Market shake-up is driving financial institutions M&A

As the global economy shows promising signs of recovery, M&A deals in the financial services sector are set to pick up

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Bright outlook despite the dark clouds

Tighter controls and sell-offs by banks form the backdrop to an exciting financial services M&A market as the global economy continues to recover

The regulatory tidal wave that has engulfed the financial services sector since 2008 still stretches all the way to the horizon. But despite a couple of minor downgrades and aftershocks, the economic picture on a global basis is more positive than it has been for some time.

Nonetheless, regulatory pressures are likely to continue to suppress any serious appetite for big, expansionary M&A deals in the financial services sector, even more so because regulators themselves remain nervous about approving them. On top of this, there are the quite staggering costs of penalties for past misconduct. Banks, especially, will continue to be forced to sell assets rather than buy.

As long as there is no big shock in Europe or elsewhere in the world, we are confident about the prospects for financial services M&A in the foreseeable future. The sorts of exciting acquisitions being made now by better capitalised (usually smaller) banks, alternative asset funds, private equity firms, sovereign wealth funds and other investors are set to grow in number and in size. Banks will continue to drive financial services M&A by offloading non-core assets as they pull back from unprofitable business lines and territories, be it under pressure from regulators or because of a desire to refocus.

In the coming five to ten years, banks will become stronger than they are now. Some will retain their investment banking divisions, others will not. There will also be many more small and medium-sized private banking, wealth and asset management businesses emerging alongside the larger banks, partly as a result of the banks' divestments.

In this report, we have canvassed the opinions of leading experts in the world of financial services M&A to paint a picture of the trends in the market, set against a backdrop of tight regulatory pressures. We examine the global picture and the state of play in the UK and Europe. We also look at the emergence of alternative investors in financial services M&A deals in Europe.

Ashley Ballard **David Crook** **Gavin Weir**

Ashley Ballard
Partner, Financial Institutions M&A
London

T +44 20 7532 2128
E aballard@whitecase.com

David Crook
Partner, Financial Institutions M&A
London

T + 44 20 7532 2105
E dcrook@whitecase.com

Gavin Weir
Partner, Financial Institutions M&A
London

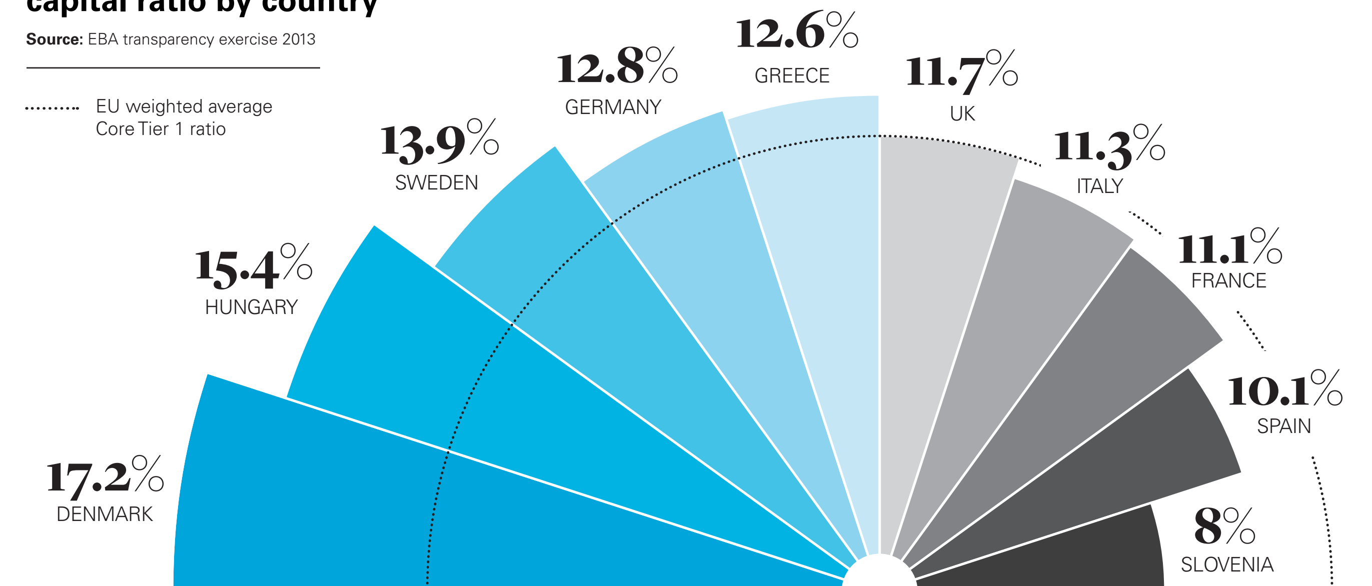
T +44 20 7532 2113
E gweir@whitecase.com

Testing time for banks could trigger more deals

Regulatory pressures on banks, in the wake of the financial crisis, are forcing some to reorganise and divest assets

European Banking Authority (EBA) core tier-1 capital ratio by country

Source: EBA transparency exercise 2013

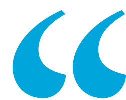


With equity markets nearing or surpassing all-time highs, better-than-expected growth in China, a resurgent Japan, a stabilising eurozone and the end of debt-ceiling problems in the United States, the world economy is in a better position than it has been for some years. The International Monetary Fund believes that the global economy will grow by 3.4 per cent this year and 3.9 per cent in 2015.

