FR 609
Rev. 10/59

Minutes for July 6, 1960

To: Members of the Board

From: Office of the Secretary

Attached is a copy of the minutes of the Board of Governors of the Federal Reserve System on the above date.

It is not proposed to include a statement with respect to any of the entries in this set of minutes in the record of policy actions required to be maintained pursuant to section 10 of the Federal Reserve Act.

Should you have any question with regard to the minutes, it will be appreciated if you will advise the Secretary's Office. Otherwise, please initial below. If you were present at the meeting, your initials will indicate approval of the minutes. If you were not present, your initials will indicate only that you have seen the minutes.

Chm. Martin

Gov. Szymczak

Gov. Mills

Gov. Robertson

Gov. Balderston

Gov. Shepardson

Gov. King

Minutes of the Board of Governors of the Federal Reserve System on Wednesday, July 6, 1960. The Board met in the Board Room at 2:30 p.m.

PRESENT: Mr. Martin, Chairman
Mr. Balderston, Vice Chairman
Mr. Szymczak
Mr. Mills
Mr. Shepardson
Mr. King

Mr. Sherman, Secretary
Mr. Kenyon, Assistant Secretary
Mr. Thomas, Adviser to the Board
Mr. Young, Adviser to the Board
Mr. Hackley, General Counsel
Mr. Solomon, Director, Division of Examinations
Mr. O'Connell, Assistant General Counsel
Mr. Koch, Adviser, Division of Research and Statistics
Mr. Robinson, Adviser, Division of Research and Statistics
Mr. Benner, Assistant Director, Division of Examinations
Miss Hart, Assistant Counsel
Mr. Leavitt, Supervisory Review Examiner, Division of Examinations

In June 1956, the Board ordered a formal hearing with respect to the capital adequacy of The Continental Bank and Trust Company, Salt Lake City, Utah. The hearing began in April 1957 and concluded in November 1958, following which Counsel for Continental and Special Counsel to the Board submitted proposed findings and conclusions. In March 1959, the Trial Examiner filed his Report and Recommended Decision, and on July 22, 1959, oral arguments were presented before the Board. Under date of May 13, 1960, there were distributed to the members of the Board a memorandum from the Legal Division dated

May 11, 1960, a supplemental law memorandum of the same date, a memorandum from the Division of Examinations dated April 11, 1960, and another memorandum from the same Division dated May 12, 1960. Attachments to the May 12 memorandum included a form presenting capital analyses of Continental as of several significant dates and a memorandum discussing the Form for Analyzing Bank Capital.

Mr. Hackley commented that this case was complex, involved perplexing questions, and was of considerable importance as a precedent. Therefore, he would like to present the views of the staff on the legal aspects as clearly as possible in order to avoid any misunderstanding. Before doing so, however, he wished to point out that the case had aroused considerable emotion on the part of those concerned, for which reason the staff had made a special effort to be as objective as possible in considering the legal questions involved. One factor that had helped was the principle of separation of functions contained in the Administrative Procedure Act; the staff members now working on the case did not participate in the investigatory phase of the proceeding and entered the case only after the presentation of oral argument.

Mr. Hackley also pointed out that although the conclusions reached by the legal staff differed in many respects from those of the Trial Examiner, they also differed in some respects from the legal conclusions of Special Counsel to the Board. This comment was not intended to reflect on the professional ability, integrity, or industry

of Special Counsel. When this case began, it was of a novel nature involving questions not theretofore explored. In perspective, one might now see things in a somewhat different light; Special Counsel might now see them in a somewhat different light if he were starting anew.

Proceeding to a review of the background of the case, Mr. Hackley pointed out that prior to February 1, 1952, Continental was a national bank chartered under the provisions of the National Bank Act. As of that date it converted to a State charter under the laws of the State of Utah, and as of the same date it was admitted to membership in the Federal Reserve System as a State bank by virtue of the Board's approval of the bank's application for membership. At the time of Continental's admission to membership as a State bank, section 9 of the Federal Reserve Act required a State bank, in order to be eligible for membership, to have capital equal to the minimum amount specified by the National Bank Act for the organization of a national bank in the place where such State bank was located, and Continental met this requirement. It was not until July 15, 1952, that the law was changed to prohibit admission of a State bank to membership unless it has "capital stock and surplus which, in the judgment of the Board of Governors of the Federal Reserve System, are adequate in relation to the character and condition of its assets and to its existing and

prospective deposit liabilities and other corporate responsibilities." However, under the statute the Board clearly had discretion as to whether to admit a State bank to membership. The Board could have refused the application of Continental on the ground that in its judgment the bank's capital was not adequate, or it could have, as it did, admit the bank to membership notwithstanding that in the Board's judgment the bank's capital condition was not satisfactory. Under the statute the Board then had, and still has, authority to prescribe conditions of membership, and in approving the application of Continental the Board prescribed two conditions similar to those prescribed in other cases. The second of those conditions provided that "the net capital and surplus funds of such bank shall be adequate in relation to the character and condition of its assets and to its deposit liabilities and other corporate responsibilities, and its capital shall not be reduced except with the permission of the Board of Governors of the Federal Reserve System." In addition, the Board prescribed two special conditions of membership. One required full payment within two years of the indebtedness to Continental of certain members of the family of Mr. Walter E. Cosgriff, President of Continental; the other provided for the elimination of certain losses prior to membership. Also, in its letter dated January 25, 1952, advising the bank of approval of its application for membership, the Board stated:

