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Statement

by

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Board of Governors of the Federal Reserve System

before the

Subcommittees on Oversight and Select Revenue Measures

of the

House Committee on Ways and Means

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I am pleased to appear before you to discuss the recent surge in merger and takeover activity and the potential effect of this activity on credit market conditions.

The magnitude of recent merger trends underscores the importance of assessing the implications of this activity, as you are reviewing in these hearings. The number of completed merger transactions in 1984 totaled more than 2,800; and it seems that almost every day we read in the press of a new combination of firms or a threatened takeover. These figures may not be unprecedented; in the late years of the 1960s, for example, more firms reportedly were involved in merger activity (attachment 1). But the dollar size of recent transactions exceeds by a wide margin any past experience. The largest acquisition in 1984 totaled $13.3 billion, nearly twice as large as any single merger of previous years. Indeed, last year there were 14 merger transactions that exceeded $1 billion each (attachment 2). These 14 combinations alone accounted for more than $50 billion in activity.

Many more smaller transactions bolstered the total dollar volume of acquisition activity to record levels last year; during 1984, nonfinancial corporations retired an estimated $85 billion of equity through mergers, takeovers, and share repurchases. Included in this total is about $15 billion of equity retired through so-called leveraged buyouts, which rely heavily on debt financing. In a typical leveraged buyout, an individual or small group of investors and/or management purchases a company or subsidiary of a company with the proceeds of loans collateralized by the assets of the company, and then takes the company private.

In my view, there is a legitimate place in our economy for mergers and takeovers. They can be important mechanisms for redeploying corporate assets to their most profitable--and socially beneficial--uses, and for bringing about better management. We must be careful about attempting to impose the judgment of governmental authorities about which among thousands of private transactions will be economically productive and which will not; in most instances the parties whose fortunes are at stake are likely to be better judges. Governmental authorities are obliged to do what they can to ensure that individual risk-taking does not jeopardize the stability of our financial system. As I will discuss below, the Federal Reserve recognizes its responsibilities in this area.

Assessing the implications of merger activity is complex. From the perspective of the Federal Reserve, concerns have focused on the effect that this activity is likely to have on aggregate credit flows and on the risk exposure of financial institutions and markets. We all are aware that a large portion of these merger transactions has been financed, at least initially, with debt, including short-term bank credit. Leveraged buyouts typically entail as much as 80 to 90 percent debt financing; and among the largest mergers last year, credit sources initially financed about 75 to 80 percent of the equity purchases.

Estimates by Board staff indicate that growth in the domestic nonfinancial debt aggregate--which is one of the aggregates that the Federal Reserve monitors in the course of its monetary policy deliberations--was boosted by about 1 to 1-1/2 percentage points in 1984 as a result of merger-related borrowings. Mergers and buyouts appear likely to have had a much more limited impact on the narrow money aggregate, M1. The checking accounts of merger participants may be increased temporarily as a result of the mergers, but proceeds from merger sales are generally reinvested in other assets, so that the effect on M1 tends to be insignificant over periods of time relevant for monetary policy deliberations. The broader aggregates, M2 and M3, may be boosted somewhat more than M1, as some proceeds from stock sales find their way into time deposits, money market mutual funds, or other assets that are included in these aggregates. But relative to the large size of M2 and M3 this effect also would be relatively minor.

The Board is aware of the influence of merger activity and takes it into consideration when evaluating the behavior of the money and debt aggregates. Given our ability to monitor the size and timing of very large transactions, we can anticipate possible distortions to the aggregates in a particular period and thus avoid inadvertly reacting to these factors in policy deliberations. Moreover, distortions in the credit aggregate, where the potential problems are largest, are less likely to mislead policy deliberations. In setting monitoring ranges for this aggregate, the FOMC recognizes that numerous factors, including merger activity, may alter the behavior of credit growth relative to GNP. Thus, I don't believe mergers present a real operational problem for us that would result in appreciable unintended variations in reserve market pressures. More fundamental determinants of credit demand, including the behavior of the household sector, capital expenditures of businesses, and, of course, the fiscal position of the federal government, exert much more powerful and persistent pressures on credit markets than does takeover activity.

