

U.S. Banking: A Challenging Road Ahead

BY RICK SPITLER & LEE KYRIACOU

As banking leaders begin planning for 2012, they face a crucial set of choices about the future of their institutions. After struggling to recover from the financial meltdown and turning in good performance, they remain stuck in a slow economy. Meanwhile, recent lift factors such as cost reduction, falling loan-loss provisions and favorable fixed-income capital markets are losing strength.

Banks must begin the difficult job of transforming their businesses for the new realities. The good news is that there will be selective growth opportunities across the major lines of business. The catch is that to sustain the current franchise and capture selective growth, bankers will need to be far more innovative in restructuring their business lines and more surgical in tapping revenue opportunities and managing risk.

The principal challenge is that the market is reviving more slowly than in previous economic recoveries, with huge variations in customer circumstances and local market conditions. Consumer (and as a result business) lending prospects are muted; net interest margin expansion has stalled; and banks are still working through a significant overhang of troubled credits, now largely limited to real estate.

The picture is further complicated by the new regulations, which have severely crimped major fee revenue streams, sealing off all possible return to pre-recession earnings dynamics in retail banking. Looking ahead, banks must deal with higher

requirements for capital and liquidity; increased compliance expense; greater risk accountability for many instruments that previously were held off-balance sheet; and more stringent risk measurements that more explicitly anticipate the possibility of extreme occurrences and may imply lower business valuations.

The inevitable result of these exogenous factors is that the banking industry is in need of restructuring and consolidation, both within and among institutions. With early belt-tightening having run its course, banks now face the challenge of transformative cost reduction, particularly within their expensive branch networks, entailing delicate transitions with customers and employees.

It is also likely that another round of mergers will ensue as lagging banks become more distantly separated from the pack. This will create important new expansion opportunities for acquisition-minded banks with superior skills in customer engagement, cost control and network assimilation.



Mortgage lending is a big story for the banking industry. Given the meltdown in securitization, the setbacks at Fannie Mae and Freddie Mac, and the current banking hunger for higher yielding assets, bank balance sheets will become a major destination for mortgage loans. Over the next few years, we estimate that banks could book from \$1–\$2 trillion of additional mortgage credit, primarily by gaining market share at the expense of securitization and government sponsored enterprises (GSEs).

Consumer lending also presents select opportunities for banks that can leverage customer relationships for superior credit cross-sell results. Purpose-driven installment loans such as auto and education loans will experience growth, while relationship-oriented innovators can also generate home equity and credit card growth (with share loss and balance runoff for others).

Wealth management, can provide new vistas for banks that can meet the emerging household cash management needs of the retiring Baby Boomers. Non-banks are formidable competitors, but as budgeting-oriented households enter retirement, payments-oriented banks can take the high ground if they act promptly.

Not surprisingly, pricing expertise in the areas of credit, deposits and fees could make the earliest performance difference at many banks, given their immediate impact on revenues. Advanced financial management and risk management skills also will be needed, both in helping executives to pinpoint performance issues and in assuring consistent performance.

In terms of business line growth:

Commercial banking will offer new opportunities for players that can accurately target select regional markets and industry sectors, with the proviso that advisory and fee-based services often will take precedence over lending. Middle-market companies remain generally cautious about expanding before they see a stronger upswing in consumer demand, but many still want help in tightening financial controls and, in many cases, in preparing for sales, mergers, acquisitions and recapitalizations.

PERFORMANCE HEADWINDS

Since the financial crisis, bank industry returns have consistently improved. However, the bulk of the recent earnings improvement has come from reductions in loan loss provisions, masking continuing weaknesses in fundamental performance trends.

Essentially, the massive loss reserves set aside at the height of the financial crisis have yet not been fully replenished as charge-offs occur, lifting the burden of heavy loss provisions from future earnings reports. This trend reflects

TOWARD THE CANADIAN BANKING MODEL?

BY RICK SPITLER & J.D. RICHARDS

We see dramatic shifts in the U.S. banking landscape playing out over the next five years. Challenging conditions will drive even more consolidation, with a total of eight to ten players ultimately controlling up to 60% of the industry. As part of this, several well-managed regional banking companies will rise to national prominence. One or two major international banks could come to the forefront in U.S. banking as well.

