Speeches FDIC

TESTIMONY OF

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ON

THE IMPACT OF HIGHLY LEVERAGED TRANSACTIONS UPON THE BANKING INDUSTRY

BEFORE THE

House COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

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Good morning, Mr. Chairman and members of the Committee. I thank you for this opportunity to address the Committee on the impact of "leveraged buyouts" ("LBOs") on our economy, and particularly on the banking industry. As the insurer of the banking system, the Federal Deposit Insurance Corporation is vitally interested in this matter.

My remarks will focus on four specific areas: first, the definition of LBOs; second, the potential effects of escalating corporate debt on the U.S economy; third, specific banking concerns regarding the volume of LBO lending, concentrations of lending and credit quality; and, finally, the FDIC's supervisory role relative to LBO activities in the banking system.

DEFINITION

"Leveraged buyout" may mean different things to different people. As of yet, there is no universal definition. Generally, LBOs refer to management-led leveraged buyouts (or as termed by Treasury Secretary Brady -- leveraged takeovers) and highly leveraged acquisitions. An LBO is one type of "highly leveraged transaction" ("HLT"), a more encompassing term that includes LBOs and other transactions financed in significant part by debt. We use the acronyms "LBO" and "HLT" interchangeably in this statement.

There is no universal standard for determining whether a company is "highly leveraged." What is considered high in one industry may not be considered high in another. Bankers Trust Company defines an HLT as "any transaction where the total debt incurred by the company -- including working capital loans, mezzanine financing [that is, instruments with combined debt and equity characteristics] and senior debt -- exceeds 70 percent of the borrowers' capital structure." Generally we agree with that definition but, again, it depends on the particular company or industry. Certainly, a firm could be highly leveraged with much lower levels of debt.

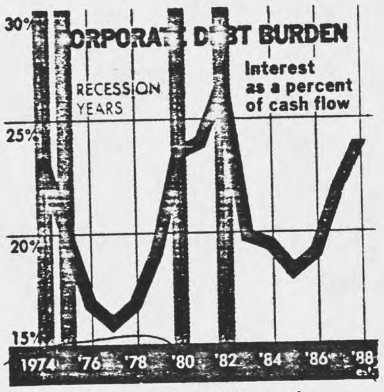
ECONOMIC POLICY CONCERNS

American corporations are going increasingly into debt. Corporate debt (excluding debt of financial institutions) totaled $1.8 trillion as of the third quarter of 1988, compared with less than $1 trillion in 1982. Between 1982 and yearend 1987 corporate debt, as a percentage of the gross national product, rose from 30 percent to 37 percent and, as a percentage of corporate net worth, expanded from 30 to 46 percent. As of year-end 1987, the corporate debt-equity ratio stood at 71 percent on a market-value basis. Although greater than the debt-equity ratios for 1985 and 1986, it was below that for each year from 1974 through 1979. The record high for the debt-equity ratio was approximately 104 percent in 1974.

The Treasury Department has estimated that, for 1988, the amount of corporate debt incurred through LBO activity is over $60 billion, or 3.3 percent of nonfinancial corporate debt. About a third of this debt is in the form of "junk bonds" while the majority is senior debt which is secured by the assets and receivables of the target corporation. Most of the leveraged acquisition lending has occurred in the past two years and is highlighted by the recent $25 billion RJR Nabisco deal engineered by the investment banking firm Kohlberg, Kravis, Roberts & Company.

As previously noted, in absolute terms, the nonfinancial corporate debt level is at record highs -- around $1.8 trillion as of the third quarter of 1988. The current nonfinancial corporate debt-service ratio (as measured by net interest payments divided by pre-tax earnings) stands at approximately 32 percent, and has been rising gradually since 1985. This is the key risk ratio. The burden on corporate cash flows by debt obligations is now above the level for every year in the 1970s, but is below the debt-burden for the 1982 recessionary period. However, the 1982 period was characterized by declining corporate earnings and high interest rates, both contributing to a high debt-service ratio. An important and sometimes overlooked fact is that the current period of increasing debt service ratios differs from highs in the past in that it has occurred while corporate earnings have been robust. Therefore, concern over the financial well-being of highly leveraged corporations in the face of an imminent economic downturn is not unfounded.

Thus, the most worrisome evaluation of the current debt burden is that the high level of interest cost as a percentage of cash flow has occurred during a strong economic upswing and not during a recession. This ratio normally has gone up during a recession as the result of reduced income caused by the downturn. During the next recession a normal rise in the debt-service ratio seen during the slow down would put the ratio well above previous record levels, thus substantially increasing the seyerity of the recession. This assessment is illustrated by the following graph:



Before LBOs, corporate debt rose in recessions and dropped during expansions.

