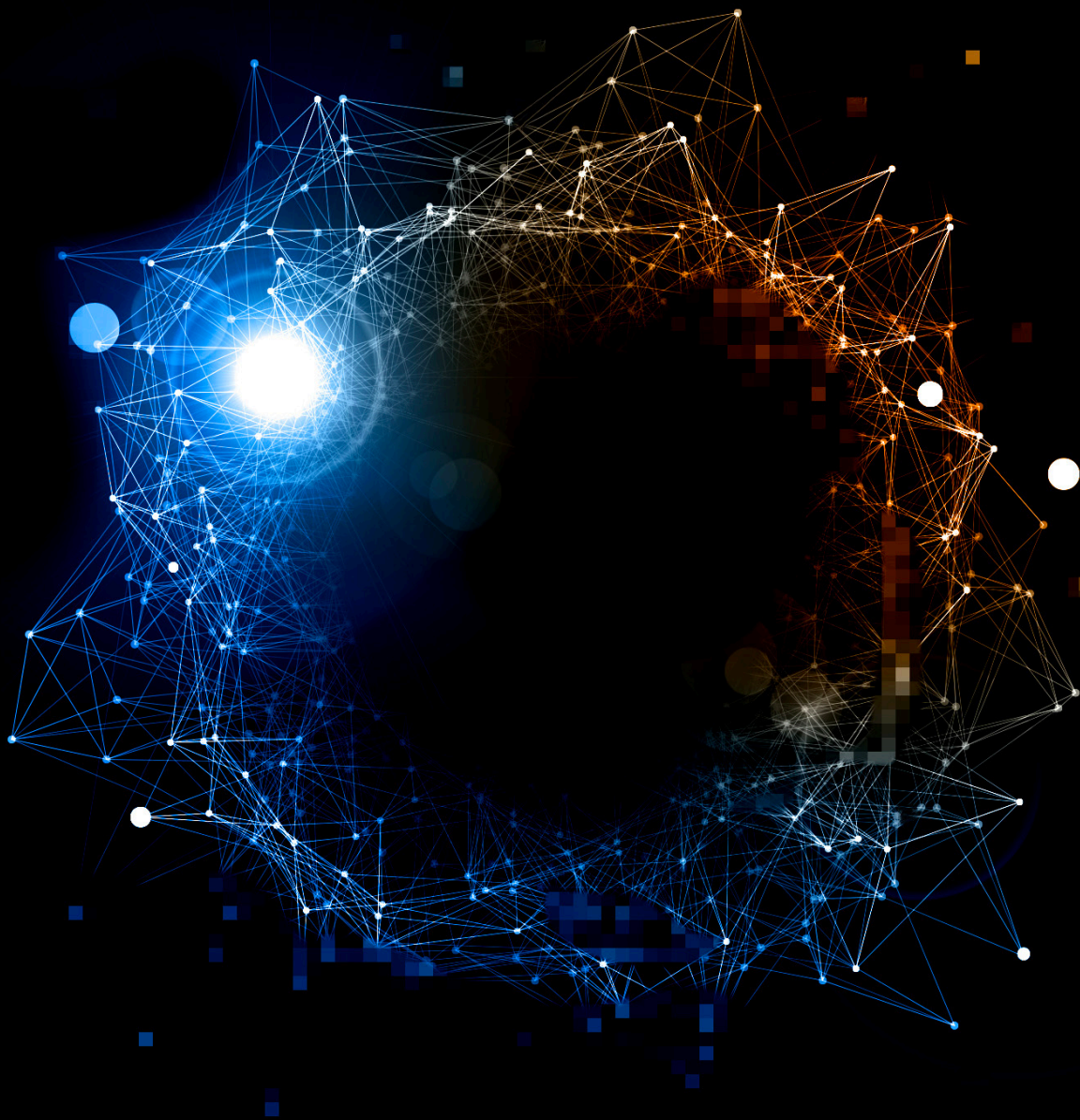


Deloitte.



2020 banking and capital markets M&A outlook
Partnering to navigate the future

Contents

Introduction	2
2019 review; 2020 outlook	3
Banking	3
Investment and wealth management	9
Fintech	13
Trends and drivers of 2020 M&A activity	16
Transform while you transact	16
Accounting, regulatory, and tax influences on M&A activity	16
Accounting developments	17
Regulatory developments	17
Tax policy developments	18
Find the right partner(s) to weather a potential storm	19

Introduction

Mounting economic and political uncertainty in 2020 is likely to create a backdrop of short-term headwinds for banking and capital markets (B&CM) mergers and acquisitions (M&A). 2019 closed with record-low US unemployment, an all-time-high stock market, and considerable available capital for acquisitions and investments—all positive indicators for continued M&A. However, a concerning mix of dropping interest rates (three cuts in 2019 alone), ongoing tariffs and trade disputes, persistent rumblings about an economic slowdown, and the upcoming US presidential election are stirring up macro-level uncertainty that may temper bank M&A—especially in the year’s second half.

Despite the headwinds, several building blocks for dealmaking remain intact: a pro-business regulatory environment, lingering tax-reform benefits, a still-by-historical-standards-low cost of funds, the desire for scale efficiency, and the need to bolster digital capabilities in a meaningful way. We therefore expect 2020 banking and capital markets M&A activity to be relatively similar to 2019, with bookended deal volume. Deal types are likely to include ongoing consolidation at the low end; a handful of mergers of equals (MOEs); serial acquirers saturating their footprint or capabilities set; and the maturation of financial technology (fintech) players—with some taking steps to operate within a proposed banking charter regulatory framework.

As banks, investment and wealth management firms, and fintech companies look for partnering opportunities to provide a solid foundation for the future, they are likely to counter uncertainty with caution. In general, we anticipate that well-capitalized institutions may continue to look for strategic partner targets to drive scale or diversify their portfolio, while those with a dimmer view of their ability to return in excess of cost of capital may sell in entirety or shed certain assets prior to an expected slowdown. As always, timing is important: If a buyer is going to make a move—especially a big one—it is likely to do so earlier in the year, or it may wait until the economic and political dust settles.

