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Deloitte M&A Institute

Top 10 Issues for Banking M&A in 2014

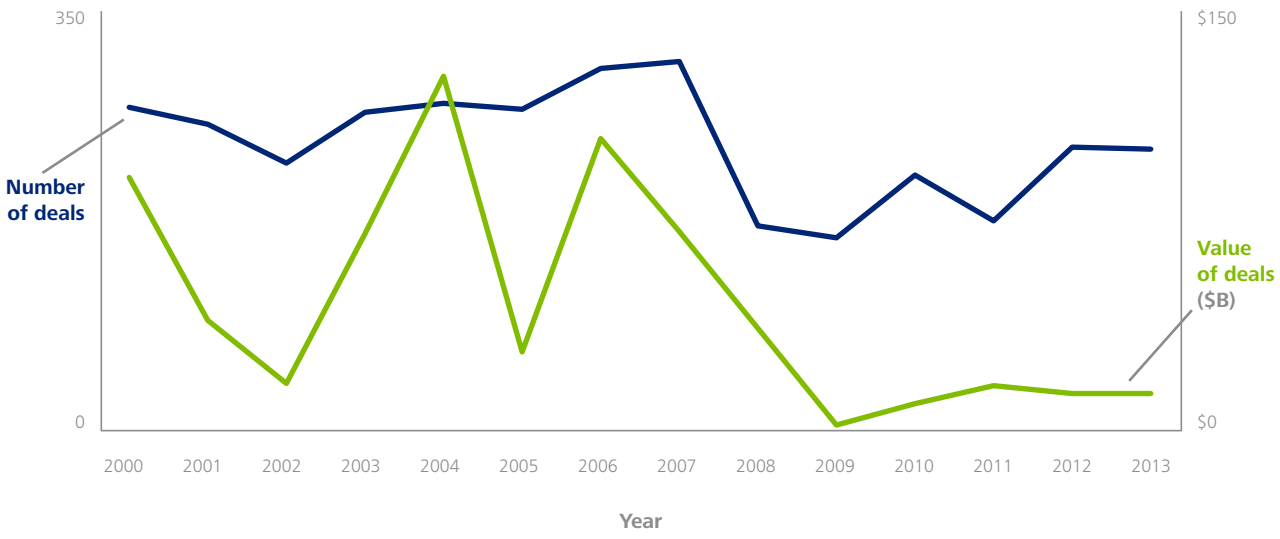
Searching for growth and scale

Contents

Overview

Banking analysts and executives had hoped 2013 would offer an improved merger and acquisition (M&A) environment after a disappointing 2011 and 2012. Although conditions improved versus the preceding two years—more deals were transacted at higher multiples and were well-received by investors—2013 remained difficult from a number of perspectives. Through December, there were 242 deals, slightly lower than the 244 in 2012 (Figure 1); total deal value in 2013 was $14.4 billion, up from $13 billion in 2012.[1] Much of the year's activity was bottom-up consolidation driven by smaller banks. Many large financial services institutions (FSIs) spent 2013 cleaning up balance sheets and getting back to "core," so divestitures, rather than acquisitions, were the norm. Regional banks remained mostly on the sidelines, trying to determine how to better participate in M&A.

Figure 1: Bank and thrift M&A activity



Source: SNL Financial

[1] SNL Financial. (Includes only whole deals where the target is based in the U.S. Reflects data at deal announcement event. Terminated deals are included.)

Fortunately, a number of catalysts could generate a steady pickup in M&A deal volume during 2014:

- Earnings per share (EPS) and organic revenue growth challenges continue to exist.
- Balance sheets have improved, with loan growth showing signs of acceleration.
- Capital and liquidity pressures are significant due to increased regulatory scrutiny and financial reform. Accessing additional capital remains a hurdle for smaller banks.
- Many bank boards and management are burned out from navigating the downturn and the heightened regulatory environment, and some are still struggling to meet capital hurdles and compliance costs.
- Certain buyers are looking to further diversify their business mix, improve competitive positioning within existing markets, and increase attractive demographics. Some are also looking to create economies of scale to absorb the costs of a heightened regulatory burden.
- Many banks are looking to acquire lenders to bolster the left-hand side of the balance sheet, whether it's credit cards, consumer finance, or business loans.
- Transaction multiples continue to improve as sales of stronger banks are driving more recent deal flow.
- Strategic deals are increasing as some buyers are uncharacteristically seeing their valuations increase after acquisition announcements.
- The market currently is rewarding buyers for recent deals with high accretion and limited tangible book value dilution.
- Foreign firms, driven by woes at home, may consider divesting additional U.S. assets.
- Private equity (PE) firms are looking to exit from investments made during the financial crisis.

Considerable pent-up demand for M&A exists. Generally, larger banks are looking to retool their product mix and geographic footprint, regional and mid-sized banks are seeking asset growth, small banks are looking for scale, and a rising interest rate environment makes deals more palatable across market segments. Also, a clearer view through the regulatory window is allowing banks to adjust their forecasting accordingly. Yet the deal market remains challenging, and M&A activity—while improving—is likely to remain well below pre-crisis levels for a number of reasons, including:

- Many buyers remain held back by both economic and regulatory uncertainty.
- Many rules have yet to be written, and the Consumer Financial Protection Board (CFPB) remains a wild card.
- Low Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity (CAMELS) ratings of buyers and pending government investigations are precluding regulatory approval.
- Focus on EPS accretion and tangible book value dilution is limiting the multiples that buyers are willing to pay. Conversely, seller expectations are on the rise again, especially in the middle market where smaller banks are no longer undervalued.
- Well-capitalized institutions remain cautious buyers. Some are returning excess capital to shareholders through increased dividends (to the extent permitted by the regulators) and share repurchases.
- PE investors recently have demonstrated less interest in the space; only a few groups have enjoyed repeated success, and others have struggled to deploy capital. Internal return hurdles are harder to clear in today's market without FDIC assistance; regulatory hurdles for PE investors remain difficult.
- Banks are not incentivized to grow past certain asset parameters. There is concern among the top 30 banks that they could move into a more stringent Global Systemically Important Financial Institution (G-SIFI) bucket requiring an additional surcharge, thus they may be limited to conducting smaller deals or pursuing organic growth in the product, customer, or geographic areas in which they have chosen to specialize.[2] Banks that pass the $50 billion mark will be subject to more stringent capital and liquidity requirements as well as living wills; banks that pass the $10 billion mark will be subject to formalized stress tests and increased regulatory requirements.

