Assessing the Bank M&A Landscape:
2017 Policy Drivers and What to Do About Them

Karen Shaw Petrou
Managing Partner

Federal Financial Analytics, Inc.
www.fedfin.com
info@fedfin.com

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Looking into the fourth quarter and beyond, it's clear that we confront strategic-planning inflection points vital to bank profitability in 2017 and beyond. The Presidential and Congressional elections are of course critical factors, but so are several less-noisy policy and regulatory decisions that will soon be made regardless of the November outcome. For banks of all sizes, these policy factors dictate a new style of deal analytics because the strategies many banks have adopted since the crisis have run out of gas. Now, cost-cutting is digging into the bone of service delivery and operational resilience even as organic growth is threatened by the ferocious combination of new rules and aggressive non-bank competitors.

Comparative advantage in an industry as regulated as banking requires identifying targets of opportunity in spite of and sometimes even because of the rules. In our practice, we have worked on several transactions based on this strategy and this morning I will outline some key considerations we have learned along the way.

First, I will lay out the 2017 policy drivers we are closely monitoring with bottom-line impact on organic growth and M&A viability. I will then suggest that these policy drivers – by which I mean the political and regulatory facts of life – require banks of all sizes and anyone interested in acquiring a bank to come out of the post-crisis bunker. Above average ROI requires best-in-class corporate-development action plans that keep a weather eye on the policy drivers that separate winners from the deals that take too long and do too little to spur meaningful profitability in a near-term timeframe.

Policy-Derived M&A Opportunities

Most banking CEOs and their boards don't like thinking about policy drivers and investment bankers generally only focus on the rules as they are, not as they may become. However, as with equity-price forecasts, M&A valuations should be forward-looking indicators. To achieve this in a regulated sector such as banking, forward profit analyses require forecasts of transaction constraints to come as well as emerging opportunities created by the confluence of policy and market realities.

One market reality to reckon with is aggressive non-bank competitors across the spectrum of financial products, many of which cherry-pick their offerings for bank customers based in part on pricing, distribution, structure, and even cross-selling options that are problematic or even off-limits for banks. Banks may fit well into these non-bank product offerings despite seeming regulatory obstacles, but banks looking to acquire, not be acquired, really have to figure out how to be better – not just bigger – if they hope to lift ROI above current, often-mediocre levels that provide little comfort for long-term franchise sustainability.

Forecasting Comparative Advantage

Now, let me lay out some helpful analytical tools to identify comparative advantage in the post-crisis policy and financial-market context before turning to some specific policy drivers I believe warrant careful and quick consideration.

As discussed in more detail on my firm's website, we adopt an analytical approach to M&A analytics derived from experimental science: we hold all exogenous factors as constant as possible and then introduce a variable, in this case the current and forecast policy framework. This might seem impossible due to the breadth of a bank and the scope, if not incoherence, of the policy landscape. But, it can be done if one disaggregates a bank or a target into its key business lines. Knowing what businesses you and the target are in and identifying your market and ROI goals, you run each business line through an analytical sieve constructed of the most important regulatory and political factors that identify where projected returns are in fact viable under probable policy conditions.

The reason for this rigorous, business-line driven analytical approach is simple: different rules have widely varying impact on different activities in both banks and non-banks. Even political attention without actual legal requirements affects business lines in very different ways – think about the brand-new furor over cross-selling and see how urgent it is to anticipate a redefined policy landscape regardless of Congressional stalemate.

Although there are some "cookie-cutter" analytics for traditional banking franchises, most are either doubling down on hoped-for efficiencies through consolidation or are increasingly non-traditional. Indeed, those that are still trying to do banking the way it was a decade ago need even more quickly to undertake comparative-advantage analytics – both the market and regulatory framework have changed so much and will change so much more that no bank enjoys the luxury of steady-as-you-go.

What have we learned about the most important differentiators of comparative advantage that provide guide posts along the way to innovative franchise design? Perhaps most important is the lesson that credit-risk capital rules – while of course a critical ROE driver – are far from the only rules that make a strategic difference. For example, when looking at fee-based activities – which we have urged bank clients to do regardless of size – operational risk-based capital requirements must be taken carefully into account. Thinking fintech? Then think legal and reputational risk. Thinking small-business lending? Hear the hoof beats coming as regulators now look to see if these loans are being inappropriately cross-sold with traditional banking products. And, foreign banking organizations have a set of home-country and U.S. rules that also require advance consideration, especially for non-traditional activities.

