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Why banking will make big profits again – and when

What is the future of banking? Will banking be profitable again? Every day I am asked this question. (Archive article from 2009)

Around 25% of my work over the last decade has been with some of the largest banks in the world, and they, together with global investors, are anxious about the future. And the answer will vary depending on what kind of banking you are talking about, and what country you are in. But we can see general principles, and plenty of opportunities for profitable banking in future.

Some say that the current crisis spells the death of old-style banking. “Financial services will never again make the same kind of returns for shareholders. New regulations will kill innovation and talented bankers will go into other industries.”

It is a fact that whatever a trend is, human nature tends to see it continuing. So when markets rise, most investors carry on buying. When it falls, most people cannot imagine (as) good times again. And we see the same investor "feelings" about banking - which is one reason for the low share price valuations. So what is the reality? What should we expect?

When will banking recover?

Firstly, we need to realise that banking cannot recover fully until house prices start rising again - probably by 2010, maybe early 2011 in the US and UK. This is for one simple reason: banks need to know the value of their assets in order to know how much they can lend. In a falling market, assets shrink, and bad debts rise.

You might think a bank could do a daily calculation about these things, but in practice it takes many months to revalue a bank’s assets. That is because the packages of assets and liabilities is so complex for most banks, sold and resold to each other around the world.

So we need to wait probably for at least six months after house prices stabilise and start to rise, before the boards of banks will start to breath easily again. As prices rise, we will see a more general recovery in the economy. We will also see a stampede of new borrowing demand, as people rush back into property markets, snapping up bargains.

And we will see a stampede of lenders wanting to rebuild their customer bases.

Once banks become convinced that the market is recovering, they are likely to take a view that property prices will go on rising for several years. And the further prices fall at the worst point, the more likely they will take the view that the bounce back will be huge. At that point we will see banks starting to lend higher proportions of purchase prices once again – maybe 85% or more – with some of the risk carried on insurance, just in case prices go into reverse.

Return on your capital invested rises as share price falls

If a bank makes $500m profit in a year, the big issue for investors is this: what is the actual return on investment for every $100 tied up in the stocks? Answer: the lower the share price, the higher the return.

If the bank’s shares dive to – say – 10% of their previous value, and earnings per share remain the same, an investor will see ten times as much income per $100 of investment as they would have done.

But that is exactly what has happened. Banking stocks crashed – very painful to those who owned those shares at the peak of the market, but very attractive possibly to new investors who are going to have to put up a very small amount now to buy a share, and with it a proportion of all future profits.

Yes, profits have also crashed and are likely to remain far lower than in the past, but are likely to recover, as we will see.

Of course we also need to take into account the actual value of the capital invested, as share prices change. But our purpose here is to answer the question about profitability alone, not to confuse it with questions about future value of banking stocks.

And we also need to remember that if share price falls, then the ability of the bank to lend may also fall, as it affects the amount of capital the bank has as a safety net. And in turn, restrictions on lending may damage profits.

Our world will continue to need banks

As we have seen in the current crisis, banking is vital to a nation's future. Banks are as important as hospitals, schools, roads and railways. Without banks, business and personal life quickly grinds to a halt in developed nations where finance needs to flow quickly and easily.

So banks have a great future and it is utter nonsense to suggest that the era of big banking is over. Indeed, as some banks have failed and others have merged, competition has melted away, and in every industry that means one thing: price rises and greater profits.

It is true that some banking activities such as investment banking may make less profits in future - at least for a while - but as HSBC has shown, there is plenty of money to be made out of traditional banking activities such as retail and small to medium commercial banking.

Bank charges will rise

In the past, investors were willing to lend huge amounts of capital to banks at relatively low cost (allowing for inflation), which banks in turn were able to lend out, or invest in various ventures. Banks are going to have to pay more for the money they borrow in future. And the amount of capital they have to keep will also grow, as a proportion of their total loan commitments, forced on them by new regulations.

But at the same time there will be no limits in future to the charges that banks can make to customers. They will charge whatever they like for a wide range of services, whether arrangement fees for home loans, credit card transactions, cash withdrawals, overdrafts, commercial loans and so on.

The entire banking community can decide to price their products higher, preventing people from wandering off to get much better deals. And that is exactly what has been happening.

Take home loans in the UK. I recently phoned the largest mortgage broker in the country for the best deal on a buy to let mortgage, for a flat containing 5 students. With a maximum loan to value of 75%, their arrangement fee alone was going to be nearly 9% of the amount secured. Plus interest rates set at nearly 4% above the bank base rate. Similar rates two years ago would have been zero fee and 1.5% above base rate.

Now these new charges are impossibly high (most borrowers will just walk away) and will come down, for the simple reason that the margins are high enough now for other banks to be willing to take a little less profit out of such a deal. But the principle remains. Banking is likely to be more expensive in future – and more profitable on such arrangements.

