

## Risks Are Many, But Half-Dozen Stand Out

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*Fourth in a series*

Banking companies are better off than they were a year ago, but as the saying goes, past performance is not necessarily indicative of future results.

The threats seem legion at times, but American Banker has singled out six major risks facing the industry. Two of them, existing credit-quality problems and sufficiency of capital, are all about overcoming the legacy of the crisis. Two others, the cost of deposit gathering and the dearth of customer trust, tie back to old-fashioned retail banking. And the final two, the dangers of consolidation and the challenge of attracting talented hires to a troubled industry, address the long term: which companies will survive and who will work for them.

Credit quality is still banks' top risk, even though the recession shows signs of easing.

Two chief concerns are dominating the outlook for the industry: How bad will banks' loan losses get? Are they setting aside enough capital to cover those losses?

The short answers: Worse, and possibly not.

Some of the largest banks said this week that they expect to book higher losses in their consumer and business lending books this year. Fifth Third Bancorp said in regulatory filings that it expects loan losses to rise 24% in the third quarter. At a banking conference in New York, top executives with Bank of America Corp. and

SunTrust Banks Inc. said they are bracing for higher losses tied to real estate.

Loan losses tend to spike even after recessions end.

"The economy certainly has caught its breath here," said Jeff Davis, an analyst at FTN Equity Capital Markets. "But that doesn't mean problem assets will become performing assets."

A Moody's Investors Service report last week indicated that the worst is yet to come with respect to banks losing money on bad business, home and credit card loans.

"There is a long way to go," said Craig Emrick, a vice president and senior credit officer there. "We don't think we're close to a peak."

Emrick estimates that the 66 banks he covers will lose \$415 billion on bad loans in 2009 and 2010, including \$70 billion charged off early this year.

He predicts the banks are facing another \$100 billion in residential loan losses, \$73 billion in commercial mortgage losses and \$41 billion in commercial and industrial loan losses.

Provisioning has not kept pace with rising nonperforming assets, Emrick said. "Nonperformers translate into chargeoffs — they will need to continue to provision," Emrick said. "That is going to hurt their profitability significantly."

### CAPITAL ADEQUACY

Though the government signed off on the capital levels of the nation's biggest banks earlier this year, many other banks are likely to need more funds to make it through the recession.

Robert Albertson, the chief strategist at Sandler O'Neill & Partners LP, said \$80 billion in capital was raised after the stress tests, but another \$28 billion is needed to fortify the balance sheets of small and midsize banks.

"There are 7,800 banks where the majority aren't there yet" in terms of having adequate capital, Albertson said. "A significant amount of capital is still needed ... to keep the blood flowing."

Fred Cummings, president of the hedge fund Elizabeth Park Capital Management, was more optimistic — "On balance I'd have to say the industry's capital position is in pretty good shape" — but even he envisions more banks raising funds to prepare for repaying the Troubled Asset Relief Program.

Regulators could also spur a need for more capital. James Rohr, chairman and CEO of PNC Financial Services Group Inc., said this week during a conference hosted by Barclays Capital that regulators may raise the threshold for being "well capitalized" to a Tier 1 capital ratio of 9%, from the current 6%.

Fortunately for the industry, bank stocks have been rising, with the KBW Bank Stock Index up 149% since March 6. Several banking companies, ranging from regionals such as the \$52.9 billion-asset Zions Bancorp. in Salt Lake City to the \$1.56 billion-asset Eagle Bancorp of Bethesda, Md., have taken advantage, selling common stock in the past month.

"Capital raising has become less dilutive and more possible," said Frederick Cannon, co-director of research at KBW Inc.'s Keefe, Bruyette & Woods Inc. "We've made a lot of progress in the last few months, particularly since the end of the second quarter."

No one knows how long the window may remain open or the degree to which investors will want to keep investing in bank stocks.

"Whether or not the window will remain open will be a function of the economy and credit quality," Cummings said. "Healthy banks with nonperforming assets in line with expectations are having no problems raising capital. There is clearly a strong appetite for banks in that position."

## DEPOSIT COSTS

The importance of deposit-gathering punctuates any conversation about the future of banking, but it is easier said than done.

Increased competition for deposits could drive up deposit costs faster than loan rates, squeezing margins, said Novantas LLC Managing Director Sherief Meleis.

"Historically, banks have been able to make a lot of money on deposits coming out of recessions, because deposit pricing has lagged interest rate increases," Meleis said. "But what if this time there isn't much of a lag, because everybody is realizing the importance of deposits?"

For every 10 basis points in deposit pricing that banks are not able to lag behind the latest Fed interest rate increase, the industry collectively loses \$5.5 billion in spread income, Meleis said.

On the flip side, \$1.5 trillion in retail money market mutual funds is sitting with brokerages and other firms that banks may be able to poach, given the challenges to the money market mutual fund industry once the government stops guaranteeing such instruments, Meleis said.

Another risk for deposit pricing — and margins — is additional special assessments or premium increases by the Federal Deposit Insurance Corp. as more banks fail, Meleis said.

Moreover, the low yield curve will drive down the profitability from low-cost demand deposits, as banks won't do as well investing those dollars in securities, said Aaron Fine, a partner in the

retail and business banking practice at Oliver Wyman Group in New York.

