RETHINKING BRANCHING

by Steve Brown

As of the end of August 2009, there were approximately 94,148 bank branches across the nation. Despite the downturn in the economy, that number is up almost 7% from the start of last year. Unfortunately, given credit problems and low rates, 2008 and 2009 will go down in history as a period where branch profitability has been some of the lowest in the history of banking. At present, we estimate that almost 48% of the average bank's branches are unprofitable.

Now granted low rates are not going to be down for long, but that begs the question - how long do you keep an unprofitable branch? If we told you that short-term rates would be below 1% for the next 3Ys, would that speed up the rate of closure? Consider this - the average net interest margin in our industry is 3.60%. The average marginal direct cost to maintain a branch is 3.50%. This cost just takes into account the act of gathering and servicing loans and deposits, but does not take into account direct fixed costs (such as depreciation) or indirect costs (like brand marketing or overhead). To cover expenses for the average branch, margins need to be north of at least 3.75% (depending on cost structure and asset size). Higher short-term interest rates would help and if Fed Funds could get above 3.00%, that would surely help. The problem is, this Maginot line of branch profitability isn't predicted to happen until the end of 1Q 2012. Even with short-term rates above 3.00%, we estimate that 20% of existing bank branches will remain unprofitable.

From a strategic planning perspective, many banks should be looking at closing branches. At a minimum, banks should be looking for alternative delivery structures in order to lower servicing costs. Take for example the rise of the iPhone/iTouch. This has been monumental to branching. 3Ys ago, smart phones were the minority. Now, because of the popularity of those products, combined with the Blackberry and Android (Google's phone operating system), almost 50% of the population now say they would be comfortable banking on their phone. Only 2% of the population does, but at some banks, this number is now 15% and expected to go to 35% in the next couple of years. Combine the increase in mobile banking with the continued growth in online banking, imaged ATMs, remote deposit capture and other technological applications, and we predict that branch visits will be cut in half by 2013. These trends make maintaining branches even more expensive.

Using the above assumptions, even with higher interest rates, our industry can do without some 24k branches by 2013. At a minimum, banks should at least be thinking of how they can pare down their average branch size and service platform in order to reduce premises and support costs. Further, if expanding your bank's footprint is a strategic initiative from year's past, then the market now presents some great opportunities to acquire branches from other banks. Instead of purchasing/acquiring branches in contiguous areas, banks should consider acquiring branches in-market so that delivery platforms can be combined.

Bank of America just announced the closing of 10% of its branches, Citi is reportedly considering even more and other banks are following similar paths in an effort to reduce their costs (while maintaining their service commitment). Given the market, the next 3Ys present an ideal time to restructure the branch network. Banks that move quickly will have a competitive advantage. This year, consider a strategic initiative to take another look at your branch structure to see if it can be improved.

BANK NEWS

Bank Closure (95 YTD)

On Friday, the FDIC closed Georgian Bank ($2B, GA) and sold it to First Citizens Bank and Trust Co ($6.8B, SC). First Citizens will assume all deposits, 5 branches and all of the assets (under a loss share agreement).

CU Closure

The NCUA closed Keys Federal Credit Union ($180mm, FL) and placed it into conservatorship.

Large Loan Stress

The annual review of shared national credits (loan commitments of $20mm or greater held by multiple banks) has been completed and shows credit quality deteriorated to record levels. Losses from syndicated loans tripled in 2009, as criticized assets jumped to 22.3% (compared to 13.4% last year) of all such loans and classified assets climbed to 15.5% (up from 5.8% in 2008).

Dilutive Equity

The WSJ is reporting that so far this year 35 community banks have completed stock offerings, compared to just 7 in all of 2008, 7 in 2007 and 14 in 2006. The article noted that the offerings were all at a discount to current market prices. Banks are raising more capital mostly to improve ratios given loan deterioration.

M&A

Analysis finds the price of acquired banks averaged 1.16x tangible book value in the 1st half of 1009, compared to 1.72x for all of 2008 (a 32% decrease).

Customer Preference

A survey by the ABA finds that for the first time ever, customers prefer online banking to any other delivery method at 25%. Branches moved to 2nd place at 21%, followed by ATMs at 17% and mobile banking at 1%.