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After the Perfect Storm – Transitioning to a Tough New World

Awaiting Publication

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Many regional bank CEOs have stabilized their banks after the crisis of 2008-9 through addressing credit quality issues, managing NPAs and raising capital in the newly rigorous regulatory context. Heading into 2011, the question will be whether and how they can lead their banks back to sustained earnings momentum.

Over the next several years, maintaining independence for regional banks will depend on gaining or buying market share in a potentially stagnant economy. The reasons for this are not hard to fathom:

- Loan growth is projected to remain anemic;
- Net interest margin may well be pressured as interest rates potentially rise over time increasing funding costs, and as banks compete fiercely on price for a smaller loan pie;
- Growth is therefore likely to depend not on primary demand growth but on capturing or buying market share; and,
- Profitability will be driven by an ever-increasing need for greater effectiveness and efficiency.

Yet, this environment offers real opportunity for high performance banks as earnings pressures show no sign of easing up, and, many bank Boards are becoming far more open to selling their banks at reasonable multiples. Meanwhile, the market is at last rewarding high performance banks with much higher P/E multiples (and penalizing under-performers) giving them acquisition currency to avoid or minimize earnings dilution from M&A transactions. And, many non-bank players like CIT Group and GE Capital Corp have exited the market, removing excess capacity.

The broader emerging macro-economic scenario is one of US consumers managing down their balance sheets on the one hand, and perhaps an export-led commercial credit growth phase on the other. The resulting focus for regional banks may be primarily in C&I lending to small and middle market business segments, with potential also in the auto loan and credit card markets given the gap left by the exit of non-bank credit sources. Whatever specific dynamics actually unfold over the next few years, high performance banks are developing a flexible set of business approaches and operating infrastructures to respond to them.

Stagnant Loan Growth?

The prospect of an extended period of slow loan growth should not be a surprise as the US economy comes out of a protracted and deep recession. Historically, loan growth has lagged the business cycle by two to four years and this time will be no different. Just prior to the last recession in 2001, C&I loans peaked at $1.1 trillion. The recession was short and ended by the fall of 2001, but the decline in C&I loans continued until the second quarter of 2004, reaching a low of $880 billion, a 20% decline. By that measure, C&I lending, which reached a peak of $1.6 trillion in the fall of 2008, would not see a meaningful recovery before at least early 2012. However, this does not take into account the fact that the latest recession was much deeper and more balance-sheet driven than earlier downturns. The economy can be expected to have an extended recovery period, perhaps well into 2013. A key question on the regional bank CEO's mind is then: when will the credit cycle truly turn positive?

<u>What will be different in this post recession phase?</u>

Even as regional banks stabilize themselves by managing down non-performing assets from the previous cycle, there is an additional hurdle to cross: additional regulatory capital requirements. To satisfy the Basel III Tier 1 Common capital requirement of 9.5%, US regionals, based on second quarter 2010 asset holdings, may require an infusion of as much as $4.5 billion in additional capital over and above the capital required to manage down non-performing assets over the next few years. The challenge of raising capital in a stagnant loan market will be another driver for high performance banks to seek increased earnings momentum by gaining or buying market share. This, in turn, will accelerate consolidation among regional banks. In this environment, in order to keep their banks independent, developing effective and efficient business approaches and operating platforms for organic and acquisition led growth will be critical for regional bank CEOs and their leadership teams.

There are no short cuts to becoming a high performance bank. Five core performance levers are being operated by successful bank leadership teams:

Know Your Strategy: Growth, both organic and through acquisition, is being driven off well thought-out and planned strategies rather than opportunistic, unplanned initiatives.

Focus on the Customer: In a slow growing market, gaining share is integral to high performance. Retaining and acquiring customers is therefore critical. However, increasingly sophisticated tools for managing customer relationships are progressively available to players of all sizes. Effectively sustaining a totally customer centric perspective is the crux of an end-to-end design that will enable superior customer retention and penetration.

Focus on Execution: Even the best planned strategies will fail if not executed well. Success in execution requires a distinctive set of business approaches and clinically designed operating platforms, processes and systems that draw upon a robust pool of talent within a structure that supports the bank's strategic priorities. Moreover, freeing up and reallocating costs to more value adding businesses requires capitalizing on opportunities to consolidate, streamline and automate business processes and functions to support new areas. Design and execution of such efficiency initiatives need to be done intelligently and pro-actively – rather than through arbitrary cost cutting for short term, financial window-dressing.

Effectively Measure and Track: Monitoring and managing to key performance measures of success in achieving strategic objectives (including customer and employee satisfaction, process change achievement and financial impact) are an integral part of high performance – "If you track it, it will happen."

Developing M&A Into a Core Competency: A systematic approach to M&A with three components is required to ensure effective acquisition-led growth. First, target identification requires a clearly defined M&A strategy and a disciplined evaluation of potential targets. Secondly, sophisticated due diligence validates strategic fit and defines integration objectives and economics while mitigating risk and maximizing upside. Thirdly, strategic integration (as opposed to the normal mere physical integration) clinically manages the transition of customers to the new bank.

The successful application of these five core operating levers creates the strategic effectiveness and operating efficiencies that differentiate high performance regional banks from their peers. A stellar example of such focus is First Niagara Financial Group. Since 2005, First Niagara has grown from $8 billion in assets to a pro-forma $29 billion for 2011 (following the completion of the latest of three major acquisitions: New Alliance of New Haven, Connecticut). They have delivered a 10% total return to shareholders versus an SNL bank index return of negative 45%; and disciplined expense management driving an efficiency ratio consistently in the mid-to-low 50s. Meanwhile, their brand value and customer and employee loyalty ratios have skyrocketed. All this from a clear strategy, driven by customer centricity, and executed with extraordinary effectiveness and efficiency both in the core bank's organic growth and its rigorously disciplined acquisition program.

Outstanding performance is at long last being rewarded with differentiated market valuation and extraordinary opportunities for growth. 2011, as a result, is shaping up to be a decisive year of opportunity for regional bank CEO's who have survived the "perfect storm" and have the appetite (the will and the skill) to excel.

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