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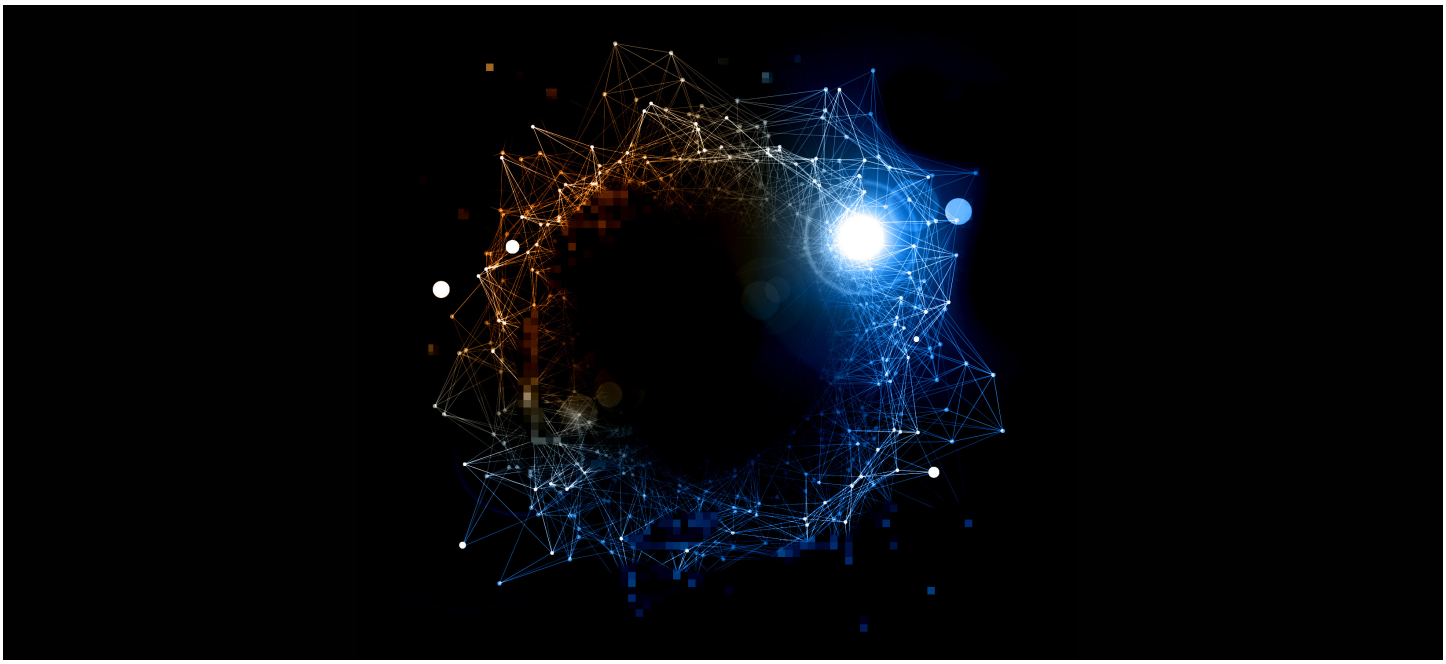

Special update to banking and capital markets M&A outlook, including potential impact of COVID-19

Moving forward into 2020, the drivers that were once favorable for continued mergers and acquisitions (M&A) activity in the banking and capital markets (B&CM) sector—regulatory landscape, enhanced earnings as a result of tax reform, desire for scale efficiency, and the search for digital capabilities—have been overshadowed by the recent market turmoil and uncertainty caused by COVID-19. COVID-19–induced concerns about the Federal Reserve Bank's (Fed) near-zero interest rate policy, the record-high unemployment rate, a volatile stock market, persistent rumblings about an economic recession, and the upcoming US presidential election are stirring up macro-level uncertainty that may temper bank M&A. In the short term, the uncertainty caused by COVID-19 may hinder or delay M&A activity. However, as in any crisis, there will be organizations that are prepared and positioned to act on strategic opportunities that may arise, and there will be organizations that are not. The following trends and drivers are expected to have an impact on M&A activity in the second half of 2020 and into 2021.

