DIARY

Book 132

Uniformity of Bank Examination Practice
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Early in January, 1938, Secretary Morgenthau asked Mr. Upham to give him his statement of the practices followed by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Board of the Federal Deposit Insurance Corporation with respect to

(1) The securities which banks may purchase

(2) The treatment of realized appreciation in securities portfolios

(3) The treatment of unrealized appreciation in securities portfolios

(4) The amortization of securities purchased at a premium

(5) The treatment of depreciation in securities portfolios.

The attached table was made up as a result of that request.
<table>
<thead>
<tr>
<th><strong>COMPTROLLER OF THE CURRENCY</strong></th>
<th><strong>FEDERAL RESERVE SYSTEM</strong></th>
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</thead>
<tbody>
<tr>
<td>National banks and state bank members of the Federal Reserve System are governed in the business of buying and selling investment securities by the Federal banking act and regulations of the Comptroller of the Currency. They may buy and sell securities and stock without recourse, upon the order and for the account of customers. They may make market in securities of any kind. They may purchase for their own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. <strong>Nonjournalized securities</strong> mean &quot;nonjournalized&quot; obligations. The Comptroller may set minimum requirements for determining whether a security is nonjournalized. They may not purchase for their own account any shares of stock of any corporation. They may not purchase investment securities in which the investment characteristics are distinctly or predominantly speculative, or of a lower designated standard than those which are distinctly or predominantly speculative. They may not purchase investment securities which are in default, either as to principal or interest. The limitations and restrictions do not apply to obligations of the United States, etc. National banks may not purchase investment securities of a grade exceeding the grade in which they now hold securities for amortization purposes. They may not purchase investment securities convertible into stock at the option of the issuer.</td>
<td>Issued banks and members of the Federal Reserve System are governed in the business of buying and selling investment securities by the Federal Reserve act and regulations of the Federal Reserve Board. The Federal Reserve act and regulations of the Federal Reserve Board contain provisions governing the business of buying and selling investment securities by the Federal Reserve System. They may buy and sell securities and stock without recourse, upon the order and for the account of customers. They may make market in securities of any kind. They may purchase for their own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. <strong>Nonjournalized securities</strong> mean &quot;nonjournalized&quot; obligations. The Comptroller may set minimum requirements for determining whether a security is nonjournalized. They may not purchase for their own account any shares of stock of any corporation. They may not purchase investment securities in which the investment characteristics are distinctly or predominantly speculative, or of a lower designated standard than those which are distinctly or predominantly speculative. They may not purchase investment securities which are in default, either as to principal or interest. The limitations and restrictions do not apply to obligations of the United States, etc. National banks may not purchase investment securities of a grade exceeding the grade in which they now hold securities for amortization purposes. They may not purchase investment securities convertible into stock at the option of the issuer.</td>
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<tr>
<td><strong>LIMITS ON APPRECIATION</strong></td>
<td><strong>IN PORTFOLIO</strong></td>
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<td>National banks are not permitted to take credit on their books by writing up or selling nonjournalized appreciation on securities in their portfolios. Such appreciation may be used to effect amortization in any other part of the portfolio.</td>
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Informal discussions and inter-agency communications continued with respect to

(1) The "Slow" column in bank examinations;

(2) The appraisal of bonds and treatment of depreciation in them by bank examiners;

(3) The treatment accorded securities profits; and

(4) A revision of the investment regulation of the Comptroller of the Currency.

These were brought to a head by the President's message to Congress, dated April 14th, copy of which is attached, in which he said, "As a part of better administration I hope that federal banking supervision can be better coordinated."
April 14, 1938

CONFIDENTIAL: To be held in STRICT CONFIDENCE and no portion, synopsis, or intimation to be published or given out until the READING of the President's Message has begun in the Senate or the House of Representatives. Extreme care must therefore be exercised to avoid premature publication.

STEPHEN EARLY
Secretary to the President

TO THE CONGRESS OF THE UNITED STATES:

The prosperity of the United States is of necessity a primary concern of Government. Current events, if allowed to run undisturbed, will continue to threaten the security of our people and the stability of our economic life. The National Administration has promised never to stand idly by and watch its people, its business system and its national life disintegrate. It is because the course of our economy has run adversely for half a year that we owe it to ourselves to turn it in the other direction before the situation becomes more definitely serious.

When this Administration took office it found business, credit and agriculture in collapse. The collapse had followed on the heels of over speculation in and over production of practically every article or instrument used by man. During the processes of over speculation and over production – in the twenties – millions of people had been put to work, but the products of their hands had exceeded the purchasing power of their pocketbooks, with the result that huge surpluses, not only of crops but also of buildings and goods of every kind, overhung the market. Under the inescapable law of supply and demand, supplies so over ran demand which would pay that production was compelled to stop. Unemployment and closed factories resulted. Hence the tragic years from 1929 to 1933.

Starting in March, 1933, the Congress and the Administration devoted themselves incessantly, not only to reestablishing reservoirs of credit, but to putting purchasing power in the hands of the consuming public and actually securing a more equitable distribution of the national income. Thus the downward spiral was stopped – and not merely stopped, but started on an upward course – a trend lasting through four years and a half.

In 1928 the national income was eighty billion dollars; in 1932 it had fallen to less than forty billion dollars.

Since the low point of 1932, each year including 1937, has shown a steady increase in the income which the Nation produced, reflected in increased wages and salaries, in increased dividends, interest and individual's income. In 1937 the total of our citizens' income had risen to sixty-eight billion dollars.

At the end of 1936 the efforts of the Government to aid in increasing the Nation's purchasing power and in stimulating business had become so well recognized that both the business community and the Government felt that a larger measure of the Government's spending activities could be materially reduced.
But the very vigor of the recovery in both durable goods and consumers' goods brought into the picture early in 1937 certain highly undesirable practices, which were in large part responsible for the economic decline which began in the later months of that year. Again production outran the ability to buy.

There were many reasons for this over-production. One was fear -- fear of war abroad, fear of inflation, fear of nation-wide strikes. None of these fears have been borne out. There were other causes of over-production, and these causes differed in each industry.

The net result of these causes and ill-advised practices was a repetition, on a small scale, of what had happened in 1927, 1928 and 1929 on a much larger scale. In other words, production in many important lines of goods outran the ability of the public to purchase them. For example, through the winter and spring of 1937 cotton factories in hundreds of cases were running on a three-shift basis, piling up cotton goods in the factory and in the hands of middle men and retailers. For example, also, automobile manufacturers not only turned out a normal increase of finished cars, but encouraged the normal increase to run into abnormal figures, using every known method to push their sales. This meant, of course, that the steel mills of the Nation ran on a twenty-four hour basis, and the tire companies and cotton factories speeded up to meet the same type of abnormally stimulated demand. The buying power of the Nation lagged behind.

Thus by the Autumn of 1937 the Nation again had stocks on hand which the consuming public could not buy because the purchasing power of the consuming public had not kept pace with the production.

During the same period prior to last Autumn, the prices of many vital products had risen faster than was warranted. For example, copper -- which undoubtedly can be produced at a profit in this country for from ten to twelve cents a pound -- was pushed up and up to seventeen cents a pound. The price of steel products of many kinds was increased far more than was justified by the increased wages of steel workers. In the case of many commodities the price to the consumer was raised well above the inflationary boom prices of 1929. In many lines of goods and materials, prices got so high that buyers and builders ceased to buy or to build.

Once more, as in 1929, the economic process of getting out the raw materials, putting them through the manufacturing and finishing processes, selling them to the retailers, selling them to the consumer, and finally using them, got completely out of balance. The Government of the United States fearing just such an event had issued warnings in April, 1937, against these practices of over-production and high prices. The Federal Reserve System curtailed banking credit, and the Treasury commenced to "sterilize" gold as a further brake on what it was feared might turn into a run-away inflation.

The simple fact is that the laying off of workers came upon us last Autumn and has been continuing at such a pace ever since that all of us, Government and banking and business and workers, and those faced with destitution, recognize the need for action.
It should be noted in fairness that since January 1, 1937, the President has recommended to the Congress only four measures of major importance to the business of the country:

1. Legislation to stabilize agriculture. A comprehensive law was approved by me two months ago.

2. Legislation to end serious loopholes in our personal income tax laws. This was enacted last summer.

3. Legislation to put a floor under wages and a ceiling over hours of labor in industry, and

4. Tax legislation to remove inequities from the undistributed profits tax, especially as they affect the smaller type of business. Both this measure and the third are still under consideration by the Congress.

The record speaks for itself. No other measures affecting business have been proposed.

All the energies of Government and business must be directed to increasing the national income; to putting more people into private jobs; to giving security and the feeling of security to all people in all walks of life.

I believe that improvement in Government and business practices must go hand in hand with recovery — that they should be, and will be, a definite aid to recovery. While I do not wish in this Message to over-emphasize some of the needs, I do want to say that I believe that we must be definitely aware of certain of them — the elimination of future tax exempt bonds of all kinds of Government agencies; the subjecting of Government salaries and wages of all kinds to Federal and State income taxes; a serious undertaking to solve the railroad problem and the problems of monopolistic practices and price fixing. These are no new subjects; nor have I anything to add to them except the statement that their solution will help and not hurt business.

At the same time, I must repeat what I believe the overwhelming majority of both Houses of the Congress will agree to — that the Congress and the Chief Executive are all-effort to weaken or destroy great reforms which, during the past five years, have been effected on behalf of the American people. In our rehabilitation of the banking structure and of agriculture, in our provisions for adequate and cheaper credit for all types of business, in our acceptance of national responsibility for unemployment relief, in our strengthening of the credit of state and local government, in our encouragement of housing, slum clearance and home ownership, in our supervision of stock exchanges and public utility holding companies and the issuance of new securities, in our provision for social security, the electorate of America wants no backward steps taken.

We have recognized the right of labor to free organization, to collective bargaining; and machinery for the handling of labor relations is now in existence. The principles are established even though we can all admit that through the evolution of time administration and practices can be improved. Such improvement can come about most quickly and most peacefully through sincere efforts to understand and assist on the part of labor leaders and employers alike.

The never-ceasing evolution of human society will doubtless bring forth new problems which will require new adjustments. Our immediate task is to consolidate and maintain the gains achieved.
In this situation there is no reason and no occasion for any American to allow his fears to be aroused or his energy and enterprise to be paralyzed by doubt or uncertainty.

Our situation is vastly different from that which we faced five years ago. Let us use the tools already forged and laid out on the bench.

At this immediate time we suffer from a failure of consumer demand. The hoped for reemployment of this Spring is not proceeding fast enough to create an economic upturn.

Therefore the problem calls for action both by the government and by the people.

It cannot be disputed that the national income which was thirty-eight billions in 1932, sixty-eight billions in 1937 is now running at the lesser rate of about fifty-six billions. If it can be increased to eighty billion dollars in the course of the next year or two the whole economic picture will be different. Hundreds of thousands more people will be employed in private industry, hundreds of thousands fewer will be in need of relief, and consumer demand for goods will be greatly stimulated. I do not set eighty billion dollars as the national income goal. It ought to rise in the next decade to more than one hundred billions. I want to make it clear that we do not believe that we can get an adequate rise in national income merely by investing, lending or spending public funds. It is essential in our economy that private funds be put to work and all of us recognize that such funds are entitled to a fair profit.

As citizen income rises, let us not forget that government expenditures will go down and government tax receipts will go up.

How and where can and should the Government help to start an upward spiral?

I propose to the Congress three groups of measures:

1. In the first category I place additional appropriations for the fiscal year beginning July 1939. These will not put more money in the hands of the consuming public than we are spending in the current fiscal year, but they will prevent men and women from being thrown out of work on July 1. They will stop the spiral from continuing its downward course:

   (a) I recommend an appropriation of one billion two hundred and fifty million dollars for the Works Progress Administration, to be used during the first seven months of the next fiscal year. Such a grant is ammunition of the highest grade for attack on recession. It will not greatly increase the present rate of expenditure, but ought to be sufficient to care for the additional men and women who have come or are coming to an end of their unemployment insurance payments.

   (b) For the Farm Security Administration an appropriation of one hundred and seventy-five million dollars for the next fiscal year.

   (c) For the National Youth Administration the sum of seventy-five million dollars to cover the full fiscal year.

   (d) For the Civilian Conservation Corps the sum of fifty million dollars additional to maintain the existing number of camps now in operation.

I call your attention to the fact that these appropriations will avert the laying off of people now receiving assistance from the Federal Government.
In this same category of stopping the downward spiral, I also place the authorization recently given for the lending of money to business enterprises by the Reconstruction Finance Corporation. I do so because the greater part or such loans will go to businesses which are in grave danger of shutting down and throwing people out of employment. Some of the money, but, in all probability only the smaller part of the loans, will enable businesses to employ more people or start new enterprises.

2. In the second category, the Administration proposes immediately to make additional bank resources available for the credit needs of the country. This can be done without legislation. It will be done through the de-sterilization of approximately one billion four hundred million dollars of Treasury gold, accompanied by action on the part of the Federal Reserve Board to reduce reserve requirements by about three-quarters of a billion dollars. The Federal Reserve Board informs me that they are willing to do so. These measures will make more abundant the supply of funds for commerce, industry and agriculture. By themselves, however, monetary measures are insufficient to start us on a sustained upward movement.

As a part of better administration I hope that federal banking supervision can be better coordinated. In addition, I am requesting that the Securities Exchange Commission consider the simplification of regulations as will assist and expedite the financing, particularly, of small business enterprises.

3. I come, therefore, to the third category which I consider to be vital. The first two categories -- maintenance of relief and the expansion of credit may prove sufficient -- but in my judgment other measures are essential. You and I cannot afford to equip ourselves with two rounds of ammunition where three rounds are necessary. If we stop at relief and credit, we may find ourselves without ammunition before the enemy is routed. If we are fully equipped with the third round of ammunition, we stand to win the battle against adversity.

This third proposal relates solely to definite additions to the purchasing power of the Nation by providing new work:

(a) I ask for certain amendments to the United States Housing Authority Act to permit the undertaking of the immediate construction of about $500,000,000 of additional projects. The Federal Housing Administration is prepared to increase the already mounting volume of home and apartment construction.

(b) I ask for a renewal of Public Works projects. I believe that by the expenditure of $450,000,000, and the granting of authority to loan up to $1,000,000,000 to states and their sub-divisions, a vast number of well thought out, needed and permanent public improvements can be undertaken this summer and autumn. I believe that the aid of the Federal Government should be put in optional form -- either the existing method of 45% grant and 55% loan, or the advancing of the whole sum as loans to states and their sub-divisions without interest. Under such a plan the Federal Government would assume the payment of interest and the borrowing authority would assume the payment of the principal by amortization or rental.
Under either method the ultimate cost to the Federal Government and to the states and their sub-divisions is approximately the same.

It is my thought that the total ultimate out of pocket cost to the Federal Government by either or both methods should be limited to one billion dollars, and furthermore that no loans or grants should be made on any state or local projects which cannot be started within six months of the date of the enabling legislation, and completed within a year or a half from the commencement of work.

(c) I recommend the appropriation of $175,000,000 to the Bureau of Public Roads for highways in excess of the amount I have previously recommended in the budget for the fiscal year 1939, but I request that this additional amount be used only for projects which can be definitely started this calendar year.

(d) I recommend an appropriation of $35,000,000 over and above estimates for the immediate undertaking of flood control and reclamation works to be expended on projects already authorized by this or former Congresses.

(e) I recommend the appropriation of $25,000,000 additional for Federal buildings.

