American Banker Podcast—Why Banking the Middle Class is No Longer Profitable

An Interview with Todd Baker, Senior Fellow at Mossavar-Rahmani Center for Business & Government at the Harvard Kennedy School and Managing Principal of Broadmoor Consulting LLC

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Key:
Marc Marc Hochstein, Editor-in-Chief, American Banker
Todd Todd Baker, Broadmoor Consulting

Marc: You're listening to the American Banker podcast. This is Marc Hochstein, Editor-in-Chief of American Banker. Today it's my pleasure to speak with Todd Baker of Broadmoor Consulting. Todd, can you briefly give our listeners an introduction? You've had a long career in the banking industry, just so they can see a perspective.

Todd: Sure. My career has spanned most of modern U.S. financial services industry—I say this because I can remember when deposits were still regulated! I started out as a lawyer working on corporate and securities and bank regulatory matters on the West Coast, and had a major career as a West Coast financial services M&A and corporate lawyer for banks, finance companies and tech companies. Then around the turn of the last century, I flipped over to the business side and ran corporate strategy and corporate development (M&A) for three large banks: the first one, Washington Mutual; the second, TD Bank US; and the third, Union Bank and MUFG Americas. So I've worked over my career primarily with banks that had significant commercial and consumer banking businesses and with finance companies. My focus has been on business model strategy and how to find ways make things work in banking. Right now I'm also a Senior Fellow at the Mossavar-Rahmani Center for Business & Government at the Harvard Kennedy School doing some academically based work in this area.

Marc: I didn't realize that. That sounds really interesting. So we're talking today about retail banking and the profitability going forward of retail banking and you have a somewhat sobering thesis on this.

Todd: Yes. What I've said to you about this, Marc, in the past, is that the retail-banking model that has been so successful for so many years is really under stress because the banking industry hasn't found a way to make a profit off the middle market customer.

Marc: And when you're talking about middle market here, we're still talking within the consumer space?

Todd: Yes. The middle market consumers I'm talking about are regular people who are neither poor nor rich who need banking services and use banking services to manage their day-to-day lives. There are a number of reasons that the historic profitability of retail banking is eroding and I can go through them if you'd like.

Marc: Yeah.

Todd: So the first reason relates to the regulatory environment's impact on core retail banking profitability--and here I'm talking primarily about the branch systems, the deposit business, and associated revenues that come with that and not credit card lending or other asset-based businesses. If you look at the large branch systems that large banks have and the more limited branch systems of the regional banks and smaller banks, and if you do a profitability analysis, what you'd conclude is that most of the profit came from the wealthier customers who carried high balances and typically were taking multiple services from the bank-- they might have a mortgage, the might have a credit card-- but they always carried bigger balances and tended to use fee-based services offered by the bank. The second group that contributed to profitability was, ironically enough, the poorer customers, the customers who did not keep significant balances but used the bank overdraft function as a way to smooth their income and expense and deal with cash flow problems on a regular basis. So they typically generated a lot of overdraft fees and those fees were a significant driver of profitability in those branches. The folks in the middle didn't have a lot of balances but also didn't do a lot of overdrafts or use fee services. Providing banking services to the middle group, which didn't really pay its way in the same fashion, worked as long as there was sufficient revenue coming from the high end and the low end to support branch based services for everyone who walks through the door.

Marc: So effectively, the middle was being subsidized by the high and the low?

Todd: Yes. That's a phenomenon you see a lot in financial services businesses but it was quite striking here. Getting back to the regulatory point, in the aftermath of the financial crisis, some very significant changes were made in two regulatory areas. The most damaging area for the profitability of branches was what we call the Durbin Amendment, which was an effort to curb bank interchange fees for debit card transactions. It hit middle market consumer profitability the most because the one source of revenue that banks could generate effectively from middle market consumers was debit interchange—banks learned to encourage consumers to use debit cards because the fee paid on every debit transaction went directly to the profit center of the retail bank. As you know, the Durbin amendment essentially was a political fight between the large retailers and the banks, allegedly on the basis that the consumers were being overcharged, and the proponents that by changing the rule and capping interchange, consumers would benefit. But in fact it was essentially a zero sum game fight for revenue between the retailers and the banks and the banks lost. And as a result, a major piece of the income stream for banks over $10 billion (there was an exception for small banks in the Durbin Amendment) went away and that revenue stream had been supporting a lot of other services for middle market customers.