2019 review; 2020 outlook

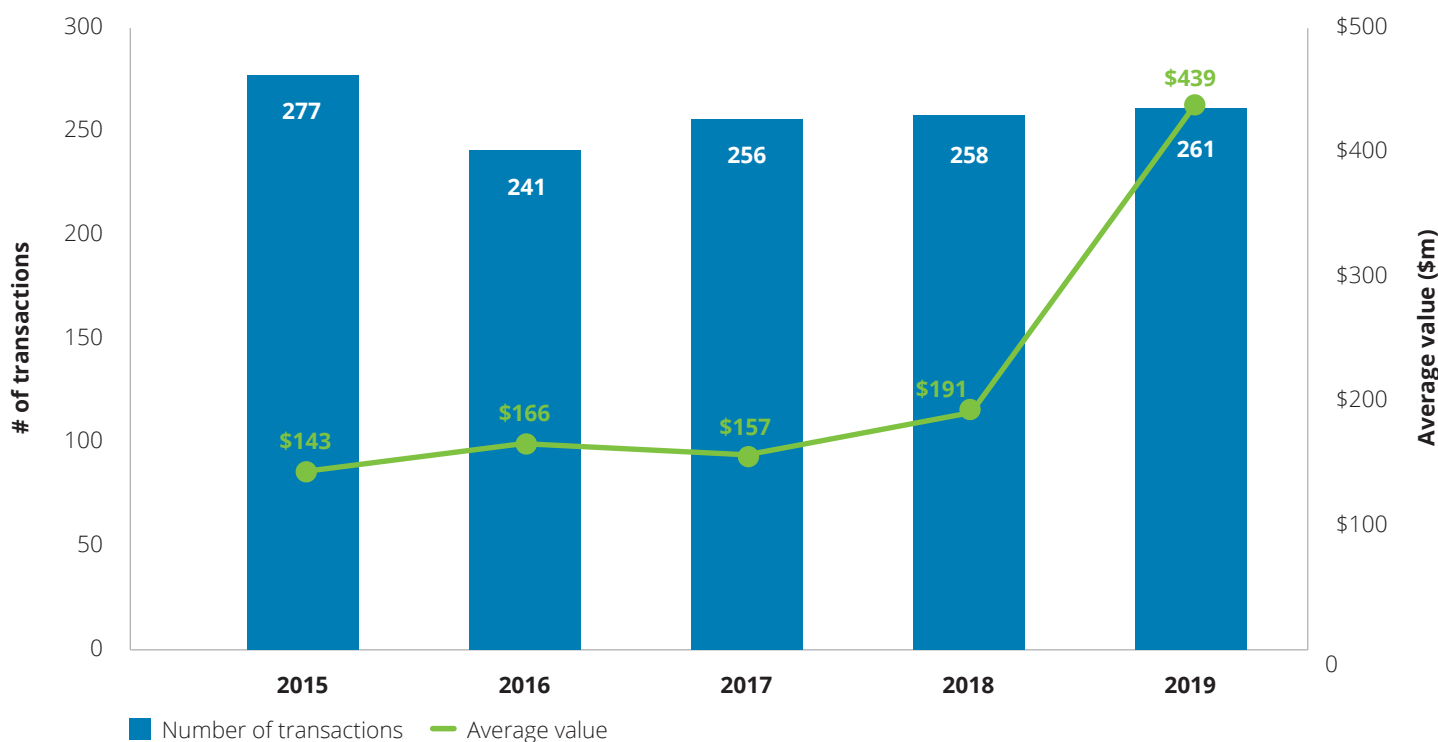
Banking

2019 review

2019 was bookended by four important and sizeable bank M&A transactions—the first-quarter announcements of two all-stock MOEs—BB&T and SunTrust¹ and TCF Financial Corporation and Chemical Financial Corporation²—and the fourth-quarter announced mergers of First Horizon and Iberiabank³ and Texas Capital Bancshares and Independent Bank Group.⁴

With 261 announced deals as of December 31, 2019, banking M&A volume year-over-year is up slightly from 2018's reported 259 deals.⁵ In addition, 2019 average deal value, at \$439 million, was up dramatically from the prior year's \$191 million (figure 1), boosted primarily by the \$28.3 billion BB&T and SunTrust mega-merger.⁶ All of the year's five top deals exceeded the \$2 billion mark.⁷ Superregionals generated the most deal value for the year; smaller banks generated the most deal volume.

Figure 1. Banking M&A metrics

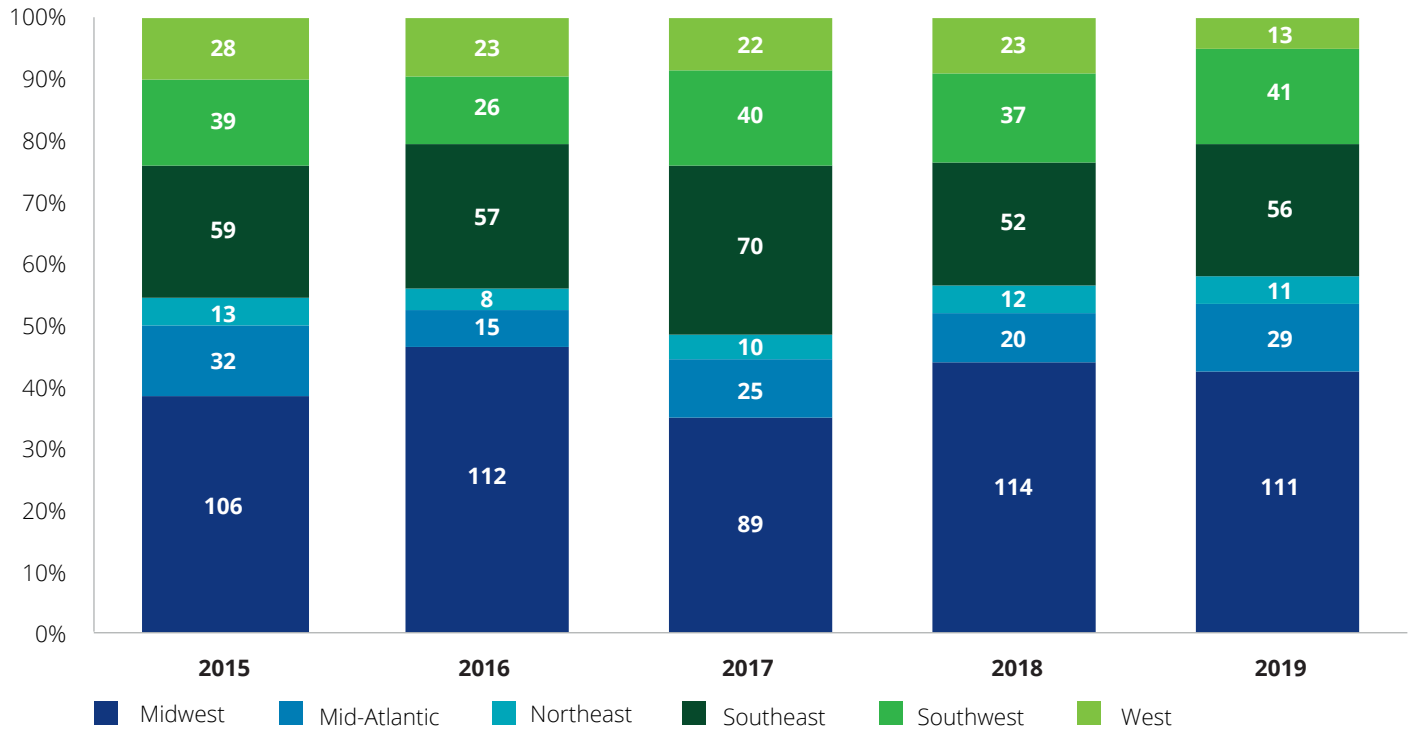


Banking: 2019 top five transactions by deal value					
Target	Buyer	Announcement date	Value (\$m)	Price/TBV	Region
SunTrust Banks Inc.	BB&T Corporation	February 7, 2019	\$28,283	179%	Southeast
IBERIABANK Corporation	First Horizon National Corporation	November 4, 2019	\$3,917	142%	Southeast
Chemical Financial Corporation	TCF Financial Corporation	January 28, 2019	\$3,552	N/A	Midwest
Rabobank National Association	Mechanics Bank	March 15, 2019	\$2,100	157%	West
LegacyTexas Financial Group Inc.	Prosperity Bancshares Inc.	June 17, 2019	\$2,082	216%	Southwest

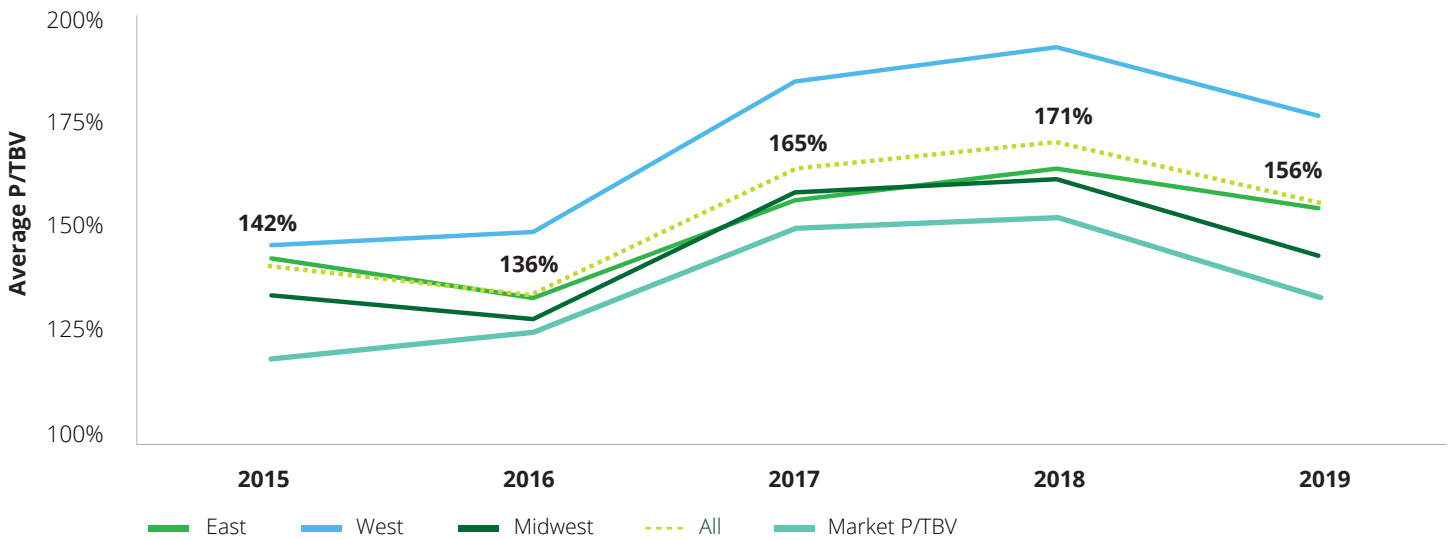
Source: SNL Financial and S&P Global Market Intelligence.

