

Facing a sharply reduced revenue cushion to compensate for losses, banks will need to be much more selective about how they operate critical aspects of the checking business.

Rebooting the Checking Operating Model

BY HANK ISRAEL

In the years leading up to recent regulatory changes, banks developed a set of deeply ingrained operating practices in the checking business. The list is fairly long and includes important activities such as setting overdraft limits, granting fee waivers, establishing priorities for handling exception items, screening account applications, managing staff sales incentives, and crafting promotional campaigns for products and services.

This complicated web of decisions and practices has a critical bearing on the overall operating stability of the checking business. Little can be left to chance in an industry that is called upon to handle millions upon millions

of accounts and daily transactions; deal with an ongoing flood of exceptions; and do so while minimizing risks to the bank and maximizing customer service and satisfaction.

But now the checking operating model has been thrown out of kilter. Currently, a significant portion of checking overdraft fee revenue is used to pay for the risk of operating the business. Not only do customers overdraw their accounts, but many also walk away from their liabilities, both for unpaid balances and fees.

In the post-Reg E market there will be much less overdraft fee revenue to compensate for this type of damage, yet much of the risk will continue. The upshot is that banks will need to be much more selective about how they operate critical aspects of the checking business. The margin for error will be even tighter than it was before.

Overdraft Limits. Ceilings on account overdrafts have risen sharply across the industry in recent years. While this increased the industry's risk exposure and loss rate on unrecovered balances and exception fees, the damage was offset by an overall rise in overdraft fee revenue. This cushion will be smaller going forward.

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Re-setting overdraft limits is not a simple matter. One complication is that under the Federal Reserve’s Regulation E, the limit must be the same for all customers, regardless of whether they have opted for overdraft coverage. Also, account features and functions, such as debit, cannot be varied based on opt-in decisions.

This would seem to argue for a much lower overall overdraft limit, given the increased need to manage outsized risk potential among a small minority of customers. Yet an extraordinarily low overdraft limit has its own drawbacks, potentially curtailing service for the overall customer base.

To sort through these factors, banks will need to build robust financial models that can anticipate varying overdraft usage and default rates across a range of potential limits, with implications for exception fee revenues, and for losses. The goal is to strike a balance that permits the bank to provide coverage for the maximum number of customers while providing a cushion for potential losses and an adequate return for shareholders. Potential pricing variations also factor into this equation.

To be sure, many institutions believe they can manage this challenge simply by requesting a new set of expert recommendations from the community of vendors that support this line business. But the answer is not that simple for larger banks.

For one thing, it does not make sense to have a number of major banks relying on similar (or identical) risk models. In addition to thwarting product differentiation, look-alike risk management strategies can expose the overall market to systemic fraud and credit risk (a mal-intentioned entity that cracks the common risk code, so to speak, then is positioned to move against multiple banks). Also, advanced players will have the opportunity to achieve competitive advantages through a superior

understanding of customer risk profiles and relationship value.

Exceptions and Fee Waivers. Two other types of balancing acts have to do with daily priorities in handling exception items and the process of granting fee waivers. Considerations include dealing with a mix of large and small items of varying importance and financial consequence to the customer, counter-parties and the institution, and the presence or absence of opt-in for overdraft coverage. Refined decision processes will be needed to manage these considerations going forward.

Account Screening. Much like with the credit card industry, the checking industry also will need to do a much better job of evaluating potential new account relationships. In an environment where business line economics are under pressure and there is less flexibility in dealing with contingencies, banks will have to be much more selective about account growth.

One particular perspective on checking overdrafts is that bank coverage actually represents a form of emergency credit. Access to this resource necessarily will be more restricted in the unfolding market, where banks will have to operate with less of a cushion on overdraft losses. Institutions will have to be more proactive and analytically adept in screening applications to assure that basic “overdraft underwriting standards” are met, given the potential for exceptions once account arrangements are established.

Sales Incentives. Front-line staff will play an important role in refining checking account acquisition. But to make this happen, sales incentives will need to be revised.

At the height of the free checking frenzy, up to half of checking account originations could be traced to households that already had other established accounts. In part, this type of “piling on” reflected skewed sales incentives that primarily

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rewarded origination volume, with little regard for balance, fee or risk potential.

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Marketing Promotions. In a similar vein, banks will also need to rethink mass-market promotional campaigns (as seen in the free checking era) that

offer incentives directly to prospective new customers. With checking’s risk/reward equation out of kilter, marketing initiatives cannot be based on outmoded assumptions about “average” account profitability. There is a heightened risk of overpaying for new business.

Few if any banks will escape the need to individually review the overall process of acquiring new checking customers and the terms of new business, including marketing messages, tactics and targeting; product design and pricing; account origination and application screening; and staff sales practices and incentives.

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