CHAPTER 2: LITERATURE REVIEW

Although it is widely believed that corporate marriages are crucial to improving efficiency, especially when a sector suffers from excess capacity there is no unanimous evidence that overall such mergers create value for shareholders or even aim to do so. In a recent survey conducted by Andersen (formerly known as Arthur Andersen) between December 2000 and January 2001, 310 senior executives from top financial institutions throughout each region of the world were asked to look at the corporate combination process through Andersen’s Value Dynamics framework when assessing their own organizations’ strength and weaknesses. More than two-thirds of the respondents surveyed had undergone some sort of corporate combination in the past 2 years. But despite this direct experience, more than half said that they believed organic growth remained the best way to create shareholder value.

Although the merger movement has held promise for more efficient and better diversified banks, and more intense competition there is accumulating evidence in surveys and empirical research that the promise has not been fulfilled for retail customers in banking markets. Neither greater efficiency nor substantial improvements in diversification appear to have been realized. There is evidence of less, rather than more, competition. With respect to the question as to whether mergers and acquisitions are profitable, empirical evidences provided by some studies suggest that synergies expected from mergers and acquisitions do not seem to exist. In particular, stockholders of offeror or acquiring firms earned either a normal return or a negative abnormal return in the post-merger periods. A study commissioned by KPMG found 53 percent destroyed shareholder values, while another 30 per cent produced no discernible difference. The conclusions came after an analysis of share price movements relative to those of similar competitors in the first year following the merger.
In the US experience, the banking sector went through a period of rapid consolidation and restructuring during the 1980s. Between 1980 and 1990, roughly five thousand commercial and savings banks were taken over by depository institutions. Consolidation has continued into the mid-1990s with an onslaught of mega-mergers pushing the volume to record levels by 1995. Although several factors have contributed to the recent surge in mergers and acquisitions, deregulation has played an important role by allowing banks to expand statewide or interstate. The rapid pace of consolidation has revitalized interest in the topic and invigorated the debate over whether mergers can have a beneficial impact on U.S. banking and the public as a whole.

The major issue in this debate is whether mergers are an effective restructuring tool. A large number of studies attempt to resolve this question by examining the long-term profitability, cost efficiency and market performance of merger survivors. Most of the earlier empirical studies investigating the effectiveness of mergers and acquisitions in the 1980s use primarily financial ratios of profitability and operating cost (Srinivasan 1992; Spindt and Tarhan 1992). One drawback of financial ratios is that they cannot accurately measure cost efficiency. As a result, several recent studies analyze bank mergers by looking at managerial efficiency (X-efficiency) and profit efficiency (Rhoades 1994). Overall evidence on the benefits of mergers in the US is mixed. Some studies (Shaffer 1993; Akhavein, Berger and Humphrey 1997) find that mergers can potentially lower costs and increase profit efficiency, while other papers (Berger and Humphrey 1992; Rhoades 1993) conclude that mergers have not resulted in any significant postmerger improvements in efficiency.

Karcés and Calomiris (2000) studied the effect of bank mergers on the welfare of borrowers. They analyzed how bank mergers influence borrower relationship termination behavior and relate propensity to terminate to borrower abnormal returns. They researched the impact of bank merger announcements on borrowers' stock prices for publicly traded Norwegian firms. Their findings showed that on average borrowers lose about one
percent in equity value when their bank is announced as a merger target. Small borrowers of target banks were especially hurt in mergers between two large banks, where they lost an average of about three percent. Small target borrowers are not harmed, and appear to even gain, from mergers between small banks. They also showed that bank mergers lead to higher relationship exit rates for three years after a bank merger, and small bank mergers lead to larger increases in exit rates than large mergers. They proved that target borrower abnormal returns are positively related to pre-merger exit rates, indicating that firms that find it easier to switch banks are less harmed when their bank merges. They found weak evidence that target borrowers with large merger-induced increases in exit rates are more negatively affected by bank merger announcements, suggesting that target borrowers can be forced out of relationships and suffer welfare losses as a result of bank mergers.

Their four main empirical results were as follows. First, the average abnormal stock price response of borrowers of acquiring and rival banks is close to zero at the announcement of a bank merger, but target borrowers experience an average stock price decline of one percent. Moreover, the reduction in abnormal returns is greater (-2.90 per cent) for small borrowers of the target banks when two large banks merge. Since target banks experience positive average abnormal returns (4.68 percent) on the merger announcement day, one might be tempted to conclude that target banks somehow take advantage of their borrowers during mergers. However, when the target bank cumulative abnormal returns (CARs) is included in cross-sectional regressions of target borrower abnormal returns, the coefficient is not statistically different from zero, implying that target banks are not gaining at the explicit expense of their borrowers. Small borrowers of target banks appear to perform better in mergers between two small banks, gaining a statistically insignificant 5.5% in the seven days leading up to the merger announcement. The fact that small borrowers of target banks are harmed in Large-Large bank mergers but fare well in Small-Small bank mergers is consistent with the idea that borrowers are injured by a change in strategic focus of the newly-merged bank. Patterns in borrower abnormal returns are not consistent with a standard market power
story of merger gains to banks. In particular, borrowers of acquiring and rival banks do not appear to suffer upon the announcement of a large bank merger.

