Pricing Rationally in Irrational Times

Presented by:

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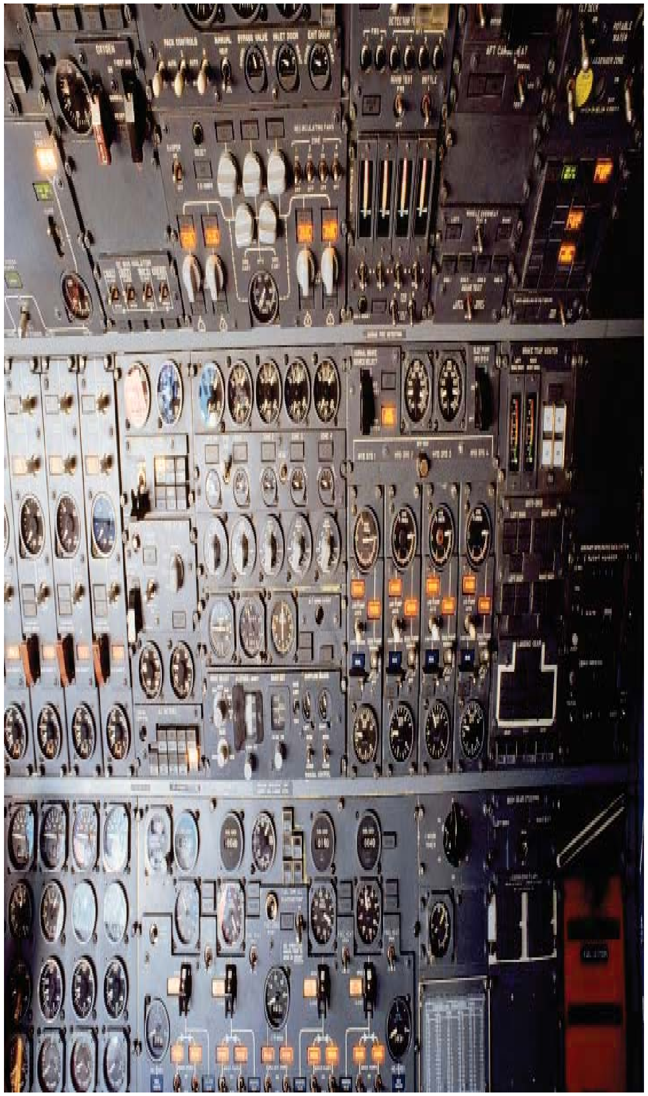
Why Pricing Matters (now more than ever)



Management Control Panel:

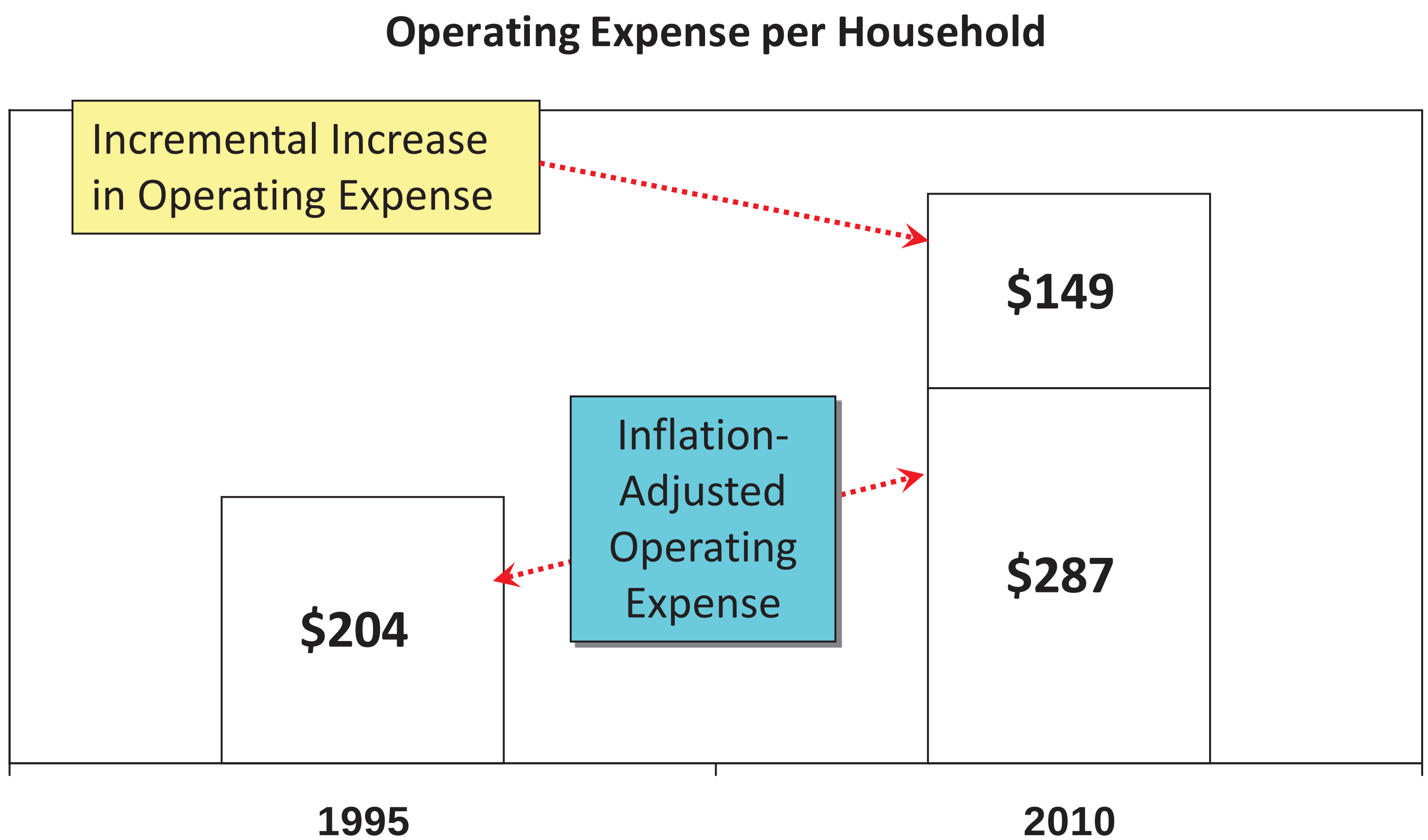
- **Earnings Levers**
  - Operating Expense
  - Non-interest income
  - Net Interest Income / Margins

Lever #1:

Operating Expense

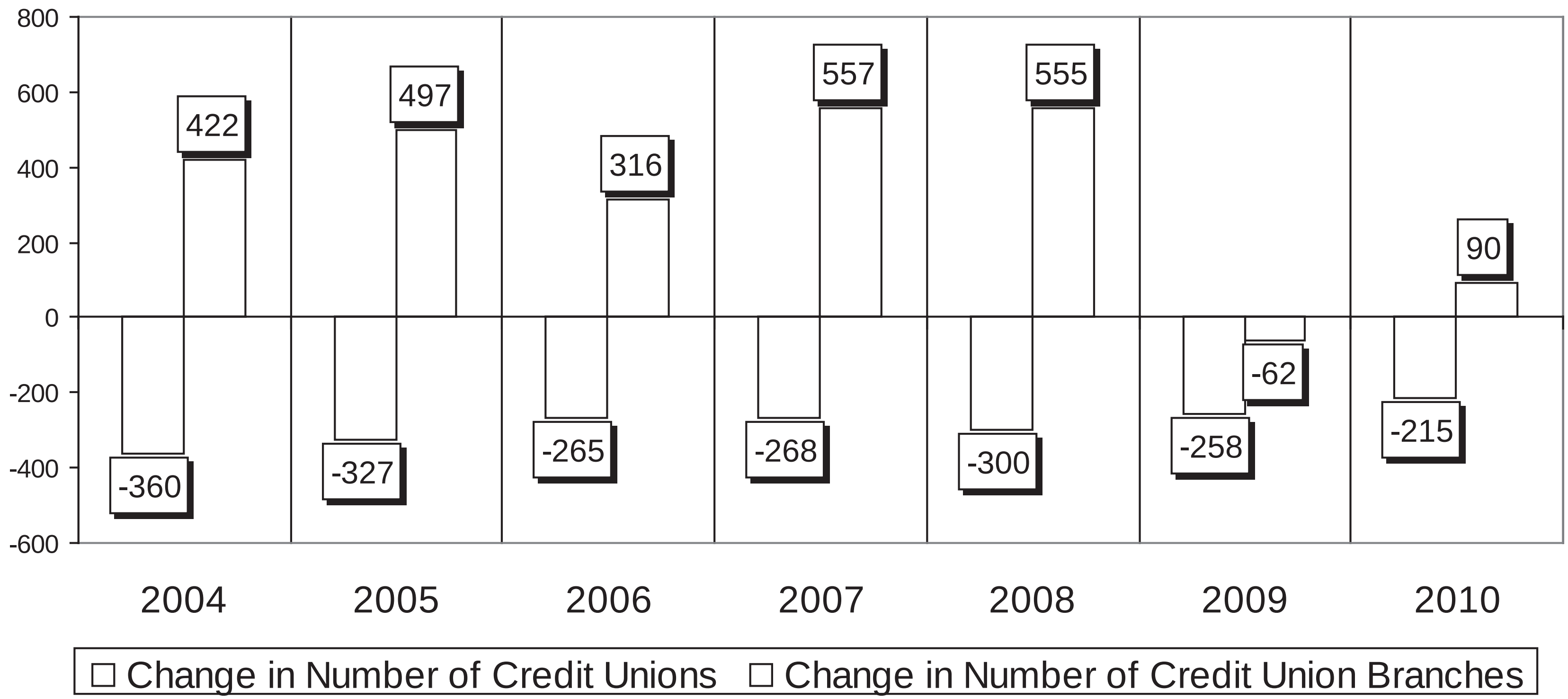
Historical Trend in Operating Expense

Adjusting for inflation, credit union operating expenses per household have risen by 52% from 1995.



