2008 SECOND QUARTER

# At the Margin

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## Achieving Competitive Relevance

### The Doctor Is In!

Community banks need to focus, and I mean FOCUS, on producing a consistently growing and **sustainable** net income. Achieving this objective requires effective use of the tools of product differentiation to "tailor-make" products for specific customer segments.

The point is that community banks must choose to be "competitively relevant."

The term "competitively relevant" is my own characterization of an economic reality. The economic discipline speaks clearly regarding which firms **succeed** and which firms sink into irrelevance. Firms that succeed must generate a consistent growth of sustainable net income. "Sustainable" means growing the net income flowing from their core business strategy. "Consistency" means growing income year after year within a reasonable level of volatility.

Understand, of course, that with banking you have a declining cost industry that produces commodities. Therefore, it is balance sheet growth that spreads operating expenses over a larger asset base in the short run and helps the bank to use technology to take advantage of economies of scale in the long run.

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What is important is not just rudderless balance sheet growth, but growth for income's sake!

If an institution is committed to achieving income growth and thereby can achieve a competitive (10 to 15 percent) return on capital, it should be able to maintain consistent growth in the balance sheet equal to the rate of growth of retained earnings.

Ugh! Financial speak! But the arithmetic is devastatingly simple. If a community bank cannot produce an adequate rate of growth of retained earnings, its growth within its own market place will be restrained. The bank's share of wallet, share of market, and thereby competitive relevance, will diminish.

Community banks can de-commoditize their products and services. They can build options and design features for their loans and deposits that reflect the changing needs of their particular customer base which distinguishes them from their competitors. Product differentiation is the key to tailor making products for individual customer segments. Whether you guaranty the availability of funds directly deposited into a checking account or guaranty to certain construction development to deliver firm forward commitments to fund qualified end loan borrowers at today's rates, the point is for the community bank to **differentiate** its products.

Developing differentiated products for specific market segments also avoids the financial trap of the cannibalization of deposit and loan balances and its resulting damage to marginal costs and revenues.

Remember a rule of retailing: the price of a product consists not only of "rates and fees" but a whole range of "non-rate features" related to the perception of safety, convenience, trustworthiness, etc. So, the more non-rate features that you can identify, create, or for which you can create customer perception, then the less rate sensitive they must be.

Community banks must also employ new ways to segment their customer markets. They must research how geography, income, wealth, life style, age, family circumstances, and ethnic demographics affect the markets in which they operate. The research is affordable and available, even to the smallest bank. However, community banks must be both willing and able to use this research to direct more targeted product development and marketing strategies.

Clearly, community banks must develop and target market products and services that will be purchased by an increasingly diverse demographic. By 2050,White (non-Hispanic) population in the United States will be 53.7%, down from 69.4% in 2000; and, Hispanic population will rise to 24.4%, from 12.6%. Over 21% of our population will be 65 and older, up from 12%, and 56% of that population will be females. Do your marketing and business plans reflect these changing demographics? Do you have the products to serve these constituencies?



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Community banks must pay close attention to how quickly technology is impacting the delivery systems for not only their products and services but for retailing in general. Everybody, and I mean **everybody**, underestimated the impact the Internet would have on the products and delivery systems being adopted by a wider range of customers than anybody expected.

It is true that your customers will migrate to new technology and delivery systems at different speeds. In many cases, community banks will need to invest in new technology and delivery systems as a defensive measure, not as a profit center. You must accept this and remain relevant. In fact, you need to earn that much more income to defease the cost of the technology!

So, focus on steadily increasing net income, innovate product options, and direct market to customer segments. Community banking is threatened in America. It doesn't have to be!

**-Tom Parliment**




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*Challenging Financial Paradigms*

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