Federal Reserve Bank Of San Francisco

1994 Annual Report

Table of Contents

The Federal Reserve Bank of San Francisco is one of twelve 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.

From the Boardroom

From left, James A. Vohs, Chairman (1994), Robert T. Parry, President, Judith M. Runstad, Chairman (1995), and Patrick K. Barron, First Vice President.

Painting in background:
Nathan Oliveira
Yucatan Sequence Figure #1 1982
oil on canvas 84 x 66"

The robust economy in much of the West during 1994 was reflected in the strong performance of banking throughout most of the Twelfth District. District banks in Nevada, Oregon, Washington, Alaska, and Idaho recorded exceptional performances. In California, the turnaround in the economy also helped boost bank earnings, though the state's economy was not yet strong enough to keep many community banks from experiencing weak returns.

Bank credit conditions in the District improved considerably, with consumer lending outside of California and Hawaii especially strong. The most notable development in lending for the District, and for the nation, was the rebound in business loans at banks.

The accompanying report on banking in the Twelfth District notes that while short-term factors continue to cause ebbs and flows in banking, it is the longer-term trends that are shaping the future of the industry. These trends include the fundamental revolution in the processing of risk information and innovations in the field of finance. These developments have heightened competition both outside and within banking, putting a premium on efficiency and broadening the horizons of financial services. One response has been consolidation in banking with interstate banking an important aspect of this. Banks in the District also continue to adapt by expanding fee-based products and services, including in less traditional areas, such as investment services.

The Report discusses the performance of the banking industry in the Twelfth District during 1994, various actions District banks are taking to meet the many challenges facing them, and the opportunities for legislated banking reform in this ever-changing environment.

It is imperative that, as the central bank, we strive to anticipate and meet the needs of our financial system in this dynamic economic and regulatory environment. The supervision and regulation of bank holding companies and state-chartered member banks is a vital area of our responsibility. As this Report indicates, maintaining a safe and sound financial system is becoming an increasingly complex task. Our goals continue to be the prudent supervision of financial institutions along with monitoring compliance with community development and reinvestment legislation throughout the Twelfth District. In wholesale banking, we continue to enhance the quality, safety, and efficiency of our payments system to benefit financial institutions and their customers in all market segments.

This Report reviews the Bank's performance in responding to new challenges and achieving our fundamental objectives during 1994.

We would like to extend our thanks and appreciation to our Twelfth District directors for their invaluable counsel during 1994. The Directors' independent assessment of economic and financial conditions throughout our nine western states is critical to the formulation of monetary policy.

In particular, we acknowledge the many contributions of James A. Vohs, (Chairman and Chief Executive Officer, retired, of Kaiser Foundation Health Plan, Inc., and Kaiser Foundation Hospitals, Oakland) who stepped down as Chairman of the San Francisco Head Office Board at the end of the year after serving in this post for three years. We are delighted that he will continue to serve the Bank as Deputy Chairman of the Board in 1995.

We also would like to express our sincere thanks and appreciation to those directors who completed their terms of service during 1994: On the San Francisco Head Office Board, William E.B. Siart (Chairman and Chief Executive Officer, First Interstate Bancorp, Los Angeles, CA), William L. Tooley (Chairman, Tooley & Company, Los Angeles, CA); on the Portland Branch Board, its Chairman, William A. Hilliard (Editor, retired, The Oregonian, Portland, OR), Stuart H. Compton (Chairman, Pioneer Trust Bank, N.A., Salem, OR); and, on the Federal Advisory Council, Twelfth District Member and President, Richard M. Rosenberg (Chairman and Chief Executive Officer, BankAmerica Corporation, San Francisco, CA).

Judith M. Runstad	Robert T. Parry
Chairman	President

Western Banking: Adapting to the Challenge of Change

In 1994, banking in the Twelfth Federal Reserve District continued its rebound, with banks reporting record earnings as well as increases in lending. Banking also continued to adapt to changes in financial markets, changes driven and shaped by technological innovations and regulations. This section examines the recent performance of banks in the Twelfth District, focusing on the effects of the growth in the regional economy and the rise in market interest rates. In addition, this section discusses the adaptations District banks are making and the opportunities for legislated banking reform in the changing environment.

Banking in the West turned in a strong performance in 1994. Banks in the Twelfth Federal Reserve District registered record profits, improved their asset quality, and maintained the strong capital positions built up over the past few years.

The performance of banking mirrored the robust economic expansion in most of the region. The long-awaited turnaround in the California economy also contributed to improved banking conditions, though it was not enough to keep many community banks in the state from weak performances. The sharp rise in interest rates spawned by the strong national economy in 1994 had only a small negative effect on reported bank earnings in the District.

A rebound in bank lending in 1994 proved reports of the demise of traditional banking to be exaggerated. Buoyed by strong bank capital positions and economic growth, credit conditions in the District improved considerably after the so-called credit crunch of the early 1990s.

Looking ahead to the 21st century, banking in the District and elsewhere will continue to be under pressure to adapt. Efficiency will remain critical, calling for continued cost-cutting and consolidation even in the wake of strong bank earnings. Furthermore, innovations that have dramatically reduced the cost of amassing and disseminating information related to financial risk, as well as the cost of measuring, evaluating, and managing risk, will mean greater competition in traditional bank business lines, from both outside and within the industry. Similar forces are behind the greater emphasis by banks on fee-based products and services.

The pace of banking's evolution in financial services, however, is still hobbled by regulatory legacies from the 1930s. The most symbolic example is the Glass-Steagall Act. Today, key parts of this barrier have been eroded--larger banks, including some in this District, can underwrite securities, and a broad array of banks offers investment services and mutual funds. Still, limits remain on this and other fronts.

Another example is deposit insurance. With the collapse of the FSLIC from the thrift crisis and the heavy losses to the FDIC from bank failures in recent years, policymakers have been acutely sensitive to the dangers of extending deposit insurance coverage. Public policy, however, also needs to be concerned with efficiency in financial markets. In recent years developments have tipped the balance between these two considerations. This should open the way to giving more weight to the potential gains in efficiency from further removing barriers separating financial institutions.

Record Earnings

The strong economic recovery in most of the region and the long-awaited turnaround in California helped push up net income for banks in the Twelfth District in 1994. Profits among District banks through September of 1994 were $4.6 billion, up from a strong $4 billion for the comparable period in 1993. Annualized, the earnings in 1994 represent an aggregate return on assets (ROA) of 1.19 percent. That was a record rate for the District and marked last year as the first since 1990 that District bank performance at least matched the national average.

Within the District, banks in Nevada, Oregon, Washington, [illegible], and Idaho recorded exceptional performances, with aggregate ROAs of better than 1.50 percent. In Utah and Hawaii, aggregate ROAs for banks were only a bit below the national average. In Arizona, despite strong economic growth in 1994, aggregate bank earnings were [illegible] below the national average, due [illegible] to isolated losses on sales of assets.

