

IMPACT NOTE

SEPTEMBER 2011

Ron Shevlin

+1.617.338.6045

rshevlin@aitegroup.com

Financial High Coup: Why High-Yield Checking Accounts Trump Free Checking

TABLE OF CONTENTS

INTRODUCTION	3
ABOUT THE DATA	3
HIGH-YIELD VERSUS FREE CHECKING ACCOUNT PERFORMANCE	4
REGULATORY IMPACT ON HIGH-YIELD CHECKING	11
CONCLUSION	13
RELATED AITE GROUP RESEARCH	15
ABOUT AITE GROUP.....	16
CONTACT	16

LIST OF FIGURES

FIGURE 1: ACCOUNT GROWTH BY ACCOUNT TYPE, MAY 2009 TO APRIL 2011	4
FIGURE 2: ACCOUNT GROWTH RANGES BY ACCOUNT TYPE, MAY 2009 TO APRIL 2011	4
FIGURE 3: MONTHLY ACCOUNT PERCENTAGE GROWTH RATE	5
FIGURE 4: REWARDCHECKING AND FREE CHECKING SHARE OF ALL CHECKING ACCOUNTS	5
FIGURE 5: REWARDCHECKING SHARE OF ALL CHECKING ACCOUNTS VERSUS BELOW CAP RATES	6
FIGURE 6: DEBIT TRANSACTIONS PER ACCOUNT	7
FIGURE 7: REWARDCHECKING DEBIT TRANSACTIONS PER ACCOUNT, HIGH VS. LOW PERFORMERS	7
FIGURE 8: AVERAGE INTERCHANGE REVENUE PER ACCOUNT	8
FIGURE 9: REWARDCHECKING INTERCHANGE REVENUE PER ACCOUNT, HIGH VS. LOW PERFORMER	8
FIGURE 10: E-STATEMENT AND ONLINE BANKING ADOPTION BY ACCOUNT TYPE	9
FIGURE 11: AVERAGE ACCOUNT PROFITABILITY BY ACCOUNT TYPE	10
FIGURE 12: TWO-YEAR DIFFERENCES IN PROFITABILITY COMPONENTS.....	10
FIGURE 13: INTERCHANGE PERCENTAGE OF TOTAL ACCOUNT INCOME	11
FIGURE 14: ACCOUNT PROFITABILITY IF DURBIN AMENDMENT HAD BEEN IN EFFECT	12

INTRODUCTION

The passing of the Durbin Amendment by the United States Congress will reduce—by roughly 50%—the revenue that U.S. banks will receive for on debit card transactions. This has led to speculation by bank executives and industry experts that financial institutions will discontinue debit card rewards programs and stop offering free (typically non-interest bearing) checking accounts. In addition, conventional wisdom holds that the decline in interest rates from mid-2009 through mid-2011 will cast dark clouds on the future of high-yield checking accounts.

Aite Group believes that high-yield checking accounts have a bright future in the lineup of banks' checking account offerings. Our analysis of the performance of high-yield checking accounts from May 2009 to April 2011 shows that, in comparison to free checking accounts, high-yield checking accounts were more effective for acquiring accounts, generating deposits, producing interchange revenue, and delivering profits.

That this happened in a period of declining interest rates is important—and surprising—because as rates decline, the spread between high-yield and free checking accounts decline, and income generated from lending and investing deposits declines, as well.

ABOUT THE DATA

Aite Group obtained data on the performance of high-yield checking accounts from BancVue, Ltd., a developer of software for the financial services sector. The firm's REWARDChecking® product offers CD-like interest, no minimum balance, and ATM fee refunds when account holders meet specific monthly qualifications that reduce cost for the institution (using a debit card, accessing online banking, receiving eStatements, making direct deposits).

There are three rate tiers and a balance cap tied to the account: 1) Qualifying account holders with balances below the cap receive the bonus rate; 2) Qualifying account holders with balances above the cap receive the high interest rate on everything up to the cap, and the middle rate on the portion of their balance above the cap; and 3) Non-qualifying account holders with balances below/above the cap receive a base rate.

BancVue, Ltd. designs and develops software, and offers marketing and consulting services for the financial services sector. The company markets its products under REALGiving, REALSaver, REALTunes, and REWARDChecking brand names. The company's products cater to banks and credit unions. BancVue works with its clients to configure a REWARDChecking account—including establishing rate and cap—that best fits their business/community needs.

