March 1967

Ethics in Banking

A Profile of Farm Lending: the Lender, the Borrower, the Loan

SCORE

A Loss Year

Business Review

Federal Reserve Bank of Philadelphia

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Ethics in Banking
. . . Laws are based on ethics, but there is a time lag.

SCORE
. . . Retired executives volunteer counsel to businesses in trouble.

A Profile of Farm Lending: the Lender, the Borrower, the Loan
. . . Farm loans are still important to banks in the Third District.

A Loss Year
. . . Losses on security sales cut into Third District banks' net income.

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ETHICS IN BANKING

by Joseph R. Campbell*

The word "ethics," according to The American College Dictionary, has the following definitions:
1. The principles of morality, including both the science of the good and the nature of the right.
2. The rules of conduct recognized in respect to a particular class of human actions.
3. Moral principles, as of an individual.
4. The science of the human character in its ideal state.

It seems to me that the context in which you use the word, and in which you wish me to talk, is definition No. 2; i.e., "The rules of conduct recognized in respect to a particular class of human actions."

Ethics and laws

From this definition it follows that laws are based on, are derived from, ethics, at least those laws which deal with "rules of conduct." It does not, of course, follow that all ethics become law or that all laws are based on ethics. But the genesis of rules of conduct law is ethics. In fact, one might say an ethic in itself is a "nonlegal law" or a nonlegal rule of conduct.

Just why certain ethics become enacted into law may not always be clear, and in different cases enactment may be for different reasons. But there does seem to be an underlying theme. First, a certain mode of conduct becomes more or less universally accepted as desirable. When that happens, an ethic is born. Then people come to believe that it would be desirable in the public interest if adherence to this mode of conduct be made mandatory rather than voluntary. When that happens, a law is born.

It is pretty generally recognized that banking is a business vital to the public interest. Consequently, it follows that many of the ethics of banking have been made into law.

I suppose the oldest banking ethic, banking law, is the one that says a banker should not steal a customer's funds. You would think this would have been universally agreed upon at a very early date and that it would have been understood quite clearly by all concerned. Some time ago I did a little research on this matter and was amazed to find this was not so. The trouble originally was that people, the courts, the parliamentary bodies, could not agree as to what stealing was. How can a man steal money from you that you "gave" to him, that you placed with him? The stumbling block in the reasoning had to do with the difficulty people had in distinguishing between a gift of property and the placing of a property in the physical custody of another, but with retention of title, of basic ownership, beneficial ownership, by the person who was handing over the property. As usual, before it became

* *Mr. Campbell, Vice President in charge of Bank Examination at the Federal Reserve Bank of Philadelphia, made these observations in a lecture before the class on "Business Ethics and Customs" at Temple University, Philadelphia, Pa., October 25, 1966.*

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illegal for a banker to convert his customer's funds to his own use, it became unethical to do so. Finally, it became agreed upon that compliance with the ethic "thou shalt not steal a customer's funds" should be made mandatory rather than voluntary and laws were passed to require such compliance.

The dimensions of ethics perhaps more often than not are somewhat fuzzy. One might say that because of this ethics usually embrace wider areas than the laws derived from the ethics; dimensions of laws, by contrast, tend to be more clearly defined. Once people became convinced that it was just as unethical for a banker to appropriate funds entrusted to him as it would be if he had gotten the funds by burglary or robbery, it was necessary in drafting laws and court opinions to define this type of thievery. It took some time to get into law definitions of, and prohibitions against, all types of this sort of thievery and maybe we haven't finished the job yet. In other words, the ethic is "Thou shalt not steal", and that may seem clear enough; but the law is "Thou shalt not do this and that, etc. because those things are stealing," and unless the form of operation is defined legally as stealing it is *not* stealing under law even though it is agreed to be highly unethical.

A little over a hundred years ago, which is not a long time as things go in the area which we are discussing, the branch manager of, I believe, the second Bank of the United States in the Baltimore office made substantial loans to a confederate. After the confederate had given notes to the branch manager to place in the bank's files and had been given the money for the notes, the branch manager went through the files and tore up the notes. He and his confederate split the loan money between them. The loans were not collectible—in fact the bank had no written evidence of debt. Despite knowledge of the court of the factual situation, the branch manager and the confederate were never convicted of anything. The court went entirely on how the money got out of the bank. If it went out legally, no subsequent act could make the pay-out illegal. It was and is perfectly normal and legal for banks to loan money on notes, so the pay-out procedure, in itself, was legal. The fact that the branch manager had an agreement with the borrower to split the money borrowed, and the subsequent destruction of the notes, had no legal bearing on the situation. So, legally, the branch manager and his confederate got off Scot free. However, the branch manager's conduct was deemed unethical and he was fired. Today, of course, both the branch manager and his confederate could be convicted.

In 1933, after the Banking Holiday and the depths of the Great Depression, there were great changes in the banking laws. Not all these new laws could be termed rules of human conduct laws, not all of them, at least as I see it, could be said to have a genesis in ethics. For example, Federal Deposit Insurance was adopted not for ethical reasons but for practical reasons to lend stability to the banking system. You might debate this and say it was deemed "ethical" to protect small depositors from loss, and hence deposit insurance came into being. But as I see it, ethics have to do with the moral conduct of human beings and not, *per se*, the structure of business organizations. For example, some States permit State-wide branch banking, others limit branch banking or prohibit it altogether. In my context these differences are not based on ethics but judgment as to what is the best sort of banking framework. It is hard for me to consider unit banking ethical and branch banking unethical, or vice versa.

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It is considered unethical, or the basis for an unethical situation, for a person to be in a position of trust and have conflicting interests. Prior to 1933, a substantial number of executive officers of banks had big loans from their own banks and were unable, or hard pressed, to repay them. A banker, from an ethical standpoint, should not be more liberal in granting loans to himself than he would be to others, but many were. These bankers, from an ethical standpoint, abused their positions. To prevent this in the future, and to remove temptation, a law was passed whereby executive officers of member banks were prohibited from borrowing from their own institutions; later, the law was changed to permit loans to executive officers up to $2,500, and there is agitation now to increase this limit. In other words, the present limit is regarded by some as both unnecessarily restrictive from the standpoint of protecting banks and unethical as far as the executive officers are concerned.

