BOND PORTFOLIOS: MUNICIPAL SECURITIES

October 6, 1958

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

BOND PORTFOLIOS: MUNICIPAL SECURITIES

By
Raymond E. Hengren, Assistant Chief
Division of Research and Statistics
Federal Deposit Insurance Corporation

Conference of Examiners and Assistant Examiners
Seventh Federal Deposit Insurance District
Madison, Wisconsin
October 6, 1958

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Bond Portfolio: Municipal Securities

As introduction to the portion of the program devoted to bank investment in municipal securities, it will be helpful for you to consider two features of the background that are of fundamental importance. In the first place, the growth in the municipal segment of bank assets has been quite rapid in recent years both dollarwise and relative to total assets. For all insured commercial banks municipal holdings in the postwar period increased from about $4 billion to $15½ billion and from 2.6 percent to 6.8 percent of total assets. For the banks you examine in the Seventh District, namely, the State banks not members of the Federal Reserve, the same growth trend is evident. Over this period municipal portfolios increased from $66 million or 2.9 percent of total assets to $261 million or 7.3 percent, respectively. Furthermore, there is no abatement in the volume of new municipal flotations and banks continue to acquire amounts ranging from one-fourth to one-third of the new issues.

In the second place, there is substantial evidence that--at least with respect to the smaller State nonmember banks--municipal investments tend to be concentrated in obligations that are unevaluated by the recognized investment advisory services. Moreover, the investments are not supported by good credit files and the banks have only meager knowledge of sound investment policies and practices. To be sure, there are exceptions among the State nonmember banks, but a sampling of the available information in examination reports suggests that in most instances these will be the characteristics of the municipal portfolios that the examiner will encounter in his work.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In view of this background, it is appropriate to inquire about current practices as regards municipals in bank examination work. If the present methods are not entirely satisfactory then what should examiners do with the municipal segment of the bank asset structure? A sample study of examination reports conveys the impression that there is now room for much more effective work in this area.

Why have the municipal holdings been treated so casually by bank investors generally as well as examiners? Probably because there is an axiom now widely accepted that all municipal obligations are good--though some may be considered better than others. This axiom has gained acceptance in the period of some twenty to thirty years that separates us from the time when municipal financing caused an endless amount of trouble. Now forgotten are the many cases of municipal credits well rated by the investment advisory services that went into default. There seems to be a feeling that misfortunes will not occur again in the field of municipal finance--or if troubles do arise they will "go away" before harm results to the bank investment portfolio.

In my opinion, this no longer is a satisfactory approach for the examiner to take when he is reviewing the municipal segment of a bank's asset structure. Ten years ago it may have been true that for the most part the items in the investment account were good. Prosperity during the war years had greatly strengthened the finances of municipalities. Furthermore, the volume of securities outstanding declined because of the fact that new construction of community facilities was for all practical purposes limited by wartime regulations.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

But that picture has changed completely. In the postwar years the total amount of municipal debt outstanding has increased from the order of $16 billion to well over $50 billion. This increase reflects the unprecedented volume of new construction in the field of municipal facilities such as schools, highways, sewer and water plants. Also, new arrangements for financing, many of them novel and untested, have been developed, and many subdivisions of government have been created or altered in important respects. Thus, it becomes increasingly difficult to believe that all of the securities in this flood of municipal obligations are bank investment quality. The sheer volume is bound to include a few potentially troublesome situations.

Henceforth, it seems to me that it will be necessary for you as examiners to scrutinize bank investment programs rather carefully and to devote some attention to the quality of each block of securities. By so doing, it is my hope that you will be able to strengthen your comments on page 2 of the bank examination report form. The studies you make of investment policy and individual credits should lay a foundation for much more constructive and effective work with bankers in the course of the examination process. Now let us focus attention on some of the important details.

