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Statement of C. Canby Balderston,

Vice Chairman,

Board of Governors of the Federal Reserve System,

before the

Committee on Banking and Currency,

House of Representatives,

April 26, 1965,

on H. R. 7539.

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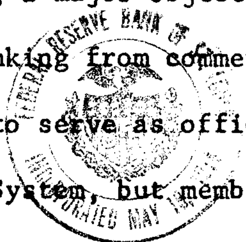
H. R. 7539, which is the subject of these hearings, presents a question that has been before this Committee for more than a decade: Should the Federal banking laws be amended to permit commercial banks to underwrite and deal in so-called "revenue bonds" issued by States and political subdivisions?

The need for Congressional action is a pressing one because a single provision of existing law is interpreted differently by the two Federal banking agencies responsible for its enforcement. One is the Federal Reserve System, which supervises State member banks; the other is the Comptroller of the Currency, who supervises national banks.

The Board of Governors interprets section 5136 of the Revised Statutes as prohibiting bank underwriting of securities that are not supported by general powers of taxation. The Comptroller of the Currency takes a different position and holds that banks may lawfully underwrite and deal in types of securities that are not so supported. Consequently, national banks may now engage in activities denied to their State-member-bank competitors, even though the same law applies to both categories. In its Annual Report to Congress submitted a month ago, the Board of Governors again recommended "legislation that would reaffirm and clarify existing law . . .. which forbids member banks to underwrite or deal in revenue bonds."

The question of principle before the Committee, however, is whether it would be in the public interest for commercial banks to engage in these activities. That question was considered by the Congress after the financial collapse of 1929-32. In fact, a major objective of the Banking Act of 1933 was to separate investment banking from commercial banking. Not only were investment bankers forbidden to serve as officers or directors of commercial banks in the Federal Reserve System, but member banks were prohibited, under



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penalty, from being affiliated with firms dealing in securities. It was made a felony for any commercial bank to engage, except within strictly prescribed limits, in underwriting, selling, or distributing securities at wholesale or retail.

Proponents of proposals like H. R. 7539 might take the position that the Congress erred in 1933, or that circumstances have so changed that the separation of commercial banking from investment banking, at least so far as revenue-bond underwriting is concerned, no longer represents sound policy, even if it did in 1933. Of course, the venerable age of the existing law does not foreclose reconsideration. But the Board of Governors believes that separation of commercial banking and investment banking continues to be in the public interest.

The fundamental objection to the bill before the Committee is that it would create conflicts of interests. The typical bank that would be likely to underwrite revenue bonds as permitted by this bill also invests for its own account in revenue bonds, accepts funds in trust for investment, and advises its correspondent banks and other customers as to how their funds should be invested. Success in underwriting an issue of revenue bonds would depend, of course, on the bank's ability to find investors to buy the bonds. Its interest as seller would tend to conflict with its interests as investor, trustee, and investment adviser. Its decision to extend credit by investing for its own account in a new issue should be made solely on the merits of the investment, without regard to its interest in the success of the underwriting. Its decision as to whether to invest trust funds in the issue also should be made without considering its conflicting interest as underwriter. And this should be true whether the trust funds are invested in bonds held by the bank itself or by another member of the underwriting syndicate. Correspondent banks

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and other customers who seek guidance from the bank as to whether they should invest in the issue should get advice that is completely impartial--free from any salesmanship bias.

H. R. 7539 attempts to deal with certain conflicts of interests by providing that a member bank, in its capacity as a fiduciary, may not purchase governmental obligations from itself, if those obligations are held by it in the capacity of an underwriter or dealer. But this addition to earlier proposals deals with only part of the conflicts-of-interests problem. The new provision would touch only the internal fiduciary relationships of the banks involved. For example, it would not solve the problems of the relationships of underwriting banks to their correspondents or to others who rely on underwriting banks for investment guidance.

Even within the relatively small area at which the new provision is directed, it would not seem to provide an effective safeguard. The prohibition is directed only at purchase by a fiduciary bank from itself, and consequently would not prevent purchases from other members of the underwriting syndicate, even though the conflict of interests would seem to be substantially the same. Consequently, it must be concluded that this modification of the bill considered at the 1963 hearings (H. R. 5845, 88th Congress) would be ineffectual to meet the objections that were considered by the Committee at that time.

