THE OUTLOOK FOR MUNICIPAL BONDS

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MEMORANDUM RE: The Outlook for Municipal Bonds

Notwithstanding the fact that municipal bonds comprise a relatively small part of the total assets held by insured commercial banks, the bank examiner can ill afford to give this segment of the investment portfolio cursory treatment. All municipal bonds are not of investment quality and at the present time changes in quality are rapid. Furthermore, certain peculiarities of these securities frequently render even top grade issues unsatisfactory for bank investment purposes.

At the outset, a review of the features which are peculiar to investments in municipal securities would seem to be appropriate. For the purposes of this discussion, the most important characteristic of municipals is exemption from Federal income taxation. Without tax exemption, these securities would undoubtedly occupy quite a different place in the investment program of banks.

Tax exempt income is not equally valuable to all banks with portfolios of municipal securities. The rate of tax applicable to institutions with less than $25,000 of income is 25% as compared with 53% for income within the $25,000 to $50,000 bracket and 38% for income above that level.

Generally speaking, quotations for municipal securities appear to discount more or less fully the value of the tax exempt feature to institutions with income subject to the 38% tax rate. This is about what one would expect because such institutions probably are a dominant factor in the market. It follows, however, that a bank with a taxable income of less than $25,000 is likely to be competing on disadvantageous terms when it buys municipal securities. On the other hand, municipals are especially attractive for institutions subject to the 53% tax rate

Distinctions with respect to the credit quality of municipal securities are beclouded by the variations in the attractiveness of tax exempt income. For banks subject to the lowest tax rate, concessions with respect to yield or quality are inevitable when they buy municipal securities. Unfortunately, these banks seem disposed to sacrifice quality rather than yield. Furthermore, quotations for individual issues sometimes depart from the basic pattern which tends to discount the value of tax exemption for institutions subject to the 38% rate. Since quotations for these securities tend to blur the qualitative differences, it is incumbent upon the examiner to emphasize these distinctions. Nothing short of a continuous program of stressing quality considerations will serve to offset the confusion which the feature of tax exemption creates in bank investment portfolios.

Whenever a bank attempts to justify its holdings of municipals on the ground that the income is tax exempt, the examiner should point out that tax exemption per se is not sufficient. From the viewpoint of investment management, the tax free yield on a given municipal issue is really not attractive unless it compares favorably with the yield on alternative investment opportunities of similar quality likewise reduced to a tax free basis.

Municipal securities have another very important characteristic: In the main, these securities are issued in serial form. Accordingly, they provide a very flexible investment vehicle for use in developing an appropriate schedule of maturities. The use of serial issues enables the portfolio manager to schedule the release of funds from his investment account and thereby take advantage of new investment opportunities or meet the demands of depositors. Furthermore, a well ordered maturity schedule would always include a substantial volume of short term obligations. Such issues can always be liquidated with a minimum of capital loss.

The national market for municipal securities is not particularly satisfactory. Instead of listings on organized exchanges, purchases and sales are effected in the over-the-counter market. The auction market conditions of the organized exchanges are almost entirely absent in the over-the-counter market with the result that it is exceedingly difficult to ascertain the level of prices at any time. Nor can the ability of the market to absorb securities be readily determined.

A review of municipal portfolios suggests that many bankers tend to forget the flexibility which they could build into their investment program by an appropriate selection of serial issues. Even at the risk of pointing out the obvious, it seems to me that examiners should tell bankers to fit serial maturities into a pattern which is logically defensible.

Most students of the American banking system would argue that local institutions are under some obligation to aid the nearby political subdivisions. Municipal securities furnish the investment vehicle for extending this assistance. Rather than concentrations in holdings of securities issued by distant municipalities, banks may be expected to have relatively large commitments in the obligations of nearby issuers. The developments affecting the quality of these local credits can be observed with a minimum of effort in assembling and analyzing the facts. Moreover, when developments tend to impair the credit, the bank situated nearby is in a good position to urge the adoption of sound policies. However, investment in the securities of nearby political subdivisions accentuates the geographical concentration of risk in a bank because loans also tend to be local in character. A desirable course of action for the examiner, in my judgment, would be in the direction of liberality regarding criticism of the total amount of the investment in local municipal obligations but the banker should not be permitted to forget what he is doing.

In concluding these preliminary remarks about municipal securities, I cannot urge too strongly the importance of viewing these obligations as a part of the total bank investment program. It is rather easy to single out a few issues in a portfolio and complain about their lack of quality. No one would deny that bankers should be warned of poor quality assets. Far more difficult and probably in the end more constructive is the job of reviewing the portfolio as a whole and calling attention to the basic elements of weakness. Lack of balance in maturity distribution, in types of issues, and in distributions of risk are deserving of comment by the examiner.

