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Corporate governance and recent consolidation in the banking industry

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Abstract

Using the universe of publicly traded banks at year-end 1993, we find that target banks' outside directors, but not inside directors, tend to own more stock than their counterparts in other banks. Having an outside blockholder is also associated with banks becoming targets. In contrast to existing research on industrial firms, board structure does not help determine which sample banks sell. Neither the fraction of outsiders on a bank's board nor having an outside-dominated board differentiate the target banks in our sample. Instead, outside directors/shareholders and blockholders appear to be primarily responsible for encouraging bank managers to accept an attractive merger offer © 2000 Elsevier Science B.V. All rights reserved.

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Financial economists have long recognized that the widespread separation of ownership and control in large US corporations creates the potential for costly agency conflicts. Dispersed shareholders' limited incentive to monitor the behavior and performance of the agents hired to run their firm can give managers substantial freedom to pursue their own interests at the expense of shareholder wealth. Absent mechanisms to control managerial behavior, usually called ''corpo-

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rate governance structures,'' wealth maximization will not exclusively motivate corporate decision-making.

A company's board of directors is one of the mechanisms within the firm to monitor and control managerial behavior.[1] The board hires, fires, and compensates a firm's top management. However, board members are subject to their own agency problems. A firm's chief executive officer (CEO) is generally a member of, and is often the chairman of, the board of directors. CEOs typically also play a major role in selecting new nominees for the board (Lorsch and MacIver, 1989). If board members are strongly influenced by or beholden to the firm's top officers, it is unclear whether the board can successfully align shareholder and manager interests.

The banking industry's ongoing consolidation offers an excellent experimental setting for examining board effectiveness. During the last decade, technological advances in communication and information technologies have reduced the costs of having a geographically dispersed banking organization. Simultaneously, laws and regulations that had previously fragmented the banking industry have been relaxed or, in some cases, eliminated.[2] The joint effect has been a dramatic surge in merger activity that has sharply reduced the number of US banks (Holland et al., 1996).

Similar to acquisitions by industrial firms, the lion's share of takeover gains in bank mergers goes to target shareholders (see Jensen and Ruback (1983) for a summary of industrial takeover research). For example, in a sample of 153 bank acquisitions between 1985 and 1991, Houston and Ryngaert (1994) find that target banks earn positive average abnormal returns of 14.4% and bidder shareholders suffer negative average abnormal returns of −2.3%. In contrast to target shareholders' gains, a target bank's managers tend to find themselves out of a job after being acquired while the bidding bank's managers preside over the newly merged institution. Hadlock et al. (1999) find that more than one-half of the top executives in their sample of target banks are not employed by the buying bank 2 years after the acquisition. Because shareholders tend to benefit from being acquired while managers generally lose both future compensation and prestige if their firm is acquired, takeovers epitomize how shareholder and managerial interests can collide.

The natural divergence of target shareholder and manager incentives in response to a merger bid makes takeovers a model experiment for exploring the firm characteristics that are associated with managers acting in shareholders' interests. However, past research attempting to discern target firms' distinctive character-

[1] Shleifer and Vishny (1986) show how outside blockholders can also discipline managers.

[2] For example, in 1994 the Interstate Banking and Branching Efficiency Act eliminated interstate bank merger restrictions and virtually eliminated restrictions on banks' ability to consolidate their subsidiaries (today, only Texas continues to require bank holding companies to maintain independent banks within their state).

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