



## **Re-igniting organic growth in retail banking**

The regional bank's challenge

May 2018

# Introduction

During the decade since the financial crisis, **many retail banks have played defense**. Increased capital requirements, new consumer protection regulations and lost fee revenues have created a focus on compliance, efficiencies and branch closures. Retail banking businesses faced further pressure when asked to provide a cheap source of funding and subsidize struggling institutional businesses and other consumer monolines within a diversified bank's portfolio.

Meanwhile, **competition from non-traditional banking models continued to strengthen**. Specialized payments companies (e.g., PayPal) increased their share of retail transactions and direct banks grew their deposit base. Wealth and asset managers continued to target retail banks' mass affluent customer relationships with increasingly competitive banking products.

Faced with these headwinds, **many retail banks underinvested in their franchise** (marketing, new technologies, talent). These banks lost ground in the marketplace with low rates of new household acquisition and lower than market average deposit and loan growth. With a difficult M&A environment, even serial acquirers could not mask their organic growth challenge.

However, **not all retail banks were impacted equally**. Retail banking has continued to grow in the past decade with the top 100 retail banks capturing nearly all the market growth in consumer deposits and assets. In particular, the five largest banks got even bigger while regional banks have appeared to be on a relative decline.

Many **regional retail banking franchises are ready to reverse the decline of the last decade and go on the offense again**. This is about re-igniting organic growth and finding the right balance between vis-à-vis profitability. As the balance of power shifted to large, quasi-national retail franchise, regional banks face a different set of challenges and opportunities.

# Retail banks: The organic growth challenge

Since the financial crisis, **retail banks have generated equity returns much closer to their cost of capital.** In the short-term term, their valuations have become more sensitive to increases in efficiency and profitability, rather than to incremental growth in their capital base.<sup>1</sup> However, banks cannot reduce their cost bases for higher efficiencies forever, lest they fall into a growth trap where poor customer experience constrains top-line growth.

Furthermore, with new (reduced) levels of corporate taxation and a steepening of the yield curve, **return spreads should increase<sup>2</sup>,** thereby increasing the value of incremental growth to shareholders. In other words, retail banks that can re-ignite organic growth will see their valuation multiples expand. Some banks may find it easier to re-start growth through M&A as the current business and regulatory environment may be friendlier to new combinations than the previous one. However, M&A is unlikely to be a substitute for organic growth given that acquisition premiums weigh on ROI for external growth.

When it comes to organic growth, most regional banks have **more of an acquisition issue than a retention issue.**

The majority of their retail banking earnings are concentrated with small business owners, pre-retirees and retirees, who are often older and fairly loyal customers.

However, there are two important reasons to be cautious and avoid any complacency: 1) digital preferences are evolving fast, even for older demographics, and 2) regional banks have typically been slow in building compelling digital experiences.

Furthermore, though loyal to their banks, these loyal customers are inclined to switch providers at certain transition points in their financial lives. For instance, customers who are building their net worth (e.g., middle age professionals) tend to graduate into a class that values investment and wealth offerings more than traditional banking offerings. At this inflexion point in their financial lives, these customers are susceptible to switching to large banks with an investment brand within the parent company's portfolio or to an investment firm with banking capabilities.

Regional banks cannot ignore customer retention as a strategic issue. However, client acquisition is still a challenge: With approximately 3% GDP growth and only 1% household growth, retail banks do not have much room to play with in the first place (even if saving rates increased a bit). Furthermore, these national averages mask important differences across geographies and customer segments. For instance, household growth is skewed towards urban centers, the south, and the two coasts at the expense of extent the middle of the country. This is good for large banks with well-established footprints in large, growing cities or for regional banks in the south of the country much less for regional banks with midwestern footprints (e.g., M&T, PNC).

By definition, new households are younger and tend to seek differentiated, digital experiences and transact through mobile channels. Large banks with significant investments in digital engagement models and mobile technologies have a substantial advantage over banks that are still betting primarily on their physical footprints. Furthermore, younger consumers always constitute a retention challenge as they do not seem to be very loyal to any bank brand.

1. At the extreme, if investors did not believe that banks would ever create a positive spread (defined as ROTCE minus Cost of Equity Capital), bank valuations would not be sensitive to changes in growth expectations at all.
2. Return spreads are defined as returns on tangible equity capital in excess of cost of capital.

# Regional vs. mega banks: The balance of power is shifting

Faced with this organic growth challenge, **regional banks will have to compete for new customers with their larger peers** (i.e., mega banks with quasi-national franchises). While we believe the balance of power will continue to shift towards mega banks, this does not mean that regional banks cannot overcome the structural advantages of their larger cousins.

