The Department of the TREASURY NEWS

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STATEMENT OF THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
THURSDAY, OCTOBER 9 AT 9:30 A.M. EDT

NEW YORK CITY'S FINANCIAL SITUATION

Mr. Chairman and Members of this Distinguished Committee:

Today marks an important juncture in Congressional consideration of the financial situation in New York City. Today we move from study, investigation and evaluation into the infinitely more demanding process of considering specific legislative responses. And as we make this transition, it becomes all the more important that the issues be dealt with in the serious and objective manner they deserve. Measured tones and deliberate analysis are imperatives. I have noted that there are two risks presented by a default: the financial and the psychological. I have often expressed the view that the financial risk can be mitigated. But at the same time, I have been equally candid about our inability to measure the psychological impact, and about our concerns that dire predictions and vigorous rhetoric may compound whatever psychological risks do in fact exist. It is our joint responsibility to see to it that these concerns are minimized.

The proponents of the legislation pending before this Committee believe that a major program of Federal financial assistance is warranted by the circumstances. I cannot agree. What is warranted, indeed required, is a comprehensive program of fiscal and financial reform in order to return New York City to the capital markets. There is a Federal role in this process, but it is not the role envisioned by the legislation before us.

Before turning to the program of reform, let me summarize for the Committee the current situation in New York City and New York State.

First, as a consequence of the events of the past month, the credit of New York State and its agencies has--rightly or wrongly--become intertwined with that of New York City. The State's bond rating has been reduced and the rating on certain of its notes withdrawn. These actions are not based primarily on concern with the fundamental finances of the State. Instead, they reflect the realities of the marketplace: investors currently are unwilling to purchase New York securities in the present atmosphere.

Second, potential inadequacies in the financial structure of the New York State Housing Finance Agency have come to light. The financial community has acted most responsibly in analyzing the finances of this Agency and in presenting a proposal to the legislature designed to cure some of these difficulties. I believe it is important that this proposal be acted upon promptly.

Building a Bridge to the Capital Markets

All levels of government, and the private sector as well, share the responsibility for developing a workable program that will restore New York City's access, and that of the State as well, to the capital markets. What must be done is to build a solid bridge, span by span, over which New York City can return to the private capital markets. In my view, such a program should involve the following elements.

-- First, and foremost, New York City must adopt a credible balanced budget plan which provides for the prompt elimination of budget deficits.

The institutional framework is now in place, but the Emergency Financial Control Board and the new Deputy Mayor must now operate in concert, devoting all of their resources to implement the fiscal policies necessary to return the City to the market. Substantial additional expenditure cuts are required. Operating expenses must be eliminated from the capital budget. Employee benefit programs must be reviewed. And capital spending must be brought under control. These measures must be accompanied by a continued re-alignment of the City's management to insure that the tough decisions which have to be made will continue to be made. Until investors are convinced that New York City's management is in control of the City's financial future, there can be no market.

-- Second, during the period of transition to balanced budget operations, the state should provide New York City with a temporary source of additional revenues, to avoid the accumulation of further deficits.

Such assistance should be provided by an emergency and temporary one or two year tax, perhaps an increase in the state sales tax. When New York City's budget has been restored to a sound fiscal basis, these funds can be repaid by the City over time through the state appropriation process.

-- Third, the financial and investment community must also play an important role.

Irrespective of what conclusions one may reach about the potential impact of a larger financial crisis on our markets and financial institutions, there is no question that it is in the best interests of all concerned to avoid a potential problem. If the City and State take the actions outlined above, if operating and capital expenditures are drastically reduced, and if pervasive control is exercised over the fiscal and financial affairs of local governments and agencies within the State, then it will be in the financial community's own self-interest to help provide the requisite credit to protect investments made to date and to insure healthy markets in the future.

It may be that further commitments from the financial community and from investors may not be necessary. But if they are, certain actions may be appropriate.

Within the context of an orderly proceeding for the restructuring of New York City's debt, holders of short term securities may, if necessary, be asked to extend maturities for a short period--perhaps 2 to 4 years.