Amid this generally positive economic picture, though, the effects of the 2008 financial crisis continue to be felt by the banking sector. Regulatory enforcers, on the warpath for half a decade, have forced banks to pay more than US$100 billion in fines and related costs. The Libor scandal, allegations of foreign exchange market manipulation, as well as a host of mis-selling scandals continue to plague the sector, and the authorities are likely to continue in the same aggressive vein for some time yet.

Meanwhile, challengers are appearing on the horizon – and not just challenger banks forced to split from big retail banks. Thanks to advances in technology and a lower level of regulatory oversight, aspirational contenders are extending their reach. Some payment services companies, for example, are dipping their toes in business lending. Crowdfunders and peer-to-peer lenders are scaling up. As desktop internet banking gives way to mobile banking, telecoms companies and technology firms are looking to increase their positions in the market.

The financial crisis provided a wake-up call for many banks. Some had become so big and cumbersome that they suddenly found it impossible to effectively manage their multitude of subsidiaries around the world. Then came a wave of new rules imposed by governments desperate to avoid another crash. The cumulative effect is that banks are reshaping. And, as yet, there is no end in sight to the fervent regulatory rule-making.



The market often takes a stricter line than the regulators

GLOBAL REGULATORY PICTURE

To avert any over-reliance on banks deemed "too big to fail", the Basel Committee on Banking Supervision, the international standards-setter for banking, spearheaded a raft of changes. The primary goals have been to expand banks' capital buffers, increase their leverage, improve their liquidity and ensure they draw up emergency rescue plans. The Third Basel Accord or Basel III is currently the essential text.

The recommendations of the Basel Committee are at varying stages of implementation. Even if they have entered national statute books, most have lead-in times before they begin to bite. Nonetheless, banks have been put under pressure to act sooner rather than later, as investors demand they get themselves into shape quickly.

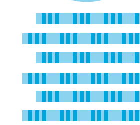
"One of the interesting things about the new regulations is that the market often takes a stricter line than the regulators," says Jonathan Warburton, head of EMEA banking at BNP Paribas. "For example, the market seems to demand that banks come with Basel III fully loaded – that is, that banks hit the regulators' required capital levels now, rather than waiting, as they are allowed to under the rules, to phase in."

From 2016, some 29 banks deemed by the Basel Committee to be of global systemic importance will be subjected to additional capital surcharges. The committee is drawing up a further list of banks of domestic systemic importance and these, too, will be forced to beef up their capital buffers further. A minimum leverage ratio of 3 per cent will come into play in January 2018.

Stephen Carter, head of financial institutions M&A at Credit Suisse, believes that the new capital requirements "will be key to helping overall stability in the banking sector".

Banks are to be forced to hold enough high-quality liquid assets to cover cash outflows for 30 days. The minimum requirement of 60 per cent cover will be phased in by 2015, rising to 100 per cent by 2019. In Europe, the schedule is even tighter at 80 per cent by 2017 and 100 per cent by 2018.

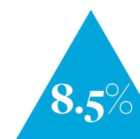
Meanwhile, the Financial Stability Board (FSB), another international standards-setter, has proposed that banks should be able to "bail-in" in an emergency, rather than use taxpayer funds for a bail-out. The bail-in technique typically involves converting creditors' financial claims into equity and was used in the UK late last year to help recapitalise the Co-operative Bank.



4.9%

of total deal value in Q1 2014 came from the finance sector

Source: Dealogic 2014



increase in deal volume in EMEA from the previous year

Source: Bloomberg 2014

Carter believes that the bail-in tool is an essential step forward, not just for nervous governments, but also, in the longer term, for banks. "It removes the pressure on governments to finance costly bail-outs," he says. "As soon as they are freed from that pressure, this will in turn relieve the regulatory pressure on banks."

The regulatory response to the financial crisis has not been harmonious across nations, with some countries choosing to be far stricter than international standards require. Increasingly, international banks are being forced by domestic governments to abide by national, rather than international, rules. These banks, as a result, are finding it harder to manage regulatory matters, such as emergency planning, on a group-wide basis. This sort of regulatory nationalism is likely to have a distinct impact on international banks, which may find it too difficult to carry on trading in certain countries.

