UNDIVIDED PROFITS AS PART OF
"CAPITAL", "CAPITAL STOCK", OR "SURPLUS"

To All Member Banks in the
Eleventh Federal Reserve District:

There follows the text of a statement released by the Board of Governors of the Federal Reserve System regarding the question whether undivided profits may be considered part of the capital or surplus of member banks.

The Board has been presented with the question whether a bank's undivided profits may be considered as part of its "capital stock", "capital", or "surplus" for purposes of provisions of law imposing requirements or limitations upon member banks of the Federal Reserve System.

It is obvious that undivided profits are not a part of a bank's "capital stock"; and Congress has explicitly indicated in the national banking laws that the more general term "capital" is limited to common stock and preferred stock (12 U.S.C. 51c).

In the banking field, the undivided profits account traditionally represents a fluctuating amount as distinguished from the relatively fixed and permanent amount of a bank's "surplus" or "surplus fund". This distinction has been explicitly recognized by the Supreme Court of the United States:

"By incorporated banks the term (undivided profits) is commonly employed to designate the account in which profits are carried more or less temporarily, in contradistinction to the account called surplus in which are carried amounts treated as permanent capital, and which may have been derived from payments for stock in excess of par, or from profits which have been definitely devoted to use as capital."


The Federal banking laws use the terms "undivided profits" and "surplus" as having different meanings. For example, with respect to the admission to membership in the Federal Reserve System of mutual savings banks having no capital stock, the Federal Reserve Act requires such a bank to have "surplus and undivided profits" not less than the amount of capital required for the organization of a national bank in the place in which the savings bank is located (12 U.S.C. 333). Similarly, various provisions of the National Bank Act distinguish between "undivided profits" and "surplus fund". Thus, a national bank may not declare dividends if its losses have exceeded its "undivided profits" (12 U.S.C. 56); and, until a national bank's "surplus fund" equals its common capital, it may not declare dividends unless a specified percentage of its net profits is carried to its "surplus fund" (12 U.S.C. 60).

If undivided profits were regarded as a part of a bank's surplus or "surplus fund", such provisions for transfer of profits to surplus would be meaningless and the application of other provisions would be uncertain and impracticable. For example, subscriptions by member banks to Federal Reserve Bank stock are based upon the amount of the member bank's "capital stock and surplus" (12 U.S.C. 287), so that, if undivided profits were regarded as a part of "surplus", the amount of a bank's subscription to Reserve Bank stock would have to be increased and decreased continuously, an inconvenient and costly procedure that could not have been contemplated by Congress.
It is recognized that the question whether undivided profits may be added to capital stock and surplus in calculating the lending limitations governing member banks is a matter for determination under applicable State law in the case of State banks and under the National Bank Act in the case of national banks, except as further limited by particular provisions of the Federal Reserve Act. For the reasons indicated above, it is the Board's opinion that undivided profits do not constitute "capital", "capital stock", or "surplus" for the purposes of provisions of the Federal Reserve Act, including those that limit member banks with respect to loans to affiliates (12 U.S.C. 371c), purchases of investment securities (12 U.S.C. 335), investments in bank premises (12 U.S.C. 371d), loans on stock or bond collateral (12 U.S.C. 248(m)), deposits with nonmember banks (12 U.S.C. 463), and bank acceptances (12 U.S.C. 372, 373), as well as provisions that limit the amount of paper of one borrower that may be discounted by a Federal Reserve Bank for any member bank or accepted as security for an advance to a member bank (12 U.S.C. 330, 345, 347).

Yours very truly,

Watrous H. Irons
President