Importance Of Pricing Strategy For Banks Granting Loans

This document is a research proposal about the influence of pricing strategy of consumer banks with respect to granting loans. The document discusses various pricing strategies involved in enhancing the banks' profits and how it fits with consumer demands.

Depositing and lending are two core areas of banking. This research will primarily focus on the lending part of the banking operations. It will take into account all the pricing strategies banks have been using in the past and the strategies that are still in practices with respect to the pricing of loans. It will help identify the areas which are crucial for devising effective pricing strategies and the areas where these strategies lack. It will further identify aspects in which these strategies have affected and still affecting banks till present day.

As technology has advanced, the retailers are able to improve their profit margins despite the prevailing competitive environment. They are well aware of their customers' buying patterns and behaviour. They know how to satisfy the needs and wants of their customers while saving a sufficient amount of profit margin for themselves. The product based industry is so very well able to understand the psyche of their customers. They are able to devise business strategies in accordance to their goals and objectives, and implement them effectively

If we glance at the service industry in the very same fashion, it is clearly visible that they are not as comfortable with their customers as product based industry. Though they are available with tools and theories to understand their market as well but it certainly is not in as much detail as product based industries.

Pricing for Banks

Pricing is one of the chief variables of strategic marketing and it has the most significant and direct impact on the sales revenue of any organization, and even then there are a very few conceptual researches making precise suggestions about setting prices. There are two pricing challenges unique to service pricing that services are intangible and irreplaceable (Rob Docters, 2004). Finch (1998) identifies some other including inseparability of production and consumption, heterogeneity and perishability (J.Howard Finch, 1998).

Banking being more complex than other services makes it more interesting and to an extent more troublesome as well. Pricing banking services is an art in itself. IulianaCetine(2010), in her research says that for a bank the price is one of the fundamentals of the marketing mix. The prices ought to be in conformity with the other Ps (product, placement, promotion) and they have to not be taken as a merely financial problem, where they are calculated by adding a margin of profit to the estimated costs; pricing is much more to it.

Depositing and lending are two core operations for a bank, pricing these deposits and loans can significantly affect the overall performance of banks; but a research shows that banking executives are not very much able to handle pricing so well. Talking about lending in particular, banks usually are not able to convert their goals and objectives into an effective pricing strategy. Many banks still rely on ancient ways of pricing and handling loans. They have acquired technology for risk-management purposes but acquiring technology for pricing is something banks still have not yet paid attention towards (IulianaCetine, 2010).

Frank Rohde, who is a chief marketing officer at Nomis Solutions, claims in one of his interviews to FST that pricing process of retail banks is fundamentally broken. He talks about the US banks and banks all over the world, mentioning about how banks price, he says that pricing executives come up with pricing strategy without any knowledge about the volume and profitability; profitability teams further come up with different sets of rates with a pure subjective judgment about the pricing behaviour of the consumers and market fundamentals. They have lack of information and analysis; they are not able to set appropriate targets. Even if they do, they are unable to understand the reasons of deviations from the set targets and how exactly can they correct their policies. Pricing technology is necessary to understand the pricing mechanism properly. Pricing instead of taking as a side operation should built as a core competency by the banks. It directly influences the targets and revenues of the banks. Frank Rohde (2008), further claims that the basic root of the credit crisis is that banks have not been able to translate their knowledge of market demand and profitability into a practical pricing strategy (Rohde, 2008).

Pricing Theories With Respect to Granting Loans

There are a number of theories devised for pricing of banking products and specifically for granting loans as well. In the research, cost plus profit, taking the cream, price depending on competition, price depending on value and price to penetrate as basic theories for banking products including lending and their relationship and applicability will be discussed.

Traditionally flat-rate pricing has been in practice by most of the banks. In flat-rate pricing strategy all customers obtain the loan at the same pre-decided rate set by the bank. As the article published by Bench Mark Consulting International says that flat rate is used by the banks which lack technology to design a sophisticated policy and therefore use a flat rate to “to keep it simple” (King, 2007). The problem with flat rate loan is that high credit quality borrowers can get loans at cheaper prices because of the regular use of risk- based pricing methods (mentioned in detail later) whereas lower credit quality loans find this rate cheaper and this leads to a very risky equilibrium which prove to be futile for the bank.

