GrowthCap
*Building SME-focused capacity*

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PROJECT TECHNICAL NOTE

# PRICING AND COSTING SME PRODUCTS AND SERVICES


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## INTRODUCTION

While it would seem that pricing and costing are closely related, in practical terms in a financial institution these may be considered separately. Product pricing, particularly loan pricing, is typically a mixture of risk assessment, establishing funding and operational costs, combined with a good eye to how the competition is pricing the same services. Banks and other financial institutions (collectively FIs) rarely look to compete head to head on pricing. Instead they tend to try to be "in the middle" of the competitive offers, and look to compete on other points, particularly quality of service, turnaround time, and location. Competing banks will typically have similar cost structures, but pricing strategies may vary.

Costing, on the other hand, is a technical area that assigns costs to a product or activity. The more accurately it can be done the more expenses can be managed, and decisions about allocation of resources can be more informed.

This Technical Note looks at the factors that determine the pricing and costing of financial products and services for SMEs and the particular issues and challenges faced in doing so for this client group, including the fact that SME relationship profitability often derives from delivery of a bundle of products and services which are difficult to extract from each other. In Kenya the Central Bank of Kenya (CBK) also plays a role in price setting as changes may require its approval.

## About GrowthCap

Over the past few years FSDK has been at the forefront of SME banking development through conducting market assessments and studies in areas such as trade finance and SME equity funds, as well as supporting development of the credit reference bureau. Through its partnerships with its Action Research Partners (ARPs), FSDK's GrowthCap initiative is supporting adoption of SME best practices by individual financialservice providers.

This paper is part of a series of Technical Notes and Resource kits that are being developed out of work with the ARPs. These provide detailed information about the best practices and are intended for use by financial service providers and those supporting such institutions which are entering the SME market.

## Abstract


This Technical Note looks at the factors that determine the pricing and costing of financial products and services for SMEs and the particular issues and challenges faced in doing so for this client group, including the fact that SME relationship profitability often derives from delivery of a bundle of products and services which are difficult to extract from each other. In Kenya the Central Bank of Kenya (CBK) also plays a role in price setting as changes may require its approval.


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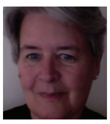

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## PRODUCT AND COSTING

Product costing is a complicated subject which depends on access to good financial information and a good understanding of the costs of delivering a service. The starting point for product costing is to go to the numbers, and to understand the costs that need to be covered. One way of tackling this is to categorise costs as follows:

- Funding Cost – if applicable
- Service Cost – direct costs of providing the product
- Capital Cost – indirect, overhead costs; opportunity costs

### 2.1 KEY COST AREAS

**Funding Cost** is only applicable for loans, i.e., funded products, which represent cost of funds on-lent. Cost of funds will include the blended cost of deposits, both current accounts and time deposits, also interest paid on borrowing for on-lending, both for longer term wholesale lines of credit and for short term advances. Funding cost also includes reserve requirement costs for deposits.

The usual approach to funding cost is to establish a central treasury that "sells" funding through a transfer price mechanism to the department or branch that is making a loan and needs it funded. In turn the central treasury "buys" funding from offices that generate deposits. For example, a branch that collects deposits is paid at that same rate that funding "costs" a branch that is making a loan. This is a way of measuring the benefit of receiving deposits, which are liabilities and a cost for the financial institution. Alternatively a branch may fund its own loans, and then sell or buy excess funding to or from a central source. Even so all branches should be using the same rates in calculations and use the same pricing structures. While there is some benefit of allowing branches or departments to operate independently one branch should not be allowed to undercut another branch on price.

Deposits are generally considered the most stable source of funding. The funding mechanism described above assumes that all funding is fungible, i.e., that funding comes into a single pot, and then is distributed as needed to fund loans. The exception to this approach is to have dedicated lines of credit that are restricted to specific use, such as donor lines of credit to FIs that are tagged for specified uses such as small scale agriculture or women-led SMEs.

**Service Cost** is the cost of selling the product and managing it. This is the most complicated for loans, as it will include calling on prospects, loan analysis and approval, and subsequent loan monitoring. This category would also include potential loan losses and collection costs.

Service costs are mostly made up of salaries, particularly of the cost of the relationship manager and other employees who directly serve the customer. While these costs are considered fixed in the short term for the FI, in the longer run they are variable, i.e. are only incurred because the service is delivered. For example, a bank will determine the number of relationship managers that it needs based on its current and projected customer book. If new customer relationships are not created the bank will cut back on the relationship manager positions. The same is true of branches, in that if a branch location is not productive enough it will be moved or closed (barring regulatory requirements).

