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STATEMENT OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE JOINT ECONOMIC COMMITTEE
WEDNESDAY, SEPTEMBER 24, 1975, 11:00 A.M.

NEW YORK CITY'S FINANCIAL SITUATION

Mr. Chairman and Members of this Distinguished Committee:

I am here today at the express invitation of the Chairman, who has called upon me to testify about the possible impact of a financial default by New York City.

This is an occasion that none of us can welcome. All of us share the hope that a default can be avoided. Personally, I am confident that if the proper steps are taken, default will be avoided. One of the great pleasures in my life was to spend some 20 years working in the financial community in downtown Manhattan. I gained from that experience not only a love for the City but also enormous respect for the wisdom and strength of its people. I sincerely believe that if those great resources are properly marshaled, New York City will emerge from its current difficulties.

As your invitation to me recognizes, however, it is also important that we seek to understand what the implications would be if default does occur. I am sure that the Members of this Committee, as well as the American people, want this inquiry to be as honest and objective as possible. This cannot be a time when we delude ourselves with excessive optimism and thus fail to act wisely. By the same token, we should not engage in excessive pessimism. Impassioned statements that a default would have catastrophic consequences for the financial markets as well as the economy -- statements which have no foundation in observable facts -- can only make the situation worse. This is a time, then, for an honest appraisal, devoid of emotionalism or partisanship. My testimony today is offered in that spirit.

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I have appeared before this Committee many times to discuss economic and financial issues. I have enjoyed our dialogues and I recognize their value in exposing your colleagues in the Congress and the nation as a whole to a wide range of views on the issues which confront us.

Our job today is not a pleasant one. This Committee has an obligation to inquire into the major economic matters which face the nation and I have a corresponding obligation to present the Administration's views: responsively, accurately and fairly. And neither of us meets these obligations unless we deal with all sides of the issues: the unlikely as well as the likely, the worst case as well as the best.

Moreover, these obligations extend beyond evaluation. To the extent we identify the potential for harm in a default, we must implement measures designed to minimize harm in the event default occurs. Properly designed, such measures should not enhance the possiblity that default will occur. Nor should they reflect a judgment that a default will necessarily occur. They simply involve the Government carrying out one of its most important roles: protecting its citizens.

It is for these reasons that we have carefully evaluated the potential impact of default. Because default has two aspects -- the objective and the psychological -- any evaluation of the impact must involve highly subjective judgments. Absolute certainty is simply not possible.

With these considerations in mind, let me outline the substance of my remarks today.

First, although the challenges and the task are great, New York City, with the assistance of the State, has both the mechanisms and the resources to avoid default.

Second, if default were to occur, the event would be primarily legal in nature: the political and social infrastructure of the City would remain intact.

Third, while a default could adversely affect the capital markets, the effect in my judgment would be tolerable and temporary.

Fourth, a default would cause little, if any, damage to our financial structure: the banking system would remain intact, no bank customers would lose their deposits, and the system would continue to be able to provide credit to all levels of the economy, including consumers.

Finally, the costs and risks associated with any program to provide special federal financial assistance to prevent default substantially outweigh the benefits which prevention would provide.

The Administration Program

At the President's request, I have put together an informal inter-agency task-force, chaired by my Under Secretary Edwin H. Yeo III, to deal with every aspect of a potential default by New York City. The evaluations and the plans outlined in my testimony today are the result of these efforts. We did not, however, feel that it would serve anyone's interests to publicize the activities of this group until this time.

Working through this group, and with the cooperation of other agencies of government, we have developed a program designed specifically to minimize harm in the event of a default. Particular aspects of the program are described in detail throughout my testimony, but let me summarize it now.

-- To complement action by the State Legislature, we have prepared, and will shortly submit to the Congress, legislation amending Chapter 9 of the Federal Bankruptcy Act to facilitate use of the protections of that Act by New York City. In addition, we are also studying the feasibility of a Chapter 11 type reorganization procedure as an alternative mechanism.

-- We will continue to provide for the flow of Federal assistance payments to New York City.

-- To protect the banking system and thus assure the continued availability of resources that system provides to consumers, corporations and governments, the FDIC will, in appropriate cases, provide capital to institutions where such action is necessary to maintain solvency. Moreover, as Chairman Burns reported to this Committee earlier this month: "the Federal Reserve will act promptly to relieve liquidity strains on the banking system, whatever the cause of those strains may be."

