COMPETITIVE POSITIONING

by Steve Brown

If you live in NY, chances are you are familiar with the "Pizza Principal." This unexplained economic correlation shows that for the past several decades, every time the price of the subway increases, the price of pizza goes up. This last happened back in 2010, when the MTA raised fares by $0.25 to $2.50 and the price of an average slice went to $2.50 by year-end. No one knows why this occurs, since the two goods are unrelated in terms of inputs and markets. The best guess goes away from economics and is more in the realm of game theory. It holds that pizza shop owners (having to take the subway into work) notice price increases and then start thinking about raising the price of pizza regardless of competition. In similar fashion, more bankers are thinking about game theory, as they decide to enter into new markets or defend themselves against competitors. From the perspective of a bank entering into a new geographical market, usually they have 4 distinct choices. 1) Match offerings and pricing of banks that are already in the market; 2) Offer products and services that are cheaper in price or come with more service attributes.; 3) Specialize in a niche offering where competition is limited such as wealth management or trust services.; Or, 4), Differentiate by providing a clearly distinctive service, such as a new deposit package targeted at seasonal youth sports teams. Conversely, the range of responses by banks in existing markets can be broken down to the following: 1) Ignore attackers and cede the market to the new entrant (maybe a strategy to consider when it comes to free checking).; Or, 2) Match or drop pricing/increase service to go head-to-head with the new entrant be it the general market or niche market. We have found that the optimal strategy chosen boils down to basically 4 factors: the cost structure of both banks (cost of funds and overhead expense); the market share of the incumbent bank; the elasticity or sensitivity of the market to price and the potential that overall demand can be increased (a shift up in the demand curve in economic terms) should competition ensue. Usually when we help banks with competitive issues, one bank does not enjoy a huge advantage in its cost structure. In addition, both the existing bank and the new bank have very little pricing power in the market, the market is not that sensitive to price and the market can rarely be expanded. As we look back over our recommendations in the past year, 4 out of 5 times, because of this profile, we recommend that the new entrant be ignored. If we advised the new entrant, we suggested they not undercut current pricing. In this manner, while the new entrant can gain market share, margins are maintained for the incumbent bank. Of course, the alternative is for the attacking bank to go into a new market and be aggressive in pricing. Then, when the incumbent bank matches or undercuts them it starts a price war. If this lower-pricing results in greater overall sales, then the strategy might be worth it. Usually this isn't the case and what happens is the incumbent bank slows down the market share gain from the new bank, but they end up cannibalizing their current customer base and lower their margins. Usually, the net result is greater market share retention, but lower profitability. Before we leave this topic we should point out that the greater the cost structure difference between both banks, the more likely we are to recommend competing on price in a market to gain share. This is why we continue to underscore the importance of using our Liability Coach product to restructure your deposit base now, to drop the cost and make your deposit base less interest rate sensitive. Having a lower cost of funds, combined with a lower overhead structure, gives you more flexibility to both enter new markets and defend yourself. Thinking through competitive tactics and positioning is an interesting exercise to get your management thinking along strategic lines. Understanding your market, the strengths and weaknesses of your institution compared to the competition and potential competitive tactics; will likely result in better performance all around. That is the case no matter what the competitive threat - a positioning that may result in being able to afford more of that great NY pizza.

BANK NEWS

4Q Earnings

Citigroup missed estimates, reporting disappointing earnings of 38 cents per share vs. 49 cents. Citi said net credit losses fell 40% as full-year net income grew 6%. Dragging performance down, Citi Holdings (bank's operation set up to handle its toxic debt remnants) saw its revenue fall $6.4B. 4Q revenue was $17.2B, a 7% decrease from the prior year period and Citi released $1.5B in loan loss reserves, a 35% decrease from 2010. Wells Fargo beat estimates, reporting earnings of 73 cents per share vs. 72 cents. The bank reported a full year ROE of 11.93%, ROAA of 1.25% and NIM of 3.94%. Net income reached $15.9B, up 28% from 2010. Revenue was $20.6B, a 4% decrease from 2010. Wells released $600mm in loan loss reserves in 4Q.

M&A

Wintrust Financial ($15.9B, IL) will buy the trust operations and a branch from Suburban Bank & Trust ($586mm, IL) for an undisclosed sum. The trust operations had about $160mm in assets under management and the branch had $50mm in deposits and $4mm in performing loans.

More M&A

In an effort to strengthen its capital position and reduce wholesale funding needs, Royal Bank of Scotland will sell its aviation leasing unit to Sumitomo Mitsui Financial Group for about $7.3B. The move gives Japan's 2nd largest bank control over the 7th largest fleet of aircraft.