

THE ART OF POSITIONING

bancography

BRANCH PRODUCT RESEARCH BRAND

Seventy institutions joined the survey, both banks and credit unions, from all regions of the country and spanning all asset tiers.

Smaller Branch Models Taking Hold as Traditional Branch Costs Remain Near \$2M

Ten years ago, Bancography surveyed banks and credit unions across the U.S. about their branch deployment plans, including number of planned branches, cost, and size of those branches. We reprised the study in 2006, but omitted subsequent iterations when branch building slowed during the recession.

Now, with the economy reviving, many institutions expanding again, and significant discussion of smaller branch footprints taking hold, we found it an appropriate time to update the study. Seventy institutions joined the survey, both banks and credit unions, from all regions of the country and spanning all asset tiers. Our findings follow.

How many branches will your institution add next year? More than 70% of respondents plan to build only one or two branches in the next year, so most planned growth appears incremental rather than oriented toward widespread expansion. Seventy-two percent of institutions plan to build traditional branches; 51% plan inline facilities; and 13% plan to add in-store branches (the proportions sum to more than 100% because some institutions plan to employ more than one format). Non-traditional branches (i.e., inline plus in-store) represent 42% of planned new branches.

What is the average square footage of the planned new branches? The average size for planned freestanding branches was reported at 3,040 square feet, down significantly from 3,500 sf in 2006 and 3,900 sf in 2003; the median was 2,950 sf. Still, not all institutions are embracing smaller branches; one in four respondents is planning branches of 4,000 sf or more. Among the planned inline branches, the average reported size was 1,950 sf, with the median at 1,800 sf. Planned sizes ranged from 750 sf to 4,000 sf, though only two respondents exceeded 2,800 sf.

What is the average land cost of the planned freestanding branches? Reflecting the wide regional disparities in land costs, this question showed the greatest variance, with responses ranging from \$250,000 to \$1.4M.

Costs tended much higher in the larger metros, especially in the Northeast corridor and the Great Lakes region. Consistent with a nationwide decline in real estate values, average cost was reported at \$675,000, down from \$1.1M in the 2006 survey.

What is the average construction cost of the planned branches (including building, furniture, and equipment, i.e., everything but land)? Reported freestanding branch costs ranged from \$700,000 to \$2M and averaged \$1.3M, down slightly from the \$1.4M of the prior survey; however, recall from above that average square footage declined from 3,900 to slightly more than 3,000. Accordingly, cost per square foot increased to \$440, up from \$360 in 2006 and \$310 in 2003. Costs ranged from \$220/sf to more than \$600/sf.

For inline branches, reported costs ranged from \$250,000 to near \$1M, averaging \$530,000. Cost per square foot ranged from \$90 to near \$500, and averaged \$275 (median \$250), up from \$190 in the 2006 survey.

The survey also addressed various equipment and configuration elements, and found:

- **Image-enabled ATMs** are becoming standard equipment, with 68% of respondents planning to use the technology in most or all new branches.
- **Teller cash recyclers (TCRs)** are increasingly common, too: 53% plan TCRs in all new branches; and 16% in some new branches; but 31% have no plans to use TCRs. **Teller cash dispensers (TCDs)** are slightly less prevalent, with 54% of respondents planning to use TCDs in at least some new branches.
- Only 31% of respondents plan to install **safe deposit boxes** at all new branches; another 20% plan to install boxes in some new branches. Traditional dual keyvaults were 2.5 times more common than single key self-service vaults.
- Eleven percent of the surveyed institutions will use **video remote tellers** at all new branches; and 32% will use the technology at some new branches; but 57% have no plans for video tellers.
- The **universal agent** model is under consideration at many institutions: 42% of respondents plan integrated teller-CSR (universal agent) workstations in all new branches; though 30% plan to install traditional teller lines in all new branches. The remaining institutions plan a mix of operating models.

How to Set Equitable, Market Driven Branch Sales Goals

Although it may seem premature to discuss 2014 at the height of summer, in a few short months summer will turn to fall and the strategic planning season. One key component of that strategic planning process is the definition of fair and appropriate balance growth targets for each branch.

