

Pricing and Elasticity in Financial Institutions

What happens when pricing changes?

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SUMMARY

The financial services industry employs several methods of making pricing decisions on its products and services. While there is not an agreed-upon industry best practice for how products and services are priced, pricing inefficiencies cause a detrimental effect on income. Furthermore, various regulations in the industry significantly impact pricing strategy and must be taken into consideration.

INTRODUCTION TO PRICING

“The single most important decision in evaluating a business is pricing power,” Warren Buffet, CEO Berkshire Hathaway¹. “If you’ve got the power to raise prices without losing business to a competitor, you’ve got a very good business. And if you have to have a prayer session before raising the price by 10%, then you’ve got a terrible business.”

The above statement is true regardless of the industry, which is why it is often quoted. The financial services industry, specifically banks and credit unions, have struggled over the last several decades with pricing. As the industry grew more competitive, giving everything away became commonplace. This “strategy” worked during times of higher interest rates and less regulation around fee income, which is why new banks opened at a rate of over 100 institutions per year from 2000 to 2007².

However, the landscape is different for financial institutions post-2008. Today, there are fewer institutions and a small number of new banks opening³. With lower-than-average interest rates persisting for more than a decade and tighter regulations around many of the fees that financial institutions grew to depend on, the environment is more challenging than ever. Also, new competitors such as fintech players are putting additional pressure on consumer demand.

Over the last few years, a favorable shift in the financial services environment has occurred. With steadily rising interest rates, a booming economy and successful efforts in regulatory relief for the industry, financial institution profitability and stock prices have soared. Consequently, a focused and communicable pricing strategy is important. As

industry revenues rise, pricing inefficiencies have a bigger financial impact on unprepared institutions. Even in a favorable market, a critical part of any pricing strategy looks at how consumer behavior changes based on pricing variations – also known as the price elasticity of demand.

PRICING STRATEGIES

Pricing is critical and frequently not well understood. Warren Buffet states, “Price is what you pay. Value is what you get.” Many financial institutions do not have a specific pricing strategy, and pricing decisions are often handled as a guessing game. At best, financial institutions review the market occasionally and price with the competition, which establishes a reactive rather than a proactive strategy. Each financial institution faces a different cost structure and a different set of objectives that influence pricing decisions. For example, the risk profile of one financial institution is very different from another, with different strengths and weaknesses, which of course impacts pricing. Pricing should also be factored into long-term strategy and the overall goals of the institution. What follows are brief overviews of some common pricing strategies.

Product-Based Pricing

The most common and basic pricing strategy is to differentiate products based on price. If a similar product costs more than another, there needs to be a compelling reason for consumers to consider the more expensive product. This is where financial institutions often fall short, in creating perceived value.

Many times the only difference in a cheap/free checking account and a more expensive account is one pays interest and the other does not. With interest rates so low for so long, there is minimal

perceived value in the more expensive account. In a recent study by Deloitte, accounts paying interest only affected consumer choice by 12%⁴. As noted above, financial institutions must create a value proposition if they use price as a differentiator.

Risk-Based Pricing

Risk-based pricing is commonly used in the lending function. In its most basic form, a borrower with a lower credit score is deemed a higher risk than one with a higher score, so the borrower is offered a higher interest rate to compensate for the additional risk.

As financial institutions advance their pricing and product mix, risk-based pricing progresses onto the deposit side of the balance sheet. If a prospective customer is considered a higher risk, products such as second chance checking offer a way for the financial institution to still profitably do business with this prospective customer, even though he or she poses a higher risk.

Relationship-Based Pricing

The general proposition of a relationship pricing model is giving pricing discounts when a high-volume or highly profitable customer opens a new account. Inversely, this strategy often requires pricing premiums for low-volume or unprofitable customers opening a new account. This type of pricing is tricky, however, as it is possible to lose out on new business due to the higher pricing premiums. Another risk is that discounts to current consumers get excessive, causing the profitability of a valuable customer to erode.

REGULATORY IMPACT ON PRICING

Nothing has a bigger impact on pricing strategies in the financial services industry than the alphabet soup of various regulatory agencies. The CFPB, NCUA, FDIC, etc., limit many areas where financial institutions earn revenue. While this paper is not intended as a regulatory discussion, pricing cannot be mentioned without recognizing the regulatory gorilla in the room.

