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THE SECURITIES ACCOUNT

By

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The Securities Account

Introduction

This session of the program will consist of two parts. First it is my intention to present a more or less formal discussion of the securities account in banks from the examiner's point of view. Following these remarks there will be a general discussion in which it is my hope that all of you will participate. Surely there are many questions about the securities portfolios that have troubled you in the course of your work as examiners. The time this morning can be employed most profitably if attention is centered on your specific questions.

At the outset of these remarks the factual background regarding bank investments will be sketched very briefly so as to identify the areas of the subject deserving of most attention. Then the nature and the scope of the examiner's job in reviewing a bank's investment portfolio will be defined. This will be followed by some specific suggestions which will be useful to you as examiners in appraising the investment quality of specific issues of securities and forming an opinion about the quality of a bank's investment program. Finally there will be some comments about remedial measures. The examiner's work comes to focus at this point. It is my hope that we can devote the principal part of this session to a consideration of the constructive side of the examiner's work with the bank's securities.

Factual Summary of Bank Investment Situation

The securities portfolio comprises the largest single category of assets held by insured commercial banks. As of June 30, 1955, securities accounted for 40 percent of total assets, as compared with 38 percent for

loans and discounts, and the remainder consisted principally of cash and a few miscellaneous items. Obligations of the United States Government made up 32 of the 40 percentage points comprising the securities portfolio, whereas the issues of States and subdivisions were responsible for over 6 of the percentage points and other securities accounted for the remainder. Furthermore, if we shift the basis of comparison from total assets to the securities portfolio itself, the predominance of Federal issues is even more notable. These obligations comprise approximately four-fifths of all securities; and a sixth of the portfolio is in the form of municipal obligations.

The picture of changes in bank investments over the post World War II period, 1946-1955, furnishes some helpful points of reference. The total assets of the insured commercial banks have grown from \$151 billion to \$198 billion. However, the investment in United States Government obligations has declined in dollar amount from \$83 billion to \$62 billion, while the municipal segment of the investment portfolios has increased from \$4 billion to about \$13 billion.

Based upon this brief summary of the essential statistical facts, it is quite clear that the municipal segment of the bank investment portfolio is the one now growing most rapidly. Furthermore, it has increased in size to such a point that it is surely deserving of careful attention. Within the 12-month period ending June 30, 1955, the insured commercial banks added almost \$1 billion to their municipal holdings.

A brief review of the investment situation now prevailing in the municipal area of finance is certainly warranted by facts. For many years

prior to World War II, municipal bond offerings ranged in the vicinity of about \$1 billion annually. During the war period these offerings declined drastically but in the post war area the increase in volume has been dramatic. Total offerings climbed nearly to \$7 billion in 1954, and it is reasonable to believe that in the current year the figure will approach this same total.

In addition to a huge volume of securities, the municipal area offers banks an extensive selection in types of issues. Historically, municipal securities have been floated by States and their subdivisions such as counties and cities to finance the construction of public facilities--for example, schools and highways. Credit worthiness depended upon the issue's unqualified pledge to levy such taxes as were necessary to pay the debt.

Municipal financing has acquired many new complexities in recent years. Many of the issues are floated by authorities which lack the general taxing power. These subdivisions of government are created for many different purposes. Some of them are business enterprises for all practical purposes. Most conspicuous in this group today are the toll roads, but there are many other illustrations. For example, the Port of New York Authority is a project that has been in existence for almost a generation. It furnishes the New York metropolitan region a great variety of services which may be generally defined as public utility in character. Also, there are projects engaged in producing electrical energy or providing water and sanitary facilities.

A serious complication in the area of municipal investments today stems from the extent to which securities are floated which have some of the characteristics of the typical general or full faith and credit obligation

and also some characteristics of the enterprise type of security. In these circumstances, it is exceedingly difficult to determine precisely the elements of credit which support the investment. Generally speaking, it is a fact that municipal offerings today present a more baffling variety of investment problems than they have at any time in history.

