



## The future of midsize banks

A new playbook for supercharging growth

THE DELOITTE CENTER FOR FINANCIAL SERVICES



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*Most midsize banks—institutions with \$10 billion to \$100 billion in assets—have fared well during the COVID-19 pandemic. But macroeconomic challenges, technology limitations, and competitive pressures are likely to threaten their growth down the road. And those who have not yet begun the transformation journey risk being left behind.*

#### **Key messages**

- Despite challenges over the past decade, most midsize banks have continued to perform well in several areas, including return on equity (RoE), net interest margin (NIM), and efficiency ratio.
- However, there is considerable variation across banks with regard to success. Our analysis indicates three distinct clusters of midsize banks based on their RoE in the past decade: The front runners generated a 14% average RoE, the middle-of-the-pack earned an 8% average RoE, and the laggards were furthest behind, with a 6% average RoE.
- While midsize banks can learn lessons from their historical performance, they should also prepare for impending new challenges over the next few years. These include pandemic-induced behavioral shifts, macroeconomic forces, and competitive pressures. For the first time in more than a decade, midsize banks' average NIM is expected to drop below 3% in 2021, compared with 3.9% in 2019.
- To supercharge growth in a postpandemic world, midsize banks should consider a playbook with a sharp focus on the following strategic actions: digitize the bank front to back, ace digital customer experience, forge dynamic alliances, modernize core systems with modular solutions, fuel a digital-first culture, expand fee-based business models, rationalize and redesign the branch footprint, and add more profitability horsepower with mergers and acquisitions (M&A).

# Impending speed bumps to overcome

**The future of midsize banks** in the United States appears more tenuous than ever before. Sandwiched between large institutions boasting a national or regional presence and smaller banks touting a community touch, midsize banks' unique advantages have been pressure-tested in recent years. The recent rise in M&A activity is a testament to the uncertainty facing this banking sector.<sup>1</sup>

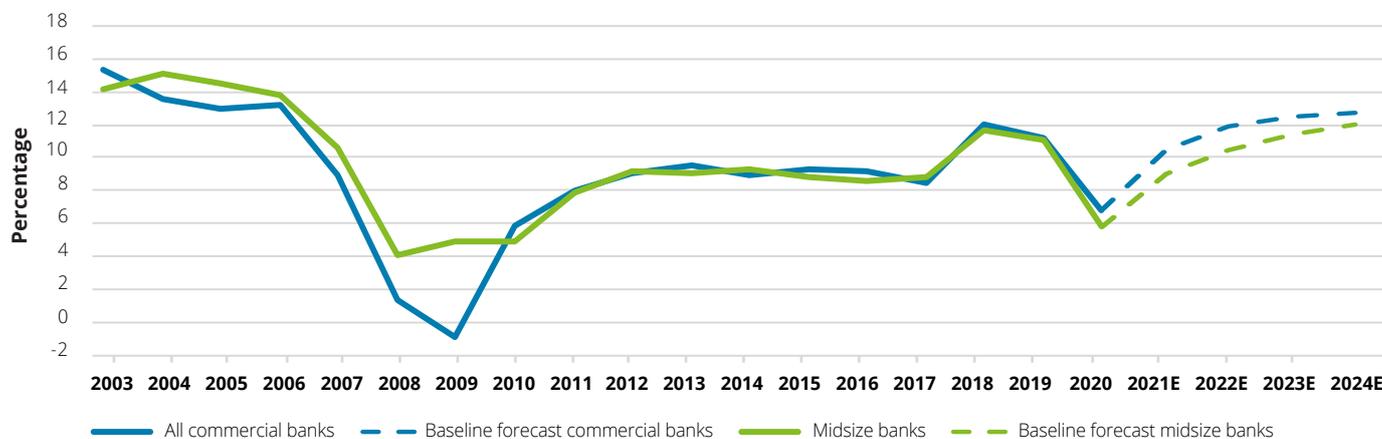
As the "balance-sheet-first" philosophy gains momentum, what's the optimal scale to thrive in the future? Is \$100 billion in assets the new benchmark in the midsize banking sector?

