OLIVER WYMAN

Financial Services

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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

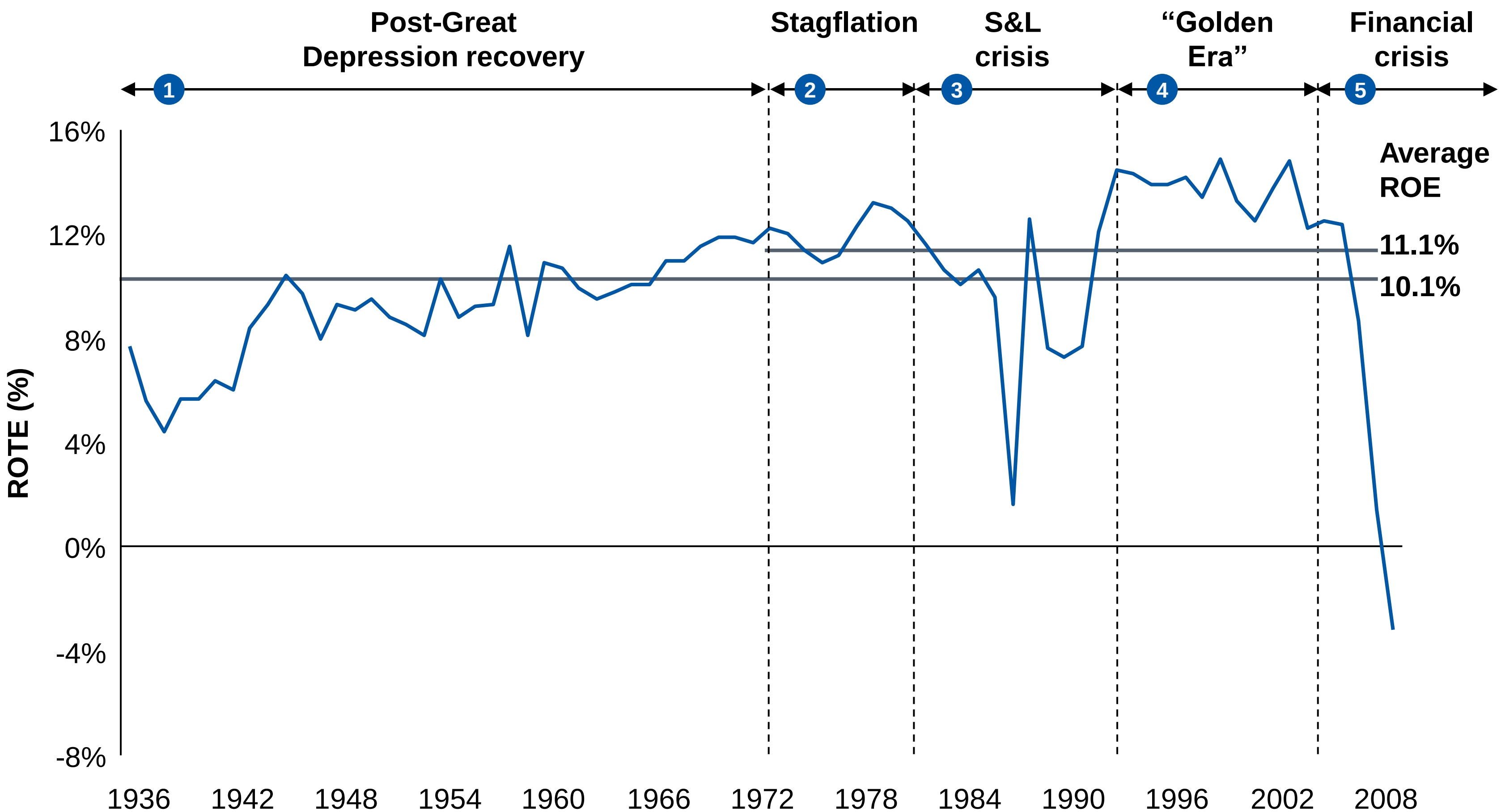
- How did we get here?
  - The long history
  - The golden decade of 1993-2003
  - The crisis
- Shaping the future of US commercial banking
  - Macroeconomics
  - Regulation
  - Competition
- Three plausible future scenarios
- The distribution of returns – what will define the outperformers?
- Discussion

Section 1

How did we get here?

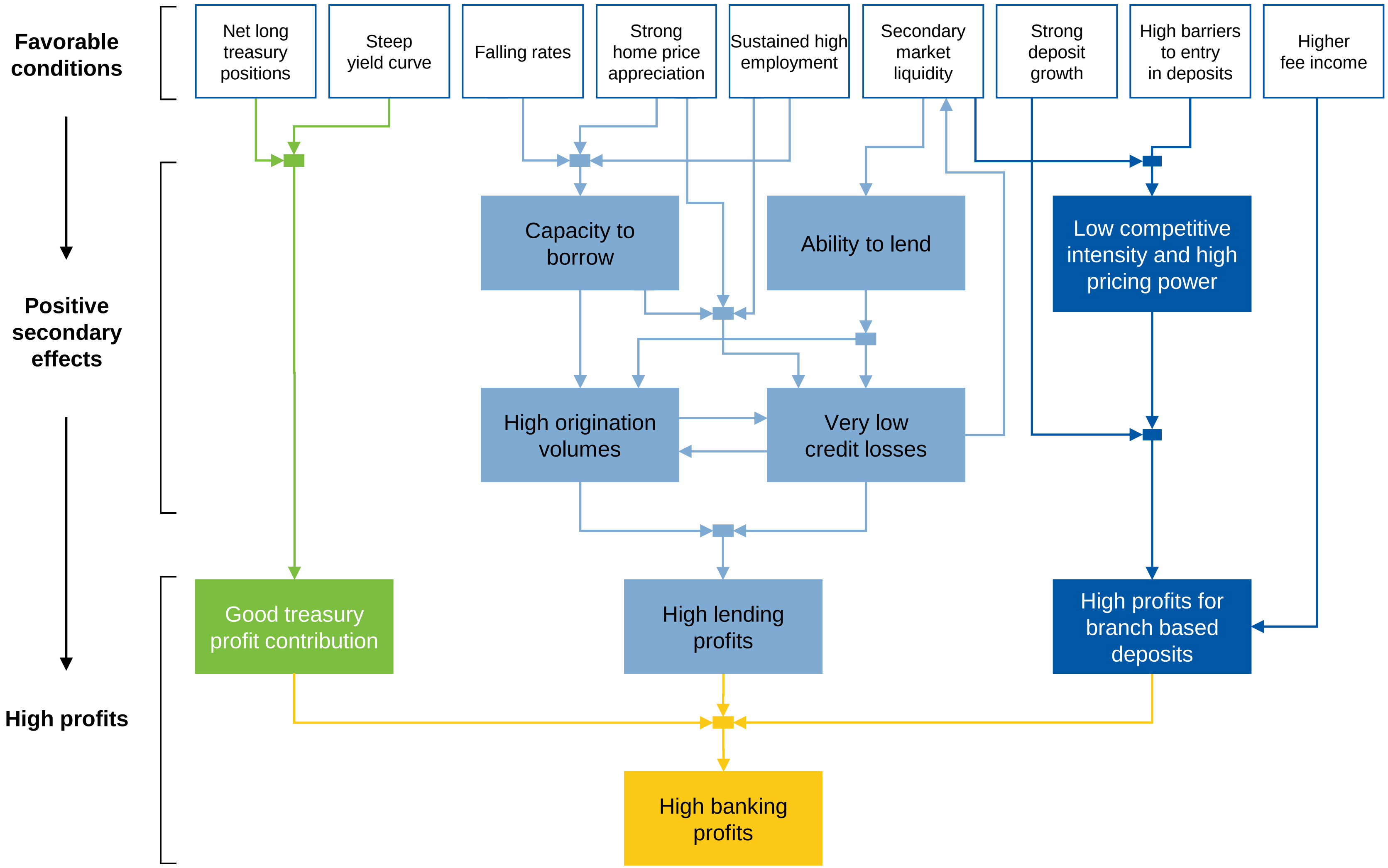
The economics of the US commercial banking industry since the Great Depression can be defined by five key eras