Facing both catalysts and obstacles for renewed M&A activity in the coming year, banks should be mindful of the issues on the pages that follow.

[2] Jane Searle, "Too Big to Merge?" *The Deal Pipeline*, September 17, 2013, as cited in *2014 Banking Industry Outlook*. *Repositioning for growth: Agility in a re-regulated world*, Deloitte.

Top 10 issues for banking M&A in 2014

1. New regulatory paradigm

The Volcker Rule, Basel III capital requirements, global liquidity rules, stress testing, Bank Secrecy Act compliance: banks should watch for regulatory issues that could delay or scuttle a deal.

Size matters when it comes to regulatory constraints on the banking sector: The bigger the players, the more restrictions on banking activities, including M&A. Banks with less than $10 billion in total assets face the least restriction, while the very largest Systemically Important Financial Institutions (SIFIs) experience the highest level of constraints. Among the major regulatory actions that are expected to hold considerable sway over bank M&A in 2014 are the Volcker Rule, Basel III capital requirements, global liquidity rules, stress testing, and anti-money laundering (AML) and Bank Secrecy Act (BSA) compliance laws.

After banks waited two years for the shoe to drop, the Volcker Rule was finalized December 10, 2013, although banks won't have to comply with the Rule until 2015.[3] Essentially, this legislation places restrictions on trades conducted as hedges against other risks. Officials say the final Volcker Rule "attempts to straddle the line" between banning proprietary trading and permitting market-making. It calls for "unprecedented surveillance" of big banks' trading operations, primarily through documentation that requires banks to justify trades and keep running tallies of their activities. However, the banks themselves will be mainly responsible for establishing parameters that determine whether they are in compliance with the Rule.[4] Volcker Rule compliance has the potential to drive larger banks' divestitures of potentially risky assets and non-core businesses. In addition, it may prompt niche fill-in opportunities for private equity investors (PEIs), opportunities for management buyouts, and opportunities for PEI roles within the fund or corporate level.

Basel III will require graduated levels of additional capital investment as banks increase in size, although some of the more burdensome requirements have been eased in the final rules, particularly for small- and mid-sized entities. Among the potential implications of Basel III's graduated capital requirements: a bank's capital structure to have a greater emphasis on equity capital; stress test requirements to result in higher risk structures that need higher capital levels; and concentrations to impact capital levels. While many U.S. institutions are fine-tuning their capital strategies, in general the top end of the sector appears to be adequately prepared for higher capital requirements. However, there appear to be numerous institutions, primarily in the small- to mid-size range, with near-inadequate capital levels.

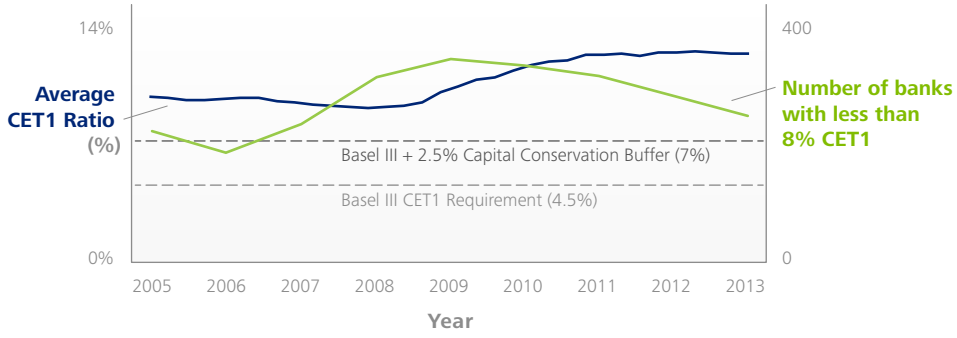
A rising capital bar could be an impetus for deal activity (Figure 2, next page). Globally, Basel III may prompt geographic retrenching for capital preservation as institutions rethink which assets truly are core. In the U.S., it could spur community bank consolidation. Also, given the incremental regulatory expense and efforts associated with exceeding defined thresholds, acquirers may desire to offset such additional costs and scrutiny with economies of scale.

Liquidity requirements also increase with size, and a legal entity's business model can impact liquidity levels. A core deposit structure offers stability and lower liquidity requirements than wholesale funding, while a holding company structure with large affiliates outside an insured institution results in elevated liquidity requirements.

[3] "Volcker Rule Finalized With Wall Street Responsible For Judging Compliance," *The Third Metric*, December 10, 2013. http://www.huffingtonpost.com/2013/21/10/volcker-rule-finalized_n_4422292.html?view.

[4] Ibid.

Figure 2: Tier 1 common risk-based ratio (CET1) for the U.S. commercial banking industry



Source: SNL Financial

Increasingly, multinationals and other large banks operating in this heightened regulatory environment are evaluating their products, geographies, and businesses and exiting areas that could cause them problems. To that end, divestitures of operating units and asset portfolios have accounted for about 45 percent of M&A activity for the past two years, almost double the 2000-2010 average of 26 percent.[5]

More stringent regulations may both drive and impede M&A in the middle market. Anticipated infrastructure and operational costs to comply with assessment and reporting requirements may be so onerous that they prompt certain institutions to merge or be acquired so they can spread those costs across a larger base. On the other hand, mid-tier M&A could be slowed by AML/BSA compliance laws, as regulators strive to prevent big-bank problems of the past from percolating at the mid-bank level.

The due diligence process likely will assume even greater importance in 2014 under the new regulatory paradigm, because buyers need to make sure that potential acquisitions don't have issues that may delay or scuttle a deal. In addition, banks contemplating M&A need to work proactively with regulators and add increased focus to regulatory (and potentially related information management infrastructure) issues as part of the due diligence process if they hope to secure timely deal approval.

Finally, banks should be realistic in their M&A timetables, as regulators are taking longer to approve deals. Three to six months used to be the norm; now a year is more typical.

