2019 Banking and Capital Markets M&A Outlook
An open door for deal making
Contents

2018 review; 2019 outlook

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Introduction

The door is opening for increased banking and capital markets mergers and acquisitions (M&A) activity in 2019—many organizations are willing and prepared to do deals. Numerous drivers for M&A in 2018—tax reform, business-friendly regulatory environment, increasing interest rates, and ample capital levels—look to remain in place; however, building macroeconomic pressures—including being deep into the current market cycle—may foreshadow a potential downturn as soon as 2020. Organizations contemplating both market opportunities and uncertainties will need to decide: Is 2019 the time to shed assets we don’t need, buy capabilities we want, and get our M&A house in order?
2018 review; 2019 outlook

Banking

2018 deal making was not at the level we expected given positive macroeconomic trends—in particular, a strong tailwind from corporate tax relief, lifting of systemically important financial institution (SIFI) thresholds, rising interest rates—which would usually support a hot banking M&A market. There were a few big deals but, in general, the year saw more selling and buying of small assets that impact banks’ ancillary services: recordkeeping, funds administration, payments processing, and similar.

With 258 announced deals as of December 31, banking M&A volume in 2018 was on par with 2017’s total of 256 transactions. 2018 average deal value, at $191 million, was up markedly from the prior year’s $157 million (figure 1). At least five deals topped the $1 billion mark, with the largest—Fifth Third Bancorp’s acquisition of MB Financial, Inc.—coming in at $4.6 billion.

Banking: 2018 top transactions by deal value

<table>
<thead>
<tr>
<th>Target</th>
<th>Buyer</th>
<th>Announcement date</th>
<th>Value (Sm)</th>
<th>Price/TBV</th>
<th>Region</th>
</tr>
</thead>
<tbody>
<tr>
<td>MB Financial, Inc.</td>
<td>Fifth Third Bancorp</td>
<td>May 21, 2018</td>
<td>$4,617</td>
<td>271%</td>
<td>Midwest</td>
</tr>
<tr>
<td>FCB Financial Holdings, Inc.</td>
<td>Synovus Financial Corp.</td>
<td>July 24, 2018</td>
<td>$2,869</td>
<td>229%</td>
<td>Southeast</td>
</tr>
<tr>
<td>Beneficial Bancorp, Inc.</td>
<td>WSFS Financial Corporation</td>
<td>August 8, 2018</td>
<td>$1,507</td>
<td>173%</td>
<td>Mid-Atlantic</td>
</tr>
<tr>
<td>State Bank Financial Corporation</td>
<td>Cadence Bancorporation</td>
<td>May 13, 2018</td>
<td>$1,372</td>
<td>248%</td>
<td>Southeast</td>
</tr>
<tr>
<td>Guaranty Bancorp</td>
<td>Independent Bank Group, Inc.</td>
<td>May 22, 2018</td>
<td>$1,037</td>
<td>319%</td>
<td>Southwest</td>
</tr>
</tbody>
</table>

Source: SNL Financial and S&P Global Market Intelligence, as of December 31, 2018

Note: Average deal size is based on disclosed deal values. 37%, 39%, 33%, 34%, and 39% of reported deals did not disclose deal values for FY14, FY15, FY16, FY17, and FY18, respectively.
From a regional perspective, Midwest deals were a bigger piece of the pie in 2018—banks there posted 114 transactions, 25 more than in 2017. The Midwest’s composition of smaller, targetable banks is a likely reason for its higher deal volume. The Southeast region followed with 52 deals, down from a four-year high of 70 in 2017 (figure 2).1

Some regional banks chose to sit out deal making in 2018—despite new government policies that eased regulatory burdens in the form of reduced costs or lower capital levels—as they reassessed their market position and strategy with the goal of maximizing shareholder value given the changing landscape. Positive macro conditions may increase regionals’ participation in 2019.

Deal valuations continued to rise in 2018. Combined, the regions saw an increase in recorded price/total book value (TBV) of 171 percent, up from 165 percent in 2017. Valuations were higher in the West; similar in the Midwest and East (figure 3).

