

WHITE PAPER



Navigating the Changing Tides Impacting Fee Income Taking a Proactive Approach to Shifting Market Conditions

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Executive Take-Aways

- Non-sufficient funds (NSF) and overdraft (OD) revenues are a major component of service charges on deposit accounts, which in turn is a major source of all non-interest income.
- Overdraft practices have recently drawn the attention of federal legislators, and large banks have started taking proactive actions in anticipation of regulatory pressures.
- Revenue from NSF/OD fell in the first two quarters of this year and has not yet returned to previous levels. Anecdotal information indicates a wide range of projected shortfalls, and a closer look at a representative sample of banks confirms this general observation.
- Transaction volumes dipped in the last quarter of 2008 and first quarter of 2009, but have now nearly returned to previous levels. Transaction volumes were driven down primarily by falling check volume. Other transaction types have maintained volumes or grown slightly.
- Personal spending fell during the fourth quarter of 2008 and has gradually grown since, though it has not rebounded to previous levels.
- DDA balances have increased over the last four quarters.
- In May 2009, consumer savings peaked at the highest level seen in over two decades, but has moderated since.
- Media and industry pundits have speculated that consumers may be undergoing a fundamental change in attitude – potentially changing American cultural norms relative to thrift and spending patterns. However, it is too soon to tell if the recent pattern changes are temporary or permanent.
- The U.S. government and regulators are considering rule changes which, if enacted, could have a profound effect on banks' revenue streams.
- Given the challenges of the current market, banks should consider the following tactics for adapting to the new environment:
 - Carefully examine customer behavior patterns to assess the longevity of the observed trends.
 - Consider developing alternative products.
 - Prepare to adjust pricing strategies to reflect potential changes.
 - Increase customer communications.

A Change of Direction

Measuring the Shift

During the finalization of this paper, several large U.S. banks have announced their intentions to change their overdraft policies, limiting the maximum chargeable daily fees and increasing the minimum overdraft levels that would trigger a fee. For many banks, lower overdraft income will be the result of these policy changes, as some of the largest financial institutions take proactive measures to reduce or limit overdraft fees and the activity associated with them. Non-sufficient fund and overdraft practices and the associated revenue will likely be an ongoing concern for many institutions, as policies continue to change and competitors take action in response to these changes.



As an industry leader in payments processing, FIS has a vested interest in any changes in consumer behavior impacting the revenue streams of client banks. Our business consultants closely track industry trends, and their findings help guide bankers on strategic decisions and tactical planning in order to enhance their payments businesses.

Over the past several years, we have worked closely with client banks to improve customer service, while enhancing revenue opportunities. Analysts have been able to closely observe activity at the customer and transaction levels. With this information tapped from FIS deposit and payment applications, we have gained insight into some of the specifics of current fee income trends. On a national level, NSF and OD revenues are declining. This paper will explore the components of this decline and offer strategies that banks can take away and implement in their own branches to minimize the impact.

NSF/OD Revenues in Decline

By staying connected to industry leaders, we received a great deal of anecdotal information, which reports that banks across the country have seen drops of 12% to 15% in their NSF/OD revenues. Since many banks recognize significant portions of their service charge income from these exception items, we determined to substantiate these trends and then quantify their potential impact.

Through a review of the sample group of banks that we have worked with, we understand that revenues are not down due to:

- System changes
- Processing errors
- Waiver rates
- Other intentional actions

We have actually seen increases in the revenue stream at banks that have increased their account base through acquisitions, or have worked on revenue-enhancing projects. However, the majority of the banks in this group have not implemented any new processes or procedures over the period.



See Figure 1, below, for the percentage of change in average daily OD/NSF charges by sample banks.

