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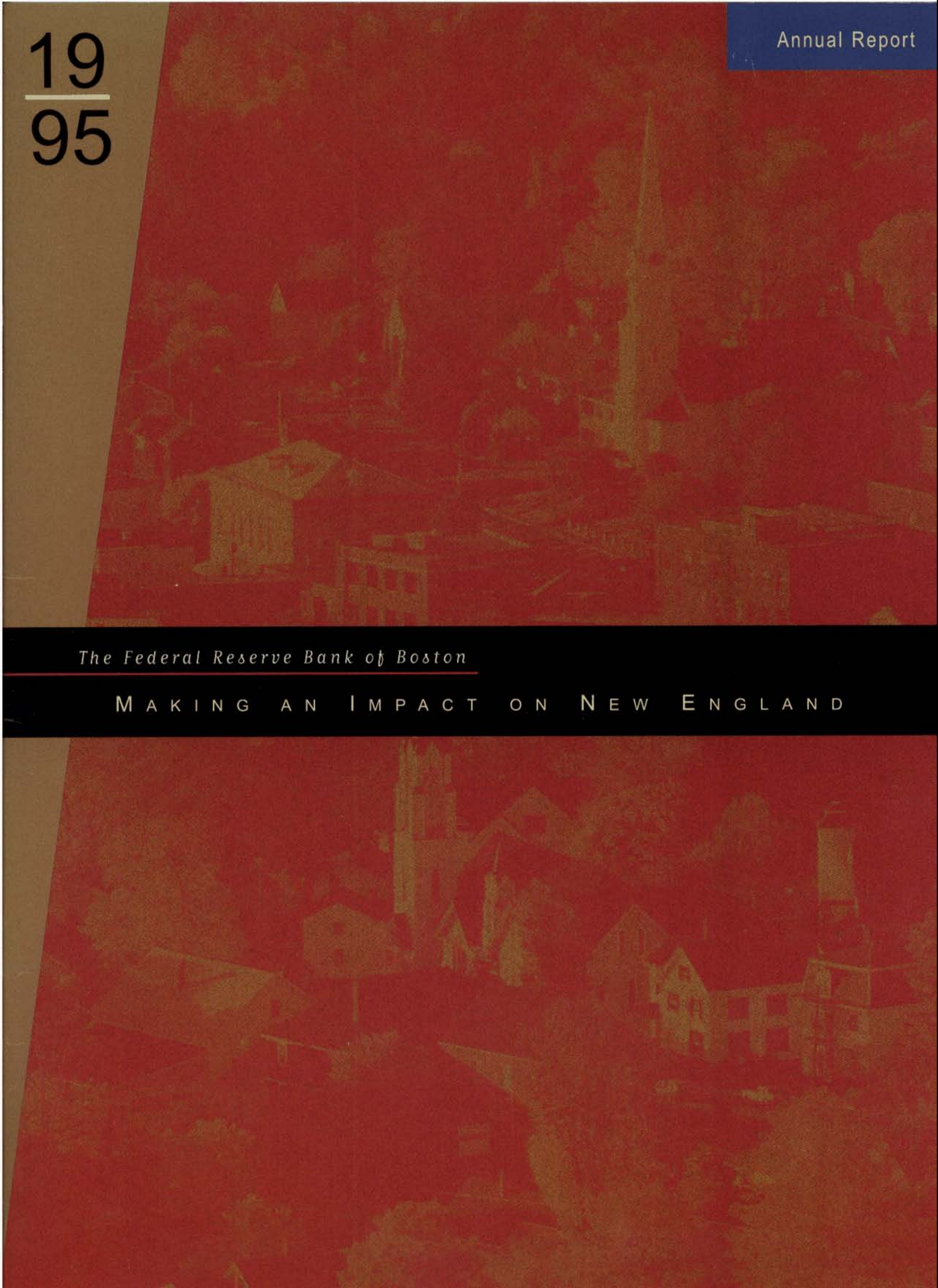
Annual Report



The Federal Reserve Bank of Boston

MAKING AN IMPACT ON NEW ENGLAND

{ New England weather

has a powerful impact

on our lives.

Sometimes welcome.

Sometimes devastating. }

New England weather has a powerful impact on our lives. Sometimes welcome. Sometimes devastating. The same nor'easter that drops white gold on ski country can rip an oil tanker apart on endangered fishing grounds. Just as natural forces shape our ever-changing weather, the pace of technological change, the globalization of markets, and the reality of the business cycle frame our economic possibilities. Promoting sound economic growth and financial stability within that framework is our mission. We keep a close watch on economic change – analyzing domestic and global market developments not only to ensure the quality of our contributions to national monetary policy decisions, but also to keep New Englanders fully informed. Through regulation and supervision, we help assure stability in the financial industry, and through the provision of innovative financial services and our national leadership efforts, we provide direction to the payments system. Most importantly, we strive to share our expertise and resources with business, community and government leaders to improve the communities of our region. Like New England weather, the winds of economic fortune can shift. Our mission is to understand those shifts and help New England and the nation weather those changes in a climate of stable economic growth and increased standards of living.

Letter from the President

For both the nation and New England, 1995 was a year of continued economic growth. The pace of expansion was solid, though a bit bumpy; employment grew and unemployment rates were low; and the rate of growth in inflation remained stable and low. At the turn of 1996, most forecasters were predicting that we would continue to see this very favorable combination of steady growth with low unemployment and inflation. As a member of the Federal Open Market Committee, I am especially pleased with these developments, which I believe can be seen as evidence of the success of monetary policy.

Continuation of these favorable economic trends occupies a lot of our attention at the Bank, since past success is an indicator, but not a guarantee, of future achievement. In this regard, during 1995 we focused considerable attention on accumulating knowledge about what is happening in New England to give us insights into the workings of the national economy that mere statistics cannot reveal. Our economists, many of our officers, and I regularly spoke at gatherings around the region aimed not only at providing information but also at gathering insights. Regular contacts with diverse business and community groups, and interactions with our Board of Directors, New England Advisory Council, and academic and financial markets advisory groups also provided important supplements to analysis by the Bank's research staff and to my own perspectives.

