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THE ART OF BANK PLANNING
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The Relationship Between Problem Occurrence and Customer Satisfaction

part I of 2

Customer service, satisfaction and loyalty tracking programs provide vital information to banks seeking to improve the customer experience. These survey instruments contain a group of questions, listed below, which measure whether the customer experienced a problem or error with the bank in the past three months.

1. *Have you experienced a problem or error in any way with the bank in the past 3 months?* ***Yes or no***
2. *If so, was your problem resolved to your satisfaction?* ***Yes, no or resolution in progress***
3. *Will you please describe the problem so that the bank can learn and prevent it from occurring again?*

Of all the attributes measured in a satisfaction tracking study, the attribute most correlated with service quality and overall satisfaction is the occurrence of a problem or error generated by the bank.

In Bancography's experience, some of the most successful service-focused banks recount that 10% of their customers reportedly experienced a problem recently. These banks strive to satisfactorily resolve these perceived problems 75% of the time. It is those customers who believe that their problems have not been resolved who are extremely likely to move their entire financial relationships. Even though management focuses on these unresolved errors, the mere existence of problems drastically affects overall satisfaction and service quality; thus, this negatively impacts loyalty.

The following chart depicts scores from two separate banks with tracking programs managed by Bancography. Bancography filtered the results from both of these banks' overall results to view the responses from just those customers who reportedly experienced a problem in the past three months. Although these banks are vastly different in terms of size and target market, the severe variance between the overall results and the results from those experiencing problems is similar for the two banks.

	Bank A		Bank B	
	Overall	Experienced a problem	Overall	Experienced a problem
Extremely satisfied w/ entire financial relationship	70%	23%	56%	31%
Extremely likely to continue to use the bank	80%	53%	74%	65%
Extremely likely to recommend the bank	67%	33%	81%	73%
Service quality overall (avg of 7attributes)	83%	43%	63%	40%

The perceptions of these customers negatively skew the results for both of these banks. Given that Bank A and Bank B are experiencing 12% and 14% problem occurrence, these results are significant.

If a bank desires to improve the customer experience, it must mitigate problems or errors. Most problems or errors are not the result of egregious errors by the institution. But, if the customer perceives it as such, the fault still lies with the bank for not better explaining account features, fees, policies, procedures or simply showing empathy. Examining what these problems are and how to minimize their occurrence will be addressed in Part 2 in the next issue of Bancology.

The Network Effect: The Benefits of Branching

The network effect – the ability of large branch networks to attract disproportionately greater deposits than small networks – occupies a familiar position in retail banking theory. In an ongoing research initiative, Bancography is attempting to confirm whether such an effect exists, and if so, its implications for branching strategy. Before bankers predicate expansion strategies on the belief that each additional branch will yield increased returns to their network overall, the network effect must be demonstrated consistently across markets and across time.

We studied the fifty largest US metropolitan statistical areas to learn whether branching yields increasing, decreasing, or proportionate returns. By examining the correlation between deposits per branch and number of branches, we can determine whether branching yields:

- Decreasing marginal returns, for example, doubling the number of branches yields less than a twofold increase in deposits; in effect, each successive branch dilutes the network overall.
- Increasing marginal returns, for example, doubling the number of branches yields more than a twofold increase in deposits; in effect, each successive branch synergistically boosts the network overall. If this holds true, then banks with high outlet share will show higher deposits even when compared on a per branch basis.

In each of the top 50 US metros, we compared each bank's deposits per branch to its number of branches. All data are as reported by the FDIC in its June 30, 2003 Summary of Deposits.

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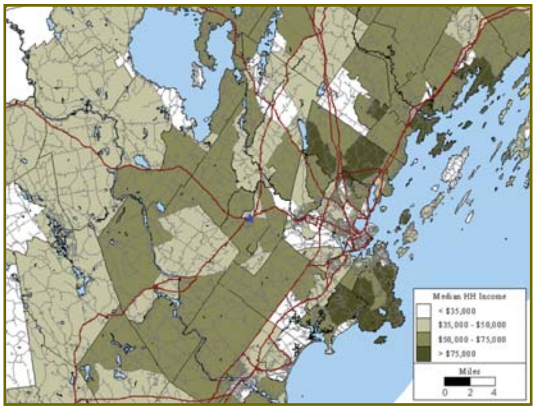
Product Briefing: New Branch Reviews

Many of the nation's largest banks have announced major branch expansion initiatives, forcing smaller banks and credit unions to consider expanding their own networks. The expansion objectives of smaller banks may consist of only one or two branches a year, rendering software tools or marketwide consulting assessments prohibitively expensive. For banks seeking professional evaluation of a specific new branch opportunity, Bancography offers quick, inexpensive new branch reviews.

