

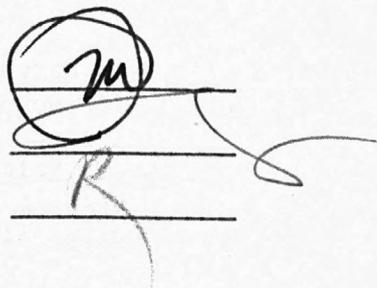
The attached minutes of the meeting of the Board of Governors of the Federal Reserve System on March 25, 1963, which you have previously initialed, have been amended at the request of Governor Shepardson to revise the last two sentences in the first paragraph on page 14.

If you approve these minutes as amended, please initial below.

Chairman Martin

Governor Mills

Governor Robertson



Handwritten initials 'M' and 'R' on lines. The 'M' is circled and the 'R' is written below it.

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Minutes for March 25, 1963

To: Members of the Board

From: Office of the Secretary

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

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

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

Chm. Martin	<u>M</u>
Gov. Mills	<u>[Signature]</u>
Gov. Robertson	<u>R</u>
Gov. Balderston	<u>CCB</u>
Gov. Shepardson	<u>[Signature]</u>
Gov. King	<u>[Signature]</u>
Gov. Mitchell	<u>[Signature]</u>

Minutes of the Board of Governors of the Federal Reserve System on Monday, March 25, 1963. The Board met in the Board Room at 10:00 a.m.

PRESENT: Mr. Martin, Chairman  
Mr. Balderston, Vice Chairman  
Mr. Mills  
Mr. Robertson  
Mr. Shepardson  
Mr. Mitchell

Mr. Sherman, Secretary  
Mr. Kenyon, Assistant Secretary  
Mr. Young, Adviser to the Board and Director,  
Division of International Finance  
Mr. Molony, Assistant to the Board  
Mr. Fauver, Assistant to the Board  
Mr. Spencer, General Assistant, Office of  
the Secretary

Messrs. Noyes, Koch, Brill, Garfield, Holland,  
Williams, Dembitz, Solomon, Eckert, Fisher,  
Gehman, Partee, Weiner, Wernick, and Yager  
of the Division of Research and Statistics

Messrs. Furth, Hersey, Sammons, Katz, Gekker,  
Irvine, Maroni, and Reynolds of the Division  
of International Finance

Economic review. The Divisions of International Finance and Research and Statistics presented information relating to recent international and domestic financial and business developments, and made further comments in response to questions asked by members of the Board.

All members of the staff except Messrs. Sherman and Kenyon then withdrew and the following entered the room:

Mr. Hackley, General Counsel  
Mr. Kelleher, Director, Division  
of Administrative Services  
Mr. Young, Senior Attorney, Legal Division

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Proposed annex building. Governor Shepardson presented for consideration a question that had arisen in connection with the plans currently being prepared for a possible annex building that would be located across C Street from the Board's present building. This question involved the number of parking spaces that it would be possible to provide under alternative assumptions. Alternatives, as described by Governor Shepardson, included utilization of the area presently owned by the Board, exploration of the possibility of purchasing from the National Park Service a piece of land contiguous to the Board's property, or negotiation for extension of underground garage facilities below some part of the land owned by the Park Service.

Following a general discussion, agreement was expressed with the suggestion of Governor Shepardson that the preferable course would be to negotiate with the National Park Service with a view to extending the garage facilities of the annex building under a portion of the land owned by the Park Service. It was also agreed that the architectural firm preparing plans for the annex building should be urged to give consideration to providing access to the garage facilities from more than one street.

All of the members of the staff except Mr. Sherman then withdrew from the room.

Supervision and examination of Federal Reserve Banks. Chairman Martin referred to the discussions on March 20 and 22 of Governor Robertson's December 4, 1962, memorandum regarding the procedures followed

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in the examination of Federal Reserve Banks, stating that he felt that these discussions had been helpful to all concerned. He then called upon Governor Robertson for his comments in the light of these discussions and the various memoranda prepared.

