The Role of the Branch in a Multi-Channel World

FSI's 40th Retail Banking Conference

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bancography

PREFACE

The seismic changes wrought by the COVID-19 crisis impacted deposit and loan demand, credit quality, and channel use, upending nearly every facet of the banking industry; but especially branch operations.

Even as electronic channels emerged, community banks and credit unions have continued to rely heavily on the personal touchpoints branches offer, yet for the better part of a year, consumers largely lost the use of that channel, and in some regions still lack lobby access.

It remains uncertain as to whether branch demand will return now that we have arrived in the post-crisis phase.

Accordingly, this session will examine the role of the branch network in the post-pandemic environment, and recommend actions bankers can pursue to maximize the value of their branches in the years ahead.

WHY BRANCHES STILL MATTER

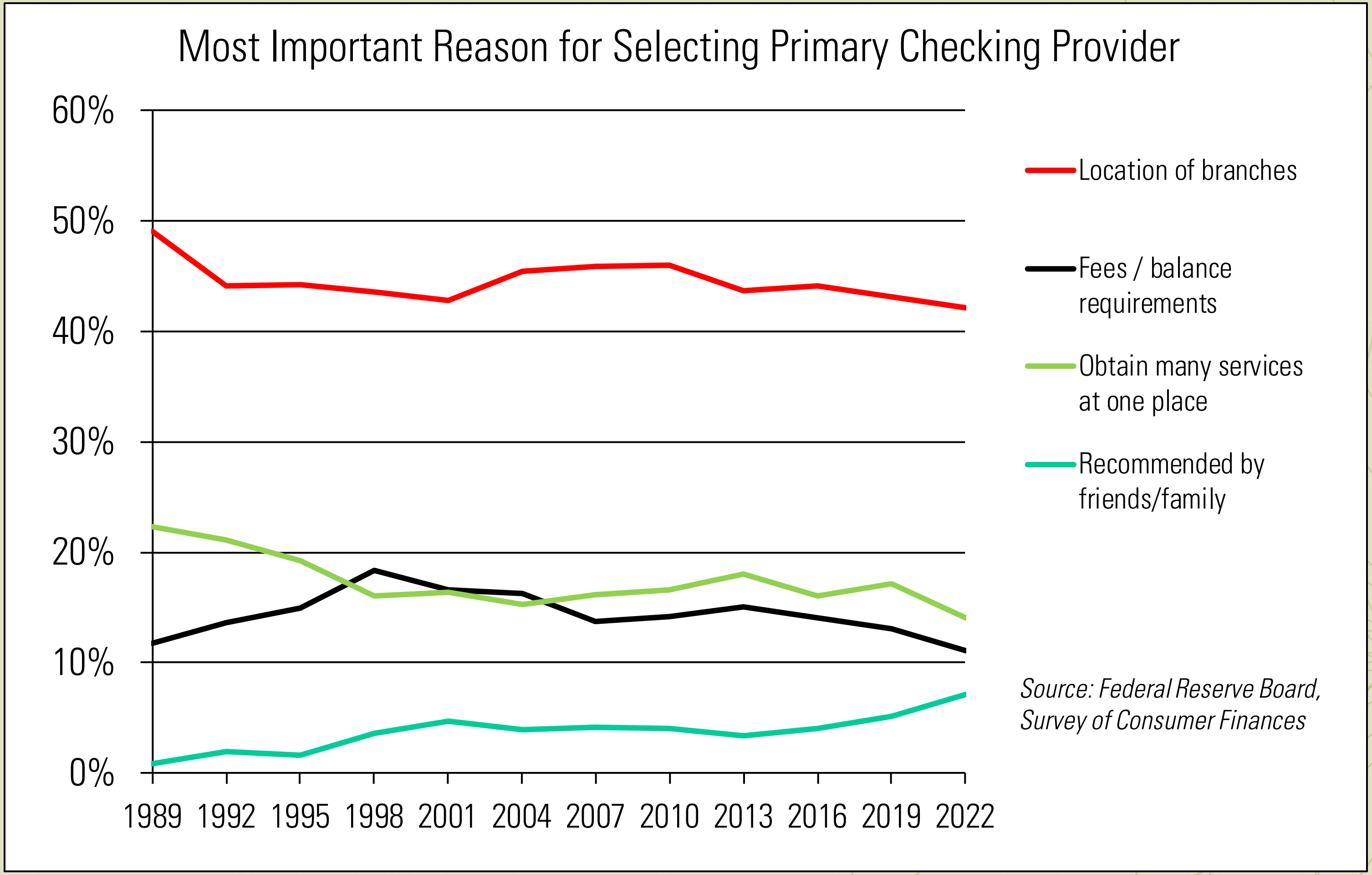
Despite the rampant growth in alternate channels, the branch remains the predominant venue for new account sales. Further, ask any community bank or credit union executive what differentiates their institution and you'll hear "our people."

And no channel places "our people" with our customer like the branch.

The branch continues to offer significant value in both customer / member recruitment and in building an institution's brand.   As the most visible embodiment of the institution, the branch channel remains critical: branches still matter, and effective branches remain at the heart of successful financial institutions.

PRE-PANDEMIC, BRANCHES STILL MATTERED

The branch remains the dominant sales channel, with more than 80% of new accounts originated or executed in a branch



PRE-PANDEMIC, BRANCHES STILL MATTERED

The FDIC's 2019 study *How America Banks: Household Use of Banking and Financial Services* found that 83% of households with bank accounts visited a branch at least once in the prior 12 months.

Branch-use rates were even greater among older households, lower-income households, and households in rural communities (which share significant overlap with the prior two categories).

21% of households cited the branch as their primary channel.

Even among households that cited mobile banking as their primary channel, 80% still visited a branch at least once in the prior 12 months, and 19% reported more than ten branch visits in the prior 12 months.

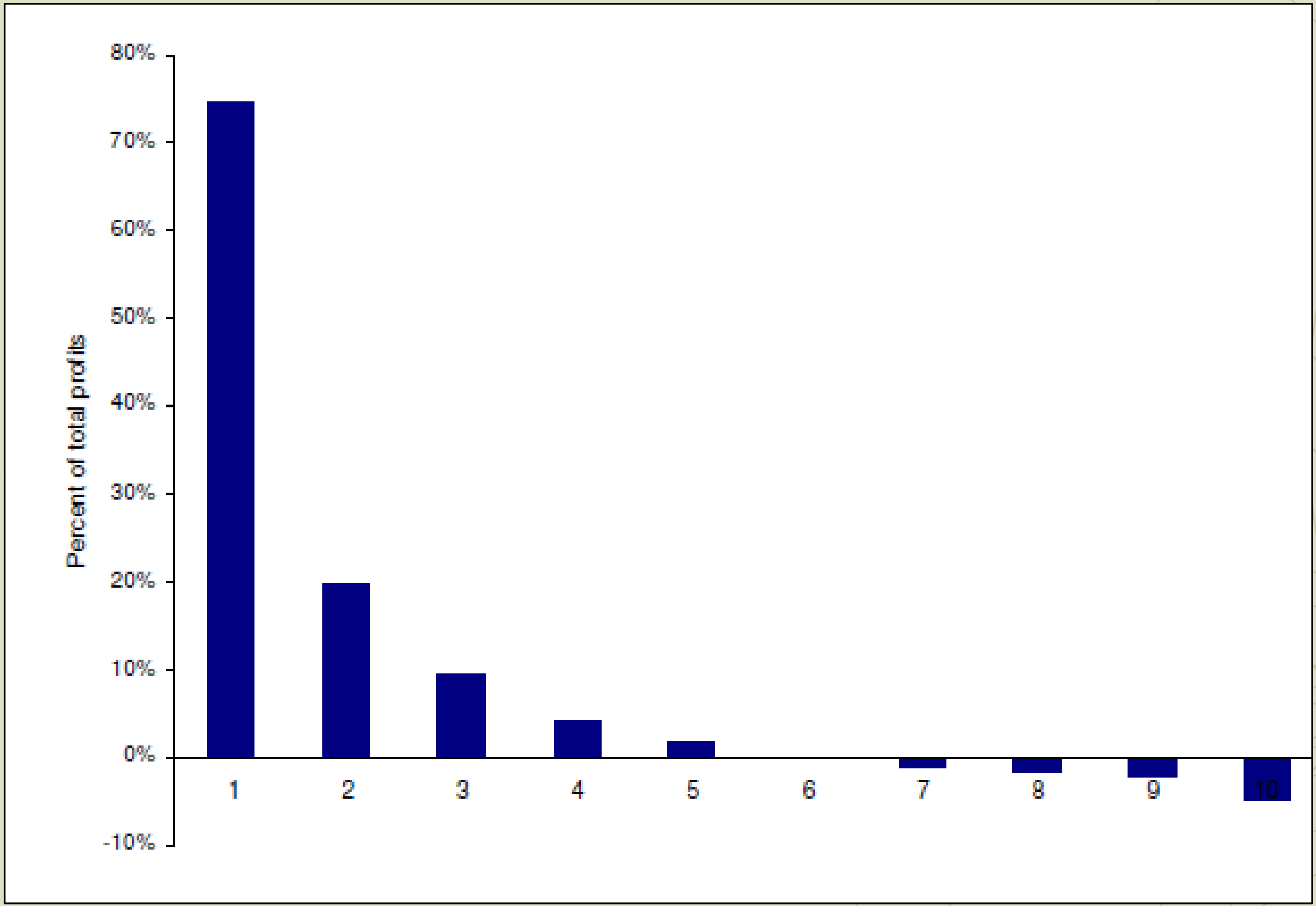
Whether these trends return as branch lobbies reopen post-pandemic remains a critical unknown.

