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FINANCIAL SERVICES PROVIDES AN ANALYSIS OF INDUSTRY PRIORITIES AND ANTICIPATED TRENDS IN BANKING OUT VISION - 2015

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ABSTRACT

Financial Services, provides an analysis of industry priorities and anticipated trends based on interviews with our leading banking practitioners to predict what's coming in 2015. In a lot of ways, banks may liken the past six years to a turbulent ride on a small aircraft. As we move into 2015, firms may finally be at the point of boosting profitability – taking off for a less bumpy ride. That’s not to say challenges aren’t ahead, but rather a new flight plan is in store.

Key words: Financial Services, Profitability, Wealth Management, Revenue, Leverage

INTRODUCTION

A bank is a company that works with the money that the people give it. If you give your money to a bank, it not only protects it but pays you interest so that it can work with the money. This is one of the reasons why people save their money in a bank. Money may also be safer there than at home. Banks also lend money to other businesses and customers. They collect extra money called banking fees with which they pay interest to savers as well as salaries for their workers. Banks make a profit because they collect more interest than they pay to savers. Without banks the world’s economy would not be able to grow. Investors would not find the money they need for new projects. Industries could not buy new machines and modern technology.

KINDS OF BANK SERVICES

Banks provide their customers with a number of services. With a checking account you can pay your bills. A check is a slip of paper that tells the bank how much money it should withdraw from your account and pay to someone else. Today, more and more people use the internet, also a banking service, to pay their bills. Banks also give their customers plastic cards with which they can get money from their account everywhere and whenever they want. They can also use them to pay without cash at shops, gas stations and other stores. Checking accounts are a comfortable way for customers to handle their money.

LOOKING BACK IN PURSUIT OF GROWTH

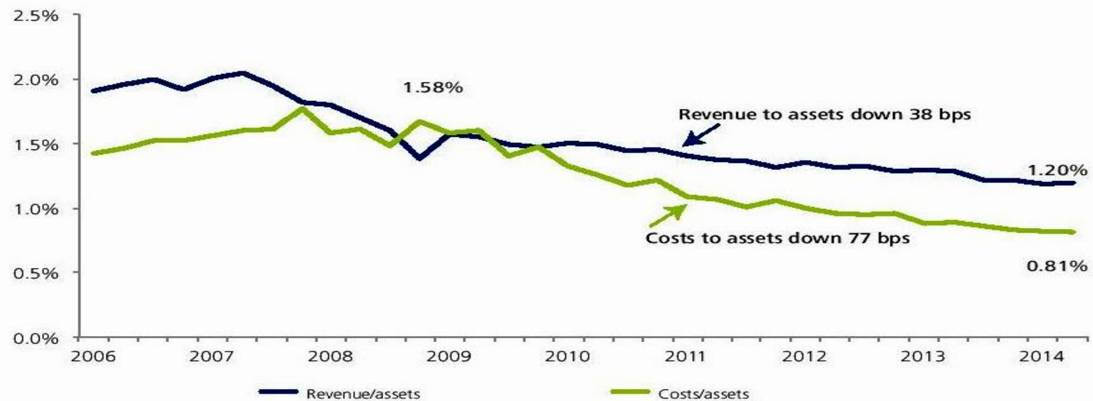
Our 2014 banking outlook — "Repositioning for growth: Agility in a re-regulated world" — emphasized how the industry would switch gears from defensive compliance remediation to a proactive search for revenue growth and further cost reduction. Looking back at 2014, most, if not all, banks pursued this repositioning. The industry sought to better acclimate to regulatory pressure by investing in compliance infrastructure and enhancing risk governance. As expected, some banks sought to settle outstanding mortgage-related lawsuits; however, the severity of the fines was greater than anticipated.

As top line revenue growth remained modest, banks focused on operational efficiencies as a way to drive financial performance. Banks continued to simplify operations, seek scale efficiencies, and rationalize their branch networks. For instance, the industry closed 1,614 branches over the 12 months ending in June 2014, the largest decline in more than two decades.1 In spite of higher litigation expenses and technology investments in 2014, the banking industry made meaningful advances: costs as a percentage of assets have fallen 49 percent in the second quarter of 2014 from the first quarter of 2009 (Figure 1).

