CORNERSTONE ADVISORS

REINVENTING CHECKING ACCOUNTS

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A WHITE PAPER COMMISSIONED BY
strategycorps

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EXECUTIVE SUMMARY

At the risk of sounding melodramatic, free checking accounts are toast (or at least they should be). Financial institutions need to establish a new value proposition for checking accounts in order to produce a core financial product upon which FIs can build and grow their customer and member relationships.

These are Cornerstone Advisors' conclusions from our analysis of a study of U.S. consumers we conducted in Q3 2017, as well as from our consulting and research experience. Broadly speaking, we have two recommendations for mid-size ($500 million to $20 billion in assets) FIs:

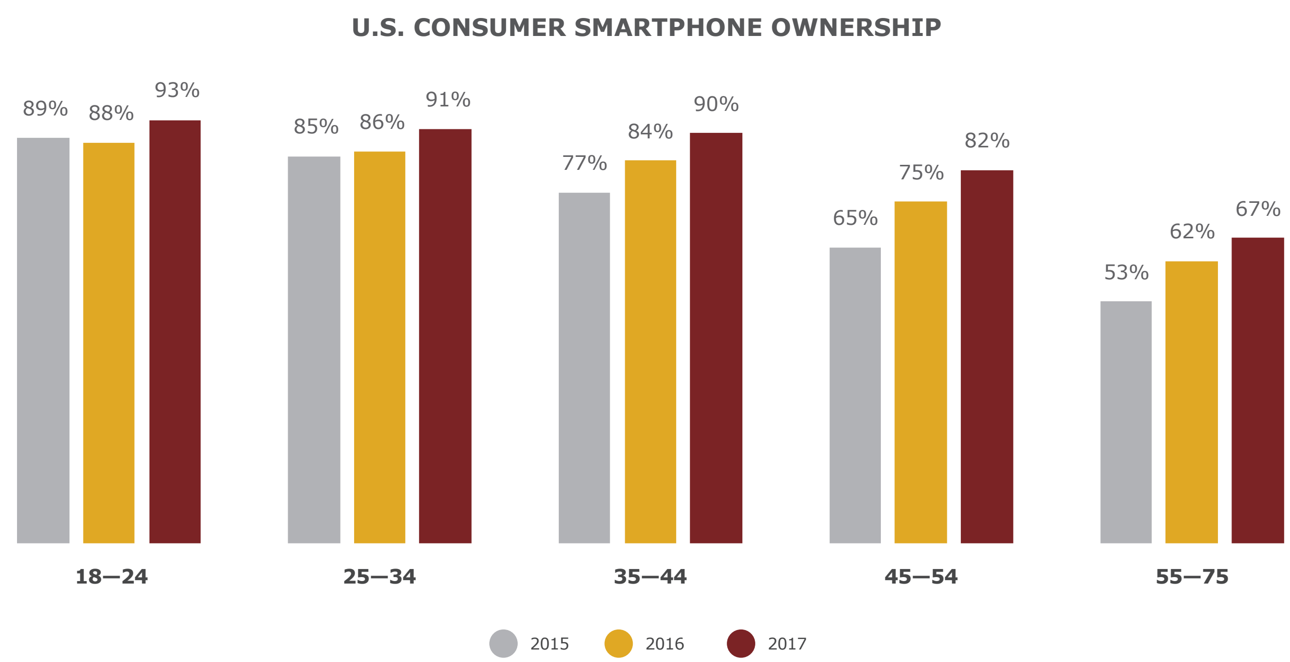
1. Phase out free checking accounts, and

2. Bundle checking account with packages of value-added services targeted to specific consumer segments.

ABOUT THE DATA

In Q3 2017, Cornerstone Advisors surveyed 2,015 U.S. adults between the ages of 21 and 72 (Millennials, Gen Xers, and Boomers, but not members of the Silent generation) who have a checking account and own a smartphone about their banking attitudes and behaviors. The sample is not representative of the overall U.S. adult population, but was selected because we believe it best represents the population of consumers that banks and credit unions are looking to acquire and serve. If you think we excluded too many Boomers with the smartphone ownership restriction, please consider this: two-thirds of consumers between the ages of 55 and 75 now own a smartphone (Figure 1).