The Volume of New Flotations

At the present time, the volume of new state and municipal securities reaching the market is of record proportions. During the war years, capital improvements to the physical facilities of the municipalities were drastically limited and the volume of security flotations ranged between one-half and three-quarters of a billion dollars annually, or approximately 50% of the level in the prosperous 1920's and the recovery period of the 1930's. Now, however, the situation has changed completely. The volume of new flotations is more than double the pre-war average. Furthermore, a review of the pertinent facts suggests that the volume of flotations will continue to remain at high levels for a number of years.

Since the war, flotations of State bonds to finance Veterans' bonus payments have been responsible for a very substantial portion of all State and municipal issues. Practically all of the large and wealthy States have sold bonds for this purpose. Since bonuses normally are paid only once to the Veterans of each war, this factor should soon disappear as a contributor to the volume of municipal financing.

At least three other major forces are now at work, all of which tend to stimulate the volume of municipal flotations. By far the most important is the huge backlog of needed public improvements. In the course of the Great Depression in the 1930's, the expansion of municipal facilities which had been fairly active during the previous decade came almost to a complete standstill. Municipal financing in the recovery period of the 1930's was devoted largely to solving the problem of unemployment relief and refunding incidental to the previous financial debacle.

The minor subdivisions of government entered the 1940's with what unquestionably was an accumulated deficit of public construction inherited from the previous decade. As time went on, improvements in the general standard of living and the population growth tended to increase rather than mitigate the actual deficit of construction. Then the war drastically limited public works for a number of years so that at the present time the deficit is probably of record proportions.

Studies of population data, and particularly the changes in the birth rate since 1940, suggest among other things that the need for school facilities over the next few years will present a building and financial problem of major importance. In less than 10 years, the population of elementary school age is expected to increase by about 50%. However, schools typically are over-crowded at the present time. Outlays for new construction in 1948 and the estimated program for 1949, while upwards of three times the annual average for the previous years of this decade, are clearly inadequate. As a matter of fact, the dollar increase may be almost completely swallowed up by the inflation in construction costs. The pressure for added facilities will evenutally appear at the high school and college levels as these children progress through the educational system.

Population shifts as well as the growth in population are a second important factor contributing to the volume of new municipal flotations. One should not be unmindful of the extent to which industry, largely as a result of the war, has decentralized. The movement to the South, the Southwest and the Far West is quite pronounced. Moreover, very substantial shifts in population have occurred within the metropolitan areas of the older communities of the North and East. All of these shifts impose requirements for new facilities upon minor subdivisions of government.

As an illustration of the extent to which population shifts can upset an area, consider the case of Hempstead, New York. Only a little while ago, one of the school districts in this community, according to reports, was served by a three-room building. Now the area has a population of more than 10,000 and the school enrollment has increased from about 50 to about 1,000. Needless to say, the former school facilities are inadequate. Nor is it surprising that we have a flock of municipal securities flotations of one sort or another financing new public facilities in and around Hempstead. This situation is almost a caricature, but it furnishes an apt illustration of the problem.

Still another factor contributing to the volume of new financing is the inflation of construction costs. While it is very difficult to measure with any degree of precision the extent to which the cost of public construction has increased, one can easily hazard a guess that it has mounted by at least 50%, and to say that it has doubled would probably be more nearly correct. The value of new public construction in 1949 is estimated at a record peacetime total of $5 billion. Measured in terms of physical volume, however, the amount of construction will be definitely below the war years as well as for 1939.

For the most part, construction costs are high because of wage increases and the compounded effect of wage increases on the cost of supplies and materials going into public works. As a consequence, these higher costs cannot be viewed as temporary phenomena which will be changed when some current supply-demand situations clear up. Rather they reflect the inflation of wages and it is reasonable to suppose that they will be as resistant to decline as any prices composed largely of a wage element.

The full force of public construction by minor subdivisions of government probably has not yet been reflected in the municipal securities market. Some municipalities in the course of the past two or three years have been persuaded to defer construction because of high costs. Many of these projects cannot be delayed indefinitely even though costs remain high. Furthermore, a fair amount of public construction has been impeded by shortages in labor and material. The very communities in which private construction is most active are also the ones likely to have a large public works program under way. As labor and materials become more plentiful, the expansion in facilities will have a counterpart in a volume of municipal flotations.

New State and municipal flotations have exceeded $2 billion both in 1947 and 1948. Over the next few years, there is every reason to believe that the growth in the volume of construction by the minor subdivisions of government will be more than sufficient to offset the decline in the volume of Veterans' aid financing. Accordingly, totals in excess of $2 billion should not be surprising in the years ahead.