Meanwhile, banks' repositioning efforts resulted in the most active period of mergers and acquisitions (M&A) since 2008, with a total of 184 whole bank and branch deals in the first half of the year.2 as we expected, large banks' efforts to specialize, regional banks' pursuit of asset generators, and community banks' consolidation were primary contributors to M&A.

Competition intensified in certain pockets, particularly in commercial and industrial (C&I) and commercial real estate lending, leading some banks to ease underwriting standards to remain competitive. Fee-based businesses such as wealth management were popular, sparking increased competition for these offerings.

Banks, especially some larger institutions, expanded their use of analytics for deeper customer insights. Investments in mobile offerings continued to receive top priority, but upgrades to core systems were not as widespread a phenomenon as expected. Meanwhile, creating a fully differentiated customer experience remains an ongoing journey for most institutions.



LOOKING BACK AT 2014

Early results of these strategic priorities were evident in industry performance. In the second quarter of 2014, loan balances grew at their fastest pace since 2007, while net income and asset quality improved from the previous year. Over the course of 2014, the banking industry made meaningful advances in repositioning for revenue growth amidst compliance and efficiency challenges. These initiatives should lead to better results as the economy improves in 2015.

LOOKING FORWARD BOOSTING PROFITABILITY

The U.S. banking industry is entering a new phase in its post-crisis journey, with a much sharper focus on boosting profitability. Although profits have surpassed historic records, return on equity (ROE) is still below pre-crisis levels (Figure 3) and has yet to reach double digits. This level of consistent growth is likely to be a multiyear process, but 2015 could be a turning point in achieving this goal, in spite of the new challenges banks will face. As the U.S. economy gets stronger, with real GDP growth expected to increase from 1.9 percent in 2014 to 2.3 percent in 2015, 4 this will likely drive greater loan originations, particularly in C&I lending. Extending retail mobile solutions to business customers may help banks differentiate their offerings. Competition from nontraditional players will increase as they seek growth of their own. Fee-based businesses, such as wealth management, will be used to support revenue growth. However, lending growth alone won't boost profitability. Improved balance sheet management will be necessary, and yet become more complex in 2015. Further, new leverage standards may create additional capital burdens for some assets. These forces, together with increased lending competition, could put additional pressure on margins in 2015, despite rising interest rates.

Efforts to improve profitability will increase M&A activity in 2015. Both deal volume and deal size may increase as regional banks become more active.

SEVEN FOCUS AREAS FOR 2015

1. Aiming for greater balance sheet efficiencies

Banks' balance sheets today are a far cry from what they looked like during the financial crisis. Capital levels are the strongest in recent history, risky assets have been minimized, and most banks are flush with deposits. As a result, net interest margins (NIM) have narrowed and yield on earning assets has declined.

New regulatory requirements such as the liquidity coverage ratio (LCR) and the supplementary leverage ratio (SLR) were finalized in 2014 and will soon force banks to make changes to their balance sheets. The rising interest rate environment is another scenario banks have begun to address by managing deposit outflows and reclassifying some securities in their portfolio from available-for-sale (AFS) to held-to-maturity.

