Towards transparency and freedom of choice
An unbundled pricing model for retail banks

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Retail banking is currently facing many challenges driven by regulations and increasing customer expectations. The financial crisis has heavily damaged the reputation of the banking sector, and both customers and regulators are now more cautious about the banks' approach to transparency and protecting customer interests.

The new regulations requiring ring-fencing of individual and business customer deposits from any investment activities, increased risk assessment and monitoring measures and minimum capital requirements are driving banks' costs beyond the levels seen to date. In addition, customers are seeking greater transparency in terms of products, pricing and accessibility (e.g. mobile channels, flexibility of customer service).

The above factors have a major impact on bank profits, and thus a more careful analysis of revenue streams is required. Changing the product and service pricing model is one of the alternatives and finding the right solution can prove to be a challenge.

Seeking a new pricing model for retail banks

In recent years, trends in pricing have mainly focused on bundled offerings and relationship pricing, aimed at creating packages of products at a particular price and targeting specific customer segments. This article presents one of the possible alternatives, i.e. a focus on an unbundled approach rather than packaging products together. This model was recently evaluated by the Deloitte Centre for Financial Services via a retail bank survey and its findings have been summarised in a report called 'Shifting retail bank pricing models: managing the transition to unbundled services[1]'. The survey was conducted online among 4,271 U.S. retail bank customers who had a personal checking account. The concepts presented below derive from this study and have been adapted to our local market characteristics.

At this point, it is important to note that this approach should not be considered as the new ultimate pricing strategy that will replace all the current methods: it is one of the available options and, as mentioned in the following paragraphs, principles or lessons learned from other approaches remain valid in this case.

The shift to the unbundled service pricing model

The trend towards offering customers freedom of choice and control over the price they pay for a service or product is not a new phenomenon. Many of us experience it when buying a plane ticket with a low-cost airline and deciding on the amount of luggage, priority boarding, extra legroom or even the snacks and drinks we want to purchase. Each of these services is given a certain price and the customer can decide which to buy.
This unbundled pricing model has advantages for both the customer and the retailer: by having a choice of items, the customer receives a service or product fulfilling his requirements and retains control over the price, while the retailer can relate the price to the cost of each item without charging the customer for extras he does not need.

1 http://dupress.com/articles/shifting-retail-bank-pricing-models-managing-the-transition-to-unbundled-services

The 'pay-per-use' model is becoming increasingly common in a number of business sectors, such as hospitality, catering or media (e.g. newspapers in print or digital format), as well as air transport. The asset servicing industry adopted a similar pricing model as products and services became more sophisticated. This approach balanced out revenues, which are not only asset based but also more service usage driven. The move in this direction is particularly relevant for retail banking.

Applying the unbundled pricing model in a retail bank is a major divergence from the current integrated approach, where the majority of services are offered once a periodic flat fee is paid. In this model, the customer gets access to the majority of services in unlimited quantities for the corresponding flat fee, while in the unbundled one, the customer pays only for the services he uses. The unbundled model offers advantages for both the bank and the customer. Banks can charge a price corresponding to the value of their services, while customers gain transparency, the possibility of choosing only the options they require and control over the price. **The unbundled pricing model could be considered as an alternative path to increasing fees, and therefore, bank revenues.** At present, the rise in periodic flat fees often generates customer resentment and negative publicity. In addition, periodic flat fees can be perceived as lacking transparency and being difficult to understand. A majority of customers say that they would switch banks following even a modest increase in their monthly fees[2].

Service profiles in the unbundled model

In the previous example of the flight ticket, the airline company applies differentiated pricing: there is a price for the flight and for each service used. This differentiated pricing of previously integrated services represents one of the major challenges in the shift to an unbundled model. **To define an effective pricing model, banks have to thoroughly understand the drivers of customer needs and their ability to meet these needs by providing the required service.**

In order to set a framework for the unbundled model, the products and services typically included in retail bank packages could be classified according to two aspects: the perceived value added and the cost of servicing. The first aspect, the **perceived value added**, is a qualitative assessment used to capture how essential the service is in the overall package. This criterion could be defined as the distance from the core, where a high distance service could be considered as a value-added service or a luxury[3]. The second aspect, **the cost of servicing**, corresponds to the cost to the retailer of providing the services. Low-cost services would be, for instance, electronic payment services, while higher-cost services would include financial advice provided by the teller or any other activities requiring manual tasks from an employee.

When classifying the services according to these two aspects, we have identified four categories: **core services, convenience services, benefits and value-added services** (Figure 1).

The **core services** are the essential products or services such as current accounts, debit cards and ATM withdrawals. These services form part of the basic package provided to all customers and are often offered for free and in unlimited quantities. They could be sustainably offered to customers without fees or limits, depending on the customer's needs (and the segmentation), as services requiring more expensive processing used to be excluded from this category.

