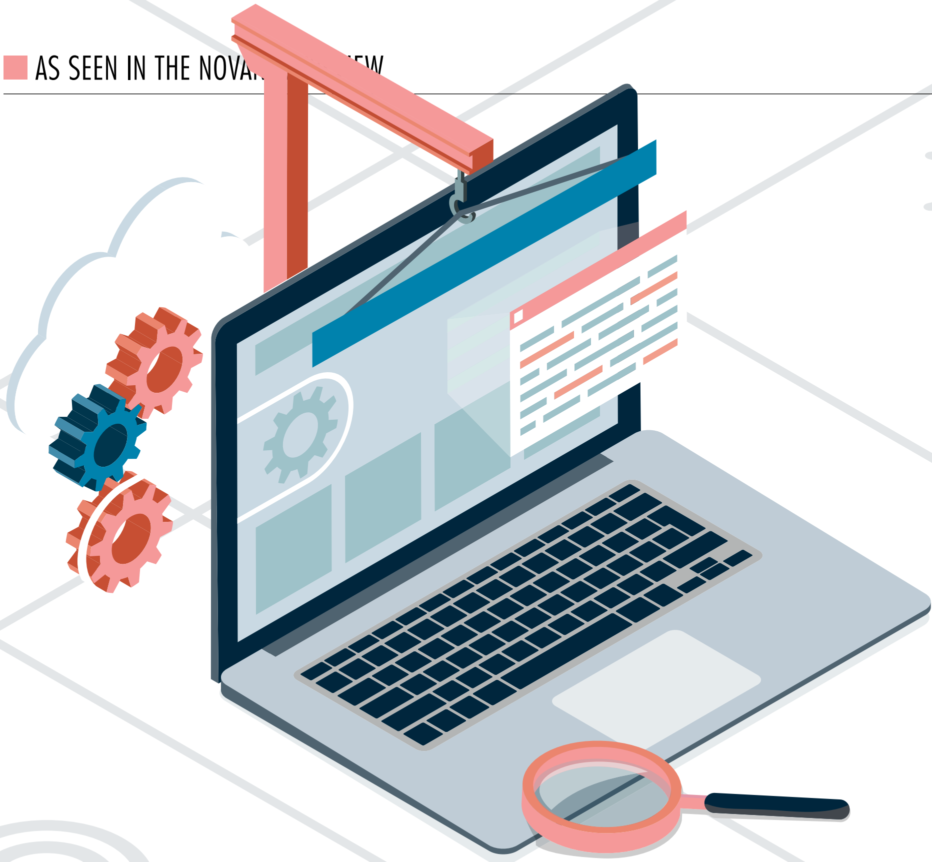


HOW TO BUILD A DIRECT BANK

— *Or Why You Shouldn't Even Try*

BY ADAM STOCKTON, HANK ISRAEL AND ROBIN SIDEL

So you think you should launch a direct bank? After all, it could be a great way to scoop up deposits across the country at a time when most banks are struggling to acquire new customers and hang onto the ones they have.

Not so fast.

While it's true that deposits at direct banks are growing at a faster rate than traditional institutions (see Figure 1), there is a wide range of performance among the different types of direct-banking products that have emerged in recent years. Some have done well. Others have quietly retreated after encountering problems. For many, the jury is still out.