Bottom line

For banks looking to grow through M&A, regulatory restrictions continue as a major hurdle, although increased clarity may also bring increased confidence. New and yet-to-be issued rules present potential challenges based on institution size and structure as well as capital and liquidity requirements. Such rules are likely to prompt large banks, in particular, to shed assets and continue to return to core banking business lines. Also, there is a bifurcation in (1) *dealing* with regulations, like Dodd Frank, which permeate the M&A process, and (2) engaging in ongoing *planning* for the new regulatory paradigm in doing deals. Essentially, banks need to "get to strong" by better integrating risk into the agendas of their boards of directors, by improving current stress testing inadequacies, and by building platforms that deliver consolidated audit trails and effective data transparency as mandated by new regulations.

[5] Thomson Financial. (Data reflect proportion of total deal value in each period by ranked deal value. Includes all U.S. deal targets. As of October 2013.)

2. Rising interest rate environment

Rising interest rates could produce higher yield curves, making deposit liabilities more valuable. Banks flush with deposits and not enough loan demand may be especially attractive.

The Federal Reserve's guidance of monetary policy could influence bank M&A activity in 2014. The Fed previously stated that it will keep interest rates low through 2015; in her first public remarks as Federal Reserve Chair, Janet Yellen said on February 11, 2014, that she strongly supports current monetary policy.[6] In addition, she stated that the Fed plans to gradually scale back its bond-buying program because economic growth has strengthened and there is "broad improvement" in the labor market.[7] Yellen also said she sees economic fundamentals calling for low interest rates to bring unemployment down and boost inflation to target.[8]

If interest rates rise, banks should generally benefit in 2014. Higher interest rates reduce excess liquidity; provide the ability to extend into longer-duration assets; generate higher reinvestment rates; and offer more attractive loan yields and wider spreads, especially for loans priced off the long end of the curve—which improves net interest income and margin. In addition, mortgage servicing rights (MSR) value, which helps fee income, is generally positively affected through lower prepayments.

At the same time, these gains may be tempered by some short-term offsets: Higher interest rates reduce available-for-sale (AFS) securities value, which generates lower unrealized gains and tangible common equity; an increase in long-term rates does not necessarily imply a rise in the short end of the curve; and the benefits of rising rates may be offset somewhat by lower loan volume, lower mortgage banking origination income, and lower gains on sale margins.

From an M&A perspective, higher rates could make deposit liabilities more valuable and increase the attractiveness of banks flush with deposits but lacking an ability to lend. 2014 may see some deposit-based acquisitions of community banks by small regionals in efforts to expand their footprints and bolster liquidity. Also, given the historic low interest rate environment, many companies have fortified their balance sheets with fairly low-cost funding and are flush with cash, which may limit loan demand over the next few years (depending upon economic growth). This may be a catalyst for M&A as banks look for alternative growth avenues.

Bottom line

The Fed's monetary policy drives interest rates and their subsequent impact on banks, including M&A activity. Rising rates, especially with a steepened yield curve, could be positive for banks overall because they may lead to greater margins and profits. However, rising rates for banks, in our view, are a bit of a mixed blessing. Some banks may have been overreaching asset duration in trying to maximize short-term earnings in the recent low interest rate environment. This could be problematic as liability rates rise faster than asset yields.

[6] "Federal Reserve Chair Janet Yellen first semi-annual monetary policy testimony before House Financial Services Committee in Washington," *Econoday*, February 11, 2014. http://bloomberg.econoday.com/byshoweventfull.asp?fid=463587&cust=bloomberg-us&prev=/bymonth.asp.

[7] "U.S. Stocks Rally as Yellen Speech Fuels Bet on Economy," *Bloomberg News*, February 11, 2014. http://www.bloomberg.com/news/2014-02-11/u-s-stock-index-futures-rise-before-yellen-testimony.html.

[8] "Federal Reserve Chair Janet Yellen first semi-annual monetary policy testimony before House Financial Services Committee in Washington," *Econoday*, February 11, 2014. http://bloomberg.econoday.com/byshoweventfull.asp?fid=463587&cust=bloomberg-us&prev=/bymonth.asp.

3. Search for capital-efficient growth

In addition to acquisitions that expand a bank's loan origination platforms (e.g., auto financing and asset leasing companies), banks are searching for assets that can help widen margins.

Striving for capital-efficient growth is a hot-button issue for bank executives, particularly since traditional lending segments are not producing yield, many institutions have cut expenses as much as possible, and regulatory compliance costs remain steep. While banks have undergone significant efforts to improve returns since 2008, they are now operating in a "new normal" with higher capital requirements, which makes it unlikely that ROE could return to pre-2008 levels. On the positive side, banks have raised more than $300 billion in Tier 1 capital since 2007, a 31 percent increase, which pushed risk-based capital ratios above 12 percent. This is a historic level for banks with more than $10 billion in assets.[9]

As substantive organic growth becomes more and more challenging to achieve, banks are examining alternatives, including M&A to unlock capital-efficient investment opportunities. In addition to considering acquisitions that expand a bank's origination platforms (e.g., auto financing and asset leasing companies), banks are searching for assets that can help widen margins. Fee-based businesses (e.g., trusts, wealth management, processing) are often an attractive option because they are capital-efficient and may offset credit-sensitive business lines. In addition, the shadow banking sector has seen a noticeable uptick in M&A as the securities and investments and specialty finance subsectors provide opportunities (Figure 3).

Figure 3: Recent shadow banking sector M&A

	Past 12 months (as of 9/23/13)				Previous trailing 12 months			
Sub-industry type	Agg. deal value ($M)	% of total	# of deals	% of total	Agg. deal value ($M)	% of total	# of deals	% of total
Bank and thrift	13,526	15	90	32	15,335	20	97	31
Financial technology	12,388	13	52	19	11,708	16	63	20
Insurance broker	5,062	5	25	9	1,965	3	32	10
Insurance underwriter	18,172	20	37	13	27,831	37	51	17
Securities and investments	18,785	20	31	11	10,630	14	35	11
Specialty finance	24,248	26	45	16	7,727	10	30	10
Grand total	92,181		280		75,196		308	

Source: SNL Financial

[9] FDIC. Data for banks with assets >$10 billion.

The challenge banks face is that increasing M&A activity in securities and investments and specialty finance has made these subsectors competitive and fairly expensive. Also, while fee-based business is attractive, scale and specialized service may separate the long-run winners from other competitors.

