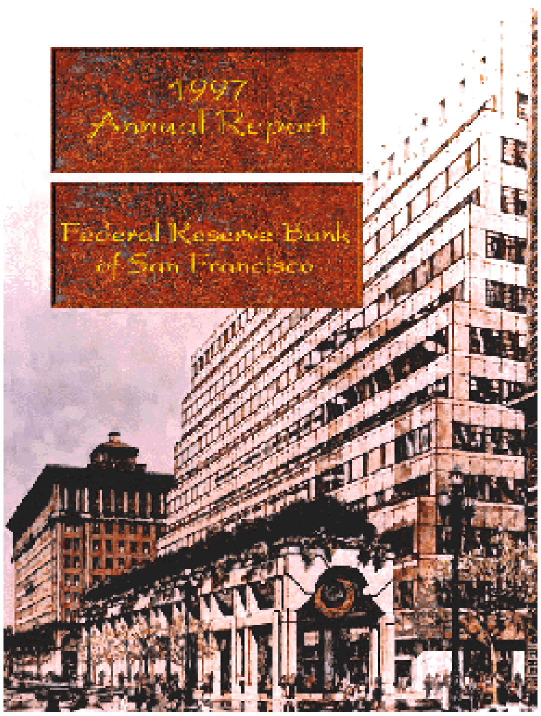
The Federal Reserve Bank of San Francisco

About the Fed

1997 Annual Report



The Federal Reserve Bank of San Francisco is one of 12 regional Reserve Banks which, together with the Board of Governors in Washington, D.C., comprise the nation's central bank.

As the nation's central bank, the Federal Reserve is responsible for making and carrying out our nation's monetary policy. It also is a bank regulatory agency, a provider of wholesale priced banking services, and the fiscal agent for the United States Treasury.

The Federal Reserve Bank of San Francisco serves the Twelfth Federal Reserve District, which includes the nine western states--Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington--Guam, American Samoa, and the Northern Mariana Islands.

To serve this expansive region, the San Francisco Reserve Bank has five offices: the headquarters in San Francisco, and offices in Los Angeles, Portland, Salt Lake City, and Seattle. Each office provides financial services to the public and banking institutions in its locale.

Previous Annual Reports:

This Report was produced by Karen Flamme. It was written by Elizabeth Laderman, Jennifer Martinez, Selma Meyerowitz, Barbara Bennett, and Karen Flamme. Design and illustrations were created by Bill Rosenthal. Color photography by Paul Schulz (somafoto@msn.com).

The Federal Reserve Bank of San Francisco

About the Fed

From the Boardroom

From left, Robert T. Parry, President; Judith M. Runstad, Chairman (1997);and John F. Moore, First Vice President.

From left, Cynthia A. Parker, Deputy Chairman (1998); and Gary G. Michael, Chairman (1998).

As we stand on the threshold of a new millennium, we in the Federal Reserve find ourselves looking forward to new, exciting ways of doing business. In addition to continuing to provide traditional financial and payments services to our customers here in the West, we are maximizing the potential of new technologies to improve and streamline our services.

We continually study trends shaping and transforming the banking industry and look for ways in which we can facilitate the transition taking place from a paper-based payments mechanism to an electronic one. We see fundamental structural changes in financial institutions, changes in the mix of products and services they offer, and new ways of delivering these services. During 1997 the Board of Governors of the Federal Reserve System convened a committee under the direction of Vice Chair Alice Rivlin to take a comprehensive look at how we fit into the changing payments mechanism and what our role should be. The Committee concluded that, while Reserve Banks should continue to provide their traditional services, they should also play an active, collaborative role in transforming the payments system.

This Annual Report looks at what trends we have observed during 1997 at financial institutions in our District, how our supervisory processes have responded to these changes, and what initiatives the Federal Reserve System has undertaken with regard to the payments system.

During the year we depend heavily on information and leadership from our directors with their special knowledge of areas and industries throughout our District. It is invaluable as we formulate monetary policy and manage the nation�s financial system. We thank all Twelfth District directors for their wise counsel and service during 1997.

In particular, we want to express our sincere thanks and appreciation to those directors who completed their terms of service during 1997: on the Head Office Board, our Chairman of the Board, Judith M. Runstad (Partner, Foster, Pepper & Shefelman, Seattle, WA) and Gerry B. Cameron (Chairman of the Board, U.S. Bancorp, Portland, OR); on the Los Angeles Branch Board, Antonia Hernandez (President and General Counsel, Mexican American Legal Defense & Educational Fund, Los Angeles, CA) and David L. Moore (President, Western Growers Association, Irvine, CA); on the Portland Branch Board, John D. Eskildsen (President and CEO, Retired, U.S. National Bank of Oregon, Portland, OR); and on the Salt Lake City Branch Board, our Chairman, Gerald R. Sherratt (President, Retired, Southern Utah University, Cedar City UT).

Gary G. Michael, Chairman

Robert T. Parry, President

The Federal Reserve Bank of San Francisco

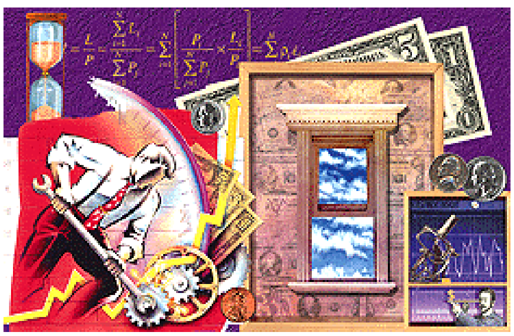
ABOUT THE FED

Banking Looks Different

You can blame (or credit) the computer, but you can�t deny it � the face of banking is changing. The three articles which follow look at these changes and focus on what they mean for the Federal Reserve, from three different perspectives. Our Research department studies western banking � shifts in market structure, trends in product mix and services, and new ways to deliver services. Banking Supervision reports on new techniques and talents they have developed to respond to the increased sophistication of the financial industry. In the Operations area the various Federal Reserve Banks are working in concert to streamline systems and to maximize technological applications to benefit the nation�s payments system.

Trends in Twelfth District Banking

By Elizabeth Laderman and Jennifer Martinez



Recent trends shaping the banking industry over the past several years � changes in market structure, alterations in the mix of products and services banks offer, and innovations in delivery channels � continued in full force in the Twelfth District in 1997.Recent trends shaping the banking industry over the past several years � changes in market structure, alterations in the mix of products and services banks offer, and innovations in delivery channels � continued in full force in the Twelfth District in 1997.

Changes in Market Structure

The banking industry in the Twelfth District remains dynamic, marked by both mergers and new entries. Notable mergers and acquisitions in the District last year were First Bank System, Inc.�s (Minnesota) acquisition of U.S. Bancorp (Oregon) and Washington Mutual, Inc.�s (Washington) acquisition of Great Western Bank (California). At the same time as mergers were tending to consolidate the industry, the formation of new banks worked in the opposite direction. In 1997 there were 35 new banks chartered in the District (including several by existing banking organizations), up from 26 in 1996 and 18 in 1995. On net, the number of banks and thrifts (savings banks and savings and loans) in the District declined by 41 (about 5 percent) in 1997, following a decline of 229 (about 22 percent) over the preceding five years.

