From Free to Fee Checking in the Age of Fee Sensitive Customers

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The Checking Experts

The world of retail checking has changed. Reg E, Dodd Frank, The Durbin Amendment, and other regulatory and economic pressures have negatively impacted the underlying economics of retail checking, namely fee income. So financial institutions must find alternative fee sources to replace lost fees, at a time when their customers sensitivity to new fees is at an all-time high. Below are the top five things financial institutions must be considering and deciding as they change their retail checking game plan.

#1 Replacing Lost Fee Income Will Be Paramount

Early results from Reg E opt-in efforts are encouraging but the material loss of overdraft income is nevertheless inevitable. Expect these fees to decrease more as the economy continues to demand that consumers save rather than spend, consumer awareness of personal financial management grows more keen, and the FDIC forces banks to do something about the chronic overdrafters (six or more per year) - where the mother lode of overdraft income resides.

Banks will find themselves constrained as they try to replace overdraft fee income with another source of checking account fee income that's not egregious. Look for traditional checking product/pricing tactics like minimum balance requirements with penalty fees or charging monthly fees for the same checking benefits services given away the last few years to not sit well with consumers. Tactics like these will be risky as customers are more ready than ever to "talk with their feet" and switch banks, particularly profitable customers angered by indiscriminate, broad brush changes. Plus, as history has shown, these fee pricing arrangements fail to deliver significant new fee income. So new creative ways of going from free to fee checking will be invented that are more customer-friendly.

#2 Debit Cards - What to Do?

The Durbin Amendment of Dodd Frank will take a bite out of debit interchange revenue, maybe even eventually for banks under $10 billion in assets. Look for the proposed cap of $.12 per swipe not to hold up due to political pressure and further analysis of costs. Nevertheless, banks find themselves with another fee revenue replacement predicament, just not sure how severe or when it will become effective.

Banks will not be able to trump the customer convenience and overwhelming popularity of debit cards as the preferred payment method. So debit cards will have to continue to be emphasized. Penalizing customer card usage by charging fees or eliminating cards to save costs is a false economy because it will cause material customer attrition. However, debit card reward programs will continue to fade away to cut costs as nearly all of these programs never consistently performed at projected financial levels and made little to no emotional connection with customers to motivate increased debit card usage.

Even with Dodd Frank's impact, banks will quickly realize that the only way to make up for a lower fee per swipe is to get more swipes. Transaction volume will be king and banks will try to maximize the number of swipes they can get, even at the future lower rate per swipe. More directly connected reward

programs related to the overall checking relationship (rather than just the debit card transactions) will be in vogue. These will more tangibly and simply "reward" the customer with higher interest rates and/or decreasing fees based on certain banking behaviors.

Any level of a per swipe capped rate could be a body blow to banks unless they get customers to use their debit cards even more to increase transaction volume, despite the lower per swipe rate.

#3 Facebook, YouTube, Twitter and Your Bank

There are a lot of very adult-sized numbers flying around about the potential of marketing, account acquisition, cross-selling and customer retention via these social media vehicles. And there is a lot of soft research about this being what customers want their bank to do and how they want their bank to communicate with them, and what banks must do to be competitive in the future. Maybe that is so in the next three to five years but most banks will go relatively slow in this area in 2011.

The first reason is social media activities are starting to show up on compliance reviews and there is no real compliance guidance yet. So banks are not sure what they can and can't do.

Second, it is still very uncertain whether communicating/marketing/selling a bank's services/products on Facebook, video promoting your brand on YouTube or tweeting about a HELOC special will really contribute financially. Those banks racing out in front will be doing it primarily for promotion purposes without a return on investment requirement (or a very low one).

Many 16-35 year olds are skeptical when you talk about banks and social media. While another highly targeted online group, the 55+ year olds still are basically uninformed. Banks with budget resources will spend their time, energy and money in 2011 upgrading their websites to make a more favorable online impression as nearly two-thirds of prospects check out a bank online before venturing into a branch, enhancing their online banking/bill pay site so that it is easier to use, and making their online account opening/funding engine work like it is expected to. Banks that focus on making it easier to bank however the customer wants to bank will win in 2011 over those who try hard (or too hard) to be cool.

Once banks get these things accomplished, they will turn their attention to mobile banking so they will not likely get leapfrogged by non-traditional competitors. Then banks will most likely turn their attention and dollars to social media. In 2011, do not fret about losing much new business to banks pushing social media. Plus you will be able to see what works and does not work from the early adopting banks' efforts.

#4 Going from Free to Fee Checking and Keeping Customers Happy

The last decade of free checking has resulted in banks training their customers that the traditional bank benefits in a checking account should be free, despite their genuine intrinsic value. So they have been valued at zero (free) in customers' eyes. Banks are going to need some non-traditional bank benefits (that aren't pre-judged to be worth zero) to justify collecting a monthly account fee that's not seen as a nuisance fee. There is hardly a bank in America that has sold more than 2% of their checking customers a monthly fixed fee account that's just a bundle of bank benefits.