This completes a brief summary of the factual background of the investment situation. It is clear that the municipal section of the bank investment portfolio is now the one deserving of careful attention. This is evidenced both by the vigorous rate of growth in the bank portfolios and the obvious fact that the volume of municipal offerings has been heavy. It is commonplace that public facilities are grossly inadequate. This points up the prospects for a continued large volume of flotations in the municipal field. One need only mention the need for highway improvements and the inadequacy of the existing school plant to highlight this situation. All of you can think of other situations which will call for additional municipal financing.

Bank Investments as Viewed by Examiners

At this point in the discussion, it would be appropriate for us to ask the question: "What is the examiner endeavoring to do when he reviews the investment program of a bank under examination?" His work will be effective only to the extent that he perceives clearly his larger objectives and adheres to an appropriate course of action.

In the first place, when an examiner reviews a bank investment portfolio he is searching for weak issues--securities that fail to measure up to the high qualitative standards for bank investments. Unquestionably

the identification of poor credits in the bank investment portfolio is the most important single service that the examiner can perform both for the Federal Deposit Insurance Corporation and the bank under examination. It is vital that the insurer of bank deposits be apprised of weaknesses in asset structure. Furthermore, the banker needs the guideposts established by the identification of weak issues to direct him along sound lines of issue selection in implementing his investment program.

As he tests the individual blocks of securities in a bank portfolio for evidence of qualitative weakness, the examiner is concerned with one aspect of his more fundamental objective, namely, to discover shortcomings in the bank's investment policy. The acquisition of issues which lack merit is only one form of weakness in the portfolio. It is conceivable that a bank would hold a portfolio consisting entirely of issues that measure up to high standards of quality and yet be following a policy that is quite inappropriate to its needs. In appraising the adequacy of the investment policy, it is necessary to pay attention to the bank's deposit structure and the prospects for turnover in bank assets. Crucial in the study of investment policy are such matters as the maturity schedule of the portfolio and exposures to geographical and economic hazards.

When the examiner has identified weak issues in an investment portfolio and discovered shortcomings in the investment policy, he has laid the groundwork for the most important part of his work--the development of constructive suggestions for improvement. At this point it is necessary for him to bear in mind that he has no authority to usurp the functions of management. The power to decide questions regarding the purchase and sale

of individual issues or of basic policy always rests with the bank under examination, but there is a place for the examiner to be constructive in his efforts. When individual issues are pointed out as unsuited for bank investment, the reasons for the opinion should be so phrased as to suggest the appropriate standards for a bank to follow in the circumstances.

Finally, it is well for the examiner to appreciate that his efforts only are effective when he succeeds in encouraging the adoption of the necessary remedial measures. It is all well and good for the examiner to point his finger at weak spots in an investment situation. Furthermore, he should be constructive by suggesting ways to remedy the situation. The truly skillful examiner, however, is the one who is able to use the facilities of communication at hand--the examination report and his conversations with bank officials--to bring about the adoption of correctives.

Testing the Investment Quality of Individual Securities

Previously in this discussion your attention was called to the fact that the municipal portfolio is the segment of bank investments now growing most rapidly. Very little change is occurring in the aggregate amount of Federal issues and other securities held by banks. Accordingly, it will be my purpose to center your attention at this time on the municipal securities field.

For the purposes of this discussion it will be assumed that all of the municipal securities in the portfolio of the bank under examination are valid obligations and that credit information is available in the files. It is easy for the examiner to satisfy himself on these matters. The validity

of a municipal security is always determined by a legal opinion. Qualified law firms specialize in this type of business and good securities are always covered by the opinion of an expert on municipal obligations in the region.

The number of governmental subdivisions with power to create debt that may find lodgment in bank investment portfolios runs in the tens of thousands. Some of the issuers are large and very well known while others are small and obscure entities with little or no ability to maintain proper accounting records. Only a relatively few municipalities publish information in a form that will readily come to the attention of the investment community. Nevertheless, when a security is acquired for investment purposes there is an obligation on the part of the bank management to accumulate such information as is needed to determine the investment merits of the obligation.