In addition, again only if necessary, the City's bondholders may be asked to agree to a moratorium on payments of interest and perhaps principal for a short period of time.

Once the threshold of budgetary control has been crossed, these actions can provide the bridge to return New York City to the capital markets. But any comprehensive program of reform must deal with longer range concerns as well. We in the Federal Government have a clear responsibility with respect to this part of the process.

-- As a <u>fourth</u> part of the program, the Federal Government must accelerate a comprehensive review of Federal, state and local relationships. To put it bluntly, we must determine whether the priorities, practices and procedures of the past are consistent with the needs of the last quarter of the twentieth century.

Specifically, in the area of assistance to the disadvantaged, we should review once again our administrative machinery and make whatever changes are necessary to provide state and local governments the full benefits they are entitled to under existing law.

But a comprehensive response requires more action as well. If we determine that large cities and populous states are unfairly disadvantaged under existing formulae or programs, we should consider corrective legislation, if necessary, to remedy whatever imbalances exist.

I have often said that assisting the poor is a legitimate, indeed a fundamental, responsibility of a compassionate democratic society. But if we allow our assistance programs to lose the support of the majority of our citizens, our ability to provide assistance may be seriously impaired.

-- <u>Fifth</u>, we must propose structural improvements in the municipal bond market.

In proposing these changes, we will not have lost sight of the fact that even in these unsettled times the municipal market has served state and local government well.

During August alone, for example, four states and 225 municipalities raised nearly $2.6 billion in long term debt. And contrary to widely held opinion, such funds were raised at a cost not disproportionate to historical levels.

Traditionally, yields on tax-exempt securities have been, on the average, 30 percent lower than taxable yields. Yield spreads will vary according to quality, maturity, call protection, monetary conditions and similar factors. Moreover, yields will also vary within rating categories. For example, largely because of the substantial volume of debt outstanding, yields on New York City securities were significant higher than yields on comparably rated securities of other issuers. It is noteworthy that in September, the spread between prime municipals and comparable quality utility issuers was squarely on the 30 percent figure: That is 6.9 percent for municipals versus 9.9 percent for utilities.

While the market has performed well, improvements can be made. In recent years an inbalance between supply and demand has developed. Tax-exempt borrowing is at unprecedented levels: $40 billion of bond and notes in the first eight months of this year alone. But the growth in demand--especially from institutions--has not kept pace. Casualty companies, always large buyers, have had their need for tax-exempt income reduced. And commercial banks, traditionally the largest purchasers of tax-exempts, have cut back their participation substantially, reflecting other sources of tax shelter such as loan losses, leasing activities, and foreign tax credits. In 1969, commercial banks were net purchasers of municipals in an amount equal to 97 percent of new issue volume. For the first six months of this year, their net purchases dropped to 12 percent of new issue volume.

In addition, also as a consequence of these specialized sources of demand, yields in the tax-exempt market tend to rise disproportionally during periods of tight money as banks are forced to commit their limited credit resources to their commercial customers.

Accordingly, to broaden the market, and to effect a reduction in the volume of tax-exempt debt, State and local government should be afforded the option of issuing debt on a taxable basis, with an appropriate interest subsidy from the Federal Government. Also, tax-exempt debt now issued for non-governmental purposes--pollution control and industrial development bonds--should be issued on a fully taxable basis, again with appropriate interest subsidies. According to our calculations, these changes should result in a substantial benefit to state and local government in the form of a broader market for their securities, which could result in lower borrowing costs, at little, if any, expense to the Federal Treasury.

-- Lastly, partically in recognition of the growing participation of the smaller investor in the state and local bond market, we believe the time has come for a Federally imposed uniform system of financial accounting and reporting by state and local issuers which sell a substantial amount of securities in our capital markets.

