GAINING THE EDGE IN A TIGHT MARKET

In a new race for market share, the focus is shifting to expanding customer relationships.

Regional C&I Growth: Focusing to Win

A Cautious Outlook for Household Credit Demand

Smart Growth in Home Equity Lending

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Strategic Turning Point

Having made great strides in stabilizing their recession-scarred portfolios, banks are now turning their sights to 2011, where the big question is revenue growth.

With loan volumes down 40−70% from the peaks of a few years ago, is there any relief in sight? To explore that question, this issue of the Novantas Review takes a look at loan growth strategy in a post-recession environment. As detailed in our cover story, “Gaining the Edge in a Tight Market,” it is shaping up to be a shallow economic recovery, setting the stage for an epic market share battle among growth-hungry banks.

The situation marks a strategic turning point in an industry that had been fixated on high-volume product origination. The new priority is relationship expansion — doing more business with established customers — with major implications for bank performance.

As outlined in “A Cautious Outlook for Household Credit Demand,” many consumers are still dealing with the aftermath of the recession and wary of new mortgage borrowing. In turn, there’s a need for enhanced sales responsiveness in the branch.

Meanwhile, in middle market commercial banking, clients are increasingly looking for specialized banking expertise. As shown in “Regional C&I Growth: Focusing to Win,” there are further opportunities to meet this need through so-called “industry verticals.”

Such customer-centric strategies will be essential in a tight market.

Steve Klinkerman

Steve Klinkerman
Editor-in-Chief

“It’s shaping up to be a shallow economic recovery, setting the stage for an epic market share battle among growth-hungry banks.”
Gaining the Edge in a Tight Market

BY RICK SPITLER

As lenders fight for growth through market share gains, the competitive emphasis will tilt from pushing products to cultivating fuller customer relationships.

Lending was an unstoppable profit engine just a few short years ago, with surging demand in all asset categories, both commercial and retail. It was an unfettered environment where banks saw opportunity in every market, risk tier and price point.

As the industry moves beyond the subsequent market collapse, however, banks are wrestling with fundamental questions about growth strategy. While the easy answer is more careful execution of traditional mass market product initiatives, realistically, now is the time to retool for a changed economy and competitive environment.

The current economic recovery, if it can be called one, promises to be a drawn out affair, quite unlike other market rebounds that saw steady increases in employment, borrowing and spending. For the next few years, most loan categories at best will grow only modestly from current recession-battered levels.

In this rugged terrain, winning banks will be the ones that gain market share at the expense of other competitors. There simply won’t be enough underwrite-able demand to support the overall industry distribution and sales capacity built up over the last decade.

Instead of pushing individual products, competitive banks’ emphasis will tilt to cultivating fuller customer relationships — doing the most to expand and retain established household and business relationships; and anchoring and engaging new customers more thoroughly and effectively.

Part of this trend is a major redirection of marketing priorities. In a low-volume market where new customers will be in short supply, revenue generation will be much more dependent on sales to established customers. There will be a major push to build multi-faceted credit relationships with customers who are already with the bank.

One clear implication is the need for greater consultative sales expertise, both within the branch and among commercial banking relationship managers. Prime customers are in short supply and have more bargaining power, and a relationship context is essential for effective cross-sell.

A second priority is targeting. Where institutions once blanketed entire regions, or even the entire franchise, with standardized offers, now they must carefully pick their way in an environment where the opportunities are few and the risks are many. Along with the shape and scope of customer demand, lenders must be much more cognizant of borrower...
Winning banks will focus on the new survival skills needed to win share in an ongoing environment of constricted loan demand.
risk profiles and variations in local market conditions.

A third priority is pricing. While many lenders work to solidify risk-adjusting pricing floors, there are other important considerations, such as pricing strategies for product bundles, and the whole question of setting the “sticker price” of credit based on elasticity of customer demand. Segment variations play into this as well.

Instead of sitting tight and hoping for a return to better times, winning banks will step up to the realities of a changed market, and focus on the new survival skills that will be needed to win share in an ongoing environment of constricted loan demand.

**THE ROAD AHEAD**

Recent challenges in commercial and retail lending are well known to bankers, but it is still helpful to consider the trend perspective and implications for future growth. Looking over the next two years or so, it is hard to make a case for a return to robust loan origination, as supported by the following:

- **Household constraints:** U.S. households are continuing to shed outsized debt loads in an era of high unemployment and impaired housing values. Many people simply can’t qualify for credit, as illustrated by a recent FICO Inc. analysis showing that one in every four U.S. consumers does not meet minimum risk standards for items such as auto loans, mortgages and credit cards.

- **Business constraints:** In middle market commercial banking, a key lending area for major banking companies, commercial realty likely will continue its slow-motion tumble for a good while longer, reflecting the intricacies of dealing with high-dollar properties in distress. Commercial and industrial companies, meanwhile, are sitting on mountains of cash and have shown a weak appetite for borrowing to finance property, equipment and hiring.

- **Banking constraints:** Along with needing to guard capital, many banks remain over-weighted in mort-
gage-related assets and burdened with heavy portfolio cleanup operations, including defaults, collections and negotiations with distressed borrowers and foreclosures. Any new credits need to be of high quality, both to counterbalance the post-recession hangover and to lower the risk profile going forward. This further makes the case for selective loan expansion.

- **Regulatory and legal constraints:** New laws and regulations for consumer protection will crimp lender flexibility and key revenue streams, further limiting banks’ ability to serve higher-risk lending segments.
- **Secular trends:** Increasing numbers of Baby Boom households are nearing retirement and won’t return to the peak borrowing and spending patterns of recent years. Credit demand likely won’t fully revive even when the economy recovers.

The point in mentioning these factors is not to convey gloom, but to emphasize the degree to which banks will be competing for a limited pool of prime customers in the years ahead. Instead of waiting for a 2005-style surging market that likely will never return, banks will need to concentrate on winning market share, a path that inevitably centers on expanding customer relationships.

**RELATIONSHIP EXPANSION**

Especially in peak market conditions, there has been a pronounced tendency for banks to operate as cafeterias, with customers taking the initiative in selecting individual products, often from multiple providers. A single bank typically will capture no more than 10% to 25% of the average customer’s total wallet, meaning at least 75% to 90% of the relationship potential is usually lost to other providers. One key to reversing this trend is learning to sell multiple credit products within a relationship context.

In building the specific business case for relationship expansion, banks can generally look to five types of advantages in increasing cross-sell product penetration with established customers, all of which contribute to improved relationship

“Instead of pushing individual products, the competitive emphasis will tilt to cultivating fuller customer relationships — doing the most to expand and retain established household and business relationships; and anchoring and engaging new customers more thoroughly and effectively.”
revenue and profit potential:
1. It is a more cost effective type of selling, compared with the effort required to sell each product separately, or to establish entirely new relationships;
2. It provides richer customer information and stronger leverage for pricing strategy;
3. It provides better information for underwriting;
4. It contributes to relationship longevity; and
5. It typically is accompanied by improved loan repayment behavior.

A key question, however, is how to locate the best opportunities to build multi-product relationships within the current portfolio. Prior Novantas research done with the Bank Administration Institute, for example, suggested that only about half of retail customers are candidates for in-depth banking relationships, with significant variations in needs within this group.

One way to focus the search is to capture more household primary payments accounts and look at customers through that lens. There is a strong information advantage in being able to process the bulk of household transactions, plus the activities surrounding the primary checking account offer more opportunities to interact with customers. Some regional banks are taking this logic a step further by also trying to capture more credit card accounts, which can provide even deeper insights into credit needs.

Such efforts will succeed on the strength of customer analytics, an essential in targeted marketing. Banks will need to sharply improve their skills in identifying high-value opportunities, many residing within various customer segments. This includes recognizing key cross-sell possibilities over the life of the relationship.

In many cases, banks have opportunities to improve their anticipatory sales strategies, based on an understanding of customer stage of life, major life events, and an analytical understanding of likely cross-sell progressions from one product family to another. Along with being financially constructive, this sort of proactive outreach brings authenticity to a relationship orientation.

CUSTOMER ACQUISITION

Although the principles of relationship expansion in theory apply to new customers as well, realistically, the waters are murky in the early going. The bank may be able to target prime prospects and model their likely response rates, but subsequent patterns in customer behavior and product usage will only become known over time, leaving question marks about relationship profitability and customer lifetime potential.

The upshot is that in new customer acquisition, product and channel considerations will predominate. In this arena, winning banks will work to target and price their offers more carefully; augment distinctiveness and overall value; and deliver offerings in the manner that elicits the strongest customer response.

