Minutes for July 21, 1965.

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. Robertson __________

Gov. Balderston __________

Gov. Shepardson __________

Gov. Mitchell __________

Gov. Daane __________

Gov. Maisel __________

Minutes of the Board of Governors of the Federal Reserve System on Wednesday, July 21, 1965. The Board met in the Board Room at 10:00 a.m.

Present: Mr. Balderston, Vice Chairman
Mr. Robertson
Mr. Mitchell 1/
Mr. Daane
Mr. Maisel

Mr. Sherman, Secretary
Mr. Young, Adviser to the Board and Director, Division of International Finance
Mr. Noyes, Adviser to the Board
Mr. Fauver, Assistant to the Board
Mr. Solomon, Director, Division of Examinations
Mr. Hexter, Assistant General Counsel
Mr. Goodman, Assistant Director, Division of Examinations
Mrs. Semia, Technical Assistant, Office of the Secretary
Mr. McClintock, Supervisory Review Examiner, Division of Examinations
Mr. Furth, Consultant

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

	Item No.
Letter to Bank of America, New York, New York, granting permission to purchase additional shares of Banca d'America e d'Italia, Milan, Italy.	1
Letter to Manufacturers Hanover Trust Company, New York, New York, approving the establishment of a branch at 156-20 Northern Boulevard, Flushing.	2

With respect to Item No. 2, Governor Robertson referred to discussions by the Board on June 14 and July 1, 1965, regarding protests to the establishment of the proposed Manufacturers Hanover branch in

1/ Entered meeting at point indicated in minutes.

Flushing that had been filed by certain banks, and at his request Mr. Solomon summarized the reply of New York Superintendent of Banks Wille to an inquiry as to the validity of the complaints. The information given by Superintendent Wille had confirmed the view of the Division of Examinations, based on conferences with officers of the protesting banks, that there was not sufficient ground for the protests to justify denial of the application. One of the facts cited by Mr. Wille was that the distance of more than a mile between the nearest office of Flushing National Bank and the proposed branch site had been considered by the State Banking Department to be too great, in a densely-populated urban area, to have any substantial adverse effect on the national bank.

Governor Mitchell entered the meeting during discussion of Item No. 2, and Messrs. Noyes and Furth withdrew.

Outside audits of insured banks. There had been distributed a memorandum dated July 16, 1965, from Mr. Solomon in connection with requests from the House Committee on Banking and Currency for reports on H. R. 40 and H. R. 123, which would require outside audits of all insured banks. The Federal Reserve Banks had been asked to comment on the bills, in response to which, generally speaking, three Banks had favored compulsory annual outside audits, seven Banks had favored or would concur in authorizing the Federal supervisory authority to require an outside audit where appropriate, and two Banks had opposed any legislation on the subject at this time.

Attached to the memorandum was a proposed report on the bills that would express opposition to compulsory outside audits, principally on the grounds of extra expense and possible weakening of the internal audit function. The draft report would express sympathy, but not strong support, for legislation authorizing the respective Federal supervisory authorities to require outside audits in individual cases where appropriate.

Governor Maisel remarked that the legislative proposals seemed to be based on the argument that examination of a bank protected the depositors but that an outside audit was needed to protect the bank's stockholders. He was unable to understand why that reasoning was not logical, and it seemed to him that the draft letter was not responsive to it.

Mr. Solomon responded that while there might be merit in that argument, he did not give it as much weight as some people did. There were serious considerations that were adverse to compulsory outside audits, first as to cost, and second as to effectiveness. He was dubious as to the alleged greater value of outside audits over internal controls for most purposes. He believed that a good internal auditing system was superior to an external one for preventing fraud, which was the important problem for most small banks. There was a danger that if a bank arranged for an outside audit, it would try to recover the cost by skimping on its internal controls, which could quite easily result in greater loss than any that might have been forestalled by the outside audit. This was especially true in the light of the fact that there were not a great number of auditors qualified to do a good job in a bank.

Governor Maisel observed that an auditor must sign a statement that he had conducted his project according to generally-accepted accounting procedures, whereas there was no similar requirement with respect to internal controls, to which Mr. Solomon replied that there was a great deal of flexibility in accounting principles as applied to banks, with a net result that as far as banking was concerned such principles became quite nebulous. Governor Maisel then commented that standards could be established over a period of time; the fact that they were not well-defined now did not preclude an effort that would establish them for general acceptance. His own feeling was that the suggestion that Federal banking authorities be authorized to require outside audits in individual cases would require that the authorities admit that they were not doing a good job in protecting depositors through examinations.

Mr. Solomon commented that some benefits in the way of establishing standards could probably be expected through administration of the Board's Regulation F, Securities of Member State Banks, under which in most cases reports and statements could be vouched for either by the bank's own officers or by independent accountants.

