THE COMING WAVE OF CONSOLIDATION OF US REGIONAL BANKING: REASONS FOR SKEPTICISM

AUTHORS

John Thompson
Dan Rosenbaum
Dov Haselkorn
Alex Becker
EXECUTIVE SUMMARY

The US banking industry is bracing for trouble. After several years of favorable economic conditions and strong financial performance for US lenders, a number of challenges – many of them macroeconomic – now loom on the horizon. Management teams must address these challenges if they hope to keep profitability intact.

Large banks are somewhat insulated from the coming storm, because of their sheer size and the breadth of their portfolios. Regional banks, on the other hand, face numerous headwinds. Competition both from big banks and nontraditional lenders has increased. At the same time, the technology capabilities of regional banks generally lag those of big banks and fintech upstarts. As customers’ expectations are changing, regional banks must improve their service in order to compete.

One way that regional banks have dealt with challenging market forces in the past has been through consolidation. Mergers have brought many positive benefits over the years, from a larger customer base and broader product offerings to opportunities for cost reduction across the combined enterprise. Oftentimes, consolidation was seen as the first line of defense.

Now, with economic growth slowing and the yield curve having inverted, several analysts have suggested the industry is in the beginning stages of yet another wave of consolidation.

We disagree. The hurdles for consolidation in the coming months will be great, for numerous reasons. Years of technological improvements have created complex institutions that are likely to prove difficult to integrate without enormous focus and effort on the part of leaders and might not yield game-changing cost savings. What’s more, the number of remaining regional banks that are suitable for mergers based on size and geographic overlap has decreased, limiting opportunities for combinations.

In short, we believe the M&A bulls are too bullish.
Regional banks have performed strongly over the past few years as they benefitted from positive market factors, including a relatively steep yield curve, tax reform, streamlined regulations, low unemployment, and overall strong economic growth. These tailwinds have moved the group toward profitability levels last seen just before the Great Recession (See Exhibit 1) as measured by return on average assets (ROAA).

But regional banks now face macroeconomic headwinds that are highly likely to affect the near-term outlook. The yield curve has inverted, while economic forecasts are calling for a slowdown. At the same time, numerous long-term industry operational and competitive issues are posing obstacles. Among them:

- **Big banks’ penetration into regional bank strongholds.**
  The biggest banks are changing the competitive landscape by continuing their expansion into traditional regional bank markets. In some cases, big banks are competing with each other as they expand, raising the stakes and increasing the pressures on regional banks. For example, JPMorgan Chase is planning to expand into nine major US markets, with more than 400 new branches over the next five years\(^1\). Bank of America announced in April 2019 its plans to open 350 new centers over the next three years, many in new markets. In other cases, the big banks are penetrating areas through expanded virtual services, aggressive digital marketing campaigns, and superior digital platforms, thereby stealing regional bank customers who are less branch-dependent. Overall, the big banks have grown their deposit base in recent times, whereas approximately half of the regional banks have experienced customer deposit decline\(^2\).

---


---

Exhibit 1: Strong ROAA performance today – similar to 2007 levels (Median of Regional Banks, excluding FBOs):
• **Increased competition from non-banks.** Competitive forces are stronger than ever, with much of the activity driven by young disruptors. Non-traditional banks have aggressively moved into the lending space, and other disruptors such as Google and Amazon are continuing to expand their presence and capabilities, posing a significant future threat to regional banks. Digital banks, and new digital platforms from existing financial-services companies, are also emerging and attracting customers away from the regional banks. Interestingly, many of the executives leading the charge are former employees of traditional banks who were displaced as a result of M&A activities.

• **Challenges to funding innovation.** Technology spending has been on the rise at banks over the past few years, but the majority has gone toward maintaining legacy platforms, with limited funds remaining for innovative investments. Yet investments in the new technologies that drive improved customer experiences are increasingly important for banks to meet customer expectations, especially in retail banking. This is especially problematic for regional banks, which typically cannot invest in technology at the same level as the big banks, with their massive customer bases across which to spread fixed costs and investment budgets.

• **Changing client expectations and purchase behaviors.** New channels for servicing customers have expanded, and the complexity of providing personalized and quality service to each customer in their preferred manner requires a new lens.

This impacts the customer interaction model, products offered, and methods for maintaining trusted relationships. Branch proximity, though still important, is no longer the dominant factor it once was.

With these changes in market forces, the road ahead will be challenging for regional banks. To survive and thrive, bold strategic moves will be needed.

