BANK INVESTMENT IN MUNICIPAL OBLIGATIONS

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Introduction

In the course of these remarks it is my intention first to sketch the background of bank investment in municipals over the past 15 years. The starting point in this discussion will be a brief description of the situation prevailing at the beginning of World War II followed by an outline of the developments in the postwar period. Secondly, I shall review the statistics regarding municipal portfolios of State nonmember banks in the Eighth District. Finally, it is my plan to focus your attention on the question: How should the examiner handle the municipal segment of the asset structure of a bank under examination? The consideration of this question will afford an opportunity to discuss various aspects of the problem such as the bank's basic investment policy, the role of municipal securities in the investment program, and the quality of these credits.

The primary objective of these remarks is to outline the subject in comprehensive terms. It is my hope that the remarks may suggest specific questions to serve as a basis for comments in our discussion period.

Trends in Bank Holdings of Municipals

At the beginning of World War II all insured commercial banks held about $28 billion of securities. Of this total about three-fourths was invested in United States Government obligations. The remainder consisted of other securities, principally the obligations of States and subdivisions of government and the issues of private corporations. Securities in the municipal segment amounted to about $3.7 billion.

During the war the securities portfolio grew with extreme rapidity. Total holdings in 1945 amounted to $96 billion of which Federal obligations made up $89 billion and the holdings of municipal and other obligations remained virtually unchanged.

Three facts characterize the bank investment situation in the postwar period. In the first place, the securities portfolio has declined to the $77 billion level. Secondly, holdings of Federal obligations have stabilized at about $61 billion. Thirdly, there has been a sharp increase in the municipal segment of the bank investment portfolio. This has climbed from a total of almost $3.6 billion to about $12.5 billion. During the same period the investment in obligations of private corporations, the so-called other bonds, notes and debentures, has remained practically stationery at about $2.5 billion. Some increase has occurred in holdings of the obligations of Federal agencies not guaranteed by the United States Government but even at present this category of securities accounts for less than $1 billion.

To sum up, then, in the postwar period all insured commercial banks have added to their commitments in municipal securities at an exceedingly rapid rate. Dollarwise the amount has increased almost fourfold. Moreover, the banks have changed markedly the fraction of their total securities account committed to municipals. At the beginning of the period about 4 percent of the total portfolio was so invested but now the amount is 16 percent. In contrast throughout the period, the dollar amount invested in the obligations of private corporations remained virtually unchanged.

The shift in the character of the bank investment portfolio is fraught with important consequences as regards the work of the bank examiner. It is a fact that during the period before World War II examiners were able to cover a very important segment of the bank investment portfolios largely by the application of the published credit ratings for corporate issues. This was true because Federal obligations presented no problem creditwise and corporate holdings were almost as large as the commitments in municipal obligations. To be sure, the appraisal of the municipal credits was then, as now, a difficult job because the coverage of published credit ratings was limited and the number of issuers was large.

Since World War II the examiner's work has been burdened by the very substantial growth in municipal holdings both dollarwise and relative to total bank investments. The number and variety of these issues and the complexities of the credit situations have increased very substantially. Although the investment services have expanded the coverage of their ratings for municipal credits somewhat, at best they are of limited usefulness in appraising the quality of credits. Thus, in handling the municipal portfolio the examiner has a variety of new problems that are deserving of consideration.

Investment Picture in District Eight

In District 8, as for the Nation as a whole, the growth of municipal holdings has been the most important single change in the investment picture over the period since 1945. Current statistical information pertaining to District 8 has recently been compiled for insured commercial banks, chartered by Illinois and Iowa, that are not members of the Federal Reserve. During this period municipals held by such banks in Iowa grew from approximately $25 million to $87 million. At the beginning of the period the municipals equalled about 4 percent of the total investment account as compared with 16 percent in 1955. These statistics reveal substantially the same picture in Illinois. There the growth was in the order of $21 million to $122 million, respectively, and percentagewise the figures were about the same. Thus, it is apparent that the Federal Deposit Insurance Corporation examiners in this District are called upon to review a very much larger volume of municipal securities and these investments are relatively much more important in the total investment portfolio.

Furthermore, the recent statistical tabulations show that holdings of obligations floated by private corporations are now relatively unimportant in the investment portfolio of Iowa banks. Altogether they now amount to about $14 million. Dollarwise such securities held by banks in Illinois is substantially higher than in Iowa: about $58 million in 1955 as compared with $24 million in 1945, but they continue to be relatively unimportant.

