Banking’s Limited Recovery and the Challenges Ahead

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BY LEE KYRIACOU

Following tedious post-recession years spent struggling through massive loan losses, declining spreads, lawsuits and constrictive new regulations, the U.S. banking industry has reached a stable cruising altitude. But are prior peak levels now reachable?

Much hope has been placed on rising rates and the potential for margin restoration. Following the net interest margin’s crash to a multi-decade low in the first quarter of 2015, a Fed-propelled lift could be just the ticket.

While rising rates may help, however, that is no panacea for the structural jolts sustained by the U.S. banking industry over the last six years. Fee revenue appears permanently lowered following new regulation. Compliance costs are significantly higher, as are capital requirements and loan-loss provisioning. On top of all this is the fundamental change in distribution, away from branches to mobile and online channels, along with the rise of major name-brand direct banking competitors that are poised to grab deposits as rates climb.

Of greatest concern is the cumulative impact of these structural changes on classic financial intermediation — the gathering of deposits and extending of loans — which looks to be marginally profitable at best. Indeed, even before the recession, creeping disintermediation had set net interest margins on a course of long-term decline.

Thus while banks may get some relief as rates rise, most cannot relax. Urgent effort on multiple fronts is needed to rebuild or replace longstanding pillars of the banking business model.

Most pressing, the branch network must be further thinned and economized, freeing up resources needed in the new
competitive arena of digital banking. Building up fee revenue sources — from mortgage origination, capital markets, investments and insurance — is critical to replace lost fees and supplement spread revenue. Meanwhile banks will need to invest in customer analytics to support smarter loan and relationship pricing, as well as in process redesign to bring down lending costs.

The overall situation creates further pressure for industry consolidation. With their powerful brands, diverse product lines and vast economies of scale, the largest banks have more options to deal with the changes and challenges ahead. While progressive and well-managed regional and community banks have their chances as well, smaller institutions generally face growing disadvantages vis-à-vis larger players.

NEW NORMAL

Though off from the second quarter’s historic peak, third quarter industry net income of $40.5 billion still topped anything seen prior to the recession. But the industry’s asset base has grown still faster, expanding by nearly 21% to $15.8 trillion since the post-recession nadir reached in late 2009. Also the industry now is stacking more equity against each dollar of assets, reflecting regulatory pressure, with an 11.4% third quarter ratio of equity to assets overshadowing a roughly 10.4% pre-crash average.

The upshot is that industry profitability continues to lag. At an annualized 1.02%, the third quarter return on assets compares with a pre-recession era when the ROA often exceeded 1.25%. Likewise, the annualized third quarter return on equity of 9.1% distantly lags the former 12%-15% ROE range for the entire industry (Figure 1: Industry Returns on Equity and Assets).

Going into 2016, profitability likely will improve modestly as loan and revenue growth continues. All commercial lending categories are now growing, although competition is pressuring margins. Most consumer lending categories are showing balance sheet growth as well (with the notable exception of home equity, which remains a holdout on net balance growth). But pre-crisis performance levels will remain elusive. In the “new normal” for banking performance, the industry ROA will do well to reach 110-115 basis points, and ROE likely will hover at 10% to 11%.

A key metric to watch will be the loan-to-deposit ratio. While balance sheets have grown — driven by the impact of Federal Reserve monetary policy on deposit growth — loans until recently had not kept pace with deposits, leaving banks to load up on low-yielding securities investments to round out the book. At 72.1% at third quarter’s end, the industry’s loan-to-deposit ratio showed a bit of improvement over recent periods, but still fell way short of the roughly 80% to 90%
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range seen in pre-crisis years (Figure 2: Soft Recovery in Loan Demand and Deposit Leverage).

Digging into the financial dynamics of the industry’s recovery, the revenue and profitability issues become clear. Virtually all of the bottom line improvement in net income from 2009 to 2014 came from falling loan-loss provisions, essentially permitting massive, crisis-provoked loss reserves to be flowed back into earnings. A welcome supplement to be sure, but also masking other ills.

In fact, total industry revenues have been relatively flat for half a decade, fluctuating around roughly $165 billion to $170 billion per quarter, with upticks in interest income largely offset by declines in fee income and rising expenses (regulatory compliance, network restructuring, post-recession legal settlements, digital banking, etc.).

DIFFERENCES FROM PAST RECOVERIES

In the classic crisis/recovery scenario, the bank focuses on portfolio cleanup and franchise preservation, looking to the day when a rebounding economy restores the industry to familiar competitive conditions. This time around is different — quite different — with no possibility of return to the market conditions of a decade ago and significant challenges and required adaptations looming ahead.

For one thing, deposit rates may reprice more quickly (as measured as a “beta” of deposit yield increases relative to federal funds), both because of information availability to web and mobile shoppers and tougher competition from online-only direct banks. And new lending will entail higher loss provisions, reflecting stricter standards and the impoundment of potential crisis-type losses into credit risk models.

Regulatory change has altered banking business economics in a variety of ways as well. Non-interest revenue has taken several hits: early on in credit card fees; then debit interchange via the Durbin Amendment; then overdraft changes; and most recently trading revenues from the Volcker Rule. Collectively, these setbacks have had a roughly $25 billion impact on annual fee revenue, decidedly reducing the share of industry revenue derived from non-interest sources, even during a period of declining NIM.

Figure 2: Soft Recovery in Loan Demand and Deposit Leverage

Consumer lending has not kept pace with a strong rebound in commercial lending, limiting total loan growth and the ability to leverage a swollen deposit base.
The impact on community banks is worse because they rely more heavily on traditional intermediation, deposit-gathering and lending, and a narrower stream of deposit- and loan-related fees. Following new regulation, the proportionate contribution of non-interest revenue has fallen quickly for these smaller institutions.

Beyond its revenue impact, regulation has significantly increased compliance costs and raised capital requirements. It has also imposed liquidity requirements that leave less room for lending and place lower value on non-core deposits.

As if this were not enough to deal with, bankers also face the one-two punch of digital, with 1) mobile and other technology enabling the untethering of banking from paper; and 2) consumers shifting transactions away from the branch at an accelerating pace. The replacement of paper or physical media by e-delivery — which blew away storefront networks for travel agencies, film development, video and now bookstores — is now visibly impacting bank branches as well. Branch transaction counts are falling year after year, and lobbies are eerily empty.

Stepping back, there is also a longer-term structural issue with the net interest margin. Looking across economic cycles over the last 25 years, NIM has risen at the start of a recession (deposit yields plummeting relative to loan yields), but then given back all the increase — and more — during the next expansion phase. This pattern reflects an overall tightening of competition for traditional balance sheet intermediation, the availability of capital markets, and non-bank sources of lending. This longer-term pattern will continue to bear down on spreads — one more reason that any potential relief coming from rising rates likely will not revive banking industry profitability to pre-crisis levels.

**WHAT BANKS MUST DO**

The tasks facing banks are manifold and individually daunting, with each requiring attention amid the ongoing struggle to adapt products, risk and performance modeling, and compliance for new regulation.

Foremost among these tasks is further rectifying the branch network while increasing investment, functionality and customer engagement in digital channels, particularly mobile. Getting the transition right is critical — we have seen banks close local branches without losing deposits and others that experienced serious runoff.

The correct network balance will vary by market. Progress will hinge on careful measurement and trade-offs — between the number and size of branches and ATMs; signage; local advertising and other elements of market presence; as well as the timing of lease expiration and the ability to cover restructuring costs and write-offs. We see dramatic declines in square footage dedicated to branches and ongoing reduction in unit count. In turn, the brand is rapidly replacing the branch as the means of differentiation — with a decided advantage to national banks and household brand names.

Striking the right balance in multi-channel banking also requires redesigning the customer cross-sell process, which has relied heavily on branch visits for incremental selling “at bats” and now must change in order to reach customers who

**What Policymakers Need to Understand**

As debate over public policy and proposed further legislative/regulatory action continues, there is a critical need to step back and consider the collective impact on the future of the U.S. banking industry.

Ironically, in an era of widespread outcry over super-sized banks that are too big to fail, new regulation itself has become a driver of further industry consolidation. Smaller banks are disproportionately impacted by compliance burdens and revenue constrictions, further magnifying their disadvantages in the emerging market and increasing the pressure to seek shelter within larger institutions. Meanwhile, nonbank players are allowed to operate with far less regulation, aiding their progress in breaking off profitable chunks of banking intermediation.

