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Statement of

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Joint Economic Committee

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In response to your invitation, I would like to discuss four major points:

1. The importance of commercial banks as investors in State and local obligations;

2. The impact of varying credit conditions on State and local finance;

3. What can be done to lessen the sensitivity of this sector to changing credit conditions and generally improve the market for these obligations, and

4. The influence of bank examinations and bond ratings on bank participation in the tax-exempt market.

COMMERCIAL BANKS AS A SOURCE OF FUNDS FOR STATE AND LOCAL SECURITIES

Among all the major financial institutions, commercial banks have the greatest incentive to acquire tax-exempt State and local bonds. Taking the entire period since the end of World War II, commercial banks have been the major provider of credit to State and local governments, acquiring about 45 per cent of the net increase in such obligations. The most rapid increase in bank holdings of State and local bonds has occurred since 1960. In part this acceleration was due to enlarged time and savings deposit inflows and a generally stimulative monetary policy through most of the period. It reflected also the fact that such securities constituted one of the more profitable uses during this period when business loan demands were relatively modest.

From the end of 1960 to the end of 1965 banks allocated about 20 per cent of the growth in their earning assets to tax-exempt issues. Commercial banks increased their holdings of State and local obligations from 8 per cent to 12.5 per cent of their total loans and investments, and the share of all outstanding municipal bonds in bank portfolios rose from 25.5 per cent to 38 per cent over these years.

During the five-year period, 1961 through 1965, commercial banks financed well over two-thirds of the net increase in State and local government obligations. But as business and other bank customers stepped up their credit demands in 1966--and monetary policy became more restrictive--banks cut back their rate of acquisitions of municipal bonds, acquiring an amount equal to about 40 per cent of new issues. In 1967, as loan demands eased and monetary policy became more expansive, banks again accelerated their purchases of State and local securities, acquiring an amount equal to over 80 per cent of that year's new issues and allocating one-fourth of their credit extensions to these securities.

Year-to-year variations in bank participation in the municipal bond market, of course, reflect both the shifting demands made upon the resources of commercial banks and changes in the availability of funds to them. Banks--like other lenders--make their investment decisions on the basis of the available supply of funds and both long-and short-run considerations of business strategy. Normally they prefer loans, where there is a long-run customer relationship, to investment in securities, where there usually is not, particularly when their funds are in limited supply.

Security investments are made partially to provide pools of liquidity and partially for income. When the credit demands of loan customers rise, banks move to accommodate these demands by adjusting their security portfolios. Thus, bank decisions to purchase and hold tax-exempt bonds are but one component of their long-run investment policy which must balance income and liquidity with service to, and protection of, their depositors.

VULNERABILITY OF STATE AND LOCAL FINANCES TO CREDIT AVAILABILITY

State and local governments, along with other sectors of the economy, have experienced higher costs of borrowing during the past three years. These higher yields have been required even while banks were heavy purchasers of State and local bonds in 1967. With large volumes of new debt coming to market, issuers generally have had to attract investors by raising yields. The higher cost of borrowing appears particularly onerous to State and local governments since they finance about half of their capital outlays from the sale of bonds in the capital markets.

The Federal Reserve System has undertaken studies of State and local financing experience on several occasions to determine to what degree public bodies are forced to alter their plans to borrow and to spend because of changing credit conditions and interest rates.

The most recent study focused on the year 1966 when credit markets were experiencing a sustained escalation of rates. While the survey results are not fully tabulated for the over 12,000 smaller governmental units that were contacted, they are completed for the 1,000 largest State and local governments. I shall, therefore, focus my remarks on these larger units.

Of the 983 large State and local units replying to the survey, slightly over one-half stated that they had planned to borrow long-term in 1966. About three-fourths of these carried out their plans fully as intended during that year. The remainder, however, altered either the timing or the amount of their borrowings, and 5 per cent of all respondents completely canceled their long-term borrowing plans for the year. In dollar terms, long-term borrowings were cutback or reduced by $1.4 billion, an amount equal to 22 per cent of the $6.2 billion that large units actually borrowed in 1966. About 80 per cent or $1.1 billion of the cutback were due primarily to interest rate factors.

