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THE ART OF BANK PLANNING
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THE ART OF BANK PLANNING

Diversification: Free Lunch and the Benefit of Small Branches

If you had the opportunity to build one large branch or two small ones, which would you choose? Consider these two options:

A. One 5,000 square foot branch in a top tier submarket, capital cost 2M, annual non-interest expense $500,000.

B. Two 2,500 square foot branches in second tier submarkets, capital cost 1.2M, each with non-interest expense of $300,000.

There are arguments in favor of option A: lower total non-interest expense; a flagship branch that consumers will perceive as strong and stable; greater traffic due to the greater visibility that the larger branch affords.

There are also arguments in favor of option B: for 20% more in non-interest expense, you can cover two distinct markets, albeit with less physical presence in each market and in lower-quality submarkets.

Now, presume that, due to its greater visibility and superior market quality, branch A can capture 50M in deposits while each of the branches in option B can capture only 25M in deposits. Note that we are not claiming that larger footprint branches automatically gain more in deposits; we are just presuming that for the sake of this specific example. The branches are otherwise comparable (same loan to deposit ratio; same non-interest revenue to deposits ratio, same deposit mix, etc.). From a financial standpoint, option A appears superior, as it would offer the same revenue with lower total costs. But in reality, option B may provide the better *risk adjusted return* to the institution.

Legendary economist Milton Friedman routinely taught that "there's no such thing as a free lunch," even titling a book with that phrase. The phrase referenced his belief that every good comes with an opportunity cost; i.e., what was foregone to obtain that good. Even the proverbial "free lunch" comes at the cost of what the diner could have otherwise done with that time or of having to listen to a pitch from a condominium developer. But another University of Chicago economist, Harry Markowitz, earned his own Nobel prize by proving that in finance, there actually is a free lunch – in the form of portfolio diversification. His 1952 thesis *Portfolio Selection* proved that if an investor held diverse stocks that were less than perfectly correlated in their movements, he could achieve the same level of return as with a single stock – but with considerably less risk. This free lunch effect, greater returns for no more risk, laid the groundwork for many of the investment and finance techniques that are commonplace today.

An institution's branch network is similar to an investor's portfolio: each branch represents an asset that provides a given level of returns, depending on certain variables. When we project a branch can reach 50M in deposits, what we're really saying is, "Depending on market economic developments, branch manager quality, entry and exit of nearby retailers, competitor behavior, and other factors, the branch will capture somewhere between 40M and 60M in deposits, with the most likely scenario being 50M." The 50M is not guaranteed – it is subject to various risks.

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The Bancography Brand Value Index: What is Your Brand Worth?

If two institutions each start with $100 million in equity capital, why can one build an enterprise worth double that while the other can grow by only half that amount? Much of the difference represents the value of the institution's brand. By brand, we're referring not only to the name, logo, and tagline – though those are all critical components of the brand – but also to the reputation, service proposition, image, and other intangible factors that cause consumers to affiliate with one institution over another.

The value of a brand can be quantified as the difference between a company's overall value and that portion of its value attributable to its tangible assets or to external market factors. To calculate a financial institution's brand value, Bancography first determines a rational long term valuation for the institution using an amalgam of two common measures: premium on deposits and the price – earnings multiple (a close relative of discounted cash flow analysis). Both measures are adjusted to reflect each institution's specific financial and market profiles.

