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Insights

A New Wave of Bank Mergers Expected

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A New Wave of Bank Mergers Expected

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Executive Summary

Consolidation in the banking sector gathered pace last year after Congress eased reporting and capital provisioning requirements imposed on bank holding companies (BHCs) under 2010's Dodd-Frank Act. Now, as the Federal Reserve Board considers further reducing the number of banks subject to enhanced oversight, the industry is preparing for a new round of M&A, spurred by the prospect of growth through scale without the burdensome cost of meeting government regulatory standards.

Dodd-Frank deemed BHCs with more than $50 billion of total consolidated assets as "systemically important financial institutions" (SIFIs) and subjected them to stricter oversight and more regulatory requirements, including the Fed's enhanced prudential standards. In May 2018, Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act, which, among other things, increased the amount of total assets a bank could hold before triggering oversight requirements.

Since July 2018, there have been nearly 200 M&A deals in the banking sector. With the proposal out to further raise the total assets trigger to $700 billion, small and mid-sized banks will have more flexibility to pursue strategic combinations. Most U.S. BHCs have assets today of less than $500 billion.

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Banks looking to expand will, of course, have tough choices to make on whether to pursue acquisitions or grow organically. Both paths are costly and time consuming. But increased competition from larger banks with scale and nimble internet-only banks makes a "do nothing" strategy equally risky.

Bank Size Matters

After the 2008 financial crisis, mergers and acquisitions (M&A) in the banking sector stalled as regulation of the industry increased and "too big to fail" institutions were constrained by additional capital requirements and regulatory oversight.

Banks seek to hold minimum capital because that money is tied up and cannot be used to generate returns. Regulators, meanwhile, want banks to hold more capital to absorb losses in a stress event. They measure the capital adequacy of banks in scenarios where asset prices are assumed to decline dramatically, markets cease to operate, and funding dries up.

Under the Dodd Frank Act, which was signed into law on July 21 2010, bank holding companies (BHCs) with more than $50 billion in total consolidated assets were deemed systemically important financial institutions (SIFIs) and were subject to stricter oversight and more regulatory requirements, including the Federal Reserve Board's enhanced prudential standards.

The combination of higher capital requirements and stringent stress tests has led banks to refrain from M&A activity for fear of being classified as systemically important.

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Relaxing the Threshold for SIFI Designation

Critics of the Dodd-Frank rules argued that limiting the risks financial firms could take also limited the growth potential of these institutions - lowering the overall liquidity of the market - and that the added regulations hampered smaller financial institutions and community banks.

As a result, Congress passed a rollback of the Dodd-Frank rules on May 24, 2018. The "Economic Growth, Regulatory Relief, and Consumer Protection Act" eased regulations on small and mid-sized banks.

BHCs with less than $100 billion in total consolidated assets became exempt from supervisory stress testing and other enhanced regulatory requirements. BHCs with assets between $100 billion and $250 billion would continue to be subject to supervisory and company-run stress testing and other enhanced regulatory requirements for up to 18 months, after which they would remain subject to periodic supervisory stress tests. The Federal Reserve would continue to have discretion to impose enhanced regulatory requirements on a case-by-case basis.

Raising the Threshold

In October 2018, the Federal Reserve Board (FRB) proposed lifting the threshold for liquidity and capital requirements from $250 billion in assets to $700 billion to lessen the burden on commercial lenders that do not have volatile trading businesses.

