

Relationship pricing ...
*The next revolution in retail
financial services marketing?*



The recent credit crisis has transformed the financial services marketplace through the formation of larger institutions with broader footprints and a wider set of products to offer small business customers and consumers. Now, more than ever, management at many of these truly national financial supermarkets – as well as at their smaller but still large regional competitors – are seeking ways to move their marketing beyond a product-centric approach toward a more customer-oriented one. In the process, these institutions hope to break down the traditional product silos that have often limited their ability to effectively manage their customer relationship in a holistic manner.

One often-discussed approach to create a more customer-centric orientation is to move from product-based pricing to relationship-based pricing. Relationship-based pricing is a system of pricing whereby the prices of products and services depend on an individual or household's *overall* product and service purchases rather than being determined on a product-by-product basis (i.e., overall purchase levels do not impact individual product level pricing). The goals of relationship pricing include: attracting new customers who otherwise might not have made a purchase; expanding the breadth of products and services provided to existing customers; and retaining existing customers when competitors offer similar relationship pricing programs.

“Triple Play” for banking?

\$99 per month for telephone services, cable television and internet access. Great marketing sound bite. Easy to understand. Simple to implement. These bundled offerings introduced by telephone and cable companies have transformed an industry where products were historically purchased separately into one where many customers have chosen to consolidate their purchases from a single provider.

Operating in a financial services marketplace where many customers have four, five, six or more providers, a similar transformation is every bank, insurance and wealth management executive's dream. Yet realizing this dream may be far more complex in financial services than in entertainment and telecommunication services from two perspectives. First, the underlying economics of and purchasing customer behavior for financial services are different from that of entertainment and

telecommunication services ... and from most other businesses that have succeeded with some type of relationship pricing. Second, bundled pricing is only one of several ways that financial services companies can move from product-based pricing to relationship pricing.

Entertainment and telecommunication services versus financial services

The economics of and purchasing behavior for entertainment and telecommunication services and financial services are fundamentally different. Once a coaxial or fiber optic cable is run to and a converter box is placed in a residence to provide a single service such as cable television, the marginal cost of providing incremental services such as telephone and internet access is practically negligible. The marginal costs are typically limited to a modest requirement for additional network capacity to provide for the extra bandwidth required which costs a fraction of the standard monthly fee for the services provided. As a result, entertainment and telecommunication companies are willing to offer these incremental services at what is a substantial discount from the à-la-carte pricing for them, which in turn makes some type of bundled offer – at a substantial discount – quite attractive to consumers.

The purchasing behavior for entertainment and telecommunication services often involves making a decision at the time one is moving into a new residence where suddenly a bundle of services is required. Or, if one is considering changing existing service providers, the decision is often accompanied by the desire to upgrade the service such as going from analog to digital cable. In addition, regulations such as phone number portability and the increasing delinking of email addresses from internet access providers have substantially lowered the effort and hassle involved with switching providers, especially when compared to the substantial financial benefit a consumer can garner by consolidating services with a single provider.

The underlying economics of providing many financial services products are quite different. While the cost of a branch network, a relationship manager or a statement are mostly fixed in a manner similar to the cost of providing entertainment and telecommunication services, there

are significant costs for many products, particularly loan, deposit, insurance and transaction-based products, that are a function of the balance/premium and/or the transaction intensity. Loans and deposits are spread-based businesses with cost-of-funds and interest costs respectively that are not “shared costs” and increase with balance amount and have large origination costs (even if originated simultaneously with other products). In addition, loan products have substantial loan loss costs and capital requirements that must be accounted for even if the sale of such products represents purely “incremental sales.” Life and property and casualty insurance products have many similar characteristics to deposit and loan products although the specifics vary somewhat. Transaction products, such as brokerage services, typically involve a high level of specialized customer service – often with a dedicated relationship manager separate from the one providing other services – and a significant volume of transactions that are costly to process.

Likewise, the purchasing behavior for financial services is very different from that of entertainment and telecommunication services. With the emergence of national financial services providers over the past decade, it is now a rarity that one has to change providers just because one moved across town – or even across the country. This has greatly reduced the number of financial services provider switches driven by customer relocation. In addition, the need for financial products typically surfaces over time. Offering a benefit to buying several products today is very unlikely to get a 20 year old student to buy a life insurance policy or a \$20,000 certificate of deposit or to open a brokerage account. Likewise a 72 year old retiree is unlikely to be in the market for a student loan. Creating packages of appropriate products is generally much more challenging in financial services than in entertainment and telecommunication services although there are still some opportunities to do so around certain life events such as being a student, getting a first job, getting married, having a first child and retiring.

