True Relationship Based Pricing for the Financial Services Industry

WHITE PAPER

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Introduction

Rewarding long term relationships is not a new practice. You can probably recall several moments in your life when you were rewarded and when you rewarded someone else in tangible and non-tangible ways. In fact, the act of reciprocating seems to be an integral part of human nature – it is something we all do unconsciously and we don't think of it as a big deal, but in the commercial world it takes on a whole new meaning. Financial institutions, especially banks are taking customer relationship to another level. Have you heard of Relationship Based Pricing, Relationship Based Profitability, or Relationship Based Billing? No! Well, then you will find this paper quite fascinating.

A very interesting facet of the society we live in today is that when businesses begin to take a dip in their profitability, they either go under or rise to the occasion and think of innovative ways of overcoming challenges. That is precisely the context for Relationship Based Pricing, Relationship Based Profitability and Relationship Based Billing. In this paper, we will focus on how banks are commoditizing the notion of relationship and the technologies they are using to achieve the same.

[1] Although each of these terms has a specific meaning, in this paper we are assuming that businesses that adopt Relationship Based Pricing are also interested in structuring their billing and in calculating profit or loss for each customer. The idea behind all three terms is that the customer's relationship with the bank forms the basis for determining pricing, billing, and profitability or loss. For a very lucid explanation of all terms and an analysis of why banks are focusing on Relationship Based Pricing, listen to Patricia Hine's Webinar entitled "Banking in Trouble Times: Using Relationship Based Pricing and Billing for Growth." Also listen to the Webinar by National City's Ed Page entitled: "Organic Growth Through Relationship-Based Pricing" (June 10, 2007) http://www.suntecgroup.com/webinar.php [July 2008] –> this represents when the site was accessed.

What is Relationship Based Pricing (RBP)?

RBP is a framework that allows the price of products or services to be established in accordance with the value of each customer, which in turn is determined by a combination of factors that capture the quality and quantity of business brought to a bank by each customer. It entails a radical shift in pricing from a standardized product focus to a variable, customized customer relationship focus. In short, RBP is all about customer-centric (vs product-centric) pricing[2]. Obviously such an approach calls for having not only parameters that accurately measure customer loyalty and business generated but also IT solutions that automate the banking business such that bank officers can have a 360-degree view of each customer.

Why are Banks Feeling the Heat?

Traditionally, banks have earned a good portion of their profits from the fees on products and services to clients. Their strategy of charging for products and services based on their intrinsic value with little consideration for the recipients of those products and services has served them very well for many years. Today, however, the problem is that the same strategy may prove too costly. This is particularly true in developed economies (e.g., North America, Western Europe, and Australia), where the banks have reached a limit to their earnings via conventional methods. The following are among the key factors that are making banks review their current pricing models and look for alternative ways of staying profitable[3] :

- Inability to increase revenue through traditional means i.e., product-based pricing (savings/chequing accounts, term deposits, loans, and the like)
- Declining profitability
- High cost of capital
- Increased competition[4]
- Lack of customer loyalty. Today, customers are shopping around for a bank that could provide them with the services they desire and at a price they consider fair[5].

[2]According to Nanda Kumar of SunTec, banks need to have a 360 degree view of each customer across various products/business lines so that they can segment, package, and personalize their offerings. For further details, see K Nanda Kumar, "Gaining Momentum Towards Customer Centricity" (October 15 2007) http://www.gtnews.com/article/6953.cfm [July 2008].

[3]Relationship Based Pricing is one among many alternatives being explored and adopted by banks. For an interesting view on what banks need to do in order to move toward relationship business models, see Rob Whitemore, "The Strategic Relationship Opportunity Cycle in Today's Banking Space" www.metavante.com/mvnt/get?m=22654 [July 2008].

[4]According to Wubker and Baumgarten, banks are competing intensely by lowering prices. They predict four reasons why this industry may end up in price wars include: low growth, pressure on pricing products, new players in the banking sector, and monopolistic nature of this industry. Among the five ways in which the banking industry can avoid falling into a 'price trap' surprisingly enough Wubker and Baumgarten have not consider RBP as an option. Nonetheless, for an interesting analysis, see Dr Georg Wubker and Jens

Challenges to the Adoption of RBP

Resistance to change is a common phenomenon arising out of our fear of the unknown or unwillingness to move out of our comfort zones. The attitude of banks towards the adoption of RBP is no exception to that assertion. Banks that saw the writing on the wall and had the foresight to plan for it are already in the process of implementing RBP in their business model. In fact, thanks to them that today we are knowledgeable about the challenges that banks choosing to go the same route will need to overcome.

The following are some of the key obstacles that banks need to overcome in order to make RBP model work in their favour:

1. **Product-Centric Mindset** focuses on products rather than on the relationship of a customer to the bank. Prices, for the most part are, therefore, determined per product or service with very little or no regard to the relationship of a customer to the bank.
2. **Existing IT Setup** locks customer data in application silos per product, service, and/or business unit. It, therefore, does not give a complete view of a customer's portfolio held at a given bank.
3. **Customer Relationship** is often the responsibility of a single individual at a bank, usually the Customer Relations Manager, rather than an important and an integral component of pricing in general and hence the responsibility of all in charge of bank offerings[6].

In spite of the above challenges, some banks have decided to adopt RBP and implement appropriate IT technologies to facilitate some form of price optimization. This, experts remind us, is just a start and a far cry from the idea of Dynamic Relationship Pricing (DRP) of new (bundles of) products and services based on customer profitability[7]. Likewise, the number of IT companies that have entered the RBP space is also quite limited, each having solutions and platform that are at various stages of maturity[8].

Baumgarten, "Price Wars, a Problem Facing the Banking Sector: Avoid Falling Prices," http://www.simon-kucher.com/eng04/530_publikationen_whitepaper.html#banking [July 2008].

[5] According to a Bank Administration Institute (BAI) survey only 12% of the respondent felt rewarded for the size and longevity of the relationship they had with their banks. For details, see Paul McAdam and B. Joseph Pine II, "Banking Strategies" http://www.bai.org/BANKINGSTRATEGIES/2006%2Dnov%2Ddec/CustomerExperience/ November/December Vol. 82, Issue #6, [June 2008]. For a summary of the findings, see Mary Pilecki et al, "Turning Pricing Optimization Into Relationship-Based Pricing" April 3, 2007 http://www.forrester.com/Research/Document/Excerpt/0,7211,41610,00.html, Endnote 1, [July 2008].

[6] According to a Gartner survey of 37 retail banks, pricing is very centralized and is determined by a number of varying factors ranging from relationship characteristics and credit history to age and income. This leaves very little room for discretionary pricing on the part of individual bank officers. See Richard J. De Lotto, "Survey Report on Relationship-Based Pricing Strategies in Banking, 2007" (ID Number: G00148026, June 25, 2007) www.gartner.com [July 2008].

Solution

Financial services industry need to consider overall relationship with customer and provides price accordingly. To do this, financial institutions withshould deploy applications that provide a flexible framework for defining, establishing parameters, and for automating fees computation and billing functionalities. These applications should allow financial institutions to set up a number of fees and billing options including, though not limited to

- **Fee identification based on user-friendly rule builder** It allows business users to control the customer pricing function and to structure the customer's charge plan in a flexible manner. The easy-to-implement fee identification functionality enables business users to create varying charge plans to suit the changing business circumstances without the need for vendor intervention.

- **Fee configuration according to requirements** It allows financial institutions to customize fees at a highly granular level as well as set fees at a general level. Fee configuration may take place at any level, for instance, at transaction type, channel, processing system, transaction currency, customer group, individual customer, and at customer account level.

Application Architecture

It is not sufficient for application to be built using the SOA reference architecture but it should be built on the following principles:

- Respond to dynamic business requirements by allowing them to modify system processes.
- Share services across multiple applications, increase reusability, and reduce implementation costs.
- Use hardware and software of their choice.
- Easily integrate changes resulting from mergers, acquisitions, and/or implementation of new applications.

[7]A good indication of this is the list of clients of IT companies offering RBP solutions (see footnote 10). That list includes well known names like American Express, National City, ABN Ambro, Well Fargo, ING, Lloyds, HSBC, ICICI, HDFC, HBOS, Abbey, Royal Bank of Canada, to mention only a few.

[8]SunTec was one of the first to enter the RBP space with its RBP and Billing Solution, and today its TBMS-F Platform is recognized the world over in the financial domain. Other well known companies in this space include Nomis Solutions, Zafin Labs, Interactive Technologies [unit of Fiserv Inc], and Amdoc.

For further details see http://www.suntecgroup.com, http://www.nomissolutions.com, http://www.zafinlabs.com, http://www.itadv.com, http://www.amdocs.com/Site/Solutions/fs/Solutions/DRP/pricing.htm. See also, "Dynamic Pricing and Profitability Management" www.sas.com/industry/banking/dynamic.pdf [July 2008], "Dynamic Relationship Pricing" http://www.intellisolutions.gr/crm_aspects.htm [July 2008], John Adams, "How Much to Charge?" (BTN: August 2007, Vol. 20, No. 8) www.ips-sendero.com/Marketing/BTN_August07.pdf [July 2008]. Interestingly enough even Credit Unions are embracing RBP. For one such case see Annie Sebastian, "Simplicity is Key for Relationship-Based Pricing Program" (May 23, 2005) http://www.creditunions.com/home/articles/template.asp?article_id=1653 [July 2008].

RBP is a win–win concept

RBP brings synergized benefits to the Financial Institution and to its Customer.

Financial Institutions are able to

✓ **Reduce cost and increase revenue** by

- Rationalizing pricing structure. Relationship based pricing allows financial institutions to weigh the cost of keeping (different categories of) clients vs the revenue they generate for the bank and charge fees accordingly.
- Taking Customer Relationship Management (CRM) to its next logical level where it is possible for banks to separate profitable from unprofitable customers.
- Tapping into a new source of revenue that allows pricing to be in line with profitability.

✓ **Rationalize IT processes** by

- Providing a single place for fee setup.
- Centralizing fee and billing service across multiple transactions processing systems in the bank's IT landscape.
- Enabling banks to choose transaction processing systems based on the core processing capabilities without being constrained by the need for flexible pricing models.

Bank customers feel valued because they are able to

- Obtain all the relevant services (ranging from loans and credit cards to regular banking) at one bank at very competitive rates.
- Get preferential treatment and flexible pricing for each service offered by their bank.

HCL PRICE is HCL's True Relationship Based Pricing engine. It is a flexible solution that enables financial institutions to set up a host of fee and billing options across lines of business and product silos with a user-friendly rule engine. The Service Oriented Architecture of HCL PRICE gives clients the flexibility of modifying the system processes to suit dynamic business requirements. To know more click here.

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An experienced Payments executive, with over 13 years of hands-on experience in banking products and project management. He has proven and successful track record of creating and delivering Payments solutions to banks; and has played various roles in Product Design, Product conceptualization, Product implementation, Solution architecture and Financial Analysis. He enjoys consulting banks with his insights into Payments domain and technology issues.