Reducing Non-Credit & Deposit-Related Losses

Perspective #3 in Dean & Company's Continuing Series on Banking Trends

The Challenge

Deposit-related losses can be quite substantial — often totalling 5–20 basis points on deposits, or $50MM–$500MM annually for a Top 10 bank. We have found that targeted analytical tools can help reduce these losses by about 30%, yielding major short-term benefits to the bottom-line.

Losses associated with deposit products (broadly defined, including check fraud, overdraft charge-offs, etc.) have not been subject to the same organizational focus as loan losses in the past. However, they represent an increasing challenge that crosses multiple product and functional boundaries.

In order to increase revenue growth, banks have devoted significant effort over the last several years to cross-selling, pricing and product changes designed to boost fee income, as well as to acquiring new customers through non-traditional channels. On the cost side, the migration of routine activity to automated channels increases anonymity and the risk of some types of fraud. These tactics are prudent, even essential. However, many banks may be unwittingly increasing their susceptibility to risk and charge-offs while still not achieving requisite growth.

As illustrated by unexpectedly high credit card charge-offs in recent years, and real estate and Latin American lending before that, pursuing "hot" revenue strategies without fully understanding associated risks can lead to unexpected consequences.

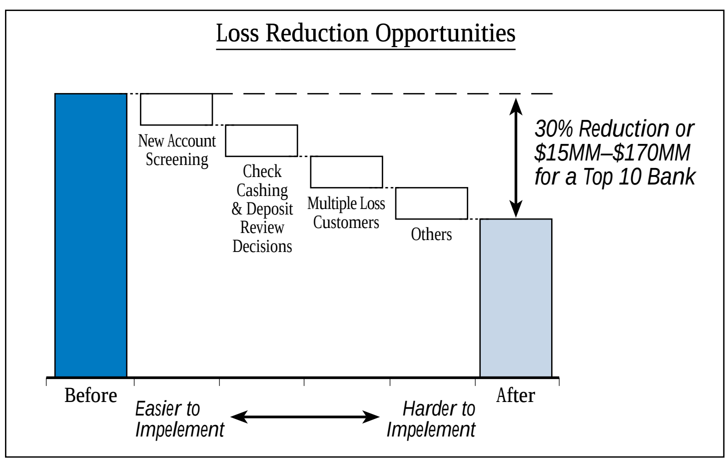
Customers with high numbers of bounced checks, for example, can generate significant fee income in terms of overdraft charges, enough so to be among a bank's most profitable customers. Yet we have found that their risk of loss can be over 200 times that of otherwise similar customers. This increased risk of loss should not disqualify them as a desirable class of customers, but the data does suggest that they be managed differentially (and carefully).

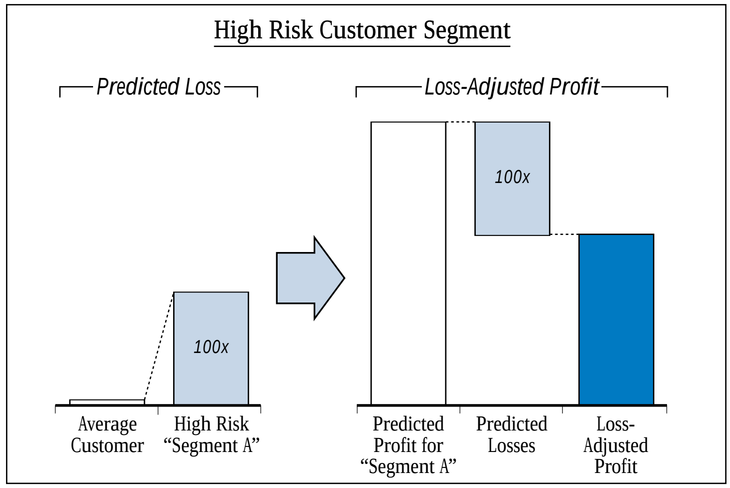
Boosting fee income clearly is sound business, but retail strategies designed to improve income should not be considered without a concomitant, quantification of their effect on risk. Incorporating risk adjustments into business cases can help better prioritize revenue and customer retention initiatives. In fact, a better understanding of non-credit loss drivers can result in increased profitable account growth (by turning away fewer "good" customers).

Bottom-line improvements, both short and long-term, require an integrated approach by marketing and risk control functions in four basic areas:

1. Managing the "Front Door": The new account opening process.
2. Managing high risk situations.

Reducing losses by 30% is a realistic target (1–3 year time frame). In addition, selective "loosening" of some policies may significantly improve revenue growth.





