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HOW BANKS CAN INCREASE FEE INCOME WITHOUT RAISING FEES

By David Furnace

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UPSIDE DOWN

Over the last decade, the banking industry has traveled a decidedly stormy sea. At banks throughout the nation, the Great Recession took a toll on loan portfolios and balance sheets. Economic recovery has enabled healing to occur and profits to return, but even in recovery the impacts remain. There are approximately 30 percent fewer community banks today. Fee income has declined significantly and not recovered to pre-recession levels. Rates are finally starting to rise but we have experienced a protracted period of time when money effectively had little value from a pure return perspective for banks.

In this more settled but still choppy sea we believe community banking is still a great business with significant opportunities. Banks can thrive in an increasingly consolidated marketplace. There are, however, important questions to address: Should community banks mimic the big banks' business models? Should they copy their products and charge their fees? Would that really work for community banks?

Consumer sentiment is clear — they don't like fees. In fact, fees are cited as the No. 1 reason customers switch banks. So, community banks are faced with a dilemma: Can we increase fee income without alienating customers? The answer is a resounding yes. Many banks are doing so right now with a strategy that, in theory, appears paradoxical but, in practice, works spectacularly well: Banks can increase fee income without raising fees.

[Community Bank] branch networks operate well easily serve more customers without adding mat

How to level the playing field with the big banks

The largest financial institutions enjoy several competitive advantages over most community banks: much larger branch networks, substantially larger marketing budgets, the perception of better technology, a wider array of product offerings, etc. Not surprisingly, larger financial institutions also have four times the number of customers per branch.

Community banks, however, are not powerless to do battle with the big banks for market share.

They are, for example, much closer to their customers and have more institutional flexibility than larger financial institutions. However, the most crucial competitive advantage that community banks have over the big banks is one they often overlook: tremendous excess capacity throughout their branch network.

Excess capacity doesn't happen by accident. Most community banks follow a business model that mandates building really expensive factories — called branches — that are run at a small fraction of their actual capacity. Few bankers would argue the point. Their branch networks operate well below capacity and could easily serve more customers without adding materially to their cost structures.

But this notion of excess capacity is almost always ignored in analyses that community banks do of their profitability drivers leading to decisions that run counter to their goals of growing core deposits and fee income.

We argue conventional wisdom needs to be turned on its head. Our data indicates that, for community banks to successfully battle bigger banks for market share, they must: 1) recognize the value of their branch network and the opportunity that excess capacity presents and 2) take action to reduce that excess capacity by filling their branches with more profitable new customers. Those that do will take market share away from their larger competitors and generate profitable growth that is both immediate and sustainable.

WHAT IS THE NEXT CORE CUSTOMER WORTH?

$200	Amount a typical community bank invests to acquire the next core customer
$300-500	Amount that customer generates in revenue per year
9+ Years	Average number of years a new customer stays with the bank
$2000+	Net Present Value of your next Retail Customer
$7000+	Net Present Value of your next Business Customer

Typical acquisition costs and marginal value of the next core customer to a community bank.

Ability to serve customers: 5,000 vs. 1,200

Community banks have high fixed costs and very low marginal costs. For example, a typical community bank averages about 1,200 core checking relationships per branch. The big banks average up to 5,000 per branch. Any other industry that operates with a similar model would then analyze how marginal revenues from selling one more widget compared to the marginal costs of producing that widget. Community bankers, however, generally have not been trained to think that way.

A key strategic opportunity for community banks is to leverage the infrastructure investments they have already made (i.e., all those fixed costs) by growing their core customer base. For most community banks, marginal revenues from the next core customer are multiples of the costs to acquire and service them. Significant growth is possible for many organizations, but it may take tossing outmoded, conventional wisdom and replacing it with new ideas based on data analysis and validated by results.

What is a customer worth?

As bankers, we monetize core customers in two key ways: balances (deposits and loans) and non-interest income. Start with the cost side of the equation — what does it cost you to service one more core relationship? You issue some a debit card. You print paper statements for some percentage of them. You put them on your core operating system. You charge off some principal for some of them. Most of our clients report that the actual marginal costs associated with servicing one more core customer are generally in the $30-$50 per year range.

Now look at the revenue side of the equation. Among our clients, the average consumer household produces about $150/year in non-interest income. They produce, on average, in excess of $17,000 in deposits and in excess of $9,000 in loans.

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FOUR TAKEAWAYS

- Your bank can effectively increase fee income, and the best way to do it is NOT to raise fees.
- Use your excess branch capacity to grow and accommodate more customers.
- Double the number of customers you are serving and your fee income will double as well.
- The fastest way to increase profitability is to acquire and serve more core customers.

Certainly, many assumptions can be made here as to the "value" of this based on an individual bank's loan-to-deposit ratio, yield on assets, etc.

If the new households borrow $9,000 of their own money (on average), which they lend to the bank at almost no cost, doesn't that create value in some way? Give that transaction a spread of, say, 3.5 percent and that generates about $315 in value even if you totally discount the other $8,000 in deposits.

Now, the typical core customer has an average life greater than 8 years, so certainly that money will have some value over time. But, say it has a value of zero. That still means an average new relationship generates marginal revenues of $450. In an industry with tremendous excess capacity that looks pretty profitable to us.

One might argue that it is inherently dangerous to use averages like this. Isn't it true that if you take this approach you are going to get more unprofitable customers? Absolutely! But recognize in the prior exercise that all of those "unprofitable" customers brought the average revenues down to only $450 compared to marginal costs of $30-$50.

What we found over time is that community banks can successfully get more of what they were getting to begin with, but they generally can't make them look much different. If you decide to grow, you will certainly get more customers in the lowest quartile, but you will get more in the highest quartile as well.

For many bankers, the notion of having unprofitable customers drives them nuts. There are a lot of businesses that have capacity where marginal revenues exceed marginal costs and those business owners realize they make more money at the margin. Take movie theaters as an example. Several studies show that more than 80 percent of their profits don't come from selling tickets. They make money from selling concessions, even though not every patron buys the expensive popcorn.

Rather than charging a lot more for the tickets (as bankers have done), they understand the fundamental business model and make more money by serving more people. More specifically, they don't get overly focused on those moviegoers that don't buy popcorn as bankers tend to do.

Marketing

Bank CEOs will consider making significant investments to make an acquisition or to acquire and build new branches to grow, but they severely underspend to fill existing branches, which are effectively empty most of the time. Your goal should be to fill up excess capacity in your existing footprint. This requires a strategic marketing approach with clear, measurable benchmarks to track your ROI.

People switch financial institutions for a variety of reasons but it is almost always event-driven. In a given year, up to 15 percent of households and businesses change banking relationships. It is an infinite pipeline of opportunity over time but it is perishable. If a customer switches today and you don't capture them, you likely won't get that opportunity for another 8 or 9 years with that particular customer.

You also can't force anyone to switch and your marketing needs to recognize that. You need to be top-of-mind before they decide to switch so they will pick you once that event happens for them. Marketing for core banking relationships is a really weird space — you can't create primary demand and your entire goal is to get into the coveted No. 2 role; it's not very sexy, but very powerful if you recognize the unique dynamics and do it correctly.

To win new customers, you need to offer simple, easy to understand products, you need to show that you are convenient to a prospective customer and you need to demonstrate that you are a great place to bank. With good marketing and effective execution, most community banks can double the rates at which they are acquiring core customers.

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