1981 Annual Report, Federal Reserve Bank of Chicago

The elegant lines of the grand staircase and its brass handrail have led visitors to the main lobby of the Federal Reserve Bank of Chicago for almost sixty years.

1981 Annual Report

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Federal Reserve Bank of Chicago
Public Information Center
Box 834, Chicago, Illinois 60690

A message from the president

It is hard for me to imagine a more exciting time—a time of greater challenge and opportunity—to have begun my affiliation with the Federal Reserve.

The past year marked the beginning of a new era for the Federal Reserve Banks. Services that were traditionally available only to a restricted group of commercial banks can now be offered, on a fee basis, to a much broader universe of institutions. This change provides the Federal Reserve Bank of Chicago with greatly expanded opportunities to foster increased competition in the marketplace and more efficient use of both public and private resources.

In another sphere, many of the changes that we in the financial services industry have been talking about for so long are at last beginning to unfold. Regulatory impediments are being reduced, either explicitly through statute or *de facto* through financial and technological innovation. The Federal Reserve Bank of Chicago, as a participant in the regulatory process, is in a prime position to nurture constructive change in the financial system.

But it is perhaps on the economic policy front that I see the greatest challenges and opportunities arising. We as a nation have arrived at a crucial juncture in our campaign to control inflation. The direction we take at this point is particularly critical for the long-term well-being of the Midwest.

Inflation and the high interest rates and other dislocations that it produces have had an especially adverse impact on the economic health of our region, contributing to a deterioration in the area's productive facilities as well as to a loss of competitive position in world markets for our products. If we are to return to sustainable long-term real economic growth, the forces of inflation must be permanently contained.

At year-end there were visible signs that real progress had been achieved. However, the outlook is clouded by several lingering concerns. Among these are the huge federal deficits projected for the next few years. To be successful, monetary and fiscal policy must work in concert. But, as the financial markets seem to be reminding us, heavy credit demands on the part of the public sector make the difficult job of monetary policy that much harder. Whether the projected deficits can be whittled down to a more manageable size is still problematical.

An even more critical question is whether we as a nation have the mettle to persevere in the battle against inflation. Our resolve will be severely tested over the next year or so as unemployment remains at high cyclical levels. Nevertheless, it is my conviction that we should not and must not give up now after having paid so dear a price for the progress already achieved. As the experience of the past decade makes clear, a failure to carry the battle against inflation to a successful conclusion would mean even greater hardships in the future.

That my position affords me direct involvement in these critical challenges I regard as a distinct privilege. I am also privileged to have become associated, through my position, with a highly professional staff and officer corps and an outstanding board of directors. To them and to the many others around the District who have provided me with invaluable support and counsel, I extend my sincere thanks.

March 1, 1982

Silas Keehn became the seventh President of the Federal Reserve Bank of Chicago on July 1, 1981 after his appointment by the Bank's Board of Directors was confirmed by the Board of Governors of the Federal Reserve System.

Before joining the Bank, Mr. Keehn served as Chairman of the Board of Pullman, Inc. in Chicago, and prior to that, as Vice Chairman of Mellon National Corporation and Mellon Bank, N.A. in Pittsburgh, Pennsylvania. He succeeded Robert P. Mayo who retired after providing more than ten years of leadership to the Bank.

The challenge of change

Unprecedented changes are taking place in the environment in which the Federal Reserve Bank of Chicago operates. Without doubt, the development having the most direct and pervasive impact on the Bank has been the recent Monetary Control Act because it fundamentally altered the Bank's relationship with the institutions it serves. But many other forces are at work that are transforming the broader economic and financial environment. These changes—and the development of appropriate responses to them—have been uppermost in the Bank's focus and operations during 1981 and will clearly continue to influence its activities in the years to come.

The elements of change

A new role for the Federal Reserve Banks

The landmark financial reform legislation enacted by the Congress in 1980 represented an effort to strengthen and modernize a financial system struggling to keep pace with an accelerating rate of economic and technological change. The stress of inflation, the rigors of foreign bank and domestic nonbank competition, and the increasingly complex needs of market participants demanded new approaches to financial regulation and monetary control.

A vital feature of the legislation, particularly from the perspective of a regional Reserve Bank, is the provision that grants all types of depository institutions—including savings and loan associations, mutual savings banks, and credit unions—direct access to Federal Reserve financial services. The Monetary Control Act calls for these services, which include check collection, processing of electronic payments through the automated clearinghouse (ACH), wire transfer of funds, shipments of currency and coin, and various securities-related services, to be provided at prices that recover production costs and reflect competitive practices.

This change was clearly a radical departure from the terms on which Federal Reserve services had been provided from the time the System was established. For almost 70 years, most Reserve Bank services had been offered free of charge, and only to banks that were members of the System.

Underlying the open access and pricing provisions of the act was a desire to insure more equitable treatment of all depository institutions in an increasingly competitive environment, foster technological innovation in the payments area, and generally lead to a more efficient allocation of both public and private resources. In addition, the change was consistent with an emerging national policy of financial deregulation and increased reliance on free market forces.

One obvious element of challenge inherent in this changing role for Reserve Banks—and a particularly significant challenge for the Chicago Bank—is the responsibility to provide services in response to the needs of a greatly expanded and far more diversified customer base. Within the boundaries of the Bank's District, which includes the industrial and agricultural heartland of America, are approximately 7,000 depository institutions—more than in any other district, and eight times the number of member banks previously served by the Reserve Bank. Potential customers now range from several thousand small credit unions affiliated with a wide variety of private and public organizations, to a handful of major correspondent banks providing an expanding range of national and international financial services. Between these extremes are almost 2,000 nonmember commercial banks, 900 member banks, and over 600 savings and loan associations.

District institutions are remarkably varied—large and small, specialized and diversified, urban and rural. Many use the latest and most sophisticated technology; others have far more limited capabilities. These institutions operate under a bewildering variety of federal and state laws and regulations that define and restrict their activities. Some are affiliated with organizations that operate worldwide, nationwide or statewide. Others are confined, by choice or statute, to a single location.

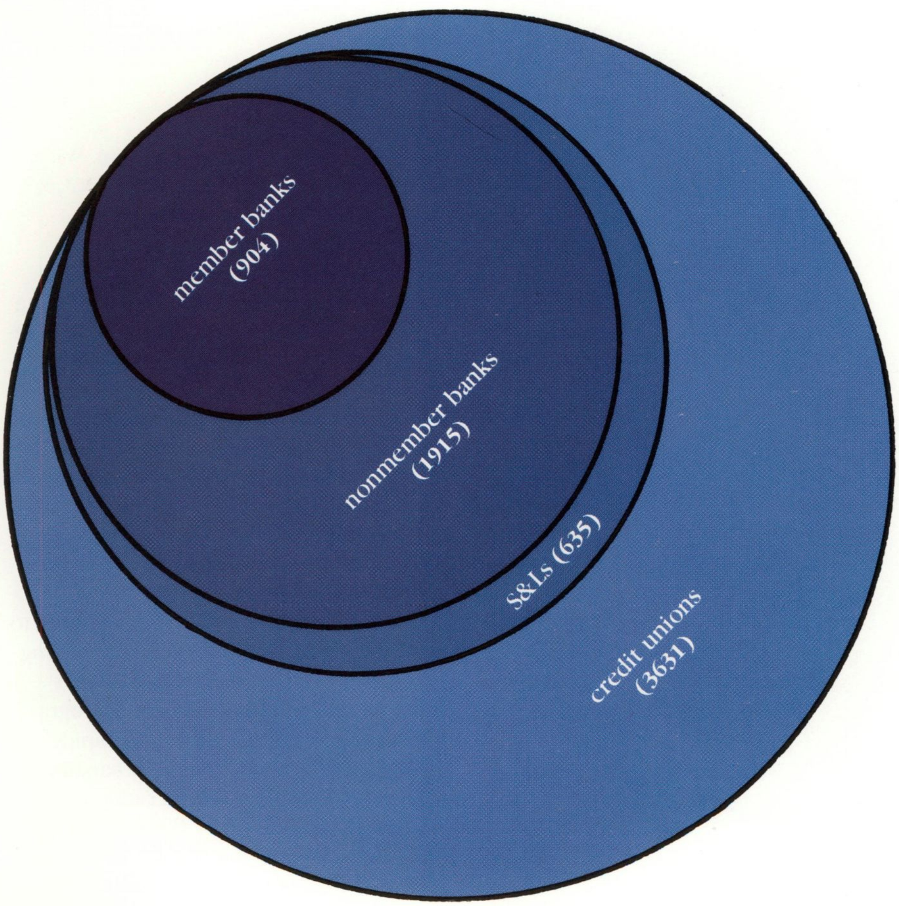
But the scope of this challenge, as broad as it is in terms of the range of institutions to be served, may well be outweighed by its complexity. Clearly, the Federal Reserve has always needed to strike a delicate balance in its multifaceted role as monetary policy-maker, regulator, and provider of financial services. By placing the Federal Reserve Banks in the marketplace to compete, within limits, with the private sector, the Monetary Control Act has made the System's task even more complicated.

