

Minutes for September 22, 1964.

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. 1/

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

Gov. Daane

1/ Meeting with the Federal Advisory Council.

Minutes of a meeting of the Board of Governors of the Federal Reserve System with the Federal Advisory Council that was held in the Board Room of the Federal Reserve Building in Washington, D. C., at 10:30 a.m. on Tuesday, September 22, 1964.

PRESENT: Mr. Martin, Chairman
 Mr. Balderston, Vice Chairman
 Mr. Robertson
 Mr. Shepardson
 Mr. Daane

Mr. Sherman, Secretary
 Mr. Bakke, Assistant Secretary
 Mr. Hackley, General Counsel^{1/}
 Mr. Hexter, Assistant General Counsel^{1/}

Messrs. Martin, Moore, Day, Stoner, Watlington, McRae, Smith, Moorhead,^{2/} Breidenthal, Aston,^{3/} and Cook, Members of the Federal Advisory Council from the First, Second, Third, Fourth, Fifth, Sixth, Seventh, Ninth, Tenth, Eleventh, and Twelfth Federal Reserve Districts, respectively

Mr. Harry F. Harrington, Chairman and President, the Boatmen's National Bank of St. Louis, St. Louis, Missouri

Mr. Prochnow, Secretary, Federal Advisory Council
 Mr. Korsvik, Assistant Secretary, Federal Advisory Council

In the absence of Mr. Hickok, Member of the Council from the Eighth Federal Reserve District, Mr. Harrington represented that District at this meeting.

Before this meeting there had been distributed a memorandum from the Federal Advisory Council setting forth the topics suggested by the Board for consideration at this meeting and the views of the Council

^{1/} Entered the meeting at the point indicated.
^{2/} President of the Council.
^{3/} Vice President of the Council.

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concerning them, together with two additional topics suggested by the Council for discussion. The topics, the statement of the Council with respect to each, and the substance of the discussion were as follows:

1. Economic conditions and prospects.

- A. How does the Council appraise the economic outlook for the next six months, particularly as to its sources of strength and weakness?

The members of the Council believe that business and economic activity in the next six months will continue to expand. The following sources of strength are present:

1. the sustained but comparatively moderate rise in consumer demand as evidenced by retail sales;
2. the absence to date of excessive inventory accumulation;
3. the anticipated outlays by businessmen for plant and equipment; and
4. the maintenance of relatively stable prices.

Among the items of concern are the following:

1. the continuing rapid expansion of credit with the possibility that the quality has deteriorated;
 2. the possibility of costly disruptive strikes or wage price inflation should the recent automobile settlements be accepted as a guide for future labor contract negotiations;
 3. an acceleration in the rate of inventory accumulation, particularly the stockpiling of steel in anticipation, first, of a possible strike in that industry next May 1, and secondly, of higher prices.
- B. Does the Council believe that recent increases in prices of sensitive raw materials signal the beginnings of a broader and more cumulative price advance?

The Council does not believe that the recent increases in prices of sensitive raw materials necessarily signify the beginning of a broader and more cumulative price advance although this is more of a possibility now in view of wage-cost developments.

- C. Is factory output beginning to press against "most desired use of capacity" for any industrial corporations with which Council members are familiar? Have Council members noted any tendencies for production bottlenecks to delay or obstruct the consummation of expansion plans of larger industrial companies?

The members of the Council do not believe that output generally is pressing against the "most desired use of capacity." However, in the steel, furniture, and in some areas of the textile industries, for example, output is pressing on capacity and some marginal plants are being brought into use.

Chairman Martin indicated interest in the views of the Council regarding the recent contract settlements by the Chrysler Corporation and Ford Motor Company with the United Auto Workers. He indicated his understanding that the negotiated terms represented an increase of between 4 and 5 per cent in labor costs, whereas, according to the Council of Economic Advisers, general industrial productivity in the year 1964 has increased only about 4 per cent.

Mr. Moore commented that according to information he had received from officials of the Chrysler Corporation, the settlement involved an increase of between 4 and 4.5 per cent in labor costs, but that because of the complexity of the factors involved a more precise figure was difficult to develop.

Mr. Day added that, according to one report, the Ford settlement involved a 4.9 per cent increase in labor costs. In his opinion, the significant thing about the Chrysler and Ford settlements was not so much that they exceeded the year's increment of increased industrial productivity,

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but rather that the head of the auto workers union had indicated an intention to seek even more liberal terms in the negotiation with General Motors Corporation.

