398

FINANCING MUNICIPAL FACILITIES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON ECONOMIC PROGRESS

OF THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETIETH CONGRESS

SECOND SESSION

JULY 9, 10, AND 11, 1968

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FINANCING MUNICIPAL FACILITIES

TUESDAY, JULY 9, 1968

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMIC PROGRESS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on Economic Progress met, pursuant to call, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman of the subcommittee) presiding.

Present: Representatives Patman and Moorhead; and Senators Proxmire and Jordan.

Also present: John R. Stark, executive director, and Arnold H. Diamond, economic consultant.

Chairman PATMAN. The subcommittee will come to order.

These hearings are a followup to those held last December on the problems of financing our hard-pressed municipalities. In the first hearings, the subcommittee heard testimony on the present practice of bond rating and its effects on municipalities. It became obvious at that time that there is great dissatisfaction with the present bond rating practices and there is feeling that these are unfair to the smaller communities and that they may often add unnecessarily to the financing costs of municipalities. This point and others, are discussed more fully in the detailed opening statement I have made available to the press, and hereby submit for the record. (See p. 190.)

In the brief time available for those hearings, we did not have time to hear from the bond rating houses, but I indicated then that we would do so later. Now, in this first day of the current hearings, we are going to have a look at the existing bond rating system and we have asked some of the leading bond rating officials to explain it to us. I would like to say at this point that I intend to raise questions in these hearings about my bill, H.R. 15991, which was introduced on March 14 of this year. It is similar to S. 3170 introduced by Senator Proxmire. I am chairman of this subcommittee; Senator Proxmire is chairman of the full committee.

(The bill introduced by Chairman Patman, R.H. 15991, follows. A similar bill was introduced in the Senate by Senator Proxmire, as S. 3170, on the same date.)

90TH CONGRESS
2D SESSION

H. R. 15991

IN THE HOUSE OF REPRESENTATIVES

MARCH 14, 1968

Mr. PATMAN introduced the following bill; which was referred to the Committee on Banking and Currency

A BILL

To establish a Government corporation to assist in the expansion of the capital market for municipal securities while decreasing the cost of such capital to municipalities.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That this Act may be cited as the "Municipal Capital Market
4 Expansion Act of 1968".

5 FINDINGS AND DECLARATION OF PURPOSE

6 SEC. 2. (a) The Congress finds that the municipal
7 security market, as now constituted, is forcing the Nation's
8 municipalities and States to pay such a high rate of interest
9 on their securities that they cannot afford to finance many
10 needed public facilities. This high rate of interest is directly

I

1 attributable to (1) the limited supply of private capital
2 available in the present municipal securities market, (2)
3 the institutional rigidities within such market, and (3) the
4 failings of the existent municipal securities rating system
5 which discriminates against most of the Nation's smaller
6 communities and many of the larger cities and which fails
7 to reflect the infinitesimally low rate of actual security de-
8 faults since World War II.
9 (b) It is the purpose of this Act to expand the municipal
10 capital market and thereby enable State and local public
11 bodies to borrow private capital funds at net interest costs
12 lower than are now obtainable through the issuance of secu-
13 rities and to provide Federal financial assistance to achieve
14 such lower net interest costs at a net gain to the United States
15 Treasury.
16 DEFINITIONS
17 SEC. 3. As used in this Act—
18 (1) The term "Corporation" means the "Municipal
19 Bond Guarantee Corporation".
20 (2) The term "State" means the several States, the Dis-
21 trict of Columbia, the Commonwealth of Puerto Rico, and the
22 territories and possessions of the United States.
23 (3) The term "State or local public body" means any
24 public corporate body or political subdivision; any public
25 agency or instrumentality of one or more States, municipali-

1 ties, or political subdivisions of one or more States (including
2 any public agency or instrumentality of one or more munici-
3 palities or other political subdivisions of one or more States);
4 any Indian tribe; and any board or commission established
5 under the laws of any State to finance specific capital im-
6 provement projects.
7 (4) The term "needed public facilities" means any pub-
8 lic work, public facility, or equipment relating thereto deemed
9 necessary by a State or local public body; but does not include
10 any industrial or commercial facility for private use, by
11 lease, conditional or installment sales contract, or other means
12 of transfer, where such facility is or will be used primarily
13 for the mining, manufacturing, assembling, fabricating, stor-
14 ing, processing, or sale of articles or commodities.

15 TITLE I—MUNICIPAL BOND GUARANTEE
16 CORPORATION

17 ESTABLISH OF CORPORATION

18 SEC. 101. There is hereby established a body corporate
19 to be known as the "Municipal Bond Guarantee Corpora-
20 tion". The Corporation shall have its principal offices in the
21 District of Columbia and shall be deemed, for purposes of
22 venue in civil actions, to be a resident of the district of
23 Columbia. The Corporation may establish offices in such
24 other places as it deems necessary or appropriate in the
25 conduct of its business.

1 BOARD OF DIRECTORS

2 SEC. 102. (a) (1) The Corporation shall have a Board
3 of Directors (hereinafter referred to as the "Board") con-
4 sisting of —— members to be appointed by the President,
5 not more than —— of whom shall be regular full-time officers
6 or employees of the Federal Government. The Board shall
7 be responsible for overall policymaking and general supervi-
8 sion of the Corporation.
9 (2) The President shall designate a Chairman and a
10 Vice Chairman of the Board.
11 (3) Each member of the Board shall serve for a term
12 of four years or until his successor has been appointed;
13 except that any member appointed to fill a vacancy
14 occurring prior to the expiration of the term for which his
15 predecessor was appointed shall be appointed for the re-
16 mainder of such term.
17 (4) The Board shall meet at the call of the Chairman
18 which shall be not less often than four times a year.
19 (b) Members of the Board, other than members who
20 are regular full-time officers or employees of the Govern-
21 ment, shall receive for their services, as members, the per
22 diem equivalent to the rate for GS-18 when engaged in the
23 performance of their duties, and each member of the Board
24 shall be allowed travel expenses, including per diem in lieu
25 of subsistence, as authorized by section 5703 of title 5,

1 United States Code, for persons in the Government service
2 employed intermittently.

3 EXECUTIVE DIRECTOR

4 SEC. 103. (a) Subject to the general supervision and
5 overall policymaking of the Board, the management of the
6 Corporation shall be vested in an Executive Director who
7 shall be appointed by the President, by and with the advice
8 and consent of the Senate.

9 (b) Section 5315 of title 5, United States Code, is
10 amended by inserting at the end thereof a new paragraph
11 as follows:

12 "(90) Executive Director, Municipal Bond Guarantee
13 Corporation."

14 GENERAL POWERS OF CORPORATION

15 SEC. 104. (a) For the purpose of carrying out its
16 functions under this Act, the Corporation shall have power—

17 (1) to have a corporate seal which may be altered
18 at pleasure and to use the same by causing it, or a
19 facsimile thereof, to be impressed or affixed or in any
20 other manner reproduced;

21 (2) to sue and be sued;

22 (3) to enter into and perform contracts, leases,
23 cooperative agreements, or other transactions, on such
24 terms as the Corporation may deem appropriate, and
25 consent to modification thereof, without regard to sec-

1 tions 3648 and 3709 of the Revised Statutes, as amended
2 (31 U.S.C. 529 and 41 U.S.C. 5), and section 322 of
3 the Act of June 30, 1932, as amended (40 U.S.C.
4 278a);
5 (4) to appoint and fix the compensation of such
6 personnel as may be necessary for the conduct of its
7 business in accordance with the provisions of title 5,
8 United States Code, governing appointment in the com-
9 petitive service, and chapter 51 and subchapter III of
10 chapter 53 of such title relating to classification and Gen-
11 eral Schedule pay rates, and to obtain the services of ex-
12 perts and consultants in accordance with section 3109 of
13 title 5, United States Code, at rates for individuals not
14 to exceed the per diem equivalent for GS-18;
15 (5) except as may be otherwise provided in this
16 title, in the Government Corporation Control Act, or
17 in any other laws specifically applicable to Government
18 corporations, to determine the necessity for and the
19 character and amount of its obligations and expenditures
20 and the manner in which they shall be incurred, allowed,
21 paid, and accounted for;
22 (6) to issue such rules and regulations as may be

1 deemed necessary or appropriate to carry out the pur-
2 poses of this Act; and
3 (7) to exercise all powers specifically granted by
4 the provisions of this Act and such incidental powers
5 as are necessary to carry out the purposes of this Act.
6 (b) All suits of a civil nature at common law or in
7 equity to which the Corporation shall be a party shall be
8 deemed to arise under the laws of the United States, except
9 that no attachment, injunction, garnishment, or other simi-
10 lar process, mesne or final, shall be issued against the Cor-
11 poration or its property.
12 SERVICES AND FACILITIES OF OTHER AGENCIES—UTILIZA-
13 TION OF PERSONNEL, SERVICES, FACILITIES, AND IN-
14 FORMATION
15 SEC. 105. The Corporation may, with the consent of the
16 agency concerned, accept and utilize on a reimbursable basis,
17 the officers, employees, services, facilities, and information
18 of any agency of the Federal Government, except that any
19 such agency having custody of any data relating to any of
20 the matters within the jurisdiction of the Corporation shall,
21 to the extent permitted by law, upon request of the Corpora-

1 tion, make such data available to the Corporation without
2 reimbursement.

3 FINALITY OF CERTAIN FINANCIAL TRANACTIONS

4 SEC. 106. Notwithstanding the provisions of any other
5 law, any financial transaction authorized under this Act shall
6 be final and conclusive upon all officers of the United States.

7 TAXATION

8 SEC. 107. The Corporation, including its reserves, sur-
9 plus, and income shall be exempt from all taxation now or
10 hereafter imposed by the United States, or by any State, or
11 any subdivision thereof, except any real property acquired
12 by the Corporation shall be subject to taxation by any State
13 or political subdivision thereof, to the same extent, accord-
14 ing to its value as other real property is taxed.

15 GOVERNMENT CORPORATION CONTROL ACT

16 SEC. 108. Section 101 of the Government Corporation
17 Control Act is amended by inserting after "Federal Housing
18 Administration," the following: "Municipal Bond Guaran-
19 tee Corporation,".

20 ANNUAL REPORT

21 SEC. 109. The Corporation shall submit to the Presi-
22 dent, for transmission to the Congress, a comprehensive an-
23 nual report of its activities under this Act.

1 APPROPRIATIONS

2 SEC. 110. Except as otherwise specifically provided for
3 in this Act, there are authorized to be appropriated such
4 sums as may be necessary to enable the Corporation to carry
5 out its functions under this Act.

6 TITLE II—FUNCTIONS OF THE CORPORATION

7 COMPREHENSIVE ECONOMIC AND FISCAL REPORTS

8 SEC. 201. (a) Upon the request of any State or local
9 public body which intends to issue bonds or other securities
10 to finance needed public facilities, or by any bond under-
11 writing firm or bank planning to submit a bid for such bonds
12 or other securities, or by any Federal agency that has re-
13 ceived an application from a State or local public body for
14 assistance in financing a public facility under a Government
15 direct loan or loan guaranty program, the Corporation is
16 authorized to provide a comprehensive report detailing the
17 public body's economic and fiscal resources. Such report shall
18 include, but not be limited to—

19 (1) a review of the economic circumstances of the
20 area served by such body, such as demographic factors,
21 business activity, construction patterns, income, employ-
22 ment, and public facilities infrastructure;

1 (2) an examination of such body's fiscal position in-
2 cluding trends of revenues, expenditures, tax levies and
3 collections, property valuations, Federal and State aids,
4 direct and overlapping indebtedness;
5 (3) if revenue-producing facilities are involved, an
6 analysis of the relevant financial statements, rate sched-
7 ules and users, and other financial development; and
8 (4) appropriate economic, fiscal, and financial
9 ratios, averages, and indices and comparisons of such
10 measures with national and regional averages.
11 Such report shall exclude qualitative judgments or compa-
12 rable comments that in any way involve an evaluation of
13 the investment merits of a prospective bond issue or reflect
14 a credit evaluation of the State or local public body con-
15 cerned.
16 (b) The Corporation is authorized to charge and collect
17 a fee for reports provided under this section to cover admin-
18 istrative and other necessary expenses. Such fee shall not
19 exceed, in the case of any such report, one-tenth of 1 per
20 centum of the amount of the bonds or other securities to be
21 issued or loans to be made, but in no event shall the fee for
22 any such report be less than $100 or more than $5,000.
23 (c) All fees received in connection with reports pro-
24 vided under this section, all funds in the form of gifts, be-

1 quests, or demonstration grants received from private foun-
2 dations or associations, Federal agencies, or other public
3 bodies seeking to improve the quality and availability of
4 information relating to the economic and fiscal circumstances
5 of State and local public bodies, and all other receipts of the
6 Corporation in connection with the performance of its func-
7 tions under this section, shall be deposited in a revolving
8 fund to be established by the Corporation which shall be
9 known as the Municipal Economic and Fiscal Reports
10 Fund. All administrative and other expenses incurred by
11 the Corporation in connection with the performance of its
12 functions under this section shall be paid from such fund.
13 (d) Notwithstanding any other provision of law, no
14 application by a State or local public body for a loan under
15 title II of the Housing Amendments of 1955, section 201
16 of the Public Works and Economic Development Act of
17 1965, section 306 of the Consolidated Farmers' Home Ad-
18 ministration Act of 1961, or the Small Reclamation Projects
19 Act of 1956 shall be approved unless there has been re-
20 ceived by the administering Federal agency a comprehensive
21 economic and fiscal report prepared under this section. Any
22 fee paid in connection with any such report, as prescribed
23 in subsection (b), may be included in the amount covered
24 by the Federal loan or loan guarantee.

12

1 DEBT SERVICE GUARANTEE CONTRACTS

2 SEC. 202. (a) Upon the application of any State or
3 local public body, the Corporation is authorized to enter
4 into a debt service guarantee contract to guarantee the pay-
5 ment of principal and interest on bonds or other securities to
6 be issued by such body to finance one or more needed public
7 facilities. Any such contract shall obligate the Corporation,
8 during any period in which the bonds or other securities are
9 outstanding, to pay to a trustee under an indenture securing
10 such bonds or other securities (or to a paying agent where
11 no trustee is provided for), such amounts as may be needed,
12 when added to the moneys available from the taxes, revenues,
13 or other funds pledged by such body as security for such
14 bonds or other securities (including all reserve funds there-
15 for), to make payments of principal and interest when due.
16 (b) No guarantee contract shall be entered into under
17 this section unless—
18 (1) a comprehensive economic and fiscal report has
19 been prepared by the Corporation, pursuant to section
20 201, with respect to the State or local public body
21 applying for the guarantee;
22 (2) the interest income from the bonds or other
23 securities with respect to which the guarantee is entered
24 into is subject to Federal taxation, and such bonds or

1 other securities are to be issued and sold to persons or
2 entities other than the United States or any agency
3 thereof; and
4 (3) the Corporation determines that (A) such
5 bonds or other securities contain satisfactory amortiza-
6 tion provisions not in excess of the debt-paying capacity
7 of the borrower, and (B) the public facility project to be
8 financed is economically sound.
9 In making the determinations under clause (3), the Cor-
10 poration shall rely, to the fullest extent possible, upon the
11 data contained in the comprehensive economic and fiscal re-
12 port referred to in clause (1), and upon the borrower's debt
13 repayment record during the twenty-five-year period pre-
14 ceding the date of application for a guarantee under this
15 section.
16 (c) The Corporation is authorized to charge and col-
17 lect an annual fee, as consideration for a guarantee of bonds
18 or other securities under this section, to cover necessary ad-
19 ministrative expenses and to provide a reserve for losses.
20 Such fee shall not exceed two-tenths of 1 per centum per
21 annum of the aggregate amount of bonds or other securities
22 covered by the guarantee contract which are outstanding at
23 the beginning of each year.

1 MUNICIPAL DEBT SERVICE GUARANTEE FUND

2 SEC. 203. (a) There is hereby established in the Treas-
3 ury a revolving fund to be known as the "Municipal Debt
4 Service Guarantee Fund" (hereinafter referred to as the
5 "fund") which shall be used by the Corporation in carry-
6 ing out section 202. Initial capital for the fund shall be ob-
7 tained through the issuance by the Corporation of debenture
8 notes, and notes so issued shall be subscribed to as follows:
9 (1) The Federal Deposit Insurance Corporation
10 shall subscribe to such notes in a principal amount of
11 $1,000,000.
12 (2) The Federal Savings and Loan Insurance Cor-
13 poration shall subscribe to such notes in a principal
14 amount of $100,000.
15 (3) Each Federal Reserve bank shall subscribe to
16 such notes in a principal amount equal to two-tenths
17 of 1 per centum of the surplus of such bank on Janu-
18 ary 1, 1968.
19 Subscriptions shall be accompanied by a certified check pay-
20 able to the fund in an amount equal to one-half of the sub-
21 scription. The remainder of such subscription shall be subject
22 to call from time to time by the Corporation upon ninety
23 days' notice. Notes so issued shall bear interest at a rate to
24 be determined in accordance with subsection (c), and shall
25 be repayable in annual installments, commencing not earlier

1 than ten years from the date of receipt of the subscription
2 price.
3 (b) All fees received in connection with guarantees
4 issued under section 202, all receipts from the issuance of
5 debenture notes, all funds borrowed from the Secretary of
6 the Treasury pursuant to subsection (c), all earnings on the
7 assets of the fund, and all other receipts of the Corporation
8 in connection with the performance of its functions under
9 section 202 shall be deposited in the fund. All payments to
10 trustees (or paying agents) under section 202(a), repay-
11 ments of debenture notes issued pursuant to subsection (a),
12 repayments to the Secretary of the Treasury of sums bor-
13 rowed pursuant to subsection (c), and all administrative
14 expenses and other expenses of the Corporation in connec-
15 tion with the performance of its functions under section 202
16 shall be paid from the fund.
17 (c) (1) The Corporation is authorized to issue to the
18 Secretary of the Treasury from time to time notes or other
19 obligations for purchase by the Secretary in amounts suffi-
20 cient, together with moneys in the fund, to make payments
21 of principal and interest on all bonds or other securities
22 guaranteed under section 202 in accordance with a debt
23 service guarantee contract. Such obligations shall be in such
24 forms and denominations, have such maturities, and be sub-
25 ject to such terms and conditions as may be prescribed by

1 the Secretary, with the approval of the Secretary of the
2 Treasury. Such notes or other obligations shall bear interest
3 at a rate determined by the Secretary of the Treasury reflect-
4 ing the average annual interest rate on all interest-bearing
5 obligations of the United States then forming a part of the
6 public debt as computed at the end of the fiscal year next
7 preceding the issuance by the Secretary and adjusted to the
8 nearest one-eighth of 1 per centum.
9 (2) The Secretary of the Treasury is authorized and
10 directed to purchase any notes or other obligations of the
11 Corporation issued under this subsection, and for such pur-
12 pose the Secretary of the Treasury is authorized to use as a
13 public debt transaction the proceeds from the sale of any
14 securities issued under the Second Liberty Bond Act; and the
15 purposes for which securities may be issued under such Act
16 are extended to include the purchase of any such notes or
17 other obligations. The Secretary of the Treasury may at any
18 time sell any of the notes or other obligations acquired by
19 him under this section. All redemptions, purchases, and
20 sales by the Secretary of the Treasury of such notes or other
21 obligations shall be treated as public debt transactions of the
22 United States.
23 INTEREST REDUCTION GRANTS
24 SEC. 204. (a) In order to achieve a decrease in the
25 interest cost burdens arising in the financing of needed pub-

17

1 lic facilities, the Corporation is authorized to enter into
2 contracts to make interest reduction grants to any State or
3 local public body in connection with bonds or other securities
4 issued by such body to finance needed public facilities; except
5 that no grant shall be made hereunder in the case of any
6 bonds or other securities the interest income from which is
7 exempt in whole or in part from Federal taxation.

8 (b) The amount of any grant made under this section
9 shall not exceed the sum of (1) the guarantee fee prescribed
10 in section 202(c), and (2) 33⅓ per centum of the annual
11 interest charge payable each year by the State or local
12 public body on the bonds or other securities with respect to
13 which such grant is made. Any such grant shall be payable
14 for each of the years in which any of the bonds or other
15 securities covered by the contract are outstanding.

16 (c) No grant shall be made under this section unless
17 (1) the State or local public body has entered into a debt
18 service guarantee contract pursuant to section 202, and (2)
19 the Corporation finds that the interest charges on the bonds
20 or other securities are reasonable, after taking into account
21 the taxable status of the bonds or other securities, the avail-
22 ability of a Government guarantee, and the general level of
23 interest rates then prevailing.

24 (d) The Corporation may make advance or progress

18

1 payments on account of any contract entered into pursuant
2 to this section, notwithstanding the provisions of section
3 3648 of the Revised Statutes.
4 (e) There are authorized to be appropriated such sums
5 as may be necessary to carry out the provisions of this sec-
6 tion. Any sums so appropriated shall remain available until
7 expended.

8 INVESTMENT OF FUNDS

9 SEC. 205. Moneys in the Municipal Economic and Fiscal
10 Reports Fund and in the Municipal Debt Service Guarantee
11 Fund may be invested in obligations of the United States or
12 in obligations guaranteed as to principal and interest by the
13 United States, or in obligations eligible for investment of pub-
14 lic funds. Such obligations may be sold and the proceeds
15 derived therefrom may be reinvested in other obligations
16 of the type herein prescribed. Income from such investment
17 or reinvestment shall be deposited in the respective funds.

18 CONFORMING AMENDMENTS

19 SEC. 206. (a) Section 202(b)(1) of the Housing
20 Amendments of 1955 is amended by striking the comma
21 after "reasonable terms" and inserting in lieu thereof "with
22 due allowance for the debt service guarantees authorized by
23 the Municipal Capital Market Expansion Act of 1968,".
24 (b) Section 201(a)(2) of the Public Works and Eco-

1 nomic Development Act of 1965 is amended by inserting
2 after "on terms" the following: ", with due allowance for
3 the debt service guarantees authorized by the Municipal
4 Capital Market Expansion Act of 1968,".

Chairman PATMAN. Both of these bills would provide Government guarantees for municipal bonds, as well as grants for one-third of the interest costs. They would also provide for Federal information on municipal securities in order to make easier a fair and adequate evaluation of municipal securities.

The news release announcing these hearings and the schedule of witnesses who will appear will be made part of the record at this point.

(Release and schedule referred to follow:)

[For immediate release, Friday, June 7, 1968]

CONGRESS OF THE UNITED STATES, JOINT ECONOMIC COMMITTEE, SUBCOMMITTEE ON ECONOMIC PROGRESS

Representative Wright Patman (D-Texas), Vice Chairman of the Joint Economic Committee, and Chairman of its Subcommittee on Economic Progress, today announced new dates for the Subcommittee's hearings on Municipal Finance. Originally scheduled for May, they had to be postponed until July because of the pressures of House business. The Texas Democrat named July 9, 10, and 11 as the new hearing dates.

The hearings are a sequence to those held last December on general municipal finance problems. In the December hearings, the Subcommittee heard testimony on the consequences bond ratings have on the ability of municipalities to finance planned facilities. The upcoming hearings will focus on three areas:

1. Methods used in determining bond ratings;
2. The role of Federal supervisory agencies; and
3. Means of improving the current rating system.

Witnesses appearing before the Subcommittee will represent bond rating and underwriting institutions and relevant government agencies.

Mr. Patman said that there is great dissatisfaction with the present system of bond rating, and, in some instances, excessive costs to municipalities by reason of bond rating practices. He said there was great demand that the underwriters and bond rating agencies be heard from, and that these hearings would afford such an opportunity.

The Texas Democrat also said that he would raise questions about his bill, H.R. 15991, introduced on March 14, 1968, and the similar bill, S. 3170, of Senator William Proxmire (D-Wis.), Chairman of the Joint Economic Committee. These bills would provide government guarantees for municipal bonds, as well as grants for one-third of the interest costs. The bills would also provide for Federal information on municipal securities in order to facilitate a fair and equitable evaluation of municipal securities.

The schedule of witnesses is attached.

HEARINGS ON MUNICIPAL BOND RATINGS, JULY 9, 10, AND 11, 1968, ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

TUESDAY, JULY 9—10 A.M.

The Existing Bond Rating System

Robert C. Riehle, Vice President, Moody's Investor Service.
Brenton W. Harries, Vice President, Standard & Poor's.
Wade S. Smith, Director of Municipal Research, Dun & Bradstreet.
Walter W. Craigie, Sr., Vice President, Craigie & Co., Inc.

WEDNESDAY, JULY 10—10 A.M.

Investor Reliance Upon Bond Ratings

Kenneth A. Randall, Chairman, Federal Deposit Insurance Corporation.
William B. Camp, Comptroller of the Currency.
William McChesney Martin, Chairman, Board of Governors of the Federal Reserve System.

THURSDAY, JULY 11—10 A.M.

How To Improve Bond Rating System

Walter H. Tyler, President, Walter Tyler & Co.
James F. Reilly, Partner in Charge of Bond Division, Goodbody & Co.
Bert A. Betts, Bert A. Betts & Associates.

OPENING STATEMENT OF REPRESENTATIVE WRIGHT PATMAN, CHAIRMAN OF THE JOINT ECONOMIC COMMITTEE, SUBCOMMITTEE ON ECONOMIC PROGRESS

Chairman PATMAN. As may be recalled, the Subcommittee on Economic Progress of the Joint Economic Committee issued in January 1967 a comprehensive two-volume study on *State and Local Public Facility Needs and Financing*. The first volume estimated capital requirements over the next decade for essential public facilities. The second volume analyzed the capacity of the municipal securities market to meet these anticipated capital requirements.

The subcommittee's study was addressed to three basic questions:

First, is there likely to be an adequate supply of investment funds in the municipal securities market, or, to put it more succinctly, who will buy the expanding volume of tax-exempt municipal bonds?

Second, is a tax-exempt security best suited to obtain the requisite funds needed to meet projected future capital requirements?

Third, can the existing marketing machinery expand sufficiently to accommodate an increasing volume of securities?

With respect to the third question, our hearings today and in the next 2 days are concerned with municipal bond ratings, that is, the ratings assigned by the private investment advisory services to securities issued by State and local public bodies. These hearings are a continuation of the hearings held by this subcommittee last December when we explored the difficulties experienced by small municipalities in marketing their bonds and the consequences of bond ratings.[1]

At the December hearings we heard from those who are directly affected by bond ratings—the mayors and other municipal officials. They testified that many small communities do not receive any rating at all on their bond issues because the sizes of their issues are less than the $600,000 and $1 million minimum observed by the rating services. One witness reported that in the State of Ohio less than one-third of the taxing public bodies had ratings assigned to their bond issues. The fact that its bonds are unrated may cost a small municipality as much as 1 percent in annual interest rates on its borrowing.

Witnesses representing several large cities, whose bond ratings had been lowered in recent years, testified that their cities are now required to sell new bond issues at interest rates higher by one-eighth to one-half of 1 percent per year over what they might have paid, if they continued to have their earlier rating. These consequences of the bond rating system—which penalizes the smaller community that lacks accessibility to the New York bond market and which punishes the larger city that goes heavily into debt in order to provide adequate public services for its citizens while supporting its poor residents—are clearly cause for concern.

The higher interest costs for municipal borrowing brought about by the bond rating system reduces the amount of funds that cities can spend for police protection, education and other essential public services. In this sense, the urban crisis now pervading many of our larger cities can in part be attributed to the consequences of the bond rating system.

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[1] "Financing Municipal Facilities," vol. I, hearings before the Subcommittee on Economic Progress, Joint Economic Committee, Dec. 5, 6, and 7, 1967.

Because we were very much disturbed by the revelations brought out in the December hearings, Senator Proxmire, chairman of the Joint Economic Committee, and I introduced legislation designed to improve the private bond rating system. We recognized that the compilation and assemblage of economic and fiscal data for particular municipalities by Moody, Standard & Poor's, and Dun & Bradstreet involved duplication and even triplication of effort. Such triplication of effort means that less resources are available for more comprehensive analyses of the large cities or for any analysis at all for the smaller communities.

To relieve this duplication on the one hand, and the apparent scantiness of data on a number of communities, we have proposed that the fact-gathering function be separated from the credit-evaluation function. As reflected by section 201 of our respective bills, S. 3170 and H.R. 15991, we have proposed that the fact-gathering function should be performed by a public agency, financed by fees paid by the local governments issuing bonds. It is our view that adequate presentation of all relevant facts pertaining to a bond issue is the responsibility of a borrower; and the costs of the requisite fact gathering should be regarded as one of the costs incident to a successful marketing of a bond issue.

On the other hand, bond ratings and credit evaluations should continue to be made by private companies as a service to their subscribers or clients who should be expected to pay for such investment advice. Neither Senator Proxmire nor I ever intended that the Federal Government should rate municipal bonds. Instead, our respective bills state explicitly that the comprehensive economic and fiscal reports "shall exclude qualitative judgments or comparable comments that in anyway involve an evaluation of the investment merits of a prospective bond issue or reflect a credit evaluation of the State or local public body concerned."

Our witnesses today are Brenton W. Harries, vice president, Bond & Data Services Division, Standard & Poor's Corp.; Robert S. Riehle, vice president, Moody's Investors Services, Inc., Wade S. Smith, vice president, Municipal Services Division, Dun & Bradstreet, and Walter W. Craigie, president, F. W. Craigie & Co., Inc.

Mr. Harries, will you proceed in your own way? We ask that you limit your oral statement to 10 or 15 minutes, with the understanding that you may file a longer statement for the record, as you decide when you get your transcript to look it over and approve it.

Mr. Harries?

STATEMENT OF BRENTON W. HARRIES, VICE PRESIDENT, BOND AND DATA SERVICES DIVISION, STANDARD & POOR'S CORP.

Mr. Harries. Chairman Patman and distinguished members and staff of the subcommittee, we deeply appreciate the opportunity to appear before this committee and assure you of our complete cooperation in these hearings.

In accordance with your request, I have submitted a prepared statement containing my answers to the questions that were posed to us, along with comments on certain specific previous testimony received by this committee, as well as an explanation of our new policy on municipal bond contract rating.

In the brief period allotted to me this morning for oral presentation, I would like to tell you something of the steps which we use to rate bonds, and also steps that we have taken to continue to provide municipal ratings. I also wish to tell you something of the research effort which we are expending in this area.

In addition, if time permits, I would like to comment on three items of specific testimony which you received back in December and which we feel should be better clarified——

Chairman PATMAN. You are certainly encouraged to do so, and you may extend your remarks as you desire.

Mr. HARRIES. Thank you, Mr. Chairman.

The committee has requested comment about the methods we use in determining bond ratings. I have covered this in my prepared statement but would like to try to give you a brief synopsis of the rudiments of rating. Basic analysis begins by covering every pertinent financial statistic, which means not only current statements but a history of the immediate prior years. This task can be difficult because of the varying inadequacies or absence of published fiscal statistics.

Certain key ratios are then determined, such as the percent of net debt to assessed valuation, and these ratios are then compared with other units.

Included in this initial examination are tax levies and collections, direct and overlapping debt, governmental aid, debt service requirements for existing debt and proposed debt, property valuations, statutory debt requirements, per capita income, per capita debt, debt repayment record and a multitude of other financial statistics.

After this initial financial investigation comes a review of the economic base and kindred socioeconomic factors. These include population, industry—both amount and composition—sources of income for the citizens, property use and tax base, welfare costs and particularly the trend of such costs and which unit of government bears these costs, school population trends and future needs, the local government, its form and demonstrated management abilities. Throughout, the analysis is comparative, with an eye toward detecting abnormalities which may influence this community's ability to repay its debt.

Lastly come some of the most difficult parts of the analysis. What can be expected to happen in the future? Has there been planning to provide the means to sustain the growth that may be expected? Is there a chance the projected growth will not take place? Has provision been made for economic setback and will there be adequate safety if recession strikes the area?

These are some of the items in the basic analysis I have time to mention in these brief remarks.

A practical case may illustrate the basic point I wish to make, which is that every factor that can influence the ability to repay the debt must be taken into account, weighed, and related to other credits to which we assign ratings.

There is a city of 90,000 in Texas, outside of Dallas, called Irving. Looking just at current debt ratios, the debt of Irving would warrant a low rating. They are incurring large amounts of debt at a very high rate. However, we must look beyond simply the numbers and try to determine more precisely what is happening in Irving, why they are doing this, in order to measure its ability to sustain the debt.

Irving is a bustling community. It is a growing suburb of Dallas. The new Texas stadium will be built in Irving. The city has annexed 5,600 acres adjacent to the Dallas-Fort Worth Airport for industrial development. Gross statistics for housing, income, and education are all above average. The city recently passed a 1-percent sales tax. They can effectively alter their property tax rate limit by changing the basis of tax assessment. Perhaps most important is the planning we see in the steps which Irving has taken to provide for the needs of its citizens. They have recently shown us a plan for the use of capital funds for the next 5 years to provide schools, streets, sewers, and water facilities. Evidence of such planning had not been previously made available. Although the historical analysis alone by the old traditional methods could lead to a downgrading of its credit rating, quite to the contrary it was our opinion that Irving was planning and providing properly for the needs of its people and on the basis of these decisions, we actually raised the rating on the city from BBB to A.

The point to be emphasized is that the rating determinations must take into account the comparative degree of possibility of debt repayment. In Irving, we believe the risk of default has been diminished, due to improving economic and managerial factors despite the volume of debt being issued.

I would now like to discuss changes which have taken place in Standard & Poor's rating policy during this year.

Since 1949, Standard & Poor's has voluntarily rated municipal debt in excess of $1 million. We also rated debt of any amount less than $1 million, but only upon payment of a fee to reimburse us for the analytical time required because the lesser debt issues were not of sufficient interest to the subscribers to our publications.

I wish to emphasize that any municipality, regardless of the amount of debt outstanding, could receive a Standard & Poor's rating, if not voluntarily by Standard & Poor's, then upon request and payment of a modest fee.

Last year alone, incidentally, we issued almost 160 of these contract ratings.

However, with the tremendous expansion of municipal issues, the task of providing voluntary ratings became too great a burden for us to handle without finding some method to be paid for our work. The revenue from the published services simply was insufficient to continue to support the rating effort.

Consequently, on March 1 of this year, we ceased the voluntary rating of issues and expanded the contract fee based rating system to encompass all our ratings. Now, we do not rate any issue unless a fee is paid to reimburse us for the analytical work and expense involved.

This new policy, has received an excellent response. Since March 1, over one-half of the new issues representing approximately 85 percent of the par value of bonds sold has received a Standard & Poor's rating and paid for it. The income generated has provided the means to raise salary levels to those which are both competitive and attractive. We have greatly increased our staff and employed resident field men who operate in Pennsylvania, and recently, just this past week, we have a man who will work out of Houston and cover Texas. We are aggressively seeking further additions to the department.

Furthermore, we are in the midst of a computer-based research study to analyze and formulate new ways to use Standard & Poor's

computer capability in the determination of municipal ratings. We have employed Dr. Roy Bahl of the Maxwell School and the Metropolitan Studies Center of Syracuse University. Dr. Bahl and a group of associates are in the process of reassessing and critiguing the methods presently used by Standard & Poor's in rating municipal bonds, and investigating and evaluating procedures for the utilization of computer technique in municipal bond analysis and credit rating. As part of this self-evaluating and streamlining program, next August 12, a seminar will be conducted at our offices in New York with some of the foremost members of the academic world who have spent years in the analysis of municipal data. There will also be Dr. John Shannon from the Advisory Commission on Intergovernmental Relations here in Washington. The seminar will be to critique and review the proposals forthcoming from this research to enable us to commence the program and data compilation.

For example, we hope to systematize the quantitative aspects of municipal bond analysis by creating a fiscal and economic computerized data bank. This standard format of data will enable each analyst to consider the same broad spectrum of fiscal and economic data in his preliminary analysis of the quality of a particular issuer's credit. Further, the continuous updating of this data bank will enable more efficient and conclusive periodic reviews of municipal bond ratings.

In the near future we would like the permission of the committee to render a supplementary report to you which will contain specific recommendations as to how certain governmental agencies may process data available to them in order to more readily accommodate the requirements for municipal data reporting.

Chairman PATMAN. We will welcome that.

Mr. HARRIES. I repeat for emphasis that our policy of fee rating is making possible this study and innovations in this area of Standard & Poor's business.

If I may take a moment, I would like to clarify three specific items of testimony which were received and for which we would like to help the committee have a clearer understanding.

Testimony was received which indicated that only 30 minutes per issue could be spent by the rating agencies in analyzing any particular rating due to time and personnel limitations. Actually, our policy is to review each rating prior to a sale and at least once a year. I submit that it is not necessary to make an in-depth analysis of every rating every 90 days. The changes that affect ratings, that is, changes in the community's economic base, its very life, when no debt is being issued are normally evolutionary ones. They did not just happen as with a riot; they do not just occur, such as a fire. They are slow to evolve.

Because of familiarity, often it is only necessary to review the current and prior annual reports of the community to detect any unusual trends. This continuing review takes notice of the reduced amount of debt outstanding as bonds mature or are called, as well as new statistical information. However, more basic analytical work is performed prior to a sale of bonds, inasmuch as the sale materially alters the debt outstanding and other key rating factors. Consequently, we believe the figure of 30 minutes per issue mentioned in these hearings is both misleading and incorrect. Some issues require that several analysts spend several days to determine the rating while others require only updating, often just annually.

Another question which the committee asked was why Standard & Poor's rated bonds of the New York City Transit Authority AA, when the bonds are guaranteed by New York City, which is rated BBB.

The answer is that the revenue bonds of the New York City Transit Authority are not normal municipal revenue bonds. Most municipal revenue bonds are secured by the net revenues of the operating facility. This means that debt service payments are paid after operating and maintenance expenses. Inasmuch as the New York City Transit Authority operates at a continuing deficit, the New York State Legislature authorized revenue bonds payable from the gross revenues of the authority. This means that, during any 6-month period during which principal and interest payments are required to be made, the transit authority turnstiles need operate only 20 rush hours in order to provide sufficient revenue to pay all their interest and principal payments. For this reason, we regard the transit authority bonds as standing by themselves, separate from the guarantee of the city of New York and, in fact, offering relatively better quality.

One other brief item: the committee was presented testimony that some 427 factors should be considered in establishing a rating, with the implication that a great deal of time is needed to review such a tremendous number of factors.

I would simply like to clarify that to the extent that we do not try to number the factors that we look at. It is not so important to us how many factors there are, but are all that have a bearing properly included and measured, and is the impact of each on credit worthiness properly weighed? For example, a rating analysis for a general obligation issue of a small, stable, residential community requires examination of a wholly different set of factors from, for example, a bridge revenue bond issue.

I am going to stop now. I appreciate very much the opportunity to appear before you. I hope I have given some insight as to what Standard & Poor's hopes to accomplish in this area. We welcome your questions.

(The prepared statement of Mr. Harries follows:)

PREPARED STATEMENT OF BRENTON W. HARRIES

Chairman Patman and distinguished members and staff of this Committee: I represent Standard & Poor's Corporation. We deeply appreciate the opportunity to appear before this Committee and assure you of our complete cooperation in these hearings.

Standard & Poor's is a financial publisher and also acts as an investment counsellor. It is particularly well known for its publications containing financial information, recommendations and advice pertaining to securities.

It is an outgrowth of the merger in 1941 of Poor's Publishing Company and Standard Statistics Company, Inc. In 1949 Standard & Poor's began publishing municipal ratings in its weekly *Bond Outlook* and disseminating this information to its subscribers.

Standard & Poor's municipal bond ratings are "quality ratings" as opposed to "market ratings." A quality rating is not a recommendation to buy or sell; it is a comparative rating which attempts to measure the relative investment quality of one municipal obligation to another. It is not merely a measure of safety of interest or principal. If it were, then municipal bonds would be rated yes or no: default likely or unlikely.

The function of ratings, therefore, is to attempt to provide the investor with a distinction between the quality of the credits available to him for investment.

One of the basic requirements for investments, by banks, for example, is that of marketability and liquidity. Bonds with certain quality ratings are considered

readily marketable, and principally for that reason, bonds with these ratings are not questioned by bank examiners as to marketability and book value. With the passage of time, ratings began to be used for the purpose of appraising relative investment quality by investors, underwriters and dealers as well as by personnel of government agencies such as the Controller of the Currency and the FDIC. I respectfully submit that these ratings have obviously established some enduring merit, or they would never have enjoyed the use to which they have been put and the respect which has been accorded them.

Today, Standard & Poor's makes its municipal ratings available in three publications.

First is the weekly *Bond Outlook* which carries ratings of issues to be sold over the next thirty days, as well as newly assigned ratings as well as ratings which have been revised since the last issue. Second is the *Bond Guide*, which, although essentially purchased as a corporate bond tool, devotes a section to listing the letter ratings assigned municipal issues. Third is Standard & Poor's *Bond Selector*, a bimonthly publication which shows pertinent financial statistics of the debt outstanding in addition to the rating.

Prior to March 1, 1968, Standard & Poor's voluntarily rated the issues of approximately 9,600 municipal issuers. On January 24 of this year, we announced that effective March 1, 1968, we would rate municipal bonds only upon payment of a fee to reimburse us for the rating costs. This major policy change is reviewed at length in the last section of this statement.

SPECIFIC ANSWERS TO PREVIOUS TESTIMONY

In addition to answering the questions specifically outlined in your letter of April 16, I think it desirable that I first comment on certain items of testimony received by this Committee in the hearings of December 5, 6 and 7, 1967.

First, testimony was received which indicated that only thirty (30) minutes per issue could be spent by the rating agencies in analyzing any particular rating due to time and personnel limitations (page 12 of Hearings, Vol. 1). Actually, our policy is to review each rating prior to a sale and at least once a year. I submit that it is not necessary to make an in depth analysis of every rating every three months. The changes that affect ratings when no new debt is being issued are normally evolutionary ones. Because of familiarity, often it is only necessary to review the current and prior annual reports of the community to detect any unusual trends. This continuing review takes notice of the reduced amount of debt outstanding as bonds mature or are called, as well as new statistical information. However, more basic analytical work is performed prior to a sale of bonds, inasmuch as the sale materially alters the debt outstanding and other key rating factors. Consequently, we believe the figure of 30 minutes per issue mentioned in these hearings is both misleading and incorrect. Some issues require that several analysts spend several days to determine the rating while other require only updating, often just annually.

Second, prior testimony indicated that Standard & Poor's did not rate issues where the total amount of debt outstanding was less than $1 million. (page 59, Hearings, Vol. 1) The word "voluntarily" should be added to the statement to make it correct. For the last several years we have rated debt in a gross amount less than $1 million when requested to do so upon payment of a fee to reimburse us for the work required. We did not perform this work voluntarily because the debt outstanding was too small to be of general interest to our subscribers. Actually, we rated over 150 such issues during 1967 alone, on a fee basis, the amount of the fee depending upon the complexity of the analytical work involved. Standard & Poor's municipal ratings have for years been available to any municipality which we did not rate voluntarily.

Third, the Committee asked "why Standard & Poor's rated bonds of the New York City Transit Authority AA, when the bonds are guaranteed by New York City, which is rated BBB." (page 65, Hearings, Vol. 1) The answer is that the revenue bonds of the New York City Transit Authority are not normal municipal revenue bonds. Most municipal revenue bonds are secured by the *net* revenues of the operating facility. This means that debt service payments are paid after operating and maintenance expenses. Inasmuch as the New York City Transit Authority operates at a continuing deficit, the New York State Legislature authorized revenue bonds payable from the *gross* revenues of the Authority. This means that, during any six month period during which principal and interest payments are required to be made, the Transit Authority turnstiles need operate only 20 rush hours in order to provide sufficient revenue to meet these payments.

For this reason, we regard the Transit Authority bonds as standing by themselves, separate from the guarantee of the City of New York and, in fact, offering relatively better quality.

Fourth, previous testimony relating to the City of New York suggested that the reduction in the New York City rating was arrived at through the intervention of the President of Standard & Poor's and was not determined by the municipal bond rating department. (page 61, Hearings, Vol. 1) This is incorrect. It has always been the normal procedure when the rating of a state or major city or authority is changed either up or down to alert the senior officers of the Corporation and to give them the opportunity to question all aspects of the analysis and to maximize our exercise of judgment.

These officials do not initiate rating changes nor do they veto the actions of a majority of the municipal rating committee.

Fifth, the testimony states that rating agencies also act as municipal consultants, implying that Standard & Poor's acts as a municipal financial consultant to the issuers and then rates the bonds. (page 19, Hearings, Vol. 1) This is not so. Standard & Poor's has never so acted, is not now so acting and has no intention of doing so.

Sixth, the hearing of December 5, 1967, seemed to indicate that Standard & Poor's should consider 427 factors in establishing a rating (pp. 40–47, Hearings, Vol. 1), with the implication that a great deal of time is needed to review such a tremendous number of factors. Actually, while it is true that the total number of the factors listed is 427, many of the factors are repeated for all the categories of municipal agencies and a number of such factors are repeated for each item under a general heading. What is important in discussing the factors which affect a rating is not how many there are; but rather are all which have a bearing properly included, and is the impact of each properly weighed? A rating analysis for a general obligation issue of a small, stable, residential community requires examination of a wholly different set of factors than, for example, a revenue bond issue.

ANSWERS TO COMMITTEE QUESTIONS

1. What is the volume of municipal bond rating activity by your firm in 1967 in terms of:

	S & P Response
(a) number of ratings assigned during the year	3,341
(b) number of different public bodies involved	3,057
(c) delineation of the ratings between:	
1. state governments and agencies	146
2. local public bodies	2,911
(d) the proportion of ratings accorded to:	
1. general obligation bonds	2,407
2. revenue bonds	932
3. special assessment bonds	2
(e) for the G. O. and revenue bond issues, separate breakdowns of the ratings assigned according to grade	
AAA	133
AA	701
A	1,492
BBB	975
BB	33
Lower	7
(f) the number of ratings accompanied by a detailed analysis of the issuer's economic and fiscal characteristics published in our weekly report	247

2a) Basic criteria that must be considered before any evaluation of a municipality's credit can be established must include at least the following:

1. Current population of the community involved.
2. True—or market—taxable valuations.
3. Gross indebtedness.
4. Net indebtedness—debt after making deductions for self-sustaining obligations, sinking funds, state assistance, etc.
5. Over-all, or combined indebtedness. (net debt plus the proportionate share of the indebtedness of any other governmental unit for which the community is liable.)
6. The ratio of combined debt to population, expressed on a per capita basis.

7. The ratio of combined debt expressed as a percentage of true—or market valuations.

8. The ratio of combined debt expressed as a percentage of per capita income.

9. The community's historical tax collection record, including levies, collections and delinquencies.

The analyst must also carefully examine the economy of the community and answer the following questions:

Is it a one industry community? Is there diversification in industry? Is there a heavy dependence on extractive industry? What are its leading sources of income? What is the percentage of industry contribution to the tax base? Other pertinent facts relative to the economy of the area are: Is the community a resort area, subject to wide economic swings? What are the value of its homes, its income levels, relative wealth, personal savings, etc.? Is the community the location of a major shopping center and related commercial activities, etc.?

The character of a community plays a vital part in its overall evaluation. What are the educational attainments of its residents? What percentage of its homes are owner-occupied? Is there evidence of civic pride, of active community programs for recreation and cultural activities, etc.?

In examining the indebtedness of a community, weight must be given to its past record; its current indebtedness and its future financing needs. Does it have a sound capital improvement program? What is its schedule of debt retirements? Is its borrowing margin within legal debt limitations, etc.?

Only when all of the above questions have been satisfactorily answered can the analyst begin to consider the rating to be assigned a given municipality. This final rating assignment, done in committee of no less than three members, is then determined by comparing the issue with other bonds of comparable rating.

b) The procedures followed to arrive at a rating are materially aided by current and well prepared financial statements. We will not and cannot rate on insufficient information. Of particular value is a well thought out and documented long range plan for capital improvement.

We heartily endorse universal adoption of the municipal accounting principles that are being promulgated by the Municipal Finance Officers Association. Not only could basic analysis be facilitated but uniform accounting would greatly promote the preparation of a computer based data bank. This could be a great benefit to the smaller municipality.

c) Of great value to us are Federal Government reports, such as those published by the United States Department of Commerce (The Bureau of the Census County and City Data Book) and similar publications.

d) We divide the country into areas such as the Northeast, the Southwest, the New England area, the Midwest farm states, etc. We have found that debt ratios, for example, have little in common on a nationwide basis. A struggling community might have very low per capita debt but could have difficulty in supporting it. On the other hand, high debt ratios might be easily supported in some vibrant, economically well-off community in another section of the country.

e) The only reasonable approach to assigning a rating to a given situation is to collect, correlate and weigh all the information available, subject it to close scrutiny and then review it with our rating committee until agreement has been reached. Frequently, such agreement can be reached in a matter of minutes. On the other hand, we might have to devote hours, or even days, to discussion until a decision is reached.

3a) In 1967, our analysts made field trips to 38 states and the Commonwealth of Puerto Rico. Field trips lasted from one to two days to several weeks with innumerable municipalities—both large and small covered. In addition, during this period, nine state governors were interviewed, including governors Hickel of Alaska, Hathaway of Wyoming, Kirk of Florida, McKeithen of Louisiana, Agnew of Maryland, Connelly of Texas, Johnson of Mississippi, LeVander of Minnesota and Ellington of Tennessee.

b) This question asked about meetings in our office with officials of prospective bond issuers. The answer is a lengthy list, and is included as Exhibit A.

c) Other first-hand reports are gathered from many sources including economic and business publications such as Rand McNally's Commercial Atlas and Marketing Guide, *Editor and Publisher*, *Sales Management*, the United States Department of Commerce bulletins, economic reviews published by the various Federal Reserve Banks, etc. Our financial library, reputed to be the largest privately

owned in the country, contains over 33,000 volumes related to financial matters. In addition, we subscribe to 42 out-of-town newspapers and over 1,000 periodicals, and three newswires. Our field staff men, sales representatives and other personnel scattered throughout the country are also available to us for local information. In addition, we currently have two resident municipal bond analysts located in Philadelphia and Houston. Their role is discussed more fully in the last section of this statement.

4) Standard & Poor's Municipal Bond Department presently consists of nine analysts supplemented by four others used interchangeably with our corporate bond department. These are supported by the services of adequate clerical people, and we have a varying number of trainees.

Length of service in our bond department ranges from less than one month for our newest member to 44 years for our senior bond man.

Most of the analysts are college or professional school graduates. Some have previous employment with underwriters, banks or other financial institutions. The range of salaries is from $12,000 to $17,000 with junior people receiving less and senior people more.

In line with our newly announced policy of fee-based ratings, the staff is being enlarged. In addition to the foregoing, eight people are presently working on research for proposed computer applications. This is more fully discussed in the last section of this statement.

5) Our bond ratings are published in our weekly *Bond Outlook*, bimonthly *Municipal Selector* and monthly *Bond Guide*. In addition, we average 85 phone calls daily requesting ratings. The Daily Bond Buyer also publishes Standard & Poor's ratings in their calendar of sealed bid openings. Many underwriters and dealers include S & P ratings in their offering circulars and bidding calendars.

Occasionally issuers or underwriters disagree with the rating assigned. We have followed a firm policy of making every opportunity available for review. This includes personal interviews, submission of further information and a volume of interchange of comments. We have consistently adhered to the principle of discussing freely and openly our reasons for the rating and have left every avenue open for continuing discussion and possible alteration of our decision.

6) The proportion of time spent by our analysts in the mechanics of compiling, collecting and assembling data relative to a municipality is rather small. In virtually all cases, sufficient information is available directly to us. If the data are considered by us to be insufficient, we request additional material, and in practically all cases, our requests are granted. The bulk of an analyst's time is, therefore, spent in doing the actual correlation of the statistics and review of the material. In certain isolated cases, sufficient information is simply not available, and when this is so, we will not assign a rating.

7) The question was asked if our rating would be facilitated if material were furnished to us two weeks prior to the date of a bond sale. The answer is emphatically yes, and we ask for as much time as possible prior to the sale in order to schedule the work load properly. In certain major new bond sales, it is necessary to have a much greater length of time in order to review from both analytical and legal standpoints the various documents that are required, including bond resolutions, official statements, engineering reports, traffic estimates, etc.

8) This question asks, "Would the market for municipal securities be materially enlarged if, (a) the interest income were to be made taxable, (b) the debt service on the securities were to be guaranteed by a Federal agency and (c) the municipality were to receive annual grants to cover one-third of the annual interest cost on the taxable securities?"

Having examined the bills introduced by Representative Patman and Senator Proxmire (H.R. 15991 and S. 3170) I have prepared my answer to this question as if the (a) (b) and (c) delineations were not present, and that all three factors occurred; i.e., the issuing agencies sold taxable bonds, guaranteed by the Federal government which paid one third of the interest cost. These are the provisions in the identical bills and the goal of the bills as stated is to "assist in the expansion of the capital market for municipal securities while decreasing the cost . . .".

Question 8 asks, "Would the market for municipal securities be materially enlarged . . ." if the three factors above took place. I think that the answer to the question as posed is "yes". However, I do not believe there would necessarily be a decrease in cost to the issuer or any new benefit to the small municipality.

Our knowledge of the marketing of municipal securities suggests that tax exemption is the primary motivation for their purchase. Tax exemption causes

municipals to appeal to buyers to whom that feature is valuable. It has created a market place that is completely separate and apart from all other domestic debt issues. The removal of tax exemption would destroy this market place, obliterate the normal marketing outlets for municipals, and literally push them into the huge market known as debt financing.

It is obvious that the market would be enlarged. Municipals, with their new higher interest rates, could stand alongside Federal obligations, corporate bonds, and even mortgages. The number of potential buyers would be increased from the traditional bank-insurance company-individual group to include the huge mass of investor institutions, funds, and individuals who presently purchase taxable securities.

I can think of no other answer to the question but that the market must be enlarged. But this enlargement is not without potentially drastic changes in municipal interest rates.

I believe that many municipal bonds, even with a federal guarantee, would have to offer higher rates in many instances than high grade or even medium grade corporate bonds. My reasoning is that a corporate bond is a debt of a profit making enterprise; the debt itself has been incurred to increase its profit making potential. Assuming similar call protection, the lesser known municipality will have to enhance its marketability by rewarding the investor with more income as opposed to a known corporate name.

There is a wide divergence now in the interest rates on Federally guaranteed municipal tax exempt bonds. Bonds of local public housing authorities vary greatly despite the Federal guarantee. Hence there can be no supposition that all municipalities will pay the same rate because of the Federal backing; they don't now, despite, incidentally, AAA ratings on all such bonds.

Insofar as ratings are concerned, the question would disappear. S & P rates all Federally guaranteed debt AAA.

The question then becomes whether or not the one third interest cost payment would compensate the municipality for the increased taxable interest rate.

My answer is that in many instances it would not, solely because in the "enlarged market" which is the goal of the bills introduced, the degree of marketability would be determined by how attractive the interest rate is made to overcome the greatly enlarged competition.

Therefore, although the market most certainly has to be enlarged, the cost to the average municipality could be extended out of proportion to any benefit to be gained by having a greater potential market.

THE FUTURE

We believe the Committee's hearings in this matter have been very timely. They have coincided with our own deliberations as to how we could cope with the sharply accelerating demands which have been placed upon us by the burgeoning growth in municipal bond financing and by the wide use of municipal bond ratings. During the last 18 months we have studied internally our rating methods, our methods of disseminating the ratings and our methods of compensation for the work involved. The spiraling demands being thrust upon us by the greater municipal financing activity and the extremely tight municipal analytical labor market strongly suggested the desirability of change. In the light of the losses which we were suffering in the rendering of this service, we felt compelled to make a basic modification in policy.

On January 24 of this year, we announced that we would no longer rate municipal bonds voluntarily but, rather, would assign ratings only upon request and payment of a fee to reimburse us for the time and expense required in analyzing the issue. The balance of this statement will explain why such a policy was necessary and what we hope to accomplish. This change was announced in a statement which was given intense national distribution. Since that time, there have been minor changes in our policy. For purposes of clarification and historical record, the entire statement is reproduced as it originally appeared, along with explanatory comments and discussion of the modifications which have been made.

"Since 1949, Standard & Poor's Corporation has voluntarily rated municipal bonds. In that year the total of tax exempts issued was $2.9 billion, and the total municipal debt outstanding was $20.7 billion. In 1967, new tax exempt borrowing reached a record of $14.2 billion and brought the amount outstanding to over $113 billion."

Standard & Poor's and its predecessor company, Standard Statistics Company, Inc. have a long record of analyzing municipal credit as an adjunct to invest-

ment counselling. Internal ratings were used long before World War II. In 1949, S&P began publishing these assigned ratings in its *Weekly Bond Outlook*. In retrospect, the advent of the published rating had an important effect on the *use* of the rating. The published dissemination of these letter ratings slowly removed them from the designed investment services of S&P, and they became in the eyes of many, part of the public domain.

As the issuance of these securities grew, the "quasi public" importance of the ratings became established.

"We have continued to meet the requirements created by this growth. However, the revenue derived from our published services that carry our ratings has never covered the cost of supporting the staff required to perform rating functions, and the gap is widening."

"While we have no intention of altering in any way our present procedures with respect to rating corporate bonds, we are faced with deciding whether we should continue to provide voluntary municipal bond ratings at great cost to us or withdraw completely from the municipal rating field."

Our corporate bond department is an integral part of S&P's large and important services in the corporate field. It furnishes information to other parts of our company, both for publication in stock services and for investment counselling. This is not the case in municipals. Aside from minor investment counselling income, the municipal analytical revenue must depend on the published municipal services. There is not the interplay in this field as with our stock services.

Consequently, we were faced with three alternatives; one, continue as in the past, in the face of continuing personnel losses in a labor market devoid of trained municipal analysts and plan to lose $100,000 to $150,000 in 1968 alone, in maintaining a "free" service; two, withdraw altogether from rating municipals, which would mean disregarding a responsibility which, to a degree, we brought on ourselves when we started publishing ratings; or three, ask to be paid for the analytical manpower and fact gathering that the job requires.

"We will not withdraw. We feel a strong responsibility to the municipal bond community in being ready to analyze and rate certain types of debt which otherwise would not be rated by a recognized agency."

Certain construction revenue bonds and bonds of various authorities have not, in the past, been rated by Moody's. We have rated such bonds and feel a responsibility to such issuers to maintain rating surveillance on their bonds if they so wish.

"In addition, we feel that when so desired, the industry should have the right to obtain at least two qualified and independent opinions on the comparative quality of an issue."

The key words here are "right", "qualified" and "independent". Certainly an investor is entitled to at least two impartial opinions of investment merit. To be qualified is our job, by insuring that we are staffed with trained and knowledgeable people who know their work. Our work policy of asking to be paid for this work is, in turn, enabling us to build and maintain an adequate and qualified staff. Independence of the rating agency is, in our opinion, most important. We are free from political pressures, underwriting alliances, consulting conflicts, or any other allegiances which could influence our rating determinations.

"We cannot, however, continue to assign municipal ratings on a voluntary basis. Effective March 1, 1968, we will rate new municipal bonds only upon request and payment of a fee to reimburse us for the time and expense required to analyze the issue."

Our fee is contingent solely upon what we have to do. We seek payment only in relation to the time and expenses we must incur to determine the rating. The amount of the fee depends not on the size of the issue or number of bonds outstanding, but upon the complexity of the analysis involved.

"This is not a totally new concept. Standard & Poor's has, for many years, offered ratings on a contract fee basis where the total debt outstanding was too small to be of interest to the majority of our clients and subscribers. The fees charged were and will continued to be based on the time and expense involved in the analytical work necessary to determine the rating."

Many people do not realize that we have performed contract ratings on a fee basis for many years. Our policy has been to rate general obligations and revenue bonds voluntarily only where the total class of debt was $1,000,000 or more; and in the case of industrial revenue bonds, $10,000,000 or more. In 1967 alone, we performed in excess of 150 contract ratings for which we charged fees.

"We are now expanding the contract fee policy to encompass all municipal

credits, including tax exempt industrial aid bonds sold by municipalities, and we will no longer continue voluntarily to rate these issues."

There is only one exception to this statement and it is probably obvious. Our entire rating structure of letter ratings is geared to unconditional obligations of the Federal Government being considered AAA quality. This is the benchmark from which our other ratings stem. Consequently, municipal bonds that are either backed by or are guaranteed by the United States Government or its obligations are automatically rated AAA. Examples are Public Housing Authority bonds and advance refunded bonds which are backed by direct and guaranteed U.S. obligations.

"We are prepared to put behind this effort all the financial and personnel resources of Standard & Poor's Corporation needed to perform complete and in depth analysis of the credits presented to us. The contract fee policy will enable us to continue to maintain high standards of performance."

The most important point here is that we mean what we say. We have already seen such acceptance of our new policy that we have confidently planned to spend whatever is required to maintain a rating staff of unquestioned capability and to provide them with the most modern techniques. The response that has been evidenced by recent rating requests has convinced us that we can now justify whatever expenses are required to meet these needs.

In line with this, Standard & Poor's has started to employ resident municipal field analysts—men permanently based outside our home office whose sole duties are to work on the credits in their particular areas. They are performing on the scene basic analysis and forwarding reports and recommendations to New York, returning frequently to discuss the area under their surveillance. Our concept of this type of branch operation is that, although all rating assignments will emanate from New York, the local man with first-hand knowledge will be the initial fact gatherer, investigator, and analyzer of the credit. Our first field man is operating from our office in Philadelphia, after an indoctrination in New York. He covers Pennsylvania and such of the surrounding area as is practical. Our second man has just been employed and he will operate out of Houston, covering Texas and the adjacent area.

Other men will be employed in other cities as requests for contract ratings justify the investment. We are pursuing actively the hiring and placing of these men as the demand warrants.

"In addition, we are planning to study what benefits may be derived by utilizing our electronic computer capacity in the analysis of municipal debt. Standard & Poor's is a recognized leader in the application of computers to corporate stock analysis. If the demand for municipal ratings so warrants and computer techniques for better evaluation appear feasible, we will undertake the costly effort necessary to utilize computer capabilities in municipal analysis. In brief, by performing municipal ratings on a fee basis, we are prepared to invest whatever is necessary for optimum results."

S & P has, in just the past three years, developed and marketed successfully a computer oriented service which provides a huge data bank of information on over 2200 U.S. corporations. We have long been aware of the possible utilization of computer techniques to assist in municipal analysis and comparative studies. But such an effort, which requires research, analysis, programming and ultimate utilization, is very costly in terms of people and dollars. Such expenditures simply could not be justified in municipal analysis because, with purely voluntary ratings, no return could be foreseen.

We have now, however, committed ourselves to such a study.

We have employed, on a continuing basis, Dr. Roy Bahl of the Maxwell School of Metropolitan Studies of the University of Syracuse. Dr. Bahl has organized a group of associates to make a study for us to investigate and evaluate procedures for the utilization of computer techniques in municipal bond analysis and credit rating. For example, we expect to be able to examine more closely the weightings of factors which make up a credit rating by having the computer perform the myriad calculations of the historical and present ratios. Dr. Bahl has recruited a full time staff and is now conducting the study.

Before the end of 1968, we expect to be well along in compiling the data bank and in programming the comparative municipal analysis.

"We believe this is a step forward in providing more expert service to the municipal bond industry. We are well aware of some of the far reaching effects of this decision and emphasize that a great deal of thought and reflection has been given to it. This decision provides a sound solution to the difficult problem of attempt-

ing to fulfill and reconcile the responsibilities we feel toward the municipal industry and to our stockholders."

Little more need be said except to emphasize two points. First, we are well aware that trust officers, portfolio officers, executors and others may be legally bound to have at least one or two independent ratings on bonds under their responsibility. Second, we are a business designed to operate at a profit. It is not our intention to reap unwarranted returns, but we *do* expect to operate this service at some profit. By our decision we have demonstrated that we *refuse* to continue to subsidize it, since the latter policy would be self-defeating anyway.

The remainder of the policy statement discussed the implementation and operation of the new policy.

Current Ratings and New Issues

"Municipal Bonds currently assigned Standard & Poor's ratings on February 29, 1968 will remain under surveillance until December 31, 1968, at which time they will be considered as not rated by us unless by contract. If a new issue of bonds is sold during the period of March 1 to December 31, the new issue and the outstanding bonds will be considered as not rated by us unless a contract rating is performed."

This clause was constructed to provide a means whereby the basic goal could be achieved—that of providing us with sufficient income to continue to perform the service thoroughly and in depth.

Shortly after our January 24th announcement, a subcommittee of the Municipal Securities Committee of the Investment Bankers Association was appointed to study the problems inherent in bond ratings. In May the subcommittee submitted an interim report at the Spring Meeting of the IBA. Shortly thereafter we received the following resolution which the Municipal Securities Committee adopted at this meeting:

"The Municipal Securities Committee urges Standard & Poor's to extend their cutoff date of December 31, 1968 to December 31, 1969 on outstanding ratings in the interest of an orderly market."

We believe that this resolution was prompted and this recommendation made, not only on behalf of the IBA, but also to serve the best interests of all underwriters, issuers and investors. We believe it is our responsibility to respond affirmatively to constructive suggestions which will benefit the entire industry. Therefore, we were pleased to cooperate with the IBA and altered our policy in accordance with their recommendations by agreeing to maintain and extend rating surveillance on all outstanding ratings until December 31, 1969, or until the next bond issue.

"We will, of course, continue to obtain and review information on new issues and outstanding bonds for portfolio recommendations for our investment counsel clients and inclusion in our weekly *Bond Outlook*."

We are receiving information on virtually all municipal bond sales, including those for which we may not be performing contract ratings. This accomplishes several purposes. First, we are maintaining active files on all municipal credits so that at any time in the future if we are asked to perform a rating our files will at all times be ready. Secondly, we are presenting the salient facts of new issues for the benefit of our *Bond Outlook* subscribers. Third, we are continuing, as in the past, to recommend purchases and sales of bonds through our investment counsel division to S & P's clients.

The statement continued:

How Contract Ratings Work

"The request for contract rating analysis may come from the issuer, underwriter, consultant, institution, etc."

Our experience to date is that requests for fee-paid ratings are coming almost entirely from the issuer. This seems most logical because, over a long period of time, the group that will ultimately benefit from the maintenance of continuing rating surveillance is the issuer. The underwriter, consultant or institution may consider a rating essential to the effective marketing of the issue, regardless of what the rating may be. But in the last analysis the ultimate investor, it seems to us, looks toward some independent source to appraise the quality of his investment. We believe the confidence of the investor, which is so essential to the issuer who must repeatedly distribute bonds to raise capital funds, places long term responsibility for rating surveillance on the issuer.

The question has arisen about conflict of interest. That is, is our judgment apt to be swayed because there is a fee relationship between us and the person

who obviously wants as high a rating as he can obtain? We can state categorically that there is no conflict, but people will only be convinced as time passes. Since March 1, we have performed over 225 contract ratings. Most of these resulted in affirmations of previous ratings, but in 8 cases, the previous rating was downgraded.

"The rating may then be used by him or not, as he desires. Regardless of whether the rating is used, our fee for performing the analytical work will be charged."

These two sentences are no longer part of our policy; they were deleted on February 16, 1968. The clause that the other party to the contract could use the rating or not, as he desired, was originally founded upon the advice of counsel that, as a matter of contract law, he should have such right. Immediately many people saw that such right included the right of suppression of the rating if the party felt the rating detrimental to selling the bonds. After much consultation within the industry and particularly with a subcommittee of the Municipal Securities Committee of the Investment Bankers Association of America, we feel that we can still have a valid contract without granting such right, and we have deleted this clause. The other party now does not have the right of suppression and S & P has the right to reveal the rating.

"The fee will depend on the amount of work necessary to arrive at the rating and can range from several hundred to several thousand dollars."

Many issuers have requested estimates of cost. Emphasizing what has been stated before, our fee depends upon the complexity of the issue, not upon its size or type. Our staff keeps a record of the time and expenses incurred, and these charges determine the fee. In brief, we are rendering a professional service for which we ask to be compensated.

"Ratings will be kept under surveillance for one year, or until the next sale, whichever is earlier, at which time the contract may be renewed at what we expect will be a fee smaller than the original."

The subcommittee of the IBA passed a second resolution at its Spring meeting:

"Be it further resolved that Standard & Poor's should assure any issuer who avails himself of a fee rating that the rating will be kept in force until a review is deemed necessary or the issuer schedules a new offering."

Again we believe this to be a well founded and constructive suggestion. We have accepted it and modified our policy accordingly. The excellent reception accorded the basic policy made possible the two modifications suggested by the IBA.

The contract form itself is not a document requiring signature or other formal execution. As a matter of practicaliy, it has been kept in simple, memoranda form and spells out the conditions under which the rating is to be performed. A copy of this memo has been included as Exhibit B.

In conclusion, I would just add that the change from voluntary to paid municipal ratings was a major decision on our part. We are very much pleased and gratified at the acceptance the change has received.

We believe that we have performed a satisfactory and worthwhile service in the past. But, in the face of the increasing demands being placed upon us, we finally had to make the reluctant decision against further subsidies. This policy change will enable us to meet the great need for these ratings, and I wish to impress upon you, above everything else, our complete sincerity of purpose in what we hope to accomplish. We do not look upon this as a market to be exploited; we look upon it as a responsibility. Our fee policy is designed to provide us with the means to discharge this responsibility in the highest order. We have committed ourselves to continue to provide an investment service that will fully merit the complete confidence of the issuers, underwriters and investors.

In summation, we again wish to thank the Committee for the opportunity to make this presentation. In your deliberations, it may be that you will uncover recommendations for courses of action which have as yet not been apparent to us. We wish to assure you and the public at large of our complete willingness to be flexible in our approach to this unusual and complex problem. We will be pleased to try to answer any questions you may have.

EXHIBIT A

MUNICIPAL OFFICIALS VISITING STANDARD & POOR'S, 1967

Date	Representatives from—	Number of persons	Time spent	Number of analysts attending
Jan. 4	Plymouth Cons. S.D., Michigan	2	40 min	1
4	Henderson, Ky. (water rev.)	2	35 min	2
5	Culver City S.D., California	1	30 min	1
6	Treasurer, State of North Carolina	2	1 hr., 15 min	3
10	Bloomfield Hills Township S.D., Michigan	4	1 hr., 5 min	2
10	Swartz Creek S.D., Michigan	4	1 hr., 5 min	1
11	Avon, Conn.; Meriden, Conn	4	1 hr	2
11	Prime Minister of Manitoba-Deputy Minister	5	40 min	1
12	Deputy Minister of Nova Scotia	4	45 min	1
13	Fresno, Calif	2	35 min	2
13	Montgomery County, Md.; Harford County, Md	6	1 hr., 25 min	2
16	Falls Church, Va	2	1 hr., 15 min	2
16	Lee County, Fla. (Water Department)	2	40 min	2
17	Centerville Township, Ill. (sewer rev.)	2	1 hr	1
17	Miami Consolidated District, Ohio	2	30 min	2
18	Ann Arbor, Mich	6	1 hr	2
18	N.Y.S. Pollution Agency	3	45 min	1
19	Fort Worth, Tex	4	50 min	2
19	State of Alaska	2	25 min	2
20	Inger-Grove Sanitary District, Minnesota	3	50 min	2
20	Edison Township, N.J	3	1½ hr	1
20	Baker, La	2	30 min	1
23	Chatham Township, N.J	5	45 min	2
23	Garfield Co. S.D. No. RE-1, Colorado	3	do	2
23	Middletown, Ohio (indl. rev.)	4	40 min	2
24	Paris I.S.D., Texas	4	1 hr., 10 min	2
24	Glassboro, N.J. S.D	3	45 min	2
25	Atlanta, Ga. airports	5	2 hr	2
26	Avon, Conn	5	45 min	2
30	Lubbock, Tex	6	1 hr	2
30	Chelan County Public Utility District No. 1, Washington	4	55 min	2
31	Treasurer, State of Oregon	3	1 hr., 10 min	2
31	Clarksville School Building Corp., Indiana	3	40 min	2
Feb. 1	College of the Mainland, Texas	3	55 min	2
6	Oak Park, Ill. (W. & S. rev.)	4	1½ hr	2
6	Miami University, Ohio	2	30 min	2
9	Fulton County S.D., Georgia	3	45 min	2
9	Prince Georges County, Md	5	do	2
10	St. Anthony I.S.D. No. 282, Minnesota	4	1 hr., 15 min	2
10	East Providence, R.I	2	55 min	2
14	Passaic County, N.J	2	1 hr	2
14	Irving, Tex	3	1½ hr	1
15	Toledo University, Ohio	1	1 hr	1
15	Mona Shores S.D., Michigan	2	do	1
15	Cape Canaveral, Fla	2	2 hr	1
16	Oakland Community College, Mich	3	1 hr	1
16	Denver Schools, Colorado	2	30 min	1
17	Grand Prairie, Tex	4	1 hr., 10 min	1
20	Holland, Mich. (Elec. Rev.)	3	30 min	2
20	Rosemont I.S.D. No. 691, Minnesota	3	40 min	2
20	Miami Parking Authority	4	1¾ hr	2
21	Florida Development Commission	4	2 hr	1
23	Kokomo School Building Corp., Indiana	5	55 min	2
23	Hamblin County, Tenn	2	35 min	2
23	Mesquite, Tex	8	45 min	2
24	West Virginia University	4	30 min	2
27	Lake Michigan College District	3	45 min	2
28	Bibb County, Ga	4	1 hr, 15 min	2
Mar. 1	Park Ridge S.D., Illinois	3	35 min	2
3	Territory of Guam	2	1½ hr	2
3	Norfolk, Va	3	do	1
3	South Lakes Schools, Michigan	4	45 min	2
6	Georgia State Authorities	4	1 hr	2
6	Jefferson Parish, La	3	1½ hr	1
7	Rush etc., CSD No. 1, New York	2	45 min	1
7	Mendham, N.J	2	do	1
8	Santa Clara County, Calif	1	1 hr	1
9	Orono I.S.D. No. 278, Minnesota	3	50 min	2
13	Wayzata S.D., Minnesota	4	55 min	2
13	Hartley S.D., Texas	10	40 min	2
14	Stone & Youngberg, Inc., San Francisco	2	55 min	2
15	Anne Arundel County, Md	7	1 hr	2
16	Saginaw County, Mich	5	45 min	2
17	Texarkana, Ark	2	do	3
20	Miami, University	2	30 min	2
20	Fayetteville, Tenn	2	45 min	2
21	Tucumcari, N. Mex	3	2 hr	1
23	Ashdown, Ark	4	1½ hr	3
23	Fort Worth, Tex	4	35 min	2
23	Bryan, Tex	4	do	2
23	Bay City I.S.D., Texas	4	30 min	1

EXHIBIT A

MUNICIPAL OFFICIALS VISITING STANDARD & POOR'S, 1967—Continued

Date	Representatives from—	Number of persons	Time spent	Number of analysts attending
Mar. 27	Irvington, N. J.	3	45 min	1
27	Chester Municipal Authority, Pennsylvania	4	55 min	1
27	State of Tennessee Sch. Bond. Auth	5	1½ hr	2
28	Allendale Boro S.D., New Jersey	5	30 min	2
29	Birmingham S.D., Michigan	3	1 hr	2
29	Dade County, Fla. (Sunny Isle Swr.)	2	do	2
30	Rockville, Md	2	45 min	2
30	Brownsville, Tex	1	30 min	1
30	Bensalem Township, Pa	1	45 min	1
Apr. 3	Ball State College, Indiana	1	35 min	2
5	Warren Hills Reg. S.D., New Jersey	2	20 min	1
5	Mobile County Board of Water District, Alabama	2	35 min	2
7	Lima, Ohio	1	do	1
7	Waco City, Tex	5	1 hr., 15 min	1
10	New Berlin S.D., Wis	3	1 hr	2
10	Hartford, Conn	4	do	1
11	Woonsocket, R.I	5	55 min	2
12	Madison County-Jackson, Miss	1	do	2
12	Treasurer, State of Connecticut	3	do	2
14	Governor Hickel of Alaska	10	1 hr	3
14	East St. Louis S.D. No. 189, Illinois	5	do	2
14	Kansas City, Kans	1	25 min	1
17	South Elgin, Ill	1	1 hr	2
17	Westport, Conn	2	30 min	2
18	Gainesville, Fla	5	55 min	2
19	Clarkstown S.D. No. 1, New York	4	30 min	2
19	Baltimore County, Md	4	40 min	2
20	Asheville, N.C	2	1 hr	1
24	Kuhn, Loeb & Co	1	55 min	1
26	Bowling Green University, Ohio	2	45 min	2
26	Naples, Fla	3	55 min	1
26	Washentaw County, Mich	1	40 min	2
26	Roswell, N. Mex	3	2 hr	2
26	Greater Juneau Borough, Alaska	2	1 hour	2
May 1	Bloomington I.S.D. No. 271, Minnesota	4	do	1
1	Kodiak Borough, Alaska	2	45 min	1
2	Kansas City, Mo	5	1 hr	2
2	California Water Resources Board	6	2 hr	3
9	Abilene, Tex	3	1 hr	2
9	Watertown, Conn	3	40 min	2
10	Angelo State College, Texas	2	30 min	1
10	Richmond, Va	1	45 min	1
15	Temple, Tex	2	55 min	1
16	Milan area S.D., Michigan	3	45 min	1
16	St. Louis Park, Minn	2	30 min	1
16	Livonia, Mich	3	45 min	2
18	Lexington, Ky	1	30 min	2
18	St. Joseph S.D., Mich	3	1 hr	2
19	Atlanta, Ga	5	1½ hr	2
23	Ball State University, Indiana	2	30 min	2
23	Texarkana, Tex	6	1 hr., 10 min	2
23	Dallas County, Tex	4	45 min	2
24	University of Wyoming	3	1 hr	2
26	Lexington, Ky	3	40 min	2
26	Upper Darby, Pa	2	35 min	1
26	Chicago Board of Education, Illinois	8	1½ hr	2
29	Worcester County, Md	4	1 hr	2
29	University of Wichita, Kans	3	45 min	2
31	Keesville S.D., New York	1	25 min	1
June 1	Montrose, Colo	2	40 min	2
1	Catskill, etc., C.S.D. No. 1, New York	2	25 min	2
2	British Columbia Hydro-Electric	5	35 min	1
2	Brookhaven & Smithtown C.S.D. No. 1, New York	4	50 min	3
5	Macomb County, Mich	4	55 min	1
6	Port Huron, Mich	3	45 min	1
6	Hayward, Calif	1	35 min	1
9	Wyoming Valley Sanitary Authority, Pennsylvania	9	1½ hr	2
9	Goose Creek I.S.D. Texas	2	1 hr	2
12	Warren, Mich	5	35 min	2
12	Bloomington, Ill	3	45 min	2
14	Pinellas County, Fla	1	1 hr	2
19	Odessa Junior College, Texas	4	55 min	2
20	San Antonio, Tex. (Sewer)	4	1 hr	2
21	Bellair, Tex	2	55 min	2
21	Omaha Pollution Control Board	5	2½ hr	2
27	Madison, Wis	3	30 min	2
28	Sacramento Municipal Utilities District, California	1	do	1
28	Fort Lauderdale, Fla	3	50 min	2
28	Columbus, Ga	4	1 hr., 10 min	2
29	Alma, Fenton & Flushing, Michigan School Districts	4	1 hr	2
29	Florida Development Commission	6	2 hr	1

EXHIBIT A

MUNICIPAL OFFICIALS VISITING STANDARD & POOR'S, 1967—Continued

Date	Representatives from—	Number of persons	Time spent	Number of analysts attending
July 3	White Settlement, Tex	2	35 min	2
5	Kettering, Ohio	1	do	2
10	Denver, Colo	3	55 min	2
10	Chicago City College, Illinois	3	30 min	2
17	Province of Newfoundland	4	55 min	2
17	Calipatria S.D., California	2	30 min	2
25	Bluffton, Ind. (wtr.)	2	25 min	2
27	Wisconsin dealers	2	1 hr	2
Aug. 3	Wichita, Kans	4	do	1
8	West Kentucky University	3	do	1
8	West Virginia Board of Education	2	25 min	1
8	Kansas City, Mo	3	1 hr	2
15	Manatee County, Fla	1	do	1
17	Campbell County, Va	2	30 min	1
30	Hudson, Wis	1	25 min	1
Sept. 6	Fort Bend, I.S.D., Texas	2	55 min	2
6	Mesa County Valley S.D. No. 51, Colorado	3	1 hr	1
7	Burlington, Mass	2	45 min	2
9	Purdue University, Indiana	2	40 min	2
9	Los Angeles Airport	12	1½ hr	1
12	Montreal Catholic School Comm	8	45 min	2
12	Sheriden, Wyo	2	1 hr	1
12	Daytona Beach, Fla	4	do	2
12	State of Hawaii	7	do	2
Sept. 13	Jefferson Parish, La	3	1½ hr	1
18	Irving S.D., Tex	3	45 min	2
18	McNairy County, Tenn	3	1 hr	2
20	Alberta Tele Comm	6	do	2
20	State of Vermont	3	45 min	2
21	Dade County Port Authority, Florida	3	1 hr	2
21	Shawnee County S.D. No. 345, Kansas	2	20 min	2
22	Metro Fair & Exposition Authority, Illinois	2	1 hr	2
28	Muscogee County, Ga	3	1½ hr	1
29	Richard on I.S.D., Texas	2	1 hr	1
Oct. 2	St. Paul Port Authority, Minnesota	2	do	2
3	Baltimore, Md	2	35 min	2
4	Decatur, Ill	2	45 min	2
5	Nome, Alaska	3	1½ hr	2
5	Eugene, Oreg	2	30 min	2
9	Pearl River Valley Water District, Mississippi	3	1 hr	2
9	Siesta Key, Fla	3	55 min	2
9	Tallahassee, Fla	2	30 min	2
10	Oyster Bay S.D. No .21, New York	3	45 min	1
17	San Francisco B.A.R.T.D	2	1 hr	2
17	Austin, Tex	5	55 min	2
19	Dunedin, Fla	3	2 hr	1
20	Hillsborough County Port District, Florida	3	1½ hr	1
23	Hennepin County, Minn	3	35 min	1
23	Ector County, Tex	6	45 min	2
26	Cook Co. H.S.D. No. 217, Illinois	4	55 min	1
26	Baltimore County, Md	5	1 hr	2
27	Minnesota State College	7	do	2
30	Temple, Tex	3	do	1
30	Treasurer, State of Mississippi	4	55 min	2
31	New Mexico University	4	1½ hr	2
31	Dunkirk, N.Y	4	55 min	1
Nov. 2	Macomb County Building Authority, Michigan	3	50 min	1
3	Edina, Minn	4	55 min	1
6	Los Angeles D. W. & P	5	1 hr	2
8	Alamogordo, N. Mex	3	1½ hr	1
9	Wichita County, Tex	4	1 hr	2
9	Hastings, Mich	2	35 min	2
13	Garland, Tex	6	55 min	2
13	Wichita Falls, Tex	4	1½ hr	1
14	Garland, Tex	3	1 hr	1
16	Savannah, Ga	3	55 min	2
17	Garden Grove, Calif	2	30 min	2
17	Fairfax County, Va	3	45 min	2
20	Northwest Houston Water District, Texas	4	1 hr	1
20	Genessee County, Mich.-Flint, Mich	3	do	2
20	Hempstead (town), New York	2	55 min	1
21	Richmond, Va	3	45 min	2
27	Camden, N.J	2	55 min	1
Dec. 1	Milwaukee, Wis	7	1½ hr	2
4	Cook County S. D. No. 102, Illinois	2	40 min	1
4	Riverhead, N.Y	2	35 min	1
5	Clinton Township, Mich	3	55 min	1
5	Warren Township, S. B. Corp., Indiana	2	50 min	2
5	Titusville, Fla	3	45 min	1

EXHIBIT A

MUNICIPAL OFFICIALS VISITING STANDARD & POOR'S, 1967—Continued

Date	Representatives from—	Number of persons	Time spent	Number of analysts attending
6	Laredo, Tex	2	35 min	1
6	Cicero, Ill	1	30 min	1
12	Hallendale, Fla	2	1 hr	1
12	Virginia dealer	1	do	1
13	Ennis, Tex	3	45 min	1
14	Austin, Tex	3	35 min	2
14	Manitowoc, Wis	2	1 hr	2
14	Sunnyvale, Calif	2	30 min	2
14	I.S.D. No. 191, Minnesota	3	35 min	2
15	Greendale, Wis	2	30 min	2
19	Longmont, Colo	4	1½ hr	2
20	Martinsburg, Pa	1	30 min	1
20	Omaha Public Power District	4	55 min	2
27	Irvington, N.Y	2	35 min	1
28	Montgomery County, Md	4	1 hr	2
28	St. Louis, Mo. (Airport Rev.)	3	do	2
	Totals	827		

EXHIBIT B

STANDARD & POOR'S CORP.,
New York, N.Y., June 3, 1968.

MEMORANDUM RE MUNICIPAL BOND CONTRACT RATINGS

Standard & Poor's Corporation no longer rates municipal bonds voluntarily, but only upon request and payment of a fee to reimburse us for the time and expense required to analyze the issue. The fee is payable upon completion of the analytical work and will depend on the amount of work necessary to arrive at the rating and can range from several hundred to several thousand dollars.

The request for contract rating analysis may come from the issuer, underwriter, consultant, institution, etc.

The party requesting the rating should submit all necessary information and agrees to supply later or current information on request. We rely on the person submitting such information for its accuracy, completeness and susbtantiation. Standard & Poor's reserves the right to withdraw from any contract if it feels that proper and sufficient information is not being received.

We will maintain continuous rating surveillance on the issue for an indefinite period or until the next bond sale, at which time the contract may be renewed by mutual agreement.

S & P reserves the right to advise its own clients and subscribers of such rating, or to publish the same at any time, in its publications or otherwise.

It must be understood that in providing such rating S & P necessarily relies on the information then before it and not on any later information. Further, it must be understood that S & P cannot guarantee the accuracy or completeness of the information upon which the rating is based, and that such rating is subject to change or withdrawal at any time without notice. Parties to contract ratings should also be aware that S & P reserves the right to enter into any future contract rating relative to the same issue or debt.

Chairman PATMAN. We appreciate your testimony. We shall return to you for questioning after the other witnesses have had an opportunity to present their statements.

Next is Mr. Riehle, vice president of Moody's Investors Service.

STATEMENT OF ROBERT C. RIEHLE, VICE PRESIDENT, MOODY'S INVESTORS SERVICE

Mr. RIEHLE. Chairman Patman, Senator Proxmire, members of the Subcommittee on Economic Progress of the Joint Economic Commit-

tee, we are privileged to have this opportunity to participate in your hearings on municipal credit and the financing of municipal facilities. I am a vice president of Moody's Investors Service, Inc., and am in charge of the research, analysis, and reports by Moody's on corporate, government, and municipal bonds. I have worked in the municipal department of Moody's Investors Service for the last 15 years.

Needless to say, we at Moody's have followed the hearings before this committee with interest and are particularly grateful for the opportunity to appear before you, not only because of the importance of the problem presented, but because of some of the things which have been said about our service and ratings. I have also read the proposed bills, S. 3170 and H.R. 15991, which would be known as the "Municipal Capital Expansion Act of 1968." Certainly every responsible citizen is in accord with the purported purposes of such legislation. It is obviously important that all communities and States raise sufficient capital at the most economical rates to provide needed public facilities for their citizens. However, I do not believe that the proposed legislation is either necessary or desirable in achieving this goal.

I doubt that the interest rates presently paid by municipalities and States are so high that they cannot afford to finance needed public facilities; nor do I believe that the level of interest rates which they do pay is attributable to the "failings of the existent municipal securities rating system." For example, it is fallacious to charge that the present interest rates being paid by the city of New York are attributable to the rating which Moody's or the other investment advisory services assigned to its bonds. The fact is rather that the credit of New York City reflects the serious financial problems which it faces and is going to continue to face.

I shall not discuss the New York City problem, but I do want to point out that for years the financial community has given New York City bonds a lower market rating than the credit rating assigned by Moody's, and continues to do so.

However, since Mr. Goodman of New York City discussed Moody's rating of certin NewYork City bonds in detail in December 1967 before this subcommittee I would like to append to my written statement a detailed reply to Mr. Goodman. It is contained in the appendix D to my written statement.

I believe that an erroneous impression has been created at the hearings before this committee as to the function performed by Moody's and the other rating and investment advisory services. Interest costs to municipal borrowers are established by the financial community and investors. The persons we serve are highly knowledgeable underwriters, banks, professional, and institutional investors. These organizations have eminently qualified professionals on their own staffs who compare, evaluate, and make decisions on what bonds to purchase and at what price. A typical bank which underwrites municipal securities, for example, has a municipal department consisting of security analysts and investment advisers with years of experience in evaluating State and municipal bonds. Smaller banks throughout the country correspond with these banks. There is a constant flow of information between them and it is not all one way. For example, the bank in Sioux City can give information to the New York bank on the situation in its local area; it can furnish its own direct first-hand evalua-

tion of the securities issued in its locality. Similarly, underwriters have correspondingly large and knowledgeable staffs.