Let me repeat, default can be avoided. But it is our responsibility -- to the Congress and to the nation -- to design programs for any eventuality.

Current Status

Let us now consider the current efforts of New York City and New York State to prevent a default.

On September 9, a special session of the New York State Legislature enacted legislation calling for:

-- Creation of a State dominated Emergency Financial Control Board to assume plenary control over the City's finances;

-- Authority to issue $750 million in short term State notes, the proceeds to be used to purchase MAC bonds;

-- A mandate to State and City employee pension plans to purchase $750 million in MAC bonds (and relief for the State Comptroller with respect to his fiduciary responsibilities regarding these plans);

-- An increase in MAC's borrowing authority from $3 billion to $5 billion; and,

-- Authorization for the City to file a petition in bankruptcy under Chapter 9 of the Federal Bankruptcy Act.

Two days later, New York State sold $755 million of short term notes, including $250 million earmarked for the City. MAC is beginning to raise from other sources the $800 million necessary to complete the $2.3 billion package which is required to finance the City through December 1.

At the City level, meanwhile, Mayor Beame has appointed a top financial executive to serve as the chief financial officer of New York City and to develop, by mid-October, an expense reduction plan to return the City to a sound fiscal basis.

These laudable efforts reflect a renewed sense of dedication to attack the causes of the problems I discussed with Congressman Rosenthal's subcommittee last June. Will these measures work? Can the City do enough between now and December to restore investor confidence? Some have answered in the negative, but I cannot agree. I would be less than candid with this Committee if I suggested the task will be easy. I would be less than candid if I failed to say that more in the way of immediate actions -- immediate expense reductions -- is required now than would have been required at some earlier time. But it would be equally untruthful to suggest that the job cannot be done. Appropriate mechanisms are now in place. It is essential that they be used promptly and well.

Impact of a Default

Necessary Concepts

To set the framework for my analysis of the impact of default, it is important to define some relevant terms and concepts. I sense that the dialogue concerning the issue has been hampered by confusion over the meaning and import of certain key words. First, there is "insolvency" which, simply stated, means that a person or a city has current obligations which exceed its available funds. "Default" is a technical legal term describing a debtor's refusal or inability to pay a creditor who has demanded payment. "Bankruptcy" describes a legal proceeding -- provided for in the Constitution -- under which an insolvent party in default turns over to a court the job of deciding how his financial resources will be apportioned among creditors.

In looking at default and bankruptcy, we should also draw a distinction between the options available in the event of a corporate default and those available with respect to a municipal default. If a corporation defaults and is subsequently brought under the jurisdiction of a federal bankruptcy court, one option -- albeit often not the most desirable one -- is liquidation: the sale of assets to satisfy the claims of creditors and the subsequent disappearance of the corporation as a continuing entity. Both common sense and Constitutional principles preclude such an option with respect to municipal defaults.

In this respect, a default by a state or local government is closely analogous to a default by an individual person. In either case, if a bankruptcy proceeding ensues, resources essential to the maintenance of life in the one case and essential services in the other, are protected from the demands of creditors.

It is important to re-emphasize this point: If New York City defaulted, it would continue to exist and to operate. Tax payments, Federal and State assistance payments and other sources of revenue would continue to flow. Schools and hospitals would remain open; police, fire and sanitation services would be provided and paid for.

In short, it is essential not to confuse the legal and idiomatic meanings of the term bankruptcy. In common parlance, we may use bankruptcy to define a condition devoid of substance or resources. By that definition, New York has not been, is not now, and will not be bankrupt. If New York City does default, however, to deal with its creditors in an orderly way, a proceeding under the Federal bankruptcy laws is the most appropriate solution.

As I have often said, no observer who is asked to predict the impact of a default can do so with absolute certitude. A default -- like any major financial reversal -- has two aspects: a tangible, objective aspect on the one hand and a psychological aspect on the other. It would be inadequate to limit the analysis to only one of these aspects. And confusing the two would further cloud our evaluation of the impact of default. Indeed, I sense that such confusion is in large part responsible for some of the more extreme predictions which have been made in recent weeks.

Moreover, as I cautioned in my letter of last week, it is important to be sensitive to the risk that the evaluation process itself may aggravate reaction to a default. Let us suppose, for example, that leaders of major financial institutions contend that their institutions and the markets in which they function would be devastated by a default. Objective factors notwithstanding, such contentions would measurably enhance the impact of default.

