Financial Services
Banking

Strategies against Price Wars in the Financial Service Industry

by Georg Wuebker and Jens Baumgarten

SIMON ◆ KUCHER & PARTNERS
Strategy & Marketing Consultants

Bonn ◆ Boston ◆ Frankfurt ◆ London
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As many industries, the financial service industry – specifically in private banking - is currently in a "price war". Competitors battle it out with one another using price as their weapon. At the same time, however, they fail to differentiate their products or services sufficiently. This price war leads to enormous value losses. But why do price wars develop? And what strategies can financial institutions pursue to end, or even avoid, a price war?

The Financial Service Industry is Currently in a Price War

A price war is a severe form of competition in which competitors in an industry try to increase their market share by continually cutting prices. Ultimately, prices drop to a level that can not be sustained. This intense form of price competition can be observed in many areas of the banking industry, e.g. in credit card fees, interest rates for real-estate credits or particularly in online banking: Here, many new competitors were trying to gain market shares by using aggressive fees which was immediately answered by established players with further price decreases. E-trade, for example, has changed the prevailing price for discount trades from USD 30 to USD 15 to USD 8 in the past few years.

Such a downward price spiral is typical for price wars. Its progression can be illustrated with the example of brokerage fees in private banking (see figure below).

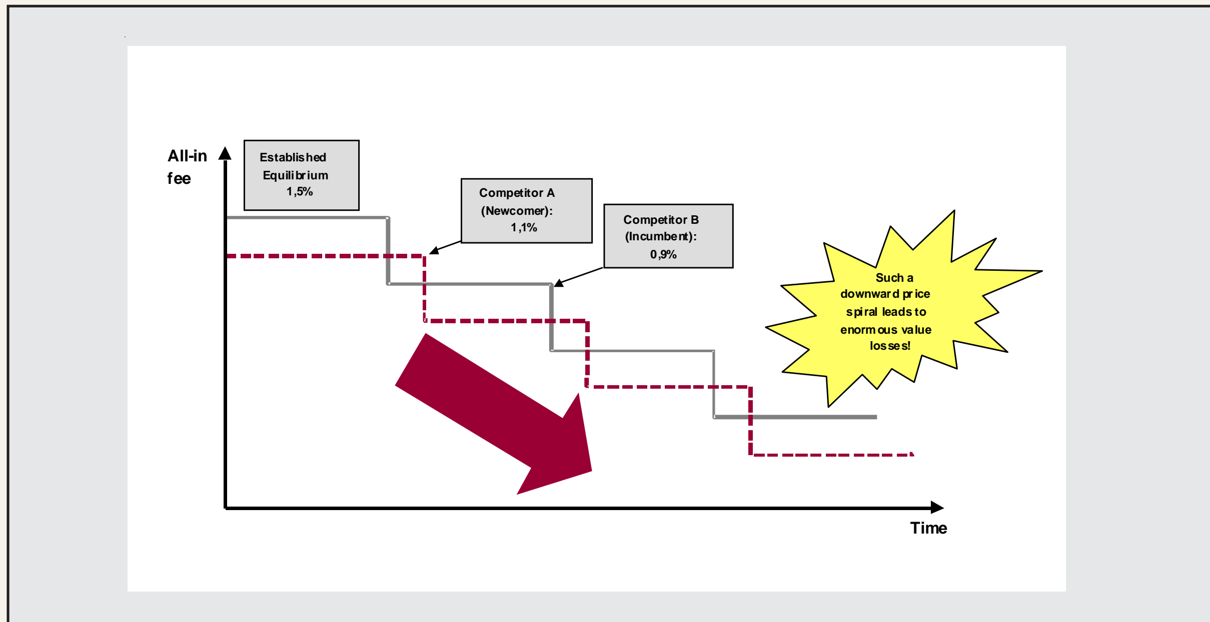

Figure 1: Progression of the downward price spiral

In a certain market, the established price equilibrium with an average all-in fee of 1,5% was disrupted by an aggressive new player who sheered out of course and offered an all-in fee of 1,1% (competitor A). As a result, the established player (competitor B) also lowered the fee to avoid losses in assets under management. In turn, the newcomer further lowers its price which again leads to a respective reaction from the incumbent. At the end, the all-in fee dropped to 0,6% within only a couple of months which lead to enormous value losses, as prices – one they are on the ground – are very hard to push up again.

