

A meeting of the Board of Governors of the Federal Reserve System was held in Washington on Tuesday, June 28, 1938, at 12:15

P. m.

PRESENT: Mr. Eccles, Chairman  
Mr. Ransom, Vice Chairman  
Mr. Szymczak  
Mr. Draper

Mr. Morrill, Secretary  
Mr. Bethea, Assistant Secretary  
Mr. Clayton, Assistant to the Chairman  
Mr. Thurston, Special Assistant to the  
Chairman  
Mr. Wyatt, General Counsel  
Mr. Dreibelbis, Assistant General Counsel

Mr. Ransom suggested that the Board give consideration to the question whether the Executive Order of June 24, 1938, "Extending the Competitive Classified Civil Service", was applicable to the Board's organization. It was stated that the Executive Order provided that, effective February 1, 1939, all positions in the Executive civil service, including positions in corporations wholly owned or controlled by the United States, which are not now in the competitive classified civil service and which are not exempted therefrom by statute, are with certain exceptions covered into the competitive classified civil service. In response to a query as to whether the Executive Order was legally applicable to the Board of Governors of the Federal Reserve System, Mr. Wyatt said that Mr. Vest, Assistant General Counsel, had been studying the matter intensively and would be prepared to render a preliminary opinion.

6/28/38

-2-

After a brief discussion, Chairman Eccles suggested that the matter be placed on the docket for consideration at the next meeting and that counsel continue the study of the questions involved with the view to preparing a memorandum on the subject as a basis for discussion at the meeting. The other members of the Board concurred.

Following the departure from the meeting of all except the members of the Board and the Board's Secretary, the Chairman reviewed the developments in connection with the agreement which had been reached by the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System on bank examination policy with respect to the treatment of loans and investments and the regulation of the Comptroller of the Currency with respect to purchases of securities by member banks of the Federal Reserve System, which was given to the press for release on Monday, June 27. He referred to the fact that all of the members of the Board (with the exception of Mr. Davis, who was out of town) had participated in a lengthy conference at the Treasury on Tuesday, June 21, with Secretary of the Treasury Morgenthau, Chairman Crowley of the Federal Deposit Insurance Corporation, Chairman Jones of the Reconstruction Finance Corporation, Acting Comptroller of the Currency Diggs, and Messrs. Oliphant, Upham and Gaston of the Treasury Department, during which an agreement was reached upon the substance of a program which was to be embodied in a statement for submission to the President. On the next day the same group (except

6/28/38

-3-

Mr. Ransom who was absent) met at the Treasury and after a preliminary discussion certain details of the final form of the agreement were left to be worked out by a smaller group consisting of Messrs. Crowley, Diggs, Eccles, McKee and Upham. The statement was then submitted by the Secretary of the Treasury to the President, who authorized its release to the press on Friday, June 24. The release was given to the press in the office of Mr. Herbert Gaston, of the Treasury, there being also present Mr. Upham of the Treasury, Mr. Thurston of the Board's staff, Mr. George Wharton of the staff of the Federal Deposit Insurance Corporation, and Mr. L. A. Kelly of the staff of the Comptroller of the Currency. This release was made for publication in the morning papers for Monday, June 27, 1938.

It was agreed by the members of the Board that it would be desirable to incorporate a discussion of this agreement in the next issue of the Federal Reserve Bulletin, which was in course of preparation, and Mr. Thurston submitted a draft for this purpose which was approved in the following form:

"In his message to Congress on April 14, the President announced the desterilization of approximately \$1,400,000,000 of Treasury gold, accompanied by action on the part of the Board of Governors to reduce reserve requirements by about three-quarters of a billion dollars, for the purpose of making additional bank resources available immediately for the credit needs of the country. At the same time the President expressed the hope that Federal banking supervision could be better coordinated. This was desirable in order to facilitate the flow of credit to commerce, industry, and agriculture.