Figure 2. Banking M&A volume by target region

Source: SNL Financial and S&P Global Market Intelligence, as of December 31, 2018
Note: Average deal size is based on disclosed deal values. 37%, 39%, 33%, 34%, and 39% of reported deals did not disclose deal values for FY14, FY15, FY16, FY17, and FY18, respectively.
Building on a multiyear trend, the majority of 2018 banking M&A deals occurred at the small-bank level, with most acquisition targets holding $1 billion or less in assets (figure 4). In one particularly active area, the number of 2018 deals in the $500 million–$1 billion range—30—outpaced those from the past three years.
Numerous community banks have become serial acquirers over the past several years and, as a result, have significantly grown in scale, spreading increased regulatory compliance and technology upgrades across a larger platform. Among such acquirers are Heartland Financial USA, Inc. (eight acquisitions between December 2014 and June 2018, 64 percent asset growth); Simmons First National Corporation (five acquisitions, 145 percent asset growth); Independent Bank Group, Inc. (four acquisitions, 142 percent asset growth); Pinnacle Financial Partners (four acquisitions, 106 percent asset growth); and CenterState Bank Corporation (three acquisitions, 123 percent asset growth).4

Typical community bank buyers are targeting sellers who are both heavy in urban areas and who sit in the buyer’s current footprint in order to drive synergy benefits to justify current deal prices. Because assets in urban markets typically are priced at a premium, deal rationale is likely to model cost takeout of targets with branch density/overlap in the footprint. Cost takeout in nonurban and out-of-footprint areas is more problematic; the Community Reinvestment Act prevents certain branch closures, thus reducing synergy opportunities upon acquisition.

Figure 4. Banking transactions by asset size

Source: SNL Financial and S&P Global Market Intelligence, as of December 31, 2018
What we expect to see for 2019

**More economic uncertainty.** Late-2018 stock market gyrations have put many organizations on edge; however, they may have an upside in 2019: Lower bank valuations might broadly entice sidelined buyers to engage in deal making, especially those who have seen their stock prices increase in value relative to peers. Still, bank stress tests are projecting a slowdown in economic activity over the next 18–24 months. On the borrower side, a cooling economy may lead to more defaults, more charge-offs, and more pressure on bank earnings. How might this translate into M&A? Larger banks may continue to shed noncore assets and markets; smaller banks may consolidate. The prospect of a slowdown coupled with pent-up demand and a pro-business regulatory environment may encourage players with healthy capital levels and strong stock valuations to move quickly to fill gaps in their geographic footprint, product portfolio, or technology capabilities.

As is typically the case with M&A, timing is everything: Banks with a dimmer view of their ability to return in excess of cost of capital may sell in entirety or shed certain assets prior to an expected slowdown—an attractive proposition to foreign buyers that want to establish or grow their presence in the United States and have a longer perspective on investments. In general, well-capitalized institutions typically look for strategic acquisition targets to grow or diversify their portfolio, but timing is crucial. If a buyer is going to make a move—especially a big one—they are likely to do so in the first part of 2019 while conditions remain steady, or wait until after the anticipated slowdown and subsequent recovery.

**Small regional ripple effect.** M&A activity at the low end of the banking spectrum is expected to eclipse top-end deal volume in 2019. Banks between $10 and $25 billion in assets may either become sellers to banks of $50–$250 billion—making a very robust market—or they may remain buyers and continue picking off banks in the $2–$5 billion range. If they do become sellers, there is the knock-on effect of more small, well-capitalized players trying to roll-up banks to fill that void. There is potential for some moves by large regional banks and foreign-owned banks, as the benefits of tax reform continue to play out and pricing comes more into line, attracting investment within and into the United States.
Specialty finance

With most of the low-hanging fruit picked during GE Capital’s 2015 sell-off, specialty finance M&A in 2018 was limited primarily to one-off plays for specific asset-generators and asset types. The year saw 73 specialty finance deals, down from 96 in 2017. However, average deal value increased from 2017, up from $232 million to $406 million (figure 5).  

2018’s top-five specialty finance transactions by deal value spanned the energy, mortgage, automotive, consumer finance, and investment industries. The year’s largest deal involved a familiar name: General Electric, which sold its energy finance project debt business to Starwood Property Trust for $2.1 billion (figure 5).

