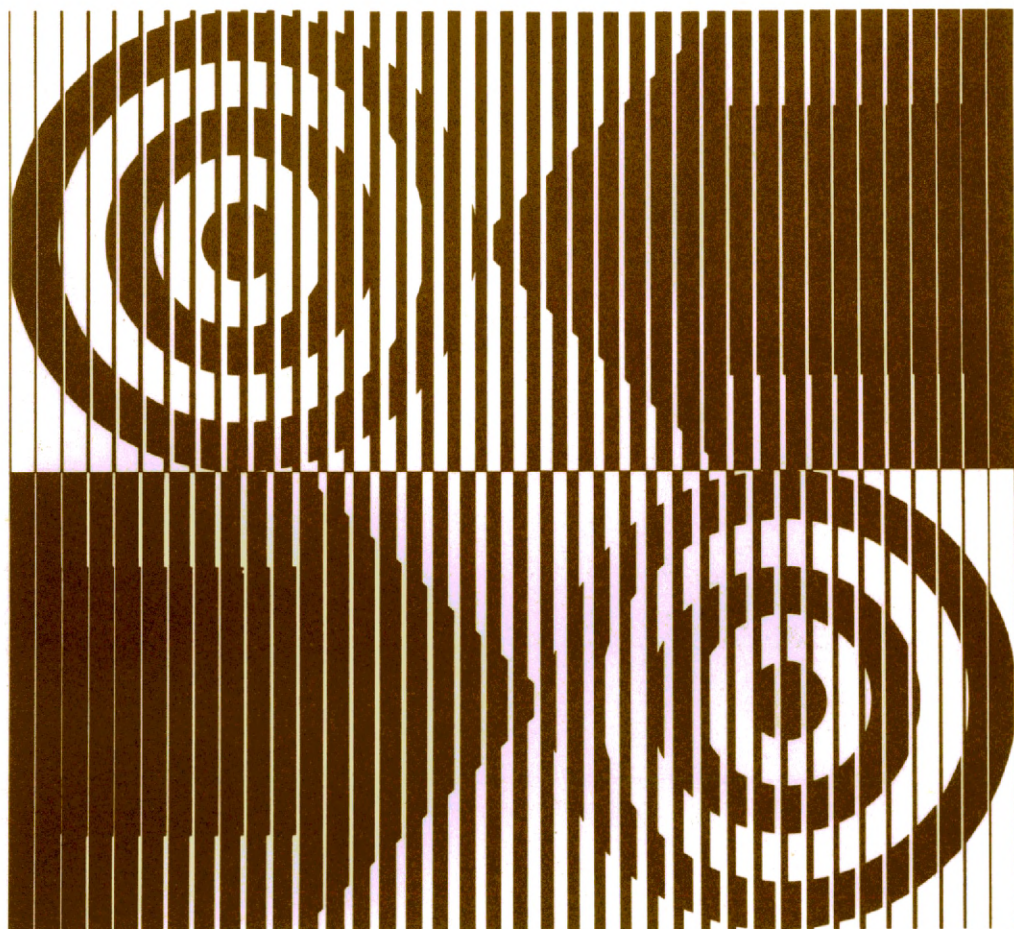
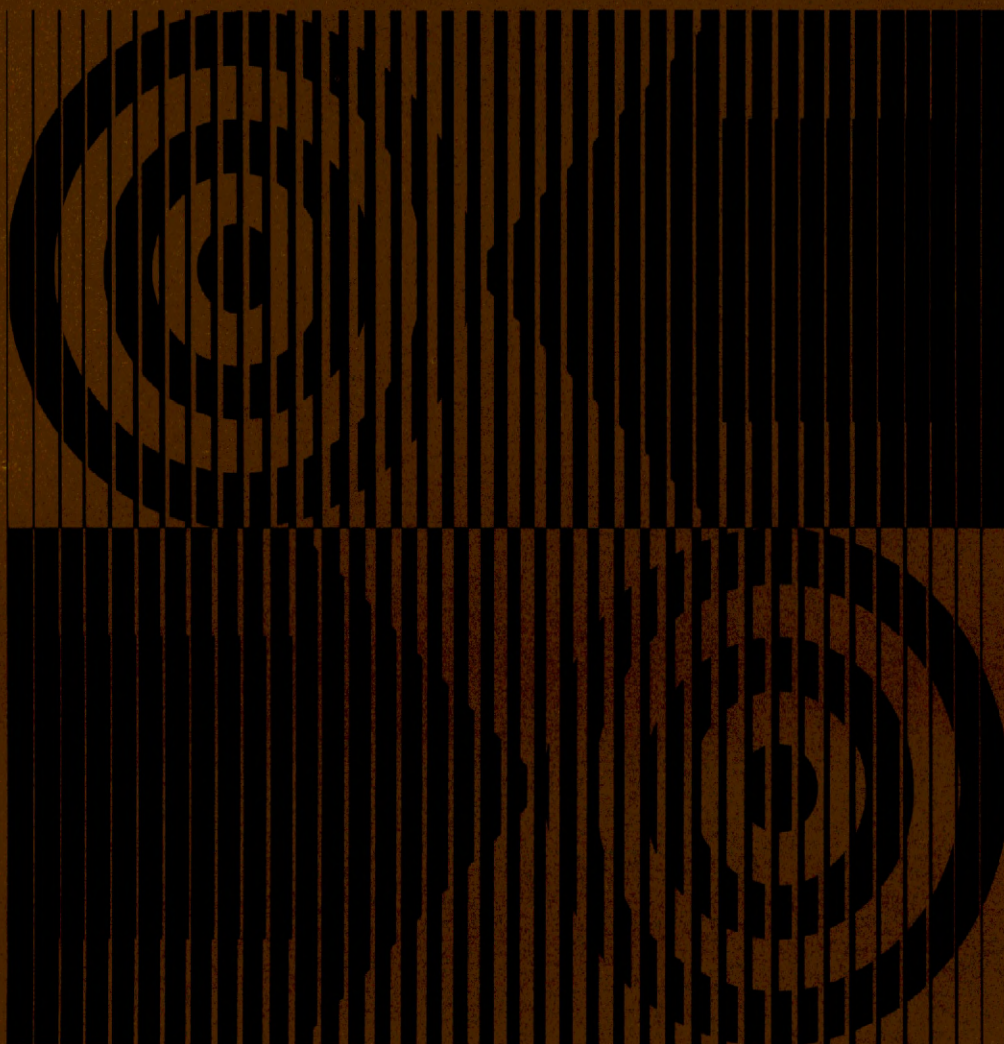


Service and Profit...Two Moving Targets for New England Commercial Banks





To the Member Banks

It is a distinct pleasure for me to send you this 1966 Annual Report of the Federal Reserve Bank of Boston.

The end of 1966 marked the seventieth month of continued expansion of our economy — an expansion which has carried both the nation and the New England region to new heights of economic activity.

As a part of this report, we have included an appraisal of some of the more significant changes which have occurred in the region's commercial banking industry during this period.

It is our hope that this review of the changing structure of banking — the problems and solutions examined — may broaden public understanding of the role of banking in an expanding economy.

Many of the ideas presented here as "new developments" in banking seem likely to be old hat before too long — if only because one of the major consequences of change is to make the future obsolete.

But *Service and Profit — Two Moving Targets for New England Commercial Banks* may still provide a benchmark of progress, as the region's banks continue to change — and to meet the changing financial needs of our society.

A summary and review of the Boston Reserve Bank's operations is included at the end of the report.

For the increasing efficiency of these operations, and for the assistance of our officers and staff in helping to improve the Bank's contribution to New England's economic progress, I extend my own thanks and those of our directors.

Our thanks go also to New England's bankers and business leaders for their generous and helpful co-operation.

January 15, 1967



President

Service and Profit...Two Moving Targets for New England Commercial Banks

PROLOGUE

The first half of the Soaring 'Sixties has brought dynamic change to commercial banking. Some of the major developments in the First Federal Reserve District — reviewed here against the backdrop of our changing national and regional economies — provide a clearer perspective of the shifting structure of commercial banking.

INTRODUCTION

Far-reaching responsibilities — to the “public interest” of their customers, and the more “private” scope of their responsibilities to stockholders — place commercial banks in unique circumstances.

In essence, banks have two primary aims — one, in the direction of full, efficient, safe, and yet effective servicing of the financial needs of the community; the other, the maintenance of bank profits sufficient to warrant the continued support of the owners' equity.

The rapidity with which the economic environment of many communities is changing — and the extent to which economic growth and opportunities are shifting — have brought an expanding need for change to the banking industry, itself.

Banks, almost by definition, are conservative in their views and actions. It's been their tradition to change — but slowly — in adjusting to their changing environment.

But conservatism is relative. And, as the pace of economic progress has accelerated in the communities they serve, banks, too, have been caught up in “catching up.”

This report provides a picture — of today's banking structure and its salient problems; a mirror — on which are reflected the patterns of change that, in five years, have framed the current banking scene; and a small window — through which we may be able to catch a glimpse of New England banking's horizons.

Four views are presented: (1) a brief analysis of the economic climate in which commercial banking functions; (2) a description of recent changes in the organizational structure of New England banking; (3) a review of some of the ways in which the internal financial structure of the region's commercial banks has been altered; and (4) a look to some things that may lie ahead.

Part I The View Reviewed

The title of this report contains a variety of implications, many of which seem particularly appropriate for New England banking-in-transition.

As might be true of a big game hunt — or even a try at the plastic ducks at some midway's shooting gallery — the principal targets toward which commercial bankers are aiming can be exceedingly elusive. For banks, intent upon protecting depositors' funds and stockholders' equity, the targets — the goals of service to the community and profit — sometimes seem to move in opposite directions.

As the 1960's progressed, service — in the sense of meeting loan demand — and profit may have moved along parallel trails. But to achieve these goals, banks were forced to sacrifice some long-held standards of liquidity and capital adequacy. Banks exposed themselves to increasing risks and uncertainties in their efforts to meet loan demand and maintain profit margins.

