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High Yield Bond Market

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THE HIGH YIELD BOND MARKET

SUMMARY OF STATEMENT BY
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In response to a request from the Honorable Carroll Hubbard, Chairman of the Subcommittee on General Oversight and Investigations, House Committee on Banking, Finance and Urban Affairs, GAO provided its views on (1) the use of high yield bonds in corporate takeovers and (2) the risks and returns of high yield bond investments for federally insured savings and loan institutions. These views are from a series of three reports GAO issued in response to the requirements of the Competitive Equality Banking Act of 1987.

Uses of High Yield Bonds in Financing Corporate Takeovers

High yield bonds were a significant source of financing for the 54 hostile nonfinancial corporate takeovers completed in 1985 and 1986, comprising about 22 percent of the total final financing. However, bank loans were the principal source. High yield bonds may have been a larger part of the financing for all takeovers--friendly as well as hostile. As much as half of all high yield bonds issued between January 1986 and June 1987 could have been used to finance takeovers.

Thrift Investments in High Yield Bonds

Thrift investment in high yield bonds more than doubled between the end of 1985 and September 1988, when thrift investment in these bonds totaled over $13 billion. However, only about 5 percent of the 3025 federally insured thrifts held high yield bonds, and 10 institutions held almost 76 percent of the total. The average of the ratio of high yield bonds-to-total assets for the 10 institutions was 11.7 percent, ranging from 3.8 to 32.2 percent. Four of these institutions were located in California, two in Texas, and one each in Connecticut, Florida, Massachusetts, and New Jersey.

There is no evidence that thrift investment in high yield bonds has been responsible for the current problems in the industry. Net returns to thrifts from high yield bond investments were second only to credit cards; the greater risk of default for high yield bonds compared to other assets were outweighed by their higher yields. However, these returns have been achieved during a period of unprecedented peacetime economic expansion, and prudent management of these portfolios is essential. Federal Home Loan Bank Board guidelines issued in January 1989, if properly understood and enforced, should help assure that thrifts invest in high yield bonds without incurring unnecessary or unreasonable risk.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our reports on the high yield bond market. This work was mandated by the Competitive Equality Banking Act of 1987. Our study focused on congressional concerns about the high yield bond market, its connection to takeover attempts, and the potential threat that high yield bond investments by federally insured thrifts may pose to the financial stability of the Federal Savings and Loan Insurance Corporation.

Our first report, issued in February 1988, discussed in general who issues high yield bonds, who buys them, and the purposes for which they are issued. Our second report, issued in May 1988, is the transcript of a March 1, 1988, public hearing held jointly by GAO, the Department of Labor, the Department of the Treasury, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the Federal Reserve System, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission. At the hearing, market participants and academicians provided their views on the high yield bond market. Our third report, which has been issued today, focuses on federally insured thrift institutions that invest in high yield bonds.

Our testimony today highlights two issues: first, the uses made of high yield bonds in corporate takeover activity and second, the experience federally insured thrift institutions have had with high yield bond investments.

Uses of High Yield Bonds in Financing Corporate Takeovers

According to data we developed, high yield bonds were a significant source of financing for hostile corporate takeovers, but not the principal source. That distinction belonged to bank loans. When we examined the financing of all takeovers--friendly as well as hostile--we found that high yield bonds may have been a larger part of the financing.

We developed data on the uses made of high yield bonds in corporate takeovers in two ways. First, we examined all 54 completed takeovers of nonfinancial corporations in 1985 and 1986 that the Securities and Exchange Commission (SEC) and others identified as hostile. By completed, we mean that the unwelcome bidder was successful or that the deal was consummated by a "white knight." Tender offer filings, bond prospectuses, and annual reports revealed that high yield bonds were used for initial financing of 12 percent of the value of these deals. The great bulk of initial financing, 42 percent, was provided by bank loans. Other sources included privately placed debt, such as debt placed with insurance companies, high grade bonds, and the sale of additional stock. Some of these initial financing sources were refinanced using high yield bonds. Thus, high yield bonds eventually accounted for about 22 percent of the total debt.

Our second approach attempted to identify uses made of high yield bonds in all takeovers, both friendly and hostile. To do this, we examined the "uses of funds" section of a randomly selected sample that included 124 of the 333 high yield bond prospectuses filed with the SEC between January 1986 and June 1987. We supplemented this data with information from the quarterly and annual reports of the issuing companies.

Our assessment revealed that 13 percent of the bonds were to be used for acquisitions, another 15 percent were to be used for future acquisitions, and 23 percent were to be used to retire debt from previous mergers and acquisitions. The information we obtained indicates only the planned usage for the high yield bonds. There is no requirement that the bonds be used exactly as planned. However, the numbers show that as much as half of the high yield bonds issued during this time period could have been for financing mergers and acquisitions.

The recent growth in the high yield bond market has been dramatic: from about $9 billion in bonds outstanding in mid-1977, to about $180 billion at the end of 1988. Federal Reserve staff told us the high yields offered on these bonds have attracted investors, making the market more liquid, and the financing of mergers and LBOs easier. High yield bonds have also provided small and medium sized firms access to long-term capital markets.

