

A black chess pawn is positioned on a wooden chessboard with a light and dark brown checkered pattern. The pawn is centered in the lower-left quadrant of the image. The lighting is soft, creating a slight shadow and reflection on the board.

Deloitte.

2015 Financial Services
M&A Selected Opportunities
New rules, new players –
new game?

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2015 Financial Services M&A Predictions

New rules, new players – new game?

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Author	Synopsis	
Jonathan Rainey & Nils-Alexander Berent	The announcement of the AQR and Stress Tests results in October 2014 provided more clarity on the banking environment in the eurozone. Jonathan Rainey and Nils-Alexander Berent explore the impact of the AQR and stress tests on M&A in the banking sector.	
Laura Scarpa	2015 looks set to see reinsurance rates remain under pressure as new capital providers persist in challenging traditional reinsurance solutions resulting in existing players needing to demonstrate a number of characteristics to remain successful. Laura Scarpa assesses how this environment will drive M&A activity in the insurance sector.	
Chris Wildsmith & Simon Thompson	The consumer finance sector became subject to FCA regulation in April 2014. The Regulator has already made changes to the conduct of business rules and committed to the introduction of a rate cap in 2015. Chris Wildsmith and Simon Thompson identify potential drivers of acquisition activity for consolidators and market participants in general.	
Jonathan Lewis	2015 is expected to see growth in third party loan administration driven by large outsourcing opportunities from banks and building societies seeking to rationalise their cost base and the growth/return of specialist lenders and asset purchasers across the UK and Ireland. Jonathan Lewis considers how this growth will drive further consolidation of the market through contract wins and M&A activity.	
Colin Farquhar	Fintech has seen considerable growth historically driven by innovation and regulation. Colin Farquhar explores this trend and the potential impact on M&A volumes in 2015 and beyond.	
Naomi Burger & Vivak Kapoor	Recent activity in the closed book life market across the UK, Germany and the Netherlands highlights investor interest in long-term, stable cash flows and the opportunity for consolidation. Naomi Burger and Vivak Kapoor examine recent M&A activity and ask whether this trend is set to continue.	
Caroline Nurse	There has been considerable M&A activity in the asset finance sector over the past year. Caroline Nurse considers the drivers behind this activity and the impact of regulation and the economy on future M&A activity.	



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Welcome to the 2015 edition of Deloitte UK's Financial Services M&A Predictions.

2014 has seen a continuation of the high level of M&A activity witnessed at the end of 2013. In 2014, banking sector activity included the IPO of TSB Bank and multiple M&A opportunities in the Fintech market. M&A in the insurance sector remained buoyant with high levels of transaction activity continuing and the announcement of Aviva's proposed acquisition of Friends Life signalling a return of major, transformational M&A.

So how did we do with our 2014 predictions? Our insurance sector predictions were largely accurate with the involvement of capital markets in Insurance and continued consolidation. Actual IPO activity in the banking sector was lower than expected due to delays and re-evaluation of opportunities. Our payments article identified key market activity and the debt purchase sector remained very active.

We think that 2015 will see a further increase in M&A activity across Europe. The greater clarity provided by the AQR and the timetable for Solvency II, the continuing development of global regulation, and ongoing investor appetite for non-core and capital-light assets provide a strong basis to believe that M&A activity in 2015 will be busier than ever.

I hope that you find this document thought provoking.

Ian Sparshott

Lead Partner

Financial Services M&A, Deloitte LLP



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The Asset Quality Review and Stress Tests have removed some concerns – primarily capital strength and balance sheet transparency – that have acted as a brake on M&A activity in the European banking sector. We expect a greater focus on resolving legacy issues and improving core profitability to generate M&A in 2015.



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Overview

After a year of extensive work by the 130 banks involved, 19 national regulators, the European Central Bank (ECB), European Banking Authority (EBA) and more than 5,000 auditors the results of the Comprehensive Assessment were released on 26 October 2014.

Clarity has been achieved through the Asset Quality Review (AQR) and Stress Tests: on standalone and stressed capital strength, the extent of non-performing exposures and appropriateness of collateral and provisioning levels, and the fair valuation of Level 3 assets. We expect this clarity to be a positive catalyst for M&A activity in the short and medium term across the European banking sector.

AQR and Stress Tests background

The AQR/Stress Tests exercise, which was a prerequisite to the ECB taking on the role of the single supervisor for all banks in the eurozone and other participating states on 4 November 2014, was a detailed review of the quality of the 130 largest European banks' assets and capital base. Its key aims were to enhance transparency, build confidence with market participants and give the ECB a clean basis upon which to take over responsibility for the sector.

To overcome the variety of national banking practices across the eurozone, the AQR/Stress Tests exercise was designed with harmonised standards and valuation practices for enhanced comparison comprising two main steps:

1. the AQR focused on three main areas:
 - a. Loan file & collateral review, an evaluation of up to 3,000 loan files at large institutions
 - b. Challenger Model, a statistical model to assess the appropriateness of a bank's collective provisioning
 - c. Fair Value Review, to revalue Level 3 assets (largely illiquid assets).

The outcome was an 'AQR adjusted CET 1-ratio' with a hurdle rate of 8%, which formed the basis for the Stress Tests.

2. Stress Tests to examine the resilience of banks' balance sheets to two pre-defined stress scenarios – a baseline (8% hurdle) and an adverse scenario (5.5% hurdle) – projecting results up to the year 2016 using banks' post-AQR balance sheets as at 31 December 2013 as a starting point.



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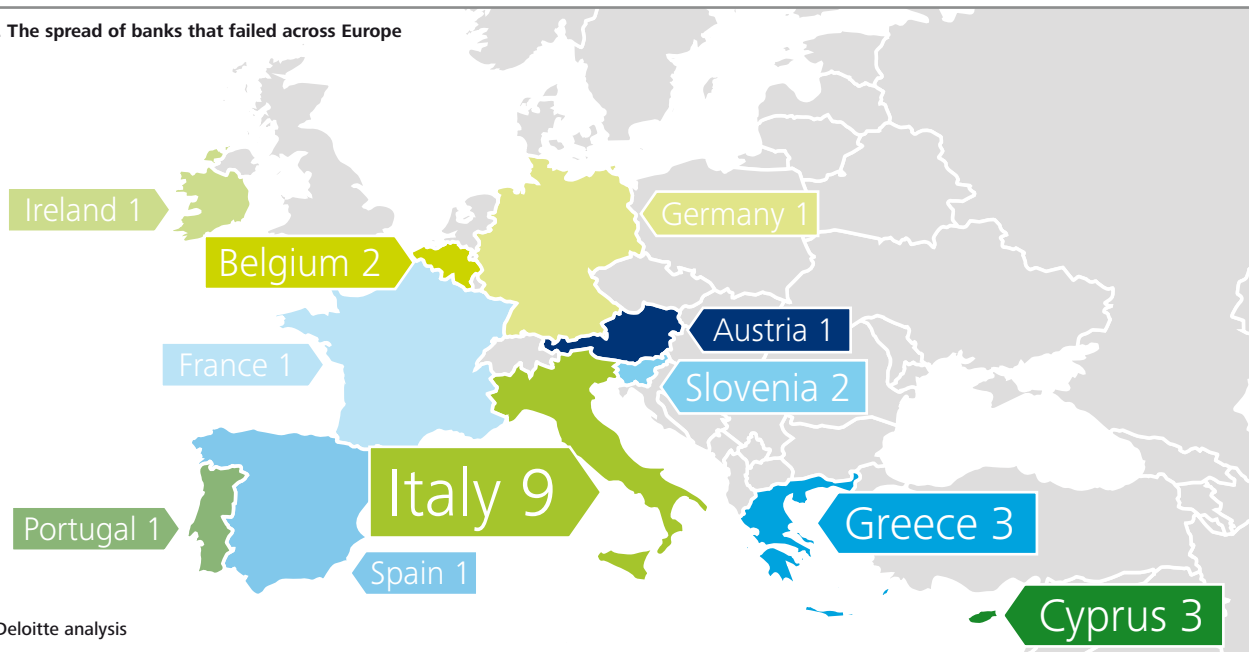
The exercise has been thorough: through the loan file review alone, approximately 120,000 loans from 800 sub-portfolios across the banks were individually reviewed.

