

# Shifting retail bank pricing models:

## Managing the transition to unbundled services



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# Seeking a new model

**G**ETTING lunch at a salad bar may not seem to have any relation to banking. But if you've been to a salad bar recently, you may have had firsthand experience of a pricing system that retail banking could capitalize on. How so? Traditionally, salad bars have offered a limited menu of options at a fixed price or weight-based pricing with all ingredients priced at a standard cost. But in many parts of the country, salad bars have started to differentiate the pricing of ingredients, giving customers basic salad greens for a set price and charging in increments for each additional item.

This "unbundled" pricing model has clear advantages: By picking each item separately, customers get the exact lunch they want and have control over the price they pay—and retailers can tie price to the cost of each ingredient while avoiding the cost of items the customer does not eat. This type of pay-per-part pricing model, effective in other industries, has yet to establish itself in financial services. But, given its potential advantages, its time in banking may be near.

Banking, like other industries before it, is likely to seek alternatives to the increasingly unsustainable integrated pricing model. The free checking model—subsidized by higher interest margins and bolstered by a very different economic and regulatory environment—is likely on its way out.<sup>1</sup>

## What options do banks have?

One potential alternative is increased reliance upon monthly account fees, but initial efforts to introduce or increase these fees have generated customer resentment and negative publicity. Monthly fee models face additional difficulty due to their lack of transparency

### ABOUT THE 2012 RETAIL BANK PRICING SURVEY

- The survey was conducted online by Harris Interactive from August 16 to August 30, 2012.
- In total, 4,271 checking account customers participated in the survey.
- Respondents were at least 18 years old and had a personal checking account.
- Responses were weighted across geographic regions, income levels, age, and gender groups to reflect the national population.

and low levels of customer understanding, as Deloitte's 2012 retail bank pricing survey shows (figure 1). Having been told for so long that most account services cost nothing, many customers have difficulty understanding how the monthly fee is set—or why it is necessary.<sup>2</sup>

Consequently, a majority of customers say they would switch banks following even modest monthly fee increases (figure 2). Even if actual defection rates are significantly lower, the challenge of doubling down on monthly fee models is clear.

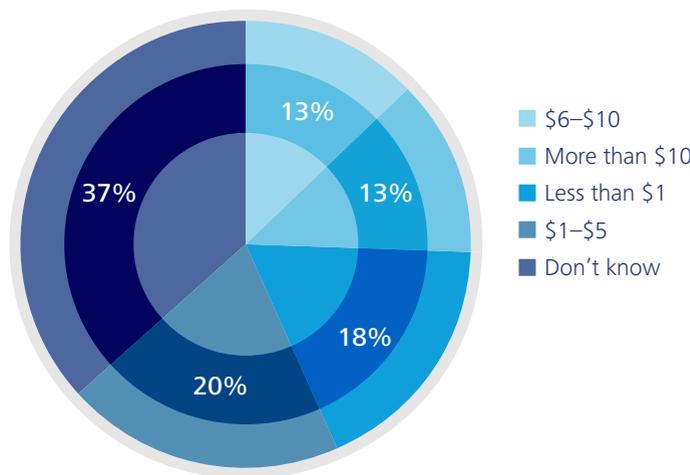
Unbundled pricing models, in which consumers pay only for the banking services they use, offer banks another path. This model is a major departure from the current integrated retail bank model in which the majority of services—whether teller visits or mobile banking apps—are offered for free in unlimited quantities once customers pay a monthly fee or meet fee waiver requirements, but it has attractions for both banks and consumers. Banks can

charge a price proportional to the value of their services; their customers get transparency and a wide range of pricing options.

In fact, nearly half of the surveyed customers say they favor a fee-per-service model over other options, including monthly fees and tiered usage plans. The model may be even more attractive if transparently structured and tailored more to high-frequency users than average users.<sup>3</sup>

While some institutions and industry observers have recognized the need for such a model, and some have begun to make the transition, the concept still lacks a coherent, actionable framework.<sup>4</sup> This paper lays out such a framework. Just as importantly—given the number of promising pricing strategies that never made it through the rollout phase—it offers a new set of principles to consider for implementation.