A summary of these recommendations falls into two categories:

1. Expenditures from the Treasury for work:

<table>
<thead>
<tr>
<th>Agency</th>
<th>Appropriation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Works Progress Administration</td>
<td>$1,850,000,000</td>
</tr>
<tr>
<td>Farm Security Administration</td>
<td>75,000,000</td>
</tr>
<tr>
<td>National Youth Administration</td>
<td>75,000,000</td>
</tr>
<tr>
<td>Civilian Conservation Corps</td>
<td>50,000,000</td>
</tr>
<tr>
<td>Public Works Administration</td>
<td>450,000,000</td>
</tr>
<tr>
<td>Highways</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Flood Control</td>
<td>37,000,000</td>
</tr>
<tr>
<td>Federal Buildings</td>
<td>26,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$2,062,600,000</strong></td>
</tr>
</tbody>
</table>

2. Loans from the Treasury for work:

<table>
<thead>
<tr>
<th>Agency</th>
<th>Appropriation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farm Security Administration</td>
<td>100,000,000</td>
</tr>
<tr>
<td>Public Works Administration</td>
<td>550,000,000</td>
</tr>
<tr>
<td>United States Housing Administration</td>
<td>300,000,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$950,000,000</strong></td>
</tr>
</tbody>
</table>

It should be noted that state and local public works undertaken on a loan basis instead of a loan and grant basis will reduce the item in the first classification and increase the item in the second classification.

Let us unanimously recognize the fact that the Federal debt, whether it be twenty-five billions or forty billions, can only be paid if the Nation obtains a vastly increased citizen income. I repeat that if this citizen income can be raised to eighty billion dollars a year the national Government and the overwhelming majority of state and local governments will be "out of the red." The higher the national income goes the faster will we be able to reduce the total of Federal and state and local debts. Viewed from every angle, today's purchasing power -- the citizens' income of today -- is not sufficient to drive the economic system at higher speed. Responsibility of government requires us at this time to supplement the normal processes and in so supplementing them to make sure that the addition is adequate. We must start again on a long steady upward incline in national income.
I have set my hope, my aim on stabilized recovery through a steady mounting of our citizens' income and our citizens' wealth. And in that process, which I believe is ready to start, let us avoid the pitfalls of the past—the over-production, the over-speculation and indeed all the extremes which we did not succeed in avoiding in 1929. In all of this, government cannot and should not act alone. Business must help. I am sure business will help.

We need more than the materials of recovery. We need a united national will.

We need to recognize nationally that the demands of no group, however just, can be satisfied unless that group is prepared to share in finding a way to produce the income from which they and all other groups can be paid. Unjust claims defeat themselves. You, as the Congress, I, as the President, must by virtue of our offices, seek the national good by preserving the balance between all groups and all sections.

We have at our disposal the national resources, the money, the skill of hand and head to raise our economic level—our citizens' income. Our capacity is limited only by our ability to work together. What is needed is the will.

The time has come to bring that will into action with every driving force at our command, and I am determined to do my share.

The responsibility for making this national will effective rests on every individual whether in the government or in industry, or in finance, or in labor, or in the professional fields. Every man and woman in the United States has the great privilege of making this will productive. And the beneficiary will be the whole of the American people.

Certain positive requirements seem to me to accompany the will—if we have that will.

There is placed on all of us the duty of self-restraint. We still rely on personal responsibility—individual responsibility guided by a common conscience. That is the discipline of a democracy. Every patriotic citizen must see to himself or herself, that he or she, that moderate statement, keeps to the rule, the creation of unfriendliness, of offenses not against an individual or individuals, but offenses against the whole population of the United States.

Use of power by any group, however situated, to force its interest or to use its strategic position in order to receive more from the common fund than its contribution to the common fund justifies, is an attack against and not an aid to our national life.

Self-restraint implies restraint by articulate public opinion, trained to distinguish fact from falsehood, trained to believe that bitterness is never a useful instrument in public affairs. There can be no dictatorship by an individual or by a group in this Nation, save through division fostered by hate. Such division there must never be.

Amid the voices which now seek to divide group from group, occupation from occupation, section from section, thinking Americans must insist on common effort in a common endeavor and a common faith in each other. Let every business man set out to use his strength of mind and heart and his confidence in his fellow-man and his country. Let every labor leader find not how work can be stopped but how it can be made
to proceed smoothly, continuously and fairly. Let every public official consider that his task is to use his authority so that the service he renders is adapted to curbing abuses and helping honest effort. Let every one of us work together to move the life of the Nation forward.

We, a successful democracy, face a troubled world. Elsewhere schools of thought contend that democracy is doomed to failure. They tell us that free speech and the free exchange of views will destroy democracies. My conviction on the contrary is that the United States retaining free speech and a free exchange of views can furnish a dynamic example of successful government, provided the Nation can unite in practical measures when the times call for united action. The driving force of a Nation lies in its spiritual purpose, made effective by free, tolerant but unremitting national will.

In the Western Hemisphere the good neighbor policy has so strengthened the American Republics that a spiritual unity in our relations now prevails. Can that good neighbor message be accepted and practised in our national life?

If we accept that high and splendid road this free democracy will give successful answer to the fears and questionings which today trouble the minds and souls of men and women the world over.

FRANKLIN D. ROOSEVELT

THE WHITE HOUSE,
April 14, 1938.
The President asked Secretary Morgenthau to get the interested agencies together and secure an agreement on whatever uniformity and coordination could be attained without legislation.

The first meeting was held on April 25th, a summary of which is attached.
April 26, 1930

A meeting of the heads of the bank supervisory agencies was held in Mr. Taylor's office at 2:30 p.m. Those present were:

**Treasury**
- Mr. Taylor
- Mr. Clifton
- Mr. Murphy
- Mr. Upham

**FDIC**
- Mr. Crowley
- Mr. Nichols
- Mr. Tuckey
- Mr. Smyth

**Federal Reserve**
- Mr. McKee
- Mr. Davis
- Mr. Paulger
- Mr. Leonard

**Comptroller's Office**
- Mr. Diggs
- Mr. Pojger
- Mr. Kelly

Mr. Taylor stated that this was a practice session for rubbing off the edges prior to a meeting on uniformity of bank examination with Secretary Morgenthau tomorrow. The immediate incentive for the present discussion is the statement in the message of the President that there should be a coordination of bank supervisory agencies. The purpose of this meeting, he said, is to find out the amount of coordination of examinations that can be accomplished without
legislation. He suggested that it might be valuable to list the difficulties and see what might be done about them. He suggested that the situation be explored from the standpoint of credit shortage.

Mr. Crowley said that there were complaints about bank credit at the Roper conference of small business men. He asked to see the letters that came in from the small business men and was given a lot of excuses and when Roper was finally pinned down, only three or four letters out of the 5,000 made any reference to it. Mr. Crowley said that he told Roper the facts didn't warrant the emphasis that was placed on it in the press release, to which Mr. Roper replied that the press played it up unduly.

Mr. Crowley said that bank examination is primarily to protect depositors from loss but that bankers have used the examiners as a whipping post for many years. The credit reluctance grows out of (1) the shock of 1933; (2) the fact that bankers are living on service charges and security profits and are out of practice on loans and other ways of making money; and (3) the fact that bank examiners really were tough in 1934 and 1935 in reorganizing banks and that a lot of liquidation resulted from loans being thrown out of banks.
He expressed his willingness to enter into the spirit of the meeting and do anything possible that would bring about coordination but not to lower the standards of bank examination. He referred to the "lousy" examinations that were made prior to the FDIC.

Mr. Taylor referred to the criticisms of the "slow classification of loans and the feeling that there was less necessity for it now that all bank assets are eligible for rediscount. He also referred to the rules with respect to marketable securities.

Mr. McKeel suggested that Mr. Folger should give the background and history of the liberalization of bank examination which began under Comptroller Pole. Mr. Taylor interposed to say that he should proceed upon the assumption that everyone is against lowering standards. Mr. Folger said that by the means of instructions to examiners from time to time, there had been warnings against a too critical attitude. He said that at the present time depreciation on governments and high-grade general market obligations is being ignored. Mr. McKeel asked what criticism there had been from the public, and Mr. Folger said he knew of very little although there had been some in Congressional hearings. He said that probably these
who had lost money in bank failures were inclined to be critical of bank examiners.

Mr. Crowley said that if the general condition of a bank is bad, examiners should look closely at the bonds and low paper of the bank and should not temporize with bad bank management. Mr. McKee said to give us something to shoot at he would say he thinks that the examinations have never been fair to general business or to the stockholder or in the public interest. There has been a dual type of examination of every institution, the classification of paper has been bad, and the appraisal of bonds has been bad. In depressions the depreciation in bond accounts has caused a deepening of the depression and calling of loans. He asked why bonds should be criticised and not notes. He thinks all assets should be treated alike. Mr. Paulger said that the exceptions in the loan portfolio are treated in the examination but all bonds are listed and their market price given. He feels this is bad. Mr. Crowley said there should be little criticism of a well-managed bank but when a bank is in and out of the market, if you let them have the profit on the up side, you shouldn’t excuse depreciation on the down side.
Mr. McKee said that if it is a good bank, he doesn't care what they do with the non-recurring profit. Mr. Nichols referred to a bank with $23 million of deposits that had had a $33 million turnover in their portfolio in eleven months and having at one time borrowed $600,000 for the purpose. Mr. Folger referred to Arthur Brown of Indianapolis as an illustration of how the Comptroller's Office bears down on bankers who speculate in Government bonds. Mr. Biggs said we were getting into shades of meanings of words and said that he favored sitting down and working out a program on slow classification and a uniform program of bond depreciation, the latter on a basis of "damn the ticker." He thought the whole thing should be handled quickly without any ballyhoo. Mr. Crowley said too that he thinks a public statement would be harmful.

Mr. Biggs asked what the opinion was as to whether there should be a slow column or whether it should have some other name. Mr. Davis said it ought to be done away with. Mr. McKee said the bank should be told about slow loans but they should not be tabulated. There should be no aggregate and no total but should merely be listed for special attention.
Mr. Folger said that whereas in 1934 twenty per cent of the loans made by national banks were listed in the slow column, following the change in instructions to examiners that were sent out after the Morgenthau conference of bank examiners, that percentage had declined by the last half of 1937 to less than ten per cent. At this point Mr. Crowley asked Mr. Tucker to read the attached letter from him to Harriner Reelco with respect to slow classifications.

Mr. McKee expressed the view that time was being wasted over one word. He would stress the type of examination and how to protect the public interest if the type of examination is varied. Mr. Crowley said there was no difference of opinion on that but that good loans ought to be taken out of the slow column. Mr. McKee renewed his suggestion that the slow column be eliminated and data concerning it be included in the confidential section. Mr. Faulger said that bankers object to the recapitulation of slow, doubtful and loss. He said that "no-kidding" examiners put too much in the slow column. He suggested that the three chiefs get together and stated that there is no disagreement in principle. Mr. McKee said it depended on the opinion of the examiners whether a loan is slow or not. Mr. Taylor asked
how about changing the name of the column and suggested that the word "slow" is not useful. Mr. Diggs thought it useful and said that it is the examiners who criticize and thus give the impression that it is a bad loan whereas they have other instructions.

Mr. McKee said that every examiner is tougher than the last one in order to make a record and that every examiner is tough because he doesn't want to be shown up by the next examiner. Mr. Folger said for that reason it is well not to change examiners too often. Mr. McKee said that every board of directors is scared to death until they have cleared up all their slow loans. Mr. Taylor said there still seems to be some disagreement on the slow column but since no decisions are to be reached today, we might go on to bond classifications. He asked Mr. Folger to tell about that.

Mr. Folger said that under Section 5136 of the Revised Statutes national banks can buy all marketable securities. There are too many low-grade securities in banks. The national bank examiners have not been charging off depreciation except defaulted issues, and in recent years have not been showing depreciation in first-grade bonds. No write-up of
appreciation is permitted. Depreciation on bonds is included in arriving at net sound capital. He has proposed that depreciation on the first three highest rated bonds and all Governments be eliminated in arriving at net sound capital.

Mr. Davis said he could see no reason for treating bonds differently from loans. He said that you might class a company loan as good and yet criticize its bond because of the market price. Mr. Upham advanced the view that since there is a market price on bonds and no market price on loans, perhaps there is some realism to taking the market price on the asset for which there is a market price.

Mr. Crowley remarked that after all securities are a secondary reserve and are supposed to be used before loans are gone into. At this point Mr. Crowley asked Mr. Tucker to read the position taken by the Corporation on treatment of bonds.

Mr. Folger read instructions which he has proposed to be sent to national bank examiners.

Mr. Crowley and Mr. Davis thought profits on sales of securities should be segregated in a special account and not used for dividends. Mr. Crowley said that the bankers have
been living on bond profits and service charges and have gotten soft and won't make any loans. Mr. Touker said that any other rule than segregation of bank profits encourages bank speculation. Mr. Folger said he doesn't see how you can tell a bank what to do with individual profits. He said the in andouters should be dealt with and anything beyond that goes pretty far.

Mr. McKee spoke for the building up of a reserve of 20 per cent of corporate issues. Mr. Crowley said he opposes any liberalization of bank examination because he feels the bank examiners have not been strict enough.

Mr. Folger asked Mr. McKee if the Federal Reserve banks would disregard the market price on bonds when they are offered as collateral.

Mr. Crowley made the point that there really is no duplication of bank examination.
Attached is an agenda for the meeting of bank agency heads on April 26th.
Agenda for meeting of banking agency heads April 26, 1938
with Secretary Morgenthau

I. Why this meeting is being held.
   A. The President's message of April 14, 1938.
   B. The long-recognized necessity for coordination
      of banking agencies on examination policy.

II. The "Slow" classification of loans.
   A. Should the "slow" column be abandoned?
   B. Should the "slow" column be re-named, and if so,
      what title should it be given?
   C. If re-named, should the type of loans listed be the
      same as now? If not, how changed?
   D. Are bank examiners too severe in their classification
      of loans as slow?

III. The treatment of investment securities by examiners.
   A. Should banks be given a greater latitude in the
      securities they may purchase?
   B. How should securities be valued by the examiner --
      cost or market price or what?
   C. How should market appreciation and depreciation be
      treated?
   D. Should any special restrictions be placed on profits
      from the sale of securities?
Mr. Folger, Chief National Bank Examiner,
Mr. Paulger, Chief, Division of Examinations of
the Federal Reserve System, and Mr. Nichols, Chief,
Division of Examination of the Federal Deposit
Insurance Corporation, met with Mr. Upham for
several days and reached the majority and minority
positions, as attached.
April 28, 1938

The majority agreement with respect to the classification of loans is that the three columns in the examination report now known as slow, doubtful, and loss will be continued. Their present form, and that of the instructions to examiners as to the type of loan to be included in each of the three columns, will remain the same as at present. It is proposed to label these three columns by the roman numerals I, II and III. At the top of each page upon which this tabulation occurs, there will appear the roman numeral I and following it a "definition of the type" of loan which is included in the column; there will also appear roman numeral II followed by the single word "doubtful"; and there will also appear the roman numeral III followed by the single word "loss."

Where there is a recapitulation of the columns now known as slow, doubtful and loss, the same device will be used, i.e., the use of the three roman numerals as symbols with the accompanying explanation of what is included under each. As now, on the recapitulation page only the totals in columns II and III will be included in figuring the net sound capital of banks.