"In approving this application the Board of Governors has considered and relied upon the assurances given by Mr. Cosgriff that his indebtedness and that of his immediate family to the affiliated banks in which they own a majority stock interest will be liquidated within two years and that the dividends of The Continental Bank and Trust Company will not exceed $108,000 per annum until the capital funds of the bank have been increased through retention of earnings by a substantial amount: at least $600,000 to $700,000. The Board feels that the present capitalization of the bank is low in relation to its total assets and, particularly, in relation to the amount of its risk assets (total assets less cash and Government securities). Therefore, the Board wishes to emphasize the fact that its present action in approving the application for membership is not to be construed as approving in any way the bank's capital position or as indicating that the Board may not hereafter insist on an increase in the bank's capital or on the correction of any undesirable condition."

Subsequently, after Continental was admitted to membership, examinations of the bank indicated that its capital condition had not improved, but instead had deteriorated, and efforts were made to induce the bank to increase its capital. The final unsuccessful attempt was made in February 1956 when, at the instruction of the Board, the Federal Reserve Bank of San Francisco requested Continental to increase its capital by $1,500,000. This was a request, not an order. After Continental failed to comply, the Board in June 1956 issued an order providing for a hearing to determine: (1) the adequacy or inadequacy of the net capital stock and surplus of the bank in relation to the character and condition of its assets and its present and prospective deposit liabilities and other corporate responsibilities; (2) the additional amount of capital funds, if any, needed by the bank; and (3) what period of time would be reasonable to allow the bank to increase its capital

funds to make them adequate, before being required by the Board to surrender its Federal Reserve Bank stock and forfeit its membership in the System.

After tracing the course of the hearing conducted pursuant to that order, Mr. Hackley referred to the report of the Trial Examiner in March 1959 which recommended that the proceeding be dismissed for (1) want of jurisdiction or lawful authority; (2) violation of due process of law; and (3) failure of the Board to sustain the burden of proof.

Mr. Hackley commented that it was important to bear in mind the provisions of the law and the language of the notice of hearing, following which he turned to a discussion of the nature of the issues involved. First, there was the legal issue; that is, the question of the Board's authority to require a State member bank to maintain adequate capital under penalty of loss of membership. Second, there were the factual issues relating to whether the bank's capital was inadequate and, if so, in what amount. These factual issues also had legal implications since the determination must be reasonable to be upheld on judicial review.

The legal questions, Mr. Hackley said, could be divided into three parts: (1) whether violation of a valid condition of membership is a ground for forfeiture of membership; (2) whether the second standard condition of membership is a valid condition; and (3) in what

manner the membership of a State bank may be forfeited for violation of that condition.

On the first question, Mr. Hackley pointed out that the ninth paragraph of section 9 of the Federal Reserve Act provides that "If at any time it shall appear to the Board of Governors of the Federal Reserve System that a member bank has failed to comply with the provisions of this section or the regulations of the Board of Governors of the Federal Reserve System made pursuant thereto, or has ceased to exercise banking functions without a receiver or liquidating agent having been appointed therefor, it shall be within the power of the Board after hearing to require such bank to surrender its stock in the Federal reserve bank and to forfeit all rights and privileges of membership. The Board of Governors of the Federal Reserve System may restore membership upon due proof of compliance with the conditions imposed by this section." Thus, under this section, three grounds are cited for forfeiture of membership: (1) failure to comply with the provisions of section 9 of the Federal Reserve Act; (2) failure to comply with regulations of the Board made "pursuant" to section 9; or (3) cessation of banking functions under certain circumstances.

Mr. Hackley noted that in the opinion of the legal staff a condition of membership is not itself a regulation of the Board. A regulation applies generally to all parties subject thereto, while a condition of membership relates to a particular case and is accepted

voluntarily by a State bank that joins the System. The legislative history of amendments to the Federal Reserve Act in 1917 and 1927 made it clear that the Congress intended to distinguish between conditions of membership and regulations of the Board. Although standard conditions of membership are found in section 7 of Regulation H, Membership of State Banking Institutions in the Federal Reserve System, they would appear to have been included only as a matter of information; but section 6(c) requires compliance with conditions prescribed by the Board in connection with admission of a State bank to membership. In one case (Peoples Bank v. Eccles, 1947) the Court upheld the power of the Board to bring about forfeiture of membership for violation of a valid condition of membership, and incidentally stated that condition No. 2 was authorized, but the Court did not discuss the question whether violation of a condition of membership constituted a violation of law or violation of a Board regulation.

