

# Gaining the Edge in a Tight Market

BY RICK SPITLER

As lenders fight for growth through market share gains, the competitive emphasis will tilt from pushing products to cultivating fuller customer relationships.

Lending was an unstoppable profit engine just a few short years ago, with surging demand in all asset categories, both commercial and retail. It was an unfettered environment where banks saw opportunity in every market, risk tier and price point.

As the industry moves beyond the subsequent market collapse, however, banks are wrestling with fundamental questions about growth strategy. While the easy answer is more careful execution of traditional mass market product initiatives, realistically, now is the time to retool for a changed economy and competitive environment.

The current economic recovery, if it can be called one, promises to be a drawn out affair, quite unlike other market rebounds that saw steady increases in employment, borrowing and spending. For the next few years, most loan categories at best will grow only modestly from current recession-battered levels.

In this rugged terrain, winning banks will be the ones that gain market share at the expense of other competitors. There simply won't be enough underwrite-able demand to support the overall industry distribution and sales capacity built up over the last decade.

Instead of pushing individual products, competitive banks' emphasis will tilt to cultivating fuller customer relationships — doing the most to expand and retain established household and business relationships; and anchoring and engaging new customers more thoroughly and effectively.


Part of this trend is a major redirection of marketing priorities. In a low-volume market where new customers will be in short supply, revenue generation will be much more dependent on sales to established customers. There will be a major push to build multi-faceted credit relationships with customers who are already with the bank.

One clear implication is the need for greater consultative sales expertise, both within the branch and among commercial banking relationship managers. Prime customers are in short supply and have more bargaining power, and a relationship context is essential for effective cross-sell.

A second priority is targeting. Where institutions once blanketed entire regions, or even the entire franchise, with standardized offers, now they must carefully pick their way in an environment where the opportunities are few and the risks are many. Along with the shape and scope of customer demand, lenders must be much more cognizant of borrower



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risk profiles and variations in local market conditions.

A third priority is pricing. While many lenders work to solidify risk-adjusting pricing floors, there are other important considerations, such as pricing strategies for product bundles, and the whole question of setting the “sticker price” of credit based on elasticity of customer demand. Segment variations play into this as well.

Instead of sitting tight and hoping for a return to better times, winning banks will step up to the realities of a changed market, and focus on the new survival skills that will be needed to win share in an ongoing environment of constricted loan demand.

## THE ROAD AHEAD

Recent challenges in commercial and retail lending are well known to bankers, but it is still helpful to consider the trend perspective and implications for future growth. Looking over the next two years or so, it is hard to make a case for a return to robust loan origination, as supported by the following:

- **Household constraints:** U.S. households are continuing to shed outsized debt loads in an era of high unemployment and impaired housing values. Many people simply can't qualify for credit, as illustrated by a recent FICO Inc. analysis showing that one in every four U.S. consumers does not meet minimum risk standards for items such as auto loans, mortgages and credit cards.
- **Business constraints:** In middle market commercial banking, a key lending area for major banking companies, commercial realty likely will continue its slow-motion tumble for a good while longer, reflecting the intricacies of dealing with high-dollar properties in distress. Commercial and industrial companies, meanwhile, are sitting on mountains of cash and have shown a weak appetite for borrowing to finance property, equipment and hiring.
- **Banking constraints:** Along with needing to guard capital, many banks remain over-weighted in mort-



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gage-related assets and burdened with heavy portfolio cleanup operations, including defaults, collections and negotiations with distressed borrowers and foreclosures. Any new credits need to be of high quality, both to counterbalance the post-recession hangover and to lower the risk profile going forward. This further makes the case for selective loan expansion.

- **Regulatory and legal constraints:** New laws and regulations for consumer protection will crimp lender flexibility and key revenue streams, further limiting banks' ability to serve higher-risk lending segments.
- **Secular trends:** Increasing numbers of Baby Boom households are nearing retirement and won't return to the peak borrowing and spending patterns of recent years. Credit demand likely won't fully revive even when the economy recovers.

The point in mentioning these factors is not to convey gloom, but to emphasize the degree to which banks will be competing for a limited pool of prime customers in the years

ahead. Instead of waiting for a 2005-style surging market that likely will never return, banks will need to concentrate on winning market share, a path that inevitably centers on expanding customer relationships.

#### **RELATIONSHIP EXPANSION**

Especially in peak market conditions, there has been a pronounced tendency for banks to operate as cafeterias, with customers taking the initiative in selecting individual products, often from multiple providers. A single bank typically will capture no more than 10% to 25% of the average customer's total wallet, meaning at least 75% to 90% of the relationship potential is usually lost to other providers. One key to reversing this trend is learning to sell multiple credit products within a relationship context.

In building the specific business case for relationship expansion, banks can generally look to five types of advantages in increasing cross-sell product penetration with established customers, all of which contribute to improved relationship

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revenue and profit potential:

1. It is a more cost effective type of selling, compared with the effort required to sell each product separately, or to establish entirely new relationships;
2. It provides richer customer information and stronger leverage for pricing strategy;
3. It provides better information for underwriting;
4. It contributes to relationship longevity; and
5. It typically is accompanied by improved loan repayment behavior.

A key question, however, is how to locate the best opportunities to build multi-product relationships within the current portfolio. Prior Novantas research done with the Bank Administration Institute, for example, suggested that only about half of retail customers are candidates for in-depth banking relationships, with significant variations in needs within this group.

