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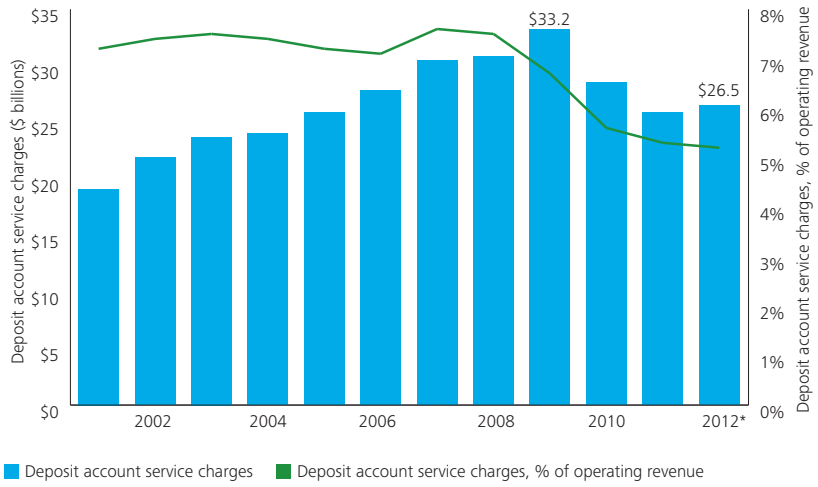
Retail Bank Pricing
Resetting customer expectations

Deloitte Center
for Financial Services

Contents

Rethinking the economics of retail banking

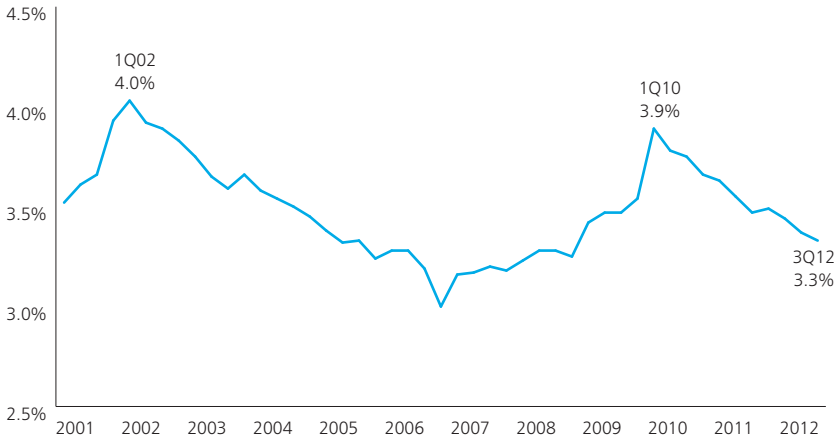
Exhibit 1. Aggregate deposit account service charges of banks with more than $10 billion in assets



Service charges include account maintenance fees, minimum balance and early withdrawal violation penalties, and insuffifient fund check charges, but do not include ATM, safe deposit box or money order/traveler check revenue. *Annualized data from 3Q2012.

Source: FDIC

Exhibit 2. Net interest margin of banks with more than $10 billion in assets



Source: FDIC Quarterly Banking Profile.

Since 2010, a number of banks known for offering "free checking" have begun to charge for checking account services. But, in at least one instance, when this pricing change resulted in customer defections and reduced service-fee income, the institution reinstated the free-checking policy.[1] Similarly, other institutions are also reconsidering their plans to impose new fees on checking accounts.[2]

Of course negative customer responses to fee increases do not affect all banks to the same degree; some can rely on other business segments to offset changes to their retail banking operations. Moreover, some institutions may not have the strong brand identification with free checking that others do, and as a result, may not experience as much account attrition when service charges are increased—especially if the customers have a strong appreciation of the value received from their overall checking account relationship.

But many banks in the U.S. are under substantial pressure to reconsider the economics of retail banking, especially given reduced income from sources such as debit interchange and overdraft fees. Service charges on deposit accounts, one measure of such income, have fallen both in absolute dollar terms and as a percentage of operating revenue (Exhibit 1). And in the context of recent declines in average net interest margins, banks are likely to need fee income more than ever (Exhibit 2). To be sure, cost cutting may play a large role in this effort, but it is safe to say that sustainable solutions will also probably involve the revenue side of the equation.

One way to compensate for falling fee income may be to have more customers pay for services that were previously "free," like checking accounts and many associated services. The free checking model, the industry norm for two decades, may no longer be as viable a strategy for many banks. In short, retail bank fee structures will likely have to change; the only real question is how.