Warburton says that despite all their efforts, regulators are unlikely to be able to prevent a future banking collapse outright. "By its nature, regulation tends to look backwards," he says. "A whole generation of regulators is trying to fight the last war. If you're going to do that, you probably won't identify the cause of the next war until it's too late. Yes, it's less of a risky climate than it was before. But will the regulations prevent a banking crisis in the future? Absolutely not."

Basil Geoghegan, a managing director in the financial institutions group at Citigroup, believes that the new regulations will create a more "utility-like" banking sector. "Big banks will be like utility companies," he says. "Stable and highly dependent on GDP growth and consumption, rather than on risky, expansionary tactics."

REGULATION IN EUROPE

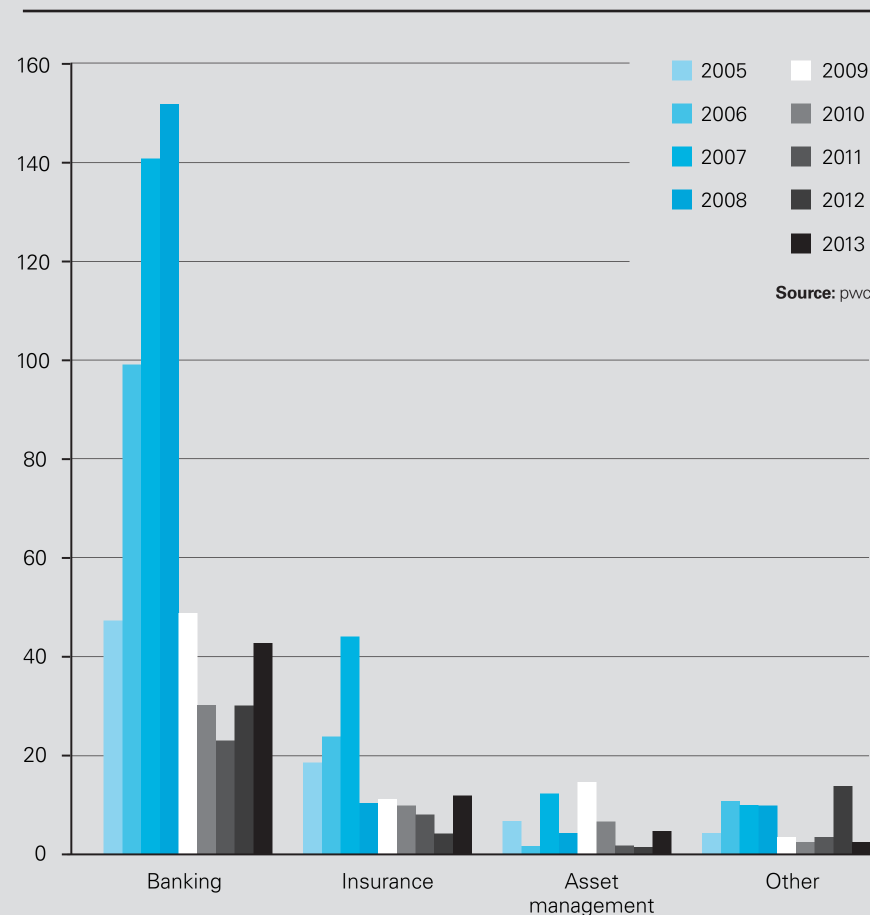
The triumvirate of European law-making bodies, the Commission, Parliament and Council, has quite often displayed reformist zeal when implementing the recommendations of the Basel Committee and the FSB.

In November, the European Central Bank (ECB) will become the overseer of 124 big banks in the European banking union, simultaneously opening a €55 billion "safety net" fund to absorb shocks

€55bn

"safety net" fund, to absorb shocks in the event of future crashes, will be opened when the ECB becomes the overseer of 124 big banks in the European banking union

European financial services M&A deal value by sub-sector 2005-2013 (£bn)



in the event of future crashes. As a warm-up exercise, the ECB is stress-testing all these banks and it is widely expected that some banks will be forced to divest assets in order to pass the test.

"This cycle of testing isn't going to stop this year," Warburton predicts. "Regulators are going to be scrutinising banks on a regular basis. While this might prompt divestments, on the other hand it is likely to deter big strategic M&A deals."

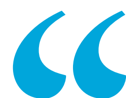
The European Commission made two proposals in January that are set to have a huge impact on international banks in the European Union (EU). It recommended that they should be banned from proprietary trading – that is, trading with client assets for the sole purpose of making profits for the bank – and that 30 of the biggest banks in the EU should split their retail and investment operations into separate units. With the Commission's latter proposal, some banks may well decide, if they have not already, that their investment banking arms are too expensive or too risky to keep alongside their retail operations and could opt to sell them off.

"Governments, as the lenders of last resort, have looked at their national balance sheets and decided whether or not they can afford to have investment banks on their books," says Geoghegan. "If they've decided they can't, they've made it very hard indeed for significant players to stay big or stay in the country at all."

