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Minutes for November 4, 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 _____

Gov. Mills _____

Gov. Robertson _____

Gov. Balderston _____

Gov. Shepardson _____

Gov. Mitchell _____

Minutes of the Board of Governors of the Federal Reserve System on Monday, November 4, 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. Cardon, Legislative Counsel
Mr. Fauver, Assistant to the Board
Mr. Hackley, General Counsel
Mr. Farrell, Director, Division of Bank Operations
Mr. Solomon, Director, Division of Examinations
Mr. Johnson, Director, Division of Personnel Administration
Mr. Hexter, Assistant General Counsel
Mr. Sammons, Adviser, Division of International Finance
Mr. Conkling, Assistant Director, Division of Bank Operations
Mr. Daniels, Assistant Director, Division of Bank Operations
Mr. Kiley, Assistant Director, Division of Bank Operations
Mr. Smith, Assistant Director, Division of Examinations
Mr. Leavitt, Assistant Director, Division of Examinations
Mr. Sprecher, Assistant Director, Division of Personnel Administration
Mr. Mattras, General Assistant, Office of the Secretary
Mr. Veenstra, Chief, Call Report Section, Division of Bank Operations

Circulated items. The following items, copies of which are attached to these minutes under the respective item numbers indicated, were approved unanimously:

| | Item No. |
|---|---|
| Telegram to the Federal Reserve Bank of Cleveland (1) interposing no objection to the Bank proceeding with the renovation of the food serving facilities and with alterations to the security court entrance, and (2) authorizing expenditures for these projects. | 1 |
| Letter to the Federal Deposit Insurance Corporation regarding the application of Scribner Bank, Scribner, Nebraska, for continuation of deposit insurance after withdrawal from membership in the Federal Reserve System. | 2 |
| Letter to United California Bank, Los Angeles, California, approving the establishment of a branch in the community of Rancho Bernardo, San Diego. | 3 |

Window dressing (Items 4 and 5). Pursuant to the understanding reached at the meeting on October 25, 1963, there had been distributed drafts of letters to the Presidents of the Federal Reserve Banks, the Office of Comptroller of the Currency, and Director Wolcott of the Federal Deposit Insurance Corporation with respect to the practice of window dressing.

The draft letter to the Reserve Banks would request each Bank President, in cooperation with the appropriate Supervising Examiner of the Corporation, to arrange meetings with the principal officers of State and national banks in the District for the purpose of attempting to dissuade them from such activity.

The proposed letter to the Office of the Comptroller of the Currency would note the doubt expressed by the Office as to the effectiveness of the program to reduce window dressing outlined in the Board's

letter of October 7, 1963, but would advise that the Board nevertheless contemplated going ahead and asking the Reserve Banks, in cooperation with representatives of the Federal Deposit Insurance Corporation, to explore with the banking community ways and means of reducing the practice. The proposed letter would also note with interest the current view of the Comptroller that banks, in addition to being required to submit call reports on a surprise basis in the form of averages or figures for selected random dates, also be required to report on two fixed call dates each year, namely, the last business days of June and December. The letter would point out that the Board had been sympathetic to such a procedure.

The draft letter to the Federal Deposit Insurance Corporation would express appreciation for its willingness to have its Supervising Examiners join the Reserve Banks in the suggested meetings with commercial banks concerning the practice of window dressing. It would also advise that although the Comptroller had expressed doubt with regard to the effectiveness of the suggested approach, the Board planned to go forward with its request to the Reserve Banks, assuming the Corporation was willing to proceed without the participation of the Comptroller's Office.

During discussion, it was agreed that the draft letter to the Comptroller should be revised to exclude a sentence which noted that while the call report measures proposed by the Comptroller's Office might be useful in reducing window dressing of official statements, the window dressing practice was also in evidence in voluntary statements presented

to the public; and that therefore the broader approach outlined by the Board appeared desirable.

The Board then approved unanimously the proposed letters to the Comptroller's Office and the Federal Deposit Insurance Corporation. It was agreed, at the suggestion of Governor Robertson, that the proposed letter to the Federal Reserve Banks not be sent until a reply was received from the Corporation regarding its willingness to proceed without the participation of the Office of the Comptroller. Copies of the letters sent to the Comptroller's Office and the Corporation are attached to these minutes as Items 4 and 5.

Audit function at Reserve Banks (Items 6 and 7). Pursuant to the understanding at the meeting on March 27, 1963, there had been distributed a draft of letter to the Chairmen of all Federal Reserve Banks expressing the Board's views on the appropriate procedure for processing personnel actions affecting the audit staffs of the Reserve Banks. In addition, there had been distributed a draft of letter to the Presidents of all Reserve Banks that would transmit a copy of the letter to the Chairmen. Both the Chairmen and Presidents would be invited to submit any comments that they might wish to offer.

The proposed letters to the Chairmen and Presidents of the Reserve Banks were approved unanimously. Copies are attached to these minutes as Items 6 and 7.

Messrs. Johnson and Sprecher then withdrew from the meeting.

Gold certificate reserve requirements (Item No. 8). There had been distributed a draft of letter to Chairman Douglas of the Joint Economic Committee in reply to a request for certain information regarding the gold certificate reserve requirements, with particular attention to action that the Federal Reserve might take if the reserves should fall below the amounts required by law.

In discussion, Governor Mills stated that he thought the draft letter was an excellent reply, but he felt that one portion (which attempted to summarize the arguments for and against keeping the gold reserve requirement) did not adequately reflect the views of those who regarded the requirement as a valuable brake to prevent the Government from adopting ill-considered financial practices that were not in the public interest. The sentence to which he objected particularly stated that the question was largely a matter of symbols rather than substance, and he proposed its elimination, with some alteration of the succeeding sentence.