Market interest was focused particularly on the outcome of the AQR result, to assess how robust the existing balance sheets were, and the adverse scenario AQR adjusted CET1 ratio, as an indication of capital resilience in the face of significant macroeconomic deterioration.

AQR and Stress Test results overview

Twenty-five banks failed at least one of three ECB thresholds with a total capital shortfall of €24.6 billion. The greatest share of the banks that failed were in Italy, Greece and Cyprus (see Figure 1). However, many banks had already carried out capital increases during the course of 2014 in anticipation of the AQR process, so that the final capital need identified as a result of AQR was €9.5 billion across 13 banks.

Figure 1. The spread of banks that failed across Europe



Source: Deloitte analysis

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These banks (with a few exceptions that have already had restructuring plans approved by the ECB in 2014) were required to submit capital plans to the ECB with approval expected by the end of 2014. These capital plans comprised specific solutions to increase capital levels or to deleverage balance sheets within the next nine months.

One of the other key talking points was the €136 billion increase in total non-performing exposures (NPEs) across the sector, from €743 billion pre-AQR to €879 billion post-AQR. Of the increase, €55 billion was due to the application of the new non-performing exposure definitions while the remaining €81 billion related to new NPEs identified in the review.

What are the relevant outcomes for M&A from the AQR/Stress Test for 2015?

We see a range of direct drivers of banking sector M&A activity in the year ahead and other indirect factors that will emerge through 2015.

The direct M&A outcomes are likely to fall into three broad areas:

1. First, those banks that failed the AQR/Stress Tests will need to execute their final capital plans within the 2015 timetables set out by the ECB. We expect all of these banks to deliver within these timetables so as to not test the ECB's resolve. The requirement to raise capital is in contrast to the European Commission State Aid-mandated disposals that in some cases saw significant slippages. This is likely to create specific opportunities, some of which investors have already been following closely up to and including Q4 2014.
2. Second, the banks considered as 'near fails'. Some of these may see a narrow pass as a pass and go back to business as usual. However, we expect that in many banks key shareholders, stakeholders and supervisory boards will ask management to take measures to achieve stronger buffers above the required thresholds but without raising capital. Profit retention is likely to be preferred but we also expect to see capital accretive transactions such as the disposal of higher risk portfolios and balance sheet light, profit generating businesses (for example payments, asset management).
3. Third, in our view banks' greater confidence in their own capital strength and clarity on underlying asset quality will be a catalyst to bring buyers and sellers closer together on pricing with a positive impact on activity levels in the debt portfolio market. However, this will continue to be a market shaped by the specifics of each national system and economy.



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As 2015 progresses, we expect two key drivers to emerge:

A greater focus on profitability – The ECB has now addressed critical capital issues and has largely removed liquidity as an issue (through its direct lending programmes to banks as well as actions to improve general market liquidity). However, a banking sector that is well capitalised and liquid is not necessarily one that is fit for purpose or one that creates organic capital (or one day might meet its cost of capital). Improving underlying levels of core profitability will be the critical success factor for management in 2015 and beyond. This is no small task in an over-banked eurozone market which in recent years has become more nationally fragmented, which operates in a lower-for-longer interest rate environment and has weak economic growth forecasts. All of these factors limit potential revenue growth so management are likely to refocus the bank’s strategy on achieving cost and operating platform efficiencies, while actively managing the bank’s portfolio of existing businesses and its capital deployment across them.

We expect that M&A activity will therefore be an important part of management’s toolkit. In addition, we see the possibility of consolidation within the banking sector both domestically as well as cross border.

The shape of future regulation and the new incentives and demands that it creates – The ECB has begun its role as the single regulator for the Eurozone and it will take time to see how it translates lessons learned from the last year into its new regulatory agenda. Consistency will be a key theme, but one that in certain areas will take many years, such as internal models to determine risk weighting of assets (the other half of the capital ratio equation).

Other developing areas of regulation that will affect larger banks in particular will be the final leverage ratio and bank separation as well as the emerging topic of Total Loss Absorbing Capacity.

Improving core profitability and adapting to the changing regulatory environment will keep banks’ strategy and M&A teams focused in the years ahead and create a range of opportunities for investors across the sector.



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We think that the pressures facing reinsurers will continue to grow and that this will lead to an increase in M&A activity.



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Adapt (and buy) to survive – A reinsurer’s tale

The global reinsurance market is going through a period of seismic change. This is driven in part by the continuing growth in the amount of alternative capital providing capacity in the market. In this context, alternative capital is deemed to be capital provided by entities from outside the reinsurance market, for example pension funds and hedge funds. Goldman Sachs highlighted alternative capital in reinsurance as one of eight disruptive themes in business today in its 2013 report “The Search for Creative Destruction” alongside disruptors such as e-cigarettes and 3D printing.¹

Although alternative capital has been in the market for a number of years the pace of growth has been accelerating. Since 2011 alternative capital is estimated to have grown at a compound annual growth rate of 28 per cent compared to traditional capital which grew at six per cent over the same period. In 2014 alternative capital reached a record level of \$59 billion and accounted for ten per cent of total reinsurance capital.²

Figure 1. Global reinsurance capital



Source: Aon Benfield Analytics, The Aon Benfield Aggregate, September 2014

1 <http://www.goldmansachs.com/investor-relations/financials/current/annual-reports/2013-annual-report-files/search.pdf>
 2 http://thoughtleadership.aonbenfield.com/Documents/201409_aba_1h_2014.pdf



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Alternative capital is typically accessed through securitised instruments such as catastrophe bonds or loss warranties that pay out based on industry-wide loss events, or private deals between an investor and a primary carrier. Another common vehicle is the 'sidecar', through which capital markets provide their funding alongside the reinsurer's own.

These alternative capital structures are generally focused on particular reinsurance classes where there is the ability to model risks effectively, for example property catastrophe, and today the majority of the capital is invested in the US market. Fermat Capital forecast that alternative capital could represent a 50 per cent or higher share of the global property catastrophe market in the future as the investor base for insurance-linked securities continues to grow.³ Currently, non-traditional carriers provide between 15-20 per cent of global property casualty capacity according to Fermat Capital.

The competition in these lines has had an impact on traditional reinsurers who have had to be flexible to retain and win business. Reinsurers have been offering rate discounts, as evidenced by all the main brokers in their renewal summaries, and have expanded terms and conditions, for example offering multi-year policies or improved reinstatement provisions.