Restructuring of the financial system

The legislation that altered the Federal Reserve so dramatically also had a significant impact on the private financial structure. In particular, the act reduced or eliminated traditional barriers to direct competition between commercial banks and thrift institutions.

At the beginning of 1981 all savings and loan associations (S&Ls) were authorized to offer transaction

Monetary Control Act expands the Federal Reserve Bank of Chicago's customer universe



accounts—which had been (except in New England) the exclusive privilege of commercial banks. By year-end S&Ls had captured 5 percent of the NOW account and demand deposit market. S&Ls were also authorized to diversify their portfolios to include assets traditionally held by commercial banks.

Perhaps most importantly, the act initiated the phase-out of deposit interest rate ceilings. Particularly in recent years, these ceilings have restricted competition between banks and thrifts and have limited the ability of both types of institutions to compete in the broader marketplace.

Forces beyond recent legislation have been radically altering the structure, function, and nature of banking and finance in America. These include technological and financial innovation, increasing competition, inflation, and high interest rates. In the face of these interrelated forces, policies adopted in the wake of the Depression to limit the activities of banks or provide them with special protection have become inappropriate and increasingly ineffective.

Technological advances have been particularly important in transforming the financial landscape. Expanding data processing capabilities, telecommunications developments, and improvements in transportation are breaking down traditional geographical and institutional barriers to competition. This process in turn is stimulating the development of new products and institutions capable of exploiting the new technology.

The growing use of automated teller machines (ATMs) and the development of home banking and bill-paying services are just beginning to transform traditional retail banking activities. These systems should make more financial services available to a broader range of bank customers and reduce the need for costly "brick and mortar" banking offices. ATM networks, such as the TYME system headquartered in Wisconsin, already are moving across state lines. Within the next few years a national ATM system is likely to become a reality.

Economic conditions—particularly inflation accompanied by extraordinarily high and volatile interest rates—have likewise exerted great pressure on the regulatory structure. Limited by interest rate ceilings, traditional deposit instruments have not met the public's demand for high-yielding liquid assets. This created a powerful incentive for competition and innovation.

The introduction of money market mutual funds (MMMFs) in 1972 is the most prominent example of a new product developed to satisfy a need not met by traditional sources. With the widening of the spread between market rates of return and maximum rates payable on savings and consumer time deposits, MMMFs have become increasingly attractive. Adding to their allure

The most advanced monitoring equipment available was added to the Bank's computer network control center in 1981 to assure high quality customer service.

has been the development of transfer and third-party payment features. In effect, MMMFs have become the first nationwide depository institutions, further reducing the dependence of consumers on local banks.

In an attempt to participate in this broadening market, a number of companies have recently been expanding into the financial services field. Examples include widely reported acquisitions of Shearson Loeb Rhoades Inc. by American Express; the Bache Group by Prudential Insurance; and Dean, Witter, Reynolds and Coldwell Banker & Co. by Sears, Roebuck (an S&L holding company).

As a result of these affiliations, commercial banks and thrifts are facing competition based not only on the creation of close substitutes for their services but also on the development of radically different products. Spurred by the inroads that other firms have made in their markets, banks and thrifts have taken advantage of certain limited opportunities to expand on an interstate basis as well as to develop new products of their own.

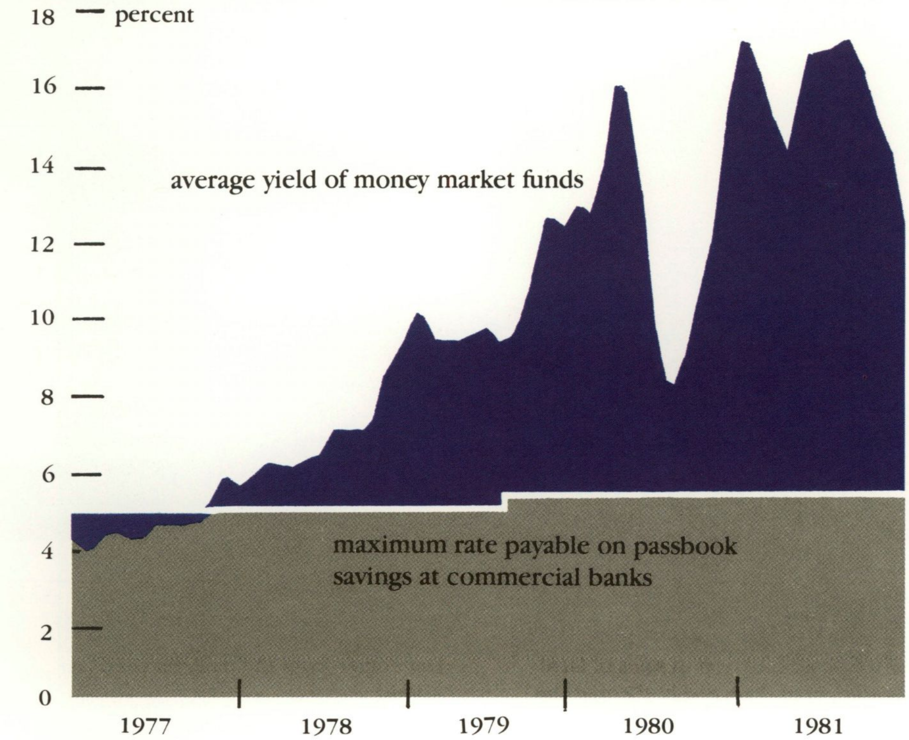
It is evident from the developments of the past few years that long-standing statutory and regulatory constraints intended to limit product and geographic markets are eroding at a rapid pace. Fundamental pieces of banking legislation such as the McFadden Act, Glass-Steagall Act, and the Bank Holding Company Act either will be amended to reflect the changing environment or they will continue to be circumvented by innovative institutions.

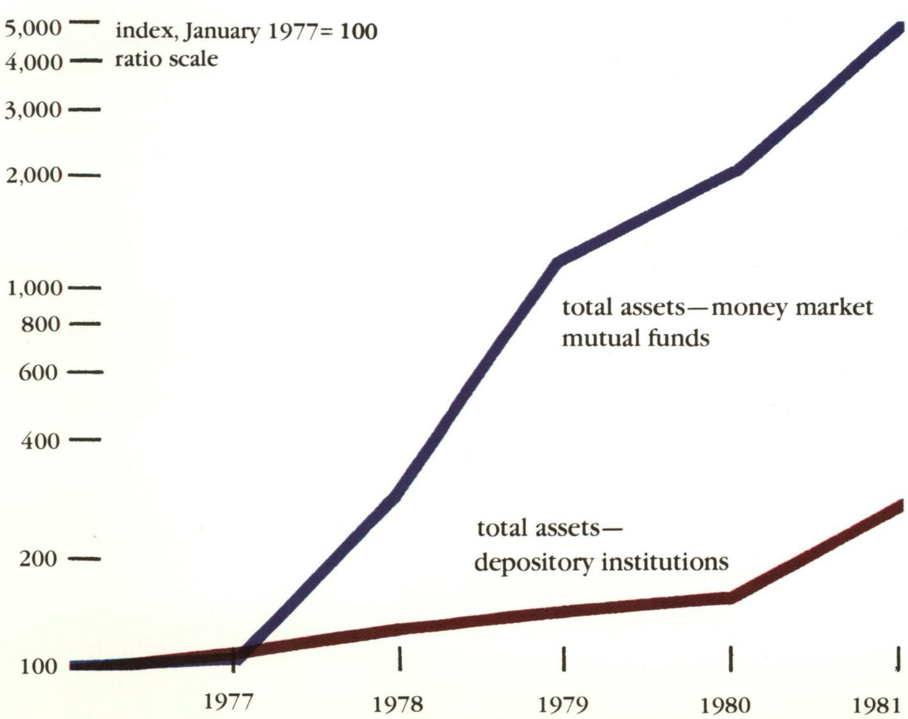
Troubled times for the District economy

Just as the financial structure has undergone dramatic change over the past decade, so has the economic base of the region served by the Federal Reserve Bank of Chicago.