Trend in Yields

The wartime low in yields on State and municipal securities registered by the indexes early in 1946 appears to have been the culmination of a downward trend which persisted over the years following the financial recovery from the crisis phase of the Great Depression in the 1930's. Two factors seem to have contributed to this trend. In the first place, these securities are tax free havens for investment funds. As the rates of Federal income taxation increased in the years immediately preceding the war and especially during wartime, the volume of funds seeking this asylum exerted a tremendous pressure upon the structure of yields. (At times, the elimination of tax exemption was advocated vigorously, but without success. Now the proposal appears to be dormant, but it certainly is far from dead.) Moreover, the effect of the pressure from funds seeking tax exemption was accentuated by the shrinkage in the amount of outstanding municipals during the war. Over those years some municipalities were able to make progress in retiring debt. Times generally were so prosperous that debt retirement programs could be followed and the severe limitations on expenditures for building curtailed new borrowing.

A second factor contributing to the decline in municipal yields was the so called "cheap money policy" which has characterized the American scene for a good many years. This policy was adopted first to stimulate business recovery during the 1930's, then continued to facilitate the financing of the war, and since the cessation of hostilities the retention of the "cheap money policy" has served to ease the burden of the public debt.

In 1946, the trend in yields on State and municipal obligations seems to have broken away from the former pattern. On the average, yields have increased about one percentage point over the past three years. Thus far, however, the yield indexes have merely returned to the levels prevailing in the years immediately preceding the war. Viewed in historical perspective, they are still extremely low. The rather modest increase in yields since 1946 has produced some startling readjustments in the prices of municipal securities. For example, long term issues, i.e. with 25 or 30 years to run and with coupons of 1% to 1½% which were floated at prices around par when yields were at the low point, now are quoted in the 60's and the 70's. This readjustment in price does not reflect deterioration in credit quality. It merely serves to place these securities on a basis which affords a yield comparable to the $2\frac{1}{4}$% and $2\frac{1}{2}$% returns now obtainable from new issues.

During most of the 1920's, a period incidentally when prosperity was widespread and the finances of municipalities were thought to be reasonably good, yields averaged in the neighborhood of 4%. As a matter of fact, municipals have seldom returned much less than 4% on the average at any time since 1900 although for a period right after the turn of the century the yield hovered close to 3% for a short time.

The future trend in the yield on State and municipal securities is an inscrutable mystery both to the expert and the novice. The attempt to forecast the trend degenerates for the most part into a guessing game. Certain forces presently at work obviously tend to increase yields. For example, the worldwide need for capital goods to repair the damage of the war, the tremendous advances in technology most of which call for added capital investments, and the expansion in the population all point to a greater rate of demand for capital in the years ahead. On the other hand, policy considerations of a fiscal and monetary character suggest the continuance of arrangements which would tend to prevent a rise of interest rates. The removal of tax exemption would certainly have a marked effect on yields. Most important of all is the question of whether we shall have war or peace. While it is rather easy to enumerate these considerations, it is practically impossible to evaluate them.

Bank examiners in the course of their work do not need to forecast trends in interest rates. As a matter of fact, bankers do not need to make such forecasts if they follow the recognized and sound principles of management. Most of these principles have developed from a background of experience which recognizes the importance of change and provides some measure of protection against untoward developments.

The banker who bought a few 30-year bonds carrying 1% coupons at 98 three years ago now can feel comfortable--even though he may be somewhat unhappy--as long as this commitment involves only a small percentage of his total portfolio. But if he invested the bulk of his funds on these terms, then his situation could easily become precarious. Fundamentally, this is why close attention to the maturity schedule is very important in the management of bank investments as well as in bank examination and why it is well to know whether yields on securities are at a relatively high or low point.

Finances of State Governments and Minor Political Subdivisions

During the war years the State governments made substantial progress with their debt retirement programs, and at the same time they strengthened their current finances. For the country as a whole, the gross debts of these governments declined from about $3.5 billion in 1940 to $2.4 billion in 1946, or by about one-third. For the most part, this record was achieved because tax collections were good. Expenditures for capital improvements were curtailed during the war and ordinary operating expenses increased rather slowly. The new sources of revenue which the States first tapped in the 1930's have proved to be very lucrative in the prosperous war and post war period. Mostly they consist of general sales or income taxes, or special levies on widely used items such as gasoline, tobacco and beverages. State tax collections excluding unemployment compensation taxes rose from $3.3 billion in 1940 to nearly $5 billion in 1946.

