

A selective approach will be needed to lift checking economics in a way that preserves the product's contribution to household growth and retention.

Whitewater: Checking Fee Strategy for a Turbulent Market

BY HANK ISRAEL

As banks race to shore up besieged checking account economics, a balancing act is unfolding with customers. Aggressive actions to increase fee revenues and lower costs have the potential to undermine checking's valuable role in customer acquisition, retention and relationship expansion. A selective approach will be needed to lift checking economics in a way that preserves the product's considerable remaining strengths.

This year going into next, banks are facing a 40% to 45% decline in the annual run rate for checking-related revenue, compared with 2009. Along with plunging over-

draft and debit interchange fees and a flat margin environment, banks are facing a potential new layer of interest expense on business checking.

Our research indicates that tide of unprofitable checking households will rise to 40% of the overall customer base, representing roughly 100 million households. Instead of a standalone profit center, checking's immediate future could be that of a subsidized product – a huge reversal. In such circumstances, there is enormous pressure to raise fees, cut costs by reducing account services, and shed accounts altogether.

On the flip side, however, checking's role in anchoring customer relationships has only grown in importance as the market has tightened. About two-thirds of new household banking business begins with some form of checking or deposit product, according to our research, with more than half of these account originations blossoming into multi-product relationships. In this sense, checking remains a revenue lifeline.

Fortunately, there are at least a few levers that can be pulled yet this year to generate and/or salvage fee revenues for the retail bank. The two

main priorities include overhauling internal processes and customer arrangements for handling overdrafts; and developing

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elasticity-based pricing for account maintenance and ancillary services, such as lockbox and the use of “foreign” automated teller machines. Banks also are developing new checking propositions that deemphasize “free” in favor of distinctive value, such as enhanced consumer cash management.

The complication is that there are sharp differences in the way that various customer groups likely will respond to new fee arrangements – and in the potential financial impact to the institution when there is an adverse reaction. Across-the-board hikes in monthly account fees, for example, can disaffect high-balance customers.

The upshot is that in the quest for new fee revenues, major banks will need a series of segment-tailored initiatives. Each revision should be considered in light of its larger potential impact on customer allegiance and relationship potential.

OVERDRAFT PROCESS ALIGNMENT

The regulatory posture on the handling of checking overdrafts has changed markedly in recent years, with the full impact not yet manifest, not even after the Fed’s Regulation E. The emphasis is shifting from moderated actions centered on transparency (i.e., fee disclosure and opt-in for electronic transactions), to activist measures (i.e., discrete overdraft limits and bank directives to take specific actions in overdraft programs).

Possible extensions of this regulatory trend, including by the nascent Consumer Financial Protection Bureau, need to be considered as banks revise their overdraft programs. Banks will also need to consider the functional and brand impact on consumers, as well as shareholder requirements for solutions that are sustainable, predictable and viable in a competitive marketplace.

There are four basic components in overdraft handling, each with issues and a variety of emerging bank responses. These include posting order; availability of overdraft services; overdraft pricing; and check clearing.

Posting order. New guidelines from the Federal Deposit Insurance Corp. recommend that banks avoid posting checks in an order that maximizes fees. Litigation in this area has focused on sorting arrangements based on the descending order of transaction amount. As an example of an early market response, JPMorgan Chase & Co. in 2009 committed to time-order posting of electronic transactions, “to recognize debit card and auto-

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mated teller machine withdrawals as they occur, reducing consumer fees.”

Overdraft availability. There’s a need to re-evaluate the risk of providing overdraft coverage, given sharply reduced revenues from this activity. And FDIC guidelines further encourage banks to limit coverage for runaway overdrafters as a curb to their habitual behavior. Meanwhile, consumers are voicing a preference for “on-request” coverage, instead of automated arrangements.

In response, regional banks increasingly are adopting credit card-style analytic approaches to limit overdraft risk exposure. Elsewhere, major players such as U.S. Bancorp, Fifth Third Bancorp and Wells Fargo & Co. are marketing products that allow customers with direct payroll deposit to obtain advances on forthcoming checks, helping to bridge cash flow requirements. Banks are also evaluating alternatives to traditional courtesy overdraft, included card-based, that will provide pre-arranged emergency credit.

Overdraft pricing. The FDIC wants banks to limit fees for small-dollar overdrafts, and it also advocates a per-day cap on the handling of overdrafts (and fees) for the individual customer. Consumer advocate groups are exerting pressure on “continuous overdraft fees,” charged if an account is overdrawn beyond a specified time period. There are also pricing disconnects on courtesy vs. on-request overdraft coverage.

One response is the introduction of tiered pricing on overdraft fees based on the amount of the transaction, including offerings from major institutions such as U.S. Bancorp and Wells Fargo. Other banks, including Keycorp Inc. and PNC Financial Services Group Inc., have introduced

thresholds on courtesy overdraft coverage. Such arrangements provide fee waivers for the first few overdrafts in a given month, and/or limits on daily fees for small-dollar overdrafts. Still other banks are re-considering continuous overdraft fees.