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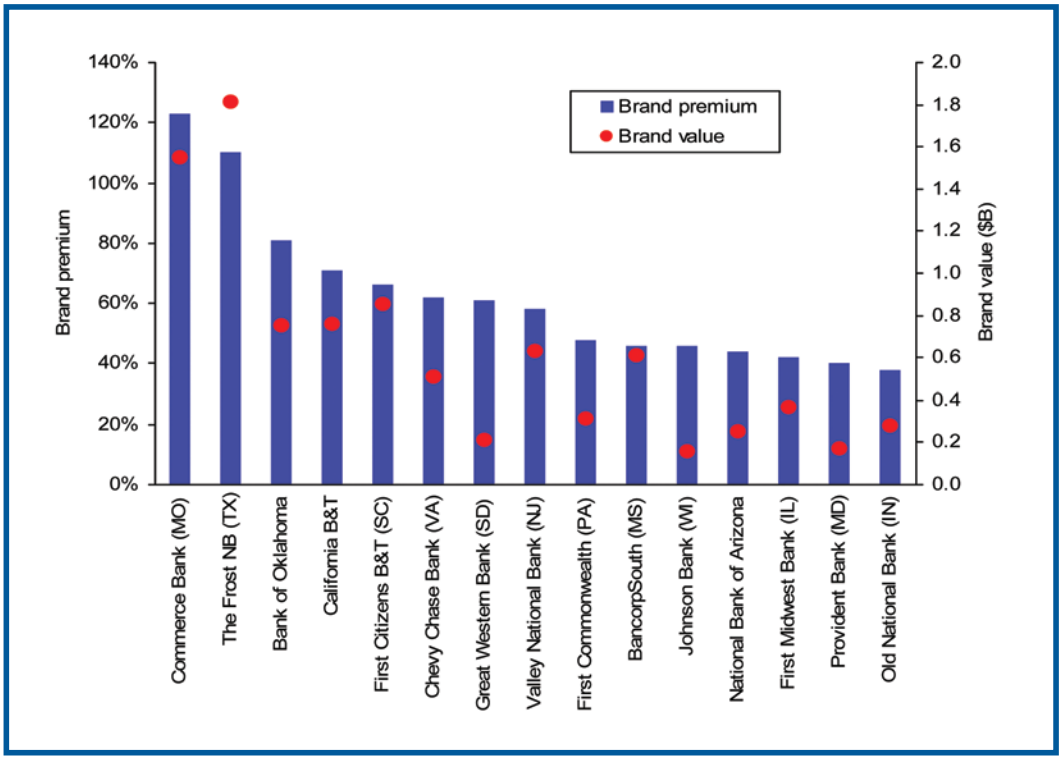
One significant adjustment involves the deposit premium, which is scaled to impound each institution's cost of funds, with a higher premium accorded to institutions with lower funding costs. Any institution can raise funds by bribing customers with top of market rates, but only a powerful brand can attract and retain customers while maintaining market-level pricing.

Similarly, in the price-earnings valuation, earnings are quantified over several years, with extraordinary gains excluded. Bancography values brands over the long term, not based on the current stock market turbulence or last quarter's slew of gains from the "Visa dividend;" neither reflects an ongoing ability to attract and retain customers. The price-earnings multiple is scaled to reflect the variability, or risk, of the earnings stream; a powerful brand insures consistent performance. Further, Bancography also adjusts the multiple for the market environment: that an institution in high growth Florida outpaces an institution in low growth Ohio partly reflects external demographics, and we need to factor that out to gauge true brand value. Income, wealth, and market competition levels also affect an institution's "default" growth rate; the best brands deliver growth above and beyond what the market's innate characteristics would imply.



Because Bancography's method uses balance sheet, income statement, and demographic measures to estimate market value rather than actual stock market capitalization, the process is equally applicable to credit unions, privately held banks, and publicly traded institutions.

To illustrate the concept of brand value, we selected 15 mid-sized institutions for comparison. The institutions are ranked by brand premium, the proportion of value that the institution's brand adds to its book value. The red dots show the absolute brand value, which of course is greater for the larger institutions. But, note that a large absolute brand value does not mean that the brand is adding above average value on a relative basis. The brand premium, because it is defined relative to the institution's size, is a better indicator of how effective a brand the institution has built. In fact, the smallest institution in the sample in terms of deposits, Great Western, ranks in the upper half of the 15 institutions shown. Notably, the institution in the sample with the most effective brand, Commerce Bank (of Missouri), recently earned a top ranking in an annual survey of retail banking satisfaction by leading quality service researcher J.D. Power and Associates.

In the next month Bancography will release its comprehensive brand rankings for all financial institutions. In the interim, if you'd like to see how your brand measures up, contact us at (205) 252-6671. And, in the next issue of Bancology, we'll discuss some of the industry's most successful brands and examine how those institutions achieved that performance.