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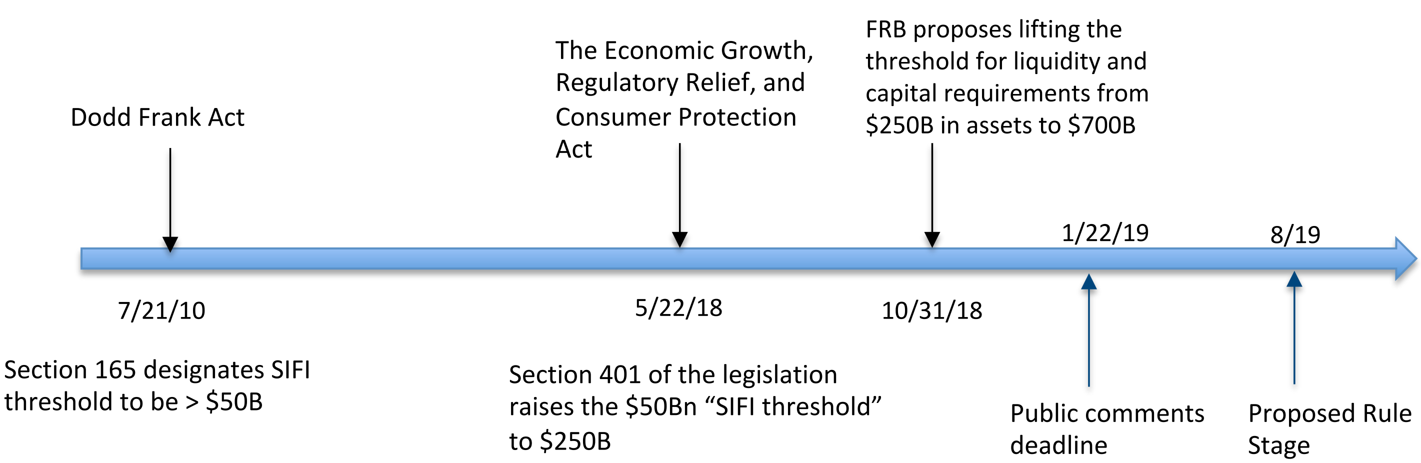
Firms in the lowest risk category - most domestic banks with $100 billion to $250 billion in total consolidated assets - would no longer be subject to standardized liquidity requirements or be required to conduct company-run stress tests, and their supervisory stress tests would be moved to a two-year cycle, rather than annual.

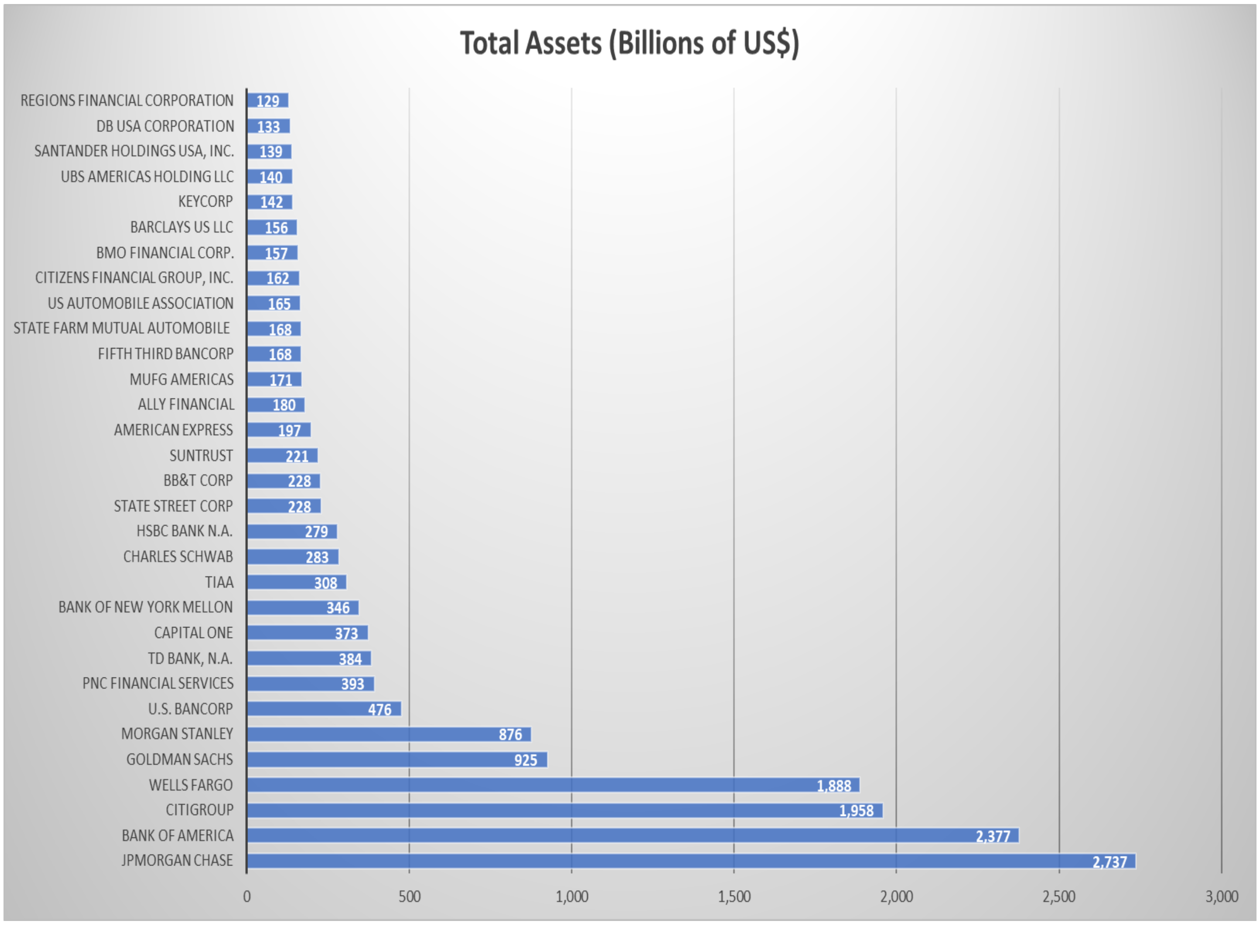
Banks with $250 billion or more in total consolidated assets that are not global systemically important banks (GSIBs) will have their standardized liquidity requirements reduced but remain subject to enhanced liquidity standards. These banks will still be required to conduct company-run stress tests on a two-year cycle and remain subject to annual supervisory stress tests.