He predicts that by 2020, the regulatory changes are likely to lead to a situation where two or three "champion" banks in each country operate under "oligopolistic conditions". "Some may well have a second or third home market, but they will be far more domestically focused," he says. "There may also be one or two continental banks."

CHANGING PICTURE FOR BANK M&A

"Banks are currently focusing on areas where they have a strategic advantage," says Carter. "That could be a high market share in a particular sector, for example, or a particularly unique capability, such as owning a market-leading product. Of course, another key driver is making top-notch returns.



The successful creation of a European banking union could be a trigger for increased levels of bank M&A activity

Management teams are becoming highly disciplined about this focus.

"Big banking groups aren't likely to get much bigger in the near term. But once they're optimised, then of course things might change." He believes that the successful creation of a European banking union could be a trigger for increased levels of bank M&A activity.

Warburton says that there has already been "a lot of tidying up around the edges", with asset sales in non-core markets and bolt-on deals in core markets. "However, there haven't been any big strategic deals. Certainly this year, the looming stress tests are making banks very reluctant to do anything big.

"But we're going to see more deals in the coming years," he predicts. "Additionally, banks now have sufficient levels of capital and liquidity to make the big, strategic purchases that have been lacking."

EU Parliament, Strasbourg

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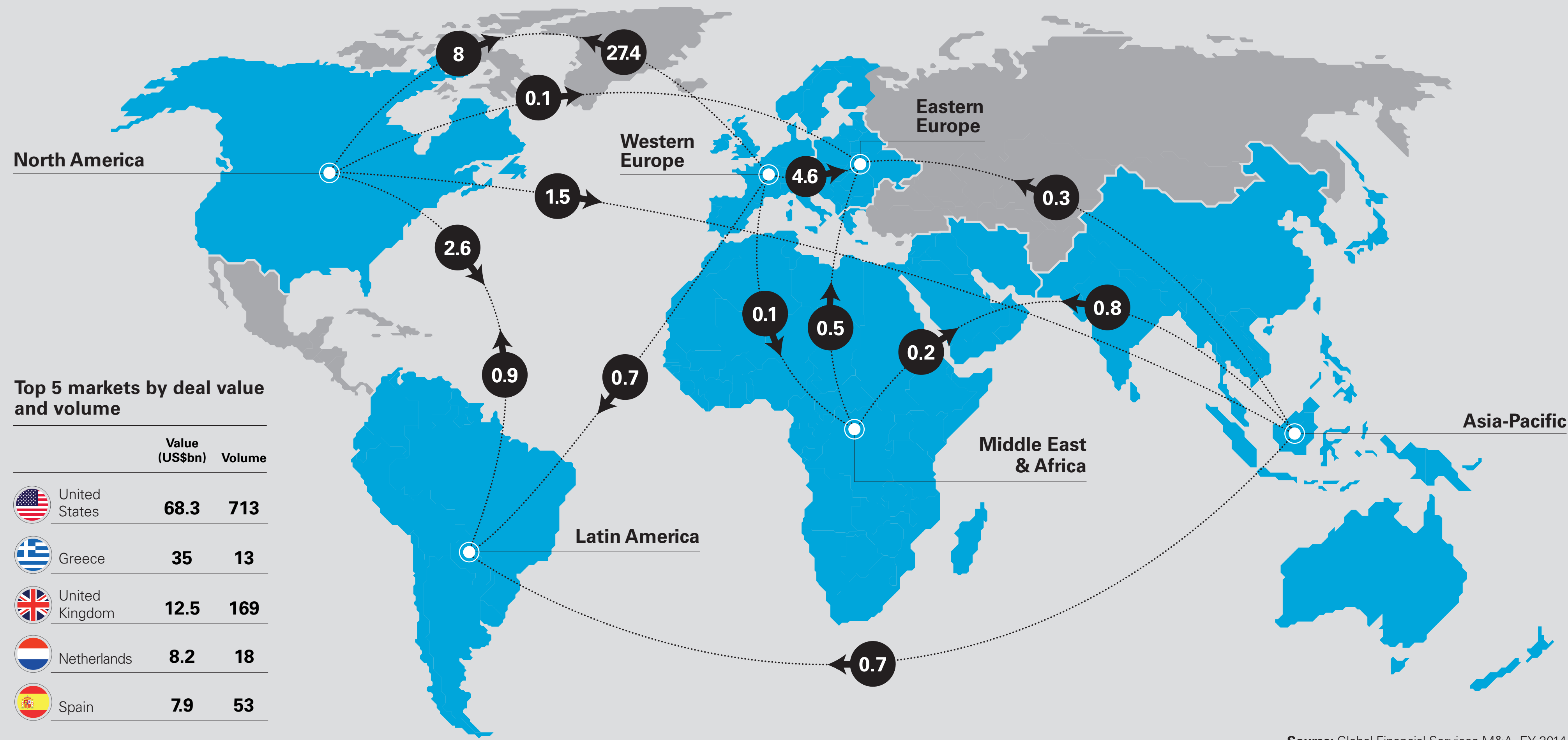
Global financial services M&A snapshot