This extra market capacity means that reinsurance prices have now fallen to a level where they represent between a half and a third of the cost of equity capital for insurance cedants.⁴ This has had an impact on reinsurers' business models, especially in relation to their revenues and margins. In response, reinsurers have been diversifying their business models as both a defensive and an offensive strategy. Specific strategies include:

- moving into primary markets in particular in speciality lines, for example Mapfre's announcement that it will write speciality lines business from its London hub in 2015
- entering new territories, for example Allied World Assurance Company buying RSA's assets in Asia
- building alternative capital arms, for example Amlin's investment in Leadenhall Partners and Lancashire's ownership of Kinesis Capital Management
- establishing sidecar vehicles, for example Credit Suisse Asset Management's entry into the market through a sidecar with the Barbican Syndicate
- M&A activity to increase scale, such as Renaissance Re's proposed acquisition of Platinum Re.

³ Comments made at Macquarie's 2014 Bermuda in Boston event by Brett Houghton of Fermat Capital.

⁴ Reinsurance Market Outlook, Aon, September 2014.



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In October 2014, Ace entered into a new arrangement by forming a joint venture with BlackRock. This new vehicle will take a proportion of Ace's outwards reinsurance capacity thus disintermediating its reinsurance brokers. This is having a knock-on effect on the reinsurance broker models with brokers considering similar diversification strategies particular where they are heavily reliant on reinsurance. This has margin implications as the margins for reinsurance broking are typically much higher than for insurance business.

Another market-leading development is the agreement between Willis and Miller. Willis is utilising Miller's wholesale broking capabilities while Miller is seeking to bolster its treaty reinsurance offering by using Willis. The CEO of Willis, Dominic Casserley, has stated that the proposals being discussed would allow Willis and Miller "to draw on each other's professional strengths".⁵

Alternative capital has a greater impact on some reinsurers than others. In particular the Bermudian reinsurers (who are heavily US catastrophe risk focused) and smaller Lloyd's participants are likely to need to diversify and grow in scale to maintain their market position. Standard & Poor's has highlighted reinsurers being at risk as a result of alternative capital.⁶ They estimated that over half of the global reinsurers it rated are susceptible to the current competitive and earnings pressure, and that consolidation may be the only solution for smaller reinsurers to remain viable. This viewpoint is also held by Fitch Ratings whose fundamental outlook for the reinsurance sector is negative.⁷

Those reinsurers who were late to recognise the impact of the disruptive forces now a need to act quickly and adapt to meet shareholder expectations. This means that many are looking to buy instead of building new capabilities which is driving reinsurer M&A activity.

Our view

We think that the pressures facing reinsurers will continue to increase and that this will lead to an upturn in M&A activity. Alternative capital now appears to be a stable component of the reinsurance market, a development that the market has now largely accepted. As such, the traditional reinsurance market needs to adapt. Waiting for a large loss to turn the market is no longer a sustainable strategy.

⁵ Willis Group and Miller in Exclusive Talks to Form Leading London Wholesale Insurance Broking Firm, Willis press release 20 October 2014.

⁶ Reinsurers face ratings cuts, S&P warns' Financial Times, 20 January 2014.

⁷ Global Reinsurance Guide 2015, Fitch Ratings, September 2014.



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We expect regulatory developments, including the forthcoming price cap, to be a key driver of change in the consumer finance sector and to result in M&A activity.



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From April 2014 responsibility for the regulation of consumer finance businesses passed from the Office of Fair Trading to the Financial Conduct Authority (FCA). The impact of this has already been significant with more stringent conduct of business rules being implemented which has resulted in potentially substantial additional costs being incurred in order to increase staff numbers and change processes to comply with the new requirements.

In addition to these cost base pressures, in November 2014 the FCA announced a price cap on high-cost, short-term (HCST) lending businesses effective from 2 January 2015, which will reduce income that could be earned by certain consumer finance businesses, principally payday lenders.

These combined pressures will affect the ability of certain consumer finance businesses to operate profitably, particularly where 'best practice' approaches to complying with FCA rules are adopted.

Price cap

From 2 January 2015, the maximum rate that can be charged by lenders on HCST credit will be 0.8 per cent of the principal advanced per day up to a total (including all interest, fees and charges) of 100 per cent of the amount borrowed. Where a typical 30-day loan is repaid to term charges will be capped at £24 per £100 borrowed. If a customer defaults, default fees will be limited to a maximum of £15 and default interest rates must not exceed the initial rate.

The rate cap of 0.8 per cent of principal advanced per day compares with charges currently levied (based on FCA research) of up to 4.3 per cent per day with no maximum cap in place.¹ Further, as permitted charges under new rules are limited with reference to the principal issued – rather than the outstanding loan balance – this will limit the extent to which compound interest can be charged on loans of this nature.

This marks a step change in the UK regulatory approach, which has historically focused on qualitative requirements around customer outcomes rather than prescriptive, quantitative lending metrics for firms to comply with. This brings the UK approach more in line with overseas markets where rate caps and fixed requirements regarding the charging of penalty interest and late payment fees are more common.

¹ Source: FCA Consultation Paper 'CP14/10: Proposals for a price cap on high-cost short-term credit'.



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Is this the end for HCST credit?

The FCA's analysis suggests that 89 per cent of consumers who previously would have been served by HCST providers will continue to have access to credit under these proposals, albeit at substantially cheaper rates.

However, this will ultimately depend on the appetite (and ability) of lenders to continue to provide loans at lower rates. Finland provides a stark example of the potential impact of rate caps in this market. The introduction of a rate cap in Finland mid-way through 2013 led to an overnight collapse in the payday loans market with a 54 per cent reduction in the number of new 'small' loans issued in Q1 2014 compared to the equivalent period in the prior year, and a 71 per cent reduction in the costs of these loans paid by borrowers over these periods.² This market has also seen significant product change, with term loans replaced by personal revolving credit facilities, as products were redesigned to deliver higher returns within the constraints of rate cap rules.

In our view, the impact of regulation in the UK may be more significant than anticipated by the FCA, driven both by the commercial attractiveness of FCA-compliant pricing and a reduction in the eligible population following the implementation of revised affordability assessment processes.

When combined with the wider requirements of FCA regulation on the sector effective from April 2014, the financial pressure on consumer finance businesses are threefold:

- first, the introduction of more detailed affordability assessments on customers will reduce the volume of loans written and income earned by lending firms
- second, for loans that are written, lower financial returns from the cap on rates, fees and charges will further reduce income earned
- third, costs will also be increased in order to implement additional conduct of business procedures, such as formal/increased affordability assessment checks.



² Statistics Finland, Uutiset, 1 July 2014.

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The costs ... and potential opportunities?

The costs and opportunities of the introduction of FCA regulation and the further tightening which is likely to follow are not limited to the HCST lenders affected by the forthcoming rate cap.

In our view, to be successful in the long term, consumer finance businesses will need to put in place a sufficiently robust governance and internal control environment that aligns more closely with that typically in place at lending businesses that were FCA regulated pre-April 2014, and that meets the spirit of the FCA's requirements. The incremental costs of this will be substantial for most firms and are likely to result in further pressure on earnings and the emergence of fewer but larger players resulting from consolidation in the market, driving M&A activity.

These rules will give rise to an opportunity for those businesses that already have strong underwriting and governance models, can position their business effectively to address changing requirements, can identify the right acquisition targets, and have the capability and funding to undertake acquisitions.

Broader opportunities and the M&A outlook

In the short to medium term, we anticipate that regulatory developments will drive change in the consumer finance sector. Such change is likely to comprise M&A-led consolidation alongside some companies exiting the market and the introduction of new products, designed for a rate-capped environment.

With regard to the M&A aspects of this, businesses demonstrating best practice in either delivering customer satisfaction or adapting to the increased operational and structural requirements of FCA regulation will likely be motivated to acquire in order to deliver economies of scale. Such acquisitions may be scale acquisitions in existing markets, or diversification into adjacent products or customer groups.

In addition to the core requirement of sufficient scale to operate profitably in a lower margin environment, there may also be opportunities from vertical integration that can give consumer finance businesses improved control over their compliance with conduct requirements, or improve the accuracy of underwriting models. We anticipate further M&A activity as businesses in the sector seek to acquire businesses with the skills or best practice to benefit the enlarged group.

Taking a longer term view, the success of businesses in this sector will depend on their ability to predict and absorb the costs of tightening regulation and build scale for the future.



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We think that growth in the Third Party Mortgage Administration market is likely to accelerate in 2015 and that further industry consolidation will occur.



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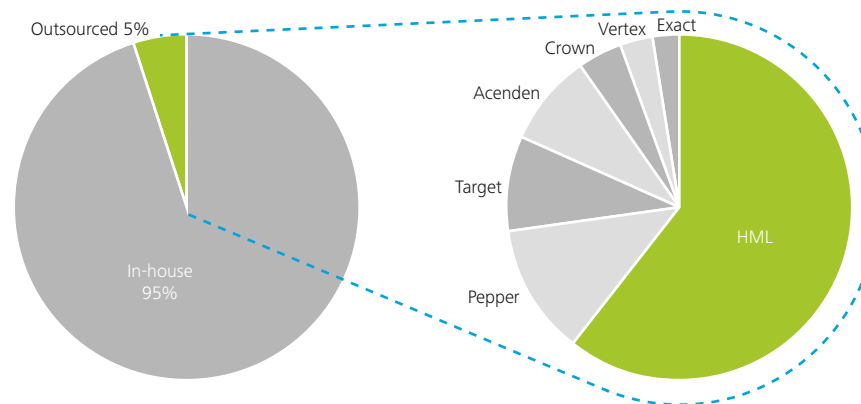
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The Third Party Mortgage Administration (TPMA) market primarily serves specialist lenders – firms that typically serve non-conforming or non-standard sectors of the mortgage market, and for whom mortgage administration is a non-core capability. TPMA was relatively embryonic in the UK until the development of the specialist mortgage market from the mid-1990s which involved a better understanding of risk and a greater distinction between 'prime' and 'sub-prime' segments. This provided new opportunities for TPMA providers with the arrival of specialist lenders such as Kensington Mortgages, Future Mortgages and Southern Pacific Mortgages.

Figure 1. Overview of TPMA market



Source: Deloitte analysis

The TPMA market in the UK is dominated by Homeloan Management Ltd (HML) which accounts for over 60 per cent of the market with £37 billion Assets under Administration (AuA). HML is currently twice the combined size of the next three competitors – Pepper (previously Oakwood Global Finance), Target Mortgage Servicing (Private Equity owned) and Acenden (originally the captive servicer of Lehman Brothers).



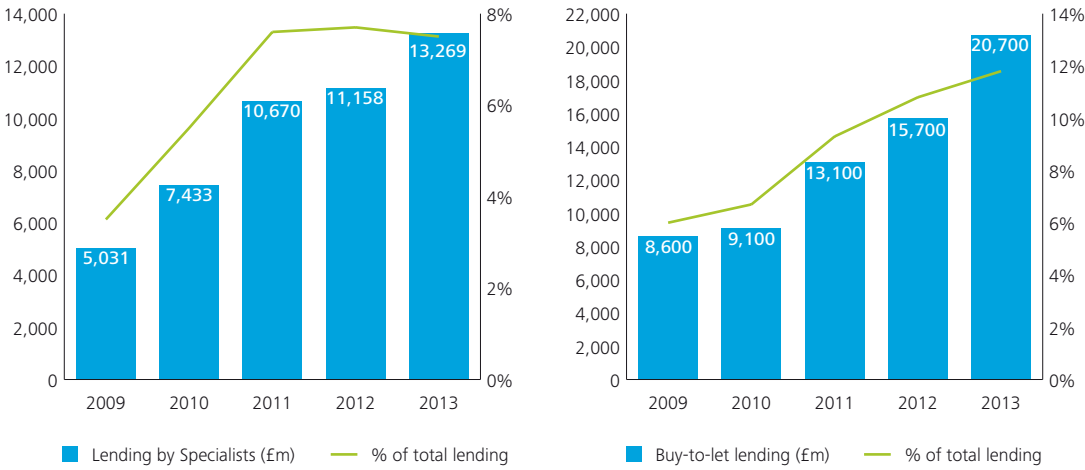
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Mortgage lending in the UK

The UK mortgage market is heavily influenced by the macroeconomic environment which is undergoing a period of recovery since the onset of the financial crisis. A key driver of market growth relates to funding costs which remain at historic lows, albeit product margins remain wider than the peak levels seen in 2007. The Bank of England (BoE) base rate has remained at 0.5 per cent since March 2009, with quantitative easing and more specifically the Funding for Lending Scheme also having a material effect in reducing the cost of funding for many mortgage providers.

As a result, homebuyers have found it easier to access credit over the last 12 to 24 months. This in turn has increased house prices to pre-2007 levels in nominal terms with annual house price inflation at 11 per cent in August 2014.¹ While the introduction of the Mortgage Market Review (MMR) in April 2014 and the anticipated increase in the BoE base rate during 2015 are expected to reduce the growth levels in mortgage approvals during 2015, the strong UK economic outlook is expected to provide ongoing support for housing demand.

Figure 2. Lending volumes by specialist lenders



Source: Council of Mortgage Lenders data and Deloitte analysis



¹ Nationwide House Price Index, August 2014.

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The volume of mortgages written by specialist lenders dropped to 3.5 per cent of total lending by 2009 having previously peaked at 18 per cent of total lending in 2007. Specialist lenders have since started to recover substantially but they still represented eight per cent of total lending in 2013. Data for buy-to-let (BTL) lending, a segment traditionally offered by specialist lenders, is now showing consistent year-on-year growth, with gross BTL lending of £21 billion in 2013, compared with £9 billion in 2009 and 2010.²

Mortgage administration in the UK

Despite the contraction in the number of specialist lenders after the onset of the financial crisis, as at 30 September 2014, £61 billion of mortgages were outsourced to TPMA providers.

However, the TPMA market still accounts for only five per cent of the UK mortgage market. Of the 20 largest lenders in the UK, 16 conduct all (or nearly all) of their residential mortgage administration in-house.



² Council of Mortgage Lenders data.



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Given that assets with higher risk profiles tend to require specialist servicing and/or higher than average levels of service, any return to growth in specialist/complex mortgages is also likely to drive growth in the TPMA market. Encouragingly, there are signs of growing provision of credit to meet demand in specialist lending categories as lenders search for increasing yields. New entrants such as Precise Mortgages, plus existing participants such as Kensington Mortgages and Paragon are growing their new business volumes, supported by the return of the securitisation market. This suggests a clear opportunity to grow due to:

- mainstream banks' increasing propensity to outsource as 'stepped' cost reduction programmes gather momentum. Additionally, in certain cases, banks may want to use outsourcing as a solution to avoid significant investment in long-lasting core system requirements
- the increase in specialist lending as investor risk appetite returns supported by the re-emergence of wholesale funding for residential mortgages (including securitisation)
- the rising number of new entrants and new independents to the UK banking sector who may wish to outsource rather than incur significant costs to purchase inadequate or non-scalable IT platforms for both mortgage administration and other activities
- exiting lenders who will look to cease their own operations and pass to a TPMA provider who can maintain scale benefits (and reflect this in reduced pricing) even during a wind down of the particular mortgage portfolio.



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Outlook for 2015

There has been an increase in M&A activity and contract wins in the market during 2014 with Capita acquiring Crown Mortgage Management in June and Computershare agreeing to acquire HML from Skipton Building Society, alongside significant outsourcing contract wins from some large financial institutions in the UK and Ireland.

In our view further consolidation of the market will take place in 2015 and only the largest players will be able to compete for significant contract wins. Alongside this, the organic growth of specialist lenders and asset purchasing businesses, who are all attracted to the specialist capabilities of the TPMA market, will help to drive further growth in the market.

We expect this to result in a continuation of the current trend of significant appetite for TPMA assets from both UK and overseas buyers looking to gain a foothold in the sector before the anticipated significant growth opportunity arising from larger tender opportunities which are expected to come to market over the next 12 to 24 months. For instance, rising house prices may prompt UK Asset Resolution, which had over £60 billion of AuA at March 2014, to consider increasing its deleveraging programme or outsourcing given growing buyer appetite, as evidenced by its sale of £2.7 billion of residential mortgages to a consortium led by JPMorgan.³ There are also other large scale lenders who are looking at their strategic options regarding outsourcing their mortgage administration platforms in the UK and Ireland.



³ UK Asset Resolution 2014 annual accounts; Merger Market, October 2014.

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We think that Fintech M&A will continue as new technologies become widespread, new and changing regulation creates market opportunities, and investors recognise the global opportunity.



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Industry background

Over the last decade, developments in technology have had a dramatic effect on the Financial Services industry. Technology and its application in financial services, often referred to as Fintech, is continuing to change the industry and is presenting traditional financial services businesses with challenges as new and innovative ideas change how businesses and individuals conduct financial transactions.

Since 2008, investment in the global Fintech sector has reached around \$3 billion a year and this is forecast to grow to between \$6 billion and \$8 billion by 2018.¹ In the UK and Ireland alone over the same period, investment exceeded \$700 million and accounted for over 50 per cent of all European investment.²

Given historical growth and the continuing development, the sector has attracted venture capital and Private Equity investment.

What has driven the growth?

Fintech growth has been driven by a number of factors including:

- technological innovation leading to creativity and new approaches. For example, near field communications (NFC) have transformed mobile payments and the manner in which payments are effected
- a willingness among consumers to adopt technological advances, for instance the widespread use of internet banking and online trading. This has led financial services businesses to amend their operating model, for example Lloyds Banking Group plans to rationalise its branch network in response to customer preference for internet banking
- technological developments creating lower cost alternatives through streamlining routine tasks and faster processing. Examples include debit cards replacing cheques and paperless/straight-through processing between insurance brokers and underwriters
- following the Global Financial Crisis there was a dislocation of the financial system with many traditional banking services no longer being offered on the same basis as before the crisis leading to high commissions, opaque fees and inflated foreign exchange or interest rate spreads. Financial institutions were under duress, resulting in limited or no funding being made available to businesses and individuals being turned down for mortgages and personal loans. The crisis provided an opportunity for Fintech companies to create innovative solutions to address the shortcomings in the system.

1 Fintech Investment Boom is an Opportunity for New York to Lead in Technology, see also – <http://newsroom.accenture.com/news/fintech-investment-boom-is-an-opportunity-for-new-york-to-lead-in-technology-according-to-report-by-accenture-partnership-fund-for-new-york-city.htm>, Accenture 26 June 2014.

2 The Boom in Global Fintech Investment, see also – <http://www.accenture.com/Microsites/fsinsights/capital-markets-uk/Documents/Accenture-Global-Boom-in-Fintech-Investment.pdf>, Accenture 26 March 2014.



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Examples of subsectors and their market drivers

The Fintech market is complex and fragmented with many participants operating across a range of services. The following are key subsectors:

Money or currency transfer

Banks and brokers previously controlled money transfers between countries and through different currencies. New technology has enabled faster operations which are more cost effective and secure for businesses and individuals. Money transfer targets have attracted a mix of corporate and Private Equity investment historically such as Western Union’s acquisition of Travelex Global Business Payments and more recently Bridgepoint’s acquisition of Moneycorp. This subsector is expected to see continuing M&A activity in 2015 from corporates and Private Equity looking to capitalise on greater globalisation and an increasing number of transactions.

An associated area is the increasing prevalence of mobile payments businesses, which are predicted to triple in size by 2018 when the industry will be worth £14.2 billion, according to the Centre for Economics and Business Research.³ Although growth prospects are high, the payments industry is becoming increasingly complex with heightened regulation and international reach. New regulation from the European Union, such as the Payment Services Directive (PSD2) and the implementation of the Single Euro Payments Area (SEPA), is expected to foster increased competition and structural change leading to M&A opportunities in 2015.

Crowdfunding and peer-to-peer lending

In recent years, small companies have often struggled to gain access to credit from traditional lenders. This has now changed with businesses such as the Funding Circle, Ratesetter and Zopa providing lending platforms. These businesses are also offering higher yields to investors who are seeking alternatives to bank deposits in the current low interest rate environment.

Crowdfunding and peer-to-peer (P2P) firms are still in their infancy. The lack of standardised valuations for these businesses has resulted in M&A being subdued or even nonexistent. There is potential for this to change as crowdfunding and P2P businesses mature and show stronger historical track records of performance which may facilitate some limited M&A activity in 2015.

³ Mobile Payments to boost UK economy, see also – <http://www.cebr.com/reports/mobile-payments-to-boost-uk-economy/>, CEBR, 5 November 2013.



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Insurance technology

The influence of new technology is also being witnessed in the insurance industry. This has occurred through business-to-business innovation such as broker software as well as customer-related elements, for example the growth of aggregators as a key distribution channel and the development of telematics to improve underwriting processes.

Insurance companies have shown an active interest in the subsector historically and this is expected to continue into 2015 as they look to gain competitive advantage and improve profitability by utilising technology to improve all areas of their business but notably distribution and underwriting in motor insurance.

Summary

A large proportion of Fintech businesses are still in their infancy and much of the technology is still at an embryonic stage. However, traditional financial services businesses are seeking operational efficiencies to drive profitability and consumers are increasingly attracted to simple, cheaper solutions especially for commoditised services.

More mature Fintech subsectors, such as money transfer and mobile payments are expected to drive M&A opportunities in 2015 as potential acquirers seek to benefit from growth in transaction volume and innovation.

Banks have been less active in the sector in recent years given capital constraints, higher costs and new regulations but are now realising that there is a risk of new Fintech-based market entrants taking their market share in certain areas. In addition banks and insurers have had to rethink the way their offering is being delivered by developing propositions in-house, partnering with innovators or making speculative investments in technology businesses. This trend is expected to continue into 2015 and beyond, driving further M&A activity levels.



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We think that M&A activity in the European Life Insurance sector will increase driven by regulatory and political change, and an increased focus on market consolidation.



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Overview

Since the credit crunch, it has not been difficult to identify the imperative for M&A in the UK life insurance industry to deal with shrinking scale, the consolidation of closed books and challenges from Solvency II (SII), the European Union's law that establishes minimum capital standards and aims to create a single market in insurance. The perennial question from the market has been: "When will deal economics align so that the return required by providers of capital can be met by a price acceptable to sellers?"

Economic recovery in 2014 has meant that a wide range of deals coming to the market have stood a much better chance of concluding. Aviva's proposed combination with Friends Life would be the largest insurance transaction in a number of years and illustrates not only the appetite but also the higher levels of confidence to execute on large scale tie ups. Prior to this the last quarter of 2013 saw the failed merger of UK dedicated run-off fund, Phoenix Group and Admin Re the UK run-off arm of Swiss Re. We have also seen a significant investment by Blackstone, GIC and Mass Mutual into Rothesay Life the specialist pensions insurer established by Goldman Sachs in 2007.

Key themes from 2014

Corporate rationalisation

The common characteristics of these deals are that they have more to do with the insurance group's overall strategy than simply the assets being traded.

Capital management

Phoenix has had a very busy year and has restructured its debt, optimised its balance sheet and generated cash. Its with-profits business derisked by selling £1.7 billion of annuities to Guardian Financial Services, while the disposal of Ignis to Standard Life for £390 million provided liquidity.

Focus on core markets

There have been a number of significant exits from the market with Rothesay Life using their new funding to buy Met Life's UK bulk annuity business. Friends Life sold Luxembourg-based Lombard to Blackstone in July 2014 for £317 million using the proceeds for a share buy-back and is in the process of considering its options regarding its remaining international business. In September, Standard Life sold its Canadian business for £2.2 billion to Manulife and having bought asset manager Ignis it continues to transition to an asset management model. Ageas, the Belgian composite insurer, sold its UK term and protection writer Ageas Protect to AIG for £181 million to focus on its core non-life markets in the UK.



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Corporate simplification

There were a number of transactions during 2013 that were driven by business simplification. XL Re reassured a block of \$5 billion of annuities to GreyCastle Holdings, a newly formed Bermudian reinsurer, derisking its balance sheet and reducing earnings volatility. Old Mutual continued its strategy of exiting sub-scale markets by disposing of its operations in Germany and Austria to a partnership between Hannover Re and the Private Equity house Cinven. Aviva continued to review and simplify its European business particularly its bancassurance joint ventures in Spain. On a similar theme Allied Irish Bank completed its bancassurance restructuring by disposing of Ark Life to Guardian Financial Services for €350 million. HSBC disposed of a block of non-core pensions business to Swiss Re's Admin Re.

An active market in open businesses

For the first time in many years insurance companies started to be acquired on an open basis (Lombard and Ageas Protect). The Ageas transaction was at a premium to embedded value as AIG paid a strategic premium to re-enter the UK protection market.

Key themes for 2015

As with 2014, we see 2015 as being a year in which further transactions that are required to implement strategic change will occur and that the themes discussed above will continue to drive transactions in 2015. Many insurers are assessing their business in the context of both Solvency II and the future economic opportunities. Overseas investors continue to be highly acquisitive and if opportunities present themselves deals are likely to be done.

While the UK market has an enormous opportunity around industry consolidation, it is a market which is well supplied with four credible consolidators. During 2014 Guardian Financial Services has been active buying annuity blocks and Ark Life in Ireland. Following their aborted merger with Phoenix, Admin Re acquired a book of business from HSBC while Phoenix has rebuilt its balance sheet with the stated aim of doing deals. Chesnara has also continued to seek opportunities and recently announced an acquisition in the Netherlands.



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The timetable for SII has been defined with an effective date of 1 January 2016. Day by day there is more clarity around its implementation. Companies have made clear plans for the implementation of SII and many companies are focussing on balance sheet optimisation. This may take many forms, such as the disposal of capital intense, low-returning businesses or the acquisition of blocks of business to balance risks and increase diversification. A particular area of focus has been annuities and the application of the matching adjustment. We think that this will be a driver of M&A activity in both the short and medium term as transactions are done to take advantage of SII grandfathering provisions.

The 2014 UK Budget proposed a new framework for pension decumulation which resulted in the market for immediate annuities being challenged with volumes of new annuity business halving. This has led conventional insurers to implement two strategies: first, turning their focus to other sources of annuity business such as the bulk annuity market and, second, repositioning their pensions business to capture greater funds under management by improving their operational flexibility and investment offerings. The new annuity framework means that there will be winners and losers leading to hard decisions being taken around market positioning.

The listed specialist annuity businesses, Partnership and Just Retirement, are working hard to identify opportunities to reinvent themselves. Both companies have gone through robust cost restructuring and there is much speculation in the markets that a merger may make sense.

More generally, companies are working to reposition themselves as asset managers, the Ignis transaction with Standard Life being a precursor of other potential transactions. However, the biggest news of 2014 was Aviva's £5.6 billion tie up with Friends Life, which at the time of writing is subject to shareholder approval. This deal illustrates the desire to drive consolidation in the UK life sector following the 2014 UK Budget.

Friends Life shares were negatively impacted by the Chancellor's announcement regarding annuities in March 2014 and Aviva has moved to capitalise on the benefits that a combination would deliver. These are stated to include significantly higher cash flows enhanced by substantial synergies, principally through operating efficiencies in the combined back books and the removal of overlapping overheads. The offer represented an indicative premium of 15 per cent to Friends Life closing share price at 20 November 2014.



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Market summary – the Netherlands

The Dutch regulator has been stressing the need for consolidation in the Dutch life industry which is among Europe's biggest with €383 billion in assets and around 40 providers. New business volumes have been falling since 2007 and the industry is facing significant challenges including the impact of reputational damage as a result of the mis-selling of unit-linked insurance policies, the increasing popularity of substitute bank savings products (largely as a result of the removal of tax advantages that individual life products benefitted from in the past) and a recent ban on commissions for complex products. As a result, economies of scale are needed to keep profits at an acceptable level as the industry faces up to lower margins and tighter regulations.

The successful Initial Public Offering (IPO) of Nationale-Nederlanden NV (NN Group) for €7 billion in July 2014 represented the largest European IPO to date in 2014. It was a direct result of the €10 billion bailout of ING Group in 2008 which in turn resulted in the forced divestment of its insurance arm. ING has reduced its stake to 68 per cent and will reduce it further to 50 per cent by the end of 2015. It will divest its remaining stake by the end of 2016.

The next wave of activity is expected to come from two state-owned composite insurance groups, ASR Nederland NV (asr) and REALL NV (VIVAT). VIVAT is the insurance arm of SNS REALL NV, which was nationalised in February 2013, and is currently the subject of an auction process expected to conclude in Q1 2015 at the earliest. The dual track exit process for asr, announced in August 2013, has been temporarily suspended to enable asr to participate in the auction for VIVAT should it be successful in attracting funding for a potential offer.