The Cumulated Losses Caused by Price Wars Can Amount to Several Billion Euros in a Single Industry.

Yet price wars are not a specific problem of the financial service industry but can be seen in a number of other industries as well:

- In the early 1990ies, the US airline industry was drawn into an intense price war that was set off by simplification of the price structure. Within one month, prices plummeted by an average of almost 50%.
- The food retail industry in Germany has been involved in a price war for years. The war was apparently sparked off by the market entry of American giant Wal-Mart, the world's largest retailer.
- German electricity company Yello declared war in the newly liberalized market for private customers. In the months thereafter, more and more new competitors entered the market with cut-rate prices, causing the price level to take a dramatic dive.
- The decline in prices in the German telecommunications industry has been even more dramatic. Fifteen months after the liberalization of the market, prices for long-distance calls between 9 a.m. and 6 p.m. within Germany plummeted more than 80%.

A price war can be triggered by a number of factors (see figure). A company that lowers prices might wrongly anticipate competitive reaction. Companies that sell commodity goods have few possibilities to differentiate their products. Other causes might be overcapacities or low market growth. In the financial service industry, several of these factors occurred simultaneously over the last couple of years, thus intensifying the competitive situation even more. But also as market consolidation is going on, banks are especially vulnerable since they often do not clearly understand how competition in an oligopoly works.

The cumulated losses caused by price wars can amount to several billion Euros in a single industry. It often takes companies years to recover from the effects. But how can a price war be prevented? How can you evade the price trap? There are many possible strategies.