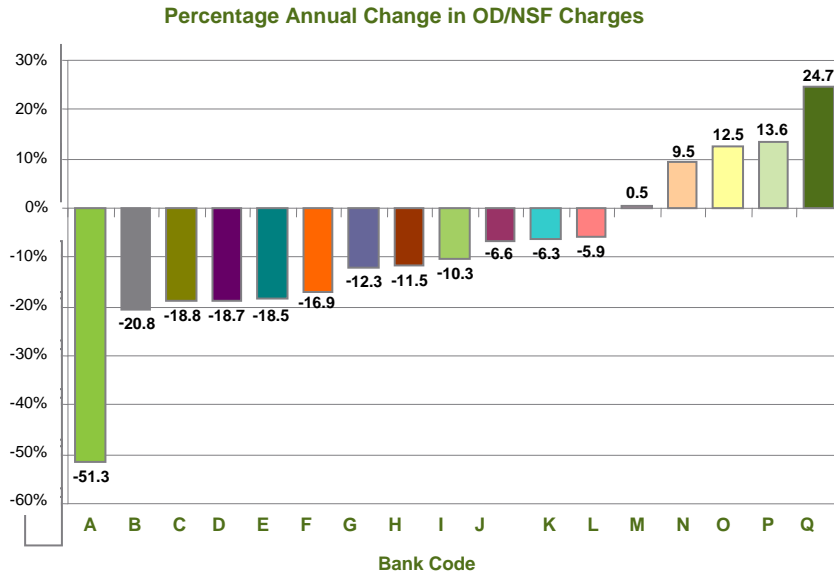


Figure 1

In general, revenues fell because the revenue potential dipped during the first two quarters in 2009. Customers were performing fewer transactions that could create an NSF situation. For years, banks and trade organizations encouraged customers to pay attention to their balances, maintain their check registers and act prudently. The current economic crisis encouraged customers to continue to follow this advice.

Within the sample banks analyzed, we tracked both the total payment volume (potential and realized) and the number of customer payment transactions. It should come as no surprise that overall payment transaction volume leads NSF exception volume. When we looked closely at our sample banks, we saw that, as a group, their customers' total payment volume declined during the fourth quarter 2008 and first quarter 2009. Only now have these volumes started to return to previous levels. However, the total dollar value of these transactions still exhibits lower levels, but seems to be reaching a floor in the valley.



Please see Figures 2 and 3, below.

