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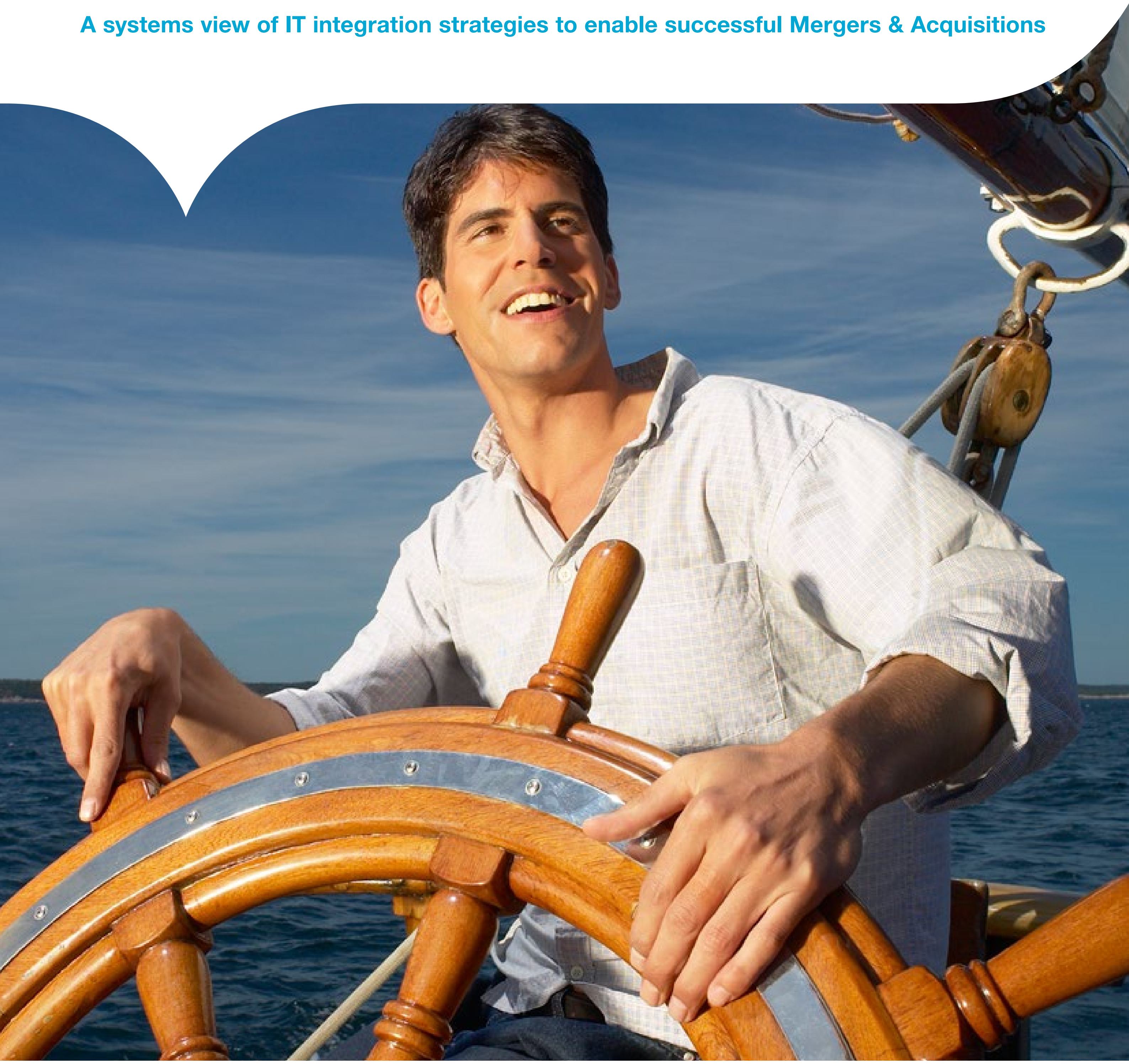
Mergers & Acquisitions in Banking: How to Steer Through the Turbulence

A systems view of IT integration strategies to enable successful Mergers & Acquisitions



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1. Introduction

Mergers and acquisitions (M&A) are core activities in the banking industry. However, the total number of M&A deals in the financial services industry in 2013 has declined to 105 in the first half of the fiscal year (H1), from 141 in H1 2012. The combined value of M&A deals has declined by 36% in H1 2013 from H1 2012.[1] The banking industry is also facing a flood of stricter new regulations such as the Dodd-Frank Act in the U.S. However, the scenario may change in the coming years as M&A activity gains traction due to new regulations, especially in the U.S. and Europe. But for smaller banks it is simply too expensive to fulfill all new regulatory requirements. In addition to regulations, an increased availability of capital is also likely to drive M&A, especially in Latin America and Asia-Pacific. Banks in these regions continue to generate reasonable profits.