In California, which accounts for close to [illegible] percent of banking assets in the District, the recovery helped to boost bank performance, with an aggregate ROA for the banks in the state of [illegible] (annualized) through the third quarter of 1994. [illegible] 1994, however, was due to the profitability of the large institutions in the state.

The drag on bank performance in California was apparent at smaller banks. Community banks (institutions with assets under $500 million) in California reported an annualized ROA of only 0.56 percent through the third quarter of 1994. Community banks operating in Southern California, the area hit hardest during the recession, fared worse as a group, barely breaking even in the first three quarters of 1994. Overall, nearly 20 percent of the banks in California lost money in the first three quarters of 1994. That is well above the national figure of 4 percent and is indicative of the lingering effects of nearly three years of recession in the state.

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Within the District, banks in Nevada, Oregon, Washington, Alaska, and Idaho recorded exceptional performances, with aggregate ROAs of better than 1.30 percent. In Utah and Hawaii, aggregate ROAs for banks were only a bit below the national average. In Arizona, which had strong economic growth in 1994, aggregate bank earnings were well below the national average, due in part to isolated losses on sales of securities.

In California, which accounts for close to 65 percent of banking assets in the District, the recovery helped to boost bank performance, with an aggregate ROA for the banks in the state of 1 percent (annualized) through the third quarter of 1994. Much of the strength in earnings in 1994, however, was due to the profitability of the large institutions in the state.

The drag on bank performance in California was apparent at smaller banks. Community banks (institutions with assets under $300 million) in California reported an annualized ROA of only 0.36 percent through the third quarter of 1994. Community banks operating in Southern California, the area hit hardest during the recession, fared worse as a group, barely breaking even in the first three quarters of 1994. Overall, nearly 20 percent of the banks in California lost money in the first three quarters of 1994. That is well above the national figure of 4 percent and is indicative of the lingering effects of the nearly three years of recession in the state.

Asset Quality Plays a Key Role

The economy gave District banking its biggest boost through an improvement in asset quality. Growth in the economy strengthened the financial position of borrowers and helped stabilize the value of collateral backing bank loans. As a result, problem loans as a percent of total loans have been coming down in the District.

Outside of California, overall loan quality generally was quite good, with total problem loan ratios below the comparable U.S. ratios. Moreover, only some states continued to report relatively poor asset quality for specific types of loans, such as Alaska's construction loans, Arizona's and Nevada's commercial real estate loans, and Hawaii's residential mortgage and business loans.

In California, asset quality improved across the board. The problem loan ratios for business and consumer loans dropped to levels close to the national averages. However, with the slower growth in the California economy, the aggregate problem real estate loan ratio remained above the national average and continues to be a drag on bank performance. This is particularly true for community banks in Southern California, many of which have both a high dependency on real estate loans and a relatively high proportion of problem real estate loans.

The bottom-line impact from the overall improvement in asset quality was a sizable reduction in banks' expenses for contributions to loan loss reserves. For the first three quarters of 1994, expenses for loan losses for District banks were about $1 billion less than for the comparable period in 1993. Western banks also reduced their holdings of real estate obtained through defaults on loans, as they "cleaned up" their balance sheets by selling off those nonearning assets.

Rise in Interest Rates

The strong national economy pushed up short- and long-term interest rates in 1994. While the jumps in rates were sizable--250 basis points on 3-month

Treasury bills and 200 basis points on 10-year Treasuries--they had little net effect on the aggregate performance of banking in the District during 1994.

One reason is that the rise in the average yield on banks' assets kept pace with the increase in the cost of bank funding. In the District, net interest margins, which have been relatively high in recent years, narrowed only slightly, and then mainly at the region's larger banks. Smaller banks as a group actually reported wider margins in the western states, other than Hawaii.

Another reason is that realized and unrealized losses on securities were limited. For the District as a whole, banks reported a net realized loss from securities sales of only $79 million through the third quarter of 1994, compared to a net gain of $128 million for the same period in 1993. Only a limited number of banks in the District had losses from securities sales that materially affected earnings, and only in Arizona were the isolated losses large enough to have a noticeable effect on aggregate earnings.

The bigger impact on banks was from unrealized losses on securities. Banks currently report unrealized losses on securities classified as available-for-sale. District banks held about $53 billion in available-for-sale securities as of September 1994, which was about 62 percent of their total investment securities. The unrealized losses reported through the third quarter were about $500 million. While the unrealized losses were larger than the realized losses, they still were relatively small. Unrealized losses in 1994, for example, represented only about 1 percent of total equity capital for banks in the District. Moreover, even if District banks had booked these losses in 1994, earnings still would have been on a par with their strong 1993 performance.

Capital Remains Strong

Capitalization is another indicator of financial strength for banking in the District. With higher earnings in 1994, banks in the District were able to maintain the strong capital positions that they had rebuilt in recent years, while also increasing dividends and buying back equity. As of September 1994, average Tier 1 and total risk-based capital ratios in the District were 9.9 percent and 12.9 percent, respectively. These figures are just below the high national averages, and compare favorably with the regulatory guidelines for identifying well-capitalized banks--the guidelines include a Tier 1 ratio of 6 percent and a total capital ratio of 10 percent. Within the District, 97 percent of bank assets were held by banks that met or exceeded these guidelines for well-capitalized institutions.

II. Rebound in Lending

Bank credit conditions in the District also improved considerably in 1994. Strong capital positions and a reservoir of liquid assets allowed banks to respond to the increase in the demand for credit. Total loans in the District rose by close to 6-3/4 percent from September 1993 to September 1994, following a contraction of over 3-1/2 percent during the previous 12 months.

Several District states experienced exceptionally strong loan growth. In Arizona, Idaho, Nevada, Oregon, Utah, and Washington, total loan growth was over [illegible] percent, compared to the national average of around 8-1/2 percent. However, in Hawaii, soft economic conditions limited loan growth, and bank loan growth in Alaska fell [illegible] in 1994. In California, both the economic recovery and the turnaround in bank lending lagged the rest of the District. As a result, bank loans for the state in September 1994 were only about 3 percent above the level a year earlier. Nevertheless, that was a marked improvement from the 3 percent decline the previous year.

Consumer lending by banks in the District outside of California and Hawaii was especially strong, as households resumed their borrowing to finance an increase in spending. Real estate lending also was strong in the faster-growing states in the District.

Perhaps the most notable development in lending for the District, and for the nation, was the rebound in business loans at banks. Competition in the market for business credit has been intense for some time, driving down the banks' share of non-mortgage business lending over the past several years. This longer-run trend made it difficult to predict when and how much commercial and industrial loans at banks would recover after contracting during most of the 1990s.