Furthermore, competitive pressures are intensifying. On the one hand, large banks are expanding in commercial lines of business. On the other hand, nimble fintechs and innovative bigtechs are expanding their reach in financial services.<sup>5</sup> For instance, California-based BlueVine offers online business banking and financing to small- and medium-sized businesses (SMBs), a core customer segment of midsize banks.<sup>6</sup> These competitive pressures could put customer retention at risk.<sup>7</sup>

Macroeconomic conditions haven't been favorable, either. Low interest rates are hurting NIMs, the biggest drivers of midsize banks' profitability. Based on our proprietary forecasting model, midsize banks' RoE could stand at 9% in 2021, compared with a 10.5% industry average (figure 1).

These questions take on additional significance when considering pandemic-induced shifts. Restrictions on in-person interactions have made most retail customers more comfortable with digital banking services,<sup>2</sup> making visits to bank branches, which have been long-standing relationship-building hubs,<sup>3</sup> few and far between. At the same time, commercial banking clients have begun to expect a level of ease, accessibility, and sophistication similar to the digital experiences they enjoy in retail banking.<sup>4</sup>

**Figure 1. RoE of midsize banks and the US banking industry**



Source: S&P Global Market Intelligence data for operating banks and Deloitte Center for Financial Services analysis.

But it's not all doom and gloom. Despite these concerns, during the COVID-19 pandemic, midsize banks rapidly embraced digitization and quickly responded to the demands imposed on them. For instance, consider the Paycheck Protection Program (PPP) loans to SMBs, where seven of the top 15 PPP lenders by volume were midsize banks.<sup>8</sup> Comprising 11% of the industry's assets, they generated 6.2% in average RoE in 2020, just shy of the 6.8% RoE of the US commercial banking industry at large.

So, should midsize banks feel proud of their recent performance? They should, but averages can be deceiving. Not all midsize banks have fared well. Our analysis of the past 10 years of financial performance of 80 midsize banks in our universe indicates three distinct clusters: The front runners, the middle-of-the-pack, and the laggards. In 2020 alone, front runners generated a 12% average RoE despite a distressed environment; the middle-of-the-pack managed an 8% average RoE; and laggards were furthest behind, with a net loss of 2% on their average equity capital.

While midsize banks can learn lessons from historical performance to bolster their competitiveness, it may also be time to reassess their strategic levers for a postpandemic world.

However, one size will not fit all, and midsize banks should prioritize the strategic levers that align with their growth agenda.

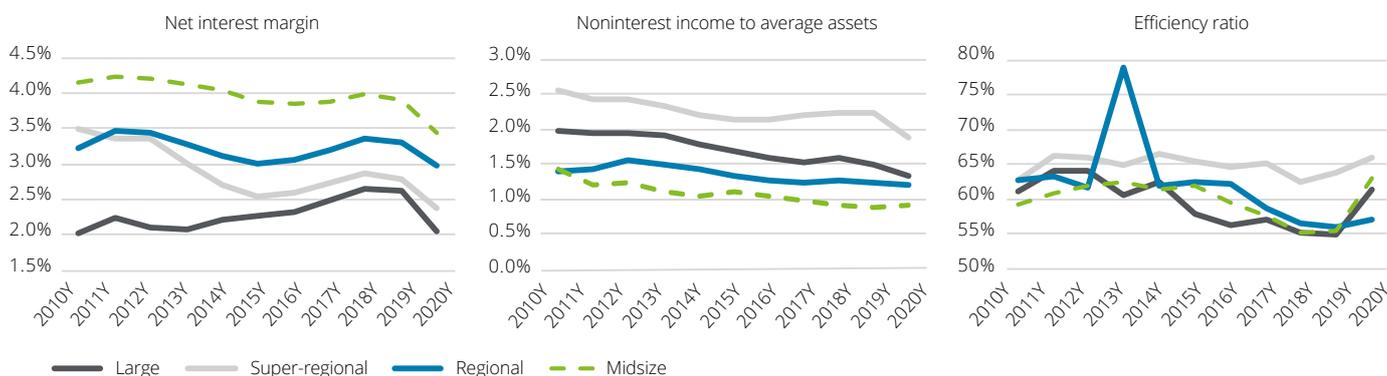
# While the industry has stayed on course, some midsize banks took the lead

Midsized banks tend to excel on a few dimensions compared with their larger peers. For decades, midsized banks championed customer intimacy and a relationship-based business model, with a laser-sharp focus on the lending business.<sup>9</sup> This has enabled them to consistently earn higher NIMs compared with larger banks in the past decade (figure 2). Midsized banks also generally maintained a strong underwriting discipline and succeeded in improving their efficiency ratio to below 60% over the past few years (barring the spike seen in 2020, as seen in figure 2).