In addition, switching costs are often significant for many products such as one’s core banking account, mortgages, auto loans, investment services and life insurance products but less so for other such as credit cards. These switching

costs are likely to make consumers reticent to make a change unless there is a compelling economic or other reason to do so – something that can occur, for example, when interest rates fall substantially and suddenly refinancing a mortgage becomes attractive. The benefit a financial institution can offer through relationship pricing for consolidating accounts may not be adequate to overcome these switching costs.

In sum, economic characteristics make it more challenging for financial services providers than for entertainment and telecommunication services providers to offer a substantial financial benefit for a consumer to consolidate with one provider or at least fewer providers. In addition, consumer purchasing behavior makes creating attractive packages of products and services that are compelling for consumers much more difficult for financial services than for entertainment and telecommunication services.

Relationship pricing benefits

If relationship pricing poses challenges in financial services, what benefits might it provide the financial institution that would make it worthwhile to overcome them?

A review of academic and consulting literature, which mostly focuses on bundled pricing – charging a single fee for a package of products and services – suggests a number of rationales for companies offering some type of relationship pricing. These include: 1) leveraging a monopoly position in one market into another more competitive one; 2) low-marginal costs to provide ancillary service; 3) convenience gains for consumers; 4) reducing customer turnover; 5) circumstances where one prospective customer values one of products being offered more than another prospective customer who happens to value another product being offered more than the first prospective customer.

Leveraging a monopoly position in one market into another more competitive one typically doesn’t apply in the highly competitive retail financial services industry as there are few monopoly positions to leverage. This is probably just as well since leveraging such monopoly positions can lead to painful and expensive anti-trust litigation.

While having low-marginal costs to provide an ancillary service frequently doesn't occur in financial services, there certainly are instances where it does such as providing debit cards and online banking services to deposit account customers. But unfortunately these services often have been "thrown in for free" rather than being viewed as an ancillary product, likely because there is no stand-alone market for these products.

Relationship pricing has been most prevalent to date in financial services for products and services that when purchased together are more convenient for customers than purchasing them separately from two different providers. Examples include consolidating one's primary checking and savings account at the same bank (with the pricing of the services dependent on the combined balances of the two accounts) or purchasing homeowners and automobile insurance from the same insurance company (often with a substantial discount). One would have to be offered something pretty attractive, for example, in order to endure the inconvenience of having one's primary checking account and one's primary savings account at different banks. So these two products naturally became "bundled." Unfortunately for financial services providers, there aren't a lot of similar examples across the broad array of financial services products one is likely to purchase over their lifetime. And, if convenience gains are a significant benefit for customers, it is unclear why they need to be offered a benefit via relationship pricing to consolidate these purchases.

Reducing customer turnover (or its converse – increasing customer loyalty) is an oft stated rationale for relationship pricing. While there is evidence across a variety of industries that having a deeper relationship (e.g., more products, higher purchase levels) does tend to correlate with lower customer turnover, unfortunately it is very hard to identify the causality. Did the deeper relationship lead to higher loyalty or did higher loyalty (driven by a variety of factors) lead the customer to decide to deepen the relationship? In reality, loyalty and purchasing depth probably drive each other in a symbiotic relationship although building empirical evidence of which is the primary driver is challenging. Some European banks enjoy a relatively higher number of products per customer than in the U.S., partially due to local customer habits and partially due to intensive marketing campaigns. However, their retention numbers are similar to U.S. banks, which make it hard to infer causality.

The final rationale for relationship pricing – circumstances where one prospective customer values one of products being offered more than another prospective customer who happens to value another product being offered more than the first prospective customer – is perhaps the least intuitive but ultimately the most compelling rationale.

The technical definition of this type of situation is one where there is asymmetry in reservation prices across two customers (or customer segments). A reservation price is the maximum price a consumer is willing to pay for a product. If the asking price of the product is less than the reservation price, the consumer will buy it. If the asking price exceeds reservation price, the consumer will not.

An example from the travel industry can be used to illustrate the concept. Consider a travel agency that is developing a six-day vacation package that will include both a roundtrip flight and five nights at a hotel. Assume that the travel agency has purchased 20 roundtrip tickets and 100 hotel nights from airlines and hotels and now must find a way to sell them for the most revenue possible.

Below is a chart that shows the reservation prices for two segments of customers (A & B).

Vacation Package Pricing - Reservation Prices		
	Customer Segment	
	A	B
5 Nights at Hotel	\$750	\$1,000
Roundtrip Airfare	\$700	\$450
Total	\$1,450	\$1,450

In this case, segment A is more willing to pay for the airfare than segment B and segment B is more willing to pay for the hotel than segment A. Hence, asymmetry exists (note: for simplicity, in this example, the total reservation prices for the two segments are the same; however, the same outcome can be demonstrated in cases where there is variation in total reservation prices as long as there is still asymmetry of the individual reservation prices).

