THE SECURITIES ACCOUNT

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The Securities Account

Conference participants: Up to now my role in the conference has been delightfully passive. It has been interesting to follow the discussion of your problems in the field of bank loans and the remarks help to develop my own perspective.

The topic for this part of your program, "The Securities Account," surely is broad enough to bring within its scope any comments or questions concerning bank investments that you would like to consider. It will be my purpose first to narrow the boundaries of discussion somewhat and then, if possible, to encourage your participation by presenting some important questions. For quite a while now, you have been looking at municipal credit memoranda with my name. Undoubtedly, some of these memoranda have not been entirely satisfactory. Occasionally you may disagree with them and here is an opportunity to tell me what's wrong. So, I am really looking forward to receiving a bit of concentrated education in the next few minutes.

First, we need a few points of reference. Securities held by all insured commercial banks account for approximately two-fifths of their assets. Federal obligations make up about 80 percent of these investments and municipal securities account for about 15 percent of the total. The remainder includes flotations by private corporations, as well as the nonguaranteed issues floated by the United States government corporations and agencies.

Dollarwise Federal issues predominate in the investment portfolios of the insured commercial banks. But from our viewpoint in this discussion, attention will be centered on the segment of the portfolio which is growing most rapidly, namely, the holdings of municipal issues. In recent years the amount has more than doubled and the rate of growth continues high. Since

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there are compelling reasons to believe that the municipal segment will continue to grow, some comment on the background of municipal finance would appear to be quite appropriate at this time.

Those of you who have followed the development in the field of municipal finance are aware of the great changes which have taken place, especially since the War. The volume of new offerings year after year has climbed to new peaks. There was a time when $1 billion of flotations annually in the municipal field seemed to be large. Now offerings of $5 billion or $6 billion annually are not surprising.

The variety in types of issues that make up the municipal flotation in recent years has been great. As a matter of fact, it is necessary to go back in the pages of history for a hundred years to find any situation which even begins to resemble the present. Then as now local governments were searching for arrangements to finance desired public facilities. When the Nation was expanding rapidly years ago, many States and subdivisions of States extended credit to encourage the development of canals and railroads. We find even some relics today of communities with equities in railroad companies: For example, the Cincinnati Southern Railway owned by the City of Cincinnati and now leased to the Southern Railway System.

In municipal finance for many years the so-called "General Obligation Bonds," which pledged the full faith and credit of an issuer, have been the typical device for raising capital to finance public improvements. Usually the borrower--a municipality, county, or State government--relied on the general property tax as the principal source of revenue. So, when a community pledged its full faith and credit, in effect,

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it was promising to levy general property taxes adequate to service the debt. Mostly such debts were incurred for the purpose of assembling the capital needed to build the conventional form of government facilities, that is, schools, street improvements, and public buildings. None of the projects were large, nor were they unconventional in character.

But great changes have occurred to the economy--notably since the War. Your attention this morning was called to the tremendous increase in population which has taken place and the expansion of general business activity. Because of these developments which have enlarged as well as changed requirements, old modes of financing public facilities are now inadequate. For example, in most States there are statutory limits on the total amount of general obligation debt that a community may create. Usually these limits are expressed as a percentage of assessed value because historically debt was considered as an obligation to be serviced from levies on real property. Now, however, important segments of wealth have developed in areas outside of real property. Moreover, governmental units have tapped new sources of revenue--such as income and sales taxes. As a consequence, the arrangements for tying debt to assessed values tend to become archaic.

Governmental units are experimenting with many new methods of financing. Today, for example, developments in the field of toll road financing are a conspicuous illustration of inventiveness in coping with novel problems. To construct modern highway facilities, it is necessary to assemble huge aggregations of capital. As a practical matter, it has not been possible to finance these improvements by the conventional arrangements. Also, State Authorities in some parts of the country are financing the

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construction of school and office buildings as well as many other public facilities. These facilities are leased to local communities, on terms which enable the authority to liquidate the debt, that is, pay principal and interest over a period of years.

Financial innovations have been especially necessary in providing facilities for entirely new governmental activities. Such an enterprise as the Port of New York Authority is a case in point. In effect this is a great public utility issuing securities that come within the definition of municipal obligations. Much innovation also has taken place in the development of arrangements to finance the construction of electric and water facilities.

Financial innovation becomes important to anyone who is called upon to form a judgment as to credit quality. The very fact that a form of finance is novel in itself presents a problem because the time-honored tests are not available as guides. Eventually new standards are devised for measuring the credit quality. This is the situation that confronts us when we endeavor to appraise the credit quality of toll road issues as well as the many other relatively new types of financing.

Now what are the prospects for a continuance of present trends? The economy is expanding at a very rapid rate, and most of the problems of growth are yet to be solved. It is exceedingly difficult to conceive of ways to finance the necessary construction of public facilities within the conventional framework of municipal finance. As a consequence, one can only anticipate a continuance of experimentation with credit investments and arrangements as well as a large volume of offerings.