The Seventh Federal Reserve District, which lies in the heart of the Midwest, includes most of Illinois, Indiana, Michigan and Wisconsin and all of Iowa. About one out of every seven persons living in the U.S. resides in the five states. This region encompasses

Rate spreads lead to surging growth of money market funds





both the nation's heaviest concentration of industrial activity and its most productive agricultural areas. The District accounts for 22 percent of all cash receipts from farm commodities and produces a fourth of the nation's manufactured durable goods. Its shares of the nation's production of motor vehicles, farm and construction equipment, industrial machinery, and steel are much larger. Its role as an international banking and trade center is rapidly expanding.

But since 1950, and especially since 1970, the performance of the Midwest economy has lagged that of the South and West. Historically, durable goods manufacturing has been vulnerable to cyclical fluctuations. Until the last three years, however, autos, steel, tractors, and other durable goods industries had always managed to ride out periods of adjustment and quickly snap back to new highs.

The present deep-seated problems of the Midwest are closely related to the rapid escalation of world oil prices that began with the Arab oil embargo of 1973-74 and to the acceleration of general price inflation and related rising interest rates.

Primarily because of lower winter temperatures, but also because of its aging buildings and factories, the Midwest consumes a relatively large share of the nation's oil, natural gas, and low-sulfur coal, but it produces only a very small share of its needs. In essence, the region is an energy "importer", both from abroad and from other states. Under these circumstances, Midwest companies have increasingly chosen to move a portion of their operations to the Sunbelt where many costs are lower.

The impact of higher energy prices has not been limited to the cost side. Demand for the region's products has been hurt as well.

The sheer magnitude of the problem created by the rapid transition from cheap, abundant energy became apparent in early 1979. The adverse impact of

Record numbers of used food stamps were destroyed during 1981 by the Bank acting as fiscal agent for the U.S. Treasury, providing a vivid reflection of the District's economic difficulties.

the high gasoline prices on sales of autos and trucks, particularly standard models, was dramatic. About the same time, tightening credit precipitated a steep decline in residential construction and related industries. Although the downturn affected the entire nation, it hit the Midwest especially hard.

Factors other than energy prices are also having a particularly adverse effect on the region. Most Midwest producers of materials and finished goods have faced increasing foreign competition in recent years. Imports of foreign goods, produced in many cases in modern plants with lower labor costs, have made inroads in many lines, but especially in motor vehicles, electronics, and steel. Imports also have become important as components in products assembled here. Exports have declined or slowed as the high value of the dollar in 1981 provided an important additional advantage to foreign competitors.

In 1980 and again in 1981, the nation experienced business recessions attributable in part to both energy costs and credit stringencies. The Midwest took the brunt of both recessions. Lagging sales reduced cash flow, eroded business confidence, and created excess capacity. These factors, coupled with record-high interest rates, caused a sharp drop in demand for equipment produced in the Midwest, especially in late 1981.

In earlier periods of industrial recession agriculture had often remained prosperous. Recently, however, declines in farm income have accompanied and reinforced the decline in industry. Depressed conditions in the agricultural sector in 1980-81 led to a reduction in sales of farm equipment and adversely affected the economies of smaller cities serving the farm community.

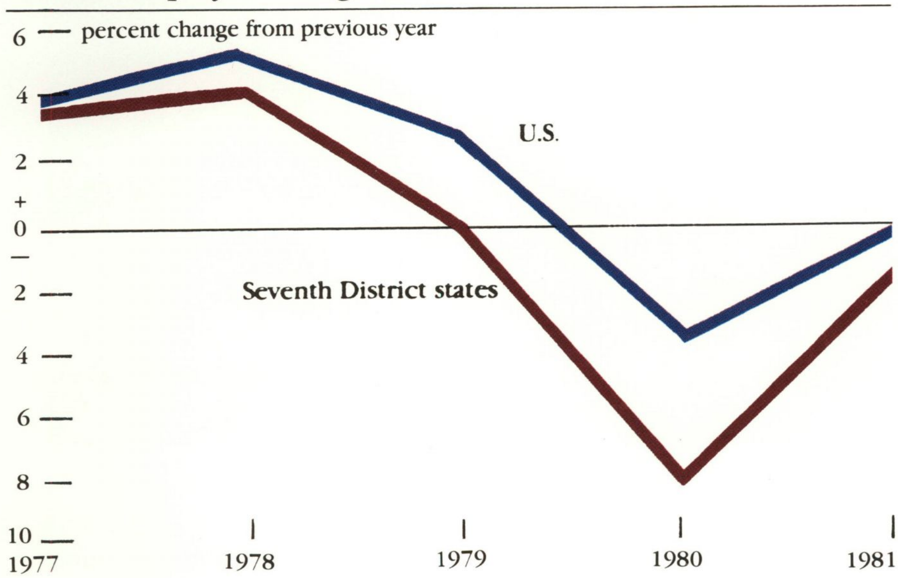
Similarly, state and local governments experienced revenue shortfalls and curtailed their spending and employment which had continued to grow in previous recessions. Indeed, the uninterrupted growth of government outlays had helped to stabilize the economy during earlier cyclical declines in private sector activity.

In late 1981 wage and salary employment in the Midwest was 4 percent below the prosperous level of late 1978. Nationally, total employment, although slipping in the fourth quarter, was still 3 percent *above* the level of late 1978. By year-end, the nation's output of durable goods had fallen 9 percent below the rate of the recent peak in July, and 12 percent below the record high of March 1979. Nondurable goods output was down 6 percent in December from the peak reached last August.

Despite the prevailing gloom in early 1982, there are hopes for a reversal of the general downturn in the national economy in the months ahead. Personal income remains at a high level and will be augmented by a tax cut in mid-1982. Investment incentives provided by the Tax Act of 1981 are expected to encourage capital spending. A clear slowing in domestic inflation late in 1981 promises to enhance the competitive position of U.S. producers in world markets. Finally, inventories of most materials and components are lean, and production cuts are reducing excessive stocks of finished goods. Any improvement in final sales will quickly bring a rise in factory orders.

But the many problems of the Midwest will not be resolved in the near future. Whatever the course of events in 1982, the region served by the Federal Reserve Bank of Chicago faces a long period of concentrated effort to regain its place in the economic sun.

Midwest employment lags nation



The Federal Reserve Bank of Chicago responds

The unprecedented changes occurring in the financial community and in the Midwest economy make it imperative that the Federal Reserve Bank of Chicago be in a position not only to perform traditional central banking functions but also to provide new services in response to the changing times. In essence, the Bank must involve itself fully in change in order to carry out its broad public mission as a provider of services, as a regulator, and as a participant in national economic policy.

To the extent possible, the Bank must not only respond and adapt to change, but anticipate it as well. Where change can be regarded as synonymous with progress, the Bank must seek to foster and stimulate it—helping wherever possible, to minimize or remove impediments to a competitive, efficient, and progressive financial system.

Looking back over the Bank's history, including its efforts of the most recent year, it is apparent that the Bank has been a significant force in shaping its changing environment. Looking to the future, there is every reason to believe that it will continue to fulfill this vital role.

Implementing the pricing mandate

The provisions of the Monetary Control Act granting all depository institutions full access to Federal Reserve services on a *priced* basis offer the Bank special opportunities as well as new challenges. In large part these opportunities consist of broadened avenues for fostering more effective and efficient operation of the financial system.