Bottom line

Banks increasingly are looking to acquire fee-based businesses that are not capital-intensive. Many have moved or are moving into wealth management. However, increasing M&A activity is driving up prices. Also, wealth management tends to require scale (high levels of assets under management) to be successful. This could limit the number of banks that consider entering the wealth management business because they have to use capital to acquire assets under management.

The process of attaining capital-efficient growth is as much about being smart about what you buy and how you run it as it is about looking for fee-based growth. While improving capital deployment and efficiency may unlock potential M&A and investment opportunities, a bank has to understand the field and execute transactions with rigor.

4. Geographic and business line rationalization

Using M&A to fill strategic gaps in customer, product, and geographic portfolios is one way banks are repositioning for growth. Divestitures may be likely as multinationals and super-regional banks rebalance, prune branches, jettison higher-risk offerings, and right-size their workforces.

M&A that supports specialization and rationalization along the vectors of customers, products, and geographies may likely continue in 2014, as strategic decisions play out and banks reposition for targeted growth amid economic, regulatory, and market constraints. Geographic and business line rationalization is a strategic response to sub-par topline growth, especially when cost-cutting alone has failed to generate sufficient return for shareholders. Divestitures often play a specific role in the process (Figure 4), as large multinational and super-regional banks rebalance markets, prune branches, jettison risk-prone products and services, and right-size their employee bases.

Following a period of global expansion, many large U.S. banks are retreating to domestic footprints and re-examining geographic expansion in the context of customer attractiveness, capital use, and regulatory restrictions. Therefore, when a bank lacks sufficient scale or share to be relevant in a particular market, and a merger or acquisition does not make economic sense, divestitures have become more common as a way to free up capital and focus more attention on core businesses and markets.

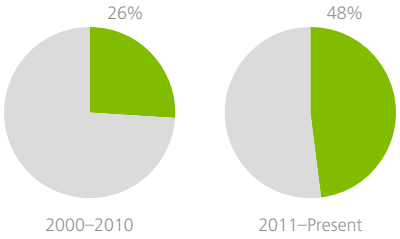
Increasingly stringent regulatory and capital requirements also may prompt larger institutions to shed assets and locations. Given new capital requirements, many U.S. banks have less flexibility to allocate capital globally and, as a result, are retrenching internationally. However, the opposite is also true: As domestic regulations increase, some larger U.S. banks are evaluating acquisitions in less capital-restrictive regions, especially if they offer broad growth and client service opportunities.

Figure 4: Specialization and rationalization

Heading into 2014:

- Specialization will continue to spur divestitures
- Increased competition may also drive M&A activity
- Many focusing on asset generators and niche markets to gain scale
- Common focus areas:
  - Business lending
  - Wealth management
  - Credit cards

Divestitures as a percentage of M&A value



Large banks from other nations are also engaging in cross-border M&A, viewing the current environment as an opportunity to bolster selected business lines or to re-enter or strengthen their presence in the U.S. and other locales. Among active acquirers in the U.S. and elsewhere are banks from Mexico, Brazil, Colombia, Chile, Canada, and Japan.

Finally, PE investors are both divesting and acquiring: Some are adopting exit strategies to monetize their minority stakes in banks they've held since the financial crisis. Others are considering acquisition opportunities outside the regulated banking space as platforms for growth.

Bottom line

The trend of returning to core and capital efficiency continues, driven by ongoing performance issues and changing market conditions, among other factors. Also, after a period of global expansion, some banks are refocusing on strengthening their domestic footprints, prompted by increased regulatory scrutiny and Basel III capital needs. M&A that supports specialization—customers, products, and geographies—may continue in 2014.

5. Branch strategy

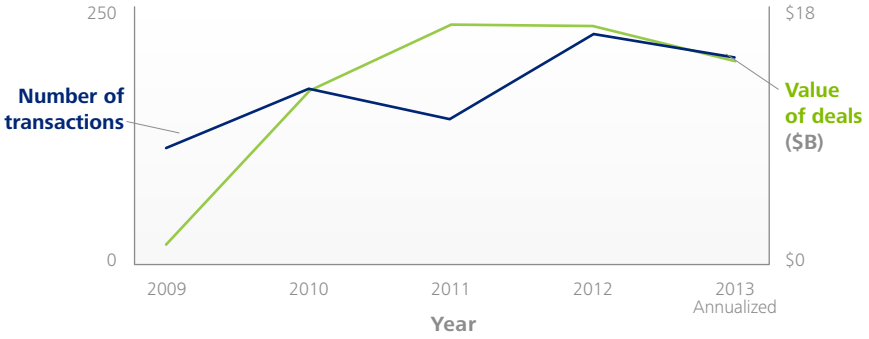
The pendulum swings. Large banks may be selling branches as a way out of non-core markets. Smaller banks may buy them to gain local deposits.

While analysts' predictions about their demise may have been overstated, there is general consensus that the United States has an overabundance of bank branches. In today's cost-conscious environment, banks are weighing the value of the branch, how to leverage their existing physical locations, and whether to expand or contract their footprints. As evidence, some large banks are selling branches to exit non-core markets, while smaller banks are buying them to increase their deposit market share in markets they serve.

A bank typically wants to be in the leading markets and—in any selected market—to be among the top two or three in market share. Some institutions made numerous post-crisis, distressed-deal acquisitions to gain customers and deposits because the pricing was right; however, they ended up with larger footprints than they wanted or needed in terms of branch numbers and/or locations. Today, these banks are starting to rationalize their footprints, closing branches or doing one-off sales to other banks that are eager to enter new markets or grow share by acquiring branch networks (e.g., a large national bank sells a number of branches to a smaller community bank). In fact, branch M&A activity in 2012 was the highest since before the crisis, although 2013 activity failed to keep pace (Figure 5).

Figure 5: Historical branch M&A activity (2009–2013 YTD annualized)

U.S. bank and thrift M&A transactions: Previous four years and YTD*



Source: SNL Financial; Deloitte analysis
*Information relates to announced or completed transactions with disclosed purchase price information as of 11/14/2013. Data includes only whole bank deals for U.S. bank or thrift targets and excludes branch sales, asset purchases, minority investments, government-assisted transactions, and mutual conversions. Terminated deals are excluded.