The liberalization of branching laws is contributing to the increase in consolidation within bank holding companies. Last June Hawaii became the final state in the District to allow interstate bank branching under the Riegle-Neal Interstate Banking and Branching Efficiency Act. Texas and Montana are now the only states that do not permit interstate branching. Wells Fargo & Company started the trend by making one of the first interstate consolidations in 1996. BankAmerica Corporation and First Security Corporation followed in 1997, combining most of their separately chartered subsidiaries, some located outside of the District, into one main bank. In addition, Keycorp, headquartered in Ohio, combined its Twelfth District banks with others into its Cleveland lead bank in 1997. In late 1997 First Bank System, Inc., acquired U.S. Bancorp, took the U.S. Bancorp name, and combined former U.S. Bancorp subsidiaries with its Minneapolis lead bank. Soon after acquiring Great Western Bank, Washington Mutual consolidated the Great Western offices into Washington Mutual�s American Savings organization, renaming the new entity Washington Mutual Bank, F.A. With the consolidation of affiliated banks and thrifts in different states, well over half of the banking offices in the District are now part of interstate branching networks. In addition, the total number of bank branches in the Twelfth District declined by 967 (about 10 percent) in 1997.

Trends in Products and Services

Shifts in market structure are accompanied by ongoing changes in the mix of products and services that District banks offer. The most important activities continue to involve credit-related services, such as derivatives, securities activities, and credit-scored small business loans. But banks are also acting as brokers for consumer financial investments, offering, for example, mutual funds and insurance. These activities are being added to and, to some degree, are displacing traditional bank products such as deposits and relationship-based loans.

Derivatives contracts continue to be important risk-hedging tools for banks and bank customers. Total notional values for interest rate contracts at western banks stood at $7 trillion as of the third quarter of 1997. Foreign exchange contracts were $1 trillion.

Modifications of the rules that apply to bank holding companies engaged in securities underwriting and dealing activities through securities subsidiaries became effective on October 31, 1997. These modifications should improve operating efficiencies at such subsidiaries and increase options for their customers. BankAmerica Corporation, currently the only Twelfth District bank holding company with a securities subsidiary, expanded its securities brokerage and underwriting activities through the acquisition of Robertson, Stephens & Company Group, L.L.C. in 1997. In addition, First Security Corporation has gained approval to engage in these activities for the first time through the formation of a new securities subsidiary.

Credit scoring, a statistically based means of evaluating the expected repayment performance of a loan, is another relatively new development. First used in consumer lending, credit scoring has the potential to benefit small business customers by substantially decreasing the time, labor, and cost of reviewing small business loan applications, thus boosting small business lending.

One of the strongest consumer trends in recent years is the shift of household financial assets out of deposits and into mutual funds. Banks are recognizing this trend and devoting more of their own resources to selling mutual funds as their deposit growth slows. In the Twelfth District, 23 percent of banks generated fee income from selling mutual funds and annuities in the third quarter of 1997.

In addition to selling annuities, banks may also act as brokers in selling other types of insurance. Although most of these policies are used for backing up credit repayment, a few California state-chartered banks are beginning to venture into more traditional insurance products.

New Delivery Channels

New delivery systems for products and services are proliferating. For example, Internet banking continues to gain in popularity as a channel for banking services. By the end of 1997 the number of banks with a Web presence had grown to 26 percent in the District and 17 percent in the U.S. While some banks are moving toward providing business banking services through the Internet, others report significant growth in PC banking outside the Internet. New developments such as electronic bill presentment may increase the use of electronic banking: bills would be presented directly to consumers� personal computers, with an electronic payment option appearing on the screen at the same time.

Banks also are developing highly automated telephone centers to help consumers handle many of their banking needs without visiting a branch. Many bankers see the telephone center as a pivotal delivery channel because of the wide range of banking services, as well as technical support, that will be provided.

Some banking organizations are beginning to shift away from traditional brick and mortar offices to lower cost �supermarket� branches. These branches may offer the full range of teller transactions or may be more limited-service "banking centers.� In the District, Wells Fargo Bank and Bank of America have increased their activity in this area substantially.

Conclusion

Today, a bank customer may log onto the Internet to inquire about her bank balance. Or, she may walk into a branch of her bank while traveling in a different state and at the same location buy groceries and mutual funds. A small business customer may receive a loan from a bank with far less paperwork than before, while a large business may turn to its commercial bank for securities underwriting services rather than to an investment bank. If 1997 trends are any indication, these scenarios will become more and more the norm in the future.

The Federal Reserve Bank of San Francisco

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Banking Supervision Meets Industry Challenges

By Selma Meyerowitz

Fewer � but larger and more complex � banks, a broadening range of non-traditional activities, a move toward PC banking, and other new ways to deliver services to bank customers � these trends characterize an industry that is evolving and becoming more complex each day. Banking Supervision has responded to the industry�s increased complexity and sophistication by developing new techniques and new talent in order to improve our process and our people. The supervisory process is more dynamic, more integrated, and more risk-focused. Supervision staff have developed new skills and competencies, emphasizing teamwork and adaptability. And training and technology � always important � are now being stressed even more.

The changes in the overall supervisory process are pervasive. As a start, significantly more effort is now placed on ensuring that the process is risk-focused. This involves tailoring the approach to the unique characteristics of the individual organization. It also entails placing additional emphasis on evaluating the organization�s risk management processes, and on assessing its condition on a real-time basis.

The entire process begins with developing an understanding of the organization, including its strategy and risk profile. A supervision plan and examination strategy which focus on the most important areas within the organization are then defined and updated periodically. Examinations must be carefully coordinated to reduce unnecessary burden and to recognize that risks or issues in a particular area may have implications for other areas of the organization. Furthermore, the focus is on assessing the processes used to identify, monitor, and control risk, as opposed to detailed transaction testing. Although effective risk management always has been central to the safety and soundness of banking, it is even more important now, given new technologies and products, and the size and speed of financial transactions.

To facilitate the risk-focused process, each banking organization is assigned to a staff member who oversees the development, implementation, and coordination of that institution�s supervisory program. These staff members establish lines of communication with their assigned institutions, and coordinate closely with other regulators both in the U.S. and in other countries. They also coordinate with their counterparts throughout the Federal Reserve System to identify and share emerging issues and sound practices.

All facets of the supervisory process, including applications processing, compliance, international and domestic examinations, and ongoing monitoring, are changing. For example, the applications process was streamlined for bank holding companies in 1997 when the Board of Governors made substantial changes to the implementing regulation. Furthermore, additional emphasis is placed on incorporating macro information into the supervisory strategy. Staff members follow international developments, as well as developments in the dynamic areas of trading, securities, and risk management. They also monitor applications of digital technology in banking to assess developments in securitization, risk modeling, and credit quality. These analysts keep the Bank properly positioned for evaluating evolving financial markets and the banking industry�s changing use of technology and delivery channels.

The changes benefit the supervised organizations, as well as the Federal Reserve. The supervisory burden is reduced for well-run organizations because on-site examinations are shorter and more focused. The process adds greater value overall since it is more forward-looking. From the Federal Reserve Bank's standpoint, it makes better use of resources and facilitates earlier identification and resolution of issues.

Clearly, superior performance depends on the talent of an organization, the quality of its people. Banking Supervision staff have met the challenges of the changing environment by developing new technical skills in a variety of areas, such as risk management, derivatives, and information technology. In addition, the competency model for staff performance is focused on such skills as the ability to adapt, to coordinate, and to understand the big picture and how the individual pieces fit together. Application of these competencies ensures that staff are able to provide effective supervision as the industry continues to change.

