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How regional and mid-cap banks are driving growth

LESSONS FOR BANKING LEADERS FROM INDUSTRY INNOVATORS

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Competition in the banking sector is incredibly high. Plus, deposits are shrinking, interest rates are going up, and inflation is making its presence felt. In this environment, many regional and mid-cap banks are struggling to drive growth because the cost of funds has increased, and capital requirements have become tighter.

In light of several recent high-profile bank failures, there's also a trend toward capital flight from smaller regional banks to larger, more established institutions. But the competition doesn't stop there. neobanks and fintech continue to disrupt the landscape, making it more challenging than ever for smaller, regional banks (<$50B in assets) to compete.

With all these headwinds comes change. Experts are predicting further consolidation in the financial services industry that will significantly reduce the number of independent banks and continue the expansion of regional and super-regional institutions. Drawing parallels between the high rate of M&A among savings and loan associations (S&Ls) in the late 1980s, the market is ripe for another major sector consolidation. In fact, more than 400 banks reported unrealized losses in their security portfolios, at the end of 2022, that amounted to at least 50% of their core equity capital, making them prime targets for acquisition.

In Brief

Based on real-world case studies, there are four key ways banks can achieve real growth right now:

1. Consider adding specific and specialized market segments to satisfy consumer preferences and needs.
2. Reimagine the role of your bank within the financial services ecosystem.
3. Drive towards a frictionless customer experience to generate and sustain strong customer relationships.
4. Seek strategic opportunities for mergers and acquisitions (M&A) to expand geography, capabilities, and resources.

In this highly competitive environment in which consumer expectations and preferences are shifting rapidly and consolidation feels imminent, the institutions that are able to balance the short-term need for deposits and the long-term need for a customer-focused and differentiated strategy are the ones that will succeed.

4 high-impact, growth-driving levers for regional and mid-cap banks

For banks that are looking to expand their growth strategy and maintain their market share, we've identified four key levers to consider along with real-world case studies.

1. Consider adding specific and specialized market segments to satisfy consumer preferences and needs.

Most banks are trying to grow faster than their peers. To do this, their products and services need to be more competitive. Historically, banks focused on being more convenient, through their branch or ATM locations, and while this is still a viable play for community banks, larger regional banks must reconsider who they serve and why their offerings are more compelling than any other banks focused on the same customers. When banks narrow their focus to zero in on a specific, ideally underserved, market segment, they can gain a deeper understanding of what that customer wants. This knowledge, in theory, should help them to create superior products or offerings while also tailoring their marketing, messaging, sales, etc. to the preferences of this group.

Let's look at a couple of examples of banks with a distinct focus on specific market segments:

- Zion Bancorp recently expanded into a new market with the release of their Zifi brand, a digital bank that caters specifically to small and medium-sized business (SMBs), sole proprietors, and contractors. This new venture offers services like invoicing and bidding that speak to the needs and pain points of this specialized market segment.

- KeyBank acquired student loan refinancing fintech Laurel Road and repurposed it as a digital bank for medical professionals. New offerings seek to help doctors pay down debt, enhance work-life balance, and plan for the future.

The strategy is to identify a group with unique needs such that you have a differentiated proposition. However, as we all learned from the Silicon Valley Bank failure, you must also have a thorough understanding of any potentially detrimental nuances associated with a proposed market segment in terms of how they might behave under different circumstances.

2. Reimagine the role of your bank within the financial services ecosystem.

What it means to operate within the financial services industry has shifted dramatically over the last few years. Just think about how the landscape has been altered by the emergence of fintech, banking as a service (BaaS), AI, and other digital innovations.

Traditional midcap banks are still entirely viable, but the banks that are going to thrive in the long term are those that are willing to be flexible about their operating models, offering suites, and go-to-market strategies. Those that aren't evolving may find themselves at a distinct disadvantage.