Banks that are thinking about a

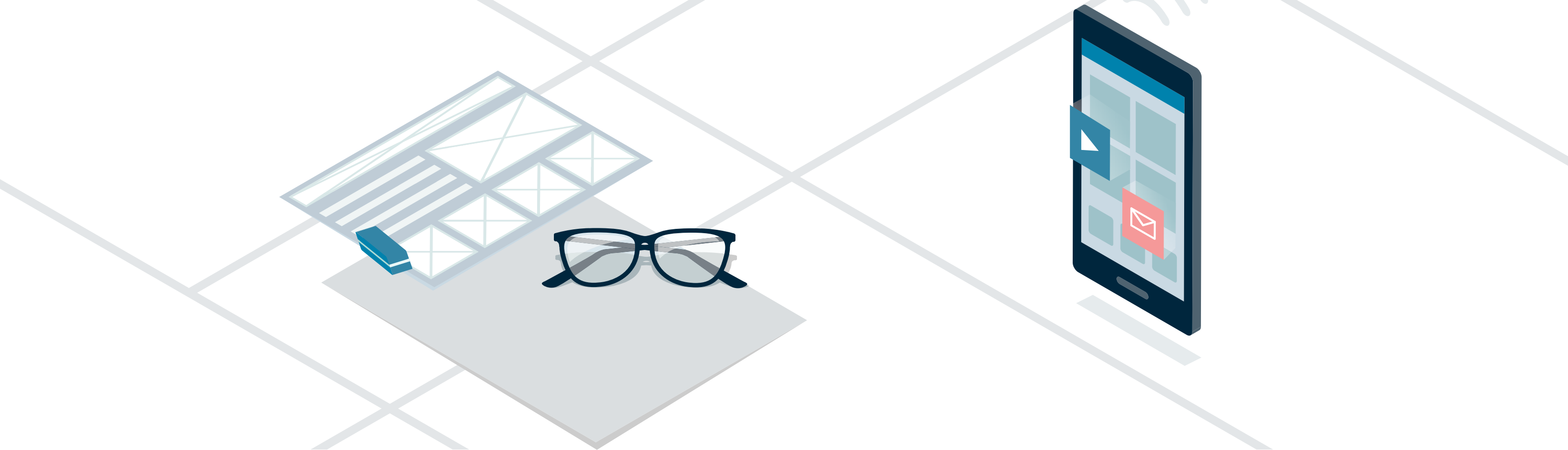
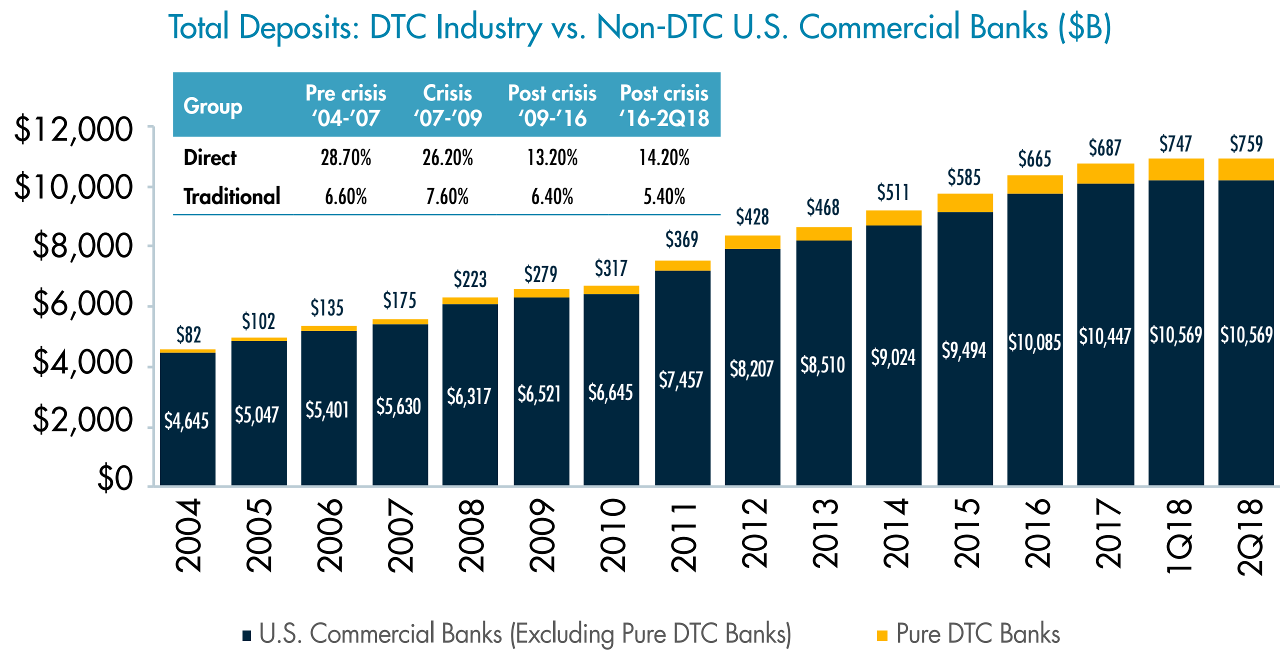


FIGURE 1: FROM 2016 TO 2Q18, DIRECT-TO-CONSUMER (DTC)BANKS SAW ANNUALIZED GROWTH OF 14.2% COMPARED WITH 5.4% FOR TRADITIONAL BANKS.