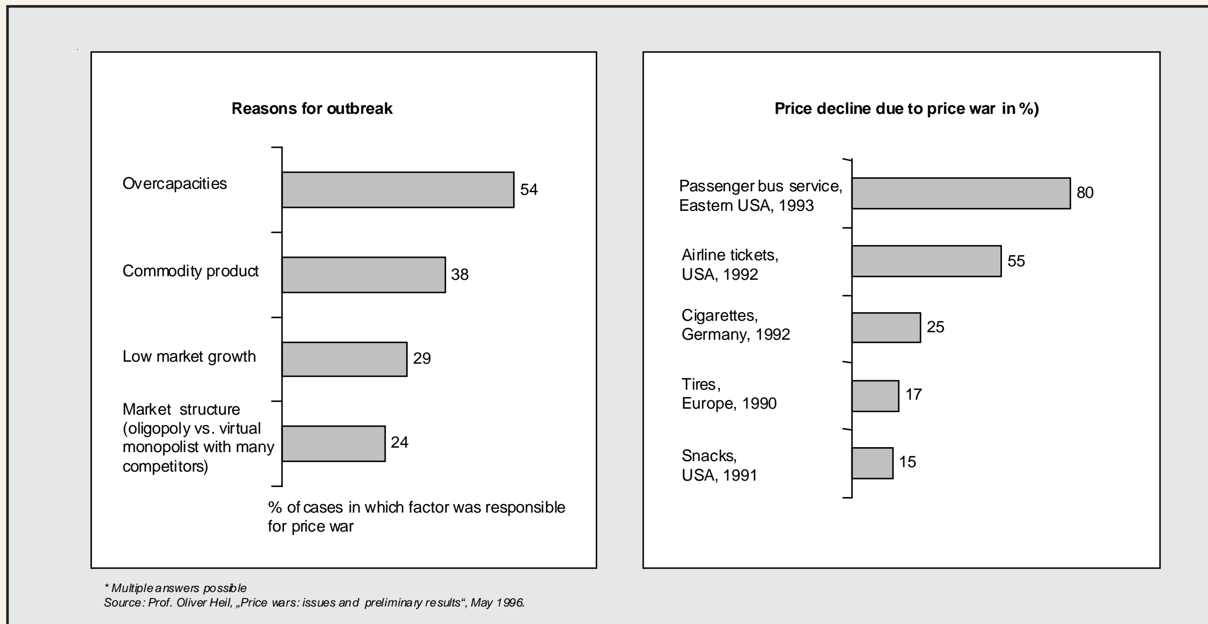

Figure 2: Causes of Price Wars

- *Anticipate the reaction of competitors:* Before you adjust your own prices, you should try to anticipate the competitive response as accurately as possible. This step is critical because the reaction of the competition will have an impact on your sales and profit situation. Game theory can be useful in predicting competitive behavior. Through different scenarios, profit effects and competitive reactions to price changes can be "acted out". Simon, Kucher & Partners developed a special simulation instrument for this problem, called SKP PRICESTRAT. In such an exercise, multiple internal experts come together in a workshop. After setting the frame by discussing the relevant key figures (like market size, most important competitors, their products/services and prices etc.) each expert estimates how the sales volume (e.g. accounts sold, assets under management) would change, if the current price was increased or decreased and how selected competitors would react on such an autonomous price change. By putting the different estimations together in a simulation tool, participants can draw conclusions on volume and profit effects immediately during the exercise. However, without asking the customer (e.g. in a large scale market study) these new insights are connected with a certain level of uncertainty. Another strategy, *signaling*, helps to diminish this uncertainty.

Intelligent Strategies Are Necessary to Avoid a Price War.

- *Signaling:* With this strategy, a bank can send early signals to its competitors and customers that it plans to adjust prices. Thus, the bank can make sure that the competitors understand the rationale behind its pricing policy and thereby avoid "panic reactions" that lead to the progression of the downward price spiral mentioned above. Signaling can take many forms: A financial institution might announce a price move, reveal what it hopes to achieve with a certain price move or announce changes in its costs structure. By sharing this information, a process of coordination can be established between the market players. Using signaling, a bank can publicly allude to its plans, motives, goals, or internal situation. Press releases, conference appearances, or announcements on the bank's web site can be used to communicate this information. However, note that legal aspects must be considered.

- *Differentiate price structures:* The likelihood that banks continually try to undersell one another is greater if their price structures make it easy for customers to compare offers. In order to prevent easy comparisons, a bank should create price structures that are clearly distinguishable from those of its rivals. Price systems with several price components are especially effective. With brokerage fees, for example, often two price components (fixed monthly and/or minimum fee and a variable fee) are combined. Bank managers should make use of more complex price systems such as two-part pricing, multidimensional pricing or loyalty programs for selected products/services.

- *Systems provider:* Another way for financial institutions to differentiate themselves and thus avoid price wars is to create product or service bundles. Bundling enables them to avoid direct price comparisons. It no longer offers merely a product, but an entire solution. Thus, the bank is seen as a problem-solver and systems provider. The solution – not the price – is in the focus of the customers' attention.

There is, at best, only one winner in a price war: the customer (and even his luck is often fleeting). Not before the financial service industry realizes this, it can implement the above-mentioned strategies and thus find its way out of the current price war.

Georg Wuebker is Partner, Head of Financial Services Global

Jens Baumgarten is Director, Head of Financial Services UK

SIMON ♦ KUCHER & PARTNERS
Strategy & Marketing Consultants

Bonn ♦ Boston ♦ Frankfurt ♦ London
Milan ♦ Munich ♦ Paris ♦ Tokyo
Warsaw ♦ Vienna ♦ Zurich

Haydnstrasse 36
D - 53115 Bonn
phone: ++49 / 228 / 98 43 253
fax: ++49 / 228 / 98 43 448
e-mail: Georg.Wuebker@simon-kucher.com
Jens.Baumgarten@simon-kucher.com
internet: http://www.simon-kucher.com