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Does your integration playbook tackle tomorrow's M&A challenges?

Banking and capital markets

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Focus on people, customers and speed – but don't forget about risk

Deal appetite across the banking sector remains strong, with 58% of banking and capital market executives expecting to actively pursue acquisitions over the next 12 months, according to the *EY Capital Confidence Barometer*, released in April 2019. As deals are realized, it is critical to understand which synergy and integration strategies offer buyers the most value for their money.

A moderating regulatory environment is favorably impacting the appetite for banking acquisitions. Notably, in the US, the partial rollback of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which raises the thresholds at which additional regulatory requirements are implemented based upon bank size, allows transactions that were once deemed impractical back on the table. Banks that were concerned about the cost of exceeding US\$50b in asset size due to an acquisition now have considerably more room before they hit the new US\$250b threshold.

However, some analysts remain skeptical. Many banks have not completed a merger in years, and without clear plans that can show earn-back of the tangible book value within three years, bank acquirer stocks are being punished. As new deals are realized, it will be even more critical for buyers to demonstrate sound synergy and integration strategies that offer buyers and their shareholders the most value for their money.

About this report

This report is part of the EY Buy and Integrate series of sector-specific reports that encourage CFOs, CDOs and transaction leaders to take a fresh look at how they identify and capture synergies during M&A. In the reports, we suggest leading strategies to improve your M&A and integration playbook.

For more EY Buy and Integrate perspectives, see the reports:

- ▶ Advanced manufacturing
- ▶ Health care
- ▶ Insurance
- ▶ Life sciences
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- ▶ Wealth and asset management

Traditional financial services providers in the banking sector are re-evaluating their M&A objectives as they face an increasingly nimble competitive landscape. In one highly visible example, digital-only banks like Ally, GoBank and Moven are challenging established banks as more customers shift to digital banking.

In this rush to stay current, banks are also turning to acquisitions for specialized capabilities, including robotic process automation, artificial intelligence and blockchain offerings. But striking a balance between core business and new technological opportunities – in a way that does not alienate existing customers – raises new questions for the sector. For example, how will banks identify capabilities that are true strategic differentiators?

This changing industry landscape will require increased nimbleness from more traditional financial services providers. When speed to value is key, they will be more willing to buy rather than build. What leading practices should banks follow to achieve their long-term synergy objectives through acquisitions?

Focus on speed to value – synergies realized earlier are more valuable

Broadly, when one bank acquires another, potential synergies break down into the following areas:

Revenue value drivers. This includes diversification of products or services, more cross-selling opportunities, opening of new markets, and better brand awareness and marketing.

Operating-expense related value drivers. This includes reduction in customer acquisition costs, improved efficiency in responding to regulatory requirements, branch consolidation, corporate consolidation, technology consolidation and infrastructure consolidation.

Capital-related value drivers. This includes improved credit ratings within a new combined entity to tax synergies, in-market acquisitions that grow business locally and require less capital, sharing capital management best practices, and the potential to release capital expenditures related to internal capability development (most notably, where technology is acquired rather than built).

Speed to value. Synergies realized early are worth more than those that take years to come to fruition, both because of the time value of money and because the longer one waits to achieve them, the more difficult they are to identify and achieve. Those acquirers that can show an ability to execute and earn back value more quickly will be able to pay higher prices because both their board and their shareholder base has confidence that they can achieve synergies faster through their proven capabilities and more quickly be ready for the next acquisition.

Banks that understand the value of speed drive their integration efforts differently. They focus on quick wins, invest in the capability of the integration team with training, tools and accelerators, and maintain schedules that accelerate delivery. Less valuable efforts are pushed out of the critical path. This allows banks to determine which resources they need to accelerate the integration and identify internal projects that must be prioritized.

Learn the lessons of successful acquirers

Successful acquirers are rewarded with strong management teams, strong core deposit bases, attractive demographics within their footprint for growth, and diverse business lines and product sets. They are also rewarded with EPS accretion, limited tangible book value dilution or earn-back of tangible book value dilution within a reasonable period of time (generally three years), as well as experience integrating acquisitions successfully.

