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Time is right for a wave of bank consolidation

Regulatory changes, desire for scale, and the search for digital capabilities will likely catalyze the next wave of bank mergers

Regional and super-regional banks have been active acquirers over the past decade primarily focused on buying new capabilities, such as, financial technology (fintech), brokerages, and investment management firms. However, until recently, banks had shied away from growth-focused mergers of equals (MOEs) and other large-scale acquisitions. Recent regulatory and marketplace changes, including the relaxation of provisions of Dodd-Frank are beginning to change this paradigm and shifting how we see the banking landscape evolving. As banks begin to view larger deals they'll need to change the lens with which they approach and execute on deals.

Shifts in the market have led to fee pressure and commoditization increasing the value of scale. When coupled with a favorable regulatory environment and updated economic indicators suggesting continued economic expansion it will likely serve as a catalyst for bank consolidation. Analysts and market advisors increasingly believe that the next wave of MOEs across regional and super-regional banks is upon us. Over the past 18 months alone we've seen:

- Cincinnati-based Fifth Third Bancorp announced in May 2018 its intention to acquire smaller rival MB Financial Inc for about $4.7 billion.[1]
- The $3.6 billion merger of TCF Financial Corp. and Chemical Financial Corp., announced in January 2019,[2] will create a larger regional bank across the Midwest.[3]
- In February, BB&T agreed to buy SunTrust for $28 billion, the biggest bank merger in more than a decade.[4] The deal creates a $442 billion-asset powerhouse in the Southeast United States.

[1] "Fifth Third Bancorp pays $4.7 billion for MB Financials' Chicago muscle," Reuters.com, May 21, 2018, https://www.reuters.com/article/us-mb-financial-m-a-fifth-third-bancorp-idUSKCN1IM0YL.

[2] "TCF Financial and Chemical Financial in $3.6 Billion Merger Deal," TheStreet.com, January 28, 2019, https://www.thestreet.com/investing/tcf-financial-and-chemical-financial-to-merge-14846701.

[3] "TCF Financial and Chemical Financial in $3.6 Billion Merger Deal," TheStreet.com, January 28, 2019, https://www.thestreet.com/investing/tcf-financial-and-chemical-financial-to-merge-14846701.

[4] "BB&T, SunTrust to combine in $28B merger," American Banker, February 7, 2019, https://www.americanbanker.com/news/bb-t-suntrust-to-combine-in-28b-merger.

Three core drivers are sparking interest and driving action:

1. A more favorable regulatory environment— 2018's Economic Growth, Regulatory Relief and Consumer Protection Act[5] raised the asset thresholds that trigger added regulatory scrutiny from $50 billion to $250 billion - unlocking a range of growth opportunities that were previously out of bounds for banks wary of taking on the cost and burden of Comprehensive Capital Analysis and Review (CCAR) in addition to the incremental quantitative capital and liquidity requirements. This, coupled with recently more openness in regulatory positions taken by the regulators, has produced a greater willingness amongst banks to consider mergers, especially if the candidates are able to demonstrate that the 'Joint Co' will strengthen financial and risk readiness.

2. The need for scale to improve efficiencies and competitiveness— Commoditization of services, ongoing interest rate compression, and regulatory limitations on fees have depressed banking revenues even while the economy remains strong. This has increased the need for scale driven efficiencies and digitally-driven growth focused on improving banks' operating expenses and strengthening their competitive positioning. Concurrently, newly reduced corporate tax rates have provided an increase in available cash delivering the powder needed to consider larger acquisitions that can drive synergies and reduce operating expense.

3. The hunt for digital capabilities—As banks' desire to differentiate via technology and digital channels grows, the number of available and differentiated fintech targets has commensurately become harder and more expensive to find. Ongoing demand for fintech targets has continued to outpace available supply driving up multiples. As a result, interest in digitally mature banks has also increased – such targets represent an integrated portfolio of fintech capabilities and may likely be a more efficient inorganic growth opportunity for a bank rather than hunting for unique capabilities in a piecemeal basis. Moreover, acquiring a digitally mature bank also helps add scale and can attract top talent, all of which can be leveraged to further differentiate legacy banks.

. The expected wave of consolidation is likely to produce a small but strong tier of super-regionals well-positioned to operate within a landscape of growing pricing pressure and differentiated customer experience.

. However, as the pace of consolidation increases, the pool of desirable—and available—MOE partners may become limited. Regional banks considering a large-scale acquisition or MOE should therefore move quickly and strategically.