H. R. 7539 is entitled "A Bill To assist cities and States ..." This is an attractive objective to which all of us would subscribe. But it is at least questionable, if not improbable, that the bill would produce that result. The argument that cities and States would be better off is built upon a tempting theory that participation by some commercial banks in the underwriting of revenue bonds would add new competitors to the numerous

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investment banking firms that are presently engaged in that business; that more competitors would make competition more vigorous; and that more vigorous competition would reduce the costs of borrowing by States and cities.

Yet as we have previously informed the Committee, a factual study we made of this question in 1963 led to the conclusion that this hope is illusory and that only an insignificant reduction, if any, in the overall costs of State and municipal financing could be anticipated. This conclusion was drawn from analysis of actual interest costs on a typical group of revenue bonds, in whose sale commercial banks could not compete, and of general obligation bonds of comparable quality, where they could. Furthermore, to the extent that bank underwriting of revenue bonds might diminish interest costs on them, an offsetting increase in aggregate interest costs could be anticipated on general obligations. This offsetting effect follows from the fact that tax exemption creates a sharply defined and relatively inelastic market for State and local bonds; an increase in investor interest in one type of tax-exempt bonds--in this case, revenue bonds--would tend to reduce demand for the other type--general obligations.

I can appreciate the feeling of some public finance officers about this bill. From their point of view, enactment of such a bill might yield some benefit; if not, nothing would be lost. To them, even a relatively insignificant saving of interest cost, if one materialized, would be welcome. They naturally feel that the passage of such a law might yield some benefits to them and, in any event, would do them no harm.

But in evaluating the proposal, this Committee and the Congress must of course take a broader view, and balance the risk of conflicts of interests against the possible gains from lower borrowing costs for public bodies. If the participation of commercial banks in securities underwriting

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posed a substantial threat to the effective performance of their banking functions and yet offered substantial benefits in the financing of States and municipalities, then your Committee would face a real challenge in balancing the relative importance of the two factors to the general public. But in our judgment, no such problem is presented here. The danger of conflicts of interest is real and substantial, whereas the promise of cost benefits in public financing is remote and insubstantial.

Unfortunately, a decision by the Committee adverse to H. R. 7539 is not sufficient to resolve the problem that confronts you. As I mentioned earlier, existing law, intended by Congress to be equally applicable to all banks, is interpreted and applied differently by the two Federal bank supervisory agencies responsible. Under rulings of the Comptroller of the Currency, national banks can underwrite and deal in revenue bonds that their State-chartered competitors cannot. This has resulted in confusion, inequity, and lessened respect for governmental processes.

For these reasons, we urge that the Committee amend H. R. 7539 to make clear, beyond any possibility of misunderstanding, the intended meaning of the statutory provision that banks may underwrite only "general obligations of any State or of any political subdivisions thereof." We propose that the provisions of the introduced bill that deal with revenue bonds be stricken, and that the bill be amended by adding at the end of the seventh paragraph of section 5136 of the Revised Statutes the following sentence:

> "As used in this paragraph, the term 'general obligations of any State or any political subdivision thereof' means only obligations that are supported by an unconditional promise to pay, directly or indirectly, an aggregate amount which (together

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with any other funds available for the purpose) will suffice to discharge, when due, all interest on and principal of such obligations, which promise (1) is made by a governmental entity that possesses general powers of taxation, including property taxation, and (2) pledges or otherwise commits the full faith and credit of said promisor; said term does not include obligations not so supported that are to be repaid only from specified sources such as the income from designated facilities or the proceeds of designated taxes."

We believe that enactment of this amendment would establish a uniform and salutary rule and remove a serious inequity.

In sum, I have expressed the hope that this Committee will reaffirm the policy to keep commercial and investment bankers at arm's length to prevent the conflicts of interests that might stem from the intermixture of selling activities with advising and investing functions.

But whatever the decision on this question of principle, the Board urges that the existing confusion and unfairness arising from conflicting interpretations of the law be settled by Congressional action at the earliest opportunity.

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