(It should be noted that this agreement would result in the complete elimination of the word "slow" from loan classifications.)
April 28, 1938

The minority position with respect to the classification of loans in the examination report is that the column now known as "slow" should be eliminated from the pages upon which it now appears and that provision be made elsewhere in the report, under a heading "Loans Listed for Information or Comment," or other suitable heading, for listing, with appropriate comment, not totaled and not included in any recapitulation, such loans as the examiner feels should be set out for the information of the directors and proper officers of the bank, with the clear understanding that such loans are not being classified as doubtful or loss and are not necessarily to be regarded as criticised assets.
April 30, 1938

The majority agreement with respect to the appraisal of bonds is

(1) That depreciation in stock and defaulted bonds be classified as loss and that securities in these groups (III and IV) be listed and priced in the report of examination. (The minority does not disagree on this point.)

(2) That depreciation on securities in group II and in the fourth grade of general market obligations in group I be deducted in the report in computing the net sound capital of the bank, and that securities in these classifications be listed and priced in the report of examination.

(3) That depreciation in all group I securities except the fourth grade of general market obligations be disregarded and that these securities not be priced in the report of examination.

(4) That unrealized appreciation be not allowed.

(5) That a premium on bonds purchased at a premium be amortized.
April 30, 1938

The minority position with respect to the appraisal of bonds is:

1. That only depreciation in stocks and defaulted bonds be classified as estimated loss, and that securities in these groups be listed and priced in the report of examination. (This is in accordance with the views of the majority.)

2. That securities in groups I and II be not priced, and preferably be not listed, in the report of examination. A complete list of all securities, however, should be attached to the report of examination sent to the Supervisory authorities.

3. That depreciation, other than in stocks and defaulted bonds, should not be taken into consideration in computing "Net sound capital." On the other hand, it cannot be affirmatively stated that depreciation in any securities constitutes sound capital. Therefore, the minority feels that the schedule showing a computation of net sound capital be eliminated from the reports of examination.

4. That unrealized appreciation be not allowed.

5. That a premium on bonds purchased at a premium be amortized.
The majority agreement with respect to the treatment of net profits from the sale of securities is that until adequate reserves against the securities account have been built up, all such profits should be impounded and be unavailable for any purpose other than to take care of losses resulting from the sale of securities.

May 2, 1938
With respect to the treatment of profits from the sale of securities

1. Estimated losses should be charged off.

2. Banks should be required to establish and maintain adequate reserves, including reserves against the securities account.

3. Until losses have been written off and adequate reserves established, bond profits should be unavailable for any other purpose.

4. Speculation should be criticized and penalized.
April 28, 1938

In 1934 with total loans in 5,275 national banks of $7,740,596,000, national bank examiners classified 27 per cent in the slow column.

In the last half of 1937 with total loans in 5,267 national banks of $8,933,216,400, national bank examiners classified only 9.81 per cent in the slow column.

<table>
<thead>
<tr>
<th>Year</th>
<th>Slow</th>
<th>Doubtful</th>
<th>Lose</th>
</tr>
</thead>
<tbody>
<tr>
<td>1934</td>
<td>27%</td>
<td>4%</td>
<td>2.9%</td>
</tr>
<tr>
<td>1935</td>
<td>16%</td>
<td>2%</td>
<td>.8%</td>
</tr>
<tr>
<td>First half of 1937</td>
<td>10.68%</td>
<td>1.14%</td>
<td>.65%</td>
</tr>
<tr>
<td>Last half of 1937</td>
<td>9.81%</td>
<td>1.06%</td>
<td>.49%</td>
</tr>
</tbody>
</table>
Mr. Morgenthau invited a few bankers to meet with him on May 4th and give him the benefit of their advice.

The majority and minority agreements were given to this group of bankers together with the attached questions.
1. Should the use of the word "slow" as a classification of loans by bank examiners be abandoned?

2. Should loans of the character described in the instructions to national bank examiners in 1934 be listed in a column parallel to the doubtful and loss columns; or would it be preferable to eliminate this column and list such loans on a separate page?

3. Is it objectionable to total the criticised loans, other than doubtful and loss, and show them on the recapitulation page?

4. Should the loans described in the 1934 instructions to national bank examiners be subjected to criticism at all?

5. Would good bankers be deterred from making good borderline loans by the inclusion of the slow column, renamed?

6. Are bank directors alarmed by the slow classification practice and is it a deflationary influence?

May 3, 1938
1. Should the list of securities in a bank's portfolio be listed by examiners in the examination report?

2. Should all or a part of the securities list be priced in the report?

3. Should all or a part of the depreciation in securities be deducted in computing the net sound capital of the bank?

4. Should the net sound capital of the bank be computed in the report?

May 3, 1938
1. Should the law which requires that securities purchased by national banks and state member banks of the Federal Reserve System be "marketable" be changed?

2. Should the text in the Comptroller's Regulation that securities purchased by national banks and state member banks of the Federal Reserve System be not "predominantly speculative" be changed?

3. Should the list of securities eligible for purchase be expanded or contracted?

May 3, 1938
1. Should banks be required to establish and maintain any particular percentage reserve against future losses in the securities account?

2. Should reserves be permitted against estimated losses in the securities account, or should such estimated losses be written off?

3. Should banks be required to impound the profits on sales of securities in a reserve account against future losses in the securities account, or should all profits be treated alike and the general condition of the bank be the test as to the reserves required?

4. Would a requirement that all profits from the sale of securities be impounded in a special reserve account

   (a) Affect the bond market adversely?

   (b) Discourage speculation and in-and-out trading?

May 3, 1938
It is the belief of the majority that bank examiners, generally speaking, put too few rather than too many loans into the column now known as "slow." It is their belief that a good many loans which are not properly classifiable as doubtful or loss should, nevertheless, be criticised. They feel that bankers expect and want the opinion of the examiner on this type of loan. They feel that bankers expect and want a recapitulation of the loans now included in the slow column. They do not believe that good bankers object to this classification practice (other than the use of the word "slow") and they do not feel that bankers are deterred from making good loans by this classification practice.

May 2, 1938
The minority view is that bankers are deterred from making many acceptable loans by reason of the practice of bank examiners in classifying loans as slow. They feel that the totaling of this classification and its recapitulation alarms bank directors unduly. They feel that since all assets of the bank are rediscountable with the Federal Reserve banks, no loans other than doubtful and loss should be criticised. They feel that the inclusion of the slow column and its recapitulation are deflationary influences.

May 2, 1938
The majority feels that requiring banks to impound security profits in a reserve account will discourage security speculation and in-and-out trading.

May 2, 1938
The minority feels that it is impossible to enforce a regulation requiring the impounding of security profits in a special reserve account, that attempting to do so borders upon management of the bank by the supervisory authorities, and that such a regulation would not discourage speculative trading.

The feeling of the bank examination supervisory heads with respect to the regulation of the Comptroller of the Currency as to what securities banks can buy is somewhat as follows:

Folger: No changes of material consequence can be made without legislation. The insistence upon marketability and upon the avoidance of securities which are predominantly speculative are minima and should not be changed.

Nichols: The securities eligible for purchase are too inclusive. Banks should be held to more rigid requirements.

Paulger: The securities eligible for purchase are not inclusive enough. Banks should be given a greater freedom in the acquisition of securities.

May 2, 1938
Attached is a summary of the meeting with the bankers on May 4th.
A group who had been invited by Secretary Morgenthau met with him in the morning and in the afternoon to discuss proposals looking toward the unification of certain bank examination practices and policies. Those present included:

Joseph A. Broderick of New York
T. J. Coolidge of Boston
Thomas J. Broom of Washington, D. C.
Robert M. Hanes of Winston-Salem, North Carolina
George L. Harrison of New York
Tom K. Smith of St. Louis, Missouri
William R. White of New York

The statements of majority agreement and minority position on the matters of loan classification, bond appraisal, and treatment of bond profits were placed before the group and the enclosed list of questions was used as a basis of determining sentiment toward the proposals now under discussion.

While there was considerable discussion and not complete unanimity of views on all the matters discussed, the consensus was

(1) That the use of the word "slow" as a classification of loans by bank examiners might well be abandoned.
(2) That the three parallel columns now appearing in the examination report be retained. A suggested definition for Column I was "not presently doubtful but requiring constant attention."

(3) No one was violently opposed to totaling and recapitulating the three columns if the new designation and definition of Column I are adopted. (There were some preferences expressed for Column I loans being carried separately and not totaled or recapitulated.)

(4) Good bankers would not be deterred from making border-line loans by the inclusion of Column I. (There were some dissents to this.)

(5) Bank directors are disturbed by the slow column and probably should be. (The view was expressed that regardless of the 1934 instructions as to what loans should be included in the slow column, bank examiners continue to list loans that are slow in fact even though good as to quality.)

(6) The entire list of securities in a bank's portfolio should be listed in the examination report.

(7) The entire list of securities in a bank's portfolio should be priced in the examination report.
(8) The net sound capital of a bank should be computed in the examiner's report.

(9) Just what depreciation in the portfolio should be deducted in computing the net sound capital of a bank was left somewhat indefinite. It was suggested by Mr. White that if the net depreciation in Group II securities, plus Baa bonds, is to be deducted in computing net sound capital (and appreciation in Group I securities, exclusive of Baa's, is to be ignored), the basis for figuring depreciation in this group should be worked out along the lines of the so-called "convention values" used by insurance companies representing, perhaps, the average price of the security over a period of a year or more past. It was suggested that if and when Group I securities show a net depreciation, perhaps the situation will have to be surveyed again. There were expressions that the inclusion of net depreciation in the lower grade securities without any benefit from appreciation in higher grade securities was a little unfair.

(10) While no definite consensus was obtained on the treatment of bond profits, I think it is fair to say that the group favored the creation of adequate reserves
against losses, but were doubtful about the success of enforcement of a rule that securities profits be impounded in a special reserve account.

(11) There were expressions of opinion to the effect that the definition of marketability contained in the Regulation of the Comptroller of the Currency interpretative of Section 5136 Revised Statutes should be revised.
A second meeting of the heads of the agencies was called for May 9th at which the following were present:

Mr. Morgenthau
Mr. Taylor
Mr. Gaston
Mr. Upham
Mr. Crowley
Mr. Nichols

Mr. McKee
Mr. Davis
Mr. Paulger
Mr. Diggs
Mr. Folger
Mr. Smyth

At that meeting it was felt that a few more days of discussion would bring unanimous agreement. The conferees adjourned to the Office of the Acting Comptroller of the Currency and continued their discussion for a time; they then agreed that Messrs. Folger, Paulger, Nichols and Upham should continue the conference.

In the interim Secretary Morgenthau had asked that the revision of the investment regulation of the Comptroller of the Currency be included as an item of group discussion. In addition to the meetings with the chief examiners, the legal staff of the Office of the Comptroller and of the Board of Governors of the Federal Reserve System were consulted and there was received from the Board of Governors a suggested revision of the regulation. Their suggested revision is attached.
SECTION 1. AUTHORITY FOR AND SCOPE OF REGULATION.

This regulation is issued under authority of the provisions of section 5136 of the United States Revised Statutes and section 9 of the Federal Reserve Act, the pertinent provisions of which are published in the Appendix hereto. The regulation embodies all of the limitations and conditions made by or pursuant to section 5136 of the United States Revised Statutes with respect to the purchase of investment securities.

Except as provided in section 9 hereof, every purchase of securities for its own account by a national bank or a State member bank must conform to the provisions of this regulation.

SECTION 2. NATURE OF SECURITIES WHICH MAY BE PURCHASED.

In order that a security may be purchased by a national bank or a State member bank, it must be an "investment security", which is defined as a security that meets the following requirements:

(a) It must be an obligation evidencing indebtedness of a person, copartnership, association or corporation;

(b) It must be in the form of a bond, note or debenture of the type commonly known as investment securities;
(c) It must be marketable, i.e., salable under ordinary circumstances with reasonable promptness at fair values;

(d) It must not have distinctly or predominantly speculative characteristics;

(e) It must not be in default either as to principal or interest; and

(f) If it 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.

SECTION 3. INFORMATION WITH RESPECT TO INVESTMENT SECURITIES PURCHASED.

In making any purchase of investment securities\(^1\) a national bank or a State member bank shall exercise the same degree of care that sound banking practice requires for making loans. Before making purchases and thereafter while it holds investment securities, the bank shall obtain and record such information with respect to the securities as shall be necessary to show that it has exercised appropriate care as to the purchase and retention of such securities. It shall not purchase any securities concerning which it does not obtain adequate information.

SECTION 4. AMORTIZATION OF PREMIUM.

If an investment security is purchased at a price exceeding par, the national bank or State member bank shall

(a) Provide for the regular amortization of the premium

\(^1\)In this connection, attention is directed to the statement of principles published in the Appendix to this regulation.
paid, so that the premium shall be entirely extinguished at
or before the maturity of the security, and the security (in-
cluding premium) shall at no time be carried at an amount in
excess of that at which the obligor may then legally redeem
such security; or

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

SECTION 5. PURCHASE OF STOCK.

No national bank or State member bank shall purchase
for its own account any shares of stock of any corporation except
in the cases referred to in section 9 hereof or as otherwise per-
mitted by the provisions of the statutes of the United States. 2

No national bank or State member bank shall purchase any
security which is convertible into stock at the option of the issuer.
Securities which are convertible into stock at the option of the
holder and securities with stock purchase warrants or rights may
be purchased by a national bank or State member bank only if
the price paid fairly reflects the investment value of the securities

2Under the statutes of the United States, it is per-
missible for a national bank or State member bank, subject to cer-
tain limitations, to purchase stock in a Federal Reserve bank, in
corporations organized to carry on a safe deposit business, in cor-
porations organized under State or Federal law to engage in inter-
national or foreign banking, in corporations holding the premises
of such bank, and in stock of national agricultural credit corpora-
tions.
independently of the conversion right or of the stock purchase
warrants or rights. No national bank or State member bank shall
convert any security held by it into stock or purchase stock pur-
suant to any warrant or right attached to or issued in connection
with any security held by it.

SECTION 6. UNDERWRITING OR DEALING.

No national bank or State member bank shall underwrite
or deal in securities or stock, except in the cases referred to in
section 9 hereof.

SECTION 7. REPURCHASE AND RESALE AGREEMENTS.

Subject to the applicable provisions of the law and this
regulation, a national bank or State member bank may purchase or
sell investment securities under an agreement providing for repur-
chase or resale, only under the following circumstances:

Repurchase by the seller. - A national bank or State
member bank may purchase investment securities under an agreement
whereby the bank has an option or an absolute right to require the
seller of the securities to repurchase them from the bank at a
stated price or at a price subject to determination under the terms
of the agreement, but in no case less than the market value at the
time of repurchase from the bank. But a national bank or State mem-
ber bank may not purchase securities if the seller has a right to
require the bank to resell them under any circumstances, whether or
not the bank has a right to require the seller to repurchase them.
A national bank or State member bank may purchase investment securities under an agreement whereby the seller or a third party guarantees the bank against loss on resale of the securities.

**Rosale by the buyer.** - A national bank or State member bank may sell investment securities under an agreement whereby the bank has an option or an absolute 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 by the bank. But a national bank or State member bank may not sell securities under an agreement by which the seller has a right to require the bank to repurchase them under any circumstances, whether or not the bank has a right to require the purchaser to resell them.

**SECTION 8. LIMITATIONS.**

The total amount of investment securities of any one obligor or maker, including securities guaranteed by such obligor or maker, held by a national bank or State member bank for its own account shall not at any time exceed 10 per cent of its paid in and unimpaired capital stock and of its unimpaired surplus fund, as determined by the par or face value of the securities held.

This limitation does not require any bank to dispose of any securities lawfully held by it on August 23, 1935.
SECTION 9. EXCEPTIONS.