The easiest way to test the quality of individual issues in a bank portfolio is to use the ratings published by the commercial services--for example, Moody's and Standard & Poor's. However, published ratings are only available for a small percentage of the municipal credits that may be found in banks. Furthermore, they are most useful for identifying the very good issues and the ones wholly lacking in merit.

Securities classified in the first two or three rating bands by the investment services are likely to be satisfactory for a bank portfolio, whereas investment quality is rarely found below the fourth rating band. To be sure, some investment characteristics are present in the fourth rating but analysis is needed to make certain that securities so classified are good enough to be included in the schedule of investment securities. So for all practical purposes, the commercial rating systems actually furnish a threefold classification--(1) investment quality, (2) subinvestment, and (3) marginal--

rather than the dual classification required for examination purposes.

At this point you should be reminded that securities rated in the four highest grades by the commercial services are deemed to be appropriate for bank portfolios pursuant to the terms of the 1938 agreement among the Federal and State banking authorities. Although the agreement provides that securities in the fourth rating band are permissible for investment, it is a fact that issues so rated are marginal in character. Accordingly, the examiner is obliged to analyze these credits if he is to resolve his doubts about their investment quality.

In practice the examiner cannot analyze the credit quality of all securities. Nevertheless, when a bank is heavily invested and the portfolio consists largely of marginal ratings, then the examiner has no alternative but to engage in a substantial amount of security analysis work. Likewise, he would be obliged to rely upon his analysis of individual issues if the portfolio was composed of unrated securities.

Beyond a doubt, the best way for an examiner to arrive at a judgment regarding the investment quality of an issue is to analyze the pertinent information. This, however, is a time consuming task. Furthermore, the information needed to support a good investment judgment is fragmentary or lacking in many cases.

To sum up this section of the discussion, then, it seems clear that the examiner will be obliged to use published ratings for purposes of screening out the intermediate and the weak or borderline issues in a bank portfolio. Then it will be necessary for him to further reduce the number of issues in the latter two categories by analyzing individual credits. When this process has been completed, he will be in a position to support a

generalization on quality. Among other conclusions he may find, for example, that the bank depends too heavily on little-known and unrated issues for which there is a shortage of financial information in assembling the portfolio. This is the case more often than not, especially among the smaller banks. Furthermore, such a conclusion offers an opportunity for the examiner to be constructive. Possibly he can induce the banker to improve credit files, and in some cases even to encourage improvement in the financial management of nearby subdivisions of government where securities have been acquired by the bank.

Summary of Municipal Credit Analysis Techniques

At this point in the discussion it may be helpful to review briefly the principal steps that must be taken in order to arrive at an evaluation of a municipal credit. Many of you will be disposed to ask the question: Why can't you give us a few ratios that may be computed from the financial data published by a municipality and tested by comparison with some approved standards for bank quality issues? The desire for the crucial ratios is an old one and it has the appeal of simplicity in application. But you must remember that decisions regarding investments all involve judgment. These decisions, if they are reached by a clerical process, will be worth the price you pay, namely, little or nothing.

It is possible for me to outline the steps to be taken in order to arrive at an investment judgment in an orderly manner. Unfortunately, there is no assurance that judgments will always be good if these steps are followed, nor that all qualified analysts will arrive at the same answer--but surely a majority of them will. As you have learned from your work in other

segments of a bank's asset structure--sound judgment of a credit situation cannot be taught.

The primary objective of security analysis is to answer the question: Can the debt be managed successfully by the obligor? From the viewpoint of an examiner, this question has two facets. At the outset, he is seeking to measure the margin of protection for debt service on each item in the bank portfolio. This measurement involves a judgment based upon the statistical information with respect to the quality of credit. After the examiner has formed a judgment concerning the margin of debt service protection, he then is in a position to turn to the next consideration: Is a security with this margin of protection suitable for bank investment purposes?

The first step in judging the credit quality of any municipal obligation is to evaluate the economic background of the issuer. This involves a study of population characteristics, the physical resources and the economic strength of the community, including industry and trade as well as the composition of the income structure. Here the analyst is looking for evidence of a healthy and growing community. Rapid growth always creates a certain amount of trouble for municipalities. However, if financial management is good, old debts have a way of being paid off in a growing situation and this gives the investor an opportunity to make another choice if he does not like current developments.

A summary of the municipal debt structure in a community under study is the most important single tabulation in the credit analysis. The object of this statement is to assemble in one place the details and the totals showing the amount of debt. Sidelights on the nature of the debt

burden are disclosed by the classifications which indicate the purpose for which securities were floated. For example, it is important to identify that part of the debt which is self-supporting. This refers to securities issued to finance such public facilities as sewer and water systems which furnish revenues that may be used to service the outstanding obligations.

Along with the statement of debt, it is helpful to record the highlights in the history of payments. It is consoling to know that a community has never defaulted on its obligations, or if default occurred, it was long ago. Even in good times, defaults occur. Mostly these are technical in character but such defaults point to defects in financial management. Generally speaking, it is unrealistic to argue that a bank must confine its investments to securities floated by obligors who never have defaulted--but the default should not be recent.

A statement picturing recent financial operations is an essential bit of information for the analyst of municipal securities. Such a statement discloses evidence that the community is maintaining its expenditures within the bounds of its receipts, and that its provision for operating expenses and debt service are adequate. Sometimes the auditors' reports on municipal finances furnish collateral evidence bearing upon the quality of a community's financial management. This is likely to take the form of comments about the condition of the records. Moreover, good management is evidenced by the promptness with which taxes are collected when due. Poor records and indifferent tax collection policy always point to inferior credits.

In this brief summary of security analysis techniques, it is only possible to outline very broadly the kind of information that is pertinent

to a decision with respect to the quality of a municipal credit. The nub of the process is the investment judgment of the analyst based upon interpretation of data. The interpretation of the data depends in important respects on the type of municipal obligation under consideration. Fundamentally the analyst is endeavoring to measure the debt burden of the issuer and to appraise his prospects for performance according to the terms of the obligation. To illustrate: The debt burden on issuers of general obligations, namely, securities covered by a pledge of the full faith and credit of the issuer, to service the debt, is customarily measured by the ratio of debt to assessed value. Generally speaking, when this ratio is low, that is, in the order of three or four percentage points, it is evident that the burden of debt is rather light. High ratios, on the other hand, may be a danger signal. In any event, it is necessary to interpret these ratios in terms of assessment practices and local economic conditions.

When the analyst is seeking to determine the credit quality of securities issued by municipal authorities engaged in activities of a business type--for example, water and electric projects or toll roads--the problem is quite similar to the analysis of any private corporation engaged in public service activities. There is no support of the credit from a general taxing power. As a consequence, the margin of protection for debt service depends upon the earning power of the project.

Projections of revenues and expenditures for the project financed by revenue bonds furnishes the starting point in analyzing these credits. Sometimes the project has an operating record which simplifies the process of estimation. Today quite frequently the examiner is likely to encounter

securities for which operating records are not available. If there is a reasonable doubt about the completion of the project according to plans or the earning power after the enterprise is in operation, then an operating record is an essential prerequisite for investment judgment. It is desirable, however, to maintain some flexibility in the operating record requirement. There are situations where collateral evidence is sufficient to furnish satisfactory assurance of the projects feasibility from an engineering point of view. Sometimes in these circumstances experience with similar types of projects provides an adequate basis for estimating the margins of protection for debt service.

There are no hard and fast rules guiding investment judgment as to the amount of margin necessary to protect debt service. To be sure, a wide margin is better than a narrow one. Wide margins will compensate for errors in estimates of revenues or expenditures.