Winners in this next wave of mergers and acquisitions will demonstrate two basic attributes: 1) superior adaptability and customer engagement, which enable the bank to win market share and grow in an overall slack environment; and 2) demonstrated management and organizational strengths that will assure the successful assimilation of acquired entities (some of which could be much larger than the acquirer).

Once the dust settles, there is a good chance that U.S. banking will look a lot more like Canadian banking (which has been heavily consolidated for quite some time), with remaining mega-players having much larger balance sheets as a percent of gross domestic product. Heavier layers of regulation will inhibit risk-taking, but will also lower the volatility of returns. Meanwhile, a more efficient distribution footprint will emerge as banks streamline multi-regional networks, close unprofitable branches and invest in web and mobile capabilities to address changing customer usage patterns.

In this newly-formed U.S. industry structure, balance sheets will initially grow significantly as more mortgage assets migrate over (we estimate as much as \$1 trillion to \$2 trillion of balances could do so over the next few years). Following the re-intermediation of the bank balance sheet, asset growth will be limited to the pace of GDP expansion, with market share gains primarily coming from customer switching. Industry profitability will be in secular decline, with “through the cycle” return on equity averaging from three to five percentage points less than pre-crisis levels.

Despite the vast scale of the consolidated mega-banks, the industry’s prominence in payments, its traditional bastion, will be threatened by savvy nonbank players. Although rivals such as Wal-Mart will continue to make inroads at the low end of the mass market and with the under-banked, the most intense new competition will come in the mobile and online space. All manner of players — PayPal, Apple, Google, Intuit, American Express and others — will cut into a broader spectrum of consumer and small business payments.

All told, the remaining major banks will be much bigger, with a lower-earning asset base and a greater share of the financing of the economy held on the balance sheet. The saviors in this scenario will be a future resuscitation of fee-based business (a major effort unto itself) and a systematic reduction of risk, lowering both earnings volatility and share price trading volatility. Betas for banks need to come down dramatically for stock prices to have a hope of remaining where they are.

growing credit confidence, which is a good thing. It also has propped up earnings statements at a time when little else is positive in the income statement as loan balances, net interest income and fee revenues have all been in decline.

Our analysis indicates that the trend of falling industry loan-loss provisions has largely run its course. Banks will no longer be able to supplement core earnings with this form of accounting relief. As a result, they will be fully exposed to consumer deleveraging, slow loan growth, high case-loads of troubled mortgage assets and continuing regulatory headwinds.

Consumer de-leveraging. Consumer banking faces setbacks as unemployment rates continue to remain stubbornly high. Current upticks in private sector hiring are offset by layoffs in the public sector, and by waves of the “shadow” unemployed beginning to look again for jobs. This offers little hope for a strong recovery in household finances, borrowing ability, and spending confidence.

Longer term, the difficulty is the structural shift away from consumption and borrowing toward savings and debt reduction. Consumers will be working down debt for several years to come. As an example of the burden consumers now face, total household mortgage debt now exceeds 60% of residential property values, up from a 35% to 40% loan-to-value ratio extending from 2006. Absent significant home price appreciation, this ratio can only be improved as households reduce spending and consumption in order to pay off loans.

Many households have already significantly revised their spending and savings patterns following the financial crisis, often permanently. Even strong survivors remain debt-averse, seeing what has happened to their neighbors, family, friends and former co-workers.

Credit overhang. Although top-level credit trends continue to improve, banks are encountering a sticking point with first mortgage home loans. Among first mortgage

balances currently held by U.S. depository institutions, fully one dollar in ten belongs to a troubled account that is at least ninety days past due in monthly payments.

Yet banks are only writing off a fraction of these non-performing first mortgages. The reasons are many, including: huge backlogs in loan restructuring or foreclosure; lender hopes for local market rebounds to limit ultimate losses; and a general impetus to delay loss recognition given uncertain circumstances.

In the meantime, however, this overhang will act as a braking force on the recent trend of falling loss provisions. As with any return to normal charge-off levels on this type of troubled asset, fresh loan loss provisions will be required to shore up reserve levels — an outcome we fully expect, and which the recent write-down by Bank of America Corp. presages. Meanwhile, this delinquent portfolio will drag on earnings as banks continue to pay interest on the borrowings used to fund the non-performing loans.

Regulatory headwinds. Banks face a number of regulatory handicaps in both consumer payments and lending going into next year. Most recently, the Fed's implementation of the Durbin Amendment has triggered a probable \$5 billion decline in annual debit interchange revenues.

