decision technology

Pulling Rank:
How to win the pricing game

Executive Summary

Price comparison websites (PCWs) are shaking up the financial sector. Companies can no longer rely on an historical brand and high street presence. Customers are moving online towards Fintechs and PCWs to look for the best deals. Firms whose products are not at the top of the rankings are losing out.

PCWs are not more than a couple of decades old: the first one launched in 1995[1]. But 20 years later they continue to succeed. They are a crucial sales channel for retail financial services firms. Customers are turning to them more and more when hunting for the best products available - studies show that 70% of UK internet users have visited one[2]. Total insurance sales in the UK are £33Bn[3], and a Competition Commission report found that among the 10 largest insurers nearly a quarter of premiums were sold via PCWs[4].

But PCWs are also increasing competition for firms, reducing revenues and encouraging customer churn. They represent both a significant risk and a considerable opportunity.

If firms want to mitigate the risks and make the most of the opportunities, they need to move beyond traditional pricing models based on outdated economic theory and inaccurate market research. Instead, commercial directors must use behavioural science to understand how and why customers use PCWs the way they do. Only then will they be able to develop a more robust pricing strategy and see their business thrive.

Decades of academic insight and robust experiments show that people are better at making comparisons than decisions without context. This means customers do not make purchasing decisions based on the absolute value of a product. Instead, they focus on how that product compares to others. This is why PCWs are so successful – they appeal to our inbuilt need to compare.

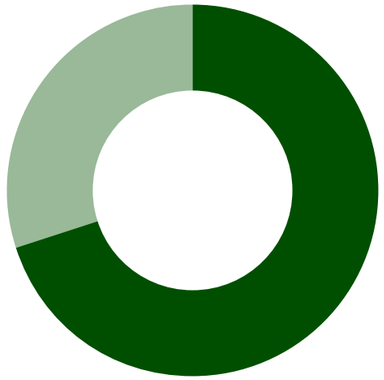
The top three products on a PCW account for around 80% of sales. This means that a small change in price can make a big difference in how attractive a product is to customers. Our research shows that a small reduction (as little as £1) in the price of an insurance policy on a PCW that moves it from second to first place in the rankings results in a 37% increase in market share.

Retail financial services firms must adapt to the reality of PCWs if they are to survive. There are five steps they should consider:

1. Ensure their products are always ranked in the top three on PCWs.
2. Create a low-cost, online-only brand to win customers on PCWs, using a smaller cost base.
3. Adapt their operations to cross-sell more profitable services to customers arriving from PCWs.
4. Conduct regular research using randomised controlled experiments to inform product design.
5. Upskill staff to ensure they understand the ongoing implications of behavioural science.

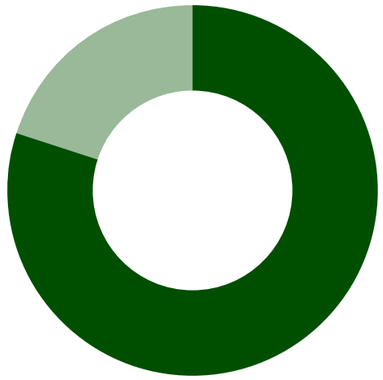
PCWs are disrupting the financial sector. They appeal to customers' natural decision-making process and provide an easy way to compare prices. This reduces the effectiveness of firms' traditional promotional activity and puts pressure on profits.

Firms that take these recommendations on board can better protect their market share, develop new opportunities and prosper. Those that continue with business as usual will soon find themselves struggling.



Percentage of UK internet users that have visited a price comparison website

70%

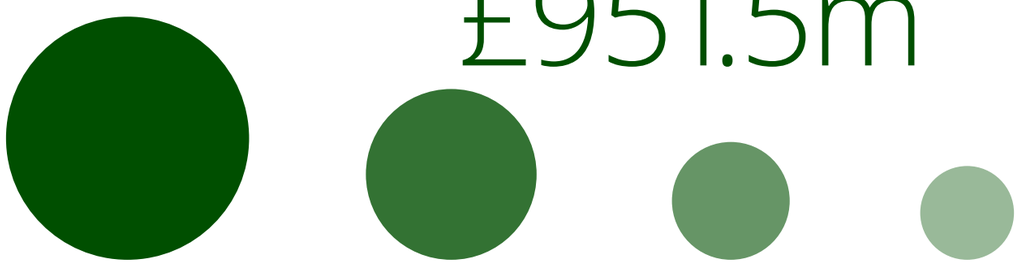


80%

of sales come from the top three products on a price comparison website

Revenue of the four largest price comparison websites in 2015[5]

£951.5m



CompareTheMarket.com
£507.0m

MoneySupermarket.com
£250.1m

GoCompare.com
£119.0m

Confused.com
£75.4m

The Business Challenges of Price Comparison Websites

Price comparison websites:

- Reduce revenues
- Make it harder to compete on service or quality
- Lead to higher customer churn
- Increase competition
- Lessen firms' control over the sales journey

The remarkable popularity of PCWs has made life more challenging for retail financial services firms in several ways.

