ECONOMIC UPHEAVAL AND ITS IMPACT ON U.S. BANKS—CONSIDERATIONS FOR THEIR FUTURE SUCCESS OR FAILURE?

by

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Abstract

The purpose of this paper is to discuss whether or not U.S. Banks will have to consolidate to survive and succeed in the 21st Century. In the past decade, the financial services industry has experienced one of three periods of great turmoil since the Great Depression. This upheaval has led to dramatic shifts in the competitive and regulatory environments in which financial service providers operate. The result of these changes is that many more small and mid-sized banks will find it necessary, or even attractive, to merge with competitors, either voluntarily or involuntarily, during the course of the next decade.

Introduction

In the past five years, financial service providers in the United States have had to weather some of the worst economic conditions experienced since the Great Depression. This is mostly due to the collapse of the speculative real estate bubble. Across America, banks that have gorged on real estate loans for years now face the prospect of taking possession of the assets left behind by bankrupt individuals and real estate companies. The sobering reality of attempting to sell these assets, often at fire sale prices compared to just a few years prior, has had a chilling effect on the industry. As a result, more banks failed in the last three years than any similar period in the last thirty years (Journal of Accountancy, 2011). What makes banks successful? What changes push banks to fail or consolidate? The answer lies in the competitive and regulatory landscapes of the 21st Century.

What Activities Make U.S. Banks Successful?

<u>Interest and Service Fee Revenue</u>

In the United States, banks have long been one of the major funding sources for individuals as well as businesses. Commercial banks collect funds from savers and make those funds available to borrowers through loans. Savers may gain some interest for their deposits and also benefit from the security and convenience that bank transactions offer (Strahan, 2008). American bankers have long understood the value underlying that relationship. An example of this is the demand deposit account which became popular during the 1870s. This new deposit gathering vehicle helped fuel industry growth well into the early part of the 20th century (Filipiak, 2009). Of course, since that time banks have introduced more products in an effort to speed payment processes and attract even more funds.

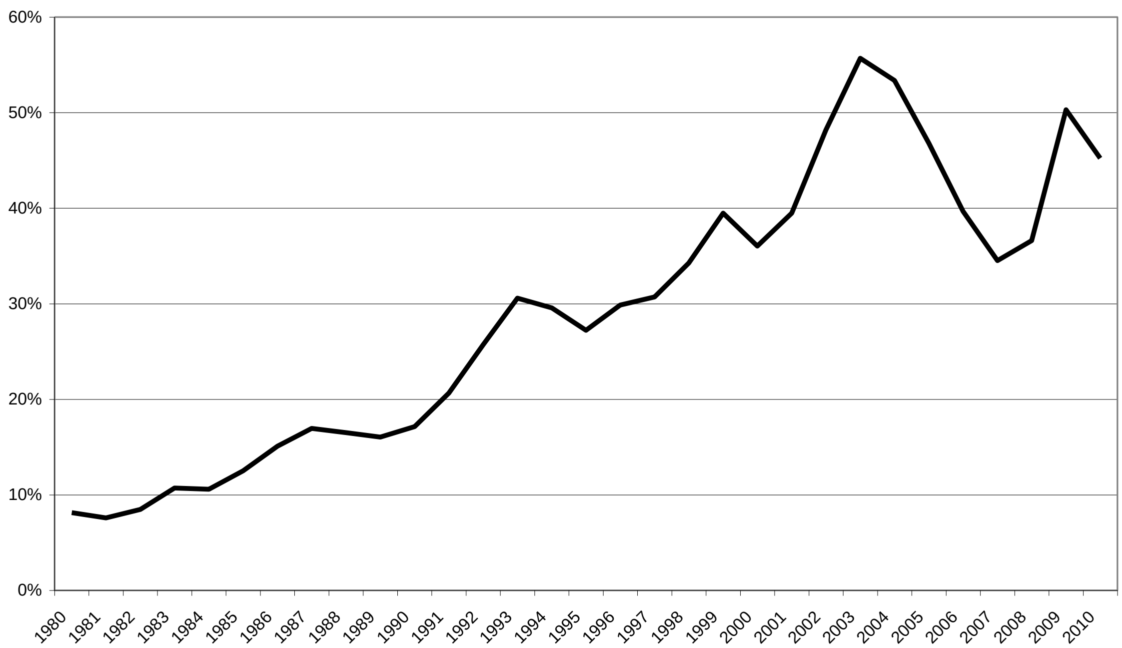
Borrowers benefit from this relationship. Namely in the form of timely access to the capital they desire (Strahan, 2008). Banks are a proven, efficient funding source for entrepreneurs and established entities as well. The difference between what a bank pays savers for their funds and what borrowers pay banks for loans is that bank's net interest income. The more money a bank gathers, the more it can lend. Additionally, the more deposits it gathers without having to pay interest, the wider that interest margin becomes. Success then is not only a matter of collecting funds, but collecting them at the lowest possible premium.

