PROFESSIONAL PRICING SOCIETY™

The PRICING ADVISOR

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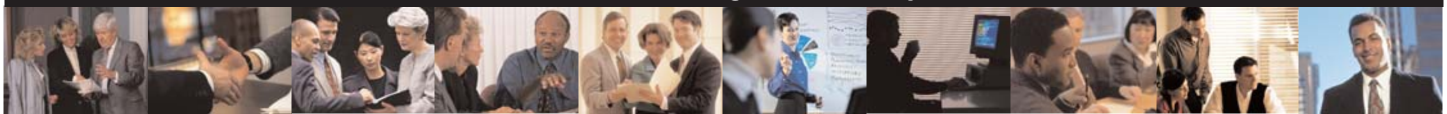

March 2006

The following article focuses on pricing processes as effective measures to improve margins in the financial service industry and presents strategies to end, or even better to avoid, a price war. Jens Baumgarten is a Director, Dr. Georg Wuebker Partner and Global Head of Simon - Kucher & Partners' Competence Center Financial Services. Contact: www.simon-kucher.com, Jens.Baumgarten@simon-kucher.com; or Georg.Wuebker@simon-kucher.com.

Powerful Pricing Processes: How to Exploit Profit Potentials

The Power of Pricing

A simple example should demonstrate the power of pricing: Assume a bank sells its premium current account package for €10 and its sales volume is one million units. The variable costs per unit are €8, which results in a contribution margin of €2 per unit. The bank's fixed costs for the value added services included in the package are €1 million. In this situation, the bank earns a profit of €1 million (= (10-8) €/unit x 1 million units - €1 million). How does each of the four profit drivers - price, variable costs, volume, and fixed costs - change profit when improved by 10 percent? The answer is summarized in Figure 1.

A 10 percent increase in price (€10 to €11) leads (ceteris paribus) to a profit increase of 100 percent, from €1 million to €2 million (= (11-8) €/unit x 1 million units - €1 million). The effect of the other profit drivers is much lower (a 10 percent improvement of variable costs, volume, and fixed

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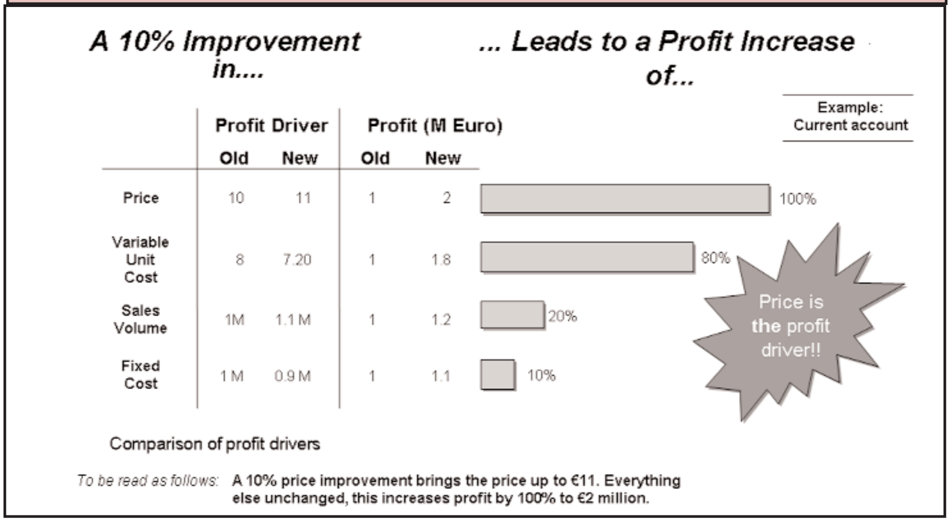
Figure 1. Profit drivers: price, costs, and volume



costs leads (ceteris paribus) to a profit increase of 80, 20 and 10 percent respectively).

Shortly summarized, decision makers must see the price as the primary profit driver. Increased margins stimulated by professional pricing immediately increase profit and do not require expensive upfront investments or severance pays. Relative to cost cutting, price optimisation offers three opportunities: it gains time, avoids additional upfront expenses and has a stronger impact on profit. So, the crucial question is: How can these profit potentials be leveraged effectively?

