The General Motivation For Divestiture

Voluntary asset sales suggest that one or more actual or anticipated changes in the selling firm's operating environment have or are expected to occur, causing management to reassess the risks and returns of the assets presently included and excluded from the firm's portfolio. These changes could be macroeconomic, technological or regulatory in nature. Divestiture allows the selling company, even one unable or unwilling to borrow funds in the credit markets, to raise cash to invest in existing or new activities (with expected return/risk trade-offs superior to those associated with the assets sold), to meet existing contractual debt obligations, to offset temporary operating problems at other subsidiaries, or to accomplish some other short-run or long-run objective.

Possible Reasons For Nonbank Divestiture By BHCs

Bank holding companies aggressively entered a variety of nonbanking fields in the early 70s. There were several reasons for this activity. One was the expectation that they could earn returns higher than those attainable in commercial banking. The other motive was a desire to diversify. Presumably, the returns earned in these activities would not be much more variable than, and imperfectly correlated with, the returns earned by banking subsidiaries, thus allowing holding companies the opportunity to reduce the investment risk of their consolidated organizations.

In general, however, empirical studies of the nonbanking operations of bank holding companies indicate that relatively few companies have realized significant benefits from these activities. In particular, the studies suggest that the nonbanking subsidiaries of bank holding companies have not been particularly profitable, relative to banks or to similar independent competitors. Indeed, evidence reported in 1984 indicates that the nonbanking subsidiaries of a number of companies have been unprofitable in one or more years over a recent five year period (1978-1982). Not surprisingly, it was also found that the amount of dividends paid by nonbanking subsidiaries to their respective parent holding companies was typically negligible. The results of these studies also suggest that a number of nonbanking activities appear to be considerably more risky than banking. Further, relatively strong positive correlations have been found between nonbanking asset returns and the returns of several popular nonbanking activities, indicating that operating such subsidiaries generally has provided limited diversification benefits.

The findings seem to support the contention voiced by Paul Jessup over a decade ago: "A bank holding company can be viewed as a portfolio of shares of banks and related enterprises. Dynamic portfolio management involves a continuous reappraisal of risk-return relationships of the shares in the existing portfolio and also of alternative opportunities. Where an alternative investment is judged to provide a greater return for an acceptable level of risk, then a less-promising asset should be sold, and the proceeds invested in the more promising asset. Through time, such a decision process will result in improved performance of the total portfolio." This appears to be the view of the market. Accordingly, divestiture activity (including bank divestitures) can be expected to increase, as a variety of forces (regulatory and others) continue to alter the number and risks and returns of the activities open to BHCs.

Summary and Conclusions

For a variety of reasons, voluntary asset sales of nonbanking assets by BHCs have grown increasingly common in recent years. Our study indicates that voluntary nonbank asset sale announcements by bank holding companies are associated with significant increases in the market value of the divesting organizations. This is in line with the findings of previous studies investigating the wealth impacts of BHC divestiture. This suggests that investors view BHC divestiture behavior of the CAAR measure suggests that voluntary nonbank asset sales. This finding is consistent with the results obtained in previous studies.

In the late 1970s and early 1980s an increasing number of nonfinancial corporations decided to alter their asset portfolios through voluntary divestitures—that is, by selling off or spinning off one or more of their operating subsidiaries. The motives and financial impacts of this activity have been examined in several recent studies. A striking trend is becoming evident in banking. A considerable number of bank holding companies (BHCs) have sold or are considering the sale of varying amounts of the assets of one or more of their nonbanking subsidiaries. Holding company sales of banking assets (i.e., the sale of entire banks) remain infrequent at present but may soon become more common as well. Voluntary divestitures by bank holding companies were relatively rare prior to the late 1970s. Nonbank asset sales are occurring at a time when the risk/return tradeoff in banking appears to be worsening and as existing barriers to BHC entry into additional nonbanking activities are being hotly debated. It is also interesting to note that the divested assets have been purchased by other bank holding companies as well as by other types of financial and nonfinancial firms.

The implications of this activity remain unexplored. In this study, voluntary sell-offs of nonbanking assets by bank holding companies that have taken place over the past decade will be examined.

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2. For example, one large Midwestern BHC recently announced it was contemplating the sale of 25% of its subsidiary banks. See The American Banker, "First Bank to Sell 25% in Restructuring Move," August 16, 1985, Vol. CL, No. 160.
3. The sale of nonfinancial nonbanking assets for example, data processing subsidiaries) is not examined.
4. Gary Whalen is an economist with the Federal Reserve Bank of Cleveland. The author would like to thank James Bailey for his assistance.
5. The views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or the Board of Governors of the Federal Reserve System.
Thus, the evidence suggests that operation of nonbanking subsidiaries during the 1970s and early 80s resulted in lower ROE for money-center BHC. Several recent developments may have convinced the management of a number holding companies that the risks and returns attainable in a variety of nonbanking fields were unlikely to reach acceptable levels in the foreseeable future and that selling some of their nonbanking assets would thus be an optimal course of action.

