Tactful Management Research Journal
ISSN :2319-7943
Impact Factor : 2.1632 (UIF)
Vol. 3 | Issue. 5 | Feb 2015
Available online at www.lsrj.in

A STUDY OF CONCEPTUAL ISSUES IN PRICING OF FINANCIAL SERVICES

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Abstract:-Pricing is one of the most important decisions in the marketing of financial services. which is both an art and a science. The art of pricing is in choosing a combination of fees and charges acceptable to customers, which should be fair and transparent. The product which has unique attributes deserves premium pricing. The science of pricing is in ensuring that the product is profitable and is competitive in the market. This paper examines pricing from the customer perspective to examine how important price is as a determinant of customers' choices and why prices of financial services are so difficult for users to understand. The paper reflects the theory with an emphasis on the significance of transparency and mechanisms and policies to improve transparency of pricing. The paper ends with consideration of factors relevant for pricing different types of financial services, including savings, loans and banking products.

Keywords: Market place, Demand Function, Financial Services and Price Change.

INTRODUCTION :

Pricing is one of the most important decisions in the marketing of financial services. Price serves multiple roles for the financial services organization as well as for the individuals who use the services. To the financial services organization, price represents the sole source of revenues. Most activities that an organization undertakes represent costs and an outflow of funds. All of these activities represent an outflow of funds, and the only way to recover these expenditures is through revenues obtained by charging prices for the financial services provided. It is critical not only to appreciate the importance of price, but also to be certain that one's prices are at optimal levels. Pricing too low or too high can have detrimental effects on profitability of financial services organizations. In addition price is the most visible component of the marketing strategy of a financial services organization. The complexity of financial services prices and the cost structure of financial services organizations have a great impact on how financial services pricing is practiced.

COMMON APPROACHES TO PRICING FINANCIAL SERVICES

Pricing the Financial Services is decided in any marketplace where buyers and sellers participate in the trade of assets such as equities, bonds, currencies and derivatives. Financial markets having transparent pricing, basic regulations on trading, costs and fees and market forces require for determining the prices of traded securities. Normally following pricing approaches are prevailed in market.

Cost-Based Pricing

The cost-based approach to pricing is one of the oldest methods of pricing in both financial and non-financial services, as well as in manufactured goods. The motivation behind this approach is that one must cover at least the costs of running a business in order to survive financially. As a result, the cost of providing a financial service is used as the lower bound for prices. Prices are set in such a way that costs are covered and a particular level of profit is secured. This is done by applying a markup to the unit cost of the service. Price is set by this simple formula: Price = Cost × (1 + Markup) the markup reflects the general objectives of the business and the financial risks of providing the service. Higher markups would be associated with higher levels of profits, while lower markups could enable the generation of a larger volume of customer transactions. In addition, the markups that are applied may reflect the company's norms and policies, the type of services it offers, and the risks that are associated with these service offerings. The prices that are arrived at through a cost-based pricing formula may or may not result in a sufficient number of customers in order for the business to break even. It is very important, therefore, to assess the receptiveness of the customer base to a price that is determined using a cost-based approach. Despite these limitations, cost-based pricing is often utilized in many financial services organizations as a primary approach for price determination. This is often the case for financial services that are highly commoditized and standardized in nature. Financial services such as commercial banking, transaction processing services, and insurance are services in which the underlying cost structure is often well established. Therefore, in these services, cost-based pricing may guide the final prices charged to the consumer more so than other approaches to pricing.

Parity Pricing

To conduct parity pricing, one would have to establish the primary competitor. The primary competitor could be the market leader who has the highest market share or the company that has the closest resemblance to one's own service offerings. This approach is appropriate for both price changes in a market in which one is currently active, as well as new financial services introductions into markets where one had never participated before. Once the key competitor has been identified, the price that is charged is then computed by applying a multiplier factor to the competitor's price: Our price = Factor × Key Competitor's Price

The applied factor is determined by the overall marketing strategy of the company. A factor of less than 1.0 represents scenarios in which the key competitor is systematically being undercut. Care must be taken if such an approach is used because price wars might easily result. A factor of greater than 1.0 might be justified by perceived or actual service advantages over the competitor, and a strategy that capitalizes on customers' perceptions of quality associated with higher priced services. Such an approach would be less likely to trigger price wars, although it would most likely not generate the same volume of sales as the use of a factor below 1.0.

