For release on delivery
9:30 A.M. EDT
May 3, 1985

Statement

by

Preston Martin

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

House Committee on Banking, Finance, and Urban Affairs

May 3, 1985

I am pleased to appear before this Subcommittee to discuss recent merger and buyout activity and the impact of this activity on domestic credit flows and the safety and soundness of financial markets.

The dollar volume of completed merger transactions totaled over $120 billion last year, more than double the experience of any previous year (attachment 1). A substantial portion of this volume--more than $50 billion--was attributable to very large combinations, each involving more than $1 billion (attachment 2). So far this year we have continued to witness a substantial volume of acquisitions and proposed combinations. Although it is unlikely that all of the proposed mergers will reach fruition, the current volume is certainly large enough to warrant continued monitoring of market impacts.

As I have noted in recent testimony before other congressional committees, I believe that 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. Thus, we must be careful about attempting to impose the judgment of governmental authorities about which private transactions will be economically productive and which will not. Nonetheless, government is obliged to do what it can to ensure that certain kinds of risk-taking do not jeopardize the stability of our financial system. From the perspective of the Federal Reserve, our concerns have focused on the effect that merger and takeover activity is likely to have on aggregate credit flows and on the risk exposure of financial institutions and markets.

Many of these merger transactions have been financed, at least initially, with debt. More than $15 billion of the 1984 volume represented leveraged buyout transactions (attachment 3), which typically rely on debt financing for as much as 80 to 90 percent of the purchase price, often using the assets of the company as collateral for the loans. Bank credit used to finance large mergers or defensive actions to avoid takeovers totaled an estimated $35 billion last year (attachment 4). About two-thirds of these loans were from U.S. banks, but foreign bank participation also was sizable. In the first quarter of 1985, large merger-related bank loans have totaled about $7 billion, with most of these loans supplied by U.S. banks.

Such credit is small relative to total credit outstanding at banks. Moreover, many merger-related bank loans are paid down fairly quickly with funds raised by sales of assets, or with proceeds from the sale of commercial paper or long-term securities. Thus, for example, approximately two-thirds of the large-merger bank loans extended in 1984 have been repaid. Nonetheless, the heavy reliance on debt, from whatever source, to effect the substantial number of mergers, takeovers, and leveraged buyouts raises questions about the potential impact that the transactions may have on aggregate credit flows and on the exposure, owing to heavy leveraging, of the firms involved.

The Board is aware of the influence of merger activity on aggregate credit flows, and takes it into consideration when evaluating the behavior of the money and debt aggregates. Growth in the domestic nonfinancial debt aggregate, which we monitor in the course of our monetary policy deliberations, is estimated to have been boosted by about 1 to 1-1/2 percentage points in 1984 as a result of merger-related credit extensions. But mergers and buyouts appear to have had a much more limited impact on the three monetary aggregates for which we establish target ranges. The narrow money aggregate, M1, may be increased temporarily as a result of a large merger, but proceeds from merger sales generally are reinvested in other assets, and the effect of M1 tends to be small over periods of time relevant for monetary policy considerations. The broader aggregates, M2 and M3, may be boosted somewhat more than M1, as some proceeds from stock sales flow into time deposits, money market mutual funds, and other assets included in these aggregates. But relative to the size of M2 and M3, this effect also would be relatively minor. Given our ability to evaluate the size and timing of large transactions, we can anticipate possible distortions to the aggregates in a particular period and thus avoid inadvertently reacting to these factors rather than more fundamental determinants of credit demand in our policy deliberations. As a result, I do not believe that mergers present an operational problem for us that could cause appreciable unintended variations in reserve market pressures.

Assessing the implications of merger activity is quite complex, however, and even though we do not believe that debt-financed merger actvity has had a significant effect on aggregate credit flows, we are concerned about the potential risk exposure that may result as firms retire existing equity with funds raised through increased use of debt.

Last year, nonfinancial corporations retired more than $85 billion of equity through mergers, takeovers, and share repurchases. 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 measures taken to lessen the possibility of outsiders buying significant amounts of stocks; other repurchases were made because corporations find them to be a more profitable way to invest funds. When a company believes that the value of its assets is higher than the market's valuation 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 less important source of equity is new stock issues. Retained earnings of all nonfinancial firms offset the net retirement of stock, and net additions to equity in the aggregate remained positive last year 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 (attachment 5). 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, in its roles as supervisor of banks and bank holding companies and lender of last resort, has responsibility in conjunction with other regulatory agencies for maintaining the safety and soundness of financial institutions and markets. To date, we have seen no evidence indicating that the credit extended to finance mergers and leveraged buyouts has resulted in significant problems for the surviving firms or the financial institutions that have extended credit to them. Of course, our economy has been undergoing an expansion that has provided a favorable economic and financial environment for growth, and thus the companies created by recent mergers, as yet, have not been tested by adverse economic conditions. Currently, there are indications that economic growth may be slowing. Should the earnings prospects of these firms deteriorate unexpectedly, or interest rates rise sharply, some firms may be strained to service heavy debt burdens. In this event, the institutions that provided the credit could in turn be exposed to possible losses.