The Bank Examiner and the Municipal Portfolio

The recent increase in the amount of municipal securities held by the insured commercial banks has substantially changed the character of the examiner's task with respect to this segment of the asset structure. In many banks there has been a notable growth in the relative importance of municipals as an element of the asset structure. Taken in the aggregate, however, municipals account for only a slightly larger proportion of the total assets of the insured commercial banks now than in the prewar period. Nevertheless, the increase in the dollar amount of securities has by itself added to the work of reviewing the municipal holdings. So examiners everywhere are faced with the need to devote more time to this part of the bank examination work.

From your viewpoint as an examiner it would be well to orient the time and effort you devote to the municipal holdings of the bank under examination around the central question: Is this portfolio appropriate for the bank in its present circumstances? To answer this question it is necessary for the examiner to have in mind some notion of what might be called a good portfolio. Sometimes the examiner will find that the portfolio of the bank under examination possesses all of the desired characteristics, but for the most part there will be some fairly obvious shortcomings. These shortcomings may result from defects in the bank's investment policy or from accident and misfortune in its implementation.

How, then, does the examiner go about it to envisage a municipal portfolio with the characteristics best suited for an individual bank? Such a portfolio should possess a variety of desirable characteristics, but for the purpose of this discussion attention will first be directed to liquidity. One should never forget that banks are primarily custodians of a community's liquid resources. They are not investment institutions even though they do hold a substantial amount of securities. Accordingly, in developing the asset structure of a bank the controling factor is the ebb and flow of its deposit liabilities.

This is not an appropriate occasion for a discussion of techniques to determine cash flows within a bank under examination. Nevertheless, it is a fact that a bank cannot be examined with much discernment unless the examiner has a reasonably clear picture in his own mind of the turnover of deposit liabilities. Related to this picture is the design of the asset structure to meet these flows.

Owing to the size of bank holdings of municipals and the nature of the market, for all practical purposes, the only dependable source of cash from these obligations is through payment at maturity. Facilities for the distribution of municipal obligations are designed primarily to place new offerings in the hands of investors. At best, the secondary market is equipped to handle only a comparatively small volume of well-known issues. There is, of course, nothing comparable to the shiftability that has developed over the decades in the market for listed bonds.

The lack of a good secondary market for municipals is not a fatal defect from the point of view of bank investment because these securities are offered in serial form, and as a consequence the individual bank can select a set of maturities that will provide a ready flow of cash. The best and simplest method to obtain cash from the municipal portfolio is by adherence to something like a five or seven-year turnover program. In accordance with such a program the bank has, for example, a definite fraction of the total portfolio maturing in each year. Funds obtained from the matured bonds then may be reinvested in the longest term obligations contemplated by the program. Not only does this plan of investment afford a steady flow of cash but in addition it gives the banker an opportunity to average the rate of return on his municipal holdings. Thus, he can iron out the fluctuations that occur in yields from year to year.

In the selection of issues for the municipal portfolio of a bank next in importance are considerations of investment quality. Especially is this true in prosperous times because then practically all obligations appear to be good even though the margins of protection are small. Nevertheless, it is inappropriate for a bank to hold assets of inferior quality. Such obligations cannot be depended upon to perform according to the terms of the contract in times of adversity.

Banks now hold almost one-third of all the municipal securities outstanding. Accordingly, one cannot expect them all to be of the very top grade. However, the issues suitable for bank holdings are only the ones that are strong enough creditwise to rule out any doubts as to performance either with respect to payment of interest or principal at maturity.

Financial literature stresses the fact that municipal securities have seldom eventuated in losses to investors. Less frequently is mentioned the fact that over long periods of time holders of inferior quality issues have been unable to collect principal or interest. In view of these facts it is quite evident that a great many municipal obligations may be good enough for the portfolios of nonbank investors. Such holders can afford to assume the credit risks because they know that ultimately the likelihood of loss is small. Bank investors, however, are not in a position to wait for better times. As a consequence they must limit their commitments to issues whose debt service is protected by substantial margins.

Marketwise there is little difference between high quality municipal securities and those of marginal or subinvestment grade when business is active. From the examiner's point of view this is both a disadvantage and an advantage. It is difficult for him to convince a bank management prone to buy securities on a yield basis that a slight differential in return ought to be surrendered so as to obtain a bank quality investment. On the other hand, it is a fact that market quotations reflect only incompletely the wide margins of protection available to investors in some issues. Accordingly, bankers frequently can improve the quality of their portfolios by making only small concessions in amounts of income. This is not always the case. During the period of the Great Depression the yield differentials between top grade issues and those of inferior quality were wide.

