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THE ART OF POSITIONING
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Of the 380 metropolitan statistical areas in the U.S., 71 show the seemingly contradictory (and historically unusual) combination of below-median unemployment but also below-median deposit growth.

Finding Deposits: *In Withering Markets, Difficulty Looms*

At the peak of the recession of 2008 - 2009, unemployment soared to 10%, the highest level in 26 years. The stock market implosion that accompanied the start of the recession brought a spike in deposits to banks and credit unions with 6% growth in 2009, the fastest rate of the past 15 years. This occurred for two reasons: first, the 'flight-to-quality' phenomenon, wherein consumers seek safer investments in times of economic tumult, favoring insured deposits versus volatile, risky stocks; and second, because of the statutory extension of the deposit insurance from $100,000 to $250,000.

However, after that initial boost, the economic slowdown manifested itself in significantly slower deposit growth, averaging only 2% per year over the next three years. As the economic recovery took hold in 2010, unemployment steadily decreased, but at varying rates in markets across the U.S. During that period, at the market level, employment levels served as an excellent predictor of deposit growth. That is, states and metropolitan areas that experienced more rapid improvement in unemployment levels saw correspondingly greater deposit growth rates, a phenomenon Bancography has previously documented (see Bancology April 2016, *The Relationship between Employment Levels and Deposit Growth*).

But as unemployment has approached record levels, exceeding the level economists typically consider as full employment, deposit growth has nonetheless stagnated in some markets; defying the once reliable trend. The cause-and-effect relationship between employment and deposit growth would appear to be readily apparent: as unemployment declines, the scarcity of available workers creates upward pressure on wages; and as employees then receive greater raises, they can deposit their excess earnings in checking, savings, money market and CD accounts.

Although certain conditions could counter the general trend, these were historically isolated outliers. Yet of the 380 metropolitan statistical areas in the U.S., 71 show the seemingly contradictory (and historically unusual) combination of below-median unemployment but also below-median deposit growth. As illustrated below, when unemployment sits above the nation-wide median, markets are 1.6 times more likely to show below-median deposit growth (30% ÷ 19%). When unemployment falls below the nationwide median, markets are 1.7 times more likely to show above-median deposit growth (32% ÷ 19%).

		Unemployment		
		Below median	Above median	Subtotal
Deposit growth	Below median	19%	30%	49%
	Above median	32%	19%	51%
	Subtotal	51%	49%	100%

In examining the 71 markets in the counter-intuitive low-unemployment/low-deposit-growth quadrant, an explanatory factor emerges. Despite their strong employment environments, almost all the low/low markets remain nearly devoid of population growth. The 71 markets in the quadrant averaged only 1.3% population growth over the past five years, less than half the nationwide 3.5% pace in that period. Understandably, the absolute lowest population growth markets consistently show the alarming combination of low deposit growth and high unemployment. Of the 38 metros that suffered

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Over the past 10 years, the unemployment rate has provided a reliable predictor of deposit growth. But as markets approach full employment, it appears a group of low-population-growth markets have hit a ceiling where marginal gains in employment can no longer overcome the constraints of a fixed population base.

Finding Deposits: In Withering Markets, Difficulty Looms (continued from page 1)

population declines of at least 1% over the past five years, 33 fall into the high-unemployment / low-deposit-growth quadrant. In these declining markets, it may be impossible to salvage deposit growth in the near or medium term. But even in markets with strong employment environments, in the absence of population growth, deposit growth remains sluggish.

The failure of high employment levels to generate deposit growth in low-population-growth markets may reflect several underlying causes:

- First, declining unemployment does not eliminate underemployment, where residents fill part-time jobs despite wanting and needing full-time employment. Markets with a sizable base of part-time employees seeking to grow into full-time employment may not generate sufficient wage pressure to create the surplus disposable income that sits in bank deposits.
- Further, as unemployment has sat below 4% for an extended period without manifesting the inflation that economists caution, many economists have hypothesized the full employment rate may sit below what has been historically theorized. In that the 4% threshold supposedly impounds workers in transition (e.g., voluntarily between jobs), the lesser friction of today's world — where online postings can quickly unite employers with job seekers — may lower the threshold, requiring even higher employment levels to create upward wage pressure. Similarly, the contractor-based 'gig' economy, where an unemployed worker can almost immediately find work with Uber, GrubHub or similar, may allow reported unemployment statistics (which count such contractors as employed) to exceed levels that previously would have created upward wage pressure.
- Perhaps reflecting some of the aforementioned factors, wage growth has remained tepid throughout the now 10-year economic recovery; especially in nonmetropolitan areas and among those who did not change jobs, which is more common in areas without expanding population bases. In every census since 1910, the proportion of Americans living in urban versus rural areas has increased, and rural-to-urban migration patterns have turned particularly acute in some markets. For example, in Nebraska the state-wide household base increased by 3.7% over the past five years, even as 55 of the state's 93 counties showed household-base declines. Larger markets such as Omaha and Lincoln gained households, but at the expense of small-city and rural markets. Numerous other states replicated this pattern. Many markets with declining population bases may have entered an economic stasis, where even low unemployment can not fuel wage growth, as firms resist investing in a perceived declining market.
- There are other possible explanations for the lack of deposit growth in low-unemployment markets, most plausibly that consumers are investing additional income in stock market or online banks, or simply spending versus saving the additional funds. However, the growth rate in consumer equity holdings remains similar to the growth rate for insured deposits (and keep in mind, stock ownership is highly concentrated, with less than 10% of households accounting for more than 50% of U.S. securities holdings); the rate of cannibalization of local deposits by online providers is unlikely to vary by market type; and the consumer savings rate has remained relatively stable across the past 10 years. Again, this leaves the combination of tepid wage growth and the inability of that to offset an absence of household growth as the primary culprit in low deposit growth in certain markets.