US Commercial Banking Post-tax ROTE



Source: FDIC Historical Data

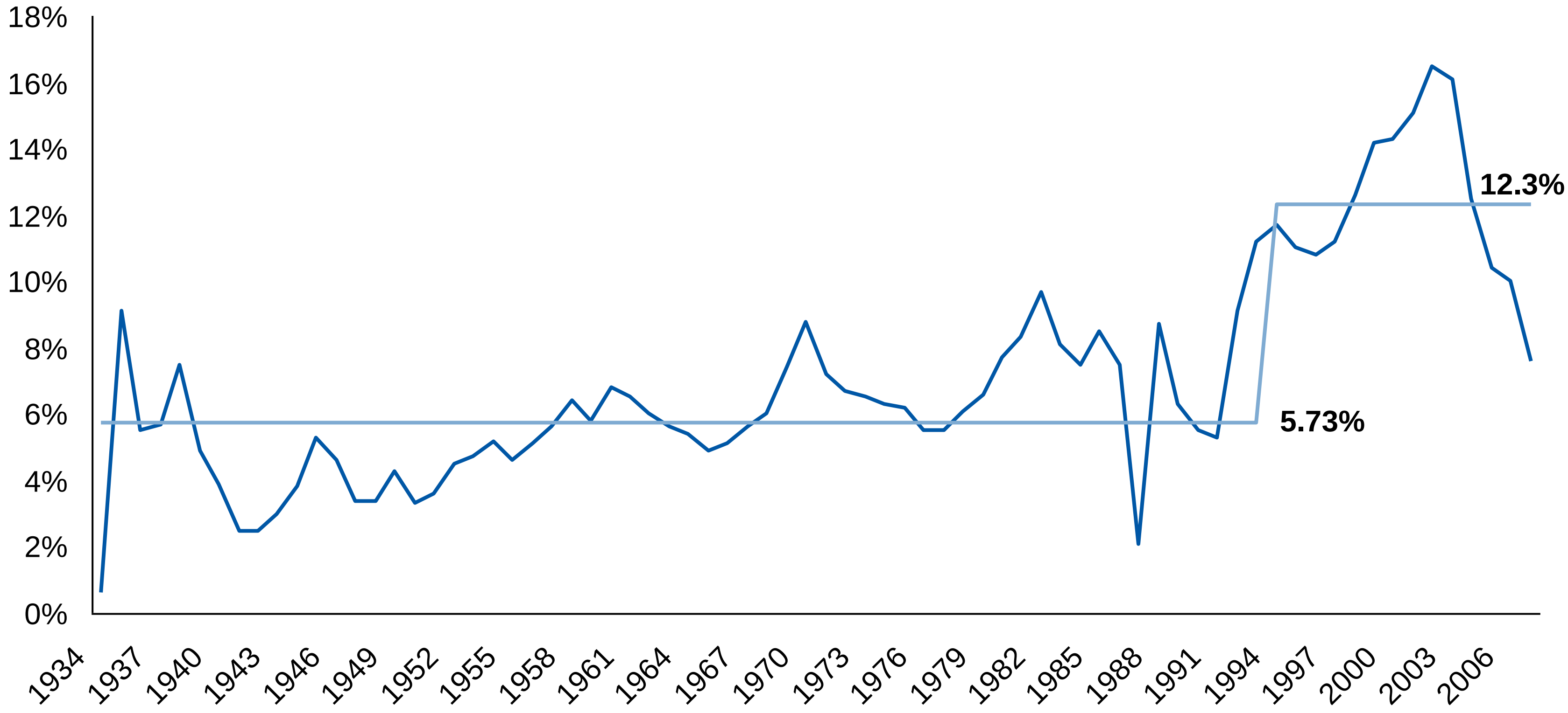
A confluence of macro factors lifted the performance of the industry during the golden era of 1993 to 2003



This perfect storm lifted industry profitability to unprecedented levels

Pre-tax net operating income

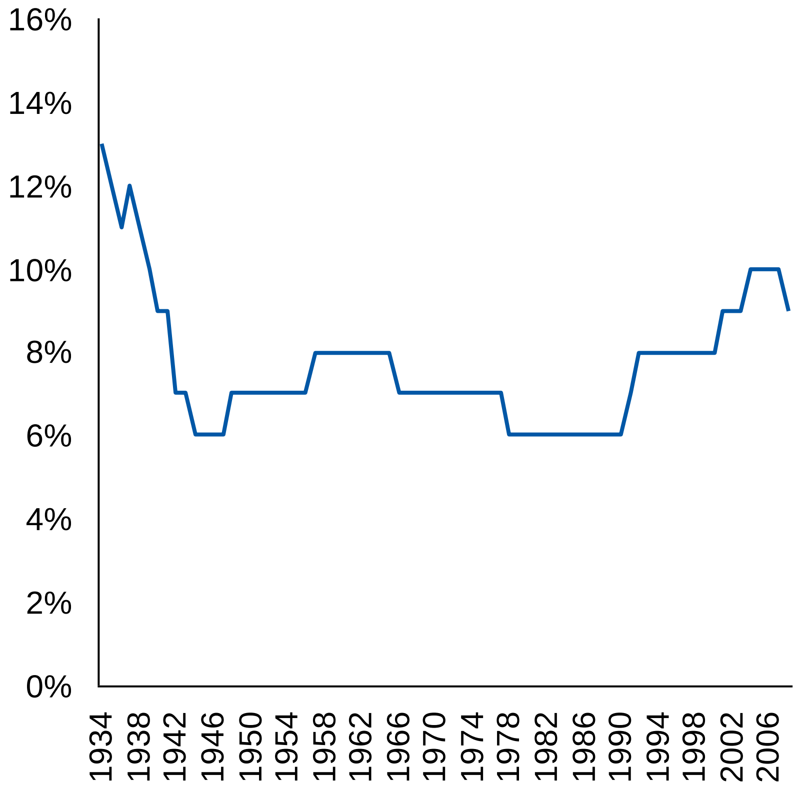
Commercial banking as a % of all US Corporations



