A Quarterly Journal

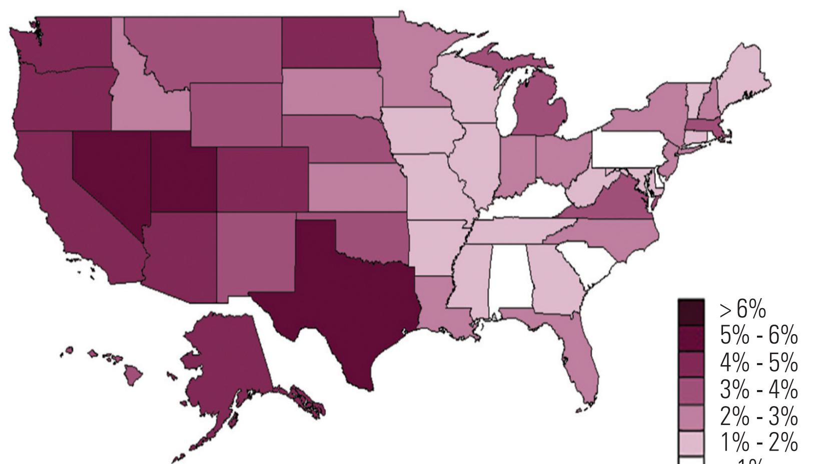
BANCOLOGY

JANUARY 2015 VOLUME 53

THE ART OF POSITIONING
bancography
BRANCH PRODUCT RESEARCH BRAND

Pruning the Obvious, Impact of Economic Recovery and Other Findings from the 2014 FDIC/NCUA Deposit Statistics

Recently released branch deposit statistics show a moderate increase in U.S. deposit totals and a moderate decline in U.S. branch counts. The FDIC and NCUA reports, which provide data as of June 30, 2014, show the U.S. as an $11 trillion deposit market, up 7% from the prior year.



Deposit Growth 2013-2014

Commercial banks and thrifts hold 91% of that total, versus 9% for credit unions. Filtering out large corporate main offices gives a truer indication of consumer and small business deposit activity; and that segment's deposit base grew by 2.8% in the past year.

In the consumer and small business segment, credit unions outpaced commercial banks, growing deposits at 3.5% versus 2.7% for banks, continuing a trend that has persisted since the onset of the recession. However, the disparity between credit union and bank deposit growth rates remained modest, mirroring 2013's level and sharply down from the peak recession years when credit unions reaped significant gains from consumer perceptions of banks and their role in the financial crisis.

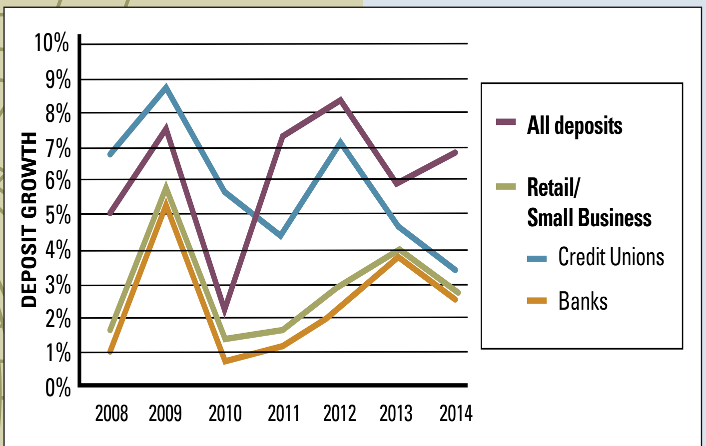
The sizable disparity between overall deposit growth and consumer/small business growth reflects the continued improvement of the health of the corporate sector. With economic growth (as measured by the U.S. gross domestic product) at its highest level in more than 10 years and corporate profits at or near record levels in many sectors, corporate deposits have soared. However, those same factors have fueled (continued on page 2)

Surveys Reveal Divergent Trends in Bank and Credit Union Customer Relationships

Branding studies evaluate an institution's brand awareness and strength in a market. Bancography's Brand Evaluator conducts telephone interviews with a random sample of households in a market, including a known group of the client institution's depositors retrieved from that bank or credit union's MCIF system. Although the survey panel includes that 'oversample' of the sponsoring institution's customers, the survey itself is masked, i.e., interviewers do not reveal the name of the survey sponsor.

