HIDDEN TREASURES - INCREASING PROFITS THROUGH BETTER PRICING STRATEGIES

Simply swapping market share at ever-decreasing prices is a mugs' game. But there are ways of improving profitability through a more sophisticated and customer orientated approach say consultants Simon, Kucher & Partners.

On average, the FTSE100 companies are giving away between one and two percentage points in Return on Sales by not fully optimising their pricing. This increase in ROS, which often equates to a profit increase of 15% to 20% or more, is what, in our experience, can be achieved by improving the price management in an organisation.

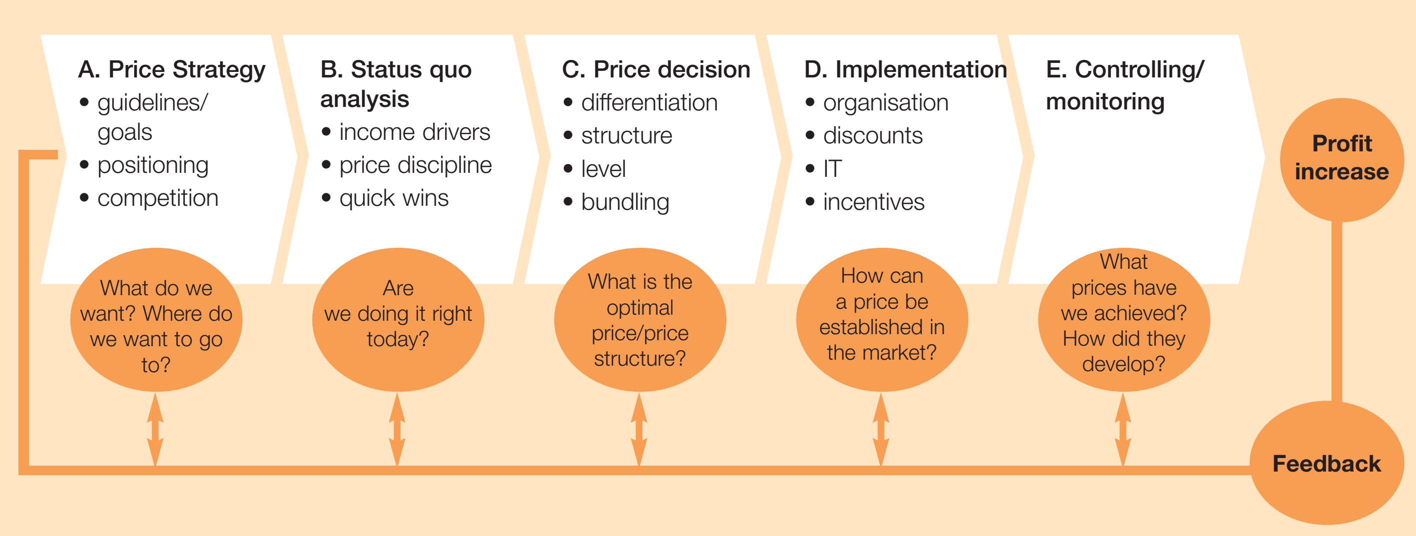
Most British banks were able to announce all time profit records for 2006. However, taking a closer look at these numbers reveals that most of these earnings come from investment banking and in some cases foreign activities. Domestic retail banking contributes only a small part of the profit of the more diversified groups. In order to achieve higher profitability in that part of the business the strategy for most banks over the last few years has been to cut cost. This certainly is important but the potential to increase profit and thus shareholder value is significantly higher today in the field of pricing as many cost cutting opportunities have already been exhausted.

Pricing Processes – The Key to Success

Simply increasing prices will not work. Prices need to be increased or price structures changed selectively in those areas where customers will react less sensibly and prices of products that are in the customers' focus might need to be reduced. Banks typically have several hundred product components for which prices have to be optimised. Such a complex system can only be managed successfully if done through a systematic pricing process, which typically covers five phases:

