

**OPPORTUNITY IN FLAT GROWTH MARKETS: WHEN CUSTOMERS RELOCATE**

When bankers evaluate a new market for branching, household growth is almost always the first statistic they seek as a gauge of market opportunity. And this is certainly sensible, since it is easier to thrive in a market where additional households can support the added branch than in a flat growth market where a new branch just carves the existing household pool into one more slice. This belief has led bankers to branch aggressively into Florida, Texas, Arizona, and other high-growth areas.

But many markets lack the level of growth that some sun belt areas enjoy, so bankers must be confident that they can grow their institutions in flat growth markets too. Of the over 900 metropolitan areas in the United States, 320 metros, or 35%, are expected to show household growth of less than 5% during the next five years. Where then, can bankers find opportunity in these markets?

Fortunately, it is not household growth by itself that creates opportunity. Rather, when new household growth is considered as indicative of opportunity, it is because the statistic impounds the number of households that will arrive in a market without a pre-established routine from their home to their nearest branch. Yet new housing construction is hardly the sole source of new household

arrivals in a market. Household turnover, or purchase/leasing of existing housing stock, offers similar opportunities.

Consider as an example the Boston, Massachusetts metropolitan area. With 4.5 million residents in 1.7 million households, it ranks among the 15 largest markets in the United States. From 2000 to 2006, its household base grew by only 4%, or an additional 77,000 households. But in that same time frame, 820,000 existing households, or nearly half the metro's household base, moved into new residences. Thus, the pool of new residents of existing homes was over ten times larger than the pool of new home constructors. The overwhelming majority of those existing home purchasers were not new arrivals to Boston, but rather the result of in-market migration.

Though certainly familiar with the Boston metro and likely already carrying a relationship with a Boston financial institution, residents in each of those 820,000 newly sold (or leased) households were finding new routes to work, to their children's schools, and to the local grocery store. And in many cases, the route would be to a different job, a different school, or a different grocery store.

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**MEETING THE CHALLENGE FROM INTERNET BANKS**

Online banking has grown precipitously in recent years, driven both by consumers' adaptation of the channel and increased marketing efforts by competing institutions. In 2000, only 17% of US consumers used online banking channels, according to the Pew Internet & American Life Project. By 2006, nearly half of all banking customers used online services for either balance inquiries, bill payments, or account openings.

The terms online banking, e-banking, and internet banking are sometimes used interchangeably. However, the FDIC distinguishes between conventional banks that offer services and internet-primary banks. The FDIC defines an internet-primary bank as a financial institution that primarily delivers services online without a traditional branch network. The nation's largest

internet-primary banks include subsidiaries of non-bank financial firms such as MetLife Bank, ING Direct, USAA Bancorp, and E-Trade Financial, as well as institutions conceived as online only banks such as NetBank and Nexity Bank.

Often perceived as the province of only the technologically savvy younger consumer, internet-primary banks are also embraced by rate sensitive senior citizens. Internet banks thrive on two attributes: the ability to re-deploy non-interest expenses that otherwise would support physical branches into premium rates; and the convenience of allowing account opening activities any time the customer chooses. However, lacking any means for face to face contact, internet primary banks face difficulties in customer retention.

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There are several implications for bankers in a neighborhood with high household turnover. In terms of customer acquisition, institutions should pursue programs targeting newcomers. These can range from simple programs such as sponsoring activities and events at local schools (always a first stop for new families in a community) to more complex initiatives such as buying a list of recent postal change of address filings and courting the new arrivals through direct mail and calling campaigns. Since many of the new residents will be arriving from within the same metro, they may have pre-existing relationships with a marketwide institution that has branches in both their former and new neighborhoods. But even these relationships are in play, as the new branch will need to demonstrate that its service matches what the customer experienced in their former neighborhood.