Bank Investment Policy

Does the bank have a definite investment policy? That is the central question on page 6 of the examination report form. The work of the examiner will be largely conditioned by the response to this question.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Undoubtedly you are familiar with cases of banks that have formalized a bank investment policy statement and then ignored it in actual practice. These banks are no better off than the ones who manage their securities account in a haphazard fashion. In short, the examiner's task is to identify the presence or absence of policy from the results and not from the files of documentation.

The lack of sound policy in the management of securities or elements of weakness in the investment practices is the signal calling for appropriate comments. By this means the examiner may be able to encourage the bank to remedy defects and to bring about the adoption of sound policy. As an effective tool, it seems to me that the page 2 comment in the examination report could be used much more effectively than it has been heretofore in this area of remedial work by the examiners.

As regards the content of a bank investment policy for the purposes of this discussion, attention will be centered on the following major elements:

(1) Requirements for credit files

(2) The size and composition of the investment portfolio

(3) Qualitative standards

(4) Maturity distribution

Adequate credit information is needed by the manager of a municipal portfolio to determine the quality of each item. Some progress has been made in recent years to establish standards for credit files. State banks that are members of the Federal Reserve and the national banks now are subject to a regulation which furnishes specific guidance on data

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

requirements. Although there are no uniform rules on credit files applicable to all State nonmember banks, it is a fact that examiners for many years have sought to persuade bankers to accumulate credit information testifying to the quality of the bonds.

As a practical matter, however, examiners know that the existing files of information on municipal securities leave much to be desired. This situation calls for a never-ending effort on your part as examiners to persuade bankers to assemble at least a minimum of information covering the quality of the credit at the time it is acquired by the bank. A copy of the circular describing the securities at the time of offering would certainly be the minimum requirement. Thereafter the files should be augmented from time to time with information that demonstrates the continued soundness of the securities, for example, an annual report on the finances of the issuer--preferably one prepared by a certified public accountant.

Precise qualitative standards for testing the size of a bank investment portfolio and its distribution among the various types of bank quality investments, viz., Federal securities, the obligations of States and subdivisions, and all other issues would be very useful as guides for portfolio managers. Nevertheless, good portfolio management is characterized by sound judgment and not slavish adherence to rule books. Generally speaking, wide departures in the shape of any bank portfolio from the pattern followed by similarly situated institutions are a signal for sharp questioning by the examiner. To illustrate, an examiner may find that a bank has a relatively large portfolio of municipal obligations. This

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

standing by itself is no cause for alarm if the management has adequate credit information and investment know-how. But if the management lacked credit files and evidenced no skill in handling securities, then even a small portfolio might be evidence of weakness.

As a general rule, bank investment in marginal quality or even lower grade securities cannot be justified. The liabilities of banks are such that they cannot afford to take any risk of loss stemming from lack of quality in their securities. Furthermore, the supply of investment grade issues is more than sufficient to care for all bank requirements. To be sure, banks sometimes buy marginal grade and sub-investment quality securities. This may occur because of the need to support the finances of municipalities in the area served by the bank. More likely, it is the result of ignorance as regards credit quality or a deliberate effort to increase earnings by sacrificing quality.

Especially in dealing with banks whose managements exhibit a propensity to buy marginal quality issues, a comment on page 2 of the examination report may be helpful. This part of the report gives the examiner an opportunity to point out the dangers inherent in sacrifices of quality in order to augment earnings. Where the difficulty stems from lack of knowledge regarding quality, the comment can be phrased to bring out the need for information and analysis.

The distribution of maturities in the bank's investment portfolio can be so designed as to free the management from any dependence upon the market as a source of cash from the sale of bonds. Evenly spaced maturities over a period of five to seven years will make funds available for

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

reinvestment or to expand other aspects of the banking business. Not only will the funds become available in balanced amounts at regular intervals, but management will be insulated somewhat from fluctuations in money rates. Thus, by dividing the portfolio into five equal parts, one portion of which is scheduled to mature in each of the next five years, and reinvesting annually the maturing portion in the longest maturity, the bank will realize a rate of return that is a five-year moving average of interest rates.

