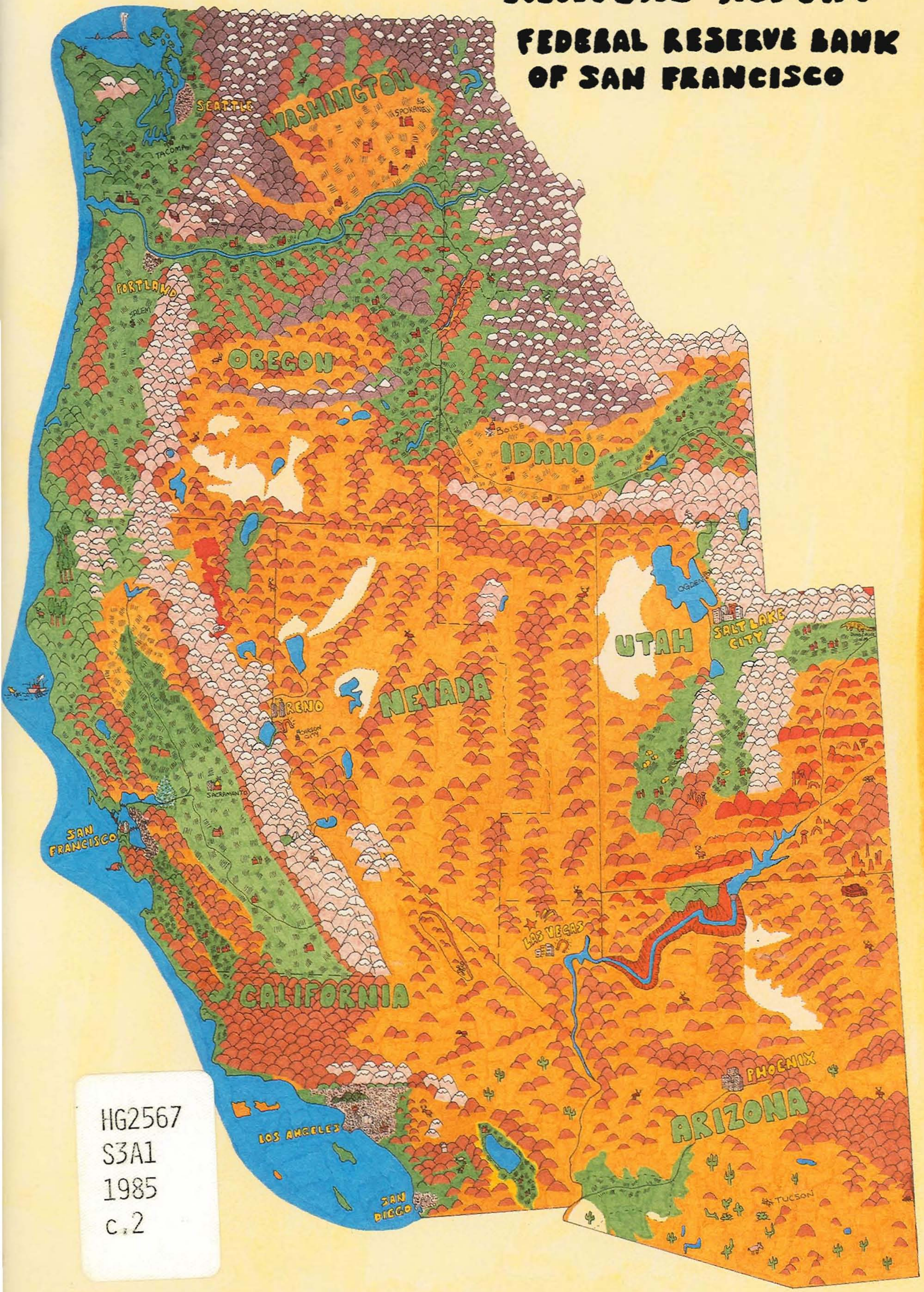
1985 ANNUAL REPORT

FEDERAL RESERVE BANK OF SAN FRANCISCO



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

As the nation's central bank, the Federal Reserve is responsible for determining 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.

FROM THE BOARDROOM

The pace of economic expansion in the U.S. and in the Twelfth District slowed in 1985, bringing into sharp relief the uneven growth patterns across different sectors that have characterized this recovery since mid-1984. On the one hand, the trade and service sectors, as well as portions of the high technology sector, prospered in 1985 as a result of continued strong consumer and defense spending. On the other hand, a sizeable number of industries, such as agriculture, forest products, mining, manufacturing and transportation, encountered difficulties in varying degrees during the year, despite the downward trend in interest rates and a welcomed depreciation of the U.S. dollar.

The depressed condition of many of the nation's and this District's key industries was a reflection of a growing foreign trade imbalance caused by the substantial appreciation in the international value of the dollar through 1984. The dollar's strength into 1985, which was an indirect consequence of the burgeoning federal budget deficit, contributed to a surge in imports and a slump in exports that continued throughout the year. The resultant deterioration in the condition of the industries that were most susceptible to increased foreign competition also showed up in the banking industry in the guise of deteriorating asset quality and continuing bank failures. In particular, this scenario was played out in the deepening farm credit crisis during the year.

In spite of the difficulties encountered in 1985, the outlook for the year ahead contains some bright spots. After three years of expansion, inflationary pressures still have not resurfaced, largely as a result of persistent Federal Reserve efforts toward long run price stability. Reduced inflation should provide a solid base for sustainable growth in the future. Also, with the decline in the value of the dollar from its peak last February, foreign inroads into U.S. markets should ease somewhat in 1986, providing relief to some of the nation's beleaguered industries.

The diverse requirements of the Twelfth District financial community placed special demands on the operations of the San Francisco Reserve Bank in 1985. In its role as a provider of payments services, the Bank sought to improve the overall quality and efficiency of its services. Moreover, Bank management placed particular emphasis on enhancing the reliability and safety of electronic funds transfer through the installation of a system to encrypt all electronic communications between this Bank and its customers. The Bank developed several new services in 1985, including a Large-Dollar Return Item Notification Service, which uses Fedwire to help banks meet the new notification requirements for returned checks, and two new enhancements to *Fedline,* the Bank's micro-computer-based electronic access service, to provide customers with on-line access to accounting information.

Other programs in 1985 also demonstrated the Bank's commitment to improved operations and service delivery. The substantial progress made on the construction of the new Los Angeles Branch building is but one example. Another is the development and implementation of a number of automated systems for the Bank's accounting, banking statistics and operations functions, all of which will enhance overall efficiency. Finally, the Bank's efforts to develop disaster contingency plans culminated in the completion of a comprehensive master plan and a successful test at the Federal Reserve System's back-up data center in Culpeper, Virginia.

Management benefited greatly during 1985 from the broad-based experience and judgment of the Bank's Board of Directors at its headquarters office and at its four branches. The Directors provided guidance on major management decisions and planning goals. In addition, they supplied information and their own views on economic conditions and the formulation of monetary policy to support the Federal Reserve in its primary function as the nation's central bank.

We would like to extend our thanks and appreciation to the Directors who completed terms of service in 1985: Bram Goldsmith (Chairman and Chief Executive Officer, City National Bank, Beverly Hills, California), John A. Dahlstrom (Chairman of the Board, Tracy-Collins Bank and Trust Company, Salt Lake City, Utah), David Nimkin (President and Chief Executive Officer, Corporate Fund for Housing, Los Angeles, California, and formerly from Salt Lake City, Utah), and Lonnie G. Bailey (Senior Vice President, United Bank Alaska, Anchorage, Alaska, and formerly from Spokane, Washington).

Finally, we wish to express our appreciation to the officers and staff whose efforts and dedication made 1985 a successful year and placed the Bank, under its new president, Robert T. Parry, in a strong position to meet new challenges in 1986.

