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FEDERAL RESERVE BANK OF NEW YORK



ANNUAL REPORT 1985



FEDERAL RESERVE BANK OF NEW YORK

April 3, 1986

To the Depository Institutions in the
Second Federal Reserve District

I am pleased to present our seventy-first Annual Report. We have departed from our past format to present a broad essay by one of our economists discussing the major features of financial change now at work. The rapid transformations in the markets are unprecedented in their scope. The forces fashioning the new environment--innovation, competition, deregulation, securitization, and the associated growth of trading of financial instruments--create a mix of new opportunities and new challenges for bankers and banking supervisors alike. We hope that you will find Mr. Frydl's perspective on these developments interesting.

A handwritten signature in cursive script, reading "E. Gerald Corrigan".

E. Gerald Corrigan
President

*Federal Reserve Bank
of New York*

**SEVENTY-FIRST
ANNUAL REPORT**

*For the Year
Ended
December 31, 1985*



Second Federal Reserve District

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THE CHALLENGE OF FINANCIAL CHANGE

Edward J. Frydl
*Vice President and Assistant
Director of Research*

The past year was the third year of economic recovery in the United States. Judged by important general indicators of economic performance, this recovery has been notable. The U.S. economy has added some 10 million jobs since the trough of the past recession and the unemployment rate has fallen to about 7 percent from its peak of 10.7 percent. Real GNP has expanded at an annual rate of more than 4½ percent over the past three years. These employment and output gains were achieved without a return of inflationary pressures. General indicators of inflation last year were in fact stable at moderate rates or even somewhat improved.

Extraordinary economic imbalances and financial strains, however, have marked the course of this recovery. The problems posed by very large Federal Government and international current account deficits—imbalances too large to be sustained in the long run—have received the most attention. But the recovery has also been associated with a disturbingly heavy reliance on debt, not just by the Federal Government but by corporations and households.

Against this background of underlying sectoral and financial imbalances in the general economy, rapid changes are taking place in the financial system that create new challenges.

- The volatility of prices for the entire spectrum of financial assets has risen considerably. In step with this development, new financial instruments—such as futures, options, and swaps—that provide additional ways to transfer price risks among market participants flourished. The active trading of these new instruments and of the more conventional instruments underlying them has burgeoned. The volume

of financial transactions has accelerated at an unprecedented rate.

- Competition has greatly increased in the whole range of financial services. Commercial banks, thrift institutions, investment banks, and insurance companies are all expanding the range of their activities and crossing over into each other's traditional business preserves. Nonfinancial businesses are directly entering financial services as well. And foreign financial institutions are increasing their involvement in markets here at the same time that U.S. firms are expanding abroad. Competitive pressures have been compounded by the ongoing trend toward financial deregulation of the terms that institutions can charge or offer, the kinds of transactions in which they may engage, and the geographical markets they may enter. This increased degree of competition has squeezed earnings margins on many conventional financial activities, accelerating the development and diffusion of innovations.
- The weakened economic and financial condition of major sectors—energy, agriculture, commercial real estate, and various developing countries—has diminished the credit standing of many borrowers. One consequence has been that in recent years the costs of capital and funding for some bank lenders to those sectors have tended to rise relative to the costs for high quality commercial credits. At the same time, the direct credit markets have become more accessible to business borrowers. Banks have had a difficult time competing with the commercial paper and securities markets for corporate credit demands, especially those of the “blue chip” firms. Indeed, in many cases, banks have sought to profit from the trend toward market financing by generating loans and selling them off, either directly or packaged as securities, or by expanding their roles as guarantors and distributors of capital markets instruments.

All of these forces—innovation, competition, deregulation, securitization, and the growth of trading—have combined to create a challenging environment. Maintaining a stable and well-functioning financial system in the face of such rapid change poses difficult issues for policymakers.

The policy mechanisms for preserving financial stability have two broad aspects. The first involves official arrangements for the regulation of financial activity and the supervision of financial institutions. The second concerns the operations of official deposit insurance and the central bank. The principal objectives of this official “safety net” are to protect the safety and soundness of the banking system and to contain and limit the spillovers from financial shocks to avoid widespread disruptions.

The rapid changes at work in the financial realm have consequences for both aspects of maintaining financial stability. New thinking is needed at a basic level about the function of regulation and supervision domestically and internationally. The current structure of financial regulation in the United States applies by and large to classes of institutions, not activities. This structure worked well in an environment where institutions were more or less specialized in conventional activities: banks in commercial lending and deposit taking; thrift institutions in mortgage lending and retail deposit taking; securities firms in underwriting, brokering, and trading; and so forth. In recent years, however, institutions have moved into new and nontraditional activities, markets in new instruments have arisen, and the scope of financial activities carried out by institutions or in markets that are not well integrated into the regulatory structure has rapidly expanded. Official authorities face the challenge of designing a framework of oversight better suited to this new environment marked by the breakdown of traditional specializations and the rise of new instruments.

The new financial environment is profoundly international in character. This makes the need for coordinated oversight among countries a serious concern. Uncoordinated regulation either creates opportunities for activities to shift from one geographical market to another or puts one set of national financial institutions at a competitive disadvantage in global markets without achieving effective regulation. Banking authorities in the major countries have set up mechanisms to harmonize supervisory policies. But much remains to be done, especially with regard to securities markets, where the latest wave of international expansion is occurring. The prospect of having an independent national financial policy—of allowing a national financial system to evolve along lines compatible with the cultural and historical traditions of a country, once a desirable and practical goal for public policy—is rapidly fading. The competitive forces at work in the new environment are shaping a global financial structure that binds domestic markets ever more closely together.

In addition to the consequences for regulation, the new environment poses two other important concerns for the safety net. The first involves the *de facto* and *de jure* operations of the Federal deposit insurance schemes. Indeed, the emerging character of our banking markets raises important questions about whether and how the deposit insurance mechanism should be altered to be more compatible with the current environment. The second challenge stems from the expanded volume of financial transactions, which has made huge intraday overdraft positions against the central bank on funds transfer systems a commonplace. Managing these potential demands on the resources of the deposit insurance funds and the central bank in a way that maintains confidence in the efficacy of the official safety net is an important issue.

All of these developments pose broad concerns to the Federal Reserve in terms of its oversight role regarding the strength and stability of the financial system. The present time offers a good perspective to assess the evolution of the new environment and the challenge of maintaining its stability. Usually, after three years of strong economic recovery and growth, financial conditions should be broadly improved and generally healthy. Instead, today many financial strains are apparent and the recovery period has been pockmarked with isolated, but none the less troubling, incidents of financial distress.

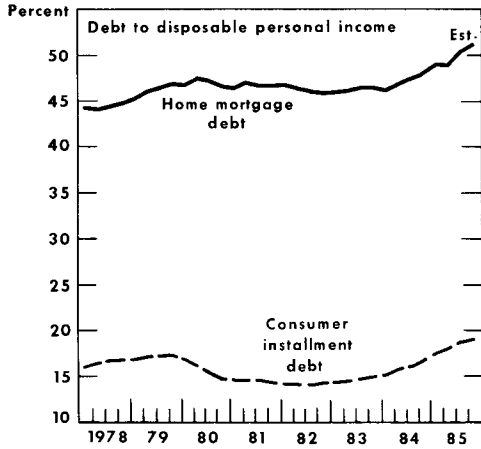
THE BASIC IMBALANCES

Financial strains have emerged against a background of some fundamental imbalances in macroeconomic policy and indebtedness in the American economy. The most prominent problem of the recovery has been the huge Federal Government deficit resulting from the excessively expansionary fiscal policy earlier put in place. Monetary policy, for its part, has been reasonably accommodative throughout the recovery, within the constraints of adhering to a long-run anti-inflationary posture. Money growth has been strong, interest rates have declined, and no general indications of frustrated demands for liquidity have been evident. Despite this accommodative tone to monetary policy, fiscal pressures have helped to keep interest rates at a high level relative to inflation. These high real interest rates certainly contributed to the extended period of dollar overvaluation, which did not undergo a sustained correction until the latter part of 1985 following the Group of Five agreement on concerted intervention. The dollar's exaggerated value weakened the competitive position of trade-intensive sectors, aggravating the financial strains on many sectors such as agriculture and manufacturing.

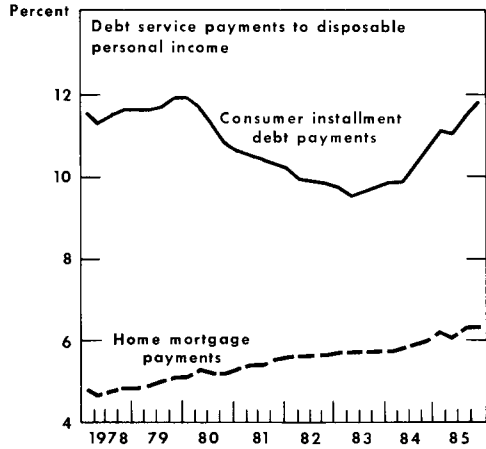
Another major imbalance has been the increased leveraging of both the consumer and business sectors in spite of the prevailing high level of interest rates. Households in the United States have steadily increased their indebtedness relative to incomes in recent years, with this ratio now at new highs (Chart 1). The growth of consumer credit has been spurred by its increased availability from suppliers who are engaged in strong competition in these markets. Several factors have been at work, among them: aggressive marketing of credit cards; lengthened maturities on automobile and other installment loans; new consumer lending efforts by thrift institutions; an expanded scope of the secondary market for mortgages, including second mortgages; and the growth of accounts that allow easy direct borrowing against the appreciated value of houses.

Chart 1. HOUSEHOLD DEBT

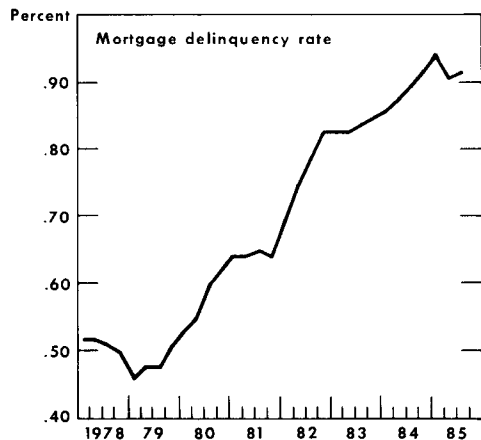
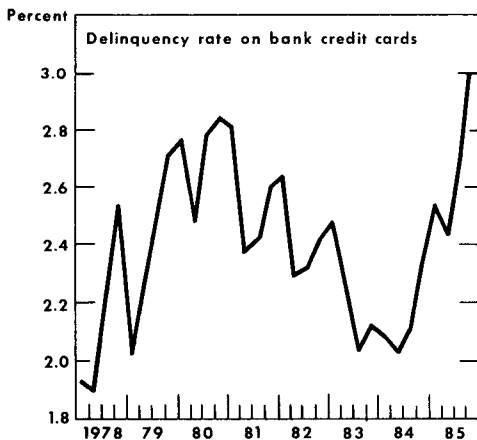
During the economic recovery, both total household debt . . .



. . . and debt service payments have outpaced personal income.



At the same time, performance indicators worsened.



There are offsetting considerations that make some observers relatively sanguine about the financial condition of the household sector. To some extent the rise in personal debt ratios mirrors demographic trends: the baby boom generation has grown up. With so many people in a prime age for family formation, typically a time of heavy borrowing, the U.S. population now has a structural tilt toward acquiring debt. Household financial assets, particularly liquid assets, have also grown strongly and overall household net worth positions are not in bad shape. Lengthened maturities have reduced the debt-servicing burdens on auto loans. Part of the expanded use of credit cards represents a substitution for other means of payment, not the accumulation of debt.

Even after acknowledging these points, though, a sense of concern about the state of consumer finances is still merited. It is very unlikely that the same households are acquiring large amounts of both financial assets and debt obligations. Household debt service ratios cannot be measured with great precision, but they are surely at or near record levels and are clearly deteriorating. And performance indicators—consumer loan and mortgage delinquency rates, mortgage foreclosures, and personal bankruptcies—are all rising, with many indicators at historical records.

On balance, household debt conditions do not pose an immediate threat to the economy. But they mightily suggest that many households are not well placed to absorb either a recession or a sharp rise in the costs of debt servicing unless their financial conditions improve.

Debt use in the business sector has been a source of concern, too. The debt of businesses has been growing at a rate in excess of GNP for several years now. And this debt build-up is associated with an increased leveraging relative to the corporate equity base (Chart 2). In the recovery years 1983-85, U.S. nonfinancial corporations added around \$375 billion to their outstanding debt while retiring on balance nearly \$125 billion worth of equity at book values, despite heavy net stock issuance during the bull market of 1983.

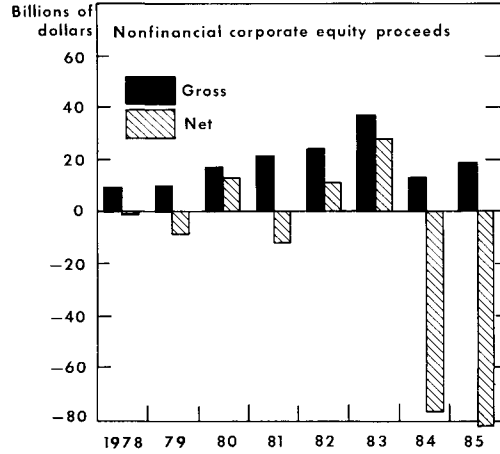
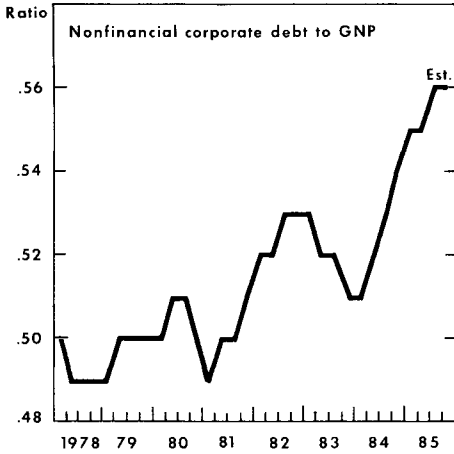
Just how advanced this leveraging is in a longer term perspective and how serious a problem it poses is not easy to say. The degree of debt to equity leverage in the corporate sector varies widely, as it has since the mid-1970s, depending on whether equity is measured at market values or as corporate net worth with assets valued at replacement cost. These two measures probably offer boundary extremes on the “real” degree of leveraging. But since the early part of the 1970s, they have diverged so much that it is practically impossible to assert whether or not corporate sector leverage has increased over a longer run.

Amid this uncertainty, one point stands out. The divergence between the two measures arose suddenly in the years 1973-74, strongly suggesting that it was linked with the

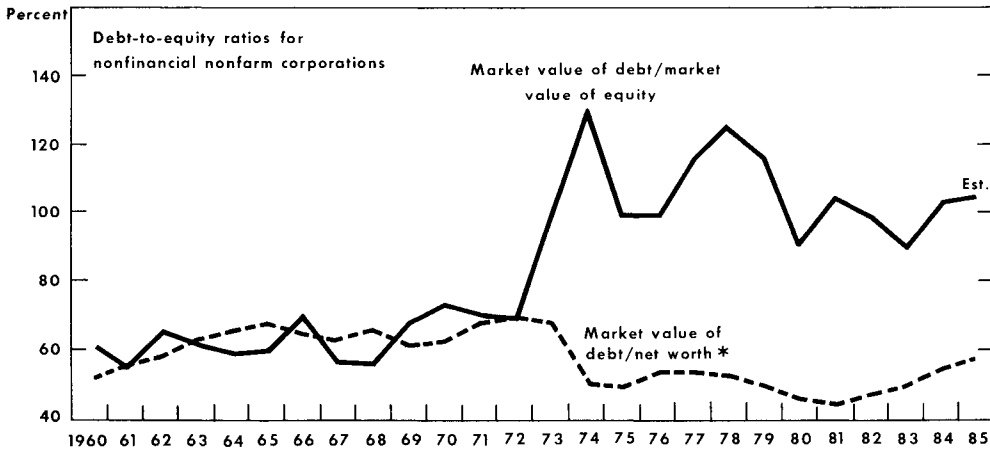
Chart 2. CORPORATE DEBT

Corporate debt has been growing rapidly . . .

. . . in large part to finance the retirement of equity capital.



Corporate debt-to-equity ratios moved up during the recovery. But where they stand in a longer perspective depends on how they are measured.



*Net worth measured as current replacement value of assets less market value of liabilities.

onset of virulent inflation and the wrenching shift in energy prices. In an environment of lower inflation and falling oil prices, a truer reading on the degree of corporate leveraging should result.

Lower inflation and lower oil prices should lead to an overall financial improvement for corporate America. The weakness in corporate equity values during the 1970s was connected to accelerating inflation in many ways: through greater variability in corporate earnings, through higher risk premiums attached to real interest rates, through extraordinary returns for competing investments like real estate, and through the interactions of inflation with the tax system that reduced after-tax yields on stocks. A return to greater price stability, then, should bode well for equity values. And lower oil prices should benefit the profitability of most enterprises by lowering production costs.