**Figure 1. Customer estimates of monthly cost to service accounts<sup>5</sup>**

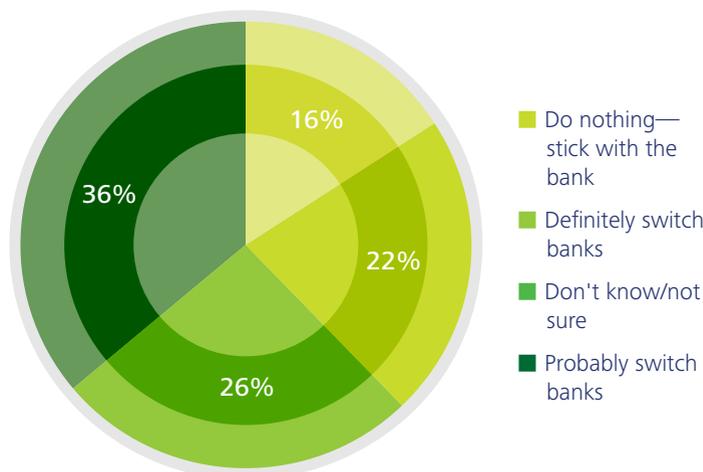


*Note: Numbers do not add up to 100 percent due to rounding.*

Source: Deloitte Center for Financial Services

Graphic: Deloitte University Press | DUPress.com

**Figure 2. Customer response to a \$5 increase**



Source: Deloitte Center for Financial Services

Graphic: Deloitte University Press | DUPress.com

# Analyzing service profiles

**T**HE example of the salad bar gives an intuitive idea of the structure and benefits of an unbundled pricing strategy. In shifting from a set menu of specific salads and/or a flat price per ounce, owners have differentiated pricing: a flat price for the base and a per-item price for the rest, with the extras priced in relation to their cost—customers are not asked to pay the same price for chicken as for carrots.

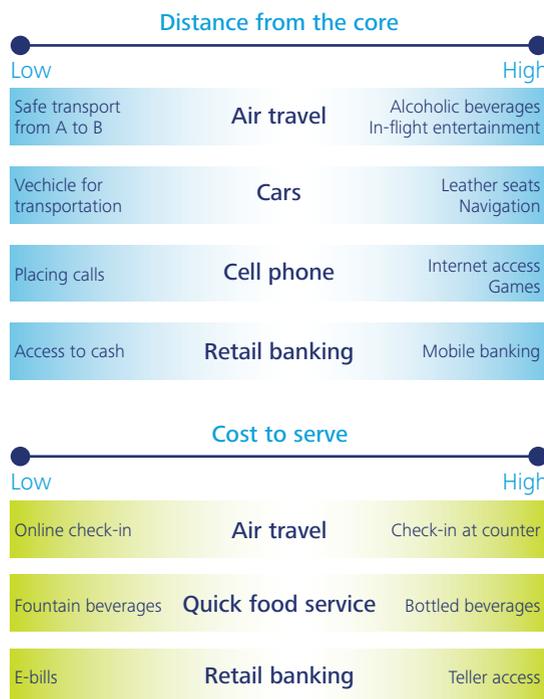
While the salad bar pricing model may have developed by trial and error, banks don't have this luxury. To effectively design a new pricing model, firms need to think carefully about drivers of customer demands and their ability to service these demands. Systematically differentiating previously integrated services

could be the most important part of the shift to an unbundled pricing strategy.

As institutions weigh their options, they should consider a series of questions about each feature or service:

- Will the product offering provide the same general benefits if a feature or service were removed?
- Does the customer identify the service as a “need” or a “want” in the context of the broader product offering?
- What does it cost to provide the feature or service to an additional customer?
- If usage is reduced, does the cost to the provider diminish?

**Figure 3. Distance from core vs. cost to serve**



Taking these questions into consideration—implicitly, the same ones considered by the salad bar owner—the features and services typically offered as part of the retail banking bundle can be classified along two dimensions: distance from the core and cost to serve (figure 3).

**Distance from the core**, a qualitative assessment, captures how essential the service is to the overall bundled product. A low-distance service is one without which the product may not offer the same core benefits; a high-distance service is one that is peripheral or a luxury.