With prospects, the analytical challenge includes not only recognizing the varying risk and demand characteristics of households and businesses, but also the varying market dynamics of the major locales in which target customers are situated. With countless households and local housing markets still in distress, for example, there’s a heightened need for selectivity in both promoting and evaluating mortgage credit.

One shared requirement in commercial and retail banking is a need for greater sales expertise. In commercial banking, middle market companies apparently are stepping up their demand for sector-specific service. Health care enterprises, for example, want to be served by relationship managers with deep knowledge of that industry. While the use of “industry verticals” is a long-running trend in commercial banking, the customer appetite has grown even as the barriers to entry (information, expertise, required market scale) have fallen, creating a window of opportunity for regional banking companies that previously may have downplayed this strategy.

In retail banking, there is a particular need for an improved branch sales process, especially as it pertains to mortgage and home equity lending. Coming out of a wrenching U.S. housing market crisis, customers want to be assured that they are handling new borrowing in a way that won’t come back to haunt them. Also the branch representative must play a more proactive role in processing and screening credit applications, helping the institution to uphold elevated underwriting standards.

ESSENTIAL SKILLS

In many ways, pricing will be the knot that ties the whole relationship lending package together. At the discount end of the spectrum, there will be opportunities to promote credit bundles and product cross-sell with attractive rates, in ad-
dition to opportunities to take market share with targeted campaigns aimed at prime prospects. At the other end of the spectrum, certain credit products and packages may even command premium prices, based on the strength of customer demand.

To unlock these opportunities, many banks will need to improve their credit pricing skills. Some players, for example, still are working to establish robust pricing floors, based on metrics such as risk-adjusted return on capital. And most banks are not yet able to set target prices based on calculations of price elasticity of customer demand.

Then along with tailoring pricing targets and floors for various marketing initiatives and customer segments, banks will need to do a better job of factoring regional market dynamics into the equation. In home equity lending, for example, Novantas research has uncovered significant national variations in the weighted average market price, spanning a range of more than 500 basis points in certain product segments.

"Where institutions once blanketed entire regions, with standardized offers, now they must carefully pick their way in an environment where the opportunities are few and the risks are many."

To respond to emerging issues and opportunities in customer acquisition, many regional banks probably will need to beef up their central analytical teams, and also find improved ways to drive information and insights to the field. At many retail banks, for example, there’s an ongoing disconnect between the comprehensive knowledge that the branch representative is expected to demonstrate and the actual information tools that are immediately available to support effective selling. Requirements for improved underwriting and pricing provide additional impetus to solve the management and system challenges that often impede the central office in augmenting branch sales effectiveness.

**MANAGEMENT IMPLICATIONS**

As banks enter the planning and budgeting cycle for 2011, management has several clear priorities in preparing for the coming battle for market share.

First, there is a need to explicitly evaluate the marketing tradeoffs in relationship expansion versus new customer acquisition.

Without going into all of the details of economic models, suffice it to say that the bank needs “dollar out, dollar in” guidance on where to place its efforts in revenue generation. This sort of economic analysis is essential in setting marketing priorities for major customer groups, major product lines, and major regional markets.

Second, the bank needs to develop a game plan to pursue key opportunities. With relationship expansion, for example, there is a need to understand the potential for customer lifetime profitability, and the various cross-sell possibilities that best contribute to relationship value, depending on the customer profile. Then with customer acquisition, there is a calculation with respect to the specific product and channel initiatives (establishing new industry verticals, for example) that will best attract prime prospects.

Finally, the bank will need a detailed map for resource allocation, in line with the net benefits that it hopes to realize with each type of revenue initiative. This includes provisions for careful monitoring and performance measurement. In an uneven market, there is a heightened risk of misallocating scarce marketing resources.

Looking over the next few years, retail and commercial lending still will provide opportunity for the banking industry, but not at the magnitude seen in prior economic recoveries. A rising tide won’t float all boats. There will be winners and losers among individual institutions, with some banks winning far more market share than others. In many cases, the determining factor will be success in expanding relationships with established customers. A companion priority will be playing a much smarter game in new customer acquisition.

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A Cautious Outlook For Household Credit Demand

BY ANNETTA CORTEZ AND GAURAV GUPTA
As retail banks gear up for 2011, they are facing critical questions about consumer credit demand. While the lingering serious challenges with mortgages and credit cards are well known, institutions still have a pressing need for earnings growth, if it can be found. It seems unlikely that household borrowing will begin to broadly climb in tandem with a reviving economy.

Instead of a strong, widespread expansion, a scenario more hospitable to product push strategies, it will be an uneven market with scattered pockets of demand and lingering pockets of risk, a scenario requiring precise targeting and a far stronger relationship context.

Along with carefully considering the shape and scope of household credit demand, retail banks will have to adjust the marketing and sales context, both to reflect the importance of remaining viable borrowers, and also to provide the advisory expertise and reassurance that people are hungry for in the post-crisis economy.

Looking ahead, we believe that U.S. households will generally continue to de-leverage, perhaps through 2012. This includes working down revolving and installment debt, rebuilding cash cushions, and for many, working through defaults. Employment remains a challenge; the housing market remains a challenge.

Even when these obstacles begin to noticeably subside, perhaps two or three years from now, the retail credit market still will look different. Increasing numbers of Baby Boom households are nearing retirement and won’t return to the peak borrowing and spending patterns of recent years. Credit demand likely won’t revive to prior levels.

The situation calls for a fundamental re-thinking of retail credit strategies. Instead of strictly pushing credit products through separate lines of business, winning banks will shift the emphasis from new account acquisition to relationship expansion among established customers. This will require a far deeper analytical understanding of customer needs and risk profiles; an improved ability to drive information to the point of sale; and a different sales orientation and skill set.

Looking at short-term growth potential, one area of at least modest opportunity is home equity lending. As of the spring of 2010, households still had more than $6 trillion of unencumbered equity, and this remains a convenient and advantageous form of borrowing. But to put it in perspective, home equity loan originations still will fall 70% short of the peak in 2005, and mortgage originations will fall 40% short. Meanwhile, we could see further absolute declines in credit card borrowing and student loans.

The upshot is intense competition for a reduced volume of household credit demand. It is a lopsided market, with severe skews in local housing, employment, and overall household financial stability. Winning banks will need superior skills in targeting, relationship management, risk-adjusted pricing and underwriting.
A CHANGED MARKET
There is no question that U.S. households are de-leveraging. Compared with a more than $1 trillion expansion in each of the peak years of 2004 to 2006, households reduced their debt load by more than $200 billion in 2009, and the contraction was continuing at an even faster annualized pace in the early part of 2010. Both for reasons of attitude and of necessity, we see this trend continuing, as supported by the following:

**Jobs.** Looking at the job picture, the national unemployment rate as of mid-2010 was just under 10%, with about 15 million people looking for work. This compares with a 5.5% unemployment rate three years earlier, in 2008. We are not in the business of econometric forecasting, but don’t yet see evidence of a strong resurgence in hiring.

“**In the coming battle for market share, lenders will face the challenge of skillfully using rates to attract new business while also assuming that they are doing a good job of protecting risk-adjusted returns.”**

**Debt.** In turn, the job situation certainly has a bearing on the ability of households to manage their debt burdens. Currently, the charge-off rate on mortgages is running at 10 times the historical average. And the current charge-off rate on credit cards is double what was seen in the bellwether years of 2007 and 2008. Given continuing high unemployment, we do not see quick improvements in credit quality.

**Housing.** A further complication is sinking housing values. At the end of 2009 nearly one of every four borrowers was upside down on the mortgage, owing more than the market value of the dwelling (the comparable ratio was 10% in 2005). Nationwide, there has been a 22 percentage-point drop in home equity value relative to household real estate holdings — from 60% in 2005 to 38% in early 2010. It’s an illiquid market where many households can’t find buyers on suitable terms; aren’t eligible to refinance; and often are struggling just to hang on.

Based on these three factors alone — jobs, debt burden and housing — it appears entirely realistic to plan for a continuing tight retail credit market in 2011, easily extending into 2012. Banks will need a different compass to navigate these waters, guided much more by customer relationships than by product dynamics.

From a risk perspective, there are fewer tiers of the retail market that banks can profitably serve. Along with underwriting challenges, banks and credit card issuers are dealing with new regulations that will have the effect of limiting fee revenues, increasing underlying costs for lenders, and limiting lender flexibility. Of necessity, institutions will gravitate toward the middle and upper credit tiers, where there will be intense competition for a smaller pool of business.

RELATIONSHIP LENDING
With fewer new customers coming through the door and a slackening of demand among established customers, the question is how to make the most of each opportunity. Obviously, a huge priority is increasing profitable penetration among the established customer base. And to the greatest extent possible, banks will want to expand new customer relationships to include multiple products.

