BOND PORTFOLIOS: MUNICIPAL SECURITIES

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Conference of Examiners and Assistant Examiners
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Mr. Hengren:

The objectives for this portion of your program which is devoted to bond portfolios with special reference to municipal securities are, as I see it, threefold. In the first place, there will be a brief discussion of the statistics concerning bank investments in municipals. In this discussion you will be furnished a frame of reference for evaluating the position of your District in the national picture. Also, the District-wide data will be broken down by State so that you will have some landmarks for identifying more particularly the situation in the various areas where you may be working. Secondly, we propose to review and discuss some specific questions concerning bank investment programs and the analysis of securities for the purpose of ascertaining credit quality. By this means we hope to round out some points of view that may be helpful to you in the preparation of comments for Page 2 of the examination report form. It is our feeling that the effectiveness of this part of the examination report form can be definitely increased. Finally, we shall enlist your cooperation in outlining a program that would be useful to you in meeting problems involving the analysis of particular credits in bank portfolios in this area.

PART I

Factual Background of Bank Investments

In this discussion our attention will center entirely on the postwar period. That now covers more than a decade and for all practical purposes the situation in the 1930's and during the war period can only be of academic interest. So far as you are concerned, the recent trends are the important ones. Of these you should be familiar so that you may judge the position of a bank under examination.

Over the period between 1946 and 1956 total assets of the insured commercial banks increased from approximately $151 billion to $204 billion. As regards investments, however, the notable development in the postwar period has been the overall shrinkage in the holdings of United States Government bonds and the rise in the municipal segment of the investment portfolios. To be sure, the magnitudes are of a very different order. The Federal portfolio declined from about $83 billion to $56 billion, whereas the municipal portfolio increased from about $4 billion to $13 billion.

Admittedly the dollar amount of change in municipal holdings is not great as compared with the various components in the asset structure of the banking business. Nevertheless, the rapidity of the increase in bank holdings of these credits has presented Examiners with a variety of problems that are quite perplexing. More banks now hold municipal bonds than ever before and the individual portfolios tend to be larger.

Nationwide Trends in Bank Holdings of Municipals

All insured commercial banks held 6.2 percent of their total assets in the form of municipals in 1956 as compared with 2.6 percent in 1946. In both years, however, municipal holdings of banks in the Fifth District stood at the head of the list. In 1946 these banks had committed 4.7 percent of their total assets to municipals. This compares with 7.5 percent in 1956.

Although the insured commercial banks of the Fifth District have a larger investment in municipals relative to total assets than banks in other Districts, the fact remains that the rate of growth over the postwar decade had been somewhat less. For example, municipal holdings for insured commercial banks in District #1 increased from 1.1 percent of total assets to 6.4 percent, and District #12 holdings increased from 4.0 percent to 6.3 percent. However, the dollar amount involved in the Fifth District portfolios, while substantial, is exceeded by several of the Districts with lower investments relative to total assets.

In these circumstances, it is quite clear that Examiners in the Fifth District will be obliged to pay much attention to the municipal portfolio.

Trends in the Fifth District

When World War II came to a close insured commercial banks in the Fifth District held about $3 billion of United States Government obligations in their portfolios and approximately a quarter of a billion dollars obligations of States and subdivisions. Ten years later the holdings of United States Government obligations had declined almost a half a billion dollars. But the municipal segment of investment portfolios had increased about 2½ times to approximately seven-tenths of a billion dollars.

Notwithstanding the very substantial increase of total assets in the banks of the District from approximately $6 billion to $9 billion, the proportion of the total committed to municipal securities increased even more rapidly. At the beginning of the period 4.7 percent of total assets were comprised by the municipal segment of the investment portfolio, whereas at the end of the period this percentage had increased to 7.5 percent. So there is no question but that we can well afford to devote some time to this phase of bank investment operations.

