An increased use of debt financing has been a hallmark of the financial restructuring of corporate America that has taken place in the mid- and late 1980s. An organization that develops from a corporate reorganization now commonly has 80 to 90 percent of its financing in the form of debt, in contrast to the 30-percent debt-to-assets ratio that prevailed in the previous two decades. Because of the high degree of leverage employed in these deals, they are often referred to as leveraged buyouts (LBOs), a form of highly leveraged financings.

The news media, Congress, and the regulatory community have all focused considerable attention on LBOs in recent months, largely because of the use of this financing arrangement to fund corporate takeovers. Media interest has been heightened by the size and volume of recent deals, particularly the reported $25.3 billion that the firm of Kohlberg, Kravis & Roberts paid for RJR Nabisco. The total volume of LBO deals for 1988 exceeded $98 billion.

Congressional attention concerns the use of LBOs in takeover deals that involve a major restructuring of the acquired company. The result in such deals may be layoffs and plant closings in communities where the acquired firm is the major, and sometimes only, employer. Some members of Congress are also wary of the LBO market's potential effect on consumer and small-business credit and on the stability of the financial system itself. Furthermore, because the tax code makes debt financing relatively less expensive than equity financing, Congress is concerned that tax considerations alone may be a major motivation behind many of the LBO deals. The LBO situation is so important that only the $100 billion thrift-industry bailout and deposit-insurance reform take precedence over it on the 101st Congress's agenda for regulatory reform in the financial sector.

Bank regulators are becoming increasingly interested in bank participation in LBO lending because of the dramatic increase in LBO credits on bank portfolios. The Comptroller of the Currency estimates that of the $150 billion to $180 billion in LBO debt outstanding, $80 billion is held by U.S. banks. Most of this exposure has been accumulated in recent years. In fact, estimates of total bank lending for LBOs in 1988 may exceed $48 billion (excluding $15 billion in bank loans to RJR Nabisco).
In addition, analysts estimate that LBO credits on bank portfolios equal 18 percent of the total dollar volume of commercial and industrial loans and 50 percent of bank capital. Concentration of LBO exposure is uneven; one published estimate of LBO exposure for the 10 most active banks in the LBO market cited a range from 40 to 400 percent of equity capital.

Bank regulators are concerned about the impact of increased LBO exposure on bank soundness and, ultimately, on the regulatory safety net. High levels of leverage are thought to be associated with both increased risk and larger expected returns than most loans to less-leveraged customers. Assuming the current system of federal deposit insurance remains intact, federal deposit guarantees may cause banks to underprice the risk of LBO credits and to book more LBO loans for their portfolios than they would in the absence of deposit guarantees. 

Because of these incentives, it is likely that LBO-related credits will be a point of exposure in the banking system.

This Economic Commentary looks at the risks associated with LBO lending and the current response of federal bank regulators to banks’ increasing participation in this market. First, we will provide a brief overview of LBOs. Then we will examine the risks associated with lending to these highly leveraged companies. Finally, we will outline the current response of federal bank regulators to the increased participation of banks and bank holding companies in funding LBOs.

A Brief Primer on LBOs

What degree of leverage must a firm have in order for its financial restructuring to be defined as an LBO? There seems to be no consensus. Bankers Trust defines a firm as highly leveraged if it has 70 percent debt financing, while the Federal Reserve System is now using 75 percent debt financing as a general examination guideline. 3

The degree of leverage that constitutes a highly leveraged firm is a relative concept. For example, the J.P. Morgan deal that created U.S. Steel in 1901 was considered to be highly leveraged because it resulted in a debt-to-assets ratio of 35 percent. 4 Although a debt-to-asset ratio of 80 percent is not uncommon in a country like Japan, a U.S. firm with this ratio is considered to be highly leveraged. Even though the transactions that have drawn the majority of attention lately are the multi-billion-dollar deals like RJR Nabisco, the data presented in table 1 show that the bulk of the $98.3 billion of LBO deals last year were relatively small. Of the 304 deals in 1988 identified as LBOs by Venture Economics, Inc., roughly 88 percent had a transaction price under $300 million. 5

