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2017 Demographic Update

Bancography recently received its 2017 update from our demographic provider, EASI Demographics. Based on the U.S. Census Bureau's Current Population Survey, American Community Survey, and other research datasets, the data underlie Bancography's branch network optimization studies, demand models, and the *Bancography Plan* software tool. The data reveal numerous interesting statistics.

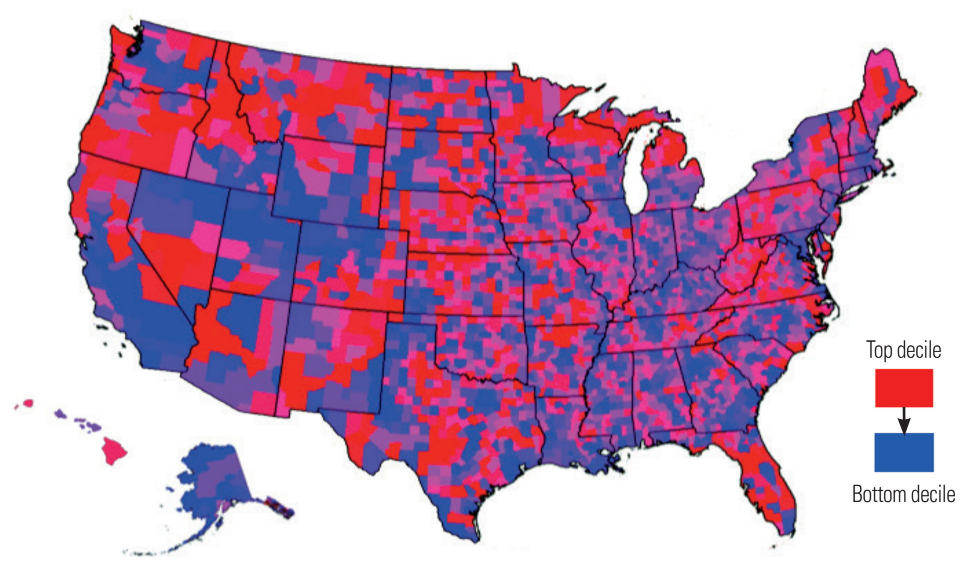
The household base in the U.S. is projected to grow by 4.5% from 2017-2022, eclipsing the 3.7% pace of the prior five years. If realized, that household growth pace will yield an additional 5.5 million households nationwide over the next five years. That growth represents a combination of two factors: the rate of new household formation (primarily from young residents leaving parental homes and establishing their own households) versus household attrition (mostly due to mortality); and the net pace of immigration.

The U.S. continues to grow increasingly urbanized, and 94% of the nation's 121 million households live in a designated metropolitan statistical area. There are 53 metro areas that house more than one million residents, and in aggregate that subset of large markets contains 55% of the U.S. household base. Over the past five years, the Austin and Raleigh metros, both noted technology hubs, showed the greatest level of household growth among the large metros. Each enjoyed household gains of more than 10%, joined by Orlando, San Antonio, Houston and Denver. While that group of mostly Southern and Southwestern markets thrived, several Northern markets, mostly in the Great Lakes region, lagged: Cleveland, Hartford, Pittsburgh, Buffalo, Detroit, Rochester and Chicago all showed household gains of less than 1% over the past five years. Four other mostly Northern or Midwestern metros eked out household gains of less than 2% in that timeframe: St. Louis, Milwaukee, Providence and Memphis.

Washington, D.C. now ranks as the most affluent large metro, with median household income reaching $112,000. San Jose follows closely at $110,000, while San Francisco, Boston, Baltimore, Harford, Seattle and Minneapolis all show median income in the $85,000 - $95,000 range. At the opposite end of the spectrum, median income hovers near $60,000 in Tucson, Tampa, New Orleans, Oklahoma City, Memphis and Orlando.

Many of the slower-growth and less-affluent metros tend older. Ranked by median age (head of household, in order), Pittsburgh, Cleveland, Buffalo, Tampa and Hartford represent the five oldest metros, all with median age of 53-55; while Austin, Salt Lake City, Raleigh, Dallas and Houston represent the five youngest metros, all with median age of 47-48 except Austin (45). The map to the left shows the age profile of the counties across the U.S.

Median Age, Head of Household



The above comments provide a few highlights about the U.S. demographic environment, but represent a small subset of our available data. Contact Bancography for demographic profiles of your institution's markets.

Evaluating Mergers as an Alternative to De Novo Branching

Mergers represent one component of a growth strategy, and bankers should avoid viewing mergers and de novo branching as an either/or strategy.