Beginning in late 1993, however, business loans at banks began to turn up in the West and in the nation. From September 1993 to September 1994, business credit extended by District banks increased by more than 5 percent. That was less than

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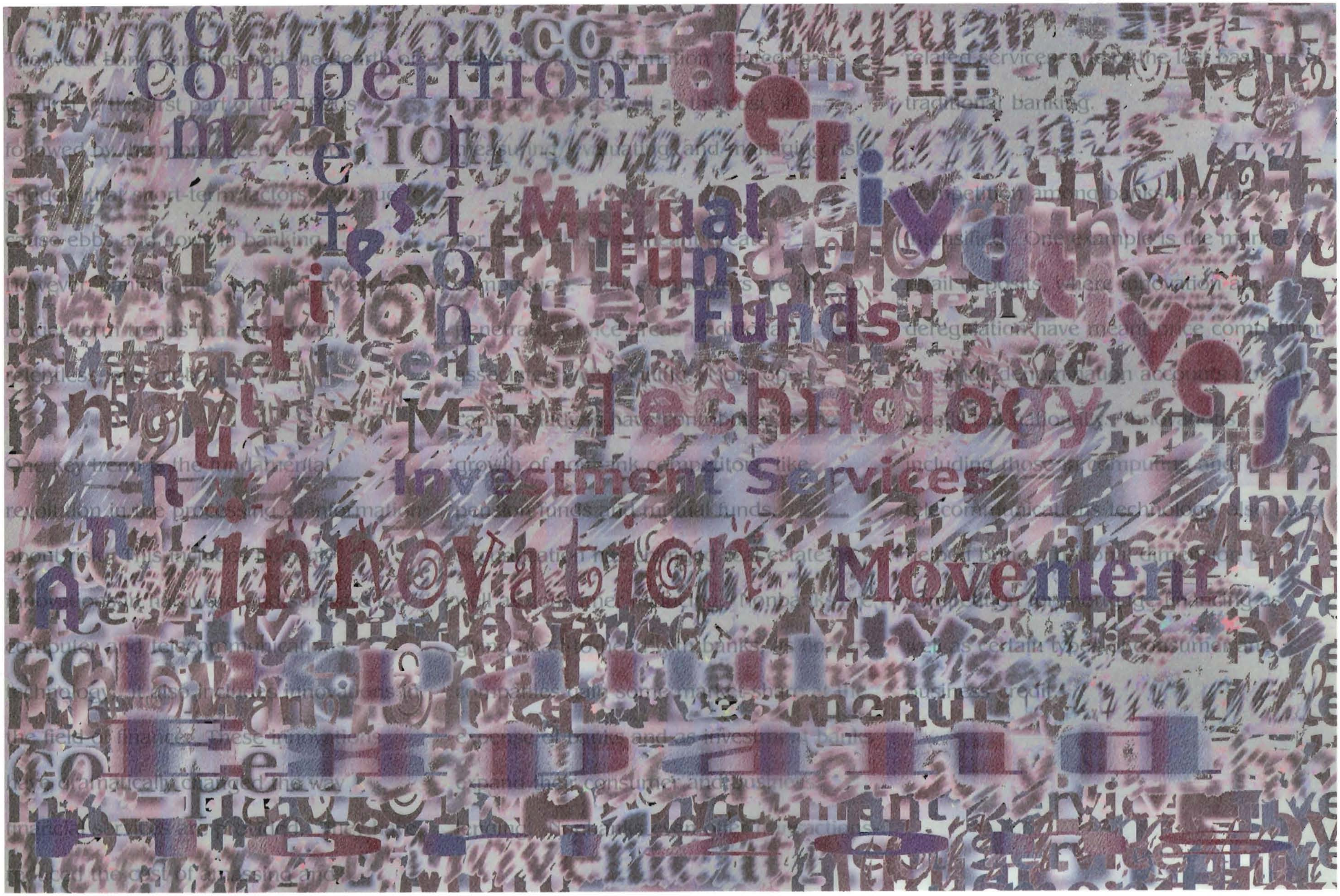
The timing of the bounceback in bank business lending is roughly consistent with the usual lagged response to an upturn in the economy, though the lag was on the long side. It also reflects the influence of other cyclical or transitory factors. One is the shift back to shorter-term financing by businesses in response to the rise in interest rates. Another is the slowing of the balance sheet restructuring by businesses, which apparently contributed to the weakness in the overall demand for business credit in recent years.


competition
Mutual
Funds
Technology
Investment Services
Innovation
Movement

The weak bank earnings and the dearth of lending in the first part of the 1990s followed by the more recent rebound suggest that short-term factors continue to cause ebbs and flows in banking. However, banking also is being driven by longer-term trends that are broad, relentless, and global.

One key trend is the fundamental revolution in the processing of information about risk. This includes not only innovations in hardware and software for computer and telecommunications technology; it also includes innovations in the field of finance. These innovations have dramatically changed the way financial services are provided. They have reduced the cost of amassing and disseminating information related to financial risk, as well as the cost of measuring, evaluating, and managing risk.

For banks this has meant greater competition. New competitors are able to penetrate service areas traditionally associated with banking. More open capital markets have contributed to the growth of nonbank competitors, like pension funds and mutual funds. Securitization has changed real estate as well as consumer financing. Nonbanks are going head-to-head with banks, as finance companies gain some market share at the expense of banks and as investment banks expand their consumer and business lending. Nonbanks even offer transactions-related services, one of the last bastions of traditional banking.

Competition among banks also has intensified. One example is the market for retail deposits, where innovation and deregulation have meant price competition for small-denomination accounts not only locally but nationally. Innovations, including those in computing and telecommunications technology, also have helped bring a national dimension to competition for mortgage financing as well as certain types of consumer and business credit.

Structural Changes

The competition from outside and from within banking is putting a premium on efficiency and broadening the horizons of financial services. One response has been consolidation in banking itself. While the evidence of the effects of bank mergers on efficiency is mixed, cost reduction remains part of the force driving consolidation in banking. For the District, the result has been around a 20 percent net reduction in the number of banks since the mid-1980s. In 1994, banking consolidation continued in the District with 45 mergers.

Interstate banking has been an important dimension of the consolidation trend. In the District, Alaska, Arizona, Idaho, Nevada, Oregon, and Utah allow entry by holding companies from all the other states in the country, while California and Washington allow access on a reciprocal basis. Alaska and Oregon also permit interstate branching. Only Hawaii still prohibits acquisitions of commercial banks by out-of-state holding companies (though even there a bank holding company has entered through the acquisition of a thrift). Though interstate banking in the West is open to holding companies nationally, most cross-border banking in the region has been initiated by holding companies with headquarters in the District.