Precipitated by major financial reversals such as the Penn Central bankruptcy, there has been a marked increase in the tendency of investors to restrict themselves to higher grade instruments--a "flight to quality" to use the terminology of the market. We must satisfy this legitimate interest of the investing public in detailed, accurate and comparable data by requiring complete and accurate disclosure. This system of disclosure has helped make our corporate markets the finest in the world. The time has come to broaden it to the municipal market as well.

In my view, it is these steps which Congress and the nation must focus upon in dealing with New York City's financial crisis:

- a sound fiscal policy administered by a realigned management, and including a credible balanced budget;
- a temporary increase in state assistance through a state tax;
- an orderly mechanism for debt restructuring, with the financial community and investors participating in the bridge back to the capital markets;
- a complete study on Federal, State and local relationships in the area of assistance to the disadvantaged;
- a broader market for municipal securities; and
- a uniform financial disclosure system for state and local government.

This is a program designed to attack the causes of the problem at their roots. But unlike the legislative proposals before us today, it is far more likely to return our greatest city--indeed all our cities--to a totally sound fiscal basis.

The Legislative Proposals

Three of the proposals before us today--S. 1833, S. 2372 and Senator Proxmire's suggestion of a taxable unsubsidized bond with a penalty premium--involve guarantees or insurance of municipal debt. We are also considering Senator Bentsen's approach in S. 1862: Federal Financing Bank purchases of State and local debt. Finally, while not specifically on today's agenda, I shall also discuss Senator Humphrey's suggestion of a National Domestic Development Bank, embodied in S. 1473.

Generally speaking, my concerns with proposals for Federal financial assistance are twofold:

First, any such assistance would involve expansion of Federal credit, driving up Federal borrowing costs, the borrowing of all other issuers and crowding out certain marginal borrowers.

Second, the discipline of the market would be lost. No longer would spending be constrained by the desire to avoid higher borrowing costs or the loss of credit. Only pervasive Federal fiscal and financial control of local government, in violation of federalism, could provide the constraint.

Guarantees or Insurance

There is absolutely no difference between a guarantee program and insurance program. Either would involve a commitment by the Federal Government to meet debt service requirements in the event the issuer is unable or unwilling to make such payments out of its own revenue sources. And once provided, a guarantee could not be withdrawn if, for example, the issuer failed to meet the fiscal conditions of the program. The government's obligation under a guarantee program would be to the investor, not the issuer.

S. 2372 proposes that the Federal Government re-insure 75 percent of the risk underwritten by private insurers of municipal bonds. This proposal would be of no value to New York or any other city of even moderate size. The private insurance sector has been unwilling to commit substantial resources to this form of insurance and consequently the risk ceiling of the larger of the two private insurers is only $20 million per issuer. Given that maximum risk level, even with Federal re-insurance only $80 million of the securities of any issuer could benefit from the program.

Loans

S. 1862 and S. 1473 would in effect provide for Federal loans to State and local government. S. 1862 would use the existing mechanism of the Federal Financing Bank of purchase municipal securities. Since the purchases would be without recourse, there would be no means of enforcing compliance with guidelines regarding fiscal restraint. I would also note that the $3 billion purchase authority would be inadequate even to deal with New York City's needs alone.

S. 1473 would create a new bureaucracy--a National Domestic Development Bank--to allocate credit to State and local governments. Federal bureaucrats, located not only in Washington but scattered throughout the country, would be given the final word on whether a particular local need was worthy of financing.

Guarantees, insurance, loans, development banks--each of these proposals has serious implications for the condition of our capital markets, would eliminate market restraints on spending at the State and local level, and could threaten the traditionally autonomy of these levels of government over their fiscal and financial affairs.

Impact on Capital Market

Too often, when we concern ourselves with the problems of the municipal bond market we tend to forget that this market is not entirely distinct, but is instead an integral part of our capital market structure as a whole. And the same things that are happening in our capital markets as a whole, the same things we warned about almost a year ago, are happening in the municipal market. Higher rates, shorter maturities, crowding out of sound, but marginal credits: these are the concerns the nation's mayors brought to the President and to the Joint Economic Committee two weeks ago. But they misplaced the blame. The blame primarily lies not with New York City, but with inflation, caused by massive continuing Federal deficits and the substantial new Federal borrowing required to finance them.