Theorists often talk about risk-based pricing when it comes to pricing bank loans. Risk based pricing, in simple terms, is charging higher to the risky entities and lesser to the lower risk entities. It keeps in line, the loan price with the anticipated loan risk. As mentioned by KANSAS on its official website that this method allows the lender to obtain a level of return that is in accordance with the taken risk and it follows the principle of financial theory of risk and return (KANSAS, 2010).

Managers of known banks claim that, despite tough economic conditions, they are able to increase volume by following the risk based pricing. They instead of avoiding risk are opting for a suitable combination of risk and return; this can help them grow. Risk Based Loan pricing can help in better risk management but there are certain limitations of risk based pricing. As Robert Phillips says that undoubtedly charging higher for higher is a sensible as well as profitable idea but this obviously is not final in pricing complexity. Risk-based pricing does not take a number of factors into account, one of which is the price sensitivity of customers into consideration (Phillips, 2005).

Bankers usually like this design in which lenders have better understanding of the available pricing options and the respective price is reached quickly. Lender can know in advance about the fee that will be charged to them and they can further look at the benefits of growth in total relationship with the bank.

With the passage of time difference non-banking financial institutions entered the place which was once the territory of banks. Banks faced a tough competition but did not lag behind. A basic rule of marketing any product or service is a differentiating factor. Relationship with the customer was a factor that banks could use as their differentiating factor to compete. Banks generally are likely to have long relationships and associations with their customers. This can build a loyalty factor among customers as well. Relationship pricing strategy takes the relationship with the customer as the basis to set a price. It usually takes into consideration, customer's loyalty time, the total amount of business he provides, the frequency and type of transactions he does etc. (SunTec, 2010).

A research on relationship banking supports this type of pricing by adding that the progress of bank-firm relationship can lead to benefits for the lender as well as borrower in terms of cost reduction or increased revenues and reduced rates. (Fredriksson, 2007) This kind of pricing takes into account all the services that a particular customer is availing.

SAP, a German software corporation providing software to support businesses globally, elaborates in its industry briefing about the pricing of banks. According to SAP banks have prospects to perk up their profitability by optimizing their price structure (SAP, 2009). Banks, instead of working on the price they need to sell and should focus on the price that customers are willing to buy (SAP, 2009).

Banks and other non-bank financial service providers, who were relying merely on risk assessments, have started employing value based approaches to pricing credit. The competitive environment in which banks are working in, value based pricing can help banks to continue with profitable growth. David Vidal (2009), in his paper identifies certain structural guidelines to implement value based pricing;

Identifying the factors that influence customers' willingness to pay,

Define pricing segments along the structure identified,

Quantify ability to profitability change your pricing by measuring price elasticity and

Implementing the selected value based pricing approach using price optimization models.

Customer Loyalty is something that is extremely important for all the banks; it can be considered as one of the most valuable assets of a bank. Taking into account the aggressive environment, retaining customers is becoming increasingly difficult. Girish (2010), in his article says that retaining and increasing good business with a current profitable customer is more cost effective than targeting a new customer. Selection of a good pricing strategy can help banks retain profitable customers (Girish, 2010).

The study differentiates itself through simple facts that simple pricing models only take monetary aspect of the transactions into account but advance models take all non-price factors to give a true picture of rates and volume. Price optimization can help banks to come up with rates according to their growth strategy. If a bank plans to increase its profits without affecting volume, price optimization model comes up with a rate that bank needs to offer a particular chunk of customers and achieve its goal. Similarly if a bank intends to augment its volume with significant profits, the model calculates a price consumer intends to spend for a product in any area of business; it also shows how the pricing is balanced among loan products to maintain the overall strategy intended by the bank.

Pricing optimization allows executives to pull pricing as a core strategic driver of performance. Pricing should not be taken as a secondary function. Pricing should be treated as core proficiency; it can be used as a tool which can quickly and significantly influence the required results of the fiscal year. (Rohde, 2008) Banks can further use what-if analysis to alter the recommended strategy according to what is more feasible and comfortable to the suggested targets.

Moreover as mentioned earlier as well, pricing strategy has a direct influence on revenues and banking targets of a bank. A suitable pricing strategy can help bank increase its revenues, achieve targets, improve business ratios, increase business effectiveness, amplify its volume, improve on profitability, enlarge its customer base, and plenty of other factors important for a business. All these variables, their influencing variables and their relationship will be comprehended further in this study.

