This is important copy

August 18, 1937.

Honorable Leo T. Crowley, Chairman,
Federal Deposit Insurance Corporation,
Washington, D. C.

Dear Leo:

Since receiving your personal letter of April 30 with regard to examination policy particularly with reference to depreciation in U. S. Government securities, I have had an opportunity to discuss this matter extensively from time to time with various members of the Board and of the staff. In reply I would like to outline informally my own views, which are not necessarily those of the members of the Board, with whom I have not taken this up as a formal Board matter. I appreciate having the benefit of your full and frank discussion, and while I would not undertake to explore all of this important matter by letter, I feel that I ought to emphasize what from my standpoint are the fundamental considerations which should underlie examination policy.

First of all, I consider it of primary importance to have bank examiners subject to policy based upon a broad conception of the monetary and credit requirements of the nation. I believe that great harm has been done in the past and could be done in the future by bank examiners appraising bank assets on the basis of market, forcing disastrous liquidation in times of depression and encouraging over-expansion in times of high prosperity. I am convinced that examination must be correlated with central banking policy, encouraging banks to maintain, if not to expand, their deposits during depression and insisting on conservatism during periods of high prices. I am not referring, of course, to individual cases, as it is obvious that any bank which is following unsound practices must be brought into line regardless of the general situation. But to put the general proposition in another way, it is wholly inconsistent for certain Federal credit and supervisory agencies, such as this Board for instance, to follow a given policy with reference

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to bank credit while bank examiners generally are influencing banks in the opposite direction. Yet this is precisely what has happened in the past with disastrous results, and what may happen in the future if bank assets are to be appraised at all times on a market basis. The view that quoted market value is true value cannot be supported on the basis of experience; in fact, I believe that market quotations frequently give a false and artificial value, reflecting, in varying degrees, the effect of trading rather than of bona fide purchasing and selling.

Nor do I believe that the exclusive function of examination is to disclose the solvency of a bank. While this is unquestionably an important purpose, I feel that it is possibly of even greater importance to derive from bank examination a comprehensive picture of bank management and the trend of banking practice, so that the supervisory authority may focus attention on and seek to correct developments which not only threaten the solvency of particular institutions, but are unsound from the standpoint of national policy.

As to the question of bond investments of banks, I share your feeling that there has been too much of a tendency on the part of bankers to trade in and out, not only with corporate and municipal bonds, but with government issues as well. A bank's investment in bonds should be limited to high quality issues so as to provide a true secondary reserve. And the amount of the portfolio normally should be maintained in relationship to the amount and character of the bank's deposit liabilities and other corporate responsibilities and should not fluctuate through sales and repurchases in the attempt to realize from market swings. The motive behind such trading is not alone the desire for profit, as bankers frequently dispose of bonds without profit or at an actual loss for fear the market is due to go off and that the resultant shrinkage in the value of their portfolio might impair the bank's capital. Thus the emphasis on quoted value induces action which aggravates the inherent instability of market quotations. This emphasis should be removed and the banks of the country should be assured that market depreciation in their high grade bonds does not in fact impair capital nor does it warrant criticism by an examiner. Such an assurance would prevent the major part of the "trading" by banks, improve the market position of such bonds, and give to the bond portfolio a true investment character.

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Whatever arguments may be offered in behalf of the proposition that depreciation in high grade bonds should not be classified as loss, such arguments would obviously be all the more forcible with reference to U. S. Government obligations, since their payment at maturity is as certain as the government itself. Leaving aside, for the moment, the question of where the line of quality should be drawn, those securities above the line should be treated as permanent investments to maturity and no depreciation from book value based upon market fluctuations from time to time should be treated as loss.

From your letter I take it that you are in general agreement with the above principle, but that your organization applies it to U. S. Government securities only, and even when so limited, there is an important exception to the application of the rule. Where the book value is above par, your organization requires that any market depreciation down to par be shown as loss, but does not make this requirement as to depreciation below par. With this exception I cannot agree, nor with the limitation of the rule to U. S. Government securities alone. I recognize that there is some force to the argument that since a government obligation will be paid at par, depreciation below par may be disregarded. It seems to me, however, that this provides an illogical preference for bonds purchased at par or below, thus in effect discriminating against high coupon bonds and in favor of low coupon bonds. The market quotations of the various government issues are based not alone upon the maturity of the bonds but upon the coupon rate as well. Thus a high coupon bond at $110, for instance, may be just as reasonably priced as a low coupon bond at, say, $98. If the general list of governments should fall five points there would seem to be no reason why the shrink in the high coupon bonds should be classified as loss whereas the shrink in the low coupon bonds should not be so classified.

I am not arguing that a bank should be permitted to carry bonds at a premium indefinitely. What I do hold, however, is that a bank is justified in carrying a government bond at its cost whether above or below par so long as the premium, if any, is amortized regularly at such a rate as will bring the bond down to par at call date or at maturity if there is no call date. Such amortization in form is in reality an adjustment of the current income to the going interest rate for government securities. Thus when the average of all long bonds yields 2½ percent, a coupon

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bearing $3\frac{1}{2}$ percent represents both an interest return at the going rate plus a margin for amortizing the bonds to par at maturity. I do not perceive that such a rule would complicate the treatment of high grade securities by examiners. On the contrary, it seems to me it would simplify the examiners' task.

As to limiting the principle to government securities, I believe there is ample logic and considerable practical ground for extending the principle to cover all high grade securities. Any line drawn must of course be somewhat arbitrary, but there would seem to be justification in determining the line upon the basis of ratings commonly used as a measure of quality for bonds generally. It would be my suggestion that bonds of the first four grades as classified by the standard rating agencies might well be included in the so-called Group I securities. If such high quality bonds were accorded the suggested preferential treatment respecting market depreciation, it would seem clear that banks would limit their purchases more and more to such securities and would cease buying the speculative grades, a practice which you and I both deplore.

By way of summary, it seems to me that the treatment of depreciation in securities suggested above, while a liberalization of present examining practice, would improve the standard of bank investment policy.

I was glad to note from your letter that your Corporation is willing to consider amending its present rules for handling realized security profits and losses and the market appreciation and depreciation of the securities held by insured banks. It is my conviction that the present is an appropriate time for a discussion along these lines and that all three of the Federal bank supervisory agencies should adopt a uniform policy and as a part of the same program should endeavor to secure the fullest possible support of such a uniform policy by the bank supervisors of the various States. Your letter, however, implies that as a condition to such a change in the rules, you would expect any profits realized from the sale of securities to be isolated in reserves. I trust you will be willing to reserve final judgment on that particular point. It seems to me that bond profits are the same as any other profits made by a bank, and that the principles of sound bank management require that a generous portion of earnings from any source whatever be carried to reserves for loss or contingency until the bank has built up adequate reserves. When this situation has been attained, however, I think it is entirely

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arbitrary and unreasonable to require that profits either from bond sales or from any other source should be impounded. After all, this question is bound up in the general question of dividend policy which will only be controlled when the supervisory agencies have full power to insist upon sound management, including conservative dividend policy.

Should you feel that this exchange of letters affords a basis for discussion, I would be happy to hear further from you and to cooperate in every way in bringing about the necessary discussions.

With kind personal regards, I am

Sincerely yours,

M. S. Eccles,
Chairman.

ET:b

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