For the States within the Fifth District during the 1946-1956 period, some interesting developments have occurred with reference to the municipal holdings of the insured commercial banks. Throughout the period the Mississippi banks continued at the head of the list in terms of the relative importance of municipals in the asset structure of the banks. In 1946 these banks invested 11.2 percent of their assets in municipals as compared with 13.9 percent at the close of the decade. The other States in the District, however, experienced a much more rapid change in the relative importance of municipal holdings. For example, in Georgia 2.2 percent of total assets were committed to municipals in 1946 as compared with 5.2 percent in 1956. For Florida, the corresponding percentages were 3.6 and 6.5, respectively, and for Alabama 5.7 percent and 9.2 percent.

The insured commercial banks in Florida now are the largest holders of municipals measured in terms of dollars for any State in the Fifth District. These holdings totaled about one-fourth of a billion dollars in 1956. The growth in the dollar amount of the portfolio for the Florida banks was especially marked over the decade. In 1956 Florida municipal holdings had increased to about 3½ times the 1946 total of approximately $70 million.

Thus, within the Fifth District the figures reveal that the importance of municipals in the asset structure of Mississippi banks has increased only moderately with the growth in the size of the entire banking structure. For other States there has been a much more rapid growth both in relative importance and the absolute volume of municipal securities.

Now it is interesting to speculate briefly about this behavior of municipal portfolios within the Fifth District. It is a fact that the Corporation has placed great stress upon our work in the field of Mississippi municipals. Historically, the emphasis that has been placed upon this work stems from the very large part that the municipal portfolio has played in the asset structure of Mississippi banks. It may very well be that much more emphasis should be placed upon your work with the municipal portfolios in the other States of the Fifth District. Surely the absolute and the relative growth in the portfolios suggest that work be done along these lines.

PART II

Key Questions for Portfolio and Securities Analysis

As Bank Examiners, it seems to me that your work with the municipal segment of the investment portfolio can best be brought to sharp focus in the comments on Page 2 of the examination report. Here there is an opportunity to verbalize the results of your review and analysis. Moreover, this is the part of the report that is most likely to be studied carefully by the officers and directors of the bank.

It is a fact that the steps to be taken in analyzing an investment program and judging the credit quality of individual securities are quite complicated. Frequently the analytical process involves some rather detailed computations. Unless the results can be expressed in simple straightforward language, all of your work may come to nought merely because no use is made of the channel for communication, namely, the Page 2 comment.

While I do not pretend to have read a great many examination reports prepared in the Fifth District, some of them have passed through my hands. By and large, I know that Examiners make a genuine effort to use the comments on Page 2 as an effective tool of bank supervision. There are times when the paragraphs devoted to the investment program and municipal securities are exceptionally good. However, it is my hope that some discussion of provocative questions to be covered by these comments will enable you as individual Examiners to improve the quality of your reports.

Investment Policy

Broadly speaking, an Examiner should carry two tests in mind when he is assessing the condition of a bank generally or of any segment of its asset structure. In the first place, he should question the quality of the assets. The only appropriate commitment for the resources of a bank are assets that measure up to high qualitative standards. Such assets provide an element of stability that will enable the bank to avoid losses. Unlike most other types of enterprise, large and unpredictable losses cannot be readily absorbed by the capitalization of banks.

As a second important test of a bank's condition, the Examiner should always be alert to the provisions with respect to liquidity. Even more than in other types of enterprise, a bank's position becomes untenable if it does not have an asset structure which assures the cash flow necessary to conduct a volume of business with a margin adjustable to unpredictable happenings. Now with these tests in mind--quality of assets and liquidity--let us turn more specifically to a consideration of some questions to be asked by the Examiner when he reviews the bank's municipal portfolio. These questions would be equally appropriate if levelled at any other segment of the asset structure.

Section H of the examination report now has a question with respect to the investment policy statement of the bank under examination. When the Examiner finds that a bank does not have a satisfactory policy, it seems to me that the situation would call for a rather detailed comment on Page 2 of the report. In this comment the Examiner could provide some helpful suggestions and give some encouragement for a remedial effort.

The hoped for result of a detailed comment on a bank's investment policy would be to encourage some constructive thinking by the bank's officers and directors. Over the course of successive examinations it may be possible for the Examiner to direct his Page 2 comments at various features of an investment program. This may succeed in stimulating the development of a well-rounded and satisfactory policy.

Mr. Thompson:

The asking of questions concerning a bank's investment policy will stimulate thought along such lines by the banker.