In conjunction with their evaluation of management, bank examiners will pay the same attention to the quality of the credits and the overall diversification, as well as to the bank’s own LBO risk exposure. 6

LBO financing is a natural market for banks. Loans to support LBO transactions are often based on a radically reorganized firm and on overly optimistic assumptions about cost-cutting measures and asset sales. There are uncertainties that make it difficult to use historical cash flows to project future cash flows. The recent expansion of lending to highly leveraged firms has occurred during the relatively stable macroeconomic environment of the mid-1980s. Although banks’ lending experience on LBO-related loans is not materially higher than for more traditional commercial loans, it is unclear how LBO credits will perform in a less stable macroeconomy. How much can interest rates rise before some highly leveraged firms can no longer meet their debt payments? What effects would an economic downturn (especially a prolonged recession) have on many highly leveraged firms’ abilities to service their debt from operating income? A large part of a bank’s LBO portfolio could conceivably go under if interest rates rise dramatically or if there is a severe economic downturn. The concern is that a bank may not be able to adequately hedge against macroeconomic risks in its LBO-related loan portfolio. Although macroeconomic risk may not be mitigated by diversifying the LBO portfolio, diversification is important. Even in a robust macroeconomy, regional or industry-specific problems can affect the ability of an LBO firm to service its debt. Through diversification, the impact of these problems on the bank’s LBO portfolio is minimized.

Regulators, using their supervisory authority, would take action against a bank only if its internal procedures were deemed inadequate. Federal supervisors would emphasize management skills and portfolio composition in evaluating a bank or bank holding company’s LBO exposure.

In their evaluation, bank examiners look for an internal definition of an LBO credit that the bank identifies in its LBO portfolio and LBO loan exposure. In addition, are there procedures in place to evaluate the risk of LBO loans? Does management have the ability to evaluate the target company’s management and operating controls?

Lending analysis should be focused primarily on reasonable projections of cash flows and secondarily on collateral values. Recent experience with real-estate lending in Texas and with agricultural loans in the Midwest illustrates the problems that can arise when lending is based on inflated asset values and not on accurately projected cash flows.

However, the valuation of collateral and cash flows may be difficult, as the value of a firm’s stock may double or triple when a takeover deal is announced. Furthermore, cash flow projections are often based on a radically reorganized firm and on overly optimistic assumptions about cost-cutting measures and asset sales. There are uncertainties that make it difficult to use historical cash flows to project future cash flows.

In conjunction with their evaluation of management, bank examiners will pay particular attention to the composition of the LBO portfolio. Specifically, they will look at the quality of the credits and the overall diversification, as well as the bank’s total capital exposure to the LBO portfolio, on both a firm and an overall basis. In the context of the overall asset portfolio, total LBO loans may be treated as a specific concentration of credit.

<table>
<thead>
<tr>
<th>Transaction Size</th>
<th>Number of Deals</th>
<th>Percent of Total</th>
<th>Dollar Volume</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $50 million</td>
<td>105</td>
<td>34.5%</td>
<td>$52,206.6</td>
<td>2.2%</td>
</tr>
<tr>
<td>$50 million - $99.9 million</td>
<td>58</td>
<td>19.1%</td>
<td>4,086.8</td>
<td>4.2%</td>
</tr>
<tr>
<td>$100 million - $499.9 million</td>
<td>105</td>
<td>34.5%</td>
<td>22,334.0</td>
<td>22.7%</td>
</tr>
<tr>
<td>$500 million - $999.9 million</td>
<td>19</td>
<td>6.3%</td>
<td>13,961.0</td>
<td>14.2%</td>
</tr>
<tr>
<td>Over $1 billion</td>
<td>17</td>
<td>5.6%</td>
<td>55,687.0</td>
<td>56.7%</td>
</tr>
<tr>
<td>Totals</td>
<td>304</td>
<td>100.0%</td>
<td>$98,275.4</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

a. Deals announced or consummated in 1988.