Credit Union Branch Growth has Slowed

Credit union branch locations grew steadily through the 2000s. Branch growth has slowed significantly in the last two years.



Source: NCUA

Consumer Use of Delivery Channels

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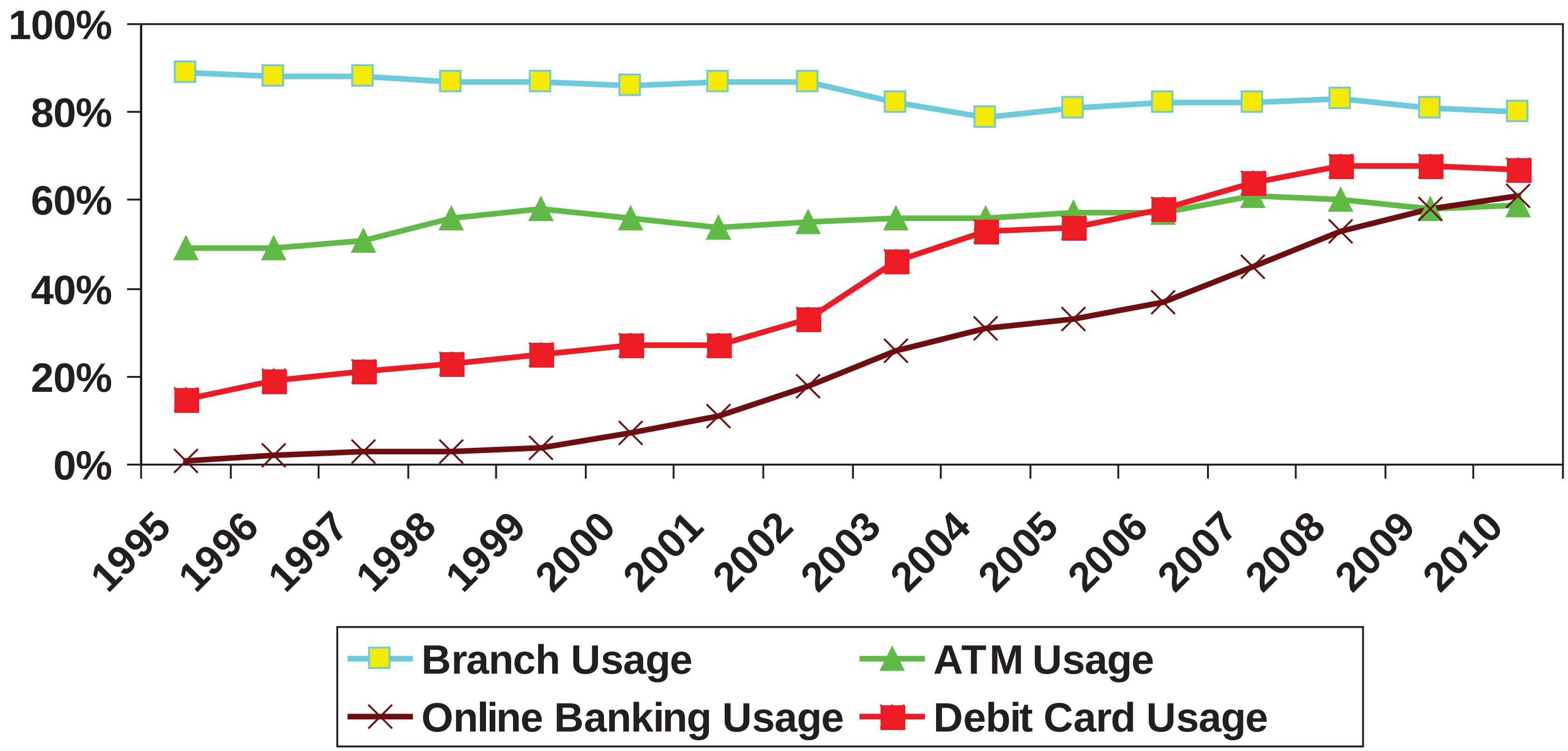
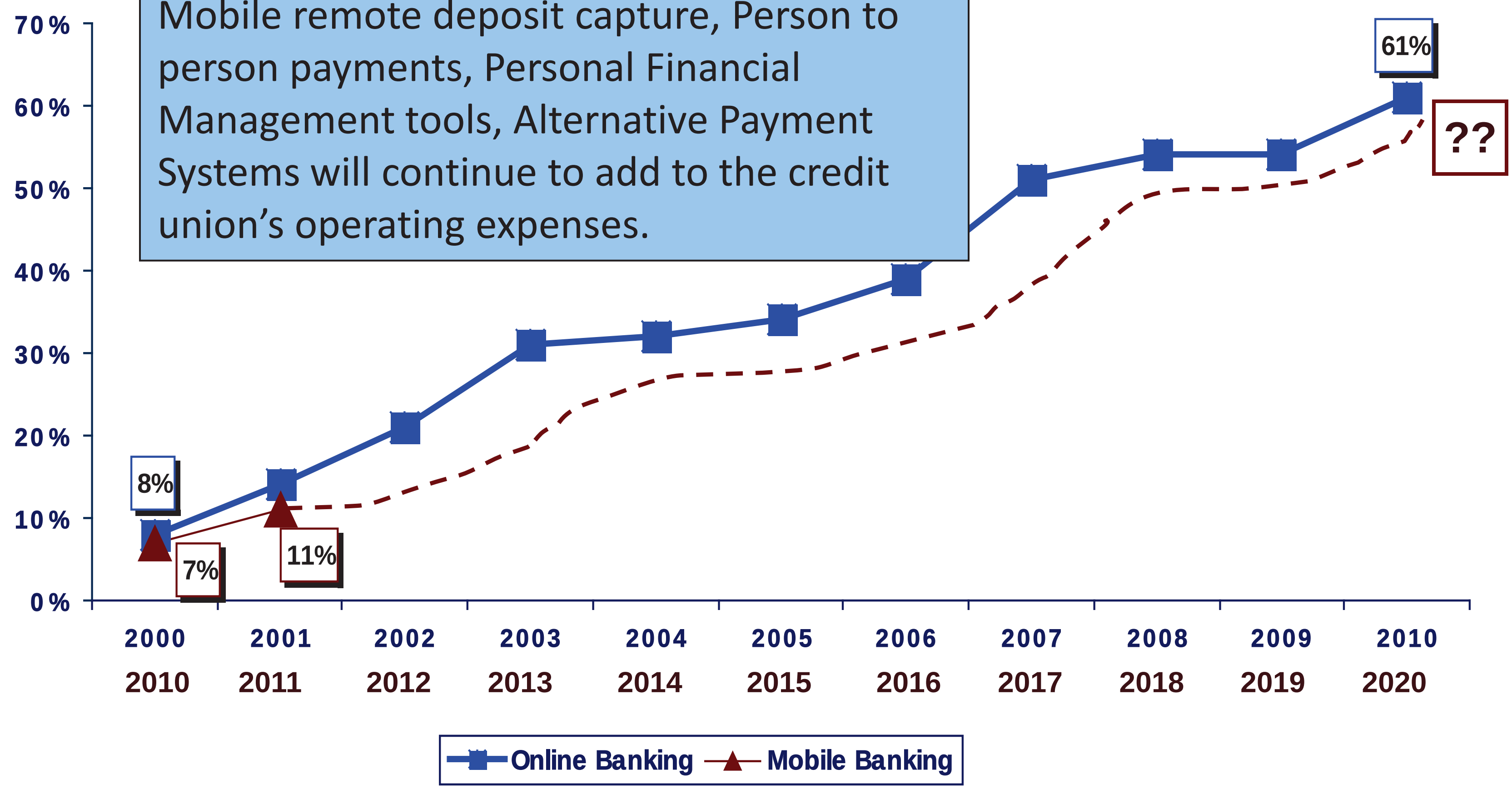
Consumer use of new delivery channels tends to be complementary, rather than substitutive.



