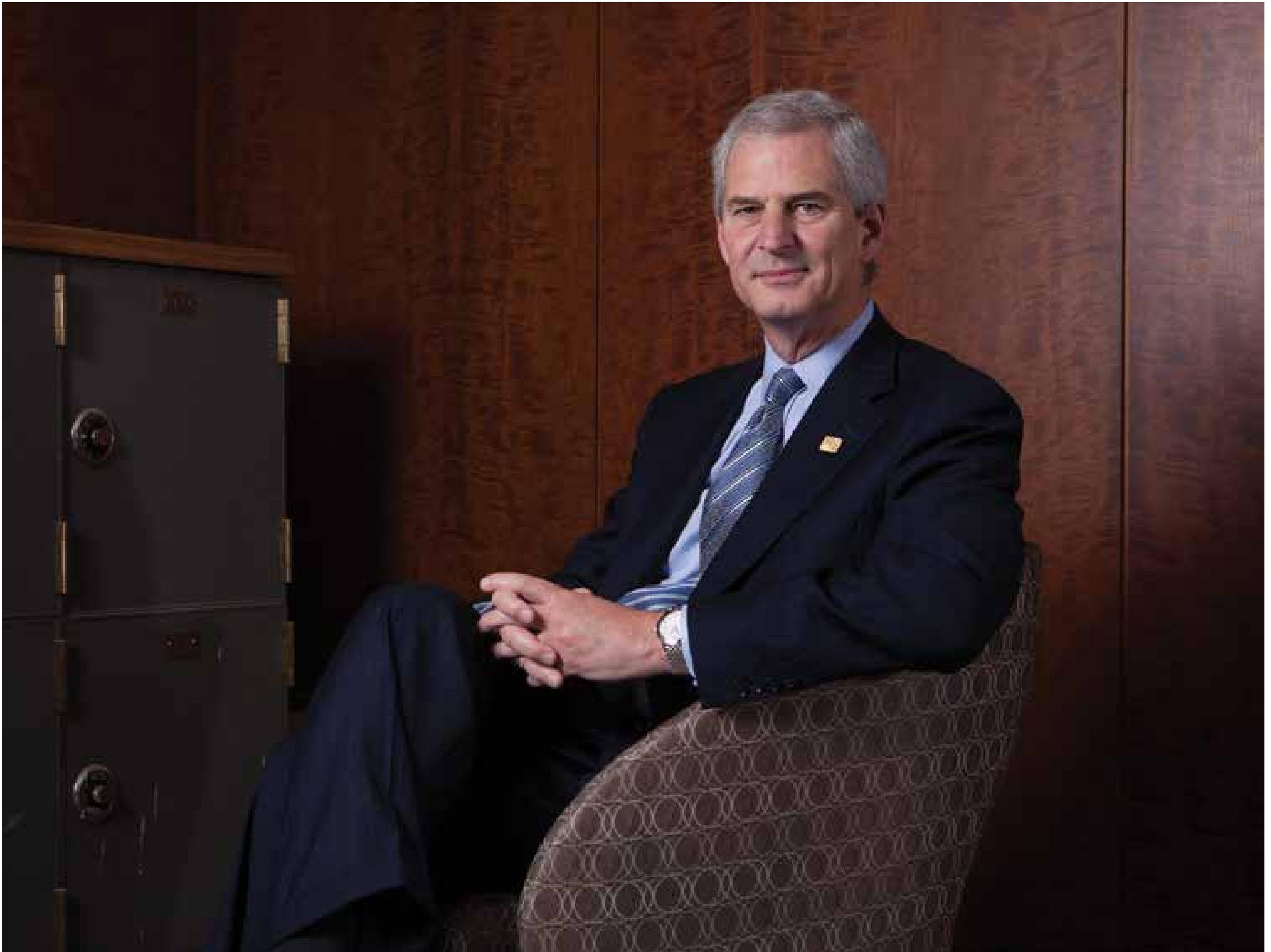
Fifth Third CEO Kevin Kabat in Cincinnati

Standing Out

Why regional banks are the right size right now

BY HEATHER LANDY



There are only a few dozen banks with assets of $20 billion to $350 billion. They always have to worry about competing with small banks that focus on service and giant banks that were built for scale. But in this regulatory climate, these banks in the middle of the size spectrum look very much like the industry's new sweet spot.