The government is exploring the sale of up to 40 per cent in asr with a further disposal to be determined at a later stage, potentially via an IPO.

While the IPO of NN represented a significant step forward for deal activity in the Netherlands, in our view the litmus test will be the outcome of the respective processes of asr and VIVAT. There has been strong interest from a range of Private Equity and trade parties who are examining deal fundamentals on cost synergies (including the ability to outsource certain processes) and latent risk with past mis-selling. The financial exposure related to the latter remains uncertain with ongoing legal proceedings including those with the European Court of Justice. Latest market reports indicate that a private consortium led by Swiss Re and CVC Capital Partners is likely to be the party which invests in asr and finances the takeover of VIVAT.



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Market summary – Germany

The German life insurance market has experienced two major drivers for M&A: several life insurers have ceased writing new business and foreign insurers have announced withdrawals from the domestic market. As a result of these the German life insurance market has attracted interest from both Private Equity and international banks.

In early 2014 Cinven (with Hannover Re as a partner) acquired Heidelberger Leben for €330 million and established the first life insurance run-off platform in Germany following the UK model. With the €220 million acquisition of Skandia Group following shortly after, Heidelberger successfully acquired a second closed book. With these transactions, the two standalone closed unit-linked books in Germany were acquired. Future transactions will likely involve with-profits business with life-long guaranteed interest rates, still a key characteristic of the German life market, but which add significantly more complexity and risk to any deal.

Looking ahead, there are some interesting questions for buyers: Will buyer and seller, under more stringent market conditions, be able to bridge diverging price perceptions? And will buyers' ideas for new business models receive approval from the regulatory authorities?

There are a number of key developments in the German market that will shape future appetite and activity levels. Through the recently enacted Life Insurance Reform Law the government is seeking to improve the capital strength of the beleaguered German life insurance sector and to balance differing interests of policyholders and insurers. Our initial analysis suggests that this will negatively impact M&A activity – in particular through its impact on dividend capacity and timing.

In the face of the challenges presented by the 'lower for longer' interest rate environment, we see three strategic options for German life insurers: operate as a full-service provider and offer limited guaranteed products, concentrate on profitable niche-products and cessation of selected product lines or, in an extreme scenario, closure to new business. In our view, only option three will generate higher deal flows in 2015.

Aside from the impact of Solvency II, which is creating slow but steady activity, greater acceptance of run-off solutions by the German life insurance industry is critical to future M&A activity levels. Cinven's acquisitions are a positive sign but there are strong forces working against this: closed books are mainly managed in-house to generate economies of scale and finance existing business operations and distribution channels.



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We think that there will be M&A activity in the Asset Finance sector during 2015, driven by bank divestments, new entrants, regulatory changes, and existing participants seeking to create operational scale and growth.



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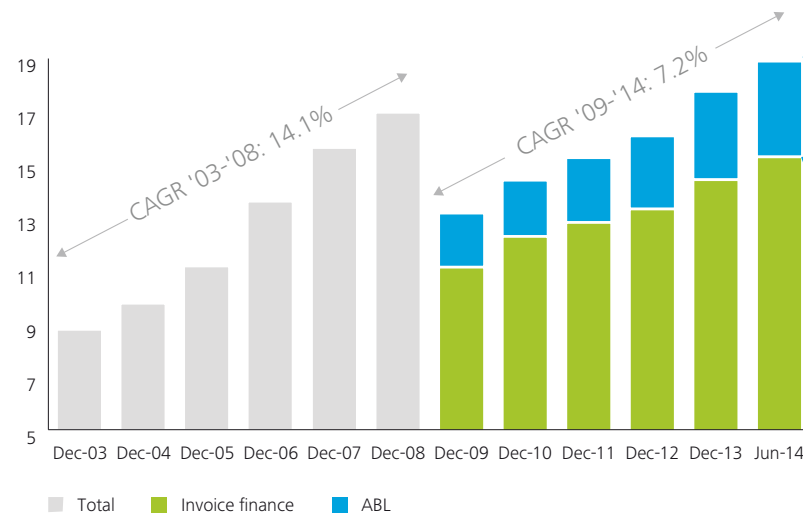


Overview

Asset finance as a collective term means different things to different people. For the purpose of this article, it covers the lending of funds against some form of collateral, and therefore encapsulates leasing, invoice finance (both discounting and factoring) and asset based lending (ABL).

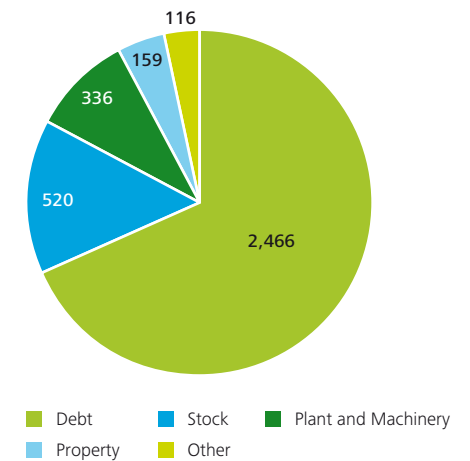
ABL is an emerging product where funds are provided to an organisation and secured against their assets, for example property, plant, machinery, stock or sometimes even their brand name. Already an established product in the United States, the UK market for this offering grew at a compound annual growth rate of 12.1 per cent between 2009 and 2014. Businesses utilise ABL to fund a variety of scenarios, such as for growth and transactional finance.

Figure 1. UK invoice finance and asset based lending balances (£m)



Source: Asset Based Finance Association (ABFA)

Figure 2. UK asset based lending by type of collateral at June 2014 (£m)



Source: Asset Based Finance Association (ABFA)

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Why has the sector attracted investors?

- **Forward visibility of earnings backed by security** – Leasing and ABL contracts, compared to invoice finance, are typically longer term in nature (between one and three years long), and are backed by an asset that has an agreed residual value at the start of the contract. Rates can be variable or fixed; however, the trend across Europe appears to be favouring variable rates which allow asset finance businesses to pass on funding costs to their clients. The contract end date is known providing an opportunity to encourage clients to renew, refinance or purchase the underlying asset.
- **Low default rates** – Default rates are lower than traditional lending as businesses prioritise payments since the underlying asset is generally business critical.¹ Invoice financing typically operates on one to three month cycles allowing exposures to be unwound relatively quickly to respond to poorly performing debtors, a specific exposure (e.g. industry or country exposures) or a change in strategy.
- **Cyclical although resilient during recent economic cycles** – While affected by the underlying economic and market conditions, asset finance has been less affected by the financial crisis and subsequent slow-down than traditional banking, and proved to be relatively resilient during the past five years with growth in volumes across the UK and Europe.

Figure 3. Growth in invoice finance and ABL vs traditional lending (£bn)



Source: ABFA and Bank of England

¹ European Leasing: An Industry Prospectus, Deloitte Conseil France and Leaseurope, 2014.