*Technology* has become a key differentiator for organic growth in retail banking. This is because (i) customers increasingly value compelling digital experiences; (ii) financial technology companies (fintechs) have set up new customer standards (e.g., mortgages to close within days rather than weeks); and (iii) cyber security has become a major concern for all customers. Regional banks clearly do not have the investment capacity of their larger peers (“We can’t invest nearly as

much as the large nationals” is the leitmotiv that we hear in many boardrooms) nor can they amortize technology investments over a larger customer base. However, regional banks can at least partially offset their scale disadvantage by embracing a new way of doing technology with cloud capabilities and software as a service. By partnering with best-in-class vendors for point solutions as well as emerging industry utilities for larger systems, they can reduce in-house capability development. This may also require bold plays like outsourcing large product and financial systems. In our experience, the biggest obstacle to doing technology differently is lack of talent in technology functions and technology proficiency in management teams.



Mega banks potentially have an *information* advantage that is hard to match for regional banks. They tend to have better data about more customers and can apply analytics to broader data sets and develop better algorithms. Fortunately for regional banks, the data infrastructures of mega banks are not in much better shape than that of regional banks, and as a result, they cannot yet exploit their advantage to develop more intelligent and compelling customer propositions. But it will happen.

Mega banks tend to have a significant *talent* advantage relative to their smaller, regional competitors. This is especially true in management positions where large banks typically have a deeper talent bench across most lines of business (LOBs) and geographies. They can also train their leaders with more job rotations and broader exposures to various roles. On the other hand, regional banks can typically count on longer tenured employees in their branches to deliver high quality service and maintain strong customer relationships in their communities. They often can access lower cost talent on account of their geographic footprint. Lastly, within management ranks, regional banks often inspire more loyalty. This is both a strength (longer management tenure) and a liability (potentially weaker performance management). Overall, we believe that regional banks have an opportunity to upgrade their talent model to narrow the gap with large banks through select external hires and stronger performance orientation.

Mega banks increasingly have a *marketing* advantage relative to their smaller competitors. They can amortize marketing spend over larger customer bases. More importantly, they are often ahead of regional

banks with digital engagement models that are cheaper and more effective in reaching their customers. As a result, they can transition faster from traditional, mail-based campaigns to higher ROI digital marketing campaigns than traditional mail campaigns. On the other hand, regional banks have a much deeper involvement and awareness in local communities.

During the financial crisis, their *brands of mega banks* suffered from their association with the volatility in capital markets and were seen by some as less safe and reliable relative to their regional peers. As cyber security has moved closer to the top of the consumer's agenda in the past decade, large banks may be seen as capable of investing more in cyber security than their smaller regional peers, reversing relative perceptions of safety and reliability.

With a few exceptions, regional banks find themselves with physical footprints in geographies with challenging *demographics* (lower population growth and lower economic growth). On the other hand, their somewhat older customer bases tend to be more loyal and more profitable (higher balances) and likely slower to transition from physical to digital origination and servicing models. While in the short term, regional banks can defend their bottom line, shrinking customer bases and limited economic growth will stress their cost base in the long-term. There is no substitute for new customer acquisition within and outside their traditional footprints.

From a *product* standpoint, mega banks are again in a winning position relative to their smaller regional competitors. For instance, large banks often own investment brands that are valued highly by mass-affluent

and affluent customers. Furthermore, mega banks can invest in new payment products or participate in industry consortia to defend against non-banking payment companies in a way not possible for smaller players. As convenience is less about physical access and more about quality digital channels, regional banks with dense physical networks in their communities could lose their deposit taking advantage over time. On the other hand, deep community roots and strong local customer relationships give regional banks an upper hand when it comes to underwriting small business loans.



# Seeking to re-ignite organic growth: Bold plays for regional banks

So, what can regional banks do to re-start organic growth? There are several potential bold plays to compete for new growth with other banks when footprints overlap. Neither exhaustive nor applicable to every regional bank, these bold plays depend on the starting point (e.g., footprint, talent, competitive advantages) and on the bank's ambition. We believe management teams at regional retail banks should have a position on the following strategies:

## 1. Seeking scale that matters: Going deep or broad.

- a. **Going deep:** This is about going deep in one product category within certain geographies: e.g., the bank doubles down on small business banking and middle market lending to establish a dominant competitive position; other LOBs support business lending (for instance, consumer banking LOB provides cheap deposit funding to the commercial banking LOB). Over time, investments in balance sheet capacity, technology and talent are skewed towards the chosen vertical to maintain competitive advantage.
  - » **Key bet:** Competitive advantage in a chosen vertical (e.g., commercial banking LOB) generates enough profit growth to offset under-performance in LOBs playing a supporting role (e.g., retail banking).
- b. **Going broad:** Banking/lending/ investment offerings are sold to the same set of customers within certain geographies. Priority is given to customers with multiple needs, e.g., retirees with banking and investment needs, small business owners with lending, banking and investment

needs. Other customers (single product category buyer) are de-emphasized. Deep community roots are critical to make this model work.