The aggregate findings from the oversample in recent surveys show increased fragmentation of bank customer relationships. The Brand Evaluator provides the respondents with the opportunity to cite up to five institutions that provide banking services, yet in 2014 19% of customers in the client sample failed to mention the sponsor institution, up from only 11% in 2012. Correspondingly, only 60% of these customers identified the sponsor institution as their primary provider, down from 72% in 2012. Further only 67% of respondents who cited the sponsor bank as their primary institution stated they would recommend it, versus 75% in 2012. In addition, the average number of total providers inched upward, as consumers reported dividing their relationships among 2.0 providers in 2014 versus 1.9 in 2012. All three statistics confirm bank customers spreading their relationships across a broader array of providers. (continued on page 3)

Impact of Economic Recovery and Other Findings *(continued from page 1)*



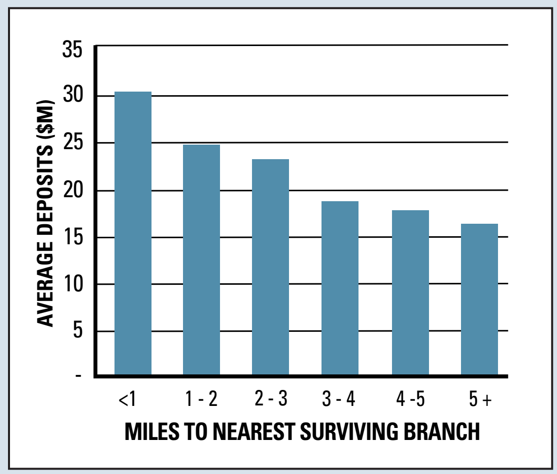
rampant gains in the stock market, luring consumers back to securities investments after years of more conservative behavior, thus tamping growth of safe, insured deposits even as declining unemployment has raised aggregate income levels.

Deposit gains were concentrated in the western part of the nation. Eleven states posted consumer / small business deposit growth of more than 4% over the past year, with Washington DC the only east coast interloper in a group that also included (in growth-rate order) Utah, Nevada, Texas, North Dakota, Washington, Colorado, Oregon, California, Arizona and Alaska. The growth in those top-performing states reflects two primary factors: energy exploration and recovery from the housing downturn. At the opposite end, the lowest-growth states were concentrated in the Southeast (Alabama, South Carolina, Mississippi, Kentucky) and the Northeast (Delaware, Pennsylvania, Rhode Island, Vermont).

Despite the modest deposit gains, branch counts declined in the past year. The U.S. shed 1,700 branches over the past year, net of opens, a decline of 1.5% from 2013 counts. The decline in branch counts pervaded all regions of the country. Only five states added branches in the past year, and of that group the maximum gain was only six offices. The largest branch declines occurred in Arkansas, Maryland, Virginia, Wisconsin, Oregon and Illinois; each shed about 2.5% of its 2013 branch inventory. Among the 20 largest U.S. banks, only Wells Fargo and US Bank countered the prevailing trend by increasing their branch networks in the past year.

Note though that the aggregate changes in branch counts mask significant opening activity; for example, a bank can show a net decline of 10 branches by opening 20 branches but closing 10. Along those lines, Wells Fargo and Chase each opened more than 50 branches over the past year, while TD Bank and US Bank each opened more than 30 branches. California and Texas each saw about 150 branch openings in the past year, and New York, Florida, Pennsylvania, Illinois and Massachusetts each saw 60 – 90 branch openings in that period.