For bankers maintaining branches in low-population growth markets, the above findings carry notable implications:

- In smaller, rural or flat-growth markets, employment-count gains are not enough. In an economy with apparently more workforce slack than previously believed, real wage growth remains elusive. Accordingly, without expanding the pool of actual depositors, it will be difficult, if not prohibitive, to generate deposit growth.
- The rural-to-urban migration trend shows no signs of abating. While numerous smaller metros are enjoying population growth (especially in the model of the Omaha example, i.e., largest metro in a mostly rural state), it helps to have a primary lure such as a university, or retirement amenities. Absent such appeals, bankers will need to focus their civic engagement efforts on work with local development agencies in job recruitment programs.
- In terms of items under the direct and immediate control of bankers in slow-growth markets, two tactics appear imperative. First, from a funding and revenue standpoint, bankers must consider expansion options into (continued on page 4)

Interactive Teller Machines: Adaptation, Use and Challenges

As in-branch teller activity continues to wane, bankers have increasingly sought ways to reduce operating costs. One prominent tactic involves the use of interactive teller machines, or ITMs. Also known as video remote tellers, the machines offer an ATM-like interface, with the enhancement of a video screen that allows customers to speak directly to a service representative domiciled in a call center. The cost savings arise because, with customer arrivals occurring episodically at branches across the institution's franchise, a single call center agent can serve multiple machines (similar to how one teller can service multiple drive-in lanes), reducing overall staff requirements.

That noted, the ITMs present challenges: perceptually, in terms of customer acceptance of a remote versus in-person channel; financially, due to the sizable implementation cost; and operationally, in terms of the implementation and functionality of the machines. To gain more information about the use of ITMs, Bancography surveyed a group of its clients, and received responses from 61 institutions: 34 banks and 27 credit unions. Despite widespread conversation in the industry about ITMs, only 14 of the responding institutions, or about one-fourth of the respondents, have implemented the technology. However, 60% of the remaining respondents cited some level of interest in ITMs, varying from the research phase to concrete plans for implementation in the next year or two.

The study was not weighted by institution type, asset size or geography to yield a representative sample of all U.S. financial providers. As such, readers should interpret the findings below as case studies (or perhaps, an email-response focus group) rather than statistically significant data points directly indicative of the industry overall.

For those considering ITMs, cost is always a key consideration, and the respondents using ITMs cited typical machine costs in the $55,000 to $80,000 range; though this does not include one-time infrastructure costs to support an overall ITM program, which can run from $250,000 to $500,000. As noted, the benefit of that cost lies in staff reduction; and on average, the ITM-using institutions show a ratio of one call center ITM service agent for every 2.4 machines. Almost every respondent using the technology cited an immediate ability to reduce overall staff levels, even net of any add-backs in the call center.

The majority of the responding ITM users have deployed machines in both lobby and drive-in configuration, though a few reserve use for drive-ins only. The group were evenly divided in terms of whether their ITM deployments allowed branches to function in a cashless environment (where the only cash on site is held in the ITM, and serviced by an external, third-party armored courier service), or whether the ITMs served to supplement traditional teller operations.

The centralized representatives operating the ITMs averaged 3,900 transactions per FTE per month, roughly double the 1,900 average transaction volume of branch-based teller FTEs. This implies a one-for-two substitution rate of call center agents for branch tellers, confirming the rationale for the capital investment of the ITMs. That noted, keep in mind ITM costs include not only the hardware of each machine, but also the aforementioned one-time, institution-level implementation costs and monthly cash-servicing and maintenance costs.

As interesting as the data from the ITM-using institutions are, the reasons other banks and credit unions have deferred on the technology remain interesting, too. Reasons cited included:

- An inability of the current core system to support ITM technology
- A belief that, given an option of live teller versus ITM, consumers would always choose the former, creating an "all-or-nothing" decision; i.e., unless the branch converts to full ITM use with no tellers, adaptation would remain sluggish.
- The need to maintain tellers for commercial deposits that are too large for ITMs to process, leaving little incremental cost to using those same tellers for consumer services.
- Costs, both upfront and operating, that push breakeven to 7-10 years.

