# What's Going On In Banking | 2023

**Fighting the Headwinds, Riding the Tailwinds**

Cornerstone
ADVISORS

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Chief Research Officer
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Cornerstone ADVISORS

# (Everything I Do) I Do It for You

This is the eighth straight year that I've been authoring Cornerstone Advisors' annual ***What's Going On In Banking*** study. What started as a look into bank and credit union executives' outlook for the coming year has grown into a detailed dive into the strategic, operational, and technology-related plans of mid-size financial institutions.

The title of the report was inspired by the Marvin Gaye classic, "What's Going On," and in this year's report, musical references are all over the place—I hope you find them all. One apology, though: Please don't expect to find many references from this century—I'm a child of the '70s.

Let me say a little about the survey sample of this report. For the past few years, we've had a sample of about 300 respondents who come, overwhelmingly, from financial institutions in the $250 million to $50 billion asset range. There are thousands of banks and credit unions in this asset range, and you could argue that a sample of 300 isn't particularly representative or statistically significant.

You could argue that, but you'll get the following argument back from me: The sample is representative of a set of financial institutions that Cornerstone Advisors refers to as "troublemakers"—institutions that are forward-thinking regarding their use of technology, aggressive about going after growth and market share, and unafraid to take on the megabanks, upstart fintechs, and anyone else competing with them for mind and market share. There are about 1,500 financial institutions that fit this bill—and our sample of 300 is representative of that group (and statistically significant, for that matter).

As **Cornerstone Advisors President and Partner Steve Williams** likes to say:

> **"Troublemakers live and die by the law of limited time, focus, and resources—a road map represents an evolving grand bargain among aspirations, priorities, sequences, and accountability."**

This report is written primarily for them—the troublemakers in the industry. But it's also for the institutions that want to be troublemakers, and for the technology providers that serve the troublemakers and want to know where their heads are going to be in the coming year.

I hope you enjoy this report. We don't get paid to do it, and we don't charge for it. We do it for you. Because everything we do, we do it for you. And there's your first cheesy musical reference.

**Ron Shevlin**
Chief Research Officer
Cornerstone Advisors

# For a Pessimist, I'm Pretty Optimistic

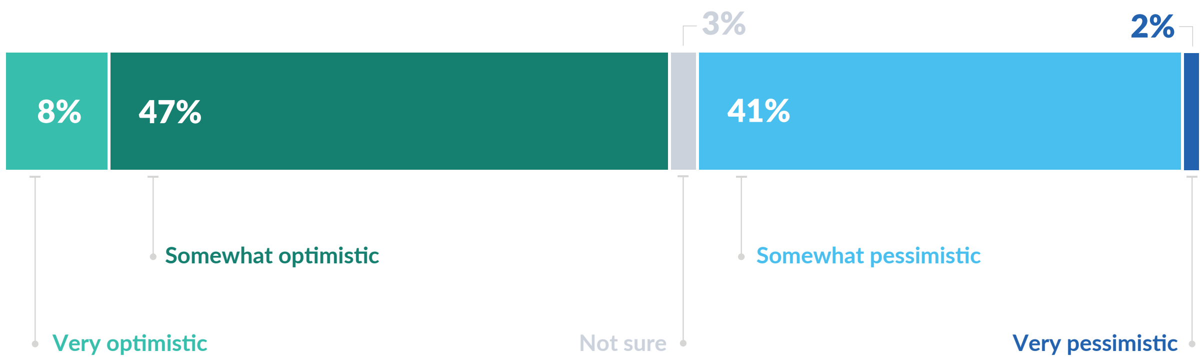
With many economists predicting a recession in 2023, and the Federal Reserve Board raising the federal funds interest rate another half a point in mid-December 2022 (after four-straight 0.75% hikes at its previous meetings), the economic picture for 2023 is not shaping up to look very bright. According to the Federal Open Market Committee:[1]

> "Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher food and energy prices, and broader price pressures."

But don't tell that to executives at mid-size banks and credit unions. Regarding the upcoming year, the optimists outnumber the pessimists. A little more than half of our survey respondents are "very" or "somewhat" optimistic about the prospects for the banking industry in 2023, while 43% express a pessimistic view (Figure 1).

**Figure 1:** Outlook for 2023

How optimistic or pessimistic are you about the prospects for the banking industry in 2023?




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

**Why do the optimists have a positive outlook?**

> "The increase in the loan rate environment has the potential to allow for an increase in margins we have not been able to achieve in several years."
>
> **—Alan Cortum, CEO, Valley Oak Credit Union, Three Rivers, Calif.**

> "We have not had steepness in the yield curve for a long time—the widening of margins gives back the opportunity to spend more on people and technology. The banks that do this will be successful."
>
> **—Julie Thurlow, CEO, Reading Cooperative Bank, Reading, Mass.**

> "Most banks in the industry are somewhat asset-sensitive, so they will operate pretty well at these levels of interest rates—provided we reach a point where increases slow down/cease. Deposit interest expense will slow down NIM advancements, but for 2023, EPS should look pretty good."
>
> **—Tom Moran, CEO, Community Bank, Walla Walla, Wash.**

> "Rising interest rates are beneficial for deposit accounts, and the additional income generated from the higher loan rates is something financial institutions have been waiting for. The struggle will be to obtain deposits to fund the loan growth as consumers and businesses do not have a lot of cash on hand."
>
> **—Nancy Roske, Chief Administrative Officer, Magnifi Financial Credit Union, Melrose, Minn.**

> "Loan rates in general should be where they are good for lenders and consumers, around 5%. Mortgage rates should stabilize."
>
> **—Rose Gunter, CEO, Alive Credit Union, Jacksonville, Fla.**

> "Despite many negative economic indicators, unemployment remains low. For primarily consumer-based institutions, this means there is still a strong opportunity to meet consumer financial needs."
>
> **—Doug Ferraro, CEO, Bellco Credit Union, Greenwood Village, Colo.**

> "Change brings opportunity. With the economic changes, a bank's role becomes more important than ever as customers look to navigate."
>
> **—Kathy Strasser, COO, IncredibleBank, Wausau, Wis.**

> "Expansion in NIM based on the rate environment. Continued leadership with small to medium size businesses. Continued leadership within our communities—both charitably, and through volunteerism. Credit and asset quality continue to be in great shape—still positive trends."
>
> **—Bob Howard, CEO, CBI Bank & Trust, Muscatine, Iowa**

**What did the pessimists have to say?**

> "Margins will be squeezed due to rising deposit cost. I believe the industry will see elevated credit issues because of economic conditions, and the deposit contraction is likely to continue."
>
> —**Blake Chatelain, Red River Bank, Alexandria, La.**

> "Pessimistic due to deposit competition from online competitors, strong possibility of recession, and a decrease in home values."
>
> **—Brian Clarke, CFO, Bethpage Federal Credit Union, Northport, N.Y.**

> "We have yet to feel the ramifications of the Covid-related cash that was pumped into the market and the extended forbearances issued on student loans."
>
> **—Mark Seymour, Chief Lending Officer, KEMBA Financial Credit Union, Columbus, Ohio**

> "When consumers choose between feeding their kids, putting gas in the tank, or paying their loans —something has to give."
>
> **—Jim Watts, CEO, R.I.A. Federal Credit Union, Bettendorf, Iowa**

> "Regulatory environment continues to hammer away at the banking industry, increasing our costs and complicating the process of helping customers. As technology players get a 'free pass' while we labor to overcome the regulatory burdens, we risk getting further and further behind the technological demands of our customers and markets."
>
> **—Jonathan Krieps, Chief Operations Officer, North State Bank, Raleigh, N.C.**

> "The interest rate environment presents an opportunity to increase NIM, however, our cost of funds and compensation costs are eroding that opportunity. Deposit runoff is a concern as is liquidity. We should be thrilled with the NIM opportunity, but the drag created by liquidity, comp, and cost of funds makes 2023 a challenging year."
>
> **—Jenna Lampson, CEO, Pacific Service Credit Union, Concord, Calif.**

> "Over-leveraging of borrowers with impending market value pressures and increasing interest costs."
>
> **—Mike Bresnahan, CEO, First National Bank, St. Peter, Minn.**

> "Challenges in raising deposits and thus creating capacity on the balance sheet without overleveraging the balance sheet. Conditions for inflation are not being moderated, and government spending will drive higher inflations/shortages of employment/supplies."
>
> **—Steven Stapp, CEO, Unitus Community Credit Union, Portland, Ore.**

## The Threat Is Real

The interest rate environment was the most frequently cited top concern for 2023 by both bank and credit union executives, but the glaring change from the previous year is the jump in the percentage of executives mentioning cost of funds as a concern, from less than 10% in 2022 to more than 40% in 2023 (Table A and Table B).

**Table A:** Bank Execs' Top Concerns, 2020 to 2023

Percentage of Banks Listing Concern as One of Their "Top Concerns"

| | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|
| Interest rate environment | 43% | 56% | 50% | 53% |
| Cost of funds | 15% | 8% | 8% | 43% |
| Ability to attract qualified talent | 27% | 19% | 67% | 42% |
| Regulatory burden | 22% | 18% | 44% | 36% |
| Cybersecurity | 23% | 28% | 51% | 36% |
| Weak economy/loan demand | 24% | 48% | 36% | 35% |
| Efficiency, non-interest expenses, costs | 32% | 36% | 39% | 28% |
| Non-interest income | 11% | 17% | 29% | 26% |
| New customer growth | 25% | 25% | 28% | 23% |
| Credit quality/problem loans | 10% | 42% | 6% | 7% |

Source: Cornerstone Advisors surveys of bank and credit union senior executives, 2019 to 2022

According to **Cornerstone Advisors President and Partner Steve Williams**:

> "It's almost surreal to see the low cost of funds of traditional banks with the sky-high yields on treasuries and rate-driven challenger banks. Banks enjoyed margin expansion in the early innings of this cycle, but coming up is a new generation of deposit competition."

**Table B:** Credit Union Execs' Top Concerns, 2020 to 2023

Percentage of Credit Unions Listing Concern as One of Their "Top Concerns"

| | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|
| Interest rate environment | 32% | 53% | 38% | 59% |
| Cost of funds | 13% | 8% | 9% | 47% |
| Weak economy/loan demand | 34% | 57% | 34% | 44% |
| Ability to attract qualified talent | 19% | 19% | 63% | 39% |
| New member growth | 43% | 40% | 41% | 36% |
| Cybersecurity | 19% | 26% | 43% | 35% |
| Non-interest income | 10% | 27% | 39% | 34% |
| Efficiency, non-interest expenses, costs | 34% | 25% | 33% | 29% |
| Regulatory burden | 16% | 20% | 39% | 27% |
| Credit quality/problem loans | 9% | 33% | 4% | 16% |

Source: Cornerstone Advisors surveys of bank and credit union senior executives, 2019 to 2022

The ability to attract talent was cited as a top issue by fewer execs for 2023 than for 2022, but it's still a struggle. Half of the institutions surveyed said they're experiencing challenges with both staff retention and recruiting and another 31% said they struggle with recruiting even though staff retention isn't an issue (Figure 2).

**Figure 2:** Staff Retention and Recruiting Issues

Many financial institutions have been impacted by the great resignation.
Which statement best describes your institution? We've had...


Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

According to **Cornerstone Advisors Partner Terence Roche:**

> "2023 will be the year financial institutions realize that hiring talent in just a few key areas like analytics, digital marketing, payments, and fraud won't be enough. Developing talent in these areas must become a core competency. 'Talent development' will become a key operating mantra."

**Cornerstone Partner Al Dominick** adds:

> "While finance, credit, and risk have traditionally trumped the power of IT, marketing, and talent—particularly in the C-suite—there will be a shift in this dynamic. As key drivers of enterprise value, CEOs will spend time striking a balance to drive greater performance."

Respondents shared what's working in their organizations regarding retention and recruiting:

> "With the ongoing mergers and acquisitions in the banking sector in our area, we continue to have access to great people. Also, our commitment to making our organization a great place to work with flexible working schedules and a company that truly cares about its people. People are always seeking us out for opportunities."
>
> **—Jonathan Krieps, Chief Operations Officer, North State Bank, Raleigh, N.C.**

"Retention issues have been most prevalent in our front-line/branch positions. Leader engagement, compensation reviews, additional PTO for enhanced flexibility are helping us. We are also reimagining our training program—from onboarding to continual development."

**—Chris Parker, CEO, Northeast Credit Union, Portsmouth, N.H.**

"As far as recruitment, we have been lucky in getting good candidates. We pay top dollar in our local area and have great benefits. But with those things we expect a lot more out of our people. We work with less staff in areas and have little to no downtime."

**—Kristy Smith, SVP Senior Operations Officer, First Oklahoma Bank, Jenks, Okla.**

"Most attrition was/has been occurring in the front-line employees hired in the last 12 months. We built an automatic increase for them on their anniversary date. That seems to have induced folks to stick it out."

**—Carl Casper, Chief Operating Officer, Connex Credit Union, North Haven, Conn.**

"We are 100% remote in the back office so we allow employees to move and still work for us, and we're able to attract talent we wouldn't normally have access to. We've had more departures than in the past, but we are attracting strong talent as replacements."

**—Carrie Birkhofer, CEO, Bay Federal Credit Union, Capitola, Calif.**

"Recruit college grads, train them, offer quarterly salary increases linked to achieving key performance milestones."

**—Dan Yates, CEO, Endeavor Bank, San Diego, Calif.**

"Reward high performers with one-time bonuses that average and low performers don't get and match any job offers great employees are getting elsewhere."

**—Bobby Michael, CEO, All In Credit Union, Daleville, Ala.**

"Word of mouth, internal recruitment fee/incentive program. Hired more internal recruiters and have them work specified areas of the bank consistently. Have interviewees go through multiple layers of interviews to assure both parties are a fit."