So what does this mean in terms of the most effective pricing strategy for a travel organization that wants to maximize revenue? It has the choice of pricing the hotel and airfare separately or creating a bundled offer. The chart below shows some alternatives and the resulting outcome assuming there are 10 prospective customers in each segment.

Vacation Package Pricing Alternatives Customer Demand & Resulting Revenue						
Prices			Sales			Revenue
Hotel	Airfare	Bundle	Hotel	Airfare	Bundle	
\$750	\$450	NA	20	20	NA	\$24,000
\$750	\$700	NA	20	10	NA	\$22,000
\$1,000	\$450	NA	10	20	NA	\$19,000
\$1,000	\$700	NA	10	10	NA	\$17,000
\$1,000	\$700	\$1,450	0	0	20	\$29,000

The first four alternatives all involve stand-alone pricing. In the first, the prices are set low enough to generate sales in both segments (i.e., at the lower reservation prices across the two segments), resulting in 20 sales and generating \$24,000 in revenue. Any higher prices than these prices will result in lost sales but some of the lost revenue is made up for through higher unit prices. Unfortunately, as demonstrated in the second through fourth alternative, the incremental revenue from higher prices is not enough to make up for the lost unit sales. So, without bundled pricing, the first alternative is the best strategy at generating the most revenue.

The final alternative shows the impact of offering a bundled option – setting the price of the bundle at the total reservation price for each segment while continuing to offer the higher prices as stand-alone options (note: this approach to bundled pricing is called mixed price bundling; there is another variant called pure price bundling where only the bundle is offered; given the significant operational and regulatory issues raised by pure price bundling in financial services, the focus here will be limited to mixed price bundling). The results show that 20 people purchase the bundled option and the total revenue of \$29,000 exceeds the revenue from the first alternative. Given that the unit sales are the same as for the first alternative it is clearly a better result for the seller.

For bundled pricing to be effective at raising revenues, there needs to be this type of asymmetry in reservation prices and the greater the asymmetry the greater the benefit derived from bundled pricing. As people’s preferences are quite diverse, for most products and services there is at least some asymmetry in reservation prices although measuring it precisely is a challenge. In addition, bundling together two items that have nothing to do with each other – such as tickets to a sporting event and a 20 pound turkey – may not make any sense even if there is significant asymmetry in reservations prices across prospective customers. Bundled pricing will be more effective where consumers see some logic and clear benefit in the bundle – and when they are likely to be in the market for both products at the same time.

The above example highlights the effectiveness of bundled pricing, particularly in cases like this example where the travel agency purchased 20 roundtrip tickets and 100 hotel nights which, without a sale, would go unused. Therefore any incremental revenue generated by bundled pricing goes straight to the bottom line. For the entertainment and telecommunication services provider, the results would be similar as most of their costs are fixed.

But for a financial services provider, as highlighted earlier, the economics of the business suggest that incremental sales have much higher incremental costs. In the above example, per unit revenue is actually highest in the second to last alternative. If there were substantial marginal costs, it is quite possible that this alternative would be more attractive than the bundled pricing outcome, not from a revenue perspective but from a profitability one. In other words, profit maximization (including capital costs), not revenue maximization is typically the dominant goal of financial institutions.

Relationship pricing alternatives

A more holistic method of pricing can be established in a number of ways. Bundled pricing is the alternative that has come to dominate the entertainment and telecommunication services business, driven primarily by its marketing simplicity. Yet other approaches to relationship pricing exist and marketing executives at financial services companies should consider the merits of these approaches as well.

Providing incremental products or services beyond the customer's initial purchase at a discount from their list price, with the discount being a function of the total purchases to date, is a common approach. That's particularly true in markets where the customer is unlikely to be ready to make a commitment at one time to the full package of products and services he or she may ultimately acquire. Department stores often use this approach – \$25 off a future purchase of at least \$75 with a \$100 purchase today – as a way to spur future sales.