However, their business model is typically less diversified, as they derive more than three-quarters of their revenues from interest income. They've gradually reduced reliance on fee-based revenues as a share of average assets over the past decade (figure 2).

However, their business model is typically less

**Figure 2. Midsized banks' financial performance compared with their larger peers in the past decade**



Source: S&P Global Market Intelligence data for operating banks and Deloitte Center for Financial Services analysis.

Note: Large banks are institutions with assets of more than \$500 billion, super-regional banks have assets between \$200 billion and \$500 billion, and regional banks have assets between \$100 billion and \$200 billion.

Looking deeper, analysis shows that not all midsize banks have been equally profitable. Some have been adept at maintaining superior financial performance on a consistent basis, while others have repeatedly lagged behind. Our analysis identified meaningful differences in their performance drivers, competitive positioning, and unique challenges (figure 3).

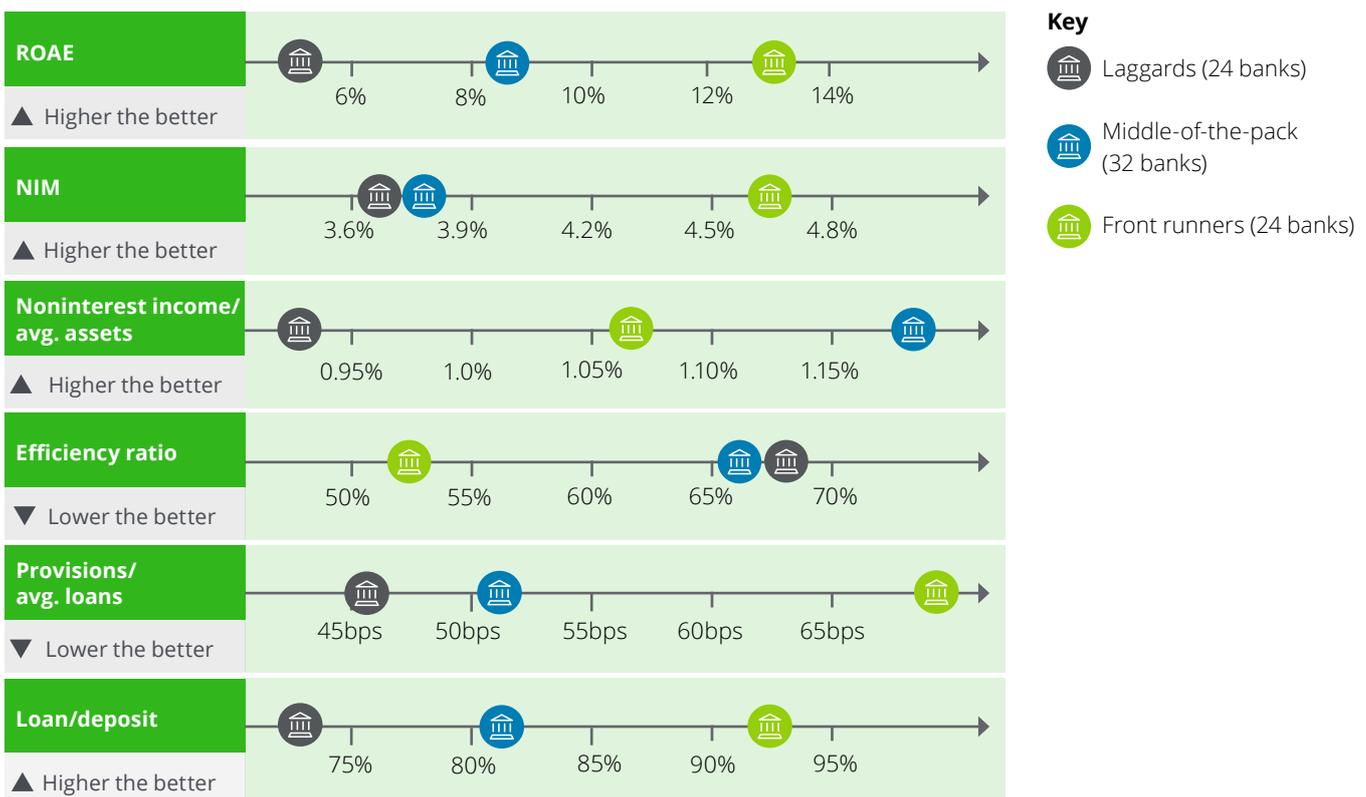
**Front runners** led the pack, with a 14%+ average RoE over the past decade. Their ability to earn higher interest income, aided by their focus on commercial businesses and relatively higher-yielding consumer loans, has been a distinctive source of higher NIMs.<sup>10</sup> Most have also been more disciplined in managing costs related to salaries, premises, and other fixed assets. These banks' leverage, as measured by assets-to-equity multiple, is also higher, in part reflecting their strength in low-cost deposit funding. However, they have generally not been as successful in generating fee income, indicating the need to diversify their revenue stream. Further, they often had the highest provisions-to-loans ratio, demonstrating scope to strengthen underwriting discipline.