The most troublesome type of credit for the securities analyst to cope with are those which have some of the characteristics of general obligations as well as revenue bonds. In these circumstances, it is extremely difficult for the analyst to measure the extent to which reliance is placed on general tax powers to support the debt. When the revenues dedicated for debt service are obviously adequate by a wide margin to cover the requirements, then it is appropriate to ignore the pledge of general credit. This, however, is not the fact in many instances. It is necessary to treat the credit as if it were a revenue obligation unless it can easily be shown that the general property tax is more than adequate to cover debt service.

These brief remarks about testing the credit quality of municipal securities do not pretend to cover the general subject of security analysis at all adequately. While all bank examiners cannot be expected to perfect themselves in the field of investments, they need to understand the rudiments of the subject. It is my hope that the comments on testing for investment quality will suggest questions you will wish to consider at length in the discussion period of this session.

Municipal Portfolio Tests: Quality

Although an examiner forms his opinion of the bank's investments by studying them in terms of bits and pieces, his final judgment will be in terms of a portfolio viewed in its entirety. The identification of weak issues in the portfolio is the first step towards an appraisal of the bank's investment program. At this point the examiner is seeking to answer the question: What is the general average of quality inherent in the bank's investment program? The answer to this question is then projected against the examiner's judgment of the appropriate qualitative requirements for the individual bank under examination.

While it is true that all banks are expected to maintain relatively high qualitative standards, in some cases it is much more important to be insistent upon quality than in others. A very skillful management is able to work successfully with securities below the very top grade. However, if management does not have any unusual investment skills, they are not in a position to deal with any securities but the best available in the investment market.

In forming a judgment of the portfolio's investment quality, the basis will be the preliminary work already completed by the examiner in the course of his review covering individual issues. By means of the qualitative ratings established by investment advisory agencies, supplemented when necessary with the analysis of individual issues by the examiner, it will be possible to develop data showing the relative amount of investment in securities definitely suitable for the bank, the ones obviously not appropriate for the portfolio, and the marginal issues.

Diversification of Risks

In addition to an opinion about the average investment quality of the portfolio, it is also necessary for the examiner to find an answer to the question: What are the risk exposures? Usually the answer to this question is phrased in terms of "concentration." Have the issues all been selected from a particular geographical area? Do they all represent obligations of the same issuer or the same type of issuer? This is best illustrated by a situation in which the bank invests the bulk of its municipal portfolio in obligations of nearby municipalities.

It is a fact that a bank is under some obligation to serve the credit needs of the community. This includes the financing of local governments. But there are very definite limits to this obligation. A bank cannot be expected to finance singlehanded all of the local school districts, counties, or cities situated in the area. To be sure, it can invest some of its funds locally and in certain circumstances the investment may be relatively high. However, a bank can always be of assistance to a community by helping the finance officers to broaden the market for their securities and thus relieve the bank of an unfortunate concentration.

Some banks tend to select securities of certain types. There is now, for example, some disposition on the part of a few banks to buy relatively large amounts of highway toll revenue bonds. Maybe this bias is motivated by a desire to maximize income. Nevertheless, the result is a serious exposure to the type of risk that can be avoided. When the examiner discovers this shortcoming in a portfolio, he surely should call it to the attention of the bank.

Maturity Distribution

The examiner's opinion about the maturity distribution of a bank's municipal portfolio is one aspect of his overall judgment regarding the bank's provision for meeting cash requirements in the future. You have already given attention to the deposit structure of the bank in the course of your examination work. The principal reason for studying deposit structure is to ascertain the cash requirements that the particular bank might reasonably anticipate. This serves as a basis for evaluating the composition of assets with respect to their ability to "throw off" cash in conformity with anticipated demands. Thus, the standards for liquidity in the municipal portfolio are a part of the overall considerations as to bank liquidity.

