

Office Correspondence

FEDERAL RESERVE
BOARD

Date July 30, 1935.

To Governor Eccles.

Subject: Section 344 of the Banking Act

From Mr. Paulger.

of 1935 as passed by the Senate.

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Attached is a memorandum from Mr. Cagle to me relating to section 344 of the Banking Act of 1935 as passed by the Senate which attempts to cure capital impairment by definition.

Outside of the criticisms of the section as set out by Mr. Cagle and pointing out that it is wrong in principle and does not conform to the facts, I, also, feel that such action is unnecessary in any circumstances. Its passage would apparently preclude the affected supervising authorities from enforcing demands for corrective action because of capital impairment. While it may not affect the form of our present call report and contemplated published statements, I have some misgivings, in the event of the section's becoming law, regarding the authority of the Board or the Comptroller to prohibit a bank in its own published statement from showing a misstatement of its capital account.

I am hopeful that the section may be stricken out in conference.

Office Correspondence

FEDERAL RESERVE
BOARD

Date July 25, 1935

To Mr. Paulger

Subject: Section 344 of the Banking

From C. E. Cagle

Act of 1935.

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As I have already indicated to you orally, I feel that the provisions of this section are unnecessary (except possibly in a very few cases which could and really should be handled without resorting to such provisions) and constitute an unsound and dangerous departure, which I believe too many banks will attempt to take advantage of.

In substance, the intent of the first two sentences of the section are apparently the same -- to provide for the curing by definition only of impairment of capital stock of banks without increasing or reducing the assets, the liabilities or the outstanding certificates of capital stock of the banks concerned.

The second sentence (relating to impairment in cases where debentures are issued) is unfortunately worded in such manner as to indicate that merely by the issuance of capital debentures impairment of capital stock may be actually cured, whereas the apparent purpose of the section is to provide a means of permitting exceptions, in meritorious cases, by supervisory authorities, involving limitations and restrictions upon investments by member banks, underwriting provisions, loan limits, applications for membership, payment of dividends, etc. I do not understand why such a law, which describes or defines capital impairment or unimpaired capital, will be needed in connection with any effort on the part of a creditor or stockholder of the bank to aid such bank by waiving temporarily a portion of the obligation or claim.

It would seem by far preferable -- if indeed any law in this connection

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must be made at all, to remove legal technicalities or for other purposes — to provide that the Comptroller of the Currency, the Federal Reserve Board, the F. D. I. C. or the R. F. C., be authorized to determine whether capital is impaired and, if so, to waive certain requirements, limitations or restrictions, or defer action where the present law requires it in certain emergency situations, at the discretion of the appropriate supervisory authority in all cases where absolutely necessary and the facts and circumstances warrant. If such exceptions are not warranted, the refusing to admit banks to membership, the placing of unsound banks in receivership, and the taking of any other action required by the present statutes to be taken would seem to be more conservative and more defensible than attempting to cure a definite impairment of capital by legal definition only in order to meet a comparatively few exceptional situations, which in the majority of cases need more new money than new definitions. Once impairment is removed by definition and certain privileges are thereby restored, certain types of banks (the ones which need vigorous supervision) will more readily oppose the efforts of the supervisory authorities to obtain needed corrections.

The section would legalize and give fresh impetus to the various plans for showing capital debentures in published statements by some of the State supervisory authorities, and which appear to be based upon the plan set forth in the memorandum dated November 20, 1933, and signed by W. J. Cummings as chairman of the F. D. I. C. In several states, (Washington, Indiana, Minnesota, Texas, etc.) capital debentures sold to the R. F. C. are not legally regarded as capital. In other states where they may be legally regarded as capital, the authorities desire to retain the value, if any, of the double liability feature of the capital stock by not permitting a reduction

thereof. In several cases the Board has taken the position that the issuance of capital debentures, subordinated to the claims of depositors and other creditors but which are obligations of the issuing bank, does not repair or cure an impairment but merely supplements the diminished capital structure for the further protection of the depositors and other creditors. In such cases the State supervisory authorities had planned to require all of their State banks to omit showing as separate items in their published statements the obligations on account of capital debentures, but to include in various items, such as "capital stock", "capital", "surplus", "reserves", (depending upon the facts in the cases) the net amounts after the elimination of losses and depreciation. In all of these cases the statements would be grossly misleading, but not more so than would follow, under legal sanction, as a result of the enactment of Section 344.

I have not handled a case where the par value of capital debentures was not the same as the retirable value -- as covered by the second sentence of Section 344. I have been advised that the R. F. C. has purchased no debentures which are subordinated to other shareholders. When banks issue their definite obligations in the form of debentures, due on specific dates and in specific amounts, which are subordinate to depositors and other creditors but not subordinate to the common stock outstanding, there can be no compromise even under the sanction of a legal definition. There still remains an impairment of capital if the sound value of all assets is not equivalent to all liabilities and the par value of all debentures and all certificates of stock outstanding. In all such cases the Board has taken the position that the published statement of a bank should correctly reflect

the facts. The enactment of Section 344 would increase the Board's difficulties in enforcing standard requirements in this connection and would most probably result in serious difficulties to the Securities and Exchange Commission in connection with the listing of bank stocks. 10

