

The attached minutes covering the meeting of the Board of Governors of the Federal Reserve System with the Presidents of the Federal Reserve Banks on May 10, 1966, which you have previously initialed, have been amended in minor respects on page 3 (first paragraph) and page 13 (first paragraph), pursuant to suggestions received from Reserve Bank Presidents.

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

Governor Robertson

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Governor Shepardson

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A meeting of the Board of Governors of the Federal Reserve System with the Presidents of the Federal Reserve Banks was held at the Federal Reserve Building in Washington, D. C., on Tuesday, May 10, 1966, at 2:15 p.m.

PRESENT: Mr. Martin, Chairman
Mr. Robertson, Vice Chairman
Mr. Shepardson
Mr. Mitchell
Mr. Maisel
Mr. Brimmer

Mr. Sherman, Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Holland, Adviser to the Board
Mr. Molony, Assistant to the Board
Mr. Fauver, Assistant to the Board
Mr. Hackley, General Counsel
Mr. Brill, Director, Division of
Research and Statistics
Mr. Farrell, Director, Division of
Bank Operations

Messrs. Ellis, Hayes, Bopp, Hickman, Wayne, Patterson, Scanlon, Francis, Galusha, Clay, Irons, and Swan, Presidents of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco, respectively

Messrs. MacDonald and Kimbrel, First Vice Presidents of the Federal Reserve Banks of Cleveland and Atlanta, respectively

Reserve requirements. Chairman Martin indicated that the Board had been giving consideration to questions involving member bank reserve requirements, including what could be done to make the situation more equitable for member banks as well as how reserve requirements could most appropriately be used as a tool of monetary

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policy. He noted that within the Board there were varying opinions as to what ought to be done. He also noted that although the fixing of reserve requirements was an authority vested in the Board of Governors, it was desirable to determine whether a System-wide consensus could be obtained. While no action could be taken that would be completely satisfactory to everyone concerned, it seemed advisable to ascertain whether a majority sentiment could be obtained within the System for making a move in principle toward a system of graduated reserve requirements. The Board had recently been discussing a couple of plans, and these would be made available to the Reserve Bank Presidents for their views in order that the Board could try to be prepared to take action in the most appropriate way when the time seemed right. It could be argued that there was never a good time to change reserve requirements, but at this particular juncture some arguments could be made in terms of using the reserve requirement instrument as a tool of monetary policy. In any event, the problem was a complicated one, and consideration on a System-wide basis would be helpful in order to ascertain whether it was possible to obtain some meeting of the minds.

Later in the meeting Vice Chairman Robertson said that some of the Board members felt it was essential to do something about reserve requirements, for several reasons. One reason would be to indicate concern about inflationary pressures by taking an overt action. A second reason would be to indicate that the Federal Reserve was moving toward a graduated scale of reserve requirements in order to eliminate some of

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the incentive for withdrawals from System membership. As Chairman Martin had mentioned, the Board had recently been discussing a couple of proposals, and they would be sent to the Presidents shortly with an invitation for comments, including analysis of shortcomings seen in them. The Vice Chairman then outlined the proposals briefly and summarized the basic objectives, following which he again expressed the desire of the Board to obtain the best possible judgments and expressed his personal hope that some action could be taken quickly.

Float. Under date of March 17, 1966, the House Committee on Government Operations issued a report entitled "Federal Reserve System-- Check Clearance Float" based on a study by its Legal and Monetary Affairs Subcommittee. The report recommended that the Board of Governors establish quantity and time goals for float elimination through technological developments and provide for periodic reviews of the results thereof; and, should the progress made not meet expectations, that the Board consider the advisability of action to lessen the float through adoption of (a) a plan of immediate debits-credits on checks, or (b) time schedules approximating actual collection times. The report also recommended that, if efforts to reduce float should fall short of expectations within a reasonable time, the Board (a) develop records to make readily calculable the proportionate use of float by member banks as reserves, and (b) study the question whether user charges should be assessed against banks in proportion to the benefits they derived from float. The report further recommended that the Board coordinate with

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Government agencies, in moving forward with technological developments, as contemplated by Public Law 89-306.