WHY BRANCHES STILL MATTER

- The role of the branch is changing as in-branch transaction volumes erode:
- Alternate channels and payment mechanisms have reduced in-branch transaction volumes by as much as 50% at some institutions
- Yet the physical distribution channel remains prominent:
- Despite increases in alternate channels, the branch remains the predominant channel for client acquisition, processing upwards of 80% of all account opens at most banks and credit unions
- Location convenience remains the top institution selection criterion for consumers; and Bancography research confirms competitors with larger branch networks continue to capture a disproportionate share of deposits.
- Fraud and other security concerns are actually creating a counter-trend toward increased branch-based account openings

WHY BRANCHES STILL MATTER

Nearly every bank and credit union shows this type of profit distribution:



WHY BRANCHES STILL MATTER

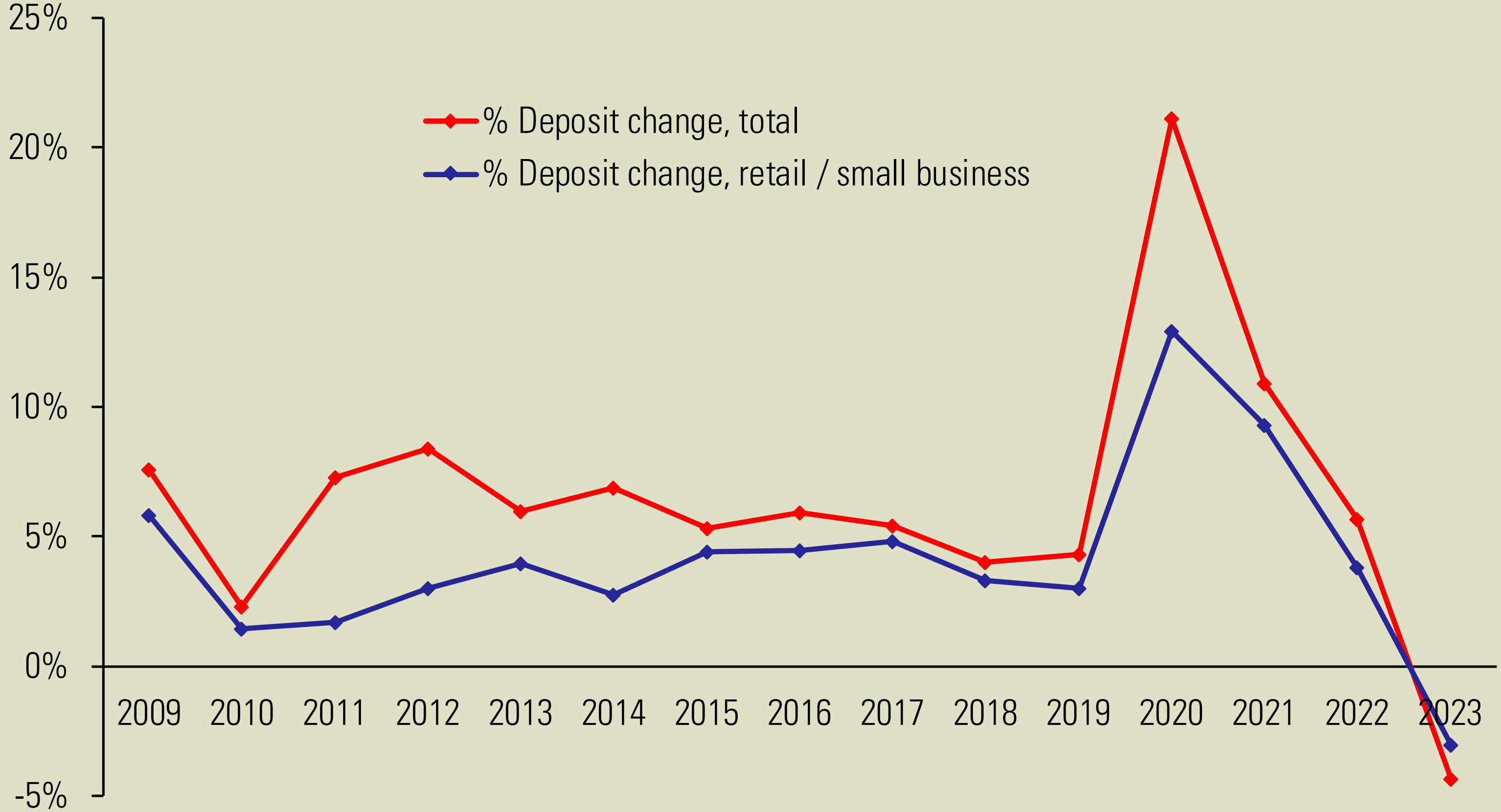
- Branch traffic volume is irrelevant, as long as the “right” customers enter:

- The top one-third of households in the U.S. by income level contribute 86% of consumer deposit demand and 53% of consumer loan demand.

- Small business customers often contribute six to ten times the average profit per household level of consumer households.

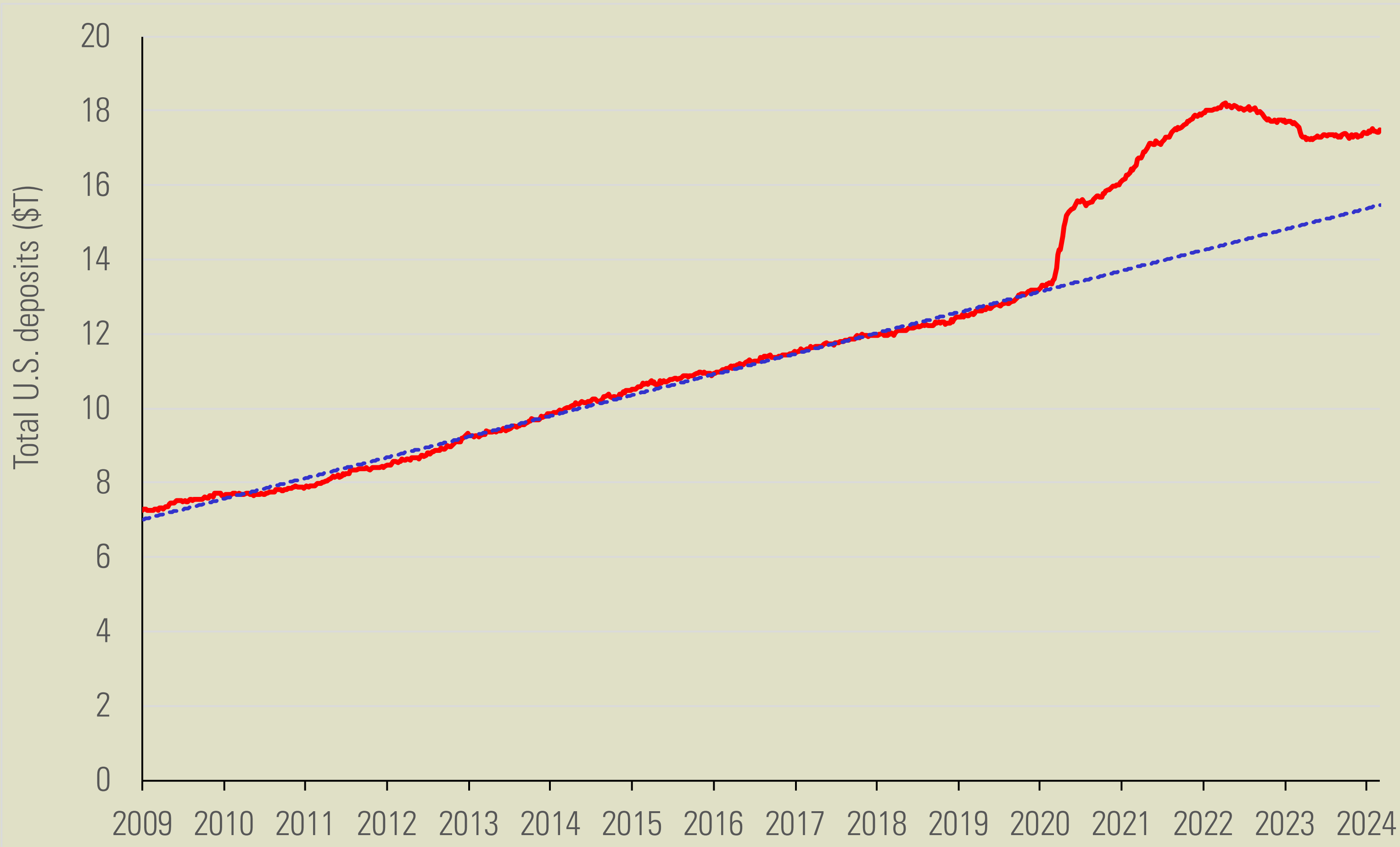
NATIONAL DEPOSIT GROWTH TRENDS

Nationwide deposit totals declined in the past year for the first time in decades, as consumers and businesses spent down surplus deposits accrued from COVID-relief funds, and the lack of spending during the peak of the pandemic. Total deposits declined by 4.4% from June 30, 2022 to June 30, 2023, while retail and small business deposits declined by 3.5% – a sharp contrast from the 3.8% gain of the prior year, let alone the 10%+ gains of the peak COVID-crisis years.