Both training and technology are being aligned to support this changing process. Training programs are being revamped, and training in risk assessment, management information systems, and internal controls has been expanded. More emphasis is placed on the use of technology with initiatives that include automating parts of the examination process, improving management information systems, and streamlining information access and storage.

In summary, we are striving to enhance our flexibility and adaptability in this rapidly changing environment. The right supervisory techniques, talent, training, and technology are critical to effective supervision. Focusing on these areas ensures that the Bank continues to meet the challenges of today�s dynamic environment and is prepared for tomorrow�s as well.

The Federal Reserve Bank of San Francisco

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Transforming Federal Reserve Services

By Barbara Bennett

The revolutionary changes in computer and telecommunications technology make it possible for financial services firms to operate on a nationwide basis and offer a broad array of new and traditional services. Open networks like the Internet are becoming a widely accepted way for U.S. households and businesses to obtain these and other services. In this high-tech and highly competitive environment, financial services firms increasingly are finding that their customers demand instantaneous and interactive access to customer-specific information.

Although the U.S. financial services industry still is heavily reliant on �brick and mortar� and paper-based payments, things are changing, particularly in the Twelfth District. A number of western institutions are leaders in the establishment of a nationwide presence and in the development of online delivery systems that offer customers up-to-the-minute information on the status of their investments and transactions. As in the rest of the country, western depository institutions are also reducing investment in physical processing and delivery infrastructures by consolidating operations wherever possible and centralizing functions such as funds management.

As a major provider of financial and payments services to depository institutions, the Fed is playing a pivotal role in this transition from a paper-based infrastructure to an electronic one. The Rivlin Committee�s fundamental review of the Federal Reserve�s role in the payments mechanism confirmed that, while Reserve Banks must continue to provide traditional payments services for some time to come, they also must work in partnership with the industry to transform the payments system.

To accomplish this transformation, Reserve Banks are engaged in three broad initiatives: developing a �common face� to Reserve Bank services nationwide; streamlining back office systems to keep costs down and deliver new products and services quickly and flexibly; and applying new technologies to add value and encourage more efficient payments practices.

Developing a Common Face

The emergence of depository institutions with nationwide branch networks makes it essential that Reserve Banks offer standardized services and provide monitoring tools needed to facilitate management of these entities� operations on a nationwide basis. Especially significant is the development of a new structure for reserve accounts to enable depository institutions to maintain a single master account for all their Reserve Bank transactions. This new master/sub-account structure became available in January 1998. It facilitates centralized funds management and offers depository institutions tools to monitor transactions by business line, region of the country, and/or type of transaction.

To simplify depository institutions� service relationships with the Federal Reserve, moreover, in 1997 the Reserve Banks developed national operating circulars for every service line, including checks, cash, ACH, securities services, funds transfer, accounting, and credit. A common set of legal agreements and procedures make it easier for institutions that operate in more than one District to standardize their use of Federal Reserve services. In addition, Reserve Banks have implemented a national key account program that assigns to a designated national account manager responsibility for addressing many of these institutions' service needs and resolving issues that may arise in coordinating services provided across Districts. In this District, for example, Los Angeles Branch Vice President Sean Rodriguez has account management responsibilities for the region's two largest customers: Bank of America and Wells Fargo Bank. For these two prominent interstate organizations, he manages longer-term service initiatives and other matters on a Systemwide basis, ensuring that the Federal Reserve's services are consistent with the strategic priorities and needs of these organizations.

Another important aspect of the effort to develop a common face for the Federal Reserve is the introduction of national products in service lines that traditionally have accommodated wide variations in product offerings across Districts, including checks, cash, and net settlement. In checks, Reserve Banks introduced an attractively-priced nationwide City Sort deposit in 1997 that generally improves funds availability on City items by allowing customers to deposit at their local Fed office items drawn on City endpoints anywhere in the country.

In cash services, in early 1998 uniform service levels and access standards are being implemented that are modeled after the approach implemented in the Twelfth District. Our District is also pioneering a service that allows depository institutions to coordinate currency ordering for their ATM networks on a nationwide basis. Also, in late 1998 an enhanced national net settlement service will be available to depository institutions participating in private clearing arrangements. Designed to provide a file-based, automated mechanism for handling settlements, including those that involve participants located in multiple Federal Reserve Districts, this new service will improve finality and offer better risk management tools through source authentication, automated linkages to the Federal Reserve�s Account Balance Monitoring System (ABMS), and timely information on the status of settlement transactions.

Streamlining the Back Office

Many of these new services would not be possible without the strides Reserve Banks have made in streamlining back office operations, including consolidating computer processing and centralizing major applications software for such systems as accounting, funds transfer, and ACH. These efforts are crucial in the Federal Reserve�s drive to provide the most efficient accounting, funds transfer, and ACH. These efforts are crucial in the Federal Reserve�s drive to provide the most efficient services possible and to develop and deliver new services in the shortened time frames that the current and future financial services environments require.

The recent centralization of ACH processing, for example, reduced by nearly half the cost of inter-District transactions and made possible the introduction of flow processing and flexible delivery times, all of which make ACH more attractive as an alternative to check payments for certain types of transactions. Likewise, centralization of the funds transfer software reduced costs and permitted price reductions totaling 20 percent since 1996. Current efforts to establish a common check processing platform for Reserve Banks and to implement an �enterprise-wide� automated adjustments system are expected to yield comparable benefits in terms of operating efficiencies and enhanced check services.

Applying New Technologies, Transforming the Payments System

The application of information technology to existing processes is central to Reserve Banks� ability to streamline back office operations. But far greater benefits from these technologies lie in their ability to deliver vast amounts of information more quickly and in more useful and flexible forms than possible in a paper-based environment.

When used to create new information services and delivery channels, these technologies have the potential to redefine the very nature of the payments mechanism. The Reserve Banks began to tap this potential some years ago with the introduction of electronic check presentment services, which enable recipients to begin �check� processing well before they actually receive the physical items, if they still receive the items at all. With the introduction more recently of digital image capture and retrieval services and the forthcoming provision of national archive services, there is even greater opportunity to speed the conversion of the check collection system from a paper-based process to an electronic one.

Depository institutions and their customers are beginning to see digital images as superior to the physical items in many respects. With the Reserve Banks� ability to deliver CD-ROMs containing digital images of checks drawn on a specific account number, depository institutions are able to meet corporate cash managers� demand for faster, more convenient, and more useful access to information on their paid items. In addition, depository institutions are using Reserve Banks� digital image services to reengineer their back offices, replacing microfilm technology and implementing retrieval systems that improve customer service and research capabilities by providing online access to copies of items.

Reserve Banks are using digital technology to improve cash services, as well. The Twelfth District developed an application that enables depository institutions to train their staffs in the authentication of the new series $50 and $100 notes. This interactive software is currently available on CD-ROM and will be available on the Federal Reserve�s World Wide Web site.

Transactional applications are also being developed to tap the online delivery capabilities of digital technology. In early 1998 the Twelfth District is piloting two important web applications: cash services and check image retrieval. The cash services module will enable depository institutions to access Reserve Banks� cash ordering and deposit notification systems using web technology. This will greatly enhance depository institutions� ability to manage ATM supply operations on a nationwide basis.