Nationally, the number of brick-and-mortar (BAM) bank branches in the United States declined in 2011 for the second straight year, from 98,853 to 98,202. Factors cited range from a still-elevated number of bank failures to a lack of foot traffic resulting from greater use of online banking.[10] In fact, it is becoming increasingly apparent that technology is disrupting traditional consumer-bank relationships and taking a toll on branch activity. Transactions such as transferring funds, checking account balances, making deposits, and paying bills increasingly are conducted using online and mobile technologies rather than branch tellers. This trend, along with branches' traditional high cost structure, is prompting many banks to question the future role and value of physical locations: How much of a BAM presence do we need in a market to get our share of new customers? How can we use branches to engage with digital customers? The answers likely will differ by institution. Depending on an organization's brand strategy, branches may evolve to become servicing facilities for small businesses, sales offices, or community gathering places.

Many banks have unprofitable branches, so optimizing existing locations and lowering their cost structure is important. Some may choose to engage in M&A, closing and selling outdated facilities and building or buying in better locations. Another option that banks might consider is doing sales-leasebacks, which frees up capital and allows banks to use it to pay down higher-cost funding. They could also continue to own specific properties but hire someone else—e.g., a hotel management company—to operate them. A fourth way to cut down on real estate costs—especially given lower transaction volumes—is to shrink the size of branches and reposition them as places for consumers to engage in more complex interactions and purchase specialized offerings (e.g., mortgages and wealth management services). Note that this changing focus is likely to lead to a changing employee profile—a shift to more knowledgeable, specialized talent such as loan officers and wealth managers who have a network of relationships to grow the bank from an origination perspective.

Bottom line

Banks should consider having a long-term, sustainable branch strategy. A branch's physical infrastructure, direct and allocated costs, associated regulatory costs, narrowed margins, and reduced fee upside make "getting this right" a necessity for all major players. Banks' efforts to reduce their footprints, optimize branch networks, and adopt omnichannel approaches to differentiate the customer experience may drive new M&A. The result may be fewer branches but more creativity in sustainable solutions.

[10] "Number of U.S. bank branches drops for 2nd year," *Chicago Tribune*, citing figures released by SNL Financial, October 14, 2011. http://articles.chicagotribune.com/2011-10-14/business/chi-number-of-us-bank-branches-drops-for-2nd-year-20111014_1_bank-branches-firstmerit-deposit-growth.

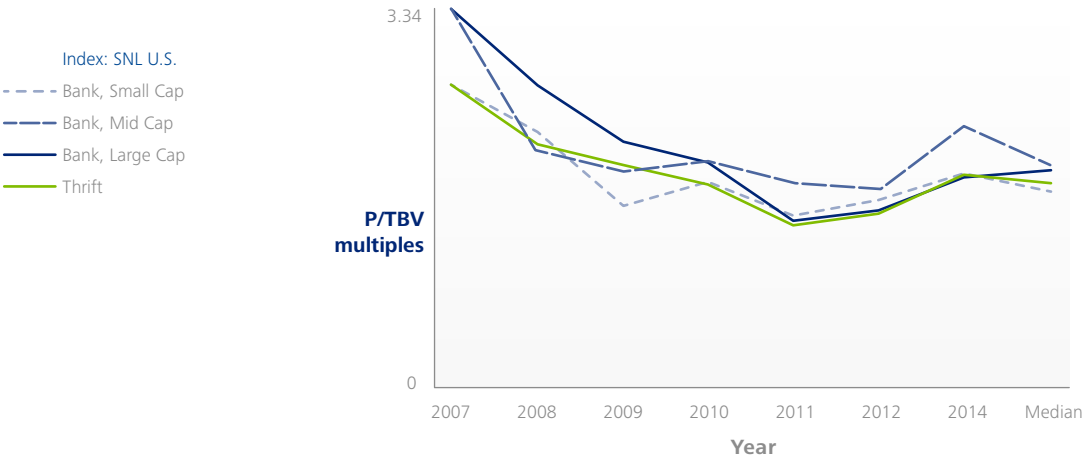
6. Valuation

Valuations during the financial crisis were so low that institutions could be purchased for their replacement cost value. Prices are rising, especially in the mid-market.

A favorable trend in valuation is reflected in improving price-to-tangible book value (P/TBV) multiples, but they remain below historic levels. As of early February 2014, small cap banks were trading at 1.64x, mid cap banks at 2.01x, large cap banks at 1.61x, and thrifts at 1.63x—a considerable drop from 2007 levels (Figure 6).

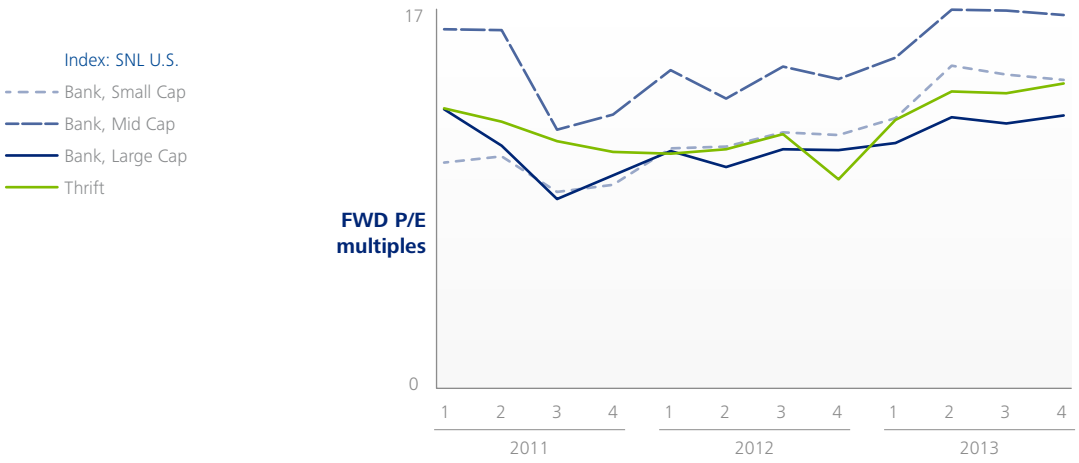
However, as earnings stabilize and capital is replenished, increased focus is being placed on forward price-to-earnings (FWD P/E) multiples for valuation purposes (Figure 7, next page). With a rising equity market, many sellers are looking for stock deals to generate longer-term benefits on the upside.

