



# branch bonanza

*Bank branches, all but given up for dead a decade ago, have kept on growing in numbers through 2004. Analysts say that location, accessibility and even architecture are the keys to a branch's success in collecting deposits.*

*They cost a lot, but customers can't get enough of them. Why bank branches won't go away*

BY DOUG CAMPBELL

This swath of real estate in Leesburg, Va., has everything you would expect in one of the country's hottest job and population markets: upscale strip malls and low-slung office buildings; construction signs and sprawling town-home complexes.

But there's one feature that crystal ball gazers of the 1990s might not have guessed: bank branches. There are nine of them within a half-mile of each other in this Washington, D.C., suburb, together keepers of almost \$600 million in deposits.

What's surprising about this scene is that technological advances were supposed to make bank branches extinct. The telephone, the Internet, and souped-up ATMs — these were the devices through which retail and even some commercial customers would interact with their banks. Bricks and mortar cost too much to build and staff; customers would grow accustomed to conducting transactions in the virtual world.

It didn't happen that way. Across America, more branches are opening than ever — some 2,000 were added

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just last year. Industry giants Bank of America and Wachovia Corp. have unveiled plans to build hundreds of new branches in new and existing territories. As much as bankers would have liked to have stopped building new offices, darn it if customers didn't demand them. Nothing beats the convenience of a neighborhood branch.

Leesburg encapsulates the rising fortunes of bank branching. Instead of seeing branches close their doors in the past decade as banks merged, more branches have opened (although that growth turns out to be anomalous in the Fifth District, a point that we'll address). Be they big or small, the banks that have found the most convenient locations here have been the most likely to ring up market-leading positions in deposits. Branches are central to a bank's success.

The enduring appeal of garden-variety banking offices holds a lesson: Just because there's a supply of new, cost-efficient technology doesn't mean there's an immediate demand. This is not to say that change isn't coming. Online services like bill paying and loan applications are slowly catching on. The shift is just taking a little longer than anticipated, and it's being accomplished mainly because of hand-holding from front-line branch employees.

"There was a feeling, back when the Internet craze was going on, that consumer behavior was going to change, and banks wanted to be out in front of that curve," says Terry Meyer, president of the Raleigh-based consulting firm MarkeTech Systems International. "They wanted to pull cost out of the distribution system. That change was greatly exaggerated."

### **Premature Death Notices**

Branch banking obituaries started appearing in the 1980s. Lawmakers in 1980 lifted Depression-era rules (called Regulation Q) that had placed ceilings on the interest rates banks could offer on savings accounts. One school of thought was that bank branches would have fewer reasons to exist in an environment with no lids on deposit rates; instead of competing branch by branch

to hand out the finest toaster, banks would compete on price.

Contrary to expectations, branch banking continued to grow. State branching laws were slowly being relaxed in the 1980s and 1990s. In 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act removed remaining state restrictions on interstate branching. In addition to opening the door to buying out-of-state institutions, banks could enter new territories with newly chartered "de novo" offices. In the 1980s alone, more than 15,000 branches were added in the United States.

Then came branch banking's second, and seemingly more threatening, death notice. This time the killer was to be technology. Voice mail trees, ATMs, and the Internet would make full-service branches a thing of the past.

Pure-play Internet banks started sprouting up, fueled by enormously efficient cost structures. But they lacked a human touch. Most of these Internet banks failed to make the impact once envisioned, says Elias Awad, the Virginia Bankers Association professor of bank management at the University of Virginia. "People couldn't see themselves having money in an artificial environment," Awad says.

So instead of a virtual banking boom, the growth came in bricks and mortar. The number of bank offices climbed 10.5 percent in the past decade to 89,814. Over the same period the average number of offices per bank leaped from 6.3 to 9.5. All this happened amid rampant banking consolidation, with the number of banking institutions declining almost 50 percent from 1994 to 2004. And it happened despite the strong incentives banks had to curb branch growth. A typical branch costs between \$1.5 million and \$2.5 million to build and then runs up to \$800,000 a year to staff and maintain.

It's a sizable investment, but the payoff is clear. "The economics of it are that it makes sense for banks to branch," says Jack Phelps, acting director for regional operations at the Federal Deposit Insurance Corporation (FDIC). "The people who are doing it

are generally finding it profitable to do so, and that's a little different than what was expected 10 years ago."

Profitable and then some. Banks with more branches are also the most efficient — but not because of economies of scale. The FDIC and Federal Reserve researchers have identified increased revenues, as opposed to reduced costs, as the driver behind efficiency improvements (as measured by the so-called "efficiency ratio," which is calculated by dividing noninterest expenses by the sum of net interest income and noninterest income). From 1970 to 1990, efficiency ratios among U.S. commercial banks were relatively flat, the FDIC found. They began to improve (fall) as the number of banks declined (with mergers) and the numbers of branches grew.