Many of the industry's branch closures appear driven by profitability constraints or efforts to rationalize blatant overlaps that likely persisted from previous mergers. Whereas median deposits for all U.S. branches exceeds $37M, the median deposits for the branches that closed in the past year was only $16M, and two-thirds reported deposits of less than $25M. About one-third of the closed branches sat within 1 mile of another branch of the same institution, indicating low-risk consolidation opportunities, and more than half sat within 2 miles of another branch of the closing institution. The two primary reasons for closure yield distinct profiles of the affected branches, with higher-balance branches typically closing only where a nearby office could mitigate the risk of severe attrition; but lower-balance branches closing with less consideration of whether a nearby branch could address that lower volume of impacted customers. The average deposit base of closed branches within 1 mile of a surviving branch of the closing institution was $30M, compared to $25M for those branches 1 – 2 miles removed from a surviving office, and deposits declining in lockstep each successive mile. The chart below confirms that banks are reticent to place larger balances at risk when branch proximity can not assure retention.



Mergers also left a significant mark on the competitive landscape in the past year, as 156 banks and 252 credit unions departed the industry through either merger or failure (with failures accounting for less than 10% of that total). As a result, there are now 6,650 banks and thrifts in the U.S. and 6,400 credit unions. Despite declining overall branch counts, the surviving institutions are maintaining slightly larger branch networks. Even with the above-noted contractions in the networks of the largest banks, U.S. banks now average 14.2 branches each, versus 13.4 just two years prior.

With many institutions having pruned their smallest branches and closest overlaps, the industry will find fewer simple close decisions remaining. Thus, those considering branch consolidations (other than overlaps created by future mergers) will need to exercise greater caution regarding customer attrition in future close decisions, especially as an improving economy gives greater value to the branch network's ability to attract low-cost deposits.

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Less is Less: Designing Effective Small Branches

Historically, branches required large lobbies to accommodate long lines of customers in queue for multiple teller stations. Nearly every banker can point to a one-time main office in their institution with a banking hall of 8,000 square feet or more and 15 or more teller windows. However, as transaction demand has eroded, branch square footage has declined commensurately, leaving many institutions to consider just how small they can compress branch floor plans. Over the past few years, numerous large banks such as Wells Fargo, Fifth Third, PNC and BMO have introduced "micro-branch" formats, and many smaller institutions have joined the effort, albeit with fewer accompanying press releases.

There is no firm definition of what constitutes a micro branch, but most pilot efforts have fallen in the 800 to 1,200 square-foot range. The concept of delivering banking services from a small footprint is by no means new; it was more than 30 years ago that Community Bank & Trust opened the nation's first in-store branch in Cornelia, Georgia, heralding a wave of 300 – 600 square foot facilities operating within the premises of grocery stores or other retail partners. However, this latest wave of small-format branches typically refers to single-tenant offices, rather than retail-partner locations.

In conceptualizing such offices, bankers must recognize that shrinking the branch footprint demands tradeoffs; simply shoehorning the same functions and processes of a traditional 3,500 square foot branch into a space one-third that size will not foster efficient operations. Rather, bankers considering small-format branches must start their pursuits by defining the objectives for the facility, and the role it will play in the institution's network; then determine what personnel and equipment are required to fulfill that objective. Some tradeoffs are obvious; for example, a 900 square foot branch will not be able to accommodate safe deposit boxes. But others require more in-depth consideration of strategic priorities.