Governor Mitchell also felt that the draft letter was well written and added that, in his view, the question of maintaining the gold reserve requirement was indeed a psychological problem rather than a substantive issue. Therefore, he was not inclined to accept the suggestions that had been made.

During further discussion, it was noted that the pro and con presentation in the draft letter was quite generalized. There was a suggestion that it could be eliminated from the letter without materially affecting the completeness of the reply. The paragraph in question would

then simply state that it seemed doubtful whether anything could be added to the testimony that the Congress had already received on the question of keeping the gold reserve requirement in the law.

The Board then approved the proposed letter with the understanding that it would be revised to exclude the portion that had been the subject of discussion. A copy of the letter, as sent, is attached to these minutes as Item No. 8.

All members of the staff then withdrew except Messrs. Sherman, Kenyon, Solomon, and Hexter, and Messrs. Noyes, Director, Brill, Adviser, and Partee, Chief, Capital Markets Section, Division of Research and Statistics, entered the room.

Margin requirements. There had been distributed to the members of the Board copies of a memorandum dated November 1, 1963, from Mr. Partee and Mrs. Ulrey, Economist in the Division of Research and Statistics, concerning stock market credit and margin requirements.

The memorandum pointed out that the rise in stock market prices in the latter half of October had put the indexes well above the previous highs reached toward the end of 1961 and again in September of this year. At Tuesday's close, the Standard and Poor's index of 500 stocks was 3 per cent higher than in December 1961 and 40 per cent above the lows reached in June 1962. Credit data were available only through September, when the total of customers' net debit balances at member firms and purpose loans at weekly reporting member banks reached $7.0 billion. This was $2.1 billion, or 43 per cent, above the July 1962 low and

$1.4 billion higher than the level associated with the 1961 year-end price peak. Customers' net debit balances, taken alone, were 25 per cent higher at the end of September than in December 1961; the ratio of such credit to the value of all stocks listed on the New York Stock Exchange had risen from 1.10 per cent to 1.34 per cent over this same period.

In view of these marked advances in prices and credit, the responsibilities of the Board under the Securities Exchange Act would seem to call for a review of the situation to determine whether a tightening in margin regulations to prevent "the excessive use of credit for the purchase or carrying of securities" was in order. Initial margins had been at the 50 per cent level for nearly 16 months, during which time stock market credit had been far and away the most rapidly expanding segment of the credit markets. The juxtaposition of rising stock market prices and lower margin requirements, moreover, had made it possible for margin customers to build up large excess credit balances in their special miscellaneous accounts (SMA's), most of which could be withdrawn in cash or recommitted to the market at the option of the holder. Though the margin regulations could not restrict the use of these balances, an increase in initial margins would have the effect of (1) reducing the potential stock purchasing power represented by these credits, and (2) halting at least for a time the tendency of higher stock prices to result almost automatically in further additions to the SMA "equity pool."

Examination of the underlying market and credit statistics indicated that the latest period of advancing prices and expanding credit was

well within the range of earlier experience when increases in margin requirements were initiated. As compared with the last three such occasions (in 1958, 1955, and 1951), the recent increase in prices had been somewhat below average but the expansion in credit had been well above average. Both dividend and earnings rates were currently somewhat higher than at the 1961 price peak, but well below the levels prevailing at the time of earlier increases in margin requirements. The daily average volume of trading had expanded sharply recently, as also had been the case in each earlier instance when margins were raised, and it was well above the volume of trading at the time of earlier margin increases.

Perhaps the least immoderate feature of the current situation was the comparative level of stock prices; the recovery had been sharp, but so was the preceding decline, with the result that the averages were still only slightly above the previous peak levels of December 1961. The present level of prices also seemed more soundly based than at that time, in view of the rise in earnings that had taken place since 1961 and the substantial increase in corporate internal funds generated as a result of the new investment tax credit and depreciation guidelines. Also, the prospects for a tax cut generally, and for a cut in the corporate income tax in particular, would seem to justify a constructive attitude concerning the future flow of per share earnings. But the similarity in the average of stock prices currently and at the end of 1961 obscured the very substantial changes that had taken place in the prices of individual stocks

and in the relative position of different industrial groups. These changes undoubtedly had marked effects on the structure of existing accounts--creating more deeply undermargined situations, while at the same time adding to the size of SMA credit balances--and could well be viewed as adding to current risks for the unwary new stock investor.

One of the most desirable consequences of an increase in initial margin requirements at this time, when stock prices still appeared to be rising, would be the tendency of higher prices to bring up the position of undermargined accounts toward the new level of required margins. Due to the widespread practice of effecting bookkeeping transfers of excess loan value from the general account to the SMA whenever higher collateral valuations permitted, almost all general accounts were currently in a margin status of 50 per cent or less, and a sizable proportion were deeply undermargined. While the existence of large SMA balances improved the real status of most accounts, these credits could be withdrawn or committed to the market at any time, subject only to the observance of the maintenance requirements of the brokerage firms. An increase in initial margins would make all of these accounts rather substantially undermargined, so that further stock price increases would work to improve the equity status of the general accounts proper. Toward this same end, an increase in retention requirements would serve to lift the margin status of most accounts when sales transactions and withdrawals were effected. Both actions in time should help to improve the positive equity cushion of accounts, and hence enhance their protection against

forced margin calls in any subsequent period of declining prices. This was a major objective of the credit recommendations of the Securities and Exchange Commission's Special Study of the Security Markets.

Aside from possible broader policy considerations, the principal regulatory objection to higher margin requirements was the probability that such a change would tend to encourage borrowing from unregulated lenders. One major recommendation of the SEC Special Study was that unregulated lenders be brought directly within the framework of margin regulation, and the Board presumably would be considering this proposal in the period immediately ahead. In view of this problem, the Board might want to minimize the incentive to turn to such unregulated credit sources by increasing margin requirements only moderately at this time--perhaps to 60 per cent for both initial margin and retention requirements. Close attention would, of course, be given to subsequent stock price and credit developments, and the Board could raise requirements again promptly at any time when this might seem necessary or desirable.