FIGURE 1: **Smartphone Penetration by Age Group**



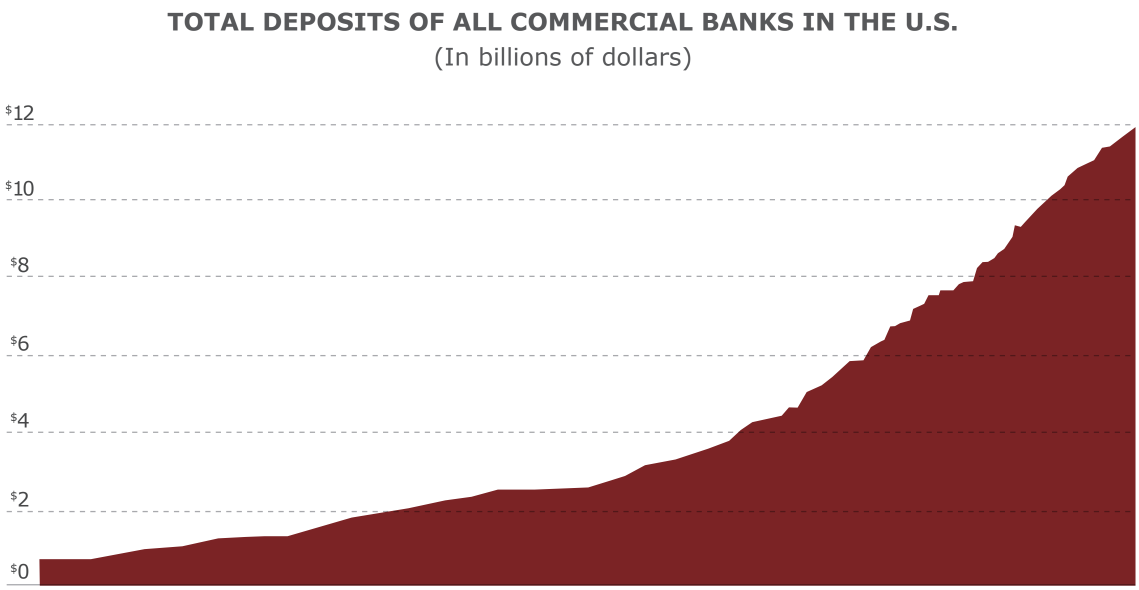
Source: Deloitte

Within the generational cohorts surveyed, respondents are representative of the age, gender, income and geographic location found in the U.S. population. For the purpose of the analysis, we grouped respondents into four segments: 1) Young Millennials, born between 1988 and 1996 (i.e., 20-somethings); 2) Old Millennials, born between 1980 and 1987 (30-somethings); 3) Gen Xers, born between 1964 and 1979; and 4) Boomers, born between 1945 and 1963.

THE THREATS TO CHECKING ACCOUNTS

Between 2000 and 2016, the number of checks written in the United States declined from 41.9 billion to 17.1 billion, a nearly 60% drop. Bad news for checking accounts, right? Wrong. According to the FDIC, the percentage of U.S. households without a checking account dropped from 8.2% in 2011 to 7% in 2017, and since 2000, deposits at banks have tripled.

FIGURE 2: **Bank Deposits, 1975 to 2015**



Source: FDIC

THE THREAT OF DEPOSIT DISPLACEMENT

So, all's well with checking accounts, right? Not quite.

There is a longer-term trend hampering FIs' efforts to keep up the pace of growth. We have a name for this trend: **deposit displacement**. Here are four examples of how deposits are being displaced from checking accounts:

1. **Health Savings Accounts.** Devenir Research projects that deposits in health savings accounts will approach $45 billion by the end of 2018, up from less than $14 billion in 2012. Where's that money coming from? It's siphoned away from consumers' primary checking accounts and into HSA accounts that are probably not held at the same banks as the primary checking accounts.

2. **P2P Payments.** Venmo is on track to do about $35 billion in P2P payments in 2017. While that's impressive, a source tells us that Venmo has $2.2 billion of funds sitting in users' accounts—and not in those users' bank accounts. Displacement through P2P payments will only increase, as Apple has announced that its P2P payment tool will park users' funds in an Apple prepaid debit card, and not in the users' checking accounts.

3. **Retailer Mobile Apps.** In 2016, *The Wall Street Journal* reported that Starbucks had $1.2 billion in deposits on customers' loyalty cards. That number is likely more than $2 billion today. As other retailers copy Starbucks' approach to mobile apps, deposits held in retailers' mobile apps will continue to grow.

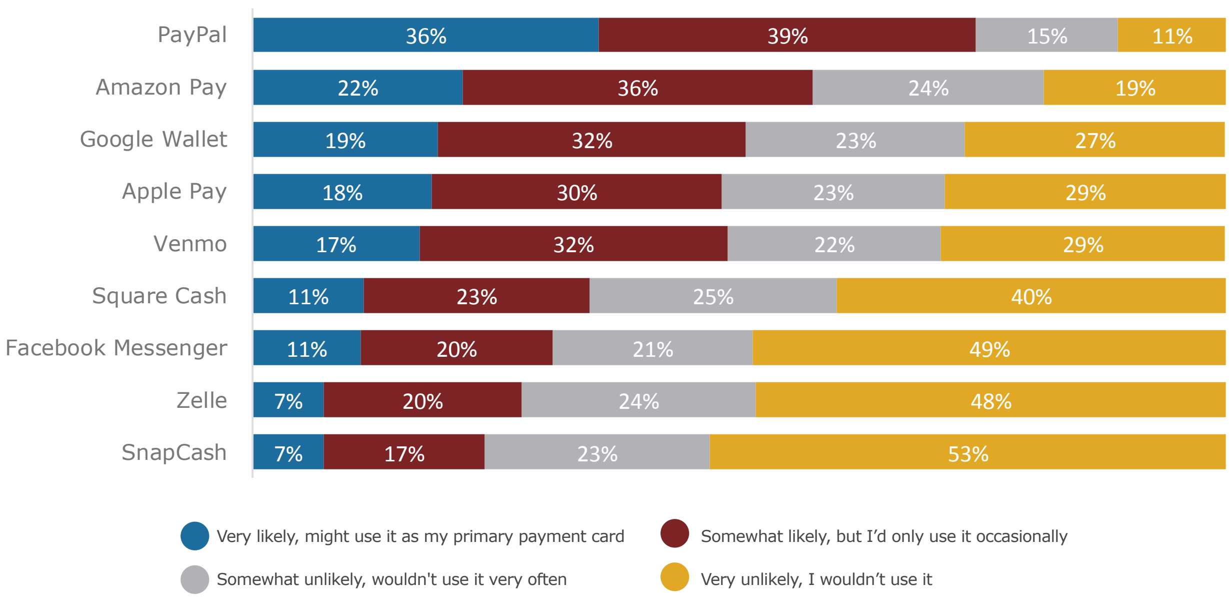
4. **Robo-Advisor Tools.** Consulting firm AT Kearney estimates that assets held in robo-advisor tools will reach $2.2 trillion by 2020. While this might point to a business opportunity for banks, it's also a threat. Kearney believes half of those assets will come from currently non-invested assets—in other words, bank deposits.