The Board has repeatedly held that capital impairment exists in all cases where the sound assets are not equivalent to all liabilities plus common capital stock outstanding plus the retirable value of all ^{preferred} stock outstanding (such as a par value of, say, \$100 per share but retirable at \$300 per share) and provision has been made for such situations in the call report form and instructions relating thereto. This position I have concurred in only in cases where the retirable amount is a definite, fixed obligation of the bank, which must be paid on a definite date and which is not affected by contingencies. In a case where a bank has issued preferred stock at a stated par value of \$100 per share which may be retired at \$300 per share only when, as and if recoveries and earnings are sufficient in the judgment of the directors of the bank concerned, and concurred in by the appropriate supervisory authorities, and which must be retired at \$300 per share only upon final liquidation of the bank, I doubt the desirability of attempting to require such bank to show in the money column of its current reports and published statements a liability for the entire \$300 retirable value. The holders of such stock cannot now force the bank into liquidation for failure to retire such stock. Accordingly, I do not believe, in the usual case of this sort, that a going bank should be regarded as having an impairment of capital but I doubt the wisdom of attempting to cover all such situations by statutory definition. This view emphasizes the difference between actual

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par value, as reflected in the outstanding certificates, and a contingent retireable value which depends upon happenings in the future and the judgment, or in some cases, perhaps the desires, of the directors and is based upon the particular contract in each case. In situations of this kind, the law might be altered to authorize the Board or the Comptroller to determine if an impairment exists and, if so, to waive certain requirements, restrictions, or limitations of the statutes if deemed necessary or advisable, in the circumstances.

Good accounting practice does not require the showing as a liability in the money column of a balance sheet (prepared as of June 30, 1935) of a going corporation of:

- (1) Bond interest coupons due between 1936 and 1950.
- (2) Cumulative dividends on preferred stock, even if past due but not declared by the directors.
- (3) Premiums on preferred stock, callable at, say, \$110 per share and accrued dividends after October 31, 1935, in the discretion of the directors.

Good accounting practice does require the segregation in the balance sheet of the various types of stock outstanding and the stated values thereof, though not the descriptive details such as the dividend rate, any peculiar preferences, etc. Details of this sort are usually covered in explanatory notes, if essential. Any difference between preferred stock of a going corporation (stated par value \$100) callable at \$110 and retirable at \$300, (both at the discretion of the directors, in view of the condition, earnings, etc. of the issuing corporation) is not in principle but in degree only. We are not here concerned with balance sheets prepared for use in connection with

liquidations, receiverships, rate hearings, etc. of utilities, etc. However, it is in the public interest for balance sheets of banks to inform potential purchasers of stock and the depositors of the bank of the actual essential facts, but this can be done effectively and in accordance with sound accounting procedure by explanatory note immediately below the capital accounts in the balance sheet and such note should contain information clearly showing the total par value and the retirable value of each class of stock or debentures outstanding and other essential information.

In the Spokane and Eastern Trust Company case the Board required the bank to show its capital accounts in the "liabilities" section of its reports and published statements in substantially the following manner (assuming certain figures for convenience):

"ILLUSTRATION #1

LIABILITIES

Capital	\$1,750,000
Includes \$1,000,000 par value capital stock and \$750,000 par value capital debentures sold to R.F.C., which debentures are subordinate to the rights of depositors and other creditors.	
Surplus	250,000
Undivided profits and reserves	68,000
Acceptances, etc.	100,000
Deposits	<u>17,000,000</u>
Total	\$19,168,000

"To illustrate the applicability of this method in cases of impairment of capital stock, assume that the bank has additional losses of \$400,000 which must be eliminated in order that its statement may correctly reflect its condition. The set up then would be substantially as follows:

"ILLUSTRATION #2

LIABILITIES

Capital	\$1,668,000
Includes \$1,000,000 par value capital stock and \$750,000 par value capital debentures sold to R.F.C., which debentures are subordinate to the rights of depositors and other creditors.	
Acceptances	100,000
Deposits	<u>17,000,000</u>
Total	\$18,768,000

"From your letters of July 18 and July 23, 1934, it is the Board's understanding that under the method you described the set up in this latter case would be substantially as follows:

"ILLUSTRATION #3

LIABILITIES

*Capital	\$1,000,000
Surplus	500,000
Undivided profits and reserves	168,000
Acceptances	100,000
Deposits	<u>17,000,000</u>
Total	\$18,768,000

*Includes proceeds of \$750,000 debentures sold to R.F.C., which debentures are subordinate to rights of depositors and other creditors."

(The above illustrations are taken from the Board's letter of August 15, 1934, to Mr. Howard H. Hansen, Supervisor of Banking, Olympia, Washington.)

The language of Section 344 would seem to encourage and legalize illustration #3 above.

In any cases where the R. F. C. has purchased preferred stock or capital debentures at a stated par value and now desires to reduce such par value, as a means of aiding the bank to make necessary eliminations of depreciation and losses, with a contract providing for the eventual retirement of the obligation at the original figure, the question of the total amount of

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"liabilities" outstanding of the bank and the resultant amount of net capital or capital impairment seems to depend entirely upon the definiteness of the contract. If the bank is relieved by the R. F. C. from payment of the original amount, obviously the amount of impairment is reduced accordingly. If the matter of the payment of the original amount is left to the discretion of the directors, to be paid only when, as and if recoveries and earnings are sufficient and ~~if~~ the directors vote to make such payments, then the eventual payment is at best a contingency and may be properly shown on the balance sheet by an explanatory note and in any such case the amount of any impairment could be reduced accordingly.

There are situations where banks might be admitted to membership or permitted to pay dividends or do certain other things which are restricted when a capital impairment exists but since such situations are so few in number it does not seem necessary to resort to a special law which would be "available" to all other banks in the country.

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