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Why are some banks recapitalized and others taken over? ☆

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This study investigates the likelihood of takeovers or recapitalizations for EU listed banks before and during the financial, using both static and sequential multinomial logistic models. Takeovers and recapitalizations are potential alternatives used to shore up financial institutions. We find that takeovers occur when the bank has low net interest margins. Instead, private recapitalizations occur for banks with lower equity, higher net interest margins, and positive growth at the bank level. Public recapitalizations occur for larger, less liquid banks with positive prospects that operate in bigger banking systems. Both types of recapitalizations occur in countries with lower growth. The determinants for takeovers and recapitalization differ between the pre-crisis and crisis periods. Overall, a need for corporate control exists when traditional banking suffers lower performance, whereas the search for stability explains recapitalizations.

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1. Introduction

The past decade has seen major restructuring in the European banking industry partly as a result of the recent financial crisis. In order to provide financial support to the distressed financial sector, EU member states introduced a number of emergency measures ranging from state guarantee schemes, to public recapitalizations, forced takeovers and acquisitions, and nationalizations (Petrovic and Tutsch, 2009). We investigate the likelihood of a listed bank either becoming involved in a takeover as a target or being (privately or publicly) recapitalized in the periods before and during the financial crisis. Because takeovers and recapitalizations are potential alternatives to shore up financial institutions, we compare the determinants of a bank being taken over with those of a bank being recapitalized. Our results show that takeovers are more likely than private recapitalizations for banks when their distress concerns traditional banking activities. Our evidence provides a tool for prudential supervision by identifying characteristics that will enable supervisory authorities to forecast the most likely outcome (takeover vs. recapitalization) and national governments/supervisory authorities to engineer recapitalizations in the case of state bailouts.

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Wheelock and Wilson (2000) examine the characteristics that make banks more likely to disappear through either failures or acquisitions, whilst De Young (2003) examines the characteristics that make banks more likely to disappear via failures.[1] In contrast, we focus on the ex-ante characteristics that make banks more likely either to disappear as independent entities through takeovers or to survive through recapitalizations in the EU banking industry both before and during the crisis. Takeovers and recapitalizations are potential alternatives to shore up financial institutions although in different ways. A takeover involves a change in control, possibly new management, and the end of the bank as an independent entity. A recapitalization involves the sale of new equity in the bank to investors in the market or to a government entity without the loss of independence. Although the characteristics of banks involved in acquisitions have been thoroughly researched,[2] to our knowledge no published empirical work investigates how these characteristics differ in the pre-crisis and crisis periods.[3] Furthermore, whilst the literature on the characteristics of banks involved in public recapitalizations (especially via the Troubled Asset Relief Program, TARP) is growing (Bayazitova and Shivdasani, 2012; Mariathasan and Merrouche, 2012; Gwilym et al., 2013; Harris et al., 2013; Elyasiani et al., 2014; Duchin and Sosyura 2014; Molyneux et al., 2014),[4] there is surprisingly little evidence on the characteristics of banks that are privately recapitalized (Dinger and Vallascas, 2015).[5] Further, no evidence exists on how these characteristics differ between takeovers and recapitalizations.[6]

Wheelock and Wilson (2000) find that the most common reasons given for bank takeovers are the aim to better manage the assets of poorly managed banks, the desire to grow, or the desire of bank managers with a large ownership stake to be acquired in the hope of receiving an attractive takeover premium. Berger et al. (2014) and Berger and Bouwman (2013) find that the most common reasons given for bank recapitalizations are the need to revive the banks, the need to reduce risk taking,[7] or to create liquidity,[8] which is a core function of banks. In this industry nevertheless banks take steps to limit the use of equity as much as possible because banks perceive equity financing as expensive. Indeed, a primary challenge for capital regulation is forcing banks to hold more equity than they would like (Kashyap et al., 2008).