Respond, recover, and thrive

Bank boards and executives will remain cognizant of the lessons learned from the 2008 market turmoil as they progress through their strategic responses for COVID-19. Bank boards will need to stress-test and assess the impact of COVID-19 on their books with a focus on industries significantly affected and exposed to the situation (such as hospitality, travel, and energy) and the related impact to capital. Only once bank executives believe the "house is in order" will they look at strategic acquisitions to identify the high-priority targets that may need a strategic partner to navigate concerns around liquidity, capital, or credit exposure to industries disproportionately affected by COVID-19. These potential targets could be other banks, financial technology companies, specialty lenders, and other shadow-banking types of businesses. The current market turmoil could disproportionally reduce the availability of liquidity for specialty lenders, and these lenders will need to keep volume up to remain profitable. Furthermore, at the current prices, buyers may not be willing to issue shares. Similarly, sellers may be unlikely to accept current valuations. Moreover, buyers may take a cautious approach to pursue bank acquisitions, as they may bring in unknown credit risks at the start of a recession. While lower bank valuations triggered by recent events present an opportunity, a focused lens on M&A strategy with the right set of tools, teams, and processes to perform diligence, execute, and integrate will be needed.

Urgency in digital transformation

A key provision of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) is funding for small businesses through federally backed loans under a modified and expanded Small Business Administration (SBA) 7(a) loan guaranty program called the Paycheck Protection Program. The passage of the CARES Act represents an opportunity for regional and super-regional banks (along with other approved lenders) to facilitate distribution of these loans. However, with many banks' physical locations and branches temporarily closed, banks will need to ensure technological solutions drive customer engagement, facilitate document workflows, and effectively serve customers in the market. Even prior to social distancing, banks had realized they needed to improve their digital reach, and the current environment further exacerbates this need. The drive to enhance digital capabilities due to social distancing and the need to digitally develop banks' small and medium-sized enterprise (SME) client channel to anticipate increased usage of the SBA program distribution may act as a catalyst in banks' digital transformation. The situation could provide an opportunity not only to add scale, but also to transform legacy banks into agile digital-first banks of the future. In the long run, investors typically place a premium on digital-forward banks, driving up multiples for banks with efficient ecosystems of digital capabilities.

Navigating the current rate environment

When the Fed decreases interest rates, the banking industry takes a hit as loans that use benchmark rates immediately reprice lower, which affects banks' net interest income. When interest rates decline, asset-sensitive banks (measured by the one-year gap ratio)[1] are likely to struggle as their assets get repriced faster than their liabilities.

On a separate note, in 2019, the battle for the customer deposit base continued to intensify. The largest banks attempted to grow their deposit market share via organic customer acquisition; the regional and super-regional banks tried to develop through acquisitions. However, declining central bank interest rates in response to COVID-19 are likely to hurt savings account interest rates, on which some banks heavily rely to acquire customers and drive deposits. In contrast, this also provides an opportunity for banks to retain customers and develop a loyal customer base through holding the higher rates on deposits steady, despite the Fed's rate cut, and balancing the exposure to loss by implementing other asset-liability management strategies. 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.

Digital lenders may look at stable deposit funding base amid current market turmoil

Digital lenders rely on two types of funding—balance sheet funding and third-party investor funding. Balance sheet funding involves both originating and retaining loans on the lenders' balance sheets. The sources of financing to fund these loans include bank loans and warehouse lines of credit. On the other hand, under the third-party investor funding model, digital lenders may sell whole loans or securities to investors or enter into up-front agreements, enabling lenders and borrowers to connect directly, thereby avoiding intermediaries. Indications of falling credit in the economy are likely to significantly reduce the availability of liquidity to digital lenders until the assets are appropriately repriced. As such, the recent trend of acquiring retail banks with a strong deposit base may accelerate. For instance, according to their press release, LendingClub's recent acquisition of Radius Bank[2] provides it with a leading online deposit-gathering platform.

Sponsor-backed deals

Similar to 2008, private equity may actively seek minority stakes, including making a private investment in public equity (PIPE) as permitted by regulators, for companies with liquidity challenges or those looking for capital to finance acquisition opportunities. PIPE transactions were common during the financial crisis due to the speed at which they can be executed and are generally more attractive investment options during market turmoil than change-of-control transactions. Furthermore, before the recent market turmoil, private equity was fueling the rise of M&A in the registered investment advisers (RIA) sector. While we expect this trend to resurface once the COVID-19–related uncertainty has subsided, in the short run, private equity-driven RIA deals may come to a pause. On the near horizon, most private equity companies are expected to actively monitor their portfolio companies. Alternatively, the slowdown could be partially offset by an increase in sponsor-backed distressed and restructuring deals. Private equity firms with the agility to evaluate changing situations quickly can present

themselves as potential solutions for companies under stress and uncertainty. Furthermore, the current crisis may provide buying opportunities for platforms to accelerate bolt-on acquisitions as smaller players struggle with profitability and the ability to grow.