The concept is well illustrated in several real-world industry examples. In air travel, safe and fast transport would be a core feature, but in-flight entertainment or alcoholic beverages may be more distant services. Similarly, the ability to make voice calls is closer to the core of cell phone service than Internet access or games.

Source: Deloitte analysis

Graphic: Deloitte University Press | DUPress.com

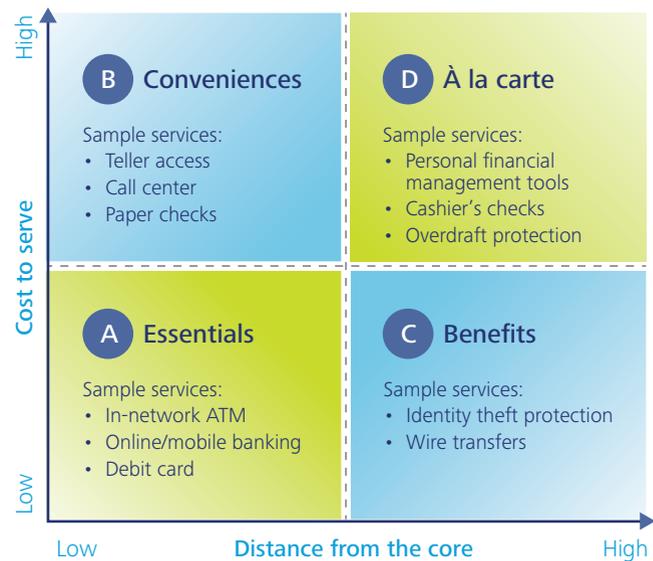
**Cost to serve** refers to the provider's expense in providing the service rather than the price paid by the consumer. The concept is straightforward: Services with high marginal cost to the provider—such as counter check-in at airlines or teller access at banks—are at one end of the cost-to-serve spectrum, while online check-in or electronic payment services are at the low-cost end.

When plotting examples of typical retail banking services on these axes, four types of service emerge: **essentials**, **conveniences**, **benefits**, and **à la carte services** (figure 4). (The exact classification of services will depend on banks' customers and their priorities; the locations shown here are illustrative.)

**Essentials**—core products or services with low costs such as debit cards and ATMs—may be offered for free to all customers in unlimited quantities, consistent with current practice. This set should be marketed as the set of essential services an average customer would need. It provides access to cash, payments, and account management without more expensive bank-teller visits or paper-check processing, and could therefore be sustainably offered without fees or limits. For example, unlimited in-network ATM withdrawals could continue to be offered for free without any balance or usage requirements.

**Conveniences**—close-to-the-core products with higher cost to serve—may be offered in limited quantities for a small flat fee, much as some banks currently do for paper statements. This structure can allow customers who want these services to take advantage of them as needed, but does not use other customers to subsidize these premium services. The usage of conveniences beyond an institution-specific threshold should trigger a per-transaction fee. This two-tiered pricing strategy can allow banks to effectively target high-frequency users without inadvertently penalizing relatively low-cost customers for incidental usage. For example, banks could offer up to two teller visits (the average usage) in the flat fee charged to most customers, and then charge a per-use fee

Figure 4. Illustration of potential service segmentation



Source: Deloitte analysis

Graphic: Deloitte University Press | DUPress.com

for each visit beyond the average-use threshold of twice a month. The fee for these additional uses would be set at near the total cost to serve per visit.

**Benefits** are services that may improve customer experience but are not an essential aspect of the banking relationship. Given their low cost, they can be made available for free to a subset of customers. For non-qualifying customers who find the product valuable, a small fee allows them to access it without a heavy cost burden. For example, wire transfers could be offered free of charge to a subset of retail customers who meet criteria such as higher average balances. Non-qualifying customers and high-frequency users pay a small fee per transaction for the service.

**À la carte services**, which are both more expensive to provide and further from basic banking, can be offered for a price directly linked to their cost. This structure, currently in place for just a few services at many banks, minimizes the subsidy of high-need customers by those with more basic needs, making provision of free basic services more sustainable. For example, personal financial management services could be offered for a flat fee to

all customers, allowing a bank to maintain the service as part of its retail product offering but limiting the subsidy given by average customers to the relatively few customers who seek management tools.

