

In a challenging market, there is a pressing need for projects that can deliver early results and also set the stage for further advances going into next year.

Regaining Revenue Altitude

BY RICK SPITLER

As earnings reports emanate from the nation's largest banking companies, there can be no doubt that the industry's revenue crisis is real. The earnings cushion from reductions in loan-loss provisions is dwindling, fully exposing the core earnings challenge at a time when markets are languid and banks are further hampered by stringent new regulations.

In such a climate, the pressure for raw cost reduction is tremendous. Yet banks know from experience that precipitous cuts have their own drawbacks. Most executives dislike the prospect of cutting costs at the risk of losing valuable customers and employees – not to mention that even successful retrenchment projects inflict their own damage on near-term earnings. And typically the single largest element of cost is the branch network itself, which is difficult to prune because most branches make at least a marginal contribution to earnings.

The implication is that while cost control is perennially important, the short term challenge is clearly one of generating revenues. Looking across the bank, management needs to come up with at least a handful of focused initiatives that will help to lift earnings yet this year, and position the institution for further momentum going into 2012.

Some options simply are not feasible. Raising prices across the board, for example, can disrupt the established customer base and also introduce competitive vulnerabilities. Excessive lead times and risk levels argue against bold moves, such as entering fundamentally new markets or segments, or launching major new products.

Thus the solution is grounded in executing against the current franchise in much more productive ways:

❖ One of the clearest available opportunities is cross-selling loans to the deposit customer base. Indeed, many if not most banks already see this as an important agenda item for this coming year. Novantas customer research strongly suggests that customers are winning to consolidate credit (except for a small segment), and that this opportunity alone could substantially make up for the fee revenue losses retail banks are facing. The objective is to incent households to consolidate their splintered borrowings with their primary bank. This translates into a basic cross-sell agenda for this year. In the next year, it

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should evolve to more sophisticated approaches such as product bundling; relationship pricing; or new “converged” credit and debit products.

❖ With respect to checking and savings, the story is quite different. Most banks have already considered any near-term increase in fees that they feel comfortable with. Here, the issue is preparing the bank for coming years. The immediate priority is to identify and target core deposit customers to ensure the bank builds and maintains long-duration deposits in light of anticipated rising rates. Another goal is to develop a long-term fee strategy that is consistent with the bank’s brand and will drive future growth.

❖ In commercial banking, fee income already provides from roughly 25% to 50% of business line revenues at major banks. There are immediate avenues to further strengthen this contribution through segment-based pricing and the systematization of negotiated pricing. We typically see significant unrealized revenues in any sphere of negotiated pricing.

❖ Finally, many banks need to revise internal funds transfer pricing metrics. High FTP rates were cemented during the recent U.S. financial crisis, when funding was scarce and banks assigned an extreme high “liquidity premium” on internal pricing for core deposits. In today’s market, however, this practice is causing some banks to over-emphasize deposit formation while over-pricing loans, a situation that needs to be corrected to meet new market and competitive realities.

Such immediate initiatives are critical at a time when the industry is facing a potential \$50 billion annual revenue shortfall compared with pre-crisis levels. The mandate for action is clear and certainly warrants executive management involvement.

CONSUMER CREDIT

Banks have a major opportunity to win more business from established customers. And for the typical hard-pressed bank, the potential payoff from relationship expansion is far more promising compared with cost reduction or fee hikes.

The prime opportunity for account consolidation is consumer credit, including credit cards, auto and other installment loans, home equity lines of credit and whole mortgages. Based on a recent Novantas national consumer survey, more than half of U.S. household loans – worth about \$4 trillion – are heavily splintered among multiple providers. Our research suggests that roughly two thirds of

these balances are held by customers who are attitudinally willing to consolidate.

Some of this consolidation potential will be realized as banks win over balances parked outside of the industry, such as with mortgage brokers. In many other cases, however, one bank will win business at the expense of another. There is a real possibility of tilting, with adept banks gaining significant market share and others losing ground.

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The coming battle for “share of customer wallet” will not be won through broad-based marketing programs and product promotions. Instead, success will critically depend on progress with specific customers who are attitudinally receptive to consolidating their business, and who have demand potential worth pursuing.

Here banks have a distinct advantage over monoline providers. Banks have more information about the financial wallet of the vast majority of customers than almost any other type of financial intermediary, and are beginning to use it.

One priority is to develop “relationship credit” scores that find pockets of high-value credit customers beyond what single dimensional risk/value scores can do. Another is to adopt credit card analytics such as account lifetime value, but expanded to include multiple products.