Between the CARD Act of 2009, the Consumer Financial Protection Act of 2010 (Dodd-Frank) and the changes to Regulation E in 2010, the entire industry was burdened with new regulations that dramatically reduced revenue. These three regulations materially changed the way financial institutions earned revenue and impacted the pricing of certain services. Financial institutions are still dealing with the ramifications from these regulations today.

NSF and Regulation E

As part of Dodd-Frank, Congress transferred the regulatory burden of Regulation E to the Consumer Financial Protection Bureau (CFPB). During 2010 and 2011, the CFPB changed how Regulation E transactions are assessed overdraft fees. Consumers cannot be charged overdraft fees on one-time/ everyday ATM or debit card transactions if the consumer did not affirmatively consent (opt-in) to participate in the overdraft program.

In 2011, other recommendations were made to the financial services industry to further protect consumers. De minimis limits and daily fee caps were recommended and subsequently adopted by most financial institutions in order to avoid any compliance concerns. All told, these revisions to how financial institutions process and collect fee income on overdrafts dramatically reduced revenue across the industry.

Durbin Amendment

Also a part of Dodd-Frank, the Durbin Amendment drastically impacted debit card interchange income, one of the primary non-interest revenue streams for financial institutions. The amendment capped interchange fees for debit purchases for institutions with more than \$10 billion in assets. The cap, which took effect on October 11, 2011, cut the average interchange fee for covered banks from \$0.50 per transaction to \$0.24 per transaction. According to a paper published by the George Mason Economics department, this decreased interchange revenue for affected institutions as much as \$6-\$8 billion per year⁵.

CARD Act

One of the most sweeping reforms in the financial services industry in recent years is the CARD (Credit Card Accountability Responsibility and Disclosure) Act of 2009. This regulation was passed to protect consumers in the extension of credit under an open-ended revolving credit plan. It effectively did away with practices such as double cycle billing, universal default and other revenue-generating tactics.

The CFPB was given control over late fees, limiting them to a maximum of either the payment amount, or the annually reviewed fee level allowed. Additionally, many modifications to interest rate structure on credit cards were made. Even with this additional regulation, the industry still considers credit cards a valuable line of business, and the market remains extremely competitive for these accounts, despite regulation changes significantly reducing revenue.

Regulatory Impact to Pricing Other Services

As previously described, regulations dramatically impacted the industry's profitability, which is why over the last ten years the industry has adjusted pricing in other areas to help offset the costs of these regulations. The leading trend is discontinuing "free checking" products. Without the revenue generated by services such as debit cards and overdrafts, free checking is a highly unprofitable product, especially for larger institutions⁶.

Other impacts of regulatory costs are consistently rising fees for other products and services, and an overall more expensive experience for the consumer. For example, unprofitable services like notarizations, which were once free, are now associated with fees. Financial institutions are also trying to offset costs by migrating consumers away from paper statements and assessing fees if they refuse to adopt electronic statements.

WHAT IS PRICE ELASTICITY?

Economics Refresher

The law of demand states that when the price of a good or service rises, consumers tend to buy less of it; conversely, when the price of a good or service

falls, consumers tend to buy more of it. However, the law of demand does not tell how much more, or less, consumers tend to buy. For some goods, the quantity demanded changes considerably when the price changes; for others, the impact is negligible.

This is where the price elasticity of demand is relevant. It is a measure of how sensitive, or responsive, consumers are to a change in price. For any good or service, the price elasticity of demand measures how much the quantity demanded by consumers responds to a change in the price of that good or service. The real question then becomes, "Do products and services in the financial services industry have elastic or inelastic demand?"

Financial Services Industry

When looking at any industry, variables that affect demand must be taken into account. This is especially true in the financial services industry. Due to rapid changes experienced over the last 10 years and competition from outside the industry, consumer behavior has been impacted.

As alternatives to banking (especially payment options) come to market, demand for certain products and services change, regardless of the price. A great example of this is safe deposit boxes; price has little to do with the falling demand that financial institutions see for this service. The market has changed, and many of the important documents that people kept in a safe deposit boxes are now digital. Increasing or decreasing the price of safe deposit boxes minimally impacts this product's future demand.

FINANCIAL SERVICE FEES: ELASTIC OR INELASTIC?