### Figure 5. Specialty finance M&A transactions and average deal value

![Graph showing number of deals and average deal value from 2014 to 2018]

### Table: Specialty finance: 2018 top transactions by deal value

<table>
<thead>
<tr>
<th>Target</th>
<th>Buyer</th>
<th>Announcement date</th>
<th>Value ($m)</th>
<th>General industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>GE’s energy project finance debt business</td>
<td>Starwood Property Trust, Inc.</td>
<td>August 8, 2018</td>
<td>$2,163</td>
<td>Energy finance</td>
</tr>
<tr>
<td>Nationstar Mortgage Holdings Inc.</td>
<td>WMIH Corp.</td>
<td>February 13, 2018</td>
<td>$1,928</td>
<td>Mortgage</td>
</tr>
<tr>
<td>Certain assets and liabilities of Wells Fargo</td>
<td>Popular, Inc.</td>
<td>February 14, 2018</td>
<td>$1,700</td>
<td>Auto</td>
</tr>
<tr>
<td>OneMain Holdings, Inc.</td>
<td>Apollo Global Management LLC</td>
<td>January 4, 2018</td>
<td>$1,428</td>
<td>Consumer finance</td>
</tr>
<tr>
<td>Golub Capital Investment Corporation</td>
<td>Golub Capital BDC, Inc.</td>
<td>November 28, 2018</td>
<td>$1,077</td>
<td>Investment</td>
</tr>
</tbody>
</table>

Source: SNL Financial and S&P Global Market Intelligence, as of December 31, 2018  
Note: Average deal size is based on disclosed deal values. 57%, 53%, 60%, 59%, and 63% of reported deals did not disclose deal values for FY14, FY15, FY16, FY17, and FY18, respectively.
Private equity (PE) firms in 2018 appeared to have lost some of their enthusiasm for specialty finance M&A; deal volume was about half of 2017's total (figure 6). Among possible reasons: Many PE firms have already used this sector as a means of investing in the financial services industry, given specialty finance’s lighter regulatory requirements; inventory is, therefore, low because many of the firms are already PE portfolio companies. Also, some PE deals in this space haven’t turned out as well as expected. Roll-ups and consolidations in mortgage origination and servicing, for example, have had tepid results. In addition, most PE firms prefer to buy assets early in the credit cycle, not in the eighth inning when assets are fully priced. They are likely to be even less inclined to buy if economic conditions are signaling a potential downturn.

Figure 6. Specialty finance transactions with private equity investment involvement

Source: SNL Financial and S&P Global Market Intelligence, as of December 31, 2018
What we expect to see for 2019

The coming year’s specialty finance M&A landscape is likely to mirror that of 2018: lower deal volume, additional consolidation in the loan origination and servicing markets, and scattered purchases of unique asset types. Deep-pocketed PE firms will likely be watching for downturn-generated opportunities to scoop up distressed assets.

There may be potential for increased M&A activity in two areas: If they haven’t already done so, large banks under intense regulatory scrutiny may want/have to unwind certain businesses that generate undue risk. Also, shrinking retailer numbers may allow banks and specialty finance (as well as PE and insurance) companies to acquire and white-label their credit card portfolios, run them off, and leverage scale and well-oiled processes to operate them at a much lower cost.

An area that may present opportunities for distressed investment includes mortgage-related and home-loan origination businesses. The 2017 Tax Cuts and Jobs Act, coupled with the rising rate environment, is making it more difficult for many families looking to buy a home. State tax deductions, which include income taxes and property taxes, are limited to $10,000. For many in higher-tax states, such as California or New York, this can be a severe restriction on tax deductions. This coupled with higher mortgage rates is likely to result in lower volume over the coming years.
Investment and wealth management

2018 investment management (IM) and wealth management M&A metrics were somewhat of a study in contrasts: The number of reported transactions—192—was down considerably from 2017’s five-year high of 252, settling below 2015 levels (figure 7). Volume also skewed heavily to asset management (136) versus broker-dealer transactions (56) (figure 8). Conversely, average deal value jumped from $285 million in 2017 to $514 million in 2018 (figure 7).