Interest is not the only source of bank income. Lenders also provide other services ranging from the transactional to the advisory. The convenience associated with funds transfers, activity reporting, and twenty-four hour access is increasingly more critical to the health of a bank. This makes fee activities extremely attractive, not only for the income they directly provide, but for the cross selling opportunities implicit in their use. Additionally, fee income is not dependent on funding sources. Banks do not need to commit as much of their capital to offer these products. This is another reason that non-interest services are so attractive to banks.

Considering Non-interest Income as a percent of Interest Income as shown in Figure 1, the FDIC data shows a significant increase from the mid-1980s to the mid-2010s, with the maximum hitting about 55% in 2007 before it dropped back to about 30% then bounced to 50% in 2009. This demonstrates how banks are increasingly depending on non-interest revenues to survive. It also indicates the poor liquidity conditions faced by banks which depend mostly on Interest Income.

Figure 1

Non-Interest Income as a Percent of Gross Interest Income FDIC Commercial Banks 1980-2010



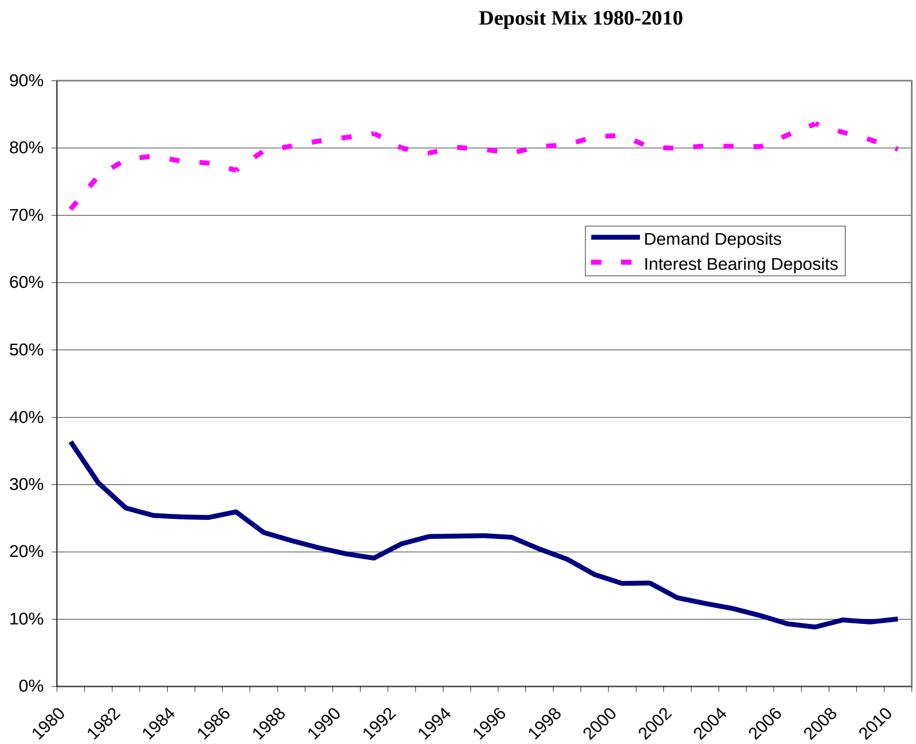
Source: Calculated from FDIC data, May 2011

<u>Understanding and Adapting to Information</u>

From the point of view of the customer, they are searching for a return on their investment dollars. This includes interest on their Demand Deposits. According to the FDIC data in Figure 2, traditional Demand Deposits account for a bit more than 10% of deposits in 2010, and just over 80% of deposits pay some interest. The rate of increase in Interest Bearing Deposits since the early 1970s has been significant, increasing from about 50% to about 80%, and leveling off at approximately 80% since the mid-1980s. Even though the rate of interest may be small, this data shows that customers will seek interest-bearing accounts, thus costing banks in the way of interest payments and also increasing competition among banks for those customers.