Pricing Processes: The Key to Success

"Simple" price increases are risky and mostly do not result in the projected effects. Just increasing existing prices or ordering sales persons to negotiate higher prices will fail. Banks must apply and implement an effective pricing process. Our experience shows that many banks and insurance companies today do not follow a systematic pricing process. Such a process is comprised of a system of organisational rules, guidelines and measures intended to determine, manage and implement prices. Pricing processes are complex and cover the following aspects (see figure 2 below):

1. Five phases: Strategic guidelines (objectives, positioning, competition), status quo check (current situation and processes), price decision (structure, level, customisation, bundling), implementation (organisation, responsibility, IT, incentives), and controlling/monitoring.
2. Information, methods, models, rules, qualifications, competencies, and deadlines.
3. Subjective (e.g. estimations, experience) and objective (e.g. market, competition data) components.

When companies offer such a large number of products as many banks do (retail price lists of banks often cover more than 200 priced items), or prices are negotiated for each transaction, pricing processes are crucial. Due to the high number of necessary price decisions, the effort involved in each decision has to be limited. Precisely defined processes are required to determine and implement prices and thereby foster acceptable yields. According to our findings, effective pricing processes increase the return on sales by up to 2-3 percentage points.

Reaping the Harvest

What has to be done to exploit the power hidden in effective pricing processes?

- First, many executive managers of banks or insurances must focus more strongly on profits and prices. They need to develop innovative pricing strategies, which are in line with customers' needs and value perceptions and are accompanied by an overall reorientation of pricing processes. At successful banks like UBS, pricing is closely linked to their organisation. Other global banks are also starting this process.

Figure 2. The five phases of the pricing process

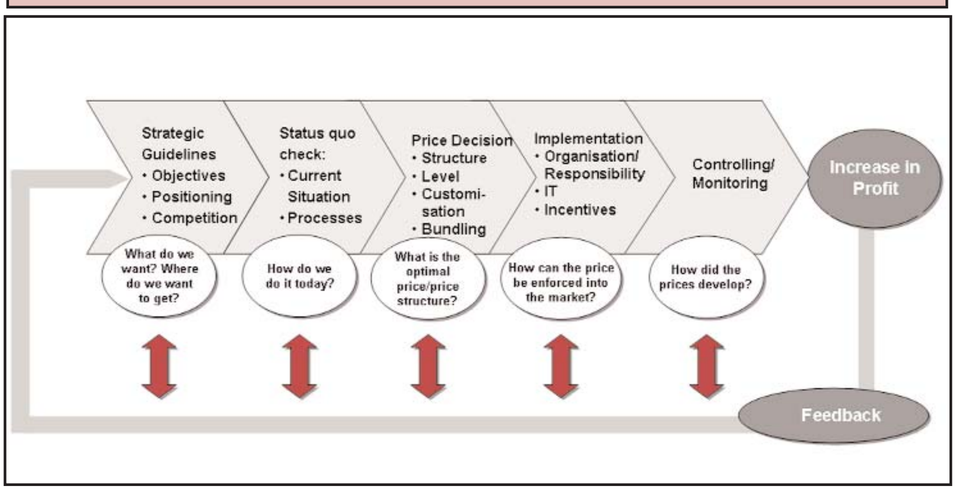


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Figure 3. Profit improvements through pricing processes

Segment	Size (revenue)*	Main improvements in the pricing process	Effect (increase in return on sales in % -pts.)
Retail securities	GBP 70 Mio.	- Systematic quantification of the "value-to-customer" - Implementation of intelligent forms of price differentiation	approx. 3,0
Retail payment transactions	GBP 50 Mio.	- Reorganisation of the whole pricing process - Introduction of a controlling tool for price implementation	2,8
Retail current accounts	GBP 35 Mio.	- Clear up of the product- and price-portfolio - Innovative und segment specific value added packages	4
Retail cards	GBP 35 Mio.	- Measurement of segement specific price elasticities - Innovative price structures, revised product and service portfolio	6,5
Private Banking securities	GBP 150 Mio.	- Development of a comprehensive pricing database - Systematic rules and processes on special conditions	5
Private Banking services	> GBP 160 Mio.	- Development of new "value added services" - Implementation of a value added strategy (modular solution packs)	3,4
Private Banking	> GBP 160 Mio.	- Detailed pricing-audit for all core products and segments - Tools for price implementation	6
Funds	> GBP 300 Mio.	- Implementation fo new pricing guidelines and processes - Price optimisation of over 100 funds	3
Corporate Banking	> GBP 200 Mio.	- Systematic identification of value drivers - Improved price and value enforcement	4

