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Financial Services

POINT OF VIEW

AUGUST 2011

AMERICAN BANKING

FACING THE GROWTH CHALLENGE

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MARSH & McLENNAN COMPANIES

In May, the US Federal Deposit Insurance Corporation reported that the banks under its watch made profits of $29 BN in the first quarter of 2011, up two thirds from a year earlier. Total equity capital also increased, up 5% over the year. With profits up and balance sheets healing, one might get the impression that prospects were finally improving up for American banks, setting the stage for renewed growth.

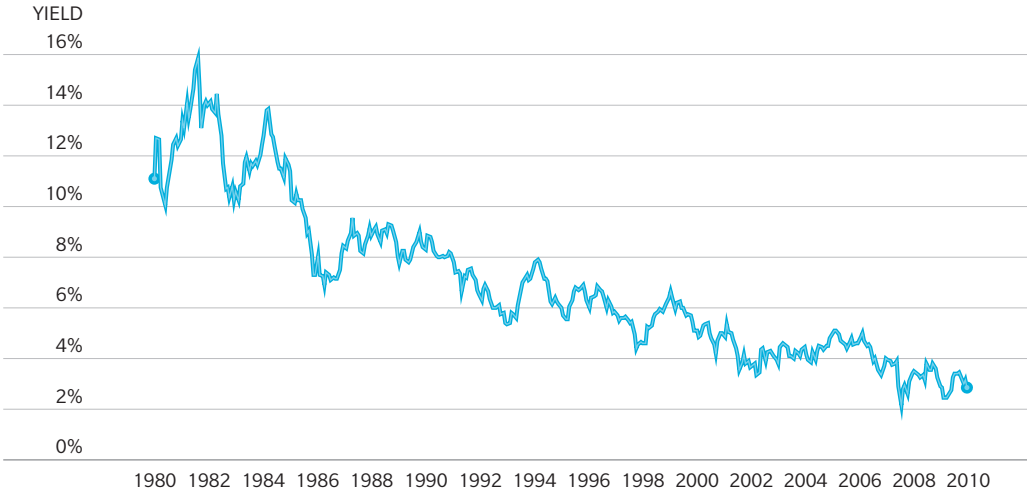
That would be a false impression. Post-crisis profits have not been the result of volume growth or increased margins. The profits are primarily the result of $21 BN of credit reserve releases. It is encouraging that banks will not actually lose as much as they thought they might at the depths of the crisis. But reserve bleeds should not be confused with strong growth prospects. Operating revenues actually fell over the past year. And bank balance sheets are not growing, despite massive monetary stimulus, the consolidation of off-balance-sheet vehicles, and the contraction of non-GSE securitization markets. Margins are tightening as well, with net interest margins also down from a year earlier.

What's constraining growth? It certainly is not lack of available funding. Deposits and wholesale funding are as cheap and plentiful as they have ever been. The problem is that there are precious few attractive lending assets where banks can put their approximately $13 TN of funding to work. And realistic projections for asset growth are not encouraging.

Today's more optimistic analysts, looking to bank recovery patterns from recent past recessions, tend to predict modest asset growth next year and strong growth thereafter. They suggest that as the real economy recovery gathers steam, bank balance sheets will return to strong growth. Stronger GDP growth would certainly increase loan demand from today's historically anemic levels. But even given a stronger recovery than we have experienced thus far, predictions of strong credit growth are Pollyannaish. Banks are facing novel supply, demand and regulatory headwinds that will constrain asset growth to well below the levels of the past thirty years.

The most obvious problem is interest rates. In the fall of 1981, the ten-year US Treasury rate was 15.8%. Over the following two decades, it fell more or less steadily bottoming out at 3.4% in 2003. After rising to 5.2% pre-crisis, it is today just under 3%. When rates fall, debt gets cheaper to carry and borrowers – consumers and businesses – can afford to use more at any given level of cash flow. From today, rates can only go up, and they certainly will if the real economy picks up. Rising rates will make credit more expensive, and suppress demand.

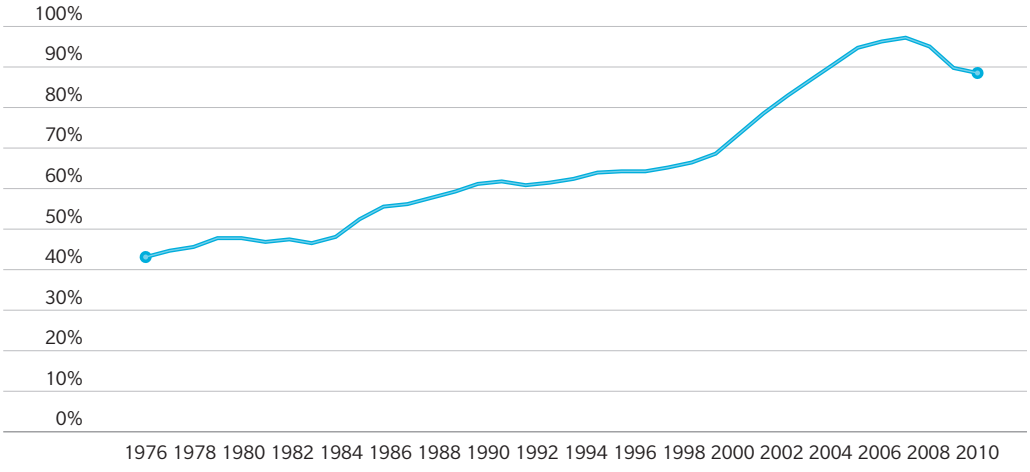
EXHIBIT 1: 10-YEAR US TREASURY BOND YIELDS



Source: US Treasury

Demand is further constrained by consumers' deleveraging from a 20-year run-up in debt, and doing so when the asset side of their balance sheets has been hammered. This process is just beginning. Also, collateral values (primarily residential and commercial real estate) are way off their peaks and unlikely to return to them soon. Then there is the aging of the US population; old people use less credit.

EXHIBIT 2: HOUSEHOLD DEBT AS % OF GDP: DELEVERAGING HAS ONLY JUST BEGUN



Source: Federal Reserve, Bureau of Economic Analysis

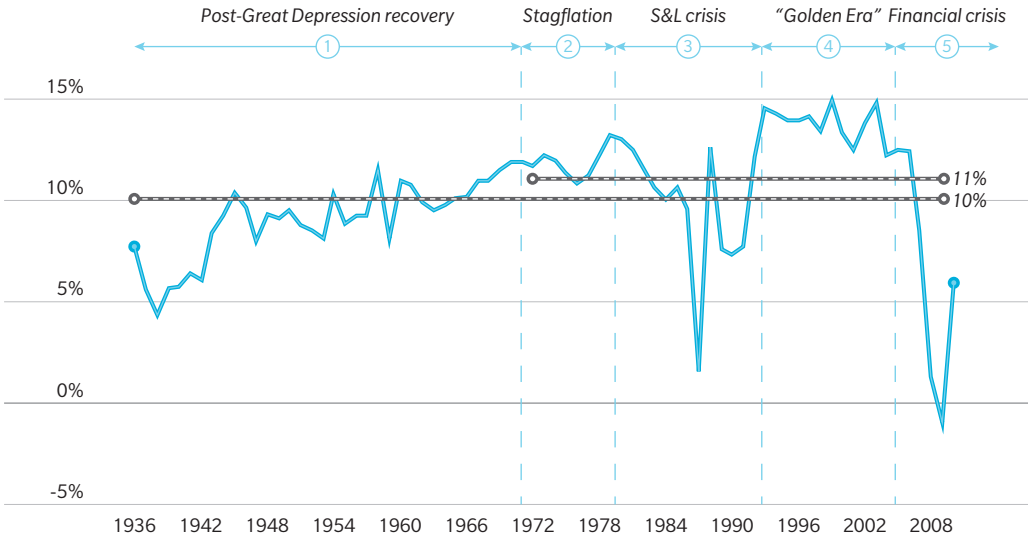
On the supply side, banks have become more cautious underwriters of credit. This is prudent. It is also contractionary. Secondary credit markets are less liquid than they were pre-crisis, and are likely to remain so for some time.

