

Remarks of
Alan Greenspan
Chairman, Board of Governors of the Federal Reserve System
Reserve City Bankers Association
Phoenix, Arizona
April 2, 1993

I am pleased once again to have the opportunity to share my thoughts with members of the Reserve City Bankers Association. Much of the efforts of Federal Reserve analysts these days has been focused on two key areas of our economic system, the banking industry and their business customers. Recently, I have devoted a good deal of time to small business issues. Tonight, I should like to focus particularly on the corporate sector of our economy, which not too long ago was struggling but has made great strides over the past couple of years in shoring up balance sheets and relieving accompanying stress. I would like to begin by reviewing some corporate sector developments that once again demonstrate the fundamental strength of American business and the flexibility of our financial system. Later, I plan to muse on how their erstwhile and prospective customers' actions affect the banks.

The improvement in the financial condition of U S corporations has been especially remarkable when we recall the financial strains on corporations just two years ago, reflecting the extraordinary developments in corporate finance in the 1980s.

Most of us are familiar with the leveraging of corporate balance sheets in the 1980s. During that time, leveraged buyouts mushroomed from less than \$5 billion in 1983 to more than \$60 billion in 1989. In addition to LBOs, corporations commonly used debt to finance mergers and acquisitions and in defensive measures aimed at repelling unsolicited or hostile takeovers. As deregulation, technological advances, and financial innovation

came at an accelerated pace in the 1980s, the cost of borrowing to many was lowered and the presumptive debt-to-equity ratio appeared to rise. Contributing to this boom in leveraging were willing lenders, mainly junk bond investors and bankers, who oftentimes seemed more optimistic than cautious in their evaluation of the risks of some of the deals being financed. As a result of these forces, the indebtedness of nonfinancial corporations grew rapidly, and firms replaced roughly \$600 billion in equity with debt over that seven-year period.

To many, this leveraging activity offered the hope that economic value would be created through more discipline on management to improve efficiency and to adapt to changing market opportunities. But, because a large cushion of equity had been removed, the debt load also posed the risk that the corporate sector would be more vulnerable to a cyclical downturn in the economy, despite the heavy concentration of such deals in presumably less cyclically sensitive companies.

Indeed, as the economy entered a recession in mid-1990 it appeared that the corporate sector would be particularly hard hit. Many indicators underscored the weakened condition of corporate finances. Most notably, interest payments claimed an increasing proportion of cash flow throughout the 1980s and by early 1991 interest payments consumed almost 40 percent of corporate cash flow. For a significant segment of the corporate sector, this share was much higher.

At the trough of the recession in early 1991, debt-rating downgrades were outpacing upgrades by a 4 to 1 ratio, and the ratings of several of our largest companies had slipped to the speculative-grade status. In the so-called junk bond market,

defaults had soared to more than \$18 billion in 1990, representing 10 percent of outstanding speculative-grade bonds, and defaults in 1991 were on a path to maintain that dismal pace. The primary market for speculative-grade bonds had all but disappeared and liquidity in the secondary market had deteriorated noticeably. Yields on junk bonds soared to more than 10 percentage points over U.S. Treasuries as mutual fund investors, savings and loans, and insurance companies herded for the exits.

Moreover, at the same time, the financial markets were not terribly receptive to financing by investment-grade firms either. In the bond market, companies with single-A ratings were paying double-digit interest rates to secure long-term funding. In the commercial paper market, a pickup in the number of defaults and new restrictions on paper holdings of money market funds had increased the cost of credit and reduced the availability of financing to all but the most highly rated companies.

Banks were also tightening up on lending to leveraged borrowers, and banks themselves were facing difficulties in obtaining funding. Even in the private placement market, which traditionally had been a stable source of funding for middle market companies, financing had become more selective and more credit sensitive.

At the darkest hour, it seemed as if the concerns of many pessimists might be realized.

But as we look back over the past two years, we must come to the conclusion that the self-correcting forces in financial markets, and the flexibility of the financial system itself, have been key factors in getting the corporate sector on the road to recovery. Indeed, the flexible response of financial markets has

not only eased stress that had been building up throughout the 1980s, it has also laid a firm foundation for facing the challenges that lie ahead in the 1990s

The most remarkable feature of the financial rehabilitation process has been the record volume of equity financing. Dozens of companies that incurred debt to finance leveraged buyouts have turned to the equity market to finance so-called "reverse LBOs." Equity financing by highly leveraged companies, which amounted to more than \$20 billion in the past two years, has eased stress on the speculative-grade bond market, where yield spreads against Treasuries have narrowed sharply. As a result of equity infusions, several corporations that were "fallen angels" in the 1980s have returned to investment-grade status in the 1990s.

The equity markets have also been receptive to a steady flow of stock offerings by investment-grade public companies that had fallen on hard times. Notably, domestic auto companies and other firms in cyclical industries have tapped the equity markets for billions of dollars of financing over the past two years. Without the ability to recapitalize through equity market financing, the downsizing at many large corporations would likely have been more pronounced. The difficulties that businesses faced in the recent downturn have reinforced the important role that equity plays in corporate financial structures, and the equity market has proven itself willing to supply the much needed capital.