Marc: And this was part of the Dodd-Frank Act of 2010?

Todd: Yes, although it kind of existed outside of the Dodd-Frank crisis environment. It was something that had been pushed for political reasons by retailers and got wrapped into the whole Dodd-Frank story. The second major regulatory change was a focus in Dodd-Frank but also by the regulators--- particularly the CFPB but also the OCC, the FDIC, the Fed and the states--on restricting overdraft fee practices, which had become fairly abusive in terms of the way that transactions were ordered to maximize bank fee revenue. Many of the things that were being done to maximize fee revenue from overdrafts have been reversed in large banks under regulatory pressure. As a result, overdraft fee revenues, while still a very significant source of revenue for retail banks, are significantly lower and that makes serving poorer customers a less profitable business than it was previously. One can argue that that's a good thing from a public policy standpoint but it did affect the lower end of this "barbell" of retail banking revenue.

The second large trend has to do with interest rates. When you look at retail banking profitability from a bank's perspective, there are the fees, which we've discussed, but the primary benefit from having a retail branch system is the financial value of deposits. And deposits have financial value to the extent that they are lower cost, more predictable and stable than alternative sources of funding. And during most of my career and the career of anyone who has been active in the banking space in the last 30 years, interest rates were meaningfully above zero and the yield curve was positively sloped, meaning that short-term deposits cost less than long-term deposits. The slope of the yield curve and the fact that money had a time value is critically important because banks make most of their spread income off the difference between short-term and longer-term interest rates.

Marc: That will be the natural state of affairs?

Todd: Well, historically and in my lifetime, that has been the natural state of affairs in the United States, although we all should look to Japan as the alternative case. What has happened since the financial crisis, because of the large interventions by the central banks to maintain economic growth and because of the paralysis of the political sector, which is essentially not taking fiscal action which would potentially affect the interest rate environment, is that we've had seven or eight years of exceedingly low interest rates and generally a very flat yield curve with three-month LIBOR at 20-30 basis points ten-year rates flirting with 1½%. I can remember when ten-year rates were 12%. So the effect of this is that the natural benefit from a deposit, which is that it is lower cost and more predictable than other sources of borrowing for a bank, has been eliminated. Essentially, there is no benefit. Deposits cost almost nothing, but so does borrowing in the bond market. The whole raison d'être of a retail deposit banking system is to provide that low-cost stable source of funds, and over the last eight or nine years that benefit has been pretty much non-existent. I can give you a personal example-- in my years as a bank strategic planning guy, post-crisis, I probably did six three-year plans, and in the third year of every three-year plan, interest rates normalized, bank profits went back up, and it was all good. And every year that turned out not to be the case. We're now looking at a situation where, at least in the short term, I see no prospect of that changing. "Japanification" and deflation seem to be greater worries than inflation and there's little need for Fed action to raise interest rates to hold back inflationary pressures. So the question for all bank strategists today is whether the interest rate situation will ever change--or change within any relevant planning period--in a meaningful enough way to provide that lift to the core profitability of a bank branch system. If you'd asked me five years ago I would have said, "Certainly. It's all going to go back to normal and that core driver of retail branch profitability is going to be there." I no longer feel quite so certain.

The third major trend is digitization. As you know, I work out of the San Francisco Bay Area so I'm constantly dealing with Fintech companies and am an eyewitness to the growth of non-traditional and digitally based systems for delivery of financial services. When you look at today's retail banking delivery system, you've got a very expensive real estate-- on an ownership or lease basis-- which is supporting three things: transactions at the retail teller level, sales efforts from people in the branch trying to sell you products, and customer support so people who have problems can come in and get them solved.