The image retrieval application will enable depository institutions to interactively query the Federal Reserve�s archive for checks that meet criteria the institution specifies, including account number, processing date, dollar amount range, etc. The system will then search the archive and return a list of checks that meet those criteria. By clicking on the specific check it would like to view, the depository institution will be able to examine the front and back of the image and zoom in on endorsements and other fields of interest. The images can be sent to a printer or saved on the institution�s desktop. This path-breaking application clearly has the potential to change the way depository institutions offer checking account services by providing instantaneous and interactive delivery of customer-specific information.

The evolution toward an electronic payments mechanism that is more convenient, efficient, secure, and reliable than the current paper-based system is a challenge that requires the combined energies and cooperation of many parties, including financial services firms, software developers, businesses, and the Federal Reserve. The initiatives in which the San Francisco Fed � and all the Reserve Banks � are engaged represent a significant step forward in this transformation.

The Federal Reserve Bank of San Francisco

About the Fed

Executive Committee, Bank Officers, and Branch Officers

- Executive Committee
- Bank Officers
- Branch Officers

- Los Angeles Branch
- Northern Region

- Portland Branch
- Salt Lake City Branch
- Seattle Branch

Executive Committee

Robert T. Parry
President

John F. Moore
First Vice President

Gordon R. G. Werkema
Executive Vice President

Terry S. Schwakopf
Senior Vice President

Elizabeth K. Christensen
Senior Vice President

Jack H. Beebe
Senior Vice President and Director of Research

Bank Officers (as of December 31, 1997)

Robert T. Parry
President and
Chief Executive Officer

John F. Moore
First Vice President and
Chief Operating Officer

Jack H. Beebe
Senior Vice President
and Director of Research

Elizabeth K. Christensen
Senior Vice President

Sara K. Garrison
Senior Vice President

Michael J. Murray
Senior Vice President

Terry S. Schwakopf
Senior Vice President

D. Kerry Webb
Senior Vice President

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Reuven Glick
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Associate Director

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Director of Public Information

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Michael J. Stan
Director

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Beverley-Ann Hawkins
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Lelia M. Jones
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Craig B. Knudsen
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James J. Tenge
Assistant Vice President

Thomas R. Thaanum
Assistant Vice President

David W. Walker
Assistant Vice President

Angela D'Alessandro
Financial Planning
and Control Officer

Lee Dwyer
Wholesale Payments and
Fiscal Services Officer

Ellen Hamilton
Audit Officer

Michael E. Johnson
Applications Officer

Joseph P. Mattey
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Joy Hoffmann Molloy
Community Affairs Officer

Brian Motley
Research Officer

Gary P. Palmer
Financial Analysis Officer

Darren S. Post
ACH, Business Development,
and Customer Support Officer

Glenn D. Rudebusch
Research Officer

Dan Shaw
EUC, LAN/Administration
and Operations Officer

Mark Spiegel
Research Officer

Gordon Tannura
Support Function Officer

Bharat Trehan
Research Officer

Associate Director
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Vice President

Elizabeth R. Masten
Vice President and
Secretary of the Board

Ronald E. Mitchell, Jr.
Vice President

Robert D. Mulford
Vice President,
General Counsel
and Ethics Officer

Susan Porterfield
Vice President

Bonnie R. Allen
Assistant Vice President

Sylvia A. Cunningham
Assistant Vice President

Gail A. Garvey
Assistant Vice President

Elaine Geller
Assistant Vice President

Louis "Skip" George
Assistant Vice President

Elizabeth L. Wood
Assistant Vice President

Barbara J. Beckman
District Procurement
Services Officer

Armen Beylerian
Information Technology Officer

Jim Callahan
Audit Officer

Research Officer

Branch Officers (as of December 31, 1997)

Los Angeles Branch

Mark Mullinix
Senior Vice President

Sean J. Rodriguez
Vice President and
Assistant Branch Manager

Darcy J. Coulter
Director

Marla Borowski
Assistant Vice President

Robert C. Johnson
Assistant Vice President

Jimmy F. Kamada
Assistant Vice President

Roger W. Replogle
Assistant Vice President

Dale L. Vaughn
Assistant Vice President

Linda Westerschulte
Assistant VicePresident

Mark E. Koegel
Payments Services Officer

Northern Region

Gordon Werkema
Executive Vice President

Portland Branch

Raymond H. Laurence
Senior Vice President

Mary E. Lee
Assistant Vice President

Robert D. Long
Assistant Vice President

Robin A. Rockwood
Assistant Vice President

Seattle Branch

Gale P. Ansell
Assistant Vice President

Kenneth L. Peterson
Assistant Vice President

Mark Gould
Check Product Officer

Lynn Jorgensen
Human Resources/Check Officer

Salt Lake City Branch

Andrea P. Wolcott
Vice President

Jed W. Bodily
Assistant Vice President

Gerald R. Dalling
Assistant Vice President

Richard B. Hornsby
Assistant Vice President

Thomas P. McGrath
Assistant Vice President

The Federal Reserve Bank of San Francisco

ABOUT THE FED

Highlights of 1997

By Karen Flamme

As the payments system of the country evolves technologically, regional Reserve Banks respond to the needs of their constituencies and look for innovative ways to achieve efficiencies, through both technology and an integration of Federal Reserve services across Districts.

The District Business Development office in Portland served as the national logistics coordinator for the important Rivlin study conducted during 1997, planning five national forums and eight regional meetings held in our District. During these meetings representatives of financial institutions were invited to discuss five hypothetical scenarios for the future role of the Federal Reserve in retail payments services. These alternatives ranged from exiting check collection and ACH services altogether to adopting a leadership role in spurring innovation and market acceptance of new payments services and products.

With information from these sessions, as well as from internal studies, the Rivlin Committee reached two major conclusions: first, it is important for the Federal Reserve to remain a provider of check collection and ACH services with the goal of enhancing the efficiency, effectiveness, and convenience of both systems, while ensuring access for all depository institutions; and second, the Federal Reserve should play a more active role, working closely with providers and users of the payments system, both to enhance the efficiency of check and ACH services and to help evolve strategies for moving to the next generation of payment instruments.

To further encourage the transition from paper to electronic payments, the District conducted a highly successful ACH Direct Payment campaign targeted initially at utility customers in portions of the San Francisco Bay Area, encouraging them to pay their utility bills through automatic deduction. The program was a partnership between our Bank, Western Payments Alliance, the utilities, and their financial institutions. More than 100,000 sign-ups were received, exceeding expectations based on similar projects in other Districts. Additional campaigns are planned for the Pacific Northwest and Southern California areas in 1998.

A variety of check imaging services were made available Districtwide during 1997. And our customers can now go to a page on the Bank�s web site at / and browse through our check product offerings.

To remind us of our roots and the ever-present demand for currency, in spring 1997 the Bank opened a stellar exhibition of American Currency in the lobby of the San Francisco headquarters. Featuring a premiere collection of historical currency, the exhibition is a resource for educators, numismatists, and the public through our tour program, as well as on a walk-in basis. A web version of the exhibition will be on-line by mid-1998.

Economic Research

Establishing and implementing the nation�s monetary policy is one of the primary functions of Reserve Banks. Ongoing research is essential to providing a strong foundation for supporting this Bank�s monetary policy recommendations. Research conducted during 1997 focused on various policy-related issues. Among them were studies examining the merits of alternative policy rules for targeting inflation; the effects on economic performance of policies to reduce inflation; and the key features of the different policy regimes in place under Federal Reserve Chairmen Burns, Volcker, and Greenspan.