Let's look at a couple of examples of banks reimagining their roles:

- Cross River Bank, a pioneer in the Banking as a Service offering, is now going to market as a technology provider that shoulders compliance for its customers. Major fintech players like Affirm, Stripe, and Square provide banking accounts to their users via Cross River's charter. In fact, the bank raised $250M in deposits over the course of six months by working with fintechs to expedite the process of enrollment.

- SouthState Bank has adopted a cloud-based solution from Volante Technologies to allow it to offer faster and more flexible payment options to customers. Recently, regional banks have struggled to keep up with larger institutions' innovative payment offerings in response to shifting consumer expectations, but this move enables SouthState to compete in this market.

The key to successfully deploying this lever is to embrace new entrants as potential partners for the next iteration of your business model. Rather than thinking about them strictly as the competition, reframe your mindset to consider the opportunities to join forces to create something greater than either of you could achieve alone.

3. Drive towards a frictionless customer experience to generate and sustain strong customer relationships.

Customer experience has long been a hot topic in the banking sector, as banks struggle to keep up with the exceptional precedent set by the retail industry. Lagging adoption of digital technologies, automation, and artificial intelligence has similarly stymied banks' ability to generate and sustain meaningful long-term relationships with customers in a digital age.

Yet, some forward-thinking regional and mid-cap banks are innovating the ways they engage with their constituencies by offering new and exciting experiences that take advantage of innovation and best practices from other industries.

Let's look at a couple of examples of banks removing friction from the customer experience:

- First National Bank of Omaha (FNBO) personalized their digital app experience for customers by linking them with a personal banker upon login. This measure effectively eliminated conversation context loss over time and gave customers a sense of familiarity and allegiance with their personal banker. In fact, when customers reach out, if their personal banker is unavailable, they are given the option to speak to another banker, but 65% of them want to wait to speak to their own banker.

- Huntington Bank has deployed a digital hub called "Marketplace" that uses data and artificial intelligence to personalize its customers' experiences and deliver curated offers. This platform is intended to increase each customer's lifetime value. Huntington's CEO has reported 400,000 unique monthly visits to Marketplace, a rate of engagement of 17% for all digital consumers.

To really make customer experience a priority and meet the continuously changing needs of their customers, regional and mid-cap banks must embrace a digital future state. The customer engagement strategies and tactics that worked 10 years ago just don't work as effectively today. Especially since the COVID-19 pandemic, consumers are more reliant than ever on convenience and experience alternatives to in-person services. The best way to respond to this new dynamic is to lean into it. Consider where there are areas of friction in your own processes and invest in technology that creates a seamless customer experience.

4. Seek strategic opportunities for mergers and acquisitions (M&A) to expand geography, capabilities, and resources.

By the end of the decade, we anticipate that the number of small and community banks in the US will be cut in half. This will be driven by several trends; the challenging economic environment, the increasing level of competition, and the natural consolidation of smaller vertically-integrated banks that may not be equipped to compete with the emergence of digitally native banks, fintechs, and tier 1 banks.

Let's look at a couple of examples of banks engaging in strategic M&A activity:

- Valley National Bank, based in Wayne, New Jersey, acquired Leumi, a New York City-based subsidiary of Bank Leumi Le-Israel, for $113 million in 2022. This acquisition gave Valley new business capabilities in technology and private banking. Since then, the bank has worked with Israel-based venture capital fund The Garage to develop a channel for Israeli fintech startups to enter the U.S. market.

- Flagstar Bank, based in Troy, Michigan, was acquired by New York Community Bancorp in late 2022. With different geographic locations and banking service specialties, the merger allows the newly consolidated institution to expand its earnings opportunities. Combined, the bank reports more than $88 billion in assets, making it one of the largest regional banks in America.

Strategic M&A requires clarity around the future role that the bank will play within the financial services ecosystem. To determine if this might be a potential opportunity for your bank, think about what might be missing from or what could be supplemental to your current strategy, whether that's new geographies, new capabilities, new products, or something else entirely.

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