Bauerle's Bank Notes

Transformers

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Consultancy McKinsey & Co. recently released its annual forecast for retail banking just as PNC Bank unveiled its new headquarters building. PNC touted the new building's "green" and democratic features. The Pittsburgh Post-Gazette wrote, "Unlike most top executives perched in offices high above the troops, CEO William Demchak and his team will occupy a floor about midway up the building. That's the way Mr. Demchak wanted it. 'I didn't want people to feel like they were coming up to the important people floor,' he said."[i]

As a recipient of the McKinsey report, Demchak is keenly aware of the challenges ahead for even the largest banks. According to Toronto's The Globe and Mail[ii]:

- More than 12,000 start-up companies have been created with the goal of hijacking the revenue and profit streams of America's >7,500 banks.

- "Consumer finance - the banks' core business of deposit taking and lending - is deemed the most at-risk: McKinsey estimates that 60 per cent of profit and 40 per cent of revenue could disappear by 2025, though the impact could vary by country. In dollar terms, $674-billion in global bank revenue would shrink to less than $400-billion."

- "The threat, McKinsey argues, isn't that new players will take balances away from the banks, but rather will take over the customer relationship and sales opportunities as disruption kicks in and migration toward non-bank services grows exponentially."

- "Bank profit from payments could slip by 35 per cent as companies such as Apple Inc. and Google Inc. capture market share with mobile-payment services that allow consumers to make small purchases with their smartphones. Profit from corporate lending, wealth management and mortgages will also fall by 20 per cent to 35 per cent, the report said."

- " 'The consequences for banks are quite dramatic,' McKinsey said in its report. 'The substantial value that banks generate from distribution may be captured by others. Margins will come under pressure, and the customer relationship, a platform from which banks sell other, higher-margin, fee-based products, will be weakened or might even disappear.' "

Demchak's Post-Gazette interview paints an optimistic picture. Banks have ample capital, trusted brands, stand by their customers in the face of cyber fraud and continue to trim their expense base by closing branches and cutting payrolls. Meanwhile, said Demchak, fear that PNC will be acquired, which gripped bank employees a dozen years ago, is a distant memory. "It would be next to impossible from a regulatory standpoint for someone to buy us simply because [regulators] are concerned already about the size of the big banks," he said.

In our view, the oligopoly position of the nation's largest banks is what makes them most vulnerable to fresh competition. The paradigm exists just six city blocks from PNC's new headquarters. Sixty-five stories high, the U.S. Steel Building opened in 1970. Its 2.3 million square feet were designed to accommodate the company's 7,000 Pittsburgh-based white collar employees, with room for 2,000 more as business grew. Employment peaked five years later. When U.S. Steel's new 250,000 square foot corporate office opens in 2017, it will be home to just 800-1,000 employees.

What happened in between has been thoughtfully chronicled elsewhere. In short, demand for steel grew modestly, in synch with GDP. Meanwhile, U.S. Steel and the other integrated steel manufacturers experienced rising costs they could afford only so long as they operated an oligopoly. Competitors like domestic mini-mills and foreign producers came to market with lower costs, new technology that enabled greater operating efficiency, and no obligations for environmental remediation of air and water pollution.

As Mr. Demchak correctly notes, regulatory barriers make further consolidation among the nation's largest banks unlikely for now. The same constraints, however, impede banks' competitiveness in the face of the 12,000 companies that are bent on creatively destroying the banking industry as we know it. Since the crisis of 2008, the largest banks have invested heavily to satisfy regulatory requirements. The first quarter 2015 earnings call of The Bank of New York Mellon illustrates the point. Ninety percent of the call was devoted to discussing expense saving and regulatory compliance initiatives. Not on the agenda was growth of the business.

The fault is not that of financial regulators alone. At least as culpable are some, but not all, bank employees who devote their days to preserving what they have and not rocking the boat. Demchak knows that. So does Jamie Dimon when he said in J.P.Morgan's annual report that financial technology companies are a serious threat, even to the bank whose name is synonymous with American capitalism.

Commercial office buildings are the mines and mills of the knowledge economy. PNC's new headquarters is a bold statement by a bank that aspires to change with the times. Our hope is that they can use the change of venue to their, and our, benefit. For according to the McKinsey report, the alternative is ugly: "Those that do not seek to transform may well become somewhat digitized, but will likely be stuck in the middle - outwardly modern, inwardly struggling, and moving slowly toward extinction."

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[i] http://www.post-gazette.com/business/development/2015/10/01/PNC-s-CEO-eyes-fresh-symbolism-ahead-of-move-to-new-building/stories/201510010079
[ii] http://www.theglobeandmail.com/report-on-business/fintech-startups-pose-threat-to-traditional-banks-retail-profit/article26587892/