Minutes for March 29, 1966

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 proposed to place in the record of policy actions required to be kept under the provisions of section 10 of the Federal Reserve Act an entry covering the item in this set of minutes commencing on the page and dealing with the subject referred to below:

Page 14 Amendment to Regulation R, Relationships with Dealers in Securities under Section 32 of the Banking Act of 1933.

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 to indicate approval of the minutes.

Chm. Martin
Gov. Robertson
Gov. Shepardson
Gov. Mitchell
Gov. Daane
Gov. Maisel
Gov. Brimmer
Discount rates. The establishment without change by the Federal Reserve Bank of Boston on March 28, 1966, of the rates on discounts and advances in its existing schedule was approved unanimously, with the understanding that appropriate advice would be sent to the Bank.
Approved items. The following letters, copies of which are attached to these minutes under the respective item numbers indicated, were approved unanimously after consideration of background information that had been made available to the Board:

Item No.

Letter to Midway Bank & Trust, Cedar Falls, Iowa, waiving the requirement of six months' notice of withdrawal from membership in the Federal Reserve System.

Letter to the Federal Deposit Insurance Corporation regarding the application of Lyon County State Bank, Rock Rapids, Iowa, for continuation of deposit insurance after withdrawal from membership in the Federal Reserve System.

Compounding of interest. Pursuant to the understanding at the meeting on February 9, 1966, the comments of the Federal Reserve Banks had been obtained on a proposed amendment to the Supplement to Regulation Q, Payment of Interest on Deposits, that would permit member banks to pay interest on time and savings deposits at the maximum permissible rate, compounded on any basis that a member bank might wish to adopt. (At present, interest could be compounded on any basis, provided that the amount of interest so compounded did not exceed the amount of interest at the maximum permissible rate when compounded quarterly. The proposed amendment would state that in calculating the rate of interest paid, the effects of compounding of interest could be disregarded.)

The Reserve Bank comments were summarized in a distributed memorandum from the Legal Division dated March 17, 1966. It appeared that
seven Banks favored the proposal, four Banks were generally in favor of the proposal but questioned whether it was appropriate at this time, and one Bank questioned both the merits and the timeliness of the proposal.

In discussion Governor Mitchell suggested additional language for the proposed amendment which would state that a member bank that elected to compound interest, either at the maximum permissible rate or at a lower rate, must state the basis of compounding in every advertisement, announcement, solicitation, and agreement relating to the rate of interest paid on deposits. The purpose of such language would be to minimize deceitful advertising.

In reply to a question whether the proposed amendment would mean that member banks could pay more than 4 per cent on savings accounts by compounding frequently, Mr. Hackley explained that at present the Board's Regulation contained a footnote intended to make it clear that banks could pay a higher rate than the prescribed maximum rate to the extent that they could compound quarterly.

Mr. Hexter observed that the proposal now before the Board was to amend the Supplement to Regulation Q, which specified changes in basic maximum rates of interest from time to time. When a change was made in the Supplement, there were various interrelationships with the body of the Regulation, and he suggested that the staff be given an opportunity to determine the full effect of the addition of language such as Governor Mitchell had suggested.
The point about timeliness that had been raised by several Reserve Banks was mentioned during the discussion, and staff expressed the view, in reply to a question, that the point was arguable both ways.

Governor Maisel suggested that the Board go through the preliminaries to adoption of an amendment and then consider the question of timeliness before taking final action, in light of whatever circumstances might prevail at that particular time. He noted that the Legal Division had suggested that the next preliminary step would be to request the views of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

At the conclusion of the discussion, it was understood that the staff would review the proposed amendment in light of the additional language suggested by Governor Mitchell, and that it would bring back to the Board a revised draft of amendment along with any comments.

**Definition of promissory notes and other forms of indebtedness as deposits (Item No. 3).** Pursuant to the understanding at the meeting on January 20, 1966, there had been published in the Federal Register a notice of proposed rule making on the definition of "deposit" for purposes of Regulations D, Reserves of Member Banks, and Q, Payment of Interest on Deposits.

The responses received from sources outside the Federal Reserve System were distributed with a memorandum from the Legal Division dated February 28, 1966. Analysis of the comments and certain staff recommendations with respect thereto were submitted with a memorandum from the
Legal Division dated March 15, 1966. There had also been distributed a letter from Chairman Randall of the Federal Deposit Insurance Corporation dated March 17, 1966, indicating that it would seem desirable for all of the Federal banking agencies to have a uniform definition of the term "deposit" and suggesting that the Board of Governors withhold adoption of its proposed amendments until the Corporation's Board of Directors had had an opportunity to consider the matter and discuss it with the Board of Governors.

After statements by Messrs. Hexter and Sanders on the Legal Division's evaluation of the comments received, attention was called to a draft of modified proposal reflecting staff recommendations, as distributed with the March 15 memorandum. At this meeting Mr. Sanders distributed a further revised draft of a part of the proposed definition of deposit.

