

Statement by

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Submitted to the

Committee on Banking, Finance and Urban Affairs

U S House of Representatives

February 7, 1989

Mr Chairman, I am pleased to address issues raised by recent trends in corporate restructuring activity. The spate of mergers, acquisitions, leveraged buyouts, share repurchases, and divestitures in recent years is a significant development. It has implications for shareholders, the efficiency of our companies, employment and investment, financial stability, and, of course, tax revenues and our tax system. While the evidence suggests that the restructurings of the 1980s probably are improving, on balance, the efficiency of the American economy, the worrisome and possibly excessive degree of leveraging associated with this process could create a set of new problems for the financial system.

Corporate restructuring is not new to American business. It has long been a feature of our enterprise system, a means by which firms adjust to ever-changing product and resource markets, and to perceived opportunities for gains from changes in management and management strategies.

Moreover, waves of corporate restructuring activity are not new. We experienced a wave of mergers and acquisitions around the turn of this century and again in the 1920s. In the postwar period, we witnessed a flurry of so-called conglomerate mergers and acquisitions in the late 1960s and early 1970s.

However, the 1980s have been characterized by features not present in the previous episodes. The recent period has been marked not only by acquisitions and mergers, but also by significant increases in leveraged buyouts, divestitures, asset sales, and share repurchase programs. In many cases, recent activity reflects the break-up of the

big conglomerate deals packaged in the 1960s and 1970s. Also, the recent period has been characterized by the retirement of substantial amounts of equity (more than \$500 billion since 1983) mostly financed by borrowing in the credit markets.

The accompanying increase in debt has resulted in an appreciable rise in leverage ratios for many of our large corporations. Aggregate book value debt-equity ratios, based on balance sheet data for nonfinancial firms, have increased sharply in the 1980s, moving outside their range in recent decades, although measures based on market values have risen more modestly.

Along with this debt expansion, the ability of firms in the aggregate to cover interest payments has deteriorated. The ratio of gross interest payments to corporate cash flow before interest provision is currently around 35 percent, close to the 1982 peak when interest rates were much higher. Moreover, current interest coverage rates are characteristic of past recession periods, when weak profits have been the culprit. Lately profits have been fairly buoyant, the current deterioration has been due to heavier interest burdens.

A measure of credit quality erosion is suggested by an unusually large number of downgradings of corporate bonds in recent years. The average bond rating of a large sample of firms has declined since the late 1970s from A+ to A-

Causes of Restructuring Activity

To fashion an appropriate policy response, if any, to this extraordinary phenomena, there are some key questions that must be answered. What is behind the corporate restructuring movement? Why is

it occurring now, in the middle and late 1980s, rather than in some earlier time? Why has it involved such a broad leveraging of corporate balance sheets? And finally, has it been good or bad for the American economy?

The 1980s has been a period of dramatic economic changes. Large swings in the exchange value of the dollar, with substantial consequences for trade-dependent industries, rapid technological progress, especially in automation and telecommunications, rapid growth in the service sector, and large movements in real interest rates and relative prices. Clearly, such changes in the economic environment imply major, perhaps unprecedented, shifts in the optimal mix of assets at firms--owing to corresponding shifts in synergies--and new opportunities for improving efficiency. Some activities need to be shed or curtailed, and others added or beefed up. Moreover, the long period of slow productivity growth in the 1970s may have partly exacerbated the buildup of a backlog of inefficient practices.

When assets become misaligned or less than optimally managed, there is clearly an increasing opportunity to create economic value by restructuring companies, restoring what markets perceive as a more optimal mix of assets. But restructuring requires corporate control. And managers, unfortunately, often have been slow in reacting to changes in their external environment, some more so than others. Hence, it shouldn't be a surprise that, in recent years, unaffiliated corporate restructurers, some call them corporate raiders, have significantly bid up the control premiums over the passive investment value of companies that are perceived to have suboptimal asset allocations. If a company

has an optimal mix there is no economic value to be gained from restructuring and, hence, no advantage in obtaining control of a company for such purposes. In that case, there is no incentive to bid up the stock price above the passive investment value based on its existing, presumed optimal, mix of assets. But in an economy knocked partially off kilter by real interest rate increases and gyrations in foreign exchange and commodity prices, there emerge significant opportunities for value-creating restructuring at many companies.

This presumably explains why common stock tender offer prices of potential restructurings have risen significantly during the past decade. Observed stock prices generally (though not always) reflect values of shares as passive investments. But there are, for any individual company, two or more prices for its shares, reflecting the degree of control over a company's mix of assets.

Tender-offer premiums over passive investment values presumably are smaller than control premiums to the extent that those making tender offers believe that, restructured, the value of shares is still higher than the tender. Nonetheless, series on tender-offer premiums afford a reasonable proxy of the direction of control premiums.

Such tender-offer premiums ranged from 13 to 25 percent in the 1960s, but have moved to 45 percent and higher during the past decade, underscoring the evident increase in the perceived profit to be gained from corporate control and restructuring.