There are many methods by which to assign sales goals. The simplest solutions include assigning each branch a fixed balance growth target, or assigning each branch a fixed percentage increase over prior year sales volumes. But those methods neglect that each branch market faces different demographic and competitive environments, and also can reward “historic nonperformance” — that is, a branch that attained minimal sales last year receives a similarly small target next year, since targets reflect prior volumes, even if those prior volumes fell far short of market potential.

Rather than predicating goals entirely upon history, effective sales goals should reflect market potential, assigning each branch a goal that is equally attainable (and equally difficult) given the branch’s environment. Below, we present a framework for establishing equitable sales goals.

First, understand that all sales goals are ultimately ‘top down.’ Even when setting goals based on market opportunity, ultimately those goals must reconcile with the institution’s overall financial targets, which emanate from the long term earnings per share goals set by the board of directors. Thus, rather than just reflecting some independent assessment of plausible opportunity, branch sales goals must equitably allocate the branch network’s share of the overall corporate earnings target. In determining that allocation, it is beneficial to start at the bottom.

- **First, define the primary trade area for each branch.**

This can be done empirically, based on the distribution of current branch customers, or by an equation that translates surrounding population density to likely trade area. In general, branches in lower density areas show broader drawing areas, as rural branches can draw from 5 miles or farther; suburban branches typically draw from 2 to 3 miles; and neighborhood urban branches from 1 to 1.5 miles. For core urban branches (e.g., in Lincoln Park in Chicago or Midtown Manhattan), trade areas are often defined in pedestrian blocks rather than automotive miles.

- **Next, estimate total market demand for each product within each branch trade area.**

This is the “100% demand” figure, i.e., if the branch owned every checking account (or savings or installment loan, etc.) in the trade area, how many accounts would it own? You can estimate demand based on underlying market

demographics, using your institution’s MCIF as a guide. In a given age/income tier, what is the average per-household use of each product type? Take that statistic and multiply by the household count in that segment in the trade area. Repeat, summing across all segments, to estimate total market demand. Then subtract the accounts a branch already owns. If the market demand is 500 accounts but the branch already holds 100 of those accounts, its remaining opportunity is only 400 accounts, since it can’t capture next-year accounts it owns today.

- Total market demand is just one component of sales goals though. **Two branches facing the same demand could still have very different performance expectations, pending three factors: the rate of household growth and turnover; the density of competition in the branch trade area; and the strength of the institution’s network in the market overall.** The first measure, household growth (i.e., households moving into newly constructed homes and apartments) and turnover (i.e., households entering the market by moving into an existing house or apartment), carries substantial impact because consumers remain more likely to switch banking providers after moving, when presumably the travel path to the incumbent provider is no longer convenient. Thus, in setting sales goals, calculate the extent to which current demand (net of what the institution already holds) will increase from growth, and the proportion of demand (again, net of current) that resides in those who will enter the market in the next year through growth or turnover.
- **With demand now divided into two components — growth and turnover, or ‘in-play’ versus stable — you can forecast attainable ‘fair share’ for each branch, and this should reflect competitive factors.** Two branches in trade areas with the same aggregate demand should still face different expectations if one competes against four branches and the other competes against 15 branches. Further, because of the network effect (the phenomenon in which institutions with larger branch networks gain a disproportionate share of balances; see *Bancology* March 2010: Network Effect Remains Strong as Ever), even two branches in trade areas with the same demand and the same number of competitors should receive different goals, if one is supported by a broad, market-wide branch network but the other serves a market where the institution holds little representation. Calculate attainable fair share by dividing the in-play demand by a factor of the number of branches in the trade area; and by multiplying the stable demand by a factor of the institution’s share of branches in the market overall (*continued on page 4*)

**NEED HELP
SETTING
SALES GOALS
FOR YOUR
INSTITUTION?**

Contact Bancography
at (205) 252-6671 or
info@bancography.com
for more information.

Does the CRA Service Test Harm Community Development Banks?