**The middle-of-the-pack** derived their strength in part from noninterest income, which has remained the highest among the three clusters in the past decade. In addition, low funding costs and the low

provisions-to-loan ratio have been accretive to their profit margins. Despite these advantages, they have generally been the least effective in generating interest income on their loans, which has weighed down their net revenue growth, and cost management could be made more efficient from rationalizing branch and office footprints.

Lastly, **laggards** seemed to have had little success in carving out their competitive differentiation. They have struggled with growing net revenues, primarily due to significantly higher funding costs, less diversified revenue sources, and a business mix comprising safer, low-yielding loan categories. For example, they maintained nearly 16% of their portfolio in less volatile, low-yielding multifamily loans, which was about three times the levels maintained by the other two clusters. Most have also had a challenging time managing their fixed costs, representing a higher share of premises expenses to average revenues compared with the other two clusters. Furthermore, they have typically had to write off a significant share of goodwill and other intangibles over the past few years, which has lessened their operational efficiency. As a result, their efficiency ratios are, not surprisingly, the highest of the three groups.

Figure 3. Competitive positioning of midsize banks in the past decade



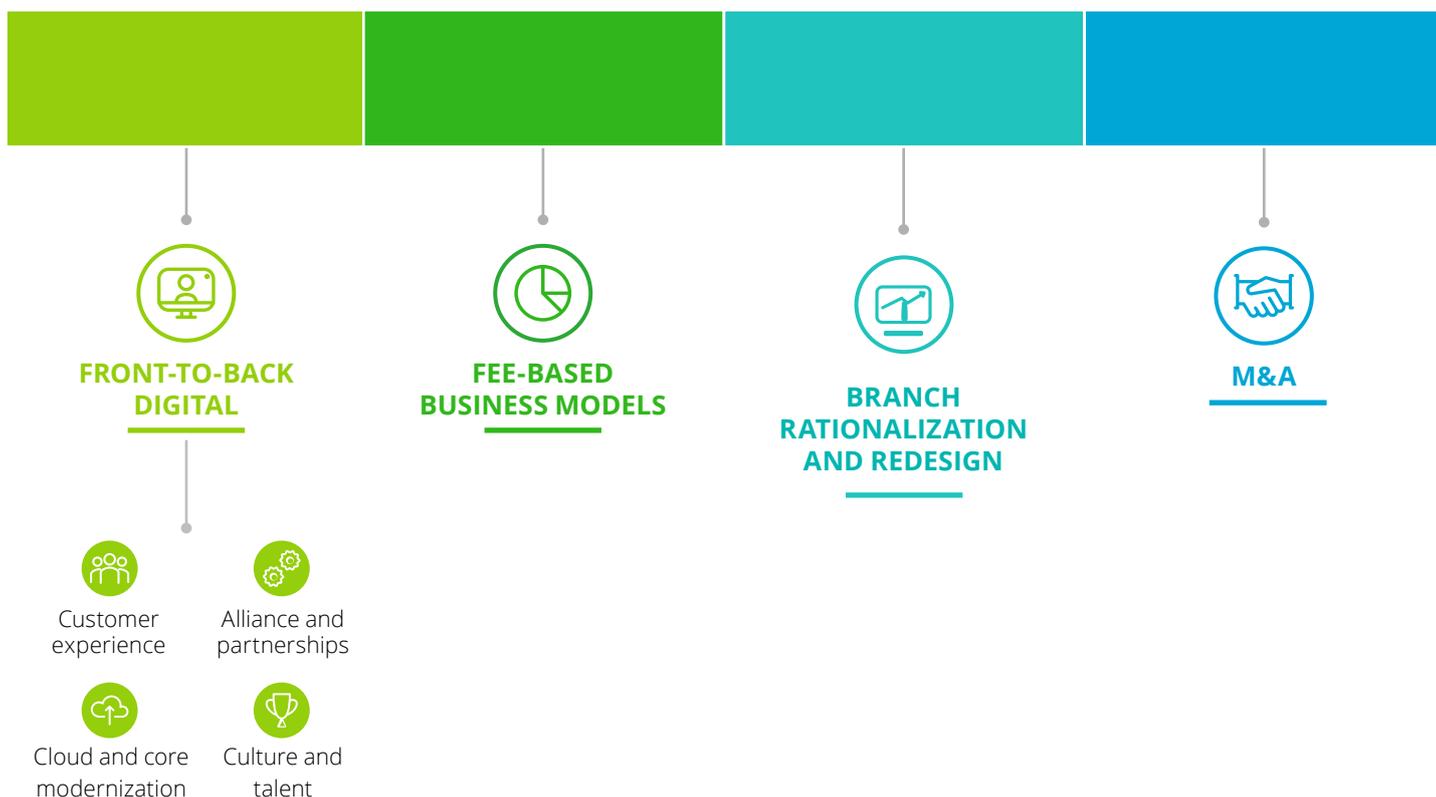
Note: The positioning of bank icons represents 10-year averages of each cluster on different financial metrics. Source: Deloitte Center for Financial Services analysis.