There are several advantages to relationship expansion through cross-sell:

- It can **dramatically improve customer relationship profitability**, depending on the products involved. A retail relationship that includes a home equity loan, for example, typically has three to four times the average profitability.
- It is **more cost effective**, compared with the effort required to sell each product separately, or to establish entirely new relationships.
- It provides a **richer context for competitive and bundled pricing strategies**. On a selective basis, for example, there are opportunities to improve sales by offering attractive rates contingent on a multi-product credit bundle. Also, product bundles are more amenable to segment variations, some of which can actually fetch premium rates based on better targeting of price, promotion and features.
- It provides a **richer context for underwriting**, line management and collections. Rich customer information can be gleaned from in-depth relationships, but such insights have not been used fully in credit risk management. For example, we believe that there are many unexplored opportunities to take advantage of in-house customer information to extend credit where it otherwise might not seem feasible.
- It contributes to **relationship longevity**, which in turn can significantly increase the profitability of lending products. Customers who have multi-product relationships with their bank are far less prone to switch providers.
There is evidence that relationship borrowers are more conscientious about keeping up with their payments when they are dealing with a single institution. Unlike in traditional cross-selling, which tends to push products to large groups of customers who may have little in common, progressive strategies will hinge on a robust understanding of customer needs and behaviors, particularly as observed in patterns among major customer groups, and a segment-based understanding of how value is created across product lines. Such insights will provide critical guidance in targeting and presenting offers; in managing credit risk; and providing effective service.

In previous years, a generally buoyant market provided an atmosphere of strong product demand that lessened the economic rationale for in-depth relationship strategies, which do entail their own costs and complexities. In our view, a shifting market has settled the question of whether banks should reconsider cross-sell. They should. If banks are to redouble their efforts in this direction, however, then they will need quantum improvements in their strategies and skills. One essential strategy is taking far greater advantage of the primary payments account.

The principal household checking account, for example, offers valuable insights into customer behaviors and needs, plus it provides more customer touch points. One clear retail banking priority is to capture the primary payments account and nurture the relationship-building opportunities that go with it, not only initially, but over the life of the relationship.

Some regional banks also may want to put more emphasis on the credit card. In conjunction with the checking account, it provides a fuller payment view, and by itself provides a window into customer behaviors and needs.

The credit card can provide rich monthly transaction information that provides strong guidance in customer segmentation for use across all products. It also can provide a valuable vantage point in understanding and tracking the credit risk of individuals and households. Some regional banks are thinking more seriously about card expansion at a time when the biggest issuers currently are on the defensive with delinquencies, reputational issues and new regulations.

Another priority is precision targeting. As the bank improves its analytical understanding of customers, then it can begin to refine offers for major customer groups, and focus on selectively presenting various offers where they will do the most good. This level of marketing detail considers variations in regional economies, housing conditions and competitive intensity, as well as variations in household demand and risk profiles.

In many cases, banks also have opportunities to improve their anticipatory sales strategies, based on an understanding of customer stage of life, major life events, and an analytical understanding of likely cross-sell progressions from one product family to another. Along with being financially constructive, this sort of proactive outreach brings authenticity to a relationship orientation.

To fully capitalize on these initiatives, retail banks will need to improve their credit pricing skills. In the coming battle for market share, lenders will face the challenge of skillfully using rates to attract new business while also assuring that they are doing a good job of protecting risk-adjusted returns. With new regulations limiting fee revenues and flexibility in account management, the importance of striking the right pricing balance up front — at the onset of new relationships — has never been greater.

**APPROACH TO THE MARKET**

In drawing up plans for next year, it is important to factor customer attitudes into the list of considerations. Many consumers are not only wounded but distrustful. There is a strong perception that banks, especially the biggest ones, actively contributed to the housing and debt crisis by knowingly helping people to get in over their heads. Adding fuel to the fire, lawmakers and regulators have gone after credit card fees, checking overdraft fees, and more recently debit card fees, in each case with the strong implication that banks have been taking advantage of customers.

Rebuilding trust, therefore, has to be a priority over the next few years. Households genuinely need the kind of guidance and service that banks can provide. Our research, for example, indicates that perhaps more than half of U.S. households with checking accounts are living paycheck to paycheck. No wonder they are wary about the next financial trap that might be lurking around the corner.

In turn, banks will need to review the tone and substance of branch service. Especially with high-value transactions, such as whole mortgages and home equity loans, customer
face time can’t lapse into forms and pencil-pushing. The advisory aspect of front line sales interaction is much more important than before, with implications for staff performance and attendant needs for training, coaching and sales management.

One management implication is the probable need for greater centralization of key lending functions, linked to a much stronger analytical capability. This is in line with management progressions in the deposit business, where regional teams are placing greater emphasis on marketing and sales, and central teams are handling pricing strategies and tactics.

“Winning banks will shift the emphasis from new account acquisition to relationship expansion among established customers.”

Underwriting is also a changed exercise, especially given the growing willingness of distressed borrowers to simply walk away from their obligations. That’s one more argument for a strong central analytical team that can help to limit exposure on the front end through advanced screening, and also help to limit losses on the back end through proactive identification of emerging borrower distress.

There is also the question of how to drive centrally generated customer analytics to the individual branch. While individual product silos will still be a major operational reality behind the scenes, the branch representative needs to be able to present something more to the customer.

From an information perspective, a comprehensive sales approach will require a fuller view of the total customer relationship at the point of sale. Additional needs include targeting information; guidance in conversational prompts; and enhanced sales training that includes more of a financial management component, suitable for identifying deeper customer needs and assisting people in making larger decisions. Some banks are already solving the management and operational problems in making this happen. Others have a long way to go and they will be at an increasing competitive disadvantage.

Mindful of past failures with mega-database projects under the heading of customer relationship management, or CRM, retail banks will need to identify priority areas where advanced information will really help, such as in promoting high-margin home equity lending, or improving risk-adjusted pricing, and build out required central capabilities in conjunction with a solid business case for improved branch performance.

THE CASE FOR CHANGE
From an organizational perspective, executive leaders will be dealing with coordination and incentive issues. Product teams will need to collaborate among themselves and with the branch team if the bank is to succeed with centrally-designed relationship-focused cross-sell offers. Also, individual product silos typically have their own performance incentive programs that discourage feature or pricing tradeoffs that, while successful with customers, might diminish the profitability of an individual product line. There also will be a learning curve in re-fitting information systems and working through the complexity of the underlying analytics.

Especially over the last decade, retail banks have built up a lot of new branch distribution capacity, and that effort seemed well-justified during an era of high product sales volume. Now that capacity faces a potential extended era of under-utilization.

Facing fewer opportunities to generate new accounts with traditional mass-market product promotions, growth-hungry retail banks will need to do a better job of expanding the amount of business done with established customers. In turn, this type of expansion can only be accomplished within a robust relationship context.

There will be a distinct revenue advantage for banks that successfully make this transition, providing a powerful business case for fleshing out relationship strategies. By contrast, banks that simply try to streamline operations, and do a more efficient job of pushing individual loan products, will be at increasing risk of losing market share.

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Regional C&I Growth: Focusing To Win

BY MICHAEL RICE AND J.D. RICHARDS

While regional banks long have placed a priority on serving middle-market commercial and industrial firms, the stakes are sharply higher coming out of the Great Recession. Compared with overflowing demand at the top of the market, banks are now fighting over a shrinking pool of borrowers who are much more cautious and demanding.

A common management response is to tighten up the business as it stands, and concentrate on superior execution of the basics. Across the industry, middle-market commercial banks have cut costs, tackled capital and credit quality issues, and redoubled the general marketing and sales outreach to prime customers.

Often overlooked in the rush, however, is the fact that a meaningful number of commercial clients are not yet receiving the level of specialized service that will be needed to acquire and expand banking relationships over the next few years. Increasingly, commercial bankers are expected to exhibit expert knowledge of the industry sectors they serve. Meeting this requirement can make all the difference in a challenging market.

Certainly, many bankers — especially those from the largest institutions — believe that they’ve already gone as
far as possible in serving “industry verticals.” There’s a decades-long trend of providing dedicated service to concentrated industries, with the healthcare sector being a prominent example.

But there are several reasons why industry verticals warrant a fresh look, especially among regional banks. For one thing, advances in management innovation and information technology have made this kind of organizational structure far more economical and effective than before. Many players haven’t paid enough attention to this opportunity anyway, plus the urgency for growth is much stronger in a tight market.

There are no magic bullets in a commercial banking market that has fallen from heady expansion to sharp contraction. Yet, especially among regional banks, increased use of industry verticals should be high on the list of options for revenue generation.