Focus for 2015

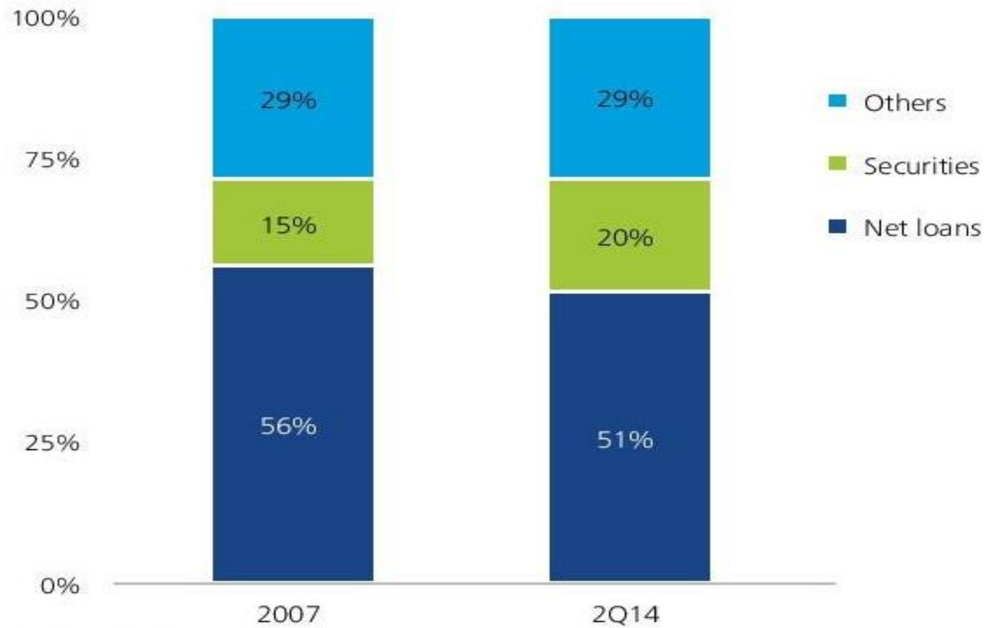
Despite an improving economy, new liquidity and capital constraints will create major headwinds for profitability in 2015, making balance sheet optimization a top priority.

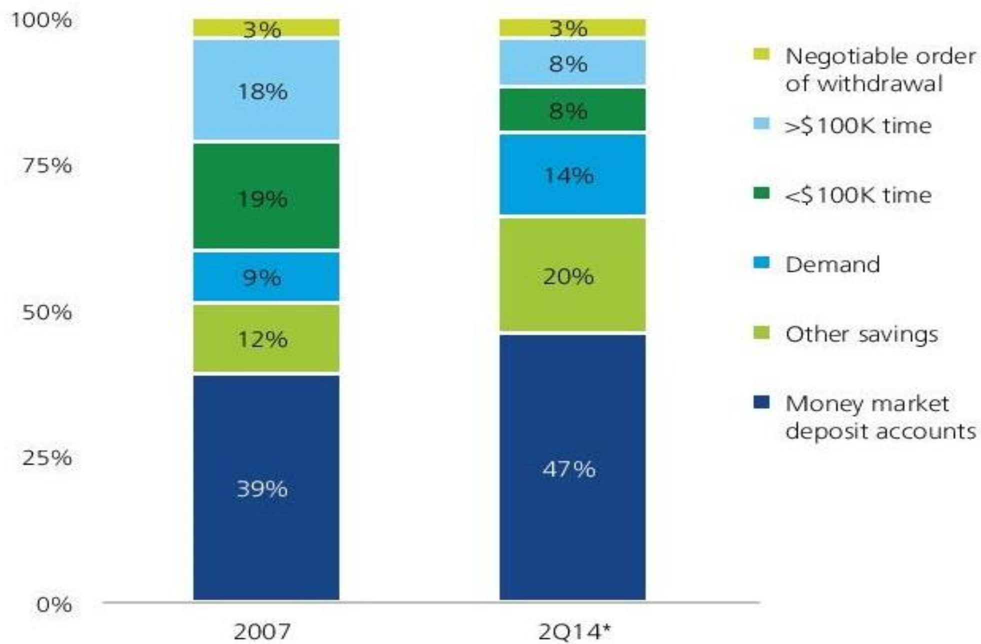
This is particularly so for the largest banks, which have to comply with the LCR rule in 2015. These institutions will have to hold enough liquid assets to weather 30 days of serious market stress. As a result, their balance sheets will be burdened with more low-yielding assets. This pressure and low loan originations have already resulted in a greater share of securities on banks' balance sheets, as shown in Figure 5.

To minimize the pressure on NIM, firms will look to control funding costs by replacing wholesale funds with retail deposits. Yet, as interest rates rise, we could see a reversal in recent trends with deposits flowing into higher interest accounts (Figure 6). This pattern may in turn lead to higher interest expenses. These conflicting pressures in combination with the potential for lower asset yields may compress margins despite rising interest rates. To prepare for rising rates, banks will continue to reconfigure their securities portfolios by reclassifying some assets from AFS to HTM to avoid unrealized losses hitting capital. This effort to protect capital locks in yields on long-term securities which could reduce interest margins as rates rise.

