MUNICIPAL SECURITIES

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From a relatively unimportant position in the asset structure of banks, municipal securities now have emerged as a substantial and rapidly expanding element. Up to the early postwar period it was only in unusual situations and specific geographical areas that bank examiners really needed to pay much attention to municipal portfolios. That time is no more. Municipals require some consideration in almost every case and there are situations wherein this category of the assets may be vitally important in the examiner's overall judgment regarding a bank.

In the course of these remarks it will be my intention first to develop in brief compass some background information with respect to trends in the field of municipal finance. Then attention will be centered on some important characteristics of the municipal securities held by banks which the Federal Deposit Insurance Corporation examines in a few selected States. More specifically, I shall comment about the quality of securities in these banks and raise a few questions for your consideration regarding municipal portfolios in your District. This will be followed by some practical suggestions that may be helpful in working with municipal securities. The liquidity aspects of the investment portfolio, and municipal securities in particular, will be covered in the concluding section of these remarks.

To make the most of our time in this portion of the program I want to encourage you to ask questions as we proceed with the discussion--or at the conclusion of the remarks--whichever seems best for you. All too often good questions are lost if they are not asked as they come to mind. Do not hesitate to interrupt with a query if you so desire.

Background of Bank Investments in Municipals

There is a sharp difference between the pre-war and the postwar picture of State and local debt volume outstanding and the portion of that debt held by banks. For the decade immediately preceding World War II the total amount of debt ranged between $16 billion and $20 billion. This was a period of financial troubles for a great many subdivisions of government, and for that reason alone there was little opportunity for the total debt to grow. Other reasons, of course, largely related to the Great Depression of the early 1930s and its consequences also had a restraining effect on the expansion of this debt.

In the post World War II period the volume of outstanding State and municipal debt has followed a strong upward growth trend. Beginning at approximately the $16 billion level in 1946, this debt has increased sharply to a 1958 total of about $58 billion. The forces that account for this strong and persistent growth continue to be in evidence. Furthermore, it is likely that the volume will continue to increase as time goes on so that the present totals should not be viewed as marking the end of an expansion period.

The reasons for the growth in debt of governmental subdivisions in the postwar period are readily apparent to any observer. In the first place, the expansion of community facilities failed to keep pace even with the modest growth in population during the depressed years of the 1930s. Next the wartime restrictions on man power and materials prevented the proper maintenance of existing public facilities even though population growth was at an accelerating pace. At the end of the war there were

sharp population shifts in the United States both of a regional character and within metropolitan areas. The shape of our cities changed with a resulting expansion in suburban areas. As a consequence of these developments, for example, there was need for expansion in highway construction, sanitary facilities such as sewer and water installations, and schools. The financial manifestation of these physical changes has been the sharp upward trend in municipal debt.

In the years immediately preceding World War II about one-seventh of the municipal debt outstanding found lodgment in the investment portfolios of the commercial banks. Dollarwise this proportion accounted for $2½ billion to $3½ billion of securities. The very great expansion in the dimensions of the banking system as measured by total resources over the war years had the effect of reducing the relative importance of the municipal segment in the asset structure of banks even though the dollar amount increased slightly.

The postwar period has been characterized by a very sharp increase in the dollar amount of municipal securities in the investment portfolios of banks. These holdings have increased from approximately the $4 billion level to almost $17 billion. Moreover, in this period between one-fourth and one-third of the total amount of outstanding municipal debt has gravitated to the investment portfolios of the commercial banks. This stands in sharp contrast with the pre-war figure of about one-seventh.

Just as there is every reason to believe that the volume of municipal debt will continue to grow over the years to come, so it seems reasonable that the commercial banks will increase the dollar amount of

their municipal holdings. At a minimum it seems likely that the proportion of outstanding municipal debt in these accounts will quite likely remain unchanged. Whether banks will acquire a larger proportion of the debt outstanding in the future is debatable. There are, however, some forces at work suggesting that possibility.

