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# PRICING

## THE WHITE KNIGHT FOR WHOLESALE FINANCIAL SERVICES?

By Sumitra Karthikeyan, Pieter van den Berg, and Deepak Goyal

Return on equity in the global wholesale-banking industry dropped from 25 percent in 2006 to 8 percent in 2011. Further, revenue declined by an astonishing 21 percent during that time period,[1] and zero growth is estimated for 2012. In such an environment, in which companies are hitting the saturation point on cost efficiencies, pricing could be the white knight.

All incremental income earned through repricing flows straight to the bottom line. If pricing initiatives are designed well and executed thoughtfully, they require little up-front investment and pose low downside risk. Nonetheless, pricing is a much-overlooked lever, and only a few wholesale banks have attempted major repricing projects.

However, in a sample of U.S. banks that we studied, some institutions achieved spectacular results from their pricing initiatives—a revenue lift of 15 to 25 percent on a run rate basis, net of attrition. In our sample, attrition itself was contained to less than 10 percent and was generally limited to the smallest and least profitable clients.

To be fair, it is easy to see why more financial services (FS) institutions have not yet capitalized on the pricing opportunity. Wholesale FS clients are typically large, sophisticated buyers with tight procurement processes. Because FS institutions seek long-term relationships with their clients, they sometimes focus on getting a higher share of wallet—at the expense of optimal pricing. As a result, pricing seldom reflects what the client can actually afford or is willing to pay. In addition, price wars are common, as competing FS institutions vie for market share. These battles can create a slippery slope on which every incremental share point comes with lower margins.

Although it may be difficult to reprice spread-based products (such as foreign-exchange products), pricing initiatives can bring excellent results in fee-based products—in which the long-term relationship

is the key. FS institutions just need to avoid common pitfalls.

## The Seven Sins of Pricing

In our view, FS institutions often make seven pricing mistakes with their wholesale clients.

**Marginal-Cost Pricing.** FS institutions with high fixed costs focus on incremental revenue to defray those costs. But if the incremental revenue covers only marginal cost, over time FS institutions can accumulate a large number of clients that don't meet margin thresholds. In one bank, we found that 17 percent of clients were unprofitable on a variable basis and about 15 percent were unprofitable on a full-cost basis.

**The Absence of Deliberate Deaveraging.** Wholesale contracts allow individual clients to be priced according to the competitive intensity and bargaining power inherent in the specific relationship. Still, we found that a majority of FS institutions do not robustly segment customers (on the basis, for example, of size, loyalty, or bargaining power). We found several examples in which smaller clients paid lower prices than larger ones. Similarly, we observed practices such as lower prices for "price insensitive" segments and flat fees for growth segments.

**Bundling Gone Awry.** Bundled pricing tends to help FS institutions increase cross selling. But when it is structured poorly, the institution can lose out substantially. The scenario can go like this: the client starts negotiating on a product's price, the FS institution agrees to lower the price if the customer buys an additional product, the customer agrees, and the institution lowers the price of the first product. So far, so good. But what if the customer suddenly stops buying the additional product? The profitable product exits but the subsidized one stays.

**One-Way-Street Volume Discounts.** Similarly, volumes may decline over time while the pricing structure remains the same. Either the original pricing was not "tiered" to volume ranges, or the FS institution doesn't effectively track volume changes. In the sample of banks that we observed, we consistently found almost zero (actual R-squared of 0.01) correlation between price and volume.

**Omitted Charges.** In industries with recurring revenue streams, it is common to see service creep. As much as 50 percent of revenue can be lost as a result of "leakage" (not billing for services rendered) and "slippage" (not charging for certain services appearing in the fee schedule).

**Dated Pricing.** For banks in our sample, we found that almost 20 percent of client contracts were more than 10 years old. Some were even 20 years old. Just on an inflation basis of, for instance, 3 percent per year, the prices could have been doubled in 20 years.

**Adverse Sales Incentives.** In pursuit of market share, sales incentives often reward revenue growth or client retention. In the absence of pricing criteria, such practices can create an adverse incentive to actually lower prices (and therefore margin) to obtain more revenue.

## How to Reprice Effectively

A typical repricing program involves a 3- to 12-month effort consisting of four key steps.

The first step is a rigorous diagnostic. This involves several actions, the first being to segment the client portfolio. The simplest method is to segment clients on the basis of revenue and industry sector, but more-sophisticated methods such as profitability (if robust) or price elasticity can be used as well. Pricing opportunities can then be assessed by comparing prices for similar services or products for clients within the same segment. In addition, product stickiness per segment, fees not charged (including those for customization), the aging of contracts, open versus closed contracts, and billing slippages can be analyzed.

The second step is to design a new pricing strategy. This involves defining standard rate cards that may differ by segment for core products and services. The price levels should reflect, at a minimum, the cost of delivering the services, and they could reflect volume-based discounts.

As the third step, with the aforementioned steps completed, we recommend launching a pilot repricing program with a sample of clients across different segments. On the basis of client reactions, the approach can be modified and optimal price levels set, helping build the expertise and confidence of the client relationship team.

The fourth and final step is to ramp up the program. This escalation is best executed in waves, with two or more segments being repriced simultaneously, and is typically guided by the bandwidth of the client relationship team. As always, strong support and attention from the executive team is critical to success.

Obviously, the leadership and relationship teams of the FS institution have to "believe in the gospel to preach it" when it comes to pricing. But if the clients value the institution's services, they are very likely to accept price increases—provided that the institution truly delivers what it promises.

NOTE
1. *Wholesale & Investment Banking Outlook: Decision Time for Wholesale Banks,* Morgan Stanley, March 2012.

## About the Authors

**Sumitra Karthikeyan** is a principal in the New York office of The Boston Consulting Group. You may contact her by e-mail at karthikeyan.sumitra@bcg.com.

**Pieter van den Berg** is a principal in the firm's New York office. You may contact him by e-mail at vandenberg.pieter@bcg.com.

**Deepak Goyal** is a partner and managing director in BCG's New York office. You may contact him by e-mail at goyal.deepak@bcg.com.

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