Check Clearing. U.S. households continue to deal with high levels of unemployment and financial stress. This elevates bank risk in clearing personal checks, yet check recipients want their deposits processed quickly, a factor in avoiding overdrafts. People also are confused about policies on funds availability.

One consumer response can be seen at JPMorgan Chase, which has introduced an application that allows people to make check deposits via their mobile phones, speeding up check-clearing for select customers.

The complexity of dealing with these four issues is compounded by the fact that they are interrelated, with potential compound impact on customers, regulatory compliance and perceptions, and shareholder returns. This is why a top-down analytical approach works best in diagnosing the overall challenge, developing and assessing response options, and refining the business case and action plan for priority initiatives. Isolated patches will capture far less lasting benefit.

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MAINTENANCE & ANCILLARY FEES

In the quest to build near-term checking profitability, the most likely options are with account maintenance fees; ancillary fees for various kinds of transactions and services; and changes in account terms and conditions. One limitation, however, is that huge changes would be needed to materially offset regulatory damage to overdraft and debit interchange revenues – especially unrealistic in light of checking’s role in acquiring

and expanding household relationships. Banks must tread carefully to ensure that near-term revenue growth does not come at the expense of long-term household growth.

Banks are using a variety of maintenance fee strategies to lift the sagging economics of the checking account. Major approaches include strict electronic delivery; high minimum balance requirements; requiring direct deposit and minimum debit card usage; and setting baseline monthly fees. Each arrangement weighs household acquisition, fee income and balance growth in a different way, depending on the institution’s near and long-term objectives.

Cost play – Here, the idea is to avoid the expenses of branch service and generating paper statements. Under e-checking, there is no account maintenance fee or minimum balance requirement, but customers must make all deposits and withdrawals online or via automated teller machine, otherwise they incur a monthly fee. One example is the “eBanking” account from Bank of America Corp.

Spread play – In this approach, the checking relationship is financially upheld through minimum balance requirements. One account offered by Citibank, for example, offers free full-service checking for customers who maintain at least \$6,000 of monthly balances held in some combination of seven different categories of checking, savings, retirement, mortgage and consumer credit products.

Engagement play – This approach often overlaps with the spread play, but with emphasis on winning the primary household checking account through direct deposit. Under Chase “Total Checking,” for example, customers can avoid a monthly service fee with a monthly direct deposit of at least \$500; a \$1,500 minimum daily checking balance; or with a \$6,000 average daily balance in linked deposit and investment accounts.

Baseline fee play – This arrangement offers a low monthly fee, typically around \$3, which covers a specified number of monthly transactions. Beyond that threshold, the customer incurs a small fee for each additional checking transaction, typically ranging from 35¢ to \$1 each. One example is the “Basic Banking” account at HSBC Bank U.S.A.

There also is a universe of fee-based services that merits thorough review.

- One value proposition is centered on insurance, for example, with an “overdraft

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protection” plan that limits per-incident fee exposure for heavy over-drafters in exchange for a small monthly fee.

- Another is for value-added services that the customer proactively selects, such as consumer payment guarantees that are used to facilitate major household purchases.

- A third category of fee-based services falls under the heading of convenience. Services such as expedited bill pay, for example, help the customer to save time and effort on transactions that matter.

- The fourth category centers on incidence fees, which consumers incur on items such as account overdrafts and stop-payment incidents.

FEE ELASTICITY

Banks have already fielded a variety of new products and arrangements in their quest to shore up the embattled checking business. We would disagree, however, with the view that institutions have pretty much done all that can be done in the short term.

Many major players have not recognized the shifting economics of fees. In today’s environment, fee strategy requires a new set of competencies, including precision measurements of elasticity of demand at the segment and customer level.

The advantage will go to banks that have equipped themselves with critical knowledge about major groups of checking customers. In assessing the options with checking maintenance fees, for example, the bank will make key trade-offs between the estimated lifetime value of customer relationships and near-term fee opportunities.

With unprofitable relationships, the bank needs to understand the preferred “payment currency” for account services (i.e. direct deposit, balance minimums, electronic delivery, etc.) for various types of customers. It also needs an ability to assess the likely impact of potential account revisions and

new offers on account acquisition and attrition, given likely competitive responses.

In sorting through the options for the pricing and marketing of services, the bank needs to consider the main categories of value sought by various customer groups; price sensitivity and the likely competitive impact of proposed revisions; and the potential impact on brand appeal and the perceptions of front-line staff. Which revisions and new offerings will have the highest financial benefit with minimal downside?

The bank that can answer such questions methodically will have the best chance of material performance improvement in the checking line of business, not only long term, but also starting this year. Because checking’s major customer groups are so different, both in terms of relationship value and sensitivity to various offers and prices, detailed segment responsiveness will be critical in reviving the business.

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