PRICING STRATEGY

by Steve Brown

One of our great ideas in fixed income was to offer banks fully disclosed 6.25bp (2/32nds) price mark up on bonds from where we purchased the bonds. We thought the lower than average margin plus the transparency would be a breath of fresh air and banks would come flocking to our desk. The problem was, very few bankers cared. We wished we could have counseled JC Penney, as their 1Q numbers shows a similar scheme failed as well and serves as a lesson to banks when in comes to pricing strategy. Back in Feb., JC Penney came out with a unique concept among retailers - no more sales, no deceptive advertising offering limited numbers of goods, no more 1-day specials, no more fine print and no more 99 cent prices. Instead, they offered clear, honest pricing. One would think that in this age of hyper- advertising and complicated promotions, consumers would love it, but unfortunately, they cared less. During the time of the retailer's promotion, revenue dropped 20% and customer traffic fell 10%. Why? Like our attempt, the answer lies between the cross-roads of behavioral economics and game theory. It turns out that consumers rarely do the extra work to make an apples-to-apples comparison of goods or services. As such, they default to either what they have traditionally done or the lower price. The classic example is computer printers. It is impossible to find a quality home computer printer these days. Manufacturers know the public would rather have low cost over quality and thus equate their cost structure to have a useful life of about 3Ys. Moreover, manufacturers drop their price on the printer, but raise the price on the ink cartridge. This makes the true cost of the printer, hard to figure out. While some buyers calculate the cost per printed page, most do not. As such, the advantage is to the seller. Hotels, airlines and retailers all use a similar strategy, despite the fact that pricing complaints are the largest filed complaint with consumer advocacy groups. In Penney's case, it turns out that customers would wait for sales at other stores. From a game theory standpoint, what Penney's did was to lower the consumer's information cost. When something went on sale, buyers assumed that it was better than Penney's everyday low price, so buyers didn't have to shop at both stores. From a behavioral standpoint, taking away a marked up price removes the ability for buyers to "anchor" or compare. Consumers feel better and perceive a higher value to a product if they get $10 of monthly fees waived from a $25 dollar account, than if the account was $15 per month. It also turns out that buyers, like bank customers, value time and money differently. Discounts and promotions appeal to those that value money over time and give banks the ability to cater and discern to that group by motivating the price sensitive. Penney's is not alone, as many other corporations have tried and failed. Intercontinental Hotels experimented with up-front pricing that included all fees on its website. Customers left in droves, taking the information and then choosing competitors with seemingly cheaper prices. While it would be nice if buyers appreciated simplicity and transparency, real world actions indicate this is usually not the case. Penney's new CEO Ron Johnson likely thought the Company was going to achieve a different outcome when he changed the pricing strategy and spent his marketing budget on those witty Ellen DeGeneres ads. The former Apple executive thought he was lifting the store out of the brutal commodity clothing market. In reality, he was exacerbating the problem by taking away information that led to sales. He may ultimately succeed, but he won't do it by telling customers the firm's pricing is fairer than what they can find at other stores.

BANK NEWS

M&A

Premier Community Bank ($204mm, WI) will buy 4 branches from Baylake Bank ($1.1B, WI) for an undisclosed sum. Baylake did not indicate why it is selling the branches.

CFPB

The agency reported that in its first 10 months it has been able to resolve about 4 out of 5 consumer complaints to the satisfaction of the consumer involved. The agency began operations July 21 2011 and through June 1 reports it had received more than 45,000 complaints.

CFPB

The WSJ reports credit card companies that received the most complaints (from July 21, 2011 to May 15, 2012) in order were: Capital One (2,700 complaints); Citigroup (2,380); Bank of America (1,800); JPMorgan Chase (1,800) and American Express (870). Expect issuers to try and leverage the data in advertising soon to try and capture & retain customers.

Mortgages

Bloomberg reports the FHFA plans to detail specific flaws that will trigger a mortgage repurchase request, in order to help remove uncertainty from the banking industry and make banks more willing to lend (worries are increasing that credit standards have tightened too much).

Minimal Jobs

The Labor Department reports job openings declined 325k, the most since 2008.

Augmented Reality

US Bank is rolling out its iPhone application where you view the street on your iPhone and it overlays directions and details of the nearest branch or ATM.

Citibank

The Bank is reporting success with its "Citi Tuesday" promotion whereby for every home Met's game that falls on a Tuesday, it offers special reserve tickets, rewards, transportation and club access for the games to its customers