A customer survey conducted by Deloitte to delve into bank pricing suggests a uniform approach to communicate and execute pricing strategies might not be effective.[3] Banks may have to account for differences in perceptions and price sensitivity among their customer base by rethinking their approach to customer segmentation.

Regulatory pressures on fee income

New regulations over the past several years have restrained retail bank fee income—particularly overdraft and interchange revenue—and more changes appear to be on the horizon.

Overdraft fees

- Regulatory directives on overdraft fees have ranged from transparency and consent to operations and implementation of programs. In 2010, Regulation DD—the Truth in Savings Act—was broadened to require all institutions to disclose overdraft fee charges on periodic statements.
- Also in 2010, banks became subject to new rules under Regulation E – the Electronic Fund Transfer Act – that required consumers to opt-in to overdraft programs.
- More prescriptive supervisory guidance for automated overdraft programs was released by the Federal Deposit Insurance Corporation (FDIC) in 2010 followed by separate guidance from the Office of the Comptroller of the Currency (OCC) in 2011. The FDIC guidance recommended daily limits on overdraft charges and waiving fees for *de minimis* overdrafts.

Responsibility to regulate overdraft rules has been transferred to the Consumer Financial Protection Bureau (CFPB). Looking forward, further regulatory changes are likely: the CFPB launched an inquiry into overdraft programs in early 2012 that broadened the scope of prior overdraft guidance.

Interchange fees

- Section 1075 of the Dodd-Frank Act, often referred to as the Durbin Amendment, directed the Federal Reserve to set a debit interchange fee that is "reasonable and proportional" to the cost of the service for institutions with assets greater than $10 billion. Prior to the rule, the average interchange fee was 43 cents per transaction, but the final rule (issued in July 2012) capped debit interchange fees at 21 cents per transaction, plus a share of the transaction's value and a one cent fraud prevention adjustment.[4]

These regulatory changes have decreased fee income for retail banks. Despite the fact that 77 percent of consumers opted into overdraft programs one year after the Regulation E opt-in requirement, overdraft revenue for banks and credit unions still declined steadily from 2008 to 2011, falling from $36.8 billion to $30.8 billion.[5] Overdraft revenue rebounded slightly in 2012 to $31.5 billion as consumers grew more comfortable with recent changes and banks adjusted pricing, yet revenue remains well below 2008 levels.[6] The Durbin Amendment, on the other hand, is estimated to have reduced interchange revenue by $6.5 to $7.0 billion annually.[7]

Free to fee

In the last year or so, a number of banks—including Wells Fargo, Citi and SunTrust—have raised fees on checking accounts.[8] And according to Bankrate, the number of free checking accounts has declined substantially over the last several years. Only 39 percent of accounts offer free checking now, compared to 76 percent in 2009.[9] Moreover, the average monthly service fee on non-interest checking accounts, now $5.48, has increased by 25 percent since 2011.[10] But many consumers are eligible for fee waivers if they maintain a minimum balance, arrange for direct deposits, or use credit cards.[11] For instance, reportedly 85 percent of JPMorgan Chase customers are eligible for such waivers.[12]

However, it appears some banks are making it harder for consumers to avoid checking account fees by raising the required minimum balance or placing limits on certain transactions. According to Bankrate, the average balance required to avoid fees is now $6,117, nine percent higher than in 2011.[13]

Will customers defect?

The recent experience of some banks suggests that some customers might consider switching banks if fees on checking accounts are raised. There is additional evidence to support this view: according to J.D. Power and Associates' 2012 U.S. Bank Customer Switching and Acquisition Study, defection rates at the large and mid-size banks in 2012 have risen to as much as 11.3 percent, against less than one percent among small banks and credit unions.[14] The primary reason cited for switching was fees.

A recent survey conducted by the Deloitte Center for Financial Services offers additional support for the link between fee increases and customers' propensity to switch banks. The data suggest that there is considerable aversion to price increases, with many consumers feeling that banks are not being fair in raising fees.[15] As discussed in the sidebar on Page 8, concepts from behavioral economics and psychology might explain why many bank customers find the shift away from free checking accounts and account services to be especially unpalatable—that is, why customers appear more likely to leave than the relatively small price increases being considered might otherwise indicate.

Such negative reactions to bank fees are likely amplified when consumers do not fully realize the value provided by banks. Large and mid-size institutions, in particular, offer a range of services—such as multichannel access points, reward programs, and a broad array of products and options—for which value received may not be readily apparent. And as this survey shows, many consumers have very little idea of the actual costs that banks bear in servicing checking accounts. The hypothesis is that better information about costs might lead to greater acceptance of pricing changes.