The States have found Veterans Aid bonds relatively easy to market because they could show substantial progress in debt retirement as well as current financial strength. Not surprising, therefore, is the fact that over $1 billion of these securities were floated in 1947 and 1948. However, these flotations have now largely offset the reduction in State debts over the preceding six years.

Generally speaking, the State governments still appear to be in a healthy financial condition, but it should be remembered that the income of States now depends to a much larger extent than ever before upon the general level of business activity. Whereas formerly revenues were derived largely from general property taxes, the States now rely very considerably upon sales and income taxes. As matters now stand, long before business reached the depression levels of the 1930's, State governments would be in serious financial difficulties.

Although the improvement in State finances has been general, it is fortunate that the recent substantial increases in indebtedness have been confined largely to the ones which appear best able to carry the burden. For example, 25 States reduced gross debt in 1948 as compared with increases in 23 States. Accordingly, it now seems appropriate to re-evaluate the relative credit standing of the States. The margin of advantage which some of the strong States formerly enjoyed has been narrowed. Absolutely as well as relatively, marked improvement has occurred in some of the Southern States which traditionally at least have been considered rather weak.

Quite in contrast with State governments, the minor political subdivisions are, generally speaking, in serious financial trouble today. To be sure, they made some progress in debt reduction over the war years. The debts of these smaller units fell from $16.7 billion in 1940 to $13.6 billion in 1946. In other words, they were able to reduce indebtedness by slightly less than one-fifth as compared with the reduction of one-third achieved by the State governments.

General property taxes continue to be the chief source of income for the minor political subdivisions. As a consequence, gross revenues cannot be readily increased. Usually this involves reassessment of property values as well as an increase in the tax rate. The former is a slow and tortuous process, and the latter quickly arouses the antagonism of taxpayers.

Reflecting the evil consequences of inflation, the local governments have experienced real difficulty in balancing revenues and expenditures since 1946. As an illustration, data compiled by the Census Bureau for 37 cities having 1940 populations of over 250,000, show that in 1947 the general revenues of these communities rose 13.8% over 1946 whereas expenditures rose 19.2%. Moreover, in 1947 new borrowing by these cities exceeded the amount of debt retirement. In the preceding four years, debt retirements substantially exceeded new borrowing.

Almost the entire pressure for capital improvements in the post war years will impinge upon the minor political subdivisions. They are called upon to provide new schools, hospitals and other institutional buildings, highways, sewer and water facilities, and a great many other types of expensive public works. To satisfy all of the demands imposed upon them would certainly be disastrous. Actually, many of these units now are so weak financially that they cannot even embark upon a program of public works. The seriousness of the problem is not yet widely recognized because times are prosperous and refinancing is fairly easy.

The rise of quasi-public entities known variously as authorities, special districts, or commissions testifies to the seriousness of the financial problem facing the minor subdivisions of government. Formed to provide services once considered to be within the scope of local government activities, these quasi-public entities rely upon revenues derived from charges for services such as sewer and water rents, bridge or highway tolls, and the like. The funds to construct the desired public works are obtained through the flotation of revenue bonds. Thus, the local governments avoid the burden of an additional financial load upon their already weak resources. But such devices will not enable the community receiving the services to avoid the cost.

Treatment of Municipal Portfolios in Bank Examinations

The foregoing review of current developments and future prospects in the field of State and municipal credits suggests that changes are occurring at a fairly rapid rate. Furthermore, deterioration in quality now seems to be a reasonable prospect for a large section of these credits. To be sure, every period which is studied carefully seems to be one of transition. At present, however, the tempo of change in this area of the investment field is much higher than it was only a few years ago. More important for this discussion is the fact that the forces making for improvement in the quality of municipal credits now seem largely to have spent themselves. Presently almost all of the forces are working towards deterioration.

For quite a few years, the municipal portfolio of a bank under examination has usually not been a very likely source of trouble. The quality of the items composing it by and large tended to improve with the passage of time. Accordingly, once the examiner had satisfied himself regarding the classification of the items, he was on fairly sound ground when he assumed that current facts would amply support his classifications or even evidence betterment. In these circumstances, neither the examiner nor the banker was likely to be much concerned about up-to-date credit files.

Now, however, the bank examiner is warranted in assuming that up-to-date information would show that a municipal credit was not as good instead of better than it had been a few years ago. As a matter of fact, current reports will likely disclose an increase in debts and possibly financial difficulties in covering operating expenses. In view of these circumstances, examiners should stress the importance of up-to-date credit files covering all of the municipal securities in the bank portfolio. The reason is twofold. The banker himself should keep abreast of current developments affecting the credit quality of his investments. Also, the examiner needs to have the information at hand when he reviews the items in a portfolio.