A model that only predicts the likelihood of loss may identify "Segment A" as one to be avoided. In fact, its high level of profitability (driven by fee income) more than compensates for the higher level of risk.

3. Understanding losses by product: Adjusting product features and pricing to reflect risk of loss.
4. Tracking losses, testing and ongoing improvement.

Managing the "Front Door": The New Account Opening Process

The focus of sales personnel in most banks is to open as many new accounts as possible. In some banks, such a mandate has been refined to refer only to "profitable accounts" with compensation linked to the value of a new relationship or to some pre-defined minimum tenure (how "value" can best be defined is a distinct topic addressed in another essay in this series). In many cases, credit score minimums or other third party screening systems are consulted to weed out the least attractive or highest risk applicants.

But how does the bank know that correct or optimal screening is in place? Are you "setting the bar" too high or too low? How many "good" customers is the bank turning away, or conversely, how many "bad" applicants is it letting in the door? Which channels are better or worse, regarding risk?

Choosing the optimal metrics for use in the account-opening process requires an understanding of a given applicant's risk of loss versus predicted lifetime profitability. A high risk of loss is not inherently bad — as long as it is quantified and resides with a customer who contributes enough value to justify that high risk.

While some banks have good estimates of the value of existing customers, far fewer predict the lifetime value of new customers. Significantly fewer still predict the likelihood of loss for a specific customer at account opening. To do so requires commitment and a rigorous, data-driven process.

Managing High Risk Situations (NSF, Cash-Back Situations, Deposit Holds)

There may be some customers who have a high predicted risk of loss but whose predicted profit is even higher than the risk of loss. This especially can be true for customers whose high revenue is driven by fee income.

Indeed, many lower-score customers can be predicted to contribute positively (and will do so). A bank should want to attract and retain these customers — yet how should the bank manage its relationship with them?

One option is to let these high risk customers retain their accounts, but tighten the standards for them when they interact with the bank in what clearly are "high risk situations." Such situations include:

- *The customer writes a check for which they have insufficient funds — should the bank honor the check?*
- *The customer deposits a check and asks for cash back — how much should the bank allow?*
- *The customer deposits a check — should the bank place the maximum allowable hold?*

A simple “yes” or “no” is unlikely to be an adequate answer to any of these questions. More likely, the answer will depend on the individual customer in question, the situation, and the dollar amount at risk.

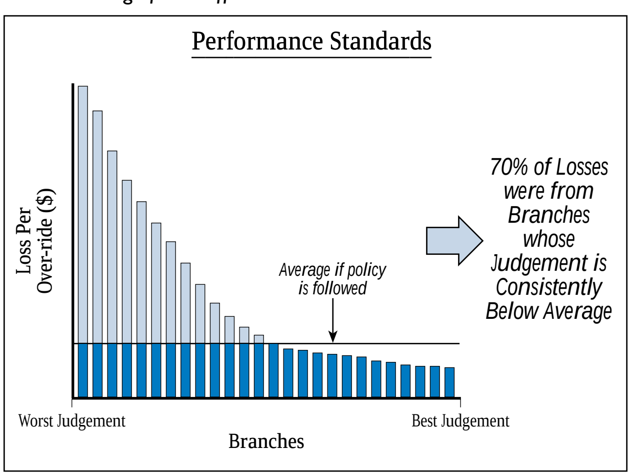
Rigorous analysis of the bank’s experience to date can result in better policies, which enable the bank to grow, while still minimizing non-credit loss.

In the first instance, predictive modeling (based on existing data and ongoing experimentation) will help quantify the likely risks of non-credit losses and weigh these risks against potential benefits. In our experience, key inputs to these models will include customer tenure, credit score, product type, recent account behavior, and average balances, among other variables.

Significant leverage can also be culled from analyzing and evaluating over-ride policy. How often do losses result from over-rides by branch personnel? How do losses and the frequency of loss vary among regions, branches, and specific personnel? Can stricter management or adherence to established procedures reduce losses?

Utilizing sophisticated analytical techniques and decision support systems to understand losses and set policy can yield very tangible best practices. Banks who do this often find that adherence to well thought out and established procedures is a critical element in reducing losses and improving both profitable retention and profitable growth.

Results vary widely between branches when they make exceptions to established policy. Tracking and managing losses related to over-rides can have a significant effect on losses.