In this vein, the Bank enunciated, in its planning for 1981, the objectives that should be supported by its activities in the new pricing environment:

- Preserve a competitive marketplace.
- Foster efficient use of private and public resources.
- Satisfy identified demand for Federal Reserve services.
- Influence the availability of financial service alternatives through leadership in constructive innovation.
- Conduct operations supporting and providing Federal Reserve services in a manner that insures high integrity, quality and reliability.
- Satisfy identified special needs of our constituency that reflect regional conditions and characteristics.

Achieving these results requires the Bank to maintain an effective presence in the marketplace. To that end, high priority has been given to activities such as comprehensive market surveys, expanded customer contact efforts, and in-depth product evaluations designed to help the Bank determine and meet the needs of its broad constituency.

Particular emphasis, including a substantial research effort, has been placed on quality of service. Through its studies, the Bank has learned that while institutions value traditional aspects of service quality such as accuracy, reliability and efficiency, the Bank should focus greater attention on providing services in a more flexible, responsive manner.

To provide this focus, both the Head Office in Chicago and the Detroit Branch have integrated key functional areas having a strong customer orientation, such as Accounting and Bank Relations, with the new marketing research

and policy activities. Staff have been added to handle the growing number of customer inquiries; account executives with thrift institution backgrounds as well as some with commercial banking experience have been recruited. These efforts represent necessary first steps in adding a personal dimension to the provision of Bank services.

To bring this focus to staff throughout the Bank, a senior level Committee on Quality has been organized to oversee the Bankwide quality assurance effort. Programs include comprehensive employee training designed to increase awareness of customer needs and the use of such modern management techniques as "quality circles." Ultimately, a comprehensive quality control program incorporating a wide range of service quality measures and standards will be implemented.

These efforts can be regarded as a new approach on the part of the Bank. But pricing has required that Bank staff do more than change their way of thinking. Product costs and prices had to be determined, customer billing and other accounting-related support systems had to be designed, critical market information gathered, and both existing and potential new financial services carefully evaluated.

In many respects, these activities have only begun. In the check processing and collection area, for example, various new check services are being developed, including MICR encoding for thrift institutions, calculated availability for institutions depositing unsorted cash letters, and new group sort deposit arrangements. All are designed to provide customers with improved funds availability at lower prices. Service enhancements such as more convenient presentment deadlines are also planned.

The market responds. In many respects, 1981 is a difficult year for which to assess the impact of pricing since several key services had been priced for only a few months by year-end. It undoubtedly takes time for most financial institutions to change their modes of operation and expand their operational capabilities in response to new price incentives. On the other hand, some large correspondent banks with sophisticated check sorting equipment and extensive vault capacity were quick to respond when the Federal Reserve began to price check and securities safekeeping services. With these limitations in mind, 1981 results can be viewed as being suggestive of the types of adjustments the private sector is likely to continue to make.

Generally, the new presence of the Federal Reserve in the marketplace has begun to increase the level of competition in correspondent services and has accelerated the development of innovative, cost-cutting service alternatives—desired consequences of the pricing mandate. There is also some movement to form and expand local and regional check clearinghouses to share processing, accounting, and transportation expenses. Commercial service bureaus are beginning to offer a wider range of services to thrifts and commercial banks alike, and the concept of "bankers' banks" is emerging. Where efficiency dictates, the private sector has begun to assume a broader role in the provision of services.

As anticipated, Federal Reserve pricing has propelled a move toward explicit fees and the unbundling of a wide range of correspondent financial services. As a result, institutions of all types and sizes are taking a careful look at the relative costs and benefits associated with each service alternative.

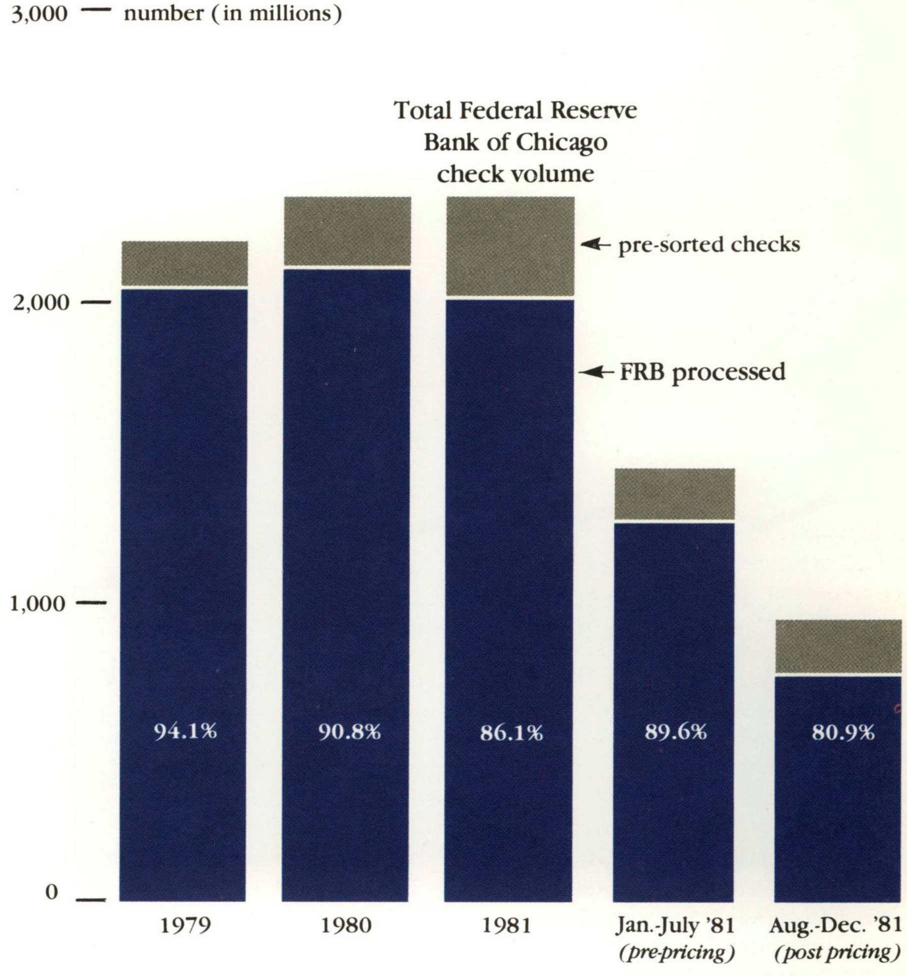
Customer accounts division employees meet in a "quality circle," a Japanese-originated management technique designed to improve operations and provide better service.

Volume changes in payments operations at the Federal Reserve Bank of Chicago seem to typify the early responses institutions have made to pricing. For example, the total volume of checks handled by the Bank between August (when pricing was implemented) and December 1981 was down by only 6 percent compared with the same period in 1980. Of that total, however, the number of checks actually processed or sorted by the Bank declined 16 percent.

This differential indicates that institutions are seeking processing alternatives—or adding additional sorting capacity—but are continuing to rely to a significant extent on Federal Reserve check collection services. It was anticipated that pricing would alter demand for each type of service. The observed shifts are consistent with what basic economic theory would suggest and provide strong evidence that the financial markets are reacting in ways that will ultimately lead to a more efficient allocation of productive resources.

Similarly, expected and desirable shifts are occurring in Fedwire funds transfer volumes. The fee schedule put into effect during January 1981 was designed to encourage institutions, both large and small, to originate their transfers on-line rather than by telephone, using one of two types of data communication terminals available through the Bank. (One of the terminals, designed specifically for low volume users, was pilot-tested at midyear by a small group of District institutions. By the end of 1981, a total of 106 low volume terminals were in operation.)

