

The Paradigm of Free Checking

Where we are and how we got here

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The rise and soon-to-be fall of free checking is a study in the nature of our relationship with consumers over time. If we let history teach us, we can learn a lot to guide us through the uncharted waters ahead.

Let's go back to the early 1960s when women accounted for only 15% of the workforce and there was no hint of the technology revolution. In those days banks attracted customers with gifts such as toasters, blankets and dishware for opening new accounts. Financial institutions portrayed themselves as the foundation of support and security for the family and the gifts reinforced that message. Although most women were not the economic decision-makers in the home, they were influencers. Driven by housewives dependent on the generosity of their husbands to spruce up the home, these gifts nudged women to exert influence on their husbands to select a financial institution, much as Happy Meal toys prompt children to influence their parent's choice for lunch. This statement is not intended to be derogatory to women of the '60s; it was simply the common social order of the day.

While there was an incentive to choose initially, the relationship between the consumer and the bank going forward was based on a value exchange. Financial institutions charged fees for services and in exchange became the family's trusted caretaker and advisor for all things financial.

In the 1970s and 1980s we experienced the women's movement AND double-digit inflation, pumping the prime rate above 21%. More women were in the workforce but the economic balance had changed so that it required two incomes to maintain a home and two vehicles to get you there. Mortgage payments soared and the free toaster was a symbol of a bygone era. The traditional home-based gifts now took on a derogatory meaning and were quickly replaced by a new concept – “free” checking.

When introduced in the late 1970s, free checking was offered only to consumers who maintained high balances (or were otherwise determined to be profitable customers) as an incentive to boost their balances or use additional services. A cost-based business model that determined who would receive these free services was still at work, resulting in a cost against profit for the account. But there was still a profit. By the mid 1980s, the offer of free checking for profitable customers was less a good idea and more a necessity to maintain market share as consumers learned they could shop for banking services. Interest rate shopping at the height of the double-digit era was a hobby for many people who owned CDs, and banks advertised their rates daily in newspapers, radio, TV, and with signage at each branch. Even though the marketplace was offering more choices, inertia kept most consumers banking where they had their checking accounts. That would not be the case for long.

In the mid-1980s, banks were struck by a perfect storm of events. Interest rates that shored up free checking fell fast. Community banks were acquired by the regional giants and consumers were swept up into faceless organizations, causing bank loyalty to plummet. Consumers demanded more value and some recognition of their importance as customers. Many turned to

credit unions after deregulation in the financial services industry allowed them to compete with banks by offering products such as share draft accounts.

Enterprising marketers during this period provided an easy fix to cure the bank's shrinking market share – offer free checking to the masses. But how could banks make money on accounts that did not carry a large enough balance to generate a profit? The answer was a loosely designed business model based on free checking as a loss-leader and cross-selling more profitable products. This model depended on flawless sales execution and tracking, something most banks did not have. By the time the banks realized consumers were not drinking the cross-sell Kool Aid, free checking had become a standard, and many credit unions offered it too. Free checking, which started as a privilege, became table stakes. The business model of these financial institutions morphed into “give away and pray” and lasted another decade.

In the 1990s, the technology revolution put computers in the majority of US homes. The rise of the internet made information and advice available to everyone. Consumers learned they could spread their financial services among institutions to shop for better terms. This single-service mentality worked against the concept of multi-service profitability necessary to support free checking. But there was hope. The introduction of the debit card in the 1990s made it easier for consumers to spend. And those free checking accounts were typically concentrated among consumers who regularly overdrew their accounts, creating overdraft fees as much as \$120 to \$160 a year per account. An FDIC study showed the top 5% of NSFers generated more than \$1,600 per year, making free checking profitable again. For many banks and credit unions, overdraft fees became a mainstay of the balance sheet.

In the late 1990s, financial institutions borrowed from history and introduced "totally free checking with a gift." This was in response to the increasing competition among financial institutions for the 14% of checking customers with the greatest tendency to overdraw.

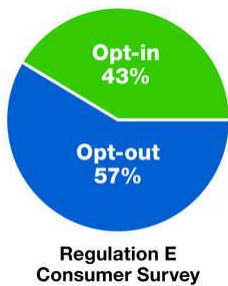
According to the FDIC these customers alone generated more than 93% of the total overdraft fee income, and an amazing 68% of the income was generated by only 5% of the accounts. The concepts of cross-selling and market share penetration were once again revived as the primary objective of "rewards checking" programs, but overdraft income usually remained the deciding factor of profitability.