**—Jeff Mefford, EVP, Banking, Midland States Bank, Effingham, Ill.**

"We have landed on a hybrid work environment for clerical and back office, so we see a lot of interest in those roles, especially as other FIs are insisting on full RTO. We have made updates to dress code policy, etc., and in roads for diversity and inclusion to further attract talent for the branch pool. Call center and branch are the primary areas where we have seen retention issues, but we are currently fully staffed."

**—Pam Villanova, VP, Operations, American Eagle Financial Credit Union, East Hartford, Conn.**

## Everybody's Working for the Weekend (From Home)

One way in which financial institutions are addressing the retention/recruitment challenges is by creating new work from home policies. Nearly two-thirds of the firms surveyed said they have a "hybrid" work location policy where staff members can—and should—split their time between remote and office work. Roughly one in five institutions require their staff to be in the office, and one in 10 have gone fully remote (Figure 3).

**Figure 3:** Work Location Policy


Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

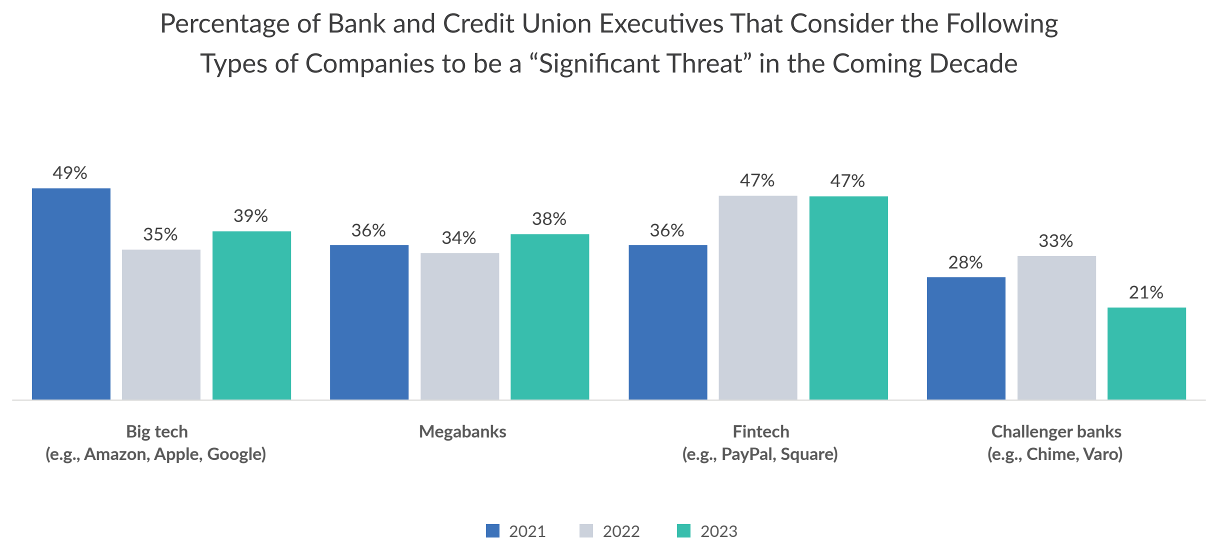
Interestingly, among the respondents whose institutions require staff to be in the office, 40% said they don't agree with their firm's policy. It will be interesting to see next year's data on this topic.

## The End of the Innocence

When evaluating competitive threats over the next few years, there were slight upticks in the percentage of bank and credit union executives that consider Big Tech companies (e.g., Apple, Amazon) and megabanks (e.g., Bank of America, Chase) to be significant threats over the remainder of this decade. And nearly half still consider the big fintech players like PayPal and Square to be threats.

The biggest change in perspective, however, was respondents' view of challenger banks as threats. In the new survey, just 21% of executives said they consider these firms to be significant threats, in contrast to the 33% who cited them as a threat in the 2022 survey (Figure 4).

**Figure 4:** Competitive Threats




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

This shift doesn't surprise us. In June 2022, Cornerstone Advisors Chief Research Officer Ron Shevlin published an article on Forbes titled ***The End of the Neobank Era*** citing three factors negatively impacting challenger banks:[2]

- The "megafintechs" have better economics and business models. Only about half of the top 10 neobanks' customers call their account with those fintechs their primary checking (or spending) account. In contrast, more than 15 million consumers call PayPal or Square Cash App their primary checking or spending account provider. That's just a small percentage of the roughly 272 million accounts Americans have with these "megafintechs." Do the math: Neobanks have to acquire two customers to get one primary spending account customer. The megafintechs, on the other hand, already count nearly every smartphone-carrying American adult under the age of 55 as an account holder. Their cost of increasing engagement is likely less than $90 per existing customer.

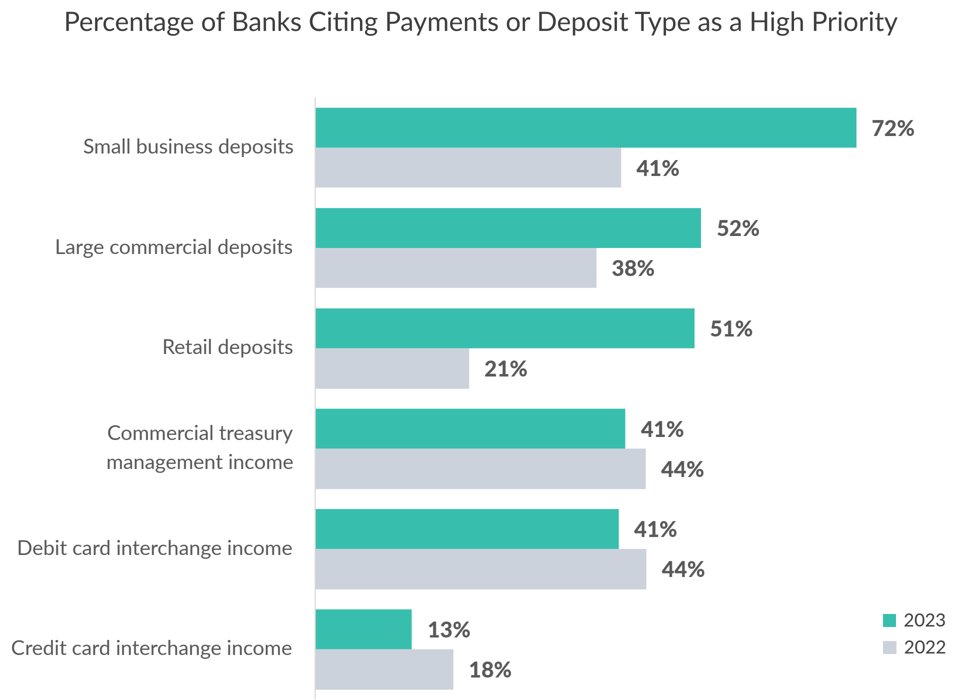
- Interchange isn't a reliable revenue source. Despite their impressive customer acquisition numbers, challenger bank customers still have accounts at traditional institutions, and increasingly split their payment activity not only across banks, but across merchants' mobile apps and buy now, pay later (BNPL) offerings.

- The niche affinity play is getting harder to capitalize on. We've been supportive of the niche affinity approach to neobanks where community fintechs like Kinly, Daylight, and Panacea Financial serve the unique financial needs of specific consumer segments. This approach, however, requires neobanks to identify a segment's unique financial needs, which is easier said than done. And with so many competing niches, which will be the dominant affinity? For example, if you're an LGBT African American doctor, do you bank with Kinly, Daylight, or Panacea?

# The Skills to Pay the Bills

What else is on the minds of bank and credit union executives? In a word, deposits. Among banks, the percentage placing a high priority on growing deposits from small businesses rose to 72% for 2023 from 41% in 2022. The percentage looking to grow deposits among their retail base of customers more than doubled from 21% in 2022 to 51% in 2023 (Figure 5).

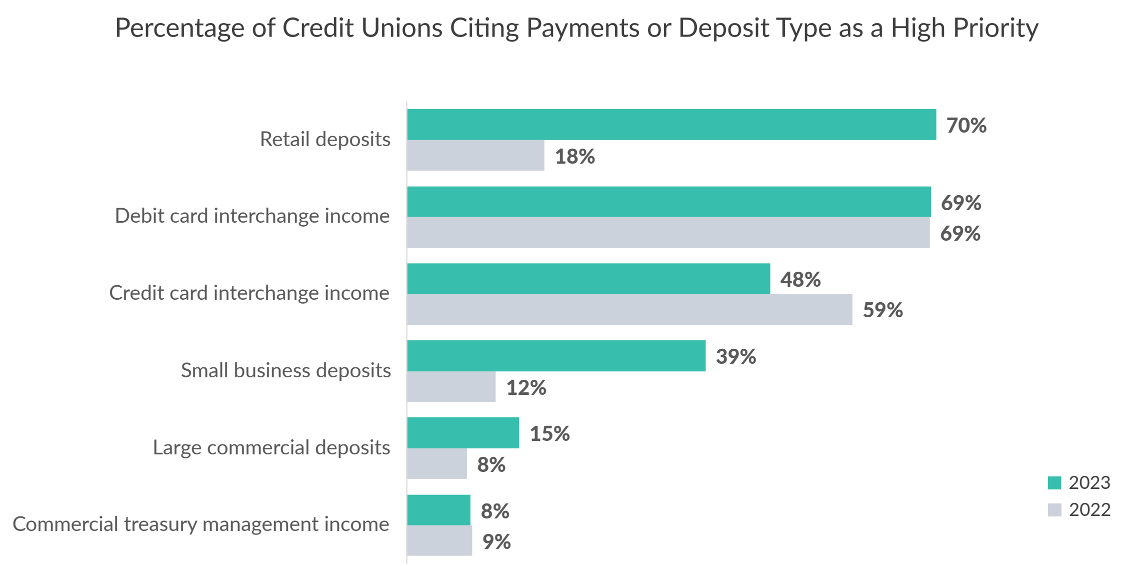
**Figure 5:** Banks' Deposit and Payments Priorities




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

It's a similar story among credit unions, where 70% said growing retail deposits will be a top priority in 2023, a nearly four-fold increase from 2022 (Figure 6). With a negative credit outlook for the upcoming year, a lower percentage of both banks and credit unions are looking at credit card interchange income as a top priority in 2023 than did in 2022.

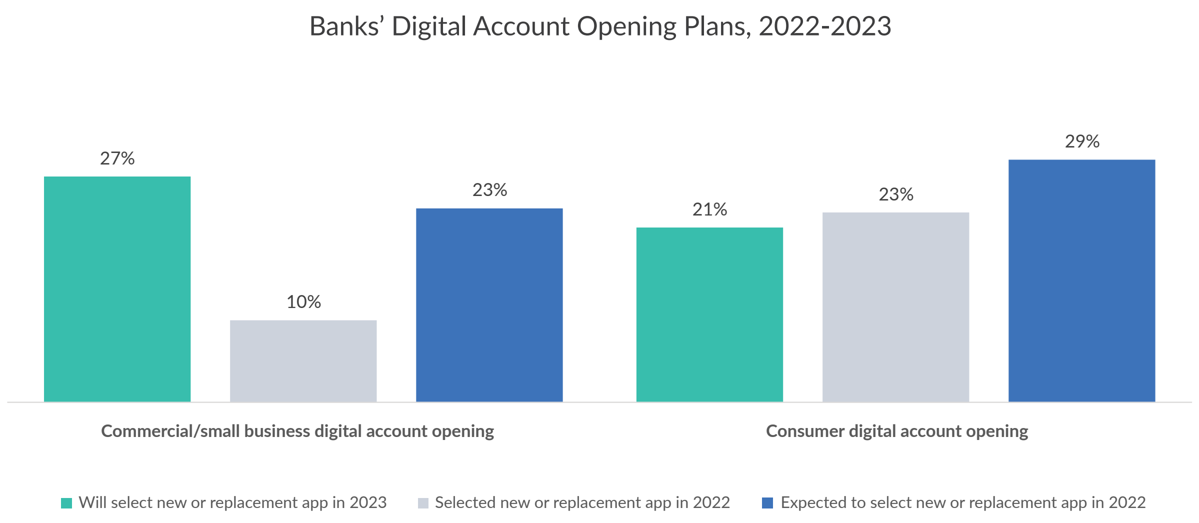
**Figure 6:** Credit Unions' Deposit and Payments Priorities




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

The renewed focus on deposit gathering will—or at least, should—result in strong demand for digital account opening systems in 2023. More than one in four banks expect to select a new or replacement commercial digital account opening app in 2023. However, in 2022, 23% expected to select a new app, but only 10% did. On the consumer side, 21% said they'll select a new system in 2023 (Figure 7).

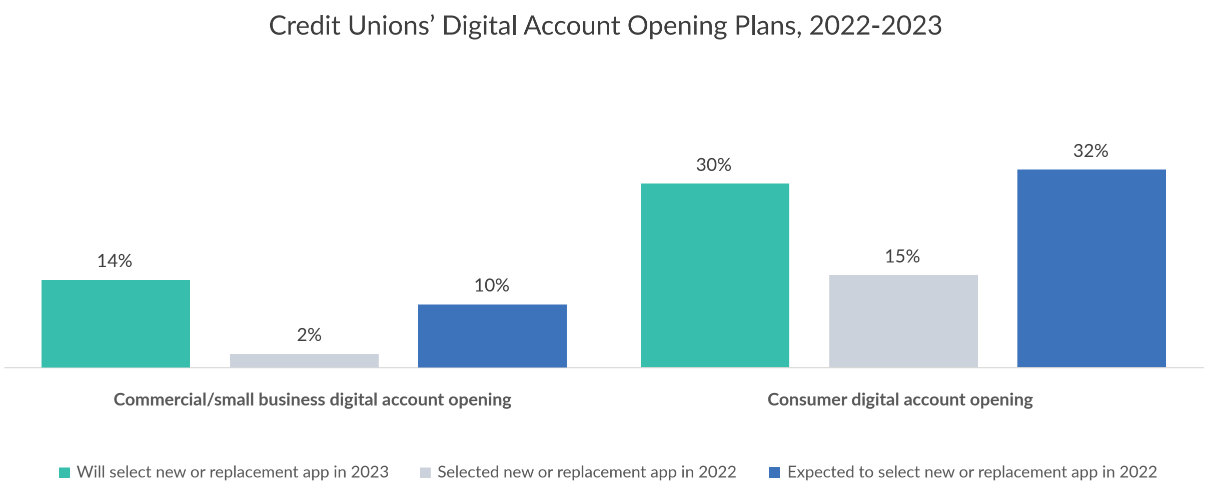
**Figure 7:** Banks' Digital Account Opening Plans




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Expectations among credit unions to select a new consumer digital account opening platform is high for 2023, as it was going into 2022. But in 2022, only about half of the percentage of credit unions that anticipated making a new selection actually did so (Figure 8).