Branches may be costly, but they're a good place to generate revenue. Allen Berger, a senior economist with the Federal Reserve Board of Governors, and Loretta Mester, director of research at the Philadelphia Fed, report in a 2003 paper that banks got so good at selling during the 1990s that they easily offset rising expenses, such as larger branch networks. "Over time, banks have offered wider varieties of financial services," they wrote. "In addition, banks have provided additional convenience."

Phelps says, "People pay attention to costs, but it's on the revenue side where the clear gains are being made."

Even small banks are finding profits in branches. In its branching study the FDIC defined small banks as those with less than \$1 billion in assets. It found that banks with more branches were more efficient — that is, they were able to produce an additional dollar of revenue at lower cost. According to the FDIC, banks with 11 or more branches were the most efficient of the small banks, followed by those with between 10 and four branches, which in turn were more efficient than banks with three or fewer branches. Meanwhile, overall bank efficiency ratios have improved by about 30 percent over the last 20 years, a period that coincides with branching expansion.



Additionally, the FDIC has found that banks of all sizes post higher returns on equity if they have more branches (see chart on page 17).

### Super Sites

The economic success or failure of individual branches is almost all about geography.

MarkeTech analyzed the performance of 5,000 young branches in the United States, defined as those around for about 10 years. The key finding was that 70 percent of a branch's success

or failure in collecting deposits was explained by micro-market variables: What other retailers were situated nearby? What competitors were there? How convenient was it to get in and out? Were there traffic lights? How dense was the immediate population?

The upshot: MarkeTech estimated that location explained up to 55 percent of deposit formation. About two out of three banking customers live within two miles of their principal branch.

That's it, folks. Location. Straight out of a circa 1950s real estate how-to manual. Location.

The Federal Reserve has studied why people choose their banks and came back with that same answer. "The single most important factor influencing a customer's choice of banks is the location of the institution's branches," said Federal Reserve Governor Mark Olson in a May 2004 speech. Ranking "location" highest in their decisionmaking were households (43 percent) and small businesses (30 percent), according to Fed surveys in 1998 and 2001.

But bankers should follow their intuition only so far. Retailers instinctively might want to seek out high-growth and affluent areas, but in branch banking that doesn't necessarily equate to performance. "Banks go to growth. They think that's where they'll be most successful," MarkeTech's Meyer says. "But the problem is everybody goes there." In MarkeTech's



*Middleburg Bank's branch in Leesburg, Va., is the fastest-growing and biggest banking office, with more than \$140 million in deposits, in fiercely competitive Loudoun County.*

analysis, the top performers in "static" markets outdid the top performers in high-growth areas.

### Middleburg Branches Out

Which brings us back to Leesburg, Va. According to a MarkeTech analysis, Middleburg Bank's Leesburg branch accomplished the rare feat of being among the top performers of all branches in the Fifth District as well as being located in one of the nation's fastest-growing markets.

It took 70 years for Middleburg Bank — based in Middleburg, Va., a Loudoun County community near Leesburg — to become a convert to the virtues of branching. In 1994 it still kept only its headquarters office and had \$110 million in total deposits for 12.9 percent market share, making it a distant third in Loudoun County. At the end of June 2004, the latest date for which aggregate records are available, Middleburg rode its five offices to deposits of \$418 million, claiming 18.46 percent of the county's market, moving up to a solid hold on the No. 2 spot in the county.

The Leesburg market opened up in the mid-1990s as community banks Farmers & Merchants of Hamilton and Bank of Loudoun were gobbled up by bigger banks. Those two banks commanded \$100 million in deposits, or almost a third of the market. Joe Boling, Middleburg's chairman and

CEO, sized up the opportunity and said: "I just want that \$100 million." In five years, he got it, and he didn't have to pay a premium for another bank to do it. Last year, the Leesburg office, which opened in January 1996, had \$140 million in deposits, most in the city.

Loudoun County is something of a no-brainer as a place to open a bank branch. Since the dawn of the 1990s, the county has seen population grow at a robust 7.5 percent annual clip, the second highest rate in the nation for that period. For

the 12 months ending March 2004, Loudoun County posted a 5.5 percent gain in jobs, sixth fastest in the nation and shattering the U.S. employment growth rate of 0.8 percent. The region has benefited as a bedroom community of Washington, D.C., and is home to many government contractors. New jobs mean new homes and new retailers, which in turn mean mortgages and commercial loans.