Having the IT function ready from day one of the post-merger period is of paramount importance for successful M&A. A lack of focus on an IT integration strategy can create a continuous challenge for the bank to become truly integrated, leading to higher technology costs as time progresses. This paper examines integration strategies, IT integration models, and best practices from a systems view for banks involved in M&A.

1 Allen & Overy, M&A Index H1 2013, http://www.allenovery.com/publications/en-gb/maindex/Pages/default.aspx

2. Regional Drivers for Banking M&A

Large banks in the U.S. are likely to focus on the restructuring required for regulatory compliance and may be holding back their M&A plans until the restructuring activities are complete.

Banking M&A activity varies across different regions, driven by differences in economic conditions and industry policies.

2.1. North America

Economic conditions in the U.S. have improved since the global economic crisis. In the third quarter of 2013, the gross domestic product (GDP) expanded at a 2.8% rate, the fastest pace since the third quarter of 2012.[2] However the banking industry witnessed an increased number of new regulations. For example, banks need to comply with new and stricter regulations such as the Durbin Amendment and Dodd-Frank Act which require an improvement in capital ratios.

Canada's banking industry is growing steadily. In 2012, the 'big six banks' in Canada reported an average of 17.1% return on equity. However, Canadian banks are also facing increased number of regulations.

As a result of these regulations, large banks in the U.S. are likely to focus on the restructuring required for regulatory compliance and may be holding back their M&A plans until the restructuring activities are complete. These regulatory rules are expected to grant some concessions for small banks, as these smaller banks will be at a disadvantage in the market. However, these smaller banks will still be affected by the investments required for implementing these regulations, which might drive consolidation.

2.2. Asia-Pacific

Asia-Pacific is currently undergoing an economic expansion. Though the GDP growth rate decreased to 5.5% in 2012 from 8.4% in 2010, the growth rate is still highest among all other regions.[3] Average return on equity (ROE) among top 40 global banks from 2009 to H1 2012 shows that Asia-Pacific banks have outpaced the ROE of North American and European banks.[4] At the same time, according to a 2013 study, two-thirds of the global middle class will be residents of Asia-Pacific by 2030.[5] There is an increased competition among banks in this region to capture this growing opportunity. However, foreign ownership policy is expected to become stricter under Basel III requirements, which could restrict opportunities for the foreign banks. Regional banks are facing tougher financial regulations. For example, in China the minimum capital adequacy ratio has been raised to 11.5% for financial institutions of systematic significance.

Asia-Pacific is expected to lead the global banking M&A in coming years due to a comparatively stable economy and growing middle income group segment. Growth opportunities in this region might attract banks from mature regions. However the mature region banks are currently struggling with capital requirements. Growth in M&A deals, initiated by foreign banks, is expected to be dampened slightly because of the strict regulation on foreign investment. On the other hand, some large Asia-Pacific banks with enough capital might start looking for M&A candidates in the mature markets.

2 U.S. Bureau of Commerce, Bureau of Economic Analysis: National Income and Product Accounts Gross Domestic Product, 3rd quarter 2013, http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm

3 World Wealth Report, Capgemini and RBC Wealth Management, 2013

4 Ernst & Young, Time for bold action: Global banking outlook 2013–14, 2013

5 By 2030 two-thirds of global middle class will be in Asia-Pacific, April 2013, Ernst & Young

2.3. Europe

The economies of the 17 nations that make up the Eurozone region are improving. In the second quarter of 2013, the combined GDP of the Eurozone region grew by 0.3% for the first time since the third quarter of 2011. This growth was mainly driven by the rebound of the top two economies of the region, Germany and France. However, the GDP is still expected to decrease by 0.6% in 2013, before growing again in 2014.[6]

The sovereign debt crisis has caused many banks in this region to reduce their staff size to cut costs and to sell assets to meet tougher capital rules under Basel III standards. These reasons are driving restructuring and consolidation in the home market. For example, the Rabobank Groep is shedding units to strengthen its finances amid slowing asset growth and competition for deposits in the Netherlands. In February 2013, it agreed to sell a controlling stake in its asset-management unit for $2.59 billion.[7] In emerging European countries, the banking industry is still fragmented, which will drive consolidation in these regions. The innovative and fast-growing retail banks in the region require capital to support their growth.