Private sector assumes larger role in response to check pricing

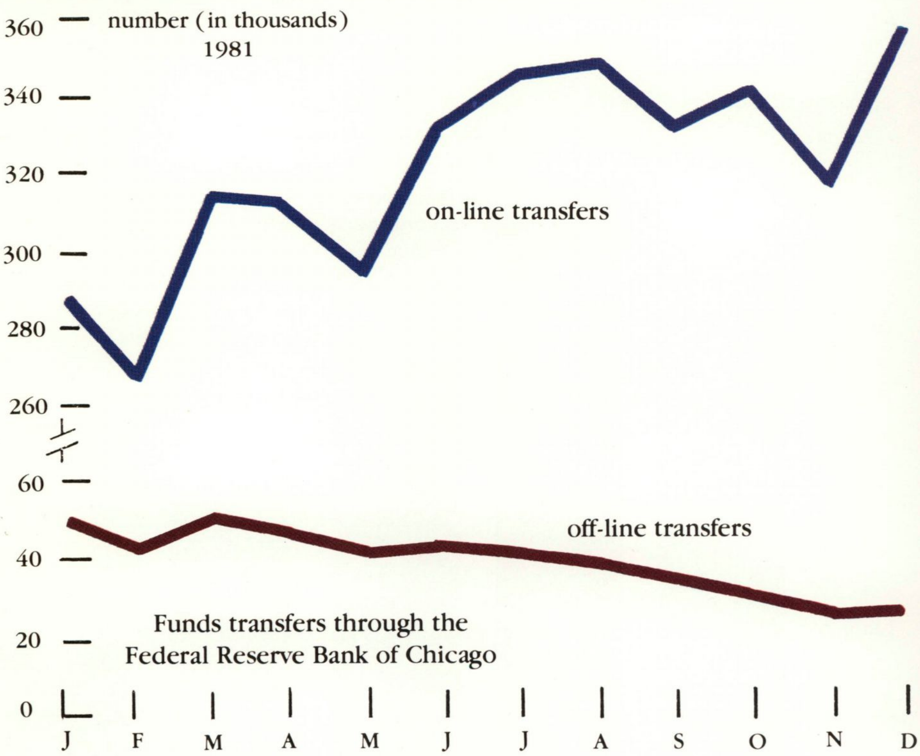


While the total volume of wire transfers increased about 12 percent during the year, the number of off-line transfers declined significantly. The combination of substantial price incentives plus the availability of an inexpensive data terminal is working to bring the benefits of improved operating efficiency, security, and convenience to institutions of all sizes. This shift toward increased automation will further improve the overall efficiency and security of the entire Fedwire system.

A look ahead. 1981 was a pivotal year for the Bank, a year of learning, planning, research, and evaluation. While all these important functions will carry over into 1982, the new year will undoubtedly see a major emphasis on action and performance as well.

New services in the planning stage during 1981—such as calculated availability and group sort check programs—will be actively marketed during 1982. Other products and service enhancements will be introduced

Pricing of funds transfer service encourages automation



as the year progresses. Already, a feature has been added to the low volume terminal, successfully marketed in 1981, that allows institutions to transfer book-entry securities on-line. In the currency and coin area, several new processing services are presently being evaluated that would augment the cash distribution services made available to all depository institutions in early 1982.

As part of the Bank's marketing plan, a comprehensive visitation program is underway, with an expanded staff of account executives to insure that institutions enjoy responsive, personalized service. Face-to-face contact, combined with ongoing research, will help to keep the Bank abreast of changing market demands.

Prices for many Bank services are to be adjusted in the year ahead. New pricing techniques are being developed to reinforce the Bank's pro-competitive influence in the market.

These efforts, combined with the Bank's commitment to provide quality services to its diverse customer base, mean that the challenge of pricing will continue to be a driving force in 1982—and in the years to come.

Building on a tradition of leadership in the payments mechanism

While the manner in which the Bank provides services has been altered in the pricing environment, the thrust of the Bank's activities today is the same as before the Monetary Control Act: namely, serving the general public good. This sustained concern is particularly evidenced in the payments area, where the Bank is continuing to build upon the leadership role it first assumed in 1918.

In that year, Chicago was designated the switching center for a wire transfer network, later to become known as Fedwire, that first linked the 12 Reserve Banks, the Board of Governors, and the Treasury Department by Morse Code. Since then, interest in the development of innovative technologies and efficient operating procedures has pervaded the philosophy of Bank management.

As message volume grew, the Bank took part in efforts to fully automate the wire transfer system. When a Western Union semi-automatic system was introduced in 1940, the Federal Reserve

The easy-to-use low cost terminal being offered by the Bank provides even the smallest depository institutions with the reliability and security of on-line access to Federal Reserve funds and securities transfer services.

Bank of Chicago was the site of the main relay station, responsible for transmitting messages across the western United States.

Some 30 years later, this same information was being routed at the speed of light by four communications computers housed in Culpeper, Virginia. The Federal Reserve Bank of Chicago took a leading role in the design and implementation of this network, known as the Federal Reserve Communication System of the 1970s (FRCS-70). Intricate features were incorporated into its design to ensure safety and accuracy and to prevent system failure. Over the years, FRCS-70 has been expanded as wire transfer volume has surged at an average annual rate of 20 percent since 1977. This growth has been paralleled in the Seventh District.

As Fedwire volume has increased, so has the number of checks written each year. The Federal Reserve Bank of Chicago has been actively involved in the development of a number of methods to reduce processing time and improve funds availability. As the System's largest processor of checks with the most endpoints to serve, the Bank has had a vested interest in seeing that these efforts come to fruition.

In particular, there were two projects whose successful implementation was due in large part to the expertise and resources provided by the Chicago Reserve Bank: the development and refinement of magnetic ink character recognition (MICR) encoding technology in the late 1950s (a joint effort with the American Bankers Association) and the establishment in the early 1970s of the Interdistrict Transportation System (ITS), an air transport service providing overnight delivery of checks between Federal Reserve offices. These efforts—along with the establishment of a nationwide network of 48 regional check processing centers—have proved to be invaluable enhancements to the check clearing and collection process.

Current efforts. Consistent with the concern and leadership shown in the past, the Bank is continuing to explore ways in which to further improve payments operations, particularly as public demand grows. In 1981, this commitment translated into authorization of a $3.6 million expenditure to expand internal processing capabilities, with additional resources allocated to ITS.

ITS was restructured in late 1980, largely as a result of effort on the part of Bank staff who oversee its operation. Eight air carriers flying 35 planes now provide dedicated transportation service, increasing the number of endpoints where overnight credit is available.

The modifications have contributed significantly to the reduction of float. In the first nine months of 1980, Seventh District float averaged $683 million a day. For a comparable period in 1981, the average was $447 million, a reduction of 34 percent. Given that the Monetary Control Act calls for float to be priced, results of these early efforts are particularly significant.

Currently under review is another means of reducing float, electronic check collection (ECC). The essence of ECC is the electronic transmission of MICR data on large dollar checks to paying institutions prior to actual presentment. Staff at both the Chicago Head Office and the Detroit Branch have taken an active role in the preparation of ECC proposals and issue papers for System review, drawing upon information and suggestions from the American Bankers Association Task Force on ECC.

The key attraction of ECC is as a bridge between paper and electronic payments systems. It epitomizes the Bank's interest in bringing efficiency to this payments mechanism through electronics while providing enhanced availability of funds to depositors. Its successful implementation, however, will depend heavily upon the commitment the Federal Reserve is making to high standards of accuracy and reliability. This commitment is fundamental to the needs of paying institutions for accuracy in accepting electronic notices.

Other current efforts keep the Bank in the forefront of new developments. The Bank is playing a substantial role in the System's development and implementation of a strategic plan for the payments mechanism, being undertaken by representatives of the Bank to the System's Conference of First Vice Presidents. Additionally, in recognition of the need for increased communications capabilities, work is underway on the Federal Reserve Communication System of the 1980s (FRCS-80) under the direction of a project team based at the Chicago Bank.

Unlike the current Fedwire system in Culpeper which relies on a central switch, FRCS-80 will utilize a series of inter-connected processors or nodes that transmit data directly from one processing center to another. Implementation of this sophisticated network will result in greater reliability plus increased flexibility in terms of accommodating growing volume and facilitating linkages with other communications systems. The Federal Reserve Bank of Chicago has begun to phase in FRCS-80 equipment and communications lines, with the system expected to be operational by mid-1982.

In conjunction with FRCS-80, a System group has been established to promote resource sharing and standardization of hardware and software among the 12 Reserve Banks. Their study of computer terminals, led by Chicago Reserve Bank staff, reviewed technical requirements and programs currently in use in order to insure that future systems take full advantage of FRCS-80 capabilities.

To meet the challenge posed by the transition to electronic funds transfer, the Federal Reserve established the Subcommittee on Electronic Payments (SEP) in 1975. SEP is currently headquartered at the Federal Reserve Bank of Chicago. It is responsible for monitoring the day-to-day operation of wire transfer and automated clearinghouse (ACH) services and providing support for current and future System-wide EFT efforts.