Middleburg Bank's Leesburg branch on Catoclin Circle is strategically located near the Dulles toll road, with easy access to neighboring housing units and not far from downtown. Nan Havens, manager of the branch, explains the success: "Location, location, location," Havens says. "It's perfect."

### In The Flesh

For now, technology is a lousy tool for accumulating deposits. People are much better. Branching has allowed Middleburg Bank to situate its people within convenient distance of its customers.

The revolutionary strategy: It's easier to sell people products if a) you're talking to them face-to-face; and b) you already do business with them. Likewise, it's even easier if you've found the perfect spot for your branch, as Middleburg Bank seemingly did in Leesburg.

"My belief is that if you can put a strategically placed financial service

PHOTOGRAPHY: JANET DENNEY/MIDDLEBURG BANK/LEESBURG

center in a core part of a market and you have the right people and the right services, they will come," says Boling. "We're building relationships, not just counting deposits."

Pacing through the carpeted office, branch manager Havens greets several customers by first name. Contractors clad in overalls and mothers toting babies in car seats ease up to the teller stand. At 11 a.m., all three drive-through teller lanes are occupied with cars.

There is very little unique about the space. A basket of toys sits to the side of the teller lines for restless children to play with. There are plans

for a coffee bar, but it's not here yet.

But it works. Branch employees open about 150 new accounts a month, Havens says, and about half of those are for existing clients. In other words, checking account customers are also signing up for insurance, investments, and other financial products. "We're doing a lot of cross-selling," Havens says. "The buzz word for now is relationship banking."

"Folks who thought it was going to go away completely forgot that they needed some touch points," Boling says. "We still like to see each other and we still like to shake hands."

## Big Banks Lead The Way

In Leesburg, the city's second-biggest branch, with \$137 million in deposits, is located directly across the street from Middleburg Bank. It belongs to North Carolina-based BB&T.

Where Middleburg Bank has used a rifle approach to branching, BB&T's has been more shotgun. It has poked the county with 12 branches, producing a market-leading \$524 million in deposits, or a 23 percent share. BB&T didn't build its Leesburg office; it was one of the prizes in the 2001 purchase of Farmers & Merchants of Winchester.

Rip Howard, Virginia market president for BB&T, says aggressive

## Bank Bait?

Banks across America are waking up to realize that "retail appeal" has become vital in the increasingly competitive banking industry. Banks are now attracting customers by introducing new technologies and branch designs.

Tony Plath, a finance professor at the University of North Carolina at Charlotte explains that nationwide, banks realize that "their business is in retail also, with a slightly different product." In this case, the products banks offer are hooks, ways to get the customer to linger and buy something they ordinarily would not have. It is the banking equivalent to placing candy bars next to the checkout.

The hooks come in different forms. For many banks, it starts with atmosphere. Increasingly, bank lobbies are beginning to look like hotels, with long mahogany counters and couches inviting the customer to stay awhile. In fact, in Annapolis, Md., BB&T even converted a house into a branch, fostering a feeling of familiarity. Garnett Hamerman, a senior vice president at SunTrust, uses the bank's new Richmond, Va., branch as an example: "Everything is designed to appear more open and light." Gone are the closed-off cubicles and offices, with glass doors and open kiosks taking their place.

Some banks are also offering a winning combination of technology and marketing. For instance, last year Bank of America, which has pioneered many of these innovations, introduced the first "keychain credit card," offering all the features of a regular credit card, but at half the size of

a normal card. Not satisfied? No problem — ask your local Bank of America branch about its "Photo Expressions" program, a way of reliving your Kodak moments each time you swipe your credit card. Photo Expressions allows the customer to have any image of their choice printed onto their card, whether it is a pet or favorite vacation spot.

This advent of technology must also be engaging for the customer. As Hamerman explains, "We're trying to be hi-tech, but also hi-touch." This concept is at work in SunTrust's new drive-up system. Highly interactive, the customer in lanes not directly next to the window is now able to communicate with the teller via video.

Bank of America isn't the only bank employing retail tools. BB&T has a plus package that offers rewards to customers, such as coupons toward travel and entertainment. Since so many banks are employing these techniques, what ensures a successful program? Tony Plath suggests that the answer lies in offering "a pro-

motion a customer wants to buy. Some promotions are just bad. ... Rewards really encourage frequent use of a product."

What all these promotions and inviting atmosphere really boil down to is a good use of space. Banks must consider who they are trying to attract and where they are located.

One thing is clear: With the rapid advance of technology and a generation that has come to expect it, banks will continue to market themselves to new customers. It's a matter of survival.