THE MOUNTAINS' RANGE

The New England banker's goals of service and profit are linked to — and part of — the economy he helps to shape.

The country's economy isn't what it was — it's much more.

And so is New England's.

Not many Americans have missed the fact that our national economy is operating at a higher — far higher — level than it was in 1960.

But fewer may be fully aware that December, 1966, marked the 70th month of the current upward movement of the national economy — which makes this the longest peacetime period of business expansion in our history.

This boom surpasses, handily, the 50 months of increasing prosperity that traced our recovery from the Great Depression. It has come within 10 months of catching up with the longest economic expansion ever — that associated with World War II.

But "longest" isn't half the story, for the low point from which our current ascent began was very near the previous all-time high in production — while the

1933-1937 peacetime period was, literally, one of "recovery" . . . of regaining lost ground.

The present growth of the economy has been to new and previously unvisited heights.

THE MOUNTAINEERS

The record books are full of New England statistics — the numbers that present the individual frames of a motion picture of our economic development. Viewed singly — or even in rapid succession — the statistics are only the barest bones of changes, large and small, that have occurred — and continue to occur — in our regional economy.

One difficulty, in trying to recall the series of economic events which have led us from the beginning of the decade to the present, lies in the inherent "flatness" of the human memory. Perhaps we need an economic stereopticon — that would permit us to focus one of our mind's eyes on 1960, as we can recall it . . . the other on the here and now, as we see it. Such a gadget, were one available, might help us to visualize the real changes we've recently lived through, in more depth — and with a clearer perspective for the future.

The economy continues to grow and prosper, even as this report goes to press. But here we consider the period from 1960 through 1965, for which a wider variety of data on banking changes is complete. Such measures as these reflect the economic climate in which the banking changes occurred . . .

Throughout New England, the signs of increased economic activity — and pressure — abound. And behind all of these signs are people. By the end of 1965, the region's 1960 population of 10.5 million had grown to more than 11.1 million. A portion of this growth came from a net in-migration from other areas of the country — but most from what the Bureau of the Census refers to as "natural increase." Whichever the source, our increasing population has brought with it a natural increase — of substantial proportions — in the region's ability to produce and consume both goods and services.

It is increasingly difficult to draw lines on the map

of New England that enable a viewer to separate the "urban" citizen from the "rural" — the "suburban" spread having so blurred the once-recognized boundaries. The fact is, however, that nearly one-third of the total population increase is estimated to have taken place in the three largest New England Standard Metropolitan Statistical Areas designated by the Bureau of Census, while the remainder of the increase has been diffused throughout the rest of the region. Since the three SMSA's represent the major metropolitan centers — and their suburbs — this suggests that the bulk of the increase in the population has been focused toward those areas already most heavily populated.

Long considered host to the plague of unemployment — as a consequence of the mature state of its industrialization when the early rashes of post-war technological innovation first appeared — New England, in the 'Sixties, not only recuperated, but has now been rejuvenated by the elixir of new industrial development.

Between 1960 and the end of 1965:

- ...total nonagricultural employment increased nearly nine percent — to 3.9 million;
- ...more than 7,000 new workers were added to our 1.4 million manufacturing labor force;
- ...and, in the non-manufacturing field, more than 300,000 new jobs boosted total employment over the 2.5 million mark.

One result: the region's jobless rate — despite a few remaining cities still in the recuperative stages — declined to 4.0 percent, the lowest level of the decade. The official jobless figure understates the employment opportunities which accompanied our economic expansion, as most any observer of the Help Wanted columns would confirm. Never in recent times have so many opportunities existed simultaneously for currently employed workers to move up — or over — leaving behind unoccupied positions for new workers to fill.

By the end of the 1960-65 period, New England's: ...average hourly earnings in manufacturing had climbed to \$2.44;

...average manufacturing workweek had climbed to 41 hours; per capita personal income, reflecting the population increase, the surge in wages, and the returns from investment opportunities, had risen to \$2,979;

...retail sales per capita had exceeded \$1,650;

...new car registrations — up 21 percent — passed 4.8 million;

...new ordinary life insurance in force — up 173 percent — topped \$4.5 billion;

...airline passenger boardings for commercial flights had soared to 3.6 million.

During the period:

...our electrical generating capacity increased 26 percent, our power sales, 39 percent;

...our manufacturers' capital expenditures for new plant facilities and equipment increased by close to 40 percent;

...defense contract awards increased 26 percent, to exceed \$2.5 billion;

...more than 55,000 new New England businesses were incorporated.

By the end of '65, New Englanders — and their industry — were paying \$1 billion a year more in federal taxes; \$437 million more in state taxes; and \$422 million more in local taxes than they had in 1960.

Their direct expenditures for local schools had risen to an annual rate of more than \$1.1 billion.

Deposits in New England commercial banks had increased 60 percent, to total more than \$13 billion.

To help finance industry, services, jobs, and the fulfillment of consumers' wants, the banks were supplying 39 percent more credit at the end of 1965, than they had when the Sixties started — \$375 million more consumer credit; \$565 million more real estate credit; and \$1.5 billion more business credit.

The Gross Product of the region — its total output of all goods and services — increased by an estimated 25.8 percent.

At no previous time in our history have so many New Englanders contributed so much to — or expected so much from — the economic activities of our society.

Part II. Banking's Structural Shifts...

And then there's this:

- ...Americans are getting younger. Today there are as many of us under 28 years old as there are over 28. Since 1935, our people have become 10 years younger, on the average.
- ...it's estimated that 90 percent of all of the scientists who have ever lived, are living now.
- ...perhaps coincidentally, it's estimated that 90 percent of all man's knowledge has been accumulated in the past 10 years.
- ...the range of experience now available to each of us is so diverse and complex, it's only natural that education — "experience, in capsule form" — should become a much sought after commodity.

In an age when "trying," "having," "wanting," and "doing" are such a vital part of "being," it's scarcely surprising that the economy, which has made such rapid and wide-ranging progress possible, is asked to do still more.

The past 70 months have amply demonstrated that the growth, the reach, and the pace of our economic development are fueled by a chain reaction of man's ideas and aspirations.

We've aspired to the full employment of our resources, the continuing growth of our productivity, and the stability of the purchasing power of our money. The changing structure of our population, our industry, our human wants, and our national security has provided unique opportunities upon which to sharpen our perspective of society's aims — and their achievement.

FEWER MAIN OFFICES . . .

One of the ways in which New England banks continued to improve the scope and quality of their services — and their efficiency — during the first half of the 'Sixties is reflected in their changing number.

Of the 33 banks that were chartered in New England between 1960 and 1965 — 28 were in Connecticut and Massachusetts (Table I)...

TABLE I The Number of Newly Chartered Commercial Banks in New England During 1960-1965

State	Number State Chartered	Number Nationally Chartered	Total Number
Connecticut	7	8	15
Maine	1	—	1
Massachusetts	9	4	13
New Hampshire	1	1	2
Rhode Island	2	—	2
Vermont	—	—	—
New England Total	20	13	33

Sources: Bank Examination Department, Federal Reserve Bank of Boston. Bank Commissioner's Reports, 1960-1965, State of Connecticut.

...but a total of 56 bank mergers more than offset the number of new banks chartered (Table II)...

TABLE II The Number of Commercial Bank Mergers in New England During 1960-65

State	Number
Connecticut	17
Maine	6
Massachusetts	23
New Hampshire	2
Rhode Island	—
Vermont	8
New England Total	56

Sources: As in Table I.

...resulting in fewer main banking offices (Table III).

TABLE III The Distribution of Commercial Banks in New England, 1960 and 1965

State	1960	1965
Connecticut	70	68
Maine	46	41
Massachusetts	171	161
New Hampshire	74	74
Rhode Island	9	11
Vermont	56	48
New England Total	426	403

Source: Board of Governors of the Federal Reserve System, *Changes in Status of Banks and Branches 1960-1965*, F.R. 412, Washington, D.C.

The apparent trend toward fewer commercial bank charters — fewer banking entities — lends slim support to the notion that the scope and quality of banking services have changed vastly for the better. But the number of main banking offices only gives one-quarter of the picture, as a glance at most any progressive New England Main Street — or Table IV — will quickly confirm.

For it's on the Main Streets — and in the suburban communities and shopping plazas — that the changes in the physical structure of banking have most obviously occurred. It's there that the banks and their branches — four where three served before — have most noticeably responded to their customers' needs and their own search for earnings.

TABLE IV Changes in the Number of Commercial Banking Offices Located in New England during 1960 and 1965

State	1960	1965	Percent Increase 1960-1965
Connecticut	267	381	43
Maine	177	216	22
Massachusetts	541	726	34
New Hampshire	77	100	30
Rhode Island	98	134	37
Vermont	89	105	18
New England Total	1,249	1,662	33

Source: Board of Governors of the Federal Reserve System, *Changes in Status of Banks and Branches 1960-1965*, F.R. 412, Washington, D.C.

ONE-PLUS-ONE . . .

One very clear sign of banks' efforts to improve their competitive position — and their services — is the development of a new range of relationships between country banks and their city correspondents.

Originally the city- and country-cousin arrangement was designed simply to provide city bank services to meet country bank needs. The only difference is that the country banks are finding that they need a wider range of wares — and city banks, increasingly, have the ability to meet the needs. Part of the increased ardor with which the larger banks have courted their country cousins can be ascribed to the city banks' increasingly diligent search for demand deposits, in the form of correspondent balances — a profit-seeking move, obviously.

A less obvious aspect of the expanding correspondent relationships is the additional workload which the country banks can provide for the larger banks' voracious — and frequently still hungry — computers. There are mutual benefits in this relationship. The country bank and its customers acquire access to more efficient data processing, at lower cost than might be possible were the bank to own its own equipment and maintain its own service staff — while the "computing" bank has an opportunity to make more efficient use of its equipment and staff by fuller utilization of capacity at only marginal additions to the cost.