Mergers & Acquisitions: Global deal flow 2013 (US$bn)

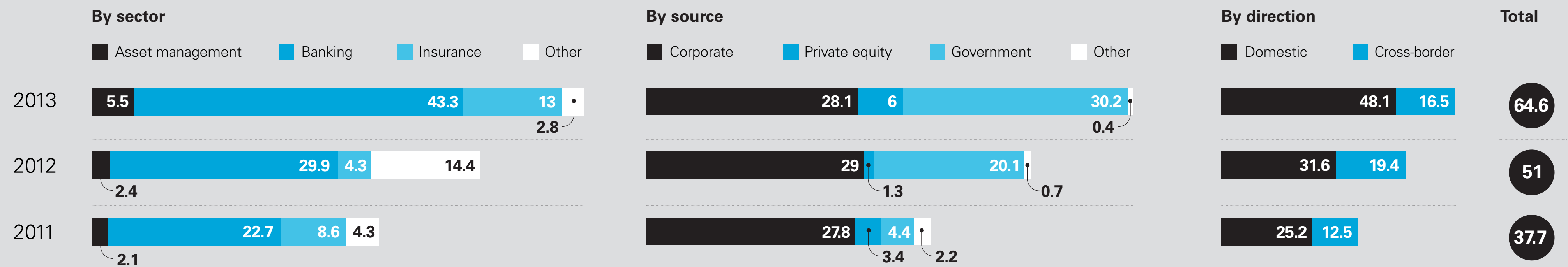


Source: Global Financial Services M&A, EY 2014

Top 5 markets by deal value and volume

	Value (US$bn)	Volume
United States	68.3	713
Greece	35	13
United Kingdom	12.5	169
Netherlands	8.2	18
Spain	7.9	53

Value of European financial services M&A deals 2011 - 2013 (€bn)



Source: Sharing deal insight European Financial Services M&A, pwc 2014

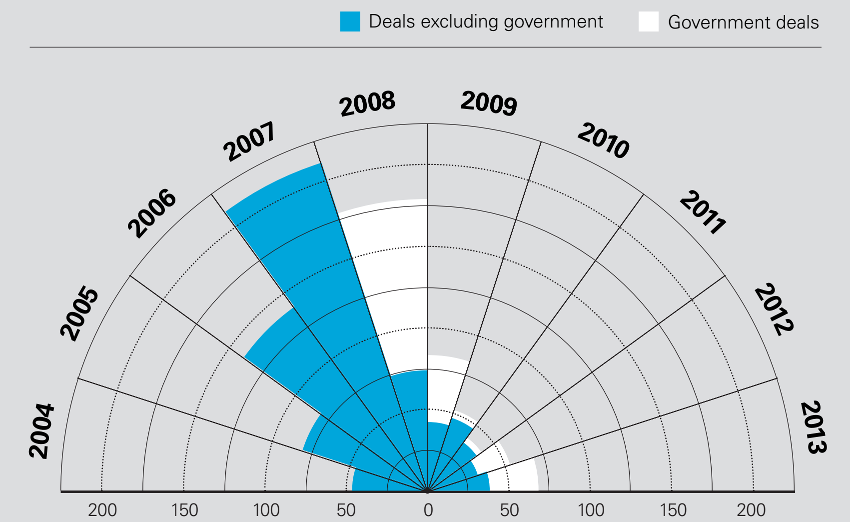
*may contain rounding errors

Top 10 global deals by disclosed value (2013)

Acquirer	Target	Value (US$m)	Stake (%)
AerCap Holdings	International Lease Finance Corporation	26,432	100%
Hellenic Financial Stability Fund	National Bank of Greece	11,403	84%
Hellenic Financial Stability Fund	Piraeus Bank	9,119	81%
Hellenic Financial Stability Fund	Eurobank Ergasias	7,633	99%
Bank of Tokyo-Mitsubishi UFJ	Bank of Ayudhya	5,595	72%
Hellenic Financial Stability Fund	Alpha Bank	5,272	84%
State of the Netherlands	SNS Reaal	5,047	100%
Hellman & Friedman	Hub International	4,400	n/a
BNP Paribas	BNP Paribas Fortis	4,385	25%
ORIX	Robeco Groep	2,590	90%

Source: Global Financial Services M&A, EY 2014

European financial services M&A deal value (€bn)



Source: Sharing deal insight European Financial Services M&A, pwc 2014

Qatar Financial Centre, located in Doha, Qatar

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Europe's banks welcome wave of alternative investors

New sources of capital are helping to power European deals

Historically, financial institutions M&A in Europe almost exclusively involved bank-to-bank sales. A limited number of financial sponsors typically bid for financial institutions.