The Community Reinvestment Act (CRA), first passed in the 1970s and amended many times since, was designed to insure that financial institutions addressed the credit needs of low-income neighborhoods. Among the modifications was the delineation of a service test, examining the extent to which banks maintain branches in low- and moderate-income communities. This excerpt from the FDIC's regulations summarizes the key parameters of the service test component of the CRA:

"The FDIC evaluates the availability and effectiveness of a bank's systems for delivering retail banking services, pursuant to:

- (1) *The current distribution of the bank's branches among low-, moderate-, middle-, and upper-income geographies;*
- (2) *In the context of its current distribution of the bank's branches, the bank's record of opening and closing branches, particularly branches located in low- or moderate-income geographies or primarily serving low- or moderate-income individuals;"*

The objective of the service test – which is applied most stringently to the largest institutions – is straightforward: to insure that banks do not concentrate branches in affluent areas while neglecting lower-income neighborhoods. However, does compelling regional and national banks to add branches in low-income communities help those communities? While ostensibly the answer should be a simple "yes," a deeper examination reveals a concern regarding the impact those mandatory branches create upon community banks that deliberately choose those markets.

Most large U.S. metros include one or more institutions founded with a goal of providing banking services to low income and/or minority communities. Some of these institutions date to before the civil rights movement, to when minority consumers and business owners faced discrimination in obtaining financial services. Others were founded more recently, seeking to help maintain the vitality of urban neighborhoods. Regardless of history, such community development banks (CDBs)¹ consistently establish branches in low-income communities, and this raises a concern regarding CRA branching: do branches added by regional banks under the impetus of the CRA in neighborhoods already served by CDBs adversely impact the CDBs by increasing competition and diluting balance potential to untenable levels?

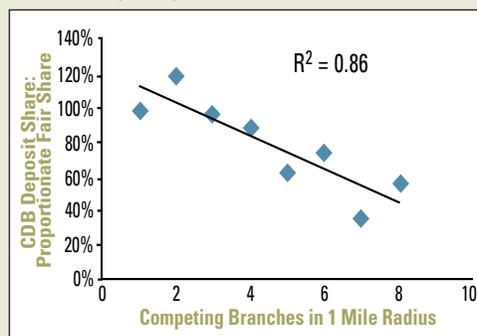
Given the scale economies, pricing power, and branch density advantages² that regional banks hold, Bancography investigated whether their presence impedes community banks by testing two hypotheses:

- Does the addition of regional bank competition in low-income markets reduce the ability of community development banks to capture their fair share of market deposits?

- Does regional bank competition in low-income markets reduce the deposit levels of CDBs?

The study focused on branches in low-income urban neighborhoods. It examined all trade areas served by a branch of a community-development or minority-owned bank³; within a metropolitan area, as designated by the Office of Management and Budget; and with median household income of less than \$45,000 in the 1 mile radius around the CDB branch⁴. For each of the 108 such trade areas, the study tallied the June 2012 deposits of the CDB branch and all other branches within 1 mile. It then examined the CDB branch deposit size and deposit share as a function of the number of competing branches in the 1 mile trade area.

If regional banks did not affect the ability of CDBs to capture share, then the research would find that, irrespective of the number of competing branches, the community branch would capture its "fair share" of trade area deposits, e.g., 50% if it faced one competing branch; 33% if it faced two competing branches. Instead, the study found that increased competition impedes CDBs' ability to capture fair share. While branches in two-competitor trade areas actually capture more than their fair share of balances, as additional branches enter the market, the CDB deposit share falls further below the expected proportionate value. CDB branches facing five or more competitors capture less than two-thirds of expected proportionate share. The graph below illustrates the strong correlation between competition and the ability to capture fair share balances.