Big loans to executive officers ordinarily were known to a bank's directors, and presumably the directors could have prevented them in some cases if they wanted to do so, and no doubt in some cases did. Some executive officers of banks went to a counterpart in another bank and arranged a loan and reciprocated by seeing to it that the counterpart got a loan from the other bank. In other words, the officer in Bank A got a loan from Bank B and the officer in Bank B got a loan from Bank A. This is known as "you scratch my back and I'll scratch yours". Now, ordinarily the directors of Banks A and B knew only that the officer of the other bank had a loan in their bank; they did not know that their officer had a loan in the other bank. This could result in neither officer pressing for payment of his counterpart's loan, realizing the pressure could be reciprocated. Withholding of such knowledge from a bank's board of directors was deemed unethical (and a possible risky situation), and a law was passed whereby an executive officer of a member bank who borrows from another bank must inform his own board of directors of the fact.

Disclosure

Now let us look at a more recent development in banking which, singularly enough, has its roots in legislation passed back in the early thirties.

In the aftermath of the Great Depression, the Securities Exchange Act came into being and the Securities and Exchange Commission was established. The purpose of this legislation was to prevent, insofar as possible, unethical situations in the securities markets. As in so many cases in this country, this legislation had a forerunner in Great Britain where a judge in, I believe, the White Star Steamship Company case, held that the withholding of a material fact constituted fraud.

Then and now when persons attempt to deceive, they in many instances deliberately avoid telling an outright lie; they simply tell what is favorable for them and omit the unfavorable. For example, a company could list in its balance sheet a property which it could say it owned and which it could say had been appraised by a competent appraiser at $1,000,000. This property might be under an option to an official of the company for purchase at $100,000, or one-tenth the appraised value. Obviously, if the option is exercised, the company stands to lose $900,000. Some one who purchased stock in the company based on the balance sheet had no redress because no outright lie had been told. The company did own the property and it was worth $1,000,000. The fact that in 1929 the company omitted to mention the option was not fraud; in 1966

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such an omission is fraud. Such practices prior to the S. E. C. were regarded as unethical; after the S. E. C. they became both unethical and illegal.

The securities law, what I shall call S. E. C. law, espouses the doctrine of full disclosure. The law does not attempt to keep investors out of risky situations, but it does endeavor to see to it that investors get sufficient material facts to realize just what they are getting into. The law endeavors to prevent insiders, officers and directors, from profiting from information by not making the information generally known to other investors.

It may seem curious that until several years ago S. E. C. law did not apply to banks. There were reasons for this, and the reason most often cited perhaps was that banks were already supervised by examining agencies and hence did not require S. E. C. coverage. It was, and is, true that banks are supervised by examining agencies; but examination coverage had been aimed at depositor protection and did not endeavor to place outside investors of bank stocks on a par with insiders insofar as information about banks was concerned.

Banks were required to publish balance sheets, but not earnings statements. Moreover, in balance sheets there could be hidden assets, hidden reserves; this was not only legal, it was in some quarters regarded as highly ethical and had the approval of many people in the examination agencies.

Why this contrast in treatment of bank stockholders as compared to stockholders of industrial concerns? Basically, it arose out of primary concern for depositors. Some people felt that if banks were required to publish earnings figures this would be all right when earnings were good but might start runs on banks when earnings were poor and charge-offs heavy. Bank examiners, sometimes plagued by efforts of banks to carry assets above true values, were very conservative minded and had come to regard any value that was clearly not above realizable value as a good value. To many bank examiners the creed came to be the lower the published value the better. Understatement of value was not only regarded as ethical, as acceptable, but was regarded as a virtue.

It was true that a bank with hidden assets and hidden reserves (hidden from the public, that is, not the examiners) could take heavy losses before any downward adjustments had to be made in published capital accounts. It was also true that officers and directors of such banks knew what the real values of the stocks of these banks were, and if they were stockholders they had a decided advantage over the public investors who were deliberately not informed, in many cases with Governmental approval. Although the motive of Governmental approval was not to give insiders an advantage but to protect depositors, one of the results was to prefer insiders.

Well, now banks with stockholders over a certain number, and eventually the law may be changed to cover virtually all banks, must disclose their financial positions much as industrial concerns do. However, administration of the law was given to the Federal bank supervisory agencies and not the S. E. C.

Recently I attended a management seminar on mergers in New York City and was much impressed by a gap which, innocently enough, apparently prevails in the information held by insiders versus outsiders, even after all information under S. E. C. requirements has been supplied by industrial concerns. Aside from myself and one or two others, the students were not bankers but were executives of substantial industrial concerns

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eager to acquire other firms by merger. It was readily agreed, not as a criticism but as a routine observation, that if one is acquiring another company, one does not rely on the published C.P.A. statements that fully meet S. E. C. requirements, but sends in one's own accountants to build up the figures on which negotiations will be based.

No implications of deception, carelessness or what not was intended or implied as regards the published figures. The problem seems to center on the fact that statements of public accounting firms are based on "generally accepted principles of accounting". And generally accepted principles of accounting in some, probably many, instances allow for different methods of treating identical transactions, with vastly different results. Moreover, even in cases where treatment is uniform, the results may not reflect true values. Everything is highly ethical, but it seems at times that "full disclosure" via "generally accepted principles of accounting" doesn't reflect true values. Efforts to reflect reality are being hampered by the limitation of present-day accounting techniques. It is a shame if efforts to provide ethical treatment of stockholders are hindered by lack of an adequate mechanism to portray the facts.

Ethics in bank examination

Well, now a word or two about the ethics of bank examiners. Like the ethics for bankers, many of the ethical standards for examiners have been codified into law. As you might expect, the law provides that an examiner shall not accept a gratuity from a bank or banker. After all, examiners examine banks for the purpose of determining unsatisfactory situations, if any, in banks, and it would be inappropriate for an examiner to accept gifts that might be proffered to him by bankers after the examiner had discovered fraud and/or the existence of heavy losses in a bank. Also, the law usually provides that an examiner shall not be permitted to borrow money from any bank that his agency examines. The basis for this restriction is similar to the one against the acceptance of gratuities. A liberal loan on which no pressure is made for payment can be a sort of gratuity and as such could be a form of bribe to overlook certain things or to recommend approval of certain things a bank may want to do.

