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"PRINCIPLES OF INVESTMENT FOR COMMERCIAL BANKS"

I am very happy to be here, not only because of the opportunity of extending the very pleasant personal contacts which I have had with you over the past two years, but because of the opportunity of learning from your experience. It has been very fortunate for me that the Corporation decided to use my study of municipal obligations before it was completed, for in this way I have the benefit of your suggestions at the time when they are most useful. I wish to take this opportunity to express my appreciation for the kind manner in which you have received my suggestions and to thank you for the help which you have already given.

It is especially fitting that this conference should discuss principles of bank investment and appraise the methods of analyzing municipal obligations now in use. The pioneer work which you have done in classifying municipal obligations has attracted favorable notice throughout the nation, with the result that other States are now looking to this District as a model. As I see it, the success of your program has been due to the hard work and serious thought of the examiners and supervisors. You have tried many new ideas, but have quickly abandoned procedures which proved unsatisfactory in practice. The friendly cooperation and exchange of information between Federal and State agencies has not only saved time and money but has resulted in sounder classifications.

Since I wish to conserve as much time as possible for discussion, I shall not repeat material which has already been covered in my memorandum. I hope, however, that you will call attention to any points which are not clear or with which you disagree. In this paper I propose to outline some principles of bank investment with a view to orienting our study of municipal finance. My following paper will deal with some special problems in municipal finance which are not covered in the memorandum.

For some time problems of bank investments have been attracting a large amount of public attention. As would be expected when a question as technical as this becomes one of public interest, much of the discussion on the subject contains such a mixture of sense and nonsense that great caution must be exercised in accepting the so-called principles. In most of the bond schools, for instance, some rather excellent suggestions for the analysis of individual securities have been given along with advice on "trading up" and "switching". We cannot even indirectly endorse such counsel. Our Corporation has taken a definite position against these practices. We have stated time and again that we believe banks should purchase sound securities with the expectation of holding them to maturity. Our objections to constant trading and shifting are based both on the practical difficulties encountered and the theoretical implications for the financial system as a whole. In the first place, the record clearly indicates that most banks which have attempted to trade have not been able to prepare the accurate forecasts necessary to make profits in the market. The risks in such transactions are great and the expense high, with the result that over a period of time a large percentage of the banks which make a practice of turning over their bond accounts get into difficulties. In the second place, one can hardly imagine a more disorganizing factor in the market than an attempt by all commercial banks or any large number of them to purchase and sell bonds in the hope of making money on short swings. The market would continue to advance rapidly as long as further advances were expected, only to decline precipitously when the general mood changed. Gyrations in the security market are upsetting to the economy as a whole.

There is a concerted publicity program under way popularizing the idea of a written investment plan. This is another program which we can only partially endorse. The preparations of a sound investment plan is obviously worthwhile, but the writing down of an unsatisfactory one only makes somewhat more certain that the management will make all the mistakes contemplated in the plan. Frankly, my first reaction to all this publicity about investment plans for banks was antagonistic, since the suggested plans which came over my desk provided implicitly, if not explicitly, for "trading up" and "switching". There is so much force back of this publicity that it would be hard to buck, however, and I now feel that the better course is not to attack the idea of an investment plan as such, but rather to concentrate our criticism on the parts of specific plans which are out of line with our policy. It is to be hoped that in the near future we can find the time to make a thorough study of the problems of bank investment, looking toward publishing a positive statement of the principles we endorse.

Although it is obvious to you as bank examiners and supervisors, it is not clear to all who offer investment advice to banks that formulation of an investment plan for a bank must start with an analysis of the entire balance sheet, rather than the bond account in isolation. Some writers, for instance, view net sound capital as a measure of the amount of bond depreciation which a bank can absorb. This is a serious error since the capital of a bank is the cushion to absorb losses on all assets. If there are numerous loans on which the chances of loss are large, it is clear that the policy in regard to securities needs to be more cautious than would otherwise be necessary.

The important principle of diversification should be applied to all assets of a bank rather than to the bond account alone. If the loans are largely of one type, any bond which is affected by the same risk should be studiously avoided. The proper maturity schedule for bonds depends upon the maturities and likelihood of prompt payment of the other assets held by the bank. The nature of the liabilities, especially the deposits, determines the need for cash and shiftable assets. If the bank may need to convert bonds into cash in the near future, it should select different issues than if it expects to be able to hold ~~securities~~ them for a long period.

Much current discussion is predicated upon the assumption that individual banks can obtain funds in the market when needed. It is possible for a bank to realize cash from the sale of securities when the markets are not under pressure, but in times of financial stress 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. One of the functions of the F.D.I.C. 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 satisfactorily we must remain calm when others become hysterical. We can be reasonably certain that actions prompted by fear and emotion will be wrong and the sale of securities under such circumstances should be discouraged. In times of panic, no asset is liquid except insofar as some government agency, such as the Federal Reserve or the R.F.C., is willing to take it over, and in this sense anything which these agencies will accept is liquid. The prejudice against rediscounting in times of trouble is baseless. It seems odd that the use of the facilities of the Federal Reserve System for the purpose for which they were created should be regarded in some quarters as reprehensible.

This is not to deny that a limited number of marketable securities are desirable in a bank portfolio. A policy of holding some marketable securities will enable a bank to readjust its position in ordinary times -- that is, when other investors are not attempting to make the same type of shift. A bank can make satisfactory sales only when others in the market are interested in purchasing such bonds. Since bonds which are readily marketable sell on a lower yield basis than non-marketable issues of equal credit standing, a bank should not purchase more marketability than it needs.

