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This opportunity to appear before the Subcommittee on Economic Progress of the Joint Economic Committee to present the views of the Federal Deposit Insurance Corporation on municipal bond ratings and the problems of municipal financing and on some general aspects of some of the current legislative proposals on these subjects is greatly appreciated. The Corporation's primary responsibilities relate to the Federal deposit insurance system and to our supervisory activities over banks in connection with these responsibilities. The problems of municipal finance are thus outside the immediate purview of our operations, although certain aspects of bank examination practices and procedures are relevant. I shall therefore confine my comments today to those topics on which the Corporation might be able to contribute some additional information and insights.

The Corporation recognizes the importance of providing State and local government units with the financing needed to supply their communities with essential facilities and services, such as highways, public utilities, and schools. With the expansion of the economy, rising population, and increasing urbanization, the financial requirements of the local government units have been growing rapidly.

The financing of governmental activities at every level of responsibility -- from the States down to the smallest unit -- is a task of tremendous complexity and ever increasing urgency.

Throughout the years, banks have furnished municipalities with a significant portion of their credit requirements. Although banks now account for the largest single investor group in municipal securities, they may be expected to play an even more important role in future financing. Banks are ideally situated in the savings market to act as intermediaries between the small savers and municipalities. In the absence of an intermediary, the small saver would not be likely to invest his funds in municipal issues -- both because he would derive virtually no benefit from their tax-exempt status and because municipal securities typically are not issued in suitable denominations.

As a consequence of the banks' activities in the market for municipal securities, the obligations of the municipalities appear in the asset structure of banks and come to the attention of the bank supervisory authorities in the course of the regular examination process. The relationship between the examination process and municipal securities, however, is a subsidiary one and one that is really peripheral to the problems of municipal financing.

It seems to me that the Subcommittee on Economic Progress is concerned at this time with ways whereby local units of government can very greatly improve their channels of access to capital markets. The capital requirements of these local government units -- for the construction of new schools, highways, sanitary facilities, and similar projects -- entail long-term borrowing. Financing of all these activities competes with home building and the related commercial and industrial construction for the same limited supply of funds in the capital market. Logically the situation calls for rationalization of the complex of these capital demands placed on the market as well as for imagination in devising new ways for municipalities to tap, either directly or indirectly, the accumulated funds of savers who are seeking investment opportunities.

If municipalities are to make real progress in bettering their access to capital funds, it will probably be necessary to move in entirely new directions. Not only would it be desirable to increase the overall supply of credit for municipalities but it would be desirable to broaden the investor base that can be tapped for funds. To illustrate, municipalities might improve or develop the machinery for mobilizing the funds of small savers in their own communities -- either on a direct basis or through improvements in intermediation by existing financial institutions. Another possibility might be the creation of a new, standardized investment security that could be offered in the capital market by financial intermediaries who in turn would use the proceeds to finance municipalities. Such an instrument (large in denomination) might prove attractive to potential investors because the obligor would be better known than many of the smaller local government units and its standardized form might improve its marketability.

Both of these suggestions are advanced merely as rough skeletons of ideas. No doubt legislation would be required at both the Federal and State levels of government, and perhaps this would not be easy to achieve. Moreover, there may very well be insurmountable practical difficulties not obvious at first glance, or untoward effects on existing financial arrangements.

Because income from the obligations of States and their political subdivisions is not subject to Federal income taxes, moreover, another complication is introduced to any discussion of possible changes in the methods of financing the capital requirements of these governmental units. Owing to the great variation in the tax status of prospective investors, it is extremely difficult to trace the impact of the tax exemption feature on the securities marketing process or to generalize with any assurance of being right as to the consequences for long-term municipal financing of its retention or elimination. To further complicate the situation, there are fifty different State jurisdictions. Moreover, municipal finance and taxation involve legal relationships between the States and the Federal Government that are exceedingly intricate. In addition, it is exceedingly difficult to appraise the incidence under existing law of exemptions from Federal income tax of the income from the obligations of the States and their subdivisions and possible shifting of the tax burden.