1. A check of the status quo to understand the current situation, its positive sides and deficits
2. The actual optimisation of price structure and level differentiated by segment, including sophisticated pricing structures such as bundling
3. Based on this, the right rules and guidelines need to be put into place to allow insights to be drawn from the right analyses and to help the pricing decision makers decide what must be done to set prices, differentiate prices, etc.
4. Implementation is the acid test every pricing process will have to face. The right organisational structure, IT support, incentives, communication strategy (internal and external), discount strategy (in particular for B2B), and training needs to be rolled out
5. Controlling and monitoring to ensure that implementation goes as planned and to identify any shortcomings early enough to correct them

Figure 1: Five phases of a pricing process



A pricing process sets a framework within which pricing decisions can be made quickly and efficiently allowing banks to react flexibly to constantly changing competitive market environments. Such a pricing process is, however, company-specific and consequently needs to be optimised in a fully customised fashion. The more customers and products a company has the more money is in it for it. Let's take a closer look at some examples from the European banking industry to demonstrate the positive effect of pricing process optimisation:

- The intensity of competition in the UK mortgage market has seen larger incumbent providers simply swap market share between them, but at a lower margin, by offering greater discounts on fixed term products. Their strategy has been to offset the margin squeeze by adding and increasing the level of up-front fees (such as application fees and higher lending charges) charged to new applicants. Recently several mortgage providers have identified that some customer segments are more willing to accept a less favourable interest rate so long as there are no up-front fees. A new breed of 'no fee' mortgages is now being positioned in the market to attract this specific customer segment. The improved segmentation and communication strategies have led to an immediate bottom line improvement.

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- In the personal current account market retail banks are developing tiered packaged offerings that bundle services with associated products, which reflect that there are customers willing to pay a monthly fee in a usually free banking environment (excluding penalty charges etc.). Notably HSBC has succeeded in positioning itself as the bank provider for 'newly arrived residents' especially from Eastern Europe. By developing segment-specific product bundles, covering regular banking, savings and insurance products, it has dramatically increased its cross-sell rate and new customer uptake.
- Personal lines insurers are also starting to optimise their 'street' pricing processes and capabilities. Fully aware that risk based pricing is no longer sufficient in a competitive market place dominated by promotional street level pricing, insurers are investing to develop deep customer insights, enabling them to advance to a new level of segmentation sophistication and more accurately match product offerings per sales channel with customer segment needs and their price elasticities.
- Throughout consumer financial services organisations are investing in optimising their pricing processes. For example, another personal lines insurer benchmarked the pricing processes of each business in its brand portfolio against best practices. Areas for improvement ranged from obtaining the right data to make like for like comparisons possible, to delivering lasting change in the pricing culture of certain underperforming business units.

Figure 2: Financial effect of pricing process improvement

Segment	Size (revenue)*	Main improvements in the pricing process	Effect (increase in return on sales in %-pts.)
Retail securities	GBP 70 m	- Systematic quantification of the 'value-to-customer' - Implementation of intelligent forms of price differentiation	approx. 3.0
Retail payment transactions	GBP 50 m	- Reorganisation of the whole pricing process - Introduction of a controlling tool for price implementation	2.8
Retail current accounts	GBP 35 m	- Clear up of the product and price portfolio - Innovative and segment-specific value added packages	4
Retail cards	GBP 35 m	- Measurement of segment-specific price elasticities - Innovative price structures, revised product and service portfolio	6.5
Private Banking securities	GBP 150 m.	- Development of a comprehensive pricing database - Systematic rules and processes on special conditions	5
Private Banking services	> GBP 160 m	- Development of new 'value added services' - Implementation of a value added strategy (modular solution packs)	3.4
Private Banking	> GBP 160 m	- Detailled pricing audit for all core products and segments - Tools for price implementation	6
Funds	> GBP 300 m	- Implementation of new pricing guidelines and processes - Price optimisation of over 100 funds	3
Corporate Banking	> GBP 200 m	- Systematic identification of value drivers - Improved price and value enforcement	4

* of the business segment analysed
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Cases like these prove that the positive financial returns from pricing process improvement arrive through many different actions depending on the respective bank – more differentiation, new fee structures, or new bundle products, to name just a few. What they all have in common, however, is the positive impact on the bottom line.

Using pricing processes to make value extraction from the market more effective and to thus increase profits requires top management to take the initiative and responsibility for such changes. Price management is not optimised overnight and requires substantial analysis and effort. However, the effort is more than justified considering the gains are usually measured in tens of millions of pounds. ☐

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