

PROBLEMS IN RATING MUNICIPAL BONDS  
WITH SPECIAL REFERENCE TO THE  
DETERMINATION OF INVESTMENT QUALITY

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By  
Raymond E. Hengren, Assistant Chief  
Division of Research and Statistics  
Federal Deposit Insurance Corporation

Louisiana Conference on  
Municipal Finance and Administration  
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That municipal bonds are a subject of recurring interest to finance officers is evidenced by the presence of the topic on your program today as well as in February, 1953. At that time a panel discussion was devoted to the subject. In the course of that discussion you were presented with a picture showing the various sources of funds which are directed to municipal securities for investment. The commercial banks are an important factor in the market for these securities and my major purpose in the panel discussion last year was to outline the standards for bank investments, as well as to stress the application of these standards to specific investment situations.

Today my remarks will be centered on another aspect of municipal finances--but surely one that is of great concern to you in the course of your work. On many occasions the municipal finance officer is faced with the question: What can be done about the investment credit standing of the community? This question has many facets and a detailed review of them promises to be rewarding. As a matter of fact, the general discussion following the municipal panel a year and a half ago was largely concerned with this question. For that reason, it would seem quite appropriate for us to devote some time to its specific consideration now.

When the municipal finance officer sets out to do something about the investment standing of his community, he would be well advised to bear in mind the requirements and practices of the various groups of investors in selecting issues. By so doing he will be able to achieve real progress and to avoid frustrations. In the first place it is well for the finance officer to remember that prospective buyers of municipal securities cannot afford to spend much time or money in making their selections. Specifically, this means that the decision regarding the suitability of a given issue for a place in a portfolio will be favorable only if it can be made quickly and with a minimum amount of investigation. The rate of return on municipal securities, as you know, is very small. Accordingly, it is not practical for investors to engage in extensive and elaborate research which is both costly and time-consuming. Furthermore, the volume of municipal offerings is large and there is a bewildering variation in the investment characteristics of these different issues. Rather than engage in the special study which is needed to understand and evaluate unusual or novel types of issues, the investor is likely to turn away from such offerings and accept the ones that conform to recognized standards.

Furthermore, when the municipal finance officer sets out to devise ways for doing something about the investment credit standing of his community it is important for him to bear in mind the fact that

the investment community uses simple yardsticks for determining quality. Analysts of credit quality employ these qualitative tests because it is an easy and more or less satisfactory solution for a troublesome problem.

In the field of municipal investment, rules-of-thumb serve to narrow the area of selection to a very small number of issues whose credit standing is unquestioned, and an investor can readily justify the use of these rules for reasons of economy. The volume of securities measuring up to his standards is always likely to be far more than enough to supply the requirements of any single portfolio. Moreover, the buyer is not concerned with the fact that many credits would be ruled out of the market place if all were expected to meet a set of high and more or less arbitrary standards.

A few illustrations will serve to point up the importance of simple yardsticks applied by investors in the field of municipal securities. Some investors, for example, confine their selections solely to issues which carry a pledge of the full faith and credit of the obligor. The application of this rule automatically excludes the so-called revenue issues from consideration despite the good record of investment performance for many of these issues. General obligations of municipalities have acquired a secure position in the investment field and as a consequence many investors tend to place considerable reliance on this simple test. Likewise, analysts selecting municipal securities for investment portfolios sometimes apply yardsticks with respect to the size of the issuer or its geographical location. There are buyers, for example, who exclude obligations issued by very large or very small communities from the area of their selection.

Financial ratios are used very extensively by analysts in selecting municipal investments. To facilitate the selection of high quality investments, buyers may exclude from consideration any general obligations of a municipality with a debt in excess of two or three percent of its assessed value. Sometimes these tests are expressed in terms of per capita debt.

Turning now from these background considerations, the remainder of this discussion will be centered about three suggestions which promise to be useful to a municipal finance officer who is endeavoring to bring about a better understanding of his community's credit by the investment market, namely:

- (1) Adopt good accounting methods and obtain proper audits of financial transactions;
- (2) Advocate and apply sound financial policies; and
- (3) Maintain high standards for reporting.

Admittedly, none of these suggestions is original but that does not minimize their importance.