John J. Balles
President

Alan C. Furth
Chairman of the Board

John J. Balles President	Fred W. Andrew Deputy Chairman	Alan C. Furth Chairman

CHANGING OF THE GUARD

The retirement of John J. Balles on February 1, 1986, as he reached the Bank's mandatory retirement age for top management, marked an important change in the leadership of the Federal Reserve Bank of San Francisco. Mr. Balles has served this Bank in an outstanding manner as its president and chief executive officer for the past thirteen years, following earlier careers in commercial banking and in academia. As his successor, the Board of Directors has elected Robert T. Parry, formerly executive vice president and chief economist of Security Pacific Corporation and its principal subsidiary, Security Pacific National Bank of Los Angeles.

With the support of the first-class management team that he developed, Mr. Balles led the Bank through a period of dramatic change for the economy and the financial system which placed new demands on the Federal Reserve System. During this challenging period, Mr. Balles participated in the development of monetary targeting and oversaw the implementation of the far-reaching Depository Institutions Deregulation and Monetary Control Act of 1980. That Act increased the scope of the Federal Reserve in monetary control and greatly broadened its role in offering direct payments services to all banks, thrifts and credit unions on a fully priced basis in a competitive environment.

This Bank, under Mr. Balles' direction, expanded to meet these new responsibilities. The staff of the Bank and its four branches grew in both quality and number. Mr. Balles led the team which obtained approval for and directed two new building programs — the San Francisco headquarters completed in 1983, and the Los Angeles branch building to be finished in 1986.

Mr. Balles was a tireless advocate of the Federal Reserve's anti-inflation policies as well as an important spokesman for the need to reduce the federal budget deficit to foster sustainable economic growth and lower real interest rates. His belief that the future of the Twelfth District economy is closely tied to developments in the Pacific Basin also led him to take an active role in developing closer ties to the other central banks of that region through the Bank's Pacific Basin Program which he initiated. Also, under his leadership, the Bank greatly expanded its economic education and public information activities, including the development of *The World of Economics,* museum-quality exhibitions designed for the lobbies of the Bank's new buildings in San Francisco and Los Angeles.

During his period of service here, Mr. Balles earned the highest professional respect from his colleagues and industry associates. Members of the Bank's Board of Directors who have worked closely with him have developed a warm spirit of personal friendship toward him. Those feelings will not fade. For his innumerable contributions during his thirteen years of service to this Bank, I speak for all the Directors in extending sincere thanks to John Balles and in wishing him well in his retirement.

This Bank also looks forward to continued outstanding leadership. To provide this, I welcome Robert Parry as he assumes the position of president of this Bank. I am confident that he will work in close harmony with Richard T. Griffith, who will continue his strong performance as first vice president and chief operating officer.

Prior to accepting the presidency of this Bank, Mr. Parry served as executive vice president of Security Pacific Corporation and in that capacity, was a member of its management and finance committees. He has also served as the chairman of the Economic Advisory Committee of the American Bankers Association, as a director of the California Bankers Association, and as president of the National Association of Business Economists. Currently, he is a director of the National Bureau of Economic Research. Before joining Security Pacific Corporation in February 1970, he spent nearly five years with the Federal Reserve Board in Washington, D.C., as a research economist. A native of Pennsylvania, he holds Ph.D. and M.A. degrees in economics from the University of Pennsylvania.

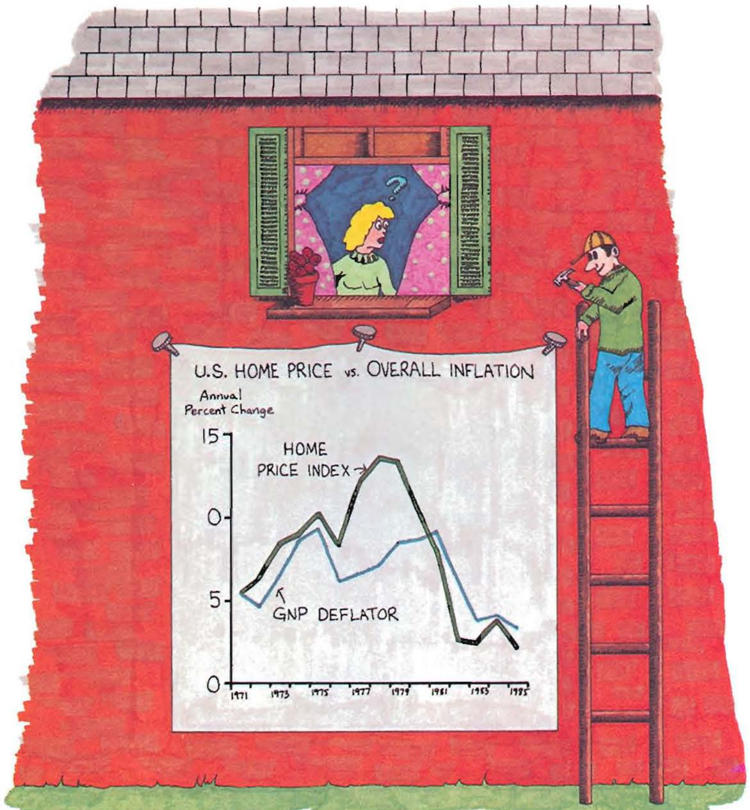
His impressive background in banking indicates that Mr. Parry has the management experience necessary to head one of the nation's largest Federal Reserve Banks. Moreover, his strong credentials as a professional economist make him well-qualified to represent the Twelfth Federal Reserve District on the Federal Open Market Committee, the key body in the formation of monetary policy. We are pleased to have found such an able candidate and, on behalf of the directors and staff of the Bank, I wish him well in his new position.

Alan C. Furth
Chairman of the Board

Robert T. Parry (standing)
John J. Balles

THE NATIONAL ECONOMY

The U.S. economy continued to grow in 1985, but at a much slower pace than in the two preceding years of the current economic expansion. Problems that began to emerge after mid-1984 became sources of persistent weakness in 1985. In particular, the large foreign trade imbalance caused both an overall slowing and an uneven pattern of growth across different sectors. This occurred despite a decline in interest rates of some 300 basis points since mid-1984. Policy-makers sought to redress these structural imbalances through legislation to curb the growth in federal spending and through international accords designed to lower the value of the dollar. In the area of monetary policy, the Federal Reserve's efforts to support noninflationary growth were complicated by the aberrant behavior of the M1 monetary aggregate — an important indicator of the thrust of monetary policy.



Uneven Expansion

Over the last three years the total volume of goods and services produced by the U.S. economy advanced to a level that is ten percent above the previous peak in 1981. At the same time, however, a number of industries have not shared in this overall prosperity. Such industries as forest products, mining and some manufacturing sectors have seen little or no employment growth since 1982. Agriculture has been especially hard-hit, with an actual loss of a half million jobs over this period.

To a large extent, the emergence of this "dual economy," in which some sectors such as trade, services and machinery manufacture prospered while others remained depressed, may be traced to the impact of increased foreign competition resulting from the substantial appreciation in the international value of the U.S. dollar through 1984. Industries producing goods for export found that the dollar's rise made their products more expensive in foreign markets, while at home, the high value of the dollar made imported goods cheaper compared to those produced by U.S. firms. The sharp run-up in the U.S. current account deficit to $120 billion in 1985 reflects this sluggish growth of exports and surge in imports.

Policy Initiatives

It is now widely agreed that these developments have a common cause: the burgeoning deficit in the federal government's budget. Between 1981 and 1983, this deficit almost tripled, and was a significant factor in the sharp rise in real, or inflation-adjusted, interest rates, which, in turn, helped to attract the massive inflow of foreign capital needed to finance this deficit. This capital inflow has been the largest single factor driving up the value of the dollar and producing the deteriorating trade position noted earlier. In a sense, then, most of the burden of financing the budget deficit has fallen on the U.S. industries that are exposed to foreign competition. This competition has led to growing demands for some form of protection.

In an effort to remedy this situation, and perhaps head off protectionist sentiments, Congress enacted the Gramm-Rudman-Hollings bill in late 1985. This legislation calls for a gradual reduction in the size of the deficit until a balanced budget is achieved in 1991. The legislation is intended to redress the major structural imbalance in the economy and provide relief over time to those sectors that have suffered from the indirect effects of the budget deficit.