Marc: And those transactions are getting fewer and fewer?

Todd: They are. The statistics are pretty striking about how few transactions are being done today in the branch. It's down to, oh, probably about 30% of total transactions are now branch-based and it's dropping rapidly. There are some customers, typically older customers, who don't want digitalization at all, but the vast majority of customers prefer using the ATM, online bill-pay and other electronic services. However, banks have also learned that customers want and need a place to go when they have a problem, and right now that means that they want to be able to go into a branch to talk to somebody.

Marc: Better than the interactive voice response system.

Todd: Yeah, although they'll use telephone banking and other services. What we've learned is that customers appreciate and use multi-channel approaches. The difficulty for banks is that if you have to provide all the cost base to support all those different channels, it's far more expensive than the situation in the past where the only channel was the branch channel and you did everything there--revenue and expense--and the costs of the physical plant was manageable because almost all the revenue associated with the retail branch system ran through the physical branch. Now banks understand that digitization is coming and, to a greater or lesser extent, they are accelerating their digital efforts and with good success. Customers are generally quite pleased with the new channels but the challenge is how-- without severely harming the profitability of the bank --you can manage a transition where you're going to have to be shrinking your branch footprint very substantially at the same time as supporting and investing in digital capabilities which are quite expensive to develop and deploy. How do you manage to both invest in your digitization and fund the reduction in your expense base without killing your earnings? Because one thing that is pretty clear is that when you're shutting things down, there's a significant financial cost.

Marc: Severance?

Todd: Yes, of course, and lease terminations and all the rest of that. So the banks are spending a tremendous amount of time thinking about this dilemma and working on it. But until the digital transition is entirely done that makes the core existing retail branch system a drag and reduces the profitability of the retail banking business. In theory, when the transition is complete, costs will go down because digitization should be cheaper than physical delivery. If you have 90% digitization and 10% physical delivery, that should be cheaper than the current situation. We have yet to see that benefit come through to the bottom line because right now the drag of the existing retail distribution system-- which is taking less and less transactions-- is overshadowing any benefit you might get from digitization. I w, ill say that I'm a little bit skeptical that digitization will be as inexpensive as we think because the rate of technological innovation in that area is so significant that there's a continuing investment to keep up. You may never get to that marvelous place where you have a zero incremental cost per transaction because you're always putting in the newest system, which costs a lot of money.

So those three trends taken together have severely hurt the overall profitability of retail banking, but particularly the profitability of retail banking related to that middle market consumer who does not generate enough revenue to offset the costs of delivery, whether through digital or physical needs. The hope is that digitization will provide cost benefits which will allow a much less expensive, but satisfactory to the customer, delivery system for retail banking so that middle market customers can continue to have deposits and relationships with banks that are profitable, but I don't think we're going to see that really come to fruition for a number of years.

Marc: How long do you think it will take?

Todd: Well, digital transformation efforts are accelerating at the large banks. There are challenges with them. One of the reasons the banks were slow in getting started is they were absolutely hamstrung by required technology investments to comply with Dodd-Frank--enormous, enormous costs. During that interim period, Fintech players took advantage of the inability of the banks to turn to fixing their own digital house and became quite prominent (at least from a press standpoint) in introducing digital banking alternatives. The banks now are turning the battleship and working pretty hard to accelerate digitization. There's a lot of differentiation in how well people are doing it. Wells Fargo, BBVA, some other regional banks, have been pretty good -- Regions for example. JP Morgan has been excellent, really. The smaller banks are having a challenge because it costs a lot and so they're looking at partnerships and other ways to digitize. There are new companies coming out that are providing alternatives to existing core systems, which is an important way in which banks can try to adapt to digitization more quickly. But really there's a cultural issue as well -- it's very hard for large bureaucratic risk-managed organizations (which banks are) to change quickly.