Total Volume of Bank Customer Transactions

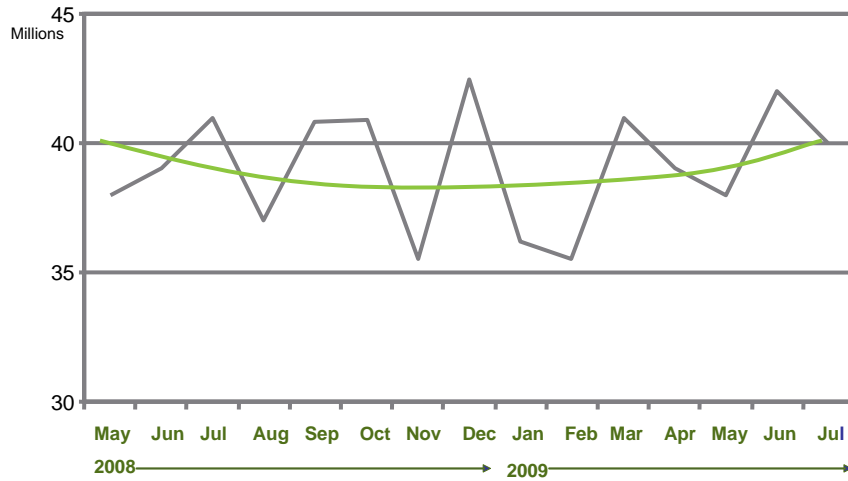


Figure 2

Total Dollar Volume of Bank Customer Transactions

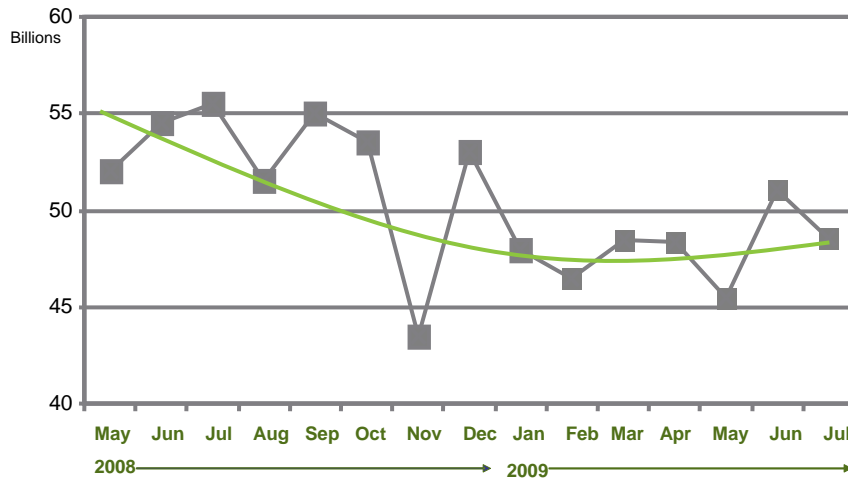


Figure 3



These charts illustrate actual dollars and transaction volumes (unadjusted for seasonality or normal business cycles) for the banks in our study. The peak volumes in December are expected for the holiday season, but are still lower than historic peaks. The smooth, red curve is a trend line that clearly shows the impact generated by the general economic conditions, which struck late in the third and the fourth quarters of 2008 and continues today.

Is this trend change deliberate on the part of consumers? Or, are they reacting to larger forces by suddenly adopting frugal banking practices? Another interesting factor to consider in the current business environment is banks' core demand deposit growth.

Deposits are up

Recent economic turmoil affected consumer savings. Consumers exited various investment positions, as banks offered the protection of insured deposits. The sample banks studied grew demand deposits by over 20% (from June 2008 to 2009, using data as reported to the FDIC).

Figure 4, below, details the demand deposit growth of the banks in the study.

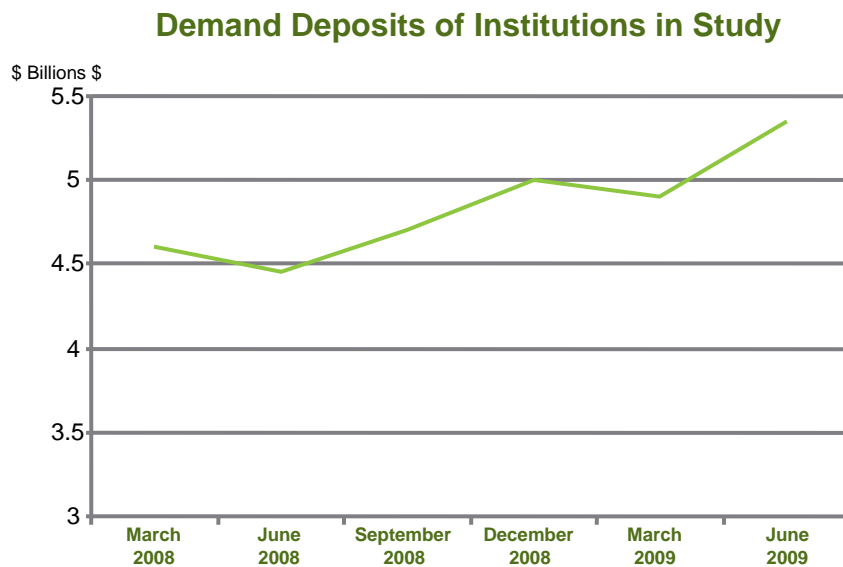


Figure 4



At the same time, according to the US Department of Commerce, Bureau of Economic Analysis (BEA), the savings rate remained strong. Personal saving as a percentage of disposable personal income surged in May 2009 to 6%, the highest level seen since 1995.

