Reviewing the Community Bank Business Model:
Can It Work in a Low Interest Rate Environment?

In my last article for this newsletter, I suggested that if interest rates were to break out of their trading range on the low end, it would be time to look at the cost structure of the bank. Rates, indeed, have fallen to levels not seen since Eisenhower was President. That means it is time to look at the cost structure and more generally the community bank business model. This article will attempt to do so.

Classic Community Bank Business Model

Community banks gather deposits from local customers through the deployment of convenient brick-and-mortar offices. Funds raised are invested in a combination of loans and securities balancing liquidity, credit, and interest rate risk to produce a net interest margin. Additional income is generated from customer traffic, and all of the revenues are used to defray the costs of building and operating the structure. So far, so good.

Profitability is dependent on the revenues generated exceeding the costs of doing business. Those revenues are in turn dependent on natural and created advantages of the business model. I will focus on two important advantages that banks have historically enjoyed to see if they will hold up in an extended environment of low interest rates. The two advantages I will discuss are convenience and yield curve arbitrage.

Convenience

Community banks should be able to raise money less expensively than other financial services companies because their business model places numerous physical locations close to the customer. The most recent figures in New York State suggest that the average bank branch holds roughly $50 million in deposits (excluding Manhattan). It is reasonable to assume that the reason banks operate the branch system (about 5000 locations excluding Manhattan) that they do is related to the ability to gather these deposits.

There are two ways to try to determine the convenience advantage of these locations. First, we can estimate what it costs to run the offices and assume that banks are rational enough to open branches only when they are likely to make a profit. Most studies I have seen suggest the marginal annual cost to operate a branch is between 1.0% and 1.5%. We can compare this operating cost to the historic average of 8% for a branch purchase and further assume it takes five years for a de novo to achieve its expected level. This suggests that a de novo branch strategy assuming a cost of 1.5% a year for five years is about the same as paying 8% for a seasoned location. On the whole, our initial estimate seems reasonable.

The additional cost of convenience is the profit we need to generate. If we assume that half of our profit should come from liabilities in a bank, we might add an additional 75 basis points (pre-tax) to our estimate. This suggests a cost of convenience of around 2%.

Another way come to the value of convenience is to look at how much cheaper deposits actually are for banks. This is akin to asking what the customer is willing to forego in the interest of banking locally. Note the following table:

Period	Federal Funds	IBANYS COF
1996-2000	5.46%	3.29%
2001-2002	2.78%	2.52%
Today's Marginal Figures	1.25%	~1.00%

During the late 1990's economic expansion our 2% estimate looks pretty good. Since then, however, it appears that the advantage banks have from convenience has been significantly eroded. It's important to remember that rates fluctuate, and if we were in a normal recovery, we may have repaired the temporary reduction in convenience advantage. However, we aren't, and my estimates of the costs for new business suggest that it is not cost effective to operate branches just to gather deposits in the current environment.

<u>Yield Curve Arbitrage</u>

There is a hidden benefit that accrues to core deposits, however. When community banks raise deposits from local customers, they take advantage of the law of large numbers. Even though each customer could withdraw the funds they have deposited at any time, the bank can count on the aggregate totals staying relatively stable. Furthermore, industry studies suggest stability of individual accounts over time. Combining these two insights allows a banker to invest what appear to be immediately repricable deposits in assets with term lives while still remaining well protected from interest rate movement. Typically, the effective term of core deposits is close to three years. The following table shows the slope of the yield curve from overnight to three years along with the reported net interest margin.

Period	Yield Curve	IBANYS NIM
1996-2000	.33%	4.31%
2001-2002	.82%	4.15%
Today's Marginal Figures	.35%	???

As you can see, a steeper yield curve since the end of 2000 had allowed IBANYS banks to moderate the squeeze in the margin implied by the COF analysis above. Obviously, the fact that assets with higher yields still remain on the books has been an aid as well. But, we are not considering past decisions, only the viability of the business model in the current and future environment.

The key issue can be stated simply. If convenience is generating an advantage much smaller than it had in the more typical late 1990's while yield curve arbitrage is being eroded, what is the business case for a branch system to gather cheap deposits? The answer is clear. There is none.

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<u>A Way Out</u>

It is very possible that the economy could quickly recover, pushing interest rates up so that the value of convenience will be reestablished. However, if we are in store for an extended period of relatively low rates (note that even the levels during 2001-2002 show little if any value to convenience), we need another reason for maintaining the network. Without the revenues needed to cover costs and generate a decent profit, branches will have to be closed.

Banks need to identify other reasons for customers to value the local office. Keep in mind, any new reasons for convenience need an operating strategy consistent with the new products and services offered. They also need to overcome the operating costs of convenience to justify maintaining the network instead of using an alternative delivery channel. Here are a few options.

Make loans. Consider hours necessary for the branch location to cater to loan customers as opposed to depositors. It may be time to look to weekend hours for this purpose. In fact, you may decide to open the office without opening the vault or bringing in the tellers. This keeps costs down while allowing for increased revenues.

Offer financial planning services. Customers may find that the value of discussing their overall finances with someone local and accessible is true value-added. The trick is finding a way to be compensated.

Carve out office space for non-bank financial products and services. Although neither insurance nor brokerage services are as dependent on convenience as is deposit gathering (lower frequency of activity), a one-stop location for all of the services may appeal to a portion of the customer base. Be careful on this, however. Whereas a particular geographic area may contain 100 bank branches, it is probably served by less than 10 brokerage offices.

The last way out is to review those offices that are not carrying their weight with an eye to selling them or simply closing or consolidating locations. This option is likely to become more prevalent (especially at larger banks) if the present level of rates holds. Be wary of purchasing these locations without considering the true value of the branch.

Community banks have historically generated a substantial portion of their profits due to their branch network. The convenient physical locations allowed banks to pay lower rates and still hold the dollars. That advantage has shrunk to the vanishing point and even the yield curve arbitrage inherent in aggregating core deposits is insufficient to create a payback for the costs of convenience today. Without other revenues that can be generated from the network, a painful round of cost cutting and/or branch consolidation awaits.

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