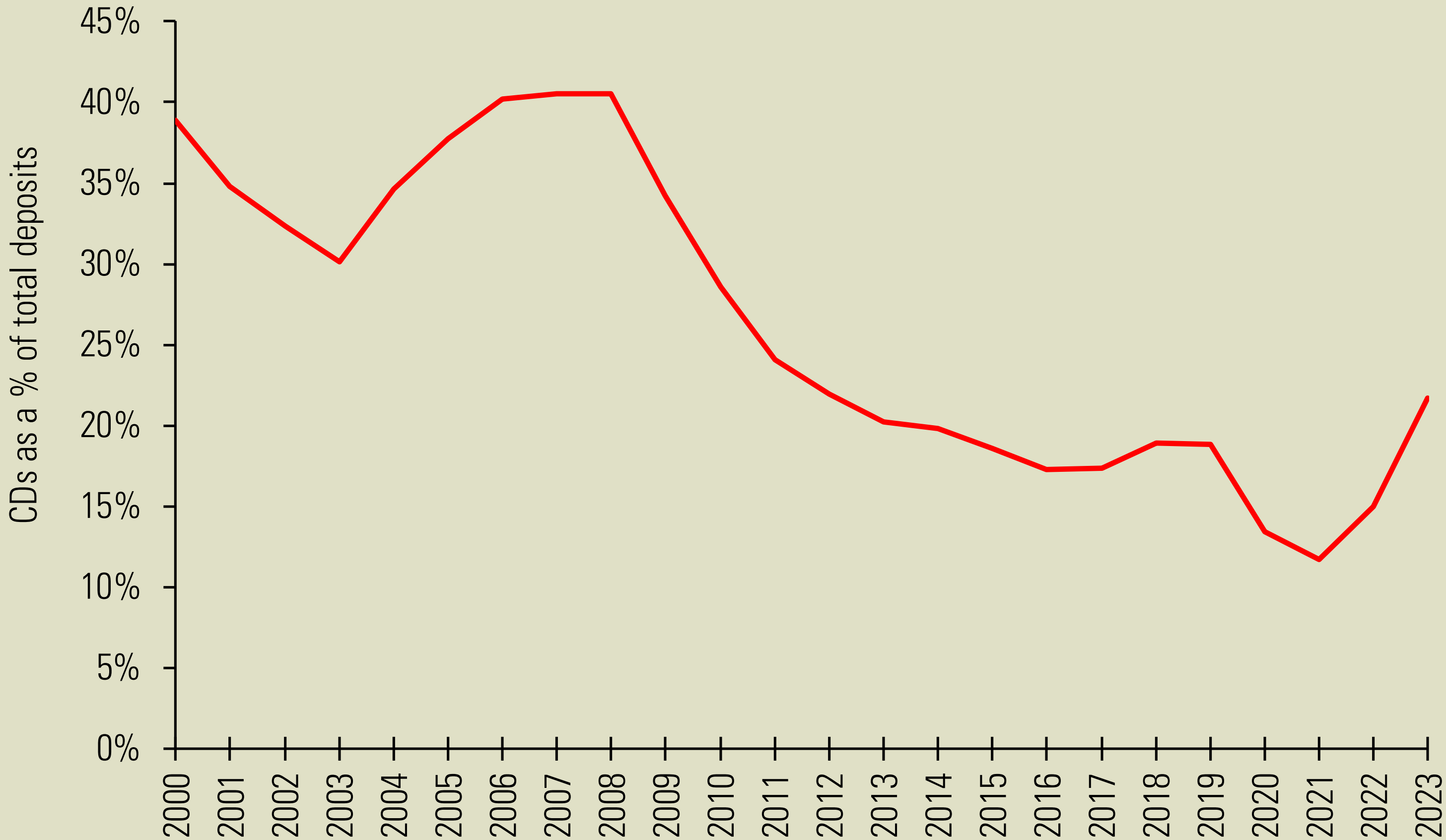
NATIONAL DEPOSIT GROWTH TRENDS

Even with the 3.5% decline in nationwide deposits in the past year, there is still evidence that deposits may erode further. If the growth trends of the post-financial crisis period persisted through the current era with no COVID disruption, current deposits would reach only $15.5T, versus an actual of $17.4T. That is, current deposits nationwide remain nearly $2T above the levels a pre-COVID trendline would have predicted for 2024.



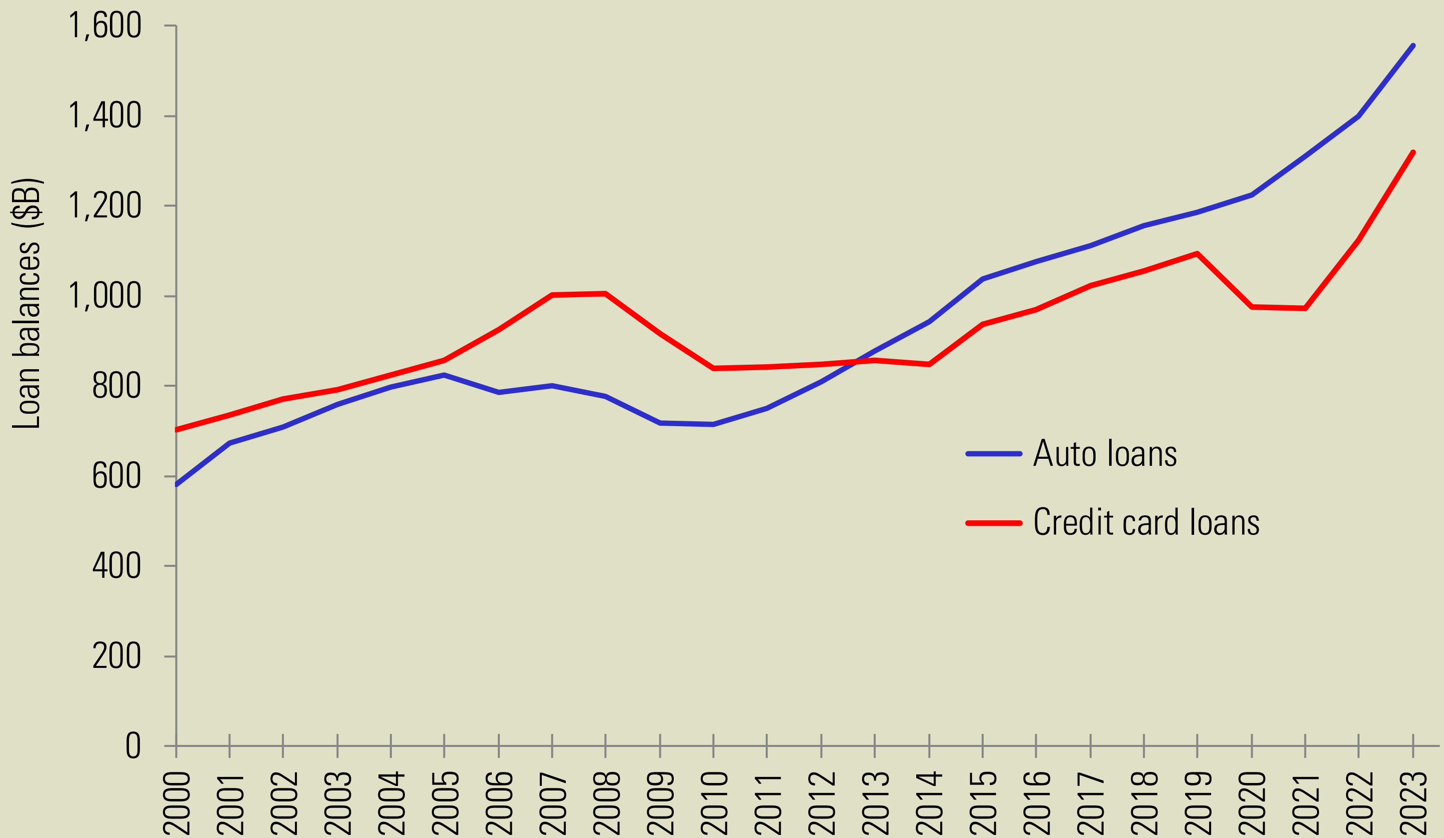
CONSUMER BALANCE SHEET TRENDS

From 2006 to 2008, CDs represented more than 40% of deposits held in U.S. bank branches. But the financial crisis of 2008/2009 and the low-rate environment that followed brought about a steady erosion in consumers' appetite for fixed-term, fixed-rate investments. The trend away from CDs finally started reversing in 2018 and 2019, only to see the COVID-driven, zero-rate environment of 2020 and 2021 take CD demand to all-time lows. However, the rising-rate environment of the past two years increased demand for CDs, which now represent 22% of consumer deposits, the highest proportion since 2012.