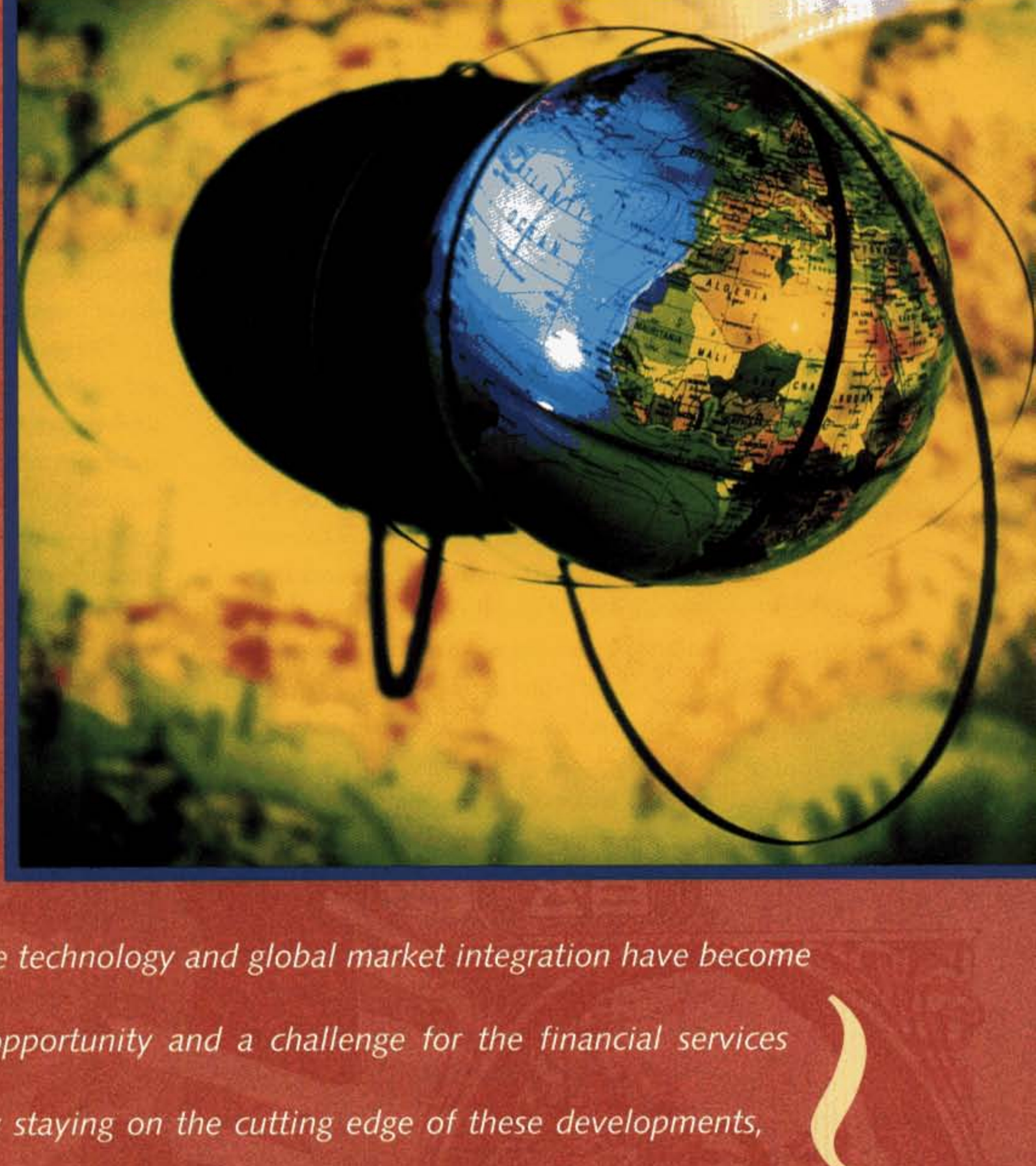
Through published research and public forums on the exploration of key issues, we assisted decision-makers in understanding their economic environment and in evaluating policy choices. Our 1995 conferences examined a number of topical subjects: the opportunities and dangers of derivative financial instruments, the economic costs and benefits of casino gambling, causes of income inequality, and the role of banks in the transmission of monetary policy.

Our goals in financial services and supervision and regulation have a common theme: to provide services and oversight that are effective, efficient, and protective of our financial system and the businesses and consumers it serves. This task is continually expanding in both size and complexity with new opportunities and threats evolving simultaneously. Some of these issues are discussed in the accompanying essay, which considers the challenges and opportunities arising from a more technologically sophisticated and global financial system.

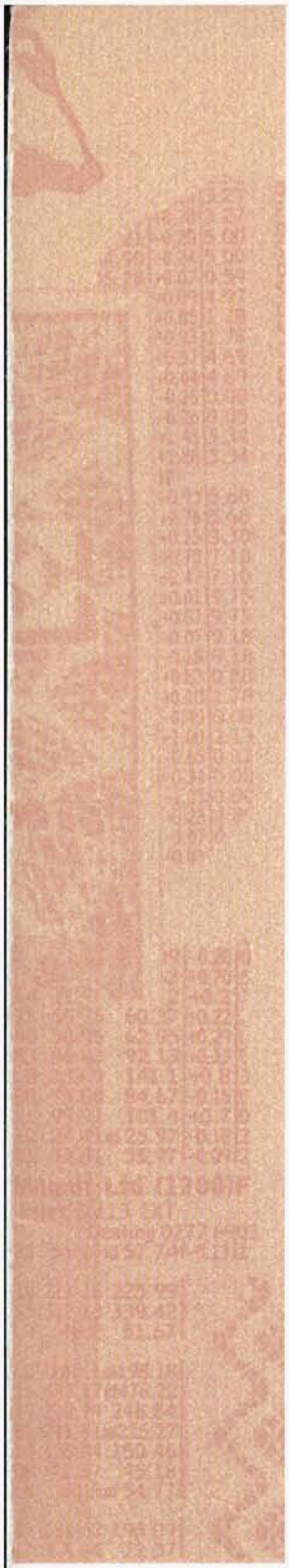
The rest of this Annual Report focuses on the Boston Reserve Bank's contributions in 1995, with emphasis on their significance to New England. The regional structure of the Federal Reserve System is its strongest underpinning, contributing in many ways to sound policy formation and implementation. We are proud of our role as an integral part of the nation's central bank and of our efforts in 1995. We hope you find this Annual Report a useful and informative review of our activities.

For both the nation and New England, 1995 was another year of economic growth, low unemployment, and low inflation... At the turn of 1996, most forecasters were predicting a continuation of these trends.

Cathy E. Minehan,
President and Chief Executive Officer



Pervasive technology and global market integration have become both an opportunity and a challenge for the financial services industry. By staying on the cutting edge of these developments, the Bank remains an informed advisor for both the New England region and the national economy.



Thoughts on Global Issues: President's Economic Commentary

The favorable economic progress made in the United States in 1995 can only be viewed as positive for us domestically and for the world as a whole. As I look around the world, certainly there are pockets of problems — some of them severe — but in general, the macroeconomic data are reasonable. These include decent rates of real growth, clear progress against inflation, and the recognition of and commitment to solve the twin problems of domestic budget and foreign trade deficits. All of these areas of progress augur well and reflect, to greater or lesser degrees, not just a cyclical upturn but, even more importantly, sustained patterns of solid economic performance amid a series of worldwide trends.

I'd like to address three of these trends: the growth and pervasiveness of technology, the global integration of markets, and the consolidation of the financial services industry, broadly defined. These trends are tightly linked: technology promotes the global integration of markets, and both technology and market integration have hastened consolidation in financial services.

These developments, if properly managed, promise greater economic growth and improved living standards worldwide. They also have the potential to create financial instability on a global basis and, for individual countries to widen income disparity among workers, with all that could imply about the potential for social instability. In the midst of rapid change and appropriate worldwide fiscal constraints, there is a need to be careful that the primary function of government — to ensure the continuing welfare of all its citizens — can be met.

It goes without saying that technology is an increasingly vital part of everything we do. Transactions that were impossible 10 years ago can now be accomplished in minutes, if not seconds, and the potential exists to reap great benefits in efficiency and productivity for individual firms and for society as a whole. Strides in telecommunications in particular have accelerated the global integration of markets. Such technology has broadened the range of financial instruments — derivatives, for example — that can help the financial services industry minimize and redistribute risk. And last, but certainly not least, technology has allowed the expansion and proliferation of payments, clearance, and settlement systems designed to provide assurance of liquidity and financial stability to global markets.

Not long ago, U.S. pension and mutual funds largely invested in domestic securities. Today, a growing portion of this money is invested abroad, a shift made attractive by higher rates of return, but made possible by technology. Information on foreign investments is now available on-line; trading in global markets can be accomplished around the clock; and worldwide, both securities and funds settlement increasingly take place electronically and in rapidly growing volumes and values. Businesses and economies not only must compete for customers and funding locally, but also must stand up to foreign competition that can, with increasing ease, supply products formerly made only locally and attract previously secure sources of investment.

Global integration has reinforced the need for all countries to shape policies in ways that are credible to foreign investors. This has meant attention to achieving long-run economic goals of low inflation and high rates of saving, and in most countries this has meant attention to deficit reduction.