Some members of the public and Congress have expressed concerns that merger activity absorbs credit that could be used to support other, perhaps more productive, purposes. But this would be true only in unusual circumstances and for temporary periods. Basically, merger and acquisition transactions involve transfers of ownership of existing assets and do not absorb net real savings in the economy. Proceeds from the transactions either are returned to bank accounts or reinvested in other financial instruments, thereby recycling the funds into the markets. Thus, these transactions should not generate significant lasting reductions in the amounts of financial resources available to other borrowers.

However, mergers may alter the cost or amount of credit available to some borrowers if banks that extend large amounts of takeover credit are subject to capital or liquidity constraints and reduce their lending to other potential borrowers for a time. In this case, those borrowers with limited access to financial markets would be vulnerable to the potential effects of these transactions. However, in the case of many mergers, corporations have begun to repay loans, frequently within a month or so after the takeover, with funds raised through sales of assets or new equity, or by borrowing in the commercial paper or bond markets. More than two-thirds of the $32 billion of bank loans extended to finance the largest mergers last year has been repaid (attachment 3); the bulk of these repayments occurred within 6 months of the loan extensions. A number of foreign banks also have participated in the financing arrangements of many of the larger mergers, thus expanding the supply of funds in domestic markets. Among the largest transactions completed last year, approximately $7 billion, about one-fifth, of the intitial bank financing reportly came from foreign banks (attachment 3). Foreign banks have also purchased merger loans originally made at large U.S. banks, though we have no statistics on the total volume of this activity.

A more pertinent consideration regarding merger financing from the Federal Reserve's perspective is the potential for greater risk exposure of the financial system. The Board of Governors, as bank and bank holding company supervisor and lender of last resort, has responsibility along with the other regulatory agencies for maintaining the safety and soundness of financial institutions and markets. In this regard, we are especially concerned about potential financial risks involved with leveraging and with acquisition activity financed with large amounts of debt. Because many mergers and leveraged buyouts have involved heavy reliance on debt and retirement of existing equity, the surviving firms have had balance sheets that leave them more vulnerable to downturns in earnings or sharp increases in interest rates. When this occurs, it of course means that the institutions providing the credit may in turn be more exposed to possible loss.

Leveraged buyouts may be of particular concern because these purchases are typically executed using larger proportions of debt and smaller amounts of equity than mergers. In 1984, leveraged buyout deals involving U.S. companies are estimated to have amounted to over $15 billion, with buyers rarely putting up more than 10 percent of the purchase price. The ability of the firm to service this debt burden depends on the value of the assets and on the company's future earnings and cash flow prospects. These factors may be particularly difficult to evaluate for buyouts, if past operations are not expected to be a guide to future profitability--which is, after all, the economic rationale of many buyouts. Because buyout loans usually involve floating rate debt, the companies would be particularly vulnerable in the event that interest rates rise substantially and cash flows are not adequate to service heavy debt burdens. But prudent lending practices established by lenders take these possible outcomes into consideration, and thus help to insure that any failures associated with heavy leveraging would be only isolated events.

The Federal Reserve has actively urged banks to evaluate carefully loans used to finance buyouts and other types of takeover transactions and to apply prudent standards in their credit decisions. Bank examiners have been instructed to review banks' involvement with leveraged buyout financing, and we have issued specific guidelines for the examiners to follow in evaluating loans used for this purpose, and for assessing the total exposure of a bank to such lending. A policy directive issued in 1984 to examiners at each of the 12 District Federal Reserve Banks by the Director of the Board's Division of Banking Supervision and Regulation pointed out that the high volume of debt relative to equity that is characteristic of leveraged buyouts reduces the cushion available to the purchased company to withstand unanticipated financial pressures or economic adversity (attachment 4).

The Board policy directive noted the following two financial risks associated with leveraged buyout financing: (1) the possibility that interest rates may rise higher than anticipated and thereby significantly increase the purchased company's debt service burden; and (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.

The Board directive stated that, given the amount of debt involved in leveraged buyouts, the value of collateral should be emphasized in order to protect the creditworthiness of these loans. The quality of a purchased company's management is also important and represents another element in the bank's evaluation of leveraged buyouts. This is because 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.

The Board of Governors has expressed its concerns about the potential hazards of mergers and leveraged buyouts with leaders of the banking community through public statements and informal discussions. Members of the banking community have indicated that they are reviewing lending practices to ensure that prudent standards are applied to potential credit extensions for takeovers. Reportedly a number of attempted buyouts have been terminated as a result of difficulties encountered in obtaining needed financing. At least $3 billion of proposed leveraged buyouts were abandoned last year because financing was not available, and we have read in the press recently of two or three sizable buyouts that were terminated for this reason. These reports suggest some selectivity on the part of lenders.

