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Statement of

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on S. 1306

To Authorize Commercial Banks to Underwrite Revenue Bonds

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I appreciate this opportunity to present the views of the Board of Governors of the Federal Reserve System on S. 1306, a bill which, broadly speaking, would repeal the provisions of Federal law that now prohibit commercial banks from underwriting or dealing in revenue bonds. At the request of the chairman of this subcommittee, the Board's staff recently undertook a study of the interest cost effects of commercial bank underwriting of revenue bonds, and the results of this study were transmitted to the subcommittee on July 21 of this year. After the study was completed, the Board had the benefit of two oral presentations, one by commercial bankers supporting the bill and one by investment bankers in opposition to it. Having carefully reviewed its position on bank underwriting of revenue bonds, the Board recommends that S. 1306 be enacted.

Section 5136 of the Revised Statutes now provides that a national bank "shall not underwrite any issue of securities," and other provisions of law apply this prohibition to State banks as well. However, section 5136 further provides that the prohibition of underwriting (as well as "dealing" in) securities "shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof."

Besides issuing "general obligations," States and many local governments, particularly cities and special purpose governmental authorities of various kinds, also issue securities that do not have the same "full faith and credit" backing. As examples, a State may issue bonds that are to be repaid _solely_ from tolls paid for use of a bridge, tunnel, or turnpike, or from a particular State tax source such as a motor fuel, sales, or severance tax. A city may issue bonds payable solely from the income of its water system or parking facilities.

In many cases a State, instead of issuing its own bonds payable solely out of a designated revenue source, will create a Roads Commission or Turnpike Authority, with power to raise necessary funds by selling its own bonds to the public. Bonds of that kind ordinarily are not binding on, or backed by, the State itself. Such bonds may completely obligate the Commission or Authority that issues them, but since that body does not possess general taxing power they have the same status as equivalent bonds issued by the State but payable only from one or more particular sources of State income. In other words, all of these securities are in the category of "revenue" bonds and may not be underwritten or dealt in by commercial banks.

As their capital needs have increased, States and localities have been turning to such revenue issues in increasing numbers. This alternate method of financing increases the flexibility and scope through which State and local governments can raise necessary funds.

Some large commercial banks, both national and State, have departments that underwrite bonds that are "general obligations" under section 5136. Either individually or as members of syndicates, they submit offers for new issues of municipal "G. O.'s," as they are called, and if the offer is accepted they distribute the securities by selling them to the investing public, including institutional investors. Many of such banks also act as dealers--that is, they buy and sell G. O.'s that are already outstanding and maintain inventories of such bonds for sale.

These underwriting and dealing functions must be distinguished, of course, from banks' investments in securities. Under section 5136 and the Investment Securities Regulation of the Comptroller of the Currency, a bank may purchase for investment (the statute uses the expression "purchase for its own account") securities of any kind, including corporate securities and revenue bonds, that are "marketable" and meet prescribed standards of quality. The pending bill does not relate to such investments, but rather to the authority of banks to underwrite and deal in securities. (For brevity, I shall refer hereafter only to "underwriting," but "dealing" should also be understood.)

Under section 5136, banks may underwrite G. O.'s without any statutory restriction as to amount or requirement as to quality. Questions respecting quality and amount are taken care of by the examination process.

S. 1306, on the other hand, would permit banks to underwrite only such revenue bonds as "are at the time eligible for purchase by a national bank for its own account"--that is, securities that are of "bank quality" and therefore already eligible for bank investment. The bill also forbids a bank to hold revenue bonds of any one issuer as a result of underwriting, dealing, or purchasing for its own account in a total amount exceeding at any one time 10 per cent of the bank's capital and surplus. In other words, if a bank already held bonds of the X Turnpike Authority in its investment portfolio in an amount equal to 6 per cent of the bank's capital and surplus, it could not, as underwriter (or in any other capacity otherwise than as fiduciary), buy bonds of a new issue of that Authority in an amount exceeding 4 per cent of such capital and surplus.

Specific prohibitions are included in S. 1306 against bank underwriting of obligations payable solely from the proceeds of special assessments and industrial development obligations, that is, obligations to finance the development of property and payable solely from rentals received from leasing the property to private manufacturers. In addition, provisions are included to reduce potential conflicts of interests. A bank participating in an underwriting syndicate could not purchase any revenue bonds for its trust department from any member of the syndicate until the syndicate had closed as to underwriting. Nor could it purchase such bonds for its trust department from itself as an underwriter or dealer unless directed to do so by court order. And if the bank sold any such obligations to any depositor, borrower, or correspondent bank, it would have to disclose that it was selling as an underwriter or dealer.