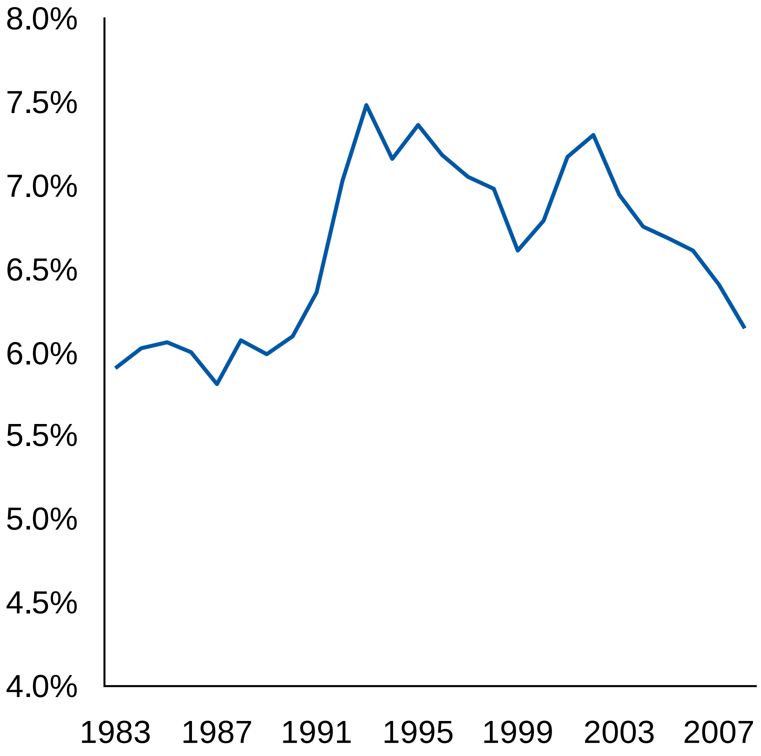
Source: FDIC Historical Data, SNL

Unlike investment banking this wasn't a leverage story

Equity capital to total assets



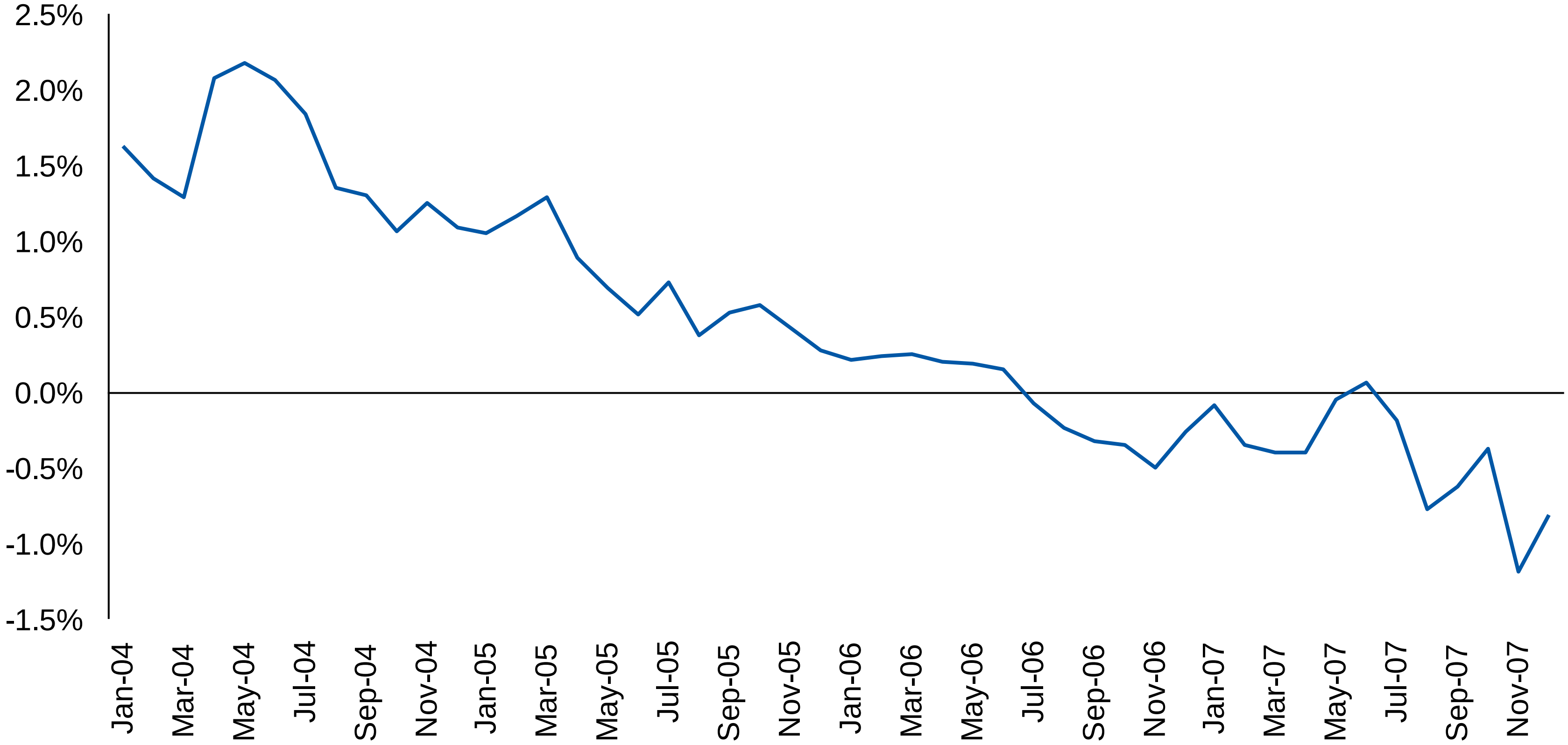
Tangible common equity/ Total assets



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

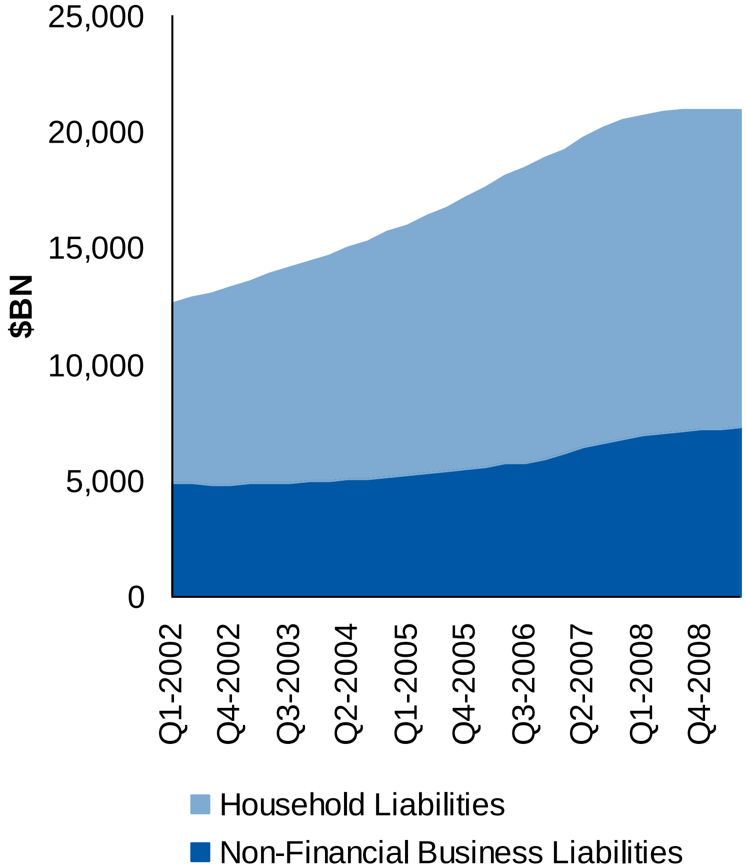
3 Year Swap Rate – 3 Month LIBOR



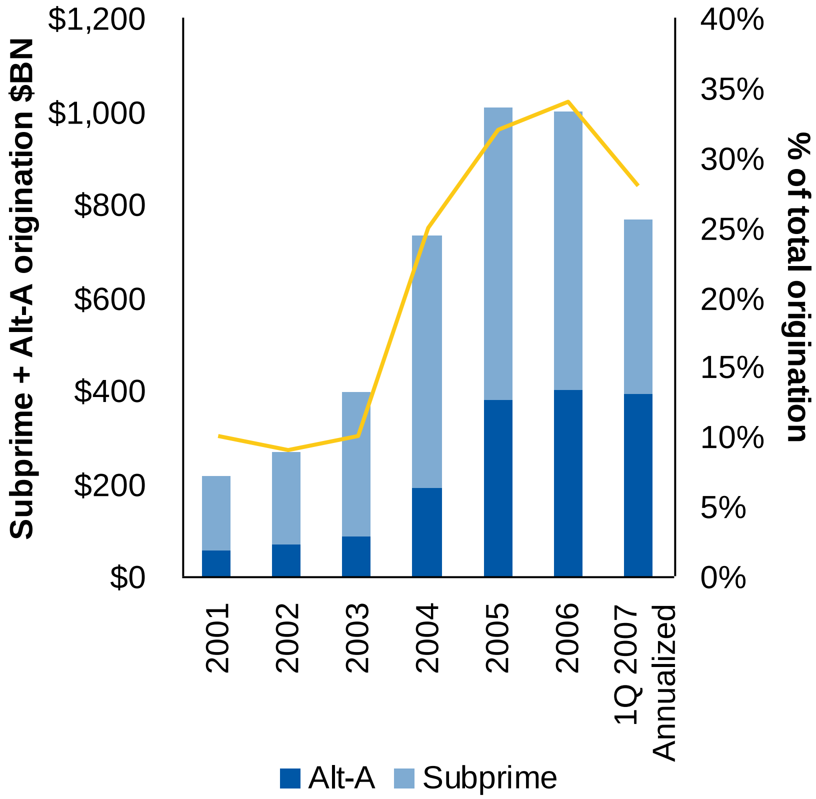
Sources: Bloomberg

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

US Credit Liabilities 2002-2009