We hope that prudent lending standards will be applied by all lenders, including purchasers of so-called "junk bonds". Junk bonds are low-rated or unrated bond issues, which seem to have gained popularity as a tool for financing mergers and takeover attempts. The large investors who purchase most of these bonds are relatively sophisticated and should be aware of the risks involved. But it would be fair to say that one cannot really be entirely comfortable about such assumptions, especially when the market has not been tested by some significant negative surprises--which inevitably will come at some point. The higher rates paid on the junk bonds suggest that they are perceived by the market to involve greater risks; the question is whether the risk premiums will in fact prove to be adequate.

I should note that, while federally chartered depository institutions may make loans to low-rated borrowers, they are prohibited from acquiring junk bonds in their investment portfolios because they are not considered to be investment grade securities. But some state-chartered institutions may not be subject to such restrictions, and some state-chartered thrifts have purchased these securities. Given the evident sensitivity of financial markets to the fortunes of individual banks and thrift institutions, I think it is incumbent upon supervisors at both the federal and state levels to keep a close eye on developments in this area.

Lending on a prudent basis to finance mergers and acquisitions need not weaken the financial fabric. Although the companies that have been created out of this recent surge in merger activity are still relatively untested, we have not seen to date significant problems for financial markets arising out of this activity. In part, this may reflect the favorable economic and financial environment of the current expansion. Most sectors have experienced substantial increases in corporate profits and cash flows over the past year and interest rates are appreciably below the levels of the early 1980s. While some indvidual firms have taken on greater leverage, other businesses have taken advantage of improved conditions to strengthen their balance sheets. For the economy as a whole, retirements of equity through mergers and merger-related activity have been partially offset by improvements in the market values of assets and by boosts to equity from retained earnings growing out of the current expansion.

We do not believe that arbitrary controls of uses of credit can be effective or desirable. Nor can a government agency determine among thousands of mergers which are good and which are bad. A given transaction may be desirable from a social and economic standpoint if it results in economies of scale, better management or a more efficient allocation of resources. A blanket prohibition of all merger financing would be undesirable. Moreover, attempts to regulate flows of credit for particular purposes run the risk of creating unintended distortions in credit flows and impeding the efficient allocation of capital. When credit controls are in existence for any length of time, they become increasingly inequitable as borrowers and lenders seek to circumvent them. Credit controls are usually extremely difficult to enforce: since credit is fungible, most financing can be achieved through alternative channels, such as borrowing through nonregulated intermediaries, foreign lenders, or the like.

I do not wish to imply, however, that we should be complacent about the implications of lending for mergers and takeovers. The Federal Reserve will continue to monitor this activity and its effects on financial markets, and our examination standards in this regard are undergoing further review. And Congress and other governmental agencies need to give close scrutiny to the numerous offensive and defensive practices that have arisen in association with mergers, leveraged buyouts, and hostile takeovers to ensure that institutions and investors are provided adequate protection. Also, a careful review should be given to features of the tax system that appear to encourage merger activity, and in particular those features that favor the use of debt financing.

Attachment 1

MERGER AND ACQUISITIONS OF U.S. CORPORATIONS[1]

	Completed transactions[2]		Announced transactions[3]	
	Number	Dollar volume ($ billions)	Number	Dollar volume ($ billions)
1967	1,800	$15.0	2,975	n.a.
1968	2,440	28.0	4,462	$43.6
1969	3,012	n.a.	6,107	23.7
1970	1,318	n.a.	5,152	16.4
1971	1,269	n.a.	4,608	12.6
1972	1,263	n.a.	4,801	16.7
1973	1,064	n.a.	4,040	16.7
1974	1,088	n.a.	2,861	12.5
1975	859	n.a.	2,297	11.8
1976	1,058	n.a.	2,276	20.0
1977	1,139	n.a.	2,224	21.9
1978	1,364	n.a.	2,106	34.2
1979	1,420	n.a.	2,128	43.5
1980	1,470	34.7	1,889	44.3
1981	2,231	72.4	2,395	82.6
1982	2,182	65.1	2,346	53.8
1983	2,191	50.5	2,533	73.1
1984	2,807	122.0	2,543	122.2

n.a.--not available.
1. Purchases of U.S. corporations by other U.S. companies and by foreign companies. Divestitures or sales of subsidiaries, divisions, or product lines also are included.
2. Data from Mergers and Acquisitions magazine. Includes transactions valued at $1 million or more in cash, market value of capital stock exchanged, or debt securities. Partial acquisitions of 5 percent or more of a company's capital stock are included if the size requirement is met. Data shown for the number of transactions completed in the years 1970-79 exclude divestitures and foreign acquisitions.
3. Data published by W.T. Grimm. Data represent announcement of transactions, some of which were not actually completed. The series records announcements of any transfer of ownership of at least 10 percent of a company's assets or equity. Foreign acquisitions of U.S. companies also are included.

