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As overdraft fees recede, so too must the subsidy of free checking accounts. How can banks restructure checking for broad-based account profitability and customer appeal?

Checking: Rebuilding the Business Model in a Fee-constrained World

BY HANK ISRAEL AND SHERIEF MELEIS

If there was any remaining doubt that banks need to move quickly to reposition the checking line of business, that certainly was erased by recent Federal Reserve rulemaking. A full-blown crisis is underway that will forever change the complexion of the checking industry.

By itself, the Fed's new Regulation E could cause a stunning 50% reduction in annual overdraft fees, a revenue stream that reached $36 billion in 2008 alone. The trigger is Reg E's requirement that customers "opt-in" to exception-handling services.

The total mix of new legislative and regulatory restrictions could eradicate up to 40% of annual checking product revenues by 2011. That is a body blow to a business line that comprises a fourth of the banking industry's market capitalization.

To address this issue, banks will need to rectify the pronounced cross-subsidies that crept into the industry with the onslaught of free checking. By eliminating account maintenance fees in order to acquire customers, the industry created a huge swath of marginal accounts, perhaps 40% of the customer base, and imprinted an entire generation of customers with the perception that the checking product is not worth paying for.

In turn, revenue shortfalls on borderline accounts were financed by a minority of customers at two ends of the checking revenue spectrum: those who maintain high balances; and those who frequently overdraft. Though never ideal, the setup at least worked financially – but no longer.

The banking industry has three major avenues in the urgent quest to rebalance the account economics of the checking portfolio:

- One is to restructure current products and services to generally strengthen the checking business as it stands today;
- Another is to create innovative new offers that will provide additional value to customers and unlock new revenue streams; and
- Most immediately, adroit tactical responses will be needed to help the bank minimize damage to revenues and customer relationships as new laws and regulations are implemented.

In all three areas, the advantage will go to the institutions most skilled in responding to the differing needs of major customer groups. Heavy over-drafters, for example, come from all household income tiers and almost universally

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