The current state of bank pricing raises a number of important questions for the future of retail banking. How do bank customers feel about their banks now, especially with regard to pricing practices? Should banks pursue alternate pricing strategies to compensate for declines elsewhere? If so, how? What can banks learn from pricing in other industries that have faced similar challenges? And perhaps most importantly, how can banks best account for consumer psychology and preferences in making these changes?

Survey findings

With these questions in mind, the Deloitte Center for Financial services conducted a survey of over 4,000 retail bank customers to take the pulse of consumers' perceptions of banks and pricing preferences. The survey also captured data on consumers' satisfaction and relationships with banks.

About the survey

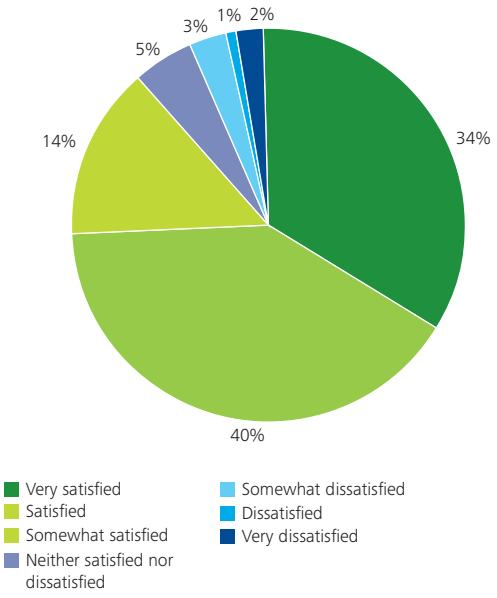
- Survey was conducted online by Harris Interactive from August 16th to 30th, 2012
- In total, 4,271 checking account customers participated in the survey
- Respondents were at least 18 years old with a personal checking account
- Responses were weighted across geographic regions, income levels, age, and gender groups to reflect the national population

Industry perceptions and satisfaction

Perceptions of banks' general business practices among survey participants were generally unfavorable. Almost two thirds (65 percent) of customers surveyed believed banks were not being fair in the way they implement new fees, and more than half agree with the statement that "all banks, including my primary bank, are only looking out for their [the bank's] own benefit." But, as illustrated later, there are substantial differences in customers' perceptions, which in turn may lead to very different reactions by certain segments to banks' near-inevitable pricing and service changes.

In contrast, of those surveyed, many consumers are satisfied with their primary bank (Exhibit 3). In a time of widespread and sometimes loudly stated discontent with the financial services industry, this finding may be surprising. This is possibly the result of self-selection—dissatisfied customers may leave banks with which they are dissatisfied. Interestingly, survey respondents are also most likely to believe banks to be the best at communicating fees and value (out of a list of eight industries including airlines and telecoms): 26 percent surveyed thought this to be the case, against just 8 percent for airlines and wireless/phone service providers.

Exhibit 3. Customer satisfaction with primary bank



Source: Deloitte Center for Financial Services

Are bank customers' perceptions and pricing preferences so unusual? Insights from behavioral economics and psychology

At first glance, there are some counter-intuitive patterns in the attitudes of the survey respondents. Notably, customers' high aversion to price increases seems unwarranted due to the relatively small dollar amounts involved. But this pattern is broadly consistent with the predictions of well-known behavioral economic research.[16] In the academic jargon, it might be considered an expression of anchoring and zero-price effects.

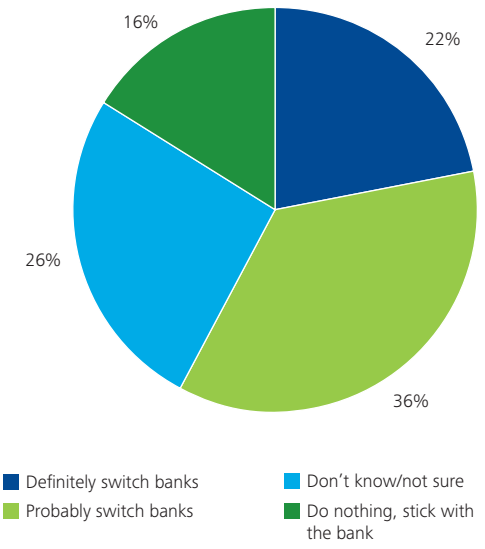
Anchoring is the process by which consumers' expectations about pricing and value depend on arbitrary values. That is, when individuals have only limited information about the value of something—such as checking account services—they tend to latch on to whatever information available to them, whether such information is relevant or not. One well-known study by Ariely, Loewenstein, and Prelec found that participants' estimates of a "fair" price for a range of goods was incredibly sensitive to an entirely arbitrary reminder of the last two digits of their social security numbers.[17] The effect appears to be compounded by past exposure; current perceptions of what a checking account should cost or is "worth," not surprisingly, have been influenced by years of free checking. In a way, consumers might believe that checking accounts are not worth much, because many have never been asked by their banks to pay for them. The anchoring process of consumers in this regard may also explain why so many believe that bank pricing changes are unfair despite the value received.

