

CONTENTS

| | | |
|------|--|----|
| I. | INTRODUCTION: OVERVIEW AND REVIEW | 1 |
| | 1. Purpose of the study | 1 |
| | 2. The structure and regulation of the banking industry | 3 |
| | 2.1. Economies of scale and scope | 3 |
| | 2.2. Concentration, competition and performance | 4 |
| | 2.3. Interstate banking | 6 |
| | 2.4. Safety and diversification | 7 |
| | 2.5. The regulation of bank mergers | 9 |
| | 3. Review of previous studies | 13 |
| | 3.1. Horizontal mergers | 13 |
| | 3.2. Antitrust actions | 14 |
| | 3.3. Bank mergers | 14 |
| | 4. Overview of the study | 16 |
| | Appendix: A state-by-state update of interstate banking legisla- tion (February 1989) | 17 |
| II. | WHY DO FIRMS MERGE: ALTERNATIVE HY- POTHESES OF BANK MERGERS | 23 |
| | 1. Motives for merging | 23 |
| | 2. The manager-utility-maximization hypothesis | 25 |
| | 3. The hubris hypothesis | 26 |
| | 4. The information hypothesis | 27 |
| | 5. The market-power hypothesis | 30 |
| | 6. The synergy hypothesis | 31 |
| | 7. The tax hypothesis | 32 |
| | 8. The inefficient-management hypothesis | 32 |
| | 9. The diversification hypothesis | 34 |
| | 10. Summary and concluding remarks | 36 |
| III. | DATA AND METHODOLOGY | 37 |
| | 1. Sample properties and sources of data | 37 |
| | 2. Characteristics of the sample of target and bidding banks | 40 |
| | 2.1. Distribution of target banks and bids by states | 40 |

| | |
|---|-----------|
| 2.2. Distribution of bids according to the year made and whether the takeover is interstate or intrastate | 42 |
| 2.3. Size and capitalization ratio for the sample of target and bidding banks | 42 |
| ● 3. Methodology | 43 |
| 3.1. Measuring the reaction of stock prices to new information | 45 |
| 3.1.1. The market model | 46 |
| 3.1.2. The mean-adjusted-return approach | 48 |
| 3.2. Testing for the statistical significance of abnormal returns | 49 |
| 3.2.1. Significance tests for mean returns | 49 |
| 3.2.2. Significance tests for the difference between two mean returns | 51 |
| 3.3. Defining potential competitors | 51 |
| | |
| IV. BANK FAILURES, DIVERSIFICATION AND THE PROHIBITION OF INTERSTATE BANKING | 53 |
| 1. Why do banks fail? | 53 |
| 2. Bank failures: The record by states from 1982 to 1986 | 56 |
| 3. Percentage of bank and deposit failures across states: Differences among states | 57 |
| 4. An examination of the cross correlation structure of bank common stock returns | 64 |
| 4.1. The structure of intrastate correlations | 66 |
| 4.2. The structure of intra-regional correlations | 67 |
| 4.3. The structure of interstate correlations | 70 |
| 5. Summary and concluding remarks | 73 |
| | |
| V. CAPITAL MARKET REACTION TO THE ANNOUNCEMENTS OF BANK MERGERS AND THE SUBSEQUENT RELEASE OF FEDERAL RESERVE DECISIONS | 75 |
| 1. Bank mergers and common stock prices | 75 |
| ● 2. Behavior of the average abnormal returns of target banks during the weeks surrounding the announcement of a merger proposal | 79 |
| ● 3. Behavior of the average abnormal returns of bidding banks during the weeks surrounding the announcement of a merger proposal: A test of the manager-utility-maximization and hubris hypotheses | 83 |
| 4. Do mergers create net aggregate wealth for bank shareholders? Another look at the manager-utility-maximization and hubris hypotheses | 86 |

| | |
|---|-----|
| 5. Market reaction to the Federal Reserve decision regarding the merger proposal | 89 |
| 5.1. Price behavior of bidder shares | 89 |
| 5.2. Price behavior of target shares: A test of the information hypothesis | 92 |
| • 6. Analysis of risk shifts due to mergers: A test of the diversification hypothesis | 94 |
| 6.1. Measuring the risk of bank stock prices | 94 |
| 6.2. Empirical results | 95 |
| 7. Some special cases: Cancelled mergers, multiple bids and insolvent target banks | 98 |
| 7.1. The case of cancelled mergers: Another test of the information hypothesis | 99 |
| 7.2. The case of multiple bids | 100 |
| 7.3. The case of insolvent target banks | 102 |
| 8. Summary and concluding remarks | 104 |

VI. EXPLAINING CAPITAL MARKET REACTION TO MERGER ANNOUNCEMENTS 109

| | |
|--|-----|
| 1. Introduction | 109 |
| 2. Alternative explanatory variables | 110 |
| 3. Market reaction to alternative means of payment in bank mergers: Cash offers versus security offers | 115 |
| 3.1. Why should cash offers differ from security offers? | 117 |
| 3.2. Empirical evidence | 122 |
| 4. Interstate versus intrastate mergers | 124 |
| 4.1. Why should interstate mergers differ from intrastate mergers? | 125 |
| 4.2. Geographical effect | 126 |
| 4.3. Legislative effect | 130 |
| 5. Bank size and abnormal returns: A test of the synergy hypothesis | 130 |
| 5.1. Is there an optimal bank size? | 131 |
| 5.2. Absolute size effect | 132 |
| 5.3. Relative size effect | 132 |
| • 6. Bank performance and abnormal returns: A test of the inefficient-management hypothesis | 135 |
| 6.1. Measuring bank performance | 135 |
| 6.2. Capitalization effect | 136 |
| 6.3. Profitability effect | 138 |
| 6.4. Market performance of target banks | 141 |
| 6.5. Market performance of bidding banks | 143 |
| 7. Target–bidder returns correlation: A test of the diversification hypothesis | 145 |

| | |
|---|-----|
| • 8. Cross-sectional regression analysis of target bank abnormal returns | 146 |
| 8.1. Selection of independent variables | 150 |
| 8.2. Empirical results | 150 |
| 9. Cross-sectional regression analysis of bidding bank abnormal returns | 151 |
| 9.1. Selection of independent variables | 151 |
| 9.2. Empirical results | 151 |
| 10. Market reaction of rival banks, potential bidders and alternative targets | 152 |
| 10.1. Evidence on the competitive effect: A test of the market-power hypothesis | 156 |
| 10.2. Evidence on the corporate-control effect | 160 |
| 10.3. Regulatory effects | 164 |
| 11. Summary and concluding remarks | 167 |
| Appendix I: Provisions of the Basle Accord | 170 |
| Appendix II: Role of current primary capital guidelines | 183 |

VII. CAPITAL MARKET REACTION TO THE ANNOUNCEMENT OF INTERSTATE BANKING LEGISLATION: THE CASES OF TEXAS, ARIZONA AND VIRGINIA

187

| | |
|--|-----|
| 1. Introduction | 187 |
| 2. Reaction of bank stock prices to announcements related to interstate banking legislation in Texas | 188 |
| 2.1. Chronology of events | 190 |
| 2.2. Regression analysis results | 191 |
| 2.3. Differences in stock price reaction | 198 |
| 3. Reaction of bank stock prices to the announcement of interstate banking legislation in Arizona | 200 |
| 3.1. Regression analysis results | 201 |
| 3.2. Cumulative abnormal returns | 203 |
| 3.3. Differences in stock price reaction | 203 |
| 4. Reaction of bank stock prices to the announcement of regional banking legislation in Virginia | 204 |
| 5. Summary and concluding remarks | 206 |

VIII. CONCLUDING REMARKS

209

REFERENCES

215

INDEX OF SUBJECTS

223

INDEX OF NAMES

229