KPMG

Banking and private capital: friend or foe?

April 2016

KPMG International

Changing roles and opportunities

Summary

Recovery is the new normal for today's global banking industry. Although most banks are much healthier than they were in 2008, the industry is still faced with an uncertain global economy, low interest rates, increased regulation, activist investors and disruptors like fintech, to name a few. In this challenging environment, Private Capital plays an increasingly important role, whether in the form of PE firms, loan purchasing, venture capital investing, lending by insurers or direct lending through debt funds. Private Capital firms are buying up bank debt, acquiring banking businesses, entering markets where regulations discourage bank lending, and investing in payment platforms and other fintech challengers. At the same time, banks and Private Capital firms are forming new partnerships and joint ventures in areas such as credit card services, asset management, collection platforms or custody. As banks continue to evolve their business models, Private Capital will influence what a bank looks like in terms of structure, offerings and interaction with customers.

The financial crisis marked a turning point in the role played by Private Capital in the financial services sector. Banks lost billions of dollars on mortgage defaults, interbank lending came to a virtual halt, and credit markets around the world dried up. In the US, the Federal Deposit Insurance Corporation (FDIC) closed 465 failed banks from 2008 to 2012.[1] In Europe, eight of the region's biggest banks have lost USD420 billion in market value since 2008.[2]

In response to the crisis, regulations such the Dodd-Frank Act and Basel were put in place that required banks to make less risky loans and to have more capital on their books. New regulations also increased requirements for financial reporting and transparency.

This new business environment presented new opportunities for Private Capital firms. Banks suddenly needed significant amounts of new funding to replenish capital lost in the credit crisis and meet higher regulatory capital requirements. Many banks applying for the Troubled Asset Relief Program (TARP) in 2008 were required to raise a matching amount of equity in order to receive capital injections from the US Department of the Treasury.[3] A number of Private Equity firms recognized that acquiring assets and liabilities of failed banks from the Federal Deposit Insurance Corporation (FDIC) was an attractive way to enter the banking business. Two of the larger early bank failures — BankUnited and IndyMac Bank — were acquired by Private Equity groups from the FDIC, as receiver. In Europe, Private Equity firms were at the forefront of buying either assets or equity in troubled banks, primarily in Spain and Ireland.[4]

Analysts estimate that private investors pumped billions of dollars from 2008 to 2012 into more than 60 financial institutions.[5]

[1] Failed Bank List, FDIC, 2013
[2] The Never-Ending Story: Europe's Banks Face a Frightening Future, Bloomberg, February 15, 2016
[3] Private Equity Investments in Financial Services Firms: Threading the Regulatory Needle, Bloomberg Law Reports, 2011
[4] BankWatch: Private Equity Firms Ramp Up Investments in Troubled Banks, DailyFinance, May 27, 2010.
[5] Private-Equity Investors Take Profits on Bank Stakes, Wall Street Journal, August 6, 2013

The retreat of banks, the rise of Private Capital

Loan Stars

U.S. private-equity firms were involved in 81% of distressed-loan transactions in Europe last year. Some have been buying up loan-servicing platforms to analyze portfolios and collect cash from borrowers.

Deal size	BUYER/ SELLER	SELLER'S HEADQUARTERS	DATE
€930 million	Lone Star/ Kutxabank	Spain	December 2014
€664 million	Apollo/ Santander	Spain	November 2013
€225 million	Cerberus/ Cajamar	Spain	June 2014
€225 million	Blackstone Group and TPG/Investec	U.K.	September 2014

€1 = $1.1551 Source: Cushman & Wakefield The Wall Street Journal

Source: Loan Firms Boom as Banks Shift Debt in Europe," Wall Street Journal, Jan 21, 2015.

Almost a decade later, the aftershocks of the financial crisis continue to be felt. Many banks are in much better shape after layoffs, penalty payments, and restructuring. However, banks still face a growing regulatory burden, low interest rates, slow economic growth rates, low commodity prices, and increased uncertainty in emerging markets such as China. Compounding these issues are new disruptors such as activist investors demanding greater performance and return on equity (ROE) from banks.

