

Power Pricing in the Private Banking Sector

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Only banks that are profitable enough to afford the ongoing high cost of information technology will survive as independent companies

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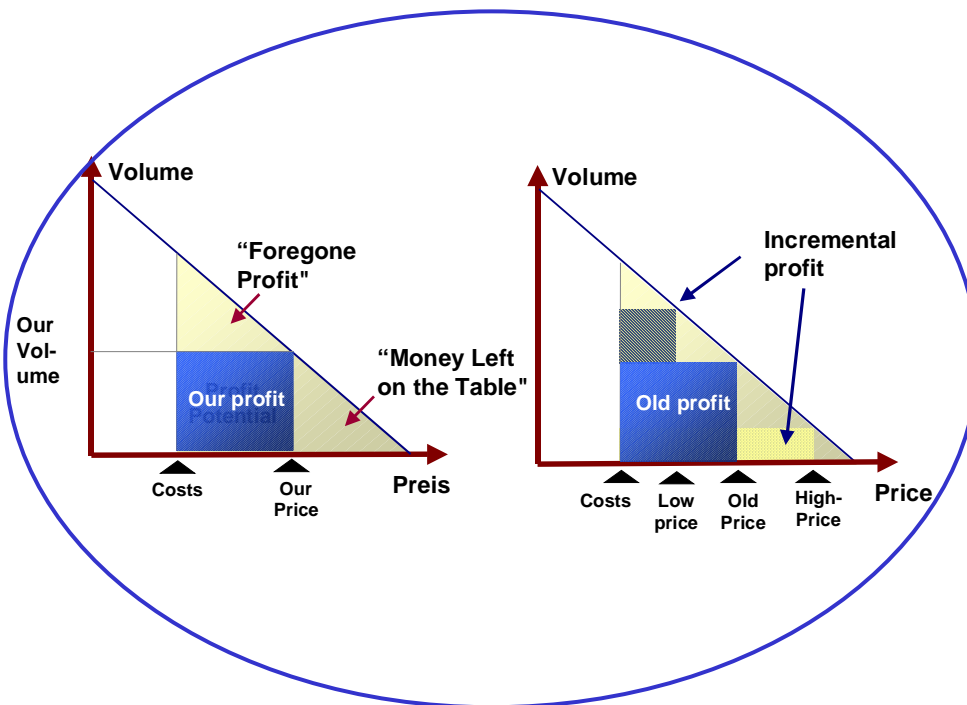
The private banking sector is still quite healthy. The question is, for how much longer?

In fact, the digital age is presenting traditional banks with a colossal challenge. The information transparency offered by the Internet together with a host of new competitors spawned by it, have begun to erode traditional sources of revenue. Innovation and well thought out marketing strategies are increasingly the most important factors for profitability. Moreover, only banks that are sufficiently profitable will be in a position to afford the ongoing high cost of the information technology which is essential to success in the new economy. Indeed, capital markets will punish banks that have poor cost-to-revenue ratios with low valuations, making them easy acquisition targets.

There are two levers for maintaining profitability: cost and revenue. While the cost lever has been addressed by most banks, surprisingly little attention is being paid to the revenue lever. Most banks continue to rely almost solely on brokerage fees, even as these begin to decline. Intelligent, creative pricing concepts that take advantage of private banking customers' willingness to pay for services other than broking remain the exception. In many cases banks have also failed to recognize the strategic relevance of pricing to customer retention.

Although the implementation of "power" pricing in private banking undoubtedly offers significant profit potential, the risks associated with getting the pricing strategy wrong should not be underestimated. In particular, lack of knowledge about the relationship between price and demand (price elasticity) for specific products is quite common, turning pricing into a hit-and-miss exercise. Once the homework has been done, however, price differentiation concepts offer an attractive mechanism for raising profitability and increasing customer loyalty.

Price differentiation refers to the concept of varying prices according to the value perceived by different client segments. Private banking clients are a heterogeneous group of individuals, each with his or her own



needs, which can be grouped into segments, such as onshore and offshore or discretionary and non-discretionary clients. Serving these clients with a one product-one price approach is in most cases not the profit-optimal strategy because too much revenue potential is foregone. The revenue potential can be better leveraged by offering segment specific products at segment specific prices. The above chart depicts this principle.