**Figure 8:** Credit Unions' Digital Account Opening Plans

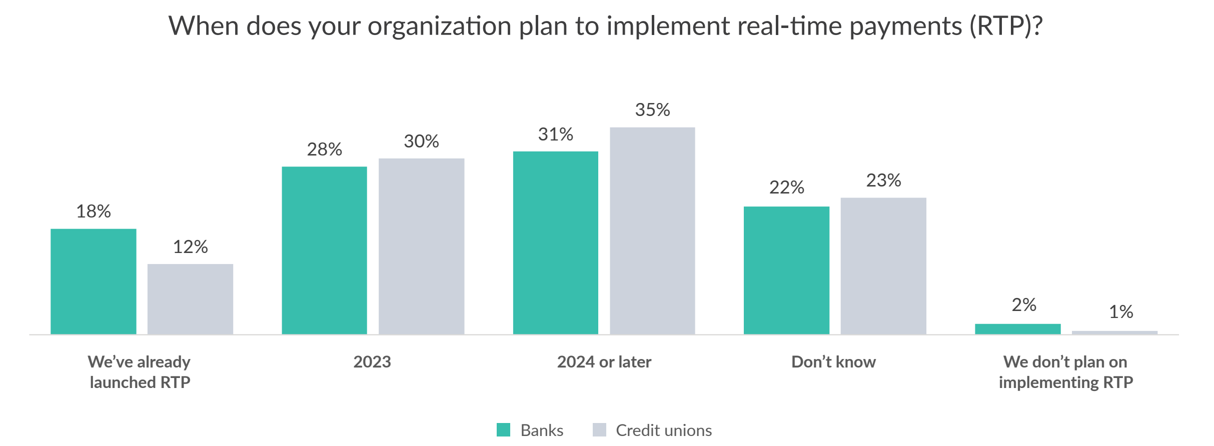



Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

## Real-Time Payments: Make It Real or Just Forget About It

The big picture in payments for 2023, however, is the payments modernization imperative creeping up on both banks and credit unions. Last year, we found that 31% of banks and 24% of credit unions planned on implementing real-time payments in 2022. That didn't happen. In the new study, roughly three in 10 financial institutions said 2023 will be the year they deploy real-time payments on top of the 18% of banks and 12% of credit unions already offering them (Figure 9).

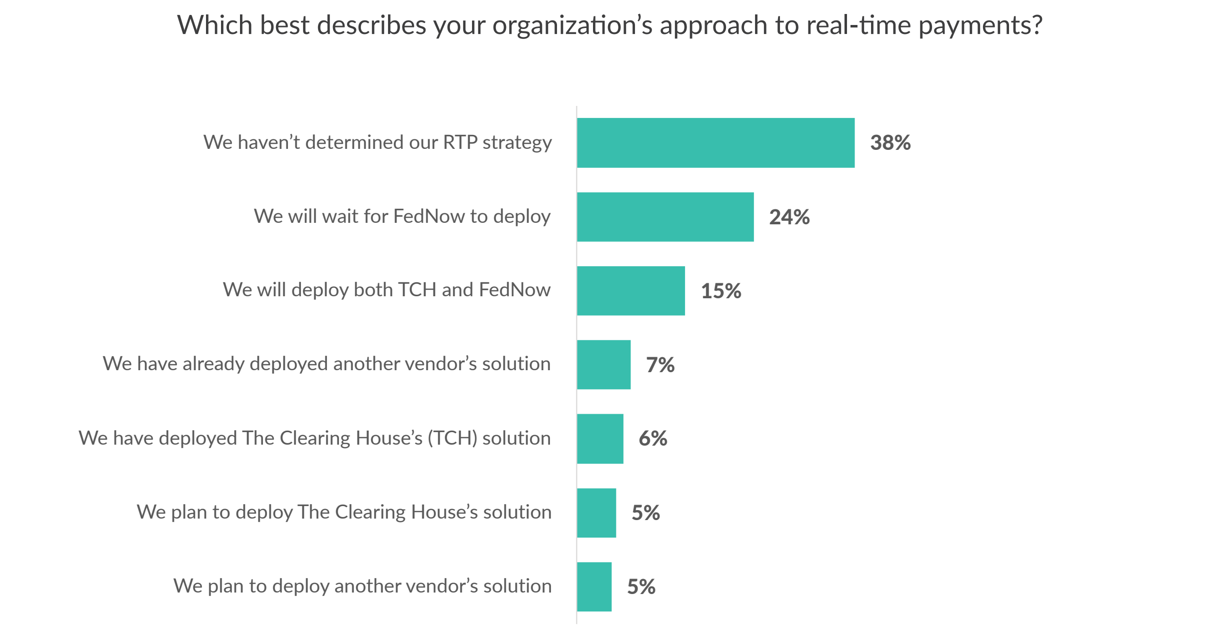
**Figure 9:** Financial Institutions' Real-Time Payments Plans




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Roughly four in 10 institutions have yet to determine their real-time payments strategy, and a quarter said they will wait for FedNow to deploy (Figure 10). Compared to smaller institutions, a greater percentage of the bigger institutions (e.g., $3 billion in assets and greater) said they will deploy solutions from both The Clearing House (TCH) and FedNow.

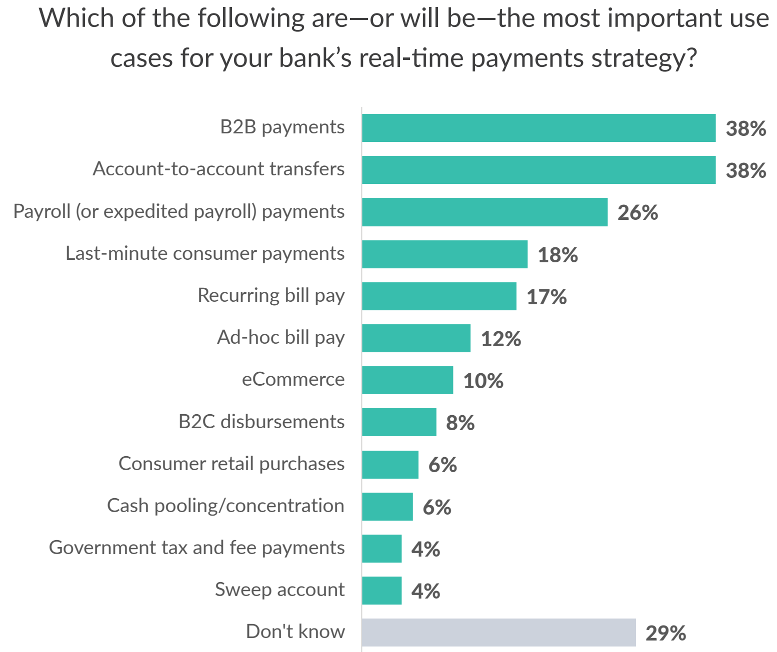
**Figure 10:** Financial Institutions' Approach to Real-Time Payments




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Not surprisingly, business-to-business (B2B) payments are one of the most important use cases for banks' real-time payments strategies along with account-to-account (A2A) transfers. Roughly a quarter of banks are looking at payroll (or expedited payroll) payments as a real-time payments offering (Figure 11).

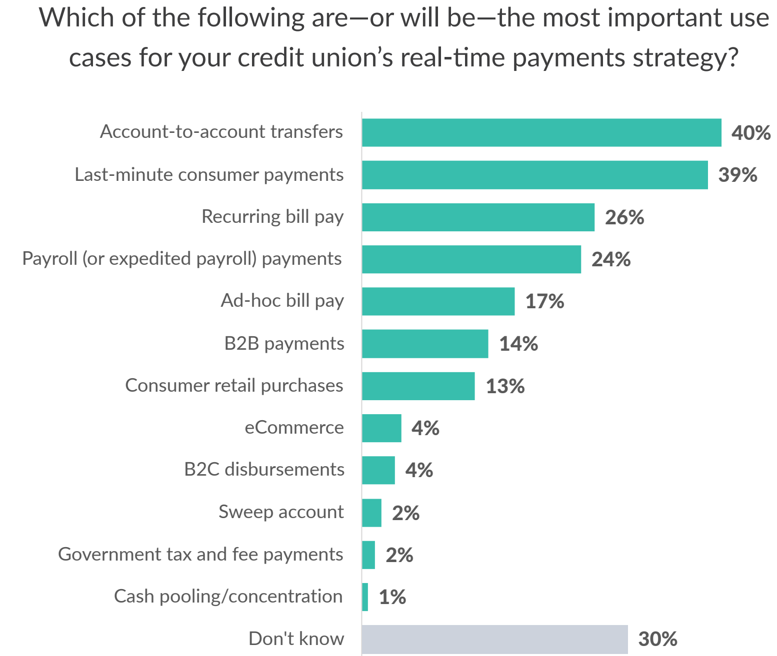
**Figure 11:** Banks' Real-Time Payments Use Cases




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

In contrast to the banks, many credit unions consider last-minute consumer payments to be a top use case for real-time payments in addition to A2A transfers, and about one in four see both recurring bill pay and payroll (or expedited payroll) payments as a potential offering (Figure 12).

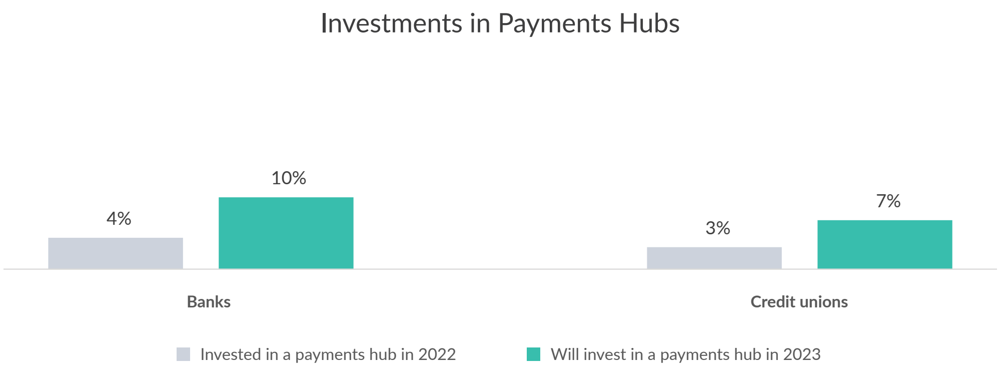
**Figure 12:** Credit Unions' Real-Time Payments Use Cases




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Although still found in just a minority of financial institutions, the percentage of both banks and credit unions expecting to make investments in payments hubs will more than double in 2023 from 2022 (Figure 13).

**Figure 13:** Investments in Payments Hubs




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

## The Payments Modernization Imperative

We'd bet that not many readers are familiar with the Beastie Boys song "The Skills to Pay the Bills" in which they sang:

"You Rip Van Winkle, now you're gonna wake up
MCs, pick up a hobby that you're gonna take up"
—***The Skills to Pay the Bills,*** The Beastie Boys

This interpretation is a bit of a stretch, but it is time for banks and credit unions to wake up and pick up a "hobby"—namely, real-time payments.

Why are so few U.S.-based mid-size financial institutions making the investment in payments hubs (and payments modernization, in general)? We believe it's because they aren't looking at it from a revenue perspective. In a study from Accenture, just a quarter of respondents cited revenue growth as the primary goal of their organization's payments modernization program.[3] According to McKinsey Consulting, however:[4]

> "New revenue streams will be the primary source of return on investment in a modernized payments infrastructure."

McKinsey identified payments modernization-driven revenue streams for banks in both consumer and commercial payments including:

- **Person-to-microbusiness payments.** Most innovation in the person-to-microbusiness arena has been on the front end, with products that make it easier for microbusinesses and small businesses to accept payments (e.g., Square and PayPal card readers). A faster back-end infrastructure would further improve the convenience of these apps. For example, in a used car sale today, a buyer usually gives the seller a check or sends a costly wire transfer. Faster-payments infrastructure will enable car buyers to send a real-time payment to the car seller on the spot and drive away in a car without the risk of a bounced check or a cash theft, and without the cost of a wire.

- **Consumer bill payments.** A real-time infrastructure combined with a ubiquitous merchant biller directory—integrated into mobile banking apps—could create a frictionless bill-payment experience involving push notifications and real-time confirmation of payment receipt. Consumers would have more control over their cash flow, a less costly and more convenient way to pay bills, and more certainty when making "consequence" payments (e.g., payments to restart a suspended utility service). The revenue opportunity here is significant, as bill payment touches every household. In the United States, more than 20 billion bills are paid each year.

- **Commercial just-in-time payments.** Real-time payments allow businesses to control when payments are made and to increase their certainty. Real-time payments are most salient for one-time, lower-value, business-to-business payments, which account for an estimated $11 billion in payments volume in the U.S. For small businesses that need to tightly manage cash flow, faster clearing with real-time notification of payment offers a way to avoid late payments and adopt just-in-time business models. In addition, real-time payments create an opportunity for corporate customers to manage their intra-day liquidity more closely, enabling banks to generate additional revenue by offering liquidity management services such as intra-day loans or overdraft protection.

- **Direct deposit for temporary and hourly workers.** In the U.S., the current ACH Direct Deposit system requires a transaction to be initiated at least 24 hours in advance. Consequently, many businesses have drifted away from direct deposit toward prepaid cards. A faster payments system would allow more businesses to pay weekly workers through direct deposit. Given that 17% of workers in the U.S. are temporary employees, the potential savings is significant.