Firstly, and unsurprisingly, PCWs increase price competition. This has a direct impact on revenues. Data from the Association of British Insurers shows that insurance premiums have fallen over the last few years – 12% in motor and 9% in property insurance[6] – at a time when capital constraints and lower investment returns should have been forcing prices to rise. Furthermore, the increase in the number of households with insurance has not counterbalanced that shortfall in revenue.

Additionally, the emphasis PCWs place on price makes it more difficult for firms to compete on other attributes such as service or product quality. This is a particular challenge for the financial sector given efforts to improve its reputation in the wake of recent mis-selling scandals.

Secondly, PCWs lead to more customers changing provider. Success stories from friends and family, along with enthusiastic encouragement from consumer groups, trigger customers to move their money. Between 2013 and 2015 two million customers switched their current account[7], and since then bank account switching has increased further, with a record number of switchers in March 2016[8].

Thirdly, PCWs offer a platform for a long tail of banks, building societies and insurers that customers were previously unaware of. The likes of Fresh! Insurance Group and Acorn receive exposure on PCWs, meaning they have to spend less on expensive adverts to achieve the same cut through as their more established peers.

PCWs can also introduce customers to alternative products and providers. Three of the four biggest PCWs now list peer-to-peer businesses such as Zopa Loans or Assetz Capital. And as the Fintech sector continues to develop, there will be more innovations to include on PCWs. So firms will face an increasingly competitive environment.

Finally, PCWs cause firms to lose control of the sales journey by acting as highly efficient brokers for customers. Firms therefore have less control over the environment in which customers interact with their brand.

Even those customers who do not buy direct from PCWs are likely to have used the sites to do research before making contact with a provider to complete their purchase. This means firms are dealing with better informed customers who feel empowered to negotiate harder than they might have done in the past.

But behavioural science offers a new approach through which retail financial services firms can confront these challenges. By understanding the latest insights into the customer decision-making process, and tailoring their pricing strategy accordingly, firms can take back control and regain market share.

Regulating PCWs

The rise of PCWs has drawn the attention of various regulators. In the financial sector, the FCA has undertaken research to ensure good customer decision-making when using PCWs[9]. Meanwhile, in its report into retail banking, the CMA has ordered banks to maintain common API standards so data can be shared with PCWs and consumers can more easily identify products which suit their needs[10].

The story is similar in the energy sector. In 2015, the Energy and Climate Change Committee published a report highlighting the need to protect customers by ensuring energy PCWs are transparent[11]. Ofgem has also strengthened its requirements for PCWs looking for accreditation through its Confidence Code[12].

As PCWs continue to thrive, regulators will continue to monitor their impact on the market. This means firms are likely to have to manage uncertainty and adapt to new policies as regulators seek to ensure best outcomes for customers.

"By understanding the latest insights into the customer decision-making process, and tailoring their pricing strategy accordingly, firms can take back control and regain market share."

Applying a Behavioural Lens to Pricing

Understanding the customer is crucial for retail financial services firms looking to address the challenges created by PCWs.

The customer is the common, crucial element in the sales process. So understanding how people make decisions is the bedrock for developing a commercial strategy and pricing model that can keep pace with the changing competitive landscape.

The Problem with Traditional Pricing Methods

For too long, the financial sector has relied on traditional economic models to understand price elasticity and predict customer purchasing behaviour. But this fails to take into account the real world mental processes that really drive behaviour.

Economic models aim to show how many products will be sold at a given price. However, they do this based on the assumption that people are utility maximising machines, with a database of prices stored in their heads. This is not the reality. As we go about our everyday lives, we are simply not paying that much attention to price. A study of supermarket shoppers found that more than 50% could not correctly state the price of an item they had just put in their trolley[13].

Another common method firms use to understand customer behaviour is market research. But while this seeks to understand customers 'as they are', it uses unreliable self-reported data rather than actual measured behaviour. This means much of it will be inaccurate – just ask a doctor how much they believe their patients' statements about levels of exercise and drinking!