Beyond potential revenue and cost-reduction benefits, this scheme could produce better outcomes for many consumers than increased

monthly fees. Customers who mostly use common and inexpensive ATM or online services would pay lower fees and would no longer disproportionately subsidize heavy users of more expensive services. Communicating these and other benefits is likely to be a crucial part of implementation.



# Implementation

**B**ANKS have tried—and in many cases failed—to make pricing changes before. In at least some cases, the failure was not in strategic vision but in implementation. While investment in areas from systems to branch talent will be a part of implementation, the design of usage thresholds and communication strategy can be particularly important to this process.

## Setting thresholds

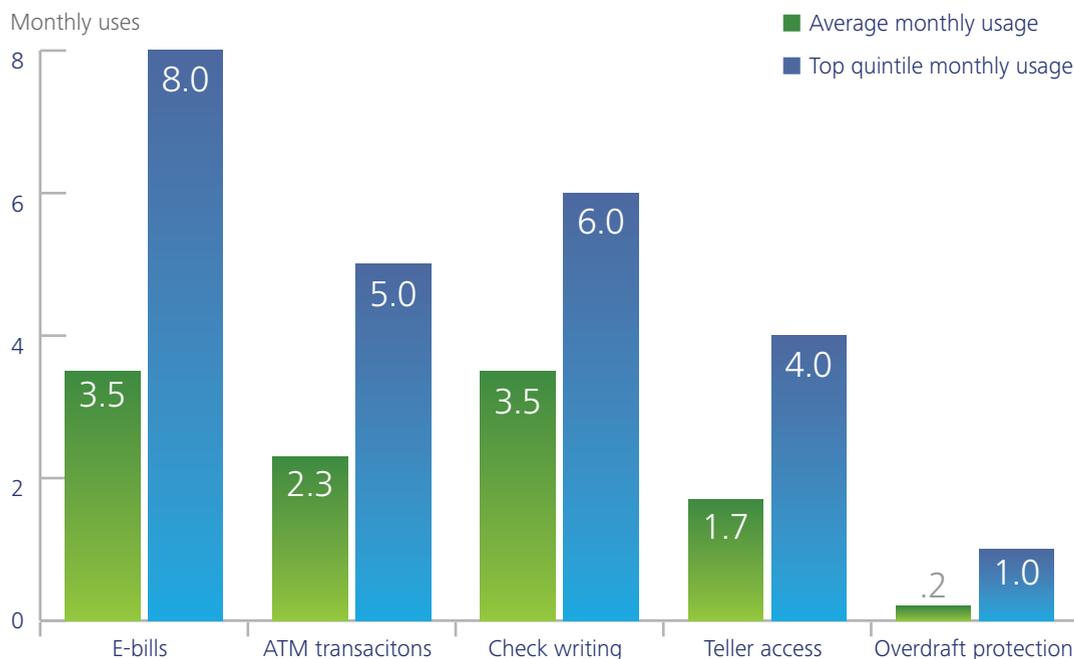
Making the transition to a more complex pricing model will not be easy. The usage thresholds banks set for fees—a crucial part of the structure described here—will depend on the individual characteristics of each institution’s customer base. Pricing decisions will naturally vary according to

institution-specific needs. But an analysis of our survey results offers clear insights into effective implementation.

As shown by the survey, 20 percent of users account for more than 50 percent of total usage across a wide range of products and services. Usage rates of the top quintile are generally double those of the average user (figure 5).

By setting free usage allotments just above average usage, banks may be able to significantly decrease the volume of costly services and raise revenue without a major impact on many customers. For example, data from the survey suggest a threshold of two teller uses per month—high enough above the average so that typical customers will rarely pay a fee, but low enough to make it likely that costly high-frequency users will pay a fee.

**Figure 5. Usage of common services by average and heavy users**



Source: Deloitte Center for Financial Services

Graphic: Deloitte University Press | DUPress.com

Again, this strategy benefits both banks and their customers: Customers pay only for what they use, and banks are able to offer services to those who need them on a more sustainable basis.

Of course, the precise threshold should depend on a carefully implemented analytical assessment of each bank's customers. In particular, banks will need to implement systems that can holistically assess customer relationships to avoid damaging profitable accounts with long-term insignificant fees. That said, the broad principle of threshold-based unbundled service pricing should benefit a wide range of institutions—provided customers are made aware of the benefits to them.