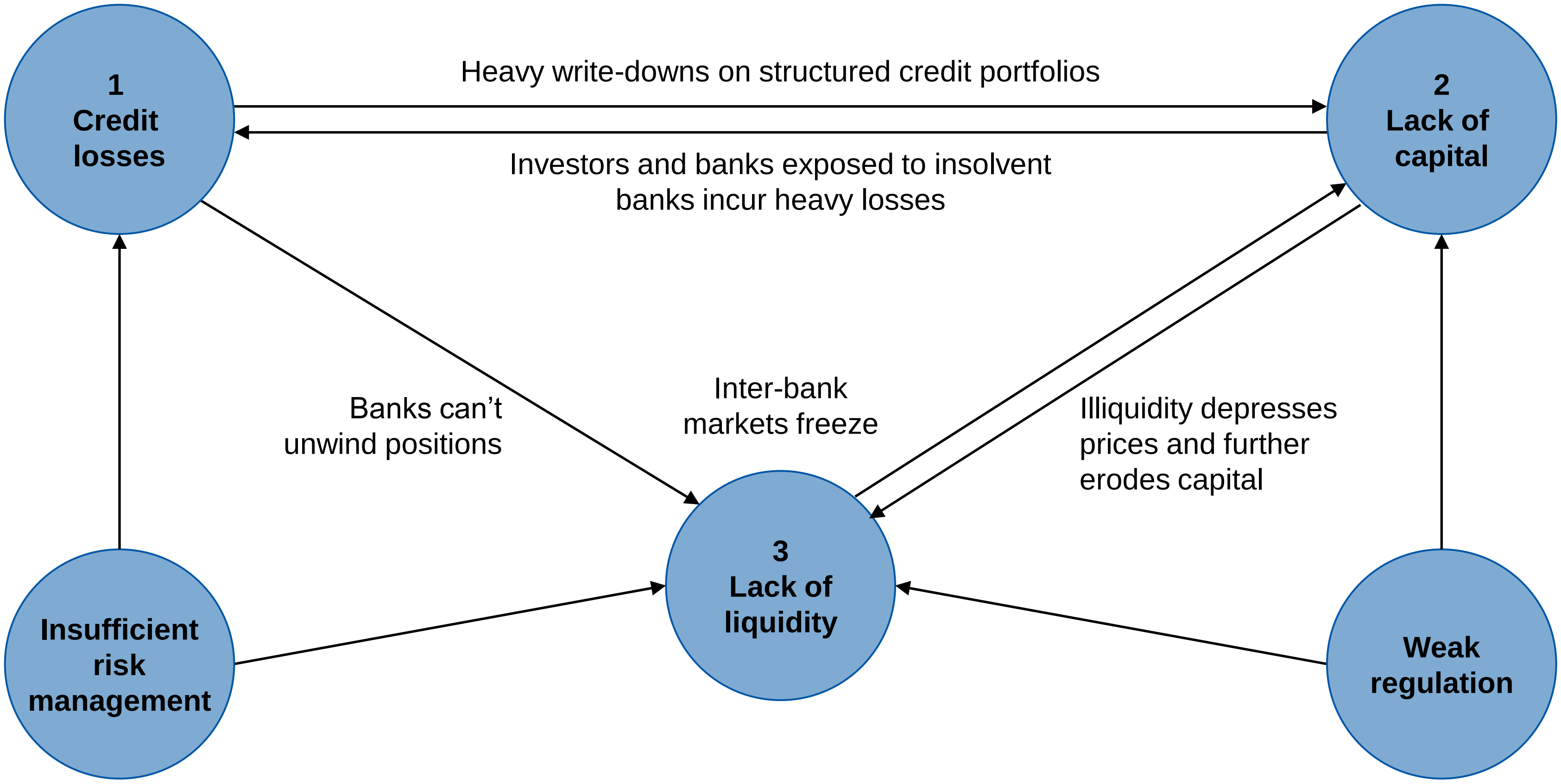


Sub-prime and Alt A mortgage originations 2004-2007



Sources: Fed Flow of Funds, MBA, Company reports

The end result was the current banking crisis



- Failures of top-level risk governance
- Originate to sell model led to over-reliance on external credit ratings who became the de-factor regulators
- Short-term funding structures

- Regulatory gaps in the shadow-banking sector
- "This time is different mentality"
- Tight-coupled architecture of the financial system

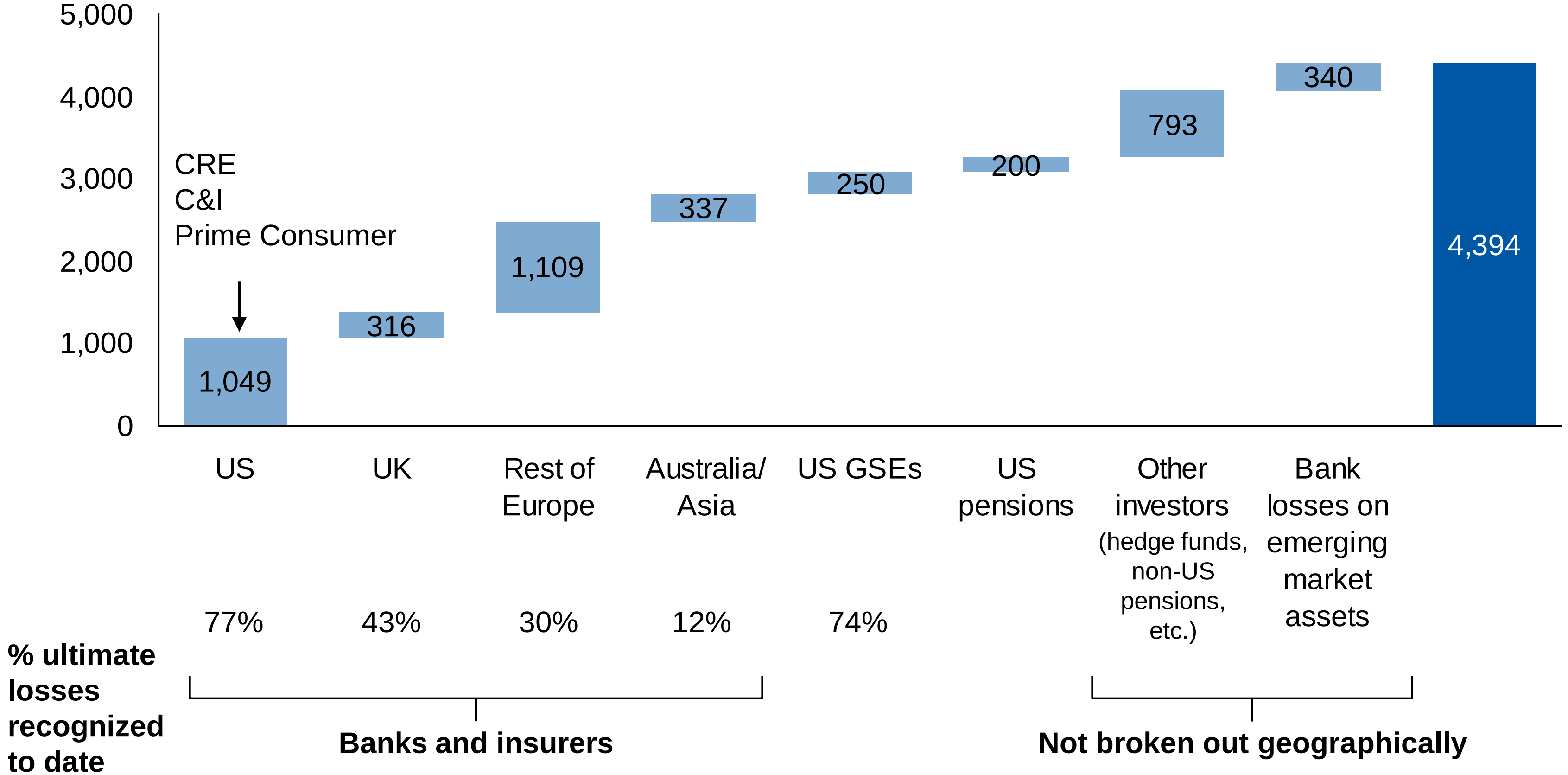
Section 2

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

Macroeconomic

- Interest rate environment
  - Trajectory of rates
  - Shape of the curve
- GDP growth
- Employment
- Home prices
- Savings rate

Regulatory

- Capital levels
  - Regulatory minimums and composition
  - Market expectations and de facto minimums
- Consumer protection- deposits
  - Overdraft changes
  - Other fee income
- Consumer protection – CPFA

Competitive

- Deposit competition
- Consolidation
- Lending business model
  - Secondary markets
  - Competitive intensity