Several articles were written on labor markets. Staff economists examined job insecurity in the U.S. and the effects of welfare reform, health insurance, and family structure on the labor force. The banking unit studied financial modernization, including implications for efficiency, risk, and profitability in banking. Other research dealt with consolidation in banking and examining evidence on contagion effects from bank mergers, as well as the effect of bank mergers on the pricing of retail deposits and interstate banking in the District.

The Bank continued to serve as a focal point for analysis of Pacific Basin issues through the activities of our Pacific Basin Center. Research staff examined the causes and lessons of the 1997 East Asian financial crisis. International studies analyzed monetary policy issues in selected countries, including Korea, New Zealand, and Singapore. Research staff also looked at the implications of trade agreements and of budget and trade imbalances in the region. The department co-hosted an academic conference with the Center for Economic Policy Research at Stanford University. The conference featured papers by eminent academic and System economists on �Recent Developments in Macroeconomics.

The department also hosted a conference with the American Committee on Asian Economic Studies on �Financial Liberalization and Development in the Pacific Basin.

Banking Supervision and Regulation

Risk-focused initiatives were the hallmark of activities in the Supervision and Regulation area during 1997. Risk-based

functional reviews were implemented at the District�s largest institutions, procedures were developed and tested for conducting risk-focused compliance examinations, and mergers and acquisitions regulations were revised to speed the applications process for organizations that are well-managed and well-capitalized.

Federal Reserve Banks have primary responsibility for supervising all bank holding companies, their nonbank and foreign subsidiaries; state member banks and their foreign branches and subsidiaries; Edge Act and agreement corporations through which U.S. banking organizations conduct operations abroad; and U.S. activities of foreign banking organizations.

At year-end there were 60 state member banks in the District. There were also 203 holding companies with assets of 511 billion, 103 agencies and branches of foreign banks, 17 Edge and Agreement corporation offices, and 40 representative offices.

Overall applications activity declined by 39, approximately 13 percent, compared to the same period in 1996. This was partially offset by an increase in bank acquisitions, continuing the industry�s trend of expansion and consolidation. Applications to form bank holding companies increased by 9 (from 26 to 35).

Community Affairs expanded its role of providing outreach and education on community reinvestment topics. Staff hosted a series of training sessions for Community Reinvestment Act (CRA) officers throughout the District to introduce them to local community reinvestment opportunities and provide education on technical CRA aspects. A conference announced recommendations of the San Francisco Mortgage Credit Partnership task forces, which had been convened to identify barriers that exist for low-income borrowers in the home purchase process. In addition, staff provided a week of intensive hands-on credit training for 60 community development professionals and community lenders in partnership with the University of Washington at the National Community Development Lending School.

In Hawaii, meetings were held to assist in the creation of a micro-loan pool for low-income entrepreneurs. To complement that effort, meetings were also held with representatives of local community-based organizations, a local bank, and the Department of Rehabilitation to discuss self-employment opportunities for people with disabilities.

The Federal Reserve Bank of San Francisco

Summary of Operations

	Volume (in thousands)		
	1995	**1996**	**1997**
Custody Services			
Cash Services			
Currency notes paid into circulation	4,212,494	4,298,035	4,317,704
Food stamp coupons processed	753,589	748,535	654,068
Securities Services			
Other Treasury original issues	201	125	105
Book-entry securities processed	894	829	751
Payments Services			
Check Services			
Commercial checks collected	2,082,513	2,188,856	2,313,792
Government checks processed	67,148	61,741	54,466
Return items processed	30,569	32,767	35,251
Electronic Payments Services			
Wire transfers processed	20,146	22,113	24,058
Automated clearinghouse transactions processed	525,549	404,974	428,564
Discounts and Advances			
Total discounts and advances*	482	461	478
Number of financial institutions accommodated*	66	83	86

**Whole number (not in thousands)*

The Federal Reserve Bank of San Francisco

About the Fed

Statement of Condition

	(in millions)	
	Dec. 31, 1997	Dec. 31, 1996
Assets		
Gold certificates	$ 1,420	$ 1,067
Special drawing rights certificates	1,241	957
Coin	69	74
Items in process of collection	2,210	1,873
Loans to depository institutions	335	15
U.S. government and Federal agency securities, net	54,604	33,393
Investments denominated in foreign currencies	3,270	2,631
Accrued interest receivable	517	301
Prepaid statutory surplus transfer to the U.S. Treasury	0	N/A
Interdistrict settlement account	0	23,441
Bank premises and equipment, net	218	220
Other assets	56	23
Total Assets	**$ 63,940**	**$ 63,995**
Liabilities and Capital		
Liabilities		
Federal Reserve notes outstanding, net	$ 54,617	$ 56,905
Deposits		
Depository institutions	3,676	3,612
Other deposits	32	22
Deferred credit items	1,893	1,575
Statutory surplus transfer due U.S. Treasury	55	49
Interdistrict settlement account	1,658	0
Accrued benefit cost	70	70
Other liabilities	14	17
Total liabilities	**$ 62,015**	**$ 62,250**

Capital		
Capital paid-in	980	880
Surplus	945	865
Total capital	**1,925**	**1,745**
Total liabilities and capital	**$ 63,940**	**$ 63,995**

The Federal Reserve Bank of San Francisco

ABOUT THE FED

Statement of Income

	(in millions) for the years ended Dec. 31, 1997	Dec. 31, 1996
Interest income:		
Interest on U.S. government securities	$ 2,877	$1,967
Interest on foreign currencies	70	61
Interest on loans to depository institutions	1	1
Total interst income	**2,948**	**2,029**
Other operating income:		
Income from services	85	82
Reimbursable services to government agencies	19	18
Foreign currency gains (losses), net	(497)	(228)
Government securities gains, net	2	3
Other income	6	6
Total other operating income (loss)	**(385)**	**(119)**
Operating expenses:		
Salaries and other benefits	147	143
Occupancy expense	16	16
Equipment expense	19	19
Cost of unreimbursed Treasury services	5	5
Assessments by Board of Governors	82	58
Other expenses	86	70
Total operating expenses	**355**	**308**
Income before cumulative effect of accounting change	1,599	2,043
Cumulative effect of change in accounting principle	0	(6)
Net income prior to distribution	**$ 2,208**	**$ 1,599**
Distribution of net income:		
Dividends paid to member banks	$ 56	$ 41
Transferred to surplus	100	338
Payments to U.S. Treasury as interest on Federal Reserve notes	0	852
Payments to U.S. Treasury as required by statute	2,052	368
	$ 2,208	**$ 1,599**

The Federal Reserve Bank of San Francisco

ABOUT THE FED

Statement of Changes in Capital

For the years ended December 31, 1996 and December 31, 1997

	(in millions)		
	Capital Paid-in	**Surplus**	**Total Capital**
Balance at January 1, 1996			
(10,833,100 shares)	$ 542	$ 542	$ 1,084
Net income transferred to (from) surplus		338	338
Statuatory surplus transfer to the U.S. Treasury			
Net change in capital stock issused (6,760,353 shares)	$ 338		$ 338
Balance at December 31, 1996			
(10,833,100 shares)	$ 880	$ 865	$ 1,745
Net income transferred to (from) surplus		100	100
Statutory surplus transfer to the U.S. Treasury		(20)	(20)
Net change in capital stock issued (redeemed)			
(2,000,851 shares)	$ 338		$ 338
Balance at December 31, 1997			
(19,594,304 shares)	**$ 980**	**$ 945**	**$ 1,925**

These statements are prepared by Bank management. Copies of full and final financial statements, complete with footnotes, are available by contacting the Bank's Public Information Department at 415-974-2163.