Although the effects of borrowing changes on expenditures may stretch out through time, the very sizable cutback of long-term borrowing did not have a large immediate impact on the capital spending of large State and local governmental units. In 1966, reduced or postponed contract awards and spending on projects already underway amounted to only about $100 million. Obviously, the bulk of the shortfalls in long-term borrowing plans did not lead to reductions in contract awards and spending. In about half the cases where there was no impact on expenditures, governments had planned to borrow well in advance of cash needs. In most of the remaining cases, outlays were kept on schedule by running down liquid asset reserves or by borrowing short-term--usually from commercial banks.

We have not completed tabulations of the survey results for the smaller local governmental units, so I can only give approximate information regarding their financing experience. Preliminary analysis seems to indicate that about 360 of the 10,000 respondents abandoned or postponed long-term borrowings that had been planned for 1966. Approximately 170 of these units reduced or postponed their 1966 borrowings because of high interest costs. In contrast to the experience of the large units, however, over one-third of these units found it necessary to cancel or reduce their contract awards in those instances where high interest rates were at least a factor in the deferral of long-term borrowing. While these results are only tentative they do seem to indicate a much lower degree of financial flexibility on the part of these smaller units--fewer short-term alternatives are open to them if their long-term financing plans go awry. They either pay the higher costs of borrowing long-term or they drop the project until more favorable times.

While not minimizing the difficulties faced by individual communities in canceling their construction plans, I do wish to point to the fact that the vast majority of State and local governments, both large and small, were able to go ahead as planned, either by paying more for their long-term borrowings--as other borrowers were required to do--or by borrowing short-term or by dipping into their liquid assets. Evidently, most were reasonably successful in adjusting to financial pressures.

REDUCING THE VULNERABILITY OF STATE AND LOCAL FINANCES

With the 1966 borrowing survey as a background, let us consider some of the actions State and local governments might take to minimize the burdens of high interest rates and reduced credit availability.

First, it is important to remember the basic purpose of restrictive credit policies. They are meant to curtail total spending when limited resources are being sought too vigorously. State and local governments do not draw upon isolated pools of commodities and services. Each unit's demands must be added to those of private enterprise, the Federal Government, and other State and local governments. Each competes for the bricks, mortar, and human skills that can build houses or office buildings as well as schools and firehouses. Thus, it is necessary that some marginal public projects, as in other sectors, be deferred or stretched out during periods of over-heating in the general economy.

One way State and local governments can avoid being squeezed in the financial markets is for them to pay for more expenditures out of current receipts. But these units, caught between pressing demands for public facilities and already heavy tax burdens, would find prolonged pay-as-you-go financing of capital outlays exceedingly difficult.

However, units might time borrowings and construction so that they complement rather than compound the needs of other sectors of the economy. By the same token, many might consider the advantages in the future of accelerating their capital outlay programs during periods of economic slack to take double advantage of both lower borrowing costs and the greater availability of construction resources.

Besides advantageously adjusting their demand for credit and resources to the pressures of the rest of the economy, State and local governments might also examine their own policies and institutions for features which complicate their financing problems. We know that in 1966 units met with delays and perhaps ultimately higher borrowing costs because of interest rate limitations imposed upon them by their own constitutions or legislatures. Rigid interest rate ceilings are but one of many legal obstacles which pervade the organization of State and local governments. Debt and property tax limits which are overly restrictive either have suspended needed public improvements or have been avoided through the use of expensive alternative forms of financing such as the revenue bond. State governments when strapped by limitations on their indebtedness that have become outmoded often must pass the burden of borrowing onto their subdivisions, where it tends to be less secure and therefore more costly.