This follows a \$15 billion hit to checking overdraft fees stemming from the Fed's Regulation E and related changes. And banks have already absorbed the lion's share of an estimated \$10 billion shortfall in credit card fees and margin stemming from the Credit Card Accountability Responsibility and Disclosure Act of 2009.

Going forward, banks will gain even further earnings "hits" from new regulation. Basel III liquidity requirements, for example, limit the ways that deposits can be invested, which will have the effect of driving more funds into low-yielding assets and limiting the availability of deposit funding for other business activities. Basel III also will require banks to hold higher levels of core capital, which seems certain to dilute earnings per share at a time when revenues are under assault on multiple fronts.

Lastly, the Dodd-Frank regulation on proprietary trading, commonly known as the "Volcker Rule," will change the business models of some of the largest U.S. financial institutions. This will have cascade effects on hedging and securitization activities, reporting requirements and transaction guidelines.

All told, we estimate that the overall banking industry will see a drop of roughly three percentage points or more in return on equity as a result of Basel III and Dodd-Frank. And the impact likely will be even heavier on Systematically Important Financial Institutions (SIFIs), as defined by the newly-formed Financial Stability Board.

COST CRUSADE

Given all of the revenue headwinds in banking, it seems clear that cost reduction will be elevated to a strategic priority. Much of this effort will center on the branch network, which represents nearly 50% of the industry expense base. A companion effort will be precision resource deployment, to carefully nurture the areas that present the best possibilities for growth in risk-adjusted returns.

Before plans can be laid, executive management teams will need a lot of additional information. Finance and risk managers will need to quantify the revenue picture for each business line, including market and regulatory drivers. They will need to come up with new risk and liquidity metrics that will foster core, stable, lower-risk earnings and help the bank to adroitly manage earnings streams with higher liquidity risk and/or credit risk.

While business line managers have a strong directional sense of the overall earnings outlook, we believe they lack an analytically based view of the liquidity and risk-based revenue gaps that lie ahead, including insights into the behavior of "hot money" depositors, and the worst-case implications of residual risks in the loan portfolio.

At many institutions, early expense reduction initiatives have largely run their course. These opportunities have largely been focused on discretionary expenses. Assuming the right metrics are in place, executive management now must look to another, deeper round of structural cuts that will be more complex to implement; more likely to affect key capabilities; and more likely to affect the customer experience. Here again, finance and risk managers will need to lead the way in pinpointing the options and their possible impacts.

A critical aspect of the new cost reduction will be customer-friendly "demand management" innovations. In retail branch banking, for example, one larger goal is to guide customers into lower cost, electronically-enabled channels that will actually speed up many types of basic transactions while permitting dramatic reductions in manual processing and attendant branch staffing requirements.

This is not unlike the transformations that certain retailers and airlines have achieved with online, kiosk and mobile approaches. Some of the largest banks have raced far ahead in re-directing customer deposit transactions from branches to automated self-service channels. These are critical advances at a time when retail banks will potentially need a 25% to 30% reduction in branch staffing costs.

Progress such as this reflects a careful customer migration approach that goes beyond simply deploying the technology. To reap the full benefit of such efforts, banks will need to consider product and pricing design; targeted customer

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segmentation; ergonomics of the use of technology; and last but not least, incentives and marketing promotion. This is a multi-year priority.

As they “re-engineer” the demand for service, banks will need to re-shape their branch networks — now overgrown due to various revenue challenges and the advancement of electronic alternatives and shifting customer usage. The time has now come for more accelerated and decisive pruning, which needs to be analytically guided by an understanding of local market potential.

Retail banks will increasingly move to “lite” networks that preserve extensive market presence at a lower cost. There will be fewer large outlets, carefully placed, augmented by a variety of touch-points that include small-footprint branches with minimal staffing, storefront-style ATM installations, and in-store branches.

This reinforces banks’ need for innovation and vision. In a retail banking market that now is permanently changed, banks need new strategies to rebuild the business. Annual plans will need to be pursued within the context of a multi-year transformation.

Not all banks will have the luxury of time, however. We expect a significant increase in the number of banks looking to sell. In some cases, exceptional management teams will be able to acquire much larger competitors. These winning teams will have already shown superior skills in revenue generation, expense control or credit origination that can support higher stock valuations for bidding and assure that newly-merged entities can wring superior returns from consolidation.

