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An examination of non-government-assisted US commercial bank mergers during the financial crisis

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ABSTRACT

In this study, we examine non-government-assisted US commercial bank merger activity prior to and during the recent financial crisis. Mergers that occur throughout the crisis appear to be more significant events for both targets and acquirers. Acquirers seek out relatively larger targets during the crisis and offer premiums are higher than pre-crisis values. Valuation discrepancies between targets and acquirers are also greater for crisis period mergers, suggesting that merger gains outweigh presumably high capital reallocation costs. Acquirers have lower capital ratios than their peers during the crisis, indicating that they may use mergers defensively as recapitalization events. However, crisis period mergers do not appear to be motivated by asset-based liquidity concerns for either the target or acquirer. Examining how firm characteristics relate to value creation, we find targets that are undervalued relative to their acquirers see larger offer premiums during the crisis, but not before. Targets with poorer-performing loan portfolios, however, observe lower offer premiums during the crisis. Lastly, we find overall merger announcement value creation during the financial crisis is greater when targets have higher quality assets, are better capitalized, and are less efficient.

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Although not at the pace observed in the period leading up to the crisis, commercial banks in the United States continued to engage in consolidation activity during the financial crisis of the late 2000s (Wheelock, 2011; Adams, 2012). As shown in Graph A of Fig. 1, regulators continue to allow unassisted merger activity within the publically traded US commercial banking sector. However, as the crisis worsened, regulators began to restrict such activity to the extent that only five mergers close in 2009 that meet our data requirements and none close in 2010[1]. In Graph B, we see a nearly opposite trend when examining the number of US commercial bank failures, which balloons to over 100 in 2009 alone. The shift from non-government assisted to government assisted (i.e., failure) consolidation activity becomes clear when we plot the annual frequency of these two types of mergers, which are reported as a percentage of their total respective samples in Graph C. As the financial crisis intensified from the third quarter of 2007 to the third quarter of 2008, much of the non-government assisted merger activity was effectively eliminated and replaced by failure-related consolidations.

While there is a well documented strain of literature that examines the rationale behind government assisted bank failures during the latest financial crisis (Cole & White, 2012; DeYoung & Torna, 2012; Aubuchon & Wheelock, 2010; Ng & Roychowdhury, 2010), little is known about the motivation behind non-government assisted merger activity that occurred largely during the early stages of the crisis. This consolidation activity is unique, in that it is initiated without direct government assistance during a tremulous period for the financial markets. Therefore, it is important to examine the motivation and economic implications of such consolidation activity. For this reason, we examine a sample of targets and acquirers involved in US commercial bank mergers during both pre-crisis (2004q1 to 2007q2) and crisis (2007q3 to 2010q4) sub-periods[2].

The pre-crisis period is preceded by episodes of deregulation, including the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (IBBEA), which precipitated a well-documented wave of bank mergers following the implementation of the Act in 1997 (Berger, Demsetz, & Strahan, 1999)[3]. Mergers that do occur during the crisis appear to be more significant events for both targets and acquirers. When compared to pre-crisis consolidation activity, crisis period offer premiums and target announcement period returns are higher. Acquirers also seek out relatively larger targets as measured by both book value of assets and market value of equity. Interestingly, results on announcement period returns suggest that more efficient mergers took place during the crisis period. In line with previous research, we find that merger announcements are value destroying events for acquiring banks, but only during the pre-crisis period. Announcement period returns for acquiring banks are significantly negative in the pre-crisis period, but not distinguishable from zero during the financial crisis. The net result is overall value creation for crisis period mergers, but not for mergers that occur prior to the crisis.

We next examine the dimensions along which targets and acquirers may differ, and whether these dimensions vary by economic circumstance. Based on the extant literature, we generally expect that target banks are valued lower, less efficient, and less capitalized than their acquirers (Peristiani, 1997; Pilloff & Santomero, 1998; Andrade, Mitchell, & Erik, 2001). Valuation discrepancies between targets and acquirers should be more evident during the crisis as merger gains must outweigh presumably high capital reallocation costs (Eisfeldt & Rampini, 2006). We expect less efficient and less capitalized targets during the crisis as mergers may help avoid failure (Carlson, 2010; Austin, 2008). We use proxies for components of CAMELS ratings employed by banking authorities to test these and additional hypotheses. CAMELS ratings are composite measures of bank 'health' used to predict the probability of default; the ratings quantify the overall safety and soundness of banking institutions[4]. In line with

[1] In Section 2, we provide a detailed description of our sample selection requirements.

[2] We include only US bank and bank holding company mergers that are initiated by the merging entities. Specifically, we examine mergers that do not involve government assistance and therefore exclude acquisitions of failed banks from the sample. Further, our main results are robust to the use of alternative definitions of crisis period, which is discussed in Sections 4 and 5.

[3] The Gramm–Leach–Bliley Financial Services Modernization Act of 1999 (FSMA) also precipitated a merger wave. However, this wave differs because the FSMA enables different types of financial institutions to merge (e.g., between commercial and investment banks). We limit our analysis to mergers between commercial banks.

[4] "CAMELS" is an acronym for; Capital adequacy, Asset quality, Managerial efficiency, Earnings quality, Liquidity exposure, and Sensitivity to market risk.