Both the banker and the bank examiner today need to guard themselves against pre-conceived notions with respect to the credit quality even of the older State and municipal credits. Attention has already been called to the fact that recent increases in State debts have removed the margin of advantage enjoyed by many of these credits. At the same time, notable improvement has occurred in the quality of some State credits which in the past were only fair. Similarly, changes are occurring rapidly among the credits of the minor political subdivisions and a variety of obligations floated by recently formed quasi-public authorities are appearing in the investment portfolios of banks.

The pattern of maturity distribution for bank investments probably has never received the scrutiny which it really deserves. The readjustment in yields on investments over the past three years, especially in the municipal field, have emphasized the importance of an appropriate selection of maturities as an essential part of a well designed portfolio. Municipal securities furnish bankers with an excellent selection of maturities. The usefulness of issues maturing serially as a means of avoiding dependence upon the market place when it is necessary to withdraw funds from the investment account has been clearly demonstrated. Furthermore, the readjustment in yields since 1946 has high-lighted the disadvantages of long term maturities especially when they are coupled with low coupons. While examiners are not in a position to insist on the elimination of long term maturities from investment portfolios, they may be able to use the recent experience with telling effect in their effort to persuade bank managements to improve maturity distributions.

Not infrequently, poor quality portfolios are justified by the argument that the bank needs these securities for tax reasons. Admittedly, tax avoidance is a consideration in developing an investment program. However, the tax status of many institutions is such that the tax exempt income derived from municipals costs more than it is worth. It is entirely too easy for a bank to lower the quality of its portfolio in an effort to secure municipal securities which furnish what is deemed to be an appropriate yield.

Summary and Conclusion

A review of the facts indicates that currently the volume of new State and municipal financing is at record levels. Furthermore, there is every reason to believe that financing will continue at this rate for some time to come. Issues of State obligations, largely for bonus purposes, have completely offset the reductions in State debts during the war period. The debts of the minor subdivisions of government are growing rapidly. To an increasing extent, quasi-public entities known variously as authorities, districts, commissions and the like are being created to perform essential public services. Mostly these entities come into existence because the older political subdivisions lack the financial strength needed to accomplish the results. Sanitary districts, transportation authorities, water and electric power and light enterprises are all cases in point.

Yields on municipal securities are going through a period of readjustment. Following their decline to record low levels at the conclusion of the war, they have now moved in the opposite direction. Where this trend will lead remains to be seen. It is well to remember, however, that even after the very drastic readjustment since the low point in yields, viewed historically, the current return on municipals is still quite modest.

The financial condition of States and minor political subdivisions is changing rapidly at the present time and many of the changes are for the worse. The inflation in prices has placed a tremendous strain upon the budgets of the local governments. Practically all of them are suffering from an inability to increase operating income sufficiently to meet the higher bills for wages and supplies. Furthermore, the suspension of building programs during the war as well as shifts and growth in population have accentuated the need for improvements. The problem is further complicated by the backlog of demand resulting from the low rate of public building in the 1930's. Capital expenditures likewise are reflecting the effects of price inflation. As a consequence of these forces, many old credits have deteriorated and many new ones are still unproved in quality.

With respect to the analysis of bank holdings of municipals, the following points need to be stressed. In the first place, the bank examiners would be well advised to pay very close attention to the quality of the individual issues in the portfolio. This admonition is quite burdensome because changes are taking place very rapidly and an opinion formed last week or last month may no longer be sound. The maintenance of adequate and up-to-date credit files covering the issues in the portfolio is now essential for any bank. Secondly, and quite apart from the considerations of quality, the examiner would be well advised to study the maturity distribution of the issues in the portfolio. One of the great advantages of municipal bonds lies in the fact that they are issued with serial maturities. Appropriately selected, these issues will provide for an in-flow of cash independent of liquidation in the market. Finally, bank examiners should view the municipal portfolio as a segment of the entire investment program.

Delivered by Mr. Hengren
at the Examiners Conference
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Distinctions with respect to the credit quality of municipal securities are beclouded by the variations in the attractiveness of tax exempt income. For banks subject to the lowest tax rate, concessions with respect to yield or quality are inevitable when they buy municipal securities. Unfortunately, these banks seem disposed to sacrifice quality rather than yield. Since quotations for individual securities tend to blur the qualitative differences, it is incumbent upon the examiner to emphasize these distinctions. Nothing short of a continuous program of stressing quality considerations will serve to offset the confusion which the feature of tax exemption creates in bank investment portfolios.