The year 2000 brought more technological sophistication in the way checking accounts were managed for profitability, with overdraft fee income taking on the primary role. "Overdraft Privilege" programs made it even easier and more desirable to overdraw an account. Erasing the stigma of the NSF notice in the mail let consumers know that it's OK to be upside down on their checking accounts.

By December 2007 – the official start date of our current recession according to the [*National Bureau of Economic Research*](#) – many of our nation's banks and credit unions relied on overdraft fees for up to 20% of their overall profitability. As the recession marched into 2008 and 2009, those numbers climbed. Banks and credit unions earned more than \$130 billion dollars in overdraft fees, offsetting losses from declining margins in lending, assessments from FDIC and NCUA to shore up shrinking reserves, and the marked increase in fraud losses due to a rise in

identity theft and information security breaches. By this time, free checking was just a commodity; it simply was taken for granted by consumers and financial institutions alike.

Leading up to the recession, overdraft privilege programs were under fire by consumer groups, drawing the attention of the regulators. In 2009 the Federal Reserve announced an [amendment to Regulation E](#) that takes effect July 1, 2010 and requires financial institutions to ask consumers to



opt-in to programs that allow ATM and debit card payments to be applied to overdrawn accounts. But few consumers will opt-in.

According to a March 2010 study by [Acton Market Intelligence](#) 57% of banking customers said they would NOT opt-in for overdraft services. Even

if there were no compelling reason to decline participation, inertia dictates that the percentage who will respond to an opt-in request very likely will be in the single digits. Of the people who opt-in for overdraft fees, how many will be among the 14% that drive the revenue? Projections indicate financial institutions could lose as much as 60% to 90% of their NSF income. This is a huge nail in the coffin of free checking.

Already many banks and credit unions have gone back to basics and implemented fees for checking accounts. For those who haven't, the time is near. The secret of a successful transition from "free" to "fee" may be found in the relationship that bankers enjoyed four decades ago - a relationship based on trust, security and an honest exchange of value that benefits both parties.

The same thing that was important in the 1960s – support for the family and a feeling of safety – is still true today except the severity of threat to security has worsened. The [Federal Trade Commission](#)'s report on identity theft shows that only 31% of the cases reported in 2009 involved checking, credit or loan fraud. Two-thirds of identity theft cases reported were other types of fraud, such as medical identity theft, government benefits fraud, and true name identity theft – all of which occur outside of the relationship with the financial institution. Nonetheless, people view identity theft as a financial crime and look to the bank or credit union for guidance. Once again, our nation's financial institutions are in a position to provide a unique form of financial security for individuals and families.

The time is right for banks and credit unions to add identity theft protection to their checking accounts and employ certified professionals to provide hands-on problem resolution in times of need. A robust security strategy for the financial institution that also offers personal protection for consumers costs very little – or nothing at all – when applied across a large group. But the benefit to each consumer is huge – and easily recognizable as having monetary value. This opens the door for a service charge on the account. If you provide the right communication and training for staff and protect your customer's privacy by not requiring them to register for the service (it should be part of the account relationship), you can create a value exchange that will be widely accepted and welcomed by your accountholders. It will allow you to react effectively to the Red Flags of identity theft based on the [requirements of FACTA Section 114](#) and prepare you for an accidental or malicious information security breach. Best of all you can provide valuable benefits for your members while recovering a significant part of the revenue lost from lower overdraft fees.

Some account holders will complain about the move to account-level service charges. If, however, you have a good story to tell about the benefits added to the account most customers will know they are getting more than they are giving up. Meanwhile the majority will simply roll with it.

If this sounds like a cultural change in your organization – a paradigm shift in the way that you think about your accounts and the members who participate in your organization – you are right. But you also need to remind yourself that in the face of regulatory change, doing nothing may not be an option.

It's up to you to trust that your members want to see their credit union on solid financial footing, generating enough revenue to continue operating and offering valuable financial services, supporting families and providing security – and writing history for many years to come.

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