If all you knew about banking was how much of it rests on customer relationships and efficient management of costs, then the existence of large regional banks would be puzzling.

You would wonder how an institution with a regional footprint could on the one hand outmaneuver community banks (any of which in theory should have a better grip on its local market) and on the other hand compete with the national brands, with their deep pockets for advertising and technology.

You would surmise that the small number of U.S. banks with assets of $20 billion to $350 billion–there are only about three dozen of them, in an industry with more than 7,000 institutions–never intended to be in that bucket. Some, you would suppose, were essentially community banks that had grown too big for their britches, while others were aspiring national players with growth plans (or exit strategies) that had somehow stalled out.

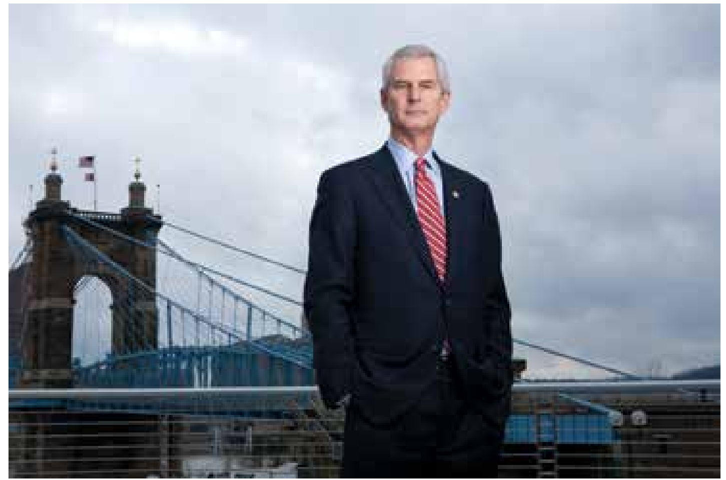
But this view would ignore many, more nuanced realities of banking, some of which convinced regionals a long time ago that they had a rightful home in the industry ecosystem, and others of which are just beginning to give new validation to that idea.

More than just surviving, many regionals are thriving now. In the post-crisis era, they've achieved a Goldilocks compromise on size: not too big and not too small.

They are able to handle new compliance burdens more easily than community banks can, and able to ward off many of the legal, reputational and regulatory challenges hampering the biggest banks. As Fifth Third CEO Kevin Kabat observes, "No one is talking about breaking *us* up."

Regionals also are benefiting from a democratization of technology, and some are using their nimbleness relative to the biggest banks to show real innovation in products and processes. What's more, the healthiest of the regional banks are poised to be effective consolidators of smaller banks as the ranks of willing sellers begin to thicken. And while they scour the lower end of the size scale for buying opportunities, the regionals can continue to capitalize on the mistakes of the national banks, which in many ways have failed to live up to expectations about the efficiencies their breadth and heft might bring, Bernstein Research analyst Kevin St. Pierre says.

"You had decades where the bigger guys could have gotten their act together. They had lower capital ratios and should have been able to price for market share gains, and they really didn't do it. So now we're in a whole new world where the bigger banks are going to be holding more capital, and to earn the same spreads they're going to have to price down on deposits and price up on loans relative to banks that are going to be running with 50 basis points to 100 basis points less on capital," says St. Pierre.



Fifth Third CEO Kevin Kabat in Cincinnati

The banks in the next tier, the midsize to large regionals, have, St. Pierre says, "enough scale to weather the regulatory changes and compliance with the Dodd-Frank Act–it doesn't hit their profitability nearly as much as a small bank–and they still have plenty of runway to roll up some of the community banks, as those banks realize it's not just the low-rate environment that's hurting them. It's a good sweet spot."

The conclusion is one that regional bank executives have been pushing for some time. But their case has been bolstered in recent years.

Fifth Third's Kabat says he has altered his line of thinking about how his bank stacks up against what he calls "the trillionaires"–banks with $1 trillion or more in assets. For starters, he says, "technology has become scalable. It's no longer a key differentiator in terms of size. .. And our model and our businesses are less complex than the trillionaires', and in this regulatory environment, that's an advantage."