The Bank has advocated development of improved ACH software and data transmission terminal capabilities. ACH is one application of electronic funds transfers that has enjoyed widespread consumer acceptance as the number of automated commercial and government payments has grown. SEP has been charged with the responsibility of reviewing ways to further enhance the attractiveness of participation in the ACH network.

Leadership in ECC, FRCS-80, SEP and other programs signifies the intense commitment the Bank is making to foster efficiency in the payments mechanism and in so doing, to further serve the public. The need to respond to changes taking place in the financial and economic environment lends added importance to this continuing involvement.

Checks are loaded for speedy delivery to New York on one of 35 nightly routes scheduled by Federal Reserve Bank of Chicago staff for the Interdistrict Transportation System.

Fostering more effective regulation

In the context of a more and more complex financial world, the Bank's responsibility for assuring the safety, soundness, and effective operation of District financial institutions becomes both increasingly important and considerably more difficult. Depository institutions handle and settle the majority of payments for goods and services in our economy. They are the principal repository of the financial assets held by most households and businesses.

While committed to maintaining institutional safety and soundness, the Federal Reserve Bank of Chicago is equally committed to fostering effective, cost-justified regulation and to minimizing regulatory burdens whenever possible. A number of recent efforts on the part of the Bank serve to illustrate how it has pursued these goals.

Reduced reporting burdens. As for any organization, public or private, information flows are vital to the effective performance of the Federal Reserve's functions. To manage money data must be collected to measure it. The impact of change has to be assessed in the development of monetary and regulatory policies. Compliance with regulations must be monitored. Statistics generated by the System are extensively used, externally and internally, as a basis for economic analysis.

Nevertheless, the burden of required reports must be held to a minimum. Before they are initiated or extended, all System reports are reviewed by the Committee for Report Review, which looks at all aspects of each program—informational needs, size of reporting panel, content, coverage, and frequency—with an eye to reducing the reporting burden. The Chicago Bank has played an active role in this committee since it was established in 1976, and has held the chairmanship of the committee for the past three years.

The Chicago Bank's concern that regulatory and reporting costs be balanced against benefits was particularly evident in the implementation of the Monetary Control Act, which subjected all depository institutions to Federal Reserve reporting and reserve requirements.

The Chicago Bank proposed that the System defer reporting and reserve maintenance for the smallest institutions and establish quarterly reporting and reserve maintenance options. The Bank believed such measures would relieve small institutions of a heavy burden without impairing significantly the central bank's ability to control or measure money. These proposals resulted in deferred coverage for 18,000 U.S. depository institutions with less than $2 million in deposits, and quarterly reporting by 9,400 depository institutions with $2-15 million in deposits. Weekly reporting and reserve maintenance were required for only one-third of all institutions covered by the act, those with deposits over $15 million. System efforts are currently directed toward obtaining congressional consideration of a permanent exemption for smaller depository institutions and periodic review of the size criteria for quarterly and weekly reporting requirements.

Enhanced monitoring activities. Based on year-end 1981 figures, the Federal Reserve Bank of Chicago has responsibility for monitoring the condition and operation of the District's 214 state-chartered member banks and 749 bank holding companies. The magnitude of this workload attaches special significance to Bank efforts to reduce burdens on institutions it supervises to the extent its supervisory responsibilities permit. Such efforts can have the added benefit of resulting in a more effective use of resources involved in examination and surveillance activities.

During 1981, the Bank continued its policy of conducting examinations of state member banks concurrently with state authorities whenever such arrangements were acceptable to the state. Most larger banks in each of the five District states were examined on a concurrent basis.

Further during 1981, the Federal Reserve Bank of Chicago established alternate-year examination programs with authorities in the states of Illinois, Michigan, and Wisconsin. Under these programs, relatively trouble-free banks are examined by the Reserve Bank one year, and during the other year, by the state. Each agency relies on the other's examination report during the intervening year.

For all other trouble-free state member banks not covered by a concurrent, alternate-year, or other limited scope examination arrangement with state authorities, the Chicago Reserve Bank relieved supervisory burdens by reducing the frequency of examinations from once a year to once every 18 months. Both the alternate year and lengthened cycle examination programs were made possible through policy changes adopted by the Board of Governors which the Federal Reserve Bank of Chicago had advocated.

Finally, the Chicago Reserve Bank has reduced supervisory burdens by employing limited-scope examinations in cases where it is not deemed necessary to collect the detailed information derived from a full-scale examination. Examiners are relying more on information supplied by banks when the information is verified through testing and statistical sampling techniques. As with other examination program changes, use of limited-scope examinations also permits resources to be focused on institutions that need closer supervisory attention.

Regulatory improvement. In 1978 the System established the Regulatory Improvement Project. The project's mandate was to conduct zero-based reviews of all the System's regulations and improve the System's rulemaking procedures. These analyses were to insure that "the need for and purpose of each regulation is established clearly and that meaningful alternatives" are considered. Other objectives of the project were to minimize compliance costs, paperwork, and other burdens and simplify the regulatory language.

Under the Regulatory Improvement Project, each Reserve Bank was asked to work with the staff of the Board of Governors on the review of one or more Federal Reserve regulations. The Chicago Bank was assigned to review Regulation Y, which implements the Bank Holding Company Act.

Following substantial review and redrafting, complicated by the passage of new laws and amendments to existing ones, the draft of a significantly revised Regulation Y was completed by a System team in late 1981. The proposed revision of the regulation is to be presented to the Board of Governors for its consideration early in 1982.

Developing a better understanding of the financial structure and District economy

Responding to the challenges of a changing environment requires that the Federal Reserve Bank of Chicago, the public, and the financial community have a better understanding of the evolving financial structure and of the changes taking place within the District economy. Over the years the Chicago Reserve Bank has developed new research programs and undertaken various special studies in light of changing needs of financial institutions, technological developments, and new regulations. These programs are, in turn, modified, up-dated, and expanded as changing circumstances dictate.

The future is now—phase-in of FRCS-80, the new Federal Reserve System communications network being developed by a team based at the Chicago Reserve Bank, will begin in 1982.

Senior research staff brief Bank management on economic conditions and policy prior to a System Federal Open Market Committee meeting.

Monetary policy research. The Research Department, with over 25 professional economists, advises the Bank's President and Board of Directors on monetary policy and related economic and financial developments with particular emphasis on the District. The staff monitors closely the behavior of aggregate income, employment, output and conditions in financial markets. Several economists devote their efforts primarily to keeping abreast of developments in specialized areas such as financial structure, international trade, and industries of primary importance in the District, including agriculture.

Complementing these current analysis efforts, the Federal Reserve Bank of Chicago also devotes resources to long-term research, focusing particularly on the fundamental relationships between policy actions and key economic variables. One area of special emphasis has been the design and evaluation of possible mechanisms to enhance the Federal Reserve System's control over money, a concern heightened by experience under the System's new operating procedures for implementing monetary policy adopted in October 1979. Research efforts have involved surveys of institutions' reactions to possible changes in the reserve accounting system as well as theoretical studies of the likely consequences of such changes for monetary control.

Focus on financial structure. The Chicago Bank has long held a special position of leadership in fostering a better understanding of the relationships between banking structure, competition and performance. In 1963, the Bank's Research Department invited a few academics and regulators to discuss issues related to bank mergers and market structure. The concept was a success. In 1964 the first formal "Conference on Bank Markets and Competition" was held in Chicago, with 43 persons in attendance.

By 1981 attendance at the retitled "Conference on Bank Structure and Competition" was approaching 200. As in previous years, the 17th conference offered a unique forum for the exchange of views and research on a wide variety of issues related to financial structure and regulation.

The format for the 1982 conference, to be held in April, is being modified in order to explore more fully the many changes taking place in the financial and economic environment. Both the length of the program and range of topics will be expanded. More importantly, participation at the 1982 conference will be broadened beyond the traditional academic/regulator audience to include many members of the financial services industry. Opportunities for academicians, regulators, and business practitioners to exchange ideas are few in number. This has had the unfortunate effect of creating a gulf between economic theory and practice and of fostering antagonism between government and business. The 1982 conference should help to bridge these gaps.