Figure 7. Investment and wealth management transactions and average deal value

Source: SNL Financial and S&P Global Market Intelligence, as of December 31, 2018
Note: Average deal size is based on disclosed deal values. 73%, 76%, 77%, 85%, and 84% of reported deals did not disclose deal values for FY14, FY15, FY16, FY17, and FY18, respectively.
Figure 8. Investment and wealth management transactions

<table>
<thead>
<tr>
<th>Year</th>
<th>Asset manager</th>
<th>Broker-dealer</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>68</td>
<td>94</td>
</tr>
<tr>
<td>2015</td>
<td>137</td>
<td>58</td>
</tr>
<tr>
<td>2016</td>
<td>142</td>
<td>65</td>
</tr>
<tr>
<td>2017</td>
<td>178</td>
<td>74</td>
</tr>
<tr>
<td>2018</td>
<td>136</td>
<td>56</td>
</tr>
</tbody>
</table>


Investment and wealth management: 2018 top transactions by deal value

<table>
<thead>
<tr>
<th>Target</th>
<th>Buyer</th>
<th>Announcement date</th>
<th>Value ($m)</th>
<th>AUM (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oppenheimer Funds, Inc.</td>
<td>Invesco Ltd.</td>
<td>October 18, 2018</td>
<td>$5,714</td>
<td>$223,037</td>
</tr>
<tr>
<td>Financial Engines, Inc.</td>
<td>Hellman &amp; Friedman LLC</td>
<td>April 30, 2018</td>
<td>$3,025</td>
<td>$169,300</td>
</tr>
<tr>
<td>Cetera Financial Group, Inc.</td>
<td>Genstar Capital, LLC</td>
<td>July 17, 2018</td>
<td>$1,500</td>
<td>$30,000</td>
</tr>
<tr>
<td>Investment Technology Group, Inc.</td>
<td>Virtu Financial, Inc.</td>
<td>November 7, 2018</td>
<td>$1,103</td>
<td>N/A</td>
</tr>
<tr>
<td>USAA Asset Management Company/USAA Transfer Agency Company</td>
<td>Victory Capital Holdings, Inc.</td>
<td>November 6, 2018</td>
<td>$1,000</td>
<td>$69,200</td>
</tr>
</tbody>
</table>

Source: SNL Financial and S&P Global Market Intelligence, as of December 31, 2018

Note: Average deal size is based on disclosed deal values. 73%, 76%, 77%, 85%, and 84% of reported deals did not disclose deal values for FY14, FY15, FY16, FY17, and FY18, respectively.
What’s behind 2018’s numbers? Diminished deal volume may be due to a lack of desirable targets—the result of rapid consolidation in wealth management and distribution over the past two to three years.

Meanwhile, banks’ and investors’ pursuit of fee-based income has driven up IM deal values in general—although, if the stock market continues to be shaky people may be less willing to invest. Finally, 2018 saw several very big deals: Invesco Ltd.’s acquisition of Oppenheimer Funds, Inc., for $5.7 billion; Hellman & Friedman LLC’s purchase of Financial Engines, Inc., for $3 billion; and Genstar Capital LLC’s acquisition of Cetera Financial Group, Inc., for $1.5 billion9 (figure 8).

PE firms’ presence in sector M&A continues to grow, particularly in asset management transactions. PEs are also becoming more active players on the wealth management and distribution side (figure 9).

Figure 9. Investment and wealth management transactions with private equity involvement

Source: SNL Financial and S&P Global Market Intelligence, as of December 31, 2018
What we expect to see for 2019

IM organizations are being hit with the double whammy of reduced rates and slower growth in assets under management (AUM) and increasing costs from front- and middle-office technology upgrades and regulatory compliance. Some have consolidated to build much-needed scale and spread the costs of doing business. Top- and bottom-line pressures are also making many banks question how much they want to play in the space; some are divesting alpha-heavy investments to pure-play IM firms. In 2019 we expect to see these trends continue, resulting in fewer but larger deals in the investment and wealth management space similar with 2018. We also anticipate some bolt-on acquisitions to bolster firms’ technology infrastructures and drive operating cost efficiencies, as well as certain value plays in which investment managers may be willing to entertain a lower sale price as part of streamlining their portfolio in advance of a potential economic downturn. Also worth noting is the potential for multi-boutique models to evolve, potentially putting more franchises on the market.
Fintech