For a bank or credit union quickly seeking to build branch density in a market, mergers and acquisitions can offer a faster option than de novo branching. Further, for new-market entry, mergers can bring not only an initial customer base, but also skilled managers with strong preexisting relationships with local business and civic leaders.

In evaluating merger opportunities, a bank or credit union can compare target franchises by the proportion of their branches which would prove beneficial, where a branch is considered beneficial if it: either serves a viable submarket and would thus replace the need to build a branch; or sits in a currently served submarket, and would thus create a 'two-for-one' expense consolidation efficiency opportunity.

For example, consider a bank with four branches in the Denver, Colorado metro. After studying the market's demographic and competitive environment, the bank determined it needed 15 branches to establish a competitive network; and further, it identified the 11 top submarkets in which to add branches to bring its network to the target 15-branch level. Now consider a merger target that maintains two branches in close proximity to the bank's current offices, four others within those 11 target expansion submarkets, and five others either in lower-opportunity submarkets in the Denver metro or outside the market. This target bank would show a 55% beneficial branch proportion: (2 overlaps + 4 target submarkets) / 11 total branches = 55%. The bank could gauge each prospective merger target in that same context; and then focus its efforts on those institutions with the greatest proportion of beneficial branches, i.e., the greatest ability to accelerate the bank's path toward the optimal franchise configuration.

Mergers represent one component of a growth strategy, and bankers should avoid viewing mergers and de novo branching as an either/or strategy. Rather, the two tactics can leverage one another, and a merger should foster rather than forestall those additional branches that would complete the franchise. Thus, in the example above, completion of the merger would address four of 11 target submarkets; so the bank should concurrently plan for seven de novo branches in its long-term horizon.

Beyond specific branch locations, any assessment of franchise value should also include an estimate of growth potential within the acquired branches. Keep in mind, any seller with an astute investment banker (and there's no reason to presume your investment banker is any more or less astute than theirs) will derive a premium reflecting the current value of all balances in the franchise, plus the natural balance growth the institution could achieve on its own. Thus, for the buyer to recover that premium, it needs to be able to realize balance growth above and beyond what the seller could attain on its own – rendering it critical to confirm that the target's collective branch submarkets hold sufficient upside balance potential to do so.

In addition, savvy purchasers will enter a transaction with a ready disposition plan for any nonbeneficial branches. The Denver example hypothesized one or more branches outside the metro area, and presumably outside the acquirer's target markets. If those markets have no role in the acquirer's long-term strategy, then in the merger evaluation phase it should consider prospective banks in those non-target markets to which it could 'spin off' the unwanted branches.

Finally, for the overlapping branches, it is critical to understand the full costs of consolidation and ensuing disposition. A branch of the target bank may sit across the street from one of the acquirer's branches, offering a low-risk consolidation from an attrition standpoint. However, if that branch carries a book value well in excess of market value, or a lengthy remaining lease term with penalties for failure to operate (often referred to as a 'dark clause') and no sublease provision or potential, or any other situation that would create an untenable charge against net income, such costs could negate the financial savings that may have initially justified the merger. Thus, it remains imperative to understand such impacts in advance of finalizing any transaction.

How Financial Institutions Can Mitigate Wealth Inequality

Every three years the Federal Reserve Board conducts its Survey of Consumer Finances (SCF), a comprehensive study of the financial holdings of U.S. households. Bancography clients and regular readers of *Bancology* will recognize the Survey of Consumer Finances as a key input to many of our demand models and published research. Spanning all facets of the consumer balance sheet (including bank accounts, securities, real estate, revolving credit, installment loans and mortgages) and cross-tabbed by various demographic variables, the SCF offers valuable insights into the financial holdings of American households across market segments.

The Fed released its 2016 iteration of the survey in September 2017, and one of the numerous interesting findings involves the distribution of wealth in the United States. Over the life of the SCF, a period spanning the past 25 years, the nation has seen an increasing concentration of wealth within a smaller proportion of U.S. households, and the 2016 SCF demonstrates continuing evidence of that trend[1]. In 1989, the top 1% of U.S. households by net worth held 29% of the aggregate net worth of all U.S. households, and the second nine percent of households (i.e., all households ranking in the top 10% by net worth but not in the top 1%) held 37% of the nation's aggregate net worth; leaving 34% of wealth in the bottom-ranking 90% of households. Today, as measured by the 2016 survey, the top 1% hold 39% of net worth, up from 36% in 2013; while the bottom 90% hold only 23% of the nation's wealth. Notably, the second 9% (i.e., percentiles two through 10) hold a similar 38% of aggregate net worth as in 1989 – so the uppermost affluent segment's gains have accrued more at the expense of households in the upper-mass, mass, and low-income segments than from the mass affluent who constitute that second 9%. Note also these statistics likely understate the wealth disparity, as the absolute most affluent households (e.g., Gates, Buffett, et al.) remain notoriously difficult to survey or even estimate, especially with much of their wealth tied to volatile company-stock prices[2].

