For mid-size banks, the route to the digital future is partnerships

How mid-size banks can get into growth areas like banking-as-a-service (BaaS) and compete in digital banking

Mid-size banks (with up to $200 billion in assets) don’t have the agility of fintechs or the resources of large banks to move quickly into the digital future. But with well conceived strategic partnerships they can catch up in digital and tap new sources of growth.

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Introduction: To compete in the digital future, mid-size banks need to jumpstart their partnership strategy

Many mid-size banks (with up to $200 billion in assets) are in a tough spot. Both fee income and margins are shrinking, and it is becoming harder to hold onto depositors. Consumers today expect a full range of digital banking services beyond traditional deposit, loan and payments products—delivered via high-touch customer experiences. These expectations are being met by new kinds of non-bank competitors, such as fintechs. Meanwhile, the branch banking model is beginning to look obsolete and COVID-19 has only made the situation more urgent—showing consumers how well they can get by without ever setting foot in a bank.

In short, this looks like a Kodak moment for mid-size banks. Not the kind where Dad takes a snapshot of the kids at the beach, but rather the kind when companies realize that the earth has shifted under them and they cannot survive without adapting. When Kodak faced such a moment, it famously failed to move its business into digital photography and a legendary brand died.

The good news: Mid-size banks still have an opportunity to stay relevant and prosper in the age of digital banking. They can still catch up on digitization, which can help them hold current customers and grow beyond the geographic limits of their service area. And they can position themselves for the emerging banking-as-a-service (BaaS) business, in which third parties, such as retailers, “resell” the services of licensed banks.

But they can’t do any of these things on their own. They need successful strategic partnerships. Mid-size banks are simply too big to move with the agility of the fintechs and too small to match the digitization investments of major banks—the two types of players that are enjoying the greatest growth today.

This paper is designed to help top leaders and technology decision makers in mid-size banks build a strategy that accelerates partnerships through the development of a scalable BaaS offering that can create a new—and highly profitable—revenue stream. We share insights about the specific challenges facing mid-size banks and the new growth opportunities they can pursue by unbundling bank services for resale in as-a-service arrangements. We show that the critical capability that mid-size banks need to develop now is a facility for identifying, executing, and managing partnerships for full participation in the BaaS business.
The growth opportunity: banking as a service

The digital revolution that has disrupted other forms of commerce—from retailing to travel to entertainment—is gaining force in the banking industry, too. JP Morgan Chase CEO Jamie Dimon recently warned that “banks are playing an increasingly smaller role in the financial system” as fintechs, as well as tech giants like Amazon, offer consumers loans, payments, credit cards, investing and other financial services.\(^1\) Mid-size banks are especially exposed to the new online competition, which can attract customers anywhere.

But mid-size banks can also turn the threat into a new and profitable growth opportunity by partnering with their new non-bank competitors. The new players use all the techniques of online retailing to find likely customers and draw them in with simple, intuitive interfaces, and smooth, friction-less transactions. Like the best online merchants, they use data analytics and AI to anticipate customer needs and continually refine their offering. But they don’t have what bank partners can provide—a license to take deposits (a funding source), consumer confidence (trust), and the infrastructure to carry out all the back-end work, such as payment “rails,” and a highly regulated compliance function (KYC, AML, FATF, cybersecurity, controls).

This is why some of the biggest players in banking are becoming “partner banks” with fintechs, consumer brands, and operators of online platforms, such as Uber. Goldman Sachs, for example, recently joined BBVA, JP Morgan Chase, Bank of America, and other leading banks in offering publicly available connections—open application programming interfaces (APIs),—to enable third parties to access their services. “We are trying to create a new industry” by offering banking products and related support (e.g., compliance, KYC) for organizations that want to provide financial services to their customers, says Hari Moorthy, head of transaction banking for Goldman. “Imagine a technology company that can use these APIs to create a solution for payments or deposits in concert with whatever else they currently provide to that client.”\(^2\)

It’s still early days for such partnerships, although they are growing rapidly. According to venture capital firm Andreessen Horowitz, “partner bank” arrangements jumped five-fold from 2010 to 2020, to about 30, and the approach has proven highly profitable for the banks, which have earned two to three times the industry average return on assets (Exhibit 1).\(^3,4\) Increasingly, the partnerships are aimed at banking-as-a-service (Exhibit 2).