Governor Robertson stated that at the outset he would emphasize that there was no significant difference between the purpose of his proposal, as presented in his memorandum of December 4, and the purpose of the present examination procedures. He then read the Board's directive to the Division of Examinations dated May 3, 1951, respecting examinations of the Federal Reserve Banks, as well as the standards for such examinations as set forth on page 10 of the memorandum from the Division of Examinations dated February 5, 1963, commenting on his proposal of December 4. Governor Robertson went on to say that these standards were identical with the standards that should be applied under the procedure that he proposed, if the Board were to adopt that proposal. The only question was how to go about revising examination procedures in order to produce the most effective results. In presenting his suggestion of last December, he had no intention of disparaging the present examinations staff. The "heat" that had been evident in the discussions of his proposal by some members of the staff was not objectionable but on the contrary was a good sign: it indicated that each member of the staff was intent on doing his best with a view to bringing about the best possible examination procedure.

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Governor Robertson noted that different divisions at the Board had responsibilities in connection with the Board's supervision of the Federal Reserve Banks, particularly the Division of Examinations, the Division of Bank Operations, and the Division of Personnel Administration. In his view the Board should insist that the functions of the several divisions having to do with supervising the Federal Reserve Banks be coordinated and existing procedures modernized, even though there was a more or less natural reluctance on the part of the staff to get out of ruts, to change the status quo. As to the present field examining force, Governor Robertson felt that only a few members were sufficiently experienced and qualified to fit into the kind of program envisioned in his December memorandum. Of those few, some had in the past indicated the desirability of moving in the direction that he suggested, but they had not found suggestions for changes in the procedures acceptable to those in charge. It also was noted that several of the men who were nearing retirement were not sufficiently flexible to be included in a force such as he had proposed. If, as alleged by representatives of the Division of Examinations, the field force contained some men who were not adaptable to the new procedures, they should not be continued in an expensive travel status but should be dismissed or placed in other positions where their services could be efficiently utilized.

Governor Robertson stated that it seemed to him the Division of Examinations was not entirely opposed to the kind of examination procedures

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that he had suggested in his December 4 memorandum. Actually, the Division had been moving in this direction during the past few years, doing more sampling and reviewing, and less verifying in the course of the examinations. In his opinion, it had been moving too slowly and the Board should press for more rapid shifts in emphasis. Nevertheless, to him it was encouraging that there had been a movement in this direction with an increased utilization of internal audit departments of the Reserve Banks and an increased opportunity for the Board's examining force to do relatively more in the way of review and analysis.

The statement had been made in the course of discussion that six men staying in Washington could not know sufficiently well what was going on in the Reserve Banks to give the Board the kind of examination that was needed. Governor Robertson felt that this was based on an erroneous premise, since the examiners would not be in Washington all the time. They would actually visit Banks frequently and check on procedures, techniques, and activities to facilitate verification of records and accounts, existence of assets, and adequacy of security controls. The proposed procedure would actually enhance the surprise element of examination. He felt that a small force of top-flight men was more likely to achieve true surprise visits or examinations than a large force such as that now used. One of the risks in the present examination procedure, Governor Robertson said, was that outside verification had come to be thought of as the prime purpose of examination. That had been true 50 years ago and as recently as 20 years ago. But the

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general procedure that he had suggested, which admittedly differed from examination procedures used from 20 to 50 years ago, was now being applied by the larger commercial banks, which had developed good internal auditing systems on which their managements placed great reliance. In his opinion, the Federal Reserve Banks had made a great deal of progress in developing better internal audit systems in the past five years, and this made possible the efficient use of a sampling technique if the procedures and guidelines were appropriately devised.

Turning to the functions of the Divisions of Bank Operations and Personnel, Governor Robertson said that representatives of those divisions did not wish to have the examining force delving into matters in their areas of responsibility. In his view, the functions of all of the divisions of the Board should be coordinated to the end that the Board would be provided with the information that it needed regarding management of the Reserve Banks, the efficiency of their operations, personnel, and all the rest. He felt that this coordination would be facilitated if the examining force were composed of higher calibre men. As he saw it, the need was to utilize the three divisions--Examinations, Bank Operations, and Personnel--in a more efficient manner.