THE P2P THREAT

The threat of person-to-person payment providers goes beyond the displacement of deposits into P2P payment accounts. When asked about their interest in using a general use debit card (that could be used at retailers and merchants), 36% of Young Millennials said they would be very likely to use one from PayPal, and another nearly four in 10 said they'd be somewhat likely to use it. Among Old Millennials, half said they would be very likely to use it and might make it their primary card, with a third saying they would be somewhat likely to use it (Figure 3).

FIGURE 3: **Young Millennials' Interest in a General Use Debit Card from P2P Providers**

HOW LIKELY WOULD YOU BE TO USE A GENERAL USE DEBIT CARD FROM THE FOLLOWING P2P PROVIDERS? (Base = Young Millennials)

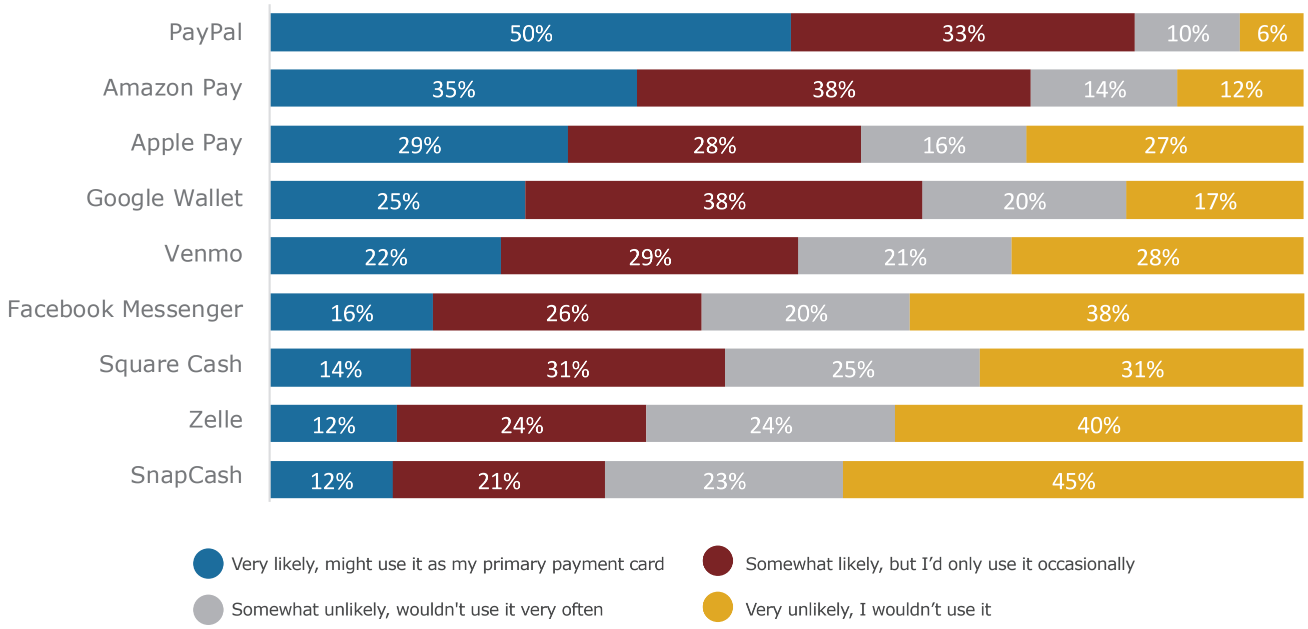


Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

Interest is even greater among Old Millennials (Figure 4).

FIGURE 4: **Old Millennials' Interest in a General Use Debit Card from P2P Providers**

HOW LIKELY WOULD YOU BE TO USE A GENERAL USE DEBIT CARD FROM THE FOLLOWING P2P PROVIDERS?
(Base = Old Millennials)



Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

SO WHAT

Many bankers have dismissed the threat of P2P payment providers like Venmo because of the providers' lack of revenue generation. What those bankers have missed is the brand affinity these firms have built with consumers.

THE AMAZON THREAT

There's plenty of speculation regarding Amazon's potential entrance into banking. Although we don't believe that Amazon wants to be a bank or acquire one (because it pursues a platform business model), the threat of an Amazon checking account is very real. But maybe not in the way that you think.