Yet another complication stems from the fact that some States also accord tax advantages to taxpayers holding their obligations. Resolution of these various tax problems is likely to be most difficult because of the complexity of existing Federal-State government relationships and the troublesome questions of tax policy and equity among taxpayers.

Another proposal recently advanced as a possible solution to easing the problems of financing municipalities suggests a guaranty --

or adoption of the insurance principle for the obligations of local governmental units. Beginning in the 1930's, the Federal Government has experimented with insurance of assets and, by and large, the experience seems to have been reasonably successful. Whether this could be applied to the financing of the various subdivisions of government poses questions both of a technical nature and with regard to desired public policy that cannot be easily resolved.

The proposal for guarantees also contemplates tapping, in part at least, the resources of the Federal deposit insurance fund for the initial financing. Use of the Federal deposit insurance fund for this purpose is, in my opinion, inconsistent with the principles of good public administration and, in addition, violates the trustee relationship between the Federal Deposit Insurance Corporation and depositors in insured banks. Diversion of even a small part of the deposit insurance fund, which consists of the proceeds from assessments levied on banks for deposit insurance, for other purposes than that for which it was established -- irrespective of how meritorious the objective -- can only be viewed as an extension of the taxing power in an entirely new direction.

Nevertheless, the consideration of new and "radical" approaches to the long-term financial problems of municipalities is essential -- and I am using the term "radical" in the sense of attacking the root of the problem. Methods of insuring municipal credits, some form of Federal subsidy to offset the Federal income tax exemption feature of municipal obligations, or improvements in the availability of data concerning the finances of municipalities could perhaps be helpful. Yet these proposals may not augment greatly the volume of funds necessary to meet the large and rapidly growing financial requirements of municipalities.

Let me turn now from this broad consideration of problems in the field of municipal financing and direct my remarks to the bank supervisory use of ratings in evaluating bank portfolio investments in municipal securities. To be sure, the subject is only of limited concern to the committee's primary interest. Nevertheless, it may be helpful at this point to review briefly the essential features of the bank examination process relating to ratings and investments in municipals in order to contribute to a better understanding of the problem of municipal financing as a whole.

Whenever a bank is under examination by the supervisory authorities, one of the crucial determinations in that process is the amount of net sound capital in the institution. Speaking now at the risk of gross oversimplification, this figure is ascertained by subtracting the amount of the bank's liabilities to depositors and others from the book value of its assets after certain adjustments. These adjustments include an estimate for losses stemming from qualitative deficiencies in some of the items. On the basis of information in credit files and any other data available to the examiner, individual loans are tested for quality, and the book value is adjusted for elements of loss deemed to be present. Items in the securities portfolio likewise need to be checked for quality and soundness.

Prior to 1938, when banks were examined, securities in the investment portfolio usually were appraised at market prices on the day of examination. Rationalization of this method was not difficult. Especially in the early decades of this century, banks invested in substantial amounts of corporate issues that were actively traded on the securities exchanges, and these holdings were viewed as a so-called secondary reserve which could be readily converted into cash if necessary.

The Great Depression of the 1930's demonstrated that bonds in the securities portfolios of banks could not be readily converted into cash through sale on the exchanges when many distressed sellers placed a large volume on the market simultaneously. Such securitites could only be shifted from one holder to another bank or individual investor. Large losses were incurred as holders of bonds were obliged to sell in a falling market -- even though the basic quality of the credit was sound. Nevertheless, bank examination practices continued to use market prices of securities for appraisal purposes.