No one can be sure at what level of debt-servicing capability the entire economy may be jeopardized. The level of debt to debt-servicing ability which is too risky to be acceptable is usually discovered too late -- only after it is proven by unfortunate actions in the real world. Those who find the increasing level of debt to servicing ability acceptable today, are more sanguine than we are.

Why have the number and volume of LBO transactions mushroomed in recent years?

Nobody knows for sure. The U.S. tax code creates a bias toward debt over equity financing in that interest on debt is a tax deductible expense whereas dividends result in double taxation. Still, these tax advantages of debt are longstanding and alone cannot account for this phenomenon.

Moreover, the Tax Reform Act of 1986, which lowered the statutory corporate income tax rate, has served to reduce the relative tax advantage of corporate leverage. Furthermore, the decline in interest rates since the early 1980s has reduced the absolute amount of interest payments that would be subject to this preferential tax treatment.

If Congress should decide to reverse this built-in bias toward debt financing, and we would recommend that they explore ways to do so, we suggest that the best way would be for dividends to carry with them a tax credit for corporate tax paid. We would not recommend a limitation on interest deductions because of the difficulty of defining good and bad interest payments. If our suggestion is adopted, shareholders -- in receiving a dividend -- would be able to take a credit against their personal tax for any corporate tax paid on the dividends received. This would avoid the undesirable effect of an undistributed profits tax if corporate dividends were deductible. If dividends were deductible, corporations would be moved to pay out all their earnings in dividends to avoid tax. This is not desirable as it reduces funds available for investment. In addition, credits would have a far less drastic effect on reducing tax revenues than deductible dividends.

While the debt bias in the tax code remains a factor, two other variables may help explain the pace of LBO activity in the 1980s. First, the diversification programs of many large corporations that began in the mid-to-late 1960s proved to be unproductive in many cases -- that is, the anticipated "synergies" did not occur. Thus, situations exist where the sum of the individual parts of the conglomerate have greater value than the whole. The diminished value in these conglomerates, as evidenced by the large takeover and restructuring premiums we now see, have generated profit opportunities for willing investors or astute managers. New financial institutions -- "buyout specialists" -- have arisen to capture these economic profits and LBOs often have been the vehicle used.

Secondly, financial innovations in the form of high-yield debt instruments have been developed to finance these deals. "Junk bonds" and mezzanine financing are among the vehicles used. These have helped facilitate increased LBO activity because they eliminate size as a deterrent to takeovers.

Are LBOs good or bad for us?

LBOs have some good and bad aspects. In their favor, buyers or owners can profit from LBOs. They can "build up" a failing or floundering company or they can "break up" the company by selling the individual pieces. When done properly, both are positive developments since the new corporate leaders have every incentive to improve management and create more efficient structures. Restoring companies to profitability and realizing their full value leads to a sound return on investment and creates wealth.

On the other hand, there are clear dangers to corporate entities with a high degree of leverage. The ability of corporations to service their debt obligations depends critically upon maintaining stable cash-flows over the business-cycle. The current evidence indicates that most LBO activity has been restricted to industries that have traditionally been fairly well insulated from business-cycles. Nevertheless, higher debt obligations relative to cash-flows place these firms at greater risk.

As we have noted, if a recession should occur, many bankruptcies could result. A large-scale increase in bankruptcies could erode public confidence and convert a mild recession into a severe one. Princeton Professors Ben S. Bernanke and John Y. Campbell recently completed a simulation study of approximately 1,400 large corporations. They concluded that 10 percent of the firms studied would become insolvent if a severe 1974-type recession occurred. Moreover, highly leveraged firms with a low net worth relative to liabilities would have more difficulty tapping the credit market and securing capital to help proceed through the economic slowdown.

While overall corporate debt levels may increase risk, many such transactions may be beneficial by improving productivity and the efficiency of the entities involved. In many cases the market discipline imposed by LBO activity and the subsequent removal of "entrenched management" have salutary effects on the resulting corporate entity. As Professor Michael C. Jensen of the Harvard Business School points out, some buyout specialists of the 1980s are "much more than an expediter of LBO transactions. [Rather, they play] an important role in management after the transaction . . . They choose managers of the firm and influence corporate strategy in important ways." They take an active role in restoring value to the corporate entity that was destroyed due to the lack of effective monitoring by corporate managers. The gains to stockholders are often positive. The total premium to public shareholders ranges from 40 to 56 percent, which captures a part of the value of the firm not realized under the previous management. In support of this view, the initial evidence on LBOs after a buyout points to real increases in productivity and operating efficiency in many cases.