In response to these and other factors, banks continue to sell assets to Private Capital firms. Citi's recent sale of OneMain to Springleaf Holdings is a case in point.[6] For Citigroup, the sale represents another step in the unwinding of Citi Holdings, which was established after the financial crisis to hold businesses that Citi hoped to sell. The cash generated from the sale will allow the bank to retire debt, increase profits and enable Citigroup to withdraw from the sub-prime lending industry, helping to reduce regulatory scrutiny on the bank.

In Europe, banks are unloading loans at a record pace to improve their balance sheets, often in response to pressure from regulators and investors. The debt portfolios have mostly been bought by Private Equity firms, which pay loan-servicing companies to analyze the portfolios, collect cash from borrowers and take on other administrative work.[7]

[6] Springleaf Renames Itself After Closing Purchase of Citi's OneMain, American Banker, November 17, 2015
[7] Loan Firms Boom as Banks Shift Debt in Europe, Wall Street Journal, January 21, 2016

Since Private Capital operates under different rules than commercial banks, private investment funds are moving into areas where banks are reducing their portfolio of loans because of regulatory restrictions, risk profile or specific loan flexibility criteria that traditional banks are less suited for compared to Private Capital investors. For example, private investment funds have increased lending to struggling companies that have not been able to secure funding from banks. Hedge funds D.E. Shaw Group and Oaktree Capital Management recently set up a pool of funds to lend to small and midsize businesses, including distressed ones.[8] In addition, Private Equity and hedge fund firms have bought up more than 100,000 mortgages in the US at a discount from banks and federal housing agencies.[9] Even insurance companies — which are generally conservative in their lending practices regarding real estate — make up a significant portion of nonbank lenders. MetLife Inc. recently lent USD505 million for a hotel portfolio in Orlando.[10]

> "Over the past year, there has been a shift as banks have moved from seeing fintech companies as disruptors to co-creators. Banks are increasingly collaborating with fintechs to embed new services and technologies that improve customer experience and drive efficiency."
>
> **Dorel Blitz**
> Head of Fintech
> KPMG in Israel