There is a surprising dearth of information related to fee and service charge pricing research in the financial services industry. It seems financial institutions pay close attention to pricing elasticity around interest rates, as they should, but there is little, if any, attention paid to elasticity of the fee and service charges that make up a large percentage of a financial institution's non-interest income.

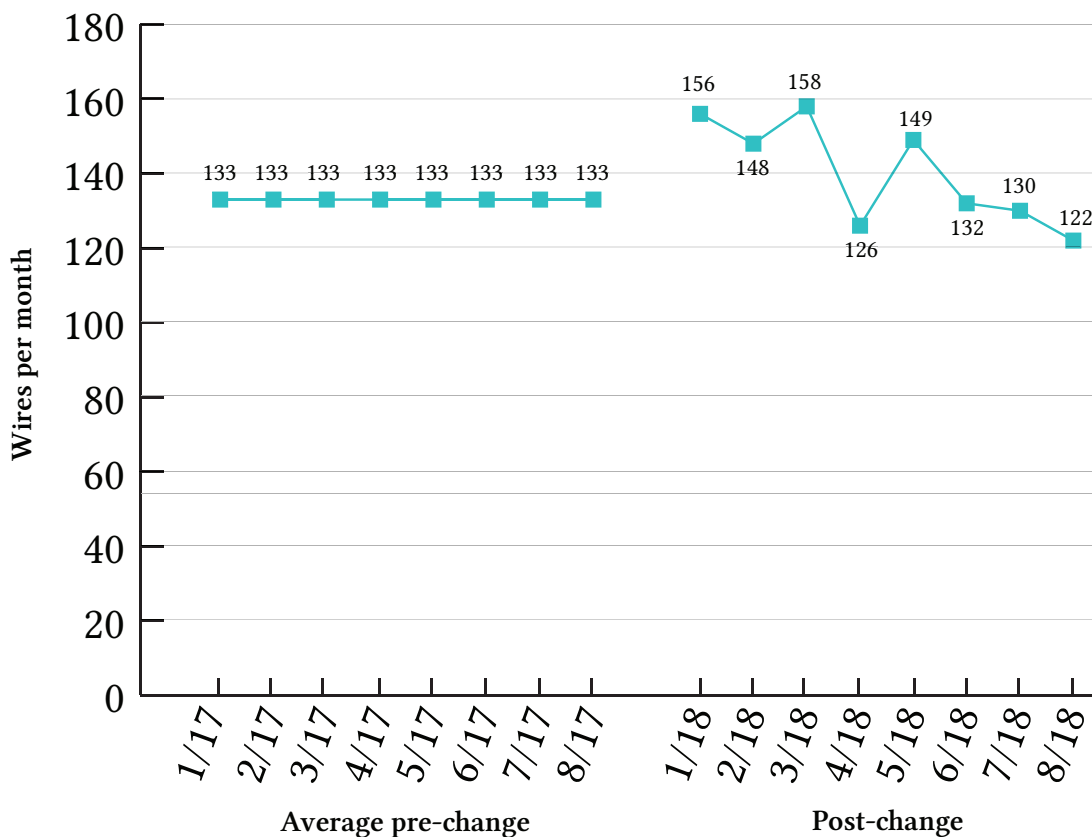
The following case studies review detailed fee and service charge alterations that took place at multiple community-sized financial institutions (under \$10 billion in assets) over the last several years. Detailed transaction data is compiled from before the changes were implemented and after they took effect. This allowed the following analysis to be done around elasticity of specific fees at the institutions. Institutions selected have disparate geographic locations and customer bases, as well as types of fee changes. The nature of this research required a limited sample size to keep the results manageable.

Case Study 1 – Wire Transfer Fees

Wire transfer fees are one of the most ubiquitous fees assessed by financial institutions. Because there is quite a bit of time and effort that goes into sending a wire for a customer, most institutions assess a fee for this service. Since it is so prevalent, this fee makes an appropriate subject for review in an analysis on elasticity. With the rise of the fintech industry,

third-party payment platforms and same-day ACH services, there are a number of alternatives to sending a wire these days. Given this environment, if financial institutions raise the cost of sending a wire, how will that affect the demand for this service? In this analysis, the financial institution made a substantial change to its international wire fee, doubling the fee from \$20 to \$40. Throughout the industry, this fee increased dramatically over the last few years due to Dodd-Frank changing how costs are disclosed to consumers. While costs are increasing for this product, most of the alternatives listed above work for sending funds in the U.S., but are not capable of sending same day funds overseas. The lack of alternative options is why the average demand over a six-month tracking period is fairly consistent pre- and post-change. As seen in the chart below, average volume post-change of 140 wires per month is very close to the original annualized monthly baseline of 133 wires per month.