DTC Share of Total	1.70%	2.00%	2.40%	3.00%	3.40%	4.10%	4.50%	4.70%	5.00%	5.20%	5.40%	5.80%	6.20%	6.30%	6.50%	6.60%	6.70%

Note: Pure DTC bank list excludes hybrids and legacy online players. DTC and non-DTC deposit growth rate from '16 — 2Q18 is annualized.
Source: FDIC Call Reports and OTS Thrift Financial Reports (SNL Financial); Novantas Analysis

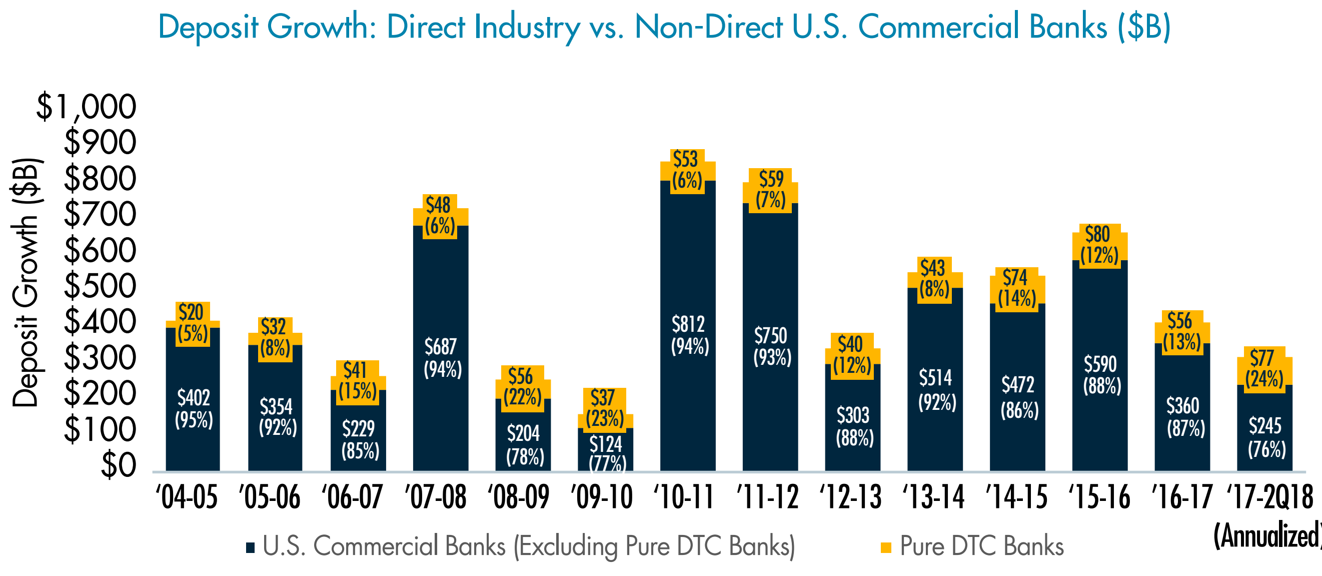
direct-bank model must carefully consider some key factors to determine if it is the right strategy. Among them: prospects for cannibalization from existing customers, whether the bank is committed to matching rate in a hyper-competitive market, and potential non-rate incentives that can help mitigate rising deposit betas.

LESSONS FROM THE PAST

There isn't a ton of history to consider when it comes to launching a direct bank at a time when rates are rising. Although online-only banks date back to the 1990s with names like Wingspan (the ill-fated unit of Bank One in Chicago), they have mostly been outliers during previous rising-rate cycles. Among the best-known success stories is ING Direct, which had $82 billion in deposits and seven million customers by the time it was acquired by Capital One for $9 billion in 2012.