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For the most part, construction costs are high because of wage increases and the compounded effect of wage increases on the cost of supplies and materials going into public works. As a consequence, these higher costs cannot be viewed as temporary phenomena which will be changed when some current supply-demand situations clear up. Rather they reflect the inflation of wages and it is reasonable to suppose that they will be as resistant to decline as any prices composed largely of a wage element.

The full force of public construction by minor subdivisions of government probably has not yet been reflected in the municipal securities market. Some municipalities in the course of the past two or three years have been persuaded to defer construction because of high costs. Many of these projects cannot be delayed indefinitely even though costs remain high. Furthermore, a fair amount of public construction has been impeded by shortages in labor and material. The very communities in which private construction is most active are also the ones likely to have a large public works program under way. As labor and materials become more plentiful, the expansion in facilities will have a counterpart in a volume of municipal issues.

New State and municipal flotations have exceeded $2 billion both in 1947 and 1948. Over the next few years, there is every reason to believe that the growth in the volume of construction by the minor subdivisions of government will be more than sufficient to offset the decline in the volume of Veterans' aid financing. Accordingly, totals in excess of $2 billion should not be surprising in the years ahead.

Trend in Yields

The wartime low in yields on State and municipal securities registered by the indexes early in 1946 appears to have been the culmination of a downward trend which persisted over the years following the financial recovery from the crisis phase of the Great Depression in the 1930's. Two factors seem to have contributed to this trend. In the first place, these securities are tax free havens for investment funds. As the rates of Federal income taxation increased in the years immediately preceding the war and especially during wartime, the amount of funds seeking this asylum exerted a tremendous pressure upon the structure of yields. (At times, the elimination of tax exemption was advocated vigorously, but without success. Now the proposal appears to be dormant, but it certainly is far from dead.) Moreover, the effect of the pressure from funds seeking tax exemption was accentuated by the shrinkage in the amount of outstanding municipals during the war.

A second factor contributing to the decline in municipal yields was the so called "cheap money policy" which has characterized the American scene for a good many years. This policy was adopted first to stimulate business recovery during the 1930's, then continued to facilitate the financing of the war, and since the cessation of hostilities the retention of the "cheap money policy" has served to ease the burden of the public debt.

In 1946, the trend in yields on State and municipal obligations broke away from the former pattern. On the average, yields have increased about one percentage point over the past three years. Thus far, however, the yield indexes have merely returned to the levels prevailing in the years immediately preceding the war. Viewed in historical perspective, they are still extremely low. The rather modest increase in yields since 1946 has produced some startling readjustments in the prices of municipal securities. For example, long term issues, i.e. with 25 or 30 years to run and with coupons of 1% to $1\frac{1}{2}$% which were floated at prices around par when yields were at the low point, now are quoted in the 70's. This readjustment in price does not reflect deterioration in credit quality. It merely serves to place these securities on a basis which affords a yield comparable to the $2\frac{1}{4}$% and $2\frac{1}{2}$% returns now obtainable from new issues.

During most of the 1920's, a period incidentally when prosperity was widespread and the finances of municipalities were thought to be reasonably good, yields averaged in the neighborhood of 4%. As a matter of fact, municipals have seldom returned much less than 4% on the average at any time since 1900 although for a period right after the turn of the century the yield hovered close to 3% for a short time.

The future trend in the yield on State and municipal securities is an inscrutable mystery both to the expert and the novice. The attempt to forecast the trend degenerates for the most part into a guessing game. Certain forces presently at work obviously tend to increase yields. For example, the worldwide need for capital goods to repair the damage of the war, the tremendous advances in technology most of which call for added capital investments, and the expansion in the population all point to a greater rate of demand for capital in the years ahead. On the other hand, policy considerations of a fiscal and monetary character suggest the continuance of arrangements which would tend to prevent a rise of interest rates. The removal of tax exemption would certainly have a marked effect on yields. Most important of all is the question of whether we shall have war or peace. While it is rather easy to enumerate these considerations, it is practically impossible to evaluate them correctly.

Bank examiners in the course of their work do not need to forecast trends in interest rates. As a matter of fact, bankers do not need to make such forecasts if they follow the recognized and sound principles of management. Most of these principles have developed from a background of experience which recognizes the importance of change and provides some measure of protection against untoward developments.

The banker who bought a few 30-year bonds carrying 1% coupons at 98 three years ago now can feel comfortable--even though he may be somewhat unhappy--as long as this commitment involves only a small percentage of his total portfolio. But if he invested the bulk of his funds on these terms, then his situation could easily become precarious. Fundamentally, this is why close attention to the maturity schedule is very important in the management of bank investments as well as in bank examination and why it is well to know whether yields on securities are at a relatively high or low point.