The realities of ever-changing technology and global integration have spawned the need for increasing consolidation in the financial services industry. No longer can any single type of financial services provider lay sole claim to a product; technology has created commodity-like products and services with low profit margins. Global integration has increased competition. This combination has driven home the need for efficiency. In response, financial services providers have consolidated into larger entities which can spread the costs of technology and global reach over a broad base. These institutions then seek to diversify geographic risk in order to deal profitably with global businesses that need support in many markets.

All three trends — technology, global integration, and financial consolidation — hold great promise both for increasing the size of the world's economic pie and for generating broad-based increases in living standards. Combined with a basically solid worldwide economic outlook, the promise is great indeed. However, there is also much about which a central banker can worry.

In a highly technological and global financial environment where volumes and values of transactions are growing rapidly, it is all too easy to forget the basics: the simple, unalterable truths that, if neglected, come home to roost just as they did 100 years ago. When we look at any of the financial debacles of recent times—Drexel, Kidder Peabody, Orange County, Barings, to name just a few — it's not the complex nature of derivatives or foreign exchange markets that has been the heart of the problem; it's the lack of attention to basics. High rewards are the result of higher risks; internal controls do matter; leverage can be overdone; and most importantly, never invest in anything the logic of which is not readily apparent.

With the benefits of increasing technical capabilities and a smaller world comes an increasing potential for bouts of financial instability. One has only to consider the phenomenon of the swift and violent "run-on-a-country" that occurred in Mexico to realize the potential for problems in the combination of technology and highly sophisticated global investors. Fortunately, in each case where global financial instability has threatened, financial markets and institutions have shown remarkable resiliency. The global economy has managed to dodge the bullet, even though those most directly involved have paid dearly. However, there is always the danger, albeit remote, that one of these disturbances could be bigger in size, affect more countries, bring gridlock to national and international payments systems, and occur faster than ever before.

For the global economy or for any individual nation or financial institution, the only way to ensure against the potential for crisis is to practice financial discipline. Conservative national macroeconomic policies maximize the attractiveness of a country for stable foreign direct investment. Increased international regulatory cooperation can anticipate a global weak link before the crisis. And increased investment and coordinated central bank attention to the payments and settlement systems that underpin global markets are necessary. Efforts to these ends are under way, but they must be stepped up to keep pace with advances in technology and global integration — no easy task, but a necessary one.

There is no doubt that increasing the level of private savings while diminishing public dissaving is a critical economic priority in every developed country. High domestic savings rates reduce dependence on foreign savings, in effect reducing vulnerability to the problems inherent in technology and global integration. Promoting high savings rates means keeping inflation low, providing attractive savings vehicles — for example, pension reforms — and addressing chronic government budget deficits. In this regard, the G-7 countries must redouble their efforts at deficit reduction, since such deficits collectively are a huge drain on savings and an ongoing source of congestion and pressure in global capital markets.

However, in the global rush to better balance government income statements, it is important not to forget that governments exist for a reason. They exist to address the fact that the invisible hand simply cannot do the job by itself. There are needs, whether in the area of national security or in the elements of a social safety net, for which only governments can and should provide.

Balancing this inherent role of government with fiscal discipline is a challenge of some dimension. I have the uneasy thought that just as countries all over the world are making headway in deficit reduction, the very public investments in human and physical infrastructure that are needed to cope with the challenges of technology, integration, and industry consolidation may have difficulty being funded. How, for example, will our public education systems turn out the highly skilled workers needed for the more technologically intense industries and services of the present and future? A real worry is that just when we need them the most, the funding for these so-called public goods will dry up, with all that implies about the potential for a permanent underclass and social instability.

U.S. and worldwide economic health is encouraging both for the present and for the immediate future. But beneath the surface are problems that must be addressed. I have touched on only a few, and while I recognize that the probability of serious difficulty is low, the assumption that these issues will go away if unattended is both myopic and dangerous. Central bankers, policymakers, and business leaders must work together to establish sound, conservative macroeconomic policies, emphasize basic financial controls, and ensure that enough investment can be made in the human and physical infrastructure to sustain growth in this challenging and ever-changing world.

In the crunch of global competition and instantaneous decision-making, it's easy to forget the principles of sound financial management. Forums provided by the Bank, such as the one on derivative risk management, are services aimed at educating the region on financial issues.

At the request of public leaders from several New England states, the Boston Reserve Bank held a conference at which District leaders from all sectors, including Native American tribes, were able to discuss with national experts the economic implications – pro and con – of casino gambling.

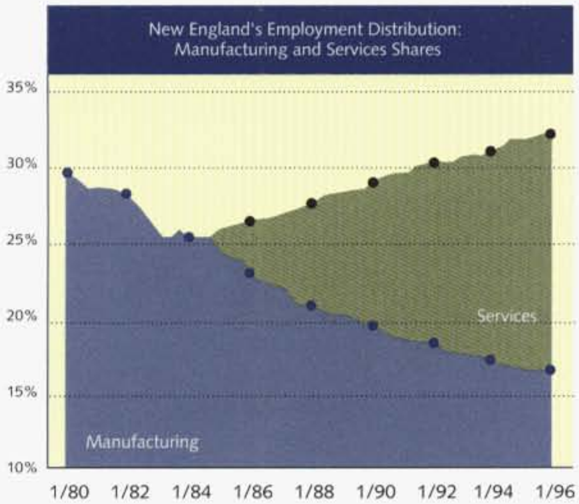
Monetary Policy and the New England Economy

The Boston Reserve Bank participates in the formulation of monetary policy and in the promotion of sound economic growth and financial stability both here in New England and throughout the country. The quality of the Bank's research and its reputation for impartial policy analysis also enable us to contribute information and provide forums for discussion of a wide range of issues important to decision-makers and communities in the First District and beyond.

Monetary Policy

Inflation averaged under 3 percent in 1995, the fourth year in a row of such low rates and the best performance since the early 1960s. Unemployment for the year was 5.6 percent, well under its 20-year average of 7 percent. The continued expansion of the economy demonstrates that we have achieved a "soft landing." The economy did not slide into recession, despite the advanced age of the recovery. Nor did growth accelerate into an unsustainable inflationary boom, as has often happened in the past.

Services industries dominated job growth in 1995 while manufacturing employment bottomed out.



Trying to understand and anticipate the path of the economy is one of the primary functions of the research staff at the Boston Reserve Bank. Gathering information on economic activity in New England for the System's periodic Beige Book entails a regular survey of firms in the region. Throughout the year, the staff prepared briefings for the Bank's Board of Directors on current conditions in the region, the nation, and among our major trading partners; advised the Bank president before Federal Open Market Committee meetings; and engaged in research on the complex issues related to monetary policy.

The interaction between regulatory policy and monetary policy and their effect on economic activity are much-debated issues to which we in New England are especially sensitive, having suffered through the credit crunch that followed the real estate collapse here in the late 1980s. Over the past year, the Boston Reserve Bank produced a number of conceptual and empirical articles exploring these relationships and showing the pitfalls of a mechanistic approach to capital regulation. In part because of New England's experience, economists and policy-makers have been debating whether bank lending has a special role in the economy; and our conference on the role of banks in the transmission of monetary policy brought together researchers from across the nation to explore whether bank lending affects economic activity, independent of the effects of interest rates and changes in the money supply.

Business executives and municipal officials attended our conference on the benefits and risks associated with use of derivatives. The opportunity to hear from prominent experts in the field led, we hope, to a better understanding by those who make investment decisions. This advice was also published in the Bank's economic journal, as was research examining banks' use of derivatives which showed that many derivatives are conceptually equivalent to more familiar traditional securities. One theme of this research is that regulation should focus on institutions' overall risk management rather than on a particular class of financial instruments.

