NOVANTAS STRATEGY & MANAGEMENT

In a challenging year, proactive measures to boost the top line are preferable to a strict focus on cost control, and their benefits can easily extend into 2012 as well.

Revenue Jump Start

BY RICK SPITLER

Major retail banks are under extreme pressure as they contend with an increasingly pinched revenue outlook for 2011. On top of other challenges, the industry now is bracing for the implementation of debit fee restrictions stemming from the Durbin Amendment. It is a perfect storm that has created great urgency for management action.

Realistically, only a few priority initiatives can be brought to fruition yet this year. Decisions over the next few months could have a pivotal impact on 2011 financial performance. In the quest for incremental revenues, there are four avenues of investigation that leading banks are working on now:

1) *Credit cross-sell* – working through the branch network to provide more mortgage, auto and revolving credit to established customers.

2) *Pricing* – reviewing loan and deposit pricing strategies, both to maximize returns in areas of stronger demand and lift any unrealistically low floors.

3) *Fee strategy* – reviewing the overall framework for fee-based businesses, including new services, price incentives to influence channel usage, and strategies and practices for usage and exception fees.

4) *Balance sheet posture* – beginning to reposition the deposit portfolio in anticipation of a potential rising rate environment.

These proactive measures are preferable to a strict focus on cost control, and their benefits can easily extend into 2012 as well. The call to action is clear. Along with the challenge of tepid credit demand in a crawling economy, retail banks are dealing with flat margins and a big drop in fee revenues following restrictive new checking overdraft regulations. Meanwhile, there's a dwindling performance cushion from falling loan loss provisions, and a further blow will come with new restrictions on debit card fees.

Credit. Despite all of the recent turmoil with residential mortgages and consumer credit, there still is a base of healthy demand from resilient U.S. households that avoided over-extending themselves and still have solid employment. There will be heavy competition for this business, however, and winning banks will be the ones able to capture greater "share of wallet" by more fully serving each household, individual and small business.

Cross-selling to established customers offers one of the best ways for retail banks to tap the ongoing market for mortgages, auto loans and credit cards. This is a more efficient type of sale, compared with the effort to acquire new-to-the-bank customers, and it is in keeping with

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the philosophy of relationship expansion.

Pricing. While retail banks have made great strides in pricing strategy for deposit portfolios, a high level of expertise is now broadly required across all business lines, certainly including consumer credit products and various fee-based businesses. There are many more opportunities, for example, to refine pricing in accordance with local market variations, product variations and customer segment variations.

Some institutions have already launched top-to-bottom pricing reviews, and we expect that many others will follow suit. This work is being done in the spirit of preserving the franchise in challenging times. Myriad pricing practices that seemed "okay" back when the market was roaring now need to be re-examined in detail.

Fees. Clearly there is a need for an updated strategic framework at many banks. Given the flat prospects for net interest income, fees strategies are essential to success.

In the near term, banks are examining the options for this year. More fundamentally, however, the current challenges call into question the entire fee strategy: Should the bank emphasize fees for high-value services, low-visibility fees for basic everyday services, or exception fees? How does the fee revenue strategy fit with the company's brand positioning? How can the bank use fees to influence customer behavior in ways that will help to reduce costs? Finally, there is the whole question of finding innovative new services that customers will gladly pay for.

The ship may be prove difficult to turn, given new regulations and consumer expectations for "free," but work on fee revenue strategies should begin now.

Balance sheet. It is not too early for retail banks to begin consider how they should reposition deposit portfolios in anticipation of rising rates. The key considerations are the balance levels and maturity structure of the rate-based book. The question is whether to heavily promote money market deposit accounts today or emphasize certificates of deposit rates to lock in term deposits. Much depends upon management's view of forward rates, as well as the willingness to forgo current profits for future profits. A scenario analysis of balances, interest obligations and the future yield curve is needed.

These four factors need to be sorted out early this year, and they are preferable to a single-minded focus on cost. Clearly it is important to keep costs in line. But efficiency ratios have revenue as the denominator, and without revenue optimization, costs are all the more difficult to manage. There is a certain defeatist element in pure cost control, moreover, almost like saying the institution is totally at the mercy of the market, which certainly is not the case for the many competent management teams in retail banking.

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The way forward, we believe, is to focus on a tight set of revenue priorities that: 1) have promise of more immediate impact; and 2) are directionally in line with strategies for a changed retail banking market. But even at that, prompt action is needed in order to realize tangible benefits yet this year.

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