In the view of the legal staff, Mr. Hackley said, the violation of a valid condition is a violation of section 9 of the Federal Reserve Act. While, as aforesaid, the standard conditions of membership are included in Regulation H, there are many other sections of that Regulation which, although included in the scope of the Regulation, are not themselves regulatory. However, section 6(c) requires that if a State bank is admitted to membership, it shall comply with conditions prescribed by the Board. Thus, violation of a condition of membership

would seem to constitute a violation of the statute, and also a Board regulation pursuant thereto. Further, unless the law implicitly requires a State bank voluntarily accepting a condition of membership subsequently to comply therewith, the provision of law authorizing the Board to admit State banks subject to prescribed conditions obviously would not have significance. In summary, it was felt that a violation of a condition of membership in this or any other case would constitute a violation of section 9 of the Federal Reserve Act. Beyond that, it would be a violation of section 6(c) of Regulation H, which is clearly authorized pursuant to section 11(i) of the Act, a section that gives the Board the power to promulgate regulations to effectuate its functions. On that theory it would be unnecessary to consider some of the questions debated during the hearing; that is, whether there is any authority in the law, express or implied, for the promulgation of regulations relating to capital adequacy or whether there are statutory standards for that authority. All that would be needed was the express authority in section 9 to prescribe conditions of membership and the provision in Regulation H which requires a State bank to comply with conditions of membership. However, in order to cause forfeiture of membership for violation of a condition, there must be a valid condition of membership. Section 9 expressly authorizes the prescribing of conditions "pursuant" to the Federal Reserve Act, and the authority for a condition relating to capital adequacy can

clearly be found in the fourth paragraph of section 9 of the Act, which requires the Board to consider various factors in acting upon a membership application, these factors being more definite than standards upheld by the courts in many cases. It seemed to the legal staff that capital adequacy is a valid factor in considering the financial condition and character of management of an applicant bank, and that the law could be said to contain clear authority and standards for prescribing conditions relating to capital adequacy.

Even so, Mr. Hackley said, Continental Bank and the Trial Examiner contended that the condition of membership itself was not sufficiently definite to enable the member bank to know whether it was complying with that condition. The legal staff felt that, to the contrary, the condition did contain within its own language sufficient definiteness and sufficient standards, and that the language was far more definite than standards upheld by the courts in other cases, including cases in the banking field. It was further contended by Continental that the condition was still invalid because it was made a condition subsequent to membership and not merely before admission to membership. This argument was believed to be untenable; if sound, it would admit to membership a State bank that had adequate capital at the time it was admitted, but it would permit subsequent deterioration. Thus, unless the condition had continuing validity it would have no meaning or significance. Finally, it was contended that the

condition was in derogation of the authority of the Federal Deposit Insurance Corporation. This argument also was felt to be untenable. The Federal Deposit Insurance Act expressly recognizes that the granting of membership to a State bank by the Board of Governors automatically gives that bank deposit insurance. Likewise, the Act provides that termination of System membership automatically causes a bank to lose its deposit insurance in the absence of action by the Federal Deposit Insurance Corporation.

In summary, it was felt that not only could the Board legally require forfeiture of a bank's membership but that the second standard condition of membership was a validly prescribed and enforceable condition.

Mr. Hackley then turned to the procedure for enforcement in causing forfeiture of membership for violation of a condition of membership. This, he said, related to the legal nature of the hearing in this case and the reasonableness of the factual determination of adequacy of capital. Section 9 of the Act makes it prerequisite to forfeiture that (1) it must appear to the Board that the member bank has failed to comply with a provision of that section or regulations of the Board pursuant thereto, and (2) having made such a determination, the Board must order a hearing before forfeiture of membership may be effected. Ordinarily, a question of violation does not involve an element of judgment, as, for example, a violation of section 22(g)

of the Federal Reserve Act, but here there was an element of judgment as to whether or not the capital of the bank was adequate. This involved not just the amount of capital but its adequacy in relation to the character and condition of the bank's assets, its deposit liabilities, and other corporate responsibilities. Condition No. 2 is not self-executing; there is no commonly accepted rule as to what is adequate capital for purposes of the condition. Therefore, for the purpose of forfeiture of membership, it was felt that the condition could not be considered violated until a determination had been made by the Board that in its judgment the bank's capital was not adequate. No such determination was made by the Board in instituting the hearing in 1956; the notice of hearing did not say that the Board had determined that the bank's capital was inadequate. Instead, the notice made it clear that the purpose of the hearing was to determine whether the bank's capital was inadequate and, if so, by what amount, and what time the bank should have to provide more capital. This was clearly recognized by the Trial Examiner in the early stages of the hearing, although subsequently he took a different view.

