LESSON FIVE

Operational Marketing 2: Pricing Policy

Objective: In the process of developing a marketing mix to reach target markets and achieve marketing goals, once an MFI has developed their products, they must determine their pricing policy. This lesson covers the three major tasks in pricing:

- Setting pricing objectives.
- Setting the base price for their products, consistent with their pricing objectives.
- Selecting which strategies, such as discounting, to employ in modifying and applying the base price.

1 PRICE

Price is the amount of money and/or other items with utility needed to acquire a product or service. Price is what you pay: tuition for receiving an education, interest for receiving a loan, rent for living in a house or using a piece of equipment, salaries or wages for employing workers.

When determining the price of a savings product, some confusion may arise about the meaning of price. Compared to typical business products, savings products are not paid for by the client, but rather by the financial institution. The income for the institution stems from intermediating deposited funds and earning a higher rate of return from their use than the costs incurred by mobilizing the funds and paying interest to the depositors.

Practical problems can arise when trying to simply state the price of a product, as demonstrated by the example below.

Suppose you paid $275 for a desk, but your neighbor only paid $190 for one of similar size and quality. At first glance, it looks like your neighbor got a better deal. Your desk - which has a beautiful finish - was delivered to your apartment on the third floor, and you had a year to pay for it. Your neighbor, a do-it-yourself person, bought a partially assembled, unfinished desk. He had to assemble, stain and varnish it. The seller provided neither delivery nor credit. Now who paid the higher price? The answer is not as easy as it first appeared.

The definition of price depends on exactly what is being sold. Price is a combination of:

- The good or service that is the object of the transaction;
- Any supplementary services provided, such as a warranty; and,
- The benefits provided by the product, which may include non-monetary benefits.
For example, to determine the price of a fixed deposit account, the interest rate must be known. Price will differ, however, depending on whether the customer earns interest yearly or at the end of the term.

It is also important to consider other variables when calculating price. For example, one MFI may offer slightly higher interest on their savings products than their competitors, while another may have better service and a larger branch network. When a customer considers the overall price of the product, transaction costs, such as their convenience in getting to the nearest sales point to carry out transactions, must be considered.

2 PRICING OBJECTIVES

Every marketing activity - including pricing - should be directed toward a specific goal. Few financial institutions consciously establish or explicitly state their pricing objective; doing so, however, will help management to remain focused through all aspects of their marketing program. Management should thus specify pricing objectives before determining the actual price of their products.

Pricing objectives should be compatible with the overall strategic plan and strategic marketing goals of an MFI. If a company's strategic goal is to increase return on investment from its present level of 15% to 20% within 3 years, the pricing objective for the period must be directly linked to achieving the specified return on investment. It would not be logical for the MFI to adopt a pricing objective of maintaining their market share or stabilizing prices.

Pricing objectives can be oriented toward profit, sales or maintaining the status quo.

a. Profit Objectives. Profit objectives may be short-term or long-term. An MFI may select one of two profit-oriented objectives for its pricing policy: to achieve a target return or to maximize profits.

- **Target Return.** An MFI may price its products to achieve a target return - a specified percentage return on its sales and investments. Retailers, wholesalers and MFIs can use a target return on sales as a short-term pricing objective. For example, the Construction & Business Bank in Ethiopia set the profit objective of increasing their return on assets from 1.33% in 1999 to 1.41% in 2000. KPOSB set the profit objective of increasing their return on net assets to 25% by the end of 2000.

  Financial institutions frequently select a target return based on inter-bank rates. For example, an MFI can set their interest for a term deposit at 0.75% below the inter-bank rate for the same time period. In this case, the MFI adds a markup to cover the anticipated cost associated with the product and to provide the desired target return for the period.

- **Maximize Profits.** The pricing objective of making as much profit as possible is used more than any other objective. To some, however, profit maximization has an ugly connotation that suggests profiteering, high prices or a monopoly. Theoretically, if profits are high in an industry due to limited supply, new capital will flow in to increase production capacity, which will increase supply and eventually reduce profits to normal levels.