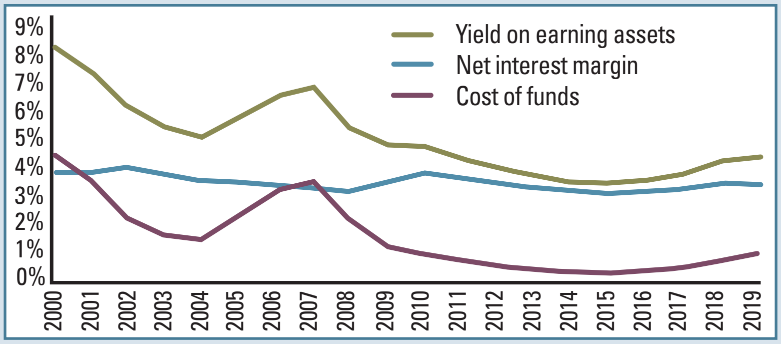
Even among those using ITM technology, some indicated challenges including: coin and currency jams when accepting deposits; unacceptable wait times for maintenance / repair from third-party providers; balancing and reconciliation issues; staff scheduling to accommodate the extended operating hours that are often a key justification for ITMs; excessive wait times between customer inquiry and video-teller response; issues with hardware and software upgrades; and, most importantly, slow customer adaptation of the new technology.

Although ITMs are no longer novel and every banker can point to some institution in their home market using the technology, overall adaptation in the industry remains cautious. Even as some institutions are enjoying expense savings from ITMs, others remain reticent to test the technology due to implementation costs or technological hurdles. Still, the sizable proportion of institutions at least researching ITMs suggests the technology will become an increasingly common component in bank delivery networks.

Quick Fact:

Irrespective of actual rates, banks maintain relatively constant margins.

Across the past 20 years, the aggregate net interest margin of U.S. banks has hovered in an 88 basis point range; across the past 15 years, only 68 basis points separate the highest and lowest margins; and excluding one high and one low outlier, that spread falls to 47 basis points. *(Source: FDIC)*



the next-nearest growth markets. Even with the staffing and marketing expenses that entry to a new market would entail, bankers must acknowledge if they are presently tethered to a stagnant market and respond accordingly. Second, community bankers must consider in-market mergers for cost efficiencies. With growth in some markets unlikely, one path to optimizing profitability lies in eliminating a competitor and folding two revenue streams into a single expense stream. Consideration of mergers involves confronting difficult choices about personnel decisions, executive roles and board seats; but in low-growth markets, such alliances may offer the only path to survival in any form.

Over the past 10 years, the unemployment rate has provided a reliable predictor of deposit growth. But as markets approach full employment, it appears a group of low-population-growth markets have hit a ceiling where marginal gains in employment can no longer overcome the constraints of a fixed population base. The challenge these markets face appears amplified by job growth occurring in part-time or other underemployed positions, which combine with employers' fear of investing in low-growth markets to truncate wage growth. Bankers operating in markets under this economic stasis face few options for survival, likely limited to expansion into higher-growth markets, or in-market mergers that deliver cost efficiencies.

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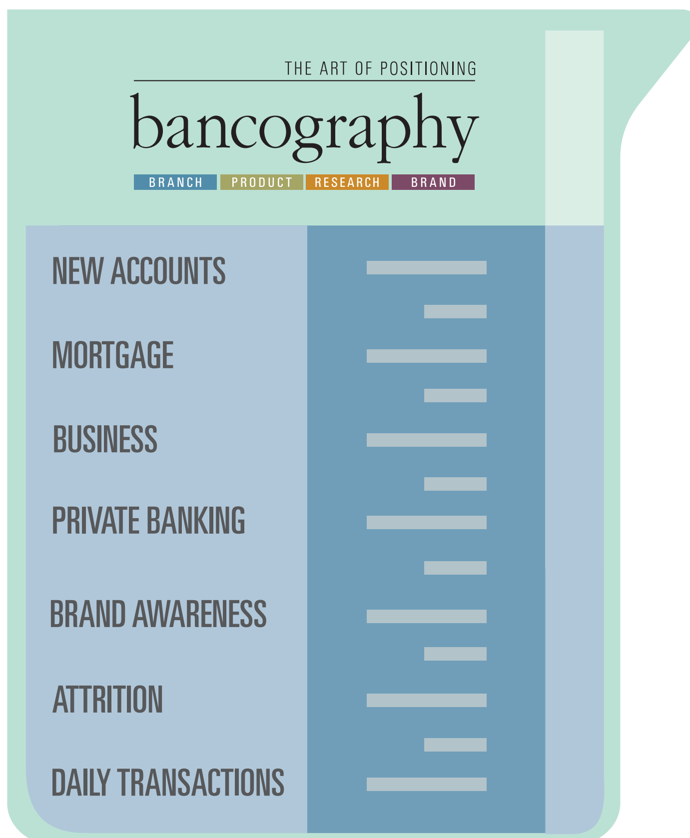

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