* of the business segment analysed

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- Second, the value-to-customer of products and services is far from being really understood by many banks. Consequently, they do not charge the appropriate price for the value delivered. Increasing profits through more effective pricing processes is a challenge for top management. Gains in the area of several tens of millions of Euros can be achieved by implementing professional pricing processes.

- One of the key points in effective pricing processes is substantial information. Price elasticities, the willingness-to-pay for different products, etc. have to be known to optimise prices and products. Reliable and valid methods (such as conjoint analysis) to collect such information do exist - but they have to be made use of in a professional way.

- Finally, intelligent means of price customisation must be used to exploit the customers' willingness-to-pay. The most important ones are non-linear pricing, multi-person pricing and price bundling. Companies like Dell or Microsoft have successfully adopted these methods. They are a benchmark for value pricing also for the financial services industry.

Price War in European Financial Services: Causes and Remedies

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 loans or particularly in online banking: Here, many new competitors have tried to gain market shares in the last years by imposing aggressive fees to which established players immediately responded with further price decreases. E-trade, for example, has decreased the prevailing price for online-trades from USD 30 to USD 15 to USD 8 in the past few years.

A price war can be triggered by a number of factors (see figure above). The most important - especially for the European financial service industry - are overcapacities which are especially relevant for Germany, France and Spain. No wonder that specifically in these markets, more and more aggressive price moves can be observed. For example Spain's second largest retail bank BBVA recently communicated aggressively on an interest and commission free loan. French Caisse d'Epargne was the fist major bank offering interest rates on current accounts after the law has changed in this respect.

Furthermore, market consolidation is accelerating, overall growth potentials are minimal and many financial products or services nowadays have become commodities, with very few possibilities to differentiate. Last but not least, many banking managers are not pro-ficient enough in the use of pricing strategies and tactics: First, they wrongly anticipate competitive reaction on their own price moves and secondly, they rarely apply intelligent tools of price communication, such as signaling.

But how can a price war be prevented? How can banks evade the price trap? There are multiple strategic and tactic paths to follow:

Bank managers should make use of more complex price systems - such as two-part pricing, multidimensional pricing or loyalty programs - for selected prod-ucts/services.

