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Accounting for distress in bank mergers

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Abstract

Most bank merger studies do not control for hidden bailouts, which may lead to biased results. In this study we employ a unique data set of approximately 1000 mergers to analyze the determinants of bank mergers. We use undisclosed information on banks' regulatory intervention history to distinguish between distressed and non-distressed mergers. Among merging banks, we find that improving financial profiles lower the likelihood of distressed mergers more than the likelihood of non-distressed mergers. The likelihood to acquire a bank is also reduced but less than the probability to be acquired. Both distressed and non-distressed mergers have worse CAMEL profiles than non-merging banks. Hence, non-distressed mergers may be motivated by the desire to forestall serious future financial distress and prevent regulatory intervention.

JEL classification: G21; G34; G14

Keywords: Mergers; Bailout; X-efficiency; Multinomial logit

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1. Introduction

The banking literature considers a variety of potential merger motives, including the improvement of efficiency, diversification of earnings and risk, growth through acquisition, realization of economies of scale or scope, or attempts to increase market power (Berger, 2003; Amel et al., 2004). Most studies find that prior to the merger targets perform poorly compared to acquirers. This finding is consistent with the *efficient management hypothesis* (Roll, 1986), which states that acquiring banks seek to replace poorly performing target bank management with more skilled executives. It also corresponds with studies that find managerial efficiency tends to improve after bank mergers (Berger, 1997; Berger et al., 1999).

However, Wheelock and Wilson (2000) report that increasing inefficiency reduces the hazard of takeovers but increases the hazard of bank failures. Hence, the probability of takeovers and failures is influenced significantly different by efficiency. Since they also report evidence that takeovers are increasingly likely when a bank is close to failure, we hypothesize that the respective probabilities of distressed and non-distressed bank mergers are also influenced differently by financial profiles of banks.

Unfortunately, most studies do not distinguish between healthy and troubled banks due to the relative scarcity of outright failures as an indicator of the latter.[1] This is because weak banks on the verge of default are often taken over by stronger banks under the scrutiny of supervisory authorities. Regulatory discretion and potential financial instability due to loss of public confidence prevent information about such distressed mergers from becoming publicly available. Attempts to measure the level of bank distress through weak capitalization and low earnings (Wheelock and Wilson, 2000) are potentially troublesome if banks are not publicly listed and financial information is not readily available.[2] This applies in particular to European banking markets, where most banks are neither listed on stock markets nor do supervisors publish financial data at the bank level.[3]

This paper seeks to contribute to the bank merger literature by distinguishing between distressed and non-distressed cooperative and savings bank mergers in Germany over the period 1995–2001. For these banks there is no (financial) market for corporate control. No outright failures have been reported in the period under investigation, even though the market witnessed approximately 1000 mergers. To test the efficient management hypothesis, we empirically evaluate whether there are important differences in the financial characteristics of distressed versus non-distressed banks involved in a merger and in the way these characteristics influence the probability of becoming a target or acquirer. We use a unique data set with detailed financial data on the bank level and confidential data provided by the German Bundesbank that allow us to distinguish between distressed and non-distressed mergers. The former event involves at least one bank that is identified as distressed by the Bundesbank on the basis of information provided by authorities

[1] Note, that US studies define mergers under the assistance of the FDIC as failures rather than mergers. No merger in this study is arranged by the government.

[2] Such a distinction is useful since any sample of historical mergers is likely to comprise a mix of different merger motives, for example efficiency enhancement versus prevention of failure.

[3] Contrary to the US, where bank-level data is publicly available in Call reports.