Closer ties have broadened another area of mutual benefit — for, increasingly, country banks have been able to co-operate with their city correspondents in sharing loans . . . particularly those loans which would have been too large for the smaller banks to handle on their own, given the limitations of their capital structure.

In many cases, these stronger correspondent banking ties have provided many of the benefits of merger — without sacrificing the smaller bank's identity.

. . . EQUALS ONE

But there were a relatively large number of mergers that did occur.

A primary reason appears to have been the increasing handicap which small size imposed on banks seeking to improve their services and operating efficiency — for 23 of the 56 mergers which took place involved banks with less than \$5 million in deposits, as one partner. All but three involved banks with less than \$25 million in deposits.

(See Table V on next page)

TABLE V Commercial Bank Mergers Classified According to the Deposit Size of the "Acquiring" and the "Acquired" Bank in New England During 1960-1965

Deposit Size of Acquiring Bank (in \$1 millions)	Deposit Size of Acquired Bank (in \$1 millions)						Total Acquiring Banks
	Under \$5.0	\$5.0 - 9.9	\$10.0 - 24.9	\$25.0 - 49.9	\$50.0 - 99.9	Over \$100	
	Number of Banks						
Under \$5.0	2						2
\$5.0 - 9.9	5	1					6
\$10.0 - 24.9	2	2	1				5
\$25.0 - 49.9	9	5					14
\$50.0 - 99.9	3	5	8	1			17
Over \$100	2	4	4		1	1	12
Total Acquired Banks	23	17	13	1	1	1	56

Sources: Bank Examination Department, Federal Reserve Bank of Boston.
Bank Directory of New England, 1960-1965, The National Shawmut Bank of Boston.

Small size apparently precluded — or, at least, made more difficult — the adoption of new cost-cutting technologies . . . of which the use of computers is a particular example.

Many of the smaller banks experienced considerable difficulty in developing new services — or improving existing ones — particularly those banking services which might require the attention of a full-time specialist.

The increasing need for specialization emphasized, and made more critical, the fact that many smaller banks simply lacked sufficient depth in their management — and their managers — to continue competing vigorously in a fast-changing market, even

with the help of their city cousins.

And the smaller banks, limited by their capital structure in the size of loans which they could service, found that growth — through merger — offered them an opportunity to continue serving the credit needs of their growing corporate customers.

An analysis of the relative populations of the towns or cities served by both "acquiring" and "acquired" banks suggests that most of the mergers involved larger banks — serving larger communities — joining forces with smaller banks — serving smaller communities. (Table VI)

TABLE VI Commercial Bank Mergers Classified According to the Population of the Community in Which the Main Offices of the "Acquired" and the "Acquiring" Banks Were Located in New England During 1960-1965

Population of the Acquired Bank's Community, in Thousands of People							Total of Acquiring Banks
Population of the Acquiring Bank's Community, in Thousands of People	Under 5.0	5.0 - 9.9	10.0 - 24.9	25.0 - 49.9	50.0 - 99.9	Over 100	
Number of Banks							
Under 5.0	1						1
5.0 - 9.9	5	1					6
10.0 - 24.9	1		1		1		3
25.0 - 49.9	3	5		1			9
50.0 - 59.9	1	1	7	2			11
Over 100	2	3	9	4	1	7	26
Total of Acquired Banks	13	10	17	7	2	7	56

Sources: Bank Examination Department, Federal Reserve Bank of Boston.
Bank Directory of New England, 1960-1965, The National Shawmut Bank of Boston.

Of the 56 "acquired" banks, 23 served towns of less than 10,000 population — nearly three-fourths served communities of less than 25,000 population. Of the "acquiring" banks, less than one-fifth were located in communities having less than 25,000 population.

Obviously, not all of the advantages accrued to the "acquired" banks. The "acquiring" banks, too, found that merging offered them the means by which to achieve their goals of increasing service and improved operating performance.

The "acquiring" banks frequently obtained one or more new community offices which could serve as a base for attracting new deposits — especially new time deposits, for which customer convenience is a major factor.

The "acquiring" banks often found it possible to provide expanded banking services — at lower operating costs, because of the fuller use which the merged operations could make of new technology.

Additionally, merging offered many "acquiring" banks an alternative to establishing new — and competing — branches in the "acquired" banks' communities . . . an alternative made more attractive by the increasingly high "start up" cost of developing branch banking offices.

BRANCHING OUT . . .

The significance of the "branch office" in today's banking is reflected in the fact that — in spite of the net decrease in *main* banking offices in New England shown here — the total number of banking offices in the region increased by one-third over this same period of time.

And, while merging provided one means to increased branch banking, most of the increase in the number of banking offices was accounted for by new branches — in locations which previously had not had a commercial bank office.

Putting "people" and "banking offices" together, Table VII shows that the marked increase in banking offices has outstripped population growth — theoretically at least, making banking services more accessible to the public. The average commercial banking

office in the United States serves 6,700 people — compared with New England's 6,636 people-per-bank. And these figures do not include the offices of the variety of other financial institutions — the mutual savings banks, the credit unions, and the savings and loan companies — which have traditionally supplemented New England's banking services to a greater degree than has been the case in many other areas of the country.

TABLE VII Average Number of People per Commercial Banking Office Located in New England, 1960 and 1965

State	1960	1965
Connecticut	9,524	7,223
Maine	5,503	4,579
Massachusetts	9,534	7,480
New Hampshire	7,909	6,390
Rhode Island	8,776	6,694
Vermont	4,382	3,771
New England Average	8,434	6,636
United States Average	7,600	6,700

Sources: Board of Governors of the Federal Reserve System, *Changes in Status of Banks and Branches During 1960-1965*, F.R. 412, Washington, D.C.

U.S. Bureau of the Census, *Statistical Abstract of the United States: 1965* (68th edition), Washington, D.C., 1965.

Rand McNally and Company, *Rand McNally Commercial Atlas and Marketing Guide* (97th edition), Chicago, Illinois, copyrighted, 1966.

WHY AND WHERE . . .

Variations between the states can be explained — in part at least — by differences in population density, branching regulations, and competition from savings banks and other thrift institutions.

Connecticut, Massachusetts, and Rhode Island — all with high population densities — serve the largest numbers of people per commercial banking office.

The northern New England states have, obviously, established more banking offices for the convenience of a more widely dispersed population.

Where regulations permit, branching appears to be the means preferred by most bankers for expanding their service areas — perhaps because the range of services offered by branch offices can more easily be tailored to the needs of those areas which have a limited potential for banking services.

Coupled with limited competition from savings

banks — which would enhance the individual community's deposit and mortgage loan potential for a commercial bank — unrestricted branching regulations would seem to be a significant key to a low population-per-banking-office ratio. This seems to hold true in Vermont, where a low population density, the permitting of state-wide branching, and very limited competition from mutual savings banks can be matched with the lowest ratio of people-per-banking office in New England.

Maine's slightly higher ratio might be interpreted as a reflection of that state's more restrictive limitation of branching to only those counties contiguous to the main office.

New Hampshire's still higher ratio might be correlated with still more restrictive branching regulations and the existence of many savings institutions.

But Table VIII suggests a somewhat different view.

TABLE VIII The Distribution of Commercial Banking Offices, Personal Income, and Commercial Bank Deposits, by States
New England, 1965

State	Commercial Bank Offices	Personal Income	Commercial Bank Deposits
Percent of New England Total			
Connecticut	22.9	28.3	24.4
Maine	13.0	6.8	6.1
Massachusetts	43.7	49.5	52.1
New Hampshire	6.0	4.9	4.2
Rhode Island	8.1	7.7	9.1
Vermont	6.3	2.8	4.1
New England Total	100.0	100.0	100.0

Sources: Board of Governors of the Federal Reserve System, *Changes in Status of Banks and Branches During 1960-1965*, F.R. 412, Washington, D.C.

Rand McNally and Company, *Rand McNally Commercial Atlas and Marketing Guide* (97th edition), Chicago, Illinois, copyrighted, 1966.

BANKS, WHERE THERE'S MONEY . . .

It appears that the number of banking offices can be roughly correlated with the distribution of personal income, and the distribution of total commercial bank deposits among the individual states.

Granting the limited precision of these measures for evaluating the commercial banks' effectiveness in serving the public's needs, evidence supplied by

these specific changes in the physical structure of the New England commercial banking system indicates a relatively rapid and significant shift toward making a broader range of commercial banking services more readily available to the public.

In itself, this is an important development in a closely regulated industry — an industry exposed to the hazard of "losing touch with its public" . . . an industry that could use regulation as an excuse for lack of imaginative management. Instead, banking has moved aggressively forward to match and support the quickening pace of the economy.

Part III. A Changing Situation...For the Books

ON THE TRAIL . . .

Looking back at the pattern of change in banks' assets and liabilities, one is impressed by the high degree of liquidity which was characteristic of banking from the Great Depression through World War II.

During the 1930's, investment portfolios — tending heavily to government securities — represented a high proportion of bank assets. Economic activity was slow, loan demand was slack, and bank management was forced to accept the low return — but high liquidity — these investments offered.

Came World War II, and loan demand increased only moderately — largely because consumer goods were “unavailable for the duration.” Money was easy — and businesses were able to meet much of their need for short-term financing from internal sources. Banks continued to add to their holdings of government securities to the extent that, by 1945, these securities amounted to some 57 percent of their total assets.

By 1950, loan demand had begun to come to life. The reservoir of liquidity dammed up in banks' investment holdings started to flow into the economy in the form of loans — to consumers, to businesses, to state and local governments, and to foreign borrowers. From 37 percent of total commercial bank assets, nationally, in 1950, government securities had declined to less than 24 percent by the end of 1960.

A few banks continued to operate as “investment houses” — continued to depend on their investment portfolios (still made up largely of government securities) as a major source of bank income. But, as the 1960's began, the pressure of the public's demand for loans encouraged most of these to put their assets to more rewarding use — or else to merge with banks that were moving to meet the demand for loans.

. . . OF MARKETS

Wherever permitted, the banking industry in New England has followed its market. Banking offices — and services — have moved in the direction of people . . . people whose needs banks might serve . . . people whose financial circumstances could provide in-

creased deposit potential.