Value-Based Pricing

The principle behind value-based pricing is to determine the price based on what customers perceive to be the value of the service. The objective of value-based pricing is to quantify in monetary terms what each of these sources of value is worth to the customer and to utilize this information in order to determine the price to be charged. The price that is charged for a service using the value based approach would have to take into account the base price of the service, which may reflect the average market price or the prices of the most closely comparable services, supplemented by the monetary values associated with the additional features uniquely provided by the company's financial service offering: Price = Base price + dollar value of additional features offered by our service. Value-based pricing encourages one to examine the sources of value in a service offering and to recognize the associated profits through the charged price. In the credit card business, for example, customers might find value in credit card offers that have fraud protection features or provide reward programs that are relevant to the types of purchases they usually make using the credit card. Customers of a commercial bank may find additional value in a bank that has a wide network of ATMs, weekend operating hours, and knowledgeable bank tellers. All of these features translate into opportunities to realize additional profits through higher prices, which customers might be willing to pay due to their own unique needs in the financial service. Regulation-Based Pricing

The final approach to pricing is driven by the forces of legislation and regulation that may govern particular categories of financial services. In certain categories of financial services, regulators may play a significant role in determining prices. The motivation behind many financial services regulations is to ensure that the prices charged to consumers are equitable and that all segments of the population would have access to financial products that are essential to their economic well being. Given this, regulators might mandate price levels, and financial services providers may have very limited input in determining the prices that would be charged. Therefore, the computational effort related to cost-based, parity-based, or value-based pricing may be of limited application in this context because regulators would determine prices or specify the allowable ranges for price. An example would be the sale of flood insurance included in home owner's insurance policies and required by mortgage companies for properties located in flood zones.

Category-Specific Pricing Practices

It is critical for financial services marketers to have a full understanding of the underlying process for pricing these particular types of services. Important categories are-

Pricing Credit Products

Credit products facilitate the lending of funds to a customer. These would include credit cards, home equity lines of credit, home equity loans, automobile loans, home mortgages, and other forms of financing within both consumer and business settings. Credit products have two fundamental characteristics. The first relates to whether the lending activity is collateralized or not. Collateralized lending occurs when an asset possessed by the borrower is used as collateral, such that it could be repossessed by the lender in case of default. Collateralized credit therefore presents the lender with relatively low risk in giving out credit. It is important to note that interest rates are not the only dimension of price in credit transactions. In fact, for many credit services, the price may be charged through additional credit components.

Pricing Savings Products

Savings products involve consumers depositing their money with a financial organization such as a bank or a saving and loan institution. The financial organization ensures the safekeeping of the customer's funds and possibly facilitates additional transactions related to the deposited funds. By depositing funds into a savings account, the customer has in effect passed on the responsibility of keeping the money in a safe place to the bank that now has to keep the funds in a secure location and possess the necessary infrastructure to facilitate the safekeeping and associated financial transactions. The safekeeping aspect of the bank's service allows it to justify charging prices for service. The first approach to pricing savings products is transaction-based: customers are charged fees for the transactions which they undertake. It is important to note that the foundation of the modern system of banking relies on consumers depositing funds into financial instruments such as savings and checking accounts. The minimum account balance provides the bank with the supply of funds that it needs in order to conduct its lending activities.

Pricing Insurance Products

The pricing of insurance is one of the more elaborate forms of pricing in financial services. In order to determine the correct price of an insurance policy, one would have to have an accurate estimate of the probability of the event being insured. These probabilities are often captured in what is referred to as actuarial tables, which report the probability that an event will take place based on a series of predictors. For example, in the life insurance, mortality tables report the probability of an individual dying given the person's age, gender, smoking habits, and other factors that relate to the risk of death. An additional variable, that needs to be taken into account when pricing insurance, is the estimated cost of claims. For example, in term life insurance, the claim amount would be the total amount of life insurance coverage purchased, which is reflected in the face value of the insurance policy. In automobile insurance, one could utilize the average claim costs for the various types of events (e.g., collision, theft, destruction) as a basis of analysis.

Pricing and Microfinance

Microfinance is in transition from a product driven to a more competitive, market led approach. The more customer responsive market led approach is characterized by more competitive markets and a focus on efficiency, product diversification and delivery channel development, each of which have implications for setting and communicating prices.

The pricing approaches discussed above are often used in combination. The task of determining the final price may involve managerial judgment as to which of the estimated prices should weigh more heavily in determining the price charged for a financial service. Alternatively, in a market where customers might value the unique features of a financial service, value-based pricing might be most relevant. The ultimate price might take one of these computed prices more into account than the others, or it may reflect an average of these prices.

STRATEGIC CONSIDERATIONS IN PRICING

In determining the price of a financial service, several strategic and tactical issues need to be taken into consideration. The long-term strategic framework of the service, as well as short-term profit and customer acquisition tactics that may be required can influence the final determination of price. Some of these considerations will be discussed below.