These institutions make their own decisions as to the bonds in which they will invest, what interest rates they will require, or what interest rates they will bid to municipalities on bonds offered at competitive sale. They have the task of evaluating the various securities available and making the decisions which ultimately determine the interest rate which will be paid by a particular municipality on a particular issue. When a State or municipality wishes to borrow through the sale of securities, it consults with potential underwriters for guidance as to the state of the market for such securities. The underwriters, in turn, may consult potential purchasers, such as banks, to see what the market reception will be. When the issue is put up for sale, the appropriate interest rate is discussed by the members of the underwriters' syndicate and an interest rate is arrived at which, in the judgment of the underwriters, will assure the success of the offering. A rating by an investment advisory service is only one of many factors considered.

The responsible financial officers of these banks often have a lifetime of experience in the field of municipal bonds. It is their duty to make their own evaluation of these securities based on their years of experience and the investment objectives of their clients. It does them disservice to suggest that they blindly follow ratings made by an investment advisory service.

One of the many sources of information used by the financial community in making an evaluation of securities is, of course, a service such as the one we provide at Moody's. However, these highly qualified professionals who have the responsibility for investing hundreds of millions of dollars know the type of information we collect, how we collect it, as well as the skills and qualifications of our staff. They know how we arrive at our ratings and what our ratings mean. They are under no illusions that our ratings or any other ratings in such a complex field have what one witness before this committee described as "Biblical authority." The processes of arriving at an investment decision is highly complicated as is the evaluation of the credit standing of an entity as complex as a city or municipality. The investment merits of particular bond issues are difficult to determine and will vary with the investment objectives of the institution. The ultimate decision must be made by the investor in light of his own investment objectives, and it must be made by him from many sources of information. Moody's is one of many sources.

Obviously, there will be borrowers who feel they should have a lower interest rate, just as there are underwriters who feel the borrower should pay a higher interest rate. These things work themselves out in the free marketplace of our financial community. There will always be some dissatisfaction by borrowers about the way the financial community evaluates their credit or the merits of a particular bond issue. The remedy is for them to present the facts as they see them. If the evaluation of the community does not change, then the borrower should attempt to improve the credit, not to eliminate the evaluation. If the process of free market evaluation is eliminated by Federal subsidies and grants, then one of the motivations for improving the financial condition of our cities will disappear.

Another serious problem of the proposed bills is that of substituting the judgment of a Federal Government agency for the judgment of

the financial community. Many persons feel that this will result in Federal superivsion of local fiscal policy and possibly in the involvement of the Federal Government in decisions as to which of several local public projects should be advanced. I understand that the Municipal Finance Officers Association has passed a resolution opposing the enactment of any such legislation.

Before reaching any conclusions as to the processes and problems involved in municipal financing, I urge the committee to hear the professionals—the banks, underwriters, and institutional investors who make the investment decisions, and ultimately, the markets.

Thank you, gentlemen, for granting me the privilege of appearing before this committee. I shall try to the best of my ability to answer any of your questions.

(The prepared statement of Mr. Riehle follows:)

PREPARED STATEMENT OF ROBERT C. RIEHLE

I am a Vice President of Moody's Investors Service, Inc. I am in charge of all of Moody's bond analysis—corporate, government, and municipal. Prior to this I was Director of Moody's Municipal Research and Services. I have been associated with Moody's Municipal Department for over fifteen years.

Moody's has conducted studies of municipal finance since 1913; it has evaluated State and municipal bonds for its subscribers since 1919. Throughout these years it has compiled information and consulted with State and local officials, investment bankers and financial advisors with reference to these securities.

Moody's ratings are designed to provide a broad-gauge indicator of independent professional opinion regarding the investment quality or safety of bonds. They represent the judgment of a group of experienced security analysts, evaluating the probable future performance of bonds over an interval assumed to include a possible business recession of some severity and length.[1]

In no sense is Moody's the sole source for evaluations of such securities; nor do Moody's appraisals dictate the rate of interest to be paid by an issuing body. Moody's sole function is to provide a service to banks, underwriters and other investors who, by their own independent appraisal and evaluation of such securities (based on information from many sources, of which Moody's is only one), create the market for, determine the price of such securities and determine the amount of interest to be paid.

When an issuing body desires to issue bonds, it consults an underwriter. The underwriter in turn contacts possible purchasers of such bonds. These purchasers indicate what interest rate they are willing to pay. They are highly knowledgeable institutions (such as banks and substantial private investors) who are intimely familiar with the field of State and municipal bonds and are well equipped to appraise the merits of particular issues and the suitability of such issues for their own investment objectives. They invest hundreds of millions of dollars annually. They do not and should not rely blindly on the ratings provided by services such as Moody's. These financial institutions have their own staffs of highly trained experts in this field who obtain information from many sources. While many of these experts use the advisory services provided by Moody's and others, they are under no misapprehension as to what Moody's does or does not do and thoroughly understand the significance of its ratings.

Under the present system the rate of interest paid by a community and the success of its bond issues are dependent upon the judgment of the financial com-

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[1] I do not believe that the ratings made by the investment advisory services have failed to reflect the rate of actual security defaults since World War II. While it is true that such defaults have been small in proportion to the approximately $114 billion of tax exempt indebtedness now outstanding, the defaults which have occurred during the post-World War II era of unprecedented prosperity have involved hundreds of millions of dollars of investors' money. In these situations investors have lost either principal, interest or both on their investments. In any event, however, our evaluation of securities today has to be based not on what has occurred in the last 20 prosperous years. We are required to evaluate in anticipation of what might happen in the next 20 years. It is a *non sequitur* to suggest that, merely because relatively few securities have defaulted in the recent prosperous era, securities will fare equally well in the years to come. Indeed, the number of defaults during the past 20 years has been surprisingly high considering the prosperity of the period.

munity of its credit, the financial merits of such issue[1] and the supply of money at the time of issue. The function performed by Moody's and the other services should be viewed in this perspective.

1. Volume of Credit Evaluations

Classes of debt in a minimum amount of $600,000 are eligible for a Moody's rating. An issuer which presently may be debt-free but planning to sell $600,000 in bonds may secure a Moody's rating in advance of bond sale. Moody's rates bonds of any size from as little as $25,000 provided the aggregate amount of debt outstanding sharing a common security following the sale is equivalent to $600,000.[2]

Moody's publishes financial data annually on the approximately 15,000 political subdivisions, each of which has an outstanding gross indebtedness of at least $400,000. This service covers issuers which may have several classes of debt outstanding, each in an amount of one or two hundred thousand dollars. Moody's currently rates 11,081 bond issues (many emanating from issuers with populations numbering barely a thousand). It has formulated investment opinions and studied operating data on an additional 1,803, for a total of 12,884. There is no need for rating many of the other unrated issues because these issues are privately placed either with the Department of Housing and Urban Development or institutional investors, such as insurance companies. Such investors receive the financial data and information which they require directly from the issuer and have no need for a service such as Moody's; furthermore, the financial information in connection with such transactions is not given to Moody's, but is kept confidential and is not made public.*

2. and 5. Procedures Followed in Evaluating Securities; the Dissemination of Bond Ratings and Opportunity to Discuss Evaluations

It has been suggested that Moody's methods for evaluating securities is shrouded in mystery. The contrary is true. We widely publicize the methods and rationale utilized in our rating studies. We do this through (a) questionnaires provided prospective borrowers, (b) numerous personal and telephone interviews with municipal officials, professional investors and underwriters, (c) lectures and published papers delivered to representatives of state and local borrowing units at their state, regional and national conferences, (d) articles contributed to trade publications, and (e) articles published in Moody's Bond Survey, an investment advisory and opinion service.

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[1] Moody's states in its manuals that the ratings "should be used in conjunction with the description and statistics appearing in Moody's Manuals. Reference should be made to these statements for information regarding the issuer."

[2] The fact that Moody's does not rate classes of debt under $600,000 does not impair the ability of small issuers to borrow at an equitable interest cost .The bonds of such bodies appeal to and are generally purchased by banking institutions and private investors located in their immediate area. These institutions and investors are well acquainted with the issuing body. Indeed, the banking institutions which purchase such securities are generally the depositories for the issuer. On the other hand, the lack of economic diversification and of professional municipal management of such issuers reduces investment appeal outside their immediate geographical area. This does not mean that such communities are required to pay such a high rate of interest that they are unable to afford to finance many needed public facilities; nor does it mean that if such communities were rated by a service such as Moody's they would pay a lesser rate of interest.

Small municipal borrowers may pay a slightly higher rate of interest than larger communities for a variety of reasons: a lack of economic strength and diversification; a lack of marketability; deficiencies in financial planning and reporting; federal and state preemption of sources of revenue which tend to grow with the economy at a far faster rate than those sources of revenue (*e.g., ad valorem* and utility taxes) left to the municipalities.

It also should be noted that there is an increasing tendency to meet the capital needs of small borrowers by combining them with other borrowers of similar size through incorporation with larger governmental units. Rural and semi-rural schools, for example, are administered and financed through centralized or merged districts; water and sewer needs are being financed through metropolitan authorities. Bonds of individual communities are being guaranteed by their respective states or counties.

Additionally, a number of states have established agencies which assist local subdivisions in the preparation and dissemination of presale information followed by annual financial statements. Some provide a consulting service to aid in the solution of individual communities' financial problems.

*No totals have been compiled of the number of reports on state governments and agencies and local public bodies. However, a count could be made from the specifics in the index to Moody's Governments and Municipals Manual. From this index one could also compute the proportion of reports relating to (1) general obligation bonds; (2) revenue bonds; and (3) special assessment bonds.

Usually, bonds are payable in the distant future. Hence, an issue's investment worth is gauged by the anticipated ability of its issuer to meet all debt service commitments on schedule, particularly during possible periods of depressed economic circumstances.

The factors which must be taken into account in judging a community's future ability to pay the interest and principal on its bonds cover the spectrum of economic, social, fiscal and financial data. We examine the stability of the economic base, the relative adequacy of the community's physical plant and municipal services in light of current and probable future near-term capital needs, the existing tax burden and the likely growth or decline of the credit base and the impact that each of these factors has on the others.

Our research, which probes many hundreds of factors, is conducted by a full-time staff of 40, supplemented by specialists in our Public Utility, Bank and Finance, Transportation and Industrial Departments.

Both data and judgments produced by Moody's are designed as one aid to professional investors who have other sources of information available to them and who independently formulate their own opinions, putting the validity of our findings to a continuing test. These professional investors include banks and underwriters which have highly qualified staffs of their own which independently obtain relevant information and make their own evaluations of such securities.[1] We encourage them to do so.

In addition, if a borrower believes that we have overlooked pertinent information or have evaluated information erroneously, we are always ready and anxious to discuss the situation with him. While there may be disagreement about our evaluation on occasion, there is no secret about the basis for it. If a bank or investment advisor evaluates the facts differently (as they on occasion do), they will act according to their own independent evaluation. Obviously, in a matter as complex as this, there may be differences of opinion even among professionals as to the credit worthiness of a given issuer. Further, credit worthiness is one of many factors involved in the evaluation of the appropriateness of a security for the particular investment objectives of a given portfolio.

Rating studies of new issues originate with the publication of the official notice of sale in the Daily Bond Buyer, the industry trade publication. The advertisement initiates a search of our files on the prospective issuer. Depending upon the amount of information in our file, a set of questionnaires tailored to the format of financial reporting in the issuer's respective state is dispatched immediately by air mail to the issuer, so that we may secure the data necessary to up-date our files, or, in the instance of a new issuer which is making its market debut, the more extensive information needed for our evaluation. Most prospective issuers are conscientious about compiling and forwarding data so that it reaches our researchers and analysts at least ten days in advance of sale time. (Sample questionnaires and worksheets are included in Appendix B to this statement.)

Our query extends from requests for audited financial statements to details of (1) the coming financing, (2) bond security features, (3) scheduled payout, (4) projected capital programming, (5) associated legal documents, (6) exhibits pertaining to community development, (7) planning and rate of growth, (8) an investigation of educational curriculum, (9) present and future adequacy of classroom capacity, (10) the level of teacher salaries, (11) the number of students matriculating to college, (12) the condition and capacity of utilities, their rate structure and services, (13) the sources and adequacy of the community's revenues, (14) the suffciency of reserve taxing powers, (15) details concerning the issuer's economic base, (16) the composition, strength, diversity and competitive position of local industry, (17) employment and many others. Finally, Moody's assesses a community's prospects in comparison with neighboring communities in its geographic and trade area.

Of course, in many instances we already have considerable information about a community in our files. Upon the receipt of financial, engineering and legal reports we extract the basic data, test it for accuracy and check it against our file of historical data to establish trends. This task is performed by a staff of

[1] Appendix A, hereto, contains a list of investment banking firms in the municipal bond business (the list being a copy of an appendix to the statement of Frank C. Carr given August 29, 1967, before the Subcommittee on Financial Institutions of the Committee on Banking and Currency of the United States Senate) and a list of underwriting banks (the list being a copy of an exhibit to the statement of Allen Morgan given August 30, 1967, before the same Committee).

twenty-five researchers who transfer the data to worksheet form for scrutiny and detailed evaluation by a staff of twelve full-time analysts. The individual analysts, each of whom is assigned approximately four states and their subdivisions as his area of specialization, performs such additional research on the issue as he deems necessary, evolving ratios and other statistical comparisons. The analyst frequently requests additional data from the issuer on points of investigation suggested by his study and visits with representatives of local management in our New York office, gaining insights into specific local problems which may have a bearing on bond security. In addition, periodic field trips are made by the analyst into his assigned territory.

Once the analyst is satisfied that he has secured sufficient information to make an evaluation and assign a rating, he consults with the analysts in Moody's Public Utility, Transportation, Bank and Finance and Industrial Departments about pertinent aspects of the issuer's economy or capital plant. He then submits his impressions and recommendations orally to the Rating Committee. The presentations to this Committee by the analysts are supported by the credit files and worksheets. The matter is discussed by the Committee and only after the entire Committee is satisfied that sufficient information has been assembled and presented does the Committee vote on the rating. The Committee may instruct the analyst to secure additional data or research new points. Although an agreement by two-thirds of the Committee is required to establish a rating, the Committee is usually unanimous in its view.

The rating is then disseminated to the issuer by telephone, along with an explanation of the rationale. Unless the issuer indicates that it disagrees with the evaluation, the rating is released immediately by telephone to all inquiring bidders and published in Moody's services. The rating rationale is also published in Moody's Bond Survey, which is a market service. Finally, ratings assigned to bond issues of $750,000 or more are published daily in the Daily Bond Buyer, an industry association publication.

In compiling our analyses of bonds, we rely upon the data furnished to us by municipalities, underwriters and others directly involved in the issuance of the new security. Our own library of financial data is probably the biggest in the country. Additional data obtained from government agencies, especially the Census Bureau, is invaluable.

It is fallacious to compute the amount of time spent on a single rating by dividing the number of ratings made in a given amount of time by the number of Moody's employees. Such a simplistic approach ignores the fact that the vast majority of our ratings do not require assembling information from scratch. In most cases we have already assembled a file on the issuer and our job merely consists of updating it.

Because we do our initial analyses in great depth, annual reviews conducted when fiscal year-end data are received can be accomplished relatively quickly with the accuracy and thoroughness which they deserve. Our researchers are trained to spot indicators which might signal any possible change in a community's circumstances, causing the credit file to be turned over to the analyst for review and further investigation.

It is our practice to spend as much time on a rating as we deem to be necessary. Our method of producing ratings is not mystical. I have described some of the techniques and these methods are well known to the bulk of our subscribers who are, in the main, very knowledgeable and sophisticated professional investors in positions to evaluate and make their own appraisals.

Ratings are reviewed at the request of the issuer, underwriter or investor; they are also reviewed whenever additional debt is issued. In any event, all ratings receive at least an annual review. Each of our subscribers may at any time request that we furnish him with the facts underlying a particular rating and we have always been happy to supply this information and discuss our analysis of the issue.

Every rated bond is supported by published financial data in Moody's Municipal Government Manual, which is updated in biweekly supplements. As stated above, our manuals specifically refer the reader to these manuals for more detailed information. Additional financial data and associated investment opinions are published weekly in Moody's Bond Survey covering all rated and selected unrated issues scheduled for sale in the coming ten days. A few issues are sold without a rating because of the issuer's failure to supply all of the information requisite to the formulation of a rating judgment which we have requested.

3. Sources of Information

PRIMARY SOURCES

The primary sources of information for Moody's credit investigations are official annual financial reports and budgets published by the respective governmental entities, supplemented by (1) interim reports provided by the respective borrower on Moody's own reporting forms, (2) prospectus materials prepared by a borrower in anticipation of a bond sale, (3) engineering reports prepared for the borrower, and (4) legal documents such as bond ordinances, resolutions and contracts governing the issuance of bonds and regulating the operations of a specific municipal enterprise.

Moody's subscribes to newspapers published in the nation's population centers. Our clipping service keeps us abreast of local developments and frequently spots circumstances or events about which our field staff is instructed to obtain more information.

SECONDARY SOURCES

Secondary sources of information include: state constitutions and statutes, local charters, state-published reports on state equalized valuations, local tax rates and associated operating data compiled by State agencies from local government reports. Economic and demographic materials are obtained from the U.S. Bureau of the Census, Departments of Agriculture, Labor and Interior, the Corps of Engineers, the Federal Power Commission, universities, foundations, bureaus of business research and other State and local business organizations.

Sources are evaluated carefully to ascertain their quality and objectivity. In addition, Moody's senior analysts make periodic personal inspection tours of the geographical areas in which they specialize, apprising themselves of local problems, inspecting physical plants and making first-hand appraisals of management and economic resources. Such trips, which are scheduled monthly, are also effective in establishing liaisons to insure a continuing flow of financial and economic data to facilitate annual credit reviews. In the first six months of this year, our analysts have toured nearly half the States—twenty-two, to be exact.[1]

At our analytical headquarters in New York the door is always open to municipal officials who care to discuss a forthcoming bond issue or who merely wish to keep us abreast of changing circumstances in their communities. Frequently, they seek advice regarding the marketing of bond issues. In a typical week, we are visited by representatives of about 15 governmental units. We have further contact with these and other municipal officials at state, regional and national conferences.

4. The Organizational Structure of Moody's Municipal Department

Moody's has a full-time staff of forty who assemble information, do research and produce municipal ratings: twenty-five of them compile data and perform research, three are librarians, and twelve are full-time analysts.

All of the analysts are college graduates. Two have graduated from law school and one is a member of the Bars of the State of New York and Washington, D.C. Six are senior analysts with an average of ten years with Moody's and many years' prior experience as analysts and buyers for municipal bond underwriters before joining Moody's.

During the four years ending May 1, 1968, we have had no employee turn over. Our salaries (ranging from approximately $8,500 to $20,000 [excluding department heads]) are competitive with those earned by security analysts employed by institutional investors and brokerage houses.

Supplementing our full-time staff of municipal analysts are the analysts staffing Moody's Public Utility, Transportation and Industrial Departments and our staff economists. These specialists keep our Municipal Department apprised of local economic conditions in the nation's trade and commercial centers and provide particularized data and opinions on water, sewer, electric, gas, transportation and port utilities as well as the health of industries whose revenues provide support for municipal bonds.

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[1] The New England States, South Carolina, Florida, Ohio, Missouri, Louisiana, Arizona, Nevada, New York, New Jersey, Colorado, California, Washington, Alaska, Alabama, Hawaii and Texas.

6 AND 7. FURNISHING OF DATA AND USE OF ANALYST'S TIME

Under the present system we usually receive financial data from a bond issuer approximately two weeks before the announced date of the bond sale. In addition to this, of course, Moody's has on file all of the information which it has compiled over the years on the municipality. This allows sufficient time for us to prepare our rating.

We have a staff of researchers whose job it is to collect and assemble this data for our analysts, permitting the latter to spend their full time studying and evaluating the pertinent material assembled and analyzing the particular situation. As to the proportions of time spent by our staff, see the response to inquiry 2, *supra.*

We are constantly considering means to eliminate time-consuming routine research and data manipulation. We have investigated and are continuing to investigate the possible use of computers in simplifying our work. While computers cannot replace experienced analysts, we have been using them to aid our researchers and statisticians in the preparation of the material from which the analyst makes his evaluation. In the corporate area Moody's has pioneered in the development of sophisticated computer-based analytical techniques. This is feasible to the extent that there are relatively uniform accounting practices. Since it was begun in 1956, this project has been under continuing improvement and expansion, producing operating histories and the basis for industry-by-industry comparisons, using ratios and indicators indispensible to the industrial security analyst.

Adoption of uniform accounting practices by a significant number of municipal issuers will hasten the broader utilization of computer techniques in the municipal bond field and relieve the staff of many time-consuming routine procedures.

COMMENTS ON PENDING LEGISLATION

I have examined S. 3170 and H. 15991, to be known as the "Municipal Capital Market Expansion Act of 1968", and wish to make the following comments.

These Bills propose creating a federal corporation which would issue reports concerning the fiscal and financial condition of communities, guanantee the principal and interest of securities issued by municipalities who choose to make their bonds taxable (providing certain statutory fiscal and financial standards are met) and rebate one-third of the interest cost of such bonds to these communities.

The effect of such legislation is problematical. Although the effect of eliminating the tax-exempt status for municipal bonds and rebating a portion of the borrower's interest cost has been discussed by many and has been the subject of a well attended seminar held by and reported on by The Brookings Institution, I know of no consensus among those who have studied the question as to its probable effect in general or in exact interest cost terms. It has been argued that increased tax revenues generated by the taxation of hitherto tax-exempts would more than offset the cost to the federal government of the rebates. However, this is problematical. The additional cost of making good on the proposed guarantees is even more difficult to estimate, since a mere projection of the default rate for the last 20 or 30 years would not begin to take into consideration the cost, should there be a major recession or depression. Federal guarantees might also encourage borrowing beyond the limits imposed by the necessity of meeting investment standards in a competitive market.

It is clear, however, that the enactment of such legislation would result in a drastic change in the bond market. Assuming that most municipalities would choose to issue taxable securities guaranteed by the federal government, these bonds would be added immediately to the supply of all other existing and future issued taxable corporate and federal securities, perhaps resulting in a glut in that market. This would probably lead to an increase in the interest cost for all who are borrowing through the vehicle of taxable bonds. While some of those investors who now purchase tax-exempt securities would shift their investments to taxables, it seems unlikely that all of them would. A number of those who presently seek tax-free income and who no longer would have it readily available might choose to invest in equities instead, in hopes that capital gains and their low deduction would compensate them for the loss of their tax benefits.

Another effect of such legislation would be to replace the judgment of the financial community with that of a federal agency. Since securities would be guarantede, there would be less incentive for local communities to exercise fiscal

control and efficiency.[1] Today the reward for such economies lies in a lower interest rate; the penalty for fiscal excesses is a higher rate. In addition, the intervention of a federal agency may well result in federal participation in the determination of what local improvements should be made. It may also bring about a greater involvment of the federal government in local fiscal affairs, since the federal agency will have to make a decision as to whether to guarantee the obligations of the local unit. In doing so, it will apply standards evolved by that agency which may or may not be responsive to the true needs or financial condition of the municipality involved.

The need for such legislation is highly debatable. A proposed finding incorporated in S. 3170 and H. 15991 states that municipalities and states now are required to pay such a high rate of interest that they cannot afford to finance many needed public facilities. It states that this is due in part to the alleged "failings of the existent municipal securities rating system which discriminates against most of the Nation's smaller communities and many of the larger cities and which fails to reflect the infinitesimally low rate of actual security defaults since World War II".

The present interest rates are not determined by firms such as Moody's. The rates are determined by responsible and knowledgeable members of the financial community based on such factors as their evaluation of the issuer's credit history, size and prominence, the relative size of the issue, its call feature, maturity schedule and exposure to or exemption from state and local taxation, and, as always, the demand for money in the market place at a particular time.

I do not believe that the present system "discriminates" unfairly. It does, however, differentiate among various issuers in terms of credit worthiness. Interest rates reflect, in part, these judgments. Interest rates presently are high throughout the country. Municipal borrowing costs are no higher today relative to the taxable bond market than they have been at any other time in recent history.[2] The high cost of borrowing is not caused by credit ratings given by an agency such as Moody's. The high cost of borrowing is due to general economic conditions and especially to the currently excessive rate of price inflation. The comparatively high cost in particular cases is due to the issuer's credit condition, the investment merits of issues as evaluated by the investment community and the portfolio requirements of the interested investors.

In my view, there is serious question of whether there is a real need for such legislation. I am certain, though, that the information assembled by this Committee will be of great aid to the Congress in determining the necessity for such legislation.

Aside from the question of the necessity for such legislation, I greatly fear that, if enacted, the proposed Bills would have a serious and detrimental effect on municipal financial management and the allocation of capital.

No community likes to find itself in the position of having a marginal fiscal condition and having to pay a higher rate of interest on its borrowing than does its fiscally sound neighbor. For whatever reason the community may find itself in fiscal or financial trouble, it is almost certain that one of the consequences will be a higher cost of borrowing in the future. The threat of having to pay higher rates is an incentive for a community to keep its financial house in order. If municipals were federally guaranteed, they would all become Aaa securities and, with minor exceptions, would sell for essentially the same interest cost. While the proposed federal corporation would be enjoined from guaranteeing obligations which appeared to have substantial risks of default, presumably the vast majority of municipal corporations would meet the necessary standards.

There is today about a ¾% to 1% spread between the interest cost to communities with the very best financial factors and the interest cost to those whose bonds, while not speculative, are of the lowest investment grade. The proposed guarantees would eliminate this spread and, consequently, eliminate one of the greatest incentives city managers have for sound fiscal policy.

Once the Federal Government guarantees municipal debt, it will have a continuing financial interest in overseeing the capital expenditures, revenues and taxes of the particular community so long as the debt is outstanding. Such a financial stake in a community would most likely lead to ever-increasing federal supervision and, if necessary, regulation of local government.

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[1] This is particularly so because it is not contemplated that the federal agency will make any judgment other than whether the particular issue should be guaranteed or not. It will not make the finer distinctions between issues that are presently made by the financial community.

[2] See Appendix C hereto, showing the spread between municipals and corporates and Treasuries.

In a capitalist free enterprise system, interest is an important mechanism of allocating capital among competing uses. No better system for such allocation has been devised. The proposed legislation, through the mechanism of interest and principal guarantees, would eliminate the gradations of interest cost which presently perform this function. Considering the lack of information which exists, the unproven need for any change in the present system of municipal borrowing and the fiscal irresponsibility which might be encouraged, there is serious question whether the proposed Bills should be enacted.

APPENDIX A

INVESTMENT BANKING FIRMS IN THE MUNICIPAL BOND BUSINESS IN THE UNITED STATES AS LISTED IN THE BOND BUYER DIRECTORY, 1966 MID-YEAR EDITION (NOT INCLUDING COMMERCIAL BANKS) LIST DOES NOT INCLUDE BRANCH OFFICES

ALABAMA

Andresen & Co., Inc.
Brodnax & Knight, Inc.
First Alabama Securities, Inc.
Hendrix Mohr & Head, Inc.
Marx & Co., Hugo
Perry & Co., Berney
Pierce, Wulbern, Murphey, Inc.
Shannon & Co., J. H.
Shropshire, Frazer & Co.
Steiner, Rouse & Co.
Sterne, Agee & Leach, Inc.
Thornton, Farish & Gauntt, Inc.
Watkins, Morrow & Co.
Wood & Company, George M.

ARIZONA

Refsnes, Ely, Beck & Co., Inc.
Southwest Municipal Bond, Inc.
Western Municipals, Inc.
Woodward & Zuber
Young, Smith & Peacock, Inc.

ARKANSAS

Delta Securities, Inc.
Hill, Crawford & Landford, Inc.
Powell & Satterfield, Inc.
Raney & Sons, T. J.
Satterfield & Co., Inc., M. A.
Smith & Co., Harrow
Stephens, Inc.
Sullivan Co., Dabbs Inc.
Villareal & Co., Inc., E. L.
Womeldorff & Lindsey

CALIFORNIA

Barth & Co., J.
Batemen Eichler Hill Richards, Inc.
Brush, Slocumb & Co., Inc.
Cavalier & Otto
Cincotta Inc.
Crowell, Weeden & Co., Inc.
First California Co.
Gross & Co., Inc.
Hanauer & Co., J. B.
Hannaford & Talbot
Lawson, Williams & Stern, Inc.

CALIFORNIA—continued

Lundborg & Co., Irving
Morgan, Olmstead & Allen
Mouiton & Co., R. H.
Overton & Co., J. A.
Rafferty & Co.
Schwabaaher & Co.
Shuman, Agnew & Co
Stern, Frank, Meyer & Fox, Inc.
Stone & Youngberg
Tannen, Wilslow & Co., Inc.
Taylor & Co.
Universal Securities Corp., The
Wagenseller & Durst, Inc.
Weeden & Co.
White & Co., C. N.
Witter & Co., Dean
Wood, Struthers & Winthrop

COLORADO

Boettcher & Co.
Bosworth, Sullivan & Co., Inc.
Coughlin & Co., Inc.
Hanifen, Imhoff & Samford, Inc.
Kirchner & Co.
Mitton, Investments, Robert L.
Mullen Investment Co., J. K.
Shirley & Co., H. Jackson
Stone, Altman & Co., Inc.

CONNECTICUT

Conning & Co.
Cooley & Co.
Putman, Coffin & Burr
Scranton & Co., Chas. W.
Young & Co., Lincoln R.

DELAWARE

Henry & Co., Allan J.
Laird & Co., Corp.
Laird, Bissell & Meeds, Inc.

DISTRICT OF COLUMBIA

Auchincloss, Parker & Redpath
Ferris & Co.
Folger, Noland, Fleming & Co., Inc.
Johnston, Lemon & Co.
Jones, Kreeger & Co.

INVESTMENT BANKING FIRMS IN THE MUNICIPAL BOND BUSINESS IN THE UNITED STATES AS LISTED IN THE BOND BUYER DIRECTORY, 1966 MID-YEAR EDITION (NOT INCLUDING COMMERCIAL BANKS) LIST DOES NOT INCLUDE BRANCH OFFICES—Continued

FLORIDA

Arries & Co., D. E.
Carter, Walker & Co., Inc.
Cates, W. H.
Childress & Co.
Cook & Co., Thomas M.
Dooly, Gerrish & Co., Inc.
Ewing & Co., Allen C.
Hough & Co., William R.
Leedy, Wheeler & Alleman, Inc.
Magurno & Co., James F.
Meredith (W. J.) & Co., Inc.
Morrison (A. B.) & Co., Inc.
Morrissey & Co., Inc.
O'Rourke, Inc., T. Nelson
Palm Beach Investment Co., Inc.
Phelps Co., The
Pierce, Wilbern, Murphey, Inc.
Pots & Shepard, Inc.
Sullivan, Nelson & Goss, Inc.

GEORGIA

Brooke (Byron) & Co.
Courts & Co.
Henderson, Few & Co.
Hilsman & Co., Inc., J. H.
Johnson, Lane, Space, Smith, Corp, The
Jolley & Co., Lex
Kable & Co.
Norris & Hirshberg, Inc.
Robinson-Humphrey Co., Inc. The
Traywick & Co., Inc., Howard C.
Varnedoc, Chisholm & Co., Inc.
Williamson & Co., C. J.
Wyatt, Neal & Waggoner

ILLINOIS

Bacon, Whipple & Co.
Barcus, Kindred & Co.
Becker & Co. A. G. Inc.
Benjamin and Lang, Inc.
Blair & Co., Allan
Blair (William) & Co.
Blunt Ellis & Simmons
Bohlander & Co., Inc., C. E.
Brophy & Co., F. J.
Carlton & Co., F. A.
Channer Newman Securities Co.
Chicago Corp., The
Collins & Co., Julien
Columbian Securities, Inc.
Douglas Securities, Inc.
First Midstate, Inc.
First Public Bond Co.
Halsey, Stuart & Co., Inc.
Howe, Barnes & Co.
Hutchinson, Shockey, Erley & Co.
Illinois Co., Ins., The
Johnson & Co., Joseph M.
Lewis & Co., Benjamin

ILLINOIS—continued

McCormick & Co.
McDougal and Condon, Inc.
McMaster, Hutchinson & Co.
Mesirow & Co.
Midwest Securities Co.
Mitchell, Hutchins & Co., Inc.
Mullaney, Wells & Co.
Municipal Bond Corp.
Negley, Jens & Rowe
Nuveen & Co., John
Rodman & Renshaw
Scott & Kegley, Inc.
Speer & Sons Co., H. C.
Vick & Co., M. B.
Vick (Robert) & McNaney Co., Inc.
Wallace & Co., Robert K.
Wilson & Co., Harry J.

INDIANA

City Securities Corp.
Morrissey & Co., O. W.
Raffensperger, Hughes & Co., Inc.
Slade & McLeish
Wildman, Neal & DeBolt, Inc.

IOWA

Becker & Cownie, Inc.
Beh Co., Carleton D.
Beyer-Rueffel & Co.
Conway Brothers, First of Iowa Corp.
Crabbe & Co., Thomas L.
Morrissey & Co.
Phillips, Blair A.
Quail & Co.
Shaw, McDermott & Co.
Vieth, Duncan & Wood, Inc.
White-Phillips Co., Inc., The

KANSAS

Beecroft, Cole & Co.
Columbia Securities Corp., The
Davidson Vink-Sadler, Inc.
First Securities Co. of Kansas, Inc.
Estes & Co., Inc.
Mid Continent Securities Co., Inc.
Milburn, Cochran & Co., Inc.
Ranson & Co., Inc.
Seltsam Hanni & Co., Inc.
Small-Lamer Co., Inc., The

KENTUCKY

Almstedt Bros.
Dupree & Co., F. L.
Graham-Conway Co.
Hilliard, J. J. B., W. L. Lyons
Kentucky Co., The
Newell, D. P.
Russell, Long & Co.
Security & Bond Co., Inc.

INVESTMENT BANKING FIRMS IN THE MUNICIPAL BOND BUSINESS IN THE UNITED STATES AS LISTED IN THE BOND BUYER DIRECTORY, 1966 MID-YEAR EDITION (NOT INCLUDING COMMERCIAL BANKS) LIST DOES NOT INCLUDE BRANCH OFFICES—Continued

LOUISIANA

Abroms & Co., Inc.
Arnold & Derbes, Inc.
Barrow, Leary & Co.
Crane Investment Co., Inc.
Dinkins & Co., Ladd
Dorsey & Co., Inc.
Ducournau & Kees
Hattier & Sanford
Howard, Weil, Labouisse, Friedrichs & Co.
Kohlmeyer & Co.
Newman, Brown & Co., Inc.
Rives, Felix M.
Scharff & Jones, Inc.
Smith-Wood Co., Inc., A. M.
Weil Investment Co.

MAINE

Payson & Co., H. M.
Pierce, White & Drummond, Inc.

MARYLAND

Baker, Watts & Co.
Brown & Sons, Alex.
Garrett & Sons, Inc., Robert
Legg & Co., John C.
Stein Bros. & Boyce, Inc.

MASSACHUSETTS

Alcock & Co., T. R.
Buck & Co., Richard J.
Davis & Co., Donald
Donohue & Sullivan
Draper, Sears & Co.
Estabrook & Co.
Hanrahan & Co., Inc.
Harkness & Hill, Inc.
Kennedy & Co., F. Brittain
Lamb & Co., Inc.
Loker, Sparrow & Co.
Lyons, Hannahs & Lee, Inc.
Marshall, W. L., Jr.
Moseley & Co., F. S.
Paine, Webber, Jackson & Curtis
Preston, Moss & Co.
Shelvey & Co.
Townsend, Dabney & Tyson
Tyler & Co., Inc.

MICHIGAN

Donovan, Gilbert & Co.
First of Michigan Corp.
Kenower, MacArthur & Co.
Manley, Bennett, McDonald & Co.
Martin & Co.
Parcells & Co., Charles A.
Sattley & Co., Inc., H. V.
Shannon & Co.
Watling, Lerhen & Co.

MINNESOTA

Allison-Williams Co.
Dain & Co., Inc., J. M.
Ebin, Robertson & Co., Inc.
Ehlers-Mann & Associates, Inc., T. G.
Evansen & Associates, Inc., T. G.
Gates & Co., Stanley
Juran & Moody, Inc.
Kalman & Co., Inc.
Miller and Schroeder, Inc.
Piper, Jaffray & Hopwood
Prescott & Co., E. J.
Rice & Co., Inc., Irvin J.
Shaughnessy & Co., Inc.
Springsted, Inc.
Tarras & Co., A. C.
Woodward-Elwood & Co.
Woolard & Co.

MISSISSIPPI

Allen & Co.
Alvis & Co.
Cody & Co., Inc.
Galtney & Co., Wm. F.
Gates. Carter & Co.
Jones Co., Hamp
Kroeze McLarty & Duddleston
Lewis & Co.
Love Co., J. S.
Newton & Co.
Nunnery & Co., John R.
Southern Bond Co.
Speed Co., Leland

MISSOURI

Audsley & Co., Harold D.
Bankers Bond & Securities Co., Inc.
Baum & Co., George K.
Dempsey-Tegeler & Co., Inc.
Edwards & Sons, A. G.
Estep, Shaffer & Plack, Inc.
Glynn & Co., J. A.
Goffe-Carkener-Blackford Securities Corp.
Goodall & Co.
Harvey-Klein & Co., Inc.
Heitner Corp., The
Jones & Co., Edward D.
McArthur, Charles E.
McCourtney-Breckenridge & Co.
McCutcheon and Co., Inc., John D.
McLiney & Co.
Newhard, Cook & Co.
Peet & Co., H. O.
Perry, Adams & Lewis, Inc.
Prescott, Wright, Snider Co.
Reinholdt & Gardner
Simon & Co., I. M.
Smith, Moore & Co.
Stepp Investments, Inc., A. F.

Investment Banking Firms in the Municipal Bond Business in the United States as Listed in the Bond Buyer Directory, 1966 Mid-Year Edition (Not Including Commercial Banks) List Does Not Include Branch Offices—Continued

MISSOURI—continued

Stern Brothers & Co.
Stifel, Nicolaus & Co., Inc.
Stix & Co.
Walckerle & Co., Inc., H. E.
Walker & Co., G. H.
Yates, Heitner & Woods
Zahner & Co.

NEBRASKA

Burns, Potter & Co.
Dinsmore, Eugene C.
Douglas & Co., Inc., John
First Nebraska Securities Corp.
Kirkpatrick, Pettis, Smith, Polian, Inc.
Rahel & Co., J. Cliff
Schwester Company, Robert E.
Van Horne Investments, Inc.

NEW HAMPSHIRE

Townsend, Dabney & Tyson

NEW JERSEY

Adams & Hinckley
Carroll & Co., Lee W.
Cole & Co., F. R.
Ewing & Co.
Gardner & Co., W. A.
Hanauer Securities Corp.
Hanauer, Stern & Co.
Knoller, David N.
McKelvey & Co., George
Moran & Co., J. V.
Outwater & Wells
Ross & Co., J. R.
Ryan & Co., John J.
Schaub, Inc., Harry P.

NEW MEXICO

Quinn & Co.

NEW YORK

Adams, McEntee & Co., Inc.
Adams, Sloan & Co., Inc.
Alcock & Co., Inc., J. R.
Allen & Co.
American Securities Corp.
Andrews & Co., Inc., James A.
Andrus, Inc., Malon S.
Ashplant & Co., F. B.
Auchincloss, Parker & Redpath
Bache & Co., Inc.
Bacon, Stevenson & Co.
Baker, Weeks & Co.
Barr Bros. & Co.
Bear, Stearns & Co.
Blair & Co., Inc.
Blyth & Co., Inc.

NEW YORK—continued

Boenning & Co.
Boland, Satlin, Gordon & Sautter
Bonbright & Co., George D. B.
Bramhall, Falion & Co., Inc.
Britton & Co., W. R.
Brown Brothers Harriman & Co.
Byrd Brothers
Byrd Brothers, King
Carter, Walker & Co., Inc.
Clark, Dodge & Co., Inc.
Cutter & Dixon
Cutter, Bennett & Co., Inc.
Davis & Co., Shelby Cullom
de Barry Co., Marquette
DeGolyer Co., Inc., John J.
Dick & Merle-Smith
Dominick & Dominick
Dominion Securities Corp., The
Doolittle & Co.
Downs & Co., Harry
Drake & Co.
Drexel Harriman Ripley Inc.
Dreyfus Corp.
duPont & Co., Francies I.
Eastman Dillon, Union Securities & Co.
Ehlenberger Co., Arthur
Eldredge & Co., Inc.
Ellwood & Co., R. W.
Ernst & Co.
Evans & Co., Inc.
Fabricand & Co.
Fahnestock & Co.
First Boston Corp., The
Freeman & Co.
Gibbons & Co., Geo. B.
Glickenhaus & Co.
Glore Forgan, William R. Stants, Inc.
Goldman, Sachs & Co.
Goodbody & Co.
Gregory & Sons
Haas & Co., G. C.
Halle & Stieglitz
Hallgarten & Co.
Hamilton & Co., Geo. F.
Hargrave & Hopkins, Inc.
Harris & Sons, Inc., Henry
Harris, Upham & Co.
Hayden, Stone & Co., Inc.
Hentz & Co., H.
Herzig & McKenna
Hibberd, William W.
Hill (Malvern) & Co., Inc.
Hirsch & Co.
Hornblower & Weeks-Hemphill, Noyes
Hornbostel & Co.
Houlahan & McCarthy
Hourwich & Co.
Hutton & Co., Inc., E. F.
Hutton & Co., W. E.
Kean, Taylor & Co.
Kelly & Co., Inc., A. P.

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NEW YORK—continued

Kenny Co., J. J.
Kidder, Peabody & Co.
King & Co., Charles
King, Quirk & Co., Inc.
Kormendi & Co., Inc.
Krieger & Co., Robert E.
Kugel, Stone & Co., Inc.
Kuhn, Loeb & Co.
Ladenburg, Thalmann & Co.
Laidlaw & Co.
Langley & Co., W. C.
Lazard Freres & Co.
Lebenthal & Co., Inc.
Lee Higginson Corp.
Lehman Bros.
Loeb, Rhoades & Co., Carl M.
Lunt & Co., S. D.
Mabon, Nugent & Co.
Mackey, Dunn & Co., Inc.
Mahoney, Inc., Paul J.
McLeod, Young, Weir, Inc.
Merrill Lynch, Pierce, Fenner & Smith
Model, Roland & Co.
Morris & Co., David
Morris & Co., William
Morton & Co., Inc., W. H.
Newburger, Loeb & Co.
New York Hanseatic Corp.
Notine & Co., Inc.
Paribas Corp.
Park, Ryan, Inc.
Pincus & Co., D. A.
Plohn & Co., Charles
Pollock & Co., Inc., Wm. E.
Pressprich & Co., R. W.
Purcell & Co.
Quincey & Co., Chas. E.
Racasi, Inc., G. W.
Rand & Co., Inc.
Rand & Foster, Inc.
Reynold & Co.
Roosevelt & Cross, Inc.
Rothschild & Co., L. F.
Sage, Rutty & Co., Inc.
Salomon Bros. & Hutzler
Scheinman, Hochstim & Trotta, Inc.
Schwamm & Co.
Scudder & German
Shearson, Hammill & Co.
Shields & Co.
Sims & Co., Inc., Herbert J.
Smith, Barney & Co., Inc.
Smithers & Co., F. S.
Starrett, Smith Co.
State Street Securities Corp.
Stern, Lauer & Co.
Stilz Co., F. W.
Stoever, Glass & Co., Inc.
Stone & Webster Securities Corp.
Sutro Bros. & Co.
Swiss American Corp.

NEW YORK—continued

Talmage & Co.
Theriot & Co.
Thomson & McKinnon
Tilney & Co.
Tobin & Co., Inc.
Tollner & Bean, Inc.
Topping & Co., Inc.
Trask (Spencer) & Co.
Trent & Co., Peter C.
Tripp & Co., Inc.
Tucker, Anthony & R. L. Day
Tuller & Zucker
Walston & Co., Inc.
Weigold & Co., Inc., Chas. E.
Wells & Christensen, Inc.
Wertheim & Co.
White (R. D.) & Co.
White, Weld & Co.
Winslow, Cohn & Stetson, Inc.
Wood, Gundy & Co., Inc.
Wood, Struthers & Winthrop

NORTH CAROLINA

Carolina Securities Corp.
Dickson & Company, Inc., R. S.
Eastern Bond and Mortgage Co.
Ferebee & Co.
First Securities Corp.
Hardin & Co., Inc., E. L.
Interstate Securities Corp.
Lewis & Co., McDaniel
McCarley & Co., Inc.
Peeler & Co., Inc., J. Lee
Powell, Kistler & Co.
Selected Investments
Southern Investment Co., Inc.
Vance Securities Corp.

NORTH DAKOTA

Mueller, Harold E.

OHIO

Assel Co., J. H.
Aub & Co., A. E.
Ball, Burge & Kraus
Baxter & Co.
Berman, Selonick & Co.
Bohmer & Co., Allan
Cincinnati Municipal Bond Corp., The
Clancey & Co., W. P.
Conners & Co., Robert L.
Davider & Co., R. H.
Doll & Ipshording, Inc.
Eustis & Co., Inc.
Fahey, Clark & Co.
Field, Richards & Co.
Fox, Reusch & Co., Inc.
Fulton, Reid & Co., Inc.

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OHIO—continued

Ginther & Co.
Gradison & Co., W. D.
Harrison & Co.
Hayden, Miller & Co.
Hill & Co.
Hinsch & Co., Inc., Charles A.
Hoetinghoff & Co., Inc., L. W.
Howes & Co., Richard G.
Hutton & Co., W. E.
Kurtz & Co., W. F.
Magnus & Co.
McCloy & Co., Inc., C. J.
McDonald & Co.
Merrill, Turben & Co., Inc.
Middendorf & Co.
Musekamp & Co., G. H.
Ohio Co., The
Pohl & Co., Inc.
Prescott & Co.
Roose, Wade & Co.
Ryan, Sutherland & Co.
Saunders, Stiver & Co.
Schwinn & Co., L. B.
Seasongood & Mayer
Sweeney, Cartwright & Co.
Walter, Woody & Heimerdinger
Weil, Roth & Irving Co., The
White & Co., J. A.

OKLAHOMA

Audsley Investment Co.
Canfield & Co.
Davis, Evan L.
Edwards, Inc., R. J.
Honnold & Co.
Oppenheim & Co., Inc., Leo

OREGON

Camp & Co.
Jones Co., June S.

PENNSYLVANIA

Arthurs Lestrange & Co.
Bioren & Co.
Blaine & Co., Inc.
Boenning & Co.
Butcher & Sherrerd
Cannon & Co., Inc.
Carroll & Sons, T. J.
Collings & Co., Inc., C. C.
Cunningham, Schmertz & Co., Inc.
DeHaven & Townsend, Crouter & Bodine
Dolphin & Bradbury
Dougherty & Co., A. Webster
Elkins, Morris, Stokes & Co.
Glover & MacGregor, Inc.
Hallowell, Sulzberger, Jenks & Co.
Harrison & Co.

PENNSYLVANIA—continued

Hess, Grant & Remington, Inc.
Hope & Co., J. S.
Hulme, Applegate & Humphrey, Inc.
Janney, Battles & E. W. Clark, Inc.
Kay, Richards & Co.
Laidlaw & Co.
Masten & Co., A. E.
McKee & Co., Inc., C. S.
McKelvey & Co.
Moore, Leonard & Lynch, Inc.
Newburger & Co.
Peelor & Co., Charles G.
Pennington, Colket & Co.
Poole & Co.
Ramblo, Close and Kerner, Inc.
Robinson & Co., Inc.
Schaffer, Necker & Co.
Schmidt, Roberts & Parke
Simpson, Emery & Co., Inc.
Singer, Deane & Scribner
Sparks & Co., J. W.
Stokes & Co., Walter
Suplee, Yeatman, Mosley Co., Inc.
Thomas & Co.
Wagner & Co., Inc.
Whittaker & Co., Robert L.
Woodcock, Moyer, Fricke & French, Inc.
Yarnell, Biddle & Co.
York & Co., Inc., Warren W.

SOUTH CAROLINA

Crawford Co., Inc., G. H.
Dargan & Co.
Furman Co., Inc., Alester G.
Hamilton & Co.
Norris, Edgar M. & Co.
Pringle & Co., E. H.
Smith & Co., Inc., Frank S.

SOUTH DAKOTA

Gefke & Co.

TENNESSEE

Bailey & Co., Lucien L.
Bass & Co., Jack M.
Bensdorf & Co., Herman
Bradford & Co., J. C.
Bradley & Co., Inc.
Bullington-Schas & Co.
Cherokee Securities Co., The
Cumberland Securities Corp.
Davidson & Co., Inc.
Estes & Co., Inc., W. N.
Equitable Securities Corp.
First U.S. Corp.
Hart & Co., Inc., A. S.
Hawes & Co., Inc., Fisher
Henderson, Few & Co.

INVESTMENT BANKING FIRMS IN THE MUNICIPAL BOND BUSINESS IN THE UNITED STATES AS LISTED IN THE BOND BUYER DIRECTORY, 1966 MID-YEAR EDITION (NOT INCLUDING COMMERCIAL BANKS) LIST DOES NOT INCLUDE BRANCH OFFICES—Continued

TENNESSEE—continued

Leftwich, Ross & Crisler
Little & Co. C. H.
Mid-South Securities Co.
Saunders & Co., Inc., M. A.
Wood & Co., J. Osborn

TEXAS

Allison & Co., Inc., M. E.
Central Investment Co. of Texas
Columbian Securities Corp. of Texas
Dittmar & Co., Inc.
Dunbar & Co., Ltd., R. K.
Emerson & Co.
Eppler, Guerin & Turner, Inc.
First Southwest Co.
Fridley & Frederking
Hamilton Securities Co.
Hugh Bass & Co., Inc.
James & Co., Judson S.
Lentz, Newton & Co.
Levy & Co.
McClung & Knickerbocker, Inc.
McKinney, Rose & Co., Inc.
Miles, C. O.
Morroney, Beissner & Co., Inc.
Moss, Jack G.
Pauls & Co., Louis
Rauscher, Pierce & Co., Inc.
Rotan, Mosle-Dallas Union, Inc.
Rowles, Winston & Co.
Rupe & Son, Inc.
Russ & Co., Inc.
Schaffer & Co., H. L.
Texas Municipal Bond Co.
Tucker & Co., Inc., James C.
Underwood & Co., Inc., R. A.
Underwood, Neuhaus & Co., Inc.
White, Chas. B., & Co.

UTAH

Burrows, Smith & Co.
Gibbs, Lauren W.
Morris & Co., Thornton D.
Ure & Co., Lincoln

VIRGINIA

Anderson & Strudwick
Craigie & Co., F. W.
Davenport & Co.
Horner, Barksdale & Co.
Investment Corp. of Virginia
Kaufman Bros. Co.
Mason-Hagen, Inc.
Mason & Lee, Inc.
Miller & Patterson
Scott & Stringfellow
Shoaf & Co., Inc., Cash
Strader & Co., Inc.
Webb & Co., Inc., Edward G.
Wheat & Co., J. C.
Willis, Kenny & Ayres, Inc.
Wyllie & Thornhill, Inc.

WASHINGTON

First Washington Corp.
Foster & Marshall, Inc.
Grande & Co., Inc.
Harper & Son & Co., Wm. P.
Marshall & Meyer, Inc.
McLean & Co., Inc.
Nelson & Co., Arthur E.
Paine-Rice & Co.
Pratt & Co., Inc., H. P.
Richards, Merrill & Peterson, Inc.
Southwick, Campbell, Waterman Co.
Thompson & Co., Terry

WEST VIRGINIA

Blundon, Montague
Young Moore & Co., Inc.

WISCONSIN

Baird & Co., Inc., Robert W.
Bingham, Sheldon & Co.
Denison Co., H. C.
Emch & Co.
Harley, Hayden & Co., Inc.
Loewi & Co., Inc.
Milwaukee Co., The

UNDERWRITING BANKS

Alabama:
- Birmingham Trust National Bank*
- First National Bank of Birmingham*
- American National Bank & Trust Co. (Mobile)*
- First National Bank of Mobile*
- Merchants National Bank of Mobile*
- First National Bank of Montgomery*

Alaska: National Bank of Alaska (Anchorage)*

Arizona:
- The Arizona Bank (Phoenix)*
- First National Bank of Arizona (Phoenix)*
- Valley National Bank of Arizona (Phoenix)*
- Southern Arizona Bank & Trust Co. (Tucson)*

See footnote * on p. 228.

UNDERWRITING BANKS—Continued

Arkansas:
- Worthen Bank & Trust Co. (Little Rock)*
- National Bank of Commerce (Pine Bluff)*
- City National Bank (Fort Smith)
- Simmons First National Bank (Pine Bluff)
- State National Bank (Texarkana)

California:
- Bank of America N. T. & S. A. (San Francisco)*
- Bank of California, N. A. (San Francisco)*
- Crocker-Citizens National Bank (San Francisco)*
- First Western Bank (Los Angeles)*
- Security First National Bank (Los Angeles)*
- Union Bank (Los Angeles)*
- First National Bank of San Diego*
- Wells Fargo Bank (San Francisco)*
- Farmers and Merchants Bank (Long Beach)
- United California Bank (Los Angeles)*

Colorado:
- Denver U.S. National Bank*
- First National Bank of Denver*

Connecticut:
- Connecticut Bank and Trust Company (Hartford)*
- Hartford National Bank and Trust Co.*

Florida:
- Atlantic National Bank of Jacksonville*
- Barnett First National Bank of Jacksonville*
- Florida National Bank (Jacksonville)*
- First National Bank of Miami*

Georgia:
- Citizens and Southern National Bank (Atlanta)*
- Trust Company of Georgia (Atlanta)*
- First National Bank (Atlanta)

Illinois:
- American National Bank and Trust Co. of Chicago*
- Continental Illinois National Bank & Trust Co. of Chicago*
- Exchange National Bank of Chicago*
- First National Bank of Chicago*
- Harris Trust and Savings Bank (Chicago)*
- La Salle National Bank (Chicago)*
- National Boulevard Bank of Chicago*
- Northern Trust Company (Chicago)*
- First National Bank & Trust Co. of Evanston*
- Capital Bank of Springfield
- First Galesburg National Bank & Trust Co.
- First National Bank (Benld)

Indiana:
- American Fletcher National Bank & Trust Co. (Indianapolis)*
- Indiana National Bank of Indianapolis*
- Dillsboro State Bank
- Madison Bank and Trust Co.
- Merchants National Bank (Muncie)
- Merchants National Bank & Trust Co. (Indianapolis)
- Second National Bank (Richmond)

Iowa:
- Central National Bank & Trust Co. (Des Moines)*
- Iowa-Des Moines National Bank*
- First National Bank of Mason City, Iowa
- Merchants National Bank (Cedar Rapids)

Kansas:
- Fourth National Bank & Trust Co. (Wichita)*
- United Trust Company (Abilene)

Kentucky:
- Citizens Fidelity Bank & Trust Co. (Louisville)
- Liberty National Bank & Trust Co. (Louisville)

See footnote * on p. 228.

UNDERWRITING BANKS—Continued

Louisiana:
- Rapides Bank and Trust Co. (Alexandria)*
- Hibernia National Bank in New Orleans*
- National Bank of Commerce in New Orleans*
- Whitney National Bank of New Orleans*
- First National Bank of Shreveport*

Maryland:
- Mercantile Safe Deposit & Trust Co. (Baltimore)*
- Equitable Trust Co. of Baltimore

Massachusetts:
- Boston Safe Deposit & Trust Co.*
- First National Bank of Boston*
- National Shawmut Bank of Boston*
- New England Merchants National Bank (Boston)*
- State Street Bank & Trust Co. (Boston)*

Michigan:
- Bank of the Commonwealth (Detroit)*
- City National Bank & Trust*
- Detroit Bank & Trust*
- National Bank of Michigan*

Minnesota:
- First American National Bank of Duluth*
- Northern City National Bank (Duluth)*
- First National Bank of Minneapolis*
- Northwestern National Bank of Minneapolis*
- American National Bank (St. Paul)*
- First National Bank of St. Paul*
- Cambridge State Bank
- Merchants National Bank of Winona

Mississippi:
- Deposit Guaranty National Bank (Jackson)*
- First National Bank of Jackson

Missouri:
- City National Bank & Trust Co. (Kansas City)*
- Commerce Trust (Kansas City)*
- Boatmen's National Bank of St. Louis*
- First National Bank in St. Louis*
- Mercantile Trust Co. (St. Louis)*
- American National Bank of St. Joseph
- Farmers and Merchants Bank (Mansfield)

Montana: Metals Bank & Trust Co. (Butte)

Nebraska:
- First National Bank of Omaha*
- First Trust Co. of York
- National Bank of Commerce Trust & Savings (Lincoln)

New Jersey:
- Boardwalk National Bank (Atlantic City)*
- Camden Trust Co.*
- Peoples Trust Co. of Bergen County (Hackensack)*
- Fidelity Union Trust Co. (Newark)*
- First National State Bank of New Jersey (Newark)*
- Prospect Park National Bank*
- Bank of Passaic & Clifton (Clifton)

New York:
- Manufacturers & Traders Trust Co. of Buffalo*
- Marine Midland Trust Co. of Western New York (Buffalo)*
- Banco Credito (N.Y.C.)*
- Bankers Trust Co. (N.Y.C.)*
- Chase Manhattan Bank (N.Y.C.)*
- Chemical Bank of New York Trust Co. (N.Y.C.)*
- Federation Bank & Trust Co. (N.Y.C.)*
- First National City Bank (N.Y.C.)*
- Franklin National Bank (N.Y.C.)*
- Manufacturers Hanover Trust Co. (N.Y.C.)*
- Morgan Guaranty Trust Co. of New York (N.Y.C.)*
- Sterling National Bank & Trust Co. (N.Y.C.)*

See footnote * on p. 228.

UNDERWRITING BANKS—Continued

New York—Continued
- National Bank of Westchester (White Plains)*
- First Westchester National Bank (New Rochelle)
- State Bank of Albany

North Carolina:
- First Union National Bank of North Carolina (Charlotte)*
- North Carolina National Bank (Charlotte)*
- Branch Banking & Trust Co. (Wilson)*
- Wachovia Bank & Trust Co. (Winston-Salem)*
- First Citizens Bank & Trust Co. (Smithfield)

Ohio:
- Fifth Third Union Trust Co. (Cincinnati)*
- The Provident Bank (Cincinnati)*
- Central National Bank of Cleveland*
- National City Bank of Cleveland*
- Cleveland Trust Co.
- Huntington National Bank (Columbus)
- The Ohio National Bank (Columbus)
- Society National Bank of Cleveland

Oklahoma:
- First National Bank & Trust Co. (Oklahoma City)*
- Liberty National Bank & Trust Co. (Oklahoma City)*
- First National Bank & Trust Co. of Tulsa*

Oregon: First National Bank of Oregon (Portland)*

Pennsylvania:
- Fidelity-Philadelphia Trust Co.*
- Philadelphia National Bank*
- Mellon National Bank & Trust Co. (Pittsburgh)*
- Pittsburgh National Bank*
- First Pennsylvania Banking & Trust Co. (Philadelphia)

Rhode Island: Industrial National Bank of Rhode Island (Providence)*

South Carolina:
- South Carolina National Bank (Columbia)*
- Citizens Trust Co. (Greenwood)

South Dakota: Northwestern National Bank of Sioux Falls

Tennessee:
- American National Bank & Trust Co. (Chattanooga)*
- First National Bank of Memphis*
- National Bank of Commerce (Memphis)*
- Union Planters National Bank (Memphis)*
- First American National Bank (Nashville)*
- Third National Bank in Nashville*

Texas:
- American National Bank (Austin)*
- First National Bank in Dallas*
- Mercantile National Bank of Dallas*
- Republic National Bank of Dallas*
- Texas Bank & Trust Co. (Dallas)*
- First National Bank of Fort Worth*
- Fort Worth National Bank*
- Bank of the Southwest N. A. (Houston)*
- First City National Bank of Houston*
- Texas National Bank of Commerce of Houston*
- Continental National Bank of Fort Worth, Texas
- Frost National Bank (San Antonio)
- National Bank of Commerce of San Antonio, Texas

Utah:
- Continental Bank & Trust Co. of Salt Lake City*
- First Security Bank of Utah, N. A. (Salt Lake City)*
- Walker Bank & Trust Co. (Salt Lake City)*
- Tracy Collins Bank & Trust Co. (Salt Lake City)

Virginia:
- Virginia National Bank (Charlottesville)*
- The Bank of Virginia (Richmond)*
- State-Planters Bank (Richmond)*

See footnote * on p. 228.

Washington:
National Bank of Commerce of Seattle*
Pacific National Bank of Seattle*
Seattle-First National Bank*
Seattle Trust & Savings Bank*
Washington Trust Bank (Spokane)*
National Bank of Washington (Tacoma)*
Peoples National Bank of Washington (Seattle)
Wisconsin:
First Wisconsin National Bank of Milwaukee*
Marine National Exchange Bank (Milwaukee)*
Citizens Bank of Sheboygan, Wisconsin
First National Bank of Oconomowoc, Wisconsin
First National Bank (Ripon)
Port Washington State Bank
Security First National Bank (Sheboygan)
State Bank of Platteville, Wisconsin
Wyoming:
First National Bank & Trust Co. of Wyoming (Cheyenne)*
American National Bank (Cheyenne)

APPENDIX B

Moody's Investors Service, Inc.

INVESTMENT COUNSEL & CONSULTANTS, NEW YORK

In addition to the conventional pre-sale financial information, we believe that the information requested in the following itemized paragraphs is a requisite to any rating study. The incorporation of this data with pre-sale materials will both facilitate and speed rating studies and better enable us to meet sale deadlines.

1. A retirement schedule of outstanding debt and a statement of balances in any related sinking funds.
2. A brief outline of any prospective financing (stating the estimated amount, purpose and method) being contemplated over the next five years, either by the subject borrower or overlapping taxing jurisdictions.
3. School enrollments by grade for June in each of the ten preceding years, the current enrollment and projected enrollment for next five years with an explanation of the manner in which the projections were arrived at.
4. The grades (if any) that are on double sessions at present. The percentage of seniors going to college. A brief description of the academic program.
5. A brief description (you may find it convenient to tabulate these) of present school structures and those under construction, showing: (a) type of construction; (b) date of construction; (c) number of classrooms; (d) area, ceiling height, seating capacity (where applicable) of the auditorium, gymnasium and cafeteria, if any; (e) designed capacity.
6. If you are a sending or receiving district, give details and comment on the permanency of the relationship. If you are a receiving district, also list the total number or non-resident pupils in each of the years covered in items 2 and 3.
7. Approximately what percentage of area is available for residential, commercial and industrial development? What are the minimum lot areas and frontages in the residential zones? Is there a building code, a zoning map? Please provide copies.
8. A tabulation of building permits issued during each of the past ten years, stating the number, valuation and purpose. What is the range and the median value of homes? Are home developments under construction or being planned? If yes: (a) what is the total number of homes to be built? and (b) what are their selling prices?
9. An audit report for the past two years and a statement of receipts and disbursements for each of the preceding three years.

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*Listed in the *Directory of Municipal Bond Dealers of the United States* (1967 edition). The banks not thus marked are listed in the *Security Dealers of North America* (1967 edition).

10. A brief description of existing water, sewer, gas, electric and transportation facilities and the areas served, including a comment on the adequacy of present facilities.

11. Annexation. What is the local procedure for annexation? Are there any annexations being considered? Describe annexations since 1960.

12. Completion of the enclosed form regarding the 20 largest taxpayers with current employment. Are any of the industries expanding or relocating? Any public institutions (I.E., colleges, state hospitals). How many employed?

13. Tax levies, tax collection (both current and total), plus the assessed valuation and basis of assessment, and tax rates for all levels of government for each of the preceding five fiscal years.

14. Median family income? Average number of inhabitants in a dwelling unit. (Census of housing.) What percentage of Homes are owned by occupants? Percentage of work force in manufacturing, professions, technical and managerial, unskilled labor, clerical.

15. Agriculture (if applicable). What are the principal crops? Soil type? Breakdown of agricultural production for last five years (available from county agricultural agent). Economic class of farms.

16. Mineral resources (if applicable) and method of assessment. Description; values of shipments and receipts in 1958 and 1954.

17. Population: 1940, 1950, 1960, 1965, 1970 estimated, 1973 estimated.

18. A breakdown of overlapping and underlying indebtedness indicating the issuer's respective share of this indebtedness.

19. Completion of the accompanying forms.

To the extent that this information is incorporated in a bond prospectus, audit report or other publication, those sources will serve as acceptable substitutes.

"COLLEGE" REVENUE BOND RATING INFORMATION REQUIREMENTS

1. Copy of the authorizing resolution.

2. Audit reports covering the revenue producing facilities for the past three years as well as a tabulation of annual income and expenses for ten years.

3. A breakdown by source of the institution's income for the past three years.

4. A 10-year record of requests for funds by the institution from the legislature and a corresponding record of the actual amounts appropriated; also, anticipated appropriations for the next five years.

5. Parietal rules now in effect covering dormitory and dining facilities.

6. Description of existing housing and other revenue producing facilities whose earnings are pledged to this issue. Data should include date built, type of construction, estimated future life and method of financing (borrowed funds, state appropriations, surplus revenues, other).

7. Schedule of tuition and room and board fees including proposed changes.

8. A 10-year record of enrollments broken down between male and female students and a projection of future enrollments over the next five years.

9. Descriptive data concerning the institution such as courses of study, type of degrees conferred, accreditation, etc. A copy of the latest catalog should be furnished.

10. Comment regarding additional borrowing intentions (detailing amounts, times and purposes) over the foreseeable future.

11. Other pertinent or related information including an official statement and notice of bond sale.

RETURN TO MOODY'S INVESTORS SERVICE, INC., NEW YORK, N.Y.

Taxing Jurisdiction: ____

Furnish information as indicated regarding the 20 largest taxpayers (based on the taxable valuation of their property) subject to taxation by this jurisdiction.

This information is vital for credit analysis purposes even though the list may include a number of residential properties. Do not trouble to report the number of employees of non-industrial taxpayers.

Name of taxpayer	Nature of business	Taxable valuation	Monthly average number of full-time employees

Prepared by..........

Title..........

Date..........

Note: Information of this nature is of vital interest to investors and Moody's Investors Service, Inc., wishes to feel free to give out such information to responsible inquirers. If you have strong reasons why such information should be held in strict confidence, so indicate.

Re..........

CASH FLOW

[Note: Because of changes in accounts receivable, working cash, etc., the columns below cannot be expected to be in perfect balance]

Year ended—	Gross income	P. & I. and bond reserve	Invested in plant	Transfers ou of utility
1960				
1961				
1962				
1963				
1964				
1965				
1966				
1967				
1968				
1969				
1970				

Re ....

Year ending—	Gross revenue	Operating expense [1] (excluding depreciation)	Balance available for debt service	Provision for depreciation	Payments in lieu of taxes	Other diversions to general fund
1955						
1956						
1957						
1958						
1959						
1960						
1961						
1962						
1963						
1964						
1965						
1966						
1967						
1968						
1969						
1970						
1971						

[1] Including taxes (if any).

Comment: ....

INFORMATION FOR RATING ANALYSIS OF AIRPORT REVENUE BONDS

1. A concise description of the airport facility as it presently exists.
2. A concise description of proposed imrovements, together with estimates of the costs involved in any proposed construction, actual bids received for such construction and the face value of performance bonds required to accompany each bid.
3. Itemized income and expense statements of the airport facility for the ten latest completed fiscal years; if the most recently completed year is more than six months past, we should like also an interim earnings statement for the current year and a comparison with the same interim period a year earlier.
4. Balance sheets of the airport system as of the close of the three latest completed fiscal years; if the most recently completed year is more than six months away, we should like also a copy of the most recent interim balance sheet.
5. Schedules of rates in force and effect from 1940 to date, with full detail regarding any changes in such schedules currently proposed.
6. A conformed copy of the ordinance or resolution authorizing and securing the proposed revenue bond issue.
7. A copy of the engineering report covering the proposed improvements.
8. A schedule of commercial carriers utilizing the airport facility.
9. A schedule of airport tenants detailing the duration of each lease and the lease rental.

INFORMATION FOR RATING ANALYSIS OF WATER AND SEWER REVENUE BONDS

1. A concise description of the water works supply, transmission, treatment, storage and distribution systems and sewer and sewage disposal systems as they presently exist, with reference to long range adequacies and deficiencies.
2. A concise description of proposed improvements, together with estimates of the costs involved in proposed construction, actual bids received for such construction, and the face value of performance bonds required to accompany each bid.
3. Income and expense statements of the water works and sewer systems for the ten latest completed fiscal years; if the most recently completed year is more than six months past, supply an interim earnings statement for the current year and a comparison with the same interim period a year earlier.
4. Balance sheets of the water works and sewer systems as of the close of the three latest completed fiscal years; if the most recently completed year is more than six months away, supply a copy of the most recent interim balance sheet.
5. Schedules of water *and* sewer (if any) rates in force and effect from 1940 to date, with full detail regarding any changes in such schedules currently proposed.

6. A conformed copy of the ordinance or resolution authorizing and securing the proposed revenue bond issue.

Obligor --

Issue --

References ---

———Basic security is lien on:
Net earnings—Plant
Gross earnings—Taxing Power

———Rate covenant:
Simply 'sufficient'
Built-in average

———Reference to free service to: municipalities? all other customers?

———Bonds a lien upon earnings of *entire* system, including extensions?

———Flow of funds:

———Required reserves:

———Will utility funds be physically segregated from general municipal funds?
Or will separate books-of-entry be kept, with funds pooled?
Or is there no covenant relating to segregation?

———Will debt service funds be segregated from operating funds?

———Is the issuance of prior lien bonds specifically prohibited?

———Provisions limiting parity lien bonds: Coverage ------ times;
Earnings base:
Debt charges defined as:
Is the issuance of junior lien bonds unlimited?

———Has the obligor covenanted to operate and maintain the plant for the life of the debt?

———Is the placing of encumbrances on the plant prohibited?

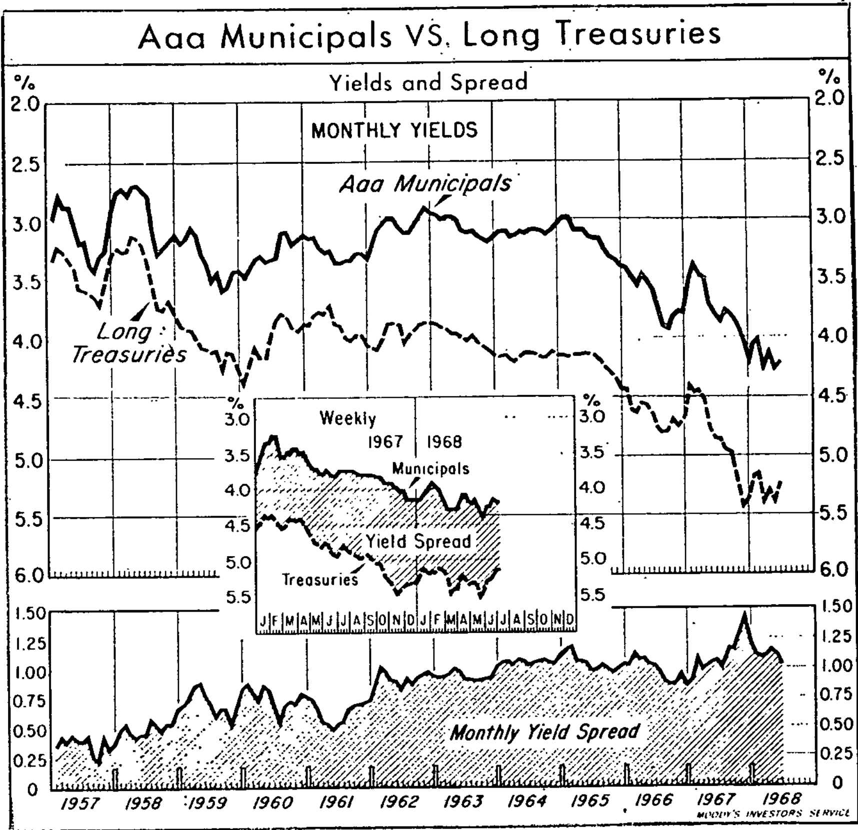
———Is the sale or disposal of the plant prohibited except as the bonds are retired from the proceeds of sale?

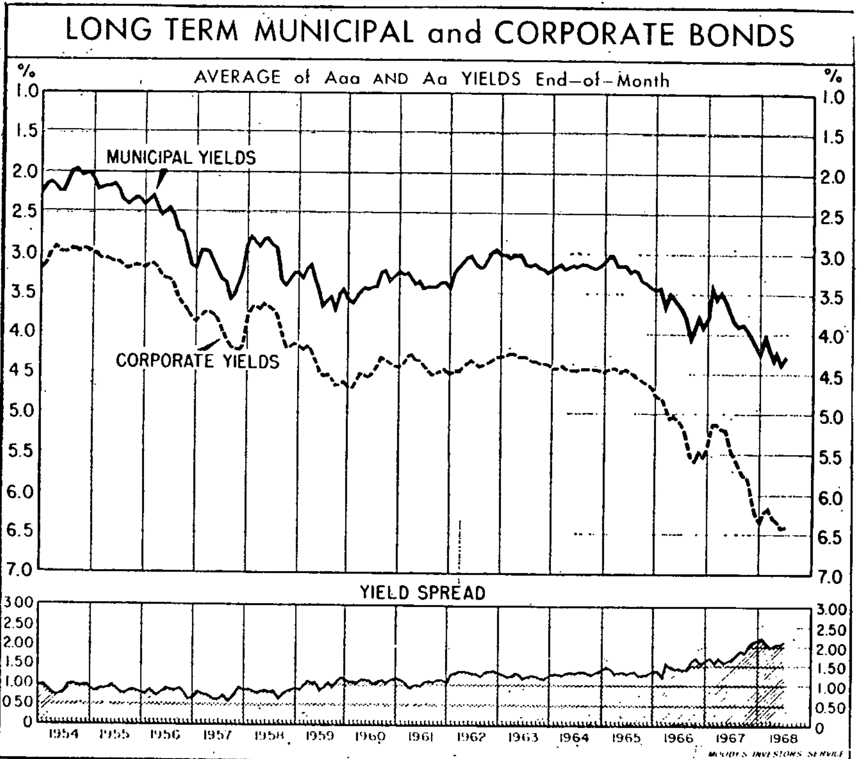
———Will the obligor provide the following:
Periodic outside technical assistance—Periodic reports of operations
Full insurance coverage—Periodic independent audits

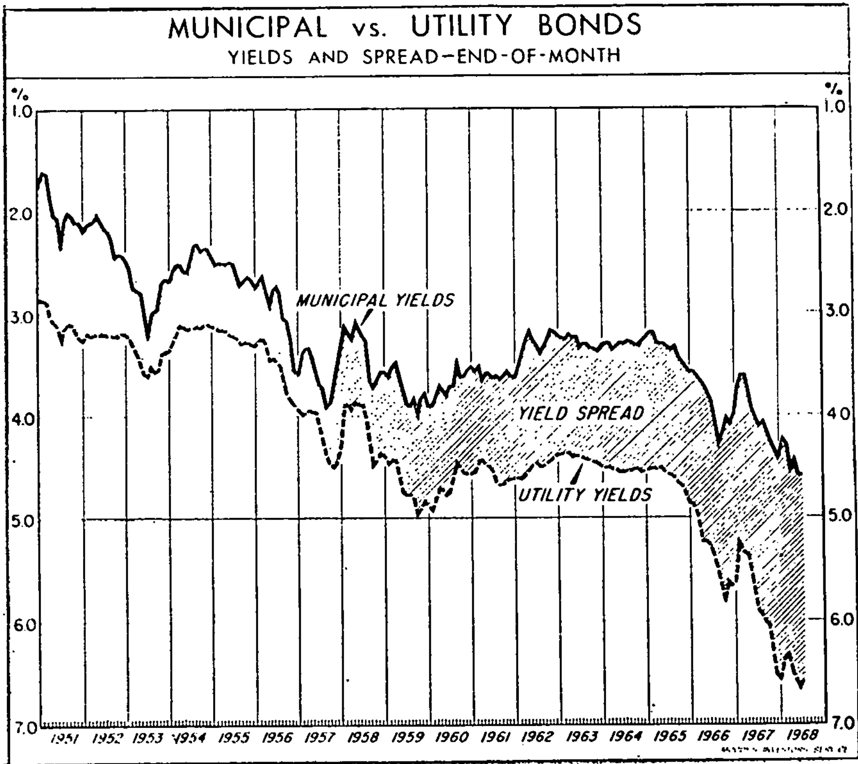
———Are the bonds protected by a trustee?

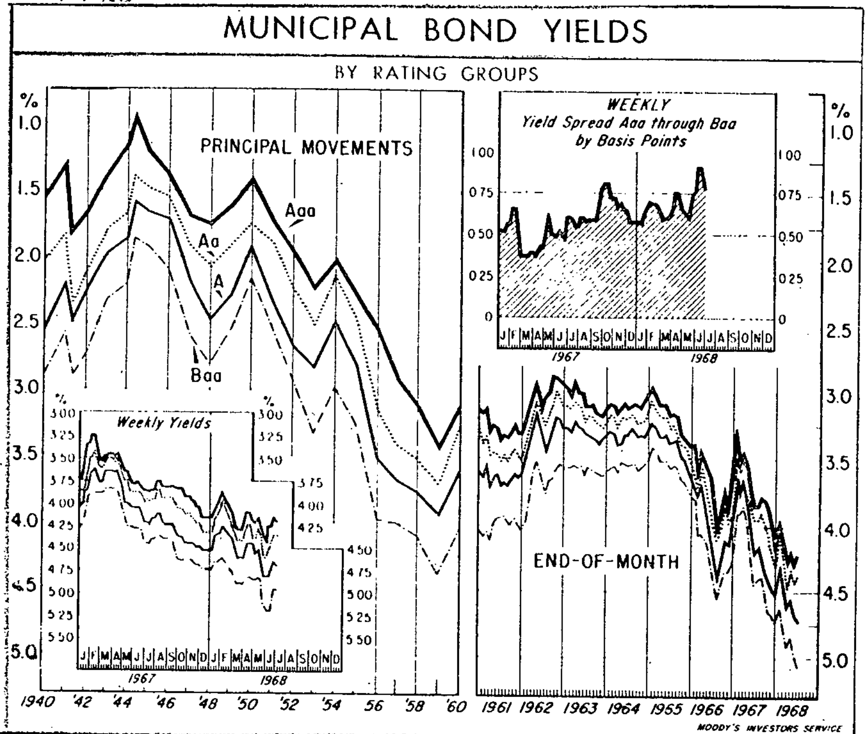
———Remedies in case of default:

———What reference to competing service?
Comments re recitals:


Aaa Municipals VS. Long Treasuries
Yields and Spread
MONTHLY YIELDS
Aaa Municipals
Long Treasuries
Weekly
1967 1968
Municipals
Yield Spread
Treasuries
Monthly Yield Spread
1957 1958 1959 1960 1961 1962 1963 1964 1965 1966 1967 1968
MOODY'S INVESTORS SERVICE


LONG TERM MUNICIPAL and CORPORATE BONDS
AVERAGE of Aaa AND Aa YIELDS End-of-Month
%
1.0
1.5
2.0
2.5
3.0
3.5
4.0
4.5
5.0
5.5
6.0
6.5
7.0
MUNICIPAL YIELDS
CORPORATE YIELDS
YIELD SPREAD
3.00
2.50
2.00
1.50
1.00
0.50
0
1954
1955
1956
1957
1958
1959
1960
1961
1962
1963
1964
1965
1966
1967
1968


MUNICIPAL vs. UTILITY BONDS
YIELDS AND SPREAD—END-OF-MONTH
%
1.0
2.0
3.0
4.0
5.0
6.0
7.0
MUNICIPAL YIELDS
YIELD SPREAD
UTILITY YIELDS
1951 1952 1953 1954 1955 1956 1957 1958 1959 1960 1961 1962 1963 1964 1965 1966 1967 1968



APPENDIX D

[APPENDIX D TO WRITTEN STATEMENT OF ROBERT C. RIEHLE, VICE PRESIDENT OF MOODY'S INVESTORS SERVICE, INC. IN REPLY TO STATEMENTS BY FINANCE ADMINISTRATOR ROY M. GOODMAN ON A RECENTLY ISSUED NEW YORK CITY CREDIT RATING]

The Statement made by Mr. Goodman before this Subcommittee on December 5, 1967 was concerned with the continued assignment by Moody's of the Baa rating on the $96,255,000 general obligation bonds of New York, New York which were publicly offered May 23, 1967. Specifically his statement comprises his own replies to various phrases, sentences and paragraphs in the article entitled New York, New York which appeared in the Tax-Exempt Section of Moody's weekly publication on Bond Survey of May 22, 1967. In view of the fact that his replies are to various phrases, sentences and paragraphs in the article of May 22, 1967 which have been taken out of their textual environment, it is an absolute necessity to become acquainted with the article's text in its entirety. Furthermore, as the article of May 22, 1967 expounds the evaluation of the propriety of continuing the Baa, rather than the formerly higher rating of New York City's bonds, it is equally essential to become familiar with the Bond Survey article of July 19, 1965, which promulgated the reasons for the change of rating from A to Baa rating at that time.

Hence, there follows the full text of the articles published in Moody's Bond Survey of July 19, 1965 and of May 22, 1967.

NEW YORK, N.Y.

The fiscal legacy inherited by the nation's older population centers—governmental expenses that are rising far faster than income—is accentuated in New York City, which recently has dramatized its plight by resorting to the avails of eight of the monthly state-run lotteries.

Many factors determine a bond's present and future market value. Simply stated, these can be reduced to the presence or absence of investor confidence interrelated with demand and supply. Investors prefer a situation founded on stability, progressive fiscal conservatism, a modern physical plant that is reasonably adequate, and effective short- and long-range planning that assures that the issuer will maintain its financial position well into the future, since bond issues frequently mature in excess of 20 years.

A borrower's net interest cost also is influenced by the supply of and demand for its bonds, both at the time of issuance, and in the secondary market on a day-to-day basis.

Years ago, New York City financed its capital improvements almost exclusively via sales of its bonds to its pension and sinking funds, thus protecting the market for its outstanding general obligations. But this practice was discontinued in the early 50's. In time, New York City became one of the nation's major borrowers, now marketing approximately $800 million annually. Thus the market became saturated with Cities, and the only way to expand the existing market is through generous yields. Cities have sold at discounted prices below bonds of comparable quality for over a decade and continue to do so.

Unfortunately, from the vantage point of the investor, New York City, as evidenced in the accompanying chart, is enmeshed in a worrisome trend which can not be disregarded despite a statutory recital which seemingly makes the payment of debt service a first lien on city revenues.

A sovereign government is charged witth several paramount responsibilities: namely, to exercise its police power, to maintain public health and safety, and to educate. Any recital which purports to impose the obligation to service debt as a first charge of government may be in conflict with these duties should its exercise of priority be allowed to impair public health, safety or education. These functions encompass virtually all services of government, even public transportation, when construed in the broadest terms.

Yet, despite the myriad of complex and some seemingly insoluble problems confronting management, New York City bonds are attractive investment-grade obligations at prevailing prices, worthy of consideration by investors who would like to maximize their rate of return at some sacrifice of bond quality.

For those familiar with the New York City scene, it takes little more than a cursory examination to highlight some of the major factors which affect its current and future credit stature.

In the opinion of a recognized authority* ". . . the real estate tax has been raised to the point where it is not only regressive in its effect on income groups, but also is inequitably administered. This latter criticism is due to the following combination of factors: differences in assessing of properties within the same class and among the various classes, absence of a systematic reassessment program, and reassessing properties only when on the market. The result is that the ratio of assessed to full value differs widely. For instance, one- and two-family houses on average are assessed at less than their full values, while stores and office buildings are assessed at 85% to 90%. The low basis of assessment of vacant land is unconducive to its development and enlargement of the tax rolls. The city's $30 billion of taxable valuations excludes at least half as much again in tax-exempt property values."

Excessive and inequitable taxation of business is an important factor in the migration of many city businesses to the suburbs.

Compounding the cost-revenue squeeze in the city's proclivity toward providing both free and subsidized services. Subsidies dissipate the city's limited revenues. The principle that users pay for the benefits that they receive is a widely accepted one. Yet, each year the city allocates millions of dollars to subsidize the water, sewer and transit systems. Except for large industrial consumers, city water is unmetered, and retailed at flat rates.

While the city continues to dissipate revenues on services which could support themselves either wholly or to a greater extent than at the present time, the city fails to spend enough to remedy the serious deficiencies in the regular and special education programs. Middle and upper income families continue their out-migration, seeking better education for their children in the suburbs. Most suburban communities spend more money per student for education. The gap is emphasized further by the concentration in New York of disadvantaged students with special and costly needs. During the past decade, school expenditures rose by 140%,

*The Final Research Report to the Temporary Commission on City Finances by the Graduate School of Public Administration, New York University.

while the number of pupils increased by 16%; the increases were absorbed by higher teachers' salaries and fringe benefits, shortened teaching time, and a larger administrative and supervisory staff. From 1955 to 1965, a mere $13 million out of a $500-million increase in school expenditures was utilized to reduce class size and that by only one pupil. Clearly, larger operating funds and heavier capital investment are needed to implement changes in the schools.

City planning tends to be short-term. The city's record of budgeting dollars rather than fundamental planning is only too evident in the transportation and education systems. Maintenance of obsolete plant is, in the long run, far costlier than constructing new facilities, notwithstanding ever-increasing construction costs. In recent years, not only have capital outlays from current financing been virtually nonexistent, but a substantial volume of current expenses has been wrongfully defined as capital outlays. Moreover, bonding financed the 1965 expense budget deficit. In recent years, partially due to the city's fairly rapid bond retirement policy, annual debt service charges have been inordinately high.

While complex, New York City's problems are not necessarily insoluble. Nor is the revenue picture as black as the lottery device suggests, for the city does have unexploited revenue sources which could be utilized to effect near-term appreciation in bond quality.

For example, the city's public university does not have to be operated on a no-tuition basis. Water, sewer and transportation services could be sold at cost. Or, preferably, water and sewer services could be sold at a profit in line with a prevailing practice among municipal corporations in the nation today. The city operates some toll-free crossings over the East River. Contributions could be sought in-lieu-of taxes on Federal and state office buildings, the United Nations and other properties exempted from the real estate tax. Unfortunately, the trend is for the total of tax-exempt properties to grow faster than taxable properties.

Far more disturbing from the aspect of credit implications, and more difficult to resolve, is the continuing exodus of the educated middle class. Implicit in this trend is the potential loss of an electorate with a desire for efficient, conservative, sophisticated government.

These trends were a long time in the making and will likely be a long time in resolution. But, due to the size and diversity of its resources, we believe that New York City has the capacity to resolve many of its major problems. Its obligations in our opinion continue to qualify as investment grade, rated Baa.

. . . is coming to market on July 20 with two lots of bonds, one of $111.1 million for various municipal purposes and one of $63,950,000, part of a $255.8-million state-approved issue (technically an amendment to the city's administrative code) to provide for payments during the period from July 1, 1965, to June 30, 1966, of pension payment and retirement liabilities. (In reality there is a gap of $255.8 million between estimated receipts and expenses in the city's executive budget for fiscal 1965–66 which this is designed to remedy.)

Ostensibly, in this connection, the legislature passed a bill (the first step in amending the constitution) increasing the city's real estate tax rate maximum for purposes other than debt service (the tax rate for debt service is unlimited) to 3% from 2½% of full valuation, and to shorten the base period for determining full value from the average of the past five fiscal years to the average of the past three fiscal years. Before this bill can become an amendment to the state constitution it must be passed by the next legislature, signed by the Governor and approved by the voters at a November general election, presumably in 1966. This proposed amendment could bring in $250 million to $300 million a year in additional income.

Over the past years, New York City has faced recurrent annual fiscal "crises." Because the city does not have home rule it derives its taxing powers from the state. So, each year the city has gone to the legislature, hat in hand, and while it has not always received all that it has asked for, the state generally has cooperated to assure the city sufficient revenues to meet its commitments and achieve a balanced budget. However, in the fiscal year just ended revenues were overestimated and a sizable deficit resulted, which has been remedied by resorting to short-term borrowing. This fiscal year new revenues approved by the state were inadequate, resulting in the authority granted to borrow up to $255.8 million.

At present, the city derives about 36.4% of the funds for its executive budget (as distinguished from the city's capital budget) from real estate taxes, versus approximately 47.0% ten years ago. It is using all but two of the tax sources now available to it, i.e., a city payroll tax, which might bring in around $100

million, and an automobile use tax, the yield from which would be miniscule in relation to the city's needs.

Actually the city's expense (executive) budget has been rising steadily for the past 20 years, more particularly over the past ten years, but this year's jump of $493.2 million is the greatest increase in any reported period. In the fiscal year ended June 30, 1955, the expense budget totalled $1.6 billion, equivalent to $202 per capita (based on a 1950 populatioin of 7,891,957), versus $3.9 billion for 1965–66, or $498 per capita (based on a 1960 population of 7,781,984), an increase of 143%. Yet, according to the U.S. Bureau of Labor Statistics, the consumer index applicable to New York City rose only from 93.1 in 1955 (1957-59=100) to 110.4 in 1964, an increase of 18.6%

Obviously then, the increase in the expense budget is due neither to a population explosion nor to a sharp rise in the cost of living. From the standpoint of the city government, Mayor Wagner, in his message of May 13, 1965, to the Board of Estimate and the City Council, summed up the problem this way:

"Our ordinary revenues have been increasing but the rate of this increase has not nearly matched the growth rate of our expenditures. The strongest force in the upward surge of our expenditure requirements is the plight of that major sector of our population which, until now, has lacked equal access to, and opportunity for, significant participation in the benefits of urban life and living. Many of these New Yorkers have long been denied both equal treatment and equal opportunity. Lacking education and skills, they have found no functional place in our economy. Instead, many of them have been a charge against it. The cost of their maintenance (especially that of the children and the aged) is a factor which defies limitation or control. Under the law, we have no alternative but to maintain the needy.