U. S. Personal Savings Rate

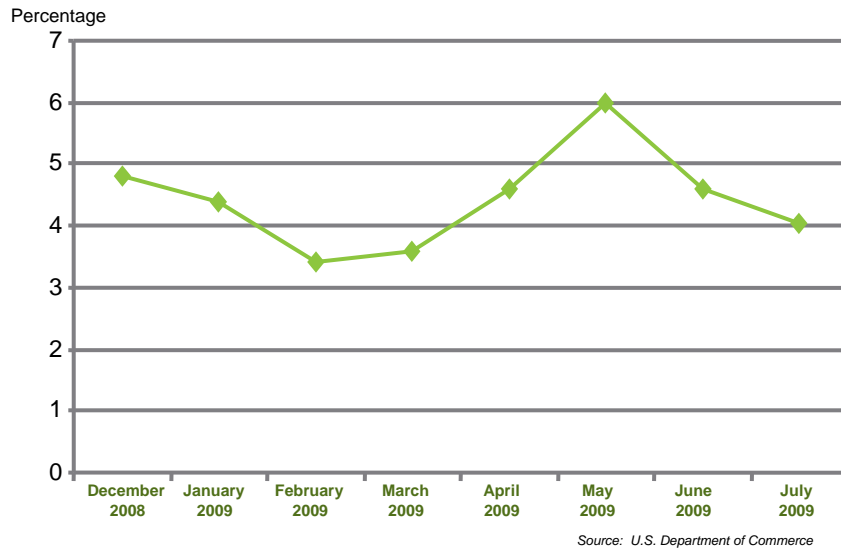


Figure 5

Also according to the BEA, U.S. consumer spending fell in the fourth quarter of 2008, but has gradually grown since then. Less spending translates into fewer transactions, which produces fewer NSF events.



U. S. Consumer Personal Spending

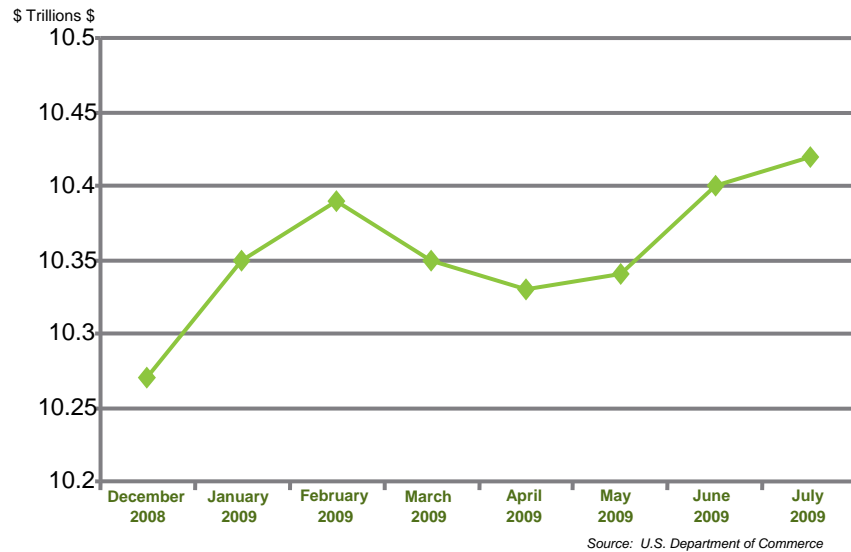


Figure 6

What does all of this mean for the revenue stream generated from NSF/OD events? A double hit – higher balances lessen the potential of an NSF condition, while reduced spending translates into fewer transactions and fewer opportunities for potential NSFs.

Transaction Patterns Change

During the same time period for these sample banks, transaction patterns changed. At this time, there is insufficient information to determine whether this trend is temporary or long-term. However, as a percentage share of the total transactions, checks have decreased approximately 4.5%. In contrast, Point of Sale (POS) transactions grew 3.2%, Automated Clearinghouse (ACH) grew 1% and Automated Teller Machine (ATM) and Bill Payment volumes remained virtually unchanged as a percentage of the total.



Figure 7 provides a breakdown in these payment transaction types.

Total Transaction Volume of Institutions in Study

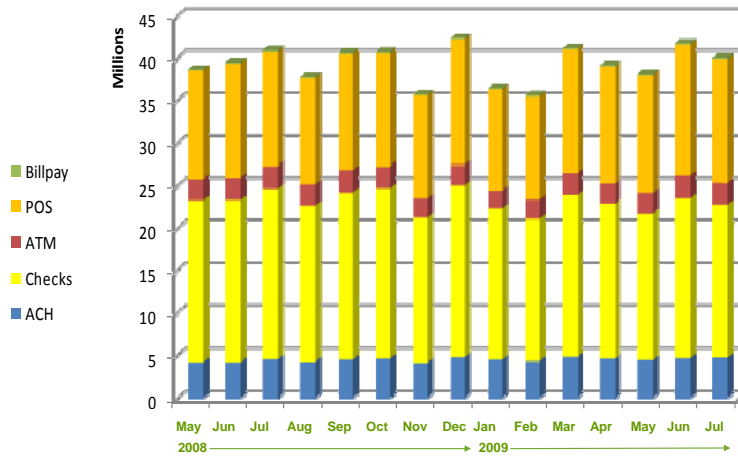


Figure 7

Figures 8 through 12 provide more specific detail on the growth trends for each transaction type. ATM volume experienced a big dip, but has nearly recovered as seen in Figure 8 below.

