MARKET DEPRECIATION ON BANK INVESTMENTS: FEDERAL AND MUNICIPAL OBLIGATIONS

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For many years the bank supervisory authorities have been in agreement that bank holdings of investment-grade securities should be valued for examination purposes at the lower of amortized cost or book. This rule supplanted the earlier practice of valuing securities on the basis of market quotations at the time of examination. The present rule has introduced an element of stability in the asset structure of banks that is highly desirable. By ignoring the vagaries of day-to-day market quotations the examiners have freed the banks from pressure stemming from valuation practices to speculate on either a rise or a decline in prices.

As long as the structure of prices for bank investments is reasonably stable, it makes little difference whether bank examiners follow the practice of valuing securities at market prices or on some so-called convention basis such as amortized cost or book, whichever is lower. However, experience has demonstrated that quotations for bank quality investments fluctuate through a wide price range. These fluctuations stem from the mathematical relationship between changes in the basic rates for investment funds and the size of interest coupons and maturity on outstanding issues. Since our concern is only with securities of bank investment grade, the price fluctuations under consideration are not a reflection of either an improvement or deterioration in the investment quality of securities.

Recently money rates have increased sharply in the marketplace. As a consequence, price quotations for outstanding obligations have dropped. Viewed in terms of market quotations, bank examiners now see large

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differences between the value of Federal and municipal portfolios measured in terms of prevailing quotations and the convention values. These sizable amounts of depreciation have raised once again the question: How should market depreciation on the investment portfolio be treated for purposes of bank examination?

Before we answer this question, let us review briefly the basic assumptions that justify the practice of valuing bank investments on a convention rather than a market quotation basis. In the first place, convention values can only be justified when a bank investment portfolio is composed of high quality issues, that is, obligations not subject to deterioration in terms of the ability of the obligor to service the debt. Secondly, this valuation practice assumes that the bank will be able to hold each individual security to the scheduled maturity date. When the facts conform to these assumptions, then it is obvious that day-to-day valuations in market prices will have no effect upon a bank under examination.

The market depreciation problem becomes a manageable one for the bank examiner, in my opinion, if he will test each individual situation in terms of its conformity with the basic assumptions underlying the practice of valuing the investment portfolio on a convention basis. The first step in analyzing the investment portfolio is to form some judgment with respect to its quality. Possibly in times like these more than the customary amount of stress should be placed on the importance of acquiring securities for bank investment purposes that are quite free from questions regarding the ability of the obligor to perform according to the terms of the bond.

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There is a tendency in prosperous times for banks to pick and sort for investments among the issues near the margin of the bank investment grade. By so doing banks hope to augment the rate of return without increasing the risk of loss. However, it is extremely difficult to make nice judgments on investment quality; efforts of this sort are likely to fail. The banks may increase the risk of loss and add nothing to their rate of return over and above the amount that could be realized from top-grade securities.

After the bank examiner has satisfied himself that the items in the investment portfolio are of suitable quality, the next question to be answered is this: Will the bank be able to carry the issues in the portfolio to the scheduled maturity dates? If the answer to this question is yes, then the portfolio may be valued on the basis of amortized cost or market, whichever is lower, irrespective of prevailing quotations. On the other hand, reasonable doubt as to the ability of the bank to retain the portfolio would call into question the wisdom of appraising the investment account on the basis of convention values.

More specifically: Has the bank been successful in anticipating its liquidity requirements? This is the crucial question that the examiner must answer when he finally comes to grips with the market depreciation problem. A bank can insulate itself from market quotations by providing a schedule of maturities in the investment account that will produce an inflow of cash that will be consistent with expected needs. In these circumstances, market quotations can be safely ignored in valuing the portfolio.

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If an examiner finds in his study of a bank's activities that reliance is being placed upon the market for investment securities as a potential source of cash to meet a shrinkage in deposits or funds for reinvestment purposes, then there is no justification for ignoring market quotations in valuing the investment portfolio. When a bank loses deposits it is necessary to convert assets into cash in order to satisfy these claims. Usually the investment portfolio is looked upon as a source of funds to meet deposit shrinkage. Accordingly, the potential loss of deposits is one of the best reasons for ignoring convention values in the appraisal of the investment portfolio.

At this point it should be observed that the Federal Reserve is the agency designed to provide liquidity for the banking system. Thus, we face the question: Can an individual bank lean upon the facilities of the Federal Reserve either directly or through the intermediate efforts of a correspondent bank for funds if the assets causing difficulties are Federal obligations? Early in World War II there were some pronouncements by the Federal Reserve regarding lending to banks at par on Federal obligations. It may be that the Federal Reserve would follow such a policy if an individual bank was unable to meet its liquidity requirements because of the nature of its investments in Federal obligations. Certainly clarification as to the extent that banks could rely upon the Federal Reserve to furnish liquidity when the depreciation in the Federal portfolio was substantial would be helpful at this time.

Losses of deposits may result from deterioration of general economic conditions in the area served by the bank. As deposits flow

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elsewhere, banks will shrink in size. Given such a situation, it is necessary for the examiner to satisfy himself that the schedule of maturities in the investment portfolio may be adjusted to cover this outflow of cash. Sometimes the examiner has reasonable assurance that attrition in the deposit accounts will cease within the near future. Even in these circumstances, however, the examiner will be justified in adhering to convention values in the securities account only if the scheduled flow of cash is sufficient to offset the shrinkage in deposits.

Recently examiners found banks that were facing a potential loss of deposits because they were losing out in a struggle to maintain a competitive position. For example, some banks are now unable to offer a rate of return on time deposits sufficient to attract savings or to prevent funds already on deposit from drifting to competitive institutions offering more favorable terms. In these circumstances, the deposit shrinkage problem stems from the failure to develop adequate earning power on the asset structure rather than a general deterioration of economic conditions in an area. Generally speaking, it is doubtful that an examiner is justified in applying convention values to the securities portfolio when a bank finds itself unable to compete.

Now let us consider some remedies for a bank with poor earning power and a substantial depreciation in its investment portfolio based upon prevailing quotations for securities. Obviously the process of valuing the portfolio accomplishes nothing of a remedial character. What, then, can be done?

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Additional capital, either in the form of retained earnings or new investment by stockholders, while it fattens the capital margin and therefore provides a bookkeeping arrangement for absorbing losses on assets, really does not solve the basic problem of the bank with a market depreciation in its securities account. Admittedly, new capital, if it is retained in the form of cash or near cash items, can improve a liquidity position. As a practical matter, an injection of capital in a weak situation is not likely to improve earning power unless the amounts involved are indeed very great.

At this point it seems to me the bank examining authorities are obliged to recognize that in the easiest case they have a situation that will require drastic educational measures applied to the management. In the truly serious case the inevitable result will be the ultimate liquidation of the bank. It will be necessary for the examiner and those who review his work to decide whether rehabilitation is possible and to encourage the adoption of the program that will accomplish the necessary results. Surely there are banks that can be saved by readjusting asset structures. Such a bank is well advised to take its losses on an investment portfolio and build up the earning power through the acquisition of higher yielding assets. The simple expedient of investing the proceeds from maturing loans and securities on a better yield basis undoubtedly will correct many situations.

In any event, it is necessary for the examiner to pinpoint the banks caught in a dilemma characterized by a loss of deposits because of

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low earnings and an inability to bolster earnings because of deposit attrition. In these cases bold action is necessary to break the link of mutual causation. Delay and inaction are certainly inappropriate methods. No doubt all of you can recall cases in your own districts that follow this general pattern. Detailed consideration of these cases may be helpful at this time.

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