Financial innovation in the equity market has also played a role. In 1991 and 1992, preferred stock accounted for a sizable share of equity market financing, and several companies issued new

hybrids of preferred stock to shore up their balance sheets. This year, several prominent nonfinancial firms have placed large issues of convertible preferred stock in the private placement market. These offerings have been sold to large, sophisticated institutions under SEC Rule 144A, which allows institutional investors to trade privately issued securities freely among themselves. As the private market has become more liquid, the pricing differences between private and public securities have narrowed.

Equity financing has not been limited only to large companies. Over the past two years, small and medium-size companies have also turned to the equity market in record numbers.

It is important not to lose sight of the heavy volume of equity financing as we evaluate whether corporations have sufficient funding to finance economic growth. If we ignore the equity financing and focus only on borrowing patterns, one might conclude that financing by businesses has been too weak to support a recovery. In particular, business borrowing at banks has actually declined over the past two years, and no doubt some of this decline evidences a credit-crunch for small businesses. But much of weakness in business loans can be traced to decisions by corporations to unwind some of the leverage taken on in the 1980s by replacing bank debt with equity. Indeed, in \$13 billion of equity offerings last year, nonfinancial corporations stated that the primary use of the proceeds was to repay bank debt. We should view this deleveraging trend as a positive development because it indicates that the corporate sector is becoming less prone to financial distress, and, moreover, it is in a better position to make commitments for long-term capital spending.

In much the same way, companies have actively used the bond market to improve their financial positions. The junk bond market has recovered, phoenix-like, from its moribund condition in 1990. Indeed, more than 100 companies issued speculative-grade bonds in 1992, as yields fell and as yield spreads against Treasuries in the primary market have retraced much of their increase recorded during the debacle of 1990 and 1991. With many firms raising long-term funds at single digit rates, the name "high-yield bond market" is becoming something of a misnomer.

Are we about to repeat the mistakes of the 1980s in this market? Hopefully not. A close look at the financing patterns in the 1990s suggests that the speculative-grade bond market in the 1990s differs in several ways from that of the 1980s. First, the credit quality of such bond financing is much higher. In the 1990s, "higher quality" double-B rated bonds have accounted for 40 percent of the new speculative-grade bond issuance volume, whereas in the late 1980s only about 15 percent had double-B ratings. A second difference is that speculative-grade bonds in the 1990s have a higher priority in corporations' capital structures. In the 1980s, about three-quarters of the bonds had a subordinated priority, but in the 1990s, more than half have a senior or secured status. Another well-known feature of the junk market in the 1980s was that it created new, and somewhat bizarre, bond structures, such as reset bonds, increasing-rate notes, and payment-in-kind bonds. While these exotic structures have not disappeared from the landscape, they are much rarer now than they were in the 1980s. Furthermore, in the 1980s a single securities firm dominated the underwriting and trading of junk bonds, but in the 1990s several firms compete actively for this business, and

these firms typically have diverse operations that span the securities business. As a result, the potential for a liquidity crisis has likely diminished. These differences suggest that, on balance, speculative-grade bonds issued in the 1990s have been significantly less risky than the bonds issued in the 1980s.

But the most striking difference between the speculative-grade bond market in the 1990s and that of the 1980s is in what companies are doing with the proceeds. In the late 1980s, two-thirds of the proceeds from junk bond offerings were used to finance mergers, leveraged buyouts, and other leveraged restructurings. In the 1990s, in contrast, companies applied only about 10 percent of offering proceeds to finance acquisitions. They have applied the bulk of the proceeds to refinance high cost debt. The reemergence of the junk bond market illustrates the powerful trend toward direct access to capital markets and away from intermediary finance. This market allows firms that previously had access only to private placements to directly access the depth and liquidity of capital markets.

Refinancing, coupled with the record volume of equity issuance and probably to only a small extent a better economy, has resulted in a noticeable improvement in the debt service burdens of leveraged companies. As a consequence, last year the default rate on junk bonds fell to below 4 percent, down from the 10 percent rates of the previous two years and near its historical average.

The financial condition of investment-grade companies has also improved dramatically from the dire days of early 1991. Since that time, yield spreads on investment-grade bonds have narrowed sharply, and yields on new offerings of long-term bonds

are at their lowest level since the early 1970s. With the most recent decline in long-term rates, a large number of companies have called bonds that were issued in 1986, when the last trough in rates occurred. Moreover, the low interest rate environment, combined with the steep yield curve, has made it efficient for corporations to refund bonds that were originally issued in the 1970s. Even more extraordinary is the fact that companies have been calling bonds that were issued as long ago as 1960. Companies have had the option to call these bonds for more than twenty-five years, and it is only now, in the current environment of low interest rates, that they have found it cost effective to exercise that option.

To a large measure, the financing and refinancing patterns that we have observed are normal phenomena that occur early in the expansion phase of the business cycle. As in previous expansions, many companies have lengthened the maturity of their debt obligations. Indeed, since the trough in 1991, companies have earmarked the proceeds from tens of billions of dollars of bond offerings to retire short-term debt, much of which was in the form of bank loans.

Not only have companies shifted financing from short-term to long-term, they have also been lengthening their bond maturities. Thus far in 1993, nearly a third of the investment-grade bond offerings have had maturities of thirty years or longer, the highest share of such long-term financing in a decade. Within the last month, one industrial company issued a rare fifty-year bond. Since every corporate treasurer plans to be alive when issued debt matures, I must assume treasurers are getting younger. The very fact that investors are willing to purchase fixed-rate

securities with such long maturities is further testimony to their confidence that inflation will remain low and the economy stable

In analyzing these financing patterns, I do want to highlight the role played by our financial markets themselves in making the adjustment in corporate balance sheets a relatively smooth and efficient process. This is especially true of the long-term bond market. Despite globalization trends, the U S market is virtually the only place in the world where borrowers can obtain fixed-rate financing with thirty-year terms. In Europe and Asia, market participants are endeavoring to establish long-term bond markets, but this remains an area where the United States is the world leader in efficiency, transparency and above all liquidity. Indeed, the ability to secure long-term funding has attracted borrowers from the rest of the world to the U S markets in record numbers in recent years. The market for "Yankee-bonds" (bonds issued in the United States by foreign entities) has allowed companies and sovereigns from Europe, the Americas and Asia to access U S investors, diversify their sources of funding, and lock into long-term funding at single-digit interest rates.

In the recent business cycle, the asset-backed securities market has also played an important role in relieving strains on the financial system. In 1990 and 1991, securitization of credit-card receivables and other assets allowed banks to meet the credit demands of many of their customers while at the same time enabling the banks to repair capital positions.

More recently, the asset-backed market has also eased financial strains on others. This has been especially true of the auto finance companies which have been able to continue to provide

financing for the purchases of their parents' products, even in the face of rating downgrades and widening yield spreads in the commercial paper and medium-term note markets

There no doubt remains much untapped potential in the asset-backed securities market. Not only has the volume of financing continued to grow rapidly, but the types of loans and receivables that are being securitized have been expanding rapidly. In addition to credit cards and auto loans, investors have purchased securities backed by home-equity loans, lease-receivables, boat loans, and commercial mortgages, to name but a few. It is not obvious what is next, but we can be sure that the financial markets will continue to search for opportunities to more efficiently provide credit for productive endeavors.

I've talked about securities markets, the question we need to ask ourselves is: What are the implications for banks, especially with regard to the decline in commercial and industrial loans? As I noted, some of the decline is a normal cyclical pattern that was likely punctuated by unusually cautious inventory stocking, fostered by the increasing prevalence of computer-based just-in-time inventory management. There are several reasons to believe that an important role remains for bank lending. First, although the public bond market has grown over the past decade, most companies that issue bonds are large, with annual sales of more than \$1 billion. Thus, for middle-market firms and small businesses, banks remain the primary source of financing. Second, banks still play a vital role in providing short-term funding to borrowers of all sizes. Although much has been made of the growth of the commercial paper market, this market is still largely one for firms with high credit ratings. For investment-grade firms

with BBB ratings and for many A-rated companies, bank loans remain the primary source of short-term financing. And third, if the credit quality of the banking system continues to improve, banks are likely to win back some of the business of corporate customers that migrated to the securities markets in the 1980s.

Although the financial condition of many U S corporations is vastly improved, some areas of concern remain. Firms have made great strides in reducing debt, but the corporate sector remains highly leveraged by historical standards. Certain industries, such as airlines, have not participated fully in the recovery of financial health. Moreover, middle market and non-investment grade companies that have traditionally relied on the private placement market are continuing to find that such credit is hard to get. And small businesses still face obstacles in obtaining loans from banks. Federal regulators recognize that regulatory burdens may be exacerbating this problem and have recently announced a program to address this situation.

But overall, the corporate sector has recorded a striking improvement in its financial condition. Interest expense now claims less than 30 percent of corporate cash flow, down from over 40 percent just two years ago. Companies are improving their balance sheets by issuing record volumes of equity, and removing large chunks of the debt that were piled on in the 1980s. Downgrades of credit ratings have become less frequent, and many firms have climbed back to investment-grade status. As interest rates have declined to twenty-year lows, companies are seizing the opportunities to call high coupon debt and to extend debt maturities by offering bonds with maturities of thirty years, and even longer. Investors have shown their confidence in the

corporate sector by bidding down yield spreads against Treasuries to levels that are roughly half what they were two years ago

There is an important lesson to be learned here. In a relatively short span of time, the self-correcting forces of the financial markets have helped to restore the financial health of the corporate sector. Were our financial markets riddled with capital controls and credit rationing, the adjustments over the past two years would not have come so readily. It may be counterargued, with some validity, that with such rigidities the excesses of the 1980s would not have occurred. However, in these circumstances, we would not have benefited from the veritable explosion of new financial instruments that unbundle risks and improve the long-term performance of our economy. As a result of the rapid pace of innovation in the financial markets over the past decade, the financial system appears more capable of dealing with stress now than it ever has been before.