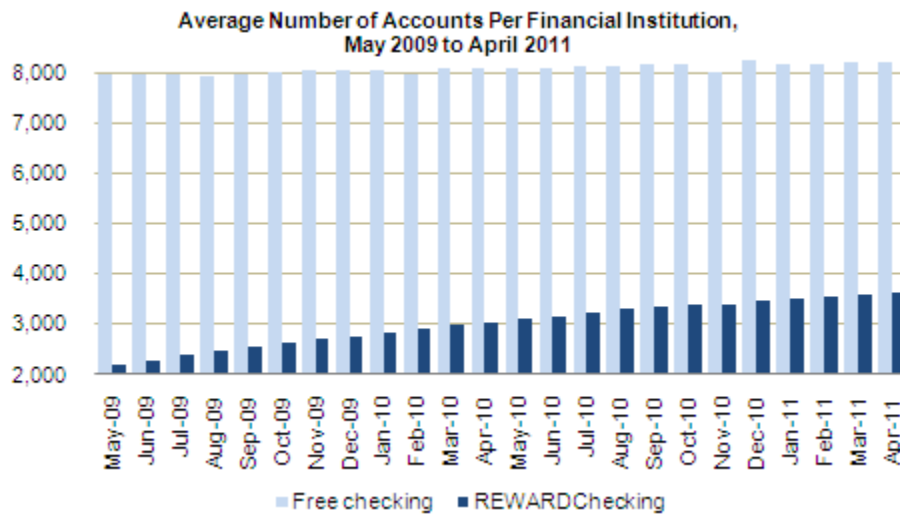
BancVue provided data on checking account performance for 120 of its clients for the two year period of May 2009 to April 2011. To avoid any bias in the selection of banks, Aite Group randomly selected 125 BancVue customer ID numbers. Valid data for the two-year period was available for 120 of the 125 financial institutions selected.

As a result of the sampling methodology, we have no data on bank size or geographic location. We do know, however, that 89 of the 120 financial institutions in the sample are community banks, and that 31 are credit unions.

HIGH-YIELD VERSUS FREE CHECKING ACCOUNT PERFORMANCE

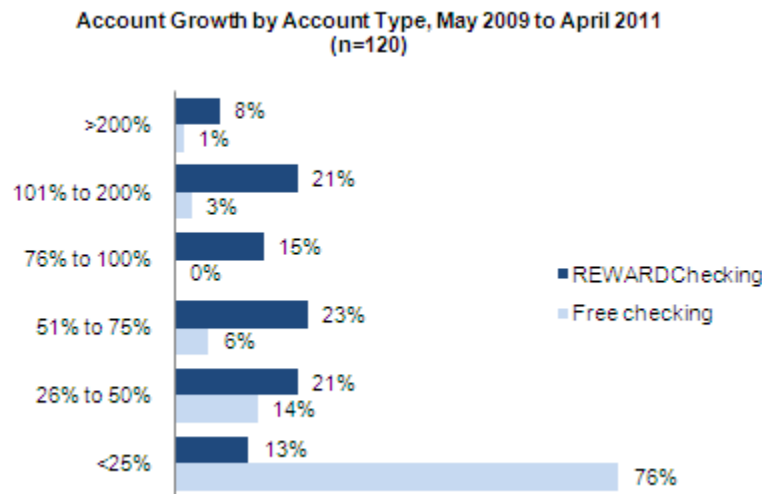
Across the 120 financial institutions (FIs) studied for the 24 month period of May 2009 through April 2011, the average growth rate in the number of high-yield checking accounts was 67%, in contrast to 3% for free checking accounts (Figure 1). Nearly three in 10 FIs saw their REWARDChecking account volume grow by more than 100% over the two year period, while three in four experienced less than 25% growth in free checking account volume (Figure 2).

