US Banks: Reading the Tea Leaves

More M&A, but how?

Industry Overview

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Equity
United States
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Ebrahim H. Poonawala
Research Analyst
BofAS
+1 646 743 0490
ebrahim.poonawala@bofa.com

Brandon Berman
Research Analyst
BofAS
+1 646 855 3933
brandon.berman@bofa.com

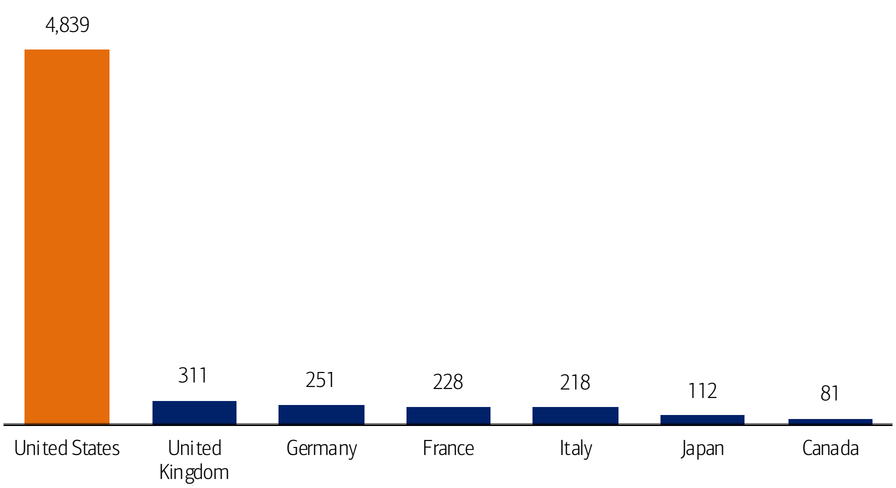
Isiah Austin
Research Analyst
BofAS
+1 646 855 0472
isiah.austin@bofa.com

Gabriel Angelini
Research Analyst
BofAS
+1 646 855 3081
gabriel.angelini@bofa.com

Hurdles to bank M&A remain significant

Last week, US Treasury Secretary Janet Yellen reiterated her view that the banking industry will need M&A as worsening profitability causes mgmt. teams to seek merger partners. Based on our conversations with the banks and industry experts there are three hurdles that are often cited to much-needed industry consolidation. These include:

Exhibit 1: US has more banks than G7 countries combined; 3X adjusted for GDP vs. next country
Commercial banks by country, G7 countries



Source: IMF, BofA Global Research. Data as of 2021.

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#1 Timeline for regulatory approval

Timeline for regulatory approval (can take years) is viewed as untenable, given the risks tied to potential franchise attrition and the potential for a significant shift in the operating backdrop between deal announcement and deal closing. This risk was most recently evident in the termination of the TD Bank/First Horizon merger last month. 14 months after the initial merger announcement the deal stalled due to the inability of regulators to provide a firm timeline for deal approval. Potential bank buyers and sellers we have spoken to in recent months have expressed a strong desire for an expedited approval process (2-3 months), especially where both parties are considered as operating in sound condition by the regulators at the time of deal announcement.

#2 Adverse view among policymakers towards M&A

While recent comments from the Treasury and the OCC reflect an openness to allowing M&A, we note that other agencies (such as the DoJ, FTC) under the Biden administration have taken an adverse view towards larger M&A (on the back of the Biden Executive Order), viewing it as anti-competitive. **Continued page 2…**

Acronyms:

OCC: Office of the Comptroller of the Currency

DoJ: Department of Justice

FTC: Federal Trade Commission

MTM – Mark to Market

#2 Adverse view among policymakers towards M&A (continued)

However, most investors (including us) have a hard time viewing bank M&A as anti-competitive given the significant fragmentation in the US financial services industry. As a result of this fragmentation, banks are mostly price-takers not price-makers across most products and services. At ~4,500 FDIC insured banks (add to this 4,853 credit unions) there is no country even close to the US in terms of number of banks, even adjusted for GDP. Regional/community banking space undoubtedly plays a vital role in serving local communities. Allowing smaller banks to increase market density via M&A should improve their ability to serve their customers while positioning them as more effective competitors vs. the largest banks. We also appreciate the need to guard against the risk of communities (particularly rural) not losing access to banking choices. However, safeguarding against this does not have to come at the expense of discouraging logical consolidation. Moreover, banks are increasingly competing with an ever-growing pool of non-banks across lending and deposit gathering services, further negating the argument that consolidation would necessarily lead to less competitive choices for the consumer.