President Moorhead expressed the view, in which there was general accord among the Council members, that inflationary problems could arise from these settlements if the automobile manufacturers decided to raise prices on the 1965 model cars, an action which in turn would probably trigger a general price increase for many other consumer goods.

Governor Balderston observed that another potential problem area lay in the fact that the auto companies were beginning to stockpile steel because of uncertainties attending the outcome of contract negotiations in the steel industry. He expressed concern that this might have undesirable effects on the economy during the balance of the year.

President Moorhead noted that the steel industry was having exceptionally good earnings this year, just as had been the case in the automobile industry. It could be anticipated that the industry would have a difficult time in holding the line against liberal wage demands by the Steel Workers Union.

Chairman Martin then called for a discussion concerning the quality of credit, commenting that there appeared to be indications suggesting an improvement during the preceding 6-month period rather than deterioration.

President Moorhead said that some difference of opinion existed on this subject. There appeared to be some deterioration of credit quality on the West Coast, but the problem did not appear to be serious there. During any period of economic expansion there was bound to be some deterioration in the quality of credit.

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Mr. Day questioned whether there had been an over-all deterioration of credit. In some cases he had observed that lenders were being more selective and less liberal.

Mr. Cook noted that in the Twelfth Federal Reserve District there was quite a tendency for looser terms on automobile financing, with some of the newer banks reaching for volume. There was some evidence of less liberal real estate lending at banks, although insurance companies were about as liberal as before and some of the newer banks were going out further in the financing of apartments, hotels, and new commercial buildings than was appropriate for sound loans.

Mr. Watlington said that in the Fifth District there had been no improvement in the quality of credit; if anything, there was an almost imperceptible deterioration. He attributed this to the highly competitive lending practices of banks occasioned by the need to generate earnings.

President Moorhead commented that he suspected there was an increase in the number of bank loans being criticized by examiners.

Mr. McRae stated that it was difficult to pin down the question whether there was a deterioration in the quality of credit, but in the Sixth District he had noted an increasing number of instances where small country banks were purchasing portfolio securities that from the standpoint of sound investment were marginal, at best.

Mr. Martin observed that, for competitive reasons, most banks felt obliged to offer the maximum permissible rate on time and savings deposits which, in turn, engendered a feeling on the part of management that available funds had to be as fully invested as possible in order

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to service the operating costs, leading to a disposition to make more risky loans. His bank had recently been screening its portfolio and selling off substandard paper, and there had not been any problem in finding others to take up this paper in the obvious hope of augmenting their earnings.

Governor Shepardson then inquired about the real estate loan market, in response to which President Moorhead observed that the recent authorization for national banks to make such loans up to 80 per cent of appraised value on residential property was being used quite generally.

Governor Shepardson noted that he was aware of a somewhat similar situation with regard to farm mortgages, where there frequently were several lenders actively seeking the business and the prospective borrower obviously selected the most liberal of the terms offered.

In response to a question from Chairman Martin concerning consumer instalment loans Mr. Martin commented that there was no evidence of deterioration in quality in the First District, and President Moorhead expressed a similar view for the Ninth District.

Governor Shepardson then inquired whether the reported shortage of skilled labor was having an effect upon industrial production.

Mr. Aston said that while there was no shortage of plant capacity in the electronics and aviation industries in the Eleventh District, full utilization was hampered by the lack of sufficient skilled labor in that District.

Mr. Cook noted that the cutback on defense contracts in the Twelfth Federal Reserve District had resulted in a number of affected

firms attempting to convert their output to consumer goods, with the result that a skilled labor surplus existed in a number of areas.

2. Banking developments.

- A. What is the Council's judgment regarding the demand for bank loans over the rest of this year?

The members of the Council anticipate that the demand for bank loans will be somewhat more than seasonal over the rest of the year, reflecting some acceleration in consumer buying and a considerably better than average holiday trade. It seems likely that consumers will adjust their spending upward to bring savings back to the historical pattern of recent years.

- B. Has there been any recent increase in loan demand to finance precautionary inventory accumulation?

Other than perhaps the metal and metal-using industries, the members of the Council have not observed any recent increase in loan demand to finance precautionary inventory accumulation.