6/28/38

-4-

"The Secretary of the Treasury initiated a series of conferences with representatives of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System for the purpose of reviewing the policies and regulations of the Federal banking supervisory authorities and determining wherein they might be improved and better coordinated in furtherance of this objective, consistent with sound banking principles.

"As a result of the conferences, unanimous agreement was reached on a program which for the first time brings about uniformity in the treatment of loans and securities by the Federal agencies in their administration of bank examinations.

"The program adopted is expected to be of benefit both now and in the future in two important respects; first, in broadening the opportunity for small and medium-sized business concerns to obtain credit from the banks on a sound basis, and, second, in relieving pressures that tend to reduce outstanding credit or prevent extension of new credit to sound borrowers.

"Included in the program is a broad revision of the Regulation of the Comptroller of the Currency governing bank investment policy. It provides that, in addition to such securities as have been authorized heretofore, member banks of the Federal Reserve System may purchase investment securities, of such sound value or so secured as reasonably to assure payment, issued by established commercial or industrial businesses or enterprises that can demonstrate the ability to service such securities, without requiring that the securities be offered for public distribution or that they must be readily marketable, provided, however, that they mature not later than 10 years after the date of issuance and that 75 percent of the principal be amortized by maturity through substantial, periodic payments, none of which would be required during the first year.

With respect to bank examination reports, the program provides that what has been commonly called the 'slow' classification will be abolished altogether. The 'slow' classification has long been a misnomer and a cause of complaint. In place of this, and of the classifications heretofore headed 'doubtful' and 'estimated loss', there will be substituted the designations II, III, and IV. Class II includes loans or portions of loans which appear to involve a substantial and unreasonable degree of risk,

6/28/38

-5-

"by reason of an unfavorable record or other unsatisfactory characteristics, and in which the possibility of future loss exists unless they receive the careful and continued attention of the bank's management. Class III includes loans or portions of loans the ultimate collection of which is doubtful and in which a substantial loss is probable but not yet definitely ascertainable in amount, and Class IV is for listing loans or portions of loans which are estimated as loss. Loans in Class I are those in which the repayment appears to be assured, and such loans will not be listed in the examination reports.

"Under the new designations, the principle is clearly recognized that in making loans, whether for working capital or fixed capital purposes, the banks should be encouraged to place the emphasis upon intrinsic value rather than upon liquidity or quick maturity.

"Similarly, the revised examination procedure recognizes the principle that bank investments should be considered in the light of inherent soundness rather than on a basis of day to day market fluctuations. It is based on the view that the soundness of the banking system depends in the last analysis upon the soundness of the country's business and industrial enterprises, and should not be measured by the precarious yardstick of current market quotations which often reflect speculative and not true appraisals of intrinsic worth.

"The revised procedure broadly divides securities into those of investment character and those of speculative character. The former will be listed in Group I, the latter in Group II. Defaulted bonds will be listed in Group III and stocks in Group IV.

"It is estimated that approximately 90 percent of the total securities held by the banks are in Group I. In conformity with the principle of measuring such securities by investment and not by fluctuating market standards, daily quotations will not be taken into account in examination reports, in which such securities will be shown at their book value, whether they be listed securities or unlisted securities. Where book value includes a premium, the premium must be properly amortized. By severing appraisal of bank investments from current market quotations, it is believed that the banks will be encouraged to purchase securities of sound business and industrial concerns, whether large or small, for their true worth and not for speculative gains.

6/28/38

-6-

"Securities in Group II are estimated to comprise not more than 5 percent of the banks' holdings, and will be shown in examination reports at their average market price for 18 months just preceding the examination. Securities in this group which are not traded in and for which quotations are not available will be shown at estimated value.

"In the case of Group III and IV securities, net depreciation will continue to be classified as loss.

"With respect to loans and securities, in estimating the net sound capital of banks, the total of loans classified as loss, as well as the total depreciation in defaulted bonds and stocks will be deducted. In addition, 50 percent of the more doubtful loans, as shown in Class III, and 50 percent of the net depreciation of bonds listed in Group II, will be deducted.

