiality

These charts show a hypothetical multidimensional pricing scheme similar to one employed at the bank cited in the case study.

3. Behavior-based dynamic pricing

In tandem with multidimensional pricing, some banks also experiment with the idea of implementing dynamic pricing based on their customers' behavior. Considering the most relevant example of overdraft fees, a bank could introduce a program that discourages overdrafts and other harmful behavior by basing annual fees or interest rates on the customer's compliance or violation of such guidelines. For example, interest rates on a savings account could go down when the customer overdraws his or her checking account. Instead of rate penalties, customers could be rewarded for positive behavior with rate bonuses as well.

> Bundling could be an especially useful tactic to encourage customers to opt in to protecting their accounts against overdraft fees.

Such complex pricing structures would have to be designed carefully and with much customer input, as well as thoroughly checked against regulatory constraints. By developing a clear link between customers' good behavior (and its benefits) and poor behavior (and the reduction of those benefits), banks can improve their customers' behavior in a way that seems fair to both parties.

4. Time-based price differentiation

Time is another means of differentiating price. Wells Fargo has taken such an approach with its CD/savings account where, for a limited time, the interest rate increases at the end of every month that the customer remains with the bank, giving the customers an incentive to save more and increase/concentrate assets held at the bank over time. Fidelity Investments introduced a similar program in Europe, by essentially

More Ways that Banks Are Responding to Today's Market

Below are three examples of new approaches taken by three banks to be more customer-centric, to meet the changed needs of customers in today's economy and to improve customer confidence and trust.

JP Morgan Chase & Co., New York, Develops a Dashboard To Help Customers Deal with Their Debts

Blueprint is a platform that allows customers to compile all debts on a single dashboard to simplify paying them off, minimize the amount of interest they will be required to pay and identify certain types of spending (like groceries, gas and other daily needs) that they wish to pay off in full every month.

The platform is fully intergrated with all of Chase's card payment systems, which allows customers to design their own financing plans for each individual purchase by selecting either the number of months they would like to take to finance a purchase or the value of monthly payments they would like to make. The platform was a result of a two-year study of more than 4,000 customers to determine what attributes were truly wanted.

Ally Bank Aligns Itself with Customers to Achieve Common Goals

In early 2009, GMAC Financial Services rebranded it's own retail bank as Ally Bank, an online bank with headquarters in Midvale, Utah (assets: $32.8 billion). The name, along with the bank's extensive marketing campaign, is aimed at regaining the trust of customers by showing them how they will work with the customer to achieve common goals. An integral part of this effort has been the development of products and services such as the "No Penalty CD" and "Sleeping Money Alerts."

The "No Penalty CD" guarantees customers that if Ally offers a better rate for this same product within 10 days of purchase, Ally will automatically apply that rate to the previously purchased CD. This goes far beyond standard industry practice of offering one- or two-day interest rate matching. More importantly, the product allows customers to withdraw funds from the CD without incurring any fees.

Ally's "Sleeping Money Alerts" proactively let customers know if their money could be earning them more interest and recommend ways to increase interest that align with the customer's specific money-use habits.

Royal Bank of Canada (RBC) Offers Financial Advice to Customers

The online "Advice Center" from RBC (assets" US$78 billion), Toronto, offers both bank and customer generated content. There are several categories of advice offered, from "Client's Stories" to "Saving Goals and Budgeting" and even one entitled "Moving to Canada."

Each section is tailored around customer's needs and how they can be met. Most content takes the form of advice articles and videos as well as simple online tools and calculators. One of the more noticeable aspects of the "Advice Center" is RBC's effort to serve as a simple adviser rather than a salesperson, as specific products are mentioned or recommended only sparingly.

reducing transaction fees for investment funds by one percentage point when a customer maintained investments with them for two years, and another percentage point after five years.

By focusing smartly on the right fees and price components (especially those with high perception but limited profit impact), time-based differentiation methods are an inexpensive way to boost customer relationship and loyalty. Furthermore, they have the advantage of appealing to existing customers as well, who are tired of seeing rewards given out exclusively to new customers, a practice that can lead to greater levels of dissatisfaction and, eventually, customer loss.

Here are some basic rules for creating and introducing pricing approaches like the ones mentioned above:

- **Create a win-win situation.** Customers' actions can be influenced by offering targeted incentives to strengthen their relationship with a financial institution. The customer wins because he gets concrete financial rewards and the bank wins because customers buy more of the bank's products, stay with the bank longer and develop responsible banking habits.
- **Design simple and transparent pricing rules.** The simpler and more transparent a pricing structure is, the clearer the advantages are—to customers and sales.
- **Explore customer willingness-to-pay before setting prices.** Professional pricing requires taking three factors into consideration—the customers' willingness-to-pay, competitors' prices and costs. By using modern analysis methods like conjoint measurement, the demand curve and the willingness-to-pay for products and specific features can be precisely measured.
- **Combine several price components to drive customer loyalty, up-selling, cross-selling and product usage.** Multicomponent pricing (i.e. a transversal pricing scheme involving several products), will help to encourage customers to strengthen their relationship with your institution by increasing the value of your offering by every additional dollar they spend with you.
- **Communicate the benefits of the new pricing structure** openly and aggressively. The new structure, if properly designed, will be attractive to customers and encourage them to grow their relationship with your institution. Therefore it should be used as a marketing effort rather than a negotiation piece. If communicated correctly, this will not only increase the business your current customers do with you, but also bring in attractive new customers.

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Change your pricing paradigm

The expected loss of billions of dollars in overdraft and other fees will undoubtedly hurt banks bottom lines. However, rather than further frustrating customers by raising or introducing another set of fees, it is essential that banks develop new products and pricing structures that benefit both their own revenue growth as well as customers' needs. By introducing these programs, banks will simultaneously grow revenues by deepening their relationships with customers and increase stickiness and security of these accounts by broadening their relationships. ■

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