The sovereign debt crisis has caused many banks in the Eurozone region to reduce their staff size to cut costs and to sell assets to meet tougher capital rules under Basel III standards.

As a result of these drivers, the European banking industry is witnessing increased consolidation activities. In addition to consolidation among regional banks, a number of large Chinese banks are also expanding into the European market.

2.4. Latin America

Brazil, the world's seventh wealthiest economy, remains Latin America's most important banking market. In 2012, Brazil's GDP growth decelerated to 0.9% from 7.5% in 2011.[8] However, in the second quarter of 2013, the GDP increased by 3.3% year-on-year.[9]

In the last decade, the middle class in Latin America grew by 50%, and now represents 30% of the population.[10] Banks are leveraging this healthy growth which creates a strong demand for banking products. Latin America has conservative banking practices and has experienced tight regulation since the financial crises of this region in the nineties. Thus, Latin American banks are better equipped to adapt to stricter regulation policy changes.

Although the stable economy in Latin America could attract foreign banks, strict regulations act as a hindrance. In addition, political risk is another reason for the slow pace of inbound M&A activity in this region.[11] To boost industry efficiency, national regulators across Latin American countries are encouraging small banks to consolidate and improve their capital ratios. Hence, consolidation among domestic players is likely to drive M&A in this region. On the other hand, foreign players might wait for a more favorable regulatory and political environment. Also, some of the Brazilian banks are looking to enter Asia-Pacific and Middle East markets due to growing opportunities in these regions.

6 Mark Thompson, Europe exits recession, CNN Money, August 2013, http://money.cnn.com/2013/08/14/news/economy/europe-economy-growth/index.html

7 Maud van Gaal and Shigeru Sato, "Orix to Buy Rabobank Asset-Management Unit for $2.6 Billion", Bloomberg, February 2013, http://www.bloomberg.com/news/2013-02-19/orix-to-buy-rabobank-asset-manager-robeco-for-1-94-billion-euros.html

8 "Brazil Overview", The World Bank, http://www.worldbank.org/en/country/brazil/overview

9 "Brazil GDP beats expectations for second quarter", BBC News, 30 August 2013, http://www.bbc.co.uk/news/business-23901453

10 "Latin America: Middle Class hits Historic High", The World Bank, November 2012, http://www.worldbank.org/en/news/feature/2012/11/13/crecimiento-clase-media-america-latina

11 "Improving Security and Economic and Political Inclusion", USAID, September 26, 2013, http://www.usaid.gov/where-we-work/latin-american-and-caribbean

According to a recent report, banking M&A deal values in the Middle East substantially increased from $1.5B in 2011 to nearly $7B in 2012.

2.5. Middle East

Several banks in Middle East have enjoyed high liquidity due to rising oil prices. However because of the unfavorable political situation, not many banks outside the Middle East are interested in starting operations in this region. Since there are already sizeable banks in this region, consolidation among local banks is likely to remain slow. Given their experience in Islamic banking activities, these banks might focus their outbound M&A[12] activities on growing Islamic banks in Central Asia and Far East.

According to a recent report, banking M&A deal values in the Middle East substantially increased from $1.5B in 2011 to nearly $7B in 2012.[13] The increase in the M&A investment in 2012 was mainly driven by restructuring efforts in this region. The political situation is still unstable in the Middle East, so well capitalized banks from this region might look for outbound M&A in nearby growth markets.

2.6. Africa

Very low banking penetration is the main driver for M&A in Africa. The banking penetration in Africa varies significantly from country to country. For example, Sub-Saharan Africa has a banking penetration level of 18%.[14] The banking industry in Africa is stable with solid earnings growth and high returns on equity.[15]

Because of the evolving nature of the banking industry in Africa, banks are likely to look for domestic consolidation. In addition, high growth opportunities and favorable banking regulations in this region could attract e foreign banks to enter this market.