Finances of State Governments and Minor Political Subdivisions

During the war years the State governments made substantial progress with their debt retirement programs, and at the same time they strengthened their current finances. For the country as a whole, the gross debts of these governments declined from about $3.5 billion in 1940 to $2.4 billion in 1946, or by about one-third. For the most part, this record was achieved because tax collections were good. Expenditures for capital improvements were curtailed during the war and ordinary operating expenses increased rather slowly. The new sources of revenue which the States first tapped in the 1930's have proved to be very lucrative in the prosperous war and post war period. Mostly they consist of general sales or income taxes, or special levies on widely used items such as gasoline, tobacco and beverages. State tax collections excluding unemployment compensation taxes rose from $3.3 billion in 1940 to nearly $5 billion in 1946.

The States have found Veterans Aid bonds relatively easy to market because they could show substantial progress in debt retirement as well as current financial strength. Not surprising, therefore, is the fact that over $1 billion of these securities were floated in 1947 and 1948. However, these flotations have now largely offset the reduction in State debts over the preceding six years.

Generally speaking, the State governments still appear to be in a healthy financial condition, but it should be remembered that the income of States now depends to a much larger extent than ever before upon the general level of business activity. Whereas formerly revenues were derived largely from general property taxes, the States now rely very considerably upon sales and income taxes. As a result, State governments now have little ability to withstand business depression.

Although the improvement in State finances has been general, it is fortunate that the recent substantial increases in indebtedness have been confined largely to the ones which appear best able to carry the burden. For example, 25 States reduced gross debt in 1948 as compared with increases in 23 States. Accordingly, it now seems appropriate to re-evaluate the relative credit standing of the States. The margin of advantage which some of the strong States formerly enjoyed has been narrowed. Absolutely as well as relatively, marked improvement has occurred in some of the Southern States which traditionally at least have been considered rather weak.

Quite in contrast with State governments, the minor political subdivisions are, generally speaking, in serious financial trouble today. To be sure, they made some progress in debt reduction over the war years. The debts of these smaller units fell from $16.7 billion in 1940 to $13.6 billion in 1946. In other words, they were able to reduce indebtedness by slightly less than one-fifth as compared with the reduction of one-third achieved by the State governments.

General property taxes continue to be the chief source of income for the minor political subdivisions. As a consequence, gross revenues cannot be readily increased. Usually this involves reassessment of property values as well as an increase in the tax rate. The former is a slow and tortuous process, and the latter quickly arouses the antagonism of taxpayers.

Reflecting the evil consequences of inflation, the local governments have experienced real difficulty in balancing revenues and expenditures since 1946. As an illustration, data compiled by the Census Bureau for 37 cities having 1940 populations of over 250,000, show that in 1947 the general revenues of these communities rose 13.8% over 1946 whereas expenditures rose 19.2%. Moreover, in 1947 new borrowing by these cities exceeded the amount of debt retirement. In the preceding four years, debt retirements substantially exceeded new borrowing.

Almost the entire pressure for capital improvements in the post war years will impinge upon the minor political subdivisions. They are expected to provide new schools, hospitals and other institutional buildings, highways, sewer and water facilities, and a great many other types of expensive public works. To satisfy all of the demands imposed upon them would certainly be disastrous. Actually, many of these units now are so weak financially that they cannot even embark upon a program of public works. The seriousness of the problem is not yet widely recognized because times are prosperous and refinancing is fairly easy.

The rise of quasi-public entities known variously as authorities, special districts, or commissions testifies to the seriousness of the financial problem facing the minor subdivisions of government. Formed to provide services once considered to be within the scope of local government activities, these quasi-public entities rely upon revenues derived from charges for services such as sewer and water rents, bridge or highway tolls, and the like. The funds to construct the desired public works are obtained through the flotation of revenue bonds. Thus, the local governments avoid the burden of an additional financial load upon their already weak resources. But such devices will not enable the community receiving the services to avoid the cost.

Treatment of Municipal Portfolios in Bank Examinations

The foregoing review of current developments and future prospects in the field of State and municipal credits suggests that changes are occurring at a fairly rapid rate. Furthermore, deterioration in quality now seems to be a reasonable prospect for a large section of these credits. To be sure, every period which is studied carefully seems to be one of transition. At present, however, the tempo of change in this area of the investment field is much higher than it was only a few years ago. More important for this discussion is the fact that the forces making for improvement in the quality of municipal credits now seem largely to have spent themselves. Presently almost all of the forces are working towards deterioration.