Figure 1: Account Growth by Account Type, May 2009 to April 2011



Source: BancVue, Aite Group

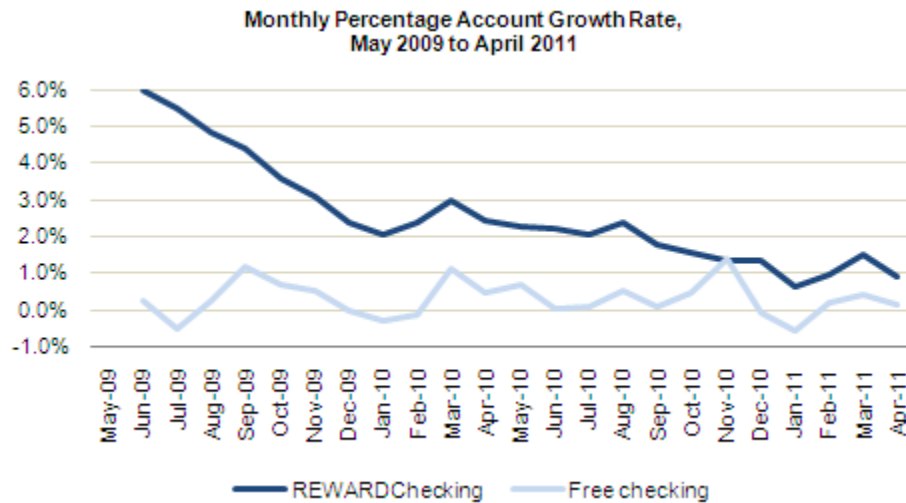
Figure 2: Account Growth Ranges by Account Type, May 2009 to April 2011



Source: BancVue, Aite Group

Month over month, the growth rate in REWARDChecking declined steadily from 6% in June 2009 to 1% in April 2011, but maintained a higher rate than free checking accounts in all but one month. Free checking accounts experienced negative growth in six of the 24 months (Figure 3).

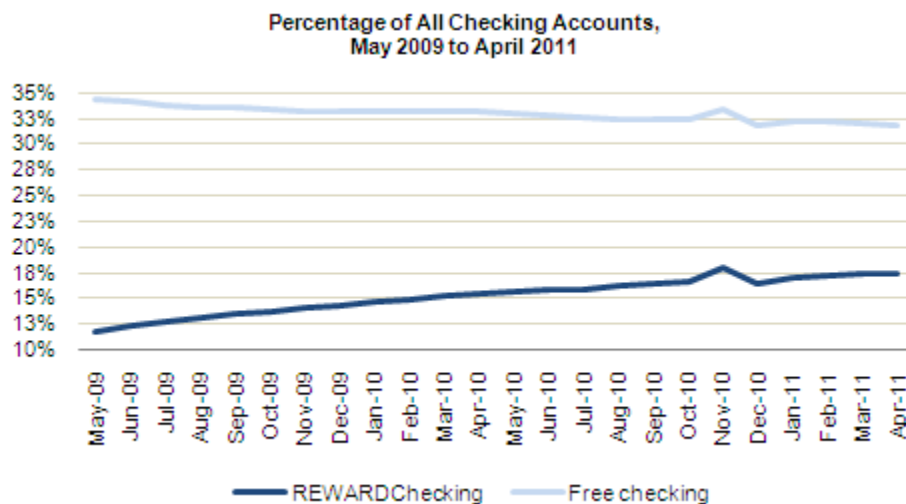
Figure 3: Monthly Account Percentage Growth Rate



Source: BancVue, Aite Group

As a percentage of all checking accounts, REWARDChecking accounts grew 5.6%, from an average of 11.8% in May 2009 to 17.4% in April 2011. During the same period, free checking as a percentage of all checking accounts slipped 2.5%, from 34.3% to 31.9 (Figure 4). As a percentage of all accounts, REWARDChecking rose by more than 8% points in one in four FIs.

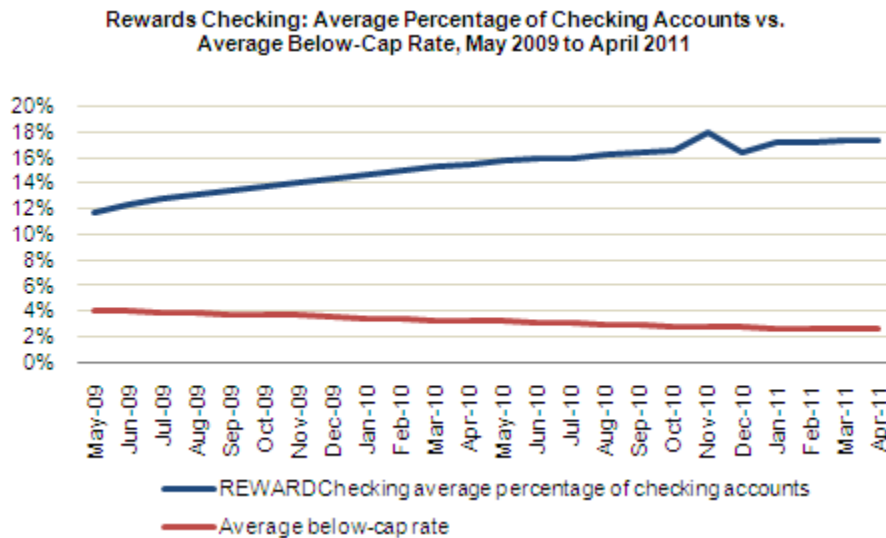
Figure 4: REWARDChecking and Free Checking Share of All Checking Accounts



Source: BancVue, Aite Group

The growth in REWARDChecking—in terms of month over month growth, as well as a percentage of all checking accounts—came during a period of declining interest rates. The “below cap rate”—the maximum interest rate paid out on REWARDChecking accounts—dropped from an average of 4.01% in May 2009 to 2.57% in April 2011 (Figure 5).