This effect is likely exacerbated by the special value people attach to something that is "free," even if the difference between a "free" and costly product is the same as the difference between two costly products. That is, people are more likely than expected (even given variations in relative change) to react strongly to a change from $0 to $1 than from $1 to $2. In the context of banking services, then, it makes sense that a very high proportion of customers say they would switch even in response to a modest fee increase. Put simply, moving from free to a fee is a much larger mental obstacle for consumers than a simple increase of the same size in existing fees.

How are bank customers likely to respond to price increases?

To gauge consumers' willingness to accept fee increases, we asked respondents how they would react to a $5 fee increase. Nearly six in ten said they would probably or definitely switch if their primary bank charged an additional $5 per month for the same level of services (Exhibit 4).[18] The question as the survey posed it explicitly excluded any change in services provided or value offered in order to get a more precise sense of consumers' price sensitivity.

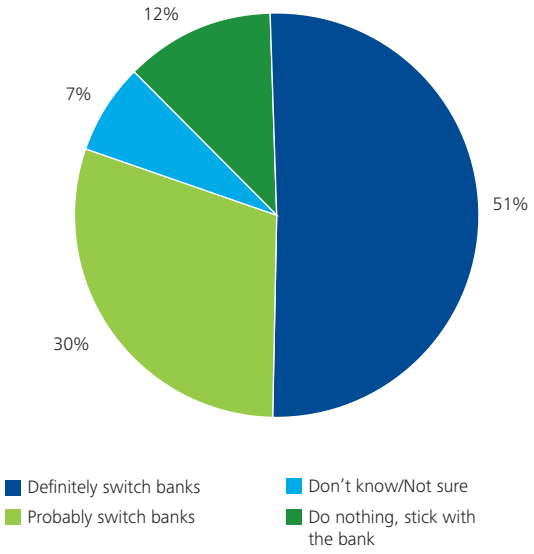
Exhibit 4. Response to a $5 fee increase



Source: Deloitte Center for Financial Services

Respondents who said they would do nothing or probably switch were then asked about their response to a $10 per month fee increase, with even stronger results—as one would expect given the doubling of the proposed increase (Exhibit 5).

Exhibit 5. Response to a $10 fee increase

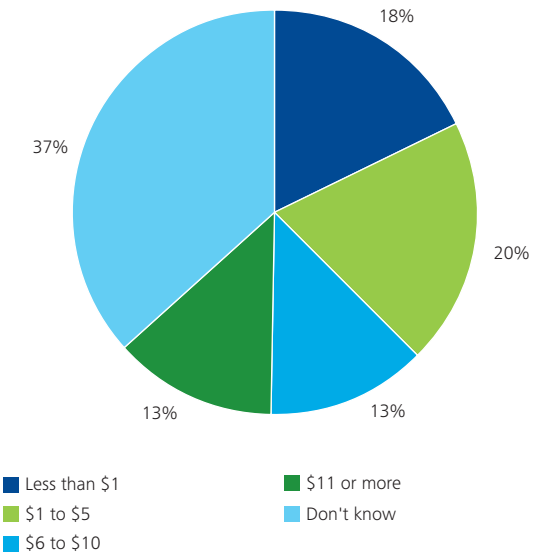


Source: Deloitte Center for Financial Services

The importance of additional fees in making banking decisions is also supported by other responses from the survey. For example, 73 percent of respondents said that fees on checking accounts were important or very important to their choice of a primary bank, and 80 percent attached the same degree of importance to fees as a factor in a decision to change their primary bank in the next 12 months.

