

"Abound Resources is a consulting firm serving the community financial services industry. In this role as an advisor to banks and credit unions across the country we have diligently remained abreast of developments and potential impacts of the Dodd-Frank/Regulation Q legislation. The following white paper was developed for Sheshunoff/A.S. Pratt and summarizes the key elements of the current regulatory environment. We hope you find it interesting and useful."

Brad Smith, President and CEO



REPEAL OF REGULATION Q

Protect Your Customers From Big Bank Market Attacks



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Repeal of Regulation Q: Protect Your Customers From Big Bank Market Attacks

by Brad Smith, Abound Resources

On July 21, 2011, the one year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Regulation Q, which prohibits banks from paying interest on commercial deposits, will be repealed, opening the way for financial institutions to pay interest on commercial checking accounts.

AT ISSUE: INTEREST ON COMMERCIAL BALANCES

The history of Regulation Q dates back to the Great Depression era with the enactment of the Glass-Steagall Act. One of the original objectives of the regulation was to encourage companies to invest money in other areas that would stimulate the economy by making commercial bank deposits less attractive.

However, banks still needed to attract commercial deposits. To do this, the industry has spent decades creating elaborate workarounds: negotiable order of withdrawal (NOW) accounts and money market demand accounts (MMDAs), earnings credit rates and account analysis, zero balance accounts, sweep accounts, repurchase agreements (REPOs), etc.

The intent of the upcoming repeal of Regulation Q is not entirely clear. The bill's sponsors claim that the intended benefits are "(1) increased small business growth due to the interest earnings on their cash assets, and (2) enhanced effectiveness for small depository institutions in competing for commercial balances." It is unclear to this author how those benefits will materialize.

Some proponents of the repeal have argued that it was designed to encourage companies to keep their cash at banks, increasing the liquidity in banks, in general, and liquidity for the Federal Reserve, in particular. These proponents argue that a substantial reduction in corporate deposits in banks has had a major impact on the Federal Reserve System. They state that the amount of actual dollars held by the Fed has declined dramatically and fear that the Fed's reserves could be completely depleted on a specific day bringing the entire banking system to a halt.

Regardless of the intent of the repeal of Regulation Q, the net effect is clear. Financial institutions *will be allowed to pay interest* on corporate checking accounts.

Brad Smith will be presenting a webinar on August 11, 2011 entitled **Durbin and Reg Q: Early Results and Updated Strategies**.

Dodd-Frank Wall Street Reform and the Consumer Protection Act has been in place for two weeks. So what are the very early results of the Durbin debit changes and the repeal of Reg Q? What's working and not working? This session will provide an up-to-the-minute review of how new debit pricing guidelines are working and how banks and credit unions are addressing the repeal of Reg Q. We'll address how the merchants are responding to Durbin, discuss some early examples of how banks and credit unions are best addressing these changes, examine how vendors are helping or hurting and provide updated strategies for minimizing the impact and maximizing the opportunities. A.S. Pratt interactive webinars are 90 minutes long and include a 30-minute Q&A session with the expert so you may ask questions specific to your institution. [Register today!](#)

In addition, though not directly related, the temporary partial extension of transaction account guarantee (TAG) must be considered as part of the Reg Q conversation. Federal Deposit Insurance Corporation (FDIC) insurance has been permanently increased to \$250,000. Through December 31, 2012, it provides unlimited deposit insurance for non-interest bearing demand deposits. So the net effect of TAG is that customers will have a choice between now and December 31, 2012: They can choose unlimited FDIC coverage or interest. But they cannot choose both.

THE CURRENT POLITICAL CLIMATE AND MISTAKEN IMPRESSIONS

Several banking trade associations are lobbying to undo, or at least slow down, the Reg Q repeal legislation. Alternatives have been proposed, including increasing the allowable MMDA transactions from 6 to 24 and phasing in the repeal over one or two years.

At the time of this writing, those proposals are expected to be attached to another bill in the House. This author would peg the chances of approval at about 30% so proceed as if the repeal will be in effect in July.