Second, borrowing firms tend to terminate bank relationships more often in the three-year period after a bank merger, especially when the merger is relatively small. When a bank merger occurs, both merging banks and borrowers may consider it an opportune time to re-evaluate and perhaps terminate their existing relationships.

Third, target borrowers that switch banks often are less negatively affected by bank merger announcements, indicating that relationship disruption caused by bank mergers has less of an adverse effect on firms that switch banks often. They interpret a borrower’s pre-merger hazard rate as a proxy for the firm’s switching costs. Thus, target borrowers with lower switching costs are not harmed as much when a bank merger is announced.

Fourth, they found weak (marginally statistically significant) evidence that target borrowers whose exit rates increase substantially due to a bank merger experience a greater reduction in announcement-day abnormal returns. This provides a measure of support for Sapienza’s (1999) claim that some borrowers of target banks are more likely to be “severed” after their bank mergers, harming the borrowers in the process. This result could actually reflect increases in economic efficiency if the relationships severed are with firms that previously received financing for unprofitable projects.

Previous studies of the impact of mergers on industry competitiveness have analyzed three different proxies for customer welfare. The first is the stock price reaction of rival firms to merger announcements within an industry. This measure assumes that positive (negative) stock price reactions by rivals indicate a post-merger decline (increase) in the competitiveness of the industry. Emphasizing the impact on rivals of a merger is problematic because the relationship between rivals and their customers is not necessarily a zero-
sum game. For example, Jayaratne and Strahan (1997) and Karceski et al (2000) argue that large efficiency gains within the banking industry partially accrue to customers so that zero or positive abnormal returns to rival banks need not imply that customers are worse off. The second proxy is the change in product prices after a merger. Using a data set of small Italian firms, Sapienza et al (1999) finds that loan rates fall after small in-market bank mergers but rise after large bank mergers. Although changes in product prices provide clearer signals about customer welfare, price is not the only product attribute that customers care about. Service, quality, selection and availability are additional product dimensions that influence customer satisfaction. The third proxy is the frequency that customers switch products. Post-merger increases in product switching may indicate reduced customer satisfaction or that merged firms effectively drive out customers. For example, Sapienza (1999) finds that exit rates for small borrowers of target banks increase after a bank merger and that post-merger termination is unrelated to borrower profitability. Her interpretation is that management of newly merged banks effectively kicks out some small borrowers. On the other hand, higher post-merger relationship termination rates need not imply that customers are adversely affected. For example, the U.S. Department of Justice interprets a high switching rate by customers as a signal of a competitive market or the presence of close product substitutes.

A number of studies have found that in a substantial proportion of M&As, a larger, more efficient institution tends to take over a smaller, less efficient institution, presumably at least in part to spread the expertise or operating policies and procedures of the more efficient institution over additional resources. In the US, acquiring banks appear to be more cost efficient than target banks on average (Berger and Humphrey, 1992; Pilloff and Santomero, 1998). Another study of US banks found that acquiring banks are more profitable and have smaller nonperforming loan ratios than targets (Peristiani, 1993). Simulation evidence also suggests that large X-efficiency gains are possible if the best practice banks merge and reform the practices of the least efficient banks (Savage, 1991; Shaffer, 1993). Case studies of US bank M&As
support the idea that potential efficiency gains act to motivate some M&As as well (Calomiris and Karceski, 1998; Rhoades, 1998). However, one study of US banks found that while poorly-capitalized banks are more likely to be acquired, banks with a high degree of cost inefficiency are, ceteris paribus, less likely to be acquired without government assistance (Wheelock and Wilson, 1998).

European studies also suggest that M&As may be motivated in part by the potential for efficiency gains. One study found that large, profitable banks tend to be acquirers, while small, unprofitable banks tend to be targets (Focarelli, 1998), while another found that large, efficient banks tend to acquire small, less efficient banks (Vander Vennet, 1997). Similar potential for improvements were possible in M&As between UK banks and building societies (Altunbas, 1995).

The research on the efficiency effects of international M&As and M&As outside the US suggest that there may be some important differences between these consolidations and those among domestic US institutions. A study of domestic and international M&As of credit institutions in Europe found that some groups of M&As, particularly international consolidations, tended to improve cost efficiency, whereas other types tended to decrease cost efficiency (Vander Vennet, 1996, 1997). A study using Italian data also found that most societies found significant efficiency gains following acquisitions (Haynes and Thompson, 1997).

