



From Free to Fee Checking at Fair Value

Banks can recover lost fee income if they introduce fees as part of a value exchange perceived as fair by the customer.

BY DAVE DEFAZIO AND MIKE BRANTON / AUGUST 16, 2011

Regulation E changes, the Durbin Amendment, and overdraft “guidance” from the FDIC and OCC have all combined recently to destabilize the economic model of consumer checking. According to the FDIC, service charges on deposits were down 13% in 2010 and 17% in the first quarter of 2011. These declines are due primarily to Reg E changes and don’t yet include the impact of Durbin or the forthcoming regulatory guidance. So, the reality of the situation is clear: your bank needs more fee income fast.

Unfortunately, your need for more fee income runs counter to consumer preferences when it comes to bank fees, and in particular, checking-related fees.

To start with, bank customers are more price-sensitive than ever before. They are previewing, comparing and price-shopping checking products at competing bank Websites. Plus, free checking has trained them to assume that if banks can give away all these checking services and benefits and remain profitable doing it, then it represents an unfair exchange of value if the banks suddenly start charging fees for the same things. It’s analogous to how you felt when the airlines started charging you for luggage.

Bankers understand the inherent value in traditional checking benefits and services, but free checking has trained customers to value those services at effectively zero. So, what’s a bank to do? Most institutions have so far taken one of two approaches:

Do Nothing. Banks responding in this manner are seemingly in denial, waiting for some sort of sign or miracle to happen, like the repeal of Durbin or overdrafts making a comeback. While the market has been patient and forgiving in the past two years to make this a viable option, time is running out; the rules are set. Fee income will decline no matter your bank size and you will have to replace it somehow.

Perform a “Fee-Ectomy” on Customers. We define a fee-ectomy as charging your customers a fee for the same products or services you’ve been giving away the last decade or so. A fee-ectomy includes account requirements to avoid punitive fees with no additional value provided, the most popular version being a minimum balance requirement with a penalty fee. This is also the most customer-despised requirement because it reinforces in their minds that they don’t have a lot of money and are being penalized for it. Checking history has shown that fee-ectomies deliver only a fraction of their projected fee income as your customers decide to terminate or alter their checking relationship with your bank and your front line waives a lot of these fees in response to such discontent.

Nearly all bankers admit these two approaches fall short of their goal of offering relationship-based products. Fortunately, there is a third option available that supports this goal: injecting value into the checking account. Banks must introduce non-traditional benefits with no pre-conceived “zero” valuation by consumers into the checking account product. By doing this successfully, you will convert what the customer perceives as an unfair exchange of value into a fair one. You still have to price your relationship product fees reasonably

because free checking will remain the consumer's reference point for comparison. But introducing new, non-traditional checking benefits combined with the most meaningful traditional checking benefits is the winning formula.

Adding Value Fairly

Let's go through the decision tree required to reach this point. First, every bank should be laser-focused on three issues: what to do about the thousands of unprofitable checking accounts your bank currently has (about 40% of all retail checking accounts); how to get more fee income and not anger customers, especially profitable ones; and what to do with free checking – keep it, ditch it, change it or add it.

In regard to the first item, banks must find a way to determine the individual profitability of each consumer checking relationship, including all other loans and deposits that the checking customer has. There has to be realistic segmentation across relationship profitability. Banks must know who is contributing how much so they can design checking solutions around these segments to fix and grow the unprofitable relationships and protect and grow the profitable ones. Cross-selling is not the cure-all here due to the elusiveness of consistent execution.

This profitability assessment is informative, but does not provide the tangible benefit of increased fee income unless the bank has the tools and expertise to design the products needed. In other words, banks must be able to answer the question after the assessment: "So, what do we do now in terms of specific product and pricing solutions that will successfully generate new fee income?"

This brings us to the second action item. A lot of banks approach new fee income generation strategy from the standpoint of a "one-size-fits-all" or an "across-the-base" approach. Fee structures, normally punitive, get levied the same on everyone. Profitable customers will get dinged with a penalty fee for not meeting a minimum balance checking requirement even though they have a war chest of certificates of deposit and a couple of sizeable loans at the bank as well. Then we all know what happens. These customers "talk with their feet" or talk loudly to branch staff and these fees get waived. So now you've angered your best customers and have nothing to show for it. (Again, if your bank can segment your checking customer base by relationship profitability, you don't have to do a broadbrush fee change but can target the product changes and pricing strategies accordingly).

The third item, the fate of free checking, is the most thought-about issue when it comes to consumer checking today. Most mega-banks have eliminated it. About 25% of banks say they are going to keep it no matter what. And the remainder of banks isn't sure what to do and seem to be waiting for a peer competitor to go first and then follow suit. Essentially, the answer to the question about free checking still is "it depends." You need to have something to offer that's competitive and consumer-appealing when it comes to opening new accounts while not undermining the optimization of profitability of existing accounts.

The introduction of value in the form of non-traditional benefits effectively addresses each of these three key issues. Such benefits can include participating in expansive local merchant-funded discount networks where customers can truly save a lot more than the account fee or identity theft protection at better than direct-to-consumer-prices; these are all benefits for which consumers will gladly pay. This allows the unprofitable accounts to be fixed, new fees to be gained and compatibility with free checking achieved no matter what you decide to do with it – if the account fee is priced and structured correctly.

Some banks have already figured this out and collectively have millions of checking customers gladly paying monthly fees for their checking accounts. Existing checking customers are generating about \$60 more per year in customer-friendly fee income per account. New checking customers are generating around \$75 more in fee income, choosing a fee-based account about 30% of the time when totally free checking is offered and about 60% of the time when totally free checking is not offered.

So, recovering at least a portion of the recently lost fee income is doable, but a fair exchange of value for the customer has to be there. In that case, you can go from free checking to fee checking and still have your customers like you.

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