The Regional Economy

Although the nation enjoys moderate growth, with low unemployment and low inflation, this prosperity has not been shared evenly by all regions, industries, or individuals. New England still has not recovered all the jobs lost in the deep recession of the early 1990s. Nevertheless, it seems likely that this unfortunate episode was a one-time occurrence rather than the beginning of a prolonged period of economic difficulty. While the rate of growth in 1995 was slightly lower than in 1994, it was consistent with historic trends. Among the six New England states, New Hampshire and Vermont continued to experience the most rapid growth.

The recovery has been characterized by pronounced industrial shifts. Services industries have accounted for most of the new jobs and have continued to dominate job growth in 1995. Construction employment also rose. Manufacturing employment, on the other hand, has fallen throughout most of the recovery. Our contacts with manufacturers, however, reveal that the employment figures give a misleading impression of the health of the industry. Large productivity gains are enabling manufacturers to do more with less, and when they do need to expand, they look increasingly to outside sources and temporary help agencies to supply staff, rather than adding to their own payrolls. In 1995, moreover, manufacturing employment appears to have bottomed out. Several traditional manufacturing industries such as metals, once dismissed as uncompetitive in New England, are expanding. High-tech employment, meanwhile, appears to be stabilizing.

Restructuring in the face of competition has prompted downsizing among utilities and in financial services. Despite employment declines, however, the banking industry in the region is healthy once again. Consolidations have reduced the number of institutions, but the industry's return to health removes a significant drag on the regional economy.

Small and medium-sized businesses are particularly dependent upon bank financing. Thus, a healthier banking sector bodes well for the availability of credit. At the same time, the increasing concentration of the industry raises concerns, since large banks devote a smaller fraction of their resources to small business lending than do their smaller counterparts. Boston Reserve Bank economists addressed this issue in several articles on the availability of bank loans to small businesses and the implications of the changing structure of the New England banking industry.

Adding to the ongoing debate over reform of the health care system, the Bank published the proceedings of our 1994 health care conference. That forum gathered prominent experts from diverse sectors to explore the impact of mergers on the health service industry, the con-

In New England one in ten jobs is directly tied to the health care industry. In 1995 the Boston Reserve Bank published the proceedings of its conference on health reform at which experts, policy-makers and consumers explored the difficult challenges and practical responses.

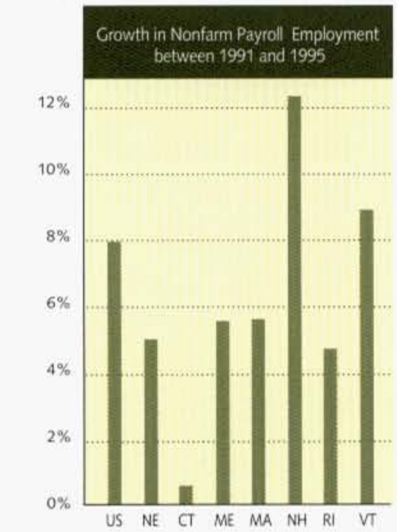
sequences of reform for the region's medical research, and the requirements for market-based health care.

The Bank also looked at the fallout from the shift from manufacturing to services and from the downsizing of major corporations. One project examined the experience of laid-off New England defense workers and found that they typically experience substantial pay cuts in their new jobs, with older workers faring the worst. Another study looked at the effect of changes in health benefits on the inequality of incomes. The study concluded that less educated workers are even more disadvantaged by recent labor market shifts when health benefits data are taken into account than when only wage data are included.

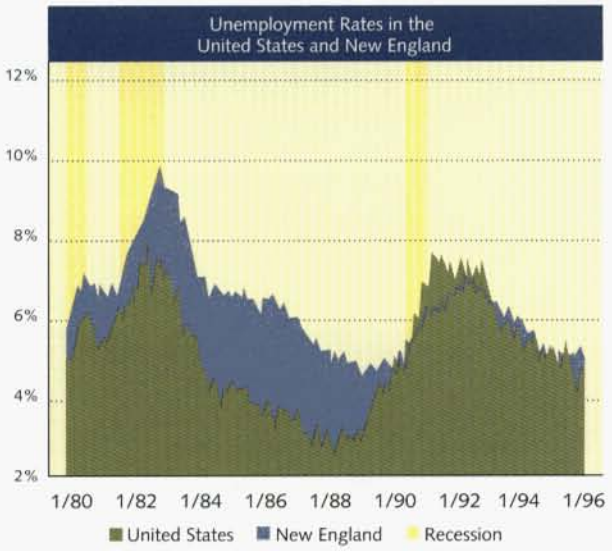
Indeed, income inequality is a serious and growing problem. To stimulate new thinking, the Boston Reserve Bank organized a symposium that brought together two groups of researchers who address the inequality issue from quite different perspectives. By mixing those who focus on location and isolation from mainstream economic activity with those who stress mismatches between the demand and supply of labor, we hoped to generate fresh ideas and set in motion new collaborations. The conference focused attention on possible institutional and neighborhood factors that might be amenable to policy action. We trust that the true measure of its success will be apparent over time, as researchers take advantage of their exposure to new colleagues and fresh approaches.

The disruptions arising from the changing character of the economy have intensified the pressure on elected officials and business and community leaders to adopt policies that stimulate local growth. Casino gambling is seen by some as an important economic development tool. At the request of public officials from several New England states, the Boston Reserve Bank held a conference that brought together policy-makers and experts from around the country to explore the costs and benefits of casino gambling. Although opinion was divided on the net outcome, agreement was widespread that, like it or not, gambling is on the upswing.

Looking ahead, the Bank's research staff will continue to seek a better understanding of the forces responsible for economic growth and contribute to policies that enhance economic well-being, with attention to the special needs of New England. The Boston Reserve Bank strives to be an impartial source of information and expertise by providing a common ground for citizens, researchers, and policy-makers to share their concerns and insights.



Unemployment rates in New England followed the national downward trend.



Supervision and Regulation

In 1995, bank consolidation and improved bank earnings continued to shape the New England banking industry. The banking consolidation trend began earlier in the decade with acquisitions of failed institutions, but by 1995 the participants in acquisitions were predominantly the healthy banks, including some of the largest banks in New England. Such mergers provide opportunities to improve efficiency, reduce operating costs, and better rationalize banks' geographic and product mix. If the expected gains are realized, they should contribute further to the current trend of improved profitability. New England banks have recovered from the low capital ratios of the last recession and asset quality continues to improve. In 1995, banks increased their return on assets to above 1 percent for the first time since 1986, and many focused serious attention on efficiency ratios. This trend of improved operations and profitability coincides with improvements in banks' ability to quantify and manage risk, enabling them to better cope with the challenges of competition and technology that are reshaping the banking industry worldwide.

Examination in a Revitalized New England Banking Market

The trends that are altering the New England banking industry also are changing the immediate direction of bank supervision. The focus of supervision in the early 1990s was on restoring the financial health of banks in the District. With our institutions revitalized, the focus has moved from working out current problems to avoiding future problems.

Our Bank Examination function is adopting new ways of managing risk, focusing supervisory attention on the areas of greatest risk to the individual institution and to the financial system as a whole. Examinations are conducted on two levels. The first is a "top-down" review of a company's business strategies and internal processes — the policies and controls that guide performance. The second level of review is a "bottom-up" testing of specific transactions to verify that stated policy is in fact carried out. In addition to confirming where a company has been, based on historical transactions, the information gained from this approach permits us to develop a better understanding of where a company is going, the risks that it is willing to assume to achieve its goals, and the steps it has taken to control those risks.

This new approach requires customizing supervision to the risk profile of each institution, based on the company's business strategy, the effect of competitive pressures, and the firm's management of attendant risks. This type of examination requires diverse skills from staff. To support the new approach, we implemented a portfolio management program in 1995 whereby teams of examiners are assigned specific companies to monitor continuously for changes in management, financial condition, or business philosophy. On-site examinations are then tailored to address the particular risks that have been identified, and examiner resources are used more efficiently.