The Federal Reserve Bank of San Francisco

ABOUT THE FED

1998 Board of Directors

- Federal Reserve Bank of San Francisco
- Los Angeles Branch
- Portland Branch
- Salt Lake City Branch
- Seattle Branch

Federal Reserve Bank of San Francisco

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Chairman and CEO
Albertson's, Inc.
Boise, Idaho

Deputy Chairman
Cynthia A. Parker
Executive Director
Anchorage Neighborhood Housing Services, Inc.
Anchorage, Alaska

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Senior Vice President and Chief Financial Officer
Amgen, Inc.
Thousand Oaks, California

E. Lynn Caswell
Chairman and CEO
Pacific Community Banking Group
Laguna Hills, California

Krestine Corbin
President and CEO
Sierra Machinery, Inc.
Sparks, Nevada

Warren K. K. Luke
Vice Chairman, President and CEO
Hawaii National Bank
Honolulu, Hawaii

John V. Rindlaub
Group Executive Vice President
Bank of America N.W. Group
Seattle, Washington

Nelson C. Rising
President and CEO
Catellus Development Corporation
San Francisco, California

Stanley T. Skinner
Chairman and CEO (Retired)
Pacific Gas and Electric Co.
San Francisco, California

Federal Advisory Council Member
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Chairman and CEO
BankAmerica Corporation
San Francisco, California

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Anne Ledford Evans
Chairman
Evans Hotels
San Diego, California

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Encino, California

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Los Angeles, California

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Senior Vice President
Del Webb Corporation
Phoenix, Arizona

Linda Griego
Managing General Partner
Engine Co. No. 28
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Karen Kane, Inc.
Los Angeles, California

Liam E. McGee
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Los Angeles, California

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Vice Chairman
U.S. Bancorp

Proprietor
Rocking C Ranch
Elkton, Oregon

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President
Oregon Coast Aquarium
Newport, Oregon

Patrick Borunda
Executive Director
ONABEN -- A Native American
Business Network
Portland, Oregon

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President and General Manager
KPTV-12, Oregon Television, Inc.
Portland, Oregon

U.S. Bancorp
Portland, Oregon

Nancy Wilgenbusch
President
Marylhurst College
Marylhurst, Oregon

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Vancouver, Washington

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Salt Lake Convention and
Visitors Bureau
Salt Lake City, Utah

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Questar Corporation
Salt Lake City, Utah

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Salt Lake Neighborhood
Housing Services, Inc.
Salt Lake City, Utah

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President
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Boise, Idaho

Nancy Mortensen
Vice President-Marketing
Zions Cooperative
Mercantile Institution
Salt Lake City, Utah

Roy C. Nelson
President
Bank of Utah
Ogden, Utah

Barbara L. Wilson
Regional Vice President
U.S. WEST
Boise, Idaho

Seattle Branch

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Chairman of the Board
Puget Sound Energy, Inc.
Bellevue, Washington

Boyd E. Givan
Senior Vice President and CFO
The Boeing Company
Seattle, Washington

James C. Hawkanson
Managing Director and CEO
The Commerce Bank of
Washington, N.A.
Seattle, Washington

Betsy Lawer
Vice Chair and COO
First National Bank of Anchorage
Anchorage, Alaska

Tomio Moriguchi
Chairman and CEO
Uwajimaya, Inc.
Seattle, Washington

Constance Leigh Proctor
Partner
Alston, Courtnage, Proctor
& Bassetti, LLP
Seattle, Washington

Helen M. Rockey
President and CEO
Brooks Sports, Inc.
Bothell, Washington

The Federal Reserve Bank of San Francisco

ABOUT THE FED

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Senior Vice President
Allied Capital Corporation
San Francisco, California

Vice Chairman
Karla S. Chambers
Vice President
Stahlbush Island Farms, Inc.
Corvallis, Oregon

Members

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Co-Founder and Director
ATCOM/INFO
San Diego, California

Paula R. Collins
Chief Executive Officer
WDG Ventures, Inc.
San Francisco, California

Paul Ecke III
Chairman and CEO
Paul Ecke Ranch
Encinitas, California

Ed P. Mayne
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Utah AFL-CIO
Salt Lake City, Utah

Lawrence S. Okinaga
Partner
Carlsmith Ball Wichman
Case & Ichiki
Honolulu, Hawaii

Peter H. Parra
Member
Board of Supervisors
Fifth District, County of Kern
Bakersfield, California

Walter F. Payne, Jr.
President and CEO
Blue Diamond Growers
Sacramento, California

Peter H. van Oppen
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Advanced Digital
Information Corporation
Redmond, Washington

Bob L. Vice
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BLV, Agribusiness Consultants
Fallbrook, California

Richard S. Walden
President
Farmers Investment Co.
Sahuarita, Arizona

Don M. "Duff" Willey
President
Willey Motors, Inc.
Bountiful, Utah

Denice A. Young, C.P.A.
President
Young Real Estate Services
Torrance, California

The Federal Reserve Bank of San Francisco

ABOUT THE FED

Twelfth Federal Reserve District

San Francisco Office
P.O. Box 7702
San Francisco, CA 94120

Los Angeles Branch
P.O. Box 2077, Terminal Annex
Los Angeles, CA 90051

Portland Branch
P.O. Box 3436,
Portland, OR 97208

Salt Lake City Branch
P.O. Box 30780
Salt Lake City, UT 84125

Seattle Branch
P.O. Box 3567, Terminal Annex
Seattle, WA 98124

The Federal Reserve Bank of San Francisco

ABOUT THE FED

Notes to Financial Statements

1. **Organization:**

   The Federal Reserve Bank of San Francisco ("Bank") is part of the Federal Reserve System ("System") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act") which established the central bank of the United States. The System consists of the Board of Governors of the Federal Reserve System ("Board of Governors") and twelve Federal Reserve Banks ("Reserve Banks"). The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. Other major elements of the System are the Federal Open Market Committee ("FOMC"), and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York ("FRBNY") and, on a rotating basis, four other Reserve Bank presidents.

   Structure:

   The Bank and its branches in Los Angeles, California, Portland, Oregon, Salt Lake City, Utah, and Seattle, Washington serve the Twelfth Federal Reserve District, which includes Alaska, California, Hawaii, Idaho, Nevada, Oregon, Utah, Washington, and the commonwealths or territories of American Samoa, Guam, and the Northern Mariana Islands. In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a Board of Directors. Banks that are members of the System include all national banks and any state chartered bank that applies and is approved for membership in the System.

   Board of Directors:

   The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. Of the six elected by member banks, three represent the public and three represent member banks. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

2. **Operations and Services:**

   The System performs a variety of services and operations. Functions include: formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse operations and check processing; distribution of coin and currency; fiscal agency functions for the U. S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies and state member banks; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

   The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, matched sale-purchase transactions, the purchase of securities under agreements to resell, and the lending of U.S. government securities. Additionally, the FRBNY is authorized by the FOMC to hold balances of and to execute spot and forward foreign exchange and securities contracts in fourteen foreign currencies, maintain reciprocal currency arrangements ("F/X swaps") with various central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks.

