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After The Crash: The Future of Finance
The Future of Commercial Banking

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Defining the topic

- A US focused analysis
  - FDIC universe used as the core data set
  - Balance sheet, regulatory and competitive issues vary greatly by country

- Focus on traditional commercial banking economics
  - Assets
  - Liabilities
  - Treasury management
  - Non-balance sheet fee income

- A future that is 2-4 years out
  - Current wave of credit losses through the system
  - New regulation in place
  - Macro-economic conditions that are currently priced into the market
Structure of the next 60 minutes

- How did we get here?
  - The long history
  - The golden decade of 1993-2003
  - The crisis

- Shaping the future of US commercial banking
  - Macroeconomics
  - Regulation
  - Competition

- Three plausible future scenarios

- The distribution of returns – what will define the outperformers?

- Discussion
Section 1

How did we get here?
The economics of the US commercial banking industry since the Great Depression can be defined by five key eras:

1. **Post-Great Depression recovery**
2. **Stagflation**
3. **S&L crisis**
4. **“Golden Era”**
5. **Financial crisis**

**US Commercial Banking Post-tax ROTE**

Average ROE:
- **11.1%**
- **10.1%**

**Source:** FDIC Historical Data
A confluence of macro factors lifted the performance of the industry during the golden era of 1993 to 2003

- Favorable conditions:
  - Net long treasury positions
  - Steep yield curve
  - Falling rates
  - Strong home price appreciation
  - Sustained high employment
  - Secondary market liquidity
  - Strong deposit growth
  - High barriers to entry in deposits
  - Higher fee income

- Positive secondary effects:
  - Capacity to borrow
  - Ability to lend

- High origination volumes - Very low credit losses

- High profits:
  - High lending profits
  - High banking profits
  - High profits for branch based deposits

- Low competitive intensity and high pricing power

- Favorable conditions:
  - Good treasury profit contribution

- High profits:
  - Higher fee income

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This perfect storm lifted industry profitability to unprecedented levels

Pre-tax net operating income
Commercial banking as a % of all US Corporations

Source: FDIC Historical Data, SNL
Unlike investment banking this wasn’t a leverage story

**Equity capital to total assets**

**Tangible common equity/Total assets**

Source: FDIC Historical Data
Note: Tangible common equity calculated as total capital – intangibles – perpetual preferred
The party should have ended in 2004 as rates bottomed out and the yield curve flattened and then inverted

3 Year Swap Rate – 3 Month LIBOR

Sources: Bloomberg
Instead, to compensate for lower spreads and to utilize fixed cost infrastructure, asset growth became the priority.

**US Credit Liabilities 2002-2009**

- $BN
- 0 5,000 10,000 15,000 20,000 25,000
- Q1-2002, Q4-2002, Q3-2003, Q2-2004, Q1-2005, Q4-2005, Q3-2006, Q2-2007, Q1-2008, Q4-2008

**Sub-prime and Alt A mortgage originations 2004-2007**

- % of total origination
- 0% 5% 10% 15% 20% 25% 30% 35% 40%

Sources: Fed Flow of Funds, MBA, Company reports
The end result was the current banking crisis

1 Credit losses

Heavy write-downs on structured credit portfolios

Investors and banks exposed to insolvent banks incur heavy losses

Banks can’t unwind positions

Inter-bank markets freeze

Illiquidity depresses prices and further erodes capital

2 Lack of capital

3 Lack of liquidity

Insufficient risk management

Weak regulation

- Failures of top-level risk governance
- Originate to sell model led to over-reliance on external credit ratings who became the de-facto regulators
- Short-term funding structures
- Regulatory gaps in the shadow-banking sector
- “This time is different mentality”
- Tight-coupled architecture of the financial system

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Section 2

Shaping the future
The immediate future will be dominated by further credit losses

Ultimate credit crisis writedowns
By type of institutions bearing losses

Source: Ultimate writedowns from IMF; losses to date from Bloomberg
Beyond that three sets of forces will shape the industry

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  - Trajectory of rates
  - Shape of the curve
- GDP growth
- Employment
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- Deposit competition
- Consolidation
- Lending business model
  - Secondary markets
  - Competitive intensity
## Modeling future industry returns

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Section 3

Three future scenarios
Our baseline has the industry returning to the long-run average of ~10% ROTE

Macroéconomics
- Steep curve with 10 year at 4%
- Unemployment at 8-9%
- Subdued inflation of 1-2%
- U-shaped recovery with 2-3% growth afterwards
- Savings elevated at 7-8% through deleveraging
- Credit volumes flat and deposits at GDP growth
- Defaults remain high but recoveries improve

Regulatory
- Minimum capital increased, especially for Tier I institutions
- Opt-out overdraft legislation plus other fee restrictions
- CFPA-light for high margin lending products

Competitive
- Wholesale lending volumes rise but pricing remains elevated
- Securitization returns for jumbo mortgage and card
- Increased deposit competition from branch and non-branch competitors
- Consolidation driven by failures in 2011 and 2012
- Some additional roll-up deals