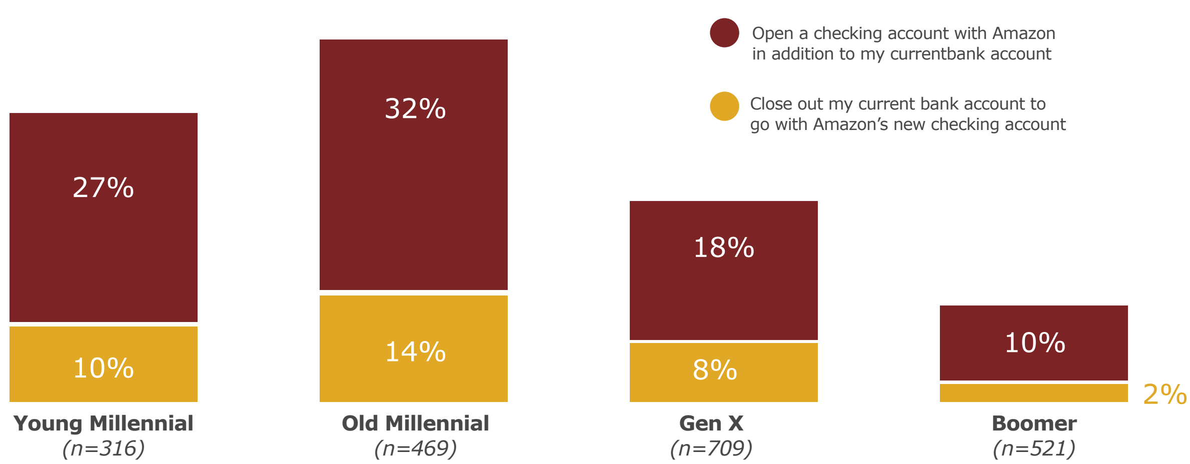
In our survey, we told respondents:

> *"Amazon is thinking of offering a checking account. For a fee of $5 to $10 a month, the service will include cell phone damage protection, ID theft protection, roadside assistance, travel insurance, and product discounts."*

Although there isn't much interest in this service from the older two generations, 37% of Young Millennials and 46% of Old Millennials said they would open this account. And among the Millennials who said they'd open the account, almost a quarter said they would close out their existing checking accounts to do so (Figure 5). In addition, 38% of Young Millennials and 35% of Old Millennials said they would consider opening the account.

FIGURE 5: **Attitudes Towards an Amazon-Offered Checking Account Bundle**

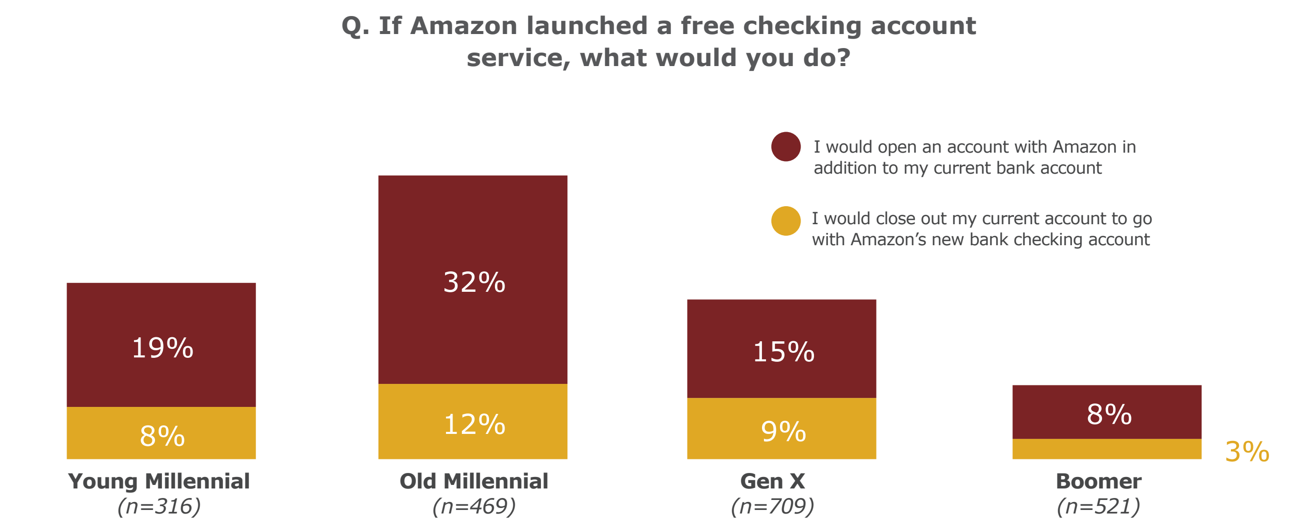
Amazon is thinking of offering a banking product similar to a checking account from a bank. For a monthly fee (somewhere between $5 and $10), the service would include basic checking account services plus cell phone damage protection, ID theft protection, roadside assistance, travel insurance and product discounts.



Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

Interest in an Amazon-offered checking account bundle isn't surprising. But when asked about a free checking account from Amazon—without the bundled services—interest is slightly lower among Old Millennials, Gen Xers and Boomers and substantially lower among Young Millennials (Figure 6).