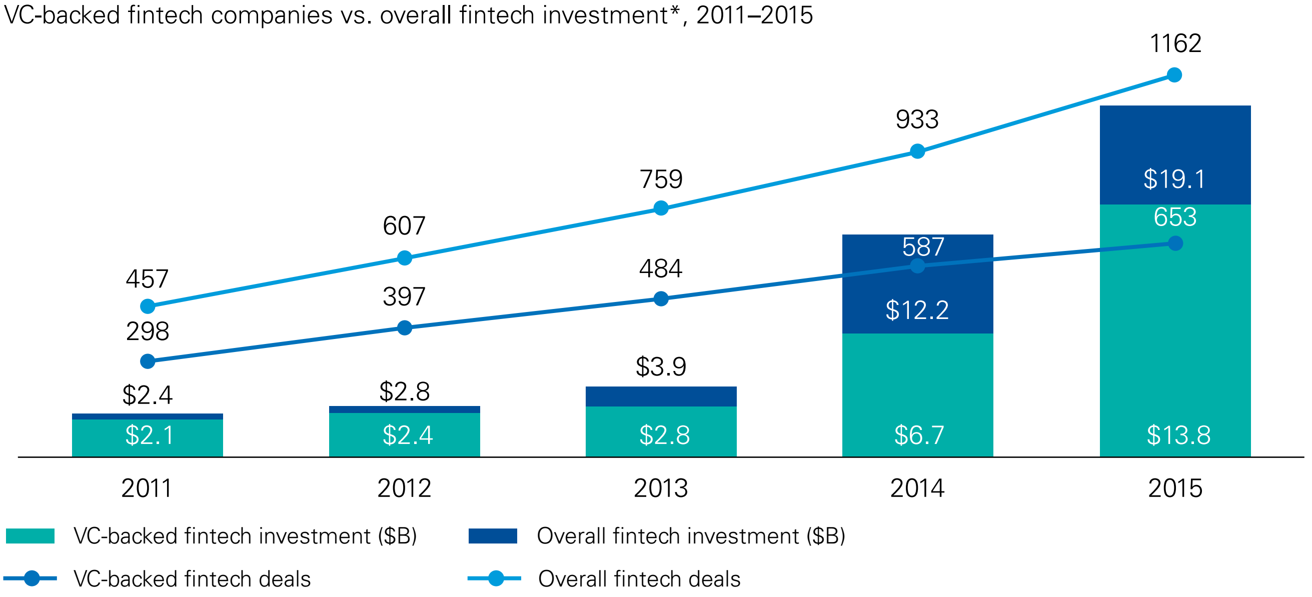
Fintech — a major game changer

The development of financial technology or fintech is a good example of today's rapidly evolving relationship between banks and Private Capital. Investors are being drawn to the potential of fintech — not only as a disruptor to big banks, but also as an enabler for big banks to kick-start their own innovation so they can improve services, reduce costs and support growth, transforming their traditional business models at the same time.

A report from KPMG International and CB Insights shows that private funding flowed freely into the fintech industry

Annual global fintech financing trend

VC-backed fintech companies vs. overall fintech investment*, 2011–2015

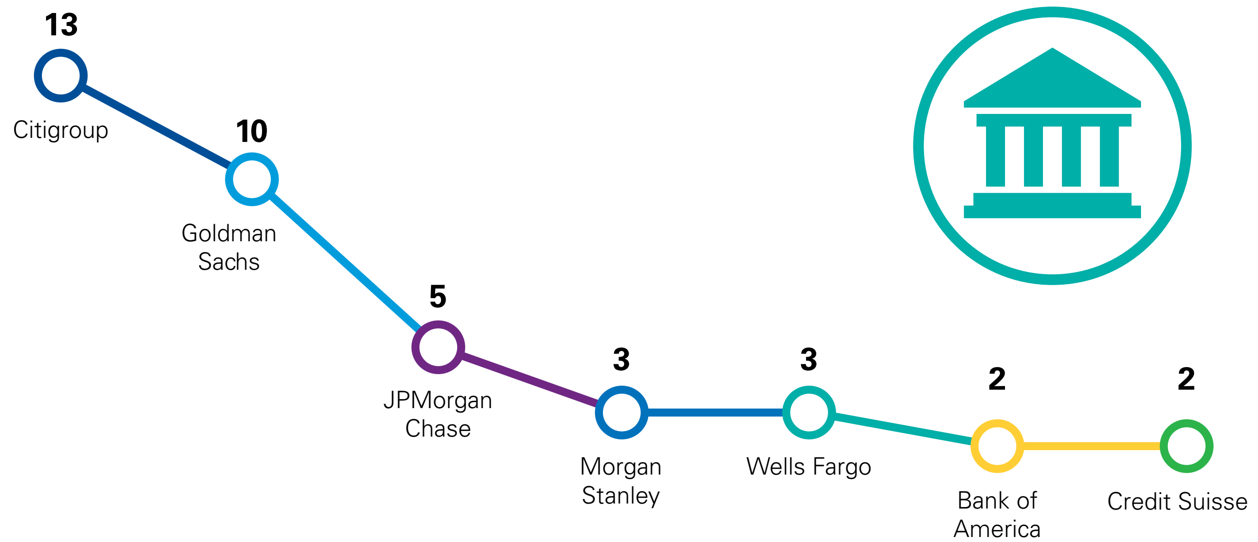


*Overall investment includes fintech funding by angel investors, angel groups, private equity firms, mutual funds, hedge funds, VC, corporate and corporate VC investors.
Source: The pulse of fintech, 2015 in review, global analysis of fintech venture funding, KPMG international and CB Insights (data provided by CB insights) March 9th, 2016.