FIGURE 1: INTERNATIONAL WIRE FEE



While the average over the time period is similar before and after the change, demand does appear to be dropping over time. It is possible since the fee increase was so large (100%) that users of the service found alternative methods of sending funds overseas. Another cause is that consumers are willing to send funds in a less rapid method due to the higher cost. Elasticity of demand for this service is higher than many bank services, since there are alternatives available with a similar cost. In the long term, the demand for this service will continue to drop as consumers migrate to alternatives.

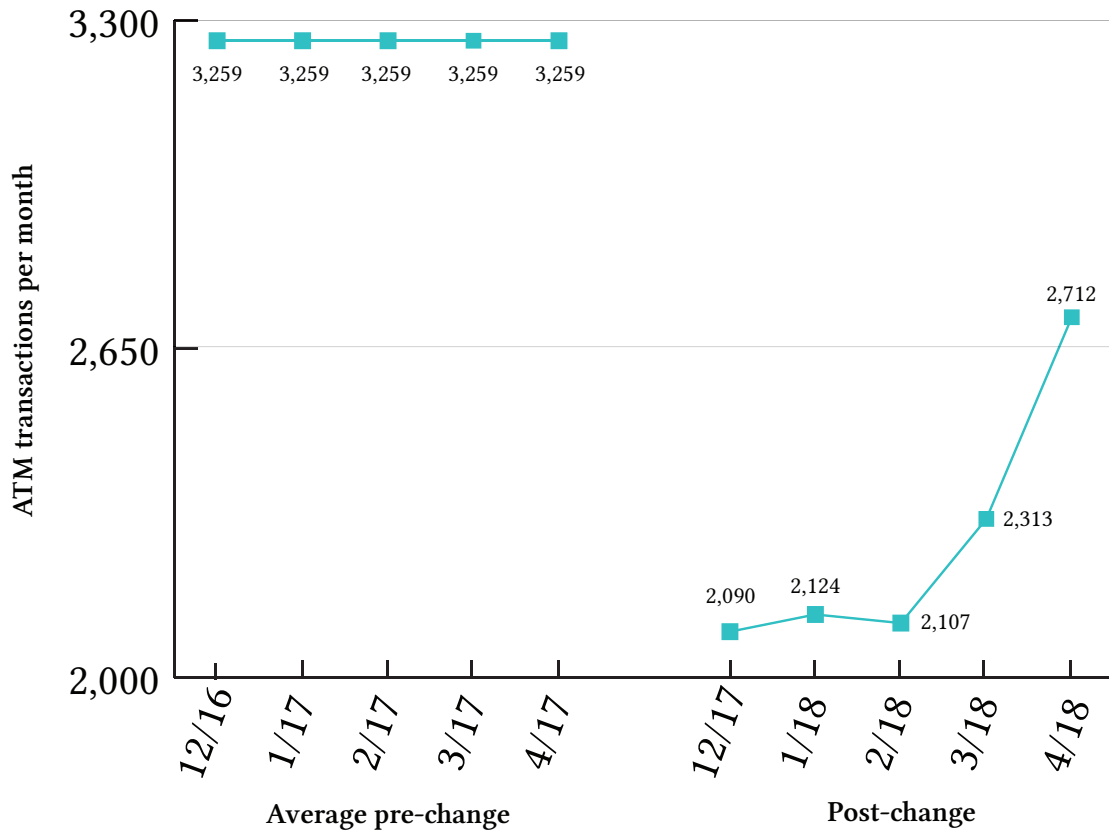
Case Study 2 – ATM Surcharges

Another fee prevalent throughout the financial services industry is the ATM surcharge, a fee assessed for using an ATM that does not belong to the customer’s financial institution. A substantial amount of industry research shows that while ATM usage is stable or even falling in some mature markets, most continue to see an increase. In the

U.S., for example, where an increase in surcharges contributed to a decline in withdrawal volumes over a number of years, transaction levels actually rose slightly in 2015. Since ATM networks are expensive to build out and maintain, it is not surprising that financial institutions attempt to recoup some of those costs from users.