Taking still another measure of municipal securities in banks, the portion of total resources committed to the obligations of governmental subdivisions has increased over the postwar period from about 3 percent to the present figure of about 7 percent. This change in percentage reflects the rapid growth in the dollar amount of municipal portfolios over a period when expansion in total resources has been only moderate. Relative to total assets the municipal portfolios now are about two percentage points higher than they were in the late 1930s. Then, of course, both the portfolios and the total resources of the banks stood at much lower levels than they do today.

This brief review of the facts regarding the debts of governmental subdivisions and the municipal portfolios of banks points to certain conclusions of importance to examiners. In the first place, it is evident that municipal portfolios have acquired a new and growing importance in the asset structure of banks. They no longer can be dismissed as items of such minor character that the limited time available to examiners should be devoted to the more important activities of banks. In the second place, there is every reason to believe that the growth trends for the debts of governmental subdivisions will persist for many years and that the municipal portfolios in banks will also expand dollarwise and possibly even relative

to total assets. Finally, the change in the growth trend of municipal debt which reflects a quickening in the life of governmental subdivisions points up the need for a restudy of municipal credit both as regards its quality and its suitability for bank investment. While it may be true that the obligations of governmental subdivisions are as good or better today than they ever were for the investment of bank resources, nevertheless, this view requires more substantial support than a bald assertion.

As regards the bank examiner, questions about the quality and liquidity are among the most important that he can direct at the items in the municipal portfolio. In the discussion to follow, first qualitative aspects of investment portfolios will be considered at some length. Then attention will be shifted to the subject of liquidity and that will also be explored.

Quality of Municipal Credit

Qualitywise, the credits of governmental subdivisions range over a wide spectrum. Altogether there are now more than 102,000 governmental subdivisions with power to create debt and some 30,000 to 40,000 do float securities in amounts large enough to deserve attention by the investing public. Because the number of issuers is so very great it is obvious that credit information about many situations will not be readily available. Viewed merely as a problem in financial reporting, municipal credits are indeed formidable. Moreover, there is a great diversity among these governmental units. They owe their existence to many different statutes, they perform a wide variety of functions, and there is great variation in the skills of financial management from one obligor to another.

A few thousand of the largest municipal credits come within the scope of qualitative ratings by the principal recognized investment advisory services such as Standard & Poor's and Moody's. For very practical reasons these services confine their adjective appraisals of credit quality to the larger issues of securities. Unless a flotation comprises at least $1 million of bonds the credit is not likely to be rated. Sometimes, of course, the services do provide ratings for smaller credits for which financial data are readily available. These, for the most part, are located near the important financial centers.

Undeniably the qualitative ratings of municipal credits by the investment advisory services do reflect the application of certain standards to the available financial data. These services have no monopoly of financial wisdom. As a practical matter, however, their ratings cannot depart too far from a consensus on credit quality among qualified analysts. The published ratings have been unsatisfactory at times in the past--witness the late 1920s and early 1930s--and there is every reason to believe that they may do so again. But the same can be said for any qualitative ratings as guides in examination work.

In some States, notably the Carolinas and in Oklahoma, there have been local efforts to appraise the quality of municipal credits. Mostly these efforts have been made because the major investment advisory services cannot furnish adequate coverage for technical reasons, e.g., lack of interest on a nationwide basis in small issues. These local rating agencies typically reflect the efforts of dealers in securities and to some extent bankers who may be called upon by their correspondents for help with

investment matters. This arrangement is not ideal for insuring objectivity in appraising credits. However, the expressions of judgment on quality are subject to the correctives inherent in public criticism by informed members of the investment community. As a matter of fact, sometimes the ratings of local agencies are the only ones available to an examiner. Accordingly, he should recognize that they are better than nothing. How much better depends on each individual case.

In bank examination work with municipal securities principal reliance of necessity will always be placed upon the qualitative ratings of the leading investment advisory services. As a first step in analyzing a municipal portfolio it is always revealing to divide the issues into two groups, namely, the rated and the unrated securities. Further clues as to the quality of the portfolio will be revealed by arranging the rated issues into three categories, namely, the securities in the three highest rating bands, the fourth or marginal grade issues, and a final group consisting of all lower ratings. Sometimes examiners have included in their reports tabulations of data on credit quality arranged in this form. Such a tabulation brings out very clearly the qualitative characteristics of the portfolio and directs attention to the marginal and unrated issues.