In the maturing fintech marketplace smaller entities are either consolidating or being acquired by financial services organizations seeking to improve their digital customer experience, streamline middle- and back-office operations, and take cost out of the system. Among sought-after technologies are cognitive and robotics to automate repetitive, low-level tasks; digital lending; financial media and data solutions; and payment processing. Meanwhile, many fintech firms of scale are evolving from startups to mature institutions; their M&A activity is about rounding out services—for some, this includes acquiring smaller banks, securing regulatory approval for a banking charter to attract deposits and investments, or creating new partnerships with existing banks to source and originate deals. In one example of a fintech roll-up strategy, PE firm CVC Capital Partners Asia Fund IV acquired OANDA Global Corporation, an online retail trading platform, currency data, and analytics company, in May 2018. Following the change in ownership, OANDA acquired GFM Solutions Group, a risk management and financial reporting company that offers software as a service (SaaS) solutions that help to mitigate currency risk and optimize efficiencies.

Fintech deal volume declined slightly in 2018—179 reported deals, compared with 188 in 2017—but average deal size rocketed from $268 million to an impressive $1.1 billion, headlined by Blackstone’s $17 billion acquisition of a 55 percent stake in Thomson Reuters’ risk business (figure 10). And, as in recent years, PE involvement in fintech M&A continues to be high and rising (figure 11).

Figure 10. Fintech M&A transactions and average deal values

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of transactions</th>
<th>Average value ($m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>188</td>
<td>$232</td>
</tr>
<tr>
<td>2015</td>
<td>206</td>
<td>$550</td>
</tr>
<tr>
<td>2016</td>
<td>197</td>
<td>$319</td>
</tr>
<tr>
<td>2017</td>
<td>188</td>
<td>$268</td>
</tr>
<tr>
<td>2018</td>
<td>179</td>
<td>$1,180</td>
</tr>
</tbody>
</table>

Fintech: 2018 top transactions by deal value

<table>
<thead>
<tr>
<th>Target</th>
<th>Buyer</th>
<th>Announcement date</th>
<th>Value ($m)</th>
<th>General industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thomson Reuters financial &amp; risk business</td>
<td>Blackstone Group</td>
<td>January 30, 2018</td>
<td>$17,300</td>
<td>Financial media &amp; data solutions</td>
</tr>
<tr>
<td>Sedgwick Claims Management Services, Inc.</td>
<td>Carlyle Group L.P.</td>
<td>September 12, 2018</td>
<td>$6,700</td>
<td>Insurance &amp; health care technology</td>
</tr>
<tr>
<td>athenahealth, Inc.</td>
<td>Investor group</td>
<td>November 12, 2018</td>
<td>$5,649</td>
<td>Insurance &amp; health care technology</td>
</tr>
<tr>
<td>Dun &amp; Bradstreet Corporation</td>
<td>Investor group</td>
<td>August 8, 2018</td>
<td>$5,458</td>
<td>Financial media &amp; data solutions</td>
</tr>
<tr>
<td>DST Systems, Inc.</td>
<td>SS&amp;C Technologies Holdings, Inc.</td>
<td>January 11, 2018</td>
<td>$5,131</td>
<td>Investment and capital markets tech</td>
</tr>
</tbody>
</table>

Note: Average deal size is based on disclosed deal values. 59%, 57%, 67%, 65%, and 68% of reported deals did not disclose deal values for FY14, FY15, FY16, FY17, and FY18, respectively.
Figure 11. Fintech transactions with private equity involvement

What we expect to see for 2019

Fintech sector M&A activity should remain steady in 2019 given the ever-growing number of entrants, with deal types illustrating a maturing market. As a hedge against growing competition, we expect larger fintechs to continue making opportunistic buys that can provide scale and enable them to own the end-to-end customer experience across multiple product offerings. We may even see mergers of equals as these firms seek to drive more volume, improve margin, and diversify their products and/or customer base.

Fintechs that underwrite loans targeting underserved markets may be motivated to acquire or partner with institutions that enable them to secure additional funding sources that can help ensure they have liquidity and access to a more stable funding base during a possible downturn.