Intensified regional emphasis. While the Bank has long been concerned with regional issues, additional research efforts are being undertaken in light of changing conditions in the Midwest economy.

Focusing on possible impediments to economic development in the Midwest, the Bank undertook the first phase of planned research into the effects of usury ceilings on the flow of financial and economic resources. Other issues designated for analysis include economic development zones in central cities, urban labor costs and workman's compensation laws, the development of economic indicators for the Seventh District, and state and local government finance, including the potential impact on the Midwest of the administration's proposed "New Federalism" policy.

Thus, in its economic research role, as in its activities as a regulator and provider of services, the Bank seems to anticipate as well as respond to the forces of change. Only through such efforts can the Bank assure for itself a continued position of leadership in a dynamic environment.


ITEM COUNTER
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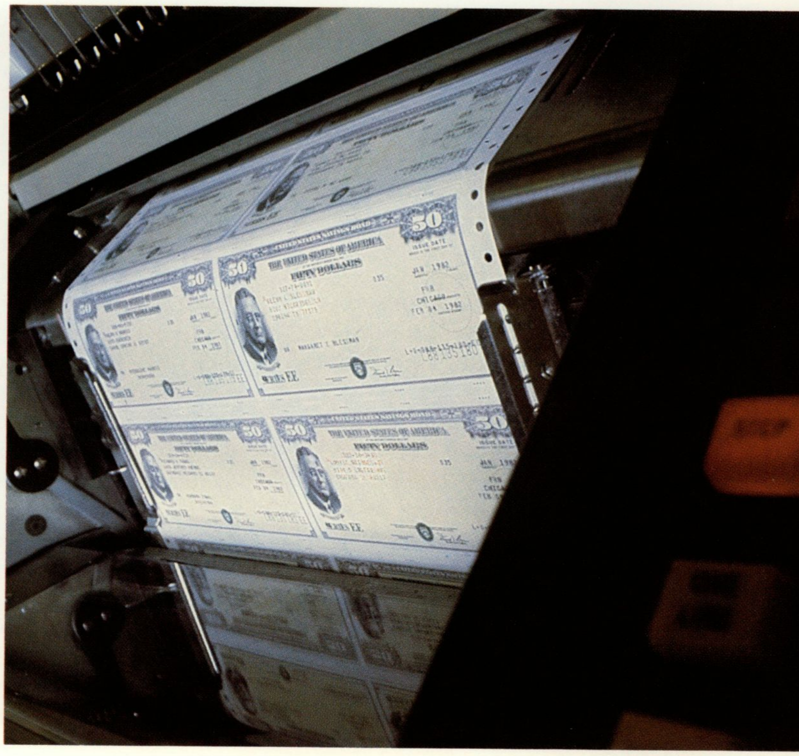
THE UNITED STATES OF AMERICA
FIFTY DOLLARS

Highlights of operations

	Dollar amount		Number	
	1981	1980	1981	1980
Check and related services				
Commercial bank checks, NOWs, and share drafts collected	1.2 trillion	1.2 trillion	2.1 billion	2.1 billion
U.S. government checks and postal money orders collected	106.2 billion	86.0 billion	84.9 million	82.3 million
Automated payments processed	61.9 billion	20.3 billion	38.0 million	27.6 million
Funds transfers	12.8 trillion	11.5 trillion	6.6 million	5.9 million
Cash operations				
Currency received and counted	10.9 billion	9.1 billion[r]	1.1 billion	1.0 billion
Unfit currency withdrawn	2.1 billion	1.5 billion[r]	375.4 million	295.8 million[r]
Coin received and processed	313.7 million	306.0 million[r]	2.1 billion	2.2 billion
Securities services for depository institutions				
Safekeeping of securities:				
Definitive, balance December 31	10.0 billion	10.3 billion	1.2 million	1.7 million
Book entry, balance December 31	70.8 billion	60.1 billion	—	—
Purchase and sale of securities	2.9 billion	1.9 billion	35.9 thousand	34.4 thousand
Collection of corporate and municipal bonds, coupons and other noncash items	11.6 billion	13.3 billion	1.2 million	1.0 million
Loans to depository institutions				
Total loans made during year	36.5 billion	34.9 billion	16,003	8,577
Institutions accommodated	—	—	428	325
Services to U.S. Treasury				
Marketable government securities issued, serviced and redeemed:				
Definitive securities	2.6 billion	3.6 billion	356.6 thousand	358.9 thousand
Book entry securities	1.0 trillion	1.3 trillion	174.5 thousand[1]	500.8 thousand
U.S. savings bonds issued, serviced and redeemed	3.0 billion	4.3 billion	39.9 million	53.0 million
Federal taxes processed	73.7 billion	66.8 billion	814.0 thousand	790.9 thousand
Food stamps received and processed	1.2 billion	0.9 billion	327.9 million	251.0 million[r]

[1]Basis for counting number of items changed from previous year.

[r]Revised.

The Bank has been able to improve service and handle increased volumes more efficiently through automation. Top: *Mutilated bills are captured in the "reject pocket" or shredded on-line by high-speed currency sorters that process 50,000 bills an hour.* Lower left: *High-speed check sorters at the Bank's five offices handle the largest volume of checks in the Federal Reserve System.* Lower right: *Mini-computers are now being used to issue savings bonds.*

Statement of condition

(in thousands of dollars)

	As of December 31	
	1981	1980
Assets		
Gold certificate account	1,171,000	1,722,000
Interdistrict settlement account	(930,308)	(966,737)
Special drawing rights certificate account	519,000	411,000
Coin	22,703	19,702
Loans and securities:		
Loans	398,512	186,220
Federal agency securities	1,393,091	1,373,212
U.S. government securities	19,500,662	18,745,536
Total loans and securities	21,292,265	20,304,968
Cash items in process of collection	1,011,076	1,729,911
Bank premises	17,478	16,469
Other assets	1,206,291	1,148,388
Total assets	**24,309,505**	**24,385,701**
Liabilities		
Federal Reserve notes	19,533,785	19,436,871
Deposits:		
Depository institutions	3,358,161	3,495,116
U.S. Treasury—general account	0	0
Foreign	46,893	51,976
Other	77,046	38,498
Total deposits	3,482,100	3,585,590
Deferred availability cash items	554,323	671,649
Other liabilities	379,187	337,953
Total liabilities	23,949,395	24,032,063
Capital accounts		
Capital paid in	180,055	176,819
Surplus	180,055	176,819
Total capital	360,110	353,638
Total liabilities and capital	**24,309,505**	**24,385,701**

Statement of earnings

(in thousands of dollars)

	Year ending December 31	
	1981	1980
Current earnings:		
Interest and surcharges on loans to depository institutions	30,154	27,056
Interest on government securities	2,226,833	1,952,245
Interest on investments of foreign currencies	82,500	17,549
Service fees	23,794	N.A.
All other	1,155	568
Total current earnings	2,364,436	1,997,418
Current expenses:		
Operating expenses	112,441	98,848
Cost of Federal Reserve currency	10,252	8,549
Total current expenses	122,693	107,397
Less reimbursement for certain fiscal agency and other expenses	8,098	8,530
Current net expenses	114,595	98,867
Current net earnings	**2,249,841**	**1,898,551**
Additions to (or deductions from) current net earnings:		
Net profit (or loss) on sales of securities	(19,187)	(31,497)
Net profit (or loss) on foreign exchange transactions	(44,981)	14,033
Assessment for expenses of Board of Governors	(9,246)	(9,154)
All other—net	(3,220)	(1,606)
Net additions (or deductions)	(76,634)	(28,224)
Net earnings before payments to U.S. Treasury	**2,173,207**	**1,870,327**
Distribution of net earnings:		
Dividends paid	10,748	10,341
Payments to U.S. Treasury (as interest on Federal Reserve notes)	2,159,223	1,851,065
Transferred to surplus	3,236	8,921
	2,173,207	**1,870,327**

N.A.—Not applicable.