Evidence indicates that borrowing costs are higher for smaller units, partially because they borrow in small amounts which are uneconomical to offer in the national market. While measures may be taken to improve the competitive position of these small issues, they still represent a low volume, high cost per unit, form of borrowing.

Some State governments have seen fit to lend credit assistance to their local units by giving direct loans, guaranteeing local borrowings, or through extending grants to help defray debt service. Others have made efforts to oversee their subdivisions' borrowing programs and to lend technical advice, thereby improving the marketability of local obligations. Many States, aware that excessive diffusion of local government responsibility and resources can be uneconomical in ways other than the cost of borrowing, are encouraging consolidation of and cooperation among local governments.

None of these efforts, which State and local governments might accomplish for themselves, will insulate them from the burdens of competing for limited funds in times of financial strain. But such measures could help in marshaling their energies and resources to plan ahead for and successfully cope with such times.

The Federal Government might also assist in alleviating State and local borrowing difficulties. For example, legislation to permit commercial bank underwriting of revenue bonds could improve the competition in the municipal bond market and might lower slightly the borrowing costs of such issues. Such legislation is supported by the Board of Governors, as Governor Mitchell testified before the Senate Subcommittee on Financial Institutions last August.

Borrowing costs on municipal bonds are already much lower than they otherwise would be because of the exemption of their interest from Federal income taxes. This feature makes these securities most attractive to those investors in the higher tax brackets--like high income individuals, as well as to the more heavily taxed financial institutions, such as commercial banks and fire and casualty insurance companies. Thus State and local governments do not have to compete on the same basis with other issuers of debt obligations, the interest income from which is fully taxable.

This implicit subsidy given to State and local governments has been less of a boon to these governments in recent years as the volume of new tax-exempt issues has exceeded the volume of funds available from investors in the highest tax brackets. In order, therefore, to attract additional investors to municipal bonds, tax-exempt yields have had to rise relative to yields on taxable securities to a point that makes them attractive to investors in lower and lower marginal tax brackets. For example, over the last decade it appears that investors in marginal tax brackets between 20 per cent and 30 per cent have had to be drawn into this market in order to meet the demands for funds by State and local governments.

Calculations by the U. S. Treasury and others indicate that the tax revenues foregone because of the present tax-exemption of the interest income of State and local obligations considerably exceed the interest cost savings enjoyed by these units. This has prompted suggestions that the interest income from municipal bonds be made fully taxable. Since such obligations no doubt would carry higher yields than is today the case, it has been suggested further that the increase in the cost of borrowing be offset by a subsidy from the Federal government. The extent to which such a subsidy plan might lower the net cost of borrowing for State and local governments and increase the revenues of the Treasury depends directly on its design. And it must be recognized that the demands of investors in particular are fluid and that their portfolios are flexible as they pursue their investment objectives. Therefore, any calculation of future tax revenues gained and subsidy payments needed if State and local securities were to be made taxable depends on a wide range of variables including the way in which markets adjust ultimately to the changed capital market environment.

Bills recently introduced by Representative Patman, H.R. 15991, and Senator Proxmire, S. 3170, propose that the Federal government subsidize 33 per cent of the interest cost on State and local obligations that voluntarily give up their tax-exempt status. Issuing governments would therefore be free to choose between issuing their securities on a tax-exempt basis as they now do, or issuing them on a taxable basis and receiving the subsidy. Governments will choose the alternative that is cheapest for them after comparing the interest cost of issuing their securities under the two alternatives. Clearly, if the cost of borrowing in the taxable market is more than half again that of borrowing in the tax-exempt market, they will find it most economical on a net-cost basis to borrow in the former and forget the subsidy. On the other hand, should the ratio of the tax-exempt to taxable bond yields rise above .67, governments will find it less expensive to issue taxable bonds and take the subsidy.