» **Key bet:** Benefits from migrating customers from one or two product categories to three or more product categories (increases in customer loyalty and profitability) more than offset lost, single product, customer relationships.

## 2. Geographic plays:

- a. **Doubling down on tier II markets:** This is to overcome intense competition from mega banks in areas with attractive demographics/economics (e.g., metro areas and on the two coasts) and leverage a community banking model with deep roots in local communities (see 1.b.)
  - » **Key bet:** Increased pricing power and strength of a local community brand can more than make up (in

terms of customer profitability, local market share, and customer retention) for lower economic growth in tier II markets.

- b. **Following students:** Concentrating infrastructure and marketing spend on student towns to establish relationships with future graduates and follow them later can drive customer acquisition in the short-term and life-time customer profitability in the long-term. This requires compelling digital offerings and light physical support networks in urban areas to maintain relationships after graduates have moved to new geographies for work.
  - » **Key bet:** Regional banks close the gap with or match the appeal of mega banks to millennials, and generate high levels of loyalty in their customer base, driving long-term profitability.





### 3. Customer plays:

#### a. **Focusing on small business (SB)**

**owners:** SB owners account for a large percentage of the profits of regional banks. Above all, SB owners value their credit and cash management relationships with their banks. Well-aligned with the value proposition of regional banks, these customers value a physical infrastructure and don't need sophisticated investment solutions. Furthermore, deep community roots allow for superior credit underwriting and risk management, creating an advantage for regional banks. To sustain a strategic focus on a particular customer segment, banks will have to gradually shift their operating model and decision rights from geographies and products to customer segments.

» **Key bet:** Strategic focus can result in superior profit growth from chosen target client segment.

#### b. **Focusing on pre-retirees and retirees:**

Retirees can account for a large percentage of a regional bank's profits and tend to value their value proposition highly: (i) safety and community involvement; (ii) stability in relationships with long tenure employees; (iii) limited levels of sophistication in investments and are less attracted to specialized investment brands; (iv) physical proximity and are slow to adopt digital channels. Regional banks have an opportunity to create customer

experiences tailored to this customer segment to consolidate their hold on them and increase share of wallet.

» **Key bet:** Profit retention and share of wallet growth from chosen client segments in short- and medium-term can more than offset potential decline in medium- and long-term (as customers exit).

### 4. Product play:

#### **Changing the nature of customer relationships with automated, digitally delivered advice at the heart of every customer relationship:**

By including advice at the heart of every retail consumer relationship, regional banks can deliver quality advice to retail customers, whatever their wealth tiers. This will require leveraging new technologies and vendors, and integrating several new offerings, from robo advice and automated personal finance management to client wellness solutions. These integrated solutions can be delivered through intuitive, digital interfaces with light support from call centers or branch personnel.

» **Key bet:** Stickier, more compelling customer experiences can reverse regional banks' disadvantage among younger customers and increase retention of the most profitable, mass affluent relationships over time.

### 5. Infrastructure plays:

#### a. **Accelerating the transition from physical to digital:**

By diligently migrating transactions from analog to digital channels (i.e., faster than

the market average), regional banks can free up fixed costs and fund investments in digital technologies. This will also enable new, digital customer engagement models and create opportunity for regional banks in terms of new market entries (outside of traditional physical footprint).

» **Key bet:** Enough customers will migrate fast enough to digital channels. The value of this strategic option (i.e., entry into new geographies) is worth more than incremental investment requirements and lost customers through branch closures.

#### b. **Outsourcing technology platforms:**

Outsourcing key banking systems to external providers to seek scale advantages in technology and product development can focus the bank's talent on customer relationship management, sales, and vendor management. This is the 'retail business model' applied to banking.

» **Key bet:** The benefits from outsourcing core technology (lower unit costs, development costs pooled across multiple banks, faster access to new technologies) will neutralize the scale advantage of mega banks, and more than offset disruptions from moving to transformative operating models.

# Conclusion

It is time for regional banks to play offense again and re-ignite organic growth. This will require bold choices from their management teams to increase strategic focus and defuse some of the competitive advantages of mega banks. This will also require clear and painful trade-offs (across lines of business, short-term vs. long-term).

In the long term, regional banks and mega banks alike will need to face off to competition from non-banks; the mega technology firms (e.g., Amazon, Facebook, Google) will vie for ownership of the customer information layer and customer insight generation tools. Fintech vendors will offer compelling point solutions for specific functions (e.g., customer onboarding) or product solutions (e.g., robo advice). Technology platform providers (core banking platforms and product systems) will strive to take over most of the banks' middle and back office operations. Banks will need to figure out what activities in their value chain they fight for or if they have a role besides integrating various vendor solutions. This will be potentially a massive transformation that not all banks will be able to manage.