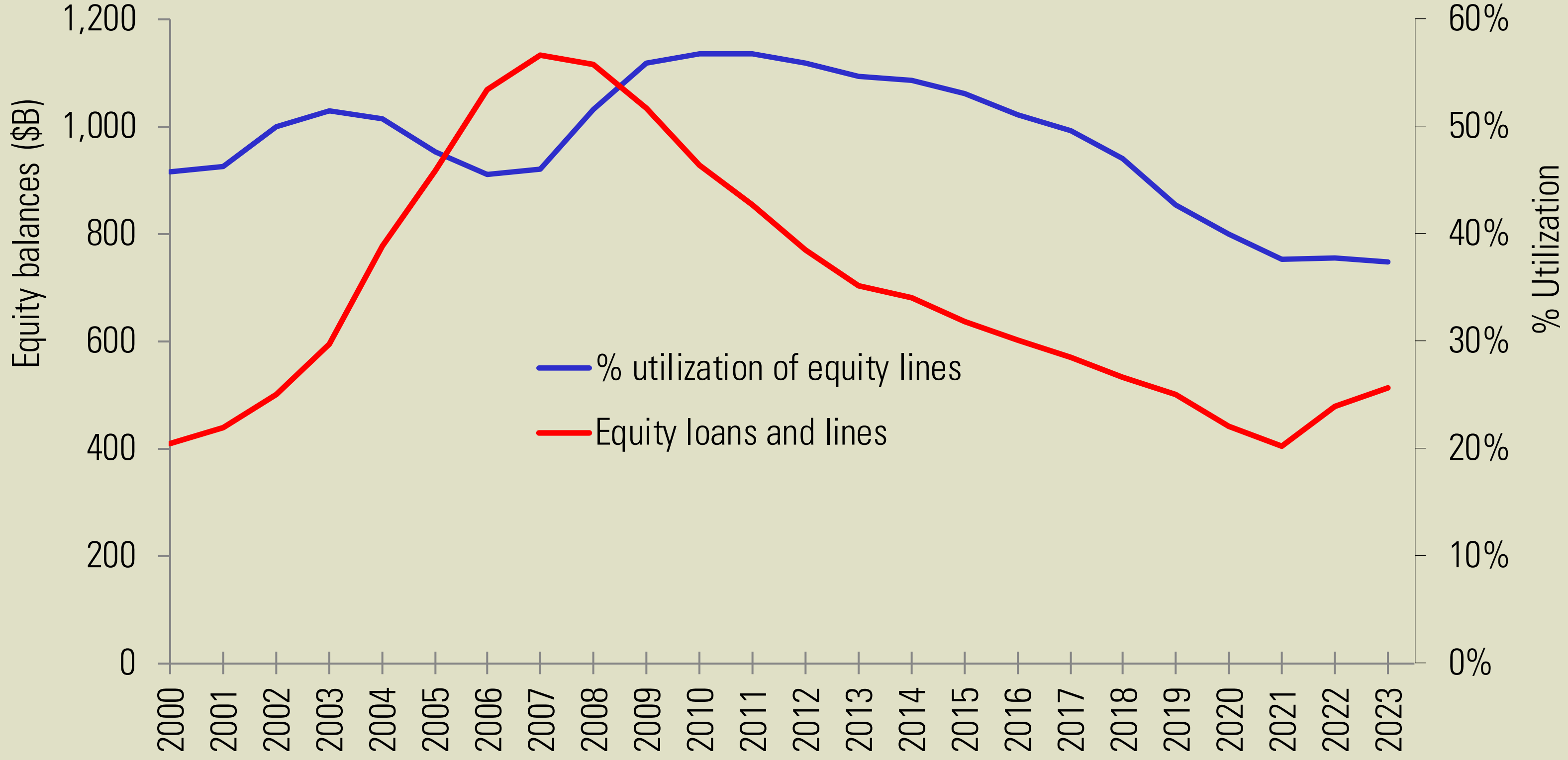
CONSUMER BALANCE SHEET TRENDS

Auto loans have surged over the past three years, reflecting both a post-pandemic rash of purchases and increased per-unit prices. Credit card borrowing stagnated during the pandemic due to reduced consumer spending and COVID-relief funds providing ample purchasing power. However, credit card borrowing surpassed pre-pandemic levels in 2022 and continued to surge in 2023; though this could be interpreted either optimistically (consumers feeling confident in repayment ability) or negatively (consumers needing credit cards as an income extension between paychecks).



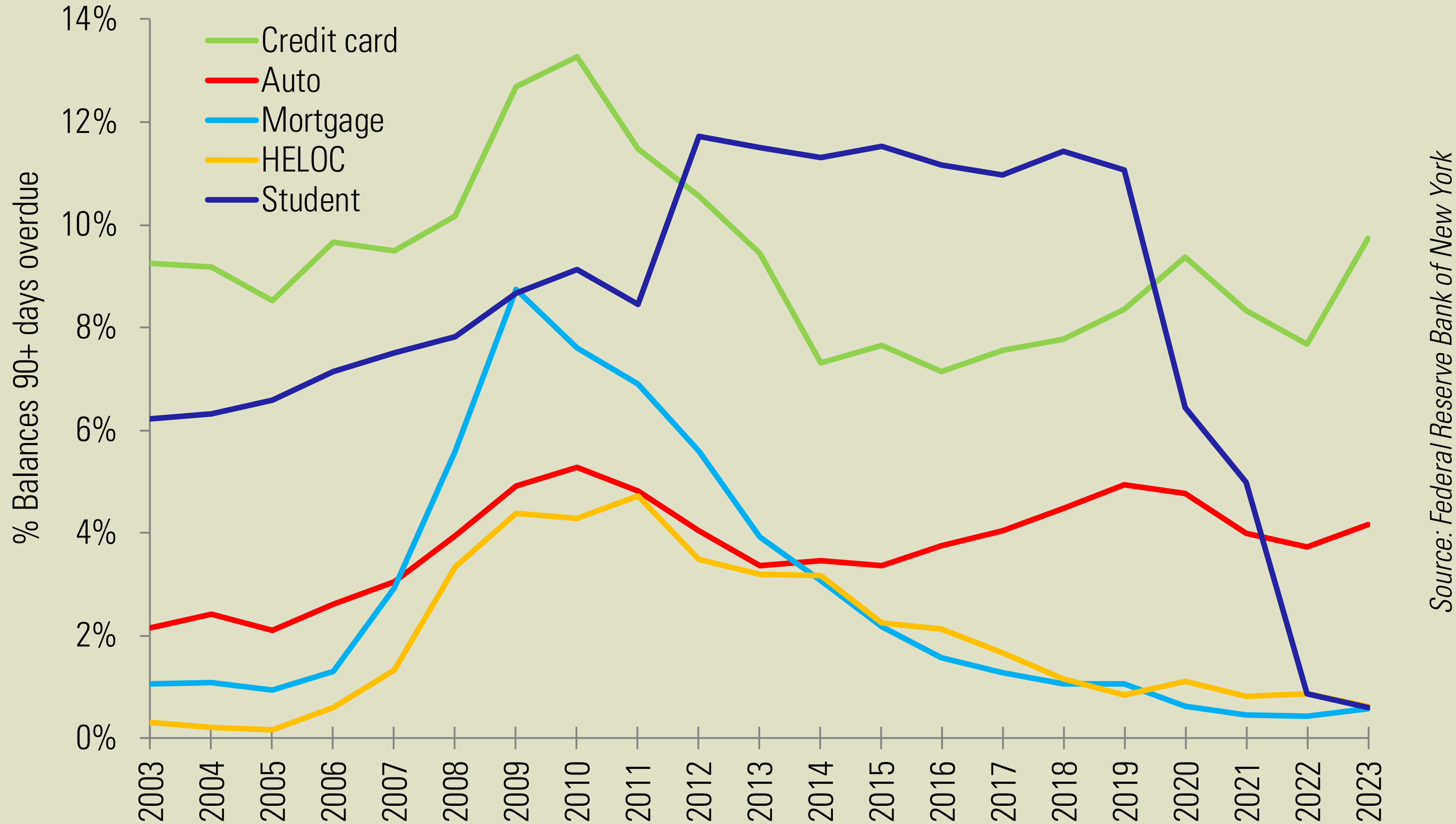
CONSUMER BALANCE SHEET TRENDS

Home equity borrowing declined every year since the 2008/2009 financial crisis, shedding $700B from the balance sheets of U.S. financial institutions. In the post-crisis years, this reflected consumers' and bankers' reticence to assume dangerously high leverage. More recently, cash-out mortgage refinancings provided a preferable means to tap equity in a home, as refinancing would also reduce the primary mortgage interest rate. Today, higher rates add value to a HELOC's tax benefits and almost all U.S. mortgages carry rates below current levels, obviating refinancing. Accordingly, HELOC demand is finally reviving, and 2023 saw home equity balances reaching levels last seen in 2018. Still, home equity line utilization also remains well below peak levels, with current balances equating to 37% of credit line amount, versus 57% in 2010.



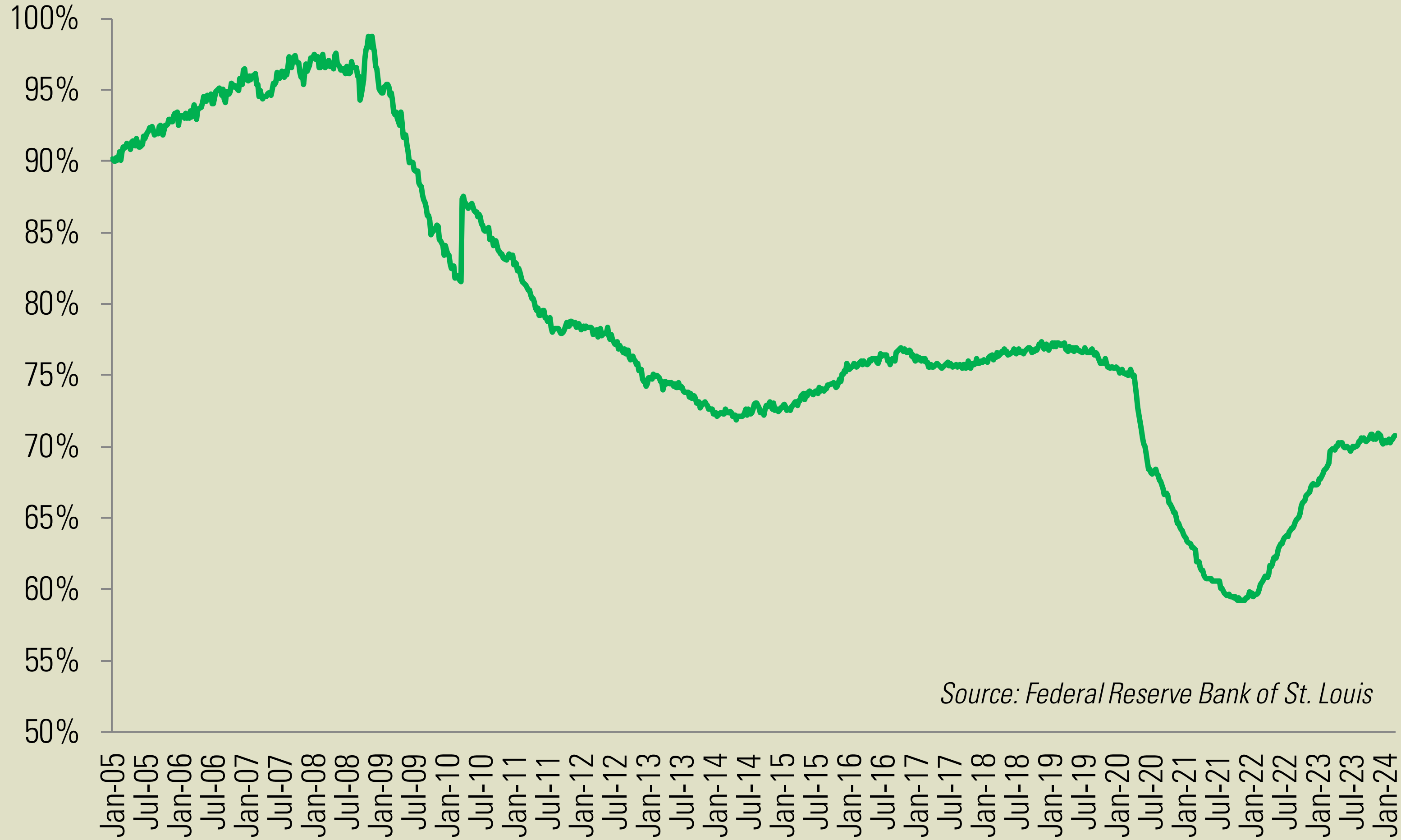
CONSUMER BALANCE SHEET TRENDS

The proportion of overdue balances generally remained steady in most consumer loan types in 2023, as a robust employment market allowed consumers to manage debt burdens. Mortgage overdue rates nudged slightly upward, but remain near historic lows, and home equity overdue rates reached their lowest point since the financial crisis of 2008/2009. Automobile and credit card overdue rates both edged upward, the latter perhaps to a point of raising concerns. Student loan delinquencies remain modest due to an array of forgiveness programs.