Directors

(as of December 31, 1981)

Federal Reserve Bank of Chicago

John Sagan, *Chairman*
Vice President-Treasurer
Ford Motor Company
Dearborn, Michigan

Stanton R. Cook, *Deputy Chairman*
President
Tribune Company
Chicago, Illinois

Roger E. Anderson
Chairman of the Board
Continental Illinois National Bank
Chicago, Illinois

Edward F. Brabec
Business Manager
Chicago Journeymen Plumbers, Local 130
Chicago, Illinois

Mary Garst
Manager—Cattle Division
The Garst Company
Coon Rapids, Iowa

Dennis W. Hunt
President
Hunt Truck Lines, Inc.
Rockwell City, Iowa

Leon T. Kendall
Chairman of the Board
Mortgage Guaranty Insurance Corporation
Milwaukee, Wisconsin

Patrick E. McNarny
President
The First National Bank of Logansport
Logansport, Indiana

O. J. Tomson
President
The Citizens National Bank
Charles City, Iowa

Detroit Branch

Herbert H. Dow, *Chairman*
Secretary
The Dow Chemical Company
Midland, Michigan

James H. Duncan
Chairman
First American Bank Corporation
Kalamazoo, Michigan

Karl D. Gregory
Professor of Economics and Management
Oakland University
Rochester, Michigan

Lawrence A. Johns
President
Isabella Bank and Trust
Mt. Pleasant, Michigan

Russell G. Mawby
President and Trustee
W.K. Kellogg Foundation
Battle Creek, Michigan

Dean E. Richardson
Chairman of the Board
Manufacturers National Bank of Detroit
Detroit, Michigan

Thomas R. Ricketts
Chairman of the Board and President
Standard Federal Savings and Loan Association
Troy, Michigan

Federal Advisory Council Member

Robert M. Surdam
Chairman of the Board
National Bank of Detroit
Detroit, Michigan

Directors discuss the state of the economy as well as Bank operations at their monthly meetings.

Officers

(as of December 31, 1981)

Silas Keehn
President

Daniel M. Doyle
First Vice President

Robert M. Fitzgerald
Senior Vice President

Charles W. Furbee
Senior Vice President

James R. Morrison
Senior Vice President

Karl A. Scheld
Senior Vice President
and Director of Research

Roby L. Sloan
Senior Vice President

Carl E. Vander Wilt
Senior Vice President

Richard P. Anstee
Vice President

Wayne R. Baxter
Vice President

Gary L. Benjamin
Economic Adviser
and Vice President

Paul J. Bettini
Vice President

Harris C. Buell, Jr.
Vice President

George W. Cloos
Economic Adviser
and Vice President

Franklin D. Dreyer
Vice President

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Vice President,
General Counsel and Secretary

Roderick L. Housenga
Chief Examiner

Oliver I. Ireland
Vice President and
Associate General Counsel

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Vice President

Joseph G. Kvasnicka
Economic Adviser
and Vice President

Robert A. Ludwig
Vice President

Larry R. Mote
Economic Adviser
and Vice President

William T. Newport
Vice President

Dorothy M. Nichols
Economic Adviser
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William Rooney
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Harvey Rosenblum
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Gerald I. Silber
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William D. Stratton
Assistant Vice President

Hilbert G. Swanson
Assistant Vice President

Warren J. Taubman
Assistant Vice President

Janet M. Terry
Assistant Vice President

Patrick J. Tracy
Assistant Chief Examiner

Jean L. Valerius
Assistant Vice President

John D. Van Pelt
Assistant Vice President

Carl C. Welke
Assistant Vice President

Thomas L. Wolfe
Examining Officer

Theodore E. Downing, Jr.
Operations Officer

Warren E. Potts
Operations Officer

Delmar W. Robb
Operations Officer

Detroit Branch

William C. Conrad
Senior Vice President and Manager

Frederick S. Dominick
Vice President

Glen Brooks
Assistant Vice President

Joseph R. O'Connor
Assistant Vice President

Richard L. Simms, Jr.
Assistant Vice President

F. Alan Wells
Assistant Vice President

District Offices

Louis J. Purol
Vice President, Indianapolis

Thomas P. Killeen
Assistant Vice President, Des Moines

Russell O. Langan
Assistant Vice President, Milwaukee

FRCS-80 Program Management Office

M. Brian Carey
Senior Vice President and Project Manager

George E. Coe
Vice President

Laurence Washtien
Vice President

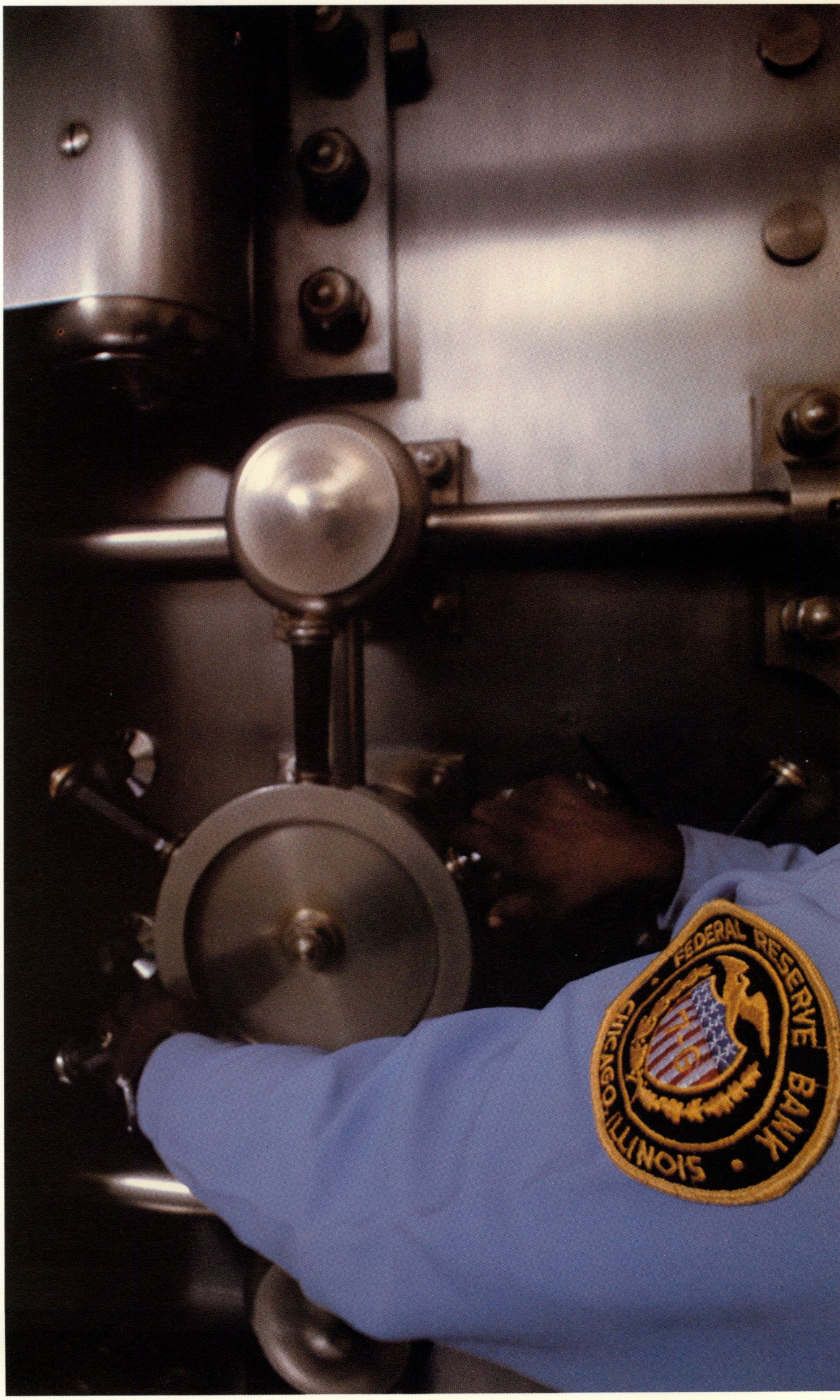
Robert W. Roberts
Assistant Vice President

Auditors *(reporting to board of directors)*

Richard P. Bush
General Auditor

Andrew M. Cook
Assistant General Auditor

George W. Steffen
Assistant General Auditor



Vault doors are closed for the night, symbolically ending the business day.


GRAHAM VERITUS SPECIAL SERVICE