CLIENT EXPECTATIONS
One of the most profound and least understood impacts of the recession is its impact on commercial client buying behaviors, particularly in various regional markets that have not received the level of specialized service seen in ultradense markets. Many such clients have chosen their banking providers primarily on the basis of credit availability; price; knowledge of banking products; and sales responsiveness.

While these performance attributes remain critically important, more clients are demanding that relationship managers (RMs) also demonstrate industry expertise, provide competitive information and benchmarks, and offer tailored solutions. As one banking executive put it, “generalists know how to ask the right first couple of questions, but not the right fifth and sixth questions.”

Verticals provide several advantages in meeting client demands for sector-specific expertise. They create “hot house” environments where intellectual capital is developed at a faster pace. This, coupled with investments in knowledge management processes, creates an information-based organizational capability that offers the potential for comparative advantage and is not easily replicated. In turn, client entrée is enhanced for relationship managers, permitting the bank to build an even deeper knowledge base.

The performance payoff can be significant. Compared with generalist relationship managers, our research indicates that vertical-focused RMs typically can generate 20% to 30% more revenue per banker, and 40%-50% more profit per banker.

While there is undoubtedly a “chicken and egg” phenomenon at work (where banks build verticals in industries where they have had success), there are underpinning behavioral reasons for the performance differences. Advantages include better pricing; more tailoring of deal structures; and an improved ability to select higher quality credits.

To be sure, the specialist model does typically entail a higher cost to serve (e.g., increased marketing spend, higher travel and entertainment outlays, research and information services). It is important to note, however, that the performance advantages identified in our research are calculated on a net basis, with productivity gains more than offsetting the increased costs. This is a vital finding, considering that cost-to-serve is often seen as the major barrier in either initiating or expanding industry verticals.

A LARGER TREND
Banks have steadily increased their focus on industry verticals over the past 20 years. This shift is part of a larger trend across all professional services (accounting, consulting, and law) as information has become more accessible and clients have become more sophisticated and demanding. At some of the largest U.S. banking companies, up to three-fourths of the large corporate client base is served through industry verticals.

“Commercial banking leaders must committed to making full investment or run the risk of increasing the cost to serve without getting the productivity uplift.”

However, the scenario is quite different when it comes to regional banks, middle market companies and small and medium enterprises, where the generalist relationship manager model still predominates. Most recently, along with perceiving barriers to entry in terms of cost and required expertise, regional banks were luxuriating in a double-digit environment for loan growth, lessening the need to go beyond a generalized outreach.

The Great Recession, however, has fundamentally altered market dynamics:

• Loan demand is not expected to recover for several years. Compared with an explosive 20% expansion nationwide in the single year of 2007, total C&I loans contracted by more than 15% in 2009, and we anticipate further contraction through 2010.
• Fee income is increasingly coming under pressure. The annual growth rate in treasury management has
fallen for five straight years, from 6% in 2006 to an estimated 2% for 2010.

- The market is burdened with excess commercial banking capacity, given that the number of creditworthy customers who are willing to borrow has fallen more than relationship manager capacity.

In an environment of slower growth and intensifying competition, banks are facing extreme pressure to develop unique strengths that will enable them to compete more distinctively and effectively for the shrinking pool of good customers that all institutions want.

Regional banking companies will need to think innovatively, in order to capitalize on the larger trend of industry verticals. The challenge is deploy specialized expertise in a way that is both carefully targeted and highly cost effective, with the goal of capturing incremental client revenues that otherwise would be forfeited to competitors.

In practice, commercial banking industry verticals operate along a continuum ranging from centers of interest (“soft” verticals) to separate lines of business (“hard” verticals). Distinguishing factors include:

- **Time allocation**: Are relationship managers fully dedicated to a particular industry?
- **Expertise**: Are relationship managers recognized experts, visible within the industry?
- **Marketing and branding**: Does the bank make targeted marketing investments to build brand recognition and imagery in the vertical?
- **Product development**: Does the bank develop products and solutions that are tailored to the particulate targeted industry?
- **Knowledge management**: Is there a system in place to support proprietary industry data, information and viewpoints?
- **Governance**: Does the vertical have distinct performance targets and/or a separate financial performance report?

What we often see in regional banks today are “medium” verticals that demonstrate some of the above characteristics. This often is the result of years of gradual field momentum, where relationship managers, by chance or by preference, gravitate toward an industry, have some initial success and as result, receive incremental marketing investment (e.g., money to attend conferences, dedicated materials).

However, most regional banks stop well short of “hard” verticals and typically do not develop the knowledge management and product capabilities needed to take full advantage of the accelerating shift in customer buying behaviors.

**WINNING FORMULA**

In our work with regional commercial banks, we have seen three primary keys to success in making greater use of industry verticals: 1) Identify high headroom markets; 2) Go deep; and 3) Compete on analytics and information.

**Identify high headroom markets.** For many banks, the decision to invest in verticals is simply based on industry concentration within the regional footprint. This is more of a threshold approach, where the bank is looking for a certain minimum count of sector-specific companies. While this is certainly a practical approach, a strict reliance on density metrics can result in missed opportunities.

A question of equal or greater importance is potential client uptake. For a certain group of prospect companies within a given industry sector, is there a reservoir of unmet demand for specialized service, offering the potential to establish a vertical that can achieve above-average growth and profitability? Identifying such “high headroom” markets is a critical decision factor in establishing an industry vertical.

“Markets” need to be defined relatively granularly, based on trade areas (typically below the state level), to ensure precise deployment of resources. Once markets are defined, there are a variety of factors to evaluate in deciding whether to move ahead, including:

- **Market attractiveness** (as reflected in size and potential growth and profitability);
- **Market specialization** (as reflected in unique industry characteristics, solution requirements, regulation, language/culture); and
- **Market accessibility** (as reflected in the type of competition; intensity of competition; relative competitive advantages; and switching behaviors).

By thinking about markets this way, management can make informed decisions about verticals, not only which industry sectors to pursue, but also in which regions and at what level of investment (e.g., hard versus soft verticals).

**Go deep.** We introduced the concept of soft versus hard verticals earlier based on six dimensions. While there is no right or wrong answer, we believe that for truly high headroom markets, most regional banks could increase growth rates by moving closer to the “hard” end of the continuum.
Customers increasingly are demanding industry-specific expertise and information, and at a minimum this requires:

- Fully dedicated relationship managers to “move down the learning curve,” develop the expertise to be credible with clients, and invest the time to participate in industry associations/events;
- A knowledge management process to capture and share industry and client information that is distinct from what other banks can do; and
- Tailored products and solutions, reflecting the unique requirements of target clients.

Commercial banking leaders must be committed to making the full investment or run the risk of increasing the cost to serve without getting the productivity uplift. They also must prepare for the change management challenges that will inevitably arise. Verticals don’t often sit easily in generalist models, and the case for change needs to be communicated and continually reinforced.

Compete on analytics and information. We often hear that banking products are commodities, that there is no real product/service differentiation, and that RMs simply must “work harder.” We hear that from bankers — not customers.

In fact, middle market and small business clients have a keen appetite for information and expertise at a time when the economy is uncertain and competition is fierce. The banker is in a prime position to fill this unmet need. Questions at the top of clients’ informational wish lists include:

- What are the key trends, issues and prevailing perspectives in my industry?
- What are the recent trends in my industry (pricing, credit structures, mergers and acquisitions)?
- What are the financial benchmarks for comparable companies in my industry?
- How is my company doing relative to best practices in our industry sector?

Clearly, banks that can put this type of sector-specific information at the fingertips of their relationship managers will have a competitive advantage in the post-recession environment of the next few years.

Industry verticals are certainly not a silver bullet, but they are a piece of the puzzle in the commercial middle market, especially for regional banks. The recession has provoked a secular change in customer buying behaviors, tilting the emphasis from general offerings to sector-specific products and service, and verticals increase the odds that relationship managers will be able to develop the skills and experiences to meet those needs.

We do not advocate a wholesale reorganization around verticals, but rather an increased focus to improve the odds for above-average growth. Banks that move quickly and decisively have a chance to create real comparative advantages and distinguish themselves from peers.

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Renewing Home Equity Lending

BY ANNETTA CORTEZ

Home equity lending has been a mainstay of retail banking, delivering superior levels of growth and profitability while providing a solid anchor for customer relationships. The market has radically changed following the wrenching U.S. recession, however, and banks will need new strategies and skills to make their way over the next few years.

At a time when the annualized pace of home equity loan origination is down roughly 70% from the 2005 peak, it is clear that lenders will be competing fiercely over a shrunken pool of borrowers who: 1) still can qualify for this type of credit, given all the issues with jobs, housing values and household indebtedness; and 2) still have an appetite for borrowing, given the fragile confidence in the economy and in banks themselves.

In many cases, the front line of this battle will be found in the branch, where live representatives are generating up to three-fourths of all new home equity credit at some major regional banks. As opposed to frenzied order-taking at the top of the market, reps now must play a prominent consultative role, not only to more thoroughly prepare and evaluate applications, but also to shore up borrower confidence.

Behind the scenes, banks will need to be much more deliberate about how they acquire and underwrite new business. This includes high sensitivity to local market housing conditions, as well as to the financial solidity of each household applicant. Then within this narrowed bandwidth of feasible lending potential, improved risk-adjusted pricing will be needed to protect the portfolio and provide adequate shareholder returns.

The good news is that there still is an important role for this business. Home equity lending provides a valuable form of consumer credit. It allows households to borrow on attractive terms, for purposes such as home improvement, education financing, and debt consolidation. And this type of borrowing facility is becoming even more important these days as many other sources of credit financing are drying up.

To win share in a sharply constricted market, however, retail banks will have to move beyond the product-push strategies of recent years. The new competitive dynamic hinges on a much more analytical understanding of markets and customers, coupled with a much more consultative and personalized interaction with each borrower.

PROMISE AND PERIL

Even as they continue to dig out from a historic crisis in mortgage and retail credit, banks still are pinning revenue hopes on home equity lending.

Indeed, if handled correctly, this line of business very well could be the top opportunity for retail loan expansion over next few years.

From the banking perspective, there are three main reasons why this is so. At the most basic level, home equity
lending still offers the potential for high returns, with such accounts fueling three to four times the customer relationship profitability, compared with the retail bank average.

“Portfolios will need to be managed more proactively, so that the bank does a far better job of detecting emerging situations before they spin out of control.”

Second, there still is plenty of latent borrowing capacity in the market. As of early 2010, battered U.S. households were still sitting on top of an estimated $6.3 trillion of unencumbered home equity. That is a valuable cushion at a time when unsecured credit is generally more costly and difficult proposition for lender and borrower alike.

Finally, most other retail lending avenues are even further in the tank. Demand for whole mortgages continues to contract; the outlook for student and small business lending appears stagnant; and for the very largest banks that have their own credit card portfolios, the near term picture is a morass of shrinking demand, reduced borrower eligibility, new regulatory restrictions, and heavy collections activity.

There’s still a lot of sand in the gears, however. From a balance sheet perspective, many banks remain over-weighted in mortgage credit and face ongoing challenges in clearing up the risk exposure already embedded in their portfolios.

And the market remains heavily impaired. Nearly one fourth of the nation’s homeowners owe more on their dwellings than the current sales value, which wipes out a huge chunk of home equity lending potential right there. Formerly prime growth markets, such as Florida, Nevada, Arizona and Southern California, remain depressed. And millions of people are looking for work, many jolted after years of steady employment.

The banking situation combined with the market and household financial situation, creates a scenario for selective growth at best. Many medium- or high-risk households that might have been considered workable loan prospects only a few years ago, now are off the radar screen for new credit. Conservative borrowers, meanwhile, didn’t overextend themselves at the top of the market and certainly aren’t going to do so now.

The bottom line is that there will be a much smaller pool of home equity loan prospects, especially over the next few years, and revenue-hungry banks will have to seek out this business and compete strenuously to win market share.

SUCCESS FACTORS
Increasingly, the retail branch will be the swing factor in home equity lending. Successful banks will not only build borrower rapport and trust within the branch, but they also will drive sophisticated central analytical abilities at the point of sale, enhancing underwriting, pricing and loan customization far beyond what is usually seen in the field.

Bankers will need to change their stance from “order takers” to relationship managers. Making that transition, and understanding the human factor in loan origination, will be essential in winning market share. In turn, branch representatives will need to play a leadership role in understanding customers and responding to their needs. Combined with specialized expertise, this type of advocacy will be vital in attracting new business, and retaining valuable customers. Households want to secure a home equity loan without having it coming back to bite them. This reinforces the role of the branch representative as an adviser and counselor.

Risk management also needs to improve. Portfolios will need to be managed more proactively, so that the bank does a far better job of detecting emerging situations before they spin out of control. This includes making greater use of stress-testing, an analytical exercise that constantly tests portfolio performance assumptions by considering the potential impact of various trends, developments and possible adverse events in the marketplace. Even when the markets return, many banks probably will stick with more conservative downside estimates to protect themselves.

A companion goal is to improve risk-based pricing. To more thoroughly analyze risk exposure, leaders will move beyond broad market trends to explicitly consider conditions
“In terms of management implications for banks, there is a clear need to strengthen the central analytical capability at many institutions, which formerly may have delegated responsibilities to regional teams or simply never considered the business case for building advanced skills.”

As the bank does a better job of analyzing potential risk exposure, then it can do a better job of factoring the cost of that exposure into loan pricing. Some major banking companies have recently discovered that a large portion of accounts—sometimes up to half—are not providing a margin that adequately compensates for risk.
Eventually, we will see that leading lenders also consider market price sensitivity when they set interest rates. This exercise is based on an economic concept called price elasticity of demand. It allows the bank to carefully balance the twin goals of balance growth and margin enhancement.

From a marketing perspective, sensitivity to local housing markets will definitely be a part of the home equity lending equation going forward. There will be fewer shotgun-style marketing campaigns, and a greater number of focused, analytically-guided initiatives that consider both household and housing risk. Under the banner of precision marketing, some banks are working to refine their initiatives to the sub-regional level.

As they look across their geographical footprints, banks will be searching for the best customers at the right prices to support their risk criteria. They will also be searching for expanded opportunities with the customers they know best — those who are already doing business with them.

There are three major types of opportunities with established customers, including: 1) encouraging activation and increased usage of outstanding home equity lines of credit; 2) selling additional banking products to home equity borrowers; and 3) providing home equity credit to customers who are already using other product lines.

To unlock these opportunities, the bank will need to improve its analytical understanding of the current customer portfolio. Among active current users of home equity lines of credit, for example, what patterns and insights can be gleaned that will be of use in encouraging inactive accountholders? What are the top cross-sell possibilities, based on knowledge of the total customer relationship? Such research-based explorations are crucial in an era when relationship expansion is the priority.

MANAGEMENT PRIORITIES

In terms of management implications for banks, there is a clear need to strengthen the central analytical capability at many institutions, which formerly may have delegated responsibilities to regional teams or simply never considered the business case for building advanced skills. In the areas of targeted marketing, precision underwriting and risk-adjusted pricing, banks will need far more sophistication than what was viewed as being necessary only a few years ago. A companion challenge is driving this knowledge to the branch for use in real-time decision-making. With full deference to the need for sensitivity to customers and an authentic relationship context, representatives still need a robust basis for quick, accurate and optimal responses to new loan applications.

While some banks have made great strides in beefing up the “analytical back office” of the branch, many others have serious work ahead of them. A recent multi-bank survey conducted by Novantas, for example, indicated that central pricing teams often are little more than skeleton crews in home equity lending, with enormous portfolios being handled by just a few individuals.

Then in terms of bringing centrally-generated insights to the branch, many banks face coordination challenges, both in terms of management and information.

Retail banks often operate as a collection of separate divisions, with one group managing the branch network; another managing products; another managing analytics, etc.

In this case, the home equity product team will need to build stronger organizational bridges. In other situations, there will be challenges in configuring information systems to supply relevant sales and customer information directly to the branch representative while transactions are in progress.

Finally, to fully capitalize on all the behind-the-scenes preparation, branch representatives will need to step up to a higher level of performance with home equity borrowers and products. The goal is to sharply improve sales effectiveness across a transaction stream that is much smaller than just a few years ago. Training, coaching and sales management will play into this, and in many cases, performance incentives will need to be revisited to encourage balance formation and cross-sell.

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Debit Legislation: Rethinking Retail Payments Strategy

BY JIM BRAMLETT, LEE KYRIACOU AND HANK ISRAEL

Banks already have been pushed into uncertain territory by recent federal regulation of checking overdraft and legislation on credit card fees. Now they face another major challenge and mandate for change from the “Durbin Amendment” to the recently enacted financial reform package, which complicates the picture for debit interchange fees, particularly for the more lucrative Signature Debit.

Even under the best-case scenario, we estimate that banks will suffer a roughly 35% curtailment in debit interchange fee revenues — a loss of roughly $5 billion annually — under a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act that empowers the Federal Reserve to regulate debit interchange rates. And the damage could easily slip to the worst-case scenario, entailing a roughly 70% interchange reduction for a loss of roughly $10 billion annually. This is on top of an estimated $12 billion to $20 billion annual shortfall stemming from new restrictions on checking overdraft fees.