Consolidation and growth at many of the largest institutions in the District have resulted in more complicated organizations to supervise. Banks as well as bank holding companies under our jurisdiction engage in a growing number of increasingly complex nonbank activities, and our examiners are developing proficiencies in such areas of emerging risk as insurance, mutual funds, capital markets, and fiduciary activities. This effort, together with a foundation in traditional banking activities, has allowed our supervisory staff to begin to understand how risk management should be conducted, and whether banks are affected by the economy in Latin America, volatility in the equities markets, or intense competition in retail banking. The beneficiaries of a more effective supervisory process include not just the institutions under our jurisdiction but also the communities they serve, because sound risk management will improve banks' ability to meet customer needs.

Bank Consolidation in New England

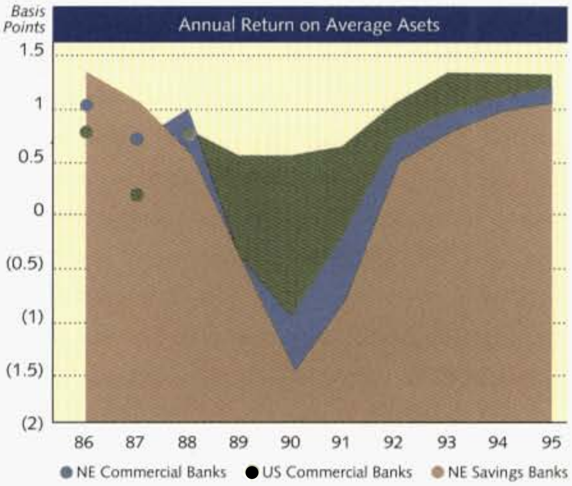
Consolidation can result in more efficient banking operations, enabling the bank to provide better services to its customers at a lower cost. Despite the potential benefits from mergers, however, poorly managed consolidation can harm both the bank and the community it serves. For this reason, before approving a merger, we consider whether the merger will impair the safety and soundness of the merged entity, whether the merger will significantly restrict bank competition, and whether the merged entity will continue to meet the needs of its local community.

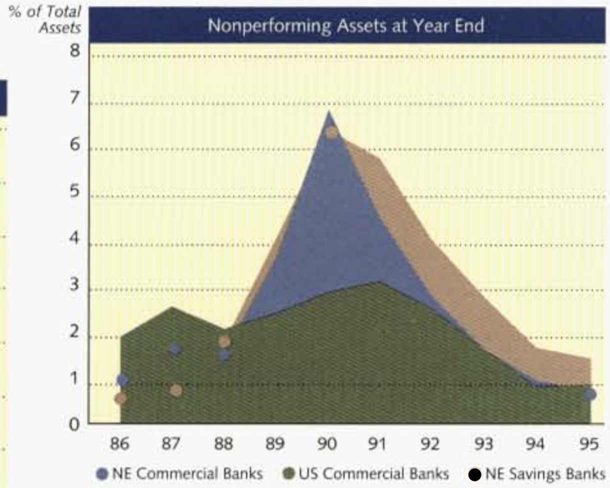
The volume and complexity of bank merger cases were striking in 1995. Reflecting the trend in increased merger activity in New England, 24 applications were processed this year. While issues of safety and soundness have become less of a barrier as the financial health of New England banks has improved, the competitive and community concerns are heightened when mergers include large, complicated banking organizations. The most prominent of the 1995 mergers was the acquisition of Shawmut National Corporation by Fleet Financial Group, Inc. Consummation of that proposal created the largest banking organization in New England and the tenth largest in the nation, with total assets of over $86 billion. Because of the intense interest in the proposal, which generated 278 public comments, the Boston Reserve Bank organized a series of three public meetings to better assess the concerns of the local community. The meetings were well attended, with a total of 161 commenters.

Outreach

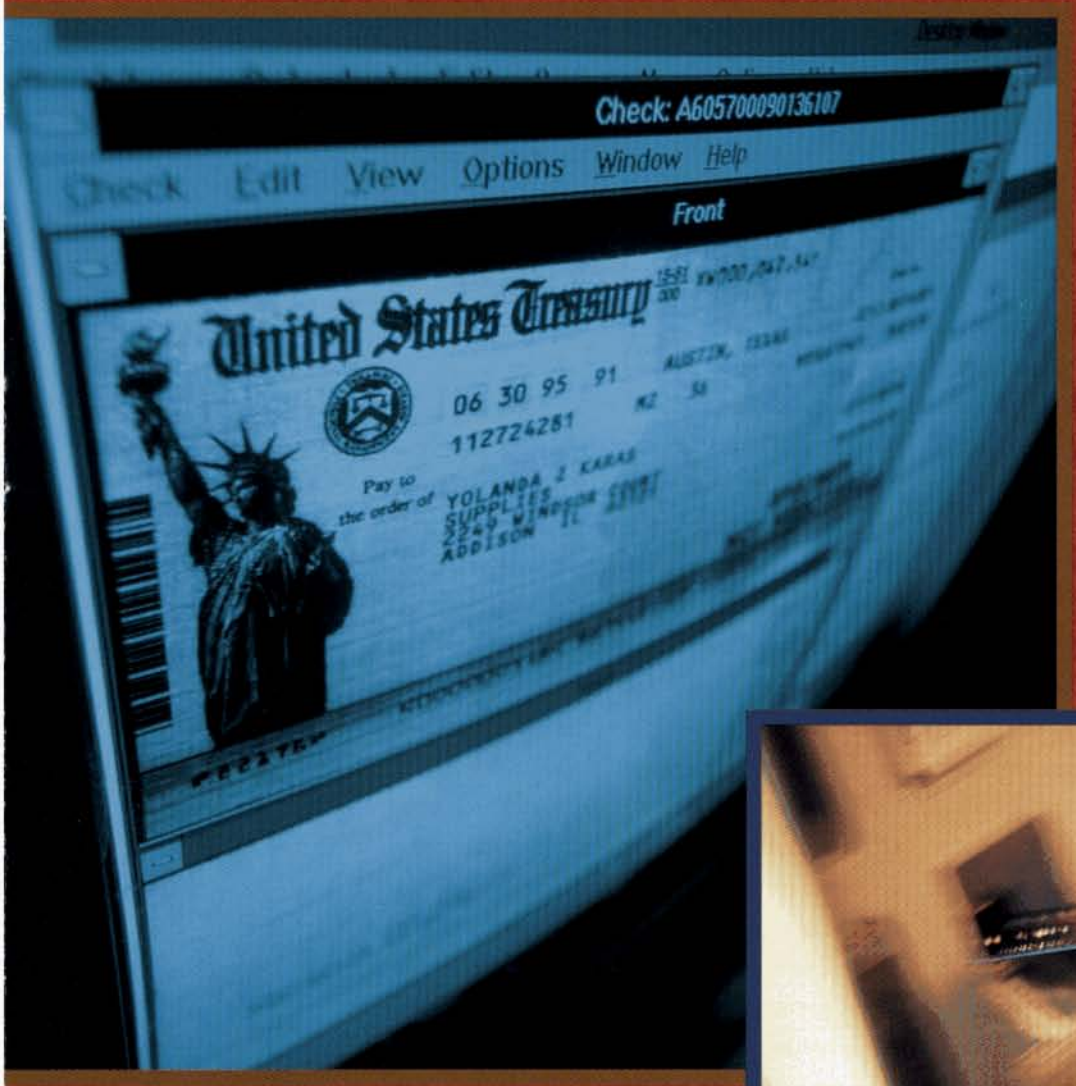
An important element of the bank examination and supervision function is education of both bankers and consumers of banking services. The Boston Reserve Bank continues to be active in educational programs and conferences on banking. This Reserve Bank remains particularly committed to encouraging lending practices that benefit all borrowers, sponsoring focus group sessions, a series of seminars in northern New England, and several local training programs to familiarize financial institutions and community groups with the new Community Reinvestment Act regulations.