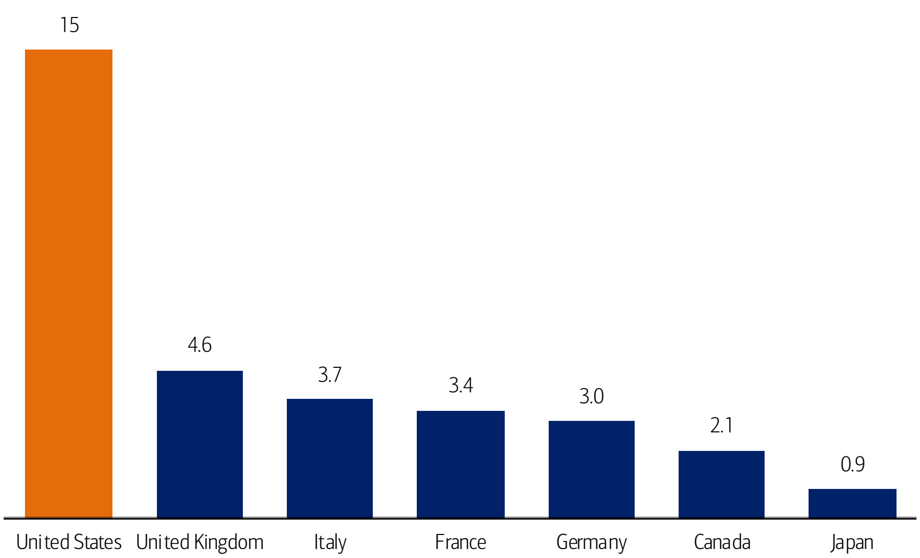
#3 MTM accounting runs into higher for longer interest rates

Purchase accounting, that requires the buyer to MTM the seller's balance sheet to fair value has made it quite punitive for potential buyers to pursue dealmaking given the immediate hit to capital ratios. In our view, this was among the factors that made it hard to execute a non-government assisted sale of the now failed First Republic. We recognize that accounting rules should not be altered just to accommodate a certain point in the economic cycle. However, it may make sense for policymakers to revisit the impact of MTM accounting and whether certain changes could make it easier to encourage deal making.

Our View: M&A to emerge as a logical option for some banks as higher for longer interest rates will likely test the quality of banking business models, balance sheets and deposit franchises.

Exhibit 2: The US has nearly 15 commercial banks per million people

Commercial banks per million people, G7



Source: IMF, World Bank, BofA Global Research. Data as of 2021.

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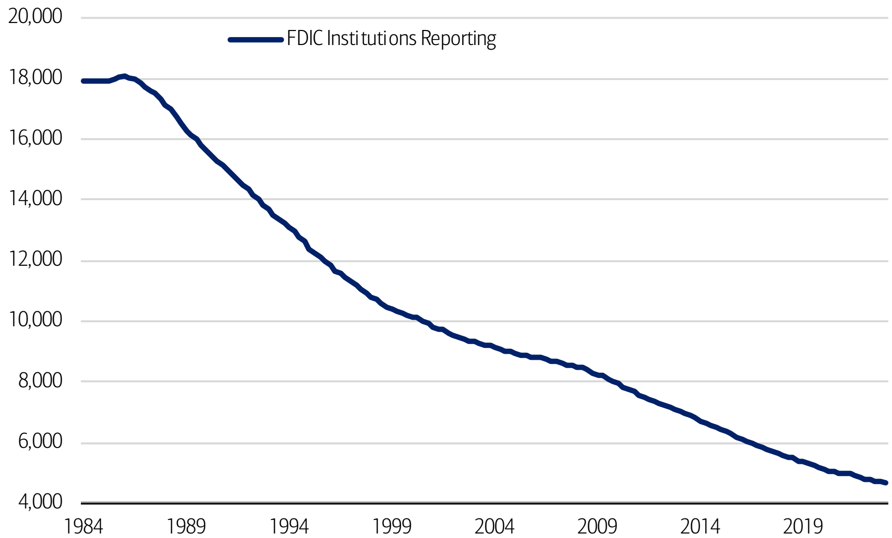
Exhibit 3: The number of FDIC insured institutions is less than 1/3 of that in 1984

FDIC insured institutions reporting balance sheet data over time



Source: FDIC, BofA Global Research

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