Sometimes touchy ethical situations develop when an examiner resigns to take a job with a bank under the supervision of his examination agency. Usually, of course, when an examiner goes to work for a bank he gets more money; the reason most often for job changing in any walk of life is more money and examiners are no exception to this generality. On rare occasions some one suspects, or concludes, the job proffer was induced by something the examiner did for the bank while he was an examiner. One such contention was brought to my attention recently in connection with an examination agency not my own. An examiner conducted the investigation of a branch application of Bank A that was strongly opposed by Bank B. The examination agency approved the branch and shortly thereafter the examiner took a job with Bank A, whereupon Bank B complained bitterly to the agency that the job proffer must have come about as a result of the examiner's favorable recommendation for the branch. In this case the interesting thing was that the examiner recommended *against* the branch, and despite his unfavorable recommendation the agency approved the branch anyhow.

To avoid the possibility of this sort of thing, proposals recur from time to time to make it illegal for examiners to take jobs with banks for X number of years after leaving an examination agency. Here is a good example of how efforts to

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insure ethical conduct in one direction could produce unethical restrictions, certainly impractical situations, in another. Bank examiners are human and have to live just like anybody else. To prevent examiners for prescribed periods from being in banking, which after all is their profession, would be something like telling doctors on the staff of a hospital they could not practice medicine for X number of years after they left the hospital staff. So what is the doctor to do for those years--be a plumber, a lawyer, or what? It is about the same with examiners. If such restrictions are adopted, it will be even harder to obtain examiners than it is now. One of the practical effects of such a restriction would be to give the examination agency a considerable club over its own men; the examiners would be in a position somewhat like that of indentured servants. This is not only unethical—it just wouldn't work.

Ethics without laws

So much for ethics and the examiners. I have indicated that much of the ethics of banking has been written into law. It does not follow that all ethics of banking have legal definitions. Let me describe one that does not. As you know, many banks, particularly the bigger banks, have trust departments. Trust departments administer assets for people, some living, some dead. In the process of doing this with respect to the living, the trust officers come in contact with people who have power to direct where their money shall go after death. Over time these people may come to develop a real liking, a real affection, for a trust officer. On occasions, rare occasions, after some old codger has died, the will is opened and it is found that he has left a big wad of money to some trust officer of the bank. Then the relatives howl, claiming undue and unethical influence. The bank is embarrassed and the trust officer usually is told by the bank either to refuse the gift or resign. If the gift is substantial, and if the officer is not particularly rich, he may take the money and resign.

Of course, if the relatives can prove the deceased was mentally incompetent when he included the trust officer in his will, there is a good chance they can bring litigation and have the gift set aside. But often the donor is competent enough, has no close relatives, only distant relatives and doesn't think much of them, and he does think much of the trust officer, so he leaves his money to the trust man.

Banks don't like this sort of thing and usually have rules that such gifts are not to be accepted. But, as previously mentioned, sometimes the gifts are accepted despite the rules. Illegal? Most times not, but acceptance of such gifts is regarded sometimes as not quite ethical.

Another situation involving ethical considerations has to do with the holdings of a bank's own stock in its trust department. Obviously, there are conflicts, or possible conflicts of interest here. Except possibly in some very unusual situations, a bank with sole authority under a trust instrument should not buy its own stock as an investment for a trust account. It would be difficult for the trust investment committee to be impartial both at time of purchase and, particularly, later when a question might well be raised as to whether to sell the stock. From time to time, a stockholder names the bank as trustee, and when that person dies the bank finds itself administering an account containing its own stock. This is still a somewhat touchy situation as to whether the bank should retain the stock and, if so, how long.

Ethical considerations are behind all these decisions but the thing that makes them extra important is that a trustee is especially vulnerable to surcharge suits where conflicts of interest

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are present. If a bank holds stock in the trust department of another corporation and that stock declines in value, this in itself is not grounds for legal action by the heirs. But if the bank holds in the trust department its own stock and that stock declines, then the heirs have a very favorable factual situation to support their action. This does not mean that they would win automatically in every case, but it does mean they have a factor most favorable to them in support of their contention.

Another question with ethical connotations is whether a bank should vote the stock it holds in its trust department. If the amount so held is big enough, it could be significant in perpetuating management in control of the institution. National banks are not permitted to vote such stock where the institution has sole authority, and where there is a co-trustee, the co-trustee, not the bank, is permitted to vote half of such shares.

Banking ethics in the future

What of the future? Will banking ethics change and, later, banking "ethical" laws change?

Some change is probable; the real question is how much. For example, it appears that practically everybody in the banking business and the bank supervisory field considers the present limitation of $2,500 on the amount an executive officer of a member bank may borrow from the bank by which he is employed as being unduly restrictive. Most people feel, I believe, that at least an exception should be made above the $2,500 limit for a mortgage loan on an officer's home. It also seems probable that disclosure requirements such as promulgated by the Federal Reserve and F.D.I.C. will have application to, or be adopted by, a wider number of banks.

Currently, the only major change in the offing, perhaps way back on a far horizon, would seem to revolve around voting power over all kinds of shares held not only by commercial banks, particularly trust departments of commercial banks, but by institutional investors of all types, including especially mutual funds. Basically, the question here has to do with whether the power held by institutional investors should be subject to some form of regulation. It appears the ethic may already exist—the tenet that there should be some limits on the amount of power a relatively small group, or small number of groups, should be allowed to exercise.