The outreach program includes activities not only in New England but also nationally and internationally. As part of its efforts to build international bridges, the Reserve Bank again participated in the Hubert H. Humphrey Fellowship Program at Boston University. The mission of the program is to foster international understanding by allowing mid-career professionals from developing countries to gain expertise in their fields. Following a two-week internship, two of the five program participants returned to the Bank to learn more specifically about regulations, policies, and procedures associated with bank supervision and related automation support. The Bank's Community Affairs officer is assisting officials in South Africa in developing a community lending program there. Such initiatives help promote sound banking practices in other countries, which will become increasingly important as we move to a global economy.





New England Banks have returned to profitability as non-performing loans have declined.



Through ATM machines, electronic banking is now at nearly everyone's fingertips. Soon "electronic imaging" will improve the security, integrity, and speed of clearing checks. The Federal Reserve is a national leader in bringing electronic communications to the payments system.

Financial Services

The accelerating pace of technological change and the application of new technology to financial services in 1995 underscored the importance of Federal Reserve efforts to ensure the integrity and efficiency of the nation's payments system. Smart cards, digital imaging and various cyber-cash alternatives, combined with pervasive communications facilities such as the Internet, are rapidly expanding the choices available for making payments. While actively encouraging these innovations, we do so with caution. The rush to introduce new technology, typically driven by competitive market forces, often precludes analysis of the potential, unintended impact of these changes. While technology may increase efficiency, it does not necessarily eliminate — and in fact sometimes increases — the risks inherent in the payments system. Properly managed, however, technology promises to yield significant benefits. The Federal Reserve thus continually asks whether existing control systems, particularly the means designed to achieve security, are robust enough for the new technology, and whether the payments system rules and regulations are compatible and supportive. Our task, then, is to facilitate improvements in efficiency while remaining ever vigilant in maintaining a safe, sound, and effective payments system.

Today's increasingly global economy demands continuous improvement in payments system cost-effectiveness — improvements now made feasible by technology. When we consider that the United States has been estimated to spend as much as one-half to one percent of its Gross Domestic Product on the payments system, and that our financial services sector increasingly competes with those of other developed countries employing highly efficient payments systems, it is apparent that the U.S. system must progress continually in order to remain competitive.

The Federal Reserve Bank of Boston is closely involved with industry, professional organizations, and public sector agencies to develop an enhanced payments system that employs technology not only to improve the system's efficiency, but also to ensure its security, reliability, and integrity. At all levels — senior management and staff — we advise both national and international payments system practitioners on the importance of payments system risk management.

The Boston Reserve Bank's Retail Payments Office leads a Federal Reserve effort to implement payments system changes across the country. The Office has as a goal the widespread conversion of paper-based check payment transactions to electronic payments in order to eliminate, or substantially reduce, the high costs and inefficiencies inherent in the check collection process.

The means to make retail payments electronically exists through the various automated clearing houses (ACH) operated by Reserve Banks and private sector service providers. However, fewer than one-half of all employees are paid via ACH direct deposit and a much smaller portion of the population uses ACH direct bill payment. In 1995, the Retail Payments Office managed the implementation of the new centralized Automated Clearing House Software — Fed ACH — which enhances our customers' access to our ACH system. In a joint effort with the National Automated Clearing House Association, we sought to expand both business and consumer awareness of direct payment. Both direct deposit and direct payment are becoming increasingly popular, and ACH payment volume has more than doubled in the last five years.

By incorporating market and customer needs along with society's demands for integrity and security, we at the Reserve Bank expect to achieve greater efficiencies through — and widespread acceptance of — payments system improvements. To gain an industry perspective, the Retail Payments Office established an Advisory Group on Electronic Check Presentment, drawing on the expertise of industry leaders in a cooperative effort to examine potential improvements to the check collection system. The Advisory Group is sponsoring operational tests and studies of economic and legal issues to help the banking industry chart a course to take us from the present system to a more efficient and integrated electronic check collection system.

In its prominent role as a provider of check collection services, the Reserve Bank continuously must improve its own services to meet the dynamically changing needs of the industry. Check services have traditionally been developed at each local Reserve Bank. During 1995, the Retail Payments Office announced the first national check services program. Taking advantage of 10 years of commitment to the development of image technology, we developed check image services for both the U.S. Treasury and the banking industry that will reduce fraud risk and increase efficiency.

Emerging "smart card" technology could potentially become a new form of currency, one which allows value to circulate, transferring from card to card, from one endpoint to another, without conversion to a more traditional form of money. These and other new electronic payment vehicles may also use the Internet. The Retail Payments Office is engaged in standards development efforts, operational pilots, and other initiatives related to these emerging technologies.

The Boston Reserve Bank's provision of financial services locally complements the work of the Retail Payments Office by responding to the needs of First District depository institutions for secure, efficient, and cost-effective financial services. Working closely with the New England Automated Clearing House Association, we sought to expand both business and consumer awareness of ACH direct payment in New England. In 1995, we worked to introduce imaging technology within the First District — by implementing our first commercial check imaging service for return-item processing; by exploring the use of imaging to enhance truncation and electronic check presentment; and by developing electronic services that make it possible for small banks to offer many of the same products as their larger competitors.

It would be counterproductive to hinder the infusion of new technologies into the payments system, but we must remain cautious as we facilitate these improvements. The Bank continually balances the potential for improved cost-effectiveness with the potential for serious problems, as technological progress makes payments system advancements possible. There are many questions — questions concerning the potential for efficiency as well as for risk, and questions concerning opportunities for fraud as well as the potential for financial market instability — that are being studied as we move forward.

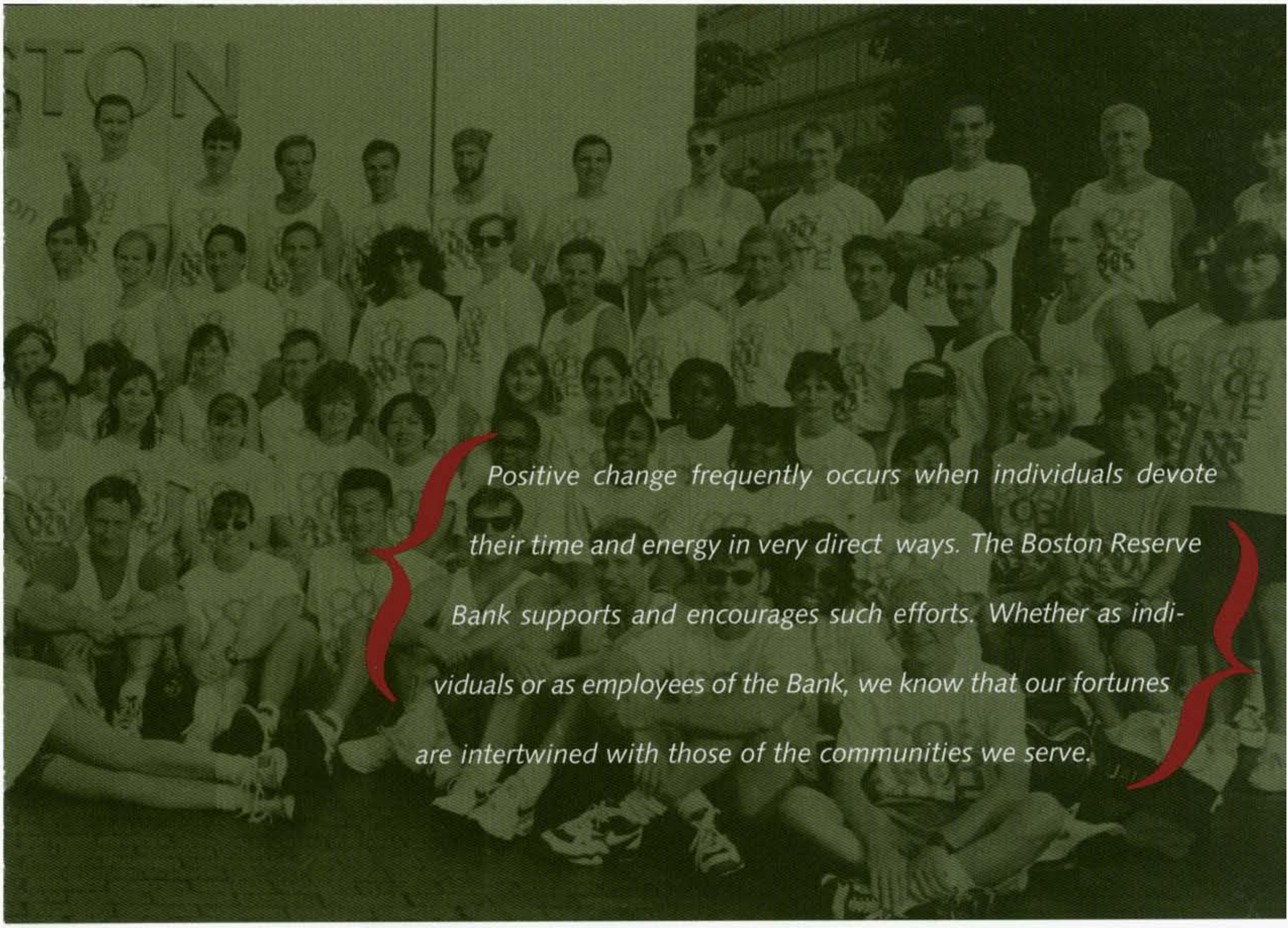
Finally, we recognize that neither technology nor payments systems are ends in and of themselves. They are the means to the larger ends of the efficient allocation of economic resources within our society. They are important, if not vital, to economic growth, and it is this growth that we seek to support through our financial services activities.

