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Statement by

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Vice Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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I am glad to appear before this Committee today to discuss the possible implications for the financial system of the New York City financial crisis.

The threat of a New York City default--and of difficulties in the tax-exempt market more generally--has caused concern in some quarters regarding the financial condition of our banking system. This concern stems from the fact that commercial banks long have been important investors in State and local government obligations, including those of New York State and New York City. I am appending to my statement a table showing the aggregate involvement of banks in the tax-exempt market. As of mid-1975, all commercial banks had total investments of $102 billion in such obligations, accounting for 47 per cent of all outstanding State and local indebtedness. This was nearly 15 per cent of all the loans and investments of the banking system.

A key consideration leading banks to acquire these large positions in State and local obligations has been the record of performance of municipals as a high-quality, low-risk investment. There are other reasons banks hold municipals, including their tax-exempt status and their eligibility as collateral that can be pledged against U.S. and State and local government deposits. While such issues do not have the liquidity and marketability features of U.S. Government issues, the soundness of such investments has seldom been questioned. The historical record for ultimate payment of principal and interest, even among governmental units that have defaulted on their obligations, has been remarkably good.

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The record is well documented by the experience of the depression years of the 1930's, when close to 4800 State and local units out of more than 150,000 were reported to have defaulted on their debts, including 48 cities with populations of 25,000 or more. According to a study published by the Advisory Commission on Intergovernmental Relations, the indebtedness of the defaulting units at time of default was $2.7 billion--close to 18 per cent of the total amount of local debt outstanding.[1/] Yet, by 1938, all 48 cities were reported out of default, and by 1945 nearly all units of any significant size had settled their default problems. The loss of principal and interest resulting from recorded defaults during the depression period, according to a study by the National Bureau of Economic Research, is estimated to have aggregated only $100 million, or about one-half of one per cent of the average amount of State and local debt outstanding in the period.[2/]

Experience with municipal debt in the postwar years has reaffirmed the record for high quality established during the depression. Although more than 400 State and local default situations had been reported between 1945 and early 1970, most of these appear to have been temporary or technical in nature and to have involved quite small governmental units. The principal amount of debt reported as in default

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1/ City Financial Emergencies: The Intergovernmental Dimension, 1973.

2/ Hempel, George H., The Postwar Quality of State and Local Debt. National Bureau of Economic Research, 1971. P. 24. The loss figures do not include lower interest payments on refunding issues or accrued interest on unpaid principal or interest.

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as to principal or interest from 1945 through early 1970 cumulated to approximately $450 million, or less than one-half of one per cent of the total municipal debt outstanding in 1970. And the bulk of this total--$334 million--was accounted for by revenue bonds on three major projects--the West Virginia Turnpike, Calumet Skyway Toll Bridge, and Chesapeake Bay Bridge and Tunnel. An additional $72 million was accounted for by 21 other default situations involving amounts of $1 million or more, of which only two were general obligation bonds.

This experience leads me to believe that the chances of ultimate significant loss, especially by investors in general obligation bonds, are relatively small. Even if New York City should default for a time on its obligations, the economic tax base will remain and the City will have to cure the default in one way or another before it can reenter the credit market. In view of the high probability of ultimate final repayment--which means that the securities will continue to have market value--the Federal bank supervisory agencies have agreed that a reasonable length of time will be permitted, if there is a default, before banks would be required to write down the book value of their holdings to market value. During this interim period of up to six months, the default might well be cured and markets return to normal. But even if this does not happen, it is important to recognize that the amount charged off against a bank's capital account would undoubtedly be far less than the book value of the security holdings involved.

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We nevertheless have reviewed our most recent examination reports--some of which may date back for a year or so--to determine the extent to which concentrations of holdings of New York City or State securities may exist among our State member banks. I am submitting a staff report summarizing this study for the information of the Committee. It shows that only 6 of our roughly 1,100 State member banks held New York City securities amounting to more than 50 per cent of the bank's capital as of the last examination; in some cases, these positions may well have been reduced or eliminated since that time. If holdings of New York State and State agency issues are included as well, the number of banks with such investments aggregating more than 50 per cent of their capital is raised to only 17; most of these are quite small institutions.

It does not appear, therefore, that there is a significant threat of capital impairment, at least among the State member banks. The studies conducted by the Comptroller of the Currency and the Federal Deposit Insurance Corporation, I believe, reach more or less similar conclusions. A more likely possibility is that, in the event of default by the City, some banks will experience a temporary liquidity squeeze--arising, for example, from sudden shifts of deposits from one bank to another, or because banks are faced with unexpected requests for credit accommodation by their municipalities, or by holders of the defaulted bonds, or by dealers in the municipal securities market who for a time may be unable to liquidate their inventories of bonds.

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In the event that such a temporary liquidity squeeze should develop, the Federal Reserve has ample power to provide additional funds to its member banks--and to nonmember institutions when other sources of funds are not available--through loans at the Federal Reserve Bank discount windows. The Board has adapted its contingency plans to deal with such an emergency, and I want to assure you, as Chairman Burns has done before other Committees, that we are prepared to act promptly and in whatever scale is deemed necessary to assure an orderly financial environment. We recognize that such special extensions of central bank credit might have to be sizable and could risk a substantially larger expansion in money and credit than is desirable over the longer run. Such credit accommodations would therefore have to be of a temporary character, and would need to be reversed later on, but they nevertheless would be made readily available in an emergency situation.