Of more immediate impact were the efforts of U.S. and other central banks to bring down the value of the dollar through substantial foreign exchange intervention first in late February and again in the fall. The second round of intervention followed the September "Group of Five" Agreement among the U.S., the United Kingdom, France, Germany and Japan. The agreement aimed to encourage orderly depreciation of the dollar through better coordination of these countries' economic policies. These efforts and, more importantly, the slowdown in the rate of growth of the U.S. economy and subsequent declines in interest rates pushed down the dollar's value by 17 percent between February and year-end. Although the dollar's value remained nearly 35 percent above that in 1980, its depreciation in 1985 should set the stage for a significant improvement in 1986 in the trade balance and in the prospects for industries which have been hurt by foreign competition.

Inflation

The transition to an environment of lower inflation continued throughout 1985. Unlike past upswings that saw inflation pick up along with real output, this expansion has been characterized by a *declining* rate of inflation. At its peak in 1980, the twelve-month rate of change in the consumer price index registered an alarming 14.7 percent. By contrast, over 1985, the third year of recovery, this index of inflation rose only 3.6 percent.

The lower rate of inflation provides a solid basis for sustained economic growth over the long run. However, the transition to this new environment has been painful for certain sectors. With lowered inflation expectations, investors no longer demand real assets as a hedge against rising prices. During the 1970s, the annual rates of price increases of real assets such as houses, office buildings, and agricultural land were consistently higher than the overall rate of inflation. But, in 1985 the situation was reversed. Farmers, in particular, who also face stiffened foreign competition for their products, have been hurt severely by the decline in the value of agricultural land.

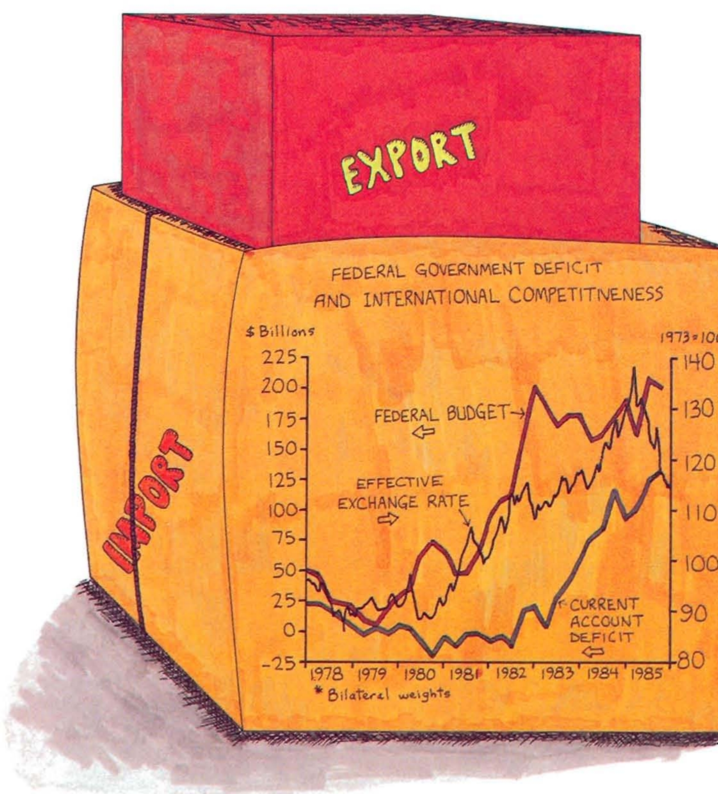
Monetary Policy

In 1985, the principal concern of the Federal Reserve in conducting monetary policy was to facilitate the transition of the economy to a sustainable rate of growth. In light of the problems caused by the budget deficit and the worsening trade balance, the Federal Reserve sought to guide the economy toward a "soft landing" with full employment. At the same time, in view of the costs already incurred in bringing inflation down to a more tolerable level, the Federal Reserve remained conscious of the risks of rekindling inflationary pressures. The task of conducting monetary policy was further complicated in 1985 by a breakdown in the usual relationship between the growth rates of GNP and the Federal Reserve's principal monetary target, M1, which comprises the stocks of currency and "checkable" deposits in the hands of the public.

As the year began, M1 was rising rapidly and by July was well above the Federal Reserve's 4-7 percent growth target for the year. Ordinarily, this would be a signal that spending on goods and services and therefore prices would be rising rapidly as well. Instead, GNP growth remained surprisingly sluggish as the velocity of M1 — the rate at which M1 is spent — declined. Faced with this decline in velocity and with some uncertainty as to whether the decline would continue, the Federal Reserve set a new and wider 3-8 percent M1 target for the second half of the year. This target also was exceeded by a significant margin as velocity continued to fall.

Economists are divided as to the causes of this unexpected decline in velocity, but most agree that the decline in market interest rates, declining inflation and deregulation of the banking industry played roles. All of these developments reduce the cost (in terms of foregone earnings on alternative investments) of holding money, thereby making the public more willing to hold M1 balances than in the past. In view of this unexpected behavior, as well as its concern to get the economy on a sustained growth path, the Federal Reserve decided that M1 growth above the target set at midyear would be acceptable. In particular, the Federal Reserve paid greater attention to other developments in the economy, the credit markets and the foreign exchange markets and less attention to movements in the monetary aggregates. This decision apparently has not led to an increase in inflationary pressures, contrary to the fears of some observers.

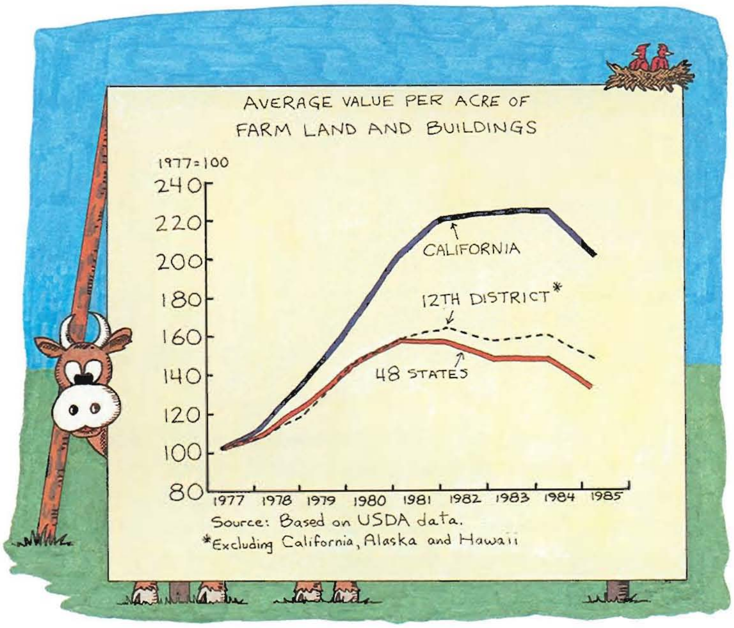
The past year was one of transition. The overall slowdown in growth brought the problems of individual sectors into sharp relief, while monetary policy was conducted with a view towards accommodating needed adjustments. With declines in interest rates and the international value of the dollar, the stage is set for continued economic growth at a moderate pace in 1986 with perhaps only a mild rise in inflation.



THE WESTERN REGIONAL ECONOMY

The diverse economy of the western region, like the nation's, experienced a slowdown in overall growth in 1985. The strength of the dollar into 1985 and the resulting unevenness in economic performance across sectors that produced slower growth nationally also hurt parts of the Twelfth District. In addition, perhaps ironically, a number of industries in the West struggled to make adjustments to an environment of lower inflation and declining real asset prices.

Because of differences in industrial composition, this slowdown has hit some states in the District harder than others. Specifically, those states with economies that depend more heavily upon agriculture, energy production, forest products and/or mining posted poorer results in 1985. By contrast, buoyant consumer confidence, lower interest rates and strong defense spending gave a boost to the economies of other states in the District.



Employment

One way to gauge the performance of this District's economy is to compare various measures of employment across the nine states that make up the western region. For the District as a whole, unemployment stood at close to 7.0 percent, down from 7.4 percent in 1984 and similar to the nation's year-end rate of 6.9 percent. Unemployment rates by state in the Twelfth District ranged from a low of 5.4 percent in Hawaii to a high of 10.4 percent in Alaska, but most were clustered in the 6.5 to 7.5 percent range. California, the District's most populous state, had a 6.5 percent unemployment rate in December, down sharply from 7.7 percent two months earlier. Another indication of diverse economic performance is that unemployment rates were higher than their year-earlier levels in three states, lower in four states and unchanged in two states.

Perhaps a better measure of economic well-being is the employment growth rate. Because potential workers tend to leave an area with few employment possibilities, the unemployment rate in a given area can *fall* even if the economy in that area is troubled. For the District as a whole, employment grew 1.6 percent. Washington posted one of the highest employment growth rates in the Twelfth District, at 3.8 percent, while Arizona's employment base fell 1.7 percent, the largest drop in the District. These changes in employment compare to increases of 1.3 percent in California and 1.9 percent for the nation as a whole.

Sources of Strength

Consumer spending throughout the nation was robust in 1985, and the western region was no exception. Consequently, employment in trade and services, which together account for almost 50 percent of total non-agricultural employment in the Twelfth District, grew by 3.7 percent.

Employment growth in construction also was strong, as the decline in interest rates boosted the demand for structures. Construction activity, however, was distributed unevenly across the District. Washington, with a generally strong economy, saw almost a 10 percent increase in housing permits and a 42 percent increase in the value of nonresidential contract awards. In contrast, in Alaska, residential construction permits declined 37 percent and the value of nonresidential contract awards declined 8 percent.

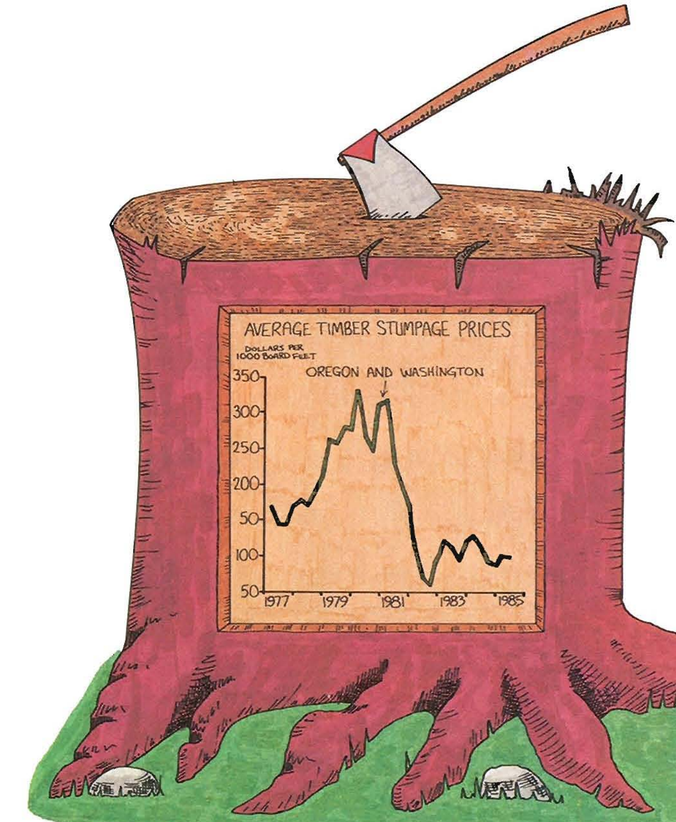
Another source of strength in the Twelfth District in 1985 was the aerospace and defense industry. Twenty-five percent of all prime defense contracts, or $37 billion, was awarded to firms in this District. These outlays, as well as improved demand for commercial airlines, kept the aerospace sector healthy and provided a boost to the California and Washington economies, in particular. In California, aerospace jobs accounted for an estimated 35 percent of all manufacturing jobs and almost 7 percent of total nonagricultural employment.

A number of major industries in the West failed to share in the prosperity created by strong consumer and defense spending, however. Even though the international value of the dollar declined throughout most of the year, these industries, which include agriculture, semiconductors and electronics, forest products, oil, and mining, suffered from its still high value, as well as from greater foreign competition, sagging world demand, and, in some cases, high U.S. costs.

Agriculture

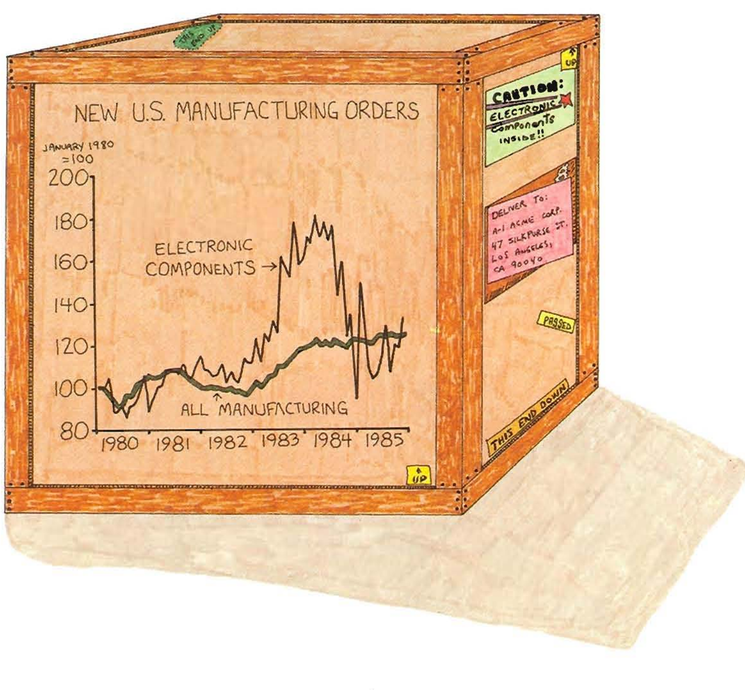
In the agricultural sector, increases in worldwide production of many important crops reduced commodity prices to exceptionally low levels. Despite its decline since February, the continued high level of the exchange value of the U.S. dollar hurt the industry as well. Moreover, protectionist trade barriers and subsidies granted by U.S. trade partners hurt sales of some agricultural products. Consequently, net farm income in California fell to around $3.0 billion in 1985 from the already low level of $3.4 billion in 1984.

Farmland values throughout the District, as across the nation, had been bid up during the late 1970s. Their sharp decline in the last few years reflects the decline in the profitability of agriculture as well as lowered inflation expectations affecting real estate generally. The Twelfth District experienced a 10 percent decline in farmland values, compared to a 12 percent drop nationwide. Many farmers who borrowed against inflated values of farm real estate during the late seventies found themselves unable to service this debt in the lower inflation and less prosperous environment of the eighties. Resulting bankruptcies and foreclosures were prevalent in 1985.



Electronics

The non-defense electronics industry, which was a source of exceptionally strong growth in 1984, stagnated in 1985 primarily as a result of a slump in semiconductor industry activity. Massive overproduction and intensified competition from Japanese producers as well as slowing growth in the demand for microcomputers all have contributed to the weakness in this industry. Widespread layoffs, reduced work weeks, and plant shutdowns were common throughout the District in 1985. The downslide apparently lost momentum over the course of the year, however, since the volume of new orders for electronic components, a leading indicator for these firms, did not decline significantly in 1985.



Resource-based Industries

Throughout the Pacific Northwest, the forest products industries continued to experience difficulties stemming from increased competition from producers in Canada and the southeastern United States as well as relatively weak overall demand. However, there were signs during the year that the shakeout was nearing its end. Price indices for various forest products no longer fell as rapidly as they once did, and in some cases even rose. Stumpage prices, which reflect expectations of future profits in the industry, likewise appear to be stabilizing. Also, looking ahead, the decline in the value of the dollar since early 1985 is expected to result in increased demand from Japan and China in 1986, although producers continue to face Japanese import restrictions.