### Rationale for Merger/Consolidation in Today’s Banking Environment

One such bold move, as highlighted by the BB&T/SunTrust combination, might be a sizeable merger – one (or more) that meaningfully helps build operating scale and/or brings new products and capabilities to the combined entity. Some of the key value drivers that a merger could bring to a regional bank include:

- Reduction in operating and infrastructure costs from branch and corporate function consolidations
- Achievement of economies of scale in regulatory compliance and back-office processing
- Larger tech and marketing budgets for the combined institution, which would aid competition with the biggest banks and native digital players
- Addition of a complementary product set or expanded customer base to enhance cross-selling of products
- Addition of incremental top talent, especially at senior levels, and an enhanced ability to attract and pay for star talent

---

Another major reason for a merger is the creation of shareholder value. Banks that have merged over the past 10 years have experienced higher share price performance than the overall banking sector (See Exhibit 2). Recognizing there are many factors that impact a company’s market value, share price uplift may be another point of value.

Overall, there is consensus in the media that the February 7, 2019, announcement of the merger between BB&T and SunTrust is likely the first of many sizeable US bank mergers to come. Market analysts signaled from late 2018 that challenging market forces ahead would be a significant trigger for mergers, and this announced merger has now spawned a new round of M&A speculation from commentators.

Counterpoint: Challenges to achieving success through consolidation

Although there are many factors that drive industry consolidation, we see a number of challenges that may limit the value a merger may deliver. Among these challenges:

- Although operational cost savings typically are realized around the one-year mark for merged banks, a significant proportion of these costs tend to come back to the combined organization after two to three years post-merger. In our analysis of nine banking mergers, operating expenses dropped by 5.3 percent of combined bank spend in the first year from the pre-merger state as compared to an index of average banks. However, over the subsequent two years, the average annual operating expense growth for these nine banks was 4.4 percent greater than the average operating expense growth of their peer banks over the same time period.

- The ability to make greater technology investments will be constrained, to some extent, by the need for large-scale technology integrations and migrations due to the merging of two technology environments. The one-time costs and ongoing expense of increased complexity typically are greater than expected.

Exhibit 2: Change in stock prices post announcement of merger, relative to NASDAQ Bank Index

Source: Refinitiv Datastream

---

5 Philip Van Doorn. (2019, February). BB&T-SunTrust merger signals more bank deals are coming. Marketwatch.
The merger itself will require focus from leadership and be a priority for top talent within the bank for multiple years. This can reduce leadership’s bandwidth for executing other critical programs, such as ones focused on growth initiatives or cost-savings.

Another counterpoint to the idea of a coming wave of regional bank M&A is that there are not many remaining bank merger opportunities that are as attractive as the BB&T/SunTrust merger. This is based on the following criteria:

- **Bank size**: Both banks need to be large enough in scale to comprise a new entity that can compete with the big banks on digital experience and larger commercial deals, realize benefits from regulatory reformation, and create scale that differentiates in the market.

- **Geographic overlap**: Both banks need branch networks with meaningful overlap to drive large operational synergies and cost reductions; these cost reductions are important offsets to the costs of the merger.

Our analysis of the branch networks of the Top 50 regional banks (by assets) shows only a handful of banks with meaningful network overlap -- i.e., greater than 20% of the branches for the combined entity within two miles of each other (See Exhibit 3). As a point of comparison, the overlap in the BB&T/SunTrust merger is about 25%. A lack of overlap, and the associated absence of meaningful branch cost synergies to help “pay for” an acquisition, is a major deterrent to a wave of regional bank mergers.

**Exhibit 3: Top 50 Regional Banks with >20% Branch Network Overlap**

<table>
<thead>
<tr>
<th>Company A</th>
<th>Company B</th>
<th>Combined Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bank</strong></td>
<td><strong>Assets ($BN)</strong></td>
<td><strong>Current rank</strong></td>
</tr>
<tr>
<td>BB&amp;T</td>
<td>226</td>
<td>11</td>
</tr>
<tr>
<td>Capital One</td>
<td>373</td>
<td>8</td>
</tr>
<tr>
<td>Fifth Third</td>
<td>146</td>
<td>18</td>
</tr>
<tr>
<td>TD Bank</td>
<td>303</td>
<td>9</td>
</tr>
<tr>
<td>HSBC</td>
<td>172</td>
<td>14</td>
</tr>
<tr>
<td>Capital One</td>
<td>373</td>
<td>8</td>
</tr>
<tr>
<td>HSBC</td>
<td>172</td>
<td>14</td>
</tr>
<tr>
<td>Signature Bank</td>
<td>47</td>
<td>55</td>
</tr>
<tr>
<td>HSBC</td>
<td>172</td>
<td>14</td>
</tr>
<tr>
<td>NY Community Bank</td>
<td>52</td>
<td>52</td>
</tr>
</tbody>
</table>

*Overlap = number of target’s branches that are within 2 miles of acquirer’s branches as a % of the total target + acquirer branches

**Rankings vs. FDIC regulated depositories as of end 2018; assumesBB&T/SunTrust are one entity

Source: S&P Global Market Intelligence, Oliver Wyman analysis
There are also a few regional banks in which a subset of their branch network is in a secondary region, and in some cases the overlap of these with other banks may also create target overlap scenario (see Exhibit 4).