3. **Significant Accounting Policies:** Accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared to the private sector. These accounting principles and practices are documented in the "Financial Accounting Manual for Federal Reserve Banks" ("Financial Accounting Manual"), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual. The financial statements have been prepared in accordance with the Financial Accounting Manual. Differences exist between the accounting principles and practices of the System and generally accepted accounting principles ("GAAP"). The primary differences are the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP, and the accounting for matched sale-purchase transactions as separate sales and purchases, rather than secured borrowings with pledged collateral, as is required by GAAP. In addition, the Bank has elected not to include a Statement of Cash Flows, as the liquidity and cash position of the Bank are not of primary concern to users of these financial statements. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. Therefore, a Statement of Cash Flows would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP. The preparation of the financial statements in conformity with the Financial Accounting Manual requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Unique accounts and significant accounting policies are explained below.

   a. Gold Certificates

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged and the Reserve Banks' gold certificate account is lowered. The value of gold for purposes of backing the gold certificates is set by law at $42 2/9 a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based upon Federal Reserve notes outstanding in each District at the end of the preceding year.

b. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U. S. Treasury, and the Reserve Banks' SDR certificate account is increased. The Reserve Banks are required to purchase SDRs, at the direction of the U.S. Treasury, for the purpose of financing SDR certificate acquisitions or for financing exchange stabilization operations. The Board of Governors allocates each SDR transaction among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year.

c. Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If any loans were deemed to be uncollectible, an appropriate reserve would be established. Interest is recorded on the accrual basis and is charged at the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Banks, subject to review by the Board of Governors. However, Reserve Banks retain the option to impose a surcharge above the basic rate in certain circumstances.

d. U. S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account ("SOMA"). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or other needs specified by the FOMC in carrying out the System's central bank responsibilities.

Purchases of securities under agreements to resell and matched sale-purchase transactions are accounted for as separate sale and purchase transactions. Purchases under agreements to resell are transactions in which the FRBNY purchases a security and sells it back at the rate specified at the commencement of the transaction. Matched sale-purchase transactions are transactions in which the FRBNY sells a security and buys it back at the rate specified at the commencement of the transaction.

Reserve Banks are authorized by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires the lending Reserve Bank to take possession of collateral in amounts in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the lending Reserve Bank on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

Foreign exchange contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with authorized foreign central banks. The parties agree to exchange their currencies up to a prearranged maximum amount and for an agreed upon period of time (up to twelve months), at an agreed upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank, and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases of foreign currencies and related international operations.

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts which contain varying degrees of off-balance sheet market risk, because they represent contractual commitments involving future settlement, and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that can result in gains or losses when holdings are sold prior to maturity. However, decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, earnings and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis and is reported as "Interest on U.S. government securities" or "Interest on foreign currencies," as appropriate. Income earned on securities lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses on the sales of U.S. government and federal agency securities are reported as Government securities gains, net. Foreign currency denominated assets are revalued monthly at current market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as Foreign currency (losses), net. Foreign currencies held through F/X swaps, when initiated by the counter party, and warehousing arrangements are revalued monthly, with the unrealized gain or loss reported by the FRBNY as a component of "Other assets" or "Other liabilities," as appropriate.

Balances of U.S. government and federal agencies securities bought outright, investments denominated in foreign currency, interest income, amortization of premiums and discounts on securities bought outright, gains and losses on sales of securities, and realized and unrealized gains and losses on investments denominated in foreign currencies, excluding those held under an F/X swap arrangement, are allocated to each Reserve Bank. Securities purchased under agreements to resell and the related premiums, discounts and income, and unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to the FRBNY and not to other Reserve Banks. Income from securities lending transactions is recognized only by the lending Reserve Bank.

e. Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from 2 to 50 years. New assets, major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs and minor replacements are charged to operations in the year incurred.

f. Interdistrict Settlement Account

At the close of business each day, all Reserve Banks and branches assemble the payments due to or from other Reserve Banks and branches as a result of transactions involving accounts residing in other Districts that occurred during the day's operations. Such transactions may include funds settlement, check clearing and automated clearinghouse ("ACH") operations, and allocations of shared expenses. The cumulative net amount due to or from other Reserve Banks is reported as the "Interdistrict settlement account."

g. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U. S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In accordance with the Federal Reserve Act, gold certificates, special drawing rights certificates, U.S. government and agency securities, loans allowed under Section 13, and investments denominated in foreign currencies are pledged as collateral for net Federal Reserve notes outstanding. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, whose collateral value is equal to the par value of the securities tendered. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy its obligation to provide sufficient collateral for its outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides that certain assets of the Reserve Banks are jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents Federal Reserve notes reduced by cash held in the vaults of the Reserve Banks of $18 billion, and $14 billion at December 31, 1997 and 1996, respectively.

h. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6% of the capital and surplus of the member bank. As a member bank's capital and surplus changes, its holdings of the Reserve Bank's stock must be adjusted. Member banks are those state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6% on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

i. Surplus

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31 of the prior year. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. Prior to October 1, 1996, this payment represented payment of interest on Federal Reserve notes outstanding.

The Omnibus Budget Reconciliation Act of 1993 (Public Law 103-66, Section 3002) codified the existing Board surplus policies as statutory surplus transfers, rather than as payments of interest on Federal Reserve notes, for federal government fiscal years 1998 and 1997 (which began on October 1, 1997 and 1996, respectively). In addition, the legislation directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of $107 million and $106 million during fiscal years 1998 and 1997, respectively. Reserve Banks are not permitted to replenish surplus for these amounts during this time. The Reserve Banks made these transfers on October 1, 1997 and October 1, 1996, respectively. The Bank's share of these transfers is reported on the Statement of Changes in Capital as "Statutory surplus transfer to the U.S. Treasury."

In the event of losses, payments to the U. S. Treasury are suspended until such losses are recovered through subsequent earnings. Weekly payments to the U. S. Treasury vary significantly.

j. Cost of Unreimbursed Treasury Services

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services. The costs of providing fiscal agency and depository services to the Treasury Department that have been billed but will not be paid are reported as the "Cost of unreimbursed Treasury services."

k. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property, which are reported as a component of "Occupancy expense."

4. **U. S. Government and Federal Agency Securities:** Securities bought outright and held under agreements to resell are held in the SOMA at the FRBNY. An undivided interest in SOMA activity, with the exception of securities held under agreements to resell and the related premiums, discounts and income, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings. The settlement, performed in April of each year, equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 12.582% and 8.470% at December 31, 1997 and 1996, respectively.

Total SOMA securities bought outright were $434,001 million and 394,261million at December 31, 1997 and 1996 respectively.

The Bank's allocated share of securities held in the SOMA at December 31, that were bought outright, were as follows (in millions):

Par value:	**1997**	**1996**
Federal agency	$ 86	$ 188
U.S. government:		
Bills	24,801	16,147
Notes	21,918	12,783
Bonds	7,474	4,179
Total par value	54,279	33,297
Unamortized premiums	780	396
Unaccreted discounts	(455)	(300)

Total allocated to Bank	$ 54,604	$ 33,393

The maturities of U.S. government and federal agency securities bought outright, which were allocated to the Bank at December 31, 1997, were as follows (in millions):

	Par value		
Maturities of Securities Held	**U.S. Government Securities**	**Federal Agency Obligations**	**Total**
Within 15 days	$ 1,630	$ 0	$ 1,630
16 days to 90 days	12,034	8	12,042
91 days to 1 year	17,348	24	17,372
Over 1 year to 5 years	11,956	19	11,975
Over 5 years to 10 years	5,147	32	5,179
Over 10 years	6,078	3	6,081
Total	$ 54,193	$ 86	$ 54,279

At December 31, 1997 and 1996, matched sale-purchase transactions involving U.S. government securities with par values of $17 billion and $15 billion, respectively, were outstanding, of which $2 billion and $1 billion were allocated to the Bank. Matched sale-purchase transactions are generally overnight arrangements.