# The post-COVID-19 journey could be bumpy, requiring bolder choices

It is clear that COVID-19 has accelerated the digitization of the global economy and has brought about structural shifts in the banking space. Midsize banks should avoid any sense of complacency and not simply rely on their past performance to chart growth and competitiveness in the future.

There are **seven strategic levers** to consider as midsize banks strategize for a post-COVID-19 world: Customer experience, alliances and partnerships, cloud and core modernization, culture and talent, fee-based models, branch rationalization and redesign, and M&A (figure 4).

Figure 4. Strategic levers to drive competitiveness



Source: Deloitte Center for Financial Services analysis.

## Digitize the bank from front to back

Large banks' massive technology budgets, along with fintechs' and bigtechs' intuitive, customer-centric offerings, are increasingly appealing to midsize bank customers.<sup>11</sup> A recent research report indicates that the six largest US banks outscored midsize and regional banks in digital engagement, which was measured across a range of activities, including account opening, problem resolution, communication and advice, and convenience.<sup>12</sup> To compete with these players and replicate the success of their customer intimacy model in a digital world, midsize banks should embrace a front-to-back digital banking model, which would require them to:

### **Ace digital customer experience**

Many midsize banks are investing in customer-facing technologies to enhance customer engagement. For instance, Frost Bank has a mobile banking app that offers customers one-click, 24/7 access to talk to a banker, along with an online banking portal for business customers to manage their cash flow.<sup>13</sup>

Yet more needs to be done. Mortgage banking is one such area where an excellent customer experience is sorely needed. Front runners should prioritize this area to maintain their edge in the lending business, given mortgages comprise almost one-fifth of their loan portfolio. They could also consider developing a digital platform that allows consumers to address all their home purchasing needs, with pull-down menus that include self-service options for obtaining appraisals, insurance, etc.<sup>14</sup> These enhancements can be easier with a modern, cloud-enabled core system and the use of artificial intelligence (AI) and machine learning (ML) models.

### **Forge dynamic alliances**

Strengthening core product and service capabilities, as well as redeploying resources where they matter most, should be key mantras for midsize banks to become more scalable and sustainable. Strategic alliances and partnerships could be more important than ever to adapt to the rapid pace of specialization and to get more done quicker and with less capital investment.