Kabat also cites all the asset shedding that's been done by the trillionaire banks. "That's done two things: one, it's begun to have a real impact in terms of what their returns can look like, and it's opened up some open-field running for us that we've invested in, for instance in the midmarket, mid-corporate and large corporate space, where we've been able to grow our C&I book."

Commercial and industrial lending to businesses with about $200 million to $2 billion in annual sales has been a particularly busy area, Kabat says. "Some of our larger brethren have vacated that spot, and we've been able to fit right in there."

It's been a different story in retail banking, where regional banks last year lost as least as many new banking relationships as they gained, according to data from the research firm TNS.

The ubiquity of branches isn't the only factor. These days, convenience seems to be driven just as much by technology, and that trend seems to be working against regionals right now, despite the claims made by regional banks executives about the quality of their technology.

Larger banks have higher retail attrition rates, but when customers leave, it's usually for another large bank, says Teresa Epperson, a managing director at the consulting firm Alix Partners. When regional banks lose a retail customer, about half the time the customer flocks to one of the national-brand institutions. "We see the large banks, the ones who are aggressively capturing mobile, capturing a disproportionately large share of the churn," Epperson says.

But churn in banking remains relatively low. Usually no more than 7 percent to 8 percent of consumers switch banks in a given year, and when it comes to consumer market share, the profitability dynamics in banking are different than in other industries, says Joe Hagan, a senior vice president at TNS.

"In the retail industry, if you're Target or Dillard's or Macy's, it's hard to have a good year without also having strong sales. That's not necessarily true in banking, and I think that's an underappreciated reality," Hagan says. "The truth is, banks, especially in the short run, but even in the middle run, can essentially be doing terribly in terms of the marketplace while improving their profitability."

That's why Kabat says he's more focused now on capital ratios and returns than market share. Given the profit-draining effect that new regulations have had on many customer relationships, "you can die a slower death growing market share in our business," he says. "What you have to look at now is economics."

It's a basic idea, but a drastic change for a company like Fifth Third, which was a leader in the free checking revolution. Now Kabat says he can't understand any bank that continues to woo customers that way.

"We ran that play. I tell people internally we ran that play to death. We've buried it, and now we have a much better value proposition," says Kabat. He points to Fifth Third's return on equity and tangible common equity ratios, both above the industry average, as evidence that the new strategy works.

Regionals also are having to show some restraint on the commercial side of the business, where community banks previously concentrated in real estate lending are in some cases sweetening C&I loan bids to speed along diversification efforts.

"In some cases we've had to say that we just have to let it go," BMO Harris Bank CEO Mark Furlong says of some of the smaller C&I deals his bankers have seen. "It's our job to stay in touch with those customers ... and if the [other] bank can't deliver, then hopefully we'll get them back."

The waiting game doesn't always take long, he adds. "Sometimes we lose on the bid sheet, and then we win when they see what it takes to work on a document with someone else."

BMO Harris Bank, formed when Canada's BMO Financial Group merged its Harris Bank subsidiary with Marshall & Ilsley Corp., is Chicago's second-largest bank by market share, after JPMorgan Chase, and it's No. 1 in commercial banking in Milwaukee, where M&I had been based.

No doubt the relative steadiness of the Midwestern economy is a help to regionals like BMO Harris and the Ohio trio of Fifth Third, KeyCorp and Huntington Bancshares.

But some regionals—like BB&T, which is in 12 states in the Southeast—have thrived in far more stressed areas of the country, and FIG Partners analyst Christopher Marinac says he has a positive view of regionals nearly across the board.

"As I see it, they're all going to be making reasonable returns on equity this year, which is going to be better than what we're going to see at a lot of the community banks," says Marinac. Most of the big regionals will generate ROE of 10.5 percent to 12 percent, versus 7 percent to 8 percent from most community banks, he says.

Regionals that take advantage of their newfound strengths will be reshaping more than just their financial statements.

"I think about a sweet spot in there being a significant amount of activity in terms of innovation and transformation and acquisitions," says Wayne Busch, managing director in Accenture's North America banking practice. "The executives of these banks have unique opportunities. They'll want to think about how they transform themselves for the next round of competition."