[8] As Banks Retreat, Hedge Funds Smell Profit, Wall Street Journal, July 22, 2013
[9] As Banks Retreat, Private Equity Rushes to Buy Troubled Home Mortgages, New York Times, September 28, 2015
[10] Nontraditional Lenders Rush In Where Banks Retreat, Law360, October 16, 2015

Major bank investments to VC-backed fintech companies

2011–2015



Source: The Pulse of Fintech, 2015 in Review, Global Analysis of Fintech Venture Funding, KPMG International and CB Insights (data provided by CB Insights) March 9th, 2016.

in 2015, supporting an overall trend that has seen startups opt to stay private for longer. Investment in venture capital-backed fintech companies more than doubled, reaching a record USD13.8 billion in 2015.[11] The number of deals also increased to 653 from 586 the year before.[12]

At the same time, larger banks in the US are considering whether they would rather buy, build or partner to keep pace with new developments. Citigroup Inc. and Goldman Sachs Group have invested in a number of fintech startups, choosing to work with the industry sector instead of compete with it. Some of these startups include Circle Internet Financial Group LLC, Motif Investing Inc. and Square Inc.[13] Goldman Sachs has also made a move into "robo" investment, buying Honest Dollar, a start-up which aims to make it quicker and simpler to set up savings accounts for retirement.[14]

In Spain, a joint venture between CaixaBank ,Banco Santander and telco operator Telefonica has launched a mobile commerce platform that lets consumers access merchant offers on their mobile device and then redeem them automatically by paying for a purchase with a pre-linked debit or credit card.[15]

In effect, these banks have moved from unbundling services to re-bundling them — from disruption to co-creation. But to fully become the real-time, innovative and modern trusted adviser, banks will have to reinvent themselves, using fintech to provide customers with a personalized, secure, easy and inexpensive experience available anytime and anywhere.

[11] The Pulse of Fintech: 2015 in Review, KPMG and CB Insights
[12] Ibid.
[13] Op. cit., Here's Why Fintech Companies Are Opting to Stay Private
[14] Goldman buys pensions robo-adviser, Financial Times, March 14, 2016
[15] Spanish banks and carrier launch mobile offers platform that links discounts to bank cards NFOWorld, June 17, 2014

Conclusion

Over the years, the banking industry has shown a remarkable ability to address any number of economic upheaval, market volatility and disruptors. Although the traditional divisions between banks and Private Capital are undergoing radical change, current trends suggest that a combination of both competition and cooperation will enable these two sectors to identify new opportunities in the global marketplace.

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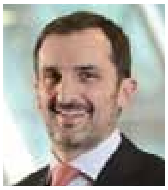
Ignacio has nearly 20 years of transactions experience and is head of Deal Advisory in Spain since 2011. Prior to KPMG he worked for Permira at its Madrid, Menlo Park (USA) and London offices. Ignacio has extensive experience of large-scale M&A and private equity transactions at national and international levels, as well as the management of portfolio companies, including designing and implementing value creation plans, securing financing and optimizing financial structures.



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Andrew leads KPMG's Global Portfolio Solutions Group in the UK and Western Europe. Andrew has undertaken both buy-side and sell-side engagements, including undertaking loan portfolio valuations, due diligence and bank advisory. Further, Andrew has worked on behalf of private banks and governments in relation to the management, valuation, option analysis and sale of their non-core loan portfolios.

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Tim leads KPMG's financial services transactions team and sits on the firm's Banking and Finance Advisory leadership committee. Tim rejoined KPMG from Bond Street Holdings/Florida Community Bank N.A. (FCB) where he was the CFO. FCB was formed to acquired distressed banks and build a top commercial bank in Florida. Prior to FCB, Tim spent six years in KPMG's Transaction Services practice advising clients on transactions in banking and specialty finance.

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Designed by Evalueserve.
Publication name: Financial services industry and private capital
Publication number: 133421-G
Publication date: April 2016