The interest earned from deposits is not the only reason for savers to place their funds with lenders. Savers are further incentivized to pool funds with banks due to the cost of gathering information (Strahan, 2008). The agency relationship created between the saver and the banker serves the interests of each. From the perspective of the saver, the cost of monitoring loans is transferred to the banker. That has the added benefit of reducing the risk of losses because a bank specializes in reading and interpreting financial information. Often, that same specialization is

Figure 2



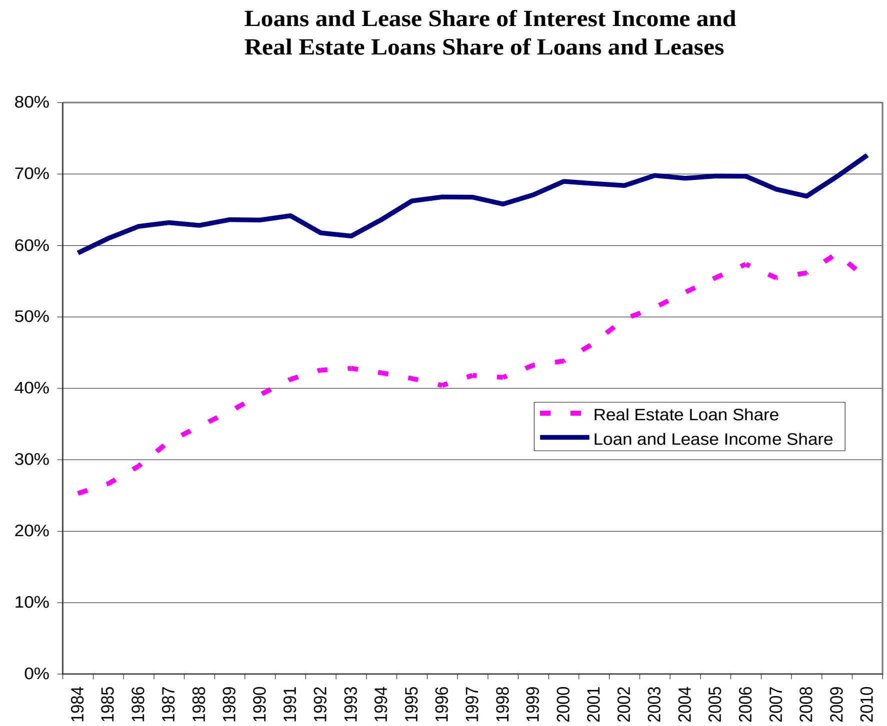
Source: www.FDIC.gov May 2011

not true of savers. The ability to understand information from various sources sets apart the successful banks from those that fail. That information may come directly from borrowers or indirectly through industry analysis.

The different processing services a bank offers its customers may also give that bank a competitive advantage over other financial service providers. The bank has a view into the inner workings of its customers that no other provider has. The flow of transactions gives the bank an idea of the health of the customer, including businesses (Strahan, 2008). That information can prompt a bank to extend a particular relationship or politely decline the advances of a company it perceives to be too risky. The management of credit risk is the most difficult area of potential success to quantify. It goes hand in hand with the other sources of success, but if managed poorly, can prove disastrous to even the largest institutions.