The merger activity in the District has altered the banking landscape, changing the names on banking offices from Alaska to Arizona. For states like Arizona, Nevada and Washington, the lion's share of banking is controlled by out-of-state holding companies. Districtwide, consolidation has meant some increase in concentration among the top few banking organizations. Many local banking markets in the District, though, have had either stable or declining levels of concentration. This has been due in part to entry by new banks and the tendency for smaller competitors to gain market share. Another reason is interstate acquisitions generally do not reduce the number of competitors in local markets. Rather, these, and other market extension mergers, expand lending and funding opportunities and allow for greater diversification. The recent adoption of federal legislation authorizing interstate branching also gives holding companies the opportunity to reduce cost by consolidating their interstate operations in coming years.

Pressures to lower overhead costs in the District also are evident in the decline in the number of bank branches and other costs, particularly in California. Over the past few years, the number of branches in California has dropped by more than 600, or about 13 percent. California banks also have cut payroll costs, including a 1.3 percent cut in the first three quarters of 1994. In other parts of the District, rapid economic growth has eased immediate pressures to reduce the number of banking offices. For the same reason, outside of California salaries and benefits at District banks rose in 1994, but by less than assets and earnings did.

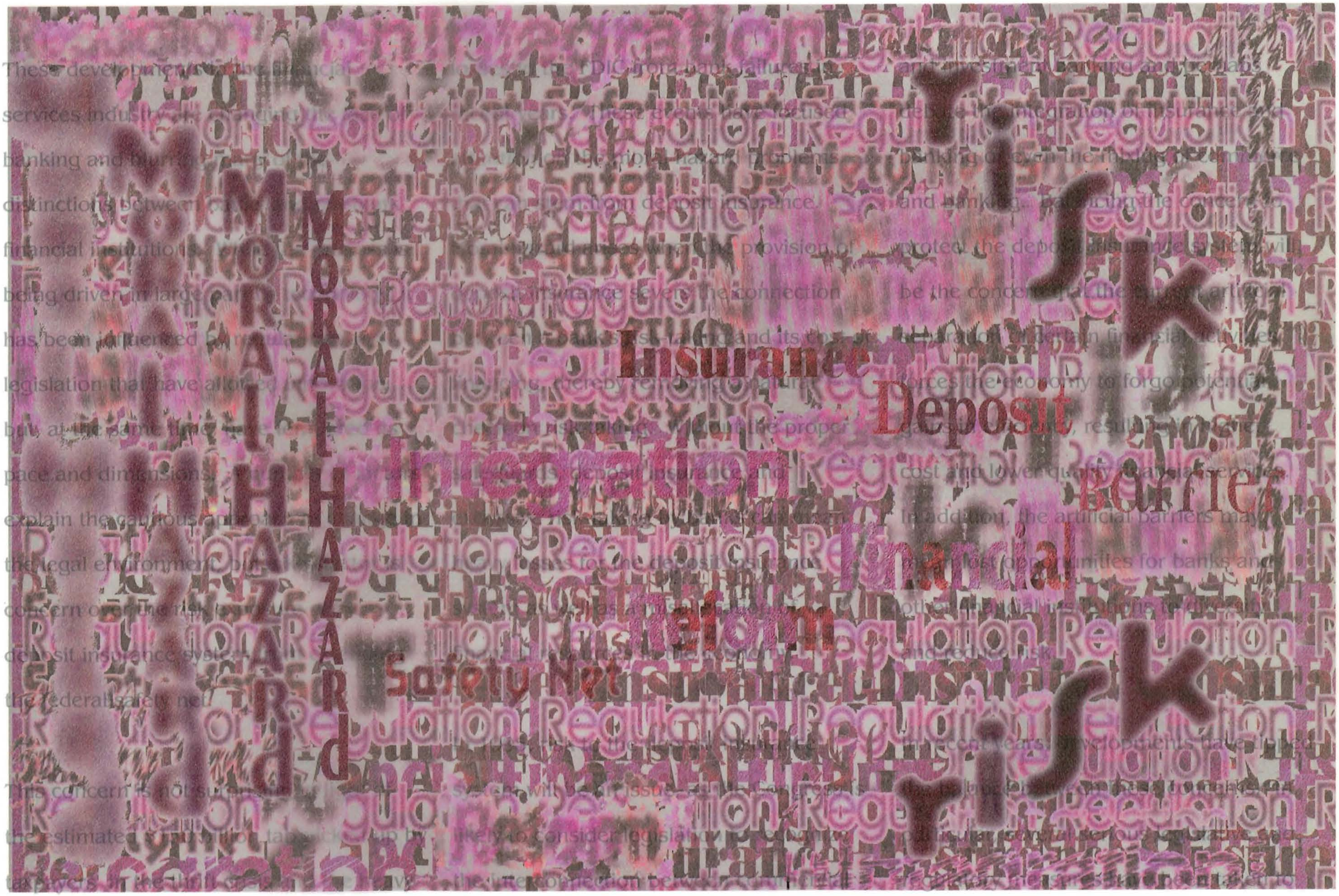
Fee-based Banking

Banks also continue to adapt by expanding fee-based products and services. The bulk of this activity is related directly to traditional bank credit and deposit services. Among these, certain off-balance sheet credit services have outpaced on-balance sheet lending. Over the 12 months ending September 1994, for example, loan commitments in the District were up 18 percent and letters of credit rose by 13 percent, compared to the 6-3/4 percent rise in loans. In addition, banks in the District garnered a large portion of their noninterest income from charges for loan servicing and for deposit and trust services.

Beyond these services, banks in the West are joining the move into less traditional areas, like investment services. Although only the largest banks are involved in securities underwriting, a broader base of the banking industry is generating fees from offering other services. In the District, one-quarter of the banks are now providing their customers with mutual funds and/or annuity products as alternatives to traditional deposit products. These include a number of smaller institutions; for example, the median size of bank offering mutual funds is about $200 million. Still, mutual fund sales in the District are dominated by a few large institutions. The top 10 banks in the District accounted for around 90 percent of the close to $55 billion in mutual fund sales at western banks in the first nine months of 1994. For the District as a whole, gross fee income from the mutual funds and annuities was $225 million, or a little less than 3 percent of total noninterest income.

Another fast-growing set of off-balance sheet items is financial derivatives. These consist of interest rate and foreign exchange rate contracts--including options, swaps, futures, and forwards. (Banks also hold on-balance sheet derivative instruments such as collateralized mortgage obligations and structured notes.) Some large banks enter into the off-balance sheet contracts on behalf of their customers, including other banks, while banks of all sizes use the derivatives as part of their own trading activities and for managing portfolio risk.