At the request of the Board, Mr. Partee reviewed the information contained in the memorandum along with certain tables included therein and the appendix thereto. He then offered explanations on several points in response to questions raised by members of the Board.

In further general discussion, Governor Mills inquired what acceleration there had been in the opening of new margin accounts over the past few months. Mr. Partee replied that the available figures were not particularly good because a substitute margin account panel was in

process of being developed. It could be said, however, that there was apparently not too much in the way of opening of new margin accounts in the month of August. For September, a blow-up of four automated firms would indicate an increase of about 10,000 accounts, out of a total of 300-350,000.

Governor Robertson inquired about foreign purchases in the U. S. stock market, and Mr. Partee replied that the only available figures--on net purchases--were those collected and published monthly by the Treasury. These figures indicated that foreign purchases were not a major factor in terms of total market volume, but it was not certain whether all foreign purchases were being reflected in the statistics. The net figures had been on the inflow side during the spring and summer, but they were not particularly large.

Chairman Martin noted that he had invited President Funston of the New York Stock Exchange to come down and discuss the margin account panel with the Board. It was planned that this meeting would occur on November 26. (Secretary's Note: The meeting was subsequently deferred.)

Chairman Martin went on to say that the problem confronting the Board was that since the date of the previous price peak in December 1961 the ratio of customers' net debit balances to the market value of all stocks listed on the New York Stock Exchange had increased from 1.10 per cent to 1.34 per cent. Even the current percentage was quite small. However, in view of the relative easiness of credit conditions that had prevailed, the Board should be alert to the potential dangers of the situation. It should consider whether it would be desirable to go to 60 per cent, or

70 per cent, both as to initial margin requirements and retention requirements, just on the basis of the increase in stock market credit that had already taken place, not on the basis of prices at all.

After additional discussion of recent developments with respect to stock market credit in the light of the Chairman's comments, Governor Mills said it was his impression that the statute that the Board had responsibility for administering called for a change in margin requirements in acknowledgment of the developing situation in the stock market. As to timing, he noted that confidence in the business outlook had risen. Obviously, therefore, an increase in margin requirements at this time would run less risk of an adverse psychological effect on the business community than might have been true during the earlier months of the year. It was his own thought that both the initial margin requirement and the retention requirement should be raised to 70 per cent.

Chairman Martin said that it was also his judgment that the requirements should be raised. He was not certain about going to 70 per cent, although he saw no particular objection. If the business situation continued as strong as generally anticipated, there almost certainly was going to be increasingly widespread public participation in the stock market. As between moving the requirements up gradually or moving at once to, say, 70 per cent, this was arguable and a case could be made either way. He gathered that Mr. Partee favored moving to 60 per cent at this time.

In response, Mr. Partee referred to the problem of the unregulated lender. A margin requirement at 70 or 75 per cent would tend to encourage the unregulated lender to become active, and he did not know whether anything of particular effectiveness could be done in that regard. He noted the proposal in the SEC Special Study that the Board revise its regulation to include unregulated lenders; presumably this would be under consideration in the months ahead, for statutory authority was available.

There followed discussion of the question of broadening the regulation when sanctions apparently would be rather weak and ineffectual. On this point, Mr. Noyes brought out that there was difficulty in policing the so-called purpose statement even in regard to commercial banks. For the making of a loan to be illegal, a determination must be made that the purpose of the loan was in fact the purchasing or carrying of listed securities. This involved the question of going behind the purpose statement and presented a difficult enforcement problem. Governor Robertson suggested that the case for broadening the regulation was not completely negative even in the absence of effective sanctions. The mere issuance of a broadened regulation would be to some extent a deterrent. Governor Mitchell expressed somewhat the same line of reasoning, pointing out that the presence of a regulation, by making certain transactions illegal, would provide a deterring influence, whereas the absence of a regulation might be regarded as an inducement.

In response to a question about past efforts to deal with unregulated lenders, Mr. Brill recalled that in 1960 the Board had asked for

reports from all lenders who would be covered under an amended regulation. Those who came forth were few in number, however, and their reports showed relatively small amounts of credit extended. It could not be known with certainty whether the reports represented an accurate census or whether they were filed only by those who were honest enough to file or were afraid of the consequences if they did not file. There were some who felt that the problem of the unregulated lender had been magnified and that the reports were rather comprehensive. Bank lending to so-called unregulated lenders was, of course, now regulated. Regulations reflecting the discussion at this meeting would have the effect of limiting the lending being done by unregulated lenders to their customers.

Governor Balderston expressed the view that an increase to 70 per cent in the margin requirement would seem an appropriate action were it not that this would tend to invite back into the field the unregulated lenders who were of some concern to the Board several years ago. At that time the Board felt some sensitivity to charges concerning lack of regulation in this area. A requirement of 70 per cent probably would invite back some of these parties in a way that 60 per cent would not. He was not sure whether in an interim period of, say, three months, any means could be devised of controlling the unregulated lenders effectively. Nevertheless, even admitting that enforcement might be quite ineffectual and that there might be charges of certain practices going on undetected, he wondered whether a regulation that could not be completely enforced was not better than no regulation at all. If the Board came to a decision

on that point, he could accept the suggestion of going to 70 per cent on the initial margin and retention requirements, although he would dislike to invite the unregulated lenders to become more active again. On the other hand, he would hate to drop one shoe, so to speak, by going only to 60 per cent in the thought that the Board might solve rather quickly a problem that it had not heretofore made progress in solving.

