Point of View Paper

Branch Strategy in a Highly Digital Yet Low-Interest Rate Environment

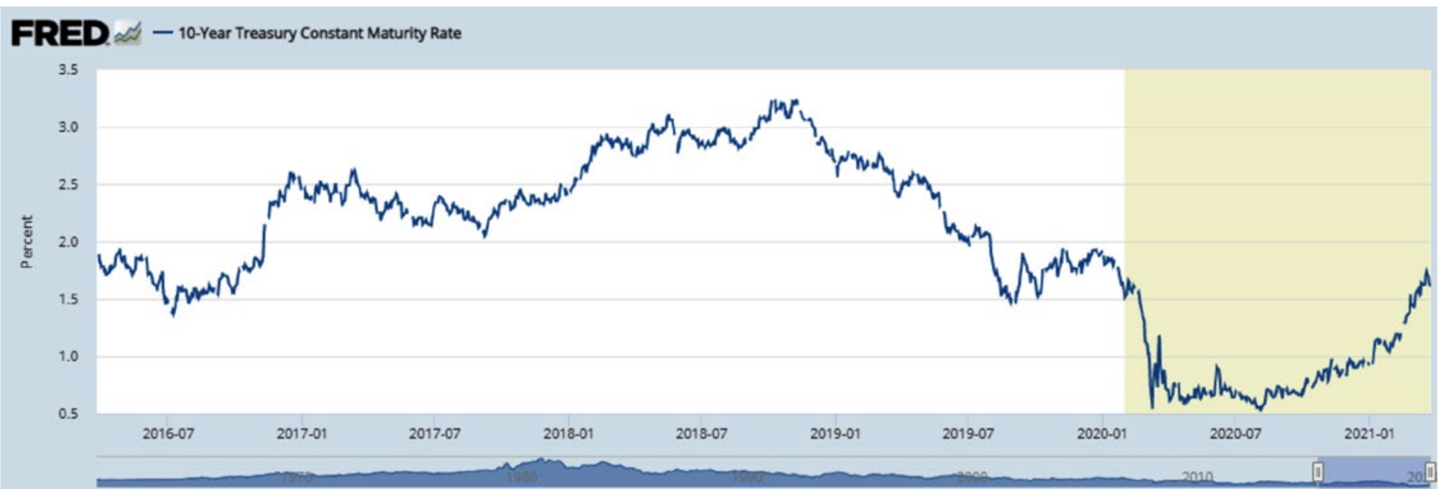
Adjust Your Branch Strategy to Navigate Uncharted Financial Waters

Branch locations remain one of the most common and (depending on the market, accountholder or survey) important channels for delivering banking services. But two variables have recently changed that have affected branch economics and strategy: the current and expected low-interest-rate environment and the impact of COVID-19 on accelerating digital channel adoption. Let's explore both.

Variable No.1: Interest Rates

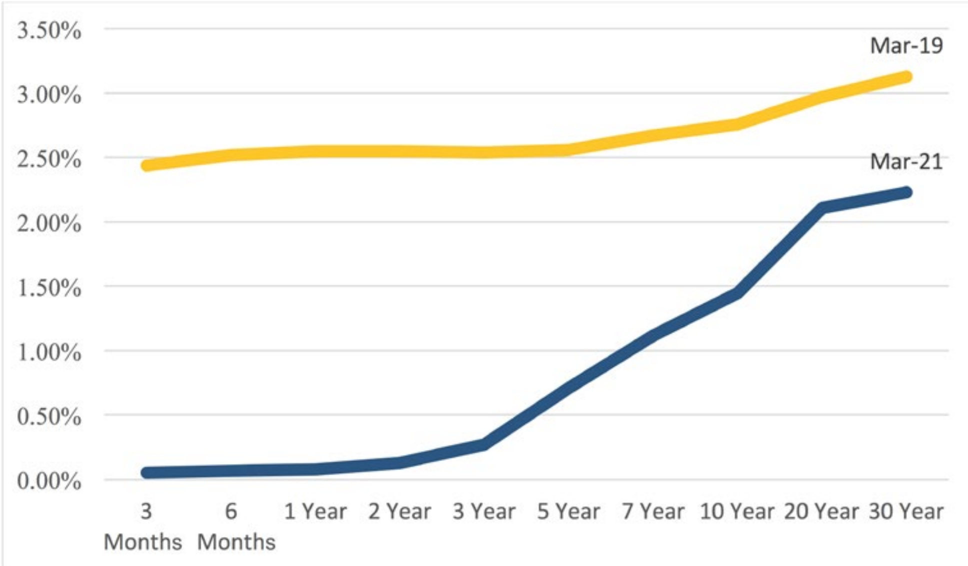
Interest rates continue to decline and remain at record low levels. Figure 1 shows the 10-year Treasury yields over the past two years, and Figure 2 shows the shift in the Treasury yield curve from March 2019 to March 2021. The relative flatness through three to four years of the March 2021 yield curve suggests that rates will remain depressed for some time. That is consistent with what appears to be an accommodating monetary policy by the Federal Reserve.

