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ABOARD AIR FORCE ONE

THE PRESIDENT HAS SEEN....

August 19, 1975

Mr. President:

The attached memo re New York City was prepared at my request to bring you an update.

It might be useful, if you have a minute, to talk about it.

Bill Seidman

Attachment

THE PRESIDENT HAS SEEN.

EYES ONLY

THE UNDER SECRETARY OF THE TREASURY
FOR MONETARY AFFAIRS
WASHINGTON, D.C. 20220

AUG 18 1975

MEMORANDUM FOR THE PRESIDENT

SUBJECT: Report on New York City

GENERAL REVIEW

Despite the success in putting together the $960 million Big MAC financing, a success achieved late last Thursday, the outlook for New York City is poorer today than at any time in recent months. The basic problem is that despite some expenditure cutbacks and moves to increase revenues, the City has not made material progress in closing the gap between what is paid out and what is received. Equally important, most observers are hard put to find tangible evidence of a growing momentum that would produce a closing of this gap in the intermediate future -- in the next year or two. Instead, posturing and maneuvering seem to dominate day-to-day developments.

As a result, we are drifting in the direction of a default on NYC obligations; and, while default can still be avoided, the probabilities of avoiding this event are slipping away. Default is per se bad; the adverse effects on financial institutions, markets, and general attitudes could be material. Absent a change in direction at the City and State levels, default could only be avoided through the issuance of a Federal guarantee on Big MAC obligations. This would require legislation for which there is a very low probability of passage and would have to be made available to other municipalities. Even if legislation were passed, it would place the Federal Government in the role of financing through its guarantee the gap between outlays and receipts, which is the heart of the NYC problem, or in the equally undesirable role of exerting pressure to close the gap. The Federal Government would have to make the decisions to close the hospitals, schools and other facilities and which would, one step removed, deal with the municipal unions.

EYES ONLY

Another possible option would be for the Federal Reserve to lend to Big MAC directly. The ability to do so stems, in part, on the elasticity with which the underlying statute is interpreted. It is desirable only in that it would prevent default; it is undesirable for the reasons mentioned above in connection with a Federal guarantee.

RECENT DEVELOPMENTS

A. The most noteworthy changes involve the transformation of Big MAC and the increasingly obscure role of Governor Carey. MAC has not done the job it was intended to do. It was conceived as a vehicle for injecting good management into City affairs and for providing interim financing until MAC's favorable impact on the City's management became apparent to investors and thus reopened the bond market for the City itself. Today it is an impotent and divided group, the most vocal faction of which seems to be lobbying for a "Federal involvement."

Three things went wrong:

1. The underlying assumption was that MAC, with its limited powers, could close the gap in outlays vs. receipts. But it appears that the gap is, roughly, three times larger than had been estimated at the time MAC was formed. It has not had the political or administrative muscle to do the job and its signal achievement, a gap-closing package equal to, roughly, $500 million*, is not impressive relative to the estimated $1.5 billion operating deficit.

* Characteristically, this package was announced by the Mayor after negotiations with MAC. To date, no one at MAC is sure what parts have been implemented and the degree to which they have been effected.

2. MAC's bonds are weakened in investors' eyes, in two important respects. The revenues to service MAC's debt were created by the New York State Legislature by taking certain taxes away from the City and giving the revenues produced by them to MAC. Investors are fearful that this transfer would be held to be an unlawful diversion of funds dedicated to the payment of the New York City debt. Moreover, MAC's access to the funds depends on annual legislative appropriations. Investors fear that the Legislature may simply fail to make such appropriations.

3. MAC, or at least several of its key board members, are heavily involved in Governor Carey's administration. The Governor has not been willing to take charge of the situation. He has, to date, benefited from an unearned immunity.

B. The Governor's MAC people, led by Felix Rohatyn, are operating on two fronts. Judge Rifkind, MAC Counsel, and the Governor's office are drafting a bankruptcy act which would be used by the City if it defaults. In addition, the Governor's men are maneuvering so that if the City defaults it will appear to be caused by either the Federal Government's refusal to provide a guarantee or the Fed's refusal to extend credit.

In order to create pressure for a guarantee, there have been rumors that are said to have come from MAC sources, that a guarantee was imminent and that the Fed has a program to lend to MAC. Another part of their overall effort is to stress and inflate the dangers inherent in a in a NYC default: the impact on the municipal bond market, on the banking system, on New York State's own credit and that of related agencies has been described in lurid and exaggerated detail.

OUR OWN EFFORTS

Our efforts have been hampered by the need to avoid appearing to be contributing to a default by NYC. With this constraint, we are in the process of planning in two overall areas, civic and financial.

-- In the civic area,, our concerns involve:

a. The absolute necessity for development of a suitable bankruptcy procedure. This can be provided for only by new Federal legislation.

   The importance of such an act is based on the fact that without it the City probably could not operate on an orderly day-to-day basis after a default because of conflicting legal claims. Without a bankruptcy act, there is a serious risk that payrolls could not be met, taxes could not be collected and the flows of funds through the City Administration would stop.

b. We are examining the flow of funds from the Federal Government to the City and determining procedures to control such flows, both with and without bankruptcy legislation.

c. We are prepared, but have not yet begun, to review civil disturbance arrangements.

-- In the financial area, we have covered the following areas:

a. Other impacted borrowers. We have concentrated on the New York State Housing Finance Agency. It is the largest State Agency with almost $4.0 billion in bonds outstanding and $1.0 billion in notes. It has been adversely affected by NYC's problems and the failure of the State Legislature to promptly live up to "moral obligations" in connection with the Urban Development Corporation.

We have been receiving information daily regarding the financial condition of this crucial Agency, and believe that it is probably sound. An audit of its affairs undertaken at our suggestion should be completed shortly.

If its affairs are in order -- namely, if it is generating sufficient cash from its operations to pay principal and interest on its debt when due -- its other problems can probably be handled.

As a consequence of the problems described above, HFA is presently unable to sell bonds in the public market and obtain funds to pay off the notes. We are prepared to take the lead in forming a consortium of lenders that would, based on the cash flow of the Agency's various projects, purchase bonds to pay off the notes.

b. The Banking System. We have collected somewhat dated information on the holdings of NYC obligations in the Nation's banks*.

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* Our data is 3-6 months old.

We have not as yet asked for current information because of the adverse effect reports of such a request would have on the marketing of MAC bonds.

From this initial survey, we have determined that no major bank would become insolvent because of a default on NYC obligations. We also believe that 25-50 or more smaller banks could become insolvent as a result of NYC default. (In this connection, it is important to mention that NYC could default on only its notes outstanding (or only a portion thereof) and not its bonds. This situation is conceivable and might even be probable if default prompted immediate belt-tightening. In that event, the threat to the banking system would be far smaller.)

To deal with the potential banking problem, we have pursued the possibility of FDIC assistance through the purchase of convertible, subordinated capital notes from severely impacted banks. This P.M., Messrs. Smith (Comptroller), Wille (FDIC), Partee (Fed), and I tentatively agreed that we could be in a position to state that no bank would become insolvent as a result of depreciation of its NYC note and bond holdings caused by default.

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SUMMARY

If a maximum effort is made by all the Agencies involved, the adverse effects of default can largely be contained. Equally important, the federalization of municipalities can be avoided. Success in containment would enable the considerable latent opposition to a guarantee to be expressed.

Edwin H. Yeo, III