Note: Avg. deal size is based on disclosed deal values. 39%, 33%, 34%, 39%, and 49% of reported deals did not disclose deal values for FY15, FY16, FY17, FY18, and FY19 respectively.

Figure 2. Banking M&A volume and price/tangible book value by region



Source: SNL Financial and S&P Global Market Intelligence.
 Note: Avg. deal size is based on disclosed deal values. 39%, 33%, 34%, 39%, and 49% of reported deals did not disclose deal values for FY15, FY16, FY17, FY18, and FY19 respectively.



Source: SNL Financial and S&P Global Market.
 Note: Avg. deal size is based on disclosed deal values. 39%, 33%, 34%, 39%, and 49% of reported deals did not disclose deal values for FY15, FY16, FY17, FY18, and FY19 respectively.

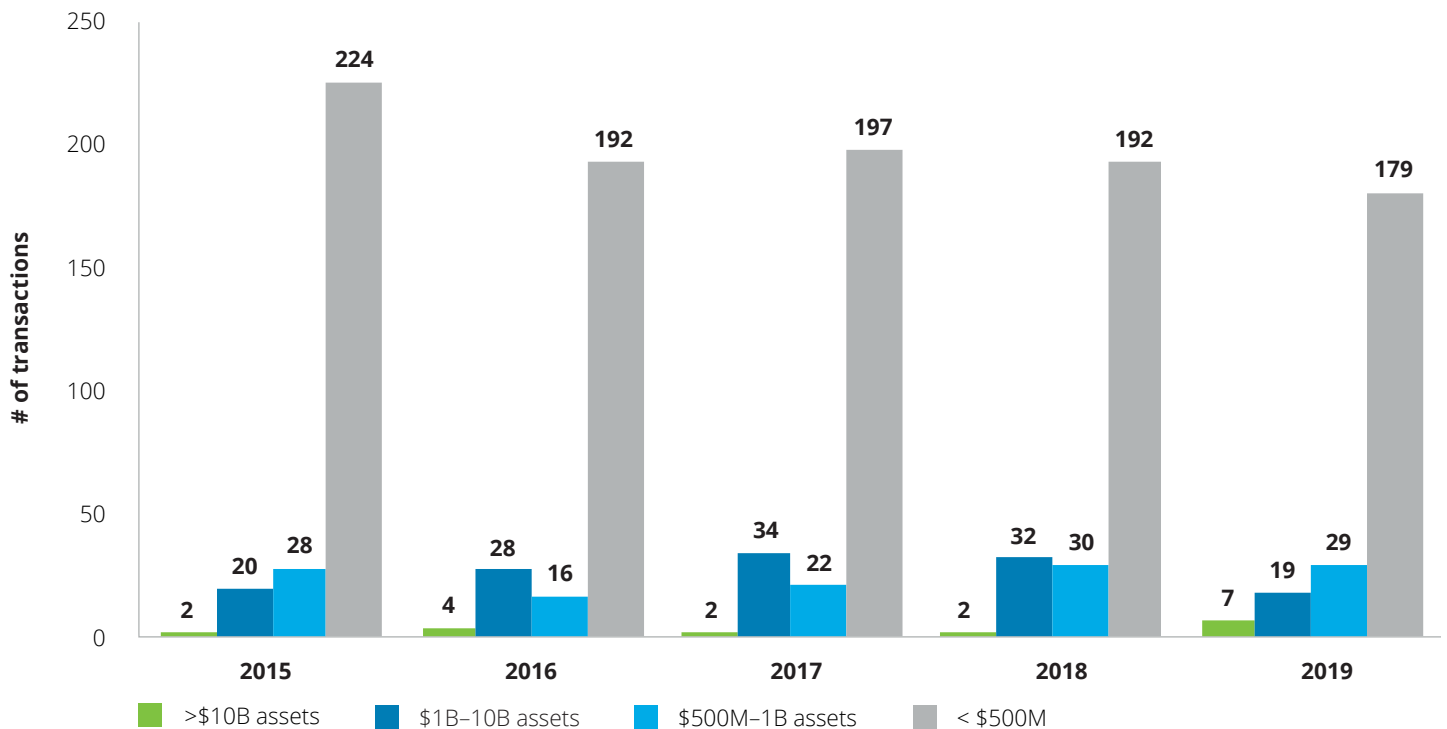
From a regional perspective, midwest bank deals totaled 111 in 2019 versus 114 in 2018. Continued consolidation among the Midwest's smaller banks is a likely reason for its continued higher deal volume. The southeast region followed with 56 deals, a slight increase versus 2018 (figure 2).⁸ The northeast had the highest level of M&A activity as a percentage of total banks, with deal concentration driven by the region's smaller number of total banks.

Combined, regionals saw a decrease in recorded price and total book value (TBV) to 156 percent, down from 2018's five-year high of 171 percent, a 16 percent decrease YoY (figure 2). This decrease in

recorded P/TBV aligned with market movements during the same period as P/TBV for all banks decreased from 153 percent to 134 percent (through Q3 2019), a 19 percent decrease YoY. Median P/TBV declined over the year as expectations from both sellers and buyers have adjusted to the current climate.⁹

Continuing a multiyear trend, the vast majority of 2019 banking M&A transactions occurred at the small-bank level, with most acquisition targets holding \$1 billion or less in assets. Deal volume for banks with \$10 billion in assets more than tripled, from two deals in 2018 to seven in 2019 (figure 3).

Figure 3. Banking transactions by asset size



Source: SNL Financial and S&P Global Market Intelligence.

What we expect to see for 2020

Further consolidation in the \$10B-\$100B space. Pragmatic, “adapt-to-survive” thinking is likely to drive further consolidation among banks in 2020, from small community entities even up to the superregional level. Aided by the change in the systemically important financial institutions (SIFI) threshold (from \$50 billion to \$250 billion), smaller institutions in the \$10-billion-to-\$50-billion asset range—which struggle with mounting technology investments and regulatory infrastructure costs—are looking for a partner that can maximize both short- and long-term shareholder value. However, finding the right merger partner in a similar peer group remains a challenge. We are more likely to see \$100 billion-sized banks targeting \$10-billion-to-\$50-billion-sized entities.¹⁰

Middle-tier banks—those with assets of \$50 billion to \$100+ billion—are likely to continue an M&A strategy of acquiring capabilities, product portfolios, and smaller institutions in an effort to drive scale, increase and saturate their footprint, and maximize customer wallet share. Also on the table for 2020 is potential consolidation among regional banks that are digitally challenged¹¹ or those looking to invest savings from scale efficiencies in adjacent or transformational capabilities.

More MOEs. For the past several years, regional and superregional banks have focused primarily on gaining new capabilities by acquiring fintechs, portfolios, and new distribution channels, and

filling in footprint gaps, rather than via MOEs and other large-scale acquisitions.¹² However, backed by a favorable regulatory climate—thanks in part to the relaxation of Dodd-Frank reforms and the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) of 2018—many institutions seeing rate and fee compression depress their growth estimates are increasing their focus on finding a partner of scale to drive efficiencies and digital transformation. This strategic trifecta appears to be bringing MOEs back into favor.¹³

Compared with smaller transactions, large bank MOEs encompass more of everything: more deposits, branches, customers, lines of business, employees, systems, regulatory exposure, risk, and dollar value worth the invested costs to extract. Acquirers face a host of additional considerations, and the typical bank’s business development function likely won’t have experience with all of them. That increases the burden on CIOs, corporate development, and other functional leaders to get more involved to shape the integration agenda and define the desired end state (see page 6). As market and competitive factors make MOEs increasingly likely in the coming years, banks can start to think strategically about the potential role of such deals in their future growth. It is imperative that they assess their capabilities and understand their blind spots ahead of time.¹⁴



Six factors to consider in a merger of equals

Realizing full deal value in a large bank MOE requires going above and beyond standard M&A practices. In particular, extra due diligence¹⁵ and planning are warranted across six priority areas:¹⁶



Digital capabilities. An MOE typically requires assessing both banks' capabilities and either taking a best-of-breed approach or moving forward with one bank's technology and scaling it to fit the integrated entity. However, there is growing interest among banks in looking at integration as a catalyst and enabler for large-scale transformation. While this can be a valuable part of a deal, it also increases the breadth and complexity of the deal team's activities and expands the scope of the technical integration required. That, in turn, increases the need for a full evaluation and understanding of legacy systems, technology operations, and customer digital needs.



An expanded customer base. Adding new customers through an MOE can create friction in the customer experience. For example, the need to file new disclosures, send welcome letters, and issue new logins and passwords can all detract from that experience, increasing the risk of attrition. To reduce the impact on customers, it is important for CIOs and other business leaders to understand both current and newly acquired customers and to carefully plan and manage the integration strategy.