Figure 1: 10-Year Treasury Constant Maturity Rate



Source: Board of Governors of the Federal Reserve System U.S. fred.stlouisfed.org

Figure 2: Yield Curve – March 2019 and March 2021



Source: Federal Reserve, 2020

When rates fall, the relative value of deposits and, specifically, free deposits, declines. That has a negative impact on branch profitability and return on investment (ROI). Figure 3 illustrates the impact on a sample branch's economics and returns when rates move 200 basis points, from 5.25% to 3.25%, as they did at the beginning of the pandemic.

In the Traditional Branch Model panel on the left in Figure 3, base interest rates are assumed to be 5.25%. Given the other variables depicted, the branch generates a positive ROI of 13.54%. The Low-Rate Environment panel on the right shows a decline in ROI to negative 3.29% when the base rate is reduced to 3.25%.

Figure 3: Declining Rate Environment Heavily Impacts Branch Profitability

Branches Are Much Less Profitable in Low Interest Rate Environments

Traditional Branch Model

	Balances	Rate
Checking	$ 15,000,000	0.25%
Savings	$ 10,000,000	0.50%
MMA	$ 10,000,000	1.25%
CDs	$ 15,000,000	1.75%
Total	$ 50,000,000	0.95%
Loans to Deposits	85%	5.25%
Interest Income	$ 2,231,250	
Interest Expense	$ 475,000	
Non-Interest Income	$ 150,000	
Overhead	$ 1,500,000	
Branch Profit	$ 406,250	
Branch Investment	$ 3,000,000	
Branch ROI	13.54%	

Branch ROI changes dramatically in a low-rate environment.

This pro forma illustrates that as interest rates decline, the value of a branch, as a provider of low-cost funds, decreases commensurately.

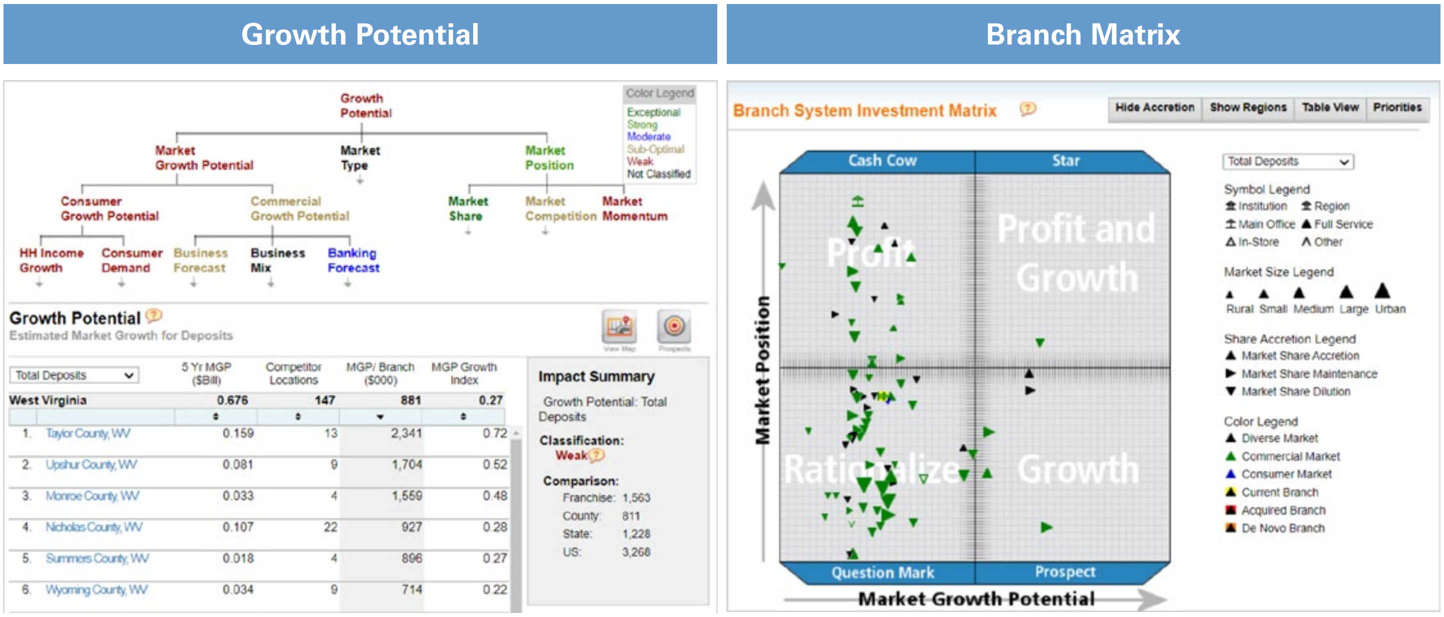
The issue: While deposit rates do come down, they cannot come down as much as asset yields.

