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THE ART OF POSITIONING
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Statistics indicate that most branch closures are being effected to resolve post-merger overlaps without reducing market leaders' geographic coverage, or by lower-tier competitors exiting markets entirely.

Are Branch Networks Really Shrinking?

Over the past three years, the inventory of U.S. bank and credit union branches has declined by almost 2,500 units. The decrease has raised questions as to whether it marks the beginning of a sharp downward trend in branches, and if so, what implications that trend would hold for U.S. financial institutions. But while the aggregate numeric decline is irrefutable, its implications remain uncertain, as a look beyond the surface statistic reveals that the decline is neither pervasive in the industry nor uniformly distributed across geographic regions or the spectrum of financial institutions.

Of the declines over the past three years, the most severe was in the 2010 FDIC reporting year, when banks shed almost 1,100 branches. The subsequent two years saw declines of 600 and 750 branches. However, those years also represented the depths of a recessionary period (note too that the 2010 FDIC reporting year ran through June 30, 2010, and thus impounded the nadir of the recession). Thus, cause and effect remain uncertain. Are branch reductions occurring in response to changing consumer preferences, in which case the inventory should continue to decline? Or were the reductions a temporal response to an earnings crisis borne of low loan demand and high charge offs, in which case economic recovery should bring a rebound in branch counts? Some statistical analysis provides insights.

Recent branch reductions are mostly a large bank phenomenon, and skewed toward just a few institutions. During the 2012 FDIC reporting year, 17 institutions reduced their branch networks by 15 or more units; collectively, these banks accounted for 80% of the industry's total branch decline. Ten of these institutions rank among the 25 largest U.S. banks, and all rank among the top 50. The 17 banks that accounted for 80% of the industry's branch reduction held only 23% of all branches (prior to the reductions).

A substantial proportion of recent branch closures arose from in-market merger overlaps. About 50% of the branch closures in the industry over the past three years directly followed in-market mergers (both open-bank and FDIC-assisted transactions). Examples include Wells Fargo – Wachovia, PNC – National City, M&T – Provident, and BB&T – Colonial. The impact of these transactions on close statistics is critical: an institution consolidating two nearby branches is taking a predictable action to improve cost efficiency, but not reducing the number of submarkets in which residents can easily access its services.

If branch closures are in response to consumer preferences migrating away from branches, then the evidence should reveal closures that impact market coverage, i.e., an educated bet by banks that consumers anticipate reduced branch needs and will thus be willing to accept institutions with lesser branch convenience. To confirm or refute this hypothesis, Bancography examined the size of the market-leading branch networks in markets across the U.S. Specifically, the research measured the change in the scope of the five and ten largest branch networks in each market from *(continued on page two)*

Consumer Finances Improving: Evidence from the Mortgage Market

No banking product is more tied to the financial crisis than mortgage loans. The precipitous increase in foreclosure filings dominated the news coverage, affected millions of U.S. households, acutely harmed the balance sheets of numerous banks, and contributed to a prolonged recession. But in 2012, foreclosure filings fell to their lowest level since 2007, and early 2013 statistics show continued improvement. The revival in the housing market should create opportunities for banks and credit unions in both mortgage and equity lending.

Ten years ago, 67% of U.S. households were homeowners. That level peaked at 69% in 2008; but with foreclosures forcing some residents from their homes and economic struggles causing others to sell homes and move to less expensive rental units, U.S. homeownership rates declined to 65% in 2012. That seemingly modest drop of four percentage points equates to almost five million fewer homeowners, so it represents a substantial contraction in the base of potential mortgage and equity loans.

The proportion of homeowners with mortgages has followed a similar pattern. In 2003, 62% of owned homes were encumbered by mortgages; by 2008, that level had risen to 72%. Today, 70% of U.S. homeowners carry mortgages, and by implication, 45% of total U.S. households carry mortgages (65% homeowners times 70% with mortgages). An improving economy *(continued on page three)*

Are Branch Networks Really Shrinking? *continued from page one*

2008 to 2012, seeking to discern whether branch reductions in recent years were a temporal response to in-market mergers or evidence of an enduring structural change. If the former held, then leading bank branch counts should have remained unchanged, with the only closures arising where the bank acquired branches redundant to current offices. If the latter held, then leading bank branch counts should have declined, reflecting closures of non-redundant branches rather than just recently acquired overlaps.