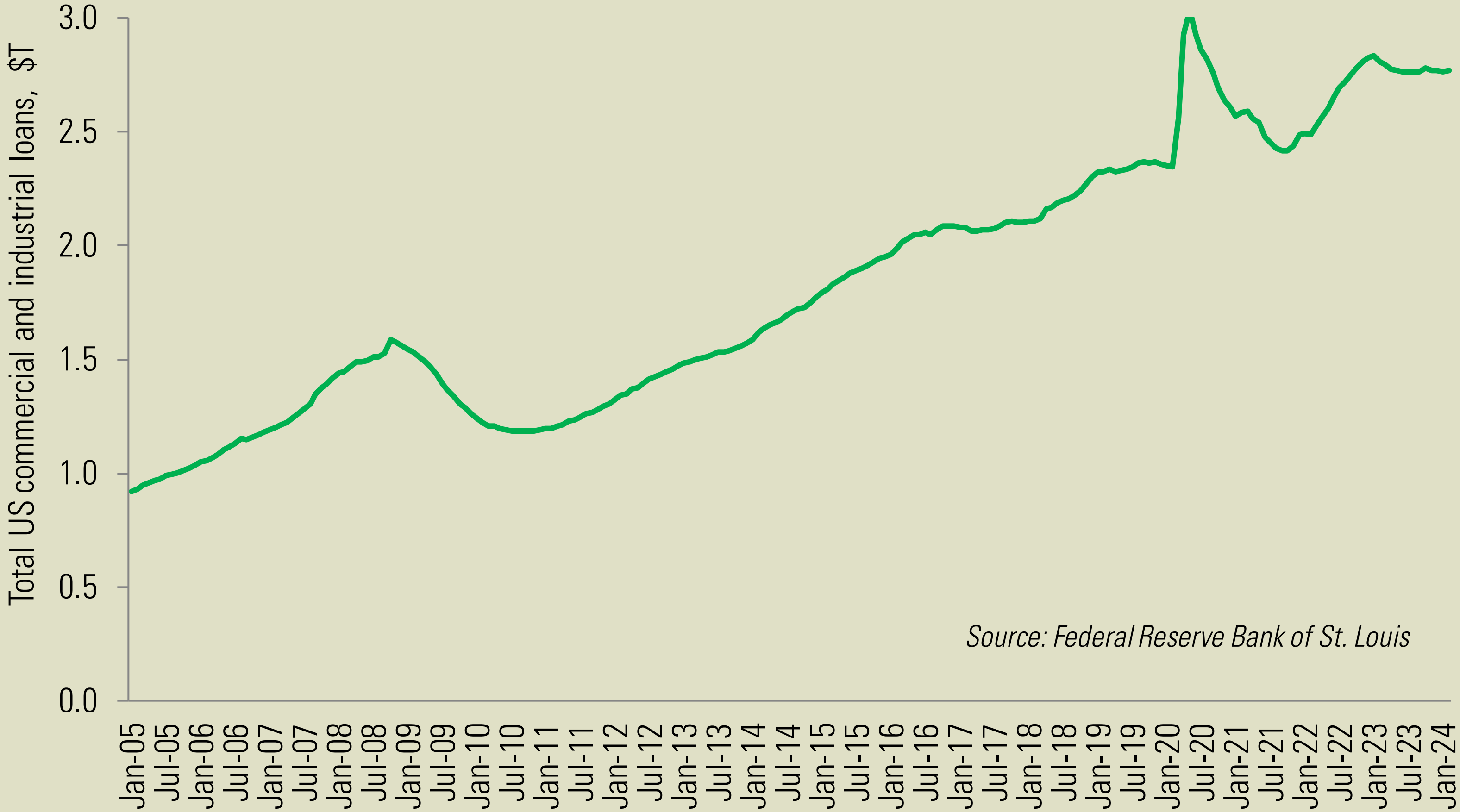
BANK BALANCE SHEET TRENDS

Industry-wide loan-to-deposit ratios hovered in the 70% - 71% range throughout 2023 – levels above the pandemic-era lows when banks were awash in liquidity, but still shy of the 75% - 77% level that held for most of the five years before the onset of the COVID crisis.



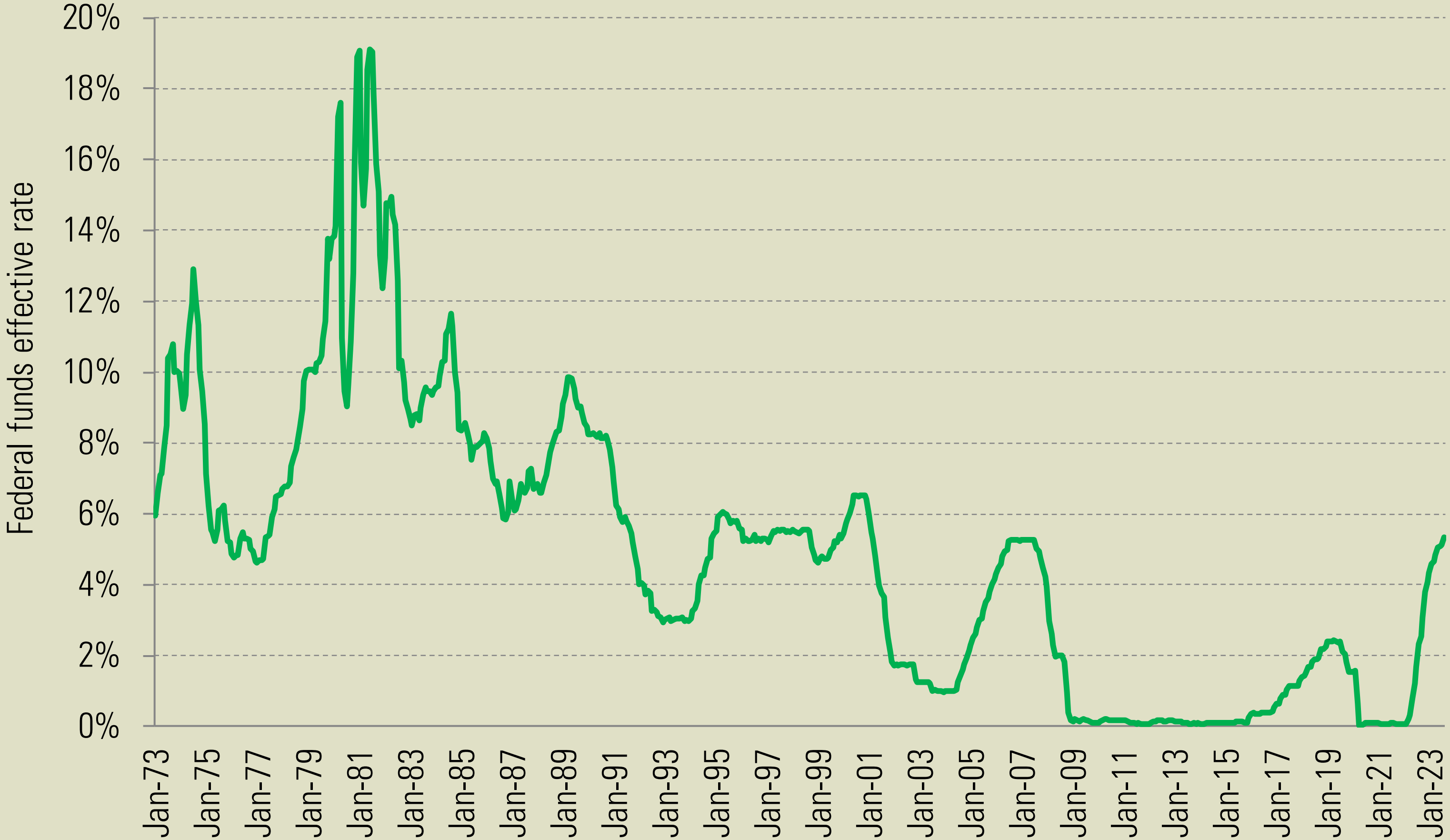
BANK BALANCE SHEET TRENDS

The reduced loan demand underlying the liquidity challenges discussed on the prior page mostly reflected a decline in commercial and industrial loans. After a spike in the early days of the pandemic due to Paycheck Protection loans, non real estate commercial loan balances plummeted, declining for 17 consecutive months. October 2021 marked the nadir of the downturn, and C&I loan balances increased for the next 16 months thereafter, before reaching a plateau in February 2023. C&I loan balances remained flat at about $2.8 trillion for the majority of 2023, an alarming contrast to the growing consumer-side credit demand.



