OPTIMAL DENSITY

by Steve Brown

We were intrigued by an article about efforts to control the number of rats living in the NY City subway system. The majority of people reading this publication have probably visited there at least, so few should be surprised to know rats snuffle among the Big Mac wrappers on the subway tracks looking for delectables. There must have been plenty to eat, as the rats looked pretty plump. New York is taking an interesting approach to controlling its rats with a pilot program that dispenses birth control of the non-elective kind to its rat population. A chemical is dispensed in bait that renders a female rat's reproductive system sterile in days. Rats can have up to 12 babies at a time and 7 litters a year, so slowing the growth of the population is key. NYC is not looking to wipe out the entire subway population, because a complete absence of rats in one area just means others will move into the unoccupied space. You see, rats are territorial, so the idea is to have an optimal density of them to keep others away from the area and reduce the risk of disease.

We are certain this line of conversation so early in the morning might make even the sturdiest of our readers queasy, but if we know community bankers, it also makes them think right away of how tricky it is to achieve optimal branch density. It is not a simple question given how quickly customer preferences are shifting, to know how many branches make sense and where they should be located. We know many customers prefer internet banking or using their phones, but one trend that began with the introduction of the ATM is interesting. That trend is the simple fact that while customers may prefer to use other means to access their bank, for more complex transactions, they still come into the branch. The convenience of other channels has made branch visits less frequent, but when a customer does come in, the transaction value has increased considerably. Basic mobile banking systems such as checking account balances by text message went from an average of 9 to about 20 a month over the past few years. Then, with he advent of smartphones, mobile banking interactions have soared above 30 per month. Thankfully, this rise in activity takes place almost entirely through automated channels.

The old fashioned branch remains an important pillar of the community bank model and measuring optimal placement is tricky. Some markets may offer the potential to open a large number of DDA accounts, but there is often a low correlation with that and capturing higher balance accounts or selling other products in those markets. These are the very activities most likely to create long-term value for the bank, so measurement of branch performance should consider both transaction volume and opportunity. Typically, banks will add branches to a successful market until that market is saturated and returns diminish. This can happen when your bank has branches too close to one another, or has too many competitors.

When density grows too high, the branch operates in a market with sub-optimal density. One study found large national banks had roughly 16% of their branches in sub-optimal markets, but community banks had almost 50% of their branches in markets with suboptimal density. No doubt some of this is due to community banks being located in smaller towns with less dense population and other factors. In the end, though, closing and opening branches takes time and money, so understanding the driving factors is critical to success. Changing trends lag and these costs are embedded, so care must be taken no matter the market. Finding the optimal density is difficult, because every action leads to a reaction that can be unpredictable, so test, tinker and try things to find the sweet spot for your own bank.

BANK NEWS

Q1 Earnings

JPMorgan reported its profit jumped 33% YOY as it cut expenses by 16%, reduced loan loss reserves by $1.2B, reported a 31% decrease in mortgage banking net income due to low interest rates. NIM declined from 2.61% to 2.31%. Wells Fargo reported its net income hit a record $5.2B, up 22% from the same period last year. Average loans grew 4% and average deposits increased 6%, NIM fell 8bp to 3.48%, the efficiency ratio was 58%, ROA was 1.49% and ROE was 13.59%. While the data overall looks good, analysts point out revenues fell at both banks and earnings gains came mostly from cutting expenses, lower legal costs or reversing out loan loss reserves.

Prepayment Risk

Community bankers should know that at current rate levels, 81% of callable agency securities with call dates in the next 3 months will be called (in the money), further reducing NIM.

CRE Rebound

Community bankers should know commercial real estate prices have rebounded strongly since declining about 40% from peak levels at the depths of the credit crisis to now sit just 20% below peak levels. It might be time to consider hanging onto OREO, releasing reserves and taking other action given such a strong rebound.

Fees

As NIM continues to get squeezed, banks have become more creative with their fee structures. Some that have recently surfaced include: charging $5 to replace a lost debit card and $20 for a rush order; $25 per month to avoid fees on out of network ATMs; $1 to have your customer service call taken next; and $1 to print an ATM statement.

Muni Bonds

Banks should note that President Obama's budget calls for a 28% cap on income deductions and exclusions (including municipal bonds).