Across the 30 largest U.S. metros, the average size of the five largest branch networks declined in 17 markets, increased in 11, and remained unchanged in two. The largest decline occurred in New York, where in 2008 the five largest networks averaged 522 branches each, but in 2012 averaged 30 fewer, or 492 branches each, a 6% decline. Other cities with substantial declines included Dallas (from 183 to 162, 12%); Philadelphia (179 to 163, 9%); and Chicago (257 to 245, 5%). The average top five branch networks in Detroit and Tampa declined by 10 units. Leading gainers included Riverside-San Bernardino, where the largest institutions now average 78 branches versus 72 in 2008; Portland (from 69 to 75); and Seattle (from 106 to 111). The average top five branch networks in San Francisco, San Diego, and Los Angeles all increased by four units.

Among all large markets (defined as the 102 U.S. metros with 500,000 or more residents), 61 suffered declines in the average size of their five largest branch networks while 24 posted increases. Only three markets outside the top 30 posted net changes of more than five branches per top five bank: Columbus, OH (positive); Austin, TX and Louisville, KY (negative). Although the statistics show moderate evidence that the largest institutions may be willing to compete with fewer branches, the second tier of competitors appear content with their current configurations. Across the 102 large metros, 26 markets showed an average decline in the number of branches held by the banks ranking sixth through tenth in outlet share, and 24 showed gains in the average branch networks of banks in that outlet tier. Only four of the 102 metros showed a net change in either direction of more than two units, even though in the largest markets the average sixth through tenth place outlet position involved more than 40 branches.

The direction and magnitude of changes in branch networks reflects the markets' respective branch concentration levels. Many of the largest gains occurred in markets with households per branch ratios well above the 1,000:1 statistic for the U.S. overall. Riverside, which posted the largest gain in average top five branch network size, ranks as the least concentrated top-30 metro, with only one branch for every 1,900 households. Other leading gainers, including Portland, San Diego, and Los Angeles, also show below average branch concentration. Conversely, some of the most concentrated markets such as Philadelphia, Detroit, Pittsburgh, Chicago, and Boston suffered the greatest branch declines. These statistics suggest that changes in branch counts are less a response to any structural change in consumer preferences than a simple equilibration, a regression of outlying markets toward established coverage levels.

Interestingly, there is no apparent correlation between average leading network size and economic conditions. Some of the metros where the leading networks increased were among the most severely affected by the recession, including Riverside, Los Angeles, and Miami; even Las Vegas eked out a modest one unit per top five bank gain. And while branch count declines occurred in recession-afflicted markets such as New York, Chicago, Tampa, and Atlanta, markets that were less impacted, such as Boston and the large Texas metros, also suffered branch reductions. This suggests that institutions did not rush to close branches simply in response to recession-induced declines in demand.

The decline in the absolute number of branches in the U.S. remains irrefutable, empirically proven in a simple numeric comparison. However, that decline is not wholly manifested in reduced breadth in the networks of leading banks. Rather, the mixture of gains and losses in the average top five bank networks in major U.S. markets suggests that many recent closures offset temporary increases that followed in-market mergers. In markets that experienced declining branch counts, the declines appear to be primarily a large bank phenomenon, wherein market leaders that already possessed near-ubiquitous networks were willing to sacrifice some marginal locations. Even those trends are not universal; though more markets suffered declines in branch counts over the past four years than posted gains, enough markets showed growth to refute the hypothesis that closures reflect evolutionary changes in consumer preferences. Middle-tier banks are showing no evidence of a willingness to reduce market coverage. In markets where leaders close branches, middle-tier banks that maintain their networks will implicitly become more convenient and competitive; and the behavior of those institutions suggests that their executives understand, and embrace, that implication.