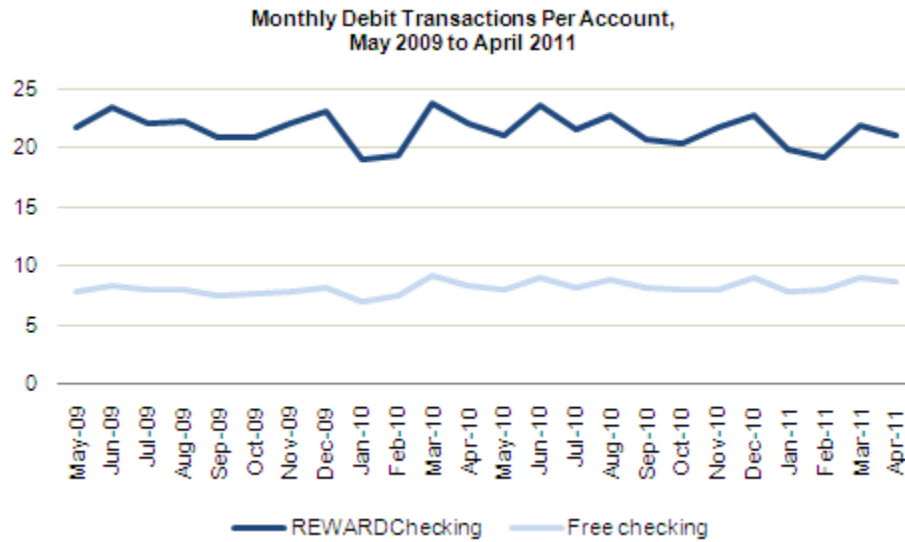
Figure 5: REWARDChecking Share of All Checking Accounts versus Below Cap Rates



Source: BancVue, Aite Group

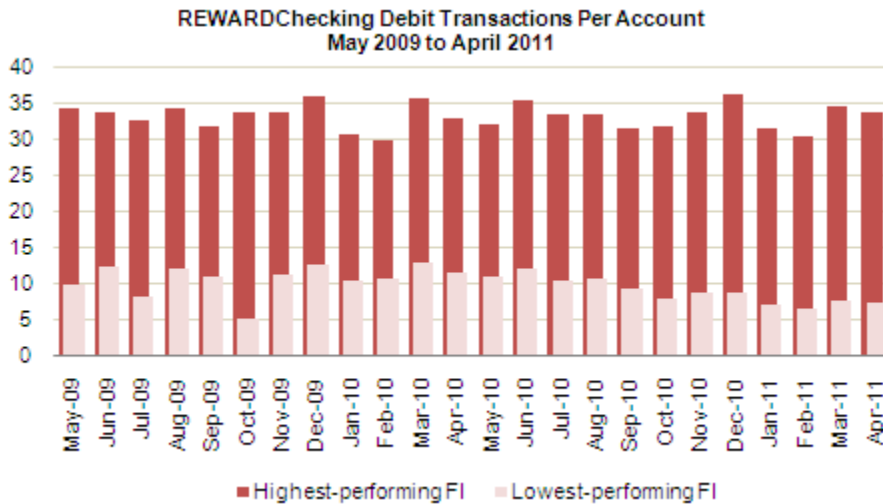
As debit transaction volume has grown over the past five years, interchange has become a key contributor to checking account profitability. For the FIs in our analysis, monthly debit transactions per REWARDChecking account averaged more than 2.5 times the number of monthly debit transactions per free checking account (Figure 6). The best-performing FI averaged 35 transactions per account per month. The low-performer averaged 10 debit transactions per account per month—higher than the average number of debit transactions per free checking account (Figure 7).

