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THE ART OF POSITIONING

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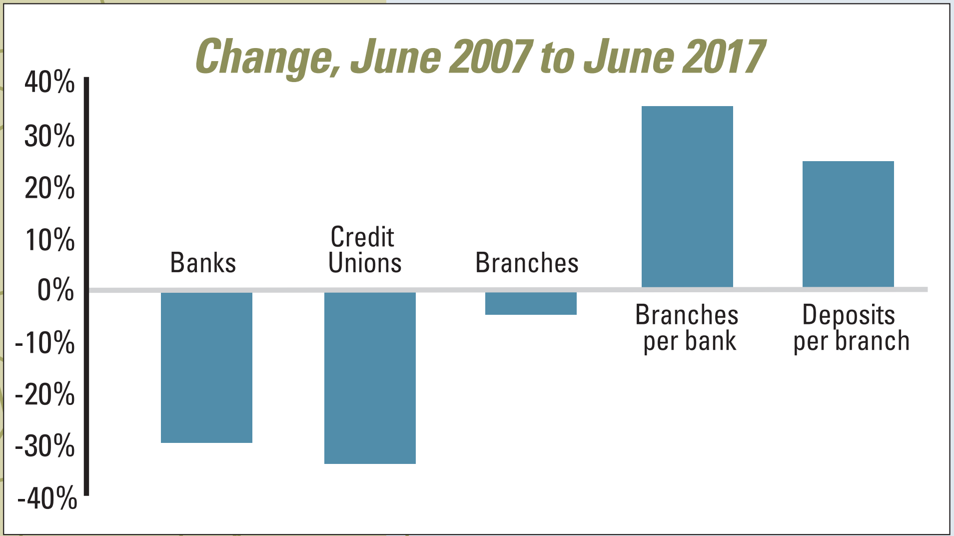
Because the number of institutions declined by a greater proportion than the number of branches, average network sizes have increased over the past ten years.

The Financial Crisis: Ten Years After

Historians broadly agree in designating October 28th and 29th, 1929 as the start of the Great Depression. Over the course of those two days, the value of the Dow Jones Industrial Average declined by a combined 25% on then-unprecedented trading volumes. Though the demise into recession and then depression ensued over several months, the market crash offered a clear point of demarcation from vibrant to stagnant economic cycles.

There was no single corresponding event that clearly demarcates the global financial crisis of 2007 and 2008. Signs emerged as early as 2006 with erosion in the U.S. housing market, but the crisis would not reach full force until the September 2008 implosions of Lehman Brothers, the government-sponsored FNMA and FHLMC mortgage enterprises, AIG, Wachovia, Washington Mutual, and others. However, a recent article in *Bloomberg BusinessWeek* magazine designates an unofficial start of the crisis in March 2008, with the failure of Bear Stearns and its agreement to sell to JP Morgan Chase for a fire-sale price of $2 per share[1]. That designation would leave us now ten years removed from the crisis' onset, a notable interval on which to examine how the crisis affected the banking industry.



From a delivery standpoint, the banking environment has changed dramatically in those intervening ten years. The financial crisis launched a winnowing of institutions, including some of the largest banks in the U.S. Washington Mutual, National City, Wachovia, Colonial and IndyMac all were acquired either on the precipice of failure or upon actual FDIC seizure; and in each of those cases but IndyMac, acquirers with overlapping branch networks consolidated hundreds of redundant branches in the ensuing years.

In all, the past ten years saw more than 500 banks and more than 300 credit unions fail; and a far greater number of institutions would disappear in open-bank (or credit-union) distress sales, unassisted by the federal insurance funds but still precipitated by likely future insolvency. At least partially due to the financial crisis, the number of financial institutions has declined precipitously in these past ten years, by 32%. In 2007, there were 8,500 banks (including thrifts) and 8,100 credit unions in the U.S.; today, there are 5,700 of each institution type.

Branch counts have also declined over the past ten years, though less acutely than the decline in the count of institutions. In 2007, there were 114,000 bank and credit-union branches across the U.S.; today, that count has declined to 109,000. The 5,000-unit change does not accurately depict the volume of closures in recent years, as branch counts peaked not in 2007, but rather in 2009 as banks brought the full volume of projects in queue pre-crisis online. Thus, the current branch count, though down only 5,000 units from 2007, has declined by about 9,000 units from peak levels.

