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Trends in Bank Holdings of Municipals

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Recent developments with respect to the obligations of States and minor political subdivisions and their financial affairs have directed the attention of the banking supervisory authorities towards the portfolios of municipal securities. Among these probably the most dramatic was the sharp reversal in the long term trend of municipal bond yields which occurred in 1946. Market conditions at that time enabled municipalities to float securities with coupons as low as 1% and maturing in the next generation at prices near par. Now this situation has changed. A reversal in yields has forced prices on the outstanding long term, low coupon securities to discounts of as much as 20% or 30%. Questions about the municipal portfolio should not be too surprising in these circumstances.

The financial problems confronting the issuers of municipal securities at the present time have been the subject of widespread discussion in the financial press and elsewhere. In general these comments suggest that local governments are unequal to the financial burdens which they now carry or which may soon be imposed upon them. However, it is a fact that most municipalities now are servicing their obligations much better than at any time in recent years and currently the financial condition of the obligors is good--at least when compared with the nineteen-thirties or even the nineteen-twenties. Nevertheless, there is a sense of uneasiness about these credits; an uneasiness which stems from an acute consciousness of the many financial uncertainties which becloud the future. Whether communities will attempt to assume impossible burdens because of the public demands, and thereby incur financial disaster, or whether new devices and arrangements will be developed to solve or alleviate existing problems is open to question.

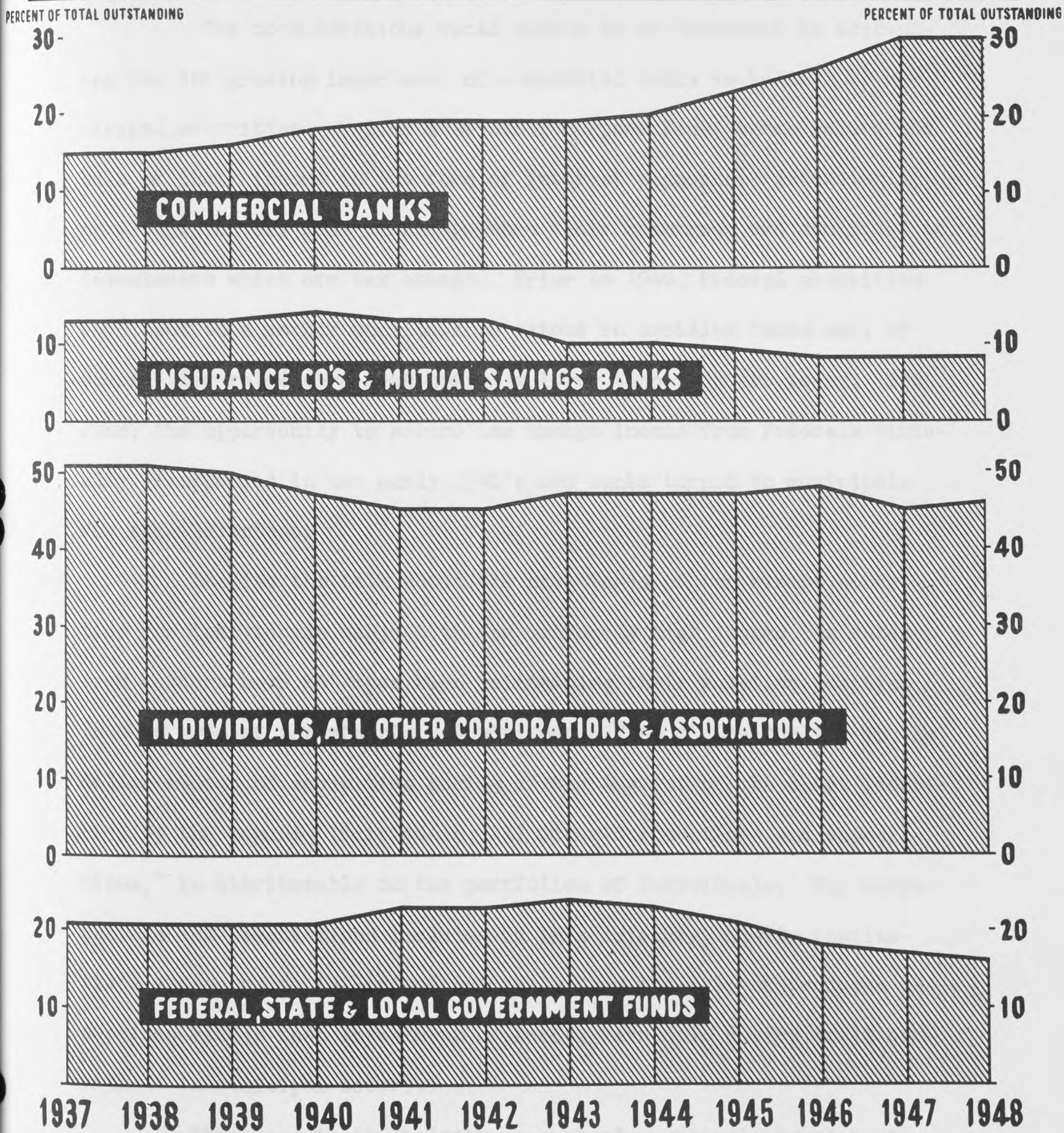
The flood of new securities floated by States and minor political subdivisions has been another factor which attracted the interest of bank supervisory authorities to this segment of bank assets. For a number of reasons the volume has climbed to record levels. That in itself has been sufficient to arouse comment and stimulate concern. Furthermore, reports of examinations reveal that a substantial amount of the new flotations soon find lodgment in banks.

