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The impact of the manager–shareholder conflict on acquiring bank returns

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Abstract

This paper examines whether shareholder value-maximizing corporate governance mechanisms assist in reducing the managerial incentive to enter value-destroying bank acquisitions. We find that diversifying bank acquisitions earn significantly negative announcement period abnormal returns (AR) for bidder banks whereas focusing acquisitions earn zero AR. We then find that corporate governance variables (such as CEO share and option ownership and a smaller board size) in the bidding bank are less effective in diversifying acquisitions than in focusing acquisitions. These results are robust to the inclusion of the usual control variables.

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1. Introduction

Several empirical studies have documented a negative relation between firm performance and the level of diversification in a firm's lines of business in the 1980s (see

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for example, Morck et al., 1990; Lang and Stulz, 1994; John and Ofek, 1995). A possible argument for lower returns from firm-level diversification is the managerial agency argument that CEOs cannot operate unrelated lines of business as efficiently as single or related business segments. Companies therefore do not create value from firm-level diversification when investors can do so more cheaply through portfolio diversification in the financial markets. According to this agency view, value-destroying managerial activities (such as firm-level diversification) can be reduced by designing effective corporate governance mechanisms.

In the industrial firm literature, bidders' announcement period abnormal returns (AR) have been found to be positively related to insider share ownership in the year before the takeover (Lewellen et al., 1985; You et al., 1986). However, the CEO pay–performance studies (e.g., Jensen and Murphy, 1990a,b; Hall and Liebman, 1987) and the board of director literature (e.g., Jensen, 1993; Yermack, 1996) have found other corporate governance variables to have a statistically significant effect on firm value. In this paper, we examine a comprehensive set of corporate governance variables and find many of them to have a significant impact on bidder AR around the announcement of both diversifying and focusing bank acquisitions. We then examine whether these corporate governance mechanisms assist in reducing the managerial incentive to enter value-destroying bank acquisitions.

Our results suggest that acquisition announcements for diversifying acquisitions (geographic and activity diversification) produce significantly smaller AR for bidder banks than focusing acquisitions. Specifically, we find that bidder AR are significantly negative in interstate and activity diversifying bank acquisitions and are not significantly different from zero in intrastate and activity focusing bank acquisitions. Importantly we find a differential impact of corporate governance variables on diversifying versus focusing acquisitions. We find that corporate governance variables (such as CEO share and option ownership and a smaller board size) are less significant in diversifying acquisitions than in focusing acquisitions. This might help explain why diversifying acquisitions earn negative AR.

We look at diversification along two dimensions; geography and activity. Unlike other industries, the banking industry allows us to examine focusing and diversifying events that are easily observable to the external capital markets. Most previous studies have used SIC codes to classify whether mergers are diversifying or focusing. However, recent research has shown SIC codes to have significant classification issues. For example, Kahle and Wakling (1996) find significant differences between Compusat and Center for Research in Security Prices (CRSP) databases in 36% of the classifications at the two-digit level and nearly 80% at the four-digit level. They also find that these discrepancies are exacerbated among utilities, financial companies and conglomerates. Further, Scarfstein, 1999 shows that segments producing very related products can have very different two-digit SIC codes, as can companies that have vertical relationships (see also Matsusaka, 1993). For the banking industry SIC codes reflect regulatory structure (e.g., federal member bank or state nonmember bank) rather than product lines. Thus, researchers cannot use SIC codes to determine activity diversification between two merging banks. Intrastate versus interstate bank acquisitions, however, is a transparent classification scheme to market