Figure 6: Debit Transactions Per Account



Source: BancVue, Aite Group

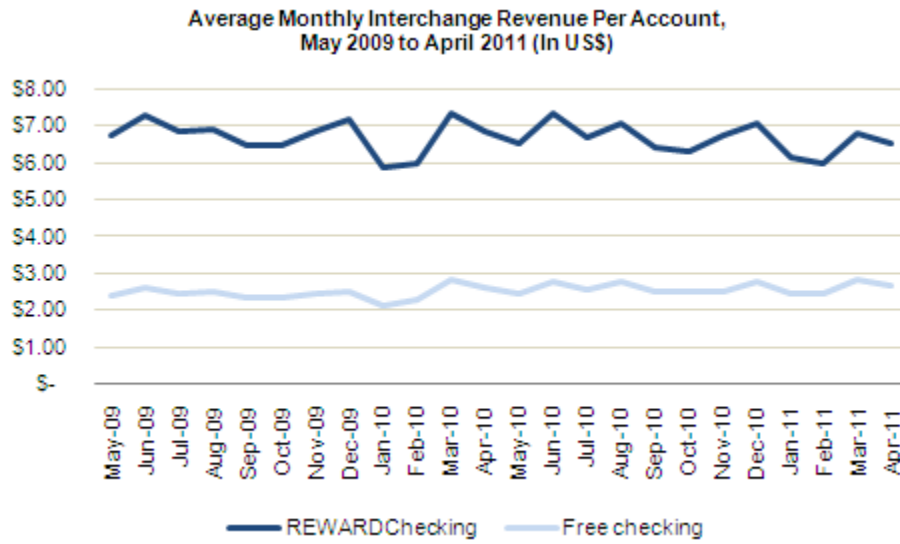
Figure 7: REWARDChecking Debit Transactions Per Account, High vs. Low Performers



Source: BancVue, Aite Group

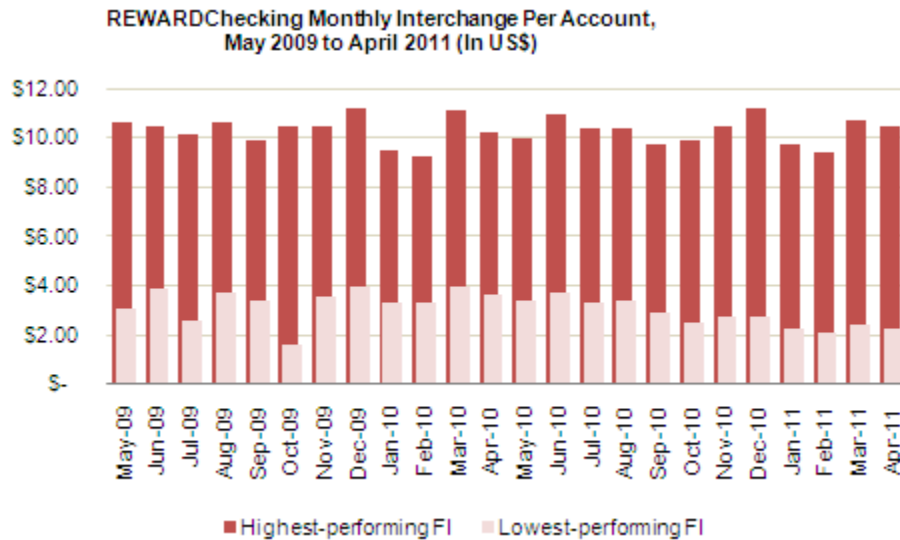
Debit transaction volume on REWARDChecking account produced an average of US\$6.68 per account per month in interchange revenue for the FIs in our sample. In contrast, Free checking accounts averaged US\$2.54 per account per month (Figure 8). This was driven strictly by debit transaction volume as the average debit transaction purchase amount was virtually the same for Rewards and Free checking accounts. The best performer averaged more than US\$10 per account, and the lowest-performing FI averaged about US\$3 per account per month over the two-year period (Figure 9).

Figure 8: Average Interchange Revenue Per Account



Source: BancVue, Aite Group

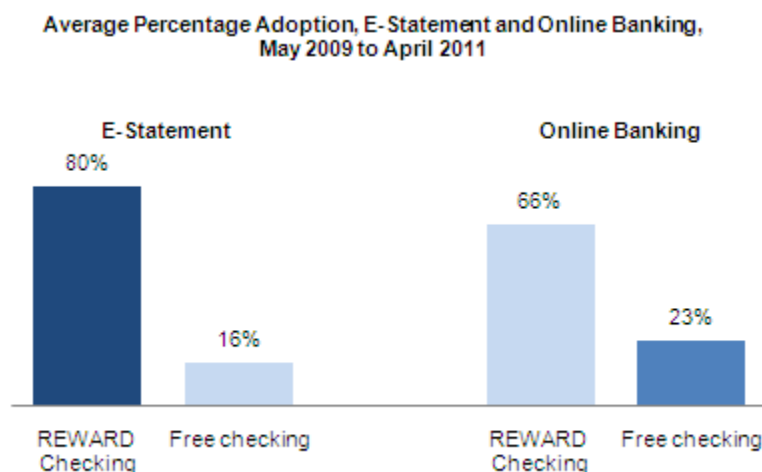
Figure 9: REWARDChecking Interchange Revenue Per Account, High vs. Low Performer