[5] S.2155 - Economic Growth, Regulatory Relief, and Consumer Protection Act. Senate - Banking, Housing, and Urban Affairs. 115th Congress (2017-2018). Public Law No: 115-174, 2018. https://www.congress.gov/bill/115th-congress/senate-bill/2155

MOE has "more of everything"

In contrast to smaller fintech buys, MOEs typically have more of everything: more deposits, branches, customers, lines of business (LOBs), employees, systems, regulatory exposure, and risk. As a result, acquirers may have to manage a host of additional considerations, not least of which is understanding how to integrate new digital capabilities, retain customers and employees, and manage regulatory concerns that may require divesting assets. The increased complexity of an MOE deal calls for additional diligence and planning across six priority areas:

Digital capabilities

An MOE typically requires assessing both banks' digital capabilities and selecting from among each bank's best-of-breed assets or moving forward with one bank's technology and scaling to fit the integrated entity. However, there is growing interest among banks to look at integration as a catalyst and enabler for large-scale transformation – allowing the new bank to go beyond delivering the "best in breed" strategy and in turn truly transforming. This increases pressure on deal teams to really understand and evaluate legacy systems, technology operations, and customer digital needs to make meaningful tradeoffs across operating costs and growth opportunities. Important questions to consider:

- What could and should the end-state product and service offerings, the technology stack, and go-to-market/service model be?
- What systems and digital capabilities will the merged organization leverage and how will that impact customer experience?
- How much of the deal value should be attributed to acquired digital capabilities and what is the risk associated with integration?

Expanded customer base

Adding new customers (in a material manner) through an MOE can create friction including distribution of new disclosures, introductory emails, website logins, debit cards, and updates to terms of service and fees. This friction may be coupled with potential changes to the product mix and changes in the bank's financial position, such as greater leverage, which may lead to even more changes to operations and the customer experience. To minimize the impact on customers and enhance the bank's value proposition, customer interactions need to be carefully planned and managed. Among the key questions to consider:

- What are the different customer segments? How do customer segments differ and how are they similar? What customer segments are most impacted by the acquisition?
- What are the product needs of each customer segment and what revenue synergies exist?
- What operating, and delivery models will be in place throughout integration and how are customers expected to react?

Geographic growth

How the integrated bank harmonizes its geographic footprint will impact growth, cost, and asset efficiency. An important aspect of MOE diligence is defining how geography will impact the investment thesis. While, an overlap in footprint is a key driver to realizing a merger's synergies, it is equally important that the deal allows the two banks to enter new markets and reach new geographies. This may mean developing marketing strategies to deepen penetration in focus geographies and assessing how and where to consolidate bank branches. Add to these complications related to buying a "digital-first" bank and geography's importance to deal becomes even more acute. The following questions should be considered when assessing geographic growth:

- What will the consolidated coverage map look like and where are overlapping markets that require branch rationalization?
- What competition will the new bank face in each geography?
- Where, when, and how may there be strategic or regulatory-required shedding of assets?

Culture and management

When merging two large organizations, it is important to evaluate how existing corporate cultures support the current business and how they will shape the integrated bank culture. This requires developing an integrated management approach model founded on new and clear governance and decision-making and getting from legacy structures and tribalism. This can enable the integration teams to drive the expected post-deal results and get answers to the questions that will determine the key tools, processes and employees' strategies shaping the integrated bank:

- Where are the banks' operating models (people, processes, and technology) similar and where are they different and how will these differences lead to efficiencies or inefficiencies?
- How formal/informal are each bank's processes (e.g., level of documentation and oversight)?
- What are likely pain points related to the deal for employees across both bank cultures?
- Where are the greatest employee attrition risks and who are the employees that should be considered for retention planning?

Risk & regulatory

A merger of equals significantly increases the resulting new entity's balance sheet. While this may not necessarily trigger additional regulatory requirements (e.g., CCAR, resolution planning or liquidity), the governance, risk management and compliance competence needed remains the same but now with a much larger and likely more complex financial base.

Moreover, the potential for heightened regulatory exposure increases the importance of creating a robust risk management plan and strong internal controls prior to deal close. Questions to consider include:

- Which banks can be acquired without crossing regulatory threshold(s)?
- What is the merger's potential impact on capital, liquidity, and risk requirements?
- What additional capabilities are needed to satisfy regulatory and risk requirements (e.g. regulatory reporting implications)?
- What are the governance implications – how will the combined entity be managed (e.g., board composition etc.)
- How can the merger proposal demonstrate a profitable and sustainable business model to regulators?
- What are the deal's resolution and recovery planning considerations?
- What is the future-state vision of risk appetite and how it might impact financial resources and planning?
- Will exposure to new geographies increase regulatory scrutiny of bank operations?

Integration

Deal teams can't just follow a standard M&A playbook when engaging in an MOE. Especially as common integration challenges are likely exacerbated by the MOE's size and complexity. As a result, integration requires more preparedness, collaboration and hypothesis-based planning. Both parties need to align on expectations, establish a clear process for how integration activities will be conducted, and work through cultural differences well before the deal closes. Questions should include:

- How will integration challenges, gaps, trade-offs, issues, and constraints be resolved?
- How and when will the new entity generate the business value that it is projected to achieve through the merger?
- How will decisions be managed who will be the ultimate decision-making authority?

What's next

Regional and super-regional banks have continued to be acquirers, some even serial acquirers, over the past decade. However, the number of large-scale acquisitions or mergers of equals during the same period has been largely non-existent. This may have led to rust in potential acquirers M&A strategy, planning toolkits, and access to experienced talent that warrants rethinking as they prepare for the next wave of consolidation.

