

As overdraft fees recede, so too must the subsidy of free checking accounts. How can banks restructure checking for broad-based account profitability and customer appeal?

Checking: Rebuilding the Business Model in a Fee-constrained World

BY HANK ISRAEL AND SHERIEF MELEIS

If there was any remaining doubt that banks need to move quickly to reposition the checking line of business, that certainly was erased by recent Federal Reserve rulemaking. A full-blown crisis is underway that will forever change the complexion of the checking industry.

By itself, the Fed's new Regulation E could cause a stunning 50% reduction in annual overdraft fees, a revenue stream that reached \$36 billion in 2008 alone. The trigger is Reg E's requirement that customers "opt-in" to exception-handling services.

The total mix of new legislative and regulatory restrictions could eradicate up to 40% of annual checking product revenues by 2011. That is a body blow to a business line that comprises a fourth of the banking industry's market capitalization.

To address this issue, banks will need to rectify the pronounced cross-subsidies that crept into the industry with the onslaught of free checking. By eliminating account maintenance

fees in order to acquire customers, the industry created a huge swath of marginal accounts, perhaps 40% of the customer base, and imprinted an entire generation of customers with the perception that the checking product is not worth paying for.

In turn, revenue shortfalls on borderline accounts were financed by a minority of customers at two ends of the checking revenue spectrum: those who maintain high balances; and those who frequently overdraft. Though never ideal, the setup at least worked financially – but no longer.

The banking industry has three major avenues in the urgent quest to rebalance the account economics of the checking portfolio:

- ❖ One is to restructure current products and services to generally strengthen the checking business as it stands today;

- ❖ Another is to create innovative new offers that will provide additional value to customers and unlock new revenue streams; and

- ❖ Most immediately, adroit tactical responses will be needed to help the bank minimize damage to revenues and customer relationships as new laws and regulations are implemented.

In all three areas, the advantage will go to the institutions most skilled in responding to the differing needs of major customer groups. Heavy over-drafters, for example, come from all household income tiers and almost universally

AS SEEN IN

BAI Banking
Strategies

acknowledge that they are responsible for overspending their accounts and do so consciously, according to a recent national survey by Novantas and Informa Research Services. Whatever the Fed and Congress does, this group will have a continuing need for liquidity and contingency funding for payments, fueling demand for a new generation of account services.

TANGIBLE DIFFERENCES

Although banks are understandably concerned with their own financial performance, it is important to remember that customer problems generally cannot be solved by looking only through the lens of internal profitability.

Instead, initiatives need to be aligned with customer needs, attitudes and preferences, including differences between major groups. Analytical knowledge of these factors is a roadmap that banks will need in forging new directions for checking.

Looking at survey respondents, Novantas has identified six major categories of checking customers, as defined by their attitudes and usage patterns. These groups include: 1) Rewards junkies; 2) Full-service control seekers; 3) Traditionalists; 4) Self-service control seekers; 5) Predictability seekers; and 6) Runaway spenders.

Rewards Junkies (27% of accounts). These customers tend to make higher monthly deposits and carry high overall balances with the bank. They expect to avoid fees; expect rewards on their monthly card purchases; and dislike debit. They have a pretty good idea of their value to the bank and want to be treated accordingly.

Full-Service Control Seekers (22%). People in this group rank a high second place in monthly deposits and overall balances, but have very different attitudes. They have little interest in rewards and are focused on exerting hands-on control over their transactions and resources. They like debit and don't mind paying fees for services.

Traditionalists (14%). Customers in this group tend to make lower monthly deposits and just want economical service, including branch access. They avoid fees like the plague and have little interest in rewards, information and control.

Self-Service Control Seekers (15%). This customer group is more centered on card-based transactions, particularly debit (plus they are receptive to stored value), and they generally do not like to be tethered to the branch or to the

traditional checking account. They like Internet banking, information and control.

Predictability Seekers (10%). These customers keep very low balances, overdraft occasionally but not habitually, and are comfortable paying fees. They expressed the greatest willingness to use low-cost payment vehicles such as stored value cards.

Runaway Spenders (12%). People in this group often use overdraft as a stop-gap payments funding mechanism, doing so consciously and habitually. They will have ongoing needs for contingency funding and options to minimize exception fees.