Mr. Partee commented that it might take a little time to draw up a regulation applicable to unregulated lenders, which would then have to be published in the Federal Register before being made effective. However, the Board could decide to go at this time to 60 per cent, which would take care of the immediate problem, and then proceed as promptly as possible with the question of unregulated lenders even though it could not expect full enforcement. In any event, a further change from the 60 per cent would have to be made if market conditions called for it.

In response to a further question with regard to timing, Mr. Hexter said that the Legal Division had not attempted to draft a regulation applicable to unregulated lenders. There was, for one thing, the question whether it should be a separate regulation or should be incorporated in Regulation U. Also, the information that the Board decided a couple of years ago that it wanted about the continuing volume of transactions by unregulated lenders had never been obtained, and this might affect the scope of the regulation. He understood that the Board's earlier plan was to institute a continuing reporting program, and on the basis of the

information obtained to think about an appropriate regulation. There was also the question of extending the Board's regulations to the area of over-the-counter securities, which transactions were not subject to Board regulation under existing law. If there should be an amendment to the Securities Exchange Act to extend the Board's authority to over-the-counter securities as well as listed securities, this might provide a broader basis for a Board regulation. However, there was not pending at the present time any legislation that would so extend the Board's authority, although this had been suggested in the SEC Special Study.

Governor Mitchell expressed the view that the facts that had been brought before the Board were not conclusive evidence of a need for a change in the margin requirements. As he saw it, the quick run-up in stock prices and the volume of credit did not provide too much cause for alarm at the moment. On the other hand, there was a hint that stock market credit was being overused. In these circumstances, it was his view that the Board could obtain the same mileage from a smaller increase in margin requirements as from a larger increase. If there was a smaller increase, the Board could then observe developments and decide whether a further change was needed. On the basis of the currently available facts, he did not judge that an increase to more than 60 per cent was necessary. As to the question of expanding the regulation to include unregulated lenders, he felt that this should be done as quickly as feasible even though the provisions of the regulation probably could not be strictly enforced.

Chairman Martin then said he was inclined to feel that the Board should act promptly one way or the other. Whether to go to 60 per cent or 70 per cent was a debatable matter; a good argument could be made either way. There would be some advantage to moving to 70 per cent, as Governor Mills had suggested, because that would be a little more than simply a gesture. On the other hand, there would be some advantage in going to 60 per cent in order to provide the Board an opportunity to observe what effect that would have on credit practices.

Governor Robertson suggested that the Board also give consideration to eliminating the substitution rule, but Chairman Martin replied that he would be strongly against such a move. It would be a major step, while the increases under consideration would not result in changing basic practices. A change in the substitution rule would, in his judgment, tend to disrupt the tenor of the whole market.

Governor Robertson then said that he felt the Board should move ahead in the area of unregulated lenders, not necessarily with the idea of acting at the same time as on margin requirements but at least by asking the staff to prepare a regulation for the Board's consideration. Possibly an announcement of a change in margin requirements might also state that the Board was studying such a possibility.

Governor Shepardson said that, recognizing the improbability of obtaining legislation, he nevertheless wondered whether the Board should not be taking steps to have a bill drafted relating to over-the-counter

securities that it might arrange to have introduced at an appropriate time. Chairman Martin agreed that it would seem desirable to try to implement the SEC's Special Study recommendations by having a bill drafted that the Board might have introduced jointly with the Securities and Exchange Commission or on its own. Mr. Partee noted that the staff was preparing a memorandum summarizing the SEC recommendations.

Governor Shepardson then commented that he was continually concerned about "unenforceable" regulations. He recognized that there might be some psychological value in issuing a regulation applicable to unregulated lenders even if it was not susceptible of effective enforcement, but he hoped that every effort would be made to find the most effective approach and minimize evasion.

After discussion of various possibilities in the light of Governor Shepardson's remarks, Governor Mitchell commented that it was easy to become defeatist. He felt it was probably possible for the Board to enforce any regulation rather effectively.

The meeting concluded with an understanding that discussion of the initial margin and the retention requirements, and of related matters, would be continued at the meeting of the Board tomorrow.

The meeting then adjourned.

Secretary's Note: Governor Shepardson today approved on behalf of the Board the following items:

Letter to the Federal Reserve Bank of New York (attached Item No. 9) approving the appointment of William E. Morfeld as assistant examiner.

Letter to the Federal Reserve Bank of San Francisco (attached Item No. 10) approving the appointment of James A. Hayes as assistant examiner.

Memoranda from appropriate individuals concerned recommending the following actions relating to the Board's staff:

Appointment

William B. Stryker, Jr., as Photographer (Offset), Division of Administrative Services, with basic annual salary at the rate of $6,614, effective the date of entrance upon duty.

Advance of sick leave

M. Callie Wickline, Nurse, Division of Personnel Administration, for a period of 14 days beginning October 25, 1963.

Secretary

# TELEGRAM
LEASED WIRE SERVICE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON

Item No. 1
11/4/63

November 4, 1963.

HICKMAN - CLEVELAND

Reurlet of October 23, 1963, Board will interpose no objection to your proceeding with the renovation of the food serving facilities and with the alterations to the security court entrance as described in your letter, and authorizes expenditures of approximately $335,000 and $47,500, respectively, for these projects.

(Signed) Merritt Sherman

SHERMAN

Item No. 2
11/4/63

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

November 4, 1963.

The Honorable Jesse P. Wolcott, Director,
Federal Deposit Insurance Corporation,
Washington, D. C. 20429.

Dear Mr. Wolcott:

Reference is made to your letter of October 22, 1963, concerning the application of Scribner Bank, Scribner, Nebraska, for continuance of deposit insurance after withdrawal from membership in the Federal Reserve System.

