

MicroSave Briefing Note # 49

The Art and Science of Pricing Financial Services¹

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Pricing and the Consumer

Participants in focus group discussions frequently raise concerns related to pricing. However, often accessibility and security of the service is more highly regarded particularly in relation to savings products. This is not a surprise when considering the high cost of participation and risk of loss involved in informal financial mechanisms.

Why Are Prices Difficult to Understand?

Consumers typically find it difficult to compare financial services, as they are intangible. Seemingly similar savings accounts can have different fees for deposits, withdrawals, transfers and other features. Loan interest can be charged flat or declining balance, with variable application and monitoring fees.

How to Price: Cost, Competition and Value

Marketing textbooks abound with pricing theories and strategies. Pricing theories include penetration pricing to penetrate a market or loss leaders, to secure lifetime business of the customer (for example a children's savings account) or skim pricing to capture a small market at a high price. Theories aside pricing is in essence very simple, and can be reduced in most cases to three core concepts, cost, competition and value.

Cost: Cost plus pricing, one of the simplest pricing methods adds the desired margin onto the base cost. The base cost can be obtained through product costing. There are two principle methods of product costing the simpler, but more subjective allocation based costing and the more complex but authoritative Activity Based Costing.

Competition: Competition in the context of pricing are the range of prices being charged by competing institutions on similar products and services. It is the most common pricing method within *MicroSave's* Action Research Partners. So for example, when Teba Bank priced its Grow With Us Savings, it compared itself with six competitors on the basis of 23 different fees and charges. This type of analysis can be especially useful when establishing on which services to promote heavily. So for example, Equity Bank in Kenya chose to make their Banker's Cheques significantly cheaper than the market and to use this to strengthen their image in their target market.

Value: The third element of the pricing strategy is to establish whether the product or service has any additional value to the customer that can justify

premium pricing. How is this done? On one level it is quite simple, it involves comparing competing services across the 8 P's of financial marketing – that is, product design, price, process, place, promotion, physical evidence, people and positioning. The competition matrix is completed using mystery shopping, local knowledge of competitors and through focus group discussions with customers.

Transparency

From a customer perspective one of the most important aspects of pricing is the degree of transparency of the products fee structure. As Wright and Rippey note in "The Competitive Environment in Uganda Synthesis"

"The qualitative studies help us understand that clients are more likely to be unable than unwilling to "shop around". It is the transparency or communication of pricing (or rather the lack of it) that prevents clients from differentiating between suppliers."

Transparency can improve business. When Equity Bank in Kenya rationalised their fee structure in 2002 and published a tariff list, the number of new accounts increased dramatically. Various techniques can be used to improve transparency. These include, tariff guides and brochures, schedules of payments, frequently asked question guides and simplification of fee structures.

Key to improving transparency is to ensure staff members know their products and services well, so that they can explain them effectively. This becomes particularly important when explaining pricing on complex products such as contractual savings schemes.

Regulation and Transparency

Regulators often attempt to ensure transparency in pricing through truth in lending laws, or policies that promote the publication of fees and charges, or effective interest rates. Effective interest rate calculations take into account all cash flows around a loan. These include, the initial disbursement of the loan, the repayment instalments and any compulsory deposits, monitoring fees and commissions. Note that even effective interest rate calculations have methodological problems in that they have to compare loans with similar amounts and loan terms. When *MicroSave* compared effective interest rates on micro-leases it found effective interest rates of between 34% and 124%.

Misdirection

Compounding the difficulty of pricing transparently, are the messages given out by staff of financial institutions on the

¹ This Briefing Note is based on a paper of the same name which can be downloaded from the *MicroSave* website www.MicroSave.net.

products of competitors. Often these messages are highly selective. Misdirection appears to be a common practice, examples include:

- Quoting flat rate interest without specifying the basis of calculation to appear cheaper than loans charged on a declining balance.
- Using confusing terminology to describe the basis of calculation.
- Having additional fees and charges and then in promotions choosing to disclose only partial information.

Pricing Savings

People have different motivations to save, for transactions, for precautions and to speculate. Products fees and charges often reflect these motivations. For example:

Transaction motive: Transaction based accounts, like current accounts return small amounts of interest and often have transaction based fees.

Precautionary motive: Contractual savings account paying higher rates of interest than ordinary savings accounts, allowing instant access on payment of a penalty.

Qualitative research throughout East Africa has indicated that low-income people prefer to be charged for the financial services they initiate rather than to be charged a ledger fee.

Transforming MFIs and Pricing Savings

Microfinance institutions that become licensed to accept deposits face multiple challenges. They need to convince customers to trust them. Part of the solution is to portray the right image and to create an appropriate infrastructure, but another challenge is to price their new savings products appropriately. One solution often adopted by Non Bank Finance Companies is to premium price their savings products and offer a higher than normal return for deposits.

Pricing Loans

Many factors should be considered when pricing loans, in addition to cost and competition, for example, differential pricing to price for risk or to reward good customers.

Flat or declining: There can be strong institutional or client preferences for calculating interest rates on a flat or declining balance method. A flat rate is considered transparent and easy to understand because it charges the same amount of interest every period. The declining balance method is usually considered fairer

because it charges interest on the loan amount outstanding.

“Customers in our market have become quite sophisticated and flat rates regardless of the actual rate being charged are perceived as being expensive and unfair.”

Ugandan MFI leader

Pricing for risk: Loans are priced for risk, this means that salary based loans are less expensive than loans secured on the basis of collateral substitutes or cash flow assessments. Some institutions reward regular customers who have repaid loans successfully, either through reduced interest rates, or through the cancellation or reduction of future appraisal or monitoring fees.

Pricing Electronic Banking

Pricing electronic banking products is challenging due to a range of overlapping factors, which include the difficulty in setting realistic assumptions, the absence of benchmark prices and the need to move to a volume rather than a value based pricing model.

Building Capacity to Perform Pricing

Based on the cost, competition, value based pricing method. It is possible to define a core set of competencies required to perform pricing within a financial institution.

To understand costs and the impact of different pricing models:

- Detailed knowledge of the management accounts of the institution and an ability to perform allocation and/or activity based costing.
- Technical knowledge on the calculation of interest rates, and an ability to perform financial modelling.

To understand the pricing charged by competition and to research the perceived value of particular services:

- Skills in qualitative market research, to produce a competition matrix, to research customer preferences on pricing and to ascertain how best to explain prices to customers.

To communicate prices transparently:

- Communication and marketing skills to produce price related communication materials.

These core competencies are unlikely to be found within a single line-function or department. Pricing is therefore, a collaborative effort, largely between finance and marketing, senior management and the Board of Directors.