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"SOME NEW VIEWPOINTS ON MUNICIPAL CREDIT"

One of the first questions which comes to mind in connection with the classification of securities in bank examinations is what do we mean by a Group 1 classification. Or perhaps the question can best be stated negatively, what does a Group 1 classification not imply? A group 1 security is a bond which can be expected to ride through a considerable amount of financial trouble without default. The financial position and income of the issuer are such that, in our opinion, interest and principal requirements can be met according to the terms of the contract, in spite of depression or other financial difficulties. Group 2 securities on the other hand are either in immediate danger of default or without an adequate margin of protection. Lack of good faith on the part of an issuer casts a shadow which makes a Group 2 classification necessary. We do <u>not</u> think Group 1 securities are riskless, but we <u>do</u> believe they have a margin of protection ample to carry them through all but the most serious financial storms. Group 2 securities will not necessarily default, but the margin of protection is inadequate.

We should make it clear to everyone that a Group 1 classification is definitely not a recommendation on our part. There is nothing quite so fallacious or dangerous as the sales argument used by some that a given bond is a safe investment and a good buy because bank examiners put it in Group 1, or because the F. D. I. C. has passed upon it for of course we never pass on anything. I have never heard anyone in the bank supervisory agencies even intimate that he considered all bonds classified in Group 1 ~~as~~ safe investments, and I am sure we all know of bonds now being placed in Group 1 which we would not think of recommending.

In view of the fact that we are spending three half days discussing evidences of weakness in municipal bonds, it seems wise at this point to reaffirm our belief that municipal obligations as a class are high grade investments. Their record over the past half century has been excellent. Defaults have been relatively few and recoveries in quite a number of instances have been excellent. Everything considered, it is doubtless fortunate that many banks have confined their purchases of bonds, other than U. S. Governments, to municipals because their record as a class is considerably better than the run of corporates acquired by banks.

Furthermore, it should be clearly understood that we have no particular apprehension at the moment about the future of municipals. Municipal debt has remained relatively stable in the last decade, and it is a pleasure to note that many local officials are giving thoughtful consideration to the important problems of finance.

Since the general situation is so good, some questions may be asked as to why we should be giving so much consideration to municipal bonds at this time. While the volume of defaults has been small compared with the volume outstanding, defaults have been common enough to make investors cautious. In certain classes of municipal bonds, such as irrigation, drainage and special assessments, the percentage of defaults has been extremely large, and in some cases the losses have been substantial. Consideration should also be given to the fact that municipal governments are being affected by the profound economic changes which are occurring throughout the whole world. Some situations are changing for the better, while the outlook for some cities is definitely less good than it was. In other words, it is important that a careful credit analysis be made before a municipal bond is purchased. When one thinks about the matter, it seems incredible that bankers otherwise regarded as prudent would risk substantial sums by purchasing large blocks of municipals about which they know nothing except that someone said they were good.

Moreover, the proper time to consider the credit quality of a class of assets is when conditions on the whole are satisfactory so that adjustments when desirable can be made without upsetting the entire market. Incidentally, an important by-product of our consideration of municipal bonds will doubtless be an improved market for the obligations of ~~some of~~ the less well-known but soundly financed municipalities.

The analysis of municipal credits is a subject which, until very recently, has attracted little attention. Excellent books have been written about corporation finance and analysis of corporate securities, but there is no published book on the analysis of municipal obligations. Until very recently the limited material on municipals obligations has dealt almost exclusively with the legal aspects of the problem. The reason for this seems to have been the general feeling that taxes could be increased if necessary, and that a municipal obligation was therefore safe if it were legal. Though this may have been true in the past it cannot be counted upon now. Local governments have assumed new and expensive responsibilities and taxes have been increased so much that there is reason to question the ability of local governments to continue this process indefinitely. Thus, while there is general agreement on the necessity for determining that an issue is legal, we think this should be only the beginning of the investigation.

Don't let my long memorandum and Mr. Wayne's six page form frighten you. Municipal credits are very similar to other credits and your experience with notes and discounts provides a useful background. Also, you are already familiar with some of the material requested in the form. I know, because I have been able to find much of the information needed on economic background in reports of examination. The analysis of a municipal obligation is not as formidable a task as the size of the form and memorandum would indicate.

The Uniform Credit File outlines the information we would like to have in analyzing municipal obligations, but we must recognize that it is often necessary to get along with much less. When the information is incomplete, the only thing we can do is to make the best classification possible, resolving all doubts against the municipality. There is no reason why bankers should not be required to support their municipal bonds with adequate credit files when the information is not otherwise readily available. It should be made clear to everyone that we will not place a bond in Group 1 on the basis of mere hearsay.

For purposes of classification, it is not necessary in most instances to prepare as complete an analysis as is necessary when a bond is being considered for purchase. It is doubtful if all the questions on this rather lengthy list which has been distributed are important in any particular case. Superficial investigation sometimes reveals weaknesses so clearly that a detailed analysis becomes unnecessary. It is only in borderline cases that it is imperative to study the situation thoroughly. The case of the investor, however, is different. It is not prudent to purchase municipal obligations without a rather definite idea concerning all of the important questions raised in these discussions.

Those of you who have followed the various revisions of my memorandum have doubtless noted a shift in point of view. Eighteen months ago I accepted the popular view that municipal obligations were a type of credit all to themselves and that it was necessary to develop new principles of analysis. As our work progressed and more material came over my desk, I slowly changed my mind, and today I believe the general concepts of credit analysis which you use every day in analyzing business credit should be applied, with appropriate adjustments, to the analysis of municipal credits.

