

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 5, 1948.

To Board of Governors

Subject: Revision of conditions of membership.

From Division of Examinations

CAUSE FOR MEMORANDUM

The Board and the Presidents of the Federal Reserve Banks have been in agreement that conditions of membership to which State member banks are now subject be reviewed for the purpose of eliminating as many of the special conditions of membership as possible, and of bringing about more uniformity. In addition, the Board has said that consideration was being given to the uniform conditions of membership to be prescribed in the future.

In December 1946 the Reserve Banks were asked for their views on several questions regarding membership conditions, Regulation H, and other membership matters. Formal consideration, however, of a revision of the conditions of membership was deferred because of the pending litigation in the Lakewood Village case.

This memorandum submits a program designed to achieve the purposes referred to above. Because the specific recommendations can best be understood after a brief discussion of the background, description of the present standard conditions, and statement of the questions involved, the specific recommendations are set forth on page 4.

There is wide variation among State member banks as to the number and type of conditions of membership prescribed when the application was approved. The Board has prescribed conditions of membership from the very beginning, the number, however, varying from time to time. Prior to the issuance of Regulation H, Series of 1924, there were no standard conditions of membership made applicable to all State banks admitted to membership in the System. After that the number of standard conditions was changed several times and a survey of the conditions applicable to the 1918 State banks that were members as of December 31, 1947, shows that they are subject to standard conditions as follows:

<u>Approved</u>	<u>Number of standard conditions (exclusive of trust conditions)</u>	<u>Number of banks subject</u>
Prior to 1924	None	407*
1924 to 1927	9	31
1927 to 3-11-33	7	80
3-11-33 to 6-30-33	14	56
6-30-33 to 1-1-36	15	237
Since 1-1-36	3	1107
		<u>1918</u>

* Subject to varying conditions, not uniform.

Of the 1511 banks subject to the varying standard conditions prescribed at the time the applications were approved, almost 700 are subject to standard conditions only. The other 800 odd are subject to special conditions as well. In considerably more than half of these cases, however, the special conditions required compliance prior to or shortly after admission, and therefore have been complied with and are now obsolete, or are continuing conditions of a type no longer prescribed. In the program recommended in this memorandum conditions of these two types would be cancelled.

The program recommended would result generally in the retention of those conditions similar to the standard conditions to be currently prescribed and of such special conditions as would be prescribed were the bank applying for membership now. Such a program would result in a much greater degree of uniformity in the conditions of membership among all member banks than prevailed heretofore.

More complete uniformity cannot be attained without legislation, since conditions of membership can only be prescribed in connection with applications for membership or subsequently by mutual agreement, as when trust conditions are prescribed in connection with an application of a State bank under general conditions of membership for permission to exercise trust powers.

The most serious gap with respect to possible uniformity is in connection with requirements for Board approval for reductions in capital. Such a condition has been prescribed since March 1933 and previously during the period 1922-27. During two extended periods, however, such a condition was not prescribed and there are approximately 400 State member banks not subject to such a condition.

PRESENT STANDARD CONDITIONS

A copy of the standard conditions of membership now prescribed is attached. Briefly they provide that:

1. The bank shall conduct its business with due regard to the safety of its depositors and, except with the permission of the Board, shall not change the general character of its business or the scope of its corporate powers.
2. The bank's capital and surplus shall be adequate and its capital shall not be reduced except with the permission of the Board.
3. The bank shall not engage as a business in the sale of real estate loans.

(Trust Conditions)

4. The bank shall not engage in self-dealing in the investment of fiduciary funds.
5. The bank shall not intermingle trust assets or invest them collectively, except as permitted in the case of national banks.
6. If funds held as fiduciary are deposited with the Banking Department, the bank shall deposit security under the same requirements as applicable to national banks.

SPECIFIC QUESTIONS

The general question of revision of conditions of membership raises a number of specific questions:

1. Should the present standard conditions be prescribed in the future? More specifically:
 - (a) Should present condition number 3 prohibiting a bank from engaging as a business in issuing or selling real estate loans be continued?
 - (b) Should any trust conditions be prescribed at all?
2. What steps can and should be taken to bring about more uniformity among present members with respect to conditions of membership?

Two possible broad approaches are suggested.

After a review by the Reserve Banks and the Board and decision has been reached as to which conditions should be kept or made effective in each individual case one of these courses could be followed:

- (1) Certain conditions could be cancelled, the member bank be advised thereof, and furnished with a clean draft of the conditions considered to be in force; or
- (2) The member bank could be offered the opportunity by formal action of its board to accept the revised standard conditions, together with such of the original special conditions as should be retained. The revised conditions thereupon would supersede the original conditions.

RECOMMENDATION

1. That the standard conditions to be prescribed in the future be revised to include only present conditions numbered 1 and 2.

