Can the Financial Sector Promote Growth and Stability?

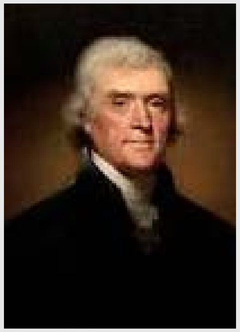
BROOKINGS

Presentation to the Brookings Institution

June 8, 2015

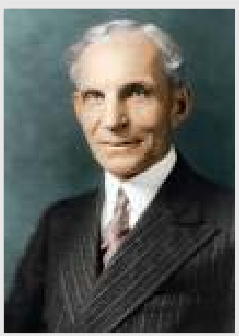
McKinsey&Company

Paranoia or visionary prophecy?



"I sincerely believe that banking establishments are more dangerous than standing armies, and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale"

– **Thomas Jefferson**

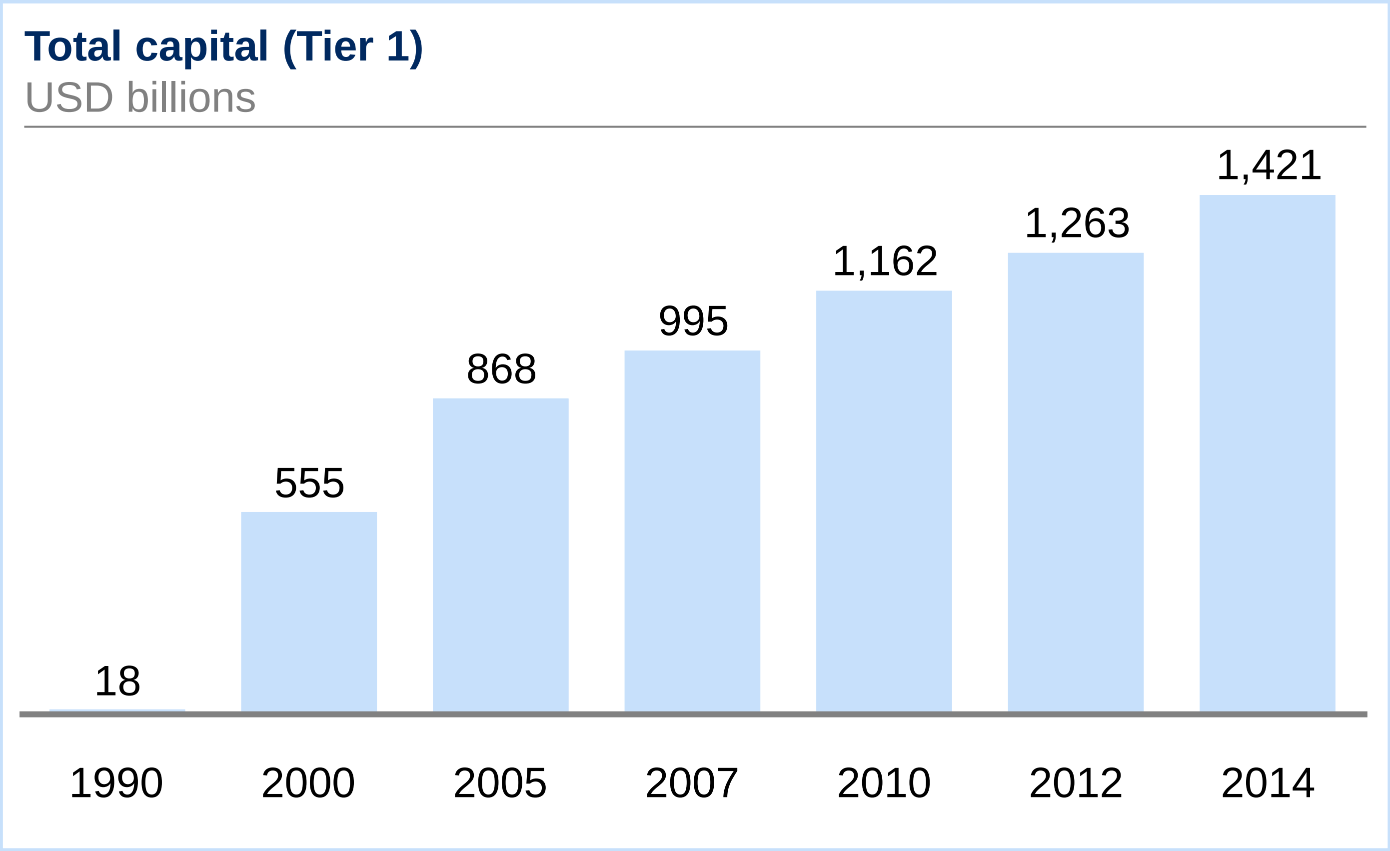


"It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning"

– **Henry Ford**

SOURCE: Web search

The banking system has become “safer”