Following this pattern of analysis with regard to ratings and credit quality, in recent months we have compiled information about the municipal portfolios of banks examined by the Federal Deposit Insurance Corporation in almost one-third of all of the States. Admittedly, there are some statistical shortcomings in these tabulations. Strictly speaking, the data are non-additive because they do not pertain to the same day.

Nevertheless, experience has shown that portfolio changes occur rather slowly and as a consequence the precise report date is not too important. Furthermore, the tabulations consolidate data for all banks in the State and give no clues as to the portfolio of any individual bank.

You may be interested in the following summary table which includes the States in your District along with several others on the high and low side of the scale presented as points of reference:

Percentages of the Dollar Amount of Municipal Securities Held
by State Nonmember Banks Arranged to Show
Quality and Rating Status

(Based upon Examination Reports for 1958 and 1959)

	Investment (Group 1)					Sub-investment (Group 2)
	Rated			Unrated	Total	
	Grades		Total			
	1-3	4				
North Carolina	80%	13%	93%	5%	98%	2%
Pennsylvania	75	7	82	16	98	2
Maryland	71	22	93	7	100	-
Ohio	58	8	66	33	99	1
Kansas	34	6	40	58	98	2
Mississippi	34	31	65	30	95	5
Iowa	33	4	37	63	100	-
Minnesota	30	15	45	54	99	1

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Study of the information in the table highlights some interesting differences that probably should claim the attention of bank examiners. In some States--including Pennsylvania--there is a very high percentage of rated issues. Furthermore, among the rated issues the percentage of the total portfolio consisting of securities in the three highest grades tends to be very high in some States whereas in others there is a substantial segment in the fourth or marginal rating band.

Offhand, one would expect a much higher degree of similarity in the data for Pennsylvania and Ohio than is revealed by this table. Why, for example, is the proportion of issues in the unrated category so much higher in Ohio? Likewise, there is the question: Why are the municipal portfolios of Pennsylvania banks dominated by securities in the three highest grades whereas that is not true to the same extent for the Ohio banks?

A few words of caution about these tabulations would be appropriate before asking for some help in interpreting the data. Up to now our work with the portfolios is concerned only with data in gross form. We have not been able to devote the resources needed to break down the figures into further meaningful categories such as local versus out-of-State issues. In other words, we do not know the extent to which Pennsylvania banks confine their investment to Pennsylvania issues or the extent to which they rely on out-of-State high quality securities. Nor do we have any information on other characteristics of items in the portfolio, such as the amount of general obligations as compared with the revenue type of issue or those which are hybrid in character. Also, it would be helpful to know something about the purpose of these issues, for example, to what extent do they

reflect school financing, highway facilities, or debt created for the general purposes of government? Any comments you would care to make on the figures would be helpful now and could set the stage for our further discussions this morning.

Generally speaking, one would expect banks to concentrate their municipal commitments in securities that come within the scope of the three highest ratings of the investment advisory services. Now it is true that the Federal bank examining agencies and the Executive Committee of the National Association of Supervisors of State Banks have voiced agreement on a uniform bank examination procedure which, among other things, recognized securities in the four highest grades qualitywise and equivalent unrated securities as investment grade. This uniform procedure was first announced in 1938 and it was restated in 1949. Consequently, securities rated in the fourth qualitative band by the advisory services come within the definition of investment quality. Nevertheless, such securities are deserving of special consideration. Careful study of the definition for this category by Moody's will reveal the marginal nature of the credit. The definition is as follows:

> "Bonds which are rated Baa are considered as lower medium grade obligations, i.e., they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well."

Likewise, in the Standard & Poor's definition of securities assigned to the fourth rating band, the marginal characteristics are emphasized by this language:

"This is the lowest group in which investment characteristics predominate. Protection is regarded as adequate, but one or more factors indicate the need for careful attention in periods of economic unsettlement. The market for securities in this group is likely to be quite volatile."

