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Statement

by

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Board of Governors of the Federal Reserve System

before the

Subcommittee on

Telecommunications, Consumer Protection and Finance

of the

Committee on Energy and Commerce

House of Representatives

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

Prior testimony underscores the importance of assessing the implications of this activity. The dollar size of recent transactions exceeds by a wide margin any past experience. Nonfinancial corporations as a whole retired more than $85 billion of equity through mergers, takeovers, and share repurchases last year; included in this total is about $15 billion of equity retired through leveraged buyouts. Equity retirements were bolstered also by firms that elected to repurchase their own shares rather than undertake new investment or acquire other firms. Some share repurchases clearly were prompted as defensive actions against possible hostile takeovers; excluding so-called "greenmail" purchases, available data suggest that more than $10 billion of stocks were bought back by firms last year. When a company believes that the value of its assets is higher than the market value of its stock, such buybacks may appear to be more attractive than alternative investments.

The unprecedented level of stock retirements associated with mergers, takeovers, and share repurchases has given rise to concerns about the potential erosion of the equity base of American business. There have been offsets, however, to this erosion. Aided by the new depreciation rules, after-tax earnings of nonfinancial corporations have rebounded strongly in the current expansion. With dividend growth remaining restrained, retained earnings have been a relatively substantial source of new corporate equity in recent quarters.

A typically less important source of equity is new stock issues. In 1983, the stock market advances attracted an unusually high volume of new issuance. Last year, the volume of new issues dropped by two-thirds; and the wave of retirements associated with large debt-financed mergers, leveraged buyouts, and stock repurchase programs greatly exceeded new issues. Even so, retained earnings of all nonfinancial firms offset the net retirement of equity, and net additions to equity in the aggregate remained positive though quite low by historical standards, especially during a business expansion.

Another source of equity growth has come from the appreciation of existing corporate assets. Reflecting the improvement in corporate profits in this expansion and a more favorable environment for future earnings, the market's evaluation of corporate assets has risen. Moreover, even though a large portion of recent stock retirements has been financed with debt, aggregate debt-to-equity ratios for nonfinancial business as a whole--based on market values of equity--have remained well below the peaks reached in the 1970s. Nonetheless, while these aggregate measures have not changed dramatically, it is clear that some firms are retiring huge amounts of their equity and are taking on appreciable amounts of debt to finance merger-related activity. The Federal Reserve is concerned that individual risk-taking associated with leveraging on such a large scale not impair the stability of our financial system.

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 more profitable uses. Many combinations promote economies of scale or scope, reinforce market incentives, and may bring about better management. However, acquisitions do not always lead to big businesses. We have seen an increasing number of divestitures in which larger companies sell operating units to smaller firms or to management. Such spin offs, which not infrequently follow a merger between big concerns, create enterprises that may function more efficiently in a more specialized environment and with more direct management control. The positive gains from mergers need not be limited only to friendly takeovers, but can occur in hostile situations as well. Thus, we must be careful about imposing the judgment of governmental authorities concerning which private transactions will be economically productive and which will not.

The Federal Reserve's concerns have focused primarily on the effect that merger and takeover activity may have on aggregate credit flows and on the risk exposure of financial institutions and markets. With respect to credit flows, our estimates indicate that growth in the domestic nonfinancial debt aggregate--which is one of the aggregates that we monitor in the course of our monetary policy deliberations--was boosted by about 1 to 1-1/2 percentage points in 1984 as a result of merger-related borrowings. But mergers and buyouts appear likely to have had a much more limited impact on the three monetary aggregates for which we establish target ranges. Moreover, the Board is aware of the 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 inadvertently reacting to these factors in policy deliberations. 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.

A more pertinent consideration regarding merger financing from the Federal Reserve's perspective is the potential for greater risk exposure of the financial system. Because many mergers and leveraged buyouts have involved heavy reliance on debt and retirement of existing equity, the surviving firms are more vulnerable to downturns in earnings or sharp increases in interest rates. When this occurs, it means that the institutions providing the credit may in turn be more exposed to possible loss. Leveraged buyouts may be of particular concern because they typically involve larger proportions of debt and smaller amounts of equity than other types of mergers.

The Federal Reserve has actively urged bank management to evaluate carefully loans used to finance buyouts and other types of takeover transactions and to apply prudent standards in credit decisions. Reserve Bank examiners have been instructed particularly to review bank involvement with leveraged buyout financing, and we have issued specific guidelines for examiners to follow in evaluating loans used for this purpose, and in assessing the exposure of a bank portfolio to such lending. A policy directive issued in 1984 to examiners at each of the 12 district Federal Reserve Banks pointed out that the high proportion of debt to equity characteristic of leveraged buyouts reduces the cushion available to withstand unanticipated financial pressures or economic adversity.

Moreover, the Board of Governors has expressed its concerns about the potential hazards of mergers and leveraged buyout lending 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, which suggests some selectivity on the part of lenders.

We expect and demand that prudent lending standards be applied by all lenders, including those who take back so-called "junk bonds" in the course of lending. The large investors who purchase most of these bonds are relatively sophisticated and should be aware of the risks involved. The rating services also play a major role in evaluating the nature of these investments. But it would be fair to say that one cannot really be entirely comfortable assuming that the risks are clearly understood, especially when the market has not been tested by some significant negative surprises--which inevitably come. The much higher rates paid on the junk bonds suggest that they are perceived to involve greater risks; the question is whether the risk premiums will in fact prove to be adequate.

Lending to finance mergers and acquisitions need not weaken the financial fabric, however. 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 any significant problems for financial markets arising out of this activity. In part, this reflects the favorable economic and financial environment of the current expansion. While some individual firms have taken on greater leverage, other businesses have taken advantage of improved conditions to strengthen their balance sheets.

We do not believe that arbitrary controls on uses of credit can be effective or desirable. As I noted previously, any given merger, acquisition, or divestiture may result in social and economic benefits through economies of scale, better management or generally a more efficient allocation of resources. 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.

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. In addition, Congress and 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 the stockholder population are provided adequate protection.

Attachment 1

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

	Completed transactions	
	Number	Dollar volume ($ billions)
1967	1,800	$15.0
1968	2,440	28.0
1969	3,012	n.a.
1970	1,318	n.a.
1971	1,269	n.a.
1972	1,263	n.a.
1973	1,064	n.a.
1974	1,088	n.a.
1975	859	n.a.
1976	1,058	n.a.
1977	1,139	n.a.
1978	1,364	n.a.
1979	1,420	n.a.
1980	1,470	34.7
1981	2,231	72.4
1982	2,182	65.1
1983	2,191	50.5
1984	2,807	122.0

n.a.--not available.

1. Purchases of U.S. corporations by other U.S. companies and by foreign companies. 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. Divestitures or sales of subsidiaries, divisions, or product lines are included in dollar volume numbers.

Source: Mergers and Acquisitions magazine.

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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		
			Cash	Stock	Debt
		---------- millions of dollars --------			
1984					
Chevron	Gulf	13,300	13,300	—	—
Texaco	Getty Oil	10,120	10,120	—	—
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	—
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
1985					
Nestle	Carnation	3,000	3,000	—	—
Rockwell International	Allen Bradley	1,650	1,650	—	—
Textron	Avco	1,380	1,380	—	—
Chesebrough-Ponds	Stauffer Chemical	1,250	1,250	—	—
Pending:					
Capital Cities Commu.	ABC	3,500	3,400	100	—
Mesa Partners II	Unocal	3,400	3,400	—	—
Coastal	Am. Nat. Resources	2,460	2,460	—	—
Cooper Industries	Mc-Graw Edison	1,400	1,400	—	—
Cox Enterprises	Cox Communications	1,260	1,260	—	—
Royal Dutch/Shell	Shell Oil[3]	1,170	1,170	—	—
Farley Industries	Northwest Industries	1,000	800	200	—

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

DEBT-TO-EQUITY RATIOS
NONFINANCIAL CORPORATIONS
1961 - 1984

Year	Debt(Par)[1] / Equity(Current)	Debt(Par)[2] / Equity(Market)	Debt(Market)[3] / Equity(Market)
1961	41.1	38.5	35.3
1962	42.5	45.6	42.4
1963	44.5	41.7	38.9
1964	45.4	39.8	37.7
1965	46.5	40.0	37.7
1966	47.4	48.4	43.4
1967	48.7	41.3	36.4
1968	50.5	40.2	35.6
1969	50.3	50.3	41.5
1970	50.7	54.7	48.0
1971	50.7	50.0	46.7
1972	50.3	48.1	45.4
1973	48.9	67.7	61.9
1974	43.9	105.2	91.1
1975	41.6	79.5	72.0
1976	41.1	74.2	72.9
1977	41.4	87.6	84.0
1978	41.1	94.8	87.5
1979	39.9	88.7	79.0
1980	37.8	70.0	60.2
1981	38.3	82.7	70.0
1982	40.0	77.7	71.1
1983	40.6	69.2	63.3
1984	45.4	82.8	73.1

1. Debt is valued at par, and equity is balance sheet net worth with tangible assets valued at replacement cost.
2. Debt is valued at par, and equity is market value of outstanding shares.
3. The market value of debt is a staff estimate based on par value and ratios of market to par values of NYSE bonds; equity is market value of outstanding shares.

Source: Board of Governors of the Federal Reserve System, Flow of Funds.

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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 <u>amount</u> and <u>type</u> (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.