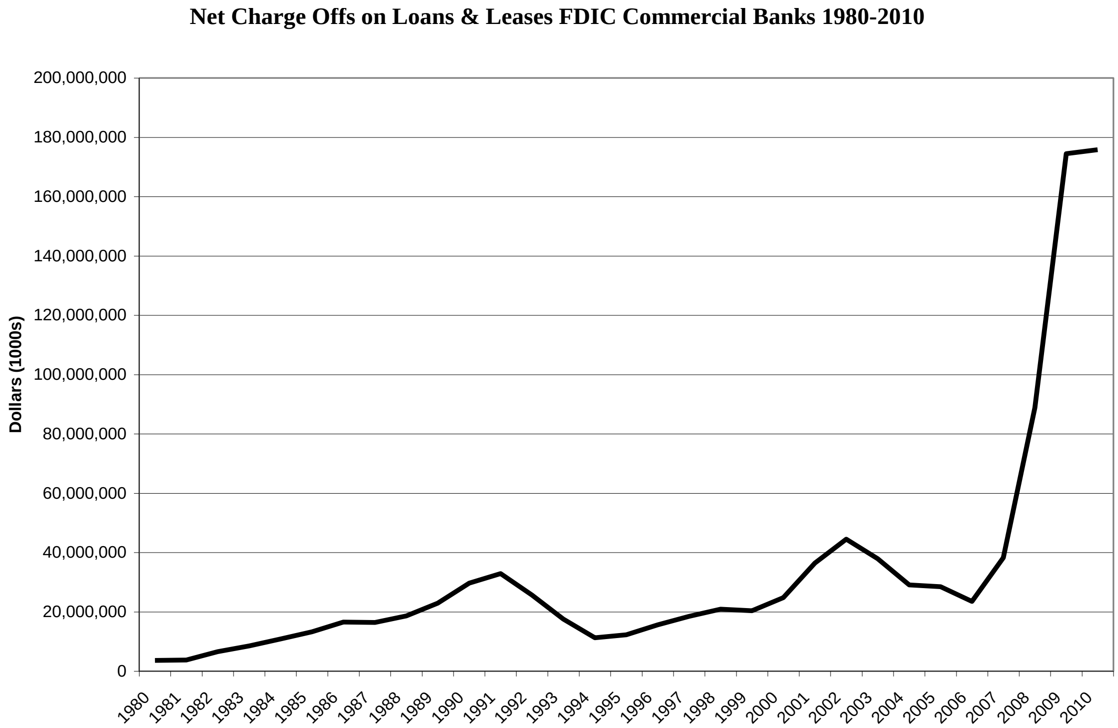
The following data, represented in Figures 3-5, focuses on the areas of real estate and credit card debt. Figure 3 highlights the growth trend in real estate loans that developed during the 1980s that resulted in the recent crisis. Figure 4 indicates the unprecedented level of chargeoffs banks continue to face from the latest crisis as compared to the significant turmoil of the 1980s.

Figure 3



Source: Calculated from FDIC data, May 2011

Figure 4

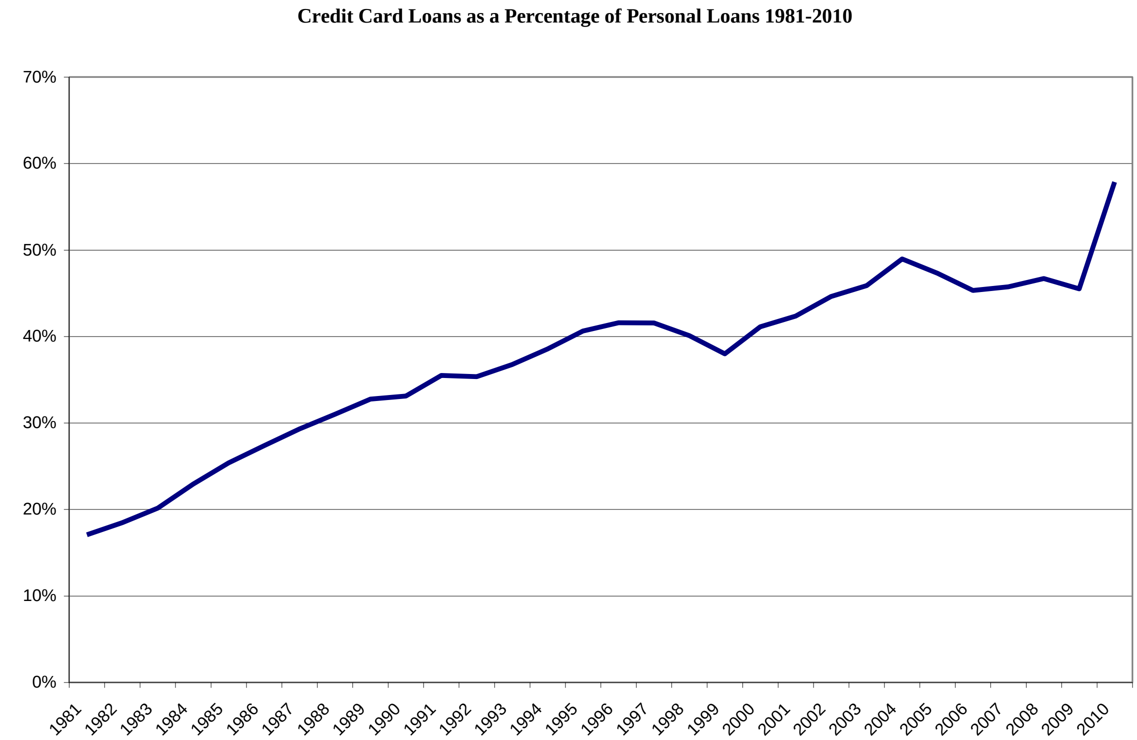


Source: www.FDIC.com May 2011

Figure 5 highlights another risk area, and that is the growth in credit card exposure since the 1980s. As of May 2011, credit card loans make up almost 60% of personal loans held by banks.