An additional concern to community banks is related to FDIC insurance. Since the federal government has clearly shown that it believes there are some banks that are “too big to fail,” community banks may be at a competitive disadvantage for large commercial deposits after the December 31, 2012 extension of unlimited insurance coverage. The “too big to fail” banks could overtly market, or covertly suggest, that commercial deposits above the \$250,000 insurance cap are safer in their “too big to fail” banks than those deposits would be in a community bank.

When asked about this issue in early May, an FDIC manager acknowledged that that issue was not something the FDIC had yet considered. More troubling, this manager did not understand why community banks were so concerned about the repeal of Reg Q. He was under the mistaken impression that all banks were using REPOs and “were used to paying interest on all commercial balances.”

THE REPEAL OF REG Q: WHAT DOES IT MEAN FOR COMMERCIAL CUSTOMERS?

Commercial customers will likely be confused by this new legislation.

If you, the banker, are not out in front of the issue communicating with your commercial customers, many of them will first hear about it from the expected bombardment of competitor advertising and sales calls beginning in June. The best case scenario is that your customers call their account officer at your bank and ask how you are addressing this new possibility. The worst case scenario is that you do not have an opportunity for discussion before they move their accounts.

Some customers will be excited about the prospect of earning interest on deposits, but will probably be disappointed when they see the market rates.

Those commercial customers with balances exceeding \$250,000 must choose between interest or unlimited FDIC insurance coverage. (Remember: they can't choose both.) Upon analysis, they will realize the need to balance hard interest payments with expense reduction through compensating balances. In addition, they will need to evaluate the tax implications of hard dollar interest versus soft dollar earnings credit.

The most prudent course of action is to be proactive and address this issue with your customers at the outset rather than waiting to see what everyone else does. If you have built your bank's brand on being trusted advisors, you need to help your customers through this decision-making process. And that should be done *before* they see a competitor's advertisement or receive a competitor's sales call.

PAYING INTEREST: WHAT DOES IT MEAN FOR YOUR INSTITUTION?

So what do you do once the repeal takes effect? You have three basic choices with regard to paying interest. They are:

- *Do nothing.* The repeal does not require you to pay interest. You are not *required* to make any changes.
- *Pay hard interest on entire balance.* This choice would effectively eliminate the soft interest credit resulting in hard dollar inter-

est payments and hard dollar charging for services rendered.

- *Pay a soft earnings credit on balances to cover service charges, and then pay hard interest on any excess balances.* Based on feedback from community bankers, this is how many community banks are leaning.

Either of the last two choices will increase your cost of funds, therefore thorough analysis is required. A simple illustration is shown below. In this illustration an \$800MM institution has \$83MM in non-interest bearing commercial deposit accounts. The chart shows three different rate scenarios of paying hard dollar interest on \$83MM deposits. Because all other variables are constant, the scenarios do not account for fees or changes in balances that depend on interest being paid or not. A copy of this spreadsheet is available at www.aboundresources.com/regulationq.

EXAMPLE: POTENTIAL IMPACT OF PAYING INTEREST

Sample Results Under Three Rate Scenarios				
Your Financial Institution	Your Baseline	Your Req Q Scenarios -Paying Interest at		
		0.15%	0.25%	2.00%
Total Interest Income	\$ 38,236,000	\$ 38,236,000	\$ 38,236,000	\$ 38,236,000
Interest Expense	\$ 7,450,000	\$ 7,450,000	\$ 7,450,000	\$ 7,450,000
Addl Interest Expense Under Scenario*	\$ -	\$ 124,497	\$ 207,495	\$ 1,659,960
Interest Expense - Adjusted	\$ 7,450,000	\$ 7,574,497	\$ 7,657,495	\$ 9,109,960
Non-Interest Income	\$ 13,509,000	\$ 13,509,000	\$ 13,509,000	\$ 13,509,000
Non-Interest Expense	\$ 29,538,000	\$ 29,538,000	\$ 29,538,000	\$ 29,538,000
Provision for Loan & Lease Loss	\$ 405,000	\$ 405,000	\$ 405,000	\$ 405,000
Realized Gain/Loss Held to Maturity Sec	\$ 7,000	\$ 7,000	\$ 7,000	\$ 7,000
Realized Gain/Loss Avail for Sale Sec	\$ 3,327,000	\$ 3,327,000	\$ 3,327,000	\$ 3,327,000
Pre-Tax Net Operating Income	\$ 17,686,000	\$ 17,561,503	\$ 17,478,505	\$ 16,026,040
Efficiency Ratio	66.68%	66.87%	67.00%	69.28%
Pre-Tax ROA	2.04%	2.03%	2.02%	1.85%
Replacement Income Needed***		\$ 124,497	\$ 207,495	\$ 1,659,960

NEAR- AND LONG-TERM IMPLICATIONS

Although we don't know exactly how the market will react, we can speculate what the near and long term implications of the repeal of Regulation Q could be for your institution.