I do not want to suggest that a default by New York City would not be a very serious matter for financial markets as well as for the City. But I do believe that the public need not fear for the stability of our banking system if a default does in fact take place. We have ample capability to provide the liquidity that the financial system may need in such a time of crisis--liquidity which, when supplied in timely fashion and adequate amounts, should help confine the damage in the municipal securities markets to only those who are most directly involved.

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ATTACHMENT I

COMMERCIAL BANK HOLDINGS OF STATE AND LOCAL GOVERNMENT DEBT
(End of year totals except where indicated)

	State and Local Government Debt Outstanding		Commercial Bank Credit		
Year	Amount ($ billions)	Bank Share (Per Cent)	Total	Holdings of State & Local Government Debt ($ billions)	State & Local Debt Share (Per Cent
1960	70.8	25.0	203.7	17.7	8.7
1965	100.3	38.8	310.4	38.9	12.5
1970	144.4	48.6	459.2	70.2	15.3
1975 (6/30/75)	216.2	47.3	708.9	102.3	14.4

Increase from 12/60 to 6/30/75	Amount ($ billions)	Per Cent Increase
State & Local Govt. Debt Outstanding	145.4	205.4
Commercial Bank Holdings of State & Local Govt. Debt	84.6	478.0
Bank share of Increase in State & Local Debt Outstanding		58.2

Source: Federal Reserve Flow-of-Funds Accounts.

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<u>ATTACHMENT II</u>

REPORT OF A SURVEY OF SIGNIFICANT STATE
MEMBER BANK HOLDINGS OF THE OBLIGATIONS
OF NEW YORK CITY, NEW YORK STATE, AND
NEW YORK STATE AGENCIES

September, 1975

In order to determine the potential exposure among State member banks to adverse developments in the market for municipal and State obligations of New York, each Federal Reserve Bank in August of this year was requested to provide information about State member banks which held concentrations of New York City, New York State, or New York State Agency securities as of the last examination report. For this purpose, a concentration was defined as holdings amounting to more than 10 per cent of a bank's capital for any of the three groups, or to more than 20 per cent of capital for the three groups combined. Principal New York State agencies included the Housing Finance Agency, the College Dormitory Authority, and the Urban Development Corporation.

The selection of the 10 per cent lower cutoff of holdings of a single group of securities relative to capital was made in view of the fact that loans to a single borrower are normally limited to 10 per cent of capital. While the limitation does not specifically apply to a bank's holdings of municipal securities, it was deemed appropriate for the purpose of assessing any possible points of potential bank exposure.

It should be noted that the data on securities were reported at par value, and were taken from examination worksheets on hand at the Reserve Banks that were not necessarily current but may date from as

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long as a year ago. Over the intervening period, it seems probable that institutional holders had lightened their investments in New York obligations, on balance, especially since the Urban Development Corporation default on February 25, 1975. Moreover, the data on securities holdings were not broken down by maturities. Many holdings could have been short-term debt and by now have been liquidated.

Of the 1,064 State member banks, 130 or about 12 per cent of the total fell within the survey guidelines. Fifty-one of the banks reported are located in the State of New York. The remaining banks are scattered throughout the country.

Table I reflects data for 112 of the survey banks which held New York City obligations. Seventy-seven of these banks held debt of the City amounting to only 10 to 20 per cent of capital. Of the remaining 35 banks, six banks held New York City debt amounting to over 50 per cent of capital; but five of the six were smaller banks--with less than 10 million in total capital.

When holdings of New York State and New York State Agency obligations are added to the analysis, the majority of banks fell into the 20 to 50 per cent of capital category as shown in Table II. This shift is primarily due to significant holdings of New York State debt. Seventeen banks were reported with total New York City, New York State, and New York Agency obligations greater than 50 per cent of capital. However, 15 of these banks, again, were smaller banks--with less than 10 million in total capital .

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On the whole, the State member banks with holdings of New York obligations reported in the survey were rather small in size. Moreover, the percentages of capital reported do not represent cause for alarm and, as previously indicated, the incidence of potential exposure has probably decreased since the last examination. In the view of the Division of Bank Supervision and Regulation, though there were a few State member banks with holdings of New York obligations representing relatively high percentages of capital, the situation on the whole appears to be quite manageable.

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TABLE I. DISTRIBUTION OF STATE MEMBER BANKS BY CAPITAL ACCOUNT AND BY HOLDINGS OF NEW YORK CITY OBLIGATIONS AS A PER CENT OF CAPITAL

Capital Account (In millions of dollars)	New York City Obligations as Per Cent of Capital		
	10-20%	20-50%	Over 50%
	(Number of banks)		
Less than one	9	12	2
1 to 10	46	12	3
10 to 25	8	--	--
Over 25	14	5	1
Totals	77	29	6

TABLE II. DISTRIBUTION OF STATE MEMBER BANKS BY CAPITAL ACCOUNT AND BY HOLDINGS OF TOTAL NEW YORK CITY, NEW YORK STATE, AND NEW YORK STATE AGENCY OBLIGATIONS AS A PER CENT OF CAPITAL

Capital Account (In millions of dollars)	Total New York City, New York State, and New York State Agency Obligations as Per Cent of Capital		
	10-20%	20-50%	Over 50%
	(Number of banks)		
Less than one	5	14	5
1-10	31	37	10
10-25	2	6	--
Over 25	3	15	2
Totals	41	72	17

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