Prior to this meeting Governor Mitchell had caused the following memorandum to be distributed to the participants:

The Board has been asked by Chairman Dawson of the House Committee on Government Operations to establish time and quantitative goals for the elimination (reduction) of present levels of FR float, now running at about \$2 billion, or 9 per cent of required reserves. In the event that such goals as the System might set are remote in time or insignificant in size, he suggests that the present deferment schedule be altered or that analyses be made so that it would be possible to identify and charge the commercial banks that are beneficiaries of float.

To respond realistically and constructively to the alternative policies that might be adopted with respect to float, the System should consider, at this point, other and more important policies that have forward-looking commitments with respect to its and the banking system's role in check settlement accounting and procedure.

Five years ago the System undertook an aggressive stand on the introduction of MICR, an early step in automation. At that point it, along with the banking system, started down the automation path. With growing momentum many commercial banks, once indoctrinated in EDP, have been broadening their horizons of the role of automation. Moreover, the data processing equipment companies and the A. T. & T. also have unusual potentials in this field because they are innovative minded and not constrained by existing relationships or processing patterns.

The automation problem in its broadest form raises the issue of how far the System's public responsibility goes to expedite and extend, at a minimum social cost, the settlement mechanism. Should it take a passive role, functioning wherever and whenever private arrangements by banks or others are non-existent or fall below service standards achieved in the past, or should it be leading the way toward a fully automated settlement?

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There is little doubt that, looking ahead a decade or so, a completely private settlement system could evolve with little more than nominal System participation. If this is judged to be the most desirable goal, it is quite clear that the float issue could be resolved in a very short time by moving up the deferment schedule to 3+ days. Float would drop about two-thirds and some other changes might reduce it to one-fourth of its present size. This course of action could dispose of the float "problem" by the end of the current year.

At the other policy extreme, the System could decide to assume a positive and dominant role in the evolution of the settlement process--working as rapidly as practicable toward the elimination of any processing delay whether involving local, regional, or national transactions. This step would involve formulating a publicly announced position and program.

There is also a middle ground. Our decision could be deferred for a year or two, or even more, to see what might happen if we do nothing. We could make a long and careful study of all aspects of the problem, including those we have studied intensively before. Some useful studies are already under way by two System committees. However, the longer we wait the less likely it is that the System can have a significant role in shaping or playing a part in a future settlement system.

I have a tentative view with regard to all of this about as follows:

1. It is desirable for the Federal Reserve System to assume, as early as possible, a positive role in assuring, on a nationwide basis, efficient, direct, and prompt settlement machinery.
2. There are some ways in which that role could be asserted within a year or so. For example, we could:
 - (a) Classify all checks, drafts, or similar instruments that are not encoded in magnetic ink with the routing symbol-transit number of the paying bank in the prescribed manner as items requiring special handling, which will only be received by Federal Reserve offices as noncash items.

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- (b) Speed up remittances through increased usage of air service and motor carriers to insure following-morning deliveries of cash letters to the maximum number of points possible within each Federal Reserve district.
- (c) Permit any Federal Reserve office that desires to accept fully qualified items payable in other Federal Reserve districts from certain member banks that are now required to send direct to other Federal Reserve offices when volume exceeds 300 items.
- (d) Encourage multiple deposits to minimize the depositing of large volumes of items at the closing hour in any Federal Reserve office.
- (e) Promote and encourage the automatic charge payment program.

3. There are longer-run improvements that should be under intensive study and experiment. In general, these add up to a variety of measures for facilitating, and broadening somewhat, local--out of the Fed--processing of checks. Service areas for existing clearing houses can be extended, clearing bureaus can be organized, and direct exchange among large computer centers can be encouraged. With some financial aid and operating integration the local checks (about 70 per cent of the total) can be promptly and economically processed without coming into the Fed.