To achieve this, they take deliberate steps to release the greatest value as efficiently as possible:

- ▶ **Separate growth and synergy plans to avoid confusion between the related strategic agendas.** This is one of the greatest challenges in any in-market merger. For example, banks may not want to give up personnel, facilities and other capacity only to have to re-acquire them as they grow. Another example would be keeping talent openings on one ledger and departures on another. If a departing employee takes up another open position, the savings in the talent selection process, along with the reduction in salary and severance costs, are tracked as a synergy, even though the employee hasn't left the bank. The new employee and salary are noted on the open positions ledger, and the position is marked closed. Both sides show a win. Likewise, branch consolidations, restacking of facilities and divesting of assets and businesses are essential parts of a robust cost takeout program. Skilled teams should be in place to deal with these divestitures and held accountable for the results.
- ▶ **Analyze sources of new value in hard-dollar terms.** The acquirer will need to assess the value proposition of each acquired business or asset to the overall enterprise strategy – for example, accounting for acquired loans is complex and must be completed quickly. Acquirers need to be clear about how much value an acquisition is going to gain in terms of lower costs, increased revenues and better products and offerings. Once accepted, synergy goals should be built into the budget for ongoing scrutiny. But don't try to do everything on the first day – day two optimization and beyond is just as important.
- ▶ **Renegotiate to achieve economies of scale.** Service providers, technology and other contracts (such as leases) of both parties should be scrutinized to determine how the merger affects their fees and whether they should be renegotiated. For example, many banks use the same vendor for comparable services. Post-acquisition, one of the two contracts may be shut down, but additional negotiation can ensue, including discounts when volumes are expanded. A new contract and its terms may be better than the sum of the originals.
- ▶ **Set an aggressive time frame and invest to meet the schedule.** Banking integration programs demand a structure and governance beyond what most banks have in place. This can prompt some to conduct integration and related activities sequentially, rather than simultaneously as early as possible alongside due diligence. Successful acquirers introduce a centralized control hub of program management to drive everything forward, using people with proven skills. The job of the central program office is to break down barriers, help decisions get made, control risk, address problems quickly and drive the schedule, with transparent reporting.

Case study: How do you manage a transaction of equals?

Challenge

A mid-tier regional bank announced a like-sized acquisition. As the acquirer had limited experience with transformative acquisitions, the bank needed help quickly mobilizing and launching an integration program, including structuring the transaction, developing a target operating model, assessing potential synergy opportunities and preparing for the transaction. They also needed assistance with legal, branding and systems close activities.

Approach

As the bank's leadership grappled with the varying (and sometimes competing) priorities of the internal and external stakeholders, they engaged the EY organization to provide advice on effectively organizing the integration effort.

The integration priorities were getting commingled with a desire to orchestrate a larger transformation of the bank's capabilities in an effort to secure the best of both worlds. Decisions were being revisited often and inconsistently, and focused too much on extracting value from the deal at the expense of other important aspects.

We helped the client mobilize the integration program and governance quickly and established guiding principles that prioritized the deal objectives. We also managed a rigorous governance program to organize execution and enhance appropriate oversight.

Key steps in the transaction included establishing clear leadership and strong sponsorship for the program; leveraging tools to streamline communications and reporting; and defining guiding principles to allow rapid decision-making.

Practices included structuring and conducting mock transitions and conversions associated with key milestones – a vital component in mitigating major risks. Resource coverage was planned in detail, with particular attention paid to the provision of critical resources.

Result

The client successfully executed the acquisition and related integration and met all Day One key milestones – including legal, branding and systems – with no material disruption. The client remained focused on achieving synergy targets beyond Day One, and maintained the program to track and report progress on promised synergies through the program.

With the successful integration of the target behind them, the client leadership could focus on the larger transformational efforts geared toward enhancing the operating model capabilities of the combined banks.

The program was critical in managing attrition of employees from the target, and instilled a culture of learning and constant improvement – a lasting legacy for the client.