### Accounting and Audits

Good financial data are essential to the analyst when he is endeavoring to judge the investment quality of a municipal security. Such information is readily available only if the municipality has an adequate accounting system. When the accounting records of a municipality are satisfactory, the investment analyst's opinion is not likely to be upset because an important fact is missing. Accordingly, the municipal finance officer can make a positive contribution to the investment standing of his community by adhering to good accounting practices.

Properly audited financial statements are a source of consolation to an investment analyst when he is studying the finances of a municipality. Audits testify to the reliability of the financial data. The finance officer should not lose sight of the fact that an audit report on his municipality may be the decisive factor in the selection of securities for investment. Furthermore, an audit of a municipality's accounts is useful to the citizens in the community and public officials as well as investment analysts. To be sure, auditing municipal finances is a specialized and exacting task but the number of qualified accountants who are interested in this work is growing steadily.

The efforts of municipal finance officers and their organizations to develop good accounting procedures for municipalities have been noteworthy. From the recognized sources of information on this subject a municipal finance officer can obtain some help with virtually any problem that may arise in the course of his work. Moreover, the publications in this field have been pointed in the direction of uniform account classifications which facilitate comparisons of operating results from one community to another. Comparative data are very helpful to analysts in determining the relative standing of municipal credits.

Someone has observed that investment analysts do not take surprises well. This is a very useful bit of information to the municipal finance officer. Moreover, it is a convincing reason for straightforward reports on the finances of a municipality which show that the affairs of the community have been managed successfully and that the financial policies are sound.

### Sound Financial Policies

In appraising a municipal credit the investment analyst is seeking to answer the question: Can the community manage its debt successfully? A good audit report will present facts needed to answer this question. But the report itself is not sufficient to establish the quality of the credit. The information in the report must indicate that the municipality's financial policies are sound and that management is competent.



Broadly speaking, sound financial policies are likely to be simple and readily explainable. For this reason as well as because they have little time for study, analysts of investment securities take a dim view of situations which present unusual complications or differ widely from customary arrangements. Thus, a simple and readily understandable debt structure is to be preferred over a complex of security issues with unusual features and an abnormal schedule of maturities. So also, reliance on conventional sources of revenue has many advantages over the unusual plans for defraying costs of government that sometimes are encountered in the finance of municipalities.

When the financial arrangements of a community are free from unusual features, the analyst who is undertaking to appraise investment quality feels considerable assurance that he understands the basis of the credit. In these circumstances he is spared the fear that there are some mysterious and uncertain elements in the situation that may undermine his conclusions. In my judgment, the municipal finance officer cannot overemphasize the importance of simplicity and straightforwardness in testing the soundness of any financial policy.

Certain standard patterns are characteristic in the field of municipal finance. As long as the community adheres to these patterns, questions as to the soundness of its financial policies are unlikely to arise. For example, major dependence on the general property tax is customarily accepted as an approved method for defraying the costs of government. Self-supporting utilities, such as electric, water, and sewer systems, also are recognized as fitting the standard pattern of municipal finance.

To the extent that your community does not have a simple financial structure, or it departs in some material respect from the standard pattern of municipal finance, then it would be well to recognize that fact at the outset. Such a situation is certain to be troublesome for an investment analyst. In these circumstances, however, the municipal finance officer can be very helpful. Since the analyst is endeavoring to assure himself that the community is following sound financial policy, when the rule-of-thumb tests point to the opposite conclusion, the municipal finance officer should make a special effort to present the picture in its most readily understandable form.

By way of illustration, let us consider briefly the case of a municipality that does not rely to any appreciable extent on the general property tax to finance its ordinary costs of government. Instead, this community is using the profits of a utility to defray the major portion of governmental expenses. On the face of it, this situation would not appeal to an investment analyst. When the simple tests are applied it is evident that the general property tax rate is too low. Thus, the ability of the community to sustain its costs of government is called

into question. Further study of the figures then suggests that the community is relying upon an electric utility to finance its operations. At this point it is important for the municipal finance officer to present the facts regarding the municipal utility in sufficient detail to convince the investment analyst that the proposition is a sound one, and that profits will be sufficient to cover the anticipated portion of governmental costs.

Innovations in financial arrangements and deviations from accepted policies may sometimes appear very attractive to the municipal finance officer. Nevertheless, he should recognize that an investment analyst is likely to question the quality of the community's credit if the solution for a troublesome problem involves a departure from customary practices.