ATM Volume of Institutions in Study

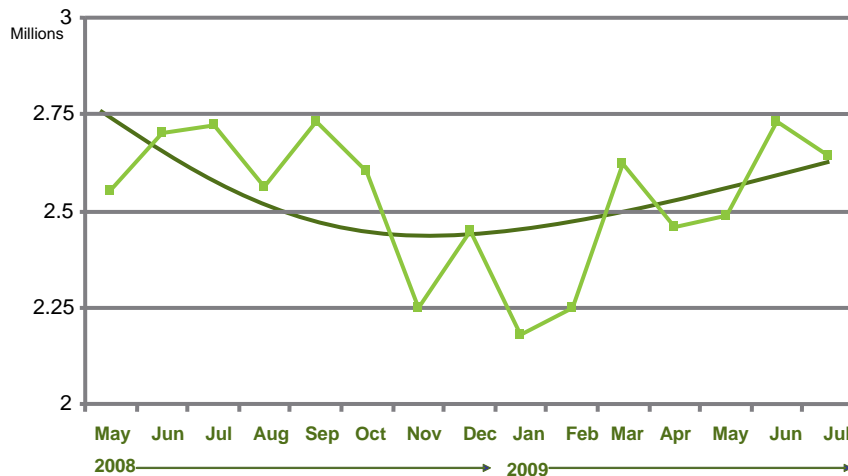


Figure 8

Bill Payment saw a significant percentage increase, due to the banks coming on-line and the relatively low absolute volume involved, as seen in Figure 9.

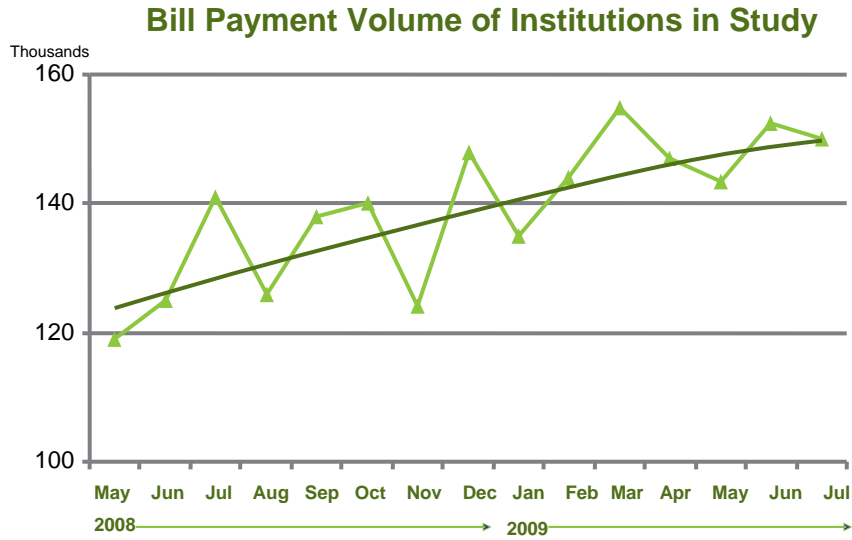


Figure 9

Check volume took the biggest absolute and percentage hit, accelerating the trend of declines previously seen according to Figure 10.