Source: Raddon Financial Group National Consumer Research

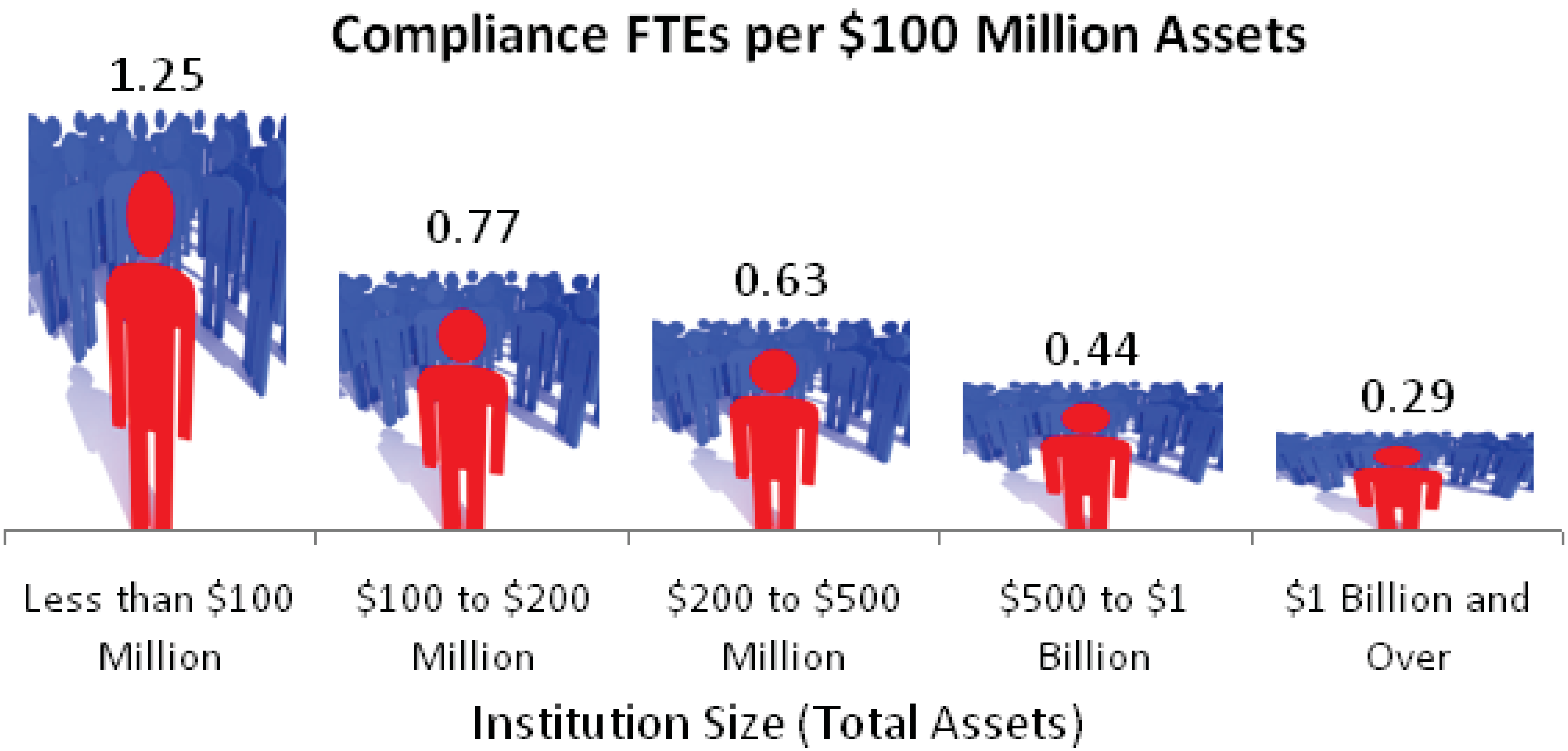
Technology Continues to Evolve …and Add Costs

“New” technologies: Mobile banking, Mobile remote deposit capture, Person to person payments, Personal Financial Management tools, Alternative Payment Systems will continue to add to the credit union’s operating expenses.



Source: RFG National Consumer Research

Compliance Costs Impact Small CUs

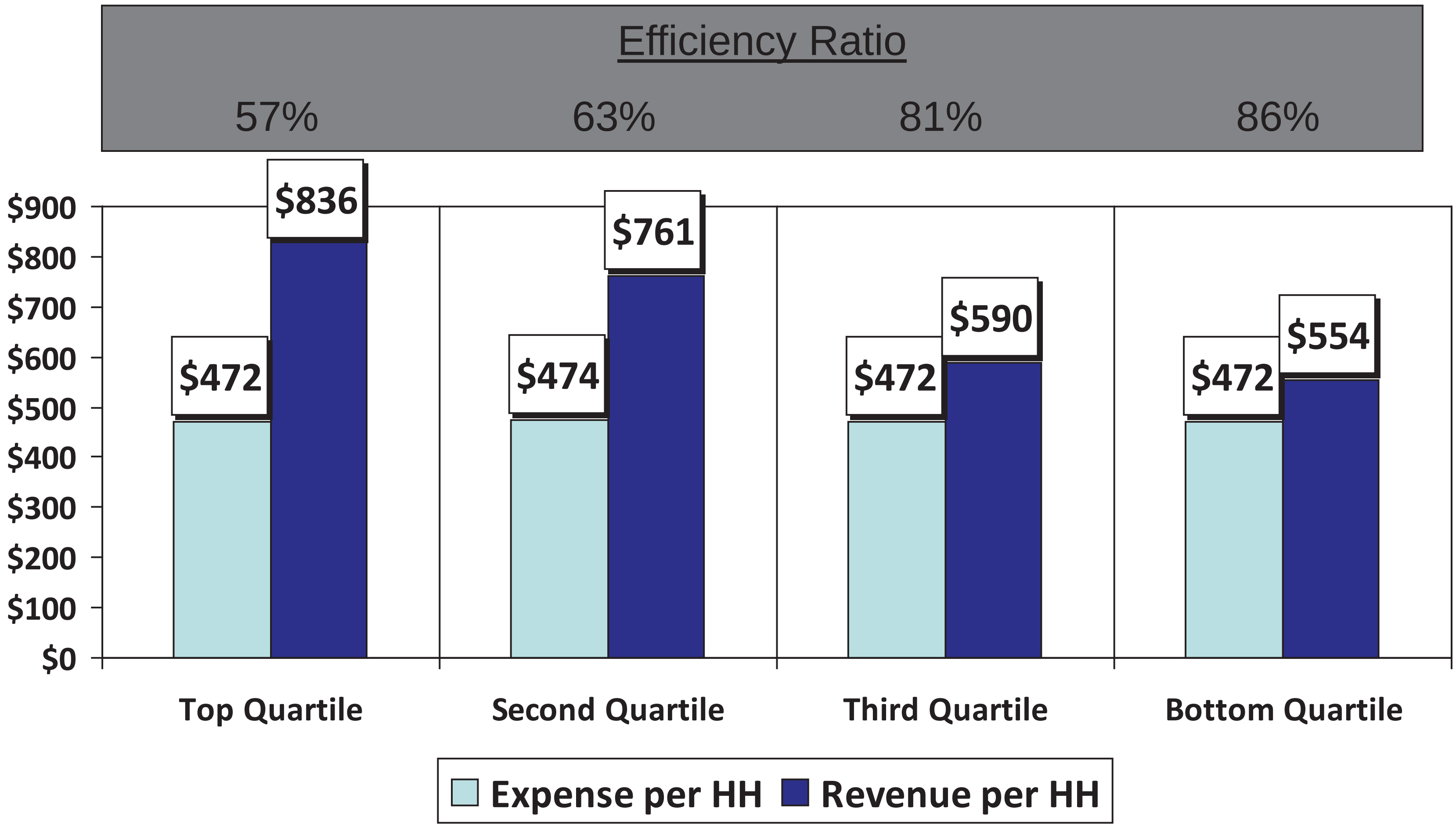


Source: Raddon Financial Group, CEO Strategies Group, Winter 2011

Operating Expense Response

- Reduce Costs
  - Branch reduction
  - Staff reduction
- Increase Revenue
  - Non-interest income
  - Net Interest income

Efficiency Ratio Tends to Be Driven By Revenue



Source: RFG CEO Strategies Group

Lever #2:

Non-interest Income

Non-Interest Income More than Doubled in the Last Decade

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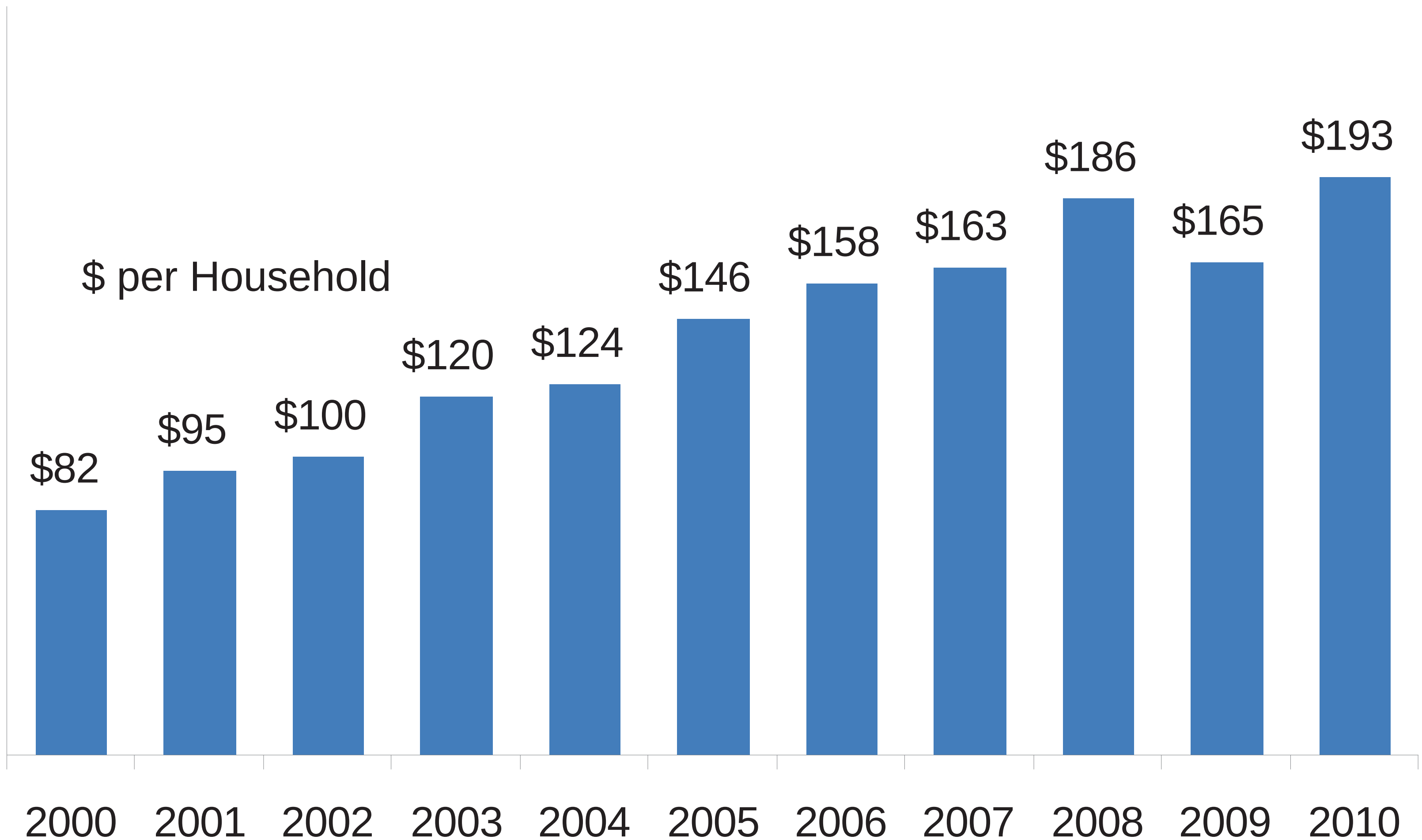


