

July 11, 2012

## SCALE INCREASINGLY MATTERS (Why Consolidation Is Destiny)

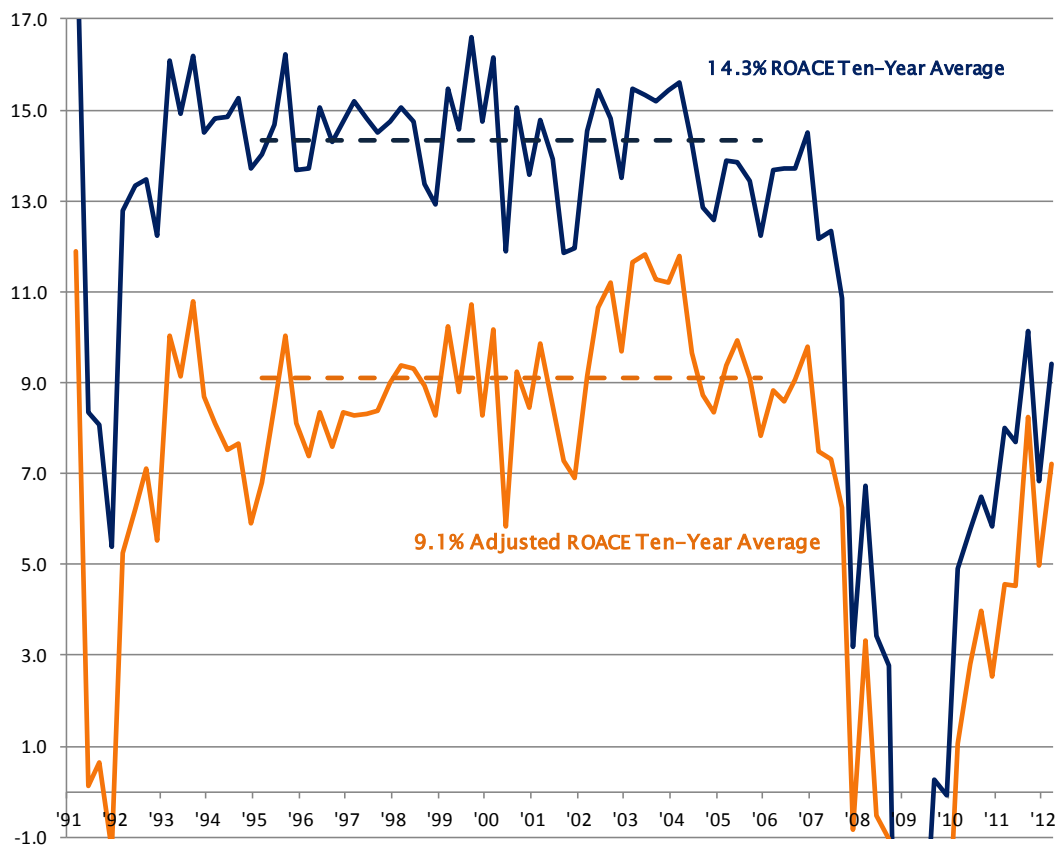
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- **Banking ROE is 80% “Recovered” Despite Higher Capital**
- **Banking Profitability Increasingly Correlates with Asset Size**

The negative narrative on banking, that it is doomed to being a moribund utility sector, burdened by regulation and hefty levels of capital, does not fit the data. Rather, recent quarterly data reveals a remarkable recovery in profitability despite record levels of capital. To see this fairly, one must recognize that the current “normal” is a period of exceptionally low interest rates. Just as pension funds can no longer base return projections in high-single digits, we should adjust bank ROE history in context with

Return on Common Equity (%)