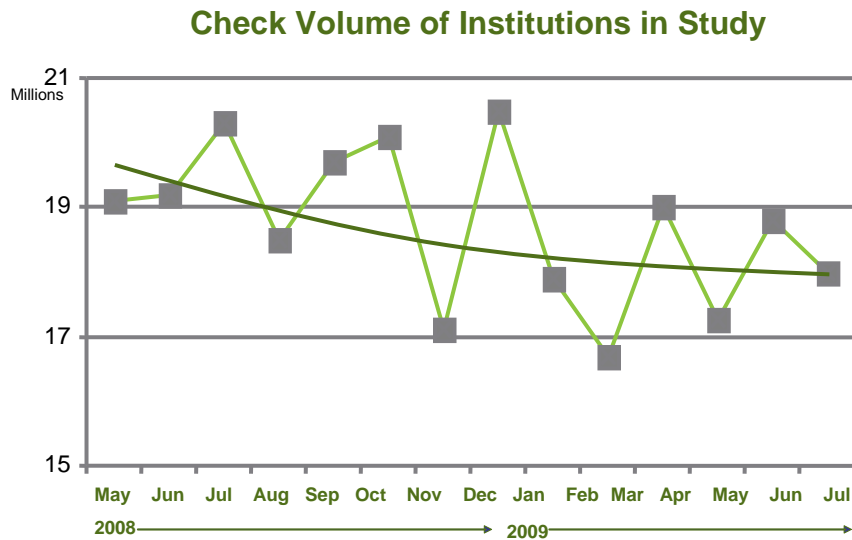


Figure 10



POS initially declined, except for the holiday season, but has since more than recovered, according to Figure 11.

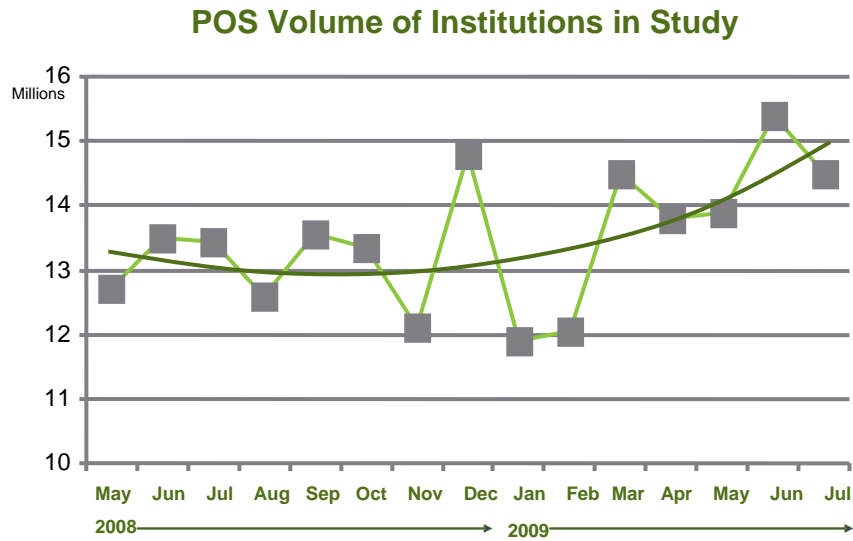


Figure 11

ACH volume alone held relatively steady, following earlier growth patterns. Now it appears to be moderating, as seen in Figure 12.



ACH Volume of Institutions in Study

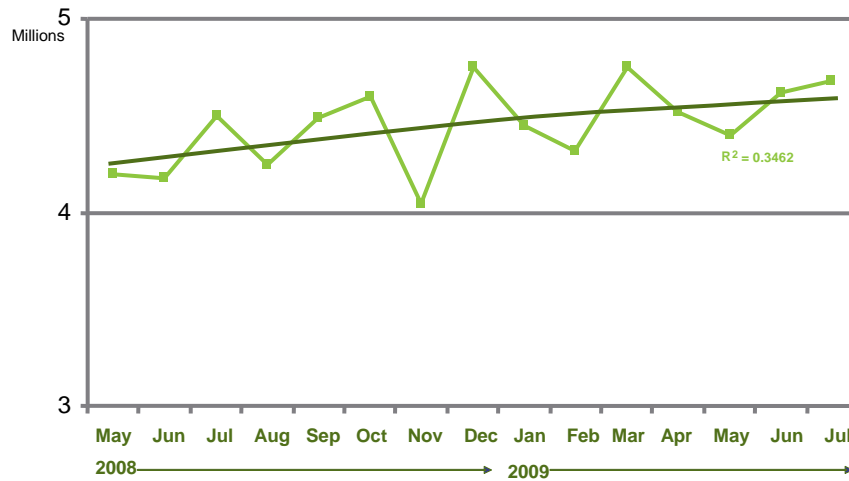


Figure 12

Is a Cultural Change Occurring?

