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Gains in bank mergers: Evidence from the bond markets ☆

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Abstract

We present evidence that the adjusted returns of merging banks' bonds are positive and significant across pre-merger and announcement months. The cross-sectional evidence indicates that the primary determinants of merger-related bondholder gains are diversification gains, gains associated with achieving too-big-to-fail status, and, to a lesser degree, synergy gains. We obtain the same finding when we examine the acquiring banks' credit spreads on new debt issues both before and after the merger. We also provide the first study that shows acquirers benefit by the lower cost of funds on post-merger debt issues.

JEL classification: G21; G28; G34

Keywords: Bank mergers; Bondholder gains; Too big to fail

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1. Introduction

Corporate mergers can affect bondholders in several ways. If the merger is synergistic, both bondholders and shareholders gain because firm value can increase by achieving economies of scale and scope and by eliminating less-efficient management (see Jensen and Ruback, 1983). In nonsynergistic mergers, bondholders can still gain if the merger reduces cash flow volatility and leads to a lower risk of default (see, e.g., Lewellen, 1971; Higgins Schall,1975; Galai and Masulis, 1976).

In the case of bank mergers there are at least two additional layers of complexity. First, the federal deposit insurer might consider the combined bank too big to fail (TBTF) as a result of the merger. This strategy allows all uninsured liabilities to have de facto insurance coverage and thereby maximizes the value of the implicit guarantees received from the government. Second, unlike nonfinancial firms, banks are subject to regulatory capital requirements. As a result, shareholders cannot simply increase leverage to make up for a merger that coinsures bondholders. Hence, even with no TBTF, bondholders could gain and shareholders could lose as bondholders expropriate some of the gains associated with the acquisition.

To the best of our knowledge, no study has examined changes in required returns on banks' debt around the time of a merger. In this paper we examine first the reaction of nonconvertible bond prices of both the acquiring and target banks around merger announcements, and then changes in the credit spread of the acquiring institution's new debt issues after the merger. Our results contrast sharply with those reported for mergers of nonfinancial firms. We observe that bondholders of both acquirer and target banks realize significant positive risk- and maturity-adjusted returns around the merger announcement month. During the seven consecutive pre-merger months and the announcement month, bondholders realize positive returns. The sum of cumulative adjusted bond returns is 4.3% for target banks during this period, significantly exceeding the acquiring banks' bond returns of 1.2%. Overall, our findings indicate that bond market participants perceive the bank merger as a default-risk reducing event.

Our cross-sectional tests focus on identifying the factors that determine the merger announcement month risk- and maturity-adjusted bond returns. Our analysis shows that all three possible rationales (diversification, TBTF, and, to a lesser degree, synergy) account for increased bondholder returns. The acquiring banks of our sample do not significantly increase their leverage ratios post-merger. This finding supports the argument that bank bondholders might benefit from the coinsurance effect. However, after we control for degree of diversification, geographic overlap, and expected changes in leverage and asset quality following merger, our analysis shows that the incremental asset size is a positive and significant determinant of the announcement month returns.

We also find that bond returns do not increase monotonically with the asset size of the firm involved in the merger, which is consistent with the existence of TBTF gains. Bondholders of medium-size banks (those that can push the combined bank's asset