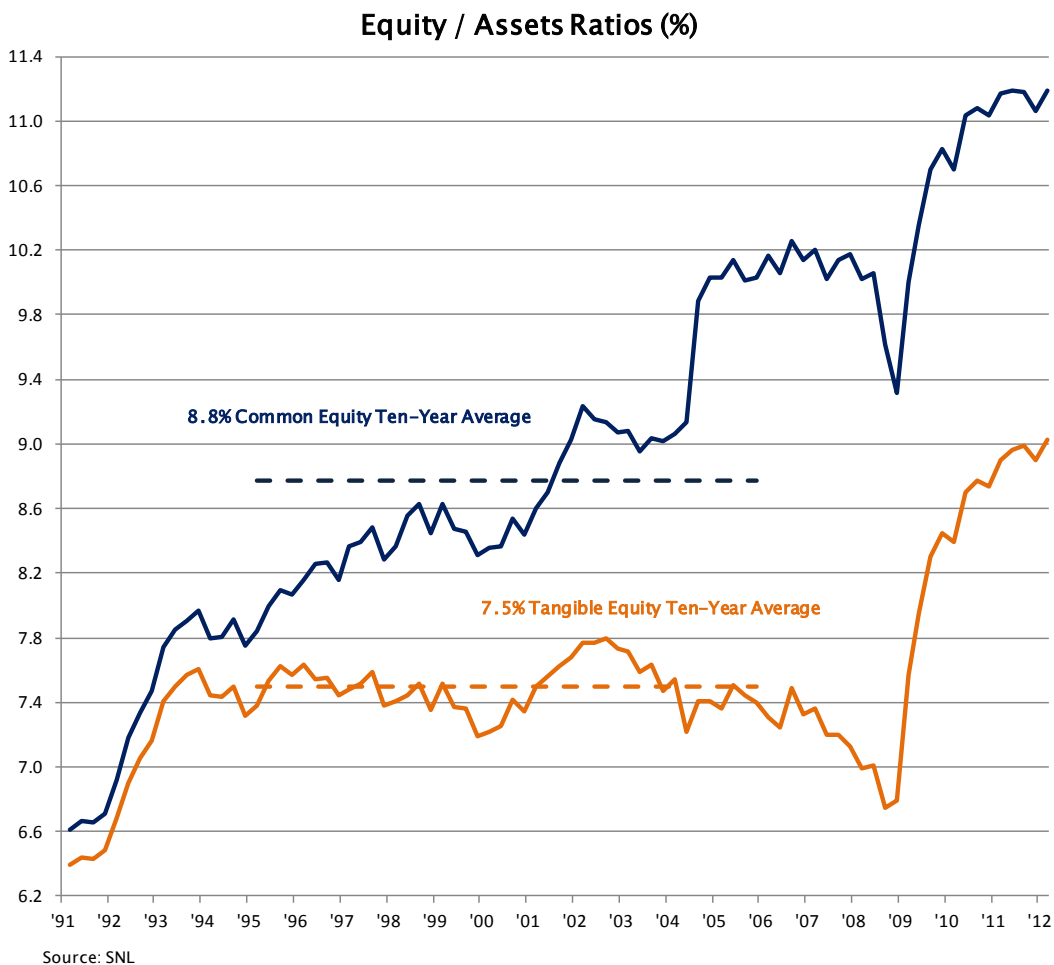


Source: SNL

risk-free interest rates. The logical choice for this is the 10-year U.S. Treasury rate. The 21-year history of banking ROE, both reported and rate-adjusted, is shown in the above exhibit. The picture is quite revealing: commercial banks reported an average return on common equity of 14.3% for the 10-year period between our last two recessions, when the risk-free 10-year interest rate was 4.2%. While commercial banks only recovered 66% of their unadjusted average profitability by the first quarter of this year, adjusting for the 200 basis point lower 10-year rate, the core ROE has already recovered nearly 80% of its historical average.

This is all the more remarkable considering that 1) total loan growth has been modest, 2) regulatory and legal costs have soared, 3) price competition has further pressured margins, and 4) capital levels have been driven sharply higher.

The recent capital expansion is displayed in the following exhibit. Common equity for the industry is now above 11%, which is 28% higher than the 1995–2005 10-year average, while tangible common is at 9% and is 20% higher than that 10-year average. Taking into account both higher capital and the abnormally