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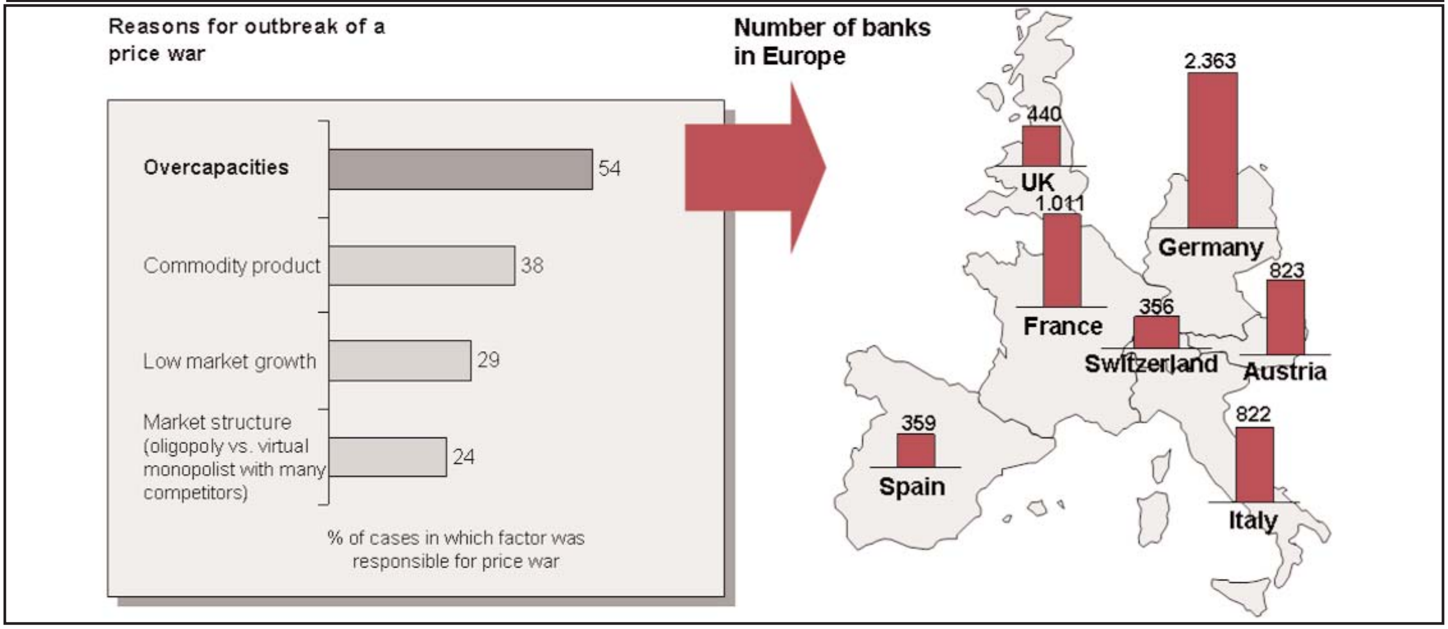
Figure 4: Causes of price wars / overcapacities in the European banking industry



accurately as possible. This step is critical because the competition's reaction will have an impact on their sales and profit situation. Game theory can be useful in predicting competitive be-havior. Through different scenarios, profit effects and competitive reactions to price changes can be "acted out".

- *Signaling:* With this strategy, a bank can send early signals to its competitors and customers that it plans to adjust prices. Consequently, the bank can ensure that the competitors understand the rationale behind its pricing policy, and avoid "panic re-actions" and thus prevent the progression of a downward price spiral typical for price wars. 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 cost 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 communicate this information. It goes without saying that legal aspects must be considered here.

- *Differentiate price structures:* The likelihood that banks will continually try to un-dersell one another is greater if their price structures enable customers to compare offers. 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, two price components (fixed monthly and/or minimum fee and a variable fee) are often 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 banks to avoid direct price comparisons. They no longer offer merely a product, but an entire solution. As a result, the bank is seen as a problem-solver and a systems provider. The solution - not the price - is at the center of the customers' attention.

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

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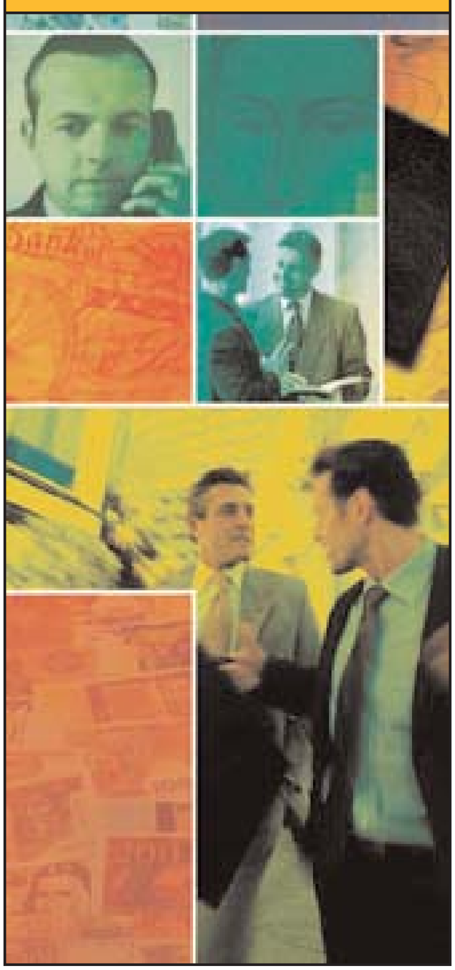
Here is a recent article from the Strategic Pricing Groups' Newsletter," Insights, reprinted with permission. In it the 3 authors argue that with the growing number of complex pricing issues affecting Fortune 1000 companies, the need for an effective pricing capability now has become critical. The authors are Elliott Yama, Peter Walsh, and John Hogan are, respectively, Principal, Chief Marketing Officer, and VP & Director of Research of the Strategic Pricing Group, a Monitor Company. They can be reached at monitor eyama@monitor.com, pwalsh@ monitor.com, and jhogan@monitor.com. E.M.