Softness in oil prices, largely due to a lack of cooperation among OPEC countries, created considerable uncertainty in the District's oil producing areas. Largely because of the oil outlook, Alaska's employment base stagnated in 1985. State and local employment in that state, which accounts for 20 percent of all employment, was particularly hard-hit since state and local government revenues depend heavily on oil tax revenues. Another sign of the weakness in the oil market was the decline in the price of drilling equipment, particularly used drilling equipment.

A continuing excess supply of metals worldwide resulted in lower prices and profits for the mining industry. Foreign competition, especially in the copper industry, forced many domestic firms to make significant reductions in production and employment. One major firm announced the indefinite shutdown in September of all of its Utah copper divisions. As a result, the state lost nearly one-third of its mining employment and an estimated 1,800 secondary jobs totalling approximately 0.7 percent of total state employment. Parts of Nevada and Arizona likewise suffered from a virtual standstill in parts of the mining sector.

The Outlook

The Twelfth District economy had a mixed year in 1985. The dollar's phenomenal rise into early 1985, increased foreign competition, declining asset values and overproduction hurt a number of the region's industries and served to slow the overall rate of growth substantially. In 1986, growth will likely continue to be moderate, but for different reasons. The growth in consumer spending is not likely to provide the boost to growth that it did in 1985, but the decline in the value of the dollar since February 1985 should begin to provide significant relief in 1986 for many of the region's beleaguered industries. Defense and construction spending also will continue to bolster the economy. Finally, the reduction in long-term interest rates that occurred in 1985 should provide some further stimulus to construction spending in 1986.

The reduced foreign exchange value of the dollar, and the fall in interest rates, along with other factors, will hopefully allow the agriculture, forest products, and electronics industries to stabilize in 1986. Some observers believe that the inventory adjustment in the semiconductor industry is essentially over. If so, and if recent declines in interest rates encourage a continuation of the high level of business investment activity seen in recent years, the electronics industry could likewise resume its growth trend in 1986.

The outlooks for the mining and oil industries remain clouded. The future of metals mining rests to a large extent on the course of inflation. If inflation remains low, demand will likely remain low, and metal prices are unlikely to rise very much. The future of the oil industry is even harder to predict since oil prices depend not only on world demand, but also on the possibility of agreement among OPEC members.

WESTERN BANKING

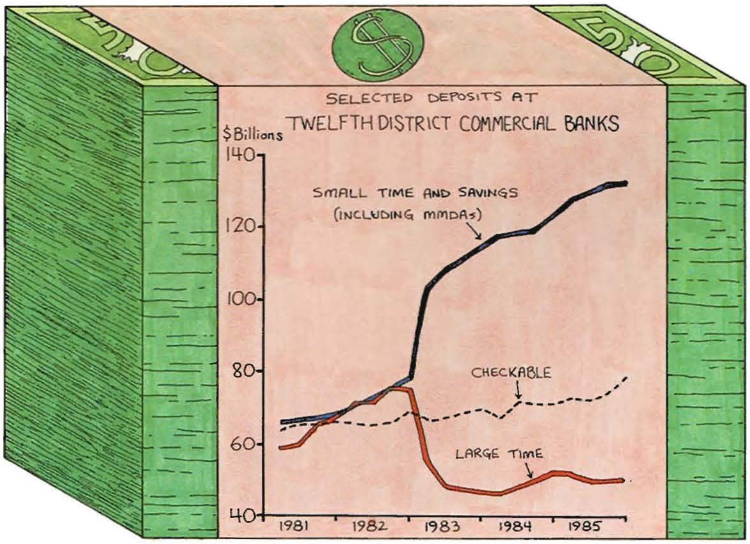
The unevenness of the Twelfth District's economy was reflected in the performance of its banking industry in 1985. Lower interest rates, strong retail deposit growth and the buoyant consumer spending that characterized much of the western economy boosted lending volume and earnings at many banks. At the same time, however, continued weakness in certain sectors of the western economy such as agriculture, energy and mining translated into further deterioration in asset quality. At a handful of banks, moreover, this deterioration was so great as to produce sizeable losses for the year. On balance, aggregate bank earnings in the West declined and trailed the results for the nation as a whole.

Deposit Growth

Western banks enjoyed strong deposit growth in 1985. In line with the surge in the Federal Reserve's M1 aggregate, which includes interest-bearing NOW and Super NOW balances as well as zero-interest demand deposits, checkable deposits at western banks grew rapidly. The growth in Super NOWs and regular NOW accounts accounted for $2.5 billion of the $6.5 billion growth in checkable deposits. Small-denomination time and savings deposits also were up, as a result of rapid growth in money market deposit account (MMDA) balances, which contributed over $5 billion to bank deposit growth. Moreover, even passbook savings balances grew in 1985 — in contrast to previous years when higher market interest rates made the passbook ceiling rate of 5½ percent relatively unattractive.

The growth in deposits at western banks can be traced to a number of factors which increased the attractiveness of bank deposits relative to other investments. First, lower interest rates reduced the opportunity cost (in terms of foregone interest on alternative investments) of holding checkable deposits, particularly since many such accounts now pay interest. Moreover, the continuing deregulation of the banking industry enabled western banks to offer market-related yields on a wider array of products in the time and savings deposit categories. The downward trend in the rate of inflation also may have had a salutary effect on overall bank deposit growth by making financial assets in general more attractive than real assets.

The growth in deposits from consumers and small businesses, in particular, enabled banks in the West to reduce their reliance on more expensive large denomination ($100,000 and over) certificates of deposit (CDs) and other managed liabilities such as eurodollar borrowings. For example, the amount of large CDs outstanding declined by 5.0 percent in 1985, compared to an 8.3 percent rate of growth in 1984. This shift away from large CDs and other managed liabilities towards



retail deposits undoubtedly helped to reduce western banks' cost of funds in 1985. Of course, the decline in the overall level of interest rates also had a significant impact on funding costs.

Lending Patterns

Western banks' lending patterns diverged sharply during the year. For the most part, small and medium-sized banks recorded sizeable year-over-year gains in lending volume, while loans at the District's large banks grew more slowly. Several factors accounted for this divergence. First, the imposition of more stringent bank capital standards by the federal bank regulators tended to constrain growth at the large banks to a much greater extent than at the smaller banks. As a group, the small and medium-sized banks in this District had capital-to-asset ratios well in excess of the new regulatory standards imposed in March. A number of the larger banks, by contrast, had to raise capital and reduce loan growth in order to increase capital-to-asset ratios sufficiently.

A second reason for the divergence in loan growth patterns was that the overall slowdown in the economy reduced the demand for business credit. Large banks are affected more by such a slowdown because they extend most of the business loans to the corporate sector. At the same time, large banks also faced stiffened competition, especially for their largest borrowers, from other sources of business credit such as the commercial paper market and the bond and equity markets. Small and medium-sized banks, by contrast, did not face such competition because they lend to smaller firms that do not have access to national credit markets. As a result, business loan growth at these banks was moderately strong, offsetting some of the weakness in this area at the larger banks.

Sluggish business loan growth contrasted sharply with the rapid growth in consumer loans and, to a somewhat lesser extent, real estate loans. Again, small and medium-sized banks recorded the largest percentage increases in these latter categories as some of the larger banks moved to curtail asset growth and improve capital ratios. Overall, consumer loans grew at a 17 percent annual rate, which was only slightly less rapid than 1984's near-record pace of 19.7 percent. Even though credit card loan rates did not begin to decline until late in the year, growth still was most pronounced in the revolving credit category as a result of western banks' aggressive marketing efforts and strong consumer loan demand. Automobile loans grew almost as rapidly, reflecting relatively strong auto sales during the year. These growth rates, which were clearly well above the growth in personal income, provided further evidence of the strength of consumer confidence in 1985.

Declining mortgage rates during the year promoted a continuing expansion in western banks' real estate lending. Although not as rapid as the 8.2 percent growth recorded in 1984, real estate loans outstanding grew at a solid 6 percent annual rate. Moreover, the growth in outstanding balances does not reveal the full extent of western banks' involvement in real estate lending since many banks chose to sell the loans they originated. Of the new loans banks kept in their portfolios, a sizeable proportion was related to commercial construction, reflecting the still surprisingly strong demand for commercial structures in many parts of the District.