## Communicating value

Communication is extremely important for an effective transition to unbundled pricing. Without customer buy-in, no amount of sophistication in pricing structure will generate the desired benefits. The task is all the more difficult given the prevalence of low levels of customer understanding and high (stated) price sensitivity (figures 1 and 2).

To secure customer support, messaging should be tailored to specific customer groups. Variations in messaging should consider factors such as current usage patterns, depth of relationship, and demographic considerations. For instance, depth of relationship may drive potential differences in appropriate messaging for services in the conveniences category. To customers who currently have broader relationships with their bank (and who may also have more positive perceptions of the bank), the new pricing model could be presented as a shift to a system in which banks charge only for products they could not otherwise provide. To infrequent or basic users, the messaging could emphasize the optional nature of these fee-based services and the consistent provision of free basic services alongside pay-per-service conveniences.

## Reassuring the skeptical majority

The themes of transparency and fairness are likely to be essential in communications to all groups. Previous analysis has shown that approximately 60 percent of customers fall into two segments—“frugalists” and “distrusters”—characterized by high price sensitivity and skeptical attitudes toward industry pricing practices.<sup>6</sup> (See the next page, “Three major customer segments,” for details.) Given this majority, banks should consider consistently emphasizing two points. First, average customer fees may remain unchanged or even decline as unbundled services take the place of monthly fee bundles. And second, the unbundled model eliminates the subsidy of high-volume users by low-volume users.

Implementing new fees without clearly representing the factors behind pricing decisions could also risk sparking substantially negative consumer reactions. Moreover, fee structures should be clearly presented. Fees that appear “hidden” may win customers, but at the cost of long-term trust.

## Drawing on lessons from other industries

Pricing model shifts in other industries offer a number of useful insights into drivers of re-pricing effectiveness. Relevant examples go far beyond that of the salad bar.

### **The *New York Times***

The *New York Times* has continued to increase the variety of its delivery options. Instead of a limited set of flat-rate print subscriptions, subscribers can now choose from a wide range of both digital and print options. Under this model, limited access is free, lower-cost digital subscriptions have correspondingly low pricing, premium digital services such as the tablet version are priced higher, and home delivery rates depend on the number of days subscribers wish to receive a physical newspaper.

The revised pricing model has been received favorably, likely because of the transparent association of fees charged with cost to serve and the accurate identification of “core” news products.

### Airlines

Over the past few years, in an effort to manage high fuel costs and continue to offer competitive pricing, the airline industry has moved toward an unbundled fee-per-service model. The industry experienced a rocky transition to the new pricing model, due in part to the new pricing system’s perceived lack of transparency and, in some cases, fees attached to low-cost items like soda or peanuts. However, since becoming the norm, the fee-per-service model has likely benefited both airlines and their customers. Base fares can be lower than they might have been otherwise, and customers pay only for the services they wish to use. The unbundled model has also allowed airlines to cultivate a valuable new revenue source: Baggage fees alone accounted for roughly \$3 billion in revenue in 2012.<sup>8</sup>

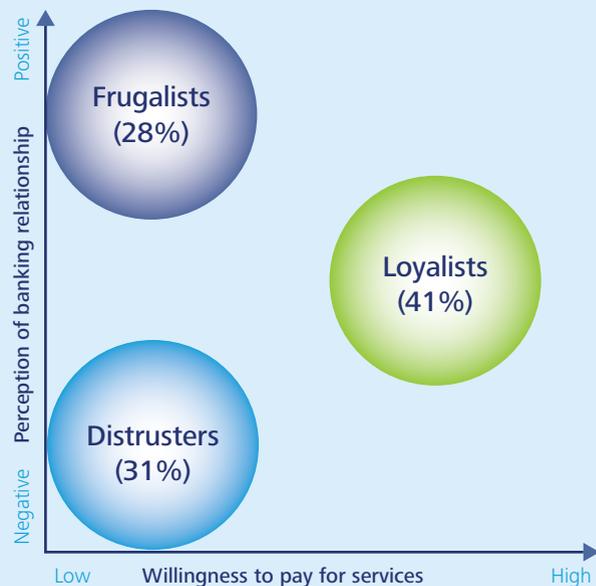
There are a number of common themes in these examples. On the positive side, presentation and positioning, transparency, and correct identification of the product’s core features appear to drive favorable outcomes. In contrast, transitions can be made more difficult by poor communication or unclear assessment of customer patterns. To effectively implement new pricing models, banks will likely need to aggressively invest in both marketing efforts and customer analytics.