The optimal asset mix will be further influenced by multiple proposals under consideration, including the Net Stable Funding Ratio — a new longer-term funding standard — and additional capital surcharges for larger banks involved in capital markets businesses. The convergence of these many factors may spark fierce competition for liquid assets funded by retail deposits, and

restrain NIM despite rising rates.





2. Regulatory pressures and growth prospects to drive M&A

Bank M&A accelerated in the first half of 2014 (1H14), with 133 bank and 51 branch deals, up 34 percent and 104 percent from the previous year, respectively. The most active half-year period for bank M&A since the financial crisis was driven by bottom-up consolidation among community banks and branch divestitures by large institutions.

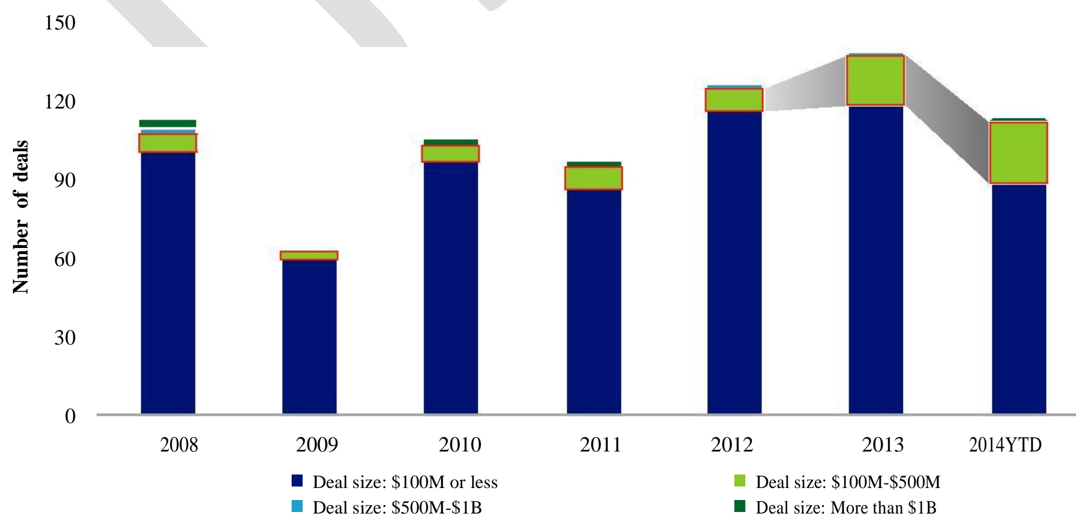
Buyers are becoming more confident about M&A, as shown by the proportion of deals between $100 to $500 million deal size that rose to 20 percent in 1H14, more than double the 9 percent in 1H13 (Figure 7). Moreover, the increased interest by some regionals is an encouraging trend.

Focus for 2015

The encouraging M&A activity seen in 2014 is likely to continue through 2015, driven by a number of factors: stronger balance sheets, the pursuit of stable deposit franchises, improving loan originations, revenue growth challenges, and limits to cost efficiencies. Pressure to improve living wills may drive further simplification at large banks. Super regionals — banks between $100 and $500 billion in assets — may remain largely restrained from fear of regulatory scrutiny. However, some may seek acquisition opportunities in smaller strategic deals. In contrast, small- and midsized regionals could show increased appetite for asset generators to buttress their core competencies or fill gaps in their portfolios. Banks with assets nearing regulatory thresholds ($10 billion and $50 billion) may also consider bigger deals, like a merger of equals, to justify the rising operational and compliance costs.