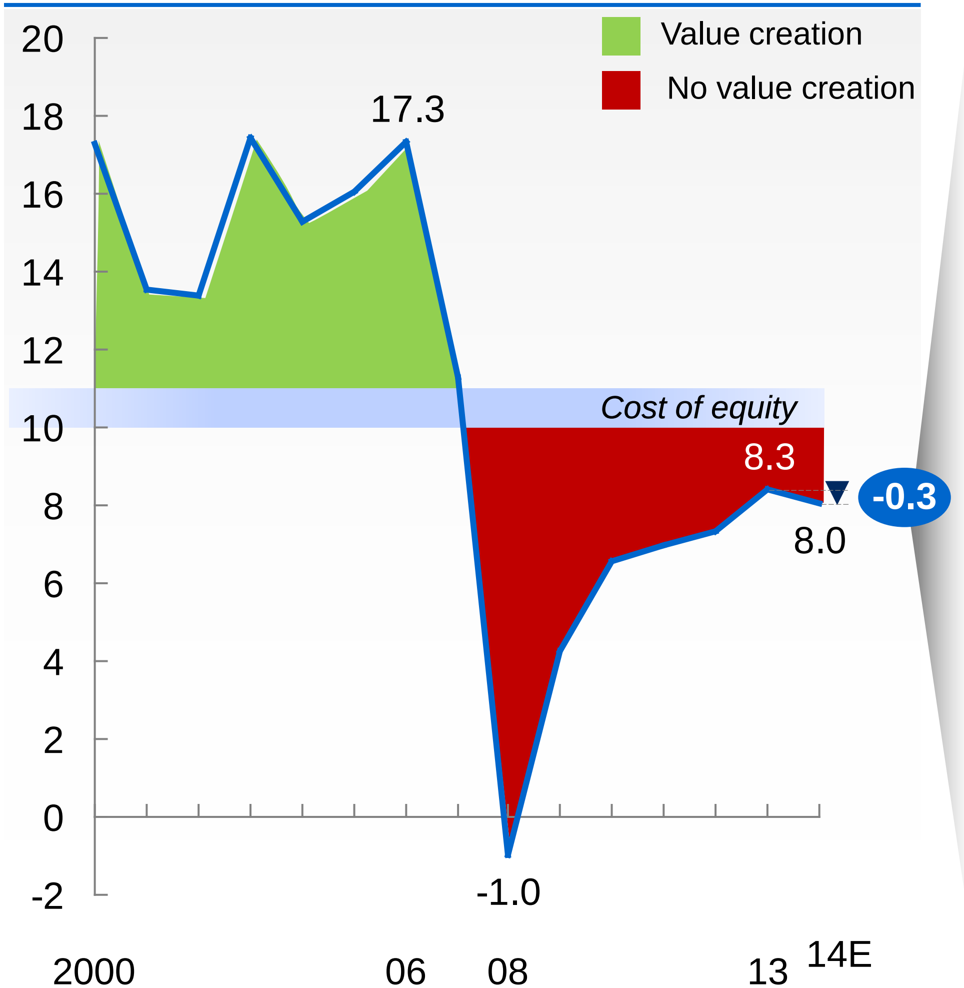
SOURCE: SNL Financial

But returns remain “unsound”