Other studies compared the efficiencies of foreign-owned versus domestically-owned institutions within a single country. Several studies found that foreign-owned banks in the US were significantly less cost efficient than domestically owned banks (Hasan and Hunter, 1996; Mahajan, 1996; Chang, 1998). Consistent with this finding, one study found lower profit efficiency for foreign-owned banks and attributed this to excessive reliance on purchased funds (DeYoung and Nolle, 1996). The foreign-owned banks may have in effect traded current profits for rapid expansion of market share, given that
purchased funds are more expensive but may be raised more quickly than core deposits. One study proposed the alternative theory that foreign banks tend to acquire domestic banks that already have performance problems, and the data are also consistent with this theory (Peek, 1999). This study also found that changes in business strategy for the foreign owners were generally not successful in raising the acquired banks' performance to the levels of their domestic peers.

Improvements in efficiency associated with consolidation may also reduce the availability of services to some small customers. M&As may help resolve control problems with managers who made non-value maximizing choices, possibly including unprofitable branch offices or small business loans. It is also possible that more efficient managers will increase the supply of services to small customers because the more efficient institutions are able to serve more customers profitably.

The increases in size and/or organizational complexity associated with M&As may also create opportunities to improve efficiency by changing focus away from or toward serving small customers. The large institutions created by consolidation may shift away from providing retail-oriented services for small depositors and borrowers because of new opportunities to provide wholesale services for large capital market participants. Small institutions generally cannot make large business loans, underwrite new securities issues, or provide the full array of risk-management services because of insufficient scale of operations, lack of diversification, legal lending limits, etc.

The larger institutions created by consolidation may also choose to provide fewer retail services to small customers because of (Williamson 1967, 1988) organizational diseconomies of providing these services along with providing wholesale capital market services to large customers. That is, it may be scope inefficient for one institution to produce outputs, which may require implementation of quite different policies and procedures. These diseconomies may most likely arise in providing services to informationally
opaque small businesses for which intimate knowledge of the small business, its owner, and its local market gained over time through a relationship with the financing institution is important. Large institutions may be inefficient at providing these relationship-based services along with the transaction-based services provided to large, relatively informationally transparent customers.

A financial institution’s organizational complexity may also make it costly to provide locally based services to small customers. For example, a multibank BHC (Bank Holding Company) with multiple layers of management that acquires an independent bank in another region or another country may find it costly to process relationship-based information acquired through contact over time by a local loan officer in a distant market.

Importantly, these arguments do not suggest that the large, complex financial institutions created by consolidation would reduce services to all small customers, rather just to those customers who rely on relationships. Small customers with strong financial statements and valuable collateral may receive essentially the same transactions-based services as large customers, and could see an increase in available services from their consolidated institutions, such as underwriting or risk management services.

An alternative theory may suggest improved availability of services to small customers from consolidation, especially during times of financial stress. Large, organizationally complex, diversified financial institutions may be better able to withstand financial crises and continue to provide services. In contrast, small unaffiliated, undiversified institutions may more often have to withdraw credit and other service from small customers in times of financial stress. Moreover, even in periods without financial stress, the large, organizationally complex institutions created by consolidation may act as inefficient internal capital markets that can allocate financial resources where and when they are most needed.
The empirical research on relationships between banks and small businesses generally supports the notions that banks use these relationships to garner information and that small businesses benefit from these relationships. The research using US data generally found that small businesses with stronger banking relationships received loans with lower rates and fewer collateral requirements, had less dependence on trade credit, enjoyed greater credit availability, and protection against the interest rate cycle than other small business (Petersen and Raja, 1994, 1995; Berger and Udell 1995; Blackwell and Winters, 1997; Berlin and Mester, 1998; Hubbard, 1998). The US data also suggest that banks gather valuable private information from depositors and in some cases use this information in credit decisions (Allen, 1991; Nakamura, 1993; Frieder and Sherrill, 1997; Mester, 1998). The evidence using European and Asian banking data also usually shows support for the value added relationships, although some of the European evidence suggests exceptions (Hoshi, 1990; Ongena and Smith, 1997; Angelini, 1998; Elsas and Krahnen, 1998; Harhoff and Korting, 1998).

The total effect of consolidation on the availability of financial services to small customers also depends upon the external effect of consolidation on the supply of these services by other institutions in the same local markets. For example, if institutions participating in M&As reduce the availability of small business services, other financial service firms may pick up these customers if it is value-maximizing for them to do so.

These theories have been tested using both static and dynamic methods. The static analyses tested the effects of financial institution size and organizational complexity on the supply of services to small customers, but did not distinguish institutions that had recently engaged in M&As from other institutions. The dynamic analyses compared the availability of these services before and after M&As or between institutions that have recently engaged in M&As and those that have not.