Not all policies which are being followed will be reduced to writing, or entered in the minute books, but there may still be well-defined limits which the bank observes.

In cases where a large volume of critical comments must be written about a bank's bond account, there may either be actually no policy, or there may be a poor one. These are the cases at which considerable effort should be directed in writing comments about investment policy. Of course, only high quality bonds should be considered at all.

Among the matters to be covered by an investment policy are the distribution of the account among U. S. Government issues, agency issues, municipals, and others. This must also take into account the bank's loan demands and practices. Ratings to be purchased might well be covered, as might the geographical area to be considered. Of very great importance is the maturity schedule, and the quantity of short-term governments to be carried to provide immediate liquidity. The maximum concentration to be permitted in individual issues is a matter of importance. If all of these things, and others which may suggest themselves appear to be poorly selected, or not selected at all, the Examiner's comments can go a long way toward stimulating some thought by the bank to straighten out its investment account.

Mr. Hengren asked whether Examiners should start a wholesale program to encourage definite investment policies in banks. Mr. Thompson thought it would be all right in the larger banks but not in the smaller ones. In regard to credit quality, Mr. Thompson brought up the question of whether fourth ratings are better than unrated securities. There are many fourth ratings in Mississippi and a banker might have to go outside the State to obtain higher ratings. He was of the opinion that a banker should be criticized if all of his securities are unrated and fourth ratings.

Mr. Hengren:

Size

When you review a bank's commitment in municipal securities, inevitably the question arises: Is the size of this portfolio appropriate for the bank under examination? This is an especially knotty problem because it is concerned with a determination that cannot be quantified in any entirely satisfactory manner.

From time to time the comments on Page 2 suggest that the bank has committed an unduly large portion of its funds to municipal securities. Some point of reference is needed, and commonly accepted ones are percentages representing the average amount of bank assets committed to this type of credit for all banks in the United States, or some subdivision such as geographical area or type of bank. There is some point to comparisons based upon these percentages because it is important to ascertain departure from normal behavior patterns. In my opinion, it is not sufficient merely to call attention to these departures. Much more detailed analysis is needed to form a judgment as to whether the departure is sound or unsound.

Mr. Thompson:

It is not enough to comment that 10%, or 15%, or 20% of a bank's assets consist of municipals. By itself that means nothing, for instance, if loans are only 10%. The total of the two would then be less than the average bank has in loans. But a heavy investment in municipals must be related to the bank's liquidity, maturity distribution, loan policies, and general degree of financial knowledge.

Mr. Hengren:

Maturity Distribution

Earlier in this discussion you will recall that stress was placed upon the importance of quality and liquidity in the asset structure of a bank. The facilities for converting the municipal segment of a bank's investment portfolio into cash by sale in the market place are poorly developed. Banks should be reminded again and again that as a practical matter the schedule of maturities in the portfolio is the only dependable source of cash inflow. Sound investment practices call for a maturity pattern that is consistent with the anticipated cash requirements.

Up to now no one has suggested a better plan for arranging the maturities of a municipal portfolio than the simple 5-to-7 year rollover program that I am certain is familiar to all of you. The proceeds from each year's maturities can then be reinvested or used for other purposes, depending upon the situation confronting the bank. Not only does this rollover program provide a measure of independence from the market place, but it also enables the bank to achieve a rate of return on its municipal investments that reflects the average yields available in the market over a period of years. This mechanical arrangement prevents banks from embarking on speculations over interest rate trends in the money market.

Mr. Thompson:

Most banks in my part of the country are trying to follow a ten-year rollover program. So many that in fact they find it hard to locate ten-year bonds, and some are going to 12 or 13 years. Maybe this is all right if it is compensated for by buying some 7 and 8 year bonds to offset, and particularly if a substantial volume of short-term governments due within one year are carried. But any substantial lengthening of maturities must be compensated for in this bracket.

I personally don't feel that we have a great deal of room for criticism if 50% of a bank's account is due within 5 years, with a reasonable portion of this due within one year.

