How Much Does Marketing Matter to Bank Performance?

Donald J. Mullineaux

Banks spend billions of dollars on marketing annually, but few bank managers, including the heads of marketing departments, can answer this question with any degree of confidence: What kind of returns are we getting on our advertising and promotion expenditures? Banks typically also spend significant sums on building new branches. What is the payoff to these investments and is spending to build new facilities more or less effective than using the same sum to promote the bank's products and services? Again, most bank managers would find it hard to provide evidence-based replies. My goal is to provide some answers to these questions based on a paper I recently published in *The Journal of Financial Economic Policy* with Mark Pyles of the College of Charleston, called "Bank Marketing Investments and Bank Performance."

The good news is that, for the typical bank, spending on advertising and promotion "works." So does building new branches. To answer the question "how well does it work," we estimated what economists call a "profit function," using data on advertising and promotion spending and on the scale of branch network as "factors of production." The results produce an estimate of the quantitative impact of each type of marketing strategy on bank income after tax, at the margin. As required by economic theory, we also considered the role of other factors, such as the prices of other inputs (such as employee expense and the cost of funds) and the prices of bank output. The data come from bank Call Reports and covered the period 2002-2006. Any bank or thrift organization spending more than one percent of its total revenues on advertising appears in our sample.

The data reveal that advertising spending per bank rose almost 5 percent a year over this period, whereas the number of branches rose much more slowly and actually declined in 2006 from 2005. There were sizeable differences in advertising and promotion expense and in the scale of branch networks among banks of different size. Banks with assets in excess of $10 billion spent an average of $153 million annually on advertising over the sample period versus $3.6 million for institutions in the $1-10 billion size group. The average bank in the largest group spends about 43 times more than the average institution in the $1-10 billion class, despite being "only" 22 times as large in terms of assets. But there is also considerable variation within group. The maximum annual promotion expenditure over the sample period by any single institution with over $10 billion in assets was $2.1 billion while the minimum was $4.2 million. Bank executives clearly have strongly divergent views on the "power of marketing"!

When we looked across four size classes (using the regulatory classifications of assets less than $100 million, $100 million to $1 billion, $1-$10 billion, and over $10 billion), we found that, for banks in the first 3 groups, advertising spending averaged about 0.12% percent of assets. For the largest banks, the same ratio was almost 3 times as high. When examined as a percentage of total expenses, promotion spending averaged about 3% for the community bank segment (assets less than a $1 billion), but increased to almost 4 percent for banks in the $1-$10 billion range, and to about 6% for banks above $10 billion. But these very large institutions are the ones most likely to hire global advertising firms, spend in the national media, and pursue expensive naming rights for stadiums.

A key question, of course, is how investing in advertising and promotion affects profits. We found that, on average, a 10% increase in such spending generates about a 2.5% gain in operating income. But the impact varies by size of bank. The returns to marketing in the form of advertising increase with bank size. The same 10% increase in promotion spending yields a 3% increase in profits at banks above $1 billion in assets. Promotion spending thus exhibits what economists call "increasing returns to scale."

Building a new branch is also a form of marketing expenditure. The average number of branches over the sample period varies from almost 2 for banks with assets less than $100 million to just over 200 for those with assets above $10 billion. We found that expanding the branch network by 10% yields an increase in operating profit of about 2 percent. But in the case of branching, the evidence indicates either constant or decreasing returns to scale. In other words, the "returns" to branching do not increase with bank size and some of our evidence suggests they actually fall.

We also examined the impacts of advertising and promotion and branching on bank market shares of deposits. The results show that a 10% increase in promotion yields about a 7% (not percentage point) increase over the existing market share and that a 10% increase in the size of the branch net work generates a 30% increase in deposit market share. The impact of advertising on market share again increases with bank size (increasing returns to scale) but declines in the case of branching (decreasing returns to scale). In fact, for banks over $10 billion in assets, building or acquiring additional branches has no significant impact on market shares.

In sum, our evidence shows that marketing in the form of advertising and promotion or adding new branches yields beneficial outcomes, on average. Spending more on each generates higher profits and increased deposit market shares. Our results are very similar if we focus on profitability ratios rather than profits themselves. Our study has some implications for strategy. For instance, since community banks spend relatively little on marketing ($53 thousand for those with assets less than $100 million and $330 thousand for those in the $100 million to $1 billion range), it would be far less costly to increase advertising by 10% than to build a new branch. An implication for the largest banks is that branching with the goal of enhanced market share is unlikely to produce a successful outcome. Finally, as a caveat, our results reflect average outcomes and individual institutions may have results that deviate, perhaps significantly, from these averages in either direction.

Dr. Donald J. Mullineaux holds the DuPont Endowed Chair in Banking and Financial Services at the University of Kentucky's Gatton College of Business and Economics. He is a member of the board of directors of the Federal Home Loan Bank of Cincinnati and serves as Curriculum Director of the ABA's Stonier Graduate School of Banking.