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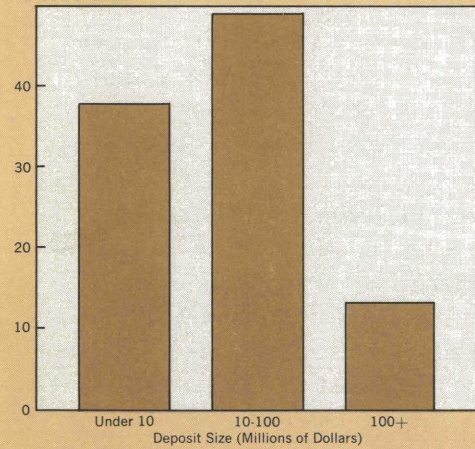
A PROFILE OF FARM LENDING: THE LENDER, THE BORROWER, THE LOAN

by Kathryn Kalmbach

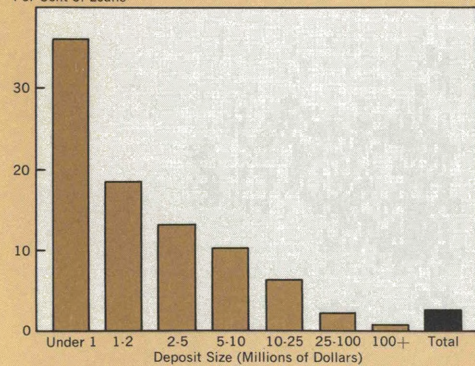
Farm lending by commercial banks looks fairly small (2.5 per cent of total loans) in the Third Federal Reserve District. However, it totals well over a quarter-billion dollars and for 31 per cent of the banks accounts for 10 per cent or more of their total loans. These charts, derived from a survey of agricultural loans and the call report as of June 30, 1966, present a profile of farm lending in the Third Federal Reserve District.

THE LENDER

1. Dollarwise, most of the farm loans are held by medium-sized banks.

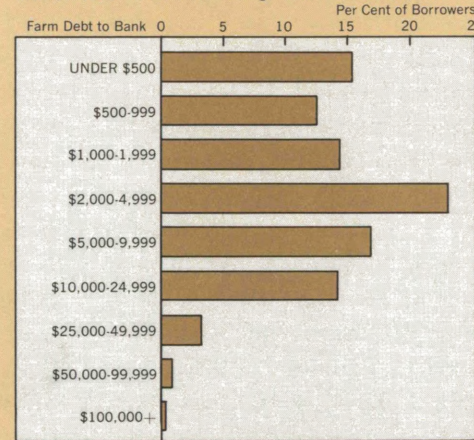


2. However, the smaller the bank, the more important are farm loans.

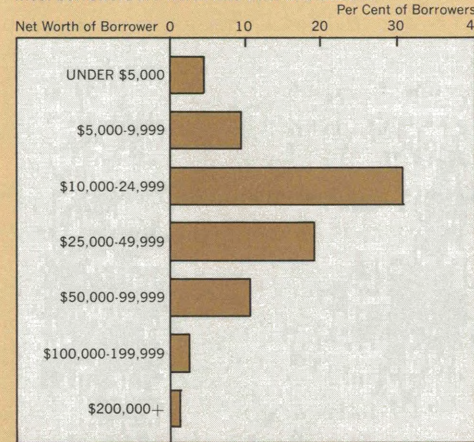


THE BORROWER

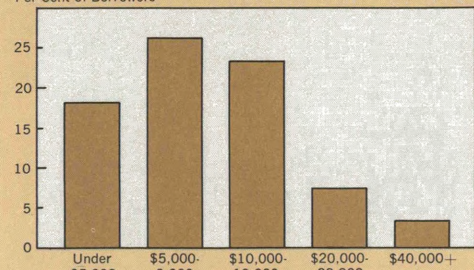
3. Most farm loans are to individuals. Most of these owe less than $10,000. In fact, the average debt is about $6,000.



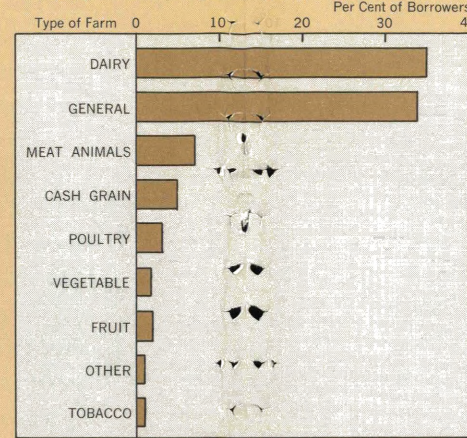
4. Although the average net worth of the borrower is $33,000, most borrowers are worth less than this amount.



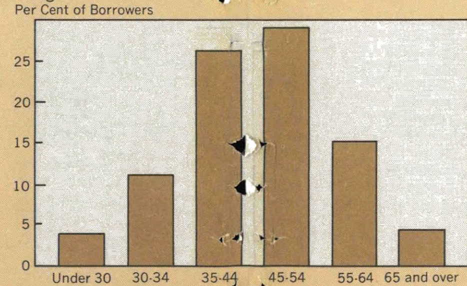
5. The borrower's gross income from farming frequently is below $10,000.



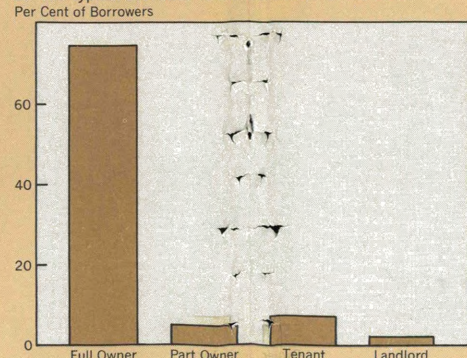
6. Usually the farm is a general-type or a dairy.



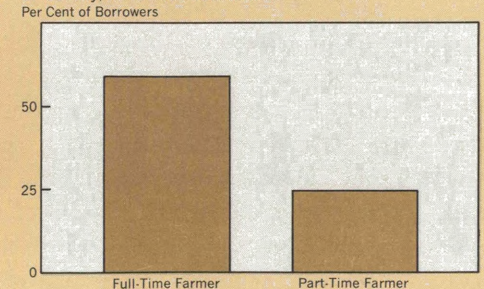
7. The majority of the farmers borrowing are over 45 years of age.



