Deloitte.

2023 banking and capital markets M&A outlook

Volatility seeds opportunity

Contents

Introduction

Banking and capital markets (B&CM) mergers and acquisitions (M&A) have been on a roller-coaster ride for several years. Transaction volumes and values climbed steadily prior to the COVID-19 pandemic, only to hurtle downward in 2020. Activity shot up the following year, then slid again in 2022 due to rising inflation, interest rate hikes, ongoing economic uncertainty, and other factors. Escalating regulatory scrutiny also may have discouraged some B&CM players from attempting deals.

All three major B&CM sectors were impacted last year. Banking saw major drops in total deal volume and value, along with an average deal value decline. Investment management (IM) and wealth management (WM) suffered from falling asset values that dented returns, though WM remains a highly profitable, sought-after specialty. Financial technology (fintech) companies stumbled as previously inflated valuations fell back to earth, particularly in the buy now, pay later (BNPL) subsector. And cryptocurrency exchanges were slammed by the Futures Trading Ltd. (FTX) bankruptcy and indictment of its chief executive officer on multiple criminal charges.

Despite the temporary M&A stall, we observe five intriguing trends and drivers for 2023:

- **The struggle for customer ownership**. Banks and other traditional financial institutions are grappling with how—or whether—to retain control of retail customers or cede them to fintechs.
- **Evolving B&CM ownership models.** Both private equity (PE) and traditional firms are making earlier, and sometimes different, types of investment structures and alliances. For example, a PE consortium has acquired a major bank.
- **More customized IM and WM products.** For example, direct indexing tools that combine index-fund returns with flexibility and tax benefits are stars. Banks' decisions to buy or build additional IM and WM capabilities may be influenced by their ability to recruit talent in these areas.
- **Increased regulatory scrutiny industrywide.** Regulators are broadening their focus from megadeals to super-regional and regional banks, fintechs, and other areas. Following the FTX debacle, crypto exchanges and currencies have regulatory targets squarely on their backs.
- **Focus on serving underbanked or debt-averse populations.** With the term "financial inclusion" on every institution's agenda, banks and other industry players are looking for new products to reach underserved markets.

Many banks, wealth and investment managers, fintechs, and PE firms have halted M&A plans while waiting for the tumult to stabilize and interest rates to level off. As a result, 2023 may present stellar opportunities for traditional banks and payment processors unafraid to make bold, proactive—albeit well-considered—moves. We expect compelling fintech players to be available at more reasonable prices, enabling risk-savvy companies to jump aboard the M&A roller coaster before its next upward climb.

2022 in review; 2023 outlook

Banking

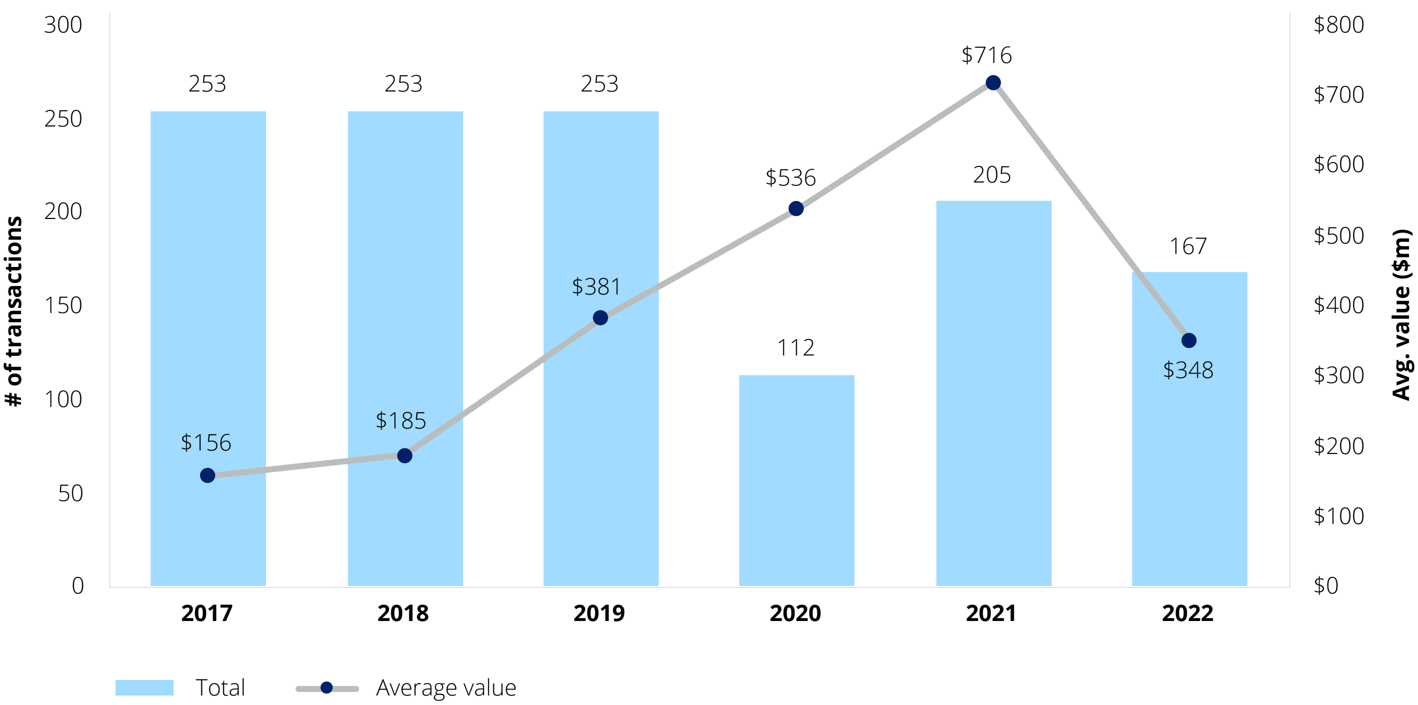
Banking was hardest hit among the three B&CM sectors last year. While US volume and values exceeded 2020's pandemic lows, the number of transactions and overall deal value fell off substantially from the soaring 2021 market. Excluding 2020, banking M&A volume in 2022 slumped to its lowest level in six years. Total 2022 volume fell to 167 closed transactions totaling $22.6 billion, compared with 205 closed deals totaling $76.6 billion the previous year—drops of 18.5% and 70.5% in aggregate deal volume and value, respectively. Significantly, average deal value fell nearly in half from $716 million in 2021 to $348 million in 2022, a 51.4% decrease.[4]

With two notable exceptions, the largest bank M&A transactions also shrank in value considerably. Toronto-Dominion Bank (TD) purchased First Horizon Corp. for $13.7 billion,[5] and Royal Bank of Canada bought Hong Kong and Shanghai Banking Corp.'s (HSBC) Canadian operations for $13.5 billion.[6] Both deals continue the reemergence of super-regional and regional banking M&A. The next-largest deal, Provident Financial Services, Inc.'s purchase of Lakeland Bancorp, Inc., was for $1.3 billion.[7]

Other leading 2022 deals were all under $650 million: Washington Federal, Inc. bought Luther Burbank Corp.,[8] Seacoast Banking Corp. of Florida purchased Professional Bank,[9] and Prosperity Bancshares, Inc. bought First Bancshares of Texas, Inc.[10] In contrast, 2021's five leading announced deals all topped $5 billion.[11]

Most megadeals closed in 2022 had been announced in 2021, but underwent regulatory scrutiny that in some cases stretched more than 14 months. U.S. Bancorp's acquisition of MUFG Union Bank, N.A. from Mitsubishi UFG Financial Group for nearly $8 billion, announced in September 2021, closed in December 2022.[12, 13] New York Community Bancorp, Inc., which struck a deal for Flagstar Bancorp, Inc. for $2.6 billion in April 2021, finally closed the transaction in December 2022—a total of nearly 19 months.[14, 15]

Figure 1: Banking M&A metrics



Source: SNL Financial and S&P Global Market Intelligence
Note: Avg. deal size is based on disclosed deal values. 33%, 37%, 43%, 54%, 48% and 61% of reported deals did not disclose deal values for FY17, FY18, FY19, FY20, FY21, and FY22 respectively.