Those investors above approximately a 33 per cent marginal income tax bracket would still find it advantageous to hold tax-exempt bonds so long as the ratio of yields on tax-exempts to alternative taxable securities remains at or above .67. On an after-tax basis they will be earning more on the tax-free income than if they had invested an equivalent amount in similar obligations the interest income of which is taxable.

Generally speaking, the ratio of yields on tax-exempt and taxable bonds in the market will depend on the demand for and supply of existing stocks of obligations. The change in the stock of tax-exempt bonds will be determined in part by the decisions of the issuing authorities between tax-exempt and taxable securities. As long as the total outstanding stock of tax-exempts exceeds the holdings desired by investors in the greater than 33 per cent marginal tax-bracket, the ratio of yields will exceed .67. But over time there will be a downward pressure on the ratio of yields. Communities will issue taxable securities and take the subsidy, and investors will bid up the prices for outstanding tax-exempt bonds as the supply of new tax-exempt issues tapers off. The ratio of tax-exempt to taxable yields will most likely tend to settle down to approximately .67. This is a problem in dynamic adjustment--it would take time to work itself out and just how long it would take, I do not know.

Channeling all or part of the new issues of State and local obligations into the taxable bond market will of course broaden the range of investor groups potentially attracted to State and local obligations. However, it is not without cost in terms of the subsidy paid by the Federal government. And it should be realized that additional Federal income tax revenues caused by investors shifting into taxable assets might not meet the full cost of such a subsidy, no matter what the extent of its use.

Taking the 33 per cent subsidy plan, as I have just mentioned, investors in the greater than 33 per cent marginal income tax bracket probably will stay in the tax-exempt market. Most investors <u>below</u> that tax bracket--as the ratio of tax-exempt to taxable bond yields falls--will shift into taxable investments. But the additional tax payments they make to the Treasury would tend to return less than the added expense of the 33 per cent subsidy. That is, it will cost 33 cents for every dollar's worth of investment income shifted into a taxable category; but the investors most likely to make such a shift will be those who on the average pay less than 33 cents in taxes on each additional dollar of interest income.

Another proposed form of Federal government assistance is the guaranteeing of debt service on State and local obligations to be financed by insurance fees. Such a proposal would virtually eliminate the default risk to investors on insured obligations, make them homogeneous in terms of investment quality (thus eliminating the need for individual bond ratings for such securities), and would enhance their marketability. These may be desirable objectives, but they are not costless. Fees must be collected to provide for the contingency that some issues may default. If the insurance fees are proportionately the same for all issues irrespective of their intrinsic quality, then this implies that governments with relatively stronger credit positions will, in part, carry those with weaker credit standing. And the Federal government would be assuming a large contingent liability, to the extent that the fund built up by the fees does not grow as rapidly as the liability.

It is not clear what the value of such a guarantee would be to issuers. The experience of Public Housing Authority Obligations indicates that such a Federal guarantee reduces the yield demanded by investors by perhaps 20 basis points on the average. Whether this would still be the benefit for guaranteed securities is problematic. Smaller and lower or unrated issues would probably be benefited the most. However, it should be pointed out in passing that increasing the supply of Federally guaranteed issues would no doubt expand the competition for funds for certain forms of Federal borrowing, thus tending to increase their interest costs.

As in the proposals of Representative Patman and Senator Proxmire, interest subsidies and guarantees could be used in tandem. The ultimate cost and benefits of a combined program depends jointly on how such securities are accepted into investor portfolios as well as on the extent of their utilization by governmental units. I cannot predict with certainty what the final outcome would be.

But on balance, it appears that the current proposals would not constitute a revenue bonanza for the Treasury. Indeed, they probably would entail a net cost to the Federal government, both through the cost of the subsidies as well as in higher direct borrowing costs, since guaranteed taxable State and local obligations would be more competitive with U. S. Governments and Agency issues. Such a program of Federal assistance most likely would lower the costs of borrowing for State and local governments, both through direct payment of the subsidy, and indirectly by relieving the volume of borrowing in the tax-exempt market. But it is not at all clear to me that the benefits for the State and local units would be as large as the costs to the Federal government.