No corrective programs that the Board of Governors believes should be incorporated as conditions to the continuance of deposit insurance have been urged upon or agreed to by the bank.

Very truly yours,

(Signed) Elizabeth L. Carmichael

Elizabeth L. Carmichael,
Assistant Secretary.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551



ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

November 4, 1963.

Board of Directors,
United California Bank,
Los Angeles, California.

Gentlemen:

The Board of Governors of the Federal Reserve System approves the establishment of a branch by United California Bank in the vicinity of the intersection of Rancho Bernardo Boulevard and Pomerado Road in the community of Rancho Bernardo, San Diego, California, provided the branch is established within one year from the date of this letter.

Very truly yours,

(Signed) Elizabeth L. Carmichael

Elizabeth L. Carmichael,
Assistant Secretary.

(The letter to the Reserve Bank stated that the Board also had approved a six-month extension of the period allowed to establish the branch; and that if an extension should be requested, the procedure prescribed in the Board's letter of November 9, 1962 (S-1846), should be followed.)

3773

Item No. 4
11/4/63

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

November 8, 1963

Mr. A. J. Faulstich,
Administrative Assistant
to the Comptroller of the Currency,
Office of the Comptroller of the Currency,
United States Treasury,
Washington, D. C. 20220

Dear Mr. Faulstich:

Thank you for your letter of October 24, 1963, transmitting the views of the Office of the Comptroller of the Currency regarding steps that might be taken to reduce "window dressing" in connection with reports of condition of banks. Although your Office doubts whether the procedure suggested in the Board's letter of October 7 would be effective, the Board contemplates proceeding in cooperation with the Federal Deposit Insurance Corporation and through the Federal Reserve Banks to explore with the banking community ways and means of reducing the practice of window dressing.

The Board also notes with interest the proposal that banks be required to submit call reports on a surprise basis in the form of averages or figures for selected random dates in addition to fixed call dates for reports of condition as of June 30 and December 31, or as of the last business days of those months. The Board has been sympathetic with such a procedure for statistical and other purposes, as has been indicated in discussions at the staff level among the three Federal bank supervisory agencies.

Very truly yours,

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.

Item No. 3374
11/4/63

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

November 8, 1963.

Mr. Jesse P. Wolcott, Director,
Federal Deposit Insurance Corporation,
Washington, D. C. 20429.

Dear Mr. Wolcott:

Thank you for your letter of October 14 advising the Board that the Corporation would be pleased to have its Supervising Examiners join representatives of the Federal Reserve Banks in meeting with the principal officers of their District banks that have been engaging in the practice of window dressing. The Board was glad to know that you were advising your Supervisory Examiners to cooperate in this program.

The Office of the Comptroller has advised the Board that it doubts whether the procedure suggested in the Board's letter of October 7 would be effective and has suggested that efforts to reduce window dressing be made through use of surprise calls for reports of condition, including the use of averages or figures for selected random dates. However, the Board feels that while such measures may be useful in reducing window dressing of official statements, they are ineffective with respect to voluntary statements presented to the public. Accordingly, the Board believes that the approach outlined in its October 7 letter is also desirable. Therefore, assuming you are willing to proceed without the participation of the Comptroller of the Currency, the Board proposes to request the President of each Federal Reserve Bank to solicit the cooperation of your appropriate Supervisory Examiner in arranging meetings with the principal officers of the State and national banks that engage in this practice.

A sample copy of the Board's letter to the Presidents of the Federal Reserve Banks is enclosed. Before sending this letter to the Reserve Banks, the Board will appreciate receiving further word from you as to the arrangements for participation by your Supervisory Examiners in this program.

Very truly yours,

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.

Enclosure

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

Item No. 6
11/4/63

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

November 8, 1963.

Dear Sir:

The agenda for the meeting of the Conference of Chairmen of the Federal Reserve Banks on November 30 - December 1, 1961, included a topic regarding the special relationship of the Boards of Directors of the Federal Reserve Banks to the audit function in their respective Banks. The material distributed noted in particular the actions taken by the Chairmen in previous years with regard to the responsibilities and duties of the Audit Review Committees of Directors. It also emphasized that the results achieved from any audit activity are peculiarly responsive to the caliber of the person performing the audit: auditors should have not only the technical competence that comes from training and experience, but also in high degree they should possess such inherent qualities as initiative, judgment, perceptiveness, and imagination. For men of such qualifications to make a career in auditing, it is essential that they be accorded a job status and a salary commensurate with their attainments.

The Board of Governors has noted with approval the constructive results from the special studies by the Audit Review Committees and the Boards of Directors of the respective Reserve Banks in implementation of the resolution adopted at the 1961 Conference, a copy of which was sent to all Chairmen on December 3, 1961. However, from information available to this Board, it appears that the practices in effect in the respective Banks do not always clearly provide for the direct handling by the Boards of Directors, through their Audit Review Committees, of personnel actions affecting the members of the auditing staffs, although such a role would seem important to the maintenance of an independent auditing function.

The desirability of the separation of the auditing function from the operating functions of the Bank has long been recognized in the Federal Reserve System, and it was formalized by the adoption of a statement of principles by the Conference of Chairman in 1942. The following is quoted from the first of such principles:

> "Emphasis must be placed upon the special nature of the Auditor's position in the bank, which differs generally in lines of authority and responsibility from that of operating officers. The Auditor is responsible directly to the board of directors of the Reserve Bank through its Chairman and the audit committee."

In 1945, the Chairmen's Conference approved a statement of the duties and responsibilities of the Audit Review Committee, from which the following quotation is excerpted:

> "The Audit Review Committee shall have the primary responsibility for maintaining contact with the Auditor, and satisfying itself (1) that appropriate audit programs and procedures are maintained by the Audit Department and (2) that the Auditor has proper official status and sufficient staff, both numerically and qualitatively, to discharge the responsibilities of his office with thoroughness and dispatch, making such recommendations to the Board as may be necessary to that end."