As to staff, Governor Robertson expressed the view that 6 men of the type he had indicated could provide the Board with more in the way of information on the Reserve Banks and what was going on in them than the Board was now getting. The report of Haskins & Sells on page 5 expressed views entirely consistent with those in his December 4

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memorandum, but that firm questioned whether 6 men could do the job. His reply would be that if 6 was not a sufficient number, then make it 12 or whatever was needed. There would have to be experimentation, but this was not the important point. The important point was to get better procedures than had existed, and in his opinion a relatively small number of men with the right qualifications could produce better results than had been produced in the past, and the Board would be put in a better position to exercise its responsibilities for general supervision of the Federal Reserve Banks as well as to meet any questions or criticisms that might be raised in the Congress or elsewhere.

The firm of Arthur Andersen was opposed to his proposal, thinking verification was of almost sole importance. Governor Robertson said that verification was needed, but this could be gotten through the internal audits supplemented by intensive, frequent, and properly devised sampling techniques. There was no question but that the firm of Price Waterhouse & Co. believed that the procedure he proposed was feasible. He himself was confident that it was feasible; similar procedures were being used successfully in larger commercial banking institutions by supervisory authorities. Whether or not a system such as he contemplated would work in the Federal Reserve would depend entirely on the quality of persons responsible for it and their willingness to make it work. It would be very difficult to put it into effect unless the personnel were in wholehearted sympathy with the plans, for that kind of support for the proposal was important to its success. If

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such a proposal were adopted by the Board, recruitment of the right personnel would be a most important step. One of the purposes of his suggestion was to assist in the recruitment of persons of the right type for the examination force. At the present time, men of the calibre needed were not interested in jobs that required that they be on the road in a continuous travel status. Under his proposal, where travel might be reduced to a month or two per person during the year, the recruitment problem would be greatly assisted.

Governor Robertson concluded his comments with a statement that he did not doubt but that the staff, if given an instruction from the Board, would endeavor to bring about a change in procedures moving in whatever direction was indicated. A great deal had already been accomplished, and the memoranda and the discussions that had resulted from his proposal had in his judgment been most helpful in bringing about thoughtful analysis of the procedures now being followed. If the Board could decide what it wanted and tell the staff of the procedures to be followed, he had no doubt but that a shift in the direction of the procedures could be made in a manner that would yield better results than the present examination procedures were giving.

Chairman Martin said that he started by wholeheartedly concurring with the last point that Governor Robertson had made, that is, that all of the members of the Board had benefited enormously from the review of examination procedures. He also thought that the staff had benefited especially from the entire review. He happened to agree

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with the broad approach suggested in Governor Robertson's memorandum. His reservations on this broad approach were mainly a matter of timing and when it might be achieved. After commenting on reasons why at the present time he believed that the Board and the System must continue to have certain aspects of the examination procedures that included detailed verification by members of the Board's staff, he stated that he felt that all of the members of the Board should consider the matter with an open mind. Verification was a part of the present procedure, he noted, and while this could be scrapped today or tomorrow, for the reasons he had indicated he did not believe this was the time to make any material change in this area. He agreed with Governor Robertson's appraisal of the examination staff. His feeling was that the Board should be pressing the Director of the Division of Examinations and his people to move in the direction indicated by Governor Robertson. Any major shift should not come at once, although he believed that in time the Board would wish to come to such an arrangement.

Governor Robertson suggested that one way in which the Board might start to move in the direction suggested was to tell the staff that it would like to move in that general direction and request the staff to start recruiting for one or two of the top positions with persons who would be competent to do the job that was outlined. In the meantime, they would be working with the staff that they presently had.

Governor Mills stated that this was an immensely important topic. Leaving aside the human equation of the personnel problems that

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lay at the heart of it and supporting the idea for improving the staff, he personally believed that the procedure now being followed was appropriate to the statutory responsibilities of the Board and to the established and conventional examination field. This was brought out in both the Arthur Andersen and Haskins & Sells critiques. He thought that the views presented by these two firms were correct. If anything, he believed that the Board may have gone too far already in cutting down on the scope of examination and verification. A legal opinion had come out of the staff, but if the Board was required by law to make an examination of the Reserve Banks, he felt that the Board would be derelict in its duty if it altered the present procedures more than in a modest way.

