



Pricing innovation in banking: The next frontier

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Why banks should revisit their pricing strategies

Traditionally, the Indian banking industry has been tightly regulated, with little scope for innovation in products and pricing. Most banks follow a cost-plus and market-based pricing strategy, which was justifiable until recently as the banking industry was in a nascent stage and the market, largely underpenetrated. This strategy has helped banks grow considerably. Typically, the approach for banks' pricing factors in the cost of funds, risk-based spread and an assessment of the competitors' product portfolios. However, there are other components that are either underestimated or not fully accounted for such as the correct cost of servicing and the customers' value perception regarding such products.

Traditional pricing approach

- Market-based approach
- Risk premium
- Cost of funds



Missing cost elements

- Cost of technology
- Cost of product development
- Cost of rollout and infrastructure
- Cost of processes



Value-based pricing

- Generates increased value for customers
- Captures customers at the right time
- Supports growth in wallet share

We believe that going forward, pricing will play an increasingly critical role in the industry's profitability. With the increase in the number of players and industry penetration, pricing will help capture a larger share of customers' wallets. We believe banks have significant value potential that can be captured if they incorporate both these elements in their pricing strategies.

1.1. Estimation of the right cost of servicing



Since most banks and financial institutions adopt a traditional approach to determine the cost of production and marketing of products, the current estimates do not take into account other associated costs. These include the cost of maintenance of infrastructure (branches, ATMs and call centres) and those incurred to support technology, product launches and pilots.

Fee-based income does not aid in the recovery of the cost of services. Instances wherein the spread (net interest margin) compensates for the cost of services are rare, and it merely compensates for risk-adjusted returns on the equity of the core lending business.



Our analysis of the current approach adopted by banks with regards to cost estimation indicates that they tend to overlook the following factors:

1) High cost of maintenance of a brick-and-mortar network in urban centres:

Banks incur significant costs in the maintenance and servicing of their vast branch network. As mentioned earlier, the margin generated by banks' core businesses merely compensates for risk-adjusted returns on equity, and cannot support these additional costs.

In the table below, we have considered a banking network with over 5,000 ATMs. We have evaluated how running a vast ATM network can impact banks' bottom line if they fail to adopt smart pricing strategies.

Table 1: Average cost of an ATM transaction

Number of ATMs in the network (A)	5000
Cost of servicing an ATM per annum (B)	INR 8-9 lakh per ATM (includes rent, security, electricity and other cash management charges)
Total cost of maintaining the network (C= A*B)	INR 450 crore
Cost of maintaining the network per day (D=C/365)	~INR 1.25 crore
Average transaction per day per ATM in India¹ (E)	125
Total transactions through the network per day (F=A*E)	6,25,000
Average cost per transaction (avg = D/F)	INR 20

These estimates do not take into account interbank change fees and the cost of setting up ATMs². Clearly, passing on INR 20 for every transaction as cost to customers is not feasible, as most users limit themselves to the number of free monthly transactions permitted by the banking regulator.

Data reveals that the cost of providing regular services at most urban locations is fairly high. According to our analysis, the average cost of each transaction in such branches is greater than INR 50, a loss-making scenario for most banks³. While private banks have been successful in passing on some costs (such as processing fees and penalties) to their customers, public-sector banks generally offer a majority of these services free of cost.

While banks can continue to provide plain-vanilla services free of cost, they should re-evaluate their pricing strategies for value-added offerings in line with regulatory guidance.

2) Incorrect distribution of the cost of central functions using traditional cost allocation methods:

Some banks follow the traditional allocation methodology, which assigns most overhead costs on an equitable basis across segments. This method is used for central functions (HR, finance, risk, etc.) and shared services (processing centres). We believe that accurate cost allocation to the last mile should be done to identify the appropriate unit cost incurred.

3) Inadequate representation of activity-based effort in cost estimation:

A walk-in analysis of multiple branches reveals that while the roles of most branch personnel are clearly defined, their activity-based time reflects a different picture. For instance, though the branch managers are responsible for the overall administration and sales, a lot of time is spent (>75% of available office hours in a week) handling customers' grievances and general operations. Similarly, the time sheet analysis of other branch personnel reveals that a substantial chunk of their overall capacities is used for services. Therefore, the cost estimation of services should take into consideration an activity-based time spend analysis of the banks' front-line staff.

