

Differentiated Pricing In Segmented Markets

Decentralized Pricing Strategies for Profitability

By Thomas J. Parliment, Ph. D.

Centralize this, centralize that.

Combine, control, economize, and generate efficiencies of scale. Big, bigger, biggest.

Hearken, holding companies. Replace those expensive bank presidents with cheaper branch managers. After all, what to underwrite anymore?

Phooey!

Retail banking strategies that are uniform across markets do not yield the most profitable results. Whether you are a holding company addressing its member banks or one institution addressing its branch network, differentiated pricing of products and services via segmented markets is the way to maximize profitability.

Cost savings are realized by the trend to centralize bank operations. The economies generated by combining bank operations is a primary consideration that fuels the frenzy of mergers and acquisitions. My gosh, almost the first declaration that you hear along with the announcement of a bank merger is how many thousand layoffs will be made.

However, the benefits of centralization do not-extend to the arena of retail pricing strategy.

The tactics used to design and price products to match the demand characteristics of individual markets are not new. Community financial institutions have been using these tactics for decades. In fact, this tailor made+feature is one of the most potent marketing weapons used by community banks to compete with the large regional and national bank holding companies. It is why community banks are feasting on the crumbs falling from the table of the big banks.

Large holding companies are exchanging decentralized pricing systems for more uniform, centralized, pricing systems. These companies need the economies resulting from a centralized management system in order to avoid becoming the acquisition target of other holding companies. I am telling you people,

Bankers eat their children.

Perhaps the administrative headaches associated with implementing a decentralized retail pricing strategy in really large holding companies overcome the advantages of exploiting the differences in markets. Perhaps, but I doubt it. In any event that is their problem, not yours. Most of you should be able to take advantage of differentiated pricing strategies.

The arithmetic of differentiated pricing will prove my point. And, I also want to discuss the more difficult problems associated with implementing such strategies.

The Great Mismatch Between Sales Incentives & Profitability

Recent discussions with a client that has a branch network spanning two distinctly separate geographic markets galvanized for me the issues inherent in adopting a differential pricing strategy. In one of the markets they were a dominant provider of financial services, accounting for approximately 30% of the household market. They recently began serving a much larger market, in which they account for an insignificant portion of the households.

At a recent sales meeting, the executive vice-president of the institution (a devotee of achieving a competitive ROE through leverage) emphasized the need to grow. In the midst of the Rah! Rah! Go! Go! Sell! Sell! Rally, the branch managers from the more mature markets noted that they have a different sales challenge from the managers in the newer market. Managers from more mature markets said that they fight constant rear-guard actions just to retain deposits. And, they added, when you already service 30% of the market, penetrating the next 5% is pretty tough sloggng; sales incentive targets are tougher to hit.

The managers from the mature markets argue that price concessions are necessary to jar the market. The branch managers from the newer markets weren't about to complain about such a proposal. Of course, everyone agreed that they would like to have some discretion about which products to put on sale, as well as some flexibility concerning the amount and timing of the sales offers.

Ironically, the Executive VP (a reincarnated CFO) approved sales pricing in the newly established markets, but rejected the idea for the mature markets! This decision nearly caused a revolt among the managers in the mature markets who complained about unfairness and mumbled that the rich get richer and the poor get poorer. Obviously %volume-driven+sales incentives had to be re-engineered.

First, let's see if the arithmetic of the Executive VP's decision make sense.

Calculating Marginal Revenues and Costs Market by Market

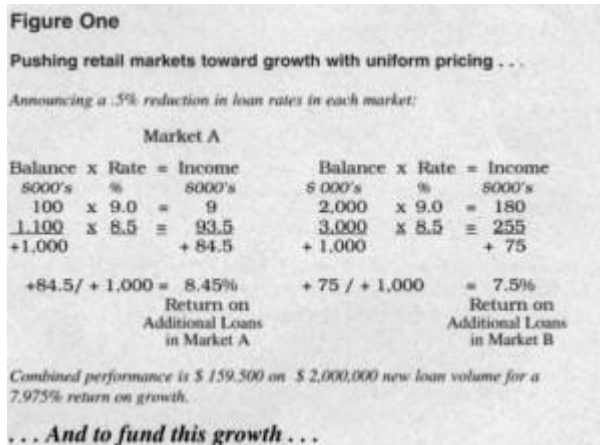
Figure One shows the results of pushing for retail growth with uniform pricing strategies in two separate markets. The situation depicted could represent different banks comprising a holding company or different branch comprising a bank. Market B is a mature market in which significant volumes of deposits and loans are already being originated. Pricing changes in Market B would affect a significant amount of existing balances. Market A is a new market in which most growth is derived from %new+money.

To generate increased loan volume, loan rates are reduced 0.5% in each market. In Market B, \$2 million in loans are expected to be originated at a rate of 9%. A drop in rates to 8.5% elicits a 50% increase of \$1 million in loan originations. The reduced incremental revenue of the price reduction reflects a loss of 0.5% on the \$2 million existing originations, resulting in a marginal return of 7.5%.

The same 0.5% rate reduction in Market A is also assumed to also elicit \$1 million in additional loan originations. But in this case, the \$1 million represents a 1,000% increase in loan originations! Because there are only a token volume of loan originations to begin with, little money is repriced downward, resulting in a considerably better marginal return of 8.45% on the new originations.

The impact of considering the marginal revenue of pricing decisions in competitive situations can be overestimated. An institution can charge predatory prices when it enters a new geographic market or offers a new product. The dominant market players suffer too much damage on the margin if they attempt to compete. A number of institutions who were late getting into the business of home-equity lines have used this pricing tactic very successfully to enter the market.

In general, the marginal revenue associated with rate reductions will be greater in markets which exhibit greater rate sensitivity. Institutions should target their growth in these markets. The principle of differentiated pricing can be effective in markets segmented by geography, product type, or customer demographics.



Next, Figure One illustrates the marginal cost of funding the \$2 million growth in the retail deposit markets. Many articles have appeared in this newsletter discussing the various aspects of minimizing the marginal cost of funding an institution. This exhibit shows a straightforward marginal cost calculation. In Market B the 0.5% increase in deposit rates raises an additional 20% or \$1 million in new deposits. But because the existing \$5 million in deposits also are priced up by

0.5%, the additional interest expense totals \$80,000 resulting in a marginal cost of 8.0% on the new money.

As in the case with loans, Market A represents a situation in which raising the deposit rates elicits mostly new balances and substantially reduces the marginal cost of this funding. The additional \$1 million in deposits represents a 2,000% increase in balances and costs 5.525% on the margin.

In general, the marginal costs associated with rate increases will be reduced in those markets which exhibit greater rate sensitivity. Institutions should focus their efforts to grow deposit balances in these markets.

These generalizations should be evoking some memories, albeit painful, of long past economic courses. Price sensitivity (referred to by economists as the elasticity of supply and demand) can relate to marginal cost and marginal revenue via the following rules: marginal cost is indirectly proportional to the elasticity of supply while marginal revenue is directly proportional to the elasticity of demand.

Unfortunately because of our sample institution's dominant position in Market B, the market is relatively less sensitive to rate changes than it is in Market A. The rate changes in Market B adversely impact both marginal revenue and marginal costs. Applying a uniform pricing strategy across markets produces a situation in which the incremental costs exceed the incremental revenues of growth in Market B! The \$75,000 in additional loan revenues is exceeded by the \$80,000 of additional deposit costs. If the managers in Market B are rewarded based on net profitability instead of on loan and deposit volume, they wouldn't ask for rate concessions.

It's Market A which saves the day. It's a new market, which by definition must exhibit substantially more rate sensitivity for both loans and deposits. The incremental spread of 2.925% (8.45% - 5.525%) on the \$1 million of growth in the market, makes up the loss in Market B and accounts for the entire incremental profitability of growth.

Exploiting Favorable Markets

Figure Two shows the favorable impact of differentiated pricing that is achieved when the relatively greater rate sensitivity in Market A is exploited. Admittedly, the extreme differences in rate sensitivity between Markets A and B solves the problem by focusing completely on Market A. But the point is made. Pricing should be differentiated based on the relative degrees of price sensitivity in segmented markets.

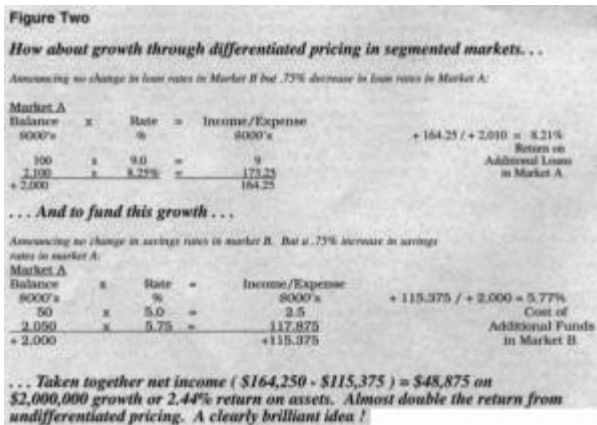
In order to get the same \$2 million in total loan growth, we lowered the loan rate an additional 0.25% for a total reduction of 0.75%. The incremental revenue of \$164,250 represents a marginal return of 8.21%.

In order to get the additional \$2 million in deposit growth, I've raised rates an additional 0.25% for a total increase of 0.75%. The incremental interest expense of \$115,375 represents a marginal cost of 5.77%.

Taken together, the net income of \$48,875 almost doubles the return gained from uniform pricing shown in Figure One.

The arithmetic is clear.

Now, how can one take advantage of differentiated pricing in the work-a-day world? How can markets be segmented? How can the administrative problems of any decentralized pricing system be worked out?



Implementing the Theory

Our example focuses on one type of market segmentation, geographical segmentation. Whether it's a small to medium-sized holding company or an institution with multiple branches, an increasing number of managers are confronting the problems and opportunities of dealing with several different retail markets. Being able to differentiate pricing according to the unique attributes of geography, product, or customer grouping requires some pretty good management planning.

The benefits of allowing each manager some autonomy in pricing deposits and loans within their unique markets depends squarely on the ability to attribute profitability to each pricing unit. Each manager must have some means to evaluate how his/her pricing decisions affect the profitability of the entire institution. This requires a management information system which can:

(1) account for the varying price sensitivities within the various market segments, and (2) employ a transfer pricing mechanism that helps each manager target the profitability of their decisions.

And, of course, performance incentives must relate solely to incremental profitability and not to sales volume targets.

For instance, price sensitivity must be estimated within the markets being segmented. Some broad generalizations can be made in more obvious situations. In my example, a benefit was gained from pricing more aggressively in the new market as compared to the mature market. But not all situations will be as clear-cut.

Because the institution's capital should be employed where it can earn the highest return, any decisions should compare and evaluate the performance of the break-even cost of funding and the break even earnings rate. This is the essence of a transfer pricing system. And, incentive compensation must be profit and not volume driven. This is often easier said than done. How often have you heard of sales incentive programs which reward a branch for the incremental profitability associated with retaining deposits when the ALCO is lowering deposit rates?

After thinking about all of the other ways product and customer markets can be segmented, one begins to appreciate the contribution that price differentiation within each of these market segments can make to the profitability of the institution.