FIGURE 6: **Attitudes Toward an Amazon-Offered Free Checking Account**



Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

This is music to Amazon's ears. Why would they want to offer a free checking account when they can bundle the services of various providers on their platform—merchants and financial services providers—and charge a fee for it. A fee that consumers are willing to pay for.

SO WHAT

THE DIMINISHING IMPORTANCE OF CHECKING ACCOUNTS

The checking account is in trouble—not because people write fewer checks—but because of the availability of easy money movement, the absence of any benefit to keeping money in the checking account, and the inability of FIs to find a value proposition beyond budgeting and expense categorization capabilities that don't appeal to a broad enough set of consumers.

Checking accounts are becoming just a way station for consumers' money. Direct deposit puts their money into checking accounts, but once there, there's little reason for consumers to keep it there, as they easily transfer it to their P2P, HSA and investment accounts.

IT'S TIME TO KILL FREE CHECKING

Why would consumers show more interest in a fee-based account from Amazon than a free account? One reason is surely the value-added services bundled in. But there's another reason: Consumers have learned (the hard way) that a free checking account isn't really free.

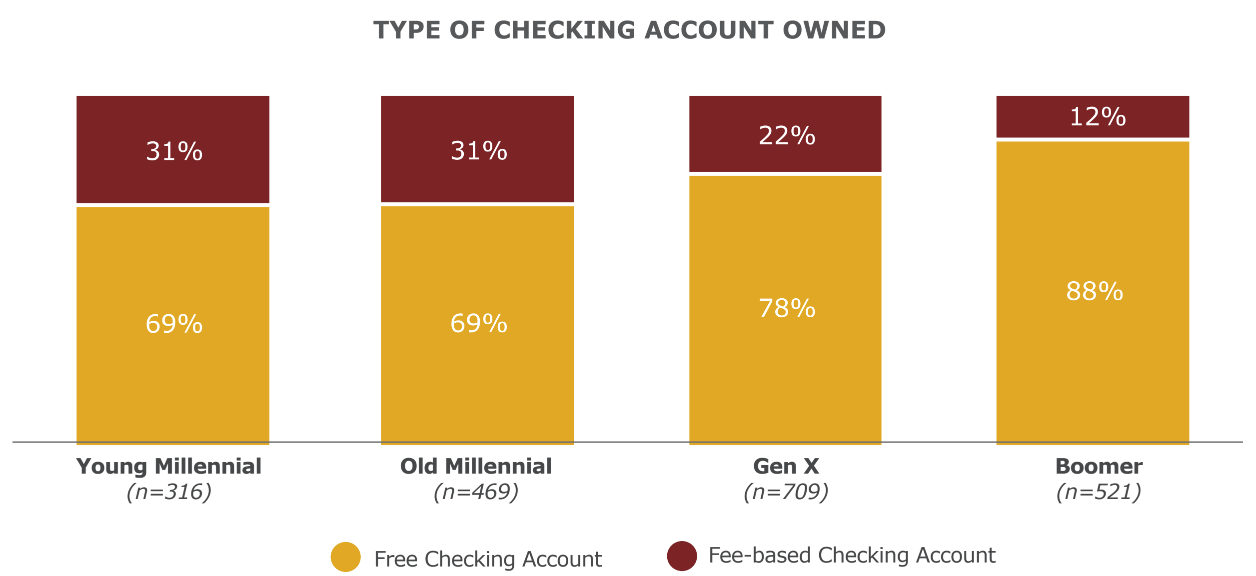
As one bank customer, commenting online, put it:

> *"The issue isn't wanting enhanced services for free, it's the lack of transparency. The $50-new-account offer advertised "free online banking" but did not disclose the $7.95/month ACH service fee on the offer itself. I don't begrudge banks charging for their services; I do begrudge their lack of transparency."*

ACCOUNT TYPE AND FEES PAID

Across our survey respondents, about three in four (77%) have a free checking account, a percentage that varies by age. Among both sub-segments of Millennials, 31% have a fee-based account. That percentage drops to 22% among Gen Xers, and to 12% among Boomers (Figure 7).

FIGURE 7: **Type of Checking Account by Generation**



Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

Among those with a free checking account, roughly a quarter paid a third-party ATM fee in the 12 months leading up to the survey, with a nearly similar percentage paying an overdraft fee. Overall, nearly every free checking account holder paid at least one fee in the 12 months leading up to the survey (Table A).

TABLE A: **Fees Paid by Free Checking Account Holders**

FREE CHECKING ACCOUNT HOLDERS					
	Total (n=1,555)	**Young Millennial** (n=218)	**Old Millennial** (n=325)	**Gen X** (n=554)	**Boomer** (n=458)
Third-party bank ATM fee	26%	27%	27%	27%	22%
Overdraft fee	25%	31%	32%	27%	16%
Replacement ATM or debit card fee	15%	22%	22%	13%	10%
Not sufficient funds (NSF) fee	13%	15%	14%	15%	9%
Wire transfer fee	11%	7%	10%	11%	12%
International transaction fee	10%	8%	16%	9%	7%
Overdraft protection transfer fee	10%	10%	10%	9%	9%
Statement copy fee	8%	7%	8%	8%	9%
Stop payment fee	8%	6%	6%	8%	11%
Check copy fee	7%	6%	8%	7%	7%
Check image service fee	6%	6%	9%	6%	4%
Rush replacement card fee	5%	9%	7%	5%	2%
Extended overdrawn balance fee	4%	5%	6%	3%	3%

Source: Cornerstone Advisors survey of 2,015 U.S. consumers, Q3 2017

The business rationale for free checking accounts is that a free checking account enables FIs to acquire a customer and then cross-sell their way to a deeper—and more profitable—relationship. The data does not support this hypothesis.