As a group, District banks tend to be relatively less active than banks nationally in providing and using off-balance sheet instruments. In September 1994, for example, District banks accounted for about 10 percent of the $15-1/2 trillion in notional value of interest rate and exchange rate contracts reported by banks nationally, compared with about a 14 percent share of banking assets. Although banks in the District as small as around $50 million in assets use off-balance sheet derivatives, their use currently is concentrated in a few large institutions. In the District, about 10 percent of the banks reported having off-balance sheet interest rate and foreign exchange rate contracts. The median asset size for those banks was $1.6 billion, and the top ten banks accounted for about 97 percent of the notional value of interest rate and exchange rate contracts as of September 1994.


Integration
Regulation
risk
MORAL HAZARD
Safety Net
Insurance
Deposit
Integration
Barrier
Financial
Reform
Safety Net
risk

These developments in the financial services industry are changing the face of banking and blurring many of the distinctions between banks and nonbank financial institutions. While the process is being driven in large part by technology, it has been influenced by regulations and legislation that have allowed innovation, but, at the same time, have tempered its pace and dimensions. A number of factors explain the cautious approach to change in the legal environment, but a key factor is concern over the risk exposure of the deposit insurance system from extending the federal safety net.

This concern is not surprising in light of the estimated $150 billion tab picked up by taxpayers in the thrift crisis and the heavy losses to the FDIC from bank failures in recent years. These events have focused attention on the moral hazard problems that can stem from deposit insurance. Moral hazard arises when the provision of deposit insurance severs the connection between a bank's risk-taking and its cost of financing, thereby removing a natural check on risk-taking. Without the proper safeguards, deposit insurance and excessive risk-taking by banks can mean heavy losses for the deposit insurance system as well as a misallocation of financial resources in the economy.

In 1995, risk to the deposit insurance system will be an issue, as the Congress is likely to consider legislation to recognize the interconnection between commercial and investment banking and perhaps debate the integration of insurance and banking or even the mixing of commerce and banking. Balancing the concern to protect the deposit insurance system will be the concern that the current artificial separation of certain financial activities forces the economy to forgo potential gains in efficiency, resulting in higher cost and lower quality financial services. In addition, the artificial barriers may mean lost opportunities for banks and other financial institutions to diversify and reduce risk.

In recent years, developments have tipped the balance between these concerns. In particular, several serious legislative and regulatory measures have been taken to deal with risk in banking and the exposure of the deposit insurance system. What these measures have in common is the goal of putting the consequences of bank decision-making, the downside and the upside, on the shoulders of the banks and of some of their liability holders. These measures include having uninsured depositors regularly bear losses when banks fail, adopting a depositor preference rule, enacting Prompt Corrective Action, accounting explicitly for the market-value of some bank assets and liabilities, as well as setting risk-based deposit insurance premiums.

The most far-reaching change, though, has been the recapitalization of the banking industry. The capital position of the banking industry today is far stronger than it was just three years ago, as banks have responded both to regulatory efforts and to market pressure to raise their level of capital. Banks issued equity and longer-term debt and used retained earnings to recapitalize. In addition, strengthened balance sheets and an improved outlook for banking have been reflected in the rise in bank stock prices from the depressed levels of the early 1990s.

The effect of this turnaround in bank capitalization has been a tremendous increase in the buffer between potential private losses in banking and the deposit insurance system. It is difficult to estimate precisely the value of deposit insurance, but available estimates suggest that well-capitalized banks likely present a minimal risk for the deposit insurance system. While a bank's capital position can deteriorate, the impact on the insurance system can be controlled if actions are taken promptly and if those actions are based on measures that reflect the true value of a bank's assets and liabilities.

These developments should mitigate concerns over the deposit insurance system, and perhaps tip the balance of the legislative agenda more toward the potential gains from removing barriers separating financial institutions.

Robert T. Parry, President and Chief Executive Officer

Patrick K. Barron, First Vice President and Chief Operating Officer

Jack H. Beebe, Senior Vice President and Director

Sara K. Garrison, Senior Vice President

Michael J. Murray, Senior Vice President

Terry S. Schwakopf, Senior Vice President

Laurence Washtien, Senior Vice President

S. Jean Hinrichs, General Auditor

Robert D. Mulford, Vice President and General Counsel

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John Y. C. Lin, Director

Susan G. Porterfield, Director

Wayne L. Rickards, Director

Kenneth M. Kinoshita, Associate General Counsel

Paige Birdsall, Assistant Vice President

Sylvia A. Cunningham, Assistant Vice President

Peter K. C. Hsieh, Assistant Vice President

John S. Hsiao, Assistant Vice President

Deborah S. Jackson-Duke, Assistant Vice President

Robert C. Johnson, Assistant Vice President

Ellsworth E. Lund, Jr., Assistant Vice President

Thomas P. McGrath, Assistant Vice President

Elizabeth M. O'Shea, Assistant Vice President

Gail G. Quarles, Assistant Vice President

Philip M. Ryan, Assistant Vice President

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Susan A. Sutherland, Assistant Vice President

James J. Tenge, Assistant Vice President

Thomas R. Thaanum, Assistant Vice President

David M. Vandre, Assistant Vice President

Kelly K. Walsh, Assistant Vice President

Beverley-Ann Hawkins, Automation Officer

Lelia M. Jones, Examining Officer

Mark Levonian, Research Officer

Brian Motley, Research Officer

Gary P. Palmer, Financial Analysis Officer

Glenn D. Rudebusch, Research Officer

Bharat Trehan, Research Officer

Dale L. Vaughan, Examining Officer

David W. Walker, Examining Officer

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Portland Branch

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Mary E. Lee, Assistant Vice President

Robert D. Long, Assistant Vice President

Robin A. Rockwood, Assistant Vice President

Seattle

Gale P. Ansell, Assistant Vice President

Jimmy F. Kamada, Assistant Vice President

Kenneth L. Peterson, Assistant Vice President

Salt Lake City

Andrea P. Wolcott, Vice President

Gerald R. Dalling, Assistant Vice President

Jed W. Bodily, Officer

Richard B. Hornsby, Officer

Los Angeles Branch

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Sean J. Rodriguez, Vice President

Anthony Fabian, Director

Nancy Olmstead, Director

Darcy J. Coulter, Assistant Vice President

Brent M. Duxbury, Assistant Vice President

Rachel A. Romero, Assistant Vice President

Mary Rector, Officer

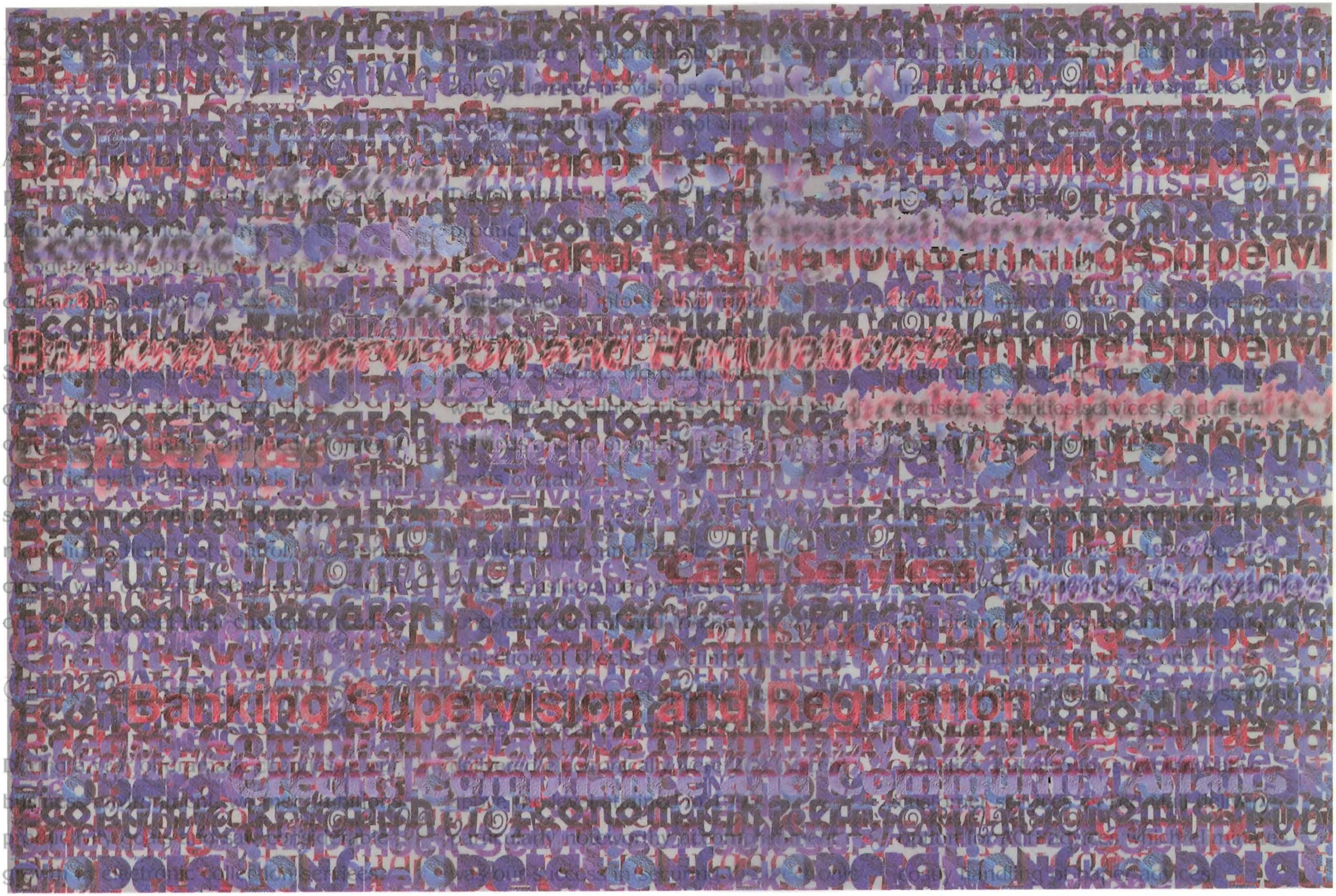
Senior Officers Retire

Three of the Bank's senior officers with combined service of nearly 90 years elected to participate in the early retirement program offered during 1994.

E. Ronald Liggett, Senior Vice President of the Northern Region, retired July 1. During his 37-year career, Liggett served in the Portland, Seattle, and Salt Lake City offices.

Thomas D. Thomson, Executive Vice President of Central Bank Functions, served the Federal Reserve Bank both at the Board of Governors in Washington, D. C. and in San Francisco before retiring February 1, 1995. Thomson began his Reserve Bank career as an economist at the Board, then worked in commercial banking for a dozen years before returning to the Fed in San Francisco.

Eugene A. Thomas, Senior Vice President of Supervision, Regulation and Credit, joined the Federal Reserve Bank of San Francisco in 1960 and retired February 1, 1995. Thomas held positions in the Portland and Los Angeles offices before heading the Supervision, Regulation, and Credit areas in San Francisco.



Operations and Financial Services

As a major provider of financial and payments services, the Federal Reserve Bank of San Francisco strives to be recognized for operational excellence, outstanding customer service, and leadership within the Federal Reserve System and the financial services community. In keeping with these objectives, the Bank continued its pursuit of efficiency and higher levels of customer service by upgrading automation, maintaining tight cost control, and working closely with our customers to ensure that our services meet their changing needs.

Check Services

During a year of dramatic changes in our business environment, we met ambitious productivity goals and saw considerable growth in electronic collection services. The January implementation of the same-day settlement provisions of Regulation CC led to a significant, but not unanticipated, decline in the volume of checks processed. Despite these losses, we increased productivity and reduced direct costs by more than 10 percent. As a result, the District moved into the top ranks of productivity performance in the Federal Reserve System. More importantly, we were able to reduce prices on a number of services and to maintain prices at 1993 levels overall.

In addition to our efficiency gains, we made considerable progress toward our long-term goal of end-to-end electronic collection of checks by refining products and services to meet specific customer needs. At year-end, volumes of items delivered electronically were 200 percent above the level attained in 1993. A particularly noteworthy accomplishment was our success in securing the electronic collection business of a large financial institution with multi-state operations.

Electronic Payments and Fiscal Agency

The focus on efficiency, quality, and continual improvement in customer service was evident in the performance of the automated clearing house (ACH), funds transfer, securities services, and fiscal agency operations in 1994.

ACH Service registered exceptional financial performance in 1994, due to careful management of costs and staffing and dramatic improvement in productivity. Our District now stands as one of the leaders in the Federal Reserve System not only in terms of these performance statistics, but also for such innovative customer services as Fed-Mail delivery option for ACH advices which eliminates costly handling of paper advices.

As part of a multi-year effort to centralize and upgrade the computer processing systems for the Federal Reserve's key electronic payments services, we moved our Funds Transfer Service to new nationwide software. As the first District with a sizeable customer base and significant wire transfer volume to shift to this system, we played a major role in identifying and resolving issues that will speed the process for other Districts. This new system will improve funds availability nationwide, enhance reliability and recovery time, and ensure a consistent, high level of funds transfer service.

Improved productivity and highly responsive customer service were evident in Fiscal Agency and Securities Services operations. Rapidly rising interest rates brought a dramatic increase in the public's demand for short- and medium-term Treasury securities and a corresponding increase in the volume of inquiries and tenders. At times, the volume of tenders processed in the Twelfth District exceeded that of all other Districts, including New York. By reevaluating our operations and improving efficiency, we were able to accommodate this surge in volume and improve overall service.

Cash Services . . .