There is no substitute for high credit quality as an essential in a bank's municipal portfolio. Fourth or marginal grade credits are an element of weakness rather than strength, and if such credits account for a substantial proportion of the total amount of investment securities, that fact is deserving of mention in the examination report. For the most part, purchases of marginal grade issues are justified in terms of price and yield considerations. However, it is doubtful that the somewhat more favorable yields on the marginal segment of investment grade issues can be expected to compensate for the risks of losses.

Because the coverage of the ratings published by the two principal investment advisory services does not coincide when the examiner endeavors to use these credit indicators as guides, at times difficult problems arise. Agreement among the two agencies on the quality of a credit will not be a source of trouble unless the examiner has reason to believe the rating is not supported by the facts. This is likely to be a very unusual case. But difficulties arise when, for example, one service rates the security in the fourth and the other one in the fifth grade. Conservatism in examination practice would suggest the use of the lowest published rating as a guide unless it can be demonstrated from the facts that the credit is better grade. The use of a rating published by only one service as a guide to credit quality is obviously not satisfactory. Occasionally, however, the examiner has no alternative but to follow this guide. More difficult is the

case of a credit rated by one service and at the same time listed by the other agency with a note suggesting the lack of adequate data for rating purposes. If the amount of securities in question accounts for a substantial portion of the portfolio, such a case would warrant insistence by the examiner to produce a credit file in support of an investment grade rating.

Unrated Issues

From the studies of data in examination reports pertaining to the municipal portfolios of State nonmember banks two facts regarding issues not covered by the investment advisory services intrude quite conspicuously. In the first place, there is a great variation from State to State in the proportion of the municipal portfolio comprising unrated issues. Even though the studies completed to date cover only a small part of all nonmember bank portfolios, the data by State range from almost token amounts to more than three-fourths of the total. Secondly, the data suggest that virtually all unrated issues are deemed to be investment grade credits.

During the war and in the immediate postwar years there probably was good reason for considering all unrated securities as bank quality unless there was clearcut evidence of financial difficulty--possibly facts indicating actual default. Let me stress again that the dollar amount of municipals in banks then was relatively small and the examiner could probably devote his time more effectively to other segments of the asset structure in the course of his work. Today times are different. Certainly in many portfolios the unrated segment cannot be dismissed as a minor element in the bank's asset structure and the examiner needs positive

evidence to support a classification of an unrated issue as a security of bank investment grade.

Unrated municipal securities can be expected to range in quality from one end of the scale to the other. Assuming for the moment that the quality pattern among rated and unrated issues is substantially the same, then one would expect some portion--perhaps almost as much as 5 percent--in the category of subinvestment quality investments. This is approximately the proportion of all municipal ratings in categories below the four highest qualitative bands. However, this assumption of relatively high quality for unrated securities in the aggregate would seem to be entirely too optimistic. To be sure, some issues may represent relatively small debts floated by communities whose finances have sufficient strength to provide a wide margin of protection for debt service. But these instances are likely to be exceptional.

More often than not the unrated issues fall within a marginal area characterized by limited or virtually nonexistent credit data, an uncertain record of performance, and obvious doubts as to the long-run prospect. For this reason it would seem desirable to combine these securities with the fourth or marginal grade issues rated by the regular investment advisory services. This has the advantage of placing some emphasis on the elements of uncertainty as regards credit quality. The only justifiable exception would be the case of the credit that is covered by adequate data in the credit files. In such instances, the credit would be reported with the appropriate note in higher grade issues.

As a practical matter, what can be done by the examiner in appraising the credit quality of unrated issues? No good purpose is served by ignoring the fact that the credit files for the most part are nonexistent. Nor is it helpful to pretend that examiners have a time schedule which enables them to study the individual items in bank portfolios and in each case to arrive at a defensible judgment respecting quality. Work schedules budget only a limited amount of time for the municipal portfolio.

In examining a bank with a volume of unrated municipal securities large enough in size and in relation to total assets to call for attention, the appropriate first step is in the direction of assembling adequate files of credit information. To be sure, there is nothing very novel about an educational effort designed to encourage the accumulation of credit data, but it is important, nevertheless. Municipal credit files will develop when bankers and examiners join forces to establish them.