But there are no guarantees that an unwinding of inflation and high oil prices will fully restore overall corporate finances to the condition of earlier stable times. There are some potential offsets to the broad benefits of lower inflation and reduced energy costs. If lower inflation is accompanied by high real interest rates, high real debt-service burdens will be in store for companies that borrowed heavily. Lower oil prices may also have some negative financial effects. For one thing, companies in the oil sector were prominent among those increasing their leverage. For another, declines in oil prices are not necessarily an unambiguous benefit to the equity values of all firms outside the energy sector. Some, like airlines, are by the nature of their business clear-cut winners from cheaper oil. Other firms, however, may have made large capital investments designed to economize on expensive energy. As oil becomes cheaper, the value of such equipment can also fall. This is a reversal of what happened in the mid-1970s to the valuation of energy-intensive capacity. Both sharp relative price shifts and their reversals can have adverse effects on stock values if the swings are far enough apart in time so that the character of the capital stock has accommodated the initial shock. This does not mean that equity values do not on balance improve from lower oil prices; rather, the benefits need not add up to a complete reversal of the losses that took place last decade.

In summary, there are good reasons to be concerned that the rapid substitution of debt for equity that has gone on during this recovery could pose a difficult financial burden for the corporate sector.

Relatively high real interest rates during this recovery have not much restricted the demands for credit of either the household or business sector. Concerns about the extent of leveraging would be somewhat less if the financial markets were responding in ways that, on balance, make the supply of credit more cautious or offered participants better hedges for the risks. Certainly the menu of hedges has greatly expanded. But the forces

at work in the new financial environment have also lubricated the supply of credit in the American economy.

THE NEW FINANCIAL ENVIRONMENT

A multitude of powerful forces is working in the financial sector to produce change. Five broad trends—innovation, competition, deregulation, securitization, and the growth of trading—are of particular consequence. The sheer pace of change from the interplay of these forces can be cause for concern. Because experience with this new environment is very brief, the ways in which it responds to shocks are not clear. What is striking, however, is that despite inherent uncertainty created by rapid growth, the current rate of expansion in new financial markets remains unrestrained.

Innovation

The pace of financial innovation has been dynamic in recent years. New instruments and techniques have arisen that transform price, credit, and liquidity risks and that promote wider use of capital markets. There is no single best perspective on innovation, but it is fruitful to view the process in terms of its effects on major broad features of the financial system: risk, liquidity, and access to capital. Following these lines, then, innovations can usefully be classified as risk-transferring, liquidity-enhancing, credit-generating, or equity-generating.

Risk-transferring Innovations

Risk-transferring innovations are new instruments or techniques that allow economic agents to transfer the price or credit risks in financial positions. Price risk-transferring innovations—interest rate and foreign exchange options, currency and interest rate

swaps, and a host of new futures markets and contracts—have been among the most prominent features. Demand for these arose because of the higher risks posed by more volatile asset prices, particularly exchange rates and interest rates. And deposit deregulation aided the growth of these innovations by amplifying the risk at some financial firms, notably thrift institutions, from a severe balance sheet mismatch.

Innovations in transferring credit risks also arose. These stemmed from the combination of general credit difficulties that lingered from the 1981-82 recession and the severe sectoral problems in agriculture, energy, and developing countries. The falls in credit-worthiness heightened lender and investor demands for protection.

New techniques to deal with these worries emerged, building on the opportunities created by a greater use of capital market financing. Insurance companies and other financial firms provided a variety of guarantees on securities issues and other credit risks. Commercial banks themselves sought to benefit from the trend to direct securities financing. They set up programs to sell off to investors certain classes of business loans, lease receivables, or consumer finance receivables. They expanded their use of stand-by letters of credit to lend their credit rating to borrowers seeking capital market access. And they sought a wider role in placing securities, often testing the limits of Glass-Steagall rules.

Liquidity-enhancing Innovations

Liquidity-enhancing innovations improve the “moneyness” or the negotiability of financial instruments. They arise from a generally increased demand for liquidity in the economy. Cash management programs, money market mutual funds, and new types of negotiable deposit accounts are all examples. The most recent steps aim at improving the liquidity of capital market-type instruments. Note issuance facilities, securities sold with various put options, or multiple financial guarantees are among the techniques employed.

High interest rates, the increased use of direct credit markets, and leveraging are all factors that have worked to promote liquidity-enhancing innovations. High rates raised the cost of holding transactions liquidity in the usual forms like checking accounts. When investors shifted away from bank deposits to capital market instruments, they generally acquired less liquid vehicles—after all, in normal conditions, deposits convert back into cash at par in short order, if not on demand. This loss of liquidity, then, created a demand for innovations that would restore it. A final underlying factor has

been the increased leveraging of the household and business sectors; a stronger demand for liquidity in the face of greater debt burdens is not unreasonable.

Credit-generating Innovations

Credit-generating innovations are a third class. These innovations, which broaden the access of economic agents to credit supplies, may result in an increase in the volume of all credit or in a shift by some kinds of borrowers from their traditional credit channels—say, bank borrowings—to nontraditional ones—say, the capital markets. Increased demands for credit in general or for broad subclasses of credit are the driving force behind these new instruments.

Credit-generating innovations appear to work in two ways. First, some innovations mobilize dormant assets to back borrowings. An example is the new type of account that allows homeowners to draw against a line of credit supported by the appreciated value of their houses. This is a far more convenient borrowing vehicle than a junior mortgage. Leveraged buyout financing, backed by the expected future cash flows of the firm, is another example.

Second, credit-generating innovations tap previously unaccessed pockets of the supply of credit. This may be done directly, as in the case of newly-issued junk bonds, or indirectly, for example, through liability-based interest rate swaps.

Equity-generating Innovations

Equity-generating innovations make up a final broad class of new instruments. They have been more limited than other types of innovations in recent years. But two examples are noteworthy: variable rate preferred stock is structured to pay a dividend that varies with market interest rates, and mandatory convertible debentures are debt instruments that must convert to equity in a definite time period. Commercial banks have made extensive use of both, a consequence of demands on the part of markets and regulators for increased capital in banking.

Innovations have been principally spurred by demands for certain characteristics or functions provided by the financial sector. But other forces have also promoted their growth on the supply side by making financial institutions more willing and able to

provide new instruments. Chief among these have been the extraordinary changes in telecommunications and computing technologies. These technical advances increased the depth and breadth of trading by forging a global financial market. They made it possible for market-makers to design and price new instruments with complex financial structures and to monitor almost continuously the exposures generated. Finally, better information for customers brought about more competitive pricing and lower earnings in traditional areas of business, thereby encouraging financial institutions to pursue more innovative lines.

Another push to innovation has come through regulatory action. Banks have been required to operate with a lower ratio of balance sheet assets to capital. Exposures generated through off balance sheet business, however, were not, by and large, subject to similar rules. At the same time, the costs to many banks of raising new capital were high, largely because of the very asset quality problems that prompted the regulators' demands for more capital. These conditions combined to move banks in the direction of earning revenues through off balance sheet activity that did not tie up capital.

Competition

A second major factor defining the new financial environment is an unprecedented degree of competition, which has come in two forms: that between the U.S. financial system and systems of other nations and that between banks and nonbanks within the United States.

Foreign financial institutions have set up significant presences in American markets in both banking and securities. Foreign banks have competed aggressively in markets for business loans and letters of credit. In the Government securities market foreign firms are a growing presence. At the same time, U.S. banks and financial firms have been active abroad, seeking to move into new banking and securities operations in major foreign countries.

With these inroads have come highly complex questions of maintaining equivalent standards for regulation and supervision of international financial firms, as well as highly charged questions concerning the equitable treatment of these firms. The governing principle of international financial relations in the United States has been that of national treatment—that is, foreign firms operating in American markets should be allowed the same scope for activities that domestic firms have. But there may be valid practical concerns in the application of national treatment when U.S. firms operating abroad do

not have access to those markets on the same terms as domestic firms. As global financial integration grows in importance, the need to harmonize principles of equitable treatment will become more apparent. Competition in world financial markets would be strengthened if this harmonization moved all countries toward applying national treatment.

In the domestic arena, competition between banks and nonbanks has intensified. Nonbanks have exploited narrow definitions of banking in existing legislation to expand into lending and deposit-taking operations across the country. Banks have sought out the limits on entrance into securities and insurance businesses. They have used the opportunities for interstate expansion offered by state and regional reciprocal banking pacts. And banks from states that are excluded from the regional compacts have seized the chances presented by bank and thrift failures to build networks across state lines.

Without doubt, a driving edge to this competition has been aggressive utilization of the “nonbank bank” loophole in current law. Unless this channel is controlled, it offers to nonbank entities the prospect of conducting the *functions* of banking on a nationwide scale simply by making rather modest changes in the *forms* of banking. The response of conventionally-structured banks has been to work on eroding existing limitations on their expansion into nonbank financial services or across state lines. One mode of these expansion efforts has been banks’ own applications to set up limited service banking organizations in new markets. If left unchecked, the current highly competitive environment certainly has the potential to render moot the program of legal and regulatory restraints on banking expansion that has been in place for many years. Whether the consequences of that are good or ill is debatable. But the process now is going on rapidly and haphazardly, and not as a conscious choice of public policy.