**Exhibit 1. Partner banks have higher returns**

<table>
<thead>
<tr>
<th>Return on Equity</th>
<th>Return on Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sutton Bank</td>
<td>40%</td>
</tr>
<tr>
<td>Celtic Bank</td>
<td>30%</td>
</tr>
<tr>
<td>Green Dot</td>
<td>20%</td>
</tr>
<tr>
<td>Celtic Bank</td>
<td>10%</td>
</tr>
<tr>
<td>Sutton Bank</td>
<td>10%</td>
</tr>
<tr>
<td>Celtic Bank</td>
<td>0%</td>
</tr>
</tbody>
</table>

10.8% Industry Average

12% Industry Average

Source: 11:FS
Source: Three-year average (2017-2019), per ibanknet.com

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1. Source: TaylorLoch, “JPMorgan Chase CEO Jamie Dimon: Fintech is an ‘enormous competitive’ threat to banks,” CNBC.com, April 7, 2021
2. Source: “Transforming Global Transaction Banking With Open APIs,” Medici on Medium.com, November 30, 2020
3. Source: The partner bank boom, Andreessen Horowitz, 2021
4. Source: Banking as a Service: Reimagining financial services with modular banking, 11:FS, 2020
### Exhibit 2. Select banking-as-a-service partnerships

<table>
<thead>
<tr>
<th>Bank (license holders)</th>
<th>Partners (providers and brands)</th>
<th>Detail</th>
</tr>
</thead>
<tbody>
<tr>
<td>BBVA</td>
<td>Google, Uber, Simple, Azlo, Xero, Modo, digit.co, Synapse, Stripe</td>
<td>BBVA was a first mover, releasing a suite of open banking products on its BaaS platform offering payments, KYC and KYB processes, account origination and management, card issuance, and other functions.</td>
</tr>
<tr>
<td>Evolve Bank &amp; Trust</td>
<td>Synapse, Stripe</td>
<td>Evolve provides deposit accounts for both payments and lending products, enabling Synapse to use its regulated capabilities to support brands such as Mercury.</td>
</tr>
<tr>
<td>Lincoln Savings Bank</td>
<td>Acorns, Q2, Qapital, Money Lion, Square</td>
<td>Lincoln’s LSBX platform offers savings and investing products, as well as compliance, to multiple fintech companies.</td>
</tr>
<tr>
<td>Green Dot</td>
<td>Walmart, Uber, PayPal, Stash, Apple Pay Cash, Pangaea, EasyCorp</td>
<td>Green Dot’s partnership with Walmart helps previously unbanked consumers gain access to banking services such as account opening, card issuing, payment processing, fraud prevention, and regulatory compliance.</td>
</tr>
<tr>
<td>Celtic Bank</td>
<td>Kabbage, Square Capital, Stripe Capital and OnDeck</td>
<td>Celtic Bank provides chartered banking services such as underwriting and online loan servicing to fintechs such as Kabbage, Square Capital, Stripe Capital and OnDeck.</td>
</tr>
<tr>
<td>Sutton Bank</td>
<td>Monzo, Marqeta, Galileo</td>
<td>Sutton Bank is the deposit holding entity for many digital-only banks (e.g., Monzo) and fintechs (e.g., Marqeta, a digitally native card platform, and Galileo, a payment processor).</td>
</tr>
</tbody>
</table>
The challenge: Stop faking digital

Before mid-size banks can vault into the digital future and unlock their services for new distribution models, they need to get their digital acts together. Customers not only want smooth, reliable online services and convenient apps, they also want their financial institution to anticipate their needs the way an online store does—offering up just the right idea for life’s big financial moments, such as the birth of a child, a home purchase, or retirement, for example.

Banks have created online front ends to existing products and provide handy apps for smartphones. But, in effect, they have been “faking” digital, rather than providing the type of digital experience that consumers have come to expect from e-commerce sites.

By contrast, new digital players have shown how it can be done and consumers have noticed. Survey research by MX Technologies shows that 71 percent of consumers use fintechs like PayPal or Venmo for payments and 39 percent say COVID-19 has made them more likely to trust fintechs for banking services.

Providing these services seamlessly all depends on digitization—intelligent systems that use data analytics to put the right product in front of the customer at the right moment. However, digitization usually requires massive technology investment and process change across both customer-facing and back-end operations. This is becoming an existential challenge for mid-size banks, which are burdened by rigid and costly-to-maintain legacy technology that does not connect easily with other platforms.