GSIBs will not see any changes to their capital or liquidity requirements.

This rule change is currently in the proposed-rule stage and is expected to be finalized in 2019. The FRB estimates that the changes will result in a 0.6% decrease in required capital and a reduction of 2.5% of liquid assets for all U.S. banking firms with assets of $100 billion or more.



Catalyst for M&A Activity



Eliminating the regulatory burdens and compliance costs for BHCs that cross the $250 billion asset threshold will lead to increased M&A transactions.

This means that mid-sized lenders including U.S. Bancorp, TD Bank NA, The Bank of New York Mellon, Capital One Financial Corp, PNC Financial Corp, and Charles Schwab will face lower liquidity and compliance requirements, and smaller banks will get even easier treatment.

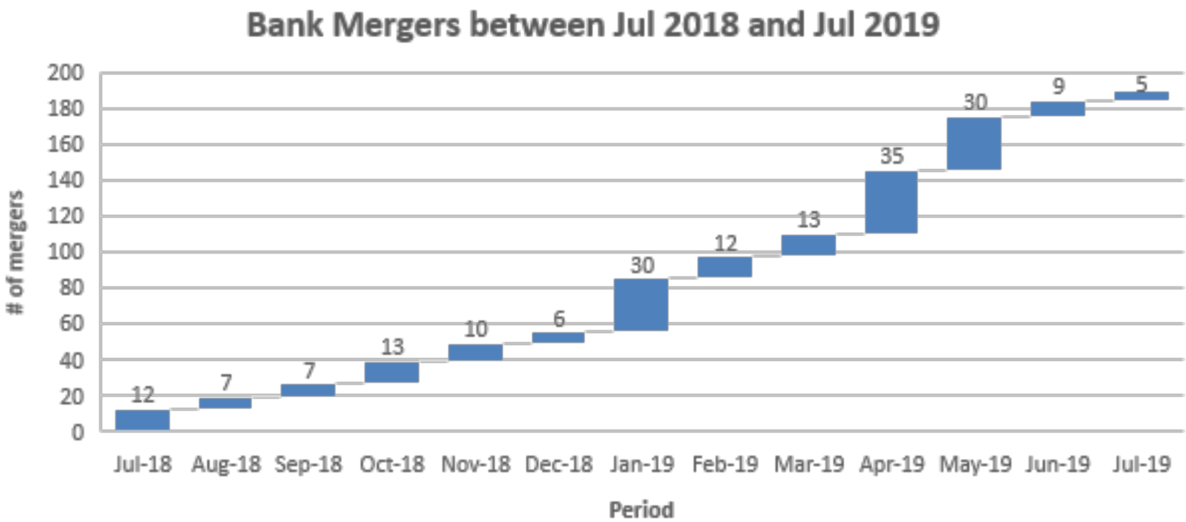
With the exception of the six largest banks, most of the U.S. banking sector falls under $500 billion in assets[1] and makes up a significant universe of potential mergers that would yield a combined entity remaining below the $700 billion threshold[1].