Now seems an appropriate time to review some of the background information with respect to municipal securities. The purpose of this review is to establish some benchmarks which may be employed in judging the current situation as well as in attempting to forecast changes.

I. Recent Shifts in the Ownership of Municipals

Banks are playing a far more important role in the financing of States and minor political subdivisions today than they did 10 years ago. As shown in the accompanying chart, commercial banks now hold about 30% of

OWNERSHIP OF SECURITIES ISSUED BY STATE AND LOCAL GOVERNMENTS



SOURCE: ANNUAL REPORT OF THE SECRETARY OF THE TREASURY the outstanding securities whereas in 1937 their holdings accounted for only 15% of the total.

Tax considerations would appear to be paramount in accounting for the growing importance of commercial banks as holders of municipal securities. Unlike most other corporations, banks secure the bulk of their income in the form of interest payments. Accordingly, they enjoy a very real advantage when their resources are committed to investments which are tax exempt. Prior to 1940, Federal securities were used to a rather considerable extent in avoiding taxes and, of course, tax rates were substantially lower than they are today. However, the opportunity to secure tax exempt income from Federals virtually disappeared in the early 1940's and banks turned to municipals for this advantage.

Despite the talk about the advantages of tax exempt securities for individuals subject to the extremely high income tax rates such holders have not even been maintaining their relative position in this area of investments. About four-fifths of the decline in the dollar amount of securities making up the segment of the chart identified by the legend "Individuals, All Other Corporations and Associations," is attributable to the portfolios of individuals. The corporations and associations included in this category, mostly institutions whose income is derived primarily from the sale of products or services rather than investment of funds, have only a very small commitment in municipal securities.

Shrinkage in the relative amount of municipals owned by insurance companies and mutual savings banks is readily explainable in terms of tax considerations. For all practical purposes, the investment funds of these institutions are not subject to Federal income taxes. Hence the alternative investment opportunities afforded by taxable securities are far more attractive. High grade industrial, rail or public utility issues of comparable quality have a yield advantage of almost one percentage point over the return on municipals.

From the viewpoint of bank examination and supervision, the remarkable changes in the relative importance of banks as owners of municipal securities is a matter of considerable significance. The change leads one to believe that the banking system is going to bear the brunt of untoward developments in the field of municipal finance, when and if they occur. Very little imagination is needed to anticipate the pressure which will be imposed upon the banks by the municipal obligors.

In fiction bankers are cruel and relentless creditors--and some may be on occasion. But what can banks do when defaults occur on municipal securities in the portfolio? Isolated individuals were never conspicuously successful in dealing with municipalities at such times--and banks would be in even a poorer position. They will be depicted as rich corporations well able to absorb some losses of principal and interest, not widows and orphans relying on small investments for a living. At best, they would be obliged to accept disadvantageous changes in the terms of the credits. More than likely they would also be called upon to make further advances.

All of these considerations suggest the importance both from the viewpoint of bank supervisory authorities and bank management of deviating as little as possible from sound investment principles in connection with bank holdings of municipals. Emphasis as usual should be placed upon quality. This is certainly no time for banks or supervisors to experiment with marginal and substandard issues irrespective of the fact that times are good and such securities temporarily enjoy a fair reputation. Nor should the importance of the maturity distribution be forgotten. By a judicious selection of serial issues banks may place themselves in an excellent position to revise their judgments of individual municipal credits as securities mature in the course of the next few years.

II. Dollar Amount and Relative Importance of Municipals in Bank Portfolios

To be sure banks are relatively more important as owners of municipals today than they were a few years ago, but the supervisory authorities should not act as if the solvency of the banking system hinged upon the credit status of States and the minor political subdivisions. For points of reference, the following chart has been prepared which shows the book value of municipal portfolios held by the insured commercial banks and also the percentage of total assets invested in municipal securities.

Over the period 1934-48, municipal bond portfolios in insured commercial banks have more than doubled in size. But in the course of this same period, municipals have declined from a level of about 5% of total assets in the mid-1930's to about 2½% in the mid-1940's. Since then the increase has been rapid but even now it has only reached the 3½% level. The decline in the relative importance of these securities resulted almost entirely from the growth in the total assets of banks during the war.