The **convenience services** are close to the core services in terms of customer needs, but the costs of servicing are higher. These services could therefore be offered to the customer for a small flat fee and in a limited quantity. The usage of convenience services beyond a defined threshold specific to each bank would trigger a per-transaction fee. This classification of services allows the bank to charge fees to high-volume users without requiring any subsidies from low-volume customers. Typical examples of services in this category would be access to the teller or call centre and paper checks processing.

The **benefits** are services with more value added, and thus improve the customer experience. However, they are not perceived as essential by customers and their servicing costs are not considered high. Given this last criterion, they could be free for certain customers, and for non-qualifying customers wishing to access these services, a small fee could be charged. For instance, international wire transfers could be provided free of charge to a particular segment of customers (such as the high-end customer segment with a higher average balance) and offered at a small fee to the mass segment or high-frequency users.

2 Deloitte Centre for Financial Services: 2012 retail bank pricing survey
3 An example could be the car, i.e. getting from A to B is the core service, while air conditioning or a navigation system are the additional services

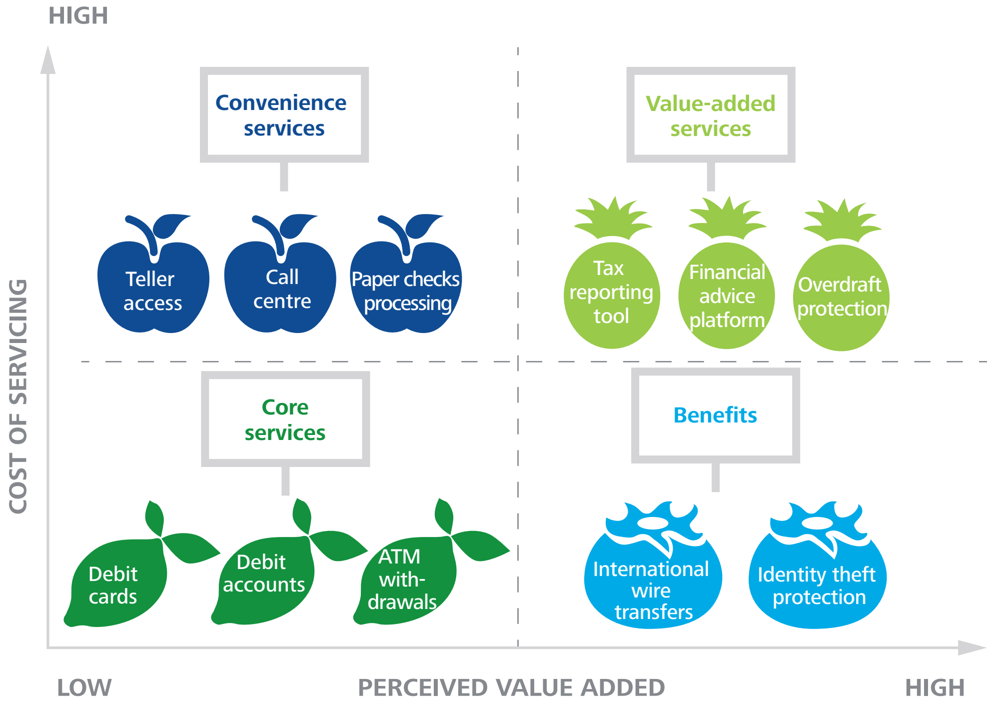
The **value-added services** are at the other end of the spectrum to the core services. These services are believed to significantly improve the customer experience, but their costs of servicing are also higher than other essential products. This classification of services allows the bank to maintain specific services in their offering that would be mainly subsidised by customers who specifically seek these products. For example, a financial advice platform or specific tax tool could be included in this category. As for the other service segments, the composition of this category depends on the target customer segments and their specific needs.

The principle of applying differentiated pricing depending on service categories is being used by asset service providers, who—apart from the asset-related thresholds—also apply different prices to core and value-added services. As mentioned above, this approach was triggered by the proliferation and complexity of products and services offered to their customers.

The impact of a classification of this nature and the related pricing on different customer segments should be carefully analysed based on each bank's customer base. Nevertheless, as a general rule, one can expect that customers who mostly use core services (such as online account management or ATM withdrawals) would pay lower fees and would no longer subsidise the services with greater value added used by higher-frequency users or high-end customers. The trend in global retail banking towards web/mobile banking confirm this tendency, as the core services delivered through these channels are provided free of charge and balanced by fees earned on value-added services.

As described in the next chapter, the benefits of such pricing should be clearly communicated to customers.