THE BANK IN THE COMMUNITY

Community outreach is central to the mission of the Bank. Our Public Affairs group stresses economic and financial literacy for all residents of New England. The Community Affairs staff members work with banks and community organizations to promote reinvestment in the region's distressed communities.

Our public education programs reach a spectrum of audiences, from young children to senior citizens, students, educators, and consumer professionals. The region has access to the Boston Reserve Bank's expertise in a variety of ways: through our 350 educational presentations to students, teachers, and the general public each year; through the distribution of over 140,000 copies of publications on various topics ranging from monetary policy to comic books on checks and money for students; through our professional development programs for college instructors and high school teachers; through our consumer regulations telephone information line; through our monthly meetings with consumer professionals; and now, through our site on the World Wide Web.

Among the programs we sponsored in 1995 were two National Consumer Week conferences in Boston and in Maine for consumer service professionals and teachers; numerous programs to inform senior citizens and the general public about uninsured bank products; and a "Money Fun For Everyone" program that was offered free to families during the December school vacation week.



Positive change frequently occurs when individuals devote their time and energy in very direct ways. The Boston Reserve Bank supports and encourages such efforts. Whether as individuals or as employees of the Bank, we know that our fortunes are intertwined with those of the communities we serve.

Community Affairs efforts were initially undertaken to further the mission of the Community Reinvestment Act, which requires banks to help meet the credit needs of the communities in which they are located. In 1995, we focused on educating bankers and community organizations about changes related to new Community Reinvestment Act regulations. And through courses in community development finance and microenterprise development, we informed lenders about new approaches to financing development in their communities. To help New England foundations identify ways to maximize the impact of their grantmaking, the Bank cosponsored a conference to discuss issues of income, employment, and economic development, and to provide a forum for increased collaboration.

The Bank's educational partnerships bring our knowledge and resources to instructional settings. Our partnership with South Boston High School prepares students for work, prevents dropouts, improves students attendance, and in 1995 provided for employment of 40 students. Our affiliation with Dearborn Middle School concentrates on career choices and preparation through a very active mentoring program. And our alliance with Oliver Wendell Holmes Elementary School focuses on improving reading and writing skills.

On a broader scale, the Bank continued its decade-long leadership in the public-private partnership for education and economic opportunity known as the Boston Compact. Some 91 Boston firms, eleven high schools, and over 1450 students are engaged in "school-to-career" learning and earning efforts. President Minehan chairs the City's School-to-Career Measurement Committee, while a Bank vice president serves on the Boston School Committee and continues to be a leader of Massachusetts' statewide effort to integrate school and work, which now includes 15 partnerships in most of the state's major cities.

As part of our school-to-career program and ongoing involvement with the Boston Private Industry Council, we employed seven students from Boston High School in the financial career training program called Project ProTech Financial Services. Boston Reserve Bank employees worked as mentors with these students to help them prepare for the transition to a career or to college.

Our employees also devote their own time toward improving the lives of some of Greater Boston's neediest residents. On Community Care Day, more than 40 employees assisted in improving the facilities of several United Way agencies. Many staff members used their lunch hours to visit elementary school classrooms as part of the nationally acclaimed Books & Kids program.

Take Our Daughters to Work

School Reading Program

United Way Road Race

Tree Donation

AIDS Ride

Project ProTech

Community Care Day

Board of Directors and Executive Management. Row 1: Cathy E. Minehan (President), Jerome H. Grossman, M.D., (Chairman) , Professor William C. Brainard (Deputy Chairman). Row 2: Joan T. Bok, Stephen L. Brown. Row 3: Jane C. Walsh, G. Kenneth Perine (1996), Paul M. Connolly (First Vice President). Row 4: Robert R. Glauber (1996), John E. Flynn, Edward Dugger III, Marshall N. Carter.

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December 31, 1995

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President and Chief Executive Officer, Hadco Corporation

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President and Chief Executive Officer
Cooper Instrument Corporation

Peter Meade
(Advisor)
President and Chief Executive Officer, New England Council

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as of December 31, 1995

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President and Chief Executive Officer

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First Vice President and Chief Operating Officer

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Executive Vice President and General Counsel

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Senior Vice President and Director of Research

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Assistant Vice President

Steven M. Whitney
Assistant Vice President

Anna M. Wong
Assistant Vice President and Assistant General Auditor

Statement of Condition

	December 31, 1995	December 31, 1994
Assets		
Gold Certificate Account	$ 575,000,000	$ 553,000,000
Special Drawing Rights Certificate Account	511,000,000	511,000,000
Coin	16,851,740	14,870,139
Loans and Securities:		
Loans to Depository Institutions	6,000,000	5,750,000
Federal Agency Obligations Bought Outright	129,541,435	190,376,114
U.S. Government Securities-System Account	18,599,975,539	19,082,041,609
Total Loans and Securities	18,735,516,974	19,278,167,723
Items In Process of Collection	299,301,360	293,173,596
Bank Premises (Net)	94,278,515	93,337,983
Other Assets	1,257,642,094	1,249,247,626
Interdistrict Settlement Account	7,062,620,659	(2,202,479,852)
Total Assets	$ 28,552,211,341	$ 19,790,317,215
Liabilities		
Federal Reserve Notes (Net)	$ 26,174,514,828	$ 17,747,015,737
Deposits		
Depository Institutions	1,414,051,848	1,213,936,471
Foreign	5,337,709	5,098,909
Other	33,222,590	31,366,271
Total Deposits	1,452,612,147	1,250,401,652
Deferred Credit Items	358,933,797	283,603,491
Other Liabilities	224,473,968	230,423,635
Total Liabilities	$ 28,210,534,741	$ 19,511,444,515
Capital Account		
Capital Paid In	$ 170,838,300	$ 139,436,350
Surplus	170,838,300	139,436,350
Total Capital Accounts	341,676,600	278,872,700
Total Liabilities and Capital Accounts	$ 28,552,211,341	$ 19,790,317,215