8. The typical borrower is the full owner of his farm.

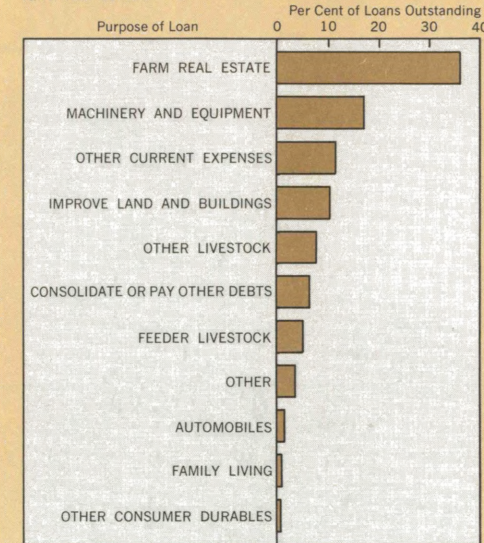


9. Usually, he is a full-time farmer.

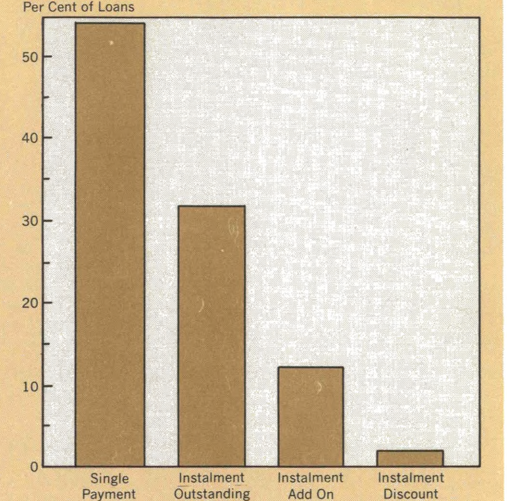


THE LOAN

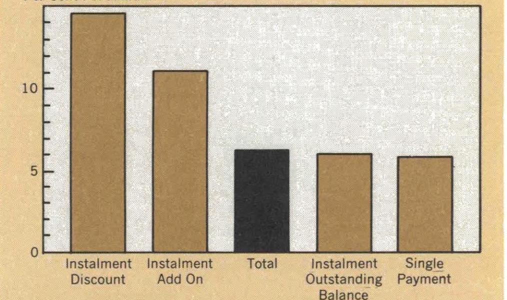
10. Over one-third of the proceeds of borrowing is used for farm real estate.



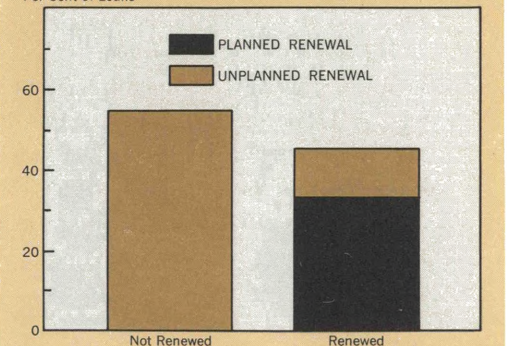
11. The method of payment most popular is the single payment.



12. For all loans, the average effective interest rate is 6.3 per cent.



13. Renewal is common, with the renewal planned when the loan is made.



Note: Charts may not total 100 per cent because characteristics of the borrower were not always reported.

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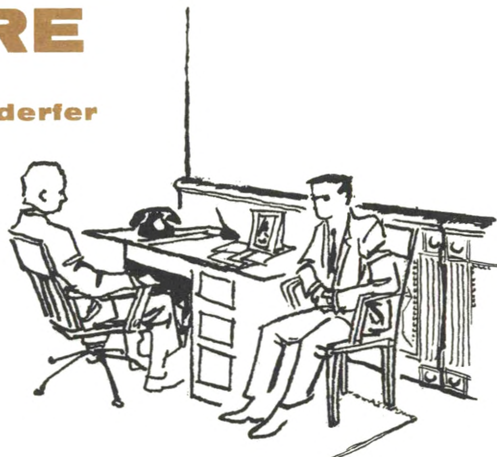
SCORE

by Evan B. Alderfer



Al Franconia's Flower Shop was going downhill. It had a good location in a growing suburb of Philadelphia. Al carried a good stock of cut flowers and potted plants which he bought from a downtown wholesaler. The customers who came into the shop he served courteously enough, and his prices were not exorbitant. He employed a full-time worker, one part-time worker, and a truck driver to make deliveries.

Al had been in business for ten years, ever since he had inherited the shop from his father. He knew flowers and loved them, but his business was going downhill. Rent, labor, materials, and other expenses kept rising. Despite efforts to make ends meet he was always short of cash. By and by he applied at the local office of the Small Business Administration for a loan.

Before advancing him a loan, the SBA office suggested that it might be to his benefit to have one of its SCORE volunteers call at his shop to ascertain the cause of his difficulties. The SBA explained that SCORE, which stands for *S*ervice *C*orps *o*f *R*etired *E*xecutives and is affiliated with the SBA, is a group of retired business executives who give counsel to small business, free of charge. Al consented, and a SCORE volunteer who had had experience in retailing, visited Al's shop to make a critical analysis of his business.

The consultant found that Al's fixtures and facilities, methods of operation, and dollar volume of sales were the same as the day he took over ten years ago. Al did no advertising or soliciting, but just accommodated what business came his way. His record-keeping was lamentably inadequate.

The SCORE consultant recommended that Al advertise in the local newspaper; that he hire an accountant to set up a simple system of bookkeeping to reveal profit or loss at the end of each month; and that he modernize his store by installing better facilities to display and prolong the freshness of his stock. In due time the business was on a profitable basis, without benefit of a loan.

Flashback

The Small Business Administration was established by Congress in 1953 to help preserve free competitive enterprise by offering assistance to small business enterprises. It sponsors management courses and conferences with the co-operation of college faculties, civic groups, trade associations, and local business organizations. The SBA also conducts local workshops on fundamentals of management. What appeals most to small business, however, is the financial assistance afforded. In 1965, the SBA had over 20,000 applications for loans, of which more than 13,000 were approved, for a total of $409 million.

