TRENDS IN BANK HOLDINGS OF MUNICIPALS

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Introduction

A brief resume of the facts about recent trends in municipal portfolios held by banks is a necessary background for our discussion which will be particularly concerned with the bank examination report as a device for remedying defects in bank investment policies. Accordingly, at the outset my remarks will cover the amount of bank investments in municipals. This will be followed by a few comments about the disposition of banks to hold municipal securities and the relative size of portfolios. Next your attention will be directed to a few peculiar developments with respect to municipal credits in bank portfolios which have recently been noted.

Following this brief summary of the facts it is my intention to turn to the first page of the revised Section H of the examination report. The usefulness of this page, in my opinion, has been greatly increased by sharpening some of the questions relating to investment policy. When it is necessary to develop a program designed to remedy an unfortunate investment situation the policy questions, I believe, lay the groundwork for a more extended comment on page 2 of the examination report. Your views regarding the work that may be done to improve the content and quality of page 2 comments would be especially helpful. It seems to me that we could do more than we have in the past along these lines.

Amount of Municipal Bonds in Banks

For the first time in a decade there has been an interruption in the rapid growth of bank investments in municipal securities. Since the late 1940's the investment in this category of assets has been increasing at the rate of about $1 billion per annum. Furthermore, the relative size

of the municipal portfolios has grown from about 3 percent of total assets to a high of 6.2 percent in 1954. In contrast to this record, over the period 1954-55 the bank holdings of municipal securities increased only about one-tenth of $1 billion, that is, from $12.4 billion to $12.5 billion. Relative to total assets municipals declined from 6.2 percent to 6 percent.

The interruption in the rapid growth of municipal portfolios held by the insured commercial banks reflects, to some extent at least, the shrinkage in the volume of new offerings. Flotations in 1955 amounted to about $6 billion--$1 billion less than the record total of $7 billion for the previous year. The drying up of toll road financing to a very considerable extent accounted for the shrinkage in the volume of offerings. Nevertheless, the 1955 total was almost double the level of annual flotations for the late 1940's.

At this time we are experiencing a breathing spell in the expansion of municipal investments held by banks. This is especially fortunate because the rate of expansion has been extremely rapid. Temporarily at least the times really serve the bank examining authorities. They now have an opportunity to take stock of the situation and, if need be, to encourage some improvements in bank investment policies. This opportunity may not be of long duration and it would be well to make the most of it while it lasts.

What Has Happened to Municipal Portfolios in Recent Years?

Comprehensive information regarding bank investment policies with respect to municipals is not too satisfactory. Nevertheless, there are a few facts that may be gleaned from a study of the information at hand.

In the first place, the facts available to us suggest that there has been a rather persistent shrinkage in the number of insured commercial banks that display absolutely no interest in this category of assets. In 1949, for example, about 1800 banks did not hold municipal securities among their assets. By 1955, almost 1500 banks were in this category. The figures declined each year between those dates.

Banks with relatively large portfolios are increasing in number. Thus, in 1949, about 750 of the insured commercial banks held more than 15 percent of their total assets in municipal securities. By 1955, this category comprised 1150 banks.

Offhand, I believe most of you will agree that a municipal portfolio compromising from 5 percent to 15 percent of total assets is substantial. With this as our test, there were about 3750 banks with substantial municipal portfolios in 1949. However, in 1955 the number of banks with such portfolios amounted to almost 5100.

The fact that more and more banks are showing some interest in municipal securities as a source of investment and the growing reliance which banks are placing upon these securities in their asset structure should not be interpreted as evidence that the banking system is headed for serious trouble. To be sure, there are weak spots already coming into sight. But there also are favorable features in this picture. For example, in 1947 about 40 percent of the municipal portfolio held by the insured commercial banks matured within five years. Today the corresponding figure based upon rather scrappy statistical evidence, to be sure, stands at about 50 percent. The issues in the longest maturities, that is, over 20 years,

account for a relatively small part of the total municipal investment. Probably at this time it is not more than 5 percent.

Admittedly many banks have poorly defined investment policies with respect to their municipal holdings--or for that matter, no policy at all. Nevertheless the maturity picture lends an encouraging aspect to the situation. It is a fact that a substantial portion of all municipal bonds held by banks are short term issues. Moreover, holdings of very long term issues are rather small.