  A profit-maximization objective is likely to be more beneficial to a company if it is pursued over a long time period. This may require, however, that the company accept modest profits or even losses over the short term. This would be true, for example, if an MFI entered a new regional market or introduced a new savings


product with high interest rates to attract a large number of new clients. If the new client group purchases additional products, such as loans or insurance products, the MFI will maximize its profits in the long run.

b. **Sales Objectives.** The management of some companies focuses pricing on sales volume. The pricing objective in these cases would be to increase sales volume or to maintain or increase market share.

- **Sales Volume.** The pricing objective of increasing sales volume is typically adopted to achieve rapid growth or to discourage competitors from entering the market. The objective is usually stated as a percentage increase in sales volume over a given period. For example, CERUDEB in Uganda set the sales objective of increasing deposits by 25% in 2000. KPOSB set monthly sales targets for each of their products to meet their objective of increasing sales volume in 2000. FUCAC in Uruguay set the sales goal of increasing deposits by 20% in 2000. An MFI may try to achieve higher sales volume by discounting (section 3.2.3) or by using another aggressive pricing strategy.

- **Market Share.** Both large and small companies pursue the pricing objective of maintaining or increasing their market share. Market share is sometimes protected or pursued due to excess capacity. In such a case, a company may decide that increasing their market share will increase their sales, which will help them achieve economies of scale and increase profits.

c. **Status quo Objectives.** The pricing objectives of stabilizing prices and matching the competition are the least aggressive pricing objectives and are intended to maintain the status quo. An MFI may select a status-quo objective to avoid price competition. If administrative costs rise, the MFI may need to increase their prices to maintain their profitability.

### 3 BASE PRICE

Once an MFI has determined its pricing objective, it can move on to the heart of pricing policy: determining the base price of their products. In general business, the base price, or list price, refers to the price of one unit of the product at its point of production. In financial services, the base price is the price of one unit of the product or service at the point of sale. The base price does not reflect modifications such as discounts, which are explained in the next section.

MFIs must consider a number of factors when determining their base prices. Several of these are highlighted below.

a. **Estimated Demand.** In order to determine the base price of a product, an MFI must estimate the total demand for the product by:

- Determining if a certain price is expected by the market; and
- Estimating the sales volume at different price levels.

The expected price of a product is the price at which customers value it - what they think the product is worth. Expected price is normally expressed as a range of prices rather than as an exact figure. The expected price for a savings account would be expressed using a range of interest rates, such as ‘between 3.5% and 4.25%’ or ‘under 1.5%’.

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1 MicroSave Africa has developed a toolkit on *Costing and Pricing of Financial Services* which provides orientation on determining base prices (MicroSave 1999).
It is possible to set a base price too low. If the price is much lower than the market expects, sales could be lost. For example, it could be a mistake for a bank that exclusively serves high-income populations to set the price for their credit card below the price set by an MFI serving the poor. When the image of an institution and the price of their product differ significantly, customers may be suspicious and decide not to purchase that product. However, if the first bank mentioned decides to change their image to being “the bank for everybody,” offering a low-priced credit card could attract new customers. When a financial institution decides to change its image, bank staff must accept the new clients targeted and make them feel appreciated, or the new clients will not remain with the bank.

b. Competitive Reactions. Competition greatly influences base price. A new product remains distinct only until the inevitable arrival of competition. The threat of potential competition is greatest when the marketplace is easy to enter and profit prospects are encouraging, which is the case for financial services. Each branch of Lhala in South Africa checks the prices of their competitors on a monthly basis to ensure that they remain competitive. Competition can come from the following sources:

- Similar products: one savings account versus another savings account;
- Available substitutes: municipal bonds versus a savings account; and,
- Unrelated products seeking the same funds of the customer: purchase of consumer goods versus a savings account.

c. Other Marketing-Mix Elements. A product’s base price is also influenced by the other elements of the marketing mix.