Another concern of bank regulators is the syndicated loans in a bank’s LBO portfolio. To the extent that the lead banks in the LBO loan syndicate primarily perform an investment banking function and retain only a small percentage of the loans on their books, the banks purchasing the loans must conduct their own independent evaluation of the loan. Examiners will scrutinize this part of the portfolio to determine the adequacy of internal procedures for evaluating and managing the risks of the syndicated loans. In addition, examiners are concerned with banks’ potential higher risk of obtaining liens on collateral and participating in any debt renegotiation.

**LBO Loans and Risk-Based Capital Standards**

Bank regulators view capital as the last line of defense between unexpected earnings losses on a bank’s portfolio and both uninsured bank depositors and the regulatory safety net. The traditional approach to capital regulation has been to set a uniform capital-to-assets ratio for all banks, regardless of their risk, and to control portfolio risk through supervision and regulation. This approach has been criticized for two reasons. First, regulators do not know with much precision how much capital an individual bank (let alone all banks) needs to hold to protect against insolvency. Second, the amount of capital required to protect the federal deposit insurance funds and uninsured depositors from loss varies from bank to bank depending on risk. In response to the second criticism, bank regulators in the United States and in the other major developed countries have recently announced new international capital standards for banks. These new standards require banks to hold a level of capital that corresponds to the credit risk in their portfolio.

The new capital standards partition a bank’s asset portfolio into four risk categories according to perceived default risk. The amount of capital a bank must hold against a particular asset (or activity) is then determined by its risk category. The premise behind this approach is that banks should be allowed to choose the risk of their portfolio without regulatory interference, so long as increased risk to depositors and to the federal deposit insurance funds is offset by increased capital protection.

Critics of the new capital guidelines claim that they do not explicitly recognize the increased risk associated with LBO-related loans. Under the current risk-based capital standards, loans to highly leveraged companies are placed into the same risk category as more traditional commercial and industrial loans. This means that a bank must hold the same amount of capital to back up an LBO-related credit as it would a similar credit to a less-leveraged firm.

Admittedly, the standards are not perfect because they do not take into account all risks. However, risk distinctions beyond those contained in the regulatory framework are difficult to define with precision. Additionally, regulating risk runs the danger of introducing unwanted effects on credit allocation. More important, the risk-based ratio is only a first step in assessing capital adequacy. As is the case with other loans, the quality of LBO-related loans and investments must also be taken into account.

Moreover, the final risk-based capital guidelines are the result of negotiation and compromise between bank regulators in the nations adopting the new capital standards. Given the differences in capital structure for non-financial firms across countries (as noted earlier, Japanese firms tend to be much more leveraged than U.S. firms), it would be difficult to gain a consensus among nations to adopt capital guidelines that differentiate among loans according to the leverage of the borrower. Consequently, it is unlikely that LBO-related loans will be assigned their own risk class under the international capital guidelines.

**Conclusion**

LBO financing is a natural market for banks to engage in, and they are in an excellent position to assess and assume this risk. With returns on LBO loans as much as four percentage points higher than those available on more traditional commercial loans, it appears that the higher risk may currently be offset by higher expected returns.

The high debt-to-equity ratio in the resulting firm leaves little or no margin for error when evaluating and pricing these loans, however. Lenders therefore need to adopt adequate controls and procedures for evaluating, pricing, and managing the risks of this type of lending activity. As long as banks adopt appropriate internal controls, bank regulators should reasonably expect that supervision—not regulation—is the appropriate approach to LBO-related lending.
5. However, not all loans to companies with LBO credits. See Barbara A. Rehm, op. cit. 


8. Additional reporting requirements for LBO loans may be required. The Y-9 report for bank holding companies may include a line item for LBO in the near future. Furthermore, the federal bank regulators may change the accounting treatment of fees on LBO credits. See Barbara A. Rehm, op. cit. 


10. Unique legal problems can arise during the first year of an LBO loan, most concerning fraudulent conveyance, equitable subordination, and more, the federal bank regulators may change the accounting treatment of fees on LBO credits. See Barbara A. Rehm, op. cit.


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