**Capital Cost** for this discussion comprises the costs of running the bank and the profit that the bank wants to realise, its return on capital. These are fixed costs that are incurred whether or not individual products are sold, or at least for a given sales range. Examples of this type of cost include SME department management, the HR department, head office rental costs, and the IT/MIS system maintenance.

## 2.2 ALLOCATION AND ACTIVITY-BASED COSTING

While the funding, service (direct), and capital (indirect) cost concept is important, major issues arise in assigning costs to particular products or activities, even for FIs with a limited number of products and staff. The two methods for further assigning costs are allocation and activity-based costing. These are useful for determining a cost basis for a product to feed into a pricing decision, but in fact are more important in generating information to determine efficiencies and cost-benefit tradeoffs.

Allocation Based Costing consists of allocating all costs to particular products. The funding costs are straightforward, as are the costs associated with dedicated departments (e.g. foreign trade transactions). Thereafter, however, the allocation becomes more complicated. The most difficult part of this is deciding how staff time should be allocated. This is generally done by asking staff to keep timesheets in order to understand how much time is devoted to generating or servicing particular products. Other bases for allocating costs, and examples of when these might be applied, are:

- **Number of transactions performed** – allocation of IT/MIS costs, branch operating expenses (rent, utilities, supplies)
- **Number of accounts** – allocation of support office expenses
- **Size of the portfolio** – executive salaries, general marketing costs, human resources
- **Staff time** – for expenses directly associated with staff such as transportation and communications, costs may be allocated on the same basis as staff time is allocated (e.g., if a relationship manager (RM) spends 50% of time on loans, 50% of transportation and communications costs are assigned to loans).

The allocation assignments will vary by bank, and will depend on the financial institution's assessment of how to assign costs and its capacity to collect relevant financial information.

The advantages of allocation based costing are that it uses the same expense breakdowns as typically found on income statements, and is relatively easy to apply. The wider the product range, however, the less accurate it becomes, and products with a large portfolio volume or number of accounts may be assigned relatively more overhead costs than appropriate. This is a particular concern when an FI has too wide a range of products that require separate management.

Activity Based Costing (ABC) provides more in-depth information about costs than allocation based costing, but accordingly is more complicated and expensive to implement. ABC ultimately will assign costs to particular products, but will first assign these to particular activities or processes.

ABC will look at the time devoted to particular processes, and assign costs to the processes and then later assign these to particular products. For instance, a Relationship Manager's time might be devoted to processes as follows:

- Calling on existing and prospective customers
- Analysing loan requests, securing approvals
- Handling customer transactions
- Overhead/internal meeting/administrative time

These processes would then be fed into product costs – analysing loan requests and securing approvals would be a direct cost for loans; handling customer transactions would be a direct cost for all products handled, as would calling on existing and prospective customers; administrative time would be an indirect cost. What is particularly useful about the ABC approach, however, is that the component costs of products can be better understood and managed. The efficiencies and cost savings from addressing turnaround time in loan approvals, for instance, could only come from a good understanding of the process of analysing loan requests and securing approvals.

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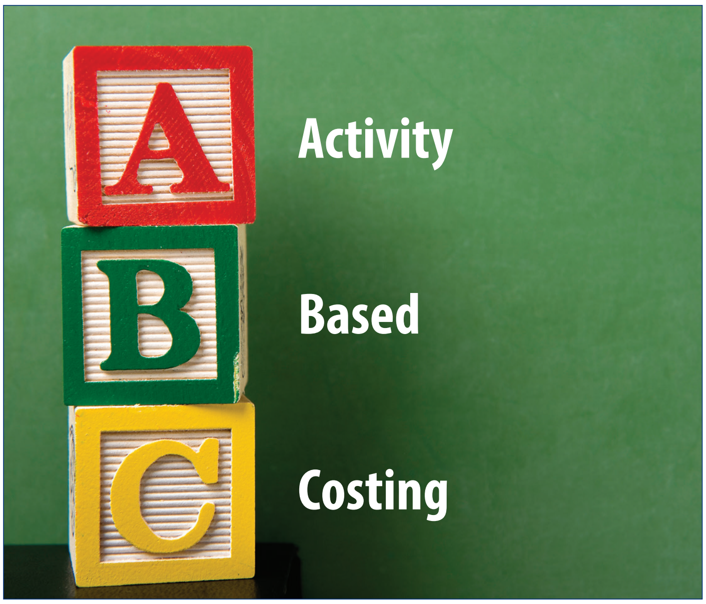


ABC is arguably more useful for time and expenses management than it is for input into product pricing, although it can be particularly useful in understanding how staff time is used and needed, for instance, if a new product is to be introduced or a product is to be eliminated. Since much of the key to SME banking is to provide standardised, cost-controlled products, ABC can help an FI to understand where its costs are incurred so that these can be managed more effectively.

