# CAN THE NEXT BANK CONSOLIDATION CYCLE DRIVE A MORE COMPLIANT, EFFICIENT, AND CUSTOMER-CENTRIC INDUSTRY?

BANKING, INSURANCE AND CAPITAL MARKETS

## INTRODUCTION

From the 1970s until the 2008 global financial crisis, the U.S. banking industry experienced massive consolidation. The number of depository organizations in the U.S. fell from over 15,416 in 1984 to 7,137 in 2008, a drop of 53 percent.

This trend was largely driven by deregulation of interstate banking, such as the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which permitted interstate branching. The deregulation allowed banks to acquire other banks in different states and to turn the acquired bank branches into their own.[1]

In the post-financial crisis era, consolidation has been a community bank strategy in reaction to increased competition, low interest rates, and rising compliance and technology costs.

The large deals, $500 million in value and up, from decades before have stagnated under post-financial crisis regulation that implemented "regulatory ozone layers" in the form of $10 billion and $50 billion asset thresholds[2] that banks have avoided.

Since 2010, there have only been two deals of $5 billion or more, compared to 23 the decade before, and the number of deals from $500 million to $5 billion in value is down 20 percent.

However, recent industry signals indicate the pendulum may finally be swinging in the other direction.

Navigant's analysis of U.S. bank deals[3] over $500 million in value found that the number of deals in 2017 is on pace to reach double digits for the first time in 10 years, up 50 percent from two years ago.

The analysis comes on the heels of a recent J.P. Morgan report that made waves in the merger world, predicting that industry consolidation will occur from a need for retail deposits to fund loan growth, the challenge of organically originating new relationships, and the scale required to support technology and brand investments.[4]

1. http://www.frbsf.org/economic-research/publications/economic-letter/2002/july/trends-in-the-concentration-of-bank-deposits-the-northwest/
2. http://independentbanker.org/2014/12/crossing-the-threshold-3/
3. Navigant reviewed bank deals with deal values over $500 million from 2001–2017 that were either pending or completed.
4. https://www.bloomberg.com/news/articles/2017-05-08/jpmorgan-tells-banks-to-partner-up-as-u-s-deposit-drain-looms


### Executive Summary

Early signals indicate bank consolidation is heating up for deals over $500mm in value:

- 50%+ growth in number of deals since 2015
- 22% increase in median deal value / deposits
- 33% increase in median deal value / assets

Regulatory approvals, cost reduction, and branch network optimization will be key focus areas:

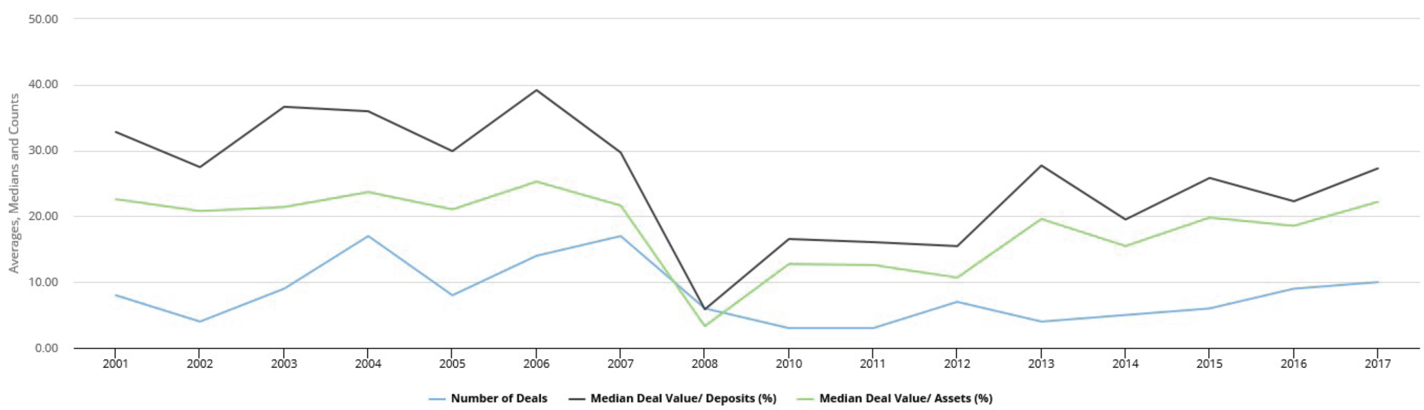
- Regulatory approvals typically take 6 – 12 months to receive, if approved…
- Banks are expecting median cost reduction of 30%+ from the target acquisition within 2 years
- Acquirers will look to reduce target branch networks by ~20% as multi-channel and self-service adoption continues

