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From Classical Pricing Theory to Behavioural Pricing

Behavioural pricing analyzes how consumers gather and process cost-benefit information. This allows the cognitive processes, which play an important role in reality and deviate from classical price theory with its utility-optimizing homo oeconomicus, to be observed. Knowledge on the perception process – from consciousness and perception to evaluation – can be useful to financial services providers in many aspects of optimizing their cost-benefit ratio. A methodological approach in five steps is recommended.

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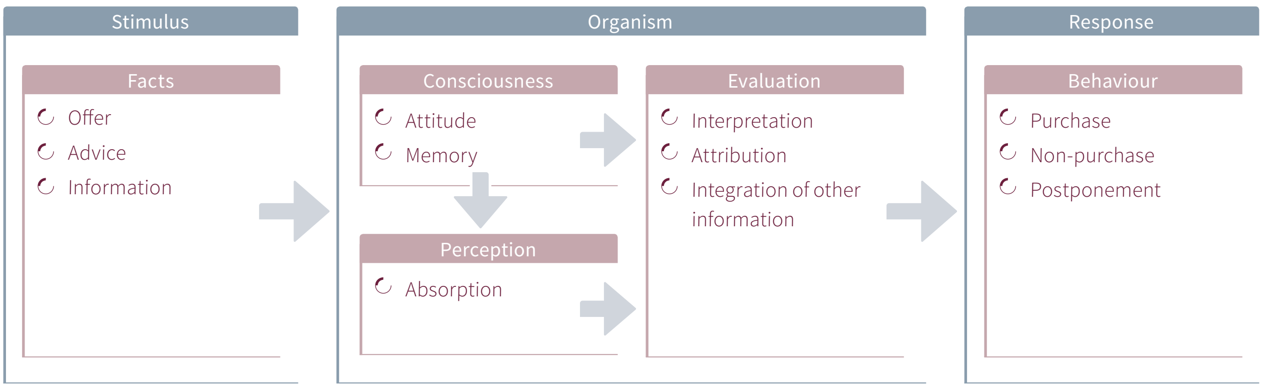
Classical pricing theory assumes that customers behave rationally and have access to complete information regarding cost-benefit ratio. Within this theoretical behavioural environment, customers aspire to optimize their benefit. With a given income they will demand as many units of a product until the benefit of an additional unit is equal to its price.

On today's markets – in particular for financial services – complete cost-benefit transparency certainly does not prevail. For many products it is almost impossible for customers to measure benefit in economic terms. Insurance products with their typically uncertain occurrence of benefits are a good example of this. Additionally, customers seldom act rationally. Classical pricing theory is therefore missing an element, namely the cognitive process of the cost-benefit perception and evaluation. This is the subject-matter of behavioural pricing (1).

Behavioural pricing assumes that consumers receive an objective stimulus, which leads to a subjective evaluation (organism), which then provokes individual behaviour (response).

Approaches for pricing in the financial industry

How can financial services providers such as insurance companies and banks take advantage of behavioural pricing? We can see numerous approaches, which cover the entire product spectrum.



Source: Synpulse, following Martin Wricke

1: Cognitive process of handling an offering

Product identification: financial products are often low-interest products; customers do not generally analyze the product in detail. Thus the following conclusion can be made: the smaller the interest in the product, the more summarized the cost-benefit offer can be. This is also called stimulus simplification. Although this insight is not new, only a handful of financial services providers package their products so that they are suitable both for low-interest customers and for those interested in the product. Depending on the customer type, which can quickly be assessed with a few entry questions, customers should receive differently packaged offerings, such as an all-in-one proposal, a proposal with few options or an offering with complete freedom. With the various approaches for «productizing», it is possible to work with varying margins.

Conclusion: you have at hand simple standard packages for low-interest customers. If your distribution channel is strong in advisory services, you should also offer sophisticated configuration options for interested customers.

Reference point: each customer, independent of whether he or she knows the product or not, has a reference price which is used to evaluate a new offer. This reference price can be assessed in the sales process if, before tendering an offer, the customer is systematically asked which information he or she has already obtained. This allows an offer to be adjusted to the reference point whereby a tolerance of ±15% is typically acceptable.

Conclusion: make sure your first offer is adjusted according to the reference point of your customer. You get a buy-in and then you can begin upselling.

Discount policy: if a client has to decide on every single component, each decision corresponds to a loss of opportunity. This can be compensated by giving a discount on each component. Compared to a large discount on the whole package, individual discounts are seen as individual negotiation achievements; the perceived price or in this case discount is valued more than an overall discount.

Conclusion: if you have to give discounts, divide the offering into parts, give a discount on each part and ensure that the customer perceives this positively.