Finally, some financial institutions may acquire and use selected fintech capabilities internally and then sell those services to others or invest minority stakes in numerous players. By doing so they may remain close to the innovation ecosystem and be advantageously positioned should more significant M&A opportunities lie ahead with potential winners. While the wild enthusiasm with blockchain has tapered off, the financial services industry continues to sail toward a blockchain future. However, the energy might now rest with artificial intelligence (AI) and cloud, as they are already transforming many aspects of the industry in significant ways.13

Source: SNL Financial and S&P Global Market Intelligence, as of December 31, 2018
Trends and drivers of 2019 M&A activity

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

1. Smaller regionals may impact broader M&A market

Banking M&A at the smaller regional level may be a catalyst for broader M&A action. Many larger regional players have remained on the sideline as they reassessed their market position and strategy to maximize shareholder value. However, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), signed into law in May 2018, increased SIFI asset thresholds from $50 billion to $250 billion16—and may whet the appetite of banks in this range to do deals. The challenge is that many of the banks in their target size—these smaller regionals around $10–$20 billion—have considered themselves to be buyers until recently (and many still do) and had been eyeing banks with $2–$5 billion as potential growth vehicles.

For most regionals of $10–$20 billion, financial performance, relative stock price values, and capital levels may be leading indicators of whether they will be future buyers or sellers. Those with a better-than-average efficiency ratio (under ~58 percent), strong P/TBV ratios, and excess tier-one capital (more than 9 percent) may be better positioned to complete a sizable acquisition—and avoid being acquired themselves by super-regional players looking to expand due to relaxation of SIFI.

Numerous market conditions could be priming the pump for ramped-up regional bank M&A in 2019:

• A lowered corporate tax rate has lifted bank earnings and is leaving many regional banks flush with cash to invest in capital activities including M&A.

• A shift in the regulatory landscape, including changes in leadership at regulatory agencies and moderating approaches to supervision and policy changes to ease regulatory burdens, are sparking renewed interest in M&A.

• Increasing interest rates are providing improved yields to banks’ investable assets.

• Competition for deposits, evident by the increases in deposit betas, is spurring M&A activity among regional and community banks.

• Reduced bank valuations (the KBW Nasdaq Bank Index decreased from a 2018 high of 116.52 on February 1 to a low of 80.78 on December 24)15 are presenting a potential opportunity to acquirers, as valuations trend in a more predictable range.

We have noticed indications that many regional banks may be preparing for a more active year. For example, a number have been hiring into their corporate development groups and conducting internal analyses of their M&A functions to make sure they have the necessary disciplines and capabilities to do transactions. Regionals’ buy-or-sell conundrum needs to shake out for deal volume to pick up; however, there are franchises out there that fit the bill, especially in certain areas of the country.

While the number of banks with $2–$20 billion in assets has grown modestly in the last 10 years—from 184 in 2008 to 202 in 201716—there have been noticeable shifts in where these banks are located, signaling potential regional M&A opportunities. The number of banks of size has grown in the East—especially in Massachusetts, New Jersey, and Florida—likely due in part to the national banks having heavy preexisting market share in this region, allowing for less M&A of scale and more organic capital formation. Conversely, the number of $2–$20 billion banks in certain Midwest and western states has dwindled from 2008 levels.17 For those banks that might be eyeing acquisition targets in these regions, there are fewer targets than in the East, likely impacting valuations and deal-making competition.

Several community banks have grown their asset base significantly over the past three to four years through acquisitions. We expect this trend to move moderately upmarket, with larger community players focused on adopting this strategy. They should prepare to move quickly and decisively because, depending on the market, the number of targets that meet their appetite might be shrinking.

2. Tax and regulatory relief

The US tax reform bill, signed into law on December 22, 2017, lowered the US corporate tax rate to a flat 21 percent and provided a considerable lift to first-quarter 2018 bank earnings. As a result, many banks (primarily national and regional players; less so community banks) were extra flush with cash in 2018 to invest internally or in capital activity including M&A.