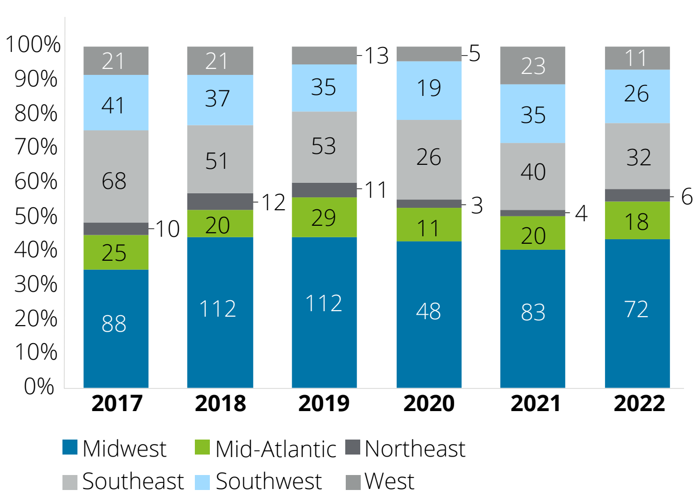
Bank of Montreal (BMO) announced plans to purchase Bank of the West for $16.3 billion in December 2021, only to find the deal challenged by community groups.

The agreement ultimately requires a five-year, $40 billion community investment in the United States to pass regulatory hurdles. Canadian regulators meanwhile shook up the transaction in December 2022 by requiring BMO to raise further capital.[16] However, in early 2023 BMO received regulatory approval to acquire Bank of the West, a deal which closed in February.[17]

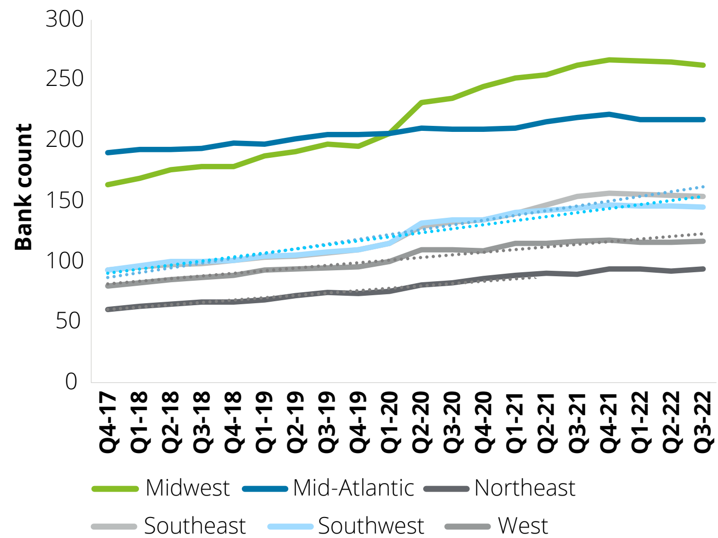
Several other large deals are still awaiting regulatory approval in the United States. For example, TD's First Horizon purchase faced substantial community and regulatory pushback. Announced in early 2022, the deal now is projected to close in the second quarter of 2023.[18]

Figure 2: Banking M&A volume & price/tangible book value (P/TBV) by region

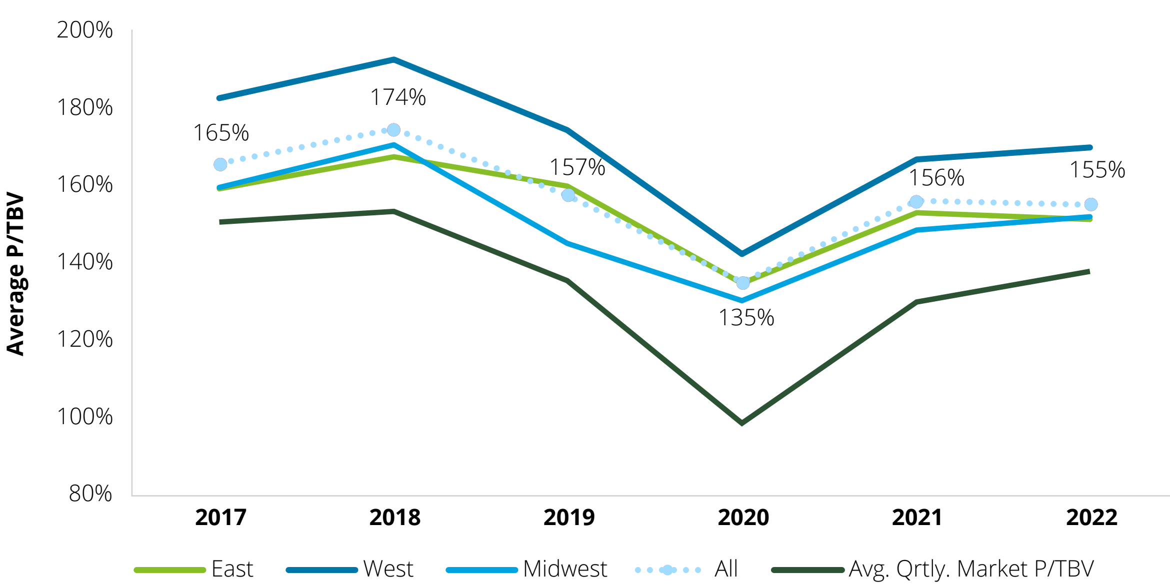
Banking M&A by target region



Banks with > $1B assets by region

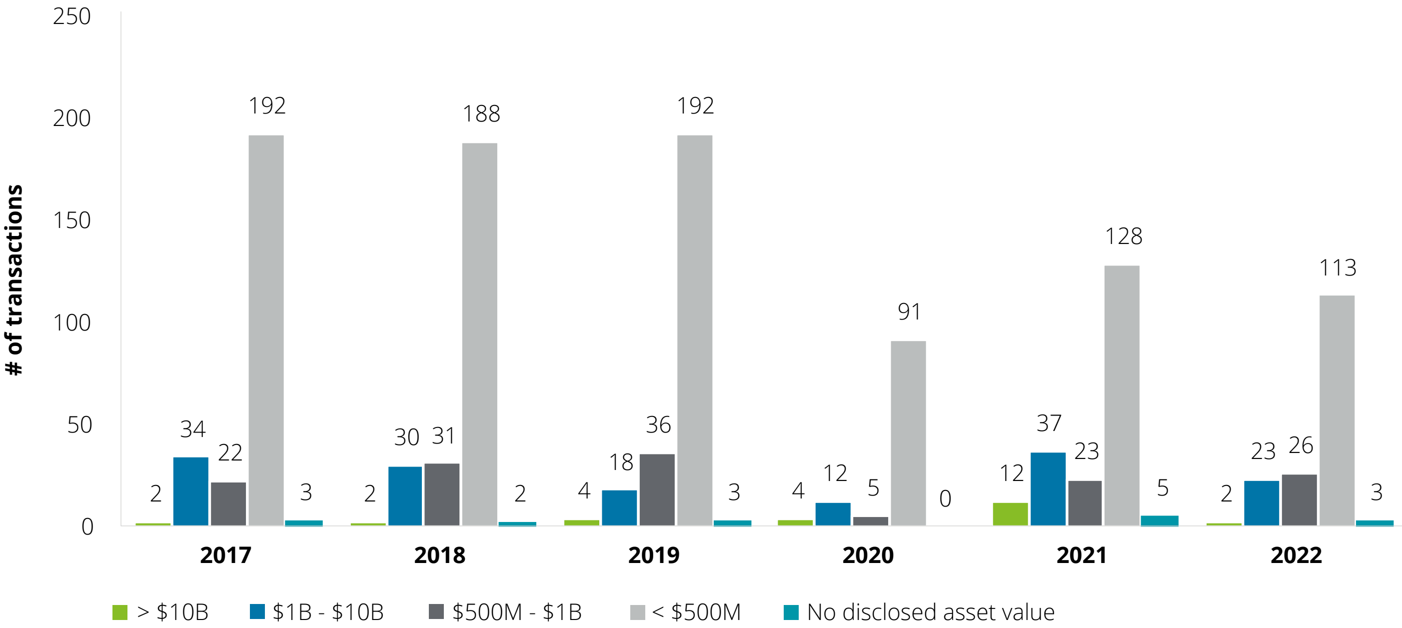


Banking deal P/TBV by region



Source: SNL Financial and S&P Global Market Intelligence
Note: Avg. deal size is based on disclosed deal values. 33%, 37%, 43%, 54%, 48% and 61% of reported deals did not disclose deal values for FY17, FY18, FY19, FY20, FY21, and FY22 respectively.

Figure 3: Banking transactions by asset size



Source: SNL Financial and S&P Global Market Intelligence

Locations and valuations

Together, the top five acquirers stretched across the continental United States: Washington Federal in the West, Prosperity Bancshares in the Southwest, Seacoast Banking in the Southeast, and Lakeland and TD Bank's US unit in the Mid-Atlantic. The largest fraction of 2022 deals was in the Midwest, which had 72 deals, followed by 32 in the Southeast and 26 in the Southwest.[19]

The lion's share of activity again occurred in institutions with less than $500 million in assets. In 2022, these smaller entities constituted 67.7% of deals, up from 62.4% the previous year. In last year's second-largest category, institutions with assets of $500 million to $1 billion, the share of deals rose to 15.6% in 2022 from 11.2% in 2021.[20] Both increases point to megadeals being supplanted by smaller ones in 2022.

Surprisingly, valuations remained stable. Average P/TBV hit 138% versus 130% in 2021. While still a substantial increase over 98% in 2020, average P/TBV last year was a tempered 8% from 2021.[21]

Price-to-earnings (P/E) ratios have been more volatile over the past several years given the impact of accounting changes on Generally Accepted Accounting Principles (GAAP) earnings. Revenue recognition shifts have made P/E ratios a less meaningful deal measurement standard.

Charting the falloff

Fast-accelerating inflation and interest rates were the principal reasons for the dip in M&A activity in 2022. Inflation peaked at 9.1% in June 2022, a 40-year high, before settling at 6.5% for the year. The Federal Reserve Bank responded with seven interest rate hikes aiming to cool inflationary pressures, ending 2022 at a 4.25% to 4.5% federal funds target rate—versus near zero one year earlier.[23]

M&A also was constrained by economic uncertainty in general, with many executives concerned about a possible recession. At 2022 year end, Deloitte was predicting a one-in-three chance of recession by September 2023. Murkiness was compounded by the Russia-Ukraine conflict, ongoing supply chain disruptions, energy and food constraints, and climate change-driven natural disasters in Florida and the West.

Increased regulatory scrutiny may have been another factor.[24] While transactions are being approved, firms may have been concerned that long regulatory queues would impact their ability to close deals and/or merge operations effectively. Liquidity meanwhile dropped in response to rising interest rates and falling asset values. Finally, many super-regional and regional banks, which have been extremely active M&A players over the past three years, may have needed time to digest their recent acquisitions.

2023 economic considerations

Economic factors impacting banks in 2023 will likely include a still-fragile economy and further interest rate hikes, which the Federal Reserve Board (the "Fed") has signaled its intention to implement—although in smaller increments than in 2022. In the short term, higher rates will impact current debt instruments and balance sheets negatively, which may be a deterrent to M&A. But rising interest rates also constitute a medium- to long-term positive as banks benefit from the widening spread between interest rates on deposits and loans. As a result, increasing rates may boost banks' earnings for the first time in years.[25] Higher rates also may boost confidence in acquiring banks and fintechs, and in making more fintech investments.

Conversely, further economic deterioration undoubtedly would disrupt large M&A transactions by fueling already rising caution among regional, super-regional, and globally systemic important banks (GSIBs.) Some economists are concerned that demand for commercial and consumer loans could be dampened to the point that many banks will be unable to achieve necessary spreads. Should deposits also flow out, regulators may have liquidity concerns that translate into still longer, deal-threatening delays.

In fact, the Fed in late 2022 asked for comments on orderly resolution of large banks should those banks fail,[26] suggesting the agency doesn't want to face the same obstacles that surfaced in the 2007 to 2009 Great Recession. At the same time, we don't expect the Fed will be taking over banks or forcing vast-scale mergers as happened in rapid succession in 2008 and 2009.

2023 banking outlook

The retail banking outlook remains positive despite inflation and deteriorating economic conditions overall. Propped up by government grants and loans during the pandemic, individuals largely are continuing to make timely mortgage and credit card payments. On the flip side, mortgage origination has fallen dramatically in the face of rising interest rates,[27] rents, and costs such as gas and groceries that make mortgages less affordable and saving for a home purchase more challenging.

While declining originations have had a major impact on revenues from home sales and refinancings, credit and deposit exposure likely will enable retail banks to reenter M&A in late 2023 or 2024. Retail banks likely will have two categories of targets. Mortgage originators suffering from lower loan originations may be forced into distressed sales. Mortgage servicers may be attractive targets, however, given that lower refinancing rates have boosted cash flow beyond expectations.

Commercial banks face a much tougher situation. Commercial lenders are facing defaults and negotiating debt restructuring with major office landlords, some of which are unable to fill space or refinance at acceptable rates.[28] Banks hold most commercial real estate debt, and a shakeout likely is coming among less desirable properties, which will be harder to sell or lease as workers continue to embrace working from home.[29] Because corporations are more exposed to rising interest rates than are retail customers, commercial banks may find themselves challenged to sell profitable products and services this year.

Investment banking pressures differ considerably. Boutique firms that have no classic banking operations have proven their resilience without consumer deposits, reducing investment operations' leverage within core banking businesses. Credit Suisse Group AG[30] and other European banks have said they intend to spin off their investment banking arms, and we expect some US banks to follow suit. The result may be a return to stand-alone investment banks, as was the case prior to widespread acquisitions a decade ago.[31] Such a strategic shift may also mean that investment banks will need to ramp up trading, wealth management, PE, and other businesses as they seek to balance their own growth.

Given ongoing economic uncertainty, we expect pure bank deal volume to be similar to 2022's level. There could be few or no megadeals, though more mergers of equals—or distressed sales billed as equal mergers—could become more common. The current lending-capacity-constrained environment may extend for one to two years, and earnings may be depressed for one to two years as the specter of recession looms. Banks accordingly will need increased capital leverage, strategic planning, and patience to complete deals.

Well-capitalized institutions are likely to have ample financial and strategic acquisition opportunities in 2023, particularly if economic conditions deteriorate further. Banks facing margin erosion may opt to sell portfolios, operations, or entire businesses. Portfolios, in particular, may provide a chance for strategic buyers with different business models to obtain desired profitability from the same assets, cementing the adage that one person's—or institution's—castoff is another's potential treasure.

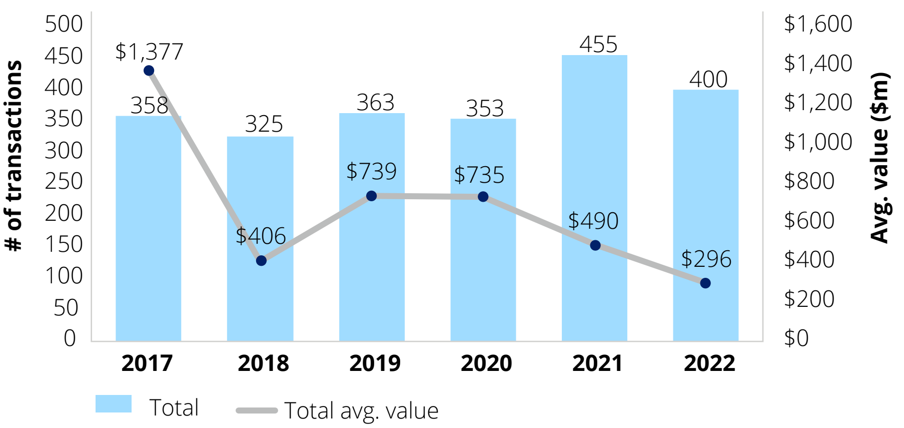
Wealth management and investment management

As in the banking sector, M&A activity WM and IM shone in 2021, only to dim considerably last year. Total disclosed 2022 deal volume fell to 400 transactions from 455 transactions in 2021, while average deal value slid to $296 million from $490 million the previous year. Significantly, however, value has been undisclosed in up to 92% of reported deals during the past seven years, making average value an uncertain measure.

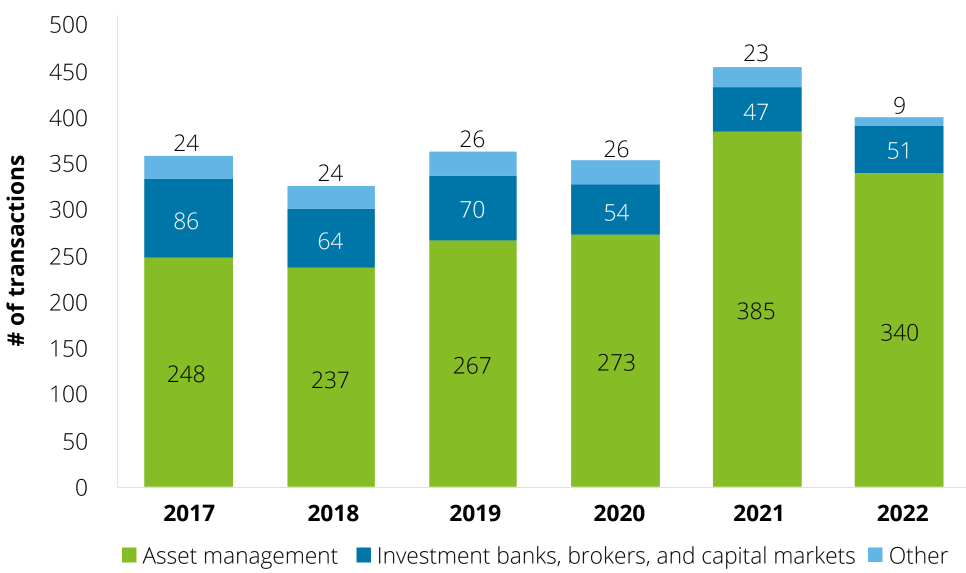
One of the few major WM deals reported in 2022: Voya Financial, Inc.'s purchase of the majority of Allianz Global Investors' US asset management business for $120 billion.[32] The transaction resulted from unusual circumstances, in which US regulators disciplined Allianz for misguiding investors during the pandemic. Allianz GL US incurred $6 billion in fees and penalties, was barred from managing mutual funds in the United States for 10 years, and needed to divest its US operations to comply. While notable for its size, the deal represents a one-off opportunity for Voya rather than a trend marker.

Figure 4: IM and WM M&A metrics

IM & WM M&A metrics



IM & WM M&A volume



Source: SNL Financial and S&P Global Market Intelligence

Note: Avg. deal size is based on disclosed deal values. 82%, 81%, 79%, 82%, 85%, and 92% of reported deals did not disclose deal values for FY17, FY18, FY19, FY20, FY21, and FY22 respectively.

Figure 4: IM and WM M&A metrics

Top IM/Securities deals (US)

Target	Buyer	Seller country	Target country	Announcement date	Value ($m)	AUM ($m)
CarVal Investors LP	AllianceBernstein L.P.	USA	USA	March 17, 2022	$1,400	$143
Cowen Inc.	The Toronto-Dominion Bank	USA	USA	August 2, 2022	$1,316	$156
Portfolio assets of CBAM Partners, LLC	The Carlyle Group Inc.	USA	USA	March 9, 2022	$814	NA

Source: SNL Financial and S&P Global Market Intelligence

Among the PE headlines: Oak Hill Capital LLC's purchase of a minority stake in wealth manager Kestra Holdings from Stone Point Capital LLC, a PE-to-PE deal in which Warburg Pincus LLC remains Kestra's majority owner.[33] Reverence Capital Partners invested in Signature Estate and Investment Advisors,[34] and Genstar Capital led a recapitalization of investment adviser Cerity Partners.[35] Activity was more subdued in investment management, which saw no major deal announcements in 2022.

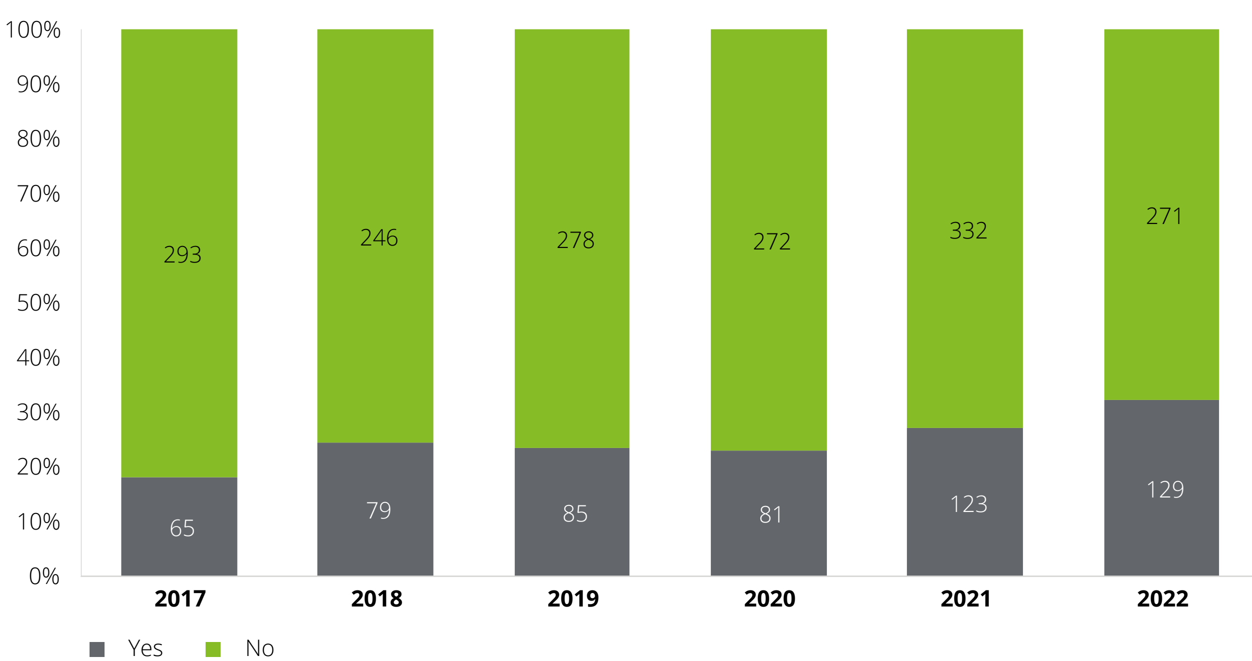
IM and WM firms were impacted by the same economic factors that hit banking last year: spiraling inflation, repeated interest rate hikes, capital markets volatility, and energy price gyrations, among others.[36]

Because both subsectors generate a substantial portion of revenue based on assets under management, each was affected by dropping asset values. WMs that retained their clients and were able to recruit new advisers with their own loyal clients may have been less affected than IMs, which tended to experience net outflows during the year.

M&A activity continued in both subsectors, but at subdued levels. As in other financial sectors, deals also suffered from bid/ask gaps between buyers pushing for lower price tags in a slowing economy and sellers clinging to 2021's loftier valuations.

Figure 5: IM and WM with PE involvement

IM/Securities deals with PE involvement



Source: SNL Financial and S&P Global Market Intelligence

Wealth management

Most WM firms were able to retain healthy margins—if thinner than in 2021—despite interest rate hikes and falling asset values.[37] WM remains immensely attractive for its fee-based income, high margins, and access to affluent investors. Many wealthy individuals do their personal and business banking at the same institutions, enabling banks that establish strong personal ties to pull in lucrative WM business and vice versa.