Marc: It's not Facebook where you break things and fail things.

Todd: No, you can't do that and post Dodd-Frank, well; some might say that the stranglehold of the risk management culture on innovation in banks has been the real culprit. That balance of risk and innovation is going to get a little bit better because the financial returns of the banks are so stressed, in that very few banks are earning their cost of capital currently, and something has change. Returns on bank equity have to exceed 10% or 11%, at least in theory, to be economically beneficial to shareholders and it's only a minority of banks that have been able to do that. So that financial and stock market dynamic will push them hard to move faster--and they are beginning to move faster--but the whole process of figuring out the new branch model and finding that proper point between some level of physical delivery and availability and full digitization will probably take the next decade to complete itself in the large banks and longer in the small ones. In the meantime, there will be lots of innovation and some loss of revenues to insurgent tech companies but I think that, although the banks will always be slow adopters, they will ultimately adopt these strategies, will adopt these technologies, will adopt a new branch model, and eventually get themselves to the point where they earn more than their cost of capital.

The wild card for all of this is the interest rate question because if banks have to adapt to new paradigm where the yield curve does not provide significant benefit to them, then they really have to think hard about the entire model for delivery of financial services. Deposits will then be fundamentally less valuable to banks and banks' inherent competitive advantage tied to deposits will be less meaningful.

Marc: So in the meantime, while we're going through this transition phase, what does that mean in terms of the bank's treatment and outreach toward that middle class customer? Are they all going to try to be First Republic now?

Todd: You have seen a lot of that in banks and you see it in all areas of our culture, because the profit pools in financial services are primarily at the high end. I don't know how many McKinsey or Bain or BCG presentations I've seen making that point. So there's a lot of attention on companies like First Republic, or SoFi in the Fintech space, the robo advisors, all enterprises focused on those who have money, the 1% or the 10%, depending on how you want to look at it. And then there are those who are actively pursuing profitability opportunities with low-income people because the nature of our financial system means that one can make a great deal of money lending money at 40% to consumers, 30% of whom will default and have their lives ruined in the process. So there is a lot of money being made at the two ends and that is where naturally new investment money is going. No one has successfully created a financial business focused solely on that broader middle market. You do see some people working in the high end of the middle market and the low end of the wealthy market, people who have found ways—Schwab, Lending Club and others--to serve a wide variety of consumers who have some money. We all have to be honest about the question of wealth distribution in the country and see that the vast majority of the wealth is in a relatively small slice of the population. And so, in banking, you go after the wealth. Or --and this type of activity is largely by financial companies outside of the banking system--you can serve the most stressed customers at very high cost to them. You can earn quite a lot of money doing that. The banks are largely staying out of that but other financial players are there.

Marc: So everyone else will still be--it's not like the middle will be shut out of the bank account but they're not going to be courted actively?

Todd: No I think you are right about that as it would be very hard for regulated banks to just drop most of the population. What I would expect to see--and I'm really surprised that I haven't seen--is very active efforts by banks to educate those middle market customers out of physical channels and into digital channels. It's highly beneficial for the bank to get any customer to use the digital or telephone or non-physical channels, but even more so for less profitable customers. I anticipate that we will see increased efforts to try to convince particularly older and lower middle income folks who typically are not big digital adopters to use mobile devices--mobile devices in the case of younger people and computers in the case of the older people--and so shift most of their banking activity outside of the branch. You'll recall that this is not a new issue around branches. Probably 20 years ago, the old Wells Fargo-- the San Francisco based Wells Fargo at the time--attempted to charge people for using the branch. This was because they wanted to push people into cheaper channels. Well, I think punitive activity is not likely to do it for banks--that was a big failure and a big public relations mess for Wells.

Marc: And then more recently, it was Bank of America with the $5 debit card, right?