Long-term issues have little place in the municipal portfolio of a bank. When the amount is small relative to the total investment account, the distant maturities furnish no cause for concern. But if the investment in long-dated bonds is more than five or ten percent of the total, then comment on page 2 of the examination report would be appropriate.

Broadly speaking, when the examiner reviews a bank investment program, he is searching for the element of balance that distinguishes a good securities account from a weak one. From time to time, it may be quite constructive for the examiner to point out departures from balance that come to his attention as he studies the various aspects of the bank's investment policy.

Testing the Credit Quality of Municipal Securities

At the outset of any discussion pertaining to the quality of individual issues of municipal bonds in bank portfolios it is well to note that each obligation presents a question as regards its legality. This question can only be answered satisfactorily by experts in the field of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

municipal law. An opinion by a qualified bond attorney pertaining to the legality of each issue should be available when the examiner is reviewing the investment portfolio. Sellers of municipal bonds ordinarily furnish a copy of the legal opinion to the buyer in the regular course of business. Furthermore, the name of the attorney approving the legality of an issue may be found in every well prepared circular offering securities for sale, and municipal bond dealers frequently are helpful in obtaining copies of documents. In any event, the examiner needs assurance that securities are valid obligations.

Qualitative ratings by the investment advisory services, namely, Moody's and Standard & Poor's, are useful guides for the examiner in evaluating the municipal portfolio. By definition, it seems clear that the credits in the three highest rating bands deserve to be considered investment grade. To be sure, at times during the acute phases of the Great Depression in the 1930's some credits in these categories were unsatisfactory as bank investments. But those circumstances should be viewed as quite exceptional.

According to the definition, speculative characteristics are recognized as inherent in obligations classified in the fourth rating band by the investment advisory services. Nevertheless, the investment characteristics of these credits are supposed to predominate and as a consequence all of the securities so rated are deemed to be suitable for bank investment purposes. The bank supervisory authorities both State and Federal recognized securities in the four highest rating bands as suitable for bank investment in the so-called 1938 agreement concerning the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

appraisal of bonds for bank examination purposes and the principle was subsequently restated in 1949. In view of these speculative aspects, however, a substantial commitment in the fourth or marginal grade is deserving of special attention and comment.

During prosperous times the yield differentials between securities in the third and the fourth rating bands tend to shrink, probably because investors overlook shortcomings qualitywise in obligations. So, when a bank is under pressure to obtain tax exempt income and the manager of the investment portfolio is very profit-minded a concentration of high yielding securities at the margin of acceptability may develop. As a practical matter, the examiner cannot classify any individual issue rated in the fourth grade as unsuited for investment purposes for that reason alone, but he can recognize the weakness in the basic investment policy and endeavor to persuade the management to follow more orthodox policy by investing funds in the best grade of issues.

The qualitative ratings by investment advisory services cover general market bonds that are traded more or less actively on a nationwide basis. Unfortunately, there is a very substantial amount of municipal debt floated by literally thousands of governmental subdivisions that falls outside of the rating system. Furthermore, it is a fact that the investment advisory services in recent years have been a bit tardy in rating certain large issues--e.g. some of the toll roads as well as other business-type enterprises--where operating records are lacking or there is some element of novelty in the situation. Sub-investment quality ratings would be helpful if there are real doubts as to the quality of the credit.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Thus, examiners are severely handicapped by the lack of guidance from the investment advisory services in evaluating credits in a large area of the municipal field.