How to Create a Branch Network Scorecard

While monitoring each retail branch's financial profitability is an important exercise, that exercise alone does not always create an understanding of which branches are the most crucial to the overall network. For example, deciding to close an unprofitable branch that contributes 25% of the institution's total transaction count would bring severe customer service consequences.

If your institution does not already use a **branch network scorecard**, it would certainly please the regulators and auditors for you to develop one so that the identification of closure, relocation, and consolidation targets becomes as methodical as possible. The branch network scorecard is distinct from a sales performance scorecard. The performance scorecard measures sales effectiveness for use in incentive programs. The branch network scorecard quantifies controllable and non-controllable factors that impact the branch's overall value to the institution's delivery network. However, it certainly can also identify branches that may be teetering on the edge of viability that can be improved with additional sales training or new management.

Building an effective branch network scorecard involves the following steps:

Step 1: Insure that the team reviewing the scorecard includes management delegates from Property Management, Retail Banking, Finance, and Strategic Planning. Others that may be brought into various discussions include the CRA director and regional or market retail management.

Step 2: Develop categories and subcategories that can be used to rank each branch fairly against one another. Determine weightings for each major and minor category. We suggest you identify no more than 7 - 10 categories that are important to your institution. Keep the scorecard simple and measurable so that retail managers understand the basis for any keep/close decisions.

To the right is a sample of categories and weights to guide the development of your institution's scorecard. Of course, each institution will find its own distinct mix of categories and weights that most appropriately define branch value in its network.

Major Category	Network Mass (25%)	
Subcategories		Total deposits (50%)
		Combined # of consumer loan and deposit accounts (25%)
		Average monthly teller transactions (25%)
Major Category	Sales Growth (25%)	
Subcategories		Open/close account ratio (40%)
		Deposit balance growth (60%)
Major Category	Profitability (40%)	
Subcategories		Return on assets or liabilities (50%)
		Net income (50%)
Major Category	Efficiency (10%)	
Subcategories		Efficiency ratio (75%)
		Transactions per day per teller (25%)

Step 3: Gather data from the various systems to feed into the branch ranking system (financial, sales, transactions, full-time equivalents, etc.)

Step 4: Rank each subcategory from best to worst (best = a rank of 1). Create the overall branch ranking by multiplying the rank by the weight of each subcategory, adding them together and scaling each major category score according to its weight. Sort the overall score from best to worst and then highlight the bottom quartile to yield a final watch list of branches. Review each of the branches in the bottom quartile for closure, consolidation, sales or other improvement opportunities.

While a measurement tool such as this provides an objective means for identifying closure candidates, decisions must also include detailed qualitative assessments. Consider community reinvestment issues as well as the proximity and capacity of nearby branches before finalizing any closure decisions.

Update the branch network scorecard quarterly or semi-annually and develop processes to minimize the administrative effort required to compile the scorecard data. Finally, send your initial ranking report to all executive and regional management and seek feedback on the measures, weightings, and decision processes. Thoughtful comments from the line officers directly responsible for branch performance will help refine the scorecard into a more useful and effective management tool.

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Now, consider the two 25M branches. In reality, each may fall as low as 20M or reach as high as 30M in deposits. But since the factors impacting performance (branch manager quality, retail neighbors, etc.) are independent at the two branches, the variances will tend to cancel each other out. An unexpected market downturn in one branch submarket could be offset by exceptional branch manager performance in the other submarket. In short, the diverse two-branch portfolio can reach 50M in deposits with less risk than the single-branch alternative.

Just as investors own stocks in retailers, utilities, and auto manufacturers to reduce their exposure to any one sector, it is similarly important for financial institutions to own a diverse portfolio of branches to minimize their overall network risk. The lower risk of the cash flows from a diversified branch portfolio, i.e., the greater likelihood that the institution will reach its forecasted balances, will even offset some additional level of operating expenses from the broader network – just one more argument in favor of small branches. A network of numerous small branches enjoys the strategic benefits of market coverage, lower breakeven requirements, and the corresponding ability to serve smaller infill submarkets unviable for traditional full-service formats. The risk mitigation that diversification provides confirms the financial wisdom of the small branch approach.

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