Framework for Branch Performance Evaluation

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Increasing pressure on an institution’s profit margin and the need to consider all types of delivery systems make branch evaluation more important than ever. This article presents guidelines for evaluating branch performance ranging from the definition and measurement of branch performance to the mechanics of developing a formal program and looks at alternative debranching strategies.

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All of these financial institutions with branches and those that are contemplating one are well aware of the significant and continually rising costs associated with this category of fixed assets. Some of these costs can or may have already become liabilities in terms of the drain on profits and net worth of a problem branch.

Branch performance evaluation is not only for those institutions that have, or may think they have, a problem branch but rather for any institution with a branch. Branch performance evaluation programs are not only to make problem branch situations good, but also to make good branch situations better. A main office is no exception. Furthermore, many of the branch performance evaluation concepts discussed in this article are applicable to ATM and other financial service delivery systems.

Although many financial institutions are taking corrective action regarding certain existing facilities, the idea of a formal branch performance evaluation program is a new one for most institutions. In addition to being a relatively new topic, it is a rather difficult one. This is not only because of the rather small amount of published research on this subject, but also because of the different disciplines involved.

There are at least four possible approaches to the evaluation of financial institution branches: an accounting approach, a marketing approach, and an operations approach. While each of these viewpoints stresses certain items, what is needed is an interdisciplinary stance that considers the key aspects of each approach and the important relationships among them.

Branch Performance

Defining Branch Performance. In the course of our work, we have asked the officers of several financial institutions of different sizes what “branch performance” means to them. Although most of the responses are along the lines of deposit volume and growth, there are many other definitions. Obviously, there is no one right answer, since branch performance must be measured relative to an institution’s branching objectives and different institutions have different branching objectives. What may be a high performance branch for one institution may not be the case for another.

A case in point is a branch of one of our smaller savings and loan association clients, a $50 million association. Deposits at this relatively seasoned branch amount to only a few million dollars. While many associations would consider this to be a problem branch because of its low deposit base, this branch has been the reason why that association was able to maintain a desirable profit margin for several years.

That officer’s objective has been to generate new mortgage business through continuing contacts with the area’s builders and realtors. The substantial mortgage origination of this office in past years enabled that association to profitably grow its mortgage portfolio in the secondary market. Even considering this high performance but low deposit volume branch, the question then becomes: would it have been better if that office’s location or some other factor enabled it to generate a greater deposit volume but still provide the same mortgage production benefits?

The most common branching objectives concern an officer’s deposit portfolio. Deposit objectives might be related to total deposit volume; absolute or relative growth in deposits; the number of accounts; or market share. Other deposit objectives may be related to the mix of deposits (e.g., fixed rate CDs, market rate CDs, demand NOW, or savings accounts); or even the mix and number of transactions.

There are still other branching objectives besides those related to deposits. As noted in the example, there is the loan side. Specific lending objectives for an officer can focus on loan volume, the mix of loans, the yield on the loan portfolio, or its maturity structure. Still other branching objectives, which may vary from office to office, relate to the institution’s overall financial development; the amount of cross-selling; the breakdown of corporate versus retail business; the penetration of the institution’s target market segments; improvement of the institution’s image; and social goals.

Branch Deposits vs. Branch Profitability. The most obvious branching objective is the maximization of branch profitability. There is usually a distinction made between short- and long-term profitability and absolute and relative income or return on investment. Regardless of the precise definition, we believe that branch performance should be measured in terms of branch profitability and the contribution to overall institution profitability.

Although branch deposit growth may be the most common branching objective for financial institutions, it is not synonymous with the branch profitability objectives. A closer look can be made by briefly examining the four financial institution de novo branches that reportedly had the most successful and aggressive open branch programs ever in terms of new deposit generation.

Each of the four New York City mutual savings bank branches described in note 1 generated new deposits in excess of $300 million in its first 20 days of operations. What do we learn from these four examples? Very simply—we cannot equate deposits and profitability. The four largest grand openings of all time were not necessarily the four most profitable.
Each of the four New York City mutual savings banks branches . . . generated new deposits in excess of $100 million in its first 30 days of operations. What do we learn from these examples? Very simply, we cannot equate deposits and profitability.

For similar reasons, it is easy to understand why a financial institutions largest offices in terms of absolute volume may not be the most profitable ones. While the nation's largest de new branch office can be identified on the basis of publicly available FDIC and TASC branch office data (see Table 1), no statement can be made regarding the profitability of any office without branch income and expense data, which are obviously confidential (when their are internally available).

The Determinants of Branch Performance. If branch profitability is to be a meaningful objective by which performance is to be evaluated, then branch management must clearly understand its specific goals relative to those of the institution and how the branch will be evaluated.