Figure 6: Improving P/TBV multiples



Sources:
- SNL Financial, data as of February 5, 2014
- SNL Small Cap U.S. Bank Index includes all publicly traded banks in SNL's coverage universe with $250MM to $1B total market capitalization
- SNL Mid Cap U.S. Bank Index includes all publicly traded banks in SNL's coverage universe with $1B to $5B total market capitalization
- SNL Large Cap U.S. Bank Index includes all publicly traded banks in SNL's coverage universe with greater than $5B total market capitalization
- SNL U.S. Thrift Index includes all major exchange thrifts in SNL's coverage universe

Figure 7: Focus on FWD P/E multiples for valuation purposes

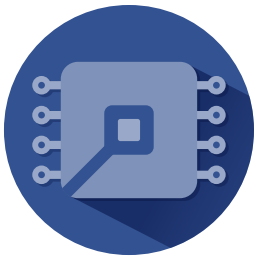


Sources:
- FactSet, data as of February 5, 2014
- SNL Small Cap U.S. Bank Index includes all publicly traded banks in SNL's coverage universe with $250MM to $1B total market capitalization
- SNL Mid Cap U.S. Bank Index includes all publicly traded banks in SNL's coverage universe with $1B to $5B total market capitalization
- SNL Large Cap U.S. Bank Index includes all publicly traded banks in SNL's coverage universe with greater than $5B total market capitalization
- SNL U.S. Thrift Index includes all major exchange thrifts in SNL's coverage universe, except for those with limited or irregular coverage
- Forward P/E calculations aggregates the daily price divided by the estimated earnings from consensus

Bottom line

With the recent uptick in valuations driven by a rising stock market and improving economic fundamentals, additional multiple expansion may be limited in the short term, given continued headwinds in driving organic EPS growth. M&A anticipation, along with solid earnings performance, high capital levels, and strong risk management are the likely catalysts for multidimensional expansion going forward.

7. Technology and data for business generation



Companies needing technology and data upgrades may turn to M&A as an alternative to in-house development. Through M&A, they can acquire the capabilities to bolster data management and deliver more accurate, consistent, timely, and secure information.

Financial services is quickly becoming a technology-driven industry. High-tech applications and data management are rapidly moving from back-office support to customer-attraction and business-generation roles, and they are increasingly serving as specific enablers of revenue growth, improved risk and compliance management, and enhanced operational effectiveness. Cloud computing is becoming a standard platform for delivery of services, and mobile deposit capture and bill payment are rapidly gaining acceptance. Additionally, banks' ability to cost-effectively and creatively use big data and advanced (i.e., predictive, prescriptive, etc.) analytics to transform large volumes and varieties of information across the enterprise into useful insights could become a characteristic of future industry winners and losers.

Historically, technology has been important to bank operations; now it is becoming increasingly important to bank M&A as institutions seek hardware, software, and data solutions to help them differentiate the customer experience (Figure 8), ramp up the sophistication of data analytics and usage, protect sensitive customer and organizational information from cyber theft, comply with more stringent regulatory requirements, and gain an overall competitive market edge. Because of technology's rapid rate of change, many banks are choosing to acquire niche solution providers—rather than develop applications in-house—to optimize their branch networks, integrate alternative channels, and improve cross-selling of products and services. Concurrently, technology companies that service the banking industry are looking to acquire their peers so they can be better vendors to the banks.

Figure 8: Differentiating customer experience

Banks' efforts to optimize branch networks and integrate alternative channels may drive new M&A.

- Improve data infrastructure and analytics
- Enhance segmentation
- Bolster cross-selling
- Optimize branch structure
- Unify mobile and branch channels

Technology considerations are adding a layer of complexity to the M&A due diligence process: To avoid bringing bad or incomplete information into a "clean" system, potential buyers should conduct a full inventory of a target's systems and databases, understand how they are supported internally or externally, and determine the quality, completeness, and trustworthiness of information being presented as part of the transaction. With risk-based capital acquisitions, in particular, a buyer needs to determine its potential exposure at a very granular level, which may call for a detailed analysis of data maturity and integrity for each line of business.

Technology issues also may present post-deal integration challenges. When one bank acquires another, it has to roll up its technology and information assets into the global enterprise, which can result in system redundancy and information silos. If merged entities are allowed to continue using siloed systems and databases, it tends to become extremely risky and costly to manage information outside the enterprise construct.

To comply with post-crisis regulatory reporting requirements—including demands for full data transparency—banks need to bring together risk management, financial management, and customer data management across multiple businesses and locations to produce integrated, global-level views of each organization's data. Banks also have to work to assure the data's quality, specifically its trustworthiness and completeness.

Beyond the mandates, banks also are being challenged to manage information as a strategic corporate asset—which can be difficult when merged entities may not know exactly what information they have and where it resides. This need shines a light on the importance of analytics to help banks compete more effectively.

Banks are taking a variety of actions to address this new paradigm for institutional data management. Some larger institutions are creating the position of chief data officer (CDO), the individual responsible for delivering a sustainable enterprise data management infrastructure and support. Under the auspices of an enterprise-wide data management office (DMO), the CDO brings together disparate departments, systems, applications, and tools while establishing ownership roles and responsibilities among various data users for critical elements of their business.

Under the direction of the CDO, many banks are establishing global data management programs to support regulatory compliance and business-building. In addition, banks of all sizes are increasing their use of analytics to enhance customer and market knowledge, defensively protect existing deposits, and offensively attract new ones. Finally, some banks are realizing post-transaction that they may have to revamp their merged systems, or build new ones from the ground up, to provide more value to the institution and extract more revenue from the acquired customer base.

Bottom line

M&A can be a more efficient way to attain technology improvements than developing them in-house. In addition, M&A can help organizations acquire the necessary capabilities to bolster data management functions and deliver more accurate, consistent, timely, and secure information. However, when considering a transaction, it is important that the buyers understand the technology issues and opportunities they may be inheriting and that they have an effective post-transaction integration strategy in place to capitalize on market and revenue synergies. It is likely that banks may need to allot more capital for technology infrastructure investments.

8. Tax

Buyers and sellers should pay close attention to two major tax issues in the coming year: deferred tax assets and Foreign Account Tax Compliance Act implications.