More specifically, according to the data in Figure 3, loans and lease income has grown to almost 75% of interest income over the last 25 years and real estate loans became the predominant asset class in loan portfolios since the 1980s. It now represents almost 60% of the portfolios.

Figure 5



Source: Calculated from FDIC data, May 2011

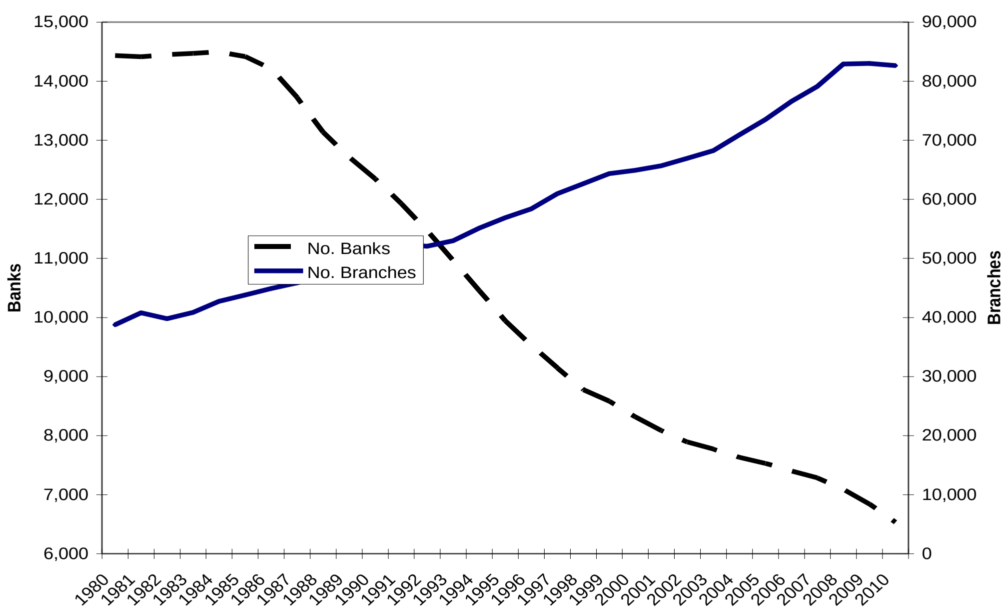
Bernanke (2010) noted to the Financial Crisis Inquiry Commission, that there were several triggers to the financial crisis including the subprime mortgage market collapse, but there were also major structural weaknesses including, 1) a mismatch in short-term funding of long term liabilities resulting in a liquidity crisis, 2) intermediaries created outside the regulatory framework to facilitate global financial transactions, 3) inadequate risk diversification and 4) relaxation of lending standards which resulted in excessive leverage. The truth, however, is that the most adept banks, no matter their size, manage the risks of their loan portfolios better than their peers. They make money from interest and fees while avoiding losses resulting from poor decision-making.

Institutional Scope

Throughout the entire 19th century and the first half of the 20th century, U.S. banks remained relatively small in terms of deposit base and geographic scope. At the time, banks could not grow larger than the community or communities where they were chartered. The geographic barrier is due in part to the limits of long distance communication at the time. In larger part though, it is due to regulatory realities. Banks could only receive their charters from their respective states until the National Currency Act was passed in 1863 (Filipiak, 2009). This act created the Office of the Comptroller of the Currency, the agency that would grant charters and regulate national chartered financial institutions. Due to taxes at the time, activity at the national charter level was slow. Growth instead came from the state chartered institutions (Filipiak, 2009). Some states were permissive and allowed state wide banking, others limited banks to particular cities or counties, and a few did not permit branch banking at all (Hayes 2008). The unequal treatment of the banking industry led to unequal growth across the country. North Carolina, for example, was extremely permissive. The result of that permissive environment is that two of its banks went on to become two of the largest banks in the country, Bank of America and Wachovia (Hayes, 2008). The latter example, however, is also a cautionary tale of managing credit risk, because Wachovia is now part of Wells Fargo. Figure 6 highlights the precipitous decline in banks beginning in the 1980s and the continuous increase in branches that began in the 1950s until a slowdown in 2010.