A preliminary analysis of data obtained from examination reports covering a substantial number of State nonmember banks suggests a sizable concentration in municipal securities deemed to be bank quality that are unrated by the recognized investment advisory services. This is especially noticeable in the portfolios of the smaller banks. But the task that confronts the examiner when he seeks to appraise the quality of the items in these portfolios becomes especially difficult. In certain areas he can obtain some help in evaluating credits from local agencies. Such agencies now exist, for example, in the Carolinas and Oklahoma. However, in most instances the examiner is likely to find himself faced with the necessity of forming a judgment as regards the credit quality for a substantial number of issues--and the credit information is likely to be inadequate or nonexistent.

From time to time people have searched for shortcut tests to ascertain the credit quality of a municipal obligation. As a matter of fact, there are undoubtedly situations for which very simple tests are entirely adequate to appraise quality. Sometimes by computing one or two straightforward ratios it is possible to demonstrate that a debt is quite small and well within the ability of the obligor to pay. Nevertheless, these tests are likely to have very limited applicability.

In appraising a municipal credit, first it is necessary to determine precisely the nature of the security under consideration. Is it

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

a general obligation supported by a pledge of the full faith and credit of the issuer or is it the obligation of a business-type of activity whose revenues are derived from the performance of specific services? In addition, there are flotations that have some of the characteristics of both of the preceding securities, namely, a general pledge of credit together with specific support from revenues such as the income of a municipal electric or water service or support from the yield of a specified tax. In detail, the pattern of analysis depends upon the precise nature of the obligation.

In the evaluation of a municipal credit the starting point should always be the study of the economic background of the obligor with special reference to questions such as the following:

1. Where is the obligor situated?

2. What are the characteristics of population trend?

3. Is there significant evidence of economic strength or weakness? The latter query includes consideration of estimated per capita income, the nature of industry structure in the area, and the basic facts with respect to transportation and trade.

By and large, the obligation of a governmental unit situated in an area that lacks a substantial economic base will be weak irrespective of all efforts to buttress the credit by legal means or otherwise. On the other hand, many situations that are thin at the outset can be relied upon to overcome these disadvantages if the growth factor is powerful enough.

The debt record, that is, the history of performance on securities that have been floated previously by the obligor is always a

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

pertinent element in the appraisal of a municipal credit. A record of default is bad. Nevertheless, old defaults do not necessarily testify to the inability or unwillingness to pay today. More significant, however, are recent defaults, that is, any failure to meet the obligation according to the terms of the bond within the past decade or two.

Even in prosperous times, defaults of a technical nature occur. While undue importance should not be given to these happenings, they are indicative of unsatisfactory financial management. Technical defaults in good times may be the forerunner of serious troubles when business is poor.

The debt statement of the obligor is probably the most important single compilation of data for evaluating a municipal security. This statement lists all of the obligations now outstanding. In addition to direct debt, the statement also should include all underlying debt, designated as such. The latter includes the debt of smaller geographical areas that are completely encompassed by the one under consideration. Also, the debt statement will indicate the amount of overlapping debt, namely, the debt of larger geographical areas that comprise the one under consideration, altogether or in part. The direct debt, the overlapping debt, and the underlying debt make up the total debt resting on the community. Though the direct debt is the sole burden of the obligor whose credit is being analyzed, the economic resources of the area must furnish the means for supporting the entire debt, irrespective of the obligor.

The crucial element in credit analysis is the determination of the margin of protection for the holder of the security under study. The margin of protection concept represents the aggregation of evidence

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

testifying to the ability of the debtor to meet his obligations. There are many bits of evidence relevant to the margin of protection. For example, such measures include the amount of direct debt expressed as a percentage of assessed value or in dollars per capita. Unfortunately, there are no satisfactory standards for appraising these measures. Viewed in terms of five or ten year trends, however, they become progressively more significant. Thus, it is important to note that an appraisal of the margin of protection for debt service is essentially subjective in character.