Geographic growth. How the integrated bank harmonizes its geographic footprint can affect growth, cost, and asset efficiency. While an overlap in footprint should enable cost synergies, it is also important to understand how technology can accelerate entry into new markets and geographies. When a digital-first bank¹⁷ is part of the deal, the importance of geography becomes even more acute, as traditional barriers to expansion disappear.



Culture and management. Merging two large organizations requires evaluating how existing corporate cultures support the business and how they will shape the new, combined culture. This entails developing new governance and decision-making processes in line with the target future-state culture.



Risk and regulatory. An MOE expands the balance sheet, which is a primary reason that relatively few such deals took place until recently. When large banks merge, regulatory thresholds should be reviewed closely to understand governance, risk, and compliance implications. The core basics of the Bank Secrecy Act/anti-money laundering/know your customer (BSA/AML/KYC), asset quality, internal controls, and overall risk management and compliance remain critical and the focus on demonstrating operational resiliency heightens given recent cloud and cyber events.



Integration. Finally, in an MOE, people, process, and technology integration often requires more preparedness, collaboration, and hypothesis-based planning. Both parties need to align on expectations, establish a clear process for integration activities, and work through cultural differences well before the deal closes.

By carefully considering these six areas and recognizing technology's ability to drive additional value, bank leaders can increase certainty that the mergers they undertake have the best chances of delivering the projected benefits.



Intensifying competition for secured customer deposit base.

As the competition for deposits intensifies, buyers are increasingly looking for banks with a secured deposit base, especially those with significant mass. Moreover, as deposit betas accelerated in the first half of 2019, banks' ability to grow deposits became more difficult. As the Federal Reserve (the Fed) lowers the Fed Funds Rate, deposit betas will likely decrease again, similar to 2016–17 levels. With the largest banks attempting to grow their deposit market share via organic customer acquisition, many regional and superregional banks are trying to develop through acquisitions. Banks that can navigate this rate environment ably should emerge as better-positioned acquirers via their stock currency or sellers through the attractiveness of their funding base.

More movement in transaction banking M&A. A large bank's transaction banking division, which provides wholesale banking and securities instruments and services (such as domestic and cross-border payments and cash management, custody, and prime brokerage) for corporations and financial institutions, is a dependable contributor to topline growth. However, transaction

banking operates in a competitive, highly commoditized landscape in which scale and liquidity are all-important. (Although they may transfer trillions of dollars daily, transaction banks typically make just microcents on each dollar). Increasingly, transaction banking M&A is being used to help solve challenges across a range of financial, technology, product, operations, risk, and regulatory functions. For example, finding themselves cost-challenged, some institutions that offer securities services or treasury payment services (or, in the case of universal banks, both types) have been shedding assets or exiting the business. On the securities side, for example, Deutsche Bank sold its prime brokerage business to BNP Paribas SA.¹⁸ Other players are consolidating, with large regional and superregional banks acquiring smaller entities to add liquidity to their trading desks. The massive universal banks are bulking up internal operations to help grow market share. Finally, transaction banks of all sizes are eyeing—as potential competitors and/or acquisitions—disruptive entrants offering new digital platforms and tools.

Investment and wealth management

2019 review

Investment and wealth management M&A activity remained steady throughout 2019, with organizations using M&A as a tool for growth, capability enhancement, and scale-enabled cost optimization to combat margin and fee pressures. There was also continued consolidation in the brokerage space, pointing to organizations' need for scale to remain competitive.

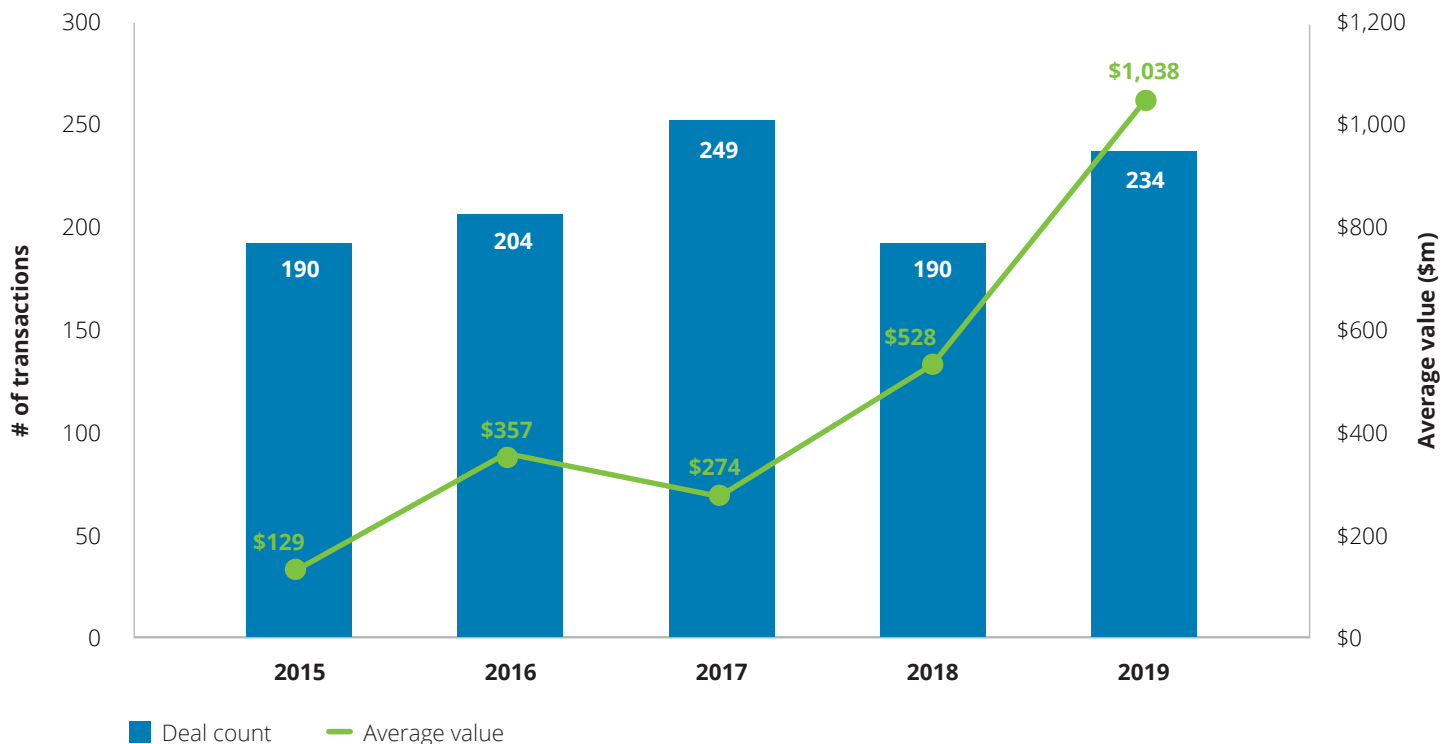
In the year's largest deal, Charles Schwab announced its acquisition of TD Ameritrade in a \$26 billion¹⁹ all-stock deal.²⁰ In addition, Brookfield Asset Management agreed to buy a 62 percent stake in Oaktree Capital for roughly \$4.8 billion, a combination that would create one of the world's largest alternative money managers.²¹ There also were some smaller, bolt-on deals to bolster firms' technology infrastructure. For example, Morgan Stanley acquired the

SaaS equity administration provider Solium Capital for \$900 million.²² Investment management (IM) firms and banks' broker-dealer arms also continued to streamline their portfolios in advance of a potential economic downturn by shedding noncore wealth and asset management platforms.

2019 investment management and wealth management M&A metrics were up across the board versus 2018. The number of reported 2019 transactions²³—234—increased from the prior year's 190 deals. Volume again skewed heavily to asset management (186) versus broker-dealer transactions (48).²⁴ Average deal value spiked at \$1.04 billion, up from \$528 million in 2018,²⁵ driven primarily by the Schwab and TD Ameritrade deal (figure 4).²⁶

Private equity (PE) firms continue to be active players in investment and wealth management M&A, particularly in asset management transactions (figure 5).

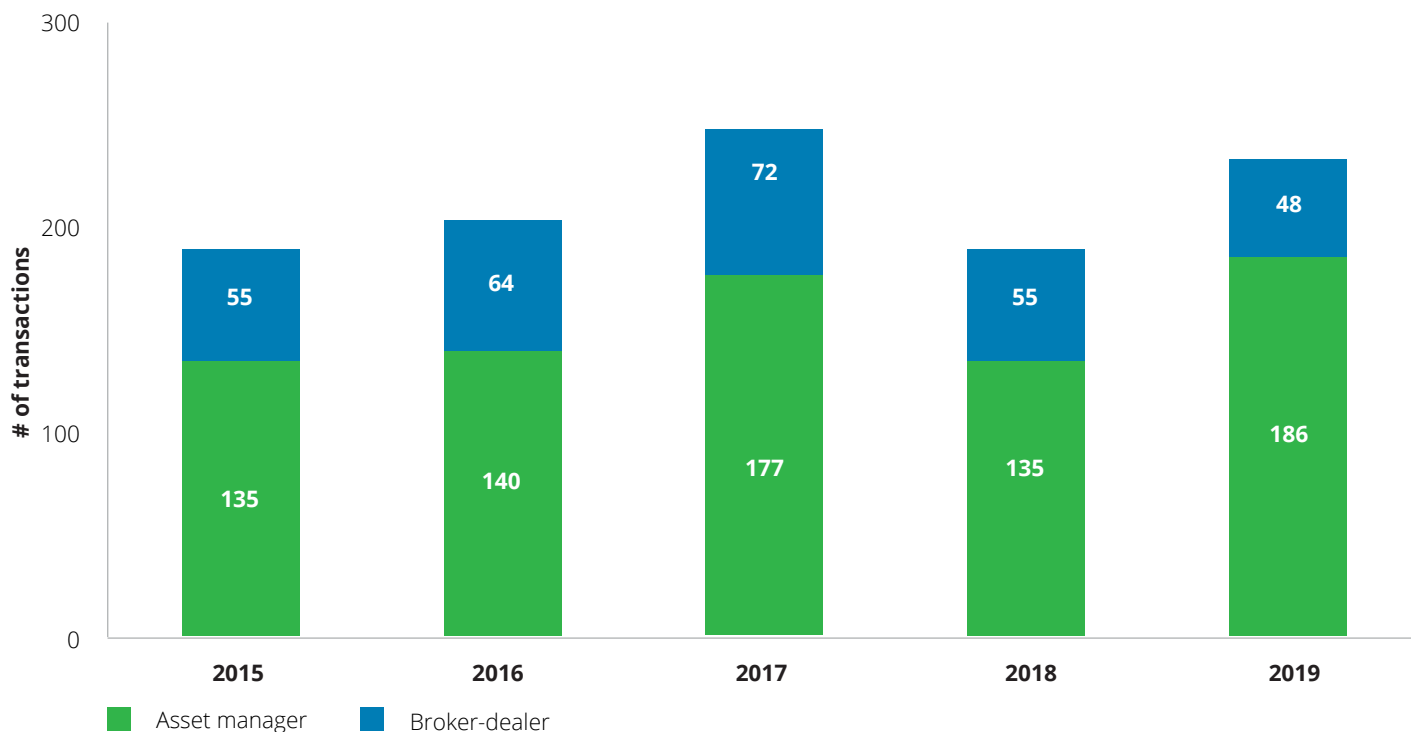
Figure 4. Investment and wealth management M&A metrics



Source: SNL Financial and S&P Global Market Intelligence.

Note: Avg. deal size is based on disclosed deal values. 76%, 76%, 86%, 84%, and 83% of reported deals did not disclose deal values for FY15, FY16, FY17, FY18, and FY19, respectively.

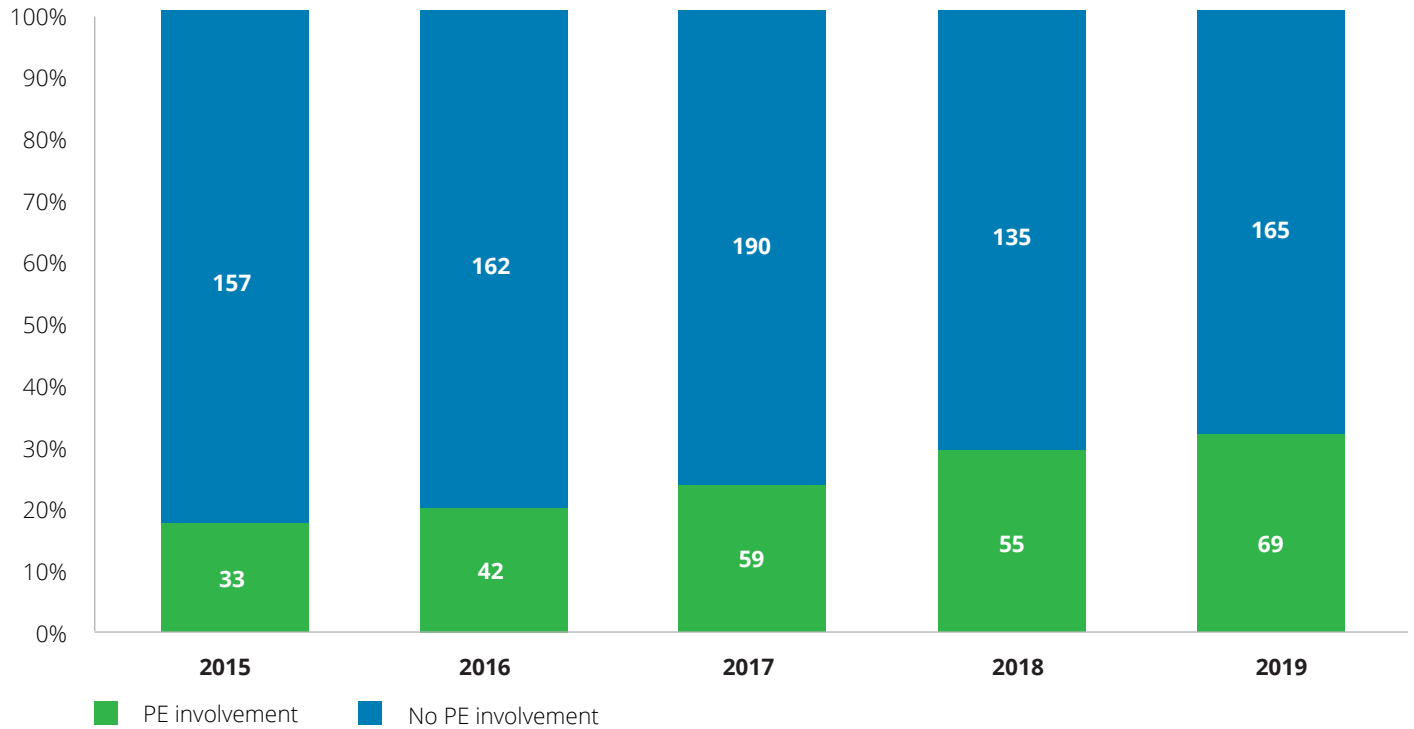
Figure 5. Investment and wealth management M&A metrics



Investment and wealth management: 2019 top transactions by deal value				
Target	Buyer	Announcement date	Value (\$m)	AUM (millions)
TD Ameritrade Holding Corporation	Charles Schwab Corporation	November 25, 2019	\$28,399	N/A
Oaktree Capital Group LLC	Brookfield Asset Management Inc.	March 13, 2019	\$4,800	\$119,560
Advisor Group Inc.	Reverence Capital Partners LP	May 9, 2019	\$2,000	N/A
Institutional Retirement & Trust business	Principal Financial Group Inc.	April 9, 2019	\$1,350	N/A
United Capital Financial Advisers LLC	Goldman Sachs Group Inc.	May 16, 2019	\$750	\$25,000

Source: SNL Financial and S&P Global Market Intelligence.

Figure 6. Investment and wealth management transactions with private equity involvement



Source: SNL Financial and S&P Global Market Intelligence.

What we expect to see for 2020

High-touch high-tech. We anticipate an uptick in IM and fintech deals in 2020 as companies pursue digital capabilities designed to improve client acquisition and retention by providing an improved customer experience. Examples include using data analytics to customize traditional one-size-fits-all product platforms to address changing investor preferences, as well as improving back-end risk management functions.

Retail distribution reboot. Several large, online broker dealers have announced they will cut commissions to zero for retail clients; this may have a domino effect with other players following suit. Already, certain retail brokers squeezed by the price war are looking to sell, partner, or add another link to their value chain—for example, a robo-advisor or an asset management product—to boost their balance sheet. Charles Schwab's acquisition of TD Ameritrade²⁷ is the first shoe to drop. We anticipate more consolidation in the brokerage industry in 2020.

