

Minutes of actions taken by the Board of Governors of the Federal Reserve System on Thursday, August 2, 1951. The Board met in the Board Room at 10:30 a.m.

PRESENT: Mr. Szymczak, Chairman pro tem
Mr. Evans
Mr. Powell

Mr. Carpenter, Secretary
Mr. Vest, General Counsel

Mr. Evans said that informal advice had been received from the Bureau of the Budget that the President expected shortly to submit to the Congress a further statement with respect to the Defense Production Act Amendments of 1951, which became law on July 31, 1951, and that, if the Board felt that the limitations imposed by the legislation on the authority over consumer instalment credit were of sufficient importance to be commented on in such a statement, the Bureau of the Budget would like to have a draft of the material which the Board would like to have included in the statement.

Mr. Evans outlined the brief statement which he felt should be submitted and, after some discussion, it was approved unanimously as follows with the understanding that it would be sent to the Budget Bureau tomorrow:

"The extent to which excessive expansion of consumer credit adds to inflationary pressures is of genuine concern in a time of rapidly expanding defense expenditures. The

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"limitations on instalment credit terms written into the new legislation will badly cripple this means of curbing an inflationary expansion of such credit.

"I am compelled to re-emphasize the view expressed in my midyear economic report to the Congress of July 23."

Mr. Evans reported that Mr. Caldwell, Chairman of the Federal Reserve Bank of Kansas City, had telephoned to say that the Bank had been looking for an attorney to succeed Mr. Johns as Counsel, that a satisfactory man had been found but that he was a member of the Kansas City Board of Election Commissioners, that his term as such a member would not expire for approximately 1-1/2 years, and that Mr. Caldwell wanted to know whether it would be contrary to the policy of the Board with respect to officers and employees of Federal Reserve Banks holding political or public office if the attorney were permitted to complete his term while serving as Counsel for the Bank. Mr. Caldwell commented, Mr. Evans said, that the Board of Election Commissioners was nonpartisan, that in the past he (Mr. Caldwell) had served as a member, and that he saw no objection to the continuation of membership until the expiration of the current term.

In response to Mr. Evans' request, Mr. Vest reported that it appeared from the statutes of the State of Missouri that membership on the Kansas City Board of Election Commissioners carried a salary of \$3,000 per annum, that the Commission was composed of two Republicans and two Democrats, and that among the duties of the Commission were the selection of judges and clerks of election, furnishing digests of election

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laws, and the determination of election districts.

In the ensuing discussion, it was agreed unanimously that while the Commission might be conceived as a nonpartisan organization for the primary purpose of insuring honest elections, the duties of the Commission would make it difficult to disassociate, in the minds of the public, membership on the Commission from partisan political activity and that therefore Mr. Vest should discuss the matter with Mr. Leedy, President of the Federal Reserve Bank of Kansas City, and if the duties of the Commission were as Mr. Vest had outlined them, Mr. Leedy should be advised that the attorney should not be appointed as Counsel for the Federal Reserve Bank of Kansas City unless he resigned as a member of the Board of Election Commissioners before assuming the duties of the new position.

At this point Mr. Vest withdrew and the action stated with respect to each of the matters hereinafter referred to was taken by the Board:

Memoranda dated July 24, 1951, from Mr. Williams, Assistant Director, Division of Research and Statistics, recommending increases in the basic annual salaries of the following employees in that Division, effective August 5, 1951:

Name	Title	Salary Increase	
		From	To
Mrs. Bruna L. Watts	Draftsman	\$2,530	\$2,650
Mrs. Marjorie C. Capps	Clerk-Stenographer	2,530	2,650

Approved unanimously.

Memorandum dated July 30, 1951, from Mr. Sloan, Director, Division of Examinations, recommending:

- (1) That for a period of approximately one year beginning August 27, 1951, Mrs. Nancy R. Porter, currently

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- Supervisor of the Recording and Stenographic Section in the Division of Examinations, be appointed a Special Assistant Federal Reserve Examiner and transferred to the field staff of examiners, with official headquarters in Washington, D. C., with no change in her present basic salary at the rate of \$4,200 per annum, and with the understanding that at the expiration of the period of approximately one year, Mrs. Porter will return to her present position;
- (2) That for a period of approximately six months beginning August 27, 1951, Miss Frances Scott, currently Secretary to Mr. Sloan, Director, Division of Examinations, be appointed a Special Assistant Federal Reserve Examiner and transferred to the field staff of examiners, with official headquarters in Washington, D. C., with no change in her present basic salary at the rate of \$4,075 per annum, and with the understanding that at the expiration of the period of approximately six months, Miss Scott will return to her present position;
- (3) That Special Assistant Federal Reserve Examiners, during the time of their service with the Board's field staff of examiners, be allowed, in addition to per diem in lieu of subsistence, a special travel allowance of \$40.00 per calendar month;
- (4) That Special Assistant Federal Reserve Examiners traveling with the Board's field staff of examiners be permitted to use Pullman accommodations costing not more than the cost of roomettes.