Mr. Holland said that he had gone over the modified proposal with the Legal Division and with Mr. Holmes, Manager of the System Open Market Account. Both he and Mr. Holmes believed the proposal was now so worded that money market operations were not going to be seriously affected except insofar as the use of promissory notes was concerned. He called attention, however, to the fact that very recently "due bills" were also being used by a few banks as a means of obtaining funds. These due bills were in substance indistinguishable from promissory notes of the type that the current proposal was designed to bring within the
coverage of Regulations D and Q. Under the proposed amendment this kind of instrument would be classified as a deposit, and hence its use would be curtailed.

Governor Daane observed that an exemption from the definition would be provided for indebtedness arising from a transfer of direct obligations of the United States that a bank was obligated to repurchase. He noted that there had been suggestions for broadening this exemption to include repurchase agreements involving obligations of agencies of the United States, and beyond that to include such instruments as municipal bonds.

Mr. Holland replied that there might be some further pressure to broaden the exemption, particularly to include repurchase agreements involving Federal agency obligations. However, while the use of repurchase agreements involving direct Government securities was a firmly entrenched method by which banks obtained short-term funds, repurchase agreements involving other obligations had not been used for this purpose to any great extent.

Governor Robertson noted that all of the comments received had now been analyzed and an attempt made to revise the original proposal in such a way as to accommodate the suggestions thought to have merit. He inquired whether, if the modified proposal was now resubmitted to the Government securities dealers, the likelihood of getting adverse comments appeared to be great. If not, that step could be taken, and the Federal
Deposit Insurance Corporation also could be advised of the modified proposal and its comments requested. Then, within about 15 days, the Board should be in a position to adopt the proposed amendments.

Mr. Holland replied that he thought the staff had dealt with all of the substantive dealer comments, with the possible exception of repurchase agreements on agency obligations.

Governor Daane noted that Morgan Guaranty Trust Company had raised a more basic question, namely, whether the promissory note did not in fact perform a useful function. When the bank now found that the due bill was also included in the definition of deposit, it might well ask for an opportunity to present views orally to the Board. As to the comments of the New York Clearing House, they seemed to boil down mostly to whether the problem should not be approached by specifically defining promissory notes as deposits rather than by adopting an all-inclusive definition of deposit, with certain exceptions. This point was debatable, and the Clearing House might still want to be heard. This raised the question whether it was desirable to deny interested parties that privilege.

Governor Maisel inquired why the Legal Division took the position in its memorandum that interested persons should not be offered an opportunity to present oral argument, and Mr. Hexter replied that the purpose of publication of a notice of proposed rule making was to elicit written comments and suggestions for study and consideration. Such comments had
now been received, and the question was one of the extent to which the Board wanted to expand this procedure by also granting opportunity for oral presentation. In the Legal Division's view, the written communications that had been received on the rule-making notice did not seem substantial enough to warrant oral presentation unless the Board was considering the possibility of dropping the entire proposal.

Governor Daane commented that the Board did not have a closed mind and that he doubted whether it would want to adopt a posture of unwillingness to hear any person of appropriate standing.

Governor Robertson remarked that the Board had an understanding with the Government securities dealers that it would resubmit to them a modified proposal. If it took this step and the dealers then requested a hearing, such a request would have to be considered.

In further discussion a suggestion was made that the group to whom the modified proposal would be submitted for comment be enlarged to include certain banks that had submitted comments and also the New York Clearing House, so that it might be ascertained whether any of these parties would still desire to present their views orally.

At this point Governor Mitchell commented that when the matter of defining promissory notes as deposits first came up, Governor Maisel had expressed the view that an attempt to classify such borrowings as deposits was not the most appropriate way of disposing of the problem. Governor Mitchell recalled that he had at first tended to agree but
later was persuaded that something ought to be done on the promissory notes only. Matters then moved ahead and the problem of definition arose, with the result that all short-term indebtedness was now proposed to be defined as deposits, with certain exceptions. This approach created a number of complications. Perhaps, therefore, it would be desirable to go back and see if the promissory note problem could not be attacked specifically, and possibly the New York Clearing House could offer some draft language that would serve the purpose. For this reason, he would welcome discussion with the Clearing House.

There followed further discussion based on Governor Mitchell's comments, during which Governor Robertson expressed the view that if any parties were to be invited to meet with the Board they should first have the benefit of a reading of the modified proposal.

Governor Maisel said he was more and more convinced that the current proposal represented the wrong approach. For example, there had now developed the question with respect to repurchase agreements. An exemption had been provided for repurchase agreements on Government obligations so as to take care of the Government securities dealers, but he was concerned about the many banks that might be using repurchase agreements on other obligations. Some banks had commented to the effect that they used such repurchase agreements as a legitimate way of dealing with customers in conducting banking business, and he thought there was a good deal of validity in this argument. This was only one indication
of the difficulty of the present approach to the problem. When one tried to decide what was a borrowing or a deposit and what was not, the situation became very complicated.

