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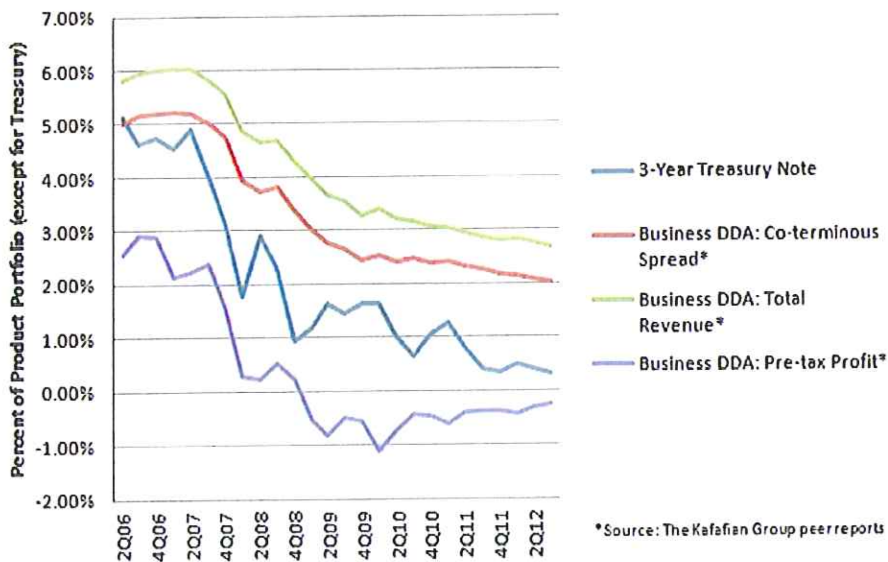
Business checking--not profitable

By Jeff Marsico, Executive Vice-president, The Kafafian Group, Inc.

Does it make sense for business bankers to seek core deposits from their customers? This question was posed to me by a senior lender at a Northeast bank that had a declining loan to deposit ratio. This was putting pressure on the bank's net interest margin--a story all too common in the current economic environment.

The more technical answer is more complex. According to my firm's product profitability report laid out in front of this banker, business checking was unprofitable. That's right, unprofitable (see chart). Regulators and the "free" everything mentality we perpetuated put heavy pressure on checking fees. The interest rate environment is



My answer: an unequivocal yes. The simple response to the "why" was that large financial institutions were being ornery to small businesses by tightening credit standards and generally being non-responsive, creating an environment ripe for community bank plundering. I told the bank to hunt when the hunting was good, not when you are hungry.

putting even heavier pressure on the spread.

The chart shows trends of four data points: the 3-year Treasury Note to provide context for the declining spread; business DDA total revenue that includes coterminous spread plus fees as a percent of business checking balances; co-terminous spread; and pre-tax profit.

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Co-terminous spread is defined as an interest credit of a similar duration market instrument (such as an FHLB borrowing) less interest expense. Which in the case of non-interest bearing checking, is zero.

Following the ski-slope progression of the Treasury, total revenue suffered a 314-basis-point decline from the second quarter 2006 until the third quarter 2012. While revenue was declining, the operating expense per business checking account rose from $680 to $844 per account for the same period. The obvious result is that business checking went profit-negative in the first quarter 2009 and has not yet recovered.

So why pursue business checking?

Because bank costs are mostly fixed. Sure, bankers are evaluating their operating infrastructure and processes to reduce cost, as they should do periodically. But costs don't shift much, if at all, on a per account basis. Even in today's low-rate environment, business checking has total revenue of 2.67% of its balances. Only business loans, commercial real estate loans, consumer loans, and retail checking deliver higher revenues per account on a percent basis--although retail checking delivers less revenue in dollars per account due to lower average balances.

Another reason to pursue business checking is because the sales cycle to win a core deposit business relationship is typically longer than the sales cycle to win a commercial loan. It would be convenient to fund loans with core deposits on an as-needed basis. But that simply does not reflect reality.

If you would like to fund a $2.5-million commercial real estate transaction with core deposits, you need 100 business checking accounts, based on my firm's peer group average deposit size per account. How long does it take your institution to acquire 100 net new business checking accounts? Business deposit acquisition takes advanced planning.

In summary, on the face of it, spending scarce resources on business checking makes little sense. Most financial institutions are awash in liquidity, there is little loan demand, qualified investments are at historically low yields, and business checking is currently unprofitable. But those that forget the past are destined to repeat it. Time deposits and wholesale funding became prolific in the mid 2000's, when loan pipelines grew faster than our ability to fund them. The recession has given us the opportunity to right-size our funding sources. Why set us up to repeat our previous lack of planning? Now is the time to win relationships, increase business customer loyalty, and enhance the value of our franchise over the long term.

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Jeff Marsico, Executive Vice President of The Kafafian Group, Inc., specializes in strategic planning, process improvement, performance measurement, and financial advisory. He has over nineteen years of financial industry experience, including: IT, trust operations, retail branch management, strategic planning, financial institution M&A, consulting, and capital formation.

The Kafafian Group, Inc. is a finance, strategy and operations consulting firm that specializes in performance measurement, profitability outsourcing, strategic planning, process improvement, and investment banking advisory services for the financial industry.

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