Mr. Freeman suggested that a 10-year rollover program would be all right if the bank had a low loan account. Mr. Hengren agreed, and Mr. Thompson said also that if the bank has short-term U. S. Securities it can extend the maturities of State, County, and Municipals. Mr. Freeman commented that the composition of deposits would also be a factor. Longer maturities could be held if substantial time deposits are carried. Mr. Hengren cautioned that maturity of securities should not be considered alone--a look must also be taken at other factors. Mr. Jones cited a problem one bank had. It was a bank with $2.2M total assets, with about $1,000M in time deposits. Interest rate of 3% required $30,000 a year for interest payments alone. This is a temptation to the bank to invest in long-term maturities that carry a higher yield.

<u>Mr. Hengren:</u>

<u>Concentrations</u>

In studying the municipal holdings of a bank the Examiner is always confronted with the question: Do we have here a concentration that amounts to a serious credit exposure? What criteria may be employed in identifying these concentrations? These may exist in terms of individual issuers of securities, geographical areas, and types of obligations. However, concentrations may also exist in other forms.

Mr. Thompson:

What is to be considered a concentration? Are all concentrations bad? Government issues? Agency issues? Municipals?

There must be some discretion in what is scheduled as a concentration. How many other concentrations are there in the bank? If there are none, a moderate-sized one might well be omitted, but if the account consisted of a series about the same size, they might all be scheduled.

What size investment should be considered a concentration? 50%, 40%, 30%, 20% or what?

How about using generally the bank's loan limit, subject to some discretion?

A substandard issue even smaller might be shown. But a well-rated State obligation of the same or larger size might be deserving of no comment.

Where possible, comments should also be directed at more than mere size. They should reflect low quality, and long maturities, as well as any other unfavorable aspects. Refrain from grouping issues which are only superficially related.

Mr. Thompson also said that Examiner Wever had made a suggestion of merit in regard to the schedule of concentrations. Mr. Wever suggested that it would be of benefit to have the securities concentrations scheduled near the section of the report pertaining to securities instead of including them with other concentrations that are presently located in the loans section. Mr. Hengren was heartily in favor of the proposal because he had been having trouble locating the schedule in Reports of Examination.

Mr. Hengren:

Valuation Reserves

Owing to tax considerations the valuation reserves to protect the securities account have grown very substantially in recent years. As a matter of fact, there is some question as to the wisdom of earmarking these reserve accounts. In other words, a reserve, irrespective of the reason for which it was originally established can be used to absorb a loss whether it occurs in the investment portfolio or among the loans and discounts. There are a number of questions that we might consider as regards the size of valuation reserves and the steps that the Examiner might take to encourage their accumulation.

Mr. Thompson:

Existing market depreciation may be used as a strong selling point for the establishment of valuation reserves on securities.

Banks are now buying bonds carrying pretty good yields. It might be a good time to bring home the idea that if in the future these same bonds are sold at a profit, such profits should be put in reserve to take care of future declines in bond prices.

Mr. Hengren:

Repurchase Agreements

From time to time you will encounter repurchase agreements in the banks under examination. Let us talk a few minutes about the nature of these agreements. Possibly we can make some use of Page 2 comments in connection with these arrangements.

Mr. Thompson:

Repurchase agreements in connection with securities sold are nothing but a form of borrowing. They are to be reported as such in Reports of Condition, and Interest Paid on Borrowings is also to reflect such interest as is involved, on the Earnings and Dividend Reports.

The difficulty is in discovering the existence of such agreements. Often correspondent banks fail to answer questions concerning them properly on tracers sent them. (Mr. Jones pointed out that incorrect answers on the officer's questionnaire also might prevent discovery.)

Securities so sold should be included in the bond account, with the offset in Borrowings.

Bank should have a copy of such agreements in its file, and it should carry the bonds and show borrowings on its statement. None that I am familiar with do so, however.

Mr. Thompson said that securities sold with only an option to repurchase did not represent borrowings.

Mr. Hengren:

Turning now from our consideration of bank investment policies generally, let us review briefly a few of the central questions that the Examiner can use effectively in determining the quality of specific credits. In the event that an issue is deemed to be unsuited for bank investment, the answer to the crucial question in this determination will serve as a basis for the Examiner's specific comment supporting the classification in the examination report. There may be times, however, when a defect in a security or a group of securities subject to classification may become so general throughout the portfolio that it would justify some comment on Page 2 of the examination report itself. Possibly it would be helpful to consider a few illustrations.