Figure 7: Composition of whole bank deals

Deal size continues to trend up in whole bank M&A, especially in deals between $100-500 million



Source: SNL Financial and Deloitte Center for Financial Services analysis

*SNL database (last accessed on October 1, 2014); excludes private equity deals deposits that banks could gain with a string of smaller-to-midsized whole bank or branch deals (Figure 8)

3. Seeking growth amidst increasing competition

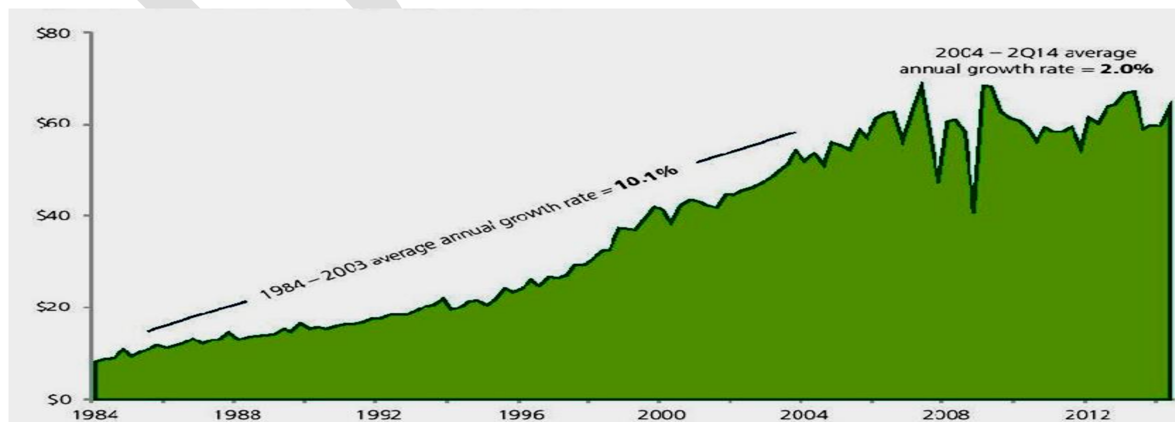
Producing revenue and asset growth has been a major challenge for banks in recent years. Low loan demand, especially for mortgages, has depressed originations. Competition for fee-based businesses like wealth management has been fierce, and regulations have limited service fees. Multifamily real estate and auto loans have both increased 30 percent from 2011. Yet, strong competition may have weakened underwriting standards.

Altogether these forces have put significant pressure on performance: NIM has fallen to 3.15 percent, the lowest level in 25 years and interest income has remained flat. Moreover, the growth of noninterest income has slowed from the historic average of 10.1 percent to 2.0 percent over 2004 to 2Q 2014 (Figure 9).

Focus for 2015

C&I lending is expected to remain a primary driver of growth as the economy improves. To be successful, banks should extend digital initiatives from consumers to business customers by adding mobile cash management tools and predictive analytics that anticipate and manage customers' short-term credit needs. Transaction banking businesses will develop a more disciplined approach to pricing and customer value while balancing rising compliance pressures for monitoring money laundering. Nontraditional players may offer a new source of competition in 2015. Lastly, given limited growth in other areas, banks of all stripes will target new offerings for the underbanked, especially given regulators' focus on this sector.

Figure 9: Noninterest income ($M) growth slows



Source: FDIC data for all insured institute

4. Banks' shrinking role in the evolution of payments

Historically, payments have been centralized within the financial services industry, driving a significant portion of annual bank revenue. Yet, many factors in 2014 set the stage for broaching change in both payments and banks' role within the sector. Banks and merchants are preparing to retire traditional cards and adopt the EMV standard of chip and PIN cards, already commonplace in many other countries. Eighty-six percent of financial institutions say they plan to begin issuing the new cards in the next two years.

Focus for 2015

Seeds of change were planted in 2014 that will likely replace banks' near exclusive grip on payments with a new shared-ownership model involving the industry and technology firms. Despite these challenges, contactless payments usher in a new generation of security with biometrics and tokenization — the use of a unique code or "token" to initiate a transaction instead of the card number. Merchants will likely be conflicted between more expensive terminals that offer both contact and contactless EMV payments, and, perhaps driven by anticipated future adoption of NFC-based mobile payments, leapfrogging contact EMV in preference for less expensive contactless-only terminals. Consumers interest in contactless payments, combined with its superior security and lower card-management costs for merchants, could slow the adoption of EMV, and may eventually replace EMV in the United States. The adoption of distributed networks, such as Ripple, may help the industry realize faster processing, as well as greater efficiencies for global payments and correspondent banking.