Figure 6

Number of FDIC Commercial Banks and Branches 1980-2010



Source: www.FDIC.gov May 2011

Technology and regulation reached critical mass in the late 1970s. Communication barriers that had hindered large branch networks gave way to computer, fax, and telephone advances. Successful banks began to petition their representatives for the right to expand their operating footprints. Regulators bowed to industry pressure and allowed that expansion (Hayes, 2008).

A series of Congressional acts allowed ever increasing growth. Among these, the Riegle-Neal Interstate banking and Branching Efficiency Act of 1994, RNIBA, removed the last barriers to nationwide branch banking (Cebula, Fenili & Koch 2011). The long expansionary economy of the last twenty years, coupled with lax regulatory constraints led to wave upon wave of bank mergers from the 1980s onward. In many areas, this led to the first large state-wide banks. These state-wide banks merged to become large regional banks. Regional banks soon merged to create super regional players. Those super regional players merged to become national behemoths and those became multinational banking entities. The scale of banks in the last quarter century is unprecedented in U.S. history. By the end of 2007, the largest one hundred banks controlled 75%

of bank deposits. That means that 1.2% of the 8,561 FDIC institutions had stockpiled the majority of domestic savings (Hayes, 2008).

Table 1 indicates that since 1992, the number of small banks—under $100 million in assets—declined by 50%, while the number of Mega banks—assets over $1.0 billion—more than doubled. As of 2010, the Mega banks account for 84% of employees in banking and 90% of banks' assets.

Table 1

Shifts in Bank Concentration 1992 to 2010

	<$100 Million	$100M- $1 Billion	>$1 Billion
1992			
Number of institutions	72%	24%	3%
Total employees (FTE)	13%	23%	64%
Total assets	10%	19%	71%
2010			
Number of institutions	36%	57%	8%
Total employees (FTE)	2%	14%	84%
Total assets	1%	9%	90%

Calculations using FDIC data

Larger banks' access to such vast stores of savings offers them a number of advantages over their smaller competitors. Two advantages stand out as the most obvious. The first is pricing power. In the same way that the largest retailers can underprice competitors through economies of scale, larger banks dictate what pricing will be due to their greater concentrations of cheap funds. A larger base of relatively inexpensive funds, such as demand deposit accounts, allows the biggest institutions to price loans at lower rates than small banks. The second most obvious benefit of scale is greater stability. A case can be made that a wider geographic base better diversifies big banks. Those banks that have a broader geographic footprint are better equipped to withstand local economic crises also. They can shift their emphasis to industries and areas that are not as affected by negative economic conditions. A number of studies have linked wider branch networks with lower bank failure rates in times of economic stress (Bordo & Lane 2010). Banks that operate in only a handful of locations simply do not enjoy similar durability due to the concentration in one particular area.

The keys to modern banking success in the U.S. are relatively simple then. Bankers provide services that induce savers to place their funds with that bank. The bank grows and lends throughout its market. As it grows, the bank must balance the desire for growth against the understanding that riskier behavior can lead to rapid destruction just as easily as it could lead to rapid growth. Once a bank has established itself, then it begins to expand its reach through branching or by purchasing competitors. This geographic expansion leads to greater stability even in recessionary periods, helping further fuel the bank's success.

What Has Changed That Is Causing Banks To Fail So Rapidly?

Competitive Landscape and Regulatory Environment

Some aspects of the competitive environment in banking are wholly within the control of the bank. For instance, the decision to lend or not is within the bank's power. The bank may also decide, to an extent, what amount it is comfortable lending. It can even determine when it wishes to be repaid. The regulatory realities facing banks today; however, are often not within their control. Recent regulation seems to have the consequence, whether intended or not, of constricting banks' traditional income streams as well as increasing compliance costs. The end result may benefit society as a whole, but it further narrows the margin for error that separates the weak from the strong.