On the other hand, if items are fully qualified for machine processing as soon as they reach the Fed it is now technologically possible to complete the settlement and accounting transactions electronically and promptly.

4. The System should be united on whatever program it adopts; otherwise the program will abort or fail to achieve the needed degree of effectiveness. I see two potential road blocks:

- (a) There are some existing arrangements in the correspondent banking system that are inimical to the objective sought. These specific situations should not be protected or promoted through any procedures or lack of facilities planned or administered by the Federal Reserve System. I believe such difficulties can be overcome on a case-by-case basis.

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- (b) The Federal Reserve is a system and should so operate in its clearing arrangements--the most convenient FR office, given present-day methods of transporting checks, should be the System's link to the commercial bank--not the less accessible home or branch office within whose boundaries a given area falls. I would propose a change in boundaries only for the purpose of check clearance.

5. The System has enough operating know-how and enough resourceful personnel to move rapidly ahead on a broad front if System policymakers clearly state the objective and make that fact generally known.

In commenting on his memorandum, Governor Mitchell observed that the fundamental issue raised in it was whether the Federal Reserve should stay in the check processing business. If it wanted to get out, an opportunity might well be afforded within the next five or ten years because automation techniques now in sight clearly would make it possible for the commercial banking system or for private companies such as American Telephone and Telegraph Company or International Business Machines Corporation to run a clearance system outside of the Federal Reserve. In his opinion, it would be undesirable to turn over to private interests something so vital to the community welfare. He would much prefer that the Federal Reserve stay in the business.

Governor Mitchell proceeded with a review of the suggestions contained in his memorandum, and in the course thereof said he had no doubt about the technical capability within the System to do a great deal more than was presently being done. A principal deterrent, he thought, was the lack of a clear understanding as to the direction in which System policymakers wanted to move. In his memorandum he had

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listed several things that he felt could be done immediately. Fundamentally, however, he had wanted to call attention to two general lines of approach. The first was to keep local checks from coming into the Reserve Banks. It would be to the advantage of the Federal Reserve to encourage the organization of regional check-clearing centers. While some expense would be involved, he did not think it would be as much as might be supposed. In any event, the plan would not involve as much social cost. Second, as to checks that had to move long distances before they could be cleared, it would be advisable to put these clearing operations on a completely electronic basis as soon as possible. If checks came into the Federal Reserve fully qualified, they could be put on tapes for transmittal to other Federal Reserve offices immediately. The commercial banks were submitting more and more qualified checks every day (the average was now over 80 per cent), so the situation was moving rapidly in the direction of being able to accomplish this process electronically. There was still a legal problem in regard to the presentation of the checks, but this was under study and the problems did not appear insurmountable if the Policymakers indicated that they wanted to have them solved. All of this would involve stepping on the toes of correspondent banks. Here again he did not feel that the difficulties could not be surmounted, particularly if dealt with on a case-by-case basis, but this was a part of the problem that would have to be worked out. It was also evident that Federal Reserve boundaries would have to be breached in

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some instances where a Federal Reserve office in an adjoining district was closer to the commercial bank concerned than the nearest office in its own district.

This was essentially the program, Governor Mitchell said, that it would seem sensible for the Federal Reserve to unfold. He did not put the program forward as one that was fully developed in any sense. Instead, the ideas were quite tentative.

President Wayne, speaking as Chairman of the Presidents' Conference, commented first on the cost factor. Without question, he said, the Reserve Banks could enlarge and speed up their check collection services, but this would cost a substantial amount of money. For example, the Richmond Bank was now considering a contract with a motor carrier that would insure delivery of cash letters the following morning. This would involve, at least initially, just about a doubling of the annual cost. It would eliminate holdover float, however, and over time it might develop that net savings would flow from the adoption of this plan.