Thus, it could not be said that the condition of membership had been violated by Continental unless and until the Board issued to the bank an order to increase its capital in a definite amount and allowed the bank a specific time to effect the increase. Only if the bank then failed to comply could it be said that the bank had failed to comply

with the condition of membership, section 9 of the Federal Reserve Act, and regulations of the Board pursuant to section 9. If this view was not followed, it was the belief of the staff the conclusions of the Trial Examiner as to lack of jurisdiction, denial of due process, and failure of the Board to sustain the burden of proof would probably be upheld by the courts.

In net effect, it was the conclusion of the legal staff that if, as contemplated at the outset of the proceeding, the hearing that was held was not the hearing required by statute prior to forfeiture of the bank's membership, it would be necessary to determine whether or not the bank's capital was or was not adequate before any proceeding was instituted to forfeit its membership.

The determination of the capital needs of this bank was primarily a factual matter, and a matter of bank supervision, but from the legal point of view such determination would need to be reasonable and not arbitrary in any sense. A court might sustain the Board's legal authority to bring about forfeiture of membership and still upset the determination of the Board on the factual question if it felt the Board's determination was not based on substantial and reasonable evidence.

Mr. Hackley commented that some testimony introduced during the hearing was criticized by the Trial Examiner and excluded on the ground

that it was biased. Even if it was not, Mr. Hackley felt it would be desirable to exclude any evidence of that kind from the Board's consideration of the matter. The same principle would apply to certain other evidence where the Trial Examiner ruled that denial of due process was involved.

Mr. Hackley said he also felt rather strongly that, as a matter of law, the Board's determination would not be regarded as a reasonable determination if it were based solely or primarily on any one mathematical formula or test. Instead, it would be desirable to base any determination on consideration of all relevant factors, including screening devices, testimony of expert witnesses, and examination reports, as well as the arguments advanced by Continental.

Mr. Hackley expressed the opinion that before the bank's membership could be legally forfeited, four steps were necessary: (1) a determination by the Board as to the definite amount of inadequacy of the bank's capital in relation to its condition, assets, deposit liabilities, and corporate responsibilities, a determination that must be based on substantial evidence; (2) the issuance of an order to increase capital by a specified amount within a specified time; (3) failure of the bank to comply; and (4) a charge of violation for noncompliance with the condition of membership, and a formal hearing as required by the statute. Thus far, none of these four steps had been taken. The hearing that had been held was essential in order to provide

the Board with adequate evidence and allow the bank a fair chance to express its views before the Board made any determination as to the inadequacy of capital, but it was not the hearing required by the statute, only a preliminary step. The Board now had its choice, at least theoretically, of at least four alternatives: (1) it could agree with the recommendation of the Trial Examiner and dismiss the proceeding on the ground that it lacked jurisdiction and authority to cause forfeiture of the bank's membership; (2) the Board could reject the Trial Examiner's Report and issue an order calling for forfeiture of the bank's membership without the opportunity for a further hearing; (3) it could reject the conclusion of the Trial Examiner on the legal question but nevertheless dismiss the proceeding on the ground that in the Board's judgment the bank did have adequate capital; or (4) it could follow the course recommended by the legal staff; namely, issue an order stating the Board's determination that the bank's capital was inadequate by a specified amount and ordering the bank to increase its capital within a specified time and, if the bank should fail to comply with that order, institute a forfeiture proceeding with a further hearing. It was felt that the first two alternatives would be contrary to law; the choice between the third and fourth involved a matter of judgment. If the fourth course were adopted, any order of the Board probably should be accompanied by a rather comprehensive statement with respect to the Board's legal authority and the basis on which the Board had made

its determination, because it was quite probable that upon the issuance of any such order the bank would immediately move into court challenging the authority of the Board to issue the order.

In reply to a question, Mr. Hackley said it was true that at one point in the proceeding Continental requested a more definite statement of law and facts, to which Special Counsel for the Board responded with a statement of particulars in which he indicated that Continental had been charged with a violation of the condition of membership and that its capital might be inadequate within a range of certain amounts. However, Special Counsel added that in any event the determination of that amount would remain for decision by the Board of Governors. Mr. Hackley said that, notwithstanding what might have been stated by Special Counsel and notwithstanding the fact that Continental could undoubtedly seize upon such statement, in his view the Board had not, and could not legally, at the time the hearing was started have charged Continental with violation of the condition of membership. That charge could be made only after the Board determined that Continental's capital was inadequate.