Todd: Right. And so although you'll continue see efforts to use fees to try to push people into preferred channels, I think the banks would be far more successful using carrots rather than sticks -- things like helping train older people to use mobile devices for banking. I would expect to see a great deal of activity in that area. It's challenging for the banks because right now they are so financially--and this is a little bit of an exaggeration--but they're financially stressed insofar as they are not satisfying Wall Street and fundamental financial metrics around return on equity. But when they get to a point where this challenge around managing branch transition and expenses is killing them, I think they'll conclude that an investment in accelerating digital adoption by their customers is probably the best thing they can be doing to cut costs.

Marc: It's funny when you talk about the sort of the lackluster financial performance in the sector. Right now as we're talking it's the week of the Democratic Convention in Philadelphia and both at this convention and last week at the Republican's in Cleveland, there's been a lot of banker bashing from the stage. And granted they are talking about Wall Street which often, in the public discourse, gets conflated with retail banking but there seems to be this impression you get from the rhetoric that the banking industry is once again making out like proverbial bandits and the picture that you're painting like having actually worked with the institutions and looked at their books is that it's much more kind of mediocre.

Todd: That's true. I think what's going on in the political realm has very little to do with what's actually going on in banking. The financial crisis created this concept or this belief that the bailout unjustly enriched not just bank shareholders but bank managers, and I think what you're seeing is banks have really become just symbols of the income distribution disparity in the country. People are using banks as a metaphor because it's a convenient way to encapsulate the idea that some people are doing well when other people aren't. And it's true that bank managers tend to be in the upper income brackets and it's pretty clear Wall Street people, hedge funders, and others are all sort of thrown in with banks in this discourse which really doesn't have much to do with actual banking. A good recent example is Tim Kaine, who was being criticized from the left because he'd signed a letter that said, "Geez, we really ought to let small community banks have a little more leeway in the regulatory process than the giant banks." A perfectly reasonable position, but because the word "bank" was attached, even though it's about First National Bank of my hometown-- one branch and all my buddies working there-- he was treated as if he had suggested that the big banks should be bailed out again, when he was really talking about small community banks. So the political discourse has lost all connection to the reality of the banking business. I think in many ways, the traditional banking business was badly damaged from a public relations standpoint by the combination of investment banking and commercial banking through the repeal of Glass-Steagall because now everyone in the banking business is treated as if they are sitting on Wall Street in One State Street Plaza. There is very little that can be done about that. Educating the greater public about these issues is pretty hopeless in the current environment. So my advice for the banking industry is hunker down, try to focus on what you can do in your own business because you're not really going to be able to affect the political discourse around this. It's surprising to see the level of hostility that the very word "bank" raises in today's society.

Marc: One more thing I would like to get your perspective on as someone who's worked inside financial stations especially someone who has done business planning and strategic planning. So recently Jamie Diamond was part of a group that put forward a document basically arguing against the use of earnings guidance by public listed corporations and I think part of the rationale here is that they think that it encourages short-termism. What's your take?

Todd: Well, I certainly agree with the overall view that the myopic approach of sell-side analysts on Wall Street, who are essentially compensated based on their ability to predict earnings effectively, creates pressure from them on banks and all other companies to provide very specific earnings guidance and that then encourages short-term actions and trading around whisper numbers and other things leading up to earnings releases, and is generally a bad thing for the financial markets in the country. But it's a small part of a larger picture. There's a need for regular trading in order to establish prices and make the market work efficiently, but we have gone well past that to a place where tiny price and timing variations when multiplied by massive amounts of electronic-based trading make it possible to make a great deal of money or lose a great deal of money based on these very small variances that occur around earnings time—like the difference between reporting 49 cents a share and 48½ cents a share. The focus has shifted over time to short-term results; that's clearly not good and creates useless volatility. This is not a recent problem. It's been a problem for the last 30 or 40 years. Many efforts have been made over time to curb this. You'll recall that the difference between short-term capital gains and long-term capital gains in the tax code was essentially an effort to encourage people to hold investments longer. So this is a problem that has been around for a while but the argument that it's damaging to long-term investment I think is true. To go back to an earlier point, we talked about investments in retail branches and the speed of digitization, and the thing to do is to go all in for digitization today, right? If you were a bank and you didn't care about next quarter's earnings but cared about earnings two years from now, you would go all in for digitization and take the pain on reducing the branch system as soon as you possibly could. But because you are so focused, and everyone around you is so focused, on what you're making next quarter and whether it's 49 cents or 481/2 cents, you're very cautious about making those necessary investments for the future to the extent that they have any impact on today's earnings, even though an intelligent person would say: "I want you to become efficient earlier rather than later. I want you to adopt digitization. I want you to move as fast as you possibly can and I'm willing to take the short-term pain because I want you to be profitable five years from now." Well, that's not happening when Jamie or anyone else has to get up there and take an enormous amount of heat because he spent $50 million too much on digitization and that takes the number from 49 cents to 481/2 cents.