Understanding Losses by Product: Adjusting Product Features and Pricing to Reflect Risk of Loss

A policy of rolling up non-credit losses to a product level also can provide bottom-line, strategic leverage. First, it helps refine the bank’s understanding of true product profitability. Just as on the loan side, where higher spread products may also carry a higher risk of loss, any estimate of product profitability which doesn’t include such differential risk can be misleading.

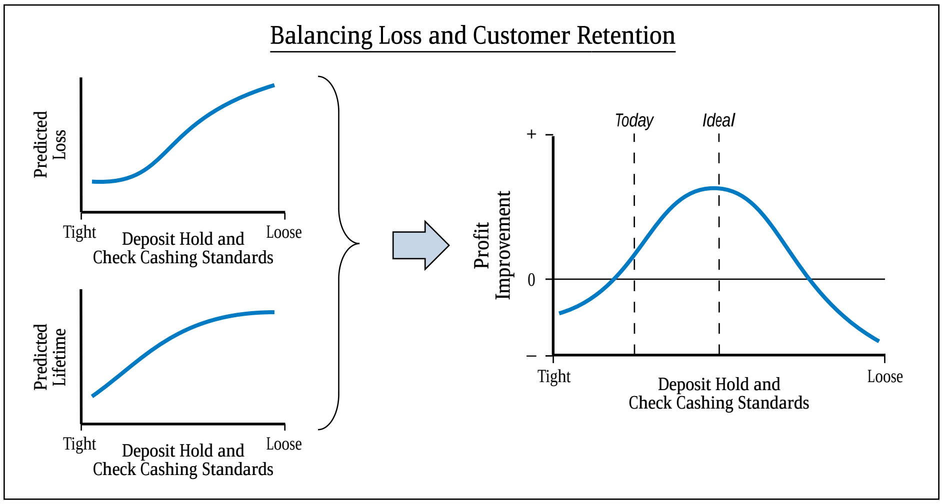
In some cases, a higher level of risk associated with a product or product family can be mitigated by making adjustments to the product’s features or pricing. Such adjustments might include:

- *Higher fees for high risk behavior.*
- *Incentives for customer loyalty (e.g., where tenure is a driver of risk of loss, options might include lower fees for keeping the account active a year, etc.)*
- *Creation of a “cash only” debit account (for customers with otherwise unacceptable levels of risk).*

Whatever the response to higher product-level risk of loss, banks first must be able to quantify the increased risk. Then, one needs to quantify the effects of proposed actions on losses, as well as retention and other variables driving lifetime profitability.
In-market customer testing is a useful tool in this environment.

Tracking Losses, Testing, and Ongoing Improvement

Beyond short-term changes to policies or product features and pricing, future improvement in controlling loss and optimizing account growth requires that banks develop, and maintain, key capabilities which allow the tracking of iterative improvement of NCL performance. This involves:



Check cashing and deposit review decisions should take into account the effect on customer tenure and risk. That trade-off is likely to vary by customer and situation.

- *Defining and maintaining key data elements — the crucial inputs into any predictive capability.*
- *Defining key performance metrics by which the best and worst performing regions, branches and individual employees will be measured.*
- *Understanding how segments respond differently to changes in policy or procedure, and why.*

While risk of loss and expected profitability is predictable under many scenarios using existing data, there are many situations in which in-market testing is crucial to fine-tuning ideas or developing sufficient confidence to roll-out across the franchise. For example, tests are themselves a low risk and integral method for identifying and quantifying:

- *The effect of selective tighter or looser funds availability policies on customer loyalty and tenure (vs. incremental impact on losses).*
- *The effect of product alterations intended to reduce losses on customer acquisition rates.*
- *The effect of better loss reporting and branch compensation adjustments.*

Developing a capability to effectively track and compare regions, branches and employees along key loss metrics is important when initiating any type of in-market testing.

Conclusion

Bankers, more than anyone, appreciate the importance of risk as a factor in making decisions. In today's world of hyper-competition, slow organic growth, consolidation, and focus on customer profitability measurement, it is crucial to be able to quantify and balance the risk of non-credit losses with initiatives or policies to grow revenues, whether through fee income or growing the account base.

Risk measurement, so viewed and managed, is a strategic tool that will enable banks who use it to grow not only more quickly but more profitably.

In the short-term, moreover, an investment in the processes to better understand and manage non-credit losses, such as those outlined above, has the potential to quickly and substantially drive earnings to today's bottom-line.

DEAN & COMPANY
STRATEGY CONSULTANTS

8065 Leesburg Pike, Suite 500
Vienna, Virginia 22182-2733
Phone: 703.506.3900
Fax: 703.506.3905