This means the elimination of present standard condition numbered 3 which prohibits a bank from engaging as a business in the sale of real estate loans and the elimination of the 3 standard trust conditions.

2. That, in order to bring about more uniformity among present members with respect to conditions of membership:

- (a) No attempt be made to persuade present members to accept new conditions to which they are not subject.
- (b) After a review by the Reserve Bank and the Board as to which conditions should be kept in each individual case, the other conditions be cancelled, the member bank be advised thereof and furnished with a clean draft of the conditions considered to be in force.
- (c) If any member bank in a particular case should express a desire to do so, it be permitted to accept by formal action of its board the revised standard conditions with such of the original conditions as should be retained. The revised conditions thereupon would supersede the original conditions.

This would further work towards uniformity since in quite a number of cases banks admitted to membership prior to January 1, 1936, are subject to the provisions of present standard conditions of membership numbered 1 and 2 but those provisions are spread over three or more conditions. It might be that some of these banks would prefer to accept the consolidated conditions.

3. That Regulation H be amended to reflect the changes in the conditions of membership with appropriate footnote to condition numbered 1 regarding the elimination of condition numbered 3 and the three trust conditions.
4. That if the proposed program meets with the favor of the Board, it be discussed with the Presidents at the next conference prior to taking final action on the revision.

COMMENTS

Conditions of membership comparable to the provisions of condition numbered 1 have been prescribed since 1924. In 1936, the provisions of two conditions were consolidated into present condition numbered 1.

The condition regarding maintenance of adequate capital was first prescribed as a general condition in 1933. The provisions requiring approval of the Board for reduction in capital were first prescribed in 1922. They were dropped in 1927 and revived in early 1933. In 1936 the provisions regarding maintenance of adequate capital and reduction in capital were consolidated into present condition numbered 2.

The provisions of present condition numbered 3 prohibiting a bank from engaging as a business in the sale of real estate loans, were first prescribed in early 1933 in view of the troubles which a number of banks experienced because of such sales. This is only one type of banking practice which has caused trouble. It would be impracticable to include in the conditions of membership specific prohibition against all mistakes of judgment and unsound policies. Therefore, it is recommended that this condition be dropped as being a specific condition out of keeping with general conditions.

Three standard trust conditions, in the case of State banks having trust powers, have been prescribed, where applicable, since 1933. The major effect of these conditions has been to apply to State banks certain provisions of Federal law or Regulation F applicable to national banks exercising fiduciary powers.

Of the 1918 State member banks, 657 have active trust departments
383 are subject to trust conditions;
274 are not subject to trust conditions;

28 are subject to trust conditions but are not now engaged in fiduciary activities.

Most of the larger banks and trust companies were admitted to membership before the trust conditions were prescribed.

The whole question of fiduciary responsibilities is essentially a local matter governed by State law. Some difficulties have arisen in connection with conflicts between the conditions and practices permissible under State laws with respect to pledge of securities for trust funds deposited in the banking department and interpretations of the condition regarding investments of trust funds in interests of directors and officers. The recommendation for dropping the standard conditions, however, is not based predominantly upon the difficulties of administration, but on the broader basis that there is no occasion for the Board to undertake to control by conditions of membership the exercise of fiduciary powers by State banks, and that any questions of improper practice can be handled under the general powers of supervision.

Abuses of the practice of selling real estate loans or failure to conduct trust business in a proper manner might, if severe enough, be considered as violations of condition numbered 1, or could otherwise be handled as supervisory matters as circumstances warrant. A footnote, as suggested in recommendation numbered 3, might read substantially as follows:

"For many years prior to _____, 1948, the Board prescribed, as standard conditions of membership, a condition which, in general, prohibited banks from engaging as a business in the sale of real estate loans to the public and certain conditions relating to the exercise of trust powers, including one which prohibited self-dealing in the investment of trust funds. The elimination of these conditions as standard conditions of membership does not reflect any change in the Board's position as to the undesirability of the practices formerly prohibited by such conditions; and attention is called to the fact that engaging as a business in the sale of real estate loans to the public or failing to conduct trust business in accordance with the applicable State laws and sound principles of trust administration may constitute unsafe or unsound practices and violate condition numbered 1."

ATTITUDE OF THE RESERVE BANKS

In a letter dated December 17, 1946, the Reserve Banks were asked for their views on several questions regarding membership conditions, Regulation H, and other membership matters. The letters are in the accompanying file and a summary of the replies is attached.

Briefly, the replies of the Reserve Banks with respect to the questions asked regarding conditions of membership may be outlined as follows (any such outline cannot, of course, reflect the extended discussion and reasoning given in the several letters):

Question

Do you consider it necessary or advisable to prescribe any conditions governing a bank after its admission to membership?

Replies

Answered affirmatively by all banks subject to the following exceptions:

Boston would prescribe only necessary special conditions in particular cases.