Deferred tax assets and the Foreign Account Tax Compliance Act (FATCA) were two focus areas for M&A transactions in 2013 that may continue in 2014. Deferred tax assets attributable to net operating loss carry-forwards (NOLs) and built-in losses (BILs) in a bank's portfolio of assets continue to be a key focus of M&A transactions, as they are a significant component of many organizations' balance sheets.

U.S. tax law imposes a limitation on the use of NOLs and, in certain cases, recognized BILs following an ownership change. A key question for acquirers and targets is whether, following the transaction, the combined bank will need to write down its deferred tax assets attributable to NOLs and BILs because of the limitation on the post-transaction use of such tax attributes imposed by the tax law. To answer that question, a bank should consider the following: Are there any existing limitations on the tax attributes? Will the transaction result in an ownership change, and, if so, what will be the amount of the limitation? If the transaction results in an ownership change, which tax attributes will be subject to a limitation (e.g., recognized BILs being subject to a limitation)? If the acquiring bank uses its stock as currency in the transaction, the considerations noted above are applicable to the acquiring bank and its tax attributes.

Another key aspect of deferred tax assets is the impact on a bank's regulatory capital. In 2014, banks start the five-year phase-in of the Basel III rules. Generally, the treatment of deferred tax assets under Basel III is less favorable than under the prior rules applied to banks. Accordingly, banks considering a transaction should model the impact of deferred tax assets on the post-transaction regulatory capital.

Banks are encouraged to get tax professionals involved early in the transaction because the technical analyses required to perform the work on the deferred tax assets can be time-consuming and have a meaningful impact on the value of the combined bank.

FATCA is expected to have a significant impact on the operations of U.S. banks and non-U.S. banks that have U.S. customers or non-U.S. customers with U.S. assets. The legislative intent of FATCA is to ensure there is no gap in the ability of the U.S. government to determine the ownership of U.S. assets in non-U.S. bank accounts. Under FATCA, foreign financial institutions (FFIs), including non-U.S. banks, generally will be required to enter into disclosure compliance agreements with the U.S. Treasury unless an exemption or FATCA Intergovernmental Agreement applies. Payments made by U.S. payors to non-compliant FFIs are generally subject to a 30 percent withholding tax. This new reporting and withholding regime will ultimately impact current account opening processes, transaction processing systems and "know your customer" procedures used by non-U.S. banks. FATCA will be phased in and be effective for some payments made after June 30, 2014. In the context of an M&A transaction, due diligence should be performed to assess FATCA readiness and, ultimately, compliance.

Bottom line

When a bank is contemplating an M&A transaction, management should consider the potential impact of a proposed transaction on the value of the deferred tax assets and the potential impact of the deferred tax assets (including any decrease in value of such assets because of the transaction) on the combined bank's regulatory capital. In addition, the parties should assess the FATCA readiness of the combined bank and, if necessary, adopt a plan to address any gaps in the bank's compliance function.

9. Underbanked market

Some organizations are eyeing technology as a means to cost-efficiently serve the underbanked market. Private equity investors see this as a way to participate in lending and banking sectors without actually owning banks.

The number of U.S. families without bank accounts grew by 821,000 from 2009 to 2011, increasing the "unbanked" population—those without checking or savings accounts at insured institutions—to 8.2 percent of the nation's households.[11] One in five households (20.1 percent) was "underbanked" in 2011, relying on non-bank services such as payday lenders and check-cashing firms.[12]

Serving the underbanked profitably has long been a challenge, but some organizations are eyeing technology as a means to cost-efficiently serve this market. Private equity investors, in particular, have focused on the area as a means to participate in the lending and banking sectors without actually owning banks. Specifically, PE firms have been focused on potential investments in cutting-edge technology providers that offer a cost-efficient option to the underbanked. By comparison, traditional banking institutions may have an opportunity to expand their customer bases by offering products and services for the unbanked and underbanked.[13] They have been trying to find cost-efficient ways to increase their service suites to include check cashing, money transmitting, prepaid cards, and the like; however, it has been difficult to bring the unbanked and underbanked into the fold. A number of hurdles exist, not the least of which is intense regulatory scrutiny of the way non-banks are serving the segment. The Justice Department's probe of payday lenders has shined a light on the practice of predatory pricing for consumers outside the banking system. In addition, the Consumer Financial Protection Bureau (CFPB) seeks to safeguard under- and unbanked consumers against abusive and deceptive practices.

Bottom line

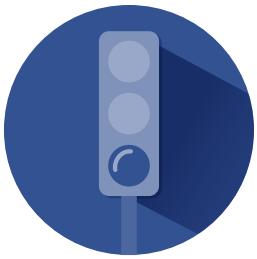
It is difficult to determine what role the unbanked and underbanked market may play in near-term M&A. While banks may focus on creative solutions and alliances, it likely will be private capital players outside the banking system doing deals.

[11] "U.S. Unbanked Households Rising as FDIC Pushes for Alternatives," results from FDIC National Survey of Unbanked and Underbanked Households, Bloomberg.com, September 12, 2012. http://www.bloomberg.com/news/2012-09-12/u-s-unbanked-households-rising-as-fdic-pushes-for-alternatives.html.

[12] Ibid.

[13] Ibid.

10. M&A readiness



Interest rates are rising, valuations have improved, capital reserves are robust, and the stock market is strong. M&A is heating up. Acquiring banks may need to be more flexible, nimble, and attentive to details, especially with transactions crossing multiple businesses, functions, and geographies.

For the first time in years, many banks are starting to put M&A back into their strategic plans, thanks to improving market conditions: Interest rates are rising, valuations have improved, capital reserves are robust, and the stock market is strong. However, the M&A process has changed from pre-crisis days due, in part, to increased regulatory scrutiny and its impact on due diligence and transaction length.