THE RATE ENVIRONMENT IN PERSPECTIVE

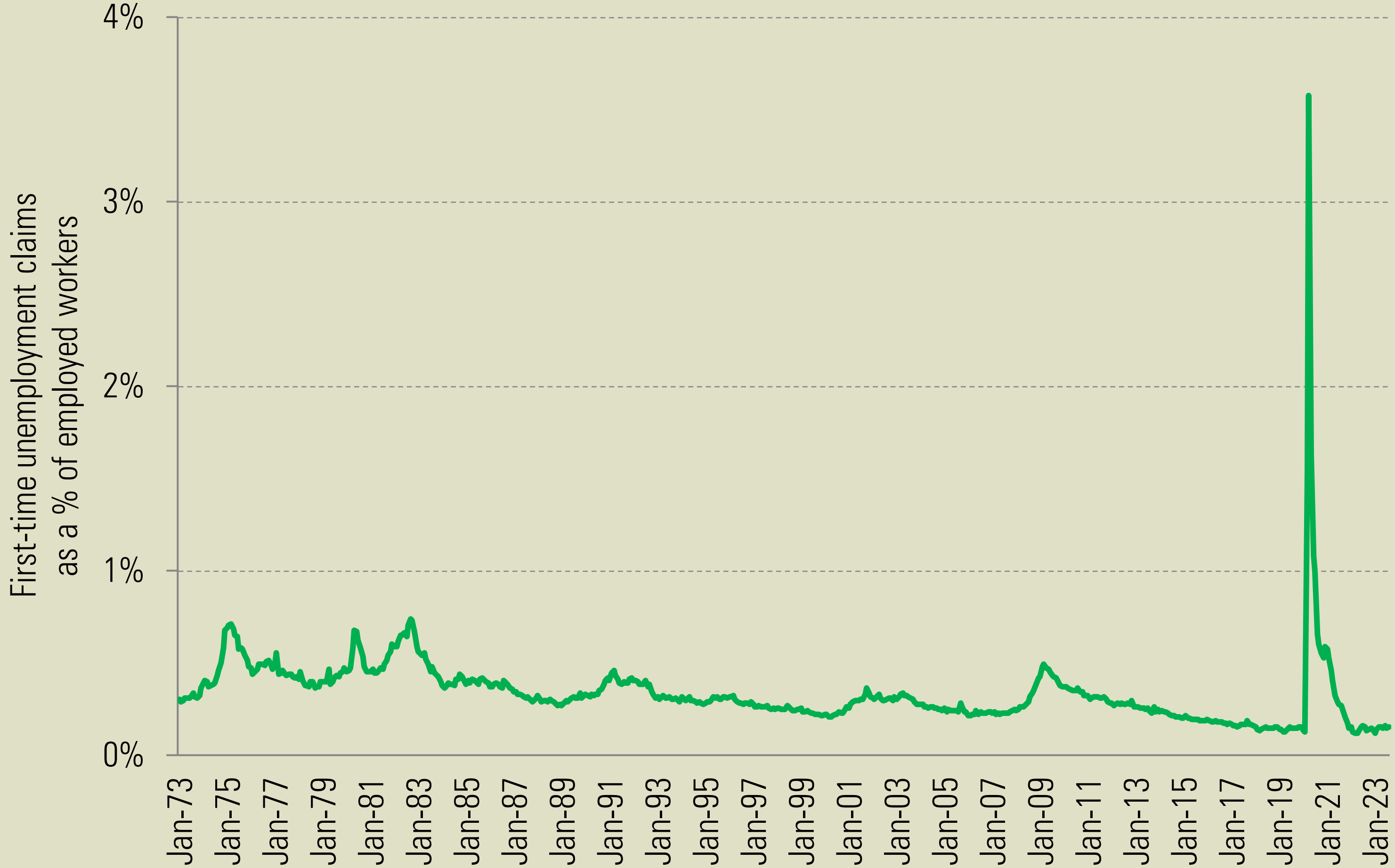
Interest rate increases appear severe relative to recent trends, but the near-zero rates of the past 15 years represent a historic aberration.



Source: Federal Reserve Bank of St. Louis

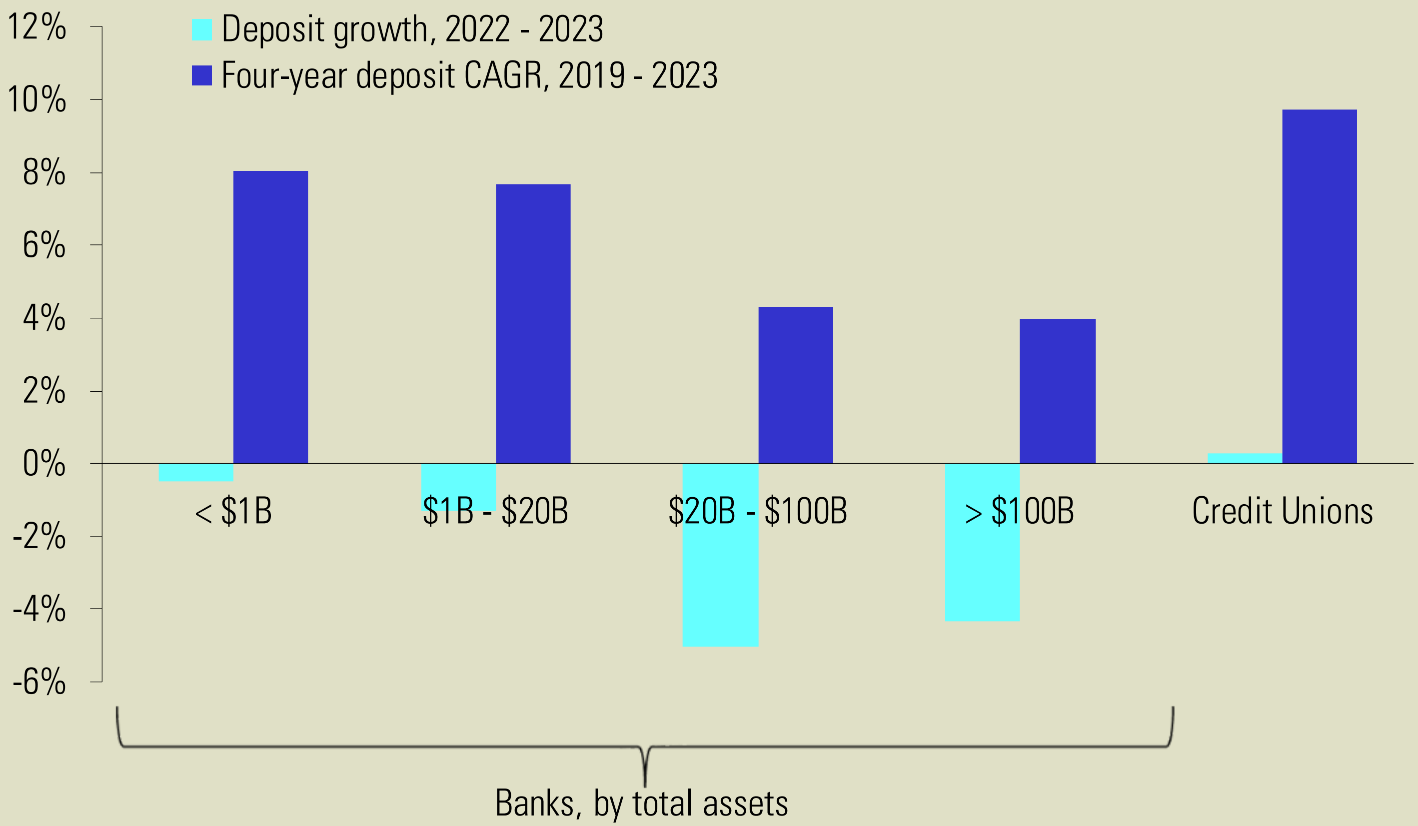
THE IRREPRESSIBLE JOBS MARKET

Despite multiple recent rate hikes, the employment market remains remarkably robust, with first-time unemployment claims continuing to hover near all-time lows – good for employees, but also contributing to inflation and hiring challenges.



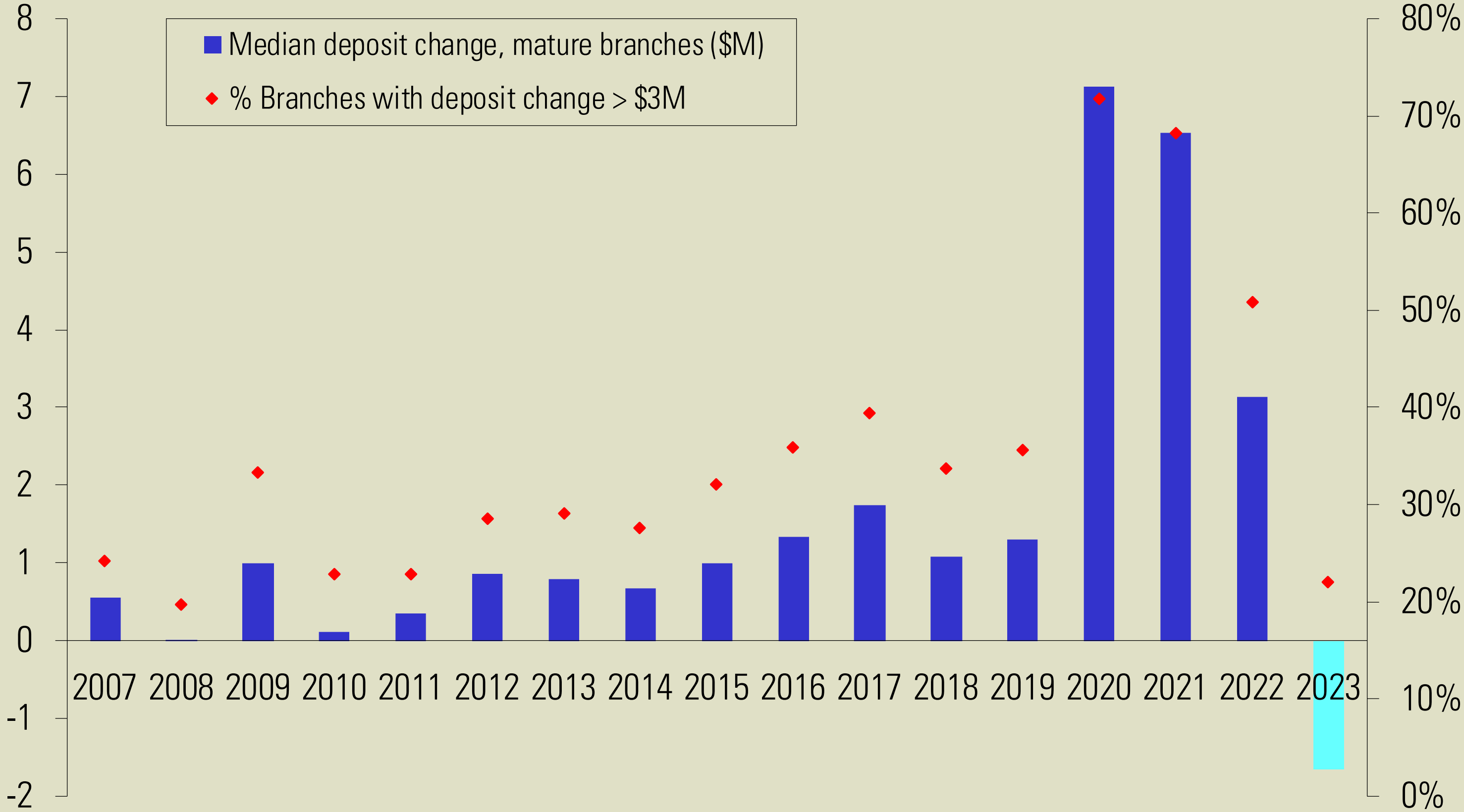
Source: Federal Reserve Bank of St. Louis

BRANCH DEPOSIT GROWTH



As deposit growth patterns normalized, credit unions and smaller banks realized greater percentage deposit growth than larger banks. This may in part reflect larger banks deliberately allowing excess liquidity to run off, as banks in the largest asset tiers suffered deposit declines of about 5% over the past year. In contrast, credit unions and the smallest tier of banks showed flat deposit growth in the most recent year. Over a longer four-year horizon, credit unions averaged 10% compound annual deposit growth, compared to 8% at smaller-tier banks and only 4% at larger-tier banks.