This regulation does not apply to:

(a) Any of the following securities:
   (1) Obligations of the United States;
   (2) Obligations fully guaranteed as to principal and interest by the United States;
   (3) General obligations of any State or of any political subdivision thereof;
   (4) Obligations issued under authority of the Federal Farm Loan Act;
   (5) Obligations issued by the Federal Home Loan Banks or the Home Owners' Loan Corporation;
   (6) Obligations insured by the Federal Housing Administrator pursuant to section 207 of the National Housing Act, if the debentures to be issued in payment of such insured obligations are guaranteed as to principal and interest by the United States; or
   (7) Obligations of national mortgage associations;

(b) Securities or stock purchased or sold without recourse solely upon the order and for the account of customers;

(c) Securities or stock acquired under the following circumstances:
   (1) Through foreclosure on collateral;
   (2) In good faith by way of compromise or settlement of a claim or liability; or
(3) In good faith to avert an apprehended loss in connection with a debt previously contracted;

(d) Any security or stock which was lawfully acquired by a State member bank prior to the date on which it became or becomes a member of the Federal Reserve System.
APPENDIX

Investment Principles

Proper administration of a bank's investment account requires firm adherence to sound principles. The following is a brief statement of some of the important principles:

1. The objective of a bank's investment policy should be reasonable income compatible with safety of principal, not speculative or trading profits.

2. The purchase of investment securities by a bank should be in accordance with an investment policy established by the board of directors of such bank to control the purchase, retention, and sale of securities and the composition of the bank's portfolio of securities, which policy should be reviewed from time to time and reaffirmed or modified, as circumstances warrant.

3. In establishing and reviewing such a policy, including the determination of the size of the investment account, the directors should take into consideration:

   (a) The amount of the bank's capital accounts in relation to its liabilities and other corporate responsibilities;

   (b) The nature of its assets and the proportion of fixed assets; and

   (c) The character of its business, including possible future demands for extension of credit and payment of deposits.

4. The policy should be formulated and carried out with a view to obtaining:

   (a) Securities of sound quality;

   (b) Adequate diversification as to classes of securities and as to individual issues; and

   (c) Proper distribution and spacing of maturities.

5. Premiums on all securities, whether or not exempt from the provisions of section 6130 of the United States Revised Statutes, should be regularly amortized.
6. Adequate reserves should be maintained for possible future losses. Until a reserve has been established in an amount sufficient to provide reasonable protection in the light of past experience and the character of the investment account, all profits on the sale of securities should be transferred to the reserve account.

Statutory Provisions

Paragraph "Seventh" of section 5136 of the United States Revised Statutes reads as follows:

"Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this title. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock; Provided, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, except that this limitation shall not require any association to dispose of any securities lawfully held by it on the date of enactment of the Banking Act of 1935. As used in this section the term 'investment securities' shall mean marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term 'investment securities' as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities
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, as amended, or issued by the Federal Home Loan Banks or the Home Owners' Loan Corporation, or obligations which are insured by the Federal Housing Administrator pursuant to section 207 of the National Housing Act, if the debentures to be issued in payment of such insured obligations are guaranteed as to principal and interest by the United States, or obligations of national mortgage associations: Provided, That in carrying on the business commonly known as the safe-deposit business the association shall not invest in the capital stock of a corporation organized under the law of any State to conduct a safe-deposit business in an amount in excess of 15 per centum of the capital stock of the association actually paid in and unimpaired and 15 per centum of its unimpaired surplus."

Section 9 of the Federal Reserve Act reads in part as follows:

"State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stocks as are applicable in the case of national banks under paragraph 'Seventh' of section 5136 of the Revised Statutes, as amended."
PROPOSED CHANGES IN REGULATIONS OF THE COMPTROLLER OF THE CURRENCY REGARDING THE PURCHASE OF INVESTMENT SECURITIES

In Section I, strike out all provisions after the first two paragraphs and insert in lieu thereof the following:

"The term 'marketable' means that the securities in question must be salable under ordinary circumstances with reasonable promptness at fair values.

"If a security which is purchased 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.

"Particular attention is called to the statutory provision that the investment securities which may be purchased, must be 'in the form of bonds, notes, and/or debentures, commonly known as investment securities.' If an obligation is in the form of a security, it must comply with these regulations as to 'marketability' as a condition to the bank's right to purchase the same.

"The purchase of any security which fails to comply with the law and these regulations is not permissible, even though the bank treats the transaction as being a loan rather than a purchase of 'investment securities', except where such security evidences real estate loans made pursuant to Section 24 of the Federal Reserve Act, (a) where the obligations actually represent an initial loan by the bank, or (b) where the obligations were purchased pursuant to said section, in which case the bank is required thereby to purchase the entire issue."

In Section II, make the following changes:

Strike out the existing paragraph numbered (3) and the footnote thereunto and in lieu thereof insert the following paragraphs:

"(3) The purchase of securities which have distinctly or predominately speculative characteristics or which are in default either as to principal or interest is prohibited.
"(4) In making any purchase of investment securities the bank shall exercise the same degree of care that sound banking practice requires for making loans. Before making purchases and thereafter while it holds investment securities, the bank shall obtain and record such information with respect to the securities as shall be necessary to show that it has exercised appropriate care. It shall not purchase any securities concerning which it does not obtain adequate information."

Renumber the remaining paragraphs in Section II accordingly.

*In this connection attention is directed to the statement of principles published in the Appendix to this regulation."
APPENDIX

Investment Principles

Proper administration of a bank's investment account requires firm adherence to sound principles. The following is a brief statement of some of the important principles.

1. The objective of a bank's investment policy should be reasonable income compatible with safety of principal, not speculative or trading profits.

2. The purchase of investment securities by a bank should be in accordance with an investment policy established by the board of directors of such bank to control the purchase, retention, and sale of securities and the composition of the bank's portfolio of securities, which policy should be reviewed from time to time and reaffirmed or modified, as circumstances warrant.

3. In establishing and reviewing such a policy, including the determination of the size of the investment account, the directors should take into consideration:

(a) The amount of the bank's capital accounts in relation to its liabilities and other corporate responsibilities;

(b) The nature of its assets and the proportion of fixed assets; and

(c) The character of its business, including possible future demands for extension of credit and payment of deposits.

4. The policy should be formulated and carried out with a view to obtaining:

(a) Securities of sound quality;

(b) Adequate diversification as to the classes of securities and as to individual issues; and

(c) Proper distribution and spacing of maturities.

5. Premiums on all securities, whether or not exempt from the provisions of section 5136 U.S.R.S., should be regularly amortized.

6. Adequate reserves should be maintained for possible future losses. Until a reserve has been established in an amount sufficient to provide reasonable protection in the light of past experience and the character of the investment account, all profits on the sale of securities should be transferred to the reserve account.
In the interim also the Federal Advisory Council of the Federal Reserve System met in Washington and adopted a resolution on the matters under discussion. The resolution is attached.
TO THE BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM,
WASHINGTON, D. C.

Gentlemen:

Owing to the unavoidable absence of the Secretary of the Federal Advisory Council during the latter part of the final day of its recent sessions, the undersigned as Acting Secretary was instructed to send to the Board a copy of a Resolution unanimously adopted by those present on the afternoon of Tuesday, May 17, 1938.

The Resolution was as follows:

The Federal Advisory Council has given careful consideration to the views of the BOARD OF GOVERNORS on the subject of the classification of loans in reports of Bank Examiners and the treatment of investment portfolios in such reports.

It is the sense of the Council that the general plan as to the classification of loans which is now followed should be continued; that the heading "Slow" should be altered, but that in Column 1 there should be brought together loans not presently considered
doubtful or losses, but of a type which a
bank would not and should not currently
make, and that the total of such loans
should be brought together in the Recapit-
ulation Sheet. "Doubtful" and "Loss" columns
should be continued as at present.

The Council also believes that the entire
investment portfolio of all banks should be
listed, priced, and totalled and that this
information is necessary if the directors of
banks generally are to have an adequate pic-
ture of the bank's condition. This is
particularly true since at the present time
the investment portfolio of the average bank
represents a large percentage of its total
assets.

The Council also feels that the difference
between market value and carrying value in the
case of all defaulted bonds, stocks, and non-
defaulted bonds of low grade should be set up
as loss or doubtful. Unless the market value
of the total investment portfolio is in excess
of carrying value, the bank should be required
either to set up adequate reserves to cover
depreciation on such items, or to charge it off.

The Council does not believe that market
depreciation in securities of high grade should
be set up as "loss" or "doubtful" by the exami-
ners. It does believe, however, that where
such market depreciation exists, that unless
the total market value of the investment port-
folio is in excess of its carrying value, the
examiners should use their influence to have
the bank set up reserves sufficient to bring
the carrying value of the investment portfolio
down to at least market value. The bank should
be given ample reasonable time to create such
reserves.

The Council believes that the Comptroller's
regulations regarding marketability and char-
acter of investment securities which a bank can
purchase should be liberalized and that all
reference to classification by manuals should
be omitted therefrom.
The Council would further favor an amendment of the law so as to remove the requirement of marketability from investment securities which a bank could purchase. The Council believes that the examiners could and should see that banks in making investments do not acquire an undue percentage of non-marketable investments in relation to their total assets and capital funds.

The Council asks the Board to consider that it was not made aware of the Board's memorandum until the final day of its sessions, and the time for consideration was necessarily limited. If, in the circumstances, the Board wishes the Council to discuss the subject further, it will be glad to appoint a committee to confer with the Board for this purpose.

Very respectfully,

(Signed) Thomas M. Steele
ACTING SECRETARY
The attached revision of the Comptroller's investment regulation was recommended to the Secretary by Mr. Diggs, Acting Comptroller of the Currency. It was referred by Mr. Morgenthau to Mr. Oliphant who was to confer with the counsel for the three banking agencies to be sure that it was in proper legal form.
By virtue of the authority vested in the Comptroller of the Currency by Paragraph Seventh of Section 5136 of the Revised Statutes, the following regulations are promulgated:

SECTION I

An obligation of indebtedness which may be purchased for its own account by a national bank or a State member bank of the Federal Reserve System, in order to come within the classification of "investment securities" within the meaning of the Seventh paragraph of Section 5136, must be a marketable security as designated by the express language of said paragraph and can be purchased for the bank's own account only under the limitations and restrictions provided in said paragraph and the provisions of these regulations.

The term "marketable" means that the securities in question must be salable under ordinary circumstances with reasonable promptness at fair values.

A security, to be marketable, must meet the following minimum requirements:

A. 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;

B. (1) 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 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
(2) - in the case of securities for which the public distribution required to be provided or made by Subsection (1) thereof cannot be so provided or so made and which are issued by established commercial, mercantile or manufacturing businesses 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 thereof and must be fully and adequately secured; and such securities must, by their terms, provide for the regular amortization of the debt evidenced thereby so that it will be extinguished by its maturity date through equal periodic payments thereon: Provided, That no amortization need be required for the period of the first year after the date of issuance of such securities. The total amount of securities held under authority of this Subsection (2) by a national bank or by a State member bank for its own account shall not in any event exceed twenty-five percentum of the capital stock of such bank actually paid in and unimpaired and twenty-five percentum of its unimpaired surplus.

Particular attention is called to the statutory provision that the investment securities which may be purchased, must be "in the form of bonds, notes, and/or debentures, commonly known as investment securities." If an obligation is in the form of a security, it must comply with these regulations as to "marketability" as a condition to the bank's right to invest therein.
Any such security which fails to comply with the law and these regulations, will not be deemed legally acquired, even though the bank considers the transaction as being a loan rather than a purchase of "investment securities", except where such security evidences real estate loans made pursuant to Section 24 of the Federal Reserve Act, (a) where the obligations actually represent an initial loan by the bank, or (b) where the obligations were purchased pursuant to said section, in which case the bank is required thereby to purchase the entire issue.

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

(b) Set up a reserve account in order 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 independent of the stock purchase warrants or conversion feature. If it is clearly 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 the stock purchase warrants or conversion feature 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 these regulations:
(a) It is permissible for the bank to purchase "investment securities" from another under an agreement whereby the bank has an option or an absolute 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 market 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 absolute 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 such agreement, have the absolute 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.

(6) As to sales of securities under repurchase agreement,

(a) It is permissible for the bank to sell securities to another under an agreement whereby the bank has an option or an absolute 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 to sell securities to another under an agreement whereby the purchaser reserves the absolute 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 option or absolute 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.

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

**EXCEPTION**

The restrictions and limitations of these regulations 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.
A revised statement of the majority agreement reached by the representatives of the Comptroller of the Currency and the Federal Deposit Insurance Corporation was given on June 6th to the Secretary by Mr. Upham as his report. The representative of the Federal Reserve agreed to only one of these—that with respect to the treatment of securities profits. Mr. Morgenthau was also given two other statements, one entitled "Securities Eligible for Purchase by Banks," giving briefly the changes in the investment regulation; and another giving briefly the reasons for all of the changes proposed both in the majority agreement on bank examination and in the revision of the Comptroller's regulation.
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 reasonably 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 certain unfavorable trends and 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.

Present practice will be continued under which the totals of III and IV above are 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 (except the fourth grade of general market obligations) will be shown in the report. Neither will be taken into account in figuring net sound capital of the bank.

Net depreciation in the securities in Group II and in the fourth grade of general market obligations will be deducted in computing the net sound capital of the bank.

Present practice will be continued under which depreciation in the securities in Group III and Group IV -- defaulted issues and stocks -- are classified as loss.

Present practice will be continued under which premiums on securities purchased at a premium must be amortized.

Present practice of listing and pricing all securities 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.

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.
Securities Eligible for Purchase by Banks

The definition of "marketability" and the minimum requirements to be met in establishing that a security is "marketable" have been changed.

1. Instead of requiring that a security to be "marketable" must have "such a market as to render sales at intrinsic values readily available" it will be required that they "be salable under ordinary circumstances with reasonable promptness at fair values."

2. Requirement that the "issue be of a sufficiently large total to make marketability possible" has been eliminated.

3. Requirement with respect to registration of the issue with the Securities and Exchange Commission has been eliminated.

4. The absolute requirement that there must have been a public distribution has been made subject to an exception in the case of certain securities issued by "established commercial, mercantile or manufacturing businesses that can demonstrate the ability to service such securities."

The reference to the use of rating manuals as evidence that securities are eligible for purchase has been eliminated.

The rule with respect to the purchase of securities convertible into stock or with stock purchase warrants attached is broadened.
Classification of Loans

1. By the complete elimination of the word "Slow" from the examiners' classification of loans and by emphasis upon the definition of the type of loan which, although neither a probable nor an almost certain loss, nevertheless should be carefully watched by the management of the bank, we meet the criticism, whether justified or not, that classification of loans as "Slow" by bank examiners is an important contribution to the alleged reluctance on the part of bankers to make loans.

Appraisal of Securities

2. By completely disregarding appreciation and depreciation in Group I securities, the importance of market price is minimized and banks are given an incentive for purchasing high grade securities for true investment.

Treatment of Securities Profits

3. By disapproving the use of bond profits for dividends, bonuses, and the like until and unless losses are written off and adequate reserves maintained, the speculative shifting of securities and in-and-out trading is discouraged.

Securities Eligible for Purchase by Banks

4. By broadening the definition of marketability we make possible a greater flexibility in permissible purchases and so meet the criticism that sound small issues cannot qualify.