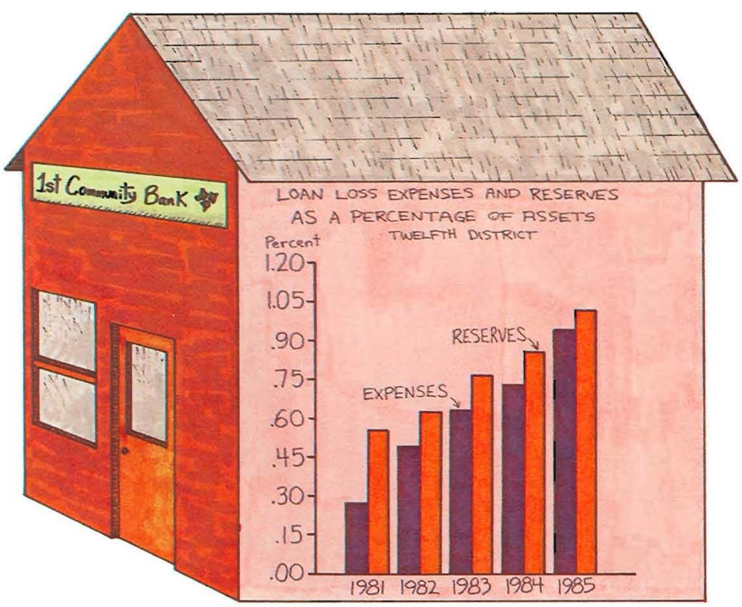
Asset Quality

For banks in the West, as across the nation, the single greatest problem in 1985 was the continuing deterioration in asset quality. Ordinarily, by the end of the third year of an economic recovery, banks can count on a significant improvement in asset quality as the financial conditions of their borrowers improve. However, a number of the region's key industries, including agriculture, energy, mining and forest products, experienced continuing difficulties, leading to a rise in bankruptcies, loan foreclosures and problem loan workouts in these areas. For the banking industry, the problems associated with the poor financial conditions of these industries were compounded by the decline in many asset prices in 1985. Loans that were made several years ago on the assumption that underlying asset prices would continue to rise at a healthy clip became problem credits in 1985 as lowered inflation expectations reduced the value of the loan collateral.

The problems that banks experienced with agricultural loans are a case in point. Many of the farmers who borrowed against inflated land values in the 1970s, a period of rising inflation, could not service their debt when the markets for many agricultural commodities turned soft in the 1980s. Bankruptcies and loan foreclosures followed, and even though banks were able to take possession of the collateral, losses still were enormous because the value of that collateral had fallen in line with the decline in farm prices and profits.

As a result of these developments, western banks experienced a substantial increase in so-called "nonperforming" loans in 1985. Recorded loan losses also were up sharply. By loan category (excluding foreign loans), the loss rate was highest for banks' agricultural loans, with business loans a close second. Banks in Idaho and California were plagued by problem agricultural credits, while banks in Oregon faced continued deterioration in their portfolios of loans to the forest products industry and banks in Alaska encountered difficulties with energy credits. Moreover, large banks experienced higher loss rates than did small banks, largely because of their generally more aggressive business lending activities in previous years. Continuing problems in large banks' international loan portfolios also contributed to these banks' relatively poor loss experience in 1985. As a result, a number of banks in this District, including some of the largest, posted very poor results for the year.

The fact that fewer western banks reported losses than banks elsewhere in the nation is of some consolation. Bank failures, the ultimate measure of bank performance, were up sharply on a nationwide basis, but in the Twelfth District did not increase at all. The problem of deteriorating asset quality was relatively less acute in this District largely because of the greater diversity of this region's economy and the greater asset diversification of this region's banks.



Weak Earnings

In 1985, as in the last three years, the aggregate earnings of western banks were hurt by poor earnings and even losses at some of the largest banks. As in past years, the single most important factor influencing earnings was the deterioration in asset quality and the consequent increase in the provision for loan losses. In the aggregate, expenses for loss provisions increased by a third, reaching nearly $4 billion for the year. Such expenses enabled banks to replenish capital reserves following loan write-offs and to boost reserves in anticipation of future write-offs against the growing volume of nonperforming loans.

Western bank earnings also suffered from the relatively sluggish growth in business loans in 1985. Slower loan growth meant reduced earnings from interest income and loan fees. At the large banks, asset growth and thus income growth were curtailed in part to meet the regulators' new capital adequacy standards.

Despite these problems, many banks in the District posted strong earnings gains of 10 to 15 percent for the year. In states with strong economies such as Washington and even California, banks fared particularly well. Overall, western banks enjoyed a modest improvement in net interest margins, or the spread between the return on assets and the cost of funds. The growth in consumer deposits as well as the decline in the level of interest rates since mid-1984 led to a larger decline in banks' interest expense than in the yield on their assets.

Banks' earnings from fee-based income also improved, as they sought to move toward more explicit pricing of products. Relatively new fee-based products, such as discount brokerage services and credit-related insurance, along with the rising importance of fees from mortgage banking activities helped with the earnings picture. More explicit pricing of checking account and other deposit services, as well as the growing popularity of commercial loan fees also added to bank revenues.

On balance, western banks made the most of a difficult year. While earnings were anemic compared to what one would expect for the third year of an economic recovery, most banks in the District dealt remarkably well with the industry-wide problem of deteriorating asset quality. Moreover, large loan write-offs taken during the year, as well as growth in equity capital and reserves now place the industry in a stronger position to deal with problems in the coming year. With improvements anticipated in some of the region's weaker sectors such as forest products and agriculture, the western banking industry should see some relief from the problems encountered in 1985.

Management Committee
John J. Balles, President and Chief Executive Officer (seated)
(Standing, from left to right)
Richard T. Griffith, First Vice President and Chief Operating Officer
Thomas C. Warren, Executive Vice President
Michael J. Murray, Senior Vice President

SUPERVISION, REGULATION AND CREDIT

Although the general condition of Twelfth District banking organizations improved slightly in 1985, persistent weakness in certain sectors of the region's economy resulted in a deterioration in asset quality in many areas. Particularly troublesome was the increase in the level of problem real estate, agricultural and energy loans. Some of the larger institutions also were confronted with difficulties arising from their international loan portfolios. As a result, some western banks posted very poor earnings, or even losses for the year.

Deteriorating conditions at a relative handful of these institutions required special supervisory attention and the establishment of formal corrective-action programs. As of year-end, supervisory actions were in place or in process at 39 state member banks and bank holding companies. This represents an increase over 1984 in the number of such actions, largely as a result of the problem of deteriorating asset quality. At the same time, however, notable progress was made toward resolving serious problems at a number of institutions for which corrective-action programs had been established in previous years.

In contrast to the increased number of supervisory actions in 1985, the number of bank failures in the District did not rise. During the year, federal and state authorities closed 10 District banks with combined assets of $400 million, compared to 12 banks with combined assets of $600 million in the previous year. This development compares with a 50 percent increase in the number of bank failures nationwide from 1984 to 1985. Because of the diversity of the economy as well as the multi-branch structure of the banking industry in this District, this region's banks tended to have better diversified portfolios than did their counterparts in other regions, enabling banks in the Twelfth District to cope better with loan losses in specific areas.

Supervisory Developments

The most important supervisory development during the year was the decision in October by the Board of Governors of the Federal Reserve System to adopt new policies designed to strengthen the Federal Reserve's supervision of state member banks and bank holding companies. The San Francisco Reserve Bank immediately began intensive efforts to implement these policies by early 1986. The new policies generally increase the frequency and scope of examinations and strengthen the communication of examination findings to each institution's board of directors. Because these initiatives will require a significant increase in examiner resources, the Bank undertook an ambitious recruiting and training program in the fourth quarter. The establishment of procedures needed to implement the new policies will be facilitated by the new automated management system for supervision and regulation which was completed during 1985.