Each financial institution office can be evaluated and continually monitored on the basis of the various controllable determinants of branch profitability. Furthermore, the enhancement of branch performance involves feasible modifications of these controllable determinants. This branch controllable and uncontrollable determinants of profitability, which may be relevant for many other delivery system facilities as well, are listed in Exhibit 1.

The set of location factors, which are often considered to be the most important determinant, includes the site's access, the immediate area in the vicinity of the site, and its primary service area or market area. All three location factors, rather than just one or two of them, must simultaneously be favorable for an optimal location.

Important site characteristics may be an office's parking, transit, and ATM facilities; its visibility; area (and peripheral) accessibility; overall appearance; interior layout; and size. Just at each of these site items should be evaluated in terms of its desirability, so too should the demand and supply characteristics of the immediate area or locale be evaluated in the vicinity of the site. For example, if the office is located in a shopping center, a major employment area, or a large downtown district, what are the prospects of that immediate area relative to the number of competitors? Even the most desirable site in an unfavorable or declining commercial area may have limited potential. Conversely, an institution may have a problem because it has an inferior site within a very desirable shopping center. How misleading we have heard, "It doesn't matter where we are at the shopping center - as long as we're there." Our location research shows that it does matter where the facility is situated in or near a shopping center, it does matter what side of the street it is on, and, it does matter what corner of an intersection it occupies.

The demand and supply factors of an office's primary service or market areas are also important. A branch may be in the right market but at the wrong site and/or immediate area to serve that market.

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These three locational factors collectively represent what a determinant of branch office profitability. A second determinant upon which an office may be evaluated is the nature of branch management and staff, and there is a fairly substantial literature on this subject. Unfortunately, it is often quite difficult to quantify this important determinant (e.g., in the case of a friendly teller).

A third determinant of branch performance is the promotional program. A successful branch opening promotional campaign can be quite important to a new facility. The follow-up advertising and other promotional programs (e.g., personal selling and direct mail) of the individual branch and the institution are part of this factor. An institution's rate and pricing structure, its product and service mix, and other market factors enter as additional determinants of branch performance. These are generally, but not always, policy or institution variables beyond the control of branch management.
important determinant of office performance in the latter category that may or may not differ by branch is the number of hours and days that an office is open.

Developing a Formal Branch Performance Evaluation Program

Considering the determinants of branch performance, the nature of a branch performance evaluation program is straightforward to evaluate the controllable determinants, both individually and jointly, related to an institution's branching objectives.

Many institutions without a formal evaluation program are now generating financial, marketing, and operations reports by branch. These reports can be the foundation of a branch evaluation effort to the extent that they enable these determinants. The most important reports in the branch profitability measurement system, however, are concerned with identifying the total costs of operating a branch and actual branch profitability.

Examples of worksheets that can be used as general guidelines for this purpose are found in Exhibits 2 and 3. These worksheets, which obviously require modification and appropriate detail for a particular institution, are utilized in the most formal approach to branch profitability measurement, an approach that only a small percentage of institutions currently utilize. There is a considerable amount of published data on the generation and appropriate use of these types of financial statement. Most institutions would require a considerable amount of new cost accounting data to implement a formal system of branch profitability measurement. A cost accounting system allows an institution to cost out individual activities such as deposit or loan account servicing, and this information may be utilized in the evaluation of a particular branch, department, or function.

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Two Important Issues: Profit Centers and Funds-Transfer Pricing

Two issues that are of particular importance in this area are the "profit center" concept and the "funds-transfer pricing" problem. An understanding of both of these accounting concepts is important in the development of a branch performance evaluation system.

The treatment of each branch department or function (fudged potentially even a customer) as a "profit center" means that such a unit's profit is evaluated as an individual entity. Since branch management does not control over a certain expenses and income items, the profit center concept is often abandoned in favor of other concepts.

While a "cost center" may be evaluated on its ability to control its income and profit, a "responsibility center" is judged only on controllable items of expense, income, and profit. Even if an institution does not implement a formal branch evaluation system, the idea of evaluating a branch based upon controllable income less controllable expense and its contribution to corporate profits is an important one to consider.

The "funds-transfer pricing" problem is a complex and not totally resolved issue. It refers to the determination of the appropriate rate to be charged on funds that internally flow from one office to another within an institution. This is essentially an internal accounting question. A "funds-multiple" branch is said to pay or to finance another branch with funds that require to meet the loan demand. However, these funds are needed for mortgages and related credit by the institution's "deficit" branch in a manner where the younger home-owning families are generating a relatively small amount of deposit.