How about regulation? For 20 years or more before the crisis, the overarching trend was toward deregulation of banking, opening new opportunities for asset and revenue growth. The tightening post-crisis regulatory environment will pull the other way. Capital levels are rising, which means lower margins, higher pricing to end-borrowers, or both. And consumer protections will continue to constrict offerings to the market, especially to the "mass market" consumers that many regulations were designed to protect.

US commercial banking recovered rapidly from the recessions of the past three decades, and even from the Savings and Loan crisis. But these crises occurred in the context of long-run trends of falling rates, increasing consumer leverage, and deregulation. Those who take comfort today from these banking recoveries are being overly optimistic. This time is different.

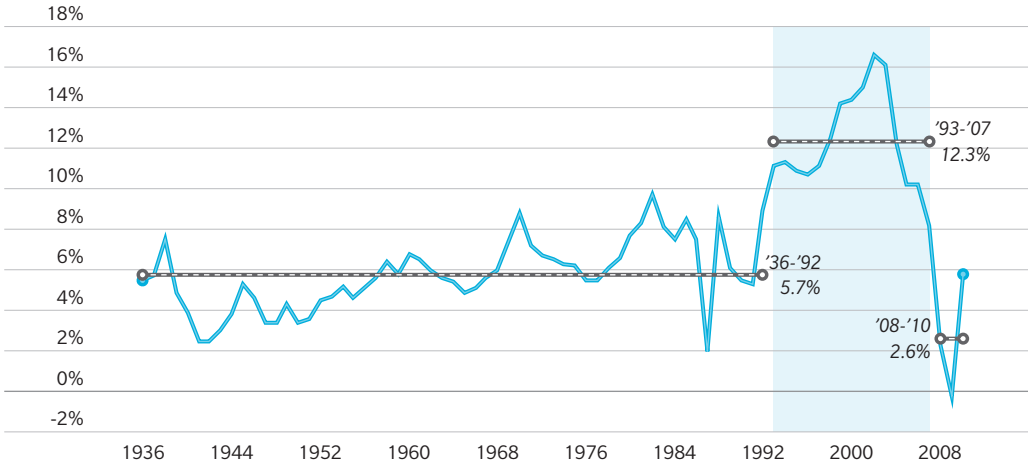
When the economy resumes at-potential growth, loan demand will pick up. But because rates will likely rise, renewed economic growth will not translate into above-GDP balance sheet growth, as it did during the 1993 to 2003 "Golden Era" for bank profits. Further, the banking industry is unlikely to achieve an average return on capital much above 10% even in a healthy economy. Though disappointing to those who came to expect the much higher returns of the boom years, this is the long-run average for US commercial banking.