Consistency with the concept that the auditor is responsible directly to the Board of Directors implies in part (2) of the second quoted statement that the Board of Directors through the Audit Review Committee should be actively concerned with appropriate staffing of the auditing department in a Reserve Bank and with salary determinations relative thereto.

In the view of the Board of Governors, it would seem that actions respecting the salary or classification of the General Auditor, who has the senior supervisory responsibility for the auditing function, should be initiated by the Audit Review Committee and referred by that Committee to the full Board of Directors for final action. Such action should, of course, be coordinated with the periodic general review of officer salaries in the Bank, and with the policies pertaining to the latter.

In personnel actions affecting the other members of the auditing department--that is, recruitment, qualitative standards, salaries, position classifications, and so on--it would seem appropriate for the General Auditor to originate recommendations for presentation to the Audit Review Committee and for such action by that Committee as it deems appropriate. It is assumed, of course, that the General Auditor in preparing his recommendations, and the Audit Review Committee in considering them, would take into account the general personnel policies of the Bank, would be guided by the salary ranges and classification standards

prescribed in the Bank's Salary Classification and Administration Plan, and would avail themselves of the technical assistance and counseling of the Personnel Department.

The Board would appreciate receiving any comments that you or your directors may wish to make on this subject. Copies of this letter are being sent to the Presidents of the Reserve Banks also, with a request for an expression of their views.

Very truly yours,

Merritt Sherman,
Secretary.

TO ALL CHAIRMEN OF THE FEDERAL RESERVE BANKS

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

Item No. 7
11/4/63

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

November 8, 1963.

Dear Sir:

There is attached for your information a copy of a letter being sent today by the Board to the Chairmen of the Federal Reserve Banks regarding personnel actions affecting members of the auditing staffs in the Banks.

You will note that the Board has asked the Chairmen to furnish it with comments they may have regarding the procedures outlined. The Board also would be pleased to have any comments that you may wish to make with respect to the matter discussed.

Very truly yours,

Merritt Sherman,
Secretary.

Attachment.

TO THE PRESIDENTS OF ALL FEDERAL RESERVE BANKS

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

Item No. 8
11/4/63

OFFICE OF THE CHAIRMAN

November 5, 1963.

The Honorable Paul H. Douglas,
Chairman,
Joint Economic Committee,
Washington, D. C. 20510.

Dear Mr. Chairman:

This is in reply to your letter of October 21, 1963, in which you asked for certain information regarding the 25 per cent gold certificate reserve requirements specified in section 16 of the Federal Reserve Act, with particular reference to action the Federal Reserve might take if the reserves should fall below the required amounts.

Paragraph 3 of section 16 provides that each "Federal Reserve bank shall maintain reserves in gold certificates of not less than 25 per centum against its deposits and reserves in gold certificates of not less than 25 per centum against its Federal Reserve notes in actual circulation." The Board of Governors has authority, under section 11(c) of the Federal Reserve Act, to suspend these requirements in order to provide time for corrective adjustment, should the reserves fall below required levels. Section 11(c) also requires the Board to impose a graduated penalty tax on Reserve Banks experiencing a reserve deficiency. The Board could comply with this requirement by imposing a nominal penalty tax, so long as System holdings of gold certificates did not fall below 20 per cent of Reserve Bank liabilities on Federal Reserve notes outstanding. For any deficiencies of reserves below this level, the law requires the imposition of a tax graduated upward from 1-1/2 per cent per annum. The discount rate of any Federal Reserve Bank so penalized would have to be raised correspondingly. The text of section 11(c) follows:

"Sec. 11. The Board of Governors of the Federal Reserve System shall be authorized and empowered:

* * *

"(c) To suspend for a period not exceeding thirty days, and from time to time to renew such suspension for periods not exceeding fifteen days, any reserve requirements specified in this Act: Provided, That it shall establish a graduated tax upon the amounts by which the reserve requirements of this Act may be permitted to fall below the level hereinafter specified: And provided further, That when the reserve held against Federal Reserve notes falls below 25 per centum, the Board of Governors

of the Federal Reserve System shall establish a graduated tax of not more than 1 per centum per annum upon such deficiency until the reserves fall to 20 per centum, and when said reserve falls below 20 per centum, a tax at the rate increasingly of not less than 1-1/2 per centum per annum upon each 2-1/2 per centum or fraction thereof that such reserve falls below 20 per centum. The tax shall be paid by the Reserve bank, but the Reserve bank shall add an amount equal to said tax to the rates of interest and discount fixed by the Board of Governors of the Federal Reserve System."

This suspension authority, together with the penalty tax provisions, was part of the original Federal Reserve Act, as enacted in 1913, except that in the original Act the reserve requirements were 40 per cent against notes and 35 per cent against deposits, and the higher tax rate became mandatory when a Reserve Bank's reserve against notes fell below 32-1/2 per cent. The reduction from a 40 per cent requirement against notes and 35 per cent against deposits to 25 per cent in each case was made by the Act of June 12, 1945 (59 Stat. 237). Since you have expressed an interest in the origin of the gold cover requirement, I am attaching material on its legislative background and intent prepared by our staff.

The Board has exercised its authority under section 11(c) to suspend reserve requirements on three occasions. On November 7, 1919, the Board authorized Governor Harding to suspend reserve requirements of the Federal Reserve Bank of New York for a period not exceeding 10 days. On March 15, 1920, the Board suspended reserve requirements for all Federal Reserve Banks for 10 days. On March 3, 1933, the Board suspended reserve requirements for all Reserve Banks for 30 days. None of these suspensions was renewed.