### Allocation vs activity based costing

The decision on whether to do allocation or activity-based costing depends on a number of factors. Both are subjective, and are not perfect ways to determine cost, but can create good estimates. Allocation based costing is quicker and simpler, and tends to follow the income statement. A disadvantage is that a lot of costs are based on product volumes, so a small group of products may be assigned virtually all the overhead costs, even if new products and diverse products may take up more management and support time.

Activity based costing is more complex, helps the bank to understand how costs are incurred and better understand the business process; it looks at how time and resources are spent, particularly understanding the processes and requirements of the activity, thus provides a better understanding of how the activity or process could be changed, steps reduced, and costs saved. Work done on reducing turnaround time in SME lending is an excellent example of this. While the costs allocated to lending would be higher than costs allocated to opening deposit accounts, only activity based costing informs how the lending process time could be reduced and costs thereby cut. Even if an FI opts to use allocation based costing, however, it is clear that additional information about the loan process (and other product delivery processes) will be derived from the type of close attention that comes from an activity based approach.

Costing can be a one-off special study for an FI, or can be an on-going activity. The latter is typically handled by the treasury department, although information will come from MIS and from the operating departments.

## KEY COMPONENTS OF PRICING

From the above discussion it is clear that there is a need to cover the cost of providing the service in product pricing, at least in the long run. Therefore, a simple form of pricing may be done as a markup over cost. However pricing is influenced by a range of factors in addition to costs.

### 3.1 COMPETITION

No matter how sophisticated an FI's costing calculations, it will always consider what its competitors are charging for the same or similar products when pricing their products.

Collecting information on competitors' pricing, however, is not as straightforward as it sounds – while a financial institution should be tracking selected close competitors' advertising and web information, pricing is affected by product bundling, discounts and concessions given, and somewhat different terms on products (e.g. early withdrawal policies, transaction fees).

FIs find it difficult to determine exactly how their competition is pricing products. There are services that track interest rates on deposits, but these tend to be more applicable to retail products for which no flexibility is allowed. Mystery shopping is possible, but this is done more to gauge quality than to determine product terms and pricing. Some banks find that their best source of information is anecdotal, from customers who deal with more than one bank, which suggests that the FI should develop a methodology to systematically collect this type of information.

Regulatory changes may also play a role. In Kenya, MFIs entering Central Bank regulatory oversight are allowed to collect deposits and thus can afford to adjust loan pricing downwards and compete with Banks on account of lower cost of funds.

Banks that have historically had high non-performing loan percentages and high losses arising from debt write offs will become more expensive than those that are more disciplined and which do not lose money in lending. FIs that carry a bloated cost of administration or which do not switch to more efficient methods of service and product delivery will generally reflect a narrowing of options when faced with a cost competition.

### 3.2 OTHER FACTORS

This is a mixed bag that may or may not be applicable to a FI or a product. Factors may include:

- **Location** – the only service provider in a remote location will not need to be as responsive to competition. Interest rates on time deposits, for example, may be lower in rural locations than in cities.
- **Newness /distinctive characteristics of a product** – for some time period a FI can get a premium price for these (compared to spreads earned over cost on more conventional products). Over time these differences will tend to disappear. For example, MFI loan rates have historically been considerably higher than those of commercial banks, and as MFIs have gone up-market to service small businesses and banks have gone down-market to serve the same or similar clients, pricing adjustments have been needed to meet the new competition. Some banks are able to make a case that their service levels are higher than their competition.


**Products ahead of the market: For some time period a FI can get a premium price for these (compared to spreads earned over cost on more conventional products)**

Other distinctive cases that occur in pricing that may cause a financial institution to price a product such that it does not cover costs, or does not provide a desired level of profit, are volume and introduction of a new delivery channel.

- **Volume targets.** An FI may have volume targets to capture market share, or may be seeking volume for capacity utilisation.
- **New delivery channel.** A delivery channel that is very new may be priced low or even provided for free to encourage use. Internet banking, for instance, is generally offered to SMEs in Kenya for free. If this does take off as a popular delivery channel the benefits to the FI may be realised in the lower cost of service delivery more so than in price per se.
- **Sticky and specialised products.** There are products that may be priced below cost or target profit margin levels because of ancillary benefits to the bank of maintaining these products for an SME customer.

Both current accounts and payroll services are often offered at a discount because they are "sticky" products, such that the SME is unlikely to move a banking relationship away from the


bank that provides these services because of the difficulty to the business and its customers and employees of uprooting the service. Conversely, an SME is likely to accept a relatively higher price on services that are not used frequently or that cannot be sourced from another bank on a one-off basis, such as transfers, wires, and foreign currency transaction rates and fees.

