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Divestitures and the financial conglomerate excess value

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ABSTRACT

We study a sample of the world's largest financial conglomerates from 15 countries and we track their largest divestitures over the period 2005–2016. We develop a novel market-based metric to analyse the impact of divestitures on financial conglomerate excess value, and our findings point to divestitures having a significant impact on financial conglomerate valuation, contributing to a reduced conglomerate discount. Our results are driven by sales of financial service assets. Selling assets unrelated to the financial sector has no significant effect on conglomerate excess value. These results are robust with the inclusion of multiple control variables and alternative econometric model specifications. Altogether these results cast doubts on the existence of large benefits for financial conglomerates from combining financial service activities. This study has implications both for financial conglomerate boards who might direct their strategies to downsize their firms, and for regulators who address issues related to financial stability.

1. Introduction

Financial conglomerates are large and complex institutions that diversify into closely related activities within the financial industry. They provide commercial banking, securities underwriting and trading, asset management, insurance and other nonbank financial activities under a single corporate entity. These behemoths control hundreds of operating subsidiaries and affiliates in domestic and foreign markets and manage investments in nonfinancial sectors.[1]

Financial literature has shown that financial conglomerates, on average, have negative excess values, or trade at a significant discount compared to matched portfolios of stand-alone financial institutions.[2] Following the predictions of the conglomerate literature we ask the following question: "If a financial conglomerate is trading at discount relative to stand-alone financial institutions, should a divestiture that reduces size and organisational complexity increase its excess value?". Despite the importance of this question,[3] no paper (of which we are aware) has verified directly

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[1] Financial conglomerates are defined in alternative ways. For instance, the European Commission (Directive 2002/87/EC) has proposed the following definition: a group of firms only qualifies as a financial conglomerate if (a) more than 50% of group activities are financial and if (b) the shares of the banking sector (including security activities) and the insurance sector in the total of the financial activities are each within the 10–90% range. In addition, if the minority share has a balance sheet larger than 6 billion euro, the group also qualifies as a financial conglomerate. The Group of Ten (Group of Ten, 2001) gives the following definition: "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, and insurance)."

[2] Laeven and Levine (2007) (hereafter LL2007) and Schmid and Walter (2009) (hereafter SW2009) both find a negative financial conglomerate excess value constructed by using the standard approach of matched portfolio of stand-alone specialised financial intermediaries. However, this issue is controversial, with several studies finding conflicting results (see Section 2).

[3] This question is important to academic debates (see literature review by Pennacchi (2012)) and has been frequently analysed in periodicals and the financial press. See, for example, *The Economist*, November 27, 2008, "Citigroup: Singing the blues", Kessler (2009) "The end of Citi's Financial Supermarket" *The Wall Street Journal*, January 16, *The Financial Times*, December 2, 2009 "Splitting big banks", Lex Column Finance and Governance.

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whether divestiture programs could mitigate a financial conglomerate discount.

This paper explores the world fifty largest financial conglomerates to analyse the link between the economic contribution of divestiture programs and conglomerate excess value. Corporate finance literature suggests several reasons for divestiture programs, which might lead to increased value. The efficiency explanation (Hite et al. (1987) and Maksimovic and Phillips (2001)) argues that buyers might manage assets more efficiently with respect to the seller. The focusing view (John and Ofek (1995) and Berger and Ofek (1999)) indicates that diversified firms might dispose of assets to become more specialised, reducing diversification costs. While some asset sales[4] may be motivated by efficiency improvements and operational reasons, financing could also be an important motive. The financing explanation (Shleifer and Vishny (1992), Lang and Stulz (1994), Borisova et al. (2013)) suggests that financially constrained firms could dispose of assets to relax credit constraints. This motivation might be relevant for financial institutions that need to improve their capital position, particularly at the time of a financial crisis. For example, in the case of nonfinancial firms, Campello et al. (2010) report that 70% of financially constrained firms increased asset sales in the financial crisis, versus 37% of unconstrained firms.

Our research question is especially important given the ongoing debate on financial conglomerate size, activities and efficiency. Bankers, regulators, policy makers, and economists have been highly critical of the huge size and organisational complexity reached by these institutions in recent times (Boot (2011), Saunders and Walter (2012), Admati and Hellwig (2014)). One consequence of their very large size and organisational complexity is the issue of “too-big-to-fail” (TBTF) – the systemic risk posed by the failing financial institution that would damage the rest of the financial system and the overall economy. Further, ever since the financial crisis struck in 2008, public interest in financial conglomerates has increased significantly as many of them faced severe financial distress. Regulators and governments have been directly and indirectly supporting financial conglomerates,[5] but at the same time they have agreed to restrict their activities,[6] discouraging strategies for higher growth and larger size through more stringent requirements on capital, risk management and liquidity, and advising them to divest assets or even to break them up.