Chairman Martin then suggested that, since the Board had gone this far, it might be well to resubmit the modified proposal to the securities dealers and the Federal Deposit Insurance Corporation and then review the whole matter thoroughly before action was taken. Mr. Hackley suggested that as a matter of equity it might be desirable to give all interested parties a chance to comment on the revised draft through publication in the Federal Register, with about 15 days allowed for comments, and Chairman Martin indicated that he would be agreeable to such a procedure.

Governor Maisel inquired whether, if the Board was going to republish, it would not be desirable to think out first the question of repurchase agreements. In his opinion the exemption should apply to all types of repurchase agreements, not only to those on direct Government obligations.

Governor Daane indicated that he tended to share this view, although he had no strong feeling, as far as Federal agency obligations were concerned. It was hard to say logically that this should not be done, particularly if these obligations were guaranteed by the U.S. Government.

Governor Robertson commented that obviously the exemption already made for repurchase agreements on direct Government obligations had been
included to avoid disturbances in the Government securities market.

Now the suggestion was to go one step further and include repurchase agreements on Federal agency obligations. He would not object strongly to republishing the proposed amendments in such form, but he had some doubt as to the necessity for it.

Governor Maisel inquired about the logic of stopping at that point, and Governor Daane noted that continued expansion of the exemptions might tend to defeat the whole purpose of the amendments.

Mr. Hexter observed at this point that the objections of the banks and securities dealers to the proposed amendments should have been anticipated. The objective of the Board in publishing the notice of proposed rule making was to try to enforce the provisions of the Federal Reserve Act which state that no member bank, either directly or indirectly, shall pay interest on deposits that are payable on demand. The Board had defined as demand deposits funds received by a bank payable in less than 30 days, and the purpose of the proposed amendments was to make that position effective. For various reasons, the Board had felt it necessary to depart somewhat from the basic position by providing certain exemptions from the scope of the proposed amendments. It was natural that the banks desired maximum freedom, but the primary objective was to enforce the law, even though banks might prefer that the law be different. As long as the law was in effect, the Board had a duty to administer it.

Chairman Martin then commented in some detail on the practice that had grown up over time with respect to the use of repurchase
agreements on direct Government obligations. This had occurred, he recalled, despite some questions, but it was an established practice that had gone unchallenged, and this had to be taken into account. However, a move to enlarge the scope of exemption might simply invite additional problems.

Governor Mitchell then said that, as he saw it, the basic difficulty was in artificially defining a borrowing as a deposit. As he recalled it, the Board had started with the proposition that it wanted to do something about promissory notes. Now it had gotten into all of the methods by which banks borrowed money on a short-term basis. With that, the problem had become highly complicated.

Governor Maisel said that his difficulty with respect to repurchase agreements had to do with drawing an arbitrary line at a point that exempted the great majority of such agreements. It would seem better to him, if that step was taken, to go ahead and exempt all repurchase agreements.

The potentialities involved in not drawing any line were then commented upon by staff, following which Chairman Martin spoke further on the growth of the use in the market of repurchase agreements on Government obligations, the standing that the existence of this practice over a long period of time had given to the device, and the distinctions that could therefore be made, at least in his mind, between making an exemption to take into account the long-standing practice and making broader exemptions covering other types of repurchase agreements.
Governor Robertson expressed the view that an exemption to recognize the long-standing practice could be justified, but he added that he saw no real need for going further.

Governor Daane said that if anything at all was to be added by way of exemption, he would go only so far as Federal agency issues.

Governor Robertson observed that the moment one exception was made, there would doubtless be requests for other exceptions. If a decision was made to stop with an exclusion for repurchase agreements on Government securities, he felt that the criticisms would be of minor proportions.

Chairman Martin then referred to Governor Mitchell's earlier comments and said he interpreted them as leading to the thought of dropping the whole proposal, at least in its present form.

Governor Mitchell confirmed that he felt the Board should give serious thought to the development of an amendment aimed directly at promissory notes. That was why he would like to hear what the New York Clearing House had to say.

Mr. Hexter suggested that the Clearing House, upon republication of the Board's proposal, might be given some hint that an alternative proposal would be in order, and the Chairman agreed that this would seem appropriate.

The discussion concluded with an agreement to republish the notice of proposed rule making in a form reflecting the recommendations.
of the Legal Division, with a request for comments not later than April 20, 1966. It was understood that the Board would be willing to receive an oral presentation by the New York Clearing House, if the Clearing House so desired, and that the question of receiving oral presentations by other parties was left open for consideration in the light of developments.

A copy of the revised rule-making notice, as published, is attached as Item No. 3.

