

2. LITERATURE REVIEW

In 1990s, bank mergers have increased tremendously. It started in the US, but in the second half of the 1990s, it was followed by Europe and Japan. Generally, the shareholders of the merger party can gain from a merger only if the merging institutions are worth more in combination than separately. In the incident the bidder offers stock or cash payment for the target's shares, the bidding institution must normally offer a premium above the value of the target to encourage shareholders to sell their shares. The acquiring institution incurs a variety of costs and expenses. The net advantage of merging to the acquirer's shareholders equals the difference between the total market value of the institution's post-merger value net of the costs of completing the acquisition and the total market value of the banks before the merger. Mergers between non-diversified financial institutions have the possibility to impact on bank performance, and thus on shareholder value, in four ways: via economies of scale, via the selective redeployments of assets, via the transfer of assets to better quality managers, and fourth, via renegotiations of implicit labor contracts, Haynes and Thomson, (1999).

Various studies were carried out which used the event methodology to analyze the effects of M&As. Most empirical studies have used US data to determine if mergers create shareholder wealth; examples are Trifts and Scanlon, (1987); Sawyer and Shrieves, (1994); Thompson and Mullineaux, (1995); Loughran and Vijh, (1997); Frame and Lastrapes, (1998); Houston et al., (2001). Commonly, on the basis of empirical studies for the most parts after US-based mergers, they find that target shareholders earn substantial positive abnormal returns from mergers, and that acquiring shareholders earn negative abnormal

returns from mergers. Overall value of the mergers increases slightly but often not in a significant manner or amount. In most studies, the evidence usually is based on returns computed over a pre-acquisition period starting immediately before the announcement date and ending on or before the effective date of the merger Loughran and Vjih, (1997). When pre-acquisition and post-acquisition stock returns are compared with benchmark returns, possible abnormal returns as a result of the merger can be found.

Rad and Van Beek (1999) study states that European bidding banks realize no significant abnormal returns at the merger announcement, while European target banks experience positive returns. Franks and Harris (1989) find similar results for over 1,800 UK takeovers on shareholder wealth. Cybo-Ottone and Murgia (2000) study mergers of 54 M&A deals covering 13 European banking markets of the European Union including the Swiss market. They find positive abnormal returns for both bidders and targets, when using a general market index. With a comparable bank sector index, however, it turns out that the buyers' abnormal returns always are small and insignificant. The sellers' abnormal returns are substantial and significant. Thus, they find that European bank mergers create value for the combined partners as well as the targets and that acquirers do not lose as its been shown to be statistically significant and economically relevant. DeLong (2003) analyzes both US and non-US bank mergers. Similar to Cybo-Ottone and Murgia, DeLong finds that announcements of non-US bank mergers enhance the value of combined partners, that bidders do not lose, and that sellers increase their values. The value enhanced for the combined partners of non-US merger announcements is not statistically different from that created through US bank merger announcements. B. Scholtens, R. de Wit (2004), study on

the announcement effect of large mergers and acquisitions in European and US markets find that buyer banks gain more than sellers.

In an ideal world of perfect capital markets, it is assumed that transaction costs are zero; therefore we have perfect operational efficiency. In an efficient capital market, prices fully and instantaneously reflect all available relevant information. This means that when assets are traded, prices are accurate signals for capital allocation, Copeland and Weston, (1983). A number of studies have been carried out that examined changes in operating performance post mergers, Healy et al. (1992), Cornett and Tehranian (1992), Jarrell (1990), Clark and Ofek (1994), Ravenscraft and Scherer (1988) and Herman and Lowenstein (1988). Healy et al. (1992) investigates if firms' operating performances were affected due to acquirer's choice of cash or stock as the method-of-payment. The study consists of 50 mergers where 13 mergers involved cash offers. Healy et al. (1992) findings are there's no relation between changes in performance and the method-of-payment. However, the study's limitation could be influenced by the small, selective sample examined. Cornett and Tehranian (1992) also find improved operating performance in a study of 30 mergers in the banking industry but do not emphasize on whether these improvements are related to the method-of-payment. Clark and Ofek (1994) investigate the relation between post-merger industry-adjusted performance and whether cash was included in the offer for a sample of takeovers involving 38 distressed targets. Clark and Ofek (1994) do not investigate the relation between cash versus stock offers and the difference between the pre and post-merger performance in their study. It also reported no findings of any general improvement in performance as a consequence of the mergers studied. Fishman (1989) argues that bidders use cash to prevent competing bids when they

have positive private information indicating a high value for the target, potentially to synergies. Berkovitch and Narayanan (1990), argue that when the buyer offers large cash it increases the possibility that the target will accept the initial bid, thus avoids any delay during which other interested firms might offer competing bids. They also argued that the share of synergistic gains captured by the bidding firm increases with the fraction of the offer represented by cash. Thus bidders with very favorable private information about future excess operating returns would tend to use larger amounts of cash in their offers, both to deter competition and to ensure that they capture a large share of the synergistic gains. S.C. Linn, J.A. Switzer (2001) conducted a study on the operating performance of 413 firm acquisitions. The study finds that the change in performance of the merged firms is significantly larger for cases where there were cash as opposed to stock offers.

Consolidation of the banking sector is particularly important to entrepreneurs because it impacts their ability to raise funds. Entrepreneurial firms are generally small, and as argued by Guiso et al. (2004) and Cole et al. (1996), among others, depend heavily on the credit provided by local banking systems for their start-up, daily transactions and continuous growth. Traditional banking theory treats borrowers as a homogenous group (Klein, 1971), and suggests that as rivalry among bank increases, banks are more likely to charge lower interest rates on loans, thereby lead to an increase in the equilibrium supply of loans (Pagano,1993). Petersen and Rajan (1995) contend that as competition among banks increases, banks have a reduced ability to inter-temporally share surplus with firms.

The significant increase in consolidation of the banking industry has also led to a significant reduction in the importance of small banks in the credit market (Black and

Strahan, 2002). Stein (2002) points out that the key distinguishing characteristic of small business lending is the “softness” of information generated in the decision making compared to large banks that rely more on “hard” information. This suggests that small firms will have a much more difficulty in obtaining credit because larger banks created from M&As tend to move away from relationship based lending to transaction-based lending, and are less likely to extend credit to small businesses, especially to those firms with almost no history (i.e., newly formed business). B. Francis et al. (2008) finds that in the short-run, bank consolidation is negatively related to the rate of new business set-up and this is due to consolidations initiated by large acquirers. However, consolidations between small-to medium sized banks have a positive impact on new business formation.