Statement of Earnings and Expenses

	December 31, 1995	December 31, 1994
Current Earnings		
Advances to Depository Institutions	$ 145,809	$ 120,337
Invested Foreign Currency	29,585,740	32,311,828
U.S. Government Securities and Agency Obligations-System Account	1,184,564,568	1,035,627,770
Income from Services	61,548,708	39,895,330
Penalties on Deficiencies in Required Balances	40,707	22,644
Penalties on Overnight Overdraft	7,058	5,442
Penalties on Daylight Overdrafts	129,236	90,629
Treasury Securities Transfer Fees	338,638	319,295
Total Current Earnings	1,276,360,464	1,108,393,276
Less:		
Current Expenses	117,261,531	94,032,256
Cost of Earnings Credit	19,801,408	14,492,606
Current Net Earnings	1,139,297,525	999,868,414
Additions to Current Net Earnings:		
Net Profit on Sale of U.S. Government Securities	253,285	(1,237,875)
Net Profit on Foreign Exchange Transactions	38,032,962	87,608,162
All Other	(4,032,598)	11,332
Total Additions	34,253,649	86,381,619
Deductions from Current Net Earnings:		
Cost of Unreimbursed Treasury Services	2,017,434	1,582,808
All Other	-0-	-0-
Total Deductions	2,017,434	1,582,808
Net Addition (Deduction) to Net Earnings	32,236,215	84,798,811
Assessments by the Board:		
Board Expenditures	6,256,100	5,334,800
Federal Reserve Currency Cost	17,221,230	18,471,633
Net Earnings Before Payments to U.S. Treasury	$1,148,056,410	$1,060,860,791
Distribution of Net Earnings		
Dividends Paid	$ 9,461,492	$ 7,849,562
Payments to U.S. Treasury (Interest on Federal Reserve Notes)	1,107,192,968	1,036,570,880
Transferred to Surplus	31,401,950	16,440,350
	$1,148,056,410	$1,060,860,791

Summary of Operations

	Calendar Year 1995		Calendar Year 1994	
Services to Depository Institutions	Daily Average Volume	Daily Dollar Value of Transactions	Daily Average Volume	Daily Dollar Value of Transactions
Wire Transfer of Funds	34,665 transfers	$88.9 billion	32,696 transfers	$73.0 billion
Automated Clearing House	839,967 items	$ 2.0 billion	718,192 items	$ 1.8 billion
Commercial ACH Items	721,822 items	$ 1.8 billion	605,074 items	$ 1.6 billion
Government ACH Items	118,145 items	$ 0.2 billion	113,118 items	$ 0.2 billion
Check Processing (Commercial)				
Total Volume	4.1 million checks	$ 2.6 billion	4.1 million checks	$ 2.6 billion
Processed Volume	3.2 million checks	$ 2.1 billion	3.0 million checks	$ 2.1 billion
Fine Sort Volume	0.8 million checks	$ 0.3 billion	1.0 million checks	$ 0.4 billion
Processed Returns	42,375 items	$ 0.04 billion	42,936 items	$ 0.04 billion
Government Volume	91,538 items	$ 0.09 billion	92,701 items	$ 0.09 billion
Adjustment Process	861 items			775 items
Cash Operations				
Cash Shipped	6.5 million notes	$85.1 million	6.4 million notes	$82.6 million
Cash Received	6.0 million notes	$77.4 million	5.8 million notes	$72.4 million
Services to U.S. Treasury				
Electronic Book Entry Securities	6,558 transfers	$87.1 billion	5,797 transfers	$79.2 billion
Savings Bonds Issued*	2,147 bonds	$382.9 thousand	10,699 bonds	$2.0 million

*All savings bonds functions have been moved to Federal Reserve Bank of New York at Buffalo as of August, 1995.

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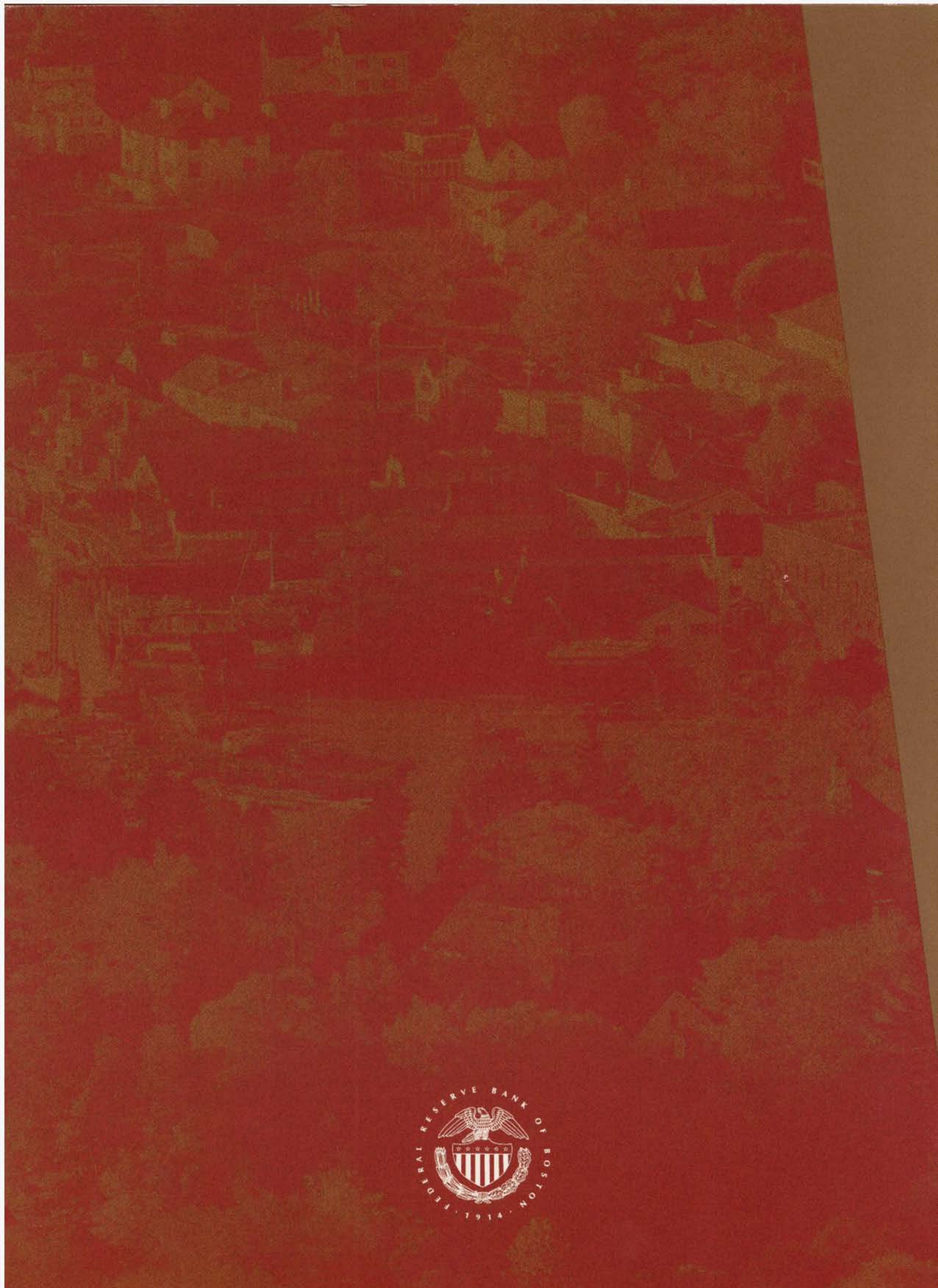
FEDERAL RESERVE BANK OF BOSTON
1914