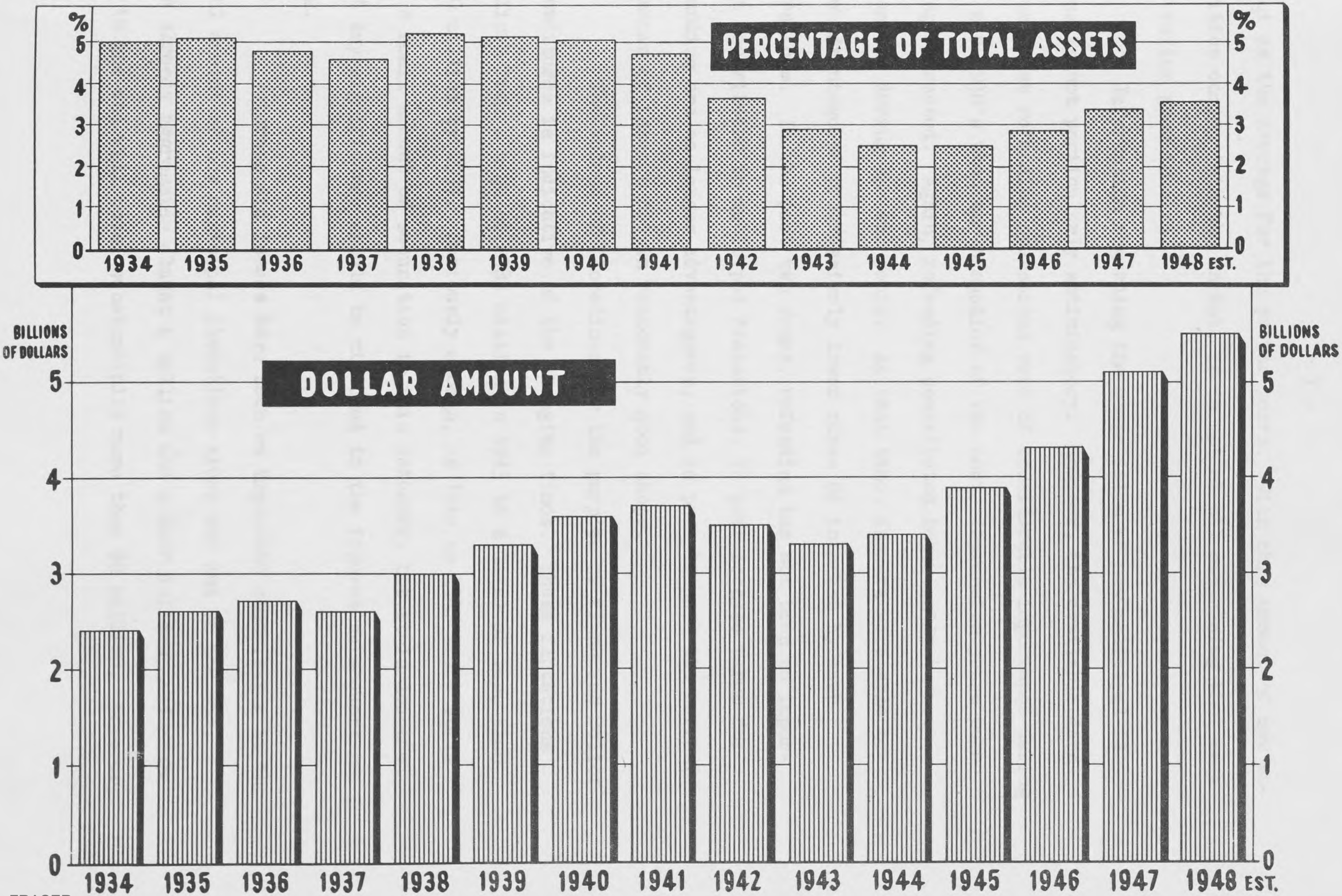
Only in the early war years, i.e. 1942 and 1943 was there a decline in the dollar amount of the municipal portfolio held by insured commercial banks. New offerings of municipal securities were practically at a standstill in these years and banks were under tremendous pressure to accumulate Federal securities. Taken as a whole, the trend in the municipal portfolio has been in the general direction of a dollar increase.

Notwithstanding the rapid growth in the dollar amount of municipal obligations held by insured commercial banks, it would be reasonable to anticipate a sizable future expansion in this portfolio. Assuming that the banks were to invest 5% of their total assets in these securities, the proportion which typified the prewar period, this would entail further substantial additions to the portfolio unless total assets were to shrink materially. Accordingly, rather than view the present municipal portfolio for commercial banks as high, it would seem more reasonable to consider the figure rather moderate and to expect an addition over the next few years that would be in the order of two or three billions.