Observation indicates that this trend has been accompanied by the development of a wide range of more readily available bank services.

Further, the increasing proportion of branch banking offices suggests the likelihood that the services offered in many communities are becoming more closely tailored to both the customer's needs and the area's banking potential.

THE “OTHER” PUBLIC . . .

But what of banking's other “public” — the stockholders of the banks?

How have they fared?

With deposits barely adequate to meet loan demand, have banks been able to maintain earnings while broadening bank services and making them more widely available?

Has new risk been added to the stockholders' equity by a decline in liquidity?

Has bank management managed to discharge its duties in a way that has served both the public's and the stockholders' interest?

Are the two goals working in opposition . . . or in concert . . . with each other?

An examination of the pressures that have been focused on bank earnings — and the simultaneous changes that have occurred on banking's balance sheet — may suggest answers to such questions.

THE BACKDROP . . .

During the early stages of the present prosperity, stimulative fiscal policy — tax cuts and the continuing expansion of federal spending, for example — plus relatively easy monetary policy — typified by the abundant availability of money — gave the economy a strong upward push.

Where there was slack in the economy in the early 1960's, those unused resources are, for the most part, now at work.

Exceptionally strong demand for goods and services — seemingly made more robust as the expansionary period matured — kindled an equally strong demand for money and credit.

Under conditions such as these, even moderate monetary restraint has resulted in sharply rising interest rates.

Periods of high interest rates on loans — plus an active demand for loanable funds — would seem to promise banks high gross returns. But with high rates of interest have come greater-than-usually-recognized increases in the banks' cost of money.

BANKING'S HYDRAULIC BRAKE — LIQUIDITY

Crucial to all banking — and more crucial to economic developments than is frequently appreciated — is the matter of liquidity.

Liquidity — as the word, itself, implies — is more easily talked about than grasped. Typically, bank liquidity refers to the maintaining of sufficient assets in the form of cash — or near-cash — reserves to permit a bank to meet the daily-changing patterns of deposits, withdrawals, and loan demand without unnecessary borrowing, excessive losses on the conversion of investments, or awkward reshuffling of the bank's loan portfolio.

In practice — with substantial shifts in a bank's deposit mix and loan opportunities — balancing off liquidity needs and liquidity flows can make shooting the rapids in a birch bark canoe seem simple and safe, in comparison.

Loan maturities stretching longer; the growing dif-

ficulty of using rates, alone, to ration credit; and the vision of gleaning more profit — but smaller profit margins — from a larger loan volume . . . each adds to the murky turbulence of the liquidity problem.

The rough rule of thumb which considered the ratio of a bank's loans to its deposits as a measure of liquidity has grown increasingly less useful.

The amortization of loans from which the flow of repayments can be counted upon as a continuing source of cash has altered the earlier rigidities of loans. The stability of time deposits — partially undermined by the growing inclination of depositors to move funds in pursuit of the return from higher rates — and the increasing velocity of demand deposits have diluted the effectiveness of the deposit-and-loan ratio as a measure of bank liquidity.

Despite difficulties in arriving at precise measurements, it appears that bank liquidity has been put under increasing pressure — and the result has been a spreading awareness of the critical interrelationships of liquidity, service, and profit.

DEPOSITS —

THE RAW MATERIAL OF BANKING

The effects of these cross currents are reflected in the comparative balance sheets of all the New England commercial banks for the years 1960 and 1965 shown in Table IX.

Over this five-year period, demand deposits in-

TABLE IX Comparative Balance Sheet of all Commercial Banks
New England, 1960 and 1965 (millions of dollars)

	December 31, 1960	Percent of Total Assets	December 31, 1965	Percent of Total Assets
ASSETS				
Cash and Due	\$ 2,247.3	19.2%	\$ 2,487.5	15.5%
U.S. Governments	2,626.2	22.4	2,144.3	13.3
Other Securities	854.9	7.3	1,769.3	11.0
Loans and Discounts	5,751.2	49.0	9,281.2	57.7
Other Assets	250.9	2.1	401.9	2.5
TOTAL ASSETS	\$11,730.5	100.0%	\$16,084.2	100.0%
LIABILITIES				
Demand Deposits	\$ 7,675.4	65.4%	\$ 8,935.5	55.6%
Time Deposits	2,579.9	22.0	4,947.1	30.8
Other Liabilities	416.9	3.6	782.9	4.9
Capital	1,058.3	9.0	1,418.7	8.8
TOTAL LIABILITIES AND CAPITAL	\$11,730.5	100.0%	\$16,084.2	100.0%

Percentage figures may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System, *Assets and Liabilities of All Operating Banks and Trust Companies*, F.R. 40, December, 1960, and December, 1965, Washington, D.C.

TABLE X The Distribution of Balance Sheet Items of New England Commercial Banks
As a Percentage of Total Assets or Liabilities, 1965

	Conn.	Maine	Mass.	N.H.	R.I.	Vt.
ASSETS						
Cash and Due	14.1	12.8	17.8	13.2	11.1	9.0
U.S. Governments	12.0	15.7	13.8	14.9	10.2	16.7
Other Securities	13.1	11.6	9.0	6.9	19.1	9.8
Loans and Discounts	58.2	57.5	56.6	63.4	58.1	62.9
Other Assets	2.5	2.4	2.8	1.7	1.5	1.7
TOTAL ASSETS	100.0	100.0	100.0	100.0	100.0	100.0
LIABILITIES						
Demand Deposits	54.8	45.4	62.3	47.7	38.7	31.4
Time Deposits	33.1	42.4	22.7	39.4	48.0	59.3
Other Liabilities	3.4	3.2	6.0	3.3	5.3	1.7
Capital	8.5	9.0	9.1	9.6	8.0	7.7
TOTAL LIABILITIES AND CAPITAL	100.0	100.0	100.0	100.0	100.0	100.0

Percentage figures may not add to totals because of rounding.

Source: Board of Governors of the Federal Reserve System, *Assets and Liabilities of All Operating Banks and Trust Companies*, F.R. 40, December, 1965, Washington, D.C.

creased by a modest one-sixth — contrasted with a near-doubling of time deposits. Simultaneously, there was an increase of nearly one-third in banks' capital funds. The result has been a marked shift in banks' liability structure, with time deposits assuming — or being forced to assume? — a more important role, although, at 55.6 percent, demand deposits still account for over half of New England commercial banking's liabilities.

The "all New England bank" totals obscure the fact that there are wide differences in the liability structures of banks in the individual states. (Table X) The state averages, in turn, mask the range of structural differences that arise from varying market potentials and management policies.

SIX OF ONE . . .

Commercial banks in Massachusetts and Connecticut averaged the highest ratios of demand deposits to total liabilities — partially because banks in these two states face more extensive competition for time deposits from a variety of savings institutions. On the other hand, it must be acknowledged that the larger banks in these two money centers have had a magnetic effect upon larger corporate — that is, demand — deposits.

At the opposite end of the spectrum are Vermont banks — with less than one-third of their liabilities made up of demand deposits. The traditional servic-

ing of both time and demand accounts, the limited industrial base, and the more limited competition from savings institutions — all serve to suggest an explanation.

Rhode Island banks, too, have traditionally serviced time accounts — a tradition enhanced by the convenience to time depositors of state-wide branching systems. This may help to account for the relatively high level of their time deposits. Conversely, the money market services which the larger banks provide for the state's industrial and business community may offer a clue to the reasons why demand deposits are also an important source of funds for Rhode Island commercial banks.

More readily compared, Maine and New Hampshire banks' demand deposits averaged 45 and 48 percent, respectively, of their total liabilities.

While it only represents a small portion of total liabilities, the category labeled "other liabilities" — which includes short-term notes, subordinated debentures, Federal Funds purchases, and similar "borrowed" funds — is of growing significance on the balance sheet of a number of banks, in Massachusetts and Rhode Island particularly. While of lesser importance among Vermont banks, this category nevertheless provides an additional indication of the alternative sources to which commercial banks have begun to turn in their search for the funds which are their raw materials.

A HALF-DOZEN OF THE OTHER . . .

Have banks been able to meet the demand for various kinds of loans?

Have they concentrated their efforts on higher earning investments . . . and the more lucrative types of loans?

The evidence presented by the shift in their asset structure clearly suggests that banks, generally, have made a very real effort to meet the market's range of demand for loans.

In general, banks have met increased loan demand by using a larger share of their liabilities for loans — while holding a smaller share in investments, cash, and near-cash.

Loans and discounts, for example, representing just under half of total assets in 1960, increased to almost 58 percent of assets in 1965 — while holdings of cash and U.S. government securities, near 42 percent of assets in 1960, declined to less than 29 percent in 1965. Holdings of other securities (mostly municipal issues) rose modestly — from just over 7 to 11 percent of assets — over this same period.

In contrast to earlier periods of tight money, outstanding commercial bank credit did not diminish as more restrictive monetary policy took hold in 1965 and 1966. The restrictiveness slowed — in some instances, very markedly — the *expansion* of credit; but even mortgage loans continued to rise, despite some evidence of increasing selectivity among longer

term loan applications in response to mounting concern for liquidity near the peak of credit demand. Instalment credit increased throughout the period, only leveling off toward the later months of 1966.

By competing more vigorously for deposits, by committing their deposit growth largely to loans, and by some reduction in their liquidity — at least as conventionally measured — New England commercial banks have generated the funds they have needed to serve the bulk of their customers' expanding credit needs.

THE COST OF KEEPING UP

In 1960, bank earnings — measured as a return on capital — compared favorably with those of other industries. During the five-year period that followed, bank earnings drifted downward — while earnings in most other sectors of the economy increased. (Table XI)

Granted, the earnings figures of all industries may not be strictly comparable. But bank earnings appear to have followed a diverging trend from those of other industries, suggesting that banks have been under heavy pressure to maintain earning levels that will continue to attract and hold adequate capital.

Banks, almost universally, have had to apply increasing amounts of leverage to their capital — in order to prevent earnings rates from dipping to even lower levels.

TABLE XI Average Percentage Return on Net Assets¹ in Selected Industries

Industry	1960	1961	1962	1963	1964	1965
Manufacturing	10.5%	10.1%	10.9%	11.5%	12.7%	13.8%
Mining	7.3	8.6	8.8	8.8	10.4	11.9
Trade	10.4	10.2	10.1	10.1	12.1	13.1
Transportation*	2.9	2.4	3.8	4.5	5.3	6.8
Utilities	10.0	9.9	10.0	10.2	10.7	10.8
Services	9.7	10.8	10.8	10.3	12.4	14.5
BANKING	10.0	9.8	9.2	9.2	8.7	8.8
Average of all Industries	9.1	8.7	9.1	9.5	10.3	11.1

*Includes Railroads

¹ Book net assets at the beginning of the year, based on the excess of total balance sheet assets over liabilities.

Source: First National City Bank of New York, *Monthly Economic Letter*, April, 1961, 1962, 1963, 1964, 1965, and 1966, New York City, New York.

EVERYBODY . . . OUT OF THE POOL!

In banking, as in any other business, "profit" represents that portion of total revenue remaining after all expenses are paid.

This concept of profit is certainly the easiest to grasp — and "profit," thus defined, is perhaps the easiest to determine, simply because the summing of all items of income, all items of expense, and the subtraction of the second answer from the first, provides the solution.

For some analyses, this straightforward approach to "profit" provides the handiest basis for comparing the total operations of one bank with another's — or with those of other businesses.

But, because it deals with total revenues, this measure tends to mix together recurring and nonrecurring sources of income.

The "current earnings" concept — which limits the evaluation of "profit" to the revenues and expenses resulting from the bank's regular operating activities, ignoring such items as loan losses, gains or losses from the sale of securities, and recovery of losses previously charged off, as being of a nonrecurring nature — provides a measure more adaptable for bank-to-bank and year-to-year comparisons. It is this concept of earnings that is used in the Functional Cost program offered to member banks by the Federal Reserve Bank of Boston.

The funds-using operations of the bank — the installment loan department, the real estate loan department, the business (or other) loan department, and the investment department — all have access to funds which have been made available for the bank's use by three sources: time deposits, demand deposits, and the bank's capital.

For some accounting procedures, it might be assumed that there is a fixed relationship between specific sources of funds and the use that is made of those funds. Time deposits, for example, might be assumed to have been earmarked specifically for real estate mortgages or term loans, because of the pre-

sumed relative stability of both the source and the uses of the funds — in effect, coupling the cost of generating time deposits to the returns from these funds-using functions.

In reality, such a direct connection between the origin of funds and the uses of funds is virtually impossible to establish, to maintain — or to reconcile.

A more realistic approach, which provides a more uniform — and therefore, more comparable — basis for judging the relative “earnings” of individual functions is the “pool of funds” concept.

Here it is assumed — with some logic — that the time and demand deposit functions, together with bank capital, net of fixed assets, contribute to the bank’s “pool of available funds,” and that the funds-using functions draw from this pool in order to gen-

erate the bulk of the bank’s “current earnings.”

The cost of money for each funds-using function is then computed as that function’s prorated share of the composite cost of the funds supplied by the three funds-providing functions.

The cost of money to the funds-using functions represents the cost of servicing each \$100 of demand and time deposits (including interest expense) less any service charge income.

Thus, if the net cost of money amounted to 2.17 percent, the lending and investment functions would each be “charged” \$2.17 for each \$100 of funds used.

Tables XII and XIII illustrate essentially comparable income, expense, and current earnings figures for a group of New England banks in the \$3.5 to \$50 million deposit range for the two years, 1960 and 1965.

TABLE XII Average Income, Expense, and Current Earnings
per \$1,000 of Deposits by Type of Deposit, 82 Selected New England Commercial Banks, 1960

Item	Time Deposits		Demand Deposits	
Loan and Investment Income	\$37.25		\$30.30	
Other Deposit Income	.36		8.10	
Total Income		\$37.61		\$38.40
Operating Expense	\$ 6.03		\$23.07	
Interest on Deposits	24.38			
Total Expenses		\$30.41		\$23.07
Net Current Earnings		\$ 7.20		\$15.33
Less Federal Taxes		3.17		6.73
Net Current Earnings After Taxes		\$ 4.03		\$ 8.60

Source: *Functional Cost Analysis*, 1961, Federal Reserve Bank of Boston.

TABLE XIII Income, Expense, and Current Earnings per \$1,000 of Deposits, by Type of Deposit,
86 Selected New England Commercial Banks, 1965

Item	Time Deposits		Demand Deposits	
Loan and Investment Income	\$40.57		\$34.41	
Other Deposit Income	.31		9.09	
Total Income		\$40.88		\$43.50
Operating Expense	\$ 6.60		\$25.25	
Interest on Deposits	33.61			
Total Expenses		\$39.67		\$25.25
Net Current Earnings		\$ 1.21		\$18.25
Less Federal Taxes		.45		6.81
Net Current Earnings After Taxes		\$.76		\$11.44

Source: *Functional Cost Analysis*, 1966, Federal Reserve Bank of Boston.

TABLE XIV Deposit and Capital Structure as a Percentage of Total Assets
for Selected Groups of New England Commercial Banks, 1965

Sources of Available ² Funds	Range of Net Current Operating Earnings ¹ Before Taxes, per \$1,000 of Available Funds								
	Group 1	Group 2	Group 3	Group 4	Group 5	Group 6	Group 7	Group 8	Group 9
	\$ 7.76 - \$12.08	\$12.21 - \$14.03	\$14.12 - \$15.39	\$15.69 - \$17.26	\$17.27 - \$18.32	\$18.49 - \$19.53	\$19.65 - \$21.98	\$22.15 - \$24.59	\$24.61 - \$34.43
Demand Deposits	40.73%	48.33%	50.15%	48.57%	53.77%	56.29%	70.48%	64.12%	62.88%
Time Deposits	47.24	41.45	37.63	38.83	33.85	30.68	14.73	21.70	21.36
Net Capital Funds	8.89	8.25	9.83	10.56	9.96	10.58	12.28	12.18	13.18
TOTAL AVAILABLE FUNDS	96.86%	97.71%	97.61%	97.96%	97.58%	97.56%	97.50%	98.00%	97.42%

1. Tax exempt income converted to taxable basis.

2. Available funds equal total liabilities and capital, less fixed and other assets.

Source: Federal Reserve Bank of Boston, *Functional Cost Analysis Comparative Study, 86 New England Banks, 1965-1964*, p. S1.

A PENNY SAVED . . .

Perhaps most striking, here, is the sharp decline in net after-tax earnings on time deposits — from \$4.03 per \$1,000 of deposits in 1960, to \$.76 in 1965.

The reason for this dramatic decline in earnings is quite apparent — while operating expenses held virtually the same, the modest increase in the gross earnings on these deposits has been more than offset by the sharp increase in interest costs — both for acquiring and holding these funds.

Earnings on demand deposits have improved — with increased income more than making up for a slight increase in operating costs.

The burden of a larger proportion of time deposits in the banks' liability mix — the income-absorbing cost of these funds — is shown in Table XIV.

The almost-perfect progression of increasing earnings — from the \$10 per \$1,000 of available funds range of the lowest earning banks (Group 1), to the \$30 per \$1,000 of the highest (Group 9) — reflects the strong influence of the time deposit burden — which ranged from over-47 percent of total assets for the lowest earners, to less-than-22 percent for the highest.

This evidence supports the axiom that the heavy burden of interest imposes a stringent handicap on the earnings of banks which depend to a large extent upon time deposits for their available funds.

Earnings are also influenced by the type of loan opportunities which are available to a bank — and by the composition of the resulting loan portfolio. The changing pattern of average net returns on various types of loans from 1960 to 1965, shown in Table XV, demonstrates how earnings are related to the composition of a bank's loan portfolio.

TABLE XV Average Net Return per \$100 of
Loan Volume by Type of Loan

Selected New England Commercial Banks, 1960 and 1965

Type of Loan	1960	1965
Instalment Loans	\$5.69	\$5.72
Real Estate Loans	\$4.42	\$4.84
Commercial Loans	\$4.36	\$4.27

Source: Federal Reserve Bank of Boston, *Functional Cost Analysis, Average Participating Bank, 1960 and 1965*, Boston, Mass.

Most banks have recognized the relative profitability of instalment loans — and have aggressively sought them, in order to bolster earnings. Not every bank, however, has had such favorable experience with instalment loans as Table XV might suggest.

THE COST OF HANDLING . . .

Because instalment loans are relatively more expensive to handle — and because of the aura of profitability which banks have assumed surrounds them — it frequently requires tight management control for banks to keep instalment loan costs — by nature,

never wholly tamed — from getting out of hand.

The rate of earnings tends to narrow if the bank achieves instalment loan growth through an expansion of loans made indirectly, through dealers.

Among banks included in the First District Functional Cost Study, those having the highest rate of net earnings on instalment loans were those which had the highest portion (83 percent) of direct loans to consumers. These same banks, not incidentally, had the lowest volume of instalment loans.

In contrast, those banks which had the highest volume of instalment loans had only slightly more than half of their portfolio in direct loans to consumers — and their rate of return from instalment loans was considerably lower.

This evidence suggests that banks which aggressively sought to build instalment loan volume frequently received lower rates of net return on their loan operations because their rapid expansion often meant a higher rate of loss on loans made, or because they failed to control the expenses of the loan department, or because they tended to achieve growth by emphasizing indirect instalment loans — or, perhaps, because of a combination of all three.

Real estate loans have recently reinforced their position as the second-most-profitable loan category. Despite this relative profitability, there is some evidence to suggest that banks have favored the somewhat lower-earning commercial loans over the more lucrative real estate loans.

One reason for this may be that the longer term real estate loans were looked upon as providing less liquidity — in a period when bankers were increasingly concerned about the declining liquidity of their assets.