Any program of Federal assistance would further exacerbate these problems. Any expansion of Federal credit--including a federally guaranteed municipal bond--would further strain our overburdened capital markets. Federal borrowing costs would rise and, since our borrowing establishes a benchmark in the marketplace, the borrowing costs of all other issuers would rise as well. Many additional marginal credits--housing, small business, consumers--would be crowded out of the markets. Yield differentials between the stronger and the weaker credits, are at record highs: recently the spread between A and Baa Industrial bonds has been as high as 200 basis points; double the 1974 figures and four times greater than the 1971-73 average. Additional Federal credit in the market could cause these spreads to widen further. And if guaranteed bonds retained the tax-exempt feature, the impact on unguaranteed municipal issuers would be especially direct and could be severe.

Fiscal Restraint

Of even more concern is the potential effect of these programs on fiscal and financial decision-making at the State and local level. Like all borrowers, a State or local government's access to credit depends upon its ability to persuade potential lenders that its financial affairs are such that the lender can reasonably expect to be repaid. A Federal guarantee would have the effect of removing this element of concern on the part of the lender and thus have the corresponding effect of removing the market imposed restraints on the borrower.

The only effective substitute for the restraints of the marketplace would be direct Federal control. While some have suggested the interposition of State control, I seriously doubt whether it would provide a viable alternative. There would be little reason for a State agency not to yield to the same pressures as a local government in the absence of discipline from the market or some other source.

Federal control of fiscal and financial affairs at the local level presents grave practical and philosophical difficulties. This is not a dispute between liberals and conservatives, but rather simply a question of the right of citizens to be governed by their duly elected local leaders rather than by Federal bureaucrats.

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.

None of us can assess with any degree of precision the contribution the division of governmental authority called for by the Constitution has made to the quality of life in this country. But I doubt our society would be as heterogenuous, as tolerant of diversity, as responsive to local needs if all basic decisions were made here in Washington.

Comparison with Existing Programs

It is such considerations which plainly distinguish the pending bills from programs such as FDIC or FHA insurance. It is altogether appropriate to require that all of the nation's banks be subject to the same operating standards and be subject to consistent and detailed Federal supervision and regulation. It is equally appropriate that a citizen seeking the assistance of the Federal government in obtaining a mortgage disclose fully his financial situation and open the property he desires to purchase to extensive Federal scrutiny.

Imposing uniform standards on State and local governments is plainly an entirely different matter. Each political subdivision in this nation has unique needs. And each is led by a person selected for the job by an electorate which believed that such a person could best translate the needs of the community into effective governmental decisions. Yet any program of financial assistance would require bureaucrats in Washington to supervise these decisions and reverse them if necessary, irrespective of the wishes of the local electorate. It is one thing to supervise a corporate management, or to reject the views of boards of directors or stock-holders. Under our democratic system, it is quite another to supervise and control the affairs of local governments.

In short, State and local government have a special status in our Federal system. The proposals for Federal financial assistance now pending before this Committee would, of necessity, require that such special status be ended.

Guaranteed Bond with Penalty

As an alternative approach, the Chairman has suggested guaranteeing municipal debt, but imposing an extremely high interest rate penalty. First, as with any guarantee program, the adverse impact on the capital markets I outlined above would be fully present. Second, any conceivable penalty rate -- 3, 4, even 5 percent -- would represent a small increase in the burden on the borrower, relative to the value of obtaining access to credit. When an issuer is faced with the possibility of losing access to credit, it is likely to cut its expenditures, but when the prospect is only higher borrowing costs, the incentives for restraint are far weaker.

Impact of Default

I have concentrated today on a variety of approaches to the financial situation in New York City and New York State. I believe the approach I have suggested is desirable and workable. I cannot support the approaches in the legislation before this Committee. To complete the analysis, however, it is necessary to discuss the consequences if none of the approaches is adopted.