How to Regain Your Marketplace Power By Investing In Pricing

Pricing: Rising to the Top of the Corporate Agenda

There is a new reality in Fortune 1000 companies today. Companies are struggling with serious issues regarding how they set and manage prices. The challenges are so great that the issue has finally made it into the executive suite. In a recent survey by the McKinsey Quarterly, pricing strategy was rated as the #1 business issue facing senior executives. So why is pricing so critical today? Let's look at some of the marketplace issues driving the need:

- Competing Against Procurement Guerillas: For over a decade, procurement organizations have mastered the art of driving prices down. Executives are finally realizing they need a way to compete against these profit-draining powerhouses.

- Selling to Global Customers: As companies operate more globally, suppliers are frequently being asked hard questions like, "why did you charge us 40% more for the same product in Australia than in America?" Executives are being pushed to coordinate policies for cross-border pricing even though they often lack global pricing systems or policies.

- The China Factor: China has now assumed a leadership role in the global economy. High quality, low cost products (for virtually every industry) are flying out of China and creating intense price competition. Many domestic industries have been turned upside down and executives are scrambling for ways to compete.

- Lightning-fast Innovation: A decade of investment into new product development processes has reduced the cycle time in most industries by 50%. The result is that marketers have less time to extract the value these new products bring to customers before it has been eroded by competitors.

The mixture of these market factors has created a toxic cocktail for companies struggling to maintain their pricing power. In this environment, each vulnerability in your pricing process cuts into profits through reduced price realization. Unfortunately, most organizations are not well equipped to handle the volume, complexity and cross-functional nature of today's pricing issues.

Pricing lies at the intersection of Marketing, Finance, and Sales, with each functional area contributing its perspective to pricing decisions. Instead of these contributions adding up to a sound pricing strategy that maximizes profitability, in most companies, pricing options are limited because each area imposes constraints on the pricing decision. In the process, viable strategic options come off the table and pricing becomes a political football with ultimate decisions being made by the functional area with the most power.

The result is an unbalanced pricing strategy with too much emphasis on costs, customers, or competition depending on who's making the decision.

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Create a Disciplined Pricing Organization

Most companies have fairly complex multi-divisional, multi-product businesses that require a pricing approach that combines elements of both centralization and decentralization. While there is no perfect organizational structure, we do recommend a centralized (or coordinating) pricing function that sets and manages macro pricing issues such as overall pricing strategies and policies for operating groups to follow. These policies should outline goals and targets for price integrity and price realization. The central group should also be responsible for measurement systems and controls that drive pricing consistency, rigor, and discipline throughout an organization. With these skills in place, decentralized units can focus on pricing decisions closer to customers and markets - issues such as value creation, offering design, price setting and negotiation tactics. With this approach, it is critical to address pricing complexity upstream. We often see clients build a pricing organization combining centralized control with decentralized execution, yet they fail to achieve the intended results because they push too much complexity to the field. Complexity needs to be strategically planned and coordinated from the center. For this model to work, downstream decision making processes must be simple and timely.

Don't make the mistake of thinking that software alone will lead to more effective pricing.

Furthermore, this pricing organization needs to have some teeth. Pricing organizations need the status to help shape strategy and the credibility and power to enforce pricing policies, the degree to which depends on your organization's culture and your ultimate objective. The pricing organization of one of our clients didn't dictate policy to business units, but it did, however, publish a monthly scorecard on how business units were performing against pricing objectives. And since the scorecard was highly visible and supported by the CEO, it wasn't long before divisional managers changed their behavior to avoid public embarrassment.

