Bank Mergers and Acquisitions in the United States 1990 -1997:  
An Analysis of Shareholders Value Creation and Premium Paid to  
Integrate with Megabanks  

by  

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Dissertation Submitted in Partial Fulfillment of the Requirement for the Degree of Doctor of Philosophy

Applied Management and Decision Sciences

Walden University
May 2001

[Dissertation Committee Chair: Dr. James T. Brown Ph.D.]

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CHAPTER 1
INTRODUCTION TO THE STUDY

Background of the Problem

The banking industry in the United States, similar to other industries, seemed to have enjoyed favorable economic successes on the various investment portfolios during the period 1990 to 1997 (Allen, 1997; Johnson, 1995). For banks as a whole, these favorable economic results were not surprising in that interests paid on deposits were relatively low, growth in the loan portfolio was strong, and the interest rate spreads were generally large. In addition, the legal framework, which previously inhibited operations in areas such as insurance, relationships with mutual funds, and other financial products, was relaxed (Spiegel, Gart, & Gart, 1996). In the light of these new developments the dilemma facing the banking industry at the dawn of the new millennium is whether to exploit the advantages it already possessed or to leverage the new, open and less-restrictive fields of operation towards a horizon of insulation from persistent bank failures. Spiegel, Gart, and Gart intimated that such bank failures characterized the banking industry especially during the first half of the 20th century. One possible way for banks to insulate themselves from the vagaries of future economic misfortunes is to adopt an aggressive growth path through systematic mergers and acquisitions activities.
For many banks, merging with a partner bank or by acquiring the assets of another bank will most likely result in tremendous savings in overhead costs, especially in cases involving in-market mergers and acquisitions (Allen, 1997). For purposes of this study, an in-market refers to the consolidation of two or more banking entities that do business within identical markets and, or geographical areas. Therefore, in-market mergers and acquisitions are within the purview of the horizontal form of integration. Identical markets are those markets where each consolidating party trades along similar product lines, whereas geographical areas may involve physical proximity, but different product lines. The merger between Chase Manhattan and Chemical Bank in 1995 is an example of geographic areas, whereas the 1997 merger between First Union Corporation of North Carolina and CoreStates Financial of Pennsylvania is essentially an example of identical markets.

Commercial banks are favorably poised to wield great economic power within the financial sector of the United States economy by virtue of their ability to dictate the loan amortization process, despite the presence of a highly competitive operating environment (Allen, 1997). The banking industry's sphere of influence is further enhanced by having an effective service distribution network by way of bank branching, the proliferation of automated teller machines (ATMs), roving teller services, and excellent franchises built around customers' inertia. Such powers of influence, however, are minimized in the light of fully functional quasi-banks such as finance houses, money stores, credit unions, and mutual fund entities. In addition, large corporations operate parallel captive finance departments that raise capital and make loans to customers for the purposes of purchasing the corporations own
products. General Motors Acceptance Corporation (GMAC), Toyota Motor Credit Corporation (TMCC), and General Electric Small Business Solutions are examples of parallel consumers’ financing entities. In addition, these large corporations have the wherewithal to raise their own capital by way of commercial paper, corporate bonds, and debentures, thereby affording them the luxury of circumventing the demand for bank loans from the banking industry.

The shifting competitive environment has forced some banks to look for more competent ways to positively impact their bottom lines and boost the return on equities (Johnson, 1995). Clearly one of the best ways to become more efficient is to increase market share, while simultaneously holding down costs to a ratio less comparable to the gains in market share. In their search for economies of scale, or more particularly in the case of banking costs function, economies of scope, a quick way to drive down unit costs and boost income is through operating and financial synergies (Gaughan, 1996). Synergy will occur under the assumption that the existing customer base will continue to patronize the new entity or that the new entity will produce a net addition to the customer base. Economies of scope imply the ability of a bank to produce a broader range of outputs from a given set of inputs (Kolari & Zardkoohi, 1987). When banks merge they can spread the fixed costs associated with technology, operating infrastructure, on-line services and so on, over a broader range of service offerings such as financial advisement, trusts, loan services, and so on. In addition, financial products comprising Certificate of Deposits (CDs), Money Market Deposit Accounts (MMDAs), and Individual Retirement Accounts (IRAs) may be offered as differentiated product lines.
In addition to the economies of scope (scale) motive for mergers and acquisition, there are three other considerations or goals that may influence a decision to integrate with another business entity. These are diversification, horizontal integration, and vertical integration. Diversification occurs when one business entity acquires or merges with another, the latter being involved in a different industry with the resulting entity being sometimes referred to as a "conglomerate" (Cooley, 1988, p. 859). For example, the 1996 acquisition of Life Insurance Co. of Virginia, an insurance business, by General Electric Co., a manufacturing undertaking, is, in effect, a diversified or conglomerate integration (Mergers & Acquisition, 1996). Diversified mergers or acquisition involving banks are not legally allowed under United States law, but combinations between finance related businesses are permitted. For example, the 1998 merger between Citibank, a commercial bank, and Travelers Group, an insurance business, is perhaps the nearest to a diversified integration. A merger between insurance and banking may best be described as an out-market merger, since both types of businesses belong to the finance industry with the product lines being more or less differentiated. Whereas, in-market integration may involve banks along identical or very similar product lines or geographic areas, out-market mergers may involve differentiated markets with related (financial) products.