Source: Raddon Financial Group, *CEO Strategies Group*

Regulatory Changes

Reg E

- Opt-in success rates vary, many were fairly successful in opting in frequent overdrafters
- Ongoing campaign – new accounts

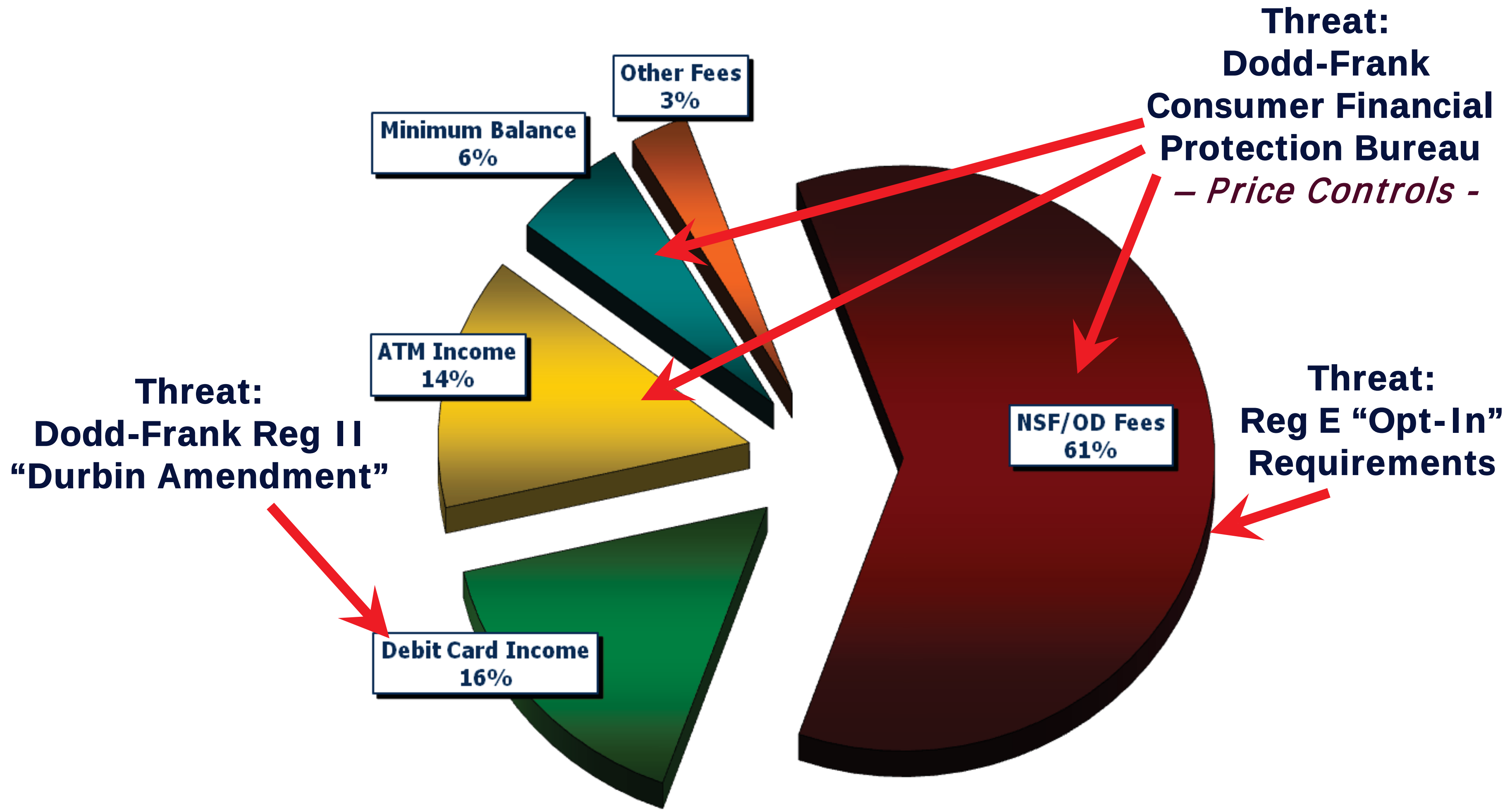
Reg II

- Potential to decrease interchange income by as much as 45%

Consumer Financial Protection Bureau

- The wildcard – the impact could dwarf that of Reg E and Reg II

Checking Account Fee Income



Source: Raddon Financial Group, *CEO Strategies Group*

What We Might Expect From the CFPB

- "Reasonable and proportional" overdraft fees
- Caps on ATM surcharges
- Limits on credit card annual fees
- Maximum daily overdraft charge
- Waiver on *de minimus* overdraft charges
- Increased disclosure requirements on all accounts
- **"Reasonable and proportional"**

Impact of Re-Regulation

1. Will reduce the size of the playing field
2. Industry concentration is likely to increase
3. Will bend the industry cost curve up
4. Limits the ability to subsidize products or members
5. "Free" becomes a less viable strategy for many financial institutions
6. Increases the focus on relationship development and share of wallet

Top 10 Largest Retail Banks - Free, *if…*

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	Free Checking, if…
CHASE	$500 Direct Deposit or $1500 min chk balance or $5k combined balance
Bank of America	eBanking: Deposits & Withdrawals made electronically or at ATM; and E-Statements required MyAccess: Direct Deposit or $1500 min avg balance
citi	Perform any of these 5 actions: Direct Deposit, Debit Card purchase, Bill-pay, Auto Deduction, ACH Payment, Check Paid, Cash Withdrawal at ATM
WELLS FARGO	Value Checking (no bill-pay): Direct Deposit or $1500 avg daily balance Custom Mgt Package: Checking and Savings packaged: $1,000 balance; or $25 auto transfer to Savings; or Direct Deposit
usbank	Easy Checking - $500 Direct Deposit; or $1500 avg account balance
PNC	FREE (no requirements) – Debit Rewards being phased out (4/30/11); ATM rebates for Avg Monthly Bal $2k+ being phased out (9/12/11)
HSBC	Direct Deposit or $1500 Deposit Balances or $5000 Combined Balances
SunTrust	Everyday Checking - $500 min balance or Direct Deposit
TD Bank	TD Convenience - $100 Min Daily Balance
BB&T	Bright Banking - fee waived if direct deposit or $1500 chk balance, or $6k combined balance, or any BB&T mtg

Seven Factors in Free Checking Decision

1. Bias towards growth or profitability?
   - What is your current member profitability
2. Your current market position – leader or niche player?
   - How is the rest of the market responding?
3. Demographics dictate potential
   - Your current member base
   - The markets in which you compete
4. How effective are you in selling product and building relationships?
5. What is your existing value proposition?
6. Do you have other options for growing non-interest income?
7. What are your core system capabilities?