A blanket statement that the recent decline in branch counts proves that banks no longer want branches or that consumers no longer need branches is not substantiable. Statistics indicate that most branch closures are being effected to resolve post-merger overlaps without reducing market leaders' geographic coverage, or by lower-tier competitors exiting markets entirely. Branch contractions by market leaders remain modest and mostly restricted to well-saturated markets; and in many less-concentrated markets leading banks continue to expand. Beyond the market leaders, second-tier competitors have shown no tendency to reduce network scope, even in the most concentrated markets.

TOP FIVE BANKS BY OUTLET SHARE

MSA	AVERAGE # BRANCHES	CHANGE IN AVERAGE NETWORK SIZE 2008 - 2012
LARGEST DECLINES		
NEW YORK	492	(30)
DALLAS	162	(21)
PHILADELPHIA	163	(16)
CHICAGO	245	(12)
DETROIT	132	(10)
TAMPA	83	(10)
HOUSTON	147	(8)
LARGEST INCREASES		
RIVERSIDE	78	6
PORTLAND	75	6
SEATTLE	111	5
LOS ANGELES	281	4
SAN FRANCISCO	126	4
SAN DIEGO	83	4

Space Available! The Square Footage Surplus

Changes in consumer behavior continue to reduce demand for traditional paying and receiving transactions at U.S. bank branches. Across the industry, median branch transaction counts declined to 7,600 per month in 2012, from 10,200 five years prior. With more than 95% of new accounts opened in the branch channel, branches remain essential to capture new relationships; but the decline in transaction needs has left many branches with an excess of square footage. The grand banking halls of prior generations often housed 15 or more teller stations, and even 5,000 square foot branches built in the 1970s and 1980s often included six to ten teller windows. The voluminous nature of early branches was not just to accommodate teller transactions; in addition, prior-generation branches included vaults for a time when cash needs were much greater, and storage capacity for a time when records were maintained in hard copy form on site. Today, with reduced teller queuing needs, virtual records storage, reduced use of cash, and even smaller computers and printers, branches require considerably less square footage.

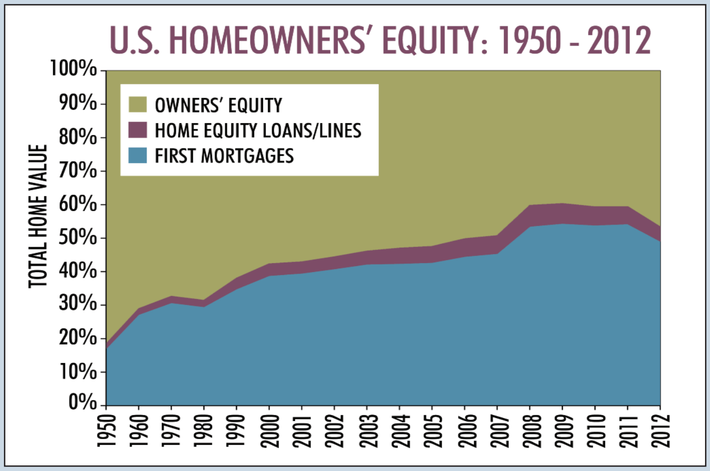
Financial institutions can easily address the current environment in their new branches, building compact facilities with limited back office space to minimize occupancy expenses. But efficient new branch design does nothing to mitigate the surplus of space that many banks face in their incumbent branches; especially those banks in longtime unit banking states (where banks could not legally establish branch offices), where a 30-branch network assembled through numerous mergers could easily include 15 former main offices. Thus, banks face a challenge in reducing excess square footage without eliminating branches. Some common tactics for addressing that challenge follow.

Converting excess branch space to a **community room** garners goodwill by providing valuable meeting space for local civic organizations, while also bringing traffic to the branch. An effective community room includes rotating merchandising displays and product brochures. Some community rooms have separate entrances for after-hours meetings and others have a glass wall on the branch side so visitors can see the branch in operation. Regardless of the configuration, a simple 30-second greeting from the branch manager can foster relationships, even without an overt sales presentation.

Surplus branch space can be used to house **back office functions** that would otherwise occupy rent-consuming leased space. Functions such as training, centralized cash vaults, or even small specialty call centers (for example, for business credit cards) can leverage surplus space and reduce main office leased space requirements. Domiciling call center or vault functions at branches carries the added benefit of allowing the back office personnel to migrate to the branch during peak demand times, since the skill sets of those branch and back office positions are similar.