One way to focus the search is to capture more household primary payments accounts and look at customers through that lens. There is a strong information advantage in being able to process the bulk of household transactions, plus the activities surrounding the primary checking account offer more opportunities to interact with customers. Some regional banks are taking this logic a step further by also trying to capture more credit card accounts, which can provide even deeper insights into credit needs.

Such efforts will succeed on the strength of customer analytics, an essential in targeted marketing. Banks will need to sharply improve their skills in identifying high-value opportunities, many residing within various customer segments. This includes recognizing key cross-sell possibilities over the life of the relationship.

In many cases, banks have opportunities to improve their anticipatory sales strategies, based on an understanding of customer stage of life, major life events, and an analytical understanding of likely cross-sell progressions from one product family to another. Along with being financially constructive, this sort of proactive outreach brings authenticity to a relationship orientation.

### **CUSTOMER ACQUISITION**

Although the principles of relationship expansion in theory apply to new customers as well, realistically, the waters are murky in the early going. The bank may be able to target prime prospects and model their likely response rates, but

subsequent patterns in customer behavior and product usage will only become known over time, leaving question marks about relationship profitability and customer lifetime potential.

The upshot is that in new customer acquisition, product and channel considerations will predominate. In this arena, winning banks will work to target and price their offers more carefully; augment distinctiveness and overall value; and deliver offerings in the manner that elicits the strongest customer response.

With prospects, the analytical challenge includes not only recognizing the varying risk and demand characteristics of households and businesses, but also the varying market dynamics of the major locales in which target customers are situated. With countless households and local housing markets still in distress, for example, there's a heightened need for selectivity in both promoting and evaluating mortgage credit.

One shared requirement in commercial and retail banking is a need for greater sales expertise. In commercial banking, middle market companies apparently are stepping up their demand for sector-specific service. Health care enterprises, for example, want to be served by relationship managers with deep knowledge of that industry. While the use of “industry verticals” is a long-running trend in commercial banking, the customer appetite has grown even as the barriers to entry (information, expertise, required market scale) have fallen, creating a window of opportunity for regional banking companies that previously may have downplayed this strategy.

In retail banking, there is a particular need for an improved branch sales process, especially as it pertains to mortgage and home equity lending. Coming out of a wrenching U.S. housing market crisis, customers want to be assured that they are handling new borrowing in a way that won't come back to haunt them. Also the branch representative must play a more proactive role in processing and screening credit applications, helping the institution to uphold elevated underwriting standards.

### **ESSENTIAL SKILLS**

In many ways, pricing will be the knot that ties the whole relationship lending package together. At the discount end of the spectrum, there will be opportunities to promote credit bundles and product cross-sell with attractive rates, in ad-

dition to opportunities to take market share with targeted campaigns aimed at prime prospects. At the other end of the spectrum, certain credit products and packages may even command premium prices, based on the strength of customer demand.

To unlock these opportunities, many banks will need to improve their credit pricing skills. Some players, for example, still are working to establish robust pricing floors, based on metrics such as risk-adjusted return on capital. And most banks are not yet able to set target prices based on calculations of price elasticity of customer demand.

Then along with tailoring pricing targets and floors for various marketing initiatives and customer segments, banks will need to do a better job of factoring regional market dynamics into the equation. In home equity lending, for example, Novantas research has uncovered significant national variations in the weighted average market price, spanning a range of more than 500 basis points in certain product segments.

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To respond to emerging issues and opportunities in customer acquisition, many regional banks probably will need to beef up their central analytical teams, and also find improved ways to drive information and insights to the field. At many retail banks, for example, there’s an ongoing disconnect between the comprehensive knowledge that the branch representative is expected to demonstrate and the actual information tools that are immediately available to support effective selling. Requirements for improved underwriting and pricing provide additional impetus to solve the management and system challenges that often impede the central office in augmenting branch sales effectiveness.

#### **MANAGEMENT IMPLICATIONS**

As banks enter the planning and budgeting cycle for 2011, management has several clear priorities in preparing for the coming battle for market share.

First, there is a need to explicitly evaluate the marketing

tradeoffs in relationship expansion versus new customer acquisition.

Without going into all of the details of economic models, suffice it to say that the bank needs “dollar out, dollar in” guidance on where to place its efforts in revenue generation. This sort of economic analysis is essential in setting marketing priorities for major customer groups, major product lines, and major regional markets.

Second, the bank needs to develop a game plan to pursue key opportunities. With relationship expansion, for example, there is a need to understand the potential for customer lifetime profitability, and the various cross-sell possibilities that best contribute to relationship value, depending on the customer profile. Then with customer acquisition, there is a calculation with respect to the specific product and channel initiatives (establishing new industry verticals, for example) that will best attract prime prospects.

Finally, the bank will need a detailed map for resource allocation, in line with the net benefits that it hopes to realize with each type of revenue initiative. This includes provisions for careful monitoring and performance measurement. In an uneven market, there is a heightened risk of misallocating scarce marketing resources.

Looking over the next few years, retail and commercial lending still will provide opportunity for the banking industry, but not at the magnitude seen in prior economic recoveries. A rising tide won’t float all boats. There will be winners and losers among individual institutions, with some banks winning far more market share than others. In many cases, the determining factor will be success in expanding relationships with established customers. A companion priority will be playing a much smarter game in new customer acquisition.

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