Amendment to Regulation R (Items 4 and 5). Discount Corporation, New York, New York, a primary dealer in U.S. Government securities, had applied for a ruling to the effect that it could deal in certificates of interest issued by the Commodity Credit Corporation without contravening the prohibitions of section 32 of the Banking Act of 1933 and the Board's Regulation R, Relationships with Dealers in Securities under Section 32 of the Banking Act of 1933. Since bids for purchase of these certificates had to be submitted no later than 1:30 p.m. on Wednesday, March 30, early consideration of the matter was requested.

As explained in a distributed memorandum dated March 28, 1966, Discount Corporation had asked the Board to hold that these certificates were not "other similar securities" within the meaning of section 32; but that if such certificates were securities for the purposes of that section, they were specifically exempted from the provisions of that section because they were fully-guaranteed obligations of the U.S. Government. Discount Corporation further requested that the Board, if it
was unable to concur in these conclusions, consider amending Regulation R so as to exempt specifically from its provisions obligations of the Commodity Credit Corporation.

The legal question was whether the certificates of interest were "other similar securities" within the meaning of section 32 and Regulation R. If the Board should hold that such certificates were securities for this purpose, then if Discount Corporation were to make a market in them, the firm would be ineligible to continue its interlocking directorates with member banks. On the other hand, if the Board should conclude that such certificates were not "other similar securities," Discount Corporation could deal in them and continue its interlocking directorates.

In 1964 the Board held that short-term promissory notes issued by banks were not "securities" and therefore were not subject to the provisions of section 32. At the time of consideration of that case, some members of the Board expressed the view that it would be unfortunate if the Board were required by its ruling in the short-term note situation to hold that short-term obligations issued by finance companies were also not securities for purposes of section 32. There were at least three unpublished cases in which the Board had held that short-term obligations issued by finance companies were securities for purposes of section 32.

In the circumstances, it was recommended by the Legal Division that no decision be made with respect to the classification of the certificates of interest as securities for purposes of section 32. If the
Board were to adopt an amendment to Regulation R specifically allowing dealing in these obligations by firms having interlocking directorates with member banks, the Board would not have to reach the question whether these obligations were in fact "securities" or whether they were fully guaranteed by the United States. Such a course of action would establish no precedent with respect to short-term obligations of finance companies or other types of similar issues.

It was the Legal Division's opinion that the evils that section 32 was designed to prevent were not present in the case of the certificates of interest and that such certificates were similar to other types of Government and Government agency obligations presently exempted from Regulation R. It was recommended that the Board adopt an amendment to the Regulation, in form submitted with the March 28 memorandum. Also submitted with the memorandum was a draft of letter to the New York Reserve Bank concerning the request of Discount Corporation.

Following an oral presentation of the matter by Mr. Forrestal, he was asked why it was difficult to find that the certificates of interest were fully guaranteed by the United States. Mr. Forrestal said this was mainly because the Commodity Credit Corporation itself took the position that they were not fully guaranteed obligations. The Corporation was permitted by law to borrow and to issue bonds, debentures, and other securities. But it claimed that the issuance of these certificates did not actually amount to borrowing, because the certificates represented
an interest in assets held by the Corporation. Mr. Forrestal added that this was the first time the Corporation had issued certificates in this form.

This was followed by further comments by the legal staff on the possible alternative courses of action open to the Board and reasons why the recommended alternative was considered preferable, after which Chairman Martin inquired about the importance of the matter.

Mr. Holland responded that this was one of the Federal agency asset sales that the Administration was pushing, but for which the market was not particularly eager. In the circumstances the Administration wanted all the underwriting strength possible. If the participation of certain dealers was lost, this might cost the Government several basis points of interest.

Mr. Hackley commented that the certificates were in the same general category as other obligations that the Board had exempted from Regulation R. In view of the time element and the problems involved in a decision that these were not "other similar securities" or that they were fully guaranteed by the United States, an amendment to Regulation R would appear to be the quickest and cleanest solution, and it would not give rise to the same questions as the other alternatives.

Most of the members of the Board then indicated they would be prepared to follow the recommendation of the Legal Division. Governor Mitchell, however, said that he would abstain from participation in the
decision. He pointed out the question had come up on short notice, and he felt that it deserved more deliberate consideration so that the Board would be fully aware of the consequences of its action.

Governor Maisel said that he would support the proposed action as an interim measure. However, when the question of broadening the exemptions in Regulation R came before the Board in another connection on November 17, 1965, he had expressed the view that the exemptions should be broadened to include all types of obligations that member banks were authorized to deal in or underwrite pursuant to paragraph seventh of section 5136 of the Revised Statutes, including general obligations of States and political subdivisions.

Upon inquiry by Chairman Martin, Mr. Shay reviewed this possibility and recalled that the controversy with respect to revenue bonds was one of the factors to be considered.

