

Final

ADDRESS OF MR. HARRY L. SEVERSON, FEDERAL DEPOSIT INSURANCE CORPORATION
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"OPENING SPERCH ON MUNICIPAL SECURITIES"

It is a pleasure to have this opportunity to discuss with you the general problems of bank investments in securities with special reference to municipals. You will kindly note that I use the word "discuss", for we mean exactly that. Both Mr. Wayne and myself are acutely conscious of the fact that local conditions vary widely, and that it is impossible to make generalizations which have anything like universal application. We have planned, therefore, a program which we hope will bring out the more important problems of this area. We have purposely made our prepared speeches short, so that there will be time to discuss the problems of your district.

Although there is an enormous volume of literature on taxation and Government finance, very little has been written on the specific subject of municipal obligations as investments. Mr. Wayne and myself are in the midst of working through a vast amount of material out of which we hope to develop some principles by which the bank supervisory authorities can judge more intelligently the credit quality of the large volume of municipal obligations held by banks. Our conclusions are tentative. Whenever I get time, I re-write one of the chapters in the memorandum, and I have lost track of the number of times Mr. Wayne has revised the Uniform Credit File.

I am glad that our Corporation has decided to use the material before it has been completed, since this will enable us to have the benefit of your experience and incorporate your suggestions in the final revision.

It seems wise at the outset to discuss the general outline of the program for the three half days assigned to the topic of municipal securities. In this opening talk I shall confine myself to a discussion of a few of the general aspects of the problem of bank investment, and at the end will make some suggestions for further study. Mr. Wayne will later lead a discussion on the memorandum and Dr. Bird's article, "Recent Trends in Tax Delinquencies". Tomorrow the discussion will be continued when Mr. Wayne will explain the development of the Uniform Credit File and his experience with its use in South Carolina. You will note that Mr. Wayne is not recommending the use of anything which he has not tried, and I know of a number of schedules which he has tried and is not recommending. This part of the program will be concluded Friday morning with a discussion of specific cases.

The first problem which comes to mind in connection with the classification of securities in bank examinations is what do we mean by a Group 1 classification, or, perhaps the question can best be stated otherwise: What does a Group 1 classification not imply? A Group 1 security is a security which can be expected to ride through a considerable amount of trouble, such as a serious

depression, without default. The financial position and income of the issuer are such that it should be able to meet interest and principal requirements according to the terms of the contract in spite of depression or other financial difficulties. Group 2 securities, on the other hand, are ones which are either in immediate danger of default, or do not have an adequate margin of protection against possible future difficulties. The lack of good faith on the part of an issuer casts a shadow which makes a Group 2 classification necessary. Group 1 securities are not necessarily riskless, but they do have a margin of protection ample to carry them through all but the most serious financial storms. We do not necessarily expect that Group 2 securities will default, but we are not convinced that they have an adequate margin of protection.

We should make it clear to everyone that a Group 1 classification is definitely not a recommendation for purchase. There is nothing quite so fallacious or dangerous as the argument sometimes made by those with bonds to sell, that Bond X is a safe investment and a good buy because bank examiners put it in Group 1. I have never heard anyone in the bank supervisory agencies even intimate that all bonds classified in Group 1 were safe investments, and I am sure we all know of bonds now being classified as Group 1 which we personally would not think of purchasing.

A given bond may not be in danger of default, and quite properly classified as Group 1, yet may be unsuited for inclusion

in the portfolio of a particular bank. A decision upon the wisdom of any bank purchasing a security can be made only in the light of an analysis of the security in question and the condition of the bank. In analyzing the securities account one should never lose sight of the condition of the bank as a whole. It must be made clear to all that the bank supervisory authorities are not giving advice on the purchase of individual securities--although they have marked out certain areas as being too risky for bank investments.

For some time past the topic of investments for banks has been attracting a large amount of popular attention. As would naturally be expected when a subject as technical as this becomes one of current interest, the printed material contains such a mixture of sense and nonsense that great care must be exercised in accepting the so-called principles. In the First New York Bond School, for instance, some excellent suggestions for the analysis of individual securities were given along with advice on "trading up" and "switching".