Inputs
- NIM 2.9%
- NII 1.9%
- NIE 3.1%
- Provisions 0.6%
- TCE 7.1%

Outputs
- ROA 1.1%
- Efficiency ratio 65%
- Post-tax ROTE 10%
A plausible malign scenario would make US commercial banking a breakeven business . . but this would almost certainly drive industry restructuring

### Macroeconomics
- Flat curve with 10 year at 3% or lower
- Unemployment at 9%+
- Inflation at 0-1%
- Double dip recession with 1% growth afterwards
- Savings at 8-10%
- Sustained losses in CRE, C&I and prime consumer
- Credit contraction with deposit growth at GDP

### Regulatory
- Capital levels rise for all institutions
- Multiple fee income restrictions imposed
- Full CFPA implementation
- High hygiene costs for compliance

### Competitive
- Wholesale lending market tight with limited asset growth
- Limited deposit competition given sustained low rates
- Consolidation is failure driven and peaks in 2011 with 600-1,000 total failures

### Inputs
- NIM 2.6%
- NII 1.6%
- NIE 3.4%
- Provisions 0.7%
- TCE 7.5%

### Outputs
- ROA 0.1%
- Efficiency ratio 85%
- Post-tax ROTE 0.9%
A benign, but also plausible scenario, would see industry returns back at golden-era levels.

**Macroeconomics**
- Steep curve with 10 year at 5%
- Unemployment at 6-8%
- Inflation at 2-3%
- U-shaped recovery with 3% growth afterwards
- Savings at 5-7%
- Credit losses back to normal cycle
- Credit expands at GDP and deposits at GDP+

**Regulatory**
- Capital levels don’t rise from current levels
- Limited fee regulation on deposits or quick substitution of other fees
- Limited lending regulation except card and mortgage disclosures already passed

**Competitive**
- Availability of credit high with rates at pre-crisis levels
- Secondary markets except sub-prime return
- Limited competition from non-branch banks for deposits
- Some merger of equals consolidation
- Failures peak in 2010 and then drop steeply and are <500 overall
- Sustained cost control

**Inputs**
- NIM 3.1%
- NII 2.2%
- NIE 3%
- Provisions 0.5%
- TCE 6.8%

**Outputs**
- ROA 1.8%
- Efficiency ratio 57%
- Post-tax ROTE 17%
Section 4

The distribution of returns – who will outperform?
Banking has become less of a sector play over the last decade with a wider distribution of returns

Return on average equity distribution
All publicly traded commercial banks & thrifts (1997-98 vs. 2007-2008)

Source: SNL, Oliver Wyman analysis
Outperformance will result from the combination of positioning and performance

**Structural**

- Market outlook
  - Economic climate
  - Demographic trends
  - Regulatory environment

**Business model selection**
- Lines of business
- Segments
- Products
- Geographies

**Performance**

- Outperform rivals
  - Efficiency
  - Productivity
  - Incentives

**Capabilities**
- Operations
- Culture
- Analytics
- Performance management

**Positioning**

**Execution**
Geography will matter

Distribution of MSAs by MSA quality index

1. Quality index is a deposit profit per branch index that incorporates average balances, balance composition, estimated income and expense assumptions.
Segment focus will matter as well – particularly in deposits

**US consumer households**

- **Households (MM)**
  - Total: 120
  - Mass: 48
  - Below mass: 39
  - High net worth: 2
  - Small business owners: 13
  - Mass affluent: 11

**US consumer banking profit pools 2007**

- **Net income ($BN)**
  - Lending: 4.0 6.5 3.0 1.5 19
  - Deposits: 5.5 10.0 7.0 7.5 7.5 5.5

- **23% of households**
- **70% of profits**

Source: Survey of Consumer Finances, Oliver Wyman analysis
Business mix will determine the impact of regulatory and NIM changes

Non-interest income revenue contribution and mix
Largest regional banks (2007-2008)

Sources: Bank analyst reports; SEC filings; Oliver Wyman analysis
Cost control will be a hygiene factor, not a strong driver of outperformance, except in a malign scenario

Efficiency Ratio Versus ROAE (Q2 2006) R² = 0.29
Common characteristics of the future outperformers

- Advantageous positioning and business mix
  - Good markets and customer segments
  - Robust non-balance sheet fee income businesses

- Reintegrating the balance sheet at the customer level to improve risk management, asset growth and pricing

- A clearer focus on the value and management of deposits including deposit related fees

- The ability to take advantage of disruption through advantaged M&A

- Balance sheet and risk management discipline
  - Credit risk
  - Funding and liquidity management
  - Continuous stress testing of capital
The new normal for US commercial banking

- A simpler business with more regulation and more transparency
  - Balanced balance sheets
  - More customer than transaction driven

- A Beta 1 business more closely tied to the macro economy, but still above hurdle rates of return

- But also a business where the dispersion of returns will continue to increase with clearer winners and losers than in the past