Leveraged buyouts may be of particular concern because these purchases typically are executed with particularly heavy reliance on debt financing. Because buyout loans often involve floating rate debt, the purchasing companies will be especially vulnerable in the event that interest rates rise substantially and cash flows are not adequate to service the heavy debt burdens.

The Federal Reserve has actively urged banks to evaluate carefully all loans, but particularly those used to finance buyouts and other types of takeover transactions, and to apply prudent standards in making credit decisions. We regularly include specific instruction with respect to the review of bank lending activity and loans associated with leveraged buyouts in our training courses for bank examiners. In June 1984, we offered additional training for dealing with leveraged buyouts for senior bank examiners. At about the same time, we issued specific guidelines for examiners at each of the 12 District Federal Reserve Banks to follow in evaluating loans for financing leveraged buyouts and for assessing the total exposure of a bank to such lending.

A recent review of the results of bank examinations indicated that only a small number of state member banks appeared to actively lend for purposes of effecting leveraged buyouts to the extent that they might be exposed to adverse changes in market conditions. No banks have experienced serious problems to date as a result of such lending. While these survey results suggest that there is little reason for alarm at this time, we will continue to evaluate this activity and to adjust our policies as needed. We encourage all lenders to apply prudent lending standards, particularly purchasers of low-rated or unrated bonds, which appear to have become popular vehicles for financing takeover attempts. Most of the purchasers of these so-called "junk bonds" that are used to finance merger activity reportedly are large, sophisticated investors who should be aware of the risks involved in holding such instruments. The higher rates paid on these bonds suggest that they are perceived to involve greater risks, but the question of whether the risk premiums will prove to be adequate to compensate investors for the exposure they undertake remains unanswered in as much as the market has not been tested by significant negative events.

I do not wish to imply that lower quality bonds are undesirable financial instruments. These securities provide an important source of financing for many small, unknown companies. A new firm may have good growth potential, but because it, as yet, is untested, its debt issues likely will be rated below investment grade; some new companies opt not to obtain a rating owing to the cost involved and to the likelihood of being granted a speculative grade. It is important that less well-known companies be able to raise funds in securiites markets and important that investors seek a thorough understanding of the investment merits and risks associated with lower grade securities.

Federally chartered banks may make loans to finance mergers; they are prohibited from acquiring below investment grade bonds in their investment portfolios. However, some state-chartered institutions currently may not be subject to such restrictions. Indeed, some state-chartered thrifts have purchased these securities. Given the sensitivity of financial markets to the fortunes of individual institutions, we continue to encourage supervisors at both state and federal levels to evaluate carefully developments in this area and to take adequate steps to prevent undue exposure of individual institutions to unexpected events.

The Federal Reserve Board does not believe that arbitrary controls on the use of credit can be desirable or effective. 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.

Since mergers can be important mechanisms for redeploying corporate assets to more profitable uses, promoting better management, economies of scale or scope, or reinforcing market incentives, we must be careful about imposing the judgment of governmental authorities concerning which private transactions will be desirable from a social and economic standpoint. When governmental controls on the use of credit are in existence for any length of time, they become increasingly inequitable as market participants find ways to circumvent them. And such controls are usually extremely difficult to enforce; since credit is fungible, most financing can be achieved through alternative channels, such as borrowing through unregulated intermediaries, from foreign lenders, or the like.

In this regard, I also would like to comment on the role of margin regulations as they may affect merger financing. Margin regulations apply to lenders making loans for the purpose of purchasing securities when those loans are collateralized with securities. Thus, investors that wish to purchase stocks on credit may, under current margin requirements, borrow 50 percent of the purchase price, and pledge the acquired stocks as collateral. The recent tendency for stock prices of target companies to rise when a takeover or merger is anticipated suggests that some investors may be purchasing shares of these companies in anticipation of realizing gains as the merger transactions are negotiated. Although we have no data on such individual stock trades, it may be that some involve margin credit extensions. The 50 percent margin requirement, we believe, is more than adequate to ensure the integrity of the market place in the event of unexpected price movements in these and other stocks.

Margin credit likely has played a quite limited role in the actual financing of mergers and takeovers. The margin regulations do not apply to unsecured loans or loans secured by assets other than securities. Well-capitalized companies may borrow to purchase shares in another company by pledging other types of assets as collateral or by using unsecured loans, in which case the lenders would not be subject to margin requirements. Given the current high margin requirements, there is a strong incentive for firms to use other means of financing acquisitions when possible. Unfortunately, there are areas in which the application of margin regulations is cloudy; in particular, questions have arisen concerning credit extended to purchase securities which may be "indirectly" secured by stock. These cases require a regulatory review to determine whether or not the extension of credit would be subject to margin requirements. As you may be aware, Federal Reserve staff currently are reviewing a petition to this effect by Unocal. Up to this time, the Board has not believed that efforts to curb takeover activity by expanding the scope of margin regulations to cover selected types of transactions has been a desirable option. Such a course runs all the risks of distorting capital flows and impeding the efficient allocation of resources like other selective credit controls.