The lesson of the Great Depression was repeated in a somewhat milder form not long after. A sharp recession in 1937 was accompanied by a shrinkage of market values for securities. Then the situation was especially acute because the appraisal of securities in bank portfolios at market prices for the purpose of determining net sound capital -- superimposed on already depressed values -- would have necessitated the closing of many banks. Notwithstanding the fact that the underlying quality of the securities in bank portfolios was generally satisfactory, the price declines tended to result in the erosion of capital margins under the prevailing bank examining procedures.

To deal more realistically with this situation, the Federal and State supervisory authorities in 1938 adopted an examination procedure which valued investment quality securities on a cost basis and only speculative issues at market prices. Implementation of this new policy required that examiners differentiate between the latter issues and investment grade securities deemed to be suitable for bank portfolios.

Determination of the credit quality of securities follows precisely the same procedure used by examiners in appraising a loan portfolio. The examiner utilizes analytical methods and information developed by the financial community as well as other information available to him to reach a judgment based on facts. With respect to municipal securities rated since the 1930's by the investment advisory services in the four highest grades (which incidentally comprise all but about 5 percent perhaps of the amount of obligations so covered), the quality of the obligation is virtually certain to be suitable for bank investment purposes. In dollar amount, the bulk of the rated issues is floated by large obligors and information to support the quality determination for these issues is readily available in the publications of the investment advisory services.

The issues at the lower margin of this comprehensive rating band composed of four grades receive closer scrutiny by examiners, however. For these issues and the issues outside of the scope of the rating system, it is necessary for the bank examiner to obtain relevant information from publications of the advisory services when available, from the credit files of the bank under examination or elsewhere. The issuer's past record of performance in servicing debt, the current financial situation such as the relative debt burden, the margin of protection against default on interest or principal payments, tax levies and collections, and future prospects for the community all must be considered in assessing the investment quality of marginal or unrated investments. For securities totally lacking in bank investment quality -- namely, defaulted issues and others with little or no margin of protection to insure performance when interest coupons come due or the bond matures -- the examiner sets the appraised value at the market price. The kind of analysis described above is not exhaustive, however, and need only be pursued to the point needed to support the conclusion.

Admittedly the definition of an "investment grade" obligation has many difficult facets. Viewed in retrospect, a security so identified will perform precisely according to the terms of the obligation: interest will be paid without delay and the principal amount will be repaid when the bond matures. But the buyer of securities and the bank examiners are looking into the future rather than the past when they make a judgment as regards investment quality. The determination rests on judgment supported by as many relevant facts as can be marshalled and appropriate analysis; it is neither more nor less than that.

The basic idea embodied in the 1938 statements by bank supervisory authorities regarding examination procedures (revised in minor respects in 1949) with respect to the valuation of securities for bank examination purposes continues in effect to this day, although there have been other changes in examination practices. Investment quality securities are still insulated from day-to-day fluctuations in prices.

The introduction in 1938 of so-called "convention values" for appraising securities (namely, the uniform basis of valuation adopted by the bank supervisory authorities) was especially relevant to the bank investment problem at that time. Banks held a substantial amount of corporate issues and the sharp upward movement in interest rate levels drove prices down on many issues, even though there had been little or no deterioration in quality. Since that time, the structure of bank investment portfolios has changed greatly. Now the bulk of the securities in bank portfolios consist of obligations of the United States, the States, and their minor subdivisions (see attached table). Furthermore, market price quotations for the bulk of the municipal securities in the portfolios of banks are very difficult to obtain because they are traded on a negotiated basis over-the-counter and actual transactions are not published.

In the absence of this convention basis for appraising bank quality securities, the sharp increase in interest rates over the past few years would have created tremendous problems for the bank supervisory authorities. After all, a high-grade bank quality municipal obligation issued in 1962 with a 3-percent coupon and a 20-year maturity would be quoted today at a minimum discount from par on the order of 15 percent so as to give the holder a competitive yield. However, such an issue would be appraised on a cost basis for bank examination purposes.