12 Outbound M&A refers to M&A done outside the country or region

13 "The Journal-- Brave new world: New frontiers in banking M&A", PwC, January 2013, http://www.pwc.com/gx/en/banking-capital-markets/journal/index.jhtml

14 The figure represents the percentage of total adults with an account opened at a formal financial institution

15 Overview of the African Banking Sector, http://www.proparco.fr/webdav/site/proparco/shared/PORTAILS/Secteur_prive_developpement/PDF/SPD16/SPD16_key_data_UK.pdf, accessed on Jan 10, 2014

3. Trends Impacting Banking M&A

Globally, the banking M&A landscape is evolving at a rapid pace. We have identified the following key trends for global banking M&A:

- Banks are optimizing their global footprint.
- Small and mid-sized banks are experiencing increased consolidation.
- Large banks are expected to have limited M&A activities in the near future.
- Banks are looking for growth in emerging markets.

3.1. Trend 1: Banks Are Optimizing Their Global Footprint

In the last few decades, banks have expanded their business to serve global customers. However, banks are now reevaluating their strategies based on the current global economic situation. Moreover, stricter regulation and stringent capital and liquidity requirements are creating challenges for foreign banks. For example, new regulations such as Basel III and the Volcker Rule would add to risk-management costs and impact global operations. Changing tax regulations in some countries are also impacting the operation of foreign banks. Hence, banks are focusing on streamlining their operations by focusing on core services. For example, in 2013, Citi agreed to sell their remaining 35% stake in Smith Barney to their joint venture partner Morgan Stanley.[16]

This restructuring of a bank, primarily driven by changed capital requirements, can also be considered as a special case of consolidation. This consolidation exercise may lead to selling or buying of specific portfolios. Larger banks are expected to focus on local operations and are expected to move away from locations where stricter regulations are being implemented. On the other hand, smaller and mid-sized banks are expected to buy these branches from the larger banks at a lower price. In 2013, Bank of America entered an agreement to sell 51 retail branches located in Eastern Washington, Idaho, Oregon, and New Mexico to Seattle-based Washington Federal.[17]

3.2. Trend 2: Small and Mid-Sized Banks Are Experiencing Increased Consolidation

After the financial crisis, regulatory bodies in most countries have resorted to regulatory reform to create a more transparent banking system. In European countries, Basel III implementation is underway. Similarly, Dodd-Frank and the Volcker Rule are being implemented in the U.S. These new regulations come with stringent capital and liquidity requirements, so banks are focusing on improving their liquidity and capital position. At present, the first priority is to comply with the regulations, which means larger banks might be holding off their inorganic expansion plans. On the other hand, stringent capital and liquidity requirements might pose a threat for the operations of small and mid-sized banks, and they might consider selling their operations. For example, in the U.S., the M&A focus is on banks with less than $1Bn in assets.[18] This environment could create opportunities for local large banks.

16 Halah Touryalai, "The Moment Morgan Stanley's Been Waiting For, It Can Buy All Of Smith Barney", Forbes, June 2013, http://www.forbes.com/sites/halahtouryalai/2013/06/21/the-moment-morgan-stanleys-been-waiting-for-it-can-buy-all-of-smith-barney/

17 Laura Marcinek and Donal Griffin, "BofA Joins JPMorgan in Having Units Ripe for Sale, Mayo Says", Bloomberg, January 2 2013, http://www.bloomberg.com/news/2013-01-02/bofa-could-join-jpmorgan-selling-units-to-boost-value-mayo-says.html

18 "Consolidation: Bank M&A volume declines further", Euromoney, January 2013, http://www.euromoney.com/Article/3135666/Consolidation-Bank-M-A-volume-declines-further.html

3.3. Trend 3: Large Banks Are Expected To Have Limited M&A Activities In The Near Future

Banks have been cautious in last few years following the financial crisis in various developed countries. M&A activities are more closely scrutinized by both public and government regulatory bodies. Large banks are heavily affected by the new regulations and have become conservative about their operational strategies. To avert the risk of losing business and reputation, banks are expected to streamline their businesses, in particular both local and global M&A. A combination of uncertain economic conditions in developed countries, increasing regulatory pressure, and concerns over reputational risk is forcing larger banks to focus on long term planning and remain cautious for any upcoming M&A. This slowdown of M&A among large banks would be particularly evident in the developed countries.