Price sensitivity: price sensitivity increases with standardized and comparable products. To influence perception of a cost-benefit structure, two strategies can be applied. To emphasize benefit a top-down approach should be chosen, whereby a comprehensive package should first be offered. Certain options can then be dropped to do justice to price expectations; perception of the services offered remains good. If, on the other hand, the low price of the offer should be emphasized, the bottom-up approach is applied. Here a lowprice cost-benefit package is offered and then further options added. The customer still tends to perceive the offer as favourable. A practical example of implementation is the offer «Name Your Price®» from Progressive. Here the customer is asked to first name the price he or she would be willing to pay for insurance cover. Appropriate offers are only made afterwards. These also include offers, which are above the price limit in order to make additional service options appealing.

Conclusion: consider whether the aspect price or service should be emphasized for each distribution channel and select the top-down or bottom-up sales approach accordingly.

Stimulus threshold: customers have a price stimulus threshold independent of the actual offer. For example, if the price is slightly over the threshold (e. g. CHF 1‘001) it is perceived as being significantly more expensive than if it were slightly under the threshold (e. g. CHF 999). This effect of price rounding has been applied to consumer goods for a long time. However, it receives little attention in the financial services industry. The effect can be increased if offers are divided into units. To stay with the example given earlier: a monthly premium of CHF 84.95 is perceived as more attractive than a yearly premium of CHF 999, even though the total is higher.

This is because many consumers multiply and compare with the factor ten because it is simpler. Conclusion: even if it is unusual for certain industries and products, take monthly payments into consideration.

Method

Synpulse has developed a proprietary method specifically for the implementation of behavioural pricing in the insurance and banking industries (2).

The method is based on five sequential steps, which run through the concept, design and realization phases. Appropriate tools and reference data can support the method where necessary.

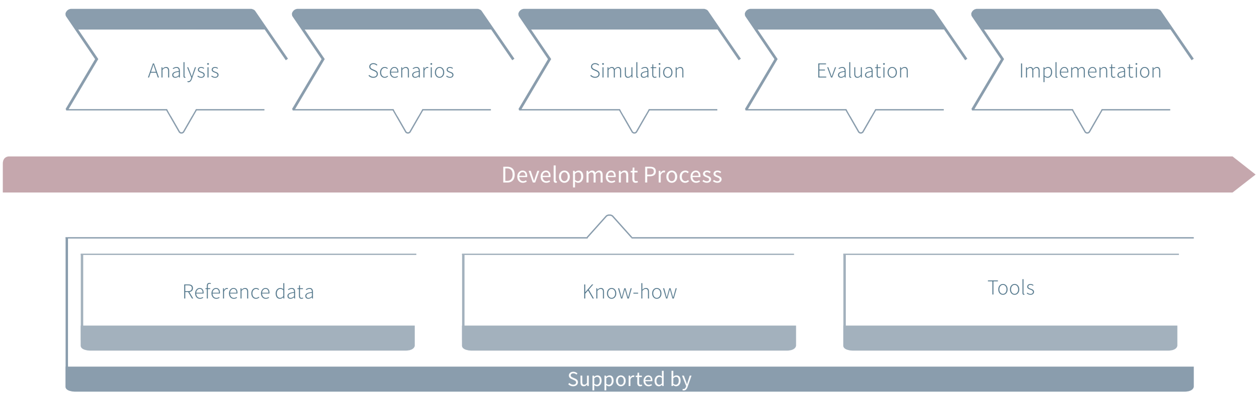
Step 1: in a first analytical step the pricing strategy must be analyzed and defined. Based on internal skills (resource-based view) and the external development of the market and competition (marketbased view) questions concerning positioning are answered. On this basis, implementation measures such as those discussed above are defined.

Step 2: the measures developed in the first step are now outlined and substantiated in different scenarios by using model customers. The aim of these outlines is to find combinations which produce an increase in benefit with simultaneous price fairness in the customer's perception.

Step 3: once the scenarios have been made plausible, they are simulated. The aim of the simulation is to gauge the expected changes in the earnings situation. Model customers are used in the concept phase. In the design phase, the simulation can be carried out with the appropriate tools for the entire customer base. This allows reliable calculation and a substantiated statement on the aspects of the suggested product modification.

Step 4: the simulation results are evaluated again in terms of whether they match the strategic alignment of the company and the chosen direction of growth. If there is a change in the product offering, accompanying measures could be necessary.

Step 5: the last step is only carried out in the design and implementation phase. With pricing and distribution processes adjusted where applicable, the agreed product modifications are implemented. Often an accompanying communications initiative is launched.



Source: Synpulse

2: Behavioural pricing introduction method