By unanimous vote, Mrs. Nancy R. Porter was appointed a Special Assistant Federal Reserve Examiner to examine Federal Reserve Banks, for all purposes of the Federal Reserve Act and of all other Acts of Congress pertaining to examinations of such banks made by, for, or under the direction of the Board of Governors of the Federal Reserve System, and was designated as a Special Assistant Federal Reserve Examiner, for approximately one year beginning August 27, 1951, with official headquarters at Washington, D. C., and with basic salary at the rate of \$4,200 per annum.

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By unanimous vote, Miss Frances Scott was appointed a Special Assistant Federal Reserve Examiner to examine Federal Reserve Banks, for all purposes of the Federal Reserve Act and of all other Acts of Congress pertaining to examinations of such banks made by, for, or under the direction of the Board of Governors of the Federal Reserve System, and was designated as a Special Assistant Federal Reserve Examiner, for approximately six months beginning August 27, 1951, with official headquarters at Washington, D. C., and with basic salary at the rate of \$4,075 per annum.

Unanimous approval also was given to recommendations (3) and (4) in Mr. Sloan's memorandum of July 30, 1951.

Letter to the Presidents of all Federal Reserve Banks, reading as follows:

"In its confidential letter of May 4, 1951, the Board referred to the large defalcation in Syracuse, New York, and stated that it would be made the subject of further advice when details could be given. You will appreciate the fact that the contents of this letter also should be considered confidential.

"The matter was brought to the attention of the Board of Governors on the morning of April 10, 1951, by the F.B.I., which had been brought into the case by the officers of the bank on the previous evening. The Federal Reserve Bank of New York was advised immediately and the Reserve Bank, in turn, advised the State banking authorities. The Federal Deposit Insurance Corporation was also advised and took immediate action to provide depositor protection, if required, although it did not appear that any unusual action would be necessary. The State member bank involved had total resources and capital accounts, respectively, of approximately \$75,000,000 and \$4,500,000. Its surplus and undivided profits approximately equaled the gross amount of the apparent defalcation and it appeared that actual loss would be much less.

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"The Reserve Bank and the State banking authorities arranged to make a joint examination as of the close of business April 12, 1951. The report of that examination has been made available to the Board as well as other information which form the basis for this report. The nature of the irregularity and the amounts involved appear to have been determined. Actual loss is still subject to adjustment although it is believed to have been estimated with reasonable accuracy. It should be noted, however, that the two bookkeepers apparently involved have been indicted along with seventeen of the bank's customers and the trial procedure may produce further information or disclose the involvement of other individuals.

"As stated in the Board's previous letter, the story is fantastic. It is alleged that the bank's head bookkeeper, named Klock, and his assistant, named Root, withheld from posting to individual ledger accounts checks having a total face value of \$2,500,695 and juggled control figures to cover. No other officer or employee was found or is believed to be involved. The checks withheld affected more than 200 checking accounts and represented overdrafts in three accounts, among others, amounting to \$1,567,300, \$367,400 and \$50,700, respectively. It was the involvement of outside parties and the need for effecting recovery to best advantage from all sources that caused the withholding of information when the irregularity was first disclosed.

"Klock is reported to have given as his reason for withholding checks the burden of the work involved in returning checks, reporting and calling customers with respect to overdrafts, the correction of missorts, obtaining proper countersignature, etc., which had caused him to work overtime. His manipulations apparently began in 1947. Prior to 1947 he is reported to have spent a lot of time at the bank after hours cleaning up his work. His wife complained of his absence from home, accused him of infidelity and divorced him in 1944 or 1945. Sometime thereafter he remarried and, when his work at the bank again became heavy, he started withholding checks to avoid working overtime and to prevent trouble at home. No other explanation was given and he stoutly maintained that he received no payment from outside parties. It is noted, however, that the newspaper account of the indictment of the party having the largest overdraft states that he was accused of paying 'various sums' of money to Klock and Root at 'various times' in 1948, 1949, and 1950.

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"Root, who covered the condition when Klock was on vacation or away from the bank for any reason was a close friend of Klock and this friendship is the only explanation of his involvement. He, also, denied any pecuniary consideration.

"The situation was brought to light by a certified public accountant who audited the books of a customer and called the attention of an officer of the bank to the fact that two payroll checks of the customer, amounting to about \$2,000 each and issued on different dates, had not been charged to the customer's account until 24 days after the date on which it was cashed in one instance and 66 days after in the other. While seeking to unravel this mystery, checks amounting to about \$22,000 were found in Klock's desk. Under questioning and pressure Klock finally produced checks having a face value of \$2,398,864, most of which he had stored away at his home.