Richmond suggests that the Federal Reserve Act should be amended to impose upon member banks the limitations and restrictions now imposed by standard conditions of membership and that thereafter only necessary special conditions be prescribed in particular cases.

Minneapolis suggests amendment of Regulation H to substitute the following for the present provisions of Section 6:

"Each member bank shall at all times conduct its business and exercise its powers in accordance with the applicable provisions of federal and state law and in a safe and prudent manner. Should any member bank fail to do so, it shall be within the power of the Board, after hearing, to require such bank to surrender its stock in the Federal Reserve Bank and to forfeit all rights and privileges of membership. Any decision of the Board on any issue of fact which is supported by substantial evidence shall be final."

Question

Do you recommend a modification, restatement, or elimination of any of the present standard conditions? Do you recommend any other conditions, and if so, what? In this connection, please consider the following more specific questions:

- (a) Bearing in mind that standard condition numbered 3 relates only to dealings in a particular class of asset and dealings in other assets are not specifically mentioned in the standard conditions, should this condition be eliminated, modified, or retained in its present form, and why?
- (b) What arguments can be made for the elimination or retention of any or all of the three standard trust conditions (numbered 4, 5, and 6)? Should there be any conditions relating to specific practices in connection with the exercise of trust powers? Should there be a general condition of broader scope relating to trust activities?
- (c) Are the first clauses of standard conditions numbered 1 and 2 necessary or desirable, and why?

Replies

The general question

Only St. Louis and San Francisco recommend no modification, restatement or elimination.

Suggestions for consolidation of conditions, inclusion in statute, regulation or application form, and for certain eliminations, are made. No new conditions are recommended except as indicated below.

(a) Condition numbered 3

Boston recommends no standard conditions.

New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis and Dallas recommend elimination.

St. Louis, Kansas City and San Francisco recommend retention:

St. Louis because it prevents a revival of an undesirable practice; Kansas City because it is sound and properly integrated with Section 5136, R.S.; San Francisco because it constitutes a warning to State member banks that such practices are not permissible.

(b) Trust conditions

Four banks -- Boston, Cleveland, Chicago, and Minneapolis -- recommend elimination of the trust conditions.

The other eight banks recommend retention of all or part of the conditions as follows:

New York - Would eliminate #4 because self-dealing prohibited by law.

Would eliminate #5 as not needed.

Would retain #6 until all States provide statutory preference for trust funds deposited.

Philadelphia - Retain all as consistent with generally accepted principles and imposing proper standards.

Richmond - Sees no pressing need for elimination of trust conditions which are based upon accepted trust principles.

Would eliminate words "or their interests" in #4.

Atlanta - Retain as based upon fundamental trust principles.

St. Louis - Recommend no change. Argument lengthy but generally to the effect that such conditions impose upon State banks standards defined in Regulation F for national banks.

Kansas City - Recommend amplification of #4 to cover sale or transfer.

Recommend clarification of #5 to require that State banks operating common trust funds should do so in accordance with Section 17 of Regulation F.

Suggest amendment of #6 to except banks in States that do not permit pledge of assets for the purpose.

Recommend that substance of sections 6 and 7 of Regulation F regarding trust management and regarding books and accounts be added as conditions of membership.

Dallas - Feel that present conditions constitute minimum requirements.

San Francisco - Do not eliminate because of contractual aspect of membership and salutary effect of conditions on members.

Some banks discussed a broader general condition, suggesting the possibility of making Regulation F applicable to State member banks.

(c) Are the first clauses of conditions numbered 1 and 2 necessary or desirable, and why?

The clauses in question are:

- "1. Such bank at all times shall conduct its business and exercise its powers with due regard to the safety of its depositors, and, except with the permission of the Board of Governors of the Federal Reserve System, such bank shall not cause or permit any change to be made in the general character of its business or in the scope of the corporate powers exercised by it at the time of admission to membership.
- "2. 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, and its capital shall not be reduced except with the permission of the Board of Governors of the Federal Reserve System."

Boston favors the elimination of all the standard conditions.

The following six banks favor elimination of the clauses, the reasons given generally being that they are unnecessary or are stated in such general terms as to be difficult of application:

New York	Chicago
Cleveland	Minneapolis
Richmond	Kansas City

The following five banks favor the retention of the clauses considering them to be desirable and helpful in strengthening the position of the Board and the Reserve Banks when corrective action is needed; the point is also made that deletion might be subject to misinterpretation:

Philadelphia	Dallas
Atlanta	San Francisco
St. Louis	

Our recommendation is that the clauses be retained.

Attachments - Present conditions of membership (Exam 37)
Excerpt from minutes of Conference of Presidents, June 7 and 8,
1946
Letter to Reserve Banks regarding revision of conditions of
membership and other membership matters (Z-1968)
Analysis of replies to letter Z-1968