June 21, 1938.

In the light of the foregoing considerations, the Board concluded that the general objectives would be best served by:

1. (a) Abolishing the "slow" column in all reports of examination, while retaining the present "doubtful" and "estimated loss" columns;

(b) Reserving elsewhere in the examination report a space for comments by the examiner on such other loans as may require the special attention of the officers and directors of the bank.

2. Discontinuing the schedule, introduced into examination reports in 1934, showing a computation of net sound capital, arrived at by deducting from the bank's capital the totals of the "doubtful" and "loss" columns as to loans, and depreciation shown by current market quotations in securities.

3. (a) Discontinuing in examination reports the listing of a bank's entire portfolio of securities* with their current market quotations;

(b) Confining the listing of securities to those in default (the depreciation thereon to be classified as estimated loss as at present) and to such other securities as the examiner has reason for considering doubtful, not solely because of current market quotations, or which for any good reason the examiner believes should be called to the attention of the bank's officers and directors;

(c) All securities other than those in default to be allowed at amortized book value with premiums periodically written off;

(d) Insistence upon provisions that banks set aside adequate reserves against their investment accounts and that until such reserves are provided, all net profits from the sale of securities be impounded, and that so long as a bank is faced with asset problems, whether in securities or otherwise, earnings be rigidly conserved.

---

*A complete list of all securities to be furnished, however, for the information of the supervisory authorities.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

4. Modifying the Comptroller's Regulation

(a) To do away with sole reliance upon private rating agencies in determining sound standards for investment by banks; and

(b) To permit banks to resume extension of credit to local business concerns by purchase of unregistered securities issued by such concerns, provided such securities are amortized 50 per cent over a period of 10 years.

The majority report proposes:

1. To eliminate the "slow" as well as the "doubtful" and "loss" loan classifications, replacing them by Roman numerals II, III and IV, these new designations to be interpreted by printing on the examination reports definitions indicating that the column to be headed II is for listing loans that the examiner considers somewhat doubtful, column III is for loans considered more doubtful, and column IV for loans in which a definite loss is estimated.

2. To retain the schedule showing net sound capital, arrived at by deducting from the bank's capital the totals of the "doubtful" and "loss" columns as to loans, and deducting also in addition to depreciation in defaulted securities the net depreciation, as shown by current market quotations, in what is to be known as Group II securities (these being securities that are not in default but are below the first four highest ratings of the private rating agencies); and disregarding either appreciation or depreciation in Group I securities (which includes the four highest ratings).

3. To continue the listing and pricing, based on current market quotations, of a bank's entire portfolio of securities.

4. To modify the Comptroller's Regulation

(a) By eliminating the restriction of investment to registered securities, rated by the private rating agencies; and

(b) Permitting banks to purchase the securities of local business concerns on an amortized basis.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

1. The Board feels that while the elimination of the "slow" classification is an improvement, it would be preferable in the interest of simplification, to retain the "doubtful" and "loss" classifications which are descriptive and understandable, rather than to substitute the Roman numeral designations and printed definitions, having in effect two "doubtful" columns, dependent upon degree of doubtfulness. Assuming, however, that the definitions to be issued will be sufficiently explicit and that they will be observed by the examiners so as to avoid listing in one or the other of the "doubtful" columns loans now classified as "slow", because of maturity, and assuming further that the banks will not be put under pressure to liquidate loans that are sound by reasonable standards, the Board feels that this part of the proposed program is acceptable in the interest of uniformity.

2. Retention of the computation of net sound capital, introduced only a few years ago into bank examination reports is, in the Board's opinion, unnecessary and undesirable, since this computation rests in large measure upon current market fluctuations that may reflect abnormal conditions or speculative or distress sales, rather than true value, and since it tends to treat bank holdings of securities (other than Group I) on a speculative rather than on an investment basis.

3. Continuing to list and price a bank's entire portfolio of securities places further emphasis upon fluctuating market quotations rather than upon fundamental investment values, in the

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Board's opinion; however, the Board feels that the proposal to compute net sound capital by deducting depreciation in Group II and disregarding either depreciation or appreciation in Group I represents an improvement over existing practice.

4. The Board is in accord with the proposed modification of the Comptroller's Regulation to drop from the regulation the reliance upon private rating agencies, and to permit banks to purchase the securities of local business concerns on an amortized basis.

While the majority proposals, in the Board's judgment, fall short of furthering the general objectives to the extent necessary to give definite assurance to the banks that they will not continue to be subjected to pressures for liquidation of sound loans and investments, during periods of business decline, the proposals represent on the whole an advance over existing procedure, particularly in the case of the modification of the Comptroller's Regulation.

The Board, therefore, is prepared to join in the majority report, for the purpose of achieving uniformity of procedure by the three Federal bank examining agencies in accordance with what is conceived to be one of the objectives of reviewing and reconsidering the entire subject at this time.

In so doing, however, the Board desires to express the view that the subject should not be considered closed to continued review and modification in the direction of further simplifying and

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

clarifying the standards, improving the procedure and otherwise bringing bank examination policies and practices into conformity with present day credit and business conditions and requirements, for the purpose of protecting not only the depositors of the banks and the banks themselves, but the broader public interest. That purpose can best be achieved, in the view of the Board, by modifying such policies or practices as may remain tending to have the perverse effect of inducing credit contraction in periods of business decline, when such contraction accentuates deflationary forces and thus delays recovery, while failing, in periods of business expansion, to improve the quality of bank assets sufficiently, or to establish reserves adequate, to offset losses and depreciation in depression. The full realization of this purpose, insofar as bank examination policies can contribute to it, will remove one factor, in the Board's opinion, tending to contribute to the accentuation of booms and depressions and to militate against a greater degree of economic stability.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis