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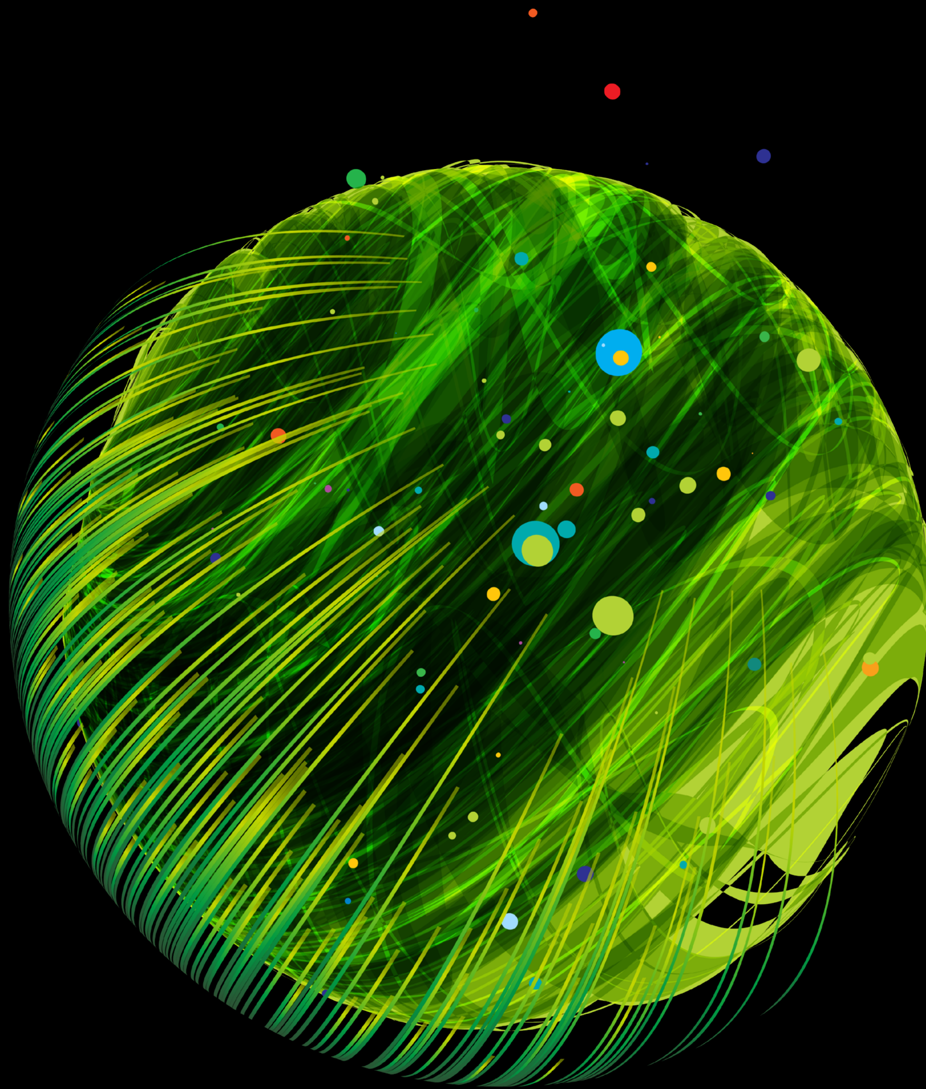

2024 Banking & Capital Markets M&A midyear outlook

August 2024

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Turning a corner in 2024?

2023 set a low bar for bank mergers and acquisitions (M&A), but a promising start to 2024 may be a cause for optimism in the near to medium term. Opportunistic bank valuations (especially among midsized regional banks, $50 billion to $100 billion in assets), market conditions, and increasing regulatory expectations appear to be driving consolidation as expected. However, uncertainty remains (interest rates, the regulatory approval process, an upcoming presidential election, etc.), creating some headwinds for bank M&A. Overall, it appears that the pendulum has come back to center from the 2023 lows and, as uncertainty subsides, the stage appears set for more bank deals in the remainder of 2024 and into 2025.