**Mergers of similar size are hard to negotiate and execute**

As highlighted by H. Rodgin Cohen, a leading financial services attorney, it is difficult to negotiate and execute deals of this size between roughly equal institutions⁶. Decisions related to leadership positions, board of director seats, headquarters location, integration objectives of product sets and lines of business, operating practices, customer bases, technology environments, and culture are some of the many points that must be addressed before a merger.

Additionally, sellers typically have unrealistic expectations late in an economic cycle of the price (premium to book value) their bank should command. Most deal books extrapolate future earnings using past performance and place a multiple (of book value or earnings) on top of lofty expectations to arrive at a selling price. As an additional data point, sellers will often look to multiples on recent transactions to set a valuation floor for their own institution—a view highly divergent from the typical buyer’s perspective, which takes a likely near-term banking downturn into account. The mismatch between buyer and seller perception of valuation can be large, especially at the peak of an economic cycle, and has the effect of limiting the supply of banks truly available for sale.

---

Data point to the contrary: A Tale of Two Banks

PNC Bank is an example of a bank that is not currently targeting whole-bank acquisition as a significant part of its future strategy, despite facing continuous questions on the topic from equity analysts. PNC CEO William Demchak has consistently stated the bank’s strategy is to grow organically, and that growth through means other than acquiring additional branches will be the primary focus. PNC has made select acquisitions that have targeted specific portfolios of banking institutions, and it has acquired some nonbank players and entered partnerships to address product gaps. It is now launching an organic, high profile, national digital strategy to complement its wholesale businesses, which are either already national or are quickly expanding to new markets, with a national retail franchise—all without significant bank acquisition. PNC’s strategy, so far, potentially represents an alternative path.

Regions Financial Corporation also has publicly stated that it is not pursuing any acquisitions at this time. John Turner, President and CEO of Regions, said prices of targets are too high and a merger would be disruptive. Regions is instead focusing its resources on improving its operations and returning capital to shareholders.

Other regional banks, rather than acquiring to compete on scale, are seeking more organic forms of transformation, such as:

- Doubling down on particular business units or customer segments that have attractive economics and greater ability to offer a differentiated value proposition
- Developing customer-led active solutions to real customer needs to reinvent the definition of a bank and transform their business model and workforce
- Investing in technology through incubating new platforms outside of the core structure (“Greenfield approach”). This allows new, lower-cost solutions to be vetted on niche products or customer segments more nimbly, and then extended across the bank once proven to establish an improved total cost of ownership technology platform.

---

CONCLUSION

The outlook for regional bank consolidation remains unclear. Market conditions have created the opportunity and pressure to consider significant deals, but for those mergers to truly deliver they will have to overcome difficult challenges.

Many mergers in the past have increased shareholder value and improved capabilities for the customer, and we will likely see more in the future. However, in the near term, the merger/consolidation activity may be significantly smaller than the general consensus suggests. If the initial mergers fail to deliver shareholder value quickly, then the new wave of bank M&A may prove short-lived.
Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

AMERICAS
+1 212 541 8100

EMEA
+44 20 7333 8333

ASIA PACIFIC
+65 6510 9700

www.oliverwyman.com

Copyright © 2019 Oliver Wyman
All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of Oliver Wyman and Oliver Wyman accepts no liability whatsoever for the actions of third parties in this respect.
The information and opinions in this report were prepared by Oliver Wyman. This report is not investment advice and should not be relied on for such advice or as a substitute for consultation with professional accountants, tax, legal or financial advisors. Oliver Wyman has made every effort to use reliable, up-to-date and comprehensive information and analysis, but all information is provided without warranty of any kind, express or implied. Oliver Wyman disclaims any responsibility to update the information or conclusions in this report. Oliver Wyman accepts no liability for any loss arising from any action taken or refrained from as a result of information contained in this report or any reports or sources of information referred to herein, or for any consequential, special or similar damages even if advised of the possibility of such damages. The report is not an offer to buy or sell securities or a solicitation of an offer to buy or sell securities. This report may not be sold without the written consent of Oliver Wyman.