## Authors:

### **Gauthier Vincent**

Principal, Deloitte Consulting LLP  
gvincent@deloitte.com

### **Gopi Billa**

Principal, Deloitte Consulting LLP  
gobilla@deloitte.com

## Contributors:

### **Rajiv Shah**

Principal, Deloitte Consulting LLP  
rajivshah@deloitte.com

### **Deron Weston**

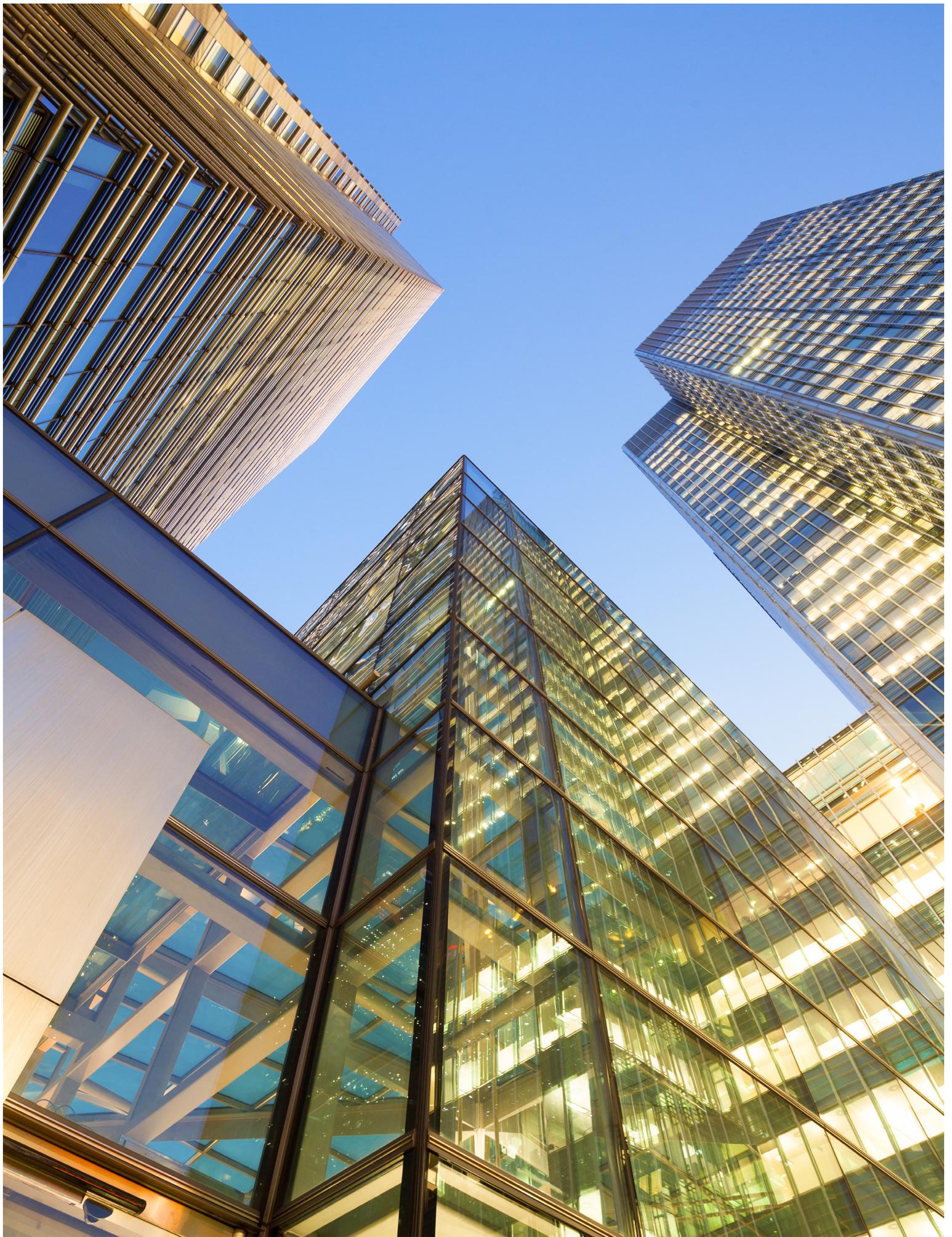
Principal, Deloitte Consulting LLP  
dweston@deloitte.com

### **Matt Jennings**

Manager, Deloitte Consulting LLP

### **Matt Johnson**

Senior Consultant, Deloitte Consulting LLP





This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

**About Deloitte**

As used in this document, "Deloitte" means Deloitte Consulting LLP, a subsidiary of Deloitte LLP. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte USA LLP, Deloitte LLP and their respective subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.