Chairman Martin commented that as he saw it what the Board was striving for was greater efficiency.

Governor Mills responded that efficiency did not come out of laxity. For the Board to place its hopes in the Reserve Bank auditors exclusively did not seem to him to meet the statutory responsibilities of the Board. The Board should go beyond an observation of the procedures followed at the Reserve Banks, if it was to make fully effective examinations of the type that Congress had a right to expect.

Governor Shepardson said that it seemed to him there had been significant developments in sampling procedures over the years that were widely accepted not only in the research field but also in inspection. This was true in quality inspections, in law enforcement,

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and in other areas. It was his impression that probably the weakness in the steps taken so far in the examination process arose from the fact that there had not been enough professional guidance in developing the sampling approach. He had thought that the Board was going to get some of this type of guidance from Price Waterhouse & Co. in its assignment to that firm in connection with observing examination procedures during the past year, but the fact is they did not contribute in this respect. The Board had already made in connection with those surveys a tentative decision to move in the direction of greater use of sampling procedures, Governor Shepardson commented, but it seemed to him there had been some dragging of feet in putting these procedures into use. When Price Waterhouse & Co. did not come up with the help that had been anticipated, that caused a further delay in putting some of the improved procedures into effect. Governor Shepardson went on to say that he thought the Board could combine sampling processes with the independent examination procedures. He agreed with Governor Mills that the Board should have an independent examination procedure. He did not think the Board could or should depend to a high degree on the audit staff of the Reserve Banks for its examinations. After all, the auditors under the existing setup live with the people in the Reserve Banks from day to day, and there was much to be said for examinations by independent outside personnel. There had to be some verification, but he was convinced that a proper sampling approach could be worked out that could do away with a good deal of waste motion that he felt now took place.

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From the standpoint of personnel, he thought it true that the Board did not now have the quality of persons on the field force that it should have. There was no resistance to upgrading of persons if they had the potential, but the field force simply had not had a sufficient number of the type of persons needed. In his opinion, the Division of Examinations must be pressed to obtain more persons of that type. His own feeling was that the Board should indicate a decision that it wished to move aggressively and with more than gradual speed into modernization of the examination approach. He did not think there should be a sudden turnover, but at the same time there should be a definite move toward more modernization.

Governor Mitchell said that he felt that the last point made by Governor Shepardson was very important. He did not think anything dramatic was going to happen, but personally he believed that something should develop. During the relatively short period he had been a member of the Board, he had criticized the examination reports and felt that some changes should be made. As nearly as he had been able to determine from the information furnished, it appeared that from 20 to 25 per cent of the time on an examination went into verification of the holdings of cash and securities. Even with the use of all modern techniques, he did not think that this could be slimmed down very much. He felt that the examination ought to have some of the direct verification in it. In fact, he was afraid that they may have gone too far in the direction of reducing verification rather than not far enough. On the

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other hand, he doubted that the cutting down of verification had been as competently handled as could have been the case if the best sampling techniques had been used. There should be an appropriate verification of various records at the Banks, such as expense account records, but to him the problem was one of balancing verification work with what was really needed in different areas. Governor Mitchell also noted that two Board divisions were largely concerned with operations at the Reserve Banks, the Division of Bank Operations and the Personnel Division. He felt that personnel in those divisions were better equipped to deal with problems in their respective areas than were the members of the examination force. He could see no need for inclusion in the examination reports of detailed summaries of matters in these areas. The Board should be doing what it could to help improve Bank management procedures. His conclusion was that time was of some importance in cutting back on the work done by the examination force in the areas of bank management and personnel. He would not move as slowly as some of the comments indicated. In addition, he would look carefully into the verification techniques to determine whether the examination procedures had already gone too far in slimming down verification in certain areas. The Board should see to it that it was using its examination force in the most modern and effective way. If it attacked the problem in this manner, he believed that it would be moving toward the objective that Governor Robertson had suggested.

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Governor Shepardson referred to Governor Mitchell's comments on the content of examination reports, stating that he had had the feeling that the inclusion in the memoranda or some of the material circulated with examination reports relating to personnel was superfluous. With respect to his comments on the function of the Division of Bank Operations, Governor Shepardson thought that it would be inappropriate to tell the examiner that, even though he observed something in a Reserve Bank that was unsatisfactory from the standpoint of bank management, he should do nothing about it. His view was that the examiner should report his findings through proper channels to the appropriate division at the Board.