According to **Chris Nichols, director of capital markets,** SouthState Bank:

> "The payment space represents a unique opportunity for banks to take back products that they ceded long ago."

## I Fought the Law (and the Law Won)

We would be remiss not the mention the regulatory activity brewing for 2023. We think one executive spoke for many when she said:

> "Someone needs to put a muzzle on the CFPB."

The CFPB isn't the only regulatory body putting a crimp in banks' and credit unions' style. According to the Federal Reserve Board:[5]

"Regulation II (Debit Card Interchange Fees and Routing) establishes standards for assessing whether a debit card interchange fee received by a debit card issuer for an electronic debit transaction is reasonable and proportional to the costs incurred by the issuer with respect to the transaction. The rule prohibits issuers and networks from restricting the number of networks over which debit transactions may be processed to less than two unaffiliated networks, and from inhibiting a merchant's ability to direct the routing of a debit transaction over any network that the issuer has enabled to process it."

Scheduled to go into effect in July 2023, what impact will the new regulations have on banks and credit unions? **Cornerstone Advisors' Managing Director Brandi Gregory and Senior Director Tony DeSanctis** expect:

- No changes to overall debit volumes or an ongoing shift to CNP
- CNP routing share to shift from dual-message to single-message networks, forcing issuers to enable more routing options
- Visa and Mastercard to try to maintain their debit routing market share by emphasizing fraud prevention methods like tokenization (which often excludes single-message networks), modifying fee structures, and promoting technical compliance with the rule, such as limitations on authorization methods

Their projected bottom-line impact of the new regs for a financial institution in the $1 billion to $3 billion asset range is a decline in interchange fees of roughly $561,000 per year (Figure 14).

**Figure 14:** Impact of Durbin Regulation II on Interchanged Fees

**Current Situation**

| Transactions | CP | CNP | Total |
|---|---|---|---|
| Signature | 225,000 | 405,000 | 630,000 |
| Pin | 225,000 | 45,000 | 270,000 |
| Total | 450,000 | 450,000 | 900,000 |

| Transactions | CP | CNP | Interchange |
|---|---|---|---|
| Signature | 50.00% | 90.00% | $315,000 |
| Pin | 50.00% | 10.00% | $64,800 |
| Total | 100.00% | 100.00% | **$379,800** |

**Post Reg II**

| Transactions | CP | CNP | Total |
|---|---|---|---|
| Signature | 225,000 | 225,000 | 450,000 |
| Pin | 225,000 | 225,000 | 450,000 |
| Total | 450,000 | 450,000 | 900,000 |

| Transactions | CP | CNP | Interchange |
|---|---|---|---|
| Signature | 50.00% | 50.00% | $225,000 |
| Pin | 50.00% | 50.00% | $108,000 |
| Total | 100.00% | 100.00% | **$333,000** |
| | Total Monthly Impact | 180,000 | **($46,800)** |

Assumes $.50 per SIG transaction and $.24 per PIN transaction for Interchange
The average $1-3B CU in the Performance Vault has ~36,586 cards performing an average of 26 transactions each month (~950,000/trans/mo)

Source: Cornerstone Advisors

# Lending 2023: Against the Wind

A higher percentage of banks said that commercial C&I loans will be a priority for them in 2023 than in 2022, and about half cited commercial real estate as a high priority—far off from the 76% that listed it as a top priority before the pandemic took its toll. It's Cornerstone's interpretation that the decline in the percentages for many of the loan types isn't a reflection of a de-prioritization of loans, but the result of a narrower focus on the part of many banks to concentrate their marketing and production efforts on certain types of loans (Table C).

**Table C:** Banks' Lending Priorities, 2020 to 2023

Percentage of Banks Citing Loan Type as a High Priority

| | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|
| Commercial C&I loans | 70% | 63% | 57% | 62% |
| Commercial real estate loans | 76% | 45% | 53% | 49% |
| Mortgage/refi loans | 56% | 47% | 37% | 20% |
| Home equity loans/lines of credit | 39% | 9% | 20% | 17% |
| Loan participations | NA | 5% | 15% | 11% |
| Auto loans | 13% | 6% | 9% | 6% |
| Other personal loans | 15% | 5% | 6% | 3% |
| POS/BNPL loans | 3% | 1% | 5% | 3% |
| Student loans | 1% | 0% | 1% | 0% |

Source: Cornerstone Advisors surveys of bank and credit union senior executives, 2019 to 2022

On the credit union side, auto loans continue to be a top priority, but the big shifts in credit unions' lending strategies for 2023 reflect a de-prioritization of commercial real estate, mortgage/refis, and loan participations (Table D).

**Table D:** Credit Unions' Lending Priorities, 2020 to 2023

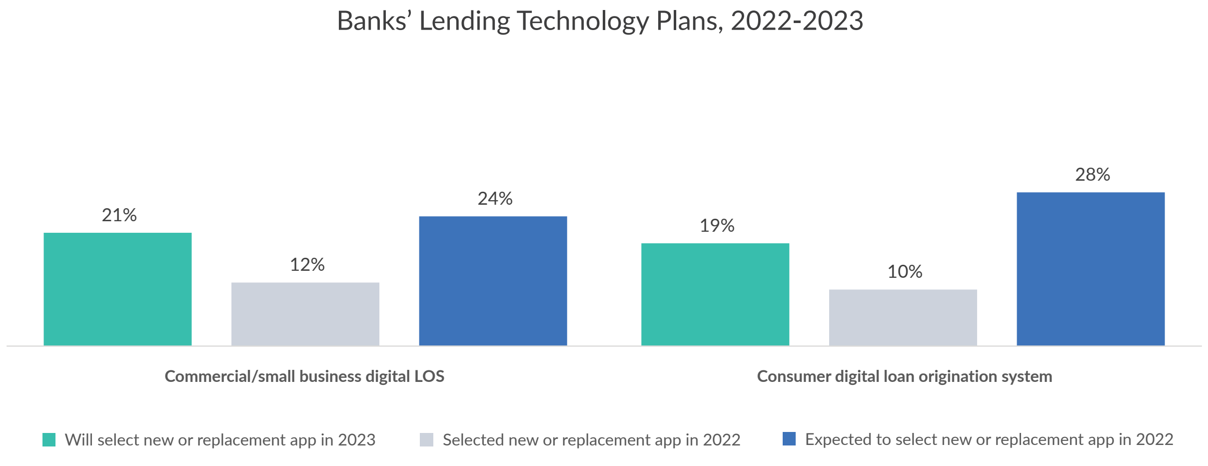
Percentage of Credit Unions Citing Loan Type as a High Priority

| | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|
| Auto loans | 69% | 72% | 63% | 68% |
| Home equity loans/lines of credit | 64% | 41% | 56% | 59% |
| Commercial real estate loans | 57% | 30% | 45% | 33% |
| Mortgage/refi loans | 84% | 79% | 75% | 30% |
| Other personal loans | 43% | 16% | 21% | 26% |
| Commercial C&I loans | 21% | 6% | 20% | 24% |
| Loan participations | NA | 16% | 27% | 15% |
| POS/BNPL loans | 5% | 3% | 6% | 5% |
| Student loans | 12% | 1% | 1% | 1% |

Source: Cornerstone Advisors surveys of bank and credit union senior executives, 2019 to 2022

Pessimism about the lending market is likely to depress investments in new loan origination systems. For 2023, roughly one in five banks expect to select new or replacement commercial and consumer loan origination systems (LOS). Looking back, however, only 12% of banks actually replaced their commercial LOS even though 24% expected to do so. On the consumer side, 28% said they would select a new or replacement LOS, but only 10% did (Figure 15).

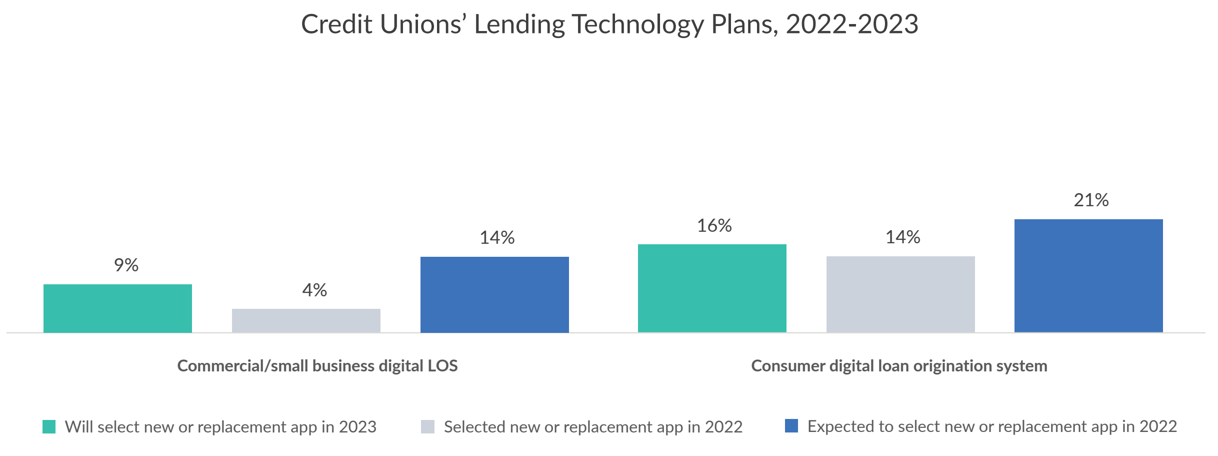
**Figure 15:** Banks' Lending Technology Investments, 2022-2023




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Among credit unions, 16% plan to replace or select a new consumer LOS in 2023, down from the 21% that expected to do so in 2022. On the commercial side, 9% anticipate selecting a new LOS, but only 4% did so in 2022 even though 14% had anticipated that they would select a new system (Figure 16).

**Figure 16:** Credit Unions' Lending Technology Investments, 2022-2023




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

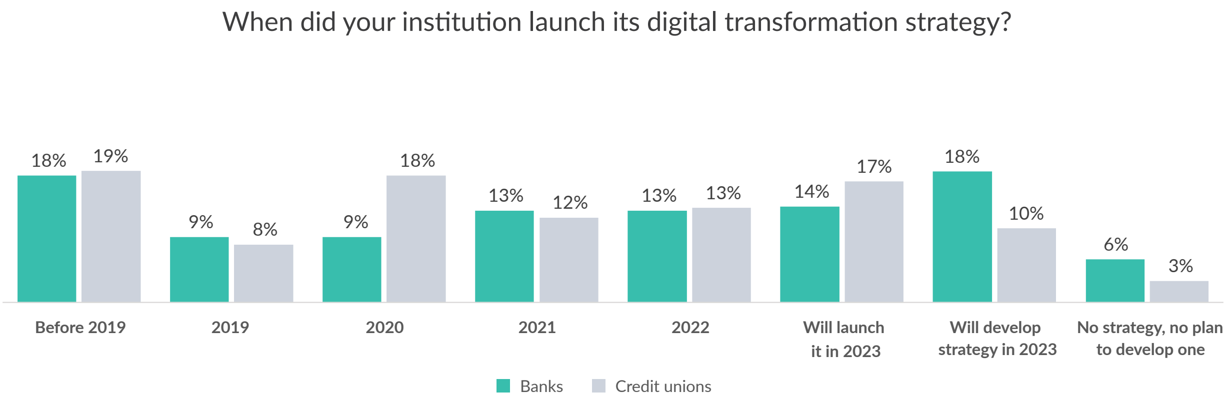
According to **Cornerstone Advisors Senior Director Daryl Jones**:

> "Given the recent surge in interest rates, most lenders have seen a significant decline in volumes. Everyone is trying to understand how to best balance the restructuring of staff, right-sizing loan officer compensation and other expenses to help offset the drop in production. Some lenders view this as a prime opportunity to re-evaluate their processes, staffing and/or technology stack given the volumes in recent years did not allow adequate time to address these issues. In addition, while many lenders have improved their overall consumer lending technology stack in recent years, most have an eye toward creating better, more intuitive, integrations with third parties such as online banking, CRMs, and workflow automation tools."

# The Long and Winding Road (to Digital Transformation)

One of these years, we'll drop the "digital transformation" section from this report, but for now, the management buzzword still rings loudly throughout the banking industry. Going into 2023, 76% of banks and 87% of credit unions have launched a digital transformation strategy or initiative. In 2023, that gap will close as 18% of banks expect to develop a digital strategy in the upcoming year (Figure 17).

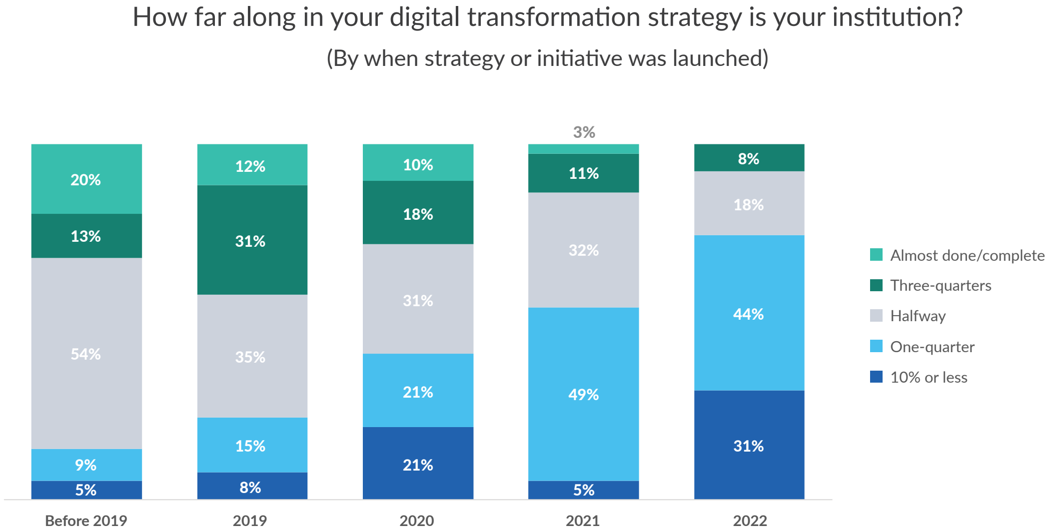
**Figure 17:** Financial Institutions' Digital Transformation Launch




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

One in five institutions that launched their digital transformation strategy before 2019 believe they're almost done with or have completed their digital transformation journey. For those that launched their strategy in 2019, 43% consider themselves to be three-quarters or more complete. Fourteen percent of institutions that launched in 2021 said they're three-quarters or more done, and 8% of those that launched in 2022 said they are three-quarters done (Figure 18).