Source: BancVue, Aite Group

Additional drivers of checking account profitability include e-statement and online banking adoption.¹ Over the two-year period included in the analysis, the FIs in the sample saw an average of 80% of their REWARDChecking customers opting-in to e-statements versus just 16% adoption among free checking customers. Two-thirds of REWARDChecking customers banked online, in contrast to just one in four Free checking customers (Figure 10).

Figure 10: E-Statement and Online Banking Adoption by Account Type

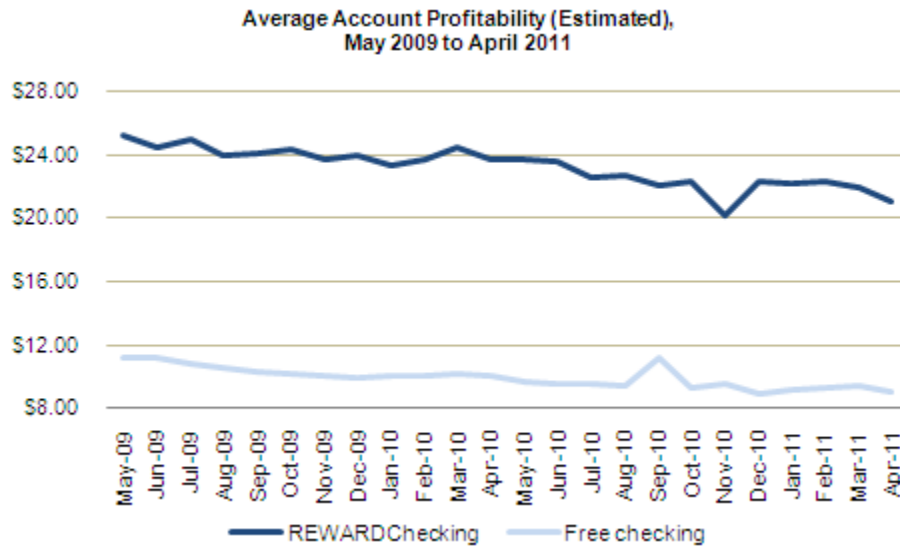


Source: BancVue, Aite Group

Overall, when factoring in higher interchange revenue, lower cost to serve, and other income generated, high yield checking accounts generate higher profits than free checking accounts (Figure 11).² On average, compared to free checking accounts, high yield checking accounts generated US\$4.15 more per account per month in interchange revenue, US\$0.71 more per account per month in direct savings from eStatement adoption, and US\$19.34 more per account per month in other income (Figure 12).

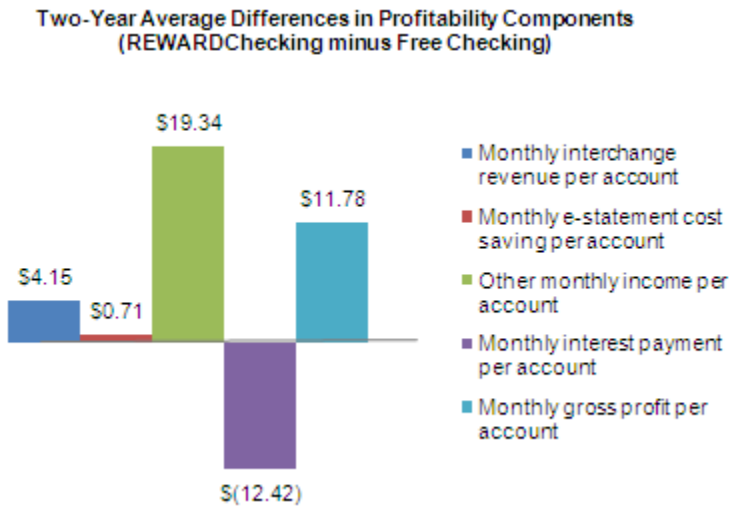
1. A 2007 study from SunTrust and CheckFree found a link between e-statements and higher account balances, customer loyalty and profitability. The study analyzed consumer data from customer households during a 13-month period from February 2006 through February 2007. It found that customers who received and paid at least three e-bills per month at the SunTrust website were 86% more profitable than offline customers, had a 78% lower attrition rate on average, were twice as likely to have a mortgage with the bank, and 60% more likely to have a savings account with the bank. <http://blog.aspenms.com/2007/11/09/electronic-billing-and-payment-linked-with-higher-customer-retention-profitability/>
2. Additional income per account—revenue generated by investing and/or lending deposit funds—was estimated using data from the Kafafian Group’s Profitability Peer Group Comparison studies from Q1 2009 and Q1 2011 which measures line of business and product profitability on a fully outsourced basis for 24 banks and thrifts. Revenue from overdraft fees may also influence additional income per account, but, according to BancVue, overdraft revenue per account is roughly equal across REWARDChecking and free checking accounts at their clients.