- **Product.** It is easier to estimate demand for an established product than for a new one. Over the course of a product’s life cycle, price changes are necessary to keep the product competitive.

- **Distribution.** Distribution channels and agents influence pricing. An institution selling through both wholesalers and retailers often sets a different price for the two classes of customers.

- **Promotion.** The extent to which a product is promoted and the methods used affect their price. For example, clients in rural areas are more dispersed, which makes promotion in rural areas more expensive than in urban areas, which affects price.

d. Product Costs. Determining the base price is also directly related to actual costs. A product’s total unit cost is made up of various cost categories.

- **Fixed costs**, such as rent, salaries, insurance, and property tax, remain constant regardless of the number or volume of deposits. Such costs are called ‘fixed’ because it is difficult to change them in the short run. The figure ‘total fixed cost’ is the sum of all fixed costs. Average fixed cost is the total fixed cost divided by the number of accounts sold. For example, in order to launch a new type of savings account, an MFI may need to purchase new computer software to manage account information. The software costs $5,000, which is a fixed cost. If the strategic plan envisions 5,000 savings accounts before a software upgrade is needed, the average fixed cost for the software is $1 per savings account.
Variable costs, such as labor or materials, are directly related to sales volume. For example, to open a savings account in a branch office, an MFI must transfer information and materials, such as savings passbooks, between the branch office and headquarters. The cost of transferring the information is directly dependent on the number of accounts opened. Total variable cost is the sum of all variable costs and increases as sales increase. Average variable cost is the total variable cost divided by the number of accounts sold. Average variable cost is usually high for the first few accounts sold, but decreases as sales increase, due to quantity discounts on printing materials and increased administrative efficiency.

Total cost is the sum of total fixed cost and total variable cost for a specific sales volume. Average total cost is total cost divided by number of accounts sold. Marginal cost is the cost of administering and selling one more account. The marginal cost of the last account is normally equal to that account's variable cost.

Through a cost analysis of their Partner Savings Plan, Union Bank in Jamaica discovered that the initial interest rates they offered were too high for them to make a profit relative to the total cost of the product. In response, Union Bank revised the base price of the savings plan, based on the actual product costs, significantly reducing the interest rate of the product.

Following the reduction, the number of accounts actually increased. This phenomenon demonstrated that the clients were relatively insensitive to the interest rate offered; which could be explained by the fact that the informal instrument that the savings plan was modeled on offered no interest to depositors. The acceptance of the revised product also demonstrated the appropriateness of the revised base price and the attractiveness of the product to the target market.

e. Cost-plus Pricing. Most business firms determine their base prices using one of the following methods:

- Prices are based on total cost plus a desired profit (break-even analysis is a variation of this method);
- Prices are based on marginal analysis - a consideration of both market demand and supply; or,
- Prices are based on competitive market conditions.

Financial institutions often determine prices based on the competition and reference interest rates. The Construction & Business Bank in Ethiopia, for example, follows the price structure of the leading bank in Ethiopia -- the Commercial Bank of Ethiopia -- for all of its savings products. Because costs vary across institutions, this pricing method can have limitations.

f. Break-even Analysis. One way to consider both market demand and costs when determining base prices is to use break-even analysis to calculate break-even points. A break-even point is the quantity of sales at which total revenue equals total cost, for each given selling price. Sales exceeding the break-even point result in a profit for each additional sale. The higher the sales, the higher the total and unit profits. Sales below the break-even point result in a loss.
4 PRICING STRATEGIES

When an MFI is preparing to enter the market with a new product, management must decide on which pricing strategy to adopt.

a. **Market Skimming.** Setting a price that is high in relation to the target market's range of expected prices is referred to as market skimming. The price is set at the highest possible level at which interested customers will purchase the new product. Market skimming is often used to price new products with high development costs. Over time, the initial price may be lowered. If competition in an MFI's area of activity is very limited, a market-skimming strategy may be applied.

b. **Market Penetration.** Setting a price that is low in relation to the target market's range of expected prices is referred to as market penetration. The primary goal of this strategy is to penetrate the market immediately and thereby generate substantial sales volume and significant market share. A market-penetration strategy can also be intended to discourage others from introducing competing products.