My views on the impact of a potential default have not changed materially. I have always believed that a default would be highly undesirable; “awful” may be the best description. I have always believed that a default could and should be avoided by any appropriate means. But putting aside for a moment the absolute desirability of avoiding default, I cannot conclude that a default would devastate our financial markets or our economy.

At the same time, I have often underscored the importance of psychological factors and our inability to predict psychological reactions with any certainty. We have been carefully monitoring the marketplace daily and have noted the developing psychological impact. Restraint is of utmost importance; I must point out that dire predictions of impending doom could well become self-fulfilling.

My views on the overall question of the impact of default are fully expressed in my testimony before the Joint Economic Committee and I do not need to repeat them in detail here. I do want to concentrate and expand upon one particular concern: the impact of a potential default on the ability of other State and local governments to raise necessary funds in the municipal market.

Earlier in my testimony, I noted that municipal governments are facing the same pressures as all other borrowers: a diminishing supply of capital at higher and higher rates caused primarily by inflation and the growing Federal usurpation of the supply of credit in this country. I also mentioned that within the municipal market itself there are structural problems which need to be addressed as State and local capital requirements grow faster than the demand for tax-exempt securities. I have also noted that all investors are increasingly sensitive to quality considerations and are demanding more and more evidence of financial soundness.

Perhaps the most important factor in today’s market is uncertainty, a psychological factor which markets do not tolerate well. A number of intermediaries and investors are, we understand, refusing to commit funds to the market--thus impairing the borrowing ability of many State and local governments -- until the New York City situation is resolved. New York City's difficulties have been the major factor in the uncertainty and have intensified investor concern with quality. But New York's financial crisis did not create the other problems besetting the market, and an end to that crisis will not make them go away.

Markets have a tendency to discount future events and a potential New York City default has been discounted to a significant degree in the form of higher overall yields and shifts in quality preferences. If default actually occurs, a possible further shift in quality preferences could influence the ability of credits which are perceived to be weak to raise funds in the capital markets. By contrast, the stronger credits may well benefit as investors' preferences shift even further in the direction of the higher grade issues.

I do not believe a default would precipitate a series of defaults by other cities through the country. No other city has had a cumulative deficit like New York City's and thus none must borrow simply to meet operating needs from year to year. To the extent other cities must borrow within a fiscal year to deal with seasonal cash flow variations, I cannot conclude that a default will materially impair their ability to do so. In short, either other cities have the money to pay their debts or they do not. Those which do should be able to obtain credit.

In asking ourselves what the impact of a default would be, we must also ask the correlary question of what would be the impact of various mechanisms to avoid default. If, for example, New York City were able to avoid default by implementation of the plan discussed at the beginning of my testimony, I believe that the result would be a renewed sense of faith in the ability of the State and local government sector and our financial institutions to deal with even the most severe problems in a responsible manner.

If, on the other hand, default were to be avoided by a Federal assistance program, the reaction could be more complex. Clearly, there would be no basis for concluding that avoidance of default meant that State and local governments were able to carry out their financial obligations. Just the contrary would be true. Meanwhile, there would be far more incentive for State and local governments to embark on more spending programs, irrespective of whether resources were available to finance them. The discipline built into the present system would be lost entirely.

And even if the assistance program were limited to New York City, its impact would be felt throughout the country. Issuers and investors would come to believe that every municipal security -- or certainly those of major borrowers -- in effect carried the moral obligation of the United States, even without a guarantee in advance. What the Federal government would do for New York, all would believe, it would necessarily do for any other jurisdiction which became unable to meet its obligations.

But perspective investors would recognize the fundamental change in our system of finance and would see the risks presented. The inflationary expectations generated by the actual and potential expansion of the Federal credit involved would serve to accelerate some of the adverse trends we have seen in the markets over the recent past. Investors would become even more wary of long term commitments and would demand even higher yields on the commitments which are made. The ability of all sectors of the economy to finance investments in our future growth could be further impaired.