If Free Checking Is Your Choice…

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Question:

If you decide to continue to offer free checking, **how should you leverage this decision?**

Answer:

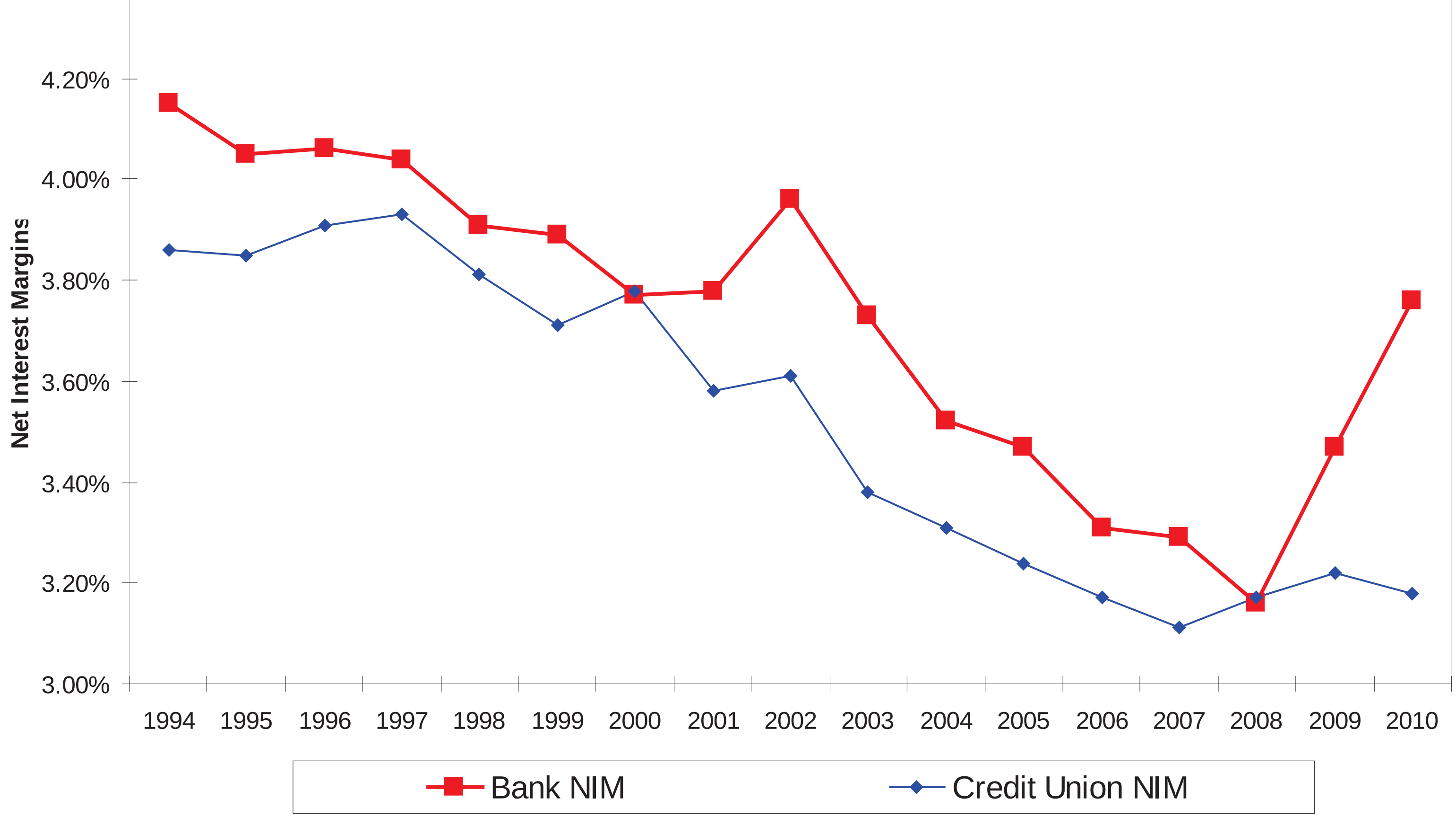
1. Set strict cross-sell metrics for the organization and measure at the branch level.
   – Focus on reducing the percent of checking accounts that are "single-service."
2. Implement formalized Onboarding Program to enhance cross-sales after onset of new relationship.
3. Target "high opportunity" non-members within three miles of branches with direct mail.
4. Implement technologies that assist in the frontline cross selling process.
5. Aggressively push cost savings tactics such as e-statements.

Lever #3:

Net Interest Income

Industry Net Interest Margin Erosion

Margins have declined for financial institutions over the past 15 years. This decline has occurred in both high and low rate environments. Banks – particularly the largest banks – are dramatically reversing this trend.



Source: FDIC

Anticipated Loan Usage Has Declined

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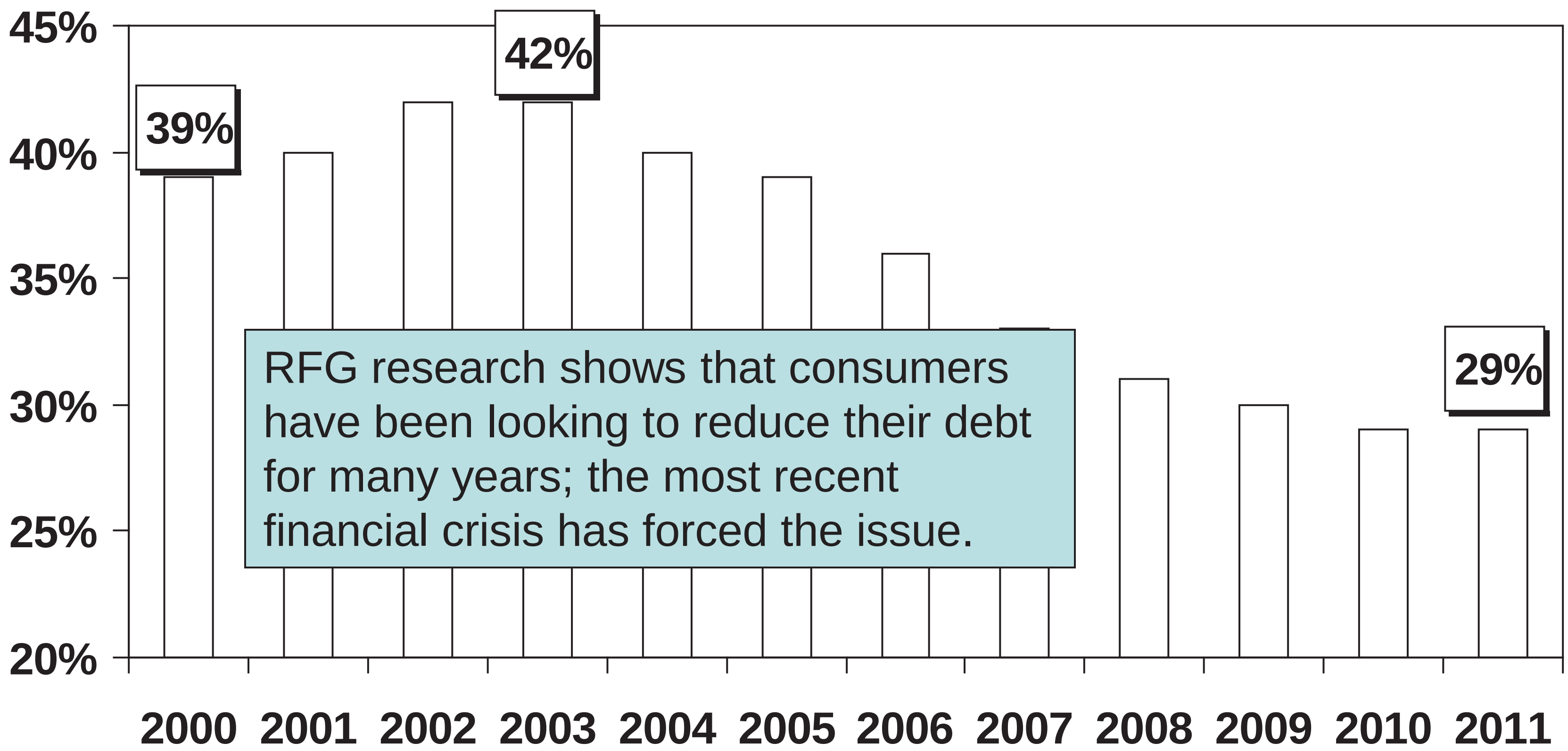
% Who Anticipate Opening a Loan in the Next Year