"Previously, it has been the practice of some of the supervisory authorities to deduct the total of all loans classified as doubtful. Experience has indicated, however, that in general an allowance of 50 percent for loss in items classified as doubtful is reasonable. Likewise, in the past it has been the practice of some of the supervisory authorities to deduct net depreciation as reflected by current market quotations for the entire investment portfolio.

"A primary purpose of the program is to encourage the private banking system of the country to adapt its lending and investment functions to present-day requirements of commerce, industry, and agriculture. It is designed to afford the banks a broader opportunity for service to the community and for profitable outlet for some of their abundant, idle funds. As the banks avail themselves of the opportunity, the necessity will be diminished for creation of government agencies to furnish credit facilities which the banks should provide.

"The program is based upon sound banking principles. The banks will be required to continue the present practice of charging off losses and of establishing and maintaining adequate reserves against doubtful and speculative loans and securities.

"The statement issued regarding the revised procedure in bank examinations and the revised regulation of the Comptroller of the Currency follow:

6/28/38

-7-

"REVISION OF PROCEDURE IN BANK EXAMINATIONS AS 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 CLASSIFICATION OF LOANS IN BANK EXAMINATIONS

"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.

6/28/38

-8-

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

#### "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 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 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.



6/28/38

-9-

"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 criticised and penalized."

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"INVESTMENT SECURITIES REGULATION

Issued by the Comptroller of the Currency

"By virtue of the authority vested in the Comptroller of the Currency by paragraph Seventh of Section 5136 of the Revised Statutes, the following regulation is promulgated:

"SECTION I

"(1) An obligation of indebtedness which may be purchased for its own account by a national bank or State member bank of the Federal Reserve System, in order to come within the classification of 'investment securities' within the meaning of paragraph Seventh of said Section 5136, must be a marketable obligation, i.e. it must be salable under ordinary circumstances with reasonable promptness at a fair value; and with respect to the particular security, there must be present one or more of the following characteristics:

- (a) A public distribution of the securities must have been provided for or made in a manner to protect or insure the marketability of the issue; or,
- (b) Other existing securities of the obligor must have such a public distribution as to protect or insure the marketability of the issue under consideration; or,
- (c) In the case of investment securities for which a public distribution as set forth in (a) or (b) above can not be so provided, or so made, and which are issued by established commercial or industrial businesses or enterprises, that can demonstrate the ability to service such securities, the debt evidenced thereby must mature not later than ten years after the date of issuance of the security and must be of such sound value or so secured as reasonably to assure its

6/28/38

-10-

"payment; and such securities must, by their terms, provide for the amortization of the debt evidenced thereby so that at least 75% of the principal will be extinguished by the maturity date by substantial periodic payments: Provided, That no amortization need be required for the period of the first year after the date of issuance of such securities.

"(2) Where the security is issued under a trust agreement, the agreement must provide for a trustee independent of the obligor, and such trustee must be a bank or trust company.

"(3) All purchases of investment securities by national and State member banks for their own account must be of securities 'in the form of bonds, notes, and/or debentures, commonly known as investment securities'; and every transaction which is in fact such a purchase must, regardless of its form, comply with this regulation.

#### "SECTION II

"(1) Although the bank is permitted to purchase 'investment securities' for its own account for purposes of investment under the provisions of R. S. 5136 and this regulation, the bank is not permitted otherwise to participate as a principal in the marketing of securities.

"(2) The statutory limitation on the amount of the 'investment securities' of any one obligor or maker which may be held by the bank, is to be determined on the basis of the par or face value of the securities, and not on their market value.

"(3) The purchase of 'investment securities' in which the investment characteristics are distinctly or predominantly speculative, or the purchase of securities which are in default, either as to principal or interest, is prohibited.