- C. What shifts in patterns of demand by customers have occurred or are foreseen as between negotiable time certificates of deposit, on the one hand, and other domestic and foreign money market instruments (including time deposits in the Euro-dollar market) on the other?

The Council has not observed any significant shift in the patterns of demand by customers between negotiable time certificates of deposit and other domestic and foreign money market instruments. However, several members of the Council reported some increase in the movement of funds to Canada in response to the aggressive efforts of Canadian banks.

The coming election in Great Britain and the relatively weak coalition government in Italy, for example, are among the uncertainties that may have tended to lessen the flow of funds abroad.

- D. Does the Council have any views as to the possible effects on banks of the recent regulation of the Federal Home Loan Bank Board limiting savings and loan association ownership of individual bank certificates of deposit?

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President Moorhead said that there had been a better than seasonal increase in bank loans but nothing spectacular. There seemed to be little tendency to accumulate inventories. With the exception of a significant outflow of deposit funds to Canadian banks, there did not appear to be a great deal of movement of deposits away from domestic banks.

On the latter point, Mr. Day observed that while the foregoing comment accurately reflected the situation as of the present time, if foreign interest rates should rise to a point where they were 60 or more basis points above the domestic rate there might be a substantial movement of funds out of the country.

President Moorhead expressed the view that while such a development was possible, political and economic uncertainty in Europe at this time would probably tend to discourage any great outflow of capital to that market notwithstanding more attractive interest rates.

Governor Daane then inquired whether the Council anticipated re-establishment of the historic pattern of consumer spending and savings that had been disturbed by the recent Federal tax cut.

President Moorhead expressed the opinion, in which Mr. Harrington concurred, that once the initial impact of the tax cut dispelled itself there should be a recovery of the historic spending pattern.

Governor Balderston stated his understanding that the effect of U. S. policy regarding foreign private investment as embodied in the interest equalization tax legislation had led to placement of funds in Canada when the interest rate spread was favorable.

Mr. Moore said that funds could move very quickly with a change in the rate. He also noted that many Canadian firms used New York as a market for short-term funds.

President Moorhead expressed the opinion that action in the area of U. S. monetary policy would probably have little, if any, effect in deterring a flow of capital to Canada in view of the spread in interest rates, the aggressive solicitation of U. S. funds by Canadian banks, and the predisposition of many U. S. firms toward investing in Canada.

3. What are the Council's opinions as to the appropriateness of recent policies with respect to the U. S. balance of payments? What are the possible contributions of commercial banking practices and policies to the solution of the balance of payments problem, especially in the light of the impact on the deficit of capital outflows?

The Council would welcome the opportunity to discuss with the Board recent policies with respect to the U. S. balance of payments.

The commercial banks might make a contribution to the balance of payments problem if they tended to limit the extension of credit abroad to the short-term financing of exports. However, the increasing demand for credit of all types by credit-worthy foreign borrowers, and the availability of reserves in the banking system, together with the desire to improve bank earnings, have resulted in the expansion of the foreign loans of intermediate maturity of the larger commercial banks. The interest equalization tax undoubtedly contributed to this development in the banking system over the past year.

Governor Daane inquired whether the uncertainty of the interest equalization tax's applicability to banks had interfered with or deterred financial transactions abroad. He was particularly interested in knowing whether the Gore amendment that would permit bank loans to be made subject to the tax had caused banks to change their attitude toward foreign loans.

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Several members of the Council stated that they assumed, even if bank loans later were brought under the tax, it would not be applied retroactively. In the meantime, it was doubtful that passage of the law had affected bank attitudes toward foreign lending.

Mr. Cook suggested that the possible applicability of the interest equalization tax may have temporarily slowed down negotiation of loans to Japan, but that the pace would undoubtedly quicken in due course because of the need for capital in that country. In judging the impact of the interest equalization tax, it was necessary also to bear in mind the distinction between loans to finance the movement of capital goods in foreign trade and foreign loans.

Governor Daane then inquired whether the interest equalization tax had had an effect upon the maturity pattern of foreign loans.

President Moorhead responded that such appeared to be the case; shorter maturities coupled with renewal clauses were being resorted to. In his opinion, this presented a potentially dangerous situation. For example, Japan had a short-term foreign loan liability of about \$2 billion, and there was no way these commitments could be worked out other than by refunding. He assumed that, so far as the balance of payments was concerned, the chief purpose of U. S. monetary policy was to maintain rates in this country at a level that would mitigate the capital outflow. This being the case, U. S. monetary policy could have a distinct impact upon the disposition of foreign borrowers to contract debts in this country, either in the form of new commitments or in connection with refinancing.