In general, respondents expressed concern about, and lack of understanding of, potential fee increases. Only 30 percent said they even somewhat understood why some banks are raising their fees, and over 55 percent were concerned that their level of service would decline. Only a limited proportion expressed willingness to pay for increased service quality or more valuable services. These issues are perhaps compounded by low information about the cost to service accounts: more than a third of respondents had no estimate of the cost to service their accounts (Exhibit 6)—estimated at an average of $250-$300 a year.[19] Insights from behavioral economics and marketing (see sidebar: Are bank customers' perceptions and pricing preferences so unusual?) point to the conclusion that customers' low level of information increases the strength of the "anchoring" effect of two decades of free checking.

Exhibit 6. How much do you believe it costs your bank to service your checking account per month ?



Source: Deloitte Center for Financial Services

These figures are an obvious warning sign for banks as they reconsider pricing strategies; the survey indicates that defection is a significant threat. This said, while these responses paint a picture of extreme price sensitivity and low information about the pressures banks face, it is important to note that customers may be less likely to switch than they claim, given the costs and inconveniences associated with changing primary banks.

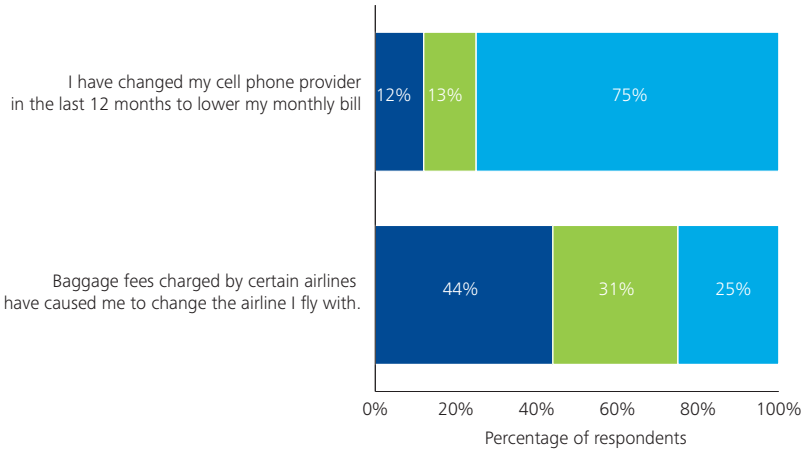
Evidence from other industries supports this hypothesis: relatively few customers say they have changed their cell phone provider in the last 12 months to reduce their fees (Exhibit 7), though many more have changed their airlines in response to increased baggage fees—perhaps because of lower switching costs involved. Since switching costs are likely a significant consideration in the banking industry—due to automatic deposit and bill payment arrangements, time involved in closing an account and opening another, and other constraints—defection patterns may be closer to those seen in the telecom scenario.

It may not be possible to know what effects price increases will have on customer behavior, but it appears reasonable to assume that such changes will pose some downside risks to banks. It is also possible that the customer defections will depend significantly upon variations in new pricing structures, highlighting the importance of a more refined approach through additional metrics to solve this difficult problem.

What do customers prefer?

To gauge relative receptiveness to pricing alternatives, we offered respondents a range of comparable pricing options and asked them to rank them by preference (Exhibit 8). Perhaps surprisingly, given the prevalence of flat-fee models for most services, customers surveyed were most likely to say that if they had to choose they would prefer to pay a set fee of 25-75 cents per transaction over all other options. Additional color provided by survey respondents indicates that this choice reflects respondents' preferences for total transparency in account and service pricing. Of course, this is not to say that a fee-per-transaction model would be a viable approach for all banks that wish to change their pricing. Strategic priorities and customer characteristics of each bank differ significantly, and, perhaps as importantly, incentives in some fee-per-transaction models may interfere with banks' revenue goals from sources such as interchange fees.

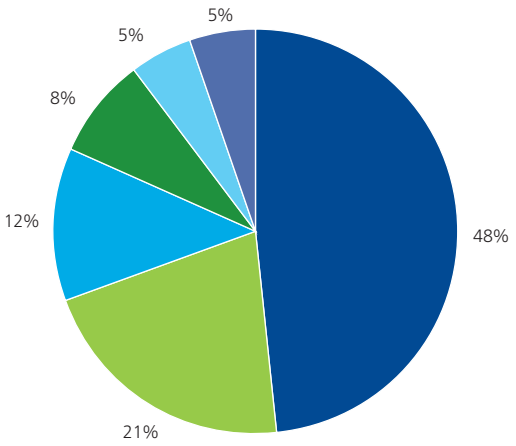
Exhibit 7. Response to pricing shifts in other industries



Strongly agree/Agree/Somewhat agree
Neither agree nor disagree
Strongly disagree/Disagree/Somewhat disagree