To put things in historical perspective, it was regulation that restricted interstate banking (and state-level branch networks), creating the atomistic structure of the U.S. banking industry in the first place. Consolidation has been a constructive response in recent decades, continuing to undo the consequences of prior federal and state banking limits. With generally strongly economics behind it, consolidation has reduced the total population of banks and thrifts from 18,000 to fewer than 6,300 over the last 30 years.

But is the trend now unstoppable? As with the geological fault lines in California, it is difficult to predict the timing and magnitude of specific events, yet the evidence of massive pressurization is abundantly clear, starting with market forces:

- **Collapse of physical distribution** — In a world gone digital, the branch is waning in importance and the marketing advantage increasingly goes to national brands.
- **Structural spread compression** — With brand-name, online-only banks squeezing deposit gathering, and non-bank and
only rarely come into a branch. In the near term, as revenues rise, expect to see many banks take restructuring charges and goodwill write-downs — though these will not likely be a once-and-done instances, but rather an ongoing series.

Building non-interest revenue is for the most part a longer-term issue. The larger players are well ahead of the game, with banks greater than $100 billion in assets deriving up to 40% of total revenue from non-interest sources, while banks with less than $10 billion deriving only 25%. Some banks have grown their way into significant mortgage origination or investment revenue volumes relative to their size, while others have acquired insurance agencies to build a revenue stream. In commercial banking, regional and larger players must beef up the quality and breadth of capital market products, sufficient to cross-sell effectively to mid-tier business customers.

Apart from branch restructuring and fee revenue sources, banks must also continue to deepen analytic capabilities and streamline processes. Foremost with analytics is pricing, which most banks have turned to as a way to wring extra basis points and fees from both deposit-gathering and lending. The next wave of analytics will go beyond regional and product pricing and begin to optimize relationship pricing.

On the process side, loan origination is ripe for improvement, both in commercial and consumer lending. On the consumer side, new compliance requirements and heightened regulatory scrutiny are driving management caution, but also ought to be driving process redesign. On the commercial side, compressing margins are forcing banks to look for efficiencies. And in small business lending, new non-bank players are promoting “instant approval,” forcing banks to redesign for underwriting speed as well as improved credit management and cost reduction.

In the end, these multiple forces are not easily fixed, and their collective weight will likely accelerate industry consolidation. Smaller banks are vanishing at a rate that tops 300 per year, equivalent to a roughly 5% cut in the total U.S. bank count annually.

Consolidation pressures also extend to larger regional banks, which need to diversify revenue and deposit sources, and more importantly, develop the strong brands that are now needed to compete with the national banks and internet-only banks with household names. One set of exceptions will be niche players — in credit card, wealth management and business owner private banking — that can successfully carve out a defensible position.

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monoline lenders doing the same in lending and payments, financial intermediation is being fractured into component markets, escalating performance and consolidation pressures on banks.

• Competition in the age of big data — New analytic firepower is needed to compete in the multi-channel marketplace, with scale advantages going to larger players.

Now stack regulatory impact atop these market forces. Disparities in non-bank versus bank regulation, both for consumer lending and deposit fees. Higher liquidity requirements and capital standards. Money market mutual fund regulation. All have unintended consequences that cumulatively make banking more difficult and less profitable (and might also hinder macro-economic policy).

To continue in its vital role of providing liquidity for the U.S. economy, the banking industry needs to be able to generate sufficient spreads to attract depositors, cover expenses and losses, and provide risk-adjusted yields. This is especially so for smaller banks that do little else other than local financial intermediation.

Larger banks are now the default survivors. They will use scale, analytics, diversification, and national branding as offsets to market and regulatory pressures, though even their long-term profitability may well still suffer. By contrast, local community banks, and even many regional banks, have fewer options — other than consolidation. Policymakers need to grasp this threat to traditional intermediation. And more broadly, the public debate going forward needs to take into account the likely impact of additional change on the long-term profitability and health of the industry.

— Lee Kyriacou