This committee faces some difficult choices. The risks of a default, in the final analysis, are unknown and unknowable. My own judgment is that such risks should be manageable. Moreover, as I have indicated in my testimony today, the proposals pending before the Committee presents a series of concerns which outweigh the risks as I perceive them. I would urge the Committee to concentrate its resources and its influence on approaches to the problem which will restore confidence in the fiscal and political integrity of the State and local governmental sector.

Mr. Chairman, I would like to conclude my remarks today with some purely personal observations. It has been nearly seven months to the day that the City's bankers reached the conclusion that a market no longer existed for the securities of the City. For this entire period, the citizens of the greatest city in the world -- its financial, industrial and cultural hub -- have lived from crisis to crisis. As one with deep personal and professional ties to New York City, I have great compassion for the plight of the citizens of New York and I share their determination to achieve a prompt and proper end to the crisis.

Over this period much in the way of laudable progress has been made. An "untouchable" expenditure increase for fiscal year 1975-76 was pared somewhat. The inexorable growth in the municipal payroll has been pared to some degree. The cumbersome overlay of bureaucratic structures has been partially reorganized and financial professionals are now playing an increasingly important role in the affairs of the City.

If this degree of progress has been made, one may legitimately ask, why hasn't the market reopened to the City? I am afraid the answer lies in timing. Each of these steps, while laudable in and of itself, invariably came too late.

It is difficult to state precisely what actions would have reopened the market at any given point in time. But it must be clear to all that what would have reopened the market in April would no longer do the job in June. And what would have been adequate in June was insufficient in August. In short, throughout these long and enervating months, events and demands consistently outdistanced actions.

Another important point emerges from this troublesome history. There can be no doubt that Federal financial involvement at any point along the way would have stopped the reform process dead in its tracks. We need only look at what occurred when MAC was created in early June. For six weeks, virtually nothing in the way of reforms was accomplished. In late June, the need to obtain legislative approval of the City's budget caused a brief flurry of activity -- announcements of lay-offs, hospital and fire house closings. But as the garbage piled up over the Fourth of July weekend, most lay-offs were rescinded; and the closing orders have been largely ignored.

It was not until it became clear that MAC would be unable to borrow in August that the process of reform began anew. Each new deadline was faced with more strident demands for Federal assistance. And, after such assistance was again refused, the City and the State managed to take another hesitant, painful step in the right direction.

At the end of August, after nearly six months of crisis, the first meaningful data regarding the city's finances was released. While subsequent events have revealed that even such data was inaccurate and inadequate, at least a benchmark with which to measure the accomplishments of the past and the challenges of the future had been established. Again I ask the inevitable question: would such actions have taken place if Federal assistance had been promised or provided? Much has been done, but much more needs to be done:

-- A credible plan for the prompt elimination of the budget deficit must be implemented;

-- in that regard, the State must act to provide a temporary supplement to the City's existing revenue base;

-- ineligibles must be removed from the City's public assistance rolls;

-- capital expenditures must be reduced severly and operating expenses must be fully eliminated from the capital budget;

-- the city's accounts must be fully conformed to acceptable accounting principles;

-- reform of the City's management structure must be completed;

-- if necessary, steps must be taken to restructure the City's short term debt.

If these things are done, and the market does not reopen, is default the only solution? In recent weeks and again today, I have expressed the view that the financial risks presented by a default can be mitigated, and, objectively speaking, the impact need only be temporary and manageable. At the same time, I have been equally candid about our inability to measure the psychological impact. We have continued to make market assessments on an ongoing basis and we remain deeply concerned that dire predictions and vigorous rhetoric may compound whatever psychological risks do in fact exist.

The time has come, ladies and gentlemen, to concentrate all of our efforts to restoring our greatest city to fiscal integrity. I have said many times that fiscal integrity is easy to lose and hard to recover. As we proceed through this difficult period in our history, I can only hope that the travails of New York City will have some impact on our attitudes as to the proper role of government in our society. What New York City has learned in the past seven months is a valuable lesson for us all. As we proceed with legislative consideration of the City's financial crisis, let us not ignore this important message.

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