Modeling future industry returns

Drivers	Second order effects	Input metrics (% of assets)	Output metrics
▪ Macroeconomic ▪ Regulatory ▪ Competitive	▪ Credit losses ▪ Asset growth ▪ Deposit growth ▪ Bank failures	▪ Net interest margin (NIM) ▪ Non-interest income (NII) ▪ Non-interest expense (NIE) ▪ Provisions ▪ Tangible common equity (TCE)	▪ ROA ▪ Efficiency ratio ▪ Post-tax ROTE

Section 3

Three future scenarios

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

Macroeconomics

- 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%

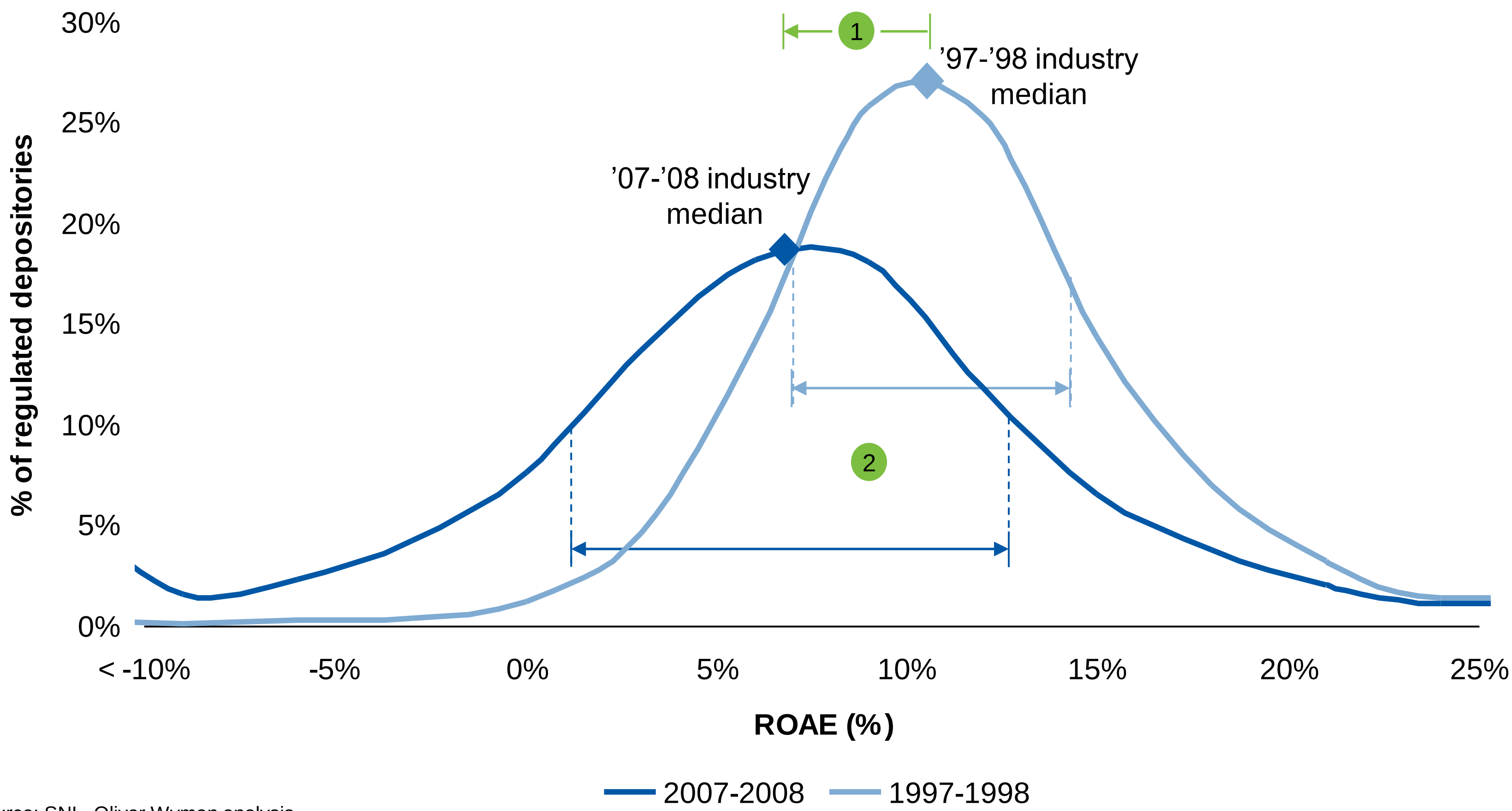
Section 4

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 ↔ **Performance**

Market outlook

- Economic climate
- Demographic trends
- Regulatory environment

Business model selection

- Lines of business
- Segments
- Products
- Geographies

Outperform rivals

- Efficiency
- Productivity
- Incentives

Capabilities

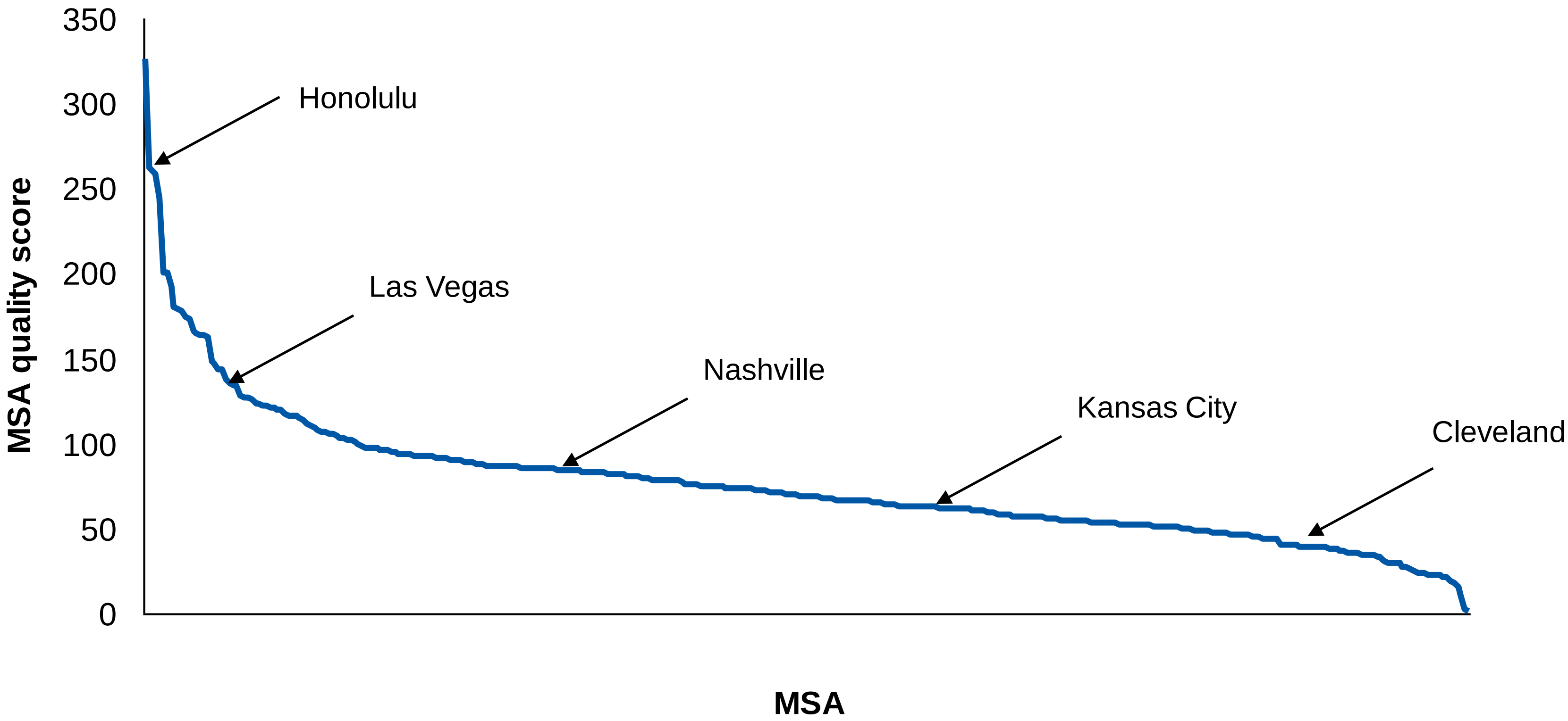
- Operations
- Culture
- Analytics
- Performance management