At present, it is doubtful that more than a handful of banks have even the beginnings of satisfactory municipal files. The trends in this area of bank investment, however, are such that the problem of credit information can no longer be ignored. Over the past 40 years there has been great progress in the development of credit files on commercial loans. There is no reason why a similar development cannot be brought about to cover the municipal segment of bank investments.

Rather than to launch a comprehensive program for building up information on all municipal securities, at the outset it would seem best to concentrate on the unrated securities in the portfolio. A minimum for the file on these issues would consist of the offering circular which presents

sketchy information about the security. From time to time thereafter, the bank should be encouraged to obtain data of the sort found in an audit report. Parenthetically, you will be interested in learning that virtually all of the services--Dun & Bradstreet, Standard & Poor's, as well as Moody's--are giving consideration to plans for publishing a limited amount of credit data on a very large number of governmental subdivisions not at present covered by Moody's Manual on Government Securities or the individual credit memoranda prepared by Dun & Bradstreet. Within the next five or ten years there is every reason to believe that the services will find a way to assemble and publish such information at a reasonable cost.

Credit information on securities in a municipal portfolio serves no good purpose unless it is used as a guide for selecting good and eliminating poor quality issues. Such use requires the application of analytical techniques. This analysis may be very simple, for example, the computation and appraisal of the debt-assessed value ratio on a general obligation bond; or it may become quite involved in a mass of computations. But there are very serious pitfalls in efforts to appraise credits on a mechanical basis by the use of mathematical ratios. Such tests have determinative value only when they are supported by sound analytical judgment.

As a practical matter, neither bank examiners nor bankers can afford to devote a great amount of time to refinements in securities analysis. If the demonstration of quality suitable for bank investment is not readily apparent, the credit would seem to be unsuited for a bank portfolio.

The desirability for simplification in assembling a portfolio of municipal securities will, in my opinion, be one of the important by-products of examiners' efforts to secure adequate credit files. By centering attention on the data requirements for ascertaining credit quality, it will become quite clear that a long list of bonds floated by a great variety of issuers presents serious difficulties in management. Frequently the complex portfolios consisting of relatively small commitments in individual credits are rationalized in terms of diversification. However, if credit data were available for such portfolios, careful study would indicate little or no reduction in risk exposure. On the contrary, all of the issues may be subject to substantially the same hazards.

Individual credits in municipal portfolios, especially unrated issues, are often difficult to identify precisely. The number of unrated issues is large and frequently it is not easy to distinguish between securities of various obligors situated in the same area. But the examiner's first step in appraising the quality of such an issue is to make certain that he has it identified precisely.

The need for care on the part of examiners in identifying securities for examination report purposes has been demonstrated more than once by our efforts to compare portfolios from bank to bank. There have been times when the same credit has been identified under more than one title. Difficulties in the identification of issues may bring on all sorts of troubles both for examiners and others working with schedules of securities. Accordingly, it is my hope that examiners will give more time to the listing of individual issues under correct titles. Documents such

as prospectuses, purchase and sales vouchers, and copies of legal opinions in the credit files of the banks under examination are always helpful in identification.

Information with respect to interest and principal payments found in the accounting records of a bank may be helpful as a guide to classifying unrated credits. Irrespective of what else may be said about a security, if interest is not paid on the due day or if the bond itself is past due, then the credit is definitely unsuited for bank investment purposes. Better evidence of poor financial management than failure to meet interest and principal payments on schedule would be hard to find. As a consequence it is unrealistic to classify any part of a municipal credit as investment grade if there is evidence of default on outstanding securities.

Liquidity

There is a tendency to look upon the municipal portfolio as a part of a bank's secondary reserve. That, in my opinion, is an ill-founded notion. As a matter of fact, only a portion of the municipals in bank portfolios can be expected to meet a rigorous liquidity test. Excluded from consideration by such a test would be issues that are too small in size or for other reasons fail to command attention in a national market. Only a rather small part of the outstanding municipal debt is traded actively on a day-to-day basis.

