FEDERAL RESERVE BANK

OF NEW YORK.

January 29, 1938.

Dear Marriner:

The Secretary asked me the other day for an expression of opinion on the question of underwriting by banks. I am sending him today the attached informal notes. I have not had a chance to go over these with my associates, so that they are in no sense an expression of bank opinion, but rather an informal personal view subject to change.

Sincerely yours,

W. Randolph Burgess

Honorable Marriner Eccles,
Chairman, Board of Governors
of the Federal Reserve System,
Washington, D. C.

WRB.H
encl.

January 29, 1938.

NOTES ON UNDERWRITING BY BANKS

In an effort to prevent abuses which had developed, the Banking Act of 1933 terminated the underwriting of securities by banks or bank affiliates, or by private bankers taking deposits, except for governmental or semi-governmental obligations. This had the effect of removing from the corporate underwriting field a large part of the capital which had up to that time been available for the purpose. Principal bank affiliates which had engaged in underwriting, such as the National City Company, the Chase Harris Forbes Co., and the Guaranty Co., were liquidated. A number of private bankers, including J. P. Morgan & Co. and Brown Brothers, elected to carry on a deposit banking business rather than an underwriting business. There remained in the underwriting business a limited number of houses which were later supplemented by several new concerns including Morgan Stanley, Brown Harriman & Co., E. B. Smith & Co., etc. But even with these additions the amount of capital available for this function is only a small fraction of what was formerly available. The amount may be estimated at something in the neighborhood of $100,000,000.

There has now been sufficient time since the passage of the Banking Act of 1933 to judge something of the operation of the market under these new conditions, the adequacy of the present amount of capital, and the prospects for the future. My own conclusion is that the present amount of capital available for underwriting is inadequate to support what should be a normal volume of capital issues for this country. My reasons for believing this may be summarized roughly as follows:

(1) On the basis of past experience there should be about $400,000,000 to $500,000,000 of corporate capital issues in this market every month to refund maturities and to make possible a rising standard of

living in the United States and a rising national income. That amount is necessary to provide the steady improvement in the country's productive capacity which is essential to assure rising standards of living. This is a larger volume of financing than can be handled safely and efficiently with only $100,000,000 of underwriting capital.

(2) There is no present prospect for an adequate increase of underwriting capital from sources other than banks. The business has not been sufficiently profitable in recent years to attract new capital, and present tax laws largely prevent the accumulation of capital from current earnings. In fact, during the past year, the amount of capital in the business has been decreased by at least $10,000,000 through losses.

(3) Even with the recent relatively small volume of financing certain weaknesses have become evident arising from the character and limited amount of capital available.

(a) Underwriters, which are dealers as well, are compelled to keep their shelves relatively clean. They cannot easily hold back an issue which is not going well because of some temporary weakness in the market. This was illustrated in the case of the Bethlehem Steel issue. While some of the issue was held back by stronger underwriters after failure of the first offering, enough was hanging over the market to depress prices as low as 80, and act as a depressing influence on the general security market.

(b) There is always the possibility of inadequate competition for issues. The limited group of underwriters may exercise what are, in effect, monopoly powers if they can all get together, and for large issues it is almost necessary that they should get together. There is thus the risk of excessively high costs of underwriting.

(c) With the limited amount of capital available each underwriter is required to take a larger risk than may at times be appropriate. This, in turn, makes the market more timid and vulnerable to changes in sentiment or temporary periods of depression.

While if we waited long enough this situation might in part correct itself by the attraction of more capital into the business, this would be a slow process. In the meantime the inadequacy of facilities is a drag on economic recovery. The problem is to enlist more underwriting capital without again running the risk of the abuses which occurred in the twenties. I believe this could be done by giving banks limited powers to underwrite a limited class of securities. The principle would be that banks should be allowed to make contracts to purchase securities, but should not be allowed to sell these securities except through the regular market channels, that is, they should not be allowed to become merchandisers of securities. Banks should be allowed to underwrite only those investment securities which they are authorized by law and regulation to hold in their portfolios.

This proposal would have the effect of making available for underwriting a larger amount of capital,, thus distributing the risk of new issues more widely, insuring more competition as between underwriters, and also subjecting new issues to the test of the credit analysis which the banks are able to give. Another important point is that it would place banks in small communities in a position to underwrite the obligations of local enterprises.

It should, of course, be recognized that this proposal deals with only part of the problem, for it provides additional capital for underwriting only those obligations which may be classified as investment securities, and which are eligible for the portfolios of banks. It does not facilitate directly the underwriting of securities involving greater risk. It is these securities involving more risk which are one of the prime essentials of expanding enterprise and a rising standard of living in this country, and for the underwriting of such securities we would still be dependent on the houses now underwriting. It may be said, however, that a wider distribution of the risk for investment securities would release the capacity of these houses more fully for the securities involving more risk.

It should be added that there is a good deal of difference of opinion on this general subject, and many of the houses doing underwriting feel strongly that their facilities are adequate to take care of the situation. Their interest, of course, lies in that direction.

It should, perhaps, also be noted that the limitations of underwriting capacity are not the only, or in fact the principal reason for the deficiency of capital issues in recent months or years, but they are one handicap which seems readily subject to correction.