A big key to pricing is that product bundles and special offers should be planned out in advance, not simply offered as defensive measures to try to retain a customer. The greatest success is achieved with pro-active planning and testing, not by reactively making concessions. This is a major challenge for most banks because SME customers are becoming aggressive and knowledgeable.

## 3.3 RISK-BASED PRICING

The advent of credit scoring has introduced risk-based pricing as a part of the scoring process. As the scoring system ranks loan applications into buckets over a risk range, it can also be used to apply an interest rate to all approvals in a single bucket. Rather than suggesting absolute rates the scoring system will be calibrated to a base rate, so that the least risky loan is priced at a small spread over a chosen base such as KBRR, the CBK reference rate. For banks that rely exclusively on scoring systems (e.g., western banks that take internet-based applications) this will be the last word on pricing. For most SME-oriented banks, however, the pricing generated by the scoring system is more likely to be a starting price, also affected by other income from the relationship and competitive forces.

The banks in Kenya that use scoring do not use it for pricing loans, although they may be using degrees of risk as measured by the scoring as a way to rate the loans for loan loss reserve purposes. For common loan purposes, e.g. mortgages and vehicle loans, Kenyan banks tend to quote a single rate as might be obtained from a branch quote or a website. This approach is common because the loan purpose is so standardised, and clients are likely to compare one bank to another when seeking this type of loan. Having said this, for the best SME customers a bank may be willing to cut rates somewhat.

### Changing Prices

How can a pricing formula be changed? Assuming that a bank charges a set amount or percentage over its costs, the key to lowering pricing, or increasing the spread, is to lower costs, particularly direct delivery costs. In SME loan pricing, costs have been brought down through simplification of credit procedures, particularly through the introduction of credit scoring, and through better risk assessment. The potential for greater profit on loans and customer relationships should encourage FIs pursuing an SME banking strategy to do the following:

- Revise approval procedures to be right-sized for SME customers – more analysis and vetting may just be costing money, once a reasonable decision has been reached.
- Bundle products and build cross-sales so that outreach costs result in the sales of several products; customers are also less likely to leave the bank.
- Use less expensive delivery channels such as prepaid cards, mobile banking, agency banking, and internet banking.

Pricing may also be affected by government actions such as taxation and incentives.

A major issue in Kenya in recent years has been transparency in credit costs, which has been addressed by the introduction of KBRR + K, the Kenya Banks Reference Rate + the premium charged on various types of loans by different banks. The KBRR is a base rate, which is the average of the Central Bank Rate (CBR) and the two month weighted moving average of the 91 day Treasury bill rate. The KBRR was first established in July 2014, and all loans after that date are to be priced at KBRR + K. By the end of June 2015 all existing facilities will be migrated to this pricing. The KBRR is revised every six months by the Central Bank of Kenya. In the future the CBK plans to publish comparative data on the "K" or premium charged by different banks on various loan products, to increase the transparency in pricing.

In addition to using KBRR+K as a lending price, banks are required to inform customers of the Total Cost of Credit, TCC, the sum of all interest payments, fees, and charges on a loan contract. The TCC is then used by the bank to disclose the Annual Percentage Rate, APR, on the loan. The APR can be used to compare loan offers .

## WHO GETS THE PROFIT?

The discussion of costing and pricing has assumed that the FI is even-handedly trying to determine the costs of delivering services and running departments, and that profit can be attributed different ways, e.g. to an RM or to a branch. In reality however, cross-selling of SME products is often dependent upon another department performing, and this is where FIs find they have problems. Their allocation of costs, prices, and profits among different departments is not good. Other challenges arise in revenue leakage due to wrong mapping of products in the system, also errors and reversals.

While issues of this type are not likely to be fully resolved, there are ways that pricing and costing information can be used to reward staff and departmental performance appropriately. For instance, if deposit accounts are usually opened by a branch rather than by the associated RM, then recognition for the branch's work could come several ways:

- Cost of opening the account could be charged to the RM and "earned", as a transfer price, by the branch.
- Some accounts could be coded to the branch and not to the RM (e.g. SME accounts and owner's account could be coded to the RM, and any family or other personal accounts coded to the branch).
- Accounts could be considered co-owned and each receives 50% credit for the account balances (transfer pricing income).
- Double count profit (and costs) for the purposes of employee and office evaluation.

Clearly the FI wants to have its employees and departments cooperate so the key is to properly incentivise them to do this. Just as SME departments realised that to have RMs who would sell/cross-sell a full line of products called for KPIs to cover more than loan portfolio growth and performance, so should KPIs be expanded to cover all types of work that the bank expects from its staff and offices.

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