The Demand Function

The most important consideration in setting prices in any market is the shape of the demand function. The demand function shows the relationship that might exist between price and sales volume. A financial services marketer responsible for setting prices needs to have an approximate estimate of what the impact of a price change would be on sales volume. This estimate is often based on managerial judgment but may also be validated by formal market research techniques and test marketing. This numeric exercise is essential because profit maximization is only possible if an accurate assessment is made of the financial effects of such price changes.

Price Complexity

An additional tactical pricing concern is that financial services prices are basically complex and multidimensional. As a result, consumers may have a difficult time determining what the exact price is that they are paying. For example, credit card companies charge customers interest, for balances carried over from one month to the next. However, they can also realize revenues by charging transaction fees, late payment penalties, fees on ATM cash withdrawals, and other forms of non-interest charges. While the customer may pay attention primarily to the interest rate associated with the credit card, the remaining dimensions of the credit card might have a much greater financial impact on the customer as well as the credit card company's profits.

Promotional Pricing

Many financial services organizations provide promotions find their way in the pricing of their services. a promotional offer may entice customers to sign for life insurance, and the insurance company would hope that some of these consumers would choose to continue their coverage by paying for the life insurance coverage following the free trial period. Several advantages can be associated with promotional pricing. Promotional pricing generates a sense of connection and excitement about financial services which may otherwise be considered dry and boring by customers. This would require that the financial services organization conduct the necessary market research and segmentation studies in order to establish which promotional offers should be extended to which customers.

Challenges in Pricing Financial Services

Financial services prices are unique in several ways. The unique aspects of price in financial services are important to recognize when developing marketing strategies and analyzing consumers' decision dynamics. Some of these unique aspects are listed below:

Multi-Dimensional nature of Financial Services: One of the most notable characteristics of financial services prices is that they are complex and often consist of multiple numeric attributes. For example, an automobile lease is often communicated in terms of the combination of a monthly payment, number of payments, a down payment, the final balloon payment, wear-and-tear penalties, and mileage charges for driving over the allowed number of miles. Therefore, unlike the sticker price for the cash purchase of a car, which is a single number, the lease price consists of many different numbers.

Elusive Measures of Quality: A second challenge in the pricing of financial services is the elusive and intangible nature of the quality of a financial service. In contrast to manufactured goods, which can be scientifically tested in laboratories and are often rated by well-established third party organizations such as Consumer Reports.The quality of financial services is far more difficult to determine. Objective levels of service quality as determined for example by the likelihood that a mutual fund will have good returns, the transaction processing accuracy and efficiency of a commercial bank, and the ability of a tax accountant to secure the highest possible tax returns, are difficult to assess.

Economic Forces: The pricing of financial services is further complicated by the fact that the attractiveness of a financial service may be affected by the general economic environment. For example, in order to appreciate the value of an investment option a consumer must compare the expected rate of return with the rates of return experienced in the financial markets. A change in the prime lending rate might make an investment option look more or less attractive to the consumer. As a result, financial services providers need to take relevant economic indicators such as interest rates and stock market returns into account when setting prices for specific financial products and services.

Poor Consumer Price Knowledge: The pricing of financial services needs to take into account the fact that consumer memory for financial services prices is quite weak. The unexciting and complicated nature of financial services often results in poor recall of the prices of financial services. For example, many consumers have a difficult time remembering the cost of their banking services, such as the monthly maintenance fees for checking account services and ATM transaction charges, or what yearly premiums they are paying for their automobile insurance. As a result, the general level of price knowledge with which consumers interact with financial services providers might be quite limited.

Difficulty in Determining Customer Profitability: An additional challenge presented in the pricing of financial services is that the profitability associated with a given customer may be difficult to assess. This is because a single customer may purchase multiple services from a financial services provider, some of which are highly profitable and others that represent losses. Therefore, while certain transactions with this customer may be perceived to be unprofitable. Other transactions may compensate for this shortfall making the individual a highly valuable customer to the bank overall.

Conflicts of Interest: The pricing of financial services is further complicated by the significant conflicts of interest that may exist in the selling process. For example, brokers may use different components of price, such as trading fees or commissions earned on the sale of specific financial products, as the means for their earnings. Therefore, the link between price and the incentive mechanism used to compensate the broker might influence the types of products that the broker would be inclined to recommend to the client.

CONCLUSION

Pricing a financial service is both an art and a science. The art of pricing is in choosing a combination of fees and a charge acceptable to a customer that are fair and transparent, and if the product has any unique attributes that deserve premium pricing. The science of pricing is in ensuring that the product is profitable and is competitive in the market, that each product returns a profit. To determine product pricing is simple, firstly, establish cost, secondly examine the fees charged by the competition and finally determine whether the product or service has sufficient customer value to deserve a premium price. In practice, pricing is complex, customers and institutions alike find it difficult to track prices regularly and to understand the nuances of pricing calculations. There is a role for regulators in promoting transparency.

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