That has changed dramatically in the past couple of years as consumers grow more comfortable opening accounts online and engaging in transactions away from the branch. (See

FIGURE 2: DIRECT BANKS ARE TAKING A BIGGER CHUNK OF RETAIL DEPOSITS THIS YEAR



Note: Direct bank list excludes hybrids and other legacy online players. Total deposit growth rate from '17 — 2Q18 is annualized.
Source: FDIC Call Reports and OTS Thrift Financial Reports (SNL Financial); Novantas Analysis

Figure 2). **More than a quarter of consumers now have a savings account or CD at an online bank, according to a survey of more than 13,000 Americans conducted by Novantas last year.**

Once dominated by players that weren't known for vast branch networks, like Ally Bank and Discover, a growing number of branch-based institutions have entered the direct-bank fray, including JPMorgan Chase and Citizens Financial Group. And more banks have expressed interest in jumping on the trend.

DIRECT BANK PLAYBOOK

For most banks, the ultimate goal of a direct-bank model is the same: collect deposits by flooding a low-rate geographic market with high-rate products and aggressively marketing the rate or convenience. For new players in the direct banking market, there are no back books to reprice and no branches to support the marginal cost of acquiring deposits. As a result, it should be far cheaper than concentrating on core markets.

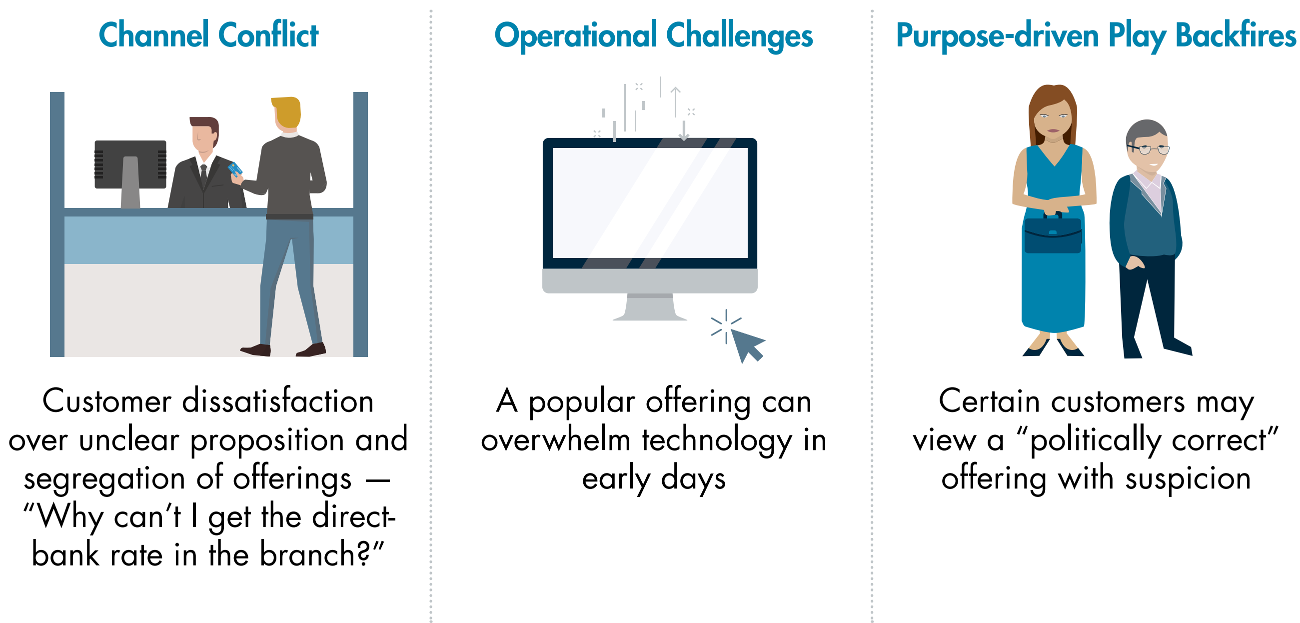
But the effectiveness of that playbook may be at risk due to a flood of new entrants who are pushing rates higher at a feverish pace. (See Figure 3). Success typically requires a bank to offer the best rate in the market, which can lead to a loss of "hot money" if the bank fails to keep up with competitors. Consumers may become fatigued by a barrage of high-rate offers, reducing the prospects for deposit growth. Additionally, regional and community banks that are pressed to compete on rate may erode their own pricing to the point of unsustainability. To make the right decision about such a market entry, banks looking to enter the direct market must consider three key issues:

First, it is critical to understand the bank's own marginal cost of funds raised through the branches compared with direct plays. Depending on the cost of the existing book of branch deposits, as well as the competitiveness of local markets, some institutions may actually find that it is *cheaper* to raise a marginal deposit dollar in a branch compared with an online model. This will change, however, as market conditions evolve. Thus, the need to monitor ongoing marginal cost of funds from all sources. Factors that determine whether direct bank deposits make sense include how direct bank betas move relative to branch betas, the pace of CD growth compared with savings growth, and product capabilities such as CD renewals and promotional savings rates.

Second, a bank must identify the near- and longer-term growth objectives to define the level of success. If a bank wants to raise $2 billion in deposits over three years, the thoughtful use of high-rate savings ***without aggressive renewal repricing*** may be sufficient. If the aspiration is $10 billion, more careful consideration of products will be needed — including potentially moving beyond vanilla savings and CDs as well as marketing spend, value proposition and sustainability.

Third, scenario-based planning is the key to understanding the potential benefits of a direct-banking strategy. What range of potential deposit growth goals is the institution facing? How competitive are local markets compared with the online market? What are in-branch options to defend against aggressive pricing from existing or new competitors? Developing a clear plan under a range of likely scenarios will ensure the sustainability of any path forward.

FIGURE 3: THE ESTABLISHMENT OF A DIRECT BANK CAN CARRY REPUTATIONAL RISKS



Source: Novantas Analysis

DIRECT BANK AS ALTERNATIVE OR COMPLIMENT TO BRANCHES

The presence or lack of branches has a profound influence on the success of the direct bank. Generically, there are three combinations of physical and digital presence in a market: launching a direct bank on top of a dense network, establishing a direct bank as part of a thin-network play, or going branchless with a direct bank that blankets the entire country.

It might sound redundant to launch a direct bank on top of a market that is already dense with branches, but this strategy can be successful in gathering deposits from consumers or businesses in the area who don't visit those existing branches. Such potential customers will likely already be familiar with the brand from walking and driving by branches, encountering local sponsorships, and an exposure to advertising in local media.

As always, there are risks associated with this strategy — the main one being the risk of cannibalization from existing customers who become aware that their friends, neighbors or co-workers who weren't bank customers now have access to a better rate than they do.

Banks that pursue this approach must determine the appropriate value proposition for the new customers and identify a plan to keep current customers happy without cannibalizing their deposits. A number of banks have sought to do just that by launching the direct bank under a different brand name.

The second option can be used by banks that already have a small brick-and-mortar presence in a specific geography. In some cases, this presence may be the result of an acquisition or it may be a city or area that had previously been identified as ripe for expansion. A direct-bank play here would demand a bigger dedication to marketing and advertising than the first strategy.

Finally, there is the national effort, which isn't for the faint of heart. In this case, a bank is filling in gaps in its footprint and seeking to draw deposits from across the country. This can be an expensive effort with a hefty marketing budget because many potential customers may be unfamiliar with the brand. **Regional banks that want to go national should create an innovative product that resonates with new customers, including non-rate-based incentives.**

In all these cases, banks need to closely monitor the banking behavior of the customers they acquire through the direct-bank channel. The development of a library of customer attributes and insights is essential in this evolving category. Otherwise, banks can quickly find themselves in a cycle of delivering high rates to customers who will only go elsewhere when the time is right.

Ultimately, launching a direct bank will make sense for some institutions, but not necessarily all. Being clear on the near and long-term objectives, having a clearly thought out purpose and value proposition, and understanding the financial impact under a range of scenarios will mean the difference between success and failure.

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