BANK PRICING IN DEFLATIONARY TIMES

by Steve Brown

Yesterday's article on reframing bank pricing to stimulate sales in a deflationary environment received strong interest. Many bankers commented that they could never get away with charging their customers for access to an elite bundle of products and services, to include financial business planning, private banking and other high-end services.

Those comments underscore our point - banking has become too much of a commoditized business. To the extent you cannot charge, we would encourage banks to restructure their product and service offerings to create both real and perceived value. For customers that deserve access to these services without the additional charge, great. For customers that value these services, but don't have the activity or balances to pay for them, our suggestion was to charge an annual fee. This approach turns unprofitable customers into profitable ones, all while increasing satisfaction and loyalty.

Some bankers also missed our point about the bundling of products and services. In addition to increasing cross-sell, boosting profitability, increasing loyalty and offering a more comprehensive solution; bundling also makes it difficult for a buyer to discern the real cost of any single aspect of the bundle. Toyota does this brilliantly when you buy a minivan. There are so many different options and packages that it is difficult to compare Toyota's price to Honda's.

Many bankers struggled over what their pricing position was. This is understandable, but it is important for everyone to know the basis of their business platform. In deflationary times, this understanding is even more critical, as bankers must strategically decide whether to sell fewer products at higher margins or more products at lower prices. If the market won't support high prices, you may need to move down a step and shoot for scale.

In addition to restructuring products and services to create proprietary offerings worthy of value, banks should also be focusing more resources on segmenting their customer base. Not every household and business needs a basic checking account. Segmenting the customer base not only allows for targeted marketing, but permits management to categorize by rate and fee sensitivity. The airlines, theaters, hotels and many other industries already do this successfully. By segmenting the customer base, aggregate margins can increase 10% to 25%. Segmenting can be as simple as providing a discount/fee waiver or rate change to certain groups of the market to incentivize them to take advantage of certain products and services. By handing in a "coupon" or using a certain promotional code, banks will automatically be able to categorize those fee or rate sensitive customers based on self-selection.

Another popular tactic in deflationary times is extended payment models. Banks offer longer loan amortization or bill consolidation services that reduce spikes in payments (by aggregating and collectively amortizing indebtedness). All of this is done in exchange for a fee. As revenue goes up, duration of the obligation gets extended (most likely creating a more valuable asset) and cash flow coverage increases. Utility companies have had phenomenal success with this business model. For well-heeled customers, selling rate caps on existing variable loans is yet another way to generate additional income, in exchange for a unique value of extending a loan's duration.

Our point is that banks can increase profitability and customer loyalty despite an environment of recessionary deflation. By reworking the value proposition of products and service, banks can use this economic downturn to become stronger.

BANK NEWS

Loan Losses

Losses in banking peaked in 1935 at 3.4% overall. We are not quite there, as 3Q '08 loan losses sit at 1.5% of loans (although analysts estimate the rate will double to 3% this year).

Portion Sold

In an effort to raise more cash, Bank of America sold $2.8B of its holding in China Construction Bank. The sale gives BofA a $1.13B profit and leaves it with a remaining 16.6% ownership.

Real Estate

In 2008, mortgage defaults and foreclosure sales more than doubled in CA, as prices dropped (in some cases up to 44%).

Shrinking Wealth

US Households with over $1mm in net worth have seen their assets shrink by 30% in the past year.

Commercial Sector

Office vacancies are projected to rise from 14.6% at the end of 2008 to 15.6% by the end of 2009, as rental income begins to fall.

Financial Sector

Financial companies tracked under the S&P 500 fell 58% in 2008, closing the year with its worst drop in the 19Y history of the index.

Corporate Sector

Large company profits have fallen for 7 straight quarters and are expected to continue the trend through the 1H of 2009. If that happens, it would be the largest continual stretch of decreases in history.

M&A Activity

Data compiled by Dealogic finds 1,309 M&A deals were scrapped in 2008 as available credit disappeared due to the crisis. This is a 29% drop from the prior year.