ESTIMATES

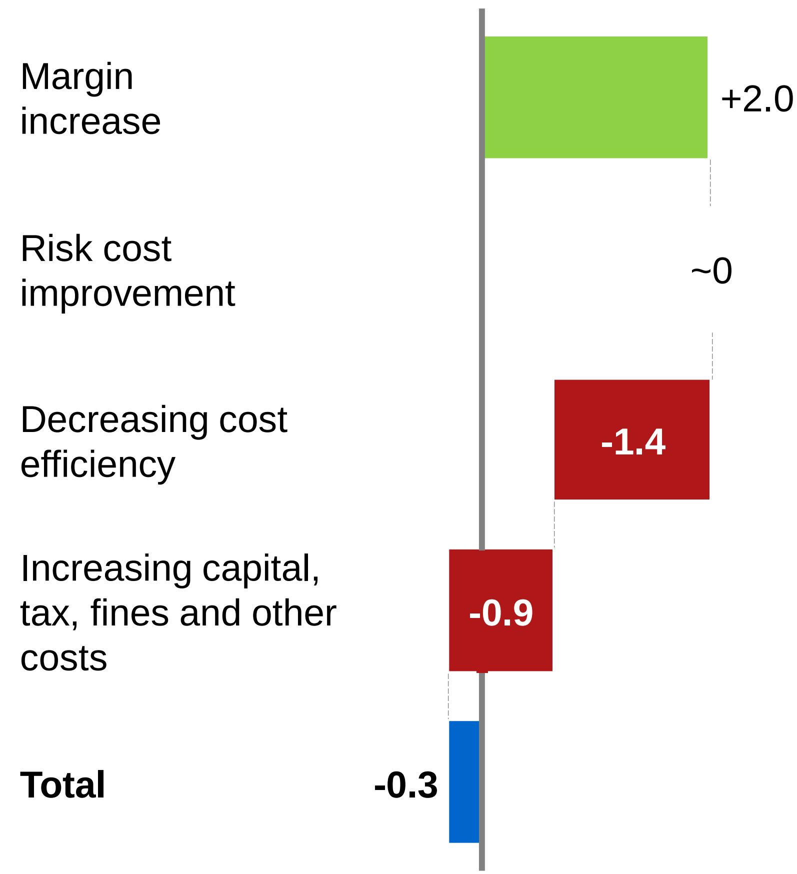
United States banking ROE[1], 2000–14E

%



ROE change 2013–14E

%

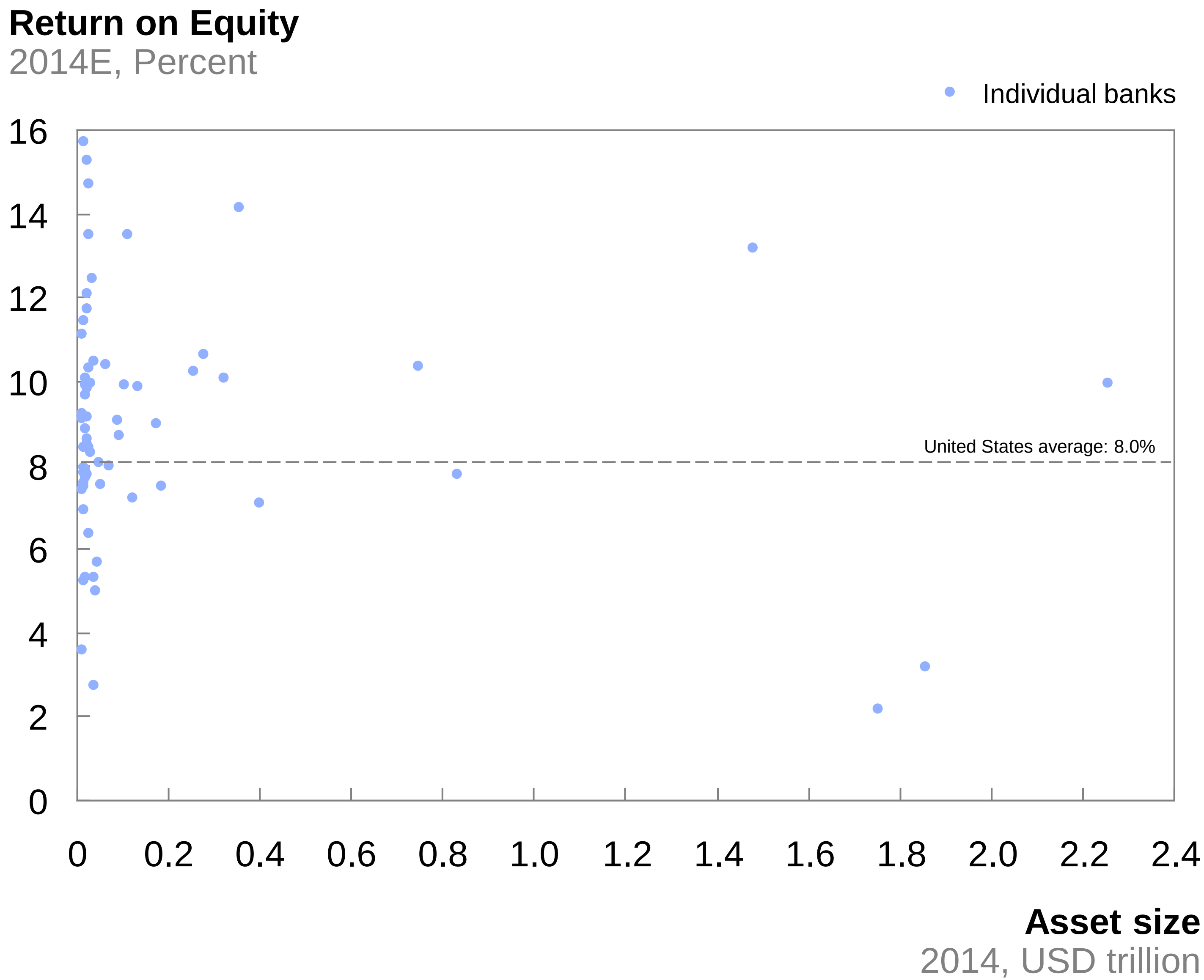


1 Based on a sample of listed banks with >$10 billion in assets.

SOURCE: Thomson Reuters; McKinsey Panorama—Global Banking Pools

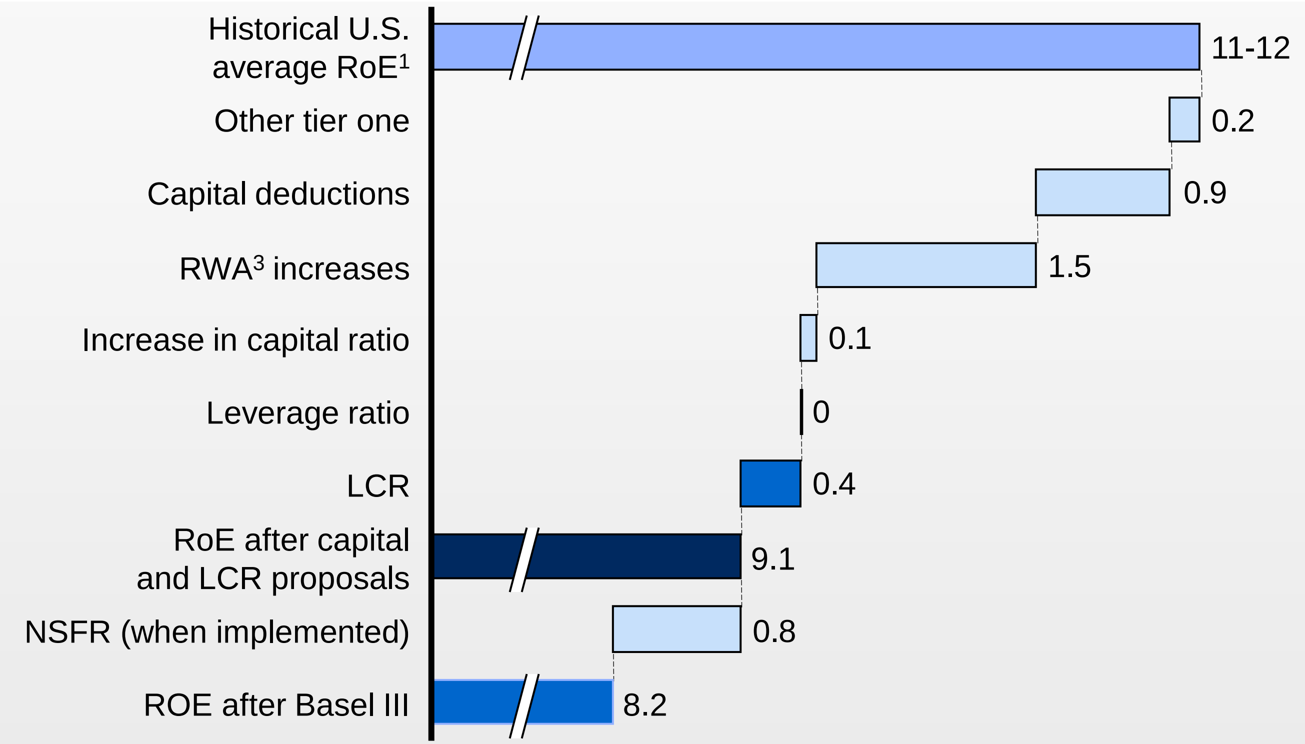
US banking ROEs range between 2.2% and 15.7% regardless of size

ESTIMATES



The capital and liquidity proposals are expected to reduce RoE by 300-390 bp, depending on implementation of the NSFR

RoE impact of Basel III capital and liquidity proposals
Percentage points



Other potential changes not included in modeling[2]

- “Too big to fail”
- “Living wills”
- Volcker rule
- Central clearing of OTC derivatives
- Bank taxes/levies
- Accounting
- Consumer protection
- …

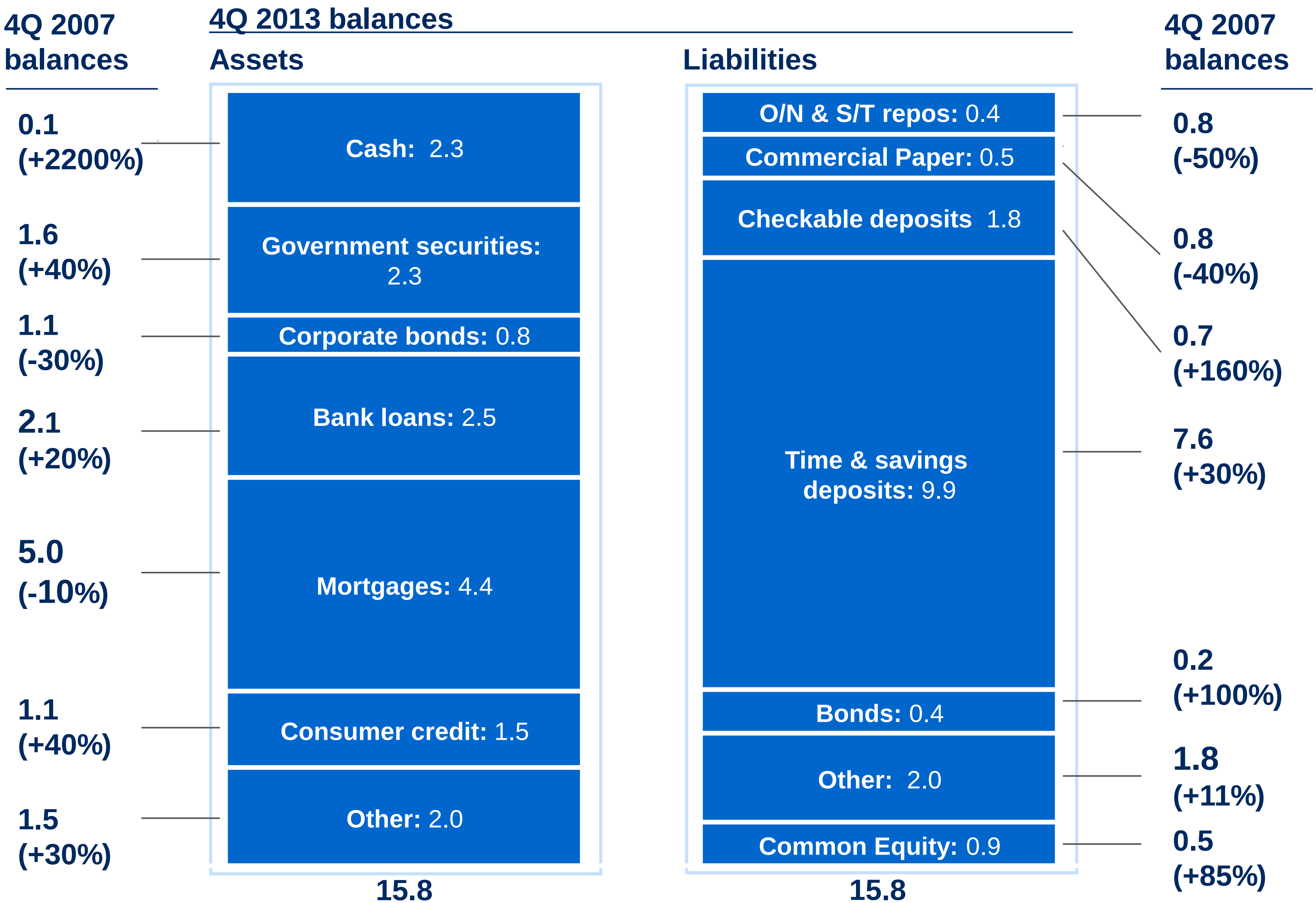
- Key question as to where the incidence of regulatory changes will fall, i.e.,:
  - On customers, through higher loan pricing
  - On banks, through cost reduction (e.g., compensation, consolidation among small banks)
  - On shareholders
- Analysis does not consider likely business model changes
- Even in an environment where banks are better capitalized and more liquid, the reduction in RoE likely to be greater than the reduction in cost of equity