That means banks will need to rely more on income from loan yields, which carries increased credit risk if banks book a lot of risky but lucrative loans to generate more spread income, Fine said.

Both Meleis and Fine pointed to another huge risk for banks: a substantial reduction in deposit fee income if Congress or regulators crack down on overdraft fees.

It is unclear how banks would replace that lost revenue, Fine said.

### **MERGER PITFALLS**

Consolidation in the banking industry is inevitable, with some experts estimating that the number of U.S. banks could shrink from 8,000 to 4,000.

The reasons for this are simple. After the recession eases, banks won't be able to rely on the excessive leverage and exotic financial products that delivered eye-popping profits before the credit crisis. Growth will have to come from buying other companies.

And there will be plenty of opportunities to go shopping at bargain prices, as small and midsize banks confront troubled business and consumer loans through 2010 at the least. The healthier banks will be on the prowl for those with attractive deposits.

But mergers are risky. Recent history is rife with examples of buyers that overpaid, did poor due diligence or branched into an unfamiliar business line.

"You're basically buying somebody else's problems," said Mark Fitzgibbon, director of research at Sandler O'Neill & Partners LP. "It could be credit. It could be structural issues

within the bank, particularly as we come out of this atypical credit period."

Some industry watchers say consolidating the banking sector among several large, stable companies is healthy for the entire industry. They will be more likely to set rational lending and trading standards than the specialty finance companies and so-called shadow banks that ran rampant in the pre-recession days.

But John Jay, senior analyst with Aite Group, said there are systemic risks in consolidation.

"You're actually, by this process, concentrating the risk," Jay said, "because you have fewer hands that are actually operating banks."

As they hunt for deals, Fitzgibbon said banks need to move cautiously and do proper diligence.

### **CUSTOMER TRUST**

Though public anger at the banking industry over the financial crisis has subsided, skepticism of what banks can really deliver persists, said Michael D'Esopo, senior partner at the New York brand strategy and design firm Lippincott Mercer.

According to a Lippincott survey of 1,004 bank customers released in July, respondents were still angry with "Wall Street," but not necessarily at their own banks. In fact, 72% said "trust" is one of the emotions that best describe how they feel about their primary bank; 64% said "loyalty" and 48% said "acceptance." In contrast, only 5% said "anger" was one of the emotions, 3% said "fear" and 2% said "rejection."

Still, banks need to back up their reputations as safe havens with actions that demonstrate the customer truly comes first, or else customers won't buy it, D'Esopo said.

For example, he said, if a bank's brand touts its employees as friendly and approachable, the

bank must ensure that its customer inquiry and dispute-resolution procedures at branches and call centers live up to those notions.

"Banks need to make sure they are delivering on their promises through interactions with customers, so superior customer experience is more than just a slogan," D'Esopo said.

Customers want even greater control of their finances as a result of the financial crisis, he said. Banks that provide tools or instructions on how customers can make more informed financial decisions can reinforce trust, he said.

Banks should not get complacent just because many customers have stayed with them during the crisis, said Dave Martin, a retail banking consultant at NCBS, a unit of SunTrust.

"Sometimes, banks lose sight that customers can and do vote with their feet, and so banks really need to step up their efforts to show customers just how much they appreciate them," Martin said.

Les Dinkin, a managing director at Novantas LLC, said banks can do everything right on one side of their business — say, in retail banking — but still suffer huge reputational hits overall if their earnings dive because of another side of their business. Bad loans to residential developers, for example, have forced many banks to explain to customers why they should still be considered safe.

"Even if it's in just one part of the institution, it can affect the entire bank," Dinkin said.

## ATTRACTING TALENT

The financial meltdown has created a recruiting challenge.

Lower earnings growth, heightened regulation, and more restrictions on compensation will hamper banking companies' efforts. The days of

the huge signing bonuses are gone, observers say.

**Rod Taylor, the senior partner in the Atlanta executive search firm Taylor & Co., said banks will have to find new ways to compete for the best prospects. Long-term viability will be a key selling point for companies that can be convincing, he said.**

**"Most banks realize they need energetic bankers if they want to be the big winners five years out," Taylor said. "Our clients are confident the industry will come back, and when it does, there will be greater opportunities for those with the skills and the time left in their career."**

Robert Voth, a partner in the financial services practice of the executive search firm CTPartners, said companies and job seekers have to take the view that the changing markets have an upside.

"The disruption has provided multiple opportunities for companies to reinvent, reinvigorate and innovate their business approaches, processes and customer relationships," Voth said. "This new playing field provides senior executives with a chance to make their own marks and leverage their leadership abilities."

Nicholas Stonestreet, who recently returned to banking, may be the new face of the industry's hiring and retention efforts.

He said he did not do it for the money. True, Stonestreet will receive some stock options from Regions Financial Corp., which hired him to be a private banker after nearly three years out of the industry. The real motivation, he said, involves the opportunity to tap into the looming economic recovery.

"Everyone is doing some soul-searching" with the profession, said Stonestreet, who left a job with Merrill Lynch & Co. in 2007 to lead a start-up water and waste management company. "If

you are in this business today to support a lifestyle, that's a mistake. If you want to impact people's futures, then you are in the right place at the right time."

Paul Davis, Katie Kuehner-Hebert and Matthew Monks contributed to this article.