Positioning

Execution

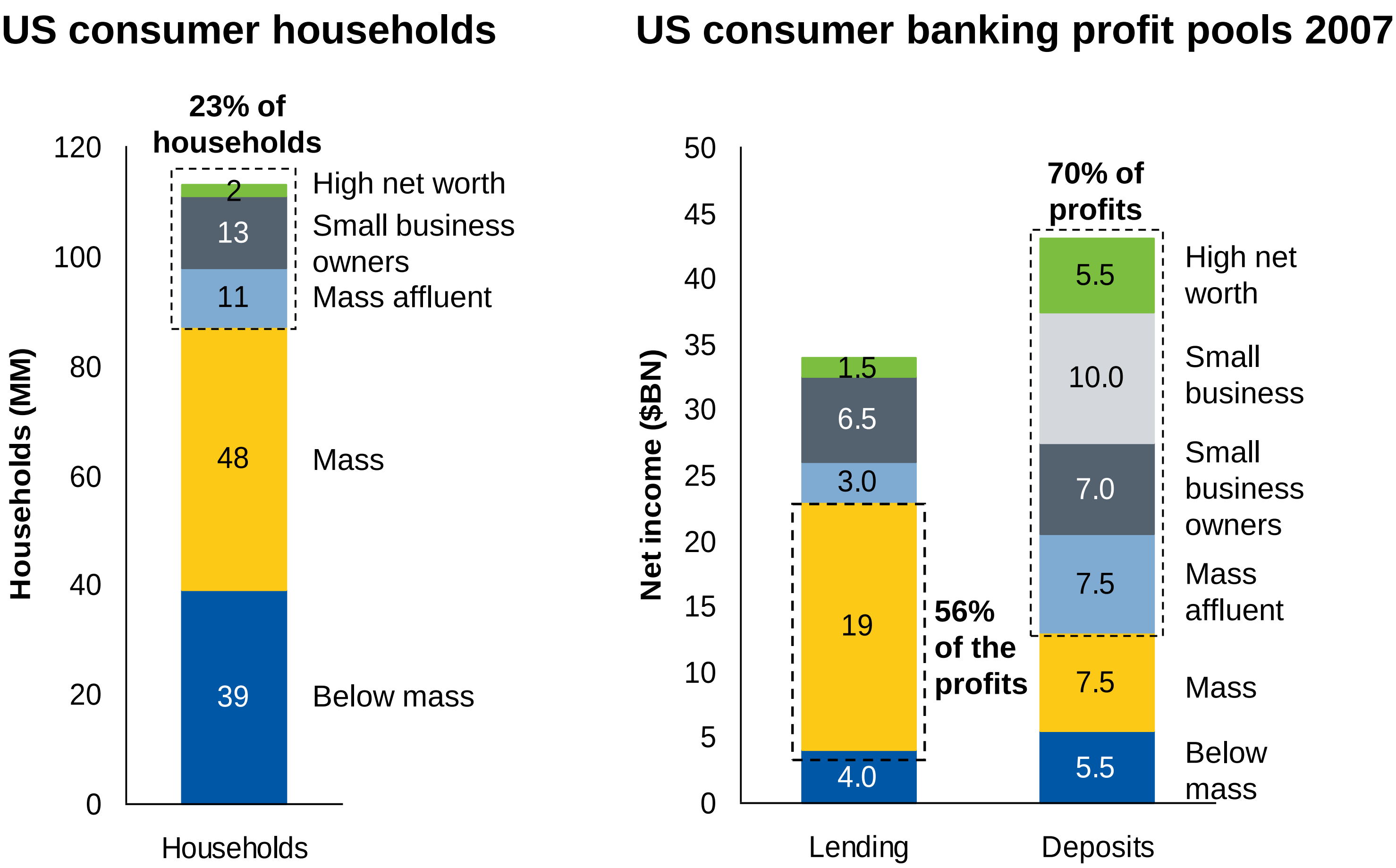
Geography will matter

Distribution of MSAs by MSA quality index[1]