"The sharply increasing cost of education has also exerted an expanding pressure upon our operating expenses. In addition to the rising cost of our regular educational programs, we are facing an ever more insistent need to take rapid steps to equalize educational opportunity, and at the same time to give proper emphasis and support to quality education.

"The demand for such measures must be met: We would deny it at our increasing peril—and social cost. But the total immediate cost in our primary and secondary schools, plus our city university, is high.

"Finally, there is the absolute need to institute emergency measures for policing our streets and subways. The growing incidence of crime (a nationwide trend) has forced us to war against crime.

"These are the major factors contributing to the irrestible pressure upon our budget for 1965–66. There has thus been produced a prospective gap which has defied all efforts to eliminate, even with major undertakings to economize and to cut."

Certainly no one can quarrel with the lofty ideals or humanitarian principles expressed by the Mayor. Care of the needy, the unfortunate, the ill and oppressed is clearly recognized as an obligation of the society in which we live. Yet there is increasing evidence that over the years the city government has tended to succumb to the pressures of special interests and minority groups, thus permitting spending to get out of hand. Furthermore, the city government has failed to show any real zeal or drive to effect economies in operations and indeed has made no effort to take steps to put certain of the city's services on a self-sustaining basis. The water system, for example, is estimated to cost about $120 million a year to operate, yet only a portion of the system is metered and it takes in only about $55 million in part due to low water rates. Sewer rates are based on water charges and are insufficient to meet costs. Also, the 15-cent fare has become about as sacred as the five-cent fare used to be, and in spite of indications that the Transit Authority's operating deficit may amount to $62 million this coming fiscal year, there is every indication that efforts will be made to provide additional subventions to the already significant sums the city pays the Transit Authority under present arrangements. (Capital expenditures and debt service are by law the responsibility of the city.) Furthermore, the city refuses to charge tuition to students attending its colleges, although it is evident that many possess the means. In a minor key it is of interest that the half-hour ferry ride from the Battery to Staten Island still costs only a nickel, the same as did a good cigar in the far distant past.

As shown in the chart, debt management has been more conservative than expense budget management. On June 30, 1955, net city debt, (gross bonded indebtedness less sinking funds) amounted to $2.6 billion, or $335 per capita whereas on June 1, 1965, debt (including this sale) amounted to $4.1 billion,

equivalent to $528 per capita, up 56% over 1955. City bond flotations have been running about $500 million a year. The maturity range has been considerably shortened during the past several years so that, while the effective interest rate has been reduced, total annual debt service costs have increased. However, as the tax rate for debt service is not limited, shortening the life of city loans is constructive in that it will accelerate the recapture of borrowing power. As the city's capital needs (evidenced in its capital budgets and long range planning) are still great, there is every prospect that city debt will continue to rise on balance, perhaps at a faster pace than it has over the past few years; the city's tax rate, if the amendment is passed, also is certain to mount. (In 1955, the city-wide rate was $36.80 per thousand, versus $44.10 this year, or up almost 20%.)

As a matter of fact few, if any, of the nation's older and larger cities have been without problems; most are suffering from blight in one form or another in their urban core, and also a migration to the suburbs by many members of the community's young, vibrant middle-income group that see in the suburbs a chance for a better family life and the sometimes illusory benefits of home ownership. Generally speaking, this outmigration has been the cause of urban population loss, offset in part by the influx of others, who often through no fault of their own possess modest skills and limited earning capacity. With more and more emphasis placed on skills in today's job market, less and less demand for unskilled or semiskilled labor presents an acute problem.

On balance, we believe that there has been a gradual but noticeable credit deterioration within New York City, due in part to some factors that the city could have ameliorated. Efforts to bring in sufficient revenues to balance outgo, sometimes brought harmful remedies (such as a high sales tax and nuisance taxes) that have weakened rather than strengthened the city's economic life and competitive position. In terms of outstanding debt we believe New York City obligations are now of lower medium grade quality and Moody's rating has been reduced from A to Baa. The rating on the New York City Housing Authority city-guaranteed issues also has been reduced from A to Baa, but the New York City Transit Authority gross revenue bonds retain their A rating.

There follows a series of direct quotations from Moody's Bond Survey article of May 22, 1967, followed by Commissioner Goodman's reply, followed by Vice President Riehle's reply.

I. The statement of the bond service:

"Unfortunately, from the vantage point of the investor, New York City, as evidenced in the accompanying chart, is enmeshed in a worrisome trend which cannot be disregarded despite a statutory recital which seemingly makes the payment of debt service a first lien on city revenues.

"A sovereign government is charged with several paramount responsibilities; namely, to exercise its police power, to maintain public health and safety, and to educate. Any recital which purports to impose the obligation to service debt as a first charge of government may be in conflict with these duties should its exercise of priority be allowed to impair public health, safety or education. These functions encompass virtually all services of government, even public transportation, when construed in the broadest terms."

Commissioner Goodman's reply:

"The provision in the New York State Constitution in Article VIII, Section 2, providing that the chief fiscal officer of any city or any political subdivision in the state shall apply the first revenues received to debt service, is a strong protective bulwark for New York City bondholders. This enduring provision requires that New York City funded debt shall be backed by the full faith and credit of the municipality. Thus, payment of the city's debt service is the first lien on its revenues. The city must pay its debt service before it meets payroll or any other expense. The taxpayer's obligation to pay real estate taxes to the city takes precedence over the obligation to pay debt service on the many billions of dollars on private mortgages held by banks, insurance companies, and other institutional investors.

"Article VIII, Section 2 cannot be altered at the whim of any city government. It can only be altered by the action of two successive State legislatures, separated by a general election, followed by a statewide referendum, or by the action of a plenary Constitutional Convention followed by a statewide referendum. It ill becomes a bond-rating service to practice law and to cast unsupported and unjustified aspersions upon both the City of New York and the New York State Constitution.

"The 'worrisome trend' shown by the chart presented by the rating service was the more rapid rise in the city's expenditures and net debt than in the City's assessed values in the past ten years. No mention was made of the fact that both the city's general fund (composed mainly of non-property taxes) and its receipts from state and federal aid have been growing much more rapidly than expenditures in the past decade. The day is long gone when real estate taxes were the only significant source of funds protecting the bondholder's investment. The chart is also misleading if one attempts to judge how property values in New York City have grown, since it omits all tax-exempt values (city-owned property and facilities, tax-exempt housing and property of such agencies as the Port Authority). These properties greatly enhance the value, productivity and livability of the city. When total property values are compared on an equalized full-value basis for proper comparability, it can be seen that values nearly doubled over the decade. Even then, the comparison omits non-real estate property values, which no doubt increased greatly."

Vice President Riehle's reply:

The provision in the New York State Constitution in Article VIII, Section 2, providing that the chief fiscal office of any city or any political subdivision in the State shall apply the first revenues received for debt service, on the surface, affords a measure of psychological comfort to the bondholder that he will receive his due on time. However, in actuality, which is the world in which the prudent investor and analyst dwell, there exists a number of factors which render this high-sounding statutory recital but an illusory bulwark for bondholders. First the pertinent Constitutional revision may be revoked by action of the State's Legislature or Constitutional convention subject to statewide referendum. Second, a potential conflict may be established by such a statutory recital because the exercise of the priority of the lien of debt service on revenues could, under financial crisis conditions, impair the municipal governments ability to provide for public health, safety or education. The latter constitute paramount responsibilities of a sovereign government. Third, it is rare that a government would forego sustaining of its day-to-day operating expenses so vital to the continued functioning of government services in order to meet pressing debt service obligations. In practicality, operation and maintenance expenses receive the first available revenues, with debt service consuming that portion of revenues not drained by the cost of sustaining the government and its services.

Analogous to this "fact of life" is the taxpayer's obligation to pay his real estate taxes to the city before his obligation to pay private mortgages and also utility bills. The hard-headed property owner faced with various debt obligations generally pays utility bills first because action on discontinuing service can be instituted almost immediately compared with the relatively longer periods of time which elapse before a financial institution forecloses on a defaulted mortgage or before a municipal body forecloses on the property and recoups the back taxes.

While actual income from real estate taxes has maintained an upward trend, though at a substantially lesser rate than non-property taxes, ever-increasing dependence in recent years has been placed on State and Federal aid. The latter two combined aggregated $711.9 million in fiscal 1962–63, equivalent to approximately one quarter of the $2.8 billion expense budget; in the 1967–68 fiscal year, such aid was estimated at $1.9 billion, equivalent to 37% of the $5.2 billion expense budget. All too frequently the State and Federal aid is viewed as outright gifts for which no contributions were made by the beneficiary; too often forgotten is the fact that the State and Federal Governments also derive these revenues from taxation of domestic residents and businesses—the City taxpayers' expenditures on State sales taxes and on Federal and State income taxes, for example, are often indirectly returned as aid.

While expense budget revenues rose by 85% ($2.8 billion to $5.2 billion) from fiscal 1962–63 to 1967–68, real estate tax receipts increased just 45% ($1.1 billion to $1.6 billion). The latter expansion was in large measure due to tax rate hikes as the estimated full market valuation of taxable property rose by just 28% ($35.1 billion to $44.9 billion) during the same period.

New York can ill afford to have the valuations of tax-exempt property increasing more rapidly than the taxable, which is the case. In the last five fiscal years (1962/63—67/68) the assessed value of exempt property increased by 29% (from $12.6 billion to $16.2 billion), while the value of taxable property rose from $27.2 billion to $32.4 billion, representing only a 19% increment. A thorough review and overhauling of the tax-exempt property privilege is long overdue. The City's plan to charge for water, garbage and sewer services would make but a

small contribution relative to the cost to the City of carrying these properties tax-free. Moreover, the increasing amount of exempt property cannot help but increase the already heavy burden of taxation on taxable properties.

The statement of the bond rating service:

"In the opinion of a recognized authority '* * * the real estate tax has been raised to the point where it is not only regressive in its effect on income groups, but also is inequitably administered * * *.' "

Commissioner Goodman's reply:

"The possible regressivity or inequitable administration of the city's real estate tax are almost wholly irrelevant to the city's credit rating. Many cities to which this rating service assigns a rating of AAA have the same problems. The Mayor has already instituted a searching study of the effects of the real estate tax and the obvious inequities in assessment procedures. The rating service has failed to note the recommendation of the Schwulst Commission and the Mayor's Task Force on the Constitutional Convention that the State constitution should be amended to raise the real estate tax limit from 2½ percent to 3 percent and to shorten the valuation base period for the limit from 5 to 3 years. The would enable a possible increase in the tax levy for current purposes within the limit of over $270 million. Of far greater relevance is the fact that in the fiscal year 1966–67, New York City's real estate tax will yield over $160 million more revenue than in the prior fiscal year. The rating service has also failed to note that the New York City real estate tax is not excessive compared to surrounding areas like Nassau County or with other localities which must pay multiple taxes to overlapping city, county, and district government. The basis of assessment varies drastically in different municipalities. Notice should also have been taken of the fact that New York City's tax collection record is good. As of April 30, 1967, only 1.2 percent of the taxes levied for the last 5 completed fiscal years had not been collected.

"The city of New York, relative to its governmental responsibilities, has the tightest tax limit of any community in the State. This is one of the basic reasons for recurring operating budget problems, but it does not affect debt service, which is outside the limit."

Mr. Riehle's reply:

The regressivity and inequitable administration of the city's real estate tax is most definitely relevant to the city's credit. Regressivity of taxes means that as family income decreases, the relative financial burden imposed by city taxes rises. In New York City, the real estate tax has been found to be regressive through most income classes, primarily because as family income increases, there generally is a less than proportionate increase in the outlay for housing whether owned or rented. This regressivity is pertinent to the city's credit stature because it helps to perpetuate the plight of those living in poverty and reduces the income available to landlords for capital improvements to their properties. Despite this medieval state of affairs, the already onerous property tax has been increased recently to a record level of 5.21%.

The inequitable administration of real estate taxes is due to the considerable lack of uniformity in property assessments. Not only are there systematic differences in the treatment of different classes of property, but there are also nonsensical discrepancies within classes. Real property in New York is supposed to be assessed at full value. Inequitable administration is pertinent to credit stature because it helps to create a hostile environment, especially for business, and can be conducive to corruption.

While the regressivity of property taxes and the inequitable administration of real estate assessments play roles in credit evaluation, neither of these considerations nor any one other factor alone functions as the sole determinant of a rating; the rating assignment represents the product of careful investigation and weighing of a great many factors. Hence, the postulation that many cities whose bonds are rated Aaa have these same problems is irrelevant.

It is highly commendable that the present administration has already instituted a study of the effects of the real estate tax and the obvious inequities in assessment procedure. Hopefully, the conclusions of the study will precipitate corrective action in the near future.

The recommendation to raise the real estat tax limit from 2.5% to 3% of full value (exclusive of the tax rate necessary to service debt) and the recommendation to shorten the valuation base period from 5 to 3 years will undoubtedly result in increased revenue for the City from real estate taxes. The shortening of the base period will help to accelerate the increase in the average assessed valuation as computed for tax rate limitation purposes; however, the longer five

year base period was designed to provide greater stability and should ratables decline in any one year or any years in succession, most of the former cushion to the tax rate limit will have been removed. The increase in the tax rate limit from 2.5% to 3% will only serve to make the already burdensome realty tax situation worse.

Differences in basis of assessment among communities are inconsequential when tax rate comparisons are stated in terms of full market valuation. However, within a single community, such as New York, where business tends to be assessed at a higher basis of assessment than residential property, then the result is that business pays more than its fair share of the realty tax.

III. The statement of the bond rating service:

"Excessive and inequitable taxation of business is an important factor in the migration of many city businesses to the suburbs."

Commissioner Goodman's reply:

"This statement overlooks Mayor Lindsay's major tax reform which substituted a business net income tax for the long-criticized gross receipts tax in July, 1966. This reform was widely hailed by business leaders. In its reference to the migration of many city businesses to the suburbs, the rating service failed to take into account that between 1947 and 1965, 66½ million square feet (182 buildings) of office space were built in New York City. This is the equivalent of 31 Empire State Buildings and exceeded the amount of the rentable space built in the rest of the United States during the same period. It failed to take into account the projection reported by the First National City Bank that over 80 million square feet will have been built between 1947 and 1970, roughly equalling all of the city's pre-War rental office space. Nowhere does the rating service report the consensus of leading real estate firms that demand for space in New York City is greater now than ever before. Prime office space is at a premium, and according to projected building plans, it will be a long time before this need for space will be reduced. In 1967, there is a 98 percent occupancy rate, the highest in history (for office space). Forty-eight million square feet of office space are on the drawing boards for the next 5 years. 6,800,000 square feet were rented in 1966. As the First National City Bank pointed out, growth is not the only yardstick for measuring performance of an economy. It is also important to examine degree of stability in face of cyclical swings affecting the nation as a whole. The New York region shows relative stability. In years when the Nation's employment went down—1954, 1958, and 1961—employment in the New York region was less adversely affected than in the rest of the Nation. Durable goods manufacturing which generally fluctuate cyclically, accounts for a significantly smaller share in the region than the nation as a whole. Many of New York City's activities, such as apparel manufacturing, are consumer oriented and less sensitive to cycles than business investment or defense spending. Employment in New York City's central administrative offices is more cyclically stable than jobs on the assembly line. In 1963, there were approximately 213,000 commercial firms in New York City and in 1966, approximately 225,000 firms, an increase of 12,000.

"In short, the rating service overlooks that New York City is the headquarters for the Nation's business, the major focal point for national and international trade, the Nation's primary money and capital market, the center of its mass communications and advertising, the fashion center of the United States, and the leading city in arts, entertainment, and culture.

"Of the top 100 industrial companies in the United States, 89 have headquarters or branches in New York City."

The migration of many city businesses to the suburbs is countered by Commissioner Goodman almost solely by talking about the increase in office space which has taken place. He overlooks the seriousness of the type of firms which have left the City. In the words on the Temporary Commission on City Finances: "The decline in recent years of New York's manufacturing employment, while offset by increases in service jobs, has been especially troublesome because it has narrowed opportunities for unskilled and semi-skilled workers. The decrease is probably due in significant part to a need for space for expansion and the apparent direct lower cost of doing business in many locations outside the City. In vast areas of the City, the gridiron pattern of short narrow blocks provides uneconomic sites and leaves a high percentage of land in streets too narrow for effective movement of people and goods."

IV. The statement of the bond rating service:

"Compounding the cost-revenue squeeze is the city's proclivity toward providing both free and subsidized services. Subsidies dissipate the city's limited revenues. The principal that users pay for the benefits that they receive is a

widely accepted one. Yet, each year the city allocates millions of dollars to educational systems. Maintenance of obsolete plant is, in the long run, far costlier to consumers, city water is unmetered, and retailed at flat rates."

Commissioner Goodman's reply:

"The subway fare has been raised over the years from 5¢ to 20¢, water frontage rates were doubled, and the mayor announced his intention to institute universal water metering as soon as it was technologically feasible to do so."

Mr. Riehle's reply:

The above reported statement of the bond rating service, after the second sentence, is a totally inaccurate summary, let alone a direct quotation from the Moody's Bond Survey article of May 22, 1967. Moody's criticism is that the City could alleviate its cost-revenue squeeze by cutting back its excessive subsidizing of water, sewer and transit systems which prudently should be self-sustaining operations. While increases in the subway-bus fare have been steps in the right direction, further rate hikes are sorely needed to eliminate the rising deficit. In the last half of 1967 the net loss of the Transit Authority aggregated $20,-854,048, equivalent to almost three times that for the comparable period of 1966; increased operating and maintenance expense in face of a slim rise in revenue is responsible.

The intention to institute universal water metering as soon as technologically feasible has been announced, but the fruition of such intentions is likely a long time hence. Not disputed is the costly and time consuming task of fully metering the system, but in the long run the system could become self-sustaining, and control of water consumption in times of scarcity would be easier. There are, however, a number of other subsidized services which could be rendered self-supporting almost instantaneously. For example bridges across the East River which are now toll-free could be quickly equipped with toll booths; Tuition could be charged in the City's public university system except to those who could not afford to pay.

V. The statement of the bond rating service:

"* * * the city fails to spend enough to remedy the serious deficiencies in the regular and special education programs."

Commissioner Goodman's reply:

"Ten years ago in fiscal 1956–57, the city's education budget was $457 million. In the current fiscal year, 1966–67, the city's education budget is $1,131 million. In the executive budget for 1967–68, the mayor allocated $1,219 million for the city's public school system. This is more than 20 percent of the total budget. Overall, public school enrollment is not increasing substantially, but in the executive budget for 1967–68, there has been a sizable increase of $88 million over the current year in the proposed allocation to the Board of Education. For 1967–68 executive budget for the Board of Higher Education provided $144 million, an increase of $25 million over 1966–67.

"The rating service also fails to mention that there will be a significant change in the source of revenues devoted to public education. The State legislature has enacted into law a city-proposed measure which changes the formula under which State aid is given to local school boards, bringing New York City much closer to a per capita parity with other localities in the State. This increased aid is contingent on the development by the City of a plan for decentralizing the citywide school system. It treats New York City as five separate school districts instead of one. It has major long-range implications."

The remedying of the serious deficiencies in the regular and special education programs should be helped by increased State aid which will accompany decentralization of the City school system. Judging by the controversy surrounding several pilot decentralization projects, it is hard to determine at this time the effects of decentralization and accompanying increase in revenues. The removal of the school system from the central political arena would seem desirable. Based on past experience, however, the rapidly increasing school budget is being absorbed by higher wages, greater fringe benefits, shortened working hours and larger administrative and supervisory staffs, instead of going to reduce class size (which is particularly important in slum areas), to meeting students' special needs and to reducing the school drop out rate. Secondary education and vocational training are the keystones to maintaining at a minimum the burden of supporting those on welfare and receiving unemployment compensation.

VI. The statement of the bond rating service:

"City planning tends to be short-term. The city's record of budgeting dollars rather than fundamental planning is only too evident in the transportation and education systems. Maintenance of obsolete plant is, in the long run, far costlier

than constructing new facilities, notwithstanding ever-increasing construction costs."

Commissioner Goodman's reply:

"This statement ignores the proposed reorganization program of the Lindsay administration through which long-range planning will be effected by 10 administrations instead of the presently existing 49 widely dispersed city Departments. Also, the Bureau of the Budget is engaged in an improvement of the budget process, moving toward the planning-programming-budgeting system now being introduced in the Federal Government. In addition, the City Planning Commission is committed to completing the city's comprehensive plan in fiscal 1967–68. The mayor has assigned this project the highest priority.

"The comment on obsolete plant overlooks the fact that replacement of such plant is the principal reason the city undertakes $500 million per year of long-term borrowing. Such borrowing is for capital expenditures and will go to modernize the city's plant. Also ignored is the fact that more than 60 percent of New York's bonds have been issued to construct partly or fully self-sustaining improvements such as parking facilities, water and sewer plants, and waterfront enterprises."

VII. The statement of the bond rating service:

"In recent years, not only have capital outlays from current financing been virtually nonexistent, but a substantial volume of current expenses has been wrongfully defined as capital outlays. Moreover, bonding financed the 1965 expense budget deficit."

Commissioner Goodman's reply:

"One of the cardinal fiscal tenets of the Lindsay administration has been the dismissal of borrow-now, pay-later philosophy. Apparently the rating service blames the present administration for the $256 million borrow-now, pay-later 5-year serial indebtedness incurred by its predecessor to meet current operating expenses. It overlooks the fact that to avoid the recurrence of such an unsound approach, the current administration instituted a job freeze which has saved $53 million to date and put an end to a 20-year practice of financing budget over-runs with emergency budget notes. Such notes were reduced from an all-time high of $68.8 million on June 30, 1965 to $21 million on June 30, 1966."

Mr. Riehle's replies:

On a short term basis there has been an improvement in fiscal management in that there has not been borrowing recently to meet current operating expenses and the long practice of issuing budget notes seems to be disappearing. Although efforts are now being made to institute long-range planning, it will be some time before real success or failure can be measured.

While a considerable portion of City debt is self-supporting, the institution or increase of user charges for certain services now subsidized (e.g. water, sewer, transit, bridges) could render a greater portion of debt self-supporting and provide moneys for financing some capital improvements from current revenues. Moreover, the elimination of these subsidies would free the moneys for use in such non self-sustaining fields as elementary and secondary education. In essence, more prudent use of funds could greatly expedite the replacement of obsolete capital plant.

VIII. The statement of the bond rating service:

"In recent years partially due to the city's fairly rapid bond retirement policy, annual debt service charges have been inordinately high."

Commissioner Goodman's reply:

"There has been a long-term trend downward in the percentage which debt service bears to the total budget. The share of the budget devoted to debt service is down from 13.6 percent in 1966–67 to 12.5 percent in 1967–68. Debt service in 1956–57 was 16.7 percent. With regard to the city's rapid bond retirement policy, this is an asset rather than a liability in evaluating the city's credit. New York's present debt structure is heavily weighted in the short end to the point that more than 50 percent is scheduled for repayment by 1975. It is true that a slight lengthening of the average maturity of debt to a mere 15 years average life would result in substantial savings in the current expense budget, but this would result in higher total future interest costs. More than 8 percent of New York's funded debt outstanding as of July 1, 1965 was paid out by June 30, 1966. This suggests an unusual ability to meet debt requirements even if economic conditions in the future warrant expenditure cutbacks."

Mr. Riehle's reply:

Sound fiscal management calls for achieving a satisfactory balance between rapid debt extinguishment and reasonable debt service charges due each year.

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New York City's annual debt service charges have mushroomed from $404.5 million in 1962–63 to $653.6 million in the 1967–68 budget; this represents a 62% increase. Admittedly during the same period the overall expense budget's revenues rose by 85% ($2.8 billion to $5.2 billion), but real estate tax receipts increased by just 45% ($1.1 billion to $1.6 billion). The latter expansion, moreover, was in large measure due to tax rate hikes as the estimated full valuation increased by just 28% ($35.1 billion to $44.9 billion).

IX. The statement of the bond rating service:

"The fiscal legacy inherited by the Nation's older population centers—governmental expenses that are rising far faster than income—is accentuated in New York City, which recently has dramatized its plight by resorting to the avails of eight of the monthly State-run lotteries."

Commissioner Goodman's reply:

"This places undue emphasis on the proceeds of State lotteries. Man may differ philosophically on the appropriateness of utilizing the proceeds of lotteries for education, but in the case of New York, the total contribution in the prospective 1967–68 budget is an estimated $55 million, just a fraction over 1 percent of the total budget of $5,185.5 million. Why this utilization of the lottery is thought to be such a dramatic indication of New York's plight is difficult to understand in the light of the excellent overall growth and increasingly broad base of the city's revenue system. The table below shows the changes that have occurred in 1965–66, 1966–67 (estimated) and 1967–68 (estimated). Each component of the city's revenue system has grown except other funds, which in 1965–66 were made up chiefly of borrowed funds.

GROWTH OF NEW YORK CITY'S REVENUE SYSTEM, 1965–66—1967–68

[In millions of dollars]

	1965–66	Estimated, 1966–67	Estimated, 1967–68	Change estimated, 1967–68 vs. 1965–66 (percent)
Real estate taxes	$1,408.1	$1,573.0	$1,659.0	+17.8
General fund, other than aid items	1,028.9	1,378.7	1,543.4	+50.0
State and Federal aid	1,107.8	1,458.5	1,895.5	+71.1
Other funds	[1] 330.5	143.7	85.6	−74.1
Total	3,875.3	4,553.9	5,183.5	+33.8

[1] Includes $255,600,000, 5-year serial bond borrowing.

"The rating service overlooks not only the expanding broader-based revenue system but the most fundamental revenue point of all, the relationship of the city's total general revenues to its debt service. Although such a relationship is normally associated with a limited group of revenue bonds, we think it appropriate in view of the unusual protection afforded to New York City bondholders under the New York State constitution to review the history of New York City debt service coverage from 1929 to the present. At the depth of the depression in 1932, when debt service totalled $201 million, city revenues aggregated $611 million. The coverage ratio was then 3.04. This was the low point for the entire 39-year period. The long-term trend in this ratio has been generally upward. In 1966–67, the coverage ratio was 4.70, and we envisage a ratio of approximately 4.89 in fiscal 1967–68."

Mr. Riehle's reply:

Reference to the introduction of the State lottery was not made in such a way as to indicate that this innovation plays a substantial part in the rating analysis, but merely to dramatise how hard pressed New York is for additional sources of revenue. Now that the lottery device has been utilized, virtually the only untapped source of revenue is the tax-exempt institutions which abound in New York. No claim was made by the Moody's Bond Survey article that the lottery would either substantially add to or diversify City revenues.

City revenues are more diversified now than in the past because traditional taxes such as the property tax are no longer capable of sustaining more than just over one third of the load. As each tax is raised to the point where officials feel that its effects will not be too harmful, another type of taxation is sought—for example in recent years the personal income tax and commuter tax. A diversified reserve of taxes which may be implemented when the need arises is

indicative of a much stronger financial position than when almost every type of tax which can be conjured up has been instituted and levied at a substantial rate. Ever-increasing reliance on State and Federal aid is not prudent because these sources, as to rate and amount received, are beyond the control of the City, and possibly with the election of more conservative legislators, such aid might not continue to increase so rapidly as it has done in the past.

The coverage ratio of debt service by revenues is not particularly useful in analysing general obligations because there is not usually an earnings test, as in revenue bonds, which restricts the issuance of additional debt. The City debt emissions are tied to the size of the tax base, not to total revenues; coverage of debt service. Hence, debt charges should be viewed in relation to the tax base, real estate tax levy and the size of the tax rate. As stated on page 13 of this statement in the past five years debt charges have increased by 62% while real estate tax receipts have grown by only 45% and the full valuation of taxable property by just 28%.

X. The statement of the bond rating service:

"Far more disturbing from the aspect of credit implications, and more difficult to resolve, is the continuing exodus of the educated middle class. Implicit in this trend is the potential loss of an electorate with a desire for efficient, conservative, sophisticated government."

Commissioner Goodman's reply:

"This statement is interested in the light of the election results of November, 1965 in which the voters brought into office the first Republican-Liberal-Fusion government since the highly respected LaGuardia administration of the 1930's. The rating service fails to mention that this administration has achieved economies totaling $100 million per year; avoided the issuance of emergency budget notes for two years in a row; advance the first plans in several decades for a basic streamlining of the city government; undertaken a strong program of economic development with emphasis on building business and employment in the city; established a Manpower and Career Development Agency to develop job training programs and to take people off welfare relief in New York City, instituted a personal income tax on residents and an earnings tax on nonresidents (commuters); substituted a new business net income tax for an outworn gross receipts tax; doubled water charges; and increased the transit fare."

Mr. Riehle's reply:

Despite the so called economies of $100 million per year, equivalent to less than 2% of the 1967–68 budget, the trend to ever increasing expense budget expenditures has not been halted—they continue to grow by leaps and bounds: $2.8 billion in fiscal 1962–63 to $3.8 billion in 1965–66 to $4.5 billion in 1966–67 to $5.2 billion for 1967–68.

The fruition of plans to streamline City government and to bolster economic development remains to be seen. Despite the establishment of a Manpower and Career Development Agency to develop job training programs and to take people off welfare relief, the total number of individuals on welfare is soon expected to reach 10% of the total City population, compared with 8.9% last year and 4% a decade prior to that. The fact that in 1966 of the 600,000 persons on welfare 79% were children and adults caring for children and that this is the fastest growing segment of the welfare population, would seem to indicate the very great need to control population. Expenditures designed to help parents control the size of their families and to reduce the rising illegitimacy rate on a vastly increased scale would have the potential to do more than anything else to alleviate the growing burden on municipal, state and federal expenditures of supporting persons on welfare relief.

The substitution of the new business net income tax for the inequitable gross receipts tax, the doubling of water charges and the hike in the transit fare were all steps in the right direction. The institution of the earnings tax on nonresidents should perhaps tone down the clamor for home rule in view of its practice of taxation without representation.

XI. The statement of the bond rating service:

"These trends were a long time in the making and will likely be a long time in the resolution."

Commissioner Goodman's reply:

"Although it is true that certain of the city's fiscal trends were a long time in the making, many will not be a long time in the resolution. The positive actions already enumerated speaking louder than words."

Mr. Riehle's reply:

Commissioner Goodman does not specify which trends he thinks will be a long time in resolution and which will not. Many of the significant trends, such as the cost-revenues squeeze, a tax base which is lagging in pace behind mounting expenditures, substantial debt emissions and heavy annual debt service charges, spreading urban blight and its associated problems of high unemployment and welfare rates in slum areas, show no signs of being reversed into a favorable direction. An effort, though, is being made at stemming the tide.

APPENDIX E

A Random Sampling of Post-World War II Defaults Nationally

Alabama
Saraland; water revenue
Alaska
Anchorage; port and terminal revenue
Arkansas
El Dorado; industrial revenue development bonds
California
Redondo Beach; harbor revenue
Rio Ramajo District; revenue
San Jacinto Winter Park Authority; revenue
Florida
West Palm Beach Marina;
Georgia
Houston County; water revenue
Illinois
Calumet Skyway (Chicago); revenue
Iowa
Sioux City Swimming Pool;
Kansas
Elqui; general obligations
Louisiana
Conshatta; industrial development revenue
Lafayette; parking revenue
Michigan
Muskegon Township Water District;
Mississippi
Baldwin
Boonsville
Clarksdale
Clearland
Coffeeville
Greenwood
Lambert
Port Gibson
Rienze
Tupelo
Nebraska
Bellevue Bridge Commission; revenue
Burt County Bridge Commission; revenue
North Carolina
Walnut Cove; general obligation
Ohio
Belmont County Sewer Dist. #1;
Oregon
Umatilla County; bridge revenue
Pennsylvania
Chester County Natural Gas Authority; revenue
Jefferson Township;
Lancaster County Natural Gas Authority; revenue
York County Natural Gas Authority; revenue
Municipal Auth., Pa. Lease Roesta
South Carolina
Chester County Natural Gas Authority; revenue
Lancaster County Natural Gas Authority; revenue
York County Natural Gas Authority; revenue

Tennessee
Anderson County;
Campbell County;
Jefferson—Coke Public Utility Dist.;
Middle Tennessee Utility;
Texas—See below after West Virginia
Utah—Spring City
Vermont
Colchester Fire Dist. No. 3;
West Virginia
Davy; water revenue
Dunbar bridge; revenue
Marshall County Public Service Dist. #1 Water
North Beckley; revenue
Parkersburg bridge; revenue
Pax; water revenue
West Virginia Turnpike; revenue

Post World War II Defaults in the State of Texas (an intensive but not necessarily all inclusive study. Because some default situations involve non profit corporations which have placed bonds privately, there is little available public information).

City of Anna; G. O. and Revenue.
City of Asherton; G. O.
City of Avery; Revenue.
Beckville I/S/D; 1946.
City of Beaumont Parking Garage; Revenue.
City of Benavides; 1951; G. O.
1953; G. O.
1954–58; Revenue.
1964: Bank failure.
City of Big Springs; Revenue.
Blooming Grove I/S/D;
Blossom Prarie; Revenue.
Brazoria County WC & Id #8; Now in default.
City of Bridgeport; Revenue.
Brownsville Navigation District; G. O.
Burnet I/S/D; Numerous payment delays up to 1946.
Cameron County WC & ID; Now in default
Cameron County WC & ID;
Cameron County WID #16;
Cisco I/S/D;
City of Cooper; Revenue.
City of Corpus Christi; Revenue.
City of Crawford;
Town of Dawson; Revenue.
Ellis County Levee Improvement District #2;
El Paso County WC & ID;
Forreston I/S/D;
Franklin I/S/D;
City of Frisco; Revenue.
City of Glen Rose; Revenue.
Golden I/S/D;
Hidalgo County FWSD #1;
City of Hubbard; G. O.
Hudspeth County WC & ID #1;
City of Hughes Springs; G. O. and Revenue.
City of Holliday;
Kaufman County Levee Improvement District #4;
City of Kerens; Revenue.
City of Kosse; Revenue.
City of La Feria; G. O.
La Joya I/S/D;
Lamar County WC & ID #1;
City of Lindale; Revenue.
City of Lockney; G. O.
Lockney I/S/D;
Lone Oak I/S/D;

City of Lovelady; Revenue
City of Lyford; G. O. and Revenue.
City of Manor; Revenue.
Maverick County WC & ID #1.
City of Megangel.
Minden I/S/D.
City of Mingus; G.O. and Revenue.
Midway I/S/D.
City of Mount Calm; Revenue.
City of Naples; Revenue.
New Diana County Line I/S/D.
Olminto I/S/D.
City of Palacias; Revenue.
City of Pearsall; Revenue.
City of North Pleasanton; Revenue.
Point Isabel I/S/D.
Polk County.
City of Port Isabel; Revenue.
Queen City I/S/D.
City of Ranger; G.O.
Ranger I/S/D.
City of Richland Springs; Revenue.
City of Rising Star.
City of Rockport; G.O.
Sabine County; Road and Bridge. General Fund Warrants.
San Augustine County; Permanent Improvement. General Warrants.
San Benito I/S/D;
  Former Highland I/S/D;
  Former Rangerville I/S/D;
  Former Los Indios I/S/D.
Town of Savoy; Revenue.
City of Seadrift; G.O. and Revenue.
Somerville County; Limited Tax Road and Bridge. Limited Tax Permanent Improvement.
City of Stanton; Revenue.
Strawn I/S/D.
City of Talco; Revenue and G.O.
Timpsm I/S/D.
City of Thornton; Revenue.
City of Tom Bean; Revenue.
Travis County WC & ID #5.
Travis County WC & ID #12.
Travis County WC & ID #14.
Travis County WC & ID #15.
Walnut Springs I/S/D.
City of Walnut Springs.
Warren I/S/D.
City of Wells; Revenue.
West Sabine I/S/D; (Former Bronson I/S/D).
West Side Calhoun County Naval District; Revenue.
City of Whitney; Revenue.
Town of Windam; Revenue.
City of Wortham.

Chairman PATMAN. Thank you, Mr. Riehle. We appreciate your testimony. We shall get back to you after we hear our other two witnesses.

Now we hear from Mr. Wade S. Smith, vice president of Dun & Bradstreet.

Mr. Smith.

STATEMENT OF WADE S. SMITH, VICE PRESIDENT, MUNICIPAL SERVICE DIVISION, DUN & BRADSTREET, INC.

Mr. SMITH. Chairman Patman, Senator Proxmire, members of the Subcommittee on Economic Progress of the Joint Economic Commit-

tee, I am honored to appear today in connection with your hearings on financing municipal facilities.

I am a vice president of Dun & Bradstreet in charge of the municipal service division. I have been a staff member of the National Municipal League; and for many years I edited the "Taxation and Finance" columns of what is now the National Civic Review. In 1959–61, I was a member and in 1961 I was chairman of the Census Advisory Committee on State-Local Statistics. I presently serve on the standing committees concerned with New York City finances of the Citizens Union of the City of New York and of the New York City Commerce & Industry Association.

The financing of municipal facilities is a subject of intense personal interest to me and one on which I am delighted to talk to anyone willing to listen. Having such a distinguished audience is a rare privilege. Members of the subcommittee have already received, I believe, copies of my prepared statement. I would like to take the 10 minutes allotted to me for oral comment to summarize that statement as a basis for any questions you may have.

The municipal service division of Dun & Bradstreet, which I manage, is engaged in the business of collecting, analyzing, and disseminating information pertinent to the determination of the credit risk inhering in the debt obligations of the States and their local subdivision. Our vehicle is a written municipal credit report. These reports are furnished to our subscribers, who are investors in municipal bonds, including underwriters. In the main, they are large institutions with highly professionalized staffs, experienced in the field of State and municipal bonds. The Dun & Bradstreet reports are one of many sources of information used by such institutions.

Although our coverage of State and local credits is specialized, we actually cover a very substantial portion of the available supply of municipal bonds coming to market. Last year, for example, the approximately 1,200 new offerings we covered represented a par value of $$10.4 billion. This compares with new issues for the year of about $12.6 billion, excluding public housing authority bonds and industrial aid revenue bonds.

Municipal bond credit quality is relative, not absolute. It is not feasible to divide all municipal credits into two groups and say these will surely default, these will surely not default. Each situation has a potential for at least some degree of improvement or deterioration. The evaluation of these differing potentials is complicated by the extreme diversity among the individual situations. What is important in one situation may be insignificant in another. One situation's vulnerability to a given weakness may be minimized by other factors; while, in another situations, the identical weakness may be without significant offsets. It is the task of municipal credit evaluation to identify all the relevant, significant factors in each situations so that their potential may be understood.

The requirements of investors are not absolute, either. Each individual portfolio or fund has its own special policies and objectives, and each seeks to maximize its return within the limits set by policy, regulation, and investment objectives. Consequently, a security readily acceptable to one investor may be simultaneously a poor choice for another.

The diversity among investment credits and the diversity among requirements give rise to two important situations with respect to the content of our reports and the advisability of municipal bonds. As respects our reports, each must contain the information needed by a subscriber to determine the extent to which that particular credit matches his requirements and whether it matches them better or worse than other municipal securities simultaneously available on the market. That is, he will be willing to pay a higher price for the qualities important to him than for others that are less important, and he will try to avoid paying a premium for qualities relatively unimportant to him.

The propensity for dealing individually in selecting securities has an important effect on the marketing of municipals. Obviously, if all investors had identical requirements, securities of a given obligor with identical characateristics would be worth identical amounts to each and every investor. But investor requirements differ, and some of these requirements have to do with characteristics related only remotely, or not at all, to the credit risk. The result is that credit quality and price or yield do not necessarily move hand in hand. Under such circumstances, the credit evaluation may have little or no practical effect on the price or yield of the security. Other factors such as the tax laws in the State of issuance, the size of the block or bonds in each annual maturity, frequency of borrowing, the public image as reflected in the news media, may be far more important as credit determinants than credit quality.

Investors do not make these kinds of investment, which often involve millions of dollars, by blindly following the reports or recommendations of financial services, including Dun & Bradstreet, nor are such services their only source of information. Traditionally, they assemble relevant information from a wide variety of sources and make their own independent evaluation and appraisals and decide what bonds to buy and at what rates.

Finally, I would like to comment very briefly on the suggestion that municipalities be offered a guarantee of their bond issues and a grant of one-third of the interest cost in return for relinquishing their intergovernmental immunity to Federal income taxation. The objective, I take it, is to widen the market for municipals, particularly for the bonds of very small issuers. The technical aspects of such an exchange I must leave to others; it is outside my sphere of expertise. But obviously, it calls for very careful scrutiny by people competent to investigate its impact on all segments of the capital markets.

I believe that the basic premises of H.R. 15991 are erroneous. It is not low ratings or the lack of ratings or of municipal credit reports that impair the marketability of bonds of small communities, nor are these factors responsible for the present interest rates. High interest rates are the consequence of economic and capital market pressures beyond the control of either borrowers or lenders, and certainly beyond the sphere of influence of the financial services.

The marketability of the loans of small communities is impaired by the very smallness of the issues and the supply of bonds; they are not of sufficient size to appeal, without price concessions, to large investors who comprise the national market. Hence, these small issues must look to the local, State, and regional markets where the small blocks of bonds involved will match the requirements of the smaller

investors. Federal guarantees will not eliminate this difficulty and so give us no reason to think that they will propel small issues into the national market. The taxation of interest of such bonds will, however, raise interest rates to the level of those on taxable securities generally. I think it likely that the increase will prove to be disproportionate for the small borrowers; and it is not impossible that despite an interest cost reimbursement, many of them will wind up paying more for their money than they would pay at present.

The assertion has been made that the Nation's municipalities and States must pay such a high rate of interest on their securities that they cannot afford to finance many public facilities. This statement assumes that municipal borrowing is closely responsive to interest costs. I know of no definitive studies on this question. There may be some marginal undertakings proposed to be financed with revenue bonds where the interest costs would be critical. Revenues might support an interest rate of, say, 3.5 percent, but would not support 4 percent, so that the project is either abandoned, or a tax subsidy or other means of financing is found.

In the case of financing governmental improvements—schools, public buildings, streets, highways, and so forth—the interest cost does not appear to be a critical factor, except in some special situations where the tax rates for bond service are legally limited. Higher than average interest costs may lead to indefinite postponement, which is simply one of the functions of the interest rate and is not necessarily bad. It may merely result in obtaining other and possibly more appropriate methods for financing such projects.

Interest costs are not caused by financial services: they are the result of situations reported by the financial services. The situations and not the reports cause the problems. The ultimate judgment on the situation, whether particular bonds are marketable and, if so, at what cost, is not made by the financial services but by the investors. These investors make their own independent judgment and act accordingly.

As a class, municipals rank second only to the U.S. Government obligations in credit strength. Were safety the only consideration, many investors would be indifferent as to whether they held municipals or governments. Moreover, except for the bonds of a relatively few larger States and cities, governments are largely superior to municipals in liquidity. Candor compels the admission that for investors generally, attraction of municipals is their higher after-tax yield—their tax exemption. Eliminate this feature and I think you will find you have a brandnew ball game, the rules of which are as yet unknown. That the taxpayers, especially those of smaller communities, will win this new ball game I very much doubt.

(The prepared statement of Mr. Smith follows:)

PREPARED STATEMENT OF WADE S. SMITH

Chairman Patman, Senator Proxmire, members of the Subcommittee on Economic Progress of the Joint Economic Committee. I am honored to be invited to appear today in connection with your hearings on financing municipal facilities. It is a subject of intense personal interest to me, and one on which I am delighted to talk to anyone willing to listen; having such a distinguished audience is a rare privilege. In fact, I have been involved all my adult life in the various facets of state-local finances, first as a student of political science, then as a staff member of the National Municipal League, which some of you are familiar with as the great pioneer and present most potent civic force in

the betterment of state and local government procedures, and for the last thirty-two years with the Municipal Service Division of Dun & Bradstreet, Inc., most recently as the head of that division.

It may be pertinent as background also to note that for many years I edited the Taxation and Finance columns of what is now the *National Civic Review*, that in 1959-61 I was a member and in 1961 chairman, of the Census Advisory Committee on State-Local Statistics, and that I presently served on the standing committees concerned with New York City finances of the Citizens Union of the City of New York and of the New York City Commerce and Industry Association.

Before proceeding specifically to the inquiries the committee has made, it will be helpful if I indicate briefly the functions which are performed by the division I head. We are in the business of collecting, analyzing and disseminating information pertinent to the determination of the credit risk inhearing in the debt obligations of the states and their local subdivisions. Our vehicle is a written municipal credit report presenting the information relevant in each particular situation, summarizing our judgments on major credit factors, and expressing an evaluation of the credit quality generally. Our customers are investors in such bonds including underwriters. They are, in the main, large institutions with highly professionalized staffs. We provide detail, and insights on these situations more economically than such staffs could secure themselves, and we afford them an independent and objective appraisal of the accuracy and completeness of such information, thereby assisting them in the prudent discharge of their responsibilities.

Some of the current criticism of tax exempt bond evaluation arises from a misconception of the purpose of securities evaluation. It assumes, in fact, that any State or local government bond can be appraised in absolute terms. Investment managers and bankers know that this is inaccurate. Any given investor is concerned with a broad array of choices as to where to put his money to work: mortgages, corporate bonds, preferred and common stocks, commercial paper, savings accounts, governments, are all available to him—and extensively used—as well as municipals. Moreover, his choice among the available alternatives is seldom completely free and unrestricted: the investment objectives of the portfolio, policy determinations as to acceptability of differing degrees and kinds of risks (either self-imposed or enforced by regulatory agencies), relative opportunities for profit, taking into consideration the tax posture of the investor, all interact to make one security more or less attractive than another. It is the responsibility of the investment officer or portfolio manager to maximize the return on the funds entrusted to him for supervision, taking into account all factors determining the scope of his authority and all the opportunities available in the market place at any given time. And since each portfolio has its special requirements and purposes, it follows that a security eminently suitable and desirable to one portfolio may simultaneously be entirely unsuitable to another.

The purpose of securities evaluation as we see it is to determine for a given portfolio at a given time which of the then available securities is most advantageous *to that portfolio*. The problem is one of relatives, not absolutes, and the problem is solved by recourse to relevant information. What is relevant information is of course determined in part by general considerations (is this company, or municipality, well-managed, is its debt within "safe" limits, etc.); but it is also a function of the unique considerations relating to the portfolio itself. From this relevant information, the portfolio manager expects to be able to make the "best decision." For reasons such as these, no absolute evaluation of security quality is practicable. The problem of the investor is essentially that of determining best value for his portfolio, not for anyone or everyone else. The problem of avoiding unacceptable risk is real, of course, but the greater risk is failure to maximize profit within eligibility limits and portfolio objectives.

The Dun & Bradstreet Municipal Credit Reports were from the start in 1932 designed specifically to facilitate the process of matching individual portfolio requirements and objectives with specific municipal securities. John Stephenson and Frederick L. Bird, who created our operation as respectively manager and director of municipal research, were imbued with the conviction that relevant information was the keystone to successful investment in the securities of the states and their local subdivisions, and that the "comprehensive report" was the most appropriate vehicle to convey that information. The format and content of our reports has changed over the years to meet changing conditions (not the least of which is the availability of markedly better statistical information now

than years ago), but the concept of the function of the report and the importance of relevant information has not changed.

While our municipal credit reports are primarily presentations of factual data, they also include a formal, standardized expression of the credit risk as we see it. These expressions, whether verbal or numeric, are not commonly referred to as ratings, although it is evident that any formalized system of classification may be described as a rating. Further, it must be emphasized that our classifications relate solely to credit risk—the likelihood the bondholder will not be paid the amount due when due. This is in contrast to a determination of investment risk, which involves not only credit risk but also additional risks associated with liquidity. This conceptual difference is well known to the professional users of our reports and of the bond ratings, but often escapes the non-specialist not involved in the day-to-day use of the materials.

The facts and judgments stated in our reports are subject to searching scrutiny by three separate and distinct groups whose economic interests are different. Borrowers seek to sell their bonds at the highest obtainable price (lowest obtainable interest cost) and their officials are quick to detect whatever they regard as inaccurate or unfair; we welcome their scrutiny. Our underwriter subscribers seek to buy cheap and sell dear, and they can be vocally unhappy if they think violence has been done to the facts as they see them. Finally, our investor clients seek to acquire their investments as cheaply as possible, but they are even more concerned that they know exactly what they are buying. We could neither hold the cordial cooperation of public officials, which we do, nor retain our subscribers, which we also do, if we did not satisfy these requirements of accuracy and objectivity.

Dun & Bradstreet is merely one source of information for investors in state and municipal securities. As such, its reports and judgments are in no sense determinative of interest rates or the marketability of particular bonds. The interest rates and the marketability of particular bonds result from the realities of the market place, that is to say, the interaction of interests of the various groups involved: municipalities, investors and underwriters.

I will now turn to the specific question raised in the Subcommittee's outline of April 16, 1968.

1. Municipal Credit Report Coverage

In calendar 1967, we issued 1,636 municipal credit reports on 1,476 different public bond-issuing bodies. Of these reports 121 were on states and state agencies and 1,515 on local governments and local government agencies. Of the reports, 72% was under our general obligation and special tax bond services, some of which also contained information on limited liability enterprise revenue bonds on the entity covered, and the remaining 28% was on entities issuing enterprise, vehicular toll, and lease-rental public building revenue bonds. We do not report, as a matter of policy, on limited liability special assessment obligations, nor on certain other categories of tax exempt securities whose past history is such that they are not generally regarded by professional investment management as suitable instruments for general investment. The excluded classes specifically include so-called industrial aid revenue bonds. We also do not report on so-called new act housing bonds, which as to credit risk have the stature of obligations guaranteed by the Federal government.[1]

It is of interest, I think, that although our coverage of new issues is specialized, we actually cover a very substantial portion of the municipal bonds coming to market. Although our new-issue reports in 1967 numbered just over 1,200, the new issues so covered had a par value of $10.4 billion. This compares with total new issues for the year, excluding public housing authority bonds and industrial aid revenue bonds, of about $12.6 billion.

In 1967 our reports ranged from one to 25 pages. They averaged six pages. It is impossible to state how long each report took to prepare since almost every report utilizes information and prior reports previously assembled or prepared. All reports utilize our prior experience and background. The importance of comprehensive files, many containing analytical data running back into the 1920's, is obviously great, not only in providing continuity in successive reviews but in permitting expeditious and dependable current review. We have no means of

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[1] The reason we do not report on certain types of issues is because there is only a very limited national interest in such issues. Since there are other sources of information and many other factors involved in the marketing of such issues I do not believe that our failure to report on such issues has any significant effect on their marketability. This is discussed further in point 9 *infra*.

estimating this overall investment of analytical time on any name, but in numerous instances it runs to the hundreds of hours and in complex, long-established borrowers to the tens of hundreds. Without this continuum of data and analysis, it would be very difficult at best to do the comprehensive reporting we undertake.

You may be interested in knowing something of the basis of our coverage of these public credits. To begin with, we serve the needs of the underwriter and investor at the national market level, which encompasses securities available in sufficient quantity to be widely distributed. These are the backbone of any sizeable municipal bond portfolio, and they are the only bonds available in sufficiently large blocks as to each maturity to satisfy the requirements of the larger portfolios. The availability of our reports on these situations releases the staff time of our subscribers for attention to the obligations of the smaller borrowers in their immediate areas, for whom they feel a responsibility. Among these substantial borrowers, something over three hundred of the issuers of general obligation or special tax bonds and about 150 of the large issuers of enterprise, toll, and lease-rental revenue bonds are kept under continuous review and are reported on at twelve to eighteen month intervals whether they issue new bonds or not. They, and other obligors, are reported on when they offer, at public sale, general obligation or special tax bonds in an amount of $1,000,000 or more, or when they offer revenue bonds, generally in an amount of $5,000,000 or more but occasionally down to $1,000,000.[1]

The cut-off points for our review of new issues are the product of very practical considerations. We believe they represent about the minimal levels of offerings of practical interest to the larger institutional investors and the underwriters with national distribution facilities who serve them, and they include the borrowing units generally capable of providing adequate and timely information.

2. Credit Evaluation Procedures

The municipal credit specialist is concerned with a large array of factors encompassing literally anything which may significantly affect the prospects that the creditor will not be repaid when he should be. Fortunately, a manageable number are of controlling significance in any individual situation. It is the analyst's function to discover these factors. Like people, each governmental unit is a distinct entity, and any acceptable system of analysis must be sufficiently flexible to resolve this diversity with meaningful appraisal. Our states and local communities, while sharing common problems, are simply not standardized, and simplistic and mechanistic system of analysis applied to such diversity would be, I believe, impracticable and undependable.

We group the relevant factors under four major headings: Economic and Social, Administrative and Legal, Debt, and Financial. The first, Economic and Social Factors, has to do with the sources of community income and employment, the levels of wealth and income, the trends, both short-term and long-term, and the identification of any peculiar risks inhering in these factors. Basic data are drawn from such sources as the U.S. Bureau of the Census, state universities, bureaus of business research, directories and studies prepared by state and local business associations, and from basic data gathered by Dun & Bradstreet, Inc., on business, building activity, business trends.

Administrative and Legal Factors has to do with governmental structure, assignment of functional responsibilities, tax and revenue systems, significant features of laws respecting particularly administration, debt, and financial operations, arrangements for budgeting and planning, as well as the more obvious factors having to do with management *per se*. Sources of information include the state constitutions and statutes, local charters, administrative manuals, organization charts, budgeting, control, auditing and reporting documents, and studies by civic, academic, research, and governmental groups.

Debt Factors are the elements having to do with the purpose, nature of security, structure, term and support of the local public debt, and its relative burden on the community. These data must come from the official records and reports of the governmental units involved. The basic sources are the regular annual

[1] Our records indicate that in the first six months of 1968 there were 725 offerings of general obligation or special tax bonds in amounts of $1,000,000 or more. Of these, offerings in the $1,000,000–$1,499,999 size range represented 24.8% of the number of offerings but only 4.7% of the dollar volume; offerings of $1,500,000–$1,999,999 represented 16.3% in number and 4.3% in dollar volume; offerings of $2,000,000–$4,999,999 represented 35.2% in number and 16.9% in dollar volume; and offerings of $5,000,000 and over represented 23.7% in number but 74.1% in dollar volume. The aggregate dollar volume of the 725 offerings was $4.6 billion.

financial reports of state and local governments, supplemented as required by interim reports (as when new bond issues are offered) or by special break-outs of needed detail. Because of the problems of comparability and identification, limited meaningful material can be obtained from secondary sources.

The final grouping, Financial Factors, covers such subjects as the magnitude and trend of expenditures, the source and trend of revenues, the solvency of the current account, the productivity, stability, and nature of the tax system, the financial status of public service enterprises, if any, and the quality and effectiveness of financial policies. Again, these data must come from the records of the governmental entities involved, mainly their annual financial reports, budgets, and long-term programs.*

Few of these data are meaningful in raw form. Some of the information, like precious metals, must be refined from a mass of conglomerate materials. Some of it must be processed statistically to make it meaningful. And much of it even when processed is of little significance standing alone; its importance is developed by studying trend or by making comparisons with other situations. The development and maintenance of meaningful comparative data is the peculiar function of the analytical organization.

The quality of the data of course varies widely. The larger municipalities all do at least an acceptable job of financial reporting, and some of them as well as many smaller cities do an outstanding job. The states and counties are spotty, ranging from first-rate financial reporting and budgeting practices to units (particularly among the states) where the decentralization of operations makes assembly of essential information a very complex job because of the numerous departments, boards, and commissions involved. School districts are notoriously substandard in their accounting, budgeting, and financial reporting practices, although there are outstanding exceptions; this is a reflection mainly of the fact that their record keeping emphasizes satisfaction of state-aid criteria, rather than management control and information. Some states have well-conceived programs for supervision of local financing and budgeting, and a few publish data in sufficient detail to be helpful to the credit analyst. Over the last thirty or thirty-five years the work of the National Committee on Governmental Accounting, and the active promotion of its recommendations by the Municipal Finance Officers Association and others interested in the reformation of financial practices, have been highly effective in raising the general level of accounting and reporting practice.

With respect to general economic and demographic data, the quality is high, and available material is suitably comprehensive, as to the states, the counties, and the larger cities. There is, however, a pronounced lack of detail on the smaller communities; population and housing census data, for example, are not reported in detail at all for "places" under 2,500 population, and in only limited detail for places of 2,500 to 10,000.

The diversity of the various sorts of pertinent information impose, I might note, a serious impediment to the use of data processing equipment in the handling of municipal credit materials. Data processing systems require highly standardized inputs, and municipal credit data are anything but standardized. We presently store certain information, and print it by computer, and we have for some years been studying computer application to actual municipal report preparation. Few practical advantages in computer usage are yet in prospect.

3. Sources of Information

Facts are the essential ingredient of credit investigation. They must be pertinent, accurate, and sufficiently comprehensive to provide a basis for dependable judgment. The most important sources of information are what the Committee refers to as "first hand." Most important of all are the official annual financial reports and budgets of the governmental entities themselves. These annual reports and budgets are frequently supplemented by special reports and studies, including statements prepared in connection with public offerings of new bonds.

*The December 5, 1967 hearings of the Subcommittee, Financing Municipal Facilities, Volume 1, pages 40–47, include a list of some 427 items which appear to represent a list of facts allegedly essential to a municipal credit evaluation. This is in fact a list of some fifteen to twenty kinds of facts, repeated with variations twenty-one times. Many of the items listed are of little or no significance in credit analysis (although they may have relevance to other uses) and some essential to credit analysis are omitted. Some of the items would be unobtainable even by direct ledger inspection, since they are not required for either budgetary control or for program management. The preparation of such lists is not useful because they imply a simplicity and standardization which doesn't exist.

Obviously, these documents must be secured directly from the state and local units concerned. Many units maintain mailing lists for distribution of their annual and other periodic reports, while for others direct inquiry must be made.

Other pertinent information needed for analysis is contained in the state constitutions, statutes, and local charters of the borrowing entities: the analyst's source is a copy of the document or a reliable, professionally prepared digest. Other data relating to economic and demographic materials are available from the U.S. Bureau of the Census, Department of Agriculture, Department of Interior, Corps of Engineers, from universities, bureaus of business research, other state and local business organizations, and from the business information compiled by Dun & Bradstreet, Inc.

Field work—visits to the area of the governmental unit under study—is an essential in the study of certain very large and complex borrowers, and it can be quite helpful in other situations. I must emphasize, however, that visits are not a substitute for the primary source materials. Moreover, field work is of little use unless such material has previously been processed and analyzed. Thirty years ago it was necessary to go into some city halls and some county courthouses to gather financial information by bits and pieces, but standards of reporting are now more sophisticated. It is a misunderstanding to assume that no evaluation is acceptable unless based on a field investigation.[1]

We see many officials and other representatives of the state and local borrowing units of places other than their offices. Some of these contacts are at conferences of public officials, state and regional conferences being especially helpful in this respect, and others are at luncheon meetings and briefing sessions attended by anything from a few to a large number of municipal bond people. And we have interviews with a considerable number of officials who come to our offices. Some of these officials have visited us regularly for many, many years and give us the benefit of their thinking during the period that their programs are in the formative stages; others come periodically as part of a routine program of keeping their bondholders, the underwriters, and the financial community informed. In general, interviews are useful in proportion to the degree that we have previously been provided with primary data and time to study it before the visit.

4. Organization and Staffing

All research operations have essentially the same operational problems: each must define its objectives, the task to be done; must formulate effective, efficient, and dependable procedures to accomplish the task; must have the means to supervise performance; and must have suitable personnel. Determination of objectives, formulation of procedures, and supervision require maturity, sound judgment, and experience. The researchers require suitable academic preparation and the requisite verbal and numeric skills. Such of these researchers as attain maturity, judgment, and experience will become in time the supervisors and the planners of tomorrow's research functions. It is noteworthy, I think, that a good deal of the world's research work in the exact sciences and in the social sciences, in the universities and in commercial applications, is in fact done not only by juniors but by students; it is not they who certify the quality and dependability of their work, but those who plan and supervise.

Our professional staff is managed by myself, our director of municipal research, and our assistant director; our combined tenure with this division is a little over 81 years. My background I have already touched on: I received a B.A. from Oberlin College with a major in political science. The research director is an economics major with his B.A. from the University of Texas and his Ph.D. from Columbia University, and is Adjunct Professor of Finance at the graduate

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[1] At the December 1967 hearings before the Subcommittee, Mr. Roy Goodman, then Finance Administrator of New York City, states "An official at Dun & Bradstreet has estimated that a proper investigation of a municipality would cost between $1,000 and $2,000." (*Op. cit.* December 5, 1968, p. 19). Substantially the same statement is contained in a report attributed to Mr. James F. Reilley, reproduced on p. 87. I believe that I recognize this as a mis-quotation, out of context, of a comment that I have made on several occasions in private discussions of the problems involved in reporting very small local units. The type of unit involved is one too small to have available standard population, demographic, and economic data and lacking published annual financial reports, and budgets. To develop the data for a reasonably dependable credit evaluation in such a situation could involve field work for gathering basic data, including direct ledger inspection for financial data, population enumeration and sampling, employment surveys, etc., that could readily run to $1,000 to $2,000 for the field work. The figure would not include processing, analysis, and the usual staff work. The figures have no relevancy to a discussion of credit investigation or reporting in situations where pertinent data are readily available.

school of New York University. The assistant director received his B.A. from Ohio Wesleyan University with a major in business administration. The professional analytical staff, exclusive of a position added this year, numbers ten persons. Nine of these ten have at least the bachelor's degree, mainly with majors in government, political science, or economics. The ten include one with eight years with the division, one with six years, three with two years, two with over one year, and three with less than six months experience. Salaries range from $6,500 to $10,000 for persons without supervisory responsibilities.

Turnover among juniors in research operations tends to be somewhat high. Over the last three years, exclusive of retirees and maternity leaves, our analytical staff turnover averaged 16% of membership, one-third of its persons separated during their probationary period. Because of our specialized requirements most of our staff comes to us from college or university with academic preparation in economics, public finance, political science, or government. Research appears to have a great deal of glamor for some young people, but it involves hard and tedious work and some of them tire of it rapidly and engage in other occupations. Others, aiming at careers in the financial industry, seek a short experience as analysts as a basis for their careers.

5. Dissemination and Review of Reports

Our municipal credit reports are available to subscribers, and the credit evaluation expressions (*i.e.*, ratings) are available with the reports, whether contained on the face of the report or in a supplementary listing.

Any organization handling and processing large quantities of statistical and other factual information will make mistakes, ranging from typographical errors upwards. All material errors when discovered are corrected, and if the error has been compounded into an error of expressed judgment, appropriate amendment of judgment is made. It makes no difference as far as correction is concerned whether the error is discovered by a subscriber, by an official of the borrower concerned, or by members of our own staff. Our procedures are designed to minimize errors, and while we must publish errata notices occasionally we rarely have to amend substantive matters.

Now, as to disagreements with our credit risk evaluations. Obviously, our first responsibility is to the integrity of our own procedures and analytical principles. If the facts are incontestable and if they lead us logically and inexorably to a single conclusion and if we are satisfied that any reasonable reading of the facts supports that conclusion, we will stick with our position. If we are wrong, we will make the necessary corrections. If we have been ambiguous, we will clarify. In our view, issuers and subscribers alike are entitled to a clear and explicit statement as to how we see things and why, and we give it to any and all who ask.[1]

In this connection, I think it should be further stated that we do not expect, and do not see it as possible to have, 100% agreement with the stated expressions of credit risk which we use—what are referred to as the ratings. These stated expressions are intended to be rough guides, broad generalizations only; the fine points are in the report, in detail. We are not surprised, particularly in borderline cases, when another specialist may see the situation as more properly lying on the other side of the border. It is a gross misuse of any rating expressions, whether stated in plain English, in alphabetic symobls, or in numeric symbols, to regard them as definitive and absolute.

6. Assignment of Staff Time

Our analysts spend all of their time working on municipal credit analysis. Certain of the tasks involved are of course carried out, or carried out in part, by others. The proportion of time spent in the various chores involved varies widely from situation to situation. In the case of a municipality being studied for the first time, considerable time may be necessary in securing and verifying basic data, while in the case of an established credit the time for this task is

[1] Officials sometimes appear to the objective student to be unreasonably protective of the public image and not entirely responsive to the realities of their situation. At the December 5, 1967 hearings, Mr. Roy Goodman refers to a quotation attributed to me by The New York Times in a story on the rating revision of New York City by Standard & Poor. His comments seem to imply that I said his city had shown vast improvement from mid-1965 to mid-1966. In fact I said in substance that the situation was encouraging in that an acute financial crisis had been avoided—payrolls had been met—but that fundamental problems remained to be solved.

negligible. Financial statements may be clear and simple in one situation, in another may be complex and obscure and require hours of tedious processing for analysis. Similarly, writing the manuscript on a relatively clear-cut situation may take only a few hours, while on a complex situation days may be required for the same task. In every case, however, sufficient time must be spent on each chore to establish the relevant facts and their significance, whether it takes a few hours or days; whenever the factual basis cannot be developed, we don't have a report.

7. Reporting by Borrowers for Bond Sales

The Committe inquires whether credit evaluation work would be facilitated "if such information were to be furnished to you in an up-to-date report transmitted to you two weeks prior to the date of the bond sale."

This question appears to assume that our sole source of information is a statement reported to us by the issuer in connection with a bond sale. I have already indicated that the issuer obviously must provide the financial information from its annual financial reports, budgets, capital improvement plans, etc. Other essential information is drawn from a variety of appropriate sources, in so far as possible primary sources—that is, the original compilers and processors of the information concerned. Secondary information such as that in official statements and prospectuses on new issues supplied by the issuer can be helpful, but it is subject to verification from primary sources.

At least as important as the timely availability of the new-issue material, is adherence to standard financial reporting by the borrower. This involves publication promptly after the close of each fiscal year of a comprehensive annual financial report based on an accounting system conforming to the principles recommended by the National Committee on Governmental Accounting. It involves publication and distribution of the annual budget in form and substance conforming to the standards of the Model City Charter, Model County Charter, Model State Constitution, and Model Budget Law, all the result of continuing studies by distinguished experts assembled by the National Municipal League. It involves adherence to and publication of long-term capital improvement plans, master plans, and up-to-date zoning codes. In the case of public service enterprises, it involves adherence to appropriate systems of utility accounting and reporting, the supplying of the complete texts of bond resolutions or trust indentures, the availability of appropriate studies by qualified engineers on the project. An official statement cannot take the place of these materials, it merely supplements them.

8. Guaranteeing Taxable Municipals and Subsidizing Interest

The Committee's final inquiry is whether the market for municipal securities would be enlarged if (a) interest income were to be made taxable, (b) debt service were to be guaranteed by a Federal Agency, and (c) the issuer were to receive an annual grant to cover one-third of such annual interest cost.

I am not an economist, nor can I claim any special knowledge of the money markets. The comments which follow I have therefore solicited from my associate, Jackson Phillips, Director of Municipal Research for Dun & Bradstreet, who holds a Ph. D. in economics. Dr. Phillips prepared the chapter on postwar default experience in municipal bonds for the study "State and Local Public Facility Needs and Financing" prepared for the Subcommittee on Economic Progress of the Joint Economic Committee, dated December 1966, and is one of the authors of a forthcoming textbook on capital markets.

This is, of course, a very complex, technical question and answer require extensive research into existing capital markets. Also, fundamental policy shifts in the conduct of government finance in the United States would probably be involved. Certainly, the effect of shifting the volume of municipal borrowing to another segment of the capital market would have to be explored, as would the effect of changes in price (interest cost) on demand for municipal securities.

At present, states and municipalities compete for capital funds with the Federal government, corporate, and other capital users. The present market for municipals is generally compartmentalized, however, by the exemption of interest from Federal income taxation. This feature, in effect, creates a unique market; the demand for municipal bonds is strongly influenced by buyers seeking tax exempt income; a lower price (interest cost to the borrower) results from the tax exemption feature. The exemption, then, creates a subsidy of varying degrees of importance to different issuers of tax exempt bonds. Removal of the subsidy

would shift new municipal borrowing to another capital market by eliminating the tax exemption which now makes it unique. Briefly, the following observations could be made, but they do not presume to substitute for the thorough study that would be required:

(*a*) Taxation of interest on municipal and state bonds would remove the existing subsidy and would increase the competition for capital funds between municipalities and other borrowers, depending on what additional steps would be taken. If smaller communities enjoying tax exemption today were deprived of that privilege, their ability to compete for capital funds with large, established corporate borrowers would probably be impaired even further. It is difficult to predict, however, just what shifts in the demand for municipals would take place following the removal of tax exemption.

(*b*) The guarantee of debt service on municipals by the Federal government or one of its agencies would tend to elevate municipal securities as a class to the credit rank of Federal agency bonds. It would eliminate the need for precise distinction among different local government issuers, although market differentiation would remain to some extent between, say, the State of New York and the Town of Clay, New York. Certainly some less well known municipals would retain the aura of mystery they hold today for less specialized lenders of capital funds, particularly outside their immediate area. A Federal guarantee would virtually eliminate the penalties of higher interest costs to less efficient municipal users of capital funds. However, it would obscure the interest cost function as a factor in the allocation of capital resources among competitive municipal users of capital funds. It would reduce existing incentives in the present situation for efficient local debt management, without the proscription by the Federal government in the volume and use of capital funds, and such Federal regulation would require careful enforcement. Additionally, a Federal guarantee on capital requirements might emphasize the capital formation function of state and local governments, as against the current operating function, probably more than under the existing system.

(*c*) A grant covering one-third of the annual interest cost of local borrowing would reimburse state and local governments for the loss of the tax exemption privilege. Only capital financing would be subsidized, as at present, and the subsidy would bear a relation to capital financing through borrowing. Some observers, however, believe that Federal subsidies to local governments should not have strings attached, *i.e.*, they should be block grants for unspecified purposes. Block grants for unspecified purposes permit the locality to determine how the funds can best be used. Federal guarantees of local obligations, however, invite Federal participation and supervision of the use of funds and may well restrict the decisions of the local governing bodies as to what projects they should pursue. A grant of one-third the annual interest cost of local obligations would underline the need for Federal regulation of local borrowing. But it would not necessarily make a national market for what are now local or regional market names.

9. Comments on S. 3170

This concludes the comment on the specific inquiries raised by the Subcommittee. However, I have read S. 3170 which would implement the proposals just discussed, and would like to comment briefly on some aspects of them.

Section 2(a) of each bill recites a finding that "the municipal security market, as now constituted, is forcing the Nation's municipalities and States to pay such a high rate of interest on their securities that they cannot afford to finance many needed public facilities." Essentially, this statement assumes that municipal borrowing is closely responsive to interest costs and that if interest rates are too high projects will be abandoned.

I know of no definitive studies on this question. There may be some marginal undertakings proposed to be financed with revenue bonds where the interest cost would be critical. Revenues might support an interest rate of, say, 3.5% but would not support 4%, so that the project is either abandoned or a tax subsidy or other means of financing the project is found. In the case of financing governmental improvements, however—schools, public buildings, streets and highways, and so forth—the interest cost does not appear to be critical except in some special situations where tax rates for bond service are legally limited. Most general obligation bonds are payable from legally unlimited *ad valorem* property taxes, and while higher interest costs may be a burden, they do not preclude the financing of necessary or desirable improvements.

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Interest costs which borrowers believe to be temporarily high may of course lead some of them to postpone the sale of their bonds until lower rates are available, but this is a different matter than foregoing needed improvements. Also, higher than average interest costs may lead to indefinite postponement of low priority projects, which is simply one of the functions of the interest rate and is not necessarily bad. In some situations it may merely result in seeking other ways of financing the improvement. Another solution is "pay-as-you-go" financing which consists of including certain projects in the current annual budget of the community.

The present generally high interest costs and the much-publicized "credit crunch" which has been with us now for fully two and one-half years have their effect on state and municipal bonds. They result from economic and money-market conditions beyond the control of the state and local units.

They certainly do not result from any "failings" of financial services. Hopefully, the recent federal income tax increase will before too long begin to exert a cooling influence on some of the over-heated elements in our economy, and interest costs may then decline to closer to the historical norms. However, as long as investors anticipate continued inflation, they are likely to continue to demand higher interest yield as a hedge against the resultant loss of purchasing power in the dollars to be paid them in the future. It should be noted that municipal yields do not stand alone; government bonds, corporate bonds, mortgages and bank loans have all undergone very sharp increases in interest yields over the last two and a half years.

The proposed S. 3170 also declares that the high interest cost of state and municipal bonds is attributable to three factors. The first cited is "the limited supply of private capital available in the present municipal securities market." This is admittedly a serious and chronic problem, far beyond the control of the municipal bond service agencies. The most rapidly growing reservoirs of savings are life insurance reserves and pension funds. Income generated by life insurance companys' reserves is taxed at a low rate and pension funds are completely tax exempt. The residual of taxable savings is the investment pool to which state and local borrowers must look and not all taxable investors find municipal yields more attractive than the yields on competing taxable securities.[1]

A second factor cited in the bills as a cause of the allegedly high cost of borrowing is "institutional rigidities within such market." Frankly I am not certain what the drafters of the bills had in mind when they spoke of "institutional rigidities" but whatever it is, it would not seem to have any reference to financial service agencies.

The last factor which is cited in the bills as a cause of high interest costs is the "failings of the existent municipal securities rating system which discriminates against most of the Nation's smaller communities and many of the larger cities and which fails to reflect the infinitesimally low rates of actual securities defaults since World War II." While the rate of defaults since the second World War has been relatively low, there have been a number of significant defaults during this period of unprecedented prosperity. If investors can lose millions of dollars in interest and principal because of such defaults during prosperous years there is all the more reason for those who evaluate municipal securities to remain prudent and cautious when they are attempting to judge the likelihood of default in periods of recession or even depression. It is an error to project our experience over the last 20 or 30 years and thereby assume that the future will necessarily be rosy.

More importantly, I do not believe that the securities rating system discriminates against most of the small communities or any of the larger cities. It is no doubt true that small communities frequently pay a slightly higher rate of interest on their bonds than do large well known cities, but this is not caused by any rating system. Rather, it is primarily a function of the fact that small communities, whose financial future often involves greater risks than large cities,

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[1] Mr. Sidney Homer, partner and economist of Salomon Brothers & Hutzler, in his paper prepared for this Subcommittee's study on State and Local Public Facility Needs and Financing, Volume 2, December 1966, page 271, points out that of some $35.9 billion of average annual bond flow for investment in 1960–64, only $8.3 billion was identifiable as taxable at rates which clearly made municipals competitive with taxable securities. At one time, life insurance companies were important buyers of municipal bonds, but they now generally prefer other securities. State and local pension and trust funds used to buy tax exempt bonds almost exclusively but the relatively low yields led to amendment of the laws to permit investment of such funds in mortgages, corporate bonds, and high-grade preferred and common stocks. Consequently, the public pension funds have for many years been sellers, not buyers, of municipals.

issue relatively smaller amounts of securities. It is obvious that a one company town, for instance, is subject to dire financial trouble if the company goes out of business or moves to another locality. Investors take this into consideration when they are in the market for municipals and require a slightly higher interest rate to compensate them for the potential risk.

Many institutional investors hold extremely large portfolios of municipal bonds. A portfolio of $25,000,000 is considered modest. These investors are interested in purchasing sizeable blocks of bonds in order to minimize their administrative cost in connection with managing the portfolios. It is no more trouble for the portfolio manager to service a block of $100,000 of a particular issue than it is for him to service $3,000 worth of the same issue. This being so, the economics of portfolio management dictate that he purchase large quantities of bonds of a particular issuer. Smaller communities simply do not issue bonds in quantities sufficient to enter the national market. This causes the smaller communities primarily to market their bonds locally. In my opinion, ratings or the lack of them are insignificant factors for the determination of the breadth of the small communities market and the ultimate interest cost to that community on its bonds, compared with factors that I mentioned above. Neither the availability of credit reports or ratings would change the basic pattern of distribution of bonds from the small communities and there is no reason, so far as I can see, to assume that there would be any change in their interest cost.

In other words, the premises upon which the proposed legislation is based do not appear to be sound and this causes me to question whether the legislation is needed. I do not know whether the additional cost to the Federal Treasury of interest rebates and portions on account of guarantees will be completely offset by additional tax revenues. I don't know anyone who does know. It is possible that if municipals are made taxable and are thus in competition for the investors' dollar with all of the present taxable forms of investment, the interest rate on taxable securities might rise to a level which would exceed the present rate on taxable securities, causing an added interest cost to the Federal government and thousands of other borrowers. Moreover, I would not be surprised to see the interest cost, even after the rebate contemplated by the proposed legislation, to smaller communities rise disproportionately to that of larger communities. Such a result would only aggravate the problems sought to be solved. In addition, as stated earlier there may be severe disadvantages associated with the contemplated involvement of the Federal government in local fiscal affairs.

Considering the complexities of the capital market and the segmented but preferred position within it presently occupied by municipals, very searching study of the effect of the proposal as outlined in the Subcommittee inquiry of April 16, 1968 on the capital markets as suggested earlier is clearly advisable. Apart from the larger aspects, however, there are features arising from the smallness of certain issues and the competitive position of municipal bonds and governments that raise strong doubts of the ability of S. 3170 to accomplish its declared objectives. I therefore cannot regard the proposal or the bill to implement it as in the interest either of the borrowers or their taxpayers; the results, I am bound to believe, would be disappointing and possibly pernicious.

Chairman PATMAN. Thank you very much, Mr. Smith.
Mr. Craigie?

STATEMENT OF WALTER W. CRAIGIE, PRESIDENT, F. W. CRAIGIE & CO., INC., RICHMOND, VA.

Mr. CRAIGIE. Mr. Chairman, Senator Proxmire, may I make one slight correction in your introduction of me? I differ slightly from one more distinguished vice president already known to you. I already am president—president, not vice president—of F. W. Craigie & Co., Inc., in Richmond, Va. I shall read from my prepared oral text, which is also my written text, leaving more time, I hope, for questions.

Mr. Chairman, I am Walter W. Craigie, president of F. W. Craigie & Co., Inc., Richmond, Va. Which has been a major underwriter of State and municipal bonds for the past 36 years. I am also a former

vice president of the Investment Bankers Association of America, as well as a former chairman of its municipal securities committee. However, I am speaking today as an underwriter of State and municipal bonds.

I might add that for 12 consecutive years, I have lectured on municipal finance as a guest lecturer at the investment banking seminar, conducted by the Wharton School of Finance at the University of Pennsylvania at Philadelphia, and the Investment Bankers Association. I am speaking today as an underwriter of State municipal bonds.

In 1967, the municipal department of my firm bid on 259 issues of bonds either alone, as managers of accounts, or as members of a syndicate. Of these we purchased 104 or slightly over 40 percent. We are extremely active in the secondary market, particularly in the issues of Virginia, West Virginia, North Carolina, and South Carolina credits. Our inventory position varies from $7 million to $11 million, with an average of about $9 million. It's about $11.4 million as of last night.

In our municipal department, we have five people engaged in underwriting, 15 in sales, four in trading, and three in research.

For issues in Virginia, North Carolina, South Carolina, and West Virginia, financial data are obtained from the official statement accompanying the notice of sale or, in many instances, directly from the municipality itself if complete information is lacking, questions arise as to accuracy, or for more up-to-date financial statistics. Our research Department consolidates the financial and economic facts into a preliminary report, which is used by our buying department as one of its guidelines in arriving at a bid for the issue. For nationally known credits, no particular research is undertaken.

On all issues in Virginia, the above preliminary report is circularized by mail to individuals, banks, and other institutions.

In addition to its own analysis, my firm subscribes to the services of Moody's Investors Service, Standard & Poor's, Dun & Bradstreet, the Daily Bond Buyer, the North Carolina Municipal Council, South Carolina Municipal Council and others. Further, we have other credit reports on the municipalities within the Fifth Federal Reserve District, newspaper reports and other items we deem valuable in order properly to evaluate the credit involved. We rely upon all of these factors rather than merely a bond rating in determining whether or not we wish to bid on or purchase any particular bond issue.

There have been numerous occasions upon which we have questioned the appropriateness of the credit evaluation or bond rating assigned by the advisory services. As an example, our firm is financial consultant to Fairfax County, Va. It is rated BAA by Moody's, A by Standard & Poor's and, out of the four categories used by Dun & Bradstreet's municipal service, it is rated "favorable" in three and "fair" in the fourth. Because of the constantly expanding population, Fairfax County is a large and frequent borrower in the market, having already sold $15 million bonds in 1968 with approximately $15 million additional to be sold in either August or September. The average life of the county's bond issues is 13 years. Therefore, on a $10 million issue, every 0.10 (10 basis points) in interest cost means $130,000 to the taxpayers over the life of an issue. Our own analysis of Fairfax County convinces us, without any measure of doubt, that it is a very solid A credit, but its bonds still are selling on the basis of a BAA credit.

There is attached (see exhibit A) the new issue reoffering yield averages as taken from the Weekly Bond Buyer of April 22, 1968. You will notice the wide spreads prevailing between AAA, AA, A and BAA-rated bonds. The Bond Buyer's Index, a widely recognized average, was at 4.33 percent on April 18, 1968—before the last increase is the rediscount rate. This 20-bond index is based upon the estimated yield of a 20-year-maturity bond. From the reoffering table you will note for the week ended April 12, 1968, BAA issues with a 20-year maturity sold on an average 4.74-percent basis and the A-rated issues at a 4.44-percent basis, a variation of 30 basis points which is about normal. Again using Fairfax County for illustrative purposes, this means that had the county sold an issue of $10 million bonds, this variation would have added $390,000 in additional interest over the life of the issue.

I might inject here that as noted by Standard & Poor's, for the past several years, Fairfax County has enjoyed a current surplus in its operating account which has been equal to the debt service. We think that is a relevant contrast to other fiscal situations.

The whole question of ratings was brought home to the taxpayers of the Commonwealth of Pennsylvania recently when Pennsylvania General State Authority bonds, previously rated AA by Standard & Poor's and nonrated by Moody's were assigned a rating of BAA by Moody's although Standard & Poor's continued its AA rating. The general obligation bonds of the State also were reduced from AA to A by Moody's. This change took place on the day before $40,820,000 Pennsylvania State Public School Building Authority bonds were marketed, with the result that the school authority bonds sold at an annual interest cost of 5.059 percent, as compared with the bond buyer index of 4.49 percent, a difference of 0.569 percent. The previous issue sold on October 17, 1967, at 4.504 percent, as compared with the bond buyer index of 4.33 percent, a difference of only 0.174 percent.

You will see that the difference between 0.174 and 0.569 is 0.395 percent; translated into the life of this issue, it meant, Representative Moorhead, that the taxpayers of Pennsylvania were paying an additional $3,976,985 over the life of the issue.

Now, in fairness to Moody's, the Pennsylvania General State Authority bonds always have been regarded in the investment fraternity as the cream of the crop. On March 12, they were rated BAA. On May 3, in the general revisionary policy of Moody's, they were increased to BAA–1, which is sort of an elevated category. On May 13, they were increased in rating to A–1, but I call the committee's attention to Moody's Bond Survey of May 13, which brings out very clearly that this upgrading in rating was because of the new constitutional provisions, and the rentals are no longer dependent upon annual appropriations, but are a direct obligation of the Commonwealth's general fund. So that must be taken into consideration in relation to my remarks.

Many banks and other investing institutions have their own standards of investment and by far the largest number of commercial banks which are customers of my firm do not buy bonds below an A rating. Therefore, when an issue is assigned a BAA or none at all, it no longer is on the eligible list of those institutions.

Earlier testimony before this committee has brought out the bank investment regulations, which are widely used by the regulatory au-

thorities, including the Comptroller of the Currency, the Federal Reserve bank, the Federal Deposit Insurance Corporation, various State banking commissioners and others.

I might say for the information of the committee, our firm is retained by the Federal Reserve Bank of Richmond to appraise the portfolios of its member banks.

Bank investment regulations are also used in connection with various financial examinations of investment firms by the Securities and Exchange Commission, National Association of Securities Dealers and the several stock exchanges.

All of this emphasizes again that ratings *do* have meaning, and this meaning spells money.

Improving municipal bond ratings is no simple task. I believe they should be numerical and not alphabetical. The numerical allows a much more finely attuned appraisal. I feel that the entire matter should be studied by a special committee of the Investment Bankers Association of America, the Municipal Finance Officers Association of America and such other organizations as can contribute data and suggestions. It is a complex problem, and, with new issues of municipal bonds amounting to nearly $15 billion a year and destined to increase rather than decrease, the staff necessary for adequate investigation and appraisal is huge with exorbitant costs.

I might say that the Investment Bankers Association has or had a special committee study the ratings. It has prepared an excellent interim report, which I am quite sure the IBA would make available to the committee should the committee so desire.

Before continuing, may I say to the chairman and members of the subcommittee, our firm has no quarrel with Moody's Standard & Poor's, and Dun & Bradstreet. We may differ with our friends on occasion but we highly respect them. If Dun & Bradstreet and Standard & Poor's happen to like Fairfax County better than Moody's does, it is our job to convince Moody's, and not to count the odd man out.

The absence of a bond rating for a smaller issue (under $600,000) definitely impairs the marketability of such bonds, but my firm unhesitatingly bids for such issues if sufficient accurate data are available and we are satisfied as to the soundness of the credit. We have found that the chief difficulty with small municipalities (under $600,000 in bonded debt) is that their financial records are either of not sufficient accuracy or depth to provide the information necessary.

For that reason, I doubt if any agency—Federal or State—can obtain the required economic and fiscal data in order to prepare properly a factual report for use by either the bond rating services or the prospective bond underwriters, and the cost involved would be prohibitive.

If, despite these handicaps, the information is to be secured and processed, it is my opinion that it could be done better and more economically by either a State agency, such as the Local Government Commission of North Carolina, or some group such as the North Carolina Municipal Council, the South Carolina Municipal Council, the Municipal Advisory Council or Texas, etc., rather than by a Federal agency. For one thing, timeliness is essential and a report 2 years old would be obsolete before it was printed. Then there would be a question of acceptance by investors and the assurance that any forthcoming rating would be a completely independent one, free of influence—political or

otherwise. I believe this would be difficult to achieve under a Federal agency.

There are certain cases in which the market for municipal securities would be larger if the debt service were to be guaranteed by a Federal agency, such as is the case with public housing bonds and similar obligations. However, I do not believe there would be a materially enlarged market for taxable bonds of municipalities where a Federal agency guaranteed debt service and made annual grants to cover one-third of the annual interest cost thereon. Nor do I believe such a policy to be desirable or in keeping with the tax immunity of State and municipal obligations.

Parenthetically, and I recognize it is not the question before this committee, I wish to state emphatically that in my opinion it is the unlimited flow of tax-free industrial revenue bonds which is doing more than anything else to handicap the smaller municipalities of the country in marketing their bonds for water and sewer purposes and other necessary improvements. The whole level of interest rates on municipal bonds has, in my opinion, been increased drastically because of the issuance of such bonds, secured by leases with some of the largest, most strongly financed of our American corporations.

Thank you, Mr. Chairman, for inviting me to appear before the subcommittee. Should there be any question, I shall be glad to answer them to the best of my ability.

(The attachment to Mr. Craigie's statement follows:)

EXHIBIT A

NEW ISSUES REOFFERING YIELD AVERAGES

This table, compiled weekly, gives the average reoffering yields of five, 10, 15, 20, 25 and 30 year maturities of primary market general obligation bond issues reported reoffered during the week. Only issues of $1,000,000 or more are used. The averages are grouped according to Moody's ratings and issues rated A-1 are included with the A group and Baa-1 rated issues are included in the Baa group. They are shown for the first week of every month for the past few months, and weekly for the current and preceding month.