For the vast majority of the small governmental subdivisions the general property tax is relied upon as the chief source of revenue. The yield from this tax which is levied at a stated rate in dollars per thousand of assessed value is dependent upon the millage and the assessment base. However, assessment practices vary greatly among governmental subdivisions. Sometimes property is valued for tax purposes on terms that approximate a fair market price while in other instances the valuation for tax purposes may be only a fraction thereof. As a result, ratios of debt to assessed value tend to lose significance in comparisons of one community with another. For still another reason the ratio of debt to assessed value is now losing significance. The general property tax appears to be declining in importance as municipalities turn to other sources of revenue such as income and sales taxes.

With respect to general obligations, the facts regarding the tax levies in terms of millage as compared with taxation practices elsewhere are indicative of the margin of protection for debt service. If some communities typically assess property at modest figures and levy low taxes,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

there is clearly a margin of protection that could be tapped by increasing assessments or tax rates.

The summary of current financial operations showing the source of revenues and the nature of disbursements is indicative of the financial strength of the municipality. But the interpretation and analysis of financial reports requires a knowledge of municipal accounting practices. Typically the accounts are maintained on a cash and fund basis. To indicate some of the difficulties confronting the analyst, inter-fund transfers may give a picture of financial strength to parts of the debt structure, when in aggregate terms the margin of protection is unsatisfactory.

To the extent that a community covers the cost of operations and thereby avoids the accumulation of a floating debt, the credit is strong. Furthermore, a margin of protection may be found in the financing of long-term capital investments in part from the current income. It is obvious that over a period of years a community should balance its financial operations without incurring deficits. Failure to do so is evidence of weakness.

As compared with obligations supported by an issuer's pledge of full faith and credit, the analysis with respect to investment quality of obligations issued by the business-type of municipal enterprise in some respects is easier and in others more difficult. It is easier because the determination of credit worthiness is not clouded by the appraisal of intangible features that may be important in a general pledge of credit.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

But at the same time, it is more difficult because it depends upon estimates of operating revenues and expenses projected into the future.

Governmental subdivisions engaged in business-type activities, for example, the furnishing of gas, electric, and water utilities, or special facilities such as bridges and highways financed by charges for services, entail evaluation with respect to credit quality as any other public service enterprise. Standard textbooks in the field of investment outline the pattern for this type of analysis. The starting point is always a projection of revenues, operating expenses, and debt service requirements for at least five years. These projections will furnish a basis for estimating the margin of protection for bondholders. To be satisfactory the coverage is expected to range from one and one-half to double the debt service requirements. However, in a very fundamental sense the adequacy of the margin can be evaluated only in terms of performance by similarly situated projects that in the past have been able to manage a debt successfully.

In evaluating the quality of municipal credits, the analyst will encounter many complications in addition to the ones covered by these remarks. There are no easy ways to resolve these difficulties. Experience has demonstrated that a sound judgment as to credit quality can always be reached by carefully analyzing the pertinent facts. Unfortunately, this work is time-consuming.

Summary and Conclusion

To sum up, then, the municipal segment of the assets held by the insured commercial banks has grown both dollarwise and relative to total

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

assets at a substantial rate over the postwar years. Moreover, the volume of new municipal flotations is high and there is no indication of abatement in the future.

The growing importance of municipal holdings suggests that it will be necessary for examiners to devote an increasing amount of attention both to bank investment policy and to the determination of the credit quality of individual securities. Especially will this be true for the State nonmember banks that are examined by the Federal Deposit Insurance Corporation. The bulk of these banks are small and they are not likely to be well equipped to handle investment problems. Municipal obligations in the investment portfolios of these banks typically are floated by small governmental units. Furthermore, the size and the location of these obligors for the most part are such that bank examiners do not have the assistance of the investment advisory services for guidance in ascertaining credit quality.

When actual or potential troubles are detected by the bank examiner, it is incumbent upon him to alert management to the difficulties and encourage remedial efforts. Comments on page 2 of the examination report may be very effective for this purpose. In a very real sense, the examiner is the man best situated to bring about improvement in the municipal portfolio. His oral and written comments may bestir the management of a bank to adopt corrective measures.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis