

THE USE OF FUNCTIONAL COST DATA IN MARKET ANALYSIS

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Cost accounting data represent an improvement over what bankers previously had for self analysis. From the viewpoint of the individual bank, however, the data fall short of the optimum, because they measure average cost and returns rather than cost of handling an additional account or returns from additional loans and investments (Marginal Cost Chart).

Many bank costs per unit handled tend to decline as bank size increases. If the decline in operating cost is sufficient to offset sizable increases in interest on time and savings deposits or decreases in service charges and rates charged on loans, a bank could, by paying higher rates or by reducing service charges, increase its market area by making its lending and depositing functions more attractive to potential customers. It could, at the same time, increase profits.

One thing to remember in bank market analysis is that all banks combined have only limited control over total bank footings. The national totals are largely determined by monetary policy. Monetary authorities permit bank deposits to grow by increasing bank reserves as the economy expands.

This does not mean, however, that an individual bank should operate as though its loans and deposits are fixed. Banking is a competitive business. One bank can get business at the expense of another. Savings can be bid away from nonbank agencies and bank credit can be expanded at the expense of nonbank financial agencies if such savings are obtained.

As most bankers already know, convenience is extremely important in determining a bank's customers. In a study by this Bank in 1966, more than half of all the small firms questioned indicated that convenience was the main reason for choosing a particular bank. Further reinforcing this conclusion is the fact that almost three-fourths of the small firms in Metropolitan St. Louis banked less than three miles from the location of the firm (bank market chart).

The individual bank market can thus be visualized as a circle with the bank office as the center and all roads or streets leading to and from the bank as radii of the circle. The size of the circle can be measured with reasonable accuracy by the use of customer surveys. The size of the circle for most banks is not very large, but it can be changed by pricing and marketing policies.

The question of prime interest to bankers is:

What can I do to enhance the market area of my bank? In other words, how do we get from here to here? (Chart) We can discuss this question from the standpoint of functional cost data. Given the incentive for customers to bank at the nearest banking office, any bank under competitive conditions determines to some extent the size of its market when it sets prices on its saleable products and on the deposits it purchases. Individual banks are neither limited in sources of funds nor uses for funds.

Pricing of Inputs and Products Important

Without belittling the impact of advertising, educational programs, and the personal qualities of the bank's staff, pricing is an important factor in determining the size of a bank's market area. For example, if two banks are operating five miles apart, and all their marketing efforts and prices are equal, their respective market areas will probably extend to about midway between the banks. On the other hand, if the pricing policies of one bank are more favorable to customers, its market area is likely to exceed half the distance between the two banks.

With the impact of bank pricing on market areas recognized, we can draw some further inferences concerning the cost analysis data. For example, lower cost of acquiring deposits from the cost analysis context may be considered a favorable factor. This is not, however, necessarily true. We could reduce the cost to zero by paying a zero rate on all time deposits and setting service charges high enough to cover all deposit servicing costs. A bank following this practice, however, would probably experience unfavorable results. Its growth would cease or lag that of competitive banks. Deposits would decline, and profits would likely disappear. Under competitive conditions it is obvious that banks should purchase deposits. What is not so obvious is the rate that should be paid for them. The rate paid is one determinant of the size of the bank's market. It is at the same time a cost factor. If a bank is maximizing profits, the amount paid for deposits will be determined largely by demand for loan funds (opportunities for income) in its market area.

Net portfolio yields may be analyzed in a manner similar to that of deposits. High yields on loans are looked upon as favorable. Again, however, this is not necessarily true.

The elasticity of loan demand will determine the lending rate which is most profitable to a given bank, and such a rate may be only average or below average, depending on loan demand. If lower rates on loans cause an increase in the size of the market area, and a more than proportionate increase in loans outstanding, this could lead to higher profits despite lower net yields.

I have used these examples to point out some pitfalls in making bank policy on the basis of apparent conclusions drawn from cost accounting data. What conclusions can be drawn from the data which will justify bank policy changes?

First, we have the more obvious conclusions which relate to internal operating efficiencies. These include comparisons of the operating expense for the various functions. If per unit handling costs are high, they obviously require analysis and answers. Conclusions relative to such expense, however, must be drawn with care.

Part of the sample with which comparisons are made in your cost analyses may be located in vastly different labor markets. Comparisons of unit costs in low wage areas with those in high wage areas can be misleading. All banks must pay a competitive wage and salary rate to get and hold qualified help, even though costs of its various functions are higher than

average. In high labor cost areas additional automation of functions may be a more desirable means of reducing costs than attempts to hold wage and salary rates down.

Next we have the less obvious uses which may be made of the data. For example, the bank with relatively low expenses for servicing demand deposit accounts and relatively high service charges per item might increase net income substantially by offering some concessions in the service charges and thereby enlarging its market area. If new accounts can be gained in this effort, they should be profitable to such a bank in view of declining marginal costs for servicing checking accounts. Similar concessions by competitive banks with higher costs will be difficult to make. Under such conditions a bank might profitably expand its market area and realize growth both from an expanded market plus further growth within its current market area.

Conversely, a bank with high servicing costs on demand deposits and relatively low charges may be getting an excess of small non-profit accounts. In other words, it may be taking losses at the margin. It might find an increase in service charges profitable, despite some loss in footings.

A bank operating in an area of high loan demand will likely find it profitable to increase its market area

through higher bids for deposits. This will narrow the profit margin, but the larger volume of business obtained may be the most profitable operating level for the bank.

In summary, the use of functional cost data in market analysis offers some interesting possibilities. Weighty decisions must still be made as the data do not provide precise answers. The size of market that provides the most profitable level of operation for a bank is the key to appropriate decision making. Credit and demand deposit customers prefer to bank at nearby banking offices. More favorable pricing, however, will overcome some reluctance to bank at more distant points. Time deposits move quite freely over longer distances. Furthermore, banking by mail is becoming more acceptable with the improvements in communication. The cost accounts provide data from which judgments relative to these problems can be made. Nevertheless, the accounts do not provide final answers. They only serve as signposts to attract attention to possible problems and potential opportunities.