January 7, 1949

Board of Governors — Uniform Agreement regarding

Governor Clayton — Bank Examination Procedure

Because of recognized lack of uniformity in application as between agencies and within agencies the question of possible clarification or needed revision of the Uniform Agreement adopted by the Federal Supervisory Agencies and the Executive Committee of the National Association of Supervisors of State Banks in 1938 has been under discussion for some time by the Inter-Agency Committee on which I serve, as the Board's representative, with Comptroller Delano and Chairman Harl of the F.D.I.C.

Such lack of uniformity has been minor in character but undesirable and it was decided that the matter should be explored at staff level with the understanding that further consideration would be given to the findings of the staff group.

The staff group has met a number of times and agreed to recommend changes substantially as follows in the report of examination with respect to the classification of assets and schedules of loans:

1. That the present classifications of loans (II, III and IV) be changed to UNSATISFACTORY, DOUBTFUL and ESTIMATED LOSS. That the definitions of the loan classifications be eliminated except that a definition of "UNSATISFACTORY" be included along the following lines: "Loans, or portions of loans, not classified as doubtful or estimated loss but with unsatisfactory credit characteristics, as noted in the examiner's comments."

The foregoing would contemplate that the one schedule would include all loans criticized because of unsatisfactory credit characterisrics, except purely technical exceptions which would continue to be included in the schedule of other loans especially mentioned, possibly under the caption: "Loans subject to technical and similar exceptions."

2. The definitions of the schedule, "Summary of Examiner's Classifications," would be eliminated except the definition of "UNSATISFACTORY" which would read: "Book assets, or portions thereof, not classified as doubtful or estimated loss but which appear to be unsatisfactory as bank assets. Included in this classification are loans so classified on page 11, that portion of the bank's fixed assets considered excessive, holdings of other real estate, and other undesirable assets as scheduled."

It was the consensus that there is no need to define "doubtful" or "estimated loss" as used in reports of examination.

3. There was agreement that the 18 months' average for Group 2 securities should be dropped and that Group 2 securities should be appraised at market value. There was also agreement that net depreciation in stocks and defaulted bonds should continue to be charged off.

I recommend that the Board give consideration to approval of revision of the "Uniform Agreement" to provide for the recommended changes in the form the report of examination as set forth above.

Staff representatives of the Office of the Comptroller of the Currency and the F.D.I.C. were strongly of the opinion that banks should be required to make some provision for market depreciation in securities other than Governments and general obligations of States. They proposed that:

(a) U. S. Government securities and general obligations of States be appraised at amortized book value;

(b) A certain portion, say 25%, of market depreciation in other Group 1 and Group 2 securities be charged off at every semi-annual examination. (A larger percentage, presumably 50%, would be charged off in the case of a State bank examined once a year.)

They were also concerned about the growing volume of municipal issues, both general obligations and revenue issues, and the difficulty of properly classifying many of them, especially the smaller ones. In view of the growing volume it was felt that more of such issues would come into the hands of banks. Some time ago the F.D.I.C. had to deal with a few non-member banks in the far south that had over-invested heavily in unseasoned small municipal issues but this situation has not arisen in State member banks to a serious extent nor, so far as we know, in national banks. There are a few State member banks, however, that hold relatively large investments in municipals which have undergone a considerable shrinkage in market value following the lowered market for U. S. Government securities.

In connection with the proposals regarding investments the Board's representatives took the position that any such change in policy would effect a complete reversal of the position taken in 1938

when the agreement discarded market values as the basis for appraisal of securities of investment grade. Furthermore, it would be a breach of faith with the bankers who have properly relied upon the assurances given in the agreement.

I recommend that the Board uphold this position and disapprove revision of the Uniform Agreement with respect to securities except as heretofore recommended. Consequently, in any negotiations with other supervisory agencies regarding revision of the Uniform Agreement, I would take the position, with respect to securities, that:

1. There should be no change with respect to Group 1 securities which should continue to be appraised at amortized book value.

2. Group 2 securities should be appraised at current market rather than on the present 18 months' average price basis and any market depreciation should continue to be classified as DOUBTFUL (presently III).

3. There should be no change with respect to Group 3 and 4 securities (stocks and defaulted bonds) and all net market depreciation in such securities should continue to be classified as ESTIMATED LOSS (presently IV).

It should be noted that the revision recommended with respect to loans does not contemplate a change in principle but proposes a simplification of terms. Also, it is believed that abandonment of the 18 months' average as a basis for valuation of Group 2 securities is in the interest of simplification and does no violence to principle in current circumstances because member banks are not permitted to purchase securities in that category, hold only a negligible amount of such securities at the present time, and, in any event, are not required to charge off any market depreciation in such securities.

With further reference to securities, I would advocate that any revision of the Uniform Agreement should include:

A statement that the 1938 agreement was intended to apply to recognized sound investment practices of banks and that it was not intended to be a protection to banks with undue concentrations in securities other than U. S. Governments. Also, that supervisory authorities may properly ask for corrections in such cases.

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Substance of Governor Clayton's Recommendations Regarding
Uniform Examination Agreement of 1938

The more important changes recommended by Governor Clayton, after considering the views of the staff group, are as follows:

1. Change the present designations of loan classifications II, III and IV to UNSATISFACTORY, DOUBTFUL and ESTIMATED LOSS, respectively; and eliminate the definitions of III and IV on the ground that these definitions are not needed.

2. Drop the 18 months' averages for Group 2 securities and appraise them at current market values. Consequent market depreciation would be classified as DOUBTFUL (present III).

Governor Clayton expressed the view that abandonment of the 18 months' averages for Group 2 securities would be in the interest of simplification and would do no violence to principle in current circumstances, because member banks are not permitted to purchase securities in that category, hold only a negligible amount of such securities at the present time, and, in any event, are not required to charge off any market depreciation in such securities.

The memorandum states certain other proposals of staff members from the Comptroller's office and the F.D.I.C. for further changes with which Governor Clayton disagrees, because they would be fundamental. It is believed, however, that they will go along with Governor Clayton's recommendations.

With reference to securities, Governor Clayton recommends that any revision of the Uniform Agreement should include:

> A statement that the 1938 agreement was intended to apply to recognized sound investment practices of banks and that it was not intended to be a protection to banks with undue concentrations in securities other than U. S. Governments. Also, that supervisory authorities may properly ask for corrections in such cases.