For quite a few years, the municipal portfolio of a bank under examination has usually not been a very likely source of trouble. The quality of the items composing it by and large tended to improve with the passage of time. Accordingly, once the examiner had satisfied himself regarding the classification of the items, he was on fairly sound ground when he assumed that current facts would amply support his classifications or even evidence betterment. In these circumstances, neither the examiner nor the banker was likely to be much concerned about up-to-date credit files.

Now, however, the bank examiner is warranted in assuming that up-to-date information would show that a municipal credit was not as good instead of better than it had been a few years ago. As a matter of fact, current reports will likely disclose an increase in debts and possibly financial difficulties in covering operating expenses. In view of these circumstances, examiners should stress the importance of up-to-date credit files covering all of the municipal securities in the bank portfolio. The reason is twofold. The banker himself should keep abreast of current developments affecting the credit quality of his investments. Also, the examiner needs to have the information at hand when he reviews the items in a portfolio.

Both the banker and the bank examiner today need to guard themselves against pre-conceived notions with respect to the credit quality even of the older State and municipal credits. Attention has already been called to the fact that recent increases in State debts have removed the margin of advantage enjoyed by many of these credits. At the same time, notable improvement has occurred in the quality of some State credits which in the past were only fair. Similarly, changes are occurring rapidly among the credits of the minor political subdivisions and a variety of obligations floated by recently formed quasi-public authorities are appearing in the investment portfolios of banks.

The pattern of maturity distribution for bank investments probably has never received the scrutiny which it really deserves. The readjustments in yields on investments over the past three years, especially in the municipal field, ~~have~~ has emphasized the importance of an appropriate selection of maturities as an essential part of a well designed portfolio. Municipal securities furnish bankers with an excellent selection of maturities. The usefulness of issues maturing serially as a means of avoiding dependence upon the market place when it is necessary to withdraw funds from the investment account has been clearly demonstrated. Furthermore, the readjustment in yields since 1946 has high-lighted the disadvantages of long term maturities especially when they are coupled with low coupons. While examiners are not in a position to insist on the elimination of long term maturities from investment portfolios, they may be able to use the recent experience with telling effect in their effort to persuade bank managements to improve maturity distributions.

Not infrequently, poor quality portfolios are justified by the argument that the bank needs these securities for tax reasons. Admittedly, tax avoidance is a consideration in developing an investment program. However, the tax status of many institutions is such that the tax exempt income derived from municipals costs more than it is worth. It is entirely too easy for a bank to lower the quality of its portfolio in an effort to secure municipal securities which furnish what is deemed to be an appropriate yield.

Summary and Conclusion

A review of the facts indicates that currently the volume of new State and municipal financing is at record levels. Furthermore, there is every reason to believe that financing will continue at this rate for some time to come. Issues of State obligations, largely for bonus purposes, have completely offset the reductions in State debts during the war period. The debts of the minor subdivisions of government are growing rapidly. To an increasing extent, quasi-public entities are being created to perform essential public services. Mostly these entities come into existence because the older political subdivisions lack the financial strength needed to accomplish the results. Sanitary districts, transportation authorities, water and electric power and light enterprises are all cases in point.

Yields on municipal securities are going through a period of readjustment. Following their decline to record low levels at the conclusion of the war, they have now moved in the opposite direction. Where this trend will lead remains to be seen. It is well to remember, however, that even after the very drastic readjustment since the low point in yields, viewed historically, the current return on municipals is still quite modest.

The financial condition of States and minor political subdivisions is changing rapidly at the present time and many of the changes are for the worse. The inflation in prices has placed a tremendous strain upon the budgets of the local governments. Practically all of them are suffering from an inability to increase operating income sufficiently to meet the higher bills for wages and supplies. Furthermore, the suspension of building programs during the war as well as shifts and growth in population have accentuated the need for improvements. The problem is further complicated by the backlog of demand resulting from the low rate of public building in the 1930's. Capital expenditures are reflecting the effects of price inflation. As a consequence of these forces, many old credits have deteriorated and many new ones are still unproved in quality.

With respect to the analysis of bank holdings of municipals, the following points need to be stressed. In the first place, the bank examiners would be well advised to pay very close attention to the quality of the individual issues in the portfolio. This admonition is quite burdensome because changes are taking place very rapidly and an opinion formed last week or last month may no longer be sound. The maintenance of adequate and up-to-date credit files covering the issues in the portfolio is now essential for any bank. Secondly, and quite apart from the considerations of quality, the examiner would be well advised to study the maturity distribution of the issues in the portfolio. One of the great advantages of municipal bonds lies in the fact that they are issued with serial maturities. Appropriately selected, these issues will provide for an in-flow of cash independent of liquidation in the market. Finally, bank examiners should view the municipal portfolio as a segment of the entire investment program.