The distribution of income in the U.S. has also shown increasing dispersion, though to a lesser extent than with net worth. In 1989, the top 1% of income-earners accounted for 18% of the nation's aggregate income, while the bottom 90% of earners received 58% of aggregate income. In 2016, the top 1% accounted for 24% of aggregate income, while the bottom 90% received only 50% of aggregate income. The divergence between the wealth and income measures, with the former being more concentrated in fewer households, confirms that wealth begets wealth. The affluent-household segments show a greater proportion of net real estate value and securities in their net worth holdings because, as households climb the income ladder, they find more disposable income available for investment into those assets – asset classes that historically have offered much greater returns than traditional insured savings products.

A strong middle class, upward wealth mobility, and lesser wealth inequality are beneficial for financial institutions, as those factors create a broader pool of qualified borrowers and valuable depositors. And most sociologists and politicians of all stripes will concede those factors as beneficial for society overall. This raises the question: how can banks and credit unions help foster wealth gains within the lower-income-earning and lower-net-worth tiers?

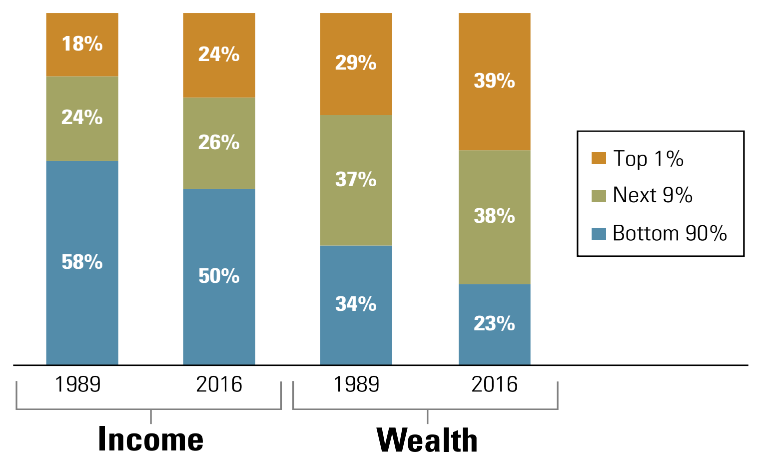
Nearly every institution of any size provides some type of financial literacy program, an outreach initiative where the institution offers educational content targeted to lower-income and mass-market consumers. Although many of these initiatives necessarily involve a fundamental introduction to the banking system, it is important to carry those lessons forward to the next phase of the consumer's life cycle, and educate how to utilize savings not only as an emergency reserve but also as a means of building wealth. Toward those ends, a financial-education curriculum should contain advanced offerings about entry-tier investment products such as annuities and mutual funds that help build wealth, as well as discussions of the myriad benefits of home ownership.

Financial institutions can offer tactics for saving for a down payment, building sufficient credit history to qualify for a mortgage, and utilizing programs such as FHA and VA loans. In addition, education about accumulating equity (versus paying rent) and tax consequences can also help clarify the benefits of

(continued on page 4)

Change in distribution of U.S. income and wealth

(by income and wealth percentiles)



[1] Federal Reserve Board Division of Research and Statistics, "Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* (September 2017).

[2] For an interesting discussion of how to account for top-tier affluent households in wealth estimates, see: Bricker, Henriques, et al., "Measuring Income and Wealth at the Top Using Administrative and Survey Data," *Brookings Papers on Economic Activity* (Spring 2016)

home ownership and foster interest in that key entry point into the middle class.

In securities, many bankers on the credit union side of the industry face a dilemma, as their institutions specifically target mass-market consumers who could benefit from introduction to instruments beyond the insured savings system; yet the credit unions lack in-house investment-management capabilities. Absent the potential for a defined sales opportunity, the credit union may find less incentive to teach consumers about securities investing. And while many credit unions overcome the absence of in-house securities offerings with third-party partnerships, it is imperative to involve those third parties in financial-education curricula to give consumers comprehensive knowledge of wealth-building tools.

Throughout education programs, it is important for bankers to teach a life-cycle approach to savings, investing and borrowing that addresses not only immediate needs but a lifetime strategy of financial positioning. By using their platforms and customer/member bases to teach the benefits of various financial instruments, banks and credit unions can foster wealth accumulation in lower-income strata, helping to build a broader, stronger middle class and in turn, more stable communities overall.

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