From the standpoint of bank involvement in LBOs, any effort to reduce the relative advantage of high-risk leveraged buyouts over equity buyouts would disadvantage banks. This is because current law restricts bank involvement in equity transactions.

Other areas that deserve careful attention in judging an LBO include the effect of the deal on the firm's employment levels and research-and-development expenditures. Firms may try to introduce cost-cutting measures in these areas in order to service the debt.

Target companies often spend considerable resources to reduce their vulnerability to takeovers. "Poison pills" (which give shareholders special rights to acquire shares at below value prices) ~~and~~ "golden parachutes" (which give senior managers high severance bonuses if they are fired) are examples of costly defenses a company can use to preserve the status quo.

Employee Stock Option Plans ("ESOPs") also have been used to prevent "takeovers." They have become something of a "double-edged sword" in their role in the restructuring of corporate America. On the one hand, they continue to serve the purpose for which they were originally created -- to place greater corporate ownership in employees' hands. The beneficial economic incentives of giving employees a greater stake in the future of the firm remain as real today as they were when ESOP legislation was originally enacted. On the other hand, over the years ESOPs have acquired tax advantages and other features that have made them a tool to both take over other firms and defend against takeovers.

Under current tax law a bank, insurance company, regulated investment company or corporation may exclude from income 50 percent of the gross interest earned from loans to a leveraged ESOP. This advantage allows them to make such loans at a lower rate than for non-ESOP loans. Companies desiring to do takeovers can use an ESOP (where an ESOP borrows funds to purchase employer securities) to raise funds on favorable terms for use in acquiring other entities.

In a leverage ESOP, the stock purchased by the corporation for its employees is held in a suspense account and allocated to the employees' accounts over time as the loan is repaid. Prior to the allocation, the shares may be voted by plan trustees so as to help thwart hostile takeover attempts.

All in all, we would suggest that there are both desirable and undesirable LBO transactions. Thus, care should be taken with respect to placing undue obstacles to such transactions. But clearly the tax system is biased toward use of debt and this is on the way to increasing the level of overall risk in the economy to undesirable levels.

BANKING CONCERNS

Most LBO financings in the United States are originated by our largest banks. Ten multinational banks serve as the originating or lead banks in most LBO transactions. As of September 30, 1988, reported LBO loans outstanding in these institutions were approximately $20.2 billion, representing only 4.4 percent of the book value of all loans in these institutions but 61.8 percent of the combined common equity of these banks. Originating banks generally do not keep all LBO loans in their portfolios. Instead they sell participations to others without recourse and often retain only 10 percent or less of a transaction. Japanese and U.S. banks, insurance companies, pension funds and thrifts have been the principal buyers.

The large banks compete vigorously in the LBO field because of the large profits available (although the spreads have been narrowing of late) and the paucity of profitable lending alternatives. Loan spreads usually approach 200 basis points above conventional type commercial lending. Substantial origination fees and selling fees create significant added inducements. This is important because traditional bank corporate lending is not as large or profitable as in the past. "Blue chip" corporations no longer have as great a need for bank loans because they can sell debt directly in the capital market through commercial paper. Margins on the remaining top corporate loans are thin as foreign and domestic banks compete vigorously for the business.

As stated above, LBO concentrations as a percentage of bank equity are relatively high at the multinational banks. The level of exposure, though, is relatively stable as the banks are selling significant portions of these loans shortly after origination and some LBO loans are beginning to drift into the regional and smaller banks. There are some exceptions, but generally the smallest banks have not acquired LBO concentrations.

Credit quality becomes especially relevant when a concentration of risk assets exceeds 25 percent of a bank's capital. Because LBO loans now average over 50 percent of the equity capital of at least the ten largest multinational banks, the FDIC is concerned about the credit quality of LBO lending, as we are about any concentration at this level. Typically -- but not always --

originating banks keep a portion of the senior debt (which is the highest quality part of a deal), but pass on the mezzanine and equity participation portions to other institutions, including non-bank affiliates of the originating bank. Nevertheless, there is risk. As discussed above, economic downturns or interest rate increases could put leveraged companies in jeopardy and result in loan defaults.

Besides relying on corporate earnings, repayment of many LBO loans also is dependent on receipts from the sale of assets. Predicting what values these sales will bring in an uncertain future marketplace is even more difficult than predicting operating cash flows. Lenders also must be concerned about interest rate risk and, therefore, most prudent LBO deals require hedging techniques by either or both the lender and the borrower in order to minimize this risk.

Banks -- at least the major ones -- grade all their loans on a scale based on credit quality. Loans backed by U.S. Treasury bonds, for example, would be at the top of the quality scale. The majority of LBO loans in commercial banks are graded on the low end of the acceptable investment grade scale. So far, very few LBO transactions have been adversely classified by bank examiners. These loans have been performing and internal grading assessments, for the most part, have been accurate.