While the graph illustrates that competing branches exceed their expected deposit share in low-income markets, the data refute the hypothesis that increased competition lowers absolute deposit volumes. There is no correlation between CDB branch size and number of competing branches. (see table in the next column)

Taken in conjunction with the preceding finding, the data imply that regional banks are not diluting CDB branch deposits to untenable levels, but that in larger markets they are outperforming CDBs in capturing deposits. Still, the result is that the CRA, by forcing regional banks into low-income communities, may

restrict the growth of CDBs founded specifically to aid those communities. If that dissuades further branching by the CDBs, it could adversely impact low-income communities overall.

Branches in Trade Area	Average Deposits, CDB Branches	Median Deposits, CDB Branches
1	27,800	21,529
2	29,274	26,150
3	28,534	25,449
4	42,921	37,045
5	37,523	24,309
6	39,335	26,082
7	24,207	17,747
8	26,084	27,880

The superior performance of the non-CDB branches likely reflects the advantages larger banks enjoy in technology, advertising reach, awareness, distribution breadth, and cost efficiency. But candid conversations would confirm that the regional bank performance does not reflect any strategic advantage. Regional bank executives may overtly espouse a commitment to low-income markets, but off-the-record most would concede they view CRA branching as a regulatory burden with little strategic benefit. But if regional banks outperform CDBs in low-income markets in spite of rather than because of their interest in the low-income segment, could there be a more efficient means to allocate the industry's resources?

One alternative may lie in a cooperative approach to low-income branching. If regional banks could fulfill CRA service obligations by providing financial, product development and delivery support to CDBs in lieu of branching, the reduced competition could enable the CDB branches to capture increased deposit share. Such contributions could take the form of outright cash payments, reciprocal fee-free ATM exchanges, shared (but separately branded) online banking platforms, or other options; in effect, the bank would be purchasing CRA service test credits. This would free regional banks to allocate non-interest expense to community development in a manner more administratively efficient than branch deployment, which they view as burdensome and divorced from their core mission. In turn, CDBs would face reduced competition, encouraging more consumers to bank with institutions that enter their communities by defined social mission rather than by regulatory imperative. An upcoming Bancography study will address these findings and implications in greater detail.

¹ Although there is a specific certification process by the U.S. Treasury Department for designation as a community development bank, this article uses "community development bank" (CDB) to represent all minority-owned institutions serving low-income neighborhoods in addition to all certified CDBs.

² The network effect (see *Bancology*, March 2010)

³ The study omits credit unions, which report deposit totals only at the institution level.

⁴ The study includes only larger markets, defined by the Office of Management and Budget (OMB) as metropolitan rather than micropolitan statistical areas. The \$45,000 median household income threshold represents 80% of the \$57,000 median income of the U.S. overall.

and by a factor that impounds the proportion of accounts that change providers each year; and then summing the two results. For the statistic of proportion of accounts that change providers, examine your institution's historic experience in each product type. A typical turnover percentage for checking accounts is 10% - 15%.

- The above calculations yield a bottom up fair share goal for each branch. **But again, note that the sum of all branch goals still needs to meet the corporate targets in the strategic plan.** To reconcile any such discrepancies, scale each branch's goal by a common factor so that the aggregate goal aligns with corporate targets. By using a common scalar, the relative goals will not change (Branch B's goal will still be two times Branch A's goal) but the aggregate will meet the corporate target.

If the goals are set appropriately, performance against those goals should follow a bell curve, with a few branches with superior sales skills well exceeding goals and a few deficient branches falling well short, but most aligning plus or minus 15% from the corporate targets. The steps above present a framework that can be altered for specific institution needs; for example, capping the allowable rise or fall versus prior-period performance; or multiplying by a balance factor to translate account goals into dollar goals. But the primary components – market demand, current holdings, account turnover and competition – should underlie any effort to compute equitable, market driven sales goals.

THE ART OF POSITIONING

bancography

BRANCH PRODUCT RESEARCH BRAND

2301 First Ave. N., Suite 103
Birmingham, AL 35203
205.251.3227

Return service requested

Presort Standard
U.S. Postage
PAID
Birmingham, AL
Permit No. 585

THE ART OF POSITIONING

bancography

BRANCH PRODUCT RESEARCH BRAND

*Welcome to Bancology,
a Quarterly Journal from Bancography*