Market-penetration pricing is most commonly employed under the following conditions:

- A large market exists for the product;
- Fierce competition already exists in the market for this product, or can be expected to materialize soon;
- Substantial economies of scale can be achieved through high sales; and,
- Demand is highly price-sensitive, as typical in the later stages of a product's life cycle.

An MFI may decide to employ a market penetration strategy to introduce savings accounts for children with the goal of developing loyal, long-term customers. The MFI would thereby offer children attractive, high interest rates for small deposits. A pioneer in this strategy may profit considerably, if the long-term loyal customer base materializes.

c. **Special Pricing Strategies.** Early in its deliberations on pricing, an MFI should decide whether it will adopt either of the following price strategies.

- **One-price strategy.** Setting the same price for all similar customers that purchase a given quantity of a product.

- **Flexible- or variable-price strategy.** Similar customers may pay different prices to purchase identical quantities of a product. Flexible pricing is sometimes used to enter new markets, to increase market share, or to match a competitor's price in order to retain clients. The decision to match a competitor's price can be an isolated case or applied only in a specific geographic market or customer target group to counteract a specific competitor.

d. **Discounts** result in a price deduction from the base price. MFIs can offer discounts in the form of an increased interest rate or another concession, such as a rebate or giveaway.

- **Quantity Discounts.** Quantity discounts are price deductions from the base price that are intended to encourage customers to deposit larger amounts or buy additional services. Discounts are based on the size of the purchase, either in
amount deposited or number of purchases. All tiered interest rate structures are a
form of quantity discount. Tiered interest rate structures reflect the differing
sensitivity of clients to interest rates as well as the lower average costs of
maintaining accounts with higher deposit volumes. For example, if a customer
deposits a large sum of money for six months, an MFI may offer to increase the
interest rate on the deposit from 4.5% to 5.0%.

➢ **Trade Discounts.** Trade, or functional, discounts, are offered to wholesalers or
customers for performing marketing functions. MFIs sometimes offer trade
discounts to distribution agents, such as post office branches.

➢ **Cash Discounts.** A cash discount is a price deduction granted to customers for
paying early. For example, an MFI may introduce a contractual savings account
with regular monthly deposits. If a customer deposits the monthly payment prior
to the due date, the MFI may offer an interest rate mark up.

5 **PRICING EXAMPLES FROM THE FIELD**

i. The overall pricing objective of **BURO, Tangail** in Bangladesh is to cover all of their
costs while remaining competitive. BT conducts costing and pricing forecasts of new
products during the design phase. During and following pilot testing, branch staff,
senior headquarters staff and member consultative groups provide feedback on all
areas of product design and BT makes necessary adjustments in design, the costing
analysis and product pricing.

BURO, Tangail carries out cost accounting activities to define the base price of their
savings products. BT considers estimated market demand and the interest rate
structure of their competitors the two most important factors when setting their base
prices.

ii. In order to determine the price of their savings products, **KPOSB** in Kenya conducts
market research that includes pricing aspects. Once products have been launched,
KPOSB tracks product costs for each product every two months through its profit
center.

In order to determine the base price for each product, KPOSB considers the following,
in order of priority:

➢ Direct costs associated with the product;
➢ Promotional costs;
➢ Estimated market demand;
➢ Competition;
➢ Distribution channels;
➢ Desired profit.

KPOSB assigns product managers to each of their products to ensure that their price
objectives are achieved.

iii. **BAAC** in Thailand introduced profit centers at its branches in 1994 and closely tracks
branch performance. BAAC management uses productivity and profit targets to award
salary bonuses and promotions. More detailed cost calculations were carried out on
the *Multiple Fortune* savings product in 1996. These calculations found that the
overall cost of mobilizing the funds for the product were slightly lower than the
average cost of funds for the fiscal year.