Governor Robertson stated that his general feeling was that bank supervision should not include an audit of banks; if it did, the supervisory agencies would have to have many times their present staff. An examination included appraisal of management and assets, and a spot-check of liabilities. In addition there must be other safeguards, one of which was internal audit. The supervisory authorities for a long time had encouraged development of good internal audit systems and had been successful in many banks, although some small banks still felt that such a system was too expensive and would rather buy a surety bond. Governor Robertson believed it was highly advisable that the Federal bank supervisory authorities have power to require a bank to have an outside audit if it did not have a good system of internal controls. Moreover, they should be, and in fact were, in the process of developing criteria; the Board's staff had been meeting with a committee of the American Bankers Association, and others, to determine means of ascertaining the quality of internal audit processes. He thought this was a step in the right direction. If outside audits were required by law, it was likely that they would be slipshod jobs because there were not enough qualified auditors to handle audits of all insured banks. In summary, he believed that the Board should be striving for good internal audits, for the power to require that any bank that did not have a good internal control system have an outside audit, and for direct verification with a bank's customers as to their accounts with the bank. In continuing comments, Governor Robertson offered suggestions for revisions of the draft letter.

The ensuing discussion included comments on the consultations with accounting firms and bankers that had preceded the issuance of the

Board's Regulation F, especially from the point of view of whether certification of bank statements by outside accountants should be required; on the wide variation of procedures among public accounting firms; and on the extent to which an outside audit would result in duplication where a bank had a good system of internal controls. It was brought out that there was some indication that the Comptroller of the Currency and the American Bankers Association were opposed to having the bank supervisory authorities have power to require outside audits, but that it was believed that the Federal Deposit Insurance Corporation now would favor such authority.

Governor Daane stated that he believed it was important that the Board and the Corporation be in accord as to such a provision.

Governor Mitchell expressed the view that the draft report was weak and evasive of responsibility. He believed that the Board had done the right thing in not requiring a public accountant's certificate under Regulation F, but the present point was different. The proposed legislation sought to make someone responsible for the integrity of accounts in banks, and he thought someone should be responsible. It seemed to him that the Board should base its position on the principle that when people put their money in a bank they could assume that adequate accounting safeguards existed in that bank; that principle ought to be enforced even if it cost the bank money. In his view, a strong, honest position would be that the Federal bank supervisory authorities should make a positive finding that internal controls in a particular bank were adequate, and if they were not adequate, the law -- not the supervisory authority -- should require the bank to have an outside audit. This would put the burden on the supervisor to remove from any bank the requirement of an audit. He did not believe that the expense of an audit to a bank should be a consideration; if a bank could not afford either adequate internal controls or an outside audit, it should not be in the banking business.

Discussion of Governor Mitchell's suggestion turned principally on the efforts that had been going forward to encourage banks to improve their internal auditing systems. The view was expressed that the program would come to a halt if a requirement were in effect that the supervisor make a positive finding of adequacy, because many banks might have a system that was not entirely adequate, but was being improved.

Governor Balderston recalled that during formulation of Regulation F there had been much discussion to the effect that bank examinations were intended to protect depositors, whereas the expansion of the Securities Exchange Act to cover bank stocks in certain respects was intended to provide guidance for stockholders in banks of a certain size. He inquired what the aim of the bills under consideration was in terms of protection. Responses indicated that the purpose was probably a combination of protection of the interests of both depositors and stockholders.

Governor Robertson expressed the view that a more fundamental purpose was protection of the public from the loss of confidence in the banking system that arose from bank failures.

After further discussion it was understood that a revised draft of letter reflecting the tenor of views expressed would be prepared for the Board's consideration.

The meeting then adjourned.

Secretary's Notes: On March 3, 1965, the Board approved the issuance of a set of guidelines for the use of commercial banks under the voluntary foreign credit restraint effort, a part of the President's balance of payments program. With the approval of Governor Robertson, acting under the authority vested in him by the Board for administration of Federal Reserve functions related to the conduct of the voluntary program, there was sent today to the Presidents of the Federal Reserve Banks, for transmittal to commercial banks, a revision of guideline 5, having to do with bank sales of foreign assets to U.S. residents. A copy of the letter to the Reserve Banks, with enclosure, is attached as Item No. 3.

Acting in the absence of Governor Shepardson, Governor Balderston today approved on behalf of the Board memoranda recommending the following actions relating to the Board's staff:

Salary increases, effective August 1, 1965

Name and title	Division	Basic annual salary From	To
	Board Members' Offices		
Ruth Elizabeth Morris, Secretary		$ 7,510	$ 7,730
	Office of the Secretary		
Mary P. Morris, Secretary		5,000	5,165

Salary increases, effective August 1, 1965 (continued)

Name and title	Division	Basic annual salary From	To
	Research and Statistics		
Julia G. Back, Library Assistant		$ 4,630	$ 4,780
James P. Bennett, Economist		10,605	10,960
Loree D. Bernard, Statistical Assistant		5,330	5,495
Edward R. Fry, Economist		12,075	12,495
John H. Wood, Economist		12,075	12,495
	Administrative Services		
Thomas A. Whitty, Guard		4,140	4,275
	Data Processing		
Dale K. Osborne, Economist		12,025	12,380
Mack R. Rowe, Chief, Economic Graphics Section		10,250	10,605

Acceptance of resignation

Barbara Joan Butler, Draftsman, Division of Data Processing, effective at the close of business July 16, 1965.