Comparative Advantage's Two-Way Street

Policy driver business-line analytics work not only for banks looking at banks, but also when a non-bank company or private-equity firm is looking at acquiring either a bank or an activity a bank wishes to divest. In a recent article, I have laid some of these policy drivers out for an insurance company, TIAA, which has now announced a regional-thrift acquisition. We have also done proprietary work finding that there can often be additional advantages in specialty insurance operations where TIAA's consumer goals do not apply. Alternative securitization models are also dependent on the applicable regulatory regime, leading us in other contexts to evaluate how subprime retail loans, conforming residential mortgages, and other asset types could move through the financial system from a bank to a non-bank or vice-versa.

Top-Priority Policy Drivers

A critical policy driver dictating which non-traditional activities go where was released on September 8. If you have not yet read the inter-agency report from the FRB, OCC, and FDIC on which products and activities they think fit well with insured depositories and which they think for sure don't, I would suggest you quickly turn to it for a road-map of which activities and acquisitions go where.

Each of the agencies has a different perspective. The FDIC's is by far the most favorable for non-traditional – albeit largely non-fintech – activities, but even the FRB seems reconciled to insurance and securities brokerage now that it has proposed its capital framework for insurance and is learning to live with Charles Schwab (the most significant company yet to cross the chasm between banking and brokerage). The inter-agency statement is replete with specific discussions of individual activities and businesses, many of which on their own seem minor, but several of which could be significant added revenue drivers without meaningfully increasing regulatory costs for banking organizations. I actually found this statement a very useful guide to non-traditional activities that may face remarkably few obstacles to acquisition.

The Big Picture

I have focused so far on specific business-line analytics that lead to rigorous transaction forecasts and, then, pricing. So, assume you want to do the deal. Can you?

Here's where the broader policy and political framework comes in – be afraid, it will advance or squelch deals for reasons that have nothing to do with the deal structure and everything to do with who's doing the deal. Developments we forecast with impact here include:

- more latitude for regional BHCs between $10 billion and $250 billion once the smoke has cleared over other, more controversial reforms after the election, diminishing organic-growth obstacles and even reducing obstacles to acquisitions with add-on assets;
- still more flexibility for community banks that cross the $10 billion threshold;
- continuation of the FSOC SIFI-designation standards and a greater focus on activity-and-practice rules in a Democratic Administration;
- additional barriers to cross-selling and to inter-affiliate transactions regardless of who wins;
- a still tougher stand on CRA if Democrats win and stringent AML, cyber-security, and related thresholds no matter what;
- a very cautious OCC when it comes to innovative fintech charters and a deal lag of at least a year if there is a gap in OCC leadership after the election;
- very slow progress on the FRB's newly-announced efforts to bar future ILC franchises and restrain grandfathered unitary thrifts. Given Congress's propensity to grandfather prior actions even if it acts, a significant window of opportunity is here at hand; and
- tough actions by the FRB on BHCs with assets over $250 billion, let alone the GSIBs with regard to capital, resolution planning, and internal controls. That said, I think niche deals are doable, especially when the niche is service or technology based and does not add a lot of assets or liabilities to the consolidated balance sheet.

Conclusion

You'll have noticed that I haven't talked much about the usual transaction issues such as getting community-group acceptance or the cost of cleaning up after a lot of legal and reputational risk. I know that you've heard many expert opinions on this in the course of this conference and I've little to add. These regulatory hurdles to transactions are very important, but also a path well-trodden by many M&As that have gone before to sometimes unhappy fates.

What I think is often less well recognized is just how much opportunity is left for banking franchises if the planning horizon goes beyond traditional structures and considers value-add deals that divest activities with comparative disadvantage and reinforce a firm's comparative advantage.

We've learned that leverage in terms of having too much risk for too little capital is all too dangerous. But there's another kind of leverage that's good for banking and great for shareholders: leveraging intellectual capital to build on profitable activities that are likely to achieve acceptable ROIs despite policy challenges.

Many of you may think that banking has been dying the "death of a 1,000 cuts" due to all the new rules, and I feel that pain. But, lots of small wins can also pile up and then fire up a successful, future-oriented earnings engine. Some big wins will come with big deals, but niche transactions even if less significant in size can also leverage a company's earnings capacity. Each bank franchise, market, and acquirer has a different formula to calculate the right amount of intellectual leverage, but I have seen that many companies find it in new-style, regulator-approved leverage if they consider deal dynamics with a keen eye on the long-term comparative advantage that comes with calling the policy framework fast, first, and right.