Source: Raddon Financial Group, *National Consumer Research*

Household Debt Levels Are Declining But Still Historically High

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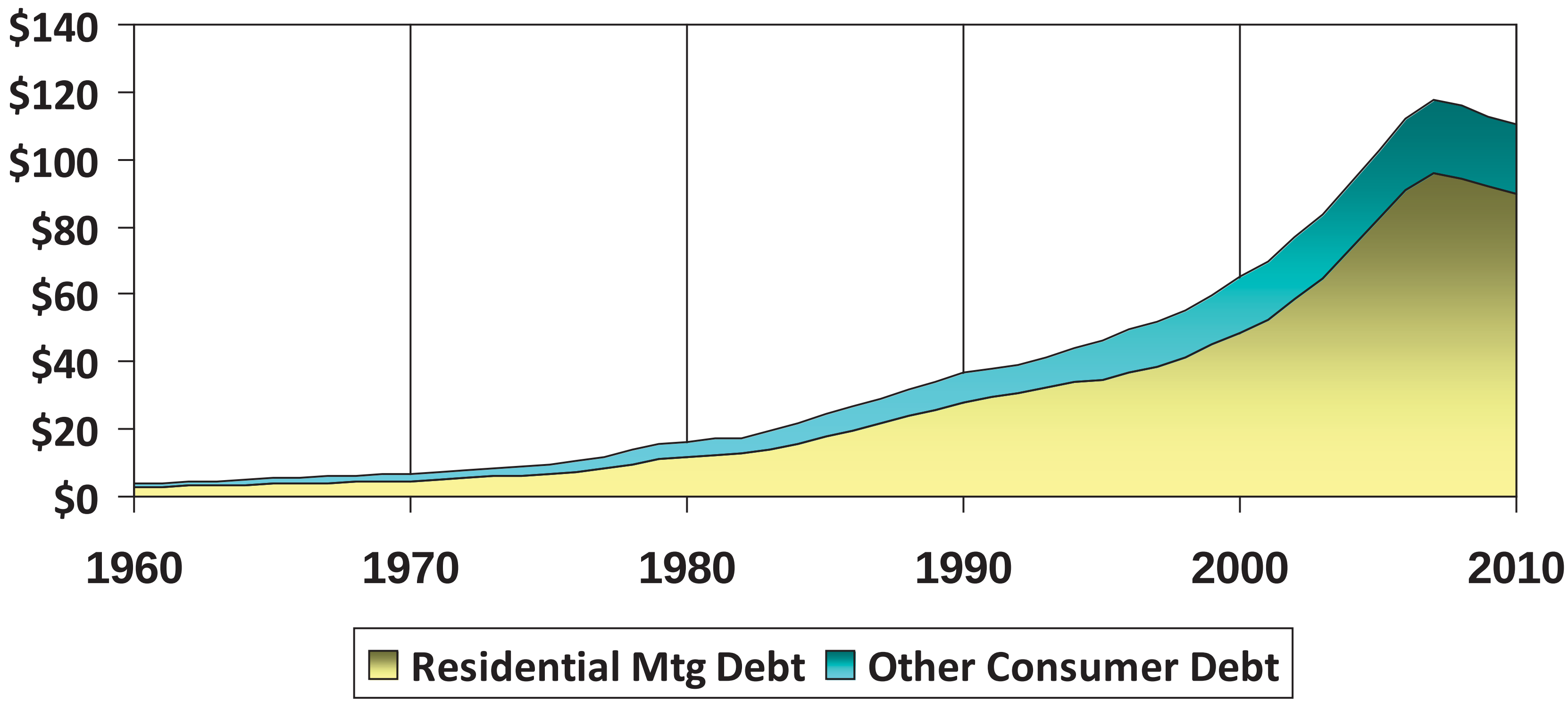
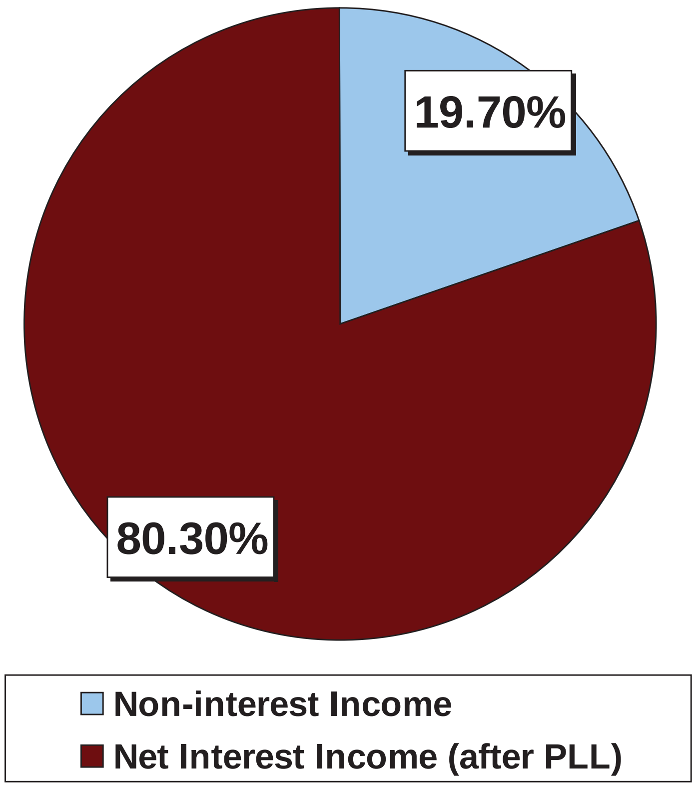
Debt per US Household ($000)



Net Interest Income Magnitude



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Expenses are usually viewed solely as operating expenses, yet funding costs are substantially more expensive than any single non-interest expense item.

Item	% of Assets
Cost of Funds	2.48%
Comp/Benefits	1.97%
Operations Expense	0.80%
Occupancy Expense	0.30%

The Big Four Dramatically Reduce the Cost of Funds

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Cost of Funds	Dec-08	Dec-09	Dec-10
CHASE	2.06%	0.74%	0.51%
Bank of America	2.23%	1.03%	0.63%
citi	2.70%	1.41%	1.08%
WELLS FARGO	1.58%	0.55%	0.51%
Credit Union Avg	1.94%	1.39%	0.97%
CUs >$100M	2.45%	1.76%	1.21%

Base Savings Rates

$1,000 in a Chase Savings account will earn the customer 10 cents/yr in interest!

CHASE

Chase Savings℠	Rate	APY
All Balances	0.01%	0.01%

Regular Savings Account Interest Rates	Interest Rate	APY*
All Balances	0.05%	0.05%

Bank of America

WELLS FARGO

Wells Fargo® Way2Save® Savings

Balance	Interest Rate	APY
$0 or more	0.03%	0.03%

Rates as-of August, 2011

Responding To The Margin Challenge

1. Remember - COF is impacted by both Deposit Mix and Rate
   - Focus on <u>core deposit</u> acquisition
     - Increasing Share of Wallet is key
     - New product innovation – link best price to core deposit account usage
     - Small businesses can be a significant source of core deposits
2. Develop a Deposit Management Matrix strategy
   - Deposit needs
   - Competition
   - Driven by key financial metrics
3. Product design to meet the varying needs of members
   - Not all members require “best” rate
   - Ask for something in exchange for best rate
   - <u>Relationship pricing – in the spirit of a true co-op</u>
4. Rational pricing – pricing to meet pre-defined objectives

Steps to Success in Relationship Pricing

Organizational Alignment	Create a common definition of relationship pricing, its purpose and a way to measure success
Research and Analytics	Use Analytics to design profitable relationship pricing program
IT Capabilities	IT system needs to be able to seamlessly support relationship pricing program
Ongoing Measurement	Measure the success of the program on an ongoing basis using pre-defined metrics
Channel Incorporation	Incorporate channel-based pricing into relationship pricing design if possible

Deposit Management Matrix

1. What is your current need for deposits?

- Attrition Mode
  - The credit union is below “sweet spot” for loans to deposits
  - Willing to shed deposits
- Maintenance Mode
  - Maintaining but not aggressively seeking new deposits
- Acquisition Mode
  - Actively trying to bring in more deposits based on high loan to share

Deposit Management Matrix

2. Where do you want rates to be relative to competition?

- Desired position relative to market
- What is the credit union's member value proposition?
- May be different depending on whether the credit union is in Attrition, Maintenance, or Acquisition mode

Deposit Management Matrix

3. Set pricing to other internal factors and financial ratios

- Loan to share
- Net Income to plan
- Capital Ratio / Reserves
- Interest Expense to plan
- Other?

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Myth:

My members will hate me if I lower deposit rates.

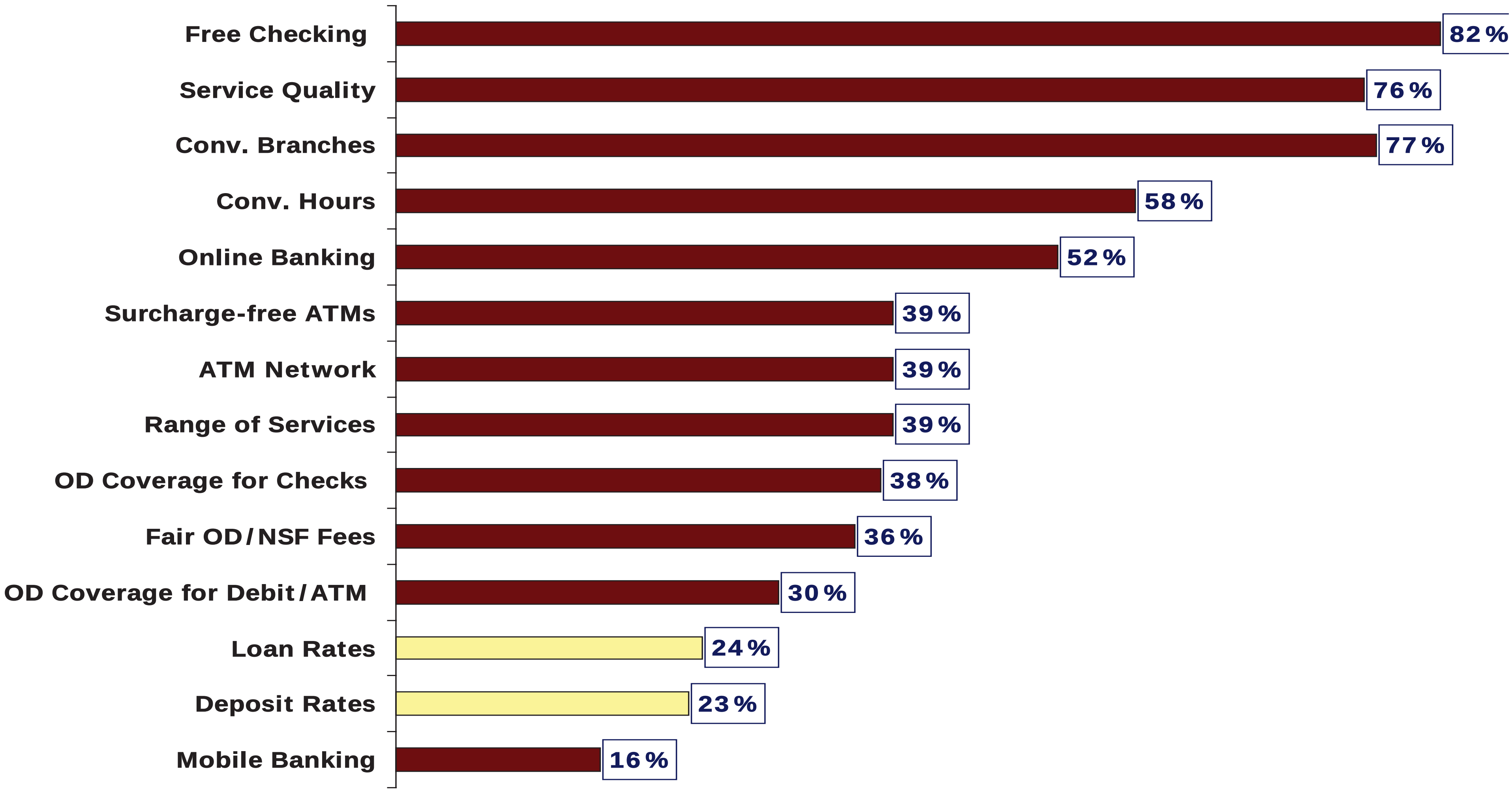
Reality:

Not all consumers are rate sensitive.