— JULIA R. TAYLOR



*Some bank interiors have developed a look more like hotel lobbies with an inviting "stay for a while" atmosphere.*

branching works in Leesburg because it's the best way to lure the bank's bread-and-butter customers — individuals and small businesses. "Their choice of banking is the branches," Howard says. "They say they want branches, that's where they want to do their business. That's driven us to build branches."

You might think BB&T would be looking to thin its branching ranks in Loudoun, but Howard doesn't see it that way. He cites a recent survey that suggested small business clients visited their branches 4.5 times a week. "I honestly think there is a certain comfort level and feeling of security" that customers get in branches, Howard says. "I don't know if you totally get that feeling on the telephone or using online computers."

"At one time, it was thought branches would be dinosaurs. The only people who didn't believe that were the clients," Howard says.

### A Branch Boom, But Not Here

While branch banking is booming in Leesburg, in other parts of the Fifth District things are quite different (see chart below). Despite the strong tie between branching and sales growth, banks for the most part in the Carolinas, Virginia, and Maryland were putting on the brakes in brick and mortar expansions. Only West

Virginia added to its banking network in the decade up to June 2004.

The lack of branching growth in most of the Fifth District is attributable to long-standing liberal banking laws in those states. North Carolina's first bank branch opened in 1804, and the competitive intrastate banking environment has produced a state that is second only to California in terms of branches per capita.

As a result, the Fifth District has developed into a banking powerhouse, analysts say. Charlotte is home to Bank of America and Wachovia, Nos. 3 and 4 nationally by assets, and No. 14 BB&T is based in Winston-Salem. Having learned how to survive in a free-for-all branching climate, North Carolina banks in particular were adept at cross-state branching as soon as it became legal to do so.

"There's no doubt that statewide branching made North Carolina banks very aggressive and very competitive," says Harry Davis, finance professor at Appalachian State University in Boone, N.C., and an economist for the North Carolina Bankers Association. "And another very important thing it did was create larger banks with layers of middle management." That meant that North Carolina could send its managers to locales like Texas to run their banks, but the opposite wasn't

happening because Texas was a unit-banking state, where branching was outlawed. "It was never a fair contest," Davis says.

The quirkiest trend was in Washington, D.C., which lost about 20 percent of its branches in the decade up to 2004. The FDIC's Phelps is unsure why this has happened, but says that one factor is probably consolidation, which caused banks to close redundant offices. Additionally, the FDIC found that economic factors have strong influence over a region's branching activity, and D.C. ranked last among U.S. states for average employment and population growth between 1994 and 2003. More generally, D.C. might reflect a trend of branch density falling in cities while rising in suburbs.

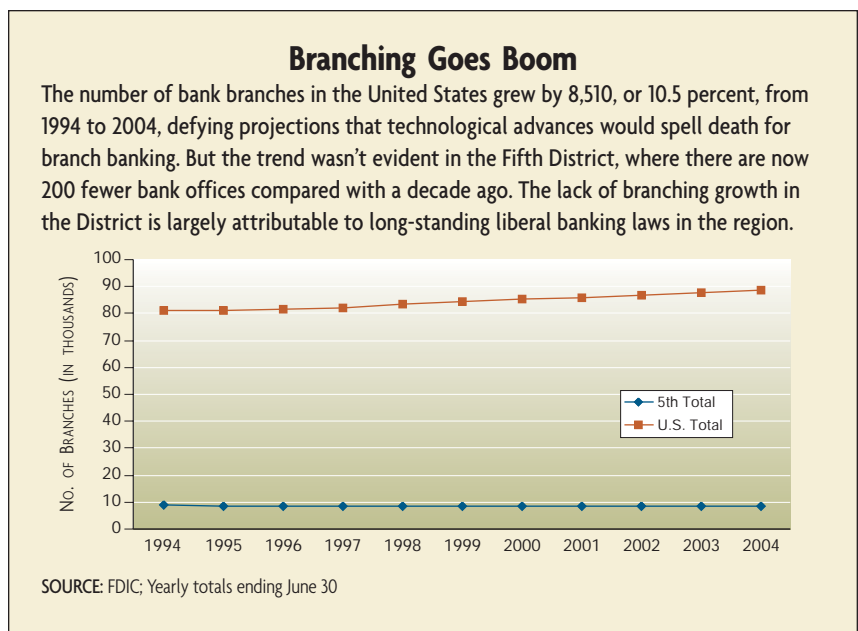
### What's Next?

High-tech branches may have sex appeal, but they haven't proven themselves to be any more profitable, Meyer says. "We haven't found a lot of things to correlate [performance] with inside-the-branch décor or things of that nature," he says. More important are branch hours, visibility and the retail characteristics of the branch's neighborhood.

