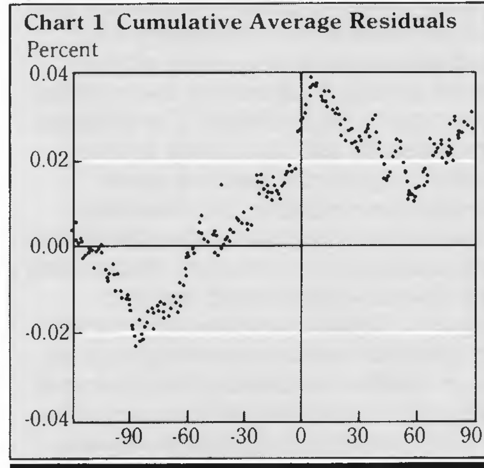

Chart 1 Cumulative Average Residuals

A plot of the CAAR measure for the sample BHCs over the interval beginning 120 days before announcement day to 90 days after appears in chart 1. The behavior of the CAAR measure suggests that investors view BHC divestiture announcements favorably, or alternatively, divestiture announcements lead to an increase in shareholder wealth. This is indicated by the sharp increase in the CAAR series that begins roughly 30 days before and ends roughly seven days after the divestiture announcement date. Particularly notable is the sharp increase in the CAAR series on the day before the announcement.

There is also a rather sharp decline in the CAAR series roughly three months prior to the announcement date. This does suggest that financial pressures do motivate BHC nonbank asset sales. This finding is consistent with the results obtained in previous studies.

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 sell-offs for nonfinancial firms. There is evidence that nonbank asset sales are motivated by financial distress.

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."[11]

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.

11. See Paul F. Jessup, "Portfolio Strategies for Bank Holding Companies," *Bankers Magazine*, vol. 152, no. 2 (Spring 1969), p. 81.

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ECONOMIC COMMENTARY

Bank Holding Company Voluntary Nonbanking Asset Divestitures

by Gary Whalen

In the late 1970s and early 1980s an increasing number of nonfinancial corporations decided to alter their asset portfolios through voluntary divestiture—that is, by selling off or spinning off one or more of their operating subsidiaries.[1] 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.[2] 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 are being 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.[3]

The General Motivation For Divestiture

Voluntary asset sales suggest that one or more actual or anticipated changes in the selling firm's operating environment has or is 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 affording holding companies the opportunity to reduce the variability of the overall returns of the consolidated organization.

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.[4] 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).[5] 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 banking returns and the returns of several popular nonbanking activities, indicating that operating such subsidiaries generally has provided limited diversification benefits.

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1. There are two types of divestitures, sell-offs and spin-offs. In a sell-off divestiture, assets are sold to another firm usually in exchange for cash and/or securities. In a spin-off divestiture, shares of a subsidiary are distributed to existing shareholders of the parent corporation. Voluntary spin-offs by BHCs are rare (only one could be identified), and so are not examined.

2. For example, one large Midwestern BHC recently announced it was contemplating the sale of 28 of its subsidiary banks. See The American Banker, "First Bank to Sell 28 Banks 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.

Thus, the evidence suggests that operation of nonbanking subsidiaries during the 1970s and early 80s resulted in marginal benefits for the typical 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 rates exceeded usury ceilings 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 risks of consumer lending.

A number of regulatory developments may have encouraged holding companies to sell off nonbanking assets. Federal Reserve Regulation Q limitations on rates payable by commercial banks have been gradually eliminated. Perhaps the most important recent development has been the elimination of intra-and interstate geographic restraints on expansion by commercial banks. Geographic and rate deregulation in banking have had a dual impact. These developments have lowered returns and increased risks in banking. The perceived increase in risk has prompted banking regulators to pressure holding companies to increase the loan loss reserves and capital levels of their banking subsidiaries. The need to 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 interstate 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 and 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 nonfinancial companies 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 asset sales 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 also be noted that several of the 1985 transactions (two to be exact) are still being negotiated and so are not yet final.

A total of 42 voluntary nonbank asset sales have occurred over the 1975-85 interval. The data clearly show an acceleration in divestitures after 1979. Ten of the divestitures, nearly a quarter of the total, were announced in 1980-81. It is reasonable to assume that many of these were motivated by the disappointing performance of nonbanking subsidiaries during this period of historically high, volatile interest rates and deep recession.[6]

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

Year	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Number of Sell-Offs	1	1	3	1	2	5	5	3	6	4	11

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

Fully half of all the transactions tabulated involved the transfer of mortgage banking-servicing assets. Twelve divestitures involved consumer finance-type assets. The remainder were commercial finance-asset-based lending, factoring, and leasing asset sales.

The transactions in 1985 were relatively large compared to those that occurred previously. In four of the seven 1985 transactions for which price data were available, the acquiring company paid more than $100 million for the assets acquired. Only two transactions in the 1975-84 period were this large. The 1985 sale of BankAmerica's consumer finance company to a unit of Chrysler was the largest transaction to date. The sale price was in excess of $400 million.

A total of 35 bank holding companies sold nonbanking assets during the decade. Seven companies engaged in two separate sell-offs over this interval. The bulk of the sellers could be categorized as relatively large regional bank holding companies. That is, the largest money center BHCs have not generally engaged in this type of activity. This is not surprising. Empirical evidence indicates that the nonbanking subsidiaries of large BHCs have performed somewhat better than those of smaller regionals.[7] It should also be noted that divesting companies typically continued to operate other types of nonbanking units after a sell-off. That is, they did not discontinue all bank-related activities.

In 14 divestitures, the buying company was another bank holding company; in 19 it was a nonbank financial company; in six it was a nonfinancial company; in three others the buyer was another type of entity, or was undetermined.[8] Five companies were multiple buyers. It is interesting to note that two bank holding companies that acquired nonbanking assets from other divesting BHCs in 1980 and 1981, subsequently became sellers themselves.

Bank holding companies headquartered in Pennsylvania accounted for seven of the divestitures announced over the decade. North Carolina-based companies announced five sell-offs. A similar number were announced by Tennessee companies. New Jersey companies accounted for four; those in Virginia did likewise. The others were headquartered in Illinois (2), Colorado (2), California (2), Missouri (2), Florida (1), Minnesota (1), South Carolina (1), Nevada (1), Ohio (1), Massachusetts (1), Texas (1), Washington (1) and Georgia (1). It should be noted, however, that the state(s) in which the divested nonbanking subsidiary is (are) headquartered and operates is (are) not always the same as that of its former owner.

The Wealth Impacts of Divestiture

Presumably management's primary goal is maximization of shareholder wealth or, alternatively, maximization of the market value of the firm. If this is the case, voluntary asset sales should only occur when the price offered by the buyer exceeds 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 unanticipated, 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 asset sale decisions 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 the positive wealth impact of a 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 announcement could be interpreted as evidence of previously undisclosed difficulties and result in weak positive or even negative returns on and perhaps even shortly after the announcement day.

The wealth impacts of voluntary sell-offs by nonfinancial companies have been investigated in a series of three recent studies.[9] All employ the so-called event study methodology. The findings are generally not surprising. In two studies, significant positive stock returns were detected for divesting firms around the time of the divestiture announcement. In the other, the authors found somewhat weaker positive impacts. Negative returns prior to sell-off announcements were evident in all three studies, suggesting that financial difficulties often precipitate asset sales.

The event study approach was also used in this study to isolate the wealth impact of BHC divestiture activity.[10] In the event-study framework, the assumption is that a firm's stock returns around the time at which some material development (the event) is initially made known to the market can be decomposed into two parts: a "normal" part and an "abnormal" part. The abnormal portion of its return presumably reflects the capital market's estimate of the expected net impact of the development on the market value of the firm. A series of positive abnormal returns around a company's event date suggest that investors believe that the development will have a beneficial impact on the firm's market value. Negative abnormal returns suggest the opposite.

The typical divestiture impact for the sample of BHCs can be investigated by constructing a measure called a cumulative average abnormal return (CAAR) measure from the abnormal return series for each individual company. If divestiture results in positive abnormal returns for a preponderance of companies around the time of announcement, the CAAR measure developed for the sample will be positive. The opposite will also be true. If divestiture is viewed as having a relatively minor impact, the abnormal returns for most sample companies will be close to zero, as will the CAAR measure constructed from the individual company returns.

4. See, for example, Boyd, et al., "Bank Holding Company Diversification," Proceedings, Federal Reserve Bank of Chicago, 1980; A. Karna, "BHC Profitability: Nonbanking Subsidiaries and Financial Leverage," *Journal of Bank Research*, Spring 1979; and Gary Whalen, "The Nonbanking Operations of Bank Holding Companies," *Economic Review*, Federal Reserve Bank of Cleveland, Spring 1984.

5. See "The Nonbanking Operations of Bank Holding Companies," *Economic Review*, Federal Reserve Bank of Cleveland, Spring 1984.

6. Nonbanking subsidiary profitability data reported in Gary Whalen's "Nonbanking Operations of Bank Holding Companies," support this view. See p. 14.

7. See "Nonbanking Operations of Bank Holding Companies," p. 14.

8. This classification was based on the identity of the parent corporation of the acquiring entity.

9. See G. Alexander, et al., "Investigating the Valuation Effects of Announcements of Voluntary Corporate Sell-Offs," *Journal of Finance*, vol.39 no. 2 (June 1984); P. Jain, "The Effect of Voluntary Sell-Off Announcements On Shareholder Wealth," *Journal of Finance*, March 1985, Vol. 39, No. 2; and James P. Rosenfeld, "Additional Evidence On the Relation Between Divestiture Announcements and Shareholder Wealth," *Journal of Finance*, vol. 39, no. 5 (December 1984) pp. 1437-48.

10. For a detailed discussion of the techniques used to estimate the wealth impacts of BHC divestiture, see Gary Whalen, "The Wealth Impacts of Bank Holding Company Nonbanking Asset Divestitures: Preliminary Findings," *Working Paper*, Federal Reserve Bank of Cleveland, forthcoming.