Over the years, the controversy surrounding proposals to authorize bank underwriting of revenue bonds has developed a variety of pro and con arguments, most of which concern subjective judgments which cannot be quantified. It may be helpful to your committee to summarize these arguments, as we understand them.

Arguments in favor of S. 1306:

1. Economies in government financing. The main argument favoring extension of bank underwriting to revenue bonds is that it would save governmental issuers money on what has become a major instrument of municipal finance. It is argued that revenue bond borrowing costs would decline, reflecting reductions in underwriting costs and in the yields necessary to attract investors. Reoffering yields would fall because (1) the market for revenue bonds would broaden as banks offered them to investors not previously reached, (2) the secondary market would improve as a result of bank operations as dealers in such bonds, and (3) the very fact that revenue bonds were accorded statutory treatment more nearly equal to G. O.'s would increase investor receptivity. Lower underwriting costs, of course, would be expected to derive from increased competition in the bidding for new issues.

The Federal Reserve staff study submitted to you in July concludes that there is a small but significant difference in borrowing costs between G. O.'s and revenue bonds, after allowing for differences in the characteristics of the two types of issues, and that the potential saving resulting from bank underwriting of revenue bond issues might amount to 1 to 2 per cent of the total interest cost. Specifically, on the $3 billion of new revenue bonds of investment grade issued last year, the study indicates that the total annual borrowing cost actually incurred ($113 million) might have been reduced by $1.9 million. Since their average maturity was 18 years, this would amount to about $34 million over the full life of the bonds. But it must be recognized that there is a considerable element of judgment in this conclusion, despite its quantitative appearance. It is possible that the residual difference in borrowing costs is due entirely to factors other than the absence of commercial bank underwriting. And even if bank underwriting did improve the revenue bond market, some of the investor interest attracted thereby might be diverted from other tax-exempt investments, thus creating a partial offset in the form of a worsening in the market for G. O.'s.

2. Improved market efficiency. It is also asserted that bank underwriting of revenue bonds would improve the breadth and continuity of these markets. Not only would there be a large increase in the number of market-makers for individual revenue bond issues, but also the issuers would have the added assistance of commercial bank underwriters in preparing the statistical and other information needed to assure that the market would give proper quality ratings to their revenue issues. Moreover, it is argued that the banks--since they are better capitalized and have multiple long-run interests at stake--would continue to

underwrite and deal in revenue bonds in both good and bad times. Nonbank underwriters, it is asserted, tend to withdraw from the market when interest rates are rising and there has been a series of underwriting losses. Our staff study did show a substantially larger rise in underwriting spreads on revenue than on G. O. bonds in 1966, and it is alleged that this tendency was accentuated in the summer of 1966, when pressure on money markets was particularly strong.

The difference in underwriting eligibility produces a noneconomic bias in favor of the issuance of G. O.'s, it is argued, even when a revenue issue might be more appropriate. Thus, a smaller municipality might use its general borrowing power to finance a revenue-producing project solely (or largely) because its commercial bank contacts are not permitted to underwrite revenue issues, even though revenue bonds would have the advantage of placing the burden of financing the project exclusively on the users.

3. Consistency in underwriting function. In many cases revenue bonds and G. O.'s may be used interchangeably by the issuing authority; in all cases, presumably, the financing represents a public need to be served. Moreover, since both types of bonds carry exemption from Federal income taxes, the characteristics of the two markets are quite similar. Thus it may be argued that bank underwriting of revenue bonds would make possible a better structuring of institutional arrangements to market realities,

would permit a more rational choice between G. O.'s and revenue bonds as financing vehicles, and would provide greater support for State and local financing requirements should the trend toward increased use of revenue bonds continue.

Arguments against S. 1306:

1. Conflicts of interests. Commercial banks occupy a central and influential role in the financial community, as advisors to a variety of customers on financial matters and as investors of their own and other people's money. Given these functions, permitting the banks to underwrite and deal in securities obviously poses problems of conflicts of interests. Therefore, it may be argued that such activities should be permitted only where there is an overriding public interest that clearly outweighs the risks of abuse.