REFERRAL AND RELATIONSHIP GROWTH BEHAVIOR

We asked survey respondents two questions about their relationship with their primary FI:

1) How many of your friends and family have you referred to your primary FI over the past 12 months?

2) What other products have you added with your primary FI over the past 12 months?

SO WHAT

The findings are clear: Compared to free checking account holders, a larger percentage of consumers with a fee-based checking account referred others to their primary FI and grew their relationship by adding non-deposit products.

Among fee-based checking account holders, 58% referred friends/family, and 43% added non-deposit products. In contrast, among free checking account holders, 44% referred friends/family, and just 27% added non-deposit products (Table B).

TABLE B: **Referral and Relationship Growth Behavior by Type of Account**

	Fee-Based Checking Account Holders (n=460)	Free Checking Account Holders (n=1,555)
Referred friends/family	58%	44%
Added non-deposit products	43%	27%

Source: Cornerstone Advisors survey of 2,015 U.S. consumers, Q3 2017

With the greater propensity for younger consumers to have fee-based checking accounts, is age driving the referral and relationship-expansion behavior? No. Across each generational segment, a larger percentage of fee-based checking account holders referred their family/friends than did free checking account holders (Table C).

TABLE C: **Referral Behavior by Generation and Type of Account**

	REFERRED FAMILY/FRIENDS	
	Fee-Based Checking Account Holders	Free Checking Account Holders
Young Millennials	61%	57%
Old Millennials	76%	54%
Gen Xers	48%	43%
Boomers	37%	31%

Source: Cornerstone Advisors survey of 2,015 U.S. consumers, Q3 2017

This difference in behavior held true for adding non-deposit products, as well, particularly for the three younger generational segments (Table D).

TABLE D: Relationship Growth Behavior by Generation and Type of Account

	ADDED NON-DEPOSIT PRODUCTS	
	Fee-Based Checking Account Holders	Free Checking Account Holders
Young Millennials	42%	33%
Old Millennials	57%	41%
Gen Xers	39%	23%
Boomers	21%	19%

Source: Cornerstone Advisors survey of 2,015 U.S. consumers, Q3 2017

This is not good news for community-based FIs. Among megabank customers, a little more than half referred family/friends and half added non-deposit products. Among community bank customers, 43% provided referrals and 29% grew their relationships. And among credit union members, 43% referred family/friends, and just 21% added non-deposit products (Table E).

TABLE E: Referral and Relationship Growth Behavior by Type of Primary FI

	Megabanks (n=947)	Large regional banks (n=354)	Community banks (n=202)	Credit unions (n=x316)
Referred friends/family	53%	39%	43%	43%
Added non-deposit products	50%	38%	29%	21%

Source: Cornerstone Advisors survey of 2,015 U.S. consumers, Q3 2017

SO WHAT

The allocation of customers between fee-based accounts and free checking accounts is a significant driver of these differences

Among consumers who consider a megabank their primary FI, 32% have a fee-based account. At large regional banks, one in five customers have a fee-based account. That percentage drops to 12% and 9%, respectively, at community banks and credit unions.

Across each type of FI—regardless of the allocation of fee versus free accounts—more fee-based customers provided referrals and added products than did free checking account customers.

Sixty-two percent of megabank customers with a fee-based account referred family/friends, in contrast to 49% of free checking account holders. At large regional banks, 51% of fee-based customers provided referrals, compared to 36% of free checking account holders. The gap was even wider among credit union members, where nearly six in 10 fee-based account holders referred family/friends, but only 42% of free checking account holders did so (Table F).

TABLE F: **Referral Behavior by Type of Account and Institution**

	% of Consumers That Added Non-Deposit Products			
	Megabanks	Large Regional Banks	Community Banks	Credit Unions
Fee-based checking account holders	62%	51%	50%	59%
Free checking account holders	49%	36%	42%	42%

Source: Cornerstone Advisors survey of 2,015 U.S. consumers, Q3 2017

Regarding relationship growth, half of megabank customers with a fee-based account added non-deposit products, in contrast to 38% of free checking account holders. Among community bank customers, a third of fee-based account holders grew their relationships, but only one in 10 free checking account holders did so. The discrepancy in relationship growth behavior is consistent among credit union members (Table G).