1 Using consensus 2012 analyst forecasts does not materially change the results
2 See separate material on Dodd-Frank for other regulatory changes
3 Risk weighted assets

Sources: BIS; Bloomberg

And bank balance sheets are undergoing dramatic transformation

Aggregated balance sheets of US commercial banks, 4Q 2013 $ Trillions

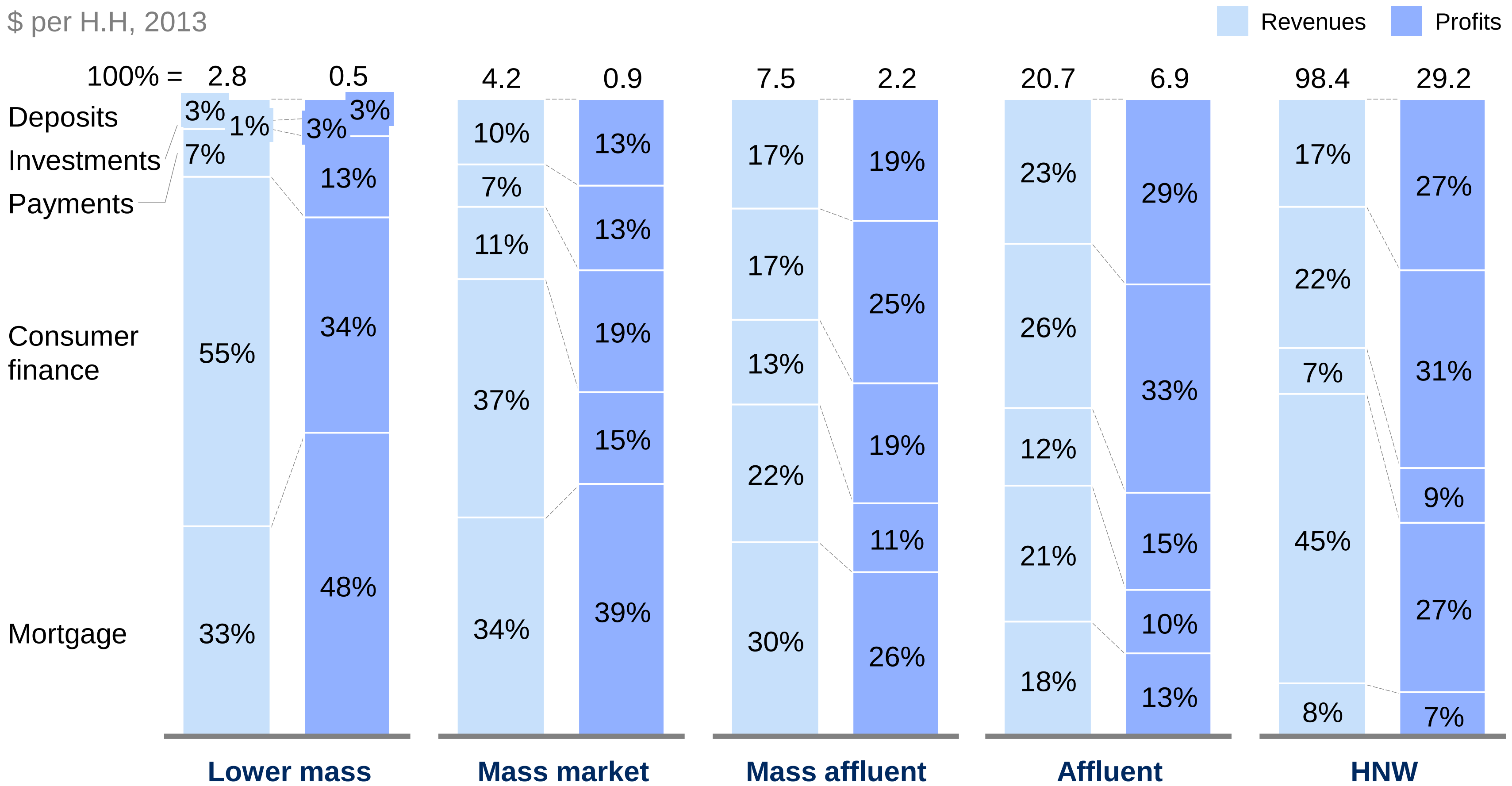


SOURCE: Federal Reserve Flow of Funds, 4Q 2013, L109 schedule

Customer View

Credit drives bank profits from lower-income households, while deposits and investments drive profits from more affluent households

Bank revenues and profits by customer segmentation



- Credit (i.e., payments, consumer finance, and mortgages) are the drivers of profit for lower mass/mass households
- Deposits and investments are the drivers of profit for more affluent households

Note: Segment cuts are the following; Lower mass: <$50k, Mass market: $50-200k, Mass affluent: $200k-1M, Affluent: $1-5M, HNW: >$5M

SOURCE: McKinsey Panorama - US micro segmentation tool

"Durbin" will have a net negative impact on Debit's wallet share, impacting the lower mass segment the most

Key provisions in the Durbin amendment

1 Debit in-terchange rate

- **Fed to set debit interchange for issuers with more than $10bn in assets at a level reasonable and proportional to issuer** transaction-related processing costs

2 Prepaid economics

- **Prepaid cards are exempt** from debit interchange regulation, unless issuers charge cardholders overdraft fees or a fee for the first in-network ATM withdrawal per month