Source: Deloitte Center for Financial Services

Exhibit 8. Most preferred pricing plan



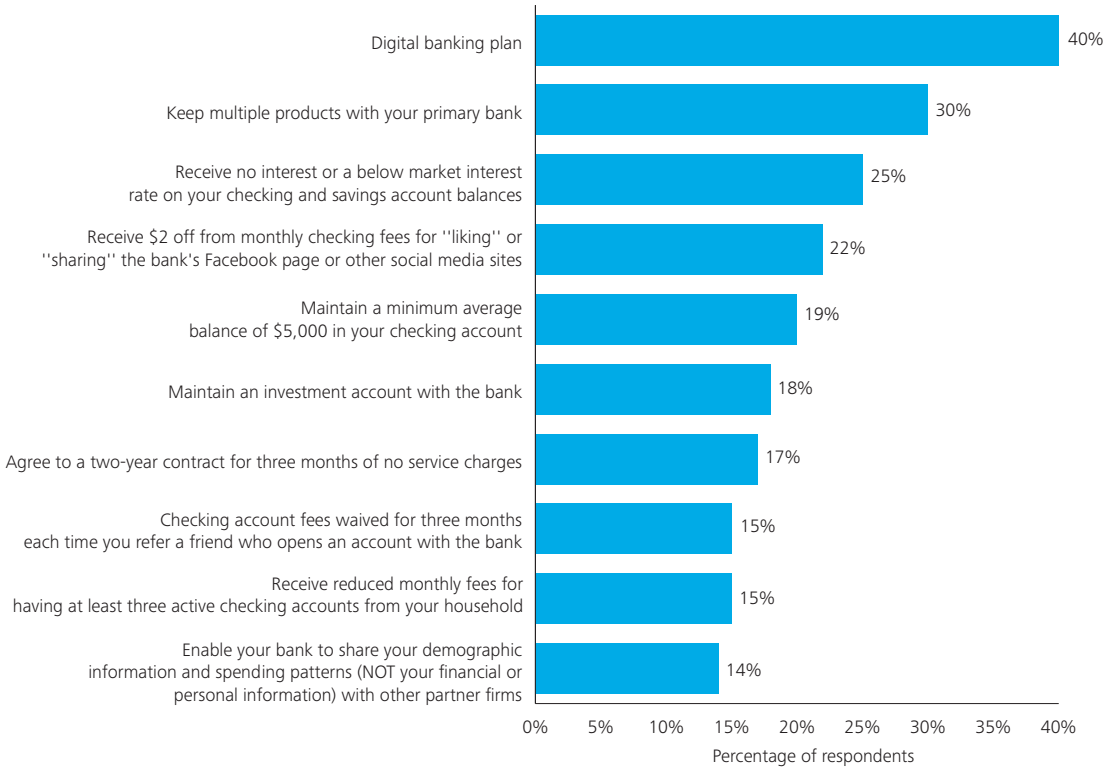
Set fee for each transaction (25-75 cents)
Fixed monthly fee (between $15 and $30)
Low fixed monthly fee ($10-$15) and lower fee for each transaction (10 to 50 cents)
Fixed monthly fee by transaction plan for each individual account
Fixed monthly fee by transaction plan
Pay $30 to $50 base fee but receive 1%-2% cash back on credit card purchases

Source: Deloitte Center for Financial Services

Of course, fee changes may be accompanied by changes to offerings and services. In fact, banks may want to be mindful of the opportunity they have to re-work their retail operating model as they change their pricing. To address this aspect of banks' likely changes to fee structures, the survey asked customers to rate the appeal of a range of new pricing and service models (Exhibit 9) in exchange for reduced fees on their accounts and account services. The aim was to get a better picture of customers' trade-offs. In designing the pricing models that banks might follow, the survey drew on other industries' pricing practices. The diverse list of options, drawing especially on the pricing practices in the telecommunications, television, and air travel industries, represents a broad cross-section of potential pricing alternatives.

Among the ten types of pricing model tested, a digital banking plan, which would provide a limited level of in-person services, proved the most popular, suggesting significant appetite for primarily electronic account services.[20] However, there were some notable differences across age groups. For example, high balance requirements were more popular among older respondents, and a discount for favorable social media activity was the most popular option among the youngest respondents. Unsurprisingly, the survey data indicate targeted offerings are likely to receive better take-up from customers.

Exhibit 9. Customer interest in pricing models in exchange for reduced fees*



Source: Deloitte Center for Financial Services

*Note: Percentage figures reflect the proportion of respondents giving a rating of 5, 6, or 7 on a seven-point scale (with '1' as 'not at all appealing' and '7' as 'extremely appealing').