[Percent of years]

Week ended—	Aaa						Aa						A						Baa					
	5	10	15	20	25	30	5	10	15	20	25	30	5	10	15	20	25	30	5	10	15	20	25	30
Apr. 12, 1968	3.70	3.85	3.95	4.00			3.78	3.91	4.02	4.10	4.63		3.90	4.11	4.26	4.44			4.10	4.36	4.58	4.74	4.87	5.20
Apr. 5, 1968							3.83	3.98	4.08	4.15			3.97	4.19	4.40	4.71	4.77	5.00	4.20	4.47	4.68	4.87	5.37	5.00
Mar. 29, 1968	3.75	3.98	4.10	4.20	4.30	4.40	3.90	4.05	4.19	4.28			4.00	4.22	4.50	4.65	4.81	5.17	4.37	4.62	4.85	4.99	5.03	5.36
Mar. 22, 1968	3.85	4.00	4.10				3.92	4.07	4.20				4.07	4.28	4.49	4.65	4.70		4.27	4.53	4.70	4.90	4.90	
Mar. 15, 1968	3.80	3.95	4.10	4.20	4.35	4.85	3.92	4.12	4.29	4.42	4.55		4.04	4.29	4.57	4.76	4.87		4.23	4.47	4.72	4.87	5.04	
Mar. 8, 1968	3.69	3.87	3.99	4.10	4.34	4.42	3.88	4.07	4.25	4.40			3.95	4.21	4.42	4.54	5.03		4.33	4.56	4.72	4.94	4.87	
Mar. 1, 1968							3.82	4.01	4.15	4.27	4.70		4.00	4.20	4.43	4.67	4.87	5.20	4.15	4.37	4.59	4.75	4.84	
Feb. 2, 1968	3.50	3.65	3.75				3.52	3.65	3.77	3.92	4.15		3.83	3.99	4.14	4.26	4.38		4.11	4.31	4.49	4.58	4.62	
Jan. 5, 1968	3.80						3.90	4.05	4.15	4.20			4.14	4.28	4.49	4.58	4.65	4.70	4.47	4.67	4.87	4.98	5.25	5.00
Dec. 1, 1967							3.92	4.03	4.17	4.23			4.04	4.20	4.32	4.45	4.58	4.80	4.33	4.58	4.71	4.90	5.00	5.00
Nov. 3, 1967							3.65	3.80	3.85				3.81	3.96	4.09	4.25	4.38	4.80	4.05	4.30	4.50	4.75	4.85	4.92
Oct. 6, 1967	3.55	3.73	3.85	3.90			3.65	3.85	4.00	4.15	4.25		3.84	4.08	4.21	4.29	4.33		3.80	4.02	4.12	4.22	4.40	
Sept. 1, 1967	3.50	3.70	3.80										3.68	3.86	4.05	4.17			3.90	4.20	4.31	4.40	4.45	
Aug. 4, 1967							3.55	3.71	3.81	3.88	4.05	4.10	3.70	3.88	3.98	4.03	4.10	4.15	3.88	4.06	4.20	4.31	4.42	4.58
July 7, 1967							3.53	3.73	3.88	3.90			3.78	3.98	4.15				3.96	4.23	4.36	4.48	4.62	
June 2, 1967							3.15	3.50	3.70				3.35	3.75	3.96	4.03			3.70	4.02	4.23	4.15		

Chairman PATMAN. Thank you, sir.

I feel that the committee is very fortunate this morning to have such able and knowledgeable witnesses who are also so prominent in their positions. We know we are getting information that we very much need.

Now, then, we will follow the traditional rules of our committee, each member being allowed 10 minutes to ask questions. Then, after the members finish, we can go back and members who have not had all the time they desire will be allowed to ask further questions.

I would like to ask a few questions and make just a comment or two.

No. 1, on the subject of industrial revenue bonds, just mentioned by the last witness, I am in favor of those bonds for a different reason than most people. I believe that the sources of big credit have dried up in this country. It used to be that you could borrow money from the Reconstruction Finance Corporation and that was a source of big credit. But then it was liquidated by Congress, and now it seems to me that a few people have control of the big credit in the country. They largely determine whether or not people go into business or do not go into business.

I know in my own district, we wanted to build a steel mill, and we needed $75 million. We went to New York with the support of some Dallas bankers who were going to put up a substantial amount. We went to one of the New York banks and we looked around the room up there and saw United States Steel, Lakeview, Bethlehem, et cetera—they were all there. They tried to talk us out of it, said we could not make steel in Texas.

Then we went back to the investment bankers and wound up in New York again. But we saw around that directors' room the same companies represented. They did not want any competitors. We did not have a chance.

So we came back to Washington and got in touch with Mr. Roosevelt and Mr. Jesse Jones and had a conference. We convinced them that we had the makings of a good steel mill, and they granted us a $75 million loan. In 20 years from the time it went into production, the men who worked in that plant and whose jobs came about by means of that $75 million had paid more than $75 million in income taxes, and the company itself had paid into the Federal Government more than $75 million in income taxes; and the Federal Government, through the RFC, had its money back with interest.

Now, there are a lot of loans like that over the Nation that do not have a chance because of the interlocking relationship with different companies and the banks. They just protect one another, like a fraternity, taking care of each other. If you are in the fraternity, you are all right; if you are not, they do not have much interest, you do not have much chance.

I feel that in desperation, because they did not have enough credit to borrow money, people resorted to this industrial revenue bond system. It is not that they wanted it, but that is the only way they had of getting large amounts of money. I just do not see how we can afford to reduce the limit on these bonds down to $1 million. That is just, in effect, saying we are going to give enough money to the little fellows to divide among themselves, but we dare not step on the toes of the big man.

So the source of big capital is absolutely dried up, and I believe that is the cause of the use of industrial revenue bonds. It is the desperation of some people trying to get big money in their own communities.

But the main thing, what Senator Proxmire and I have been disturbed about, is the loopholes in the tax laws. Too many people are tax exempt and getting tax breaks, and some of these are among the wealthiest. It would be better, I think—of course, people differ—not to have these tax-exempt bonds; and we are trying to go in the direction of getting rid of tax-exempt bonds, where everybody would more or less participate in the affairs of their Nation and pay the same as everybody else.

Our foundations, of course, are the same way, we have terrific loopholes in the foundations. Some big estates, way back before the income tax law, ran into lots of money. They get an exemption through a foundation and never pay any taxes; and they would pay taxes running into hundreds of millions of dollars, perhaps billions of dollars, if they had paid taxes like everybody else. And they have not.

These loopholes are spreading. Instead of having more, I think we ought to reduce the number we have.

We have a concern over near Chicago called Americans Building Constitutionally. It is an impressive name, as you will note. It is teaching people how to organize their own foundations. They will first join that particular foundation with the understanding that they will pay in $10,500 for the information and knowledge that will enable them to build a foundation of their own. This concern will help them build other foundations, with the understanding that if they will carry out the rules given them with the guidance by the parent foundation, they will not have to pay any taxes while they are living, and inheritance taxes will not be required when they pass away. That is quite an inducement. They have a lot of people who have joined for $10,500 each.

That is going on all over the country. We brought that up over a year ago, and nothing has been done effectively to stop that. It is not right for a few people to get the benefit and others not to get the benefit of it. I think eventually it will be stopped, either by a law or regulation or by the courts. But meanwhile, it is not being stopped.

Our tax-exemption statutes have been so loosely drawn or so loosely administered that it is a great detriment to the good, law-abiding citizens of our country who want to support their Government in every way, to pay their taxes, when so many people are avoiding their taxes.

The interest rates, of course, concern me a lot. I believe the second witness, made a statement something about interest rates, suggesting that we are not concerned too much about that. That was Mr. Riehle. But I will just wager that these mayors and city managers are pretty well concerned about that, because it is costing them a lot of money and denying them a lot of funds. Hospitals over the country cannot be built in lots of areas right now because of the high interest rates. They are double what they were some time ago.

I have a feeling that we should go in the direction of getting rid of tax exemptions. How do you gentlemen feel about that entirely? Are you adamant? Would you make just a brief statement on how you feel about tax-exempt bonds?

You know, the banks are buying most of the tax-exempt bonds. It would surprise you. I will put in the record tomorrow the exact amount. I am sure that it will be shocking to you. They are buying most of them. The commercial banks can buy them just by manufacturing the money on the books of their banks. It does not cost them anything. It is a mighty fine way. They can create money just like the counterfeiters do, but counterfeiters have to go to a penitentiary if they get caught; banks do not have to do that. It is a way for them to make a lot of money.

How do you feel about going in the direction of finally stopping these tax-exempt bonds, Mr. Harries?

Mr. HARRIES. Without getting into the constitutional question?

Chairman PATMAN. We can amend the Constitution if we get enough pressure for it.

Mr. HARRIES. Yes; I believe you could. I do not believe the overall cost to the municipality would necessarily drop. Last year, there were $16 billion in corporate issues brought to market and $14 billion in municipals, for a total of $30 billion. These are two separate markets. They have two marketing procedures.

In the corporate procedure, there were only 540 issues; in municipals, there were closer to 5,000. We have two separate groups of buyers, they are two types of marketing procedures.

If you put them all together and then throw in the amount of Federal money which has to be rolled over and the amount of new money which is authorized, you would have Federal debt, corporate and municipal, all taxable. Under the bills which you and Senator Proxmire have presented, you would rebate one-third of the interest cost. My feeling is that by throwing these municipals into the intense competition—where you are absolutely right, there is a shortage of cash for any type of security and we have recognized the fantastic volume as people who are interested in equities are switching from debt securities. They do not like the intense inflation in fixed income securities. They would rather switch to a stock and hope for a growth situation.

I am of the opinion, and I would have to run all kinds of tests to find out for sure, that the municipalities would have to pay a higher rate than even the corporate bonds.

Chairman PATMAN. My time has expired. Would you gentlemen extend your remarks in the record and answer that point when you get your transcript?

I yield to Senator Proxmire.

Senator PROXMIRE. I would like to ask Mr. Harries, Mr. Riehle and Mr. Smith—I understand you are the gentlemen who represent rating services—Mr. Craigie does not?

Mr. CRAIGIE. I am only an underwriter.

Senator PROXMIRE. I concur in the chairman's statement that these are all very competent and most helpful statements, including that of Mr. Craigie, of course. But is there not a problem, gentlemen, in the smaller cities? You have various kinds of exclusions; but, by and large, a small city with an issue of less than $600,000 does not secure a rating the way a big city would, and would seem to be somewhat disadvantaged under the present system.

Mr. Harries?

Mr. HARRIES. Just before you came in, Senator, I made a comment attempting to clear the record that Standard & Poor voluntarily rated

bonds of at least $1 million. But we are always ready to rate less than that. Last year, we had between 150 and 160 such ratings.

Senator PROXMIRE. How many issues were there at less than $600,000?

Mr. HARRIES. I do not know.

Senator PROXMIRE. A very small percentage?

Mr. HARRIES. Yes, but the rating was always available, Senator. It was never denied them. The only time we would ever deny a rating is for lack of information or when we felt information was inadequate.

Senator PROXMIRE. When you go in to make a rating for a small city, what kind of fee do you charge?

Mr. HARRIES. If the information is accurate and up to date, the fees range from $250 to $300 up to $1,000, $1,500.

Senator PROXMIRE. Suppose it is a small city and they have the problems that small cities often have, as has been testified to by other witnesses here, that they often do have difficulty. The material could cost much more?

Mr. HARRIES. Not much more than $1,000 or $1,500. If we cannot get the information we want, we simply do not——

Senator PROXMIRE. It might go up to $1,000 or $1,500.

Mr. HARRIES. Yes, we do, if the time required ran to that figure.

Senator PROXMIRE. You have indicated that only a very small percentage of cities with issues less than $600,000 are in fact rated?

Mr. HARRIES. I would say that is correct. The $600,000 figure, incidentally, is Moody's. Ours was $1 million. Now we have no figure. under our new policy.

Senator PROXMIRE. I would like to give you the arithmetic we have figured out as to why we contend that this bill Congressman Patman and I have introduced would save both the Federal Government and the city money. The marginal tax rate of the typical investor in tax-exempt securities is 42 percent, according to the Treasury. That is their calculation and I have not seen it challenged. The saving to the city because of the tax exemption, it is our understanding, has been calculated at 25 percent. You may want to challenge these figures or argue with the arithmetic.

The cost to the Treasury, therefore, is 42 percent. A subsidy of 33 percent would mean a net saving to the Federal Treasury of 9 percent. So the Federal Treasury would be better off if the option were exercised to go the guaranteed route.

Then the cost to the city of 25 percent would be more than compensated by a 33-percent subsidy, being 9 percent better off. The net gain to the city would be 8 percent. So you would have a situation in which both the Federal Government and the municipalities would be better off.

It is true that the present wealthy investor, who gets his taxes reduced sharply, would not be as well off. But it would seem to us on the basis of equity that this would be a fair achievement, if these figures stand up. What is the matter with them?

Mr. HARRIES. You may be right. My only feeling is that it may be possible that the city of Sheboygan, for example, may have to come into the market and sell 8s in order to complete with Consolidated Edison 6½s. Consolidated Edison could come in with a 6⅓-percent rate with its earning, its growing power, whereas Sheboygan, Wis.,

may have to come in, even with a Federal guarantee, and pay a much higher rate in order to achieve marketability and liquidity.

Senator PROXMIRE. There is not much question that there are still going to be differences. I would agree with that. The guarantee—not all these securities are sold at exactly the same price. The savings seem to me to be mathematically irrefutable, both for the city and the municipality and the Federal Government.

Mr. HARRIES. I disagree that you can categorize the mathematics. You are going to be dealing with $30 billion in a market or——

Senator PROXMIRE. We are dealing with a saving.

Mr. HARRIES. I may be quite wrong, but I think you are asking for what I would hope to call expert testimony. If I were a bond buyer and I were presented with an alternative of buying a General Motors at 6.25 versus a State of Pennsylvania, I would want to know how fast I could unload either one and what their market appreciation might be expected to be. The Commonwealth of Pennsylvania is probably a bad example, but General Motors being a prime quality issue would mean that it would have greater marketability and liquidity, and Pennsylvania might have to pay a much higher rate in order to overcome the competition from GM in selling its bonds. This means that the Federal Government's one-third subsidy would be a larger absolute number than under existing interest rates. Quite obviously the municipality's share—two-thirds of the new, taxable interest cost—would also be a larger amount of money than they now pay.

Senator PROXMIRE. Actually, the Patman and Proxmire bill would tend to broaden the market, because you would have S. & L.'s life insurance companies——

Mr. HARRIES. I do not think there is any question that the market would be broader.

Senator PROXMIRE. Would that not help to get the market cost of capital down for municipalities?

Mr. HARRIES. No, sir, I do not think so, because you are going to throw these municipals into an area of much greater competition. They are going to compete with every Federal bond.

Senator PROXMIRE. They cannot compete now. You would agree that they cannot compete in these areas now?

Mr. HARRIES. They do not compete because they have one advantage that no else has: the most salient sales feature of a tax-exempt bond is its tax exemption.

Senator PROXMIRE. They can still have that if they want. It is strictly optional.

Mr. HARRIES. I understand that.

Senator PROXMIRE. I would certainly expect that they would have some tax exemption, but we would have less, less of a loophole and you would have an opportunity for the cities to benefit if they feel they could.

Mr. HARRIES. I understand it is a voluntary thing.

Senator PROXMIRE. Mr. Riehle?

Mr. RIEHLE. I have to concur that they do have the option I assume, sir, that the committee has read the Brookings Institution study published in 1963. The thing in that study that really impressed me was that the panel of experts, and I think they were acknowledged to be experts both on the money market and the mar-

keting of securities and as economists, was that the group could not concur. They could not reach any conclusion as to the ramifications of taxing municipal bonds, just what their reception as taxable securities would be in the marketplace.

Senator PROXMIRE. Is this not true of economists on every occasion? I have never seen an occasion when all economists concurred. Many of them were for the tax increase, many were against the tax increase. We cannot find any agreement. In a free society, we do not get that, do we?

Mr. RIEHLE. They are on both sides of the fence, but people expert in the marketing of securities are also on both sides of the fence, with a proclivity toward tax-exempt securities.

Senator PROXMIRE. How about this arithmetic calculation we have here, which indicates that on the basis of the Treasury's best figures, the best figures that they could get, they would benefit, the U.S. Treasury would benefit, tax revenues would increase, and the cities would be better off.

Mr. RIEHLE. I am not equipped either to accept that figure or to dispute it.

Senator PROXMIRE. Mr. Smith?

Mr. SMITH. Well, Senator, I am always rather uneasy in calculations that are based on aggregated data as these have to be. I am also uneasy when I get into these money market areas where I am not a specialist. But I am impressed in the literature that there appears to be a paucity of positive information about the actual distribution of tax-exempt bonds. We know from time to time, with considerable reliability from the national income statistics and so on, which groups buy the new issues. I think the Treasury compiles annually a summary of who holds them.

In the study which was published in 1966, the two volumes on the local facility needs, Mr. Sidney Homer, who is quite an acute money market specialist, complained of the lack of information on the tax brackets of the holders of municipals. I have an idea that it might turn out to give entirely different results if you were to be able to compile the information on tax brackets of holders, impute the tax contribution that they made from those brackets, and then see what the effect might be on the market.

I know in the interpretation of municipal financial figures in general, the aggregated figures for the country as a whole and for a State will conceal very important factors with respect to individual communities. I am uneasy when you get into this area that we may be doing the same thing with these aggregated figures.

Senator PROXMIRE. My time is up and I think you raised an excellent point. However, it is, it seems to me, true that if you are going to deal with statistics and you have to in order to get the best information you can get, it seems to me we have to accept what the Treasury has done, unless we can show that they are wrong, and they did try to do just exactly what you said, recognizing, of course, that they are aggregate figures.

I shall come back.

Chairman PATMAN. Senator Jordan?

Senator JORDAN. Thank you, Mr. Chairman. With your permission, I should like to present an opening statement.

Chairman PATMAN. Without objection, you may proceed, Senator Jordan.

OPENING STATEMENT OF LEN B. JORDAN, A U.S. SENATOR FROM THE STATE OF IDAHO, AND MEMBER OF THE SUBCOMMITTEE ON ECONOMIC PROGRESS OF THE JOINT ECONOMIC COMMITTEE

First of all, I would like to commend the chairman for convening this second set of hearings on the financing of municipal facilities. The demand for increased and improved public facilities in our towns, cities, and counties has never been greater than it is today. I doubt if there is a city, large or small, that does not wish to provide better police and fire protection, hospital and health services, water and sewerage facilities, transportation, housing, and recreation opportunities, The difficulty they all face is in financing the capital requirements for these services.

A most important method of finance is by borrowing in the tax-exempt municipal securities market. A Joint Economic Committee study has estimated that 50 percent of municipal facility needs to 1975 will be financed in this manner. Last year, over $14 billion in State and local bonds were issued, a growth of nearly 100 percent since 1960. If the trend of the first quarter of this year is maintained throughout the year, an even larger amount will be offered in 1968.

One of the major determinants of the borrowing costs facing a county or municipality is how the lending public values the issuing authority's credit worthiness; that is, its ability to pay interest and redeem the bond on schedule. These judgments are conditioned to a large degree by the ratings provided by the various bond-rating services.

Generally, the higher a rating given a municipality, the lower will be the cost necessary to attract buyers. It has been estimated that a difference of one level in a rating may mean as much as one-half of 1 percent in annual interest costs. To a municipality or county strapped for funds, as virtually all are these days, this can mean the difference between enlarging a police force or not, providing more hospital facilities or not, or building extra classrooms or not. So, in a very real sense, the manner in which bonds are rated affects the welfare of millions.

Since the effects of the bond rating system are so widespread, influencing the very progress of this Nation toward improving the well-being of its people, I feel it is entirely appropriate that this subcommittee of the Joint Economic Committee examine this facet of municipal finance most thoroughly. I believe we can make a significant contribution by outlining the limitations of the present rating system and suggesting areas for improvement. With these thoughts in mind, I wish to welcome the witnesses here today who will open our inquiry.

I would like to join you, Mr. Chairman, and Senator Proxmire in expressing my appreciation for this panel. I think it is an outstanding group of individuals who have brought a great contribution to the problem at hand.

Starting first with the underwriter, Mr. Craigie, you piqued my curiosity when you said, toward the end of your statement, that it is the unlimited flow of tax-free industrial and municipal bonds which is doing more than anything else to handicap the municipalities of the

United States to market their bonds for water and sewer purposes and other necessary improvements.

How serious is that, in your opinion?

Mr. CRAIGIE. Mr. Jordan, it is extremely serious. May I give you a few illustrations?

Senator JORDAN. Yes; you may.

Mr. CRAIGIE. We are financial consultants to Augusta County, Va., Water and Sewer Authority; Campbell County Water and Sewer Authority; the Portsmouth Port and Industrial Commission, Portsmouth, Va.; the Winchester, Va., Parking Authority. If you are faced with the choice of buying 6-percent tax-exempt bonds of Scottsboro, Ala., secured by a lease with Revere Copper & Brass Co., a strong, well-managed, financially sound firm, how in the world are you going to justify buying bonds of a smaller water and sewer authority at 4¾ or 5 percent? The chairman of the Winchester, Va., Parking Authority asked me the other day what price he would have to pay for his parking revenue bonds. I said, at what price did Winchester just sell Rubbermaid-Lease industrial revenue bonds?

He said they were 5¾.

I said, you have set your own rate, sir.

Senator JORDAN. Well, following that up, are you saying there should be no tax reimbursable revenue bonds?

Mr. CRAIGIE. I am flatly opposed to them. I have been for 17 years. I am speaking not of Richmond, Va.; I am speaking of ARMCO Steel, of Revere Brass & Copper—the list is endless. It is about $2.5 billion a year hitting the market, and if the trend continues, I see that it could get to $5 or $7 billion. It is having a very direct impact upon the interest rates of State and municipal bonds.

Senator JORDAN. In your opinion, it is drying up the source of revenue for communities to finance their public improvements?

Mr. CRAIGIE. There is no question in our minds as underwriters in that connection, sir.

Senator JORDAN. Now, turning to the services, the analysis, it is quite obvious from your respective statements that bond analysis is not an exact science. You use the same basic data, you employ the same professionals, probably some of them move from one firm to another, even. Yet you come up with vastly different ratings on the same bond issue. How do you explain that?

Mr. Harries?

Mr. HARRIES. You are absolutely right, Senator Jordan, when you say it is not an exact science. The outline which I have given you of some of the efforts we are making in the research area, particularly with a computer-based data bank, indicate our hope to make it a more exact science than it is now. But in the last analysis, these are judgments. We make judgments on this particular bond we are analyzing in relation to other bonds we have rated of a comparable quality.

I cannot explain it to you, sir. It is a matter of judgment. That is why they are different. We vary with Moody's. This is the closest we have been with Moody's in years.

Senator JORDAN. That is what makes a horse race; everybody sees a different potential in his choice.

Mr. Riehle?

Mr. RIEHLE. I will concur with what Mr. Harries just said. Ratings are opinions—judgments. I think each individual, each organization that rates or characterizes the quality of municipal securities works with essentially the same basic data, but sometimes we arrive at slightly different conclusions, depending upon our individual philosophies at various points that we emphasize.

I think we can say that the majority of the time, we concur.

Senator JORDAN. It does make a vast difference to this borrower over the lifetime of the bond issue whether it is a bond rated BAA or A.

Mr. Smith, you raised the interesting thought that if we eliminate tax exemptions, we have a wholly new ball game. Suggestion has been made that we do eliminate tax exemption on municipal securities, and those occasioned by States and local authorities. What would happen, in your opinion, Mr. Smith, if this were done? Would we leave the municipalities and the State competing with the Federal Government, trying to finance a $25 billion deficit, with industries trying to expand? They would all be competing in the same capital market at the same time, would they not, at a competitive rate?

Mr. SMITH. I do not know, Senator. That is an intriguing aspect of this.

We can generalize on certain factors, of course. The interest rates would tend to rise to taxable levels, but what would that be? Would that be the present taxable level? Would that be something else?

There would be a tendency to bring into the market for municipals investors who do not now buy them. On the other hand, there would probably be investors who buy them now who would no longer buy them.

Would this be a standoff? Would there be a net gain? Would there be a net loss? I do not know the results, frankly.

I think this is something where the Treasury people, the Federal people, money market specialists with sufficiently broad comprehensive data, could make a very shrewd guess.

I should say on this, the matters that Chairman Patman brought up, some of the aspects of Senator Proxmire's comments, these are, of course, policy matters for congressional determination. They concern the Congress and the legislators in the respective States. As with many other matters affecting finances, there are costs associated with getting desired ends. The question is whether the costs cause a net loss or whether you get a net gain. I believe there will be a net loss, and it will be sustained by the municipalities in higher borrowing costs and additional Federal intervention in local programs.

There are elements of fiscal policy locally that are completely a matter of policy determination on the part of the governing body. They pay a price for whatever they do. They and they alone can make the decision as to whether the benefit offsets the cost. I think when you talk about this matter it is very important. But essentially, in this area, no one can say exactly what the shape of the end result may be.

You are making, I think, fundamental changes. I think that you have economists, money market specialists who can guess, given the necessary data, very closely what it is likely to be. Then it is a matter of legislative judgment as to whether you are getting a net benefit or a net loss. But as to the precise shape of the change, certainly I am not

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qualified to guess. All I can say is that your changes will tend to go in certain directions.

As with anything, I might say, it is a hazard to the best informed judgment you can make.

Mr. CRAIGIE. Senator Jordan, I was a member of the Brookings Institution Study Committee which spent 2 solid days and many other hours off the record in studying this particular question. At that time, the municipal market average was 3 percent. Simultaneously, the city of Richmond AAA bonds sold at 3 percent, slightly less, I think, 2.94. At the same time, the International Bank or World Bank sold an issue of 4½'s, Federal Land Bank sold 4½'s. Even though that committee could not reach any definitive conclusion it was a general consensus that there were about 150 basis points' difference between a similar high quality taxable security and a tax-free bond which is about 50-percent increase or differential in interest rate.

Certainly I agree with Mr. Harries that very small municipalities, lacking marketability, could conceivably be paying 7.5 percent for Federal money if they could get it.

Does that answer your question?

Senator JORDAN. Yes.

My time is up, Mr. Chairman.

Chairman PATMAN. Mr. Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

I was interested in your comment that this is the closest you have been to Moody's in a long time. But is it not true that if you found out something about a particular municipality's misfortunes that you would pass it along to Moody's? Do you not exchange information?

Mr. HARRIES. Prior to the issuance of a rating on a coming sale, we do not talk. However, there are situations where you have threatened defaults, and we would mutually get together to try to help that situation, do things to get it out of that trouble. But that is about as close as we come.

Please understand, we are intensely competitive in many areas.

Representative MOORHEAD. Well, would not the technicians at the lower levels say, "We know that this municipality has just adopted an ordinance which will help"—you do not exchange this kind of information?

Mr. HARRIES. Mr. Moorhead, I think the answer is "No." I like Mr. Riehle very much, but I do not talk to him.

Mr. RIEHLE. We think that our judgments should be independently arrived at. The answer is "No"; we do not exchange information.

Representative MOORHEAD. May I ask you gentlemen, is the factor of whether the issue is eligible for commercial bank underwriting a significant factor in the ratings that you would give prior to an issue?

Mr. HARRIES. No; it is not. In other words, whether or not it is eligible for commercial bank underwriting—and I assume you are talking about differentiation between general obligation and revenue bonds—the answer is "No."

The factors are all of the credit factors relating to that particular issue. We do not care or care to know or have any interest in who is going to buy it. In other words, we are rating for the investor, we are not rating for the underwriter. Perhaps that answers your question.

We do not rate bonds for the underwriter, or primarily for his benefit. We are rating primarily for the benefit of the investors, subscribers

to our service, who want better investment opportunities and wish to have an opportunity to measure them.

Representative MOORHEAD. But would this be rated before the underwriter made his bid?

Mr. HARRIES. Yes, sir; that is right.

Representative MOORHEAD. And so far as your rating is concerned, it does not matter, then, whether it is eligible for bank underwriting or not?

Mr. HARRIES. No.

Representative MOORHEAD. Do you agree with that, Mr. Riehle?

Mr. RIEHLE. I concur, sir.

Representative MOORHEAD. That is agreed across the board?

Mr. SMITH. That is right.

Representative MOORHEAD. I would imagine Mr. Craigie would be interested. Obviously, I am bringing up this question of a bill that is pending before another committee that usually sits in this room, which is the revenue bond underwriting legislation, with which I am sure you are familiar, Mr. Craigie.

Mr. CRAIGIE. I am quite familiar with it. I might say, while we are speaking of the question of communication between the three rating agencies, I am of the firm opinion that they operate completely independently, and I value that independence. I might disagree with one or more, but I would not change it for anything in the world.

As far as bank underwriting of revenue bonds is concerned, I have not found either lack of willingness or ability on the part of recognized dealers in State and municipal bonds to handle all of the flow of bonds which come to the market. We do bid with the banks on general obligation bonds—we are joint managers in many cases. We feel that there are revenue bonds, and the very fact that the banks say they will only buy the good ones reawakens a few memories in me. I went through 1929 and various other shakedowns, and I know quite well where that road eventually leads.

I firmly believe that banks should participate in the underwriting of general obligation bonds. I do not feel they should be in the field of revenue bonds.

Representative MOORHEAD. But you say, do you not, Mr. Craigie, that there are revenue bonds and there are revenue bonds. I take it from that that there are good ones and bad ones—that that is what you mean. Should we not let the commercial banks participate in the underwriting of the good ones?

Mr. CRAIGIE. That gets to be very enticing money, Mr. Moorhead. I remember quite well when one bank had a national affiliate, and a bank in Virginia passed a resolution that it would not buy bonds from anyone but the affiliate of this well-known bank. It ended up with Republic of Peru 6's and Bolivia 7's, and so on; and had a very unhappy experience, to say the least.

I think you get to the point eventually of trying to increase yields, and when you get to that point, quality invariably goes by the board.

I was with the Federal Reserve Bank for 4 years, from 1918 to 1922, so I know; and I was formerly with a commercial bank, so I have been around for a long time.

Representative MOORHEAD. Is it not true that there are some revenue bonds of a higher quality than some general obligation bonds?

Mr. CRAIGIE. Yes, sir; it is partly true. I know I would rather have the revenue bonds of certain municipalities than their general obligation bonds, but it is not always so easy to differentiate between the two. Then you get into this unhappy trail of extending the risk a little bit more to get a higher rate, and eventually, you can get into trouble. I do not want to see any more liquidity crises such as we went through in 1929 and 1932. If you live through them once, you only want to live through them once.

Representative MOORHEAD. So you see a difference between general revenue bonds and general obligation bonds?

Mr. CRAIGIE. Yes, sir; that is my philosophy. I recognize there are people with other philosophies.

Representative MOORHEAD. Do any of you want to comment on that?

(There was no response.)

Representative MOORHEAD. I want to ask you about general tax exemption on industrial bonds; do you see any justification for putting a limit, below $1 million, should we continue their exemption below, and above that figure, now, which would eliminate the Borg-Warner situation you described?

Mr. CRAIGIE. I think if the Congress in its wisdom wants to put a million-dollar limit on such issues, it will lessen the evil. I see no good in any of them. I am just flatly opposed. I think it is a sheer prostitution of the tax immunity privilege, sir—right, rather than privilege. The Federal Reserve Bank of Philadelphia has just issued a rather interesting survey of municipal borrowings experience of 1966 during the recent money crunch. It brought out the fact that during the money market crisis of August 1966, most of the municipalities of the Federal Reserve district which encompasses Pennsylvania were able to effect borrowings.

Actually, I should like to add here, because the various members of the committee questioned it, the effect upon interest costs of ratings is really de minimis as compared with the various inflationary policies with which we have had to cope. We find that Fairfax County, where we have from time to time suggested that they defer, if possible, the building of much-needed schools, has now reached the conclusion that a quarter of 1 percent in interest rate is a small price to pay compared to an increase of 16 to 17 percent per annum in construction costs. The gain just is not worth the gamble.

It has been, really, lack of fiscal policy in this country that has raised interest rates, and not any question of ratings. This is apart from the point, but real. I happen to be an economist, also.

Representative MOORHEAD. Thank you, Mr. Craigie.

Chairman PATMAN. I would like to ask you gentlemen about the availability of large amounts of capital and its effect on the consumer market. You take your large concerns that produce most of our consumer goods. If there is no market where large funds can be obtained to go into competition with a big concern, I think the consumers are definitely faced with a disadvantage, because competition is not allowed. Since we are in an era of mergers and conglomerates and similar practices, every time we have a merger of a concern, they lose all their directors—at least in practice, they do. Then, if these people who are out as managers or in the management area of a concern—if they are good ones—if they had opportunities to get large capital,

they could go in competition with concerns manufacturing consumer goods. But as it is now, they have no place to turn. Certainly they cannot go into competition with the three big automobile manufacturers, the textile companies, General Electric and so on, as producers of consumer goods. Do you think we are lacking in failing to provide large capital now at this time? Should there be another Reconstruction Finance Corporation or some way provided where people could, under the rules of the RFC, when they could not get it from some other financial institution at reasonable terms, have capital provided for them? Do you think we should set up some agency, just a shotgun in the corner we will say, to take care of these situations that develop where the public interest is really being hurt, in order to allow competition?

What do you say about that, Mr. Harries?

Mr. HARRIES. Mr. Patman, I am a little bit confused. Are you relating this at all to industrial revenue bonds?

Chairman PATMAN. No. I am relating this to general business conditions. Big concerns now dominate the market in consumer goods. You admit that, do you not?

Mr. HARRIES. Yes, sir.

Chairman PATMAN. Now, how can anybody go into competition with them. There is no RFC to go to. They used to be able to go to RFC. We can go to the Small Business Administration if they are little and let the little fellows fight among themselves. But never have we been in competition with the big concerns, where real competition should take place.

Mr. HARRIES. Certainly the RFC did a fabulous job, particularly its director, Jesse Jones. But I am not sure we have reached the point of extremes yet.

Chairman PATMAN. We have not reached that point?

Mr. HARRIES. May I make a comment on industrial bonds, which is on this point?

Chairman PATMAN. Yes.

Mr. HARRIES. I do not share Mr. Craigie's view that all industrials are bad. I share your view that the $1 million figure in the bill which was recently passed is meaningless, a figure in excess of $1 million. I would prefer to see—now I relate to your question—an industrial revenue bond bill passed that provided tests of need.

Now, these are not difficult tests: No. 1, does the corporation pass the test? You would have to say that it does not have the financial resources to be able to do it by itself—that is, a relationship of assets to liabilities; is the figure greater or less than a certain specified number? You lay it right out. You would also have to demonstrate need by the municipality.

Certainly I do agree with Mr. Craigie that an outfit like Borg-Warner, well financed, solid companies, in my feeling do not deserve the privilege of tax exemption for corporate financing.

Chairman PATMAN. How can you deny these communities, which have such strong needs for funds, the opportunity to deal with these companies unless you provide available capital elsewhere under fair conditions? Do you not think the Government of the United States has a responsibility if the people are being imposed upon in different ways; do you not think that before denying them the

right to go and use the methods suggested, the Government should provide a method under fair terms and conditions whereby the communities can get that available capital elsewhere, under fair conditions?

Mr. HARRIES. Not yet.

Chairman PATMAN. Not yet. All right.

Now, then, one other point. We have a situation here that disturbs me. I appreciate competition. We do not have too much competition among big businesses. There are not many of them, so there cannot be too much competition. But what disturbs me is that when you learn something about an issue, a prospective issue that is either good for industry or bad for industry, even in an extreme case, you have no way of communicating and pooling your information even in the public interest. Now, if the Federal Government had a rating system, it would help us to do that. I think they would get all available information and everybody would be treated fairly. If something were known that would enable any municipality to get a much lower rate, that would be in the public interest and would help the municipality.

You take the Weather Bureau. Now, of course, they cannot make the weather, but they can report the weather honestly, sincerely. They certainly would not discriminate against a town or a city. The Federal Government would not say "We do not like that town or city or the people who live there, so we will just let this cyclone come that will cause devastation or destruction and not advise them of it."

Do you not think we need something, some agency, Federal Government or private, that will not withhold information that is good for a community? Do you not think you are in a little vulnerable position there?

Mr. HARRIES. No, sir, we do not withhold any information.

Chairman PATMAN. You still think it is cold competition?

Mr. HARRIES. We publish a weekly Bond Outlook in which we publish our ratings. This is published and appears all over the country on Monday morning of the week prior to the sale. Our ratings are there, spelled out, and our reasons for the ratings. But we do not talk to Moody's on the Friday before we go to press and say, what do you say about the issue? But we divulge everything that is pertinent.

May I answer your comment about the Federal rating agency? I think the point in your bill and Senator Proxmire's is an excellent one about a Federal agency providing factual information but not getting involved in rating.

On point 3, I go back to Senator Proxmire and some of his comments back in December; to have the Federal Government in a position of quality rating and judgment, in my opinion, could be disastrous.

Chairman PATMAN. I can see where you have something there, because the real objection I would have to your failure to transmit this information to a competitor would be in an extreme case, of course. But where the Federal agency was furnishing the information, that would suffice, I assume, and would take care of that weakness, if there is a weakness.

Mr. HARRIES. What may be a weakness to Moody's might not be to us, but we certainly would attempt to divulge in our rating analysis a brief summary of the facts.

Chairman PATMAN. As you say, it is a matter of judgment.

Now, off the record.

(Discussion off the record.)

Senator PROXMIRE (now presiding). I understand that Senator Jordan has a question.

Senator JORDAN. Thank you.

Mr. Riehle, you have raised a very interesting point and I did not get a chance to discuss it with you. You were highly critical of the proposed legislation in several respects. You state in your statement that another factor of such legislation would be to replace the judgment of the financial community with that of a Federal agency and since securities would be guaranteed, there would be less incentive for local communities to exercise fiscal control and efficiency.

In other words, under the rule of the marketplace which now obtains, certain disciplines are automatic in inducing these municipalities, these borrowers, to upgrade the quality of their offering, is that not true?

Mr. Riehle. That is correct, sir. I think that is a very important discipline.

If I may go back to a previous point, the point that Chairman Patman was just discussing for a moment, I do not believe that there is any privileged information that any one of the credit evaluators use, whether it is the rating agencies or the professional investors and the underwriters. Moody's publishes all of its data in a biweekly news service which is widely used in the marketplace, so that we are not using any privileged information. There is no such thing.

Now, I also think that it would be very difficult, if not perhaps impossible, to collect data without evaluating it, because as one collects and assimilates data, puts it together, through the process of analysis, one detects that data is missing or that additional points should be researched, so that any data collecting agency has to do a certain amount of evaluation, whether or not it arrives at an investment judgment.

I would also like to spend just 2 minutes clarifying a point that Mr. Craigie made in his opening statement, wherein he was talking about the Commonwealth of Pennsylvania and the State public school building authority. Mr. Craigie made the point that the Pennsylvania Public School Building Authority had to pay a higher rate of interest on that sale and I think he infers that that was due to the fact that Moody's had lowered the rating assigned to the Commonwealth's general obligation bonds. I think the point is that that differential in the interest cost was due to the fact that a constitutional referendum was going to take place the week after the sale and the voters were to decide whether or not they were going to guarantee the obligations of all of the agencies of the Commonwealth of Pennsylvania except the State public school building authority.

Now, it happens that the following week, the voters did guarantee all of the State agencies indebtedness except the public school building authority and it continues today on the basis that the investor has to assume the risk of the obligations of that agency entirely on his own.

So there was a market reaction, but it was not, I believe, a reaction to our rating change.

Senator JORDAN. The basic data changed?

Mr. RIEHLE. Yes. It was the fact that the Commonwealth was unwilling to guarantee the bonds of the State school building authority, but guaranteed all others.

Senator JORDAN. Thank you.

Senator PROXMIRE. I would like to start with Mr. Smith.

Mr. Smith, I have before me a listing of the various investor groups, including commercial banks, mutual savings banks, savings and loan, life insurance, fire and casualty, pension funds, et cetera. We have totaled this up and we find out that if you provide a guarantee and the other provisions in our bill, that you will broaden the market from approximately $470 billion of investment now or of assets available for investment, some of which may go into municipals, to more than twice that, you bring in another $500 billion of demand. Now, is it not logical, would not every economist agree that when you bring in this much more demand, you are bound to have a better price for your bonds and a lower rate so that the municipality would be benefited by it?

Mr. SMITH. I do not know, precisely, but in my view the municipality will not benefit.

Senator PROXMIRE. Would not that particular element have that effect?

Mr. SMITH. That is a plausible suggestion of a circumstance like that. But I think it is a matter that is far too complex to be completely confident that you would get that result. You would, I believe, be more likely to get the opposite result.

Senator PROXMIRE. Well, let me just add at that point, I would agree that you cannot project arithmetically that you are going to get a reduction of a half percent or a quarter of a percent, but would it not be logical to argue that the tendency will be in the direction of that?

Mr. SMITH. Oh, I think so; it could be so argued. Of course, the $64 question is at what price; from what level would the reduction occur? I think here, from what I read of the market specialists, it is prudent to assume that a new price structure would result from such a substantial change. This is really the area of concern. Obviously, if you enlarged the market and there was no material change in demand or in the price structure, and the borrower was reimbursed for a third of his interest, in the main at the prevailing differentials now between corporates and municipalities, there would be a net saving to the municipal borrower, but only if these assumptions were realized. As I noted in my formal statement, I doubt the assumptions will be realized. In the long run the local units may pay more for their money.

Senator PROXMIRE. Let me ask you——

Mr. SMITH. I am not enough of a specialist to be able to hazard a guess as to what the probabilities are.

Senator PROXMIRE. The chairman started off questioning in an area that is of concern to me and also of concern to the overwhelming majority of the Members of Congress. I would like to ask it in a different way.

Do any of you gentlemen argue that an American who has $10 million should be able to invest it at 5 percent, receive $500,000 a year and not pay one nickel of taxes on it? Five hundred thousand dollars a year, $10,000 a week, and not pay any taxes at all? Is that a fair and equitable tax system?

Mr. HARRIES. Tax avoidance is different from tax evasion.

Senator PROXMIRE. Oh, yes, certainly. Many have investments in municipalities. There is nothing wrong about it. I am asking should we pass laws to encourage and permit this, or should we recognize that this is something we ought to try hard to correct?

Mr. HARRIES. You mean socially wrong.

Senator PROXMIRE. Just that particular element, is that not wrong?

Mr. HARRIES. You put me on a spot. We have a large number of wealthy investment counsel clients to whom we suggest that they buy municipal bonds.

Senator PROXMIRE. Of course I am. After all, you obey the law. All I am asking is, is it wrong?

Mr. HARRIES. I think I would have to go back and ask how he got the $10 million in the first place. Did he pay a legitimate tax?

Senator PROXMIRE. Certainly.

Mr. HARRIES. Certainly you have a valid point. He uses the streets and does not pay for them, and so on.

Mr. RIEHLE. I think one aspect of it is this, the fact that the investor does have the option of buying tax-exempt bonds undoubtedly works to the benefit of a municipality and allows them to advance at a preferred rate of interest.

Senator PROXMIRE. That is exactly right. What we are working for is to try to develop an alternative way that is cheaper eventually for the municipality. Certainly we have, and I think the first gentleman made a point that there are a lot of difficulties.

Just from the point of the tax exemption feature, you would not agree that this is something we cannot justify?

Mr. RIEHLE. I am not a political scientist. I would like to say that I feel a little out of my element in answering this question.

Senator PROXMIRE. But you are a taxpayer. If they pay you a salary, you have to pay taxes.

Mr. RIEHLE. I do. But I think that when the municipality I live in—the county I live in, the State I live in, borrows money, I am getting a return on that benefit that probably equalizes this whole thing if there is an inequity.

Senator PROXMIRE. Mr. Smith?

Mr. SMITH. I think this is a very, very difficult problem. As a political scientist, I am impressed with the doctrine of intergovernmental immunity. I recognize that at the same time, for any of our governmental economic social arrangements, we have costs involved. Now, the cost that results from the exemption of interest on municipals in certain aspects, of course, can be abhorrent economically from the standpoint of justice. But whether the benefits from correction of the tax inequity would overcome loss of the advantages that result from immunity on the parts of State and their localities, I am not sure. I tend to believe that as a general proposition, we should uphold the doctrine of intergovernmental immunity and perhaps find other methods of getting around inequities in the tax system.

Senator PROXMIRE. This would not, as would be stressed over and over again, this would not prohibit the localities and States from issuing tax exempts. They are free to do it. This just gives them another outlet.

Mr. SMITH. Senator, if the governing bodies of these State and local agencies behave as economic man is intended to behave, if this arrangement will save them on the average one basis point, one-tenth

of 1 percent, then in time, all bonds will be taxable, all new issues will be taxable.

Now, we have a great deal of evidence that man does not behave according to the economic model and we know that there are individual officials who have attitudes that make it very unlikely that they will do this. But if the cost differential is there, in time this is the way it will be done.

Now, as a political scientist, I would have doubts about the longrun viability of this in its impact on government, because I believe very firmly that in a system of subventions, there should be restrictions by the grantor of the subvention.

Senator PROXMIRE. This is a very strong debating argument you make, but on the other hand, I think to say they necessarily will not, 90 percent of the time, I think you are saying that because Ford or General Motors has a better car, they will get 100 percent of the market. You would move into a rate where you would get some tax exemption and it seems to me we would get probably a preponderance of nontax exemption.

Mr. SMITH. I think we would have a compromise, as we always do. No system operates purely.

Mr. CRAIGIE. Senator, I am still old fashioned enough to believe that this Nation was founded on the doctrine of reciprocal immunity and while there might be certain cases which one might deem socially inequitable, this is a small cost compared with reducing the sovereignty of our States given them by the Constitution. I would have to be opposed to it.

I might say, as you probably know, Senator, the Federal water pollution control bill was reported out of the committee stripped of this particular provision last night. I got a wire just as I was leaving the office.

Senator PROXMIRE. Could you give me any citation from the Federalist Papers or any other constitutional document that would indicate that our Founding Fathers had the notion that you ought to have anything like tax-exempt municipals? Further, I might stress once again that you do not take anything away from the States, we just give them an option, another opportunity.

Mr. CRAIGIE. They did not envisage the type of taxation at that time, I believe, which exists now. But if you are talking about the question of broadening the market on taxable bonds, you have to take into consideration the sources of funds and the demand for funds. You just do not get money out of a vacuum. If you take it away from one place and put it into taxable securities, you are going to have to take it away from the mortgage field or from the savings and loan institutions or something else. You just do not have a half billion dollars or a half trillion dollars lying around uninvested, Senator. It just does not work that way.

Senator PROXMIRE. Of course, and in order to provide an opportunity for everybody to have a lower cost of money, we have to have monetary and fiscal policies, as you very well argue. This would simply, however, give a greater option, it would seem to me, in municipalities.

Did you want to comment, Mr. Harries. I did not want to cut you off.

Mr. HARRIES. No, only to come back to your rationale about what is socially good about a man who lies on a beach all day and collects $50,000 a year, at least I know if I am selling bonds in my town, I have a market where that man will come and buy my bonds, rather than buy Xerox. If I am giving him tax exempt status, he will come to me.

Senator PROXMIRE. We are taking nothing away from them. We are creating an option.

Mr. HARRIES. I realize that.

Senator PROXMIRE. Do all of you agree with Mr. Harries, that at least a provision in the bill providing for a data bank, that would gather the information as comprehensively as possible and make it available?

Mr. HARRIES. This could be extremely useful——

Senator PROXMIRE. No rating, no guarantee, simply make the information available.

Mr. HARRIS. And extremely helpful to some of these small municipalities who do not even retain full-time clerks.

Senator PROXMIRE. Any disagreement on that?

Mr. CRAIGIE. Yes, sir; I would like to disagree. I am deeply interested in reducing the budget, not increasing it. I do not think this is either feasible or essential. By the time you go in and talk to a corner druggist who acts as a treasurer to a small town and try to get the data you need to supply to anybody, I think it can be done better at the State level, say the Local Government Commission of North Carolina, which requires such information. We can bid on the town of Cornelius, N.C., with full information from the State and local government commission.

Senator PROXMIRE. Mr. Craigie, you are a man after my own heart. We are all in favor, Senator Jordan and I, very much, very much in favor of economy where we can find it. But it would be self-financing. In the first place, it would cost less than a million dollars. In the second place, there would be a charge for this service.

It would seem to me, furthermore, that to rely on North Carolina, Virginia, Wisconsin, and so forth, to do this on a spasmodic basis, here and there, would not be at all satisfactory, naturally. Some States would not do it, some would. To have one national comprehensive bank self-financing, it seems to me, would hardly be an abridgment of anybody's rights. It seems to me it does not affect it any other way.

Mr. CRAIGIE. By the time you would get it, it would be obsolete. second, the cost of it would be prohibitive. Third, the securities to which you refer would enjoy only a local market, not a national market. Nobody in Idaho, Wisconsin, Pennsylvania, Texas will bid on Brookneal, Va., bonds.

Senator PROXMIRE. I would like to comment on Mr. Riehle's comment that Government guarantee of securities would reduce incentive for fiscal control and efficiency. This is exactly the argument used against the Federal Deposit Insurance Corporation when it was established by the Government. Many people feel it was the least controversial and most constructive reform we had in the 1930's. It certainly achieved a great deal but it was opposed by the banks. They argued it would kill incentive for being efficient if the Federal Government were to insure deposits.

Well, it has worked out very well, I think you will agree, the banks are still efficient, and heaven knows, we have a tremendous benefit from this.

Is it not true that guarantees in the same way would provide great benefits and there would still be the incentive to be efficient? After all, every taxpayer of a municipality is going to be a far more effective disciplining force, on this a municipality, than a bond rating, no matter how important that bond rating may be.

Mr. RIEHLE. I think I tend to disagree. That is, as I attend town meetings—I attend a few a year—it always concerns me that citizens are not represented. They are not interested in spending proposals many times. But the competition for money in the marketplace, one municipality competing with 30 others on a given day of the week for capital, is a very real inducement toward efficient management, particularly among most of our municipalities today that have professional management. They have professional city managers, professional directors of finance. There is a lot of esprit de corps among the professionals in their fraternities. There is a lot of pride in their fiscal operation. That is very evident as one attends the conventions of the municipal finance officers.

Senator PROXMIRE. Do you think that pride would evaporate? There is a terrific reward in our public service, for those who do an efficient job of running a municipality. There is hardly anything more appealing to the voters. After all, you have regular elections and heaven knows when you have your bond issues up, we have a very emphatic discipline in the referendum.

Mr. RIEHLE. I suppose one of things that would be missing is that you are taking away one of the yardsticks of achievement. You are taking away one of the real means of measuring achievement.

Senator PROXMIRE. One of the other ways, of course, is that you keep your taxes down and your cost down.

Mr. RIEHLE. That is true, sir. I agree.

Senator PROXMIRE. You say this guarantee will mean Federal interference in the local government. Has the FDIC meant serious Federal interference with the operation of our banks?

Mr. RIEHLE. No, sir; it has not. But I think in a number of our programs—and I cite specifically the programs conducted by the Department of Housing and Urban Development that has made funds available to small municipalities, and to colleges and universities—wherein the agency has certainly done an outstanding job—there have been strings attached. Loan agreements, on occasion, have been too stringent, making it difficult for them to sell bonds in the public market at a later date. Additionally, many times there are stipulations as to how a facility is to be designed and what it can have in the way of frills, and so on. I think the FDIC legislation is a poor analogy to the legislation here proposed.

Senator PROXMIRE. Of course, if the strings get too stringent, you always have the option to go tax exempt.

Mr. RIEHLE. I agree and disagree.

Senator PROXMIRE. I would like to ask you gentlemen one other thing which has concerned us. I do not think we have much in the record on it.

It is my opinion that your different letter rating reflect your judgment as to the probability of default? Is that true?

Mr. RIEHLE. That is true, in part; but bond ratings signify much more—mainly the relative investment quality of each bond, relative to all of those outstanding and trading in the marketplace.

Senator PROXMIRE. Do you all agree on that?

Mr. HARRIES. We do not quite express it that way, sir. We express it in a way that it is a rating of relative investment quality.

Senator PROXMIRE. Is that not what that means, however? If there is no possibility of default, you would give your highest rating?

Mr. HARRIES. If there were absolutely none at all, it would have an AAA.

Senator PROXMIRE. This is the heart of it?

Mr. SMITH. I am going to have to dissent, although Dun & Bradstreet is not generally regarded as putting out ratings, but we do use these classifications. Our top grade we call a prime grade credit risk. I do not know how we could possibly say this is a guarantee that there would be no default.

Senator PROXMIRE. Of course not.

Mr. SMITH. This is a statement that compared to the others, this has the least likelihood.

Senator PROXMIRE. That is not the way I put the question. I said that if, and this would be a strictly theoretical supposition, something that I am sure you would not run across, if you theoretically find an issue in which there was no probability of default, you give it a top rating. Then I am saying if you feel the chances of default are very small, infinitesimal, you give it a top rating.

Along that line, are these probabilities a reflection of post-World War II experience or do they encompass the experience that we had in the 1930's?

Mr. HARRIES. I know exactly what you are driving at and perhaps I can answer your question this way: The degree of default of the four top grades of municipal bonds is remote. In fact, the degree of possibility of default of municipal bonds is very remote. On the basis of the testimony in December, I figured the thing out to be three ten-thousandths of a percent, which is very tiny. That is why I shy away from your definition of what a quality rating is. To us, it is a comparative rating of investment quality. I did not use the word "default" because our investment clients want those fine delineations of security. They do not want the absolute definition of default because that is so remote.

Do I understand your question?

Senator PROXMIRE. You do. I am just wondering if—I cannot understand what "quality" means if it does not imply "default."

Mr. HARRIES. It dose, except that the incidence of default in municipal bonds is so remote. These fine delineations are not our making, they are the desire of our subscribers. Our subscribers seem to desire these fine delineations, which are very fine, because you are looking at the cream of investment.

Senator PROXMIRE. How do you define "quality"?

Mr. HARRIES. It would have to be the investment characteristics of one bond as opposed to another, always relative.

Senator PROXMIRE. And those investment characteristics——

Mr. HARRIES. I suppose they would have to run, if they were way up here, down to the very bottom, which would be a default situation.

But ratings measure only the top of the scale. Put another way, ratings in the top four grades measure only the remotest chance of risk. Ratings provide a way to show deterioration or improvement in fiscal soundness. There seems no other way we can provide—to furnish the investor with this information. From the importance ratings have attained, it should be apparent that investors respect these ratings, and most certainly they are as aware of the remoteness of default as the committee is.

Senator PROXMIRE. Have there been any defaults or bond issues sold since 1966 accorded a bond rating of BAA or better?

Mr. HARRIES. Yes; I was appreciative of the remarks Mr. Diamond put in about what is a default. We have bonds, rated bonds in default; but the possibilties are——

Senator PROXMIRE. How many have there been?

Mr. HARRIES. Just the one that was rated, Senator.

Senator PROXMIRE. You said that was rated.

Mr. HARRIES. There have been others that have defaulted. We did not rate them.

Senator PROXMIRE. Yes, the four top ratings. How much was that?

Mr. HARRIES. $860,000. We expect them to bail out, that is why we enjoyed Mr. Diamond's definition of what is a default.

Senator PROXMIRE. I have something here by Jackson Phillips and Roger Baum, Dun & Bradstreet, which appears on pages 244, 245 of the Joint Economic Committee Study on Public Facility Needs and Financing, and according to the tabulation made by Peter Harkins of the National League of Cities, appearing in the December hearings. There have been 45 defaults in municipal bond issues since the December 1947 issues, after subtracting the default of issues for default of developments, turnpikes, bridges, marine ways and tramways, there have been less than 20 municipal bond defaults in the postwar period where roads were used for essential public facilities.

How are these remarkable records reflected in your credit bond ratings for municipals and are they implicit in your bond ratings of AAA, AA, and BAA? From what you have told us, unless you are expecting that we might have a recurrence of the 1930's, it would seem that this differential, which is very costly to the cities, is very hard to justify.

Mr. SMITH. Senator, may I comment on that, since my organization did the research work for that paper?

Senator PROXMIRE. Yes.

Mr. SMITH. There are two factors that are relevant. In the first place, it is very difficult to get comprehensive data on defaults. The entire industry is very sensitive in this area, understandably. I know of no definitive listing of postwar defaults. These 50 that were found were cases that could be studied and we cannot put any importance on the fact that it was 50 rather than any other number.

In the second place, I think it is very significant that these defaults all fit into historic patterns in that they arose from causes which in the past have occasioned difficulty, from causes which are ascertainable ahead of time, so that the difficulties could have been predicted.

Furthermore, I think it is very significant that two of these defaults represent a rather significant portion of the kind of bonds that have

been issued for that purpose in the postwar period—that is, the West Virginia Turnpike and the Chicago Calumet Skyway defaults. The former is in default on interest on its $133 million of bonds, the latter on interest on its $101 million, their bonded debts combined thus amounting to $234 million. Three other large toll facilities are not earning interest charges, have exhausted or will shortly exhaust their reserves, and are regarded as probable defaulters in the near future. These three have a total bonded debt of $441 million, of which $191 million is in immediate jeopardy. The bonds already in default represent 3.5 percent of the outstanding bonded debt of 59 major turnpike, toll bridge, and toll tunnel projects financed with revenue bonds in the postwar period, and the bonds in imminent jeopardy of default represent an additional 2.9 percent. I think this is a disquieting record considering the generally prosperous period in which it occurred. It seems to me the record itself demands the differentials we make.

Senator PROXMIRE. No school bond issue has defaulted, is that correct?

Mr. SMITH. Not to my knowledge.

Mr. RIEHLE. I believe that a few have.

Senator PROXMIRE. You believe that a few have?

Mr. RIEHLE. A few have, yes.

Senator PROXMIRE. Can you tell me where they are?

Mr. RIEHLE. In those instances that I am acquainted with, sir, it was due to the fact that the school board was not willing to face up to its responsibilities of enacting a realistic budget. It was due to shortsightedness and an attempt to keep taxes down. It was not due to a lack of financial resources. They were all corrected within a short space of time.

Mr. CRAIGIE. I might say, Senator, in Virginia, there is a law that in the event of default, the Governor steps into the picture and withholds State funds until the default has been corrected. That applies particularly to school bonds. I know of one case in which there was an incipient default and the Governor simply called up the leading local power and said, I want those bonds paid and paid in a hurry. They were paid, sir.

Mr. RIEHLE. If I may inject a comment here, I think the default experience of post-World War II should be viewed in the perspective that this has been an era of peak prosperity in our Nation's economy which has been unequaled. Really, there should not be defaults during this period of prosperity. A list of some of the defaults is attached as appendix E to my written statement.

Senator PROXMIRE. Well, we had a period of prosperity certainly since 1960. We had a number of recessions between 1946 and 1960.

Mr. RIEHLE. Yes, we have.

Senator PROXMIRE. Many people would argue, and that was the basis of my initial questions, that the changes we have had in our society since the 1930's, right or wrong, like the Federal Deposit Insurance Corporation, social security, unemployment compensation, and others, plus the commitment of the Government through the Employment Act of 1946, which said that the Government will do whatever is necessary to prevent depressions, that we are unlikely to have the kind of devastating depression, with the enormous amount

of bankruptcies and so forth that we had in the 1930's. I assume from your answer that this is the basis on which you are making your ratings. Perhaps I misunderstood that.

Mr. RIEHLE. That is true. We are taking cognizance of those features.

Senator PROXMIRE. Under those circumstances, it seems to me it is hard to understand why there is this difference between BAA and AAA when we have had one default in 22 years and that default was for less than a million dollars, with the literally thousands and thousands of issues and the billions and billions of dollars that have been subscribed.

Mr. SMITH. This is very true; we have mechanisms that we have created in the last 30 years that we have every reason to believe will be of material help in preventing the kind of thing we have had in our severe depressions in the past.

At the same time, we have had changes in the structure and methods of State and local finance which have injected new elements that were not present in earlier generations—certainly they were not factors in the 1930's depression period. A few of these have already given evidence of their potential for causing trouble under relatively mild downturns.

When we went into the depression of the 1930's, for example, the main support of local government was a general property tax. Now, there are a couple of features of the general property tax that give a great deal of viability under general pressure conditions. Almost universally, the general property tax is a lien on the property tax. That lien may be foreclosed in accordance with State law. This means that past due unpaid taxes are bankable. That is, the governmental unit can go to the banks and pledge those taxes for the loans. This is actually the way that the deficits of the localities were financed in the depression.

Senator PROXMIRE. What is the present situation?

Mr. SMITH. Today, the dependence on the general property tax has on the average been reduced by more than half. Instead of the average city getting about 75 percent of its revenue there, it gets about 45 percent.

Senator PROXMIRE. Where does the rest come from?

Mr. SMITH. Taxes primarily based upon income and consumption. This is income, governmental income, that cannot be borrowed against. If the incomes are not earned, if the retail transactions do not take place, there is no tax accrued.

Senator PROXMIRE. How much of that 55 percent comes from the State and Federal Government?

Mr. SMITH. Close to 25 percent, on the average in the last 5 or 10 years has come from fiscal aid, the greater part from the States. However, part of the State revenue in turn comes from the Federal Government. The major source of support for both State and Federal Governments is revenue based on income and consumption.

Senator PROXMIRE. Is it conceivable that in the case of a difference, the Federal Government would turn its back on municipalities.

Mr. SMITH. I do not think so. I think the Federal Government will do all it can, but at the same time, I think the Federal Government will have some major responsibilities that will limit its ability, just

as it was limited in the 1930's. I think there are some other technicalities like this, it is not a complete net gain.

Senator PROXMIRE. I think that is a good point. It is quite different to have your taxes based on income rather than property, and it is far less assured in terms of a bankable base.

Mr. SMITH. That is right. Then in the postwar period, there has been a great use of revenue bonds. In the 1930's, very few cities issued water revenue bonds, but practically every city that had a water system operated it profitably. Many cities around the country helped finance essential governmental services by diverting water surplus temporarily. Today, many cities issue water revenue bonds and under contracts with their bondholders, they cannot divert their surplus water earnings.

Senator PROXMIRE. I have just two more questions which are related and which are interesting from a social standpoint.

In making credit evaluations or assigning bond ratings for a particular city, do you react favorably to the occurrence—well, how unfavorably do you react at the occurrence of a riot within the city or the outmigration of population to the neighboring suburbs, or when an increasing proportion of the city's population is nonwhite?

Do any of you take these into consideration?

Mr. HARRIES. The riot, no. Riots are transitory; they are important only as it is indicated that Nos. 2 and 3 are present.

Senator PROXMIRE. The outmigration of the municipal population to neighboring suburbs?

Mr. HARRIES. Very strongly.

Senator PROXMIRE. And an increasing proportion of the city's population is nonwhite?

Mr. HARRIES. To a degree, yes; if it goes hand in hand with the outmigration.

Senator PROXMIRE. Mr. Craigie?

Mr. CRAIGIE. I would like to comment specifically on that, Senator. The city of Richmond, in which I have always lived, enjoyed a triple-A rating by both services. Its nonwhite population is about 52 percent, its nonwhite school population is over 60 percent. We are pleased with the character of all of our citizens. We are an all-American city. I should like to think, with all due respect to my three friends to the right, that even after what I said about them today, Richmond will still continue to enjoy an AAA rating.

Senator PROXMIRE. I am sure there is nothing in what Mr. Harries said that would contradict that.

Mr. CRAIGIE. No, I do not think so.

Senator PROXMIRE. You could have 90 percent of your city nonwhite and have a very big exodus of middle-income people and yet have a fundamental strength in the inner city and such a relatively low ratio of the size of your issue to your income and so forth that it would be obviously a good investment. But this is a question which obviously must be looked at in considering the fundamental important considerations of a rating.

Mr. HARRIES. I would like to emphasize that the nonwhite factor would be looked at only from the economic standpoint.

Senator PROXMIRE. Of course.

In terms of improving the credit standing of municipalities subject to these social upheavals and population migrations, what compen-

satory actions on the part of the Federal Government would you deem appropriate—Federal grants, Federal loans, loan guarantees, or do you feel these are entirely local problems that do not require Federal assistance?

In other words, you acknowledged, Mr. Harries, and I think the other gentlemen do, that these are serious problems for rating. Do you think the Federal Government should act or should not?

Mr. HARRIES. I think in many areas of the large urban problems that we have today is some of our major cities, I think Federal loans and Federal activities in the area of training unskilled and so on is the heart of it. I have always felt that way.

Senator PROXMIRE. Mr. Riehle?

Mr. RIEHLE. I think, unmistakably, education is probably the solution. I have not seen it demonstrated that any one of our major population centers does not have the economic capability of educating these underprivileged.

I imagine that in a matter of time, the welfare load or burden on major cities is going to be transferred to the Federal Government as a Federal responsibility.

Senator PROXMIRE. There is a feeling on the part of a lot of people that despite all the Federal assistance, they are not doing the job that has to be done. These are fine people in character; but with a modern world, with the skills that are required, education is very, very expensive. These are people who probably require, in many cases, a better teacher-pupil ratio than we have in our finest schools if we are going to make any progress in a reasonably brief period. This is very expensive to do. Something like the Teacher Corps on a comprehensive basis, something of that kind, it seems to me would have to be financed to some extent by some kind of Federal assistance and many people feel this is about the best investment the Federal Government can make in helping people who otherwise are going to become unemployable burdens on the society and instead help them to become workers and taxpayers.

Mr. RIEHLE. Undoubtedly, that is probably true. I somehow have the feeling that no one community has really come to grips with this problem, specifically in terms of how to educate and how to set the wheels in motion—so it has not yet been reduced to costs.

Senator PROXMIRE. Mr. Smith?

Mr. SMITH. You tempt me, sir, to do a lecture that the last time I delivered took about an hour and a half to develop. I know we do not have that time.

Very briefly, I think we are in a stage where our academic and research people are beginning to indicate some findings that suggest that we are going to reexamine our prevailing traditions of intergovernmental assistance. I know we are concerned right here with capital financing and this is a serious problem for what I believe is to be a rather small minority of communities. On the other hand, the operating function of our local governments, particularly, and especially the larger cities, is a very serious problem.

Now, the method by which we have sought to cope with this in the past has been by intergovernmental transfer payments: First, the State making payments down to the local units, then the Federal Government coming into the picture. Up until very recently, the Federal

payments were entirely for capital purposes. You recall during the war, programs to help impacted areas meet operating costs began. Particularly in the educational field, these have increased in recent years.

Now, the statistical fact with relation to intergovernmental transfer payments is that for the purposes for which they are made, they are not matching needs. The functional expenditures for certain purposes are increasing faster than the available revenues, as we provide them at the present time, are increasing. These rapid functional increases are in welfare, special education, and pollution control, to mention the three most intractable.

If you look at local government expenditure trends in recent years, whatever period you take, whether 5-year or 10, you will find that increases in these functional expenses at the local level are outstripping the increases of local revenues, even taking into account the fiscal aid that is being granted.

On the other hand, if you exclude these, you will find increases of local revenue are keeping pace with functional demands on local revenue. Our traditional method has been periodically, with great travail, to increase the transfer payments, to try to match the higher level of functional costs for particular programs.

Our academic people are now beginning to suggest that maybe we are looking down the wrong end of the telescope, that what we should be doing is considering functional reallocations. For example, when welfare became a local responsibility, it was controllable by the localities. In the main, welfare was the care of the incapacitated and there were very few people who had to be supported at public expense. This was because primarily our economy had a demand for a tremendous amount of unskilled labor and for a man willing to work, we could find a job. This is no longer true and a man must have rather complex training and skills. We have very little unskilled work, so the man's willingness to work is no longer much of a factor as to whether or not he can get a job and be self-supporting. The conditions which cause this change are national, not local. Yet the responsibility for welfare primarily continues to rest at the local level.

Similarly, when education was a matter of the three R's, it was controllable. And so on down the line. When we had less mobility, our large cities had these jobs in proportion to their capacities. They no longer have them. The large cities are the magnet for the underprivileged, who understandably go where they think there are opportunities.

Now, these research people today are concluding that maybe what we need to do is look at the reallocation of responsibilities and place some of these things which are national in scope at the level where the revenue expands in accordance with the requirements. I expect, sir, that over the next 5 years, the Congress will become increasingly concerned in this area, because there is a well-defined trend today on the part of the people who are doing the fundamental thinking to direct attention along these lines.

Senator PROXMIRE. You are making this as an objective judgment rather than a value judgment?

Mr. SMITH. Yes.

Senator PROXMIRE. Mr. Craigie?

Mr. CRAIGIE. Senator, I can speak, I think, from experience as a trustee of the Virginia Union University, which used to be called a Negro university though we no longer call it that. I am a member of the board of the Richmond Urban League and former chairman of the Department of Public Welfare Advisory Board of the City of Richmond, so I have been closely related to the socioeconomic questions here. I think there is a distinct role for the Federal Government. I think in the whole field of air and water pollution, it is so vast that it transcends State boundaries, even. I think there is a proper role for the Federal Government to play here.

I like to think that we are not doing things for people, but we are all Americans working with people. In my own firm, we do not employ Negro keypunch operators, we employ keypunch operators. I think all of this is helping people help themselves. Otherwise, you are in this endless rat race of welfare, which seems like a bog from which you never can emerge.

It is really a very big problem, a very human problem, one of no easy solution, sir.

Senator PROXMIRE. Gentlemen, thank you very much. This has been most enlightening and helpful. You have done a fine job. I think we have brought out a good record, thanks to your participation and excellent statements.

The committee will adjourn until tomorrow morning at 10 o'clock in this room, when we will hear from additional witnesses.

(Whereupon, at 12:30, the committee adjourned, to reconvene, Wednesday, July 10, 1968, at 10 a.m.)

FINANCING MUNICIPAL FACILITIES

WEDNESDAY, JULY 10, 1968

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON ECONOMIC PROGRESS
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman of the subcommittee) presiding.

Present: Representatives Patman and Moorhead; and Senator Proxmire.

Also present: Representative William B. Widnall, member, full committee; John R. Stark, executive director; and Arnold H. Diamond, economic consultant.

Chairman PATMAN. The subcommittee will please come to order.

Today is the second day of hearings on municipal bond ratings by the Subcommittee on Economic Progress of the Joint Economic Committee. Yesterday we heard from representatives of the private bond rating services regarding the methods they employ in determining bond ratings.

They do not make public their criteria for grading municipal bonds; nor do they publish any averages of important economic and fiscal benchmarks by which one can judge the consistency of their credit evaluations.

Their methods of analyzing tax and debt burdens are predicated upon the local property tax and general obligation debt. Hence, they make little allowance for the growing importance of local sales and income taxes or the widespread use of revenue bonds, secured by user charges.

Cities that borrow and tax relatively more than other cities are frequently accorded lower bond ratings, thereby increasing their interest cost burdens. Most serious of all, their judgments of credit quality, as measured by bond rating gradations, are based upon an assumption of a possible recurrence of the severe depression experienced in the 1930's, without rgard for the many safguards and built-in stabilizers of the U.S. economy and without regard for the infinitesimally low default rate for municipal securities during the past two decades.

Despite these glaring inadequacies, the Federal bank supervisory agencies continue to rely upon bond ratings in their regulations governing commercial bank investments in municipal securities. Our witnesses today are representatives of the three bank supervisory agencies: Mr. William Camp, Comptroller of the Currency; Mr. Kenneth Randall, Chairman of the Federal Deposit Insurance Corporation; and Mr.

William W. Sherrill of the Board of Governors of the Federal Reserve System.

I am hopeful that they will be able to explain to this committee why bond ratings are still relied upon in their agency's investment regulations and guides for bank examination in this age of computers and extensive data banks. I am also hopeful that they can explain the logic of the current municipal securities market wherein commercial banks are accounting for about 90 percent of the net expansion of outstanding municipal securities.

According to committee staff estimates, outstanding State and local government obligations increased by about $9.5 to $10 billion in 1967. Call report data indicate that commercial bank holdings of municipal securities rose by over $9 billion in 1967, so that commercial banks, buying for their own accounts, acquired over 90 percent of the net growth of municipal debt. When account is taken of the bank-administered personal trust funds, for which there are no adequate figures regarding the composition of their asset holdings, commercial banks are clearly the dominant force in the current municipal securities market.

Among the other important financial institution or investor groups only fire and casualty insurance companies have continued to add significant amounts to their holdings of municipal securities. On the other hand, holdings of municipal securities were decreased in 1967 by such major institutional groups as life insurance companies, savings and loan associations, mutual savings banks, nonfinancial corporations, State and local retirement funds, and State and local governments. In addition, noninsured pension funds and credit unions reportedly do not hold any municipal securities. I am placing in the record, and distributing to the witnesses, several tables showing the distribution of holdings of municipal securities by investor groups.

(The tables above-referred to, follow:)

TABLE 1.—YEAREND HOLDINGS OF STATE AND LOCAL GOVERNMENT OBLIGATIONS

[Dollar amounts in millions]

	Total outstanding[1]	Commercial banks	Mutual savings banks	Life insurance companies	Fire and casualty insurance companies	State and local governments[2]	Federal credit agencies[2]	Nonfinancial corporations[2]	Individuals and others[1]
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1960	$69,300	$17,570	$672	$3,588	$8,062	$7,210	$1,650	$2,520	$28,000
1961	76,100	20,345	677	3,888	9,036	6,960	1,910	2,440	30,800
1962	83,000	24,795	527	4,028	9,713	6,290	2,220	2,110	33,300
1963	89,200	29,847	440	3,853	10,587	5,600	2,350	2,790	33,700
1964	95,300	33,594	391	3,774	10,926	5,140	2,670	3,140	35,600
1965	101,900	38,728	320	3,530	11,293	4,800	3,010	3,640	36,600
1966	109,000	41,111	251	3,114	12,654	4,480	3,670	3,340	40,400
1967	119,000[3]	50,124	217	2,973	14,294	4,100	3,790	2,840	40,700
Percent growth, 1960-67	+72	+185	−68	−17	+77	−43	+130	+13	+45

[1] Rounded to nearest $100,000,000.
[2] Rounded to nearest $10,000,000.
[3] $118,500 if net increase in 1967 was $9,500,000,000.

Sources: Col. 1: Estimated by relating annual bond sales data, compiled by the Bond Buyer to June 30 total municipal bonds outstanding, as reported by OBE. Col. 2: FDIC call report data for all commercial banks. Col. 3: National Association of Mutual Savings Banks. Col. 4: Institute of Life Insurance Fact Book. Col. 5: Best's Aggregates and Averages, adjusted by SEC, 1967 figure estimated. Col. 6: Bureau of the Census, Governmental Finances; figures represent average of overlapping fiscal year data; statistics reflect holdings by State and local retirement funds and State and local governments. Col. 7: Federal agency reports. Col. 8: Compiled and estimated by SEC. Col. 9: Residual.

TABLE 2.—ANNUAL NET CHANGE IN HOLDINGS OF STATE AND LOCAL GOVERNMENT OBLIGATIONS

[Dollar amounts in millions]

	Total holdings	Commercial banks	Mutual savings banks	Life insurance companies	Fire and casualty insurance companies	State and local governments[1]	Federal credit agencies	Nonfinancial corporations	Individuals and others	Ratio commercial banks, total (percent)
1961	$6,800	$2,775	$5	$300	$974	(−$150)	$260	(−$80)	$2,800	40.8
1962	6,900	4,450	(−150)	138	677	(−670	310	(−330)	2,500	64.5
1963	6,200	5,052	(−87)	(−174)	874	(−690)	130	680	400	81.5
1964	6,100	3,747	(−49)	(−78)	339	(−460)	320	350	1,900	61.4
1965	6,600	5,134	(−71)	(−244)	367	(−340)	340	500	1,000	77.8
1966	7,100	2,383	(−69)	(−416)	1,361	(−320)	660	(−300)	3,800	33.6
1967	10,000	9,013	(−34)	(−141)	1,640	(−380)	100	(−500)	300	[2] 90.1

[1] State and local retirement funds and State and local governments.
[2] 94.5 percent if the net increase in total holdings in 1967 was $9,500,000,000.
Source: Derived from table 1.

TABLE 3.—HOLDINGS OF MUNICIPAL SECURITIES BY SIGNIFICANT INVESTOR GROUPS AT END OF DECEMBER 1967

[Dollar amounts in millions]

Investor group	1967 yearend holdings: Total assets	Municipal securities: Amount	Municipal securities: Percent assets	1967 net change
1. Commercial banks	[1] $367,736	$50,124	13.6	$9,013
2. Mutual savings banks	66,366	217	.3	(−32)
3. Savings and loan associations	143,602	74	.1	(−3)
4. Life insurance companies	177,201	2,973	1.7	(−141)
5. Fire and casualty insurance companies	44,470	[2] 14,300	32.2	1,640
6. Noninsured pension funds	71,820			
7. State and local retirement funds	[2] 41,500	[2] 2,300	5.8	(−200)
8. State and local governments	[2] 68,000	[3] 1,800	2.6	(−200)
9. Nonfinancial corporations	[3] 90,700	[2] 2,840	3.1	(−500)
10. Credit unions	12,713			
Subtotal	1,084,108	74,630		
Other significant holders:				
Federal credit agencies		$3,790		$120
Personal trust funds		[2] 15,000		1,000
Individuals and others		[2] 25,000		(−700)
Total outstanding		[2] 119,000		10,000
Or		118,500		9,500

[1] Total loans and invstments.
[2] Approximate.
[3] Cash, Government securities, other short-term investments.

Chairman PATMAN. As will be noted, the municipal securities market currently is very narrow, consisting essentially of commercial banks, bank administered personal trust funds, other individual investors, and fire and casualty insurance companies. These are the only investor groups that find the tax exemption accorded to the interest income on municipal securities attractive. All the other investor groups apparently do not have any need for tax-exempt income,

mainly because they, themselves, are either tax-exempt or enjoy relatively low effective corporate income tax rates.

In effect, then, we have a situation wherein commercial banks are using their unique money creation power to acquire tax-exempt municipal securities so as to minimize their income tax liability. Their success in minimizing income taxes is reflected by the record levels of after-tax profits currently being reported by many of the Nation's large banks.

With the marginal tax rate for most large commercial banks now exceeding 50 percent whereas the interest rate savings for municipalities because of tax exemption is frequently under 30 percent, purchases of tax-exempt municipal securities has become quite profitable for commercial banks. This profitability is increased by the workings of the bond rating system that adds to the interest costs most municipalities must pay because their bonds are either unrated or rated below the top grade. Yet the possibilities of actual default are very remote, when one considers the postwar default experience for municipals.

By relying upon bond ratings in their investment regulations for commercial banks the three bank supervisory agencies are contributing to the higher interest costs that most of the Nation's municipalities must pay for borrowed funds. Since many of these municipalities, be they cities, counties, school districts or other public bodies, are financially hard pressed, higher interest costs mean less money is available for education, hospitals, and police services. Higher interest costs on municipal securities also result in increasing demands for more and more Federal grant assistance.

I trust that our witnesses today will tell us how we can disentangle this financial web which envelops the Nation's municipalities.

We will have these witnesses testify in the order of: Mr. Camp, first, then Mr. Randall, then Governor Sherrill.

Mr. Camp, you are recognized, and you may read your testimony if you desire. However, I will ask you to limit your statement to 10 or 15 minutes, and anything you wish to expand on, you may do so later in the record.

STATEMENT OF HON. WILLIAM B. CAMP, COMPTROLLER OF THE CURRENCY

Mr. Camp. Thank you, Mr. Chairman. I have a short statement which I shall read, and a longer statement which I shall file with the committee in a few days and, if necessary, we would like to submit some additional material.

Chairman Patman. You may do so, sir, and after you conclude, we will call the other witnesses.

Mr. Camp. I have here in the room a number of people from my staff. I have with me Mr. W. Paul Smith, who is a senior economist and who has done a great deal of work in this area, particularly on bond underwriting.

I have with me also Mr. Robert Bloom, our Chief Counsel: Mr. Justin Watson, our First Deputy Comptroller; and Mr. Radcliffe Park, Associate Chief Counsel.

Mr. Patman, before I go to my prepared statement, if I may, sir, I would like to speak to one part of your prepared statement which I

do not think is entirely correct. Maybe it is a misunderstanding, but as I understood you, in your opening statement, you said that the regulatory agencies rely on bond ratings.

Is that correct?

Chairman PATMAN. That is one of the things you rely upon. In other words, you do rely upon them. Of course, you rely upon other things, but you rely upon those, too, if my information is correct.

Mr. CAMP. Well, your information is not entirely correct, sir, and I would like to, if I may, go to that.

Chairman PATMAN. Do you not use bond ratings?

Mr. CAMP. Could I read from our formal instructions? I believe you have a copy of them.

Chairman PATMAN. Yes, sir.

Mr. CAMP. I will go first to the paragraph entitled, "Rating Services."

> Rating Services provide useful supplemental information regarding the credit quality of a security. The Examiner should be familiar with the various rating services and their definition of what constitutes a security which is considered speculative.

Now, here is the key, Mr. Patman, we think:

> Although a rating service provides an indication, it must be stressed that the assigned rating is not an overriding or controlling factor regarding the credit quality of a security.

Now, that is in our instructions to examiners. I shall read further:

> Careful credit analysis is as essential in making sound investments as it is in granting sound loans. The responsibility for prudent management of a bank's investment account—

This is very important; I would like to repeat it—

> The responsibility for prudent management of a bank's investment account cannot be delegated to a correspondent, brokerage house, or rating service.

Paragraph 1.8 of the Investment Securities Regulation Section of the Comptroller's Manual for National Banks requires every bank to maintain complete credit files dealing with information for all investment securities.

> Public securities, except the United States Government and Federal Agency obligations, are not exempt from the above requirement.
>
> In determining the soundness of a public security, the following information should be obtained and analyzed:
>
> 1. Statement of total debt, including all related obligations;
> 2. Assessed valuation including the basis of assessment;
> 3. Property tax rates;
> 4. Tax collection records;
> 5. Receipts and disbursements;
> 6. Sinking fund obligation and requirements;
> 7. Future debt service requirements;
> 8. Population;
> 9. Economic background;
> 10. Default records;
> 11. Per capita debt.

I would like to repeat, once again, this sentence: "The responsibility for prudent management of a bank's investment account cannot be delegated to a correspondent, brokerage house, or rating service."

So this is a formal part of our instructions to all banks and to all examiners.

Now, if I may, sir, if I have not used too much of my time, I would like to read my statement.

Chairman PATMAN. That is all right, sir. Go ahead.

Mr. CAMP. I appreciate this opportunity to discuss with you the problems of municipal financing. Of necessity, State and local governments are undertaking huge programs of capital investment. They have the principal responsibility for supplying many goods and services including streets and highways, public safety, education at all levels, sewerage, electric power, and an extended variety of health and welfare services. The orderly and efficient functioning of the markets supplying these funds is of prime concern to all of us.

In recent years, the responsibilities of municipalities have expanded greatly due to the rapid growth in population and the increased complexity of urban living. As a result, the volume of new municipal debt issued annually has roughly doubled since 1960, rising from about $7 billion to a record high of over $14 billion last year. During the same period, outstanding municipal debt rose from $64 billion to $118 billion.

Throughout our history commercial banks have been in the forefront in meeting the Nation's credit needs, both private and public. Even prior to the development of municipal bond financing, commercial banks by extending direct loans were actively assisting State and local governments in meeting the demands for services. During the past few years, commercial banks have provided the major impetus to the increased competition among municipal bond underwriters. Moreover, as investors in municipal bonds, commercial banks are the most important source of funds for State and local governments.

The performance of commercial banks in supplying the funds needed by State and local governments has been truly remarkable. In this decade, State and local security holdings of commercial banks have increased from $17 billion to $50 billion. The additional funds provided by commercial banks have accounted for 52 percent of the total increase in outstanding municipal debt during the 1960's. The expansion of commercial bank investment in State and local securities primarily reflects the overall growth of banks' total loans and investments.

I might point out that the greatly increased investment in State and local securities by national banks has not been associated with a comparable increase in examination problems. I think this speaks well for both the care and thoroughness with which banks invest their money and the basically high quality of the underlying public projects for which the bonds were issued.

The supervision of national banks emphasizes appraising and remedying problem loans, problem investments, and other matters which may impinge on the banks' safety. This emphasis on bank safety overrides the attention given to the yields on individual loans or investments. Our knowledge as to the effect on yields of variations in quality—or ratings—is more limited than our knowledge as to the overall quality of banks' municipal security investments.

In examining national banks, we give careful attention to all facets of bank operations including, of course, the banks' investments, portfolios. Our concern is that national banks' investments, like their loans, be sound. We especially stress that the banks' investments not include obligations which are predominantly speculative. The quality

standards that we apply to municipal bonds in determining whether such bonds are suitable for bank investment correspond to the quality standards for bonds given the top four ratings by the rating services.

I want to stress, however, that just as national bank examiners undertake an independent, thorough evaluation of the banks' loans, they also conduct a thorough examination of the banks' investments. The ratings are useful, at times, to corroborate our own evaluation, but the ratings are not used in exclusion of our own appraisal of investment securities.

The examiners' analyses of investment securities are broadly analogous to their appraisals of the banks' loans. We recognize, however, that the analysis of municipal securities involves many particular considerations which differ from those involved in analyzing, say, commercial and industrial loans or consumer installment loans. Accordingly, the problems of evaluating investment securities are given special attention in the training programs for our examination force, both new and experienced.

The factors we consider in appraising the quality of bank investments are outlined in the *Comptroller's Policy Guidelines for National Bank Directors*, which I just read to you.

In order to provide the data needed for bank examinations as well as for the banks' investment decisions—I would like to repeat this—in order to provide the data needed for bank examinations as well as for the banks' investment decisions, national banks are expected to maintain supporting credit data to establish the soundness of the securities in which they invest.

Briefly, the data that national banks must provide in support of the soundness of their investments include (1) statement of total debt including all related obligations; (2) assessed valuation, including basis of assessment; (3) property tax rates; (4) tax collection record; (5) receipts and disbursements; (6) sinking fund operation and requirement; (7) future debt service requirement; (8) population; (9) economic background; (10) default record; and (11) per capita debt.

Most commercial banks do not find it onerous to provide this information to buttress their investments. When deciding whether to invest in particular municipal bond issues, banks obtain, or already have at hand, the data required to justify their investments to examiners. Thus, they have adequate data to undertake their own analysis of the merits of the particular issues which they may acquire. Again, it appears that the banks themselves find the ratings helpful to corroborate their own appraisal of different issues and, from time to time, they may rely heavily on the rating services' appraisals of particular issues—especially those given higher ratings.

Banks do not rely exclusively on rating services for their investment decisions, as their frequent investments in unrated issues testifies. Many municipal bond issues, particularly those of smaller communities—are not rated by the rating services. However, upon thorough analysis, these issues are often found to represent top-quality securities that are fully comparable to any of the rated issues. Such issues are purchased by small and large banks alike.

I am pleased to report that these situations have not presented any discernible bank supervisory problems. Frequently, the bonds are

those issued by local or nearby communities, and the banks involved are thoroughly familiar with the communities' needs, future prospects, and ability to service their debt. In fact, these situations are best characterized as ones in which the banks provide a valuable public service by supplying needed funds and, in doing so, acquire high-quality earning assets.

We share this subcommittee's concern for the problems of municipal financing. The projects at stake are urgently needed by the people in the towns and cities across our Nation. It behooves us to do whatever is necessary to provide the required funds. The funds must be made available to the people—the State and local governments and their authorities—on the best possible terms.

Commercial banks have been instrumental as investors and underwriters in providing the funds for public projects in recent years. I am confident that our commercial banking system will continue to assist the people they serve by helping to supply funds for worthy public projects.

That concludes my statement.

(The prepared statement of Mr. Camp, above-referred to, follows:)

PREPARED STATEMENT OF WILLIAM B. CAMP

Mr. Chairman and Members of the Subcommittee: The Office of the Comptroller of the Currency appreciates this opportunity to discuss with you the problems of municipal financing. State and local governments have the principal responsibility for supplying many social goods and services. The importance of these goods and services is self-evident from an enumeration of merely some of them: streets and highways, public safety, education at all levels from pre-elementary to graduate and professional, sewerage, electric power, and an extended variety of health and welfare services. Funds for these purposes are urgently needed, and the orderly and efficient functioning of the markets supplying them is of prime concern to all of us.

In recent years, the responsibilities of municipalities have expanded greatly due to the rapid growth in population and the increased complexity of urban living. The resultant expansion in the capital requirements of municipalities—which now approach $30 billion annually—as led to a concomitant expansions in municipal debt financing. During the past few years, State and local governments have borrowed in excess of $10 billion annually; in 1967 total new long term municipal debt exceeded $14 billion. As a result, the volume of new municipal debt issued annually has roughly doubled since the beginning of this decade, rising from $7.2 billion in 1960 to a record high of $14.3 billion in 1967. During this period, the level of outstanding municipal debt has increased by $53.8 billion, rising from $63.7 billion at the beginning of 1960 to an estimated $117.5 billion at the end of 1967.

Throughout our history commercial banks have been in the forefront in meeting the nation's credit needs, both of the private sectors of our economy and of governmental units. Even prior to the development of municipal bond financing in the early 1800's, commercial banks by extending direct loans were actively assisting State and local governments in meeting the demands for social services.

Commercial banks are active in the municipal bond market, both as underwriters of the bonds issued by State and local governments and as investors in those bonds. During the past few years, commercial banks have provided the major impetus to the increased competition among municipal bond underwriters. Moreover, commercial banks are the most important source of funds for State and local governments as they are now the largest single group of investors in municipal bonds. In addition, commercial banks still frequently make direct loans to municipalities when the size of the credit needs or their duration makes it inadvisable for the municipalities to float new bond issues.

The performance of commercial banks in supplying the funds needed by State and local governments has been truly remarkable. At the beginning of this decade, State and local security holdings of commercial banks amounted to $17.0 billion, about 26.7 percent of the outstanding municipal debt. Individual

investors were then the most important holders of municipal securities with $25.7 billion, about 40.3 percent more than commercial banks. Throughout the 1960,s, commercial banks have been heavy net investors in municipal securities. At the end of 1961, State and local obligations held by banks amounted to $20.3 billion; at the end of 1963, $29.8 billion; and at the end of 1965, when bank holdings first exceeded that of individuals, $38.7 billion. During 1966 and 1967, banks expanded their municipal portfolio by over $11 billion. Their holdings of $50.0 billion at year end 1967 represents an increase of $33.0 billion over the beginning of the decade, whereas the holdings of individuals rose by only $15.7 billion during this same period. The additional funds provided by commercial banks accounted for 52 percent of the total increase in outstanding municipal debt during the 1960's.