Government intervention and evolving regulatory environment

The Fed's actions (propping up the repo markets, backstopping money market funds, and lending to corporates directly), were not only massive in terms of their dollar size, but also broader and quicker than what was used during the financial crisis. These actions, combined with the CARES Act, should help bring stability to the equity markets in the near term. Separately, for any recent and near-term M&A deals, the regulatory approval process could also become more challenging and take longer than normal, as banking regulators become more concerned about credit quality deterioration and pro forma capitalization of merged banks in the current economic environment. Furthermore, companies should pay increased attention to the potential implications of the recent accounting, regulatory, and tax policy developments in response to the COVID-19 pandemic. From an accounting policy development standpoint, the Fed's interim final rule provides banking organizations that implement current expected credit loss (CECL) before the end of 2020 the option to delay for two years an estimate of CECL's effect on regulatory capital.[3] Furthermore, loan modifications for borrowers affected by COVID-19 will not generally be required to be treated as troubled debt restructurings,[4] including suspending determinations of "impairment for accounting purposes" for any such loan. On the regulatory front, the Federal Reserve Board (FRB) announced a temporary change to its supplementary leverage ratio rule, which would exclude US Treasury securities and deposits at federal reserve banks from the calculation of the rule for holding companies. The change would temporarily decrease tier one capital requirements by approximately two percent in aggregate.[5] Furthermore, the CARES Act temporarily eliminates counterparty lending limits, allowing a bank to make unsecured loans to any single counterparty (financial institutions and nonbank financial institutions), without limit, at the discretion of the Office of the Comptroller of the Currency (OCC), until the earlier public health emergency declaration is lifted or December 31, 2020.[6] These policy developments, including the option to delay for two years an estimate of CECL's effect on regulatory capital and the decrease in tier one capital requirements, may result in less stress on capital, albeit temporarily, and thus affect deal flow. As accounting, regulatory, and tax policy developments continue to evolve, banks should continue to assess their impact on financial modeling, including their impact on regulatory capital.

Alignment of corporate strategy with M&A strategy

Financial firms planning to engage in dealmaking should have a laser focus on the underlying financial, operational, and cash-earning condition of the seller. Organization leaders should carefully align their corporate and M&A strategies, 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 in the short term should be better positioned to execute the right deal opportunities. Due diligence should be viewed as an investment in identifying and quantifying exposures and gaining deeper clarity on sustainable business performance. Corporate loans with exposure to hospitality, travel, and energy industries are expected to face a greater risk of defaults. Similarly, consumer loans will experience increased delinquencies due to an extended period of unemployment. Due diligence efforts should be viewed as an integral part of dealmaking to assist bank boards in understanding the nuances of COVID-19 impact on acquirees' assets, including potential impact of the CECL standard, buildup of significant unrealized gains in most banks' investment portfolios, and potential goodwill impairment charges on valuation or modeling. A robust due diligence can help an organization price risks and exposures properly into a deal.

In summary

Once the dust settles, organizations contemplating M&A should continue moving forward, but also exercise caution. Drivers such as availability of a significant amount of dry powder, attractive valuations, a very favorable low-interest-rate environment, and access to financing and certain underlying dynamics that have been driving M&A to this point (such as the search for digital capabilities or the desire for scale efficiency) will likely continue. Moreover, the challenges COVID-19 has introduced and the heightening risk of a potential recession may drive strategic decisioning for banks struggling today as they look for the best shareholder value in the future, thus driving more potential sellers in the market. We may see transformational deals supported by a friendly regulatory environment that is pro-growth following an economic downturn. **Bank boards' resulting decisions—to be a buyer, seller, or an observer on the sidelines—will shape bank M&A activity in the second half of 2020 and into 2021.**

Endnotes

1. One-year gap ratio is defined as the total amount of assets scheduled to mature or reprice within one year minus the total amount of liabilities scheduled to mature or reprice within one year, divided by total assets.
2. https://radiusbank.com/lendingclub-announces-acquisition-of-radius-bank
3. https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200327a.htm
4. https://bankingjournal.aba.com/2020/03/loans-modified-due-to-covid-19-generally-not-treated-as-tdrs-agencies-clarify
5. https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200401a1.pdf
6. US Congress, H.R. 748 U.S. CARES Act., accessed on April 9, 2020.

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