Through the metric of customer lifetime value, for example, the bank can anticipate all of the main benefits of deeper relationships with primary customers, including: longer duration, lower credit risk and reduced price sensitivity. This additional value allows the primary bank to make motivating offers to established customers that should be superior to anything competitors can offer.

It is important to understand which “currency” customers favor as inducements to consolidate their business. In our analysis of customers and their willingness to consolidate, we found that for one significant segment of customers, banks simply need to ask for the business. That implies being at

the right place at the right time to interact with targeted prospects and win more of their accounts. Another segment, by contrast, won't consolidate no matter whether you ask or what you offer.

Finally there are those who will consolidate, but only if offered attractive prices – if not the best. It is here that the superior information banks have about their relationship customers, as well as the value drivers described above, should enable banks to selectively offer attractive discounts on loan rates and origination fees, targeted on the basis of customer-level price elasticity.

Successful banks are applying this knowledge through a mix of targeted offers and campaigns to specific segments and customers; relationship pricing; and relationship product bundles and packages, in all cases with incentives for relationship consolidation.

CHECKING AND SAVINGS

Banks face a high-stakes balancing act with checking and savings. Efforts to improve the short-term economics of those business lines must be balanced with the need to preserve valuable customer relationships for the long term. This is why it is time for banks to migrate to at least segment-level pricing. A segment-based strategy will be critical in setting priorities and engaging various customer groups effectively.

In the deposit business, for example, banks are overloaded with balances relative to loan demand. Many feel they have already lowered rates as much as they possibly can. Given the average results from product-level pricing, banks are unwittingly hurting their best customers for the sake of product economics. In such circumstances, banks need to identify core depositors and offer them a better deal, while further lowering rates on marginal accounts, i.e. customer/segment based pricing.

There are many factors to consider in developing customer behavioral segments, including variations in demonstrated customer loyalty; the estimated lifetime value of relationships; price sensitivity; tradeoffs between products; and patterns in account usage and balance formation. By studying customers in this way, leading players are able to more precisely value the deposits associated with each major customer group and act on this knowledge (assuming the FTP of the bank incorporates segment variations).

We see a window of opportunity as we face, at some point, a period of rising interest rates. That

opportunity is to consolidate the balances of the core franchise (loyal, less price-sensitive customers) before rates rise. These balances tend to be stickier and more valuable in higher rate environments. Buried in today's low-rate product balances are segments that have much more favorable economics in a higher rate environment than the rest.

A similar situation is unfolding in checking, which is in dire need of restructuring but whose 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.

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It seems the industry is likely to dodge the Dodd Frank bullet. Meanwhile, there are other levers that can be pulled to generate and/or salvage fee revenues for the retail bank yet this year. The two main priorities are developing analytical, elasticity-based pricing for fees and, of course, continued management of overdrafts (including opt-in and posting order).

Longer term, banks are active in developing new checking propositions that deemphasize “free” in favor of differentiated value, such as enhanced consumer cash management. But in the near term, it is all about optimizing current offers.

COMMERCIAL FEES

Fee-based services are a major contributor to the commercial banking line of business, providing roughly a fourth to a half of revenues at larger banks. Yet banks have found it difficult to wring peak performance from their commercial services,

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with many opportunities lying hidden among splintered operations.

Addressing the fee optimization challenge has moved to the front burner in a protracted era of slack loan demand. The immediate opportunity centers on revising pricing practices with established customers and products. Often, for example, price negotiation practices within a bank offer major opportunities to improved fee yield. Not only is the negotiation process largely unsupervised today, but also negotiated pricing contracts and fee waiver concessions are often left unattended following implementation.

We have found that improved information sharing on similar deals, lost business and competitive offerings can improved the negotiating confidence of the banker and the yield on negotiated prices. With respect to prior concessions to customers, there are many possibilities to selectively revise these arrangements, incorporating factors such as relationship tenure and profitability; product usage; customer segment and geography.

These short-term avenues fall under the heading of *optimization*, and hold the potential for a 10% boost in overall commercial fee revenues within the first year. In the medium term, the emphasis expands to *new sales*, based on winning market share through targeted prospecting; team selling; and multi-product solutions. In the long term, the emphasis more fully turns to *expansion*, and at this level the institution deploys resources to tap new geographic markets, customer segments and product possibilities.