The expansion of commercial bank investment in State and local securities during the 1960's primarily reflects the overall growth of banks. Total loans and investments of all commercial banks increased by $171.9 billion, from $190.3 billion to $362.2 billion, of which 19.2 percent stemmed from the increased holdings of State and local securities of $33.0 billion. There has also been a modest increase in the proportion of municipal securities to total loans and investments of all banks. State and local security holdings represented about 9 percent of all banks' total loans and investments at the beginning of this decade, rising to roughly 14 percent at the end of 1967. As the attached tables indicate, there has been no marked change in the relative importance of National banks compared to all commercial banks in terms of their investment in municipal securities.

I might point out that the greatly increased investment in State and local securities by National banks has not been associated wih a comparable increase in examination problems. I think this speaks well for both the care and thoroughness with which banks invest their money and the basically high quality of the underlying public projects for which the bonds were issued.

The volume of State and local securities held by commercial banks has been increasing steadily from year to year. The annual net increase in municipal securities held by banks has averaged about $6.2 billion over the past eight years. Of course, the amount of the net increase has varied from year to year, with the largest increases being during the more recent past. State and local security holdings rose by slightly more than $600 million in 1960, about 6.5 percent of the $9.2 billion increase in the total loans and investments of all banks. In 1965, the holdings of commercial banks increased by $5.1 billion, 17.8 percent of the $28.7 billion increase in total loans and investments. The increase in State and local holdings in 1967 was somewhat larger, $9.0 billion, and constituted 23.5 percent of the $38.3 billion increase in total loans and investments of all commercial banks. The increase in bank holdings of State and local securities in 1960, 1965, and 1967 represented 12.0 percent, 77.3 percent, and 87.4 percent, respectively, of the total increase in outstanding municipal debt during these years.

As underwriters of municipal bonds, commercial banks also serve a vital role in assisting State and local governments in meeting their financial requirements. Competition in the municipal bond underwriting market is much more highly competitive now than even a few short years ago. The more vigorous competition among municipal bond underwriters is largely attributable to the entry and expanded participation of commercial banks in this area. This is clearly apparent from the data published in *State and Local Public Needs and Financing.*[1] Using that data, we have calculated that bank competition for municipal bond issues expanded by over 300 percent between 1957 and 1965.[2]

Our Office has studied intensively the problems surrounding competition in municipal bond markets. Competition does indeed matter. An increase in the number of bidders for new municipal bond issues—be they general obligation issues or revenue bond issues—benefits the public by lowering the interest paid by State and local governments. Briefly, we find that an added competitor for new general obligation issues, on the average, would reduce the rate of net interest cost by one basis point.[3] By comparison, an added competitor for new revenue bond issues, on the average, would reduce net interest costs by twice

[1] U.S. Congress, Subcommittee on Economic Progress, Joint Economic Committee, *State and Local Public Facility Needs and Financing,* 89th Cong., 2d sess. (Washington: U.S. Government Printing Office, 1966), Vol. 2, chapter 9.
[2] Unfortunately, similar data are not available for 1966 or 1967.
[3] A basis point equals 0.01 percent.

as much. Our statistical analysis covered the new municipal bonds issued during the first six months of 1964, 1965, and 1966.

We found that differences in the number of competitors had a larger effect on the interest cost to municipalities during 1966, a period of tight money, than in 1964 and 1965. Our results show that during this period of tight money each additional bidder for new general obligation issues reduced net interest cost by 1.3 basis points. However, the effect on the interest paid by issuers of revenue bonds was more pronounced. An added competitor for new revenue issues reduced net interest costs by 3.5 basis points, almost three times the effects for GOs. At first blush, interest savings of 1.0 to 3.5 basis points on municipal bond issues may not appear to be large. However, the projected volume of new municipal debt to be issued during the next few years is quite large. Hence, the seemingly small reduction in interest costs of 3.5 basis points on new revenue issues would lead to an interest savings of about $300 million on the revenue bonds to be issued between now and the end of 1975. Furthermore, an increase of two, say, in the number of bidders for all municipal bond issues would result in an interest savings to municipalities of from $550 million to $1.1 billion on the bonds to be issued up through 1975.

Our studies clearly reveal that competition is an important determinant of the interest costs paid by municipaities. We cannot say that competition is adequate for general obligation issues, although, by comparison, competition for new revenue issues is woefully deficient. The evidence does abundantly demonstrate that there are large benefits to be gained from augmenting competition for new municipal bond issues. This is an area that deserves our interest; indeed, I feel that it should be the area of our first concern.

In my opinion, the first step to enhancing competition in municipal bond markets in to encourage, not restrict competition. As I indicated earlier, the increasing degree of competition among municipal bond underwriters stems directly from commercial bank entry into municipal bond underwriting and from the expanding activities of banks with established municipal bond departments. My conversations with bankers about the country indicate that many intermediate size banks are contemplating entry into municipal bond underwriting. The initial underwriting activities of many of these banks would be limited to serving nearby municipalities. Of course, the opportunity to underwrite municipal revenue bonds as well as GOs will lead these banks to enter underwriting of municipal securities much more readily. Hence, authorizing commercial banks to underwrite revenue bonds will often have a favorable effect on competition for new general obligation issues in the same geographic area.

Bank entry into revenue bond underwriting would not have an unfavorable effect on competition for new general obligation issues. The expansion of bank underwriting activities from year to year has been quite large. Indeed, the increase in the number of bids for new issues each year is roughly equal to the number of new revenue issues that commercial banks would be permitted to bid for under the pending legislation.

Thus, the opportunity for commercial banks to underwrite revenue issues would not have an unfavorable effect on the competition for general obligation issues, but, instead, can be expected to enhance competition for GOs. My personal knowledge of the operations of our National banks supports the same conclusion. They want to expand their service to the communities and they will do so as readily as the opportunities permit.

The present system of rating municipal bonds has been widely discussed during recent months. The issues discussed include: (1) the effect of different ratings on the rate of interest paid by municipalities; (2) the number of unrated issues—mostly bonds of smaller issuers whose outstanding debt is below the minimum cut off for rating by the two major rating services, $1,000,000 for Standard & Poor's and $600,000 for Moody's; and (3) the quality or reliability of the ratings given different municipal bond issues.

The supervision of National banks emphasizes appraising and remedying problem loans, problem investments, and other matters which may impinge on the bank's safety. This emphasis on bank safety overrides the attention given to the yields to banks on individual loans or investments. Our knowledge as to the effect on yields of variations in quality as denoted by differences in ratings is more limited than our knowledge as to the overall quality of banks' municipal security investments. I am confident that the lessons gained from our supervisory experience as to the quality of banks' municipal investments will be meaningful to your deliberations. However, my impressions as to the yields banks

receive on those investments are based on less pervasive evidence, and therefore may be less helpful.

In discussing municipal bond ratings, we should be careful to distinguish between the qualitative and quantitative issues involved. That is, the differences in the quality of municipal bond issues as denoted by various ratings should be distinguished from the magnitude of the differential in net interest cost associated with those rating variations.

The widespread discussion of the function of municipal bond ratings in large part stems from the differences in interest costs associated with variations in ratings, including the absence of a rating. Net interest cost differs as much as 20 to 30 basis points with a variation of one notch in rating. However, the maturity of the issue, the number of bidders, and other factors affect net interest cost. When account is taken of these factors, a somewhat smaller differential in net interest cost is associated with the differences in ratings. Even so, a one step lower rating means an increase in net interest cost of 16 to 20 basis points. I might add that the effect of rating on the interest cost of revenue issues is about the same as for general obligation issues.

The various symbols used by the rating services denote broad qualitative differences among issuers and their bonds: they do not denote definite, specific probabilities as to default or possible variations in value. At *most*, different rating symbols may indicate merely that the *likelihood* of default, for example, is greater for one issue than for another issue. The charge of incorrect rating—of mistaken judgments by the security analysts in giving one issue a higher rating than another of comparable or better quality—is a separate problem. The qualitative differences denoted by ratings assume a quantitative significance only when the issues are marketed. The higher net interest costs, and yields, for lower rated issues presumably compensates for the greater risk to investors that is signfied by the lower ratings.

Fortunately, very few municipal bond issues have gone into default since World War II. Indeed, the number of issues in default, or in arrears on interest payments, has been so small that we cannot say whether the ratings are reliable indicators of the likelihood of default. Nonetheless, investors have come to demand higher yields to compensate for the added risk which they believe to be associated with lower ratings. Considering the number of municipal bond issues that have gone into default during the past two decades, the extent of the higher yields may be more than adequate compensation to investors for the risk incurred. This problem does not arise from the manner in which the rating services operate or from the reliance upon ratings by investors. It stems from the quantitative importance assigned by the market to qualitative differences among municipal bond issues. Remedying this facet of the overall "rating problem" does not rest on changing our system of ratings. Instead, what is required, is recognition by investors that the probability is extremely low that municipal bonds given very low ratings will actually go into default.

It seems to me that the fluctuations in value of municipal bonds of different ratings at times may reflect a sort of self-justifying behavior of investors. Investors seemingly believe that lower rated issues will decline relatively more in value during periods of "tight money." Hence, they may sell off lower rated issues while retaining the higher rated issues. Insofar as this happens, their initial belief is proven to be valid: after all, an increase in the relative quantity of such lower rated issues offered in the secondary market would force prices down. This, I submit, is not a problem of ratings and of the rating services, but of the significance investors impute to the ratings and of investors' reactions to changes in monetary conditions.

In examining National banks, we give careful attention to all facets of bank operations including, of course, the banks' investment portfolios. Our concern is that National banks' investments, like their loans, be sound. Therefore, the examinations involve careful scrutiny of all the investment securities in the banks' portfolios. We especially stress that the banks' investments not include obligations which are predominantly speculative. The quality standards that we apply to municipal bonds in determining whether such bonds are suitable for bank investment correspond to the quality standards for bonds given the top four ratings by the rating services. I want to stress, however, that just as National Bank Examiners undertake an independent, thorough evaluation of the banks' loans, they also conduct a thorough examination of the banks' investments. The ratings given municipal bonds by the different rating services, at

times, are useful to corroborate our own evaluation, but the ratings are not used in exclusion of our own independent appraisal of investment securities.

The examiners' analyses of investment securities are broadly analogous to their appraisals of the banks' loans. These analyses are directed to determining the future soundness of the investments and in turn they parallel the evaluations of the credit worthiness of other institutions or individuals to which banks extend credit. We recognize, however, that the analysis of municipal securities involves many particular considerations which differ from those involved in analyzing, say, commercial and industrial loans or consumer installment loans. Accordingly, the problems of evaluating investment securities are given special consideration in our training programs for our examination force, both new and experienced.

The factors we consider in appraising the quality of bank investments are outlined in the *Comptroller's Policy Guidelines for National Bank Directors.* A copy of the relevant section of the *Policy Guidelines* is attached. In order to provide the data needed for bank examinations as well as for the banks' investment decisions, National banks are expected to maintain supporting credit data to establish the soundness of the securities in which they invest. Briefly, the data that National banks must provide in support of the soundness of their investments include: (1) Statement of total debt including all related obligations; (2) Assessed valuation, including basis of assessment; (3) Property tax rates; (4) Tax collection record; (5) Receipts and disbursements: (6) Sinking fund operation and requirement; (7) Future debt service requirement; (8) Population; (9) Economic background; (10) Default record; and (11) Per capita debt.

Most commercial banks do not find it onerous to provide information buttressing their investments. As a matter of course, commercial banks, when deciding whether to invest in particular municipal bond issues, obtain, or already have at hand, the data required to justify their investments to examiners. By the same token, banks therefore have adequate data at hand to undertake their own analysis of the merits of the particular issues which they may acquire. Thus, banks' municipal investment decisions are based on adequate data. Again, it appears that the banks themselves find the ratings helpful to corroborate their own appraisal of different issues and, from time to time, they may rely heavily on the rating services' appraisals of particular issues—especially those given higher ratings.

The suggestion that banks may rely exclusively on the rating services for their investment decisions is contradicted by their frequent investment is unrated issues. Many municipal bond issues—particularly those of smaller communities—are not rated by the rating services. However, upon thorough analysis, these issues are often found to represent top quality securities that are fully comparable to any of the rated issues. Such issues are purchased by small and large banks alike. Indeed, unrated issues occasionally represent a substantial portion of smaller banks' investment portfolios.

I am pleased to report that these situations have not presented any discernible bank supervisory problems. Frequently, the bonds are those issued by the local, or nearby communities, and the banks involved are thoroughly familiar with the communities' needs, future prospects and ability to service their debt. In fact, these situations are best characterized as ones in which the banks provide a valuable public service by supplying needed funds and, in doing so, acquire high quality earning assets.

In order to appraise the quality of a municipal bond issue, potential investors, rating services, supervisory agencies, and others must have data concerning the economic and fiscal conditions of the municipality. At present, the data are often compiled by the issuer for the benefit of the rating services, underwriters or potential investors. Not infrequently most of the necessary data is developed as a part of a background study for a local industrial development program or something of that order. However, such data are not developed by all communities and, since they are only prepared for special occasions, may soon be out of date. Whether these data are supplied by the local community or prepared by a State or Federal agency, they are indeed helpful in appraising the quality of municipal securities. By supplying such comprehensive economic and fiscal information for forthcoming municipal bond issues, a governmental

agency could enhance the functioning of the municipal bond market. The compilation of such information by a Federal agency would benefit many communities, especially smaller ones if the costs to them were modest. Such information might be compiled equally well, and possibly more economically, by agencies of the various States. State agencies, of course, would enjoy advantages of location, and, in many cases, may have more ready access to crucial information than would a Federal agency. Wherever and by whomever such information were compiled, I believe that the potential value of such information is sufficient to merit careful consideration as to the possibilities and costs of providing it as well as to associated problems.

I have some misgivings about the propriety of having a Federal agency provide such reports. It seems to me that, by compiling thorough, comprehensive reports on various communities' economic and fiscal conditions, a Federal agency would come perilously close to making the ratings themselves. The reports, of course, would be sufficiently detailed to enable a security analyst to evaluate readily the quality of the communities' debt obligations. It would then be only a small step to bow to the pressures for a Federally operated rating service. Taking that step would constitute a dramatic new departure for the Federal government. By analogy, it would be like requesting the Federal Drug Administration to publish lists of "best" drugs or the Federal Communications Commission to publish a guide to the "best" television programs. Applied to banking, the Federal government in this case would be predetermining the credit quality of bank investments. A logical next step would be for government to be asked to predetermine the credit quality for all loan applications for, say, over $100,000. All of us, I'm sure, would have serious reservations concerning the wisdom of such policies. But such policies seem to me to be the natural consequence of a Federal program of providing the reports upon which ratings are based and of the inevitable strong pressures to extend the scope of that program.

During the past couple of years many groups of borrowers have protested that credit was not available to them, that the quantity of credit or terms were inadequate, and so forth. As we would expect, their points are similar, as all borrowers have been subjected to the same pressures. To me, it does not appear that any particular group of borrowers—be they small businessmen or large corporations, private individuals or municipal authorities—has been subjected to discriminatory restrictions on its borrowing. The problems for all borrowers including State and local governments have reflected the national economic and political problems of the past several years.

One cannot belittle in any fashion the importance of the purposes for which various borrowers—public and private—have desired. The need for added schools, new highways, better streets, water and sewerage facilities in expanding residential and industrial areas is clearly evident. These projects are of vital importance to the communities involved. Furthermore, the population and economic growth which leads to the demand for these social services is pervasive. The scope and extent of these demands—North and South, East and West, metropolitan and rural—necessarily makes them a national problem. By the same token, our expanding population, high levels of family formation and rising incomes make residential construction vital, be it in central city or suburban areas. The construction and expansion of industrial facilities in order to expand the production of old products, and to produce the new, also must have a high priority. Expanding manufacturing facilities provide employment, goods for domestic consumption. and, by no means least in importance, assist in meeting our foreign political and military obligations. Indeed all groups of borrowers can readily make a case that their cause is an important and just one.

When a major war effort is grafted onto an economy already operating at a high level, it is simply not possible to meet all demands. Nonetheless, given the time. commercial banks have done a tremendous job in meeting the legitimate credit needs of different borrowers. I am impressed by how little credit to various borrowers has been restricted during the past months, given the magnitude of the problems we have faced.

TABLE 1.—OUTSTANDING STATE AND LOCAL DEBT, 1959-67

[In billions]

Year	Yearend total	Annual change
1967	$117.5	$10.3
1966	107.2	6.0
1965	101.2	6.6
1964	94.6	6.6
1963	88.0	5.5
1962	82.5	7.0
1961	75.5	6.8
1960	68.7	5.0
1959	63.7	

TABLE 2.—MUNICIPAL SECURITY HOLDINGS, AND TOTAL LOANS AND INVESTMENTS FOR NATIONAL BANKS AND ALL COMMERCIAL BANKS, 1959-67 [1]

[Dollar amounts in billions]

	All commercial banks			National banks		
	Total loans and investments (a)	Municipal securities (b)	Percent, col. (b) to col. (a) (c)	Total loans and investments (a)	Municipal securities (b)	Percent, col. (b) to col. (a) (c)
1967	$362.2	$50.0	13.8	$206.4	$29.0	14.1
1966	323.9	41.0	12.7	184.5	23.8	12.9
1965	306.1	38.7	12.6	174.1	22.5	12.9
1964	277.4	33.5	12.1	149.9	18.6	12.4
1963	254.2	29.8	11.7	135.6	16.4	12.1
1962	235.8	24.8	10.5	127.3	13.6	10.7
1961	215.4	20.3	9.4	116.4	11.1	9.5
1960	199.5	17.6	8.8	107.6	9.4	8.8
1959	190.3	17.0	8.9	102.6	9.0	8.8

[1] Yearend totals.

TABLE 3.—ANNUAL INCREASE IN MUNICIPAL SECURITY HOLDINGS, AND IN TOTAL LOANS AND INVESTMENTS FOR NATIONAL BANKS AND ALL COMMERCIAL BANKS, 1960-67

[Dollar amounts in billions]

	All commercial banks			National banks		
	Total loans and investments (a)	Municipal securities (b)	Percent, col. (b) to col. (a) (c)	Total loans and investments (a)	Municipal securities (b)	Percent, col. (b) to col. (a) (c)
1967	$38.3	$9.0	23.5	$21.9	$5.2	23.9
1966	17.8	2.3	13.2	10.4	1.2	11.9
1965	28.7	5.1	17.9	24.2	3.9	16.3
1964	23.2	3.7	16.1	14.4	2.2	15.4
1963	18.3	5.0	27.5	8.3	2.8	33.4
1962	20.4	4.4	21.6	10.9	2.5	23.3
1961	15.9	2.8	17.4	8.9	1.7	18.8
1960	9.2	.6	6.6	4.9	.4	7.5

TABLE 4.—OUTSTANDING MUNICIPAL DEBT AND HOLDINGS OF MUNICIPAL SECURITIES BY NATIONAL BANKS AND ALL COMMERCIAL BANKS, 1959-67 [1]

[Dollar amounts in billions]

	Outstanding municipal debt	All commercial banks		National banks	
		Municipal securities	Percent of total	Municipal securities	Percent of total
1967	$117.5	$50.0	42.6	$29.0	24.7
1966	107.2	41.0	38.2	23.8	22.2
1965	101.2	38.7	38.2	22.5	22.2
1964	94.6	33.5	35.4	18.6	19.7
1963	88.0	29.8	33.9	16.4	18.6
1962	82.5	24.8	30.1	13.6	16.5
1961	75.5	20.3	26.9	11.1	14.7
1960	68.7	17.6	25.6	9.4	13.6
1959	63.7	17.0	26.7	9.0	14.1

[1] Yearend totals.

TABLE 5.—ANNUAL NET INCREASE IN MUNICIPAL DEBT AND IN MUNICIPAL SECURITY HOLDINGS OF NATIONAL BANKS AND ALL COMMERCIAL BANKS, 1960-67

[Dollar amounts in billions]

	Change in outstanding municipal debt	All commercial banks		National banks	
		Change in municipal securities	Percent to total	Change in municipal securities	Percent to total
1967	$10.3	$9.0	87.4	$5.2	50.4
1966	6.0	2.3	38.3	1.2	20.0
1965	6.6	5.1	77.3	3.9	59.1
1964	6.6	3.7	56.0	2.2	33.3
1963	5.5	5.0	90.9	2.8	50.9
1962	7.0	4.4	62.9	2.5	35.7
1961	6.8	2.8	41.2	1.7	25.0
1960	5.0	.6	12.0	.4	8.0

Instructions to Examining Staff Concerning Investment Securities, Comptroller's Policy Guidelines for National Bank Directors

INVESTMENT SECURITIES

INTRODUCTION

It is essential for all National Bank Examiners to be thoroughly familiar with the provisions of Paragraph 7 of 12 U.S.C. 24 and Regulation 1 (12 CFR 1), the Investment Securities Regulation for National Banks. In addition to a technical knowledge of the laws and regulations, the Examiner should be familiar with the principles of prudent investment practices, liquidity requirement, trading, and underwriting.

REPURCHASE AND RESALE TRANSACTIONS

The sale of securities by a bank under an agreement whereby the bank agrees to repurchase the securities at the end of a stated period of time, is a purchase and sale of its securities, and is not to be considered a borrowing or a lending transaction. Likewise, when a bank purchases securities subject to resale agreement, the securities purchased are to be treated as investments, not as loans.

DISTINGUISHING INVESTMENT SECURITIES FROM LOANS

Separate limitations apply to a bank's loans (12 U.S.C. 84) and to its investment securities (12 U.S.C. 24). Therefore, it is essential for Examiners to know the distinguishing characteristics of these two types of obligations.

An investment security must be marketable, that is, it must be negotiable in form and saleable with reasonable promptness at a price which is commensurate with its fair value.

Loans are generally negotiated directly between the borrower and the bank. Investment securities are usually purchased through a third party or a broker.

CREDIT INFORMATION

Careful credit analysis is as essential in making sound investments as it is in granting sound loans. The responsibility for prudent management of a bank's investment account cannot be delegated to a correspondent, brokerage house, or rating service.

Paragraph 1.8 of the Investment Securities Regulation Section of the *Comptroller's Manual for National Banks* requires every bank to maintain complete credit information for all investment securities. Public securities, except United States Government and Federal Agency Obligations, are not exempt from the above requirement. In determining the soundness of a public security, the following information should be obtained and analyzed:

1. Statement of total debt including all related obligations.
2. Assessed valuation, including basis of assessment.
3. Property tax rates.
4. Tax collection record.
5. Receipts and disbursements.
6. Sinking fund operation and requirement.
7. Future debt service requirement.
8. Population.
9. Economic background.
10. Default record.
11. Per capita debt.

Appropriate credit information should also be obtained for investment securities as defined in Paragraph 1.3(b) of the Investment Securities Regulation.

EVALUATION AND CLASSIFICATION

In reviewing an investment account, the Examiner should determine the quality, market value, and liquidity of the account and whether the bank is complying with related laws and regulations.

ELIGIBLE SECURITIES

Except for certain specifically exempted or authorized stocks, all securities, including public securities, purchased by a bank for its own account must qualify as investment securities as defined by 12 U.S.C. 24 and 12 CFR 1. The term *investment security* does not include investments which are primarily speculative. To qualify as an investment security, the obligation must be marketable. In addition, certain credit standards must be met, including evidence of the obligor's ability to meet all debt service requirements. Paragraph 1.5(b) of the Investment Securities Regulation permits a limited investment in securities where the bank's judgment is based predominately on reliable estimates.

Public securities must qualify as investment securities and meet the standards of Paragraph 1.3(c) (d) and (e) of the Investment Securities Regulation. Public securities are not exempt from the credit and marketability standards applicable to all investment securities. Subject to prudent banking judgment, a bank may underwrite and deal in public securities. Public securities of one obligor may be held in excess of 10% of capital and surplus.

If the bank holds securities of one obligor in excess of 10% of its capital and surplus, or underwrites or deals in a security, the security must qualify as a public security. In cases of doubt, a specific ruling should be requested from the Comptroller of the Currency. It is incumbent upon the bank to retain sufficient information to support its determination that the security is a public security.

The eligibility of an obligation as an investment security is based primarily upon a thorough credit analysis. Investment securities are by definition sound investments and therefore not subject to adverse classification. If a bond is subject to classification, it is not an investment security and should be listed as speculative or defaulted. The amount of market depreciation of an individual investment security is not to be charged off. However, if the aggregate depreciation is excessive, the advisability of establishing a reserve should be considered.

RATING SERVICES

Rating services provide useful supplemental information regarding the credit quality of a security. The Examiner should be familiar with the various rating services and their definitions of what constitutes a security which is considered speculative. Although a rating provides an indication, it must be stressed that the

assigned rating is not an overriding or controlling factor regarding the credit quality of a security.

MARKET VALUES

The Examiner should determine the current market value of all securities owned by the bank. Undue depreciation in any individual security may be the result of credit deterioration and warrant a speculative classification.

SPECULATIVE SECURITIES, DEFAULTED ISSUES AND STOCKS

All speculative securities, defaulted issues, and stocks should be listed separately in the Report of Examination and appropriately classified. The net market depreciation in speculative issues is to be classified as *doubtful*. All depreciation contained in individual issues of defaulted securities and stocks should be classified as a *loss*.

In general, banks are prohibited from purchasing stocks for their own account. However, there are specific exceptions for stocks of corporations engaged in: safe deposit business (12 U.S.C. 24); holding bank premises (12 U.S.C. 371); international operations (12 U.S.C. 618); providing bank services (12 U.S.C. 1862); and small business investments (15 U.S.C. 682B); and otherwise as authorized by the Comptroller of the Currency. The investment in stock of a Federal Reserve Bank is obligatory (12 U.S.C. 282). Stocks may also be legally acquired when necessary to prevent a loss on a debt previously contracted.

The Examiner should discuss all marginal and speculative securities as well as defaulted issues and stocks with the management. An evaluation of these securities should be made, based on the information contained in the bank's credit files and from other sources.

LIQUIDITY POSITION

In addition to evaluating the quality and market value of an investment account, it is necessary to consider its maturity position. Credit and interest rate risks increase with the length of the maturities of the securities. The amount of long-term issues that an individual bank may hold with reasonable safety must be judged in relation to the following factors:

1. Adequacy of capital structure.
2. Quality and liquidity characteristics of the loan portfolio.
3. Stability, behavior and composition of deposits.
4. General quality level of the long-term securities.

As a general rule maturities should be spaced with a reasonable preponderance in short and medium term obligations and a relatively conservative amount in long-term issues.

CONCENTRATIONS

A well managed investment account should have adequate diversification. Undue concentration in the corporate obligations of one industry or in the obligations of a single municipality, violates a sound investment principle. All undue concentrations should be commented upon fully in the Report of Examination. A concentration in United States obligations is naturally not subject to criticism as a credit risk.

UNDERWRITING AND DEALING IN SECURITIES

National Banks may underwrite and deal in public securities. In underwriting or dealing (trading) in securities, a bank purchases and hold securities primarily for resale to others.

Underwriting refers to the purchase, usually through competitive bidding, of a block of securities from the original issuer. When a bank deals or trades in a security, it purchases the security on the market, not from the obligor.

For tax and control purposes, it is essential that securities held for investment be segregated from those held for resale to customers. Separate records should also be maintained.

A bank should maintain complete credit information on all securities held for resale as well as for their own account.

In addition to making a credit analysis of all securities held for resale, the Examiner should carefully review the bank's underwriting and trading activities for any indication of a possible conflict of interest with the bank's trust activities. Section 9.12 of Regulation 9 provides in part:

"(a) Unless lawfully authorized by the instrument creating the relationship, or by court order or by local law, funds held by a National Bank as fiduciary shall not be invested in stock or obligations of, or property acquired from the bank. . . ."

This prohibition is strictly enforced. The Examiner must report fully on any evidence of a possible conflict of interest.

Regulatory Standards Concerning Investment Securities, Comptroller's Manual for National Banks

§ *1.1 Authority*

This part is issued by the Comptroller of the Currency under the general authority of the national banking laws, 12 U.S.C. 1 et seq., and under specific authority contained in paragraph Seventh of 12 U.S.C. 24. The Comptroller of the Currency is charged by the national banking laws with the execution of all laws of the United States relating to the organization, operation, regulation and supervision of national banks and in particular with the execution of 12 U.S.C. 24 which sets forth the corporate powers of national banks. This part interprets and applies paragraph Seventh of 12 U.S.C. 24 to provide for its due execution and for the proper regulation and supervision of the operations of national banks. Paragraph Seventh of 12 U.S.C. 24 also specifically provides for the Comptroller of the Currency to prescribe by regulation (a) limitations and restrictions on the purchase of investment securities by a national bank for its own account and (b) further definition of the term "investment securities."

§ *1.2 Scope and application*

This part applies to the purchase, sale, dealing in, underwriting, and holding of investment securities by national banks, banks located in the District of Columbia, and by state banks which are members of the Federal Reserve System. It may also apply to a limited extent to others engaged in the banking business. The Comptroller of the Currency is charged by various provisions contained in Chapter 1 of Title 26 of the District of Columbia Code with the supervision of banks located in the District of Columbia. State banks which are members of the Federal Reserve System are, under 12 U.S.C. 335, subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph Seventh of 12 U.S.C. 24. Dealers in securities are prohibited by 12 U.S.C. 378 from engaging in banking business. Section 378 specifically provides, however, that it does not prohibit national banks or state banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing and selling investment securities to the extent permitted to national banking associations by the provisions of 12 U.S.C. 24.

§ *1.3 Definitions*

(*a*) The term "bank" includes national banks, banks located in the District of Columbia, and state banks which are members of the Federal Reserve System.

(*b*) The term "investment security" means a marketable obligation in the form of a bond, note or debenture which is commonly regarded as an investment security. It does not include investments which are predominantly speculative in nature.

(*c*) The term "public security" means an obligation described in 12 U.S.C. 24 as not subject to the limitations and restrictions contained therein "as to dealing in, underwriting and purchasing for its own account, investment securities". Public securities include:

(1) Obligations of the United States;

(2) General obligations of any State of the United States or of any political subdivision thereof;

(3) Other obligations listed in paragraph Seventh of 12 U.S.C. 24.

(*d*) The term "political subdivision of any State" includes a county, city, town or other municipal corporation, a public authority, and generally any publicly owned entity which is an instrumentality of the State or of a municipal corporation.

(*e*) The phrase "general obligation of any State or of any political subdivision thereof" means an obligation supported by the full faith and credit of the obligor. It includes an obligation payable from a special fund when the full faith

and credit of a State or any political subdivision thereof is obligated for payments into the fund of amounts which will be sufficient to provide for all required payments in connection with the obligation. It implies an obligor possessing resources sufficient to justify faith and credit.

§ *1.4 Limitations and restrictions on purchase and sale of a public security*

A bank may deal in, underwrite, purchase and sell for its own account a public security subject only to the exercise of prudent banking judgment. Prudence will require such determinations as are appropriate for the type of transaction involved. For the purpose of underwriting or investment, prudence will also require a consideration of the resources and obligations of the obligor and a determination that the obligor possesses resources sufficient to provide for all required payments in connection with the obligation.

§ *1.5 Limitations and restrictions on purchase of an investment security*

(a) *Evidence of obligor's ability to perform.*—A bank may purchase an investment security for its own account when in its prudent banking judgment (which may be based in part upon estimates which it believes to be reliable), it determines that there is adequate evidence that the obligor will be able to perform all that it undertakes to perform in connection with the security, including all debt service requirements, and that the security may be sold with reasonable promptness at a price which corresponds reasonably to its fair value.

(b) *Judgment based predominantly upon reliable estimates.*—A bank may, subject to limitations set forth in § 1.6(b), purchase an investment security for its own account although its judgment with respect to the obligor's ability to perform is based predominantly upon estimates which it believes to be reliable. Although the appraisal of the prospects of any obligor will usually be based in part upon estimates, it is the purpose of this paragraph to permit a bank to exercise a somewhat broader range of judgment with respect to a more restricted portion of its investment portfolio. It is expected that this authority may be exercised not only in the absence of a record of performance but also when there are prospects for improved performance. It is also expected that an investment security purchased pursuant to this paragraph may by the establishment of a satisfactory financial record become eligible for purchase under paragraph (a) of this section.

(c) *Securities ruled eligible by the Comptroller of the Currency.*—A bank may consider as a factor in reaching its prudent banking judgment with respect to an investment security a ruling published by the Comptroller of the Currency on the eligibility of such security for purchase. Consideration must also be given, however, to the possibility that circumstances on which the ruling was based may have changed since the time of the ruling.

§ *1.6 Limitations and restrictions on holding investment securities*

(a) *Obligations of any one obligor.*—A bank may not hold at any time investment securities of any one obligor in a total amount in excess of 10 percent of the bank's capital and surplus. For this purpose the amount of an investment security is to be determined on the basis of the par or face value of the security.

(b) *Obligations purchased predominantly on the basis of reliable estimates.*—A bank may not hold at any time investment securities which would not be eligible for purchase pursuant to paragraph (a) of § 1.5 in a total amount in excess of 5 percent of the bank's capital and surplus.

(c) *Limitations prescribed in eligibility rulings.*—When a ruling published by the Comptroller of the Currency provides that an investment security is eligible for purchase subject to a specified limitation, a bank may not at any time thereafter purchase such security, if, after such purchase, the bank's holdings of such security would be in excess of the specified limitation.

(d) *Public securities.*—Public securities are not subject to the limitations contained in this section.

§ *1.7 Limitations and restrictions on purchase, sale and holding of specified obligations*

A bank may deal in and underwrite the obligations of the International Bank for Reconstruction and Development and the Inter-American Development Bank and all bonds, notes and other obligations of the Tennessee Valley Authority, but it may not hold at any one time the obligations of any one of such obligors in a total amount in excess of 10 percent of the bank's capital and surplus.

§ 1.8 Prudent banking judgment; credit information required

Every bank shall maintain in its files credit information adequate to demonstrate that it has exercised prudence in making the determinations and carrying out the transactions described in §§ 1.4 and 1.5.

§ 1.9 Requests for rulings

Any bank may request the Comptroller of the Currency to rule on the application of this part, or paragraph Seventh of 12 U.S.C. 24, to any security which it holds, or desires to purchase for its own account as an investment security; or which it holds, or desires to deal in, underwrite, purchase, hold or sell as a public security. Such a request for a ruling should be supported by (a) information sufficient to enable the Comptroller to make the necessary determination and (b) the bank's appraisal of the information furnished.

§ 1.10 Convertible securities

When a bank purchases an investment security convertible into stock or with stock purchase warrants attached, entries must be made by the bank at the time of purchase to write down the cost of such security to an amount which represents the investment value of the security considered independently of the conversion feature or attached stock purchase warrants. Purchase of securities convertible into stock at the option of the issuer is prohibited.

§ 1.11 Amortization of premiums

When an investment security is purchased at a price exceeding par or face value, the bank shall:

(*a*) Charge off the entire premium at the time of purchase; or

(*b*) Provide for a program to amortize the premium paid or that portion of premium remaining after the write-down required by § 1.10 so that such premium or portion thereof shall be entirely extinguished at or before the maturity of the security.

§ 1.12 Exceptions

The restrictions and limitations of this part do not apply to securities acquired through foreclosure on collateral, or acquired in good faith by way of compromise of a doubtful claim or to avoid a loss in connection with a debt previously contracted.

[Dated: September 10, 1963.]

Chairman PATMAN. Thank you very much, Mr. Camp.

Mr. Randall, you may proceed. You have a statement, I believe.

STATEMENT OF HON. KENNETH A. RANDALL, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. RANDALL. Yes, sir. I am submitting a supplement with my statement which I would like to have included in the record.

Chairman PATMAN. You may be assured that the paper you mention will appear in the record.

Mr. RANDALL. Thank you, sir.

It is a pleasure to be in the distinguished company of a present member of the Board of Directors of the FDIC and a former member, who is a graduate now serving on the Federal Reserve Board. It is very comfortable to be between these two Texans that I have served with for quite some time.

This opportunity to appear before the Subcommittee on Economic Progress 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 muicipalities 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 homebuilding 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 50 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 guarantee—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 securities 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 from not long after. A sharp recession in 1937 was accom-

panied 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 portfolio 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 serving 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 marshaled 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 coroprate 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 table, p. 324.) 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 on 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, that is, 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 measure 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, for example, a $5,000 block of bonds in a $5 million 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 specfiic 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 super-

visory 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.

(Table follows:)

INVESTMENT SECURITIES HELD BY INSURED COMMERCIAL BANKS

[In millions]

	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. Government, 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	(1)	(1)
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 United States)	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 corporations	107	92	(1)							
Other domestic corporations	670	854	764							
Federal Reserve bank stock	146	131	140	183	231	316	426	902	1,472	2,149
Other corporate stocks, total	535	510	327	132	99	119	166			
Real estate corporations	79	(1)	(1)							
Bank and bank affiliates	100	(1)	136							
Other domestic corporations	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.

Thank you, Mr. Chairman.
(Supplement submitted by Mr. Randall follows:)

SUPPLEMENT TO JULY 10, 1968, STATEMENT REGARDING MUNICIPAL BOND RATINGS AND THE CREDIT PROBLEMS OF SMALL MUNICIPALITIES

(Responses to questions in Outline of Points to be Covered in Statement by Bank Supervisory Agencies)

"In view of the dominant position of commercial banks in the municipal securities market, comment on what may be done: (a) to reduce the vulnerability of State and local government borrowings to the fluctuations of credit availability in response to the exercise of credit policies, and (b) to assure greater competition for general obligation municipal securities with respect to both underwriting and acquisition for investment."

The first segment of this question (a) is concerned with the impact of changes in credit policies on the financial needs of State and local governments. In the conduct of monetary policy, the monetary authorities must necessarily give consideration to the requirements of all users of credit, including governmental units. At times, no doubt, the impact of credit policy may be burdensome to those sectors, such as governments, that are heavy users of fixed capital. Because monetary policy is a generalized instrument and also because it is to serve the broad public interest, each user of credit must be expected to assume his fair share of the burden of restraint or the benefits of easier credit. Accordingly, governments should not expect to be immune from the consequences of credit policy. To insulate them against vulnerability would be inequitable, and could also frustrate monetary policy significantly under certain circumstances. Nevertheless, it is no doubt important on occasion to maintain the ability of municipalities during periods of credit stringency to proceed with capital projects already underway and continue other essential services. This could be accomplished without negating monetary policy objectives by such means as more effective long-term planning and better spacing of projects over time.

In regard to greater competition in the issuance and distribution of general obligation municipal securities, present practices for financing of States and their subdivisions of government have evolved over the long history of the United States. These practices are based upon laws governing municipal corporations in each of the 50 States. The statutes in turn are applicable to literally thousands of political subdivisions that have been granted statutory authority to create debt and collect revenues. Any change contemplated in State and local financing, therefore, would have to take into account some formidable statutory barriers and also existing Federal-State relations. In addition, there are knotty problems involving financing practices and taxation, which would have to be solved.

Various proposals to change current arrangements for issuing securities and placing them with investors have been advanced from time to time. An evaluation of their relative advantages and disadvantages, however, is really outside the scope and responsibilities of the Federal Deposit Insurance Corporation for bank supervision and administration of Federal deposit insurance. The importance of the problem is fully recognized, nevertheless, because the well-being of our local government units is essential to the well-being of the banking system and the economy as a whole.

"Describe your agency's regulations governing commercial bank investments in municipal securities, with particular reference to the status accorded to bond ratings in the four highest grades."

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Executive Committee of the National Association of Supervisors of State Banks jointly issued a statement in 1938 with respect to uniform bank examination procedure. The statement was subsequently revised in 1949. (See the accompanying excerpts from the Annual Report of the Federal Deposit Insurance Corporation for the year ending December 31, 1938, pp. 61–78 and the Federal Reserve Bulletin, July 1949, pp. 776–7.)

One section of the statement was concerned with the appraisal of securities—including municipal obligations—in bank examinations. (In 1938, corporate securities comprised a major element among bank investments, whereas more recently they have been almost totally eclipsed by municipal securities.) The

purpose of the statement was to bring about uniformity among the supervisory authorities with regard to the basis for valuing securities. Under the terms of the agreement, securities deemed to be of bank investment quality are to be valued for bank examination purposes on a cost basis. Other securities, i.e., securities not measuring up to this qualitative standard, are to be valued at market prices prevailing at the time of the examination.

With respect to the securities comprised by the investment category, the language of the agreement states "this group includes general market obligations in the four highest grades and unrated securities of equivalent value". The "distinctly or predominately speculative" issues, according to the agreement consist of obligations "in grade below the four highest and unrated securities of equivalent value".

The procedural agreement among the bank supervisory agencies contemplates the use of ratings as *one* indicator of investment quality. But investment grade issues are not limited exclusively to those rated in the four highest grades. Furthermore, examination practices has throughout its entire history recognized that appraisal of assets is solely the responsibility of the examiner at the time that he performs his work. In making this appraisal he is expected to use the best information at hand. Whether a security in a bank portfolio is of suitable quality for bank investment purposes is a judgment based on facts. A qualitative rating with respect to that security published by an investment advisory service is but one piece of evidence to be considered by an examiner in reaching that judgment.

The bank supervisory authorities have always been concerned with the quality of bank assets, whether they are part of the loan portfolio or classed as bank investments, and all bank assets are expected to measure up to a standard of acceptability. If it is reasonable to expect that interest on the obligation—whether on a loan or on a security—will be paid on the due day as well as the principal amount at the maturity of the obligation, then the obligation is deemed suitable for bank investment purposes. To be sure, these performance determinations are in the nature of estimates because of the impossibility of making exact forecasts, but the legal status of the obligation and the past record of the obligor as well as its present financial strength and future prospects are all relevant considerations and generally provide a firm basis for the estimates.

Ratings of the investment advisory services, irrespective of where in the spectrum of ratings, do not—and cannot—alter the facts. Nevertheless, an expression of an opinion as to quality by a major investment advisory service is worthy of consideration when an examiner is arriving at a judgment, although it is not conclusive.

"What standards or guides does your agency have by which your bank examiners can evaluate the credit quality of municipal securities held by banks that are either unrated by a bond rating service or have been assigned a rating below the four highest grades?"

The Federal Deposit Insurance Corporation's *Manual of Examination Policies* has for many years included the following section for the purpose of guiding examiners in the classification of municipal securities:

THE ANALYSIS OF MUNICIPAL BONDS

Because bank holdings of municipal bonds are growing rapidly and the published credit ratings cover only the major and better-known issues, it will be necessary for the Examiner to develop some skill in analyzing these credits. There are literally thousands of political subdivisions whose obligations are found in bank portfolios. Very often the Examiner will be obliged to judge the quality of these credits on the basis of information in the bank's files.

A study of the economic background of the community furnishes the basis for practically all analyses of municipal bond credit quality. Even if the debt burden is heavy, a community with a strong economic footing is quite likely to meet its obligations. Population data furnish good clues with respect to economic conditions, and the products of the area are some indication of basic strength. Among other measures useful to the analyst in judging the economic background of a community are per capita income, sales of electric energy, or the number of telephones installed.

The past record of performance in debt management is an important guide in judging both the ability and the willingness of a community to service its debt. Primary interest should center on the past ten years, for poor financial administration seldom becomes good overnight. The total amount of debt

outstanding and its structure during recent years furnish an important point of departure in the analysis. Study of the debt structure will reveal the portions incurred for general purposes, highway construction, schools, utilities, and other identifiable purposes. A good quality credit will be characterized by balance in its proportions as well as reasonableness in the total. A rapid increase in the amount of outstanding debt, unless compensated by growth in the local economy, raises a question as to the ability of the community to service the debt successfully. Essential to good credit standing is a satisfactory record for current financial operations. This is one of the easier factors for the Examiner to judge. The financial and operating statements will show whether income is sufficient to cover expenses with an adequate margin for the retirement of debt.

For purposes of convenience in analysis, municipal securities may be divided into the following three groups:

(1) General obligations;
(2) Revenue issues;
(3) Obligations which are hybrid in character.

Historically, the obligations issued by a municipality have been secured by a pledge of the full faith and credit of the issuer. These are known as general obligations and their quality is determined by the community's ability to bear the debt burden. The ratio of debt to assessed value has long served as a useful yardstick for measuring the credit quality of general obligations. However, experience has demonstrated that no specific debt ratio is equally applicable in all instances. For communities whose principal source of income is derived from taxes levied on property, the debt ratio affords a significant test. Years ago practically all municipalities relied heavily on general property taxes for support. Profound changes have now taken place in municipal finances and new sources of revenue have been developed—for example, tax on sales or income. It would be inappropriate to place great stress on the debt ratio of a community which relies only to a limited extent upon the general property tax for income.

Some municipalities and other political subdivisions of States have issued securities whose debt service is dependent solely upon revenue derived from furnishing specific goods or services, such as electric energy or water. This type of obligation does not carry the unqualified pledge of the issuer's credit. Irrespective of the nature of the project financed by revenue bonds, there is an orderly way for the Examiner to proceed in analyzing credit quality. It is necessary to make a study of revenues and expenses both in terms of historical facts and the projected estimates. The object of this study is to ascertain the margin of protection for debt service. Tests for the adequacy of the margin vary with the type of facility, and in some fields, for example, toll roads, it is extremely difficult to assemble the factual information needed to estimate or establish a record of performance. Although analysts have developed various "rules-of-thumb" for coverage ratios, there are no hard and fast standards. However, some margin of protection is needed, and generally speaking, the wider the margin the better the credit.

In the field of municipal credit there is a growing number of issues which do not fit neatly into either the category of general obligations or revenue securities. These issues are hybrid in character, possessing in varying degrees some of the qualities of both groups. Most commonly, there is a pledge of revenues from a specific source to cover debt service and in addition there may be a general pledge of the full faith and credit of the obligor. Broadly speaking, it is necessary to make sure that one of the pledges—either the specified revenues or the full faith and crdit of the issuer—is fully sufficient to support the credit. A mediocre general obligation plus an inadequate source of revenue will not add up to a high quality credit.

Finally, it should be observed that prejudice against the credit quality of any particular class of security is wholly unwarranted. There are good revenue obligations and there are bad ones, just as some general obligations are much better than others. Certainly there is no merit in the contention that any general obligation is better than a revenue issue merely because it has a pledge of the full faith and credit of a State or a political subdivision thereof. For analytical purposes, the controlling question is not the class of the security or the terms of the pledge—rather it is the margin available to protect the debt service of the obligor.

Obligations issued by local housing authorities are to be included with obligations of States and political subdivisions. They are, in fact, a special type of revenue issue.

"What data does your agency require of a bank under the agency's supervision to support its view that the unrated municipal securities or municipal securities with ratings below the four highest grades, which are held in its bond portfolio, qualify as 'investment securities'?"

The section of the Federal Deposit Insurance Corporation's bank examination report form covering *Investment Policies* includes the following question:

> "5 State names and types of statistical or advisory services to which bank subscribes in connection with its securities account and comment upon the adequacy of each service and credit information."

The Corporation's *Manual of Examination* states:

CREDIT FILES

Question 5 on Page 6 requires comment concerning the names and types of statistical or advisory services to which the bank subscribes, as well as upon the adequacy of the credit files maintained in connection with the securities portfolio. Failure to maintain credit files should be criticized, and deficiencies in such files should be noted in the description and comments column of the Detailed List of Securities. Adequate credit files are particularly important in connection with unrated issues and in instances where a bank's investment is relatively heavy.

The Legal opinion with respect to an individual municipal credit may appear as a separate document, copies of which are held by investors, or it may be printed on each bond. In the latter circumstances, the offering circular and prospectus should furnish details as regards the opinion, including the identification of the Municipal Bond attorney. Since the securities are not likely to be available for inspection, the Examiner may rely on the information in offering circulars, prospectuses, letters of acknowledgment, and other records for information with respect to the Legal opinion. If the Legal opinion is a separate document, then the credit files should include a copy or some indication as to its whereabouts. Lack of evidence as to the legality of a municipal credit should be noted as a deficiency in the bank's credit files.

"Inasmuch as only about 125 commercial banks have established municipal security departments with personnel trained in municipal security analysis, do the other banks encounter difficulty in furnishing the requisite information to justify their holdings of municipal securities that are not with ratings in the four highest grades? How about the smaller banks?"

Irrespective of whether the bank under examination by the Federal Deposit Insurance Corporation is large or small, the viewpoint of reference in the examination process is the bank's total investment policy and not just one segment, such as municipal securities. In each case the examiner is expected to satisfy himself that the bank has an investment policy that is appropriate to its particular situation and that management is qualified to implement the policy. The investment policy of a small bank may be quite satisfactory for its requirements even though it does not have trained municipal securities analysts or an established municipal securities department. The *Manual of Examination* gives the examiners the following guidance for this portion of his work.

THE INVESTMENT POLICY OF A BANK

The adoption by a bank of a definite investment policy will facilitate the management of its securities portfolio. By "investment policy" is meant a formal program to guide the management in making decisions regarding the purchase or sale of securities. Such a program must be related to the bank's general policies and activities. Its development is the responsibility of the directors and of the senior executive officers. The principal objectives of a well reasoned policy are to provide the bank with sound earning assets and at the same time to prevent serious troubles which may result from the haphazard purchase of securities without regard for portfolio requirements. A sound investment policy will establish standards in the selection of securities regarding: (1) Credit Quality; (2) Maturities; (3) Diversification; (4) Marketability; and (5) Income.

A security which lacks credit quality has no place in a bank investment portfolio. Credit quality, however, is not the only consideration. For example, a high

quality issue may be inappropriate for a bank portfolio because the maturity is too long; or its purchase may result in a lack of diversification; or it may lack marketability. Credit quality is but the first test to be applied in the selection of an issue.

The maturity pattern appropriate for a bank will depend upon its individual circumstances and Examiners should avoid the adoption of any dogmatic rule or formula for application to all banks. The maturity schedule appropriate for a bank will take into consideration the bank's prospective cash needs which reflect loan demands and fluctuations in deposits. Generally speaking, long-term obligations have a place in a bank portfolio only when it is reasonable to believe that the investment can be held to maturity. This is true because price quotations for such bonds fluctuate more widely in the market as the result of changes in interest rates than for short-term obligations of equal credit quality.

Proper diversification of a bank's investment account will avoid an excessive commitment in the obligations of a single issuer or in securities, the credit of which depends largely upon the same set of factors of circumstances. Excessive diversification, however, creates serious managerial problems. When a portfolio is composed of a multitude of issues in small blocks, it becomes virtually impossible for the management to maintain the necessary familiarity with the items in the portfolio.

A bank which ignores all considerations of marketability in developing its securities account merits criticism. Marketability standing by itself, however, is not sufficient to make a security suitable for bank investment. For example, many defaulted issues are readily marketable and subject to frequent quotations, while obligations of small enterprises and political subdivisions which have rather high credit quality may never be quoted in a recognized source of price data. The latter issues should not be deemed unsuited for bank investment for that reason alone. Examiners must classify them on the basis of the available credit data, and a reasonable investment in such issues will not properly be the subject of criticism.

In essence, a sound investment policy seeks to maintain a balance of income requirements with the safety factors of credit quality, maturity, diversification, and marketability. If a bank is too aggressive in seeking a high return on its investments, the result may be disastrous. Relatively high yields on a security are primarily a reflection of the basic investment risks.

Factors to be considered in appraising an investment policy

The following topical outline is suggested as a guide for the Examiner in his discussions of bank investment policies:

(*a*) *General Character of the Bank's Business.*—A thorough study of the type of business conducted by a bank is needed to determine credit requirements of customers and the degree of stability in deposit accounts. A bank serving an agricultural area or a single-industry community is likely to experience greater fluctuations in deposit volume than one operating in a community with a well-diversified economic base. If correspondent banks, large corporations, or public funds account for a substantial portion of a bank's deposits, a more liquid condition is needed than if deposits are chiefly moderate-sized accounts of individuals and business enterprises. The character and maturities of a bank's loan account are also important. It is essential for the investment policy to take into consideration seasonal variations and long-term trends in the demand for loans.

(*b*) *Analysis of Deposit Structure.*—Long-term trends upward or downward in the total volume of deposits as well as changes in the composition of the accounts are important factors to be considered in judging a bank's investment policy. The accounts should be analyzed with respect to source (individual, business, public, banks, etc.) and degree of permanence, for example, demand or time, including thrift accounts. A study of account balances by size may reveal abnormal and excess balances of particular customers, unusual volumes of public funds, and other special accounts that may become particularly vulnerable. Such an analysis of savings accounts may disclose abnormal balances temporarily idle and not, strictly speaking, thrift accumulations.

(*c*) *Capital Funds.*—A bank's capital funds provide the margin to absorb losses that may be sustained on all of its operations, including its investment activities. The volume of Loss, Doubtful, and Substandard classifications in loans, investments, and other assets, the size of the bank's investment in fixed assets, and the volume of losses which may arise through any specific acts or through negligence on the part of the bank are factors to be considered in judging the adequacy of this capital margin. While the total capital accounts are available

to absorb losses, as a practical matter a bank will be obliged to suspend or reorganize if its losses impair capital stock (and in some cases certain other capital segregations). Accordingly, the investment policy of a bank will depend to some extent upon the availability of the capital cushion to absorb losses that may be sustained from commitments in certain types or classes of securities. Generally speaking, the smaller the capital cushion, the greater is the need for caution in the selection of investments.

(*d*) *Economic and Monetary Factors.*—An endeavor to predict with any degree of assurance the future course of economic events is futile. But it is quite possible for any intelligent observer to ascertain a few basic facts about the prevailing economic climate, such as whether business conditions are stagnant, expanding, or contracting—in short, whether times are prosperous or depressed. Study of graphic material will show whether money rates are relatively high or low and whether the financial structure of the economy is expanding or shrinking. Intelligent portfolio management will give consideration to these basic factors in formulating and executing investment policies. Preoccupation with these considerations, however, may be indicative of speculative tendencies which are unwholesome in banking.

Primary reserves, secondary reserves, and the investment account

These terms are frequently used in discussions of securities portfolio management and policies. Since there is no general agreement on precise definitions, their terms should be used with care to avoid misunderstandings.

(*a*) *Primary Reserves.*—For all practical purposes, primary, reserves consist of cash and demand balances due from other banks.

(*b*) *Secondary Reserves.*—As usually defined, secondary reserves consist of short-term, readily-marketable securities and other paper which can be converted into cash at little risk of loss, thereby providing the major liquidity beyond primary reserves. Other than such U.S. Government obligations as are included, secondary reserves under most definitions will consist of bankers' acceptances, open-market commercial paper, call loans to securities brokers and dealers, and other high-quality, marketable obligations having a maturity not in excess of one year.

(*c*) *Investment Account.*—In contrast to the secondary reserve, whose purpose is to provide liquidity, with minor importance attached to production of income, the appropriate purpose for the bank's investment account is to produce the maximum income consistent with the safety of the principal. Since banks in the aggregate cannot liquidate their investments at the same time without collapsing the price structure for securities, it is axiomatic that the investment account of each bank should be so designed in size and nature that the securities may be retained to maturity through good or bad times. Very little reliance should be placed upon sales of items from the investment account as a source of cash. The regular spacing of maturities and the operation of the investment account as a revolving fund offers many advantages. Periodic reinvestment affords a bank an opportunity to achieve an average of the interest rates prevailing in the investment market.

Furthermore, the revolving fund program of investment results in regular collections of principal which may be reinvested or not as justified by the circumstances. Moreover, such a program enables a bank to obtain maximum yields on purchases because it may reinvest funds in securities at the long end of the maturity pattern. The maximum length of the maturity pattern for such a revolving fund will vary widely from bank to bank. Any program, however, which contemplates a maturity program in excess of ten years could only be justified in very special circumstances.

Speculative trading in securities

That securities should be purchased and held for income and not in anticipation of speculative profits is axiomatic. Securities may be sold to meet a shrinkage in deposits or to provide for additional loans. But a well-considered investment program will anticipate these requirements by including short-term securities in the portfolio. In many instances the cash will become available automatically from the maturity of obligations. Such arrangements avoid the dangers inherent in speculative transactions.

Generally speaking, no banker is in a position to forecast future trends in interest rates successfully. An attempt to take advantage of anticipated fluctuations in interest rates over the long-term is fundamentally a speculative venture. Nevertheless, banks sometimes will inadvertently become involved in speculating

in interest trends by acquiring long-term, low-coupon issues at times when prevailing interest rates are very low. The market value of such securities will decline sharply if interest rates rise. An Examiner should be alert to this type of situation and bring it to the attention of management.

Examiners should refrain from instructing or advising banks to purchase or sell individual securities. The decision to buy or sell a security is the sole responsibility of the bank. Quite apart from the fact that Examiners have no special qualifications for anticipating price movements in the markets for securities, their primary function in their contacts with bankers is educational rather than managerial. They should rely upon intelligent criticism of a bank's investments and policies in order to bring about sound banking practices.

"Would these data requirements be more easily met, if there were available a series of factual reports, prepared by a Federal agency, that provide comprehensive economic and fiscal information for forthcoming municipal bond issues, irrespective of size of bond issue?"

Current factual reports that provide comprehensive economic and fiscal information about all new municipal bond issues would be generally helpful to bank investors as well as to nonbank buyers of these securities. Such a reporting system, however, would probably be quite costly, and the costs must be judged in terms of the benefits to be gained.

The FDIC has generally found that insured nonmember banks investing in municipal securities have managed to obtain sufficient information on the issues in their portfolios to support their investments—particularly in those instances where the borrower is a local government unit and where the bank has access to local sources of information. In this connection, it is also important to reemphasize the fact that the appropriateness of a specific issue in a bank's portfolio can be appraised only in the context of its overall asset and liability mix—for which purpose a factual report prepared by a Federal agency would be helpful but not decisive for the bank and the examiner.

"Would the burdens of commercial banks in justifying their holdings of municipal securities to bank examiners be materially eased, if such municipal securities were to be guaranteed by a Federal agency?"

An unequivocal answer to this question would require detailed information with respect to the nature of the Federal guaranty. The credit quality problem would evaporate if the guaranty were to pledge the full faith and credit of the United States to the support of municipal obligations. On the other hand, a limited guaranty could actually increase the work of bank examiners. For example, a cumbersome procedure for guaranteeing municipal securities might create pitfalls for the unwary, and the checking needed to make certain that all the necessary steps had been taken to qualify for the guaranty could result in a situation perhaps worse than the present.

At the same time, commercial banks are not operating under an added burden in regard to their need to justify particular securities investments to the bank supervisory agencies; or at least to no greater extent than their need to be able to defend their lending policies. The data that bank examiners review are exactly the same as those that should be considered by any well-run bank in managing its loan and investment portfolios.

"In recent years commercial banks have become by far the major source of funds for State and local government borrowing. In this context, explain the economic justification for having commercial banks employ a significant portion of their unique money creation power to acquire municipal securities, the interest income of which is tax exempt."

Commercial bank investments in State and local government obligations constitute but one outlet for long-term funds deposited with banks by savers. Banks mobilize the funds placed in their institutions and allocate them to various uses on the basis of a broad range of considerations—including the relative attractiveness of alternative investment opportunities which may be affected by the tax status of the investments.

The impact of the tax-exempt status of interest income from municipal securities on the position of individual investors is, however, difficult to determine because legal—rather than economic—considerations tend to be overriding. The Federal income tax structure, for example, presents many knotty problems—both with respect to equity among taxpayers and the consequences to the economy generally.

Statutes in the various States also confer tax advantages of one sort or another

on holders of certain municipal issues. The tax treatment now accorded income from municipals as a consequence depends primarily upon Federal and State laws rather than upon economic considerations.

"Would the market for municipal securities be materially enlarged, if (a) the interest income were to be made taxable, (b) the debt service on the securities were to be guaranteed by a Federal agency, and (c) the municipality were to receive annual grants to cover one-third of the annual interest cost on the taxable securities?"

The Federal Deposit Insurance Corporation as an insurer of bank deposits and a supervisor of insured State-chartered banks not members of the Federal Reserve System claims no special competence to deal with marketing problems of municipal securities.

However, as matters now stand, investors who derive little or no benefit from tax exemption (for example, individuals in the lower income tax brackets and mutual institutions, such as mutual savings banks and mutual savings and loan associations that are not subject to Federal income taxes), do not bid for these securities when they are offered in the market. Current yields on such securities are only advantageous to investors who can derive some benefit from the feature of tax exemption. A change in tax status no doubt would affect yields, and securities which now appear attractive because of a tax advantage to certain buyers might lose this segment of the market if the law were changed. The consequences obviously would depend upon the balance of various forces in the market place—namely, investors seeking to find an outlet for their funds in the municipal market, investors not attracted to these securities because of yield, and the many competitive investment opportunities. Because the underwriters make a very careful study of prospective buyers in any individual flotation of municipal securities, generalizations by these dealers might be helpful in answering this part of the question.

The second segment of the question, (b) likewise concerns market reactions to a change in the investment characteristics of obligations floated by States and subdivisions. The effect of the guaranty would depend upon its precise nature. Conceivably it would be so comprehensive in character that the securities would in effect constitute an extension of Federal credit. Whether this would help the market for municipal securities or merely impair the market for Federal issues is a question that cannot be answered without additional intensive study by qualified analysts.

Part (c) of this question is concerned with a proposed subsidy to States and their subdivisions. Again, whether the proposed contribution amounting to a fraction of annual interest cost would make any difference to a credit would need to be more carefully studied. If adopted, the proposal could set other forces in motion that could neutralize the anticipated result completely.

Excerpt From Annual Report of the Federal Deposit Insurance Corporation for the Year Ending December 31, 1938

Development of Uniform Examination Procedure Among Federal and State Bank Supervisors

At the time the Federal Deposit Insurance Corporation was created there were more than 50 State, Federal, and territorial authorities supervising banks eligible for insurance. In examining banks in the 48 States to determine their ability to qualify for deposit insurance and in developing, in cooperation with the State authorities, rehabilitation programs for a number of these banks, the Corporation was impressed by the diversity of standards and procedures which made the task of coordination of policy throughout the country difficult. One of the earliest objectives of the Corporation, therefore, was to secure improvement and uniformity of standards and procedure among the various supervisory authorities.

In 1934 and 1935 the Corporation undertook to review the principles of bank supervision with a view to providing a basis for improvement of standards, coordination of policy, and uniformity of procedure. Numerous conferences were held with other supervisory authorities. Consideration was given to the following subjects:

(1) Standards of chartering and admission to insurance;
(2) Operating standards of banks relating to capital, loans, and investments;
(3) Purpose of bank supervision;
(4) Purpose of bank examinations;
(5) Principles of classification and valuation of assets;

(6) Determination of net worth or adjusted capital account of a bank;
(7) Form or method of presentation of results of examinations;
(8) Principles underlying and methods of developing corrective programs.

For the most part, the supervisory authorities were in agreement that supervision should seek to prevent the development of unsound situations in individual banks and to correct, as promptly as feasible, such unsound situations as exist. The examination, as one of the principal tools of supervision, should present as accurately and clearly as possible the examiner's appraisal of the bank and his determination of the bank's asset, capital, and operating position, in order to form a basis for the determination of supervisory action with regard to the bank.

Classification and valuation of loans.—When the Corporation began to examine banks, the practice was general among Federal and State supervisory authorities of calssifying criticized loans in three categories, "estimated loss," "doubtful," and "slow." "Estimated loss" loans represented those loans or parts of loans which, in the opinion of the examiner, could not be collected. "Doubtful" loans or parts of loans were those in which there existed, in the examiner's opinion, a substantial probable loss not yet definitely ascertainable in amount, as a consequence of which the ultimate collection or value was doubtful.

There was considerable confusion, however, as to the meaning of the "slow" classification. Some examiners included in the "slow" column loans which were slow in a literal sense, were perhaps not collectible at the stated maturity, or were not strictly of a seasonal nature, regardless of the inherent soundness and colectibility of the credit. Other examiners were including in this classification only those loans which were unduly risky as to ultimate collectibility but which did not warrant so severe a classification as "doubtful" or "loss". Still other examiners were including both of these types of loans in the "slow" column.

In September 1934, a joint examiners' conference was held in Washington for all chief and supervising examiners of the various Federal agencies dealing with banks. This conference was called at the request of the Secretary of the Treasury for the purposes of establishing a uniform method of asset appraisal and of ascertaining whether or not Federal bank examiners were forcing liquidations and freezing credit through their classification of assets. An attempt was made to clarify the "slow" classification in reports of examination, and to standardize its application.

The conference adopted the following recommendation:

"Loans which are reasonably well protect as to ultimate payment by reason of the sound net worth of the maker and/or endorser, even though their assets or a large part thereof may not be of a liquid nature under present conditions, and loans which are reasonably well protected by collateral or other security of sound intrinsic value but which, due to present or local conditions, may not be salable at this time, should not be classified as slow.

"In other words, it is believed that under present conditions the examiner should only list as slow, loans which in his opinion will become doubtful or worthless in whole or in part unless placed in proper bankable shape by the bankers."

The term "'slow" was inconsistent with the definition of the classification as agreed upon at the joint examiners' conference. It did not correctly describe the type of loan to be classified thereunder and its continued use encouraged the placing of improper emphasis upon maturity. As a consequence, efforts were made from time to time to secure agreement among the supervisory authorities to discontinue use of the term and to substitute therefor some other term such as "substandard." Following extended consideration of the question by representatives of the Corporation and the Executive Committee of the National Association of Supervisors of State Banks, the latter Committee adopted a resolution recommending abandonment of the term "slow" in the examination reports and the substitution therefor of the term "substandard." The resolution is presented as Exhibit A.

At the request of the Secretary of the Treasury representatives of the Federal bank supervisory agencies held a series of conferences in April, May, and June, 1938, with a view to developing uniform procedures. On June 27, an agreement was announced whereby, in classifying assets in the examination, the Federal agencies would discontinue the use of the terms "slow," "doubtful," and "loss," and substitute therefor the numerals II, III, and IV, respectively. The agreement with respect to loans is presented as Exhibit B. This procedure was endorsed by the Executive Committee of the National Association of Supervisors of State Banks and its adoption by the various State bank supervisory authorities recommended.

All loans not criticized are placed in Classification I. The three classifications of criticized loans were defined as follows:

II. "Loans or portions thereof which appear to involve a substantial and unreasonable degree of risk to the bank by reason of an unfavorable record or other unsatisfactory characteristics noted in the examiner's comments. There exists in such loans the possibility of future loss to the bank unless they receive the careful and continued attention of the bank's management. No loan is so classified if ultimate repayment seems reasonably assured in view of the sound net worth of the maker or endorser, his earning capacity and character, or the protection of collateral or other security of sound intrinsic value.

III. "Loans or portions thereof the ultimate collection of which is doubtful and in which a substantial loss is probable but not yet definitely ascertainable in amount. Loans so classified should receive the vigorous attention of the management with a view to salvaging whatever value may remain.

IV. "Loans or portions thereof regarded by the examiner for reasons set forth in his comments as uncollectible and as estimated losses. Amounts so classified should be promptly charged off."

Classification and valuation of securities.—Up to the middle of 1938, the Corporation, in its examinations, valued securities on the basis of market prices.[1] The net amount by which market or estimated value of a bank's securities was below the value at which they were carried on the bank's books was regarded as an "estimated loss."[2]

In examination reports the Corporation also grouped securities on the basis of credit risk or quality. The groupings were as follows:

Group 1. Direct and fully guaranteed obligations of the United States Government, obligations issued by States and their political subdivisions, and by instrumentalities of governments on which the risk of default seemed slight, and all other security obligations placed within the first four ratings by a recognized rating service.[3]

Group 2. Obligations of States and their political subdivisions, and of instrumentalities of governments, not now in default but which appeared to involve a substantial and unreasonable risk for a bank, and all other security obligations not in default and not placed within the first four ratings by a recognized rating service;

Group 3. Obligations in default;

Group 4. Stocks.

The distribution, by groups, of securities in insured commercial State banks not members of the Federal Reserve System, as shown by examinations in 1938, is given in Table 34.

This procedure of grouping was similar to that followed by the Office of the Comptroller of the Currency. While this practice had originated in that Office primarily in connection with security valuation, it had come to be used also for the purpose of analyzing the quality of the portfolio of individual banks.

Review of principles of valuation of securities.—While securities were valued on the basis of current market prices, other assets of the banks were valued on the basis of examiners' appraisals. Fluctuations in bond prices from day to day, often of an erratic character, frequently resulted in substantial changes in values between examinations. The appraised values of the other assets, on the other hand, ordinarily changed little from one examination to another.

The amount of securities held by insured banks is approximately three times their capital. As a consequence, under the procedure of valuing securities on the basis of market prices, an average rise of 5 percent in bond prices would result in a 15 percent increase in the adusted capital account of the banks. Conversely, a decline of 5 percent would reduce the adjusted capital account of the banks by 15 percent. Inasmuch as fluctuations in bond prices reflect changes in interest rates and trading pressure more than they do changes in the credit standing of individual issues, the conclusions of bank examiners and supervisors as to the adjusted capital account or net worth of the banks were largely dominated by the state of the bond market.

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[1] The classifications "doubtful" and "slow," which were relatively unimportant, were used in connection with local securities subject to criticism. Having no market, these were accordingly classified on the same basis as loans.

[2] In 1934 the practice was adopted of disregarding any depreciation, within certain limitations, in United States Government securities. Inasmuch as these securities were generally selling at a premium the change was one of principle with no practical effect upon the current status of individual banks.

[3] In 1936 provision was made by the Corporation for inclusion in Group 1 of sound, unrated issues.

TABLE 34.—BOOK VALUE OF SECURITIES: 7,094 INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

	Amount (millions)	Percent distribution
Total securities	$2,498	100.0
Satisfactory for bank investment—Group 1	2,187	87.6
Obligations of the U.S. Government—direct and guaranteed	1,205	48.2
Obligations of U.S. Government corporations and agencies, not guaranteed, and of territorial and insular possessions of the United States[1]	41	1.7
Obligations of States and political subdivisions	473	18.9
Other bonds—total	468	18.8
1st grade	25	1.0
2d grade	76	3.0
3d grade	129	5.2
4th grade	194	7.8
Other bonds satisfactory for bank investment	44	1.8
Unsatisfactory for bank investment	340	13.6
Low grade bonds—Group 2	210	8.4
Defaulted bonds—Group 3	48	1.9
Stocks—Group 4	82	3.3
Unallocated valuation allowanes (net)—deduction	(29)	(1.2)

[1] Includes joint stock land bank bonds satisfactory for bank investment.

The practice of valuing securities at the market was subject to the further objection that it placed primary emphasis upon the trading aspects rather than the investment aspects of bank purchases and holdings of securities.

It was believed that difficulties created by valuing securities at the market would be largely avoided if securities were valued on a basis similar to that used for loans. In the case of securities such valuation would be par or book value less allowances for chance of loss.[4] However, valuation of securities on the basis of par, book, or cost values encourages speculative trading by banks, unless banks are willing to segreate profits from security sales into special reserves available only for meeting losses. Unless profits are so segregated, banks in a rising market can follow the market up simply by trading, thereby establishing new and higher book or cost values. If profits from security sales are not segregated, a special motive for such trading will exist, since profits could be paid out in dividends and any depreciation in securities below book or cost could be disregarded.

Consideration of these questions led the Executive Committee of the National Association of Supervisors of State Banks on April 5, 1938, to adopt a statement endorsing a policy of valuing high grade securities at cost with premiums amortized over the life of the securities and with profits from the sales of securities isolated in reserves available for use only in taking losses. The statement of policy is presented as Exhibit C. On June 27, 1938, simultaneously with the announcement of an agreement for classifying loans and other assets, the Federal agencies announced that they had agreed upon a basis for grouping, valuing, and classifying securities in the examination. This procedure was also approved

[4] One method of valuing securities under such a procedure would be as follows: Securities judged by the examiner to involve but a small degree of risk of loss would be valued at par or cost and placed in Classification I. Securities involving substantial degree of loss would be valued at par or cost less a loss allowance appropriate to the estimated risk, and the estimated recoverable value placed in Classification II. Securities involving a very great risk of loss would be valued at face less a loss allowance of large magnitude, possibly 50 percent, and the estimated recoverable value placed in Classification III. Securities involving only slight chance of ultimate repayment would be placed entirely in Classification IV. Thus Classification IV would consist of all securities with little chance of realization plus the loss allowance of securities in Classification II and Classification III.

Another method would be to value securities at cost, or book, or market, whichever was lowest, with a minimum level below which the valuation of securities of a given grade would not be required to follow the market. For example, the valuation of securities of the three highest grades would not follow the market below par; those of the fourth grade, below a given price, perhaps 90; of the fifth grade below, perhaps 80; the sixth grade, below 70; and the seventh grade, below 60. The valuation of bonds of the eighth grade or lower would not be required to follow the market below 50, but would be required to be charged off over a 5-year period. The minimum prices given here for illustrative purposes would actually be determined presumably on the basis of the approximate risk of loss from default in securities of a given grade. This plan, or some variation of it, may prove worthy of consideration at some future time.

by the Executive Committee of the National Association of Supervisors of State Banks. The agreement included a statement of the position of the Federal bank supervisory authorities on the segregation of profits from the sale of securities. Under the uniform procedure the value of securities is determined by groups as follows: [5]

Group 1 securities are valued at book or at cost, less amortization of premiums, whichever is less;

Group 2 securities are valued on the basis of average market prices over the preceding 18 months. In practice the average is based upon the mid-point between the high and low for the 18 months. Any security purchased subsequent to the date the policy was put into effect which was a Group 2 security at the time of purchase is placed in a separate group and valued at market;

Group 3 securities (obligations in default) are valued on the basis of market prices;

Group 4 securities (stocks) are valued on the basis of market prices. The agreement is presented as Exhibit D.

As compared with the use of current market prices, the use of average prices over the preceding 18 months in valuing Group 2 securities appears to be an improvement in supervisory practice. The use of current market prices can result in serious injustices. If securitiy prices were high in the spring, declined to low levels in the summer, and recovered again in the autumn, banks examined in the spring and autumn might be shown by the examinations to be in a relatively better position, while banks with virtually identical types of assets examined in the summer might be shown to be in a relatively poorer position. The use of the 18-months' average reduces such discrimination substantially.

In addition, use of the 18-months' average lends support to supervisory objectives. Group 2 securities are securities not of investment grade and their acquisition by banks should be avoided. In valuing securities on the basis of 18-months' average prices, bank supervisors tend to value these obligations at above the market when that market is under pressure and declining, and below the market when the market for such securities is active and prices are rising. As a consequence, banks will be encouraged to hold these obligations during periods in which the market is unfavorable and to sell them during periods when the market is active and able to absorb them. This procedure contributes not only to an improvement in the banks' position but to stability of the markets as well.

A distribution of securities by groups showing their book value, market value, and appraised value under the uniform examination procedure, is presented in Table 35. The data relate to insured commercial State banks not members of the Federal Reserve System examined during 1938. The market value of the securities is the value at which they were appraised under the original procedure. The appraised value is the value given the securities under the uniform examination procedure. The table shows that, as compared with the original procedure, the high grade securities (Group 1) have a lower value and the Group 2 securities a higher value under the uniform procedure.

TABLE 35.—BOOK, MARKET, AND APPRAISED VALUES OF SECURITIES: 7,094 INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

[In thousands of dollars]

	Book value	Market value	Appraised value [1]
Total securities	2,497,963	2,463,473	2,466,820
Unallocated valuation allowances (net)—deduction [2]	(29,523)		
Group 1	2,187,216	2,199,134	2,183,354
Group 2	209,757	166,819	[3] 185,946
Group 3	48,062	28,974	97,520
Group 4	82,451	68,546	

[1] According to uniform examination procedure; for additional examiners' adjustments in analysis of capital accounts see exhibit E and table 39, pp. 342-343.
[2] Valuation allowances of $30,055,000 less bond premium accounts of $532,000.
[3] Partly estimated.

[5] The basis of grouping securities was in all essential respects the same as that already used by the Corporation and described on page 64.

There has been some confusion about the meaning of the grouping of securities in the reports of examination. The Corporation believes that a supervisory agency should not assume the management of the banks' portfolios, and its examiners are instructed not to express an opinion on the wisdom of the purchase or sale of a specific security. In the case of insured banks not members of the Federal Reserve System a security is placed in Group 1 when, in the judgment of the Corporation, the risk of loss from default is not unreasonable, even though the security may be too high priced in the market or for some other reason unsuited to the needs of a given bank. A security is placed in Group 2 when the risk of loss from default appears to be substantial or unreasonable because of an unfavorable record or outlook for the obligor, regardless of price, and even though the market is such that the bank appears to have no alternative but to hold such a security. Thus, the placing of a security in Group 2 should under no circumstances be interpreted to mean that the Corporation is recommending immediate sale.

The appraised value of assets as determined by the foregoing procedure is subject to further adjustment in determining the net worth or adjusted capital account of the bank.

Analysis of capital accounts.—One of the most important purposes of an examination is to determine the net worth of the bank and to measure the amount of the owners' interest available for the protection of depositors and other creditors against risk of loss through deterioration of assets. The adjusted capital account represents the excess of the adjusted value of assets over the determined liabilities of the bank. The Corporation's method of determining the adjusted capital account of banks prior to the adoption of the uniform examination procedure is illustrated by the computation in Table 36, based upon figures of all insured commercial State banks not members of the Federal Reserve System examined in 1938.

TABLE 36.—DETERMINATION OF ADJUSTED CAPITAL ACCOUNT, ORIGINAL EXAMINATION PROCEDURE:[1] 7,094 INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

[In thousands of dollars]

	Amount
Total capital accounts—book value	994,674
Addition: Determinable sound banking values not on books	3,406
Deductions:	
Assets classified as "loss"	105,254
Assets classified as "doubtful"	16,258
Determinable liabilities not on books	3,462
Total	124,974
Examiners' net deductions	121,568
Adjusted capital account	873,106

[1] For determination of adjusted capital account under the uniform procedure, see table 41, p. 344.

The uniform examination procedure altered the method of analyzing capital accounts in two respects:

(1) The method of valuing securities and of applying values to the measurement of the adjusted capital account was changed. The change in method of valuing securities has been explained above. The change in method of applying those values to the measurement of adjusted capital account was chiefly in the handling of net depreciation in Group 2 securities. Under the original procedure such depreciation was deducted from total capital accounts as a "loss." Under the uniform procedure the depreciation was placed in Classification III, of which 50 percent is deducted from total capital accounts.

In the case of the insured commercial State banks not members of the Federal Reserve System examined in 1938, the change resulted in an increase in the computed adjusted capital account of $3 million, or one-third of 1 percent, over that computed on the basis of the procedure followed by the Corporation in 1937 and early 1938.

(2) Whereas under the original procedure all of the "loss" and "doubtful" assets were deducted, under the uniform procedure all of the assets placed in Classification IV, comparable to the earlier "loss" classification, and 50 percent

of the assets placed in Classification III, comparable to the earlier "doubtful" classification, are deducted from book capital. The total amount of assets other than securities (discussed above) put into Classification III was $16 million in the case of the insured commercial State banks not members of the Federal Reserve System examined in 1938. This change, therefore, resulted in an increase in the computed figure of the adjusted capital account of these banks of $8 million, or slightly less than 1 percent.

The combined effect of these changes was to make the computed figure of adjusted capital account of these banks $11 million, or 1.2 percent, higher than under the original procedure. The method of adjustment of capital accounts under the uniform procedure is explained in detail in Exhibit E, and the results for insured commercial State banks not members of the Federal Reserve System examined in 1938 are shown in Table 41, page 78.

TABLE 37.—NUMBER OF BANKS GROUPED ACCORDING TO CAPITAL RATIOS COMPUTED UNDER ORIGINAL AND UNIFORM EXAMINATION PROCEDURES: INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

	Original procedure	Uniform procedure
All banks	7,094	7,094
Banks with adjusted capital account per $100 of adjusted value of assets of—		
$0 or less	33	7
$0.01 to $4.99	155	45
$5 to $9.99	1,505	1,427
$10 to $14.99	2,771	2,917
$15 to $19.99	1,547	1,593
$20 to $24.99	652	674
$25 to $29.99	254	255
$30 to $34.99	104	102
$35 to $39.99	36	38
$40 or more	37	86

The adjusted capital account obtained by the uniform examination procedure amounted to $884 million, or 12.8 percent of the adjusted value of assets, compared with the computed adjusted capital account of $873 million, or 12.6 percent of the adjusted value of assets, obtained under the procedure followed by the Corporation in 1937 and early 1938. A comparison of the distribution of banks according to their capital ratios, computed in accordance with the uniform procedure and in accordance with the Corporation's practice followed prior to adoption of the uniform procedure, is presented in Table 37. A more detailed distribution is given in Table 38. The tables reveal that fewer banks show very low capital ratios under the uniform procedure than under the procedure previously followed by the Corporation.

TABLE 38.—DISTRIBUTION OF NUMBER OF BANKS ACCORDING TO CAPITAL RATIOS COMPUTED UNDER ORIGINAL AND UNIFORM EXAMINATION PROCEDURES: INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

Banks grouped according to adjusted capital account per $100 of adjusted value of assets (original procedure)	All banks	Banks with adjusted capital account per $100 of adjusted value of assets (uniform procedure) of—									
		$0 or less	$0.01 to $4.99	$5 to $9.99	$10 to $14.99	$15 to $19.99	$20 to $24.99	$25 to $29.99	$30 to $34.99	$35 to $39.99	$40 or more
All banks	7,094	7	45	1,427	2,917	1,593	674	255	102	38	36
$0 or less	33	7	8	14	4						
$0.01 to $4.99	155		33	103	18	1					
$5 to $9.99	1,505		4	1,108	387	6					
$10 to $14.99	2,771			202	2,353	210	5	1			
$15 to $19.99	1,547				155	1,319	73				
$20 to $24.99	652					56	565	30	1		
$25 to $29.99	254						29	215	10		
$30 to $34.99	104						2	9	90	3	
$35 to $39.99	36								1	35	
$40 or more	37					1					36

Conclusion.—The uniform procedure represents improvement in practice. Confusion of objectives, which had resulted from use of the term "slow" in classifying assets, has been eliminated. Valuation of securities has been placed on a basis more nearly comparable with that used for other assets, namely, appraisal of risk of loss through inability of obligor to pay.

Under conditions existing in 1938 the uniform procedure does not materially alter the general picture obtained under the Corporation's earlier procedure. As compared with the procedure previously followed by the Corporation, a more optimistic picture of the banks in a weak position is given by the uniform procedure. On the other hand, a slightly less favorable picture is given of some banks in a sound position, particularly those with a large proportion of securities.

Exhibit A

RECOMMENDATION OF THE EXECUTIVE COMMITTEE OF THE NATIONAL ASSOCIATION OF SUPERVISORS OF STATE BANKS REGARDING SLOW CLASSIFICATION, ADOPTED, APRIL 5, 1938

The Executive Committee of the National Association of Supervisors of State Banks recommends that the term "Slow" no longer be used to designate a loan classification in connection with examinations of State banks and that the term "Substandard" be substituted therefor. The Committee recommends the adoption of this change by all Supervisory Authorities. The Federal Deposit Insurance Corporation is currently adjusting its examination report form in conformance with this policy.

This change is principally one of terminology and not one of definition. It is believed that the present outstanding instructions of the several State Authorities and the Federal Deposit Insurance Corporation as to the type of loan which should be classified as Slow are satisfactory. These same instructions should perhaps be reiterated in connection with the new term "Substandard."

The real difficulty has been that the word "Slow" was neither accurate nor descriptive of the loans which the instructions indicated should be so classified. Somewhat as a result of this ambiguity in terminology, there has been an apparent tendency upon the part of some examiners to criticize, by including in the Slow column, loans sound as to ultimate repayment although not immediately collectible. With the adoption of the term "Substandard" the inconsistency between the title of the column and its real purpose is finally cleared up.

The Slow column originated as a definite classification in national bank examinations during the Comptrollership of John Skelton Williams at which time the theory that commercial banks should make only self-liquidating seasonal loans was widely held. It was probably intended when the column was inaugurated, that inclusion of a loan in the Slow column would be determined in large measure by whether the loan conformed to the tenets of that theory. Strict application of that principle, however, has never been feasible as a practical matter, since it would have necessitated the Slow classification of a large percentage of all loans in commercial banks.

Nevertheless the self-liquidating loan theory, if not applicable to the letter was until 1934 an important coloring influence in the use of the Slow category. The result of this influence was that prior to 1934 the column served for the inclusion of two rather separate and distinct types of loans: (1) loans which were slow in a technical sense but which were nonetheless intrinsically sound and collectible, and (2) loans concerning which there was some question as to the ultimate repayment. As a result of the Examiners' Conference of 1934 called by Secretary Morgenthau, the column was defined to exclude loans of the first type and to include only those of the second; that is, only loans which had unfavorable or criticizable characteristics which, unless corrected and the loan placed in proper bankable shape, might lead to an eventual loss.

The fundamental characteristic, therefore, of loans which were to be classified in the Slow column was not their slowness in a literal sense but whether they were of satisfactory quality as credit risks. Resultingly, there existed an unfortunate inconsistency between the caption of the column and what it was to include. It is believed that adoption of the word "Substandard" will remove this inconsistency.

It should also be mentioned that renaming the Slow column will increase its general usefulness. While at present loans of unsatisfactory credit quality and other real estate, not classified as Doubtful or Loss, may be included in the Slow column, there is no place in the Examiner's Summary of Classified Assets for the inclusion of all securities of inferior credit quality. If the emphasis of the caption of the column is upon the quality of assets and upon their general

desirability as bank holdings, securities of inferior grade can be included. The present word "Slow" precludes such inclusion since many issues of a substandard character are marketable under certain circumstances. Alteration of the caption of the column will, therefore, permit recapitulation in examination reports of all assets, not Doubtful or Loss, which are substandard for banks.

Exhibit B

Statement Released to Press June 27, 1938, Regarding Classification of Loans in Bank Examinations

Agreed to by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Directors of the Federal Deposit Insurance Corporation, and the Comptroller of the Currency.

The present captions of the classification units, namely, "Slow," "Doubtful," and "Loss" are to be abandoned;

The classification units hereafter will be designated numerically and the following definitions thereof will be printed in examination reports:

I. Loans or portions thereof the repayment of which appears assured. These loans are not classified in the examination report.

II. Loans or portions thereof which appear to involve a substantial and unreasonable degree of risk to the bank by reason of an unfavorable record or other unsatisfactory characteristics noted in the examiner's comments. There exists in such loans the possibility of future loss to the bank unless they receive the careful and continued attention of the bank's management. No loan is so classified if ultimate repayment seems reasonably assured in view of the sound net worth of the maker or endorser, his earning capacity and character, or the protection of collateral or other security of sound intrinsic value.

III. Loans or portions thereof the ultimate collection of which is doubtful and in which a substantial loss is probable but not yet definitely ascertainable in amount. Loans so classified should receive the vigorous attention of the management with a view to salvaging whatever value may remain.

IV. Loans or portions thereof regarded by the examiner for reasons set forth in his comments as uncollectible and as estimated losses. Amounts so classified should be promptly charged off.

Present practice will be continued under which the totals of II, III, and IV above are included in the recapitulation or summary of examiners' classifications.

Fifty percent of the total of III above and all of IV above will be deducted in computing the net sound capital of the bank.

Exhibit C

Policy of Securities Valuation by Bank Examiners

Endorsed by the Executive Committee of the National Association of Supervisors of State Banks, April 5, 1938

I. A sound policy for valuing securities held by banks should accomplish the following:

1. Discourage speculative in and out trading;
2. Encourage purchase of only high grade securities for investment purposes;
3. Induce the write-down and gradual disposal of presently held securities of inferior grade;
4. Provide for segregation of all profits on securities sold in a special liability or valuation account;
5. Provide for an amortization program with respect to securities purchased at a premium;
6. Provide a valuation method which is equitable regardless of market fluctuations.

II. A bond valuation policy which places chief reliance on market quotations is unsatisfactory.

1. Speculative trading in bonds is encouraged.

(*a*) Bankers holding high securities as investments are penalized in times of low market prices and by inference are criticized for not having sold their holdings when apparent profits could have been realized.

(b) The banking system as a whole cannot successfully speculate in the bond market since, for the most part, one bank's sales are another bank's purchases.

2. Certain injustices result at present because of different appraisal treatment of bonds as compared with loans and real estate. In times low bond prices, banks with mediocre loans or large real estate holdings appear in a more favorable light than banks holding relatively large portfolios of high grade bonds. In times of high bond prices, the banks with large bond portfolios appear in an unduly favorable light.

3. The amount of securities held by insured banks is approximately three times their capital. Consequently a rise of 5 percent in the bond market appears to result in a 15 percent increase in net capital. Conversely, a decline of 5 percent appears to decrease net capital by 15 percent. Therefore, the conclusions of bank supervisors as to the net capital of the banks are largely dominated by the state of the bond market. Under present practice, the banks can trade their securities when the market rises 5 percent, giving the impression of a 15 percent profit on capital, while when the market falls 5 percent we attempt to get the banks to take a loss at the rate of 15 percent on capital.

III. It is unanimously recommended by the Executive Committee that, effective immediately and until further notice, the following rules for bond valuation shall apply to examination of banks by examiners of State Supervisory Authorities:

1. Securities of the three highest credit ratings and other securities of equivalent credit status:

(a) Market price is to be ignored;

(b) Valuation is to be at cost. (By "cost," wherever used in this memorandum, is means "cost less amortization or book, whichever is lower.")

2. Securities of the fourth highest credit rating, unrated securities of equivalent credit status and Group II securities shall be priced at market, but for net balance sheet purposes, shall be valued at cost.