In a notable 2022 transaction, HSBC Bank USA, NA closed the sale of more than 90 of its US branches to Citizens Bank owner Citizens Financial Group on the East Coast and to Cathay General Bancorp's Cathay Bank on the West Coast. HSBC cited its desire to focus on high-net-worth individuals and international businesses, for which it will maintain 20 to 25 branches, as the reason for exiting mass-market retail in the United States.[38]

We expect M&A to continue thriving given wealth management's dynamics, including a large number of independent firms and sellers looking for succession or exit in consolidating markets. Activity may blossom as entities heavily dependent on assets under management for revenue—and hence impacted by shrinking asset values—may look to be sellers.

Investment management

2021 and early 2022 saw robust IM deal volumes and values for substantial acquisitions, not simply bolt-ons to existing capabilities. By mid-2022, however, valuations began to be impacted by falling capital markets.[39] With widening bid/ask spreads, buyers and sellers are unlikely to see eye to eye for some time.

IM firms that didn't need to focus on operating efficiently in fast-rising capital markets now find the backdrop has been repainted. Revenues are dropping just as inflation-driven costs for digital channel upgrades, competitive salaries, and day-to-day operations are rising. The margin squeeze is forcing most IMs to focus rigorously on capital expenses while simplifying and modernizing their operating models.[40] We expect little M&A acceleration until economic and market dynamics become clearer in or beyond the second half of 2023. With IM growth slowing relative to historic norms, firms probably will focus on obtaining a greater share of assets from existing clients by adding products such as real estate and liquid alternatives.

Despite those concerns, investment management is still a growth industry. Acquirers with access to capital likely will eye differentiated IM firms with in-demand capabilities. The choice for IMs will be whether to buy companies with covetable expertise and client lists, or to expend the sums and time required to grow capabilities internally. Approaches undoubtedly will depend on firms' individual situations.

There are likely to be opportunistic deals for expertise or valuable clients, along with growth in new specialties.[41] For example, we expect private credit will merit a growing allocation in IM portfolios. There's also deep interest in capitalizing on vast IM data resources for operating efficiencies, distribution alternatives, and investment insights. The most successful deals will likely be made by firms and buyers that are thoughtful and deliberate on the process, as well as clear and intentional on benefits to clients, not just to buyer and seller.

Fintech

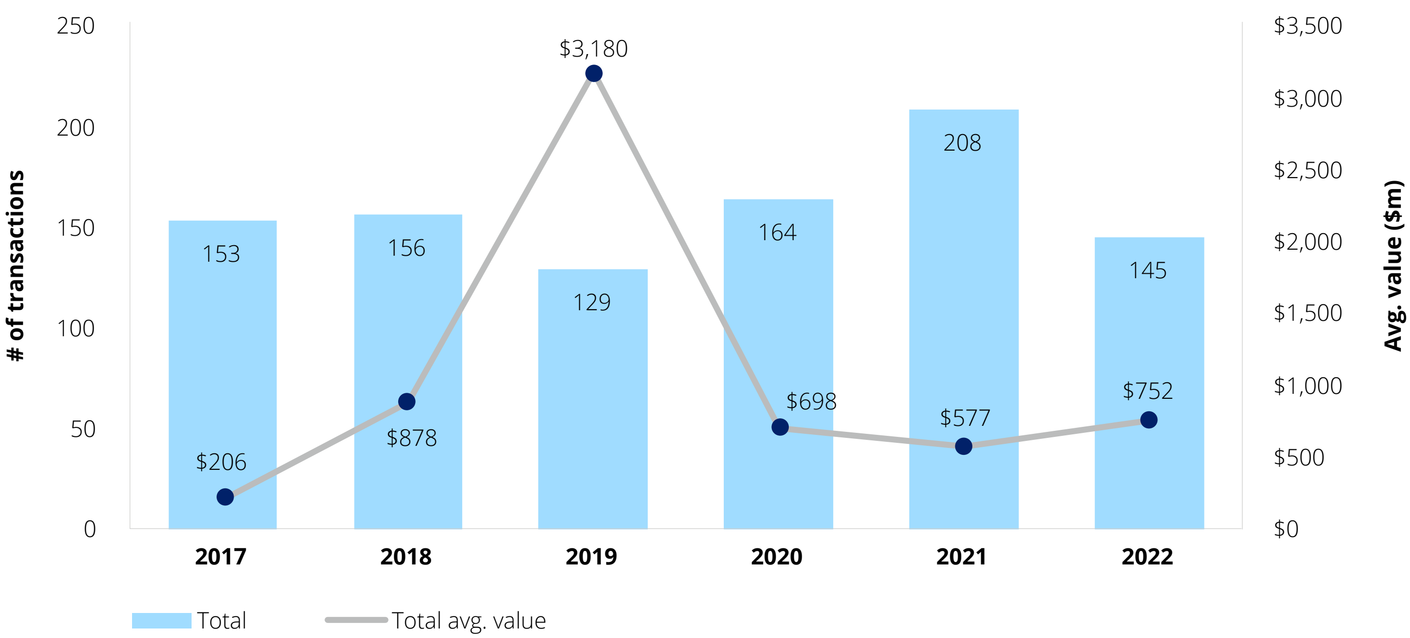
For fintechs, 2022 was the year when M&A valuations retreated to more historical levels. Total transaction volume dropped to 105 deals totaling $30.1 billion, compared with 138 deals totaling $40 billion the previous year. Those shifts represent 23.9% and 25.5% declines in aggregate deal volume and value, respectively.

The gap in number of deals was much less than the gap in dollar volume, which suggests the M&A market continued to be vibrant, but smaller deals became more of the norm. To that end, we saw more tuck-in acquisitions, with large financial institutions choosing to acquire strategic tech capabilities rather than invest several years and considerable effort in attempting to build similar platforms.

For example, PNC Financial Services Group, Inc. bought Linga rOS,[42] and Huntington Bancshares, Inc.[43] acquired Digital Payments Torana, Inc. Fintech tuck-ins included Fiserv, Inc.'s purchase of Finxact, Inc.,[44] Jack Henry & Associates, Inc.'s purchase of Payrailz,[45] and the London Stock Exchange Group's purchase of Acadia.[46] Visa Inc. and Mastercard Inc. also have made or attempted acquisitions in the past few years, including Visa's derailed purchase of Plaid Inc.[47] and Mastercard's purchase of Finicity.[48]

Figure 7: Fintech M&A metrics

Fintech M&A metrics



Source: SNL Financial and S&P Global Market Intelligence

Note: Avg. deal size is based on disclosed deal values. 61%, 61%, 66%, 67%, 66%, and 72% of reported deals did not disclose deal values for FY17, FY18, FY19, FY20, FY21, and FY22 respectively.

Figure 7: Fintech M&A metrics

Top five Fintech deals (US)

Target	Buyer	Seller country	Target country	Announcement date	Value ($m)	General industry
Black Knight, Inc.	Intercontinental Exchange, Inc.	USA	USA	May 4, 2022	$16,337	Banking technology
EVO Payments, Inc.	Global Payments Inc.	USA	USA	August 1, 2022	$3,031	Payment processors
Claims Editing Business (ClaimsXten) of Change Healthcare Inc.	TPG Capital, L.P.	USA	USA	April 22, 2022	$2,200	Insurance technology
Computer Services, Inc.	Investor Group	USA	USA	August 22, 2022	$1,541	Banking technology
Assets of Voyager Digital LLC	Binance	USA	USA	September 27, 2022	$1,022	Financial media and data solutions

Source: SNL Financial and S&P Global Market Intelligence

Note: The numbers listed in the table represent Enterprise Value, while the numbers listed within the text represent Equity Value.

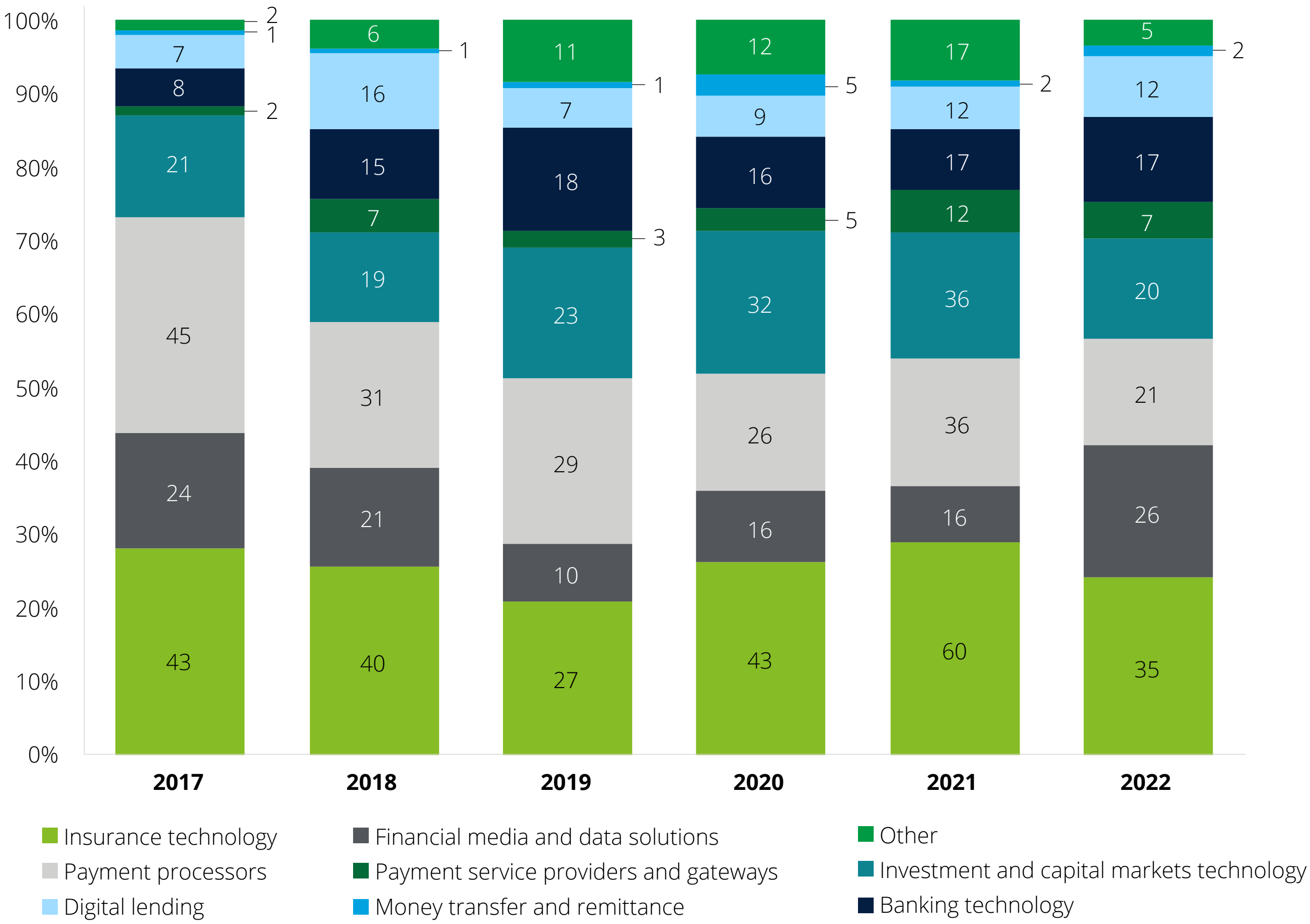
Private market funding meanwhile dropped to $32.8b during 2022 from $65.7b the previous year, a 50.1% slide. The number of private deals tumbled to 1,863 in 2022 from 2,045 in 2021.

Special-purpose acquisition companies (SPACs), merger-seeking public shells that enable startups to circumvent the demanding IPO process, lost steam after two frenzied years.[49] Many SPAC startups were too immature for standard IPOs and fell far short of expected results. Rising interest rates, increased Securities and Exchange Commission (SEC) oversight due to lack of finance-function sophistication, and other factors also impacted the appeal for SPACs. Valuations in many cases fell below initial share issue prices.[50]

Notable deals completed despite the falloff included Intercontinental Exchange, Inc.'s purchase of Black Knight Financial, Inc. for $13.1b consideration,[51] Thoma Bravo LP's purchase of Anaplan, Inc. for $10.7b,[52] Vista Equity Partners' purchase of Avalara, Inc. for $8.4b, Global Payments Inc.'s purchase of EVO Payments, Inc. for $4b,[53] Madison Dearborn Partners' purchase of MoneyGram International, Inc. for $1.8b,[54] and EQT Group's purchase of Billtrust (BTRS Holdings Inc.) for $1.7b.[55]

Figure 8: Fintech M&A metrics

Fintech deals by sector



Source: SNL Financial and S&P Global Market Intelligence

Behind the deal drop

Fintech valuations soared in 2020 and 2021 primarily in response to keen interest from strategic and financial investors.[56] Banks realized they needed better ways to engage with customers digitally and no longer had to own every phase of the operational value chain. Instead, traditional banks could partner with fintechs to provide innovative, high-value services to more customers at lower costs than attempting to replicate those services internally.[57] PEs also identified an opportunity to enter lucrative financial services minus banking regulatory burdens. Fintechs' allegiance to the software-as-a-service (SaaS) operating model, with predictable cash flows and sticky revenue, also proved alluring.

As a result, enterprise value-to-revenue (EV/R) for disclosed deals leapt from 10x to 12x in 2020 to 15x to 20x by mid-2022.[58] (The vast majority of fintech M&A values are undisclosed.) Inflationary pressures, rising interest rates, and the uncertain economy have impacted fintech M&A activity.[59] Banks became more risk-averse and, in some cases, discovered a deep cultural gap between their generally traditional working styles and fintechs' often more progressive culture. PE firms reliant on low-cost borrowing to fund purchases and/or arbitrage debt service with fintech cash flows found themselves squeezed by rising interest rates, making highly leveraged deals more challenging. Yet some multibillion-dollar take-private acquisitions did occur later in 2022, such as the Anaplan and Avalara deals.

Emerging subsectors

Last year's hottest fintech subsector was embedded finance and digital payments, which have become so commonplace that most consumers now take transaction ease for granted.[60] Another thriving area: Banking as a Service (BaaS), which provides back-end functionality rather than front-end access, enables virtual banks and nonbanks to offer banking services.[61] BaaS companies rely on licensed banks for infrastructure and, in turn, offer services to other fintechs—a three-way bank-fintech collaboration.

Payments and exchanges, including blockchain and crypto applications, largely sizzled until FTX's high-profile bankruptcy. FTX competitor Binance, which processes more transactions than most of its rivals combined, faced scrutiny next for limited information disclosure and the sudden decision of its auditor, Mazars Group, to pause work for crypto clients following FTX's bankruptcy filing.[62] The year was so bad for crypto overall that the term "crypto winter," coined to describe previous price drops, came into widespread use to describe the fate of cryptocurrencies and exchanges.

As for buy now, pay later (BNPL), startups' first-mover advantages began coming under stress. Lowered consumer purchasing power stemming from inflation, higher interest rates that dampened consumer enthusiasm, and increased regulatory scrutiny resulted in substantial BNPL valuation cuts. Competition also hit valuations as retailers, including Apple, Inc. and Wal-Mart, Inc., brought BNPL in-house.[63] A prime example: Sweden-based Klarna Bank AB's valuation shrank from $45.6 billion in mid-2021 to $6.7 billion in a financing round just one year later.[64] Affirm Holdings, Inc. saw its stock down 87% in December 2022 for the year.[65]

The BNPL concept remains popular with consumers, however, and established BNPL companies may begin recovering as economic conditions and household finances improve in coming years. Retailers also continue to like BNPL for its ability to generate cash, despite high merchant fees, at a time when banks are tightening credit-card standards.[66]

2023 fintech outlook

We believe a sizable fintech shakeout will occur over the next few years, with survivors being bought out at highly discounted prices from those of a year or two ago. The embedded finance and digital payments subsectors will be winners, while blockchain, crypto, and non-fungible tokens (NFTs)—the unique digital identifiers recorded in a blockchain that grant no actual rights to physical and electronic images or text—are likely to struggle, at least in the near term. Consistent with 2022, most fintech deals are likely to be "tuck-in" acquisitions for banks, rather than purchases by other fintechs or by PEs sidelined by interest rates.