However, many commercial bankers are held back from this progress by two common practices:

Over-delegation – By extensively delegating fee tactics to managers of various product lines, regions and customer groups, banks have limited their field

of vision for opportunities that span across the organization. No one is looking across the product and operating silos to think comprehensively about customer needs and buying behaviors, and how to structure a “standard” negotiation platform that gives the banker as much salient information as possible for dealing with the customer.

Under-investment – Along with a narrower focus, line managers have a shorter-term performance orientation. Possibilities beyond selling in the current quarter often are deferred or crowded out altogether, and this tendency has been further exaggerated in the current environment, where staffing and investment resources are tight. The irony is that while limited developmental resources have been further curtailed in a slack market, a failure to invest makes it all the harder to boost fee income.

To break this logjam, commercial banks should look across the organization to create a holistic view of fee-based activities and the various kinds of upside that can be captured with cohesive effort – short, medium and long-term.

FTP AND THE LIQUIDITY PREMIUM

Some of today’s distortions with internal funding metrics were set in motion during the global recession and financial crisis of a few years ago. During the downturn, bankers became highly sensitized to the potential for funding disruptions in a crippled market.

Having few other options, institutions scurried to raise deposits and slammed the brakes on lending. Along with management fiat, banks effected change by dramatically increasing the liquidity premiums paid on deposits and charged on loans – as much as by 100+ basis points. In an era of record low rates, the liquidity premium became a dominant factor in pricing loans and deposits.

In using the liquidity premium for decision-making today, however, feedback from the market on the cost of liquidity (embedded in the bank’s credit spread) needs to be balanced with the bank’s balance sheet position and strategies. At the start of the downturn, for example, banks had lent to the limits of their deposit resources – many even beyond. A high value of liquidity tended to discourage lending and encourage deposit-taking, in line with the objectives of most bank at the time.

Now most markets have unfrozen and banks can get incremental funding from multiple sources

other than deposits. Bank balance sheets have changed dramatically, meanwhile, with deposits now far exceeding loans for the industry.

Certainly, the wholesale market cost of liquidity should remain part of any determination of the liquidity premium. The credit spread provides transparent and objective information about the financial market's view of the bank's creditworthiness. But more dimensions are needed.

A second consideration is the bank's overall need for liquidity. Banks with excess liquidity should value liquidity differently than those that are in need of liquidity. This difference in valuation should be communicated in the bank's financial performance measures and pricing models.

There are other factors which should be incorporated into the calculation of the liquidity premium as well. At many institutions, internal funds transfer pricing is in need of an overhaul, not just a patch. Banks are in need of systems that are much more anticipatory and precise, both to satisfy higher regulatory requirements and to optimize institutional performance in a continuing challenging market.

Banks with comprehensive internal pricing frameworks will have metrics that not only accurately depict the market cost of liquidity, but also reflect the balance sheet posture and implications for growth and pricing targets for deposits and loans. These banks will be able to price loans and deposits more accurately, and gain an advantaged position relative to competitors, without resorting to arbitrary management overlays on pricing. They also will be able to communicate more effectively with regulators by showing how their internal measurements align with their overall liquidity position.

CORPORATE NERVOUS SYSTEM

In reviewing the near-term performance levers for growth-hungry banks, it is clear that many banks need to finally make the transition to a customer led – versus product led – company. Comprehensive customer information and coordinated effort is needed, yet banks continue to rely heavily on product silos and discrete business units, which typically focus on a single facet of the customer relationship, centered on a particular product.

In prior conditions of strong market demand, banks put off the larger question of customer relationship expansion. Major players prospered on the strength of mass-market product promotions,

backed by efficient product production within the business silos and effective delivery within the retail branch system.

Now, however, the industry is facing a permanently changed market. There will be no return to the peak conditions seen in 2004 to 2006, reflecting the realities of a post-crisis economy and a newly-constrictive regulatory environment.

In turn, banks can no longer shy away from more complex revenue propositions that require more customer-centric efforts. To serve retail customers more fully, the bank needs a stronger corporate nervous system, including comprehensive information drawn from multiple product lines; an analytical ability to generate segment-specific marketing and sales initiatives; and a coordinated outreach across multiple customer touch-points.

Fortunately, there are immediate ways to pursue this vision, without holding up the train with mega-projects that no one can afford and that never seem to deliver promised results. In areas such as checking and savings; consumer credit and commercial fee-based services, there are segment-informed projects that will deliver early financial results and also set the stage for further advances going into next year. Executive management will need to pave the way, however, given the heightened need for collaboration among teams from multiple areas of the bank.

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