Another reason may have been the traditionally close relationship between commercial banks and their business customers. Business loans tend to encourage economic growth in a community — and there is a close correlation between a bank's business loans and its demand deposits.

Knowing the wider margin of return available

from demand deposits, most bankers are reluctant to restrict business loans severely, at the risk of slowing down the growth of their community's economic base — and the subsequent growth of their own demand deposits.

Part IV Taking Aim

It's obvious that pressure on profit is not unique to the banking industry.

But, given the relatively narrow profit margins in banking, it is equally obvious that New England banks are confronted with some critical problems as they search for the means to at least maintain — but, preferably, enhance — their profit positions.

There are limits to how far banks can go in continuing to reach for high cost sources of funds — in stretching loan-to-deposit ratios — in shifting toward higher earning investments — and in thinning down their capital ratios. Their recent, rapid, and extensive adoption of most — if not all — of these measures would appear to leave little room for additional maneuvering in such areas.

Now new avenues for maintaining banks' profit margins must be explored. And a sizable number of the more promising of these routes are prominently marked by signs pointing to the fuller utilization of available computer technology.

THE MACHINE THAT KNOCKS . . .

Computer technology opens up two areas of opportunity for banking.

First, computers are already proving that they can effectively lower — or, at least, hold down — bank operating costs.

More important, computer technology suggests a wide range of new services that banks can offer in order to broaden their earnings potential, perhaps without having to expand their deposit base.

Most New England commercial banks in the \$50 million-or-more deposit category are already using computers — to streamline their own operating functions, and to reduce the impact of sharply rising labor costs. The more advanced and successful of these installations are currently demonstrating their ability — even at the present state of the art — to restrain the escalation of operating costs.

Almost every bank that is presently equipped with computer facilities is — or soon will be — offering expanded services to its customers. Payroll prepara-

tion, account reconciliation, customer billing, even credit cards — or similar devices — with built-in overdraft or line-of-credit provisions are examples of some of the new services that are fast becoming commonplace.

The potential is probably limited only by the imagination and competence of the bank's staff — and by such legislative or regulatory restrictions as may subsequently emerge.

THE PRICE OF PROFIT

Profits from these newer services will depend in large measure on the banks' ability to do a realistic job of pricing them. This is apt to be a difficult task — considering the intensity of the competition already in the field.

Most banks acquiring computer facilities install capacity in excess of their own immediate needs, in anticipation of their own potential for growth. In order to attract new business — to put this excess capacity to use — some banks may price computer services to customers at little more than their marginal cost. Since marginal cost pricing practices contribute little, if anything, to overhead costs, a pattern of prices based upon marginal costs may result in more, rather than less, pressure on bank earnings.

BIG MACHINES — LITTLE BANKS

How smaller banks — those with, say, less than \$50 million in deposits — can take advantage of the computer's potential is a challenging problem. Several alternatives to "owning their own hardware" have already begun to emerge.

One approach is for a group of smaller banks to join in forming a co-operative computer center. At least two such arrangements have developed, so far, in the First Federal Reserve District.

Another alternative is the development of the holding company data processing center — and at least two of the larger New England bank holding companies are providing computer service for their banks in this way.

A third alternative — making use of the data proc-

essing services offered by a non-bank computer facility — is being followed by a few banks.

Taking a different tack, a number of the smaller banks near Boston are making use of the computer services offered by their correspondent banks. The fact that most of the smaller banks participating in these programs are located within a 75-mile radius of Boston emphasizes the limitations imposed by the costs — and time — required to transport paper documents to and from the computer center. These limitations would seem to rule out this approach for many small banks — particularly those located in northern New England.

PAPER CHOPPERS

In some areas outside New England, helicopters and other forms of air transport are already in use — moving computer “input” and “output” between city banks and their country correspondents. Some combination of air-ground transportation appears to be a promising development that would permit more distant country banks to use the extensive — and expanding — computer services offered by the Boston correspondent banks.

As an alternative to this, in cities such as Worcester, Springfield, Hartford, Providence, and Portland, a number of the larger banks are offering data processing services to the smaller banks in their geographical area — and there are indications that banks of similar size in other areas are planning to follow suit in the not-too-distant future.

It appears, then, that smaller banks will have a variety of opportunities to buy the service, rather than the computer. And, as the competition continues to stiffen, it seems quite likely that the small bank will be able to acquire data processing services that are not only “a good buy,” but also, perhaps, superior to what it might be able to provide economically for itself.

FROM YESTERDAY'S PAPER . . .

In a longer view, improved transportation should allow computer-equipped banks to offer their services over a yet wider geographical area. And — not too remote — is the possibility that data . . . including the information represented on documents such as checks . . . will flow to and from computer centers over a wire communication network, eliminating, or

at least sharply reducing the necessity of moving the actual paper.

This possibility suggests that the structure of commercial banking in New England is far from fixed — far from rigid — far from certain. Many questions — but few answers — are apparent.

. . . TOMORROW'S ANSWERS

Is it likely that a whole new group of banks — the larger institutions outside of the Boston area — will emerge as correspondents in their respective areas?

If they do, will they be able to compete — not only in offering a wide range of computer services, but also in providing the more traditional services offered by city correspondents in the major money market cities?

Or will more efficient transportation systems — perhaps the development of a practical system for data communication — leapfrog this alternative, and encourage the smaller country banks to continue their present city correspondent relationships?

To what degree will the larger banks, with a broader range of services, be willing — and able — to serve corporate customers in more distant locations directly? What would such a development mean for the smaller local banks?

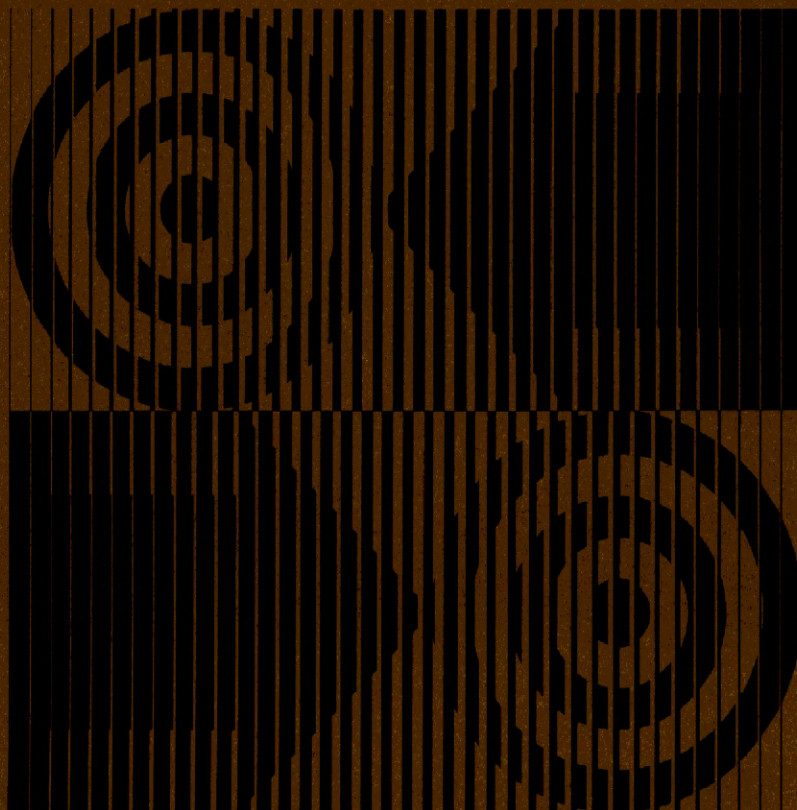
Is there a real danger that, by “buying” the machinery and skills they need from larger, more aggressive banks, small banks may eventually undermine their own ability to continue as unit banks?

What does the future hold for the “personal touch” in banking — the tailor-made service that so often has allowed the smaller bank to compete successfully with the giants of the industry for a share of local business?

When the answers to such questions as these are available, the chances are they'll not be clear-cut — black or white — yes or no. Developments so far seem to show that if the smaller bank is able to build and maintain a staff at least conversant with today's technology — and tomorrow's possibilities — it will find a way to provide the services and make a profit.

Those who *can't* will merge. But those who *can* will somehow, with typical Yankee ingenuity, devise a package of services with which the larger, but more remote institutions may compete — but which they will not be able, profitably, to supplant.

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Comparative Statement of Condition

	December 31, 1966	December 31, 1965
ASSETS		
Gold Certificate Reserves	\$ 775,433,679.75	\$ 801,268,563.80
Federal Reserve Notes of Other Federal Reserve Banks	58,371,719.00	74,022,168.00
Other Cash	9,133,494.05	9,522,174.01
Discounts and Advances	500,000.00	1,927,000.00
U.S. Government Securities — System Account	2,325,959,000.00	2,096,777,000.00
Cash Items in Process of Collection	630,085,289.47	518,593,365.39
Bank Premises	2,756,130.85	2,873,167.45
Foreign Currencies	41,961,851.06	29,525,645.83
All Other	17,730,777.60	15,823,765.25
Total Assets	<u>\$3,861,931,941.78</u>	<u>\$3,550,332,849.73</u>
LIABILITIES		
Federal Reserve Notes (net)	\$2,387,404,007.00	\$2,249,766,171.00
Deposits:		
Member Bank Reserve Accounts	859,163,298.98	701,894,331.60
U.S. Treasurer — Collected Funds	525,261.98	48,210,404.48
Foreign	7,680,000.00	7,050,000.00
Other	8,547,198.92	6,482,090.78
Total Deposits	875,915,759.88	763,636,826.86
Deferred Availability Cash Items	532,090,131.73	474,262,002.02
Other Liabilities	11,914,843.17	9,470,049.85
Total Liabilities	<u>\$3,807,324,741.78</u>	<u>\$3,497,135,049.73</u>
CAPITAL ACCOUNTS		
Capital Paid In	\$ 27,303,600.00	\$ 26,598,900.00
Surplus	27,303,600.00	26,598,900.00
Total Capital Accounts	<u>\$ 54,607,200.00</u>	<u>\$ 53,197,800.00</u>
Total Liabilities and Capital Accounts	<u>\$3,861,931,941.78</u>	<u>\$3,550,332,849.73</u>