Busch predicts that the industry, which 35 years ago had more than double the number of players it does today, will shrink by another 1,500 banks through the end of this decade. He says regional banks are certain to be part of the consolidation, whether they're gobbling up community banks or perhaps in some cases coming together to form super-regionals. Either way, the impetus will not be a growth-at-all-costs approach but more considered thinking about optimizing product sets and exploiting geographic adjacencies, he says.

Even Synovus Financial, which has had a long climb

back to health and is considered by many analysts to be more of a potential seller than buyer, is looking forward to the day when it revives its acquisitive streak.

"Today we're focused on organic growth and fixing our own company," Synovus CEO Kessel Stelling says. But "we like to think we will play a part in future consolidation. We think Synovus has been a very good acquirer of companies" over its 125-year history.

For now, Stelling waves off speculation that his Columbus, Ga., company is a takeover target. "I tell our team all the time I think it's flattering when people talk about how attractive our franchise is" to potential suitors, he says.

Stelling says there will always be a growth imperative for banks—shareholders rarely want to settle for status quo. But he doesn't feel pressure to grow the $27 billion-asset Synovus just for the sake of spreading new regulatory and compliance costs across a broader asset base.

"We think we fall into that sweet spot of banking where we can absorb the cost. We don't like it, but we can absorb it ... and [still be] more nimble and act more local than many of our larger friends in the industry."

How far in either direction does that sweet spot extend? Stelling laughs, "I joke with my peers about this: most bankers will say that below a certain asset threshold, there is no way to absorb the new regulatory costs, and the threshold most people pick is the asset level immediately below them."

A more defined answer comes from investment banker Jimmy Dunne, senior managing principal of Sandler O'Neill & Partners. "You want to be either $9.9 billion or $49 billion," he says, referencing the impact of new regulations—including some that apply only to banks with assets of $50 billion or more and others where exemptions were carved out for banks under $10 billion in assets.

Dunne's eyes crinkle as he considers the narrowness of the options he has laid on the table, and he quickly offers up a second, more charitable view. "In general, $3 billion to $9.9 billion is a good place to be, $20 billion to $49 billion is a good place to be, and $100 billion to $300 billion is a good place to be."

Clearly others in the industry agree, as evidenced by recent deals such as FirstMerit Corp.'s purchase of Citizens Republic Bancorp, which boosted Akron, Ohio-based FirstMerit's assets from $14.6 billion—right in the middle no-man's-land based on Dunne's assessment of the industry—to $24 billion.

William Cooper, the outspoken chairman and CEO of the $18.2 billion-asset TCF Financial, says he's hopeful that the regulatory exemptions for banks under $10 billion in assets will be broadened to protect banks up to the $50 billion threshold. But he still sees advantages for the banks in the middle like TCF, which is based in Wayzata, Mich., and has nearly 430 branches in eight states.

"The midsize banks at $10 billion to $50 billion are in my judgment right in the sweet spot of being large enough to attract and retain good, solid management to a bank where management can still get its arms around everything that is going on. I think there's an inherent efficiency in that," Cooper says.

For decades now, many in banking have argued the importance of size, not just growth, as a factor in a bank's success. In the Dodd-Frank era, they may finally be right.

"Until fairly recently, the notion that size was such an advantage was not really accurate," Dunne says. "Now, size is almost an imperative to attract that cold investment dollar."

The benefits of size have been top of mind the past few years for Furlong, who ran the $52 billion-asset M&I before its sale to Harris. The deal was announced in December 2010 and completed in July 2011. "If you looked at both organizations prior to the merger and tried to figure out how they were going to have successful branding and advertising campaigns and how they were going to have successful development capability—everything you do from an overhead standpoint, even aside from the regulatory [picture], which was really evolving just then, it becomes more difficult" the smaller you are.

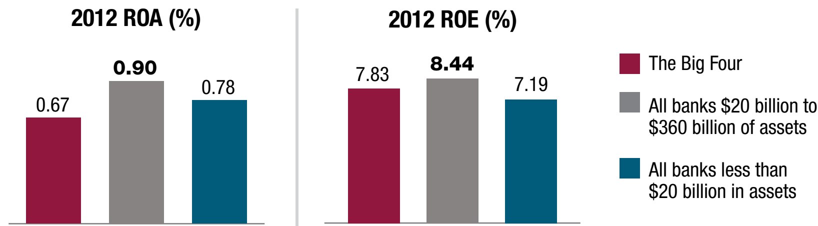
These days, Furlong appreciates even the subtle differences size can bring. "I was at our training office in Milwaukee just this morning," he says, marveling that the facility can be used now by BMO Harris' entire U.S. employee base, and not just the piece of the company that used to belong to M&I.