EXHIBIT 3: RETURN ON EQUITY FOR COMMERCIAL BANKS: LITTLE CHANCE OF A REVERSION TO GOLDEN ERA RETURNS



Source: FDIC historical data

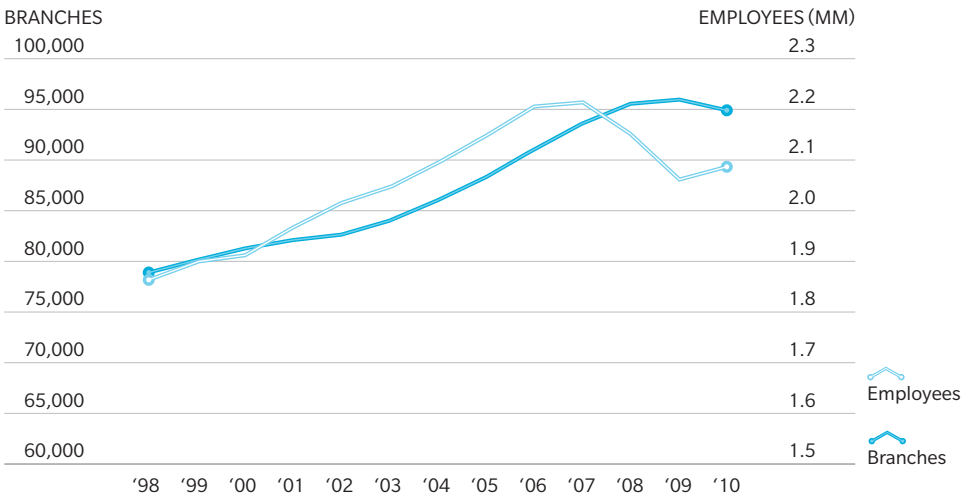
EXHIBIT 4: BANKS' SHARE OF ALL CORPORATE PRE-TAX NOI



Source: FDIC historical data, Bureau of Economic Analysis

Slow growth and lower average returns have important implications for the US banking industry. The most obvious is that distribution capacity, which expanded during the boom times to support extraordinary growth, is still too high. In Q4 2006, average US bank operating costs were 3.1% of earning assets. In Q1 2011, they were 3.5%. And this despite massive industry headcount reduction – employment is down to 2004 levels. Headcount is the easiest cost to control in the near term. But it is also the least structural. Banks have yet to make fundamental cost-structure changes to adapt to a new environment of slower growth. For example, in contrast to headcount, the number of bank branches is still near its all-time peak. If assets fail to grow rapidly over the coming years, excess capacity will become a burden that banks must reduce to avoid becoming vulnerable to acquisition by more efficient competitors. Much rationalization and consolidation is likely over the next 10 years.

EXHIBIT 5: BANK BRANCHES AND EMPLOYEES

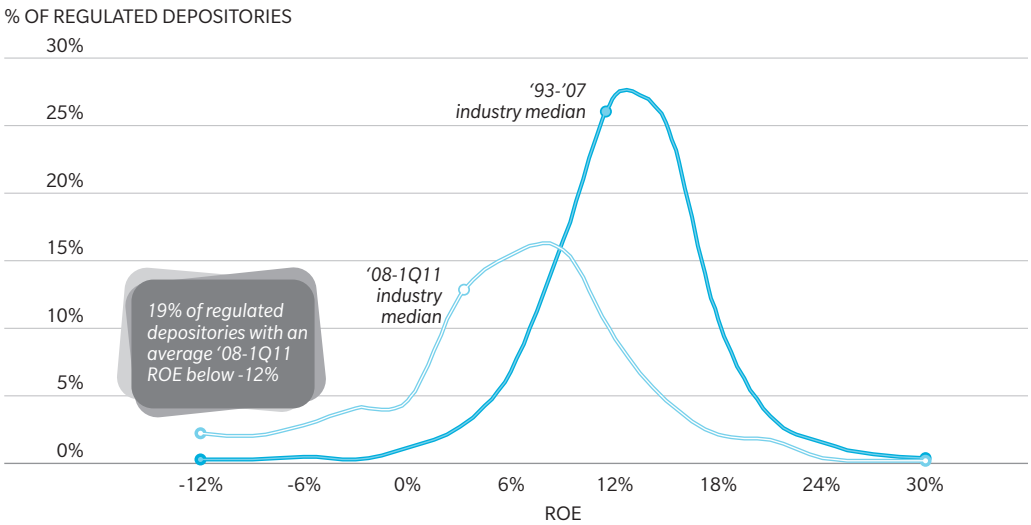


Source: FDIC historical data, SNL

To be sure, prospects are not all bleak for banks. Rising rates will reflate deposit profits, and the recent credit performance of consumer borrowers has been stellar in light of persistently high unemployment. But, from a *growth* perspective, these improvements will be a silver lining against a gray macro environment.

Even in a difficult environment, it is possible to prosper. Some parts of the country will present higher growth rates than others, some customer segments will prove more profitable, and relative winners will take share. But given the challenges, the spread between winners and losers will be much wider, whether measured by share gains, returns or valuations. It will be easier than in past recoveries to fail altogether, and many banks will – not because they have too many bad loans on their books, but because they cannot find the revenue growth required to support their capacity. Their decline will provide another opportunity to banking's winners: perhaps the most attractive part of US banking in the coming years will be M&A.

EXHIBIT 6: ROES FOR ALL COMMERCIAL BANKS: IN THE COMING ERA, WINNERS WILL CONSOLIDATE LOSERS



Source: SNL

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