Figure 11: Average Account Profitability by Account Type



Source: BancVue, Kafafian Group, Aite Group

Figure 12: Two-Year Differences in Profitability Components

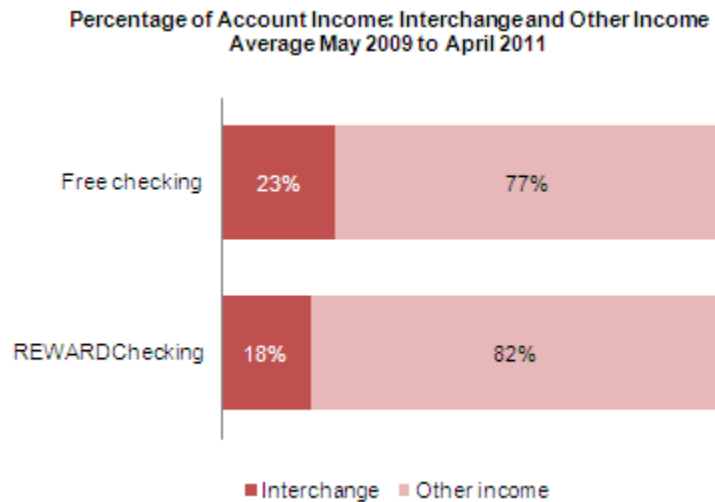


Source: BancVue, Kafafian Group, Aite Group

REGULATORY IMPACT ON HIGH-YIELD CHECKING

Over the two-year analysis period, interchange revenue accounted for an average of 18% of the total income generated by REWARDChecking accounts. For free checking accounts, interchange averaged 23% of the total income generated by that type of account (Figure 13).

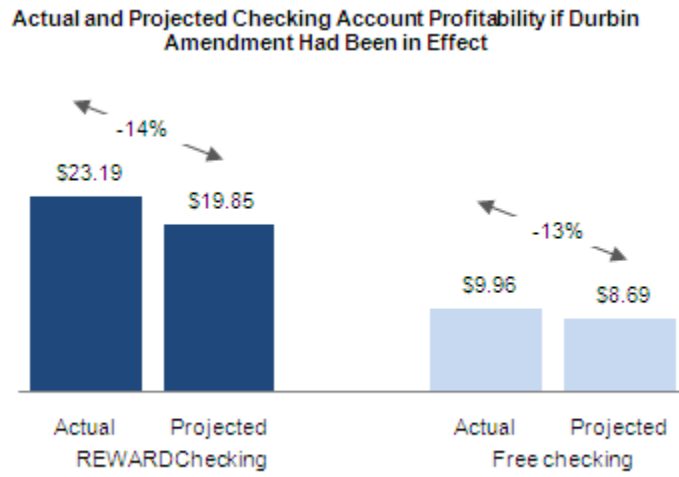
Figure 13: Interchange Percentage of Total Account Income



Source: BancVue, Kafafian Group, Aite Group

If the debit interchange guidelines issued by the Federal Reserve in June 2011 had been in place throughout the analysis period, REWARDChecking accounts would have been, on average, 14% less profitable per month. Free checking accounts would have been impacted, as well, of course, and would have demonstrated 13% lower profitability per account (Figure 14).