"Some of the checks recovered appeared to have been withheld merely because of missorts or lack of proper countersignatures or similar reasons and were subject to charge to individual accounts having available balances. The following is a statement of the condition found:

Total ledger difference		\$2,500,695
Amount for which no checks have been located to cover		<u>101,831</u>
Checks found		<u>\$2,398,864</u>
Less checks paid		
In full (152 customers)	\$203,261	
In part (10 customers)	<u>136,100</u>	<u>339,361</u>
Checks representing overdrafts		\$2,059,503

The overdrafts were as follows:

Interests of a local real estate operator		\$1,567,322
An appliance and radio dealer		367,385
A restaurant		50,742
A dry cleaning and dyeing establishment		8,329
Sundry customers:		
33 accounts considered collectible	\$ 31,671	
74 accounts - loss conceded	<u>34,054</u>	<u>65,725</u>
		<u>\$2,059,503</u>

"The bank was able to obtain control of the properties of the real estate operator involved and, largely from this source,

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"has effected substantial actual recoveries. Based upon apparently assured further recoveries and conservative valuations it is estimated that the net loss to the bank may amount to less than \$200,000 after applying \$650,000 surety coverage. The bank has excess valuation reserves to cover and capital accounts will not be disturbed.

"It appears that the totals involved had been greatly increased since the bank had been last examined on May 17, 1950. Investigation by the examiners revealed the fact that the difference had been concealed at that time by debits to two large and active accounts, one in the amount of \$722,629 and the other in the amount of \$359,214, a total of \$1,081,843. The dollar amount of these debits, which were offset by blind postings a few days later, were not unusual in the accounts involved. Daily entries in each account were frequently as high as \$1,000,000 and perusal of the ledger sheets would not have aroused suspicion. It was possible for the concealing entries to be made because of the semi-delayed posting system used in the bank and it is assumed that the same method of concealment had been used at previous examinations.

"The fact that the audit procedure in the bank was ineffective is quite apparent. In the course of the examination it was developed that the so-called commercial ledger had not been proved to its control by the auditor for over six years. It had been the practice of the auditor to prove a particular ledger to its control in the bookkeeping department occasionally but he did not prove the controls to the general ledger. Various needed improvements in audit procedure and control had been discussed with the management in previous years and the examiners were assured that the necessary improvements had been effected. It appears that the auditor failed to effect the procedure which the officers believed to be in operation.

"This case emphasizes the difficulties for examiners inherent in the system of delayed and semi-delayed posting of individual ledgers which, as you know, has been sanctioned by legislative action in 39 States and recognized in the Board's Regulation J. When examiners enter a bank to find a portion of the items to be posted to the individual ledgers unposted, almost insurmountable difficulty is encountered in placing such ledgers under effective control. The major problems should be obvious and will not be outlined in detail. While procedures may be followed which would approach complete

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"control in some instances, it is doubtful that absolute control could be effected in any instance by examiners.

"In the case under consideration, the bank maintained 85 individual commercial and savings ledgers and the examination was started with 34 men who had to establish and maintain control of cash, securities, etc., as well as such control of individual ledgers and other records as was practicable. To have established reasonably effective control of individual ledgers operating under the semi-delayed posting plan would have required at least two or, perhaps, three times the number of examiners. Another practical consideration in such circumstances is the effect upon the internal operations of the bank under examination. If examiners were available to apply the procedures necessary to effect reasonably satisfactory control the functioning of the bookkeeping department would be seriously delayed.

"In the numerous cases, such as the one under consideration, where the examiner in charge is unable to establish an effective control of individual ledgers or other records, it would appear to be incumbent upon him to investigate carefully the scope and effectiveness of the audit program in the bank and to satisfy himself that an adequate program is scheduled and, through examination of workpapers, reports, etc., that such program is actually and efficiently maintained. In fact, it is felt that appraisal of the adequacy and effectiveness of the system of audit and internal controls is one of the most important matters for consideration by the examiner. The procedure for determining the adequacy of audit and controls and for determining the actual and proper functioning of the programs ostensibly in effect, as well as securing improvement and correction where needed, is the most pressing current problem for study by the supervisory authorities.

"Copies of this letter are being forwarded to the Officers in Charge of Examinations at each Federal Reserve Bank."

Approved unanimously.

Memorandum dated July 30, 1951, from Mr. Chase, Assistant Solicitor, recommending that the Board's file in the case of Gould Investment Company, Beverly Hills, California, a registrant under Regulation W, Consumer Credit, be closed, inasmuch as Mr. Murray Goldman, sole owner

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of the Company, allowed investigators for the Federal Reserve Bank of San Francisco to inspect his books after a subpoena was served upon him in accordance with the Board's order of May 8, 1951.

Approved unanimously.