5. Strengthening compliance and risk management

In 2014, the industry focused on acclimating to regulatory pressure. Banks sought to improve internal controls, bolster their compliance staff, and resolve outstanding legal and regulatory issues. Regulators pressured banks to improve their risk governance. The Office of the Comptroller of the Currency issued its heightened expectations for large banks, and the Federal Reserve finalized its enhanced prudential supervision standards.

Focus for 2015

New regulatory actions — including the heightened risk governance expectations and the enhanced prudential supervision rule — require improvements in firms' risk capabilities and culture. Recognizing that significant risk-based decisions are made throughout the organization

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on a daily basis, weaving risk-intelligent behavior into the fabric of the bank's culture will become the new benchmark of a mature governance program. Risk and compliance functions must balance budget pressures when pursuing these efforts. Seeking cost efficiencies wherever possible will help realize goals to enhance the risk and compliance culture to complement the business strategy.

6. Data and analytics:

Banking regulators have recently stepped up their pressure on banks to address shortfalls in data management. This fact is reflected in the most recent survey by the Risk Management Association and Automated Financial Systems, Inc. on data quality: only 40 percent of the 37 global financial institutions surveyed felt the quality of their data was above average or excellent. CDOs, responsible for managing data and analytics within the institution, have become a key interface between technology, operations, and the business functions.

Focus for 2015

We expect the banking industry to pursue further data transformation with greater gusto in 2015. One main focus area will be strengthening data-enabled capabilities across front-line operations, business units, and functions, including finance, compliance, and risk.

The role of the CDO must also evolve beyond immediate priorities such as data governance and data quality. For instance, seeking value creation through collaboration with the business lines and functional groups will increasingly become the hallmarks of success.

There will be a strong move toward a federated data management structure. CDOs embedded in the lines of business will seek to support the business agenda while also ensuring that data governance and quality standards are met. Following these, banks will begin to solidify the integration of data management programs with information security programs, with strong linkages between the CDO and the chief information security officer (CISO) function.

7. Cybersecurity:

Cybersecurity has rapidly risen to the top of the risk agenda at institutions of all sizes.[27] 2014 witnessed an acceleration in the number and severity of cyberattacks, and there is every reason to believe these threats will only become more pervasive, sophisticated, and disruptive going forward. Banks' integral role in the payment ecosystem leaves them entangled in the often messy aftermath of security breaches, experiencing both economic and reputational loss even in

instances where they are not direct targets of cyberattacks.

Focus for 2015

To improve cybersecurity efforts in 2015, banks will likely add new defensive and offensive measures to their toolkits, borrowing from military and government agencies — given their vast experience in defense and intelligence. The Cybersecurity Information Sharing Act of 2014, if and when it becomes law, will further boost these actions. Recruiting and retaining both technical and managerial talent will continue to be a high priority. Fierce competition for specialized talent, especially with military and government backgrounds, will increase banks' compensation costs in this area. Smaller banks may be at a disadvantage given the extent of resources and specialized skills required to shore up their cybersecurity capabilities. For instance, given their scale, they already face lower cyber fraud reimbursement rates than those of larger institutions (Figure 10).

Figure 10: Reimbursement rates for breaches between 2009 and 2014
Smaller banks faced lower reimbursement rate for previous breaches

Source: American Bankers Association's Target Breach Impact Survey, July 2014

CONCLUSION

As we contemplate the future of the banking industry, the temptation to merely focus on the immediate concerns is only natural. After all, the post-crisis experience, unlike any other period in recent history, has conditioned us to be myopic. But we might soon be reaching the endpoint of this chapter in the industry's evolution, forcing us to take a longer-term view. With

remediation hopefully behind them, banks can intensify their focus on improving the economic fundamentals of their businesses. As highlighted in this report, banks, in making 2015 the year of boosting profitability, face a number of opportunities and challenges.

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