2024 so far...

Generally, there have been more deals, and more valuable deals, in 2024. The 48 deals announced in 2024 as of May 20 have an aggregate value of $6.22 billion, which already surpasses the $4.18 billion aggregate value of the 100 deals announced in the entire year of 2023.[1] Most notable are UMB's $1.99 billion proposed acquisition of Heartland Financial Corp announced on April 29 and South State's $2.02 billion proposed acquisition of Independent Bank Group announced on May 20.

Figure 1: US bank deal statistics[2]

	2020	2021	2022	2023	YTD 2024*
Number of deals (actual)	112	202	157	100	48
Total deal value ($B)	27.93	76.69	8.95	4.18	6.22
Assets sold ($B)	276.00	590.73	86.57	55.83	72.74
Deposits sold ($B)	221.65	493.08	72.97	45.92	58.93
Median deal value-to-tangible common equity (%)	134.8	151.8	753.9	126.5	119.6

*Year to date and quarter ending May 20, 2024.

Source: S&P Global

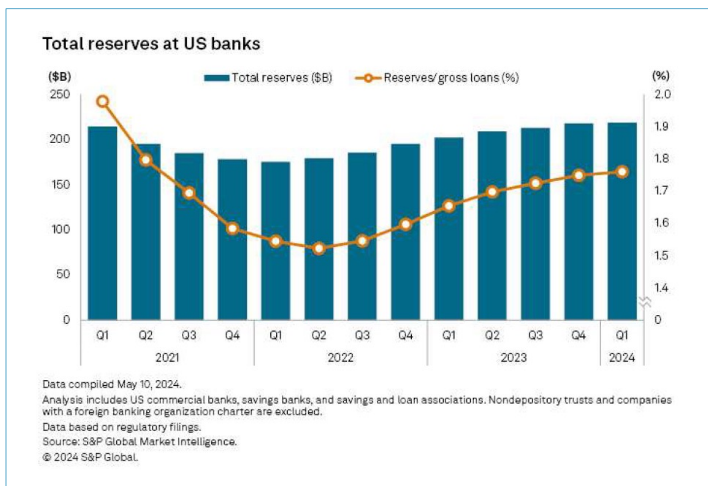
This increased activity appears to be driven by a desire for scale and portfolio diversification, geographic expansion, and succession issues.[3] In addition, the cost of savings accounts and overall cost of funds increased in Q1 2024 at a slower quarter-over-quarter clip for the fifth quarter in a row, and the cost of interest-bearing transaction deposits decreased quarter over quarter for the first time since the Federal Reserve Board (FRB) started raising interest rates in 2022.[4] Decreased cost-of-funding pressures is allowing many banks to think bigger and more long-term strategy in dealmaking (whereas M&A in a high-cost environment may be driven by a need to find low-cost deposits and generate yield to satisfy short-term funding needs).

While there has certainly been cause for optimism with the thawing of the bank M&A market, 2024 has not been without its headwinds. Higher-for-longer interest rates (which continue to make deal math difficult), uncertain economic conditions, and a markedly tougher regulatory environment have kept many on the sidelines thus far.