That level of consolidation has yielded larger, stronger institutions. Among the thousands of branch closures that followed the worst of the financial crisis, more than half represented direct overlaps that arose from acquisitions[2]. As a result, many branches derived (continued on page 2)

[1] Subsequent negotiations would raise the final price to $10 per share, still well below the pre-crisis peak of $133. The initial $2 agreement endures in business history at least partially due to the iconic photo of a $2 bill that someone, likely a dispirited trader, taped to the door of Bear Stearns' headquarters in Midtown New York the day of the bank's collapse.

[2] Direct-overlap closures were defined as a closure of either bank's branch when the acquirer and the acquired had branches within close proximity; with the distance defining proximity in this study determined as an inverse function of the surrounding population density, i.e., closer in urban areas, broader in rural areas.

The Financial Crisis: Ten Years After (continued from page 1)

The Impact of Branch Closures in Lower-Income Communities

As noted above, the industry has shed more than 9,000 branches from the peak levels of 2009. Because branch balance levels skew lower in lower-income communities, banks' branch-consolidation initiatives raise concerns over whether those efforts will disproportionately affect low-income markets. The branch contractions of the past ten years, borne not only of the financial crisis but also of consumer migration to electronic channels, carried mixed impacts for low-income communities.

By one measure, closures appeared evenly distributed across the economic spectrum of U.S. markets. In 2007, 28% of U.S. branches sat in census tracts with median household income of $50,000 or less; and a matching 28% of the branch closures executed from 2007 to 2017 occurred in those tracts. Thus, branches in low-income markets were not disproportionately culled in the post-crisis years, a testament to the will of banks to serve disparate communities, and the encouragement the Community Reinvestment Act provides to ensure such behavior.

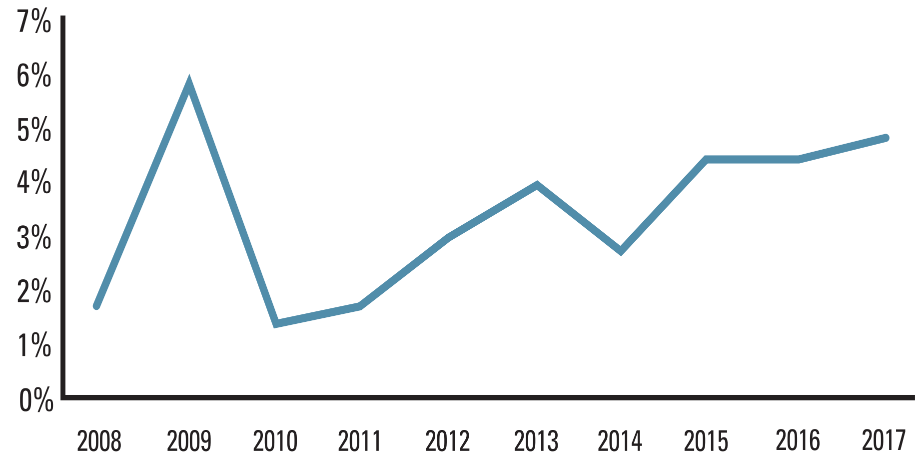
However, a more in-depth assessment reveals certain adverse impacts. Roughly half the 73,000 census tracts in the U.S. contain bank branches. The absence of branches in the other half does not necessarily imply the banking industry is avoiding those consumers, as some tracts are near-exclusively residential, with few viable locations for a bank or any other retail establishment. However, the number of tracts lacking a branch increased by 1,500 from 2007 to 2017, i.e., there are 1,500 census tracts across the nation that hosted at least one branch in 2007 but now lack any financial-services options.