To properly motivate and evaluate branch management and to efficiently allocate resources, it is necessary to develop a control over funds-pricing schedule to credit the older funds surplus branch for funds supplied to a home-office pool, and likewise debit the newer funds deficit branch for funds used from the pool. These credits or debits show up as income or expense items on the profit and loss statement of the respective branches (e.g., see Exhibits 2 and 3). Even small changes in the internal "funds-transfer rate," which may encourage or discourage the generation of new deposits or loans by branch management, can have a major impact on measured branch profitability.

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Just as in the case of the profit center concept, problems can develop through the inappropriate use of even a sophisticated funds-transfer pricing system. Specifically, a branch or profit center may set in a dysfunctional manner to maximize its profitability, as it is supposed to do, but only at the expense of overall system profitability. This is contrary to the systems approach (i.e., overall institution profit maximization). Also, there is no general agreement on the appropriate transfer rate, although a marginal cost of funds rate is often used for this purpose.

The Problem Branch. Each institution should appropriately examine its delivery system in
terms of whether or not each component is consistently contributing to corporate objectives. If this is not the case with some of its institutions, the analyst may be talking about a "problem branch."

A problem branch is typically defined as an office with chronic under-performance relative to the branching objectives of an institution. In terms of profitability analysis, a problem branch would be defined as a chronically unprofitable one. These problem branches could be de novo or acquired offices and may vary considerably in the number of years opened. Some may even be relatively large offices opened in expensive shopping centers in the early seventies. Also, problem branches are like problem banks, differ in terms of the degree of their problems.

An ongoing branch profitability measurement program should act as an early warning system for potentially unprofitable branches. In this way, corrective action can be taken well in advance before the problem reaches the bottom line. Just as the regulators have early warning systems for problem institutions, each institution should have its own early warning system for problem branches.

**Identifying Feasible Branch Performance Enhancement Strategies**

Once an existing or potential problem branch situation has been diagnosed, it is necessary to prescribe corrective action in the form of an appropriate branch performance enhancement strategy. Rather than taking the costly (in terms of corporate resources and time) "trial and error" approach to performance enhancement strategies, an institution should utilize the systematic approach inherent in a formal branch evaluation program. This involves the identification of feasible alternative strategies and the selection of the optimal one.

The identification of feasible alternative strategies will vary in each situation depending upon the four types of feasibility: financial, marketing, operational, and regulatory. These are the same feasibility considerations that are used in branch and ATM feasibility studies. Consequently, the definition of feasible alternative strategies should concern the views of an institution's financial, marketing, and operations personnel, all within regulatory constraints.

We believe that the most important feasibility consideration should be financial feasibility, as exemplified in Exhibits 4 and 5. It is here that an institution quantitatively compares the expected benefits and costs of feasible alternative strategies involving the important present value concept (principally on a risk-adjusted basis) of capital budgeting. Exhibits 4 and 5 for problem branch X conclude that the branch modernization option is the most desirable of the four identified feasible alternatives.

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The branch planning function, as we define it, involves a financial institution's total financial services delivery system, both existing and proposed branch and EFT units. According to the systems approach, an institution should consider all existing branches and electronic units in its new location decisions, and conversely, consider its proposed branch and EFT network in its existing facility decisions. Exhibit 6 depicts a ranking of the various feasible branch planning proposals available to one hypothetical institution. With a $1 million 1982 capital budget for this purpose, it would consider the first four proposals, but carefully monitor its problem branch Z as a branch-closing candidate.

*Percent value of $1 is 1982 to be received in a future year with a 20% required rate of return.*

Note: The first column lists the financial institution and the second column lists the resulting $1 million 20-year present value of future income.
The second type of feasibility is the marketing feasibility. The various possible branch enhancement strategies may differ in terms of their impact on an institution’s image and promotional programs or its efforts to increase the share of its “target market.” These potential marketing benefits should be quantified, as they are the greatest possible, as part of the overall analysis.

The operational feasibility of a branch enhancement strategy involves an examination of not only its impact on an institution’s existing operational policies and branch personnel, but also the nature of actual equipment, property, and structural limitations. Relative to the branch equipment factor, ATMs (approximately 30% of which are on-premises locations) have expanded the potential alternatives available to an institution in deciding to add a problem branch. Again, many important operational considerations may be difficult to quantify.

Now, if a branch enhancement strategy is feasible from the financial, marketing, and operations viewpoints, shouldn’t that be enough? While the answer to that question may be yes, there is obviously one other type of feasibility for a branch enhancement strategy — regulatory feasibility. The Community Reinvestment Act (CRA) is probably the most important factor in this respect due to its potential limitations on the branch closing alternative. The regulatory climate in banking today is unique because it not only involves potential barriers to branch exit, but also to branch entry. However, the Federal Home Loan Bank Board’s new regulations to streamline the branch application procedure, and with the Office of the Comptroller of the Currency and other bank regulators apparently following their pre-competitive lead, the barriers to branch entry are being significantly reduced.