BANK EXAMINATIONS AND COMMERCIAL BANK HOLDINGS OF STATE AND LOCAL OBLIGATIONS

Mr. Chairman, in concluding this statement I would like to make a few remarks on bank examinations and their effect on the portfolios of the smaller commercial banks.

The broad objective of bank supervision is the maintenance of a sound banking system. An important part of bank supervision is the examination of bank portfolios which are undertaken for the purpose of protecting the individual depositors and the banking system at large from unwise extensions of credit. In the course of these examinations of loan and investment portfolios, the regulatory agencies are concerned with appraising the general solvency of bank earning assets, including the obligations of State and local units, and not with rating the quality of particular issues. Banks are asked to stand ready to review their reasons for selection of specific holdings if there is any doubt of their credit worthiness--regardless of any bond rating.

The information needed to document the credit worthiness of a particular bond issue--relating to such factors as taxes and receipts, trends in outstanding debt, tax base,and population--are matters of public record and are readily available. It is the type of information basic to the bank's having made an informed and rational investment in the first place. It is the type of information always given in bond prospectuses, and is generally available from dealers selling bonds to the bank. Additionally, many of the holdings of the smaller banks are the obligations of their own local governments or those of the surrounding communities, whose finances they should know well.

It is possible, as has been suggested, that factual data reports prepared by a Federal agency might be useful to investors and, therefore, might improve the marketability of very small issues. But we feel that much of this data used in reaching investment judgments are already available to prospective investors.

It has been the experience of our examiners that the number of cases where bank holdings of State and local obligations have been criticized--whether they have been nationally rated or not--has been infinitesimal. According to the latest data we have (for 1966) less than .01 per cent--one ten thousandth--of the total dollar amount of member bank "other security" holdings (made up predominately of municipal bonds) were classified as being below investment quality.

I think that the best evidence that examination procedures and quality of investment requirements have not deterred commercial banks from investing in State and local obligations, especially those of a small and unrated nature, is found in the magnitude of their holdings of these securities. In this respect, the results of a recent survey of the State and local obligations held by insured <u>nonmember</u> banks during the period 1960-1964 are helpful. These banks are regularly examined by the FDIC using procedures which, under the various uniform examination agreements, are the same as those employed by the Federal Reserve and the Comptroller of the Currency. We have no reason to believe that results for member banks would be substantially different.

The point I wish to call to your attention is that on average these banks held a high percentage--about 30 per cent--of their State and local obligations in the unrated category. At the outside, during the 5-year period 1957 through 1962 unrated bonds accounted for about 1/3 to 1/4 of the dollar volume of all tax-exempt issues--general obligations and revenues. Moreover, the smaller the bank, the higher, on the average, was its percentage holdings of the unrated issues. Holdings in the unrated category amounted to well over 1/2 of all State and local issues for banks with deposits of less than $5 million. This seems to indicate that far from being regulated away from the unrated market, smaller banks have taken a very strong interest in these securities.

This, of course, is to be expected. The local bank is aware of local needs and conditions and its stake in the community. It is the traditional source of credit for small borrowers, both private and public.