Figure 1: Illustration of possible service segmentation



Source: Adapted based on Deloitte Centre for Financial Services: 'Shifting retail bank pricing models: managing the transition to unbundled services'

The essential principles in a repricing implementation

Whatever the industry, shifting the pricing model has always been a sensitive initiative. Over the years, banks have tried to change their fee structure several times, but many have failed to achieve a complete and efficient deployment. In many cases, the failure did not stem from the strategic decision, but rather from the implementation. Moreover, fee changes are usually drivers of negative perceptions among customers.

For all these reasons, certain elements should be carefully considered, especially when shifting to the unbundled model:

- **Knowing your customer**—adopting a customer-centric approach to thoroughly understanding the customer's needs and perceptions is more important than ever. The first objectives would be to classify the services offered in accordance with the two aspects identified above. The new pricing strategy can then be based on a complete understanding of customer preferences and behaviours. In this case, clear customer segmentation could be considered a good starting point.

  The second objective would be to set precise usage thresholds for fees per service, in a similar way to the asset servicing industry, where it is common practice. This step is crucial in the structure described here and will depend on the individual characteristics of the bank's customer base. For instance, the survey conducted by Deloitte showed that 20% of users account for more than 50% of total usage across a wide range of products and services. Consequently, customer analytics should be considered a key element in the implementation process.

- **An opportunity to refocus on target customer segments**—pricing changes can potentially alter or modify the characteristics of the customer current base. New fee grids could not only change the customer's perception but may also materially affect product usage and hence result in a switch in customer behaviour. As a consequence, a new pricing strategy could be leveraged to refine customer segmentation and allow the bank to refocus on its long-run strategic objectives.

- **Tailored communication to specific customer segments**—communicating value and keeping a high level of transparency are essential when shifting to unbundled pricing. Without customer buy-in, all efforts to change the pricing would be to no avail. Although the themes of transparency and fairness are likely to be central in communication to all groups, messages should be tailored to specific customer groups to secure their support. Furthermore, changes in distribution channels and the increasing digitalisation of communication could be leveraged to ensure efficient communication.

- **Understand your ability to service the customer's needs**—in order to classify the products and services along the cost of servicing axis, the bank needs to have a clear and exhaustive view of their current product offering. Pricing changes could also be an opportunity to streamline the offering. A simplified offering could limit pricing complexity and facilitate customer understanding.

An analysis of these elements together with a classification of services should allow the bank to categorise its service offering per customer segment as illustrated below (Figure 2).

Figure 2: Illustration of possible service segmentation for two client segments

MASS SEGMENT	Debit account	Debit cards	Regular credit cards	International wire transfers	Gold credit cards	Financial advice platform	Specific tax reporting tool
	Core services		Convenience services	Benefits	Value-added services		
Fees	None		Small flat fee	Small fee	High fee level		
Threshold	None		Low	High	High		
Main distribution channel	Alternative		Alternative	Alternative	Alternative & traditional		
Usage rate							

HIGH-END SEGMENT	Debit account	Debit cards	Regular credit cards	International wire transfers	Gold credit cards	Financial advice platform	Specific tax reporting tool
	Core services			Benefits	Convenience services	Value-added services	
Fees	None			Small fee	Small flat fee	High fee level	
Threshold	None			High	Average	Low	
Main distribution channel	Alternative			Alternative	Alternative	Alternative & traditional	
Usage rate							

Source: Deloitte analysis

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Repricing implementation—specific topics

As mentioned above, the implementation phase is critical for this type of initiative and dozens of key points and challenges could be highlighted.

The areas to focus on when shifting to a new pricing model mainly concern: simplification of the product offering, adoption of a customer-centric approach and changes in the distribution channels. In view of the breadth and the complexity of each area, this article only provides a high-level description of those topics.

Simplification of the product offering

Currently bank customers want choice and diversity in the product offering. However, such variety implies maintaining a complex product portfolio that can eat into profits. For instance, this broad product offering involves cumbersome front office tasks. This complexity not only negatively affects customer perception but also drives the servicing costs up. This is also the case for the middle and back office, which have to struggle with the complexity of maintaining such product portfolios. Complex product portfolios that push revenues down and costs up can often be explained by the following:

- **A product-centric view**—traditional product offerings tend to focus on the product, valuing the success of individual products rather than viewing it at the customer or relationship level
- **No product lifecycle**—banks tend to launch new products without discontinuing the old ones. As a result, a significant portion of the product portfolio comprises legacy products
- **The complexity of banking products**— banking products may have hundreds of variations, and the complexity can be further increased by hundreds of specifications and characteristics

When facing a situation of this nature, the complexity of the product portfolio could be reduced by:

- Trimming the current portfolio by removing redundant, underperforming products, or even products that are misaligned with the bank's current strategy
- Reviewing the organisational and operating models of correspondent departments ensuring that all bank departments involved in product management (from development to monitoring) are in the scope of the analysis
- Aligning products with the current strategy and objectives, but more importantly, with customer preferences

Streamlining the product portfolio requires adopting a customer-centric approach, beginning with the definition of customer segmentation and targeting. This last element also plays a central role when shifting to a new pricing model.