There is a vast literature on the benefits and costs of conglomeration, mostly developed for nonfinancial conglomerates (see literature reviews by Stein (2003) and Maksimovic and Phillips (2007) and the references therein), with the bulk of research focusing on the market valuation consequences of corporate diversification.[7] By comparing the performance and value of conglomerates and single-segment firms, empirical studies find that diversified firms trade, on average, at discount. Conglomerate market undervaluation compared to specialised firms has been associated with investment inefficiency and negative synergies, which often translate into high agency costs. An important implication is that managers of conglomerate firms destroy value. This line of research was extended by LL2007 and SW2009 to the financial services industry, confirming that financial conglomerates' market value is lower than matched portfolios of specialised financial intermediaries. Both LL2007 and SW2009 corroborate the view that diversification in the financial services industry intensifies agency problems, impairs market value of banks that engage in multiple activities, and they point out that economies of scope are either non-existent or not sufficiently large to compensate the diversification costs.

Conglomerates might address investment inefficiency, market undervaluation, negative synergies and the organisational conflicts that arise when undertaking restructuring activities. Comment and Jarrell (1995) and John and Ofek (1995) find that nonfinancial conglomerates divesting assets observe an increase in their market value. Gertner et al. (2002) and Dittmar and Shivdasani (2003) highlight that conglomerate break-ups executed through spin-offs and divestitures improve the efficiency of the remaining business segments. How divestitures affect firm value, investments, financing and overall efficiency is a longstanding debate in finance literature.[8]

With this background, our paper extends the literature on the effect of divestitures to the financial industry, and to the particular case of large financial conglomerates. Our study is the first to address this research question, and investigates the economic contribution of alternative divestiture programs on the financial conglomerates' relative market valuation (i.e., excess value). We identify the world's largest financial conglomerates at year-end 2005 from 15 countries and track their asset sales over the period 2005–2016, which encompasses the recent financial crises. Divestitures in financial conglomerates might be different from divestitures in nonfinancial conglomerates, because on one hand they typically sell financial assets that operate within the same industry (i.e., they share the same 6 Standard Industry Classification (SIC) code), and on the other hand their divestiture programs do not lead to selling an entire business segment and reducing their level of diversification, but rather they are partial sales of line of business. A financial conglomerate may sell off loan packages, banking subsidiaries, asset management firms, and insurance companies. As illustrative divestiture deals, in 2008 Citigroup sold its German retail banking business to Credit Mutuel, a French retail bank, for $6.6bn. In 2007 Intesa Sanpaolo sold 78 branches to Banca Carige for a total deal value of $1.3bn. In 2012 Bank of America Corp announced the sale of its international wealth management business based outside the US for $883.3 mil to Julius Baer Group, a Swiss private banking group. The first two transactions are commercial banking asset sales while the third transaction is an investment banking asset sale. Commercial and investment banking assets have, however, different degree of liquidity, risk-return profiles, operational characteristics, and regulatory requirements. Financial conglomerates, similarly to nonfinancial ones, might sell off investments in nonfinancial sectors, such as property, real

4 In this paper, divestiture and asset sale are used as synonyms.

5 For example, in 2008 in the US nine large financial institutions – Citigroup, Wells Fargo, JPMorgan, Bank of America, Goldman Sachs, Morgan Stanley, State Street, Bank of New York Mellon, and Merrill Lynch – received an aggregate infusion of $125bn. In 2008 in the UK, the Bank of England and the Government had to rescue Royal Bank of Scotland Group Plc, at that time the largest British lender. In 2011 the Belgian operations of Dexia Group were taken over by the Belgian government while its French operations were sold to two French banks.

6 There have been various initiatives on structural bank regulation aimed at changing how banks organise themselves. The Vickers Commission in the UK, the High-Level Expert Group (Liikanen Commission) in the EU, and the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US advise to limit the scope of financial conglomerates. Among other things, the Dodd-Frank Wall Street Reform and Consumer Protection Act also caps the size of large banks at 10 percent of total U.S. consolidated financial liabilities. Furthermore, the Financial Stability Board decided in 2011 to address the systemic risks and the associated moral hazard problem for institutions that are seen by markets as TBTF and announced which financial institutions were systemically vital to the global economy, defined as Global Systemically Important Banks (G-SIBs). The EU has implemented Basel III through two legislative acts, the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) (together CRD IV). These regulatory interventions address requirements on quantity and quality of capital, liquidity, counterparty credit risk, and leverage.

7 See Ozbas and Scharfstein (2010), Hund et al. (2010), Hoechle et al. (2012), and Ammann et al. (2012).

8 Recent studies that provide support to the positive view are: Owen et al. (2010), Zhou et al. (2011), Borisova et al. (2013), Clayton and Reisel (2013), Prezas and Simonyan (2015), and Kaprielyan (2016).