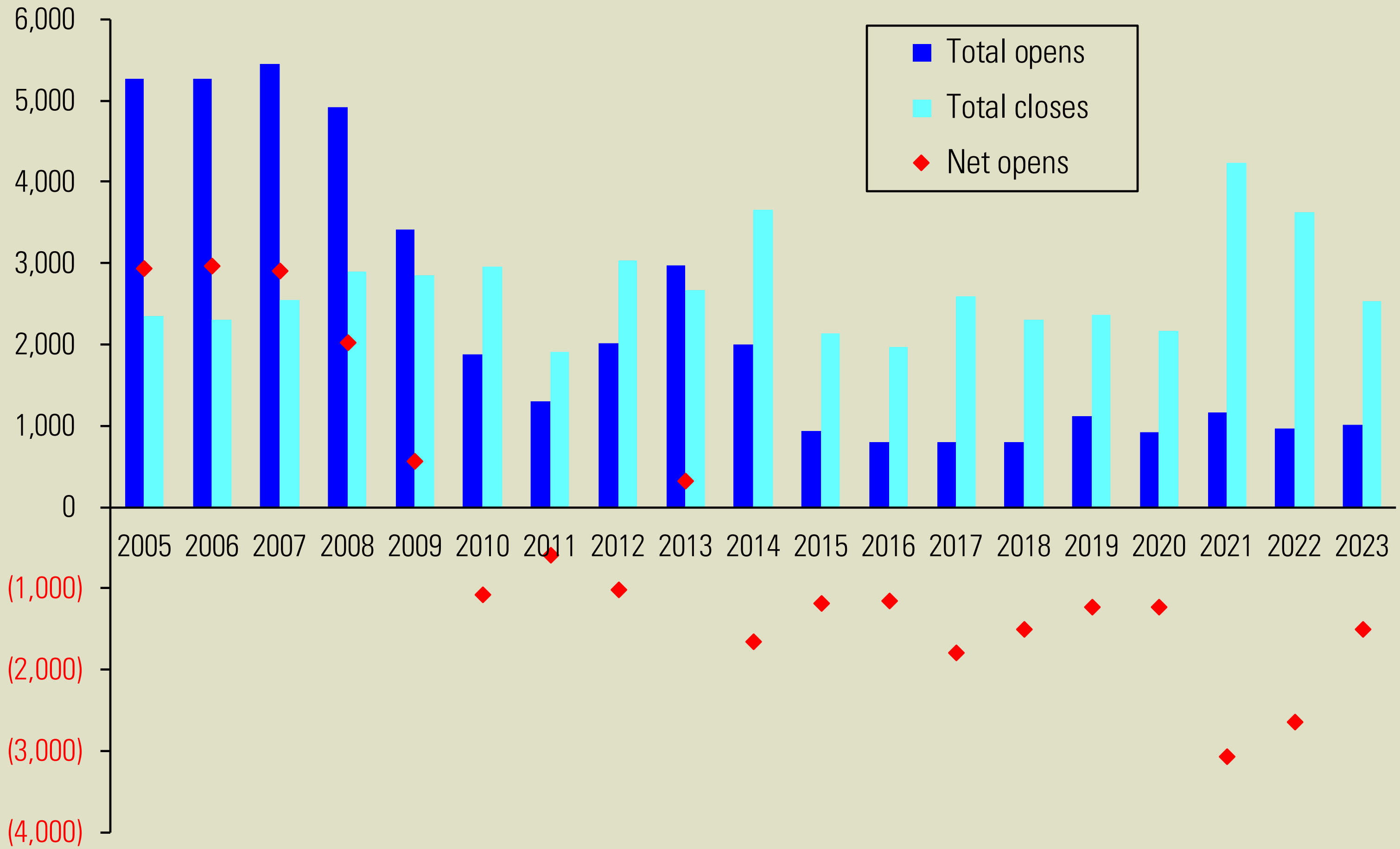
BRANCH DEPOSIT GROWTH



The erosion in deposits pervaded the industry. In most years prior to the pandemic, mature branches (defined as opened at least five years) showed median annual deposit gains in the $700m to $1.1M range. After that median spiked to $7M and $6.5M in 2020 and 2021, 2023 saw the median mature branch lose $1.6M in deposits. In most pre-pandemic years, only about 35% of branches posted deposit gains of more than $3M. That figure spiked to near 70% in 2020 and 2021, but in the past year, only 22% of mature branches were able to gain more than $3M in deposits.

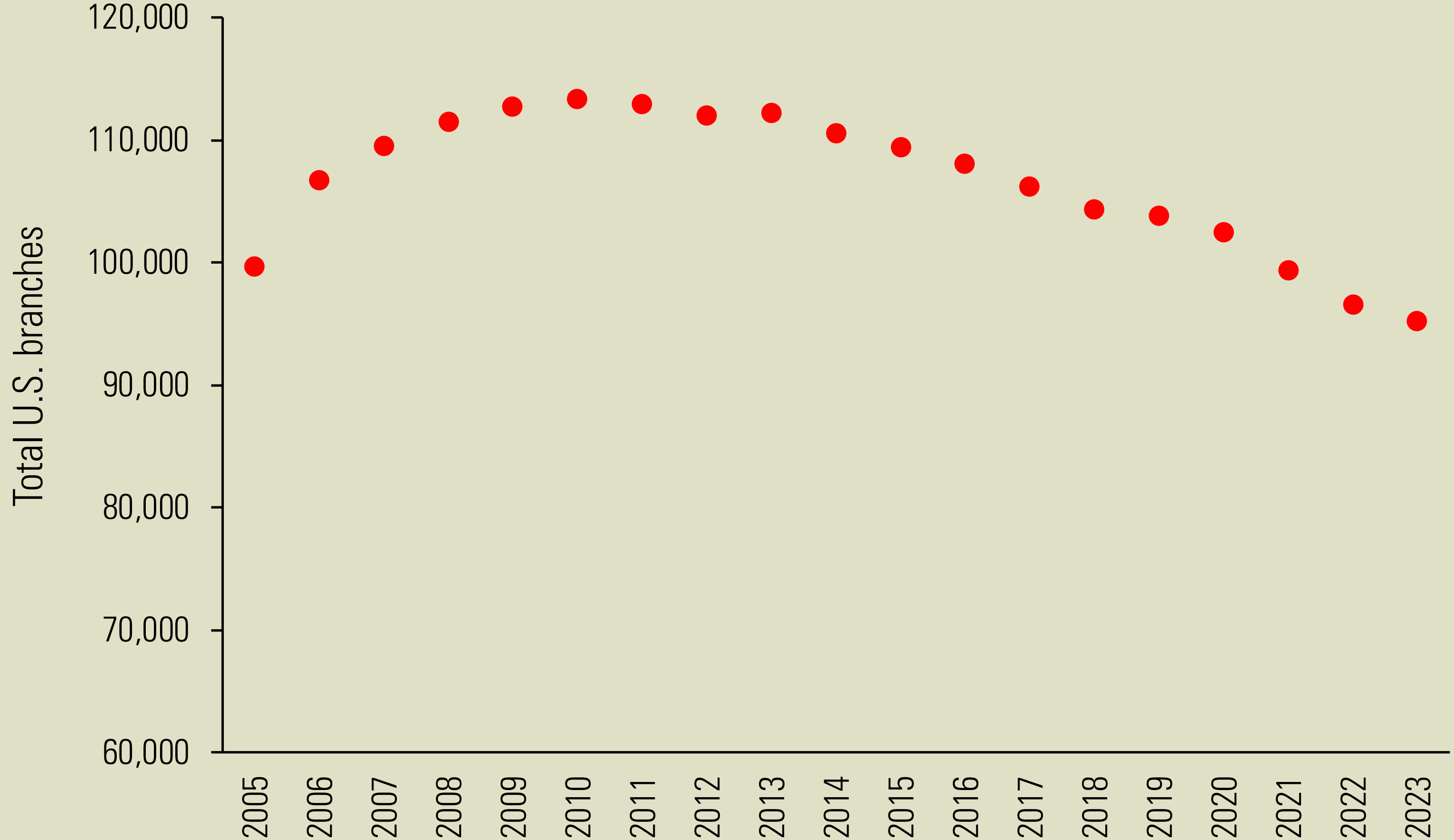
BRANCHING ACTIVITY OF U.S. BANKS

Branch closings abated in the past year. After the industry closed nearly 8,000 branches in 2021 and 2022 combined, 2023 saw only about 2,500 branch closures. Further, banks and credit unions added more than 1,000 branches in 2023, yielding a net decline of 1,500 branches – notably less than the net declines of 2,700 and 3,100 branches in the two years prior. Even with net consolidation, the presence of more than 1,000 new branches confirms bankers' willingness to invest in branches where market conditions allow.