"(4) Purchase of an investment security at a price exceeding par is prohibited, unless the bank shall:

(a) Provide for the regular amortization of the premium paid so that the premium shall be entirely extinguished at or before the maturity of the security and the security (including premium) shall at no intervening date be carried at an amount in excess of that at which the obligor may legally redeem such security; or

6/28/38

-11-

"(b) Set up a reserve account to amortize the premium, said account to be credited periodically with an amount not less than the amount required for amortization under (a) above.

"(5) Purchase of securities convertible into stock at the option of the issuer is prohibited.

"(6) Purchase of securities convertible into stock at the option of the holder or with stock purchase warrants attached is prohibited if the price paid for such security is in excess of the investment value of the security itself, considered independently of the stock purchase warrants or conversion feature. If it is apparent that the price paid for an otherwise eligible security fairly reflects the investment value of the security itself and does not include any speculative value based upon the presence of a stock purchase warrant or conversion option the purchase of such a security is not prohibited.

"(7) As to purchase of securities under repurchase agreement, subject to the limitations and restrictions set forth in the law and this regulation:

(a) It is permissible for the bank to purchase 'investment securities' from another under an agreement whereby the bank has an option or a right to require the seller of the securities to repurchase them from the bank at a price stated or at a price subject to determination under the terms of the agreement, but in no case less than the value at the time of repurchase.

(b) It is permissible for the bank to purchase 'investment securities' from another under an agreement whereby the seller or a third party guarantees the bank against loss on resale of the securities.

(c) It is not permissible for the bank to purchase 'investment securities' from another under an agreement whereby the seller reserves the right or the option to repurchase said securities itself or through its nominee at a price stated or at a price subject to determination under the terms of the agreement, notwithstanding the fact that the bank may also, under

6/28/38

-12-

"such agreement, have the right or option to compel the seller to repurchase the securities at a price stated or at a price subject to determination under the terms of the agreement.

"(8) As to repurchase agreements accompanying sales of securities,

(a) It is permissible for the bank selling securities to another to agree that the bank shall have an option or right to repurchase the securities from the buyer at a price stated or at a price subject to determination under the terms of the agreement, but in no case in excess of the market value at the time of repurchase.

(b) It is not permissible for the bank selling securities to another to agree that the purchaser shall have the right or the option to require the bank to repurchase said securities at a price stated or at a price subject to determination under the terms of the agreement, notwithstanding the fact that the bank may also, under such agreement, have the right or option to repurchase the securities from the buyer at a price stated or at a price subject to determination under the terms of the agreement.

"In view of the fact that some banks may have bought or sold securities under a form of agreement which is prohibited by this regulation, the bank should either terminate or modify same so as to conform to this regulation, where such action may lawfully be taken. Existing agreements of the prohibited type must not be renewed.

#### "EXCEPTION

"The restrictions and limitations of this regulation do not apply to securities acquired through foreclosure on collateral, or acquired in good faith by way of compromise of a doubtful claim or to avert an apprehended loss in connection with a debt previously contracted, or to real estate securities acquired pursuant to Section 24 of the Federal Reserve Act, as amended.

"This regulation supersedes prior regulations governing the purchase of 'investment securities' and is effective from and after July 1, 1938."

6/28/38

-13-

Consideration was then given to each of the matters hereinafter referred to and the action stated with respect thereto was taken by the Board:

The minutes of the meeting of the Board of Governors of the Federal Reserve System held on June 23, 1938, were approved unanimously.

The minutes of the meeting of the Board of Governors of the Federal Reserve System held on June 24, 1938, were approved and the actions recorded therein were ratified unanimously.

Bond, in the amount of \$50,000, executed under date of June 22, 1938, by Mr. John August Links as Federal Reserve Agent's Representative at the Federal Reserve Bank of St. Louis.

Approved unanimously.