**Figure 18:** Financial Institutions' Digital Transformation Status

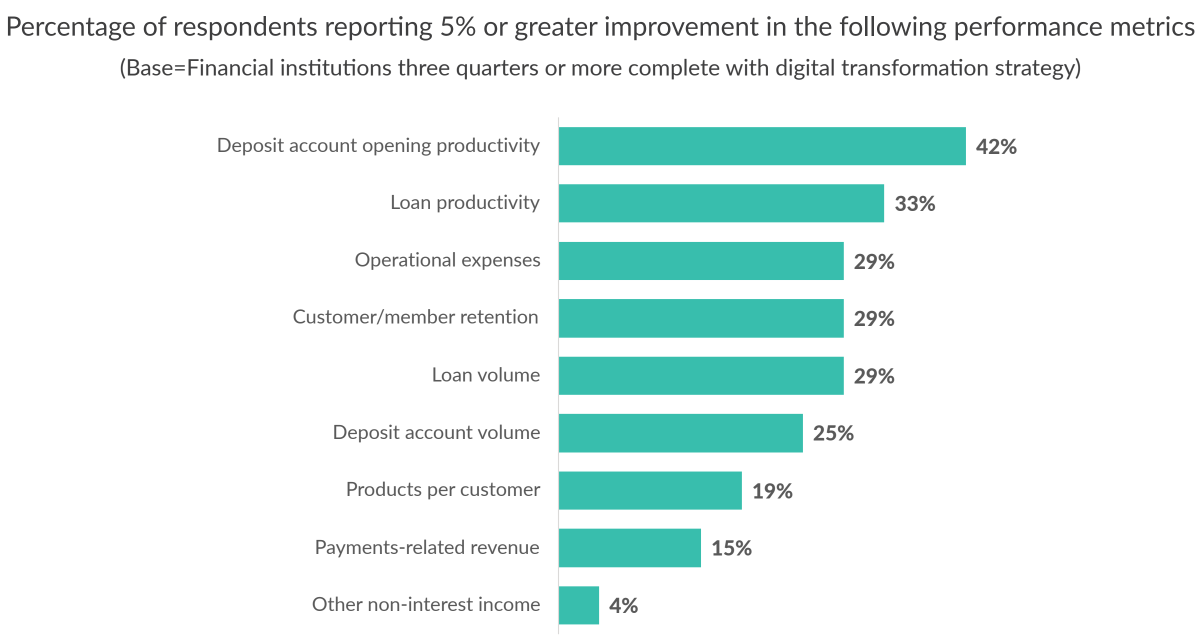



Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Wow! That was fast. And to think there are people who say the banking industry moves slowly!

It all comes down to how you define "digital transformation strategy," of course, but we're not buying these claims. Overall, 25% of institutions said they're three-quarters or more done with their digital transformation efforts. What do they have to show for their efforts? Not as much as we would expect. Among these institutions, 42% said they've achieved a 5% or better improvement in deposit account opening productivity and a third said they've improved loan productivity by 5% or more (Figure 19).

**Figure 19:** Financial Institutions' Digital Transformation Impact

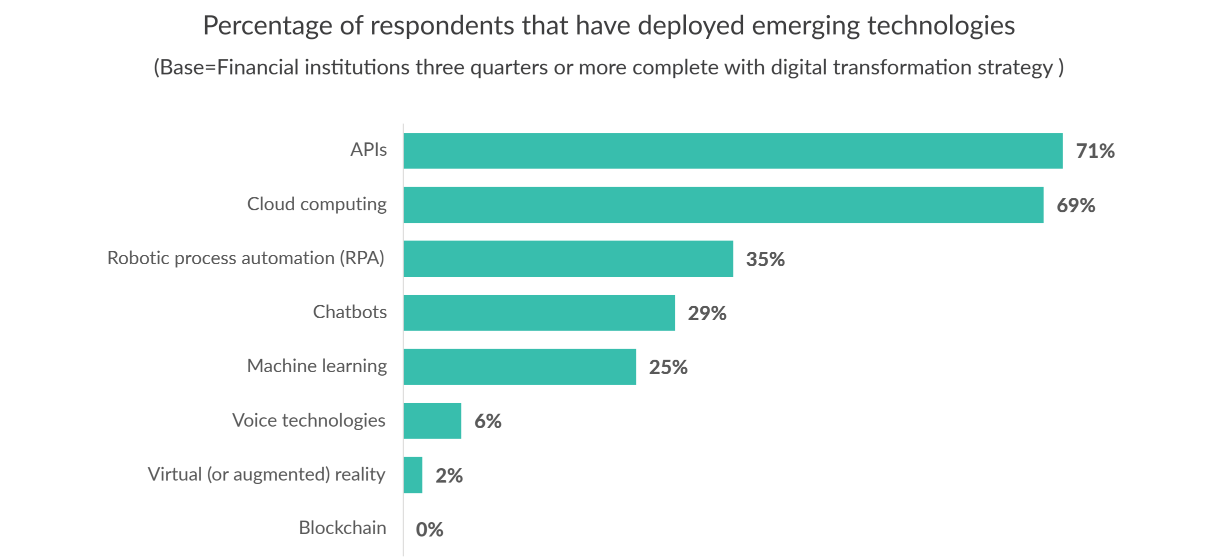



Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Five percent improvement isn't exactly a high bar, but not even a majority of institutions have achieved that level of improvement in any of the metrics we asked about. And these are the institutions that think they're done with or at least significantly down the road on their digital transformation journeys.

Furthermore, there are significant percentages of institutions that consider themselves down the digital transformation road that have yet to deploy emerging technologies like machine learning, chatbots, and robotic process automation (Figure 20).

**Figure 20:** Financial Institutions' Digital Transformation Impact




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

It's hard to believe that a bank or credit union three-quarters of the way (or more) through its digital transformation has yet to deploy cloud computing. To drive digital transformation, it's important to eliminate bottlenecks that slow the ability to deliver new customer experiences and business capabilities. The DevOps culture that is present around cloud computing brings development and operations teams into one, paving the way for faster build, testing, and release cycles. Banks are optimistically looking to a cloud future as a means of moving from "legacy speed" to "innovation speed."

Financial institutions also need to make investments in conversational AI to accelerate their digital transformation efforts. This requires more than just "chatbot" deployment, however. Responding to the need for a higher caliber of digital service and engagement, financial institutions increasingly need to implement intelligent digital assistants (IDAs), which support a wider range of use cases with greater ease of deployment and onboarding, and a higher quality, more sophisticated conversation capability. Although the terms chatbots and IDAs are often used interchangeably, there are differences:

> "In layman language, IDAs are evolved chatbots. Chatbots can be simply defined as rule-based systems which can perform routine tasks with general FAQs. IDAs are fully equipped with natural language understanding (which aids in understanding and retaining context for polished conversations while carrying out a variety of tasks to fulfill a user's requirements)."[6]

Intelligent digital assistants differ from chatbots along a number of dimensions including conversational capabilities, quality and delivery, and their ability to orchestrate experiences and provide data, insights, and reporting. IDAs provide service superior to chatbots in three ways:

- **Knowledge base.** When faced with a consumer query, chatbots pull from a limited library of scripts and frequently asked questions (FAQs). This "single turn" approach to providing answers can limit customer service by delivering only a simple path to a predetermined response. IDAs, in contrast, are pre-trained with knowledge from a wide array of financial situations, which gives them a more comprehensive conversational foundation of experiences, languages, and terms to draw upon to address specific customer needs. IDAs deliver personalized conversation starters based on their deep knowledge of a customer's financial history and behavior patterns.

- **Resolving versus advising.** The primary role of banking chatbots is to swiftly resolve consumers' basic, transactional questions, or move them on to human intervention. This limitation often leads to incomplete problem resolution and a high customer abandonment rate. IDAs, on the other hand, act as knowledgeable bankers who can walk alongside a customer and recommend the most informed nextstep in their specific financial journeys.

- **Future growth.** Chatbots fill support gaps without much capacity to retain and grow relationships, while IDAs guide customers through interactions and help them discover additional insights and services that are potentially relevant to their personal financial goals and situations. Using conversational skills, a deep data library, and AI-driven analysis of usage patterns, IDAs understand what customers are asking and can direct them to what they want while encouraging them to explore other engagement options.

Conversational AI is becoming (or at least, will become) a foundational technology in banking. Without it, claims of "digital transformation" are suspect. According to **Cornerstone Advisors Managing Director Jim Burson**:

> "Financial institutions' digital transformation focus in the coming year should be on bringing scale to the front office while maintaining a point of competitive differentiation in the markets they serve. Regardless of how much they invest in new deposit or loan origination platforms or leverage analytics to be timely and relevant with digital marketing and engagement offers, personal interactions still matter. To be successful, community institutions must focus on humanizing the digital experience through tight interconnectivity across marketing, contact centers, and digital delivery. It's not an easy task when being 'local' has driven differentiation."

Lastly, there is the question of whether a financial institution is ever done with its digital transformation:

> "When asked how far along our institution is in digital transformation, I didn't know how to answer, because are you ever done? To me, digital transformation isn't a destination or even a journey, it's a highway. We're all driving at different speeds, and where we fall at any given moment changes depending not only on what we do, but on what everyone else does. That's why digital transformation will never be done. We'll never be 'transformed'... because if you are, you're stopped dead on a highway watching everyone pass you by."
>
> **—Stacy Armijo, Chief Experience Officer, Amplify Credit Union, Austin, Texas**

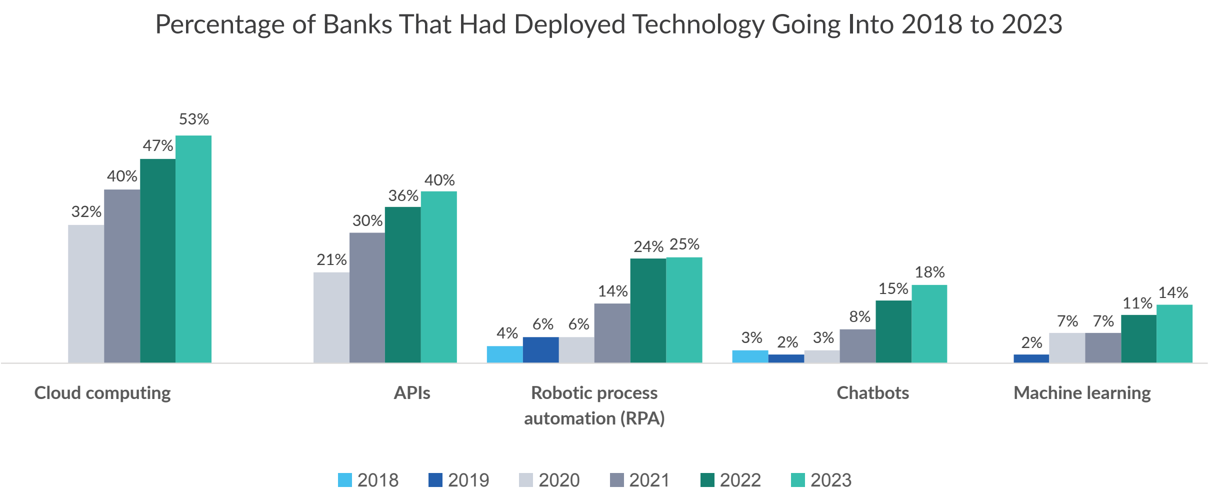
# Papa's Got a Brand New Bag (of Technology)

## The Deployment of Emerging Technologies

The discussion of cloud computing and conversational AI begs a broader look at a set of technologies often referred to as "emerging technologies," which—in addition to the two just mentioned—also include application programming interfaces, machine learning, robotic process automation, and blockchain.

Among banks, adoption of cloud computing has increased from 32% going into 2020 to 53% heading into 2023. In addition, the percentage making investments in APIs has nearly doubled over that timeframe from 21% to 40%. And although found in just a minority of banks, the percentage having deployed RPA, chatbots, and machine learning continues to increase year-over-year (Figure 21).

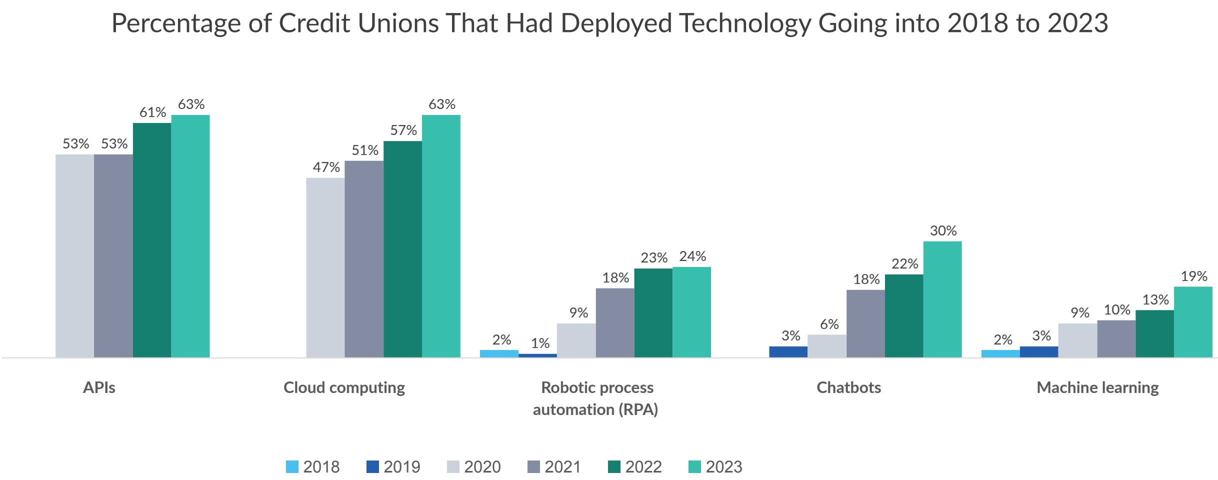
**Figure 21:** Banks' Deployment of Emerging Technologies




Source: Cornerstone Advisors surveys of bank and credit union senior executives, 2017 to 2022

Credit unions stand out from the banks in two key areas—their adoption of APIs (with 63% of credit unions now having deployed these tools) and of chatbots, with 30% of credit unions having invested in this technology (Figure 22).