Marc: I always think of this famous Stanford marshmallow experiment where you tell the kid, "Okay, here's a marshmallow. You can have one marshmallow right now or you can wait 15 minutes and you can have two marshmallows." And supposedly and I know the idea has been question, but supposedly the kids who weighted 15 minutes for two marshmallows were more successful in life. And so the question is how do you turn people from marshmallow takers into those who are willing to wait?

Todd: Right. And our whole trading system, what with the rise of electronic trading and speed trading and all that stuff, really doesn't encourage marshmallow self-control. I think the other big impact is the explosion of hedge funds and private capital vehicles, which are not at all interested in long-term investments, looking only at a three to six month horizon, and very focused on short-term movements in stock price.

Marc: Because they need Alpha.

Todd: Absolutely. And getting Alpha means Alpha now It's fine to promise somebody you'll have Alpha five years from now but nobody's going to invest in your hedge fund on that basis. Private equity on the other hand really does look at generating Alpha on the longer-time horizon. But the enormous amount of money in hedge funds and the need for hedge funds to focus on short-term results is a big change from the past. If you look back in history to 30 years ago, there were nowhere near the number of private capital vehicles that had as much influence as they do today in the stock market.

Marc: Does that ultimately trace back to monetary policy as well?

Todd: Well, a lot of things--bad things or distorting things--are happening in the markets because of monetary policy. Today there are no--well, I shouldn't say there are none, but finding relatively safe investments that yield anything in the debt markets is difficult. So you can go to risky junk bonds. You can go to marketplace loans currently. Deposits are not good. Investment grade bonds are not good. Government bonds are terrible. And there are a large number of places in the world in which a steady stream of not particularly exciting but at least meaningful income on fixed income investments is an important part of the financial structure—think pension funds. And the market distortions come as investors chase that yield and distort risk-return assessments. One can argue that the problems in the marketplace lending business are tied to short-term yield chasing by institutional investors and if you look at equity activity, everyone's trying to deliver short-term benefit through aggressive equity trading and activism. You're also seeing sector shifts towards dividend paying stocks and a variety of things that are happening that are really tied to what one would argue is an artificial repression of interest rates in order to support the global economy through rate action alone. The fiscal side is still unwilling to live up to its part of the bargain and do stimulus and other things that would stimulate an economic activity without necessarily having interest rates at zero. So there's a lot of distortion in here, and that is part of the reason that retail banks are having difficulty with their profit model because you can only pay zero on deposits and spreads get compressed. And so I'd say that overall, we continue to be at a delicate place in the world economy. This not going to resolve quickly and it looks like it is spinning off not only distortions in investment activity but also in political activity—political distortions like we're seeing around the world that are likely to add volatility to the political environment and lessen the likelihood that governments will do fiscal things that are needed to take some of the pressure off the central banks trying to hold up the world on their own.

Marc: Thank you, Todd Baker. For American Banker, this is Marc Hochstein saying patience is a virtue.

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