Invest in Your Analytical Capability

Few would argue with the old adage "you can't make good decisions with bad information." Nevertheless, most companies make pricing decisions with inadequate information about customer value, competitor pricing, sales trends, and profitability. This was an understandable situation in the past when there simply weren't many options for doing pricing analytics. Today, there is no excuse. Technology vendors have developed excellent software programs to support strategic pricing decisions. There are at least a dozen software vendors who have entered this arena whose systems support three basic functions: pricing analytics, price optimization, and deal management.

But don't make the mistake of thinking that software alone will lead to more effective pricing. Analytical tools are vital to making timely decisions and helping integrate a pricing process into organizations. However, great care must be taken to ensure systems are not implemented before the right process and organization is in place.

Consider the example of a CMO at a large industrial manufacturer. He joined the organization about a year ago when their pricing was in disarray. The company had a cumbersome, paper based, overly complex pricing structure that resulted in a price book over 100 pages long. Because customers were complaining and the company was loosing deals due to slow response times, the CMO believed he needed to act quickly. He bought and implemented the full suite of pricing software from one of the leading vendors. But because he didn't have a sound strategy and process in place and lacked the necessary organizational pricing skills, the software they implemented simply caused them to make bad decision even faster. The pricing software was not at fault - software can only do what it's programmed to do.

Develop Pricing Leadership

Today, many Fortune 1000 companies are actively recruiting for pricing talent, both at the junior and senior levels. However, since pricing skills are a relatively new corporate discipline, finding expertise can be challenging. Most companies will need to build their capabilities internally and train individuals on the key pricing concepts such as waterfall analysis, price banding, economic value estimation®, value assessments, and price segmentation. We find that the most effective pricing organizations recruit individuals who have credibility

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across all functional areas and are capable of working up and down the organizational hierarchy.

However, the critical mistake made by many firms is assuming that simply developing these skills is enough. To be effective, senior leadership must be willing to change some of its own behaviors as they relate to pricing strategy. We've seen many senior executives unravel years of pricing integrity by agreeing to a highly unprofitable deal just to make a quarterly revenue target. We've witnessed countless organizations muddle though critical decisions because senior leadership couldn't decide about whether they wanted more share or greater profits. For many executives, pricing strategy is a blind spot that they need to correct to insure they are positioned to lead on this very important issue.

Conclusion

There is no one-size-fits-all approach to building a pricing capability that can regain your pricing power in the marketplace. The best-in-class pricing companies view pricing as an important strategic function of the firm. To be effective, pricing needs to work at the crossroads of your Marketing, Sales and Finance organizations. Pricing must be directly linked to the strategy-setting function within a company, and at the same time, linked to a "local-level" understanding of customers and the economics that drive their businesses. We believe pricing organizations will grow in importance much the way strategic sourcing has grown over the past decade. It's time to start building your pricing muscle today. If designed and managed effectively, this capability will be a significant driver of revenue growth and profit for years to come.

Here is a brief but stimulating thought starter article on pricing visibility-or lack thereof-from Author Tim Smith. PhD. Tim is Editor of The Wiglaf Journal, Principal of Wiglaf LLC, and Adjunct Professor at DePaul Graduate School of Business. He can be reached at tim_smith@wiglaf.biz. E.M.

Grappling With Pricing Opacity

In consumer markets, prices are transparent. Anyone wanting to know the price of a good or service, competitors and prospective customers alike, can easily call for a price quote or look-up the list price. In contrast, prices are opaque in many business markets. Even in markets where price lists are available, the practice of discounting allows transaction prices to vary within a broad range. The opacity of prices in business markets biases buyer behavior towards slower demand growth, creates uncertainty in setting strategic prices, and presents a management challenge in pricing individual transactions.

Structurally Induced Opacity

Opaque pricing in business markets is partly due to the structure in which value offerings are constructed. Through the solution selling process, salespeople uncover the demands of customers and develop solutions to address their challenges. The correct solution for any one prospect could differ significantly from that needed by others. In constructing the vision of the correct solution for a specific prospect, the price is also constructed. Prices can only be set once the deliverable is well defined; thereby the practice of solution selling naturally forces opaque pricing.

Price discovery through the sales process is sometimes practiced in consumer markets, for example in home remodeling or auto repair, yet most consumer markets function with list prices. Even in business markets that can be classified as transactionally oriented and dealing with commodity inputs, price variances are common. Discounting practices in business markets created from the competitive environment and volume/delivery based cost differentials drive prices away from published price lists when such lists are available.

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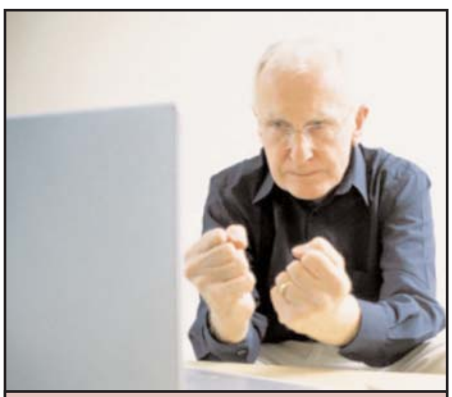
Buyer Behavior

The opacity of pricing in business markets affects buyer behavior. In making purchasing decisions, buyers require prices to evaluate whether the value of utilizing the product or service is greater than cost to acquire. To help buyers in their quest for information, businesses may communicate to prospects a general price range early in the sales process for budgetary purposes. Later, when the buyer is close to making a purchasing choice, the actual price for the deliverable will be delineated. This creates a challenge in managing expectations between the earlier communicated price range and that at the actual price of the transaction.

If the budgetary figures quoted early in the sales process are too high, prospects may dismiss the value offering as exorbitant and pursue a different course of action. Alternatively, if the budgetary figures are too low, prospects may have unrealistic expectations during closing negotiations. While these challenges can be managed by a skilled sales team, the uncertainty facing prospective buyers concerning price has a tendency to slow down the velocity of individual sales as well as depress overall demand.



If the budgetary figures quoted early in the sales process are too high, prospects may dismiss the value offering as exorbitant.

Off-competitor Value Based Pricing

Opaque pricing induces uncertainty in strategically pricing off-competitors that is not present in price transparent markets. In transparently priced markets, suppliers can easily observe competitors' prices through a number of informational sources including direct observation. With the competitors' prices revealed, suppliers can then price at parity, competitively, or at the high-end of the market depending upon their value differential. With opaque pricing practices, business marketers must make decisions in the face of uncertainty in pricing according to their value differential.

In most business marketers, price managers rely upon sparse quantities of questionably valid information. The wins and losses associated with individual transactions may be used to uncover competitor prices, yet price information derived from individual transactions will be entangled with information concerning positioning and value differentiators. Likewise, asking customers about a competitor's price is likely to be biased towards a lower number.

Tactical Pricing

Along with the informational challenge of strategically setting prices at the corporate level, executives face further challenges in tactically managing prices at the individual transaction level. In tactical price management, executives must manage when prices are communicated, how they are communicated, and the size of price variances. These tactical pricing issues must be managed for each and every sale at the individual transaction level. Outside of a few rare markets, no consumer marketer has to manage prices on a transaction by transaction level.

Concurrently, much of the information required for sound strategic pricing is gathered at the tactical level. Through direct contact with individual prospects and customers, salespeople will inquire about their competitors' prices. This information is used for decision making both tactically to win individual customers and strategically to set pricing policy.

Managing pricing, price information dissemination, and price information collection on a transaction-by-transaction basis increases the importance of the seller's tactical price management skills. Organizational processes are required to facilitate tactical pricing challenges and the acquisition of tactical pricing information. Sales team skills must be developed to manage buyer's price expectations and negotiations. The organizational culture must accept a higher level of uncertainty and privacy regarding pricing.

Summary - It is a Different Skill Set

Structurally induced price opacity in business markets influences buyer behavior, competitive pricing uncertainty, and tactical price management. Even in price transparent business markets, discounting practices will drive uncertainty with respect to transaction prices. The influences of opaque pricing on setting prices, managing price variances, and communicating prices to customers creates challenges for business marketers which their counterparts in consumer markets may never address. While some of the underlying pricing concepts may be transferable from consumer markets to business markets, the implementation and priorities will be very different.