Eliminating the regulatory burdens… will lead to increased M&A transactions.

[1] *Source: National Information Center as of 3/31/19*

Bank Mergers Over the Last 12 months

Looking back over the last 12 months, nearly 200 bank mergers[2] have taken place following the enactment of The Economic Growth, Regulatory Relief, and Consumer Protection Act. This M&A activity has primarily taken place among small and medium-sized banks.



With the subsequent FRB proposal further relaxing the capital and liquidity requirements we will see a further wave of bank consolidation among small to mid-sized banks looking to achieve greater efficiency and scale to compete with the larger banks and new online banking entrants.

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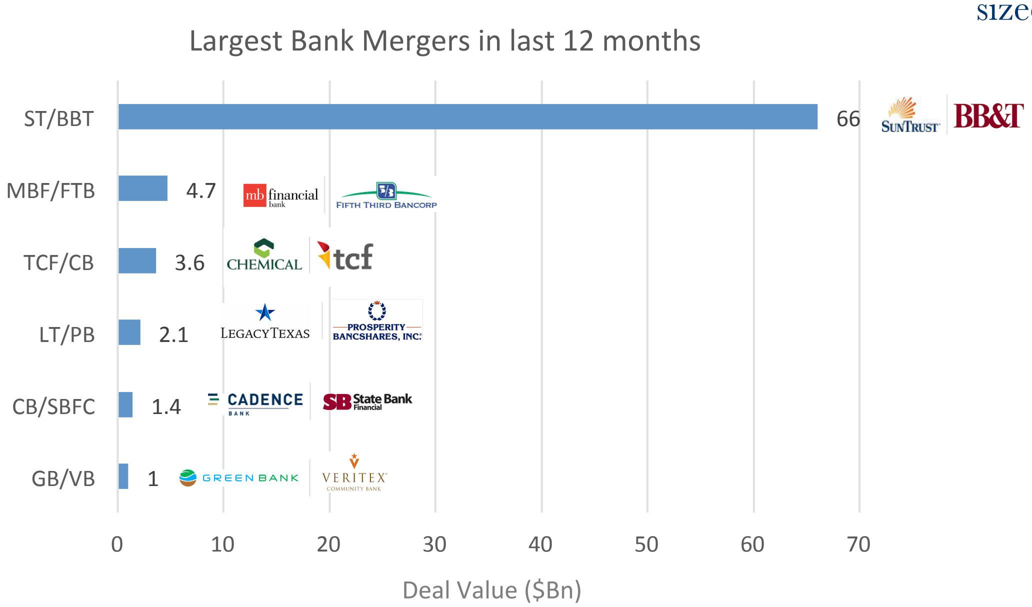

[2] *Source: iBanknet and Crunchbase*

The Pressure to Grow

Banks looking to expand their business either domestically or internationally will be making tough choices on an organic strategy or growth by acquisition. Either choice is costly and time consuming. Doing nothing is risky as competitors consolidate around them and grow market share.