Let me turn to a sector-by-sector analysis.

<u>Essential Services</u>

If New York City defaulted on an obligation to redeem a maturing note issue for cash, a question of immediate importance is whether the City could continue to provide essential services: police and fire protection, sanitation, mass transit, water and sewerage facilities, and the like. We evaluated the outlays required to provide these services against the City's level of receipts. While, as I have indicated on earlier occasions, levels of outlay for these services are extreme in relation to the outlays of other cities, New York City's revenues appear sufficient to provide an adequate level of services in the event of default.

Federal Assistance Programs

Another potential concern relates to continuation of the various Federal Assistance programs which benefit the citizens of New York. The Office of Management and Budget and the Domestic Council have completed a survey of the most important of these programs with the objective of identifying the potential consequences on scheduled assistance flows in the event local mechanism temporarily become unavailable. As the Committee knows, certain assistance to the City and its citizens depends upon local matching funds. The great bulk of this assistance is matched by the State of New York. However, under State law, the City is required to provide some share of the State portion. In our view, and under current Federal law, the State is responsible to make the matching payments if the flow of Federal assistance is to continue.

Speaking more broadly, programs of assistance to the disadvantaged are fundamental in a compassionate democratic society. But if such programs lose the support of the American people -- if they are perceived as too often providing the wrong benefits to the wrong recipients -- our ability to provide any assistance of this nature will be limited.

For these reasons, the President has asked Vice President Rockefeller, as Chairman of the Domestic Council, to conduct a thorough re-evaluation of all Federal assistance programs and to develop proposals for reform. While that review is not yet complete, my views are well known. I personally have long favored a simple program of income maintenance as the most efficient approach to our responsibilities in this area.

Debt Adjustment

The requirement that the City continue to provide and finance essential services underscores the importance of insuring that there is an orderly mechanism for allocating the City's financial resources and effecting a restructuring of the short term debt. Absent such a mechanism, there is the risk of a multitude of lawsuits, each seeking a legal injunction against the payment of City funds to one class of creditor or another.

It is for this reason that we have prepared, and will submit shortly to Congress, legislation amending Chapter 9 of the Federal Bankruptcy Act. This legislation is designed to insure that the claims of all legitimate creditors would be dealt with in a single proceeding. It would be complementary to the legislation enacted by the New York State Legislature authorizing New York City, in the event of default, to seek reorganization of its debt under the plenary jurisdiction of a federal court.

Specifically, our proposal would modify existing law by eliminating the existing requirement that a city must file a reorganization plan and written assents to the plan from 51% of the creditors before obtaining the protection of a Federal bankruptcy court. Under the revised procedure, Federal protection would be provided upon the filing only of a simple petition by the City. As is the case with respect to other types of reorganizations under our bankruptcy laws, the reorganization plan and the creditors' assent thereto would be developed in the course of the proceeding. In the interim, however, the City would be protected from conflicting claims and injunctions regarding its resources, and could continue to conduct its affairs in an orderly manner.

I would point out that this proposal is substantially consistent with the recommendations of the National Commission on the Reform of the Bankruptcy Laws, embodied in S. 235.

Financial Markets

In assessing the impact of a default on the financial markets, we are dealing in the realm of judgment; as I have said, absolute certainty is simply not possible. My analysis is based on a detailed review of all the factual circumstances, discussions with a wide range of market professionals in the private sector, and my own conclusions, based on more than twenty years of experience in the investment banking business.

The impact of a default on markets other than the municipal market is, in the final analysis, closely related to the impact on the overall economy. As I shall discuss more fully in a few moments, it is our judgment that a default would not damage the prospects for the Nation's economic recovery. The public understands that New York City's problems are unique in most important respects. Moreover, over the past six months and in the months to come, the public has had, and will have, ample opportunity to decide whether a default by New York City is merely representative of a more fundamental flaw in our economy. Only if such a conclusion were reached -- and there is no objective reason why it should be -- could we expect a serious and lasting adverse impact on these markets.

Municipal Bond Market

Our conclusions with respect to the municipal bond market are at once more precise and more complex. Over at least the past year, the municipal market has been unsettled due to a variety of complex factors.