Of course, while high turnover creates opportunity, it also carries risk. For every existing household that has a new occupant, an old occupant needed to leave. And, except for those who left due to mortality, each departing household represents a possibly retainable relationship. In order to maximize retention, be sure that current customers understand the reach of your institution's branch network and the breadth of its telephone and Internet offerings. And when customers show signs of relocation such as changing their address, applying for a mortgage, or closing a home equity line, ask questions and take the opportunity to inform customers of how they can continue to use your institution in their new neighborhood.

Over 10 million American households will move in the next year. In a flat growth market, it is imperative to have a strategy to court those moving in and to retain those moving out. Even when there's no growth, there is still ample opportunity in most markets.

## MEETING THE CHALLENGE FROM INTERNET BANKS

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Rather, internet-primary banks must rely on call centers, e-mails, and live online chats to interact with their customers in real time.

Of course, internet banking is not only the domain of internet-primary banks. Many large institutions and an increasing number of smaller institutions also support online account openings. However, conventional banks can not readily match the rates promised by internet-primary banks for fear of having to price up their entire portfolios – including their more expensive branch-captured deposits.

So how can a conventional bank compete against the premium rates offered by internet-primary banks without jeopardizing its margin?

- ✦ Emphasize relationships over individual accounts. With most internet-primary banks emphasizing only a single product, usually money market accounts or CDs, these institutions have little ability to match the one stop financial needs shopping that traditional banks can offer. Over 85% of internet-primary bank households maintain single service relationships with their providers, compared to 45% - 55% for most traditional banks.
- ✦ Although rate remains the primary motivator for internet-primary banks, customers also choose such

institutions for their ability to open and service accounts on a 24 hour basis. Upgrading your institution's call center service levels to offer similar capabilities can mitigate the rate advantage online banks enjoy.

- ✦ Convenience of locations nearly always ranks as the most frequently cited reason why consumers choose their primary financial provider. Despite prepaid mailers for deposits and fee reimbursements for ATM withdrawals, the branchless banking model remains less than convenient in the eyes of most consumers. Emphasize the convenience and service quality of your bank's branch network in advertisements, merchandising, and in customer conversations.
- ✦ Promote your bank's own internet offerings, not necessarily from a pricing standpoint, but be sure your customers understand all the services you can support even when your branches are closed. Can consumers view product information on your web site? Compare account options? Change their address? Open new accounts? Be sure your customers know that just because you don't portray your institution as an exclusively online bank doesn't mean that the online channel isn't available to those who prefer banking remotely.

## BRANCH PROFITABILITY: HOW TO CALCULATE MARGIN USING SPREADS

In building a model to project the profitability of new branches, the calculation of net interest margin represents one of the more challenging tasks. Since interest margin reflects the interest earned from loans and the interest paid on deposits, it comprises the most significant line item on the projected branch's income statement. Yet because it can require assumptions about current and future rates, the margin calculation can prove difficult.

Two of the common questions regarding margin calculations are:

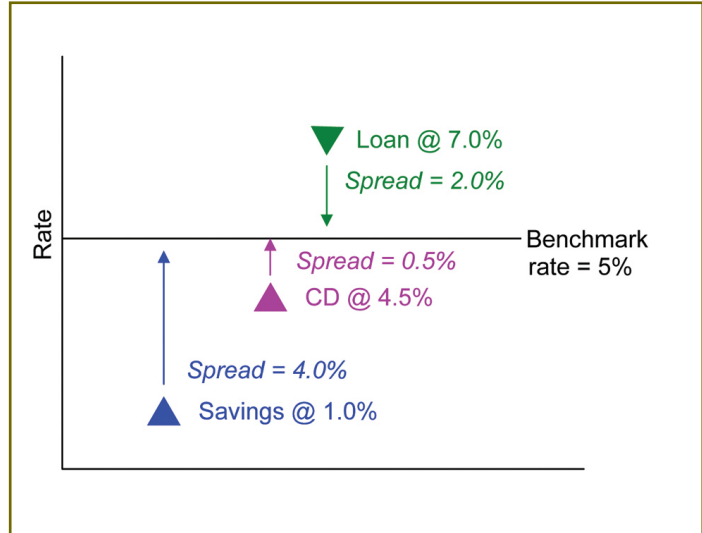
- If margin represents the difference between interest earned and interest paid, what rates should we apply to our forecasted balances in each product category, especially since rates could vary widely over the next five years?
- And since in most branches deposits greatly exceed loans, how do we reconcile the fact that net interest margin will be negative, rendering the branch unprofitable even before we factor in expenses?