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Chairman Martin observed that the rate of interest was the only aspect of policy for which the Federal Reserve had a direct responsibility. However, he felt that Government departments generally had adhered to the guidelines concerning the balance of payments set out by President Kennedy on July 18, 1963.

Chairman Martin then inquired whether on the basis of the discussion this morning it would be fair to say that the availability of funds rather than the rate of interest was the important consideration in the movement of funds abroad.

President Moorhead responded that availability of funds plus the rate plus the season or other timing factors all had a bearing, and Mr. Smith stated that the availability of funds was a very important factor.

Mr. Day said that there was another important aspect: it was customary for Japanese borrowers to keep substantial compensating balances at the lending bank--up to 30 per cent of the amount of the loan in many cases--and this was something that banks could not get in their domestic loans. The result was that the effective rate on foreign loans was increased. On the other hand, he observed that of the approximately \$2 billion of Japanese short-term liabilities, only about 25 per cent was represented by so-called "impact loans" requiring refinancing; the balance of the commitments was of a self-liquidating nature.

4. What are the Council's views regarding the appropriateness of recent monetary and credit policy?

At the April meeting with the Board of Governors the Council observed that

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" . . . recent monetary and credit policy has been a major factor in the expansion of the economy to its present high level. However, in view of the current volume of business activity, and the anticipated additional stimulation from the tax cut, the possibility of a renewal of wage-cost increases, and the probable pressures on prices, the Council believes that monetary and credit policy should now move gradually in the direction of restraint."

In the light of the continuing expansion of the economy since then, the Council reaffirms this view.

Chairman Martin invited further comment from the Council regarding the opinion expressed in its memorandum to the Board that "monetary and credit policy should now move gradually in the direction of restraint." He indicated that of particular interest in this connection would be the Council's judgment on how gradually the recommended restraint should be imposed.

President Moorhead observed that the matter of timing was difficult to assess; in his view, the economic situation during the last six months had been relatively stable, although there was increasing evidence of inflationary pressures on prices.

Mr. Watlington noted that at the meeting of the Council on the previous day the consensus had been that a movement toward restraint should commence promptly.

Mr. Aston thought it fair to say that there was an inflationary tone in the economy that was a little louder and clearer than for some time.

Governor Robertson then sought the opinion of the Council as to what might be done in terms of monetary policy to offset this tendency toward inflation. For example, would the Council recommend an increase in the discount rate?

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Mr. Aston replied that he thought the System had already moved in the direction of less ease by lowering the amount of free reserves. A further step might be to increase the discount rate, but he doubted that this was called for at the present time.

President Moorhead commented that, in his judgment, the economic situation was about right at the present time. He would like to see things maintained about as they are--the general level of business, interest rates, and so on. This might require a little less ease than at present, but he would not think that anything as drastic as a change in discount rate was called for.

Mr. Harrington said that he would not favor an increase in the discount rate at this time.

Mr. Moore agreed with the comments of President Moorhead. It had not yet become entirely clear whether the Federal Reserve was tightening up, but free reserves had gone down for the past three weeks and many persons had wondered whether the System had moved toward a lower level of free reserves or whether this was just an aberration. If this proved to be a sustained move, it would be a signal that would start to be understood soon and would have an effect. He thought that the System could go along for a while in this manner although his feeling was that this was not an inappropriate time to consider the kind of policy that would be a little more restrictive. There was still a lot of uptake in the economy. He could not see that the economy would be disrupted if the System moved ahead toward a little less ease than now existed. It might have an effect in the real estate area and this might be a very desirable thing. To sum it up, a consistent dropping of free reserves

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to the level that had existed in the past three weeks would be a mild signal to the public of less ease. It was his feeling that a change in discount rate might wait.

President Moorhead added the comment that if the balance of payments problem became serious enough the domestic economy would be able to stand an increase in the discount rate and such a move would have a definite effect.

Chairman Martin then sought clarification of the Council's recommendation for a "gradual" movement in the direction of restraint. He expressed the opinion that there had not been significant inflationary developments in the economy as yet, and solicited the views of the Council as to whether it would be preferable to wait until there were clear indications of an inflationary move, or whether the System should anticipate such a development by action at the present time. He noted that the Council also had recommended last April a "gradual" move toward restraint, and he asked for comments on whether the members felt that the present need was different from that in April.

