SUPPLEMENT TO JULY 10, 1968, STATEMENT REGARDING MUNICIPAL BOND RATINGS AND THE CREDIT PROBLEMS OF SMALL MUNICIPALITIES

(Responses to questions in Outline of Points to be Covered in Statement by Bank Supervisory Agencies)

"In view of the dominant position of commercial banks in the municipal securities market, comment on what may be done: (a) to reduce the vulnerability of State and local government borrowings to the fluctuations of credit availability in response to the exercise of credit policies, and (b) to assure greater competition for general obligation municipal securities with respect to both underwriting and acquisition for investment."

The first segment of this question (a) is concerned with the impact of changes in credit policies on the financial needs of State and local governments. In the conduct of monetary policy, the monetary authorities must necessarily give consideration to the requirements of all users of credit, including governmental units. At times, no doubt, the impact of credit policy may be burdensome to those sectors, such as governments, that are heavy users of fixed capital. Because monetary policy is a generalized instrument and also because it is to serve the broad public interest, each user of credit must be expected to assume his fair share of the burden of restraint or the benefits of easier credit. Accordingly, governments should not expect to be immune from the consequences of credit policy. To insulate them against vulnerability would be inequitable, and could also frustrate monetary policy significantly under certain circumstances. Nevertheless, it is no doubt important on occasion to maintain the ability of municipalities during periods of credit stringency to proceed with capital projects already underway and continue other essential services. This could be accomplished without negating monetary policy objectives by such means as more effective long-term planning and better spacing of projects over time.

In regard to greater competition in the issuance and distribution of general obligation municipal securities, present practices for financing of States and their subdivisions of government have evolved over the long history of the United States. These practices are based upon laws governing municipal corporations in each of the 50 States. The statutes in turn are applicable to literally thousands of political subdivisions that have been granted statutory authority to create debt and collect revenues. Any change contemplated in State and local financing, therefore, would have to take into account some formidable statutory barriers and also existing Federal-State relations. In addition, there are knotty problems involving financing practices and taxation, which would have to be solved.

Various proposals to change current arrangements for issuing securities and placing them with investors have been advanced from time to time. An evaluation of their relative advantages and disadvantages, however, is really outside the scope and responsibilities of the Federal Deposit Insurance Corporation for bank supervision and administration of Federal deposit insurance. The importance of the problem is fully recognized, nevertheless, because the well-being of our local government units is essential to the well-being of the banking system and the economy as a whole.

"Describe your agency's regulations governing commercial bank investments in municipal securities, with particular reference to the status accorded to bond ratings in the four highest grades."

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, and the Executive Committee of the National Association of Supervisors of State Banks jointly issued a statement in 1938 with respect to uniform bank examination procedure. The statement was subsequently revised in 1949. (See the accompanying excerpts from the Annual Report of the Federal Deposit Insurance Corporation for the year ending December 31, 1938, pp. 61-78 and the Federal Reserve Bulletin, July 1949, pp. 776-7.)

One section of the statement was concerned with the appraisal of securities--including municipal obligations--in bank examinations. (In 1938, corporate securities comprised a major element among bank investments, whereas more recently they have been almost totally eclipsed by municipal securities.) The purpose of the statement was to bring about uniformity among the supervisory authorities with regard to the basis for valuing securities. Under the terms of the agreement, securities deemed to be of bank investment quality are to be valued for bank examination purposes on a cost basis. Other securities, i.e., securities not measuring up to this qualitative standard, are to be valued at market prices prevailing at the time of the examination.

With respect to the securities comprised by the investment category, the language of the agreement states "this group includes general market obligations in the four highest grades and unrated securities of equivalent value". The "distinctly or predominately speculative" issues, according to the agreement consistof obligations "in grade below the four highest and unrated securities of equivalent value".

The procedural agreement among the bank supervisory agencies contemplates the use of ratings as one indicator of investment quality. But investment grade issues are not limited exclusively to those rated in the for highest grades. Furthermore, examination practices has throughout its entire history recognized that appraisal of assets is solely the responsibility of the examiner at the time that he performs his work. In making this appraisal he is expected to use the best information at hand. Whether a security in a bank portfolio is of suitable quality for bank investment purposes is a judgment based on facts. A qualitative rating with respect to that security published by an investment advisory service is but one piece of evidence to be considered by an examiner in reaching that judgment.

The bank supervisory authorities have always been concerned with the quality of bank assets, whether they are part of the loan portfolio or classed as bank investments, and all bank assets are expected to measure up to a standard of acceptability. If it is reasonable to expect that interest on the obligation--whether on a loan or on a security--will be paid on the due day as well as the principal amount at the maturity of the obligation, then the obligation is deemed suitable for bank investment purposes. To be sure, these performance determinations are in the nature of estimates because of the impossibility of making exact forecasts, but the legal status of the obligation and the past record of the obligor as well as its present financial strength and future prospects are all relevant considerations and generally provide a firm basis for the estimates.

Ratings of the investment advisory services, irrespective of where in the spectrum of ratings, do not--and cannot--alter the facts. Nevertheless, an expression of an opinion as to quality by a major investment advisory service is worthy of consideration when an examiner is arriving at a judgment, although it is not conclusive.

"What standards or guides does your agency have by which your bank examiners can evaluate the credit quality of municipal securities held by banks that are either unrated by a bond rating service or have been assigned a rating below the four highest grades?"

The Federal Deposit Insurance Corporation's Manual of Examination Policies has for many years included the following section for the purpose of guiding examiners in the classification of municipal securities:

THE ANALYSIS OF MUNICIPAL BONDS

Because bank holdings of municipal bonds are growing rapidly and the published credit ratings cover only the major and better-known issues, it will be necessary for the Examiner to develop some skill in analyzing these credits. There are literally thousands of political subdivisions whose obligations are found in bank portfolios. Very often the Examiner will be obliged to judge the quality of these credits on the basis of information in the bank's files.

A study of the economic background of the community furnishes the basis for practically all analyses of municipal bond credit quality. Even if the debt burden is heavy, a community with a strong economic footing is quite likely to meet its obligations. Population data furnish good clues with respect to economic conditions, and the products of the area are some indication of basic strength. Among other measures useful to the analyst in judging the economic background of a community are per capita income, sales of electric energy, or the number of telephones installed.

The past record of performance in debt management is an important guide in judging both the ability and the willingness of a community to service its debt. Primary interest should center on the past ten years, for poor financial administration seldom becomes good overnight. The total amount of debt outstanding and its structure during reçent years furnish an important point of departure in the analysis. Study of the debt structure will reveal the portions incurred for general purposes, highway construction, schools, utilities, and other identifiable purposes. A good quality credit will be characterized by balance in its proportions as well as reasonableness in the total. A rapid increase in the amount of outstanding debt, unless compensated by growth in the local economy, raises a question as to the ability of the community to service the debt successfully. Essential to good credit standing is a satisfactory record for current financial operations. This is one of the easier factors for the Examiner to judge. The financial and operating statements will show whether income is sufficient to cover expenses with an adequate margin for the retirement of debt.

For purposes of convenience in analysis, municipal securities may be divided into the following three groups:

(1) General obligations
(2) Revenue issues
(3) Obligations which are hybrid in character

Historically, the obligations issued by a municipality have been secured by a pledge of the full faith and credit of the issuer. These are known as general obligations and their quality is determined by the community's ability to bear the debt burden. The ratio of debt to assessed value has long served as a useful yardstick for measuring the credit quality of general obligations. However, experience has demonstrated that no specific debt ratio is equally applicable in all instances. For communities whose principal source of income is derived from taxes levied on property, the debt ratio affords a significant test. Years ago practically all municipalities relied heavily on general property taxes for support. Profound changes have now taken place in municipal finances and new sources of revenue have been developed--for example, tax on sales or income. It would be inappropriate to place great stress on the debt ratio of a community which relies only to a limited extent upon the general property tax for income.

Some municipalities and other political subdivisions of States have issued securities whose debt service is dependent solely upon revenue derived from furnishing specific goods or services, such as electric energy or water. This type of obligation does not carry the unqualified pledge of the issuer's credit. Irrespective of the nature of the project financed by revenue bonds, there is an orderly way for the Examiner to proceed in analyzing credit quality. It is necessary to make a study of revenues and expenses both in terms of historical facts and the projected estimates. The object of this study is to ascertain the margin of protection for debt service. Tests for the adequacy of the margin vary with the type of facility, and in some fields, for example, toll roads, it is extremely difficult to assemble the factual information needed to estimate or establish a record of performance. Although analysts have developed various "rules-of-thumb" for coverage ratios, there are no hard and fast standards. However, some margin of protection is needed, and generally speaking, the wider the margin the better the credit.