No one can speak for the future, however. Current LBO loans have been booked in a favorable economic climate with repayment assumptions predicated on the continuation of a nonrecessionary environment. In the last several years, for example, a few steel companies that restructured with high leverage got into financial difficulty. Revco, once the biggest drug store chain in America, was a major LBO deal that floundered. Nonetheless, downturn in the economy could trigger other LBO bankruptcies and push many of the LBO loans from the "barely acceptable" credit quality category into "substandard" or worse.

Should an economic downturn occur, defaults on excessive LBO debt could increase the risk of bank failures and thereby increase costs to the FDIC insurance fund. Thus, as the insurer of the banking system, we will be closely monitoring LBO transactions to assure that risks are controlled and our insurance fund protected.

FDIC ACTIVITY

We have been monitoring LBO lending for several years. Examination guidelines pertaining to evaluation of LBO loans were distributed to examiners in 1984. The discussion of LBO financing in our Manual of Examination Policies has been updated twice since 1986. We have surveyed our regions to determine the extent of LBO exposure in the banks we supervise and will do so again this year. We are preparing additional guidelines to help examiners and bankers evaluate the adequacy of bank policies, procedures and controls relative to LBO lending.

From a supervisory standpoint, the FDIC's policy is to list concentrations of credit that exceed 25 percent of a bank's capital in our examination reports. We consider LBOs to be a concentration category. Aggregating all LBO transactions together as a concentration in an institution has analytical merit because high leverage entails high risk. However, there also are mitigating factors. LBOs are scattered among many industries that respond differently to economic cycles. Risk is also diversified by holding small pieces of numerous deals rather than concentrating exposure in a few transactions.

The listing of such concentrations in reports of examination, therefore, is primarily informational and the degree of any criticism accorded such a concentration will depend on several factors. Those factors include the diversification within the LBO portfolio, the quality of the individual credits, management's expertise, the bank's policies and internal controls, management's demonstrated ability to conduct independent credit analysis of each deal and the capital and earnings capacity of the bank.

Banks that do not have the expertise to conduct in-house independent credit analyses of LBOs should not be engaging in or buying participations in such transactions. This pertains to the vast majority of small banks and some regional banks. Potential purchasers must not rely on the seller to perform the analysis for them -- especially because sales are made without recourse.

Our interest in LBOs is not limited to just the banks we supervise (*i.e.*, state-chartered banks that are not members of the Federal Reserve System), but extends to all banks insured by the FDIC. Several years ago, for example, the federal and state bank supervisory agencies adopted a "Uniform Agreement on the Classification of Assets and Appraisal of Securities." It was reaffirmed as recently as 1979. This policy effectively dissuades all insured banks from acquiring subinvestment quality securities since securities rated below the top four rating bands by a nationally recognized rating service (or unrated securities of equivalent quality) are classified as substandard assets. "Junk bonds," as we know them, fall within the subinvestment quality definition and therefore are criticized if acquired by FDIC-insured banks. Consequently, almost no "junk bonds" are held by FDIC-insured institutions.

We believe that LBO lending requires more than the minimum amount of capital protection. We expect any FDIC-insured bank with a significant exposure in LBO loans to operate with a correspondingly higher level of capital. We also expect these banks to provide loan loss reserves that adequately recognize the additional portfolio risk inherent in highly leveraged financings.

In addition to our individual attention to LBO activity, we also will be involved in cooperative efforts with the Office of the Comptroller of the Currency and the Federal Reserve Board in learning more about LBO lending. During 1989 we will participate with those agencies in the examinations of several multinational and large regional banks. Part of that effort will be to ascertain which banks are purchasing LBO loans from originating banks, particularly if the buyers are regional and community banks. We want to monitor what credit and documentation information is provided to the participating banks, and what type of loan analyses those banks perform.

The vast majority of LBO credits fall within what the three federal bank regulators call the "Shared National Credit" ("SNC") program. These are credits of $20 million or greater that are shared by two or more banks. The credits are examined and classified in the spring of each year by special, highly qualified interagency teams of examiners to ensure that the loan is treated the same way at each participating institution. At the upcoming SNC examinations, we will focus more closely on LBO lending. Examiners will receive specialized training at the commencement of the examinations. The purposes of all loans will be clearly highlighted so that HLTs can be readily flagged and totaled on a nationwide basis.

CONCLUSION

Our information at this time is that banks are managing their LBO financing risks prudently. We do not now perceive any serious threat posed by such financing to the banking industry. However, we will continue to monitor the situation closely.

For the U.S. economy, the risk of increasing debt is clearly rising too rapidly.