

**DISCUSSION OF REVENUE BONDS WITHOUT PERFORMANCE RECORD**

**By**

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## Discussion of Revenue Bonds Without Performance Record

Among the many questions posed to the bank examining authorities by recent developments in the field of municipal finance the ones clustering about revenue bonds are especially troublesome. To establish a framework for your discussion, which will be concerned with an aspect of this financing, it is my intention at the outset to sketch the factual background briefly. Then the central question will be brought into focus as sharply as possible. This will be followed by some comments about practical difficulties that are encountered in our endeavor to come to grips with the questions and a review of a few typical cases. Finally, my remarks will suggest some alternatives for your consideration. It is my hope that your views and observations in the course of the discussion will provide me with some much needed help in analyzing revenue bond issues as regards their suitability for bank investment portfolios.

### Factual Background

There has been an enormous volume of revenue bond financing in recent years. This has been stimulated by an apparently insatiable demand for huge and costly public facilities, for example, highways, bridges and tunnels, and public buildings designed to serve such purposes as education, trade centers, and recreation.

The old subdivisions of government and the customary arrangements for credit have been totally inadequate to finance the public facilities now deemed to be essential in our way of life. There was a time when the cities, the towns, and the counties were able to provide a network of highways adequate for the public needs. Similarly, the school districts

were able to furnish such facilities as were deemed appropriate for the current educational standards. Huge and costly facilities to serve the needs of the trade, for example, port authorities and elaborate recreation establishments were unheard of. But times have changed, and now we must face the fact that demands placed upon subdivisions of government have increased tremendously both qualitatively and quantitatively.

The notion that users can be made to pay for all or a large part of the cost of public facilities in many cases has gained widespread acceptance in recent years. Thus, our attitude with respect to public highways has gone through a remarkable change. A generation ago most people would have found it unthinkable to finance the construction of such a public facility on a basis which would anticipate the defrayment of cost by the collection of tolls from users. Now that notion is widely accepted. As a consequence, in part because of the great increase in the variety of facilities sought for public use and in part because user charges have been accepted as an appropriate means of financing them, construction of these facilities in the field of municipal finance has been characterized by an almost unbelievable variety of complex and unusual financial arrangements. In other words, the rather prosaic task of analyzing municipal credits when most obligations rested upon a pledge of the full faith and credit of a very conventional type of user has been to a considerable extent altered. Today the analyst is presented with as knotty an assortment of problems in this field as he could ever expect to find in the area of private enterprise credits.

Municipal revenue bonds--so-called--have developed out of this complex situation. Although there is adequate precedent for this type of

financing in the history of municipal finance, the fact remains that the recent developments have given it almost entirely new dimensions and coloring. Accordingly, history furnishes the analyst some guidance at the outset but soon he finds himself almost lost in a maze of innovations.

Many of the projects financed by municipal revenue bonds represent departures in the scope of public activities. Some projects are in the nature of public utility enterprise customarily deemed to fall within the private sector of business activities. Many of these projects, of course, are on the borderline. Historically, for example, we have had both public and privately owned water companies as well as gas and electric utilities. More recently the need for complex and highly specialized facilities in trading centers has given impetus to creation of port authorities with broad powers to finance and operate enterprise.

Practically all of the projects financed by municipal revenue bonds are new. In other words, the individual project has no record of operations. Similarly, most of the financing is cast in the form of long-term bonds. This is a serious departure from the principle which was firmly established and thoroughly tested during the period of the Great Depression, namely, that serialization of maturities is the best way to arrange for the management of a debt created by a subdivision of government.

#### The Problem

From this background of rapid change and experimentation in the field of municipal finance there emerges the problem of concern to the bank examining authorities. Phrased in simplest terms, it may be expressed as follows: Are municipal revenue bonds suitable for bank investment when they have the following characteristics?

- (a) The proceeds are used to finance a novel project, and
- (b) There is no operating record.

Quite frequently the enterprise may belong to a type that has been proved feasible in terms of engineering and economic considerations. Nevertheless, the project under consideration has not demonstrated its ability to service a debt.

Orthodox credit analysis does provide some tests for situations of this character. As a matter of fact, all such revenue bonds would automatically be defined as credits unsuited for bank investment purposes. The basis for this conclusion is quite reasonable. Thus, prior to the completion of a project the obligations floated to finance it are deemed to be construction loans. Since construction is fraught with many uncertainties, it is easy to understand why municipal revenue bonds under the orthodox approach to the credit analysis problem are deemed to be unsuited for banks until the project is completed. The second orthodox test stresses seasoning of a credit. Specifically this means that the credit cannot be appraised with any real assurance until the ability to service the debt has been demonstrated by a satisfactory operating record.

At this time it seems to me that one must recognize the serious difficulties arising when the orthodox criteria are applied rigorously to all current revenue bond financing. The fact is inescapable that some very promising projects have performed exceedingly well after completion. In this connection one need only mention the New Jersey Turnpike and the Delaware Memorial Bridge. Parenthetically, it should be noted that if there is a single thread running through all the tangled skein of financing it leads to the conclusion that very frequently a few good projects at the



outset lull investors to sleep and they fail to apply proper criticism to the inferior projects that appear later in the course of development.

Furthermore, it is obvious that some informed bond buyers have abandoned the orthodox tests and substituted analysis in appraising current municipal revenue flotations covering ventures that may be novel and without operating records. Finally, it is a fact that the commercial rating agencies seem to reflect a difference of opinion regarding the treatment of these situations.

Practically all of these revenue bond projects involve questions of engineering feasibility. These questions, however, can only be answered by qualified technical experts. The analyst of credits is scarcely in a position to second-guess engineering reports. Experience has shown that projects deemed to be practical by competent engineers can in fact be constructed as planned.

Occasionally, to be sure, a project that is feasible from an engineering viewpoint does not prove to be a sound economic venture. For example, we have illustrations of toll roads constructed in the face of great engineering difficulties that have failed to pay their way once they were completed. As a matter of fact, the credit analyst is as competent as anyone to appraise the evidence and form a judgment as regards the earning power of a project.

### Typical Cases

By taking advantage of hindsight, the characteristics of a successful municipal revenue bond project stand out rather clearly. In

the first place, even before such a project is launched there is always convincing evidence of a substantial and growing demand for the service. Secondly, estimates of revenues based upon the existing demand for services and the cost of the project demonstrate that the project will be able to service its debt. In short, this means that it is unnecessary to rely upon any projected growth in the demand for services in estimating the adequacy of earning power.

Other important characteristics of revenue bond projects that have proved to be successful are low operating costs and the absence of difficult managerial problems. Furthermore, in all of these projects the legal position of the creditor has been well protected by arrangements designed to safeguard bondholders.

Your comments in the discussion period regarding specific flotations of municipal obligations that have been marketed within the past two or three years will be helpful in suggesting the extent to which the bank examining agencies may depart from the so-called orthodox rules in appraising new offerings. It seems to me that the authorities cannot be entirely rigid in their thinking. When banks with admittedly competent investment departments acquire issues for investment purposes that do not measure up to the orthodox standards then it is time to scrutinize those rules very carefully.