3 Network exclusivity

- Debit card issuers must issue cards that **allow authorization via more than one network operator** (i.e., prohibits Visa- and Interlink-only debit cards)
- Network agreements **cannot restrict merchant's routing of debit authorizations** (e.g., prohibits priority routing mandates on cards with many PIN networks)

4 Merchant steering

- **Eliminates any restrictions** on merchants to **discount based on any method of payment**; upholds network rules prohibiting discrimination by issuer
- **Merchants may set a $10 minimum for credit card purchases** (governments and universities may also set a maximum)

Likely reactions and impact on debit

↓ **Increased DDA costs to consumers** due to decreased interchange revenue will increase unbanked population, and thus, decrease number of potential debit users

↓ **Elimination of debit rewards** pushes transactors to credit where rewards still proliferate

↓ **Issuers steer consumers away from debit** to higher interchange instruments (credit, charge cards)

↑ **Targeted merchant steering to debit** (i.e., offering discount coupons particularly to customers that have used credit in the past)

National banks are replacing free checking with ‘free with stipulations’ products, while smaller banks have kept these free (thus far)

Key trend

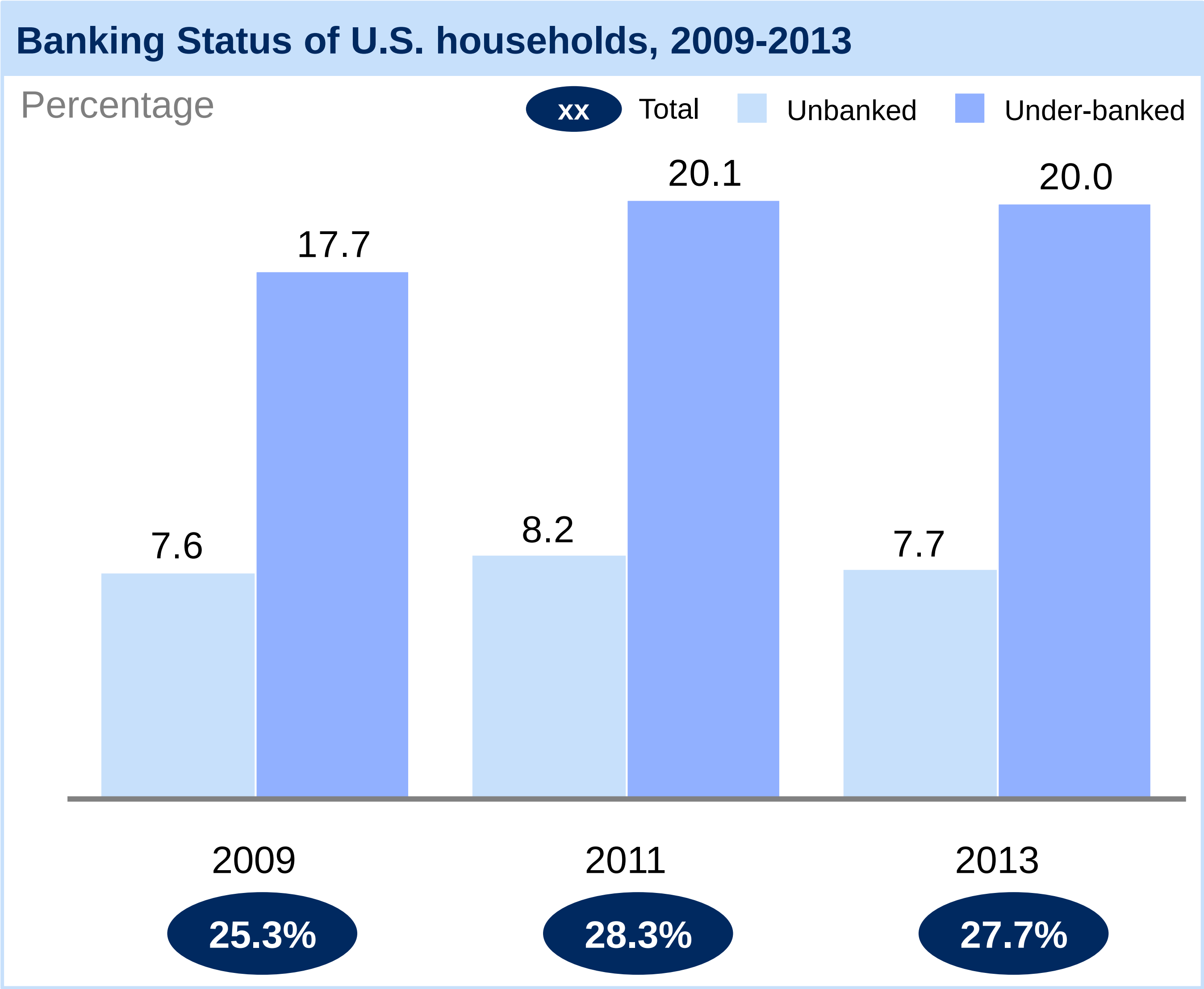
	National banks				Regional banks					Community/ credit unions		
Product	*	WELLS FARGO		citi	5/3		KeyBank	Sovereign	SunTrust	USAA	PSECU	A-K VALLEY FEDERAL CREDIT UNION
Student-centric product	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓		
Free checking						✓	✓	✓	✓	✓	✓	✓
Free with stipulations product	✓	✓	✓	✓	✓							
Enhanced checking with added features		✓	✓	✓	✓		✓	✓				
Interest-bearing product		✓		✓	✓	✓	✓	✓	✓			
Tiered-interest premium product	✓	✓	✓			✓						