3.4. Trend 4: Banks Are Looking For Growth In Emerging Markets

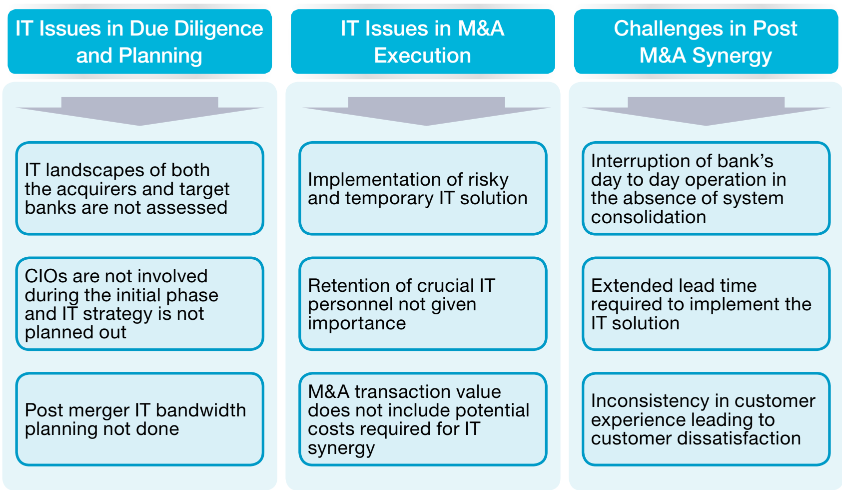
In the past few years, developed countries were faced with several economic challenges, such as the sovereign debt crisis in Eurozone and the debt crisis in the U.S. Compared to this, emerging markets such as Asia-Pacific witnessed a more stable economic condition. Despite the moderation in growth, Asia-Pacific still remains the most attractive economic region globally and exerts increasing influence on other developing regions. While developed countries have a mature banking industry, the rise of the middle-class is leading to an increased demand for banking products. This is likely to drive an increased interest in this region and global banks are likely to increase their footprints here. To strengthen the banking industry, regulators in some emerging markets are encouraging banks to consolidate. For example, in the Philippines, regulators introduced a set of incentives in 2012 to encourage local banks to consolidate.[19] Banks from mature markets such as Europe and North America might be planning on expansion into these emerging markets through M&A.

19 Ehda M. Dagooc, “More mergers to strengthen Phl banking system – Gesta”, PhilStar.com, March 2013, http://www.philstar.com/cebu-business/2013/03/06/916420/more-mergers-strengthen-phl-banking-system-gesta

4. IT Issues and Challenges in Banking M&A

Despite continued global uncertainty, M&A remains an essential instrument for growth initiatives in the coming years. However, IT integration is not considered a driver for banking M&A and is seldom given full attention during the entire M&A execution. This lack of focus leads to multiple post-M&A challenges for banks.

Exhibit 1: Issues and Challenges in Banking M&A from an IT Perspective



Source: Capgemini Analysis, 2013

CIOs and IT executives should be involved in the early stages of M&A planning, and banks should make their IT systems ready for the impending IT integration well in advance.

4.1. Due Diligence and Planning

In banking M&A, IT integration is often ignored by acquiring banks. The valuable inputs of the IT department regarding IT synergy, transformation requirements, and timeline required for such integrations are not generally considered during the due diligence and planning phase. CIOs and IT executives should be involved in the early stages of M&A planning, and banks should make their IT systems ready for the impending IT integration well in advance.

The target bank's IT environment and the synergy between the IT systems of the two banks should be assessed during the pre-M&A phase. Planning for IT integration associated costs and personnel requirements, should be done before the M&A, otherwise the IT integration would take much longer time than required.

4.2. M&A Execution

When acquiring banks fail to do proper pre-merger planning, they often implement quick IT solutions so that the bank can start operating from day one. These temporary solutions carry a high risk of failure and result in an inconsistent customer experience. Eventually, the temporary solution will need to be replaced by a permanent one, which results in higher costs in the long term.