5. By eliminating the reference to rating agencies as a source of evidence as to the investment quality of a bond we meet the criticism that we have delegated to the rating agencies the right to determine which bonds banks can buy and which they cannot buy.
On June 9th Mr. Upham told Vice Chairman Ransom of the Federal Reserve that in his opinion the Board of Governors was making a mistake in not going along with the majority agreement, making it unanimous. He told Mr. Ransom that he thought they were not only being unfair to the Secretary of the Treasury and the President of the United States but, moreover, that they were putting themselves in the undesirable position of being the agency which blocked uniformity. Mr. Ransom called Secretary Morgenthau and told him that he was going to step into the picture and see if he couldn't bring the Board of Governors into line. Statement of the issues prepared by Mr. Upham at Mr. Ransom's request and given to him on June 11th is attached.
Classification of Loans

Majority

Define but not name four classes of loans. Designate them by numerical symbols. List classes II, III and IV (which would include the same loans as are now included as Slow, Doubtful and Loss). The three classes listed will be totaled in the summary of examiners' classifications, and the totals of III and IV will be deducted in figuring the net sound capital of the bank.

Minority

Eliminate the slow column from the pages where it now appears. List elsewhere in the report under some such heading as "Loans listed for information or comment" loans fitting that description. (These would probably not be those now called Slow, some of which would be thrown over into Doubtful, and some not criticized at all.) This class of loans would not be totaled in any recapitulation. Eliminate computation of net sound capital from report.

Issues: The change in name; including (by reference) uncriticised loans; three columns or two with a separate list; recapitulating "Slow" loans; figuring net sound capital in the report. Undoubtedly also there is a difference of opinion as to what loans are criticisable.
Appraisal of Bonds

**Majority**

That appreciation and depreciation in Group I securities (except the fourth grade of general market obligations) be neither shown in the report nor taken into account in figuring net sound capital. That the net depreciation in Group II securities (including the fourth grade of general market obligations in Group I) be deducted in computing net sound capital. That all securities be listed and priced.

**Minority**

Do not list or price securities in Group I in the report.

Do not list or price securities in Group II in the report.

Do not compute net sound capital.

Attach to the report for transmission to the supervisory authorities a complete list of securities.

Issues: Listing and pricing securities in the report; computing net sound capital in the report; if computed, deducting net depreciation in Group II securities (plus that in the fourth grade of general market obligations.)
Treatment of Bond Profits

I think we have a unanimous agreement that (1) Estimated losses should be charged off; (2) Banks should be required to establish and maintain adequate reserves, including reserves against the securities account; (3) Until losses have been written off and adequate reserves established, bond profits should be unavailable for any other purpose; and (4) Speculation should be criticised and penalized.

The main issue here was whether bond profits should be required to be actually impounded in a special reserve account and no other use of them permitted.
On June 16th there appeared in the Congressional Record the attached letter from Chairman Eccles to Senator Vandenberg.
June 14, 1938.

Dear Senator Vandenberg:

Your letter of May 17 is of much interest to me and to the other members of the Board of Governors, for it raises fundamental questions of public interest. I appreciate, as I know my colleagues do, your interest in having a correct statement of the facts with which to meet misleading and damaging propaganda that jeopardizes not merely our banks but our entire economic structure and, in the final analysis, our democratic institutions.

You state that in your part of the country there is agitation to abolish the Federal Reserve System and to substitute greenbacks for bonds, and that the advocates of this course make two main points: first, that, although the Constitution gives Congress the power to "coin money and regulate the value thereof", Congress has abdicated this power; and, second, that in consequence of this abdication, private banking, operating through the medium of the Federal Reserve System, is the actual controller of coinage and values and thereby takes a profit to itself through the exercise of this power.

We are constantly bombarded, as you are, by those who imagine that all the complicated problems of our economic life can be solved by monetary magic. Unfortunately, the problems are not as simple. The failure on the part of many groups to understand how our economic system functions increases the difficulty of finding practical solutions to the vital problems that confront us.

One of the most conspicuous and arresting facts of the situation as it exists now and has existed since the banking holiday is that we have an abundance, not a scarcity, of money and of funds seeking investment in profitable and productive outlets. It would be supposed that in the presence of this fact those who imagine that a mere increase in the volume of money would assure full employment and prosperity would at least reexamine their arguments. I doubt whether in all history there has ever been such a convincing demonstration of the falsity of the theory that mere creation of a vast volume of funds will of itself produce or maintain prosperous conditions.
The vital point which is so strangely overlooked by the quantity of money theorists is that in order to have prosperity we must not only have an adequate supply of money but it must be put to active use for productive enterprises.

The great need now, as has been the case ever since the late twenties and, indeed, throughout much of the so-called prosperous era is to draw upon our existing human and material resources and put them to productive use. Our problem is not and has not been in any sense one of an inadequate supply of money and credit. As you are aware, a larger volume of currency and bank deposits than we had at the peak of the boom in 1929. Interest rates have been and continue to be at unprecedentedly low levels. This would not be the case if there were a scarcity of money. It is a scarcity of money, together with demand for it, that makes interest rates rise.

Excess reserves of the banking system are and have been very much greater than they were throughout the period of the twenties. At present they exceed $2,500,000,000, and by the end of the year they are likely to exceed $3,500,000,000, which is greater than they ever have been in all history. Excess reserves represent idle money. In their present proportions, they represent credit resources on which business could draw practically without limit if business were able or willing to use these resources for productive purposes.

In my judgment, one reason why bank credit is not flowing adequately into productive business channels is because the banks are under too severe restrictions in their lending and investing operations. This is due both to Federal and State bank examination policies and to the Regulation of the Comptroller of the Currency governing investments by member banks. As to loans, many would-be borrowers cannot get deserved accommodation by the banks, not because the bankers are necessarily at fault, but because of the restrictions imposed upon them. While larger units of business can obtain ample bank credit, there are numerous cases where sound local businesses need working capital or fixed capital on longer terms than the banks can make without being criticized by most bank examiners who have been trained in the school which identifies liquidity with soundness. Similarly, the Comptroller's Regulation in effect confines permissible bank investments to registered securities that are given approved ratings by recognized rating firms and that have a wide and active market. Thus many local industries of small and
medium size, which cannot stand the costs of registering and issuing securities for general public offering but which are perfectly sound risks, are denied access to that type of credit which is available to larger business units through the purchase of their securities by banks. Without questioning the necessity for regulations in the field of investment securities, I am confident that it is a mistake to prohibit member banks from purchasing sound securities of local businesses. I have urged that the Comptroller's Regulation be revised so that bank lending and investment policy can meet changed conditions and present day requirements of business and industry. In a recent address, I stated: "Bankers cannot justly be held responsible for such restrictive governmental banking policies as confuse soundness with liquidity or true worth with current depressed market values. I favor modernization of these practices and regulations, to encourage the bankers to meet changed credit conditions and needs within their own communities, and thus to discourage the alternative which is multiplication of governmental agencies set up to provide credit accommodation that the banking community could and should in normal times be adapted to extend to the public."

Thus while the actual and potential supply of funds is unprecedented, and the trouble is by no means a lack of such resources, monetary policies which have aimed at providing this abundance of money are frustrated when, at the same time, examination and investment policy remain restrictive and, indeed, are exactly contrary to monetary policy. It is for this reason that I have likewise contended that bank examination and investment policies must be closely coordinated with monetary policy. Otherwise, the result is likely to be the stalemate that now exists in the case of many sound but small business men who would obtain credit and put it to productive use, and to whom the bankers would make loans, but for the fact that the Government's underlying policy of creating ample credit at reasonable rates for the encouragement of legitimate business is balked, in the cases I have indicated by restrictive rules and regulations.

I have digressed from discussion of the specific points raised in your letter since I felt it necessary to emphasize that even in the field of credit control, which is generally entrusted to the Federal Reserve authorities, improvement and coordination of the activities of different branches of the Government is necessary. This situation indicates the urgent need for amendments to the banking laws to insure correlation of policies among the various banking and other financial supervisory authorities.
But, aside from the obstacles just described to the flow of money into productive enterprise, the principal reason why this flow is held back is that business and industry generally see no way to use funds profitably. They are not sure of finding a profitable market for their products. And this condition cannot be remedied until consumers have sufficient incomes to buy those products.

Lack of recognition of this fact lies behind much of the monetary agitation, particularly that directed against the banking system and against the methods of financing the requirements of the Government.

Our banking system has developed its present pattern since the beginning of the Republic and while no one familiar with it would contend that it has attained perfection or has yet approached the ideal, it has been adapted, step by step, in accordance with American principles and traditions of democratic government and to avoid too great a concentration of or an abuse of power. So many safeguards against these evils have been established over the years as to present other difficulties, such as those arising from divided responsibilities. Yet, with all of the admitted faults, the system is infinitely preferable to one which completely abandons the basic principles upon which democratic governments were long ago established and have since been maintained. Similarly, the procedure whereby the Government issues its securities, pays interest upon them, and repays them at maturity, has been established out of long experience.

The Government represents all of our people. Its debts are the debts of all of our people. When we as a people, acting through our collective medium of government, borrow money, we are borrowing from ourselves, and when we pay interest on or pay back the principal of the debt thus created, we are paying ourselves. The money required to pay the interest and to pay back the principal is raised by taxation levied broadly on the basis of ability to pay.

What is to be gained by doing away with this established process? If the Government is not to pay interest, then it can no longer borrow from its citizens. Certainly they cannot be asked to lend their savings without any return whatsoever—not if we are to preserve a democratic system of private capital. The Government would have to fall back, then, upon issuing currency. Currency is used only for a small part, not more than 10 per cent, of our business transactions. The heart of our system is the extension and contraction of credit in accordance with the requirements of commerce,
industry and agriculture. But let us suppose that the Government were to issue more and more currency in order to meet its current obligations and also to pay off its bonded debt entirely, as some of the advocates to whom you refer have proposed. The recipients of the currency, if they are on the relief rolls, for example, would spend the money as they do the cash they receive now, but ultimately it would find its way into the hands of some merchant or producer who would deposit it in his bank, and the bank in turn would forward the cash to the Federal Reserve bank where it would add to excess reserves. Or, if the recipient is the holder of a Government bond which he is obliged to exchange for currency, he might possibly spend some of the currency, or he might endeavor to buy some other security which would return a yield on his capital, or he might deposit the currency in his bank, which in turn would forward it to the Federal Reserve bank, but in every case the currency ultimately would find its way to the Federal Reserve banks and add to excess reserves.

Suppose that the entire national debt were to be paid off in this fashion. About $54,000,000,000 of the Government debt is represented by Treasury securities held by banks, insurance companies and other corporate and individual investors. To replace these securities with cash would mean that the cash would flow into the Federal Reserve banks and build up excess reserves by $54,000,000,000, or to a prospective grand total of more than $57,000,000,000. There is no way in which any such deluge of excess reserves could be kept within control to prevent them from being used as a basis for a reckless inflation. Under our system of so-called fractional reserves, for every dollar of excess reserves they have the banks can lend approximately seven dollars. Thus, $57,000,000,000 of excess reserves, if used as a basis for loans, would be capable of expanding into some $250,000,000,000 of bank loans, an astronomical figure that, if ever realized, would mean the wildest inflation imaginable. Yet the figure serves to illustrate the absurdity of the proposal to pay off the Government's debt in cash.

Assuming that the banks would not indulge in any such orgy of inflation—and, as I have pointed out, there would be no way to control the situation—then all that would be accomplished by the proposal, is that the holders of Government securities, whether they be individuals or insurance companies, or savings and other banks, would receive cash for their Government securities and this cash they would try to invest in some other interest-bearing obligation, presumably one issued by a private corporation, and if they
failed to find a satisfactory investment they would deposit the cash in the bank. In any event, the currency would finally find its way back to the banking system, because no more currency will remain in circulation than the public needs for pocket, payroll and a few other purposes.* The heart of the American financing system is credit—not coins or paper money. They are the small change. The great bulk of business is done by bank checks.

After the money was deposited in the bank it would probably be added to the already redundant amount of funds that fail to find a satisfactory investment outlet. The effect would be to bid up to larger and larger premiums the existing supply of such investments, which are even now at extremely low yields.

The creation of more idle funds would not create more real wealth. It would not lead industry to produce more of the necessaries and comforts of life which our people need or want. It would not help to distribute among the people of the country the needed and wanted things, housing, clothing, food, and all the infinite variety of other products, which our economy could and should produce.

Furthermore, the use of the printing press by the Government would remove all restraint on public expenditures. When the Government prints money someone has to pay for what it buys. Production does not increase and in the exchange of goods some group in the population must bear the cost of uncompensated acquisitions by the Government. Who pays in the first instance depends on circumstances, but ultimately it is paid for by those least able to bear the cost. For inflation inevitably follows this course, and the burden of inflation, through loss of buying power of money, falls heaviest on the poor who spend all their earnings to meet the cost of living. It is far cheaper and more equitable to pay for Government expenditures out of taxes, to which contributions are in accordance with ability to pay, than to pay for them by inflation, which destroys the value of the pay envelope, the savings account, and the insurance policy.

*The reasons for this are explained in more detail in "The Currency Function of the Federal Reserve Banks", copy of which is attached.
There is no question whatever as to the sovereign right of the Government to abandon tried and tested principles and to issue greenbacks. What is at issue, is not the right of the Government to do virtually what it pleases with its currency. The issue is whether the Government shall adhere to principles established through long and often bitter experience or throw those principles to the wind in favor of the printing press methods that we as a nation have discarded, but that have led some countries to financial ruin.

As I have indicated, the basic fallacy of the groups to whom you refer appears to be that of mistaking money for real wealth. The Government might, and certainly constitutionally could, flood the nation with paper currency, unbacked by anything other than the air we breathe, and limited only by the ability of the presses to turn out the printed money. Yet that would not add one dollar to our real wealth. It would not better the lot of our people. It would serve only to engulf all of us in a ruinous inflation and collapse. Possibly a few shrewd speculators might benefit by that, but for the great mass of our people it would be utterly disastrous.

Stripped of the specious profundities about the constitutional right of the Government to coin money, the argument for abandonment of the established principles on which this Government has always stood leads to the same and as the bolder, franker cry for an unlimited inflation. That would be the inescapable outcome, unless it be argued that the Government would be as likely or more likely to avoid the pitfalls of reckless, inflationary issuance of its non-interest bearing obligations, than is the case today when it is committed to pay the interest and principal on its debt. Experience disproves that argument. Governments have too often been tempted to travel this path to national bankruptcy when all restraints were removed. That is why the proponents of greenbacks also would abolish the Federal Reserve System, which was created nearly a quarter of a century ago as a means of assuring elasticity of our money system and at the same time to prevent abuses and to impose restraints against reckless inflation and speculation. It is not surprising that those who want greenbacks also want to remove even such limited restraints against inflation as Congress has given to the Reserve System.

This background serves to indicate the answer to the two propositions you set forth as characteristic of current monetary agitation: first, the argument that Congress has abdicated its constitutional right to coin money and regulate the value thereof; and,
second, the contention, that as a result of this abdication, the private banking system reaps large profits. Both contentions are false.

Under the division of powers between the Legislative, Executive and Judicial branches of the Government provided for in our Constitution, it is not the function of Congress to execute the laws. It is the function of Congress to make the laws and the function of the Executive branch of the Government to execute them.

When the authors of the Constitution provided that Congress should have power to coin money and regulate the value thereof, they did not mean that Congress should set up mints and printing presses in the Capitol and operate them itself. They meant that Congress should pass laws regarding the coining of money and regulating the value thereof and leave it to the Executive branch of the Government to execute these laws, and this is exactly what Congress has done.