III. Recent Trends in the Volume and Character of Municipal Flotations

Even a cursory view of the chart showing the volume of new State and municipal bond issues is sufficient to emphasize one of the major causes for the concern about bank portfolios of municipal securities. In 1948 the total amount of flotations was almost three times as

STATE, COUNTY AND MUNICIPAL OBLIGATIONS HELD BY INSURED COMMERCIAL BANKS



great as the average for the prewar years. With this amount of new securities coming into the market, it is not at all surprising that bank portfolios grow in size.

Information regarding the composition of new municipal flotations is not particularly satisfactory. However, the available data reveal that refunding operations were of considerable importance during the mid-1930's when the tragedies of the acute depression years were being corrected. Again, refunding contributed importantly to new financing during the war years. At that time, issuers were able to take advantage of progressively lower rates of interest by such operations. In the past two years, refunding has not been an important contributor to municipal flotations, in part because terms for refunding are no longer advantageous, and in part because the current finances of issuers are in reasonably good shape.

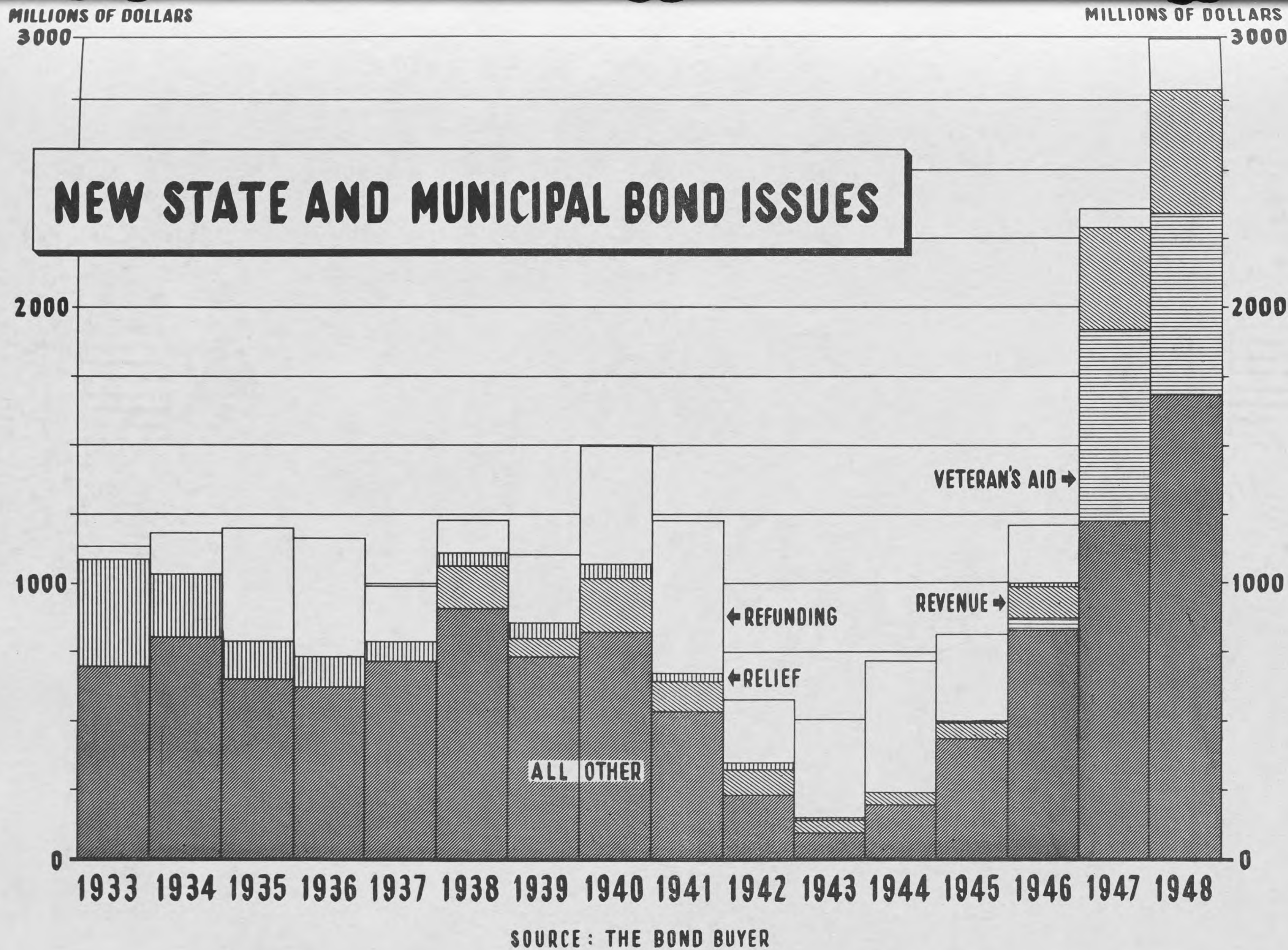
The volume of flotations for the purpose of financing relief expenditures is indicative of the changing times. These flotations declined from a high of $385 million in 1933 to a level of less than $100 million by 1937. Curiously enough, as late as 1947 there still was a small amount of securities in this category, but it is doubtful that any significance should be attached to the figures subsequent to 1942.