Horizontal mergers and acquisitions take place between companies in the finance industry and may include both in-market and out-market combinations. Horizontal mergers and acquisitions, in a strict sense, involve firms merging with or acquiring a rival in identical or related markets, the likely end result being, increased market share and increased market power (Gaughan, 1996). Economic theories suggest that there
are two extreme forms of market structures. On one end there is the pure competitive form resting on assumptions such as numerous buyers and sellers, perfect information, homogeneous products and so on.

On the other extreme there is the monopoly form, which rests on the assumptions of being a single seller with the almost unrestricted ability to set a price-output combination that maximizes its profits. Horizontal integration involves a movement from the purely competitive end of the spectrum to the monopoly form at the other end. Along the way, however, may be found other differentiated market structures such as monopolistic competition (many firms with differentiated product lines), oligopoly (only a few firms), and duopoly (only two firms). Figure 1 depicts a continuum line of a hypothetical industry that can move from the so-called purely competitive market form, comprising of a huge number of firms, to a monopoly situation comprising of only a single seller.

![Market concentration continuum](image)

One of the major problems with mergers leading towards the monopoly end of the spectrum is that monopolies can cost society. Economic theories suggest that activities such as mergers and acquisition can result in dead weight or welfare loss, that is, losses involving both consumer and producer surpluses. The basis for such dead weight or welfare losses hinges on the fact that the monopoly situation ultimately
leads to higher price and lower industrial output and possibly greater profits for the single seller. Whether the banking industry within the United States will move closer to even an oligopoly situation is anyone's guess. However, there is a tendency for the number of banks that are servicing a growing United States market to be on the decline.

In the 1990s shrinkage in the number of commercial banks was mainly due to the dynamic nature of a competitive environment (Spiegel, Gart, & Gart, 1996), changes in the legal and operating frameworks (Johnson, 1995), and transformation within the global, economic, and capital markets (Allen, 1997). In 1980 there were some 14,400 commercial banks, while in 1990 that number was reduced to 12,250. By 1997 the number of independent commercial banks operating was approximately 9,360 (U.S. Bureau of Census, 1998). According to Johnson (1995), the shrinkage is likely to continue rapidly and may flatten out when the number reaches approximately 5,000 commercial banks.

The movement around merger and acquisition activities reveals an interesting pattern of behavior with respect to assets size. Taking the categorization of banks as proposed by financial information expert, SNL Securities LC, who categorizes large banks as those banks with assets of $1 billion to $5 billion and medium-size banks as those with less than $1 billion, this study will consider megabanks as banks with assets of $5 billion or more. Data available for the period 1990 to 1995 reveal that there were some 71 mergers and acquisitions in the $1 billion to $5 billion asset category which constitute approximately 17% of banks from that group. In the megabank category, in which case assets are in excess of $5 billion, mergers and
acquisitions involved some 68 banks or approximately 18% of all banks within that
group (SNL Securities LC, 1998). However, by 1997 the number of banks involved in
mergers and acquisitions in the megabank category was very much close to 80

Two important effects originated from the changes to Regulation Q that took
place during the 1980s and paved the way for the favorable economic climate in the
banking industry, inclusive of the merger and acquisition impetus, for the period under
review (Johnson & Johnson, 1989). First, banks could compete for deposits among
themselves and other quasi-banks and related financial institutions. Second, the
changes allowed banks to counter the disintermediation problem, which manifested
itself in situations where consumers withdrew cash deposits from banks and invested
these funds directly in various financial products, thereby attracting higher returns on
their investments.

Regulation Q, however, facilitated the disintermediation problem faced by
banks while simultaneously setting the ceiling on interest that banks can pay on
liabilities such as demand deposits, negotiated order of withdrawals, checking
accounts, and other similar bank liabilities. The repeal of Regulation Q was a
necessary condition for the banking industry to seriously afford the luxury of growth
and value maximizations that can be generated directly from bank mergers and
acquisitions.

The period covered by this study was also characterized by low interest rates,
given that the Federal Reserve Board continuously monitored these rates and took
action by way of moral suasion and direct intervention in order to prevent the interest
rates from escalating too rapidly (Allen, 1997). Given that the caps on interests paid to various types of deposits had been removed, the funds placed in banks were more rate-sensitive. One of the main funds management techniques attributed to banks was the ability to maximize the gap between interest income on assets and interest expense on liabilities. A bank sought to maximize its total income by carefully managing and periodically adjusting its mix of assets and liabilities based upon speculation of the interest rate movements (Hatler, 1991). Banks that possessed the capabilities to anticipate interest rate movements and manage interest rate gaps in a timely manner experienced higher profitability ratios and abnormal stock returns. It is no surprise, therefore, that the decade of the 1990s provided most commercial banks with safe operating margins and relatively high returns on equities (Johnson, 1995; Allen, 1997).

Statistics compiled by the United States Bureau of Census revealed that the net income of commercial banks moved from a low of $14 billion in 1980 to a moderate $16 billion 10 years later (U.S. Bureau of the Census, 1996). By 1995 net income had grown to a massive $49 billion, attesting to the fact that the first half of the 1990s was an economically fertile period for commercial banks. In addition to very favorable economic returns, the build-up of capital impacted the returns on equity as the capital to asset ratio continued to improve. Capital to asset ratio strengthened from 5.8% in 1980 to 6.5% in 1990 and to 8.1% in 1995. This ratio continued to climb and in so doing increased to 8.2% in 1996 and 8.3% for the year 1997 (U.S. Bureau of the Census, 1998). The progression in capital strength tended to suggest that banks may seek to either increase dividend pay outs, initiate stock buybacks in order to increase