**Figure 22:** Credit Unions' Deployment of Emerging Technologies




Source: Cornerstone Advisors surveys of bank and credit union senior executives, 2017 to 2022

It's hard to believe that cloud computing is still not on the radar at 7% of banks and that APIs aren't on the radar at 12% of banks. One positive sign is that nearly three in 10 banks intend to invest in or implement APIs in 2023 (Table E).

**Table E:** Banks' Emerging Technologies Plans for 2023

| | Have already invested in or deployed | Planning to invest and/or implement in 2023 | Have discussed with board or executive team | Not on our radar |
|---|---|---|---|---|
| Cloud computing | 53% | 17% | 23% | 7% |
| APIs | 40% | 28% | 20% | 12% |
| RPA | 25% | 14% | 25% | 37% |
| Chatbots | 18% | 12% | 29% | 41% |
| Machine learning | 14% | 16% | 33% | 38% |
| Virtual reality | 2% | 3% | 11% | 84% |
| Voice technologies | 2% | 6% | 33% | 60% |
| Blockchain | 1% | 3% | 35% | 62% |

Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

On the credit union side, investment in chatbots will continue into 2023 with one in four credit unions expecting to make investments in this technology. Machine learning tools are also on the drawing board for credit unions in 2023 (Table F).

**Table F:** Credit Unions' Emerging Technologies Plans for 2023

| | Have already invested in or deployed | Planning to invest and/or implement in 2023 | Have discussed with board or executive team | Not on our radar |
|---|---|---|---|---|
| APIs | 63% | 18% | 13% | 6% |
| Cloud computing | 63% | 16% | 12% | 9% |
| Chatbots | 30% | 25% | 33% | 12% |
| RPA | 24% | 19% | 32% | 25% |
| Machine learning | 19% | 31% | 34% | 16% |
| Voice technologies | 7% | 16% | 44% | 33% |
| Blockchain | 4% | 5% | 52% | 39% |
| Virtual reality | 1% | 3% | 36% | 61% |

Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

## Can We Talk About Submerging Technologies?

There are emerging technologies and then there are… well, submerging technologies. You know, like cryptocurrency. In the 2022 ***What's Going On In Banking*** study, we found that 10% of financial institutions were planning to offer cryptocurrency trading and investment services in 2022, with another 13% expecting to offer these services in 2023 or later.

In the new study, just 1% of banks said they're offering crypto investing services, and just 1% said they will offer it in 2023. On the credit union side, 5% of respondents currently offer crypto investing to their members and another 5% said they will launch a crypto service in 2023.

## What's Going On with Core Technologies?

For all the talk about emerging technologies, banks and credit unions are still investing in a host of core technologies. IT budgets are taking a hit in some financial institutions, however. In 2022, just 3% of banks and credit unions said their IT budget would be lower in 2022 than it was in 2021. For 2023, 9% of banks and 7% of credit unions expect their IT spending to be lower than in 2022. Not a big number, but the percentage of banks expecting a greater than 10% increase in their IT budget drops from 23% in 2022 to 14% in 2023, and among credit unions, that percentage drops from 25% to 16% from 2022 to 2023.

Where's the money going? For banks, the percentage planning to select a new or replacement commercial digital account opening app tops consumer digital account opening apps for the first time, with an uptick in plans for marketing automation and business intelligence tools in 2023 (Table G). Among credit unions, planned replacements for 2023 are down across the board, with a few isolated exceptions (Table H).

**Table G:** Banks' New System Selections/Replacements

| | Will select new or replacement app in 2023 | Selected new or replacement app in 2022 | Expected to select new or replacement app in 2022 |
|---|---|---|---|
| Commercial digital account opening | 27% | 10% | 23% |
| Consumer digital account opening | 21% | 23% | 29% |
| Commercial/small business digital LOS | 21% | 12% | 24% |
| Consumer digital loan origination system | 19% | 10% | 28% |
| Customer relationship management (CRM) | 17% | 13% | 15% |
| Fraud/BSA/AML | 17% | 16% | 15% |
| Marketing automation | 16% | 9% | 12% |
| Data analysis/business intelligence | 16% | 8% | 12% |
| Call center system | 15% | 12% | 13% |
| Commercial/small business online banking platform | 13% | 9% | 13% |
| Consumer mobile banking platform | 12% | 11% | 13% |
| Commercial mobile banking platform | 12% | 9% | 13% |
| Document imaging/workflow | 12% | 9% | 8% |
| Consumer online banking platform | 11% | 11% | 14% |
| Person-to-person (P2P) payments | 10% | 15% | 14% |
| Payment hub | 10% | 4% | 7% |
| Enterprise risk management | 9% | 7% | 3% |
| Core processing system | 9% | 7% | 7% |
| Core integration/middleware platform | 8% | 8% | 8% |
| Debit card processing | 7% | 6% | 10% |
| Interactive teller system | 7% | 3% | 7% |
| Credit card processing | 6% | 6% | 7% |
| Online bill payment | 5% | 7% | 8% |
| Card self-service | 5% | 2% | 7% |
| Mobile bill payment | 4% | 6% | 7% |
| ATM processing | 1% | 3% | 6% |

Cornerstone Advisors surveys of bank and credit union senior executives, 2021 to 2022

**Table H:** Credit Unions' New System Selections/Replacements

| | Will select new or replacement app in 2023 | Selected new or replacement app in 2022 | Expected to select new or replacement app in 2022 |
|---|---|---|---|
| Consumer digital account opening | 30% | 15% | 32% |
| Customer relationship management (CRM) | 20% | 8% | 28% |
| Call center system | 19% | 17% | 21% |
| Person-to-person (P2P) payments | 18% | 24% | 26% |
| Consumer digital loan origination system | 16% | 14% | 21% |
| Marketing automation | 16% | 7% | 13% |
| Credit card processing | 16% | 6% | 11% |
| Commercial digital account opening | 14% | 2% | 10% |
| Debit card processing | 13% | 10% | 9% |
| Consumer online banking platform | 10% | 8% | 16% |
| Consumer mobile banking platform | 10% | 11% | 12% |
| Core processing system | 10% | 10% | 4% |
| Commercial/small business digital LOS | 9% | 4% | 14% |
| Online bill payment | 9% | 4% | 11% |
| Data analysis/business intelligence | 9% | 7% | 15% |
| Interactive teller system | 9% | 8% | 10% |
| Enterprise risk management | 8% | 9% | 9% |
| Mobile bill payment | 7% | 4% | 6% |
| Fraud/BSA/AML | 7% | 11% | 5% |
| ATM processing | 7% | 4% | 4% |
| Commercial online banking platform | 7% | 5% | 14% |
| Payment hub | 7% | 3% | 10% |
| Document imaging/workflow | 6% | 3% | 8% |
| Card self-service | 6% | 5% | 10% |
| Core integration/middleware platform | 5% | 6% | 6% |
| Commercial mobile banking platform | 4% | 5% | 12% |

Source: Cornerstone Advisors surveys of bank and credit union senior executives, 2021 to 2022

According to **Brad Smith, Partner at Cornerstone Advisors:**

> "It's not surprising to see the increased importance of commercial deposit account opening as financial institutions search for cheap(er) commercial deposits, but they shouldn't discount the importance of continued investments in commercial digital banking systems. A strong digital treasury platform is now table stakes to grow commercial deposits and support C&I lending, and B2B fintechs have a head start on emerging commercial customer priorities such as integrated invoicing and commercial payments."

According to **Sam Kilmer, Managing Director at Cornerstone Advisors:**

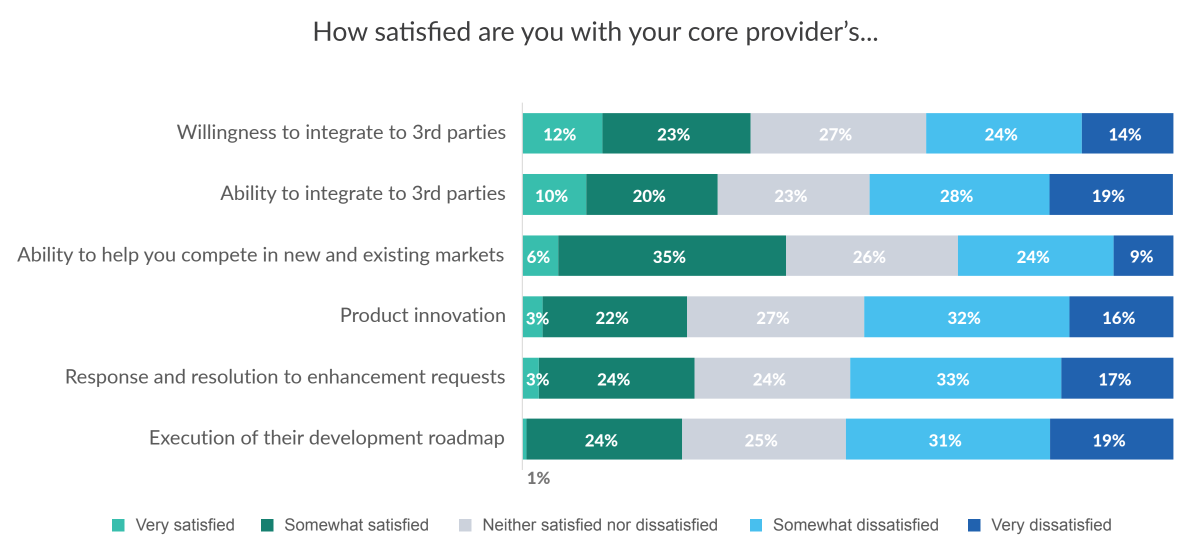
> "Sales-oriented systems (origination and CRM) continue to be where most of the system replacement action is and it's consistent with what we continue to hear in mid-size banks and credit unions that continue to be challenged at systematically growing organically. Organic growth is where the action is for the vast majority in the industry—and organic growth doesn't saunter into a branch anymore."

# Love Will Keep Us Together

The ***What's Going On In Banking*** study isn't meant to provide bankers with a forum to complain about their technology providers, but when we ask "what's on your mind?" many of the responses relate to their provider relationships. We think it's helpful to provide those technology companies with perspective on what their clients think about them.

Regarding their core system providers, few banks are "very satisfied" with the attributes we asked about. Roughly one in 10 said they are very satisfied with their core provider's willingness and ability to integrate third parties, but it was downhill from there. To be fair, though, there wasn't a particularly large percentage of bankers who are very dissatisfied with their core vendors (Figure 23). "Meh" might be the best way to characterize bankers' feelings toward their core providers.

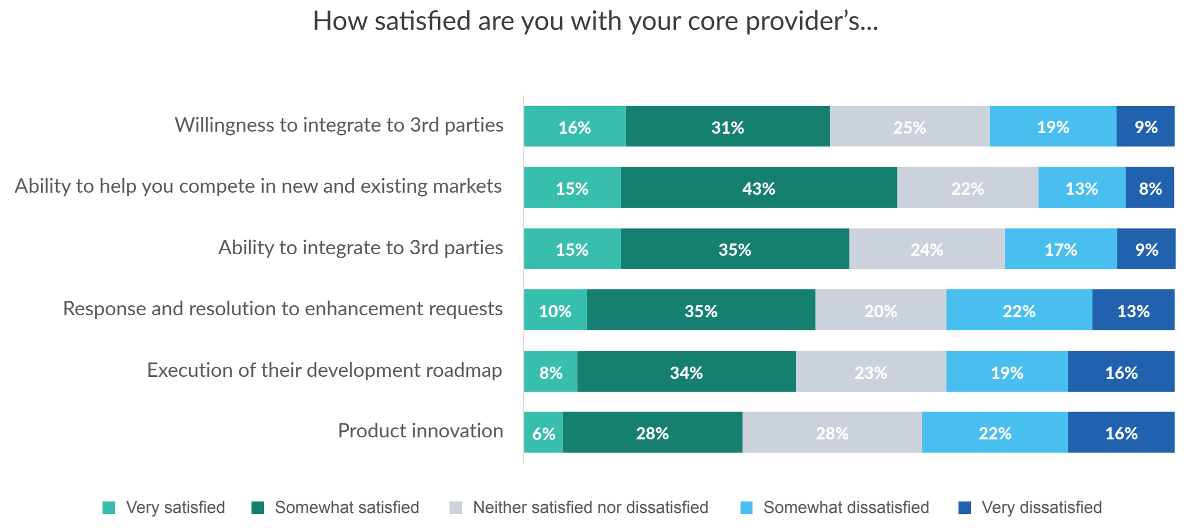
**Figure 23:** Banks' Satisfaction with Core Providers




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Credit union executives were more generous in their assessments of their core providers—nearly six in 10 are at least somewhat satisfied with their vendor's ability to help them compete in new and existing markets (Figure 24). As with the bankers, satisfaction—or lack thereof—with execution of the vendor's development roadmap is a sore point.