Veterans Aid issues have been an important contributor to the total amount of new municipal flotations since the end of the war. This already aggregates almost a billion and a half dollars, and probably in the end will total substantially more than $2 billion. However, bond offerings for this purpose are bound to disappear soon. They lifted the total amount of new issues for 1947 and 1948 but even when the total amount of Veterans Aid is eliminated the figure is still large.

Flotations of securities to finance local housing projects thus far have never accounted for a large portion of the total amount of State and municipal bond offerings. Considering the amount of discussion with respect to public housing, it is reasonable to suppose that eventually such issues will appear in tremendous volume. Housing ventures always require large capital investments and this area of municipal financing could easily take some turn which would present serious problems to the banks as well as the bank supervisory authorities.

Issues of State and municipal bonds to finance so-called revenue projects have grown very rapidly. A study of the chart shows that financing of this type got well under way in the late 1930's. The war years dampened but did not eliminate the financing, and since the war the volume is next to Veterans Aid in importance.

Because revenue issues are definitely crowding the market, it is not hard to account for the widespread interest in this type of financing. Heretofore the traditional political subdivisions have been able to finance the capital improvements needed to render the types of service demanded by the citizens. As the variety and costliness of the services increases, however, the municipalities are obliged to adopt various expedients. Thus, community facilities requiring heavy capital investments and on the border of customary State and municipal activities are financed on a self-liquidating basis through the creation of what amounts to ancillary quasi-municipal corporations.


MILLIONS OF DOLLARS
MILLIONS OF DOLLARS
NEW STATE AND MUNICIPAL BOND ISSUES
3000
2000
1000
0
VETERAN'S AID
REVENUE
REFUNDING
RELIEF
ALL OTHER
1933
1934
1935
1936
1937
1938
1939
1940
1941
1942
1943
1944
1945
1946
1947
1948
SOURCE: THE BOND BUYER

Originally revenue issues were only used to finance the well established utility services such as water, electricity, gas, sewer, and the like. More recently there has been a rash of financing in the form of revenue securities for the construction of toll bridges and toll roads. But in addition to these projects, there are now a host of other ventures of one sort or another ranging from amusement facilities to public buildings financed by revenue bond issues.

Insofar as revenue bond issues are part of an arrangement for making the users of a municipal service pay for the benefits derived therefrom, they possess considerable merit. When operators of motor vehicles demand such facilities as limited access, super highways, as well as monstrously expensive bridges and tunnels, it is reasonable to make them pay for the projects by tolls, motor fuel taxes or otherwise. Citizens generally may derive some benefits from these costly facilities but none that can be readily traced. Certainly it would be unreasonable to contend that the burden of these capital improvements should be supported by the ordinary revenues of local governments, even if that were possible.

On the other hand, revenue bond financing has been used to facilitate the construction of projects which are clearly within the scope of ordinary governmental activities. For example, in some places public buildings, such as city halls, jailhouses, and schools are financed by the issuance of so-called revenue bonds. The revenue in such instances takes the form of rental payments received from the municipality using the facilities. Proper service of the debt depends upon the adequacy of these payments. Fundamentally these arrangements are subterfuges adopted because of weaknesses in local finances, e.g. unusually low statutory debt limits or an antiquated tax structure.

When minor political subdivisions in Kentucky, for example, finance the construction of school buildings and jails by the issuance of securities honorifically called revenue bonds the fact would appear to be evidence that all is not well in municipal finance. If the minor subdivisions of government are so weak that they cannot finance the buildings necessary for their regular activities, the appropriate remedy is not a revenue bond issue. Rather the situation calls for the strengthening of local government credit. This may involve an overhaul of tax machinery, an increase in the physical size of the political subdivisions, or other drastic changes.

The chart of new municipal bond flotations raises some interesting questions with regard to the future trend. It could be argued that the high level for 1947 and 1948 is a temporary situation resulting largely from the Veterans Aid issues and the accumulated deficit of financing during the war period. You may recall that in the years 1942-1945 it was practically impossible for municipalities to secure the materials necessary to make normal public improvements. According to this view, the flotations will soon taper off and regress back to a level between a billion and a billion and a half dollars annually.