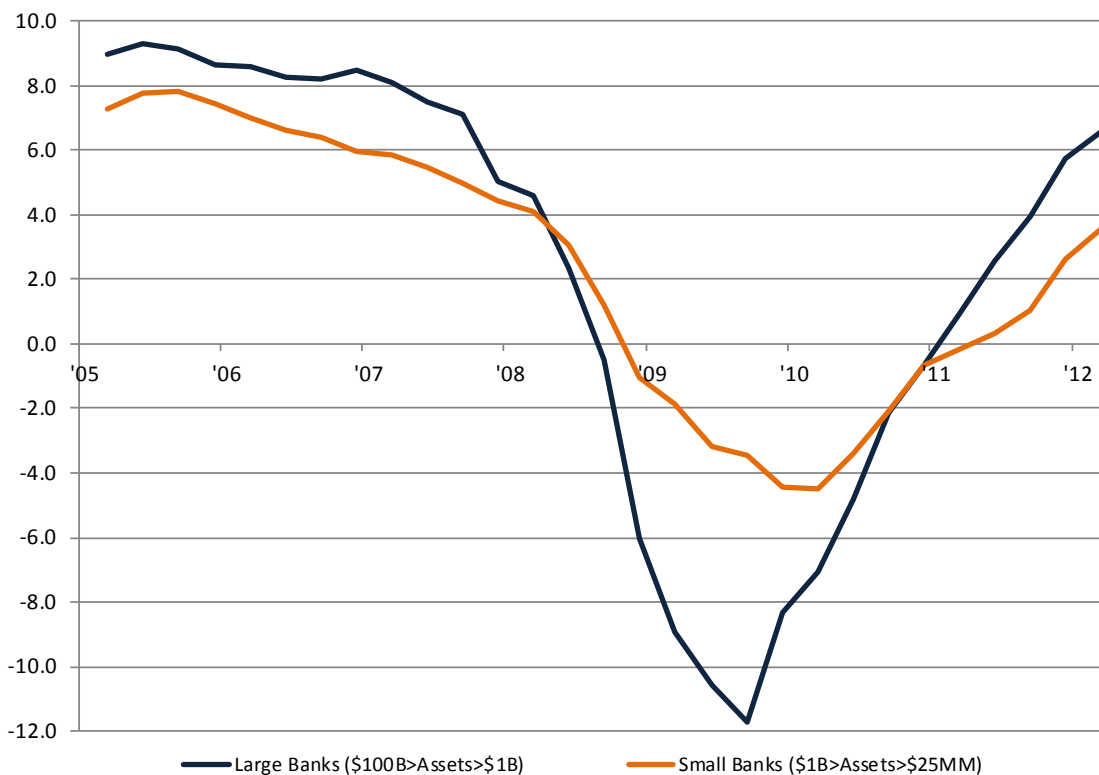
low interest rate environment, it would be fair to say that the underlying profitability of banking has not really changed much. Interest rates will certainly recover, and we doubt capital hurdles will go higher. Longer-term, product pricing and loan demand should fill in the remaining gap.

The largest, systemically important banks already carry higher capital than smaller banks by Dodd-Frank fiat, reversing decades of disadvantage to the small. But regulatory and legal costs do not scale well, and bank models weighted to the business sector are more deliverable with increased size. While this is broadly accepted and understood, it has not been easy to quantify. A degree of quantification becomes more apparent when we examine bank profit performance and capital achievement by asset size.

Delineating these measures by asset size, we chose to minimize distortions by excluding the very smallest – those below \$25million in assets – and the very largest – those greater than \$100 billion in assets. While the latter includes the multinationals and investment banks that comprise 60% of total “banking” industry assets, we do not view them as representative of classic spread banking. We also exclude savings banks and subchapter S corporations. SNL data allows these refinements, although it is only available from 2005 forward. Examining those between \$25 million and \$100 billion, we then split those above and below \$1 billion in assets using un-weighted averages. There are 505 commercial banks above and 5,512 below the \$1 billion mark on this basis.

We think this approach better captures the increasing importance of scale. Those above \$1 billion in this methodology achieved a reported, or nominal, return in excess of 10% on average common equity, while those below are returning just under 8%. Using four trailing quarters of returns, and adjusting both series for the 10-year Treasury, the larger banks have exceeded smaller banks for four consecutive quarters,

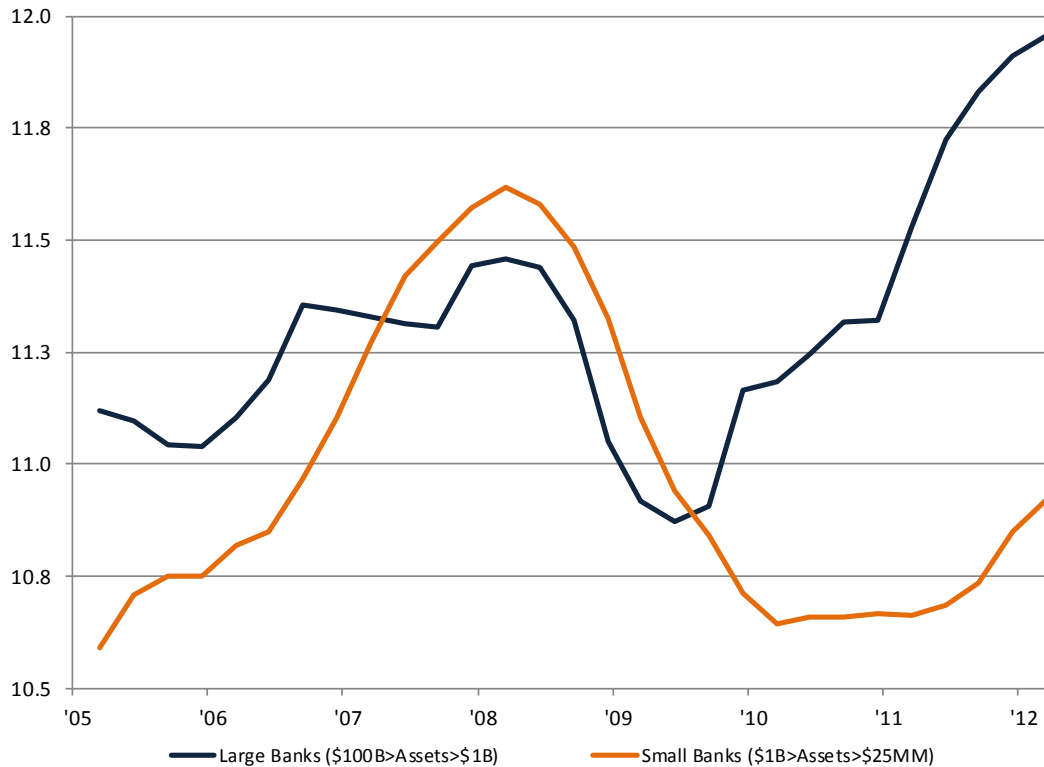
**Return on Common Over the 10-Yr UST (%)  
Trailing 4 Quarters**



Source: SNL

with the gap widening to 300 basis points through the first quarter of this year. Banks above \$1 billion in assets have now recovered 73% of their rate-adjusted returns from seven years ago, when the data by size was first available, while those below have recovered only 49% of their (lower) profitability on this same basis. Importantly, common equity ratios are approximately 105 basis points higher for the larger institutions in this exercise, versus being only 30 basis points higher seven years ago. This obviously indicates a substantial, increasing core profitability advantage for larger banks.

**Common Equity / Total Assets (%)  
Trailing 4 Quarters**



Source: SNL

One could argue whether subtracting the 10-year UST is the best means for adjusting bank returns over historical periods. Using a shorter-term Treasury rate, or even a yield curve proxy, might appeal based on their direct, theoretical impact to bank net interest margins. But bank equities, like all equities, should be first considered and marked against the ambient level of a commonly representative, risk-free yield alternative.

One could also argue for segmentation above and below asset levels other than \$1 billion, but the practical size threshold has advanced over the years, with \$1 billion increasingly seen as the new minimum, while many conclude the optimal minimum is above \$5 billion.

One could also base comparisons on capital ratios other than common equity, but permutations of all the above do not seem necessary to make the point that recovery from the financial crisis has redrawn the dividing line between the “haves” and the “have-nots.”

The message is sufficiently clear. Scale increasingly matters, and the ability to economically raise capital, absorb new regulatory burdens, and offensively capture market share all appear more sensitive to size than ever before. The sheer acceleration in common equity capital and return on capital for large institutions since mid-2009 makes a compelling case for future industry consolidation.

These economics demand a tidal wave of consolidation. The beginning ripple has largely been the result of an inordinately conservative and time-consuming regulatory process in conjunction with an unusually uncertain economic and political outlook. These too shall pass, to the betterment of banking and its investors.

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