Taken together, these two developments would seem to crush the checking industry, a bedrock line of business for banks. Yet banks stand to lose even more if they go into extreme defensive mode. In a tight market, a high priority is nurturing customer relationships, and a robust payments interaction is critical to this effort.

To re-establish the economic foundation of the checking business, there are three interrelated courses of action that retail banks should be working on now:

- The first is to create new configurations of payments accounts, adding features and niche services that will either lower the cost to serve or justify new categories of fees.
- The second is to explore alternative payments solutions, including new types of credit card plays; prepaid account solutions; and mobile payment capabilities.
- The third is to flesh out the customer relationship dimension of checking strategy, including new types of conditional free checking offers; analytically based relationship pricing; recasting debit rewards programs; and exploring new hybrid product concepts.

Combined with new distribution arrangements that will help lower the cost to serve, these three avenues will help to usher banks into a healthy new era of checking and payments competition, with far less reliance on outsized fee revenues from a minority of customers. From that perspective, the erosion of debit interchange fees simply accelerates the
course that banks should already be on today. In proceeding, however, it is critical to understand the new economics of debit and the role that merchants will play in shaping the market.

THE ROLE OF SIGNATURE DEBIT

Retail banks have grown increasingly reliant on the interchange revenues generated by debit card transactions. Total debit card interchange reached an estimated $14 billion in 2009, more than six times the total from 10 years earlier, reflecting the ascendancy of debit into a major U.S. payments vehicle (Figure 1). This year debit transactions will account for roughly one-fifth of U.S. retail payments dollar volume.

Of particular significance is the fact that Signature Debit offers a higher interchange rate to issuing banks. In round numbers, banks earn $1.50 on a Signature Debit transaction worth $100, compared with only 60¢ on PIN Debit. Signature Debit accounts for roughly 75%-80% of total debit interchange revenue for U.S. banks, further underscoring its recent economic importance. In turn, many banks have built their payments growth strategies around the higher Signature interchange rate, incentivizing cardholders to sign for a debit transaction even when a PIN terminal is available.

Merchants, on the other hand, have encouraged customers to enter their PIN numbers for debit transactions, eager to secure a PIN interchange rate that is 60% lower than for Signature. The financial reform law now introduces a significant tilt in the balance of power between merchants and banks, probably signaling an end to the era of Signature Debit as a major standalone revenue growth and profit engine for banks. Specifically, the amendment:

- Enables merchants to discount products and services...
based on the type of payment media, effectively over-riding contractual restrictions in merchant agreements that traditionally prohibited them from doing so.

- Empowers the Federal Reserve to set debit interchange rates on the basis of pass-along cost (with the potential to seriously undercut or even eliminate the banking profit margin). Rates will be based on the established cost of transaction authorization, clearing and settlement (This provision does not apply to credit and prepaid cards, and it excludes debit issuers with less than $10 billion of assets).

These provisions will create a new competitive landscape for all players in retail payments. Retail banks will need an in-depth understanding of the new terrain to make their way in the post-Durbin market for checking and payments.

**IMPLICATIONS FOR THE FED**

The mandate to develop a universal pricing scheme for debit card issuers with more than $10 billion in assets presents the Fed with several challenges:

**Which costs?** The legislation requires that debit interchange rates be based on “incremental” cost of authorization, clearing and settlement, and that it should exclude costs “which are not specific to a particular electronic debit transaction.” Even with these requirements, the definition of cost should not overlook the many shared activities and expenses that increase in banks as debit card activity grows.

This includes, for example, write-offs from fraud and charge-offs, along with the operational costs associated with limiting them, as well as customer servicing costs related to transactional activity (e.g., transaction inquiries and dispute resolution via the phone and website, and in the branches). Debit represents roughly 50% of the monthly payment transaction volume related to the consumer checking account. In turn, an “assigned” debit interchange rate should reflect a similar proportion of the ongoing processing costs associated with providing checking services.

**Whose costs?** Historically, the interchange rate for a specific product and type of transaction has been the same for all banks participating in the network. But the unit cost of transactions varies across banks, based on institution-specific factors such as operational effectiveness, outsourcing policies and procurement practices, and operating scale. A bank with 25 million debit cardholders has a huge efficiency advantage over a bank with 500,000 cardholders. Outsourcing of transaction processing to third parties only narrows the efficiency gap, moreover, and certainly doesn’t eliminate it.

If the Fed sets a uniform interchange rate based on some version of “average” cost, it will introduce a competitive tilt. Larger, more efficient banks will realize a profit margin while smaller, less efficient banks will be unable to cover their costs. Given the artificial carve-out of banks with less than $10 billion in assets, we estimate that banks between $10 billion and $40 billion in assets will be the most disadvantaged by uniform interchange rates.

Alternatively, interchange rates could be differentiated not just based on whether a bank is above or below the $10 billion threshold, but also based on the individual cost profile of the bank. This approach would add enormous complexity to the interchange system, however, and would, in effect, reward banks that are less efficient.

**MERCHANT INFLUENCE AT THE POINT OF SALE**

As merchants gain the ability to selectively discount payment methods, steering customers to lower-cost payment vehicles, they will face new choices and potential opportunities.

There is more than meets the eye in merchants’ newfound ability to discount by payment method. On the one hand, merchants can now elect to pass along to consumers the sav-
As the incentive to discount between PIN and Signature Debit disappears, merchant discounting would then morph into a merchant tool to move customers away from credit card payments, which continue to command the highest interchange rate.

ings from lower-cost payment methods, including PIN Debit, cash, checks, and ACH/point-of-purchase transactions. And some will immediately seize upon this newly-sanctioned means for influencing customer payments. There is a definite overseas precedent, including in Australia and other markets where debit interchange rules have been modernized.

On the other hand, many other merchants likely will proceed quite cautiously in their experimentations with discount by type of payment media. After all, not all businesses have the same motivations or considerations to address.

Consider the local grocery stores, which likely already pay among the lowest interchange rates because of the lower ticket price and risk of their transactions. Modestly discounting PIN, say, by 0.25%, likely will be greeted by indifference from customers, whereas higher discounts may require a financial offset in the form of higher shelf prices that are uncompetitive. Similarly, discounting cash, check, and POP may lower direct transaction costs, but the net benefit is lowered by cash slippage and collection costs on returns.

Other broad categories of merchants, such as liquor stores and bars that pay relatively higher interchange rates, have a greater opportunity for discounting. But they also need payment authorization services, typically more firmly tied to Signature Debit, to reduce transaction risk (Try taking a check from a bar patron at midnight).

While it is easy to see how PIN (from a process point of view) would work at the liquor store, it is not clear how well it would work with current card payment terminals at the bar — currently authorization and settlement are tied together, and the tip would need to be handled separately. Moreover, the discount would need to be material to encourage significantly higher PIN debit usage among patrons.

Finally, the general incentives for merchants to offer discounts for preferred payment types will change over time. Once interchange rates are reduced under Fed guidelines, the cost of Signature Debit will certainly fall, and quite probably PIN Debit rates will fall as well. At that point, as the incentive to discount between PIN and Signature Debit disappears, merchant discounting would then morph into a merchant tool to move customers away from credit card payments, which continue to command the highest interchange rate (thus far untouched by new legislation or regulation).

The point is that within a rational merchant base, there will be great variations in the degree to which newfound discount abilities will prove feasible. Alert banks will take time to study the various categories of merchants to stay abreast of likely evolutions of discount structures as the debit interchange rate environment changes.

**MERCHANT PAYMENTS STRATEGY**

Large merchants and merchant groups will likely leverage the law to negotiate more favorable interchange rates with card associations as a trade-off to steering. For many merchants, this path will be easier and represents a larger potential savings, allowing them to save on transaction fees without necessarily passing along savings to the consumer.

If this negotiation approach advances, it will likely lead to significant pressure on credit card interchange rates — as opposed to merchants attempting to steer customer transactions with significant discounts for PIN debit.

In any case, the reduction of interchange rates will likely increase the pace of innovation in payment solutions for merchants, creating a large opportunity for merchant acquirers to support the development of new payment solutions. The successful players will likely provide more than just a lower cost of payments as they additionally focus on generating new categories of value to both merchants and consumers.

Payment options have long been used by merchants to build customer relationships and loyalty. But the disconnect has been that high interchange rates have been used to fund loyalty to card issuers and banks, rather than to the merchants who are footing the bill in the first place. In the new world, rather than making anonymous contributions to customer loyalty on behalf of banks, merchants could reinvest their savings in robust and consistent loyalty programs centered on purchases within their own brand families.