- **What is the institution's position in the market?** If your institution holds strong market share, transaction demand may be significant, indicating a design where a prominently located teller function would be essential to quickly dispatch routine deposit and withdrawal functions.
- In a newer market where an institution maintains a small customer base, transaction demands should remain moderate, allowing the branch to deemphasize the teller function. But this still leaves **several options for resolving transaction needs:** a traditional-teller approach, but with a smaller than typical teller complement and the support of teller cash recyclers; a remote teller approach, where cash needs are fulfilled by video remote tellers domiciled in a centralized call center but operating dispenser machines within the branch; or a fully automated approach, where advanced-function ATMs support all deposit, withdrawal and check-cashing activities. Which option an institution pursues should reflect its brand and value proposition, including the degree to which it values personal service versus being perceived as a technological leader.
- It is also important to consider **whether the branch trade area contains a high concentration of businesses.** Many retail-and service-sector firms have daily cash requirements and as such may question whether a branch lacking a dedicated commercial teller station can efficiently address their needs. Consider business demand carefully before committing to a small-format branch; and if pursuing a market with high business concentration, be sure the branch design provides adequate space for cash storage and handling.
- Underlying the above considerations is whether the branch will maintain cash at all, or whether it will rely on ATMs for all **cash-handling needs.** An intermediate option is to use teller cash recyclers in lieu of a vault; i.e., all cash at the branch is stored within the recycler machines, and there is no cash safe or vault. Both of these options can reduce the footprint required to house the branch, but both may preclude servicing business customers who require opening change orders. The no-vault model also limits the ability to accept and reconcile night deposit bags; non-cash branches can still accept night deposits, but must use couriers to transport the contents to other branches or a centralized cash facility for processing. If opting for traditional teller functions, teller capture — where incoming checks are scanned for item processing at the teller station versus in a separate workroom — can also reduce space requirements.
- **Can the branch dispense with traditional platform workstations entirely?** One tactic to reduce space needs is for customer service representatives to use laptop or tablet computers versus traditional workstations. Untethered from a specific desk, they can then host discussions with customers in designated sales areas of the branch.
- **Will in-house personnel be equipped to deliver all products, or will more sophisticated products require support from officers at nearby branches?** If the latter, be sure to reserve space in the floor plan for the visiting bankers and provide sufficient connectivity to support their needs.
- **How will the branch ensure customer privacy in such a small space?** Be sure to consider tradeoffs between privacy and branch operational efficiency. Traditional walled offices maximize customer privacy, but prevent a senior branch officer from seeing potential security *(continued on page 4)*

Surveys Reveal Divergent Trends *(continued from page 1)*

Credit unions showed contrasting results, as the proportion of members in the oversample failing to cite the sponsor institution declined from 36% in 2012 to 27% in 2014. Fifty-four percent of respondents named the sponsoring credit union as their primary financial institution in 2014, versus 44% in 2012. While the improvement in those levels countered the experience of bank customer respondents, note that banks still outperform credit unions in terms of the absolute values of those measures. However, credit unions outperform banks on a key loyalty indicator, with 80% of members who cited the sponsor institution as their primary provider indicating a willingness to recommend that credit union to others, the same proportion as in 2012. The oversample group on average reported using 2.0 financial providers in 2014, down from 2.1 in 2012. In direct contrast to the bank findings, each credit union statistic confirms greater consolidation of relationships among customers in that sector of the industry.

The recession weakened brand loyalty for commercial banks, and credit unions leveraged that event to invest in cross-sell initiatives, closing the gap with commercial banks in terms of awareness and propensity to serve as a customer's primary financial provider. Though still trailing commercial banks on those measures, the disparate trends in credit union versus bank performance may herald increased competitive parity across the two types of financial services providers.

issues or customer backlogs. Accordingly, even enclosed offices may need glass (or other transparent glass-like) partitions so that bankers can maintain visual control of the branch.

- Finally, **consider the message the branch seeks to convey to its audience.** Does the small-format branch represent a new operating model that underlies a broad expansion strategy ina new market? Or is it a one-time endeavor to position the institution as aligned with the latest trends and technology in the industry? The merchandising themes in a branch with operational goals will differ from those in a branch that pursues branding goals first with new-account volumes only a secondary consideration.

In any small-branch effort, it remains critical to balance operational and aesthetic considerations. Thus, when planning a micro-format branch, define the objectives, and be sure that branch operations personnel join the retail delivery, marketing and facilities representatives in the effort. Take cues from in-store branches, which have experience operating in limited square footage, and visit competing branches, too. But keep in mind that while a key objective of small-format branches is to reduce operating costs, the greatest benefit any branch offers is the ability to place the institution's best asset – its skilled, knowledgeable, local bankers – in front of customers. Toward that end, even the most technologically forward branch should seek to enhance rather than replace the abilities of the branch sales staff.

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