The number of regulations that have had significant impact in recent years could go on for pages and pages. Instead of citing each act, it is more useful to peruse a more limited list. Legislation that is meant to increase competition and thereby protect the consumer does not always have the intended effect. Take the RNIBA again as an example. The act was passed in 1994 with the intent of removing the last remaining barriers to branch banking on a national scale (Cebula, et al 2011). Cebula (2011) makes the case that RNIBA actually had the opposite effect. It induced banks to expand their branch networks in an effort to garner larger shares of deposits and become more conveniently located. The argument being that geographic expansion is what is desired. Physical expansion remains a requirement of convenience, but to what extent should banks build new branches especially in today's environment? Too many closely located branches overlap and lose much of their intended value. The result is greater operating costs which could easily equate to less return per branch. Again, this is a balancing act and bank management must choose wisely. Obviously, this is merely one act, and taken alone in the course of fourteen years, is not the sole reason for the recent banking crisis. It is, however, part of a larger tapestry of regulation that affects the decision-making of bankers today.

Not all of the regulatory changes are acts like the RNIBA. Some changes affect the accounting rules surrounding the banking industry. In 2001, the FASB stated that for business combinations, purchase accounting should be used rather than the pooling of assets method that banks had favored for some time (Garver, 2011). This is sometimes referred to as the mark-to-market rule. The assumption behind the rule was that the fair market value of loans held-to-maturity would be fairly close to what other banks would be willing to pay to acquire those loans (Garver, 2011). In an expansionary economy that may be true. Banks may be willing to pay premiums on portfolios or in the purchase of competitors. The effect in a down market though is to "slow the wheels" on sales. Banks considering the purchase of other banks, now look with a more jaded view at downtrodden institutions; albeit, they have not yet failed. The fear is that in purchasing another bank, the purchaser will end up having to report the value of the purchased loans as something less than their initial projection. Whatever the shortfall, the purchaser would likely show the difference as goodwill. That is small comfort to a purchasing institution. Goodwill is not included in the capital ratio requirements that regulators impose on U.S. banks (Garver, 2011). Regulators have increased those ratio requirements in recent years.

That combination of factors creates even greater pressure for managers of banks that are financially troubled to find well-capitalized suitors earlier rather than later. Managers in decades prior may have attempted to ride out the downturn in the bank's fortunes. Now, however, that point of no return can be reached sooner than in the past. Purchaser banks have little incentive to save banks that seem on the verge of collapse. Instead, they merely bide their time and wait for eventual auction of that institution after the FDIC takes control of it. Banks acquiring failed banks account for much of the merger activity in 2010 (Engen, 2011).

Banks at the bottom will fail and be taken over. This is nothing new. But the timing is accelerating. Banks that are only moderately profitable, or are moving from treading water to trending more unfavorable, will have to worry about their prospects in the near term. These institutions will be forced to consider selling themselves sooner than at any time in recent memory.

The enforcement of existing laws, coupled with the legal liability current regulation extends to managers, is extremely daunting to managers and bank directors. Financial service companies found this out in the first half of 2010, when 30% of all class action suits filed were filed against the financial services industry (Engen, 2011). The question now becomes whether the managers of banks will find it worthwhile to expose their companies, and themselves, to civil and criminal penalties. The specter of possible litigation must weigh on the minds of the most senior decision-makers in a financial services company. The difficulty of trying to serve the interests of shareholders and employees, while being under intense scrutiny themselves makes many of the senior-most positions that were once fun and profitable now difficult and stressful (Engen, 2011). Bankers have always enjoyed a high level of civic position in both small and large communities. However because directors are often shareholders with significant ownership, it is likely that the increased tempo of enforcement actions will provide some impetus for directors to sell their banks rather than toil for years more under the burden of low returns and unhappy constituencies inside and outside of their institutions.

Another even more current policy fueling changes across the banking landscape is the Troubled Asset Relief Program, commonly referred to as TARP. The intention of TARP is to avert a complete melt down of the financial services industry during the worst of the recent credit crisis. Many feel that it did succeed in its initial task. Banks that have taken funds from TARP are now faced with paying back that money or risk the Treasury department restricting dividend issuance (Witkowski, 2010). TARP was created as a temporary program with the understanding that banks that took advantage of it should repay the Treasury department for its efforts relatively quickly. As of Sept 30, 2010 banks had returned 89% on their pool of $245 million and as of July 5, 2011 the bank portion of TARP returns was positive according to the Treasury Department (US Treasury 7/5/2011). Nevertheless a quick review of any major stock index shows that equity markets are not fond of financial service providers at the moment. Given that, many banks are not prepared and need to find a partner ready to expand.