Using Behavioural Science to Understand the Customer Journey

Traditional economic models and market research fail to accurately understand and predict customer behaviour. Firms need to use a behavioural approach that does not rely on flawed assumptions about human decision-making or self-reports by customers.

This is not a new innovation. Behavioural science is built on decades of academic research and the use of robust experimental techniques to understand how people really make decisions. Then why hasn't it been adopted faster? Because organisational inertia leads firms to do what they've always done, to use the same old approaches to tackle new problems. Firms need to adapt quickly before Fintech delivers the financial services sector an 'Uber moment'.

To fully understand PCWs and develop an effective commercial strategy, it's important to understand the psychological effects at play when customers use PCWs. Firms need to understand the mental biases that influence purchasing behaviour and develop a commercial strategy based on these insights[14]. Two mental biases are clearly relevant to PCWs.

First, we consider framing effects, where people's preferences vary depending on the context of a decision. Framing effects happen because people don't have an absolute sense of value, but are good at making comparisons. For example, fifty pounds seems like a lot when compared to the price of a coffee, but tiny when compared to the average mortgage payment, so prompting customers to think in a certain way will change their choice. PCWs frame decisions in terms of price alone, and therefore customers focus on price to the detriment of other considerations, such as level of service or restrictions in product small print.

Second, there is a phenomenon called the status quo bias. This is simply the fact that, since losses loom larger than equally sized gains, we generally prefer things to remain the same and need a large incentive to move away from the status quo. The status quo bias is why the Government introduced auto-enrolment for company pensions, which were previously ignored by many employees making decisions about how to spend or save their money because the rewards of regular investment were so far in the future. Clearly customers can be tempted away from the status quo bias, otherwise customers wouldn't use PCWs to switch. But there is still some advantage of being a customer's current provider, as we shall outline later in the report.

The Importance of Comparison

Related to these two behavioural biases is a feature of human decision-making called reference dependence. This term refers to the fact that people are better at making comparisons than absolute judgements. It is best explained with an example, such as wages. It has been said that "a wealthy man is one who earns $100 a year more than his wife's sister's husband"[15]. That is, what each of us actually earns in pounds and pence matters less to us than whether it trumps what our friends or colleagues earn.

This observation that salary is relative is borne out by research[16]. For example, when people were shown a list of 11 salaries and asked to judge the attractiveness of each wage, their verdicts reflected more than just the cold cash.

The graph in Figure 1 plots the two lists presented to the respondents. What we can see is that rather than each salary having absolute level of value and therefore being treated the same, people instinctively convert the unevenly distributed set of wages into an evenly distributed range of relative attractiveness. So a salary of £26,000 (labelled A and B) seems more or less attractive depending on context, whether the salary ranks second or fifth in the range of options. It is not the amount but where it ranks that is important. This is why PCWs have become so popular – they appeal to our tendency to make comparisons using rankings.

This inclination to make comparisons also means that how alternative products are presented will have a significant impact on customer choice. This often happens in counterintuitive ways. One example of this is known as the decoy effect, where customer preference is altered by changing how the decision is framed. In his book 'Predictably Irrational', Dan Ariely demonstrates the decoy effect using the example of subscriptions to The Economist magazine.

Figure 1: Salary Judgements

As Figure 2 shows, when customers were given the standard options of a web only subscription or a more expensive web and print subscription, more than two thirds chose the cheaper option. However, when a decoy third option was added in the form of a print only subscription at the same cost as the web and print subscription, the vast majority of customers chose the more expensive web and print option rather than the cheaper web only subscription previously preferred. This shows that the addition of decoy products onto PCWs could increase uptake of more profitable products.

PCWs appeal to humans' preference for comparison. Retail financial services firms need to understand the science behind the behaviour and consider how various mental biases influence consumer behaviour, and in turn impact their sales.

Figure 2: The Decoy Effect

Standard Portfolio		
Subscription type	**Price**	**Choice**
Web	$59	68%
Web + Print	$125	32%
Total Revenue = $8,012		

Decoy Portfolio		
Subscription type	**Price**	**Choice**
Web	$59	16%
Print	$125	0%
Web + Print	$125	84%
Total Revenue = $11,444		

"Retail financial services firms need to understand the science behind the behaviour and consider how various mental biases influence consumer behaviour, and in turn impact their sales."

What Determines What a Product is Ranked Against?

We know that people rely on comparison when making decisions, and will consider where a product ranks compared to others more than its absolute cost or value. This begs the question: what determines what a product is ranked against?