Permission to engage in outside activities

Edward C. Ettin, Economist, Division of Research and Statistics, to teach courses in Money and Banking at George Washington University and the University of Maryland.

After consideration of a memorandum of July 14, 1965, from Mr. Langham, Assistant Director of the Division of Data Processing, and a memorandum of July 16, 1965, from Mr. Kakalec, Controller, Governor Shepardson on July 20, 1965, authorized Mr. Langham to negotiate with the appropriate representative of the Department of State concerning the Department's request for 20-30 hours a week on the Board's computer for the next four or five months, such negotiation to be on the basis that the rate of reimbursement would be $45 per hour.

Secretary

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

Item No. 1
7/21/65

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 21, 1965.

Mr. Tom B. Coughran,
Executive Vice President,
Bank of America,
41 Broad Street,
New York 15, New York.

Dear Mr. Coughran:

Reference is made to your letters of February 26, 1965, and July 13, 1965, regarding the acquisition of shares of your substantially owned subsidiary, Banca d'America e d'Italia ("BAI"), Milan, Italy.

It is noted that under the consent granted by the Board of Governors on September 12, 1957, your Corporation acquired 11,674,456 shares of BAI. Under the Board's consent of November 18, 1957, authorizing the purchase of such shares of BAI owned by minority shareholders as might be offered for sale until March 31, 1958, it is understood that 822 additional shares were acquired.

Your letter of February 26, 1965, stated that, in order to provide a basic authority for acquisition of additional shares of BAI, the Board of Directors of your Corporation authorized the purchase of up to 200,000 shares of stock at a price not to exceed Lire 2,000 ($3.20) per share. You further stated that several offerings had been made and that as a result you had acquired 71,150 additional shares at a cost of $223,076.32. Your letter of July 13, 1965, stated that during the second quarter of 1965 you purchased 28,586 additional shares of BAI at a cost of $90,066.59 and that this brings your total investment in BAI to 11,775,014 shares at a total cost of $11,870,756.50.

In accordance with your request and consistent with condition numbered (1) of the Board's consent of September 12, 1957, the Board grants consent for your Corporation to purchase and hold up to 200,000 additional shares of BAI, including the 99,736 shares above mentioned.

The foregoing consent is given with the understanding that the foreign loans and investments of Bank of America, combined with those of Bank of America National Trust and Savings Association, including the investment now being approved, will not exceed the guidelines established under the voluntary foreign credit restraint effort now in effect.

Very truly yours,

(Signed) Karl E. Bakke

Karl E. Bakke,
Assistant Secretary.

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

Item No. 2
7/21/65

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

July 21, 1965.

Board of Directors,
Manufacturers Hanover Trust Company,
New York, New York.

Gentlemen:

The Board of Governors of the Federal Reserve System approves the establishment by Manufacturers Hanover Trust Company, New York, New York, of a branch at 156-20 Northern Boulevard, Flushing, Borough of Queens, New York, New York, provided the branch is established within one year from the date of this letter.

Very truly yours,

(Signed) Karl E. Bakke

Karl E. Bakke,
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.)

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

VCRI-8 Item No. 3
7/21/65

JAMES LOUIS ROBERTSON
MEMBER OF THE BOARD

July 21, 1965.

TO THE PRESIDENTS OF ALL FEDERAL RESERVE BANKS.

Dear Sir:

Bank Guideline No. (5) has been revised to permit banks to sell foreign securities owned on December 31, 1964, to U.S. residents without an equivalent reduction in the bases of the banks.

This revision, which represents mainly a technical adjustment, was prompted by the nature of the asset. The requirement to reduce the base upon the sale of foreign securities restricts the flexibility of the investment accounts of the banks. The application of the guideline to sales of securities to U.S. residents is impractical in view of the impersonal nature of the securities market. Finally, the revision is consistent with an interpretation issued recently relating to foreign securities held by nonbank financial institutions.

Sales to U.S. residents of foreign loans or participations therein owned on December 31, 1964, by banks will continue to require a reduction in the base by an equivalent amount.

There is enclosed a copy of the revised Guideline No. (5) which may be reproduced for distribution to commercial banks in your District.

Sincerely,

J. L. Robertson

Enclosure.

(5) Bank Sales of Foreign Assets to U.S. Residents.

In general, banks should not expand their lending abroad by selling to U.S. residents (including U.S. banks) claims on foreigners (except foreign securities) existing on the base date and replacing such assets with other loans to foreigners. Sales to U.S. residents of foreign loans or loan participations could assist a bank to stay within the 5 per cent target, but clearly would not benefit the U.S. payments position. Therefore, in the event of any such sales the bank's base should be reduced by an amount equivalent thereto.