While ATM networks are expensive, they are also quite prevalent in the majority of markets, so alternatives to ATMs are readily available. Therefore, this fee has a high degree of elasticity if the fee goes above what is common in the local market. The financial institution in this analysis had an ATM surcharge that was significantly below market, at \$1.50. The market average was \$3.00, and the financial institution decided to raise the ATM surcharge to \$2.50, a 66.7% increase. As seen in the chart below, the change in the surcharge had a temporary impact on transactions.

FIGURE 2: ATM SURCHARGE



The financial institution's transactions dropped from the average of 3,259 per month to an average of 2,269 per month during a five-month tracking period – a 30% reduction in volume. The drop was dramatic immediately after the fee increase, as users searched for alternatives. However, demand eventually began to return to previous levels, as consumers realized the institution was still priced below market.

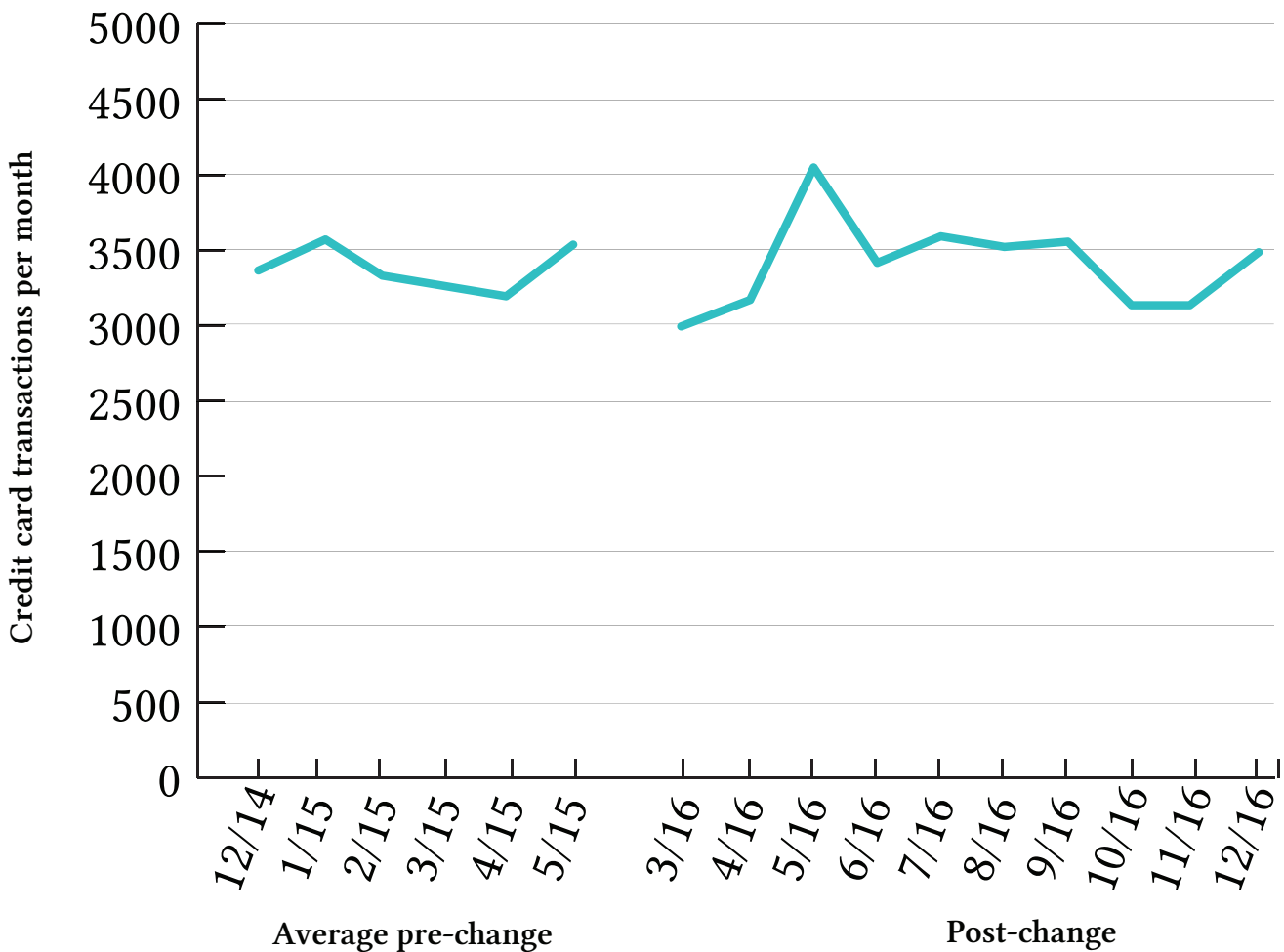
Case Study 3 – Credit Card Late Fee

Credit card late fees are a common fee that many consumers encounter in the management of their financial lives. They are also highly regulated fees, with limitations placed on them by the CFPB. Current credit card late fee limitations for 2019 are \$28 for an initial late payment and \$39 for subsequent late payments in a six-month period.

Due to the high degree of regulation around this particular fee, it is interesting how many institutions do not consider it a competitive issue, but instead just follow the regulations as to what they are allowed to charge. That said, late fees on credit cards are a sizable generator of fee income and cannot be ignored.

This particular fee was reviewed due to the large data set provided by the financial institution. The original data was six months of late payment fees assessed. Fairly substantial adjustments of \$5 and \$10 to the fee amounts were implemented, and the results tracked for ten months. As demonstrated in the chart below, new annualized fee volumes were 98% of the original annualized volumes, post implementation.

FIGURE 3: CREDIT CARD LATE FEE VOLUME



This trend is a perfect example of a highly inelastic fee. There were large changes to the fee structure, increasing the cost to consumers by 20% on average, but the volume of transactions remained flat over the monitoring period. This is also an area where it is not possible to price the fee out of the market, since the upper range of the fee is controlled by the CFPB.