Percentage of free checking accounts fell from ~75% in 2009 to ~35% in 2012

* Bank of America offers free checking if the account is opened online

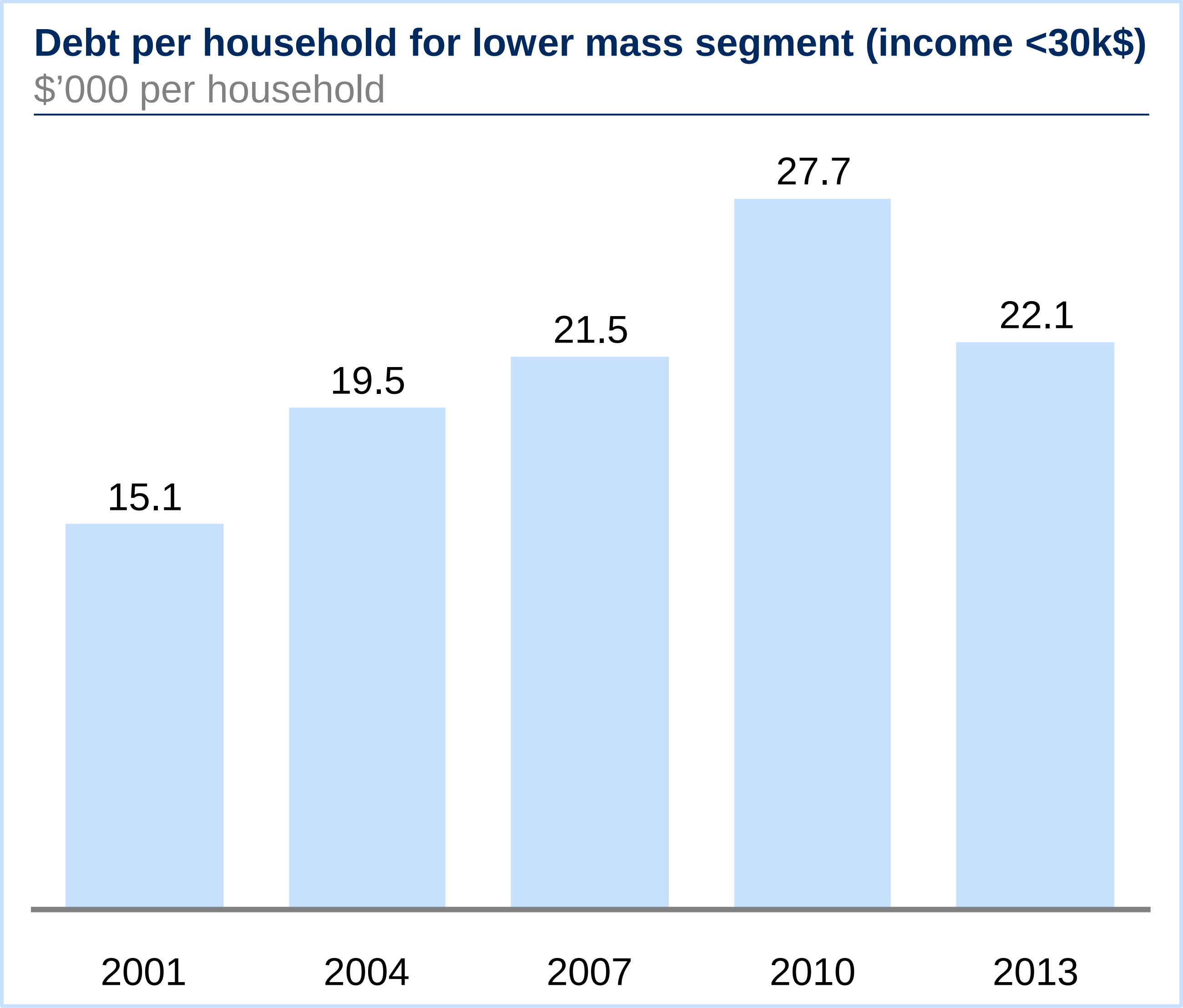
Source: FI literature; McKinsey payments practice

As a result, the unbanked and under-banked U.S. households have increased between 2009 and 2013



SOURCE: FDIC National Survey of UnBanked and UnderBanked Households, 2009, 2011, 2013

Moreover, credit for lower mass segment has declined by 20% since the new regulations

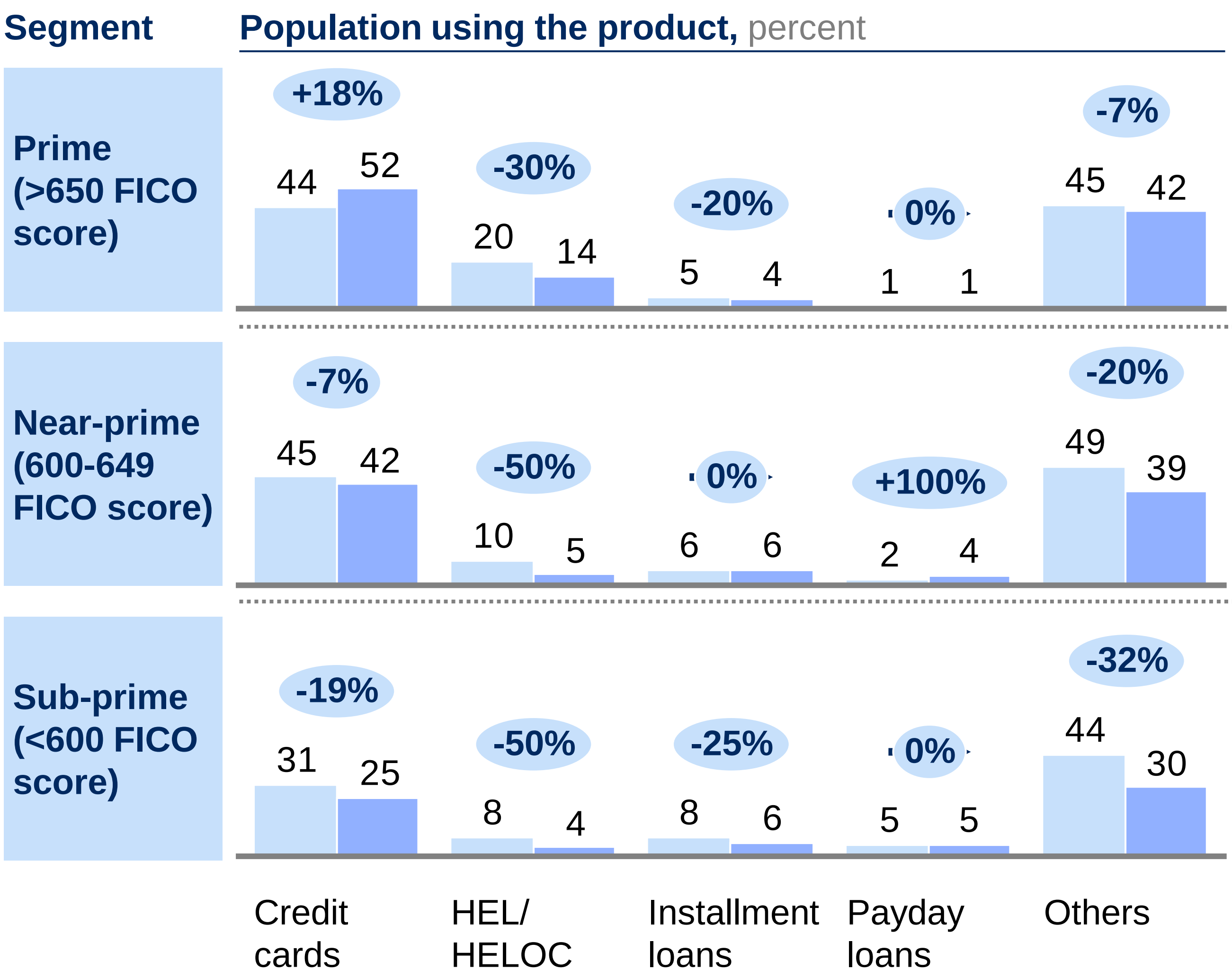


SOURCE: Survey of Consumer Finance 2013

Access to credit has fallen for both the near-prime and sub-prime segments since 2009