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To be sure, it would be easier from the analyst's point of view if one could hammer municipal finance back into the shape that it had acquired by the late nineteen-thirties. Then the general obligation bond was the customary debt instrument. Most of the revenue issues were floated to finance projects that could be analyzed much as a private utility enterprise, e.g.--electric or water facilities. But today we find so many situations where the issues have some of the qualities of general obligations, some of the qualities of revenue obligations, and then some additional feature that appears to be completely novel.

At this point it may be helpful to make a few brief comments about the question: How does the pattern of investments in municipals for the Fourth District compare with the rest of the U.S.? Since the statistics are not very satisfactory, only a very few generalizations are possible. It appears that the banks in the Fourth District hold about a half a billion of municipals in the portfolios as compared with a total for the entire nation of $12 billion or $13 billion. Probably the State nonmember banks are invested somewhat heavier than average in municipals. Moreover, a small number of banks have relatively large portfolios. For example, one bank in this area has more than 50 percent of the total assets in municipals. That seems a little high but maybe there is a good explanation.

Well, so much for the brief comment on investment patterns. Now what should the examiner do about the municipal portfolio in a bank under examination? A few comments along those lines may be helpful. First, there is a question regarding the adequacy of the bank's investment policy. In your other discussions today considerable stress has been placed on the

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importance of a well-rounded loan policy. It seems to me that the same comments would apply to investment policy with equal force. Specifically, the examiner ought to ask the question: Does the bank have a definitive policy statement? With such a statement--and I'm talking now about something formalized in writing--a bank would be more likely to manage a portfolio successfully than if it had none. In addition, there is some point to finding out whether the officials actually managing the portfolio are fully informed on the details of the bank's investment policy.

A good investment policy statement is something more than a solemn pronouncement about securities. As a comprehensive and understandable guide for investment action, it establishes the standards for determining the size and composition of the total investment portfolio. I do not see how anyone can manage bank investments successfully without criteria as to the size of the portfolio relative to total assets and the proportion to be invested in Federal issues, State and local obligations and other securities.

Criteria for the selection of individual issues are an essential part of the investment policy statement. Most important in this connection are guides with regard to the type and quality of issues appropriate for the bank's portfolio. Whether it is desirable for a bank to invest only in full faith and credit obligations or to make commitments in other types of credits as well depends upon the availability of knowledge and investment skill.

Since general obligations floated by municipalities are comparatively easy to analyze and readily available in substantial volume, such issues are well suited for banks with limited investment facilities.

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In addition to the general obligation municipal bonds, flotations now include a wide variety of newer types--the revenue obligations and what I choose to call the hybrid issues--those which have some of the characteristics of general obligations as well as revenue issues. The place for such issues in the bank's investment portfolio should certainly be outlined in the policy statement. Guidance along these lines is as essential part of a successful investment program.

Also, the policy statement should include qualitative standards for municipal securities. These may be expressed in terms of the rating bands used by the commercial services in the investment field. For example, it may be wise for a bank to confine its investments to issues in the three highest rating grades even though the four highest grades are deemed to be suitable for bank investment. However, only a small portion of all municipal issues are covered by the established rating systems so that as a practical matter the investment policy statement should furnish guidance in terms of debt service coverage and other accepted standards of credit quality. Credit standards expressed in terms of interest coverage, debt related to assessed value, sources of revenue and the like are difficult to apply but they are generally more useful than commercial ratings.

The question of marketability is obviously a very important aspect of bank investment policy in the municipal field. Such securities are traded only on a negotiated basis. There is no market comparable to the one which exists for corporate bonds. As a consequence, the investment policy of a bank--it would seem to me--should cover specifically this aspect of the investment problem. One of the obvious solutions is to adopt a five-to-seven-year roll-over principle achieved by an appropriate selection of maturities.

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Thus, commitments are limited to serial maturities with a fraction of the portfolio maturing each year. Proceeds from the matured issues are reinvested in the most remote maturities permitted under the policy. That, of course, enables the bank to average its rate of return--and at the same time it builds into the portfolio a mechanism for liquidating a substantial portion of the issues each year.

There is a new trend in municipal finance--the appearance of thirty and forty-year term bonds in considerable volume--which is not conducive to the maintenance of an appropriate schedule of maturities in bank portfolios. Much of the toll highway financing recently has taken the form of long-term rather than serial bonds. To assume that a long-term municipal issue--especially if it is large--enjoys an active market on an organized exchange is definitely a mistake. There is no organized exchange for trading municipal securities.