A cultural change may be underway, resulting in fee resistance and hostile reactions to changes in any punitive fees. Examples supporting such a cultural shift are actions taken by major banks backing away from announced fee increases, capping daily fees and setting threshold levels for which they will not charge OD fees. Additionally, recent announcements of new credit card product structures and financial management tools provided by large banks created a positive impact with consumers.

Regulatory Change Will Happen

In the last several years, growing populist sentiment has encouraged the consideration by the US Congress of legislation to regulate NSF/OD practices. Two proposed regulations are now final. Beginning in January 2010:

- Banks must explicitly disclose both cycle-to-date and year-to-date NSF/OD fees on bank statements, whether or not they promote discretionary OD protection¹.
- Banks will be prohibited from including an OD protection limit, whether from credit lines, account sweeps or discretionary protection, as part of the available balance disclosed via automated delivery channels² (except as an additional balance that clearly explains that funds from OD protection are being included in that additional balance).

¹ Final Review Regulation DD—Disclosure of Aggregate Overdraft Fees January 2009

² Final Review Regulation DD—Disclosure of Balance Information January 2009



At the time of writing this paper, there are proposals under consideration which may require banks to have customers either opt in or opt out of discretionary NSF decision systems, define acceptable posting sequences and perhaps even require customer notification when a transaction is about to incur an OD fee. Such regulations would have significant impact on banks. Certain proactive banks are starting to try and get out front of possible regulatory changes.

Recently, a major regional bank changed certain policies and procedures surrounding their overdraft decision-making process. As part the change, the bank told customers they could opt out of the overdraft process entirely, returning all NSF items rather than paying them. After six weeks, the customer-initiated opt-out rate stood at .02% of the total eligible base. When properly explained, and given the option, the overwhelming majority of customers did not opt out.

For electronic channels such as POS, there is another potential consequence that could follow from customers being allowed to either opt in or opt out of overdrafts and the customer being charged. If proposed and adopted, such regulation or legislation could cause the renegotiation of many merchant agreements on floor-limits, and perhaps network agreements.

What is entirely unknown at this time is how the legislature will address the consequences and customer service aspects of returning items NSF rather than pay them into overdraft. The vast majority of banks today charge an NSF fee equivalent to an overdraft fee. Since, on average, over 85% of customers have one or fewer NSF items per year, this will result in no difference in the fees paid by the majority of bank customers.

Additionally, a paper item (or substitute) being returned will need to work its way back through the clearing system increasing workloads and lowering productivity. When such a payment is finally returned, the merchant or depositor will still have recourse against the payee customer and may assess a fee for the returned payment.

For electronic items such as POS, there could be an increase in declines. While this may prevent charging \$40 for a cup of coffee, it could literally result in the merchant holding the cup, unless of course the customer selects a viable alternative payment mechanism.

In the most serious cases, banks may be forced to send negative reports on customers to credit bureaus. In extreme cases, a situation like this could possibly generate civil suits, and in the worst of cases, criminal prosecution.

Depending on the regulatory scenario, the margins associated with promoting and servicing checking accounts, particularly free checking accounts, are clearly threatened. As a result, banks are rethinking the design, pricing and positioning of their products. The following actions can help bankers overcome today's revenue decline and help position themselves for future shifts in the payments landscape.

Actions to Counter Fee Income Decline

FIS (FIS) consultants offer the following observations and recommendations to help bankers offset declines in fee income.

- Focus on making money on payment services.
- Leverage the value you provide as a supplier of payment services to both retail and commercial customers. Although the banking industry's payment system franchise may have eroded in recent years, customers still recognize the safety, convenience and efficiency of using banks to disburse or collect their payments.



- Maximize retention levels of core account customers.
- With less opportunity for the more immediate high-margin NSF/OD fees, the retention period for core checking account customers becomes even more important to profitability. To achieve acceptable margins, banks will need to sell more products, particularly more payment products.
- Continue to look for opportunities to optimize NSF/OD income.
- OD income will still be a significant income component despite regulation and economic conditions. A segment of your customer base will continue to overdraw their account. The bank should continue to re-examine its NSF/OD policies and practices for both income and servicing enhancements that are competitive and justifiable to the customer base.