In the field of municipal credit there is a growing number of issues which do not fit neatly into either the category of general obligations or revenue securities. These issues are hybrid in character, possessing in varying degrees some of the qualities of both groups. Most commonly, there is a pledge of revenues from a specific source to cover debt service and in addition there may be a general pledge of the full faith and credit of the obligor. Broadly speaking, it is necessary to make sure that one of the pledges--either the specified revenues or the full faith and credit of the issuer--is fully sufficient to support the credit. A mediocre general obligation plus an inadequate source of revenue will not add up to a high quality credit.

Finally, it should be observed that prejudice against the credit quality of any particular class of security is wholly unwarranted. There are good revenue obligations and there are bad ones, just as some general obligations are much better than others. Certainly there is no merit in the contention that any general obligation is better than a revenue issue merely because it has a pledge of the full faith and credit of a State or a political subdivision thereof. For analytical purposes, the controlling question is not the class of the security or the terms of the pledge--rather it is the margin available to protect the debt service of the obligor.

Obligations issued by local housing authorities are to be included with obligations of States and political subdivisions. They are, in fact, a special type of revenue issue.

"What data does your agency require of a bank under the agency's supervision to support its view that the unrated municipal securities or municipal securities with ratings below the four highest grades, which are held in its bond portfolio, qualify as 'investment securities'?"

The section of the Federal Deposit Insurance Corporation's bank examination report form covering Investment Policies includes the following question:

> "5. State names and types of statistical or advisory services to which bank subscribes in connection with its securities account and comment upon the adequacy of each service and credit information."

The Corporation's Manual of Examination states:

Credit Files

Question 5 on Page 6 requires comment concerning the names and types of statistical or advisory services to which the bank subscribes, as well as upon the adequacy of the credit files maintained in connection with the securities portfolio. Failure to maintain credit files should be criticized, and deficiencies in such files should be noted in the description and comments column of the Detailed List of Securities. Adequate credit files are particularly important in connection with unrated issues and in instances where a bank's investment is relatively heavy.

The Legal opinion with respect to an individual municipal credit may appear as a separate document, copies of which are held by investors, or it may be printed on each bond. In the latter circumstances, the offering circular and prospectus should furnish details as regards the opinion, including the identification of the Municipal Bond attorney. Since the securities are not likely to be available for inspection, the Examiner may rely on the information in offering circulars, prospectuses, letters of acknowledgement, and other records for information with respect to the Legal opinion. If the Legal opinion is a separate document, then the credit files should include a copy or some indication as to its whereabouts. Lack of evidence as to the legality of a municipal credit should be noted as a deficiency in the bank's credit files.

"Inasmuch as only about 125 commercial banks have established municipal security departments with personnel trained in municipal security analysis, do the other banks encounter difficulty in furnishing the requisite information to justify their holdings of municipal securities that are not with ratings in the four highest grades? How about the smaller banks?"

Irrespective of whether the bank under examination by the Federal Deposit Insurance Corporation is large or small, the viewpoint of reference in the examination process is the bank's total investment policy and not just one segment, such as municipal securities. In each case the examiner is expected to satisfy himself that the bank has an investment policy that is appropriate to its particular situation and that management is qualified to implement the policy. The investment policy of a small bank may be quite satisfactory for its requirements even though it does not have trained municipal securities analysts or an established municipal securities department. The Manual of Examination gives the examiners the following guidance for this portion of his work.

The Investment Policy of a Bank

The adoption by a bank of a definite investment policy will facilitate the management of its securities portfolio. By "investment policy" is meant a formal program to guide the management in making decisions regarding the purchase or sale of securities. Such a program must be related to the bank's general policies and activities. Its development is the responsibility of the directors and of the senior executive officers. The principal objectives of a well reasoned policy are to provide the bank with sound earning assets and at the same time to prevent serious troubles which may result from the haphazard purchase of securities without regard for portfolio requirements. A sound investment policy will establish standards in the selection of securities regarding: (1) Credit Quality; (2) Maturities; (3) Diversification; (4) Marketability; and (5) Income.

A security which lacks credit quality has no place in a bank investment portfolio. Credit quality, however, is not the only consideration. For example, a high quality issue may be inappropriate for a bank portfolio because the maturity is too long; or its purchase may result in a lack of diversification; or it may lack marketability. Credit quality is but the first test to be applied in the selection of an issue.

The maturity pattern appropriate for a bank will depend upon its individual circumstances and Examiners should avoid the adoption of any dogmatic rule or formula for application to all banks. The maturity schedule appropriate for a bank will take into consideration the bank's prospective cash needs which reflect loan demands and fluctuations in deposits. Generally speaking, long-term obligations have a place in a bank portfolio only when it is reasonable to believe that the investment can be held to maturity. This is true because price quotations for such bonds fluctuate more widely in the market as the result of changes in interest rates than for short-term obligations of equal credit quality.

Proper diversification of a bank's investment account will avoid an excessive commitment in the obligations of a single issuer or in securities, the credit of which depends largely upon the same set of factors of circumstances. Excessive diversification, however, creates serious managerial problems. When a portfolio is composed of a multitude of issues in small blocks, it becomes virtually impossible for the management to maintain the necessary familiarity with the items in the portfolio.

A bank which ignores all considerations of marketability in developing its securities account merits criticism. Marketability standing by itself, however, is not sufficient to make a security suitable for bank investment. For example, many defaulted issues are readily marketable and subject to frequent quotations, while obligations of small enterprises and political subdivisions which have rather high credit quality may never be quoted in a recognized source of price data. The latter issues should not be deemed unsuited for bank investment for that reason alone. Examiners must classify them on the basis of the available credit data, and a reasonable investment in such issues will not properly be the subject of criticism.

In essence, a sound investment policy seeks to maintain a balance of income requirements with the safety factors of credit quality, maturity, diversification, and marketability. If a bank is too aggressive in seeking a high return on its investments, the result may be disastrous. Relatively high yields on a security are primarily a reflection of the basic investment risks

Factors to be Considered in Appraising an Investment Policy

The following topical outline is suggested as a guide for the Examiner in his discussions of bank investment policies:

(a) General Character of the Bank's Business. A thorough study of the type of business conducted by a bank is needed to determine credit requirements of customers and the degree of stability in deposit accounts. A bank serving an agricultural area or a single-industry community is likely to experience greater fluctuations in deposit volume than one operating in a community with a well-diversified economic base. If correspondent banks, large corporations, or public funds account for a substantial portion of a bank's deposits, a more liquid condition is needed than if deposits are chiefly moderate-sized accounts of individuals and business enterprises. The character and maturities of a bank's loan account are also important. It is essential for the investment policy to take into consideration seasonal variations and long-term trends in the demand for loans.

(b) Analysis of Deposit Structure. Long-term trends upward or downward in the total volume of deposits as well as changes in the composition of the accounts are important factors to be considered in judging a bank's investment policy. The accounts should be analyzed with respect to source (individual, business, public, banks, etc.) and degree of permanence, for example, demand or time, including thrift accounts. A study of account balances by size may reveal abnormal and excess balances of particular customers, unusual volumes of public funds, and other special accounts that may become particularly vulnerable. Such an analysis of savings accounts may disclose abnormal balances temporarily idle and not, strictly speaking, thrift accumulations.

(c) Capital Funds. A bank's capital funds provide the margin to absorb losses that may be sustained on all of its operations, including its investment activities. The volume of Loss, Doubtful, and Substandard classifications in loans, investments, and other assets, the size of the bank's investment in fixed assets, and the volume of losses which may arise through any specific acts or through negligence on the part of the bank are factors to be considered in judging the adequacy of this capital margin. While the total capital accounts are available to absorb losses, as a practical matter a bank will be obliged to suspend or reorganize if its losses impair capital stock (and in some cases certain other capital segregations). Accordingly, the investment policy of a bank will depend to some extent upon the availability of the capital cushion to absorb losses that may be sustained from commitments in certain types or classes of securities. Generally speaking, the smaller the capital cushion, the greater is the need for caution in the selection of investments.