TABLE G: **Relationship Growth by Type of Account and Institution**

	% of Consumers That Added Non-Deposit Products			
	Megabanks	Large Regional Banks	Community Banks	Credit Unions
Fee-based checking account holders	50%	29%	33%	37%
Free checking account holders	38%	21%	10%	20%

Source: Cornerstone Advisors survey of 2,015 U.S. consumers, Q3 2017 Reinventing the Checking Account

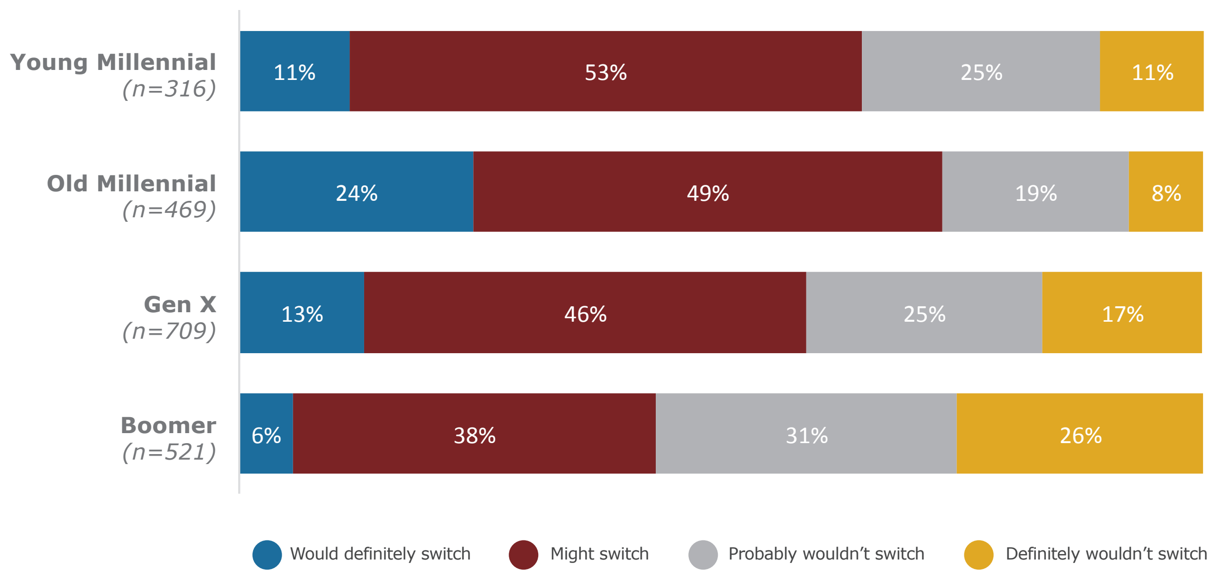
REINVENTING THE CHECKING ACCOUNT

Is it "game over" for mid-size banks and credit unions when it comes to checking accounts? Are the threats from deposit displacement, P2P providers, Amazon and megabanks insurmountable? No.

Despite the prevalence of free checking accounts, many consumers express interest in switching to that hypothetical Amazon-offered bundled checking account we discussed earlier in this report. Even with the prospect of paying a $5 to $10 monthly fee, nearly one in four Old Millennials said they would switch accounts if their primary FI offered a checking account bundled with value-added services, and about half said they might switch (Figure 8).

FIGURE 8: **Account Switching Intentions**

If your primary FI were to offer that Amazon package for a fee somewhere between $5 and $10 per month, how likely would you be to switch from your current checking account to this new account?



Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

The good news for banks and credit unions: Among the 31% of Millennials (young and old combined) who aren't willing to switch accounts, very few (roughly 10%) cited an unwillingness to do more business with their primary institution as a reason why.

VALUE-ADDED SERVICE PURCHASE INTENTION

In addition, consumers show strong interest in purchasing those value-added services—cell phone damage protection, identity theft protection, travel insurance, etc.—from banks and credit unions. Three in 10 Young Millennials and four in 10 Old Millennials said they would purchase these services from an FI—a larger percentage than said they'd buy them from the big tech titans like PayPal, Google and Facebook (Table H).

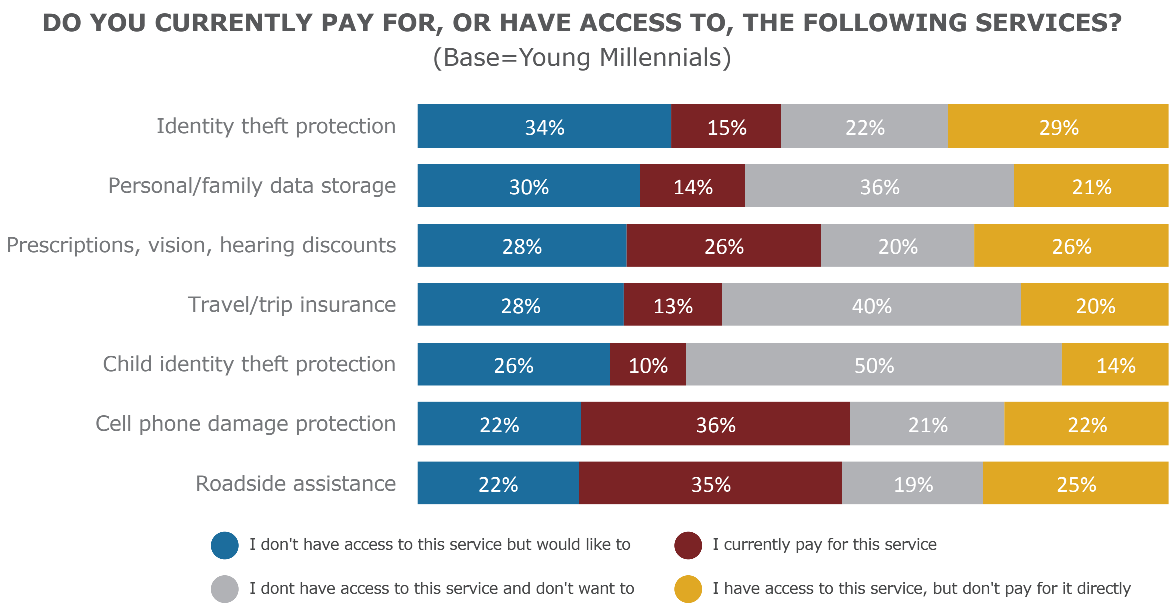
TABLE H: **Value-Added Services Purchase Intention**