Although the "lost-every-open-branch" tracts spanned all income strata (and note in many cases every open branch amounted to only a single branch), the last-remaining-branch closures disproportionately occurred in low-income tracts. There are 22,000 census tracts in the U.S. with median household income of less than $50,000; and 7,500 of these tracts carry median income of less than $35,000. In 2007, 52.7% of the sub-$50,000 tracts lacked any financial-institution branches, whereas 47.5% of the over-$50,000 tracts lacked any branches. By 2017, the proportion of the lower-income tracts lacking branches had increased by 2.6 percentage points to 55.3%. The proportion of higher-income tracts lacking branches also increased, but by only 1.9 percentage points, to 49.4%. Thus, the disparity in the availability of banking services between lower- and higher-income communities increased in the past ten years, even if only modestly.

Delving deeper into the statistics reveals that low-income urban markets (demarcated by the same $50,000 median income threshold but restricted only to tracts within metropolitan or micropolitan statistical areas, and with population density of at least 800 residents per square mile) suffered even greater service withdrawals. The proportion of such tracts lacking branches increased by 2.9 percentage points from 2007 to 2017, so that now 60% of such tracts lack any banking option. Those tracts combine to hold 12 million households, or roughly 10% of the entire U.S. household base. (continued on page 4)

greater revenue streams from the same trade areas and with the same fixed asset and noninterest expense levels, thereby improving operating efficiency. Because the number of institutions declined by a greater proportion than the number of branches, average network sizes have increased over the past ten years. The remaining banks now carry an average of 16 branches each, compared to 12 in 2007 (or 3.5 branches per credit union versus 2.3 in 2007). The contraction in branch counts plus natural growth (i.e., from inflation, population growth, and other persistent economic factors) has yielded larger branches, too: the median mature branch (open at least five years) now carries deposits of $50M, compared to $38M in 2007; with the average increasing to $63M from $50M ten years prior.

Deposit Growth (June to June)



However, the combination of fewer branches and a rising population has diluted branch-coverage ratios. In 2007, the U.S. supported one branch for every 1,030 households; today, that ratio is one branch for every 1,130 households. That shift likely reflects more than the post-crisis winnowing of overlapping and unprofitable branches, but also a belief by financial institutions that the rise of electronic channel alternatives can allow some degree of reduced physical coverage.

Aggregate consumer and small business deposits[3] have increased by 40% over the past ten years, but that growth did not occur linearly. Rather, the financial crisis sparked a period of volatility in deposit growth rates, with a 'flight-to-quality' spike in 2009 followed by several stagnant years, and then growth returning to a steady 4% - 5% annual clip in the past three years. As national banks either deliberately shed deposits due to excess liquidity or were hampered from growth by a focus on problem assets, credit unions' share of retail deposits crept upward, to 16% today from 13% in 2007.

With most regions of the country having escaped the worst impacts of the recession by 2014 or 2015, many measures of bank profitability have returned to pre-crisis levels. The regulatory environment carried measurable impact in reducing fee income, which declined from 2.2% of assets across the banking industry in June 2007 to 1.5% ten years later; however, offsetting gains in noninterest expense levels left the industry's efficiency ratio at the same 57% level as ten years prior. To the negative, though, return-on-asset levels remain about 20 basis points short of pre-crisis levels, and problem assets also remain higher as banks work through the last of the post-crisis issues. In one example, the ratio of noncurrent assets plus other real estate owned to assets sits at 72 bps, versus 62 bps in June 2007, and as low as 50 bps in prior years. Other credit-quality ratios track similarly.

In sum, an industry that at its nadir placed 12% of all banks and thrifts on the FDIC's troubled institution list has now escaped most of the impacts of the financial crisis, emerging with a smaller footprint, greater share concentration in the hands of fewer banks, and near comparable earnings and efficiency ratios. However, the greater concentration and reduction in delivery options could carry adverse implications for consumers, perhaps creating opportunity for a new wave of entrants in certain markets. Our next issue of *Bancology* will explore the impacts of industry consolidation on consumer convenience.

[3] This measure seeks to exclude corporate, public funds, and other non-retail / small business deposits by truncating individual branch deposits at $250M.