More realistic, in my judgment, is the view that flotations of municipal securities will persist for years to come at levels above two billion. A number of factors lend support to this view. In the first place, the bulk of the State and municipal bond flotations finance the construction of more or less permanent facilities, and construction costs are now high. There are various answers to the question "How high are building costs?" but most of the indexes agree that the figures are about double the level of the 1930's. Nor is there much reason to believe that costs will soon decline to the prewar level. High construction costs would help to sustain a high dollar volume of municipal financing.

Other factors are contributing to the volume of municipal security offerings. The lack of public construction usually is thought of as a wartime phenomenon. As a matter of fact, it is a phenomenon of both the war and the depression of the 1930's. Few of us realize that the proportion of school expenditures for capital outlays, mostly new buildings, in the two decades prior to the great depression was about twice as high as the proportion in the 1930's. In short, we now have an accumulated deficit of school construction extending over a period of 20 years, assuming that facilities were reasonably adequate in the first three decades of this century,--and that is a very dubious assumption. Furthermore, population growth, and particularly the expansion in the birth rate which has characterized the 1940's will accentuate the burden on the existing school facilities. As yet the magnitude of the prospective needs for new school buildings receives very little consideration by persons other than careful students of the data. To illustrate the problem, a 50%

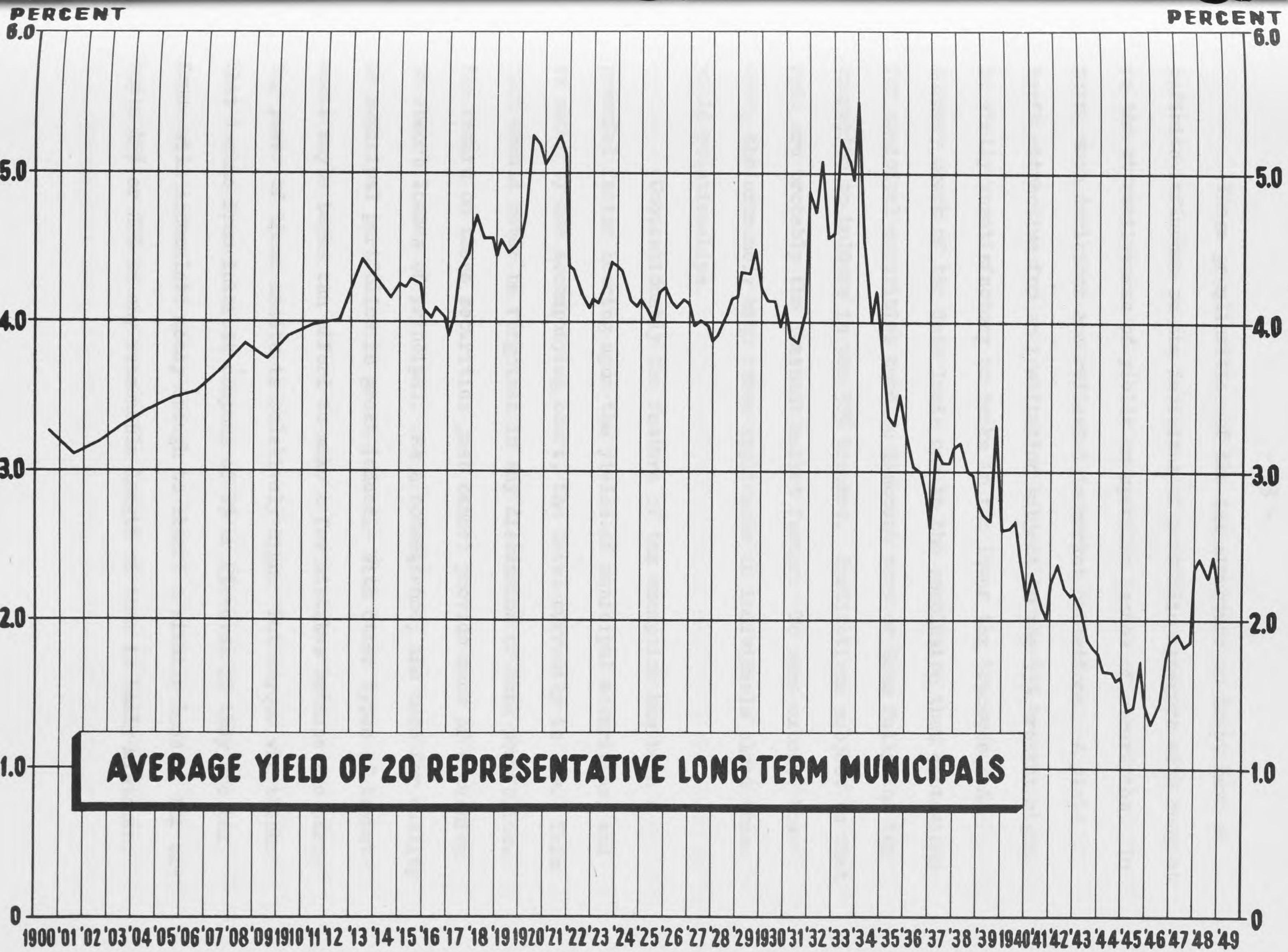
increase in the number of elementary school attendants is certain before 1955, and increases may be greater.