The investment bank machinery in the field of municipal securities is designed primarily to float new issues. More than a thousand dealers and representatives of banks with active municipal departments maintain contacts with governmental subdivisions and potential buyers of these tax-exempt

securities. These arrangements appear to be quite satisfactory for selling new issues but the arrangements for redistributing securities among investors after the initial offering to the public are almost archaic. The over-the-counter market provides the only machinery for effecting transactions and each sale involves direct negotiating. There is no satisfactory machinery for reporting price and volume information such as characterizes the organized securities exchanges. To be sure, "The Blue List" furnishes the advertizing medium which gives some indication of interest in securities being offered for sale. The publication, however, provides only a starting point for negotiations.

In view of these limitations with respect to marketability the municipal segment of a bank's investment portfolio is likely to make only a limited contribution to liquidity requirements. To be sure, securities of good quality maturing within a very short term--up to a year--may prove dependable as a secondary reserve. Certainly, if such maturities are the obligation of large, well known credits trading actively in the over-the-counter market, they may be converted to cash with a minimum of trouble. But the sale of long-dated issues, especially if the obligors are small and unknown, presents great uncertainties as to price.

Except for the portion of the municipal portfolio consisting of near-term high grade issues, municipal securities are for all practical purposes term loans. Accordingly, in appraising the balance in the asset structure of the bank it is appropriate to consider the municipal portfolio as part of the bank's long-term extensions of credit. It would seem appropriate to limit such credit extensions to a period of five to seven

years for the maximum term with the average considerably short of the most distant maturity.

Two major advantages result from limiting the maturity schedule of the municipal portfolio to a maximum of five to seven years. In the first place, this sets the stage for periodic testing of credit quality in the one unequivocal fashion--by providing a demonstration of the ability to repay. Regardless of statistical tests, an investment is certainly bank quality if the obligor pays interest coupons promptly and the principal when it falls due. Unfortunately, this is an after-the-fact test.

The second advantage of a five to seven-year limit on maturities in the municipal schedule stems from the fact that such a portfolio can serve as a basis for obtaining an average rate of return if the bonds composing it are scheduled to mature in more or less equal annual amounts. Thus, periodic reinvesting in the most remote maturity permits the holder to average the rate of return prevailing in the market. A portfolio so designed furnishes some element of liquidity as well as insulation against the violent fluctuations of money rates encountered at times in the financial markets.

Not only is it important for the examiner to formulate some very definite views in his own mind as regards the municipal portfolio of the bank under examination, but in addition it is necessary to bring these views to the attention of management. Good comments on page 2 of the examination report provide an effective means for accomplishing this result. It is my opinion that examiners should take the long view in organizing their page 2 comments on the investment program of a bank. By this, I mean that it is

well to cover various aspects of the situation in the course of successive reports. If, for example, it appears that the bank has no comprehensive policy that would furnish a good starting point for a page 2 comment, examiners preparing the reports to follow then would have some basis for encouraging and guiding the management in the development of a program. It is not necessary to cover every shortcoming in the municipal portfolio at one time, but it is important to cover at least one facet of the subject in an effective manner. The way of the world is such that there will always be another examination and some work should be left for that time.

Summary

To sum up this discussion before we turn to questions that may bring out points in this field of interest to you, it is a fact that the municipal segment of bank assets has grown very substantially over the past decade. Furthermore, it promises to continue to increase in dollar amount and even relative to total assets. These securities have certain characteristics which make them especially difficult for the examiners. As regards investment quality, the examiner may obtain some guidance from the investment advisory services. Unfortunately, the coverage of these services is limited to the larger and better known municipal credits. The bulk of the securities found in the small, State-chartered, nonmember banks do not come within the scope of rating systems, nor is the credit quality readily determinable from published information.

Only a limited amount of time can be devoted to the municipal portfolio in the course of a bank examination and the files of essential

information regarding these credits will generally be inadequate. Accordingly, considerations of expediency will largely shape the examiner's work on this segment of bank assets. In the long-run, efforts devoted to the encouragement of satisfactory credit files and the adoption of sound investment policies are most likely to be productive of good results.