First, the enormous volume of tax-exempt securities coming to market -- more than $51 billion of bond and notes in 1974 and more than $40 billion in the first eight months of this year alone -- has not been matched by a corresponding increase in demand for such securities. Second, inflation and now its inevitable handmaiden -- the anticipation of future inflation -- caused by massive Federal demands on the market has dampened investor interest in committing funds for the long term. Finally, a series of events -- the repeal of the Port Authority covenant by the legislatures of New York and New Jersey; the default by UDC, occasioned by the New York State Legislature's initial refusal to carry out its "moral obligation;" and the problems of New York City itself -- have all sharpened investor awareness of risk and created an element of doubt about the willingness of public bodies to carry out their financial obligations.

To a significant extent, these doubts have already led to some adjustments in the market. In the event of default, we would expect only a temporary period of moderate adjustment. And over a slightly longer time frame, we can see some potentially favorable signs. We understand that numerous intermediaries and investors are currently withholding funds from the municipal market because of the current uncertainties. When the New York City situation is resolved -- one way or another -- we can expect a substantial return of funds to the market, improving liquidity and lowering borrowing costs.

But the implications of default are broader than short range fund flows or price adjustments. Since at least the beginning of this decade, there has been a marked increase in the tendency of investors to restrict themselves to higher-grade instruments -- or a "flight to quality" to use the terminology of the market. Inflation and its by-products is the primary cause, but there is little question that major financial reversals -- the penn central bankruptcy, for example -- have served as important catalysts.

Clearly, New York City's situation has caused this trend to accelerate. Issuers whose obligations are viewed as less than prime are paying high rates of interest relative to the general structure of interest rates. Conversely, well-run issuers are benefitting in the form of lower rates.

In short, when we move away from this period of uncertainty, underlying credit characteristics -- financial soundness -- will be the dominant factor in the pricing of all municipal debt. The result will be a better and more efficient municipal bond market.

At the same time, we cannot ignore the way in which the municipal market has performed even under these seriously unsettled conditions. During August alone, four states and 255 municipalities raised nearly $2.6 billion in long term debt. And contrary to widely held opinion, such funds were raised at a cost not grossly disproportionate to historical levels.

Traditionally, there has been a 30% spread between tax-exempt and taxable issues of comparable quality. When we hear complaints about the record rates municipalities are paying for funds, we must keep in mind that conditions in the corporate market are no better. This month, the spread between long term prime municipals and comparable utility issues was squarely on the 30% figure.

This is not to suggest that the municipal market has not been impacted by the uncertainty surrounding New York City's condition. But it does place the reaction of the market in a more accurate perspective than some of the rhetoric of recent months.

Finally, the disruptions which have occurred in the market place can provide an impetus for some very important reforms. One reason our capital markets are the finest in the world is that, under our laws and procedures, investors are provided with detailed and accurate information concerning potential investments. To the extent investors begin to receive such information from tax-exempt issuers, the market will clearly benefit.

New York State and Its Agencies

We have taken a particularly careful look at the credits within New York State to determine whether any credit would be able to withstand an increased level of scrutiny. We now believe there is little risk that a default by New York City would directly precipitate a default by New York State or its agencies.

Impact on the Banking System

As the Committee is aware, the Treasury Department, in conjunction with the Comptroller of the Currency, the Federal Reserve Board and the FDIC, has taken a close look at the holdings of New York City securities in our banking system. While significant amounts of New York City's debt is held by commercial banks, we do not believe a default would have a material impact on the banking system.

Specifically, our analysis revealed that only an infinitesimal number of the nation's 14,000 commercial banks could face serious capital impairment if New York City defaulted. Moreover, all of the nation's larger banks would be secure in the event of default.

But as is the case in other areas, we have felt an obligation to develop mechanisms to minimize all risks, however small. Accordingly, with respect to any bank which may be impacted, various mechanisms are now available to insure that none will fail as a result of a decline in the value of their holdings of New York City obligations. Bank customers have no need to fear for their funds.

1. Where possible, bank directors will be required to contribute additional capital.

2. Certain banks may be sold to, or merged with, other banks or bank holding companies.

3. As a last resort, in appropriate cases, the FDIC may provide capital in the form of convertible subordinated debt, at the same time imposing appropriate sanctions on the bank officials directly and indirectly responsible for the bank's exposure.