The result has been a turbulent financial sector. Struggles to get and keep market shares in the face of strong competition have led to pricing structures that even participants describe as unacceptably narrow.

Technological advances have played a strong role in this. Telecommunications equipment and computers—technologies commonly available to all enterprises, regardless of their business traditions—work to level the field of financial competition. They allow any company from any business tradition to generate and control offers of generic versions of financial services—loans, deposits, credit cards, and insurance are all important examples—to the company’s existing customer base. Out of this comes the concept of the financial supermarket. Efforts to implement this supermarket strategy have led to intense competition in exploiting customer bases. Any company with a large number of customers, such as a merchandise retailer or national credit card issuer, is at an immediate advantage, even if it has no tradition of financial services.

Also, in part, this competition reflects stronger entrepreneurial attitudes in finance. Managements of many firms in the financial sector now follow a strategy of expanding into new areas and testing the market and regulatory limits to growth. This attitude has certainly been promoted by another strong force at work, the trend toward deregulation and liberalization of financial markets.

Deregulation

Deregulation differs in its nature from the forces of innovation and competition. The latter two have grown up within the financial markets themselves. Deregulation, however, has been a political process, with the chief goal of providing to end-users of financial services higher returns and lower costs. Actions on deregulation fall into two major categories: rate deregulation and liberalization of powers for financial firms, including the relaxation of geographical restrictions on business.

Rate deregulation has been the more familiar; it is the more advanced and has so far had the more pronounced effect on the broad economy. Recent legislation has almost totally removed limits on the payment of deposit interest (with the major exception of ordinary demand deposits). One important consequence of this has been to aggravate the squeeze on net interest margins from traditional business lines for many depository institutions, spurring the growth of competition and innovation. Another has been large, unanticipated changes in the deposit-holding behavior of the economy that have made monetary aggregates a significantly less reliable compass for policymakers.

Interactions between interest rate changes and deregulation played a big role in the erratic behavior of the aggregates, especially last year. As rates declined, the cost of holding what are basically precautionary savings rather than true transactions balances in checkable deposits like NOW accounts also fell. More and more, depositors opted for this more liquid form of savings, throwing far out of kilter the expected relation between money measures and the level of GNP. With further deposit rate deregulation occurring in 1986 and with monetary aggregate velocity behavior so abnormal, great uncertainties still surround monetary targeting in the new environment.

The second major trend in deregulation is the liberalization of powers. To date this has gone on in a piecemeal and uneven way as a result of specific judicial and regulatory challenges by market participants. At times, different regulators have held different views of permissible powers. There has been no sea change in powers deregulation as there was in rate deregulation. But inroads have been made in many directions: nonbanks

have assumed the functions of banking; banks have expanded their activities across state lines; and banks have entered areas related to brokering, underwriting, and insurance. This has led to a confused, even inequitable, regulatory environment. And it may very well have increased the total risk in the overall financial system by allowing previously segregated institutions to engage in new markets but in a hit or miss way. The need for a legislative rationalization of this confusion grows clearer and more pressing.

Securitization

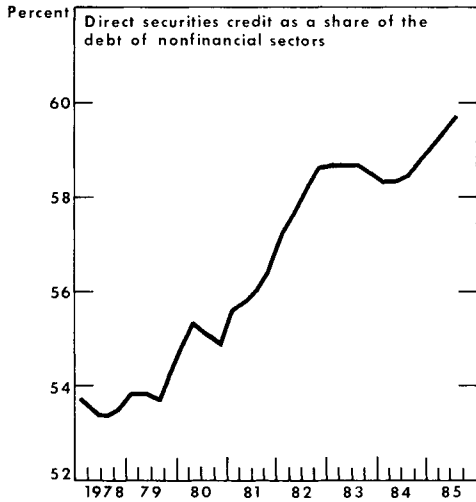
Another major force to note that is at work in the new financial environment is securitization. This refers to an increased use of capital market-type instruments—commercial paper, bonds, pass-through securities, etc.—as a source of finance, sometimes at the expense of traditional channels of bank credit (Chart 3). Occasionally this trend has taken the form of banks themselves setting up new structures that move assets off their books into the open market.

A number of influences have converged to bring about a setting conducive to securitization trends.

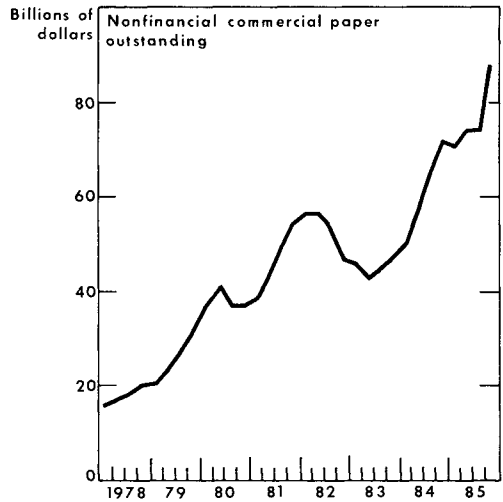
- *Expensive intermediation.* High-quality business borrowers could easily fund more cheaply in commercial paper markets than from banks. Large banks in particular saw their business loan growth stall. The very competitive interest rate swap market could also be used as a way to gain attractively-priced floating rate funding while bypassing the banking system.
- *Cheaper credit enhancement.* The market for credit enhancements—letters of credit from banks and guarantees from insurance companies or other institutions—has been highly competitive. Borrowers have found a ready supply of inexpensive enhancements. This has broadened borrowers' access to capital markets and increased the use of securities issuance.
- *Mobilization of assets.* Financial markets are proving particularly inventive in finding new ways to mobilize assets to support securities issuance. The pass-through structure has been extended far beyond its original roots in FHA/VA home mortgages. Commercial mortgage pass-throughs on selected properties have been issued. Lease receivables and auto loan receivables have been securitized using

Chart 3. THE GROWING IMPORTANCE OF SECURITIES FINANCE

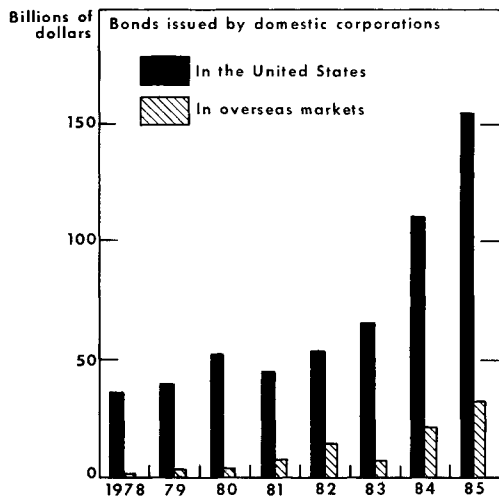
Direct securities credit continued to rise in overall importance . . .



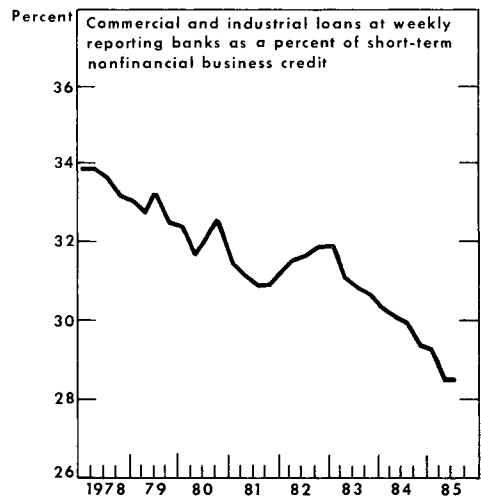
. . . as activity in the commercial paper market . . .



. . . and in the bond markets surged.



Large banks, in particular, saw their share of short-term business credit fall.



related structures. Thrift institutions have used Treasury and agency securities or other good quality assets to structure highly secured, over-collateralized issues of floating rate notes for the Euromarket that trade mostly on the quality of the collateral rather than the name of the issuer. These and other related techniques have one major feature in common: they are innovative ways of using existing assets to back the creation of new capital market liabilities. And they can contribute to the growth of debt and leveraging in the economy.

- *Capital requirements.* Regulatory demands for a stronger capital base in banking have also played a role. Asset sales programs at banks are underpinned by the greater willingness of nonbank investors to hold direct claims, but they also reflect the pressures on banks of tighter capital requirements. These techniques allow banks to turn over their asset positions more frequently, thereby increasing the loan origination and sales fees components of earnings per dollar of capital required against balance sheet exposure.