- ▶ **Keep the customer at the heart of the deal.** A degree of attrition is to be expected after a deal is done – there is usually a temporary dip in anticipated synergies, as everyone gets used to new systems and processes. Banking products are not always tangible; true differentiators are found in the quality of the experience. Bank customers and regulators expect 24-hour service accessible via multiple channels (e.g., phone, chat, email, social media). Personalize that experience. Establish a customer experience team across integration work streams to engage with and align communications to all key stakeholders to minimize customer attrition and offset it with new growth. Provide a white-glove treatment for business-critical customers: where possible, contact them to inform them of your future plans and let them know you value their relationship. Get it right and you'll gain new customers. Get it wrong and you risk losing not only those of the target company, but many of your own.
- ▶ **Identify potential customer complications.** Inform branches, call centers and go-to-market teams of any new messaging or mitigating resolutions as soon as possible, especially for any standardized processes that may change. For example, an acquired bank may submit loan documentation via fax or print. Moving these processes online can prove difficult and cause friction across a large branch network. Reinforce an issues management and tracking system that collates customer issues and feedback, and provides a single version of the truth that can be updated in real time.

Preserve value by mitigating risk

- ▶ **Identify opportunities and vulnerabilities in your target operating model.** In retail banking, this may involve rationalizing products, channels and customer engagement features, strategies for migrating and retaining customers, new cross-selling opportunities, consolidating the branch network and optimizing technology. In commercial banking, this may include aligning credit policies and procedures, and managing credit risk. Banks will want to consolidate the risk governance framework in both organizations, recalibrate their compliance and risk management functions, align the finance function and oversight in the combined organization, and define how problem assets will be handled. Banks also need to evaluate the business value chain, the target operating model and the markets where the combined business wants to operate. Appropriate resources need to be invested in the design of the target operating model as this is critical so that the right decisions are being made to realize synergies without risking the strategy of the combined firm.
- ▶ **Establish a dedicated synergies team that can cope with the scale involved.** In banking, integration can take place over months and involve multiple interdependent resources. Identify the team responsible for synergy definition and tracking from the start of the program, whether the finance department or an integration management office. Have them engage early with key departments, particularly IT and HR. Create a formal communications program for cross-team collaboration as well as processes for documenting and distributing outcomes from key work sessions and decisions. Include synergy targets in all budgeting and planning processes for lines of business and functional areas. The synergy team should remain in place

after the integration is complete – anywhere from six to nine months – to confirm synergies have been achieved and provide models, reports and documentation to the board and key constituents (including shareholders and analysts).

- ▶ **Provide adequate coverage of foundational integration risks.** Key execution risks such as data and platform migrations can quickly destroy forecasted deal value. Given the publicity that often accompanies such failures, the impact is often compounded with poor public perception and lost trust of the combined entity. Successful acquirers maintain an objective view of program issues and risks; and set a culture of transparency and openness so that program execution teams are empowered and encouraged to present factual information in a timely manner.
- ▶ **Mind the integration culture gap.** Value is lost when staff in a newly acquired company loses morale, perhaps because a buyer is undercutting the innovation and nimbleness of a franchise that was acquired for talent, skills and specific assets. Procurement limitations, additional reporting, approvals processes, new metrics and quotas can cause friction. Successful acquirers of an out-of-sector target anticipate potential risks areas, such as data protection and compliance, with defined training and objectives provided to the new business. They implement rules of engagement so that the larger organization doesn't overwhelm the smaller one and reduce the capacity of the new business function. The key is to sit down with major players on both sides, appoint culture champions and recognize the role played by informal leaders. Companies must determine must-have requirements and agree upon the right course of action to train and communicate the new policies in a jointly conducted manner.

An accelerated integration time frame will almost always enhance deal value. But without robust planning, centralized governance and dedicated resources (both financial and talent), speed is often achieved by cutting corners rather than enhancing capabilities.

Quality and risk mitigation may cause delay, but such decisions should be transparent and vetted in go and no-go discussions. There will always be mistakes, even in the best programs, so contingency plans should include triage and response teams as well as adequate staffing of customer-facing and internal employee functions (such as IT and training help desks). By mitigating preventable risk, banks can focus on creating value without leaving anything on the table.

Conclusion

Deal appetite remains strong in the banking sector, and buyers need to identify integration strategies that offer the most value for their money. Speed to value is essential, but to achieve that goal, the sector will need to learn the lessons of successful acquirers: keep value creation, customers and culture at the heart of any deal, and start the integration process as early as possible to avoid losing value along the way.

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EYG no. 003054-19Gb1
1810-2940249

ED None

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