COMMERCIAL BANK PARTICIPATION IN MARKET FOR STATE AND LOCAL GOVERNMENT OBLIGATIONS

Year	Change in Commercial Bank Holdings Of S&L Government Obligations		Level of Commercial Bank Holdings Of S&L Government Obligations	
	Net Change ($ billions)	A % of Total Net Issue	Level ($ billions)	As % of Total Outstanding
1950	1.6	59.2	8.1	32.8
1951	1.1	57.8	9.2	33.8
1952	1.0	38.4	10.2	34.1
1953	0.6	16.2	10.8	31.6
1954	1.8	4.1	12.6	31.8
1955	0.1	3.1	12.7	28.3
1956	0.2	6.7	12.9	26.1
1957	1.0	22.7	13.9	25.8
1958	2.6	30.0	16.5	28.1
1959	0.4	8.9	17.0	26.7
1960	0.6	16.7	17.6	25.6
1961	2.8	57.1	20.3	26.9
1962	4.4	88.0	24.8	30.0
1963	5.2	77.6	30.0	34.1
1964	3.6	59.3	33.5	35.7
1965	5.1	67.6	38.6	38.5
1966	2.4	40.0	41.0	39.2
1967	8.5	82.5	49.5	42.2

Source: Board of Governors, Federal Reserve System.

YIELDS ON COMPARABLE MUNICIPAL AND CORPORATE BONDS AND MARGINAL INCOME TAX RATE GIVING EQUIVALENT AFTER-TAX YIELDS 1950-67

Year	Annual Average Yield*		Equivalent** Yield Tax Bracket 1 - [(1)/(2)]
	Municipal Bonds (1)	Corporate Bonds (2)	
1950	1.56	2.62	40
1951	1.61	2.86	44
1952	1.80	2.96	39
1953	2.31	3.20	28
1954	2.04	2.90	30
1955	2.18	3.06	29
1956	2.51	3.36	25
1957	3.10	3.89	20
1958	2.92	3.79	23
1959	3.35	4.38	24
1960	3.26	4.41	26
1961	3.27	4.35	25
1962	3.03	4.33	30
1963	3.06	4.26	28
1964	3.09	4.40	30
1965	3.16	4.49	30
1966	3.67	5.13	28
1967	3.74	5.51	32

* Moody's Investor Service, Aaa, long-term bonds.

** Investors in the calculated marginal income tax bracket earn the same after-tax yield on municipal and corporate bonds of comparable quality.

ANNUAL AVERAGE INTEREST RATE SPREADS BETWEEN PUBLIC HOUSING AUTHORITY AND MUNICIPAL OBLIGATIONS
(Per cent)

	(1) 33-40 year PHA Obligations	(2) 30 year "Good Grade" Municipal	(2) - (1) Interest Rate Spread
1962	3.18	3.42	0.24
1963	3.11	3.36	0.25
1964	3.33	3.48	0.15
1965	3.31	3.45	0.14
1966	3.74	3.99	0.25
1967	3.89	4.15	0.26
Total*	3.45	3.66	0.21

* Figure is the averaging all observations of given issues.
SOURCE: U.S. Department of Housing and Urban Development; Salomon Brothers & Hutzler, An Analytical Record of Yields and Yield Scales, Part II.

HOLDINGS OF STATE AND LOCAL GOVERNMENT OBLIGATIONS BY INSURED NON-MEMBER COMMERCIAL BANKS EXAMINED IN 1964, ANALYZED BY SIZE OF BANK

Size of Banks By Total Assets ($ millions)	Total Holdings of State And Local Government Obligations ($ millions)	Holdings of Unrated Issues As A Percent Of Total Holdings (Per Cent)
Under 1	11	63.8
1 to 2	89	61.8
2 to 5	559	50.8
5 to 10	848	36.7
Over 10	2,502	18.8
All sizes	4,009	28.1

HOLDINGS OF UNRATED OBLIGATIONS AS A PERCENTAGE OF TOTAL HOLDINGS OF STATE AND LOCAL GOVERNMENT ISSUES BY INSURED NON-MEMBER COMMERCIAL BANKS EXAMINED 1960-1964*

Year	Total Holdings of State and Local Government Obligations ($ millions)	Holdings of Unrated Issues As A Percent Of Total Holdings (Per Cent)
1960	2,881	31.7
1961	2,912	31.5
1962	3,158	30.3
1963	3,466	29.2
1964	4,009	28.1

* Both tables based on tabulations from Federal Deposit Insurance Corporation examination reports.