The impact of rising rates on PEs' operating model offers banks and established payment processors a fresh fintech buying opportunity. Traditional players can expand tech-driven offerings, widen geographic footprints at reduced prices, and build competitive advantage without dedicating the time and resources—and risking the uncertain outcomes—of organic growth.[67] We believe that astute institutions will devote themselves to identifying targets and performing due diligence while valuations stabilize and depleted inventories of mature fintechs are replenished.

But that scenario assumes that M&A won't be widely impeded by regulators. One of the biggest deals of the past two years, Visa's purchase of embedded finance provider Plaid, was undone by regulators who considered the combination anticompetitive.[68] We expect more clarity on regulators' views of other fintech deals, along with increasingly demanding standards, in 2023 and 2024.[69]

There remains the thorny question of what will happen if emerging fintechs begin to falter. Many are burning through cash and are entirely dependent on venture capital to survive. Should investment pools dry up, these startups may cease to exist. Yet many banks now have fintechs deeply embedded in their technology stacks. Faltering fintechs could jeopardize partner banks' carefully cultivated ecosystems.

Shaky fintechs could be acquired by partner banks, but many don't want to own fintechs due to regulatory issues with bringing fintechs in-house, potential cultural conflicts, and the discomfort of becoming service providers to competitors. The emergence of bank consortia, in which banks join forces to enable a fintech to remain independent, may be more likely. Or PEs could opt to make smaller investments in preferred financial instruments, rather than buying large chunks of equity or entire fintechs, until markets stabilize.

Crypto and blockchain are another matter. There may be some mergers of equals, such as crypto exchanges acquiring each other. But acquisitions by leading payment processors are unlikely until the regulatory horizon becomes clearer. While we expect banks to become more comfortable with crypto over time, technologies and markets contain too many unknowns for most banks to consider them now. We do see banks exploring other blockchain avenues, however, such as JPMorgan Chase, which has its own blockchain-based trading platform in place.[70] Goldman Sachs is building its own version while trading some bonds and other debt securities on blockchain-based networks.[71]

Trends including the democratization of advice, millennials' immersive comfort with technology, and generational wealth transfer bode well for fintechs over the long run. For example, UBS Group AG and robo-advisor Wealthfront Inc. mutually agreed to scrap a $1.4 billion deal last year. While reasons weren't disclosed, UBS may have been concerned about overpaying, among other reasons.[72] But UBS substituted a nearly $70 million note convertible into Wealthfront shares and says it remains committed to the broad-based US market.[73]

Regulatory and tax changes

Regulatory considerations

Large bank mergers in 2021 and 2022 appear to be drawing escalating regulatory attention. Banking regulators have been scrutinizing deals of all sizes more closely. Each agency—the Fed, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC)—has flagged increasing escalating levels of discomfort. Their common concern is that existing statutory requirements are no longer sufficient for the size and nature of the deals that regulators are being asked to approve.

Banking regulators are likely to avoid a repeat of 2008's frantic bailouts and forced mergers of too-big-to-fail banks, and are looking more intently at competition in proposed merger markets, banks' capital levels, treatment of minority borrowers, and commitments to underserved communities. Some regulators have expressed concern that super-regionals and regionals, while not subject to GSIB risk capital rules, might have inadequate loss absorbing capital for the nature of their operations. And while deals are being approved, some carry stiff public and/or nonpublic conditions, including significant community investment programs.

Major regulatory developments that will likely impact M&A activity in 2023 include:

- **Bank merger policy review:** Banking regulators continue to evaluate their approach to reviewing banks' proposed acquisitions of depository institutions. Launched in mid-2021, the review seeks to ensure the integrity of the Bank Merger Act of 1960 by providing sufficient banking choices and limiting GSIB market power. The Fed is asking for comments, and updates are likely to follow.[74]
- **Advanced notice on rule changes to resolution planning, including total loss absorbing capacity (TLAC) extending to non-GSIBs:** The same week that the Fed put a notice out about the TLAC notice on risk capital extension, the agency approved U.S. Bank's acquisition of MUFG Union Bank—and noted concerns about larger banks hovering near or just below the $750 billion GSIB threshold.[75]
- **Joint proposal to modernize Community Reinvestment Act regulations:** The Fed, FDIC, and OCC jointly seek to strengthen regulations addressing credit inequities and adapt to industry changes, including mobile and online banking services not anticipated at the Act's 1977 signing.[76]
- **Expanded Consumer Financial Protection Board (CFPB) role in financial institution M&A:** While not part of the voting process on approving deals, the CFPB has been very vocal on deserving a seat at the table.[77]

To succeed in a stiffer regulatory environment, most banks may want to manage risk and compliance expectations proactively and be prepared for changing regulations. They also should pay close attention to fundamental building blocks of operating within the US banking system, which will likely drive application credibility overall.

Banks should also understand, anticipate, and comply with:

- **Risk management and remediation of outstanding supervisory findings:** Supervisory findings involving governance and controls matters have risen in the past year. As regulators focus on remediation, banks should be deliberate about resolving identified weaknesses and preventing those issues from escalating. Banks should keep a close eye on Regulation YY—Enhanced Prudential Standards and OCC Heightened Standards, which lay out a broad set of risk and compliance expectations.
- **Data governance and reporting:** Data availability and quality remain critical priorities for most banks, which can suffer serious operational and reputational consequences when unable to provide accurate, granular information on demand. Inadequate data governance can compromise data quality and integrity, create security risks such as improper access, and prevent tracking of data provenance—directly hindering firms' ability to manage risk and regulatory compliance.
- **Third-party risk management:** Outsourcing business and risk management functions—and/or incorporating new products, services, and capabilities into business lines—creates new privacy, data quality, and other risks for the hosting institution. Banks should ensure that any risks presented by external entities are monitored, identified, measured, and mitigated swiftly.
- **Cyber and information technology risk:** Regulators are monitoring banking-sector technology adoption and innovation, along with cyber incidents. Laws, regulations, and practices involving critical infrastructure have been updated to coordinate approaches to cyberthreats.

Tax development

One high-profile development internationally is the 15% global minimum tax (Global Anti-Base Erosion or GloBE) rules, which continues to move ahead. Agreed by more than 130 member countries of the Organisation for Economic Co-operation and Development (OECD) in 2021, GloBE creates a framework for a worldwide common corporate taxation.[78] Its Pillower Two relies primarily on book accounting data versus tax data, with a variety of adjustments, including those relating to deferred tax expense, which is likely to add complexity and compliance burdens. Pillar Two is expected to take effect on January 1, 2024, for most jurisdictions, suggesting that companies may spend much of 2023 getting ready for its implementation.

While only South Korea has enacted legislation to adopt the agreement so far, the prevailing assumption is that Pillar Two will come to pass in most major jurisdictions other than the United States. To that end, the EU recently announced unanimous support for Pillar Two.[79] When enacted, Pillar Two may drive companies to pay tax in jurisdictions where they might otherwise not be subject to taxation, and likely will increase cross-border investment costs. Financial institutions will need to consider Pillar Two's impact before pursuing M&A on the international stage as Pillar Two can be applicable if any entity in a corporate structure is in a jurisdiction that has adopted Pillar Two.

We advocate modeling best- and worst-case financial scenarios carefully prior to acquisitions, creating corporate-structure contingency plans that consider where targets and parents are located, and determining whether operations can be moved, if necessary.

One of last year's US tax headliners was the Inflation Reduction Act of 2022 (IRA), whose goals range from raising taxes on corporations to investing in domestic energy production.[80] One of the IRA items that may affect M&A among financial firms: a new book income minimum tax on corporations with three-year annual average adjusted financial statement income greater than $1 billion. Companies required to pay the minimum tax will be subject to it prospectively. While there are a lot of currently unanswered questions with regard to how this new tax will be practically applied, Treasury and the IRS has issued some initial guidance (that can be relied upon) on its application and has also requested comments on a number of open items.[81]

Another IRA provision, which applies a 1% excise tax on certain share buybacks will affect corporations that buy back stock in certain transactions, including "economically similar transactions." Thus, a transaction that is not technically a stock buyback in the traditional sense may become entangled in these new rules. M&A transactions will need to be reviewed carefully to ensure whether or not the 1% excise tax is applicable, whether the transaction goals can be achieved in a manner that does not trigger the 1% excise tax, and, if the 1% excise tax is triggered, who will bear the burden of the tax. Treasury and the IRS also issued some preliminary guidance that answers some questions on the 1% excise tax and also requested comments on a number of open items.[82]

Another IRA provision caps interest deductibility for nonbanks at the amount of interest plus 30% of adjusted gross income. That means companies that are heavily leveraged and don't have substantial interest income will be further limited in the amounts they can deduct. In short, PEs and other firms pursuing leveraged transactions will need to consider the interplay between interest deductibility, other depreciation, and bonus depreciation in the M&A process. In situations such as competitive bidding, buyers should analyze whether they are including the impact of these more restrictive interest disallowance rules in their models.

2023 M&A trends and drivers

We are watching the following trends, which may impact M&A activity in the B&CM industry in 2023:

The struggle for customer ownership

Retail banks currently are struggling for control of consumers—or ceding links with them to fintechs, and choosing only to perform back-office services instead. In 2023, we expect to see banks, fintechs, Amazon, and other players tussle over who will own retail customers, similar to the ways in which Apple Pay® (mobile payments solution) and Google Pay have effectively taken ownership of customers and payment data. With the United States populated with retail banks, some are voluntarily embracing the back-office role as their core strategy. Others are more reluctantly choosing to be the back office for fintechs that control the customer but that require bank ties to operate.

Many banks still would prefer to keep direct customer ties, but doing so is increasingly tech intensive. Cost and talent issues can be obstacles to recruiting tech-savvy employees, since many prefer Silicon Valley pay scales and unstructured cultures to those of banks. Nor has engaging customers digitally been a historic banking strength. We expect to see more stratification of strategy as banks figure out what roles make sense for their own futures.

Evolving B&CM ownership models

Banks: Joint bank ownership can be structured so that the controlling entity doesn't automatically become a bank holding company. In an unusual move, a group of PE-led investment funds last year purchased the Teachers Insurance and Annuity Association of America's TIAA Bank. Buyers included PE funds managed by Stone Point Capital LLC, Warburg Pincus LLC, Reverence Capital Partners LP, Sixth Street Partners LLC, and Bayview Asset Management, LLC.[83]

In another unconventional transaction, Nasdaq in 2021 spun out its Nasdaq Private Market trading platform to a consortium of banks that included Citigroup Inc., Goldman Sachs Group, Inc., Morgan Stanley & Co., and SVB Financial Group (formerly Silicon Valley Bancshares).[84]

PEs ordinarily don't buy banks precisely because the considerable regulatory constraints and slower growth are averse to PEs' high-risk, high-return investment model. The question now is whether the TIAA and Nasdaq deals are one-off transactions or the beginning of a PE push into traditional banking akin to activity more than a decade ago and a banking push into securities trading—either of which could reshape financial services in intriguing ways.

Fintech: We are seeing more banks and PEs diving into fintech investments earlier in their life cycles—a change from a preference for more mature startups. Earlier investment unquestionably is riskier, but valuations also are lower. Banks may be seeking to put smaller investments into more fintechs to leverage their in-house venture arms to evaluate best-in-class startups as they evolve.

More customized WM and IM products

As noted earlier, there was considerable WM activity in customized products in 2021 and 2022, such as direct indexing products that amplify tax benefits. Investors who buy exchange-traded funds (ETFs) benefit when share values rise but don't get the full benefit of portfolio-company drops unless the investor sells at a loss. In contrast, direct indexes mirror EFT returns, enable investors to harvest tax losses directly, and allow further tailoring of holdings.

IM also appears to be focusing on product innovation, including PE, private credit, real estate, and other options packaged into customized investment vehicles. Some managers also are looking to democratize alternative investments by creating vehicles that bridge daily traded investments and private funds, and that have lower eligibility requirements, to reach an untapped investor base.

Increased regulatory scrutiny industrywide

Given the fintech proliferation, distinguishing between banks and software companies is becoming increasingly difficult. The OCC has announced its intention to set up an office of financial technology in 2023[85] and will seek to understand whether BaaS is actually SaaS—or akin to traditional banking.

The latter conclusion could mean that BaaS companies will be required to hold additional licenses. PEs, in turn, might not want, or be allowed, to own certain types of fintechs. Regulators meanwhile are seeking to understand what types of fintechs PEs are acquiring and how their PE ownership factors into portfolio companies' financial situations.

In crypto, it's clear regulators will move to investigate and take greater control over what has been perceived as the Wild West of finance. The Fed has already indicated that it will continue working with Congress and other regulatory agencies to address risks inherent in stablecoins, a crypto asset in which values are pegged to an external asset such as a currency or commodity[86]—and on creating safeguards for banks' crypto-related activities to protect customers and the banking system overall.

Focus on serving underbanked or debt-averse populations

With the term “financial inclusion” on every institution’s agenda, financial institutions increasingly are exploring BNPL deals, such as PayPal’s 2021 purchase of Japanese BNPL Paidy for $2.7 billion.[87] In Japan, BNPL offers a culturally acceptable alternative to credit cards.

Interestingly, one of the most promising applications of crypto may be in stablecoin cross-border remittances. Transferring funds from, say, the United States to Central America is now a weighty process of buying and receiving fee-heavy money orders in person. In nations with far fewer bank branches per capita than the United States, accessing those funds also can require large amounts of time and effort.

Stablecoin transactions could help developing nations by providing ready-access funds that aren’t physical cash. According to proponents, smartphones could function like portable bank branches, enabling their owners to store funds and pay for goods without carrying cash. They also would provide a less volatile payment option in countries with rampant inflation. Not surprisingly, crypto is being adopted faster in countries with the fewest bank branches, much as cell phones took off in nations that had poor wired-phone infrastructure.

Capitalizing on B&CM opportunities

M&A in 2023 will likely look much like the sector did in 2022: fewer, smaller deals, but still with compelling rationales—divesting lagging businesses, adding key capabilities, and spreading increasingly fixed costs over a larger base. Banks also may have prime opportunities to pick up new customers while more cautious or shallower-pocketed competitors wait out the economic slowdown. Winners likely will focus on strategic deals, rather than those with purely financial merits. Despite hurdles to completing transactions near term, we believe many B&CM firms are still interested in doing deals.

We believe astute buyers revisit their overall strategies, core and noncore business lines, and efficiency and margin drivers. Selling underperforming assets may make sense for those that command reasonable prices. Firms eyeing expansion should determine the strength of their acquisition appetites and corporate development expertise. For institutions that haven't executed deals in several years, moving quickly and making wise judgments can be difficult without the right people in place. It will also be important to identify top targets and work behind the scenes to prevent a potential deal from going to auction.

We believe the premiere B&CM opportunity in 2023 will be finding fintechs at appropriate valuations. Sharp acquirers will scan markets constantly for innovative, revenue-additive capabilities they can pick up at steep discounts. Those who succeed should anticipate the culture shock between banks and fintechs that may follow.

Companies not already exploring consortia or similar funding mechanisms, which expand banking value chain participation without full ownership, might want to begin.

While B&CM likely will remain constrained in 2023, firms also need to prepare for better times ahead. The US economic recovery following the 2007 to 2009 recession proved much longer and stronger than the downturn had been. One of the challenges for executives this year will be to manage the current economic slowdown while positioning their businesses to thrive post-recession.

B&CM winners will recognize that M&A has entered a very different world, with lowered valuations and evolving ownership models. The most successful companies will likely be thoughtful buyers and sellers prepared to initiate bold, proactive moves. In a year when companies need to make choices, the most successful companies will likely be those that recognize 2023 is not a time for idleness.

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