Loyalty programs that offer some type of rebate or other benefit based on total purchases over time are yet another approach to relationship pricing. These are particularly common in industries where adjusting the price of products is challenging for practical or regulatory reasons as well as in industries where a customer is likely to have an ongoing relationship and make a series of purchases over time. Many supermarket and pharmacy chains have chosen this approach to relationship pricing as it is impractical to change the price of spaghetti or toothpaste based on the relationship status of the person purchasing it and people return to the store over and over again over the course of a year. Airlines have chosen a similar approach through their frequent flier programs. This approach has likely been driven more by the ability to provide a benefit – a free trip or a first-class upgrade – that is of much greater value to consumers than the cost of providing it than by the inability to charge differential prices based on relationship status (as airlines already charge a dizzying array of prices based on a number of other factors). In addition, these programs have been particularly attractive to customers as airlines have been able to structure the programs so that the benefit typically goes to an individual who has not paid for the original purchase with their own money but rather with their employer's money.

Implications for retail financial services

Clearly, ascertaining whether some type of relationship pricing program will be effective in financial services and how to structure it is quite challenging. It is unlikely that something as simple and straightforward as the "Triple Play" initiatives in entertainment and telecommunication services will emerge in financial services. Nor are the discounts that are likely to be able to be offered consumers likely to be nearly as large as in entertainment and telecommunication

services given the differences in the underlying economics of the business. However, some of the rationales posited for relationship pricing likely exist in financial services (even if they haven't been proven as conclusively as one might like). These include:

- Convenience gains for consumers
- Reducing customer turnover
- Asymmetry in reservation prices

The most likely approach to relationship pricing is an expansion of the types of loyalty programs that have begun to emerge that provide a reward account based on purchases across multiple products rather than the historical ones that focused on a single product. The size of the contribution to the reward account could vary based on the size of the purchase as well as the overall relationship size (and/or length). There may even be opportunities for companies in different sectors of financial services (e.g., banking, insurance, investment management) to get together on a joint loyalty program since few institutions are likely to offer the full range of financial products consumer are likely to need.

There are, however, significant risks to relationship pricing unless financial institutions have a clear understanding of:

- Profitability dynamics of their products and customers
- Variation in sensitivity of customers to prices charged

Implementing a relationship pricing program without improved understanding in these areas is likely to result in much of the investment going toward customers that are unprofitable, are not very price sensitive (and therefore are unlikely to provide much return on the investment being made), or both.

The way that financial products are frequently offered today, behavior differences across customers often drive large variations in profitability at the product and customer level. Usage differences can vary greatly, which for balance-based products such as deposits and loans drive large variations in revenue. In addition, some customers prefer high cost-to-serve service channels (e.g., branch/office based personnel) while others use predominantly lower cost-to-serve service channels (e.g., ATMs, telephone centers). Finally, some customers purchase one or two products and others purchase many more. These three factors – widely varying revenues and

costs at a product level plus widely varying product usage at a customer level – result in significant profitability differences across customers. As a result, large cross-subsidies typically exist so that a financial institution can lose money with many customers within a business that overall is quite profitable. And this profitability dynamic can change considerably over interest rate cycles and credit cycles, while recent regulatory changes (e.g., limits on banking fees and interest rates) will have a significant one time impact. Yet, most retail financial institutions do not have a good understanding of their profitability at as granular a level as a customer. Without an understanding of which customers are most and least profitable as well as what is driving those profitability differences, it is a challenge to determine toward which customer a relationship pricing program should be targeted even if an attractive program can be designed.

Likewise, relationship pricing programs are not going to be equally effective as some customers will be more sensitive to pricing changes than others. But most financial institutions' understanding of these variations in price sensitivity is in their infancy. Data often exists to analyze these differences – or can be created through a conscious price testing program – and predictive modeling approaches and software tools exist to analyze price elasticity in great detail, but only modest progress has been made to date. Without a better understanding, much of the benefits of any relationship pricing program may go to customers that aren't likely to change their behavior based as a result of receiving it. Once financial institutions more fully understand variations in price sensitivity, they will be able to target relationship pricing programs (and any other pricing related initiatives) toward those customers that are most price sensitive (and also profitable).

The bottom line

The consolidation in the financial services industry along with other market changes may be driving a quest for new pricing paradigms that shift the focus from individual product pricing toward more relationship oriented approaches. Financial services, however, is a complex business that is unlikely to be generally conducive to simple approaches such as "bundled pricing." Loyalty programs are more likely to be an effective avenue to relationship pricing in financial services.

However, before moving too quickly to launch loyalty programs designed to break down the traditional product silos found in many financial institutions today, it is probably important to gain an enhanced understanding of the underlying profitability dynamics of the business at a product and customer level as well as to determine which customers are sensitive to lower prices and which are less so. After obtaining this improved understanding, financial institutions will be in a much better position to design relationship pricing programs that target their most profitable customers who are sensitive to price so that they can retain and expand those relationships as well as new customers that have the characteristics that are likely to make them profitable over time. At that point, a financial institution will be much better positioned to get a good return on their investment in their relationship pricing program.



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