President Moorhead responded in the negative, stating that he would be inclined to wait.

Mr. Smith observed that the tone of the economy when the Council last met in April was somewhat different from that prevailing now, but in his opinion the Board had done a good job in the area of monetary policy during the intervening period. However, the longer credit restraints were delayed the more inflationary stimulus there would be to the economy. In his view, there was now enough evidence of inflationary developments

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to justify moving definitely to tighten the availability of lendable funds, holding the adjustment of discount rates in reserve for use at a later date if necessary.

Mr. Watlington expressed the opinion that inflation was much more apparent now than last April. He agreed with Mr. Smith's views now, although he had not felt in April that a definite move toward restraint was called for.

Mr. Breidenthal posed the question whether there was any thought that action by the monetary authorities in April would have had an effect on the terms of the Chrysler Corporation's wage contract settlement. He doubted it, and he now felt that more would be needed than an increase in discount rate to deal with the situation. He did not like the word "gradual"; positive steps would be needed and the Board should be on the alert and ready to act as soon as the boom appeared.

Mr. Martin commented further that in April we were facing the dilemma of the Federal tax cut and its consequences. The economy absorbed this development readily and business was now at a high level. In his opinion, the monetary policy pursued by the Board had been exactly right. However, with the second stage of the tax cut in prospect, some move toward lower free reserves might be desirable; this would be helpful and the most flexible of the steps that the System might take at this time.

Mr. Stoner expressed concern about the inflationary trend he saw developing in the economy. He would move gradually toward less ease but would not be in favor of raising discount rates at this time.

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5. The Council would appreciate discussing with the Board the relatively recent techniques employed by some commercial banks in an effort to obtain funds in the money markets. These techniques include negotiable Certificates of Deposit, subordinate debentures, and more recently the sale of shorter-term notes. The discussion would also deal with Regulation Q and present interest rate ceilings.

The members of the Council would like to discuss these developments with the Board. The following are among the items of interest: Will notes eventually be issued for shorter and shorter maturities such as 10 days, five days, one day, or on demand? How small are the denominations likely to be? Will State banks in some States have far greater borrowing power than national banks? How widespread must this development be before it significantly affects monetary policy? Will the use of notes result in an important decline in demand deposits? In negotiable certificates of deposit? In savings deposits? Are Fed funds considered borrowings, thereby limiting the amount of notes a national bank may issue?

Would it be desirable now to consider a change in Regulation Q relative to deposits with a maturity of more than one year?

President Moorhead said that the Council would be interested in discussing whether there should be an increase in the maximum permissible rate payable on time deposits maturing in more than a year.

Mr. Watlington said he did not think there was any feeling of unanimity that such rates should be raised, and he assumed that no banks wanted an increase in the rates for less than a year.

In connection with the new techniques being developed by banks to gain access to money-market funds, Governor Robertson expressed the opinion that the practice of selling unsecured negotiable notes recently inaugurated by the First National Bank of Boston could well spread rapidly and create problems for bankers and supervisory authorities alike. In his view, two important issues in connection with this question were

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whether there was a need for regulatory legislation and whether the practice constituted an evasion or circumvention of Regulation Q. In Governor Robertson's opinion, the practice was entirely legal under existing law and regulations, but that fact was not determinative of the desirability of the practice because--should it become widespread--the ability of the monetary authority to function could be seriously hampered in periods when restraint was needed. Under sections 11 and 19 of the Federal Reserve Act, the Board had an obligation to issue regulations to prevent the evasion of statutory provisions which it administers. Thus, under Regulation Q, the Board could define time and demand deposits to cover all lendable funds, procured from whatever source, except Federal funds. At the present time, he felt that it would be well for the Board to observe developments in this area and to act only if the practice should develop to the point that supervisory problems appeared imminent. He noted that certain collateral difficulties were presented by the fact that some State statutes were more liberal regarding the issuance of notes by State banks than were the Federal statutes governing such activities by national banks. Also, the ruling by the Comptroller of the Currency that Federal funds transactions constitute a purchase and sale rather than borrowing and lending could complicate the framing of an effective regulatory provision to cover all possible methods that might be developed by banks to procure lendable funds.