President Wayne then spoke of the potential conflict with the correspondent banking system as being even deeper than Governor Mitchell appeared to envisage. City banks actively solicited smaller correspondent banks to send them volumes of checks, which they immediately analyzed as a basis of determining the balance that the correspondent must carry with them. From the standpoint of social cost, a lot of money was

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going down the drain in this process. Nevertheless, studies undertaken in cooperation with bankers associations had shown that the problem was not easily solved.

Turning to regional clearing arrangements, President Wayne said he believed technical factors could be worked out should it be agreed that it was appropriate for the Reserve Banks to pay part of the cost. There were a number of areas where he thought such arrangements could be worked out advantageously.

President Scanlon, Chairman of the Committee on Collections, suggested that the Federal Reserve might find itself taking over a clearing operation that was already in existence, with others paying the cost. The System would have to be in a position to justify this absorption of cost if it should be questioned.

Governor Mitchell expressed the view that the System would be able to justify costs involved in extending the efficiency of the whole collection system, since such expenditures would be essentially in the public interest. He added that some clearing house arrangements were hostile to those who did not happen to be in the clearing house. In his opinion, the System would be justified in setting up a complete arrangement and paying some of the cost.

President Wayne agreed that if the Reserve Banks could absorb part of the cost they could overcome part of the objections. He referred, by way of illustration, to the clearing problems existent in the District of Columbia metropolitan area and noted how a substantial

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amount of float was generated under present arrangements. If the Federal Reserve paid part of the cost, it might be able to work out a clearing arrangement that would disregard political lines.

President Clay said that his Bank had entered into a contract for delivery of most of its Kansas checks under which it could send checks out as late as midnight. This meant an increase in dollar transportation cost, but when everything was taken into account the Bank felt that it was saving money. It was able to tell local banks that instead of a closing hour of 3 p.m., qualified items would be accepted until 6 p.m. For the Reserve Bank this meant the use of fewer machines and operating personnel over a longer working period, with a resultant cost reduction. Also, some banks had found that they were able to set up clearing arrangements in their own areas, using the Reserve Bank trucks as they went through.

President Wayne commented that it was the conclusion of the Presidents' Conference that the Federal Reserve should stay in the check-clearing business, and the approach being followed was to seek answers aggressively in terms of what could be done in the longer range through the use of improved hardware. As to the shorter-range problem, machinery was in motion to study regional clearing arrangements, to enlarge capability for overnight delivery of checks through arrangements with contract carriers, and to attempt to encourage participation in automatic charge payment programs. However, he hoped it would not

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be said that at the end of five years the problem would disappear, because he did not think that would be true.

President Clay mentioned that each time the Kansas City Bank had rendered assistance in setting up regional clearing arrangements there had been a request for some kind of subsidy. This had been avoided so far. If there was no general policy, however, every one of the clearing operations would expect a subsidy.

President Galusha remarked that in the light of his previous experience with American Telephone and Telegraph Company he thought it was doubtful that they would have available for several years the kind of data transmission equipment that would be needed to implement the program Governor Mitchell had outlined. As he understood the proposal, it would require what was equivalent to "touch-tone" equipment, and it was his understanding that as recently as a year ago the telephone company had only three exchanges with the capacity to handle this kind of equipment. Furthermore, progress to this stage had been 12 years in the making.

There were some ensuing comments, however, to the effect that while "touch-tone" equipment would be needed to link individuals in a no-check economy, it would not be needed to link Federal Reserve offices or other clearing facilities.