In the near term, you will need to devise customer retention strategies, new commercial and small business market strategies, and new product packaging/pricing. Some customers will forego interest in this economic climate in order to get maximum insurance. This may be an opportunity for you to exploit to retain those accounts right now.

The longer term implications are harder to predict, but here are some to consider:

- Sweeps may go away or may survive as a means for commercial customers to earn higher rates than those a bank might offer in a demand deposit account (DDA).
- Money market and NOW products will remain, at least for awhile, as long as banks intend to offer a product that can pay more than a transaction account.
- MMDAs could become incorporated as a tier in a tiered-rate transaction account, with the lowest tiers paying nothing, or next to nothing.
- Account analysis could eventually disappear or potentially survive as the billing system for corporates. Whether the earnings credit rate (ECR) will survive is up for debate.
- Deposit volatility could increase if commercial customers chase rates just as some consumer segments do now.
- Community banks will add many more commercial products that drive commercial fee income.

There are a number of other decisions to make around product packaging and pricing. The profitability of your commercial DDA accounts will change if interest payments are added, and the worst thing you can do is simply add interest payments to an existing business checking product. You may need to:

- Establish new balance requirements
- Add new fees
- Decide on tiered rates
- Review sweeps, zero balance accounts (ZBAs), and REPO products for pricing and effectiveness

With the appeal of non-bank liquid investments diminished, more funds will start to flow back into bank transaction accounts. But the majority of those large dollar movements will benefit the larger banks.

THE COMPETITION HEATS UP

We are likely to see a dramatically more competitive environment for small business and commercial checking accounts. The net effect of the Durbin amendment, Regulation E, and the new FDIC guidance on not sufficient funds/overdraft (NSF/OD) fee limits means that consumer fee income (and profitability) will continue to decline. The industry is starting to realize that future fee income growth must come from the commercial side of the business. That is one of the reasons Bank of America recently announced the hiring of 1,000 business bankers. The big banks are clearly going after small business and commercial customers.

The big unknown is what everyone else is going to do. What happens if a big bank, community bank, or credit union in your market offers a teaser rate of 2% on commercial checking? How will you respond?

There is a lot of wait and see right now. Waiting to respond to the competition is never a good strategy, in part because, by the time you respond to a competitor's offering, you are likely to have lost the accounts in the market that would have moved.

DETERMINE YOUR STRATEGIC DIRECTION

We are encouraging our clients to be proactive rather than reactive. Your bank has a number of decisions to make, but the biggest decision is whether to take an offensive or defensive approach.

An offensive strategy exploits the opportunity to grab market share. Those on the offensive will be the first banks in their market to advise their customers on what to do. Banks on the offensive may also be the first in their market to offer interest — perhaps even offer teaser rates. This can be a sound strategy for some banks because early adopters will gain market share.

A defensive strategy is one in which the bank develops one or two plans based on different competitive scenarios and knows how and when to launch its plans. One approach is to design a plan based on the worst case scenario: a large competitor aggressively markets a teaser rate on its free business checking account. Another plan might be designed based on a 1% rate scenario.

The benefit of having a plan ready to execute is that you increase your speed to market. Banks that don't respond quickly to competitors could lose their most profitable relationships. Ideally, you will have already thoroughly considered the scenarios, run through the models, and have a sound strategy in place. You are set to roll out a smart strategy quickly, rather than spend 60 days in late summer trying to develop one.

As you develop your strategy, you will need to evaluate liquidity, volatility, the new asset/liability management (ALM) model, general risk, compliance, customer issues, product and packaging changes, etc. But at the end of the day, the decision as to how your bank responds to Reg Q is going to be driven by your bank's commercial line of business strategy and whether an *offensive* or *defensive* approach is best.