Mr. Cook suggested that perhaps one answer to the dilemma might be to allow banks to pay different rates on stipulated proportions of their funds. Banks were faced with the necessity of conforming to too

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many regulations, leading to difficulty in figuring out how to use lendable funds most effectively within the structure of the various regulations, so that there was a tendency on the part of banks to underlend. By contrast, finance companies, unhampered by such a regulatory maze, had been able to put their short-term money to good use. The development of devices such as the issuance of unsecured notes resulted from the fact that many banks were already at or close to the Regulation Q ceiling of interest rates on time and savings deposits and they were seeking alternative devices to secure additional funds.

Mr. Day concurred in Mr. Cook's concluding observation, stating that banks had been forced into the position of departing from their traditional sources for lendable funds in order to meet the loan demands of their customers.

Governor Balderston commented that during a discussion with Mr. Harrington the previous week, the latter had raised the point that the use of negotiable notes to procure funds was in the nature of a "seasonal equalizer." However, Governor Balderston indicated some reservation as to the marketability of notes of small banks, a factor which was a major consideration in assessing the impact of the use of these notes upon the banking structure; the result could well be a significant flow of capital to large city banks at the expense of their metropolitan competitors or small country banks.

President Moorhead said that country banks might find that the market for their notes would be the banks' own customers, which would mean that there would be an equivalent loss of deposit funds; in other

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words, for these banks the net result would generally be merely the payment of interest on a portion of their loanable funds higher than that permitted by Regulation Q, rather than any augmentation of the pool of such funds.

Mr. Harrington indicated his belief that most small banks would not use this technique. However, at the right rate they could always find a market.^{1/}

6. The Council would like to discuss with the Board of Governors the new regulations with respect to "securities of member State banks" including the "proposed form of registration of securities of a bank."

The members of the Council are deeply concerned about the practical implementation of the proposed new regulation with respect to "securities of member State banks" including the "proposed form of registration of securities of a bank."

The Council feels strongly that the Board of Governors should hold a series of private hearings to consider all aspects of the proposed regulations before they are made effective.

Chairman Martin noted the suggestion for "private" hearings, and he questioned why the Council felt that any such hearings should not be open to anyone interested.

Mr. Day responded that he had suggested this wording, thinking that the regulation in question was solely within the purview of the Board's responsibility vis-a-vis the banking community.

President Moorhead said that there was no objection to full disclosure. The Council was simply suggesting that there be an opportunity

^{1/} At this point Mr. Hackley, General Counsel, and Mr. Hexter, Assistant General Counsel, entered the meeting room.

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for discussion by all entities interested in the subject matter. There were a number of problems raised by the proposed regulation, and since commercial banks would be directly affected they should be given the fullest possible opportunity to bring them to the Board's attention. He had not thought a public hearing necessary.

Chairman Martin expressed doubt that many witnesses would seek the opportunity to appear, and therefore was inclined to the view that open hearings would be entirely feasible.

Mr. Moore replied that he did not think the Council cared whether the hearings were private or public, but there were a good many important issues to be resolved in connection with the proposed regulations, especially in the area of compliance with the registration and filing requirements, and it was important that interested persons be given full and complete opportunity to point these matters out to the Board.

Governor Robertson commented that the very manner in which the regulation had been published for comment indicated that the Board wanted the views and assistance of experts before promulgating the regulation in final form. This was especially true in the area of establishing a uniform system of accounting. Over the years, bankers and supervisory authorities alike had been concerned with disclosure to protect depositors rather than investors, and a uniform system of accounting was not needed for this purpose. However, the Board was now faced with the problem of attempting to bring about uniform reporting of financial data for the benefit of investors. Collateral questions to be considered were whether, if uniform accounts were utilized, there would be any need for certification of

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financial statements by certified public accountants; whether, indeed, there was any need at all for such certification if banks had a good internal auditing system; and, in the latter connection, whether bank examination procedures should be expanded to include spot checks of auditing procedures.

Mr. Watlington observed that the vast majority of banks wanted to make full and adequate disclosure of their financial affairs, but they hoped this could be accomplished without handicapping them in their communities. The problem was compounded by the fact that the accounting profession itself had no uniform system of accounts. He commented that the auditing department of the bank of which he was an officer verified not only the books but critically reviewed operating procedures as well, something that an outside firm of auditors would be unable to do. His bank had estimated the cost of an outside audit at \$200 thousand; in view of the expense involved, he suggested that perhaps an effective compromise that would still be sufficient to protect the interest of stockholders would be for an outside auditing firm to make test checks rather than a complete audit. Nevertheless, he expressed skepticism that outside audits would accomplish the desired result in terms of permitting effective comparison of the financial data reported by banks unless the accounting profession itself could develop uniform procedures to be applied.