In fact, relatively few truly are.

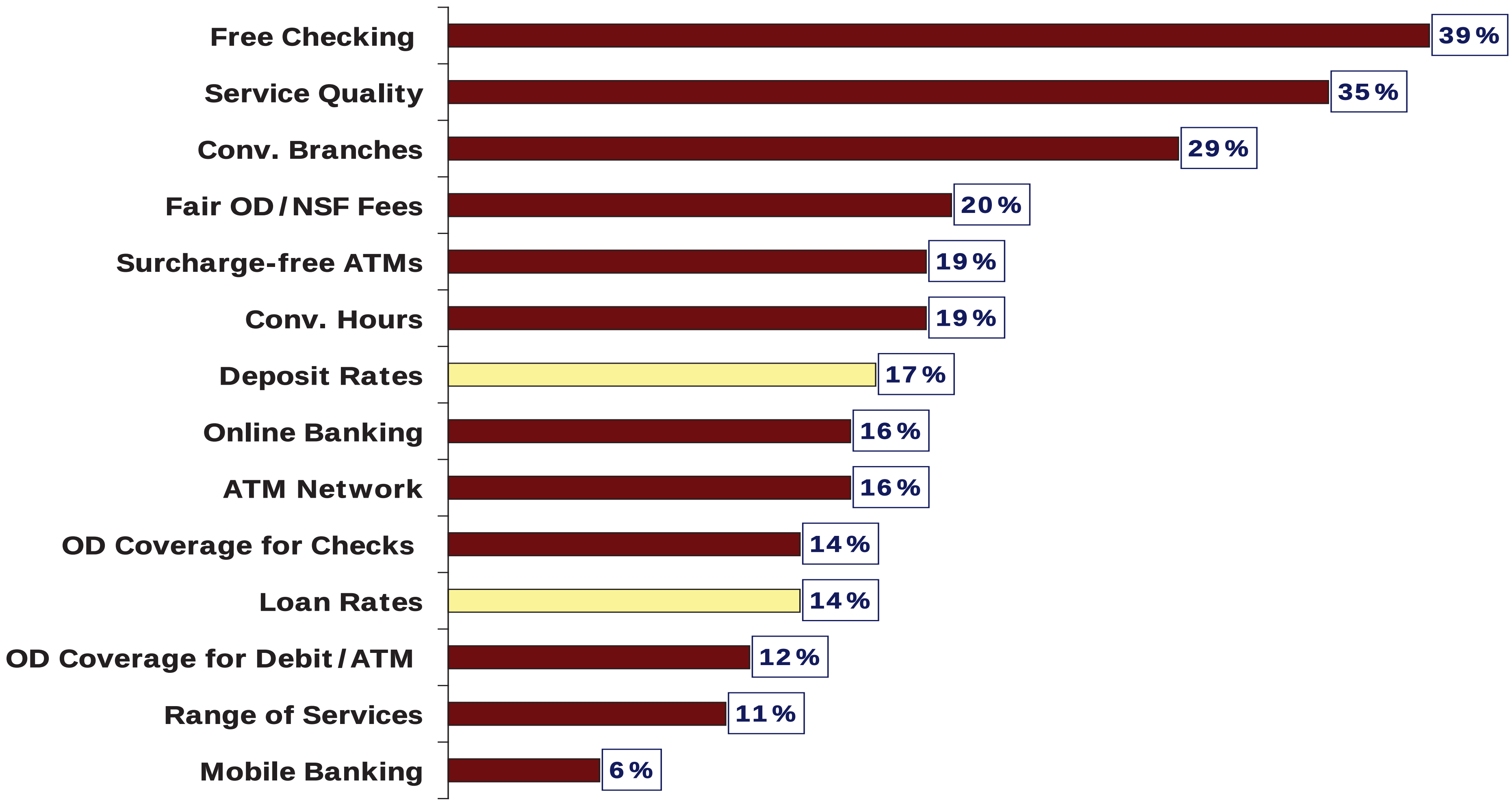
Reasons Consumers Value their Primary Financial Institution

(it's **Not** Rate)



Source: Raddon Financial Group, *National Consumer Research*

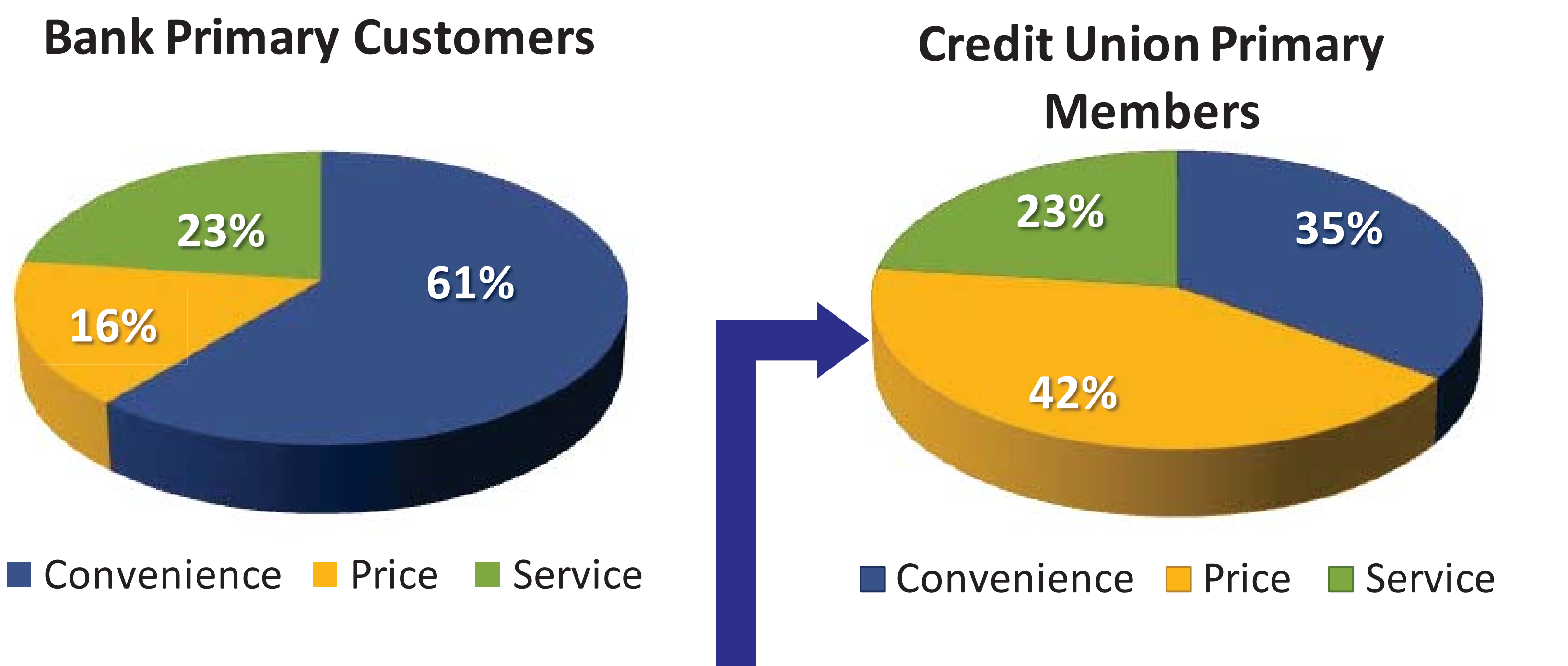
Reasons That Prompt a Consumer to Switch Financial Institution if Things Changed



Source: Raddon Financial Group, *National Consumer Research*

…yet, Credit Unions have built a large component of the value proposition around price.