Taking a more nuanced view of bank customers

Interestingly, differences in price sensitivity and industry perceptions appear to be driven not by demographics but instead largely by individual experiences and beliefs. Through statistical cluster analysis of the survey data, it is possible to identify three distinct groups of bank customers (Exhibits 10 and 11), classifiable along the two broad axes of willingness to pay and perceptions of banks: **Loyalists, Frugalists, and Distrusters**.

Frugalists tend to bank with smaller institutions, perhaps reflecting their desire for simple but low-cost services such as those offered by community banks and credit unions. In contrast, Distrusters are disproportionately likely to bank with national and regional banks. Loyalists, the largest and likely most valuable segment because of their higher willingness to pay and more positive perceptions, are evenly distributed across all types of banks.

In many cases, Distrusters' price sensitivity seems to be a product of past experience with price increases, showing high customer sensitivity to changing fee structures.

With this in mind, banks may wish to consider engaging in informational and trust-building campaigns to lay the groundwork for customer acceptance of future shifts in their pricing models.

Banks have a clear opportunity to target Loyalists, who are more willing to pay for improved services, for cross-selling efforts. Frugalists, however, are likely to remain a challenging segment for national and regional banks to reach because of their affinity for smaller banks and their extreme stated price sensitivity—the latter of which community and local banks may wish to note before making changes to their pricing models.

Exhibit 10. Loyalists, Frugalists, and Distrusters

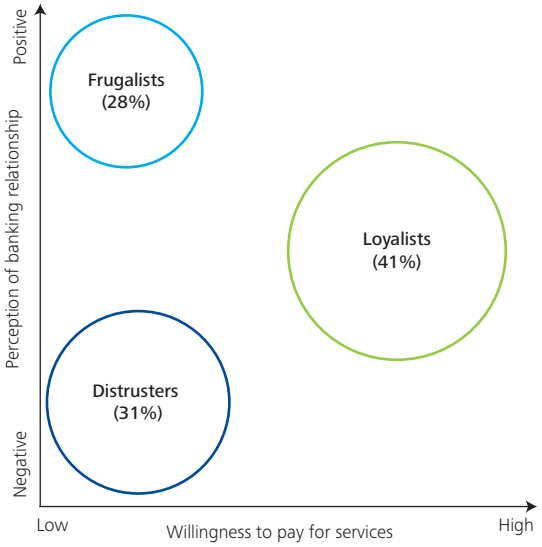


Exhibit 11. Segment descriptions

Loyalists	Frugalists	Distrusters
• More willing to pay for services • Positive view of their bank • Less likely to switch banks due to fees	• Unwilling to pay for banking services • Have the most positive perception of banks • Few have experienced fee increases • Will likely switch banks if fees are increased	• Unwilling to pay for new or improved services • Less favorable perceptions of their bank • More likely to have experienced fee increases • More likely to switch banks if fees are increased

Principles for re-pricing

In spite of efforts made by the industry to regain customers' trust over the last several years, it appears there is more to be done, as the survey data clearly suggest. Even though customers are generally satisfied with their own primary bank, effectively responding to the lack of trust among the Distrusters identified in the study is likely to be an industry imperative. Evidence suggests that past experience of fee changes is a significant driver of negative perceptions—those customers who say their fees have increased in the last 12 months are about half as likely to report being very satisfied or satisfied with their primary bank. Without renewed or improved trust, changes to fees and services may be much more difficult than institutions anticipate.

So how do banks build trust, and what does this analysis indicate for the future of retail banking? A few points stand out:

1. **"Knowing your customer"** is perhaps more important than ever. Understanding the unique characteristics and preferences of an institution's customers may be essential to ensuring new fees do not harm the primary customer base or derail an institution's business strategy. As the survey shows, in many cases simple demographic or satisfaction analysis is probably insufficient for segmentation and pricing strategies; successful implementation of changes to pricing models will likely rely on a more complete understanding of differences in customer preferences.

2. **Communicating value** provided may be essential to cultivating sustainable customer relationships. Helping consumers understand the benefits they receive is possibly an essential aspect of a broader transparency-oriented pricing policy. Though the survey results indicate banks in general already outperform other financial institutions and other industries in customer assessment of value and fee communications, customers' relative lack of comprehension of banks' pricing changes indicates in many cases there is substantial room for improvement. By giving better information about services provided, banks could positively influence both customer reference points and beliefs about fair policies.