The process, which requires only one week and costs only $1,100, begins when the bank submits the address of its target site. Bancography provides reports and maps detailing the demographic and competitive composition of the proposed submarket, and thematic maps illustrating household growth, income, and home values in the target submarket and adjacent communities. If the bank supplies an extract from its customer files, Bancography will also map the bank's existing consumer and business households relative to the proposed site.

Finally, Bancography will generate complete pro forma balance sheets and income statements under various market penetration scenarios. The income statement includes critical measurements such as internal rate of return, efficiency ratio, return on liabilities, and years to break even. The final document will include a summary of the proposed site's demographic, competitive, and financial composition and Bancography's recommendation as to whether to pursue the site, as well as any potential risks associated with entering the new submarket. In just one week, the bank will receive a document that it can present directly to its management committee or board of directors for approval; the document is also delivered electronically so that the bank can incorporate specific components into its own presentation document.



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Main offices were excluded from the deposit totals to eliminate the impact of large commercial accounts, public funds, and other centrally booked deposits. The study uses Spearman's rank order correlation coefficient to compare the ranks of the banks on each attribute (number of branches and deposits per branch), and to resolve whether the broadest networks yielded the largest branches. Contact Bancography for a more detailed explanation of the statistical methods underlying the study.

The study revealed that consumers consistently select banks that offer the broadest branch networks. The largest competitors in a market capture not only the largest share of deposits, but they also show the highest deposits per branch, as consumers disproportionately reward the largest competitors with their balances. That is, large networks outperform smaller networks even on a per-branch basis, as each successive branch captures its own deposit base and, by improving the bank's perceived convenience, also renders consumers in other submarkets more likely to select the institution. Large networks disproportionately attract consumers because the networks create a perception of ubiquitous availability that reassures consumers they will always find their bank conveniently available.

In 49 of the 50 metros analyzed, the study demonstrated a positive correlation between network size and average branch size. In 43 of the 50 metros, the correlation proves statistically significant at the 95% level, a standard cutoff for determining validity. The effect is stronger in larger markets, with 24 of the 25 largest metros showing significance at the 95% level. In nearly every market, the banks operating the largest networks enjoy the largest branches. Notably, the study found similar results examining 1998 and 2003 FDIC data, with the strength of the correlation actually increasing over the past five years.

In the example below, note the increasing relationship between network size and deposits per branch in the Providence, RI MSA. Each point represents a different bank, with the regression line showing a weighted average relationship for all the banks. By reading from the 'Branches' axis to the 'Deposits per branch' axis, you can see that a 5 branch network yields an average branch size of approximately $40M; a 10 branch network yields an average branch size of approximately $45M; while a 20 branch network yields an average branch size of almost $55M.

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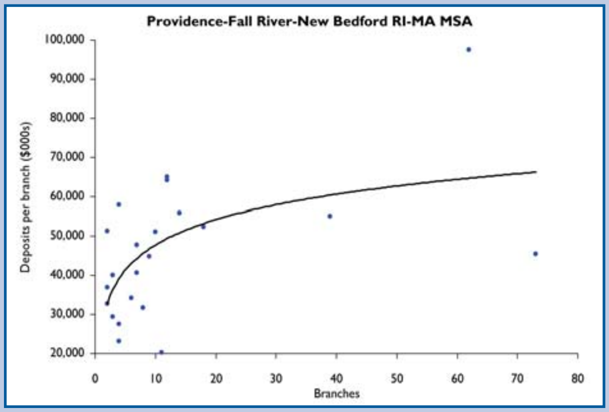

How To Choose the Right Location for A New Branch: Dos and Don'ts

Myriad demographic and competitive databases can help bankers determine the optimal area, or submarket, for a new branch. But no report, software tool, or database can discern the optimal property within your target submarket. Actual site selection requires ground-level research and local market knowledge. These guidelines can assist you in reviewing potential sites.

DO: Seek locations near routine retail anchors such as grocery stores, discount retailers, and pharmacies. These businesses create gravity, that is, they represent a consumer's primary destination, and the presence of these stores can change consumer travel patterns. By locating near such a retailer, a branch, as a secondary destination, can benefit from the anchor store's draw.