Governor Mills stated that the new approach outlined by Mr. Hackley confounded his original understanding of developments since the demand for additional capital was first asserted against Continental. He would regard the statement that had been made by Mr. Hackley as a repudiation of the position of Special Counsel to the Board, which he

thought was a serious matter. He also felt that Special Counsel would have to be heard if the approach now recommended by the legal staff should be decided upon by the Board and followed. However, what concerned him more, as a practical consideration, was that the Board made a demand upon Continental to introduce $1,500,000 of additional capital into its capital structure with the supposition, at least, that that amount would be adequate to correct the complaint that the Board had made. Now, four years later, it was suggested that the Board render an opinion that $1,500,000 additional capital would not be adequate, this in face of the fact that during the four-year period Continental had added a substantial amount of additional capital, the quality of its assets had improved, and only recently the Federal Deposit Insurance Corporation had changed the bank's classification from a serious problem bank to a problem bank. What concerned him deeply was that the Board would open itself to a charge of persecution and of prolonging a case since, during the period of the proceeding, Continental had in some practical ways fulfilled the demands asserted against it.

Mr. Hackley replied that on the second point he felt the Division of Examinations would be better qualified to respond. On the first point, as he had indicated at the outset, it was rather awkward for the legal staff to be forced in its consideration of the matter to reach conclusions somewhat at variance from those of Special Counsel.

He did not feel, however, that the legal staff was repudiating Special Counsel's whole view of the case. The minutes of the Board indicated that before the proceeding was instituted Mr. Powell stated that he would contemplate that any order of the Board would have to be followed by another hearing. The only difference was that Mr. Powell apparently felt that the second hearing would be a simple, perfunctory hearing in order to reach a determination that the bank had failed to comply with the Board's order. The view of the legal staff was that the first hearing could lead only to a factual determination by the Board and an order of the Board for Continental to increase its capital, and that a charge of noncompliance with the condition of membership would follow only upon failure to comply with that order.

In reply to a question regarding the nature of the request contained in the letter sent by the San Francisco Reserve Bank to Continental in February 1956, Mr. Hackley said it was clearly understood at the time that it constituted only a request and not an order.

Governor Balderston referred to the three questions that the hearing was intended to answer, as stated by Mr. Hackley, and inquired whether it was not true that if the Board had attempted to answer the first two questions without benefit of the hearing, its order might have been attacked as arbitrary and capricious.

Mr. O'Connell replied in the affirmative. The Board could have issued an order for an increase in capital without a hearing. However,

as Mr. Hackley had indicated, if Continental had immediately taken the matter to court it would have had a far better basis for contesting the reasonableness of the order by alleging that it had not at any time been shown the basis for the Board's determination and had not been given an opportunity to present evidence.

Governor Balderston then noted that the Trial Examiner had expressed the view that Continental was denied due process because of certain rulings of the Board. He inquired whether, if the Board's statement of the case should treat the hearing as having been held for the purposes just described, the due process charge of the Trial Examiner would have the same weight in the eyes of the court as would be the case if denial of due process were charged in any further hearing that might be held. He also inquired whether, if an order should be issued by the Board and Continental should take the matter to court, the Board would have to envisage changes in the rules already made concerning evidence in order to avoid the charge of denial of due process.

Mr. O'Connell replied that the Trial Examiner had made multiple findings as to denial of due process. In its memorandum the legal staff had indicated that it disagreed with the Trial Examiner on certain of those findings. As to the confidential sections of examination reports, it was the opinion of the legal staff that the question was a close one. If the court should view the reason for that demand by Continental as

purely to permit it to cross-examine certain witnesses, it could be noted that the Board had stricken the testimony of those witnesses in its consideration of the matter. However, if the court should say that the confidential sections could have been used not only for that purpose but to allow Continental to frame its case, the situation might be different. The hearing that was held was required by the rules of fair play established in the Administrative Procedure Act; such a hearing must in all respects be fair and provide adequate opportunity for expression of views of the parties. If the failure of Continental to have access to the confidential sections of examination reports deprived it of adequate opportunity to develop its case, then it might be held that denial of due process existed if the Board used such information as a basis for its order. If in any further proceeding the Board was called upon to establish the basis for that order, Continental in all likelihood should be allowed to have the material upon which the Board's judgment had been based to further its opportunity for rebuttal or cross-examination.

Governor Balderston then asked whether he understood correctly that denial of access to certain material during the hearing already held would not be vital if the order of the Board was not based upon that portion of the evidence, whereas in any further hearing a similar denial might be vital.

Mr. O'Connell replied that an order issued by the Board at this time should be based on testimony and other material that was available to

Continental during the process of the hearing that had been held. If the Board should issue an order based on material held by the Trial Examiner to have violated due process, the order would be faulty to that extent. If Continental should go to court and challenge the validity of the order, the Board must show evidence substantial in nature; and if the order was based on confidential, undisclosed information it might be found unreasonable. The order should be based on material that was equally available, or would be equally available, to Continental.