But traditional outsourcing relationships that worked in the past, when there was low volatility and low value in change, may be misaligned with today's digitally enabled business operations. The current operating models at several large financial institutions also bear testimony to this challenge.<sup>15</sup>

Perhaps midsize banks should pivot to managed services or cosourcing relationships for their noncore operations, such as cyber risk management or the tax function. These relationships could encourage a higher commitment and shared ownership from alliance partners and increase banks' ability to quickly sense, respond, and adapt to the high dynamism in today's business environment.

### **Modernize core systems with modular solutions**

Competing with digitally savvy players will not be an easy feat for midsize banks burdened with legacy infrastructure and limited budgets, which tend to be allocated to run-the-bank initiatives<sup>16</sup> and leave little room for bold transformation.

And while midsize banks are generally faring well on cloud migration,<sup>17</sup> core modernization hasn't been a smooth journey for institutions, and many midsize banks still maintain disparate data sets. Meanwhile, existing contractual obligations with traditional core service providers give them little flexibility to switch providers to completely modernize their core. The result? Higher cost of operations, slower response time, and suboptimal customer experience.

Midsize banks should consider a capital-light, modular architecture that gives them the ability to scale and the flexibility to integrate third-party offerings. Some of them are also demanding that their traditional core providers open their systems to fintech digital offerings. But it could be hard to push the business case, especially for smaller banks with niche demands. To be fair to core providers, meeting the wish list of each individual bank could be both challenging and expensive. Midsize banks should continue to demonstrate the "power of the crowd" and collectively raise these new demands to negotiate with their core vendors.

**Fuel a digital-first culture and upskill the crew:**

In a world where fintechs excel in quick-to-market offerings and digital-native customer experiences, midsize banks can't risk falling behind with a traditional, hierarchical, and consensus-driven culture.

Midsized banks' leadership should be open to embracing a fintech-like culture where agility and (virtual) collaboration among the business, technology, and operations teams, in addition to alliance partners, are the cornerstones of customer-centricity in a postpandemic world.

At the same time, these transformational efforts should be complemented with a skilled, specialized, and dynamic workforce. Given their low personnel costs-to-revenue ratio, front runners could use their budgets in acquiring new, specialized skills in business and/or technology talent. On the other hand, banks in the middle-of-the-pack and laggards could prioritize continuous upskilling of their workforces in the areas of technology and digital-first culture as they manage higher personnel costs. Moreover, upskilling the beginner-level and/or less-experienced talent on emerging technologies could provide much-needed staffing support to their technology specialists and lower their risks of burnout and attrition.



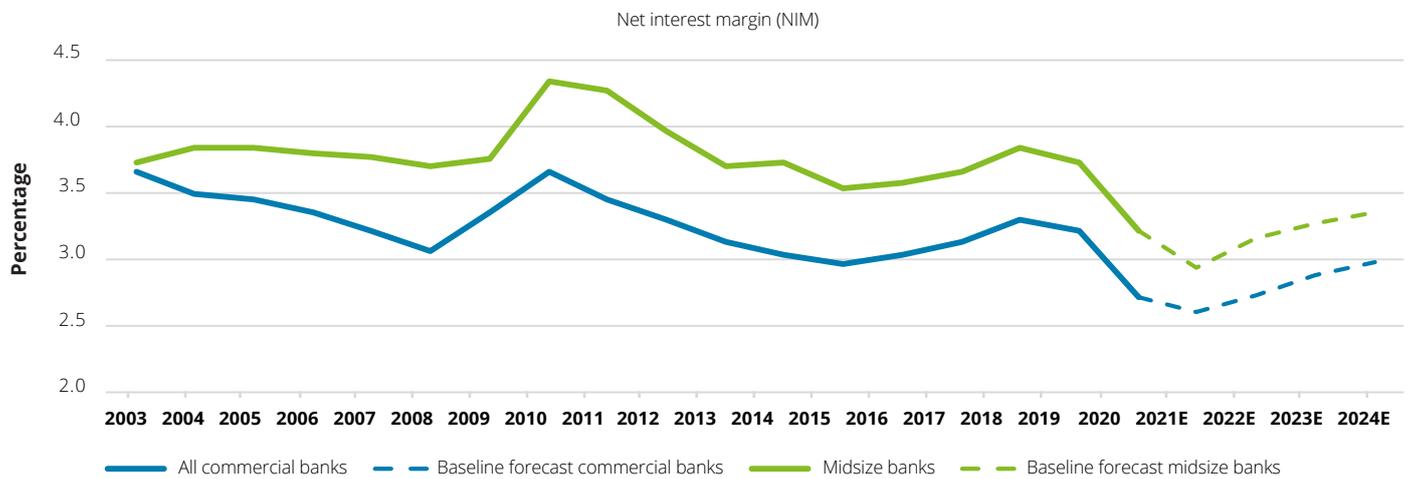
### Experiment with fee-based business models

For the first time in more than a decade, the average NIM among midsize banks is expected to go below 3% in 2021, compared with 3.9% in 2019 (figure 5).