Banks will need to tackle lofty deal expectations with "in the trenches" capability investments:

- Regulatory Approval Readiness will have a sharp focus on operations and compliance due-diligence and strong relationships with regulators and community groups
- Incremental Automation ("IA") can increase efficiency through incremental automation / digitization while avoiding large-scale "rip and replacement" of legacy IT systems
- Spatially optimized branches aim to deliver cost savings through efficient, technology-intensive branches designed to expand access, reduce cycle-times, and accommodate high-value interactions.

The winners of the next wave in Banking M&A will make "in the trenches" capability investments in regulatory compliance, aggressively automate back-office workflows, and spatially optimize their branch network with smaller, convenient, technology driven designs.

2001–2017: Bank M&A that are >$500 million in deal value




Please note there were no deal values over $500 million in 2009

Median of Deal Value / Assets (%)


Median of Deal Value / Deposits (%)


Navigant's research found banks are already paying significantly more for deposits and assets than recent deals.

Pending deals in 2017 over $500 million in deal value are experiencing a 22 percent increase in the median deal value/ deposits and 33 percent increase in median deal value/assets of pending deals vs. closed deals over the last two years.

In a recent example, an institution increased their initial bid by $1.3 billion, up 26 percent from the initial terms, to get shareholder approval from the target bank.[5]

On the other hand, the regulatory environment continues to put headwinds on consolidation as banks struggle to sell the benefits to their regulators, communities, and shareholders.

In one exceptional case, the regulatory approval required three years to finalize.[6] In another high-profile deal, the acquisition was terminated a year after the announcement due to regulatory approval delays.[7]

Banks are responding with significant termination fees included in deals, with one recent acquirer agreeing to an $85 million termination fee should their deal get axed under certain circumstances.[8]

The approval process is now a high-stakes public examination that requires a tactical plan to demonstrate commitment to compliance and the betterment of consumers and communities.

As the regulatory approval risk looms, and the need for new relationships, deposits, and scale drives consolidation, Navigant predicts three new trends in the next banking M&A era.

1. **Regulatory approval readiness will emerge at due diligence as a critical workstream:**

Banks can typically expect 6–12 months before M&A approvals. The longer the wait, the greater the risk of board/shareholder fatigue resulting in an eventual collapse.

5. http://business.financialpost.com/news/fp-street/cibc-sweetens-bid-for-privatebancorp-for-second-time-in-best-and-final-offer
6. https://www.wsj.com/articles/m-t-bank-completes-acquisition-of-hudson-city-after-3-year-delay-1446470410
7. https://www.thestreet.com/story/13933324/1/new-york-community-bank-scraps-2b-astoria-deal-as-fed-review-lingers.html
8. https://blogs.wsj.com/cfo/2017/02/06/the-morning-ledger-financial-regulation-rollback-could-see-banks-return-100-billion-to-shareholders/