Mid-size banks have invested significant sums in digital technologies, but progress has been slow, and few institutions have seen great results. In a recent survey, 62 percent of retail bank executives said their digital deployment was only partial or their digital investments were not delivering as expected. At most banks, it still takes several days to open a new account—even at banks that offer robust online services—because of the limitations of legacy systems. Digital-only banks have cut the cycle time to a fraction of this. Similarly, it still can take days or weeks to get a mortgage approved at a bank. Google Cloud promises to process mortgages in hours or even minutes using AI.

Many bank CIOs understand that legacy technology is a barrier to competing in the digital future. But when it comes to partnering with fintechs or other BaaS partners, legacy technology need not be a deal breaker. There are now ways to open up legacy systems and unbundle services without completely updating bank architecture. Architectural innovations on the cloud, such as microservices patterns, service mesh, and container orchestrations, all simplify and modularize the bank technology stack. Open API capabilities and microservices make access to legacy systems less onerous. A modernized, external-facing API platform will create a secured real-time bridge between the bank’s systems and the partner’s customer-facing front end. Meanwhile, cloud adoption and DevOps can speed up the modernization process.

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5 Source: COVID-19’s Impact on the Fintech (MX Technologies, 2020
6 Source: 2020 innovation in retail banking report, Efma and Infosys Finacle, Nov. 2020
7 Source: Google Cloud releases AI-powered mortgage processing tool, Finextra Research, October 20, 2020

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The roadmap: Accelerating partnerships

Unless they act quickly, mid-size banks risk getting left behind—saddled with operating models that were designed for a world that no longer exists and unable to take advantage of the BaaS opportunity. But, as the record shows, they can’t rely solely on the capabilities within their four walls to transform themselves for the digital banking business. This is why smaller banks need to get very good, very quickly, at forging the partnerships that can move them into the digital future and capitalize on new growth opportunities. Based on our work with banking clients, we recommend a four-step approach.

1. Define the bank partnership strategy

The field of potential BaaS partners is wide and growing. In addition to fintechs, online platforms, and consumer brands, banks may have opportunities in healthtech, mediatech, edtech, real estate, logistics and many other areas. Identifying the right partners is critical to executing a successful BaaS strategy.

To get to the right partnerships, we start with two questions to frame the partnership strategy:

1. How do digital marketplace opportunities align with where the bank wants to be in the future?

   Banks should start with their overall strategy and financial goals, especially customer growth objectives, as well as a clear view of product portfolio and geographical reach. Banks must understand both the current value contribution and future value creation potential of any partnerships, whether formal joint ventures, strategic partnerships or acquisitions.

2. How does the bank manage cultural friction and change?

   Banks also need to assess the cultural readiness to make the transition from the legacy banking mindset—typically risk-averse and insular—to dealing with external partners and people from different industries.

2. Ring fence bank services

Once a bank partnership strategy is agreed, the next step is to slice up the bank’s capabilities into a catalog of discrete services that can potentially be offered as “white label” services to third parties. This requires a detailed understanding of all bank capabilities, the role they play in the current bank’s product and marketing strategy, and how that might change with a partnership model.

We know that creating this catalog of services will involve different levels of difficulty. Bank processes that are more easily extracted likely include KYC, depository services, debit and credit card services, treasury management, and PSD2-compliant account access. In contrast, unbundling services such as payments, simple fixed loan approvals, and employee services may require significant improvements to back-office processes. And services with complex regulatory and compliance processes may not be conducive to unbundling.

To successfully monetize unbundled services, banks need to map this comprehensive suite of services against market demand and level of difficulty to unbundle.
Banks have an option to build an internal competency using specialized tech vendors (HSBC worked with Mulesoft, for example), acquire a third party with this capability (BNP Paribas bought Compte Nickel) or share a platform with a third party (more than 100 banks use Raisin).

Whatever path is selected, building a modern API platform is essential for any BaaS partnership. For many banks, APIs are already being used as a distribution model (e.g., electronic payments and money transfers) but less commonly as part of a strategy to partner externally.

KPMG has defined four dimensions of an API strategy...