When a business concern runs into trouble, the difficulty always seems to be a shortage of cash.

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Indeed, many, if not most businesses, howsoever well run, must borrow on occasion. That is why there are banks and other lending agencies. In many instances, however, shortage of cash is only a superficial evidence of a more serious shortage—a shortage of managerial ability. About half of the new small businesses that failed before they were two years old were attributable to poor management, according to a 1964 Dun and Bradstreet survey. In such instances the solution is counsel rather than cash. And so the SBA organized SCORE about two years ago.

Volunteers on call

SCORE volunteers are a heterogeneous group of retired business executives, financially independent. In active business some had been corporate treasurers or comptrollers, production managers or sales managers, or ex-entrepreneurs. Some had former experience in accountancy, law, or income tax. Collectively, they are a vast and variegated pool of business know-how with years of experience in production, wholesaling, retailing, banking, transportation, foreign trade—the whole gamut of business specialization. Except for their diversified experience in all phases of business, the only thing they have in common is that they do not have to work but want to work. So eager are they that they work for free. All they accept for their services are modest traveling expenses of $5 to $10, depending on the distance, so that they are not too much out-of-pocket.

How the Philadelphia chapter operates

At this writing, the Philadelphia chapter of SCORE has a corps of 28 volunteers. All of them live in the Philadelphia metropolitan area which they serve, and they hang their hats in the Philadelphia SBA office where they meet periodically to plan their field work.

Requests for assistance usually are made over the telephone to the SBA office, where the volunteers meet fortnightly for their assignments. One of the volunteers, serving as chairman, presents to the group the requests for help and each member takes a case or two best suited to his past business experience. A request for assistance from the owner of a bakery or a sandwich shop, for example, will be taken on by a volunteer formerly associated with the food industry, or next of kin thereto.

Each assignee then pays a visit to his client with whom he spends as much time as necessary to familiarize himself, with the entire operation and to diagnose the cause or causes of difficulty.

SCORE volunteers encounter, as might be supposed, all kinds of business mismanagement or ineptitude. The basic trouble may be underpricing a product or service, as in the case of the woman with a talent for designing and altering dresses. She opened a women's dress shop and as a sideline also taught in a dress design school. As a teacher she was a whiz but as a business woman she encountered rough going because, as her SCORE consultant found, she charged for her alteration service the same low hourly rate she made in teaching.

Volunteers encounter all kinds of deviations from basic fundamentals of management. One of the most frequent is careless bookkeeping. Another is the employment of needy friends or relatives. Other examples are: picking a poor location, renting too spacious or too skimpy or too high-priced quarters, stocking slow-moving or unsalable merchandise, failing to take discounts, poor production control, and lack of financial planning.

Then, too, some make the mistake of embarking upon ill-conceived ventures that have no

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reasonable chance of success, or enter a highly competitive industry already over-crowded. Two young men with $50,000 of resources sought to set up in the business of manufacturing floor tile. Before going abroad to buy a $25,000 machine, they consulted SCORE and were referred to an ex-tile manufacturing executive. He talked them out of their project by citing the forbidding nature of all the risks to be encountered.

The volunteer's job, like that of a doctor, is diagnosis and prescription. For a doctor, diagnosis is often the more difficult; but for a business consultant, prescription is usually the more troublesome. The client is accustomed to follow well-worn patterns of thought and action. He can't conceive that his business has fallen upon hard times because of any fault of his own. He is running the business just the same as formerly when it prospered. The fault is his competitors or the Government or the union or something. But the consultant must convince him of his shortcomings and explain the prescription in terms that the client can understand. "Yes, but my business is different" is an all-too-common rationalization.

The SCORE consultant's basic function is to analyze and advise, not to "work" for his client. For example, upon discovery that a businessman's basic difficulty is keeping records on the backs of envelopes and other captive scraps of paper, the consultant does not stay on to set up a bookkeeping system but advises the client to hire an accountant to set up an appropriate system for the business. For a period of about 90 days, however, the consultant keeps in touch with the client to oversee the adoption of the remedial procedures recommended.

Areal chapters

The same type of service that the 28 SCORE volunteers affiliated with the Philadelphia chapter perform for the local area are also available in other localities. The Philadelphia SBA office is the regional headquarters for a larger area that is practically conterminous with that of the Philadelphia Federal Reserve District. In addition to Philadelphia, SCORE chapters have been established in 16 smaller cities of this Federal Reserve District, such as Scranton, Lancaster, Harrisburg, Trenton, Wilmington, and Dover. The 17 chapters, including Philadelphia, have a total of 121 volunteers serving small business. The smaller chapters may not operate precisely as described above but the type of service is essentially the same.

Serving the country as a whole are approximately 3,000 SCORE volunteers affiliated with 169 SCORE chapters. In 1965, they counselled over 10,000 small business firms.

The beneficiaries

When a large concern runs into trouble—serious trouble—it is likely to seek the specialized help of a management consulting firm. Independent research studies indicate that the small company (under 25 employees) is less likely to do this. SCORE, therefore, not only provides practical advice on his current problems but also helps the small business manager to understand better the value of an outside viewpoint.

About 95 per cent of the approximately 5 million business concerns in the country are small firms. Furthermore, each year there is a large crop of new businesses. In 1965, over 200,000 new businesses were incorporated and,

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according to Dun & Bradstreet, over 13,000 businesses failed—a surprising number in a year when business conditions were generally favorable.

Curiously, despite the huge potential demand for assistance from SCORE, most chapters are not overworked—probably because of the availability of the service is not sufficiently well known. While operating well below capacity, SCORE volunteers have more time to pursue their respective hobbies, but they welcome greater opportunities to serve small business.

The benefactors

SCORE volunteers, the benefactors, are themselves beneficiaries of their benefactions because so many executives upon retirement don't know what to do with themselves. Retirement in anticipation and retirement in hand are two entirely different things. What fond dreams of retirement one conjures up while in active business life! To travel and see the world! But much travel is hard on the feet. Of all the books one stored for reading upon retirement! But much reading is a weariness of the flesh. And one can also get fed up with golf. And to sit in a board room day after day watching the gyrations of the stock market is perhaps one of the most dismal ways of spending retirement.