The Indian banking industry can assess missing cost elements and the reasons for the same. Further, as the market matures, banks should shift their focus from a cost-plus pricing strategy to a value-based pricing approach. We believe that customers in India appreciate the advantages of product differentiation and are willing to pay a premium for higher perceived value. This aspect has also been observed in several other industries, and it should now be implemented in the Indian banking industry.

1. 'Back to square one? Cash withdrawals from ATMs up by 22% in April, says RBI', June 2018

2. PwC analysis

3. PwC analysis, 'As digital banking grows, branches get smaller', *Business Line*, January 2018

1.2. Value-based pricing



A value-based pricing approach focuses on understanding the customers' willingness to pay a premium for products or services on the basis of the value offered. Banks can optimise their pricing and secure a larger share of customers' wallets with an increased focus on product innovation and customer analytics applications.

Value-based pricing advocates segmenting customers first. It calls for a gradual shift from a product-centric mind-set to a customer-centric approach. Banks should consider the following points while deciding on pricing strategies for products:



How to make a product differentiation strategy more relevant for their customers?



What price point will attract customers to buy products?



What makes a channel more desirable from the customers' perspective?

The following aspects will enable banks to determine the appropriate value across all dimensions – product, pricing and channels. These would also help them understand the customers' reaction to a pricing strategy:

1. **Costly customer acquisition does not always lead to a sustained increase in market share:** To increase their market share, many banks and financial institutions tend to price their products aggressively. While in the short term, this could help attract customers at high costs, it does not always lead to increased profitability or growth for banks. Therefore, they need to define a matrix analysing their acquisition cost versus the potential realisable value across the product lifecycle for customers.
2. **Customers have easy access to market information:** With the advent of third-party platforms, customers can easily access the products' features, and compare the value they derive from each offering. Our experience also reveals that banking products with complicated features are often avoided even if available at discounted prices.
3. **Poor marketing could lead to dissatisfaction with prices:** Customers do not realise the value proposition of the product, if it is not marketed appropriately. This may result in price dissatisfaction even if the products offered by banks are good and customers have the capacity to pay the premium. Therefore, the marketing strategy is as essential as appropriate pricing.
4. **Low-involvement products are difficult to price higher:** Customers are more emotionally attached to certain products than others. For instance, a savings account may not lead to high emotional satisfaction, whereas a vehicle loan which results in acquisition of a tangible asset can be extremely satisfying. Another point worth noting is that value-based pricing can only take place with product differentiation. Therefore, product-related criterion such as customers' involvement and differentiation of features are key parameters for any pricing strategy.

It is important to note that value-based pricing does not always call for an increase in the products' pricing. Optimised pricing may also be needed to win a large share of customers' wallets, thereby improving profitability.

Through a use case, we will depict how banks can use product innovation and smart pricing to maximise the value that can be secured from a transaction. It will also help banks gain significant market share.



Customer profile: A young retail customer has a savings account with bank XYZ. He also has a long family history of banking with the lender, as his parents hold multiple fixed deposits and salary accounts in it.



Transaction

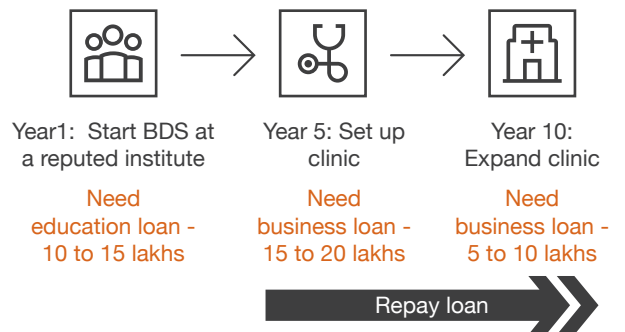
The client needs an education loan for the study of dentistry. The education loan market has low product differentiation, and being unsecured, most banks charge high interest rates for these products.