New rules on fiduciary standards. We expect a push toward less risky investment advisory models in 2020. The implementation of the Securities and Exchange Commission's (SEC) new rules on fiduciary standards (Reg BI) and the Form CRS Relationship Summary will likely affect US wealth management firms' business models, operational processes, technology infrastructure, and compliance programs.²⁸ Firms must embed the "best interest" in their governance, disclosure, process, and training procedures, even as individual states (such as Massachusetts and New Jersey) potentially develop their own fiduciary standards.²⁹

Private equity fueling the rise of the RIA. We expect the recent trend of registered investment advisor (RIA) roll-ups to extend into 2020 as numerous small firms size up to become regional and even national players. Strategic players, and PE firms in particular, have been active shapers of this space. In addition to the earlier-mentioned TD Ameritrade deal, Charles Schwab acquired the assets of USAA's Investment Management Company, including brokerage and managed portfolio accounts, for \$1.8 billion.³⁰ Goldman Sachs' \$750 million acquisition of United Capital is its biggest acquisition in 20 years.³¹ LPL and Silvercrest also have made a couple of acquisitions each.

PE-driven transactions generally have taken one of two forms:

- **Wealth managers changing hands from one PE firm to another.** We saw the start of this trend back in 2017, when Focus Financial changed hands from a consortium of PE investors. A larger volume of these deal types went through in 2019, including Advisor Group changing hands from Lightyear to Reverence,³² Kestra moving from Stone Point to Warburg Pincus,³³ Mercer Advisors (which is backed by Genstar and Lovell Minnick) getting additional capital from Oak Hill,³⁴ and Wealth Enhancement Group moving from Lightyear to TA Associates.³⁵ The purchase prices of these have been relatively higher than some of the other wealth management deals (excluding the Schwab and Goldman deals), as they have built a certain level of scale after a number of years under the control of a PE firm.
- **PE-backed wealth managers acquiring smaller wealth managers in an arbitrage play.** Focus Financial continues to be active, with nine announced acquisitions during 2019. Soon after it was acquired by Reverence, Advisor Group made a significant acquisition in Landenburg Thalma. Mercer Advisors announced seven acquisitions during 2019, Wealth Enhancement Group five acquisitions, and Hightower Advisors (backed by Thomas H. Lee Partners) four acquisitions. Others, including Rockefeller Capital Management (backed by Viking) and Cetera (backed by Genstar), have also made acquisitions in 2019.



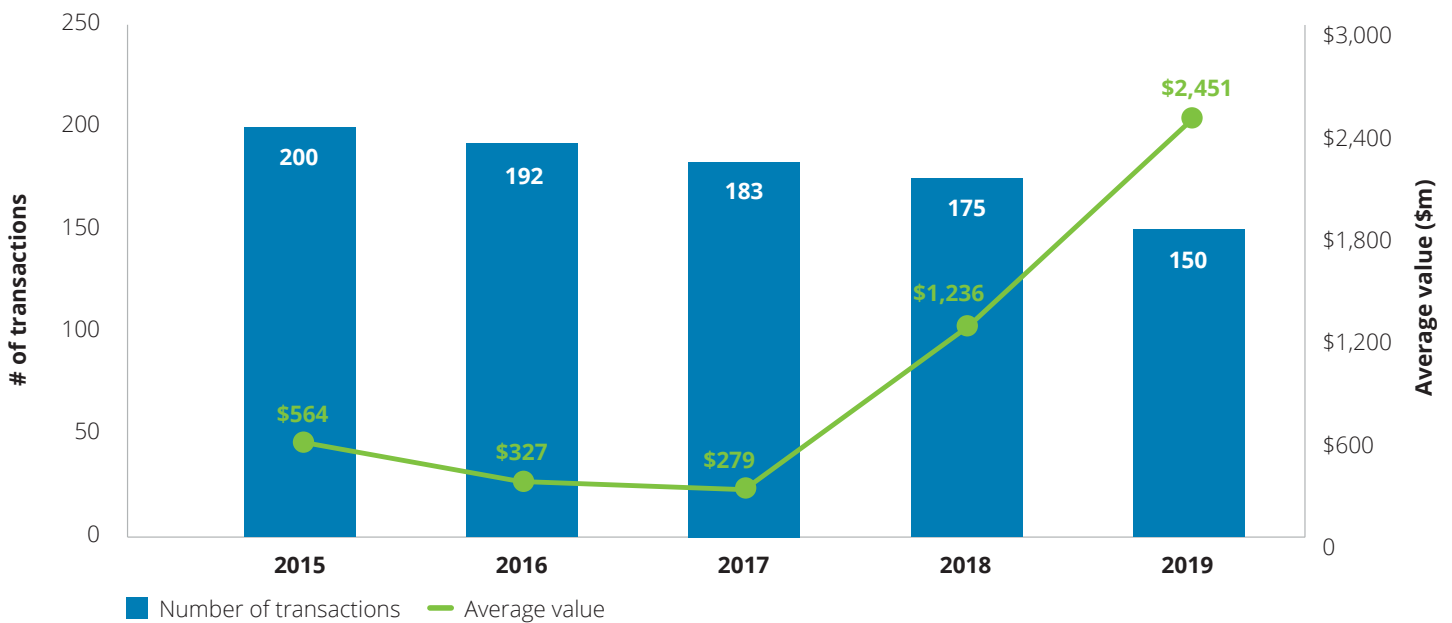
Fintech

2019 review

Increasing competition and the quest for scale catapulted 2019 M&A deal value to record highs in the \$1.6 trillion global payments processing business.³⁶ Heavy consolidation at the top reduced the number of large incumbents from seven to four: Among the deals attesting to the global growth ambitions of payments industry players,³⁷ Fidelity National Information Services (FIS) agreed to take over Worldpay for \$43 billion, including debt—the largest-ever deal in the payments industry³⁸—and Fiserv completed its \$22 billion, all-stock acquisition of First Data Corporation.³⁹

The proliferation of digital payment options and innovative platforms is encroaching on the turf of traditional payment providers and forcing them to reassess their business models. During 2019, incumbents responded to numerous trends and drivers by engaging in targeted M&A to fill in adjacencies and add capabilities and talent to address challenging areas such as cross-border payments, an improved end-to-end payment experience, multipayment integration, and business-to-business (B2B) payments.⁴⁰

Figure 7. Fintech M&A metrics



Note: Avg. deal size is based on disclosed deal values. 58%, 68%, 66%, 69%, and 65% of reported deals did not disclose deal values for FY15, FY16, FY17, FY18, and FY19, respectively.

Fintech: 2019 top transactions by deal value

Target	Buyer	Announcement date	Value (\$m)	Industry
Worldpay Inc.	Fidelity National Information Services Inc.	March 18, 2019	\$35,365	Payments
Total System Services Inc.	Global Payments Inc.	May 28, 2019	\$22,149	Payments
First Data Corporation	Fiserv Inc.	January 16, 2019	\$21,792	E-commerce & marketing technologies, payments
The Ultimate Software Group Inc.	Investor Group	February 4, 2019	\$10,971	HR and payroll technology
Symantec Corporation	Broadcom Inc.	August 8, 2019	\$10,700	Security technology