Although the preponderance of the issues held by banks -- as contrasted with the dollar amount -- have not been covered by the rating system, the qualitative ratings published by the generally recognized investment advisory services have furnished some useful guidelines for bank examiners. Admittedly it would be desirable if all relevant information were available to cover all issuers of securities. But, as a practical matter, from the bank supervisory point of view, the securities not so covered present difficulties to examiners no greater than the ones that they face in appraising a loan portfolio.

A few additional remarks about "ratings" in the examination process may be helpful. In the first place, the ratings are used only as indicators in making generalized rather than sharp and precise differentiations. For bank supervisory purposes the fine gradations of quality are ignored. In examining a bank's securities portfolio, it is sufficient to identify on the one hand the bank quality issues and, on the other, those securities wanting in prospective investment performance, i.e., so speculative in character that they are not appropriate for bank investment purposes.

Buyers and sellers of securities are naturally interested in minute gradations of quality as are underwriters distributing securities to their customers. From the point of view of the bank supervisory authorities, however, it is unnecessary to inquire precisely into the terms of each transaction. Presumably banks will exercise good investment judgment when they acquire securities; and their total investment activities must measures up to some acceptable standard of profitability. It is the overall picture that is important. The bank supervisory authorities, therefore, are careful to refrain from managing a bank's investment activities. Such efforts would be inconsistent with the supervisors' basic responsibilities.

Worthy of emphasis also in a discussion regarding qualitative ratings for obligations issued by municipalities -- or for that matter any other securities -- is the fact the evaluation is in terms of the individual bank's overall condition and position. Any determination with respect to credit quality must always be relevant to the portfolio of the individual bank under examination: whether an issue is suitable for inclusion in a specific portfolio. Does the management of the bank have the capacity to cope with the investment problems that may be anticipated from a particular block or issue of securities? For example, some managements are much more skillful than others in handling credits or investments that might be classed as marginal in quality. Or, the relative size of the securities holding, e.g., a $5,000 block of bonds in a $5,000,000 portfolio, has a bearing on the importance attached to its quality at the time of examination. It should be obvious that an examiner would not focus the attention of management on a relatively unimportant problem when other matters are much more deserving of attention.

From time to time, the rating system has been criticized for its limited coverage, erroneous judgments of the quality of specific issues, and the lack of consistency in explanations of the rating. Since the investment advisory services are business enterprises, rating coverage tends to be limited for very practical reasons to the credits deemed to be of most interest to their clientele as the most effective use of available resources. Nonetheless, in recent years the services have rated a very substantial proportion of the outstanding dollar amount of municipal securities. The investment advisory services also have an impressive record of performance in judging of quality of credits, especially over the past 30 years and in the upper rating groups. Misjudgments, if they could be so called, have been confined mostly to the margin between the various ratings comprising the investment category. The qualitative ratings established at the onset of the Great Depression and during the crisis years were -- not surprisingly -- a poor guide for investors. However, virtually no one can point to outstanding foresight during those trying times.

Looking toward the future, the question of how best to provide examiners with guidance in appraising the quality of securities in bank portfolios remains as important as ever. Though the efforts of the investment advisory services recognized in the financial community have been helpful in the past, changes in the scope and method of their operations may and do occur. Here at the Corporation we are endeavoring to ascertain the consequences to our examining activities of recently announced changes in segments of the rating system. Our objective continues to be to provide examiners with the best assistance that the times permit -- and we shall pursue this objective with steadfast determination.

In the course of bank examination, no determinations of credit quality by the examiners are made available to the public.

Not only would it be inconsistent with the scope and nature of bank supervisory authority for such agencies to rule generally on the credit quality of any issuer of securities, but it would be as inappropriate as an effort to pass generally on the quality of commercial or industrial credit.

In the American financial community specialized institutions have developed whose business is concerned both with appraisals of the quality of mercantile credit and of securities. There have been investment advisory services engaged in compiling financial data of interest to investors in securities floated by private corporations as well as governments for many decades. Incidentally, this type of service has developed only in the United States.