Furlong says that while getting his management team together involves "bigger rooms than it used to," he and his lieutenants still visit the field every week as before.

But Furlong admits that a larger company has certain constraints on management. "Certainly if you double the size you don't double [the length of] the year—it still has the same number of days," he says. The balancing factor, he says, is the consistency of culture that comes with a stable employee base. "If we'd had massive turnover like you often see in an integration like this, then it becomes a whole different game. But that didn't happen to us. Even the senior management team is a real mix of former M&I and Harris" executives.

As a competitor to national brands and community banks alike, regional banks walk a tricky line when it comes to culture and management style. "At Fifth

HOW THE REGIONALS STACK UP



REGIONAL RUNDOWN: STATISTICS FOR SELECT INSTITUTIONS

	Assets ($B)	ROA% 2012	ROE% 2012
U.S. Bancorp	354	1.65	15.02
PNC	305	1.02	8.17
TD Bank	219	0.26	2.47
BB&T	184	1.11	10.19
SunTrust	174	1.13	9.55
RBS Citizens	128	0.50	2.69
Fifth Third	122	1.34	11.50
Regions	121	0.92	7.35
BMO Financial	116	0.40	3.37
UnionBanCal	97	0.70	5.18
KeyCorp	89	1.00	8.44
M&T Bank	83	1.29	10.61
BancWest	80	0.80	6.19
BBVA USA	69	0.74	4.56
Comerica Incorporated	65	0.83	7.43
Huntington	56	1.15	11.30
Zions	56	0.65	5.37
First Niagara	37	0.48	3.45
Synovus	27	3.16	29.04
First Horizon	26	-0.11	-1.20
Associated Banc-Corp	23	0.81	6.11
Cullen/Frost	23	1.16	10.03
Commerce Bancshares	22	1.32	12.02
First Citizens	21	0.64	6.96
Webster	20	0.90	8.92

Note: Data is for top-tier institutions that reported consolidate financials at yearend. Companies where gross loans or deposits were less than 30% of assets have been excluded from medians.

Source: SNL Financial

Third we fight hard every day for our people to think small, think community, and when you're 21,000 people strong and in a 12-state geography with national businesses, you've got to make sure you're deliberate about your culture, your approach, your customer experience. That doesn't just happen" on its own, Kabat says.

John B. McCoy, who was CEO of Banc One when it purchased First Chicago NBD in 1998, remembers this as the tipping point at which his Columbus, Ohio, company began to model itself more in the image of the largest banks than the local ones.

"When we had 20 presidents in Ohio, I could manage that. When we got up to 50 presidents, it got to be a real issue," McCoy says. "We got to a point after we acquired First Chicago that we really needed to centralize more. There's a size where it gets difficult to make [the local model] work." Banc One eventually was sold to JPMorgan Chase, in 2004.

McCoy generally applauds the work being done at today's regional players. Reached at his office in Columbus, he says in that city, Huntington, which is headquartered there, does a good job of replicating a community bank feel that belies its $56 billion asset base.

"It's not black and white," he says of the prospects for regional banks everywhere, "but if I was a Fifth Third or if I was a Huntington, I'd probably like my position. Now would I rather be Fifth Third or JPMorgan? I can tell you that I'd like to be either one of them, especially if we can get an upward sloping yield curve. If the economy starts to move, they [both] have good opportunities."

It isn't just JPMorgan Chase that has regional executives looking over their shoulders. As all of the big banks start to wrap up the exercise of jettisoning noncore assets and honing their focus on plain vanilla banking, competition in markets across the country will increase. Kabat points to Wells Fargo as a prime example of a stirring giant.

"In the past, Wells Fargo was an acquisition machine. But they can't play that game anymore, by law, because of the 10 percent deposit cap. So ... now Wells will focus on the core delivery of value–and maybe they always have, but they also had these other business lines."

And that, Kabat says, "will raise the bar for all of us."■

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