Once you have decided that, then all the other decisions can be made, including how you increase commercial fee income to offset interest expense, what your new packaged product offerings look like, and how your sales and marketing model changes.

SIX STRATEGIES FOR ACCOUNT GROWTH AND RETENTION

As you consider whether to take the offensive or defensive approach, here are a half dozen strategies to consider that might help retain and even grow your commercial line of business.

Strategy 1 — Emergency Retention

To be proactive, assume that your commercial customers will receive teaser ads touting “free checking plus 2%!” and plan accordingly. The first strategy then is to protect your customers from those attacks through an emergency retention plan. Here's a simple plan:

- *Identify your most profitable commercial customers.* If you don't have the necessary software to do detailed customer profitability, do some simple calculations based on average balances, activity/fees and loan relationships. Then put them into three profitability tiers (high, medium, low). It is not important to have “to the penny” profitability measures for this exercise. Directional profitability is fine.

- *Identify the most “at-risk” customers.* These are customers that are most at risk of being teased away by an aggressive competitive offering. The factors will vary by institution but, generally speaking, high risk customers are those that have few accounts, do not use sticky cash management products like bill pay and remote deposit capture, and do not have a strong personal relationship with their account officer or executive at the bank. Low risk customers have the opposite profile. They have multiple accounts, are active users of sticky products, and/or have solid relationships with their banker. Based on these factors or your own, put your commercial customers into three risk tiers (high, medium, low).
- *Create retention strategies for each grouping.* Your retention strategies might include officers making calls and visits to customers, incenting them to use stickier products, or simply educating them on what the repeal means. Your high profitability and high risk customers probably warrant an officer visit, whereas your low profitability and low risk customers may simply get a statement stuffer.

Even if the competition’s attacks on your commercial customers do not materialize, you will still have benefitted by cementing your relationship with them.

Strategy 2 — Pursue Small Business

There are a number of ways to segment commercial customers — revenues, number of employees, life stage, industry, cash needs, treasury management needs, etc. If nothing else, segment customers into two groups based on size — small business and medium to large business. Look at whether small business is a market you want to pursue. It could be a huge opportunity.

There are 27 million total businesses in the US. Only one million businesses are over \$1 million in revenue, leaving 26 million businesses with less than \$1 million in revenue. Of those 26 million, roughly 25% have between \$100,000 and \$1 million in annual revenue, leaving the other 75% with less than \$100,000 in annual revenue (and 89% of them have no employees). So this is an enormous market.

Many banks focus their sales and marketing efforts on the multi-million dollar business — what most people consider the middle market. These are the companies that maintain large balances, buy treasury management services, and have lending needs. But, most banks ignore the small business segment, even though they already have most of the products to service it.

Small business customers are 2.5 times more profitable than a retail customer. They are also more affluent — an estimated 66% of small business owners are affluent versus 33% of consumers. In addition, there is a strong cross-sell opportunity between an owner’s personal and business accounts; an estimated 65% of small business owners have their personal account with the same bank.

The small business segment is also underserved by the big banks. This segment values trust, advice, service, and long term relationships. Effective small business banking requires a level of service and understanding that big banks struggle to provide.

This segment wants to bank with you, but they don’t know whether you have the products. You do! You just have to let them know.

With all the indicators pointing to a perfect match between community banks and small business — the segment’s large size, its affluence, its appreciation of relationship, and its unfilled need for products and services — it is

curious why community banks do not devote more resources to growing their small business segment.

Experience shows us that, in fact, many community banks have a strong desire to grow small business and even pride themselves on being a small business bank, but they often make some fundamental mistakes when approaching this market:

- They lead with lending instead of deposits and payments.
- There's no ownership or accountability for developing small business.
- They offer “me too” products.
- They wait for small businesses to walk into the branch.
- They are reactive order-takers instead of proactive, advice-based sellers.
- They give away too many services for free.

This market requires a different go-to-market strategy than consumers or higher-end commercial customers. They want simple payments products, QuickBooks integration, and their loans are in the range of \$50,000 or maybe \$100,000. That speaks to a different sales and delivery model than your consumer or high-end commercial models.