Governor Robertson said that even the large accounting firms had very few persons capable of handling the audit of a bank. The only concern of the Board was that some system of accounting be employed that

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would allow uniformity of comparison and analysis of financial statements for the protection of investors, while at the same time not imposing an undue burden on the banks. The key question was how this objective could be achieved.

Mr. Day suggested that one approach would be to have independent auditors evaluate and pass upon the adequacy of procedures and controls set forth in the banks' audit manuals, as was already being done by many banks in the Third Federal Reserve District.

Mr. Watlington noted that the Federal Reserve examiners already got a good idea of the adequacy of the internal auditing procedures in the banks which they examined. The real problem in connection with implementing the proposed regulations was, in his view, securing uniformity in such procedures. Another matter to which the Board might well give serious consideration would be allowing banks to lump officers' salaries in their financial statements; the Board already had access to information concerning individual salaries from its examination reports, and he could see no virtue in itemizing this information for public scrutiny.

Governor Balderston observed that the Board was faced with a dual problem, one of a short-term nature and one of a long-term nature; on the one hand, the Board had a statutory mandate that it had to implement promptly, while on the other hand it would be folly to expect that the accounting practices of an entire industry could be changed in a few short months. One method of coping with this dilemma which he thought might be feasible would be to work out short-run standards for immediate application, subject to review, and change where indicated, on the basis of continuing study.

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Mr. Day pointed out that another stumbling block to uniformity in accounting lay in the area of banks' reserves for bank debts; under some views, a particular reserve might be considered excessive in comparison with reserves of other banks, yet this was essentially a matter within the purview of the Internal Revenue Code rather than a matter that was susceptible of comparison based solely upon uniform accounting treatment.

Mr. Aston said that the matter of uniform accounting practices was not the only problem area in connection with the proposed regulations; for example, with respect to legal proceedings in the preliminary stages, how could a bank possibly be expected to decide whether they would develop into anything significant from the standpoint of deciding whether disclosure was necessary for the sake of investor protection? And even if this could be determined, there remained the further question of how much comment would satisfy the disclosure requirements. Another matter for consideration which he cited was the policy of a bank regarding remuneration and fringe benefits of its officers; this information usually is extremely sensitive from the standpoint of morale and motivation of a bank's official staff, and its disclosure might well lead to serious problems for bank management.

Mr. Watlington suggested that perhaps the solution to the matter of uniform accounting procedures would be to form a committee, comprised of representatives of leading accounting firms, the controllers of several member banks, and members of the Board's staff, to develop a proposed standard report based on sound accounting principles.

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Governor Robertson inquired whether his understanding that the American Bankers Association had appointed a committee to study the Board's proposed regulation regarding securities of member State banks was correct.

The response from Members of the Council was affirmative, the consensus being that the A.B.A. committee would develop positive suggestions for revision of the proposed regulation rather than merely objecting to its present form.

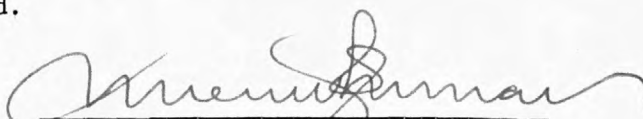
In response to inquiries as to when the Board might promulgate the new regulation, Governor Robertson stated that October 21, 1964, had been set as the closing date for comments by interested persons, but the amount of time thereafter that would be required to revise the preliminary draft was an unknown factor.

Mr. Breidenthal expressed the view that commercial accounting firms would not be prepared to provide the certifications called for in the Board's proposed regulation. In his opinion, the development of uniform accounting methods and procedures was the only solution.

Mr. Watlington commented that in this connection the need for developing such uniform standards was particularly acute with respect to the financial affairs of smaller banks, since the larger ones already had, in general, sophisticated and reliable internal audit procedures that could be relied upon to disclose operating data accurately.

It was agreed that the next meeting of the Federal Advisory Council would be scheduled for November 16-17, 1964.

The meeting then adjourned.


Secretary