Many retired executives have tried all these forms of diversion and others; but among the happiest are those who turn their autumnal energies and talents to some useful purpose such as SCORE. And that may be why SCORE has been able to get so many volunteers in the short span of two years. In helping others, they help themselves.

NEW PUBLICATION

MAINSPRINGS OF GROWTH: studies of the structure of the Philadelphia Metropolitan Economy. This pamphlet, composed of twelve articles from past **Business Reviews,** treats the subjects of employment, wages, banking, port commerce, economic growth policies, and the research and development industry in Philadelphia.

Copies are available upon request from Bank and Public Relations, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101.

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In recent weeks commercial banks have released a spate of glowing earnings reports. The gist of most of these reports is that 1966 was indeed a very good year—at least as far as current operating earnings were concerned. But for many of these banks, 1966 was also . . .

A LOSS YEAR

by William F. Staats

Heavy loan demand and high interest rates in 1966 enabled commercial banks to score impressive revenue gains. In the Third Federal Reserve District, Philadelphia banks racked up a 9 per cent increase in net current operating earnings over the previous year while country banks scored a 6.8 per cent hike.

But current operating earnings, contrary to the implication of many earnings reports, are not the whole story. For some of these banks, net income—which includes profits and losses on securities and other assets—was less in 1966 than in 1965. Rising interest rates in 1966 reduced market values for securities owned by banks. Consequently, many banks suffered hefty capital losses when bonds were sold to provide funds for meeting intense loan demand.[1] For all Third District banks, the effect of losses on securities and charge-offs of loans which went sour was to hold the gain in net income over 1965 down to less than 1 per cent. As may be expected, earnings performance varied widely among individual banks in the district.

Reserve city banks

In spite of sharply higher net current operating earnings, net income chalked up by Third District reserve city banks in 1966 declined about 3 per cent.[2] But four of the six Philadelphia banks scored increases in net income for the year.

Philadelphia banks had a combined net loss on securities sold equal to 5 per cent of net current operating income. Of the six reserve city banks, two had profits on the sale of securities equal to about 1 per cent of operating earnings while the other four rang up losses ranging from 1.2 per cent to nearly 10 per cent of net current operating income.

As shown in the chart, profitability of Third District reserve city banks as a group dropped markedly in 1966. The ratio of net income to average total assets stood at .82 last year compared with .92 in 1965.

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[1]Of course, some of the losses sustained by banks on sale of securities were motivated by tax considerations. Commercial banks are permitted to deduct losses on the sale of securities from ordinary income in computing their tax liability. Therefore, in periods of high interest rates when banks have paper losses on their bonds, they may sell some of their securities and buy others simply to secure tax benefits. The newly purchased bonds are bought at discounts from par value. The difference between the purchase price and the sale or exchange price gives rise to a capital gain which is taxed at a maximum rate of 25 per cent. Thus, a bank selling securities for a tax loss trades ordinary income taxed at a 48 per cent rate in the current year prospective for future capital gains taxed at 25 per cent.

[2]As used in this analysis, net income refers to reported net income adjusted for actual losses on loans. The adjustment is necessary because transfers to reserves usually exceed actual losses on loans and result in understating income. Current earnings is the difference between so-called current revenues and certain operating expenses. Current earnings ignores such items as gain or loss on sale of securities, losses on loans, recoveries of previously charged-off loans, and income taxes.

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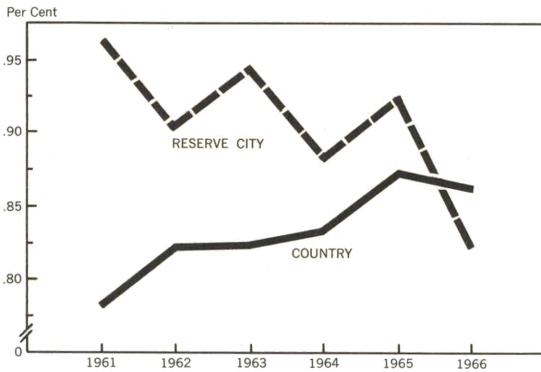
CHART 1

PROFITABILITY* OF THIRD DISTRICT BANKS



* *Ratio of net income to average assets.*

Country banks

Net income of country banks in the Third District increased by nearly 5 per cent in 1966 and net current operating earnings rose about 7 per cent.

Losses on sale of securities jumped from one-half of 1 per cent of current operating earnings in 1965 to nearly 4 per cent in 1966 as about 45 per cent of district country banks had net losses on sale of securities. As shown in the table, the smaller banks as a group had the lowest ratio of security losses to net operating earnings.

While for individual banks, results of security sales ran the gamut from a profit equal to 35.6 per cent of operating earnings to a loss of 54 per cent, there seemed to be no correlation between size of bank and the ratio of gain or loss on securities sold. However, two-thirds of country banks having average deposits of over $100 million had some net loss on sale of securities while only one-third of the banks with deposits of less than $5 million recorded such losses. Apparently, the larger banks were generally more willing to take losses on securities.

Several factors may explain this relationship. First, the larger banks more likely had profits large enough to be taxed at the marginal rate of 48 per cent. Tax considerations are more important for banks with profits in excess of $25,000. Second, larger banks may have been faced with heavier loan demands in 1966 than were smaller banks. Consequently, the larger banks were under pressure to get funds by selling securities, even at a loss. Third, the larger banks may have been more aware of the array of investment alternatives at the lofty interest rates prevailing in 1966. And it is likely many large banks accepted capital losses while reinvesting funds in other securities such as long-term municipal bonds.

As expected, profitability of country banks in the district varied widely among banks. Four banks suffered net losses of from .3 per cent up to 1.6 per cent of average assets and net income for the rest ranged from .2 per cent to 1.8 per cent of assets. The greatest variation in profitability occurred among the smallest banks.