The answer lies in the mind of the customer. Whenever we think about making a purchase decision, we create a mental list of options. But rather than precise lists of product prices and other features, as economists would assume, these lists are fluid, inaccurate and created on the fly.

The items customers include in their mental list come from three sources:

- Firstly, people draw on their memory of past purchases. If they are looking to buy car insurance, for example, they will think about the premium they paid last year.
- Secondly, people think about prices advertised by businesses. In our car insurance example, this would include the provider's renewal quote as well as premiums offered by competitors.
- Thirdly, and usually only if no other information is available, people use relevant contextual information. So they might think about the cost of other types of insurance such as building and contents insurance.

PCWs recognise and respond to our need to compare prices. Against the chaotic mishmash of past recollections, advertising and other data that customers use to form mental lists, PCWs provide a simple, relevant and ordered list of options for customers to choose from.

Behavioural Science Theory in Practice

Given the importance of PCWs, we wanted to explore their impact on market share. So we studied the relationship between a product's price and its rank using an experiment based around car insurance.

We created a fictitious PCW and presented a random selection of policies to over 500 motor insurance customers, as shown in Figure 3.

Any economist would expect market share to rise as prices fall. And that is exactly what we find – the market share of a given insurer rises from 0% to 65% as its policy drops from £500 to £350.

Figure 3: Insurance Choice

Here are your insurance quotes...

Provider	Price	Excess	Service
PRUDENTIAL	£379	£75	★☆☆☆☆
Insurance	£396	£200	★★★★☆
	£417	£75	★★☆☆☆
Lloyds TSB	£443	£150	★★☆☆☆
esure	£464	£150	★★☆☆☆
RSA echoice	£497	£75	★★★★★
	£526	£125	★★★☆☆
churchill	£532	£100	★☆☆☆☆
AVIVA	£559	£250	★★☆☆☆
RAC	£589	£150	★☆☆☆☆

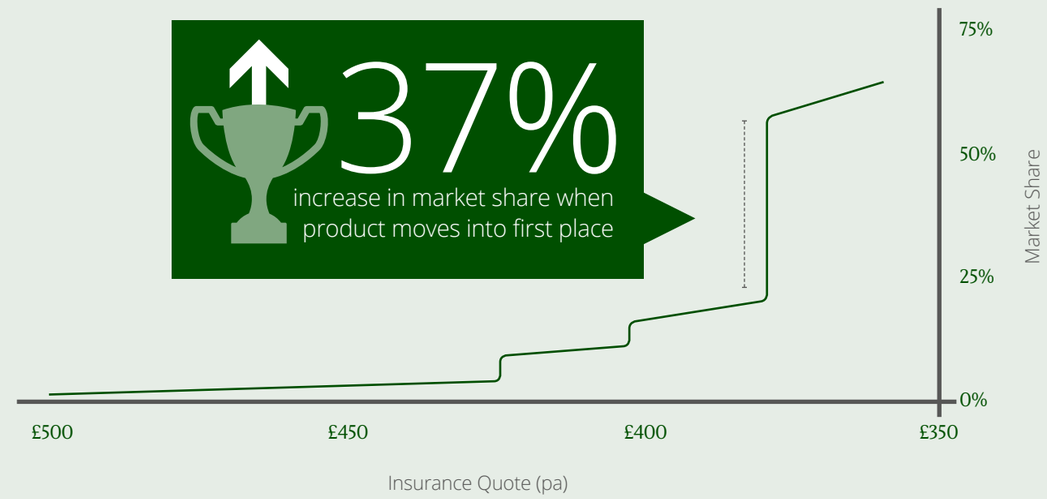
But, crucially, this transition is not as smooth as traditional econometric analysis assumes. As Figure 4 shows, as the policy moves past its competitors into third, second and finally first place in the rankings, we see corresponding jumps in market share, as the policy is framed as incrementally better than its alternatives.

So the small price reduction that takes the product from second to first place on a PCW has far greater impact than the same reduction when the product's rank is unaffected. In this experiment, the prize for first place is an extra 37% market share over the competition in second place.

This research demonstrates what financial services firms need to do in order to acquire customers on PCWs. As the sales environment of PCWs is heavily rank dependent, firms need to cut prices until their product is ranked in the top three; no other rank gets traction. To consistently achieve this, firms will need to rethink their approach to product pricing. Since price elasticity is so context dependent, slight changes in competitor prices will shift demand significantly. Tackling such a dynamic problem requires up-to-date information and, crucially, the right model, since traditional 'optimal price' analyses will be obsolete within hours.