Future of retail banking

Many countries in developed nations are "over-banked". Despite some bank closures, there are still far too many small banks - especially in countries like America. That means extra costs. There are too many retail outlets - bricks and mortar bank branches are expensive to maintain, and increasingly unnecessary for retail banking. Many banks have been re-inventing local branches as specialist advisory centres for financial services products such as pensions, life insurance, larger mortgages and home loans. But even so, expect consolidation - either bank mergers, or branch mergers of the same bank.

Technology is a huge cost for banking and here again we can expect pressures to save cost through mergers. For example it is a massive task to keep up to date with all the latest options for online banking, using mobile devices and so on. Smaller banks can easily get left behind, and are also unable to invest in next-generation call centres or customer management systems.

So we can expect retail banking to continue a relentless shift from face to face to online.

At the same time, expect non-banking competition to grow, as companies like Wal-Mart, Tesco, Carrefour and others look to grab market share by encouraging their existing customers to bank with them. We will see these companies provide most services online, and deposits / withdrawals provided in local stores at very low cost.

So retail banking will employ less people, charge more for services, and see more non-banking competitors, attracted by the profits that retail banks are making (again).

Future of investment banking

People say – “What about investment banking? Surely that is where the real money was made in the past, and those days are now over.” Once again, the answer is not so simple.

Our world will continue to need big finance to pull off the largest commercial deals. Mergers and acquisitions will still need access to major funding – whether in loans or capital investment. Our globalised world will see a frenzy of mega-deals, mergers and break-ups, as business lurches into the next chapter of the twenty first century. All these deals will generate arrangement fees, financing charges and a host of related earnings.

Yes it is true that banks will have to use much more of their own money in such deals, rather than borrowing almost all of it. That will reduce earnings per dollar invested in good times, but also reduce losses per dollar invested in bad. There will be less gearing. Less people making millions of dollars overnight, and less people losing millions of dollars during a single day.

Future of private banking

Private banking services for high net worth individuals will continue to grow rapidly. Even though total wealth of private banking clients has fallen in many nations, every year there are another few million who enter this category due to the rise of emerging economies, and the rapid growth of many family-owned businesses. So private banking will continue.

Expect however a shift from free advice and charging on activity, to charging for advice which is truly independent. Expect also a shift from managing people's investments, to co-managing as wealthy individuals become more actively involved in how their money is used. Expect a revolution over the next decade as trillions of dollars moves down a generation, mainly from women who die over the age of 80, to her children who may not yet have retired, and who have very different attitudes and priorities.

New banking products and services will make money

And then there will be new financial products and services. We will see a massive amount of innovation in the next decade for two reasons. Firstly, history shows that whenever new regulations come in, there is a rush of activity to find ways round them. Expect this to happen even more so after huge numbers of new regulations come into force during 2010-2011.

Secondly, the world itself is changing. Technology is opening up vast new horizons to reinvent financial products. Take for example new partnerships between mobile phone companies and banks. Within the next decade we could see a new world order where almost all financial transactions are conducted in developed nations using mobile devices in people's pockets and bank cards have been consigned to history.

Radical shifts like this will create huge opportunities for new profitable banking business, with major threats to traditional players.

New markets are also emerging. Look at how carbon trading has grown. Almost unheard of just five years ago, the value of carbon credits (permission to emit CO_2) is already a market of over $80 billion a year.

Profitable for carbon traders.

History shows that owners of banks tend to make money

So then, many banks will make great profits in future. If banking shares remain lower in value than in the past, earnings per share may in some cases be correspondingly greater than they would have been. And banks will charge far more than in the past for the services they provide to the community.

History shows that owners of banks have always tended to be in a powerful negotiating position and have usually made money in most years. They will do so again. In the past, owners of banks had to factor risk into their investments in banking, because there was always the possibility that a large bank might fail. Indeed history shows us that every bank eventually fails - unless it is bought by another bank or rescued by government.

Recent government action has shown that such failures will rarely be allowed to happen in future, while the risks of banking shocks will also be far less because of the new rules requiring banks to hold much more capital.

So owning shares in banking will be a less exciting and less nerve-wracking experience than in the past.

Investors who still fear that they will never make the returns on banking shares that they made in the past, have missed one vital fact. Those inflated returns were only made by taking on much greater risks than those investors realised. If those investors had properly priced those risks into their valuations of their banking stocks, they would have realised that their banking shares were not really as valuable as their booming share prices suggested. There are no free lunches. Over-performing shares in any industry should always be considered to contain hidden risks unless otherwise proven.

Those who are heavy users of banks rather than owners of them, who rely most on banks for deals which stretch them to the limit, will as always pay for that privilege, for the risk the bank is taking. As always, banks will take every opportunity to make profit out of such arrangements, even after allowing for the costs of covering losses on bad debts.

And banking share prices? Expect great variation in recovery, but one thing is certain. Some investors will do very well out of investing in banks, over the next decade. The big questions is: which ones.

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