Econ 466
Spring, 2010
Group Project 1
Plausible answers

Two agricultural lenders, A and B, compete for farm loans in a trade area that is served by approximately six financial institutions. Lender A focuses on cost-reducing innovations – computerization, very limited investment in buildings and other hard assets and well-trained loan officers who are capable of handling large numbers of borrowers using complex analytical techniques. Lender B, on the other hand, focuses on new product and service innovations, convenient business locations and versatile loan officers capable of providing a broad set of financial services. Both lenders are profitable and successful. Lender A continues to expand its market share whereas Lender B continues to maintain its market share and increase its profit margin.

1) **What can you infer about the demand for agricultural credit in this market?**

   The critical issue underlying the two banks' strategic choice is the extent of horizontal differentiation in firm level demand facing each bank. Bank A is pursuing a cost strategy and Bank B is pursuing a benefit strategy. Since both banks are successful it would appear that they are operating in distinct markets – one with a low level of horizontal differentiation (Bank A) and one with a high level of horizontal differentiation (Bank B).

2) **What pricing strategy would you recommend for the two firms? Explain why your proposal would work.**

   Bank A has, apparently, identified a market segment that views credit as a commodity. This group of borrowers would be quite price sensitive. Therefore Bank A should try to exploit its cost reducing technologies by cutting interest rates and growing market share. Bank B is operating in a market with a high level of horizontal differentiation – borrowers who value service, convenience and a variety of loan and investment products. This market segment is not very interest rate sensitive. Consequently Bank B can extract a premium for the benefits without losing market share and, in the process, it would increase its margin (or interest rate spread).

3) **Are the two firms competitors? Why or why not?**

   Not really. Because there are two relatively distinct market segments, the banks are likely competing against other lenders pursuing similar cost or benefit-based strategies. However, horizontal differentiation is not an absolute concept. As a consequence there would be consumers, who at the margin, might shift from A to B or vice versa depending on the mix of price and benefits offered.