All of that is changing. Now a growing number of deals include alternative capital providers, such as private equity firms, sovereign wealth funds and pension funds, which are eager to acquire bank assets or to co-invest in bank-to-bank transactions. As financial institutions M&A activity resumes after four difficult years, these new players are leading the charge in promoting M&A deals.

Several factors are contributing to this trend. Some banks must divest certain assets, particularly with new regulations requiring them to maintain higher capital ratios than in the past. Other banks may not be in a position to buy those assets, often for the same reasons. Traditional bank lending, constrained during the past few years, has remained tight in the wake of the economic crisis. So the relatively small number of banks that do plan to make strategic acquisitions may require assistance to fund their deals.

At the same time, many alternative capital providers have weathered the worst effects of the economic crisis, with some having accumulated significantly more available cash than they held a few years ago. On the hunt for yield, these investors have noticed enticing opportunities in the financial sector, an industry that previously had not been a focus for them.

The rise of alternative capital providers affects traditional financial institutions in several important ways. A broader array of potential purchasers and financing partners are now available to acquire bank assets, and to help banks fund transactions and share risks. The emergence of these investors as a growing force means future competition for good deals may become more intense. In addition, the presence of investors that may not have a long-term interest in bank assets, and may be buying with an eye towards an exit, could affect the banking industry's dynamics.

Three key categories of alternative capital providers have become increasingly involved in financial institutions M&A and this market may evolve even further.

PRIVATE EQUITY FIRMS

For a few years after the financial crisis struck, private equity firms were unable to play a major role in financial services M&A as they struggled to raise financing and off-load prior investments. Recently, though, many private equity firms have successfully shed their pre-crisis investments and are raising fresh capital intended for investment in Europe.

In 2013 alone, Europe-focused private equity funds raised US$64 billion, according to data provider Preqin. At the end of last year, private equity funds targeting the European market held approximately US$265 billion of undeployed capital. In January 2014, one Europe-focused private equity firm, the Luxembourg-based CVC Capital Partners, held an estimated US$20 billion of undeployed capital, more than half of which is earmarked for investments in Europe.

As private equity funds fill with fresh capital, they have been preparing for new investments, including in the financial services sector. For example, Bridgepoint, another Europe-focused private equity firm, bought Quilter & Co from Morgan Stanley in 2012 for approximately £175 million and then merged Quilter with Cheviot Asset Management to form Quilter Cheviot, the UK's second-biggest wealth manager, with £15.7 billion in assets under management.

In 2014, several notable deals are continuing this trend. First, Permira, also a Europe-focused private equity firm, bought the Birmingham, Edinburgh, Glasgow and Liverpool offices of Tilney Investment Management from Deutsche Bank, and merged the Tilney offices with Bestinvest, an investment adviser it bought from listed private equity house 3i, to bring the combined company's assets under management to approximately £9 billion. In May, two of the United States' biggest buyout houses, Warburg Pincus and General Atlantic, bought a 50 per cent stake in Santander Asset Management for an estimated US$1.4 billion. Then in July 2014, Blackstone Group bought Lombard, the European wealth adviser, from Friends Life Group for approximately £317 million.

"When you look at the amount of money that's been raised and is being raised, you would expect there to be significant deal activity," says Alexander Pietruska, managing director and European head of global financial services at The Carlyle Group. Michael Whitman, a senior managing director at The Blackstone Group and head of the European business of GSO Capital Partners, adds: "Private equity will look to play a prominent role in picking up the pieces from a stream of divestments."

Moreover, some of the largest US-based private equity firms, including Kohlberg Kravis Roberts, BlackRock and Apollo Global Management, have set up specialist desks to target investments in the European financial services sector, which may indicate their intent to focus intensely on European financial services transactions in the months ahead.

SOVEREIGN WEALTH FUNDS

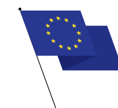
Figures from the Sovereign Wealth Fund Institute indicate that sovereign wealth funds had US$6.4 trillion in assets at the end of March 2014, up from US$5.4 trillion at the same point in 2013.

In seeking new investment opportunities for this abundant capital, many sovereign wealth funds

19.2%

increase in the value of deals through European deal-making in Q1 2014

Source: Mergermarket 2014



€1.02trn

EMEA deal volume in 2013, increased by 8.9% from last year

Source: Bloomberg 2014

€64.2bn

Total value of annouced European financial services M&A in 2013

Source: PWC 2014

22%

2013 deal volume for M&A in financials was the most active sector

Source: Bloomberg 2014

have begun turning to the financial institutions sector. According to Mergermarket, from 2011 to 2013, bids by sovereign wealth funds for financial services targets more than doubled as a value share of total activity, compared with the previous three years.