There is no merit in the contention that the analyst is opposed to progress in developing new and better financial policies. As a practical matter, however, he lacks the time to study the facts with much care in a complicated situation. Instead, he will be disposed to turn to a credit that fits into an approved pattern and therefore can be readily classified as to quality. When a municipal finance officer is faced with a troublesome problem, he should strive to find a conventional solution. If there is no alternative but a departure from the conventional patterns, a special effort should be made to demonstrate in a convincing manner that the solution is good.

There is a long record of experience in the municipal credit field and analysts have developed standards which enable them to test the relative strength or weakness in individual communities. As municipal finance officers, you are familiar with these qualitative tests. By applying them, you can determine for yourselves what the reaction of investors will be to the securities of your community. Furthermore, the application of these tests will enable you to determine what segment of the investment market will be interested in your obligations. Should your community conform to the very top grade of investment credits, then you will have some assurance that your securities will appeal to banks and individuals with very high qualitative requirements. On the other hand, there are a great many investors who are in a position to absorb securities below the top grade.

### Municipal Reporting

Municipalities, in my opinion, have much to learn from the field of corporation finance in preparing and distributing reports on their activities. Spirited competition has developed among corporations to present reports on their affairs in a form designed to be helpful and

attractive to shareholders. To be sure, some municipalities have developed reports that are as good as the best found in the corporate field, and some are far better than most corporation reports. For the most part, however, reports on the activities of municipalities leave much to be desired. Partly, no doubt, this is a result of the statutory limitations on municipal finance officers which prescribe the form and content of the reports. But the finance officer has many reasons for going beyond the minimum statutory requirements in this aspect of his work.

By seizing the initiative in the preparation of reports, the municipal finance officer can do much to improve the standing of his community in the investment market. Here the endeavor should be to bring the information to the attention of those who can use it rather than to wait for them to pry the data out of public records. It is a fact that a great many analysts of securities cannot afford the time and expense of research. Instead, they will turn to securities for which information can already be found in the regular sources of investment data.

Reports on municipalities usually do not present much information of a general background nature about a community. This is a serious shortcoming. The municipal finance officer is in an excellent position to secure information about the basic economic trends. He could perform a very worthwhile service to his community as well as to the investors by assembling this information and presenting it in useful form as a preface to the regular financial report.

Comprehensiveness is a distinguishing feature of a good report on the finances of a community. By assembling the pertinent data and organizing it in a simple and understandable form, frequently the municipal finance officer can improve the credit standing of his obligations in the investment market quite materially.

Finally, the municipal finance officer would be well advised to anticipate the questions that investors may ask about a community and to include the answers in the regular financial reports. You may recall that considerable stress has been placed in these remarks upon the importance of sound financial policies, as well as the fact that simple structures and standard patterns of finance are taken usually as evidence of soundness. Sometimes the affairs of a community may be quite sound and yet the financial arrangements may depart from the standard patterns. If this is the case, it would be desirable for the finance officer to develop the facts necessary to facilitate a ready understanding of the situation.



### Summary and Conclusion

To sum up these comments--the municipal finance officer is often confronted with the question: What can be done about the investment credit standing of his community? In developing an answer to this question, there are two important realities which demand consideration. First of all, investors in municipal securities cannot afford to spend much time or money in making their selections. Secondly, the selections are based largely upon the application of comparatively simple rules or tests for credit quality. The yardsticks applied by analysts are concerned with matters such as the nature of the obligation--Has there been a pledge of the full faith and credit of the obligor?--the size and location of the community, and a few simple ratios, such as debt expressed as a percentage of assessed value or the amount of debt per capita.

To answer the central question posed in this discussion, it was suggested that the municipal finance officer adopt and adhere to good accounting methods and make certain that the financial affairs of his community are audited properly. Also, it was suggested that he make every effort to encourage the adoption of sound financial policies in his community and to adhere to them with steadfast determination. Finally, improvement in reporting by the municipal finance officer was suggested as almost certain to bring about a better understanding of the investment credit position of his community.

Simple and readily comprehended plans for debt management and conventional arrangements for obtaining the revenues needed to defray the costs of government are the earmarks of sound financial policy. When a municipal finance officer discovers that his situation does not fit into any of the standard patterns, then it is incumbent upon him to marshal the facts which will demonstrate that his community has adopted appropriate policies.

Progress along all of these lines is essential in a program for strengthening the position of a municipal credit.