Throughout 1985, the Bank continued to work closely with other federal and state regulatory agencies in coordinating examination and supervisory efforts. In August and September, the longstanding cooperative relationships with the state banking authorities in the nine western states were made even stronger as a result of meetings between Reserve Bank officials and each state's banking supervisor. The purpose of these successful meetings was to explore and establish new ways in which the Reserve Bank and each state could coordinate their efforts to enable each agency to meet its responsibilities more efficiently.

Regulatory Activities

Twelfth District banking organizations took a cautious approach to expansion in 1985. Bank holding company applications filed during the year clearly reflected this. Overall, bank holding company applications ran slightly below the previous year's level and formations, which primarily are changes in organizational form, constituted a larger share of the total. Even nonbank applications, which focused on small acquisitions and/or service-related activities, did not represent a major diversion of resources into nonbanking activity. Change in Bank Control Act applications exhibited the strongest growth, but these tended to reflect changes in ownership rather than expansion. Finally, the number of state member banks increased, but at a slower pace than in 1984.

Lower court decisions halted the processing of applications to form "nonbank" banks. These institutions are not technically banks under the Bank Holding Company Act because they do not offer both demand deposits and commercial loans. For bank holding companies, nonbank banks appeared to offer a means of circumventing laws limiting interstate expansion. In January 1986, a Supreme Court decision that centered on the definition of "bank" may have opened the way, in the absence of Congressional action, for a resumption of nonbank bank expansion.

In a 1985 decision, the Supreme Court confirmed the constitutionality of regional interstate compacts which permit interstate expansion on a regional basis. This decision opened an alternative avenue for interstate expansion. As of year-end, five states in the District (Oregon, Utah, Idaho, Nevada and Washington) had passed laws permitting acquisitions by out-of-state bank holding companies located in other specified western states. Alaska and Arizona had also passed interstate banking laws, but without any such regional restrictions, and interstate banking legislation was pending in California. During the year, the first applications were processed to permit regional interstate acquisitions of banks in Oregon, Utah and Nevada.

International economic conditions in 1985 restrained overseas expansion by District banks. Applications for new offshore activities by domestic banking institutions fell by a third and typically involved only minor changes to existing activities. Only two new export trading companies were approved during the year, and other bank holding companies which had previously received approval for these companies either did not open them or cut back such operations. (Congress authorized export trading companies in 1982 to encourage U.S. exports, but to date, the results have been disappointing because of the high value of the dollar.) The number of District Edge Act corporations fell from 51 to 47 and the total number of foreign banks' branches and agencies was almost unchanged.

Discount Window

Borrowings from the discount window were moderate throughout the year. The Bank extended loans to 149 depository institutions in 1985. Among the borrowers were a small number of institutions having severe financial problems. These were accommodated under the "other extended credit program." Moreover, the Credit Unit implemented a special seasonal credit program aimed at dealing with the farm credit problems of agricultural banks. Also during the year, the Credit Unit strengthened its relationships with other bank and thrift regulators to provide a procedural foundation that can effectively respond in the event liquidity needs arise in the future. Total collateral pledged by institutions in the District at the end of 1985 amounted to $26.3 billion, up from $25.4 billion in 1984.

Summary of Operations

	Volume (thousands)			
	1982	1983	1984	1985
Custody Services				
Cash Services				
Currency paid into circulation	1,767,236	1,925,085	2,188,831	2,438,168
Coin paid into circulation	4,779,409	5,078,150	5,302,832	4,773,898
Securities Services				
Savings Bonds original issues	995	1,235	1,549	2,019
Savings Bonds redemptions processed*	339,820	285,420	279,342	292,786
Other Treasury original issues	182	116	138	108
Food coupons processed	313,761	333,512	310,450	272,231
Payments Mechanism Services				
Check Processing Services				
Commercial checks processed	1,210,143	1,226,778	1,337,350	1,478,448
Fine sort bundles processed*[1]	2,619,403	3,367,031	509,560	577,883
Government checks processed	101,310	96,136	95,548	93,451
Return items processed	23,952	24,707	35,580	28,800
Electronic Funds Transfer Services				
Wire transfers processed	5,882	6,674	7,757	8,521
Automated clearinghouse transactions processed	76,944	91,838	111,408	129,930
Discounts and Advances				
Total discounts and advances*	1,281	1,234	2,348	1,818
Number of financial institutions accommodated*	105	108	136	149

*Number (not in thousands)

[1]Reported in packages beginning in 1984.

ORGANIZATION CHART

February 4, 1986

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John J. Balles
President
and
Chief Executive Officer

(Retired February 4, 1986)

Robert T. Parry
President
and
Chief Executive Officer

(February 4, 1986)

Jane W. Langhorne
Ombudsman

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and Director of Research

John H. Beebe
Vice President and
Assoc. Director of Research

John P. Judd
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Macroeconomic Studies

Adrian W. Throop
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and Legislative Analyst

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Douglas R. Shaw
Associate
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Vice President
and Secretary of the Board

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First Vice President
and
Chief Operating Officer

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Executive Vice President

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Corporate Planning

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Statistical and Data Services

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Applications Systems

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Applications Systems

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Systems Officer

Margaret A. Linderman
Systems Officer

Laurence Washtien
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Systems and Communications

Patrick Tong
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Computer Operations

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Finance and Product Managem

John Gleason
Vice President
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Buffington Clay Miller
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Product Management

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Accounting Automation

Thomas R. Thaanum
Asst. Vice President
Financial Accounting

Gregory B. Williams
Asst. Vice President
Financial Planning and Control

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Vice President
in Charge

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Asst. Vice President
Payment Services

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Asst. Vice President
Securities Services

John H. Wong
Cash Services Officer

Peter W. Homes
Financial Services Officer

Seattle Branch

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Senior Vice President
in Charge

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Custody Services

Gayle P. Ansell
Asst. Vice President
Analysis and Control

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Asst. Vice President
Payments Services

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Asst. Vice President
Financial Services

Salt Lake City Branch

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Vice President
in Charge

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Asst. Vice President
Analysis and Control

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Asst. Vice President
Custody Control

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Asst. Vice President
Payments Services

Andrea P. Wolcott
Asst. Vice President
Financial Services

Portland Branch

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Senior Vice President
in Charge

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Administrative Services

H. William Pennington
Asst. Vice President
Custody Control

Dean C. Gonnerman
Asst. Vice President
Payments Services

Susan L. Roberson
Asst. Vice President
Financial Services

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General Auditor

Gul Gidwani
Assistant
General Auditor

Peter K. C. Hsieh
Audit Officer

Bruce H. Thompson
Assistant
General Auditor

Charles O. Bowden
Audit Officer

Gary G. Hoeth
Audit Officer

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Supervision, Regulation and Credit

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Vice President
Credit and Consumer Affairs

Wayne L. Rickards
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Bank and Consumer Regulations

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District Credit

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Salt Lake City

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Examining Officer

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Director
Applications and Analysis

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Applications Officer

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Director
BHC and International Supervision

Philip M. Ryan
Examining Officer

Richard S. Campos
Examining Officer

Thomas J. Backer
Examining Officer

Terry S. Schwakopf
Examining Officer

and Product Management

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President
Product Management

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Clay Miller
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Robert B. O'Donoghue
Asst. Vice President
Product Management

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Automation

Thaanum
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Williams
resident
anning and Control

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Senior Vice President
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John F. Hoover
Vice President
District Financial Services

Oren L. Christensen
Vice President
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Personnel and Administrative Services

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Dawn B. Allen
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Asst. Vice President
Data Security

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Vice President
Building and Property Management

James J. Tenge
Asst. Vice President
Administrative Services

Sylvia A. Cunningham
Procurement Services Officer

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S. Carella
Vice President
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othy Carr
ice President
istrative Services

iam Pennington
ice President
ty Control

C. Gonnerman
ice President
nts Services

L. Robertson
ice President
cial Services

Los Angeles Branch

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Senior Vice President
in Charge

Hector M. Martin
Vice President
Operations

Ross G. Ashman
Asst. Vice President
Payments Services

Theodore A. Schroeder
Asst. Vice President
Securities Services

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Asst. Vice President
Cash Services

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Vice President
Administration

Brent M. Duxbury
Asst. Vice President
Administrative Services

Mary Ellen Martin
Asst. Vice President
Financial Services

BANK ADMINISTRATION

During 1985, senior management sought to enhance the Bank's ability to respond to current needs and to anticipate new trends and challenges arising from a changing regulatory, technical, financial and competitive environment. To that end, the Bank's management team established a new corporate planning function to coordinate and integrate the key bankwide planning processes. This integrated approach was evident in the many planning and development initiatives undertaken in 1985. Development and implementation of a number of automated systems for the Bank's accounting, banking statistics and operations functions received particular emphasis. At the same time, construction of the new Los Angeles Branch building moved forward, and preliminary planning for a scheduled occupancy date beginning in mid-1986 was completed. Progress in disaster contingency planning included a successful test at the Federal Reserve System's back-up data center in Culpeper, Virginia, and development of a comprehensive master plan for staff safety and recovery of operations in the event of a major earthquake, fire or other catastrophe. Finally, in the payments area, the Bank moved to improve security and reduce risk associated with funds transfer networks.