Understanding customer needs

The customer-centric approach requires a deep understanding of what customers need, want and expect. It is crucial therefore for a retail bank to perform a comprehensive analysis of its customer base and invest in collecting and managing the data. Advanced analytics need to be deployed in order to obtain an enhanced view of customer behaviour, thereby allowing for accurate segmentation.

A recent survey of retail banking executives performed by *The Economist*[4] identified the urgency of *"improving client segmentation and considering its impact on product design and distribution"* as the second-highest priority in the years to 2020. It shows that banks' management acknowledge the importance of segmentation and the need to adapt the approach to customer data. Consequently, it involves not only financial and personal data collection but also data interpretation allowing for identification of customer behaviour. Managing information has become as important for retail banks as money inflows, and data management is significantly affecting banks' market share.

Traditionally customers are segmented according to lifecycle principles such as age, stage of professional life and income. However, these methods will not be sufficient given fast-forward changes in customer behaviour, where technology plays a central role. In response to changing demographics and customer preferences, the bank of the future needs to focus on mobile services and applications to increase customer convenience and loyalty. While developing these innovative solutions, it is essential to cater for the less tech savvy customer as well.

Banks may therefore apply customer segmentation, combining the traditional lifecycle and revenue-driven approach with a focus on the following groups:

- Traditionalists, for whom a personal relationship is imperative
- Techies, which represent an increasing number of customers embracing the use of efficient and uninterrupted ways of connecting with banking services

A clear shift in the source of retail bank growth can be observed, where product innovation and the creation of more complex offerings, as well as the ability to quickly adapt to changing customer behaviour, will generate growth.

At present, the rise in periodic flat fees often generates customer resentment and negative publicity

4 The Economist Intelligence Unit: Future factors: How regulation, client expectations and technology are transforming retail banking

Distribution and the emergence of alternative channels

In a similar way to customer segmentation, the ongoing evolution of technology is impacting the role of distribution channels. The traditional operating model built on bricks and mortar is rapidly shifting towards an online model. Mobile banking is no longer an extension of the traditional channels (branch, ATM, call centre, web banking), it is becoming a major tool for the customer to perform various operations and interact with the bank. Each distribution channel has a distinctive role, yet overall integration is required to allow the customer to navigate through them with ease.

Consumers expect more services, at a lower price and with 24/7 access. The alternative distribution channels, including social media, are now meeting these requirements—especially in terms of transactional business focused on the lower-value customer. The role of a branch is now concentrating more on offering customers financial advice, rather than performing simple banking operations. Worldwide trends show the drive towards a lean branch structure, with fewer, smaller branches. Low-cost branches—and increasingly, virtual branches—where customers use a combination of online tools to manage their accounts and consult their account manager via a web communicator are on the rise. These changes allow for more direct customer targeting on a larger scale, as well as significant cost efficiencies when compared to traditional branch or direct sales focused distribution. Banks should continue their efforts to offer a multi-channel experience, with a view to moving towards full-fledged mobile banking in the near future.

These factors will have a significant impact on the bank's pricing strategy and product development, allowing for the creation of a more competitive offering delivered directly to the customer at an attractive price.

Conclusions: pricing strategy—a central piece of the global strategy puzzle

Pricing plays a central role in customer satisfaction and profitability. This is especially true in the current financial situation, where retail banks have to cope with cost pressure, changing customer expectations and increasingly stringent regulatory requirements. Furthermore, retail banks have again begun to implement strategic moves in order to reposition for profit and growth opportunities, in this very competitive market space. The strong drive towards digital banking and transformation of this channel into a sustainable revenue stream with more products/services being offered via online and mobile tools is one of the trends. In that context, pricing is a key lever that could be used alongside other initiatives in order to retain existing customers and attract new ones.

Several approaches can be adopted to redefine the pricing model, ranging from dynamic pricing to relationship pricing via the unbundled model described above.

Nevertheless, in all cases, shifting from one pricing model to another is likely to mean embarking on a long path full of challenges. An in-depth analysis of the bank's product offering, customer base and distribution channels is required in order to determine the expected benefits and how best to tackle any potential issues.

Finally, and more importantly, pricing strategy should be part of an overall/global corporate strategy. As mentioned above, the implementation of a new pricing model requires strong interaction with other strategic areas of focus. Thus, pricing should not be tackled in isolation, but form an integral part of the bank's global strategy—after its impact on other business areas has been analysed. At the end of the process, as with other strategic initiatives, pricing must be aligned with the organisational model and corporate values, in order to ensure that business objectives are achieved.

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