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Attachment 2

LARGEST MERGER AND ACQUISITION TRANSACTIONS OF U.S. COMPANIES[1]

Acquiring company	Acquired company	Total price paid	Initial means of payment to selling stockholders			Subsequent public stock offerings
			Cash	Stock	Debt	
		----------- millions of dollars ---				-----------
1984						
Chevron	Gulf	13,300	13,300	--	--	--
Texaco	Getty Oil	10,120	10,120	--	--	113
Mobil	Superior Oil	5,700	3,800	--	1,900	--
Royal Dutch/Shell	Shell Oil	4,500	4,500	--	--	--
KMI Continental[2]	Continental Group	2,750	2,750	--	--	--
Beatrice	Esmark	2,725	2,725	--	--	--
General Motors	Electronic Data Sys.	2,500	1,900	600	--	191
Champion Int'l.	St. Regis	1,840	1,000	840	--	--
Dun & Bradstreet	A.C. Nielsen	1,300	--	1,300	--	--
IBM	Rolm	1,260	--	--	1,260	--
PACE Industries[2]	City Investing	1,250	1,250	--	--	--
American Stores	Jewel Cos.	1,150	817	333	--	--
JWK Acquisition[2]	Metromedia	1,130	825	--	305	--
Texas Eastern	Petrolane	1,040	1,040	--	--	--
	TOTAL	50,565	44,027	3,073	3,465	304
1985						
Nestle	Carnation	3,000	3,000	--	--	--
Rockwell International	Allen Bradley	1,650	1,650	--	--	--
Textron	Avco	1,380	1,380	--	--	--
Pending:						
Coastal	Am. Nat. Resources	2,460	2,460	--	--	--
Chesebrough-Ponds	Stauffer Chem.	1,250	1,250	--	--	--
Royal Dutch/Shell	Shell Oil[3]	1,170	1,170	--	--	--
Capital Cities Commu.	ABC	3,500	3,400	100	--	--
Cooper Industries	MC-Graw Edison	1,400	1,400	--	--	--

1. Acquisitions of $1.0 billion and over of shares in U.S. companies. Divestitures are excluded. Data are based on public information.
2. Leveraged buyout.
3. Final portion of Shell shares.

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Attachment 3

LARGE MERGER-RELATED BANK CREDIT DEVELOPMENTS IN 1984

	Total (U.S. and foreign banks)	Estimated U.S. bank participation[1]
	-------billions of dollars------	
Estimated large credit lines arranged for potential acquisitions of U.S. nonfinancial firms in 1984[2]	57.9	35.5
Merger-related loans taken down[3]	31.9	24.9
Memorandum:		
Total loans outstanding at all banks, December 1984 (excluding interbank loans)	—	1,326.8

1. Includes U.S.-chartered commercial banks, U.S. branches and agencies of foreign banks and foreign branches of U.S. banks where known.
2. Includes credit lines of Texaco, Chevron, ARCO, Mobil, Teledyne, Limited/Carter Hawley Hale, Beatrice Foods, JWK (Metromedia), Champion, American Stores, Texas Eastern, Kiewit-Murdock, Nestle, Houston Natural Gas, Gulf and Western, Textron, Phillips Oil, PACE Industries.
3. Amounts reflect estimated maximums taken down before repayments commenced. Substantial repayments (over two-thirds of the total) were made by borrowing companies using proceeds of borrowings in the commercial paper and bond markets as well as from sale of assets. Three of the credit lines arranged for merger financing were not taken down in 1984.

Attachment 4

GUIDELINES FOR EVALUATING LEVERAGED-BUYOUT LOANS

The Board directive to its bank examiners specified the following examination guidelines to supplement existing loan procedures:

1. In evaluating individual loans and credit files, particular attention should be addressed to i) 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 the 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 examinations 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.