Take banking-as-a-service (BaaS), for example: an emerging model among some US banks to power both bigtech and fintech platforms.<sup>18</sup> In BaaS, a bank offers its license, infrastructure, and/or products in the background to a nonbank institution in order to gain access to the latter’s customer base.

Given their lower revenue growth, laggards could consider experimenting with this model to generate fee income from the partners accessing their BaaS platform. In addition to building revenue, this model could also allow them to offer greater personalization of their products and services and enable their partners to roll out new solutions that are both timely and more cost-effective.<sup>19</sup>

**Figure 5. NIMs of midsize banks and the overall industry (%)**



Source: S&P Global Market Intelligence data and Deloitte Center for Financial Services forecasts.

## Rationalize and redesign the branch footprint

With efficiency ratios climbing north of 60% in 2020, most midsize banks are hunting for areas to streamline costs. Rethinking branch infrastructure is an obvious choice, especially for the laggards and middle-of-the-pack clusters, given the acceleration in customers' digital adoption during the pandemic. In addition, there's a clear opportunity to make branches more efficient. In the past year alone, the average laggard bank maintained \$105 million in deposits per branch across its 48 active bank branches, and the average middle-of-the-pack bank had \$132 million in deposits per branch across its 56 active branches.<sup>20</sup> On the other hand, the average front runner bank held as much as \$287 million per branch across its 32 active branches in the past year.<sup>21</sup> Clearly, more doesn't always mean better in this regard.

Yet, it will not just be about reducing the branch footprint, but also about redesigning branches to attract and retain customers, both retail and commercial. This strategic lever could particularly benefit laggards in need of more low-cost retail deposits to fund their lending business. For branches to become vital engines of customer acquisition and experience, digital technology capabilities (such as interactive kiosks) will likely be critical to lower the need for front-office personal interaction at bank branches. Increasingly, hybrid experiences that merge physical and digital spaces will be the norm. Midsize banks should not stand by as others take the lead in this transformation.

## Add more "profitability" horsepower with M&A

Arguably, M&A has become an important lever to scale in the midsize banking industry. However, "more" doesn't necessarily translate into "profitable." Front runners, the most profitable midsize banks, were less active in M&A compared with the other two clusters. In the past decade, they pursued 139 of the 542 midsize bank deals as acquirers, compared with 245 deals by the middle-of-the-pack and 158 deals by the laggards.<sup>22</sup>

Going forward, front runners are expected to act on their tried-and-true M&A strategy of acquiring specialty businesses to strengthen their revenue growth. In addition, they may benefit from acquiring digital capabilities to accelerate their digital transformation efforts.

The middle-of-the-pack and the laggards may engage in a defensive M&A play by looking for a dance partner to drive down costs and increase economies of scale. We may see additional merger-of-equals deals as more midsize banks aspire to join the \$100 billion-plus regional banking club.

However, simply having the vision to become a \$100 billion bank won't suffice, as hiccups in postmerger integration, such as differences in organizational culture or core systems and processes, could often impede midsize banks from reaching their profitability targets.

Midsize banks should articulate a clear and bolder vision for the postmerger entity with regard to its specialization and unique value proposition. They should also consider the regulatory and competitive implications of both in-market deals for scale and across-market transactions for scope. Furthermore, M&A decisions should be grounded in thorough due diligence to account for the pandemic-induced impact on the target's asset quality.<sup>23</sup>