Governor Balderston said that his ideas were similar to some of those expressed by Governor Mitchell as far as personnel matters were concerned and to those expressed by Governor Shepardson as far as operations were concerned. He distinguished between the "inspector general" and the work of the Division of Bank Operations. The approach of the two was quite different. There needed to be coordination of these functions at the top, but he was apprehensive that the man who served as the "inspector general" not be the one to put into effect changes in procedures that were the concern of the operating management. Generally speaking, he was sympathetic with most of the things that had been said this morning. He did not think that the Board should scrap everything it had. On that he agreed with Governor Mills. He would take the examiner out of the work he was doing that was not necessary.

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As to how to proceed on Reserve Bank operations, his feelings were much like those of Governor Shepardson. He would let the examiner report whatever he observed, but he did not believe that the examiner was the man to do the fixing that might be called for in the Reserve Bank.

Governor Shepardson referred to Governor Mitchell's comment that the Board may already have gone too far in sampling techniques. Perhaps this was true. His point was that he was not convinced that the sampling techniques that had been used had been devised by persons with sufficient knowledge of sampling procedures.

Governor Mills said that he sensed from the discussion that he was much less willing to streamline the Board's examination procedures than were other members of the Board. If streamlining of the sort discussed should at any point reach a degree where he felt that the examination procedures did not meet the Board's responsibilities, he would feel bound to bring this to the Board's attention and also would feel that it was his responsibility to call such views to the attention of the Congress.

Chairman Martin stated that there should be no misunderstanding of this morning's discussion. The Board had not decided to change anything other than to move in the direction of greater efficiency in its examination operations.

Governor Mitchell said that he personally wished that the Board had made a decision to make some changes, although he had indicated earlier that he did not think that was the case.

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Governor Shepardson inquired whether something might be done to straighten out the relationships between the different divisions of the Board along the lines discussed.

Chairman Martin responded that he did not think that seven members of the Board could do this. He felt that this was something that would have to be worked out with the staff.

Governor Robertson stated that he wished to comment on the points that Governors Shepardson and Mitchell had made as to completely disassociating the work of the Examinations Division from the functions of the Division of Bank Operations and the Division of Personnel. His concept was that the examiner should get the information just as he had endeavored to do in the past. However, having gotten it, he would not have the examiner discuss matters of this nature with the management of the Reserve Banks. But the examiner should be in a position to give information that might be gathered to the Divisions of Bank Operations and Personnel, which would then give the Board a report on the matters observed by the examiners.

Governors Shepardson and Mitchell commented that this was probably a matter of semantics: that so far as they could see there was no real difference in the views that they had expressed from those just given by Governor Robertson.

Governor Shepardson then inquired whether in moving in the direction indicated by the discussion responsibility fell within his area as the Board member having the responsibility for matters of an

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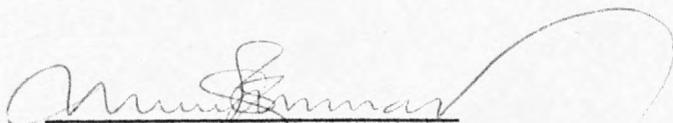
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internal management nature, to which Chairman Martin gave the response that he thought they did fall in that area. Governor Shepardson went on to inquire whether the Board would wish to have him discuss with the three divisions--Examinations, Bank Operations, and Personnel--an approach along the lines indicated, and no member of the Board indicated disagreement with such a procedure.

Governor Shepardson then referred to the letter from Price Waterhouse & Co. dated February 13, 1963, that had been circulated to the members of the Board in which Price Waterhouse & Co. had asked that there be an indication from the Board as to whether the firm had completed its assignment in connection with the observation of examination procedures and techniques during 1962. He wondered whether the Board had any views as to the kind of acknowledgment, if any, that might be sent to Price Waterhouse & Co.

Governor Mills and Chairman Martin indicated that if anything was sent it be merely an acknowledgment.

The meeting then adjourned.

  
Secretary