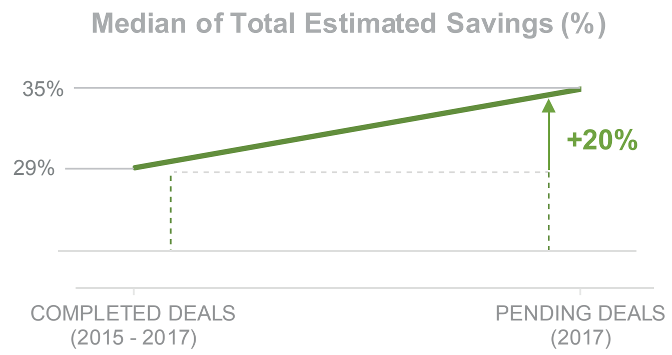
Success calls for a sharper focus on operations and compliance due diligence, a strong commitment to politicized compliance topics, effective remediation of known deficiencies, and proactive stakeholder engagement, specifically with regulators and community groups.

Below are some tactical steps that banks can learn from recent merger regulatory approval successes and setbacks:

- **Be conscientious…** Establish confidence in execution with an experienced M&A team, proven integration plan, and governance model.
- **Engage and listen…** Partner with regulators early on to address concerns (e.g., anti-competitive items, job losses, community interests, etc.).
- **Know who you're buying…** Beef up operational and compliance due diligence (e.g., reviews of policies, procedures, products, processes, controls, compliance systems, and model validations of automated monitoring tools, etc.).
- **Anticipate common objections…** Demonstrate commitment to fair-lending compliance (e.g., designated Community Reinvestment Act ("CRA") officer and/or a CRA committee, detailed plans for improving community lending assessment areas, etc.). Confirm any Bank Secrecy Act/Anti-money laundering issues have been completely addressed by both banks.
- **Issues don't age well, be responsive…** Establish a rapid remediation capability. This includes identifying impacted population(s), implementing short-term stopgap controls, remediating harm, root cause analysis and process re-design, and implementing sustainable controls to prevent future issues.
- **Be resourceful, remove surprises…** Leverage complaints, internal and external findings, and external industry issues to scan for emerging issues as the deal is under review.
- **Get ahead of trends…** Cybersecurity is an example of another area of focus for future mergers. This has already had early impacts on deals in other industries, and the recent "WannaCry" virus has renewed fears around cyber vulnerabilities.

**2. Incremental Automation will come into its own as a key lever in cost-reduction efforts:**

Navigant's analysis found that pending bank deals are targeting ~35 percent in cost reductions from the target bank's noninterest operating expenses within two years, up 20 percent from recently completed deals.




The playbook of tried-and-tested techniques should continue to deliver significant cost-reduction benefits well into the foreseeable future (e.g., centralizing functions, integrating systems, renegotiating contracts, eliminating redundancies, rationalizing products, and spans and layers org design, etc.).

One emerging industry cost-reduction opportunity is Business Process Automation ("BPA"), or the automation of processes by integrating applications, restructuring labor resources and using software applications throughout the organization.

There has been a lot of promising potential in the last few years around BPA. Citi recently warned that 30 percent of the banking jobs are at risk of automation by 2025.[9]

However, legacy technology, data quality, process complexity, and the volume of regulations present a formidable challenge for a single bank to fully automate; when two banks merge, the mission borders on impossible or at least impractical with all the other peripheral activities occurring.

Banks completing acquisitions may not have an appetite for the capital- and resource-intensive investment required to undertake such a transformation.

While Robotic Process Automation dominates the headlines for its potential transformative impacts, we believe that Incremental Automation ("IA"), the less-popular alternative, will come to dominate cost-reduction efforts on the front lines of bank integrations.

The goal of IA is to create an automated and digitized workflow that does not require a rip and replacement of IT systems and can more practically plug into a merger road map.

Integrations represent a perfect time to consider IA as processes are already inventoried and evaluated to determine which will be merged, stand alone, or eliminated.

9. http://money.cnn.com/2016/04/04/investing/bank-jobs-dying-automation-citigroup/index.html

The return on investment and payback can be quick, which is essential in the post-merger environment. Even under conservative estimates, banks can reduce millions of dollars of expenses annually by automating only five to 10 unique process steps.