Weaknesses Noted in Municipal Portfolios

A few banks have always invested too heavily in the obligations of issuers situated within the adjacent trade area. In this situation the potential difficulties from the point of view of the bank are quite evident. Unless the credits are very well known in the financial community the bank cannot dispose of such assets readily when it is necessary to obtain cash. Furthermore, any developments which would weaken the loan portfolio also would impair the municipal investment. On the other hand, it has long been recognized that a bank is under obligation to furnish credit for the area it serves. This includes credit to municipalities as well as to any other local borrowers. So far as the bank is concerned it is necessary to find a balance between its obligation to serve the credit needs of the municipality and the investment requirements of its portfolio.

Turning now to another group of difficulties, some banks, it seems to me, are investing too freely in warrants. Very frequently the root of the difficulty is concentration in local securities floated by a

municipality. In a few cases a study of examination reports suggests that the pressing needs for local community facilities have induced banks to overextend their warrant holdings. In addition, the question of validity as regards warrants is always a knotty one. When a bank acquires a municipal security it is an elementary precaution to have a legal opinion as to the soundness of the obligation. However, it is doubtful that banks generally take the precaution to secure legal opinions as to the validity of the warrants acquired for investment purposes.

The so-called industrial bonds comprise another group of municipal obligations which are of special concern to the bank examining authorities. In these times of shortage in public facilities to serve the ordinary needs of government, namely, schools, highways, sanitary facilities, and other ordinary public improvements, municipal financing becomes greatly complicated by issues of municipal obligations designed to encourage or assist in the industrialization of a community. Industrial bonds may be suitable for bank investment but that requires a determination in each instance--and their securities are not easy to analyze with respect to credit quality.

At this place it would be appropriate to comment on the recent flotations of very long term municipal issues, especially the bonds issued in connection with toll road financing. The Great Depression of the 1930's taught the investing public that serial maturities were of help in maintaining order in the finances of States and subdivisions of government. Now, unfortunately, it seems that we are on the way to forgetting this valuable lesson. A remarkable number of bonds to finance large projects

have appeared in recent years with 30 and 40-year maturities. Moreover, these issues provided sinking funds rather than serial arrangements for retiring the debt. By and large, the sinking funds did not serve the purpose well during the years of the Great Depression.

Comment on Investment Policy in Examination Reports

The recent revision in the investment section of the bank examination report furnishes the basis for sharpening the examiner's analysis and comments on the investment policy of the bank under examination. The first question in this section is now concerned with the bank's investment policy. We know that banks have a growing interest in municipal securities. Furthermore, banks are making heavy commitments in this category of assets. Accordingly, it is important for them to have an investment policy which guides their selection of issues and the management of the portfolio.

The first of the questions regarding investment policy in the examination report can be used by the examiner to lay the basis for much needed remedial efforts in certain cases. Recently, for example, I studied a number of reports for banks with rather substantial municipal holdings. It was interesting to note that out of a dozen cases two examination reports led directly from the reported fact of no investment policy to an extended page 2 comment indicating that the bank was studying its investment situation for the purpose of establishing policy. Thus, the examiner was making a very immediate and practical use of the question. If he finds at the next examination that some progress has been made, then it will be possible to change the shape of the page 2 comments depending upon

the results of the study. On the other hand, the failure on the part of the bank to develop an investment policy during the interval between examinations would lay the groundwork for further discussion of this aspect of the bank's operations on page 2.

As time goes on, it seems to me that examiners should be encouraged to use page 2 for an extended discussion of bank investment policies. Not only should this section of the report be used to urge the development of a policy, but it also would be appropriate to comment on weaknesses in policies and to encourage improvements. In my opinion, consistent use of the page 2 comments would be as effective as any single device for pointing out and encouraging the correction of investment difficulties such as the ones noted previously in these remarks.

For example, the examiner can make some very practical suggestions in his page 2 comment when he finds that the bank has invested heavily in the obligations of a local municipality. Usually this situation occurs in a small community and the remedy involves an effort on the part of the bank to assist local finance officers to develop a broader market for their securities. In these circumstances the bank probably could solve the problem by calling upon its correspondents in nearby financial centers. Not only would this help the issuer to obtain access to a larger pool of funds, but in addition it would facilitate the resale of securities in the event that a bank is obliged to convert its municipal holdings into cash.

The warrant situation is another one that I feel can be approached through the use of page 2 comments. In this case it seems that nothing more is required than insistence upon legal opinions regarding the

validity of the obligation. If these obligations are valid, and if the amount is not excessive, then, of course, there is no difficulty. On the other hand, if there is some defect in the legal situation, or if the total amount is excessive, then the bank has no alternative but to insist that the municipality use other arrangements for financing its needs.

Similarly, page 2 comments may be used to cover other situations such as industrial bond issues or excessive holdings of long term revenue obligations.