**Figure 24:** Credit Unions' Satisfaction with Core Providers




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

There are some bankers who may take issue with our "meh" characterization. Comments from respondents included:

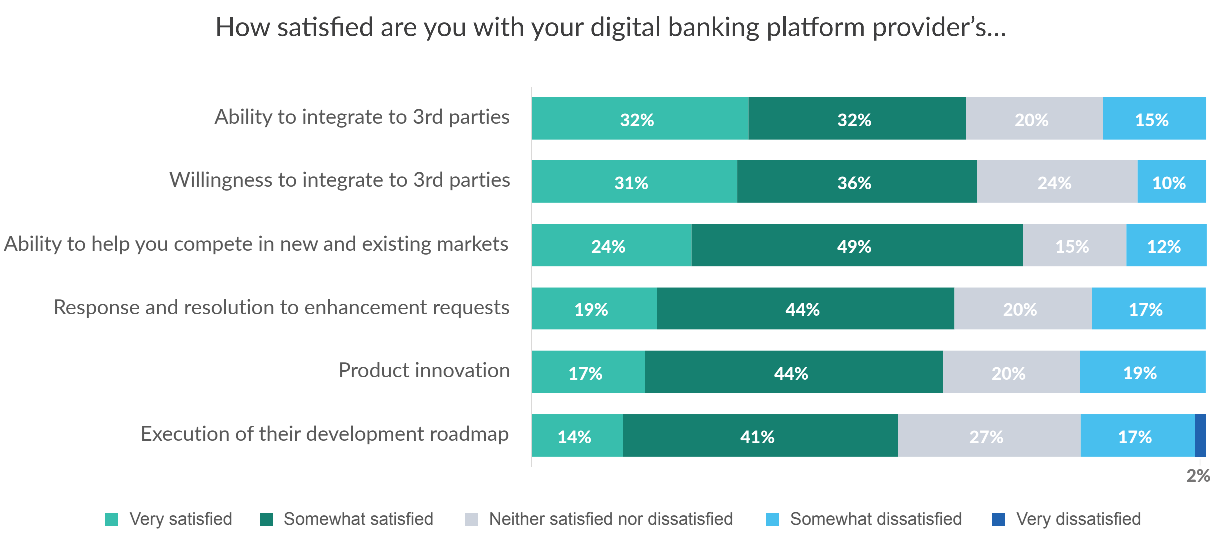
> "Core providers continue to be horrible at helping smaller banks remain competitive with larger bank and non-bank competitors. They, in my opinion, are missing out on a huge consulting/revenue opportunity."
>
> **—Anonymous bank/credit union senior executive**

> "Our core provider performance has declined significantly. Although their roadmap sounds good to address shortcomings, they rarely execute on these as planned."
>
> **—Anonymous bank/credit union senior executive**

> "The future is not monolithic platforms that the Big 3 continue to try and shove down our throats. The shift towards the cloud and open APIs is inevitable. We need core solutions with fully documented and open REST APIs without needing to spend an additional seven figures on platforms like Mulesoft. We need core vendors that are willing to start to put together their own low-code/no-code software factories so we can easily extend the core. If vendors like Fiserv want their investments in neo cores like Finxact to pay off, they need to start actively partnering with community-based FIs and not paying lip service to partnerships. If they don't wake up, at some point they aren't going to have a client base to sell to."
>
> **—Jack Ingram, CIO, WECU, Bellingham, Wash.**

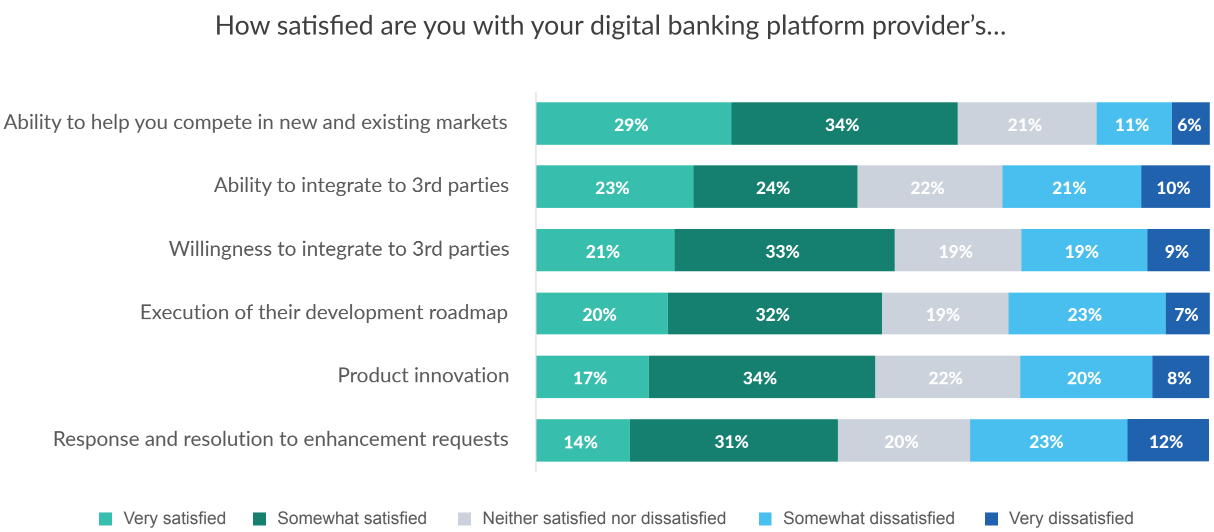
Satisfaction with digital banking platform providers was a bit higher among both bank and credit union respondents (we only asked this question of respondents whose digital banking platform is from a different provider than their core system is from). About three in 10 bankers are very satisfied with their digital banking platform provider's ability and willingness to integrate to third parties (Figure 25). Among credit union respondents, 63% expressed some level of satisfaction with their digital banking platform provider's ability to help them compete in new and existing markets (Figure 26).

### **Figure 25:** Banks' Satisfaction with Digital Banking Platform Providers




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

### **Figure 26:** Credit Unions' Satisfaction with Digital Banking Platform Providers




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

According to **Cornerstone Advisors' Smith:**

> "Troublemaker financial institutions have given up on waiting for a 'white knight' to solve every core need. Instead, they're building a core modernization strategy that decreases their reliance on any one core, unbundles legacy core functionality into more manageable components, is heavy on API integration, and increases control of their underlying tech ecosystem. The days of a core vendor being a strategic partner are gone. Financial institutions need to be in charge of their core strategy going forward."

According to **Cornerstone Advisors' Kilmer:**

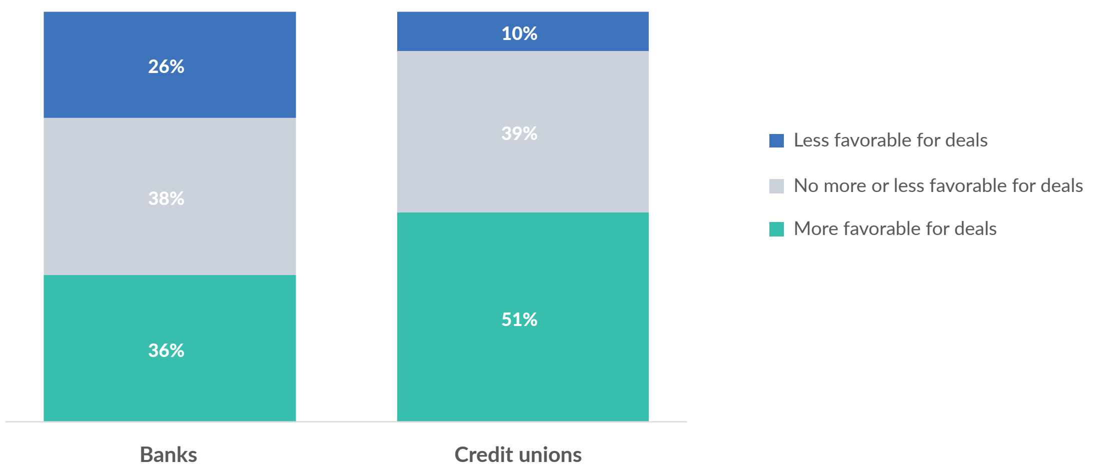
> "Competitive forces from both megabanks and fintechs have led to less satisfaction with buying turnkey you-get-what-you-get-don't-throw-a-fit solutions off-the-rack. More platforms, toolkits, and products-with-SDKs are the norm with ambitious leaders. More building will be the norm with at least one survey respondent pointing to our needing to ask questions in the future around internal development shops."

# Someday We'll Be Together

About half of credit union execs—but only 36% of bankers—believe 2023 will be more favorable for mergers than 2022 was. In fact, a quarter of bankers feel the upcoming year will be less favorable, altogether (Figure 27).

**Figure 27:** Prospects for M&A Activity in 2023

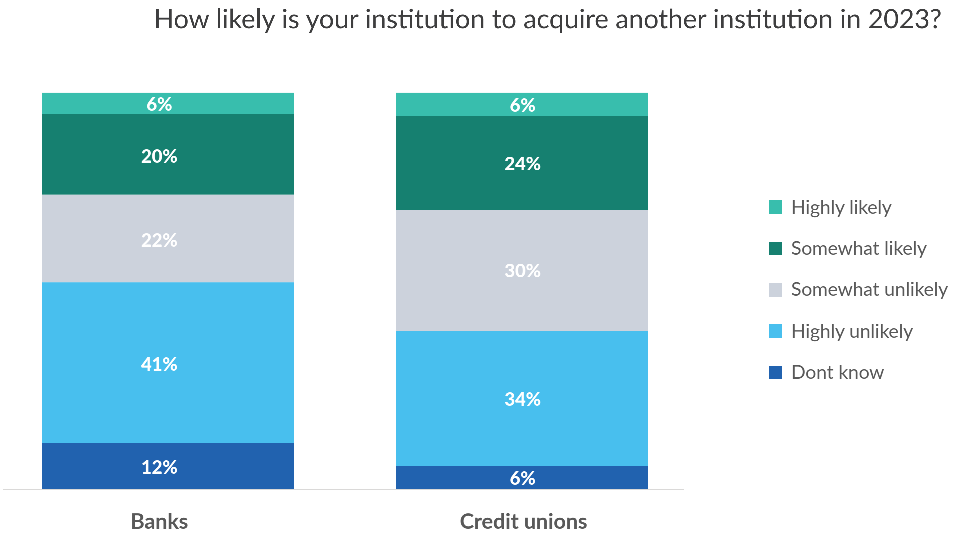
What are the prospects for M&A activity in the banking industry in 2023 compared to 2022?




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Just a handful of respondents said they're highly likely to make an acquisition in 2023, while 20% of bank respondents and 24% of credit union respondents indicated they will be somewhat likely to do so (Figure 28).

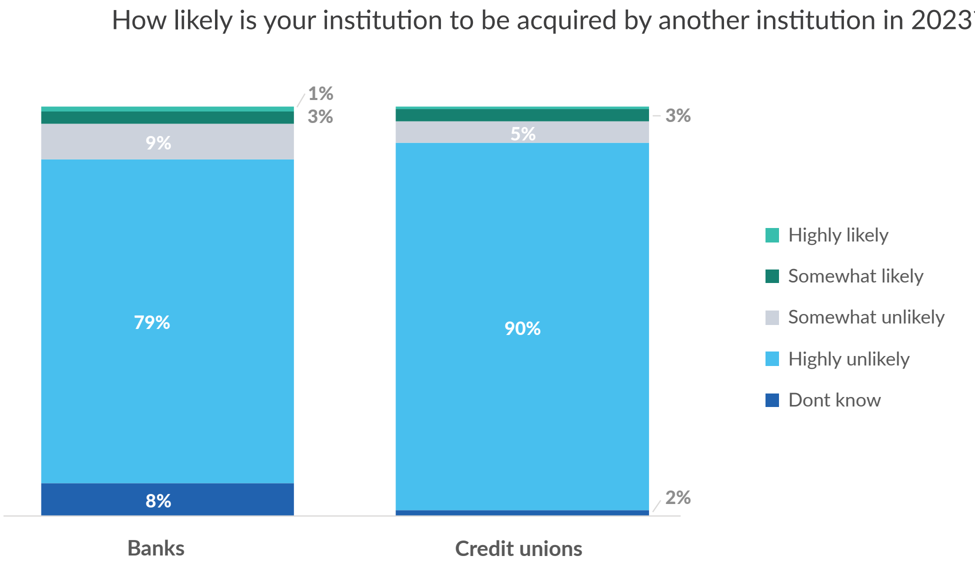
**Figure 28:** Likelihood to Acquire Another Institution




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Few respondents believe they will be on the acquired end of a transaction, however (Figure 29).

**Figure 29:** Likelihood to Be Acquired




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Similar to the findings in the 2022 study, growth opportunities, market expansion, and economies of scale are the leading drivers of M&A activity (Table I).

**Table I:** Drivers of Merger and Acquisition Plans

What are your organization's primary drivers for seeking an acquisition or merger, or being acquired?

| | Banks | Credit unions |
|---|---|---|
| Growth opportunities | 84% | 91% |
| Market expansion | 76% | 69% |
| Economies of scale | 67% | 69% |
| Regulatory costs | 16% | 5% |
| Revenue recession | 13% | 2% |
| Succession planning | 11% | 12% |
| Obtain investment funds for capital investment, digital transformation, etc. | 11% | 2% |
| Other | 4% | 2% |

Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

According to **Cornerstone Advisors Managing Director Vincent Hui:**

> "We will see a greater bifurcation between the 'haves'—financial institutions with sustainable business models that can weather economic cycles—and the 'have nots' as attractive merger partners and/or acquirers. The 'have nots' with vanilla business models, limited marketplace differentiation, and lack of sustainable financial performance will struggle in delivering value to their shareholders (and customers) in an economic environment that many management teams have never worked through before. This will show up as a greater gap in shareholder and customer value and force the 'have nots' to determine if they can make course corrections themselves or if they have to look for a 'have' who can help them drive the value that their shareholders and customers are looking for before they fall further behind."