As shown in the table, profitability did not vary much among different groups of banks classified by size. Banks having average assets of less than $10 million and more than $100 million were slightly more profitable in 1966 than were other groups of country banks.

TABLE 1

SELECTED EARNING RATIOS OF THIRD DISTRICT BANKS

	Net Income To Average Assets		Profit (Loss) on Securities To Net Operating Income	
	1965	1966	1965	1966
Reserve City Banks	.92	.82	−1.4	−3.9
Country Banks	.87	.86	− .5	−3.9
Less than $5 million	.77	.86	.2	−3.2
$5 to 10 million	.75	.84	−1.1	−2.2
$10 to 20 million	.79	.79	−1.8	−5.1
$20 to 100 million	.85	.79	.3	−4.7
More than $100 million	1.00	.96	2.4	−4.8

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After chipping away at the profitability gap for several years, country banks in 1966 surpassed Philadelphia banks in terms of return on assets (see the chart on the preceding page). The improved standing of country banks was more the result of a poorer performance of the reserve city banks than the result of an outstanding improvement among the country banks. In the aggregate, profitability of all country banks was only slightly lower than in 1965—.86 per cent of average assets compared with .87 per cent.

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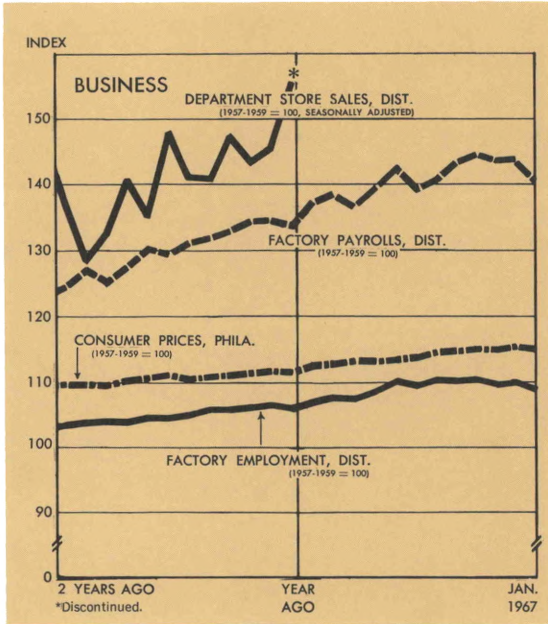
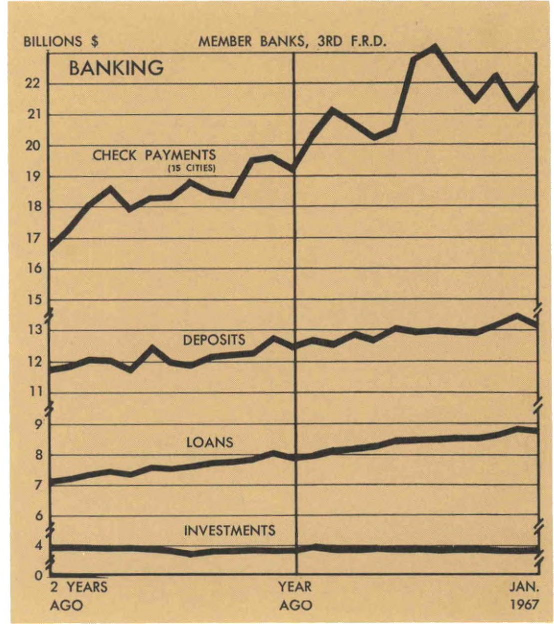
FOR THE RECORD . . .





SUMMARY	Third Federal Reserve District: Per cent change, Jan. 1967 from mo. ago	Third Federal Reserve District: Per cent change, Jan. 1967 from year ago	United States: Per cent change, Jan. 1967 from mo. ago	United States: Per cent change, Jan. 1967 from year ago
MANUFACTURING				
Production	....	....	−1	+5
Electric power consumed	0	+6	....	....
Man-hours, total*	−2	+1	....	....
Employment, total	−1	+2	....	....
Wage, income*	−2	+5	....	....
CONSTRUCTION**	−3	−5	−11	−16
COAL PRODUCTION	−1	−4	−4	+5
BANKING				
(All member banks)				
Deposits	−2	+6	−2	+5
Loans	−1	+11	−2	+8
Investments	0	−2	+1	0
U.S. Govt. securities	+1	−10	0	−7
Other	0	+9	+2	+9
Check payments***	+2†	+11†	0	+15
PRICES				
Wholesale	....	....	0	+2
Consumer	0‡	+3‡	0	+3

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSA's
‡Philadelphia

LOCAL CHANGES Standard Metropolitan Statistical Areas*	Manufacturing: Employment, Per cent change Jan. 1967 from mo. ago	Manufacturing: Employment, year ago	Manufacturing: Payrolls, Per cent change Jan. 1967 from mo. ago	Manufacturing: Payrolls, year ago	Banking: Check Payments**, Per cent change Jan. 1967 from mo. ago	Banking: Check Payments**, year ago	Banking: Total Deposits***, Per cent change Jan. 1967 from mo. ago	Banking: Total Deposits***, year ago
Wilmington	−1	+2	−7	+8	−2	+32	−10	+5
Atlantic City	....	....	....	....	+1	+1	−1	+12
Trenton	−1	+1	−2	+4	−30	−6	+2	+10
Altoona	+1	+7	−6	+2	0	+11	−1	+9
Harrisburg	+1	+6	+7	+17	+11	+15	−1	+11
Johnstown	−2	+3	+5	+12	−1	0	−1	+5
Lancaster	−1	+3	−3	+5	+7	+11	−1	+8
Lehigh Valley	+1	+2	0	+5	+7	+6	−1	+3
Philadelphia	−1	+2	−3	+6	+5	+8	−3	+8
Reading	+1	+2	+1	+7	+5	−3	0	−43
Scranton	0	+3	0	+12	+5	+4	−1	+7
Wilkes-Barre	−1	+7	−2	+12	+7	+16	−2	+7
York	−2	+2	−1	+11	−2	+22	−1	0

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.

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