Interest in restructuring also has been spurred by the apparent increased willingness and ability of corporate managers and owners to leverage balance sheets. The gradual replacement of managers who grew

up in the Depression and developed a strong aversion to bankruptcy risk probably accounts for some of the increased proclivity to issue debt now

Moreover, innovations in capital markets have made the increased propensity to leverage feasible. It is now much easier than it used to be to mobilize tremendous sums of debt capital for leveraged purchases of firms. Improvements in the loan-sale market among banks and the greater presence of foreign banks in U S markets have greatly increased the ability of banks to participate in merger and acquisition transactions. The phenomenal development of the market for low-grade corporate debt, so-called "junk bonds," also has enhanced the availability of credit for a wide variety of corporate transactions. The increased liquidity of this market has made it possible for investors to diversify away firm-specific risks by building portfolios of such debt.

The tax benefits of restructuring activities are, of course, undeniable, but this is not a particularly new phenomenon. Our tax system has long favored debt finance by taxing the earnings of corporate debt capital only at the investor level, while earnings on equity capital are taxed at both the investor and corporate levels. There have been other sources of tax savings in mergers that do not depend on debt finance, involving such items as the tax basis for depreciation and foreign tax credits. And taxable owners benefit when firms repurchase their own shares, using what is, in effect, a tax-favored method of paying cash dividends. In any event, the recent rise in restructuring activity is not easily tied to any change in tax law.

Evidence about the economic consequences of restructuring is beginning to take shape, but much remains conjectural. It is clear that the markets believe that the recent restructurings are potentially advantageous. Estimates range from \$200 billion to \$500 billion or more in paper gains to shareholders since 1982. Apparently, only a small portion of that has come at the expense of bondholders. These gains are reflections of the expectations of market participants that the restructuring will, in fact, lead to a better mix of assets within companies and greater efficiencies in their use. This, in turn, is expected to produce marked increases in future productivity and, hence, in the value of American corporate business. Many of the internal adjustments brought about by changes in management or managerial policies are still being implemented, and it will take time before they show up for good or ill in measures of performance.

So far, various pieces of evidence indicate that the trend toward more ownership by managers and tighter control by other owners and creditors has generally enhanced operational efficiency. In the process, both jobs and capital spending in many firms have contracted as unprofitable projects are scrapped. But no clear trends in these variables are yet evident in restructured firms as a group. For the business sector, generally, growth of both employment and investment has been strong.

If what I've outlined earlier is a generally accurate description of the causes of the surge in restructurings of the past decade, one would assume that a stabilization of interest rates, exchange rates, and product prices would slow the emergence of newly

misaligned companies and opportunities for further restructuring. Such a development would presumably lower control premiums and reduce the pace of merger, acquisition, and LBO activity.

This suggests that the most potent policies for defusing the restructuring boom over the long haul are essentially the same macroeconomic policies toward budget deficit reduction and price stability that have been the principal policy concerns of recent years.

Financial Risks

Whatever the trends in restructuring, we cannot ignore the implications that the associated heavy leveraging has for broad-based risk in the economy. Other things equal, greater use of debt makes the corporate sector more vulnerable to an economic downturn or a rise in interest rates. The financial stability of lenders, in turn, may also be affected. How much is another question. The answer depends greatly on which firms are leveraging, which financial institutions are lending, and how the financings are structured.

Most of the restructured firms appear to be in mature, stable, non-cyclical industries. Restructuring activity has been especially prevalent in the trade, services, and, more recently, the food and tobacco industries. For such businesses, a substantial increase in debt may raise the probability of insolvency by only a relatively small amount. However, roughly two-fifths of merger and acquisition activity, as well as LBOs, have involved companies in cyclically sensitive industries that are more likely to run into trouble in the event of a severe economic downturn.

Lenders to leveraged enterprises have been, in large part, those that can most easily absorb losses without major systemic consequences. They include mutual funds, pension funds, and insurance companies, which generally have diversified portfolios, have traditionally invested in securities involving some risk, such as equities, and are not themselves heavily leveraged. To the extent that such debt is held by individual institutions that are not well diversified, there is some concern. At the Federal Reserve, we are particularly concerned about the increasing share of restructuring loans made by banks. Massive failures of these loans could have broader ramifications.

Generally, we must recognize that the line between equity and debt has become increasingly fuzzy in recent years. Convertible debt has always had an intermediate character, but now there is almost a continuum of securities varying in their relative proportions of debt and equity flavoring. Once there was a fairly sharp distinction between being unable to make interest payments on a bond, which frequently led to liquidation proceedings, and merely missing a dividend. Now the distinction is much smaller. Outright defaults on original issue high-yield bonds have been infrequent to date, but payment difficulties have led to more frequent exchanges of debt that reduce the immediate cash needs of troubled firms. Investors know when they purchase such issues that the stream of payments received may well differ from the stream promised, and prices tend to move in response to changes in both debt and equity markets. In effect, the yields on debt capital rise toward that of equity capital when scheduled repayments are less secure.