The right of Congress to entrust to administrative agencies the execution of the laws which it enacts is as old as the Republic. It has never been seriously questioned. It has been so long recognized and established by the courts as to be beyond serious controversy. Similarly, the Congress has a right to assign execution of its will to whatever agency it cares to select or create. In so doing, the Congress frequently selects an executive agency of the Federal Government, such as the State, War, Navy or Agriculture Departments. Or it may select an independent agency, for whose operations it appropriates the necessary funds, such as the Federal Trade Commission or the Interstate Commerce Commission. Congress assigns the execution of its power to coin money, for instance, to the Treasury Department, and, in recent years, has given the President a limited authority to determine the gold value of the dollar. In all such cases, Congress has not abdicated its power. Congress has only done what it constitutionally has the right to do: It has set up or used existing administrative agencies to execute its will, while retaining the power to take back the authority or to place that authority elsewhere. Abdication of a power means its surrender. Congress surrenders none of its power to coin money and fix the value thereof. It simply designates the Treasury as the instrument of its will and power to coin money.
In exactly the same way, Congress has established the Federal Reserve System as an independent agency to carry out its mandate in connection with the terms and conditions upon which member banks may create credit currency. The only important point of difference between creation of the Reserve System and creation of the Interstate Commerce Commission as independent agencies to carry out the will of Congress is that the expenses of the former are paid out of the earnings of the System, while the expenses of the latter are paid out of the Treasury. Congress ordained that this difference should exist in respect to the Reserve System as a further safeguard of its independence of action in the exercise of the delegated authority of Congress. At the same time, Congress has the power to abolish the System, to change it, to require that its expenses be paid in some other manner, and to appropriate the earnings and surplus of the System. In fact, Congress has exercised this power by appropriating to the Federal Deposit Insurance Corporation fund approximately $140,000,000 from the surplus of the Reserve System built up out of earnings. By no stretch of the imagination can this be called an abdication or surrender of a constitutional power by the Congress. It is, as in innumerable other cases, an assignment by Congress of the execution of an unquestioned and fully retained constitutional power.

As for the question of the profits of the banking system, so far as the Federal Reserve System is concerned, it is not and never has been operated with a view to making profits, and in this respect differs fundamentally from the usual commercial bank. Such profits as have accrued to the System through its operations, from which reserves have been established to cover contingencies, from which expenses of the System have been paid, on which franchise taxes have been levied at times by Congress, and which have been appropriated by Congress as in the case of the Federal Deposit Insurance Corporation fund, have been derived as an incident of and not as a result of the objective of the System's operations.

The System's operations are intended to serve the general public welfare. Such operations are a part of the financial mechanism necessary in all modern governments. To abolish the System would not do away with the necessity for creating some similar mechanism to perform the credit and supervisory functions which Congress has deputized the System to perform. Opinions may differ as to whether some other mechanism might be better, but the right of the Congress to create the Reserve System as the agency for the performance of these essential functions cannot be seriously challenged.
Accordingly, there is no substance whatever to the assertion that Congress has abdicated its constitutional powers by authorizing the Reserve System to carry out its will, and, by the same token, the argument that thereby private banking improperly derives a profit falls to the ground. The assumption that the Reserve System, created by and existing at the will of Congress, is a privately-owned System springs from a misconception of the facts. The major monetary, credit and supervisory powers of the System are exercised by a Board of Governors, nominated by the President and confirmed by the United States Senate. All national banks are required by law to be members of the System. The banks are admitted to membership under specified conditions laid down by the Congress. All of these member banks are required by law to subscribe a proportional amount of their capital to the Federal Reserve banks in their respective districts, on which subscription a rate of return, fixed by Congress and changeable at the will of Congress, is paid. What is, in fact, a compulsory contribution by the member banks is termed a purchase of stock, but this designation is misleading since no member bank is permitted by law to trade in the stock or to enjoy various other privileges which are usually associated with stock ownership.

In any case, regardless of whether the member banks are required by law to subscribe to this unprivileged stock or whether some other device be substituted for the subscription, the matter is relatively unimportant, for it would make no real difference to the proper functioning of our economic system if this detail were changed. The effort of agitators to raise this bugaboo obscures the true meaning of their attacks, which, if successful, would undermine the foundations of our economic institutions.

They would destroy to no purpose the established first principles upon which our Government and all solvent governments have operated for centuries. They would do away with the Reserve System created out of long experience and adapted, step by step, over the past quarter of a century. Yet doing away with it would not do away with the necessity for a similar medium to perform essential functions for the Government and the public at large. They would, in the end, destroy our banks, our savings, insurance, and other fiduciary institutions, for the day that the Government abandoned interest-paying and turned to the printing press would mark the beginning of the end of the basic principles upon which our economic institutions are founded.
Permit me to express again my appreciation of the spirit in which you write and your desire to help the public to distinguish between sound principles of government and of economics that have been established by centuries of experience and proposals which could only bring disaster to the great mass of our people.

Sincerely yours,

(Signed) M. S. Eccles

M. S. Eccles,
Chairman.

Honorable Arthur H. Vandenberg,
United States Senate,
Washington, D. C.

Attachment.
Mr. Eccles and Mr. Ransom were at lunch on June 14th and were given an additional week in which to bring about a unanimous agreement.
On June 17th Mr. Diggs, Mr. Crowley and Mr. Upham were guests of Mr. Eccles at lunch and spent the afternoon going over the questions under discussion. Mr. Eccles read the attached memorandum. He also referred to the attached "Statement in Support of Revision of the Comptroller's Regulation on Investment Securities."
Classification of Loans in Bank Examinations:

1. Objectives of the Revised Procedure.
   a. To eliminate any pressure which bank examination procedure may exert towards the liquidation of sound loans.
   b. To eliminate examination procedure as a reason or excuse for a bank refraining from making sound loans.
   c. To eliminate the "slow" classification which has been a source of irritation and a cause for misunderstanding.
   d. To improve and simplify the schedules of classified loans.
Proposed Plan Regarding Classification of Loans in Reports of Examination, as Submitted by Mr. Upham:

1. Abandonment of the present caption of classified loans; namely, slow, doubtful, loss.

2. Continuation of 3 columns of classified loans, such columns to be designated by the Roman numerals II, III, IV, with the definitions of the classifications to be printed in the examination reports. In effect, in accordance with the definition submitted, this would mean 3 columns of criticized assets which might be briefly described as "Somewhat doubtful", "More doubtful", "Loss".
Board's Proposal:

1. Retention of the classifications "doubtful" and "loss".
2. Elimination of the "slow" classification.
3. Inclusion of a schedule on a separate page entitled "Loans listed for special comment", in which schedule should be listed with appropriate comment such loans as the examiner feels should be set out for the information of the directors and proper officers of the bank. Such loans should not be totaled and should not be included in any recapitulation of classified or criticized assets.

Reasons for Board's Position:

1. Inasmuch as all are apparently agreed that the "slow" classification should be eliminated, it is not considered necessary to cite reasons at this time for such elimination.

2. From the supervisory point of view, it is believed that it would be more effective to have the definitely criticized loans, i.e., "doubtful" and "estimated loss", shown on one page, and loans which are not so classified but listed for comment shown separately.

3. A logical basis for classification of loans in reports of examination is from the point of view of whether payment will be collected in full or whether some loss will be sustained. This seems to be adequately covered by classifications of "doubtful" and "estimated loss".
Objections to the Above Proposal:

1. It is inadvisable to print in the reports of examination detailed definitions of the classifications as such matters should be covered by instructions to examiners which should be changed from time to time, as they have in the past, in accordance with economic conditions.

2. The terms "doubtful" and "Loss" are readily understandable and some part of the effectiveness of such classifications may be lost through designation as Class III or Class IV.

3. The necessity of advisability of dividing the "doubtful" classification into two degrees of doubtfulness is not clear or, if such division is necessary or advisable, why two subdivisions are sufficient and not 3 or 4, such as "potentially doubtful", "tinged with doubt", "doubtful", "very doubtful". It has been contended that loans classified as "slow" are not criticized loans. The Group II loans as defined are definitely criticizable loans. It must be expected, however, that regardless of the instructions, for a considerable time, at least, many loans which were formerly classified as "slow" will be classified as Group II. To the extent that such loans are doubtful, they should be so classified; to the extent, however, that loans so classified are not doubtful, such classification will defeat one of the purposes of the revision.
Securities:

1. Objectives of revised procedure.
   
a. Encouragement of sound investment policies with emphasis upon regularity of income and safety of principal and toward the discouragement of speculative policies based on trading profits.

b. To get away from fluctuating market quotations to as great an extent as possible, regardless of whether security prices be high or low, and to place the emphasis upon quality of individual issues and provision of adequate reserves.

c. To minimize, except where necessary, the effect of bank examination and supervisory policies as an influence for the liquidation of securities at a time when such liquidation accentuates deflationary tendencies.
2. Proposed plan for treatment of securities in reports of examination, as submitted by Mr. Upham.

   a. Continued listing and pricing of all securities.

   b. Classification of depreciation in Group III and Group IV securities (defaulted issues and stocks) as estimated loss.

   c. Deduction of net depreciation in Group II securities (this includes general market obligations not in default but which are rated below the 4 highest ratings as used by the recognized rating agencies) and in the fourth grade of general market obligations (Baa, Bll, BBB, etc.) in computing net sound capital of the bank.

   d. Discontinuance of showing appreciation or depreciation in Group I securities (except the fourth grade of general market obligations) and disregard of such appreciation or depreciation in computing the net sound capital of the bank.
3. Objections to above proposal.

a. Continued emphasis of market quotations.

b. The disregard of appreciation in Group I securities in computing net sound capital while deducting depreciation in other securities will tend to force sales in order to realize profits to provide for charge-offs of depreciation in lower grade securities.

c. The dropping in effect of the fourth grade of general market obligations (Ba, B1, BBB, etc. as rated by the rating agencies) from Group I to Group II. This is a restrictive measure which is proper but should be made at a time when security prices are at a higher level, i.e., a year or two ago, or after recovery has developed.
4. The Board's proposal.

a. Classification of depreciation in defaulted bonds and stocks as estimated loss, other securities in general being allowed at amortized book value.

b. Insistence upon provision of adequate reserves and upon the requirement that until adequate reserves against the investment account have been provided, all net profits from the sale of securities be impounded, thus preventing the treatment of such profits as regular, rather than non-recurring, income available for regular operating expenses.

c. Insistence upon the conservation of earnings so long as the bank is faced with asset problems, whether in securities or otherwise.

d. Elimination of the schedule listing all securities, substituting therefor a schedule of stocks and defaulted bonds and a schedule of any other securities listed as exceptions for appropriate comment.

(A complete list of all securities, however, should be attached to the report of examination sent to the supervisory authorities.)
5. Reasons for the Board's proposal.

a. Reports of examination are not detailed inventories of all assets but to a great extent are based upon exceptions. It is inconsistent with the general scheme, therefore, to incorporate in a report of examination a detailed list of all securities, including those not subject to any adverse comment or criticism. The inclusion of such a list, especially if the bonds are priced, tends to over-emphasize the importance of fluctuating quotations.

b. It is desirable to minimize the emphasis upon market quotations.

1. Experience has shown that market quotations do not reflect actual prices which may be received or paid with respect to sales and purchases on a substantial scale.

2. The sale of comparatively few bonds may result in a marked, though temporary, decline in market quotations of such issue. Quotations so established, however, even on forced sales and depressed markets, control the appraised value of all bonds of that issue held by banks examined as of that date.

3. It is illogical to use as a test in determining the solvency or soundness of a bank market quotations perhaps representing forced sales on distressed markets when the bank is in no need of selling its bonds, or if called upon to dispose of the bonds, has no assurance that even an
approximation of the market quotations could be obtained.

4. Emphasis on market quotations tends to stimulate trading and speculative activity.

5. Emphasis on market quotations tends to inspire sales on a declining market which in turn accelerates the extent of the decline, thus starting a vicious circle.
Net Sound Capital

The suggested program as submitted by Mr. Upham provides for a schedule in reports of examination showing net sound capital, which is computed by deducting from total capital account all estimated losses, doubtful assets, and a certain amount of depreciation in securities. (The present reports of examination of both the Comptroller of the Currency and the F.D.I.C. include such a schedule in which all depreciation in securities is deducted.)

Board's position. The Board favors the elimination of such a schedule for the following reasons:

1. Any good which may be accomplished by not classifying depreciation in securities as estimated loss or doubtful is offset to a considerable extent, at least, by showing it as a deduction in the computation of net sound capital.

2. It is inconsistent for the computation to include as a deduction depreciation which is not shown in the recapitulation of assets, the soundness of which is questioned.

3. It focuses attention on depreciation based upon fluctuating market quotations.

4. In accordance with the purpose of minimizing depreciation in higher grade securities, the program provides that such depreciation be not deducted in computing net sound capital. It cannot be said, however, that depreciation in any securities constitutes sound capital and it is felt that such implication should be avoided.

5. The concept of "net sound capital" may have different meanings
in different circumstances. For example, an excessive investment in banking house or large holdings of other real estate, even though not classified as estimated loss or doubtful, frequently afford little protection to depositors or the F.D.I.C. and, it is suggested, do not warrant the designation of "sound capital" even by implication.
While the question of the desirability of amending the Comptroller’s Regulation on Investment Securities was discussed in recent conferences at the Treasury respecting bank examination policy, the problem is not one of examination policy but of bank investment policy. Nor has the problem only recently arisen, as it has been apparent for some time, certainly for a year or more, that one aspect of the unsatisfactory business situation was the lack of bank investment in certain types of securities. However the problem of bank investments should not be approached solely as a problem of bank earnings, important as that is with bank revenues declining due to low interest rates and relatively high liquidity in the banking system. The more vital aspect of the problem is the relationship of bank investments to the business world and in particular to the financial requirements of commerce and industry. What is the function, or rather, what is the normal function of bank investments as related to business finance?

Bank investments have always been an indispensable factor in the capital market. Important limitations upon such investments have been imposed since the ’20’s and these restrictions have not been inherently qualitative but have taken the form of a limitation of bank investments to registered issues of the four highest grades as determined by recognized rating services. The
result of this restriction has been a virtual drying-up of the
normal flow of capital to small business and a serious slowing-
up of such flow to medium-sized business. There is some complaint
that capital for larger business units does not flow as freely as
it should because of overregulation in the entire field of secur-
ities, but this discussion will not concern itself with that phase
of the problem.

Another factor in the situation is the prohibition against
the underwriting of security issues by banks of deposit. Opinion is
divided as to the merit of this restriction and many informed people,
who previously approved of the complete prohibition, now favor some
relaxation under proper safeguards. Leaving aside the pros and cons
of underwriting by banks, that process was a mechanism for providing
credit and capital for business which is not now available. Further-
more, during the period when banks were underwriting, there was no
requirement of registration and the cost of underwriting and dis-
tributing small issues was consequently moderate whereas, under exist-
ing registration requirements, as we shall see, the cost of funds
raised through small issues is disproportionately high if not pro-
hibitive. We can safely conclude, therefore, that the outlawing
of underwriting by banks has hurt small business more than large
business. This is a further indication of the need of encouraging
investment by banks in securities of small business.

