Statement by

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before the

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I am happy to appear before this Committee today to discuss the implications for financial markets of the New York City fiscal crisis. My comments will be confined to its possible effects on the banking system, since Chairman Burns will be covering some of the broader aspects of the problem in his testimony before the Committee later this week.

A possible default by New York City on some of its debt obligations--and the recent difficulties of the municipal securities market more generally--has caused concern in some quarters regarding the stability of our banking system. This concern apparently stems from the fact that commercial banks long have been major investors in State and local obligations, including those of New York State and New York City. As of mid-year, the commercial banks as a group had total investments in tax exempt securities of $102 billion. These holdings accounted for 47 per cent of all State and local indebtedness, and for 15 per cent of total bank loans and investments. The aggregate investment in this class of securities considerably exceeds the capital and reserves of the banking system, which amount to nearly $75 billion.

Very few of these investments, of course, are in any question. For the most part they represent the securities of highly rated States and localities, the repayment of which rests upon the general power to tax the private economic base of these jurisdictions. Over the years, the record of repayment for such bonds has been extraordinarily good. Even when there have been some defaults in payments of interest or

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principal on these so-called general obligation bonds, as during the depression years of the 1930's, the defaults have almost always subsequently been cured and investors have suffered little if any ultimate loss of principal.

It would be a mistake, therefore, to conclude that a default on a general obligation bond will mean a total, or even partial, loss on the investment. In contrast to a business firm, which may not survive a financial default, a governmental entity will continue in existence, its economic tax base will remain as a source of revenue, and the default will need to be cured in one way or another before the borrower can hope to reenter the credit markets. Even if New York City should default on some or all of its $12 billion in indebtedness, what this would be likely to mean for the investor would be a temporary loss of liquidity, and perhaps some loss of current earnings, rather than a permanent loss of face value on the security held.

In view of the high probability of ultimate repayment--which means that the securities should continue to have a substantial market value--the Federal bank supervisory agencies have agreed that a reasonable length of time will be permitted, if there is a default by a major municipality, before bank examiners will require that banks write down the book value of the defaulted holdings to market. During this interim period of up to 6 months, the default might well be cured and markets return to normal. But even if a full restoration of value

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does not occur, it is important to recognize that the amount charged off against a bank's capital account is not a projection of ultimate loss, but a conservative judgment to assure that the bank's capital is adequate for the other purposes to be served. In any event, such a charge-off would undoubtedly be far less than the book value of the security holdings involved. A review by Federal Reserve staff of the most recent examination reports of State member banks last summer indicated that very few had such large concentrations of New York City issues that a writedown would threaten impairment of their capital; I am attaching a summary of that study for the Committee's information.

A more likely problem for the banking system, in the event of a New York City default, is the possibility that financial flows could become distorted for a time. Some commercial banks might suffer deposit outflows, or have unusual demands for funds to meet their needs and the needs of their customers. 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 eventuality arising from a disturbance in the municipal securities market, and is prepared to act promptly and in whatever scale deemed necessary to assure an orderly financial environment.

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In conclusion, I firmly believe that there is no need for concern by the public about the viability of our banking system. Some few institutions do appear to have heavy concentrations in New York City investments relative to capital, but I doubt that any writeoffs that might eventually be required would be too large for the banking system to handle. Liquidity pressures on particular banks and on some of their customers--including municipalities--might develop for a time, but the powers of the Federal Reserve System to liquify both individual banks and the banking system as a whole are ample to accommodate such needs.

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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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ATTACHMENT II

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 Banking 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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