In 1994 Cash Services made further progress in a multi-year effort to upgrade automation, efficiency, and customer service. The renovation of all five offices' facilities and the installation of new, second-generation currency processing equipment moved forward at a rapid pace. Nine machines were installed, bringing the total to 12 and marking the midway point in our conversion process. The Salt Lake City office was fully converted early in the year and served as a national test site for improving the processing of poor quality currency. These second-generation machines will increase currency throughput, enhance counterfeit detection capabilities, and provide for more effective monitoring of deposit quality.

The Bank also continued its efforts toward the installation of an automated materials handling system in the vaults of our San Francisco and Los Angeles offices. Delays encountered in integrating the automated storage and retrieval devices with the newly installed rack led to the use of manually operated vehicles for storage and retrieval purposes. In 1995 the Bank will work with the vendor to obtain the full benefits of an automated environment.

Despite these challenges of automation, our District continued to deliver a high level of customer service. For example, our Los Angeles office accommodated a spike in food coupon volume following the Northridge earthquake.

Our Bank led the Federal Reserve's zero-based review of customer service levels in cash operations. In this effort to provide for a more consistent level of service nationwide, we met with several dozen customers, whose input will help shape the new policy to be announced in 1995.

System Support Product Office

In recognition of our strategic contributions to Federal Reserve System payments services, our Bank was given responsibility for the System's new Support Product Office in 1994. This new office is part of an overall restructuring of the System's management of financial and payments services, which also includes the creation of product offices for retail payments, wholesale payments, and fiscal services. This office will be responsible for setting strategic and tactical direction for the accounting functions, customer electronic access to Federal Reserve services, and non-centralized automation services.

This office expands our existing Federal Reserve System responsibilities for customer electronic access, which cover such facilities as Fedline and Computer Interface connections. A key 1994 initiative was the development and piloting of FED-Mail, which uses e-mail technology to deliver low-security data to customers. By year-end some 300 customers in four Districts were receiving FED-Mail service, which will expand nationwide in 1995.

Public Information

Media outreach continues to focus on expanding awareness and understanding of the Federal Reserve System. Media visits ranged from Oregon and Washington to California's central valley and Arizona.

Economic education expanded with workshops for teachers on money, banking, and two new topics. The new programs focused on instruction in the use of Bank software on monetary policy and the System video/collaborative material product, The Federal Reserve. Using a satellite distance learning program, we brought together 360 Oregon high school seniors to learn about the Federal Reserve.

The Audiovisual staff completed several major projects, among them "Closing the Gap," a System-wide Community Affairs program explaining 10 basic fair-lending guidelines. "Your Money Matters," a training program to help cash handlers detect counterfeit currency, was revised for the Treasury and the Board of Governors.

The Research Library introduced FedWest OnLine, a public bulletin board service containing economic and banking information produced by the Bank.

Approximately 300 users log on each month to read or download files.

Employee communications grew as the District newsletter, 12L Times, increased from quarterly to bi-monthly, and received two national awards for design and content. In addition, we introduced 12L Newswire, an e-mail bulletin board, for San Francisco employees.

Economic Research

This year's research addressed a wide variety of policy-related issues. Some studies examined monetary policy issues in the U.S., including the effectiveness of various targets and indicators, while others covered monetary and exchange rate policies in East Asian countries. Other macroeconomic studies included various aspects of business cycle behavior in the U.S., as well as international research on inflation and growth, investment and saving, stock returns, and budget and trade deficits. Several issues in bank capital regulation and bank lending were examined. Regional studies dealt with NAFTA, interstate banking, the California economy, and the convergence of income levels across states.

A joint conference with the Center for Economic Policy Research at Stanford University brought together academic and System economists to discuss monetary policy in a low-inflation environment.

Policy issues were presented to the public through various formats. The Weekly Letter presents analyses of policy issues and economic developments for business and academic readers. The Economic Review contains technically oriented research. Fedviews is a monthly video discussion between two department economists on current macroeconomic policy issues. Western Economic Developments contains discussions and data on developments in District states. Pacific Basin research and analysis is disseminated by the Center for Pacific Basin Monetary and Economic Studies.

Economic Research staff delivered 67 speeches to non-profit organizations. Public outreach efforts also included 75 meetings between staff and officials who visited the Bank from the U.S. and abroad, particularly Pacific Basin countries.

Supervision, Regulation, and Credit

During 1994 the Supervision, Regulation, and Credit department was reorganized into two departments, one focusing on safety and soundness supervision and regulation (Banking Supervision and Regulation), the other on credit, compliance and community affairs.

Management Committee

From left, Robert T. Parry, President and Chief Executive Officer, Michael J. Murray, Senior Vice President, Corporate Administration, Patrick K. Barron, First Vice President and Chief Operating Officer, and Thomas D. Thomson, Executive Vice President, Central Bank Functions.

Painting in background:
Byron Gardner
Ribbon Landscape 1981
acrylic on canvas 68 x 50 1/8"

Banking Supervision and Regulation

Examiners conducted 68 examinations of commercial banks. Outstanding formal and informal supervisory actions involving state member banks declined from 25 at year-end 1993 to 22 in 1994.

Examiners completed 130 on-site inspections of bank holding companies, 8 more than 1993 because new bank holding companies were formed and problem institutions required heightened supervisory attention. At year-end there were 58 outstanding supervisory actions (not including supervisory letters) in place at holding companies in less than satisfactory condition, 13 less than 1993.

At year end, there were 142 agencies and branches of foreign banks in the District, 19 Edge and Agreement corporation offices, and 42 representative offices. Of these, international examiners examined 92 agencies and branches, 15 Edge Act offices, and 4 representative offices. This Bank was actively involved in the development of a new Supervisory Program for Foreign Banks with initiatives designed to improve the supervision of Foreign Banking Organizations operating in the United States.

Domestic application filings totaled 257, up from 252 in 1993. Applications to form bank holding companies or acquire additional banks or nonbanking businesses increased significantly (from 52 in 1993 to 83 in 1994), reflecting continued interest in consolidations and the desire of banking organizations to expand during favorable economic conditions.

In another major project, staff completed validation of District data in the National Information Center database, the Federal Reserve's central repository of structure, financial, and supervisory information on financial institutions.

Credit, Compliance and Community Affairs

Community Affairs provided information to more than 600 lenders by sponsoring six small-business lending seminars. They helped District bankers learn how to make small business loans profitably, how to integrate public sector programs and lending criteria successfully, and how to enhance their institution's CRA program. Two other seminars, "Resolving Legal Issues When Lending on Indian Reservations," focused on resolving legal and jurisdictional issues, sovereign immunity questions, and underwriting problems that arise when lending on Indian reservations.

At other conferences in San Francisco, Honolulu, and San Diego, more than 900

Branch Operations

From left, Andrea P. Wolcott, Vice President, Salt Lake City, John F. Moore, Senior Vice President, Los Angeles, and Gordon R. G. Werkema, Senior Vice President, Northern Region. A. Kenneth Ridd, Vice President, Portland, was not available for the photograph.