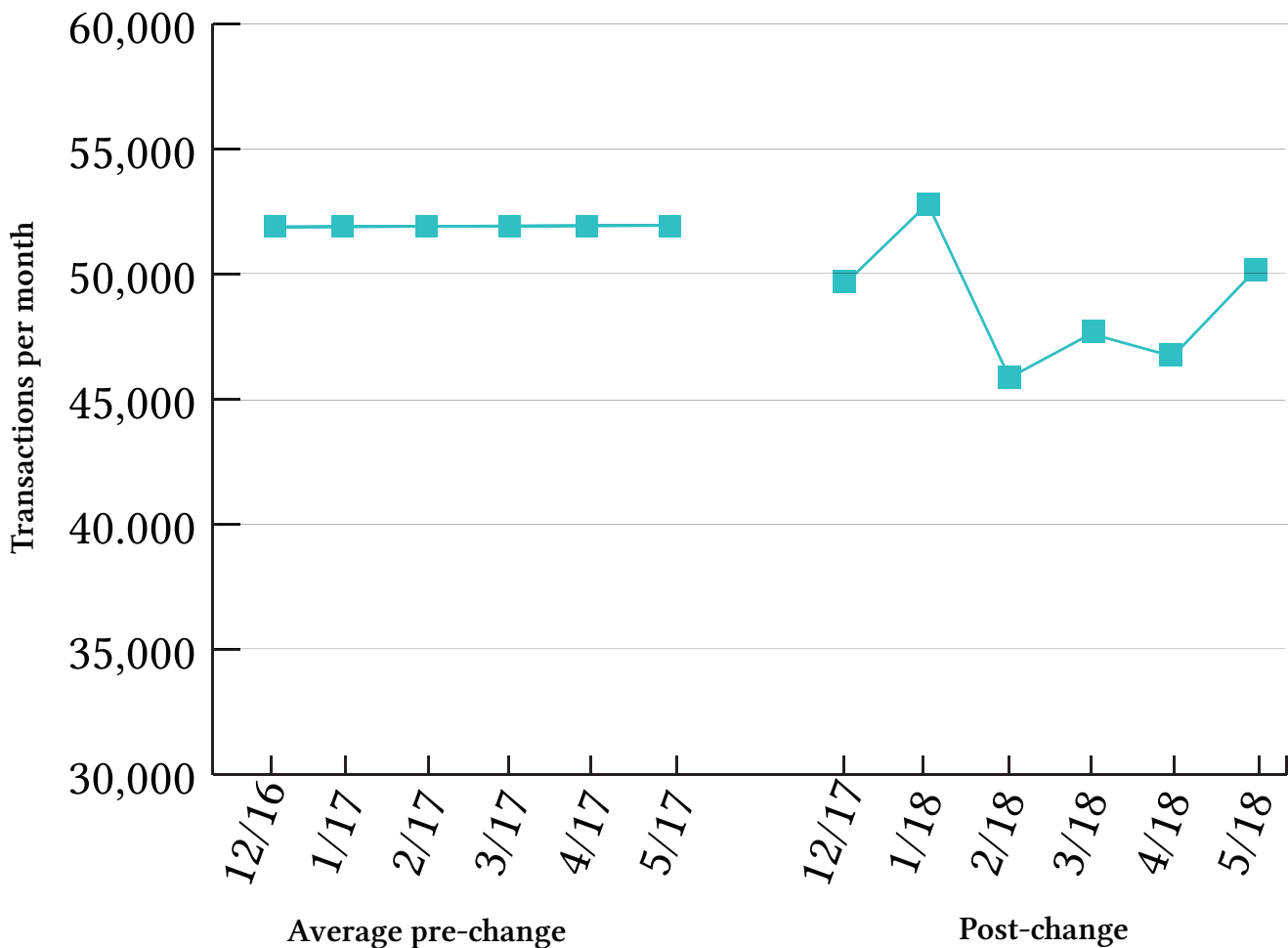
Case Study 4 – NSF Fees

Non-sufficient funds (NSF) and overdraft fees continue to be a significant percentage of financial institutions’ non-interest revenue. Changes to Regulation E in 2010 dramatically changed how financial institutions managed these fees, and industry revenue from NSF/OD dropped due to new regulations. NSF fees are still a hot-button topic with regulators, but there are not currently any regulations in place to cap or limit this fee. While

most financial institutions are cautious in this area, the fee has continued to increase over the last few years, partially to offset the changes to regulations that hurt income.

For this analysis, detailed data was used due to a longer period of tracking available than most of the data sets. The initial data included a blend of income and transactional data for the year, so it had to be averaged monthly to do a comparison. This financial institution also made some very large changes to the fee structure of the NSF/OD fee, with the average fee increasing by about 33%. The baseline for transactions before the fee changes on an annualized basis was 620,484, or 51,707 per month. Transaction volumes post-fee change were tracked for six months due to the high variability in the month-to-month volumes, as seen below.

FIGURE 4: NSF/OD VOLUMES



While there is a good deal of variability in the monthly transaction data, comparing the average volumes before and after the changes reveal that the financial institution experienced a drop in transaction volume of about 7.5% over the six-month period. Compared to the 33% fee increase, there does not appear to be a high degree of elasticity in NSF/OD fees for this institution.