The “Debranching” Premise/One Strategy. Our term for the branch divestiture alternative is “debranching,” and it refers not only to the selling of branches by an institution desiring of reducing or eliminating its branch network but also to the closing of chronic problem branches. The primary reasons most cited for financial institution branch closures are the lack of deposits, the deteriorating financial condition of an area, a duplication of services (usually because of a merger), and security problems.

The closing of a problem branch, if feasible on a regulatory basis, raises several important marketing and operational questions, not to mention the potential loss of deposits, a financial feasibility consideration. However, one major New England bank found that it retained approximately 70 to 80 percent of the deposit balances of a few of its closed branches, one to two years after they were closed.

Other banks, of which we are aware, that have closed offices have likewise reported fairly high deposit retention rates as long as another office was within reasonable proximity. The evaluation of the closing or divestiture of a branch alternative should be based on a fairly conservative deposit retention rate assumption. In some cases involving relatively related branches, it may not be reasonable to expect any significant amount of retained deposits, except those maintained by an aggressive branch-by-mail program.

Alternative Strategies. Debranching represents one extreme performance enhancement strategy. Alternative enhancement strategies are all related to modifications of the controllable determinants of branch profitability. For example, an institution has many alternatives involving the locational factors: an office may be rehabilitated, remodeled, expanded; supplemented by electronic or other facilities; downscaled to a “mini-branch” (or, a limited facility) or a “micro-branch” (i.e., a satellite); closed and replaced on the same site; or relocated within the immediate area or market area. Regardless of the alternative selected, the Economic Recovery Tax Act of 1981 provides for expanded investment credits, and this should be taken into account in the evaluation of the financial feasibility of such an alternative.

Many branch enhancements involving the locational factors are structured around the so-called “hub concept.” This delivery system strategy centers around a large main or regional office that acts as a hub in a given market to many smaller branch and mortar facilities and various off-premise ATMs. The supporting offices, all of which have at least one ATM, include a few conventional branches (e.g., 2,000-3,000 square feet in size) in key service centers and a larger number of strategically placed mini-branches (e.g., 500-200 square feet in size) in service centers and off-premise micro-branches. The micro-branches of 200-400 square feet, with one or two employees and an ATM (with 24-hour deposit capability) may only be staffed for certain hours of the day or certain days of the week.

A conventional delivery system that is re-structured in this manner (as a result of various branch closings, downsizing, acquisitions, and deployment of pre-engineered ATMs) is not only more efficient but also more productive. This is because a greater rate of profitability is distributable and flexible locations, each of which is tailored to the level of enhanced banking potential in its respective area, are less capital- and human-intensive.

Other possible branch enhancement strategies that may or may not be used in conjunction with modifications of the locational factor include changes in an office’s size, personnel, its branch promotional program, or any combination of these. While modifications of locational factors can represent major and costly changes, the revision of these factors may not, and they could be the cause of a problem branch. An institution can also enhance branch profitability by substituting some of its prime lobby space to a “compatible” user that could potentially serve to increase the “drawing power” of the branch; at least one bank in New York City is obtaining some rental income from this source.

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Conclusion

A branch performance evaluation program is not only important for those financial institutions that are experiencing a turnover in assets and equity and desire to improve, but also for those with diminishing and even disappearing premium margins. Some financially troubled thrift institutions, for example, might find that a branch performance evaluation program is more important than ever, since these may be significant opportunities to cut or eliminate costs associated with problem branches.
Such thrift institutions might be able to close their problem branches easily now since the public is aware of that industry's profitability problem. In fact, it is possible that a federal regulator may even require a branch performance evaluation to "weed out" and close an institution's unprofitable branches as a condition of financial assistance.

A leaner and more cost efficient version of such an institution's existing branch delivery system may be a very attractive part of the overall package that may be considered by another financial institution in a possible merger or acquisition. This is especially true since a large acquiring institution may be precluded from closing those same problem branches after a merger or acquisition because of regulatory factors (i.e., the Community Reinvestment Act).

As is evident from this article, there are various ways an institution can go about developing and implementing a branch performance evaluation system, ranging from a formal and sophisticated system to a less formal and less structured approach. Regardless of the approach an institution decides to take, the important point is that the institution is evaluating branch performance. And if not, the time to start is now—

Notes

1. For a discussion of the mechanics of calculating branch profitability utilizing these types of schedules, see Bank Administration Institute, Bank Costs for Planning and Control (Park Ridge, Illinois: Bank Administration Institute, 1972), pp. 195-200.

2. Ibid., p. 218 and p. 221.


4. Bank Administration Institute, op. cit., p. 96.