The Chairman expressed doubt whether the Board should go that far at this particular juncture, and Governor Maisel stated that his point was that he thought the question should be reconsidered when time permitted.

Mr. Shay then mentioned that Regulation R, in the form in which it was reissued January 25, 1966, pursuant to the action taken by the Board on November 17, 1965, failed to include, through inadvertency, obligations of public housing agencies in the list of exceptions contained in section 218.2. He suggested that this inadvertent omission be corrected, and there was agreement that this would be appropriate.
Accordingly, Regulation R was amended, effective March 29, 1966, Governor Mitchell abstaining, so as to include certificates of interest issued by the Commodity Credit Corporation and obligations of public housing agencies in the exceptions contained in section 218.2. Attached as Item No. 4 is a copy of the notice published in the Federal Register, and attached as Item No. 5 is a copy of the letter sent to the New York Reserve Bank.

Coin shortage (Item No. 6). There had been distributed a draft of reply to a letter dated March 21, 1966, from Chairman Fascell of the Legal and Monetary Affairs Subcommittee of the House Committee on Government Operations with respect to the coin shortage.

Following comments by Mr. Farrell on the current and prospective situation, certain suggestions for modifications in the draft reply were made by members of the Board, after which unanimous approval was given to a letter in the form attached as Item No. 6.

All members of the staff except Messrs. Sherman and Brill then withdrew from the meeting.

Foreign travel. Mr. Koch, Associate Director, Division of Research and Statistics, was authorized to travel to Basle, Switzerland, during the period April 1-7, 1966, to participate in a meeting of central bank economists being held at the Bank for International Settlements and was also authorized to visit the Bank of England en route, with reimbursement on the basis of actual necessary travel expenses.
Request for technical assistance. A representative of the International Monetary Fund had made known to the Board's staff the desire of the Central Bank of Paraguay to obtain the services of a Spanish-speaking bank examiner for a period of about a year to help improve that country's bank supervisory procedures. The staff believed that Examiner Robert Hochstatter of the Federal Reserve Bank of Chicago had appropriate qualifications for such an assignment.

The staff was authorized to ascertain the availability of Mr. Hochstatter for this assignment.

Reports by Board members. Several of the members of the Board reported informally, for the information of the other members, on Governmental meetings in which they had participated recently.

The meeting then adjourned.

Secretary's Note: Following the meeting Governor Shepardson informed the Secretary that, acting pursuant to authorization by the Board in earlier executive sessions, he had approved the appointment of Lawrence H. Byrne, Jr., as Director of the Division of Data Processing to succeed M. H. Schwartz, who had resigned to accept a position with First National City Bank, New York, such appointment to be effective upon entrance on duty (expected to be April 18), with salary at the rate of $20,000 per annum.

Secretary's Notes: There was sent today to The First National Bank of Boston, Boston, Massachusetts, a letter acknowledging receipt of notice of its intent to establish an additional branch in England, to be located in Chelsea, London.
letter noted that establishment of the branch would not require an additional capital expenditure and that the expenses involved in opening the branch would be nominal.

Governor Shepardson today approved on behalf of the Board the following items:

Letter to Mr. Bopp, Chairman of the Presidents' Conference Committee on Bank and Public Relations, interposing no objection to continued service by Charles Molony as associate member of the Subcommittee on Bank and Public Relations.

Memorandum from the Division of Administrative Services recommending the appointment of Mary E. Yingling as Cafeteria Helper in that Division, with basic annual salary at the rate of $3,745, effective the date of entrance upon duty.
March 29, 1966

Board of Directors,
Midway Bank & Trust,
Cedar Falls, Iowa.

Gentlemen:

The Federal Reserve Bank of Chicago has forwarded to the Board of Governors a letter dated March 17, 1966, signed by President Berg, together with the accompanying resolution dated March 14, 1966, signifying your intention to withdraw from membership in the Federal Reserve System and requesting waiver of the six months' notice of withdrawal.

The Board of Governors waives the requirement of six months' notice of withdrawal. Under the provisions of Section 208.10(c) of the Board's Regulation H, your institution may accomplish termination of its membership at any time within eight months from the date that notice of intention to withdraw from membership was given. Upon surrender to the Federal Reserve Bank of Chicago of the Federal Reserve stock issued to your institution, such stock will be cancelled and appropriate refund will be made thereon.

It is requested that the certificate of membership be returned to the Federal Reserve Bank of Chicago.

Very truly yours,

(Signed) Karl E. Bakke

Karl E. Bakke,
Assistant Secretary.
March 29, 1966

The Honorable K. A. Randall, Chairman,
Federal Deposit Insurance Corporation,
Washington, D. C. 20429

Dear Mr. Randall:

Reference is made to your letter of March 7, 1966, concerning the application of Lyon County State Bank, Rock Rapids, Iowa, for continuance of deposit insurance after withdrawal from membership in the Federal Reserve System.