President Hickman stated that the Cleveland Bank had been successful in reducing average float from around \$150 million to something in the order of \$50 million. Holdover float had been eliminated

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by the use of better equipment, and better training and utilization of personnel. About \$20 million had been cut from average time schedule float by policing direct-sending banks and by prompt presentation of checks through better shipping schedules. Better scheduling and automatic charge had cut down remittance float. He saw no particular need for regional clearing bureaus in the Cleveland District because of the proximity of Federal Reserve offices to all major centers. Instead, the problem could be handled by having direct-sending banks send to the Federal Reserve all fully encoded items. Eventually these could be put on tape and sent to other Federal Reserve offices; this should not be an insuperable problem. Nor should the physical presentation of checks involve an unsurmountable problem; it might be possible to send the checks on later.

President Ellis agreed with the view that the Federal Reserve should continue to play a central role of leadership in the payments mechanism. The principal barriers were those that had already been mentioned, including the cost factor and member bank relationships. Reserve Banks were making some progress, along the lines President Hickman had mentioned, in terms of the housekeeping functions. Everyone should be prepared to take such steps within the limitations of general policy on questions such as whether to assume the cost of regional clearings. However, this would not permit an answer to the Congressional Committee that these steps were going to effect a substantial reduction in float in the next two, three, or five years.

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Governor Mitchell replied that nevertheless the Committee must be given, at some point, an estimate as to where the matter would stand at the end of a certain period, such as two years. To be responsive, the System should supply some realistic estimate as to how much it could reasonably accomplish. This might be expressed in terms of a percentage of required reserves, which would afford more leeway.

President Ellis remarked that even if the Reserve Banks eliminated holdover float, which would be responsive, and effected a reduction in remittance float, which also would be responsive, they would still not be within the target range.

Governor Mitchell expressed the thought that the establishment of local clearing bureaus might help quite a bit, and President Ellis replied that he knew of no figures that would afford a basis for saying how much float could be curtailed through the use of such arrangements. As he saw it, there were only two approaches that would really make a substantial dent in the volume of float. The first would be the automatic charge; the only other possibility would be a change in maximum deferment to three days. Either move would generate an enormous amount of banker hostility.

President Irons stated that the Dallas Reserve Bank had been trying to promote an automatic charge plan for almost a year, but with very little success.

Governor Mitchell then inquired whether it was the consensus that a temporizing letter should be written to the Committee at this

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stage, and Mr. Farrell expressed the view that it would be a mistake to do anything else. He feared it would be found that the System was worse off than now believed in terms of time schedule float. If credit float was eliminated through better housekeeping procedures, time schedule float would increase.

President Wayne suggested informing the Committee that a System-wide study was being planned to seek to identify and quantify the components of total float, that studies were under way to determine the degree to which it would be feasible to develop regional clearing facilities, that the extent to which it was feasible and economically justifiable to expand contract carrier arrangements and improve other Reserve Bank operating procedures also was being studied, but that it was not feasible to specify a time schedule according to which these things would be worked out.

There followed discussion of indications as to the time that would be needed for completion of the current studies, from which it appeared that it would be optimistic to think in terms of reports being available earlier than the September meeting of the Presidents' Conference.

President Swan urged that the letter to Chairman Dawson not create the impression, in asking for more time to complete the studies, that a drastic reduction in float was going to be achieved immediately, and other Presidents expressed themselves to like effect.

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Stock market credit regulations. Vice Chairman Robertson stated that the Board had been studying possibilities for closing some of the loopholes in the stock market credit regulations, including extension of margin regulation to previously unregulated lenders, changing the margin regulations to make the treatment of convertible bonds more nearly parallel under Regulations T and U, reducing the liberality of the subscription account privilege, and changing the same-day substitution privilege. The objective was to have proposals in readiness so that the Board could be in a position to take action when the time was right. He was not sure whether the Board would be sending specific materials to the Reserve Banks on these matters at this time because the proposals were still in a formative stage, but the Board would appreciate having any general views that the Presidents might care to express.

The meeting then adjourned.

A handwritten signature in cursive script, appearing to read "Kenneth B. ...", written over a horizontal line. Below the line, the word "Secretary" is printed in a serif font.

Secretary