Irrespective of the shortcomings in the machinery of the organized securities markets, the issues admitted to trading are, generally speaking, more readily turned into cash than the ones not so listed. There are no means other than negotiation in the over-the-counter market to trade municipal securities. That fact certainly minimizes the usefulness of long-term issues in the investment portfolios of most banks. So it is quite essential for the bank's investment policy statement to furnish some guidance as to the selection of maturities.

In the bank's statement of investment policy, consideration should be given to the need for tax exempt income. The financial press is replete with comments about the advantages of tax exempt income that may be obtained

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from municipals. But it seems to me that some banks can use tax exempt income very much more effectively than others. If I am interpreting the data correctly, it is evident that some banks actually pay premiums for tax exempt income that is not advantageous to them. After all, when banks buy municipal issues they are competing in the market with buyers in the highest tax brackets.

Guidance as regards trading in municipals as well as other securities is an essential feature of any comprehensive bank investment policy statement. In certain circumstances, for example to improve quality or to maintain an appropriate maturity distribution, trading issues may be quite necessary. Unfortunately, some portfolio managers are fascinated by the apparent opportunities that they see for speculative profits in trading. Nevertheless, banks are not designed to engage in speculation and experience has demonstrated time and again that the traditional policy in bank examination of discouraging trading activities is sound. If it were possible to draw up a statement of bank investment policy which would assure profits from trading, then it would be far more profitable for management to quit the banking business and turn to the stock market. The chances for profits would be much better.

Finally, in studying these statements of policy, the examiner should look for arrangements to review the statement periodically and appraise the investment performance of the bank portfolio. Without such review, it is impossible to keep policy statements up to date or to make certain that management is adhering to the standards.

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So much for those rather general comments on the investment policy. Sources of investment information is the next subject deserving of attention. This subject has been mentioned in connection with loans but it applies equally to securities. The examiner when he is reviewing the bank's investment activities should raise questions about the sources of information on securities--especially municipal obligations. Is the information complete? and is it adequate? I am sure that credit files are hard to obtain in the municipal field. If a bank follows the policy of buying the better known issues, I suppose a subscription to Moody's Manual will be sufficient. But there are many thousands of municipals and only a few are covered in the comprehensive investment Manuals. Probably most of the municipal issues in the portfolios of banks you examine will not be reported in the usual sources of investment information. So the bank will need to assemble credit files on the individual issues. That is a troublesome job so far as I am concerned.

How do banks secure the necessary facts about the individual municipal securities in their portfolios? Offering circulars are one source. Also, it is possible for bankers to go to the issuer--this usually means a visit to the city hall or the county building--and assemble data from the records. That is slow, painful, and costly business. Banks are not likely to assemble such information on any uniform basis although you may recall a number of years ago that the Corporation did endeavor to develop some enthusiasm for a uniform credit file. So far as I am concerned, information in the form issued by a municipality--whatever that may be--would be better than none. In a number of States there is now a systematic effort to obtain annual reports from the subdivisions of State and local government and to

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make them available to the public. Furthermore, it seems to me that the investment community is doing a little better job than it did years ago in assembling and publishing data on municipal securities. Probably all one can do is to urge the bankers to pull the information together and hope for the best.

Sources of information on prices for municipals certainly would be useful to portfolio managers in banks. I am thinking both in terms of price data on individual issues as well as the measures showing price trends. When one looks at the data on yields over the past five years, one can't help but be impressed with the importance of this information in successful portfolio management.

A few comments on the remedial measures would seem to be appropriate at this time. To the extent that it's possible, the examiner should endeavor to secure the adoption of policy statements by bank managements. That is an educational job, as I see it. Also, education is needed to improve the maturity distribution of bond portfolios. With the appearance in volume of long-term municipal issues, there is some basis for the belief that banks may drift into municipal portfolios composed of longer maturities. That would not be a very fortunate development. Maybe the solution of this problem will be some invention for shifting long-term issues out of investment accounts when pressures arise for cash and banks are obliged to liquidate their portfolios. But we're a long way from that now. The market machinery certainly is not going to furnish much liquidity. Furthermore, quality in times like these should not be forgotten. Defaulted issues are rare and the market does not distinguish very sharply between the

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top grade and the lower quality credits. Accordingly, the examiner as part of his remedial work should stress the importance of improving the overall quality of the municipal portfolio.

These remarks will be concluded with a few comments about valuation reserves for securities. Bankers may not be too enthusiastic about establishing these reserves. There are no tax advantages such as you find in set-asides for loss reserves on loans. However, losses can occur in the municipal portfolio; they have occurred; and there is every reason to believe that they will continue to occur. Furthermore, it is quite beside the point to say that only a half of 1 percent or some other trivial amount of municipal issues ever defaulted. A bank can lose money on high grade credits; in other words, there is a market risk. Bankers should be encouraged to anticipate losses in the investment portfolio and to make some provision for their absorption by establishing valuation reserves in prosperous times.

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