The current discussion of the need of capital aid for
small and medium-sized business has brought forth many suggestions
including various types of legislation to set up new mechanisms for providing capital and credit for business. These suggestions seem to ignore the fact that there is at present in the banking system a huge reservoir of funds available for the direct supply of credit and capital. If new mechanisms are set up, the funds loaned would be provided by the sale of bonds or debentures in the market, which means that the idle funds in the banking system would be tapped only indirectly by the sale of these obligations instead of directly as was the case in the '20's. The net result of such a scheme is the setting up of additional governmental or quasi-governmental organizations and a further diversion of the banking system from its normal function of a direct supplier of credit. Such a diversion has already taken place to an important extent in the agricultural field through the Farm Credit Administration, the home mortgage field through the Home Loan Bank System and the Federal Savings and Loan System, and in the field of consumer instalment financing through other financing organizations. In the past, the banking system has been the chief supplier of capital and credit for the business community and there would seem to be no good reason for taking the banks out of this normal field of direct financing and leaving them only the indirect function of purchasing bonds or debentures of other financial agencies to supply these funds. The banking system is in need of expansion of its credit outlet and only artificial barriers are preventing the flow of idle bank funds to industry and commerce. These barriers have taken the form of a limitation of bank investments to registered
issues of the four highest grades, as determined by rating organ-
izations, and for which continuous market quotations are available
and, therefore, automatically exclude the obligations of small or
local business enterprises regardless of quality. The sensible
thing is to remove these barriers rather than to furnish new,
elaborate and expensive mechanisms to syphon the idle banking
funds over the existing barriers.

Needed reform in the distribution of securities based
upon abuses in the '20's has been carried so far that small and
medium-sized business has been left without adequate means of
acquiring capital and credit. No one today questions the wisdom
of the separation of securities affiliates from banks of deposit.
There is also universal support for the principle of the registra-
tion of security issues distributed by underwriters and dealers
to the public. But in this general reform movement there has been
little attempt to separate the sheep from the goats and no provision
has been left for financing smaller business through the purchase
by banks of local security issues, as in the '20's. At that time,
any local business needing from $100 to $200 thousand up to $1
million would approach a local underwriter or banker and without
much delay or expense a group of the local banks would consider an
issue of bonds, debentures or notes, and if found attractive the
entire issue would be placed locally. At present the underwriter
cannot touch such an issue unless it is registered, nor can the
local banks purchase all or part of such an issue unless it is not
only registered but also widely distributed and highly rated. Aside
from the time element which is important, the cost of capital obtained through the issue of registered securities in small amounts is prohibitive. From a statistical survey by the Securities and Exchange Commission of the estimated costs involved in the issuance of new securities (bonds, notes and debentures) from January 1, 1936, to June 30, 1937, the following percentages of cost as against gross cash realization from the securities illustrate the heavier burden on the smaller issues, particularly those under one million dollars:

<table>
<thead>
<tr>
<th>(In thousands)</th>
<th>Under $250-</th>
<th>$250-</th>
<th>$750-</th>
<th>$1,000-</th>
<th>$5,000-</th>
<th>$10,000-</th>
<th>$25,000 or more</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of issues...</td>
<td>11</td>
<td>8</td>
<td>6</td>
<td>6</td>
<td>50</td>
<td>11</td>
<td>37</td>
</tr>
<tr>
<td>Commission and discount (per cent)...</td>
<td>6.4</td>
<td>6.2</td>
<td>5.2</td>
<td>4.2</td>
<td>3.4</td>
<td>2.3</td>
<td>2.2</td>
</tr>
<tr>
<td>Other expenses (per cent)...</td>
<td>2.2</td>
<td>2.0</td>
<td>2.5</td>
<td>2.0</td>
<td>1.4</td>
<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td>Total (per cent)...</td>
<td>8.6</td>
<td>8.2</td>
<td>7.7</td>
<td>6.2</td>
<td>4.8</td>
<td>3.4</td>
<td>3.1</td>
</tr>
</tbody>
</table>

The total cost of distribution including registration and rating may not seriously hamper the marketing of large issues but the greatly higher cost of distributing smaller issues under the existing statutory and regulatory restrictions explains the financial strangulation of smaller businesses and has thus created an unjust discrimination against them. In this manner, these desirable and needed reforms, through a lack of provision for proper exemptions for local or small issues, have fostered bigness and monopoly, the very things which the present Administration abhors.

From the foregoing it is obvious that both the Securities Act of 1933 and the Comptroller’s Regulation on Investment Securities
constitute effective barriers between small and medium-sized business and the available supply of capital funds. And with the banking system loaded with idle funds it must be equally clear that if these barriers were removed or at least greatly lowered, capital funds would again flow to small and medium-sized business. This discussion will not concern itself with suggestions for amendment of the Securities Act of 1933 or for liberalization of the regulations and rulings of the SEC pursuant to that Act. The Securities and Exchange Commission has recognized the need of liberalization of its regulation by its announcement of April 22 of this year accompanying the promulgation of a new rule designed to broaden the exemption for issues of less than $100,000 and to reduce the amount of financial information required in the registration statements for issues of small established enterprises. The announcement contained the further information that the SEC would continue studies as to the advisability of further liberalization. The discussion which follows will point out what is believed to be a reasonable and intelligent basis for amending the Comptroller's Regulation. This would also automatically change an important ruling of the Comptroller based upon the existing Regulation.

The Comptroller's Regulation is of rather recent origin. It is based upon section 5136, enacted by Congress in 1926, which recognized a practice already in effect, namely the investment by national banks in securities in the same manner as such investments were being made by State banks. The statute,
boiled down to its essentials, requires only that the securities be "in the form of obligations such as bonds, notes and/or debentures", that the securities be marketable, and authorizes the Comptroller to further define the terms "investment securities" and "marketable". Under the conception prevailing at the time in the banking world that liquidity is synonymous with quality, it was only natural that the first regulation defined "marketable" as "readily marketable" and thereby placed emphasis upon daily quotations and active trading. No important change was made in the regulation until the 1936 revision when the term "readily marketable" was further defined as involving wide distribution and in effect required both registration and rating. It would be hard to imagine a more effective way to prevent small business from obtaining capital through the issue of securities. This definition in itself virtually eliminated the purchase of sound unregistered securities by banks, including local securities. There would have remained, however, direct loans from banks to business or industrial enterprises represented or secured by bonds, notes or debentures, which type of transaction had been traditionally regarded as a loan rather than a purchase of the paper evidencing the obligation. Even this time-honored lending mechanism was prevented by a ruling of the Comptroller based upon the revised regulation. Under this ruling a bank is prohibited from acquiring an obligation in the form of a security even though in good faith the bank treats the transaction as a loan. Since the statute covers only the "purchase" of securities by a bank, it is going a
It would seem that evasion of the general purposes of the Comptroller's Regulation could be prevented by limiting the restriction to the acquisition of paper in the form of securities if purchased from others than the obligor. Such a ruling would permit one or more banks to loan capital funds directly to local industrial enterprises against their bonds, notes or debentures, which is the most convenient form in which a group of banks can furnish such capital funds.

The suggested revision of the Comptroller's Regulation attached hereto meets the foregoing difficulties and, without breaking down the general principle of qualitative selection of security investments by banks, would permit sufficient leeway to enable banks to supply capital funds to small and medium-sized businesses. The suggested revision liberalizes the definition of the term "marketable" as used in the statute, removes any reference to rating manuals as a test of quality, and does away with the requirement that investment securities be registered. In addition, the Regulation enunciates a principle of bank investment policy in stating that a bank subject to the Regulation "shall exercise the same degree of care that sound banking practice requires for making loans" and puts the principle into practical use by requiring that the bank obtain and maintain such pertinent information with respect to its investment securities "as shall be necessary to show
that it has exercised appropriate care as to the purchase and retention of such securities". An appendix to the suggested revision contains a statement of some of the important investment principles which have developed out of the best practice followed by banks.

While it would be possible to bring about the desired changes in the existing Regulation by various specific amendments, for the sake of simplicity and clarity the complete revision of the Regulation is suggested.
June 20, 1938

Secretary Morgenthau invited to his home at 8:30 p.m. Mr. Jones, Mr. Crowley, Mr. Diggs, Mr. Oliphant, Mr. Gaston, and Mr. Upham.

The suggested revision of the investment securities regulation of the Comptroller of the Currency, particularly that section dealing with securities which do not have a public distribution (probably thought of as securities of small local concerns) was under consideration for some time.

Mr. Jones urged that the maturity of such securities be a maximum of fifteen years. Mr. Diggs was not willing to go beyond ten years. Mr. Jones urged that the maximum limit of 25 per centum of capital stock and surplus which might be represented by loans of this character be eliminated. Mr. Diggs agreed to this.

Mr. Jones urged that the wording "established commercial, mercantile and manufacturing businesses" be changed for the sake of uniformity to the language employed in the Reconstruction Finance Corporation Act for industrial loans "established commercial or industrial businesses or enterprises." Mr. Diggs agreed to that.
It was urged that instead of requiring that the securities be "fully and adequately secured," that they be "of such sound value or so secured as reasonably to assure its payment." This was agreed to.

It was urged that complete amortization by maturity date be not required. Mr. Diggs agreed to a 75 per cent amortization.

Upm
On June 21st at 2:30 p.m. Messrs. Eccles, Ransom, McKee, Szymczak and Davis of the Federal Reserve, Jones of the RFC, Crowley of the FDIC, Diggs of the Comptroller's Office and Oliphant, Gaston and Upham of the Treasury met with Mr. Morgenthau. The revision of the investment securities regulation of the Comptroller of the Currency was agreed to without change. It is attached.

There was considerable discussion of the agreement as to bank examination procedure and some changes were agreed to. The agreement, as revised, is attached.

A second meeting, attended by all of the above except Mr. Ransom, was held on June 23rd to clear up a few details and make sure that the agreement was unanimous.
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 cannot 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 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

   (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 se-
curaries 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 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 pro-
hindered 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.

Signed and promulgated this 28th day of June, 1938

Acting Comptroller of the Currency
The Classification of Loans in Bank Examinations

The present captions of the classification units, namely, "S Tea," "Unprofitable," 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 in 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 ultimate 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.

Fifty per cent of the total of II above and all of IV above will be deducted in computing the net sound capital of the bank.
June 23, 1938

The Treatment 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 losses.

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.
June 22, 1959

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 these, will not be approved.

Present practice will be continued under which estimated losses must be charged off.

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 criticized and penalized.
Treasury Department

TELEGRAPH OFFICE

NEW YORK, NY

M. 71

HON. HENRY MORGENTHAU, JR.
ATTENTION C. B. UPHAM

MR. UPHAM HAS JUST ADVISED ME BY TELEPHONE OF THE AGREEMENT REACHED YESTERDAY BY ALL FEDERAL BANK SUPERVISORY AGENCIES RELATIVE TO UNIFORM EXAMINATIONS. THE PROGRAM AGREED UPON IS IN ACCORD WITH THE ONE RECENTLY RECOMMENDED BY THE NATIONAL ASSOCIATION OF SUPERVISORS OF STATE BANKS. ALL ESSENTIAL DETAILS OF THE PROGRAM AS OUTLINED TO ME HAVE ALREADY BEEN CONSIDERED AND APPROVED BY STATE BANK SUPERVISORS AT DISTRICT MEETINGS HELD THROUGHOUT THE COUNTRY.

WILLIAM R. WHITE . . . . 1121 A
The attached is a suggested explanatory statement prepared by the FDIC and the Comptroller of the Currency.
MEMORANDUM:

Subject: Bank Examination Program

The Comptroller of the Currency and the Federal Deposit Insurance Corporation, together with the Executive Committee of the National Association of Supervisors of State Banks, have agreed on a program of uniform standards in connection with the appraisal and classification of loans and securities in bank examinations. These standards have been adopted with a view to promoting a wholesome recovery and providing permanent high standards in bank examinations and bank supervision.

This program, which is the result of careful study and of conferences extending over a period of several months, is a substantial step forward toward attaining a high degree of uniformity in future examinations of banks of all classes. A better coordination of bank supervision and a greater degree of protection to the millions of depositors in the nation's banks are thereby assured.

An important aspect of the program is the proposed abandonment of the term "Slow" in connection with the classification of loans in bank examinations. The confusing nature of the term "Slow" is evidenced by the present requirement of the Federal Agencies that a loan should not be so classified if its ultimate repayment is reasonably assured, even though the loan is slow in a literal sense. The adoption of numerical captions for the loan classification units, with each classification uniformly and clearly defined, should do much to eliminate this confusion.

It has long been recognized that the lending of funds to sound and solvent borrowers, small and large, for reasonable periods, is a legitimate function of a commercial bank, provided there is proper provision for the orderly or ultimate payment of such loans. Bankers should be willing to assume reasonable risks and should not be criticized for so doing. No loan should be classified in a bank examination if the loan is sound in view of the valuable net worth of the maker or endorser, his earning capacity and character, or the protection of collateral of sound intrinsic value. All of these steps add up to more reliable and trustworthy bank examinations.

The abandonment of emphasis upon quoted market prices as a basis for valuing investment securities is another constructive aspect of the program. Both appreciation and depreciation in securities of this quality are to be disregarded. The use of market values has not proved satisfactory as a method of appraising high grade bonds. Approximately 85% of the securities presently held by banks are of investment quality, and appraisal at cost will give recognition to the principle that such securities are investments and are not intended to be continually turned over in the market.
Securities of speculative quality, although not defaulted, represent
about 10% of bank holdings. Consideration of net depreciation in
these securities in determining a bank's net position is necessary if the
risks involved in speculative securities are to be appropriately reflected.
Defaulted bonds and stocks are approximately 5% of total bank holdings
and net depreciation in these securities is an estimated loss which
should be charged off. The present practice will be continued under
which premiums on securities purchased must be amortized.

Another important part of the program relates to the treatment of
profits from the sale of securities. Until losses have been written off and
adequate reserves established, the use of profits from the sale of securities
for any other purposes will not be approved. The present practice will be
continued under which the establishment and maintenance of adequate reserves,
including reserves against the securities account, are to be encouraged.

This treatment of profits is a sound procedure which many well-run
banks have been following for some time past. It will tend in some measure
to discourage speculative in-and-out trading in the bond market which is a
practice to be criticized and penalized. Too many bankers have viewed their
holdings not as investments but with a view to obtaining speculative
profits from turnover and this condition has contributed to the instability
of the bond market. Furthermore, the so-called profits from security sales
are in many instances not actual profits but merely write-ups in book value.
This results from the fact that a banker, in disposing of securities at a
profit, frequently reinvests at approximately the same price levels.

In connection with the Regulation of the Comptroller of the Currency
governing purchases of securities by member banks of the Federal Reserve System,
purchases of local issues of high credit quality will be permitted, provided
there are sound provisions for the regular amortization of such debt by the
obligor, and provided further that such issues are not held in excessive
amounts. The Federal Deposit Insurance Corporation will continue its present
practice which is in line with the above.

This program, viewed as a whole, is believed sound and workable.
The nation's banking system is a strong factor in the present situation and
the merited confidence of the depositing public in this system must be pre-
served. This merited confidence cannot be preserved unless bank supervision
is courageous and realistic.
The attached is Mr. Upham's draft of statement for possible use by President in connection with a release.
June 22, 1938

A greater degree of uniformity in bank examination procedure by examining agencies of the Federal Government and of the state governments has been made possible through an agreement reached by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Board of the Federal Deposit Insurance Corporation, and concurred in by the National Association of Supervisors of State Banks.

Coordinated with this agreement as to bank examination practice is a revision of the investment regulation which governs the security purchases which may be made by national banks and state banks which are members of the Federal Reserve System.

The program of coordination which has been agreed upon concerns itself with the loans and investments which banks may make and their treatment in bank examination and supervision.

It is believed that the interest of depositors will be protected as in the past and that the sound banks that were opened following the banking holiday of 1933 will continue to be soundly conducted and adequately supervised in the
public interest. At the same time it is hoped that some impetus will be given to the flow of bank credit into business and industry in the interest of economic recovery for with a permanent and enduring prosperity will come an added assurance and safety for bank depositors.

It has been said frequently in the past few years that the practice of classifying certain loans made by banks as "Slow" has deterred banks from making sound and profitable advances to business. The agreement which has been reached completely eliminates the word "Slow" from the loan classifications by examiners and clearly defines the types of loans which are subject to criticism.

The agreement minimizes the importance of market price or day-by-day fluctuation in the quoted value of investment securities in the portfolio of the bank and thus encourages the acquisition of securities of investment grade for continued retention until maturity, and discourages speculation in securities. The treatment of profits from appreciated securities will be such as to further give encouragement to sound investment practices by banks.
The revision of the investment regulation governing purchase of investment securities by national banks and state banks which are members of the Federal Reserve System will make possible an expansion of bank credit in the field of sound local security issues. It is believed also that elimination in this regulation of reference to the ratings of securities will bring about an improved practice in the testing of the quality of bonds in the banks.
Attached is Mr. Eccles' statement to the President.
BOARD OF GOVERNORS
of the
FEDERAL RESERVE SYSTEM
Washington

Office of the Chairman

June 24, 1938

Dear Henry:

In accordance with my understanding with you, I am sending you herewith a copy of the statement which I have sent to the President.

Sincerely yours,

(Signed) Marriner

Honorable Henry Morgenthau, Jr.,
Secretary of the Treasury,
Washington, D. C.
In my message to Congress on April 14, I announced the desterilization of approximately $1,400,000,000 of Treasury gold, accompanied by action on the part of the Federal Reserve Board 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 I expressed the hope that Federal banking supervision could be better coordinated, with a view to facilitating the flow of credit for commerce, industry and agriculture.

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.
They have unanimously agreed upon and submitted to me a program which for the first time brings about complete uniformity in the rules and regulations to be followed by the Federal agencies in their administration of all bank examinations under their respective jurisdictions. This is an important forward step in removing from the field of bank supervision sources of conflict and of irritation that do not make for the efficient functioning of the banking system.

Beyond this, however, the program adopted should be of benefit both now and in the future in two important respects; first, by opening the way especially for the small and medium-sized business concerns to obtain needed credit from the banks, and, second, by relieving pressures that tend to reduce outstanding credit or prevent extension of new credit to sound borrowers.

The program includes a broad revision of the Regulation of the Comptroller of the Currency governing bank investment policy. It provides that 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 per cent of the principal be amortized at maturity by substantial, periodic payments, none of which would be required during the first year.

The program provides, with respect to bank examination reports, that what has been commonly called the "slow" column will be abolished altogether. In place of this, and of the columns heretofore headed "doubtful" and estimated "loss", there will be substituted the designations, II, III, and IV, which are to be defined respectively for the listing of loans that are somewhat doubtful, more doubtful, and in which loss is estimated. The "slow" column has long been a misnomer and a cause of complaint.

The important fact, however, is not the designation of the columns, but the clear recognition that in making loans, whether for working capital or fixed capital purposes, the banks should be encouraged to place the emphasis upon soundness rather than upon liquidity or quick maturity.
Similarly, the revised examination procedure clearly recognizes the principle that bank investments should be considered in the light of their inherent soundness rather than on a basis of day to day market fluctuations or liquidating value. The soundness of the banking system depends in the last analysis upon the soundness of the country's business and industrial enterprises. It should not be measured by the precarious yardstick of ticker quotations which often reflect speculative and not true appraisals of intrinsic worth. In their purchase of securities the banks should be encouraged to invest, not to speculate.

Accordingly, the revised procedure broadly divides securities into those of investment quality and those of speculative or sub-standard character. The former will be listed in Group I, the latter in Group II. Defaulted bonds and stocks will be listed in Groups III and IV, respectively.

It is estimated that approximately 90 per cent of the total securities held by the banks are of investment quality and will be carried 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, which will require that such securities be shown at their book value whether they be listed or unlisted securities. By thus severing bank investment from the ticker, banks will be encouraged to purchase the securities of sound American business and industrial concerns, whether large or small, for their true worth and not for speculative gains.

Sub-standard or speculative securities, to be carried in Group II, are estimated to comprise not more than 5 per cent of the banks' holdings, and will be shown in examination reports at their average market price for the 18 months preceding the examination, a method which would more accurately reflect intrinsic values in this group. Unlisted securities in this group will be shown at estimated value. In the case of Group III and IV securities, net depreciation will continue to be classified as loss.

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 per cent of the more doubtful loans, as shown in Class III and 50 per cent of the net depreciation
of the sub-standard bonds listed in Group II, will be deducted. Previously, the total of all of the loans classified as doubtful has been deducted, but experience has shown that not more than half result in loss. Likewise, in the past deductions have been made for all of the 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 will afford the banks a broader opportunity for service to the community and for profitable outlet for some of their abundant idle funds. If the banks will avail themselves of that opportunity, the necessity will be diminished for creation of government agencies to furnish credit facilities which the banks should provide. A first step in stopping deflation requires that credit contraction in the banking system be arrested. This is essential in order to provide a basis upon which necessary expansion can be brought about. This program should assist in halting private credit contraction and encouraging private credit expansion which
in turn will lessen the need for reliance upon public credit. Thereby it can contribute to general economic health upon which the welfare of the public as well as of the banker and bank depositor depends. At the same time, this program does not mean unsound banking. 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.
Attached is Secretary's letter to President of June 24th submitting the agreement on bank examination and the revised text of the Comptroller's regulation. There is also attached a memorandum showing the old and new provisions.
June 24, 1938

My dear Mr. President:

In your message to the Congress of the United States, on April 14, 1938, you said "As a part of better administration I hope that federal banking supervision can be better coordinated."

You asked me to bring this about through getting an agreement by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Board of the Federal Deposit Insurance Corporation for uniformity in bank examinations and revision of the regulation governing purchase of securities by banks.

I am pleased to be able to report to you that after two months of conferring, we are able to send you a unanimous report. I am attaching hereto the following:

1. Agreement on classification of loans in bank examinations.

2. Agreement on the appraisal of bonds in bank examinations.

3. Agreement on the treatment of securities profits in bank examinations.

4. Revision of the investment securities regulation of the Comptroller of the Currency.

The agreements and the revised regulation meet with the approval of the Chairman of the Reconstruction
Finance Corporation and the National Association of Supervisors of State Banks.

I feel that this is a constructive step and should be most helpful in carrying out your recovery program.

Yours respectfully,

Henry Morgenthau, Jr.,
Secretary of the Treasury

The President,
The White House.
The Classification of Loans in Bank Examinations

The present captions of the classification units, namely, "Good," "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 reports.

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 ultimate 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.

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 Survival of Banks in Bank Failures

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 losses.

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 Survival of Banks in Bank Failures

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 losses.

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 values will be continued.
June 23, 1933

The Treatment of Securities Profits in Bank Operations

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.

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 criticized and penalized.
June 23, 1938

Classification of Loans

Old

Loans are classified by bank examiners as

Less" if it appears pretty certain that the borrower cannot pay;

"Doubtful" if it appears "very doubtful" that he can repay; and

"Slow" if the loan is inferior in quality and likely to become doubtful unless watched.

New

These classes of loans will be designated by number rather than name with specific definition of the kind of loan to be included. The word "Slow," which has been alleged to deter bankers from making many sound loans, will be completely eliminated.
Valuation of Bonds

Old

All securities for which there are quotations are valued at market price.
The net amount by which depreciation of securities (other than defaulted issues and stocks) has brought them below book value (amortized cost) is deducted from capital account in computing the "real" capital of the bank.

The full amount of depreciation in defaulted issues and stocks is deducted in computing "real" capital.

By minimizing the importance of day-by-day quotations, emphasis is placed on quality of investment, and speculation is discouraged.

New

Market quotations on securities of investment quality will be disregarded.
Securities of inferior or distinctly speculative quality (other than defaulted issues and stocks) will be valued at an eighteen-month average and fifty per cent of their depreciation below book value will be deducted in computing the "real" capital of the bank.

No change.
June 23, 1956

Treatment of Securities Profits

Old

Some banks are inclined to sell securities when they have appreciated in price and use the so-called "profit" for paying dividends or for similar purposes, without adequate provision having been made for writing off losses sustained and for establishing reserves against future losses.

New

Use of securities profits for dividends, and similar purposes, will be disapproved until and unless losses have been written off and adequate reserves provided.
Securities Eligible for Purchase by Banks

Old

They must be marketable obligations:

1. Sales at intrinsic values readily available.

They must meet minimum requirements:

1. The issue must be of a sufficiently large total to make marketability possible.

2. Unless exempt, must be registered with SEC.

3. If issued under trust agreement, trustee must be bank or trust company.

4. Such public distribution of the issue or of other existing securities of the issuer must have been made or provided for as to protect or insure the marketability of the issue under consideration.

New

They must be marketable obligations:

1. Salable with reasonable promptness at fair values.

2. Reference to size of issue eliminated.

3. No registration requirement.

4. Such public distribution of the issue or of other existing securities of the issuer must have been made or provided for as to protect or insure the marketability of the issue under consideration.

OR

Public distribution is not necessary in the case of certain securities issued by established commercial or industrial businesses or enterprises that can demonstrate the ability to service such securities. These must mature within ten years and be of such sound value or so secured as reasonably to assure payment, and must provide for amortization to extinguish at least 75% of the principal by the maturity date.

5. Same.

Purchase of investment securities in which the investment characteristics are distinctly or predominantly speculative, is prohibited. Purchase of securities in default is prohibited.

Where there is doubt as to the eligibility of a security for purchase, such eligibility must be supported by not less than two rating manuals.

This requirement has been eliminated.
Unused memorandum by Mr. Upham for information of the press.
MEMORANDUM - Not for publication in whole or in part as a Treasury statement.

June 23, 1938

(1) The Government which charters a bank permits it to accept deposits, and to invest such deposits in loans and securities.

(2) The Government requires those who operate a bank to provide a capital cushion as a protection to other peoples' money deposited with it.

(3) The Government stipulates some general rules with which a bank must comply in making loans and buying securities. These rules are also made for the protection of the depositor.

(4) Banks try to make loans that will be repaid. If it becomes pretty certain that one will not be paid, it is classed as a "loan." (As of the end of 1937 the "loan" classification for national banks included one half of one per cent of their total loans.) To replace this loss an equivalent amount must be taken away from the owner of the bank (capital) and added to the assets held for account of depositors.

If it becomes very doubtful that a loan will be paid (but not certain that it will not be), it is classed as "doubtful" and bank examiners now require the bank to play safe by also taking an equivalent amount away from the owner (capital) for the benefit of the depositors. (As of the end of 1937 the "doubtful" classification for national banks included slightly over one per cent of their total loans.) Losses thus fall on the bank owners—not on the depositors.

One of the changes made under the agreement just reached is to require that only fifty per cent (rather than all) of the amount of the loans, repayment of which is very doubtful, be transferred from capital account to depositor account. Some of them may prove to be good.

There are some other loans in banks which certainly cannot be classed as loss, and the repayment of which is not "very doubtful," but which for one reason or another are of somewhat inferior quality and which are likely to become "doubtful" unless watched. These loans have come to be known as "slow"—generally agreed to be a misnomer, for the test of a bank loan should be its quality rather than its liquidity or maturity. (As of the end of 1937 the "slow" classification for national banks included slightly under ten per cent of their total loans.)
Except in special cases no limits are placed on the period of time for which a bank may make a loan. It is banking custom which has made the commercial bank loan a relatively short extension of credit.

One of the changes made under the agreement just reached is to abandon completely the use of the word "Slow" by bank examiners. There will be no "Slow" loans. This classification as well as those of "Doubtful" and "Loss" will be replaced by the numerical designations of II, III, and IV. Those loans designated as IV will be the ones which are pretty certain not to be paid. Those loans designated as III will be the ones repayment of which is doubtful. Those loans designated as II will be the ones which for one reason or another are somewhat inferior in quality and are likely to become doubtful unless watched. Loans designated as I will not be listed in the report of examination at all, since they are not in any way subject to criticism from a credit standpoint. (As of the end of 1937 this classification for national banks included almost ninety per cent of their total loans.)

This change should meet the charge sometimes made that bankers are deterred from making sound loans with relatively long maturities for fear they will be classified as "Slow" by examiners.

(5) Banks try to purchase investment securities which will not go into default as to interest or principal and which can be sold prior to maturity if need arises. National banks and state member banks are limited in their purchases to marketable obligations which are not distinctly or predominantly speculative in character.

One of the changes made under the agreement just reached is a broadening of the definition of investment securities so that there will be greater latitude for banks to acquire sound securities issued by small local businesses, whether or not listed on a securities exchange, or rated as to quality by a rating agency, or registered with the SEC, or widely distributed to the public.
Another change made under the agreement just reached is to eliminate the requirement that the non-speculative character of a security must be supported by ratings of rating agencies.

(6) The bank examiner has to put a value on the assets of the bank if he is to determine whether the full value of the deposits is intact without resort to the capital to make good the difference, and determine how much of the capital must be transferred from the bank owners to depositors account. We have seen how he values the loans. What value shall he place on the securities? Is he to value them as of the market quotation on the day of examination, or on some average basis, or at par, or cost, or what?

Under the agreement just reached the market price of securities of investment grade will be disregarded completely and they will be valued as carried on the books of the bank—at cost, with premiums amortized. Bonds which are speculative in character or below bank investment grade will be valued at their average quotation over the eighteen months prior to the examination. Fifty per cent (rather than all) of any net depreciation in these speculative securities below book value will be transferred from capital account to depositors account.

(7) Bank examiners discourage speculation in securities. Securities should be bought by banks for investment.

To discourage speculation it has been agreed that there is to be stricter adherence to the principle that profits resulting from the sale of securities be devoted to offsetting losses and to building up adequate reserves, and not used for dividends, bonuses, and the like.
Press release on bank examination and the Comptroller's investment securities regulation issued on June 25th to be used in June 27th papers.
For Release to Morning Newspapers of Monday, June 27, 1938.
6/26/38.

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.

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.

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 penalised.
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 pro-
vided, 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 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 invest-
ment 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

(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 se-
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 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.

(b) 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 pro-
hibited 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.

Signed and promulgated this 27th day of June, 1938.

MARSHALL R. DIGGS
Acting Comptroller of the Currency
Attached is printed copy of Comptroller's Investment Securities Regulation.
INVESTMENT SECURITIES REGULATION

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 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, whether 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
The purchase for its own account of investment securities by a national bank is governed by paragraph Seventh of Section 513 of the Revised Statutes of the United States, as amended, which paragraph now reads as follows:

"Seventh. To exercise by its board of directors or any authorized officer or agent, subject to law, all such incidental powers as shall be necessary to carry on the business of banking by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidence of debt, by receiving deposits, by buying and selling exchange, notes, and bills; by issuing money or personal security; and by obtaining, issuing, and circulating notes according to the provisions of this title. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without reserve, solely upon the order and for the account of customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock. Provided, That the association may purchase for its own account investment securities under such limitations and restrictions as the recommendation of the Board of Governors may by regulation prescribe. In no event shall the total amount of the investment securities of any one bank or borrower, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 20 per centum of its unimpaired surplus fund, except that this limitation shall not apply to obligations in the form of bonds, notes, and/or debentures, commonly known as investment securities under such further definition of the term "investment security" shall mean stock obligations evidencing indebtedness of any person, partnership, association, or corporation in the form of bonds, notes, and/or debentures, commonly known as investment securities under such further definition of the term "investment security.""

Section 9 of the Federal Reserve Act, as amended, provides in part as follows:

"A state member bank shall be subject to the same limitations and restrictions with respect to the purchase, selling, underwriting, and holding of investment securities and stock as are applicable to the purchase of national banks under paragraph Seventh of Section 513 of the Revised Statutes, as amended."