Admittedly, earning power is a factor of importance in guiding the selection of issues for inclusion in a bank's municipal portfolio. However, it is an unfortunate fact that over the postwar years much of the discussion regarding bank holdings of municipals has centered on the advantages of tax exempt income. Bankers and securities dealers have been almost completely preoccupied with the effort to find a haven of refuge from taxation. This preoccupation has diverted attention from the central problem, which is the appropriateness of the securities for the investment portfolio of the bank.

Now, what can the bank examiner do when he finds sharp differences between the characteristics of the securities actually held by a bank and the ones that would comprise a good portfolio? At this point it should be noted that the examiner has a number of tools at his command. For example, the investment section of the examination report raises questions about the bank's investment policy. If the examiner pursues these questions vigorously, the answers will disclose any serious weaknesses that may exist in the basic policy or the management of the investment program. Thus, the stage will be set for a genuine remedial effort and a detailed comment on page 2 of the examination report is the appropriate place, in my opinion, for the examiner to present his views as regards the situation and the possible remedies.

To the extent that a bank's investment portfolio suffers from weaknesses of a policy character, the difficulties can be isolated readily enough. Sometimes, for example, a portfolio has undesirable characteristics simply because the bank follows no specific investment policy. Securities are acquired for vague reasons or virtually none at all. If they happen to be appropriate, it is an accident. On the other hand, the examiner occasionally finds a bank with a fundamentally unsatisfactory investment policy. The bank may be committed to acquire securities with relatively high yields, irrespective of quality or the appropriateness of the maturity. Such a situation requires clear-cut comment by the examiner.

Deviations from a sound investment policy in most instances can only be corrected by means of a rather long educational program. Not only must the examiner identify the weaknesses in the situation but thereafter a concerted effort on his part is needed to encourage the adoption of an investment policy that is suitable for the individual bank.

Sometimes an examiner will find that a bank has adopted a satisfactory statement of investment policy but as a practical matter the implementation is poor. It may be, for example, that the statement recognizes the importance of liquidity and establishes the broad outlines of policy with regard to this feature of the portfolio. Moreover, there may be rules in the policy statement for determining the quality of securities to be selected for investment purposes. But actual practice may depart widely from avowed policy. The examiner can be of great service to the bank in reviewing the composition of the portfolio and calling attention to evident weaknesses.

Tests of Credit Quality

The amount of the examiner's time available for studying the bank's municipal portfolio depends in good part upon its importance in the asset structure. Thus, the examiner may conclude from his preliminary survey that brief study is sufficient for the purposes of his examination. On the other hand, in some cases the portfolio stands out as an element of major importance in the bank operation. This is certainly true if municipal investments account for a large percentage of total assets. But it also may be true in the event that the portfolio evidences a lack of coordination with the cash requirements of the bank or if obvious weaknesses in credit quality suggest the need for intensive study.

How can the examiner test the quality of municipal issues in a bank portfolio within the limitations of his work schedule? Insofar as possible the use of published ratings by commercial investment services furnishes some clue as to quality. To be sure, the standards were developed for quite a different field, namely, corporate issues, but they may be quite helpful.

The presence of a large number of securities that have not been rated as to quality by the recognized sources of investment information is a signal for the analysis of individual credit if the municipal portfolio is important to the bank. However, the determination of credit quality is a time-consuming endeavor. As a starting point the examiner needs a substantial amount of information about each individual credit before he can undertake any analytical work.

The bank examining authorities have always adhered to the rule that a properly managed bank maintains adequate credit files on all of its assets including the securities portfolio. Credit data are readily available in the published sources of investment information such as Moody's Manual for all of the issues that enjoy a national market as well as many other obligations of regional importance. Unfortunately, the examiner is likely to find that the facts regarding the credits of small communities are not available in any published sources. Information necessary to determine the quality of such credits can only be obtained from copies of audit reports and sometimes from offerings circulars. The latter, however, frequently gloss over points of importance in analytical work.

If an examiner finds that a bank has committed a substantial portion of its funds to municipal issues that are not covered by reports in the manuals, he should insist on satisfactory credit files. Such data are essential to support qualitative judgments with respect to securities. As a matter of fact, there is reason to believe that the banks with adequate credit files tend to be more sensitive to differences in the quality of securities available for investment. Too often, I feel, the examiner notes the shortcomings of credit files covering the items in the investment account and then neglects to comment on the seriousness of this lack of information.

In analyzing the credit quality of municipal securities the required data depend basicly upon the type of security under consideration. For this reason the examiner's first task in analysis is to divide the issues into appropriate groups. Obligations carrying the pledge of the full faith and credit of the issuer are, generally speaking, the easiest to appraise with respect to credit ratings. Fortunately the securities in this group comprise the bulk of all outstanding municipal obligations.

The exigencies of municipal finance have given rise to a group of securities floated to finance enterprise of a business type. These securities do not carry any unqualified pledge of credit. On the contrary, the funds available for debt service are derived solely from revenues earned by the project. For all practical purposes these enterprises resemble public utilities although there is no ownership margin of protection. The examiner may find it difficult to judge the credit worthiness of these projects but in any event it is of a nature that does not present any novelties in finance. In general the techniques for ascertaining the credit worthiness of securities floated by a privately owned utility are applicable in this situation.

Probably the most troublesome areas of municipal finance are characterized by the issuance of securities that have some of the characteristics of general obligations and at the same time embody some features that ordinarily one would expect in revenue projects. Because of the tremendous expansion in the demand for municipal facilities there has in recent years been a great deal of inventiveness in the field. As a consequence many flotations now present problems to the analyst that cannot be handled by means of the conventional techniques.

Analyzing Credit Worthiness of General Obligations

Broadly speaking, it is not difficult for an examiner to satisfy himself that the obligation of a community that has pledged its full faith and credit to service the debt measures up to high qualitative standards. Likewise, the obviously inferior credits are readily identified by the application of a few simple tests. However, there is always a residue of issues--which in good times tends to be sizable--that is marginal in character. About these issues one can speak with assurance that debt service will be met as long as the economy is in an expanding phase. But it is problematical that the credits could withstand a great deal of adversity.

What, then, are the tests of a good credit? In the first place such securities are issued by a community with sound economic background whose physical facilities are in good shape. The bank examiner in the course of his work has an opportunity to visit a great many municipalities whose obligations are found in the banks he examines. He can detect the evidences of a thriving community with well-maintained public facilities adequate to serve current needs. By contrast, he is aware of the fact that some municipalities are literally down-at-the-heels. The obligations of such issuers are rarely better than the physical appearance of the community.

Evidences of good financial management characterize the sound municipal credits. This management is reflected in the financial statements of the obligor. The accounts measure up to approved standards of reporting; the debt structure is simple; and the record of receipts and expenditures reveals a margin of protection for debt service that will help to absorb the shrinkage in tax collections when times are bad.

Not only is good management reflected in an orderly state of current finances but there is also a history of performance that testifies to the community's ability to manage its affairs. While it is unreasonable to insist on so-called unblemished debt records running back from 50 to 100 years, it seems to me that evidences of good management should have accumulated over a period of at least 10 years before there is any assurance that the operating conditions rest on a sound basis.

The burden of debt is an important measure of credit worthiness and it is relatively light in a community whose credit is deemed to be high quality. As a matter of fact, there is no simple test of debt burden. The historical one, namely, the ratio of debt to assessed value is still widely accepted because most communities continue to rely heavily on the general property tax as a source of income. When the debt amounts to only 2 percent or 3 percent of the assessed value, it certainly rests lightly on a community. However, in many States the general property tax is declining in importance as a source of revenue and municipalities are placing an increasing amount of reliance on sales taxes, fees, licenses, and charges for specific services to support their activities. Moreover, Federal and State allocations of funds are a very substantial part of the total income available to finance the activities of many municipalities. Thus, municipalities are not obliged to rely solely upon the general property tax to service the burden of debt. When the general property tax was virtually the only source of income for debt service the analyst was justified in placing great reliance on the ratio of debt to assessed value. Now, however, this measure is much less useful. In any case, it must be interpreted in terms of the total revenue picture of the community under consideration.

To facilitate the interpretation of the ratio of debt to assessed value sometimes it is desirable also to determine the per capita debt. This ratio has the advantage of ruling out of consideration the varying dependence of communities upon the general property tax and the vagueness of assessment practices. However, it also can be misleading. For example, a wealthy agricultural community that is thinly populated may very well have a high per capita debt. Such a measure of debt burden would not be as helpful as a computation of the amount of debt per acre of land.

The diversity of practices with respect to the assessment of property is one of the serious weaknesses in any ratio that endeavors to relate the obligations of a municipality to the assessment rolls. From time to time there have been efforts to estimate the so-called "true" values of property from assessments in a municipality. As a practical matter it seems to me such efforts are quite unlikely to be successful merely because it is so difficult to arrive at any defensible measure of true or fair market values.

The credits that fail by a wide margin to measure up to high qualitative standards can easily be identified by the examiner as bad investments for banks. The lack of quality is readily apparent to anyone who will look at the data. Accordingly, it is not difficult for the examiner to prepare his comment for the substandard issues. But real trouble is encountered when the examiner is dealing with the borderline quality of credit. In such cases it is difficult to make a convincing argument that the obligation is unsuited for bank investment.

Any municipal portfolio is likely to have a few issues of marginal investment quality. These holdings could result from accident and mistake or because of differences in credit judgments. However, if the amount is small it need not be of much concern to the examiner. Occasionally the examiner will find a bank that shows a disposition to invest a substantial portion of its funds in municipal securities whose quality is marginal in character. In these circumstances it is my suggestion that the examiner strike definitely at the investment policy that is responsible for the trouble. Thus, a pointed comment on page 2 of the examination report would be appropriate. To the extent that it is possible this comment should be supported with a list identifying the marginal quality issues.

Revenue Issues

Municipal obligations depending for credit worthiness upon the revenues of a specific project are not objectionable in a bank portfolio if the bondholder has a good margin of protection. As a matter of fact, these issues are not too hard to analyze. Usually the projects follow straight forward accounting methods and a review of the operating data quickly discloses the margin of protection for debt service. If the margin is adequate, one cannot object to the obligation merely because debt service depends on revenues rather than taxes.

In analyzing the financial operations of business-type enterprises to ascertain the margin of protection for bondholders, the question of depreciation always presents a knotty problem. For purposes of comparison there is much to be said in favor of computing debt service coverage before depreciation charges. These items earmark cash that may be used to augment the property supporting the credit. Nevertheless, it should be noted that cash income after it has been incorporated in the improvement of property will not also be available as a margin of protection for debt service. An operating property may become completely unbalanced if the project follows the practice of financing extensions from depreciation and neglecting to replace wornout equipment.

A rapid amortization schedule is in itself good protection for the bondholder. Likewise, the bondholder is protected when a substantial amount of income is segregated to cover depreciation even though the amortization of debt is moderate. To depreciate property and at the same time amortize debt, generally speaking, is evidence of a strong credit but it is unrealistic to expect such performance from many projects.

Analysis of Hybrid Credits

Recent years have witnessed the rise of a vast number of municipal issues that do not fall into the neat categories of either general obligations or revenue issues. Financial exigencies have forced the invention of many securities that possess some but not all of the characteristics of general obligations and some but not all of the characteristics of securities depending primarily upon business-type activities to support the credit.

It is extremely difficult to analyze the credit quality of hybrid issues by any of the customary patterns of credit analysis. A few suggestions, however, can be made. In the first place, the examiner should satisfy himself that he has in fact a hybrid issue under consideration. Then it is necessary to study all of the facts and circumstances which have a bearing on credit worthiness and to develop the analytical approach, bearing in mind that the crucial question is simply this: Can the community service the debt in accordance with the terms of the bond?

Summary and Conclusion

To sum up, then, the examiner's task has changed materially in recent years as a result of the growth in the size of the municipal portfolios held by the insured commercial banks. The performance of this task calls for a measurement of the actual portfolio of the bank under examination in terms of appropriate standards. However, the development of investment standards is difficult. Generally speaking, to determine the standards for a portfolio best suited to a bank under examination it is necessary to consider liquidity and qualitative requirements.

In analyzing the quality of securities in the municipal portfolio the examiner is confronted with a number of perplexities. It is a fact that only a small portion of all of the outstanding municipal issues have been rated by the recognized investment advisory services. Accordingly, the examiner is obliged to form his own credit judgment as regards the bulk of the issues that come to his attention. This requires a knowledge of appropriate techniques for credit analysis and may impose heavy demands upon the time of the examiner.

The results of the examiner's work on the bank's holdings of municipals are brought to focus in his comments on page 2 of the examination report. This section of the report affords the examiner an opportunity to point out evidences of poor implementation when the basic investment policy is sound and to call attention to serious weaknesses that may exist in the policy itself. It is almost impossible to over emphasize the importance of discerning comments on page 2 of the report because this is the part of the document that lays the groundwork for remedying weak situations.