Because of their scale, sovereign wealth funds frequently invest larger amounts than the average co-investor. Qatar, which has assumed large stakes in a number of big European financial institutions, has recently paid €1.75 billion for a stake in Deutsche Bank in addition to stakes taken in Barclays, Credit Suisse, Bank of America and Agriculture Bank of China. Kuwait has joined the consortium that is buying Williams & Glyn, the challenger bank being spun out of Royal Bank of Scotland.

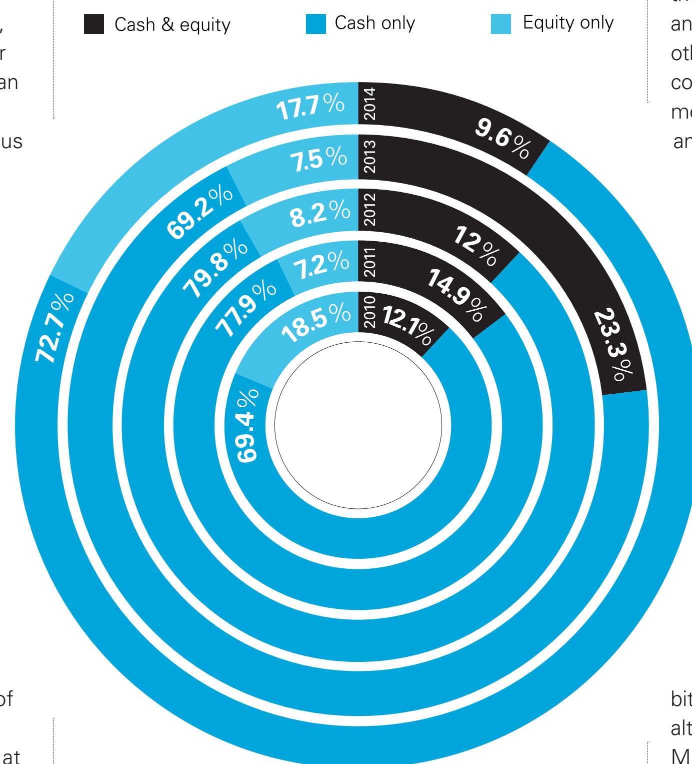
Fabrizio Cesario, head of M&A at Anacap Financial Partners, points out that many sovereign wealth funds have also recently hired financial services experts to build their skills in the sector and allow them to co-invest in private equity deals. "They are almost becoming competitors to private equity firms," Mr Cesario says. "They have huge pools of capital, so they are becoming an increasingly potent force."

PENSION FUNDS AND OTHER INVESTORS

Other alternative investors that have been investing in European financial M&A deals include pension funds, insurance companies and wealthy individuals.

In one of Europe's largest leveraged deals so far in 2014, ATP Group, the Danish state-owned pension fund, teamed up with Advent International and Bain Capital, two American private equity firms, to buy Nets, the biggest card payment company in Scandinavia, for approximately US$3.1 billion from a group of Scandinavian banks, including Danske Bank, Nordea and DNB. This deal came after Advent and Bain bought WorldPay, a card payment company owned by Royal Bank of Scotland, for just over US$2 billion in 2010.

SOURCES OF FINANCE: FINANCIAL SERVICES M&A



Source:
Mergermarket 2014

According to Mr Cesario, some of the world's largest pension funds have begun to operate like private equity funds and sovereign wealth funds by making considerable investments together with, rather than through, other firms. These investors demonstrate "an increasingly huge appetite" for participating directly in deals, he says, instead of investing indirectly through private equity firms, as they had done in the past.

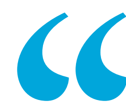
Pension funds and similar investors have learnt that investing directly in financial M&A deals can increase their control over deal structures and eliminate amounts they would otherwise pay to middle parties. This combined lure of greater control and more robust returns has created yet another class of financial players capable of both supporting the goals of and competing with traditional financial institutions.

LIKELY CONTINUED GROWTH

In the near future, the types of financial institutions M&A deals being conducted by private equity firms, sovereign wealth funds, pension funds and other alternative investors are likely to continue to grow in number and in size. In the next 18 months, "we should see a fair bit more M&A activity" involving alternative capital providers, says Mr Pietruska. Although regulatory pressure is restricting large M&A transactions among financial institutions in Europe, he believes confidence among financial services businesses is growing.

"Over the last few years, the increasing number of financial investors taking part in financial institutions M&A transactions has been noteworthy," White & Case partner Ashley Ballard concludes. "These investors often outnumber strategic buyers and many of them have worked to build relationships with the relevant regulators so that these regulators will be predisposed to welcome them into a sector that historically has been reserved for strategic investors."