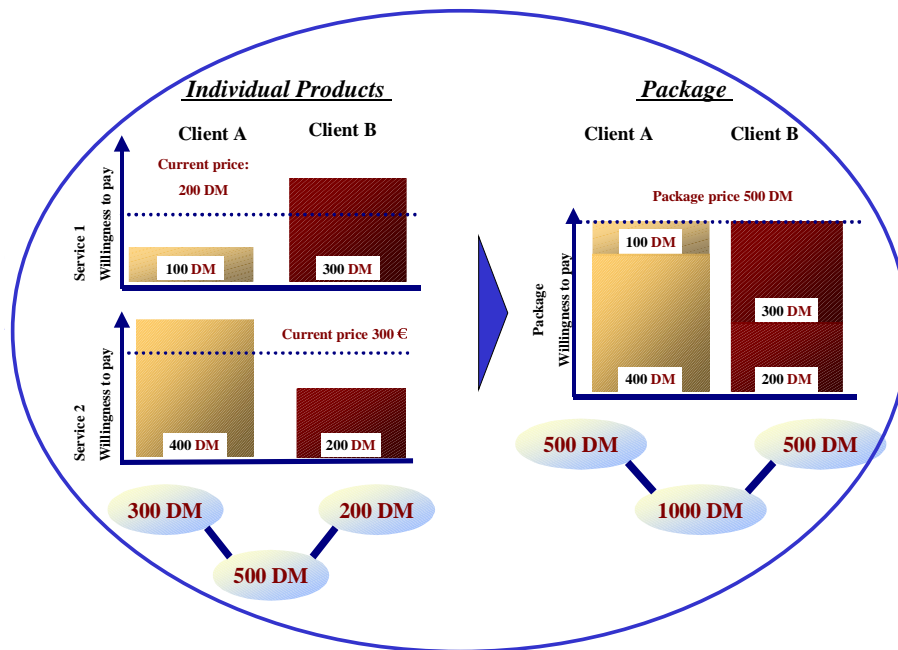
A successful product/price differentiation strategy must be based on the right information. Only by knowing the utility which each target segment perceives for each product/product feature, the segment's willingness to pay and the relationship between price and volume (price elasticity), can products that are ideally suited to the needs of each segment be developed and optimally priced.

This information can be acquired based on modern market research methods such as conjoint measurement used in conjunction with market simulation models, an approach with a proven track record in private banking. The crucial point is to include both external market data and existing customer data. Two of the most successful price differentiation concepts are described below.

Only by knowing the willingness of each customer segment to pay for various services can an optimal product and pricing strategy be developed

Bundling/Packaging

Bundling refers to combining a number of separate bank services into a package that is offered to customers at a price which, as a rule, is lower than the sum of the individual component prices. Packages work because the value perceived by customers for a combination of products and/or services can be better matched with their willingness to pay than is the case with individual



**Higher revenue per client
through packaging**

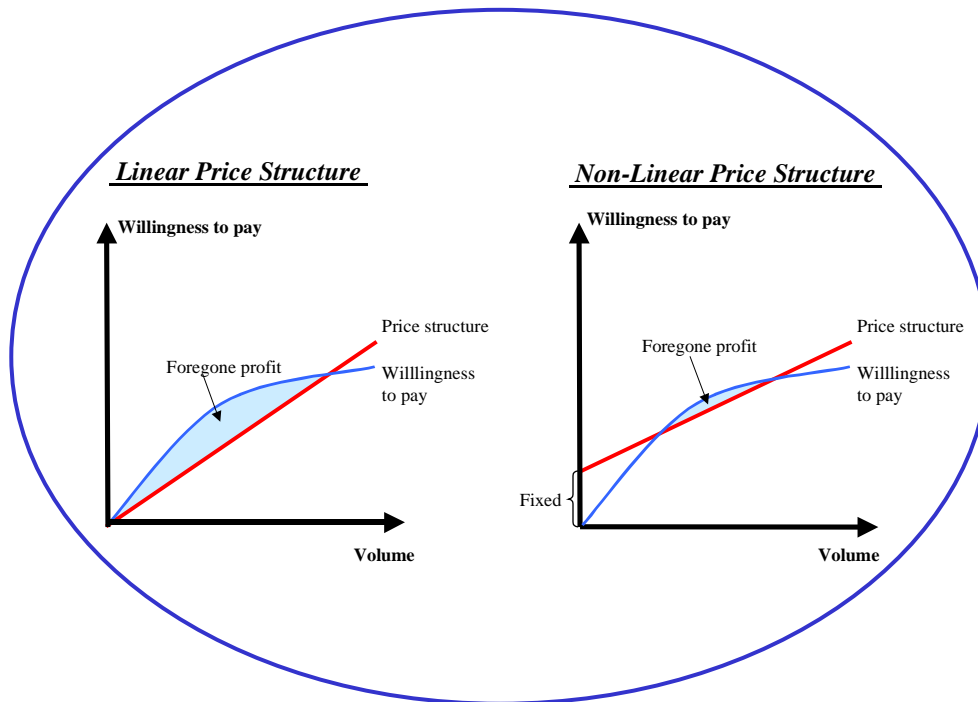
products or services. At the same time, customers can no longer identify the prices of individual elements within the package, for example broker's fees. Of course, detailed knowledge of customers' willingness to pay is essential, since additional profit can be generated only if incremental revenue is greater than the cumulated price discount given plus increased variable expenses due to higher volume.

Thus, the development of appropriate product/service bundles and shifting as many customers as possible to them, is an excellent strategy for maintaining or even increasing profits in the face of further declining brokerage fees.

This idea has been applied very successfully by Microsoft, whose Office-Package has a quasi monopoly position with a market share of over 80%, and by fast-food chains such as McDonalds, which have successfully used their menus to increase revenue per customer.

Non-linear Price Structures

Non-linear pricing is a pricing approach that sets the price for private banking services depending on the level of usage. Non-linear pricing strategies consist of two components. As a rule, a fixed price which is independent of the level of use plus a usage-related



variable price are paid. Good examples of non-linear pricing are the Deutsche Bahn's BahnCard and the electricity tariffs of many utilities companies. From the customer's perspective, the fixed pricing component is an "entry ticket" that gives access to usage-related, cheaper prices.

Non-linear pricing results in additional profits by increasing client loyalty and by encouraging clients to shift assets from other banks

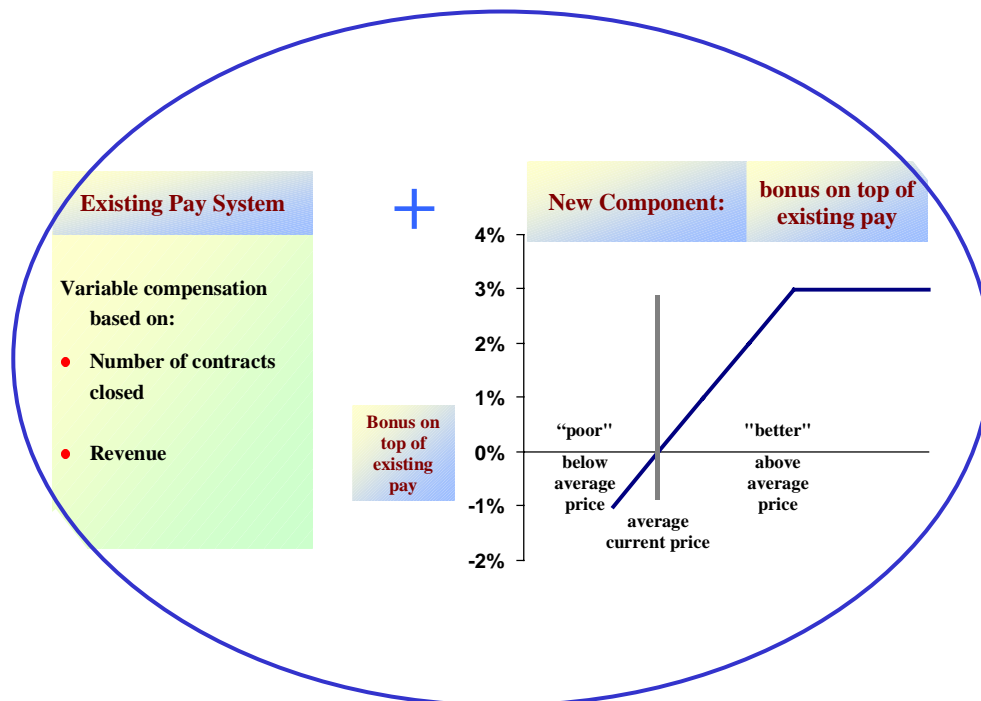
Non-linear pricing offers several advantages. The existing willingness of customers to pay can be better leveraged than with linear pricing structures, resulting in higher sales per customer. Non-linear pricing leads to a decrease in the average price paid per transaction as usage of the service increases, providing the customer with a tangible benefit. Moreover, the impact of non-linear pricing on customer loyalty is significant. Since the price for each transaction effectively decreases, there is a strong incentive for clients to continue doing business with the same bank and even to shift business, for example from other banks with more traditional pricing approaches. Thus, banks can increase both revenue and customer loyalty with non-linear pricing.

Any pricing system, no matter how good, can be undermined by sales people

Implementation

A centrally imposed new pricing system can only be successful if the concept is supported by sales and customer service personnel. Typically, however, the path of least resistance, i.e. higher rebates is taken, because their remuneration system encourages sales staff to maximize volume rather than profit.

The purpose of an optimal incentive system is to align the goals of customer-serving personnel with those of the bank. In this context, it has generally proven useful to link compensation not only to volume (e.g. number of new contracts closed or growth in assets invested), but also to profits. Only thus way can a bank's long-term viability be ensured.



A well designed incentive system can help

In order to counter pressure from customers and competitors, the compensation system ideally incorporates a contribution-linked variable incentive component. Moreover, by incorporating this variable element into the bank's customer interface IT-system, service personnel is made aware of the impact that a price discount will have on both profitability and their own pay. Such an incentive component can often be integrated into the existing compensation scheme, as shown above. Sales people who get above average prices can thus increase their total compensation.