The ability to pay is the all important consideration, both in corporate and municipal obligations. Any debt is high when debt service absorbs a large proportion of total income. Due notice must, of course, be taken of the possibility of increasing income if necessary. If taxes are low, the income of a unit can, in all probability, be increased by raising the tax rate, and if public utility rates are unusually low, there is the possibility of increasing them. The only significant difference is that taxes can be raised somewhat more easily than utility rates. In one of the loose chapters which have been distributed, you will find what is, as far as I know, the first attempt to adapt to the analysis of municipal credit the concept of coverage so universally used in analyzing corporate bonds. Will you please read this chapter critically and give me the benefit of your suggestions? I would appreciate it, if you will annotate your copy and return it to me.

One of the most misunderstood topics in finance is the proper type of maturity schedule. In the early days of corporation finance, the accepted principle was to have the entire bond issue mature two generations hence, or, if this were not possible, at least one generation away. A whole volume of literature grew up justifying perpetual debt on the grounds that constant maintenance would keep a property efficient indefinitely. No one seriously questioned the assumption that the public would always want the services provided by the property. Today the only refutation needed to that doctrine is to point to the traction companies and the railroads. The popular theory of level debt service is only a little better. The typical schedule calls for small maturities in the early years when interest costs are high and larger maturities in the later years as the principal has been reduced and interest costs become less. The only good thing to be said about this is that it is better to pay off a little on the principal than not to pay anything.

What is a reasonable maturity schedule? In my judgment, the only sound maturity schedule is one which combines cost of maintenance and debt service, so that the total declines as the property grows older. In the early years when the property is new, efficiency is highest, and repairs are light, bond maturities should be heavy, and as the need for maintenance increases debt service should decline. Since obsolescence makes old properties, even those in good repair, less desirable than new properties, the total of debt service and maintenance should decline. The rapidity with which this total should fall off depends, of course, upon the type of property, but I fail to see how one can question the general principle that debt service plus maintenance should decline as the properties grow older. The latest style in maturity schedules which provide for serial maturities over periods as long as sixty years with a balloon maturity at the end is absurd. How useful are most properties which were constructed in 1880? Is it not true that with very few exceptions such value as these properties possess is due to extensive repairs made rather recently?

The use of revenue bonds, or quasi-municipals as they are sometimes called, is increasing so rapidly that it seems wise to sketch some of the problems involved in their classification. This type of financing, when properly used, is sound. Some of the earlier projects were well set up and can be expected to pay out, but as so often happens in finance, when a type of security becomes popular, new projects are promoted which are not as sound as the earlier ones. Revenue bonds, you will remember, are not supported by the taxing power and must stand on the earnings of the project alone. There are many serious engineering problems involved in constructing a sound public utility plant and I have heard rumors that, in isolated instances at least, the plants were not designed by competent engineers. Also, the question as to whether the area can support the new utility is one which should be carefully considered before making commitments.

The prospectuses of the new enterprises usually carry an estimated income account for the next sixty years and almost invariably these estimates show a nice coverage. In many instances, such coverage is predicated upon high rates and low cost of operation. This shows a failure to use prudent business judgment. Even though a project has a monopoly in an area, there is reason to question its ability to collect, year after year, rates substantially above those charged in neighboring areas. I am afraid of utilities (public and private) whose financial success rests upon a high rate structure. Conservatism is also needed in forecasting costs of operation. Although it is true that capital costs are a large percentage of the total costs of a utility, regular operating expenses are considerable, and should not be underestimated. There is a temptation in particular, to under-estimate the costs of maintenance. In spite of the example of the irrigation projects of the last generation, which were wrecked because of the failure to provide for ample maintenance, many revenue projects today make a negligible allowance for this item. It is a good guess that all of these publicly owned projects will need a considerable amount of repairs before they are 25 years old and very few will escape at least one unforeseen contingency in that time.

The most foolish talk of all centers around the amount of coverage necessary to make a revenue bond safe. One banker gave a speech last Spring at a bond conference in which he stated that a coverage of one was sufficient for revenue bonds. What would you do with a note of a maker who was barely earning interest? To ask such a question is to answer it. The obligations of such a maker are not satisfactory investments. There is no good reason for demanding lower credit standards for publicly owned revenue projects than for comparable private utilities.

We now come to our most serious criticism of revenue financing. In the corporate field, lip service is being given to the propositions that corporate structures ought to be simple and that many corporations need more equity capital. At the very same time, an incredibly complicated system of Government finance is developing by the use of authorities and overlapping districts. Once these entities have been created, simplification can be accomplished only at great inconvenience and expense. It is just assumed nowadays that a local government should bond for the full cost of an improvement. In fact, it is current practice to arrange temporary financing so that any unexpected costs can be included in the bond issue.

Since a large percentage of the special revenue bonds are excellent investments, we cannot arbitrarily classify them all in Group 2, but I hope that we will be able in the near future to give serious study to this entire problem. In the meantime, wherever there is reason for doubt, revenue bonds should be classified in Group 2 on the basis of low coverage, or lack of an established earnings record. This leaves the question of what to do about the cases where estimates of earnings do not appear reasonable. Should we try to analyze on the basis of an adjusted schedule? I think not. It would consume a large amount of time and besides we do not have the information to work out a reasonable schedule. My suggested answer is Group 2 -- no established record of earnings.