On the basis of an examination by the Federal Reserve Bank of Chicago as of the close of business July 6, 1963, the general condition of Lyon County State Bank was found to be less than satisfactory. The volume of classified loans was excessive, capital funds of the bank were considered to be less than the minimum desirable amount, the liquidity position of the bank was not consistent with its needs, and management was no better than fair. The first examination in 1964 reflected further general deterioration. A change in ownership and management took place later in the year, and a subsequent 1964 examination indicated that the deterioration in the general condition of the bank had been reversed although a substantial volume of troublesome loans originated by former management remained in the bank. Most recently the bank was examined as of the close of business November 29, 1965, and the condition of the bank's assets and the adequacy of its capital structure were substantially improved. The bank's capital position is now considered fairly satisfactory. While the bank retains a number of asset problems, management is considered competent of resolving such problems without major losses.
In August 1965, control of the bank was acquired by Mr. Paul Dunlap, who is also president of Houghton State Bank, Red Oak, Iowa, an insured State nonmember institution. Mr. Dunlap has had considerable banking experience. Since acquiring control, policies established by former owners have been continued and management is considered satisfactory.

Following the most recent examination, the bank was urged to give careful attention to the fairly sizable volume of criticized loans.

No other corrective programs have been suggested to the bank.

Very truly yours,

(Signed) Karl E. Bakke

Karl E. Bakke,
Assistant Secretary.
Notice of Proposed Rule Making

The Board of Governors announced on January 20, 1966 (published in the Federal Register of January 26, 1966, 31 F.R. 1010) that it was considering amending § 204.1 of Regulation D ("Reserves of Member Banks") and § 217.1 of Regulation Q ("Payment of Interest on Deposits") by inserting at the beginning of each a new paragraph defining the term "deposit" for purposes of those regulations.

The Board has now revised its proposal in the light of comments received from interested persons. The revised proposal would amend § 204.1 and § 217.1 as follows:

(a) By inserting at the beginning of each the following new paragraph:

(a) Deposit. - The term "deposit" means any indebtedness of a member bank that arises out of a transaction in the ordinary course of its banking business with respect to either funds received or credit extended by the bank, except

(1) indebtedness due to a Federal Reserve Bank;

(2) indebtedness due to another bank for its own account that is not reflected on books or reports of the debtor as a deposit or of the creditor as a bank balance;

For the purpose of this definition, indebtedness does not include (1) an obligation to deliver securities sold, (2) a contingent liability such as arises from the issuance of a letter of credit or a commitment to make a loan, or (3) a liability such as arises from the creation of a bank acceptance.
(3) indebtedness arising from a transfer of direct obligations of the United States that the bank is obligated to repurchase;

(4) indebtedness that (A) is due to a Government securities dealer that makes primary markets in obligations of the United States and reports its activities regularly to the Federal Reserve Bank of New York, and (B) arises from a loan, for one business day, of proceeds of a transfer of deposit credit in a Federal Reserve Bank (or of other immediately available funds) in connection with payment on that day for obligations of the United States or any agency thereof; and

(5) indebtedness with an original maturity of more than two years that is subordinated to the claims of depositors and general creditors.

This paragraph shall not affect the status, for purposes of this part, of any indebtedness incurred prior to January 20, 1966.

(b) By redesignating the present paragraphs (a), (b), (c), (d), (e), (f), (g), (h), and (i) and footnotes 1, 2, 3, 4, 5, 6, and 7 of § 204.1 as paragraphs (b), (c), (d), (e), (f), (g), (h), (i), and (j) and footnotes 3, 4, 5, 6, 7, 8, and 9, respectively.

(c) By redesignating the present paragraphs (a), (b), (c), (d), and (e) and footnotes 1, 2, 3, 4, and 5 of § 217.1 as paragraphs (b), (c), (d), (e), and (f) and footnotes 3, 4, 5, 6, and 7, respectively.

2/ This exemption is applicable to an entire account of this type, even though it may include relatively insignificant transactions in other money market assets.
The following are illustrations of the effects of the amendments, from the standpoint of rules governing payment of interest on deposits.

(a) In consideration of the receipt of funds, a member bank issues to an industrial corporation its promissory note (either negotiable or nonnegotiable) to mature in six months. The bank's liability is a deposit. Consequently the rate of interest on the note may not lawfully exceed that permitted on a certificate of deposit.

(b) A member bank issues to an industrial corporation its note payable on demand or within less than 30 days, either negotiable or nonnegotiable. The bank's liability constitutes a demand deposit, and it may not lawfully pay any interest thereon.

(c) A member bank purchases stationery and office supplies on credit. Such indebtedness does not arise from "funds received or credit extended by the bank", and consequently it is not a deposit.