Thus, it would be inconsistent with bank supervisory responsibilities to engage in a competition with the established facilities of the financial community for compiling data on investments and publishing ratings as to credit quality of securities. Whether any agency of government should undertake to compete with the established private facilities in this area of activity raises questions of public policy far beyond the scope of bank supervision. The requirements of bank supervision itself would not be able to justify an extension of these investment advisory services as a necessary sphere of governmental activity.

Proposals have been advanced recently to institutionalize the accumulation of financial data with respect to subdivisions of State governments. This is a worthwhile endeavor. For many years the Census of Governments has been engaged in efforts along these lines, but the practical limitations to undertaking such a project are indeed very formidable. There are perhaps somewhere between 50,000 and 100,000 separate governmental subdivisions to be covered by any reporting system, and the difficulties of obtaining reports on any timely basis would be enormous.

Viewed then in its entirety, it seems quite evident that ratings of the investment quality of securities in bank portfolios play a relatively minor part in bank supervision. To the extent that the investment advisory services publish material helpful to examiners in isolating securities which are weak or speculative, admittedly they can be helpful. As a matter of fact, virtually all of the published ratings fall within the scope of investment grade issues, and only a small portion of the total securities outstanding are identified by the rating services as lacking in investment quality. For securities not covered by the investment advisory services, bank examiners are obliged to follow the conventional methods of financial analysis in ascertaining the quality of the asset.

As far as we can determine, ratings of municipal securities by investment advisory services have not been a major factor limiting bank or other investment in these issues. Financing municipalities is beset with numerous more important and exceedingly complicated problems -- many of them legal or statutory in origin -- which deserve our concerted efforts at solution.

INVESTMENT SECURITIES HELD BY INSURED COMMERCIAL BANKS
(Amounts in Millions of dollars)

	June 30, 1934	June 30, 1936	June 30, 1941	June 29, 1946	June 30, 1951	June 30, 1956	June 30, 1961	June 30, 1965	June 30, 1966	June 30, 1967
Total Assets	$43,436	$53,578	$72,984	$150,743	$163,351	$204,252	$252,632	$352,795	$384,908	$411,917
Total Securities	16,498	22,184	26,279	90,642	69,919	72,127	83,053	98,306	101,533	110,220
Obligations of the U. S. Govt. - total	10,301	14,772	19,371	82,998	57,482	55,941	61,350	56,495	53,180	53,976
Direct	9,708	12,515	15,291	82,974	57,471	55,928	61,208	56,392)	1/	1/
Guaranteed obligations	593	2,257	4,080	24	11	13	142	103)		
Other securities - total	6,197	7,412	6,908	7,644	12,437	16,186	21,703	41,811	48,353	56,244
Obligations of States and subdivisions	2,280	2,778	3,551	3,975	8,344	12,731	18,490	36,351	40,427	46,679
Securities of Federal agencies and corporations (not guaranteed by the U.S.)	307	398	552	1/	1/	1,689	1,752	3,739	6,454	7,416
Bonds, notes and debentures of domestic corporations - total	2,595	3,297	2,160	3,354	3,763	1,273	869	819)		
Railroads	915	1,174	824					)		
Public utilities	903	1,177	572					)		
Real estate corp.	107	92	1/					)		
Other domestic corp.	670	854	764					)		
								)	1,472	2,149
Federal Reserve bank stock	146	131	140	183	231	316	426)	)		
							)	902)		
Other corporate stocks - total	535	510	327	132	99	119	166)	)		
Real estate corp.	79	1/	1/					)		
Bank and bank affiliates	100	1/	136					)		
Other domestic corp.	356	1/	191					)		
Foreign securities - total	334	298	178	1/	1/	58	1/	1/)		

1/ Not available separately.
SOURCE: FDIC published reports of assets, liabilities and capital accounts of insured banks.