RESULTS BASED ON MCKINSEY SURVEY OF 1,500 CONSUMERS

2009
2013



Takeaways

- Increase in credit card usage, as an alternative for the reduction in HE credit
- Reduction in access to most forms of credit; alternative forms (installment, payday) held steady
- Significant reduction in access to all forms of credit

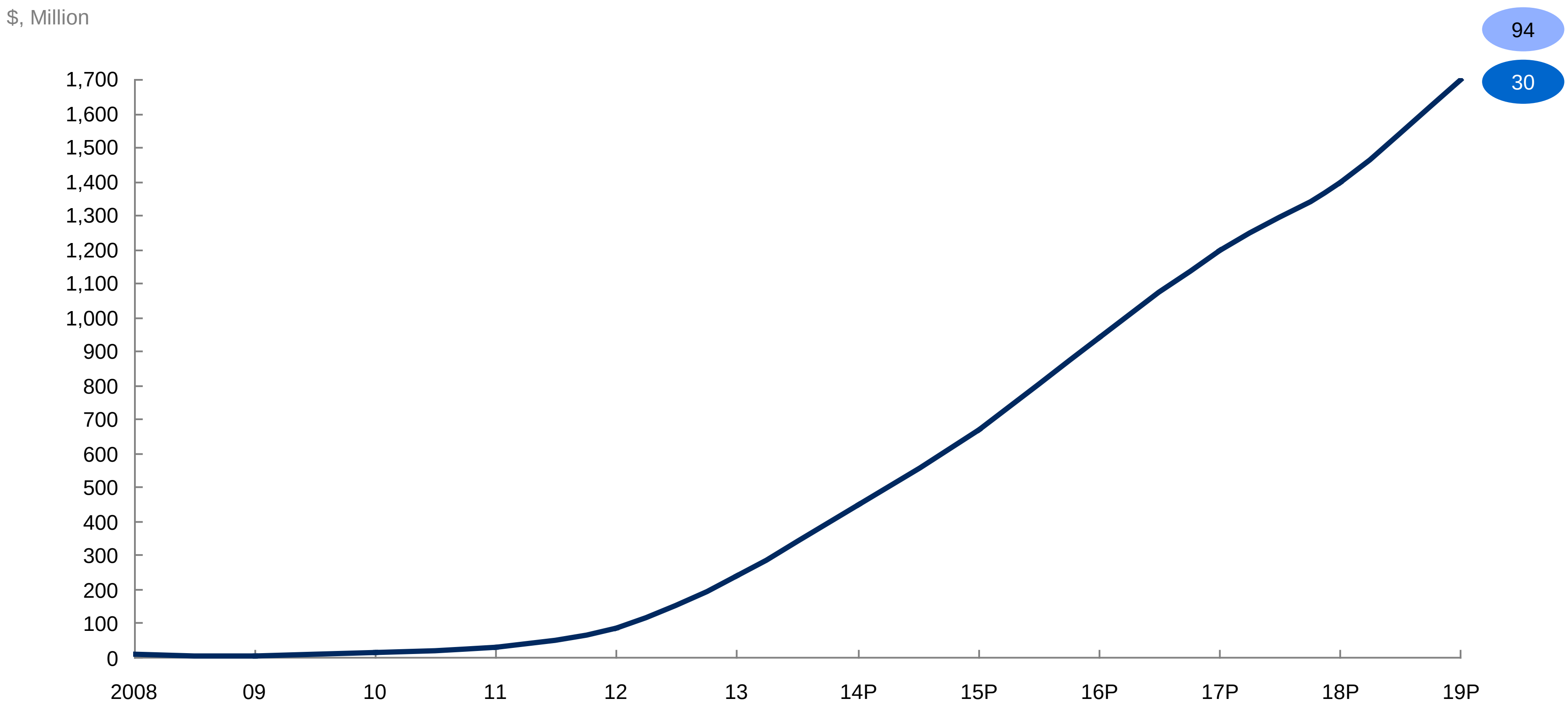
SOURCE: CFLS data from GCI

P2P lending has grown over 90% p.a. since 2008 with the number of loans growing more than 10x and loan sizes doubling

CAGR, %

2008-13	2014-19
xx	xx

U.S. Peer to peer (P2P) lending volume, 2008-19



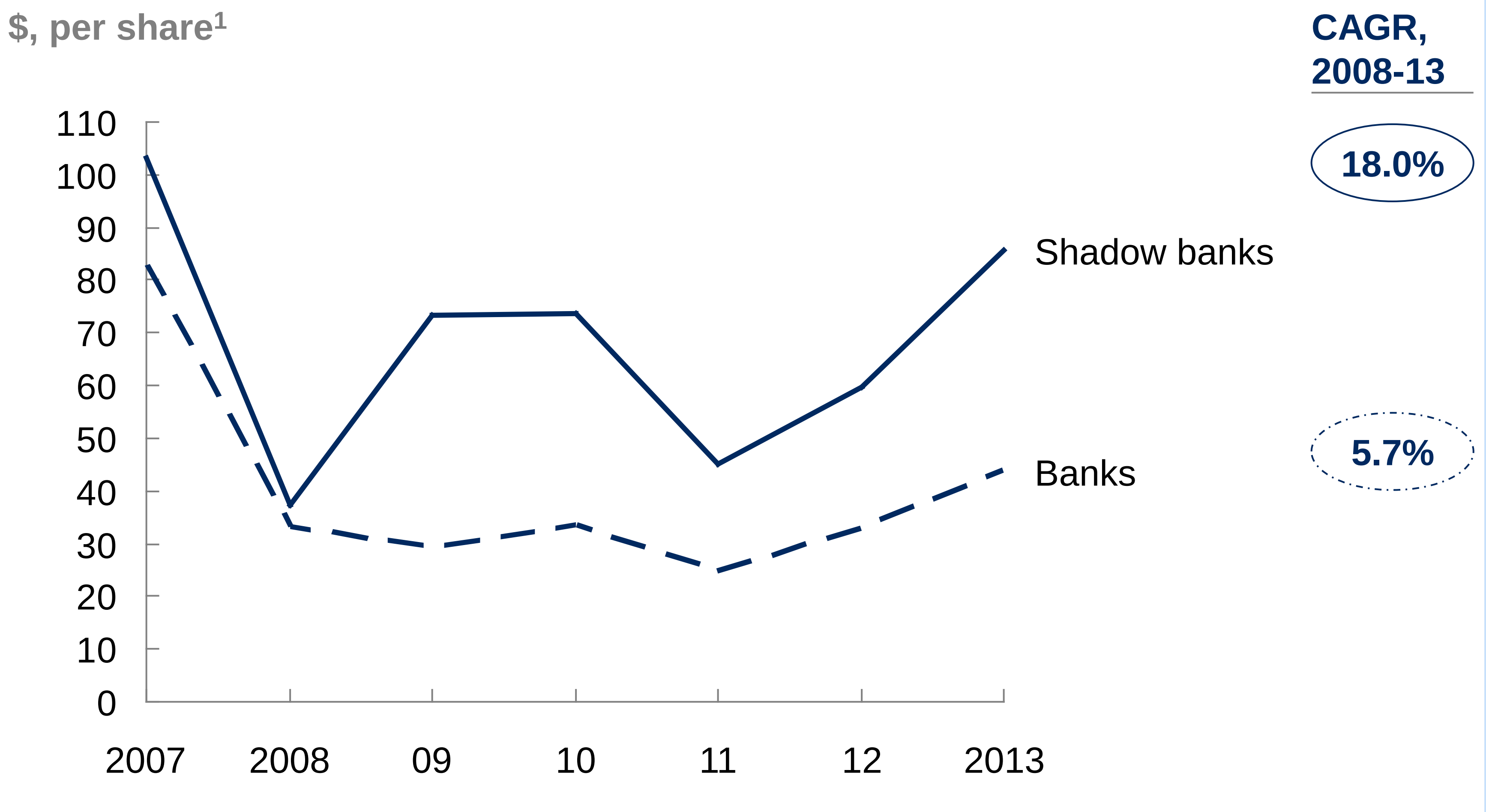
	2008	09	10	11	12	13
Number of loans	13,900	7,300	18,200	32,900	72,900	178,000
Average loan size, $	6,400	8,400	8,400	10,000	11,900	13,600

