Banks Must Adjust to Network Expansion as a Fact of Life

■ BY TIMOTHY RYAN
and STEVEN REIDER

Banks are adding branches at an unprecedented rate, and some analysts are questioning the wisdom of such rapid expansion.

Concerns about higher costs are warranted, but the proliferation is unlikely to slow, because it is being driven by customers.

Bankers should accept expansion as a persistent trend and adjust their assumptions about branch economics and network design accordingly.

THE CASE FOR BIG NETWORKS

Consumers overwhelmingly select banks with the largest networks. Those banks capture not only the most deposits in a market but the most deposits per branch. Many bankers understand this "network effect" and pursue market share growth through expansion.

We examined the 50 largest metropolitan areas and confirmed that larger networks generate more deposits per branch than smaller ones. (Main offices were excluded, to eliminate distortion from large commercial and other centrally booked accounts.)

The study started with the hypothesis that deposit share is independent of outlet share and looked for a correlation between them. It found a positive one between network size and average branch size in 49 of the 50 areas.

We found similar results when we examined Federal Deposit Insurance Corp. data from 1998 and 2003, with the correlation increasing over that period.

The result's pervasiveness indicates that its root cause is consumer behavior. Large networks attract consumers because availability itself has value in banking. "Selling" a transaction account initiates an open-ended relationship within the network, and customers consider how well it can meet their current and future needs.

Branches are often compared with retail or fast-food outlets, yet these similes are only partly correct. A fast-food restaurant must meet an immediate need only; we do not choose to eat at McDonald's today because another one will be convenient when we are hungry two weeks later.

Cell phones provide a more appropriate analogy: Users decide on a particular service with an extensive network so they will never be out of range.

If more branches yield incremental deposit growth, every bank has an incentive to add them. But if all banks add at the same rate, the relative rankings will not change. Facing this "prisoner's dilemma," banks can take one of three approaches:

• Maintain network size, risking the loss of market share as competitors expand their networks.

• Add conventional branches to maintain or increase share, risking profit erosion as balances per branch decline.

• Build a network that maintains or increases outlet share, and reduce per-branch expenses to offset smaller average balances.

THE FUTURE OF NETWORKS

As the number of branches increases, the composition of networks will change. Insights into that future should inform current decisions about infrastructure.

It is critical to understand the process that will govern network development. As markets are scoured for sites, pockets of untapped potential will decrease. Successful branches will attract new entrants, as will emerging growth areas. As a result, average deposits per branch will fall, jeopardizing branch profitability.

Skeptics expect the threat of runaway expenses to restrain expansion. But a "rational" decision by one bank to reject competing for location supremacy will not dissuade competitors or protect it from revenue erosion as others open branches. Equilibrium will be restored only when every bank sees equally dim prospects for de novo profitability.

Under these circumstances, those that can achieve acceptable profits with lower average revenues will have the most options. They will find opportunities in markets that appear "overbranched" and will thrive in locations that would produce a crippling drag on earnings for less adept players.

There are two dimensions to that achievement: outperforming competitors in attracting customers, thereby generating more revenue share; and reducing expenses. Rather than being mutually exclusive, these points are a continuum along which branch programs must be positioned.

Typically, branch design discussions emphasize revenue enhancements from improved sales environments. To the extent that these notions result in added capital and operating expenses, they shift the balance from a low-cost model to dependence on higher revenue. But only anecdotal evidence supports most projections for improved sales. Thus, banks that pursue this approach will struggle to justify new branches as markets continue to tighten.

Competition will be shaped by banks that can continue to act as per-branch revenue drops. When you accept the challenge of having more branches while reining in expenses, it becomes obvious that per-branch costs must decrease. Unless customer patterns shift dramatically, networks will consist of many smaller branches that cost less to operate than today's conventional branches.

Branch design must support location strategy — not the reverse. Just as architectural design cannot overcome the wrong location, so no prototype branch program will succeed unless it enables the execution of an effective strategy.