Also serving as a banking and capital markets M&A enabler: a business-friendly regulatory environment. As detailed in the Deloitte 2019 Banking Regulatory Outlook, legislators and regulatory agencies have been shifting their focus from creating new regulations to reviewing and refining requirements that are already on the books. Among actions that support potential banking and capital markets M&A:

• Looking to make the Community Reinvestment Act (CRA) easier: Passed in 1977, the CRA statute could not have anticipated
Increasing regulatory events around BSA/AML:

The Bank Secrecy Act (BSA) was passed in 1970, but because of changing technologies and shifting areas of anti-money laundering (AML) focus, firms have found AML compliance to be problematic over the years. Recently, there have been legislative and regulatory proposals to reform AML programs; however, nothing concrete has yet happened. Ideas that could simplify compliance while adhering to the intent of AML include: raising the $10,000 threshold for filing Currency Transaction Reports and the $5,000 threshold for filing BSA/AML-related Suspicious Activity Reports; facilitating and encouraging increased AML information-sharing among financial firms; and improving communication and feedback from government agency recipients to the filing institutions.

Fintech regulatory events:

In July 2018 the US Treasury Department issued A Financial System That Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation, which outlined core principles and recommendations for a fintech regulatory framework. One key recommendation was for the OCC to move forward with the national fintech charter. Hours later, the OCC announced it would begin accepting applications for special purpose bank charters for fintech firms that offer bank products and services.

We expect that pro-business tax and regulatory conditions will extend through 2019 and provide opportunities for banks (as well as IM firms and fintechs) to pivot to inorganic growth through acquisitions, investments, and partnering arrangements. The new Democrat-controlled House Financial Services Committee is likely to broadly focus its legislative agenda on protecting consumers and investors, preserving financial sector stability, and encouraging responsible innovation in financial technology. The Republican-controlled Senate will likely stay the course, focusing its legislative agenda on remaining refinements not already addressed in EGRRCPA.

One important takeaway from the United States’ easing of financial services–related regulatory burdens is that the long-awaited “pendulum swing” is now occurring, albeit in a very measured way. Although these generally appear to be positive developments, financial services organizations that may be contemplating upcoming M&A should confirm that they and their targets employ sound risk frameworks to avoid running afoul of regulators. And regardless of what future changes lawmakers and regulators might make, safety and soundness across key regulations (e.g., CRA, AML) and overall regulatory standing matter. Organizations should continue to strive to address regulatory feedback and ensure effective risk and compliance programs so that they can meet supervisory expectations.

3. Digital decisions

Build, buy, invest, partner? Banking and capital markets organizations have been eyeing and pursuing numerous options to secure the digital capabilities they need to differentiate and grow. We expect their digital decisions in 2019 to further evolve financial institutions’ relationships with fintechs and strengthen their position against the anticipated market entry of the world’s largest technology companies.

Early in the digital era, many financial institutions may have looked upon fintechs as unwelcome market disruptors or threats to their customer and revenue base. Today, most have pivoted to more engaged and proactive collaboration. Many financial services firms are looking not merely to keep up with how fintechs are changing the industry; they are looking to become major players in shaping, financing, and using financial technology to fuel their own reinvention and growth. In one recent example, State Street Corporation, a leading provider of financial services to institutional investors, acquired Charles River Development. The combination is expected to create an open platform that connects the front, middle, and back office with one provider, and standardizes data and systems across multiple asset classes and the entire investment life cycle.

New and maturing fintechs offer tools, platforms, capabilities, and approaches to improve customer experience and bolster middle- and back-office operations. Fintechs are increasingly seen as the spark—and in some cases the engine—of true innovation and transformation within a growing number of financial institutions. For example, many banks and wealth management firms are looking for better ways to connect with their retail clients (especially the younger ones who have less brand appreciation for financial institutions) and grow deposits. Acquiring, investing in, or partnering with fintechs that offer a friendlier customer interface or more diverse, digitally powered product lines could become a bottom-line boon.

One of fintech’s biggest dilemmas: Should we become a bank? We already deal with some of the same financial regulations as banks (e.g., AML, BSA); we just can’t have deposits or release funds. But do we want to operate within all of banks’ regulatory restrictions? Would it be easier and more lucrative to partner with a technology giant to...
offer a financial product? Deloitte views bank/fintech partnerships, primarily on the lending or payments side, as a potentially mutually beneficial solution. Banks would continue to hold the deposits and provide wholesale funding; the fintechs would provide access to their customer base and the technology to underwrite more effectively and efficiently. It's a one-stop shop that can offer customers security and efficiency.

While financial services firms and fintechs look for ways to safeguard their revenue and relevancy in the digital future, big technology players appear to be laying the groundwork for their entry into the industry. Technology giants’ strength and value lie in their distribution channels, analytics capabilities, and customer relationships: Will they leverage these assets to disrupt traditional banking and investment product and service distribution? Might they seek to become financial institutions themselves? Or could they choose to collaborate with, rather than disintermediate, financial institutions?

Collaboration could be tech companies’ initial path to market entry. Rather than deal with the regulatory restrictions that are part and parcel of being a financial institution, technology giants may decide to partner with banks and IM firms to create a larger, more cost-efficient, product distribution channel. They could, for example, provide the digital platform or “marketplace” to sell white label or co-branded products that are provided by a top-tier bank.

Other advantages of collaborating versus competing: Tech companies won’t have to assemble an in-house team of banking and investment experts or develop the products they want to sell. This is a plus for banks and IM firms, as well; having access to a large digital platform, established customer base, and (potentially) tech company funding could allow banks and investment firms to cost-effectively incubate new products and services—especially those targeted to younger consumers. Tech companies already have mastered the challenge of providing an easy, direct-to-consumer experience; financial services firms can learn from that. The challenge for banks in this scenario is that they sacrifice “owning the customer” and leave themselves exposed down the road to be disintermediated should those who own the customer today want to integrate vertically and own the entire value chain.
Approaching the tipping point: Upside/downside scenario planning

Financial institutions’ recent M&A scenario planning likely has reflected upside influences including a sustained bull market, tax reform, interest rate increases, competition for deposits, digital investments, and pro-business regulations. In 2019, we expect that many of these positive factors for continued M&A will remain in place. However, signs of a potential credit cycle turn/economic slowdown as early as 2020 are increasing, so banks, PE firms, and other financial institutions should model both the upside and downside impacts of the following issues in their strategic planning:

- Tax relief may turn out to be more a hindrance than a boon; we are seeing fewer companies borrowing from banks because they are flush with money. Is it a short-term blip as tax relief works its way through the system, or an indication that companies are stockpiling capital and avoiding leverage as a hedge against a coming potential recession that may depress growth and valuations?

- The market has moved on from the post-election stock market appreciation that raised all bank stocks to tracking banks’ individual performance and reflecting that in the stock price. Although valuations for some players remain on the high side, continued market choppiness is creating pressure on company leaders considering M&A in 2019 to set their plans in motion. However, many banks remain on the fence about buying or selling. To aid decision making, executives should consider what their performance indicators are saying about the health of the business: Banks with stock price valuations above peers, strong efficiency ratios, and a secure, strong capital base may look for value-priced acquisitions that are available both pre- and post-downturn to, in part, monetize the valuation delta now. Conversely, banks with a more limited capital base, poor stock values relative to peers, and a portfolio susceptible to tightening credit and loan defaults in a downturn may decide to act and sell to a large regional bank or foreign buyer looking to expand their footprint in 2019.

- As interest rates have continued to move up, competition for deposits among banks, money market funds, and other short-term investments has intensified. Deposit betas (the change in deposit interest rates relative to the change in market interest rates) are increasing, banks’ ability to grow deposits is becoming more difficult, and the long-expected margin expansion is surprisingly hard to provide. Banks that can navigate this rate environment ably should emerge as better-positioned acquirers via their stock currency or sellers through the attractiveness of their funding base and associated spreads.

- A supportive regulatory environment that opens the door to increased M&A may, ironically, create a deal bottleneck. Regulators only have so many resources to process applications and review diligence to facilitate merger approvals. Deal planning should factor in the possibility of regulatory review delays.

The above factors bear watching as banks and other financial services organizations progress through their strategic M&A planning. Their resulting decisions—to be buyer, seller, or sideline observer—may tip the balance in favor of a stellar year for M&A or, conversely, a waiting game for economic clarity. In either case, organization leaders should remain alert to potential opportunities and have the tools, teams, and processes in place should M&A planning move to action. Firms that develop and hone these competencies today can be well positioned to execute the right deal tomorrow.
Endnotes

2. Ibid.
3. Ibid.
7. The number of reported IM M&A transactions tends to be low and skews toward public company deals because, by law, they must be disclosed.
9. Ibid.
15. KBW Nasdaq Bank Index, as of January 3, 2019.
17. Ibid.
22. Ibid.
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