(d) Economic and Monetary Factors. An endeavor to predict with any degree of assurance the future course of economic events is futile. But it is quite possible for any intelligent observer to ascertain a few basic facts about the prevailing economic climate, such as whether business conditions are stagnant, expanding, or contracting -- in short, whether times are prosperous or depressed. Study of graphic material will show whether money rates are relatively high or low and whether the financial structure of the economy is expanding or shrinking. Intelligent portfolio management will give consideration to these basic factors in formulating and executing investment policies. Preoccupation with these considerations, however, may be indicative of speculative tendencies which are unwholesome in banking.

Primary Reserves, Secondary Reserves, and the Investment Account

These terms are frequently used in discussions of securities portfolio management and policies. Since there is no general agreement on precise definitions, their terms should be used with care to avoid misunderstandings.

(a) Primary Reserves. For all practical purposes, primary reserves consist of cash and demand balances due from other banks.

(b) Secondary Reserves. As usually defined, secondary reserves consist of short-term, readily-marketable securities and other paper which can be converted into cash at little risk of loss, thereby providing the major liquidity beyond primary reserves. Other than such U.S. Government obligations as are included, secondary reserves under most definitions will consist of bankers' acceptances, open-market commercial paper, call loans to securities brokers and dealers, and other high-quality, marketable obligations having a maturity not in excess of one year.

(c) Investment Account. In contrast to the secondary reserve, whose purpose is to provide liquidity, with minor importance attached to production of income, the appropriate purpose for the bank's investment account is to produce the maximum income consistent with the safety of the principal. Since banks in the aggregate cannot liquidate their investments at the same time without collapsing the price structure for securities, it is axiomatic that the investment account of each bank should be so designed in size and nature that the securities may be retained to maturity through good or bad times. Very little reliance should be placed upon sales of items from the investment account as a source of cash. The regular spacing of maturities and the operation of the investment account as a revolving fund offers many advantages. Periodic reinvestment affords a bank an opportunity to achieve an average of the interest rates prevailing in the investment market.

Furthermore, the revolving fund program of investment results in regular collections of principal which may be reinvested or not as justified by the circumstances. Moreover, such a program enables a bank to obtain maximum yields on purchases because it may reinvest funds in securities at the long end of the maturity pattern. The maximum length of the maturity pattern for such a revolving fund will vary widely from bank to bank. Any program, however, which contemplates a maturity program in excess of ten years could only be justified in very special circumstances.

Speculative Trading in Securities

That securities should be purchased and held for income and not in anticipation of speculative profits is axiomatic. Securities may be sold to meet a shrinkage in deposits or to provide for additional loans. But a well-considered investment program will anticipate these requirements by including short-term securities in the portfolio. In many instances the cash will become available automatically from the maturity of obligations. Such arrangements avoid the dangers inherent in speculative transactions.

Generally speaking, no banker is in a position to forecast future trends in interest rates successfully. An attempt to take advantage of anticipated fluctuations in interest rates over the long-term is fundamentally a speculative venture. Nevertheless, banks sometimes will inadvertently become involved in speculating in interest trends by acquiring long-term, low-coupon issues at times when prevailing interest rates are very low. The market value of such securities will decline sharply if interest rates rise. An Examiner should be alert to this type of situation and bring it to the attention of management.

Examiners should refrain from instructing or advising banks to purchase or sell individual securities. The decision to buy or sell a security is the sole responsibility of the bank. Quite apart from the fact that Examiners have no special qualifications for anticipating price movements in the markets for securities, their primary function in their contacts with bankers is educational rather than managerial. They should rely upon intelligent criticism of a bank's investments and policies in order to bring about sound banking practices.

"Would these data requirements be more easily met, if there were available a series of factual reports, prepared by a Federal agency, that provide comprehensive economic and fiscal information for forthcoming municipal bond issues, irrespective of size of bond issue?"

Current factual reports that provide comprehensive economic and fiscal information about all new municipal bond issues would be generally helpful to bank investors as well as to nonbank buyers of these securities. Such a reporting system, however, would probably be quite costly, and the costs must be judged in terms of the benefits to be gained.

The FDIC has generally found that insured nonmember banks investing in municipal securities have managed to obtain sufficient information on the issues in their portfolios to support their investments -- particularly in those instances where the borrower is a local government unit and where the bank has access to local sources of information. In this connection, it is also important to reemphasize the fact that the appropriateness of a specific issue in a bank's portfolio can be appraised only in the context of its overall asset and liability mix -- for which purpose a factual report prepared by a Federal agency would be helpful but not decisive for the bank and the examiner.

"Would the burdens of commercial banks in justifying their holdings of municipal securities to bank examiners be materially eased, if such municipal securities were to be guaranteed by a Federal agency?"

An unequivocal answer to this question would require detailed information with respect to the nature of the Federal guaranty. The credit quality problem would evaporate if the guaranty were to pledge the full faith and credit of the United States to the support of municipal obligations. On the other hand, a limited guaranty could actually increase the work of bank examiners. For example, a cumbersome procedure for guaranteeing municipal securities might create pitfalls for the unwary, and the checking needed to make certain that all the necessary steps had been taken to qualify for the guaranty could result in a situation perhaps worse than the present.

At the same time, commercial banks are not operating under an added burden in regard to their need to justify particular securities investments to the bank supervisory agencies; or at least to no greater extent than their need to be able to defend their lending policies. The data that bank examiners review are exactly the same as those that should be considered by any well-run bank in managing its loan and investment portfolios.

"In recent years commercial banks have become by far the major source of funds for State and local government borrowing. In this context, explain the economic justification for having commercial banks employ a significant portion of their unique money creation power to acquire municipal securities, the interest income of which is tax exempt."

Commercial bank investments in State and local government obligations constitute but one outlet for long-term funds deposited with banks by savers. Banks mobilize the funds placed in their institutions and allocate them to various uses on the basis of a broad range of considerations -- including the relative attractiveness of alternative investment opportunities which may be affected by the tax status of the investments.

The impact of the tax-exempt status of interest income from municipal securities on the position of individual investors is, however, difficult to determine because legal -- rather than economic -- considerations tend to be overriding. The Federal income tax structure, for example, presents many knotty problems -- both with respect to equity among taxpayers and the consequences to the economy generally.

Statutes in the various States also confer tax advantages of one sort or another on holders of certain municipal issues. The tax treatment now accorded income from municipals as a consequence depends primarily upon Federal and State laws rather than upon economic considerations.

"Would the market for municipal securities be materially enlarged, if (a) the interest income were to be made taxable, (b) the debt service on the securities were to be guaranteed by a Federal agency, and (c) the municipality were to receive annual grants to cover one-third of the annual interest cost on the taxable securities?"

The Federal Deposit Insurance Corporation as an insurer of bank deposits and a supervisor of insured State-chartered banks not members of the Federal Reserve System claims no special competence to deal with marketing problems of municipal securities.

However, as matters now stand, investors who derive little or no benefit from tax exemption (for example, individuals in the lower income tax brackets and mutual institutions, such as mutual savings banks and mutual savings and loan associations that are not subject to Federal income taxes), do not bid for these securities when they are offered in the market. Current yields on such securities are only advantageous to investors who can derive some benefit from the feature of tax exemption. A change in tax status no doubt would affect yields, and securities which now appear attractive because of a tax advantage to certain buyers might lose this segment of the market if the law were changed. The consequences obviously would depend upon the balance of the various forces in the market place -- namely, investors seeking to find an outlet for their funds in the municipal market, investors not attracted to these securities because of yield, and the many competitive investment opportunities. Because the underwriters make a very careful study of prospective buyers in any individual flotation of municipal securities, generalizations by these dealers might be helpful in answering this part of the question.

The second segment of the question, (b), likewise concerns market reactions to a change in the investment characteristics of obligations floated by States and subdivisions. The effect of the guaranty would depend upon its precise nature. Conceivably it would be so comprehensive in character that the securities would in effect constitute an extension of Federal credit. Whether this would help the market for municipal securities or merely impair the market for Federal issues is a question that cannot be answered without additional intensive study by qualified analysts.

Part (c) of this question is concerned with a proposed subsidy to States and their subdivisions. Again, whether the proposed contribution amounting to a fraction of annual interest cost would make any difference to a credit would need to be more carefully studied. If adopted, the proposal could set other forces in motion that could neutralize the anticipated result completely.

