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Statement by

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before the

Committee on Finance

U S. Senate

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## Summary

The continuing heavy flow of mergers, acquisitions, leveraged buyouts, share repurchases, and divestitures in recent years is a significant development. While the evidence suggests that the restructurings of the 1980s probably on balance are improving 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.

These transactions have involved the retirement of substantial amounts of equity (more than \$500 billion since 1983), and have been mostly financed by borrowing in the credit markets. The increase in debt has resulted in an appreciable rise in leverage ratios for many of our large corporations, and the ability of firms in the aggregate to cover interest payments has deteriorated.

Major changes in the economic environment imply substantial, perhaps unprecedented, shifts in the optimal mix or use of assets at firms. Managers often have been slow in reacting to changes in their external environment and the potential gains from a change in corporate control have risen, as evidenced by the sharp rise in tender-offer premiums since the 1960s.

Moreover, innovations in capital markets have facilitated this process. Improvements in the loan-sale market among banks and the phenomenal development of the market for low-grade corporate debt, so-called "junk bonds," have enhanced the availability of credit for a wide variety of corporate transactions. Evidence about the economic consequences of restructuring is limited. Many of the internal adjustments brought about by changes in management or managerial policies are still being implemented. So far, available evidence indicates generally enhanced operational efficiencies.

We cannot ignore the implications that heavy leveraging has for risk to lenders. Most of the restructured firms appear to be in mature, stable, non-cyclical industries. Some of the lenders are well diversified, familiar with risky investments, and not themselves highly leveraged. The sizable share of restructuring loans held by banks, though, is of concern.

It would be unwise to arbitrarily restrict corporate restructuring, including the leveraging feature. However, 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.

Exposure of the banking system to highly leveraged firms also warrants attention. The circumstances associated with highly leveraged deals require that creditors exercise credit judgment with special care. This entails assessing those risks that are firm-specific as well as those common to all such firms.

Mr Chairman and other members of the Senate Finance Committee, I am pleased to be here today 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 restructurors, 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.