FREE CHECKING ACCOUNT HOLDERS				
	Young Millennial (n=316)	**Old Millennial** (n=469)	**Gen X** (n=709)	**Boomer** (n=521)
Amazon	44%	52%	33%	17%
Apple	32%	36%	19%	11%
Bank or Credit Union	30%	40%	21%	14%
PayPal	30%	36%	21%	11%
Google	27%	34%	17%	5%
Mobile Phone Provider	25%	36%	20%	7%
Credit Card Provider	24%	32%	17%	9%
Facebook	18%	25%	13%	3%
Venmo	13%	15%	5%	1%

Source: Cornerstone Advisors survey of 2,015 U.S. consumers, Q3 2017

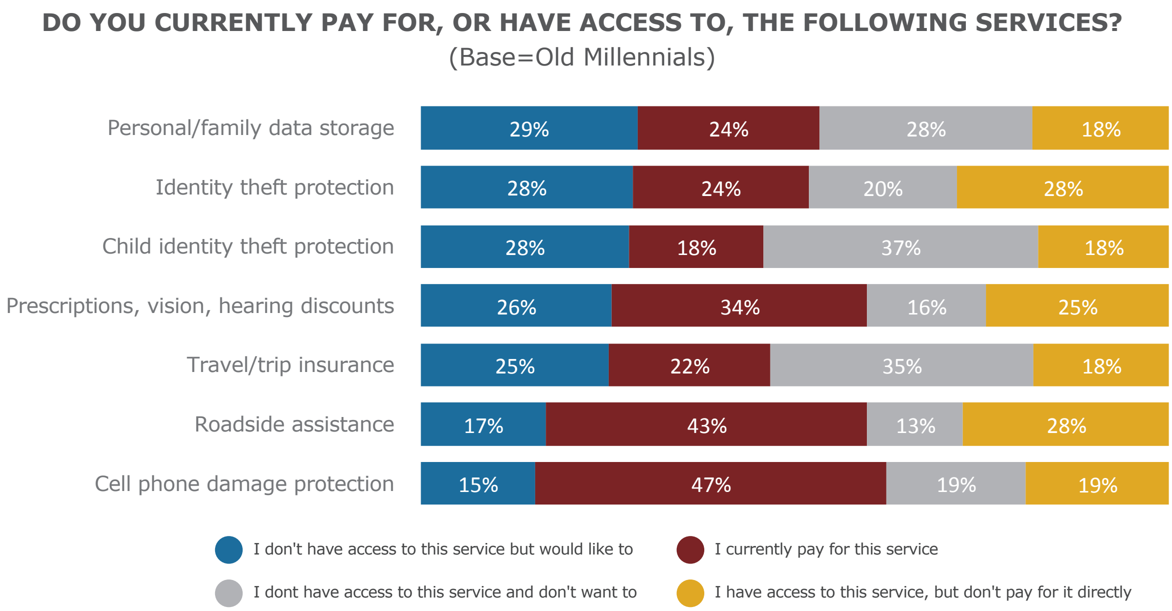
While many consumers already have some of these value-added services, there are still opportunities for banks and credit unions. Among Young Millennials, between a fifth and a third said they don't have access to—but would like to—the seven services we inquired about (Figure 9). Among Old Millennials, between a quarter and three of 10 said they don't have access to—but would like to—five of the seven services (Figure 10).

FIGURE 9: **Young Millennials' Demand for Value-Added Services**



Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

FIGURE 10: **Old Millennials' Demand for Value-Added Services**



Source: Cornerstone Advisors survey of 2,105 U.S. consumers, Q3 2017

CONCLUSION

Mid-size banks and credit unions are faced with a strategic dilemma: how to protect and rejuvenate their checking account product strategies in the face of deposit displacement and threats from non-traditional competitors.

In our interactions with many bank and credit union senior executives, we hear time and time again how they're struggling to remain "relevant" (their word) or become more relevant as consumers' expectations evolve and change, and new technologies emerge.

Our conclusions, based on the consumer study we conducted, are:

1) Today's predominant deployment of a checking account as a standalone product is no longer tenable, and

2) Offering a free checking account in hopes of growing the relationship has not paid off.

The prescription for mid-size banks and credit unions is simple (to describe, if not to execute): Reinvent the checking account to provide more value to how consumers manage their financial lives.

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