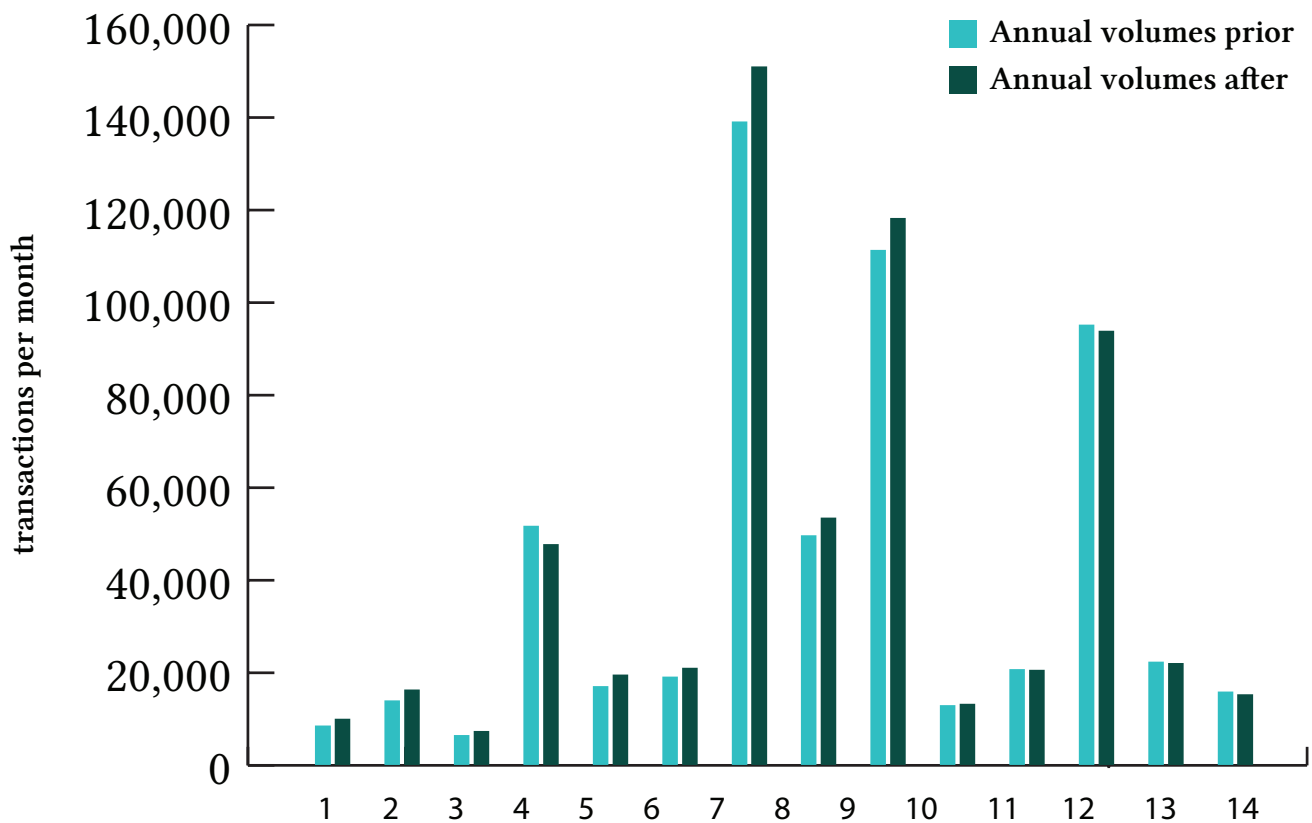
Macro Data – NSF/OD Fees

This analysis takes a broader look at NSF/OD fees, due to the high industry scrutiny they receive. Taking a detailed look at data from 14 banks and credit unions that increased these fees in the last several years, only four showed potential decline in transaction counts for this fee, with the highest drop of 7.5% discussed above. Overall, the 14 financial institutions averaged fee increases of almost 11%,

while also increasing average volume of transactions by more than 6%.

The data around these fees has some variability, as most institutions only provided data for several months before and after the fee change. NSF/OD volume varies significantly from month to month, as shown in the above analysis, and annual volumes were not available for most institutions. While the analysis does not suggest that increasing the fee increases the volume, it is obvious that the fee increases are not causing volume to go down, as they would if there was strong elasticity of demand. Once adjustments are made for average deposit growth of 5-7% – which according to S&P Global⁷ was the average annual deposit growth for community banks in 2018 – the average NSF/OD transaction volumes are flat after the fee increases.

FIGURE 5: NSF FEE VOLUMES: SIX CREDIT UNIONS AND EIGHT BANKS



CONCLUSION

Pricing significantly impacts profitability. Unlike other areas such as growing market share or reducing operating costs, changes to pricing directly impacts the bottom line. The reality is that price optimization creates more value than a financial institution expects from overall reduction in variable costs or fixed costs, or an increase in volume. According to PwC, changing price by 1% impacts profitability more than increasing volume (growth) or reducing costs (efficiency) by a similar amount⁸.

Since pricing is vital to profitability, it is critical to have an understanding of which products' and services' demands are closely related to price. Through many analyses, it is apparent that price is always going to be a critical factor in a consumer's buying decision. But as long as financial institutions are fairly priced when compared to the market, small changes to pricing have a negligible impact on demand, while providing a considerable impact to profitability.

ABOUT THE AUTHOR

Matthew Speed has more than 16 years of experience encompassing virtually every aspect of banking, with particular expertise in the areas of retail banking, commercial banking, capital markets and wealth management activities. As a Vice President for the Consulting Services Group at Ceto and Associates, he focuses on increasing profitability for banks and credit unions through identifying revenue gaps.

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