(d) A member bank borrows funds on its note, secured by a mortgage on the bank premises, and uses the proceeds to pay for renovation. Although this indebtedness arises from "funds received" by the bank, the transaction is not "in the ordinary course of its banking business", and therefore the indebtedness does not constitute a deposit.

(e) A member bank lends funds to a customer and credits the proceeds to his account. The amount so credited is, as heretofore, a deposit.
(f) A member bank receives funds, in the ordinary course of its banking business, from a correspondent bank—whether member or nonmember, domestic or foreign. Consistent with traditional practice and understanding of the parties, the liability of the recipient bank is a deposit. The definition of "deposit", however, excepts from its coverage an interbank indebtedness that is entered and reported by both banks as a loan transaction. A loan of what are commonly termed "Federal funds" is an example of an indebtedness that falls within such exception.

(g) A member bank issues debentures or notes to provide additional "capital" funds. By contract, the claim of the security holders against the assets of the bank is subordinated to the claims of depositors and all other creditors. Such notes are excepted from the definition of deposit if they have an original maturity of more than two years.

(h) A Government securities dealer that reports to the New York Reserve Bank has an arrangement with a member bank whereby the bank maintains a running account of "Federal funds" debits and credits with respect to the dealer's purchases and sales of Government and Federal agency securities that are settled in such funds. The indebtedness of the bank to the dealer in connection with such account is not a deposit.

(i) A member bank contracts to sell securities to a customer. Instead of making immediate delivery of such securities, the bank gives the customer a "due bill", promising to make delivery at a subsequent time. Such an obligation to deliver securities is not a money transaction and is not a deposit, unless the "due bill" procedure was used by the bank primarily as a method of raising funds.
(j) A member bank accepts a draft drawn on it in connection with the importation of goods into the United States. Since the bank's obligation is not an "indebtedness" as defined in the regulations, the transaction does not give rise to a deposit. (Of course, if the acceptance procedure was used primarily as a device for procuring funds for the bank's use, the bank's obligation would constitute an "indebtedness" and, accordingly, a deposit.)

The purpose of these proposed amendments is to prevent evasions of laws and regulations governing payment of interest on and maintenance of reserves against deposits. They are based upon the premise that, with few exceptions, indebtedness of member banks must be considered and treated as deposits subject to Regulations D and Q in order to effectuate Congressional directives and policies, as expressed in section 19 of the Federal Reserve Act (12 U.S.C. 461, 462, 371a, and 371b).

Data, views, or arguments on the proposal as revised should be submitted in writing to the Secretary, Board of Governors of the Federal Reserve System, Washington, D. C., 20551, to be received not later than April 20, 1966.

Dated at Washington, D. C., this 29th day of March, 1966.

By order of the Board of Governors.

(Seal)  (Signed) Merritt Sherman
Merritt Sherman, Secretary.
1. Effective March 29, 1966, § 218.2 is amended to read as set forth below. The footnotes to § 218.2 are unchanged.

§ 218.2 Exceptions.

Pursuant to the authority vested in it by section 32, the Board of Governors of the Federal Reserve System hereby grants permission for any officer, director, or employee of any member bank of the Federal Reserve System, unless otherwise prohibited, to be at the same time an officer, director, or employee of any corporation or unincorporated association, a partner or employee of any partnership, or an individual, engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of any stocks, bonds, or other similar securities, if so engaged only as to the following securities: bonds, notes, certificates of indebtedness, and Treasury bills of the United States; obligations fully guaranteed both as to principal and interest by the United States; general obligations of Territories, dependencies, and insular possessions of the United States; obligations of Federal Intermediate Credit banks, Federal Land banks, Central Bank for Cooperatives, Federal
Home Loan banks, the Federal National Mortgage Association, and the Tennessee Valley Authority; certificates of interest of the Commodity Credit Corporation; and, subject to specifications contained in paragraph Seventh of Section 5136, Revised Statutes (12 U.S.C. 24), obligations of the International Bank for Reconstruction and Development, the Inter-American Development Bank, local public agencies, public housing agencies, and obligations insured by the Federal Housing Administrator.

2a. The purpose of this amendment is to add two categories to the obligations presently listed in this section, which exempts relationships between member banks and firms dealing only in certain types of obligations. Those two categories of obligations are (1) certificates of interest issued by the Commodity Credit Corporation and (2) obligations of public housing agencies.

b. The notice, public participation, and deferred effective date described in section 4 of the Administrative Procedure Act are not followed in connection with this amendment, nor is the effective date thereof deferred. In the circumstances, such procedure and delay would serve no useful purpose (See 262.1(e) of the Board's rules of procedure (12 CFR 262.1(e))).
(12 U.S.C. 78.)

Dated at Washington, D. C., this 29th day of March, 1966.

By order of the Board of Governors.