IT is a support function for banks. It is among the first functions where employee downsizing is done, and sometimes crucial IT personnel with in-depth knowledge of the acquired bank's IT landscape become a part of the downsizing effort. The absence of these people makes post-merger system integration more difficult to plan and implement.

Finally, since IT is seldom considered during the due diligence phase, the M&A transaction value often doesn't include the cost required for IT integration. This sometimes results in an overvalued M&A transaction cost, making the deal unprofitable due to the amount required for post-merger system integration.

4.3. Post M&A Synergy

The absence of an integrated IT system leads to costly and inefficient operations. The IT system, which should comply with all security and risk concerns, needs to be ready to use from the very first day after a merger. It would take time after a merger to create an integration strategy such as whether to keep the acquired bank's system, integrate the acquired bank's system with an existing system, or go for a system transformation. When treated as an afterthought, the lead time required to implement the permanent IT solution often overshoots the projected lead time. The lack of integration of systems such as CRM or the bank's websites, can negatively affect customer service, which leads to customer dissatisfaction.

5. Way Forward

In banking M&A there are four IT integration models commonly selected by acquiring banks, based on their business strategy and the target bank's size.

5.1. IT Integration Models

Disparate

In this strategy, the IT systems of both the acquirer and acquired banks are kept in place and are not integrated. This commonly happens in the case of business expansion M&A.

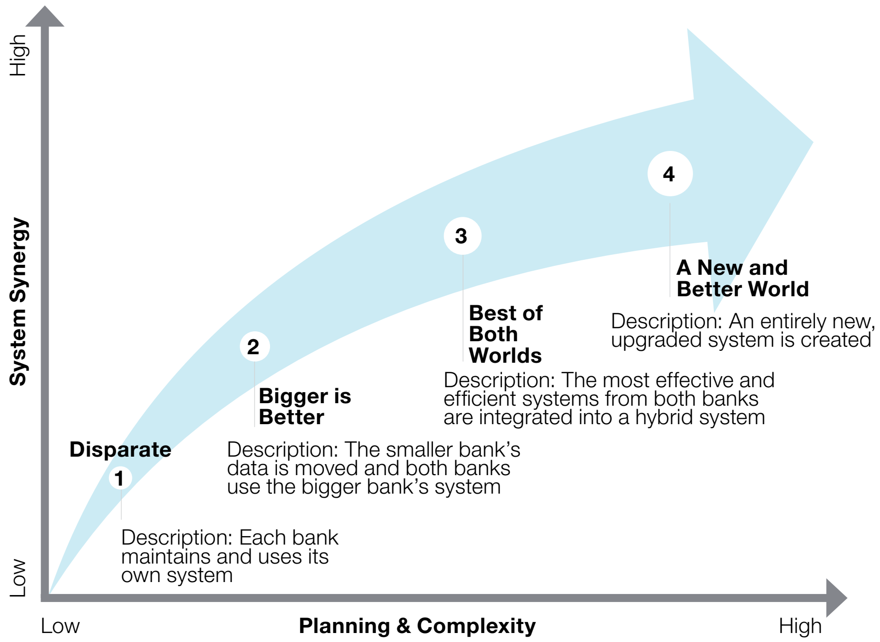
Bigger is Better

In this model, it is assumed that the bigger banks have better technology in place. The IT systems of the smaller bank are replaced by that of the bigger bank.

Best of Both Worlds

In this strategy, the IT systems of both banks are fully assessed, and the most effective and efficient systems from either bank are retained.

Exhibit 2: Integration Models Adopted in Banking M&A



Source: Capgemini Analysis, 2013

A New and Better World

Instead of spending money on integrating two separate systems, the acquiring bank can choose to go for an overall system transformation. The existing IT systems in both banks would be replaced.

Each of the IT integration models has its own strengths and weaknesses, and should be selected based on the specific business strategy.

5.2. Business Strategies

The business strategies that drive banking M&A can be classified under four categories.

New Business Acquisition

In this case, the business strategy for the acquiring bank is to venture into a new line of business. The acquired bank is a business extension, and the acquiring bank doesn't need to worry about integrating the IT functions. They mostly choose the **Disparate** IT integration model. The major advantage of this model is that the lead time is very short.