Penalty tax rates have been established at varying levels over the years under section 11(c). They have always been graduated according to the size of the deficiency, but three different beginning rates have been fixed. From the inception of the System until 1933, the rate on the first five percentage points of deficiency in reserve requirements was 1 per cent per annum. On March 13, 1933, the Board cut the beginning rate to 1/10 of 1 per cent per annum. This rate prevailed until June 30, 1945, when the Board adopted a higher rate schedule, following enactment of the legislation lowering reserve requirements to 25 per cent. That schedule has continued unchanged up to the present time, as follows: 1/2 of 1 per cent per annum when either the note or deposit reserve ratio falls to between 25 and 20 per cent; 2 per cent upon deficiencies below 20 per cent down to 17-1/2 per cent, 3-1/2 per cent upon deficiencies below 17-1/2 per cent down to 15 per cent, and an additional 1-1/2 per cent for each 2-1/2 per cent further decline in either reserve ratio below 15 per cent.

In round numbers, the System's gold certificate reserves stand at $15 billion, to cover $18 billion in deposits and $31 billion in Federal Reserve notes. (A table is attached showing actual figures for October 30,

1963, but round figures will simplify the discussion at this point.) If there were a continued loss of gold reserves to the point where they were about to become insufficient to cover note and deposit liabilities (that is, if they fell from $15 billion to $12 billion), the Board could suspend the requirements to permit time for corrective adjustment. While the initial suspension is limited to 30 days, unlimited renewals are authorized, and, although no single renewal may be for more than 15 days, no over-all limit is imposed on the duration of successive suspensions. If a reserve deficiency should prove unresponsive to corrective measures, the Board could, therefore, continue a suspension for as long as necessary to permit enactment of remedial legislation.

As long as a reserve deficiency were confined to what we may call the first "layer"--the reserves required against deposit liabilities--the only action required by law would be the imposition of a tax against the Federal Reserve Banks. Under a long-standing interpretation of section 11(c), the tax need not be added to the Banks' discount rates until the reserve deficiency penetrates into the second "layer"--the reserves required against Federal Reserve notes. For the System as a whole, therefore, reserves could fall from their present level of $15 billion to $8 billion before any increase in discount rates would be required by the Act. Under the present schedule of penalty rates, if reserves fell all the way through the first "layer" (down to $8 billion), the annual taxes on the reserve deficiency (using $18 billion as the figure for deposits) would be something under $300 million a year. Payment of these taxes would diminish net earnings of the Federal Reserve Banks and reduce by an equal amount their payments to the Treasury as interest on Federal Reserve notes, which amounted to $800 million in 1962. It should be understood that the total payment to the Treasury would not change; it would simply be divided into two parts adding to the same total, one part labelled "tax on reserve deficiencies" and the other labelled "interest on Federal Reserve notes." In the example, the total payment would still be $800 million, but $300 million would be in the form of a tax and $500 million would represent interest on notes.

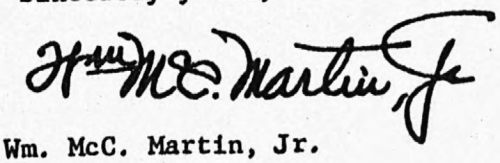
If reserves continued to fall, so that a deficiency occurred in the reserve against Federal Reserve notes, with a consequent additional penalty tax for that deficiency, the statute would require the Reserve Banks to "add an amount equal to said tax" to the rates they charge on advances to borrowing member banks. While the statute is not at all clear on the mechanics of imposing this added charge, perhaps the most reasonable method would be to raise the discount rate by the same number of percentage points as the penalty tax rate on the <u>note</u> reserve deficiency. For example, if the gold certificate reserves fell to 20 per cent of Federal Reserve notes--or to about $6 billion--the penalty tax under present rates for the <u>note</u> reserve deficiency would be 1/2 of 1 per cent (or $10 million). Adding the penalty tax rate to the present discount rate of 3.5 per cent would result in a discount rate of 4 per cent. Again, it should be understood that the Board could establish a different penalty tax rate in this case; the statute simply requires that it be "not more than 1 per centum per annum." The statutory minimum penalty tax

rate would come into effect only if reserves fell below this point.

It seems reasonable to conclude that if this country's gold losses should continue to the point where the Reserve Banks were unable to comply with the 25 per cent statutory reserve requirement, there is ample authority under the present Act to meet the situation without disrupting the economy or the international payments mechanism, and to provide time for Congress to consider legislative action.

In response to your question about the arguments for and against keeping the gold reserve requirement, I doubt that I can add anything more to the testimony your Committee has already received. In my judgment, no change in the requirement should be undertaken at this time, because the risks of such an undertaking outweigh the benefits to be gained. The principal risk in such a move under current conditions is that the public might interpret it as a sign of weakness portending failure in the Government's efforts to maintain the value of the dollar. I see no need to run this risk, because the gold cover requirement does not pose any obstacle to the use of our gold reserves in defense of the dollar, and the best way to deal with worries on that score is to lay before the public a full explanation of what the statute requires and the procedures for meeting its requirements. I appreciate this opportunity to contribute to that end.

Sincerely yours,



Wm. McC. Martin, Jr.