The Dodd-Frank Act

The most recent significant legislative reform of the financial services industry is the Dodd-Frank Act. This act was signed into law on July 21, 2010 (Jeong, Pat & Shomir 2010).The impact of this law is not fully understood, because many of its provisions have not been completely realized. The scope of it is so large that it may be months, or even years, before that occurs. Much of the framework it calls for is still under construction (Cocheo, 2011). Foremost among the impacts that are still relatively unknown is the creation of a new regulatory agency that will serve as a financial services consumer watchdog. It is unclear whether the Consumer Financial Protection Bureau will be content with the examinations conducted by the Office of the Comptroller of the Currency or whether it will demand further review from its own auditors

(Cocheo, 2011). The result though is that if two sets of examiners are dispatched to the bank, then the compliance costs for that bank will increase. In response to this, banks will need to strengthen their compliance departments. The learning curve for these departments will shorten as banks are scrutinized by not one, but two, governing entities. The cost of doing business under the Dodd-Frank Act then will rise, and with it, net income will shrink (Cocheo, 2011).

The second major issue is what impact this act has on fee income. The Durban Amendment to the act specifically limits interchange fees banks charge for card payment processing services (Cocheo, 2011). Many bankers worry that this is not just a reduction to current income, but it will have an even greater impact on future revenues. Younger customers tend to use debit cards almost to the exclusion of checks or paper money. This means that one of the largest sources of non-interest income is now limited depending on what regulators deem to be a fair price. Again, this may well serve society as a whole; however, the impact on the financial services industry though, will be a reduction of income which will drive many banks to consider some form of cost-cutting in an effort to reduce fixed expenses.

The Durban Amendment's impact is not fully known yet. On the other hand, parts of the Dodd-Frank Act that limit other forms of income have had tangible effects on the bottom line and are relatively recognizable. For instance, the restrictions that now limit overdraft fees have had the effect of ending free checking across the industry (Cocheo, 2011). For the majority of banks, overdraft fees made up the single largest source of non-interest income. With that source of income decreasing, many banks are turning to new usage fees as well as internet or mobile only deposit accounts. Fees could be assessed on those consumers for simply processing a transaction at a teller window.

Mergers as a Coping Mechanism

Banking is one of the most heavily regulated industries in America. Whether at the federal or state level, the United States government has actively regulated the financial sector throughout its history (Filipiak, 2009). Filipiak notes that "politicians, like generals, tend to fight the last war" (p. 8). While amusing, there is a great deal of truth in that statement. Regulations tend to be weighted towards preventing abuses. It also seems that more restrictive regulation tends to follow in the wake of economic contraction resulting from some speculative behavior. Assuming that holds true in this cycle, which the passage of the Dodd-Frank Act indicates, then the pendulum has swung towards correction rather than growth. These changes directly affect the cost-benefit analysis of financial institutions. It is more difficult to grow revenue in downward economic cycles, so expense reduction is the next logical focal point. Logically, it follows that banks will need to find ways to reduce expenses. This will come in a number of forms, but more and more, mergers will seem to be a viable mechanism for coping with that reality. Again, this is confirmed via Figure 6 showing the reduction in the number of commercial banks and branches. Many merging institutions seek both the capital of a stronger rival as well as the economies of scale gained by combining back office activities.

Summary and Conclusions

The banking industry in the U.S. has changed dramatically in less than two decades. In the course of that time, the traditional model for bank success has undergone radical changes. Particularly, the competitive environment is markedly different due to sweeping regulatory reform. Now, more than ever a bank's margin for error is smaller. This is in terms of what losses they can absorb and how long they can wait for better days. Regulatory reform has reduced key, non-interest income sources and increased fixed expenses in the form of higher compliance costs. Additionally, greater specialization and skill will be needed, particularly in the risk management and compliance groups within banks. All of these features, coupled with the fact that the majority of banks in the U.S. are small to mid-sized institutions, means that many of these banks will not remain independent entities. They will need to merge with banks that have stronger capital positions and that have demonstrated an ability to avoid the over indulgences of expansionary cycles. A consequence of these likely trends to redevelop a profitable banking sector will increasingly cause policy makers to pause and contemplate too-big-to-fail and the likely scenarios that could unfold and the risks that taxpayers are unwittingly taking.

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