Volume Title: Deterioration in the Quality of Foreign Bonds Issued in the United States, 1920-1930

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Volume Publisher: NBER

Volume ISBN: 0-87014-051-5

Volume URL: http://www.nber.org/books/mint51-1

Publication Date: 1951

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Chapter URL: http://www.nber.org/chapters/c2538

Chapter pages in book: (p. 54 - 58)

Chapter 4

Quality of Foreign Loans Initiated by Individual Banking Houses

To supplement our analysis of the decline in foreign loan quality by borrowing countries we examine the different and changing attitudes of individual banking houses. Classifying loans according to issuing houses will again test the diffusion of credit deterioration and provide some clues to the forces responsible for this process.

The bankers who testified in 1931-32 at the Senate hearings on foreign lending were requested to file information on their loans, primarily with a view to ascertaining their profits. The records prepared for this purpose by 11 New York banking houses form the basis of our investigation. They were often hurriedly prepared at short notice; moreover, they were not organized in a uniform fashion. Still, these lists do roughly describe the role of individual banking houses in originating foreign loans and this is our only purpose in using them. It must be stressed that our study refers in no sense to the financial success of the various investment houses. Issuing a loan does not imply holding any part of it; and a banker who has not initiated a loan may very well have underwritten it.[1]

Of the bond issues reported by the bankers we include those covered in our sample B (which excludes Canada). About 90 percent of the total amount of issues in sample B — \$5 billion of loans — are reported by the 11 banking houses.

[1] The usual procedure in floating foreign loans was as follows: The borrower as vendor sold an issue of securities to an American banking house, the originating or issuing house. The originating house either marketed the entire issue itself, or, more commonly, associated itself with one or several other investment houses, forming a buying or underwriting syndicate. The participants in such a syndicate "do not actually purchase the securities, but instead underwrite them. That is, they guarantee or really insure the sale of an issue by agreeing to an arrangement whereby the unsold balance of an issue is taken over" (G. W. Edwards, *Investing in Foreign Securities,* Ronald Press, 1926, pp. 110-1).

The original house usually managed the syndicate it had organized. The underwriting syndicate disposed of the securities to the distributing syndicate, a large association including possibly hundreds of participants, which in turn offered the bonds to the public.

The statistical data presented in this chapter are not as trustworthy as those presented in earlier chapters. They are based on less reliable compilations, as indicated above, and they do not cover all issuing houses. Furthermore, the lending of each banking house is, of course, only a fraction of total lending, and as the number of observations becomes smaller, measurements are more affected by special factors which tended to cancel out when all loans were treated as a whole. Thus the findings of this chapter must be taken as rough approximations. Yet for all their limitations the results are surprisingly stable and the story they tell seems so reasonable that they are well worth studying.[2]

Arraying the 11 investment houses in the order of the soundness of the loans they originated we get the results shown in Table 11 (for definitions of 'sound' and 'defaulted' loans see Ch. 2). The differences in the activity and judgment of individual banking houses are striking. The wide range of the default indexes is the more remarkable as the "responsible and prudent issuing houses . . . are liable to be blacklegged in negotiating their business and

[2] As an experiment we added first Canadian, then private corporate loans to our sample. The results were essentially the same as those shown below.

Table 11

Default Index, 11 Banking Houses, 1920-1930

BANKING HOUSE	AMOUNT OF FOREIGN GOVERNMENT LOANS INITIATED All ($ million)	Defaulted ($ million)	DEFAULT INDEX (%)
1	323	43	13
2	1,680	232	14
3	377	100	27
4	314	103	33
5	832	397	48
6	468	338	72
7	157	126	80
8	233	227	97
9	294	284	97
10	133	131	98
11	157	157	100
A Group (1-2)	2,003	275	14
B Group (3-5)	1,523	600	39
C Group (6-11)	1,442	1,263	88
Total	4,968	2,138	43

to have sound transactions made unsound by subsequent extravagance".[3] When the banking houses are grouped by their default indexes it turns out that Group A, the initiators of $2 billions of loans, assessed risks so well that only 14 percent of their issues went to borrowers who defaulted; but more than one-third of the issues of Group B, which initiated $1.5 billion of loans, and almost nine-tenths of the nearly $1.5 billion initiated by Group C proved unsound. To put it differently: only 13 percent of defaulted loans stemmed from bankers who originated 40 percent of all loans, while 59 percent stemmed from bankers who issued only 29 percent of all loans.

Though equality was not to be expected in view of the different characters of investment houses and the role of chance, the range of default indexes for individual banking houses, 13-100 percent, is astonishing. Evidently the factors determining the quality of credit were not of uniform importance for all bankers. Some issuing houses must have been almost immune to the forces which caused the deterioration of credit. Others, on the contrary, were utterly under their sway.

Are the differences between banking houses due to the different timing of their loans? That is, did those with a low default index extend loans primarily in the early period, and those with a high default index in the late period? Or does a low default index mean that a banking house lent wisely throughout the period and a high one that it made serious mistakes all the time?

Table 12 reveals that the decline in loan quality was widely diffused. The default index of only 1 of the 11 banking houses did not decline. This makes the rise in the general default index more meaningful and strongly supports our interpretation of it as a gauge of credit deterioration.

The timing of the loans and their outcome were closely related. The more the lending of a banking house was concentrated in the second half of the period the more unfavorable the result (col. 3 and 4).[4] Of the four most careful lenders two lent less after

[3] Salter, op. cit., p. 123.

[4] The coefficient of rank correlation between the degree to which loans were concentrated in the second period (col. 3) and the default index (col. 4) is .92.

Table 12

Timing and Quality of Foreign Government Bond Issues Initiated by 11 Banking Houses

BANKING HOUSE	AMOUNT OF LOANS INITIATED ($ million) 1920-24	1925-30	RATIO: *Loans 1925-30 to Loans 1920-30*	DEFAULT INDEX (percentages) 1920-30	1920-24	1925-30
	(1)	(2)	(3)	(4)	(5)	(6)
1	150	173	54	13	0	25
2	869	811	48	14	15	12
3	213	164	44	27	0	61
4	147	167	53	33	0	62
5	311	521	63	48	8	71
6	188	280	60	72	57	82
7	37	120	76	80	62	86
8	39	194	83	97	85	100
9	6	288	98	97	....*	99
10	0	133	100	98	....	98
11	0	157	100	100	....	100
A Group (1-2)	1,019	984	49	14	13	14
B Group (3-5)	671	852	56	39	4	67
C Group (6-11)	270	1,172	81	88	61	94
Total	1,960	3,008	61	43	17	60

* This firm did not issue a loan until 1926 except for a single issue in 1920. In this case, it would be pointless to speak of a default index of zero for 1920-24. Therefore we disregard this loan here and in the discussion of the default indexes for 1920-24.

1924 than before; the other two lent only slightly more. At the other end of the scale are the three banking houses with the worst records which went into foreign lending only in 1925 or later. Evidently, when the more cautious bankers refrained from expanding their loans, their place was taken by the more careless ones. As the latter did a larger share of total lending the average quality of loans declined. The rise in the average default index is in part attributable to the changed structure of the lending community.

But the big variations in the fate of loans initiated by the 11 banking houses are by no means due entirely to their different timing. The range of default indexes in the early and in the late period is as wide as for the period as a whole: from 0 to 85 percent for the first period, from 12 to 100 percent for the second (Table 12, col. 5 and 6). We have banking houses with 'good' and 'bad' results in every subperiod as well as during the period as a whole and, what is more interesting, a bank's relative position among its colleagues — as far as the quality of its foreign lending was concerned — remained much the same.[5] The five issuing houses with the best record made practically no mistakes in the first period. The default index of four rises considerably in the second period; but not one becomes as high as those of the three firms that had a high percentage of mistakes already in the early period.[6]

The parallelism of the ratios in columns 3-6 suggests that each individual banking house had a definite attitude with respect to this part of its business, an attitude that determined the quality as well as the timing of its loans. This parallelism is even more striking when we consider the aforementioned influence of random forces.

Thus from the viewpoint of the role of individual issuing houses the rise in the total default index may be regarded as the resultant of two processes. The first is a decline in the quality of loans extended by the individual banking house; this alone would account for an increase in the total default index from 17 percent in the early period to 41 percent in the late period.[7] The actual index for the late period was 60 percent, however, and the remaining part of the increase is explained by the second factor, the shift in the role of individual banks, the greater proportion of loans originated by less careful or less competent houses.

The same forces are responsible for both factors. Whatever induces a cautious banker to grant riskier loans will still more encourage a less cautious one to expand his lending and will attract new firms to such ventures. An analysis of these forces will be attempted in Chapter 6.

[5] The coefficient of rank correlation between the default indexes for the early and those for the late period is .74.

[6] Banking house 2 is the only one of the 11 whose default index does not rise in the second period. Its only defaulted loans were the Dawes and Young loans in 1924 and 1930; in 1926, 1927, and 1928, the years when most of the defaulted loans were made, it issued about half a billion dollars of foreign government bonds; not one of these was a failure.

[7] Computed by applying default indexes of the late period to the amounts of loans issued in the early period.