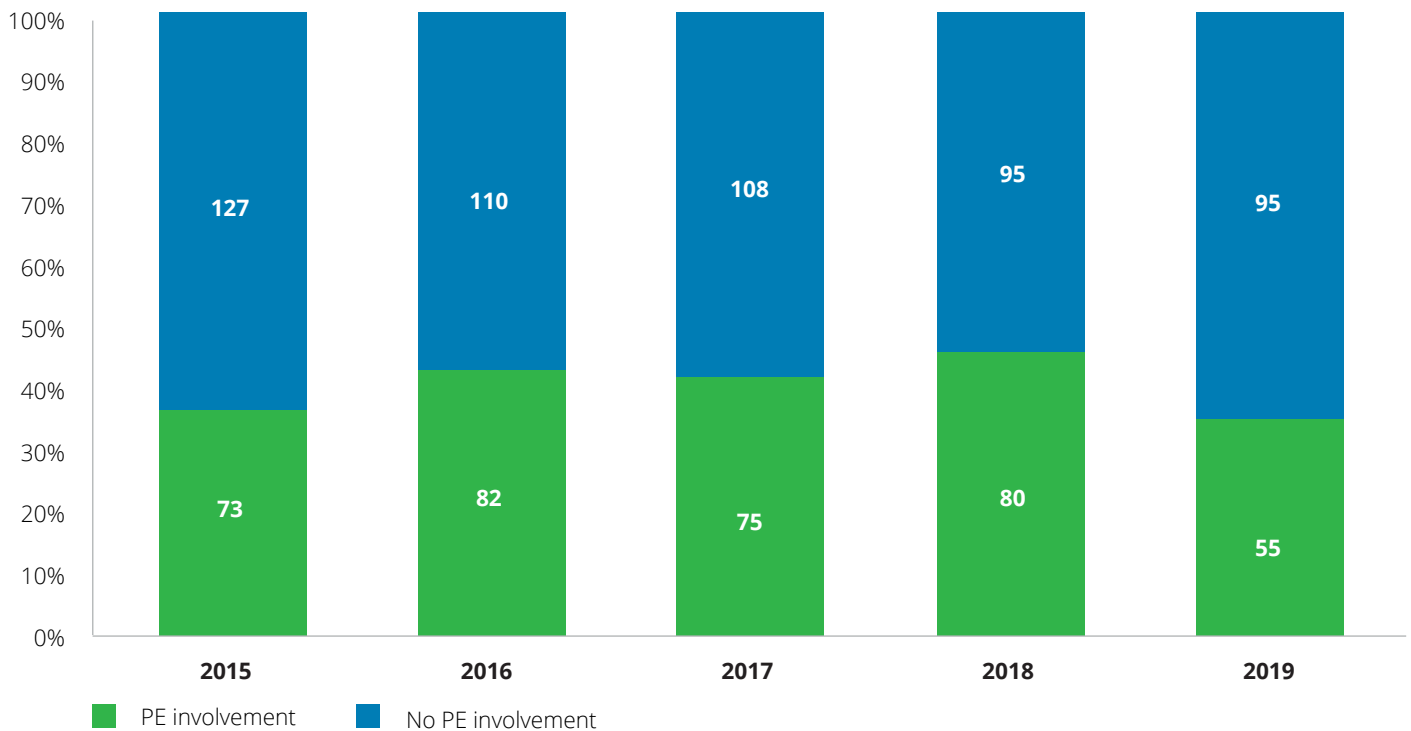
Source: SNL Financial and S&P Global Market Intelligence.

The active payments landscape had a ripple effect on overall 2019 fintech M&A, although most of the segment continues to focus on little pieces of the pie through small acquisitions and investments in early-stage startups. However, there are signs that the fintech landscape is maturing, with late-stage startups attracting a greater share of funding—numerous startups are choosing to stay private longer for this reason. Some established fintechs are also tweaking their business models by diversifying across geography and segments.⁴¹ Leveraging its successful payment platform, Stripe, for instance, has forayed into small-business lending.⁴² In addition, balance sheet-oriented fintechs looking for financial resiliency might consider taking steps to operate within a proposed regulatory framework for fintech bank charters.

Although fintech deal volume declined in 2019—150 reported deals, compared with 175 in 2018—average deal value virtually doubled to nearly \$2.5 billion, powered by the aforementioned major consolidation in the payments space (figure 7).⁴³

Continuing a trend lasting more than a decade, PE firms' involvement in fintech M&A continues to be high (figure 8).

Figure 8. Fintech transactions with private equity involvement



Source: SNL Financial and S&P Global Market Intelligence.

What we expect to see for 2020

Next wave of payments deals. In the wake of 2019's major wave of payments sector consolidations, traditional payment providers are being challenged to remain relevant and quickly adapting to the new competitive environment. While fintechs are driving much of the disruption, incumbents are not far behind. We anticipate that 2020 strategies will likely be about the formulation of "big bets" that could take the shape of either going all-in on a targeted set of preferred partners and platforms or going broader via capabilities acquisitions (for example, distribution software for brokers) in an attempt to service the ecosystem. The next wave of payments deals also may include post-consolidation divestitures to exit businesses that are now off strategy and noncore, shed redundant assets, take out back-office costs, and support changing business models. In addition, incumbents are likely to collaborate with smaller fintech players and other market entrants as strategies and playbooks for partnering continue to evolve.⁴⁴

Subscribe, buy, or invest? Artificial intelligence (AI), digital voice assistants (DVA), cloud, and advanced analytics are gaining traction in banks and IM firms as an efficiency or effectiveness play in front-, middle-, and back-office processes.⁴⁵ Still, banks, IM companies,

and PE firms eyeing fintech targets in 2020 may have difficulty deciding which approach will glean the most value from their investment. Should they subscribe to or pay an ongoing fee for a specific capability (for example, SaaS or cloud-based computing) rather than carry it on their own platform? Should they buy a fintech, use selected capabilities internally, and then sell those services to others? Or should they invest minority stakes in numerous players to remain close to the innovation ecosystem and be advantageously positioned should more significant M&A opportunities lie ahead with potential winners? Two primary strategies are emerging that reside at opposite ends of a sliding scale of integration. The first is a capability-driven strategy, wherein established banks seek to acquire and integrate new products, channels, or capabilities into their existing business portfolio to fill a gap and/or prepare for a potential market shift. The second adheres more closely to a holding-company model, where the acquiring institution builds a portfolio of fintech companies that continue to stand on the strength of their respective business cases while leveraging the scope and scale provided under the umbrella of the parent company.⁴⁶



Trends and drivers of 2020 M&A activity

The following trends and drivers are worth watching for their potential catalyzing or hindering effect on industry M&A activity during the coming year.

Transform while you transact

Reaping the full benefits of an M&A transaction can be a long and costly journey, especially when technology is a key value driver. Banks often have bloated infrastructures and legacy systems unable to keep pace with evolving customer demands. IM firms generally lag in digital maturity compared to other industries. As if dealmaking isn't complicated enough, many organizations also face the daunting prospect of transforming their platforms, processes, and products to attain post-M&A integration goals.

Functional integration at multiple levels—internal business units, bolt-on capabilities, or enterprise-wide M&A—creates competitive advantages at scale, as well as sizable economic benefits. Successful integration strategies in asset management M&A, for example, typically take difficult but decisive action across four key sources of legacy duplicate costs: organizational models, distribution strategy, enterprise and investment operations, and technology.⁴⁷

Traditionally, companies engaging in M&A have focused first on integration—then, in some cases, on transformation. Today, many CIOs and other executives are increasingly taking a different approach. Rather than risk failing to achieve desired benefits because of a lengthy integration process and the limits of existing technologies, they are opting instead to “transform while they transact” and work toward both goals concurrently.⁴⁸

By establishing a vision for the desired post-M&A end state—as well as the infrastructure required to support it—early in the deal process, the newly combined companies can more quickly align their business models and IT architectures with overall strategy; realize M&A synergies more rapidly; and reduce one-time integration costs.⁴⁹ For example, if the plan is to consolidate data centers and that requires moving all applications from one center to another—which may take up to 18 months—why not take advantage of the integration and go straight to the cloud?

The benefits of a transform-while-you-transact approach can be considerable; however, realizing them requires that business leaders give careful thought to planning, governance, and disaster recovery. Critical decisions must be made about which systems to keep and which to discard when there are overlaps, whether and how best to implement shared services, what capabilities to keep in-house and which to move to the cloud, how emerging technologies such as blockchain or AI might enable new value opportunities, how to combine and effectively manage previously separate sets of data, and how to address any problems with existing processes or infrastructure.⁵⁰

Accounting, regulatory, and tax influences on M&A activity

The financial services industry in 2019 enjoyed the benefits of operating in a pro-business regulatory and tax environment. Conditions favorable to M&A should extend into 2020; however, the landscape may be tinged with uncertainty linked to the upcoming US presidential election and a possible political regime change. Financial firms engaged in dealmaking should continue to focus their diligence efforts on the core basics of asset quality; BSA, AML, and KYC compliance; internal controls; governance; and risk management protection.⁵¹ They also should pay increased attention to operational resiliency: IT failures across financial institutions have focused regulatory and supervisory attention on the risks that technology change can pose to the financial services sector. Finally, they should consider the potential implications of several recent regulatory and tax policy developments.

Accounting developments

Potential deal considerations related to CECL accounting.

As part of M&A modeling, banks will need to evaluate how the current expected credit loss (CECL) standard may affect accounting for acquired loans, as CECL may negatively affect capital. The most significant change relates to how banks account for acquired nonpurchased, credit-deteriorated (non-PCD) loans (fully performing loans). Under the current guidance, banks record non-PCD loans at fair value with no separate allowance recorded on day one (as the fair value mark already consists of yield and credit components). However, under CECL, non-PCD loans will have to build a credit loss allowance separate from the recorded purchase price, commonly referred to as “double counting” (upon acquisition, the loans will need to be adjusted to fair value and then additionally layer in day-one allowance). As such, the new accounting guidance may further increase the dilution from a deal accounting perspective, albeit temporarily—thereby extending the earn-back period. While we do not expect CECL to prevent banks from pursuing a deal, it may complicate financial modeling, including its impact on regulatory capital.