Loyalty cards pre-encoded with a customer’s checking account number for ACH debits offer a simple example of such a program. A more ambitious version would harness such mechanisms to create a merchant coalition loyalty program. This arrangement potentially provides consumers with far greater relevance and value than any one merchant could offer, and it allows participating merchants to leverage brand equity across the coalition, cross-marketing to each others’ loyal customer base.

Merchant acquirers can facilitate such programs by
offering the right combination of data and access devices to support analytically driven rewards programs, and tailoring the content and complexity of the information offering to the size and sophistication of the participating merchants.

In this way, payments innovations can provide significant value to merchants with recurring, day-to-day transactions — grocery stores, pharmacies, etc. — well beyond the direct savings in cost. Indeed, even the major categories of merchants who historically have voiced vigorous objections to interchange rates that are forced upon them may turn around and voluntarily pay fees to participate in an effective customer loyalty program.

**RETAIL BANKERS AND DEBIT ISSUERS**

If there were clear losers in the debit card interchange legislation, that regrettable distinction goes to retail banks, especially those that built payments growth strategies around the higher interchange rate of Signature Debit.

**Best-case scenario.** If Signature Debit interchange merely falls to the current levels of PIN Debit as a percentage of purchase volume, the first order revenue impact will be an industry-wide loss of roughly $5 billion annually, or roughly 35% of total debit interchange revenue. From a larger perspective, this shortfall represents roughly 9% of estimated total 2009 checking account fee revenue.

**Worst-case scenario.** Most estimates of Fed-driven debit interchange reductions are considerably more aggressive, particularly if the cost of PIN Debit is also determined to be well below the current posted interchange rates. In that case, the total reduction in annual debit interchange revenue could easily double, cutting as deep as 70% — or as much as $10 billion annually.

While the revenue impact of reduced interchange is not at the same magnitude as the recent restrictions on overdraft fees ($12 billion to $20 billion annually), the marginal impact will be even more acutely felt, hitting banks at a time when they already have seen up to 35% of annual checking fee revenues evaporate under Reg E.

Indeed, the double-whammy on fees is concentrated with many of the same banks — i.e., banks that have the greatest exposure to debit interchange revenue also tend to be the ones most impacted by the recent regulation of overdraft fees (Figure 2). This in part reflects differences in customer mix across banks, in that the impact of interchange reduction is often skewed toward many of the same customer segments most affected by the loss of overdraft revenues. Smart banks will be unwise to back away from developing active, engaged payments relationships with their customers.

**PAYMENT ACCOUNT REDESIGN**

The most fundamental impact of interchange reduction will not be as much on those customer segments which currently generate the most interchange revenue. Rather, on top of Reg E, the impact of Durbin will be to further unmask the cross-
Debit Legislation: Rethinking Retail Payments Strategy

Post-Durbin Executive Agenda for Retail Banks (Fig. 3)

To thrive in what essentially will become a new market for checking and payments, winning retail bankers will aggressively pursue new payment priorities and craft new strategies to recast customer relationships.

New Payment Priorities

| Prepaid Solutions as a more economical way to support payments-only relationships |
| Innovative Credit Card Plays integrated into the demand deposit account to recapture higher-spending customers |
| Merchant Partnerships to accelerate share shift from credit to debit |

Relationship Strategies

| New Checking Propositions such as “free-with” accounts |
| Relationship Pricing built on a solid analytical foundation |
| Hybrid Product Concepts such as the U.K.’s “offset accounts” |
| Recasting Debit Rewards by expanding programs beyond the debit card to relationship loyalty |

Source: Novantas, LLC

subsidization of the many checking account-holders who do not generate enough revenue (through fees and/or spread) to cover their cost to serve.

Free checking in this traditional form as a standalone proposition is doomed. And yet, both research and experience show that customers will strongly resist fees for services they are accustomed to receiving for free.

Consequently, the erosion of interchange revenues will accelerate the course that banks should already be on today, seeking to create new configurations of payment accounts, adding features and niche services that will either lower the cost to serve or justify new classes of fees. The cost to provide each component feature of the checking account has to be carefully evaluated, and then features must be priced in a manner to encourage economically constructive account-holder behavior.

ALTERNATE PAYMENTS SOLUTIONS

Once the interchange incentive to promote Signature Debit evaporates, retail banks will become even more aggressive in their quest for new types of payments offerings that will meet the emerging needs of checking account clients (Figure 3). Not all of these will entail high-risk, breakthrough innovations. Examples might include:

Aggressive credit card volume plays. The legislation oddly exempts credit cards from interchange legislation (at least for now). Large credit card issuers could find an opportunity to make the credit card part of the transaction account proposition, increasing credit card volumes with their checking customers.

This could be done by integrating two products into a single cash management solution, with integrated statements and online transactional information. For banks that feature a strong rewards platform for their credit cards, an integrated credit card/checking proposition could allow them to reclaim payments share among affluent customers who have been lost to monoline card providers.

Prepaid account solutions. Prepaid accounts are also treated differently in the Dodd-Frank legislation. Historically, prepaid accounts have often been narrowly viewed as a way to serve the “underbanked” segment. In fact, they could be repurposed and configured to provide a better, more cost-effective solution to a large segment of less profitable checking customers.

Mobile payment capabilities. The trend toward mobile payments is accelerating, with profound long-term implications for consumer payments strategy, and banks will want to be sure to stay abreast of that trend. But that is a wild and woolly world that will take time to sort itself out.

In the meantime, banks will want to seek simple, pragmatic solutions that will solve basic customer needs. For example, the transition from checkbooks to debit cards left customers without the simple reassurance of always knowing the running balance in their check registers — contributing to mismanagement of their checking balances and/or growing stress and uncertainty.

Such lack of control compels customers to embrace throwback cash management solutions. For example, Novantas research shows a growing consumer practice of literally keeping hundreds — even thousands — of dollars in envelopes where nervous households can keep track of funds and curb the spending impulse.

That customers have to turn to such tricks in an information-drenched world seems like a failure on the part of banks. As an example of an innovative response, simple, readily available communications technologies can turn the mobile phone into a real-time check register, fulfilling the information and control needs previously ignored in the evolution to electronic payments.
RELATIONSHIP STRATEGIES
Checking accounts will continue to be important as a relationship gateway product even when their standalone profitability evaporates. Relationship Value will provide a new lens for valuing debit card transactional activity, which in many cases will be greater than the direct revenue benefits of debit card interchange.

Targeted free checking. Banks that understand Customer Lifetime Value on a relationship basis will have a superior lens for setting the criteria for “free” checking accounts, and the insight needed to maximize Relationship Value beyond the checking account itself.

For example, the quest for checking portfolio profitability will lead the market to focus on checking propositions that are “free” to customers who meet specific conditions, offering the most attractive payment account terms to customers who drive profitable overall relationships.

Analytically-based relationship pricing. Historically, relationship pricing has been approached with good intentions and common sense — for example, a lower loan rate when the customer maintains a certain minimum savings balance. However, this approach often proves counterproductive when the lowest rates are offered to the least price sensitive customers, thereby forfeiting the full economic value of the customer relationship.

As the arms race for analytically driven, elasticity-based pricing strategies extends past individual products to take the full relationship into account, the next generation of Relationship Pricing strategies will require a full understanding of relationship impact.

Recasting of debit rewards programs. The debit card rewards programs that have proliferated in recent years have mostly been predicated on the higher interchange from Signature Debit. However, simply terminating such programs would be a mistake for deposit account providers. Rather, rewards programs must be quickly reconfigured to reflect the value of the entire relationship of the customer with the bank, including deposit and loan balances, high payment volumes and other profitable behaviors.

Hybrid product concepts. In place of stand-alone products that operate as independent accounts, banks will explore new product concepts that tie the functionality of accounts across the relationship. Some may operate in a “lite” form, such as Bank of America’s Keep the Change program, stitching debit card transactional activity to savings accounts (although reduced interchange will surely alter the business case for this program, in particular the matching provisions).

“Strong” forms of hybrid product will also deserve new consideration. For example, offset mortgages — in which customers consolidate the balances of their mortgage, traditional current accounts, personal loans and their saving accounts into one account — are popular in the United Kingdom. Variants of such a concept, reflecting U.S. tax considerations, stand to offer a distinctive, relationship-consolidating proposition to customers who either already have significant savings, or who plan to save regularly.

LONG-TERM COST REDUCTION
While the triumvirate of account cross-subsidization flourished, most banks tolerated the high costs of gathering deposits. With two of those three now limited (and how far away are real interest rates for retail deposits?), banks will have to look extensively at the high fixed costs of deposit gathering, particularly with brick-and-mortar branches. Forward-thinking banks are already exploring new network models, for example, “thin networks” that provide a more cost-effective reach to selected segments.