BRANCHING ACTIVITY OF U.S. BANKS

The net reduction of about 8,500 branches over the past four years represents a 9% contraction from 2019 levels, and the count of 95,000 bank and credit union branches nationwide sits 16% below the peak levels of 2010.



BRANCHING ACTIVITY OF U.S. BANKS

- The bank side of the industry remains more concentrated than the credit union side, due to the greater geographic reach of the largest banks. The 10 largest branch networks now hold one-third of all U.S. bank branches; and concentration continues through the next tier of institutions, as the 50 largest branch networks account for 52% of all U.S. bank branches. Just 250 of the nation's 4,500 banks own nearly 70% of the bank side of the industry's total branches.

- The credit union side of the industry remains much less concentrated, as the 10 largest credit union networks hold only 7% of credit union branches; and even the 250 largest networks impound only 38% of credit union branches.

By Branch Count	Banks	Credit Unions
Top 10	32%	7%
Top 50	52%	16%
Top 250	69%	38%

LOOKING AHEAD: NORMALIZATION

- The elusive soft landing?
- Recession chances fading, inflation waning
- But still lurking concerns on both fronts
- To the positive, adverse events in employment or inflation could ease job recruitment and hiring difficulties
- The end of the zero-interest rate era should benefit the industry
- Industry performance increased in 2022 over 2021 on an array of measures, even with the rate increases; and then remained roughly equivalent in 2023
- The prominent bank failures of the first half of 2023 were more repudiations of a niche business model than harbinger for the industry overall
- In sum: stability over upheaval

CHALLENGES AND BRIGHT SPOTS

- Rising interest rates did not prohibit a revival in corporate loan demand
- But did the promise of rising rates accelerate borrowing forward (i.e., let's borrow now, before the rates go even higher)?
- In that case, late 2022 may have 'stolen' some of 2023 and 2024's loan demand, leaving a gap in demand in the year ahead; but drawdowns of COVID-era inflows should join with an evaporating fear of recession to revive commercial borrowing.
- To the positive, a post-COVID missive to 'control your own supply chain' has led to a raft of manufacturing investments in the U.S., both in a revival of current plants and in the construction of new ones. Bolstered by several governmental programs, spending on manufacturing construction (i.e., new factories) has soared to levels triple previous highs; and this should bring positive impacts to commercial lending portfolios.
- Still, borrowing costs remain reasonable, especially for commercial and mortgage / equity loans that can leverage the tax-deductibility of interest payments.

CHALLENGES AND BRIGHT SPOTS

- To the branches: HELOC!!

- Eventually, the mortgage market will become unstuck; and rates in the 6s and 5s will look favorable; but the rise in home values still leaves downpayments unattainable to many first-time buyers, mandating an array of products (e.g., FHA/VA; ARM).

- Overall industry deposits sit at a level nearly $2 trillion above the levels a pre-COVID trendline would have predicted for 2024. And this suggests 2024 should see flat deposit growth, or perhaps a minimal increase.

- The mathematics of loan demand increasing at a faster pace than deposit growth indicates continued pressure for bankers striving to raise funds, and especially to do so at reasonable cost. This signifies a need for active marketing initiatives, innovative product offerings, and a disciplined approach to pricing, reserving premium rates for only the largest and most valuable overall relationships.

- Regulatory and competitive pressures will force reductions in NSF/OD and other fees; banks and credit unions will need to find new revenue sources to offset these reductions.

LOOKING AHEAD: UNCERTAINTIES

- Workplace dynamics and corresponding residential migration patterns in the post-COVID era.

- How entrenched will work-from-home become in the long term?

- If the jobs market finally sees some cooling, it could return leverage to employers that would prefer on-site presence.

- Many Americans migrated to smaller-tier markets during the pandemic, seeking areas with large-metro amenities but less congestion. With work from home facilitating such moves, mandated returns to office work could reverse those migrations, especially if a less-robust job market reduces potential to change employers.

- To the extent that work-from-home or even hybrid models become more ingrained, commercial real estate in bedroom-suburban neighborhoods will become more valuable, as typical workday errands – including banking – may now take place closer to a consumers' residence than to their workplace.

LOOKING AHEAD: UNCERTAINTIES

- The impact of remote and hybrid work environments has already manifested in another hybrid model – the seemingly oxymoronic suburban downtown development.

- The trend is effectively summarized in the headline and subheading of a recent Washington Post article (May 25, 2022) on the subject:

  "As office-centric downtowns struggle, suburbs cater to the laptop crowd: Developers are adding outdoor co-working space – bocce ball, anyone? – to attract remote workers to stores and restaurants."

- Borrowing a phrase from the early days of the Internet, "clicks and bricks" returns

- A *Credit Union Journal* article published March 9, 2023, titled: "Credit union branches welcome a surprising demographic: millennials."

  Citing research by core-systems provider Fiserv, the article states, "*millennials are not only using branches more frequently than all other generations today, but they also say they will do so more often post-COVID than they did prior to the pandemic*."

LOOKING AHEAD: UNCERTAINTIES

The COVID crisis may have permanently changed banking behavior

- The crisis forced consumers to use non-branch channels, and forced banks to elevate their capabilities therein
- However, the early e-channel adopters had already left the branch; so those that remained pre-pandemic may prove difficult to permanently redirect
- The pandemic demonstrated the value of ITMs, which could operate irrespective of whether the hosting branch was open, with extended hours
- The pandemic allowed bankers to observe whether their electronic channels, could truly fulfill all aspects of the account-opening process

LOOKING AHEAD: UNCERTAINTIES

To the extent that revisions in operating procedures during the pandemic reduced costs, consider which shifts can turn permanent

- Can certain branches remain in drive-in only mode?
- Have ITMs displayed a benefit beyond the crisis environment?
- Is there benefit in maintaining extended call center or online chat hours?
- Can excess branch space support work-from-home models?

LOOKING AHEAD: UNCERTAINTIES

- Throughout the history of our industry, electronic channels that emerge as differentiators quickly get bargained down to “table stakes,” a minimum cost of entry.
- Thus, while bankers must find the ability to offer an array of distribution channels, they cannot forsake the branch in doing so.
- The differentiation the branch can provide lies not at its four walls and a roof, but in the skilled service representatives available there, and for the ability of those bankers to interact with their surrounding communities – providing civic and philanthropic leadership that yields awareness, goodwill and ultimately business development.

REMEMBER THE CHOICE EQUATION

Choosing a pizza for delivery: a simple model of consumer choice

Customer A				
	Importance	Brand 1	Brand 2	Brand 3
Taste	20%	10.0	1.0	5.0
Speed	40%	3.0	8.0	5.0
Cost	40%	1.0	10.0	5.0
Points		3.6	7.4	5.0
Customer B				
	Importance	Brand 1	Brand 2	Brand 3
Taste	60%	10.0	1.0	5.0
Speed	30%	3.0	8.0	5.0
Cost	10%	1.0	10.0	5.0
Points		7.0	4.0	5.0

REMEMBER THE CHOICE EQUATION

Now let's choose a financial provider: if your bank or credit union is equal across all dimensions to a competitor today, but then reduces its branch convenience, which other attributes can you improve to offset that loss? If you have everything the digital consumer wants, but they have everything AND BRANCHES, why not them, just in case?

	Importance	Us Before	Them	Us After
Availability of credit	5%	7.0	7.0	7.0
Community reputation	10%	8.0	8.0	8.0
Convenience of locations	15%	7.0	7.0	5.0
Knowledge of officer	20%	7.0	7.0	7.0
Many services available	15%	5.0	5.0	5.0
Multi-channel access	10%	7.0	7.0	7.0
Pricing	10%	5.0	5.0	5.0
Service quality	15%	8.0	8.0	8.0
Points	100%	6.8	6.8	6.5

REMEMBER THE CHOICE EQUATION

There are multiple ways to travel from New York to Philadelphia.

	FlixBus	Amtrak Acela	Drive Your Car
			
Base cost	$9.00 (yes, really)	$50 (business)	$12 (est fuel cost)
		$128 (first class)	
Parking	None	None	~ $1 Zillion
Time	2 hours 30 minutes	1 hour 12 minutes	Feeling lucky today?
Maximum speed	65 mph	140 mph	Play it safe, please
Work environment	Wi-Fi	Wi-Fi	Please don't!
		Quiet car	
		Conference tables (first class)	
Snacks	Whatever you bring	Café car (free w/first class)	Jersey Turnpike rest stops!
Other benefits	Meet interesting people?	Quiet, spacious, trains rule	Blast the radio!

- How do our clients wish to travel to their destination?
- Do all consumers value the same features and options?
- Will their preferences change over time; and if so, are we able to notice, and meet those new preferences?

EPILOGUE: A FUTURE WITHOUT BRANCHES?

For years some industry pundits have forecasted a future without branches, and perhaps at some point that transpires; but if so, what would that imply for a smaller institution, such as a community bank or credit union?

In a world without branches, how does an institution gain awareness? And if geographic bonds dissolve, are the survivors only those with the largest national advertising budgets?

Could we see massive consolidation / elimination of financial institutions? Or just a few massive for-profit banks, with credit unions filling the traditional community-bank role?

- California: population 39 million, 191 banks and 316 credit unions
- Canada: population 38 million, 5½ retail banks, a handful of specialty providers, some commercial branches of foreign banks, and 250 credit unions

EPILOGUE: A FUTURE WITHOUT BRANCHES?

If we ultimately see our own retail apocalypse in the industry, are there societal impacts to consider that the surviving community banks or credit unions would be especially well-positioned to address?

If the smart phone supplants the branch, what does that imply for those on the low side of the digital divide?

One preparation we can launch for a less branch-centric world is to remember that the branch has always been more than four walls and a roof; at its core the branch is the knowledge, empathy, skills, and relationships of the bankers therein.

To that extent, the physical branch may become more a venue for employee meetings and a domicile for paperwork and equipment; while in practice the branch becomes the bankers themselves, the knowledge and relationships they carry, at whatever venue – physical or virtual – the customer wishes to engage them.

Questions, Comments
or More Information?

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