In addition, in recognition of the likelihood that any default could be cured promptly, the bank regulatory agencies have agreed that in the event of default, no bank will be required to write its holdings to market for six months.

Overall Economic Impact

As I suggested earlier, we cannot conclude that a default by New York City would result in a broad-based decline in consumer or investor confidence or in the adoption of unnecessarily restrictive lending policies by financial institutions. The American people know the reasons New York City is having financial difficulties and they know that there is little, if any, direct relationship between these difficulties and the condition of the national economy.

New York City is facing a possible default because for years it has spent far more than it takes in. New York City is facing a possible default because, until recently, it has not shown itself willing to implement the necessary reform measures required to restore confidence and regain access to the capital markets. No change in the national economic picture will measurably improve conditions in New York. And by the same token, no change in New York's condition will materially influence the economy as a whole.

Federal Financial Assistance

The only event which could modify this conclusion would be the provision of Federal financial assistance to avert a default. Indeed, such assistance -- be it in the form of a guarantee or a loan, insurance or a grant -- would, in my view, cause many problems for the process of recovery.

As the chief financial officer of this great country I have a responsibility to all the people, not simply to particular groups or sectors at particular times. My job, in essence, is to protect and restore the eroding fiscal and financial integrity of the United States for the benefit of every citizen. To state my views on special financial assistance for New York City most directly: I would be ignoring this fundamental responsibility if I were to support such assistance.

For years, government at all levels has been promising more than it can deliver. This is the cause of New York City's problem and, in my view, it is the cause of our severe problems at the Federal level as well. More and larger deficits and the increased level of Federal borrowing required to finance these deficits have combined to threaten our economic system with fundamental change: No longer can we be confident that our private sector will have access to the capital required if it is to meet the needs of all our citizens. Yet some would have us accelerate these changes to deal with the consequences of fiscal irresponsibility at the local level.

Any form of financial assistance would directly increase the burden the Federal Government imposes on the capital markets. Who would suffer? All borrowers, including every other state and local government, would pay higher interest rates. And certain sectors -- housing, small and medium-sized companies, for example -- could discover that funds were not available at any price.

Moreover, we do not escape these problems by making the assistance slightly less direct; by providing a guarantee or insurance for municipal debt. Indeed, such a program would create a security superior to those of the Federal Government itself: Backed by the full faith and credit of the United States and exempt from Federal taxes. The impact on any municipal issuer which did not have a guarantee would be direct and severe: The guaranteed bonds would skim the cream of the market and all other issuers would pay higher rates.

And what would such a program do to fiscal policies at the local level? Today, the desire to maintain access to credit at the lowest possible rate is the most important incentive for fiscal restraint. A Federal guarantee program would provide all participants with the credit of the United States: This critical restraint on spending would be lost entirely.

But, some will ask, why not have the Federal Government impose these restraints as a condition for the guarantee? That possibility concerns me more than any other because it would amount to no less than a Federal takeover of the fiscal and financial decision-making process at the State and local level.

We would have to create a new bureaucracy, simply to concoct and enforce the guidelines as to local priorities we here in Washington would be imposing on the Governments of the nation. We would be confronted with the sorry spectacle of duly-elected local officials lining up outside my door, attempting to persuade me that they were carrying out their responsibilities in a satisfactory fashion. We would, in short, be contravening constitutionally - imposed principles of Federalism; principles which lie at the heart of the structure of government in this nation.

Thousands, perhaps tens of thousands, of governments would resist this intrusion into local affairs. And they would be absolutely right. But in the final analysis, theirs would be a Hobson's Choice: Submit to Federal control or pay the price of independence in the bond markets. Are we really prepared to inflict this choice on the nation?

Finally, there are those who say that New York City is a special case; that helping New York will not obligate us to help other cities in the future. But we are already obligated. We are obligated to local officials throughout the country who have risked their careers by insisting on fiscal restraint. Would financing the deficits of New York City be consistent with our obligation to them? And can we really draw the line at New York City? I doubt it. Assistance to one city would create an intolerable precedent for the future.

Before concluding, I must return once again to an important point. As strong as our economy and our financial system may be, it remains somewhat vulnerable to attacks from within. We in the Administration have done all we can to evaluate the risks a default presents and, where possible, to provide mechanisms to minimize those risks. But if I may borrow a thought from Justice Holmes, the most elaborate fire protection system in the world may not protect theatergoers from the man who cries "fire."