## THREE MAJOR CUSTOMER SEGMENTS

The report *Retail bank pricing: Resetting customer expectations* identified three distinct groups of bank customers based on willingness to pay and perceptions of banks: **loyalists**, **frugalists**, and **distrusters** (figure 6).<sup>7</sup> Perceptions and beliefs, rather than demographics and geography, drive this differentiation.

Loyalists tend to be evenly distributed across banks, but distrusters—those with low willingness to pay and negative perceptions of banks—are concentrated in national and regional banks. Given that almost 60 percent of customers fall into the frugalist and distruster categories, banks should emphasize aspects likely to appeal to these segments in all communications related to a new pricing model.

**Figure 6. Loyalists, frugalists, and distrusters**



Source: Val Srinivas, Ryan Zagone, and Dennis Dillon, *Retail bank pricing: Resetting customer expectations*, Deloitte Development LLC, 2013, [http://www.deloitte.com/view/en\\_US/us/Services/consulting/industry/f44cc7c20ab8c310VgnVCM3000003456f70aRCRD.htm](http://www.deloitte.com/view/en_US/us/Services/consulting/industry/f44cc7c20ab8c310VgnVCM3000003456f70aRCRD.htm).

Graphic: Deloitte University Press | DUPress.com

# Toward an unbundled model

**E**VEN with a rigorous framework in place, transition to an unbundled model will depend on the careful orchestration of a wide variety of efforts. Three factors in particular, are likely to be crucial to meeting strategic goals:

- **Banks' ability to understand customer perceptions regarding "core" and tangential services.** Misunderstanding these perceptions could keep a new pricing framework from getting off the ground. While the service segmentation proposed here offers a useful general assessment, customer bases between banks are likely to differ substantially, making investment in customer insight more important than ever. Customer analytics should be considered one of the cornerstones of a new pricing strategy.
- **Minimizing the broad impacts of new fee thresholds.** With careful analysis of usage rates, new pricing strategies can profitably target a small subset of the population with distinct, high-use consumption patterns. In this manner, new pricing frameworks may be implemented without affecting large numbers of bank customers.
- **Tailoring messaging to specific customer segments.** While pricing frameworks can be uniform across customer groups, messaging should be tailored to specific types of customers. Different groups—whether segmented by breadth of relationship, demographics, or other factors—will require different communication styles and emphases to win them over to the new model. But given widespread price sensitivity, increased transparency, the potential for lower costs, and fairness should be common themes in all communications.



Across industries, it appears consumers value choices over constraints, flexibility over rigidity, and customization over standardization. Full-service, full-price bundles may no longer appeal to many consumers, potentially making a shift to unbundled offerings an imperative.

The unbundling option has been explored by banks in the past, but to little effect—because it was not executed with customer priorities and behavior in mind. A customer-centric unbundling strategy should consider:

- Distance from the core and cost to serve
- Positioning that emphasizes choice rather than price

- Customer behavior and usage patterns for various services
- Differing customer profiles and their implications for managing customers' perceptions of a changing pricing model

The primary research presented here indicates that unbundling offers a significant opportunity in an industry where customer perceptions and loyalty are paramount.<sup>9</sup> Banks that employ a well-structured unbundling approach may not only mitigate customer attrition, but also attract and grow their retail customer base.



# Endnotes

1. For further discussion of the free checking model and customers' pricing perceptions, see Val Srinivas, Ryan Zagone, and Dennis Dillon, *Retail bank pricing: Resetting customer expectations*, Deloitte Development LLC, 2013, [http://www.deloitte.com/view/en\\_US/Services/consulting/industry/f44cc7c20ab-8c310VgnVCM3000003456f70aRCRD.htm](http://www.deloitte.com/view/en_US/Services/consulting/industry/f44cc7c20ab-8c310VgnVCM3000003456f70aRCRD.htm).
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