More financial institutions deals may arise in the near future as banks divest additional non-core assets, such as surplus retail divisions, wealth management groups and other components, in response to regulatory pressures to withdraw from unprofitable business lines and territories or to refocus their businesses. With alternative capital providers now serving as new potential purchasers for bank assets and as savvy partners in funding transactions, financial institutions should explore the full range of their sales and financing options to be sure to get the best deal.



A growing number of deals include alternative capital providers, such as private equity firms, sovereign wealth funds and pension funds, which are eager to acquire bank assets or to help finance bank-to-bank transactions

UK banking shake-up is driving acquisitions

Sell-offs by banks will refocus priorities and strengthen the sector

With a slash of its sword, Brussels calmly sliced two big chunks from two of Britain's biggest lenders. By forcing Lloyds Banking Group and the Royal Bank of Scotland (RBS) to sell more than 1,000 branches, it also brought about two of the largest divestments from British retail banks in years.

Both banks were forced to sell "mini banks" as a condition of the state bail-outs they received in the depth of the banking crisis. RBS revived the Williams & Glyn brand for its 314 branch network and has sold a 49 per cent stake to a consortium led by Corsair Capital, a private equity firm. Lloyds tried and failed to sell 632 of its branches to the Co-operative Group in 2013, and floated them as TSB in June 2014.

But TSB and Williams & Glyn are not alone. The demand for greater customer choice and availability of niches not served by high street lenders has led to the emergence of the UK challenger bank segment.

To boost competition, the government has halved the minimum size of capital buffers for new banks relative to their older competitors. Aldermore, Bank of Ireland UK, Clydesdale, Metro Bank, OneSavings Bank and Virgin Money are all constituents of this segment and we expect more challenger banks to emerge in the coming years.

In the near term, investors in and owners of most of these challenger banks are focused on IPO exits. A public market valuation will underpin a flurry of M&A activity in the longer term.

However, recent divestments have not necessarily involved retail banking assets or been forced sales. A rethink of business models and an evolving regulatory landscape have influenced bank restructuring activity.

HSBC and Lloyds are good examples of banks that have proactively recalibrated their scope and footprint. As announced in its June 2011 strategic review, Lloyds has trimmed its international presence from 30 countries to fewer than ten in 2014. It has also narrowed its scope by selling Scottish Widows Investment Partnership, its asset management arm, to Aberdeen Asset Management; offloaded Heidelberger Leben, its German insurance arm, to Cinven, the private equity firm; and sold its majority stake in St James's Place, its wealth management platform.

This steady stream of divestments is the driving force behind financial services M&A at present. The trend is set to continue for the next few years, as management teams across the industry continue to optimise their business structures to maximise returns.

Regulation has also necessitated change. For example, the introduction of a leverage ratio requirement has led to a rethink of investment banking models across Europe over the last couple of years. Deutsche Bank is targeting a €500 billion reduction in leverage exposure by 2015 and has recently raised €8 billion through a rights issue. Similarly, Barclays raised some £6 billion through a rights issue last year and has put £340 billion of leverage exposure into a non-core unit for run-off.

In the medium term, we see regulation as a catalyst for M&A activity. As the European regulatory landscape converges under a banking union, business managers will be forced to think beyond borders.

While concentration in individual eurozone countries has increased, compared to pre-crisis levels as a whole, it still lags behind the United States. Estimated deposit market shares of the five largest US banks are about 44 per cent compared with around 26 per cent in the eurozone.

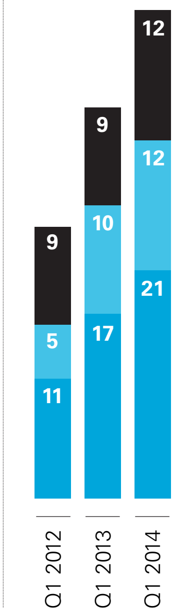
As "buy" signals begin to turn from amber to green in the financial services sector, a variety of sophisticated investors have become more willing to take risks. Private equity firms, which are showing signs of renewed confidence after years in the wilderness, are emerging as hungry buyers of divested financial services assets, as could be seen with Corsair leading the purchase of Williams & Glyn.

Helpfully, the economic ground upon which we stand is also far more solid than it was a year ago. At the same time as it downgraded its global growth predictions in May, the Organisation for Economic Co-operation and Development raised its growth forecast for Britain from 2.4 per cent to 3.2 per cent this year.

Come 2020, thanks to all of this activity, the UK financial services market will be more competitive and its customers will be better served. The divestments set to take place in the next few years will serve to refocus priorities, freeing up companies to concentrate on what they are best at. And, with time, these companies will become more profitable than they are now.

UK FINANCIAL SERVICES M&A TRANSACTIONS BY VOLUME

£5m-25m
£25m-100m
£100m+



Source:
IMAS Corporate Finance 2014

Stephen Carter
Head of Financial Institutions, Credit Suisse

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