At least three potential conflict of interest areas must be recognized:

First, is the possibility that banks will be undesirably influenced in their dealings with correspondent banks and other customers. There would be a natural tendency, it is asserted, to promote the sale of bonds in which the bank is involved as underwriter or dealer, even though such bonds might not be as suitable (or well-priced) as others in meeting the customer's needs.

Second, is the problem of handling the investments of trust accounts administered by the bank. If, as trustee, the bank buys bonds in which it is interested as underwriter or dealer, its responsibilities as trustee might be subordinated to the objectives of its bond department. If, on the other hand, the bank trustee refrains from such purchases in order to avoid that risk, it may be depriving its trusts of the most suitable investment available at the moment.

Third, is the conflict in function between the bank as underwriter and as investor. There is danger, it is asserted, that some banks would be tempted to hide their underwriting mistakes, and avoid immediate losses, by taking "sticky" securities into their own investment accounts. Conversely, it is argued that the underwriting banks might have an unfair investment advantage over other investors, since as underwriters they could earmark the most attractive issues (or segments of issues) for their own portfolios.

2. Risk of market concentration. Aside from the conflict of interests problem, some opponents of bank underwriting of revenue bonds question whether the long-run result might not be a decrease, rather than an increase, in underwriting competition. It is argued that there is a demonstrable tendency towards concentration in this field--6 of the 10 leading managing underwriters of municipal bond offerings already are banks, even though the banks may now underwrite only G. O.'s--and that a broadening of bank authority would tend to drive some nonbank underwriters out of the business. It is argued that banks have an inherent competitive advantage--with their broad and varied customer contacts,

large capitalization, and cheaper and more certain availability of credit--and that this is already evident in other fields, such as dealing in U.S. Government securities. If nonbank underwriters were to withdraw from the business the end result might be higher rather than lower borrowing costs.

As this review of the arguments may have demonstrated, persuasive reasons may be advanced for and against enactment of S. 1306. In testimony before the House Banking and Currency Committee in 1963 and 1965, the Board opposed enactment of bills to authorize commercial banks to underwrite revenue bonds, largely because of concern over conflicts of interests. The Board continues to believe that the principle of separation of commercial banks from investment banking, which was recognized and adopted by the Congress in the Banking Act of 1933, is a sound and significant one. This separation tends to minimize possible conflicts of interests that might otherwise impair the ability of commercial banks to devote themselves single-mindedly to their primary function of serving their depositors, borrowers, correspondents, and trust accounts.

Nevertheless, the Congress has concluded that some exceptions to the general rule are warranted, among them being an exception for the general obligations of States and their political subdivisions. To the best of my knowledge, no one is seriously proposing that the authority of commercial banks to underwrite G. O.'s should be repealed, even though the possible conflicts of interests are the same as for revenue bonds. And we have no evidence that bank underwriting of G. O.'s has resulted in abuses that call for legislative correction. Rather, the question before you now is whether, given the fact that banks are allowed to underwrite most municipal obligations, they should nevertheless be prohibited from underwriting a particular kind of municipal obligation, which was of little consequence in 1933 but which is now of major importance. Today revenue bonds account for roughly 40 per cent of outstanding long-term State and local debt. We see no reason to conclude that the risks inherent in bank underwriting of revenue bonds are any greater than those involved in G. O.'s. Nor can we see any other reason to prohibit underwriting of revenue bonds that would not apply equally to G. O.'s. We therefore recommend favorable action on S. 1306.

This should not, in our view, constitute a precedent for later authorization of commercial bank underwriting of corporate bonds or other securities of private borrowers. The case for exempting municipal obligations rests, as we see it, on a special concern for assisting public bodies in borrowing to meet public needs. We strongly believe that any further expansion of bank underwriting--for example, to assist in financing private utility companies--would be unwarranted.

Although we have discovered no very reliable way to quantify the possible benefits of this bill in reducing State and local borrowing costs, we are inclined to believe that greater competition and an increase in the number of underwriters and dealers would lead to lower costs in this field. This implies, of course, that entry of commercial banks into the field will supplement, rather than replace, the existing underwriting of revenue bonds by investment bankers. In our view, there is ample room for both. In the fiscal year ended June 30, 1967, total new issues of municipal obligations amounted to $13.1 billion, more than double the total for fiscal 1957, and continued rapid growth seems assured. This prospect presents a challenging opportunity for both commercial banks and investment banking concerns to contribute in developing and improving this market.