Comparative Statement of Earnings and Expenses

	1966	1965
Current Earnings:		
Advances to Member Banks	\$ 1,586,882.21	\$ 694,594.39
Foreign Loans on Gold	31,346.20	40,701.19
Invested Foreign Currency Balance	1,054,797.03	664,162.10
U.S. Government Securities — System Account	96,255,480.94	78,583,698.39
All Other	19,324.21	13,188.46
Total Current Earnings	98,947,830.59	79,996,344.53
Net Expenses	12,190,897.99	12,135,443.26
Current Net Earnings	86,756,932.60	67,860,901.27
Additions to Current Net Earnings	63,723.42	47,943.42
Deductions from Current Net Earnings:		
Loss on Sales of U.S. Government Securities (net)	129,795.03	475.22
All Other	19,382.59	5,386.07
Total Deductions	149,177.62	5,861.29
Net Addition or (Deduction)	(85,454.20)	42,082.13
Net Earnings before Payments to U.S. Treasury	<u>\$86,671,478.40</u>	<u>\$67,902,983.40</u>
Dividends Paid	\$ 1,619,325.71	\$ 1,546,585.23
Payments to U.S. Treasury (Interest on F.R. Notes)	84,347,452.69	64,608,898.17
Transferred to Surplus	704,700.00	1,747,500.00
	<u>\$86,671,478.40</u>	<u>\$67,902,983.40</u>

Volume Figures for Years 1965 and 1966

TRANSACTION	Volume in Pieces or Units (Daily Average)		Volume in Dollars (Annual Total)	
	1966	1965	1966	1965
Discounts and Advances			\$ 4,104,361,000	\$ 2,699,764,000
Daily Average Outstanding			35,254,750	17,233,000
Purchases and Sales of U.S.				
Securities for Member Banks	10	12	324,157,700	428,834,650
Currency Sorted and Counted	1,391,735	1,315,414	2,457,556,194	2,418,706,765
Coin Counted and Wrapped	4,204,636	3,513,582	96,234,850	65,980,750
Check Collection	1,596,301	1,492,011	130,793,598,296	108,711,081,383
Noncash Collection:				
Notes, Drafts, and Coupons (except U.S. Government)	5,188	5,075	1,113,532,949	756,750,638
Safekeeping of Securities:				
Pieces Received and Delivered	421*	919	18,794,938,718	16,595,552,818
Coupons Detached	2,494	2,636	51,107,601	50,356,347
Transfer of Funds	927	818	191,210,841,147	168,587,789,069
Issues, Redemptions, and Exchanges:				
U.S. Securities (Direct Obligations)	1,139	1,096	17,121,717,387	18,594,613,243
U.S. Savings Bonds	40,449	39,539	559,878,356	528,412,984
All Other	42	254	120,100,550	136,014,150
U.S. Government Coupons Paid (Direct Obligations)	2,204	2,331	216,498,645	209,525,594
Federal Taxes: Depository Receipts and Direct Remittances	3,680	3,482	3,238,609,901	2,440,284,769
Currency Verified and Destroyed	245,542	183,179	87,162,000	54,282,000
Deposits and Withdrawals — Treasury Tax and Loan Accounts	651	597	11,570,585,441	9,951,851,166

*1966 data not comparable with earlier years, due to change in reporting procedure.

Statement of Condition

At the end of 1966, total assets of the Bank had increased by more than \$311 million — to a record high of some \$3.8 billion, as of year end. The rate of increase — 8.8 percent — was more than twice that of the year earlier, and exceeded the most recent record gain of 8.3 percent, registered in 1962.

Among the assets, gold certificate reserves declined by nearly \$26 million — about 3 percent — as a result of the district's net unfavorable balance in the interdistrict settlement fund. Treasury transfers of funds to New England — for debt payments, defense outlays, and other fiscal operations — while heavy, were not sufficient to offset the outflow of funds stemming from private financial and commercial transactions with areas outside of the district, and the effect of this Bank's near-\$230 million — 11 percent increase in the System Account holdings of U.S. government securities.

The low level of discounts and advances on December 31 is a reflection of the traditional reluctance on the part of many banks to carry indebtedness to the Fed on their year-end statements. More meaningful, perhaps, average daily borrowing at the Bank's discount window during 1966 was more than double the level of 1965.

The 42 percent increase — to almost \$42 million — in the foreign currencies account provides a measure of the Bank's share of System activities in implementing existing reciprocal currency agreements. These agreements — which were established between the System and foreign central banks in 1962 — continue to play a major role in offsetting temporary pressures on the key currencies, the dollar and the pound, throughout the world.

The 21 percent increase in cash items in process of collection, combined with the 12 percent increase in deferred availability cash items on the liability side of the balance sheet, indicate a more-than-doubled float, as compared with the same date a year earlier. While weather — and the day of the week — are major factors in float fluctuation, the increased number and dollar volume of check clearings are

added reflections of the region's high level of economic activity.

Despite this increased volume of clearings, continued improvements in operating efficiency held daily average float to \$34 million — almost precisely the same daily average experienced in 1965.

The 6 percent increase in the total of this Bank's Federal Reserve notes in circulation reflected, in part, the increased economic activity both within the district and the nation — the 8 percent, plus, increase in vault cash held by member banks — and the continuing withdrawal of silver certificates from circulation.

The increase in total deposits — up \$112 million from the same date in 1965 — stemmed primarily from the substantial increase in the member bank reserve account. The higher levels of both demand and time deposits that accompanied the year's expansion of commercial bank credit resulted in reserve balances which more than compensated for the sharp reduction in the Treasury's account during the latter weeks of December.

Paid-in capital, and the surplus account, showed more modest gains than last year — the result of a somewhat slower rate of growth in the capital and surplus additions of member banks.

The Bank's gold reserve ratio stood at 32.5 percent, compared with the 35.6 ratio of a year earlier. The decline — while partially attributable to the increase in notes in circulation, against which the reserve is measured — is an indication of the nation's continuing balance of payments problems.

EARNINGS AND EXPENSES

Total current earnings of the Bank rose more than 23 percent — almost \$19 million — compared with an \$11 million increase last year. More than \$17 million of this increase came from the Bank's participation in the System's U.S. securities account. The increased volume of the System's open market operations, larger holdings, and the higher yields prevailing during 1966 contributed to the increase.

Earnings from loans and advances were more than double those of 1965.

The Bank's earnings from the System's foreign currency account increased by some \$390 thousand — half again more in 1966 than in 1965.

Although the volume of the Bank's operations continued to expand, continuing improvements in efficiency — both through technological changes and increasing automation of certain operations — held the increase in net expenses to less than one-half of one percent.

Net earnings, after adjustments, totaled \$86.7 million — \$18 million higher than in 1965. Of these earnings, slightly more than \$1.6 million was paid to member banks as their statutory 6 percent dividend on Federal Reserve Bank stock. Just over \$700,000 was transferred to surplus — bringing that account to \$27.3 million — to equal paid-in capital.

All of the balance — more than \$84.3 million — was paid to the Treasury as an interest charge, levied by the Board of Governors, on Federal Reserve notes not secured by gold certificates, under Section 16 of the Federal Reserve Act.

FOREIGN CREDIT RESTRAINT PROGRAM

During 1966, the New England financial community continued its excellent co-operation in the voluntary Foreign Credit Restraint Program for banks and nonbank financial institutions, inaugurated in February, 1965, under the President's program to improve the U.S. balance of payments position. The guidelines for financial institutions, which are established by the Federal Reserve Board and administered through the Federal Reserve banks, were revised for 1966, to permit a moderate expansion of foreign loans and investments and to remove certain inequities inherent in the 1965 program. The guidelines generally suggest that export credits, and credits to less developed countries be given priority within the allowable expansion of foreign holdings.

The commercial bank guidelines suggested a target ceiling which permitted a small increase in each calendar quarter — to a maximum of 109 percent of December, 1964, base date holdings by the final quarter of 1966. As of November 30, 1966, the nine larger

monthly reporting banks in New England, as a group, were 25 percent under target, and more than \$30 million below aggregate base date holdings. The six quarterly reporting banks, with foreign assets of less than \$500,000, remained well under their targets.

With 105 reporters in the nonbank financial institution group (comprising large insurance companies, mutual funds, pension and endowment funds, and trust departments of commercial banks) holding \$2.6 billion in foreign assets, New England represents approximately 20 percent of the national total — both in number of institutions and in dollars invested abroad. On September 30, 1966, the most recent quarterly date for which figures are available, the liquid foreign assets of New England nonbank financial institutions were 17 percent below the September 30, 1965, base date target holdings; intermediate-term foreign assets were 12 percent below a target ceiling set at 108 percent of December, 1964, holdings; and long-term investments in developed countries (excluding Canada and Japan) were 1.6 percent below the target ceiling computed at 105 percent of September, 1965, holdings.

VOLUME OF OPERATIONS

Nearly 407 million checks — with a dollar value of \$135 billion — were processed by the Bank during 1966. This represents an increase of more than 6 percent in the number of checks, and a 21 percent increase in dollar value. Volume averaged 1,626,000 checks per day, including those presented in sealed envelopes. On a daily average basis, the number of amount encoded checks received — ready for processing on electronic equipment — increased from 1,162,000 in January, to 1,348,000 in December. Conversely, the number of checks requiring internal encoding decreased by about 50,000, on a daily average basis. The total volume of checks handled on high speed equipment during the year was 367 million — compared with 313 million during 1965. It is anticipated that the conversion to Burroughs' 300 series equipment — begun during the latter part of the year — will be completed in January, 1967.