# With a Little Help from My Friends

Fintech partnerships have been a top-of-mind concern for bankers over the past few years, and 2023 won't be any different. Roughly seven in 10 financial institutions said partnerships will be important to their business strategies for the upcoming year. There are some differences between banks and credit unions regarding their partnership objectives, however.

A little more than four in 10 banks cited loan productivity as one of their most important fintech partnership objectives, with 36% mentioning deposit volume and 31% listing loan volume. In contrast, nearly six in 10 credit union execs said increasing loan volume was an important objective (Table J).

**Table J:** Fintech Partnership Objectives

What are your organization's three most important objectives for fintech partnerships?

| | Banks | Credit unions |
|---|---|---|
| Improve loan productivity | 45% | 33% |
| Improve deposit account opening productivity | 43% | 34% |
| Create new products/services | 39% | 33% |
| Increase deposit account volume | 36% | 27% |
| Reduce operational expenses | 34% | 31% |
| Increase loan volume | 31% | 58% |
| Increase non-interest income | 26% | 19% |
| Reduce fraud losses | 24% | 28% |
| Expand geographic footprint | 13% | 21% |

Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Despite the importance of fintech partnerships among financial institutions, partnership activity will be largely unchanged in 2023 from 2022 levels. About half of financial institutions won't enter into any partnerships, one in five will find one partner, and just a handful will partner with four or more fintechs (Table K).

**Table K:** Fintech Partnership Activity

How many fintech startups did you partner with in 2022, and how many do you expect to partner with in 2023?

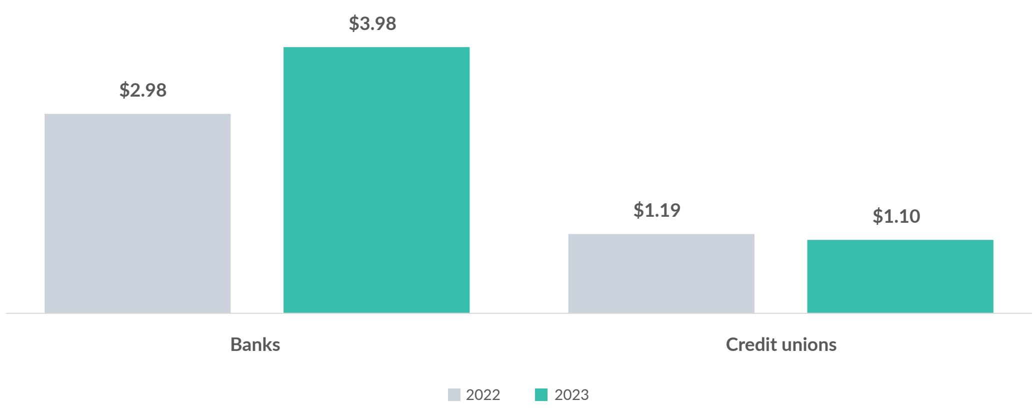
| | 2022 | 2023 |
|---|---|---|
| None | 55% | 53% |
| One | 20% | 21% |
| Two | 16% | 14% |
| Three | 5% | 7% |
| Four or more | 5% | 5% |

Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Banks, however (more so than credit unions), will be stepping up their investments in fintech startups in 2023. In both 2022 and 2023, 26% of survey respondents said their institution invested in fintech startups (Figure 30).

**Figure 30:** Financial Institutions' Investments in Fintech Startups

Roughly how much did your institution invest in fintech partnerships in 2022, and how much do you expect it will invest in 2023? ($ in millions)




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

## But It's All Right Now, In Fact, It's a BaaS

One aspect of fintech partnerships attracting a lot of attention is banking as a service (BaaS), which Cornerstone defines as:

> A partnership model in which a financial institution leverages its bank charter to enable non-bank financial services companies to offer financial services to consumers on a white label or affinity basis.

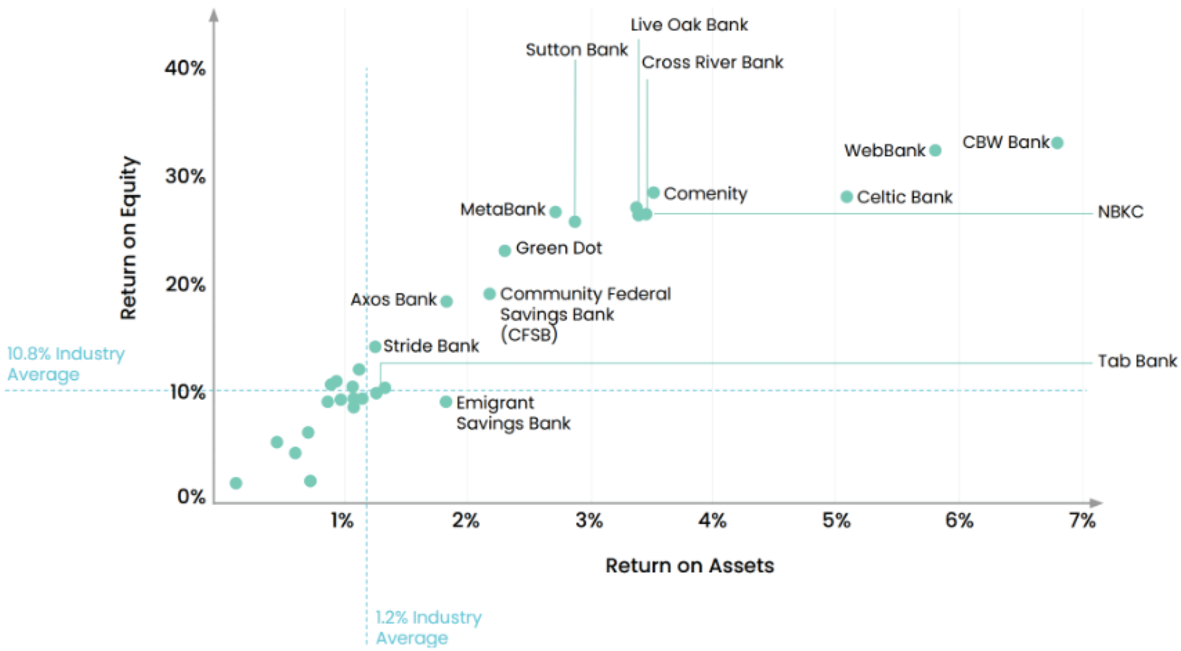
Among our survey sample, 7% of respondents are already providing BaaS services and 4% more are in the process of developing a BaaS strategy. Another 13% are considering the possibility of launching BaaS services (Figure 31).

**Figure 31:** Financial Institutions' Banking as a Service Plans


Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

Why the strong interest in BaaS? Growth and return. In addition to providing banks with new sources of revenue, the returns on assets and equity for BaaS banks (often referred to as "partner banks") exceed the industry averages for all banks (Figure 32).

**Figure 32:** Return on Assets and Equity for BaaS Banks




Source: Cornerstone Advisors survey of 300 community-based financial institution executives, Q4 2022

There are attractive economics on the revenue side of the coin, as well. Providing BaaS-related services enables banks to disaggregate the sources of revenue, and although they may have to share interchange revenue with the sponsoring brand (and third-party platform provider, if they use one), many of the banks pursuing or planning to launch a BaaS strategy view fees generated from ACH, fraud management, know your customer (KYC), account verification, and card issuing and processing services as very important to their efforts.

We'll have a lot more to say about BaaS and embedded finance in 2023.

# It’s the End of the Report as We Know It (and I Feel Fine)

Before concluding with some of our own thoughts for what 2023 might hold, we wanted to share some perspectives from survey respondents that didn’t fit neatly into other sections of the report:

> “It’s an incredibly tough time to be a banker. Yes, technology challenges abound and the regulatory burden is crushing, but it’s been that way forever. The interest rate environment has quintupled the degree of difficulty. It’s challenging to manage your cost of funds in this environment, especially if loan growth at these new higher yields doesn’t materialize. Fintechs have stubbed their toes or are having a hard time raising capital so that may give us a respite. But man, it’s tough.”
>
> **—Anonymous**

> “I think we’re spending too much energy trying to protect the status quo instead of embracing innovation. The slow tide of customer preference will soon turn into a tidal wave and it will be too late to catch up. These transformations take years.”
>
> **—Curt Queyrouze, President, Coastal Community Bank, Seattle, Wash.**

> “The banking industry is facing an identity crisis. Increased pressure on revenue streams requires openness to new business models, causing us to ask ourselves, ‘what is banking?’ Banks who continue to entrench in traditional lines of business will find themselves without the ability to meet consumer needs.”
>
> **—Kim Compton, SVP Chief Strategy Officer, The Farmers Bank, Frankfort, Ind.**

> “A lot of potential areas to invest in, but we need to be selective with the macro economic and geopolitical headwinds. We can’t stand still, however, and the best approach is to be true to our ethos or DNA which is our customers’ well being, meeting their needs, solving their problems. One can’t go wrong with that approach.”
>
> **—Uday Shetgeri, EVP, Enterprise Architecture, IT Strategy & Innovation, Frost Bank, San Antonio, Texas**

> “When I started in the industry, there were about 13,000 credit unions and 13,000 banks. Now, it’s about half of that. It might seem that efficiencies of scale are forcing the mergers, but it’s really the overregulation of credit unions that’s putting many small credit unions out of business. I would not be surprised to see the number of credit unions to decline to less than 1,000 in my lifetime. It’s really a shame.”
>
> **—Steve Bowles, CEO, SRI Federal Credit Union, Menlo Park, Calif.**

> “While there’s been a significant amount of disruption over the last few years, there’s an opportunity to evolve banking for those willing to pay attention and act. Disruption has just started and we’ve seen customer adoption accelerate globally as a result of the pandemic. I’m looking forward to what the next wave of disruption brings. It will give the banking industry, regardless of institutional size, a chance to meet the demands of our customers through technology and innovative thinking while being a fun industry to work in again.”
>
> **—Tim Dively, SVP, Chief Technology & Operating Officer, Peoples State Bank, Wausau, Wis.**

"It will be an interesting few years as we navigate the impact of interest hikes, the squeeze on liquidity, higher operating costs, additional regulatory scrutiny that's sure to come, an overzealous CFPB, and the loan losses that result from the looming recession. Well-capitalized institutions should bear the burden well, but the pool of credit unions and smaller community banks is likely to shrink through consolidation as the pressure builds. In the end, it will lead to a loss of local decision making and fewer choices for the consumer."

**—Carl Casper, Chief Operating Officer, Connex Credit Union, North Haven, Conn.**

## The Future's So Bright, I Gotta Wear Shades

To close, here are my predictions for 2023:

- **Big banks will get into the BaaS space.** Conventional wisdom holds that BaaS is a small bank's game because of the favorable interchange rates sub $10 billion (in assets) banks have. Durbin II is going to hammer on those interchange rates, as are other consumer behavior trends. For large banks, making a 70/30 revenue share deal (fintech to bank, versus the 50/50 offered by smaller banks) is just a margin decision for a big bank like Chase or Bank of America. If the potential partner—which is more likely to be a major retailer or merchant than a startup fintech—promises a high volume of payments or, better yet, loan volume, the large banks will be more than willing to take the hit on the interchange margin.

- **Embedded fintech will be a bigger trend in 2023 than embedded finance.** Consulting firms like McKinsey and Bain are estimating that embedded finance will grow to trillions of dollars of revenue in the U.S. over the next few years. In a recent LinkedIn post, I wrote that by 2025 there would be no more than 300 banks providing BaaS services. Most of the commenters thought I was overestimating by a factor of three. So, if only 100 banks are going to be in the BaaS business, what are the other 1,400 troublemakers going to do? Embedded fintech—the integration of fintech products and services into financial institutions' websites, mobile apps, and business processes. According to Cornerstone's research, more than 50% of consumers want identity theft and data breach protection, subscription management, and bill negotiation services bundled with their checking accounts.

- **Buy now, pay later will make a comeback at banks' expense.** Buy now, pay later (BNPL) providers will evolve from financing individual purchases to financing lines of credit. In other words, BNPL will become the new entry-level offering for credit cards. While there are providers helping banks offer BNPL services, very few banks show any interest in this service as the data in the report shows. With fewer banks and credit unions focusing on credit cards in 2023, mid-size financial institutions are potentially positioning themselves out of future credit card growth. Many people—not just bankers—misunderstand the BNPL space. Firms like Klarna and AfterPay aren't "BNPL companies"—they're merchant enablement platforms. They help merchants sell more—with payments being just one small piece of the offering.

- **The Supreme Court will uphold the constitutionality of the CFPB.** In a blow to the banking industry, Roberts and either Barrett or Kavanaugh will side with the left-leaning judges in upholding the constitutionality of the Consumer Financial Protection Board. If you think the CFPB is a thorn in your side now, just wait until 2023. Overall, the regulatory environment for banking in 2023 is going to be nasty. As I write this, the FTC has told Mastercard that it must provide other debit networks with the keys needed to convert tokenized card account information—encoded for security purposes—back to the original account number for online transactions. Apparently, merchant and retailer revenue is more important than fraud prevention and consumer security.

Have a great 2023.

# Endnotes

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# About the Author

As Cornerstone Advisors' chief research officer, Ron Shevlin heads up the firm's fintech research efforts and authors many of its studies. He has been a management consultant for more than 30 years, working with leading financial services, consumer products, retail, and manufacturing firms worldwide. Prior to joining Cornerstone, Shevlin was a researcher and consultant for Aite Group, Forrester Research, and KPMG. Author of the Fintech Snark Tank blog on Forbes, Shevlin is ranked among the top fintech influencers globally and is a frequent keynote speaker at banking and fintech industry events.

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# About Cornerstone Advisors

After 20 years in this business, Cornerstone Advisors knows the financial services industry inside and out. We know that when banks and credit unions improve their strategies, technologies, and operations, improved financial performance naturally follows. We live by the philosophy that you can't improve what you don't measure. With laser-focused measurement, financial institutions can develop more meaningful business strategies, make smarter technology decisions, and strategically reengineer critical processes.


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