Our Corporation has taken a definite position against these practices. In our official publications we have stated that we believe banks should purchase sound securities with the expectation of holding them to maturity. The most important consideration in determining the suitability of a security for bank investment is quality, and we have defined a bond of high quality as one issued by a maker with sound financial resources and sufficient and stable income to meet its obligations according to the terms of the contract.

Much current discussion is predicated upon the assumption that an individual bank can obtain funds in the market when needed. It is possible for a bank to obtain cash by the sale of securities when the markets are not operating under pressure, but in times of market stress, additional funds cannot be obtained in this manner. Any concerted attempt to sell securities in such periods results in disaster for the system as a whole. In times of panic nothing is liquid except insofar as some government agency, such as the Federal Reserve or the Reconstruction Finance Corporation is willing to take it over, and in that sense, anything which these agencies will accept is liquid.

One of the functions of the Federal Deposit Insurance Corporation is to give confidence and stability to the banking system which will in turn add stability to the entire economic order. If we are to perform this important function, we must remain calm when others become hysterical. In panic periods all sorts of rumors circulate, the most dangerous of which are those containing a grain of truth, but you can be reasonably certain that anything done in periods when fear and emotion are high is wrong and under no circumstances should the sale of securities be encouraged.

This is not to deny that a limited number of marketable issues are desirable in a bank portfolio. A policy of holding marketable issues will enable a bank to readjust its position more

easily in ordinary times--that is, when other holders are not attempting to make the same type of shift. We must always remember that a bank can only make satisfactory sales when others in the market are interested in purchasing such bonds. Since bonds of a readily marketable character ordinarily sell on a lower yield basis than non-marketable issues of equal credit standing, a bank should not purchase more marketability than it needs. The amount of such readily shiftable issues a bank needs depends upon the condition of the entire bank, that is, upon such items as the amount of idle cash, character of the loans, and type of deposits. Since you all know more about the analysis of these factors than I do, I shall not discuss them further.

Banks should be encouraged to acquire sound assets--that is, assets on which cash will be received according to the terms of the contract. If banks restrict their holdings to such assets it will not be difficult for the Government agencies charged with the responsibility of maintaining the liquidity of the banking system to bail out the unfortunate ones in time of trouble without loss, or with at least a minimum of loss.

Bonds are not as different from notes as we are sometimes led to believe. A bond, like a note, should be acquired for income. In each case care should be taken to ascertain that the maker is in a position to meet his obligations. There are, however, two important differences between bonds and notes: First, since securities

have longer maturities, it is necessary when analyzing a bond to give more consideration to the long-term prospects of the issuer; secondly, the presence of market quotations which indicate the day to day fluctuations has led to considerable confusion. There are three sets of factors which at times explain changes in the market price of bonds:

- (1) Changes in the estimates of risk of loss of principal and interest;
- (2) Changes in the level of interest rates and the anticipation of further changes;
- (3) Other money market factors such as hysteria, technical position of the market, and in rare instances, manipulation.

In an actual case these factors may work out so that they neutralize each other, or they may become cumulative. A stable price may merely indicate that the factors are neutralizing each other, while a drastic decline in price may or may not indicate that the credit of the company has changed for the worse. A decline in price thus merely indicates the need for a careful study of the credit of the issuer. Little is gained by recognizing market fluctuations which are not due to changes in credit quality in bank examinations. Everything considered, it is highly undesirable for bankers and bank examiners to become market conscious.

We have heard a great deal lately about the necessity of a written investment plan. To some this appears to be an end

in itself. The preparation of a sound investment program is obviously worthwhile, but the writing down of an unsound one only makes somewhat more certain that the management will make the mistakes contemplated in the plan. Some of the written plans which are circulated as models are positively vicious in that they provide, sometimes explicitly, but more often implicitly, for "trading up" and switching". The problem from our point of view then is not to ascertain that the bank has a written plan, but rather to evaluate the soundness of its program, whether written or not.

In view of the fact that we are going to spend three half days discussing evidences of weakness in municipal bonds, it seems wise to preface our remarks with some generalizations about the high quality of municipal bonds as a class. Their record over the past half century has been excellent. Defaults have been relatively few and recoveries in quite a number of instances have been excellent. Everything considered, it is doubtless fortunate that many banks have confined their purchases of bonds, other than U. S. Governments, to municipals because their record as a class is considerably better than the run of corporates acquired by banks.

Furthermore, it should be clearly understood that we have no particular apprehension at the present time about the future of municipals. Municipal debt has remained relatively stable in

the last decade, and it is a pleasure to note that many municipal officials are giving thoughtful consideration to the important problems of finance.

Since the general situation is so good, some questions may be asked as to why we should be giving so much consideration to municipal bonds at this time. In the first place, while municipal defaults have represented a very small percentage of total outstanding municipal debt, in absolute numbers they have been considerable and in individual cases the losses have been substantial; while in certain classes of bonds, such as irrigation, drainage and special assessments, the percentage of defaults has been extremely large. A concentration in a few of these issues might easily result in pay off. Also the municipal governments are being affected by the profound economic changes which are occurring throughout the whole world. Some situations are changing for the better, while the outlook for some cities is definitely less good than it was. In other words, municipal bonds should not under any circumstances be purchased without a credit analysis. When one thinks about the matter, it seems incredible that a banker otherwise regarded as prudent would risk substantial sums by purchasing large blocks of municipal bonds about which he knows nothing except that someone said they were good.

Moreover, the proper time to consider the credit quality of a class of assets is when conditions on the whole are satis-

factory so that adjustments when desirable can be made without upsetting the entire market. Incidentally, an important by-product of our consideration of municipal bonds will doubtless be an improved market for the obligations of some of the less well-known but soundly financed municipalities.

One of the most serious fallacies in regard to municipal obligations is that bigness adds strength. It has been argued that it is safe to purchase the obligations of a large unit on the theory that a vague "someone" will support the market in times of difficulty. This is simply not good credit analysis. Any large bank which purchases sizeable blocks of bonds on this basis is assuming the risk of having to do the supporting. A number of the large cities have large debts, and there is considerable evidence to support the contention that they are declining economically. Even where the metropolitan area as a whole is holding its own, there is often a decline within the city proper. This, combined with the relief problems and the political mismanagement, has resulted in financial weakness.

It is true that the obligations of large units are more marketable ordinarily than those of small units, but we regard safety as more important than marketability. In one respect obligations of large units have an advantage. We would ordinarily expect to find more diversification in the economy of a large unit than of a small one, although even here there are exceptions. Even

though we admit that the financial management of some small towns is terrible and that some of the larger units are extremely well managed, there is considerable reason to believe that the financial condition of the smaller units as a group is sounder than that of the larger units of government. The recent study by the Illinois Tax Commission, for instance, indicates that the financial condition of the great bulk of small units in that state is rather good. The competition for this class of investments is not great. The larger investors regard the cost of investigation as being excessive and ordinarily are not investigated. This makes it possible for bankers, with their special knowledge of local situations, to pick up obligations of well-managed towns or villages on a favorable yield basis. Even here a word of caution is necessary. The general rule against concentrations should not be relaxed. We all realize the dangers of concentrations of risk. Also it is not easy to be objective when we are evaluating situations close to home. Our town does things pretty well, but our competitor has a poor economic background, its method of finance is not sound, and it is rumored that the city fathers are crooked.

Market price is apt to be particularly misleading as an indicator of the quality of municipal bonds. In the first place, municipal bonds have a preferred demand because of their exemption from the Federal surtax. Hence, many large well-known issues sell on a yield basis below Government bonds of comparable maturities.

Since banks are not subject to a surtax, it is poor business for them to pay any substantial premium for this feature. In the case of small municipalities, market quotations may be misleading as an indicator of credit quality for quite a different reason. In these cases there are not enough bonds outstanding to make a continuous market. You all probably have encountered instances when you obtained quotations on the identical issue on the same day from several different sources which were several points apart. This is to be expected in a thin market; in fact, any other result would call for an explanation. We are especially suspicious of the credit quality of small issues which have a high market turnover.

