PRICE COMPETITION-The Sandwich

by Steve Brown

One of the items that we will be exploring at our High Performance Workshop is utilizing the "Sandwich Strategy." This strategy is a tool in bank product design to answer competition that wants to compete on price. This is best exhibited by looking at how FedEx handled recent price competition. FedEx charged $12 for their overnight letter delivery package. The United States Postal Service ("USPS"), feeling the loss of business, decided to compete on price and offered a similar overnight delivery service called Express Mail for an $8.95 flat rate. At this point, FedEx had two choices: do nothing, maintain its margins and cede the price-sensitive customers to USPS; or, it could match/undercut the $8.95 price and risk legitimizing the competition, lowering margins and giving up its position as a price leader. Does this situation sound familiar? FedEx reacted by the classic sandwich strategy which froze competition and further defined the company. FedEx replaced its standard overnight letter product with 2 new products one priced high and the other low to effectively "sandwich" USPS's Express Mail prduct. The company launched "FedEx Priority" with a guaranteed 10am, next day delivery and priced this product at $13.00. Additionally, it launched FedEx Standard, with a guarantee of a next day delivery and priced at $9.00. FedEx noticed that most deliveries occurred before 10am, so it was not all that a stretch to reorganize to assure early delivery. FedEx increased its marketing spend to cement its reputation of reliability and to further define the products in the eyes of the customer. The move was a hit. Those customers that were price inelastic that needed to get the product there the first thing in the morning paid the $13, while those that didn't paid the $9. The end result was that FedEx neutralized the competition, micro-segmented its customer base (further allowing the company to determine which customers were price sensitive and which were not) and further differentiated itself on the dimensions of speed and reliable delivery. FedEx took a situation that was most likely going to cost it either revenue or margin, and turned it into a situation that increased both revenue and margins. Within 2Ys, FedEx drove USPS out of that business, as they were compelled to outsource Express Mail to FedEx. In banking, this same sandwich strategy is applied every day in both loans and deposits. If you want a higher deposit rate at Zions or Citibank, they channel you away from the branch to a lower cost, lower service, Internet portal. Meanwhile, if you want the bells and whistles that come from first class service (but a lower rate), both banks are happy to provide their premium money market or CD accounts through their branch network. On the lending side, banks execute this strategy by utilizing multiple options in their term sheet or better yet, go so far as to establish a product brand for their loans, such as "Quickloan," "Quick Credit," "Cash Flow Manager," or "The Silver Line." To execute the sandwich strategy, banks must be willing to build a product brand, get innovative on product design and be willing to take marketing seriously. If you are the low cost provider, then it is fine to compete on price. Otherwise, the only way to combat price competition in the long-run is to innovate in order to create and promote a better value proposition.

BANK NEWS

MBA Index

Mortgage applications declined 6.7% to their lowest level since November 2003. Purchases fell 6.2% while refinancings dropped to a six-month low.

Cross Sell

Wells Fargo said it has increased the average number of products it sells each customer from 4.6 at the end of 2004 to 4.8 as of 4Q 2005. The bank said it continues to target 8 per customer.

Boomers

Some $45T in wealth will be transferred over a 55Y period ending in 2052, as Baby Boomer assets get passed on to heirs. Interestingly, nearly 50% of the money will come from the wealthiest 7% of estates.

Expansion Plans

Mitsubishi Financial Group announced plans to begin acquiring U.S. consumer banks to boost profits from the Americas.

Mortgage Risk

An FRB study finds IO and payment option loans in some parts of the country have jumped to 50%. Other findings indicate that people with payment-option loans tend to have FICO scores below 700 and were considered financially stretched. Meanwhile, nearly 17% of such borrowers earned less than $48k.

New Clients

Banks seeking new clients should take note that a recent survey of 1,400 wealthy clients indicated 54% were referred by an accountant or attorney, while 30% were referred by another client. Does your referral program target these professionals?

FOMC

The 2-day session starts today (with a policy release tomorrow) and Fed officials have given every indication that the Fed Funds target rate will be raised to 5.25%, despite talk in late April of a "pause." Look for a moderately worded statement tomorrow regarding the Fed's concern over inflation. While moderating slightly, it is still at the upper range of what is comfortable for many market participants. We believe that the market will overreact over the course of the next week and rates will move higher.

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