Excerpt from ANNUAL REPORT of the FEDERAL DEPOSIT INSURANCE CORPORATION for the year ending December 31, 1938

Development of Uniform Examination Procedure Among Federal and State Bank Supervisors

At the time the Federal Deposit Insurance Corporation was created there were more than 50 State, Federal, and territorial authorities supervising banks eligible for insurance. In examining banks in the 48 States to determine their ability to qualify for deposit insurance and in developing, in cooperation with the State authorities, rehabilitation programs for a number of these banks, the Corporation was impressed by the diversity of standards and procedures which made the task of coordination of policy throughout the country difficult. One of the earliest objectives of the Corporation, therefore, was to secure improvement and uniformity of standards and procedure among the various supervisory authorities.

In 1934 and 1935 the Corporation undertook to review the principles of bank supervision with a view to providing a basis for improvement of standards, coordination of policy, and uniformity of procedure. Numerous conferences were held with other supervisory authorities. Consideration was given to the following subjects:

(1) Standards of chartering and admission to insurance;
(2) Operating standards of banks relating to capital, loans, and investments;
(3) Purpose of bank supervision;
(4) Purpose of bank examinations;
(5) Principles of classification and valuation of assets;
(6) Determination of net worth or adjusted capital account of a bank;
(7) Form or method of presentation of results of examinations;
(8) Principles underlying and methods of developing corrective programs.

For the most part, the supervisory authorities were in agreement that supervision should seek to prevent the development of unsound situations in individual banks and to correct, as promptly as feasible, such unsound situations as exist. The examination, as one of the principal tools of supervision, should present as accurately and clearly as possible the examiner's appraisal of the bank and his determination of the bank's asset, capital, and operating position, in order to form a basis for the determination of supervisory action with regard to the bank.

Classification and valuation of loans. When the Corporation began to examine banks, the practice was general among Federal and State supervisory authorities of classifying criticized loans in three categories, "estimated loss," "doubtful," and "slow." "Estimated loss" loans represented those loans or parts of loans which, in the opinion of the examiner, could not be collected. "Doubtful" loans or parts of loans were those in which there existed, in the examiner's opinion, a substantial probable loss not yet definitely ascertainable in amount, as a consequence of which the ultimate collection or value was doubtful.

There was considerable confusion, however, as to the meaning of the "slow" classification. Some examiners included in the "slow" column loans which were slow in a literal sense, were perhaps not collectible at the stated maturity, or were not strictly of a seasonal nature, regardless of the inherent soundness and collectibility of the credit. Other examiners were including in this classification only those loans which were unduly risky as to ultimate collectibility but which did not warrant so severe a classification as "doubtful" or "loss". Still other examiners were including both of these types of loans in the "slow" column.

In September 1934, a joint examiners' conference was held in Washington for all chief and supervising examiners of the various Federal agencies dealing with banks. This conference was called at the request of the Secretary of the Treasury for the purposes of establishing a uniform method of asset appraisal and of ascertaining whether or not Federal bank examiners were forcing liquidations and freezing credit through their classification of assets. An attempt was made to clarify the "slow" classification in reports of examination, and to standardize its application.

The conference adopted the following recommendation:

> "Loans which are reasonably well protected as to ultimate payment by reason of the sound net worth of the maker and/or endorser, even though their assets or a large part thereof may not be of a liquid nature under present conditions, and loans which are reasonably well protected by collateral or other security of sound intrinsic value but which, due to present or local conditions, may not be saleable at this time, should not be classified as slow.
>
> "In other words, it is believed that under present conditions the examiner should only list as slow, loans which in his opinion will become doubtful or worthless in whole or in part unless placed in proper bankable shape by the bankers."

The term "slow" was inconsistent with the definition of the classification as agreed upon at the joint examiners' conference. It did not correctly describe the type of loan to be classified thereunder and its continued use encouraged the placing of improper emphasis upon maturity. As a consequence, efforts were made from time to time to secure agreement among the supervisory authorities to discontinue use of the term and to substitute therefor some other term such as "substandard." Following extended consideration of the question by representatives of the Corporation and the Executive Committee of the National Association of Supervisors of State Banks, the latter Committee adopted a resolution recommending abandonment of the term "slow" in the examination reports and the substitution therefor of the term "substandard." The resolution is presented as Exhibit A.

At the request of the Secretary of the Treasury representatives of the Federal bank supervisory agencies held a series of conferences in April, May, and June, 1938, with a view to developing uniform procedures. On June 27, an agreement was announced whereby, in classifying assets in the examination, the Federal agencies would discontinue the use of the terms "slow," "doubtful," and "loss," and substitute therefor the numerals II, III, and IV, respectively. The agreement with respect to loans is presented as Exhibit B. This procedure was endorsed by the Executive Committee of the National Association of Supervisors of State Banks and its adoption by the various State bank supervisory authorities recommended.

All loans not criticized are placed in Classification I. The three classifications of criticized loans were defined as follows:

> II. "Loans or portions thereof which appear to involve a substantial and unreasonable degree of risk to the bank by reason of an unfavorable record or other unsatisfactory characteristics noted in the examiner's comments. There exists in such loans the possibility of future loss to the bank unless they receive the careful and continued attention of the bank's management. No loan is so classified if ultimate repayment seems reasonably assured in view of the sound net worth of the maker or endorser, his earning capacity and character, or the protection of collateral or other security of sound intrinsic value.
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> III. "Loans or portions thereof the ultimate collection of which is doubtful and in which a substantial loss is probable but not yet definitely ascertainable in amount. Loans so classified should receive the vigorous attention of the management with a view to salvaging whatever value may remain.

IV. "Loans or portions thereof regarded by the examiner for reasons set forth in his comments as uncollectible and as estimated losses. Amounts so classified should be promptly charged off."

Classification and valuation of securities. Up to the middle of 1938, the Corporation, in its examinations, valued securities on the basis of market prices.[1] The net amount by which market or estimated value of a bank's securities was below the value at which they were carried on the bank's books was regarded as an "estimated loss."[2]

In examination reports the Corporation also grouped securities on the basis of credit risk or quality. The groupings were as follows:

Group 1. Direct and fully guaranteed obligations of the United States Government, obligations issued by States and their political subdivisions, and by instrumentalities of governments on which the risk of default seemed slight, and all other security obligations placed within the first four ratings by a recognized rating service.[3]

Group 2. Obligations of States and their political subdivisions, and of instrumentalities of governments, not now in default but which appeared to involve a substantial and unreasonable risk for a bank, and all other security obligations not in default and not placed within the first four ratings by a recognized rating service;

Group 3. Obligations in default;

Group 4. Stocks.

The distribution, by groups, of securities in insured commercial State banks not members of the Federal Reserve System, as shown by examinations in 1938, is given in Table 34.

This procedure of grouping was similar to that followed by the Office of the Comptroller of the Currency. While this practice had originated in that Office primarily in connection with security valuation, it had come to be used also for the purpose of analyzing the quality of the portfolio of individual banks.

Review of principles of valuation of securities. While securities were valued on the basis of current market prices, other assets of the banks were valued on the basis of examiners' appraisals. Fluctuations in bond prices from day to day, often of an erratic character, frequently resulted in substantial changes in values between

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1 The classifications "doubtful" and "slow," which were relatively unimportant, were used in connection with local securities subject to criticism. Having no market, these were accordingly classified on the same basis as loans.

2 In 1934 the practice was adopted of disregarding any depreciation, within certain limitations, in United States Government securities. Inasmuch as these securities were generally selling at a premium the change was one of principle with no practical effect upon the current status of individual banks.

3 In 1936 provision was made by the Corporation for inclusion in Group 1 of sound, unrated issues.

examinations. The appraised values of the other assets, on the other hand, ordinarily changed little from one examination to another.

The amount of securities held by insured banks is approximately three times their capital. As a consequence, under the procedure of valuing securities on the basis of market prices, an average rise of 5 percent in bond prices would result in a 15 percent increase in the adjusted capital account of the banks. Conversely, a decline of 5 percent would reduce the adjusted capital account of the banks by 15 percent. Inasmuch as fluctuations in bond prices reflect changes in interest rates and trading pressure more than they do changes in the credit standing of individual issues, the conclusions of bank examiners and supervisors as to the adjusted capital account or net worth of the banks were largely dominated by the state of the bond market.

