THE SECRETARY OF THE TREASURY
WASHINGTON

December 12, 1989

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Don:

Thank you for your recent letter discussing junk bonds and leverage in general. I appreciate your thoughts and suggestions.

The Treasury Department takes very seriously its role in monitoring trends in the financial markets and their impact on American corporations. In fact, last Spring I established an Office of Corporate Finance within Domestic Finance at Treasury which focuses on these issues.

Clearly the junk bond market is experiencing some dislocations at the present time. The spread between Treasury securities and high yield debt has doubled from 350 basis points to about 700 basis points. Concurrently, the market is beginning to single out particularly risky bonds, and their declining prices reflect a significant weakening of demand.

As you know, high yield debt is largely held by well-capitalized, sophisticated institutions. In this regard, I have attached a copy of a recently published estimate of holders by category. Significant analysis usually precedes the purchase of these securities, and portfolios are typically limited to a small portion of the capital of investing institutions.

Banking regulators are keenly aware of the risks posed by highly leveraged transactions and are monitoring such investments in insured depository institutions. As you are well aware, there are strict limitations on both commercial banks and thrift institutions regarding investments in securities of this type.

The heightened concern over recent disruptions in the junk bond market is understandable; however, it is my belief that the market will best adapt to trends such as this without interference from the government. In the past two months, it is estimated that 15% of the assets have been withdrawn from the junk bond market. Recent transactions which have failed to secure financing show that the market responds to excesses.

In conclusion, while I share some of your concern about high risk brought on by high leverage, I feel the proper response is twofold: (1) to allow the market to adjust for any excesses, and (2) when budgetary considerations permit, to eliminate the tax penalty faced by equity investments which has made stock a substantially more costly funding source than debt. Any effort to penalize debt in whatever form, including junk bonds, would only raise the cost of capital American companies face and further disadvantage U.S. businesses in a world economy.

I appreciate your concern over these issues and hope this response has been of assistance.

Sincerely,

Nick

Nicholas F. Brady

Enclosures