

June 23, 1938

Dear Mr. Berle:

In accordance with our telephone conversations, I am enclosing confidentially a suggested statement which represents what I think the President should give to the press and the public in summing up the results of the bank examination review prompted by his recovery message to Congress. It also represents what I believe would be the most effective summary and one that would be of real benefit both from the standpoint of the Administration and particularly that of smaller businesses and the banks--though, of course, I know that the President himself could put it in words that are more trenchant.

I feel a strong responsibility for making this suggestion because I had requested the President to include in his message this move to lift restrictive policies by the several Federal bank supervisory agencies as a means of helping to facilitate the flow of the superabundance of bank credit already existing and added to by his recovery program. In fact, the Board's willingness to reduce reserve requirements was closely connected with the expectation that restrictions on the banks would be lifted if the President requested it, as he did in effect in his message. I feel that something

very worthwhile has resulted for which he is entitled to great credit, but that the effect will be completely lost if what is accomplished is announced merely as a further step to "protect the bank depositor", as if we had not been protecting him heretofore. However, I do not need to elaborate the subject to you because I know you have a full appreciation of it. I merely felt that my responsibility to the President would not be discharged unless I made every effort to let him know my own view as to the significance of this program on which the banking agencies have unanimously agreed, not without reluctance on the part of those of the old school who resist all change or adaptation to modern conditions and represent the typical bank examiner mentality.

Sincerely,

M. S. Eccles,
Chairman.

Honorable A. A. Berle, Jr.
Assistant Secretary of State
Washington, D. C.

ET:ead

June 23, 1936.

In my message to Congress on April 14, I announced the desterilization of approximately \$1,400,000,000 of Treasury gold, accompanied by action on the part of the Federal Reserve Board to reduce reserve requirements by about three-quarters of a billion dollars, for the purpose of making additional bank resources available immediately for the credit needs of the country. At the same time I expressed the hope that Federal banking supervision could be better coordinated, with a view to facilitating the flow of credit for commerce, industry and agriculture.

The Secretary of the Treasury initiated a series of conferences with representatives of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System for the purpose of reviewing the policies and regulations of the Federal banking supervisory authorities and determining wherein they might be improved and better coordinated in furtherance of this objective, consistent with sound banking principles.

They have unanimously agreed upon and submitted to me a program which for the first time brings about complete uniformity in the rules and regulations to be followed by the Federal agencies in their administration of all bank examinations under their respective jurisdictions. This is an important forward step in re-

moving from the field of bank supervision sources of conflict and of irritation that do not make for the efficient functioning of the banking system.

Beyond this, however, the program adopted should be of benefit both now and in the future in two important respects; first, by opening the way especially for the small and medium-sized business concerns to obtain needed credit from the banks, and, second, by relieving pressures that tend to reduce outstanding credit or prevent extension of new credit to sound borrowers.

The program includes a broad revision of the Regulation of the Comptroller of the Currency governing bank investment policy. It provides that member banks of the Federal Reserve System may purchase investment securities, of such sound value or so secured as reasonably to assure payment, issued by established commercial or industrial businesses or enterprises that can demonstrate the ability to service such securities, without requiring that the securities be offered for public distribution or that they must be readily marketable, provided, however, that they mature not later than 10 years after the date of issuance and that 75 per cent of the principal be amortized at maturity by substantial, periodic payments, none of which would be required during the first year.

The program provides, with respect to bank examination reports, that what has been commonly called the "slow" column will be abolished altogether. In place of this, and of the columns

heretofore headed "doubtful" and estimated loss", there will be substituted the designations, II, III, and IV, which are to be defined respectively for the listing of loans that are somewhat doubtful, more doubtful, and in which loss is estimated. The "slow" column has long been a misnomer and a cause of complaint.

The important fact, however, is not the designation of the columns, but the clear recognition that in making loans, whether for working capital or fixed capital purposes, the banks should be encouraged to place the emphasis upon soundness rather than upon liquidity or quick maturity.

Similarly, the revised examination procedure clearly recognizes the principle that bank investments should be considered in the light of their inherent soundness rather than on a basis of day to day market fluctuations or liquidating value. The soundness of the banking system depends in the last analysis upon the soundness of the country's business and industrial enterprises. It should not be measured by the precarious yardstick of ticker quotations which often reflect speculative and not true appraisals of intrinsic worth. In their purchase of securities the banks should be encouraged to invest, not to speculate.

Accordingly, the revised procedure broadly divides securities into those of investment quality and those of speculative

or sub-standard character. The former will be listed in Group I, the latter in Group II. Defaulted bonds and stocks will be listed in Groups III and IV, respectively.

It is estimated that approximately 90 per cent of the total securities held by the banks are of investment quality and will be carried in Group I. In conformity with the principle of measuring such securities by investment and not by fluctuating market standards, daily quotations will not be taken into account in examination reports, which will require that such securities be shown at their book value whether they be listed or unlisted securities. By thus severing bank investment from the ticker, banks will be encouraged to purchase the securities of sound American business and industrial concerns, whether large or small, for their true worth and not for speculative gains.

Sub-standard or speculative securities, to be carried in Group II, are estimated to comprise not more than 5 per cent of the banks' holdings, and will be shown in examination reports at their average market price for the 18 months preceding the examination, a method which would more accurately reflect intrinsic values in this group. Unlisted securities in this group will be shown at estimated value. In the case of Group III and IV securities, net depreciation will continue to be classified as loss.

In estimating the net sound capital of banks, the total of loans classified as loss, as well as the total depreciation in defaulted bonds and stocks will be deducted. In addition, 50 per cent of the more doubtful loans, as shown in Class III and 50 per cent of the net depreciation of the sub-standard bonds listed in Group II, will be deducted. Previously, the total of all of the loans classified as doubtful has been deducted, but experience has shown that not more than half result in loss. Likewise, in the past deductions have been made for all of the depreciation as reflected by current market quotations for the entire investment portfolio.

A primary purpose of the program is to encourage the private banking system of the country to adapt its lending and investment functions to present-day requirements of commerce, industry and agriculture. It will afford the banks a broader opportunity for service to the community and for profitable outlet for some of their abundant, idle funds. If the banks will avail themselves of that opportunity, the necessity will be diminished for creation of government agencies to furnish credit facilities which the banks should provide. A first step in stopping deflation requires that credit contraction in the banking system be arrested.

This is essential in order to provide a basis upon which necessary expansion can be brought about. This program should assist in halting private credit contraction and encouraging private credit expansion which in turn will lessen the need for reliance upon public credit. Thereby it can contribute to general economic health upon which the welfare of the public as well as of the banker and bank depositor depends.