



Does deregulation induce competition in the market for corporate control? The special case of banking



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ABSTRACT

Using a sample of 936 acquisitions of commercial banks, we examine the relation between the probability to engage in value-reducing acquisitions and corporate governance structures, as well as the relation between acquirer announcement-period abnormal stock returns and antitakeover indices and measures, and how these relations were affected by the change in the market for corporate control, caused by deregulation due to the implementation of the Interstate Banking and Branching Efficiency Act of 1994 and the Financial Service Modernization Act of 1999. We find that prior to deregulation there is no relation between probability to engage in value destroying acquisitions or acquirer returns and antitakeover indices, whereas after the adoption of the FSMA, probability to engage in value destroying acquisitions and the stock market reaction to bidder M&A announcements are both significantly related to governance indexes and measures. Our findings further confirm the linkage between the market for corporate control, antitakeover indices and firm value.

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1. Introduction

Managerial propensity to expropriate corporate resources for their own benefit at the cost of shareholders' interests and the mechanisms that limit the opportunities to do so have been issues of great attention for both academics and policy makers. Among these mechanisms, the market for corporate control is one of the most effective. Specifically, financial economists contend that a competitive market for corporate control enhances firm valuation by forcing more efficient utilization of economies of scale and scope, and by motivating managers to exert greater effort, in response to fears of loss of control. However, a series of studies (Gompers et al., 2003; Bebchuk et al., 2009; Cremers and Ferrell, 2011, among others) have established that the effectiveness of the market for corporate control can be jeopardized by anti-takeover barriers created by individual firms, or imposed by regulation. Specifically, extant research shows that anti-takeover provisions (ATPs), like poison pill and staggered board that delay (and, hence discourage) or thwart hostile takeover attempts, have significantly adverse impact on share values. To measure the extent, to which managers in individual firms are protected from the market for

corporate control, extant research uses several recently developed governance indices. Gompers et al. (2003), develop the G-Index, which includes a complete set of the 24 ATPs, tracked by IRRC and establish that a portfolio of long democracy firms with strong shareholder protection (G-Index < 5) and short dictator firms with weak shareholder protection (G-Index > 14) significantly outperforms the market. Complimentary evidence is provided by Masulis et al. (2007) who show that acquisition announcements by firms with more ATPs are associated with significantly lower abnormal returns. Bebchuk et al. (2009) show that the negative effect of ATP measures is attributable mainly to only six of the anti-takeover mechanisms, which they use to form an Entrenchment Index (E-Index); the other 18 have only marginal negative effect on value. Cremers and Ferrell (2011) use 1985 – the year when Delaware court validated the adoption of poison pills – as a pivotal year, and find that the negative association between G-Index and firm value exists only after 1985 and that the effect of poor shareholder protection (high G-Index) is mainly due to poison pills.

Furthermore, the impact of anti-takeover regulation depends on the structure of the market as highlighted in a recent study by Giroud and Mueller (2010) who examine the notion that the less competitive an industry is, the greater the managerial slack and waste are, and consequently, the more adverse the effect of anti-takeover regulation is. Specifically, Giroud and Mueller (2010) examine the effect of a moratorium imposed by business combination (BC) laws, passed in various states between 1985 and 1991. By preventing certain transactions by large shareholders for a period of time after they

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acquire their stakes, the moratorium rendered hostile takeovers almost impossible, thus weakening corporate governance and allowing managerial slack to increase. The authors find the effect of BC laws to be less adverse in competitive industries, which is consistent with the idea that competition mitigates managerial slack.

Giroud and Mueller's (2010) findings have important policy implications – when considering new takeover regulation, policy makers ought to pay particular attention to its potential impact on less competitive industries. Our objective is to provide new insight on the effect of regulatory changes on the market for corporate control by examining the differential impact of ATPs around new legislation. Specifically, we focus on two important regulatory changes in the banking sector in the last two decades. The first is the Interstate Banking and Branching Efficiency Act (IBBEA, also known as the Riegle-Neal Act) of 1994, which removed the intricate details of the various state laws governing interstate bank acquisitions and allowed BHCs to acquire banks in any state in the Union. Brook et al. (1998) document a significantly positive reaction of bank stocks to the passage of IBBEA. The authors attribute the effect to the transformation of the banking industry from one where takeover activity was restricted to one where restrictions on mergers and acquisitions were largely eliminated.

The second regulatory change is the Financial Services Modernization Act of 1999 (FSMA, also known as the Gramm-Leach-Bliley Act), which permitted combinations of commercial and investment banks, and insurance companies, and facilitated the creation of financial holding companies that can participate in sale of insurance and marketable securities. Akhigbe and Whyte (2001) find that the passage of FSMA induced a significantly positive revaluation of financial institutions including banks, brokerage firms, and insurance companies. The authors attribute the effect to the benefits, associated with cross-industry mergers and acquisitions following the deregulation. In corroboration, the data indicate that FSMA ushered in an era of consolidation in the banking industry – the percentage of inter-industry mergers among financial firms increased from 11.5% in the three-years before FSMA to 17.7% in the three-years following FSMA (Carow et al., 2011).

Notwithstanding the favorable stock market reaction to the passage of IBBEA and FSMA (Brook et al., 1998; Carow and Heron, 1998; Akhigbe and Whyte, 2001; Czyrnik and Klein, 2004, among others), governance by the corporate control market, especially the role of ATPs, remains an issue with very limited evidence in the banking sector. We contend that the changing environment of deregulation, initiated by the enactment of the IBBEA and FSMA, affords us a unique opportunity to explore this issue. Specifically, the setting allows us to examine how the transition to an unconstrained market for corporate control influences managerial disposition to value-reducing acquisitions, and the impact of ATPs on acquirer's stock returns. Of particular interest is the effect of diversifying acquisitions, in view of the evidence that in absence of strict monitoring, entrenched managers tend to deploy free cash flow to diversifying acquisitions despite the associated loss of share value (Masulis et al., 2007; Harford et al., 2008). For evidence in the banking sector, DeLong (2001) classifies mergers according to activity and geographic diversification and finds that mergers that diversify these attributes induce loss of value. Laeven and Levine (2007) find that diversification reduces the value of financial conglomerates. Conceivably, pursuit of multiple activities intensifies agency problems in financial conglomerates.²

We investigate the role of ATPs in banking in two specific contexts: (1) the likelihood of value-destroying acquisitions; and, (2) the valuation effect of acquisition announcements. We hypothesize that following deregulation, (1) the likelihood of value-destroying acquisitions

will be positively related, and (2) abnormal returns surrounding acquisitions will be negatively related to ATP indices. Conversely, prior to deregulation, ATPs are redundant, and have no impact on firm's takeover decisions and the associated valuation effect.

We analyze 936 acquisitions from 1991 to 2011 by banks (SIC codes 6021, 6022, 6029, 6035 and 6036) over three periods separated by the passage of IBBEA and FSMA: pre-IBBEA (January 1, 1991–September 29, 1994), post-IBBEA to pre-FSMA (September 30, 1994–November 12, 1999), and post-FSMA (November 13, 1999–December 31, 2011). Previous research has established that passage of IBBEA initiated the transition from a regulatory environment imposing severe limits on takeovers (pre-IBBEA period) to one that allows intra- and interstate acquisitions (Brook et al., 1998), and ultimately during the post-FSMA era to an environment of full flexibility by allowing not only full interstate branching, but also combinations among banking, insurance and investment firms (Akhigbe and Whyte, 2001). As expected, our data reveal a significant increase in diversifying mergers since deregulation, as well as varying type and frequency of diversification across sub-periods. We find a significant increase in activity diversification from 8% of all acquisitions in the first period (pre-IBBEA) to 28% of all acquisitions in the last period (post-FSMA). Over the same period, geographic diversification also increases but by a smaller margin – from 58% to 66%. We also observe that while activity diversifying acquisitions increase significantly over post-IBBEA–pre-FSMA period, these combinations occur within the same 2-digit SIC code. In contrast, in the post-FSMA period, there is a significant increase in the number of diversifying M&As involving industries with different 2-digit SIC code.

We measure the degree of anti-takeover protection at individual firm level by using G-Index (a number from 0 to 24, which adds one for each of the 24 anti-takeover provisions tracked by IRRR and adopted by the firm, as developed by Gompers et al. (2003)). We also examine the impact of staggered board, poison pill and golden parachute provisions separately.³ Finally, we analyze the importance of all other provisions that are part of the G-Index, but excluding staggered board, golden parachute and poison pill ATPs, by forming an O-Index equal to G-Index minus staggered board, golden parachute and poison pill. Our analyses reveal two important results. First, when controlling for firm characteristics and corporate governance, activity diversification is positively related to firm value in the pre-deregulation (pre-IBBEA) period, when banks were restricted in diversification activities. Furthermore, geographic diversification is negative in the third period (post-FSMA), when such limits were removed.⁴ Our results in the post-FSMA period are consistent with DeLong (2001) and Schmid and Walter (2009) who show that diversifying acquisitions destroy value. Our findings with respect to the relation between geographic diversification and cumulative abnormal returns for the entire period studied from 1991 to 2011 are consistent with a recent study by Schmid and Walter (2012), showing a weak and changing relation between geographic diversification and value, which depends on the firm's main activity-area within the financial services industry.

Second, consistent with our hypotheses, prior to deregulation (pre-IBBEA period), G-Index as well as the other ATP measures have

³ We also investigate the impact of the E-Index, a number from 0 to 6, which equals the sum of the presence of the six most important ATPs, identified by Bebchuk et al. (2009). However, we observe that the three most important components of the index are staggered board, poison pill and golden parachute. Furthermore, their impact in each period is different. Therefore, rather than discussing the E-Index, we choose to examine each of the three ATPs separately, in order to show their changing importance over time.

⁴ We find no significant relationship between activity diversification and abnormal returns in the third period. However, in results, not reported in the tables, activity diversification is significantly negatively related to value in the third period, when we do not control for corporate governance and ATP measures in the models. We obtain similar results using Activity diversifying alt, based on Morck et al. (1990) approach, but our sample size is reduced significantly as to define this type of activity diversification, the target must be a public firm.

² Similarly, Schmid and Walter (2009) show that broadening of functional scope is detrimental to both competitive performance and shareholder value of financial conglomerates.

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