Customer retention is another challenge. Clearly, the savings offered by PCWs are large enough to coax many people away from their current provider and towards cheaper alternatives. But the status quo bias means customers would generally prefer to stay where they are. In practice, this means customers need an annual saving of roughly £20 before making the decision to switch. This means, in order to retain customers, firms only need to close the price gap enough to ensure the status quo is preferred over marginally cheaper competitors.

Figure 4: Product Pricing



Looking Beyond Price

Despite the importance of price, it makes up just one piece of the sales puzzle, albeit a large piece. Clearly there are other product features that influence customers' decisions.

Branding is one such example. In other investigations of PCWs, we have found that customer familiarity with a brand influences their choice of product. Specifically, customers are a third less likely to select a product from a brand they had never heard of. Similarly, customers are three times more likely to choose a product if it is offered by their current provider.

This should offer some hope to firms seeking to compete on PCWs. Despite the fact that PCWs increase overall churn, there is still some innate loyalty among existing customers.

> *"Customers are three times more likely to choose a product offered by their current provider."*

Recommendations

It is clear that PCWs have become popular because they cater to psychological effects and mental biases that are deeply embedded within us.

They align with our natural tendency to make comparisons, make complicated mental processes effortless and allow customers to include far more products than they would otherwise be able to consider.

So how should retail financial services firms respond to the changing market environment caused by PCWs?

We recommend five steps that will help firms survive and thrive:

1. Embrace PCWs

Firms need to ensure that their products are always ranked in the top three on PCWs. Our research shows that only the brands in these positions will capture market share. Achieving this while maintaining reasonable margins is the challenge.

2. Move online

Follow the strategy of some energy brands and create a low-cost, online-only brand. Doing this can help manage the lower cost base required to acquire customers from PCWs, and compete in an efficient way.

3. Up-sell

Firms should use low cost products to draw in significant volumes of customers via PCWs and follow up with strong cross-selling of more profitable services. It is vital that firms identify and work to attract the groups of customers that are receptive to cross-selling.

4. Test and learn

Firms should conduct regular randomised controlled experiments to monitor the latest trends in customer behaviour. New initiatives and proposed changes to pricing strategy should be rigorously tested before being implemented more widely.

5. Embed behavioural science

Firms must upskill staff to ensure that all teams fully understand the behavioural science behind customer decisions. Pricing teams need to overhaul their modelling to account for behavioural quirks. Retention teams need to identify and mitigate the triggers of customer churn. Communications teams need to reassess customer touchpoints to secure customer loyalty.

In times of greater competition, it is crucial that business decisions are based on reliable evidence. Neither standard economics nor traditional market research provide the rigorous quantitative output required to develop a robust pricing strategy. Instead, retail financial services firms must use behavioural science to develop a strong understanding of customers and how they really make choices in the world of PCWs.

Firms that take these recommendations on board can capture market share and succeed. Those that continue with business as usual will soon find themselves at the bottom of the pack.

“In times of greater competition, it is crucial that business decisions are based on reliable evidence.”

About Decision Technology

Decision Technology specialises in helping businesses and policymakers understand and manage customer decision making, from acquisition through to retention and all the points in-between. We are members of the Market Research Society and Management Consultancies Association.

We seek to define a new category of insight that is both market research agency and strategy consultancy. We deliver field research and customer insights alongside financial analysis and business advice. We believe in this hybrid approach because it marries a necessary focus on commercial results with a practical understanding of what drives human behaviour. In practice, this means we are differentiated by three methodological pillars: we are experimental, behavioural, and statistical.

PriceLab

We used these three methodological pillars, experimental, behavioural, and statistical, when developing PriceLab – a means of understanding how customers behave in existing decision environments.

With PriceLab, we develop a bespoke digital environment that replicates the decision process your customers routinely face. Whether it’s a virtual shop front or a price comparison website, we ensure the customers’ choices are true to life.

Within this environment, there is plenty of room to experiment. New propositions, pricing strategies and sales architectures can be tested without risking your brand.

We track customers’ behaviour as they follow the purchase process, and use sophisticated statistical techniques to determine how each feature of your products influences decision making.

This approach means our insights are tailored, relevant and actionable, which provides a clear roadmap for your commercial decisions.

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Find Out More

For more information, visit our website at www.dectech.co.uk, email us at enquiries@dectech.co.uk, or call +44 (0)20 7193 9812.

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