Painting in background:
Fritz Scholder
Galloping Indian After Leigh 1978
etching and aquatint 15/90 43 1/2 x 62 1/2"

bankers, housing and small business developers, representatives of non-profits, Native Americans and native Hawaiians, and government officials heard nationally recognized speakers discuss community reinvestment, economic development, lending on trust lands, fair lending, and other related issues.

In its continuing role in the guidance of non-profit mortgage banking consortia, the department was key to the development of the Association of Reinvestment Consortia for Housing which represents over 300 commercial banks, thrifts and savings and loans, with loan commitments and fundings of over $700 million.

Some 2,000 regulatory inquiries were received, about the same as previous years. These usually involve truth-in-lending issues, but there was a notable increase in fair lending inquiries.

During 1994, 56 depository institutions borrowed from the discount window compared to 64 in 1993, and 587 loans were extended, compared to 483 loans in 1993. The dollar amount of funds borrowed declined from $5.1 billion in 1993 to $3.5 billion in 1994, primarily reflecting reduced amounts borrowed under adjustment credit. This Bank held $39.0 billion in collateral accounts at year end compared to $29.3 billion at the end of 1993, as banks had been pledging additional assets to their collateral pools.

Summary of Operations

	Volume (in thousands)		
	1992	1993	1994
Custody Services			
Cash Services			
Currency notes paid into circulation	3,758,533	4,069,935	4,212,494
Food stamp coupons processed	604,544	651,348	694,306
Security Services			
Other Treasury original issues	150	113	216
Book-Entry Securities processed	766	702	805
Payments Services			
Check Services	2,978,582	2,994,572	2,269,690
Commercial checks collected	76,781	73,648	69,567
Government checks processed	33,496	32,709	29,941
Return items processed			
Electronic Payments Services			
Wire transfers processed	19,416	19,962	19,925
Automated clearinghouse transactions processed	380,448	406,220	459,032
Discounts and Advances			
Total discounts and advances *	910	483	587
Number of financial institutions accommodated*	78	64	56

*whole number (not in thousands)

Earnings and Expenses
(in thousands of dollars)

Current Earnings

	December 31, 1994	1993
Discounts and Advances	611	834
United States Government Securities	1,919,419	1,943,930
Foreign Currencies	130,257	182,225
Income from Services	78,131	86,370
All Other	936	622
Total Current Earnings	2,129,354	2,213,981

Current Expenses

	December 31, 1994	1993
Total Current Expenses	196,427	190,474
Less: Reimbursement for Certain Fiscal Agency and Other Expenses	16,058	15,584
Net Expenses	180,369	174,890
Cost of Earnings Credits	19,536	19,800
Current Net Earnings	1,929,449	2,019,291

Profit and Loss

	December 31, 1994	1993
Additions to Current Net Earnings		
Profit on prior period Adjustments	-	-
Profit on Sales of United States Government Securities (Net)	-	4,503
Profit on Foreign Exchange Transactions (Net)	392,452	39,161
All Other	2	8,198
Total Additions	352,494	51,862
Deductions From Current Net Earnings		
Loss on Sales of United States Government Securities (Net)	-	-
Loss on Foreign Exchange Transactions (Net)	2,177	-
All Other	13	61,817
Total Deductions	2,190	61,817
Net Additions (+) or Deductions (-)	350,304	(9,955)
Cost of Unreimbursed Treasury Services	(4,755)	(4,260)
Assessments by Board of Governors		
Board Expenditures	(21,315)	(20,692)
Federal Reserve Currency Costs	(28,180)	(44,506)
Net Earnings Before Payments to the U.S. Treasury	2,225,503	1,939,878
Dividends Paid	30,255	28,758
Payments to the U.S. Treasury (Interest on Federal Reserve Notes)	2,177,906	1,866,540
Transferred to Surplus	17,342	44,580
Surplus, January 1	494,875	450,295
Surplus, December 31	512,217	494,875

Comparative Statement of Account

(in thousands of dollars)

Assets	December 31, 1994	December 31, 1993
Gold Certificate Account	1,102,000	1,392,000
Special Drawing Rights Certificate Account	904,000	904,000
Other Cash	33,059	60,625
Loans to Depository Institutions	33,295	0
Federal Agency Obligations	342,931	541,512
United States Government Securities:		
Bills	16,726,325	18,722,081
Notes	13,592,343	15,419,200
Bonds	4,054,557	4,619,775
Total United States Government Securities	34,373,225	38,761,056
Total Loans and Securities	34,749,451	39,302,568
Items in Process of Collection	544,324	1,554,904
Bank Premises	155,956	150,876
Operating Equipment	38,263	31,746
Other Assets:		
Denominated in Foreign Currencies	3,207,077	3,295,072
All Other	1,073,067	862,844
Interdistrict Settlement Account	(3,685,226)	(12,121,651)
Total Assets	38,121,971	35,432,984

Liabilities	December 31, 1994	December 31, 1993
Federal Reserve Notes	31,023,861	26,322,759
Deposits:		
Total Depository Institutions - Reserve Accounts	4,938,398	6,790,730
Foreign	20,515	20,503
Other Deposits	80,318	21,320
Total Deposits	5,039,231	6,832,553
Deferred Credit Items	639,717	1,016,233
Other Liabilities	394,728	271,689
Total Liabilities	37,097,537	34,443,234
Capital Accounts		
Capital Paid In	512,217	494,875
Surplus	512,217	494,875
Total Liabilities and Capital Accounts	38,121,971	35,432,984

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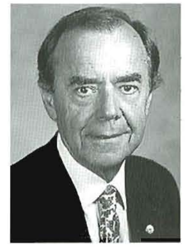

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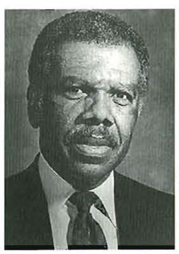

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This Report was produced by Karen Flamme, designed and illustrated by Mark Hendricks. Western Banking was written by Frederick T. Furlong and Gary C. Zimmerman with editorial assistance from Judith Goff. Highlights was written by Barbara Bennett and Karen Flamme. Color photography by Paul Schulz.

The background paintings in the photographs are from the art collection of the Federal Reserve Bank of San Francisco. Acquired between 1981 and 1987 with funds designated as part of the budget for the construction of the new San Francisco and Los Angeles facilities, the collection is comprised of over five hundred artworks by artists from the Twelfth District. The objects are installed in public and work spaces in the San Francisco headquarters and the four branches where they provide an environment that is not only enjoyable and stimulating, but educational as well. While its primary emphasis is on contemporary art, the collection is given added dimension by a select sampling of traditional crafts.

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