Low Rate Environment

	Balances	Rate
Checking	$ 15,000,000	0.00%
Savings	$ 10,000,000	0.15%
MMA	$ 10,000,000	0.25%
CDs	$ 15,000,000	0.60%
Total	$ 50,000,000	0.26%
Loans to Deposits	85%	3.25%
Interest Income	$ 1,381,250	
Interest Expense	$ 130,000	
Non-Interest Income	$ 150,000	
Overhead	$ 1,500,000	
Branch Profit	$ (98,750)	
Branch Investment	$ 3,000,000	
Branch ROI	-3.29%	

To keep the previous ROI of 13.54% in the low-rate environment, the branch would have to grow by over 40%. Figure 4 is an example of an analysis of the branch's market where consumer and commercial growth potential is weak and the location is in a rationalize category, making 40% growth unlikely.

Figure 4: Branch Market Analysis



Source: Bank Intelligence Solutions

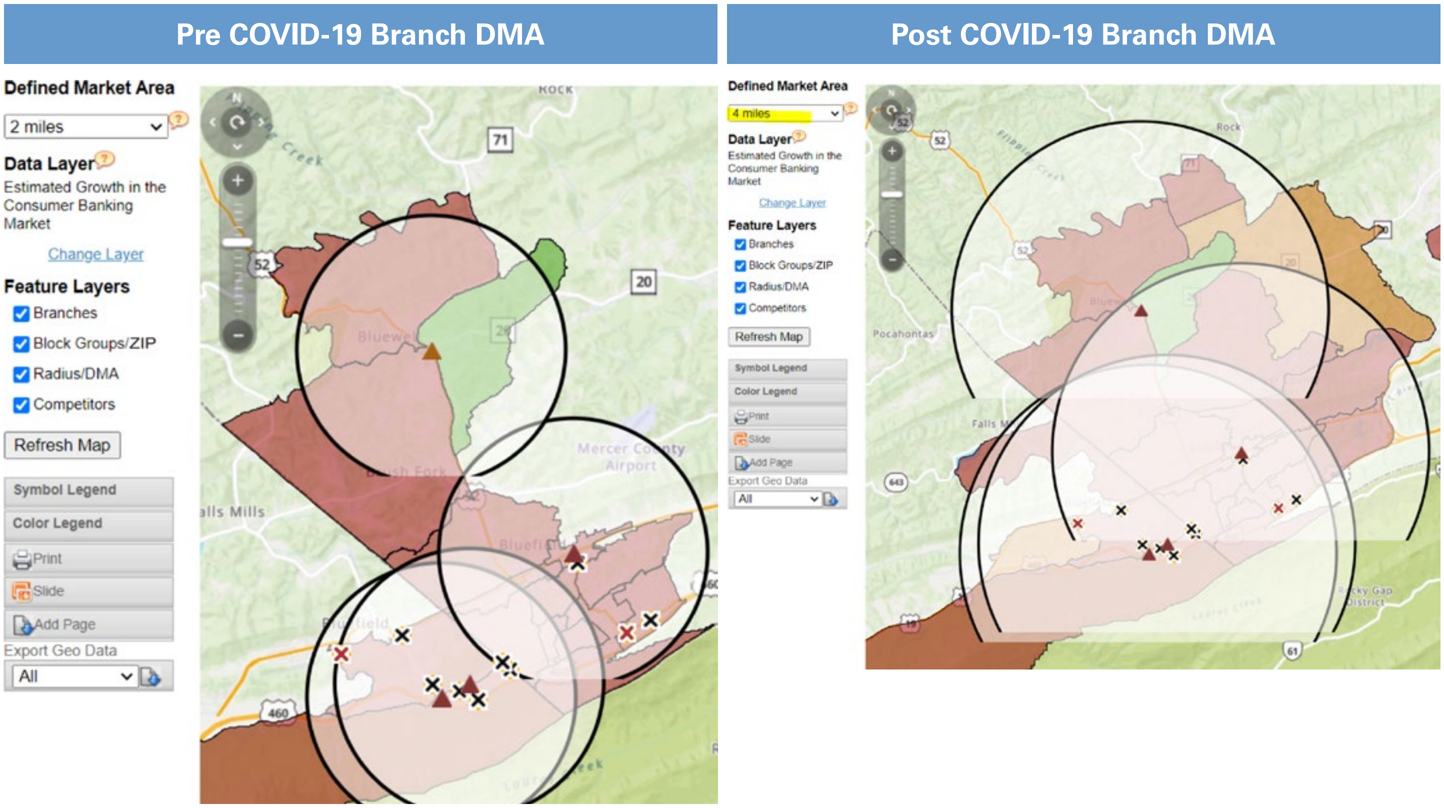
Each branch's economics will be different, so it's best to think in directional and not specific terms. In general, as rates fall, so do branch contribution and ROI. This analysis alone doesn't mean the financial institution should close the branch (because rates can move back up), but it is a consideration.

Variable No. 2: COVID-19 Accelerated Digital Channel Adoption

COVID-19 has accelerated the adoption of and preference for digital channels across all aspects of banking. That adoption and preference has affected some financial institutions and markets more than others, but it represents a significant variable change that is, most likely, here to stay. Among the many benefits of increased digital channel usage is the expansion of the branch's typical market reach.