Attachments

ATTACHMENT A

Application of Federal Reserve Gold Certificate
Reserve Requirements
October 30, 1963
(Dollar amounts in millions)

| | | |
|---|---|---|
| 1. | Combined Federal Reserve deposit liabilities | $17,810 |
| 2. | Combined Federal Reserve note liabilities | 31,442 |
| 3. | Total Federal Reserve liabilities subject to reserve requirements | 49,252 |
| 4. | Total Federal Reserve gold certificate reserve | 15,310 |
| 5. | Less: 25 per cent reserve requirement on Federal Reserve notes and deposits | 12,313 |
| 6. | Equals: Excess gold certificate reserves | 2,997 |
| 7. | Plus: 25 per cent requirement on Federal Reserve deposits (deficiencies in this requirement necessitate no discount rate increase) | 4,453 |
| 8. | Equals: Total gold certificate reserve releasable without mandatory discount rate increase | 7,450 |
| 9. | Plus: Difference between 25 per cent and 20 per cent requirement on Federal Reserve notes (deficiencies in this range require only a small discount rate increase) | 1,572 |
| 10. | Equals: Total gold certificate reserves releasable without substantial mandatory discount rate increase | 9,022 |

ATTACHMENT B

Legislative background and intent of gold reserve provisions of Federal Reserve Act.

The House Report on H. R. 7837, 63d Congress, the 1913 bill which became the Federal Reserve Act, contains the following statement regarding the purpose of imposing reserve requirements on the proposed central banks:

> "In a general way the committee believes that requirement of a fixed reserve is not a wise or desirable thing as viewed in the light of scientific banking principle. It believes, however, that in a country accustomed to fixed reserve requirements the prescription of a minimum reserve may have a beneficial effect, . . . ." 1/

Since the "real bills doctrine" formed the theoretical basis for the original Federal Reserve Act, the members of the House Banking and Currency Committee evidently believed that limiting central bank credit expansion to the discounting of eligible paper would provide a sufficient check on monetary expansion, and that imposition of gold reserve requirements would be inconsistent with the "real bills" principle. However, because the precedents of reserve requirements for national banks and for various foreign central banks suggested that there might be a problem of public confidence, the Committee members were willing to recommend gold reserve requirements. Other legislators, and the majority of the National Monetary Commission, were strong supporters of the idea that the central bank's liabilities should be restrained by the level of gold reserves.

1/ U. S. Congress, House, Committee on Banking and Currency, Changes in The Banking and Currency System of the United States, Report No. 69 to accompany H. R. 7837,63d Cong., 1st Sess., 1913, p. 71.

According to the House Report on H. R. 7837, the Federal Reserve Board's power to suspend reserve requirements was based upon a similar provision in the National Bank Act of 1864. 2/ Under this latter provision the Comptroller was required to notify a bank with a reserve deficiency to "make good" the deficiency. If after 30 days the deficiency still continued, the Comptroller could, with concurrence of the Secretary of the Treasury, appoint a receiver to wind up the business of the bank.

Section 22 of H. R. 7837 was taken almost word for word from this section of the National Bank Act. Hence, in this early version of the Federal Reserve bill the Board would apparently have been required to close a reserve deficient Reserve Bank and appoint a receiver therefor if such Bank should fail to make good its required reserve after receiving 30 days notice from the Board to eliminate such reserve deficiency.

In later versions of the bill, the Board's power to close a Reserve Bank was replaced with the mandatory requirement to impose a graduated tax on any Bank with a reserve deficiency. Such a change would seem to shift the emphasis of adjustment from the mechanism of temporary suspension of requirements to the process of tax and discount rate increases and consequent restraint upon monetary expansion.

The provision of a penalty for reserve deficiencies appeared to be drawn from European central bank regulation, most specifically

2/ Ibid., p.46. See Section 5191 of the Revised Statutes for this provision in the National Bank Act of 1864.

the German central bank. 3/ Inclusion of a penalty is confirming evidence that the Congressional authors of the Act were not prepared to follow unequivocally the "real bills" doctrine with its attendant implications that Federal Reserve discounting of "real bills" would automatically provide the "right" amount of money. This conclusion is a logical consequence of the provision which requires a reserve deficient Reserve Bank to respond to the penalty tax by raising the interest and discount rates which it receives on such "real bills." The Congress evidently envisioned that the tax-induced increases in discount rates would reduce Federal Reserve credit, which, in turn, would eliminate the reserve deficiency while reducing bank reserves and the money supply.

The language of the Act as enacted could be interpreted as suggesting that the effects of the penalty were expected to apply to individual Reserve Banks, encouraging asset transfers or liquidation of liabilities only by the particular Reserve Bank affected. Study reveals, however, that penalty provisions were included in early versions of central bank bills, including the Aldrich bill which proposed one centralized monetary institution, and hence there are grounds for presuming that the deflationary consequences of the penalty tax were expected to be nationwide in scope.

3/ Owen, Robert L., The Federal Reserve Act, New York, Century Co. (1919), pp. 12-14 and 19-24.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

Item No. 9
11/4/63

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

November 5, 1963.

Mr. Howard D. Crosse, Vice President,
Federal Reserve Bank of New York,
New York, New York 10045.

Dear Mr. Crosse:

In accordance with the request contained in your letter of October 28, 1963, the Board approves the appointment of William E. Morfeld as an assistant examiner for the Federal Reserve Bank of New York, effective November 15, 1963.

Very truly yours,

(Signed) Elizabeth L. Carmichael

Elizabeth L. Carmichael,
Assistant Secretary.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

Item No. 10
11/4/63

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

November 5, 1963.

CONFIDENTIAL (FR)

Mr. E. H. Galvin, Vice President,
Federal Reserve Bank of San Francisco,
San Francisco, California 94120.

Dear Mr. Galvin:

In accordance with the request contained in Mr. Cavan's letter of October 28, 1963, the Board approves the appointment of James A. Hayes as an assistant examiner for the Federal Reserve Bank of San Francisco. Please advise the effective date of the appointment.

It is noted that Mr. Hayes is indebted to Manufacturers Hanover Trust Company, New York, New York, a State member bank located in District No. 2, but that he will not participate in any examination of that bank.

Very truly yours,

(Signed) Elizabeth L. Carmichael

Elizabeth L. Carmichael,
Assistant Secretary.