Why Consumers Are Loyal To Their Primary Financial Institution

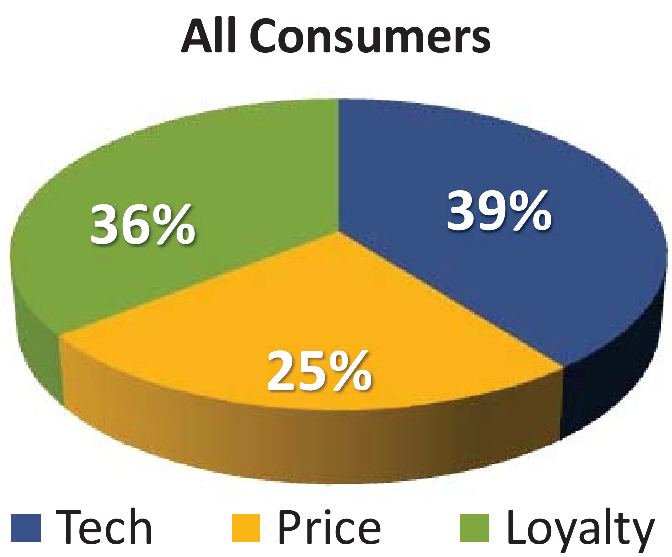


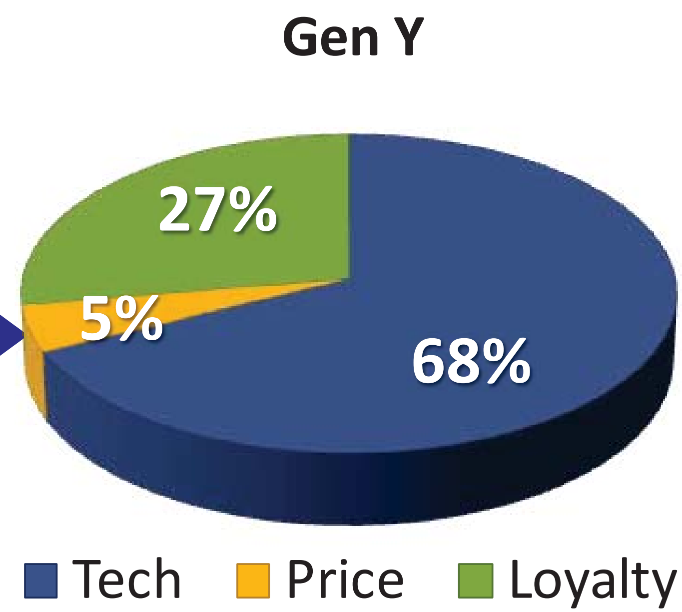
<u>Credit Union Issue</u>: Too much of the value proposition is built on price.

We have to move beyond philosophy of “one size fits all.”

Source: Raddon Financial Group, *National Consumer Research*, Spring 2010

Behavioral Segmentation: What Influences Consumers





Gen Y: Much more influenced by technology, and less concerned with price

Source: Raddon Financial Group, *National Consumer Research*, Spring 2010

Rationale for Rational Pricing

In a typical institution, Chief Lending Officers and VPs of Lending carefully craft a wide array of rates, tiers, and features to maximize the earning asset yield while minimizing the impact of risk.

Key question:

Who at the Credit Union is responsible for managing deposits, setting rates, and controlling cost of funds?

Common Answer:

At many (most) credit unions, deposit rates are set by committee.

A rational pricing strategy attempts to take the guess-work out of rate setting, and uses a more scientific/calculated approach.

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Myth:

All deposits are equally valuable to the credit union.

Reality:

All deposits are not the same.

- Would you rather fund your loans with deposits for which you paid 0.50%? Or deposits for which you paid 5.00%?
- If you could bring in the same dollars for 1.5% that you bring in for 2.0%, why wouldn't you?
- Would you pay California prices for land in Nebraska? Overpaying only increases your cost.

Borrowing from Members vs. Borrowing from the Market

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Ultimately, every deposit you take comes down to this question:

Should I borrow from my members or should I borrow from the market?

- Are you borrowing from your members at a rate greater than current FHLB rates (current 1-year advance ~0.50%)?
- There may be justifiable reasons to spend more than necessary to keep members satisfied or to reward loyal business, but ultimately, is it worth laying off staff to overpay for deposits?

What is Rational Pricing Strategy?

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- **Standard deposit account rates** should be set to achieve profitability objectives.
  - Set standard deposit rates so you are indifferent between deposits and wholesale funding.

- **Special accounts** are offered in order to be rate-competitive and to generate more rapid deposit growth when needed.
  - Specials typically demand some action on the part of the member.
    - Larger minimum or opening balance requirement
    - Checking account with direct deposit.
    - Online access only.
  - If the deposit account is a term product, the special always renews into standard products.
    - 7-month CD special automatically renews into standard 6 month CD.

Setting Rational Strategy

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Product Type	Standard Accounts – Driven by profit	Specials – Driven by competition
Checking	■ Free Checking	■ High Rate Checking ■ Rewards Checking
Money Market Accounts	■ Tiered MMA	■ High-Minimum, High Rate MMA (requires checking)
CDs	■ 3 month CD ■ 6 month CD ■ 1 year CD ■ 2 year CD	■ 7 month special CD ■ 11 month special CD ■ Bump rate CD ■ Flex CD

Standard account pricing is driven by profitability and is targeted to non-rate sensitive members.

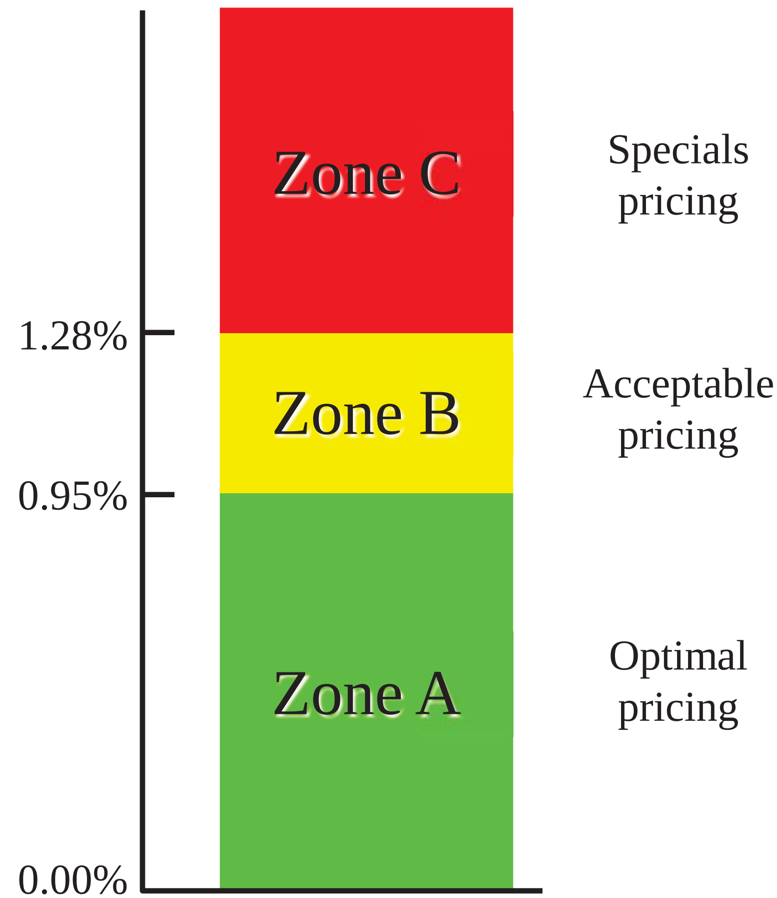
Special account pricing is driven by competition and is designed to foster growth and preserve relationships with high value members.

Setting Rational Pricing:

One Year CD

Alternative Funding Rate

Example 1 year FHLBB advance rate	1.49%
Average CD Balance per Account	$11,500
Marginal Expense per Account	$24
Fully Allocated Expense per Account	$62
Marginal Expense per Balance	0.21%
Fully Allocated Expense per Balance	0.54%
Zone A Maximum Rate	0.95%
Zone B Maximum Rate	1.28%



Remember – Not All Members are Rate Sensitive

- **Anywhere from 33% to 50% of all standard rate certificates roll over without any contact with the institution.** These are not rate-sensitive members.
- Members that do contact the institution can get a special CD at going market rates (13 months instead of 12).
- By lowering the rate for your less-sensitive members, you can lower your CD cost by a significant amount

	% of Members	Before	After
Non-rate Sensitive	50%	2.30%	1.20%
Rate Sensitive	50%	2.30%	2.30%
Weighted Cost	100%	2.30%	1.75%

	% of Members	Before	After
Non-rate Sensitive	33%	2.30%	1.20%
Rate Sensitive	67%	2.30%	2.30%
Weighted Cost	100%	2.30%	1.94%

Why should I bother?

Think of it this way:

If a $500 million asset institution can reduce its funding costs by only 20 basis points, that would **save that institution around $1 million in interest expense**.

Now think of how much staff you would need to cut to reach $1 million in cost savings.

Savings Rate Impact on ROA

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The matrix below measures the expected ROA increase associated with reductions to the Savings interest rate. For example, if Savings balances represent 30% of all Deposits at the institution, and the Savings rate is decreased by .50%, the ROA would increase by 0.15%.

Drop in Savings Rate	Savings % of Total Deposits				
	10%	*20%*	*30%*	*40%*	*50%*
0.05%	0.01%	0.01%	0.02%	0.02%	0.03%
0.10%	0.01%	0.02%	0.03%	0.04%	0.05%
0.25%	0.03%	0.05%	0.08%	0.10%	0.13%
0.50%	0.05%	0.10%	0.15%	0.20%	0.25%
1.00%	0.10%	0.20%	0.30%	0.40%	0.50%

ROA Impact

Summary

Effective Pricing Summary

- Operating Expenses continue to rise due to new technology and delivery channels, along with rising compliance costs
  - The **key to efficiency is revenue growth**; leveraging the same operating expenses over a larger base
- Non-interest income will continue to be under **regulatory threat**
  - Credit Unions need to develop a checking strategy for the new environment
  - Diversification of non-interest income
- A return to **margin management** is paramount – COF is key
  - COF is impacted by both Mix and Pricing
  - Balancing the need to manage to Cost of Funds without:
    - Alienating rate sensitive members
    - Reducing member loyalty (particularly those that are rate sensitive)
- Differential Pricing – **Rewarding members** that conduct revenue generating activities with the institution or bring additional balances
    - Activity based pricing
    - Relationship pricing
- Analyze product by product to identify where you have room to **rationalize**, which products to keep competitive, and processes needed to keep funding costs low.
- Move away from a strict reliance on **price as your differentiator**.
  - Look for create other distinctive competencies of your organization

Thank You

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