Payments and receipts of currency to and from our member banks increased 4 percent in dollar volume during 1966 — from \$4,858 billion, in 1965, to \$5,032 billion. In 1966, 928 counterfeit notes — with a face value of \$11,160 — were detected by our counters and delivered to the United States Secret Service. This represents an increase of 9 percent in the number of notes detected. Only 5 percent of the \$1 denomination bills handled during the year were Silver Certificates — compared with 10 percent last year — which is a reflection of the continuing withdrawal of Silver Certificates from circulation. Armored car service for the delivery and pick up of coin and currency was expanded to include 25 additional banking offices, so that a total of 600 banking offices now receive this service. The volume of coin handled increased 62 percent — from \$142 million, in 1965, to \$229 million. Except for half dollars, we were able to meet the normal coin needs of member banks throughout the year.

In 1966, the Fiscal Agency handled a greater total number of subscriptions for new issues of marketable United States government securities and Treasury bills. Although there were fewer issues of marketable securities, there was an increase in both the dollar amount and number of issues of Treasury bills. Much of the increase in subscriptions was due to the higher yields on Treasury bills, which increased their appeal to a wider variety of individuals and institutions. The aggregate total amount of deposits placed in Treasury Tax and Loan accounts increased by about \$1.1 billion. Average balances, however, were less because of unusually high withdrawals. The dollar volume of savings bond sales improved about 8.5 percent. This increase was partially offset by a 7.7 percent increase in savings bond redemptions. The change in regulations, requiring certain employers to make more frequent deposits of withheld taxes, contributed to an 8 percent increase in the number — and an \$838.3 million increase in the dollar value — of validated receipts. The verification and destruction of United States currency decreased by 37 million pieces, as fewer Silver Certificates remained in

circulation. During the year, 67.8 million pieces of unfit whole and half Federal Reserve notes — the principal kind of currency in circulation — were verified and destroyed.

Wire transfers of funds for member banks set a new record in 1966 — increasing 13 percent in both number and amount. During the year, the daily average number of transfers was 927; the annual dollar value exceeded \$191.2 billion. The bulk of the increase in transfers was a reflection of the continuing increase in Federal Funds trading.

Conditions of peak business activity, expanding credit demand, and increasing monetary restraint, which prevailed during most of 1966, resulted in sharply increased borrowing at the discount window. Daily average borrowings rose from \$17.2 million in 1965 to \$35.3 million in 1966 and constituted 5.5 percent of System borrowings — up from 3.7 percent the previous year. Except for 1957, when average daily borrowing was \$38.8 million, the level of discounting by First District member banks in 1966 was the highest since the 1920's. The trend of higher borrowing during the year was also reflected in the number of banks using the discount window, which increased from 106, in 1965, to 140, in 1966. The aggregate dollar amount of notes discounted rose from \$2.7 billion last year to \$4.1 billion in 1966, the largest amount since 1928.

During the second quarter strong seasonal pressure — superimposed on the already high cyclical credit demand — resulted in peak average daily borrowings of \$55.5 million. Discounting remained high during the third quarter — at \$44.4 million — before dropping sharply in the fourth quarter to \$14.6 million.

This greater-than-normal fourth quarter decline may possibly reflect the cumulative effect of several factors — including restrictive loan policies of member banks, initiated earlier in the year; earlier anticipatory borrowing by many bank customers; and a more determined resort to other forms of adjustments, principally Federal Funds. The trend possibly reflects the effect of the System's September 1 letter on bank attitudes toward discounting, as well as less-

than-anticipated attrition in large negotiable certificates of deposit, and some easing in money market conditions toward the end of the year.

There was a noticeable shift from the relative concentration in the dollar volume of borrowing among the large city banks, which had been particularly pronounced in 1965. As money conditions tightened — and Federal Funds accommodation from large city correspondent banks became more costly and less available — a number of country banks increased

their reliance on the discount window. Average daily borrowing by the District's eight largest banks, although increasing from \$12.3 million to \$19.3 million, dropped from 72 percent of total District borrowings in 1965, to 55 percent in 1966.

Even though the Bank's business volume increased, it was carried on by a decreased number of employees. The staff averaged 1,150 during 1966, of which 1,099 were full-time employees and 51 were part-time employees.

DIRECTORS

In the annual election of the Directors of the Bank Charles A. Beaujon, Jr., President of The Canaan National Bank, Canaan, Connecticut, was elected a Class A Director for a three-year term ending December 31, 1969. He succeeds Darius M. Kelley, President of The Orange National Bank, Orange, Massachusetts, who served as a Director from 1964 through 1966.

In the same election F. Ray Keyser, Jr., Counsel and Personnel Director, Vermont Marble Company, Proctor, Vermont, was elected a Class B Director for a three-year term ending December 31, 1969. He succeeds William R. Robbins, Vice President for Finance, United Aircraft Corporation, East Hartford, Connecticut, who served as a Director from 1960 through 1966.

W. Gordon Robertson, President of the Bangor Punta Corporation, Bangor, Maine, was elected a Class B Director on November 23, 1966, to fill the unexpired term, ending December 31, 1968, of John R. Newell, former Vice Chairman of Bath Iron Works Corporation, Bath, Maine, who resigned effective October 1, 1966. Mr. Robertson, former President and Chief Executive Officer of the Bangor and Aroostook Corporation, now serves as Chairman of the Board of the Bangor and Aroostook Railroad Company.

Howard W. Johnson, of Cambridge, Massachusetts, was appointed a Class C Director for a three-year term beginning January 1, 1967. A native of Chicago, Mr. Johnson joined the Massachusetts Institute of Technology faculty in 1955 and was installed as President in July of 1966. He succeeds William Webster, Chief Executive Officer of the New England Electric System, Boston, Massachusetts, who served as a Director from 1961 through 1966.

Erwin D. Canham, Editor in Chief of *The Christian Science Monitor*, Boston, Massachusetts, was redesignated Chairman of the Board of Directors of the Bank and Federal Reserve Agent for 1967.

Charles W. Cole, President Emeritus of Amherst College, Amherst, Massachusetts, was designed Deputy Chairman of the Board of Directors for the year 1967.

FEDERAL ADVISORY COUNCIL

John Simmen, President, Industrial National Bank of Rhode Island, Providence, Rhode Island, was reappointed by the Board of Directors to serve for a second year as the member of the Federal Advisory Council representing the First Federal Reserve District for 1967.

OFFICERS

Oscar A. Schlaikjer, who served the Bank as Vice President and General Counsel since 1943, died November 9, 1966.

Laurence H. Stone, formerly Secretary and Associate General Counsel, was appointed General Counsel of the Bank, effective January 1, 1967.

John J. Arena, former Senior Financial Economist, was appointed Monetary Economist, effective January 1, 1967.

Daniel Aquilino, formerly Assistant Cashier, was appointed Assistant Vice President of the Bank, effective January 1, 1967.

Robert M. Scanlan, who served in various departments of the Bank before holding the post of special assistant to the First Vice President, was appointed Assistant Cashier of the Bank, effective January 1, 1967.

Philip A. Shaver, formerly Legal Assistant, was appointed Secretary and Assistant Counsel of the Bank, effective January 1, 1967.

Directors, January 1, 1967

ERWIN D. CANHAM

Chairman of the Board and Federal Reserve Agent;
Editor in Chief, The Christian Science Monitor, Boston,
Massachusetts (*Appointed 1959*)

CHARLES W. COLE

Deputy Chairman of the Board; President Emeritus,
Amherst College, Amherst, Massachusetts
(*Appointed 1966*)

CHARLES A. BEAUJON, JR.

President, The Canaan National Bank, Canaan,
Connecticut (*Elected 1967*)

JAMES R. CARTER

President, Nashua Corporation, Nashua,
New Hampshire (*Elected 1962*)

HOWARD W. JOHNSON

President, Massachusetts Institute of Technology,
Cambridge, Massachusetts (*Appointed 1967*)

F. RAY KEYSER, JR.

Counsel and Personnel Director, Vermont Marble
Company, Proctor, Vermont (*Elected 1967*)

LAWRENCE H. MARTIN

President, The National Shawmut Bank of Boston,
Boston, Massachusetts (*Elected 1966*)

W. GORDON ROBERTSON

President, Bangor Punta Corporation, Bangor, Maine
(*Elected 1966*)

WILLIAM I. TUCKER

Chairman of the Board, Vermont National Bank,
Brattleboro, Vermont (*Elected 1965*)

MEMBER OF FEDERAL ADVISORY COUNCIL

JOHN SIMMEN

President, Industrial National Bank of Rhode Island

Officers, January 1, 1967

GEORGE H. ELLIS, *President*
 EARLE O. LATHAM, *First Vice President*
 D. HARRY ANGNEY, *Vice President*
 ANSGAR R. BERGE, *Vice President*
 ROBERT W. EISENMENGER, *Vice President and Director of Research*
 LUTHER M. HOYLE, JR., *Vice President*
 STANLEY B. LACKS, *General Auditor*
 LAURENCE H. STONE, *General Counsel*
 JARVIS M. THAYER, JR., *Cashier*
 CHARLES E. TURNER, *Vice President*
 G. GORDON WATTS, *Vice President*
 PARKER B. WILLIS, *Vice President and Economic Adviser*
 PAUL S. ANDERSON, *Financial Economist*
 DANIEL AQUILINO, *Assistant Vice President*
 JOHN J. ARENA, *Monetary Economist*
 LEE J. AUBREY, *Assistant Vice President*
 CHARLES H. BRADY, *Assistant Vice President*
 WALLACE DICKSON, *Assistant Vice President*
 HARRY R. MITIGUY, *Assistant Vice President*
 LORING C. NYE, *Assistant Vice President*
 RICHARD A. WALKER, *Assistant Vice President*
 JOHN J. BARRETT, *Assistant Cashier*
 JOHN A. HAYES, *Assistant Cashier*
 RIPLEY M. KEATING, *Assistant Cashier*
 DONALD A. PELLETIER, *Assistant General Auditor*
 RICHARD H. RADFORD, *Assistant Cashier*
 ROBERT M. SCANLAN, *Assistant Cashier*
 PHILIP A. SHAVER, *Secretary and Assistant Counsel*