DON'T: Locate on the 'apron,' or ring road surrounding a major enclosed shopping center. Enclosed malls represent a periodic, perhaps once-a-month destination, rather than a weekly errand. Accordingly, they lack the routine traffic that can benefit a nearby branch. Further, mall traffic can discourage consumers seeking a quick errand at the branch, and holiday season mall traffic may render the branch completely inaccessible. Finally, mall locations can prove particularly burdensome to branches not equipped to handle large merchant currency deposits.

DO: Begin hiring and marketing activities in the submarket in advance of opening the branch. This will build excitement in the community for your impending branch and allow the branch to start with an initial base of business.

DON'T: Fear a location with a high number of competing banks. A branch near competing branches can capitalize on those offices. Consumers that leave one of the existing providers will seek an alternative within their same travel pattern. Since they have come to view their current location as a place where banking services are offered, they will seek to replace those services in a nearby location. If you are confident in your product line and service quality, nearby competitors present opportunity, not obstacles.

DO: Be willing to incur extra land costs for a location in the heart of the submarket. Land purchases are not an expense, but rather an asset to asset transfer on the bank's balance sheet. Land does not depreciate and does not affect the expense side of the income statement. Its only cost occurs in the form of the opportunity cost of foregone loan or investment revenue.

DON'T: Select a location in between two submarkets in hopes of serving both. In between locations, especially on high traffic roads, can appear appealing, but in reality only constitute very expensive billboards. Consumers will bypass a branch between submarkets for competing offices located nearer to destinations at the core of either adjacent submarket. The bank that strives to serve two submarkets through one office will serve neither, as competitors in either submarket will offer greater convenience.

DO: Retain a local commercial real estate professional to assist with your site selection. An apparently good site may face zoning restrictions, signage ordinances, or poor traffic circulation. Professional real estate agents bring an understanding of such issues to your site search and can offer historic insights as to the success or failure of previous occupants of your potential location. Bankers occasionally fall victim to the belief that choosing a branch site is no more difficult than purchasing a house. In fact, site selection is tremendously complex, and a banker should no more pursue such a transaction unaided than a real estate sales person should attempt to underwrite a commercial loan.

DON'T: Zero in on one specific site in the submarket. Find several alternatives that will meet your bank's needs, evaluate the sites comparatively, and be willing to switch primary choices if the price of your initial site proves untenable and inflexible.

Finally…**DON'T:** Purchase a site simply because a member of your board of directors owns the property. DON'T build a branch simply because you can't otherwise dispose of a piece of foreclosed property. DON'T purchase a site without reviewing appraisals and comparable sales in the submarket. And DON'T fall for the "if you don't decide today I have another bank ready to purchase tomorrow" line.

DO: Purchase a site if, after thorough review and analysis, you conclude that it meets your bank's demographic and financial criteria.

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We can show similar relationships in almost every US metro. Although one obvious implication of this finding is that banks should pursue dominant branch networks in their market areas, the study yields more complex implications regarding the format of these branches. A future issue of Bancology will explore the potential damage from widespread branching that neglects branch format and cost considerations, and will argue that, if branching remains imperative for market share growth, then branch formats must change.

Current Events

Bancography's Steven Reider will teach a course in "Delivery Channel Management" at the American Bankers Association's **Stonier Graduate School of Banking**, June 12 – 19 in Washington, D.C. Stonier is the only national graduate school for bank executives. Its curriculum includes an intense three-year program, structured around the business of banking, business management, strategic planning, and organizational leadership. For more information, visit www.aba.com.

Steven Reider has contributed to the following radio program and magazine article:
NPR, February 2004, "Banks Seek Customers with Friendly Branches"
Colorado Springs Gazette, March 2004, "Branching Out"

Steven will also discuss branching in upcoming issues of the American Bankers Association ***Bankers News*** and ***Bank Marketing***.

www.bancography.com

Bancography's web site has a fresh look with a greater emphasis on our products and services. Visit our site today to download brochures, request software demos, view back issues of Bancology, order research studies and more.

Banking Businesses, Bancography's latest syndicated research study with findings from 21 bank case studies, is now available. The following topics are explored in the study:

- Management Structure
- Sales Process
- Incentive System
- Private Banking
- Marketing
- Market Differentiation
- Competition

The cost of the study is $525 for clients, $750 for non-clients. Contact us at 205.251.6227 or visit www.bancography.com for more information.

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