In some cases branch space can be subdivided with the surplus portion leased to an **external firm**. However, building a dividing wall and separate entrance is costly, and the resulting space will need to be leased at a sufficient rate (to more than offset those costs) to a tenant with traffic patterns that would complement those of the branch rather than compete with it for scarce parking spaces. Subdivision is not always practical, either. If the teller line is on one side of the branch and the vault on the other, you can not simply build a wall down the middle that would bisect the functional parts of the branch. *(continued on page four)*

Consumer Finances Improving: Evidence from the Mortgage Market *continued from page one*



brought an intangible effect on consumer confidence. With less perceived wealth in their homes, consumers were less likely to borrow in equity or other credit vehicles, and that reticence was compounded by the uncertain job market. Rather, consumers deleveraged, whether by selling homes or paying down debts more aggressively. As a result, consumer mortgage balances decreased from $10.6 trillion in 2008 to $9.4 trillion in 2012, an 11% drop.

should increase the number of households that own their primary residences, but decrease the proportion of owners carrying mortgages, as more households will be able to pay down their notes in full.

In recent years, consumer borrowing has been burdened by declining property values and risk aversion. Declining property values had the tangible effect of reducing the level of credit a bank could extend. If a home's value declines by 10%, the maximum prudent loan amount will fall commensurately. But declining home values also

The more severe drop occurred in home equity loans (including lines of credit). When consumers held confidence in the wealth impounded in their homes, they freely used home equity lines to augment their spending capacity. But home equity-secured borrowing declined by 32% between 2008 and 2012, from $1.1 trillion to $770 billion. Although 2012's level was down almost 10% from 2011, increasing home values may signal a reversal in the trend. For much of the 20th century, American homeowners maintained modest debt levels. In 1960, homeowners' equity equated to 71% of total home value; and mortgage holders "owned" just 29% of aggregate home value. As late as 1980, the split was 69% / 31%. But owners' equity dropped below 60% in the mid-1990s and to 50% in 2006 when for the first time, mortgage holders owned as much of the value of America's homes as the homeowners did.

Even as consumers deleveraged during the recession, home values fell by a greater percentage, reducing owners' equity to just 40%. But with the recovery in home prices over the last two years and reduced consumer debt levels, the equity to home value ratio has rebounded all the way to 46%. That increased wealth cushion, in concert with a more stable job market, should coax more consumers back to borrowing – so long as banks and credit unions are willing to address that demand. After years in a conservative credit posture, it may be difficult to reorient branch staff toward mortgage and equity line sales. But the institutions that can successfully do so will likely capitalize on an impending revival in credit demand. Modest increases in interest rates may dissuade some consumers from returning to borrowing, so bankers must present rates not relative to the recent all time lows, but rather as still favorable in a longer term historic context.

Some banks have subleased parts of their lobbies in a '**store within a store concept**,' contracting with a coffee vendor (e.g., Starbucks) or copy store (e.g., FedEx Kinko's) to place a kiosk configuration of its concept wholly within the branch. This is most effective in urban settings with high pedestrian traffic, and can be beneficial because the coffeehouse or copy center brings customers into the branch who gain awareness of the institution's offerings simply by reading merchandising displays as they pass through the building. The model is a reversal of traditional in-store banking, in that the bank becomes the lessor; but the same refrain about the importance of relations between store and branch holds true.

As one Bancography client suggested, if other options prove infeasible, get some **potted plants**. Using greenery or other attractive divider screening will not generate lease revenues, increase branch traffic, or reduce operating expenses. But some inexpensive but attractive furnishings can reduce the perceived space of the branch, eliminating the cavernous feel that afflicts many former main offices and creating a more quiet, professional, and comfortable environment for employees and customers alike.

Debate remains over whether the industry holds a surplus of branches, but it certainly holds a surplus of square footage. In the long period before every oversized branch can be relocated into more appropriate quarters, bankers should consider all options for redeploying space no longer needed in the current banking environment.

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