Beyond these actions, immediate and more traditional areas banks can look at to help improve their fee income include:

- Collection Efficiency – Although a bank may have good net collection efficiency, opportunities may exist in the future to enhance this area if NSF/OD activity levels decrease and the rationale for refunds become less defensible to both bank staff and customers.
- Evolving Pricing Trends – If regulation significantly drives down income levels, look to the largest banks for new and possibly higher pricing levels for NSF/OD activity. That said, consider non-traditional pricing structures that may represent a more benign approach.
- POS/ATM Opt-Out/In Regulation – Stay well ahead of this evolving issue to ensure that a timely, effective message is delivered to customers if this regulation is adopted. The consequences of ineffectively communicating this issue could be detrimental to both bank staff and customers.
- Direct Deposit Advance Product – Several of the largest banks, including Wells, US Bank and Fifth Third, have introduced a direct deposit advance product to their customer base. The product allows a customer that currently has the direct deposit feature and is in good standing (without credit underwriting), to access an emergency advance of \$300-\$500. This amount is automatically repaid from a subsequent direct deposit(s). Fees are assessed on the face amount of the advance, normally at rates that are a half or a third of most payday lender rates.
- Formal Overdraft Protection Fees and Interest – A number of banks have recently increased their OD protection transfer fees, decreased the number of free transfers allowed on premium accounts, introduced an annual OD protection fee or increased the interest rate on outstanding OD protection balances.
- Overdraft Fee Protection – Some bankers are considering a type of OD fee protection or insurance where a monthly fee is charged, either within or outside the context of a packaged account, in exchange for the waiver of “x” number of NSF/OD items per month or year.
- Increasing Customer Communication – Banks need to consider explaining proper financial management to customers, including how NSF/OD processes and procedures fit within the range of services the bank offers. Banks should also thoroughly explain the alternatives that are available to customers.

As banks review their deposit products, packaging options and pricing, they should consider the following offerings:

- Not-So-Free Checking – A number of banks continue to redefine “free” checking with usage and/or servicing conditions. Conditions and restrictions would reflect the value of payments income and servicing cost.
- High-Interest Checking – A large number of smaller community banks have also introduced a high-interest checking account that pays an extremely aggressive interest rate on lower balances (e.g. >\$ 2,500 but <\$25K) if certain usage requirements are met (e.g., ten debit card transactions per month and electronic deposits and statement).



- Value-Added Packaged Accounts – Banks continuing to expand the menu of value-added services and discounts/fee waivers in a packaged account in exchange for a minimum balance, total relationship balances or a fixed monthly fee. Some banks have also linked the package to usage and servicing requirements.
- Re-Pricing Payment and Ancillary Deposit Services – Some of the larger banks have already begun raising fees on many of the ancillary services provided to support particular deposit accounts (e.g., return deposited items, stop pays, etc.). We believe many banks will be forced to follow suit if NSF/OD income continues to deteriorate.

Beyond traditional deposit products, bankers should review their debit card and prepaid debit card products and services including the following:

- Debit Card Usage Incentives – Banks continue to aggressively promote debit card usage via reward programs, cash back and linkage to minimum usage criteria on the checking account. The payoff is interchange income, which continues to represent an increasingly significant component of non-interest income.
- Debit Card Targeting – Banks will increasingly leverage more granular “business intelligence” on account-level payment patterns and become much more effective at targeting promotions and incentive programs to select customers.
- Prepaid Debit Cards – Banks are increasingly leveraging prepaid cards to attract new fee income and new customer segments, particularly the unbanked or under-banked consumer segments.

More to Come

This is the first in a series of in-depth studies based on unique insight gained from transactional data. Over the course of the next several months, we intend to issue updates on the issues impacting payment trends and their associated revenue streams. We intend to refine and develop additional alternative strategies through working with FIS (FIS) client banks.

For More Information

FIS's (FIS) team of specialists comprises practitioners in financial services, operations, technology, risk management, and retail and commercial banking. Our operational expertise covers the many facets of deposit growth and branch network effectiveness. We deliver measurable results that aim to increase efficiency, grow revenue and improve profitability. We welcome the opportunity to discuss your specific areas of interest and learn how our consulting group may be able to help your organization move forward with key opportunities.