For example, Figure 5 shows a hypothetical increase in branch market service area and related overlap due to greater digital channel adoption – a market area that expanded from 3 to 6 miles. As a result, more accountholders are now served by multiple branches, which creates inefficiencies and weakened investment allocation. Again, this is a specific scenario, but it's best to think of these changes in more directional terms than specific, as each market's situation will be different.

Figure 5: Branch Market Service Area Expansion After COVID-19



Source: Bank Intelligence Solutions

There is debate about how much movement will occur, but many experts believe branch service areas and overlap are likely to increase as more activity moves to digital. As a result, the market will need fewer branches. This is important because, if financial institutions can serve the same market with fewer physical locations, they become more efficient and can more easily afford the costs of digital enhancements.

Doing the Math

With respect to branch overlap and how to consider the potential impact, Figure 6 shows an example of a branch projected to contribute revenue of $468,752 in 2021, rising to $519,699 in 2025. Over that same period, the branch is expected to provide $88,379 to $105,697 in direct contribution or approximate profitability. So, while this branch appears to be a solid performer, a more intriguing question arises: How many of its accountholders are being adequately served by other branches or channels?

In this example, if we estimate that only 10% of accountholders and potential accountholders are negatively affected by a branch closure or reduction, there should be a rationalization discussion regarding the branch. This analysis compares the total value of the branch's direct contribution against the post-closing direct contribution, which has the branch variable expenses eliminated.