The impending loss of debit interchange revenues offers a silver lining to the banks that move quickly and correctly in responding. While painful, it removes another of the unrealistic planks of deposit account revenue, and accelerates the demise of free checking. Those banks that restructure effectively around customer segments, desirable product bundles, smart pricing and rationalized cost structures will find new opportunities in retail consumer relationships.

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The Relationship Approach
To Retail Loan Growth

BY RICK SPITLER AND GAURAV GUPTA

Increasingly, it has become clear that the current economic recovery promises to be a drawn out affair. For the next few years, it is likely that most consumer loan categories will grow only modestly from current recession-battered levels.
The tepid recovery presents a critical challenge for retail banks, in that there may not be enough loan demand — particularly among customers with acceptable credit risk profiles — to support the overall industry distribution and sales capacity built up over the last decade. Winning banks will be the ones able to gain market share at the expense of competitors, primarily by doing more business with each customer.

The situation has introduced a turning point in consumer lending strategy. Instead of pushing individual products, as seen during peak market conditions, the competitive priority will be cultivating fuller customer relationships. This includes expanding and retaining established household and small business relationships; and anchoring and engaging new customers more thoroughly and effectively.

To succeed in the quest to build multi-faceted credit relationships, retail banks will need a far better understanding of household financial profiles and emerging needs. The splintered customer information residing in product silos will need to be pulled together in a way that supports specific initiatives, a challenge unto itself.

Improvement in targeted cross-sell will provide one of the most immediate payoffs on this effort. A precision outreach will be possible, based on a much clearer understanding of the receptivity for various products and combinations (which, along with revenue potential, can vary dramatically among different customer groups).

There also are near-term opportunities to leverage customer relationship insights in underwriting, risk exposure management, and collections. The larger knowledge of household financial profiles will enable banks to make better informed loan origination decisions, for example, and extend credit in situations where it otherwise would not. A unified approach is also more effective in working with households experiencing repayment difficulties with multiple accounts.

Longer term, progressive banks can make more fundamental revisions in areas such as product bundling, pricing and service that will bring new substance to relationship-based growth strategies. This will establish a more enduring relationship orientation that will serve the bank and its customers well beyond the current slow recovery.

**THE CASE FOR RELATIONSHIP EXPANSION**

Looking ahead, we believe that U.S. households will generally continue to de-leverage, perhaps through 2012. This includes working down revolving and installment debt, rebuilding cash cushions, and for many, working through defaults. Employment remains a challenge; the housing market remains a challenge. In such circumstances, intense market share battles are a certainty for retail lenders.

But conventional product-centered strategies will be far less effective. In peak market conditions, there has been a pronounced tendency for banks to operate as cafeterias, with customers often taking the initiative in selecting individual products, typically from multiple providers. A single bank typically will capture no more than 10% to 15% of the average customer’s total wallet, meaning at least 85% to 90% of the relationship potential is usually lost to other providers.

Such fragmentation is far less of an issue in a rapidly expanding market, where there is plenty of business to go around. In the current soft market, however, splintered customer relationships can have a very real financial consequence, both for winners and losers in the battle for wallet

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**Credit Risk Relationship Factor (Fig. 1)**

Customers who have deeper, multi-account relationships with their banks exhibit lower credit risk.

![Credit Risk Relationship Factor Diagram](source: Novantas, LLC)
share. Every sales opportunity matters at a time when mortgage and home equity loan originations, for example, are running more than a third slower than the pace seen in the peak year of 2005.

The bottom line is that loan growth will be much more dependent on selling to established customers. There will be a major push to build multi-faceted credit relationships with households that are already doing business with the bank.

In building the specific business case for relationship expansion, it is important to look beyond the obvious fact that providing two profitable products to the customer is better than just one. There are powerful additional benefits (often ignored), including:

- **Lowered credit risk** (Figure 1), given that institutions with deeper ties to consumers are likely to be placed higher in the repayment hierarchy;
- **Longer life and higher usage** (Figure 2), given the extra stickiness that is observed when customers commit more of their finances and transaction stream to an institution; and
- **Higher pricing power**, essentially reflecting an attitudinal shift that occurs as in-depth customers place more emphasis on intangibles such as rewards, recognition and service.

To capture these advantages, however, banks will need to proceed in a systematic manner. Cross-sell activities must be identified and prioritized within the context of customer needs and receptivity, along with variations in economic potential (including the three additional benefits of deeper relationships discussed above). Critical streams of information need to be pulled together and distilled, with an eye toward specific revenue-producing initiatives that will more than justify the effort that went into them.

**INFORMATION ADVANTAGE**

Not only do in-depth customers behave in ways that are more profitable to the institution, but they also provide access to a richer and more comprehensive picture of their finances. It is helpful to be able to spot important patterns in borrowing and saving, for example, as well as monthly transaction patterns and repayment behavior.

Such information helps the bank to proactively identify customer needs and meet them more fully. Banks can also detect impending household financial distress earlier. This improves chances of extending a helping hand in time, mitigating or even preventing further deterioration in a situation.

One aspect of this quest is unifying the slivers of customer and household information that often remain scattered among the various product silos within the bank. In an age of information overload, many major banks still are in a state of information scarcity when it comes to a composite view of retail customers and households.

Another aspect is making fuller use of information already on hand. The principal household checking account, for example, offers valuable insights into customer behaviors and needs, plus it provides more customer touch points. One clear priority is to capture the primary payments account and nurture the relationship-building opportunities that go with it, not only initially, but over the life of the relationship.

Some regional banks also may want to put more emphasis on the credit card. In conjunction with the checking account, it provides a fuller payment view, and by itself provides a window into customer behaviors and needs. Along with providing strong guidance in customer segmentation for use across all products, the credit card account can also provide a valuable vantage point in understanding and tracking the credit risk of individuals and households.

As a richer information stream comes into view, the focus then turns to analysis and the extraction of salient insights for specific initiatives. Some banks are beginning to analyze this information in sophisticated ways. Leaders, for example, are working to identify the key customer profiles, circumstances and product progressions that are the most hospitable to the cross-sale of high-value offerings such as home equity loans.

This is a distinctly different approach than what was seen 15 to 20 years ago, when cross-sale first gained widespread
“Progressive banks can make more fundamental revisions — in areas such as product bundling, pricing and service — that will bring new substance to relationship-based growth strategies.”

industry attention. Early attempts were more of product-push exercise, with lots of time wasted on low-value or implausible offers, and less consideration given to underlying customer needs.

Under the new approach, the bank marries product profitability metrics with probabilistic estimates of customer receptivity, typically down to the segment level, and sometimes to a customer level. Then the cross-sell menu is narrowed to a short list of offers that will generate the greatest value for the bank and customers alike.

The early fruition of this effort lies in targeted initiatives that, through intelligent marketing, allow the bank to get a lot more mileage out of the current product set — without a lot of reinvention. For example, one major regional bank was able to lift its home equity cross-sell effectiveness by more than 15% by establishing a multi-faceted relationship filter that allowed it to focus on a prime subset of the most eligible and potentially receptive customers within the retail bank.

FOLLOWING THROUGH

Typically, relationship strategies don’t go very far within the organization without executive management involvement. Individual product teams will need to collaborate among themselves and with the branch team if the bank is to succeed with centrally-designed cross-sell offers that branch representatives can sell within a relationship context. Also, individual product silos typically have their own performance incentive programs that discourage feature or pricing tradeoffs that, while successful with customers, might diminish the profitability of an individual product line.

There also will be a learning curve in re-fitting information systems and working through the complexity of the underlying analytics. One management implication is a probable need for greater centralization of key lending functions, linked to a much stronger analytical capability. This is in line with management progressions seen in the deposit business, where regional teams are placing greater emphasis on marketing and sales, and central teams are handling pricing strategies and tactics.

Then there is the question of how to become more proactive and responsive in the field. In many cases, for example, banks have opportunities to improve their anticipatory sales strategies, based on an understanding of customer stage of life, major life events, and as we have mentioned, an analytical understanding of likely cross-sell progressions from one product family to another.

One clear implication is the need for greater consultative sales expertise within the branch, especially as it pertains to mortgage and home equity lending. Coming out of a wrenching U.S. housing market crisis, customers want to be assured that they are handling new borrowing in a way that won’t come back to haunt them.

While relationship expansion does represent a more complicated growth strategy, the effort will be more than justified during the prolonged slack environment that apparently stretches ahead. This is the most constructive option at a time when fewer new customers are coming through the door.

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We work with clients to develop these customer-focused strategies, and provide strategy implementation and information services to help clients measure and maximize competitive positioning. Novantas counts among its clients most of the top-30 companies in the banking, brokerage, insurance, and credit card industries.
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