Strategy 3 — Lead with Deposits

To be effective in the commercial space, particularly in the small business market, banks must lead with deposits. A bank's commercial sales focus should start with getting the deposit business. The customers' payments business will follow, and eventually their loans. The reason for this strategy is simple: every business needs a checking account, but not every business needs a loan. You will have much more sales success if

your first and consistent focus is on getting your commercial client's deposit and payments business than if your sales model is to sit back and wait for that client to need a loan.

This may require a culture and philosophy change within your institution, and it must start at the top with support from the CEO.

Strategy 4 — New Sales Model

In our experience, the number one problem in growing community bank's small business and commercial cash management lines is selling. The sales model we typically see works as follows:

- Commercial lenders focus on selling loans to medium and large-sized companies. As one of our client CEOs put it: “They only want to hunt elephants. They're not interested in hunting quail.”
- The cash management group sells their services to medium and large-sized companies. Although, the commercial lenders are supposed to bring in the cash management group on most deals, that rarely happens.
- Branch managers are supposed to be out in the community selling to small businesses. The reality is that they are so bogged down in branch management that they hardly ever leave the branch. As a result, the only new small business accounts the bank gets are those that are opened by the small business owners that walk through the front door.

The end result of this typical sales process is that no one officer in the bank “owns” small business. This is why we recommend establishing the Business Banker position. Their responsibility is to sell deposits, targeted cash management services, and loans to the small business segment. They are expected to be out of the



branch, pounding the pavement, making cold calls, and even opening accounts at the *customer's* location.

This is a simple illustration of the sales continuum and where branch bankers fit.

Community banks are generally very strong on the right side of the arrow. You know how to provide excellent service and can build good relationships.

Unfortunately, most community banks come up short on the left side of the arrow.

It is rare that an individual possesses the skills and traits required to excel at performing the functions at both ends of the process. Therefore, the primary strengths of the Business Banker should be in performing those functions on the left side of the sales process: cold calling prospects, qualifying and establishing needs, and building relationships.

Strategy 5 — New Packaging

Before you start paying interest on them, it is time to revisit your business packaged accounts and all their parts and pieces. In addition to looking at balance requirements and service charges, consider bundling in sticky products like bill pay or remote deposit capture — even if you don't overtly charge for it. We are also

encouraging our clients to evaluate a simplified commercial DDA offering — perhaps one free, one almost free, and one analyzed account.

One best practice in building bundles is to build them with the sales interview process in mind. What three to five questions does a CSR need to ask to be able to point customers to the right product? You want to employ advice-based selling and that means the CSR will need to do more than just ask, “How many checks do you write?”

You might also evaluate industry-specific packages. For example, we recently did a market analysis for a \$200MM bank, and they were shocked to see that they had 2,800 health services companies in their markets. As a result, we built a healthcare package for them that includes medical lockbox (EOB) and remote deposit capture. They will add equipment leasing as a lending product as well.

Strategy 6 — Competitive Differentiation

Before we wrap up our discussion of strategies for responding to the imminent repeal of Regulation Q, let's not forget good old competitive differentiation. How do you differentiate your bank from the competition? And — before you say it — the answer cannot be “We give better service.” Why not, you ask? Because a

prospect cannot immediately see “better service” as a differentiator. “Better service” must be experienced, meaning that the prospect cannot appreciate that differentiation until they are already a customer.

Here is an example to illustrate this concept: Suppose you are shopping for a mechanic. You see advertisements touting “Great service” and “We treat you like family.” Then, you see an ad that states “15 minute oil change or it’s free.” Which one stands out?

Your differentiation might be that you offer a special product or a good price, or that you have some particular industry knowledge. Whatever it is, it needs to be a truly unique differentiator — one that no one else can claim. Then proclaim it! And deliver on it every day.

SUMMARY

With the repeal of Regulation Q fast approaching, banks face a number of decisions. While you are developing your strategic plan and deciding whether you will take an offensive or defensive approach, your first step is to implement the emergency retention strategy to protect relationships with your current customers. Once you have done that, you can begin executing your plan step by step, keeping a close eye on the competition — including credit unions. July 21st is right around the corner. Get started today!