To address these issues, Bancography recommends using a spread to pooled rate approach to calculating interest margin. This approach presumes that the institution maintains a central treasury that will buy or sell funds at a fixed benchmark rate. The difference between the rate paid on deposits (or the rate earned on loans) and the pooled rate – the spread between those rates – represents the margin income from a given product.

There are two primary benefits of the pooled rate approach. First, it rewards every product with a positive contribution to earnings, reinforcing the branch's incentive to sell all products that meet the consumers' needs while placing the responsibility for re-deploying excess deposits with the corporate treasurer. Second, because all product rates tend to move in close correlation with benchmark rates, spreads tend to remain constant over time even as specific rates vary. The following example explains the pooled rate approach.

Suppose an institution has set a benchmark pooled rate of 5%. If a customer opens a savings account paying 1%, the treasury will 'buy' the deposit from the branch at the benchmark rate of 5%, leaving the branch with a spread of  $5\% - 1\% = 4\%$ . If the customer opens a CD at 4.5%, the spread would only be  $5\% - 4.5\% = 0.5\%$ . Similarly, if the customer opens a loan account at 7%, the treasury will 'sell' the branch the funds for the loan at the same benchmark 5% rate, and the branch will earn a spread of  $7\% - 5\% = 2\%$ .

The spread value, when multiplied by projected balances for the corresponding product type, yields the net interest margin for each product portfolio.



The benchmark pooled rate can be any number between the institution's weighted average cost of funds and its weighted average loan yield, but is typically the Federal Reserve discount rate, the LIBOR, or some other widely available statistic. By choosing a value between the cost of funds and the loan yield, the institution divides its margin between deposit and loan products, with all products receiving a positive spread. Raising or lowering the pooled rate will reward either deposit or loan products, respectively, so manipulating the rate allows the institution to determine which products will carry more weight in the branch financial projections.

Bankers sometimes fall into a trap where loans are credited with the difference between their funding cost and their yield; and deposits are credited with the difference between their cost and the rate at which they're invested. But, this approach will double-count all revenues and yield a net interest margin twice the correct value. By using a pooled rate that splits the total margin between deposit and loan products, one avoids the double counting trap.

### Apology

You may have noticed that you're receiving the March issue of *Bancology* in April. Apologies...but we've been swamped. But a sincere thanks to all our clients who have kept us so busy, and a promise that you will receive the June issue...in June.

Bancography will exhibit at these upcoming conferences:

- **Texas Credit Union League Annual Meeting & Convention**, April 10 - 12, Austin, Booth 513
- **Credit Union Executives Society NEXUS Conference**, April 24 - 26, Dallas, Booth 405
- **Texas Bankers Association Annual Convention**, May 9 - 11, Austin, Booth 211

Kimberly Clay will present "Banking Best Practices from the Customer's Perspective" at the **Financial Communications Forum** in Boston, April 11.

Steve Reider will present "Designing and Implementing a Retail Sales Scorecard" at the **Indiana Bankers Association Mega Conference** May 1 - 3 in Indianapolis.

Bancography employee **Paul McDaniel** recently received his Master of Science in Geography from the University of Tennessee.

Bancography will release **Delivery Channels: The ATM White Paper** in April. Web-based technology has transformed the ATM since the beginning of the 21st century. This White Paper will detail the daunting challenges and the exciting possibilities of the new generation of ATMs. For more information or to order **Delivery Channels: The ATM**, call (205) 251-6227 or visit [www.bancography.com/ATMWP.html](http://www.bancography.com/ATMWP.html).

Bancography is pleased to announce its partnership with the **Arkansas Community Bankers Association**. Bancography will offer discounts on its Bancography Plan software and Branch Site Analysis products to ACB member banks.

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