As the M&A market heats up, acquiring banks may need to be more flexible, nimble, and attentive to details, especially since transactions may cross multiple businesses, functions, and geographies. Timing and speed to close are critical: Lacking executive sponsorship, an M&A playbook, established decision-making and approval processes, and a dedicated business development team (composed of internal and external resources) to facilitate transactions, even the most promising deal may be scuttled if execution spools out too long. In fact, getting deals done efficiently remains an elusive goal at many companies: Three-quarters of the respondents to Deloitte's *2013 Corporate Development (CD) Survey, Pushing Boundaries in M&A*, reported having "well-defined M&A approval processes," but only 19 percent characterized the efficiency of these processes as "excellent." Close to one-third rated the efficiency as "fair to poor."[14]

Almost three-quarters of the Deloitte survey respondents cited strategic clarity, executive access, and a business development team's deal-making credibility as the top elements of an efficient M&A process.[15] Factoring in the changing business and regulatory landscape is also important to banks seeking to engage in M&A—particularly if they have been inactive for a year or more—as the margin for error on a deal has diminished. Preparations should begin with an assessment of the bank's M&A readiness; a detailed diagnosis of its strengths and weaknesses in key areas such as risks and regulations, finance, technology, human capital, operations, customers, brand, and culture. Vetting these issues before engaging in M&A may help an acquirer better understand how to meld post-acquisition cultures, attract and retain good employees, and generate synergies and sustainable cost savings. It is also important to involve regulators early in the process.

[14] "Improving M&A Decision-making: Leading Practices," *CFO Journal*, December 16, 2013. http://deloitte.wsj.com/cfo/2013/12/16/improving-ma-decision-making-leading-practices/.
[15] Ibid.

Other practices that may improve M&A decision-making and speed the deal approval process include:

- Having a playbook with a set of criteria for evaluating deals that the CEO, CFO, and board can work with consistently, whether the objective is growth, profitability, or another goal.
- Establishing strong relationships, both internally and externally, before getting into a deal to quickly bring in the necessary resources.
- Quickly articulating the inherent value of the transaction. Focus on the main value drivers and challenges, strategic merits, the way the deal could be presented to Wall Street, and the way it aligns with specific financial criteria.
- For each deal, assembling a team of specialists from key functional and business areas to gather and analyze data, and identify risks and opportunities in their areas of expertise.
- Actively engaging regulators at the onset of M&A plans to help smooth the approval process.
- Establishing clear roles for each decision-maker—who gets what information when, and when each person should be brought into the decision-making process.[16]

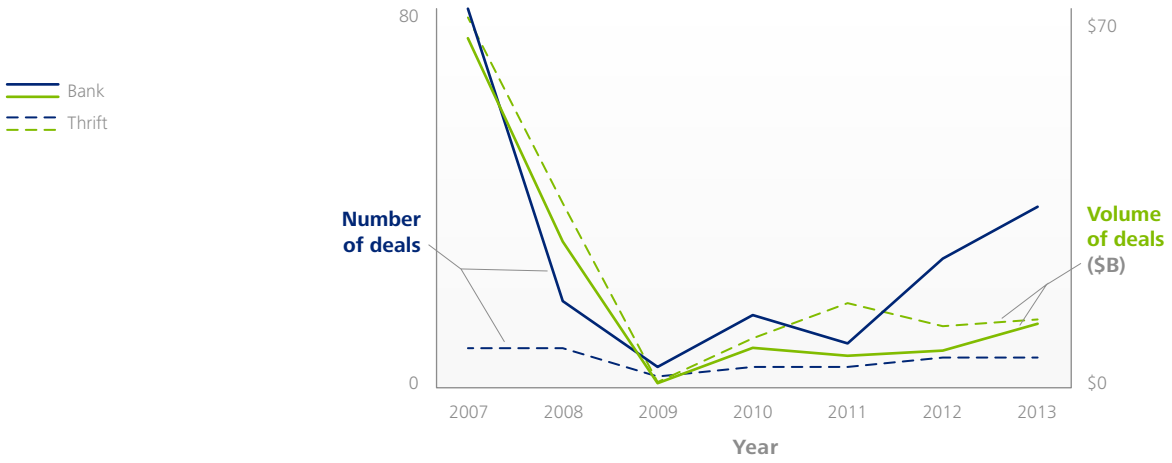
Bottom line

Banks need to be well-prepared buyers and/or sellers so they are able to move quickly on potential M&A deals as well-oiled machines. Readiness activities should include gap assessments; detailed due diligence to identify financial, regulatory, operational, cultural, and brand risks; and upfront vetting of potential deal synergies and integration costs. Proactive planning to address the full range of M&A lifecycle challenges—including post-integration issues—is essential to improve transaction efficiency and construct deals that enrich shareholders and customers.

[16] Ibid.

Moving forward

Figure 9: U.S. depository M&A announced deals



Source: SNL Financial
Transactions are whole deals as of December 31, 2013
Excludes: Terminated deals, deals less than $50MM, government-assisted deals, and branch and asset deals

The M&A market is likely to gather steam in 2014, as evidenced by recent trends in transaction volume (Figure 9). While large banks and super-regionals are not anticipated to engage in major, transformational deals, many are likely to continue divesting assets to avoid regulatory issues. Many bigger community banks, frustrated with sluggish organic growth prospects, are intensifying their searches for appealing targets that could provide asset generators and earnings expansion. Small lenders, in turn, appear to be evaluating the advantages of joining forces with larger players because consolidation may rationalize the playing field and drive increased investor demand (Figure 10). European banks are expected to continue deleveraging and reducing their U.S. presence due, in part, to changing capitalization rules, while some players from other countries still seek opportunities to enter or expand in the U.S. market. Finally, non-banks and PE firms may take advantage of limited regulatory oversight and leverage disruptive innovation and M&A to grow.

In general, banks appear to be moving from a defensive to an offensive position regarding M&A as they seek growth and scale. However, a lack of substantive targets and a longer regulatory approval process could slow M&A's momentum, especially for large banks. Actively engaging regulators at the onset of M&A plans may help banks move past regulatory issues more easily and shift M&A in the coming year from a reactive mode to more of a strategic one.

Figure 10: Impacts of consolidation

The following impacts of consolidation increase investor demand:

» Strong management team
» Compelling stories
» Strong franchises (attractive customer base, strong core deposit base, meaningful competitive advantage)
» Prospect for top-line revenue and strong core earnings growth
» Manageable credit issues
» Solid capital levels with opportunity for dividend payments and share buybacks
» Acquisition upside
» Transactions/use of proceeds resulting in early EPS accretion, limited TBV dilution, and attractive returns

Banks also should view M&A through a risk lens that reassesses their current business lines, geographic footprints, and potential returns on capital deployment. Analytics can help acquirers gather and process data from a wealth of external sources and validate assumptions about particular acquisition targets, as well as the information provided by the targets. Further, banks should take steps to ensure M&A plans are rich with efficiencies, especially in today's cost-conscious environment.

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