Smaller banks face increasing competition from larger banks and internet banks which don't have the cost base of a branch network. It is likely that CEOs will be thinking of who their best merger partner will be before the window closes on potential targets. There are over 90 BHCs with assets between $10-$50 Billion and M&A activity is likely to be the greatest here.

Mergers help banks build up their deposit base, so they can extend more loans with a larger presence in the marketplace. Technology is an ever-increasing cost for banks as customers demand 24/7 access to their money and the ability to do their business online and via their mobile devices. Banks will need to invest in technology as well as reduce costs to remain competitive. Economies of scale through consolidation is one means to achieve this.

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Challenges of Banking M&A

Bank mergers takes years to complete due to:

- **Regulations**: Require a large number of regulatory and compliance staff to interpret and implement rules.
- **Staff Retention:** Key employees are often targeted by competitors during times of uncertainty.
- **Culture:** Differences between banks and even among product lines can create friction and resistance.
- **Complex Products:** Understanding, managing and unwinding complex financial instruments can be a long, difficult process.

- **Logistics:** Where will the main operating and management centers be, and who needs to be there?

- **Infrastructure:** Identifying strengths, redundancies, system strategy takes time. Integration takes years to complete. Documentation is often missing, and key process and control plans take time to understand.

- **Legal Entities:** Hundreds of legal entities are created for securitizations, tax arbitrage, deal structuring and revenue transfer.

- **Illiquid Contracts:** Deals made on property and other physical assets have long-dated contracts, where profits have been booked but the investments have turned sour.

Challenges to Address

Banks considering M&A need to address several questions:

- How do we avoid the mistakes of the past as we merge operations in the months and years ahead?

- How do we ensure value is created from the merger (e.g. greater scale, cost efficiency, larger branch network, increased customer base) while simultaneously ensuring that the existing business thrives?

- How do we successfully integrate operations to reduce costs?

Integrating banks is a major undertaking, one that many banks misjudged in the past, instead opting to run their new acquisitions as standalone entities under existing management. Lack of oversight can create a high level of risk, especially with regulatory and compliance issues.

Two examples, Citibank's Banamex bank in Mexico and HSBC Finance Corp (ex Household International) in the US were both run as "black box" operations. They were highly profitable businesses that were run with great autonomy by local management until they ran into financial and regulatory issues.

If your strategy is to purchase a bank, re-brand it and continue operations without addressing the differences between the organizations, the complexity of the integration, and the cultural differences, you can face similar risks. Taking this approach also limits the amount of synergies that can be realized and leads to increased operational risk.

As many banks have grown through acquisition, they still retain remnants of past purchases, which makes future integrations more complicated. There is therefore a need to understand which areas can be addressed quickly to reduce costs and realize near-term synergies and those areas which can be integrated more slowly.

Risks can be mitigated by detailed due diligence, identifying the “known unknowns” as well as the “unknown unknowns” with realistic assumptions on synergy benefits.

There is no substitute for having an integration team that has been through a merger before, knows what to look for, how to mitigate risks, and has an integration playbook to reference. If those capabilities do not exist in house, then to fill in the experience gaps, seek external help to partner with your execution team. ❖

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About the Author

Andrew is a leader in the firm's merger integration practice and has extensive and diverse experience spanning 25+ years across capital markets, insurance, technology, and aerospace. He is a leading authority on delivering "change" across large scale, international organizations.

His expertise is in business and finance transformation, operating model design, risk management, and process optimization. Andrew has extensive international experience of operating in global organizations, across cultures, and business functions. He has lived and worked in Europe, Asia, and the US.

Previously he held executive positions at AIG, HSBC, Credit Suisse, and Goldman Sachs managing large scale transformations associated with finance re-engineering, business performance improvement, regulatory change, and control enhancements.

Andrew holds a D.Phil from Oxford University, M.Sc/DIC in Control Systems from Imperial College, and a B.Sc in Mathematics from Manchester University.

He is also a Finance Risk Manager (FRM), Certified Change Management Professional (CCMP), Prince 2 project management practitioner, and Black Belt in Lean Six Sigma.

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