January 28, 1938

Memorandum for Mr. Upham

From: Lawrence Clayton

This is in reply to your telephone request for a brief statement of the policy of the Federal Reserve System respecting four questions involved in examination policy. The questions and the policy with reference thereto are set forth separately below. I have changed the order of the points in order to dispose of the simple ones first.

(1) What kind of securities can be purchased for investment by member banks?

This matter is governed by the Comptroller's Regulation on Investment Securities since State member banks are by law subjected to the same standards to which national banks are subject.

(2) What is the Reserve System policy respecting unrealized appreciation in securities?

Any such appreciation is not treated as profit; however appreciation in any part of the member bank's portfolio may be used to offset depreciation in any other part of the portfolio.

(3) What is the Reserve System policy respecting depreciation in a member bank's securities?

As to this the Reserve System policy differentiates between so-called group 1 securities and other securities. Group 1 securities include the following:

a. Issues of the United States Government, direct or fully guaranteed.
b. Issues of Federal Land and Intermediate Credit Banks.

c. Issues considered of good standing, and not in default, of States and municipalities in the United States and of the territories and insular possessions.
d. Miscellaneous issues in the four highest grades as classified by a recognized investment service organization regularly engaged in the business of rating or grading securities.

Depreciation in other grades is shown as loss except that as noted in #2 above any appreciation in group 1 securities may be offset against such depreciation and the net depreciation only is required to be treated as loss.

(4) What is the Reserve System policy respecting profits realized by member banks on the sale of securities?

There is no rule of examination policy of the Federal Reserve System nor is there any sanction in law for treating such profits differently from profits realized from any other banking operation. The policy involved here is really a part of the System's policy with reference to the sound capital and reserves of member banks. Thus if a member bank should realize a large profit from the sale of securities and the securities sold were replaced by others on a high market, the Federal reserve examiner would require that such portion of the profits be transferred to the bank's reserves as would be necessary to make adequate provision for possible loss in the securities purchased. On the other hand, where a bank is carrying a large portfolio, particularly where it is weighted heavily with non-government issues and no profits have been realized on the sale of securities, our examiners would require that an appropriate portion of profits realized from other banking operations should be transferred to reserve which would be available to absorb loss in securities. Thus the treatment of profits realized from sales of securities as well as any other profits realized by the member bank is subjected to the System policy respecting the adequacy of net capital and surplus funds which include, of course, reserves. At the time of applying for membership, State banks are uniformly required to agree, among other things, that "the net capital and surplus funds of such bank shall be adequate in

relation to the character and condition of its assets and to its deposit liabilities and other corporate responsibilities."

Yours very truly,

Lawrence Clayton
Assistant to the Chairman

LC/fgr

Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date January 28, 1938

To Mr. Eccles

Subject:

From Mr. Clayton

At 10:15 this morning Cy Upham called and said the Secretary would like the information regarding the System's policy on bond profits, appreciation and depreciation by 10:45. I told him it would be impossible to get him a written memorandum by that time so I gave him the high spots over the telephone. My memorandum was completed about 10:45 and I called Leo Paulger down to check it. Leo is not entirely in accord with the statement under (4) which is the matter we discussed yesterday evening. He does not specifically object to what is said but would like to say that the System policy requires that bond profits be set aside in reserves unless the bank has already accumulated ample reserves for all other losses plus about 25% of the bond portfolio. He does not like to admit that bond profits are treated the same as any other profits.

As a matter of fact, after an extended discussion with Leo and referring to the extensive file on this question, it appears that the System does not have a firm policy. The last instructions on the matter were issued to the Federal reserve agents in December 1933 and April 1934. These instructions exempted group 1 securities from any charge-off requirement but stated "it is believed that the Federal Reserve Agents should endeavor generally to obtain the same corrections on the part of State member banks as would be required in the case of banks applying for membership in the System." It is interesting to note that in carrying out this "endeavor policy" there is considerable variation among the several reserve banks in spite of the fact that in transferring the examining function to the banks, we specifically reserved the right in effect to determine policy.

In view of the above, do you think the attached memorandum, even if in accord with your personal views, should go to the Treasury? Perhaps your meeting this morning offers a way out.