However, Federal Reserve Chairman Greenspan recently expressed concern about the increased risks that the heavy reliance on debt financing associated with mergers and buyouts poses for both borrowers and lenders. The Federal Reserve has actively urged bank management to exercise caution and apply especially rigorous lending and investing standards when participating in LBOs and other leveraged transactions. In addition, on February 16, 1989, the Federal Reserve issued new guidelines to assist its examiners in identifying highly leveraged bank financings that may warrant closer scrutiny. These guidelines define highly leveraged financings as exposures that meet two criteria: (1) loans that involve corporate restructurings such as LBOs or mergers and acquisitions funded with borrowed money and (2) loans to borrowers whose total debt-to-total assets ratios exceed 75 percent.

Thrift Investments in High Yield Bonds

Let us shift now to the second issue--thrift investment in high yield bonds. Concern over high yield bond investment by thrifts stems from the financial disaster that the industry has experienced since its product offering powers were deregulated in

1982. The thought of having troubled thrifts investing their depositors' money in another seemingly risky investment like high yield bonds bothered many in Congress. This led to a requirement in the Competitive Equality Banking Act that we compare the risks and returns from high yield bonds to other thrift investments and assess their effects on safety and soundness.

In general, we found the following about thrift investments in high yield bonds.

-- Since the end of 1985, thrift investments in high yield bonds have grown from less than $6 billion to over $13 billion in September 1988. However, these investments are highly concentrated in only a few federally insured thrifts. About 5 percent of the 3025 federally insured thrifts held these investments, and 10 institutions held about 76 percent of the total. The average of the ratio of high yield bonds-to-total assets for the 10 institutions was 11.7 percent, ranging from 3.8 to 32.2 percent. Four of the institutions were located in California, two in Texas, and one each in Connecticut, Florida, Massachusetts, and New Jersey.

-- Reasons given by thrifts for investing in high yield bonds include: (1) they provide higher risk-adjusted returns than other potential investments, (2) their similarity to commercial loans allows thrifts to become commercial lenders without the expense and effort of developing a commercial lending group and building customer contacts and, (3) they provide an opportunity to diversify geographically that is not available on some other assets in thrift portfolios.

-- Finally, federal regulations limit federally chartered thrift investment in high yield bonds to no more than 11 percent of their assets. Six states had laws that allowed state chartered thrifts to invest higher percentages of their assets in high yield bonds. The amounts permitted ranged generally between 15 and 30 percent. As of September 30, 1988, only seven thrifts chartered in five states had invested more than 11 percent of their assets in high yield bonds. Three of the seven were located in California, and one each in Florida, Ohio, Texas, and Utah.

When we tried to compare the risks and returns of various thrift investments, we found the data needed were limited. Only two of the thrifts we visited had data available, and Federal Home Loan Bank Board data do not allow a direct comparison of high yield bonds to other thrift investments. However, the data from the two thrifts and that available from a study of thrift investment returns by Wharton Econometric Forecasting Associates indicate that high yield bonds have provided thrifts high returns in relation to their other investments.

The Wharton Econometric study was done for the Alliance for Capital Access, a group which represents the interests of high yield bond issuers and investors. It compares data on gross and net returns; that is, returns after deducting the cost of money, servicing costs, and defaults for various types of assets held by thrifts, including high yield bonds. The study concluded that the net returns on high yield bonds were second only to credit cards, and greater than residential mortgage lending, commercial and consumer loans, and Treasury and high grade bonds. The study also showed that defaults on high yield bonds were greater than on other types of assets, except for credit cards, but the higher yields on the bonds outweighed the higher losses.

We found that Wharton Econometric's study had certain methodological limitations. Most importantly, the study does not, and was not intended to, predict future trends of asset risks and returns. It calculates only past returns--results that have been achieved during a period of prolonged economic growth. Nevertheless, its overall conclusion--that net returns on high yield bonds are high relative to other assets--is consistent with (1) other published studies which compare high yield bond investments to other investments in general, (2) the testimony we received at our public hearing, and (3) statements from officials at the thrifts we visited. The published studies we reviewed were done by Dr. Edward Altman of New York University and Drs. Marshall Blume and Donald Keim of the University of Pennsylvania's Wharton School.

As a final note on safety and soundness, there is no evidence that investment in high yield bonds has been responsible for the current problems of the 500 insolvent institutions comprising the troubled segment of the thrift industry. We found only one instance where mismanagement of a high yield bond portfolio played a part in a thrift failure. In that case, the problem was only part of a broader pattern of unsafe and unsound lending and investment practices that led to the institution's collapse.

These findings do not mean that safety and soundness regulation, oversight, and supervision should not be designed to cover such investments. The size of the high yield bond market has expanded significantly, and high yield bonds are being used increasingly to finance mergers and acquisitions, leveraged buyouts, and financial restructuring. These changes in the market occurred during an unprecedented peacetime economic expansion, and many market observers point out that the market in its present size and form has not weathered a severe recession that could test many issues and increase defaults.

For these reasons and because many thrifts have failed due to mismanaged operations, we believe that the Federal Home Loan Bank Board's January 1989 issuance of a thrift bulletin which provides guidelines for federally insured thrifts to use in purchasing and managing high yield bond investments is an important step in the prudent management of high yield bond portfolios.

These guidelines establish Board of Directors' responsibility for high yield bond investments, suggest minimum diversification standards, require that thrifts thoroughly analyze each high yield bond investment, and require adequate reserves for losses. The bulletin also restricts the amount of high yield bond investing that can be done by insolvent or undercapitalized institutions. If properly adopted by thrifts and enforced by the Bank Board, the guidelines should help assure that thrifts invest in high yield bonds without incurring unnecessary or unreasonable risk.

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Mr. Chairman, this concludes my prepared statement. We will be pleased to answer questions.