- Consumption profiles
- Pricing and monetization
- Content curation
- Deployment model

... and three critical elements of API development:

- Microservices
- DevOps
- API management

These elements will usually be tackled by different technology teams but are independent and must be coordinated. Like many companies, banks typically have some of these skills but may lack skills in all these areas. They can rely on specialized third-party integrators to help guide, design, and deploy an open API architecture that is compliant with recognized banking data standards. These API platforms should be peer reviewed and approved by third parties to help develop a vibrant marketplace, as we’ve seen with APIs from CIBC, Shopify, Uber, and Chime.

Build and execute the BaaS marketplace

Banks should vet partners through a due diligence process that establishes an independent understanding of the financials, as well as key aspects of the partner’s technology capabilities. Effective due diligence research and analysis will reveal both strengths and weaknesses in potential partners’ businesses and operations, spanning technologies, customers, and markets (Exhibit 3). In addition, guiding principles for the partnership should be agreed in advance so there is complete clarity about monetization models, one-time investments, and operating requirements, such as managing customer data privacy.
### Exhibit 3. BaaS partnership technology due diligence framework

<table>
<thead>
<tr>
<th>Diligence Area</th>
<th>Category</th>
<th>Basic</th>
<th>Emerging</th>
<th>Advanced</th>
</tr>
</thead>
<tbody>
<tr>
<td>Platforms/Technology</td>
<td>Software</td>
<td>Leading dev Framework, SDLC, Embedded security provisions, Optional metrics, SaaS metrics, APIs offered, Persistence selections, Content/Asset management</td>
<td>Code generation, Algos, High touch UI, Executable cloud strategy, DevOps, infra automation, Scalable infra environment, System architecture</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Infrastructure</td>
<td>Code reusability/Extensibility, Team Collaboration (on/off shore)</td>
<td>Code generation, Algos, High touch UI, Executable cloud strategy, DevOps, infra automation, Scalable infra environment, System architecture</td>
<td></td>
</tr>
<tr>
<td>Process Automation</td>
<td>Digitized customer processes</td>
<td>Account &amp; transaction inquiry, Account maintenance, Tiered authentication, 3rd party fulfillment, Digital form generation and signing, Ongoing screening (fraud, OFAC), Portfolio management, Robotization</td>
<td>Guidance and credit checks, Underwriting and pricing, Digital T&amp;C, Initial screening (KYC, AML, etc.), Self-learning compliance, Sales to financial reporting</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Automated compliance management</td>
<td>Embedded security provisions, Code generation, Algos, High touch UI, Executable cloud strategy, DevOps, infra automation, Scalable infra environment, System architecture</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Partnerships</td>
<td>Data, analytics, commerce and payment functions</td>
<td>Market data, Payment processors, Ad networks, CDNs, Unified audience management, Service operations, Industry alliances</td>
<td>Development contractors/ vendors, Incubator/ accelerators, Industry networking, Digital commerce collaboration, SEO/ SEM, Supplier power, P2P utility</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Market proposition, hurdles</td>
<td>Market participants/ competitors, GTM strategy, Omnichannel features, Regulatory adherence-RegTech, Fin tracking</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: KPMG
How KPMG can help

The KPMG Bank Strategy practice has deep experience helping banks develop and execute transformative M&A transactions that drive long term value to the business.

What we do:
We have helped banks develop viable and practical digital strategies, weigh the financial and operational pros and cons of in-house development versus partnerships or acquisitions, and identify potential partnership targets in line with the overall product strategy. We have also guided the evaluation of potential deal targets, including the strength of the target’s core banking platforms, potential applications of the target’s products and services, the technical depth of the target’s engineering team, and the rigor of the target’s cybersecurity processes.

How we work:
Our approach brings the talent and depth of KPMG to the significant challenges facing the banking industry. Our specialists apply the firm’s well-tested, cross-industry approaches, leveraging the technical know-how of our highly trained in-house digital banking team. We can also bring several technology accelerators for modernizing legacy systems and methods for building the API platform, needed to support a BaaS partnership strategy.
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Sanjay is a managing director in the KPMG Strategy practice, specializing in guiding clients in M&A strategy and execution of deals in banking and capital markets. Sanjay has advised on more than 100 transactions, including corporate acquisitions, spin outs, and management buyouts. He is actively engaged in fintech incubators and well versed in emerging technologies and their impact on the valuation and integration of banking assets.

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