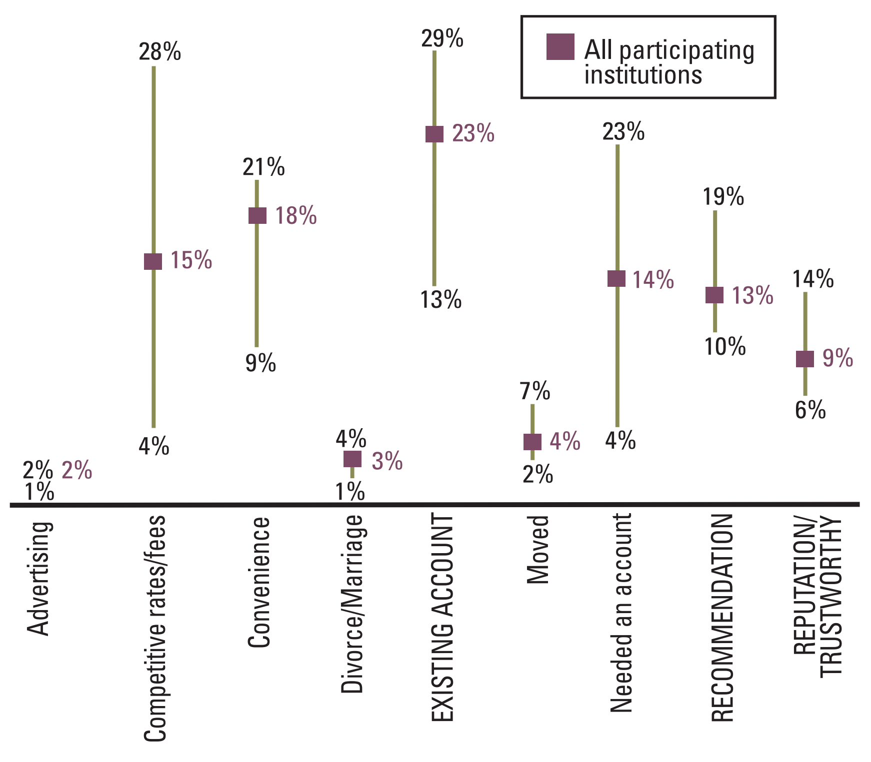
New Account Customer Experience: Reason for Choosing the Institution

For its New Account Customer Experience research program, Bancography compiles data from interviews conducted via internet surveys. Participating institutions continually post new consumer and business account files for Bancography to initiate survey invitations.

In the survey, new account holders were asked to cite the primary reason for choosing that institution to open their account. Across the group of surveyed institutions, *existing relationship* captured 23% of the responses, followed by *convenience* with 18%, as shown in the graph below (the motives listed in all capital letters have shown the highest correlation with brand loyalty in more in-depth branding studies). Those proportions have remained relatively constant since this study began in 2015.

The overall averages, however, mask broad differences across the participating institutions; as each showed a distinct mix of motives. Differences across institutions reflected market competitive environment as well as the institution's branch density, longevity and brand positioning. For example, one community bank serves markets with a strong credit-union presence, mandating an aggressive pricing structure. Reflecting that, 28% of its new account holders cited *competitive rates / fees* as their primary selection criterion. In contrast, a larger bank had more new account holders who cited *convenience* as their primary motivator. *Advertising* received few mentions for any participating institution; but note that reasons overlap, as advertising can drive awareness of other primary decision criteria such as product features or convenience.

Primary Reason for Choosing Institution



The Impact of Branch Closures in Lower-Income Communities (continued from page 2)

Even in the low-income-urban subset, the disparity remains modest when compared to the higher-income subset: a one-percentage point difference in the change in unserved tracts over a ten-year horizon. Still, that change further amplified a gap that already stood at 14 percentage points (as in 2007 61.5% of the lower-income urban tracts lacked branches, compared to 47.5% of the higher-income tracts) to 15 percentage points, and now 64.4% of all lower-income-urban census tracts lack any financial-institution branch.

Thus, while the wave of post-crisis closures did not disproportionately occur across branches in low-income communities, they did more frequently result in a low-income community, and especially a low-income urban community, losing its last remaining branch. Anecdotally, bankers often cite regulators as invoking the Community Reinvestment Act as an impediment to closing the last remaining branch in a market; but in reality, the combined efforts of bankers and regulators have proven more effective in ensuring closures affect all income strata similarly than in ensuring a common minimum level of branch availability across those income tiers.

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