X-4457

MEMORANDUM BY PROF. SPRAGUE

regarding

LEGISLATIVE PROPOSALS ACCEPTED BY THE ADVISORY COMMITTEE.

November 21, 1925.

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The Advisory Committee has approved without change all of the numerous provisions of the first McFadden bill designed to liberalize the national banking law, suggesting changes only in Section 5200 covering loan limitations and in the new investment banking section. No action was taken on the branch banking proposals contained in the bill, the Committee being of opinion that it would be unwise for the reserve system to take any position on this highly controversial matter. The Committee also agreed upon a limited number of additional amendments, confining itself to those which presumably would not arouse serious opposition. The text of the various proposals of the Committee is herewith submitted together with summary indications of their scope and purpose.

SECTION 5200, REVISED STATUTES.

(Suggested changes are enclosed in brackets)

Section 5200. The total liabilities(other than those incurred under Section 13 of the Federal Reserve Act)to any (national banking) association of any person, firm, company, or corporation for money borrowed, including in the liabilities of a company or firm the liabilities of the several members thereof, shall at no time exceed 10 per centum of the capital stock of such association actually paid in and unimpaired, and 10 per centum of its unimpaired surplus fund. This limitation as to such liabilities to such association shall be subject to the following exceptions:

> No change in the present statute other than the specific exclusion of bank acceptances.

(1) Liabilities arising out of the discount (or purchase) of the following described paper shall be subject to no limitations based upon the amount of such capital and surplus:

> The phraseology of the Senate draft of the McFadden bill is followed here with the addition of definite provision to cover purchased paper.

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With its numerous exceptions, both limited and unlimited, this section of the national bank act is unavoidably long and complicated, giving rise to many difficulties of interpretation in practice. Much might be said in favor of the policy embodied in the recent legislation of a number of States, notably New York and Missouri, limiting the amount which may be lent to any one interest regardless of the form or nature of the obligation, loans secured by U. S. Bonds or by bonds of the State or its local governing units being the sole unlimited exception. In New York, for example, there is a blanket limitation of 15 per cent for city banks and 25 per cent for country banks covering all paper as to which more than the customary 10 per cent is allowed. Owing to the wide diversity of conditions in different sections of the country, this does not seem to be a feasible policy in the case of the national banks.

(a) Bills of exchange drawn in good faith against actually existing values; (b) Commercial or business paper actually owned by the person, firm, company or corporation negotiating the same; (c) Drafts and bills of exchange secured by shipping documents conveying or securing title to goods shipped --(but provided that no such drafts, bills of exchange, or commercial or business paper included under (a), (b), and (c) of this subtitle, shall be included within the meaning of this exception when both drawer and drawee, or both maker and payee are corporations and one such corporation is affiliated with or a subsidiary of the other, i.e., if a majority of the stock of one such corporation is owned by the other or by the stockholders thereof.)

The purpose of the additional clause is to exclude at least some portion of those bills of exchange and notes that are in substance nothing more than the obligations of a single interest.

(d) Demand obligations when secured by documents covering commodities in actual process of shipment (when such obligations are or have

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been discounted or purchased for the account of the drawer or endorser.)

> The additional proviso here is designed to exclude the holding of accepted demand obligations for an indefinite period of time by a bank, a practice which involves making an unsecured loan to the borrower.

(e) Bankers' acceptances of the kinds described in Section 13 of the Federal Reserve Act.

(f) (Obligations secured by not less than a like face amount of bonds, notes, or certificates of indebtedness of the United States.)

> A bank may purchase an unlimited amount of these securities. Loans thus secured would appear to be a no less satisfactory investment. It is, therefore, proposed that the present limitation to an additional 15 per cent of capital and surplus be removed.

(2) Liabilities arising out of the discount (or purchase) of the following described paper shall be subject to the following limitations based upon the amount of such capital and surplus, (but provided that the exceptions permitted under this sub-title shall not be cumulative.):

(a) Liabilities as surety, drawer, endorser, or guarantor, other than of bills of exchange, (notes) and commercial and business paper excepted under (1) hereof and excluding accommodation paper, having a maturity of not more than six months, where the surety, drawer, endorser, or guarantor obtains a loan from or discounts paper with or sells paper to any national banking association, shall at no time exceed 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus (but provided further that such obligations as surety, drawer, endorser, or guarantor of any corporation a majority of the stock of which is owned by

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any borrower shall be included as a part of the aggregate obligations of such borrower.)

> This paragraph does not appear in any form in existing law, which imposes no limitation upon indirect liabilities, although under a ruling of the Comptroller of the Currency endorsements of accommodation paper are included within the 10 per cent limitation. To the McFadden bill draft amendments definitely excluding accommodation paper and eliminating the guarantees of interrelated corporations are suggested.

(b) Notes secured by shipping documents, warehouse receipts, or other such documents conveying or securing title covering readily marketable non-perishable staples when such property is fully covered by insurance, provided that the market value of such staples is at no time less than 115 per centum of such obligations, shall be subject to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus, (but this exception shall not apply to obligations of any borrower arising from the same transactions and secured upon the identical staples for more than six months in any consecutive twelve months); and provided further that obligations of this character shall be subject to a further increase of limitation of 15 per centum of such capital and surplus in addition to such 25 per centum of such capital and surplus for a period of not more than three months in any consecutive twelve months.