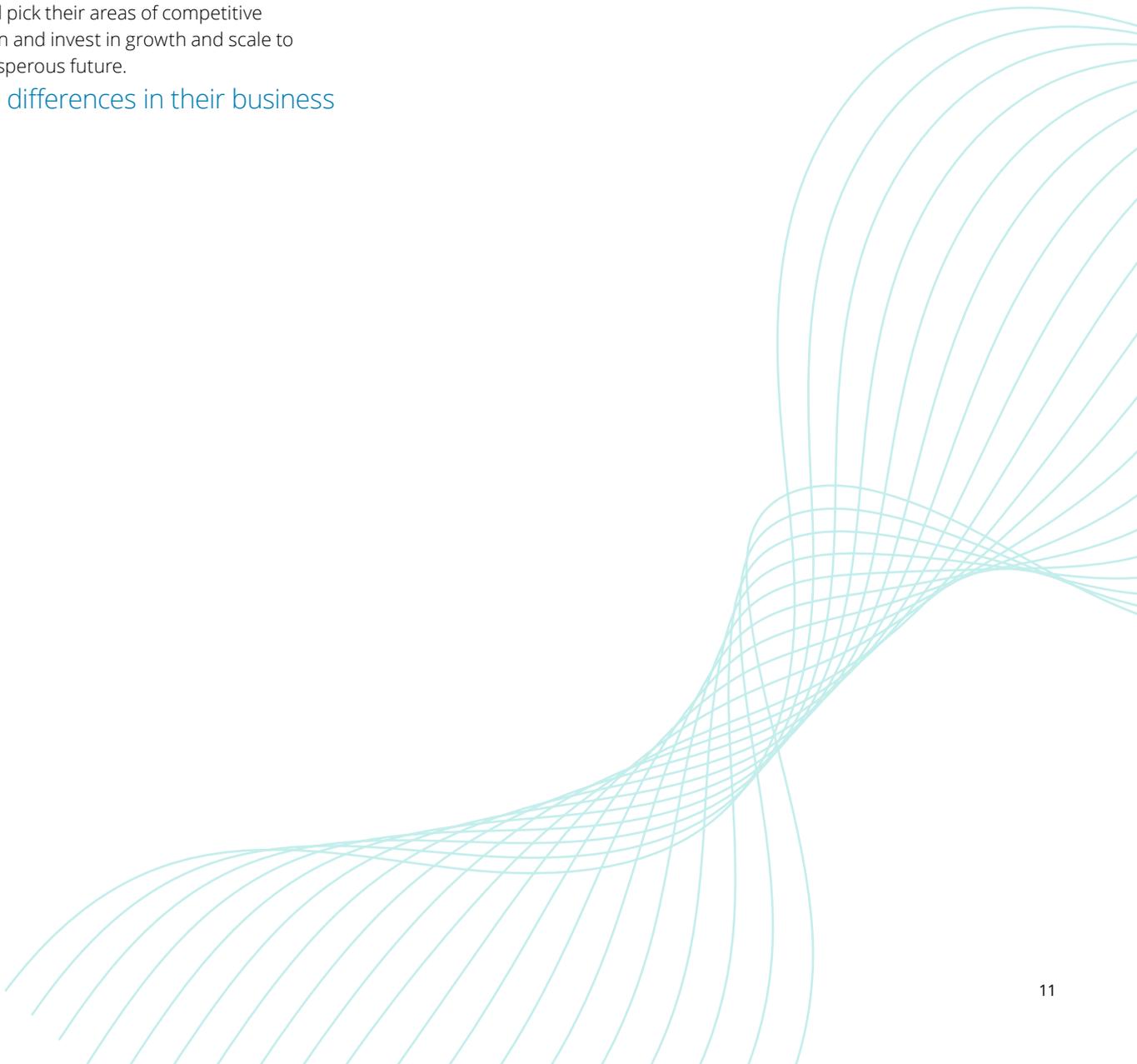
# Gearing up to competitively position in a postpandemic world

Midsized banks have played a vital role of financial intermediation in the US economy and have supported millions of consumers' and businesses' financial needs and dreams for decades.

But historical performance alone can no longer determine their future success. And uncertainty and impending challenges in the short term shouldn't discourage them from making the bold, uncomfortable choices often required to position themselves competitively in the long run and find their niche to thrive. Trying to be a bank for all customers and all needs will likely not be the road to success. Midsized banks should pick their areas of competitive differentiation and invest in growth and scale to ensure a prosperous future.

Given the differences in their business

models, these strategic choices will likely vary by institution. Those that adopt a new strategic playbook based on their distinct positioning could stand a brighter chance of supercharging their growth in a postpandemic world.



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