Regulatory developments

New tailoring criteria. In October 2019, the Fed issued a final rule that tailored the Enhanced Prudential Standards (EPS) for domestic and foreign holding companies. The rule fine-tunes the requirements for capital, stress testing, liquidity, large exposures, and reporting based on financial metrics that serve as a proxy for a firm’s size, complexity, interconnectedness, and systemic importance.⁵² While the Fed used its discretion in establishing the tailoring metrics, the rule is largely consistent with the asset-size thresholds laid out in EGRRCPA.⁵³ In a complementary rulemaking, the Fed and Federal Deposit Insurance Corporation (FDIC) also tailored requirements related to resolution plans (“living wills”) in a similar manner. Moreover, the banking agencies are working to finalize their related EPS and other rules at the insured depository level. Efforts to tailor the post-crisis reform standards reflect concern that the initial efforts had gone too far and did not adequately balance the tradeoff between safety and soundness and burden, especially for smaller and less complex firms.⁵⁴ The new tailoring requirements should ease companies’ regulatory burden and may encourage them to refresh their M&A thinking.

Operational resilience. Over the past year, IT failures across financial institutions have focused regulatory and supervisory attention on the risks that technology change can pose to the operational resilience of the financial services sector. The volume, velocity, and complexity of change can present a significant challenge, and often it is during change programs—such as post-M&A integration—that disruptions arise. Regulators and industry watchdogs in the United Kingdom and European Union have been shifting focus toward strengthening technology and business resilience. For example, the European Banking Authority (EBA) has launched a consultation on its draft Guidelines on ICT and security risk management, which could be applicable starting as early as 2020.⁵⁵ In the United States, the Fed is conducting horizontal examinations to evaluate the ability of financial services organizations to stay resilient and recover from operational disruptions and failures.⁵⁶ We expect US regulators to focus more heavily on operational resilience in 2020, emphasizing its importance when conducting M&A due diligence.



Fiduciary responsibility. The SEC approved Reg BI in 2019,⁵⁷ which enhances conduct standards for broker-dealers and investment advisors when dealing with retail clients. More fiduciary standards could be in the pipeline at the state level—New Jersey and Massachusetts are contemplating their own rules, potentially complicating the compliance burden for broker-dealers.⁵⁸ These federal- and state-level standards may negatively affect companies' bottom lines and potentially drive more M&A.

Regulating fintechs. As fintechs become mainstream, how best to regulate them has become more urgent. On one hand, incumbents and fintechs want the latitude to experiment and innovate without the weight of stifling regulation. On the other, innovators also want a degree of regulatory certainty to ensure that their investments will pay off over the long run and not be shut down or create unexpected legal, compliance, or regulatory costs.⁵⁹ Some progress has been made on addressing this uncertainty, although issues remain. After the OCC announced in 2018 that it would begin accepting fintech bank charter applications, it was sued by both the New York State Department of Financial Services and the Conference of State Bank Supervisors on the grounds that it had overstepped its authority. The suit could discourage fintechs from applying for a charter in the interim.⁶⁰ A resolution that provides a clear path forward may increase deal activity as fintechs focus on more fully serving their clients.

Tax policy developments

Seeking further clarity around US tax reform. The US financial services industry was very active during 2019 in engaging with the Treasury Department and the Internal Revenue Service (IRS) to request further clarity around the application of 2017 tax reform rules to their business models. Some organizations have attempted to push through the ambiguity (for instance, by repapering cross-border contracts), while others are awaiting further clarity that may lead to consideration of recalibrating their business models and strategies.⁶¹

Proposed Section 382 safe harbor regulations. On September 9, 2019, the Treasury Department and the IRS issued a proposed rule under Section 382 of the Internal Revenue Code⁶² that, if finalized, will considerably limit the amount of net operating losses (NOLs) that companies have available to them following an ownership change. Specifically, the regulations would eliminate an IRS safe harbor dating back 15 years. If the regulations are finalized as proposed, banks and other corporations that carry significant NOLs into an M&A deal may find they are worth significantly less going forward.

Reporting requirements. Complex, real-time reporting requirements—such as the Automatic Exchange of Information (AEOI) global standard that mandates the flow of information between countries⁶³—are placing additional pressure on banking tax departments. As a result, many have begun to rethink their technology, data, and analytics capabilities to improve processes and boost efficiency. Some are exploring managed tax and technology services to keep costs low while they secure a larger budget to perform these activities in-house. Others are experimenting with moving their processes and data to the cloud.⁶⁴

Find the right partner(s) to weather a potential storm

With continuing political and economic uncertainty increasing the prospect of a 2020 downturn, banks and IM firms should consider acquisitions, investments, and partnering arrangements with organizations that have offsetting capabilities (such as fund certainty or digital prowess) to their strengths and weaknesses. Potential benefits of combining forces rather than going it alone in today's unsettled marketplace include:

- Improve efficiency ratios and take costs out on a go-forward basis
- Manage technology evolution over larger-scale operations
- Mitigate treasury inefficiencies through improved asset and liability matching
- Distribute one partner's great product or cross-sell both partners' similar products across a larger platform
- Reduce or eliminate location overlap
- Leverage in-house financial, operational, and technology expertise of both parties

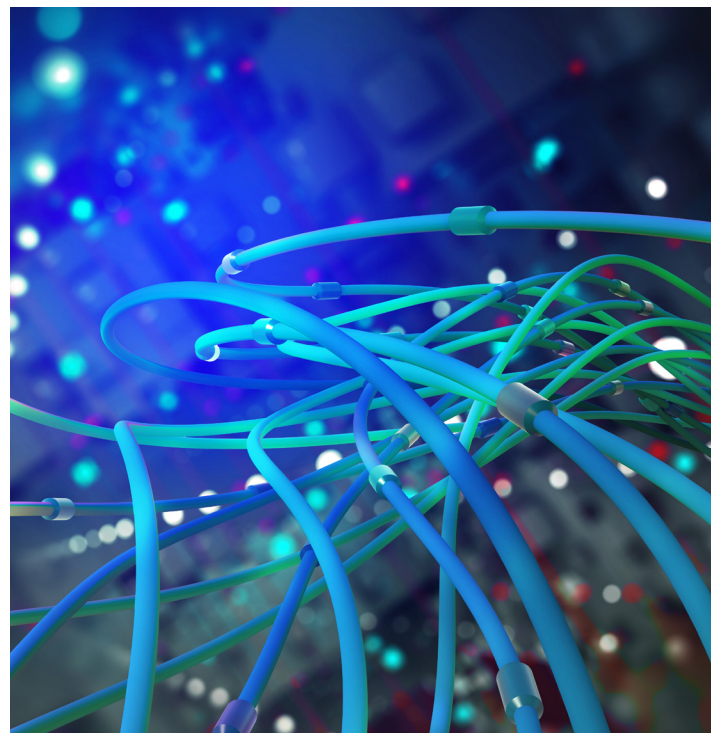
An MOE presents a particular set of partnering challenges. Potential buyers are often faced with paying a premium, so the deal rationale needs to emphasize top- or bottom-line gains—cost take-out to improve efficiency, for instance—that can justify the purchase price. The key may be to find a partner with strategic overlap to drive the synergies, as well as provide opportunities for the newly combined company to grow revenue and geographic footprint. Furthermore, unlike smaller tuck-ins, which typically look at targets' historical performance more so than forward projections, an MOE requires additional strategic diligence, including the ability to successfully integrate and scale capabilities; cross-sell to newly acquired segments; consolidate branches in overlapping markets; and integrate divergent management processes and culture.

IM firms are likely to focus their 2020 partnering efforts in the fintech space to build out capabilities, add products and services, and enter adjacencies. On wealth management's retail side, goals include expanding reach and getting in front of clients—for example, by acquiring an investment platform that links to a mobile app—and improving the overall customer experience using platform customization and data analytics.

Continue moving forward, but with caution

Escalating uncertainty won't bring banking and capital markets M&A to a standstill in 2020. There are substantial reasons for organizations of all sizes to seek partnering opportunities. We are optimistic that dealmaking will remain active, at least in the first half of the year. Regulatory and tax conditions remain favorable, consolidation continues among small- and medium-size institutions, and companies with strong balance sheets have more money to spend on investments and acquisitions.

Organizations contemplating M&A should continue moving forward, but also exercise caution. Carefully align corporate and M&A strategies, conduct thorough due diligence, look for a solid mix of cost-takeout and revenue-generating opportunities, and make sure the resulting footprint and/or capability overlap isn't too extensive. Plan integration steps early to fully realize post-transaction financial and operational synergies. While M&A always comes with risk, especially in a changing landscape, the greater risk may be failing to partner to navigate uncertainty and add financial strength and operational resiliency.



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