Ideally the IT integration model should be selected based on the IT landscape of the acquired bank. For example, if the acquired IT system is outdated, the acquiring bank can choose to merge or transform the two systems for a seamless operation from day one. The major drawbacks of this model are that the process is costly and requires longer lead time.

Small Bank Acquisition

The primary strategy for the acquiring bank in this category is volume expansion. The acquired bank is much smaller in size, and it is assumed that the bigger bank has better IT system in place. The IT integration model typically selected for this type of M&A is **Bigger is Better** as the major advantage of this model is that the lead time is very short. However, since the IT landscape of the smaller bank is often not assessed, the acquiring bank loses an opportunity to leverage some of the more efficient systems of the smaller bank.

Full Bank Acquisition

In this strategy all the business operations of the target bank are acquired, achieving both volume and business line expansion. The most common IT integration model followed in this type of M&A is **Best of Both Worlds**. This model requires an IT landscape assessment of both banks well ahead time to create proper integration planning.

M&A Among Equals

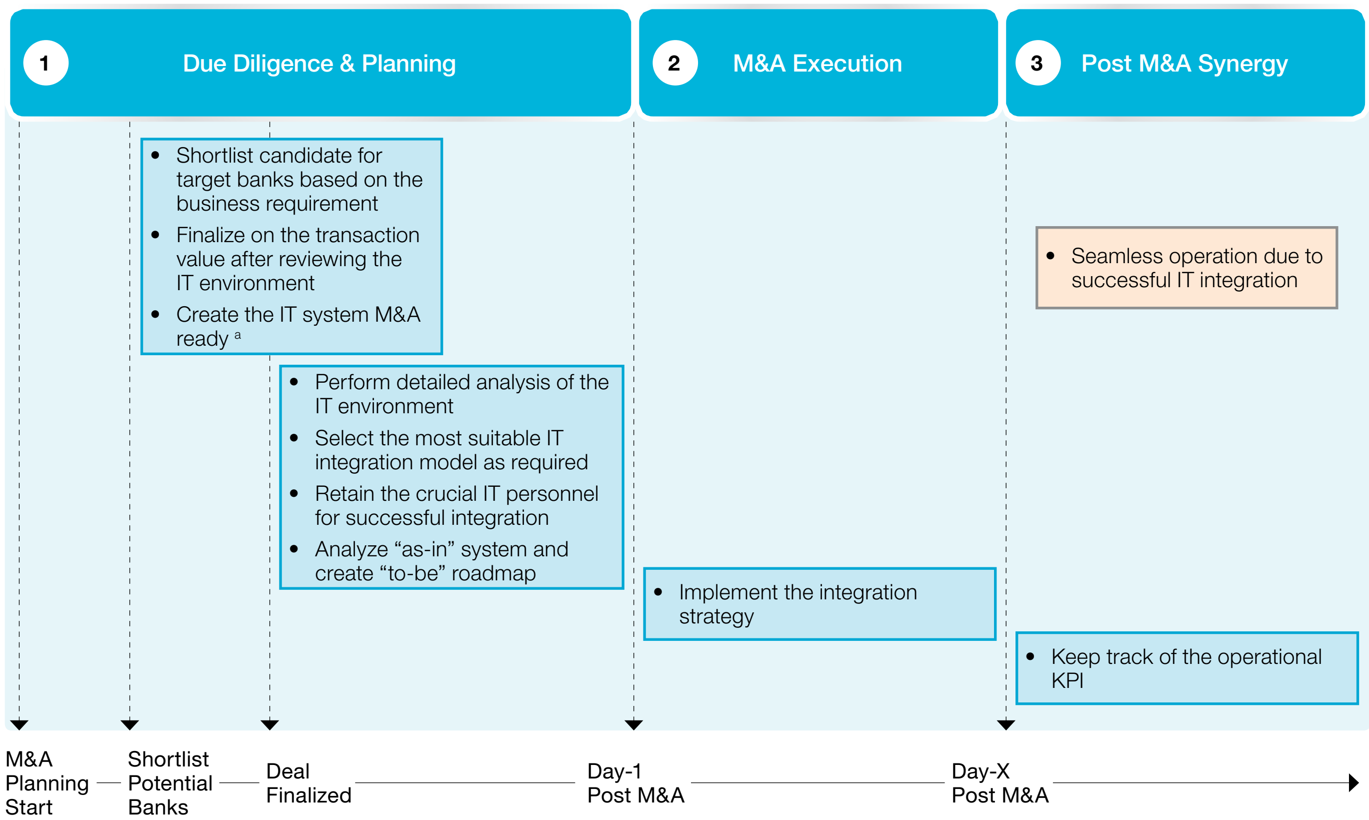
The acquired bank is similar in size to the acquiring bank and the business strategy is for volume and business expansion. In this case, both banks have similar reputations in the market, as opposed to full bank acquisition where the acquired bank can be of any size. The most used IT integration model in this strategy is **Best of Both Worlds**. However, acquiring banks can also choose **A New & Better World**, an overall transformation of the IT system. The IT systems of both acquirer and acquired banks can be transformed for a seamless operation from day one. However, a best practice in this case is to transform only required processes.[20]