For poorly performing banks, which are therefore potentially subject to bank runs especially in the crisis period, takeovers have several advantages over private recapitalizations. First, equity investors in a bank are not capable of monitoring the management (Jensen and Meckling, 1976). Therefore, they constantly worry that bad decisions by management will dissipate the value of their shareholdings. This was especially important in the case of a bank badly managed in the past (Kashyap et al., 2008): the high level of discretion that an equity-rich balance sheet granted to bank management explains the cost-of-capital premium and the preference for takeovers rather than further capital injections in badly managed banks. Second, under the debt overhang framework (Myers, 1977), existing shareholders might not benefit from new capital injections because most of the benefits might go to existing creditors, especially when the equity capital is low (Admati et al., 2012; Elyasiani et al., 2014).

Furthermore, in an emergency context in which the time required to solve the bank's distress is a primary issue due to systemic risk, state recapitalizations appear preferable to private recapitalizations. They tend to be quicker, whilst private recapitalizations tend to be sluggish due to higher coordination costs and higher information asymmetries faced by small shareholders. In such a context of high information asymmetry, the state is expected to be better able to evaluate the quality of a counterpart bank than small shareholders, which should reduce the adverse selection problem faced by the small shareholders (Myers and Majluf, 1984). In addition, capital is a relatively costly mode of funding at all times, and it becomes particularly costly during times of great uncertainty (Kashyap et al., 2008) given the higher concerns among private investors for bank failures (Okonkwo Osili and Paulson, 2009). Finally, a state recapitalization is less likely to involve information leakages to depositors and thus less likely to lead to bank runs. This explains why government intervention during crises has driven the recapitalizations aimed at restructuring in order to avoid contagion (UK House of Commons Treasury Committee, 2009).

The main aim of this paper is to investigate the characteristics that determine the likelihood of banks becoming targets or being recapitalized, by using (static and sequential) multinomial logistic and Cox regressions. With reference to the EU banking industry, our results show that if we consider takeovers and recapitalizations as potential alternatives for restructuring banks, private recapitalizations are more likely for banks with less tangible equity but with higher net interest margins and positive growth, and bank takeovers are more likely when their distress concerns low net interest margins that reflect weak performance in traditional banking activities. However, the determinants differ widely between the pre-crisis and crisis periods. Whilst few differences arise in the pre-crisis period, major differences emerge during the crisis period. The major

[1] Cole and White (2012) examine the same issue over the 2007–2008 crisis.

[2] Moore (1997), Hadlock et al. (1999), Wheelock and Wilson (2000), Hannan and Pilloff (2009), Goddard et al. (2009), Hernando et al. (2009), Pasiouras et al. (2011) and Beccalli and Frantz (2013).

[3] For the US, there is evidence on the ex-post effects on market performance of acquirers in the resolution of failed banks during the crisis (Cowan and Salotti, 2013), and on the impact of disclosure requirements in the acquisition of undercapitalized banks promoted and subsidized by governments (Granja, 2011).

[4] Evidence is provided on the ex-post effects of government assistance on bank risk taking (for the US see Duchin and Sosyura, 2014; for Germany see Gropp et al., 2014), on the effects on bank risk taking and liquidity creation following regulatory interventions and capital support (Berger et al., 2014).

[5] The literature provides evidence on the effects on bank performance (survival and market share) associated with capital during the crisis (Berger and Bouwman (2013)), whilst not specifically on the ex-ante determinants of capital injections. The non-banking literature has instead extensively investigated the most common reasons given for private recapitalizations (see for a review Eckbo et al., 2007).

[6] Mariathasan and Merrouche, 2012 estimate a multinomial logistic regression to differentiate among the forms of public resolutions (public recapitalizations, forced takeovers and nationalizations), but they ignore private interventions (private takeovers and recapitalizations, where our paper focuses).

[7] See among the others the theoretical models of: Bhattacharya et al. (1998), Diamond and Rajan (2005), Allen et al. (2011) and Philippon and Schnabl (2013).

[8] See among the others theoretical models: Bryant (1980), Diamond and Dybvig (1983) and Kashyap et al. (2002).

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