Centering your attention specifically on the bank's municipal portfolio, the first important fact to be noted is one that arises as a direct consequence of serialization in the retirement of municipal debt. The bulk of these securities are floated in such form that a bank can readily establish its pattern of liquidity by selecting maturities appropriate to the schedule. Most municipal bond issues mature serially within 15 or 20 years of flotation. Thus, by selecting the appropriate maturities, it is possible for portfolio managers to avoid market risks.

Lest the fact be forgotten, it should be noted that when banks seek to dispose of municipal securities they are obliged to rely on the over-the-counter market rather than an organized exchange. In this respect municipals differ very sharply from the corporate issues, most of which are readily marketed through the facilities of the New York Stock Exchange. Negotiation is necessary to shift municipal securities from one bank to another. Since the number of issues is great and the problem of sale is further complicated by serialization--a buyer must be found not only for the issue but for the specific maturity--banks cannot rely successfully on the market for liquidity.

Contrary to the usual practices, in recent years a substantial amount of municipal financing has taken the form of 30 and 40-year term bonds. This is especially characteristic of toll highway financing. Issues of this type would fit into the portfolio of an insured commercial bank only in most unusual circumstances. It would take a remarkable stability of the deposit structure to justify such investments. Furthermore, it is doubtful that the mechanism of the over-the-counter market would be adequate for shifting any appreciable amount of these securities to other investors in the event that the bank needed cash.

One simple plan for organizing the maturity schedule in a municipal portfolio is to adopt the so-called roll-over principle of investment. Such a program calls for a commitment of substantially equal amounts of the portfolio in maturities scheduled for each year over the maximum term of investment. For example, if a bank decides that its portfolio should turn over in seven years, then one-seventh of the portfolio would be scheduled to mature each year. The program has many advantages. It insures a dependable

inflow of cash from scheduled maturities if securities of bankable quality are selected. Furthermore, it enables the bank to average its interest return because the amount of the maturing portfolio is reinvested each year at prevailing terms. Few bankers can expect to speculate successfully on trends in the rate of interest. Most of them would be well-advised to accept the market rate whatever it may be and to adopt this mechanism for averaging.

Remedial Measures

If the review of the bank's investment portfolio satisfies the examiner that the bank is following proper investment policies, then it is unnecessary to devote further consideration to this subject. But in almost every case the examiner will find some aspect of a bank's investment portfolio that suggests the need for improvement. Possibly the bank has not analyzed its requirements as closely as necessary. Maybe the issues have not been properly selected in all cases. It would certainly be a rare situation where the examiner would find credit files that are adequate. Defects of this character are not impossible to remedy. The examiner can call attention to the situation and encourage the adoption of remedial measures.

Up to now in this discussion, the bank's investment program has been considered in terms of its parts. The details of this program cover such matters as the amount of assets to be committed to investments, the type of investments appropriate for acquisition by the bank, the maturity schedules, and qualitative standards. However, a bank's investment policy can be effective only when it has definitive shape and it is understood by the managing officers. To facilitate this understanding, it is desirable to

have a formal statement of policy. In developing a formal statement, it is desirable to have the bank's investment policy embodied in a resolution approved by the board of directors of the bank. The resulting document which embodies investment policy furnishes a source for reference when questions arise.

Probably the best single means that could be suggested for improvement in this area of banking activities would be an insistence by examiners on the preparation of formal statements of bank investment policy. When the examiner finds such a policy statement, it would be well for him to review it for completeness and adequacy as well as to make certain that management understands and follows the program.

Summary and Conclusion

This concludes the formal part of the program devoted to the securities account. To sum up briefly, the factual background suggests that bank investments comprise the largest segment of asset structure. Within the securities account the municipal portfolio has grown rapidly in the post war years and most of the discussion has centered on these securities. The examiner's job has been defined primarily in terms of judgment regarding first the quality of issues and then the bank investment policy. Stress has been placed upon the importance of constructive suggestions and means for encouraging the remedial effort when banks have deviated from sound principles. Brief comments on the steps to be taken in analyzing the credit quality of individual issues and in testing security portfolios will refresh your memory of this work and suggest questions to consider in our general discussion of the Securities Account.