RESTRUCTURING CURRENT OFFERINGS

In responding to the accelerating checking fee revenue crisis, most banks will look for opportunities to revise the terms and conditions of outstanding accounts. This is a high-stakes exercise where the wrong near-term actions can have devastating long-term consequences, in terms of customer loyalty and brand imagery.

As a general principle, research indicates that checking customers will be much more willing to consider certain behavioral changes and/or commitments, as opposed to paying higher out-of-pocket account maintenance fees. Indeed, the Novantas-Informa survey identified a variety of tradeoffs that checking customers might be prepared to accept in order to avoid monthly service fees on their accounts.

- ❖ One opportunity, for example, is based on a fee discount play to gain share of wallet, with 61% of overall survey respondents expressing a willingness to consolidate their financial services relationship with a single provider in order to avoid fees and commissions.

- ❖ In another vein, some checking customers would be at least receptive to considering various account usage minimums as a way to avoid monthly account service fees. Such options include maintaining minimum balances; using the debit card for a certain number of transactions each month; and even foregoing rewards.

“Customer problems generally cannot be solved by looking only through the lens of internal profitability.”

❖ Another encouraging finding is that many checking customers are potentially willing to limit their branch and call center usage to either reduce or avoid account maintenance fees. On a weighted average basis, 58% of respondents said they would at least consider service curtailments.

These customer proclivities are already being factored into product design, and the trend will do nothing but accelerate. The winning formula will marry rational account economics with customer-friendly options in trading off behaviors with fees.

JP Morgan Chase & Co., for example, has a free checking offer that is linked to activity requirements, i.e. free checking with direct deposit, or with five signature debit card transactions monthly. And at BBVA Compass, a design-it-yourself checking product varies the fee structure depending on the features that the customer wants.

But here again, such innovations cannot be forced and indeed can backfire if applied within the wrong segment. Rewards junkies are the most receptive to minimum balance requirements, for example, while self-service control seekers are the most receptive to minimum activity requirements.

NEEDS-BASED INNOVATIONS

Thanks to the proliferation of real-time payment information and processing, banks are poised for a new era of checking-related product innovation, focused on enhanced consumer cash management. In the emerging market, it is no longer a checking account; it is a cash management account.

This transition is a two-stage exercise that most immediately includes repackaging current offerings, followed by more creative cash management-themed packages that can be introduced to various target customer groups over time.

Five different aspects of value are being fleshed out by various innovative competitors, falling under the general headings of: 1) information; 2) control/security; 3) liquidity and payment; 4) rewards; and 5) convenience and access.

Information. Innovations in this area include services that variously provide overdraft warnings at the point of sale and analyze household spending. At *Mint.com*, for example, customers can build a summary of balances and transactions across all accounts, and use the information to analyze spending, income, balances and net worth.

Control/Security. Control-related innovations include stored value accounts and services that help to manage spending. The “Virtual Wallet” offered

by PNC Financial Services Group, for example, allows households to manage checking resources via an electronic wallet that can segregate balances for monthly spending and emergencies, and funds earmarked for long-term growth.

“In the new era of checking-related product innovation, it is no longer a checking account; it is a cash management account.”

On the security side, there is a growing consumer demand for fraud protection services, and for services that combine planning and information protection. Online estate planning services, for example, can help to guide customers through critical decisions and documentation requirements, and then provide encrypted storage for materials.

Liquidity & Payment. Here, innovations include deferred debit, which provides some of the float characteristics of the credit card, and purchase installment plans at the point of sale. At *BillMeLater.com*, for example, customers can obtain installment plan financing for merchandise purchased online.

Rewards. This is a new battleground in debit competition, with innovations seen among merchant coalitions, individual merchants, and financial services providers.

Looking internationally, the “Axess” service offered by Akbank T.A.S, based in Turkey, provides real-time rewards at the point of sale, based on behavioral criteria set by banks and merchants. The arrangement builds brand awareness for both bank and merchant while rewarding the customer based on the pattern of purchase behavior.

Convenience & Access. Innovations in this area include mobile confirmations of transactions and remote deposit service. At USAA “Deposit@Home,” for example, customers can deposit checks straight from their residences using a computer and scanner, and funds are immediately credited to accounts.

Ultimately, major institutions will need to deploy a suite of innovative offers to various key groups of checking customers. Novantas research,

for example, suggests that segment receptivity ranged from 2% to 49% on rewards; 1% to 15% on overdraft text alerts; and from 2% to 20% on stored value payments.