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

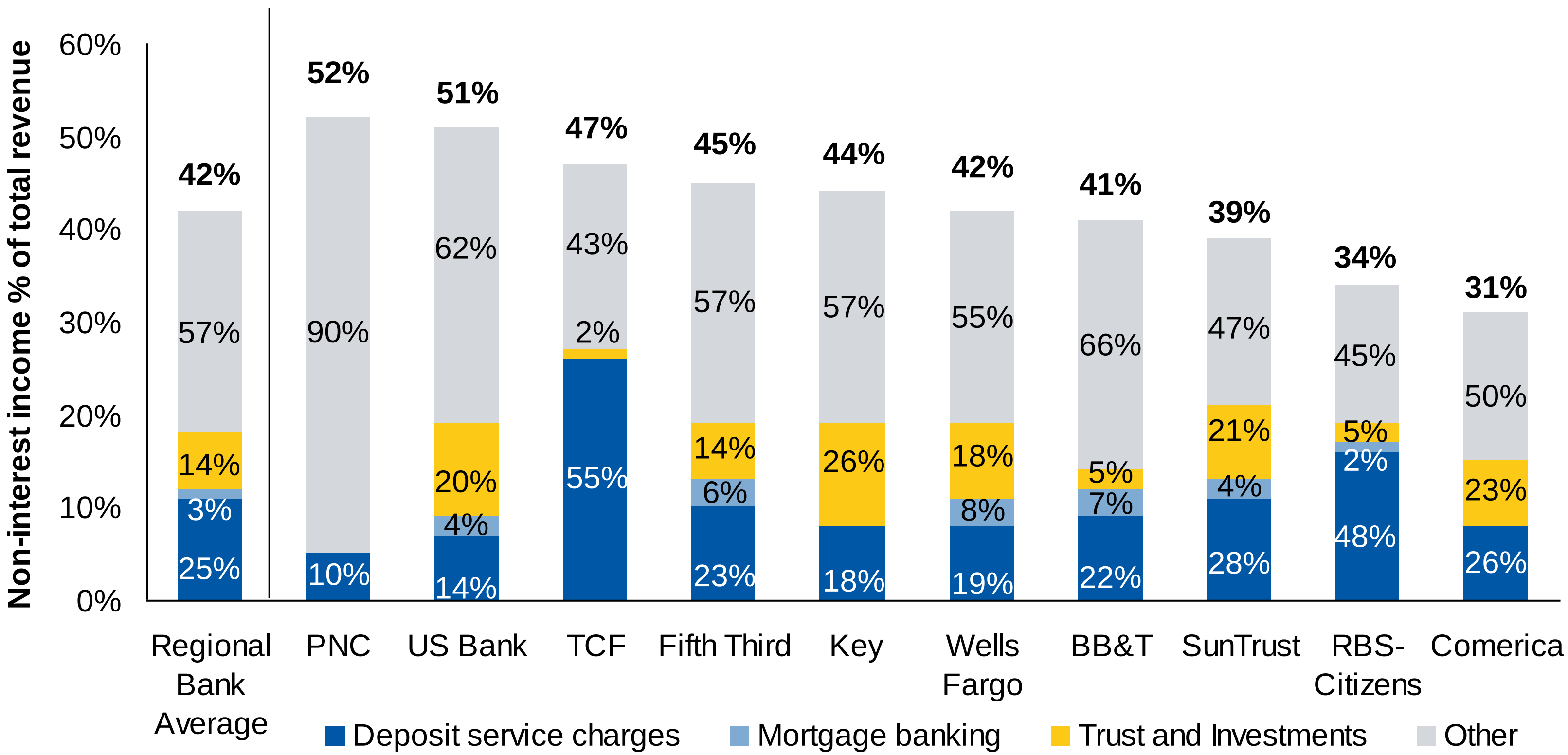


Source: Survey of Consumer Finances, Oliver Wyman analysis

Business mix will determine the impact of regulatory and NIM changes

Non-interest income revenue contribution and mix

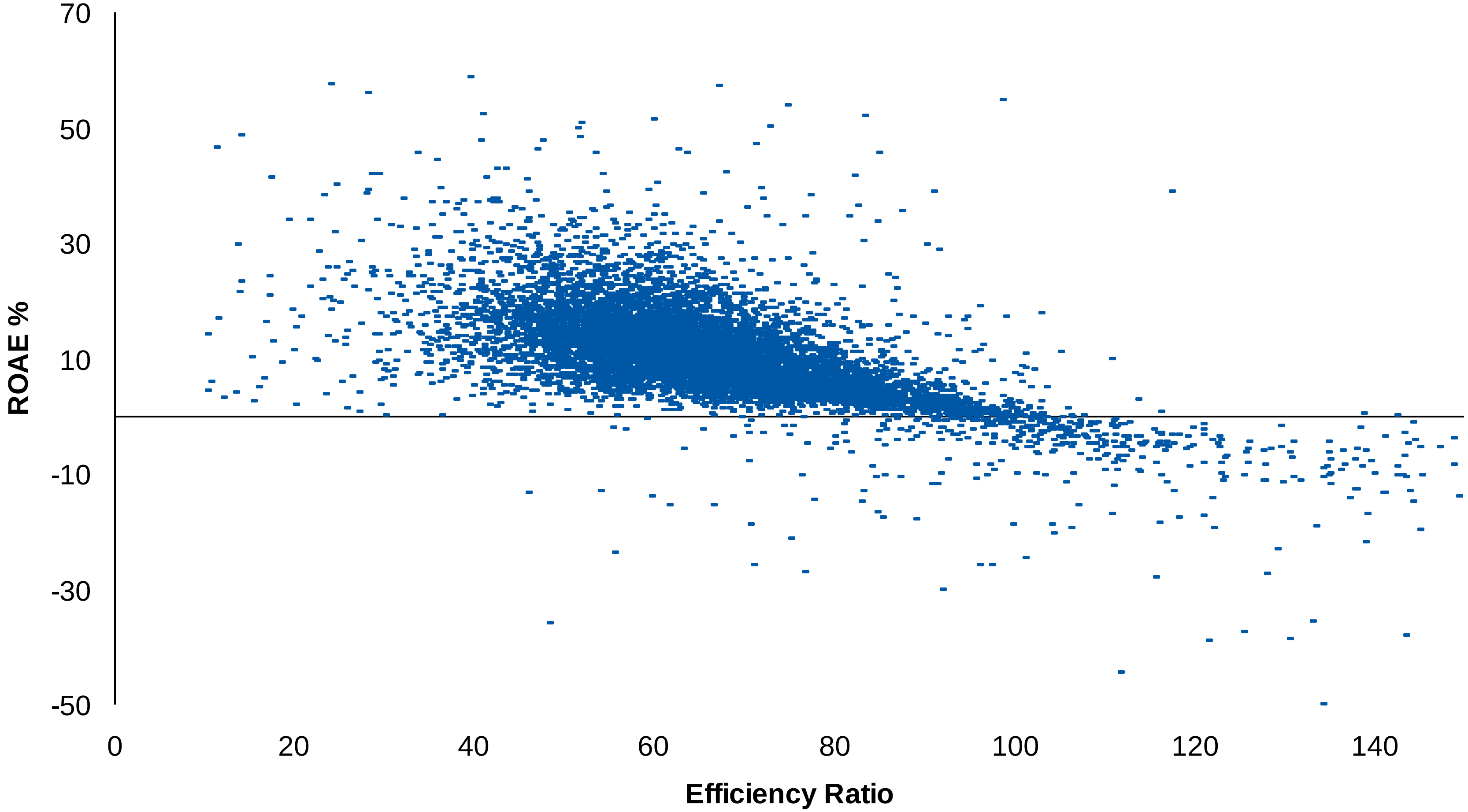
Largest regional banks (2007-2008)



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

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