Policy Implications

In view of these considerations, and the very limited evidence on the effects of restructuring at the present time, it would be unwise to arbitrarily restrict corporate restructuring. We must resist the temptation to seek to allocate credit to specific uses through the tax system or through the regulation of financial institutions. Restrictions on the deductibility of interest on certain types of debt for tax purposes or on the granting of certain types of loans unavoidably involve an important element of arbitrariness, one that will affect not only those types of lending intended but other types as well. Moreover, foreign acquirers could be given an artificial edge to the extent that they could avoid these restrictions. Also, the historical experience with various types of selective credit controls clearly indicates that, in time, borrowers and lenders find ways around them.

All that doesn't mean that we should do nothing. The degree of corporate leveraging is especially disturbing in that it is being subsidized by our tax structure. To the extent that the double taxation of earnings from corporate equity capital has added to leveraging, debt levels are higher than they need, or should, be. Our options for dealing with this distortion are, unfortunately, constrained severely by the federal government's still serious budget deficit problems. One straightforward approach to this distortion, of course, would be to substantially reduce the corporation income tax. Alternatively, partial

integration of corporate and individual income taxes could be achieved by allowing corporations a deduction for dividends paid or by giving individuals credit for taxes paid at the corporate level. But these changes taken alone would result in substantial revenue losses. A rough estimate of IRS collections from taxing dividends is in the \$20 to \$25 billion range.

Dangers of risk to the banking system associated with high debt levels also warrant attention. The Federal Reserve, in its role as a supervisor of banks, has particular concerns in this regard. In 1984, the Board issued supervisory guidelines for assessing LBO-related loans, which are set forth in an attachment to my text. The Federal Reserve is currently in the process of reviewing its procedures regarding the evaluation of bank participation in highly leveraged financing transactions. The circumstances associated with highly leveraged deals require that creditors exercise credit judgment with special care. Doing so entails assessing those risks that are firm-specific as well as those common to all highly leveraged firms.

ATTACHMENT

The Federal Reserve's directive to examiners on leveraged buyout loans, issued in 1984, provided the following supervisory guidance to supplement standard loan review procedures

The nature of leveraged buyouts and, in particular, the level of debt typically involved in such arrangements give rise to supervisory concerns over the potential risk implications for bank loan portfolios. The high volume of debt relative to equity that is characteristic of leveraged buyouts leaves little margin for error or cushion to enable the purchased company to withstand unanticipated financial pressures or economic adversity. Two principal financial risks associated with leveraged buyout financing are (1) the possibility that interest rates may rise higher than anticipated and thereby significantly increase the purchased company's debt service burden, and/or (2) the possibility that the company's earnings and cash flow will decline or fail to meet projections, either because of a general economic recession or because of a downturn in a particular industry or sector of the economy. While either one of these developments can undermine the creditworthiness of any loan, the high degree of leverage and the small equity cushion typical of most leveraged buyouts suggest that economic or financial adversity will have a particularly large and negative impact on such companies. Thus, a leveraged buyout arrangement that appears reasonable at a given rate of interest or expected cash flow can suddenly appear to be questionable if interest rates rise significantly or if earnings should fail to provide an adequate margin of coverage to service the acquisition debt.

In addition to unfavorable interest rate movements and earnings developments, adverse economic conditions may also have a negative impact on the value of a company's collateral. For example, if a general economic slowdown reduces a company's sales and earnings, the marketability and value of its collateral may also suffer. In any event, given the amount of debt involved in leveraged buyouts, the value of collateral is extremely important, and the risk that collateral coverage may be insufficient to protect the bank is a significant factor in evaluating the creditworthiness of these loans. In light of all of these considerations, the quality of a purchased company's management is also extremely important and represents another critical element in the bank's evaluation of leveraged buyouts. This is because such management must oversee both the special financial risks associated with the leveraged buyout form of acquisition financing as well as the normal day-to-day affairs and operations of the purchased company's business.

In the course of on-site examinations, examiners should review a bank's involvement in leveraged buyout financing as well as the loans associated with individual leveraged buyouts. The following general

guidelines are provided to underscore and supplement existing loan review procedures

- 1 In evaluating individual loans and credit files, particular attention should be addressed to 1) the reasonableness of interest rate assumptions and earnings projections relied upon by the bank in extending the loan, ii) the trend of the borrowing company's and the industry's performance over time and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle, iii) the relationship between the company's cash flow and debt service requirements and the resulting margin of debt service coverage, and iv) the reliability and stability of collateral values and the adequacy of collateral coverage
2. In reviewing the performance of individual credits, examiners should attempt to determine if debt service requirements are being covered by cash flow generated by the company's operations or whether the debt service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes
- 3 Policies and procedures pertaining to leveraged buyout financing should be reviewed to ensure that they incorporate prudent and reasonable limits on the total amount and type (by industry) of exposure that the bank can assume through these financing arrangements
- 4 The bank's pricing, credit policies, and approval procedures should be reviewed to ensure i) that rates are reasonable in light of the risks involved and ii) that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions
- 5 Total loans to finance leveraged buyouts should be treated as a potential concentration of credit and if, in the aggregate, they are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report
- 6 Significant deficiencies or risks regarding a bank's leveraged buyout financing should be discussed on page 1 of the examination report and brought to the attention of the board of directors