Institutions that develop successful small-branch formats will realize a significant advantage over those who cling to a conventional, expensive model. Small branches will form the backbone of delivery networks. Banks should begin now to develop the skills needed to excel in this environment.

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Credit Unions Don't Buy Support

■ BY JOHN MCKECHNIE

It is time to speak plainly about the frenzy of bank attacks on the credit union movement.

We are puzzled by the campaign's virulence. As credit unions work to gain the flexibility to better serve their members in a 21st-century marketplace, bankers seem to be striving to eliminate credit unions as a valuable alternative for consumers.

The campaign is not in favor of anything. It is not for increased powers for banks, decreased taxes for smaller banks, or an equal playing field. It is purely a negative campaign against credit unions' attempts to preserve a place in the financial services world by offering a fuller array of services.

And as we watch the bankers' tactics degrade into bounty hunting and buying testimonials, our reaction borders on alarm.

What could be the thought process behind offering a $1,000 bounty for photos that illustrate credit unions' "overreaching" or their "opulent" locations? Does a photo show the hard work, volunteer efforts, and community spirit that can be wrapped up in any exterior? Isn't it misleading to imply a credit union's location means the credit union isn't dedicated to its mission statement? Frankly, we are appalled by the bankers' throwing money around this way.

And can paid-for testimonials really be a good idea? The CUNA recently received a copy of a bank's "Write now!" campaign against the Credit Union Regulatory Improvement Act. The bank's employees are asked to attach their names to a pre-written e-mail opposing the bill and send it to lawmakers. "What's in it for you?" A chance to win prizes.

Does paying people to parrot a position really add to an honest and open discussion? Or does it stack the numbers?

The need to offer compensation to get employees to support a position speaks volumes about the differences between commercial banks and credit unions. If commercial banks stopped looking for ways to rain down new fees on customers and backed away from the megamerger mania that knocks out any local bank's presence in communities, perhaps they would experience the kind of loyalty credit unions receive — a loyalty money can't buy.

The CUNA also asks members to support issues important to the movement. They are not offered prizes or bribes for doing so. Yet time and again board members, employees, and credit union members respond to our calls to action, from our Save Our Sharedraft campaign in the 1970s, to Operation Grassroots in the early 1990s, to our 1998 Campaign for Consumer Choice.

We have gotten millions of signatures on petitions. Most recently, in July we launched a national drive to get members involved in preserving the credit union tax exemption. When we present a petition, lawmakers can be assured that those who signed it did so because they believe in their credit union, not because they won a trip to Hawaii. Credit union employees and members will do voluntarily what the bankers seem to have to pay to get done.

There may be a lesson for the $9.3 trillion commercial banking industry to learn from the $630 billion credit union movement: Members love their credit unions and are very concerned about any attempt to tax them.

Credit unions have tax-exempt status because they are not-for-profit, cooperatively owned, democratically operated institutions whose boards operate on a volunteer basis. Banks do not have tax-exempt status because they are for-profit corporations. Their boards get paid (often very well). They are not democratically operated; in fact, they owe their allegiance to stockholders, not customers.

Fair treatment does not always mean identical treatment.

The argument that credit unions should be taxed if they want to offer a fuller array of services is disingenuous. Not-for-profit hospitals expand their services by bringing in state-of-the art technology. Should they be taxed for wanting to provide better service? Should they retain their exemption only if they offer shoddy treatment? Isn't the exemption better spent on a fully functioning business that serves its community well?

Credit unions, banks, customers, and stockholders would all benefit if the bank lobbying groups would take back their prize money, halt their anti-credit-union campaign, and refocus on productive endeavors.

Congress can expect a vigorous debate on the issues surrounding credit unions and their 85 million members. Constituents on all sides will surely weigh in. I can promise this: When credit union members contact a legislator, they will give a genuine representation of their feelings. And they won't be paid to do it.

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