(a) Market price of this class of securities will appear in the report as a memorandum item but will not be taken into consideration in computing net sound capital nor in computing estimated loss.

3. Groups III and IV securities shall be valued at market and any net market depreciation on the total securities of these classes held by banks shall enter into the computation of net sound capital and estimated loss. If there is net unrealized appreciation, it shall be ignored.

4. All profits realized from the sale of securities shall be segregated in a special liability or valuation account.

5. Even though a bank does not place net realized security appreciation (profits from sale) in a valuation account, the examiners shall so treat all net security appreciation realized after June 30, 1938.

6. All banks shall be discouraged from henceforth purchasing securities of a credit quality below that which is generally required of rated bonds which appear in the three highest grades.

Exhibit D

STATEMENT RELEASED TO PRESS JUNE 27, 1938, REGARDING THE APPRAISAL OF BONDS AND THE TREATMENT OF SECURITIES PROFITS IN BANK EXAMINATIONS

Agreed to by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Directors of the Federal Deposit Insurance Corporation, and the Comptroller of the Currency

The appraisal of bonds in bank examinations.—Neither appreciation nor depreciation in Group I securities will be shown in the report. Neither will be taken into account in figuring net sound capital of the bank.

Group I securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group includes general market obligations in the four highest grades and unrated securities of equivalent value.

The securities in Group II will be valued at the average market price for eighteen months just preceding examination and fifty percent of the net depreciation will be deducted in computing the net sound capital.

Group II securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes general market

obligations in grades below the four highest, and unrated securities of equivalent value.

Present practice will be continued under which net depreciation in the securities in Group III and Group IV are classified as loss.

Group III securities: Securities in default.

Group IV securities: Stocks.

Present practice will be continued under which premiums on securities purchased at a premium must be amortized.

Present practice of listing all securities and showing their book value will be continued.

The treatment of securities profits in bank examinations.—Until losses have been written off and adequate reserves established, the use of profits from the sale of securities for any purpose other than those, will not be approved.

Present practice will be continued under which estimated losses must be charged off.

Present practice will be continued under which the establishment and maintenance of adequate reserves, including reservs against the securities account, are encouraged.

Present practice will be continued under which speculation in securities is criticized and penalized.

Exhibit E

Analysis of Assets and Capital Accounts Under Uniform Examination Procedure

The analysis of assets and of capital accounts under the uniform examination procedure is shown in Tables 39 to 41.

TABLE 39.—ANALYSIS OF SECURITIES UNDER THE UNIFORM EXAMINATION PROCEDURE ADOPTED IN 1938 7,094 INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

[In thousands of dollars]

Line		Total securities	Group [1]			
			1	2	3	4
	Book value:					
1	Gross book value	2,527,486	2,187,216	209,757	48,062	82,451
	Allocations to security accounts:					
2	Bond premium accounts	+532	+532			
3	Valuation allowances	−30,055	−4,261	−7,365		−18,429
4	Net book value	2,497,963	2,183,487	202,392		112,084
	Appraised value (items on books):					
5	Appraisal by uniform procedure [2]	2,466,820	2,183,354	185,946		97,520
6	Excessive appraisal disallowed [3]	−9,494		−1,200		−8,294
7	Net appraised value	2,457,326	2,183,354(I)	184,746(II)		89,226(II)
8	Net depreciation (difference between net book value and net appraised value)	40,637	[4] 133(IV)	17,646(III)		22,858(IV)
	Adjusted value:					
9	Net book value	2,497,963	2,183,487	202,392		112,084
10	Examiners' deductions [5]	−31,814	−133	−8,823		−22,858
11	Adjusted value of items on books	2,466,149	2,183,354	193,569		89,226
12	Examiners' additions [6]	+1,206				+1,206
13	Adjusted value	2,467,355	2,183,354			284,001

[1] For definition of groups, see p. 75. Roman numerals in parentheses show examiners' classification of net book value.

[2] Group 1—net book value less writeups on books and premiums not properly amortized. Group 2—average market price over the preceding 18 months. Groups 3 and 4—market value.

[3] Amounts by which total appraised value exceeds net book value of any group in individual banks.

[4] Writeups in book value above cost and premiums not properly amortized.

[5] Half of classification III and all of classification IV—That is, ½ of net depreciation in group 2, and all of net depreciation in groups 1, 3, and 4.

[6] Determinable sound banking values not on books.

Table 39 illustrates the manner in which the securities of the banks are appraised and classified. Line 1 shows the book value of securities in each group. Line 4 shows the net value of each group after adding in the bond premium account and subtracting out the valuation allowances as allocated by the examiners.

Line 5 in Table 39 shows the appraised value of securities as determined in accordance with the uniform procedure. The appraised value of Group 1 securities is cost less amortization, or book value, whichever is lower. The appraised value of Group 2 securities is determined on the basis of 18-months' average prices. The appraised values of Groups 3 and 4 are based on market values at the time of examination. From the appraised values are deducted those amounts which under the procedure are excessive. Such excessive appraisals consist of those amounts by which the appraised values exceed the book values of any given group in any individual bank.

The net appraised value obtained in line 7 is deducted from the net book value shown in line 4 to obtain the net depreciation shown in line 8. The net depreciation in Group 1 consists of write-ups in book value above cost and premiums not properly amortized.

The net appraised value obtained in line 7 and the net depreciation shown in line 8 are carried into the adjusted balance sheet and the classifications in the following manner:

Net appraised value of Group 1 is placed in Classification I;
Net appraised values of Groups 2, 3, and 4 are placed in Classification II;
Net depreciation in Group 2 is placed in Classification III;
Net depreciation in Groups 1, 3, and 4 is placed in Classification IV.

The analysis of the assets of the banks is shown in Table 40. The examiners' deductions consist of the total of Classification IV and 50 percent of the total of Classification III. The examiners' evaluation of assets not on the books is added. The "not criticized" adjusted value of assets is the total of Classification I. The adjusted value of substandard assets consists of the total of Classification II, 50 percent of the total of Classification III, and values not on the books.

TABLE 40.—ANALYSIS OF ASSETS UNDER THE UNIFORM EXAMINATION PROCEDURE ADOPTED IN 1938: 7,094 INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

[In thousands of dollars]

	Total assets	Type of asset			
		Cash and due from banks	Securities [1]	Loans, discounts, and overdrafts	Miscellaneous assets
Examiners' classifications of book value:					
I	6,022,149	1,510,265	2,183,354	2,178,117	150,413
II	875,368		273,972	370,640	230,756
III—50 percent to be deducted	33,904		17,646	14,702	1,556
IV—100 percent to be deducted	94,067		22,991	37,510	33,566
Total (net) book value	7,025,488	1,510,265	2,497,963	2,600,969	416,291
Examiners' adjustments:					
50 percent of classification III	[2] −16,969		−8,823	−7,351	[2] −795
100 percent of classification IV	−94,067		−22,991	−37,510	−33,566
Determinable sound banking values not on books	+3,406		+1,206	+488	+1,712
Examiners' net deductions	−107,630		−30,608	−44,373	−32,649
Adjusted value of assets—total	6,917,858	1,510,265	2,467,355	2,556,596	383,642
Not criticized [3]	6,022,149	1,510,265	2,183,354	2,178,117	150,413
Substandard [4]	895,709		284,001	378,479	233,229

[1] See table 39.
[2] Difference of $17,000 is due to rounding of figures of individual banks.
[3] All assets in classification I.
[4] All assets in classification II, ½ of those in classification III, and items not on books.

The analyis of the capital accounts is shown in Table 41. The addition of $3,406,000 corresponds with the items not on books shown in the previous table. The deductions consist of the same deductions used in obtaining the adjusted value of assets, plus the amount of liabilities which are not shown on books but are determined by the examiner to exist. For the insured commercial State

banks not members of the Federal Reserves System examined during 1938, examiners' net deductions amounted to $111,092,000, leaving an adjusted capital account of $883,582,000.

TABLE 41.—ANALYSIS OF CAPITAL ACCOUNTS UNDER THE UNIFORM EXAMINATION PROCEDURE ADOPTED IN 1938:[1] 7,094 INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

[In thousands of dollars]

Total capital accounts—book value	994,674
Addition: Determinable sound banking values not on books	3,406
Deductions:	
50 percent of classification III of total assets	16,969
Classification IV of total assets	94,067
Determinable liabilities not on books	3,462
Total	114,498
Examiners' net deductions	111,092
Adjusted capital account	883,582

[1] For determination of adjusted capital account under the original procedure, see table 36, p. 337.

REVISION IN BANK EXAMINATION PROCEDURE

JOINT STATEMENT OF THE COMPTROLLER OF THE CURRENCY, THE FEDERAL DEPOSIT INSURANCE CORPORATION, THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, AND THE EXECUTIVE COMMITTEE OF THE NATIONAL ASSOCIATION OF SUPERVISORS OF STATE BANKS[1]

The Comptroller of the Currency, The Federal Deposit Insurance Corporation, The Board of Governors of the Federal Reserve System, and the Executive Committee of the National Association of Supervisors of State Banks have adopted minor changes in the bank examination and reporting procedure which has been followed by the supervisory agencies since July, 1938.

The revision provides for abandonment of the use of Roman numerals II, III and IV in the examiners' classification of bank assets, and substitution of the terms "substandard", "doubtful", and "loss", and for discontinuance of the practice of appraising Group 2 securities on the basis of the 18-months average of market value. Such securities will be appraised at current market value.

There will be no change with respect to evaluation of U.S. Government and other Group 1 (investment quality) securities. This policy is intended to apply to recognized sound investment practices of banks, and is not intended to apply to undue concentrations in securities other than U.S. Government issues, nor to other cases where the condition of the portfolio requires special treatment by the supervisory agency or agencies concerned.

The revision involves no fundamental change in the present procedure nor does it signify any intention on the part of the supervisory authorities to become more severe in the classification of bank assets. Its purpose is clarification and simplification of procedure in the interest of more uniform applcation. It also recognizes the fact that use of the 18-months average price for Group 2 securities is no longer of practical significance since the banks of the country have only a nominal investment in such securities.

BANK EXAMINATION PROCEDURE A: REVISED JULY 15, 1949

THE CLASSIFICATION OF ASSETS IN BANK EXAMINATION

The present captions of the classification units, namely, "I", "II", "III" and "IV" are to be abandoned.

The classification units hereafter will be designated as "Substandard", "Doubtful" and "Loss". The term "Substandard" will be defined as follows:

Book assets or portions thereof not classified as doubtful or loss and which involve more than a normal risk due to the financial condition of unfavorable record of the obligor, insufficiency of security, or other factors noted in the examiner's comments. These assets should be given special and corrective atten-

[1] Released for morning papers of July 15, 1949.

tion, for example, by obtaining suitable reductions in amount, additional security, more complete financial data concerning the obligor's condition, or other such action as the specific circumstances may require.

Present practice will be continued under which the totals of the three classifications are included in the recapitulation or summary of examiners' classifications.

Fifty percent of the total of "Doubtful" and all of "Loss" will be deducted in computing the net sound capital of the bank. Amounts classified "Loss" should be promptly charged off.

THE APPRAISAL OF BONDS IN BANK EXAMINATIONS

Neither appreciation nor depreciation in Group I securities will be taken into account in figuring net sound capital of the bank. However, this policy is intended to apply to recognized sound investment practices of banks, and is not intended to apply to undue concentrations in securities other than U.S. Government issues, nor to other cases where the condition of the portfolio requires special treatment by the supervisory agency or agencies concerned.

Group I securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group includes general market obligations in the four highest grades and unrated securities of equivalent value.

The securities in Group II will be valued at the market price and fifty per cent of the net depreciation will be deducted in computing the net sound capital.

Group II securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes general market obligations in grades below the four highest, and unrated securities of equivalent value.

Present practice will be continued under which net depreciation in the securities in Group III and Group IV are classified as loss.

Group III securities: Securities in default.

Group IV securities: Stocks.

Present practice will be continued under which premiums on securities purchased at a premium must be amortized.

Present practice of listing securities and showing their book value will be continued.

Present practice will be continued under which the establishment and maintenance of adequate reserves, including reserves against the securities account, are encouraged.

Present practice will be continued under which speculation in securities is criticized and penalized.

THE TREATMENT OF SECURITIES PROFITS IN BANK EXAMINATIONS

Until losses have been written off and adequate reserves established, the use of profits from the sale of securities for any purpose other than those, will not be approved.

Chairman PATMAN. Thank you very much, sir.

Mr. Sherrill, we are glad to have you. You may present your testimony in any way you choose to do so. If there is anything further you wish to submit later, you may do so

STATEMENT OF HON. WILLIAM W. SHERRILL, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. SHERRILL. Thank you, Mr. Chairman.

In response to your invitation, I have prepared a statement to submit for the record. There are four major points in it that I would like now to review briefly, if I might.

Chairman PATMAN. You may, sir.

Mr. SHERRILL. Those four points are:

1. The importance of commercial banks as investors in State and local obligations;

2. The impact of varying credit conditions on State and local finance;
3. What can be done to lessen the sensitivity of this sector to changing credit conditions and generally improve the market for these obligations; and
4. The influence of bank examinations and bond ratings on bank participation in the tax-exempt market.

Commercial Banks as a Source of Funds for State and Local Securities

Among all the major financial institutions, commercial banks have the greatest incentive to acquire tax-exempt State and local bonds. Taking the entire period since the end of World War II, commercial banks have been the major provider of credit to State and local governments, acquiring about 45 percent of the net increase in such obligations. The most rapid increase in bank holdings of State and local bonds has occurred since 1960.

In part, this acceleration was due to enlarged time and savings deposit inflows and a generally stimulative monetary policy through most of the period. It reflected also the fact that such securities constituted one of the more profitable uses during this period when business loan demands were relatively modest.

From the end of 1960 to the end of 1965 banks allocated about 20 percent of the growth in their earning assets to tax-exempt issues. Commercial banks increased their holdings of State and local obligations from 8 percent to 12.5 percent of their total loans and investments, and the share of all outstanding municipal bonds in bank portfolios rose from 25.6 percent to 38.5 percent over these years.

During the 5-year period of 1961 through 1965, commercial banks financed well over two-thirds of the net increase in State and local government obligations. Their share of all outstanding municipal securities rose from 25 to 38 percent.

As bank customers stepped up their credit demands in 1966—and monetary policy became more restrictive—banks cut back their rate of acquisitions of municipal bonds, acquiring an amount equal to about 40 percent of new issues. In 1967, as loan demands eased and monetary policy became more expansive, banks again accelerated their purchases of State and local securities, acquiring an amount equal to over 80 percent of that year's new issues and allocating one-fourth of their credit extensions to these securities.

Year-to-year variations in bank participation in the municipal bond market, of course, reflect both the shifting demands made upon the resources of commercial banks and changes in the availability of funds to them. Banks—like other lenders—make their investment decisions on the basis of the available supply of funds and both long- and shortrun considerations of business strategy. Normally they prefer loans, where there is a longrun customer relationship, to investment in securities, where there usually is not, particularly when their funds are in limited supply.

Security investments are made partially to provide pools of liquidity and partially for income. When the credit demands of loan customers rise, banks move to accommodate these demands by adjusting their security portfolios. Thus, bank decisions to purchase and hold tax-

exempt bonds are but one component of their longrun investment policy which must balance income and liquidity with service to, and protection of, their depositors.

VULNERABILITY OF STATE AND LOCAL FINANCES TO CREDIT AVAILABILITY

State and local governments, along with other sectors of the economy, have experienced higher costs of borrowing during the past 3 years. These higher yields have been required even while banks were heavy purchasers of State and local bonds in 1967. With large volumes of new debt coming to market, issuers generally have had to attract investors by raising yields. The higher cost of borrowing appears particularly onerous to State and local governments since they finance about half of their capital outlays from the sale of bonds in the capital markets.

The Federal Reserve System has undertaken studies of State and local financing experience on several occasions to determine to what degree public bodies are forced to alter their plans to borrow and to spend because of changing credit conditions and interest rates.

The most recent study focused on the year 1966 when credit markets were experiencing a sustained escalation of rates. While the survey results are not fully tabulated for the nearly 13,000 smaller governmental units that were contacted, they are completed for the 1,000 largest State and local governments. I shall, therefore, focus my remarks on these larger units.

(Remainder of Mr. Sherrill's prepared statement follows testimony, p. 349.)

During 1966, large governmental units reduced their long-term borrowings by approximately $1.4 billion below planned levels. About 80 percent of this decrease, or $1.1 billion, was attributed to high interest rates. But this sizable cutback in long-term borrowings had only a limited impact on contract awards and capital spending. In 1966, large State and local units reduced these by only $100 million because of high borrowing costs. In other words, the great majority of large units reducing or postponing their long-term borrowings were able to proceed with capital expenditure plans in that year.

On the basis of preliminary analysis, it appears that small units were less likely to postpone their long-term borrowing than large units. However, they did find it somewhat more difficult to carry out their expenditure plans in the event they cut back their borrowings. These tentative results suggest a lower degree of financial flexibility on the part of smaller units: few short-term alternatives are open to them if their definitive financing plans go awry.

The difficulties experienced by individual units should not be minimized; but it is evident that in 1966 the bulk of State and local governments were able to realize their expenditure plans by either borrowing long term at higher rates of interest or by using temporary financing arrangements.

In considering the vulnerability of State and local governments to high interest rates, we should not lose sight of the purpose of restrictive monetary policies. They are meant to curtail total spending when limited resources are being sought too vigorously. State and local governments compete with other sectors of the economy for the bricks,

mortar, and human skills that can build houses or office buildings as well as schools and firehouses.

One way they can avoid being squeezed is to time borrowing and construction so that they complement rather than compound the needs of other sectors. State and local governments might also examine their own policies and institutions for features which complicate their financing problems, such as rigid interest rate ceilings and overly restrictive debt and property tax limitations.

Moreover, evidence indicates that borrowing costs are higher for smaller units, partially because they borrow in small amounts which are uneconomical to offer in the national market. Some State governments, taking cognizance of this, have attempted to assist local units through loans, grants, guarantees, and technical advice.

The Federal Government might also assist in alleviating State and local borrowing difficulties. For example, legislation to permit commercial bank underwriting of revenue bonds, supported by the Board of Governors, might somewhat lwer the borrowing costs of such issues by improving competition in the municipal bond market.

Borrowing costs on municipal bonds are already much lower than they otherwise would be because of the exemption of their interest from Federal income taxes. But this implicit subsidy given to State and local governments has been less of a boon in recent years. To attract sufficient funds to municipal bonds, tax-exempt yields have had to rise to a point that makes them attractive to investors in lower and lower marginal tax brackets. Calculations by the U.S. Treasury and others indicate that the foregone tax revenues involved in the present tax-exemption of the interest income of State and local obligations considerably exceed the interest cost savings enjoyed by these units. This has prompted suggestions that the interest income from municipal bonds be made fully taxable, with the consequent increase in the cost of borrowing being offset by a subsidy from the Federal Government.

Bills recently introduced by Representative Patman and Senator Proxmire both propose that the Federal Government subsidize 33 percent of the interest cost on State and local obligations that voluntarily give up their tax-exempt status. Governments would be free to choose between issuing their securities on a tax-exempt basis as they now do, or issuing them on a taxable basis and receiving the subsidy. Clearly, if the cost of borrowing in the tax-exempt market were more than two-thirds that of borrowing in the taxable market, governments would find it most economical on a net-cost basis to borrow in the latter and take the subsidy.

Channeling all or part of the new issues of State and local obligations into the taxable bond market would broaden the range of investor groups potentially attracted to such securities. But it should be realized that additional Federal income tax revenues created by investors shifting into taxable assets might not meet the full cost of such a subsidy.

Another proposed form of Federal Government assistance has been the guaranteeing of debt service on State and local obligations to be financed by insurance fees. Such a proposal would virtually eliminate the default risk to investors on insured obligations and thus eliminate the need for individual bond ratings for such securities. But in

judging the desirability of guarantees it is necessary to consider the costs involved. Funds must be set aside to provide for the contingency that some issues may default. And it should be noted that such federally guaranteed issues would compete with certain forms of Federal borrowing, increasing their interest costs.

As in the proposals of Representative Patman and Senator Proxmire, interest subsidies and guarantees could be used in tandem. The ultimate cost and benefits of a combined program depends jointly on how such securities are accepted into investor portfolios as well as on the extent of their utilization by governmental units. I cannot predict with certainty what the final outcome would be.

Mr. Chairman, in concluding this statement, I would like to make a few remarks about bank examinations and their effect on the portfolios of the smaller commercial banks.

The data banks need to document the credit worthiness of a particular bond issue are generally matters of public record and are readily available. It is the type of information basic to the bank's having made an informed and rational investment decision in the first place. Banks evidently have had little difficulty in substantiating the quality of their municipal holdings; the number of cases where State and local obligations have been criticized—whether they have been nationally rated or not—has been infinitesimal.

But I think that the best evidence that examination procedures and quality of investment requirements have not deterred smaller commercial banks from investing in State and local obligations, especially those of an unrated nature, is found in the magnitude of their holdings of these securities.

A recent survey by the FDIC indicated that on average commercial banks which they examined held a high percentage, about 30 percent, of their State and local obligations in the unrated category. Moreover, the smaller the bank, the higher, on the average was its percentage holdings of the unrated issues. This seems to indicate that far from being regulated away from the unrated market, smaller banks have taken a very strong interest in these securities.

This, of course, is to be expected. The local bank is aware of local needs and conditions and its stake in the community. It is the traditional source of credit for small borrowers, both private and public.

Thank you very much, Mr. Chairman.

(The remainder of Mr. Sherrill's prepared statement follows:)

PREPARED STATEMENT OF WILLIAM W. SHERRILL

* * * * * * *

Of the 983 large State and local units replying to the survey, slightly over one-half stated that they had planned to borrow long-term in 1966. About three-fourths of these carried out their plans fully as intended during that year. The remainder, however, altered either the timing or the amount of their borrowings, and 5 per cent of all respondents completely canceled their long-term borrowing plans for the year. In dollar terms, long-term borrowings were cut back or reduced by $1.4 billion, an amount equal to 22 per cent of the $6.2 billion that large units actually borrowed in 1966. About 80 per cent of $1.1 billion of the cutback were due primarily to interest rate factors.

Although the effects of borrowing changes on expenditures may stretch out through time, the very sizable cutback of long-term borrowing did not have a large immediate impact on the capital spending of large State and local governmental units. In 1966, reduced or postponed contract awards and spending on

projects already underway amounted to only about $100 million. Obviously, the bulk of the shortfalls in long-term borrowing plans did not lead to reductions in contract awards and spending. In about half the cases where there was no impact on expenditures, governments had planned to borrow well in advance of cash needs. In most of the remaining cases, outlays were kept on schedule by running down liquid asset reserves or by borrowing short-term—usually from commercial banks.

We have not completed tabulations of the survey results for the smaller local governmental units, so I can only give approximate information regarding their financing experience. Preliminary analysis seems to indicate that about 360 of the 10,000 respondents abandoned or postponed long-term borrowings that had been planned for 1966. Approximately 170 of these units reduced or postponed their 1966 borrowings because of high interest costs. In contrast to the experience of the large units, however, over one-third of these units found it necessary to cancel or reduce their contract awards in those instances where high interest rates were at least a factor in the deferral of long-term borrowing. While these results are only tentative they do seem to indicate a much lower degree of financial flexibility on the part of these smaller units—fewer short-term alternatives are open to them if their long-term financing plans go awry. They either pay the higher costs of borrowing long-term or they drop the project until more favorable times.

While not minimizing the difficulties faced by individual communities in canceling their construction plans, I do wish to point to the fact that the vast majority of State and local governments, both large and small, were able to go ahead as planned, either by paying more for their long-term borrowings—as other borrowers were required to do—or by borrowing short-term or by dipping into their liquid assets. Evidently, most were reasonably successful in adjusting to financial pressures.

REDUCING THE VULNERABILITY OF STATE AND LOCAL FINANCES

With the 1966 borrowing survey as a background, let us consider some of the actions State and local governments might take to minimize the burdens of high interest rates and reduced credit availability.

First, it is important to remember the basic purpose of restrictive credit policies. They are meant to curtail total spending when limited resources are being sought too vigorously. State and local governments do not draw upon isolated pools of commodities and services. Each unit's demands must be added to those of private enterprise, the Federal Government, and other State and local governments. Each competes for the bricks, mortar, and human skills that can build houses or office buildings as well as schools and firehouses. Thus, it is necessary that some marginal public projects, as in other sectors, be deferred or stretched out during periods of over-heating in the general economy.

One way State and local governments can avoid being squeezed in the financial markets is for them to pay for more expenditures out of current receipts. But these units, caught between pressing demands for public facilities and already heavy tax burdens, would find prolonged pay-as-you-go financing of capital outlays exceedingly difficult.

However, units might time borrowings and construction so that they complement rather than compound the needs of other sectors of the economy. By the same token, many might consider the advantages in the future of accelerating their capital outlay programs during periods of economic slack to take double advantage of both lower borrowing costs and the greater availability of construction resources.

Besides advantageously adjusting their demand for credit and resources to the pressures of the rest of the economy, State and local governments might also examine their own policies and institutions for features which complicate their financing problems. We know that in 1966 units met with delays and perhaps ultimately higher borrowing costs because of interest rate limitations imposed upon them by their own constitutions or legislatures. Rigid interest rate ceilings are but one of many legal obstacles which pervade the organization of State and local governments. Debt and property tax limits which are overly restrictive either have suspended needed public improvements or have been avoided through the use of expensive alternative forms of financing such as the revenue bond. State governments when strapped by limitations on their indebtedness that have become outmoded often must pass the burden of borrowing onto their subdivisions, where it tends to be less secure and therefore more costly.

Evidence indicates that borrowing costs are higher for smaller units, partially because they borrow in small amounts which are uneconomical to offer in the national market. While measures may be taken to improve the competitive position of these small issues, they still represent a low volume, high cost per unit, form of borrowing.

Some State governments have seen fit to lend credit assistance to their local units by giving direct loans, guaranteeing local borrowings, or through extending grants to help defray debt service. Others have made efforts to oversee their subdivisions' borrowing programs and to lend technical advice, thereby improving the marketability of local obligations. Many States, aware that excessive diffusion of local government responsibility and resources can be uneconomical in ways other than the cost of borrowing, are encouraging consolidation of and cooperation among local governments.

None of these efforts, which State and local governments might accomplish for themselves, will insulate them from the burdens of competing for limited funds in times of financial strain. But such measures could help in marshaling their energies and resources to plan ahead for and successfully cope with such times.

The Federal Government might also assist in alleviating State and local borrowing difficulties. For example, legislation to permit commercial bank underwriting of revenue bonds could improve the competition in the municipal bond market and might lower slightly the borrowing costs of such issues. Such legislation is supported by the Board of Governors, as Governor Mitchell testified before the Senate Subcommittee on Financial Institutions last August.

Borrowing costs on municipal bonds are already much lower than they otherwise would be because of the exemption of their interest from Federal income taxes. This feature makes these securities most attractive to those investors in the higher tax brackets—like high income individuals, as well as to the more heavily taxed financial institutions, such as commercial banks and fire and casualty insurance companies. Thus State and local governments do not have to compete on the same basis with other issuers of debt obligations, the interest income from which is fully taxable.

This implicit subsidy given to State and local governments has been less of a boon to these governments in recent years as the volume of new tax-exempt issues has exceeded the volume of funds available from investors in the highest tax brackets. In order, therefore, to attract additional investors to municipal bonds, tax-exempt yields have had to rise relative to yields on taxable securities to a point that makes them attractive to investors in lower and lower marginal tax brackets. For example, over the last decade it appears that investors in marginal tax brackets between 20 per cent and 30 per cent have had to be drawn into this market in order to meet the demands for funds by State and local governments.

Calculations by the U.S. Treasury and others indicate that the tax revenues foregone because of the present tax-exemption of the interest income of State and local obligations considerably exceed the interest cost savings enjoyed by these units. This has prompted suggestions that the interest income from municipal bonds be made fully taxable. Since such obligations no doubt would carry higher yields than is today the case, it has been suggested further than the increase in the cost of borrowing be offset by a subsidy from the Federal government. The extent to which such a subsidy plan might lower the net cost of borrowing for State and local governments and increase the revenues of the Treasury depends directly on its design. And it must be recognized that the demands of investors in particular are fluid and that their portfolios are flexible as they pursue their investment objectives. Therefore, any calculation of future tax revenues gained and subsidy payments needed if State and local securities were to be made taxable depends on a wide range of variables including the way in which markets adjust ultimately to the changed capital market environment.

Bills recently introduced by Representative Patman, H.R. 15991, and Senator Proxmire, S. 3170, propose that the Federal government subsidize 33 per cent of the interest cost on State and local obligations that voluntarily give up their tax-exempt status. Issuing governments would therefore be free to choose between issuing their securities on a tax-exempt basis as they now do, or issuing them on a taxable basis and receiving the subsidy. Governments will choose the alternative that is cheapest for them after comparing the interest cost of issuing their securities under the two alternatives. Clearly, if the cost of borrowing in the taxable market is more than half again that of borrowing in the tax-exempt market, they will find it most economical on a net-cost basis to

borrow in the former and forget the subsidy. On the other hand, should the ratio of the tax-exempt to taxable bond yields rise above 0.67, governments will find it less expensive to issue taxable bonds and take the subsidy.

Those investors above approximately a 33 per cent marginal income tax bracket would still find it advantageous to hold tax-exempt bonds so long as the ratio of yields on tax-exempts to alternative taxable securities remains at or above .67. On an after-tax basis they will be earning more on the tax-free income than if they had invested an equivalent amount in similar obligations the interest income of which is taxable.

Generally speaking, the ratio of yields on tax-exempt and taxable bonds in the market will depend on the demand for and supply of existing stocks of obligations. The change in the stock of tax-exempt bonds will be determined in part by the decisions of the issuing authorities between tax-exempt and taxable securities. As long as the total outstanding stock of tax-exempts exceeds the holdings desired by investors in the greater than 33 per cent marginal tax-bracket, the ratio of yields will exceed .67. But over time there will be a downward pressure on the ratio of yields. Communities will issue taxable securities and take the subsidy, and investors will bid up the prices for outstanding tax-exempt bonds as the supply of new tax-exempt issues tapers off. The ratio of tax-exempt to taxable yields will most likely tend to settle down to approximately .67. This is a problem in dynamic adjustment—it would take time to work itself out and just how long it would take, I do not know.

Channeling all or part of the new issues of State and local obligations into the taxable bond market will of course broaden the range of investor groups potentially attracted to State and local obligations. However, it is not without cost in terms of the subsidy paid by the Federal government. And it should be realized that additional Federal income tax revenues caused by investors shifting into taxable assets might not meet the full cost of such a subsidy, no matter what the extent of its use.

Taking the 33 per cent subsidy plan, as I have just mentioned, investors in the greater than 33 per cent marginal income tax bracket probably will stay in the tax-exempt market. Most investors *below* that tax bracket—as the ratio of tax-exempt to taxable bond yields falls—will shift into taxable investments. But the additional tax payments they make to the Treasury would tend to return less than the added expense of the 33 per cent subsidy. That is, it will cost 33 cents for every dollar's worth of investment income shifted into a taxable category; but the investors most likely to make such a shift will be those who on the average pay less than 33 cents in taxes on each additional dollar of interest income.

Another proposed form of Federal government assistance is the guaranteeing of debt service on State and local obligations to be financed by insurance fees. Such a proposal would virtually eliminate the default risk to investors on insured obligations, make them homogeneous in terms of investment quality (thus eliminating the need for individual bond ratings for such securities), and would enhance their marketability. These may be desirable objectives, but they are not costless. Fees must be collected to provide for the contingency that some issues may default. If the insurance fees are proportionately the same for all issues irrespective of their intrinsic quality, then this implies that governments with relatively stronger credit positions will, in part, carry those with weaker credit standing. And the Federal government would be assuming a large contingent liability, to the extent that the fund built up by the fees does not grow as rapidly as the liability.

It is not clear what the value of such a guarantee would be to issuers. The experience of Public Housing Authority Obligations indicates that such a Federal guarantee reduces the yield demanded by investors by perhaps 20 basis points on the average. Whether this would still be the benefit for guaranteed securities is problematic. Smaller and lower or unrated issues would probably be benefited the most. However, it should be pointed out in passing that increasing the supply of Federally guaranteed issues would no doubt expand the competition for funds for certain forms of Federal borrowing, thus tending to increase their interest costs.

As in the proposals of Representative Patman and Senator Proxmire, interest subsidies and guarantees could be used in tandem. The ultimate cost and benefits of a combined program depends jointly on how such securities are accepted into investor portfolios as well as on the extent of their utilization by governmental units. I cannot predict with certainty what the final outcome would be.

But on balance, it appears that the current proposals would not constitute a revenue bonanza for the Treasury. Indeed, they probably would entail a net

cost to the Federal government, both through the cost of the subsidies as well as in higher direct borrowing costs, since guaranteed taxable State and local obligations would be more competitive with U.S. Governments and agency issues. Such a program of Federal assistance most likely would lower the costs of borrowing for State and local governments, both through direct payment of the subsidy, and indirectly by relieving the volume of borrowing in the tax-exempt market. But it is not at all clear to me that the benefits for the State and local units would be as large as the costs to the Federal government.

BANK EXAMINATIONS AND COMMERCIAL BANK HOLDINGS OF STATE AND LOCAL OBLIGATIONS

Mr. Chairman, in concluding this statement I would like to make a few remarks on bank examinations and their effect on the portfolios of the smaller commercial banks.

The broad objective of bank supervision is the maintenance of a sound banking system. An important part of bank supervision is the examination of bank portfolios which are undertaken for the purpose of protecting the individual depositors and the banking system at large from unwise extensions of credit. In the course of these examinations of loan and investment portfolios, the regulatory agencies are concerned with appraising the general solvency of bank earning assets, including the obligations of State and local units, and not with rating the quality of particular issues. Banks are asked to stand ready to review their reasons for selection of specific holdings if there is any doubt of their credit worthiness—regardless of any bond rating.

The information needed to document the credit worthiness of a particular bond issue—relating to such factors as taxes and receipts, trends in outstanding debt, tax base, and population—are matters of public record and are readily available. It is the type of information basic to the bank's having made an informed and rational investment in the first place. It is the type of information always given in bond prospectuses, and is generally available from dealers selling bonds to the bank. Additionally, many of the holdings of the smaller banks are the obligations of their own local governments or those of the surrounding communities, whose finances they should know well.

It is possible, as has been suggested, that factual data reports prepared by a Federal agency might be useful to investors and, therefore, might improve the marketability of very small issues. But we feel that much of this data used in reaching investment judgments are already available to prospective investors.

It has been the experience of our examiners that the number of cases where bank holdings of State and local obligations have been criticized—whether they have been nationally rated or not—has been infinitesimal. According to the latest data we have (for 1966) less than .01 percent—one ten thousandth—of the total dollar amount of member bank "other security" holdings (made up predominately of municipal bonds) were classified as being below investment quality.

I think that the best evidence that examination procedures and quality of investment requirements have not deterred commercial banks from investing in State and local obligations, especially those of a small and unrated nature, is found in the magnitude of their holdings of these securities. In this respect, the results of a recent survey of the State and local obligations held by insured *nonmember* banks during the period 1960–1964 are helpful. These banks are regularly examined by the FDIC using procedures which, under the various uniform examination agreements, are the same as those employed by the Federal Reserve and the Comptroller of the Currency. We have no reason to believe that results for member banks would be substantially different.

The point I wish to call to your attention is that on average these banks held a high percentage—about 30 percent—of their State and local obligations in the unrated category. At the outside, during the 5-year period 1957 through 1962 unrated bonds accounted for about ⅓ to ¼ of the dollar volume of all tax-exempt issues—general obligations and revenues. Moreover, the smaller the bank, the higher, on the average, was its percentage holdings of the unrated issues. Holdings in the unrated category amounted to well over ½ of all State and local issues for banks with deposits of less than $5 million. This seems to indicate that far from being regulated away from the unrated market, smaller banks have taken a very strong interest in these securities.

This, of course, is to be expected. The local bank is aware of local needs and conditions and its stake in the community. It is the traditional source of credit for small borrowers, both private and public.

COMMERCIAL BANK PARTICIPATION IN MARKET FOR STATE AND LOCAL GOVERNMENT OBLIGATIONS

[Dollar amounts in billions]

	Change in commercial bank holdings of S. & L. Government obligations		Level of commercial bank holdings of S. & L. Government obligations	
	Net change	As percent of total net issue	Level	As percent of total outstanding
Year:				
1950	$1.6	59.2	$8.1	32.8
1951	1.1	57.8	9.2	33.8
1952	1.0	38.4	10.2	34.1
1953	.6	16.2	10.8	31.6
1954	1.8	4.1	12.6	31.8
1955	.1	3.1	12.7	28.3
1956	.2	6.7	12.9	26.1
1957	1.0	22.7	13.9	25.8
1958	2.6	30.0	16.5	28.1
1959	.4	8.9	17.0	26.7
1960	.6	16.7	17.6	25.6
1961	2.8	57.1	20.3	26.9
1962	4.4	88.0	24.8	30.0
1963	5.2	77.6	30.0	34.1
1964	3.6	59.3	33.5	35.7
1965	5.1	67.6	38.6	38.5
1966	2.4	40.0	41.0	39.2
1967	8.5	82.5	49.5	42.2

Source: Board of Governors, Federal Reserve System.

YIELDS ON COMPARABLE MUNICIPAL AND CORPORATE BONDS AND MARGINAL INCOME TAX RATE GIVING EQUIVALENT AFTER-TAX YIELDS, 1950–67

	Annual average yield [1]		Equivalent [2] yield tax bracket 1—[(1)/(2)]
	Municipal bonds (1)	Corporate bonds (2)	
Year:			
1950	1.56	2.62	40
1951	1.61	2.86	44
1952	1.80	2.96	39
1953	2.31	3.20	28
1954	2.04	2.90	30
1955	2.18	3.06	29
1956	2.51	3.36	25
1957	3.10	3.89	20
1958	2.92	3.79	23
1959	3.35	4.38	24
1960	3.26	4.41	26
1961	3.27	4.35	25
1962	3.03	4.33	30
1963	3.06	4.26	28
1964	3.09	4.40	30
1965	3.16	4.49	30
1966	3.67	5.13	28
1967	3.74	5.51	32

[1] Moody's Investor Service, AAA, long-term bonds.
[2] Investors in the calculated marginal income tax bracket earn the same after-tax yield on municipal and corporate bonds of comparable quality.

ANNUAL AVERAGE INTEREST RATE SPREADS BETWEEN PUBLIC HOUSING AUTHORITY AND MUNICIPAL OBLIGATIONS

[In percent]

	(1) 33- to 40-year PHA obligations	(2) 30-year "good grade" municipal	(2)—(1) Interest rate spread
Year:			
1962	3.18	3.42	0.24
1963	3.11	3.36	.25
1964	3.33	3.48	.15
1965	3.31	3.45	.14
1966	3.74	3.99	.25
1967	3.89	4.15	.26
Total [1]	3.45	3.66	.21

[1] Figure is the averaging all observations of given issues.

Source: U.S. Department of Housing and Urban Development; Salomon Brothers & Hutzler, "An Analytical Record of Yields and Yield Scales," pt. II.

HOLDINGS OF STATE AND LOCAL GOVERNMENT OBLIGATIONS BY INSURED NONMEMBER COMMERCIAL BANKS EXAMINED IN 1964, ANALYZED BY SIZE OF BANK

Size of banks by total assets	Total holdings of State and local government obligations	Holdings of unrated issues as a percent of total holdings
Under $1,000,000	$11,000,000	63.8
$1,000,000 to $2,000,000	89,000,000	61.8
$2,000,000 to $5,000,000	559,000,000	50.8
$5,000,000 to $10,000,000	848,000,000	36.7
Over $10,000,000	2,502,000,000	18.8
All sizes	4,009,000,000	28.1

HOLDINGS OF UNRATED OBLIGATIONS AS A PERCENTAGE OF TOTAL HOLDINGS OF STATE AND LOCAL GOVERNMENT ISSUES BY INSURED NONMEMBER COMMERCIAL BANKS EXAMINED, 1960–64 [1]

	Total holdings of State and local government obligations	Holdings of unrated issues as a percent of total holdings
Year:		
1960	$2,881,000,000	31.7
1961	2,912,000,000	31.5
1962	3,158,000,000	30.3
1963	3,466,000,000	29.2
1964	4,009,000,000	28.1

[1] Both tables based on tabulations from Federal Deposit Insurance Corporation examination reports.

THE ADMINISTRATOR OF NATIONAL BANKS,
Washington, July 16, 1968.

Hon. WRIGHT PATMAN,
Chairman, Subcommittee on Economic Progress,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: On Wednesday, I appeared before the Subcommittee on Economic Progress of the Joint Economic Committee and you asked, on page 131 of the transcript, that we furnish for the record what our total Office expenditures are for rating services. The attached chart is self-explanatory in

that it puts the unit cost and total cost to our Office for both fiscal year 1968 and fiscal year 1969.

Sincerely yours,

WILLIAM B. CAMP,
Comptroller of the Currency.

Attachment.

Chairman PATMAN. None of you gentlemen seem to rely on the ratings services. Are Moody's and Standard & Poor the principal ones, Mr. Camp?

Mr. CAMP. Yes, sir, they are.

Chairman PATMAN. What other ones do you sometimes consult?

Mr. CAMP. There is Dun & Bradstreet, from time to time.

Chairman PATMAN. In other words, those three?

Mr. RANDALL. Mr. Chairman, also, the State of North Carolina and the State of South Carolina have rating systems.

Mr. CAMP. Of their own, yes, sir.

Chairman PATMAN. I understood that from testimony yesterday. Now, you do not rely upon either one of them?

Mr. CAMP. Not as overriding or controlling factors; no, sir.

Chairman PATMAN. What is your statement on that?

Mr. RANDALL. That is correct. I concur.

Chairman PATMAN. What is your statement?

Mr. SHERRILL. That is correct.

Chairman PATMAN. I just wonder how much you are paying for all these services that you do not seem to consider of such great importance. Could you tell me, Mr. Comptroller?

Mr. CAMP. I would be glad to. I imagine it is less than $2,000 or $3,000, infinitesimal.

(The following information was subsequently supplied by the Comptroller of the Currency:)

RATING SERVICES COSTS

Publisher and title	Fiscal year 1968, number of copies ordered	Price	Total	Fiscal year 1969, number of copies ordered	Price	Total
Moody's Investor Service (Moody's Bond Record)	20	$18.00	$360.00	15	$18.00	$270.00
Standard & Poor's (Bond Guide)	446	5.00	2,230.00	450	5.48	2,466.00
Standard & Poor's (Stock Guide)	445	5.40	2,403.00	450	5.88	2,646.00
Commercial and Financial Chronical (Bank and Quotation Record)	806	4.00	3,224.00	806	4.00	3,224.00
Moody's (Stock and Bond Survey)	1	215.00	215.00	1	216.00	216.00
Bond Buyer (weekly and daily)	2	96.00		2	96.00	
	1	480.00	672.00	1	480.00	672.00
Financial Publishing Co. (Comprehensive Bond Values)	189	6.75	1,276.00			
Dun & Bradstreet Municipal Credit Report		450.00	450.00		450.00	450.00
Total		1,280.15	10,830.00		1,275.36	9,944.00

Chairman PATMAN. The banks also?

Mr. CAMP. I could not tell you. It would be a tremendous job to get the banks to tell you.

Chairman PATMAN. How much does the FDIC pay out for these services, generally, on an annual basis?

Mr. RANDALL. I would have to check that, Mr. Chairman. I think we have all said that we use them as a supplemental source of information and that they are a valuable source of information and a valuable market check.

Chairman PATMAN. I understand that. That is the reason you pay so much for it, I imagine.

Mr. RANDALL. I do not believe there is a great deal paid, Mr. Chairman.

The Corporation currently is paying about $10,000 per annum to investment rating services for their manuals, booklets, and other literature used by some 1,000 field examiners and the Washington office in evaluating municipal bond portfolios.

Chairman PATMAN. Mr. Sherrill, what about you? Will you furnish that information from the Federal Reserve Board?

Mr. SHERRILL. I will get that information for you.

(The following information was subsequently supplied by the Federal Reserve:)

The Federal Reserve Banks and the Board of Governors spend a total of approximately $17,000 per year on investment advisory services. There is no practical way of determining how much of this expenditure is made for the purpose of "rating" municipal obligations and how much for other purposes. The services include statistical and other information about all types of securities, and this information is used by the research departments as well as other departments of the Reserve Banks and the Board.

Chairman PATMAN. You are duplicating the other agencies, since you cover the national banks, too.

Mr. CAMP. Let me see if I understand you correctly. Do you want Mr. Sherrill and Mr. Randall to solicit the banks?

Chairman PATMAN. No; I want you gentlement to get it yourselves.

Mr. RANDALL. You are talking about the agency cost?

Chairman PATMAN. That is right.

Now, I am rather discouraged by the statements that you gentlemen are making to the effect that it is a great thing for the banks to invest in municipal bonds, tax-exempt securities. That is a great disappointment to me. I consider the banking system as the most lucrative and the greatest franchise that was ever offered to individuals or corporations or an entity in the civilized world. There is no more lucrative franchise than using the Government's credit to buy tax-exempt bonds and pay no taxes on them.

It occurs to me, that concentrating on tax-exempt bonds is bordering on abuse of the use of Government credit by the banks.

A further fact is that the bankers are organized to help the public have a sufficient medium of exchange and money. Now, we desperately need more housing money and at the very time when the banks could be investing in housing paper, they buy tax-exempt bonds instead. That looks to me like a distortion of their proper role. They do not buy any housing bonds that amount to anything.

They do not go into that market, but buy tax exempts.

I have put into the record tables which illustrate these facts. They were made part of the record.

They cover the last several years, 1961–67. They show total holdings of the different investor or institution groups of tax-exempt bonds. Last year, 1967, according to the figures that I have, the net increase of total holdings was $9.5 billion of tax-exempt bonds, and the banks accounted for 94.5 percent of them.

That means almost all the new bonds were taken up by the banks. If they had been going into the housing market and helping the housing market, millions of people would have homes now who do not have

them. I admit it is a fine thing, it is a sweet deal, as you would call it on the street, for the banks to buy these tax-exempt bonds, with the ability to manufacture money, create money, and not have to pay any taxes. But it does not look right in the public interest to me.

The point was made by Mr. Sherrill that he objected to using any of the FDIC money for capital stock of a new concern to guarantee these bonds. I do not think that is a good, valid argument, particularly in view of the fact that the money—$289 million, to the best of my recollection—was furnished by the Federal Reserve and the U.S. Treasury, for the creation of the FDIC, and you, the FDIC, lacked by about $80 million of paying it all back.

There is a subsidy of over $80 million since 1946, I believe the year was, which has never been repaid, and the interest on it up to now would be probably $83 million or more.

Mr. RANDALL. Mr. Chairman, we paid back as much as the Congress allowed us to pay.

Chairman PATMAN. Certainly, you insisted on it. In other words, you had Government bonds. You took the money we let you have and bought Government bonds with it, and the Government bonds paid a certain percent interest, say, 2.5 percent, which was the going rate at about that time. You collected that annually. But in paying back your initial capitalization, you did not pay back all of it; you just paid back a part of it, the major part, if history is correct. But you lacked about $80 million.

I figured this out one time with an FDIC witness—their answer is a matter of public record. They admitted, the person holding the place that you are occupying right now admitted, that it was a subsidy amounting to about what I said at that time—I shall put it in the record—about $80 million that has never been paid back yet.

Of course, as you say, you settled for less than that, but that does not keep it from being a subsidy, Mr. Randall. Although you persuaded the committee to let you pay a lot less, it is still a subsidy in your organization.

Mr. RANDALL. Mr. Chairman, I think this has been reviewed before, as you know. The bill was settled with the Federal Reserve on the highest terms that the Congress allowed. I am familiar with your calculation, but I do not believe that the rest of the committee or the Congress agreed with you, sir.

Chairman PATMAN. It is not a matter of terms. We knew exactly how much it was. I made the people figure it out right before us in the committee, how much they had gotten from the Federal Reserve through our efforts in appropriating the money. It was money belonging to the Government anyway, and then how much interest you received, and you just failed to pay back about that much.

Now, as to whether or not you got an agreement out of the committee that you would not pay it, I do not dispute that. But I do insist that you have a big subsidy in the FDIC now, and if you want to pay that back, it would be a good time to do it, because the Treasury desperately needs that money. You are solvent in your organization all the time.

Mr. RANDALL. We are solvent and if the Congress in its wisdom wanted to produce such legislation, I am certain we could meet the bill.

Chairman PATMAN. You would do what?

Mr. RANDALL. Meet the bill.

Chairman PATMAN. I know you could, because you have done pretty well on this. At one-twelfth of 1 percent, which is the amount you are paid and you got an offer from us on it, you got written into the law an offset. You had to offset that change some way and you got the Congress to write into the law at one stage or another, going through both Houses, that it would be unlawful to pay interest on demand deposits. That saved the commercial banks from $3 to $10 billion a year interest, because they get the free use of all those demand deposits, because they had to pay that one-twelfth of 1 percent. So they got a pretty good deal on that.

Now, it is my understanding that Senator Proxmire will be able to stay on after I have to leave, and conduct the hearings as long as he can. I appreciate you gentlemen being here and available to answer questions.

Now, I yield to Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Sherrill, you say, in discussing the so-called Patman-Proxmire proposal for municipalities, that indeed, it probably would entail a net cost to the Federal Government, both through the cost of the subsidies, as well as in higher direct borrowing costs, since guaranteed taxable State and local obligations would be more competitive with U.S. Government and agency issues.

I disagree and here is why: We calculated the marginal tax rate for those investing in municipals is 42 percent. So, if you have $1 billion of tax exempt interest income the Treasury forgoes $420 million of revenue.

Now, instead of the Treasury losing that, our measure provides a 33⅓ subsidy to the municipalities issuing taxable bonds. Instead of foregoing $420 million, they would be paying out $333 million for a net gain, an increase in Treasury revenues of about $87 to 90 million.

So, it is difficult for me to understand your reasoning that there would be a Treasury loss, except that you would argue that there will be more competition for available funds in the taxable capital market, inasmuch as the municipalities would then compete, because there was a Government guarantee. They would compete with the Federal obligations.

The other part of your argument, which is that only those whose income tax is 33⅓ percent or above would stay in tax exempts does not seem to me to cut much ice, because that is the entire market for municipal obligations today. Last year, 90 percent or so of these securities were sold to banks, a great proportion, at least. They are certainly overwhelmingly in the higher tax bracket; the individuals who invest, that is, those who invest in municipalities now, are in the higher tax brackets, either that or they are out of their minds.

It is ridiculous to invest in these tax-exempt obligations if you are not in the higher tax brackets.

So I cannot see any solid basis for your argument that the Treasury is going to have a net cost instead of a net gain.

Mr. SHERRILL. Senator, the basis of it is the difference in judgment on which bracket of marginal taxpayer would be involved. As you say,

your calculation rests on the 42-percent marginal tax bracket. Certainly, if that is so, there would not be a cost to the Government.

Senator PROXMIRE. That is the Treasury figure that we accepted?

Mr. SHERRILL. Yes, sir; and we came with our studies to a conclusion that it is more likely to attract a marginal tax bracket on the order of the 20 percent margin.

Now, since this is a very fundamental judgmental factor——

Senator PROXMIRE. You say it is more likely to attract a marginal tax bracket of 20 percent? You mean, people whose income tax bracket is 20 percent of their income would be inclined to invest in municipal bonds today?

Mr. SHERRILL. This would be a break even if they had a choice of which way to go between taxable and tax-exempt municipals.

Senator PROXMIRE. It certainly is not now, as a matter of fact?

Mr. SHERRILL. No, it is not today because they have no choice.

Senator PROXMIRE. They would not be investing in municipals now?

Mr. SHERRILL. They cannot invest in either an exempt or nonexempt. They do not have the security before them in both forms, which they would have under the plan.

Senator PROXMIRE. As a matter of fact, would you question the Treasury's estimate that 42 percent is the present average tax bracket of those who invest in municipals?

Mr. SHERRILL. No, I think that is a calculation on the present average. Our calculation would be on the marginal investor as opposed to the average investor. It would be under the new circumstance.

Now, what I would like to do, Senator, on this point, because I think it is very critical to this decision, is supply you with the calculations that we made and with the assumptions that went into the calculations and ask you to take a look at it and see what you think of it.

(The following material was subsequently supplied by Mr. Sherrill:)

AN ANALYSIS OF THE COST AND REVENUE IMPLICATIONS OF THE STATE AND LOCAL BORROWING SUBSIDY PLANS FOUND IN H.R. 15991 AND S. 3170

The interest subsidy plans contained in H.R. 15991 and S. 3170 involve the subsidizing of 33 per cent of the interest cost burden for State and local government units which choose to issue their securities on a taxable basis and receive the subsidy, rather than retain a tax-exempt status for their obligations. It has been argued that the cost of this subsidy would be more than offset by increased revenue collections arising from the taxation of the interest income of these securities.

For reasons set forth below and summarized in the accompanying algebraic analysis, this very well might not be the case: in fact, it appears quite possible that there would be a net cost involved with the increase in tax revenues not covering the full amount of the subsidy.

Clearly, the absolute amounts of both the subsidy and the new tax revenue will be figured on the same volume of bonds; that is, only those bonds producing a tax revenue are eligible for the subsidy. Thus, the size of the net return to the Federal Government after the payment of the subsidy depends solely on the differential between the average of marginal income tax rates of the taxable bond purchasers and the subsidy rate (33%).

The market for State and local government securities follows rather closely that of a classically competitive commodity. On the supply side of the market, investors want to maximize their return and will choose the security which provides them with the highest after-tax yield, given comparable liquidity and risk characteristics. The net yield differential between tax-exempt and taxable securities to the investor will depend on his marginal tax bracket. Given the supply of taxable and nontaxable securities of comparable characteristics, the ratio of their yields will be determined by the value of the tax exemption to the marginal

investor who, in making his purchase, assures that the market is cleared. That is to say, investors will purchase tax-exempt bonds until, for the marginal investor, the yield from the tax-exempt bond equals the after-tax yield of the taxable security.

Dynamically, as the supply of tax-exempts expands, and the demand of the highest bracket taxpayers are fulfilled, the marginal buyers of the tax-exempts must be attracted from lower and lower tax brackets in order that the supply be fully absorbed. Table 1 illustrates these ideas using the ration of yields between corporate and municipal bonds of highest quality as of December 1967. In this table are given the various major investor groups and approximations of their marginal tax brackets. Note that the yields on the two securities equated at the 25 per cent bracket; that is, investors in this bracket were receiving the same after-tax yield on corporate bonds, which are taxable, and on municipals. Of course, investors with varying objectives and attitudes toward risk may be comparing municipals and other types of securities, and the ratio of yields and the applied tax rate of the marginal investor may vary accordingly. But the point is that the higher the relative market yield on municipals, the lower the tax bracket in which investors will find tax-exempts an attractive investment.

The government units will display similar behavior with the objective of minimizing the cost of borrowing. They will issue taxable bonds until the yield on the tax-exempt obligations is equivalent to the net interest cost to them, after the subsidy, of the taxable issues.

In accordance with national behavior, it has been assumed thus far that investors will buy taxable securities until after-tax yields on taxable and tax-exempts are equated to the income tax rate of the marginal investor; also, State and local government units will offer taxable obligations until the interest cost burdens of both taxables and tax-exempts are equated by the subsidy rate. For the market to be cleared, then, the marginal income tax rate of the marginal holder will equal the subsidy rate. But this means that the determinant of Federal Government net revenues can be restated as the differential between the tax rate of the *marginal* holder and the *average* tax rate of all investors in those State and local issues which are now taxable. This differential represents the crux of the cost-revenue problem.

If the subsidy rate is to be 33 per cent, then that figure will also be the marginal income tax rate of the marginal investor. The crucial fact is that the average income tax rate of all those investors now opting to purchase taxable securities rather than tax-exempt probably will be less than 33 per cent.[1] This, in turn, means that tax revenues from taxable securities will, on the average, be less than the subsidies paid to support these issues. This implies a Federal Government deficit for any such program.

The problems with the subsidy plan toward which this analysis is directed must be made clear. The Treasury estimate of the present cost of the subsidy is predicated on the assumption that the tax-exempt feature would be lifted from all new issues of State and local government securities; that these securities would experience an interest rate increase; and that this new interest income figure would be fully taxable at an average marginal tax rate, given the present structure of tax-exempt holdings. However, neither of the current proposals would produce such a result. There would continue to be a large stock of outstanding tax-exempt obligations. Hence, even if every new issue were to opt for the subsidy plan, it would take many years before the current stock of tax-exempts would be retired. In the interim, those with the highest tax brackets would find it prudent to continue to hold tax-exempts and to bid up prices accordingly.

But, more importantly, the stock of tax-exempts will never be completely retired. The fact that the choice between the subsidy and use of the traditional tax-exempt market is one made voluntarily by the communities, guarantees that

[1] A decline in the relative advantage of tax-exempt issues to taxables might lead some holders in tax brackets higher than 33 percent to shift out of tax-exempts as well, for portfolio reasons other than those found in a simple comparison of after-tax yields. But it is unlikely that they would purchase taxable bonds as an alternative investment. They would be more inclined to shift into equities or some other form of investment which offers tax-shelter. A likely situation is that they would purchase common stock in hopes of capital gains, paying only a maximum of 25 percent tax on these when they are realized. These purchases would most likely replace investments by those to whom the capital gains possibilities are not so attractive from a tax standpoint. The latter group consists of the lower bracket individuals and institutions which on balance would replace their stock holdings (or acquisitions) with purchases of the taxable bonds. See David H. Ott and Allan H. Meltzer, *Federal Tax Treatment of State and Local Securities* (Brookings: Washington, D.C., 1963), pp. 73, 120–122.

there will continue to be a stock of tax-exempts as long as there continue to be taxpayers in the 33 per cent plus marginal tax brackets. It is argued that, with higher bracket investors bidding up the price of tax-exempts, many communities will not take the subsidy and will choose to market their bonds in the conventional manner once the ratio of tax-exempt to taxable yields falls below the .67 ratio.

Our conclusion is that, barring any substantial change in the tax structure or in investor behavior, the plan to subsidize State and local obligations, subject to a tax on the interest income of investors, very likely will not generate enough tax revenues to cover the subsidies.

TABLE 1.—COMPARISON OF AFTER-TAX YIELDS ON AAA CORPORATE AND STATE AND LOCAL BONDS FOR INVESTORS IN VARIOUS TAX BRACKETS AS OF DECEMBER 1967

[In percent]

Representative investor group	Marginal income tax bracket	Net (after-tax) yield [1]	
		Corporate	Municipal
Top bracket individual	70	1.65	4.15
Corporate bracket (commercial banks, nonlife insurance company, nonfinancial corporations)	48	2.87	4.15
Medium bracket individual	40	3.31	4.15
Low bracket individual	25	4.15	4.15
Low bracket, financial corporation (life insurance company, savings institution)	20–14	4.41–4.74	4.15
Zero tax bracket (pension and retirement funds, Government agencies, foundations)	0	5.51	4.15

[1] Yield on AAA corporate (Moody's) as of December 1967, 5.51 percent. Yield on AAA Municipal (Moody's) as of December 1967, 4.15 percent.

AN ALGEBRAIC ANALYSIS OF THE SUBSIDY AND TAX REVENUE IMPLICATIONS OF A SUBSIDY OF INTEREST COSTS FOR OBLIGATIONS WITH THE ALTERNATIVE OF THEIR BEING ISSUED WITH AND WITHOUT TAXABLE INTEREST INCOME

DEFINITIONS

S—the subsidy paid by the Federal government.
B—bonds issues with taxable interest income (taxable bonds).
T—tax revenue on taxable interest income.
k—the percentage of the taxable bond interest cost that is subsidized (the subsidy rate).
i_t—the yield on taxable bonds.
i_e—the yield on tax-exempt bonds (which are otherwise equivalent to those yielding i_t on a taxable basis).
t_m—the marginal income tax rate of the marginal purchases of taxable bonds.
t_{am}—the average marginal income tax rate of purchasers of taxable bonds.

IDENTITIES

The Amount of the Federal subsidy

(1) $$S = k i_t B$$

The Amount of tax Revenues resulting from taxable bonds

(2) $$T = t_{am} i_t B$$

The Net Return in taxes after the Subsidy

(3) $$T - S = (t_{am} - k) i_t B$$

BEHAVIOR ASSUMPTIONS

Investors will purchase bonds until for the marginal investor, the after-tax yield is equivalent for taxable and tax-exempt bonds:

(4) $$i_e = (1 - t_m) i_t$$

Governments will take the subsidy and issue taxable bonds until the tax-exempt yield is equivalent to the net interest cost to them after the subsidy.

(5) $$i_e=(1-k)i_t$$

CONCLUSION

Therefore, in equilibrium the subsidy rate equals the marginal investor's marginal tax rate.

(6) $$t_m=k$$

Substituting t_m for k in (3) we have

(7) $$T-S=(t_{am}-t_m)i_tB$$

Since in a progressive income tax structure, the marginal tax rate of the marginal taxable bond purchaser will be higher than the average marginal income tax rate for such purchasers, we may reasonably assume that

(8) $$(t_{am}<t_m)$$

which implies for (7) that

(9) $$T-S<0, \text{ or } T<S$$

therefore the additional tax revenue will most likely be less than the amount of the subsidy.

Senator PROXMIRE. It seems to me inconceivable that more than 1 or 2 percent of the investors in obligations today are in the lower tax bracket than 33⅓ percent. I cannot see how the Treasury could suffer a significant loss on that score.

Mr. SHERRILL. Here again, Senator, we seem to find that the present volume of the municipal issuance in the tax-exempt bracket have been attracting persons in the 20-percent ranges, the 20- to 30-percent range, by increasing their yield. This is part of the increased cost in municipal tax, tax-exempt issues, in order to attract lower and lower tax brackets.

Senator PROXMIRE. Well, as we say, the apparent situation is, we are told, that by far the biggest investors are commercial banks, and they are in the 48-percent tax bracket.

Mr. SHERRILL. Yes.

Senator PROXMIRE. It is hard for me to understand how the man who is in a low-income bracket—after all, 20 to 25 percent is pretty low for an investor—will invest very heavily in municipal bonds.

Mr. SHERRILL. This would be his marginal tax dollar as opposed to average.

Senator PROXMIRE. It may be, but at the present time, the Treasury is forgoing, on the basis of their own figures, as I say, on each $1 billion of interest income on municipal issues, $420 million.

Well, let me get to something else here.

Mr. SHERRILL. Yes, sir.

Senator PROXMIRE. Mr. Sherrill, on pages 3 and 4, you argue that although the 1966 tight money cut back State and local long-time borrowing by 22 percent, it had little effect on contract awards, and spending underway. Is that correct?

Mr. SHERRILL. Yes, sir. That is what our studies showed for the thousand largest State and local units.

Senator PROXMIRE. Well, this is a very large proportion of State and local?

Mr. SHERRILL. Yes, it would be.

Senator PROXMIRE. This seemed to me to be a kind of confession of the impotence of monetary policy as far as State and local activity is concerned. Either that, or a terrific lag. You cut back on the issues but you did not have any effect on the spending, and the purpose of monetary restriction, as I understand it, is to reduce the inflationary pressure by reducing the expenditures throughout the economy.

Mr. SHERRILL. Yes, sir. It is an indication of the lag, of course, as one factor. The other factor, though, is the reduction of pressures on financial markets, which was a part of that critical period.

Senator PROXMIRE. Of course, again, it is housing that takes it on the chin. When you have a tight monetary policy, housing seems to be the victim.

Mr. SHERRILL. I think that is well documented.

Senator PROXMIRE. Housing declined, as I understand it, by 30 to 35 percent in a situation like that in 1966—housing starts.

Mr. SHERRILL. That is correct.

Senator PROXMIRE. That is directly in accord?

Mr. SHERRILL. That is correct.

Senator PROXMIRE. Mr. Randall, I would like to ask you, inasmuch as Federal deposit insurance has worked so brilliantly—I think all of us recognize that this is one of the truly great improvements in the last 30 or 40 years in our society—everybody favors it. It has worked very, very well for the banks. Why should it not also work for municipal obligations?

Mr. RANDALL. I think, Senator, that this certainly is one of the dimensions that needs to be studied. The Federal Government has done a great deal of work in the guaranteeing of assets, or in the guaranteeing of operations of various segments of the economy, since the thirties. I think there has been a lot of "plus" activity in this area, and I think your proposal is deserving of a great deal of consideration.

I think I would be opposed to the guarantee of a tax-exempt issue, and I know that the bill you and Chairman Patman presented contains that exclusion. I think it is an idea worthy of consideration, although I must say that this is not my area of expertise and that I am not a well-informed witness regarding the guarantee of things other than bank deposits. But I know it has worked most satisfactorily in the banking area.

Senator PROXMIRE. Any one of you gentlemen may reply to this question who wish to, relating to that.

Would you agree that the fundamental reason for the discrepancy between a BAA rating, for example, and a AAA rating is that the AAA has a far lesser chance of default and that the BAA has maybe a very slight chance, too, but a little bit bigger. This is what you are trying to measure, this is the essence of the quality of the bond rating, that you measure the prospect of default? Is that what we are trying to get at?

Mr. RANDALL. Senator, I think that this area is one that differs as between the bank supervisor and the bond underwriter, or the salesman. I think we look at the top three bands as one segment or dimension for bank acceptability, and those below or not rated take on a different degree of acceptability from our point of view.

Now, BAA is kind of the dividing line, and that is where we increase our activity in looking at the credit itself. Those that are rated in the A's take less verification to qualify them for investment by the bank.

I think the ratings in the upper three bands are more sales aids from our point of view than they are really indications of quality. This is my view. I think they have value as a sales aid and may have value to a banker in trying to work out a balanced portfolio.

Senator PROXMIRE. My time is up, but my point is, and I want to extend this considerably as soon as I get another chance, that the whole difference here, what you are really getting at, is the prospect of default. That is why you have to take a closer look at it.

If there were no prospect of default, you would not have ratings. That is the essence of it; you want to be sure it is going to be paid on time and in full.

Mr. RANDALL. That would be an item we would consider in determining credit quality.

Chairman PATMAN. And outside the speculative issues, there are very, very few defaults. That is correct, is it not?

Mr. RANDALL. I believe that is true.

Chairman PATMAN. Mr. Widnall would you like to question?

Representative WIDNALL. Thank you, Mr. Chairman.

I am just sort of sitting in today. I am not a member of the subcommittee, though I am a member of the full Joint Economic Committee.

I appreciate the opportunity of being in on this discussion, as I think it is extremely important that more light be shed upon the subject matter.

I would like to ask the same question of each of you on bond ratings. Bond ratings are certainly not the only factors taken into account by investors evaluating municipal bond issues. What other factors are considered?

Mr. CAMP. Well, sir, the factors that I enumerated—possibly before you came in; I do not recall—there would be other factors.

Oh, investors. Well, I still say the same factors: the per capita debt, the record of delinquency, the assessed evaluation basis, all of those criteria.

I would also think that in certain tax brackets, tax features would be, naturally, a consideration.

Mr. RANDALL. I think the tax consideration is important. I do not agree with Chairman Patman's view of the "morality" issue. I think the right to purchase a tax-free issue has been clear since the *McCulloch* v. *Maryland* decision, which is an historic decision in this area, and I think that a bank that does not maximize its position profitwise in the utilization of these instruments may be subject to a suit from stockholders for not performing the duty that it has.

But I think a more important issue, and especially in the small bank, in reaching the small municipality, is dedication of the banker to serving the credit needs of that community. We can go into a State like Minnesota, which has a tremendous number of small banks—and we have responsibility for almost 600 banks in the State of Minnesota—and we will not find a rated bond in the entire area because the banks are serving the legitimate credit needs of their own communities and are making certain that those needs are met.

Now, these are not rated securities, but in most cases, we will, through credit analysis, find them to be of investment grade. We think it is a most satisfactory way to finance the local community.

Representative WIDNALL. Mr. Sherrill?

Mr. SHERRILL. One thing the investor looks at, probably the prime thing, is his yield. The bond-rating situation is normally at the initial issue of the bond, and then remains unchanged, so that other than considering its initial sale, the bond rating becomes less important, although it is an important initial indication to the investor of quality.

The investor is interested in the market price, he is interested in the marketability, the resale possibilities; he is interested in the remaining life of the bond. A number of factors of that sort are important to the investor other than the bond rating itself. In the initial phases, of course, where the bond rating is more important, he is still trying to look beyond that bond rating to these future possibilities, because he knows that has to be dealt with after he initially buys.

Representative WIDNALL. How can the municipality improve the attractiveness of the bond issue other than trying to improve the rating? What does the municipality itself do?

Mr. SHERRILL. If you assume the bond rating is a function of the financial safety and viability of the community, then you do the same thing if you are working for a bond rating or just working to improve your ability to float bonds at a lesser cost; that is, to keep the finances of your community in the best possible shape.

Representative WIDNALL. Would either of you care to answer this?

Mr. CAMP. I could not really answer that. There is one facet of this hearing I would like to touch on a bit, though.

Chairman Patman mentioned the housing industry, and we certainly all agree that that is an important segment, one of the most important segments of our economy. But I do not agree with the chairman that banks, by investing in municipal bonds, are neglecting their communities.

Just as people need new shops in a community, they need new schools. When they need new homes, they will have to have sewerage systems to with them. As they need employment in new factories, they need streets and highways. Clearly, public projects are vital to our people, as are private ventures.

It seems to me that this is a natural alliance. When housing is built, they do have to have sewers, and there have to be bond issues floated to support all these public improvements.

It seems to me that the banks ought to be commended for going along with that. It is part of the package. If you built houses and did not have a sewerage system, if you did not have somebody to buy the bonds, where would we be?

Representative WIDNALL. The banks certainly have heavily invested in municipal securities, as shown by the record. One thing that has bothered me a great deal is the broadening of the financial institutions of one kind or another. Originally, they were created for one purpose. They want to broaden their authority and be able to diversify their investments the way the banks do.

The other financial institutions have always opposed the broadening of authority, but they are always seeking more authority for them-

selves and broadening their interests. The one segment of the economy that is constantly being shortchanged is the housing area. I think that at the present time, there has been a tendency in all institutions to try to get out of the housing business so they can be in a more liquid position when there is unsettlement in the financial community, and also as to the stability of the dollar.

To what extent do you think that the large increase in yield on Government securities has affected money going into the housing market? I would like all of you to comment on that.

Mr. CAMP. I would have to have that studied, sir, and give you an answer for the record.

Mr. RANDALL. I think it has been a fundamental issue, Mr. Widnall. I think the impact of monetary pressures that resulted from the inability to have the administration's tax package passed at the time that it should have been passed has increased these problems. Interest rates have increased, and the institutions have moved into other areas to maximize their investment position.

This is a part of our free enterprise system, as I understand it—that institutions we have do maximize their positions. This has been a phenomenon of our free enterprise system.

I think all of us are concerned about housing. I believe, however, that in the present situation, we are unable to insulate one segment of the economy—whether it be municipalities or whether it be housing—from the impact of monetary policy. Perhaps—and we discussed this idea before the House Banking and Currency Committee just a short time ago—one of the better answers would be the development of a direct subsidy for the housing program. This would be a better answer in order to make housing a palatable investment during periods of market constraints through monetary policy.

Representative WIDNALL. Well, of course, that is a part of the purpose of the current housing bill that is pending before the House. We hope we will finally have action on it today. The essential part is the subsidization of the interest rates.

Mr. RANDALL. A liberalizing of the powers of special institutions, such as is proposed by that bill—by increasing or liberalizing their lending powers and authorizing them to invest in other segments of the marketplace—works diametrically in the opposite direction from any program designed to increase housing support.

Representative WIDNALL. This is probably the first housing bill that has included something for everybody in it, so that we will not have such fierce opposition.

My time is up; thank you, gentlemen, and thank you Chairman Patman.

Chairman PATMAN. I want to invite the attention of you gentlemen—I have here the December 1967 municipal bond sales section of the Bond Buyer. In going over this, you will find the smaller towns and communities invariably pay a very high rate. Of course, the very obvious answer is that they are not rated. Although 99.99 percent of them are as good as the finest rated bonds in the country, they do not have any official rating; therefore, they pay a righer rate of interest.

You take for instance here in Alabama, they have to pay up to 5.5 percent on a million and a half dollars. Another place in Alabama paid 5.67 percent on an issue of approximately $1 million.

Then in Alaska, on a $500,000 issue, they paid 5.5 to 5.75 percent.

In California, on a $460,000 issue, they paid 6 percent. They go all the way from 5.5 to 6 percent on all of these small issues of around a million dollars. They are unrated bonds. Now, there is a difference under your rating system. Certain cities and counties got a very favorable rating—if they are rated by the rating agencies like Moody's or Dun & Bradstreet, or Standard & Poor's. But those not rated pay a terrific rate of interest. I think that is very important here.

Of municipal bonds, outside of the West Virginia Turnpike bonds or similar ones, which obviously are speculative bonds, and outside of the industrial development speculative bonds, but just including bonds of States, counties, cities, and municipal subdivisions for schools, roads, purposes like that—what percentage of them would you consider would possibly be bad? Would you want to make a statement on that, Mr. Camp?

Mr. CAMP. Sir, excluding the categories that you enumerated, I would say it is an absolutely infinitesimal group.

I might say I would agree that certainly, in my experience, there is no onus whatsoever attached to an unrated bond. In many, many cases a bond is unrated because a municipality may have had no occasion to ever borrow before. It is sort of like ordering a credit report on you or me. If we have never borrowed before, we are going to come back unrated if we always paid cash.

Chairman PATMAN. That is an argument against ratings, then, because why should you low-rate all these little places?

Mr. CAMP. Let me say, sir, that in most cases, the unrated bond of the sizes you have mentioned here are largely taken up by the local banks, banks within their communities, in many cases they are the banks right across the street from the courthouses and they know the financial picture of the county, in my judgment, and know it better than the rating service.

Chairman PATMAN. You mention the reason that Congress in its wisdom in 1933 made it unlawful for banks to deal with certain revenue bonds of cities, counties and States. That proved unlawful. Then along came your predecessor, Mr. Saxon, who said notwithstanding the law, national banks can do that anyway, did he not?

Mr. CAMP. No, sir, we have never said they can underwrite or deal in revenue bonds.

Chairman PATMAN. I am talking about the revenue bond issues they are trying to legalize now for underwriting purposes.

Mr. CAMP. That is right, we have never permitted underwriting of these bonds. I thing banks should be allowed to do so, however. It is a good thing.

Chairman PATMAN. You permit the banks to buy them, do you not?

Mr. CAMP. We permit them to buy up to their legal limit, but not underwrite them.

Chairman PATMAN. Why do you permit them to buy them at all?

Mr. CAMP. The law does not say they should not, Mr. Chairman. The law clearly says they can purchase these bond up to their legal limit, which is 10 percent of their capital and surplus.

Chairman PATMAN. I am talking about the 1933 act where the practice was so repugnant to decent people that Congress just reacted unanimously and said you cannot underwrite these bonds that way

because you are in collusion with the local officials. As you said a while ago, there is usually just one bank doing it.

Mr. CAMP. Did not you say underwrite, Mr. Patman, rather than buy?

Chairman PATMAN. I am talking about buying.

Mr. CAMP. I do not believe they have ever been prohibited from buying.

Chairman PATMAN. Of course, it precludes underwriting which is buying for somebody else.

Mr. CAMP. They are buying for another account.

Chairman PATMAN. Either way, they are buying the bonds.

Mr. CAMP. If they are buying for their own account, they are not precluded by the statute from doing so, provided they do not go over 10 percent of their capital.

Chairman PATMAN. Can they sell to somebody else?

Mr. CAMP. Of course, this is a free enterprise system.

Chairman PATMAN. I am saying Congress found it so repugnant that Congress passed a provision making it unlawful for the banks to do that. That was one of the most revolting things to come before the Congress.

Mr. CAMP. It is not unlawful now, sir, is it? Do I understand you correctly? It is not unlawful at present.

Chairman PATMAN. They can buy them, but not underwrite them.

Mr. CAMP. That is right, and I think they should be able to underwrite them. I think that would be a great help.

Let me say, if I am not going too far, if you will research the depression, you will find that revenue bonds of certain types—of certain types—held up much better, much better creditwise, than general obligations.

Chairman PATMAN. That is the argument made for it, I know.

Mr. CAMP. Well, it is true.

Chairman PATMAN. Well, we still do not want to permit these banks to go in with the local politicians and rob the people there.

Mr. CAMP. I do not think local politicians rob the people.

Chairman PATMAN. You said one bank just used the——

Mr. CAMP. I do not think they are robbing the people. I say I think they are doing the community a service because they are in touch with the whole economic environment of their community.

Chairman PATMAN. There is no competition and Mr. Randall put his finger right on it in the bill Mr. Proxmire introduced.

You said that in Minnesota, there are about 600 banks. They buy these small bonds and their experience in buying them is just as good as any triple-rated bonds. They have no losses. There are no losses in these things. They are practically nil, just as you said, Mr. Camp.

Therefore, why should we sit idly by and permit people to be burdened with high interest rates, 6 percent on tax-exempt bonds, when there are no losses anyway? We ought to have something there, put them on a parity with the AAA bonds that are no better.

We are falling down in our duty. It is your obligation as the Comptroller of the Currency to make a recomendation to Congress if you do not agree with this. It is yours, Mr. Randall and yours, Mr. Sherrill, to recommend how we should do this if we are not trying the right ap-

proach. Something ought to be done, because people are being robbed, absolutely robbed.

Mr. CAMP. Mr. Chairman, I would say, going back to the depression, that the general obligation bonds, as I said earlier, did not stand up in many cases as well as revenue bonds of certain types. I would say this particulaly applied in those areas where the tax assesor and collector was an elective office.

Mr. RANDALL. Mr. Chairman, I have a proposition that I would like to present to you.

Chairman PATMAN. Wait just a moment on that.

Nearly all of the defaults pointed out in our December hearings were defaults of revenue bonds. That is in the hearings of last December 1967.

All right, Mr. Randall.

Mr. RANDALL. If the tax shelters for savings and loan associations and mutual savings banks were eliminated, the marketability of these issues might well be affected and more savings might accrue to the Treasury than is contemplated by your bill.

Chairman PATMAN. Let me make an observation there. I suspect if the truth were known, we would discover that the savings and loans pay more taxes than the commercial banks. The commercial banks evade more taxes. I should not say they "evade" more taxes. That is something that is much worse than "avoid." But they avoid taxes, Now, the large industrial concerns in the same tax brackets pay 48 percent and the bankers are paying an effective rate of about 32 percent. That is about 16 percent less. Are those figures not approximately correct, Mr. Randall?

Mr. RANDALL. I would have to check them, Mr. Chairman.

Chairman PATMAN. You know, they are pretty low, Some banks pay only 15 percent. Banks have so many ways of avoiding taxes, like buying tax-exempt bonds with the other fellow's money and not paying anything for it.

Mr. CAMP. No, Mr. Chairman.

Mr. RANDALL. As an industry, Mr. Chairman, the net profit brought down by banks is one of the lowest among major industries.

Chairman PATMAN. In every issue of the paper—you can see something from 1 year ago, 2 years ago, 5 years ago—the bankers down South are doing better than the cotton industry. They have it made. They are the only part of our economy that is doing so well all the time. Of course, the obvious answer is that you have such a lucrative franchise from the government which you use to your advantage all the time without reference to the public interest.

Mr. RANDALL. Mr. Chairman, those are net operating earnings figures and not net profit figures. There is a distinct difference. I thing perhaps most of us find net operating earnings an illusion, not a reality.

Chairman PATMAN. Senator Proxmire.

Senator PROXMIRE (presiding). I would like to follow up on the default question I was asking the gentlemen a while ago. I remember we made the point that the real difference between the AAA and BAA and so forth, is that I presume, if you are measuring anything, you are measuring the default or lack of default potentiality.

Mr. RANDALL. Senator, I think the size of the issue is also a factor. Marketability is rather a different thing to analyze, but the fact that a

small issue may be held by one person or by two limits the degree of marketability. A part of price is marketability of the issue.

Senator PROXMIRE. Well, it still goes back to default. The overwhelming majority of the issues that are rated—in fact, we have had a lot of testimony that they rarely rate issues of minimal size, say $600,000 or $700,000. Usually it is a million dollars or up.

Mr. RANDALL. Default, maturity—U.S. Governments do not pull the same rate that agency issues pull, although they supposedly are backed by the full faith and credit of the Government. They do not pull the same rate that PC's pull. So, there is a market determination.

Senator PROXMIRE. Well, the experts on ratings who were here yesterday—they represented Dun & Bradstreet, Moody's, Standard & Poor's—they conceded that the probability of default was at the heart of the rating system, the difference between AAA and BAA. There may be other elements of choice. As you know, they might have bond ratings that are selling at different prices for good reasons.

Mr. RANDALL. Yes.

Senator PROXMIRE. For this reason, it seems to me it is hard to justify what ratings have done to municipal bonds and their cost. We calculate that there have been about $40 billion on the average over the last 20 years of municipal and State bonds outstanding. Now, the difference between the AAA and the other ratings is at least 30 basis points, three-tenths of a percent. You multiply that by the $40 billion and it means a cost to the municipalities of $120 million a year, or $2.4 billion over 20 years, which is a whale of a lot of teachers' salaries, school buildings, and all kinds of local services—fire and police protection and so forth—which these communities have either lost or they have to impose a higher tax on their citizens because of the impact of the ratings.

Because of the fact that there has been a total loss according to the testimony yesterday of exactly $800,000 on rated bonds out of many billions in the last 20 years, one issue out of thousands and thousands of issues, it would seem that the cost is way, way out of proportion to any kind of rational evaluation with the actual risk exposure. Thus the guarantee would serve a most useful purpose in eliminating the necessity for municipalities paying this much of an additional interest and therefore causing this much in additional taxes.

Mr. RANDALL. Senator, I think in essence, though, that you are discussing a marketing problem which I think we all acknowledge. Our problem, as supervisors and as bankers, is not caused by this dimension. We really do not have a problem either in ascertaining credit worthiness or in maintaining a purview of municipal portfolios. From the supervisors' point of view, our relationship with the banks is satisfactory and we have access, through the banks, to this credit information.

Senator PROXMIRE. Mr. Randall, you are the outstanding expert in the country on the impact of Government guarantee or Government insurance for the marketability of investment. People can invest now with assurance up to—what is it—$15,000?

Mr. RANDALL. Yes, sir.

Senator PROXMIRE (continuing). In any bank in the country and know it is 100 percent safe. This has been an element in making the marketability of deposits as fluid as any investment has ever been made in any country.

Mr. RANDALL. Yes, sir.

Senator PROXMIRE. Why would not a guarantee of municipalities which have the obligations or this great record over the last 20 years, with very, very few defaults, and, as a matter of fact, much better than banks in the 1930's—far better. It would seem to me under these circumstances, there is a pretty strong case for providing a similar kind of Federal deposit or Federal municipal bond insurance corporation for municipalities.

Mr. RANDALL. Again, Senator, I do not mean to imply that we have necessarily been objecting to this proposal. If I have implied that, it may be——

Senator PROXMIRE. You have not. I would like to ask you something else, Mr. Randall, because this ties in with—well, you and Mr. Camp, and I guess Mr. Sherrill, too, in response to the chairman's questions.

I would feel strongly that it is perfectly proper for a bank to invest in tax exempts. Why not? You are obeying the law. It makes sense to me. If I were a banker, I would do it. If I were a stockholder, I would complain if my bank did not do it and benefit from it. At the same time, it is up to us, Senators and Congressmen, to decide whether or not this law should be continued.

Mr. RANDALL. Yes, sir.

Senator PROXMIRE. It seems to me that if it is not immoral, it is at least not acceptable that the Government should follow policies that we know will expand greatly the opportunities for tax avoidance like the man who invests $10 million in municipal bonds, enjoys a $500,000 a year, $10,000 a week income, and pays not a nickel of taxes, nothing, while somebody else has to work, and work hard, for a living and pay 20 percent or more of his income in taxes. This to me just does not make any sense and if we can possibly prevent it we should.

Now, it is true that if we simply end that exemption, it would cause great distress and I think it would be wrong and I would be strongly opposed to it.

On the other hand, it seems to me it would be logical for us to try to look for an opportunity for a municipality to have an option, a choice if they wish to do so, to follow an alternative route involving a guarantee, a one-third subsidy, surrender if they wish to do so in a particular issue their tax exempt status, and in doing this, you limit what to me is a loophole—you do not end, but you limit, you reduce over the years a loophole which we recognize as being inequitable. You gentlemen seem to have conceded that it would help municipalities, would broaden the market, would tend to reduce their interest rates. I contend, although there is some disagreement, that it would increase revenues for the Treasury.

Why would there not be some enthusiasm for this? You say you are not necessarily against it, but why cannot you support something that has these benefits?

Mr. Camp?

Mr. CAMP. Senator, I would have to have that studied. I would not want to come up with an affirmative or definitive answer at this time. It does seem to me that if you had a split off on that sort—that is, one section of the bond or municipal market being unguaranteed and tax free as opposed to the proposal that you make, the guaranteed

portion—that is, that which would be taxable—those issues that would be taxable would be very attractive to foundations, tax-free foundations.

Senator PROXMIRE. That is good, is it not?

Mr. CAMP. Well, there are a lot of complaints about tax-free foundations.

Senator PROXMIRE. It should be attractive to everybody. That just broadens the market for it. Looking at it from the standpoint of the property-tax payer——

Mr. CAMP. I am just saying that tax-free issues would likely go to one section and those that would be taxable would largely be taken by the foundations.

Senator PROXMIRE. Yes, but in the first place, as far as the tax-free part is concerned, the return, the rate that would tend to be produced—because after all, if fewer municipalities get into the tax-free area because they have an option which is more attractive, there would be fewer issues and therefore, instead of being able to get a 5-percent return, you would have to get a four or three, or two——

Mr. CAMP. I am saying that would be substantially correct.

Senator PROXMIRE. Now, I cannot see why—I do not necessarily oppose these foundations. I think you have to take them on a case-by-case basis. There is a lot of abuse, but by and large, I think they are providing a fine and useful purpose.

Mr. CAMP. I agree with you, sir. But some do oppose them. I think they have done a very fine job.

Senator PROXMIRE. Well, where the foundation is not serving a public purpose it seems to me that is up to us once again to tighten the law.

Mr. CAMP. Right.

Senator PROXMIRE. I would like to ask also that in view of the relatively narrow market at the present time for municipals—commercial banks, fire and casualty insurance companies, and individuals—I understand there is $570 billion of investment by retirement funds, pension funds, life insurance companies, savings and loan associations, mutual savings banks and so forth, from which municipalities are excluded. That is, they do not invest in municipals. If you broadened the market, this would make it much better.

In view of the concentration of municipal security investment now by commercial banks, does this not make municipalities especially vulnerable to monetary policy that is restrictive? This goes back a little bit to a question we asked before. There may be a lag involved, but nevertheless, there is a vulnerability that is peculiar and unfortunate and could be diminished if we had some option of the kind we are suggesting.

Mr. RANDALL. I think you can only look at the record on that point, Senator. During this period of very constrictive monetary policy, the action by the banks with respect to tax-free municipals has been rather astounding. It may be a substitution factor that is somewhat inherent in their business. I would have to acknowledge the superior wisdom of the Federal Reserve Board, though, in this regard.

Senator PROXMIRE. You say it has been outstanding. Let me give you what the record shows: In 1964, the net change here for bank investments in municipalities was 61.4 percent; in 1965, it was 77.8. Then

came the crunch in 1966 and it was 33.6, a spectacular dropoff. Then in 1967, when the crunch eased, it went back to 90 percent. So it seems that during the crunch, the municipalities were hit hard by monetary policy.

Mr. CAMP. I think, sir, going to bank liquidity, I think that is correct, because in order to fulfill loan commitments already made and of long standing, in many cases, the banks did have to, in order to honor those commitments, sell off some of their municipals.

Senator PROXMIRE. Exactly. Is this not an unfortunate position for the municipalities to be in?

Mr. CAMP. I do not know that it was an unfortunate position for the municipalities. The bonds were already marketed.

Senator PROXMIRE. If they wanted to go into the market in 1966 for very essential public services, they were seriously handicapped.

Mr. CAMP. I would say that is entirely correct. It was also very unfortunate for the banks, because many of them had to take substantial losses.

Senator PROXMIRE. Yes, indeed. I recognize that and it is something we have to be concerned about. But also you would concede the municipalities did suffer?

Mr. CAMP. I would say so, yes.

Senator PROXMIRE. Can you see any objection to the data bank part of this proposal; that is, that we have a Federal agency that brings all this data together, makes it available? It would be self-financing, would not present any cost to the taxpayer, but it would take advantage of the modern techniques. It seems to us that that part of the bill—at least, we hope—I do not know if you are nodding your head that you have an objection, or in approval.

Mr. RANDALL. I presume I have a little expertise in this area, though perhaps not in other fields. We have been developing a data bank involving data on 14,000 insured banks in the country and have been attempting to utilize third-generation computers in this activity. If I magnify the problems that we have had in the last 3 years—and Mr. Sherrill was intimately involved in this project and supervises similar projects in the Federal Reserve—and extend them to some 50,000 to 100,000 municipalities, the technical problems that would be encountered in developing a data bank of this magnitude seem almost incomprehensible. The cost of doing this, of creating the equipment, of reaching into an already tight market for the technical people, of developing a method for gathering data which is very complex—now, we as bank supervisors have a legal basis for gathering data and it still is difficult to gather the data—of putting the data together in a usable format, and of disgorging it at a time needed, is almost beyond possibility. I would estimate——

Senator PROXMIRE. I am impressed by your testimony, because you certainly are well qualified here. But at the same time, after all, what you are telling us is that there is so much information that should be put together that for the Federal Government to try to do it would be at very heavy cost. Yet this is the kind of information we ought to have if we are going to obtain a fair assessment. We now rely on rating agencies. One of the best rating agencies, one of the most highly thought of who testified yesterday, had only nine analysts for analyzing this enormous spectrum, plus five additional people who came in at least on a part-time basis.

You are saying that if the Government uses its resources for computers and so forth to do this, the cost is going to be so enormous. Are you not perhaps overemphasizing the amount of information we would have to get?

Mr. RANDALL. I think there is a difference between the amount of information required for a subjective analysis for a rating based on a few quickly selected items and the amount of information required for what I understand is involved in creation of a data bank, at least for those similar to the ones that have been tried by the Census Department. I think there is a remarkable difference. If we are talking about a data bank of credit information, as I understand from Chairman Patman's opening remarks—not to qualify credit, not to give a rating, but to give descriptive material and a profile of every municipality so that anyone looking at the material can make his own judgment—and if there is to be enough material in the data bank for individual judgments by bankers, by individuals, and by people marketing securities, then, Senator, I think, on the basis of our experience, that the cost to the Federal Government would run someplace between $30 million and $50 million a year.

Senator PROXMIRE. Well, the cost to the Federal Government would be zero, because it would be self-financing. It would charge for this service. However, I think you make a very, very proper point, a very helpful point. You have the experience to make your criticism stand up. We just have to chop the cost down to make it realistic. Obviously, at modest cost we could provide an improvement over what we have now in the rating services. You would agree to that. At the same time, there would not have to be a comprehensive profile of every aspect of a municipality. Clearly with changing developments, that would be expensive and perhaps 99 percent redundant or unnecessary.

Mr. RANDALL. My judgment was based on the chairman's opening remarks yesterday.

Mr. CAMP. Senator, would that envisage just the assembly of the salient information for assessment and judgment by prospective purchasers, or would that be assigning a specific rating? Would that agency assign a specific rating?

Senator PROXMIRE. No, the Federal agency would not rate.

Mr. CAMP. It would be good that they did not.

Senator PROXMIRE. It would just get the information and make it available. We do need a study and you and Mr. Randall have given a very helpful appraisal of it.

I do not think it was asked for the record before. I would like to ask each of you if you would have any objection to the Federal agency providing a guarantee of bonds for municipalities, provided the interest income were taxable?

Mr. CAMP. Sir, I would rather consult others in the Treasury. That is a tax matter. Before I would state a position, I would like to talk to the people in the Treasury.

Mr. RANDALL. I think I would have strong objections if a Federal guarantee were extant as to bonds not taxable.

I would like to make this point. You asked about the guarantee earlier in talking with Mr. Camp. A guarantee by the Federal Government requires a great deal of policing. We exist as a deposit insurance system because we have a body of examiners—both Mr.

Camp's examiners, the Federal Reserve examiners, and our own—that can work with banks. There are approximately 6,000 men in the field constantly making certain that banking standards are at a level of acceptability. Absent this, I do not believe deposit insurance as we know it could exist on the cost standard we have developed in this country. I think policing in this area of municipal bond guarantee is something that has yet to be looked at in depth, Senator, and I think this is the one area in which I would reserve my position as to whether or not I would want to endorse a guarantee program.

Senator PROXMIRE. Certainly there is a terriffic difference between providing deposit insurance for a bank on the one hand and providing a guarantee for municipal obligations. You see, there is a record of 22 years with virtually no defaults—only one default of all that are rated and very, very few defaults except in the part that would not be guaranteed.

Mr. RANDALL. Yes, sir.

Senator PROXMIRE. That is speculative issues. It should be far different from the situation that confronted the banks in the 1930's.

Mr. RANDALL. I agree. I think that the parallel would be much closer to the FHA guaranty of home loans.

Senator PROXMIRE. Right.

Mr. Sherrill?

Mr. SHERRILL. Yes, Senator, the Board has not studied this proposition directly, nor has it taken a position, so I have no official position to put forward on the proposition directly. But I would note from the reflections on this particular study on this matter that it raises two questions in my mind.

One is the cost of the guarantee, and number two would be the feasibility—that is, the amount of savings that this cost would bring about.

You notice attached as one of the appendixes to the statement I submitted, there is a comparison of the public housing obligations which are guaranteed with 20 year good grade municipals, and you will note over the period, 1962 through 1967, that the average interest rate spread has been 21 basis points. So this would give at least a preliminary indication of the value of the guarantee.

Now, this is not at all an exhaustive study on this matter and I perfer to hold a position until we see it in much more depth.

Mr. RANDALL. On those housing bonds, Senator Proxmire, I believe you can also see that where they come from may determine the rate. Those that come from the southern part of the country tend to bring rates as high as a full percentage point above those from other areas just by geography. Yet they are fully guaranteed.

Senator PROXMIRE. It is the small town with unrated issues that cause the problem. That is where you have the big difference in the rate.

Mr. RANDALL. These are the housing bonds, though, Senator.

Senator PROXMIRE. That is on the basis point. It is 100 basis points, 150 basis points—that is, 1 or 1½ percent.

All the testimony, including the Camp testimony this morning, is that including all the small issues that do pay more. You argue that they can go to the local bank across the street from the courthouse. The local bank can lend up to 10 percent of its capital surplus.

Mr. CAMP. Not on the public issues. They can legally buy the entire issue if it is a general obligation.

Senator PROXMIRE. It is limited. It would not be good judgment for a bank to move in and take an entire issue under many circumstances. I think you would agree to that.

Mr. CAMP. I would.

Senator PROXMIRE. Under these circumstances, it is understandable why these small cities with the fine records who have not defaulted have to pay a percentage or a percent and a half more, which is a very heavy cost over the life of the issue.

What do you gentlemen propose be done to eliminate this discriminatory treatment if we do not do something like we have here? Do you have any idea?

Mr. SHERRILL. Senator, I have included several propositions in my testimony. Combining them with State or State financing would help to make the issues larger, because certainly a smaller issue does cause a premium in cost. So combining local issues with——

Senator PROXMIRE. Has this been done to any substantial extent?

Mr. SHERRILL. Not to any substantial extent, but it has been done.

Mr. CAMP. I do not know of it being done. It seems to me it would raise some substantial questions—legal questions.

Senator PROXMIRE. I should think it would raise some very tough questions. Municipalities are kind of like farmers. It is hard to get them together. When you get the two mayors together, they find all kinds of reasons for disagreeing—city councils even more so.

Mr. SHERRILL. Senator, I think that as long as they remain small issues, regardless of the other attributes they have, relative to the same quality of larger issues, there will have to be a larger premium.

Senator PROXMIRE. Unless you have some kind of a guarantee.

Mr. SHERRILL. Even with a guarantee as opposed to other bonds with a guarantee.

Senator PROXMIRE. There may be a difference, but it would not be a difference as big as it is now.

Mr. SHERRILL. That is possible.

Senator PROXMIRE. I should think an eighth of a point or so. I should think anybody would be delighted to invest in East Overshoe bonds if they were guaranteed by the Federal Government. They would not care if it were $50,000, $100,000, $150,000, why not? It would be the same as if I were interested in investing in New York City. They would both be guaranteed.

Mr. SHERRILL. There is the cost of handling the smaller issues. Just the handling costs themselves as far as the major investor is concerned, there is a problem.

Senator PROXMIRE. We have a very difficult problem of heavy population migrations. Many of the Nation's larger cities are being called upon to assume larger welfare and education costs for the poor who reside in the urban areas. A number of these areas have been downgraded on their bonds by the bond rating services, thus aggravating their already serious financial problems. How would you go about alleviating the plight of these cities? By Federal grants, Federal loans, Federal loan guarantees? Any ideas?

Mr. CAMP. I think a combination of those.

I might say also that I think the financial community, particularly the banks, is awakening largely to community development. I think

in today's paper or yesterday's, the Bank of America has just committed $100 million to making loans not of top quality to rehabilitate slums. The Citizens and Southern National Bank of Georgia has done an outstanding job in this area. So I think it is a combination of all—the Government, and an awakening of the responsibility, not only the financial community, but the whole community as to what should be done in these areas.

Senator PROXMIRE. I think that is true and ought to be encouraged. But without giving any indication of where I stand on this controversial proposal, what would you think of a requirement that the national banks be required to invest a certain portion of their assets in municipal securities?

Mr. CAMP. Sir, I can speak very forthrightly on that. I would be against it. I do not think the Government should ever get into the role of managing private enterprise. That is the reason I asked you the question earlier about whether Government would assign a rating to these bonds as opposed to just having the material available.

There are just too many facets to assess management in banks.

Senator PROXMIRE. I think that is right and I would sympathize with that. I have had a little experience with a bank. I worked for J. P. Morgan for $25 a week in 1940 before I got this much more lucrative job. But again, you see, we are in a position where we can wonder whether we should just let nature take its course, if we are going to get this enormously tough problem of the cities solved if we do not have anything like a guarantee. Guarantees seem to me a more conservative approach than grants.

Mr. CAMP. I would agree. I think that is more acceptable than statutorily saying you have to have *x* number of assets in your loans.

Senator PROXMIRE. That is right and certainly, a grant approach is limited.

I would just like to ask you gentlemen one more question: What would happen if your investment regulations were revised so that evaluations from a bond rating service—the top four grades—would no longer be acceptable as justification for holding a particular municipal security qualified as an investment quality security. In other words, if you threw out bond ratings; what would happen?

Mr. CAMP. I do not necessarily believe that anything would happen. We pointed out earlier, we do not rely entirely on bond ratings. Our examiners are expected to make their own evaluations.

Senator PROXMIRE. You say do not rely entirely, but Mr. Randall or you or Mr. Sherrill indicated this was a very useful, helpful supplement.

Mr. CAMP. That is correct. I do not rely on the Washington Post, but I read it and it has certain guidelines for me.

Senator PROXMIRE. Serves as a guideline?

Mr. CAMP. Not altogether. I do read it.

Senator PROXMIRE. Mr. Randall?

Mr. RANDALL. I think it would only result in perhaps the banks' maintaining credit files on their municipals in a little more detail.

Mr. CAMP. That is right.

Senator PROXMIRE. In a lot more detail?

Mr. RANDALL. Not necessarily, sir. For the most part, when banks acquire a portfolio, they establish a credit file. One of the elements

in that credit file may be information from the rating services but that information does not necessarily have to be in the file. If the banks have other material to supplement this information—for instance, they may be dealing with a municipality that has a rated security or the credit file may contain the annual report of the city—then this material would be much more important than the rating as far as we are concerned, in analyzing the credit.

Senator PROXMIRE. Mr. Sherrill?

Mr. SHERRILL. I think it would have little practical effect, Senator. You are talking about removing the instructions to the examiner as opposed to removing the rating totally?

Senator PROXMIRE. Yes.

Mr. SHERRILL. I think an examiner would still notice the rating even without the instructions and as it stands now, he has no right to rely on it. It is possible for the circumstances of a community to change between the time the bond is rated and the time the examiner looks at it. So the examiner cannot rely on that rating for his protection in determining the asset.

Also, the situation in communities will change. For example, a major taxpayer might move, a factory or a plant in some communities, and change the circumstances of the community quite markedly. An examiner has to be aware that those risks exist.

Senator PROXMIRE. Such as Kenosha, Wis., where we have a town of 60,000 and their principal employer by far is American Motors, that employs 12,000 people, many of them from Kenosha. Obviously, if American Motors moved, it would have a very substantial effect.

Mr. CAMP. Right.

I think, Senator, again, on this, if I may emphasize a part of our material which goes out to all national banks. On this subject, the key here is that the responsibility for prudent management of a bank's investment account cannot be delegated to a correspondent, brokerage house, or a rating service. In other words, we expect the directors and the management of that bank to have financial information in their files in support of their investments.

Senator PROXMIRE. Well, gentlemen, I want to thank you very much. You represent the great regulatory agencies for our banks and you have done an excellent job.

I would hope that in the next few weeks, you would give this measure that Congressman Patman and I introduced your consideration. It obviously could be amended and improved in some ways. Any kind of constructive criticism would be very much appreciated. We do think there is some way we can and should reduce the cost to municipalities. We think we can do so with a net benefit to the Treasury. We think there is a loophole here that ought to be reduced if at all possible. At the same time, we want this to remain optional, so if you can see any way that you could either support this or suggest another approach that you think would be more desirable, it would be most helpful. We obviously have a serious problem we must solve.

The subcommittee will stand in adjournment until 10 o'clock tomorrow morning.

(Whereupon, at 12:10 p.m., the committee adjourned, to reconvene Thursday, July 11, 1968, at 10 a.m.)

FINANCING MUNICIPAL FACILITIES

THURSDAY, JULY 11, 1968

Congress of the United States,
Subcommittee on Economic Progress of the
Joint Economic Committee,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman of the subcommittee) presiding.

Present: Representatives Patman and Moorhead; and Senator Proxmire.

Also present: John R. Stark, executive director, and Arnold H. Diamond, economic consultant.

Chairman Patman. The subcommittee will please come to order.

Today is the third day of hearings on municipal finance and municipal bond ratings. Today our focus will be on possible ways of improving the bond rating system. We are fortunate to have with us three highly expert witnesses: Walter H. Tyler, president of W. H. Tyler & Co., Inc.; James F. Reilly, partner in charge of the municipal department, Goodbody & Co.; and Bert A. Betts of Bert A. Betts & Associates.

In the interest of full discussion, we are asking each witness to confine his oral statement to 10 or 15 minutes, with the understanding that he may submit a fuller statement for the record. You may include anything in the record that you think is germane to your arguments.

We shall have Mr. Tyler first.

Mr. Tyler, you may proceed in your own way.

STATEMENT OF WALTER H. TYLER, PRESIDENT, W. H. TYLER & CO., INC.

Mr. Tyler. Chairman Patman, gentlemen of the committee, thank you for inviting me.

My name is Walter H. Tyler. I am president of W. H. Tyler & Co., Inc. By trade, I am a municipal analyst and my hobby is rating municipal bonds. I have devoted nearly 40 years to the trade and roughly 25 to the hobby.

Since I have found it impossible to condense a 40-year experience into a 10-minute statement, I will confine my remarks to the questions you have directed to me and hope that my answers will elicit other questions.

I believe that ratings are more important today than at any time in the past 30 years. While there have been relatively few defaults in the postwar era, this is due in large part to the fact that inflation has tended to cushion the sharp rise in State and local debt.

Debt service has risen from about $1,132 million in 1945 to $7,772 million in 1967 but the ratio of debt service to national income has advanced only from 0.62 percent to 1.20 percent. The latter figure is still well below the 1.45 percent of 1929 and far less than the 3.56 percent of 1933 or even the 1.75 percent of 1940.

However, several factors are at work that could produce a drastic change. First, debt service is now rising much faster than total debt, as the 1.50 percent bonds of the 1940's and the 2.50 percent bonds of the 1950's are being replaced by today's 4.50's and 5's.

Second, while I do not think that 1929 is inevitably followed by 1933, I do not regard a drop of 10 percent or even 20 percent in national income as unthinkable. The latter would leave a ratio well above the 1940 level, and there were a lot of defaults around in 1940.

The function of a rating service is to keep investors out of trouble, not to tell them how they got into it. The time to exercise care in the selection of bonds is before, not after, the difficulties arise.

Also, I think the question bypasses two other thoughts: (1) the fact that, while the number is small, there are $300 million of bonds now in default and another $300 million that could be within a year or so, and (2) the part the rating agencies may have played in inhibiting the issuance of more unsound bonds.

I believe the best features of the existing municipal bond rating systems are (1) they are available; (2) they are understood, at least as far as the end product is concerned; and (3) they are accepted.

There is, and will continue to be, a vital need for a comprehensive low-cost method by which small banks and other investors can avoid the purchase of unsuitable securities.

Within their limitations, and when assigned by competent analysts, the ratings range from good to excellent. Even at their worst, they are better than the alternative, which could be nothing at all.

Even if the older agencies are fully staffed with competent people, however, I still regard their services as inadequate for several reasons:

(1) coverage is much too narrow. Somewhere between 60 and 75 percent of the outstanding issues are unrated.

(2) The rating bands are far too wide, and it is impossible to tell at which end of a band an issue falls, or whether the credit is improving or deteriorating.

(3) Ratings cannot be related to the market and, since there is a strong tendency to concentrate purchases in the highest yielding issues in the preferred rating band, most portfolios are loaded with candidates for down grading.

(4) The present system is horribly wasteful of the limited supply of competent people. Too often a man spends 90 percent of his time as a statistician and 10 percent as an analyst.

(5) Criteria are not well defined, which is frustrating for the analyst and the borrower and makes the training of new analysts extremely difficult.

Two years ago, we left Standard & Poor's to develop a system that would answer these criticisms. We have had such a system in operation for more than 18 months. Samples of our work are attached.

The obvious answer lies in the application of data processing techniques to the great volume of social, economic, and financial informa-

tion on localities compiled and published by various governmental and private agencies.

I doubt that the job can be completely automated, but we have narrowed the value judgment area down to about 10 percent.

We start with the ratio of per capita debt—net direct and overlapping including a share of State debt—to per capita wealth. We then make adjustments for somewhere between 25 and 30 factors, subtracting points where conditions are better than the national average or some other norm or adding points where they are worse than average.

Since there is always the possibility of error in published material, we try to minimize the impact by using many factors with relatively low weights and by utilizing several sources wherever we can. We can spot a problem in almost every case.

Our rating is expressed in numerical terms ranging from 00—best—to about 100. This eleminates the wide band problem. It also makes it possible to spot the slightest change and to locate the issue with precision. We can relate the bonds to the market and determine which are attractively priced in relation to their quality.

It takes years to train an analyst competent to make the value judgments required under the old system. We can train a clerk to take the figures from column A, divide them by the figures from column B, add the results to the figures in column C and transcribe the result to column D in about the time it takes to describe the operation. Moreover, low weights and by utilizing several sources wherever we can. We can do a better job.

As neither our budget nor our volume indicates computerization, we are still in the clerk and lead pencil stage, but we can automate the major part of the job on a moment's notice.

Our factors fall into five groups: (1) Stability, (2) growth, (3) intangibles, (4) management, and (5) legal.

Stability factors include the size of the community and the county or metropolitan area in which it is located, diversification, unemployment, employment in education and public administration, and college enrollment. Weights are generally from plus two to minus two, although they may be higher in some cases.

Growth factors include 5-year retail sales and income trends, long and short population trends and long and short payroll trends. Again, weights generally range from plus two to minus two.

Intangibles are military and nonwhite population, income distribution, education, sound housing, and any other factors the analyst may care to include—large utility plants, and so forth. The range may go as high as plus four to minus four in some cases, but these are rare.

Management factors include the maturity schedule, current operations, tax collections and—when available and pertinent—plant condition, planning, reporting, revenue exploitation, future requirements, and special considerations. In most cases, these are in the plus two to minus two range, but may run much higher in unusual situations.

Legal factors are tax rate limits, tax priorities, revenue priorities, and so forth.

The final rating is simply the debt/wealth index adjusted. We assign a market rating by locating the yield on a chart which we prepare weekly. If the market rating is substantially higher than the quality rating we regard the bond as relatively attractive. The reverse indicates, obviously, an unattractive bond.

As to questions six and seven, only a rather small part of our rating is taken from "official" sources. In fact, by using Moody's Manual—which we do—or State or private reports such as Ohio Municipal Advisory Council or Municipal Advisory Council of Texas material we will rate issues on which we have never seen a prospectus.

The answer to question 8 will, I suspect, vary considerably from agency to agency. Moody's, who derive an important part of their revenues from compiling and publishing factual information, will probably take a dim view of "cutrate" competition.

Standard & Poor's, who now rate only on order and for a fee, have no real need for information from other than official sources. Naturally, we love anything that contributes to our understanding at a low cost. We would, of course, like a vote as to what material was included.

With regard to question 9, there is little doubt in my mind that such a procedure could be helpful. For example, I would direct your attention to a questionnaire—exhibit C—which we prepared several years ago for submission to all units contributing funds to a city's operation. This is the questionnaire that Mr. Goodman brought in when he was here. This was not, as you might have thought, a rating questionnaire. It was our idea of the minimum information required to determine the cost of government, a factor we would love to include in our system if the material was available on a comparable basis.

We are a bit dubious where "official" ratings are concerned. We doubt that these can be produced with no taint of political pressure and without the social desirability of a project intruding on the only consideration we feel should be involved—the quality of the bond.

Finally, as to who should pay for a rating, the answer must be the user. It is possible to avoid conflict of interest, but I can tell you from long experience that it is rather like walking tightrope on the edge of a razor. It is increasingly difficult to remain incorruptible as the stakes go up.

If I sound a trifle bitter, it may be because I am. For years I heard all about the inadequacies of the rating systems. Eventually, I decided to do something about it.

I split with Standard & Poor's after a very fruitful 25-year relationship. It was my belief that I could find a better way to do the job. They felt that, even if I did, I would lose my shirt. We were both right.

After 2 years of hard work and the investment of something over $75,000 of my own money I am forced to conclude that, except for Mr. Reilly and ourselves, the concern is primarily a matter of conversation. All the average dealer or municipal official really wants to do is to "shake up" Moody's and Standard & Poor's so as to make them more "liberal." In my opinion, this would be the ultimate disaster.

Committees have been appointed and studies have been undertaken. For the last 18 months we have been trying to sell—even give away—the service that everyone says he is crying for. To date, we have 50 users.

The system is not perfect, but it is perfectible. It has gone as far as we can take it with our resources. We are serious. We think Mr. Reilly is serious. We wonder if anyone else is.

Thank you, Mr. Chairman.

(The attachments submitted Mr. Tyler follows:)

Unit____

Short Title_______________________________Code__________

1 Quality Rating				
2 Market Rating				
3 Per Capita Wealth				
4 Per Capita Debt				
5 Debt/Wealth Index				
6 Current Population				
7 Diversification*				
8 Unemployment*				
9 Pref'd Employment*				
10 College Enrollment*				
11 5-Year Sales Trend				
12 5-Year Income Trend				
13 Long Pop Trend*				
14 Short Pop Trend*				
15 Long Payroll Trend*				
16 Short Payroll Trnd*				
17 Intangibles				
18 Management				
19 Legal				
20 Assessed Value				
21 Per Cap Ass'd Value				
22 Est Co Full Value*				
23 Local Val/Co Val				
23a Tyler Value*				
24 Est Local Full Val				
25 Ind Ass't Ratio				
26 Accepted Ass't Ratio				
27 Est Prop'ty Value				
28 Per Cap Prop'ty Val				
29 Per Capita Income				
30 Median Home Val/4				
31 Local Income				
32 Local Inc/State Inc				
33 Local Val/State Val				
34 State Debt Inc Base				
35 State Debt Val Base				
36 Net Direct Debt				
37 Other Local Debt				
38 Combined Debt				
39 Population Indices				
40 Current Sales				
41 5-Year-Ago Sales				
42 5-Year-Ago Income				

43 Military*
44 Non-White
45 Income $3,000 -
46 Income $10,000 +
47 Income Index

48 High Sch or more
49 5 Yrs Sch or less
50 Education Index

51 Sound Housing
52 Other Intangibles
53 Total Intangibles

54 Maturity Schedule
55 Current Operations
56 Tax Collections
57 Plant Condition
58 Planning
59 Reporting
60 Revenue Exploit
61 Other
62 Total Management

63 Tax Rate Limits
64 Tax Priorities
65 Revenue Priorities
66 Other
67 Total Legal

68 Gross Debt
69 Sinking Funds
70 Utility Debt
71 Net Direct Debt

72 Overlapping Unit

TYLER'S TAX-EXEMPT BOND RATINGS—CONNECTICUT

	Ansonia	Avon	Berlin	Bethel	Bloomfield	Bolton	Branford	Bridgeport	Bristol	Brookfield
Quality rating	23	12	18	16	19	26	20	10	23	22
Per capita wealth	13,625	25,283	20,081	17,054	21,540	13,063	16,836	14,396	16,995	16,837
Per capita debt	351	458	477	337	614	487	454	256	476	483
Debt/wealth index	26	18	24	20	29	37	27	17	28	29
Population, 1965	20.7	8.0	14.8	9.6	18.8	3.3	19.2	158.4	51.7	6.5
Population index	0	+1	0	+1	0	+4	0	−4	−2	+1
Diversification	+1	+2	+2	+3	+2	+1	+1	+3	+2	+3
Unemployment	4.9	4.6	4.6	3.9	4.6	5.1	4.9	3.9	4.6	3.9
Unemployment index	0	0	0	−1	0	0	0	−1	0	−1
Preferred employment	9.5	8.3	8.3	7.3	8.3	13.4	9.5	7.3	8.3	7.3
Preferred employment index	0	+1	+1	+2	+1	−1	0	+2	+1	+2
College enrollment	2.1	1.3	1.3	1.2	1.3	8.2	2.1	1.2	1.3	1.2
College index	−1	0	0	0	0	−2	−1	0	0	0
5-year sales trend	12.4	11.3	41.5	0	65.8	23.1	2.3	15.4	0.9	67.7
5-year sales index	+1	+1	−1	+1	−1	0	+1	0	+1	−1
5-year income trend	15.2	21.3	15.4	14.5	15.4	13.8	16.1	15.8	16.4	18.9
5-year income index	0	0	0	0	0	0	0	0	0	0
25-year population trend	43.4	59.3	59.3	63.6	59.3	119.2	43.4	63.6	59.3	63.6
25-year population index	0	−1	−1	−1	−1	−2	0	−1	−1	−1
5-year population trend	9.7	11.6	11.6	13.5	11.6	25.2	9.7	13.5	11.6	13.5
5-year population index	0	−1	−1	−1	−1	−2	0	−1	−1	−1
5-year payroll trend	25.1	32.6	32.6	35.0	32.6	53.3	25.1	35.0	32.6	35.0
5-year payroll index	0	0	0	−1	0	−1	0	−1	0	−1
2-year payroll trend	8.2	11.1	11.1	7.0	11.1	28.5	8.2	7.0	11.1	7.0
2-year payroll index	+1	0	0	+1	0	−2	+1	+1	0	+1
Intangibles	−2	−5	−6	−5	−6	−4	−6	−1	−4	−8
Management	−1	−2	+2	−1	−2	0	−1	−2	+2	+1
Legal	−2	−2	−2	−2	−2	−2	−2	−2	−2	−2

TYLER'S TAX-EXEMPT BOND RATINGS—CONNECTICUT—Continued

	Canton	Cheshire	Clinton	Coventry	Cromwell	Danbury	Darien	Derby	East Hampton	East Hartford
Quality rating	12	07	32	14	21	22	00	36	16	17
Per capita wealth	21,536	19,031	15,960	12,625	15,743	13,150	35,515	13,727	16,595	17,063
Per capita debt	384	399	592	345	369	360	545	554	355	483
Debt/wealth index	18	21	37	27	23	27	15	40	21	28
Population, 1965	5.6	14.9	6.6	8.0	7.5	46.2	21.3	12.7	6.4	49.5
Population index	+1	0	+2	+3	+2	−1	0	0	+2	−1
Diversification	+2	+1	+2	+1	+2	+3	+3	+1	+2	+2
Unemployment	4.6	4.9	4.5	5.1	4.5	3.9	3.9	4.9	4.5	4.6
Unemployment index	0	0	0	0	0	−1	−1	0	0	0
Preferred employment	8.3	9.5	5.3	13.4	5.3	7.3	7.3	9.5	5.3	8.3
Preferred employment index	+1	0	+2	−1	+2	+2	+2	0	+2	+1
College enrollment	1.3	2.1	1.6	8.2	1.6	1.2	1.2	2.1	1.6	1.3
College index	0	−1	0	−2	0	0	0	−1	0	0
5-year sales trend	20.7	51.0	23.1	37.5	−15.4	19.1	41.2	23.8	44.7	52.7
5-year sales index	0	−1	0	−1	+1	0	−1	0	−1	−1
5-year income trend	10.2	38.4	15.9	13.4	16.1	8.9	13.2	5.2	22.6	14.7
5-year income index	+1	−2	0	0	0	+1	0	+1	−1	0
25-year population trend	59.3	43.4	69.0	119.2	69.0	63.6	63.6	43.4	69.0	59.3
25-year population index	−1	0	−1	−2	−1	−1	−1	0	−1	−1
5-year population trend	11.6	9.7	16.8	25.2	16.8	13.5	13.5	9.7	16.8	11.6
5-year population index	−1	0	−1	−2	−1	−1	−1	0	−1	−1
5-year payroll trend	32.6	25.1	39.1	53.3	39.1	35.0	35.0	25.1	39.1	32.6
5-year payroll index	0	0	−1	−1	−1	−1	−1	0	−1	0
2-year payroll trend	11.1	8.2	13.6	28.5	13.6	7.0	7.0	8.2	13.6	11.1
2-year payroll index	0	+1	0	−2	0	+1	+1	+1	0	0
Intangibles	−5	−8	−6	−4	−3	−4	−13	−3	−4	−6
Management	−2	−2	0	0	−1	−1	−2	−1	0	−2
Legal	−2	−2	−2	−2	−2	−2	−2	−2	−2	−2

	East Haven	East Lyme	East Windsor	Easton	Ellington	Enfield	Fairfield	Farmington	Glastonbury	Greenwich
Quality rating	22	37	20	20	17	17	13	24	23	01
Per capita wealth	16,273	16,077	18,316	20,271	14,101	15,264	19,343	21,169	21,853	31,869
Per capital debt	489	638	432	530	410	381	513	690	720	467
Debt/wealth index	30	40	24	26	29	25	27	33	33	15
Population, 1965	25.5	8.9	8.5	4.4	7.4	40.7	53.8	12.4	19.0	61.3
Population index	—1	+2	+1	+2	+3	—1	—2	0	0	—2
Diversification	+1	+1	+2	+3	+1	+2	+3	+2	+2	+3
Unemployment	4.9	4.1	4.6	3.9	5.1	4.6	3.9	4.6	4.6	3.9
Unemployment index	0	0	0	—1	0	0	—1	0	0	—1
Preferred employment	9.5	10.4	8.3	7.3	13.4	8.3	7.3	8.3	8.3	7.3
Preferred employment index	0	0	+1	+2	—1	+1	+2	+1	+1	+2
College enrollment	2.1	1.5	1.3	1.2	8.2	1.3	1.2	1.3	1.3	1.2
College index	—1	0	0	0	—2	0	0	0	0	0
5-year sales trend	83.9	—8.3	23.3	0.0	10.3	16.2	33.2	5.5	33.7	19.1
5-year sales index	—1	+1	0	+1	+1	0	—1	+1	—1	0
5-year income trend	16.0	8.9	9.9	11.0	20.5	15.8	15.5	15.4	15.4	14.6
5-year income index	0	+1	+1	+1	0	0	0	0	0	0
25-year population trend	43.4	59.3	59.3	63.6	119.2	59.3	63.6	59.3	59.3	63.6
25-year population index	0	—1	—1	—1	—2	—1	—1	—1	—1	—1
5-year pouulation trend	9.7	15.4	11.6	13.5	25.2	11.6	13.5	11.6	11.6	13.5
5-year population index	0	—1	—1	—1	—2	—1	—1	—1	—1	—1
5-year payroll trend	25.1	59.2	32.6	35.0	53.3	32.6	35.0	32.6	32.6	35.0
5-year payroll index	0	—1	0	—1	—1	0	—1	0	0	—1
2-year payroll trend	8.2	33.0	11.1	7.0	28.5	11.1	7.0	11.1	11.1	7.0
2-year payroll index	+1	—2	0	+1	—2	0	+1	0	0	+1
Intangibles	—4	0	—5	—8	—4	—5	—9	—7	—7	—10
Management	—1	—1	0	—2	—1	—1	—2	—2	—1	—2
Legal	—2	—2	—2	—2	—2	—2	—2	—2	—2	—2

	Griswold	Groton (city)	Groton (town)	Guilford	Hamden	Hartford	Hartford county (metropolitan)	Killingly	Ledyard	Litchfield
Quality rating	14	26	10	12	15	21	15	28	29	32
Per capita wealth	14,998	15,442	15,439	16,769	19,086	18,502	19,367	12,989	14,946	15,206
Per capita debt	267	521	315	342	468	572	511	376	518	500
Debt/wealth index	18	34	20	20	25	31	26	29	35	33
Population, 1965	7.0	12.1	35.7	9.2	49.9	162.5	322.0	12.5	9.2	7.4
Population index	+2	+1	0	+1	−1	−4	−3	+2	+2	+2
Diversification	+1	+1	+1	+1	+1	+2	+2	+1	+1	+2
Unemployment	4.1	4.1	4.1	4.9	4.9	4.6	4.6	6.2	4.1	5.3
Unemployment index	0	0	0	0	0	0	0	+1	0	0
Preferred employment	10.4	10.4	10.4	9.5	9.5	8.3	8.3	8.3	10.4	8.8
Preferred employment index	0	0	0	0	0	+1	+1	+1	0	+1
College enrollment	1.5	1.5	1.5	2.1	2.1	1.3	1.3	1.1	1.5	0.6
College index	0	0	0	−1	−1	0	0	0	0	0
5-year sales trend	−10.2	185.1	8.4	17.8	51.2	2.4	14.2	4.1	39.1	14.1
5-year sales index	+1	−1	+1	0	−1	+1	+1	+1	−1	+1
5-year income trend	13.4	15.7	15.7	16.9	15.9	16.1	15.7	14.2	10.7	21.0
5-year income index	0	0	0	0	0	0	0	0	+1	0
25-year population trend	59.3	59.3	59.3	43.4	43.4	59.3	59.3	31.7	59.3	44.8
25-year population index	−1	−1	−1	0	0	−1	−1	0	−1	0
5-year population trend	15.4	15.4	15.4	9.7	9.7	11.6	11.6	10.9	15.4	10.0
5-year population index	−1	−1	−1	0	0	−1	−1	−1	−1	−1
5-year payroll trend	59.2	59.2	59.2	25.1	25.1	32.6	32.6	46.6	59.2	24.4
5-year payroll index	−1	−1	−1	0	0	0	0	−1	−1	+1
2-year payroll trend	33.0	33.0	33.0	8.2	8.2	11.1	11.1	8.2	33.0	7.2
2-year payroll index	−2	−2	−2	+1	+1	0	0	+1	−2	+1
Intangibles	0	−1	−4	−7	−8	+1	−2	−2	−1	−5
Management	−1	−1	−1	−1	−1	−7	−6	−2	−1	−1
Legal	−2	−2	−2	−2	−2	−2	−2	−2	−2	−2

	Madison	Manchester	Mattabassett District	Meriden	Middletown	Milford	Monroe	Montville	Naugatuck	New Britain
Quality rating	27	04	11	15	18	18	16	14	16	14
Per capita wealth	16,542	18,629	18,108	15,281	15,299	15,269	19,814	15,225	17,722	17,730
Per capita debt	584	304	397	421	341	416	538	283	385	380
Debt/wealth index	35	16	22	28	22	27	27	19	22	21
Population, 1965	7.0	45.8	110.6	56.2	35.4	46.7	8.8	12.2	21.0	89.8
Population index	+1	−1	−3	−2	0	−1	+1	+1	0	−2
Diversification	+1	+2	+2	+1	+2	+1	+3	+1	+1	+2
Unemployment	4.9	4.6	4.6	4.9	4.5	4.9	3.9	4.1	4.9	4.6
Unemployment index	0	0	0	0	0	0	−1	0	0	0
Preferred employment	9.5	8.3	8.3	9.5	5.3	9.5	7.3	10.4	9.5	8.3
Preferred employment index	0	+1	+1	0	+2	0	+2	0	0	+1
College enrollment	2.1	1.3	1.3	2.1	1.6	2.1	1.2	1.5	2.1	1.3
College index	−1	0	0	−1	0	−1	0	0	−1	0
5-year sales trend	51.0	32.4	27.3	24.5	−29.7	50.5	73.9	21.9	13.6	−10.1
5-year sales index	−1	−1	−1	0	+1	−1	−1	0	+1	+1
5-year income trend	16.4	15.6	16.0	15.8	15.4	15.4	13.4	6.9	20.7	16.2
5-year income index	0	0	0	0	0	0	0	+1	0	0
25-year population trend	43.4	59.3	59.3	43.4	69.0	43.4	63.6	59.3	43.4	59.3
25-year population index	0	−1	−1	0	−1	0	−1	−1	0	−1
5-year population trend	9.7	11.6	11.6	9.7	16.8	9.7	13.5	15.4	9.7	11.6
5-year population index	0	−1	−1	0	−1	0	−1	−1	0	−1
5-year payroll trend	25.1	32.6	32.6	25.1	39.1	25.1	35.0	59.2	25.1	32.6
5-year payroll index	0	0	0	0	−1	0	−1	−1	0	0
2-year payroll trend	8.2	11.1	11.1	8.2	13.6	8.2	7.0	33.0	8.2	11.1
2-year payroll index	+1	0	0	+1	0	+1	+1	−2	+1	0
Intangibles	−7	−7	−4	−4	−2	−5	−8	0	−4	−4
Management	0	−2	−2	−6	−2	−1	−1	−1	−2	−1
Legal	−2	−2	−2	−2	−2	−2	−2	−2	−2	−2

	New Canaan	New Fairfield	New Haven	New London	New Milford	Newington	Newton	North Branford	North Haven	Norwalk
Quality rating	03	21	25	08	26	10	12	18	26	24
Per capita wealth	36,317	14,993	16,454	16,040	14,462	21,738	20,255	16,725	19,086	19,348
Per capital debt	519	408	537	221	416	384	314	446	682	577
Debt/wealth index	14	27	33	14	29	18	16	27	36	30
Population, 1965	18.3	4.4	150.9	33.7	10.7	23.0	14.0	9.6	20.3	76.6
Population index	0	+2	−4	0	+1	0	0	+1	0	−2
Diversification	+3	+3	+1	+1	+2	+2	+3	+1	+1	+3
Unemployment	3.9	3.9	4.9	4.1	5.3	4.6	3.9	4.9	4.9	3.9
Unemployment index	−1	−1	0	0	0	0	−1	0	0	−1
Preferred employment	7.3	7.3	9.5	10.4	8.8	8.3	7.3	9.5	9.5	7.3
Preferred employment index	+2	+2	0	0	+1	+1	+2	0	0	+2
College enrollment	1.2	1.2	2.1	1.5	0.6	1.3	1.2	2.1	2.1	1.2
College index	0	0	−1	0	0	0	0	−1	−1	0
5-year sales trend	4.2	25.0	4.9	24.7	26.0	14.7	9.3	0.0	63.8	5.1
5-year sales index	+1	0	+1	0	−1	+1	+1	+1	−1	+1
5-year income trend	12.9	15.2	16.4	15.0	16.6	15.4	14.6	15.9	16.1	15.4
5-year income index	+1	0	0	0	0	0	0	0	0	0
25-year population trend	63.6	63.6	43.4	59.3	44.8	59.3	63.6	43.4	43.4	63.6
25-year population index	−1	−1	0	−1	0	−1	−1	0	0	−1
5-year population trend	13.5	13.5	9.7	15.4	10.0	11.6	13.5	9.7	9.7	13.5
5-year population index	−1	−1	0	−1	−1	−1	−1	0	0	−1
5-year payroll trend	35.0	35.0	25.1	59.2	24.4	32.6	35.0	25.1	25.1	35.0
5-year payroll index	−1	−1	0	−1	+1	0	−1	0	0	−1
2-year payroll trend	7.0	7.0	8.2	33.0	7.2	11.1	7.0	8.2	8.2	7.0
2-year payroll index	+1	+1	+1	−2	+1	0	+1	+1	+1	+1
Intangibles	−12	−8	0	+1	−4	−7	−5	−7	−7	−4
Management	−1	0	−4	−1	−1	−1	0	−1	−1	−1
Legal	−2	−2	−2	−2	−2	−2	−2	−2	−2	−2

	Norwich	Oakville Fire District	Old Saybrook	Orange	Plainfield	Plainville	Plymouth	Portland	Redding
Quality rating	06	24	20	20	16	13	25	21	20
Per capita wealth	14,264	17,055	15,626	14,361	13,830	17,919	14,761	16,156	19,025
Per capita debt	191	436	382	440	224	316	414	414	498
Debt/wealth index	13	26	24	31	16	18	28	26	26
Population, 1965	41.3	7.0	8.6	12.7	9.9	14.8	9.6	8.2	4.8
Population index	0	+2	+2	0	+3	0	+2	+2	+2
Diversification	+1	+2	+2	+1	+1	+2	+2	+2	+3
Unemployment	4.1	5.3	4.5	4.9	6.2	4.6	5.3	4.5	3.9
Unemployment index	0	0	0	0	+1	0	0	0	−1
Preferred employment	10.4	8.8	5.3	9.5	8.3	8.3	8.8	5.3	7.3
Preferred employment index	0	+1	+2	0	+1	+1	+1	+2	+2
College enrollment	1.5	.6	1.6	2.1	1.1	1.3	.6	1.6	1.2
College index	0	0	0	−1	0	0	0	0	0
5-year sales trend	15.6	27.8	40.1	60.0	57.9	28.3	31.0	25.8	0
5-year sales index	0	−1	−1	−1	−1	−1	−1	−1	+1
5-year income trend	16.9	16.6	15.1	15.6	11.4	10.0	18.7	15.8	13.1
5-year income index	0	0	0	0	+1	+1	0	0	0
25-year population trend	59.3	44.8	69.0	43.4	31.7	59.3	44.8	69.0	63.6
25-year population index	−1	0	−1	0	0	−1	0	−1	−1
5-year population trend	15.4	10.0	16.8	9.7	10.9	11.6	10.0	16.8	13.5
5-year population index	−1	−1	−1	0	−1	−1	−1	−1	−1
5-year payroll trend	59.2	24.4	39.1	25.1	46.6	32.6	24.4	39.1	35.0
5-year payroll index	−1	+1	−1	0	−1	0	+1	−1	−1
2-year payroll trend	33.0	7.2	13.6	8.2	8.2	11.1	7.2	13.6	7.0
2-year payroll index	−2	+1	0	+1	+1	0	+1	0	+1
Intangibles	0	−5	−4	−7	−2	−4	−5	−4	−8
Management	−1	0	0	−2	−1	0	−1	−1	−1
Legal	−2	−2	−2	−2	−2	−2	−2	−2	−2

	Regional High School District 5	Regional School District 8	Regional School District 10	Ridgefield	Rocky Hill	Seymour	Shelton	Simsbury	Somers
Quality rating	18	17	20	27	13	24	19	16	23
Per capita wealth	15,227	17,892	17,508	19,743	21,861	15,454	17,933	22,128	12,477
Per capita debt	427	386	390	680	460	461	419	577	435
Debt/wealth index	28	22	22	34	21	30	23	26	35
Population, 1965	22.4	6.5	7.0	14.0	8.2	11.1	21.4	13.8	4.5
Population index	0	+1	+1	0	+1	0	0	0	+4
Diversification	+1	+2	+2	+3	+2	+1	+3	+2	+1
Unemployment	4.9	4.6	4.6	3.9	4.6	4.9	3.9	4.6	5.1
Unemployment index	0	0	0	−1	0	0	−1	0	0
Preferred employment	9.5	8.3	8.3	7.3	8.3	9.5	7.3	8.3	13.4
Preferred employment index	0	+1	+1	+2	+1	0	+2	+1	−1
College enrollment	2.1	1.3	1.3	1.2	1.3	2.1	1.2	1.3	8.2
College index	−1	0	0	0	0	−1	0	0	−2
5-year sales trend	67.1	46.9	0	2.1	216.3	89.5	11.4	2.3	45.0
5-year sales index	−1	−1	+1	+1	−1	−1	+1	+1	−1
5-year income trend	16.9	10.3	3.7	14.6	19.0	16.1	14.7	21.3	18.4
5-year income index	0	+1	+2	0	0	0	0	0	0
25-year population trend	43.4	59.3	59.3	63.6	59.3	43.4	63.6	59.3	119.2
25-year population index	0	−1	−1	−1	−1	0	−1	−1	−2
5-year population trend	9.7	11.6	11.6	13.5	11.6	9.7	13.5	11.6	25.2
5-year population index	0	−1	−1	−1	−1	0	−1	−1	−2
5-year payroll trend	25.1	32.6	32.6	35.0	32.6	25.1	35.0	32.6	53.3
5-year payroll index	0	0	0	−1	0	0	−1	0	−1
2-year payroll trend	8.2	11.1	11.1	7.0	11.1	8.2	7.0	11.1	28.5
2-year payroll index	+1	0	0	+1	0	+1	+1	0	−2
Intangibles	−7	−5	−5	−7	−5	−3	−3	−8	−4
Management	−1	0	0	−1	−2	−1	−2	−2	0
Legal	−2	−2	−2	−2	−2	−2	−2	−2	−2

	South Windsor	Southington	Stamford	Stonington	Stratford	Suffield	Thomaston	Torrington	Trumbull
Quality rating	23	19	19	10	15	39	21	15	09
Per capita wealth	19,384	15,973	22,098	14,474	15,995	16,705	15,337	15,240	21,939
Per capita debt	593	431	578	200	360	761	314	285	454
Debt/wealth index	31	27	26	14	23	45	20	19	21
Population, 1965	16.0	26.3	103.8	15.0	46.5	7.9	6.5	30.7	27.1
Population index	0	−1	−3	+1	−1	+1	+2	0	−1
Diversification	+2	+2	+3	+1	+3	+2	+2	+2	+3
Unemployment	4.6	4.6	3.9	4.1	3.9	4.6	5.3	5.3	3.9
Unemployment index	0	0	−1	0	−1	0	0	0	−1
Preferred employment	8.3	8.3	7.3	10.4	7.3	8.3	8.8	8.8	7.3
Preferred employment index	+1	+1	+2	0	+2	+1	+1	+1	+2
College enrollment	1.3	1.3	1.2	1.5	1.2	1.3	0.6	0.6	1.2
College index	0	0	0	0	0	0	0	0	0
5-year sales trend	34.3	48.0	4.4	−19.9	19.3	17.6	19.8	36.2	260.3
5-year sales index	−1	−1	+1	+1	0	0	0	−1	−1
5-year income trend	17.8	15.5	15.4	17.0	15.1	15.6	16.5	15.9	14.5
5-year income index	0	9	0	0	0	0	0	0	0
25-year population trend	59.3	59.3	63.6	59.3	63.6	59.3	44.8	44.8	63.6
25-year population index	−1	−1	−1	−1	−1	−1	0	0	−1
5-year population trend	11.6	11.6	13.5	15.4	13.5	11.6	10.0	10.0	13.5
5-year population index	−1	−1	−1	−1	−1	−1	−1	−1	−1
5-year payroll trend	32.6	32.6	35.0	59.2	35.0	32.6	24.4	24.4	35.0
5-year payroll index	0	0	−1	−1	−1	0	+1	+1	−1
2-year payroll trend	11.1	11.1	7.0	33.0	7.0	11.1	7.2	7.2	7.0
2-year payroll index	0	0	+1	−2	+1	0	+1	+1	+1
Intangibles	−5	−4	−4	0	−6	−5	−3	−3	−7
Management	−1	−1	−1	0	−1	−1	0	−2	−3
Legal	−2	−2	−2	−2	−2	−2	−2	−2	−2

	Vernon	Wallingford	Waterbury	Waterford	Watertown	West Hartford	West Haven	Weston	Westport
Quality rating	25	18	19	14	21	1	17	35	08
Per capita wealth	12,259	15,165	15,057	16,051	17,047	28,763	14,757	22,107	29,131
Per capita debt	472	419	419	338	384	528	378	929	679
Debt/wealth index	39	28	28	21	23	18	26	42	23
Population, 1965	20.9	33.4	115.6	16.8	16.1	71.0	48.1	6.1	29.9
Population index	+2	−1	−3	+1	+1	−2	−1	+1	−1
Diversification	+1	+1	+1	+1	+2	+2	+1	+3	+3
Unemployment	5.1	4.9	4.9	4.1	5.3	4.6	4.9	3.9	3.9
Unemployment index	0	0	0	0	0	0	0	−1	−1
Perferred employment	13.4	9.5	9.5	10.4	8.8	8.3	9.5	7.3	7.3
Preferred employment index	−1	0	0	0	+1	+1	0	+2	+2
College enrollment	8.2	2.1	2.1	1.5	0.6	1.3	2.1	1.2	1.2
College index	−2	−1	−1	0	0	0	−1	0	0
5-year sales trend	45.2	61.2	11.4	67.6	27.8	57.1	64.0	0.0	47.1
5-year sales index	−1	−1	+1	−1	−1	−1	−1	+1	−1
5-year income trend	13.8	15.6	16.0	8.9	16.6	14.6	15.2	6.6	13.6
5-year income index	0	0	0	+1	0	0	0	+1	0
25-year population trend	119.2	43.4	43.4	59.3	44.8	59.3	43.4	63.6	63.6
25-year population index	−2	0	0	−1	0	−1	0	−1	−1
5-year population trend	25.2	9.7	9.7	15.4	10.0	11.6	9.7	13.5	13.5
5-year population index	−2	0	0	−1	−1	−1	0	−1	−1
5-year payroll trend	53.3	25.1	25.1	59.2	24.4	32.6	25.1	35.0	35.0
5-year payroll index	−1	0	0	−1	+1	0	0	−1	−1
2-year payroll trend	28.5	8.2	8.2	33.0	7.2	11.1	8.2	7.0	7.0
2-year payroll index	−2	+1	+1	−2	+1	0	+1	+1	+1
Intangibles	−3	−5	−5	−2	−4	−9	−5	−8	−11
Management	−1	−2	−1	0	0	−4	−1	−2	−2
Legal	−2	−2	−2	−2	−2	−2	−2	−2	−2

	Wethersfield	Willimantic	Wilton	Winchester	Windham	Windsor	Windsor Locks	Wolcott	Woodbridge
Quality rating	11	18	16	24	17	11	28	16	20
Per capita wealth	23,623	14,669	24,127	14,630	14,672	20,898	19,035	14,925	15,983
Per capita debt	551	243	595	335	237	394	653	374	480
Debt/wealth index	23	17	25	23	16	19	34	25	30
Population, 1965	24.0	14.2	11.0	11.1	17.4	21.1	13.3	11.0	6.6
Population index	0	+2	0	+1	+2	0	0	0	+1
Diversification	+2	+1	+3	+2	+1	+2	+2	+1	+1
Unemployment	4.6	6.2	3.9	5.3	6.2	4.6	4.6	4.9	4.9
Unemployment index	0	+1	−1	0	+1	0	0	0	0
Preferred employment	8.3	8.3	7.3	8.8	8.3	8.3	8.3	9.5	9.5
Preferred employment index	+1	+1	+2	+1	+1	+1	+1	0	0
College enrollment	1.3	1.1	1.2	0.6	1.1	1.3	1.3	2.1	2.1
College index	0	0	0	0	0	0	0	−1	−1
5-year sales trend	64.9	−1.9	23.7	−36.4	10.5	45.0	−48.1	27.3	93.8
5-year sales index	−1	+1	0	+1	+1	−1	+1	0	−1
5-year income trend	15.0	15.4	10.9	16.6	19.4	15.5	15.4	15.9	14.0
5-year income index	0	0	+1	0	0	0	0	0	0
25-year population trend	59.3	31.7	63.6	44.8	31.7	59.3	59.3	43.4	43.4
25-year population index	−1	0	−1	0	0	−1	−1	0	0
5-year population trend	11.6	10.9	13.5	10.0	10.9	11.6	11.6	9.7	9.7
5-year population index	−1	−1	−1	−1	−1	−1	−1	0	0
5-year payroll trend	32.6	46.6	35.0	24.4	46.6	32.6	32.6	25.1	25.1
5-year payroll index	0	−1	−1	+1	−1	0	0	0	0
2-year payroll trend	11.1	8.2	7.0	7.2	8.2	11.1	11.1	8.2	8.2
2-year payroll index	0	+1	+1	+1	+1	0	0	+1	+1
Intangibles	−8	−2	−8	−3	−2	−4	−4	−7	−7
Management	−2	0	−2	0	0	−2	−2	−1	−2
Legal	−2	−2	−2	−2	−2	−2	−2	−2	−2

EDUCATION

ELEMENTARY SCHOOLS (K–6) (K–8)

1. Estimated population of appropriate age.
2. Enrollment.
3. Number of available classrooms.
4. Number of classroom teachers.
5. Number of principals, supervisors, guidance personnel, and other assigned to a specific school, but not meeting classes.
6. Number of superintendents, business managers, secretarial and clerical personnel, and others not assigned to a specific school.
7. Number of custodial and maintenance personnel.
8. Number of other employees (please specify function, if possible).
9. Income from property taxes.
10. Income received from the State.
11. Income received from the Federal government.
12. Income received from fees and charges.
13. Income received from other sources.
14. Long term borrowing.
15. Teachers' salaries (as in line 4).
16. Supervisors' salaries (as in line 5).
17. Administrative salaries (as in line 6).
18. Custodial and maintenance salaries (as in line 7).
19. Other salaries (as in line 8).
20. Expenditures for textbooks and educational materials.
21. Expenditures for plant maintenance and operation (excluding line 18).
22. Expenditures for transportation (excluding any salaries in line 19).
23. Your contributions to pension funds.
24. Capital outlay (excluding long term borrowing).
25. Interest on debt.
26. Long term debt retired.
27. Other expenses (please specify, if possible).

SECONDARY SCHOOLS (7–12) (9–12)

28. Estimated population of appropriate age.
29. Enrollment.
30. Number of available classrooms.
31. Number of classroom teachers.
32. Number of principals, supervisors, guidance personnel, and others assigned to a specific school, but not meeting classes.
33. Number of superintendents, business managers, secretarial and clerical personnel, and others not assigned to a specific school.
34. Number of custodial and maintenance personnel.
35. Number of other employees (please specify function, if possible).
36. Income from property taxes (if separate from line 9).
37. Income received from the State (if separate from line 10).
38. Income received from the Federal government (if separate from line 11).
39. Income received from fees and charges (if separate from line 12).
40. Income received from other sources (if separate from line 13).
41. Long term borrowing (if separate from line 14).
42. Teachers' salaries (as in line 31).
43. Supervisors' salaries (as in line 32).
44. Administrative salaries (as in line 33).
45. Custodial and maintenance salaries (as in line 34).
46. Other Salaries (as in line 35).
47. Expenditures for textbooks and educational materials.
48. Expenditures for plant maintenance and operation (excluding line 45).
49. Expenditures for transportation (excluding any salaries in line 46).
50. Your contributions to pension funds.
51. Capital outlay (excluding long term borrowing).
52. Interest on debt.
53. Long term debt retired.
54. Other expenses (specify, if possible).

HIGHER EDUCATION

55. Enrollment in two-year colleges.
56. Enrollment in four-year colleges.
57. Enrolled for graduate studies.
58. Number of professors and instructors.
59. Number of supervisory and administrative personnel.
60. Number of other employees (specify function, if possible).
61. Income from property taxes.
62. Income received from the State.
63. Income received from the Federal government.
64. Income received from fees, charges, etc
65. Income received from other sources.
66. Long term borrowing.
67. Salaries of professors and instructors (as in line 58).
68. Salaries of supervisory and administrative personnel (as in line 59).
69. Salaries of other employees (as in line 60).
70. Expenditures for plant maintenance and operation (excluding salaries in line 69).
71. Your contributions to pension funds.
72. Capital outlay (excluding long term borrowing).
73. Interest on debt.
74. Long term debt retired.
75. Other expenses (specify, if possible).

OTHER EDUCATION

76. Enrolled in schools for the handicapped.
77. Enrolled in special or vocational schools not covered above.
78. Enrolled in adult education classes.
79. Number of classroom teachers.
80. Number of supervisory and administrative personnel.
81. Number of other employees (specify function, if possible).
82. Income from property taxes (if not included above).
83. Income received from the States.
84. Income received from the Federal government.
85. Income received from fees, charges, etc.
86. Income received from other sources.
87. Long term borrowing.
88. Teachers' salaries (as in line 79).
89. Supervisory and administrative salaries (as in line 80).
90. Other salaries (as in line 81).
91. Expenditures for textbooks and educational materials.
92. Expenditures for plant maintenance and operation (excluding line 90.)
93. Expenditures for transportation (excluding line 90).
94. Your contributions to pension funds.
95. Capital outlay (excluding long term borrowing).
96. Interest on debt.
97. Long term debt retired.
98. Other expenses (please specify, if possible).

HIGHWAYS

99. Miles of city streets maintained.
100. Miles of expressways maintained.
101. Number of employees.
102. Income from property taxes.
103. Income from motor fuel taxes.
104. Income from excise taxes or licenses.
105. Other highway income from local tax sources.
106. Income received from the State.
107. Income received from the Federal Government.
108. Income received from fees, charges etc.
109. Other income (please specify, if possible).
110. Long term borrowing.
111. Cost of maintenance by own forces (excluding salaries & wages).

112. Cost of contract maintenance.
113. Salaries & wages (as in line 101).
114. Snow removal costs (excluding line 113).
115. Your contributions to pension funds.
116. Capital outlay (excluding long term borrowing).
117. Interest on debt.
118. Long term debt retired.
119. Other highway expenses (please specify, if possible).

SANITARY SEWERAGE

120. Miles of laterals and mains maintained.
121. Depreciated value of treatment plants.
122. Number of employees.
123. Income from property taxes.
124. Income received from assessments or sewer charges.
125. Income received from the State.
126. Income received from the Federal Government.
127. Income received from other governmental units.
128. Other sanitary sewerage income (please specify, if possible).
129. Salaries & wages (as in line 122).
130. Your contributions to pension funds.
131. Cost of maintaining the collection system (excluding line 129).
132. Cost of operating and maintaining treatment plant (excluding line 129).
133. Capital outlay (excluding long term borrowing).
134. Long term borrowing.
135. Interest on debt.
136. Long term debt retired.
137. Other sanitary sewerage expenses (please specify, if possible).

STORM DRAINAGE

138. Miles of mains maintained.
139. Depreciated value of flood control works, etc.
140. Number of employees.
141. Income from property taxes.
142. Income received from assessments or charges.
143. Income received from the State.
144. Income received from the Federal Government.
145. Income received from other governmental units.
146. Other storm drainage income (please specify, if possible).
147. Salaries & wages (as in line 140).
148. Operation & maintenance costs (excluding line 147).
149. Capital outlay (excluding long term borrowing).
150. Long term borrowing.
151. Interest on debt.
152. Long term debt retired.
153. Your contributions to pension funds.
154. Other expenses (please specify, if possible).

OTHER SANITATION

155. Average pickups per week.
156. Depreciated value of equipment.
157. Number of employees.
158. Income from property taxes.
159. Income received from other governmental units.
160. Income received from fees or charges.
161. Other income (please specify, if possible).
162. Salaries & wages (as in line 157).
163. Operation & maintenance costs (excluding line 162).
164. Capital outlay (excluding long term borrowing).
165. Long term borrowing.
166. Interest on debt.
167. Long term debt retired.
168. Your contributions to pension funds.
169. Other expenses (please specify, if possible).

WATER

170. Number of retail water customers.
171. Number of wholesale customers, including other systems.
172. Storage capacity.
173. Maximum daily treatment capability.
174. Peak daily demand.
175. Average daily demand.
176. Income received from fees and charges (retail).
177. Income received from wholesale customers.
178. Income received from other governmental units.
179. Income received from property taxes.
180. Other water income (please specify, if possible).
181. Number of employees.
182. Salaries & wages (as in line 181).
183. Operation & maintenance cost (excluding line 182).
184. Capital outlay (excluding long term borrowing).
185. Long term borrowing.
186. Interest on debt.
187. Long term debt retired.
188. Your contributions to pension funds.
189. Other water expenses (please specify, if possible).

TRANSPORTATION

190. Miles of bus lines operated.
191. Miles of trolleys or trolley buses operated.
192. Miles of subway or elevated line operated.
193. Total passengers carried in year.
194. Depreciated value of rolling stock.
195. Income from fares.
196. Income from property taxes.
197. Income received from other governmental units.
198. Other income (please specify, if possible).
199. Number of employees.
200. Salaries & wages (as in line 199).
201. Operation & maintenance costs (excluding line 200).
202. Capital outlay (excluding long term borrowing).
203. Long term borrowing.
204. Interest on debt.
205. Long term debt retired.
206. Your contributions to pension funds.
207. Other transportation expenses (please specify, if possible).

HEALTH AND HOSPITALS

208. Beds in own hospitals.
209. Beds in other hospitals to which you contribute.
210. Average daily occupancy of own hospitals.
211. Licensed personnel in own hospitals.
212. Other employees in own hospitals.
213. Income received from fees and charges.
214. Income received from property taxes.
215. Income received from the State.
216. Income received from the Federal Government.
217. Other income (please specify, if possible).
218. Salaries of licensed personnel (as in line 211).
219. Salaries & wages of other employees (as in line 212).
220. Operation & maintenance of own hospitals (excluding lines 218 & 219).
221. Contributions to other hospitals.
222. Cost of inspections and other health services.
223. Capital outlay (excluding long term borrowing).
224. Long term borrowing.
225. Interest on debt.
226. Long term debt retired.
227. Your contributions to pension funds.
228. Other health and hospital expenses (please specify, if possible).

Public Welfare

229. Number of welfare recipients.
230. Resident requirements.
231. Number of case workers and other employees.
232. Income received from property taxes.
233. Income received from the State.
234. Income received from the Federal government.
235. Other income (please specify, if possible).
236. Salaries & wages (as in line 231).
237. Other costs (excluding line 236).
238. Cash payments to welfare recipients.
239. Payments to vendors.
240. "War on Poverty".
241. Your contributions to pension funds.
242. Other welfare expenditures (please specify, if possible).
243. Contributions to charitable institutions.

Protection

244. Number of policemen.
245. Number of civilian police employees.
246. Number of crimes reported (please specify, if possible).
247. Number of arrests made.
248. Depreciated value of police stations and equipment.
249. Police salaries & wages (as in line 244).
250. Other police salaries (as in line 245).
251. Other police costs (please specify, if possible).
253. Number of firemen.
254. Number of civilian fire employees.
255. Number of fire alarms answered.
256. Fire losses.
257. Depreciated value of fire stations and equipment.
258. Fire department salaries & wages (as in line 253).
259. Other fire department salaries (as in line 254).
260. Your contributions to fire pension funds.
261. Other fire department costs (please specify, if possible).

Correction

262. Population of prisons.
263. Population of asylums.
264. Population of other correctional institutions.
265. Number of prison personnel.
266. Number of asylum personnel.
267. Number of other correctional personnel.
268. Income from property taxes.
269. Income received from the State.
270. Income received from the Federal government.
271. Other income (please specify, if possible).
272. Salaries & wages of prison personnel (as in line 265).
273. Operating & maintenance costs of prsions (excluding line 272).
274. Salaries & wages of asylum personnel (as in line 266).
275. Operating & maintenance costs of asylums (excluding line 274).
276. Salaries & wages of other correctional personnel (as in line 267).
277. Other correctional operating costs (excluding line 276).
278. Capital outlay (excluding long term borrowing).
279. Long term borrowing.
280. Interest on debt.
281. Long term debt retired.
282. Your contributions to pension funds.
283. Other expenses (please specify, if possible).

Housing and Urban Renewal

284. Number of public housing units maintained.
285. Average number of rooms.
286. Average rent.
287. Vacancy rate.

288. Depreciated value of buildings.
289. Income received from rents.
290. Income received from the City government in cash.
291. Income received from the City government in tax abatements, etc.
292. Income received from the State.
293. Income received from the Federal government.
294. Housing receipts other than above.
295. Number of housing police and other employees.
296. Salaries & wages (as in line 295).
297. Other operating & maintenance costs (excluding depreciation & line 296).
298. Capital outlay (excluding long term debt).
299. Long term borrowing.
300. Interest on debt.
301. Long term debt retired.
302. Your contribution to pension funds.
303. Other housing expenses (please specify, if possible).
304. Number of acres involved in urban renewal projects.
305. Value removed from tax rolls in year.
306. Value added to tax rolls in year.
307. Income from property taxes.
308. Income received from the State.
309. Income received from the Federal government.
310. Other receipts, including sales and rentals.
311. Number of urban renewal employees.
312. Salaries & wages (as in line 311).
313. Cost of property acquired.
314. Other capital outlays (excluding long term borrowing).
315. Long term borrowing.
316. Interest on long term debt.
317. Long term debt retired.
318. Other urban renewal expenditures (please specify, if possible).
319. Your contribution to urban renewal employees pension funds.

PARKS AND RECREATION

320. Number of acres of parks maintained.
321. Number of acres of playgrounds maintained.
322. Value of other recreational facilities.
323. Number of park and recreation employees.
324. Income from property taxes.
325. Income received from fees and charges.
326. Income received from the State.
327. Income received from the Federal government.
328. Other park & recreation income (please specify, if possible).
329. Salaries & wages (as in line 323).
330. Operation & maintenance costs (excluding line 329).
331. Capital outlay (excluding long term borrowing).
332. Long term borrowing.
333. Interest on debt.
334. Long term debt retired.
335. Your contributions to pension funds.
336. Other park and recreation expenses (please specify, if possible).

LIBRARIES

337. Number of libraries maintained.
338. Total number of volumes.
339. Number of library employees.
340. Income from property taxes.
341. Income received from fees and charges.
342. Income received from the State.
343. Income received from the Federal government.
344. Other library income (please specify, if possible).
345. Salaries & wages (as in line 339).
346. Operation & maintenance costs (excluding line 345).
347. Capital outlay (excluding long term borrowing).
348. Long term borrowing.

349. Interest on debt.
350. Long term debt retired.
351. Your contributions to pension funds.
352. Other library expenses (please specify, if possible).

UTILITIES OTHER THAN WATER, SEWER AND TRANSPORTATION

353. Services provided.
354. Number of employees.
355. Income from property taxes.
356. Income received from rates and charges.
357. Other income (please specify, if possible).
358. Salaries & wages (as in line 354).
359. Operation & maintenance costs (excluding line 358).
360. Capital outlay (excluding long term borrowing).
361. Long term borrowing.
362. Interest on debt.
363. Long term debt retired.
364. Your contributions to pension funds.
365. Other utility expenses (please specify, if possible).

PARKING

366. Number of on-street parking meters.
367. Number of off-street parking spaces maintained.
368. Parking income from rates and charges.
369. Other parking income (please specify, if possible).
370. Number of employees.
371. Salaries & wages (as in line 370).
372. Operation & maintenance costs (excluding line 371).
373. Capital outlay (excluding long term borrowing).
374. Long term borrowing.
375. Interest on debt.
376. Long term debt retired.
377. Your contributions to pension funds.
378. Other parking expenses (please specify, if possible).

AIRPORT

379. Number of airports maintained.
380. Number of airplane arrivals and departures.
381. Number of passengers enplaned.
382. Income from property taxes.
383. Income received from fees and charges.
384. Income received from the State.
385. Income received from the Federal government.
386. Other airport income (please specify, if possible).
387. Number of employees.
388. Salaries & wages (as in line 387).
389. Operation & maintenance costs (excluding line 388).
390. Capital outlay (excluding long term borrowing).
391. Long term borrowing.
392. Interest on debt.
393. Long term debt retired.
394. Your contributions to pension funds.
395. Other airport expenses (please specify, if possible).

GENERAL

396. Number of employees not elsewhere listed.
397. Assessed valuation of real property.
398. Ratio of assessed to market value.
399. Property tax rated per $1,000.
400. Assessed value of other taxable property.
401. Tax rate or rates.
402. Gross bonded debt payable from full faith and credit (year-end).
403. Debt included above payable from revenues, if earned.
404. Sinking funds applicable to line 402.

405. Sinking funds applicable to line 403.
406. Debt payable solely from revenues.
407. Guaranteed debt.
408. Income received from property taxes.
409. Income received from income taxes.
410. Income received from general sales taxes.
411. Income received from other taxes (please specify, if possible).
412. Income received from the State.
413. Income received from the Federal government.
414. Income received from fees and charges.
415. All other receipts (please specify, if possible).
416. Salaries & wages (as in line 396).
417. Expenditures not elsewhere listed (excluding capital outlay and debt service).
418. Capital outlay not elsewhere listed (excluding long term borrowing).
419. Long term borrowing not elsewhere listed.
420. Interest on debt not elsewhere listed.
421. Long term debt retired not elsewhere listed.
422. Pension fund contributions not elsewhere listed or that could not be segregated under preceding heads.
423. Other expenditures (please specify, if possible).
424. Total cash receipts (excluding borrowing).
425. Total borrowing.
426. Total cash expenditures (excluding debt retirement).
427. Total debt retirement.

Chairman PATMAN. Thank you very much, Mr. Tyler.

Our next witness will be Mr. Reilly, partner-in-charge of the Municipal Department of Goodbody & Co.

Mr. Reilly, we are glad to have you, sir. You may proceed in your own way.

STATEMENT OF JAMES F. REILLY, PARTNER-IN-CHARGE OF THE BOND DIVISION, GOODBODY & CO., NEW YORK, N.Y.

Mr. REILLY. Thank you, Mr. Chairman, Senator Proxmire, members of the committee.

In 1967, Goodbody & Co. bid on 553 issues and was a member of 125 syndicates which were successful in the purchase of bonds. Goodbody & Co. maintains a position of approximately $20 million bonds in making markets all over the country. We are committed to a strong support of local markets. For instance, we believe we sell and trade more bonds in the State of Florida than any other firm. We maintain positions in California, New England, Kentucky, Arizona, Texas, and New Mexico as well as the entire Midwest. We are now beginning to develop markets in the Northwest and that Rocky Mountain area.

Aside from a number of clerical people, we have over 60 professional municipal people all over the country in the various segments of the business. We have 20 people who do nothing but underwrite bonds; we have 15 people who work on trading; we have 12 people in new business and 15 people in research. We have a very large sales staff in both the retail and the institutional area. We are probably one of the largest retail distributors of tax exempt bonds in the securities business.

Our firm prepares information on all the issues that we bid on. We use the ratings as a guide, especially when offering bonds to our clients. We use the credit reports, such as are issued by Dun & Bradstreet, for backup information. However, we are not deterred by a low rating especially when we have knowledge of the area. However, we are not able to offset a low rating no matter how unjustified in the pricing

of the bonds. The interest rate and the yield will be based on similar rated bonds because, after all, the municipal bond business is a business of comparisons. However, in many cases we have been able to upgrade an issue because of our intimate knowledge of a situation, or our ability to sell a bond in a specific area. This is true of Florida bonds.

I have been asked about the present rating systems and my opinion of them. I, of course, have been on record for many years as a critic of the system, but I have never been a critic of the integrity of these people. It is important to make this distinction. It is sometimes very upsetting to me and others to read statements maligning these agencies.

I am a critic of the system and not of the people who run it. I believe that they are excellent technicians. In fact, if we ever formed a new rating system, I would prefer that the personnel that would comprise the cadre of such an organization be drawn from the present people in the ratings agencies, if they were available.

It is important to fix the role of the rating agencies in the right perspective. You hear many questions such as "If we have had such few defaults in municipals over the past 25 years, why do we need ratings?"

The simple answer is, "Who will determine what the worth of a bond is if we do not have a neutral third party."

The issuer is naturally biased on the worth of his issue because he thinks his issue is the best ever. The underwriter wants to sell the bonds.

Therefore, the investor who does not have the time or background to investigate a credit has to have someone give him an opinion as to value. This is the value of the rating agencies.

You hear suggestions about a Government sponsored rating agency and I am opposed to this proposal. I worry about the day when a governmental agency would have the power to rate bonds of local areas, perhaps based on the willingness of that area to "go along" with the Federal people.

This is a projection of the overall fear that most of us have about more Federal control. Our State and local areas may need bolstering as far as their personnel is concerned, but they do not need more direction from here, Washington. If they allow it to happen, this in my opinion will be the beginning of the end of the Federal system as we know it. I am not opposed to the Federal Government forming a data bank of financial and statistical information on local governments that would be available to all at fees which would pay for the operation. I do not believe it belongs at HUD or any such agency. I do not really know where it should be and I am not singling out HUD for any special reason. I am saying it should be operated by the Census Bureau, which seems to have the bulk of informational statistics about us now. They would seem a normal extension of what they do.

I also want to comment on the small issues which seem to be shut out by the rating agencies. I would think that some of my suggestions later might go a long way toward solving this problem. In September of last year, the Institute for Local Self Government in Berkeley, Calif., printed a monograph which contained my ideas on this subject. I have updated the conclusions and recommendations of that paper and present them now.

Chairman PATMAN. We are glad to have them, sir, and they may be printed in the record.

Do you have them with you?

Mr. REILLY. Yes, sir, it is right in the statement here.

Chairman PATMAN. I see.

Mr. REILLY. Shall I continue, sir?

Chairman PATMAN. Yes.

Mr. REILLY. The rating agencies as they now exist are not able to give primary consideration to the public interest as it is involved with bond issues of municipalities and borrowing for public purposes. Moody's and Standard & Poor's are not official agencies and their financial support and clientele reflect this. Their ability to profitably employ the staffs and resources necessary to insure rating for public issues cannot be assured. Since the rating agencies private interests expectedly are paramount, there is no reason to expect that they would continue to do so at a loss. Proper ratings, alone, will not provide that assurance. But, incorrect ratings will most certainly prevent it.

A new system may well be required—adequately financed to guarantee thoroughness, independently operated to prevent obvious conflicts of interest, and nationally organized to have each issuing jurisdiction personally inspected so that communities will not be rated solely on the basis of available printed information. In so vital a matter as a municipality's credit and bond rating, information must be gathered on the spot by people who know what to look for and where to find it.

The main difficulties with the ratings today stem from the quality of information used. Often, too often, this information is erroneous or incomplete.

The ratings which result from the present system are deficient. Whereas present agencies try to simplify questionnaires to avoid costly detail, proper ratings require even greater detail—more facts, figures, anything and everything which may help to evaluate an issue in question. Factors such as a community's management, outlook, and promise should be analyzed. Only personal investigation can be used as a basis for that kind of analysis. Only by assembling and correlating all available information can an analyst properly and adequately assess the investment quality of a given offering.

A new system could be organized around a central office, well staffed to act as a sort of editorial review board to give final approval to all ratings recommended by a series of field offices strategically situated throughout the country. Concurrently, a network of correspondents and researchers could be established, comprised of competent people to be called upon to investigate a particular locality—usually one issuing only limited amounts of bonds.

The new agency could have as its primary function the rating of bond issues, but it could also serve as a source of data for those seeking information about particular issues. In any event, its operation would be in the interests of the public and the issuers in order to provide the most complete and thorough information necessary for a true, accurate, and fair rating.

The agency could have a secondary role to maintain current files which would give financial and economic pictures of political subdivisions.

The new agency would not simply be a reformed version of those in existence. It would be an expanded system, providing those in-

creased services made necessary by the growth of municipal financing in the United States in the last two decades, which bids fair to expand at an increasing rate to the end of the century.

The information should be gathered and stored, using modern EDP methods with a library of computer tapes to provide at a moment's notice complete histories of municipalities being examined. This service could be available to all, whether subscribers or not, at a nominal cost. The agency should properly apply other computer techniques for analyzing issues.

The final rating should be expressed numerically rather than be limited to alphabetical categories. This is in line with Walt Tyler's idea. The North Carolina Municipal Council, for example, has had great success in rating bonds from 100 down—with default situations occurring at about 60. This system allows fine lines of distinction, not presently available, to be drawn.

Periodic reports should be provided covering all new issues to be sold in the immediate future. These reports would supplement a larger volume of data containing facts about all bond issues and issuing municipalties. The format should be such as to make seriatum changes, additions, and deletions.

While further study is necessary and is also recommended, preliminary research indicates that such a system would cost $750,000 to $1 million per year. Many will ask whether our industry can afford this system. The real question is whether we can afford to be without it. The requirements of the public interest in today's multibillion-dollar bond market make it impossible to any longer "afford" the old system.

The new agency could, in fact, be supported by subscriptions sold to dealers, private investors, insurance companies, and all other institutions interested in municipal bonds. Most probably the cost of maintaining this operation could be raised through these subscriptions.

Of course, the agency would be totally independent of all subscribers and have no connection with any issuer or underwriter. This independence would have to be firmly established at the outset. The agency would then, undoubtedly, be approved by the Comptroller of the Currency, and its ratings would be respected by bank examiners.

How long would it take to make this new system operative? If a plan were put into action fairly soon, it could be established within 5 years.

As a first step, it is recommended that a committee be formed representing the Investment Bankers Association, the Municipal Finance Officers Association, the National League of Cities, the National Association of Counties, the Federal Deposit Insurance Corporation, and other Federal agencies concerned, as well as other major investment groups. The committee's primary goal would be the establishment of a uniform municipal finance credit analysis. One of the philanthropic foundations interested in the development of municipal finance and its relationship to the public welfare should be willing to support the nationwide study herein recommended.

The rating agencies, no doubt, will be among the first to recognize the need for another opinion. The creation of any agency specifically designed to rate municipal bonds would relieve the existing agencies of a great and apparently unrewarding burden.

The rating agencies operate on very limited budgets and rating

is only one of numerous functions they perform. Increasing public pressure to have all issues rated causes those available resources to be spread rather thinly. A new agency would relieve that pressure and allow present agencies to concentrate only upon those bond issues which are of greatest interest to their clients.

The new agency would better serve the public interest while enabling the old rating agencies to better fulfill their primary role of serving public interests of their clients and subscribers.

The market volume necessary to fill tomorrow's needs requires new ideas and new approaches.

Finally, most students of public administration would agree that the paucity of revenue and accompanying financial plight of cities is one of the factors inhibiting the full utilization of our system of local self-government. More and more, it is becoming necessary for municipalities to turn to higher levels of government for funding sources.

Reform of the rating system should result in lower interest costs and, consequently, be at least one step in the direction of providing more money to municipalities for implementation of local government programs, services, and functions.

The inescapable conclusion is that the bond market has grown too big in volume and frequency for the present rating system to do full justice to the public interest.

Since then, I have been privileged to be a member of the Subcommittee on Municipal Ratings of the Municipal Securities Committee of the Investment Bankers Association, which is headed by David M. Ellinwood of the Morgan Guaranty Trust Co. of New York. Mr. Ellinwood, as you probably know, headed the Moody's Municipal Ratings Department for many years and is usually known as "Mr. Ratings." While he and I have had our differences over the years on these matters, as have Walt Tyler and I, I would like to publicly commend him and the other members of that committee for the work that they are doing. We have been working on the problem for several months. We have issued an interim report to our organization and we would hope to issue a final report at the December convention of the IBA in Florida.

We had many things to think about, and I am going to review some of them now. We had to ascertain in our own minds whether the ratings were indispensable or unnecessary and I think we've decided that they are pretty necessary. There are people who think they can get along without them. There are institutions who rate bonds themselves and who don't really pay any attention to the ratings. However, we think that in the marketing of the very heavy volume of new bond issues, we need ratings. The need, we think, is especially felt by that individual or small institution who hasn't anybody else to depend upon.

We were also concerned about whether one or two ratings were necessary; whether the industry could get along without the Standard & Poor's organization rating bonds. We have more or less decided that we did need two ratings—that a minimum of two ratings were necessary both for issuers and investors.

We then had to take up some fundamental considerations, and there is one thing that we are certain about, in fact unanimous about, on the committee: any rating system must be independent; it cannot be federally dominated.

We hear the idea of forming a Federal rating agency and basing it in Washington put forth as the answer to all the problems. We don't think this is the answer to the problem. We think this would probably just be incubating several other problems.

The problem of continuity bothers us because we think it is a serious problem for issuers. One of the things we worried about was the cutoff dates that Standard & Poor's had set. I am sure Mr. Harries of Standard & Poor's has filled you in on the fact that they have extended those dates.

We also discussed the propriety of fees. It is a problem. We found a number of people in our business were disturbed about fees even though these are the people who are not paying the fees. Some people will worry about anything that they have to pay a fee for. They will wonder what the connection might be, what the problems are, whether or not there is a conflict.

However, we feel that Standard & Poor's, which is a subsidiary of McGraw-Hill, one of the great corporations of the world, is the type of organization that could be trusted to handle any situation like this without any hanky-panky, with the very moderate fee that they charge.

We saw alternative courses of action. We could just wait and see what happens. We could ask that the securities industry endorse the fee system. We could endorse State ratings systems such as they have in the States of North Carolina, Michigan, Ohio, and Texas. We also have other organizations that can be used to rate bonds. We think there is a good possibility here. We are also thinking about my independent agency idea.

I would like to comment on the subject of what would happen if State and local bonds were made taxable.

Most people think that we underwriters have a vested interest in tax exemption and that our business would materially suffer if tax exemption were removed. This is not true. Our industry would continue to sell bonds whether they were taxable or nontaxable. The losers would be the local areas as they would pay much higher interest rates. While this might be painful, I would think that their biggest loss would be the trade that they would have to make for their right to be autonomous. Aside from this very serious question, I have my doubts as to whether the Federal Government could really do the job they think they can. I would predict "backups" in projects such as we witnessed in the past several years.

Will everything stop when the Federal Government gets tight for money, as it has been recently?

Will the Government feel the stress of local areas asking for money at the wrong time as they do in England, thus causing "runs" on the Central Bank at the wrong times?

I think that tampering with the tax-exempt system to satisfy some bureaucrats who have fought tax exemption for years is dangerous.

I would reiterate that the basis for a really healthy Federal system lies in the retention of tax exemption. The lure of Federal guarantees, in my opinion, is a cruel trap for our local areas.

In summary, I believe that the rating situation is better today than it was a year ago. I still believe that the people who do that rating have to be just as cognizant of change as any of us. I believe that the

cities of our Nation must be viewed with a different perspective than in past years. I do think subtle changes of thinking are taking place in the rating field, which will benefit the local and perhaps even the city areas. Perhaps, we will not see the establishment of an independent agency. Remember that the independent agency idea is not a threat against the present agencies.

I think of it as an adjunct to what we already have to handle, the tremendous volume of the future. I think that either the establishment of the independent agencies or the building of the State-sponsored agencies will help the small issuer who cannot get a rating.

I also believe that our industry, through the IBA and our rating committee, will come up with some meaningful answers on this problem and I believe that the rating agencies will accept them in the spirit in which they will be made. I, for one, am very optimistic about the future in this area.

Thank you, Mr. Chairman.

Chairman PATMAN. Thank you very much.

Mr. Betts, you have your statement with you, I assume. We failed to get copies.

STATEMENT OF BERT A. BETTS, BERT A. BETTS & ASSOCIATES, SAN FRANCISCO, CALIF.

Mr. BETTS. Mr. Chairman, I wish to apologize for one of the major airlines, in that they said they put the 125 copies of my statement on one of their airplanes outside San Francisco, in Sacramento, and when I got to Washington, no one seemed to know where they were. I am working from one of my originals. I apologize.

Chairman PATMAN. Well, that is satisfactory. These things happen; we cannot avoid them.

Mr. BETTS. I am having my office turn out additional copies.

Chairman PATMAN. Very well.

You may proceed in your own way.

Mr. BETTS. I may say my own way may be changed a little bit because of the papers not getting here.

Chairman Patman, Senator Proxmire, other members of the committee, I want to thank you first of all for the opportunity to be present and give you my thoughts on the municipal-bond rating system and its problems.

How to improve the present system of rating municipal bonds in reality is just one question among many that I think could and should be asked of a stagnating, overworked, and perhaps downright sick municipal bond market. One way to approach the problem of ratings is to consider the many problems of the industry and the solutions thereto, which I shall try to do in this short 10- or 15-minute period.

"Change," unfortunately, is a word which the industry or profession, if it can be identified as such, appears unaware of. Or perhaps the market's aloofness to change, is calculated. I do know that as treasurer of California for 8 years, may times—even though the majority of the time we certainly had tremendous cooperation—my efforts to seek progressive change were thwarted and rebuffed.

Maybe those are harsh words; maybe we met with polite indifference in trying to introduce change in the industry. In any event, change was slow and hard to attain, as it is elsewhere within our society.

As an example, we have coupon clipping. This industry is issuing tens of millions of little pieces of paper like this every year, still using manual procedures, very little mechanization, very little electronic type of accounting for such coupons.

One answer to this might be—and they have studied it, I realize; I do not mean to be completely negative or critical here of the IBA—they and the ABA have studied a means of going to fully registered bonds, such as many corporations and some large entities have done in recent years. It seems to me a little effort and time devoted to some of these changes and solutions possibly would mean we would not be hearing what I have heard in the industry from time to time, and that is, "we did it this way in this industry 100 years ago, so what is wrong with it today?"

I think there are many reasons, and I am not going to try to give them to you today, that people within the industry—and I mean issuers, underwriters, consultants, and rating agencies—I think there are many reasons that they advance for this resistance to change, and I think I probably have heard most of the reasons or rationalizations that they come up with for not making changes or not studying the future.

I am not one that says we can study the situation for the next 20 years. At some point, decisions have to be made after the studies, and then if we try something new, we try it in the practical field.

I think that we have many other things which actually create a structured industry—for example, we have monopolistic bond counsel, and we have historical underwriting syndicates. I am not saying these are bad, I am merely saying they should be looked at once in a while with a thought to change. We have outdated methods at ratings, compiling ratings. I think we have an opposition to a new segment which is moving into the industry—although I know it has been there for the last 30 or 40 years in some places—and that is the truly professional, independent, financial consultant.

So I say to this committee that I think the rating change or the changes necessary in the ratings are not the only changes needed throughout the industry; the industry must be willing not only to seek change but to institute the change when they have found what is necessary.

I think the industry is too inelastic; it is not flexible enough. I think one of the examples of this is H.R. 15991 and S. 3170. I think it is well known to you people and to others within the industry that not only this legislation but this type of legislation is opposed by the majority of the people in the industry.

I say that if the issuer benefits, and the other segments of the market are not hurt, what is the basis of the opposition? Certainly the Federal Government is going to benefit from additional taxes, thus this is not a point of opposition. I do not think that people oppose it on this. They oppose it on the many things which you are well aware of and I am not going into now. Mr. Reilly has covered it, as well as others.

But again, I am using this only as an example of the resistance to change. I want to make it very clear that I am not supporting these bills or endorsing these bills at this hearing. I think that as a former

issuer of bonds, my position—and I issued some $3.5 billion worth of bonds on a State level—my position would have to be that unless the Federal Government could guarantee that these measures I mention were not a wedge which would eventually strip State and local government of what I believe is a constitutional right, then I could not support the bill.

In other words, I think the measures are not in themselves unacceptable, but it surely must be stipulated that these proposals, if adopted, do not constitute local governments' waiver of the constitutional right to issue tax-exempt bonds in the future.

Time is certainly short here today. I am not going to be able to cover many of the areas within the industry, and I am sure that people here at this table today between them have 10 times as much experience in this field as I do, anyway, so that they can, I am sure, cover these things in the question and answer period—and I would be happy to try to answer questions at that time as well. But I do feel there has been a tremendous paperwork hangup in this industry, as in all of society, but particularly in this industry. I think this is something that has brought about what has been presented to you in testimony many times; that is, that only a small percentage of the issues being brought to the public are actually rated on today's market.

I think, in addition, the underwriter has a responsibility for analysis. I am sure that they attempt to fulfill this responsibility. Yet it seems clear that an inordinate amount of emphasis is placed on a single letter rating, and I think this has been shown throughout your testimony of these 3 days and last December.

One result of the emphasis, I think, is the disadvantageous position in which non-rated issuers are placed. By policy, certain size issues and certain types of entities are not rated. You had testimony on the small entities which are not rated and the effect on them. In addition, I might say, entities such as redevelopment agencies in California are not rated. This is certainly a policy matter and I do not quibble with the rating agencies' opinion that they cannot afford to rate this type of thing. But I do think the one most important factor not taken into consideration in ratings in the past has been on-the-spot information obtained by actually visiting the entity to be rated. The rating agencies should look at things other than the mere mechanical details normally used in a rating. Therefore, they cannot rate a California redevelopment agency without going to California and without actually studying and seeing the project in being.

I do think it is unfair; and I think this is what we are here for today, to try to find a way to overcome this unfairness. I think it is not just unfair to the people sitting here, by any means. The unfairness is to the taxpayers of the United States in the local entities involved.

I also think it is interesting that underwriters are in the financial consulting field—and I think it is not a place they should be. Maybe that is because I am a financial consultant, but I hope that I can look at this objectively. Unfortunately, from the issuer's standpoint, if the consultant and the underwriter are the same person or the same firm. This is the equivalent of selecting a lion to handle negotiations with a tiger which is about to devour you.

It must be clearly understood that the underwriter represents the ultimate investor, and thus is seeking to obtain bonds at the lowest

price. This is certainly a legitimate function. Underwriters are the oil which turns the gears of the market. But it also should be remembered that the issuing agency, justly and reasonably, seeks to sell its bonds at the highest price—lowest interest cost.

Can an underwriter who seeks to pay the lowest price fairly represent the issuer who seeks the highest price? I think the possibility of a conflict of interest is evident, and I question the advisability of a single firm representing both buyer and seller, because their interests are very different.

I think one of the reasons that after November of 1966 I entered the financial consulting business rather than going back into practice as a certified public accountant was that I felt there are not sufficient people around independently representing the issuer and thus the taxpayer. I looked at the volume of bonding, and it seemed to me that local and State bonding is not going to decrease in the next 20 years, at least—probably never. It is a problem which you people face here in this committee day in and day out.

I think that we must have a major realinement of responsibilities within the municipal bond industry. I think we are going to see over the years a changing role for all concerned and I think that this becomes a part of the answer to your more specific short-term question of how do we correct the rating problem.

Two things are particularly important in what I have said in relation to this problem that we are talking about: No. 1, if a method of obtaining computer-stored information as a means of getting all the basic facts from throughout the United States, whether it be Federal—not a rating agency but a Federal computation agency—or whether it be private enterprise, whatever it might be, if this were available, then I think these figures could be used by whoever is in the field making an evaluation or compiling the information so that an evaluation can be made later. And No. 2—again I say that I think on-the-spot information is of utmost importance. I notice in one of the testimonies that one of the rating agencies has already started by putting someone out in the field in another city, which I think is certainly a step in the right direction if we retain the present system.

Now, if we go to the system that I envision here, it would seem to me that a financial consultant's responsibility would have to change considerably. The financial consultant is the individual out in the field who is actually in contact with the issuer and who has the opportunity to obtain—for later evaluation by others—the facts which the mechanical details of debit, and that sort of thing, leave out—such facts as what are the economic conditions today in that city?—not 6 weeks ago or 6 months ago or 6 years; and what is the city doing in the way of administration to try to improve these things? We have many, many problems, and complications are brought about by riots and that sort of thing within our society today.

So I think that in my concept of what is necessary, a financial consultant must become a professional individual, must be licensed by a governmental agency—State or Federal—or by a private licensing organization much as the attorney is licensed by the bar association, or the CPA's are licensed by State government. This, I think, should be the No. 1 factor that we consider before we go any further. I do put

emphasis on the consultant, because the consultant is the man in the field.

Now, from there, it seems to me that the information which is compiled by the consultant would then be accepted and could be accepted by the rest of the industry. I am not talking about a licensed professional financial consultant who takes a 2-week cram course and then gets a license. I am talking about a truly professional person and this is going to take a few years to bring about.

Then we come to the rating agency, and what role does the rating agency play? I think they would have a very important role, but a role considerably changed in concept from that which rating agencies perform today. There is general agreement that ratings are a vital aid to underwriters and investors in determining what the interest cost of a bond should be. It is my contention, however, that the single-letter rating has become too important—I cannot stress that enough—in the underwriter's and investor's judgment at precisely the time when you are studying this—so there must be some problem as to whether or not ratings have become too mechanical in nature. All of a sudden—not really all of a sudden, because for many years it has been developing that this single-letter rating is the important thing upon which an analysis is based, and which determines the interest cost limits on a particular bond.

I do not think that the ratings today are adequate. I am not going to go into that. I certainly agree with what Mr. Reilly stated today. I have great respect for people within the rating agency business. They have had economic problems, time problems, and other such things, but I do not think the ratings are adequate. I think it is very unfair at the present time to the issuer and to the taxpayer. If we are to reestablish ratings as meaningful indicators upon which the underwriting fraternity and the ultimate purchasers can place reliance, I would personally throw away the word "rating." I think the word is wrong. I think it is too limited. It should be an evaluation or comprehensive analysis. I do not personally believe it can be contained in a single letter—which is directly opposite to what was said here today, and to what most people think, but I am sure this is not the first time in the last 10 years that I have taken a stand somewhat different from the rest of the industry.

In summary, very briefly, I think that the analysis is actually the responsibility of the underwriter and they cannot delegate it—they can delegate the analysis but not the responsibility. I think this again goes back to the fact that the underwriter is actually representing the bond issues to the ultimate investors. I think that the large underwriter or the syndicate that might be formed in most cases would develop the analysis for themselves. Again, now, I am talking about the analysis they would develop from figures compiled in the field by a professional independent consultant, very similar to a CPA's audit report and opinion report. I might add—not a nonopinion report—which could be accepted, much as a CPA's report and opinion are accepted. I think our society has come to the point where we have accepted those. So consultants are compiling this information, and maybe whatever comes out of this bank of computers—if we can get the computer to compile the 80,000 issues, statistics, and so forth, which are purely mechanical.

Then we come to the fact that some of this started many, many years ago, long before most of us were probably in the business—at least before I was in it—that is, that the underwriters have a problem paperwise and timewise and staffwise. That is certainly to be understood. So they are really looking for a way to obtain help in analysis. I say in analysis, and not in developing a rating, per se. So they turn to the municipal bond-rating people. These are the rating agencies of today. What the underwriters order, they pay for, so the rating agencies do not have an economic squeeze. They have a business in which they can make a profit. This is the way I understand the private enterprise system.

I think, in conclusion, I will merely say that I think the concepts expressed here in what I have said today represent fundamental changes—perhaps drastic changes—in the various functions of rating agencies, underwriter, bond counsel, and consultant. I think that we can say that it is a complete realinement of management responsibilities within the municipal bond industry. I believe that, as the final and ultimate answer to professionalizing the entire industry, we must bring about an evaluation rather than a rating—set definite responsibility so that we do not have this problem that we have had up to this point, wherein a governmental agency says that everybody who has looked at a prospectus is responsible for some piece of information in it. This results in three or four different parts of the industry all saying they have to do the same work. We have to become professionalized to a greater extent so that the work that each part of the industry does can be accepted.

I realize this is short, brief, it is inadequate. I wish it could be longer. I do, again, wish to thank the committee for the opportunity to be here today and I apologize again for one of the major airlines in not having my comments before you.

Thank you.

(The prepared statement of Mr. Betts follows:)

PREPARED STATEMENT OF BERT A. BETTS

THE MUNICIPAL BOND RATING SYSTEM—HOW IT SHOULD BE CHANGED

How to improve the present system of rating municipal bonds in reality is just one question among many that could and should be asked of a stagnating, overworked, and perhaps downright sick municipal bond market.

Change, unfortunately, is a word which the industry (or profession, if it can be identified as such) appears unaware of. Or perhaps the market's aloofness to change is calculated. I know, as Treasurer of the nation's largest State for eight years, that my efforts to seek progressive change were sometimes rebuffed, or at least met with polite indifference. Change was slow and hard to attain. Here we have an industry, for example, which every year produces tens of millions of little pieces of paper known as interest coupons. These coupons must be submitted to the issuing entity for payment. It is entirely possible in this age of electronic wizardry that some form of computerized accounting could be devised to handle these coupons, yet manual or semi-automatic clipping and counting is still the process by which this chore is accomplished—and simply because the market resists what really could be tremendously valuable *change*.

And though many corporate bond issues are now fully registered, this is not true of municipals. This change to fully registered issues would result in a sizeable decrease in paper work, with no loss in efficiency or accountability.

I know there are many so-called reasons for the hesitancy to make changes; the underwriters, the ultimate investors and even the issuing agencies advance reasons for maintaining the status quo. I'm glad the Wright Brothers weren't prepared to accept ground transportation as the final answer to our needs to

move people rapidly from one place to another, or perhaps we would not be able to appear at hearings such as this, because we would have no airplanes to fly in.

I think this disaffection with change is one of the major reasons that bond ratings are now subject to some criticism. The ratings are structured in a very precise but essentially inadequate manner. We have the same situation in almost all phases of the municipal bond industry. I think the term "structured industry" fits it very well.

From the monopolistic bond counsel, to the formation of "historical" underwriting syndicates, to outdated methods of compiling ratings, to the opposition to the truly professional, independent consultant who attempts to create an objective, comprehensive analysis of issues he brings to market—all smack of the "structured industry" that I speak of. The typical comment of the industry—and I have heard this many times—"We did it this way 100 years ago, so why change now?"

Why change? If only for the realistic alignment of the municipal bond market with the volume of present day bonding. The necessity for handling an ever-larger volume of municipal bonds must be apparent to everyone in the industry.

People in this business should be aware of the necessity for change, but even more so they should be willing to *institute* change, for without such an attitude, I fear that the necessary funding for the increasingly varied and numerous projects planned by state and local entities will not be possible.

The market is too inelastic, gentlemen, and simple physics defines what happens to an inelastic substance when it is twisted, molded or subjected to pressure. It cracks—and this may be the fate of the municipal bond market if the change which produces elasticity is not forthcoming.

We have one example immediately at hand. I speak of H.R. 15991 and S3170. I believe it is well known that a vast majority of people in the municipal bond business oppose not only this legislation, but also oppose this *type* of legislation.

But if the issuer benefits, and the other segments of the market are not hurt—what is the basis of the opposition? Certainly the federal government will benefit because of these bills, to the tune of 100s of millions of dollars in new tax revenues, but this is not a logical point of opposition, and I don't think many people oppose the proposed legislation on this point.

I submit that, given the qualifications set forth, opposition to these bills may be unreasonable, and perhaps is based almost solely on resistance to change.

I should make it perfectly clear that I am not endorsing these bills, but only using this as an example of the "anti-change" school of thought.

As a former bond issuer who marketed nearly $3½ billion in tax-exempt bonds during my years as Treasurer, I certainly would oppose these bills unless I had the federal government's guarantee that these measures were not the wedge which eventually would strip state and local governments of their *right* to issue tax-exempt bonds. In other words, the measures as written are not in themselves unacceptable; but it surely must be stipulated that these proposals, if adopted, do not constitute local government's waiver of the constitutional right to issue tax-exempt bonds in the future.

Time is short and a discussion of all of these problems would be quite lengthy, but I will touch briefly on some of them as they relate to your question for the day.

The tremendous increase in the volume of municipal bonding has created a paper-work "hangup" for almost all phases of the business. Statistics quoted in past studies conducted by your subcommittee reflect the fact that rating agencies have been unable to keep up. They are swimming against the tide, and for every foot they progress, the flood of new issues pushes them back two feet. And this is true even though rating agencies *do not attempt* to rate more than 20 to 40 percent of the new issues.

The volume problem has affected the underwriters similarly, with interesting side effects. The underwriters, in my opinion, have abdicated a portion of their responsibility, shifting a part of the task of analyzing new issues upon the rating agencies which, as we have seen, are already bogged down. It seems to me that the underwriters have a responsibility to the ultimate investors (their customers) to review thoroughly any issue with which they are associated, large or small. To rely on a 'single letter' rating is grossly unfair and, of course, in placing major reliance on this single element, the responsibility for determining the quality of an issue thus, by default, rests largely on the rating agency.

The underwriter has a responsibility for analysis, and I am sure that they attempt to fulfill this responsibility, yet it seems clear that an inordinate amount of emphasis is placed on that "single letter" rating.

One result of such emphasis is the disadvantageous position in which non-rated issuers are placed. By policy, certain size issues and certain types of agencies are not rated (California Redevelopment Agencies, for example), an obviously inequitable situation.

I think it is interesting as well that underwriters are entering the financial consulting phase of the business—perhaps on the theory that this, in effect, permits them to discharge their responsibility for analysis of the issues they plan to market.

Unfortunately, from the issuer's standpoint, this is the approximate equivalent of selecting a lion to handle negotiations with a tiger which is about to devour you. It must be clearly understood that an underwriter represents the *ultimate investor*, and thus is seeking to obtain bonds at the lowest possible price. This is a perfectly *legitimate and useful function*. Underwriters are the oil which turns the gears of the market. But it must also be remembered that the issuing agency, *justly and reasonably*, seeks to sell its bonds at the *highest possible price* (lowest interest cost). Can an underwriter, who seeks to pay the lowest price, fairly represent the issuer, who seeks the highest price? I think the possibility of a conflict of interest is evident; and I question the advisability of a single firm representing both buyer and seller, because their interests differ.

In fact, a major reason for my decision to become an independent consultant, rather than re-entering practice as a Certified Public Accountant, was the obvious lack of independent representation available to the bond issuer (and, of course, to the taxpayer, since the issuer actually represents the taxpayers). Unfortunately, there are only a handful of independent consultants in the U.S. and while they are performing excellent service, their ranks are too thin particularly in view of the expanding volume of bonding at the state and local level.

This situation is dramatized by the weight of advice and counsel available to investors. Underwriters represent the ultimate purchaser; rating agencies, in effect, represent the ultimate purchaser; and even bond counsel represents the ultimate purchaser. Balance this against the few consultants who can offer truly independent consultation, and the inequity is apparent.

I well realize that my point leads to two questions: First, where are more qualified independent consultants to be found? I suggest that formal recognition of independent consultants through establishment of, for instance, a professional or governmental licensing agency would have the effect of encouraging formation of such firms, with resultant benefits to bond issuers. Such recognition would carry with it a definition of responsibility as well, setting forth the areas in which competent performance by the independent consultant must be demonstrated. The official statement which the consultant publishes in connection with a bond offering would no longer carry a 'non-responsibility' clause (as it does now). The consultant should be entirely responsible for the information in this statement; and, the information so compiled should be complete, factual and fully representative of the proposed bond issue and the issuing entity.

The independent consultant should *properly be considered* the authoritative source of information relative to the offering. Underwriters, rating agencies, and bond counsel should have every right to rely o the consultant's information and such conclusions as may be drawn from this information.

The second question raised by my statements: What role does the rating agency have in this system as I conceive it? A very important role, but a role considerably changed in concept from that which rating agencies perform today.

I think there is general agreement that ratings are a vital aid to underwriters and purchasers in determining what the interest cost (or price) of a bond should be. It is my contention, however that the rating has become *too* important in the underwriter's and purchaser's judgment—at precisely the time when bond ratings are too often little more than arithmetic calculations based on mechanical factors such as tax burdens, debt records and assessed valuations.

The rating itself is inadequate—not the rating agency. In my experience, rating agencies sincerely attempt to provide an unbiased rating, based upon all the information available. Economic pressures, for the most part, have been responsible for the gradual erosion of bond ratings into the mechanical process described above.

The solution, I believe, lies in re-establishing ratings as *meaningful* indicators upon which the underwriting fraternity and ultimate purchasers can place reliance. I would throw away the word 'ratings' because 'ratings' are too narrow, too limited in scope. A rating should actually be an evaluation, a comprehensive analysis, and it cannot be contained in a single letter.

To retrace my steps for a moment, this analysis is actually the responsibility of the underwriter, because it is the underwriter who represents bond issues to ultimate purchasers. And I certainly expect that the large underwriters (or perhaps syndicates when they are formed) would develop this analysis for themselves. But the multiplicity of issues, and the fact that there are many underwriters and investors without the resources to maintain appropriate research staffs, demand the services of the rating or evaluation agencies.

The rating agencies, I feel, have a role in the municipal bond business that is considerably more important than the function they presently perform. I would convert their task from a perfunctory exploration to an in-depth evaluation, based largely on requests from underwriters for analysis of issues coming before them, and, I foresee gradual assumption of the responsibility (which is already implied) to evaluate *every bond issue which comes to market.*

How can the rating agencies accomplish this when economics presently preclude adequate research capability? Here, I feel, is where the independent consultant can lend both stability and reliability to the marketing process.

The consultant produces the information—complete and accurate information—upon which the underwriter and rating agency base their evaluation. The evaluation is thorough and substantial—a truly representative basis for determining the investment potential of the bonds.

The necessity for underwriter and/or rating agency to develop information would be eliminated; the licensed, professional, independent consultant would absorb this responsibility. On the other hand, both underwriter and rating agency would assume a much greater responsibility for developing an evaluation procedure that analyzes far more than mere mechanics; a reliable evaluation must include the economic dynamics as well.

I realize that the concepts expressed here represent fundamental changes in the various functions of consultant, underwriter, bond counsel and rating agency. This is in effect a realignment of major responsibilities within the municipal bond industry, I also realize that this brief explanation is inadequate to fully explore the issue which is being raised by this committee. But I do wish to express my appreciation for this opportunity to appear before you, and to present my ideas relative to bond ratings and problems of the municipal bond market.

I believe I have, in essence, answered most of the 10 specific queries set forth by your committee as pertinent to this investigation. but to assure that I have covered them all, I will provide a very brief comment on each below.

1. Why is there a need for bond ratings? I don't believe there is a need for a "single letter" rating per se. There is a need for thorough, comprehensive evaluation which considers all factors, not merely the mechanics of existing tax rate, assessed valuation base, etc. As I envision a realistic approach to bond marketing, an independent consultant would develop all pertinent data, making this available to both underwriters and rating agencies for their evaluation and determination of the individual issue's investment potential.

2. What are the good features of the present rating system? Simplicity. The present rating is simple, because it evolves to a "single letter" which, in turn, translates to an interest rate range. The simplicity is deceptive, however, because the rating so established fails to take into consideration factors which properly should form a part of the basis of the rating?

3. What is wrong with the present rating system? It is inadequate, and thus unfair. The mechanistic approach fails, as mentioned above, to consider aspects which should be included in determination of the rating. In addition, more than half of all bond issues are not rated—which is extremely disadvantageous to the entities which do not receive ratings.

4. What should be done to improve ratings? This is covered in the formal statement.

5. Indicate the basic factors which should be taken into account in establishing ratings. In addition to such mechanical factors as debt burden, tax burden, delinquency records, budget status, assessed valuation and expenditure-revenue trends, emphasis should be placed on factors which sometimes receive little or no weight in the rating—population trends, general economic status and potential, transportation, labor market, residential desirability, recreational advantages, and factors which presently or may in the future enhance the economic condition of the entity.

6. Should data be supplied through independent research and investigation? Absolutely. This is the proper function of the independent financial consultant; to supply all data and statistics.

7. How should a rating agency verify information furnished to it by a prospective borrower? If supplied by an independent consultant, licensed in the fashion described in my formal statement, the information may be considered reliable. Otherwise, the agency could only verify information by sending a representative to investigate the entity.

8. Could rating agencies make more thorough analyses if they were relieved of the task of gathering economic and fiscal data? Yes, but not at the expense of creating a governmental agency simply to undertake this task. The expense to taxpayers for an agency to collect these statistics is probably not justifiable, in my opinion.

9. Would it be helpful if a Federal Agency were to provide factual reports on state and local public borrowers? This is difficult to answer categorically. It might be useful if such data were supplemented by "on the spot" information gathered immediately prior to the bond offering.

10. Who should pay for reports? The bond underwriters. (Of course, the cost ultimately will be passed along to the taxpayers in any event).

Chairman PATMAN. Thank you, sir.

Each one of you gentlemen has presented a very interesting statement, something that we need here. We need the information you have given to us. I am very much impressed with what you said.

With regards to what you said about guarantees, Mr. Betts, we already have that system pretty well in our economy now. I do not hear many people complaining about it.

Mr. BETTS. The guarantees, Mr. Chairman?

Chairman PATMAN. Yes. In other words, this really revolves around protecting these municipalities, which have no way of getting ratings now in a satisfactory way and where there are no losses. We had information compiled by Dr. Diamond that showed that over a period of 20 years, there were only about 20 defaulted nonspeculative issues, or about one a year. That does not mean that the loss was total. It is practically nothing, it is insignificant, practically nil. That being true, why should there not be some way to give some protection or guarantees from some agency, by means of which the Federal Government might act to save these local governments the enormous costs they are now having to pay on interest, which they should not have to pay given this negligible risk, which is practically nonexistent.

Take, for instance, the Federal Deposit Insurance Corporation, which guarantees deposits of up to $15,000 in commercial banks, and the Federal Savings and Loan Insurance Corporation, which guarantees the share accounts in the savings and loan associations in a similar way. I think that mutual savings banks come under the FDIC. This is a guarantee system.

We have guarantees for building houses, and any other guarantees, so the practice is in our system now.

We are talking about helping these small municipalities which are victims of the rating system, although the problem is not caused directly by the people who rate these bonds. It just happens that the small units do not have ratings and they are not big enough to know much about it. Their bond issues are selling at terrific rates. Even when the average interest rate was 4½ or 4 percent, they were selling at 6 percent—from 1, 1½, to 2 percent more—just because there was no guarantee, and no rating like the big ones have.

So then it occurred to me that there should be some solution that you gentlemen could suggest, since you see the public interest suffering here whenever these bond issues have to be sold for 6 percent, which is a terrific cost. The local people have to pay that. If they have to pay

a reasonable rate of interest, that is all right. If they have to pay what might be considered an extortion rate, that is very burdensome.

Most of this money goes for public improvements like highways and streets and sewers and water and things like that. It seems to me there ought to be some system worked out, that you gentlemen might even sponsor, that would cure this terrible defect in the issuance of tax-exempt securities with respect to small issues.

Do you not have something to suggest on that, Mr. Betts?

Mr. BETTS. Mr. Chairman, I certainly agree with some of your statements here in that the small issuer, which is what I think you are referring to at this time, has suffered and will undoubtedly continue to suffer until some change is made. This is what I was talking about, that the entire industry must be willing to look at change and then make change and not just look for the next 10 or 20 years. I suggest—my suggestion is that we have—I am not opposed, for instance, at this time to the compiling of these mechanical statistics by someone, as I said whether it be the Federal Government, whether it be State agencies, whether it be private enterprise. I am not opposed to the compiling of these statistics as possibly some people are. I think this would help. I think it would make it least expensive to do the job at the time of the bond issue—to put out a prospectus.

But I go back—you have two ways of possibly doing this if I read your previous testimony correctly. One is that you put a guarantee on the bonds and go to a taxable bond. Then you have, I believe I read that one of the agencies said this would automatically make them an AAA taxable bond, which eliminates the need for much of anything else, according to that testimony, if I remember it.

Whether then to continue with that, with the bonding in this industry which would be required, which I think is the question most of us have uppermost in mind, I say the proper way to do it is to get that information from that local entity. I say if it is an entity such as XYZ Water District in the middle of nowhere, but you do have someone who is going to prepare a prospectus or an official statement for that entity—now, that cannot be done, I do not think, and give proper weight to the necessary factors which would, in effect, give a fair interest cost to this community. It cannot be done from Wall Street or from Washington or from any other place, one place in this Nation. I think it has to be done by compiling that information which you will not get from your bank of computers from on-the-spot analysis—not analysis, on-the-spot gathering of the additional important factors to be considered for later analysis by the rating agencies or by the underwriter who, in effect, is going to have to sell those bonds.

Chairman PATMAN. Well, anyway, I think something should be done about this. I do not think you gentlemen can just complain. I think you should suggest something. There is certainly a wrong here and there is bound to be a remedy. If you do not come up with a remedy, it will not surprise me if we pass something that will be in the direction of guarantees—at least we would consider it a giant step in the direction. We might have mistakes in it, but we cannot continue to let municipalities, such as I have described here, suffer for reasons that can be corrected and that have been corrected in other guarantee systems. There is practically no loss here at all, practically none.

The testimony received yesterday was that 700 banks in Minnesota had the policy over a period of time of buying all local issues and they did not have any loss. Well, that is about the same situation that exists over the Nation. We know that by not taking some action, we are requiring people who are hard hit and who must vote bonds for different worthwhile purposes, to pay what is considered to be an extortion rate of interest. We should not let that go on.

May I just make one comment and I will turn it over to Senator Proxmire?

About this clipping of coupons—what attracts my attention is that you still use a horse-and-buggy method of clipping coupons, I believe you said. I will give you a little experience, just briefly.

About 30 years ago, I went to the Federal Reserve Bank of New York and I told them I wanted to see the open market portfolio. They took me to a room about the size of this hearing room and I bet there were about 200 or 300 people clipping coupons, most of them women. They were all clipping coupons, very busily engaged. We went up to see the part of the portfolio they were not clipping and looked that over.

Then about 25 years later, I was back in New York and I told them I wanted to see the portfolio again. I went into this same room and there was nobody there clipping coupons. I said, "What, there is nobody here clipping coupons?" They said, "Well, we have a little different method, now. We will take you back here where the portfolio is." It was about the size of a safe, about 30 inches one way and 40 the other. I said, "You mean to say you have all the bonds"—it was a few billion dollars then—"in that small safe?"

"Oh, yes," they assured me; then they opened it up for me. I said, "How can you keep them in there?"

They said, "Just feel up there and feel the bonds, pull one out."

I felt them and pulled a bond out that was $500 million. What they were doing, they were taking the small bonds and shipping them to the Treasury and getting one big bond.

Of course, I know that is not too feasible in your business, but I know the Federal Reserve solved it rather quickly that way. I just thought I would bring that to your attention as a means of making these bonds a little easier to clip.

Mr. BETTS. Mr. Chairman, might I comment on that? The State of California, when I was treasurer out there, we had probably as large a supply of bonds as most places handle. We made great strides toward converting what we could, what we were holding in the vault, into fully registered pieces of paper, which is what you are talking about.

Chairman PATMAN. Yes, sir.

Mr. BETTS. My complaint is not what we think of as a clipping. We have automatic clippers.

Chairman PATMAN. Anyway, that is not exactly relevant to our testimony here.

We will have about a 3-minute recess.

(Short recess.)

Senator PROXMIRE (presiding). The committee will come to order.

I want to emphasize to Mr. Betts once again—I want to clear the air, because there always has been in these hearings the notion that somehow the proposals that have been made by Congressman Patman and

by me are aimed at weakening tax-exempt status of municipalities. You said unless there is some assurance that the guarantee proposed in the legislation would not constitute a wedge to end the right to issue tax-exempt bonds in the future, you could not support it. I agree with you wholeheartedly. I want to emphasize that and I hope that there cannot be any question about it.

As a matter of fact, if you feel that there is anything in this legislation that implies that this would end tax exemption, any of you gentlemen—Mr. Reilly, Mr. Tyler, as well as Mr. Betts—we would be delighted to welcome any safeguards you would like to suggest along that line.

Mr. Betts. Thank you.

Senator Proxmire. Anything you gentlemen would like to consider, either now or when you revise your remarks to make it stronger, it certainly is not our intention to endanger tax exemption. Our intention is to help the municipalities by this, which brings me to my second point.

As you know, a big issue, perhaps the biggest domestic issue, is what we are going to do to help our cities. Our cities are in heavy trouble—big cities, you gentlemen know this from your California experience. Vice President Humphrey, who has perhaps an even chance of being President of the United States, has proposed one way of meeting the problem. We have proposed another. His way is a Federal bank that would loan money, financed by taxable bonds, of course, issued by the Federal Government, to the municipalities in a big way, in a massive way. He calls it a Marshall plan. Those were grants, but these would be loans.

What we are proposing, instead, what I think would be a more conservative approach. This is an approach which I hope would be more acceptable to the municipalities. It has the same purpose, but it would tend to preserve the municipalities' rights as much as possible, would provide a guarantee, and provide an option for the municipalities. I stress "option." If they want to go the tax-exempt route, they are free to do it. But if they do not want to go the tax-exempt route, and want instead to take advantage of a subsidy to supplement the loss which they would suffer by not going the tax-exempt route, then they would choose that option and issue taxable securities, with a 33⅓-percent subsidy. Since their interest cost saving, we have calculated, is about 25 percent by following the nontax route, they would have an incentive for issuing taxable securities.

And since the Federal Government finds that the average tax rate for investors in municipals is about 42 percent, the Federal Government would pick up about 9 percent, increase its revenue—at least, that is our calculation. It was disputed yesterday by some of the expert witnesses, but we think it would pick up substantial Federal revenues.

Why, gentlemen, is not this approach, on the assumption that we want to do something in a substantial way to help our cities—they are in trouble, they are going to be in even more trouble in the coming decade—why is this approach not appropriate? If it is not, what would you suggest?

I would like to start with Mr. Tyler and ask each of you gentlemen.

Mr. Tyler. I suspect that my major objection is a philosophical one.

I tend to distrust centralization in any form. I guess it is what Mr. Reilly refers to as my 19th-century mind.

Senator PROXMIRE. No, no, Mr. Tyler, I agree with you 100 percent. I do not think there is anything 19th century about mistrusting centralization. Centralization is something we can all see serious problems with, not only from the standpoint of interference ultimately with political rights and freedoms, but also with the inefficiency involved. But you see, I would contend that the approach we suggest here is more decentralized than the approach suggested by the Vice President.

Mr. TYLER. I would agree to that.

Senator PROXMIRE. The initiative, the option, is entirely in the hands of the municipalities and anything we can do to safeguard that, as I say, we would be delighted to welcome it.

Mr. TYLER. Several years ago, 30 or 40 of us sat over at the Brookings Institution for the best part of 3 days trying to figure out what percentages would be saved, what the differences would be as a result of the elimination of tax exemption and the suggestion of some sort of a Federal——

Senator PROXMIRE. I do not want to interrupt you, except to say nobody is proposing to eliminate tax exemption. We would not contemplate that it would ever be eliminated. They would always exist side by side.

Mr. TYLER. But in the opinion of the 35 or 40 of us who sat there, I doubt that two of us walked out of the room in agreement as to what the percentage advantages and disadvantages would be. I know that there were all kinds of minority reports flying around and everything else.

I think the matter is one that is going to take an awful lot more thought than it has received to date before I would say we will provide such percent subsidy or such percent subsidy. I simply do not know.

I was impressed by the fact that there was simply no one in agreement, really, after a 3-day session.

Senator PROXMIRE. Has that not always been the situation? You find the experts and the economists always disagree.

Mr. TYLER. I think so.

Senator PROXMIRE. We have to recognize the problem here. We recognize the real plight of the cities that is getting worse. We just cannot accept the inability of experts to agree on a solution or to get a consensus we would like o have.

Mr. TYLER. To even arrive at a consensus. I think we wound up with a flat stalemate as far as even should exemption be eliminated, should a subsidy be substituted. I think even there, we had an absolute Mexican standoff. I would just want to spend an awful lot more time thinking about it and thinking about how and what lies behind it.

Senator PROXMIRE. Mr. Reilly?

Mr. REILLY. Senator Proxmire, my colleagues and myself at Goodbody and Co., with Prof. Larry Ritter, head of the Economics Department of the New York University Graduate School, have just spent several weeks preparing a monograph which unfortunately is not going to be released until Monday, but I think you will have a copy of it tomorrow, which we call "A Capital Plan for the Urban Areas"——

Senator PROXMIRE. Fine, we will welcome it.

Mr. REILLY (continuing). This plan uses the Marshall plan of post-World War II as Mr. Humphrey and Whitney Young have done in

the past as a possible blueprint for helping the cities. I have written an epilog to suggest the investment banking participation in this. I think we have a middle of the road, meaningful situation. It would be unfair of me to release it today because of certain commitments we have on it. But I think you will find that it will be something unusual for a Wall Street house to have such a plan. We have been very conscious of the urban areas for a long time.

Chairman Patman asked about what we were suggesting for the agencies. The reason that I have been pushing the independent agency for several years is just that. We would get down to helping the smaller credits. We all talked about here today, I think, the desirability of having people on the ground, not somebody sitting in a Wall Street office or looking over the Hudson and not seeing too many miles past. We would have people in California, people in Iowa, people in Texas, knowing the area. I have always found over many years in the bond business in negotiating bonds and so forth, that I never could get the feel of the issue by sitting in New York and looking at a prospectus.

Senator PROXMIRE. You are getting at a partial answer by saying we can get a rating on the small issuers by having people out to do the job. The cost of that would be borne by the issuers; right?

Mr. REILLY. By the issuers and supported by underwriters and investors.

The one thing that I feel strong about is the guarantees—I know we have many subsidies in Government. We have had subsidies since 1951 on new housing bonds. We have subsidies in the local areas by States of certain bonds. I am not afraid of guarantees or subsidies.

But I question whether any local area has a right to trade its tax-exempt privilege. It was not given to the local area. It was given to the State, as I understand the doctrine of reciprocal immunity. It was given to the States; therefore, it is not the right of the local areas to trade it off.

Senator PROXMIRE. The staff advises me that they have been advised by bond counsel that the State legislatures would have to pass enabling legislation or the city council would have to pass enabling legislation. But this is a democracy in which we can do whatever we wish to do, either by constitutional amendment or legislative enactment. The people are sovereign. If they wish to provide this option, which might be attractive, or might not be, to a municipality, they have a right to do it, or not to do it.

Mr. REILLY. I am sure if they take those safeguards, that it will be all right.

Senator PROXMIRE. Mr. Betts?

Mr. BETTS. Senator Proxmire, I feel that the statement that your staff just gave you certainly clarifies my thinking to some extent, because if you are going to the local area and saying that they must also exact enabling legislation, I think we are getting down to—at least it would seem to me—the necessary things to overcome what Mr. Reilly has said, and I therefore would not be opposed to this type of legislation. I think this is probably something for someone who has sat where I did for 8 years and continually spoke against the Federal Government usurping any of our rights in this tax-exempt position to make this

change. I certainly have spoken out the other way all along. But you have also given me complete assurance here today on the question I have in my mind. You have also now given me an assurance that the local entity is going to have the opportunity to pass enabling legislation.

So I would not be opposed to guarantees under those circumstances.

Senator PROXMIRE. That is a very welcome statement, Mr. Betts. If you have any other suggestions as to how we can provide additional safeguards on further consideration when you go over your remarks, they would be very welcome.

Now, Mr. Reilly, you were reported to have said, while participating in a panel of the Municipal Finance Officers Association, in response to questions about Mr. Patman's bill, you said it would "regiment all your municipalities over the country into an agency fed out of Washington."

Then you went on to say in pretty blunt and emphatic language that you oppose the legislation. You said:

> This is just another ploy among many ones that he has made over the years. We just had not given his considerations much time at all. We think there are much more important problems than what Mr. Patman is suggesting. Although if Mr. Patman's ideas may prevail—and they might prevail someday if people like the municipal finance officers didn't do something about it or keep alert—all of a sudden you might have restrictive amendments put on tax bills and so forth, and you may find out that Mr. Patman, will sneak some of this stuff across. But this depends on the municipal finance officer more than it depends on the investment banker or the investor.

There are two pretty clear safeguards. I have great respect and admiration as well as affection for Mr. Patman. I think he has been a man of tremendous courage, and whether you agree with Mr. Patman or not——

Mr. REILLY. I agree with him on many things and admire him greatly, but do not agree with him in this area. The response that I made in New Orleans was to a question which was sort of "planted," and I gave the expected response. I did not mean it as a reflection on the chairman.

Senator PROXMIRE. He has certainly been like a bulldog on many things, he has great tenacity and courage, as well as wisdom.

Now, on this particular point, let us consider this bill. Do you really argue that this bill would regiment municipalities in this country into an agency fed out of Washington?

Mr. REILLY. I think it eventually would.

Senator PROXMIRE. Why?

Mr. REILLY. What we need in this country today is the bolstering of the local area in personnel—people. I can see that the easy way out would be in the Federal guarantee route. There is also the basic consideration that the free market has always been the best way for the American economy, whether the free market was for corporations or local areas which issue bonds.

Senator PROXMIRE. No. 1, you would still have a free market to the extent that they decided to exercise their option and go the tax-exempt route.

Mr. REILLY. Right.

Senator PROXMIRE. No. 2, if they do not exercise their option and go the guarantee taxable route, you would still have a free market,

although the market would be somewhat different because of the guarantee aspect. But it would still fluctuate to some extent.

All guaranteed issues do not sell at the same price; do they?

Mr. REILLY. No; this was evidenced in the new housing deals, where we have AAA guaranteed housing bonds. If the investor liked the city, he would pay a higher price for it, if he did not like the city, he would pay a lower price for it and there was no difference in the guarantee at all.

I still say, Senator, on another consideration, that if XYZ in the State of "Way Out Somewhere" sold with a Federal guarantee, they might be surprised at the high rate they are going to pay regardless of the guarantee.

Senator PROXMIRE. That may be, but the interest rate would be less, certainly, than without the guarantee. Because after all, XYZ, or "East Overshoe," out somewhere in Wisconsin or Minnesota, people in the market do not know much about it, maybe the local banker can or cannot take it. If he can take it, if it is convenient for him, he may get a fair price. If not, they may not get that fair price.

It seems to me with a guarantee, and when you add the taxable element, you broaden the market considerably over what it would be now.

At any rate, if localities can raise their own money in the market, which is what this bill provides, they would be less dependent than they would be if they had to rely on a Federal grant or a Federal loan, of the kind which has been proposed as the alternative.

You say you have something going which I will have a chance to take a look at on Monday?

Mr. REILLY. This only pertains to the urban areas, especially to the ghetto area.

Senator PROXMIRE. Then that is quite limited, because, of course, we are talking about the great area of municipalities all over the Nation, large and small.

Mr. REILLY. Right. I think the problem of getting a bond sold today probably divides down into two areas. First, the small unknown place, the little place that cannot get a bid—or at least a decent bid. I fully sympathize with them. I know what their inclination is to move toward a system like that, despite what I say.

Then on the other side of the coin, we have the problem of the large city, which is now having to pay more money because of the way we look at their problems.

Senator PROXMIRE. Let me just point to the arithmetic of this, the desirability from the standpoint right now of getting something like this enacted, the way it looks to us, at least, for the municipalities. See if you can attack this arithmetic.

A Government-guaranteed municipal bond would sell in today's market at an interest rate of about 6¾ percent. With a 33-percent interest subsidy, the net cost to the municipality would be 4½ percent. Currently a large proportion of municipal bonds are being sold at a rate exceeding 5 percent. That difference between 4½ and 5 percent over 20 or 30 years, of course, can make a whale of a lot of difference in teachers' salaries, police and fire protection, or not having the burdensome property taxes that we have in so many of our municipalities. So the taxpayer and the beneficiary of a city's services would have a chance to gain from this kind of proposal,

plus the fact that we still have the real initiative in the hands of the local municipality. They issue the bonds, it is their obligation, they are responsible for it, they take the initiative right along the line rather than the Federal Government.

Mr. REILLY. Well, I have spent quite a bit of time with local finance officers at a convention recently, the municipal finance officers in New Orleans. I found there was practically unanimous sentiment against this idea and these are the fellows who have to sell the bonds. They are thinking—again, perhaps as Mr. Tyler said before—perhaps philosophically rather than of the arithmetic involved. Over the long run, they feel they can develop better credits that will generate more interest in the market. They would rather be in the free market.

I probably should not speak for them, but I had quite a few conversations at the convention. I found that there was this long-term "fear" of this encroaching federalism that changes the concept of the federal system as I think many of us understand it.

Senator PROXMIRE. I want to get back to that encroaching federalism later.

I want to ask Mr. Tyler how much Federal regimentation you experienced in the rating of college housing revenue bond issues when you were at Standard & Poor's?

Mr. TYLER. I had no problem with that at all.

Senator PROXMIRE. That was a federally subsidized one?

Mr. TYLER. Yes, it was. We never thought about it in those terms, particularly.

Now, wait, Arnold.

Senator PROXMIRE. Arnold tells me it is not.

Mr. TYLER. I was going to say I should not shoot at the counsel, but those were not——

Senator PROXMIRE. Identify the counsel more formally. We keep referring to him as Arnold.

Mr. TYLER. Of course; Dr. Diamond.

We had no problems at all with it. I think it was an entirely different situation.

Senator PROXMIRE. Now, let me get back to the safeguards which Mr. Betts found helpful and interesting. One that we have not mentioned is the fact that you do not have simply Mr. Patman's idea or Mr. Proxmire's idea. You have the Congress, which has to approve this. Believe me, the Congress is very, very sensitive on this. Just yesterday on the floor of the Senate, I questioned Senator Muskie on a billion dollar program for providing Federal assistance in the antipollution area. In the course of the questioning, I questioned the kind of financing. I said this looks to me as if it is at least a partial guarantee of tax-exempt bonds and this contradicts the Treasury position and my own position, the position of many people. We feel this is just morally wrong, you should not have a guarantee of a tax exempt.

We had quite a colloquy. At first, he denied it, but it was clear that there was at least a partial guarantee there. Then in the course of the colloquy, he agreed that the administration's original proposal would have provided a cheaper way of financing for the municipalities, would have provided the taxable route with a subsidy, the kind we have here. He was for it. But he said there was such a tremendous outcry by the

municipalities that they found they just could not get it through, even though the municipalities would gain from it.

So he had to go this route, which is a route that I think is highly questionable, and may be killed in the House. You may not get any benefit at all from it because there is a fundamental opposition on principle to having a guarantee with a taxable exempt status. I think perhaps you share it. The men we had here yesterday were all very much against it.

So you see, there is this feeling in the Congress that it is going to take a very, very carefully drafted bill. Undoubtedly, our bill will have to be amended considerably before it gets through, if it does get through. So you have that safeguard against any notion that there is going to be an encroachment against any right the municipalities have in issuing tax exempt securities.

I hope that serves to assure you. I did not ask for a rollcall. If I had, I would have been badly beaten.

Mr. REILLY. I think I agree with you on that stand. We have done a lot of work in the area of air and water pollution. We at Goodbody & Co. have come up with a formula for doing it that might not appeal to you, because it employs the industrial bond technique. But we have come up with the idea of forming authorities around the country and putting the pollution equipment in the hands of those local authorities and leasing it out to the various industries who are involved in the area of pollution, this means that there is no Federal guarantee, no State guarantee. It will be paid for by the people who are causing the pollution, without adding to their capital costs, which is a big consideration to many corporations.

Senator PROXMIRE. That would be tax exempt?

Mr. REILLY. Yes, sir.

Senator PROXMIRE. That is much better, that is right.

Mr. REILLY. The bonds would be issued through local areas.

Senator PROXMIRE. In addition to that, of course, you have the safeguards that you have to have action by your local municipality before you could exercise the option to follow the taxable route.

Mr. REILLY. In deference to Dr. Diamond, I would like to ask my counsel about it, too.

Senator PROXMIRE. All right, that is fair enough.

Now, I would like to ask further here, Mr. Reilly, I am delighted to see that you seem to favor the data bank, is that right?

Mr. REILLY. Yes, sir.

Senator PROXMIRE. That is most encouraging. That part of the bill we find has substantial favor.

I would like to ask you if you know of anybody, if you can identify anybody who has suggested a Government-sponsored rating——

Mr. REILLY. What is that, sir?

Senator PROXMIRE. In your statement you said there are some who have suggested a Government-sponsored rating agency.

Mr. REILLY. I think that this was proposed by Roy Goodman of New York City way back when this rating problem was at its height. I did not mean to say any member of this committee had suggested it.

Senator PROXMIRE. Now, once again, recognizing that we should preserve the tax-free option, the option to have issued nontaxable bonds, nevertheless, do each of you gentlemen not agree that we

should do our best to limit the issuance of tax-exempt bonds from a moral standpoint? We are going to have them and they are going to persist, but it is very, very hard for me to understand, recognizing that we are going to have an enormous increase in municipal bonds in many, many areas, far out of proportion, probably, to other kinds of capital that is available—if all of this is going to be on a tax-exempt status, it seems to me that the tax avoidance is going to be very considerable and develop quite a problem in our system.

I just cannot accept the notion of a fellow with $10 million putting that $10 million into tax exempts, getting a 5-percent return, $500,000 a year, $10,000 a week, and paying not one nickel of taxes on it. That just is wrong. It is even worse than the oil depletion provision, it seems to me. You at least have some kind of rationale for that. But for this—recognizing, of course, that the municipalities are going to continue and should continue, is there not a strong moral case for trying to limit that, trying to provide a free option to limit what seems to be a real discrimination and abuse?

Mr. Reilly. Senator, first of all, I would like to address my remark to the ideas that the millionaires have all the tax-exempt bonds.

Senator Proxmire. Certainly they do not, the banks have most of them. Not that the banks are paupers, but the banks have them.

Mr. Reilly. We hear many times, I think Mr. Martin said a few years ago that he did not like the idea of people sitting on beaches clipping tax coupons. However, I have a day-to-day experience selling tax-exempt bonds. We are one of the largest distributors of tax exempts to retail customers. I wish the people in that very high bracket, now 70 percent plus, would buy bonds. But we find out that the guy who buys the bonds is down in the 40- to 50-percent bracket, not the millionaires. This is a fact.

Senator Proxmire. A 40- to 50-percent bracket is maybe not a billionaire, but it is a pretty comfortable bracket to be in.

Mr. Reilly. Some of them are still struggling.

Senator Proxmire. Who is not? Yes.

Anyway, would you gentlemen concede that there is at least this moral force behind the effort to limit this? We do not want it to get out of control.

I think the one thing that could probably resolve in an effective public outcry against issuance of these securities is that they become so general and there was so much tax avoidance through people investing in tax exempts that finally you had an effect on the State legislatures and the Congress that would result in really abridging.

Mr. Reilly. Well, you turn it around and if you make them taxable, then they are purchased by tax-exempt foundations or tax-exempt pensions, which are on the rise. The pension situation, as far as buying corporate bonds in this country, is a very big factor. The difference between the corporate and the municipal market is that we have a wider spectrum of people who will buy. The corporate market can count, sometimes, on their 10 fingers, the number of pension funds that will buy a particular issue. In most of those cases, there is no revenue for the Federal Government because of the taxable aspects of the bond.

Senator Proxmire. Well, my point in rebuttal to that, of course, is that the market in municipals now is so confined, so limited. It is confined almost to banks——

Mr. REILLY. I agree on that.

Senator PROXMIRE. Another real advantage on this is that it would really broaden the market for municipal bonds. As a matter of fact, it would more than double it. We have statistics here that say, right now, municipals are in fact available to investors who have assets in the neighborhood of some $400 billion. If you opened it up through making an optional taxable route, you would have more than a trillion dollars of investment which could go into taxable municipals. So you would certainly broaden your market. This would certainly tend also to make it more attractive; less costly for municipalities to borrow money.

Is that not correct?

Mr. REILLY. I think, if we did a better job in our industry, we could certainly do a better job of broadening our own market under the tax-exempt situation. I think we have probably not. Perhaps we have not been cognizant of change, as Bert Betts said. However, I think we can do a whale of a job——

Senator PROXMIRE. Everybody can do a better job. I can do a better job as a Senator. We can all do much better than we are doing at the present time. But any economist would say if you double your demand, you are going to increase the price and lower the interest rate. It is the demand for these bonds that is going to go from less than $500 billion to a trillion dollars. You are going to enjoy a situation which, to some extent, by some number of basis points, the cost is going to go down. I do not know how you can avoid that. At least, that seems to me to be one strong argument.

Now, I have some questions I would like to ask briefly here.

According to the average yield tabulations for new issue municipal bonds as compiled by Rand & Co. for a 20-year maturity of a general obligation bond, the difference in yields between a AAA rated and a BAA rated bond was around 75 basis points during the first half of 1968. Is this in line with your experience? Is that about right?

Mr. REILLY. About right.

Senator PROXMIRE. Would you confirm that, Mr. Tyler?

Mr. TYLER. I would think that is in the ball park.

Mr. REILLY. A 25-percent rating jump between grades.

Senator PROXMIRE. How about the difference between AAA and unrated bonds?

Mr. REILLY. It could be 75, although it might be a hundred sometimes.

Senator PROXMIRE. It is 75 between AAA and BAA? It must be more between AAA and unrated.

Mr. REILLY. Sometimes an unrated will do as well.

Senator PROXMIRE. Sometimes. I am talking about on the average, they do not do as well as BAA.

Mr. REILLY. There are issues that are traditionally not rated by the agencies that do just as well.

Mr. TYLER. This is a very hard thing.

Senator PROXMIRE. It could be as high as 1½ to 2 percent, right?

Mr. REILLY. I do not think so.

Mr. TYLER. Not on an average, I would not think.

Mr. REILLY. I do not know of many that do.

Senator PROXMIRE. Not on the average, but many small ones are.

Mr. TYLER. Oh, well, in the case of a very small issue in a rural area, in a State that does not normally command a low interest rate, yes, it could get that high.

Mr. REILLY. Senator, on this balance between ratings, sometimes you can have a BAA today at 5 percent and you can have an unrated speculative situation at around 6 percent or 5¾ percent. The idea is that when you pass 5 percent, it sort of gets blurry. I think Dr. Diamond would testify to that.

Senator PROXMIRE. At any rate, there is a sharp difference between the AAA and the BAA and there may be about the same difference or a little more between the AAA and the unrated bonds.

Now, that difference between the AAA and the BAA concerns me especially in view of the experience that we have had with defaults. We had testimony here 2 days ago that in the last 20 years, there has been exactly one issue that was rated that was in default—one issue, $880,000. Now, when you recognize the enormous number of issues, thousands and thousands, the over 100,000 issues, and one in default, and this a relatively small issue, it would seem to me that this difference between BAA and AAA, which is 75 basis points, is a whale of a big cost to pay when there is no significant risk, apparently, in any of these rated bonds. Therefore, it is a most unfortunate burden which the ratings services, who are doing as good a job as they can, tend to impose on the municipalities that are BAA rated—on their taxpayers.

Mr. TYLER. In the first place, I believe that the last 20 years has not been a fair test of the situation at all, because we have been in a constant inflationary period which has, as I said in my statement, tended to cushion the impact of this increase. I would not be at all surprised to see us back in a situation similar to, say, the 1940 situation, at some time in the not too distant future and there were a lot of defaults around in the 1940's.

Senator PROXMIRE. The year 1940?

Mr. TYLER. The year 1940, that is as far as the ratio of debt service to national income is concerned.

Senator PROXMIRE. Well, there are several things that have developed. It is true that, in 1940, many of the reforms had already been established, but they were brand new, they had not had a chance to work it out. We were still in the aftermath of a depression, we had 15 percent of the work force out of work. At the present time, we have more than 30 years of experience with insurance of bank deposits, share accounts, establishment of the Federal Home Loan Bank System, social security, unemployment insurance, insurance of housing mortgages, et cetera, plus the Employment Act of 1946 which gave birth to this committee and charges Congress with the responsibility of taking whatever action it seems to us is necessary to prevent the kind of wholesale depression we had in the 1930's, and it was not over by 1940. So it would seem that a reasonable analysis of the outlook in the coming years—I would agree with you, there can be recessions of the kind we had in the 1950's. There were a series of them, as you know. The likelihood of a deep depression would seem to be very, very slight.

Mr. TYLER. I should not be the questioner, but would a 10- or 20-percent drop in national income be unthinkable?

Senator PROXMIRE. In 1 year?

Mr. TYLER. No, from this level. I mean could we ever see national income 10 or even 20 percent below the current level?

Seantor PROXMIRE. That would be, I understand, four or five times the postwar dips that we have had. By and large, we consider a period in which we have no real growth a recession. Certainly no dollar GNP increase would be a recession. Inflation alone, as you say, makes a 2-, 3-, or 4-percent increase. So I think the likelihood of a 20-percent drop in 1 year is slight and in more than 1 year it is less, because the Congress is going to take action that might have other consequences, but we just could not have a government that would stand still for anything of that kind.

You see, this is the argument, it would seem to me, that is a pretty strong argument against a situation that puts so many municipalities in a position where they have to spend literally billions of dollars for interest that would seem to me to be an unnecessary burden and some kind of a guarantee would overcome this.

Mr. TYLER. Of course, my own solution is to broaden the coverage and rate more issues, rate smaller issues.

Senator PROXMIRE. Broaden the coverage in what way?

Mr. TYLER. Broaden the coverage of issues rating. That is, rate smaller issues and more issues. This is what I intended to do with my——

Senator PROXMIRE. If you rate more issues, you still have many issues rated BAA, which you say is a discrepancy of 75 basic points.

Mr. TYLER. Sure you would.

Senator PROXMIRE. Many of these smaller issues would be rated partly because they are small, I presume, in the BAA category. Some would be given a higher rating, of course. You would still have this problem of issues in which there was no significant prospect, at least in the view of most people, of default. Yet they have to pay this excessive amount in interest over the years. Even if you had a comprehensive rating system.

Mr. TYLER. I still do not subscribe to the theory that because we have had one default on a general obligation issue, a rated general obligation issue in the last 20 years, I simply do not subscribe to the idea that we are going to have one default in the next 20 or 25.

Senator PROXMIRE. Mr. Reilly, in today's market, what interest rate would be required to sell a $200,000 tax-exempt water revenue bond issue maturing serially over 20 years, if the issuer is relatively unknown, if the population is 5,000?

Mr. REILLY. It would be very difficult on the national market.

Senator PROXMIRE. Mr. Diamond contrived that question. I am not guilty.

Mr. REILLY. I recognized his hand.

Senator PROXMIRE. He has such respect for your ability to give us a question like that.

Mr. REILLY. Well, of course, I would think that it might not be as bad as you would think. There is no doubt that the $200,000 amount would prevent many people from even looking at it. However, the people in the local area could be interested. Where a person sitting in New York might think that the bond was worth 6.5 percent, the local area could, we find, with our vast network of offices, buyers for bonds because the potential buyers know their own area and are loyal to their bonds. This is why many local bonds sell above the national average.

Senator PROXMIRE. Do you have a situation geographically in the country where, because the money markets are in the East, that especially in the South and Southeast, you have much higher interest rates, less capital available for investment, therefore, the rate might be considerably higher than if this 5,000 were in a suburb of New York City, as contrasted with a small farm center out in Oklahoma or New Mexico?

Mr. REILLY. Could be, but I still think that you would be surprised to find that the bond that the national market would bid, as I said before, about six and a half percent, the local area might take at perhaps five and three-quarters.

Senator PROXMIRE. The local area, something like this, would be 6.5?

Mr. REILLY. If it had to be marketed nationally. But supposing a firm such as ours, or Merrill Lynch had an office in that area——

Senator PROXMIRE. So it would range between five and three-quarters and six and a half?

Mr. REILLY. Right.

Senator PROXMIRE. If Federal agencies were to sell long-term bonds in today's markets, what interest rate would be required?

Mr. REILLY. I guess the figure you mentioned before, 6.5 to 6¾ would be about right.

Senator PROXMIRE. Would you say, in light of sales experience in the sale of federally guaranteed merchant marine bond issues, a Government-guaranteed municipal bond issue where the income was taxable, would command an interest rate that would be equal to the rate that would be obtained by a Federal agency bond issue?

Mr. REILLY. You are talking about those merchant marine bonds that have been issued in the past?

Senator PROXMIRE. Right.

Mr. REILLY. We have never been involved in them, but my feeling is that they did not gain really wide acceptance. I am not so sure that just because you do put a Federal guarantee on a bond that it guarantees distribution. I think that some of these small issues that do go into the local market at tax exempt prices might get a better clientele than if it had the Federal guarantee. Many people might be interested in the tax situation; of course I am talking now from the investment point of view.

Senator PROXMIRE. I would like to ask Mr. Betts—I am just about at the end of this questioning.

Mr. Betts, you combine here a very helpful combination of qualifications—you are a CPA, have had experience in business, been the treasurer of the biggest State in the Union, you are one who has considered the political and social elements in this problem for our cities, as well as the strictly financial elements. You know that owing to heavy population migrations during the last few years, both in and out of the big cities, the cities are called upon to assume larger welfare and education costs to support the poor residing in these areas. A number of these large cities have been down-rated on their bond issues by the services, causing a rise in the interest cost of their new borrowings. What would you think would be the best way to go about alleviating the plight of these cities—by Federal grants, Federal loans, Federal loan guarantees, or do you feel that the additional fiscal burdens are entirely the responsibility of the cities?

Mr. BETTS. Well, No. 1, as far as the last item, whether the fiscal problem is all the cities', I do not think this is true. I think that we must have other than the cities to help solve it.

But in answer to how do we go about it, whether it be a guarantee or some other method, I have indicated here today that I do certainly see the good points in the bills before Congress at the present time. But I also feel that even though we have had this problem in some of our larger cities and some of the smaller ones, medium-sized ones, if the ratings were not based strictly on the items which have been historical and those which have been used on a historical basis, but would take into consideration what I said a while ago, I still do not think you can come down to a single letter rating.

I also feel, and I think all of us here at the table today are saying the same thing, that if in the evaluation and analysis of the credit when they go to borrow the money, the *local consideration* is brought in—just because we have had a tremendous number of people brought into the cities does not mean that that city does not have good administration. It does not mean that city is not run well.

In addition, I think that if, on the local level, it is thoroughly looked into, we would find many factors which would weigh in favor of that city which is becoming more crowded and having tremendous problems that we know of in some areas.

The city is still a good, could have a good evaluation, and I do not use the word "rating." This is not to say that in some other places than just borrowing funds for certain capital expenditures, the city should not have assistance from the Federal Government.

Senator PROXMIRE. That is the point. What kind of assistance do you think would be best here? Do you think it would be possible to do a substantial part of this job with loan guarantees, with Federal grants, with Federal loans, or—then I take it from the first part of your statement, you say they cannot be expected to solve in all cases all their problems just by being left alone.

Mr. BETTS. I do not think they can be expected really, in today's society and what we know the problems are in the old cities, the old parts, to go into debt on the local level to the entire extent of what is required, whether it be guaranteed or whether it be tax exempt. This is what I meant by the first part of my statement.

Senator PROXMIRE. Right.

Mr. BETTS. So, in effect, I think you are going to still have Federal loans and Federal grants for this type of situation. In addition, I say we are going to have to improve the interest cost, lower the interest cost that is paid by these entities.

Senator PROXMIRE. Guarantees is one way to do that?

Mr. BETTS. Guarantees with safeguards is one way to do it and I think in addition, we must consider that somebody has to get out there in the local area; you cannot do it from a centrally located office.

Senator PROXMIRE. Mr. Reilly, do you want to comment on that?

Mr. REILLY. Senator, I would think that whether I oppose the guarantee or not, your big customer may soon be the large city—as it is buffeted about by his State, and when the proper perspective of cities in our economy is not recognized by the rating agencies. If the rating agencies think New York and Detroit are going to go out of business, then what do they think is going to happen to the rest of us? If Detroit

goes down the drain, the bastion of our whole industrial democracy will go. New York is the capital of the world. If the worth of the city and what the city has done for our Nation is not put into proper perspective, then you are going to have a customer whether I like it or not.

Senator PROXMIRE. Then you are saying that we have to follow these routes. I am wondering if you would not agree that a Federal guarantee is a careful, conservative approach that does leave a certain amount of initiative with the localities, more than a Federal loan or Federal grant system would.

Mr. REILLY. I am afraid I cannot go that far.

Senator PROXMIRE. Why not? Why not a Federal guarantee—after all, the entire initiative and so forth are with the issuer. If you have a Federal loan or a Federal grant, Congress has to—we do not have any option. If we are going to be responsible Members of Congress, we have to tie that money we give out to a certain amount of performance. We have to interfere in order to make sure it is done in a way that we think is appropriate. If it is their money, they are borrowing it themselves, they repay it, there is a Federal guarantee element. But it would seem to me that that is a more conservative approach, is it not?

Mr. REILLY. I agree that the city should have its choice. I did not mean to say that they should not, even though I am opposed to it.

Senator PROXMIRE. Then you are for our bill. That is great.

Mr. REILLY. I do not think so.

Senator PROXMIRE. You said they ought to have their choice. How can they have that choice if you do not give them a choice? The only way we can pass the bill is to have an option. The only way they can have an option—which you favor—is to pass the bill. So you favor the bill.

Mr. REILLY. I say they ought to have their choice, but I do not think it would be a wise choice.

Senator PROXMIRE. That is up to them. They have to pass legislation, they have to take formal action before they can take advantage of this.

Mr. REILLY. I question not whether they can do it or not but the wisdom of it.

Senator PROXMIRE. Then you would not oppose our bill. All our bill does is give them the choice. It does not say you must do it, not that it is the wise thing to do. It says "Make up your own mind, here is your chance. If you want to do it this way, if you want to do it that way, you have a choice."

Mr. Diamond tells me there are two other points we ought to clear up for the record.

Mr. Reilly, I am interested in your statement that a fact-gathering operation on the economic and fiscal circumstances of municipal borrowers would cost $750,000 to a million dollars per year.

Yesterday, Mr. Randall, chairman of the FDIC, said that the kind of profile that we are thinking of—and I do not know how he got that notion, anyhow—would cost $60 or $70 million to do the kind of job necessary. Clear this up for us if you can.

Mr. REILLY. What I was referring to in my statement was that this would be the cost of operating an independent agency. These estimates were actually made by Dave Ellenwood. We have not published them

in our IBA reports because we are not sure of them although we believe it is a close approximation.

Senator PROXMIRE. Mr. Ellenwood is a professor of economics——

Mr. REILLY. No; he is a former head of Moody's, now with Morgan Guaranty Bank, the chairman of the IBA Committee on Ratings. In drawing up a sort of salary schedule and expenses and so forth, we thought that an independent agency could be run for $750,000 to $1 million a year.

Maybe what Mr. Randall was talking about was setting up this giant computer or data operation. That is a separate deal.

Senator PROXMIRE. Mr. Tyler, you note that $300 million of municipal bonds are now in default. According to data compiled by the National League of Cities and set forth on page 102 of our December hearings,[1] most of these figures are accounted for by the West Virginia Turnpike and Chicago Calumet Skyway. Most of the rest are accounted for by speculative loans for bridges, industrial aid, marinas, and aerial tramways. Thus, the amount of default on municipal bonds for essential public facilities is infinitesimally small. Would you agree?

Mr. TYLER. It is very small, I agree; yes.

Senator PROXMIRE. Yes; thank you very much. This has been a wonderful morning for me. I think I have learned a lot. I think you have made a very good record thanks to your presentations and your responses. I am most grateful to you for the fine job you have done.

Before we depart, I would like to add that I have received a statement from the Municipal Securities Committee of the IBA which, without objection, will be appended to the printed record of the proceedings.

The committee will now adjourn. This completes our hearings.

(Whereupon, at 12:15 p.m., the committee adjourned.)

(The statement referred to by Chairman Proxmire follows.)

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[1] Financing Municipal Facilities, vol. I, hearings, Dec. 5, 6, 7, 1967, Joint Economic Committee.

APPENDIX

INTERIM STATEMENT BY THE SUBCOMMITTEE ON MUNICIPAL RATINGS OF THE MUNICIPAL SECURITIES COMMITTEE OF THE IBA

INTRODUCTION

The subcommittee believes that it would be most appropriate at this time to present an interim statement of its investigations and findings rather than to attempt, wihin a rather limited and somewhat critical period of time, to reach definitive conclusions and recommendations. It is anticipated that a further report at the Annual Meeting in Florida will include conclusions which will be based upon further exploration of the subject and more extensive appraisal of the effectiveness of the new Standard & Poor's rating policies.

THE SETTING

Standard & Poor's Corporation recently announced a new policy applicable to the rating of state and local government securities. Bonds rated on and prior to February 29, 1968 will retain present ratings until December 31, 1968, except as new circumstances arise requiring review rating analysis. Beginning March 1, 1968, S&P will no longer rate municipal bonds on a voluntary basis. New issues will be rated only upon request, accompanied by an agreement to pay a cost-plus fee to compensate the Corporation for analytical and fact-gathering time and talent. New "contract ratings" will be subject to renewal after one year or on the occasion of the next bond issue of the obligor, whichever first occurs; it is expected that renewal fees will be lower than original fees.

Subsequent to the S&P announcement, representatives of Moody's Investors Service, Inc., declared their intent to continue to assign municipal ratings voluntarily and without fee, but without ruling out the possibility that circumstances may dictate a revision of their policy sometime.

This subcommittee received a very broad charge from the Municipal Securities Committee to investigate and report upon the significance of S&P's new policy. In our consideration of our charge, we of the subcommittee have deemed it necessary to explore at length basic concepts about ratings and their nature, importance, reliability, present use, and proper role in the over-all financial scene. At this time we are able to report as follows:

I. RATINGS: INDISPENSABLE OR UNNECESSARY?

Dating from 1918 or 1919, Moody's represents the only system of municipal bond ratings continuously available over a span of fifty years. Subsequently, at least two other national systems (Fitch and Poor) and several systems confined to a single state were offered, but lapsed into disuse. Late in 1949 S&P announced its intention to enter the field, and its system as a whole was first published in July, 1950. So far as we now are able to determine, no one system or group of systems developed into a significant marketing factor prior to 1938.

In July, 1938, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Executive Committee of the National Association of Supervisors of State Banks adopted and promulgated uniform bank examination and reporting procedures. Significantly, among other things, these applied to the treatment of bank holdings of marketable securities other than obligations of the United States. Designed to apply uniform valuation practices to securities of investment grade, they place an aura of official approval upon nationally recognized bond ratings. It is understood that the primary concern of the regulatory authorities at the time was commercial bank holdings of corporate bonds, but in practical application ratings came into increasing use in regulatory purview of bank holdings of municipal securities as well.

Since the adoption of ratings for "official" use, the character of the municipal securities business has changed materially. Income tax rate increases associated

with World War II and its aftermath caused a shift of emphasis on municipals among classes of investors; savings banks and mutual life insurance companies have lost major interest, their place having been taken by commercial banks. Concurrently, the number of new issues is little changed, but average size has increased greatly. Distribution of lesser known issues necessarily has shifted from local marketing areas. In this connection, it may be helpful to keep reviewing the size of the municipal bond market as set out below:

	Long-term loans (number of issues)[1]	Par value (thousands)		Debt outstanding, end of period (millions)
		Total	Per issue	
1920–29 average	7,155	$1,309,600	$183	$16,922
1930–39 average	4,733	1,153,900	244	19,761
1940–49 average	3,434	1,488,500	433	20,538
1950–59 average	6,239	5,741,100	920	61,985
1960–66 avefage	6,284	9,567,285	1,522	104,750
1967	5,773	14,240,548	2,467	113,300

[1] Source: The Bond Buyer.
[2] Source: U.S. Treasury Department, Bureau of Accounts.

With the growth of the market, ratings have replaced a substantial part of security analysis which, in the absence of ratings, necessarily would be done independently or regretably left undone. Could we operate effectively without ratings? By types of users of ratings, we believe the following answers are realistic:

(a) *Issuers of bonds.*—Large, recurrent issuers probably would continue to market their bonds effectively in the absence of ratings. Availability of ratings and their widespread use clearly has eased the distribution of the bonds of infrequent borrowers. Assuming continuance of total bond financing in the volume seen in recent years, the borrowing costs of local government would be expected to rise if, in the absence of ratings, national distribution is denied their loans.

(b) *Underwriters.*—Reference to ratings has become so commonplace, we foresee a demoralized situation if it should become necessary to scale new issues without benefit of valid comparisons.

(c) *Trading.*—In the secondary market the necessity for quick decision emphasizes reliance upon ratings to an extent exceeding their use in underwriting.

(d) *Regulatory agencies.*—We have reason to believe that the insurance industry and its supervisors could operate without ratings, with minor adjustment to present practices. In the case of commercial banking, it is possible to argue that the role of ratings in bank examination procedures has been overemphasized. On the other hand until such time as superior procedures are developed there appears to be no generally accepted alternative.

(e) *Major investing institutions.*—Of all users of ratings, this group could best afford to do without them, substituting (if they would) their own independent investigation and security analysis. However, perhaps because of the availability of ratings, even large investors do not always have an adequate staff or utilize their personnel so as to perform independent credit investigations in the depth and number true diligence would require.

(f) *Individuals and small institutions.*—In the main, this group lacks the means and the expertise to investigate and analyze. To the extent their investment decisions are directed by quality decisions, apart from price, it is believed they must rely heavily on ratings.

II. One Rating or Two?

During the weeks which have elapsed since S&P's dramatic announcement on January 24, we have watched with interest the impact on the new issue market. We note that some major borrowers, and a scattering of essentially local market borrowers, have contracted for S&P ratings. We note that the majority of new issues, including many of general market character, have been successfully sold and distributed with only a single (Moody) published rating. Our count of all issues of $1 million or more scheduled for marketing in March and April shows that something like 60% to 65% came to market without two ratings.

The gamut of tax-exempt securities includes unlimited tax general obligations, limited tax general obligations, enterprise revenue bonds, dedicated tax revenue bonds, and quasi-revenue quasi-general debt instruments. Some security analysts tend to stress the finances of a specific credit situation, other analysts the legalistics, and still others the socio-economic background. With such diversity of security types and personalities, we find that *quality appraisal is not susceptible to such accurate determination as to leave no room for differences of opinion.*

In appraising the investment attributes of a bond, analysts consider many factors. In the area of general obligations the following list is offered as illustrative but is not represented as being all-inclusive:

Economic and social factors:
- Population—growth, composition, characteristics
- Residential aspects and values
- Commercial development
- Industries—size, type, diversity, relative stability of payrolls, growth prospects
- Agriculture—soil, water supply, profitability and diversity of output

Debt factors:
- Relative debt load
- Repayment schedule
- Debt in prospect
- Borrowing record
- Payment record

Financial operations:
- Tax collection record
- Taxing powers
- State aid and supervision
- Relations with other local governments
- Budgeting skills

Management factors:
- Organization and performance, nonpartisan vs. partisan
- Availability and intelligibility of reports
- Legal debt limit
- Outside-the-limit borrowing
- Capital planning and programming
- Zoning

Some of the factors listed above are responsive to objective, computerized handling. *Many are predominately intangible by nature, and induce a considerable subjective element into quality appraisal.*

Factors entering into the analysis of various types of revenue securities would differ materially, yet it is believed analysis here too would involve a mixture of objective and subjective approaches.

With considerable frequency, the existing agencies have arrived independently at approximately the same final rating. We believe this circumstance is fortunate in that it tends to reduce the pressures which otherwise might be brought to bear upon a single agency.

The presence of two nationwide rating systems has been beneficial to the better functioning of the municipal market in three significant ways:

1. It provides an alternative for anyone who feels that a given security is misjudged by one rating agency. Occasional difference of opinion to the extent of one rating level is probably a wholesome condition, but wider differences may be cause for concern; this may be said without implied criticism of either's rating philosophy. The following examples of recently published ratings warrant attention.

	Moody's	S. & P.
Pennsylvania:		
General obligation	A	AAh
General State authority	Baa	AA
Chelan PUD:		
Rock Island	Baa	AA [1]
Lake Chelan	Baa	AA [1]
Grant PUD:		
Priest Rapids	Baa	AA
Wanapum	Baa	AA
Detroit:		
General obligation	Baa	A
MVHF bonds	Baa	AA
Water general obligation	Baa	AA
Water revenue	Aa	AA
Louisiana, Port of New Orleans:		
General improvement	Aa	AA
Port improvement	Baa	AA

[1] Subsequently reduced to A.

2. It provides a quality guide for a security which, for operational or policy reasons, is denied a rating by one agency. For example:

	Moody	S. & P.
Rhode Island Turnpike and Bridge Authority: Revenue		AA
Virginia State Ports Authority: Revenue	A	
Triborough-Narrows Bridge: Revenue		A
Pennsylvania Public School Building Authority		AA
Glen Ridge School District, New Jersey	Aa	
Fair Haven School District, New Jersey	A	
Metropolitan Seattle		AA
New York State Dormitory Authority, Columbia		A
New York State Dormitory Authority et al		A
Chandler, Ariz	Baa	
Prescott High School District, Arizona	Baa	

3. The presence of two rating systems, competing for acceptance and prestige, instills a healthy element of competition which may be expected to sustain or improve the quality of security analysis. The virtues of competition, being self-evident, need no demonstration.

Moody's assures us that, in their case and so far ahead as they can see, analytical and related expense is adequately financed by the sale of services and publications which emanate from the ratings. In the case of S&P, the unwillingness of investors and other interested parties to subscribe in adequate volume to published and other advisory services is the stated cause of its policy change.

We sum up the present situation as follows:

To the extent issuers, dealers and investors feel there should be more than a single rating system, they must accept some sort of revision of past methods by which the ratings were financed. For the time being, it is likely that many major borrowers will arrange, directly or through financing advisors, for the assignment of a S&P contract rating. Similarly, in the case of negotiated sales, there will be instances where the underwriter will wish to contract for a S&P rating, including the related fee in the calculation of underwriting expense.

To those unwilling to operate with sole dependence upon Moody ratings and to whom the concept of fee-financed S&P ratings is repugnant, possible alternatives may be mentioned.

(1) For the benefit of subscribing investors alone, Dun and Bradstreet offers its security grading and detailed reporting services; W. H. Tyler & Co. supplies ratings and summary statistics on general obligation securities only at this time; several respected firms of investment counsel and some major banks provide for the needs of their clients; none of these provide ratings which have entered the public domain as in the case of Moody and S&P, or which seem likely ever so to do.

(2) For a single state, widely used and respected numerical ratings for local credits are furnished to its members by North Carolina Municipal Council, a nonprofit organization of dealers and dealer-banks. The Council is financed by a combination of membership dues and new issue service fees which are absorbed as an item of underwriting expense, hence indirectly reflected in the interest costs of local units. As discussed below, additional state-wide rating systems developed along the North Carolina model are a future possibility, but are not an immediate solution to "the rating problem".

IV. Fundamental Considerations

1—Rating Systems Must Be Independent

We believe there is general agreement throughout the municipal bond industry, comprised of issuers, distributors, and investors, that to be widely accepted and susceptible of complete reliability the ratings must be established by analysts of unquestioned independence. Taken as a whole, dealers and investors alike are strongly opposed to the establishment or maintenance of any rating system which could be dominated or even occasionally influenced by outside pressures.

We are mindful that, from time to time, there has been occasional, very vociferous criticism of the rating assigned to a particular bond issue, and even to a group of ratings assigned to credits in one geographic area or another. Such criticism has led, now and then, to the suggested establishment of an "official" rating system. We are advised that, up to this time, the regulatory authorities

headquartered in Washington have realized that the inherent possibility of political intervention would jeopardize the acceptability of such a system.

2—The Problem of Continuity

Continuity of ratings is a matter of real concern to investors and to dealers active in the secondary market. Transactions here are not a matter of a carefully compiled public record but are generally presumed to run roughly double the new issue market. Outstanding municipal securities amounted to $113 billion a year ago, and now probably is pushing $120 billion. Secondary market trades are estimated on the order of $25 to $35 billion.

Subject only to the availability of requisite data, of course, continuity is no problem for Moody's where we are assured present subscription services provide both a satisfactory working base and the ability to expand with growth of the industry. On the other hand, under S&P's new, present method of financing, it is logical to expect that the greatest part of its fee income will be derived from ratings assigned to new issues. For those who depend upon S&P ratings a substantial problem soon may arise in connection with maintaining up-dated ratings for bonds of issuers which do not sell bonds every year. One suggested solution to this problem requires issuers who will be willing to pay for annual or other periodic credit reviews under an individual or state-wide contract; this solution may be quite limited in probable scope.

3—The Propriety of Fees

We have received from the industry numerous requests that we state our views relative to the propriety of rating fees; some few express doubt that an agency will be able to operate with complete absence of bias under an entirely fee-financed system. After long deliberation on this point, we will grant that impartiality might be suspect if ratings are assigned on an infrequent issue-by-issue basis. On the other hand, if fee-financed ratings are assigned in profuse number by a sizable, experienced rating staff, we believe the mere number of assignments will tend to assure reliability of the agency's ratings on an over-all basis.

We would emphasize that we do not question S&P's sincerity in its belief that it will continue to assign ratings without fear or favor. But we believe it is inevitable that impartiality will be questioned from time to time so long as rating fees are a matter of negotiation between the rating agency and the prospective issuer or underwriter.

4—The Nature and Size of Fees

Inevitably, it is the issuer who will pay a rating fee. Payment will be direct where the issuer makes the arrangement for the rating. Payment may be indirect, but no less a financing expense of the issuer, where the underwriter makes the arrangement, including related costs in the calculation of his bid.

We have not been commissioned nor privileged to investigate the economics of the established rating agencies. Nonetheless, we reason that there is no more than an incidental, random relationship between an agency's expense attirbutable to the making of an individual rating and the amount of bonds associated with the same rating. Complexity of factors entering rating analysis may increase somewhat with size of issue (or class of debt); hence, size may influence agency expense to some degree. On the other hand, size produces a mounting plethora of information; the expense of data accumulation would seem to relate inversely to size. From the foregoing rationalization it may be argued that agency expense varies little with size of issue (or class of debt).

To the extent that the presence of ratings broadens marketability, the ratings tend to reduce interest costs associated with new issues. Therefore, the value of ratings to the issuer increases with size of issue or debt. If issuers are to pay for ratings, it would be equitable for large and recurrent borrowers to pay more (in absolute dollars, not necessarily proportionately) than small and infrequent borrowers.

V. Alternative Courses of Action

We have received a variety of comments and suggestions from a number of people representing different facets of the municipal securities industry. Outlined below is a synthesis of each major type of proposal. The first is posed by those who question the need for published ratings even by one agency or by not less than two nationally recognized agencies. Other proposals arise from the belief that it is vital that positive steps be taken to preserve not less than two reliable rating systems.

1—Wait and See

It is, of course, possible for the IBA as an organization, and the members as individuals to do absolutely nothing at this time, to sit back and "let nature take its course".

According to the terms of the S&P announcement, published ratings as of February 29 will continue in force until December 31, 1968 except as a new issue is scheduled. Since March 1, only contract ratings are being assigned; contract ratings are good for one year or until the next financing by the same issuer. Officials of S&P assure us that they realize their new contract-rating system is a major revision of previous operating procedures; they expect to be flexible, modifying their ground rules if experience suggests further change may be desirable.

To the extent that borrowers place substantial value on their S&P ratings, two national systems of ratings will continue to be available, applicable to new underwritings. Conversely, as we reported earlier, a majority of new borrowers seem convinced that successful marketing and obtaining a S&P rating are not one and the same thing. In either case, conditions in the secondary market may become radically revised as bonds of infrequent borrowers appear; the number of published S&P ratings in full force and effect appears likely to drop drastically in January, 1969.

The possibility of the disappearance of S&P ratings as a cross-reference to Moody ratings raises in some people's minds the spectre of governmental intervention. The present reliance of the regulatory authorities upon ratings would seem to warrant some consideration of this matter. Our studies have not progressed to the point where such a fear can be labelled either groundless or realistic.

Members whose experience preceeds 1950 may be able to recall operating conditions when a Moody rating alone was available. Our canvas of the views of such members is incomplete, but the consensus so far is that a single rating service was adequate at that time to cover the lesser volume of business and the fewer types of credit instruments then available.

Arguments *against* "laissez faire" stress the desirability of having more than a single rating; the great increase in volume and complexity of revenue bonds, lease obligations and various hybrids outside the straight general obligation category argues that a double check on ratings now is considerably more important than 20 years ago.

The counter-arguments come from those who hold that the Moody rating is the significant rating, that the S&P rating has been essentially an added convenience; they point out that, since the S&P announcements in January, Moody has stated its intent to rate numerous types of issues previously rated only by S&P.

2—Securities Industry Endorsement of the Fee Principle

Some IBA members urge an agreement among bond underwriters providing that for each bond issue coming to market the successful bidder would automatically become liable for payment of S&P's fee. (This arrangement could easily be extended to Moody's if subsequently they also move to a fee basis for rating). In return for this assurance of payment of its fee to be established and promulgated prior to bidding for a new issue, S&P would be asked (a) to waive negotiations with the issuer, (b) to rate all sizable new issues, and (c) also to maintain ratings on sizable outstanding issues. This approach satisfies the elements developed in Part IV above.

This proposal in essence follows the pattern, long established in certain states (Michigan, North Carolina, Ohio, South Carolina, Texas) where investment bankers voluntarily have agreed that the successful purchase of each bond issue will pay a small fee to the municipal advisory council within the state. The amount of the fee is established in advance, and each bidding group includes the fee in its calculation of underwriting spread. This arrangement has proved workable and remarkably free of trouble.

Out of a conviction that the maintenance of two rating systems is highly desirable for investors, issuers and investment bankers, this arrangement is urged because there are already in existence two organizations, Moody and S&P, which have had long experience in rating municipal securities. It seems logical to sustain these two organizations rather than to build an entirely new rating service.

Other arguments in favor of this proposal include:

1. The rating services* would receive a relatively predictable and substantial income which would permit them to provide superior and comprehensive ratings. This would eliminate problems related to the unprofitable nature of rating services, the services heretofore.

2. Since payments to the rating services for each new issue would be made on a regular basis by the successful syndicate and not subject to an appraisal of the rating for any one issue, the independence of the rating systems would be preserved.

3. Since local government, although clearly bearing the burden for financing the rating services, would not be asked to appropriate direct payments to rating services, the area of political sensitivity would be minimized.

The chief argument against this proposal is that is is difficult, if not impossible, to get a substantial majority of the investment bankers to agree to abide by an industry policy. The mavericks who did not pay the rating fee would enjoy a competitive advantage over the conformists who do. On the other hand, this semi-voluntary approach has worked well in the case of a number of statewide advisory councils, as noted above, and if everyone abides by the policy no one suffers any competitive injury.

Although it is not an essential part of this proposal, its advocates feel that the municipal rating function is so important to all segments of the municipal bond industry that it deserves a permanent standing committee, whose principal duties would be to keep abreast of rating trends and problems, to maintain continuing liaison with the rating agencies, to discuss problems of mutual interest, and to make recommendations for the improvement of the rating function on an industrywide basis. It should be emphasized that *under no circumstances* would this committee concern itself with the rating problems of individual issuers.

Such a committee should have broadly based support and representation. It might include representatives of such organizations as the Investment Bankers Association, American Bankers Association, Municipal Finance Officers Association, the Municipal Section of the American Bar Association, the National League of Cities, the National Municipal League, institutional investors such as insurance companies, banks and bank trust departments not otherwise represented, and delegates from the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, and possibly state regulatory auhtorities. As to the optimum size and composition of such a committee, the Sub-committee, will welcome suggestions from the membership.

3—Fee-Financed Ratings—A Revised Approach

Other IBA members, agreeing with the objectives of the '"industry endorsement" approach outlined above, offer the view that the goals may be better achieved by a more formalized solution; they suggest the interposition of an industry-sponsored non-profit corporation. Such an intermediator could serve to meet S&P's financial problem initially, or that of other agencies of no lesser calibre which might qualify for support in time.

It is immaterial who sets out to organize such a non-profit corporation, but the organizers should enlist the continuing sponsorship of the IBA and the other broad-based associations and trade interests mentioned above in connection with the proposed advisory committee. The sponsors would seek to establish as standard trade practice, in the same manner that approving legal opinions are required to effect good delivery, the principle that appropriate steps have been taken to secure ratings for all bonds eligible for rating under established criteria.

The corporation would derive its revenues from a new issue fee, payable by the account manager and imposed on each underwriting of bonds eligible for a rating under established criteria. The fee would be calculated under a schedule of rates modeled after the consumption brackets commonly used in the billing of electric, gas and water service, thus satisfying the equities developed under section IV 4 above. In a manner similar to the endorsement proposal, the interposition of the corporation removes the objectionable aspects of negotiations between the issuer and the rating agency (see IV 3 above).

The corporation could contract with Standard & Poor's, for a fixed annual stipend not specifically related to new issue volume, to supply ratings on new issues, and to continue ratings on outstanding bonds, subject to negotiated criteria such as:

(a) the availability of data deemed sufficient for conclusive rating analysis.

*The proposal assumes, perhaps erroneously, that Moody will follow S&P's lead toward adopting a schedule of fees.

(b) size of issues to be rated (e.g.—all situations involving $500,000; $750,000; $1,000,000 or other floor).

(c) types of issues to be rated (some types of risks have not been rated in the past).

Assured that ratings activities are no longer a loss leader, S&P should be as willing to promise continuity of ratings on the debts of occasional borrowers as it now stands willing to supply new issue ratings, thus meeting the problem of continuity (Section IV 2).

Moody's maintains that for the present its expense of producing ratings is adequately financed through the sale of related services and publications. Should this situation change, the proposed corporation could be in a position to negotiate for continuity of Moody ratings. Similarly, the corporation could contract for the services of any newly organized rating agency qualifying as to technical ability and consistency with the principles of complete freedom of though, freedom of expression, freedom from political influence, and freedom from outside economic pressures.

The suggested endorsement solution (section 2 above) and the non-profit corporation have many elements in common. Under both plans, the rating fee would be billed to the underwriter. They differ in that, in the first instance and as S&P now operates, fees would be calculated by the rating agency; the corporation would both fix the schedule of fees calculated to be economically necessary, and collect individual fees. Some members of the Rating Subcommittee are unhappy about the concept that the corporation would fix fees, fearing too generous revenue; they prefer to let the rating agency set its own fees which presumably would reflect competitive considerations and would be set to recover costs and earn a modest margin of profit. Other members argue that the non-profit character of the corporation forecloses the problem of over-charging, while the annual contract with the agency adequately provides for the element of competition.

Some of our correspondents argue that the corporation idea is a superior long range solution to an industry problem which will increase in intensity over the months ahead. Others argue that establishing the corporation could prove to be a cumbersome process, and the "industry endorsement" approach could be adopted readily.

Both solutions fail to provide for the case of the issuer (e.g.—New York City) which is eager for an extensive in-depth review of its financial position, and therefore willing to pay the necessary fee required to secure such a review. There is some question as to whether a municipality which is willing to make such an effort can properly be denied the opportunity provided the fee is directly related to the time and effort required of the rating agency. The counter argument holds that an adequately staffed and equipped agency should not need the motivation of a fee to conduct comprehensive review credit analysis without the prospect of a new issue by the ambitious municipality.

4—New State Rating Systems

Mention previously has been made of the local ratings promulgated by North Carolina Municipal Council which have been generally accepted for many years as valid, objective and unbiased. Parallel developments elsewhere clearly would be possible under conscientious sponsorship. A necessary prerequisite, of course, must be a willingness to place the common, long range good above near term individual advantage.

Fact gathering and reporting dealer-oriented and dealer-financed organizations already are active in Michigan, Ohio, South Carolina, Tennessee and Texas. To extend their present services to include ratings would require some modification of organizational philosophy, but no major expansion of clerical staff. If experienced analysts are available for hire, they would move into offices already well equipped with factual information.

Among states not similarly endowed with a local reporting service in being, New Jersey would be a facile situation for the establishment of a state rating system. Here, audited financial statements for the great majority of all counties, municipalities and school districts are on file in the capital city, available for public inspection. Detailed economic data also are readily accessible, and the comparatively small area of the state would seem to minimize travel expense related to field investigations.

Few states (if indeed any) match the opportunity offered by New Jersey to start up a state rating system, based very largely on central, public sources of information. At the opposite end of the scale, very few state archives hold only little promise for researchers and bond analysts. Between these two extremes

there is great variety. Several states, like New Jersey, have enacted statutes requiring independent audits of local government; among these, the extent of enforcement varies, as does the currency of reports rendered. Many states require varying detail of local government financial information to be reported to state achives, on prescribed forms, and with varying attention to timeliness and to accuracy.

If state rating systems come to be established, their size of staff and operating budgets will vary accoring to the following elements, among others:

a—Number of governmental units; trend toward consolidations or new creations

b—Minimum size of issue or debt to be rated

c—Variety of debt instruments (e.g.—general obligations, utility revenue bonds, lease-back authorities, etc.)

d—Provision for independent audits

e—Provision for centralized reporting, audited or unaudited

f—Availability and periodicity of directory of manufacturers, etc.

g—Significance of inter-governmental relations, state aid in support of local debt, etc.

We have not attempted to calulate reasonable budget estimates for one or more individual states; this may be done by local area specialists more capably than by this sub-committee.

5—A New Nationwide Rating System

Many individuals have expressed the wish that it would be feasible to set in effective operation still a third national, completely independent rating agency. This would provide a corroborating or alternative (according to circumstances) expression of investment quality.

A new agency conceivably could be undertaken by an individual, a group of individuals, the office of the Controller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Investment Bankers Association, the American Bankers Association, organizations of state and/or local governmental officials, or any two or more of the foregoing acting together. Whoever would think to set up a new rating agency, however, should be cautioned that sponsorship by any governmental or quasi-governmental organization, acting by itself alone, however well-intentioned will inevitably raise concern over the possibility of insidious political pressures influencng the agency's ratings. Reference is made back to section IV–I.

To produce a reasonably competent end product deserving of sincere respect would require a substantial staff equipped with widespread sources of information. *It could not be created quickly.* We strongly doubt the present availability of trained personnel in sufficient numbers to organize an adequate staff in short order; it could be possible to make a start with a small nucleus and build gradually through an intensive training program.

In an attempt to answer questions (already put to us) we have attempted to produce realistic calculations of staff size, space requirements, equipment, travel, subscriptions to services and periodicals, and so on, related to a new agency, *when in full operation* which might take 5 years or even 10 to accomplish. We calculate an annual budget at 1968 price levels, *after 5 to 10 years*, in the range of $750,000 to $1,000,000.

Thus, in the present environment where new issue volume is pushing toward $15 billion, at a cost between 5¢ and 10¢ per bond on total state and municipal sales, it should be possible to produce a thoroughly satisfactory service competent to rate 8–10,000 credits annually withoutstanding debts of $1 million or over. The budget contemplates a reasonable degree of reliance on computer services for storage and analysis of basic statistical information, utilization of services and statistics now available in many leading states, and assembly of primary data on a regional basis for home office analysis.

With a budget of the indicated order, it appears necessary that a new rating agency would require extensive subsidization. Eventually, such a service could be supported in part by the sale of weekly, monthly and annual reviews in a manner similar to that of existing services. The publications could extend into corporate bonds and stocks for wider budget support. Long term benefits to the industry through avoiding governmental regulation and promoting more complete credit analysis might justify a considerable subsidy in the early stages. Proponents of this plan argue that the establishment of a new, prestigeous rating agency would facilitate marketing of the much greater volume of state

and municipal financing which may be ahead, and would counter the trend toward centralization of public financing by departments and agencies of the U.S. Government.

CONCLUSION

At this time the sub-committee recommends no specific plan of action or inaction. Our aim has been to spread before the full membership of the Municipal Securities Committee an array of facts and consideration relative to the topic assigned, to the end that IBA members may be fully informed. We have endeavored to develop each point and each proposal without bias against or favor toward any one suggestion. The subcommittee urges that all members of the IBA be encouraged to comment on the subjects discussed in this interim report to the end that the broadest possible spectrum of ideas may be received and considered by the subcommittee over the next few months.

Respectfully submitted,

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