Chairman Martin referred to discussions of the Board relative to admission of Continental to membership in early 1952 and asked for further comment on whether it appeared that at that time the Board believed that Continental's capital was inadequate.

In reply, Mr. Solomon read portions of the Board's letter to Continental approving its membership application which specified that the dividends paid by Continental should not exceed $108,000 per annum until the capital funds of the bank had been increased through retention of earnings by a substantial amount, at least $600,000 or $700,000.

Chairman Martin noted that the provisions relating to restriction of dividends and retention of earnings had been complied with, together with the condition relating to removal from the bank of certain indebtedness of members of the Cosgriff family. He asked whether it appeared to have been the assumption at the time of admission that if Continental complied with those conditions its capital would be considered adequate.

Mr. Hackley then read additional portions of the letter to Continental which indicated that the Board felt that the bank's capital was low at that time and that approval of the application in no sense meant that the Board could not later insist upon an increase in capital.

Mr. Solomon commented that if Continental had increased its capital funds to the extent indicated in the letter and there had been no other developments, there would have been no basis on which to institute the proceeding. However, situations with respect to the adequacy of capital are constantly changing. In this case the asset distribution of the bank changed radically. From a situation where $700,000 of additional capital might have made the bank reasonably capitalized, the bank got itself by 1955 or 1956 into a position where that amount was quite inadequate.

Chairman Martin then asked for further comment about developments since 1956.

Mr. Solomon replied that the situation was somewhat similar to that which existed during the period between 1952 and 1956. The bank had increased its capital funds by some $900,000; on the other hand, it had substantially increased its risks even though its footings remained relatively constant. The adequacy of capital must be considered in relation to other factors; it would be difficult to imagine any such thing as a bank's capital being adequate or inadequate in a vacuum.

It must be adequate or inadequate in relation to the character and condition of the bank's assets, its deposit liabilities, and other corporate responsibilities. In order to form a judgment, one must look and see what all of the circumstances were. Sometimes those circumstances may fluctuate or change for reasons beyond the control of the bank, but they are largely under the control of the bank; it is within the discretion of management to distribute the bank's funds in one way or another.

Chairman Martin commented that the Board had leaned over backward at the time Continental was admitted to membership in order to avoid a charge of bias. The Board, he felt, should also be sure that, having admitted the bank, it was not leaning over backward in the opposite direction. Chairman Martin said he was trying to put the matter in terms of the thinking that he had gone through on reading the record. What should be clear in the Board's mind was that it had made a fair analysis.

Mr. Solomon commented that the examining staff had tried hard to make a fair analysis, and Mr. Hackley commented that, as Mr. Solomon had pointed out, the amount of a bank's capital, by itself, is not the criterion. Instead, the amount of capital must be related to the character of assets and to deposit liabilities.

Mr. O'Connell noted that the various methods of analysis that had been used all came within a relative small area of difference in

their ultimate conclusions. Over the years Continental had increased its capital in an absolute sense, yet it apparently had failed to comply with the condition that its capital be maintained in adequate relationship to its assets, deposit liabilities, and other corporate responsibilities.

Mr. Hackley then stated that there might be a fifth alternative course of action open to the Board, although he would not recommend it. The original hearing was ordered in 1956 and there had been changes in the interim, which raised the question whether another hearing for the purpose of determining the facts on a current basis would be a more practical approach than to attempt to reach a current judgment on the basis of the hearing that had been held.

Mr. Solomon described the type of analysis that the examining staff had attempted to make, which led him to the conclusion that the Board would not be in an appreciably better position, from the standpoint of information on which to make a factual determination, if it were to institute another hearing at the present time. The information used by the expert witnesses at the hearing came out of the bank's own records, and current information of that kind was available to the Board. Therefore, the factual analysis of the examining staff was not based on stale information.

Governor Balderston said it appeared that the examining staff had arrived at a capital deficiency of about $2.2 million using figures

based on examination of the bank in February of this year.

Mr. Solomon stated that this was correct and added that the call report for June of this year would permit a further judgment as to the direction in which the situation was moving.

Chairman Martin inquired whether the Board was felt to be in a stronger position on $2.2 million than on the $1.5 million that Governor Mills had mentioned. He noted that in 1956, when the Board through the Federal Reserve Bank of San Francisco suggested $1.5 million additional capital, it was requested that the bank increase its capital by that amount in a six-month period. Thus, in effect, the Board was following one of the four alternatives suggested by Mr. Hackley, but without the benefit of a hearing as to the question of capital adequacy. Now, in view of that hearing and what had transpired since, the Board would be reaching a new decision that $2.2 million would be required to make the bank's capital adequate. However, instead of suggesting that the San Francisco Bank ask Continental to increase its capital to that extent, the Board would issue an order.