Industry Background

Banking industry is the backbone of any economy. It is considered fundamental to economic growth. Banking industry alone can affect the entire economy, if banking industry of an economy is not working well; it will directly impact the working of the whole economy and vice versa.

Banks in simple terms are described as financial institutions which accept deposits and issue loans. Banks extend loans to corporations and individuals to invest, handle savings and handle transactions. Though banking industry has evolved over time in economic, financial and technological aspects, the loan component of the banking has not advanced as much as the other services provided by banks. Banks have been able to handle their loans very well. Banks which extended credit have encountered loan defaults while other banks did not extend sufficient credit to perform well.

Some banking executives and theorists claim that the pricing component of the loans to lack. Banks cannot effectively price their loans; some do not take all the pricing components into account while others which do, are unable to comprehend their behaviour. Banking professionals also have pricing theories for their assistance which have improved with the passage of time but despite focused considerations banks have not been able to perform up to the mark. This clearly indicates that either the pricing strategies bankers are available with are not enough or they lack in some key areas which still need to be addressed in order to completely understand the key influencing variables.

Research Aim

The aim of this research is to comprehend the pricing strategies and key influencing variables in pricing of loans, so that the banks are in a position to develop better performing and effective pricing strategies that alignment with their strategic business plans.

Research Questions

Research question 1:

In what aspects can pricing strategy be important for the banks with respect to granting loans?

Research question 2:

What factors are taken into account by Banks while devising their pricing strategy?

Hypothesis

Poor loan pricing strategy is the key factor due to which banks are unable to achieve their strategic business objectives

Existing pricing theories cannot help banking loans to perform up to the mark

Objectives

Comprehend the strategies that banks use for pricing their loans

Indentify and elaborate on the aspects that can be influenced by pricing strategies banks adopt for pricing their loans

Identification of the most suitable loan pricing strategy and suggestion for further improvement in the weaker areas of existing loan pricing models and theories.

Research Methodology

Business researches, depending on the nature of a research, can usually be classified into three basic categories which are exploratory, descriptive and causal research. Exploratory research is carried out in the beginning stages of decision making when the decision circumstances are vague and management is very unsure about the nature of the problem. Descriptive research is carried out when the management knows about the problem but not completely aware of the entire situation. (Zikmund, 2001) This type of research answers who, what, where and how questions. Causal study is carried out when the problem is very clear, specific and sharply defined. The cause and effect relationship among the variables are identified. (Zikmund, 2001)

This study will fall under the causal category of research. The problem of the study is clearly defined and the hypothesis are stated which would be defended further in the research. The problem area is the loan pricing and its causal relationships with other variables will be identified to further clear and discuss the areas where current loan pricing strategies lack. It may have a little tinge of descriptive category as well when the pricing strategies that banks have used in the past or are still using will be identified and elaborated upon.

This research will primarily be based upon secondary data sources for the first question at hand. Different studies of different authors from different corners of the globe will be thoroughly studied and scrutinized in order to get hold of the subject and get a complete understanding of the subject matter. All the direct, indirect, moderating and intervening variables will be identified, a theoretical framework will be designed identifying the relationship among the variables and their significance; they will be studied in detail to reach justifiable conclusions. Dependent variable is the variable of primary interest to the researcher. The researcher analyses the dependent variable to get his answers. Here in this study it may be the volume of the loan, the profitability or the effectiveness of the strategy (this will be dealt further in detail). The independent variable is the one which influences the dependent variable. In this case it may be the interest rates, economic repercussions, loyal relationship etc. A moderating variable has a strong effect on the relationship of direct and indirect variable. The intervening variable is a surface in time when indirect variable starts influencing and the time when its influence is felt.

All the relevant literature, studies, theories will be examined. The empirical evidences and regressions run in other applicable studies will also be taken into account to deduce the relationship among variables. The objectives of the research will be kept in mind while examining other studies in order to stay focused.

To build and maintain a better understanding of factors that are taken into account by Banks while devising their pricing strategy, a well-structured questionnaire will be prepared and will be floated around to gather primary and first-hand information regarding the concern. The questionnaire will be circulated among the regular bank customers as well as to the staff who manage the operations of a bank. Moreover, feedback from the higher hierarchy will also be keenly taken into account as the main instructions and strategies regarding the pricing schedule and lending grants trickle from top to bottom. The information will then be processed, data will be analyzed, through the usage of various softwares and presented in the form of ratios, graphs, tables and charts, hence enhancing the readability and understanding experience of the primary data.

Hermeneutical text analysis will be used in the study to analyze and discuss the strategies used by banks for pricing their loans. Hermeneutics is a research technique which is followed by an interpretive pattern on text scrutiny. Hermeneutics is widely used in social sciences including researches in economics and business.

Hermeneutics is a method of research which allows the researcher to interpret the texts in its background and draw a meaning accordingly. In order to understand something properly, one needs to take it in context and one need to have knowledge about it, and hermeneutics allows the researcher to combine both of these necessary elements to gain complete understanding of the relevant text. Thus hermeneutics makes use of the blend of information and contexts to generate fresh facts and gain additional understanding in research (Cole &Avison, 2007); as in order to draw legitimate and justifiable conclusions, it very important to know about the social, political, economic and historical aspects of an event. Hermeneutics comprises of five concepts: the hermeneutic cycle, the hermeneutic horizon, fusion of horizons, rejection of author-intentionality and critique (Mir & Prasad, 2002)

A research on hermeneutics says that “Hermeneutics means the theory of interpretation, i.e. the theory of achieving an understanding of texts, utterances, and so on (it does not mean a certain twentieth-century philosophical movement)” (Forster, 2007)

Hermeneutics is the research method in the field of text analysis which offers the researcher to interpret texts in their context and therefore derive meaning. As knowledge about something needs both information and context, hermeneutics enable to combine both to gain understanding. In social sciences the historical, political, economic and social backgrounds of phenomena have to be analyzed carefully to draw correct and legitimate conclusions (Mir & Prasad, 2002).

The major philosophy and concept of hermeneutics is its cycle. The cycle states that “the part can only be understood from the whole and the whole can only be understood from the parts.” (Mir & Prasad, 2002) This means that in order to get the complete understanding of the parts, one need to know about the context and the whole scenario and in order to understand the whole scenario, one need to have a complete understanding of the parts. The social and cultural aspects are also taken into consideration. Not only the research subject is what the analysis will be based on but a separate analysis of the context is also required.

While studying loan pricing, not only the directly related variables are taken into account, the environment in which those variables work has also to be taken into account to get an enhanced understanding of the working of actual variables.

The secondary research for this paper will be done through various already acclaimed journals, both online and the ones available in the University library. Also, the information will be gathered through other online sources like banks’ websites and portals. Whereas, a direct contact will also be ensured by having a hands on experience gained in conducting this research. Validity and reliability will also be taken as a key player as this research will aid any works done in this field in the future. The data collected will be put up as such that it stays valid and reliable in the times to come with some exceptions and limitations.

The research questions will support the aim to conduct this research through mentioning the importance of pricing strategies currently used in the banking system today and impacts of devising new strategies, which are more consumer centred, on banks’ profitability. Whereas, many factors concurring to the objectives of our research will be discussed aiding to the comprehension of strategies for banks.

Timescale

The way this research will be carried out is suitably planned; expected time for each part of the study is also determined. Things will take place exactly according to the pre-determined plans as this will help to give appropriate time to each section and as well as finish the study on time. In order to work in a systematic manner, keeping the time constraint in mind, the analysis part of the report is divided into four sub-parts, relevant data collection, analysis of the data collected, further analysis and final deductions. Therefore, these stages will be carried out with utmost care. Following table shows how the time divided among different stages of the research:

Task

No of Weeks

1

Literature review

3

2

Analysis – Relevant Data Collection

3

3

Analysis of Data Collected

2

4

Further Analysis and Data Collection

2

5

Analysis – Final Deduction

2

6

Final Report write up

2

7

Final Presentation write up

1

8

Presentation Preparation

1

Though the planned will be followed strictly, still a room for delays is kept in mind. Some tasks (most likely analysis and literature review) may require extra time depending on the situation. If such things happen which is not very likely, the room kept for delays can be used or reduce time from other stages if they can be completely early without any compromise with the quality of work.

Resources

This study will be carried out with the help of secondary as well as primary research. Access to Business and Marketing Journals is the major resource needed for this research. Access to quality data is major requirement and something that will significantly influence the quality of this research work. Moreover a computer with an online access to articles is all what is needed.