Table 34. BOOK VALUE OF SECURITIES

7,094 INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

	Amount (in millions of dollars)	Percentage distribution
Total securities	**2,498**	**100.0**
Satisfactory for bank investment—Group 1	**2,187**	**87.6**
Obligations of the United States Government—direct and guaranteed	1,205	48.2
Obligations of United States Government corporations and agencies, not guaranteed, and of territorial and insular possessions of the United States[1]	41	1.7
Obligations of States and political subdivisions	473	18.9
Other bonds—total	468	18.8
First grade	25	1.0
Second grade	76	3.0
Third grade	129	5.2
Fourth grade	194	7.8
Other bonds satisfactory for bank investment	44	1.8
Unsatisfactory for bank investment	**340**	**13.6**
Low grade bonds—Group 2	210	8.4
Defaulted bonds—Group 3	48	1.9
Stocks—Group 4	82	8.3
Unallocated valuation allowances (net)—deduction	*29*	*1.2*

[1] Includes joint stock land bank bonds satisfactory for bank investment.

The practice of valuing securities at the market was subject to the further objection that it placed primary emphasis upon the trading aspects rather than the investment aspects of bank purchases and holdings of securities.

It was believed that difficulties created by valuing securities at the market would be largely avoided if securities were valued on a basis similar to that used for loans. In the case of securities such valuation would be par or book value less allowances for chance of loss.[1] However, valuation of securities on the basis of par, book, or cost values encourages speculative trading by banks, unless banks are willing to segregate profits from security sales into special reserves available only for meeting losses. Unless profits are so segregated, banks in a rising market can follow the market up simply by trading, thereby establishing new and higher book or cost values. If profits from security sales are not segregated, a special motive for such trading will exist, since profits could be paid out in dividends and any depreciation in securities below book or cost could be disregarded.

Consideration of these questions led the Executive Committee of the National Association of Supervisors of State Banks on April 5, 1938, to adopt a statement endorsing a policy of valuing high grade securities at cost with premiums amortized over the life of the securities and with profits from the sales of securities isolated in reserves available for use only in taking losses. The statement of policy is presented as Exhibit C. On June 27, 1938, simultaneously with the announcement of an agreement for classifying loans and other assets, the Federal agencies announced that they had agreed upon a basis for grouping, valuing, and classifying securities in the examination. This procedure was also approved by the Executive Committee of the National Association of Supervisors of State Banks. The agreement included a statement of the position of the Federal bank supervisory authorities on the segregation of profits from the sale of securities. Under the uniform procedure the value of securities is determined by groups as follows:[2]

Group 1 securities are valued at book or at cost, less amortization of premiums, whichever is less;

Group 2 securities are valued on the basis of average market prices over the preceding 18 months. In practice the average is based

[1] One method of valuing securities under such a procedure would be as follows: Securities judged by the examiner to involve but a small degree of risk of loss would be valued at par or cost and placed in Classification I. Securities involving substantial degree of loss would be valued at par or cost less a loss allowance appropriate to the estimated risk, and the estimated recoverable value placed in Classification II. Securities involving a very great risk of loss would be valued at face less a loss allowance of large magnitude, possibly 50 percent, and the estimated recoverable value placed in Classification III. Securities involving only slight chance of ultimate repayment would be placed entirely in Classification IV. Thus Classification IV would consist of all securities with little chance of realization plus the loss allowance of securities in Classification II and Classification III.

Another method would be to value securities at cost, or book, or market, whichever was lowest, with a minimum level below which the valuation of securities of a given grade would not be required to follow the market. For example, the valuation of securities of the three highest grades would not follow the market below par; those of the fourth grade, below a given price, perhaps 90; of the fifth grade below, perhaps 80; the sixth grade, below 70; and the seventh grade, below 60. The valuation of bonds of the eighth grade or lower would not be required to follow the market below 50, but would be required to be charged off over a 5-year period. The minimum prices given here for illustrative purposes would actually be determined presumably on the basis of the approximate risk of loss from default in securities of a given grade. This plan, or some variation of it, may prove worthy of consideration at some future time.

[2] The basis of grouping securities was in all essential respects the same as that already used by the Corporation and described on page 64.

upon the mid-point between the high and low for the 18 months. Any security purchased subsequent to the date the policy was put into effect which was a Group 2 security at the time of purchase is placed in a separate group and valued at market;

Group 3 securities (obligations in default) are valued on the basis of market prices;

Group 4 securities (stocks) are valued on the basis of market prices.

The agreement is presented as Exhibit D.

As compared with the use of current market prices, the use of average prices over the preceding 18 months in valuing Group 2 securities appears to be an improvement in supervisory practice. The use of current market prices can result in serious injustices. If security prices were high in the spring, declined to low levels in the summer, and recovered again in the autumn, banks examined in the spring and autumn might be shown by the examinations to be in a relatively better position, while banks with virtually identical types of assets examined in the summer might be shown to be in a relatively poorer position. The use of the 18-months' average reduces such discrimination substantially.

In addition, use of the 18-months' average lends support to supervisory objectives. Group 2 securities are securities not of investment grade and their acquisition by banks should be avoided. In valuing securities on the basis of 18-months' average prices, bank supervisors tend to value these obligations at above the market when that market is under pressure and declining, and below the market when the market for such securities is active and prices are rising. As a consequence, banks will be encouraged to hold these obligations during periods in which the market is unfavorable and to sell them during periods when the market is active and able to absorb them. This procedure contributes not only to an improvement in the banks' position but to stability of the markets as well.

A distribution of securities by groups showing their book value, market value, and appraised value under the uniform examination procedure, is presented in Table 35. The data relate to insured commercial State banks not members of the Federal Reserve System examined during 1938. The market value of the securities is the value at which they were appraised under the original procedure. The appraised value is the value given the securities under the uniform examination procedure. The table shows that, as compared with the original procedure, the high grade securities (Group 1) have a lower value and the Group 2 securities a higher value under the uniform procedure.

Table 35. Book, Market, and Appraised Values of Securities

7,094 insured commercial state banks not members of the Federal Reserve System examined in 1938

(Amounts in thousands of dollars)

	Book value	Market value	Appraised value[1]
Total securities	**2,497,963**	**2,463,473**	**2,466,820**
Unallocated valuation allowances (net)—deduction[2]	*29,523*		
Group 1	2,187,216	2,199,134	2,183,354
Group 2	209,757	166,819	[3]185,946
Group 3	48,062	28,974	97,520
Group 4	82,451	68,546	

[1] According to uniform examination procedure; for additional examiners' adjustments in analysis of capital accounts see Exhibit E and Table 39, pages 76-7.
[2] Valuation allowances of $30,055,000 less bond premium accounts of $532,000.
[3] Partly estimated.

There has been some confusion about the meaning of the grouping of securities in the reports of examination. The Corporation believes that a supervisory agency should not assume the management of the banks' portfolios, and its examiners are instructed not to express an opinion on the wisdom of the purchase or sale of a specific security. In the case of insured banks not members of the Federal Reserve System a security is placed in Group 1 when, in the judgment of the Corporation, the risk of loss from default is not unreasonable, even though the security may be too high priced in the market or for some other reason unsuited to the needs of a given bank. A security is placed in Group 2 when the risk of loss from default appears to be substantial or unreasonable because of an unfavorable record or outlook for the obligor, regardless of price, and even though the market is such that the bank appears to have no alternative but to hold such a security. Thus, the placing of a security in Group 2 should under no circumstances be interpreted to mean that the Corporation is recommending immediate sale.

The appraised value of assets as determined by the foregoing procedure is subject to further adjustment in determining the net worth or adjusted capital account of the bank.

Analysis of capital accounts. One of the most important purposes of an examination is to determine the net worth of the bank and to measure the amount of the owners' interest available for the protection of depositors and other creditors against risk of loss through deterioration of assets. The adjusted capital account represents the excess of the adjusted value of assets over the determined liabilities of the bank. The Corporation's method of determining the adjusted capital account of banks prior to the adoption of the uniform examination procedure is illustrated by the computation in Table 36, based upon figures of all insured commercial State banks not members of the Federal Reserve System examined in 1938.

Table 36. DETERMINATION OF ADJUSTED CAPITAL ACCOUNT, ORIGINAL EXAMINATION PROCEDURE[1]

7,094 INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

(Amounts in thousands of dollars)

Total capital accounts—book value			**994,674**
Addition:			
Determinable sound banking values not on books		3,406	
Deductions:			
Assets classified as "loss"	105,254		
Assets classified as "doubtful"	16,258		
Determinable liabilities not on books	3,462	124,974	
Examiners' net deductions			**121,568**
Adjusted capital account			**873,106**

[1] For determination of adjusted capital account under the uniform procedure, see Table 41 page 78.

The uniform examination procedure altered the method of analyzing capital accounts in two respects:

(1) The method of valuing securities and of applying values to the measurement of the adjusted capital account was changed. The change in method of valuing securities has been explained above. The change in method of applying those values to the measurement of adjusted capital account was chiefly in the handling of net depreciation in Group 2 securities. Under the original procedure such depreciation was deducted from total capital accounts as a "loss." Under the uniform procedure the depreciation was placed in Classification III, of which 50 percent is deducted from total capital accounts.

In the case of the insured commercial State banks not members of the Federal Reserve System examined in 1938, the change resulted in an increase in the computed adjusted capital account of $3 million, or one-third of 1 percent, over that computed on the basis of the procedure followed by the Corporation in 1937 and early 1938.

(2) Whereas under the original procedure all of the "loss" and "doubtful" assets were deducted, under the uniform procedure all of the assets placed in Classification IV, comparable to the earlier "loss" classification, and 50 percent of the assets placed in Classification III, comparable to the earlier "doubtful" classification, are deducted from book capital. The total amount of assets other than securities (discussed above) put into Classification III was $16 million in the case of the insured commercial State banks not members

of the Federal Reserve System examined in 1938. This change, therefore, resulted in an increase in the computed figure of the adjusted capital account of these banks of $8 million, or slightly less than 1 percent.

The combined effect of these changes was to make the computed figure of adjusted capital account of these banks $11 million, or 1.2 percent, higher than under the original procedure. The method of adjustment of capital accounts under the uniform procedure is explained in detail in Exhibit E, and the results for insured commercial State banks not members of the Federal Reserve System examined in 1938 are shown in Table 41, page 78.

Table 37. Number of Banks Grouped According to Capital Ratios Computed Under Original and Uniform Examination Procedures

INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

	Original procedure	Uniform procedure
All banks	7,094	7,094
Banks with adjusted capital account per $100 of adjusted value of assets of—		
$0.00 or less	33	7
$0.01 to $4.99	155	45
$5.00 to $9.99	1,505	1,427
$10.00 to $14.99	2,771	2,917
$15.00 to $19.99	1,547	1,593
$20.00 to $24.99	652	674
$25.00 to $29.99	254	255
$30.00 to $34.99	104	102
$35.00 to $39.99	36	38
$40.00 or more	37	36

The adjusted capital account obtained by the uniform examination procedure amounted to $884 million, or 12.8 percent of the adjusted value of assets, compared with the computed adjusted capital account of $873 million, or 12.6 percent of the adjusted value of assets, obtained under the procedure followed by the Corporation in 1937 and early 1938. A comparison of the distribution of banks according to their capital ratios, computed in accordance with the uniform procedure and in accordance with the Corporation's practice followed prior to adoption of the uniform procedure, is presented in Table 37. A more detailed distribution is given in Table 38. The tables reveal that fewer banks show very low capital ratios under the uniform procedure than under the procedure previously followed by the Corporation.

Table 38. Distribution of Number of Banks According to Capital Ratios Computed Under Original and Uniform Examination Procedures

INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

Banks grouped according to adjusted capital account per $100 of adjusted value of assets (original procedure)—	All banks	Banks with adjusted capital account per $100 of adjusted value of assets (uniform procedure) of—									
		$0.00 or less	$0.01 to $4.99	$5.00 to $9.99	$10.00 to $14.99	$15.00 to $19.99	$20.00 to $24.99	$25.00 to $29.99	$30.00 to $34.99	$35.00 to $39.99	$40.00 or more
All banks	**7,094**	**7**	**45**	**1,427**	**2,917**	**1,593**	**674**	**255**	**102**	**38**	**36**
$0.00 or less	33	7	8	14	4						
$0.01 to $4.99	155		33	103	18	1					
$5.00 to $9.99	1,505		4	1,108	387	6					
$10.00 to $14.99	2,771			202	2,353	210	5	1			
$15.00 to $19.99	1,547				155	1,319	73				
$20.00 to $24.99	652					56	565	30	1		
$25.00 to $29.99	254						29	215	10		
$30.00 to $34.99	104						2	9	90	3	
$35.00 to $39.99	36								1	35	
$40.00 or more	37					1					36

Conclusion. The uniform procedure represents improvement in practice. Confusion of objectives, which had resulted from use of the term "slow" in classifying assets, has been eliminated. Valuation of securities has been placed on a basis more nearly comparable with that used for other assets, namely, appraisal of risk of loss through inability of obligor to pay.

Under conditions existing in 1938 the uniform procedure does not materially alter the general picture obtained under the Corporation's earlier procedure. As compared with the procedure previously followed by the Corporation, a more optimistic picture of the banks in a weak position is given by the uniform procedure. On the other hand, a slightly less favorable picture is given of some banks in a sound position, particularly those with a large proportion of securities.

Exhibit A

Recommendation of the Executive Committee of the National Association of Supervisors of State Banks Regarding Slow Classification, Adopted April 5, 1938

The Executive Committee of the National Association of Supervisors of State Banks recommends that the term "Slow" no longer be used to designate a loan classification in connection with examinations of State banks and that the term "Substandard" be substituted therefor. The Committee recommends the adoption of this change by all Supervisory Authorities. The Federal Deposit Insurance Corporation is currently adjusting its examination report form in conformance with this policy.

This change is principally one of terminology and not one of definition. It is believed that the present outstanding instructions of the several State Authorities and the Federal Deposit Insurance Corporation as to the type of loan which should be classified as Slow are satisfactory. These same instructions should perhaps be reiterated in connection with the new term "Substandard."

The real difficulty has been that the word "Slow" was neither accurate nor descriptive of the loans which the instructions indicated should be so classified. Somewhat as a result of this ambiguity in terminology, there has been an apparent tendency upon the part of some examiners to criticize, by including in the Slow column, loans sound as to ultimate repayment although not immediately collectible. With the adoption of the term "Substandard" the inconsistency between the title of the column and its real purpose is finally cleared up.

The Slow column originated as a definite classification in national bank examinations during the Comptrollership of John Skelton Williams at which time the theory that commercial banks should make only self-liquidating seasonal loans was widely held. It was probably intended when the column was inaugurated, that inclusion of a loan in the Slow column would be determined in large measure by whether the loan conformed to the tenets of that theory. Strict application of that principle, however, has never been feasible as a practical matter, since it would have necessitated the Slow classification of a large percentage of all loans in commercial banks.

Nevertheless the self-liquidating loan theory, if not applicable to the letter was until 1934 an important coloring influence in the use of the Slow category. The result of this influence was that prior to 1934 the column served for the inclusion of two rather separate and distinct types of loans: (1) loans which were slow in a technical sense but which were nonetheless intrinsically sound and collectible, and (2) loans concerning which there was some question as to the ultimate repayment. As a result of the Examiners' Conference of 1934 called by Secretary Morgenthau, the column was defined to exclude loans of the first type and to include only those of the second; that is, only loans which had unfavorable or criticizable characteristics which, unless corrected and the loan placed in proper bankable shape, might lead to an eventual loss.

The fundamental characteristic, therefore, of loans which were to be classified in the Slow column was not their slowness in a literal sense but whether they were of satisfactory quality as credit risks. Resultingly, there existed an unfortunate inconsistency between the caption of the column and what it was to include. It is believed that adoption of the word "Substandard" will remove this inconsistency.

It should also be mentioned that renaming the Slow column will increase its general usefulness. 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 Classified Assets for the inclusion of all securities of inferior credit quality. If the emphasis of the caption of the column is upon the quality of assets and upon their general desirability as bank holdings, securities of inferior grade can be included. The present word "Slow" precludes such inclusion since many issues of a substandard character are marketable under certain circumstances. Alteration of the caption of the column will, therefore, permit recapitulation in examination reports of all assets, not Doubtful or Loss, which are substandard for banks.

Exhibit B

Statement Released to Press June 27, 1938, Regarding Classification of Loans in Bank Examinations

Agreed to by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Directors of the Federal Deposit Insurance Corporation, and the Comptroller of the Currency.

The present captions of the classification units, namely, "Slow," "Doubtful," and "Loss" are to be abandoned;

The classification units hereafter will be designated numerically and the following definitions thereof will be printed in examination reports:

I. Loans or portions thereof the repayment of which appears assured. These loans are not classified in the examination report.

II. Loans or portions thereof which appear to involve a substantial and unreasonable degree of risk to the bank by reason of an unfavorable record or other unsatisfactory characteristics noted in the examiner's comments. There exists in such loans the possibility of future loss to the bank unless they receive the careful and continued attention of the bank's management. No loan is so classified if ultimate repayment seems reasonably assured in view of the sound net worth of the maker or endorser, his earning capacity and character, or the protection of collateral or other security of sound intrinsic value.

III. Loans or portions thereof the ultimate collection of which is doubtful and in which a substantial loss is probable but not yet definitely ascertainable in amount. Loans so classified should receive the vigorous attention of the management with a view to salvaging whatever value may remain.

IV. Loans or portions thereof regarded by the examiner for reasons set forth in his comments as uncollectible and as estimated losses. Amounts so classified should be promptly charged off.

Present practice will be continued under which the totals of II, III, and IV above are included in the recapitulation or summary of examiners' classifications.

Fifty percent of the total of III above and all of IV above will be deducted in computing the net sound capital of the bank.

Exhibit C

Policy of Securities Valuation by Bank Examiners

Endorsed by the Executive Committee of the National Association of Supervisors of State Banks, April 5, 1938

I. A sound policy for valuing securites held by banks should accomplish the following:

1. Discourage speculative in and out trading;
2. Encourage purchase of only high grade securities for investment purposes;
3. Induce the write-down and gradual disposal of presently held securities of inferior grade;

4. Provide for segregation of all profits on securities sold in a special liability or valuation account;
5. Provide for an amortization program with respect to securities purchased at a premium;
6. Provide a valuation method which is equitable regardless of market fluctuations.

II. A bond valuation policy which places chief reliance on market quotations is unsatisfactory.

1. Speculative trading in bonds is encouraged.
   a. Bankers holding high grade securities as investments are penalized in times of low market prices and by inference are criticized for not having sold their holdings when apparent profits could have been realized.
   b. The banking system as a whole cannot successfully speculate in the bond market since, for the most part, one bank's sales are another bank's purchases.
2. Certain injustices result at present because of different appraisal treatment of bonds as compared with loans and real estate. In times low bond prices, banks with mediocre loans or large real estate holdings appear in a more favorable light than banks holding relatively large portfolios of high grade bonds. In times of high bond prices, the banks with large bond portfolios appear in an unduly favorable light.
3. The amount of securities held by insured banks is approximately three times their capital. Consequently a rise of 5 percent in the bond market appears to result in a 15 percent increase in net capital. Conversely, a decline of 5 percent appears to decrease net capital by 15 percent. Therefore, the conclusions of bank supervisors as to the net capital of the banks are largely dominated by the state of the bond market. Under present practice, the banks can trade their securities when the market rises 5 percent, giving the impression of a 15 percent profit on capital, while when the market falls 5 percent we attempt to get the banks to take a loss at the rate of 15 percent on capital.

III. It is unanimously recommended by the Executive Committee that, effective immediately and until further notice, the following rules for bond valuation shall apply to examination of banks by examiners of State Supervisory Authorities:

1. Securities of the three highest credit ratings and other securities of equivalent credit status:
   a. Market price is to be ignored;
   b. Valuation is to be at cost. (By "cost," wherever used in this memorandum, is meant "cost less amortization or book, whichever is lower.")
2. Securities of the fourth highest credit rating, unrated securities of equivalent credit status and Group II securities shall be priced at market, but for net balance sheet purposes, shall be valued at cost.
   a. Market price of this class of securities will appear in the report as a memorandum item but will not be taken into consideration in computing net sound capital nor in computing estimated loss.

3. Groups III and IV securities shall be valued at market and any net market depreciation on the total securities of these classes held by banks shall enter into the computation of net sound capital and estimated loss. If there is net unrealized appreciation, it shall be ignored.
4. All profits realized from the sale of securities shall be segregated in a special liability or valuation account.
5. Even though a bank does not place net realized security appreciation (profits from sale) in a valuation account, the examiners shall so treat all net security appreciation realized after June 30, 1938.
6. All banks shall be discouraged from henceforth purchasing securities of a credit quality below that which is generally required of rated bonds which appear in the three highest grades.

Exhibit D

Statement Released to Press June 27, 1938, Regarding the Appraisal of Bonds and the Treatment of Securities Profits in Bank Examinations

Agreed to by the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, the Directors of the Federal Deposit Insurance Corporation, and the Comptroller of the Currency.

The appraisal of bonds in bank examinations. Neither appreciation nor depreciation in Group I securities will be shown in the report. Neither will be taken into account in figuring net sound capital of the bank.

Group I securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group includes general market obligations in the four highest grades and unrated securities of equivalent value.

The securities in Group II will be valued at the average market price for eighteen months just preceding examination and fifty percent of the net depreciation will be deducted in computing the net sound capital.

Group II securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes general market obligations in grades below the four highest, and unrated securities of equivalent value.

Present practice will be continued under which net depreciation in the securities in Group III and Group IV are classified as loss.

Group III securities: Securities in default.
Group IV securities: Stocks.

Present practice will be continued under which premiums on securities purchased at a premium must be amortized.

Present practice of listing all securities and showing their book value will be continued.

The treatment of securities profits in bank examinations. Until losses have been written off and adequate reserves established, the use of profits from the sale of securities for any purpose other than those, will not be approved.

Present practice will be continued under which estimated losses must be charged off.

Present practice will be continued under which the establishment and maintenance of adequate reserves, including reserves against the securities account, are encouraged.

Present practice will be continued under which speculation in securities is criticized and penalized.

Exhibit E

Analysis of Assets and Capital Accounts Under Uniform Examination Procedure

The analysis of assets and of capital accounts under the uniform examination procedure is shown in Tables 39 to 41.

Table 39. Analysis of Securities Under the Uniform Examination Procedure Adopted in 1938

7,094 INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

(Amounts in thousands of dollars)

Line		Total securities	Group[1] 1	Group[1] 2	Group[1] 3	Group[1] 4
	Book value:					
1	Gross book value	2,527,486	2,187,216	209,757	48,062	82,451
	Allocations to security accounts:					
2	Bond premium accounts	+532	+532	....	......	
3	Valuation allowances	-30,055	-4,261	-7,365	-18,429	
4	**Net book value**	**2,497,963**	**2,183,487**	**202,392**	**112,084**	
	Appraised value (items on books):					
5	Appraisal by uniform procedure[2]	2,466,820	2,183,354	185,946	97,520	
6	Excessive appraisal disallowed[3]	-9,494	....	-1,200	-8,294	
7	**Net appraised value**	**2,457,326**	**2,183,354(I)**	**184,746(II)**	**89,226(II**	
8	**Net depreciation (difference between net book value and net appraised value)**	**40,637**	**[4]133(IV)**	**17,646(III)**	**22,858(IV)**	
	Adjusted value:					
9	Net book value	2,497,963	2,183,487	202,392	112,084	
10	Examiners' deductions[5]	-31,814	-133	-8,823	-22,858	
11	**Adjusted value of items on books**	**2,466,149**	**2,183,354**	**193,569**	**89,226**	
12	Examiners' additions[6]	+1,206	....	+1,206		
13	**Adjusted value**	**2,467,355**	**2,183,354**	**284,001**		

[1] For definition of groups, see page 75. Roman numerals in parenthesis show examiners' classification of net book value.

[2] Group 1—net book value less write-ups on books and premiums not properly amortized.
Group 2—average market price over the preceding 18 months.
Groups 3 and 4—market value.

[3] Amounts by which total appraised value exceeds net book value of any group in individual banks.

[4] Write-ups in book value above cost and premiums not properly amortized.

[5] Half of Classification III and all of Classification IV—that is, one-half of net depreciation in Group 2, and all of net depreciation in Groups 1, 3, and 4.

[6] Determinable sound banking values not on books.

Table 39 illustrates the manner in which the securities of the banks are appraised and classified. Line 1 shows the book value of securities in each group. Line 4 shows the net value of each group after adding in the bond premium account and subtracting out the valuation allowances as allocated by the examiners.

Line 5 in Table 39 shows the appraised value of securities as determined in accordance with the uniform procedure. The appraised value of Group 1 securities is cost less amortization, or book value, whichever is lower. The appraised value of Group 2 securities is determined on the basis of 18-months' average prices. The appraised values of Groups 3 and 4 are based on market values at the time of examination. From the appraised values are deducted those amounts which under the procedure are excessive. Such excessive appraisals consist of those amounts by which the appraised values exceed the book values of any given group in any individual bank.

The net appraised value obtained in line 7 is deducted from the net book value shown in line 4 to obtain the net depreciation shown in line 8. The net depreciation in Group 1 consists of write-ups in book value above cost and premiums not properly amortized.

The net appraised value obtained in line 7 and the net depreciation shown in line 8 are carried into the adjusted balance sheet and the classifications in the following manner:

Net appraised value of Group 1 is placed in Classification I;

Net appraised values of Groups 2, 3, and 4 are placed in Classification II;

Net depreciation in Group 2 is placed in Classification III;

Net depreciation in Groups 1, 3, and 4 is placed in Classification IV.

The analysis of the assets of the banks is shown in Table 40. The examiners' deductions consist of the total of Classification IV and 50 percent of the total of Classification III. The examiners' evaluation of assets not on the books is added. The "not criticized" adjusted value of assets is the total of Classification I. The adjusted value of substandard assets consists of the total of Classification II, 50 percent of the total of Classification III, and values not on the books.

Table 40. Analysis of Assets Under the Uniform Examination Procedure Adopted in 1938

7,094 insured commercial state banks not members of the Federal Reserve System examined in 1938

(Amounts in thousands of dollars)

	Total assets	Type of asset			
		Cash and due from banks	Securities[1]	Loans, discounts, and overdrafts	Miscellaneous assets
Examiners' classifications of book value:					
I	6,022,149	1,510,265	2,183,354	2,178,117	150,413
II	875,368	....	273,972	370,640	230,756
III—50 percent to be deducted	33,904	....	17,646	14,702	1,556
IV—100 percent to be deducted	94,067	....	22,991	37,510	33,566
Total (net) book value	**7,025,488**	**1,510,265**	**2,497,963**	**2,600,969**	**416,291**
Examiners' adjustments:					
50 percent of Classification III	[2]-16,969	....	-8,823	-7,351	[2]-795
100 percent of Classification IV	-94,067	....	-22,991	-37,510	-33,566
Determinable sound banking values not on books	+3,406	....	+1,206	+488	+1,712
Examiners' net deductions	**-107,630**	....	**-30,608**	**-44,373**	**-32,649**
Adjusted value of assets—total	**6,917,858**	**1,510,265**	**2,467,355**	**2,556,596**	**383,642**
Not criticized[3]	6,022,149	1,510,265	2,183,354	2,178,117	150,413
Substandard[4]	895,709	....	284,001	378,479	233,229

[1] See Table 39.
[2] Difference of $17,000 is due to rounding of figures of individual banks.
[3] All assets in Classification I.
[4] All assets in Classification II, one-half of those in Classification III, and items not on books.

The analysis of the capital accounts is shown in Table 41. The addition of $3,406,000 corresponds with the items not on books shown in the previous table. The deductions consist of the same deductions used in obtaining the adjusted value of assets, plus the amount of liabilities which are not shown on books but are determined by the examiner to exist. For the insured commercial State banks not members of the Federal Reserve System examined during 1938, examiners' net deductions amounted to $111,092,000, leaving an adjusted capital account of $883,582,000.

Table 41. Analysis of Capital Accounts Under the Uniform Examination Procedure Adopted in 1938[1]

7,094 INSURED COMMERCIAL STATE BANKS NOT MEMBERS OF THE FEDERAL RESERVE SYSTEM EXAMINED IN 1938

(Amounts in thousands of dollars)

Total capital accounts—book value			994,674
Addition:			
Determinable sound banking values not on books		3,406	
Deductions:			
50 percent of Classification III of total assets	16,969		
Classification IV of total assets	94,067		
Determinable liabilities not on books	3,462	114,498	
Examiners' net deductions			111,092
Adjusted capital account			883,582

[1] For determination of adjusted capital account under the original procedure, see Table 36, page 69.

REVISION IN BANK EXAMINATION PROCEDURE

Joint Statement of the Comptroller of the Currency, The Federal Deposit Insurance Corporation, The Board of Governors of the Federal Reserve System, and the Executive Committee of the National Association of Supervisors of State Banks[1]

The Comptroller of the Currency, The Federal Deposit Insurance Corporation, The Board of Governors of the Federal Reserve System, and the Executive Committee of the National Association of Supervisors of State Banks have adopted minor changes in the bank examination and reporting procedure which has been followed by the supervisory agencies since July, 1938.

The revision provides for abandonment of the use of Roman numerals II, III and IV in the examiners' classification of bank assets, and substitution of the terms "substandard", "doubtful", and "loss", and for discontinuance of the practice of appraising Group 2 securities on the basis of the 18-months average of market value. Such securities will be appraised at current market value.

There will be no change with respect to evaluation of U. S. Government and other Group 1 (investment quality) securities. This policy is intended to apply to recognized sound investment practices of banks, and is not intended to apply to undue concentrations in securities other than U. S. Government issues, nor to other cases where the condition of the portfolio requires special treatment by the supervisory agency or agencies concerned.

The revision involves no fundamental change in the present procedure nor does it signify any intention on the part of the supervisory authorities to become more severe in the classification of bank assets. Its purpose is clarification and simplification of procedure in the interest of more uniform application. It also recognizes the fact that use of the 18-months average price for Group 2 securities is no longer of practical significance since the banks of the country have only a nominal investment in such securities.

[1] Released for morning papers of July 15, 1949.

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Bank Examination Procedure As Revised July 15, 1949

THE CLASSIFICATION OF ASSETS IN BANK EXAMINATION

The present captions of the classification units, namely, "I", "II", "III" and "IV" are to be abandoned.

The classification units hereafter will be designated as "Substandard", "Doubtful" and "Loss". The term "Substandard" will be defined as follows:

> Book assets or portions thereof not classified as doubtful or loss and which involve more than a normal risk due to the financial condition or unfavorable record of the obligor, insufficiency of security, or other factors noted in the examiner's comments. These assets should be given special and corrective attention, for example, by obtaining suitable reductions in amount, additional security, more complete financial data concerning the obligor's condition, or other such action as the specific circumstances may require.

Present practice will be continued under which the totals of the three classifications are included in the recapitulation or summary of examiners' classifications.

Fifty per cent of the total of "Doubtful" and all of "Loss" will be deducted in computing the net sound capital of the bank. Amounts classified "Loss" should be promptly charged off.

THE APPRAISAL OF BONDS IN BANK EXAMINATIONS

Neither appreciation nor depreciation in Group I securities will be taken into account in figuring net sound capital of the bank. However, this policy is intended to apply to recognized sound investment practices of banks, and is not intended to apply to undue concentrations in securities other than U. S. Government issues, nor to other cases where the condition of the portfolio requires special treatment by the supervisory agency or agencies concerned.

> Group I securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group includes general market obligations in the four highest grades and unrated securities of equivalent value.

The securities in Group II will be valued at the market price and fifty per cent of the net depreciation will be deducted in computing the net sound capital.

> Group II securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes general market obligations in grades below the four highest, and unrated securities of equivalent value.

Present practice will be continued under which net depreciation in the securities in Group III and Group IV are classified as loss.

> Group III securities: Securities in default.
> Group IV securities: Stocks.

Present practice will be continued under which premiums on securities purchased at a premium must be amortized.

Present practice of listing securities and showing their book value will be continued.

Present practice will be continued under which the establishment and maintenance of adequate reserves, including reserves against the securities account, are encouraged.

Present practice will be continued under which speculation in securities is criticized and penalized.

THE TREATMENT OF SECURITIES PROFITS IN BANK EXAMINATIONS

Until losses have been written off and adequate reserves established, the use of profits from the sale of securities for any purpose other than those, will not be approved.