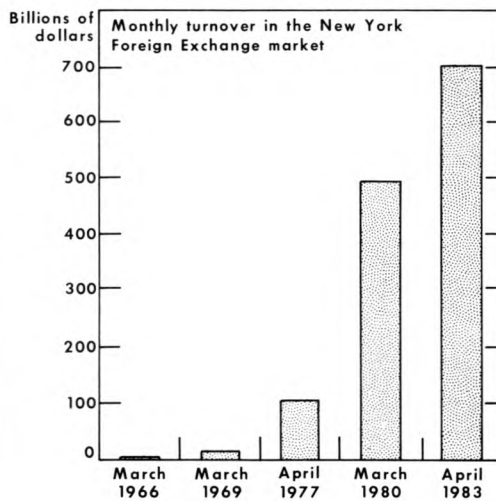
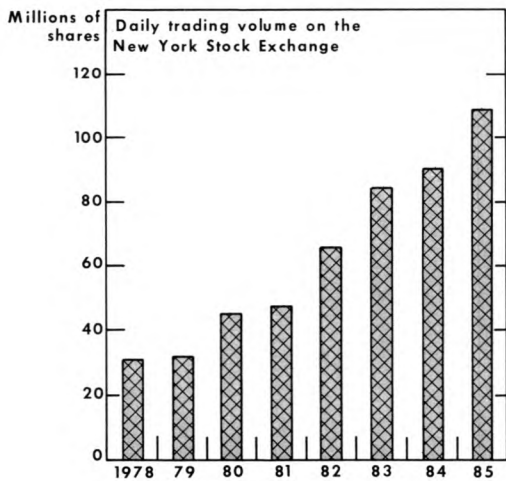
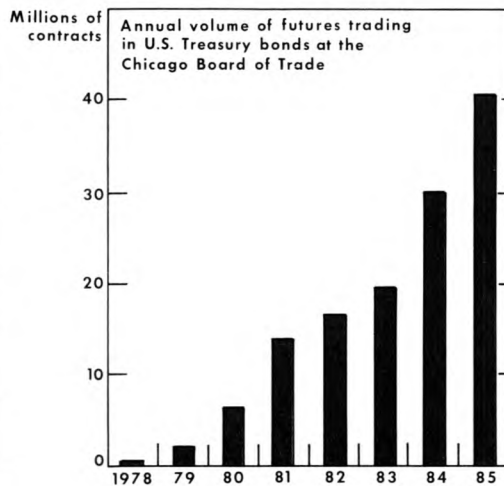
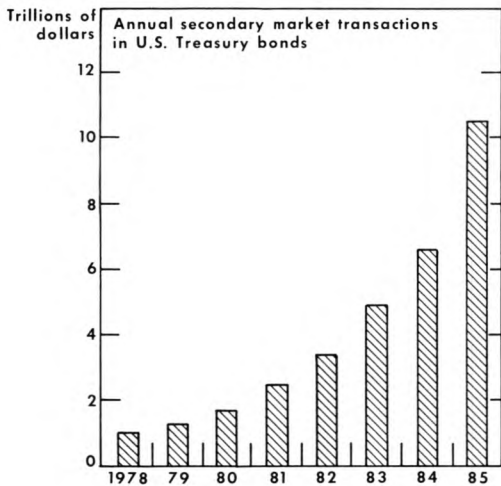
Asset sales and securitization generally can work to lubricate the supply of credit in the economy. They enhance the transferability and improve the liquidity of assets. Such efforts can also create attractive new asset characteristics for investors. Securitized automobile loan receivables, for example, can generate high yield notes with maturities of two to four years, a range usually populated only by lower yielding Government paper. Institutional investors, then, may provide a strong demand for such securities. With a ready resale market established, originators may be more competitive and aggressive in making new loans. Through such channels, the securitization process can work to boost the supply of credit.

The Growth of Trading

An enormous growth in the volume of financial instruments traded has come along with securitization and the other forces in the new environment (Chart 4). To some degree, this is a part of the process of absorbing the volume of debt issues coming from all quarters. Expanded secondary securities markets activity and expanded trading of hedges—swaps, options, futures, and forwards—are needed to give the markets enough breadth and liquidity. Otherwise, investors could balk at taking up the new debt offerings.

But other factors have promoted the growth of trading as well. The new technologies

Chart 4. THE GROWTH OF TRADING



have played obvious roles. They have linked previously segregated markets on a global basis and have allowed analysts and traders to resolve complex relations among asset prices and to act promptly when prices are “out of line”. These developments produce a nearly continuous stream of ever-changing arbitrage opportunities that feed the high volume of trading. The success of trading-oriented firms that were early to exploit these conditions has started a trend. Managements of many financial institutions, and even of treasury departments in some large corporations, have committed substantial resources to trading and view such commitments as essential in the new environment.

An emphasis on short-term financial performance, itself a consequence of the greater degree of competition, also spurred trading volumes. Pressures to beat broad market averages necessitate going beyond diversification and taking trading risks to increase total returns.

With the ballooning of financial transactions have come new risks—or, more precisely, the magnification of old risks to an unprecedented scale. The volume of daily transactions on large dollar payments systems such as CHIPS or Fedwire has become huge. Annual Fedwire volume totaled \$175 trillion in 1985. And daily amounts for the CHIPS and Fedwire systems combined at times exceeded \$1 trillion. With this growth in traffic, many institutions regularly build up payments imbalances within the course of a trading day before settlement that are very large relative to their capital base. Total intraday overdrafts on reserve accounts easily exceed \$100 billion.

Normally, of course, the ebb and flow of payments on these systems occur without incident. But the exposures involved are so large that even minimal risks of settlement failure cannot be ignored. Active efforts have to be made to control these payments-risk exposures.

Settlement can fail because of technical problems in completing payments transactions. Large dollar payments systems are complex, and complex systems are subject to unanticipated problems. The frequency of delays in concluding settlements has risen as higher volumes of traffic tax the operational limits of existing computer systems. And last November a major clearing bank for securities transactions experienced a severe computer problem that could not be put right before closing. As a consequence, this Bank extended a record \$22.6 billion loan on an overnight basis.

That incident was well-contained and did not threaten to spill over to other institutions or markets. The computer difficulties were resolved the next day. But it dramatically points out the types of risks we face. Settlement disruptions stemming from more protracted operational problems may not be so limited in their consequences. And, of course, a settlement failure stemming from a default could play havoc throughout the financial system.

Concern with these risks has led the Federal Reserve, working with the banking industry, to press for more control over the growth of daylight overdraft exposures. A key feature has been a voluntary program for banks using large dollar payments systems to classify themselves into overall categories that will limit their maximum daylight overdraft position across these systems. Disciplines such as these can provide some help in limiting the spillover effects of a major settlement failure, although they can hardly isolate the financial sector from those consequences. Their principal benefit is to strengthen the incentives for bank management to set up and monitor good controls for payments systems operations. That, in turn, lowers the chances of a systemic disruption.

ADAPTING TO FINANCIAL CHANGE

The financial sector was caught in the crosscurrents of change last year. Financial institutions were adapting to the quickly shifting environment and making important progress toward putting themselves on a stronger footing.

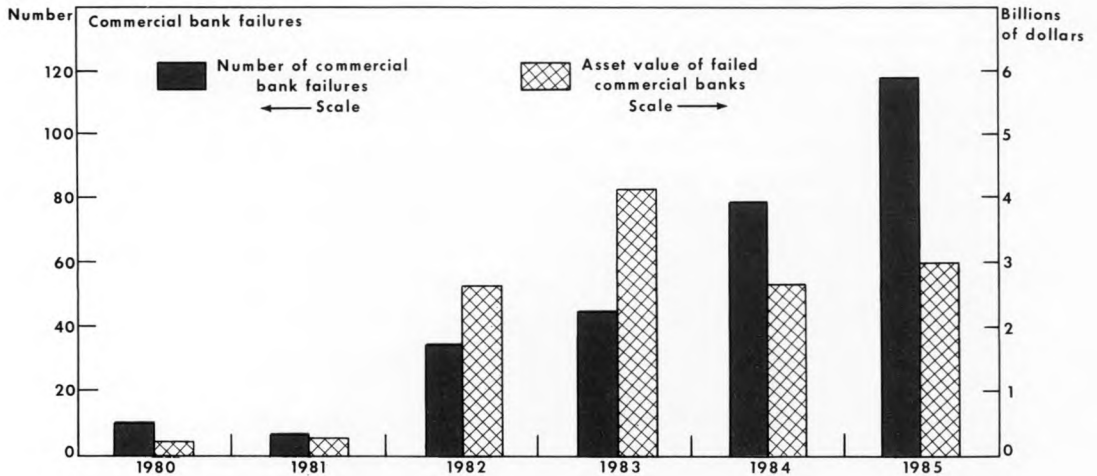
The commercial banking system offers an example of constructive response to the challenges of financial change (Chart 5). Faced with a need to strengthen capital positions in light of expanded activities—both on and off the balance sheet—and of weakened loans to some sectors, commercial banks responded notably. Over the recovery period 1982-85, banking system primary capital rose from \$142 billion to \$182 billion and capital to asset ratios increased almost eighty basis points to 7.27 percent. Gains for the large bank groups were even more impressive, despite historically high levels of charge-offs. In fact, large banks have significantly reduced their exposures relative to capital on loans to developing countries and other troubled sectors.

The overall earnings performance of commercial banks last year was also noteworthy. The slide in their rates of return on assets and equity that characterized the past several years leveled off. Again, the large bank group showed a good profit performance last year, despite another large addition to loan loss reserves.

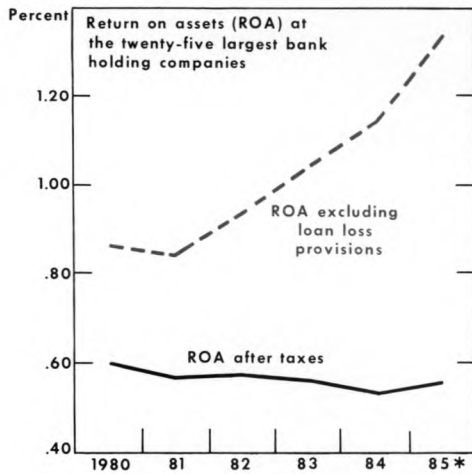
So the banking system in recent years has been able to improve its capitalization significantly and stabilize its earnings while still dealing with losses on troubled loans—a strong performance that overshadows the limited problem of bank failures in weakened

Chart 5. COMMERCIAL BANKING

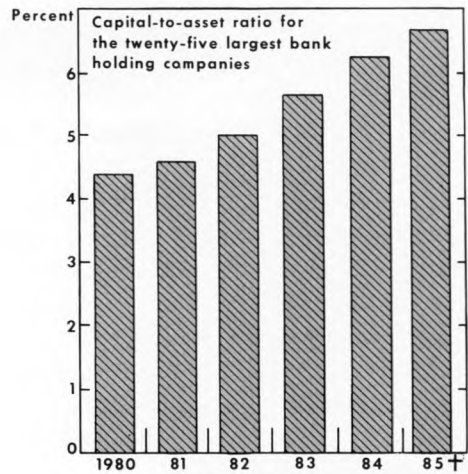
The number of bank failures rose again in 1985. But the problems were confined to small banks.



Large banks improved their earnings performance despite bigger loan loss reserves . . .



. . . and also improved their capitalization.



* Nine months of 1985, annualized.
† September 30, 1985.

sectors such as agricultural lending. Still, a complacent attitude has to be avoided and efforts to maintain an adequate margin of soundness in the financial condition of banks must go on.

To that end, banking regulators have taken a number of actions to complement the requirements for adequate amounts of capital. One step in this broader approach has been the Federal Reserve's proposal of a supplementary set of risk-based capital guidelines (other bank regulators have proposed similar actions). These guidelines are compatible with the general supervisory principle of distinguishing among the risks in broad asset classes when judging capital adequacy. They also extend capital requirements directly to some contingent items, notably letters of credit and loan commitments, as the first step in a thorough review of the regulatory treatment of off balance sheet instruments.

A total supervisory policy must, of course, encompass features other than capitalization. Important examples here include the issuance by the Federal Reserve of a policy statement on payment of dividends by banks and bank holding companies experiencing financial difficulties and a stepped-up frequency of examinations for large banks and banks with weak ratings. In addition, work is now under way to review the supervisory guidelines on loan concentrations and loan loss reserves. And active efforts are being made to upgrade the amount and quality of resources dedicated to supervision. These are some illustrations of the comprehensive approach to supervision and regulation in the new environment that is being fashioned.

COMPLEXITY AND INTERDEPENDENCE

A hallmark of the current financial environment is its complexity. Markets and institutions lock together in new connections and risks spill over in previously unexpected ways. A telling illustration of such a network of exposures arises from the failures last year of two relatively obscure trading firms in the Government securities market. The two firms—ESM Securities in Florida and Bevil, Bresler, and Schulman in New Jersey—had built up very large positions in the repurchase agreements market and had masked major losses in their own capital positions by structuring multiple repurchase deals on the same underlying securities. They were able to keep up this pyramid of dealing because their counterparties—a wide range of thrift institutions and local government

organizations—did not take actions to safeguard their own positions, failing to secure their underlying collateral or providing excess collateral to the dealer.

Perhaps the most dramatic consequences of this were the temporary closures of nonfederally-insured thrift units in the states of Ohio and Maryland. The Ohio events were a direct consequence of the failure of ESM Securities. Losses sustained by a large Ohio thrift that was an ESM counterparty were so large that they threatened the integrity of the state-sponsored insurance fund. As that news became widely known, runs by depositors on some other nonfederally-insured units arose. In fact, the international attention focused on these developments had repercussions in the exchange markets, contributing to declines in the value of the dollar in late-March.

Later a similar string of events arose in Maryland. Some thrift units in that state were revealed as counterparties to the two failed dealing firms. Although the securities positions involved were not so large as in the case of the Ohio thrift, the market attention focused on thrift institutions throughout Maryland exposed other serious weaknesses. With depositors in an already sensitive condition, that news was enough to touch off a similar sequence, leading to the closure of some thrift institutions in that state.

Fortunately, such problems did not spread to other states with similar insurance coverage. Thrift units in those areas were in a sounder condition, or state-sponsored or private funds insured only a very small portion of the thrift industry. The erosion of depositor confidence was limited. But the episodes do point out conditions when the sensitivities of depositors are heightened and they underscore the need to take steps to strengthen financial stability in the new environment.

Still, there were further spillovers from the problems of the Maryland thrifts, reaching out this time into the secondary markets for mortgages and mortgage-backed securities. Equity Programs Investment Corporation (EPIC), a subsidiary of one of the Maryland thrift institutions under depositor pressure, defaulted on more than \$1 billion of mortgages and mortgage-backed securities. The cash flow generated on the real estate came from rental incomes and property sales plus borrowings from the Maryland thrift. This cash flow was inadequate to service the debt. Some major mortgage insurance firms were heavily exposed on the EPIC securities and suffered damaging losses.

A common feature of this and other recent mortgage market incidents has been a slippage in the monitoring of credit risks. Originated mortgages were resold to investors in a national market, either directly or repackaged as securities. The responsibility for credit judgments on the underlying mortgage loans has been diffused among originators, agents, investors, and guarantors. This laxity in standards may have been helped along by the ready availability of credit enhancements and financial guarantees, whether from mortgage insurers or other sources.

While these kinds of problems have particularly plagued the secondary mortgage market, they are a concern across the whole range of securitized assets. Right now the risks are significant but limited. As the markets for traded assets expand, however, the threat of widespread disruption from shocks to financial guarantors can become a greater worry.

Another important consequence of the shocks in the Government securities market was the rise of Congressional pressures for some regulation specific to trading Government securities, an area so far basically free of regulation. Even before the failures, the Federal Reserve had promulgated voluntary guidelines on adequate capital for unregulated dealing operations. Whether those or other rules should now extend to all dealing firms, whether that extension should be voluntary or compulsory, and which body should make the rules are all still being actively discussed.

Both the United States Treasury and the Federal Reserve have strong, direct interests in maintaining an efficient, well-functioning Government securities market. To this end, any regulatory framework should be limited and tailored to address the specific areas of weakness. Any rule-making should be restrained. After all, the notorious failures of recent years have all been firms on the fringe of this vast market. The core of the market—comprised of the primary dealer group and the trading operations of other sophisticated, well-capitalized firms—has performed well over this period. It should not be disrupted by restrictions aimed at the market periphery. Provided such a judicious approach is followed, the Federal Reserve does support steps to regulate the Government securities market that do not upset the Government's ability to place its debt or the central bank's ability to conduct monetary policy operations.

The financial shocks of 1985 were serious but they were not a systemic danger. Yet they teach a broad lesson that must be heeded. The interconnections among institutions and markets in the new environment get more and more complex. A shock that starts in one market may spread quickly along this network of linkages until it finds a weakness in some seemingly unrelated place. In fact, there is a growing tendency to build financial links along regulatory "faultlines", where the responsibility for supervisory oversight is weak, divided, or cloudy. Nonfederally-insured thrift units engaged in the unregulated Government securities market were a prime example. For the public authorities, maintaining financial stability today means making a concerted effort to find these faultlines and repair them.

THE TASK AHEAD

The financial landscape is rapidly changing. The speed of change has obscured a full understanding of the long-term implications of these events. Clearly, the financial system is moving to a new level of sophistication and such a step is in line with its earlier evolution. But the history of finance also teaches that rapid change can bring new sources of uncertainty. Even those actively involved in these new markets wonder aloud if all of the complexities are understood and all of the risks appreciated. The challenge ahead, for regulators and market participants both, is to deepen our understanding of how the new markets and techniques affect the whole financial system, to consolidate the useful features of this financial revolution, and to tailor the regulatory structure to the changed environment.

Financial Statements

STATEMENT OF EARNINGS AND EXPENSES FOR THE CALENDAR YEARS 1985 AND 1984 (In dollars)

	1985	1984
Total current earnings	5,851,363,158	5,795,629,347
Net expenses	208,566,877	211,272,339
	<hr/>	<hr/>
Current net earnings	5,642,796,281	5,584,357,008
Additions to current net earnings:		
Profit on sales of United States Government securities and Federal agency obligations (net)	33,056,598	16,151,134
Profit on foreign exchange (net)	295,250,560	—0—
All other	22,049	30,694
	<hr/>	<hr/>
Total additions	328,329,207	16,181,828
Deductions from current net earnings:		
Loss on foreign exchange (net)	—0—	110,974,967
All other	1,160,787	1,563,926
	<hr/>	<hr/>
Total deductions	1,160,787	112,538,893
Net deductions	—0—	96,357,065
Net additions	327,168,420	—0—
Assessments by the Board of Governors:		
Board expenditures	19,025,200	20,162,400
Federal Reserve currency costs	52,739,089	51,203,994
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Total assessments	71,764,289	71,366,394
	<hr/>	<hr/>
Net earnings available for distribution	5,898,200,412	5,416,633,549
Distribution of net earnings:		
Dividends paid	25,607,747	22,886,593
Transferred to surplus	42,930,900	39,073,250
Payments to United States Treasury (interest on Federal Reserve notes)	5,829,661,765	5,354,673,706
	<hr/>	<hr/>
Net earnings distributed	5,898,200,412	5,416,633,549
SURPLUS ACCOUNT		
Surplus—beginning of year	396,509,800	357,436,550
Transferred from net earnings	42,930,900	39,073,250
	<hr/>	<hr/>
Surplus—end of year	439,440,700	396,509,800

STATEMENT OF CONDITION

In dollars

Assets	DEC. 31, 1985	DEC. 31, 1984
Gold certificate account	3,276,825,394	3,356,584,828
Special Drawing Rights certificate account	1,354,000,000	1,335,000,000
Coin	16,102,893	17,788,603
Total	4,646,928,287	4,709,373,431
 Advances	 2,060,475,000	 78,150,000
United States Government securities:		
★Bought outright	59,304,687,096	53,453,237,996
Held under repurchase agreements	3,528,905,000	1,626,895,000
Federal agency obligations:		
Bought outright	2,744,267,910	2,816,403,197
Held under repurchase agreements	1,693,395,000	387,840,000
Total loans and securities	69,331,730,006	58,362,526,193
 Other assets:		
Cash items in process of collection	1,338,272,704	725,094,536
Bank premises	30,546,080	25,584,445
†All other	3,233,873,931	1,990,276,344
Total other assets	4,602,692,715	2,740,955,325
 Interdistrict settlement account	 (3,210,013,157)	 (2,007,767,455)
Total Assets	75,371,337,851	63,805,087,494

★ Includes securities loaned—fully secured 1,419,795,000 1,092,275,000

† Includes assets denominated in foreign currencies revalued monthly at market rates.

STATEMENT OF CONDITION

In dollars

Liabilities	DEC. 31, 1985	DEC. 31, 1984
Federal Reserve notes (net)	53,847,800,939	51,096,394,262
Reserves and other deposits:		
Depository institutions	8,153,348,889	4,392,132,027
United States Treasury—general account	9,350,978,604	5,316,146,626
Foreign—official accounts	366,626,943	139,851,548
Other	495,725,063	479,787,646
Total deposits	18,366,679,499	10,327,917,847
Other liabilities:		
Deferred availability cash items	1,484,943,003	687,840,471
★All other	793,033,010	899,915,314
Total other liabilities	2,277,976,013	1,587,755,785
Total Liabilities	74,492,456,451	63,012,067,894
Capital Accounts		
Capital paid in	439,440,700	396,509,800
Surplus	439,440,700	396,509,800
Total Capital Accounts	878,881,400	793,019,600
Total Liabilities and Capital Accounts	75,371,337,851	63,805,087,494

★ Includes exchange translation account balances reflecting the monthly revaluation of outstanding foreign exchange commitments.

Changes in Directors and Senior Officers

CHANGES IN DIRECTORS. In November 1985, the Board of Governors of the Federal Reserve System reappointed John Brademas a Class C director for a three-year term beginning January 1, 1986 and redesignated him *Chairman* of the board of directors and *Federal Reserve Agent* for the year 1986. Dr. Brademas, President of New York University, New York, N.Y., has been serving as a Class C director and as *Chairman* and *Federal Reserve Agent* since January 1983. Also in November, the Board of Governors redesignated Clifton R. Wharton, Jr. *Deputy Chairman* for the year 1986. Dr. Wharton, Chancellor of the State University of New York System, Albany, N.Y., has been serving as a Class C director since January 1983 and as *Deputy Chairman* since January 1985.

In December 1985, member banks in Group 1 elected Lewis T. Preston a Class A director and Richard L. Gelb a Class B director, each for a three-year term beginning January 1, 1986. Mr. Preston, Chairman of the Board of Morgan Guaranty Trust Company of New York, New York, N.Y., succeeded Alfred Brittain III, Chairman of the Board of Bankers Trust Company, New York, N.Y., who had served as a Class A director since January 1983. Mr. Gelb, Chairman of the Board of Bristol-Myers Company, New York, N.Y., succeeded William S. Cook, President and Chief Executive Officer of Union Pacific Corporation, New York, N.Y., who had served as a Class B director since August 1980.

Buffalo Branch. In November 1985, the Board of Governors of the Federal Reserve System appointed Mary Ann Lambertsen a director of the Buffalo Branch for a three-year term beginning January 1, 1986. In addition, the board of directors of this Bank designated her *Chairman* of the Branch board for the year 1986. Mrs. Lambertsen is Vice President-Human Resources of the Fisher-Price Division of The Quaker Oats Company, East Aurora, N.Y. As *Chairman* and a Branch director, she succeeded M. Jane Dickman, a partner in the accounting firm of Touche Ross & Co., Buffalo, N.Y., who had served as a Branch director since January 1977 and as *Chairman* of the Branch board since January 1983.

At the same time, the Board of Governors appointed Matthew Augustine a director of the Buffalo Branch for the unexpired portion of a term ending December 31, 1986. Mr. Augustine, President and Chief Executive Officer of Eltrex Industries, Inc., Rochester, N.Y., succeeded Laval S. Wilson, former Superintendent of the Rochester City School District, Rochester, N.Y., who had served as a Branch director from January 1984 until his resignation in September 1985.

Also in November, the board of directors of this Bank appointed R. Carlos Carballada, and reappointed Donald I. Wickham, directors of the Buffalo Branch, each for a three-year term beginning January 1, 1986. Mr. Carballada, President and Chief Executive Officer of Central Trust Company, Rochester, N. Y., succeeded William Balderston III, President and Chief Executive Officer of Chase Lincoln First Bank, N.A., Rochester, N. Y., who had served as a Branch director since July 1984. Mr. Wickham, President of Tri-Way Farms, Inc., Stanley, N. Y., has been serving as a Branch director since January 1983.

MEMBER OF FEDERAL ADVISORY COUNCIL. In November 1985, the board of directors of this Bank selected John F. McGillicuddy to serve during the year 1986 as the member of the Federal Advisory Council from the Second Federal Reserve District. Mr. McGillicuddy, Chairman of the Board of Manufacturers Hanover Trust Company, New York, N. Y., succeeded Lewis T. Preston, Chairman of the Board of Morgan Guaranty Trust Company of New York, New York, N. Y., who had been this District's member of the Council during 1983, 1984, and 1985.

CHANGES IN SENIOR OFFICERS. The following changes in official staff at the level of Vice President and above have occurred since the publication of the previous *Annual Report*:

Henry S. Fujarski, Senior Vice President, died on May 2, 1985. Mr. Fujarski had joined the Bank's staff in 1958 and became an officer in 1973. Since 1982, he had been serving as the officer in charge of the Operations Group.

Effective June 20, 1985:

Suzanne Cutler, Senior Vice President, formerly assigned to the Management Planning Group, was assigned responsibility as the officer in charge of the Operations Group.

Israel Sendrovic, Senior Vice President, formerly assigned to the Automation Group, was assigned responsibility as the officer in charge of the Automation and Electronic Payments Group.

Effective July 1, 1985, J. Andrew Spindler, formerly Vice President and Executive Assistant to the Vice Chairman of Continental Illinois National Bank, Chicago, Ill., was appointed an officer of this Bank with the title of Vice President and assigned to the Bank Supervision Function with supervisory responsibility for the Bank Analysis and Banking Studies Departments.

Effective July 19, 1985:

James H. Oltman, General Counsel, was appointed Executive Vice President and General Counsel and assigned responsibility for the Management Planning Group and the Administrative Services Group in addition to his responsibility for the Legal Function.

Chester B. Feldberg, Senior Vice President, was assigned to the Bank Supervision Function, in addition to his assignment as the officer in charge of the Loans and Credits Function.

M. Akbar Akhtar, Assistant Director of Research, was appointed Vice President and Assistant Director of Research.

James O. Aston, Vice President, formerly assigned to the Check Processing Function, was assigned to the Personnel Function.

Carol W. Barrett, formerly Assistant Vice President, was appointed Vice President and assigned as the System Product Director for Securities Services in the Electronic Payments Function.

Robert T. Falconer, Vice President, formerly assigned to the Loans and Credits Function, was assigned to the Foreign Exchange Function.

Edward J. Frydl, Assistant Director of Research, was appointed Vice President and Assistant Director of Research.

Roberta J. Green, Vice President, formerly assigned to the Personnel Function, was assigned to the Loans and Credits Function.

Charles M. Lucas, Vice President, formerly assigned to the Foreign Exchange Function, was assigned to the Foreign Relations Function with responsibility for the newly established International Capital Markets Staff.

Cathy E. Minehan, Vice President, formerly assigned to the Accounting Function, was assigned to the Check Processing Function.

A. Marshall Puckett, formerly Vice President assigned to the Bank Supervision Function, was appointed Payments System Adviser.

Don N. Ringsmuth, formerly Assistant General Counsel, was appointed Associate General Counsel.

William L. Rutledge, formerly Assistant Vice President, was appointed Vice President and assigned to the Bank Supervision Function.

Effective in the fall of 1985, Stephen G. Thieke, Senior Vice President, formerly assigned to the Bank Supervision Function, was assigned to the Open Market Operations Function.

Effective January 1, 1986:

Ralph A. Cann, III, Vice President, formerly assigned to the Fiscal Services Function, was assigned to the Accounting Function.

Whitney R. Irwin, formerly Senior Bank Services Officer, was appointed Vice President and assigned to the Fiscal Services Function.

The Bank Supervision Function was restructured as the Bank Supervision Group, consisting of the Bank Examinations, Banking Applications, and Banking Studies and Analysis Functions. In this connection:

Frederick C. Schadrack, Senior Vice President, was assigned responsibility for the Group.

Chester B. Feldberg, Senior Vice President, was assigned responsibility for the Bank Examinations and Banking Applications Functions, continuing as the officer in charge of the Loans and Credits Function.

William L. Rutledge, Vice President, was assigned to the Banking Applications Function.

J. Andrew Spindler, Vice President, was assigned responsibility for the Banking Studies and Analysis Function.

Directors of the Federal Reserve Bank of New York

DIRECTORS	<i>Term expires Dec. 31</i>	<i>Class</i>
T. JOSEPH SEMROD Chairman of the Board, United Jersey Bank, Hackensack, N.J.	1986	A
ROBERT W. MOYER President and Chief Executive Officer, Wilber National Bank, Oneonta, N.Y.	1987	A
LEWIS T. PRESTON Chairman of the Board, Morgan Guaranty Trust Company of New York, New York, N.Y.	1988	A
JOHN R. OPEL Chairman of the Board, International Business Machines Corporation, Armonk, N.Y.	1986	B
JOHN F. WELCH, JR. Chairman of the Board, General Electric Company, Fairfield, Conn.	1987	B
RICHARD L. GELB Chairman of the Board, Bristol-Myers Company, New York, N.Y.	1988	B
CLIFTON R. WHARTON, JR., <i>Deputy Chairman</i> Chancellor, State University of New York System, Albany, N.Y.	1986	C
VIRGINIA A. DWYER Senior Vice President-Finance, American Telephone and Telegraph Company, New York, N.Y.	1987	C
JOHN BRADEMAS, <i>Chairman and Federal Reserve Agent</i> President, New York University, New York, N.Y.	1988	C

DIRECTORS — BUFFALO BRANCH

MATTHEW AUGUSTINE President and Chief Executive Officer, Eltrex Industries, Inc., Rochester, N.Y.	1986
HERBERT FORT President, The Bath National Bank, Bath, N.Y.	1986
ROSS B. KENZIE Chairman of the Board, Goldome FSB, Buffalo, N.Y.	1987
JOSEPH YANTOMASI UAW Consultant, United Auto Workers, Region No. 9, Buffalo, N.Y.	1987
R. CARLOS CARBALLADA President and Chief Executive Officer, Central Trust Company, Rochester, N.Y.	1988
MARY ANN LAMBERTSEN, <i>Chairman</i> Vice President-Human Resources, Fisher-Price Division of The Quaker Oats Company, East Aurora, N.Y.	1988
DONALD I. WICKHAM President, Tri-Way Farms, Inc., Stanley, N.Y.	1988

MEMBER OF FEDERAL ADVISORY COUNCIL—1986

JOHN F. MCGILLICUDDY Chairman of the Board, Manufacturers Hanover Trust Company, New York, N.Y.	1986
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Officers of the Federal Reserve Bank of New York

E. GERALD CORRIGAN, *President*
THOMAS M. TIMLEN, *First Vice President*

SAM Y. CROSS, *Executive Vice President*
Foreign

PETER FOUSEK, *Executive Vice President*
and *Director of Research*
Research and Statistics

JAMES H. OLTMAN, *Executive Vice President*
and *General Counsel*
Administrative Services; Legal; Management Planning

PETER D. STERNLIGHT, *Executive Vice President*
Open Market Operations

AUDIT

JOHN E. FLANAGAN, *General Auditor*
ROBERT J. AMBROSE, *Assistant General Auditor*
LORETTA G. ANSBRO, *Audit Officer*
EDWARD J. CHURNEY, *Manager*,
Auditing Department
H. ALLAN VIRGINIA, *Manager*,
Audit Analysis Department

ADMINISTRATIVE SERVICES GROUP

JAMES H. OLTMAN, *Executive Vice President*
and *General Counsel*
EDWIN R. POWERS, *Vice President*
JEROME P. PERLONGO, *Manager (Night Officer)*

ACCOUNTING

RALPH A. CANN, III, *Vice President*
LEON R. HOLMES, *Assistant Vice President*
DONALD R. ANDERSON, *Manager*,
Accounting Department
JOSEPH R. PRANCL, JR., *Manager*,
Accounting Department

SERVICE

JOHN M. EIGHMY, *Vice President*
RONALD E. LONG, *Assistant Vice President*
JOSEPH C. MEEHAN, *Manager*,
Building Services Department
JASON M. STERN, *Manager*,
Administrative Support Services Department
RUTH ANN TYLER, *Manager*,
Food and Office Services Department

AUTOMATION AND ELECTRONIC PAYMENTS GROUP

ISRAEL SENDROVIC, *Senior Vice President*

DATA PROCESSING

PETER J. FULLEN, *Vice President*
HOWARD F. CRUMB, *Assistant Vice President*
RONALD J. CLARK, *Assistant Vice President*
GEORGE LUKOWICZ, *Assistant Vice President*
JAMES H. GAVER, *Manager*,
General Purpose Computer Department
PETER M. GORDON, *Manager*,
Telecommunications Operations Department
JOHN C. HEIDELBERGER, *Manager (Evening Officer)*
KENNETH M. LEFFLER, *Manager*,
Analytical Computer Department

ELECTRONIC PAYMENTS

JORGE A. BRATHWAITE, *Vice President*
CAROL W. BARRETT, *Vice President*
HENRY F. WIENER, *Assistant Vice President*
H. JOHN COSTALOS, *Assistant Product Manager*
(*Securities Services*)
ANDREW HEIKAUS, *Manager*,
Funds Transfer Department
FREDERICK P. SHIELDS, *Manager*,
Securities Transfer Department

SYSTEMS DEVELOPMENT

SUSAN C. YOUNG, *Vice President*
OM P. BAGARIA, *Assistant Vice President*
BARBARA R. BUTLER, *Assistant Vice President*
PATRICIA Y. JUNG, *Assistant Vice President*
VIERA A. CROUT, *Manager*,
Common Systems Department
IRA KAHNER, *Manager*,
Data Systems Department
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