MarkeTech consultant Hal Hopson sees a lot of phone banks and Internet consoles growing cobwebs at bank branches. "The high-tech, whiz-bang stuff doesn't get a lot of use," he says.

None of this is to conclude that virtual banking offerings aren't taking hold. In 2004, an estimated 7.3 percent of banking transactions took place online, according to industry consultant TowerGroup. Next year, almost one out of every 10 transactions is expected to happen over the Internet. A recent *American Banker*/Gallup survey found that 30 percent of U.S. consumers now pay their bills online and most of those were very satisfied with their service.

Home mortgages are easily obtained over the phone and Internet, and firms not bound by bricks and mortar are discovering new ways to translate lower costs into landing

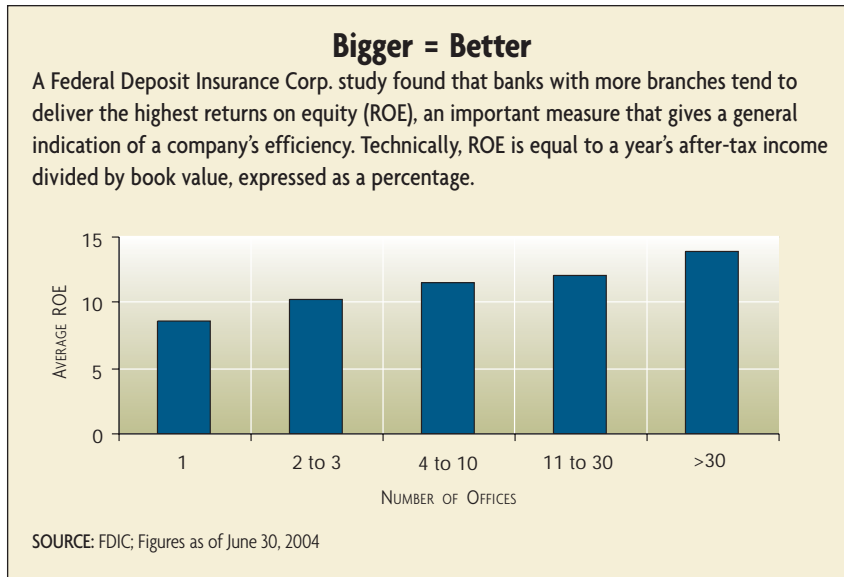


customers. Capital One Financial, the McLean, Va.-based credit card company, bills itself as “America’s largest online vehicle lender.” Its Web site can approve applications within minutes and deliver “blank checks” for buying cars by the next day. And since it doesn’t have to build and maintain costly branch offices, Capital One’s auto lending business can undercut interest rates offered by banks and credit unions.

Some financial institutions have proven you don’t need branches. NetBank, one of the first online-only financial services companies, is profitable and growing, with a strong mortgage banking business. At the same time, NetBank’s biggest drawback may be its lack of physical presence. Last fall, at least one investment bank lowered its stock rating for NetBank in part because so much of its business is derived from highly competitive wholesale and correspondent channels — not retail-oriented branches, like many of its rivals. Recognizing the power of bricks and mortar, E\*Trade Financial Corp. — which started as an online stock-trading firm — has begun opening branches, most recently in Chicago. E\*Trade’s branches do more than just court stock traders; they offer comprehensive financial services, including checking and lending.

We’re ending up with institutions that operate in both the real and the virtual world.

“Clearly as we go through time, more and more people will use



electronic banking and have less need for an on-site visit to a bank,” Davis says. “But right now, there’s still a very large percentage of bank customers who want to go talk to a person face-to-face. That percentage has surprised everyone by its size.”

Awad, the University of Virginia professor, says banks possess far more sophisticated technology than customers to date have shown a willingness to try. Part of that is simple aversion to change; part of it is a very real aversion to giving up personal information over online channels. Awad describes a standard pitfall for banks that offer loan applications on their Web sites. Many customers get to the point of downloading the form, but when it comes to keying in their Social Security numbers, they balk. “When they were asked for sensitive information, more and more

customers click away [from the site],” Awad says. “People are still sensitive about something that they consider personal.”

Now industry observers think the building spree is nearing its end. Having fleshed out their retail networks with bricks and mortar, banks in 2005 and beyond will start concentrating on training their customers to use more of the technology available at their branches. The future is expected to be full of offices that are staffed with fewer employees, making them more cost-effective. In an industry based on rules, regulations and standardization, branches in fact offer banks their best vehicles for customizing products and services to specific customers. “Branch banking is growing, but it’s with the idea of becoming as fully automated as possible,” Awad says. **RF**

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