The macroeconomic environment has made it increasingly difficult to successfully operate all types of financial institutions in the 1970s and 80s. For example, in the early 80s, interest rates were unusually high and volatile, making activities such as mortgage banking riskier than it had been previously. Open market operations of the Federal Reserve in several states during this time, limiting the profitability of various types of consumer lending done through nonbanking subsidiaries. Personal bankruptcies rose, lowering the returns and increasing the risk of holding companies that diversified into consumer finance.

A number of regulatory developments may have encouraged holding companies to sell off nonbanking subsidiaries. Federal Reserve Regulation Q limits on rates payable by commercial banks have been gradually eliminated. Perhaps the most important recent development has been the elimination of interstate and interstate geographic restraints on expansion by commercial banks. Geographic and rate deregulation in banking have had a dual impact. These developments have lowered reserves and increased risks in banking.

The perception of less risk in other financial institutions has led regulators to pressure holding companies to increase the loan loss reserves and capital levels of their banking subsidiaries. The need and augment reserves and capital when bank earnings are relatively weak has made it very difficult for holding companies to support marginal nonbanking subsidiaries.

More importantly, because many holding companies now can or soon will be able to diversify geographically by acquiring banks outside their home state, they no longer need to operate nonbanking subsidiaries to achieve this goal. Sale of nonbanking assets allows holding companies to obtain funds to invest in present subsidiaries and/or to make additional intra- or interlocal bank acquisitions without having to tap public capital markets. It is also possible that technological developments have increased the minimum efficient scale of operations in some nonbanking fields (e.g., mortgage banking), prompting some BHCs with small nonbank subsidiaries to sell out their other BHCs, or nonfinancial companies, to buy.

An additional strong motivation for BHCs to sell nonbanking units in the 80s has been the recent emergence of strong demand for such assets by an increasing number of institutions that have made the strategic decision to diversify into financial services.

A Summary of BHC Divestiture Activity

Selected summary data on bank holding company nonbank assets that have taken place over the past decade appear in Table 1. The year of the transaction is the year in which the initial announcement of the intention to divest occurred. These data have been compiled by the author from a variety of sources. Great care was taken to include all such transactions that took place. However, it is possible that this listing is incomplete. It should be noted that several of the 1985 transactions (two to be exact) are still being negotiated and are not yet final.

A total of 42 voluntary nonbank assets have sold nonbanking assets during the 1975-85 interval. The data clearly show an acceleration of activity for the 1980s. Ten of the divestitures, nearly a quarter of the total, were announced in 1980 and 1981. This suggests that many of these were motivated by the disappointing performance of nonbanking activities during this period of historically high, volatile interest rates and deep recession.9

After slowing somewhat in 1982, nonbank asset divesture picked up in 1983 and 1984. In 1985, this activity accelerated sharply to 11 announced transactions. The recent acceleration may be due to a combination of factors including the advent of regional interstate banking, new geographic and regulatory pressures to increase capital, and the demand for financial assets by nonfinancial companies. Serious operating problems at the nonbanking units sold do not appear to be a primary reason for these transactions. Typically, the units sold have been profitable.

In 14 divestitures, the buying company is another bank holding company, in six it was a nonfinancial company; in six it was a nonfinancial company; in six it was a nonfinancial company; in six it was a nonfinancial company. Five companies were multi-players. It is interesting to note that banks have acquired nonbanking assets from other BHCs, from other banks, and from other nonfinancial companies.

The wealth impacts of voluntary sell-offs by nonfinancial companies have been investigated in a series of three recent studies. However, only one of these studies, that of BHCs, has been examined.

The table below shows the number of divestitures by year for the period 1975-1985.

### Table 1: BHC Nonbank Asset Sell-Offs: 1975-1985

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<thead>
<tr>
<th>Year</th>
<th>Number of Divestitures</th>
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<tbody>
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<td>1975</td>
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In 42 voluntary nonbank stock sales, the buyer exceeded the seller's estimate of the present value of the net cash flows generated by these assets. If investors share this view and the transaction is largely anticipated, voluntary divestiture announcements should result in a sharp rise in the selling firm's stock price, and also in its market value, around the time of the announcement.

However, because announcements may indicate that the selling firm's management has altered previously held expectations about the performance of various subsidiaries (including those not sold), it is possible that stock prices may fall sharply upon announcement. Divestiture announcement might be preceded by, and/or be partially or totally diluted by a negative wealth effect. If investors become aware that changes in the operating environment have adversely affected the prospects of some of the operating units of the selling firm prior to the divestiture announcement, negative stock returns might be observed prior to the divestiture announcement. If no change in the firm's prospects is discernible prior to the announcement and the divestiture is totally unanticipated, the announce-