5. **Investments Denominated in Foreign Currencies**: The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and the Bank for International Settlements and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities held under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

   Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 19.180% and 13.656% at December 31, 1997 and 1996, respectively.

   The Bank's allocated share of investments denominated in foreign currencies, valued at current exchange rates at December 31, were as follows (in millions):

	1997	**1996**
German Marks:		
Foreign currency deposits	$ 1,586	$ 1,400
Government debt instruments including agreements to resell	617	379
Japanese Yen:		
Foreign currency deposits	110	87
Government debt instruments including agreements to resell	940	753
Accrued interest	17	12
Total	$ 3,270	$ 2,631

   Total investments denominated in foreign currencies were $17 billion and $19 billion at December 31, 1997 and 1996, respectively. The unearned interest balances that were allocated solely to FRBNY were $3 million for 1997 and $5 million for 1996.

   The maturities of investments denominated in foreign currencies which were allocated to the Bank at December 31, 1997, were as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	**1997**
Within 1 year	$ 3,216
Over 1 year to 5 years	14
Over 5 years to 10 years	40
Total	$ 3,270

   At December 31, 1997 and 1996, the Bank had no open foreign exchange contracts.

   At December 31, 1997 and 1996, the warehousing facility was $ 20 billion, with nothing outstanding.

6. **Bank Premises and Equipment**:

6. **Bank Premises and Equipment:**

A summary of bank premises and equipment at December 31 is as follows (in millions):

	1997	1996
Bank premises and equipment:		
Land	$ 23	$ 23
Buildings	150	145
Building machinery and equipment	35	35
Construction in progress	1	2
Furniture and equipment	128	124
	337	329
Accumulated depreciation	(119)	(109)
Bank premises and equipment, net	$ 218	$ 220

Depreciation expense was $16 million each year for the years ended December 31, 1997 and 1996, respectively.

The Bank leases unused space to outside tenants. These leases have terms ranging from 1 to 10 years. Rental income from such leases was $1 million each year for the years ended December 31, 1997 and 1996. Future minimum lease payments under agreements in existence at December 31, 1997, were (in millions):

1998	$ 1
1999	1
2000	1
2001	1
2002	1
Thereafter	4
	$ 9

7. **Commitments and Contingencies**:

At December 31, 1997, the Bank was obligated under noncancelable leases for premises and equipment with terms of approximately 1 year. These leases provide for increased rentals based upon increases in real estate taxes, operating costs or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $438 thousand and $459 thousand for the years ended December 31, 1997 and 1996, respectively. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 1997, were (in thousands):

	Operating	Capital
1998	$ 357	$ 0
1999	89	0
2000	0	0
2001	0	0
2002	0	0
Thereafter	0	0
	$ 446	$ 0
Amount representing interest		(0)
Present value of net minimum lease payments		$446

There were no other commitments and long-term obligations in excess of one year at December 31, 1997.

Under the Insurance Agreement of the Federal Reserve Banks dated as of June 7, 1994, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of 1% of the capital of the claiming Reserve Bank, up to 50% of the total capital and surplus of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital bears to the total capital of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 1997 or 1996.

The Bank is involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position or results of operations of the Bank.

8. **Retirement and Thrift Plans:**

Retirement plans:

The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for

Employees of the Federal Reserve System ("System Plan") and the Benefit Equalization Retirement Plan ("BEP").

The System Plan is a multi-employer plan. Contributions to the System Plan are actuarially determined and fully funded by participating employers at amounts prescribed by the Plan Administrator (with the exception of a mandatory contribution of 7% of salary by certain employees of the Board of Governors that participate in the plan). No separate accounting is maintained of assets contributed by the participating employers. It is the System's policy to fund the pension liability as accrued. No contributions by the Bank were required to the System Plan during 1997 or 1996.

The BEP is an unfunded plan that was established January 1, 1996. Net pension cost for the period is actuarially determined and is based on the same economic and mortality assumptions used for the System Plan. The Bank's projected benefit obligation and net pension costs for the BEP at December 31, 1997 and 1996, and for the years then ended, are not material.

Thrift Plan:

Employees of the Bank may also participate in the Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Thrift Plan is a defined contribution plan. Under the Thrift Plan, employees may contribute a percentage of their salaries up to a maximum 20% limit. Matching contributions by the Bank are based on a fixed percentage of each employee's basic contribution. Currently, the Bank matches 80% of the first 6% of salary contributed by the employee. The Bank's Thrift Plan contributions totaled $5 million each year for the years ended December 31, 1997 and 1996, respectively, and are reported as a component of "Salaries and other benefits."

9. **Postretirement Benefits Other Than Pensions and Postemployment Benefits**:

Postretirement benefits other than pensions:

In addition to the Bank's defined benefit retirement plans, employees who have met certain age and length of service requirements are eligible for both medical benefits and life insurance coverage during retirement. The retiree medical plan is contributory and provides benefits to retirees, their covered dependents, and beneficiaries. The life insurance plan is noncontributory and covers retirees only.

The Bank funds benefits payable under the medical and life insurance plans as due. Net postretirement benefit cost is actuarially determined, using a January 1 measurement date. The following is a reconciliation between the plan's funded status and the amounts recognized as of December 31 (in millions).

	1997	**1996**
Accumulated postretirement benefit obligation:		
Retirees and covered spouses	$ 22	$ 22
Actives eligible to retire	2	3
Other actives and disableds	9	10
Total accumulated postretirement benefit obligation	33	35
Unrecognized net gain (loss)	11	11
Unrecognized prior service cost	17	16
Accrued postretirement benefit cost	$ 61	$ 62

Accrued postretirement benefit cost is reported as a component of "Accrued benefit cost."

The assumptions used in developing the postretirement benefit obligation are as follows:

	1997	**1996**
Discount rate	7.00%	7.25%
Rate of increase in health	9.00%	9.50%
Rate of increase in health	5.00%	5.50%

The ultimate health care cost rate is expected to be achieved in 2005.

The following is a summary of the components of net periodic postretirement cost for the years ended December 31 (in millions).

	1997	**1996**
Service cost	$ 1	$ 1
Interest cost of accumulated benefit obligation	2	2
Net amortization and deferal	(2)	(2)
Net periodic postretirement cost	$ 1	$ 1

Net periodic postretirement cost is reported as a component of "Salaries and other benefits."

Changing the assumed health care cost trend rates by one percentage point in each year would change the accumulated postretirement benefit obligation at December 31, 1997 and 1996, by approximately $ 3 million and $4 million, respectively, and would change the aggregate service and interest cost components of net periodic postretirement benefit cost for the years ended December 31, 1997 and 1996, by approximately $333 thousand and $300 thousand, respectively.

Postemployment benefits:

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 1997 and 1996, were $ 8 million and $8 million, respectively. This cost is included as a component of "Accrued benefit cost." Net periodic postemployment benefit costs included in both 1997 and 1996 operating expenses was $2 million and $2 million, respectively.