As banks start to think about the potential role of mergers in their future growth, a few considerations may enhance their outcomes:

- **Think broadly broad about the opportunity set.** Develop an understanding of where you want to focus your growth and what attributes you'd like to see in a potential target based on their potential value-add to operations, customer experience, and capabilities (including digital) to develop the universe of targets. Only once you've developed a broad opportunity set should you begin to tailor the list down to a short-list of targets to consider
- **Understand how you're being viewed.** A MOE is not only about the diligence you do on a potential acquisition, but also about how your potential targets view you and the opportunities, culture, and capabilities you will bring to the table. Conduct sell-side diligence on yourself and evaluate areas of potential vulnerability to proactively address prior to engaging in conversations with a potential target
- **Quickly evaluate M&A readiness and capabilities needed for the deal.** Deal teams should review their internal capacity and capabilities to identify gaps and areas for support before engaging a potential target. External deal support should be leveraged to plug capability and talent gaps and help accelerate and de-risk potential acquisitions, particularly when approaching a target of material size

If merger discussions are already underway, banks should keep the following in mind:

- **Stay in close contact with regulators.** Deal planning should include early and frequent engagement with regulators to demonstrate both banks' understanding of the regulatory requirements and show how the Joint Co will enhance financial and risk readiness.
- **Establish a robust decision-making process.** MOE planning, execution, and integration decisions should be fact-driven with clear governance that delineates who holds ultimate decision-making power and how decisions are made as early as possible in the merger process.
- **Make sure the end-result is bigger and better, not just bigger.** A clear source of truth for the deal rationale and value drivers should be created, communicated, aligned, and executed on throughout the entire deal lifecycle.

Integration challenges prevent 70 percent of transformative mergers from achieving the projected post-deal synergies. In addition, productivity during the first four to eight months can be reduced by 50 percent, and 45 percent of executives leave by year three.[5] Customers, employees, and stockholders may become frustrated by change, and competitors may take advantage of the disruption to attract talent.

Should you be thinking about acquisition readiness, target evaluation, or execution, or if you simply want to learn more about the trends driving the new wave of mergers of equals and how your bank may benefit, we should talk.

[5] Deloitte Making the Deal Work 2017

Contacts

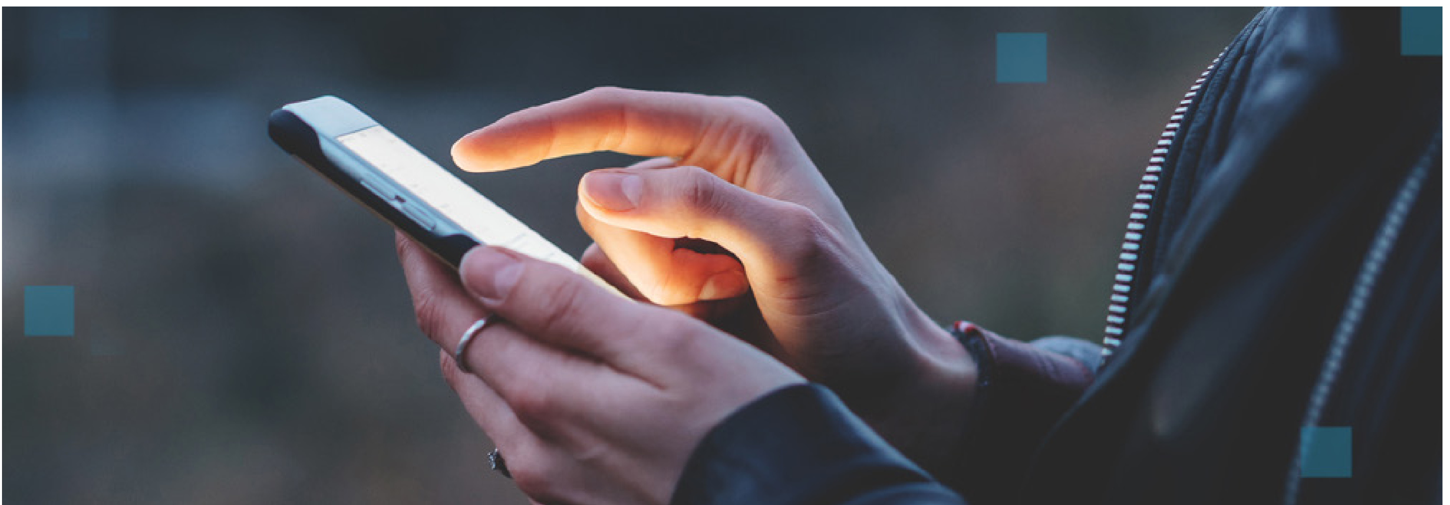
Jason Langan
Principal
Deloitte & Touche LLP
jalangan@deloitte.com

Max Bercum
Principal
Deloitte Consulting LLP
mbercum@deloitte.com

Nadia Orawski
Principal
Deloitte Consulting LLP
norawski@deloitte.com

Anupam Shome
Senior Manager
Deloitte Consulting LLP
anshome@deloitte.com

Richard Rosenthal
Senior Manager
Deloitte & Touche LLP
rirosenthal@deloitte.com



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