This is the old marginal cost versus marginal revenue analysis. In this example, marginal costs in 2021 are the full $356,700, while marginal revenue is the amount the financial institution would lose – $46,852, or 10% of $468,572. So, the net is $46,852 minus $356,700, or negative $309,848. That result may indicate that it's time to reconsider the investment and strategy. Rationalization doesn't mean closing the location altogether, just that the financial institution reconsiders what the branch makeup needs to be for current circumstances.

Figure 6: Branch Marginal Cost Versus Marginal Revenue Analysis

	2021	2022	2023	2024	2025
			Projected Total Revenue		
	$ 468,572	$ 480,755	$ 493,322	$ 506,288	$ 519,669
		Variable Non-Interest Expense			
Salaries and Benefits	$ 232,300	$ 234,623	$ 236,969	$ 239,339	$ 241,732
Branch Occupancy	$ 84,000	$ 88,200	$ 92,610	$ 97,241	$ 102,103
Other Var. Branch Expense	$ 40,400	$ 40,804	$ 41,212	$ 41,624	$ 42,040
Non-Interest Expense	$ 356,700	$ 363,627	$ 370,791	$ 378,204	$ 385,875
Pretax Contribution	$ 111,872	$ 117,128	$ 122,531	$ 128,085	$ 133,794
Prov for Taxes	$ 23,493	$ 24,597	$ 25,731	$ 26,898	$ 28,097
Direct Contribution	$ 88,379	$ 92,531	$ 96,799	$ 101,187	$ 105,697
Non-Interest Expense	42.85%	4.70%	4.61%	4.53%	4.46%

WACC/Discount	10.00%	Year	Year	Year	Year	Year
LT Growth in Contribution	0%	1	2	3	4	5
PV of Direct Contribution		$ 80,344	$ 76,472	$72,727	$ 69,112	$ 65,629
				Terminal Value		$ 1,056,696
				PV of Terminal Value		$ 656,295
				Total Br. Val w/o Fixed Costs		$ 1,020,579
PV of Total Revenue Minus Tax		$ 336,520	$ 313,881	$ 292,806	$ 273,183	$ 254,912
				Terminal Value		$ 4,105,384
				PV of Terminal Value		$ 2,549,120
Expected Revenue and Growth Potential Lost				Total Value		$ 4,020,422
	10%					
PV of After-Tax Total Revenue	0	$ 302,868	$ 282,493	$263,525	$ 245,865	$ 229,421
				Terminal Value		$ 3,694,845
				PV of Terminal Value		$ 2,294,208
				Total Value		$ 3,618,380
				Difference		$ 2,597,801
				Minus PV of Closing Exp		$ 250,000
			RATIONALIZE	Net		$ 2,347,801
	P&L Cost/Imp	$ 309,843	$ 315,552	$ 321,459	$ 327,575	$ 333,908

Moving Forward Past COVID-19

The artist Pablo Picasso is quoted as saying, "Every act of creation begins with an act of destruction." While the COVID-19 pandemic might not have destroyed all business behavior, it has altered many of the ways clients engage with us. These changes will likely be long-lasting, if not permanent.

How financial institutions recreate their branch investment and approach should be front and center in the strategy discussion. And while they may not decide to close doors, it is time to be mindful of the variables that have changed and how to best match resources with the needs to compete in the post-COVID-19 era.

About the Author

Alan Smith, Senior Strategist, Fiserv, has more than 25 years of banking experience, including eight years as director, president and chief operating officer of a $500 million bank. As a Senior Strategist for Bank Intelligence Solutions® at Fiserv, Alan works in an advisory role to client banks using the BankAnalyst® suite, helping bankers make the best use of the online advisory tools for strategic and tactical planning to drive bank performance and maximize franchise value. Prior to joining Fiserv, Alan was president and chief operating officer at The Bank/First Citizens Bank, where he was responsible for identifying and executing business priorities that maximized the bank's value.

Connect With Us

For more information about BankAnalyst Financial and BankAnalyst Market:

800-872-7882

getsolutions@fiserv.com

fiserv.com

Fiserv is driving innovation in Payments, Processing Services, Risk & Compliance, Customer & Channel Management and Insights & Optimization. Our solutions help clients deliver financial services at the speed of life to enhance the way people live and work today.

Visit **fiserv.com** to learn more.

Fiserv, Inc.
255 Fiserv Drive
Brookfield, WI 53045
fiserv.com

fiserv.