Mr. Hackley said that if the Board should issue an order requiring an increase in capital, he presumed Continental would attack the validity of the order and also the amount of capital required to be supplied. If during a further hearing reasonable evidence were presented by Continental clearly indicating that it did not need an additional $2.2 million, presumably there would still be an opportunity for the Board to modify the amount.

Mr. O'Connell commented that on the basis of the method of analysis developed during the hearing the examining staff had made an analysis of the need for capital through February 1960 and was willing to recommend that an order of the Board be based on that analysis. Therefore, at the time of the next hearing, if the Board should order one, the Board could be quite firm in its position that on the basis of analysis this was the right figure, and there would seem to be little likelihood that an adjustment would be necessary. Either Continental would disprove to the court's satisfaction the validity of the tests used, or the validity of those tests would be established and the amount of capital called for by the Board's order would be affirmed.

The Chairman then suggested that the Board go on to the factual analysis of the amount of capital deficiency of Continental.

Mr. Solomon commented that those members of the examining staff who prepared the analysis for the Board had tried to approach the matter from a fresh viewpoint. They had had no interest in the prosecution of the proceeding that took place earlier through the Board's Special Counsel and those associated with him. In making the analysis, all evidence had been excluded that was subject to criticism by the Hearing Examiner. The staff had not attempted to judge the significance or accuracy of that criticism; it had simply excluded the evidence in question.

Mr. Solomon went on to say that the matter of adequacy of the capital of Continental Bank and Trust Company had been a continuing question from the time the bank was admitted to membership in the System as a State bank, as reflected in the Board's letter approving the bank's membership application. He then turned to the question of the nature of bank capital and its functions, and stated that sometimes this question was presented as a complex matter. However, this did not seem to him to be the case, for it was simply one form of financial analysis of the kind made continually by people analyzing the value of securities and by banks extending credit. A bank extending credit is interested in the earning power of the borrower and its management, but primarily in whether the borrower's inventories are likely to get to the place where they will not pay out. A bank's capital is essentially a matter of net worth, and appraisal of its adequacy involves a question of how this net worth compares with the risks that are being taken. The unusual analytical factor, as far as bank capital is concerned, is that a bank has more varied assets than the usual lines of inventories. Also, a bank has liabilities that are in practice payable on demand, including time and savings deposits. To some extent, this is offset by the fact that in practice deposits do not always have to be paid on demand. There are certain percentages that can be played on the basis that certain amounts of deposits are quite likely to stay at the bank. Also, public policy has provided some sort of assistance and banks can lend to each other.

Mr. Solomon then turned to methods of measuring the adequacy of bank capital and referred to the fact that there are a number of screening devices. After commenting that these devices do not provide final answers to the adequacy of capital in a particular situation, he enumerated the screening devices that had been used by expert witnesses at the Continental hearing and referred to the conclusions reached by seven of the expert witnesses as tabulated in the memorandum that had been distributed to the Board, noting that the estimates of these witnesses as to capital deficiency ranged from $2.5 to $3.6 million. In each case the estimate reflected adjustment for factors that the witness found were not fully reflected in the screening devices he had used. The conclusion of these seven witnesses was that Continental had from 50 per cent to 59 per cent of the capital that it needed.

Mr. Solomon then referred to the testimony of the witnesses presented by respondent, including the testimony of Mr. Cosgriff, and the conclusions of the examining staff with respect to the points made by Mr. Cosgriff, Mr. Solomon's comments in these respects being based on the memorandum that had been presented to the Board.

Mr. Solomon next described how the examining staff had arrived at the recommendation that the Board order Continental to increase its capital to the extent of $2.2 million, and in this connection explained why it was felt that the Form for Analyzing Bank Capital had certain advantages as a screening device not inherent in other screening devices.

The procedure, he said, had been to apply that form to the situation existing in 1956 and to see what adjustments should be made for various factors, such as the area served by the bank, the value of the bank's building, and management. After discussing in some detail these three factors and the weight attached to them in adjusting the results indicated by use of the Form for Analyzing Bank Capital, he said the conclusion was reached that in 1956 there was a need for additional capital amounting to somewhat more than $2.2 million. The question then remained of updating the information, and the examining staff had attempted to deal with this by reviewing the situation of Continental over a period of years and appraising trends and tendencies. The results were indicated on page 32 of the memorandum to the Board and in an attachment to that document. This analysis indicated that although capital had been increased between 1951 and 1956 the bank's risks also increased, and that the same trends prevailed from 1956 to 1960. It appeared that at present Continental was operating in a range of risks about $2.2 million greater than the capital covering those risks. By June 1960 the bank's capital had increased to the extent of $900,000 since 1956, but the bank's risks had increased fully as much. Among other things, the bank had gone into long-term Government securities heavily, and there was market depreciation to the extent of $800,000 in such securities. In summary, it was felt that the capital deficiency in 1956 was about $2.2 million, that in

February 1960 it was still about $2.2 million, and that probably the deficiency today was in that same general neighborhood. Another look could be taken when the latest call report figures were available, but it seemed unlikely that the staff would want to change its appraisal on that basis. As to the time within which the increased capital should be required, a period of six months was suggested.