Uncertain economic conditions

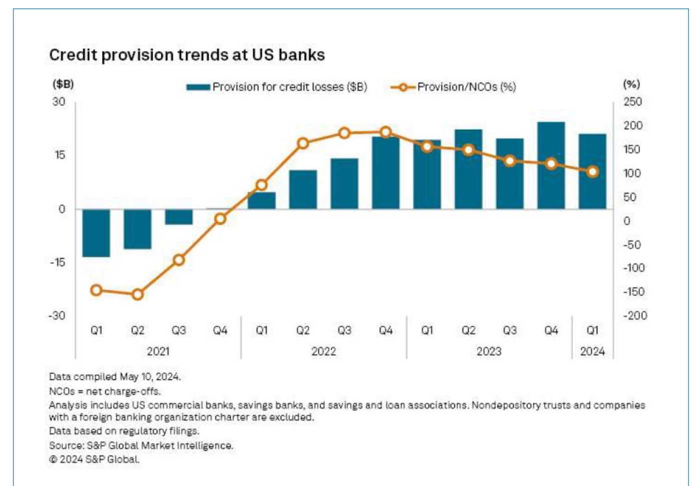
For the eighth consecutive quarter, US banks increased their reserves, reaching $218.57 billion in Q1 2024, up from $217.83 billion in the previous quarter. This growth seems to reflect a general sense of caution around credit quality of certain portfolios, especially commercial real estate (CRE) and consumer lending.[5] Even though US banks have lowered their provisions for credit losses to $21.10 billion in Q1 2024, from $24.43 billion in the previous quarter, these figures still indicate uncertainty.[6] These ongoing concerns could continue to dampen M&A activity, as potential acquirers may be reluctant to take on troubled portfolios.

Figure 2: Total reserves at US banks[7]



Source: S&P Global

Figure 3: Credit provision trends at US banks[8]



Source: S&P Global

Regulatory guidance

In 2021, President Biden signed an executive order for federal banking agencies to update their bank merger guidelines.[9] Recently, the federal banking regulators appear to be making good on the Executive Order's directive. In the first quarter of 2024, the Federal Deposit Insurance Corporation (FDIC)[10] finalized a rule, and the Office of the Comptroller of the Currency (OCC)[11] proposed a separate policy statement, both detailing the principles and standards each agency will use when evaluating transactions under the Bank Merger Act (BMA). The new policy statements would significantly increase the scrutiny applied to bank mergers and raise the standard for approving such transactions.

For example, the FDIC proposal would expand competitive considerations beyond deposit concentrations to include specific products or customer segments, and would require acquirers to prove that the resulting institution would *better* meet the convenience and needs of the community.[12] The OCC's notice of proposed rulemaking[13] provides a list of "factors" that are generally consistent or inconsistent with approval, which shows a preference toward smaller banks (resulting institution with less than $50 billion in assets is generally consistent with approval) and reemphasizing Community Reinvestment Act (CRA) and Bank Secrecy Act/anti-money laundering compliance programs.

While the FRB is not expected to issue a separate proposal on its bank merger review process, the agency has issued proposed revisions to several merger-related application and notification forms.[14] Although these updates do not change the FRB's BMA statutory factor analysis, they do require more information from applicants earlier in the review process, including detailed integration plans and greater information on financial projections and underlying assumptions.

There are several areas that bank leaders should consider as they navigate a shifting, but strengthening, M&A market, including:

- **Prepare credible integration planning efforts early:** Under the proposed regulatory rules, pre-close planning will likely need to be more robust and ready to share with the FRB at a much earlier stage than before. The updates also increase the importance of how acquirers present these plans to the FRB, as pre-close integration plans could become an earlier and more prominent part of the approval process. It will be crucial for banks to demonstrate understanding and control of the risks associated with the transaction, and with the target's portfolio, prior to deal announcement.

- **Get the house in order:** Firms that are well rated by banking regulators and have the strategic plan and ambition to make an acquisition have a significant competitive advantage and are likely more able to pursue their business strategies. Understanding the firm's existing remediation issues, self-identified areas, areas of likely regulatory focus, and how the organization is positioned on these topics will be critical.

- **Understand potential new regulatory obligations:** It is important to have a proactive plan in place, including when surpassing specific asset thresholds. With increased regulatory expectations from reaching certain asset thresholds—in particular, $100 billion in assets under Enhanced Prudential Standards—firms will need a view on how to address additional capabilities and explicit expectations to enable confidence that the bank does not pose a greater regulatory risk as it grows larger.

- **Focus on deeper due-diligence:** In keeping with a theme from guidance recently proposed by the OCC and FDIC, the merger regulatory proposals are looking for acquirers to perform more robust due diligence. This includes proactively demonstrating a deep understanding of the combined entity's possible credit exposures and concentration risks, newly applicable regulatory obligations and how the bank plans to address them, as well as impacts to existing regulatory remediation portfolios. The proposed rules double-down on a pre-existing focus on the strength and capitalization of the proposed combined entity. This is one more reason why it could be critical for acquirers to differentiate themselves from recent cases where the acquirer struggled post-close. Regulators are increasingly relying on the acquirer's level and depth of due diligence.

Testing the regulatory appetite for deals

Recently announced proposed mergers, such as UMB's bid to take over Heartland Financial, or the proposed Capital One and Discover merger, are expected to serve as litmus tests for bank mergers in the wake of the FDIC, OCC, and FRB's proposed updates noted above. How the regulators apply existing standards and (depending on approval timings) their updated guidance will give the industry valuable intelligence on how amenable regulators are to mergers and how to meet thresholds for deal approvals. The following will likely be in the regulatory spotlight:

- **Effect on competition:** This topic has appeared to be at or near the top of regulators' lists for some time now. It was one of the first topics discussed at the OCC's February 2023 Bank Merger Symposium,[15] and publicly available FDIC data shows the trend toward fewer banks in the United States in recent decades,[16] highlighting shrinking competition. The FDIC's proposed guidance is especially noteworthy here as it would shift the burden to the acquiring bank to prove that a deal would help competition (e.g., consumers).
- **Financial stability:** Lawmakers have often opposed deals to protect consumers and financial stability and this is also true for recent deals. Although these arguments against mergers are not novel, they may be enhanced due to proposed updates from the OCC and FDIC (see above) and following several bank failures in 2023. A renewed interest over financial stability may likely lead to more demands on acquirers, along with increased scrutiny.
- **Regulatory remediations:** There is potential for M&A targets to present themselves at attractive valuations precisely because they have remediation portfolios, and acquirers will need to plan on how to tackle inherited issues. This scenario may already be playing out—and how those acquiring banks communicate such plans, and how well it is received by the regulators, may influence potential acquirers in the industry that are looking for an updated playbook.

Lessons learned from recent bank deals

Some of the recent trends that we have observed include more extensive diligence, longer approval timelines, higher emphasis on CRA ratings, deals undergoing a public hearing, and the need to comprehend how acquired products/risks affect the buyer's strategy and business models (and the need to articulate this clearly to regulators).

Based on recent deal activity, it appears that crossing $100 billion in assets subjects a bank to enhanced prudential standards and moves a bank into Category IV of the FRB's tailoring rule, resulting in a substantial increase in regulatory requirements along with generally increased scrutiny. NYCB's recent acquisitions of Flagstar Bank in 2022 and assets from failed Signature Bank last year highlight this point.

Figure 4: Requirements by Federal Reserve "Tailoring Rule" categories[17]

	Regulatory requirements	Category II	Category III	Category IV	Other
		≥$700B total assets or ≥$75B cross-jurisdictional activity	≥$250B total assets or ≥$75B in nonbank assets, weighted short-term wholesale funding (wSTWF) or off-balance sheet exposure	Other firms with $100B to $250B total assets	Firms with less than $100B in assets
Capital	Stress testing: Company run (DFAST)				
	Stress testing: Supervisory*		Annually	Every 2 years	
	TLAC/long-term debt				
	G-SIB surcharge				
	Advanced/expanded approach				
	Countercyclical capital buffer				
	AOCI opt-out not available				
	Supplementary leverage ratio				
	Tier 1 leverage ratio				
Liquidity	Liquidity coverage ratio and net stable funding ratio	Full	Reduced – 85%; 100% if wSTWF > $75B	Reduced – 70% if wSTWF > $50B	
	Liquidity stress tests	Monthly	Monthly	Quarterly	
	Liquidity risk management			Tailored	
	Liquidity buffer				
	FR 2052a reporting	Daily	Monthly; daily if wSTWF > $75B	Monthly	
Others	SR 21-3/CA 21-1: Supervisory Guidance on BoD's Effectiveness				
	Single-counterparty credit limits				
	Resolution plan submissions				

CUSO-specific requirement | Requirement applies | Proposed changes | Requirement does not apply

Recently proposed regulatory changes, such as Basel III, support the view that regulators may place greater scrutiny on banks with more than $100 billion in assets. On the other hand, these changes appear to have a positive effect for banks already above that threshold: The move from Category IV to III would become less burdensome, theoretically making it easier for banks that have already passed $100 billion in assets to grow via M&A.

As the $100 billion asset threshold has become more onerous, the $50 billion asset threshold appears to have gone in the opposite direction in recent years. Since 2018, 16 banks have crossed the $50 billion asset mark, whether via M&A or organically, compared with just three banks that did so from 2012 to 2018.[18] Crossing $50 billion in assets does carry some increased regulatory expectations, but banks appear to be less concerned about those than the jumps required at $10 billion and $100 billion, which may have reduced deal inhibitions among the smaller institutions.

The bank M&A market is expected to recover and attract the attention of US banking regulators, after a solid first six months of 2024 that delivered some noteworthy results and insights. As these events continue to unfold, they will likely have an effect on future deal activity.

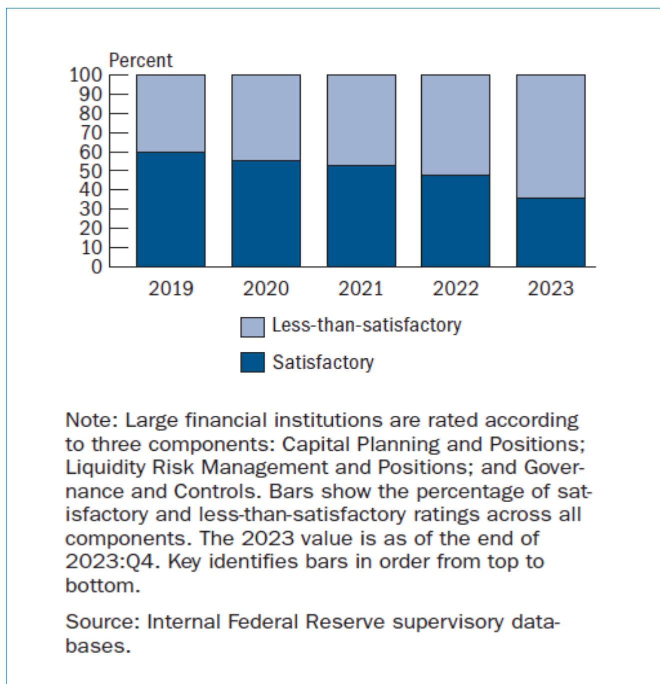
Looking ahead to the remainder of 2024 and 2025

As it stands, we believe the future is murky but improving. An uncertain economic outlook and interest rate environment, recovering bank valuations, proposed changes to regulators' bank merger guidance and processes, pending changes to the broader bank regulatory landscape, a presidential election, and lingering effects from some key 2023 events are combining to muddy the current waters:

- Even as the economy and markets show signs of strength, the FRB's ongoing grapple with persistently higher inflation means a longer-than-expected wait for lower interest rates, making it harder to achieve price certainty when evaluating M&A deals.

- The number of outstanding supervisory findings for large banking organizations rose more than 30% between 2022 and 2023 with governance and controls making up approximately 66% of such findings. This level of enforcement action may create challenges for bank deals as banks focus on their own remediation activities and worry about inheriting a target's remediation portfolio, all drawing resources away from M&A.

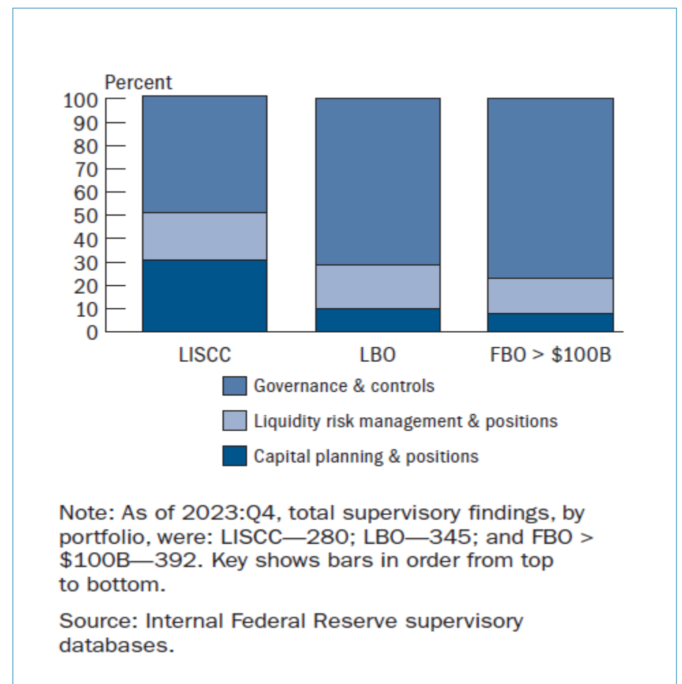
Fig. 5: Ratings for large financial institutions



Note: Large financial institutions are rated according to three components: Capital Planning and Positions; Liquidity Risk Management and Positions; and Governance and Controls. Bars show the percentage of satisfactory and less-than-satisfactory ratings across all components. The 2023 value is as of the end of 2023:Q4. Key identifies bars in order from top to bottom.

Source: Internal Federal Reserve supervisory databases.

Fig. 6: Outstanding number of supervisory findings, by category, large financial institutions



Note: As of 2023:Q4, total supervisory findings, by portfolio, were: LISCC—280; LBO—345; and FBO > $100B—392. Key shows bars in order from top to bottom.

Source: Internal Federal Reserve supervisory databases.

- The future of the Basel III Endgame in the United States remains undecided, as the FRB rethinks the implementation of the capital rules, which would likely have a significant effect on the industry (especially on banks at or around the $100 billion asset threshold). This makes it difficult for acquirers to evaluate revenue synergies and future capital requirements.

- As discussed earlier in this report, the federal banking regulators have proposed changes that will likely make deal approvals more difficult and take longer to obtain. Adding uncertainty is the upcoming presidential election, which may influence the timelines for these proposals becoming final rules or may lead to a more dramatic shift in regulatory priorities. Without clear and final rules in place, banks will likely be hard-pressed to evaluate whether a deal will be approved with any degree of certainty.

- Increased regulatory scrutiny means longer time frames for approvals, which increases the risk of deals falling through after announcement. Acquirers and targets will likely press for more favorable terms in purchase agreements (ticking fees, break clauses, etc.) to hedge these risks, making it harder to find common ground and strike deals.

- Many banks are using other levers such as booking model and legal entity optimization (i.e., evaluating how lines of business use entities) to progress their US strategy. Maximizing profitability, reducing reliance on higher cost funding, and simplifying the US legal entity structure (and potentially the regulatory footprint) are some potential benefits of these initiatives that can set up banks for future M&A success. These can also be M&A-like—for example, if a bank were to move a product's booking point from one legal entity to another—and so can be good practice for the types of considerations faced in future M&A.

The good news is that most of the aforementioned factors have predictable end dates on the horizon. For example, the outcome of the presidential election later this year will provide clarity on regulatory direction of travel and the proposed updates from the OCC, FDIC, and FRB. Banks can also expect clarity around Basel III Endgame as the FRB finalizes rules ahead of the July 2025 effective date. As these dominoes fall and uncertainty abates, banks will likely be able to evaluate and make deals with considerably more clarity, which we expect will correlate to an uptick in M&A.

Conclusion

The first half of 2024 has shown promising signs for a bank M&A market rebound from the lows of 2023, and it appears the dealmaking will continue to strengthen as economic and regulatory uncertainties subside. As we move forward through the second half of the year and into 2025, it will be key for prospective acquirers and sellers to stay informed on the latest regulatory updates and to keep their integration playbooks sharp in an effort to achieve the smoothest path from deal to close to integration.

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