TACTICAL ADAPTATIONS

In many cases, banks will have significant opportunities to mitigate the impact of various new laws and regulations, depending on how well they master the intricacies of new rules and requirements while maintaining a rapport with customers. This will necessitate a review of key considerations and practices, including:

Addressing the requirements of the regulation – Banks must understand the regulation and their core deposit processes intimately before taking action. Some institutions will be able to minimize the impact by conforming to certain provisions or exceptions, thereby avoiding significant effort and compliance risk. Others will need to look deeply inside the institution to revise core processes, procedures and customer communications.

Account opening risk reviews – Many institutions use vendor-supplied automated systems to evaluate new account applications. In many cases these filters will need to be tightened, given the lessened maneuverability in dealing with overdrafts and the pressing need to improve overall checking economics by limiting the influx of marginal accounts.

Overdraft decision logic – Many banks rely on rudimentary analytics to authorize or decline transactions in real-time (authorized transactions) or batch (checks and ACH debits). The new regulatory environment will require more precise decisions to avoid increased portfolio losses.

Communications strategy – Should the bank choose to continue authorizing Regulation E transactions into negative funds, a process for managing “opt-ins” will be needed, along with a communications strategy to maximize customer awareness of the fact that they must opt-in in order for the bank to continue to authorize transactions.

Ancillary impact – Overdraft has evolved over the past 20 years and has become an ingrained aspect of deposit processing. Banks need to review their processes and understand the second- and third-order effects that changes will have on item processing, returns, customer service and debit card functionality. They also will need procedures to honor each customer’s choice to “opt-in.”

A QUESTION OF STRATEGY

Before diving into the many details that are involved in restructuring the checking business, each bank needs to first step back and consider competitive strategy relative to its position in the industry. Does the bank want to be a “first mover” or a “fast follower”? Should it concentrate on restructuring current offerings, or innovate to take market share?

Generally in times of great change, institutions with dominant market share are more able to concentrate on revising current offerings, while hungry mid-size players often try to gain share through innovation. Smaller players, meanwhile, often try to emulate leading developments as they gain traction in the market.

Looking inside the organization, a number of key attributes and skills will be required for success in the new checking environment, including:

- ❖ Upgraded product management capabilities, more in line with what is seen in the non-financial retail industries, where skilled brand managers play an important role in aligning offerings with customer needs and perceptions.

- ❖ An innovation incubator with all the staffing, processes and discipline needed to support continuous improvement and adaptation. A well-established system is needed so that new product and service offerings can constantly be conceptualized, tested and refined.

- ❖ Advanced analytics that enable the institution to: 1) assess the risks entailed in offering certain product permutations and serving certain customer groups; 2) accurately measure and manage pricing dynamics; and 3) segment major customer groups based on salient differences in needs, attitudes and behaviors.

- ❖ An integration of checking and payments functions, in line with the evolving role of the checking account as a cash management vehicle that can include credit extension. If this is how customers increasingly will come to view checking, then this is how checking will have to be managed.

“In many cases, banks will have significant opportunities to mitigate the impact of various new laws and regulations.”

In the wake of free checking, there are literally tens of millions of U.S. checking accounts that are unprofitable on a fully-loaded basis. Retail financial institutions have put off dealing with the situation during recent years, depending instead on a significant revenue stream from a minority of overdraft-prone customers.

But even though overdraft revenues are now under assault, retail banks must avoid taking

“The banking industry has reached a defining moment when a core product line must be restructured.”

precipitous action that would disaffect customers and further starve branch networks of needed revenues. There’s an urgent need to constructively revise the terms of engagement with checking account customers, and segment-based innovation will play a growing role in this transition.

The banking industry has reached a defining moment when a core product line must be restructured. This happens only rarely and there will be sharp divisions between the winners and the losers. Customer-informed strategies will make all the difference in this radically changed market.

Hank Israel is a Director and Sherief Meleis is a Managing Director in the New York office of Novantas LLC, a management consultancy.

NOVANTAS

Novantas LLC

485 Lexington Avenue
New York, NY 10017
Phone: 212-953-4444
Fax: 212-972-4602
www.novantas.com

Novantas LLC

311 South Wacker Drive
Chicago, IL 60606
Phone: 312-924-4444
Fax: 312-924-4440
www.novantas.com