3. **Moving from free to fee** could be the hardest step. Free checking became the norm over the last two decades, but it may have become unsustainable for many institutions. Yet the transition from free to fee-based services may face higher-than-normal hurdles because of not just low customer information but also the unique psychology of free prices. Bearing this fact in mind, banks may wish to be very selective in what pricing changes they make and how. While increases in existing fees are perhaps more easily implemented, the jump from free to a fee is likely to hinge on the bank's ability to understand how its customers might react to pricing changes.

4. **Pricing changes** have the potential to alter the make-up of the customer base. New fees may not only change customers' perceptions, but also have the potential to materially affect an institution's customer base through changes in satisfaction, product usage and switching behavior. This fact, while no doubt challenging, could also be seen as an opportunity to redouble institutions' focus on core customer segments and ensure their pricing strategy supports their long-run strategic objectives.

An approach to re-pricing with these principles in mind, then, may be undertaken in the following fashion. Institutions might consider beginning by engaging with customers to better understand their pricing preferences and the elasticity of their banking relationships. Lack of easy demographic identifiers for pricing preferences likely makes "knowing the customer" more important than before; re-working pricing models will probably require engagement across multiple dimensions. The aim, unsurprisingly, is to build loyalty and satisfaction through better-tailored, high-quality services and offerings, the combination of which is expected to drive customers' willingness to pay for products and services. With these initiatives, banks may receive "permission" to make significant changes to their pricing policy.

As they make these changes, institutions should consider both servicing costs and revenue generation. By refining fee structures to provide increased incentives for customers to use lower-cost online and automated service—for example through rewards policy or fee reductions—banks might retain a competitive pricing advantage. And on the revenue side, adding or promoting higher value-added products (for which a significant customer segment is willing to pay) may offer banks an opportunity to cross-subsidize lower-revenue, basic services. On both sides, transparency will likely remain crucial to maintaining customer satisfaction.

As banks seek to recalibrate their business models to suit current regulatory and market conditions, one crucial factor in their plans will likely be customer response to retail pricing shifts. Institutions will potentially have to redouble their efforts to engage and win over skeptical customers. They should consider investing in a data-driven understanding of their customers to tailor efforts to strategically important segments such as the Loyalists identified in this survey, as well as attempt to convert Distrusters to Loyalists. Resetting customer expectations may be challenging, but with a targeted approach it may lead to substantial competitive advantage.

Endnotes

[1] Victoria Finkle, "Changing Its Mind on Free Checking; TCF has done away with the fees it implemented in 2010. Will other banks follow suit?" *American Banker Magazine*, September 1, 2012.

[2] Shayndi Raice and Robin Sidel, "Bank of America Backs Down on New Fees," *Wall Street Journal*, November 30, 2012.

[3] Deloitte Center for Financial Services Retail Bank Pricing Survey, August 2012.

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[9] Robin Sidel, "Free Checking Costs More," *Wall Street Journal*, September 24, 2012.

[10] Bankrate Inc., "Free Checking Gets Rarer as ATM Fees and Other Checking Account Fees Continue to Rise," Press Release, PRNewswire, September 24, 2012.

[11] Tuli Banerjee, "BofA planning to revamp checking account fees," SNL Financial, March 1, 2012.

[12] Victoria Finkle, "Changing Its Mind on Free Checking; TCF has done away with the fees it implemented in 2010. Will other banks follow suit?," *American Banker Magazine*, September 1, 2012.

[13] Bankrate Inc., "Free Checking Gets Rarer as ATM Fees and Other Checking Account Fees Continue to Rise," Press Release, PRNewswire, September 24, 2012.

[14] J.D. Power and Associates, "Bank Customer Switching Rates Rise Again, Fueled by Issues with Fees and Poor Service," Press Release, PRNewswire, February 27, 2012.

[15] Deloitte Center for Financial Services Retail Bank Pricing Survey, August 2012.

[16] Ariely, Dan, George Loewenstein and Drazen Prelec. 2003. ""Coherent Arbitrariness": Stable Demand Curves Without Stable Preferences." Quarterly Journal of Economics 118 (1): 73-106.

[17] Ibid.

[18] "If your primary bank announced that it would start charging an additional $5 monthly fee for the same services on your checking account, which of the following actions might you take?"

[19] Robin Sidel, "'Free' Checking Costs More," *Wall Street Journal*, September 24, 2012.

[20] The digital banking plan we proposed had the following conditions: have at least one direct deposit per month, pay bills online or with debit or credit card only, write no more than two checks per month, receive online statements only, and use ATMs only to make deposits and withdrawals.

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