1 Return on Tangible Equity

SOURCE: The Finovate Group: Online Banking Report forecast, Jan 2014

Post crisis, average share prices of shadow banks have increased by nearly 20% p.a. since 2008, compared to 6% for banks

Weighted average share price of US financial institutions



1 Based on Q4 data for each year; weights for each bank/shadow bank based on proportion of total assets relative to the industry (in 2013)

SOURCE: FDIC

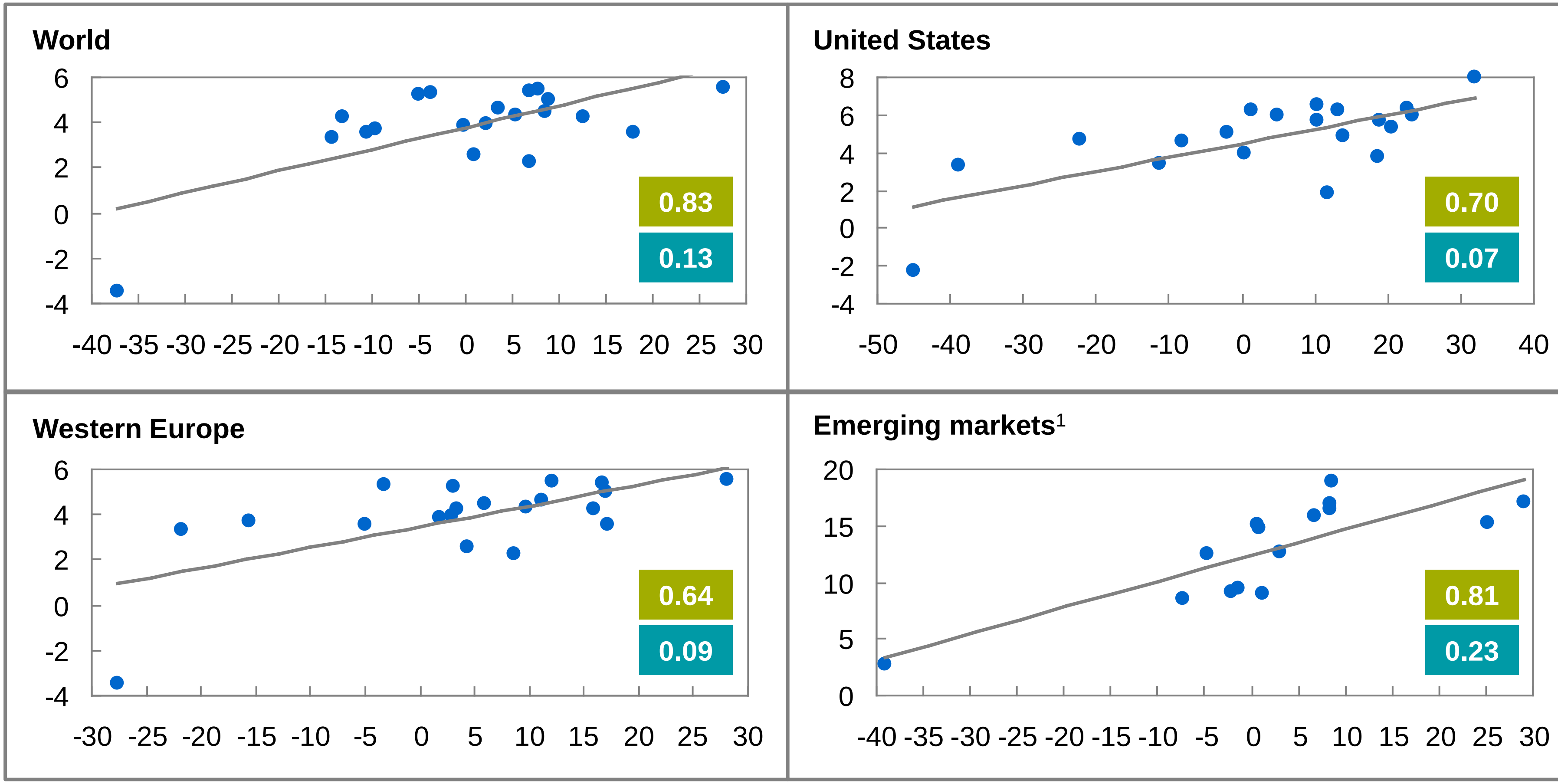
Banking matters: GDP growth is correlated with private-sector financing

Correlation

Slope of regression line

X axis: Change in household and corporate debt and book equity as a share of GDP (t-1)

Y axis: Nominal GDP growth (t) (%)



1 Emerging markets excluding China shows correlation of 0.66 and a slope of 0.20.

NOTE: Not to scale.

Key contributions of the financial sector to the economy and society

Savings and liquidity	▪ Banks facilitate savings through deposits, and protect businesses and households against unexpected needs for cash
Credit and financing	▪ Banks significantly boost economic activity by supporting individual household investments (e.g., buying a home) and offering credit to businesses to invest beyond their liquid resources
Risk management	▪ The banking system enables businesses and households to pool their risks from exposures to financial market and commodity price risks, mostly through derivatives transactions
Trade, payments and transactions	▪ A robust banking system has enabled society to move beyond the barter system for transactions and payments ▪ Moreover, international payment systems (backed by banks) enable cross-border trade, remittances and financial market transactions in large volumes at low unit transaction costs
Employment provider	▪ The financial sector is one of the main providers of employment in the economy (e.g., 5-6% U.S. workforce is employed in the financial sector)