Two non-traditional benefits that have enough traction with consumers in a retail checking account to be able to charge monthly fees in 2011 are:

Merchant Funded Discount Network

As mentioned above, the new debit card economics will decrease the number of debit card reward programs. The next version of reward oriented benefits emerging, which will meet the new Dodd Frank debit card economics, is a merchant funded discount program - where a merchant pays for the purchase discount (the reward) and not the bank, plus the bank gets a share of the revenue from the program.

Visa, MasterCard, large core processors and other third parties are touting these programs as a way to be different product-wise and to spur debit card activity by helping checking customers save money when they have to spend it for selected purchases. Look for some product differentiation benefits early on but then they must financially perform.

A quick look at the depth of the current programs shows just a few dozen participating merchants. They are primarily a handful of national mass merchandiser discounts that, in most cases, a customer can get directly from the internet for free without having a checking account relationship.

Spurring debit card activity via primarily national retailer discounts will not likely be a huge money maker in terms of new fee income. And some of the more popular programs are available only to online banking customers, so a large portion of the retail checking base will not participate.

The revenue-sharing portion of this to the bank also won't be a huge contributor. Since the merchant is doing all the funding of the program, only a very small sliver of the purchase discount from a low number of transactions will not yield a significant amount of new revenue to fill the gap of declining overdraft and debit interchange fees.

To get the most impact, a merchant funded discount program will have to include local merchants, which provide limited access to their discounts inside the checking account relationship rather than unlimited access outside of the checking account relationship. This also provides differentiation from the other savings networks with national retailers.

Two year old Groupon (which turned down a purchase offer from Google for $6 billion) illustrates the power of the limited access local merchant network versus the national retailer open access savings network. To be different enough to collect a fee for this benefit, you will ultimately need local merchant funded discounts, and a lot of them. Look for these merchant funded programs to "shakeout" in 2011 with the winners having many more local discount offerings in order to pique customer interest and materially increase fee income.

It is still too early to say how much debit card usage lift you will get from national or local merchants discounts but it provides much more financial and promotional potential than just the national merchants alone.

Regardless in 2011, you will see banks touting "checking accounts that pay you back" by saving customers money when they spend it, in order to be different enough to charge a monthly fee for this benefit.

Identity Theft Protection

The losses and media attention attributed to identity theft are increasing almost as fast as the number of companies that provide identity theft protection benefits. For the last five to seven years, banks have been trying to sell ID theft protection benefits to customers either as an add-on sale in the branches or by renting their customer list to a third party who pounds these customers with direct mail offers, some of which border on being deceptive. Both methods have generated anemic sales rates to customers, which is tolerated by banks because they have no financial investment in these programs due to these providers doing it for free and then revenue-sharing (with banks getting a very small amount of revenue). The more successful identity theft protection programs to date are sold by going direct to the consumer with infomercials and other direct marketing techniques. Using banks as a sales channel has not generated a lot of sales volume for id theft protection companies. Expect to see both banks and the major identity theft protection companies moving away from these types of arrangements due to this lack of sales performance.

It is true that your customers see your bank as the natural provider of identity theft protection services. So your bank should still offer these services to checking customers but in a much smarter and effective way. Look for banks to start bundling these benefits in selected accounts for no additional fee other than the account fee. Being the bank that really cares about identity theft protection will mean offering and selling this service in this bundled arrangement. Otherwise, you will find yourself again not making much new fee revenue in 2011 trying to sell it as a stand-alone product.

#5 Getting the Most Financial Lift — Improved Account Profitability or New Account Growth

Due mainly to #1 and #2, most banks will be focusing on the bottom line of retail checking in 2011 just like they have been doing for the entire bank in 2009 and 2010. Banks cannot afford to continue to subsidize the 30% to 50% of retail checking accounts that are unprofitable. Banks must find a way for these customers to start paying their way without resorting to hassle fees but rather relying on providing more value and getting customers to pay for it.

Cross-selling is always an option but it is as elusive as ever so banks won't spend a lot more time and money here in 2011. Instead they will invest in their "super profitable" checking relationships to protect and grow them by simply giving them the best checking account in the bank with the best benefits and services, then trying to follow-up with this segment more efficiently.

In terms of a few banks interested in aggressively growing their account base, they will avoid the one dimensional metric of gross account openings and focus on the right new account mix with built-in profitability. This will ensure that they won't be right back where they are now in terms of the large percentage of unprofitable accounts in the checking portfolio.

Marketing campaigns will continue to focus on bank stability and security, interest rate paid or incentives (namely cash) to open an account. Look for less on the bank stability and security side, more on the interest side if rates rise (probably in the form of a reward checking account whose popularity and results has fallen with the low interest rates) and incentives tied to select accounts and activation of services in those accounts (much less "open a free account and we'll blindly pay you $100" incentives). There will still be a plethora of free checking offers from banks that still think that free is a difference maker in the mind of a customer looking to change banks.

For 2011, the overall retail checking objective will be banks finding new and creative product strategies to define a customer as someone who pays for valuable services and products and not someone who believes your services aren't worth paying for. Banks cannot financially afford not requiring this as the 2011 definition of a customer.

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