Chairman Martin referred to the comments made by Mr. Solomon regarding the market depreciation in Continental's portfolio of Government securities and inquired whether in the process of analysis any allowance was made for Government securities as distinguished from securities such as mortgages.

Mr. Solomon replied that the general history of Federal Housing Administration and Veterans Administration mortgages appeared to have been quite similar to Government securities with maturity over 10 years. Therefore, in the Form for Analyzing Bank Capital they are put in the same category. Conventional mortgages are treated like all other loans.

In response to further questions, Mr. Solomon verified that the analysis by the examining staff of the Continental case included no added capital provision for the management factor. Therefore, the computation of capital deficiency was somewhat less than the figure derived by the expert witnesses. He felt that adequate recognition had been given to the bank building and that the result of the analysis in this respect was objective.

With reference to the management factor, Governor Balderston said it seemed to him that the analysis of the examining staff argued for some additional capital provision on account of that factor. However, the conclusion of the staff was not to add anything, and he inquired whether this was not rather inconsistent.

Mr. Solomon replied that a question of policy was involved. He felt personally that some additional allowance could be justified since the expert witnesses seemed to feel that way. However, the staff recommendation was based on the fact that the management factor was not as susceptible of reduction to a dollar basis as some other factors. Therefore, the staff decided to lean over backward and give the benefit of doubt to the bank. He noted that some weight would be given to the management factor if the Board took the view that the bank should increase its capital to the full indicated capital requirement.

Governor Balderston then commented to the effect that the consensus of the expert witnesses as to the extent of capital deficiency was around $3 million, and that a court might wonder in the circumstances how the Board in its judgment had come out with a figure of $2.2 million.

Mr. Solomon replied that he did not believe most of the expert witnesses had considered the bank building in too much detail. The main difference in the figures, however, appeared to be the much greater weight given by the witnesses to the management factor than was proposed to be given by the staff, the witnesses apparently having been quite

impressed with the negative characteristics of the management of this bank. While there was some justification for that position, the staff would suggest that the allowance for the management factor at least be scaled down. In actuality, the difference between the staff and the consensus of the expert witnesses was not as significant as might first appear, because in terms of total capital the difference would be between $6.7 million and $7.5 million.

Governor King referred to the original request of $1.5 million in 1956 and to the fact that the current staff recommendation contemplated a larger increase despite additions to the bank's capital. In this connection, he also referred to an application of the Form for Analyzing Bank Capital which indicated that the capital deficiency in October 1956 may have been as much as $3.1 million. Since the request of $1.5 million in February 1956 was made by the Board on the basis of a staff recommendation, it might appear that a great deal of change in the bank's condition took place between then and October 1956. However, a more likely assumption would be that the initial request represented a scaling down, or compromise, of what was thought to be actually needed. Nevertheless, once that request was made, it seemed rather inconsistent to come into the hearing procedure and demand all of the capital that was indicated by the analysis form. Instead, it would seem that the Board perhaps should settle for less than the amount indicated by the form in order to be reasonable in the light of the original request.

Mr. Solomon responded to the effect that the $3.1 million figure as of October 1956 apparently was an unadjusted application of the Form for Analyzing Bank Capital and did not take into account, for example, allowance for the bank building. As shown on page 32 of the memorandum submitted to the Board, the adjusted figure as of October 1956 was about $2.2 million. Also, as of October 1956 the bank's portfolio contained a quantity of Government securities with maturity of slightly more than five years. When the form was applied mechanically, those securities were thrown into the category of maturities over five years. However, this was considered too severe and an adjustment was made.

With regard to the original request of $1.5 million, Mr. Solomon noted that the request had to be based on data no more current than the examination made in April 1955. The examination showed that the bank's deposits had increased substantially, but there could have been a question whether the deposit increase was permanent. In the circumstances, it would not have been unreasonable to say that the Board was not going to insist on moving right up to the most recent deposit totals.

Governor King said it would still seem reasonable to him to scale down on some basis similar to that on which the request of February 1956 evidently was scaled down, to which Mr. Solomon replied that many times people make offers and compromises which would not be made if the situation should continue indefinitely. Beyond that, the

picture had changed in the sense that the Board now had a record that would enable it to make a more definite determination of the need for capital than was possible in early 1956.

After additional discussion, it was agreed that the matter of Continental Bank and Trust Company would be considered further at another meeting of the Board.

The meeting then adjourned.

Secretary