(SEAL)  (Signed) Merritt Sherman

Merritt Sherman,
Secretary.
March 29, 1966

Mr. Alfred Hayes, President,
Federal Reserve Bank of New York,
New York, New York. 10045

Dear Mr. Hayes:

This is in response to a request from Discount Corporation of New York for confirmation of the Corporation's conclusion that it is not precluded by Regulation R from underwriting and dealing in an offering of Commodity Credit Corporation certificates of interest, if such conclusion is not confirmed, early consideration by the Board of an amendment to Regulation R so as to exempt specifically from its provisions obligations of Commodity Credit Corporation.

Discount's request was contained in a letter dated March 21, 1966, which was transmitted to the Board by your Bank under a covering letter dated March 22, 1966. The Board is also in receipt of your Bank's letter of March 28, 1966, commenting on this request.

Discount has concluded that it is not precluded by Regulation R from taking an active part in the underwriting of this offering because the Commodity Credit Corporation certificates are not "other similar securities" within the meaning of section 32 of the Banking Act of 1933, but if they are, such obligations are fully guaranteed by the United States and, therefore, fall within the exceptions contained in section 218.2 of Regulation R.

The Board has concluded that the certificates are of such a nature that Regulation R should be amended to include them in the exceptions thereto. Accordingly, there is enclosed a copy of an amendment to Regulation R giving effect to this conclusion. This amendment will be published shortly in the Federal Register and the Federal Reserve Bulletin. It would be appreciated if you
would communicate the Board's action with respect to this matter to Discount Corporation.

You will also note that the Board has further amended Regulation R to include within the exceptions thereto obligations of public housing agencies. These obligations were inadvertently omitted from section 218.2 when the Regulation was last amended.

Very truly yours,

(Signed) Merritt Sherman

Merritt Sherman,
Secretary.

Enclosure
March 29, 1966

The Honorable Dante B. Fascell, Chairman, Legal and Monetary Affairs Subcommittee of the Committee on Government Operations, Rayburn House Office Building, Room B-349-A, Washington, D. C. 20515

Dear Mr. Chairman:

In your letter of March 21, 1966, you refer to Circular No. 5785, dated March 15, 1966, issued by the Federal Reserve Bank of New York to announce the termination of certain practices adopted in August 1964 to help relieve the coin shortage that then prevailed. You asked to be advised as to the bases upon which the decision was made to discontinue the practices adopted in August 1964, and as to whether Reserve Bank inventories of coin and other circumstances are such as to indicate that the shortage is over.

On August 13, 1964, the Board authorized all Reserve Banks to pay transportation costs on shipments of coin from nonmember banks and to accept deposits of wrapped coin. These procedural changes were emergency measures taken at a time when coin was in extremely short supply. It was recognized when the new procedures were adopted that they would add to the cost of operations of the Federal Reserve Banks, and that the acceptance of deposits of wrapped coin would be especially troublesome.

Ordinarily, the Federal Reserve Banks will not accept wrapped coin because when deposits are made in this form there is no opportunity for the depositing bank to inspect the coin before forwarding it to the Reserve Banks. Under these circumstances each roll of 40 or 50 coins has to be broken by hand at the Reserve Bank and the wrapper removed so that the coin can be screened for slugs and foreign coin, and that the amount claimed in the deposit can be proved. This is a laborious and time-consuming process that could only be justified under emergency conditions.

The decision to discontinue the emergency measures adopted nearly two years ago was based on evidence that by the
end of 1965 the Treasury's massive production program had improved the situation to the point where coin inventories at the Reserve Banks, with the exception of half dollars, were reaching satisfactory levels. There was additional evidence that the improved supply is resulting in a more normal flowback of coins from circulation. An indication of these developments may be seen in the following table.

<table>
<thead>
<tr>
<th></th>
<th>Receipts from circulation during month</th>
<th>Inventory on hand at month end</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(Millions of pieces)</td>
<td></td>
</tr>
<tr>
<td>February 1963</td>
<td>830</td>
<td>763</td>
</tr>
<tr>
<td>August 1963</td>
<td>769</td>
<td>316</td>
</tr>
<tr>
<td>February 1964</td>
<td>563</td>
<td>329</td>
</tr>
<tr>
<td>August 1964</td>
<td>180</td>
<td>207</td>
</tr>
<tr>
<td>February 1965</td>
<td>378</td>
<td>736</td>
</tr>
<tr>
<td>August 1965</td>
<td>402</td>
<td>1,208</td>
</tr>
<tr>
<td>February 1966</td>
<td>643</td>
<td>1,886</td>
</tr>
</tbody>
</table>

Although there has been a tremendous improvement since 1964 in the coin situation, the chaotic conditions of the last two or three years, coupled with growth in coin used for vending machines and for numismatic purposes, make it extremely difficult at this time to determine what normal demands may be and what inventories may ultimately be needed.

Sincerely yours,

(Signed) Wm. McC. Martin, Jr.

Wm. McC. Martin, Jr.