3. **Spatially optimized branches into smaller, technology-intensive networks with cross-trained employees will become a merger play of choice:**

Pre-financial crisis, banks generally took a binary, keep or close, decision framework around acquired branches.

Navigant's analysis found that pending bank deals are generally targeting ~20 percent reduction in branches at the acquired bank, but with a median of only 31 acquired branches, the resulting reduction translates to ~6 branches per acquisition.[10]

As the front-line battle for deposits intensifies, Navigant expects banks to take a surgical approach to closures and look to branch spatial optimization to reduce branch costs, minimize customer impact, and safeguard the bank's deposit share pickup.

Spatial optimization is concerned with finding the best locations, dimensions, staffing models, designs, and technology that maximize output in terms of customers served per square foot and branch employees, while optimizing the customer transactional experience in terms of convenience.

A recent report by JLL estimates the U.S. banking industry could save as much as $5.1 billion annually if it downsized the average bank branch from 5,000 to 3,000 square feet.[11] Today's technology-powered micro-branches are already less than 1,000 square feet and serve as an excellent example for the potential of branch spatial optimization.

With the consensus that branches play a significant role in deposits and driving the sales of other products,[12] spatially optimized branches will become a prominent integration strategy that pulls on the following key levers of convenience:

- **Better decision-making:** Quickly and accurately provide customers appropriate information and the benefits of products and services so they can make informed decisions.
- **Increased access:** Smaller formats can be placed in higher-traffic areas for lower costs so banks can target more customers and increase proximity convenience.

10. Source: SNL Analysis of U.S. bank deal
11. http://www.reuters.com/article/us-bank-branches-idUSKBN17Q28N
12. http://www.us.jll.com/united-states/en-us/Research/US-Banking-Outlook-2017-JLL.pdf

- **Shorter cycle times:** More self-service technology, fewer customer handoffs, and more efficient branch design will reduce cycle times for customers and increase customers-per-branch-employee metrics for banks.
- **High-value interactions:** Enables employees to focus on higher value business development or loyalty-building opportunities such as advising on complex financial products or solving customer issues.

**We are entering an unprecedented era of banking M&A driven by the convergence of regulatory uncertainty, advancements in technology and data analytics, changing customer behaviors, and the need for funding to drive loan growth.**

Even in the face of regulatory approval risks, termination fees, increased valuations, and aggressive cost reduction targets, the current bank deal landscape is likely just the beginning of an emerging wave of consolidation among banks.

The winners of the next wave in banking M&A will make "in the trench" capability investments in regulatory compliance, aggressively automate back-office workflows, and spatially optimize their branch network with smaller, convenient, technology-driven designs.

If this is executed well, merging banks can achieve the trifecta competitive advantage of a more compliant, efficient, and customer-centric institution.

## ABOUT AUTHOR

**Jonathan Shiery** is a Director with the Banking, Insurance, and Capital Markets practice at Navigant. He has over 12 years of Commercial and Retail Banking experience advising on merger integrations, technology enablement, operational effectiveness, and regulatory compliance.

Mr. Shiery has led key initiatives on several multi-billion dollar mergers for a Top 10 bank, including a legal entity consolidation and restructuring resulting in over $100M annual savings, a $20B commercial portfolio integration, and the operating policy and procedure integration of a $27B U.S. credit card portfolio.

Mr. Shiery holds a B.Sc. in Industrial Engineering from The Pennsylvania State University, MBA from the IE Business School in Madrid, ES, and MSc in Banking and Financial Services from Boston University.

He is PMP and Scrum certified and has received an executive strategic decision making certificate from Cornell University. In addition, Mr. Shiery has been published on a number of topics in American Banker, Mortgage Banking, ABA Banking Compliance, and was a co-author of "Maximum Synergy Potential (MSP) for Merger Integrations."

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