The more we study municipal bonds, the more convinced we become of the soundness of the general position that credit is a matter of judgment and cannot be subjected to rules. Times change, and conditions and traditions vary so much from state to state, and even within the same state, that rules and standards when applied indiscriminately run into absurdities. However, some markers are needed. While we do not wish to develop anything approaching rules, we do feel that conferences, such as this, at which we discuss the various factors influencing credit quality are very useful. It is possible, and in general, desirable, to work out some rough standards which will have local, if not general, application. The danger in such standards is that they will be used generally, and we will become less alert in watching for unusual factors which may be important

in given cases.

The analyzing of the obligations of a large number of diverse municipalities is a big job, but bank examiners have a knowledge of conditions in the area served by the bank under examination which is of great assistance. Now that attention has been directed to the subject, I am convinced with the experience gained in the general field of credit analysis and the knowledge of local conditions, that the bank supervisory authorities are in a position to do a better job of evaluating municipal obligations on a national scale than has ever been done before.

Although this talk is devoted almost entirely to a discussion of general aspects, I do wish to raise one specific problem for further discussion tomorrow or Friday. In Mississippi you face a very complicated structure of overlapping debts. You have all of the districts you would ordinarily expect, such as counties, schools and towns, and the counties are divided up into five road districts or beats, a considerable number of which have bonds outstanding. This is further complicated by a considerable number of drainage districts which, generally speaking, are not co-terminous with any other unit. I think we should discuss the easiest methods of getting the information about these many districts. Bulletin No. 22 of the Mississippi State Tax Commission Service gives some of the information which we wish, but it is going to be necessary to supplement it considerably before we can properly analyze the bonds of these units.

Since you may wish to do additional study on some of the aspects of this subject, I shall outline briefly some reading material before turning the meeting over to Mr. Wayne.

Dr. C. O. Hardy's book entitled, "Risk and Risk Bearing", is a worthwhile text which covers, among other things, the broad subject of risk and investments. The handling of the problem of risk as it related to the analysis of securities has direct application to the subject at hand.

Arthur Stone Dewing's "Financial Policy of Corporations" which was first published in the early 20's is the outstanding book in the field of corporate finance. The thing that I particularly like about this book is the fact that although it has been revised from time to time, the conservative point of view of the first edition has stood the test of time. The book is long and the organization is not the best from our point of view, but it does provide invaluable background material for the study of investments.

Another excellent book on corporate bonds as investments is "Security Analysis" by Benjamin Graham and David L. Dodd. The handling of the principles of investment is particularly well done, and I cannot urge you too strongly to read at least these early chapters. The discussions of the reasons why small investors and institutions should purchase only high-grade bonds are excellent. We do, however, take exception to the interpretation in one important respect. They place a great deal of emphasis on the importance

of marketability, and the desirability of a stable market price. As I indicated earlier, we do not believe that it is necessary for a bank to confine its investments so drastically, or that a decline in market price is serious provided the risk of default has not increased. One of the purposes in adopting the uniform evaluation procedure of 1938 was to minimize the influence of market price on the investment policy of banks.

The Committee on Local Government Activities and Revenues of the Municipal Finance Officers Association in January, 1939, published an interesting pamphlet entitled, "The Support of Local Government Activities". This is an excellent statement of the problems confronting local government, although it too should be read critically. In spots it seems to be almost special pleading for local governments.

The only book on municipal bonds which can be recommended is A. M. Hillhouse's book, "Municipal Bonds, A Century of Experience". On the whole, it is a very useful study. The approach, however, is historical and statistical, rather than analytical and the book is not easy reading.

"Local Debt Administration" by Carl Chatters and A. M. Hillhouse, looks at many of these same problems from a slightly different angle. In this book they discuss the principles of municipal finance from the standpoint of the city itself. Since a program which strengthens the finances of a city also strengthens

its credit, we can to good advantage study their suggestions for the improvement of the finances of a city.

As was indicated earlier, there is very little literature on the subject of municipal bonds as investments, but a tremendous amount on the general subject of public finance. There is no end to the reading which can be done on aspects of this subject, and you may wish to read some of the books and articles mentioned in the rather lengthy bibliography which has been passed out.