Adequate Credit Files

Credit files with sufficient information to disclose the quality of securities in a bank's investment portfolio are always recognized as essential. Notwithstanding this fact, occasionally an examiner will encounter a situation where the obligations of comparatively unknown issuers have been acquired for investment purposes. The bank will not have pertinent credit information nor will it be able to point to the existence of such data in satisfactory form elsewhere; for example, in the files of a correspondent bank or, for that matter, even in the hands of security dealers. To be sure, the bank management may entertain some belief that it understands the credits it has assembled in its investment portfolio, but it may not be able to make a very convincing demonstration of this knowledge.

What should the examiner do in these circumstances? Should these issues be classified as unsuited for bank investments?

Mr. Thompson:

Small banks do not have much opportunity to develop good credit files on municipals. However, they can retain circulars received from bond dealers on issues purchased or held. They can from time to time cut out newspaper articles which contain valuable information, and in

Mississippi they can maintain the data sheets sent out by the State Banking Department.

Mr. Hengren:

Mechanical Tests of Credit Quality

In determining the credit quality of the municipal issues, the basic question to be answered can be phrased in very simple terms: Will the issuer be able to service the debt according to its terms and at the same time provide a sufficient margin of protection so that bond holders may consider themselves well protected against the possibility of default either as to principal or interest payments? Practical difficulties arise when the Examiner sets out to answer this question in specific instances.

In order to finish his job in a reasonable length of time the Examiner is disposed to look for some readily applicable mechanical tests to determine the investment quality of issues in the bank portfolio. This opens up the whole question of the appropriateness of financial ratios for judging credit quality.

Every competent student of credit analysis will agree that financial ratios are valuable tools in analytical work. As indicators of sound or unsound conditions they may be helpful in forming a judgment. But it seems rather clear that the heart of the analytical process is the judgment rather than the manipulation of arithmetical computations. One cannot emphasize too strongly that it is a mistake to attempt to classify securities on the basis of a ratio or a set of ratios. There will always be exceptions to any standard that can be applied mechanically.

Nevertheless, these ratios may be of some guidance to the Examiner. How can they facilitate his work?

Mr. Thompson:

There are just too many variables in bond situations to make any hard and fast rules workable. Property assessments vary widely. Income statistics are so different for a number of units that no automatic test can be relied upon. I think that you just have to try to find what element has real significance and base your analysis on it.

Mr. Hengren:

Types of Municipal Issues

What should the Examiner's attitude be with regard to the type of obligation found in the bank's municipal portfolio? Should general obligations which carry the pledge of the full faith and credit of the issuer be given some preferences? Are obligations arising out of business type activities such as sewer and water utility revenue bonds of lower standing than general obligations floated by the same community? How about these hybrid issues which combine some of the characteristics of general obligations as well as revenue issues?

Mr. Thompson:

By no means are all general obligations better than revenue bonds of the same city or unit, or vice versa. Don't be dogmatic on such a matter, or you will frequently be badly wrong.

Mr. Hengren:

To sum up, then, a Page 2 comment would seem to be indicated whenever the Examiner encounters some evidence of general weakness in the bank's overall investment policy, or in the methods followed by a bank in analyzing the quality of the credits that make up the investment portfolio. It may very well be that the educational value of a comment in this part of the report would be greater than repeated notes in the stated reasons for classifying individual issues.

PART III

Updating the Program for Municipal Credit Analysis in the Fifth District

Over the years the Securities Unit in the Washington Office has maintained a fair coverage in analyzing Mississippi municipal credits. Its work in connection with the Florida situation has been much less systematic and as a matter of fact in recent years scarcely updated at all. For the other States in the District little or no work has been done.

At this time it would seem appropriate to review the situation and to obtain your suggestions for redirecting our activities, if that is indicated. Earlier in this discussion you will recall that there was mention of the very rapid growth in municipal portfolios over the past decade, especially in Florida and Georgia. What does this mean in terms of the Examiner's work? Are there troublesome situations that should be covered by credit analysis?