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FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON

September
12
1938

Honorable Marriner S. Eccles, Chairman,
Board of Governors of the
Federal Reserve System,
Washington, D. C.

Dear Mr. Eccles:

Thank you for your letter of July 22 and the copies of the schedules to be used by Federal Reserve bank examiners in examinations of State member banks. So that you may be currently advised, we enclose copies of the corresponding schedules adopted by the Federal Deposit Insurance Corporation for use in examinations of State non-member insured banks.

The Corporation's revised examination forms have been worked out in collaboration with the Executive Committee of the National Association of Supervisors of State Banks and State Authorities generally. The forms have been thoroughly reviewed and discussed during the last several months at meetings of the Executive Committee in Washington and at meetings in New York, Atlanta, Chicago, Topeka, and Salt Lake City, with the Supervising Authorities representing the States adjacent to these cities.

Needless to say, many diverse and conflicting viewpoints have been expressed and reconciled. Some changes have been made in the forms since the original drafts were considered last February and March so that the new forms would be acceptable to as large a number of States as possible. A minority of the States are inclined to continue their present practice of pricing and appraising all bonds at market, but general uniformity will be definitely accomplished. The Corporation and those States adopting the examination program believe that the new forms are a marked improvement over those heretofore used and that the program will result in not only more uniform standards, but also in more accurate and effective examinations and supervision.

As you stated, there are several differences between the schedules adopted by the Board of Governors and those approved by the State Authorities and this Corporation. While recognizing the lack of identity in all details, we do feel that the Corporation's schedules are in line with the approved classification definitions and are consistent with the broad purposes of the agreement announced by the Secretary of the Treasury with respect to coordination of bank examination policy and procedure.

The reason for including a memorandum of security depreciation immediately following the Capital Account Analysis is specifically stated in our examination report form. The amount shown in this memorandum "is for information purposes and is to be taken into account in connection with dividend policies of bank and any proposed retirements or reductions of capital stock, notes or debentures".

Section 12B of the Federal Reserve Act, as amended, imposes upon some three thousand State non-member insured banks the necessity of securing the prior written consent of the Federal Deposit Insurance Corporation to all retirements or reductions of preferred capital. It is our understanding that the consent of the Board of Governors of the Federal Reserve System is not generally required with respect to corresponding action by State member banks. Our position with regard to the maintenance of adequate capital is known to you and I feel that we are in substantial accord on that subject.

In addition to the depreciation in securities shown by the memorandum to which reference has been made, the Corporation before granting its consent to capital retirements gives consideration also to a number of other factors, such as potential loss in contingent liabilities, adequacy of fidelity coverage, subordinated claims, and general asset condition, which may or may not affect a bank's net worth. As in the case of security depreciation, none of these are included in the Capital Account Analysis.

We feel, therefore, that this memorandum item is essential in view of the requirements of law and of Corporation policy respecting retirements of capital. We hold that the general policies of supervisors should be available and well known to bank managers not only with respect to capital retirements but with regard to other matters also. We are sure that you will agree that we cannot exclude mention from examination reports of an influential factor in the determination of dividend policy or the advisability of capital retirements. We are sure that you will agree also that it is impracticable to use one form of examination report for banks which have preferred capital and another form for banks which have none.

The purpose of the memorandum items immediately following the Recapitulations of Securities by Credit Quality and the Estimated Market Value column of the Recapitulation of Securities by Class Diversification is to afford information as to the probable cash value of a bank's securities on the date of examination. This data, while not of greatest significance in well managed institutions, is none the less informative. Certainly as a part of any comprehensive analysis of a bank's securities their market value is a consideration along with their distribution by credit quality, by class diversification, and by maturity, the comment and figures indicating the extent of in-and-out trading in the market, the information as to the amount of valuation allowances established and maintained, and certain other data included in the report. We think that no lasting good is to be gained by failing to reveal all relevant information to the directors and officers of banks. Surely, bank management is entitled to all available data which may influence the conclusions and policies of bank supervisors.

These memorandum items, however, are not as a rule used in an examiner's appraisal of a bank's securities. Appraisal methods are covered in the examination program mutually adopted and I am informed that the schedules of the Board of Governors and of the Corporation in this connection are in approximate conformity.

The agreement concerning classifications treats only with the disposition of certain types of depreciation in securities. With regard to the inclusion in Classification II of the lower of book or appraised value of securities in which investment characteristics are distinctly or predominantly speculative, securities in default, and corporate stocks, the position of the Corporation was first stated in my letter to you of February 9, 1938. The following paragraph is quoted from that letter:

> "It also should be mentioned that if the Slow column were appropriately renamed, its general usefulness would be greatly enhanced. While at present loans of unsatisfactory credit quality and other real estate, not classified as Doubtful or Loss, may be included in the Slow column, there is no place in the examiner's summary of criticized assets for the inclusion of sub-standard securities. If the emphasis of the caption of the Slow column were upon the quality of assets or upon their general desirability as bank holdings, securities of inferior grade could be included. The present word "Slow" precludes such inclusion, since many issues of a sub-standard character are marketable under certain circumstances. Altering the caption of the column would, therefore, permit recapitulation in examination reports of all assets, not Doubtful or Loss, which are unsatisfactory for banks".

In our opinion, inclusion in Classification II of the lower of book or appraised value of speculative and defaulted bonds and corporate stocks is consistent with the general definition of that classification: "book assets, or portions thereof, which appear to be of unsatisfactory quality as credit risks or otherwise unsatisfactory as bank assets". Moreover, such securities cannot be purchased legally by member banks of the Federal Reserve System. Although there are no Federal restrictions against the purchase of this type of securities by State non-member insured banks, their acquisition is not viewed with favor by the Corporation. To exclude securities of this category from Classification II would be inconsistent, therefore, with law, with regulations, and with supervisory policy, and could be interpreted by banks to mean that such assets are of satisfactory quality and included in Classification I.

I trust that the foregoing will clarify the concepts of the State Authorities and ourselves and will provide satisfactory explanations of the points raised in your letter.

Sincerely yours,

(signed) Leo T. Crowley

LEO. T. CROWLEY
Chairman

September 16, 1938

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

My dear Mr. Crowley:

In the absence of Chairman Eccles, I am acknowledging your letter to him of the 12th, with which you enclose copies of the schedules to be used by the bank examiners of the Corporation in examinations of State non-member insured banks.

It is noted that you recognize the lack of identity in all details between the schedules adopted by our Board and those approved by your Corporation, but feel that your schedules are in line with the approved classification definitions and are consistent with the broad purposes of the agreement announced by the Secretary of the Treasury with respect to coordination of bank examination policy and procedure. This is a matter of opinion.

It is also noted that you state that the schedules forwarded with your letter and their interpretation as therein stated represent the concepts of the State Authorities as well as yourselves.

Sincerely yours,

Ronald Ransom,
Vice Chairman.

RR/ac