Telegram to the Presidents of all Federal Reserve Banks and officers in charge of Federal Reserve Bank branches, reading as follows:

"Certain Reserve Banks have asked what changes, if any, need to be made in the wording of the identification certificates for investigators under Regulations W and X by reason of extension of the Defense Production Act. We see no necessity for any change but suggest that if and when you reprint the identification certificate you add the phrase 'as amended' after 'Defense Production Act of 1950'."

Approved unanimously.

Letter to the Honorable Alexander Wiley, United States Senate, Washington, D. C., reading as follows:

"This acknowledges your letter of July 11, 1951, to Mr. Guy E. Noyes, Director of the Division of Selective Credit Regulation, which was accompanied by nine telegraphic protests about Regulation X, Real Estate Credit. The nine telegrams, filed at Madison, Wisconsin, on July 10 around 6 p.m., were sent by the following:

E.B.A. Sokoloski
2017 South Park Street
Madison, Wisconsin

E. O. Dahl
3721 John Street
Madison, Wisconsin

Jim Imhoff
2133 Oakridge Avenue
Madison, Wisconsin

Grant Kittle
708 Brittingham Place
Madison, Wisconsin

Harold Bewick
101 Vandusen Street
Madison, Wisconsin

Ivan Gregory
3301 Harvey
Madison, Wisconsin

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"B.F. Killian
Schroeder Road
Madison, Wisconsin

Tom McGovern
Route 4
Madison, Wisconsin

C.J. Goucher
3300 Monona Drive
Madison, Wisconsin

"In view of the fact that all of the telegrams are generally of the same tenor, a uniform response to each would seem to provide the most satisfactory form of reply. Copies are enclosed for each of your correspondents.

"Regulation X was issued under the authority of the Defense Production Act of 1950 and Executive Order No. 10161, and is designed to conserve materials and labor for the defense effort and to restrain inflationary forces. In considering the terms prescribed by the regulation and the accompanying restrictions of the Federal Housing Administration and the Veterans Administration, the Board and the other Governmental agencies concerned took great pains to establish requirements which would be as equitable as possible in their effect on the various income groups. As a result, we established, after prolonged study, down-payment requirements which start at 10 per cent for houses valued at \$5,000 or less (Veterans can buy a \$6,000 house with a down payment of only 4.2 per cent) and increase gradually to 50 per cent for houses valued at more than \$24,250. The regulation, therefore, is proportionately much more restrictive, as we think you will agree it should be, on those persons buying more expensive residences. If, however, the regulation is to be effective it must be restrictive to some extent with respect to all classes of persons; hence, some persons may be obliged to defer the purchase of a new house until they have accumulated greater savings, or perhaps buy an older or lower-priced house. The Board, however, is deeply concerned that the impact of the regulation be as equitable as possible, and stands ready to make whatever adjustments may be necessary to achieve this end.

"The Board has also consistently stated that the terms of the regulation will be modified if it is demonstrated that they are too restrictive. When Regulation X was issued, the several governmental agencies responsible for curtailment of real estate credit estimated that a volume of 850,000 housing starts for 1951 would be consistent with the objectives of the

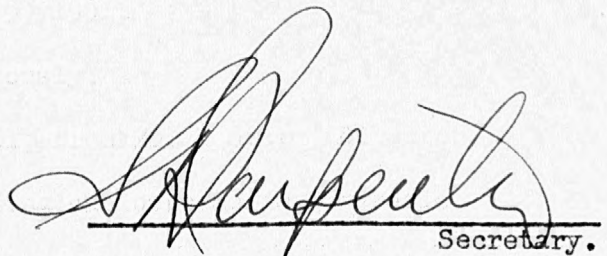
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"enabling legislation. This represented a 40 per cent reduction under the real estate boom year of 1950, but still compared favorably with other years since the war. Already more than 600,000 housing starts have been made in 1951 and, with nearly six months of the year still ahead, there is a reasonable presumption that the 850,000 goal may not only be reached, but may be exceeded. We would like to see the building industry produce as many houses in all price classes as would be consistent with the defense effort and non-inflationary prices. However, the Federal expenditures for defense and related activities are expected to rise precipitously and may account for as much as 20 per cent of total national output within a year. If renewed inflationary trends are to be controlled, therefore, public policy will need to limit private spending, especially such spending as is financed by borrowing. During the first four months of 1951 nonfarm mortgage recordings of \$20,000 or less totaled \$5,254,000,000, an increase of 19 per cent over 1950. Until the needs of the defense program have been taken care of and the dangers of further inflation have moderated, a general liberalization of real estate credit regulations would not seem to be desirable.

"Despite all these considerations, we wish to assure you that we believe the regulation should be as equitable as possible to all persons, and we are glad to give consideration to any proper means to accomplish this purpose. If we can provide you with further information, we will be glad to do so. The copies of the telegrams you sent us are returned herewith."

Approved unanimously.


Secretary.