> The McFadden bill, as it passed the House, had extended the period from six to ten months on loans secured by non-perishable staples, but the Senate Committee did not approve the change. The House bill, also, contained a provision for loans on staples up to 50 per cent of capital and surplus, requiring additional margins in a succession of steps until for the final 5 per cent a 40 per cent margin was necessary. This extension of the loan limit was stricken

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out in the Senate draft. There is reason to believe that it will be brought forward again and with strong backing. As an alternative, a more liberal provision than is contained in the present law is suggested, but for the relatively short period of three months. Under the proposed arrangement it is believed that all financing requirements for marketing staples can be supplied by the banks.

(c) Notes secured by documents conveying or securing title covering livestock when the actual market value of such livestock is not less than 115 per centum of the face amount of the notes secured by such documents, (when such livestock are being prepared for market during the period of the loan and provided no part of the total accommodation granted the borrower is unsecured,) shall be subject to a limitation of 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus, but this exception shall not apply to the obligations of any one borrower for more than six months in any consecutive twelve months.

The present law includes livestock in the paragraph in which an additional 15 per cent loan is allowed for six months secured by insured staples. Insurance on livestock is generally impracticable, and this requirement was eliminated in both the House and the Senate bills, which contain separate livestock paragraphs. The House bill further does not retain the six months limitation which reappears in the Senate draft. The substitute favored by the Committee does not require the maintenance at all times of the 15 per cent margin, but introduces a provision designed to exclude dairy and breeder loans. On the ground that livestock loans are less liquid and involve more hazards than loans secured by staples, a further provision is added requiring the entire loan to be on a secured basis.

(d) (Obligations of any borrower in the form of bonds,

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notes, debentures, and the like, purchased for investment or resale, under such restrictions as to the character and volume of such securities as may be made by the Comptroller of the Currency, shall at no time exceed 15 per centum of such capital and surplus in addition to such 10 per centum of such capital and surplus, but this limitation as to amount shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof, or obligations issued under authority of the Federal Farm Loan Act.)

The McFadden bill, as an additional paragraph to Section 24 of the Federal Reserve Act, contains provisions relating to investment security dealings by national banks. Business in which the banks have long been engaged is thus recognized and placed under the supervision of the Comptroller and is also restricted as to amount in the case of any one obligor. The Advisory Committee favors transferring this matter to Section 5200 of the Revised Statutes, and also the elimination of the provision in the McFadden bill subjecting this business to the Blue Sky laws of the several States.

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AMENDMENTS TO THE NATIONAL BANKING LAW DESIGNED TO FURNISH MORE ADEQUATE DATA REGARDING THE CONDITIONS OF THE BANKS THROUGH EXAMINATIONS.

I.

All obligations of every nature both direct and indirect arising out of the sale, pledge, or hypothecation of any of its assets by a national banking association shall be definitely recorded upon its books at the time such assets are sold, pledged, or hypothecated. For each failure to comply with this requirement a national banking association shall be subject to a fine of Five Hundred Dollars, to be imposed by the Comptroller of the Currency.

> This proposal is designed to cover the rather common practice of the assumption of obligations by banks in an informal fashion, often in correspondence between bank officials. These obligations frequently escape the notice of bank examiners because they are not definitely recorded on the books of the banks.

II.

Where an officer or director of a national banking association is an officer or director of any other bank, banking association, trust company, securities company or investment company, and where in the judgment of the Comptroller of the Currency the national banking association is related in management and operation in such close degree with such other bank, banking association, trust company, securities company or investment company, that the examination of the national bank fails to disclose its true condition in the absence of detailed information regarding such other related institutions, then such other bank, banking association, trust company, securities company or investment company shall furnish the Comptroller of the Currency with a copy of an examination simultaneously made by the State authorities or through such arrangements as may be deemed satisfactory by the Comptroller of the Currency furnish detailed information regarding its condition and operations; and upon failure so to do the officer or director may be disqualified by the Comptroller of the Currency from further acting in such capacity, and in such cases the Comptroller of the

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Currency, upon request, is authorized to furnish the State Supervisor of Banking, or other similar officers, copies of such examination of the affiliated national bank.

> This proposal is designed to secure adequate information regarding national banks which are closely affiliated with other financial institutions, in particular the situation in the case of chains of banks -- a type of branch banking which readily lends itself to grave abuse. During the last few years, a number of such chains have collapsed, and investigation shows that when a national bank was in such a chain, the examination of the bank failed to indicate its true position on account of the shifting of assets back and forth between the various institutions in the group.

III.

That Section 5146 of the Revised Statutes of the United States, as amended, be amended by adding at the end thereof a new paragraph as follows:

It shall be unlawful for any national banking association to make a loan or loans of more than Five Hundred Dollars in the aggregate unless secured by readily marketable collateral, to any salaried officer of such association or to any corporation in which such officer or any director of such banking association owns or controls a majority of the stock or is an officer or director, except upon submission to and approval by the board of directors of such association, as a condition precedent, of a financial statement from such officer or from such corporation as the case may be. A violation of this provision shall disqualify any such officer or director and vacate his place.

> It would seem not unreasonable to require financial statements from all directors borrowing on an unsecured basis, but as such a proposal would probably arouse widespread opposition this recommendation is limited to salaried officers and to corporations in which they or the directors are interested.

MISCELLANEOUS AMENDMENTS

Sec. 5205. Shorten the period allowed for payment of assessments in cases of impaired capital from three months to two months with a further provision

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authorizing the Comptroller of the Currency to extend the period when in his judgment it may be deemed advisable.

Sec. 5146. Last Sentence. Any director who ceases to be the owner of the required number of shares of the stock (or who pledges or hypothecates the same), or who becomes in any other manner disqualified, shall be declared by the Comptroller of the Currency to have vacated his place.

This is a minor change designed to meet an apparent oversight in the Banking Act which fails to disqualify a director who pledges his stock.

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