As in the field of education, there are many other areas of demand for municipal services involving capital investments which tend to augment the pressure for new issues of securities. Populations have shifted. New roads and other community facilities will be needed to serve both the old communities and the new ones better. Taken altogether, these demands for capital additions will reach huge proportions.

IV. The Trend in Municipal Yields

Study of the long term trends in yields on municipal securities emphasizes the great decline in the rate of return since the 1920's. A low point was recorded in the mid-1940's and thereafter yields increased but the amount was small. To a considerable extent, of course, the yields on municipals merely reflect the general trend of interest rates on long term investments, but there is the important complication--the feature of tax exemption. These securities now are the only haven of refuge for funds seeking to avoid the high income tax rates. When Federals lost practically all of their tax exemptions in the early 1940's, the pressure of funds seeking this advantage was directed towards municipal securities.

Banks are now subject to combined Federal tax rates ranging from 21% to 25% on the blocks of taxable net income up to $25,000. In the next tax block, $25,000 to $50,000, the combined rate is 53%. Above that bracket a 38% rate is applicable for all taxable income. Accordingly, the tax saving value of municipal income depends upon the earnings position of the individual bank.



SOURCE: THE BOND BUYER 1900-1914 AVERAGE YIELDS · 1915-1948 QUARTERLY YIELDS

These peculiarities of the tax structure no doubt have a definite influence on the decisions of portfolio managers with respect to the attractiveness of yields on specific issues of securities. In turn, such decisions are reflected in market quotations. A yield basis attractive for an institution subject to the 53% bracket might be wholly unsatisfactory to banks in the lower tax brackets. A cursory check of the data leads one to the conclusion that quotations for municipal securities tend to discount more or less fully the tax exemption to holders in the 38% bracket. Institutions subject to that rate are probably the dominant market factor. To some extent, however, the extremely high rates applicable to individuals cloud these yield relationships.

Unquestionably the feature of tax exemption has been a powerful factor bearing upon the yields of municipal securities, and as shown by the accompanying chart, the level currently is low. This fact should never be forgotten in any discussion of bank portfolios. The return on these securities just cannot provide much of a cushion to absorb losses of principal. As a consequence, the need for quality in municipal portfolios is great indeed. With other types of investments maybe banks can afford to make a few mistakes because the earning power of these assets is relatively high. But anyone who thinks that income from interest coupons of 1% or 2%--even if they are tax free--will accumulate money enough to absorb a sizable loss of for example 15% or 20% in any reasonable length of time is badly mistaken.

V. Rules and Guides for Municipal Portfolios

The foregoing review of the essential facts with respect to the bank holdings of municipals and prospective trends in this area of finance suggests that in the future the municipal portfolio in banks is likely to present a series of very troublesome problems both to banks and supervisors.

Over-sized portfolios will be acquired by a few banks. As a consequence difficulties when they arise with respect to quality, marketability or maturity will be far more serious for such institutions than for others with a reasonable amount of these securities. Most certainly the sales pressure by the security dealers who will be called upon to distribute the prospective volume of new flotations will be much greater than in former years. Bankers probably will be persuaded to buy issues which are not entirely suited to their needs. Efforts by security distributors to force banks and bank supervisors to accept lower standards of quality are always discernible but they now seem to be growing more vigorous.

When issuers experience financial difficulties the interested banks will be involved in a whole new complex of problems. More than ever before the banks, as such, will be identified as principal creditors. In this role they will be subject to all of the pressures that arise in salvage operations: the business of sending good money after bad. Banks and bank supervisors will be well advised to view the present trends carefully. By an appropriate course of action it may be possible to avoid or alleviate problems before the evil days arrive.

Actually there are not many principles for the guidance of bank supervisory authorities in dealing with securities, but there is one which is simple and sound: There is no place in a bank portfolio for an asset of poor quality. That principal, I know, is honored in the breach as well as in the observance, but in my judgment, when the supervisory authorities compromise on quality, they should recognize the compromise as a misfortune that attends administrative activities in a rather imperfect world. The elimination of poor quality assets should always be a major objective.

When business is prosperous and markets are strong the time is appropriate to clean up a municipal bond portfolio, or for that matter any assortment of assets. Occasionally I note in our files an exchange of correspondence between supervisory authorities and bank officers indicating that an institution has sold a block of securities classified as borderline or substandard in quality. These cases usually follow a pattern and the next step is an assertion by the bank officials that the securities were sold at a substantial profit. Thereafter correspondence in such files sometimes indicates that the bankers have attempted to embarrass supervisory authorities by calling attention to the fact that prices for these securities subsequently climbed even higher. In my judgment, this is an illustration of very sound supervision, because a banker who succeeds in cleaning up the weak spots in his municipal portfolio at a profit is indeed fortunate. The fact that he might have sold the securities on even more profitable terms is of small concern to me or anyone who looks at the matter objectively. The real question and the one which is seldom answered in the correspondence is this: "What did the banker do with the money which he freed from his substandard investment at a profit?" Assuming he is at all competent, he should have been able to employ these funds in a sound fashion and with some return for his trouble.

