



Global Warming and Fee Income Cooling — An Inconvenient Truth?

by Jeff Burton, Senior Vice President and Managing Director, Carreker Corporation

For those of you who haven't followed your GL's very closely, weather conditions aren't the only things that are unseasonable. Bankers around the country have been asking, "What's going on with fee income?"

The winter has been cold for bankers, and despite countless hours spent devising strategies to address it, revenue growth continues to lag while charge-offs grow at an alarming rate.

Carreker's understanding of fee income has continued to evolve over the past few years. This article reviews recent findings and includes ideas for future fee income initiatives so that future years aren't rife with turmoil.

Okay, you're going to think I used to eat paint chips as a kid, but bear with me. Everyone knows the Apple Computer story. But who is aware of the fact that Apple Computer is no longer Apple Computer? The company recently dropped "Computer" from its name. Why? Because as Steve Jobs will tell you, Apple isn't in the computer business anymore. It is in the *digital lifestyle business*. Jobs recognized that as technologies converge, many non-computer devices are replacing computer functionality and appeal. Interesting concept but where is the relevancy?

Similar changes have occurred in retail banking. For years, retail banks did two things well — take deposits and lend money. Each of these functions over time has become more diverse. Lending has consolidated (err) evolved. Deposits on the other hand have expanded to include brokerage, payments and courtesy overdraft services. But how do you characterize overdraft (OD) services? Bankers and regulators would string me up if I said they are loans, because OD services are not underwritten, nor are they guaranteed to the customer. I would instead characterize them as discretionary short-term liquidity services for certain customers.

This means that anybody providing short-term liquidity services to customers is competing in the overdraft services market. It also means that if non-bank entities compete in this space, then looking solely at overdraft revenue would render a myopic perspective on what is actually happening in the market.

Fast forward to the last few years. As banks have witnessed a shift in overdraft revenue seasonality, unexpected shortfalls have prompted banks to make changes across their portfolios with little regard for how specific sub-segments might be impacted. Two types of "portfolio-level" changes are OD limit increases and pricing increases. Our contention is that unless banks are aware that the market for short-term liquidity services is broader than just banks, that changes like these have contributed to, and even exacerbated, the perceived issues with fee income.



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Whether banks have used a dynamic scoring model or simple flat limits, many have found that raising the floor or the ceiling will extend more service and result in more revenue. This to me is the banker's equivalent of Bill Cosby's theory that if "you put a bullet in a furnace, it will explode." And explode is exactly what happened with OD limit changes. Specifically, short-term revenues have risen for banks implementing such changes, but then they peaked and later began to retreat, while charge-offs continued to climb. Why?

I am not saying that selectively giving higher limits is a bad thing. We just believe that uniformly increasing limits beyond a customer's short-term liquidity needs will ultimately lead to a negative outcome. Some customers will get in over their heads, which leads to charge-offs, which leads to hugely profitable customer accounts being closed by the bank, which leads to revenue disappointments. The solution to reverse this trend is simple to understand, but can be complicated to execute.

Leverage deposit, transaction and customer information to properly determine the 'right' limit that balances the customer's need, the customer's ability to repay and an equitable risk/reward equation for both parties.

Sounds simple enough, but what data does a bank need? If you don't definitively know whether the customers you are giving higher limits to actually have a lower probability of charge-off, you qualify for a better solution which in turn can reward the bank with a significant upside (10% or more effective revenue growth in some cases) derived from principal charge-off reductions and revenue retention.

On the flip side, while price increases are never desired, they are always the "ace up the sleeve" for banks relative to filling budget shortfalls. Let's discuss a real example around a customer that is charged a \$30 fee as a result of a \$1 purchase of Dentyne gum. As any Mensa candidate would deduce, if the customer didn't like the historical \$30 charge, the bank probably won't have any success up-selling him on the added benefit he gets for paying an extra \$2 related to the price increase. As banks continually charge more for their services, the chasm between value and cost has widened. One might speculate that as this gap has grown, some customers may have even found a similar product or service elsewhere, for a lower price.




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That's right, the paradigm around fee income has shifted from "penalty to product" and the pricing of that product requires careful consideration in light of competition from both banks and non-banks. But don't take my word for it, talk to the payday lenders that service your customers to the tune of \$40 billion in annual loans. I know what you're thinking; banks don't lose customers to payday lenders. Lose is probably the wrong statement. One study suggests that 50 percent of payday lending customers maintain a banking relationship. A better term might be "dilutes". Try asking the person that processes your ACH files to send you the ACH debit file on a payday. You might be interested to see some of these institutions, that can't possibly be competitors, showing up as your customers' payees, while you wonder why overdraft revenue is declining.

So what is my point? Resist the temptation to increase fees every chance you get. Raising fees for loyal customers is a knee-jerk strategy that will lead to long-

term demise. An alternative is to design a new product that enables customers to proactively manage their short-term liquidity with less risk.



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Your customers now demand a controlled product that lets them manage their short-term liquidity without the penalty of unexpected fees. The reality is that the payday lending products actually deliver on these needs better than banks' overdraft services. Now you are probably thinking, "But we don't want to be in the payday lending business." Guess what, the payday lenders don't want to be in the payday lending business either. Instead, they are competing in the short-term liquidity business — just like you. We have recently worked with clients on new products that compete against payday lenders, and despite obvious objections regarding revenue cannibalization and the like; banks that have taken our approach have increased overall revenue and customer utilization.

So "what is going on with fee income?" The overall fee income market is fine, if you include both bank and non-bank establishments. However, banks have not yet positioned themselves to share in the total market by demonstrating the creativity of non-bank competitors in meeting customers' needs.

A better question might be, "how can I revamp my products, processes and supporting technologies to better compete in this growing market?" That's a great question. Call us to learn more! ■



Jeff Burton is senior vice president and managing director of Revenue Enhancement at Carreker Corporation.

Carreker's Revenue Enhancement practice helps financial institutions meet their revenue and customer relationship objectives through emerging best practice opportunities. For more information contact Jeff Burton at 818.259.4134 or jburton@carreker.com.