THE DEMISE OF FREE CHECKING

by Steve Brown

As banks look around to squeeze profitability, one deposit account that has been standing out is free checking. Many banks resisted free checking when it was introduced on a mass basis back in the 1995. Then, as it is now, the fully-loaded cost of selling and administering a free checking account was between 65bp and 140bp per annum (depending on account volume, cost structure of the bank and account attribute). This is a minimum cost structure of just over $500 per account. This makes all but the highest balance accounts unprofitable on a stand alone basis. However, by 2001, most banks found they could make money by attaching free checking to overdraft protection and charging fees for the privilege and usage.

Now, proposed changes in the Unfair and Deceptive Acts or Practices ("UDAP") statute, coupled with lower cost of funds estimates for community banks (thereby driving down free checking's risk-adjusted return) and negative public sentiment, has put the future of this product in question.

Practical proof of this is evidenced in the demise of Washington Mutual. Their high interest cost of deposits, in combination with a high infrastructure cost, paired with low margin assets, doomed their business model from the start. When we questioned them about their deposit account structure, such as the use of Free Checking, one of their points was that it was a customer attractant and a loyalty builder. When Wamu started to have problems last year, it was their online banking and direct deposit customers that stuck around, not their free checking clients. Like high cost CD depositors, free checking customers are a fickle and fee sensitive bunch.

We understand that HSBC, Regions and TD Banknorth may stop offering free checking going forward (but will keep existing accounts). Meanwhile, Wells Fargo and JP Morgan have not traditionally offered free checking and they are rumored to be interested in ending the practice at their respective acquisitions (Wachovia and WaMu).

The Fed, OTS and NCUA have all agreed on a set of changes to UDAP that will fundamentally alter free checking. It is highly likely that going forward, banks will need to offer greater OD/NSF fee disclosure, in addition to offering the ability to opt out of overdraft protection, with free checking. The result will be higher cost, lower fee revenue and increased credit risk for banks (as an estimated 5% of accounts will opt out, but still OD their account).

Don't get us wrong, we are fans of free checking, as long as it is used efficiently. The best way to do this is in a bundled package and/or through balance constraints. For banks that offer standalone free checking, the future trends of higher infrastructure cost, lower interest rates, more overdraft regulation and lower checking volume dramatically alters the profitability of these deposit accounts. The simplest solution is to re-institute a monthly fee. However, to gain a competitive advantage, the better move is to continue to build the bank's brand and product bundle to increase loyalty and profitability. Fax machine-based (a new consumer trend) remote deposit capture, direct deposit, money market accounts, greater branch availability and better financial tools (that we discussed yesterday) are just some of the many tactics banks can employ to improve profitability.

Given this environment, free checking is just one of many products in a bank's deposit line-up that should be reviewed. While free checking may be free for your customers, most likely that is no longer the case for your shareholders.

TARP CPP S-CORP CAPITAL MODEL

The release last week of the S-Corp TARP Term Sheet has prompted us to update our TARP capital model. The cost and structure of the S-Corp capital is similar to Private Bank terms with the exception of the fact that it does not create a second class of stock. For S-Corp banks that are interested in calculating the all-in cost of the capital, please click to complete the registration and receive this complimentary model: http://www.zoomerang.com/Survey/?p=WEB228QBLNKURF

BANK NEWS

FDIC Backed Debt

The FDIC announced that it will unveil the details on the new 10Y debt guarantee program this Tuesday. While the same 125% debt limitation remains, insurance premium pricing is expected to be in the 50bp range (versus 1% with the TLGP Program).

US Bank

4Q earnings dropped 65% to $330mm as the bank wrote down $253mm in securities and increased ALLL.

CRE Prices

Moody's indicated commercial real estate prices fell 3.4% in November, the 2nd biggest drop in history.

Sallie Mae

The Federal Gov't has agreed to be the buyer of last resort for student loan conduits (the 1st of its kind) in an attempt to spur student loan volumes. Lenders will sell Federal Family Education Loan Program loans to the conduit in exchange for cash for new student loans.

Foreclosure Numbers

According to the FDIC, nearly $23B in real estate is owned by lenders, a 134% rise from 2007. On the flip side, 45% of sales involve foreclosed homes, though according to RealtyTrac's database, 70% of foreclosed homes have yet to be listed for sale.