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Information about the FDIC Policy Statement on
LEEWAY INVESTMENTS

From an Address of
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Federal Deposit Insurance Corporation

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of the
New Jersey Bankers Association

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On March 31, the Federal Deposit Insurance Corporation published in the Federal Register a Statement of Policy under which limited investments could be made by banks which the Corporation's examiners would not criticize except in the case of actual default or bankruptcy. The policy statement was published for a 45-day comment period, and it is perhaps appropriate as this period expires to review the proposed Statement in some depth in view of the divergent public reaction it has produced.

First, it should be made clear that the policy statement applies exclusively to State chartered banks which are not members of the Federal Reserve System. Although the Corporation's responsibilities extend to all insured banks, including State member banks and National banks, the Corporation's examining and supervisory responsibilities are directed only to insured State nonmember banks. The policy statement by its terms does not apply to National banks or State member banks. Some of the investments, in fact, which would be covered by the Corporation's policy statement are presently treated in much the same way for National and State member banks by the examining policies of the Comptroller and the Federal Reserve System.

The essence of the FDIC's policy statement is contained in the proposed revision of traditional Corporation examination policies with respect to "investment grade" securities. Historically, "investment grade" securities have been narrowly defined and interpreted by the bond rating agencies, securities analysts, the Corporation, and other regulatory authorities in such a manner that many banks were inhibited from providing even limited financial support to numerous public spirited projects encouraged by legislative bodies and civic groups throughout the country. Many of these projects reflect national goals and objectives. Yet, by the Corporation's strict adherence to

convention in defining "investment grade" securities and the resulting influence exerted on banks under its jurisdiction, they were denied a major source of long-term capital.

The "Leeway Investments" policy statement was intended to overcome this negative influence. It attempts to do so by granting bank management sufficient flexibility to participate imaginatively and responsibly in such projects through a very small segment of the bank's securities portfolio and by substituting for the previous inflexibility management's own judgment and experience. In effect, the policy statement merely provides that under certain conditions State nonmember banks may, without fear of criticism or penalty from the Corporation, invest in equity or debt capital securities which, by conventional standards, might technically fall short of "investment grade" quality. Such a situation might arise with respect to debt securities associated with community rehabilitation or development corporations, which, while lacking the qualitative elements of "investment" grade securities, are regarded by knowledgeable bankers as "tolerable" risks to depository financial institutions on a restricted and controlled basis. Similar circumstances may prevail in the case of securities of a foreign government, particularly among the new emerging nations, which not only suffer from liquidity imperfections arising from limitations on transfer and exchange rate fluctuations, but also qualitatively because of the absence of a reliable past record of debt performance and financial stability and an uncertain political climate.

Please note that the Statement applies solely to equity or debt securities and does not apply to loans and discounts, which the Corporation's examiners will continue to analyze and evaluate as they have in the past. The distinction is important for two reasons. Examiners have been far more tolerant and flexible

in analyzing loans. They also have far more freedom to exercise independent judgment in the analysis of the loan portfolio. Investment securities, on the other hand, have traditionally been judged on the basis of rigid and inflexible standards. Even slight hint of risk was sufficient to classify securities as not being "investment grade" quality, while the same degree of risk might not result in the classification of a loan.

It is also important to note that the FDIC's policy statement is framed within four restrictive requirements, which, taken together, materially minimize any unfavorable impact its implementation might have on the safety and soundness of an insured bank. First, all such investments must be allowed for State non-member banks by State law. If State law or court cases prohibit such investments, they cannot be made in the first place. The second condition requires compliance with the Voluntary Foreign Credit Restraint guidelines promulgated by the Board of Governors of the Federal Reserve System for balance of payments purposes, a condition that is self-explanatory and would come into effect only if there were a foreign obligor on the securities.

The third and most important condition from the standpoint of safety and soundness is an aggregate limitation on all "leeway investments" to ten percent of the bank's combined capital and surplus. For the purposes of the policy statement, surplus is narrowly defined as that segment of the bank's capital structure duly established as "Surplus" by action of the bank's board of directors and so captioned on the bank's books. It excludes undivided profits and other capital reserves, which for the average State nonmember commercial bank usually represents in excess of one-third of its total capital and reserves. Consequently, for the average State nonmember commercial bank, the ten percent limitation in the policy statement is equivalent to approximately

six and one-half percent of total capital and reserves and little more than one-half of one percent of total assets. We estimate, accordingly, that the "Leeway Investments" privilege would free some six hundred million dollars nationally for such purposes, if fully utilized by all 7,875 insured State nonmember commercial banks. Similarly, if the privilege were fully utilized by all 326 FDIC-insured mutual savings banks, approximately three hundred fifty million dollars more would be freed nationally for such purposes. If these leeway investments are made by a bank's board of directors or board of trustees there is nothing in banking history to justify a gloomy or pessimistic outlook concerning the safety of these investments, or the likelihood of payment of both interest and principal. We have no reason, therefore, to expect that this slight relaxation in our traditional examination practices would subvert the management prudence, good judgment or expertise which has long been characteristic of the vast majority of banks in our banking system.

The fourth and final condition requires that all such investments be formally approved by the bank's board as "Leeway Investments" and be so identified on the bank's general or subsidiary records. Formal board approval would bring such investments specifically to the attention of a bank's board of directors or trustees before they are made, a requirement we thought essential if such investments were not to be subject to classification or criticism and might not, therefore, be brought to the attention of the directors during examinations or through examination reports. The approval requirement assures full knowledge and control over all such investments by a bank's board and fixes responsibility where it properly belongs. The twin features of board knowledge and accountability also constitute effective safeguards against abuse of the "Leeway Investments" privilege, for there is nothing in the policy

statement that absolves a bank's board of directors of their responsibility to conduct the bank's affairs in a prudent manner.

I have only briefly alluded to the rationale for this policy statement, but perhaps further amplification would be beneficial. As you are all aware, there has been a tremendous increase in the social awareness and responsibility of all segments of our society. Congress and State legislatures, the elected representatives of the people, have reacted by enacting legislation designed to accomplish a variety of programs they consider to be of high social priority. This legislation has in turn given impetus to the organization of many new community organizations whose primary objectives are for one or more of these legislated goals. The National Corporation for Housing Partnerships, a vehicle for investment in low income housing projects, is one of many such organizations that come to mind. Another is the formation of Minority Enterprise Small Business Investment Companies ("MESBICS") developed by the Small Business Administration. This program, aimed at facilitating the flow of capital to minority owned small business enterprises, may be expanded further if the Minority Enterprise Small Business Investment Act of 1972 is enacted. Most of you are also familiar with Minbanc Capital Corporation, a closed-end investment company whose primary objective is to make capital funds available to qualifying minority-owned banks. "Minbanc" was sponsored by the Urban Affairs Committee of the American Bankers Association, and its capital stock is being exclusively offered to ABA member banks. The decline of our cities has also led to the rapid formation of community rehabilitation corporations, alongside a steadily growing number of community development corporations, organized locally, regionally, and on statewide levels. The policy statement is intended to free State nonmember insured banks from previously rigid supervisory constraints, so that they may plan a responsible but limited role, within the limitations

previously outlined, so that they may plan a responsible but limited role, in meeting the capital needs of those organizations -- if, and only if, a bank's management is minded to do so. The policy statement, to repeat, is permissive and not mandatory, and the ultimate choice will rest as it always has when alternative investments are being considered, with the bank's board of directors or trustees.

The policy statement is not revolutionary. As I indicated at the outset, it corrects an existing regulatory imbalance between State nonmember insured banks vis a vis national or State member banks, although going somewhat beyond the specific authorizations promulgated from time to time by the Comptroller and the Federal Reserve System. For example, National banks are already authorized to invest up to five percent of total capital and surplus in equity or debt securities of community development projects, provided no more than two percent of total capital and surplus is invested in any one project. Moreover, the Comptroller's definition of "surplus" includes undivided profits and portions of loan and securities valuation reserves. Inasmuch as the Corporation's ten percent limitation is, on the average, equivalent to six and one-half percent of total capital and reserves, the difference in the limitations is not as great as they might otherwise appear to be. The narrow definition of surplus in the Corporation's policy statement was largely dictated by the fact that most State banking laws, including New Jersey's interpret "surplus" narrowly in the application of legal limits pertaining to loans and investments. Similarly, State member banks have been authorized by the Federal Reserve System to invest as much as two percent of total capital and reserves in community development corporations and in equity securities of Minbanc Capital Corporation.

The substance of the policy statement is also not without precedent insofar as the Corporation is concerned. Examiners have been instructed in the past to refrain from adversely classifying investments in Small Business Investment Corporations, the National Corporation of Housing Partnerships and other similar investments closely identified with national goals and priorities, unless classified on positive evidence of loss. What is unprecedented is the formal publication of this kind of policy statement. The Board of Directors of FDIC strongly feels that the Corporation's policy positions should be in the public domain, so that everyone knows the ground rules, and it is in this context only that the policy statement departs substantially from past Corporation practice. Our position in this is fully consistent with the spirit of the Freedom of Information Act enacted by Congress several years ago.

Public reaction to the policy statement has been limited and about evenly divided. Those favoring the statement were equally matched by others who opposed it. Similarly, two of the nation's leading financial publications expressed diametrically opposed views -- one, The American Banker, praising the "affirmative spirit of the proposal", and the other, The Wall Street Journal, accusing the Corporation of endorsing a policy which advocated "happily handing out money to one and all." The Journal's misunderstanding of the policy statement was particularly unfortunate because many of those who expressed opposition to the Statement referred to its editorial, which failed to note the restrictions and mistakenly interpreted the policy statement to encompass bank loans as well as securities investments.

From those opposed, we heard such things as the following:

"The policy to permit a bank to make investments for socially desirable objectives without regard to investment quality, can hardly be considered in the best interest of sound banking practices. Such a policy, if adopted, would indicate that the corporation has abdicated the responsibility for which it was founded."

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"I have read this statement of policy in great detail and in my judgment I am shocked to learn of the Board of Directors' policy.

"Such an investment policy will not lead to anything but trouble for such institutions that would engage in such a program."

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"Although the objective here may be commendable, I feel that this practice would establish a very dangerous precedent."

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"The recent FDIC proposal to give banks broad powers to make very risky but socially desirable investments and remove them from examiners' criticism strikes me as losing sight of the original concept under which the FDIC was conceived... I deplore the proposal."

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From those who favored the policy statement, we received comments like these:

"We are very happy about the publishing of a new policy statement providing for a category of 'leeway investments.' We have recently purchased stock in a MESBIC in order to do something about the venture capital needs of the minority businessman in our area. This is a fine gesture on the part of the Corporation and we are very much in favor of it."

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"Such an approach on the part of the Federal Deposit Insurance Corporation cannot help but encourage banks to carry out their broad responsibilities to the communities in which they are located, for you are easing one of the barriers which inhibits such activity by the banks, namely, the fear that the examiner will mark the bank down for making riskier loans than normally acceptable. I suspect that these fears by banks have been more imagined than real, but your new policy should clear the air considerably."

The American Bankers Association also weighed in with an endorsement of the policy statement saying:

"We believe this is a positive step which will allow insured state non-member banks to pursue a constructive yet prudent program of 'socially desirable investments' for the benefit of the communities they serve. Our experience indicates that the need for this form of capital investment is substantial. Further, we fully concur with the conditions applied to these investments. The fact that the investment decision remains discretionary with each bank and subject to approval by the bank's board of directors, together with the requirement of compliance with applicable state law are necessary and appropriate safeguards."

In our view, the policy statement does not in any sense suggest any abrogation by the Corporation of its responsibilities, nor indeed, a lessening of its historic concern for, and vigorous pursuit of, a safe and sound banking system in this country. The limitations incorporated in the policy statement are fully consistent with our traditional responsibilities. Moreover, we regard the "Leeway Investments" policy statement as a positive move in the public interest as well as a positive move to correct existing differences in examination policies applicable to different categories of insured banks. We believe that the broader investment discretion permitted by the policy statement is in the public interest and fully within the industry's capacity to administer in a responsible and sound manner.

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