I would like to reiterate that I do not wish to imply that we should be complacent about the implications of lending to effect mergers and buyouts. The Federal Reserve will continue to monitor this activity and its effects on financial markets, and review our examination standards in light of developments in this area.

Attachment 1

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

Period	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
1985-Q1p	746	29.5

n.a.--not available.
p--preliminary.
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.

May 1, 1985

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	--	--
Coastal	Am. Nat. Resources	2,460	2,460	--	--
Rockwell International	Allen Bradley	1,650	1,650	--	--
Textron	Avco	1,380	1,380	--	--
Chesebrough-Ponds	Stauffer Chemical	1,300	1,300	--	--
Pending:					
Turner Group	CBS	5,400	--	1,000	4,400
Capital Cities Commu.	ABC	3,500	3,400	100	--
Mesa Partners II	Unocal	3,400	3,400	--	--
Hospital Corp. of Am.	Am. Hospital Supply	2,400[3]	--	2,400	--
Cooper Industries	Mc-Graw Edison	1,400	1,400	--	--
Cox Enterprises	Cox Communications	1,260	1,260	--	--
Kohlberg, Kravis Group	Storer Commu.	1,640	1,240	400	--
Royal Dutch/Shell	Shell Oil[4]	1,170	1,170	--	--
Farley Industries	Northwest Industries	1,000	800	200	--

1. Shares in U.S. companies totaling $1.0 billion and over. Divestitures are excluded. Data are based on public information.
2. Leveraged buyout.
3. Valued as if American Hospital Supply were the acquired firm.
4. Final portion of Shell shares.

May 1, 1985

Attachment 3

COMPLETED LARGE LEVERAGED BUYOUTS[1]

Year	Buyouts of entire companies		Buyouts of divested units	
	Number	Volume ($ billions)	Number	Volume ($ billions)
1980	1	.5	n.a.	n.a.
1981	4	1.9	n.a.	n.a.
1982	10	2.7	n.a.	n.a.
1983	14	2.0	11	1.5
1984p	35	15.8	13	2.4

p--preliminary.
1. Includes transactions of $60 million and over for which public information is available.

Source: Federal Reserve staff estimates.

May 1, 1985

Attachment 4

LARGE MERGER-RELATED BANK CREDIT DEVELOPMENTS

	1984		1st Quarter 1985	
	Total (U.S. and foreign banks)	Estimated U.S. bank participation[1]	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 corporations[2]	60.3	35.8	9.3	8.7
Merger-related loans taken down[3]	34.9	25.3	7.0	6.7
Memorandum:				
Total loans outstanding at all banks (excluding interbank loans)	--	1,329.4 (12/84)	--	1,347.3 (3/85)

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 for merger financing and takeover defenses arranged in 1984 by 21 companies in amounts ranging from $0.5 to $14.0 billion. First quarter 1985 figures include 10 credit lines in amounts ranging from $0.3 to $1.8 billion. Very large credit lines, such as those associated with the largest mergers in early 1984, require greater participation of foreign banks in part due to lending limits applicable to U.S. banks.
3. Amounts reflect estimated maximums taken down before repayments commenced. Substantial repayments (over two-thirds of the total taken down in 1984) were made by several borrowers using proceeds from sales in the commercial paper and long-term markets as well as from sale of assets. Three of the credit lines arranged for merger financing were not taken down in 1984, but one of these was used in 1985. Two of the credit lines arranged in the first quarter of 1985 have not yet been utilized.

April 30, 1985

Attachment 5

DEBT-TO-EQUITY RATIOS
NONFINANCIAL CORPORATIONS

Year	Debt(Par)[1] / Equity(Current)	Debt(Par)[2] / Equity(Market)	Debt(Market)[3] / Equity(Market)
	----------percent----------		
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	47.5	79.8	70.5

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.

May 1, 1985

Attachment 6

DOMESTIC BOND OFFERINGS BY U.S. CORPORATIONS IN 1984

	Total	Below investment grade[1]	
		Total	Merger-related[2]
	---billions of dollars---		
Public offerings[3]	63.6	16.1	6.5
Private placements	36.3	n.a.	4.3
Total[3]	100.0	n.a.	10.8

n.a.--not available.
1. Bonds with a rating of Bal or below or no known rating.
2. Bond offerings by corporations that had made acquisitions or repurchases of own stock within 12 months of the offering. Those offerings that specifically listed as a purpose of the issue the repayment of debt from mergers extending further back are also included.
3. Excludes mortgage-backed bonds.

May 1, 1985