NOVANTAS STRATEGY & MANAGEMENT

As the urgency grows to drive revenue growth, banks will get more lift from expanding customer relationships than from raising fees or cutting costs.

Relationship Expansion: Sharpening the Focus

BY SHERIEF MELEIS AND HANK ISRAEL

Retail banking is facing an unprecedented "revenue drought" under the twin pressures of regulatory reform and a sustained low-rate environment. New hope is emerging that winning institutions can significantly offset the damage by serving customers more fully. But success will hinge on skillfully engaging the customer subsets that are most receptive to consolidating business with a single bank.

With the implementation of the Durbin Amendment right around the corner, retail banks face a perfect storm. Along with Durbin's impact on debit interchange fees, banks have seen checking overdraft fees tumble in the wake of Regulation E, and they now must pay interest on business deposits as well, per Regulation Q. Meanwhile, the sustained low rate environment has depressed deposit margins to record lows.

All told, these setbacks will have slashed retail banking revenues by more than $50 billion per year, compared with pre-crisis levels. And the vast majority of this revenue loss is not coming back, even as rates rise.

Just to put this shortfall in perspective, by our calculations the equivalent cost savings needed to offset the damage would entail closing over 50,000 branches – more than half the industry total. The calculus for using offsetting fee increases is equally impossible – it would take a 1,500% hike in maintenance fees.

A much better approach is to focus on serving customers more fully. For the industry as a whole, for example, we estimate that the $50 billion revenue shortfall could be offset by 15% increase in the amount of business done with each customer. This is much more feasible from a

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proportional standpoint (keeping mind that this is an illustration and that business gained by one bank often comes at the expense of another).

Bringing it down from the macro level, what we are saying is that for the typical hard-pressed bank, the potential payoff from relationship expansion is far more promising compared with cost reduction or fee hikes.

CONSOLIDATING "ON US"

The good news is the money is there to be had. Among consumers, about one fourth of deposits remain unconsolidated with their primary financial institutions, based on a recent Novantas national consumer survey, and more than half of their loans and investments are unconsolidated. In terms of relationship expansion potential, that translates into $900 billion of deposits held "off us," or outside of the primary institution; $4 trillion of loans; and $3.7 trillion of investments.

Novantas research suggests that as much as 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 and investment houses. 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.

The coming battle for "share of customer wallet" will not be won on the strength of 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. The question is how to follow through.

The first thing is to clarify the opportunity, which is all about consolidating primary banking relationships, typically defined by a core checking account. While there may be some opportunity from consolidating off-us wallet from single-service customers (i.e., people who hold a single certificate of deposit), it is a much more difficult task.

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The next thing is to financially model the current and future value of primary relationships. The bank needs to understand the upside potential and get a sense of the latitude to offer various benefits that might inspire customers to bring additional business.

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 a primary bank to make motivating offers to established customers that should be superior to anything competitors can offer.

The next challenge is to understand which "currency" customers favor as inducements to consolidate their business. Obviously price is one factor. The superior information banks have about their relationship customers, as well as the value drivers described above, should allow banks to offer attractive loan and fee discounts and rate bumps. These offers should be targeted based on an understanding of customer-level price elasticity to rates and fees.

But many other relationship customers are in fact less price sensitive, so indiscriminate price offers (e.g. a 25 basis-point CD bump or a home equity line of credit discount for all premium checking customers) simply leave money on the table (and risk re-pricing the current high-margin portfolio). By contrast, sophisticated banks are using targeting to identify specific segments and customers who warrant special offers.

NON-PRICE FACTORS

Beyond price, people have very different motivations for bring more business to the bank. These factors also must be taken into account in

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crafting specific offers that will be compelling for the customer and constructive for the bank. Some customers value relationship rewards; others see benefit in combined statements and inter-operability (e.g. easy transfers between accounts); others simply need to be asked for the business.

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.

The upshot is that in the quest for growth through customer account consolidation, careful analytical preparation will be needed, both in targeting attitudinally receptive customers and in crafting offers that will resonate with various segments. By contrast, broad offers aimed at boosting any type of cross-sell will take a distant second place in the intensifying battle to serve customers more fully.

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