Typically, a banker has more control over the bond account than over the other balance sheet accounts. Although a banker does exercise some control over the type of deposits he has, the fact remains that for the most part he accepts what comes his way, and to a somewhat lesser degree, the same is true of loans and discounts. The notes in a portfolio are usually those of local businessmen and reflect the needs and customs of the locality, rather than the preference of the banker. But a banker need be under no such obligation when he plans his bond account. He can purchase such bonds as are required to round out the program for the entire bank. Geographical and industrial diversification can be obtained by careful planning of the bond account, although a word of warning is needed here. Some bankers, in an attempt to get geographical and industrial diversification, have purchased securities about which they knew little and in so doing have accepted larger risks than they would have assumed if they had fully comprehended the situation.

We are convinced that credit standards for bonds should be high -- higher, in fact, than for notes. The type of the credit instrument is immaterial as long as the issuer is in sound financial condition, but when losses develop and reorganization threatens, the form of the obligation becomes very important. The cost of adjudicating conflicts of interest between various classes of bonds and stocks and the difficulty of obtaining competent managements which will operate the properties in the interest of the creditors are such that recoveries on bonds which go through receivership have been on the whole discouragingly low. Bond issues run for long periods and it is difficult to make satisfactory provisions in the contract for the many contingencies which may arise. If bondholders are scattered, as is usually the case, compromises by which receivership can be avoided can be arranged only at great expense, if at all.

On the other hand, banks have developed facilities which enable them to work out notes of corporations facing financial difficulties, with the result that the recoveries on notes have typically been greater than on bonds. Even in cases where the corporate structure is complicated, the regular renewal of notes gives bankers an opportunity to readjust contracts and obtain such additional collateral as may have become available. If the bank is the main creditor, extensions can often be granted with a view to avoiding the expense of receivership.

A great deal of attention has been given in recent years to the risk involved in holding long-term bonds. It has been pointed out repeatedly that an increase in the interest rate would result in declining bond prices. There are, however, some disadvantages to a bank purchasing only short-term paper, and I am, therefore, taking this opportunity to present the case for longer maturities. As I do not wish to complicate the question with a consideration of the bond quality, the discussion will be confined to United States Government obligations.

The question of maturities can only be considered in the light of the large volume of excess reserves held by many banks today. The chief disadvantage of a bank holding excess reserves is the loss of interest, a loss which becomes considerable if funds are kept uninvested for as long as six years, as some banks have done. This loss is exaggerated, moreover, if the interest rate continues to decline, and income-bearing assets can be acquired only on progressively less attractive terms.

There are, however, some advantages in a bank holding excess reserves. A decline in deposits, for instance, is a matter of small concern to a bank with a sizeable volume of excess reserves. Under such circumstances the bank is not forced to borrow money, collect loans or sell bonds. Also, a bank with excess reserves is in a position to take advantage of economic conditions and acquire earning assets whenever they can be obtained on an especially favorable basis.

Short term governments are similar to cash. A bank with a large volume of short terms is also in a position to meet deposit withdrawals or to make attractive investments without borrowing money or selling its earning assets at a loss. These great advantages and the policy of the treasury in regard to maturities have forced the net return on short term governments to an exceedingly low figure. Much of the time they sell on a negative yield basis and the investors must depend upon the speculative value of the rights for their return.

The chief advantage of long term governments is the fact that a bank can earn interest by holding them, without assuming any risk of loss because of default; ~~while the chief disadvantage is that a bank may be forced to absorb a loss in case the interest rate advances.~~ However, If conditions do change and interest rates advance, a bank loaded with long term bonds is not in a position to take advantage of the better rate.

Large withdrawals of deposits while bond prices are low might conceivably force a bank to sell at a large loss, but the facilities for obtaining funds from the Federal agencies have become so liberalized that such a catastrophe is not as likely as was formerly the case. On the other hand, a large portfolio of long term governments is highly desirable if the interest rate declines. Those banks which, over the past six years, purchased long term governments as they had funds to invest have had a good income and now hold earning assets which cost considerably less than current quotations. Moreover, if they have followed the policy of staggered maturities, they now own a number of short term governments on which they are obtaining a favorable return.

Price declines in long term bonds often cause bankers needless worry. A severe decline in the bond market is a matter of serious concern to banks which may be forced to sell bonds, but is of <u>no</u> consequence to those banks which do not face large withdrawals or which have sizeable excess reserves. The computation of paper losses during periods of market instability is apt to be more confusing than helpful. A more rational position for the banks which have funds awaiting investment, is to look forward to periods of market declines as opportunities for making additional commitments on a favorable basis.

The course of interest rates depends upon the action and inter-action of such a large number of complicated social, political and economic factors that there seems little hope of any large group of banks successfully forecasting changes in the interest rate. Certainly, the record of the bulk of the banks which have attempted to speculate in interest rate changes over the past decade is far from reassuring. It is doubtful if a bank should even try to do better than to average out these fluctuations over the course of a cycle. Everything considered, the safest policy for an individual bank~~s~~ seems to be to hold reasonable amounts of excess reserves to care for unusual developments and to invest the balance of its funds in government obligations with fairly long maturities when purchased, but selected in such a manner that the maturities of the portfolio as a whole are staggered. Such a policy if consistently followed would provide the bank with a sizeable volume of short term governments at any given time, and, if necessary, readjustments could be made with a minimum of loss.

The greatest risk of advocating such a program is that it may be misunderstood and that some banks which have held excess reserves for a long period will suddenly decide to change their policy and purchase a large volume of long term governments at one time. The banks which do this at the wrong ~~time~~ phase of the interest rate cycle will be locked into a low earning position for some time. A bank can only average out the interest rate cycle by purchasing ~~at~~ in all phases, ~~of the~~ cycle.

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