The maturity distribution of a municipal bond portfolio needs careful scrutiny at the present time. Banks who bought the 25 and 30 year maturities with 1% coupons two or three years ago have learned by rather painful examples that a mathematical relationship obtains between coupon, yield and maturity irrespective of the question of quality. To be sure, banks with a few of these bonds, and prospects for reasonably stable deposits, need not be concerned about discounts from book value of 20-30 points. But that is only true for institutions with a relatively small portion of their portfolio in extremely long maturities. A systematic plan for spacing maturities over a term of years, e.g. 10 or 15, enables an institution to average its rate of return for the period and to be comparatively free from problems attending fluctuations in market prices.

Customs of financing in connection with the issuance of State and municipal bonds have firmly established the practice of serial maturities. Even at the expense of boring reiteration, it is well to insist that the managers of municipal portfolios take advantage of the serial feature. Anyone who knows anything at all about the market for municipal securities knows that it is a distinctly poor one in terms of liquidity. Every transaction involves negotiations. The blocks change hands in relatively large amounts. When a bank attempts to buy or sell less than five bonds, the transaction is treated as an odd lot with prices even further away from the prevailing quotations. Furthermore, the area of investment for individual issues is surprisingly narrow because the number of issues is great and the dissemination of investment knowledge in a great many cases is almost literally pedestrian in character. As you know, only the larger communities have issues that enjoy a situation that remotely resembles a nationwide distribution.

Largely because of the increased volume of municipal flotations as well as the rise of novel types of issues such as the revenue securities, the methods and principles for municipal credit analysis are coming up for discussion. It is my judgment that neither bankers nor bank supervisory authorities need to be alarmed about the prospects for a revolution in the techniques of municipal security analysis. Now, as ever, the top grade of issues will always stand out very conspicuously. Troubles there will be in judging quality if the issue deteriorates. Most of the difficulties will likely be encountered in connection with the borderline cases. The supervisory authorities and the bankers would be well advised to abandon the effort to make nice distinctions between the securities which are competing for place on the marginal or substandard list. To be sure, issuers of such securities need a market. So far as I am concerned, they may be sold wherever the distributors find a customer, but only providing the salesmen stay away from banks.

Comment in the financial press recently has noted that changes in the composition of municipal revenues as well as changes in character of the services required from these governmental units tend to render unsatisfactory the old ratio tests of credit quality. Usually discussions of this sort inveigh against the use of the time honored debt ratio (the amount of debt expressed as a percentage of property valuations for tax purposes) as a criterion. It has been my observation that the attempt to judge municipal credit on the basis of a ratio, or even a series of ratios, not only is unsound today, but it probably never was satisfactory.

In judging credit quality, the past history of the community and its current economic resources has a place in the process. The total amount of debt outstanding and the character and composition of the revenue and expenditures are important facts. As a matter of fact, the debt ratio test becomes progressively less meaningful with the rise in the importance of revenue sources other than the ad valorem taxes. But the analyst of municipal credits is not limited to any standard pattern in his work. For example debt service requirements expressed as a percentage of the total amount of expenditures is a good measure to employ when the debt ratio is of limited usefulness. In analyzing credit quality, every bit of pertinent information at hand should be so marshalled that it contributes as much as possible to the understanding of the credit.

Conclusion

The foregoing discussion sought to present in orderly fashion the major pieces of background information with respect to bank investment in municipal securities. Facets of the investment problem are many and varied, however, and a complete study is far beyond the scope of this brief discussion.

While it would be extremely difficult to maintain the proposition that weakness in municipal securities may jeopardize the soundness of our banking system, the figures do indicate that acute problems may develop for individual banks. The rapid growth in the total amount of these portfolios as well as the sharp increase in their relative importance leaves one with the feeling that some institutions may very well acquire portfolios which are wholly out of balance. Such institutions with excessive holdings of municipals, marginal and substandard issues or poorly selected maturities, could easily get into trouble. Supervisory authorities should be searching for these institutions, and appropriate remedial measures adopted when the cases are discovered.

Banks certainly are not now in a very good position to accept losses. Their capital margins are pitifully thin and earning power is far from impressive. The growth trend over the years in the municipal portfolio calls attention to a segment of assets wherein potential losses may be accumulating. Losses in this portfolio are going to be as unpalatable as losses elsewhere.

April 5, 1949