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- Alternative funding needs** – The shortage of traditional funding has created an opportunity for asset finance providers to offer funding to small and medium-sized enterprises (SMEs). At the time of writing the UK Government has introduced a Small Business, Enterprise and Employment Bill in parliament. It will require UK banks to forward SME’s unsuccessful loan applications to alternative lenders so that they can offer finance instead. According to the UK Asset Based Funding Association (ABFA), 40 per cent of businesses do not seek funding from alternative providers after being turned down by their banks. The legislation also proposes to outlaw the use of clauses in businesses’ contracts with their suppliers that prevent the use of invoice finance. These clauses are often demanded by larger businesses, particularly in the retail sector, preventing their SME suppliers from using the invoices they issue to secure funding to grow their businesses. Asset finance volumes are also expected to grow as businesses’ understanding of, and focus on, how they can maximise free cash and/or manage their working capital improves, and they seek operational efficiencies and opportunities to grow.
- Additional profitable income streams** – providers can also offer additional products to their clients to assist with their financial and operational needs, generating additional fees. For example, lessors can take on and manage residual value risk and maintenance. Providers may also offer other financial products, including stock financing, factoring services and other loans.
- No capital requirements for non-banks** – In the UK, there are no capital requirements for non-bank operated asset finance businesses. However, banks are required to hold capital in accordance with CRD IV/Basel III. In some other EU countries, certain asset finance businesses are required to hold capital (see below).
- Lower regulatory requirements** – The UK asset finance industry is largely self-regulated. Although, there are guidelines published by the two main industry bodies (the Finance and Leasing Association and ABFA) for good operating practices, there is no obligation to adopt them. However, in April 2014, leasing contracts which are three months or longer in duration became regulated by the Financial Conduct Authority (FCA) (see below).

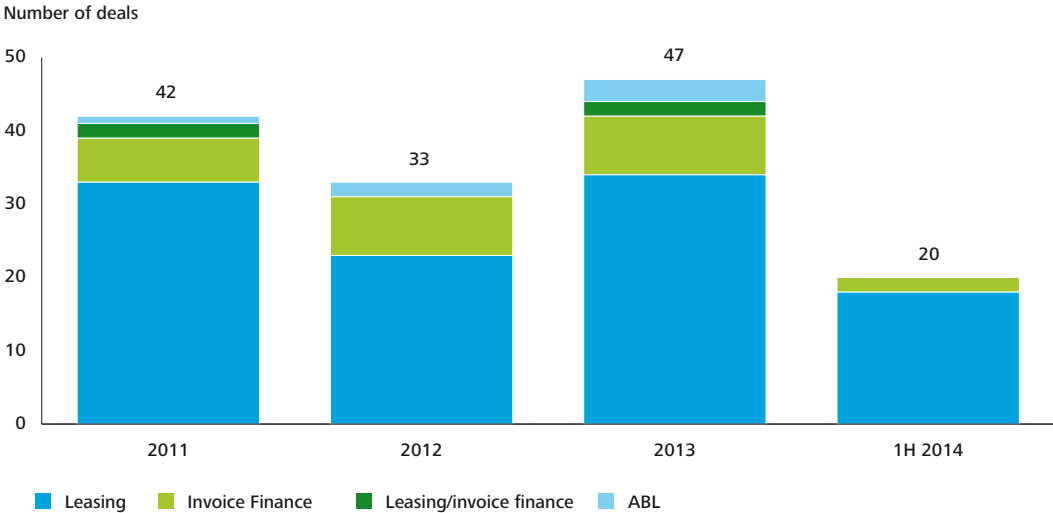


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Potential M&A drivers in 2015

Between 2013 and June 2014, there were 69 asset finance deals across Europe. Asset finance M&A included bank divestments, overseas and Private Equity investors acquiring businesses to enter the European market, together with acquisitions to generate growth.

Figure 4. European asset finance deals



Source: Mergemarket, Thompson Reuters and Deloitte Analysis
 Note: Information on deal value was undisclosed for a large number of deals. Hence, we have not sought to present analysis on this basis.

There are a number of potential drivers that could lead to M&A activity in 2015 including:

- **Banking divestment** – Increasing capital and liquidity requirements under CRD IV/Basel III. The results of the Asset Quality Review and Stress Tests may also lead banks to consider divesting non-core businesses.



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- **Growth aspirations** – Challenger banks are looking to expand their product offerings, build their client base and utilise deposit funding for higher returns. For example, Metro Bank acquired SME Invoice Finance, an invoice and asset finance provider, in 2013. In 2012, Shawbrook Bank acquired Singer Asset Finance, a UK-based provider of corporate and healthcare financing for SMEs. Existing players will look to divest businesses that are not delivering the returns on capital required or are in lower growth territories. This provides opportunities for new entrants or those looking to build the scale of their existing operations.
- **UK regulation** – On 1 April 2014, the FCA assumed responsibility for the regulation of consumer credit activities from the Office of Fair Trading and will operate an interim regime for the regulation of consumer credit until 1 April 2016. These changes will affect asset finance businesses that hire or lease goods for more than three months. Businesses with interim permission will have to apply to the FCA to receive full authorisation by 1 April 2016. The FCA expects that 25 per cent of applicants will not meet the required standards for authorisation and will be forced to drop out of the market.² In addition to the increased conduct and operational controls required under the new regime, the FCA is undertaking thematic reviews to assess and make recommendations for new rules. These are likely to lead to consolidation or the run-off of portfolios as operators exit the market.



² [Blogs.deloitte.co.uk/financialservices/2014/04/consumer-credit-regulation-going-beyond-conc.html](http://blogs.deloitte.co.uk/financialservices/2014/04/consumer-credit-regulation-going-beyond-conc.html), Deloitte, 25 April 2014

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- **EU regulation** – Following the introduction of CRD IV which covers all credit institutions, individual EU countries are able to adjust their definitions and resulting regulatory obligations. For example, in France, prior to the introduction of CRD IV, leasing companies were operated as sociétés financières and regulated similarly to banks. By October 2014, sociétés financières were required to choose between being a credit institution subject to CRR (part of CRD IV), in which case they would have to start collecting deposits, or to become a 'financing company', a new category of French regulated entities, for which the prudential rules would be similar to CRR except that some of the liquidity and leverage ratios are not applicable. However, in Germany, Switzerland and Italy, non-bank leasing businesses are not required to hold regulatory capital.
- **Scale** – The asset finance market in the UK and continental Europe, with the exception of a small number of large bank or vendor-owned participants, comprises a number of small and medium-sized businesses. While there was some consolidation in 2013 and 2014, there is further opportunity to consolidate, improve margins and prepare for future operational and technological challenges. In 2013, HgCapital acquired Zenith and Leasdrive, the 12th and 14th largest vehicle leasing businesses in the UK.
- **Disrupting the value chain** – A number of asset finance providers distribute through brokers to whom they pay commissions and/or fees. Cabot Square Capital acquired Leasedirect Finance in 2013 and Henry Howard in 2014, which both offer broking and leasing services, with the aim of taking the broker relationships out of the value chain to improve margins and build client relationships. As part of the Leasedirect Finance acquisition, a £75 million block discounting facility was secured.

Looking further ahead, there are a number of factors which will affect asset finance businesses including the impact of product innovation and technology. Moreover additional operational and data requirements are expected under the proposed Global Leasing Standard which is expected to be issued in 2015 (although the effective date has not yet been announced).

The adoption of existing and new technologies varies across the asset finance sector. Technology has enabled the capture and analysis of vast quantities of data to support business decisions, including marketing and credit decisions. Technology has also opened up new channels to market via online processing and social media. In addition, new mobile solutions provide customers and business representatives with real-time information to support buying and credit decisions. Further investment in technology will be required to refine current business models and respond to increasingly dynamic and information enabled competitors.



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