20 "Winning with an IT M&A Playbook", AT Kearny, 2013, http://www.atkearney.com/mergers-acquisitions/ideas-insights/featured-article/-/asset_publisher/4rTTGHNzeaaK/content/winning-with-an-it-m-a-playbook/10192

5.3. Overall IT Strategy Planning

In order to maximize the benefits of a banking M&A, IT functions should be ready from day one. Planning for IT integration should start as soon as possible and IT personnel should be involved from the very beginning of the entire M&A process. The acquiring bank can select an external IT consulting firm for a seamless integration process.

Exhibit 3: Bank M&A IT Integration Planning Timeline



a. This step is not required for M&As categorized under New Business Acquisition
Source: Capgemini Analysis, 2013

For overall successful system integration during M&A, the acquiring bank should follow the following five best practices:

- Involve CIOs during initial phases
- Create a flexible architecture
- Keep the IT team ready for M&A
- Assess target bank's IT system to plan integration strategy
- Decide on the future IT service model

Best Practice 1: Involve CIOs during initial phases

The M&A team should make sure that IT leaders and CIOs are involved from the very beginning of the M&A process. After creating a shortlist of potential target banks, the team can use IT as one of the filtering criteria to decide on the most suitable M&A candidate. The IT leadership team can assess the target bank's system and can plan for the system integration. This would give a clear idea about the projected timeline and cost for full system integration, which would help to create the right value for the M&A transaction.

Best Practice 2: Create a flexible architecture

For a successful post M&A IT integration, the acquiring bank should create a flexible in-house architecture so that the integration process becomes smoother. Banks have several options including a service-oriented architecture (SOA), which is more flexible and easy to adjust. Banks can also look for cloud-based applications for cost efficiency. However for security reasons, they could look for private cloud based solutions. Also, they should reduce the number of standalone systems and move to a centralized Enterprise Resource Planning system.

Best Practice 3: Keep the IT team ready for M&A

A successful integration requires the best IT employees. Crucial IT personnel who know the ins and outs of the IT system of the acquired bank should be retained as part of the new IT team.

Best Practice 4: Assess target bank's IT system to plan integration strategy

Apart from creating a flexible architecture, the acquiring bank should also assess the current IT landscape of the target bank. This would help to create tan integration strategy which can be implemented from day one.

Best Practice 5: Decide on the future IT service model

The acquiring bank should assess the service delivery model used by both banks and decide on the optimum one to be used post merger. For complex processes it is advisable to use external IT consulting help. This will ensure a seamless transition of the IT systems.

6. Conclusion

Banks are under more pressure to improve their operational efficiency due to the changing regulatory landscape and challenging economic conditions around the world. Banks are expected to be more cautious in their expansion strategy and to leverage the full benefits of a successful M&A. One way to do this is to create the IT integration strategy in the early stages of the M&A.

The acquiring bank needs to assess the IT landscape of both banks, and can adopt one of the four IT integration models discussed above. The acquiring bank should also create a flexible architecture in-house so that the integration process becomes seamless. There are several options to create a flexible architecture, including a flexible SOA model.

The acquiring bank needs to assess the complexity of the IT integration process and can leverage the expertise of external IT consulting firms. A successful IT integration will translate into improved operational efficiency and customer satisfaction, helping the bank realize the full potential of a strategic M&A.

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