WINNING ATTRIBUTES

As more fully discussed in the various companion articles in this issue of *Novantas Review*, there are many growth possibilities for next year for players with the right focus and skills, including select opportunities in commercial, mortgage and consumer lending. As executive management teams review the various business line plans, we believe that three major performance themes will cut across virtually all areas of the bank. One is precision targeting and pricing. Another is surgical cost reduction/management. The third is a need for new performance measurement tools and approaches.

Precision targeting & pricing. At this point, most major banks have visibly progressed in deposit pricing, including analytically-driven local market and product variations, and

segment-tailored initiatives, which all reflect price elasticity of demand. In many other areas of the bank, however, pricing remains stuck in a zone that is bounded by internal cost estimates, competitor actions, and executive interpretations of recent results.

Especially in the areas of mortgage, treasury management and consumer credit, there are several opportunities to improve pricing strategies by considering major categories of borrowers. Uniform home equity pricing typically overlooks, for example, the extent to which account holders actually will use their lines of credit; likely balance duration; shopping attitudes (price-sensitive versus convenience-oriented); and the extent of consolidated business done with customers across all areas of the bank.

This leads to lost opportunity in balance formation and margin enhancement. Based on research findings from multiple regional banks, margin enhancements of up to 20% are possible within certain home equity customer segments, for example, while significant balance growth is possible elsewhere — all depending on pricing strategy.

In all major business lines, growth will critically depend on a bank’s ability to target priority markets and customer groups, and sell within a relationship context. In a market where mortgage origination volume is down 50% from the pre-recession peak, mass-market campaigns that focus on product promotion will be far less effective than before.

Accurate targeting requires a detailed understanding of market differences. During the four years leading up to the spring of 2011, for example, housing prices declined by 37% on average in the Pacific region (which includes California), but by only 3% in the West South Central region (which includes Texas). Such differences extend into individual regional markets as well. Both to minimize risk exposure and to optimize prospecting, banks will need to carefully study variations in local markets.

The same is true of commercial lending, where different industry sectors are experiencing different rates of recovery. For example, the old “rust belt” metal-bending companies are enjoying a bit of a renaissance because of the recovery of the U.S. auto industry. Clearly, targeting the right sectors in the right geographies is important.

Success will often hinge on advanced analytical capabilities. As executive management teams review the various business line plans, recurring questions will be: “What are



the priority markets and customer groups? “What is the strategy for each major type of opportunity? “What skills are needed to guide and implement the effort?” In each case, the answers will have a strong quantitative component.

Surgical cost reduction. It is not time to take the meat cleaver to expenses. The easy stuff is done and there is the risk that such approaches will crimp long-term revenue growth. Instead, it is time for smart cost management and cost containment. We see more banking companies focusing on the “marginal efficiency ratio” to assure that at the margin, revenues are rising more quickly than expenses.

It is time for careful consideration of all expense drivers, with emphasis on a substantial untapped opportunity — the careful management of demand for costly sales and service. What that means is that the right value propositions and pricing will be needed to incent customers to use the least expensive delivery channels (typically online and self service kiosks) for a lower cost-to-serve and a higher quality customer experience.

In other service industries, research indicates that when customers are empowered to do it themselves, they usually are happier with the experience and, if a problem occurs,

more appreciative when the company steps in to help as needed. This is clearly an opportunity for banking.

Performance measurement. If the crisis taught anything, it is that banks need more robust risk and liquidity measuring tools. This not only pertains to the improved capital allocation approaches that regulators are insisting upon, but also to new portfolio risk and liquidity management tools. We see a major shift in risk management and measurement occurring, in which models are moving from analyzing past performance to forward-looking scenario analyses that consider crisis occurring risk correlations.

New customer-level (versus product-based) liquidity measures are also necessary to isolate hot money and comply with new regulatory requirements for liquidity coverage. All of this upholds “quality earnings,” based on stable assets with robust diversification, funded by truly core liquidity.

INDUSTRY TURNING POINT

This coming year will be a time when new leadership and fundamentally new directions begin to emerge in U.S. banking. Although hard transitions lie ahead, we fully expect to see some institutions come through with fresh strengths, including important cost adaptations and next-generation capabilities in pricing and segment-based customer responsiveness.

Knowing that individual banks are basically in the same boat on many issues, executive management teams should resolve to outperform their competitors in rapidly and effectively adapting to the new market. In turn, winning teams will play a lead role in the likely next round of merger-driven industry consolidation.

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