Figure 14: Account Profitability if Durbin Amendment Had Been in Effect



Source: BancVue, Kafafian Group, Aite Group

CONCLUSION

From our analysis of high-yield checking account performance between May 2009 and April 2011, Aite Group concludes that:

- **High-yield checking accounts trump free checking.** Although month over month account growth for REWARDChecking accounts declined between 2009 and 2011, high-yield accounts still grew more rapidly than free checking accounts. Additional revenue generated from interchange and other income, together with lower service costs, made high-yield accounts more profitable than non-interest bearing accounts. This suggests that high-balance consumers were more likely than other consumers to look for new accounts during the recession, and that pushing free checking—which is what many community banks and credit unions did—was a flawed strategy.
- **Reduced debit interchange will not have a materially negative impact on high-yield accounts.** Over the two-year analysis period, interchange revenue accounted for an average of 18% of the total income generated by high-yield checking accounts. If the debit interchange guidelines issued by the Federal Reserve in June 2011, had been in place throughout the analysis period, REWARDChecking accounts would have been 14% less profitable each month—but still more profitable than free accounts.
- **Community banks and credit unions need a high-yield checking account in their product portfolio.** Aite Group believes that the decline in the growth rate for high-yield checking accounts between May 2009 and April 2011 resulted from the recession in the United States, and does not represent a long-term shift in consumer preferences. Our analysis of checking account prospects in 2008 found that 94% of online searchers on FindABetterBank.com listed interest on balances as a “must-have” or “nice-to-have” checking account feature, and that 64% ultimately selected an interest-bearing account over a non-interest bearing account.³
- **Active product design is critical for maintaining profitability.** The profitability of REWARDChecking accounts from May 2009 through April 2011 didn’t come solely from just account growth due to higher-than-average rates. Profitability was also driven by cost savings resulting from steering customers to lower cost channels, and from the revenue generated from debit interchange. All this points to the need for active product design regarding fees, rates, and behavioral incentives regarding channel and debit card use. The continuing emergence of the mobile channel means that the need for an analytically-driven approach to product design will only increase. The ability to adjust different aspects based on changing business needs will become increasingly important.

3. See Aite Group’s October 2008 Impact Report, *Checking Accounts: Who’s Winning The Battle Online?*

- **Other revenue sources associated with high-yield checking accounts will accelerate.** The rate at which FIs earned revenue from investing and/or lending deposit funds from deposit accounts declined between May 2009 and April 2011. Looking ahead, a new source of revenue associated with checking accounts will emerge in the form of merchant-funded incentives.⁴ Increasingly, FIs will compete for brands' marketing dollars by providing brands with more effective and efficient ways to reach customers and prospects through the FIs' online banking and personal financial management (PFM) platforms. The higher penetration of online banking adoption among REWARDChecking account holders (compared with free checking account holders) will enable financial institutions to generate higher levels of additional income on deposit accounts.

4. See Aite Group's June 2011 Impact Report, *The Case for Merchant Funded Incentives: New Opportunities for Card Issuers*.

RELATED AITE GROUP RESEARCH

[*The Case for Merchant Funded Incentives: New Opportunities for Card Issuers*](#), June 2011.

[*Online Marketing Maturity Model for Financial Institutions*](#), February 2011.

[*Personal Financial Management: A Platform for Customer Engagement*](#), February 2010.

[*Credit Unions' Online Channel Priorities 2010*](#), February 2010.

[*Online Banking: Product Development Roadmap for 2010*](#), December 2009.

[*Financial Services Rewards Programs: The Quest for Profitability*](#), December 2009.

[*Engaging Gen Y: Cultivating a New Generation of Banking Customers*](#), September 2009.

[*The Next Generation of CRM in Retail Banking: Sense-and-Respond Marketing*](#), June 2009.

[*Measuring Customer Engagement: Making the Metric Matter*](#), June 2009.

[*How to \(Re\)Build Consumer Trust in Banks*](#), April 2009.

[*Banks' New ROA: Return on Advertising*](#), March 2009.

[*Checking Accounts: Who's Winning The Battle Online?*](#), October 2008.

ABOUT AITE GROUP

Aite Group is an independent research and advisory firm focused on business, technology, and regulatory issues and their impact on the financial services industry. With expertise in banking, payments, securities & investments, and insurance, Aite Group's analysts deliver comprehensive, actionable advice to key market participants in financial services. Headquartered in Boston with a presence in Chicago, New York, San Francisco, London, and Milan, Aite Group works with its clients as a partner, advisor, and catalyst, challenging their basic assumptions and ensuring they remain at the forefront of industry trends.

CONTACT

For more information on research and consulting services, please contact:

Aite Group Sales

+1.617.338.6050

sales@aitegroup.com

For all press and conference inquiries, please contact:

Patrick Kilhaney

+1.718.522.2524

pr@aitegroup.com

For all other inquiries, please contact:

info@aitegroup.com