Memorandum dated June 24, 1938, from Mr. Goldenweiser, Director of the Division of Research and Statistics, submitting the resignation of Robert C. Witherspoon as a library clerk in the Division, and recommending that the resignation be accepted at the end of such annual leave as may be due Mr. Witherspoon.

The resignation was accepted, to become effective as of the close of business on June 30, 1938.

Letter dated June 27, 1938, to Mr. Sinclair, President of the Federal Reserve Bank of Philadelphia, reading as follows:

"There is attached a copy of a report of the survey of the Bank Examination Department of the Federal Reserve

6/28/38

-14-

"Bank of Philadelphia, recently conducted by Mr. C. E. Cagle of the Board's Division of Examinations.

"It will be appreciated if you will review the attached report of the survey and give the Board the benefit of your reactions to any of the statements or conclusions concerning which you would like to express your views.

"Although the report should be regarded as confidential, the Board sees no objection to the report, or parts thereof, being submitted to, or discussed with, such of the bank's senior officers and directors as you deem advisable."

Approved unanimously.

Letter dated June 27, 1938, to Mr. Worthington, First Vice President of the Federal Reserve Bank of Kansas City, reading as follows:

"Reference is made to your letter of June 15, addressed to Mr. Paulger, in which you point out that the Commerce Trust Company, Kansas City, Missouri, treats liabilities for guaranteed letters of credit issued for other than cash consideration as direct liabilities, whereas the International Trust Company, Denver, Colorado, treats such liabilities as contingent liabilities, and you inquire as to which manner these liabilities should be treated in the statement on page 1 of the reports of examination prepared by the Reserve bank. You state also that a question has been raised as to whether your office should suggest to either of the two member banks that its method of showing the liabilities under the guaranteed letters of credit should be changed.

"As pointed out in your letter, the Board's form of condition report, Form 105, provides that letters of credit issued under guaranty or deposit of securities be shown in Schedule C as contingent liabilities, and the instructions issued by the Board for the preparation of condition reports, Form 105a, contain a statement to that effect. The condition report forms of the other two Federal agencies and, it is understood, of a majority of State departments, also provide that liabilities for letters of credit of the

6/28/38

-15-

"type under discussion be treated as contingent liabilities. Therefore, it is felt that in the interest of uniformity these liabilities should be treated as contingent liabilities in reports of examination unless there are conflicting requirements of the State authorities. If there are no such conflicting requirements of the Missouri authorities, it would probably be in order for you to take the matter up with the Commerce Trust Company with the suggestion that in the future such liabilities be treated as contingent liabilities instead of direct liabilities. If, however, the State authorities should require that the liabilities for letters of credit issued for other than cash consideration be shown as direct liabilities, it is felt that they should be so shown in reports of examination."

Approved unanimously.

Letter to Mr. Fleming, President of the Federal Reserve Bank of Cleveland, reading as follows:

"As you know, the existing arrangement under which the accounts of the Board's Fiscal Agent are audited by auditors from your bank under the direction of Mr. Grayson will terminate as of the close of June 30, 1938. Mr. Grayson and his assistants have very ably performed this work during the past five years, but since the Board feels that it is desirable to rotate the task among the auditors of several of the reserve banks it has requested the Federal Reserve Bank of Chicago to undertake the work during the year ended June 30, 1939. President Schaller has advised me that auditors of the Federal Reserve Bank of Chicago will be pleased to take over this work, and that, in accordance with our suggestion, he has asked Mr. Endres to get in touch with Mr. Grayson for the purpose of obtaining detailed information regarding the scope of the audit as made by him and the procedure followed heretofore.

"The Board appreciates the splendid cooperation it has received from your bank in the handling of this work, and feels that Mr. Grayson is to be commended for the painstaking and thorough manner in which he has made these

6/28/38

-16-

"audits and for the fine spirit of cooperation he has displayed at all times."

Approved unanimously.

Thereupon the meeting adjourned.

Robert Morris  
Secretary.

Approved:

W. C. ...  
Chairman.