Pricing

This is a great opportunity for banks to create a niche for themselves in this sub-segment. Dentistry is a booming profession with demand-supply dynamics working in favour of professionals. The entrepreneurial journey in this profession is a capital-intensive one, but is followed by a stable payback with a strong career trajectory. Banks can target this segment with new products that combine an education loan with the option of a pre-approved business loan (with conditions attached to it, e.g. scoring at least 70% through the course). The loan repayment schedule can be designed in a format that will provide flexibility during the education period (e.g. with reduced rates and a moratorium) with the aim of recovering the loan amount during the customers' earning life cycle.

During the education phase, banks can gain access to transaction-related data of the user and his or her family by offering credit card services and a savings account. This will enable it to appraise credit and offer pre-approved loans nearing the time of the student's graduation.



Value addition

An environment in which the customers' education and profession are key parameters enables banks to maximise their share of wallets by gaining their loyalty. A combi-product that identifies customers at a young age and possesses the right set of institutional partners has the potential to establish itself as a market leader.



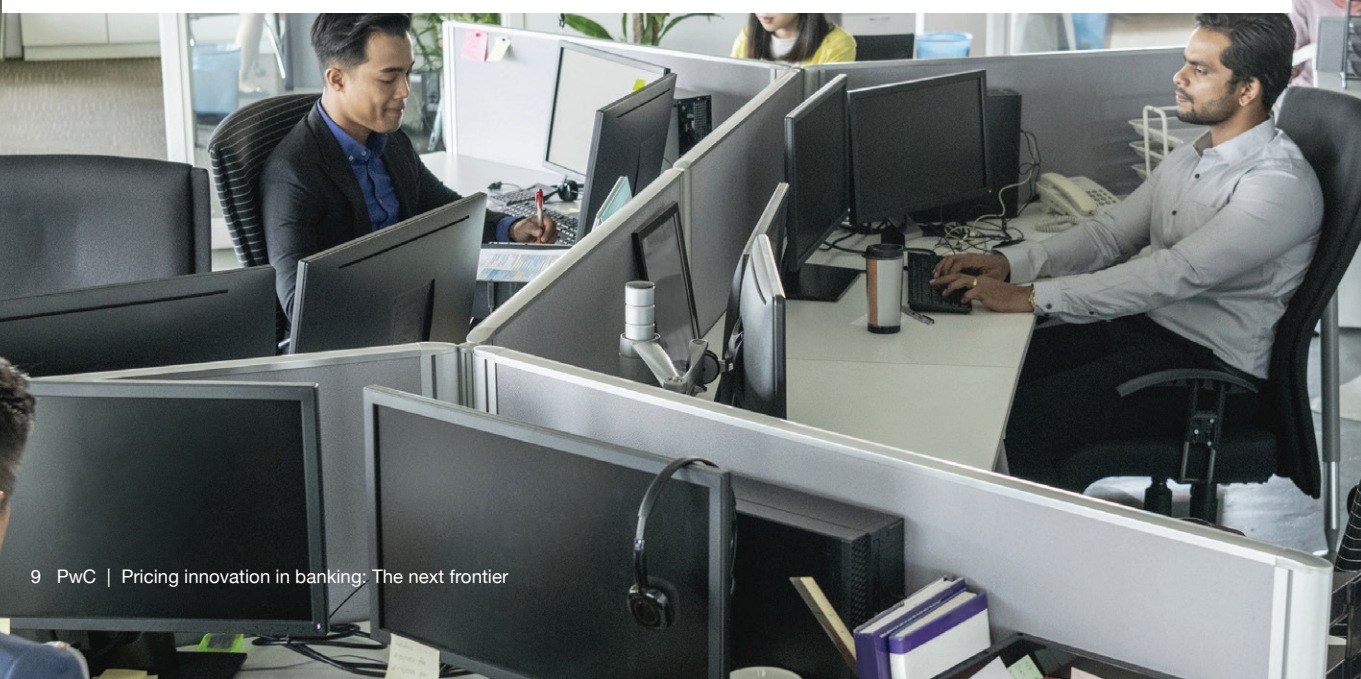
Implementation of value-based pricing

2.1. Perceived challenges in implementation



While banks appreciate customers' affinity to product-differentiation, there are some myths and perceptions which prevent them from implementing the value-based pricing strategy. We have made the following observations during our interactions with senior management across banks:

Observations / Myths	PwC's Point of View
India is a highly regulated market with no control over pricing	While it is true that a strongly regulated market provides few opportunities for customers to decide on pricing, the regulatory regime does not discourage banks from pricing their services as per the value perceived by their customers. It only mandates the provision of basic services free of cost, especially to customers at the bottom of the banking pyramid.
There is enough room to grow in the market without differentiated pricing	India's banking industry has witnessed significant growth in the last four years on the back of initiatives such as Jan Dhan, expansion of branches and the emergence of Fintech. Under penetration in the industry has decreased substantially. As per World Bank estimates (2018), ~80% of adult Indians have bank accounts. As the market grows, we expect to see significant penetration-led growth in the next three to five years. Thereafter, banks will have to focus on improving their customer service and innovation in products and pricing.
Banks may lose customers and market share if prices are increased	Increasing prices is often considered a definite outcome of any pricing strategy, which is not true. A robust pricing strategy acts as a lever to increase banks' share of wallets, cover the cost of services it provides and stop revenue leakages. More often than not, an effective pricing strategy also rewards loyal and high-yield customers by providing bundled services at reduced costs.
Banks do not have the bandwidth to decide on pricing strategies	Most banks do not need dedicated groups to design and implement their pricing strategies. Small cross-functional teams can coordinate with those that are existing. Capabilities in their product management and analytics functions can help drive such strategies.
It takes a long time for banks to realise benefits	Pricing-related changes should be implemented in a phased manner after successful pilots. Once a pricing strategy has been successfully rolled out, the benefits are immediately visible.



Banks should deploy a dual transformation strategy focussed on both tactical measures and strategic enablers to implement value-based pricing strategy. In the long term, banks should set up strategic analytic functions, which should be supported by pricing operations, product management, data analytics and technology. Notwithstanding the effort involved, there are certain tactical methods which can be deployed swiftly and effectively to realise benefits in the near term. These include:

Marketing campaigns:

Banks should deploy dedicated marketing campaigns for the launch of new product features, while targeting a set of customers. Marketing campaigns that emphasise differentiated value propositions for dedicated customer segments enable a faster go-to-market approach.

Dynamic pricing:

Industries that have successfully implemented dynamic pricing can be used as examples by banks looking to adopt the same approach. The concept implies that the pricing of products and services adjust on a real-time basis to the prevailing demand. Customers exposed to e-commerce are familiar with this concept and will not view it as a negative. They would attempt to make the best use of this opportunity, which in turn will prompt banks to optimise their services. For example, the usage of ATM networks or call centres can be dynamically priced on the basis of time and location.

Loyalty pricing:

Rewarding loyalty can provide a special price differentiation feature to banks' products. This will not only enable them to retain and increase their share of wallets with existing clients, but can also help increase market share. The concept is gaining prominence in e-commerce and credit cards, and can also be used to market other banking products. For instance, any bank can offer a 'next vehicle loan' to its existing vehicle loan customers at a slightly competitive rate. This enables it to capture significant value, as most car owners purchase new vehicles every five to six years.

Behavioural pricing:

A fairly new concept, behavioural pricing is a form of price differentiation based on customers' usage or buying history. However, the prerequisite for using this strategy is access to a large amount of customer data. Behavioural pricing can be easily applied in the allied areas of e-commerce like mobile banking, cards and other payment-related products.



2.2. Strategic enablers to be worked on in the long term



In the long term, banks and other financial institutions will need to work on the following parameters to incorporate value-pricing in their DNA:

Process control	Product management	Data analytics	Organisational alignment
<ul style="list-style-type: none"> Defined processes should enable banks to implement their pricing policies consistently and efficiently Product launch pilot process (Beta launch) Regular monitoring and optimisation as per market feedback 	<ul style="list-style-type: none"> Product management team to profile target customer segments and modify or bundle product offerings to include required features so that maximum value – either in terms of pricing or customers' share of wallet can be gained Understanding market and competition better by regular market assessment and benchmarking 	<ul style="list-style-type: none"> In-house capability to apply customer and transaction analytics to understand customers and their requirements better Customer insight to be used to create elasticity bands for each customer segment to adjust pricing accordingly 	<ul style="list-style-type: none"> Empowered decision management leadership to resolve pricing-related conflict between internal teams (sales and credit or product management and sales) Partial decentralisation of pricing authority at mid- or senior level Clear roles responsible for managing external and regulatory communication

These four levers will enable banks to utilise a large amount of data, integrate their pricing strategies in their overall business policies and communicate pricing and product differentiation benefits to end customers.

Utilising data

Pricing-related decisions are only as effective as the underlying information and data available. Banks' data analytics and product management teams need to gain capacity in identifying the right information, competitors and market trends, and price their products accordingly.

Integrating pricing strategy with that of the overall business

Pricing should be centre stage in the banks' overall strategy for effective functioning. It should align with both the customers' points of view and the banks' organisational structure.

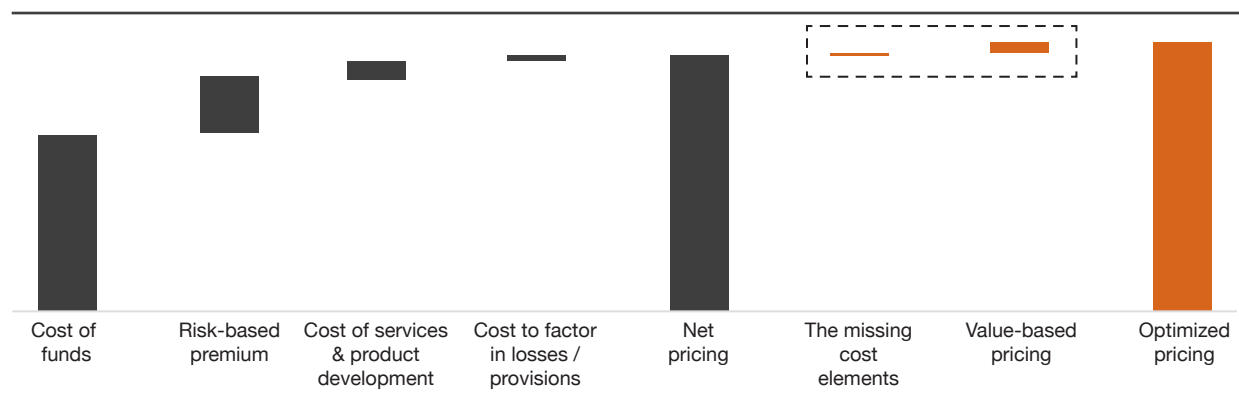
Marketing and communication

Banks' marketing and product management teams should step up communication to make customers aware of the increased benefits of the value-added products.

Pricing innovation in the current market landscape

Pricing strategies have never been as important as in the current context of increasing competition, shifting customer preferences and a fast-approaching market saturation. It is therefore imperative that banks are cognisant of the value their customers are deriving from their products and price them accordingly.

Pricing matrix factoring in right cost of services and value-based considerations optimises net pricing



Banks and financial institutions should start validating their existing cost dynamics to incorporate missing elements in their unit cost economics. This can be followed by the implementation of value-based pricing strategies to effectively realise the upside potential in their bottom line.



PwC's Financial Services practice

What makes our practice distinctive

Integrated global network

With 34,000 industry-dedicated professionals worldwide, PwC has a network that comprises both cross-border and regional teams. This provides us access to global knowledge, and enables us to provide the same to our clients.

Extensive industry experience

PwC's resources have extensive industry experience. We understand the complexities of strategic initiatives and appreciate the underlying objectives. We carefully hand-pick teams for such transformation programmes to ensure the right skills, and their demonstrated and proven capabilities to make your projects a resounding success.

Strategy and implementation

We specialise in designing strategic directions and their long-term implementation, which enable us to deliver results with a focused approach.

Multidisciplinary problem solving

Critical issues that financial services companies face today affect their entire businesses. Addressing these complexities requires both breadth and depth. Our service teams include specialists in strategy, risk management, finance, regulation, and technology, and have the experience to meet these needs. This enables us to provide end-to-end support to our clients.

Our proprietary tools and frameworks

PwC has invested significantly in creating proprietary tools to measure the current state of our clients' capabilities – business and digital. We have customised these tools for various industries, including banking, and they are available to help our clients deploy them.

Notes

About PwC

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 158 countries with over 250,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com.

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