Corporate Planning

As the economic and technological environment becomes more complex, a systematic and integrated approach to strategic planning is increasingly important. In response to these requirements, the Bank's Management Committee established a formal corporate planning department during the first quarter of 1985. This new unit provides coordination and integration of District planning processes, offers consulting services to Bank functions regarding the planning process and supports Federal Reserve System planning initiatives.

Automation Efforts

Automation efforts encompassed a wide range of initiatives and programs in 1985 in support of the Federal Reserve System's multiple roles in monetary policy, regulation and supervision, and the nation's payments system. A number of these initiatives involved the development or implementation of standard applications suitable for use throughout the entire Federal Reserve System. For example, the Bank took steps in 1985 to prepare for the March 1986 implementation of the standard Integrated Accounting System (IAS). Initially, three modules will be implemented — Data Entry, General Ledger and Deposit Accounting. The new system will replace processing at the Bank's five offices with a centralized, uniform system which is easier and less costly to change. IAS also will improve control of the Bank's financial data by reducing sharply the number of manual entries and thus the chance for error. Additional modules will expand the system to include other accounting functions and provide enhanced services over the next few years. Preparations for IAS during 1985 included staff training and the development of software to link IAS with the Bank's other automated systems. Because an accounting system must work in concert with many other functions, this accomplishment involved creating automated links to approximately 30 other systems, defining more than 15,000 accounting transactions and training the staff in each of the affected areas.

In 1985, the Bank also played a key role in the Federal Reserve System Automation Program as a development site for two of the program's eight resource-shared applications. This program standardizes the software for systems meeting common needs of the twelve Reserve Banks, which share the costs of development and maintenance. One such application is the Banking Statistics System which was developed by this Bank and is now being installed in all other Reserve Banks and the Board of Governors. This system provides the basis for automated processing of the wide range of data that are collected from depository institutions and used in the computation of the various money supply measures. The system will result in significant cost savings and increased flexibility in responding to changing data collection needs.

The Bank also serves as development site for the Automated Securities Handling System. In this capacity, the Bank modified existing software to support the Treasury's ability to offer a broader range of securities. Finally, the Bank implemented additional resource-shared applications during 1985 which were developed at other Reserve Banks. These include the new Transfer of Funds System, Automated Clearing House System, and Customer Information System. The successful completion of these programs will enable the Twelfth District to realize the long term automation program benefits of improved operating controls, cost effectiveness and ability to accommodate change.

Another important focus of the Bank's automation program was in the electronic payments area. Along with enhancements in the Bank's intradistrict communications network, management improved the security procedures involving the electronic transfer of money. As a result, the majority of electronic connections with depository institutions are now encrypted, with full encryption targeted for 1986.

The Bank's growing use of computer resources resulted in the need for a computer upgrade in the San Francisco Data Center. The complex acquisition process for this computer was completed and the new central processor will be operational early in 1986. The new computer, which represents the state of current technology, should serve the Twelfth District's needs for the next several years. As an extension of its large centralized computer complex, the Bank also seeks both to exploit emerging microprocessor technology and to use smaller computers capable of serving the needs of individual departments.

New Building Program

During 1985, construction of the new building for the Los Angeles Branch moved forward on schedule, with completion expected before the end of 1986. In addition to construction progress, the Bank initiated a program for purchasing furniture and equipment to make the building ready for the planned sequential move-in process starting in mid-1986. Final designs were completed and fabrication began on the *World of Economics Exhibition* which will be featured in the main banking lobby. This exhibition is a close replica of the exhibition that has proven to be a highly popular and effective tool for economic education in the head office building in San Francisco. When completed, the new building will provide the Los Angeles Branch with more space, vaults and equipment critically needed to accommodate the increasing demands for Reserve Bank services in southern California, Arizona and southern Nevada. Looking even farther ahead, the Bank made plans to hire a developer to renovate the existing branch building and lease it through an outside agent in order to retain the space for expansion of the branch's operations, if needed in the distant future.

Disaster Contingency Planning

In 1985, the Bank participated in the Systemwide planning effort to develop the Contingency Processing Center in Culpeper, Virginia, as a backup data center for all twelve Reserve Banks. The site would be used in the event of a long-term service disruption that might occur after a major computer room fire or natural disaster, such as an earthquake. A major accomplishment was the successful testing of the Bank's ability to relocate the operations of the San Francisco Data Center to this site. This backup will enable the Bank to operate critical functions at near normal service levels.

In addition, the Bank published its "Disaster Contingency Plans for Staff Safety and Recovery of Critical Operations." Its publication marks a significantly increased level of emergency preparedness and awareness, providing for recovery of critical business functions from short term service disruptions. The document also describes the Bank's newly established emergency management organization and details bankwide responsibilities and procedures for response to an emergency. It includes provisions for executive communications, backup power to critical building work areas, medical care, and systematic search and rescue after a major disaster.

Payments System Risk Reduction

In light of the substantial risk even a single institution's failure now poses for the payments system, which moves trillions of dollars through national and international electronic networks, the Federal Reserve Board adopted a policy to reduce payments system risk. The new policy, which will take effect March 27, 1986, calls for the electronic transfer networks and individual institutions to limit the amount of credit risk they pose for the payments system. To remain eligible for Fed net settlement services, private funds transfer networks must control the level of risk incurred by participating institutions. At the same time, each institution that participates in a large-dollar funds transfer network, including Fedwire, is encouraged to adopt a cross-system net debit cap. The cap, which establishes the maximum net amount an institution can owe all other institutions across all large-dollar payments systems at any one time, is based on each institution's evaluation of its own creditworthiness, operational controls and credit policies and procedures. The Federal Reserve will review each institution's policy during regular financial examinations.

This Bank took several steps in 1985 to prepare for the implementation of this new policy. In addition to the necessary staff training in the operations, accounting and examination functions, the Bank hosted a series of educational seminars throughout the District to acquaint depository institutions with this new policy and the steps needed for implementation. The Bank also installed the software necessary to monitor institutions' net debit positions on an after-the-fact basis.

PRICED PAYMENTS SERVICES

The Bank strives to promote the efficiency of the payments system by exploring advances in automation and by continually improving the quality of its services in response to the needs of the financial community. To understand the needs of this diverse marketplace, the Bank conducts market research to assess customer needs and to provide information to all institutions concerning direct access to Federal Reserve Payments Services. Of the approximately 3,600 depository institutions in this District, over 1,700 now use one or more of the Bank's services. Electronic access to these services has proven particularly popular, with over 1,200 terminals now in use at depository institutions. With the growth in electronic access, the Bank has taken steps to ensure that such access remains error-free and reliable through encryption of all data electronically communicated between this Bank and its customers.

Check Services

The San Francisco Reserve Bank handles the largest volume of checks of any Reserve Bank in the Federal Reserve System. Moreover, the large geographic size of this District and time differences from eastern financial centers, require a highly sophisticated check transportation system. Given the substantial volume and complexity of its check transportation system, the Bank continuously seeks opportunities to improve service levels and quality. In 1985, the Bank implemented mid-year price reductions, as well as some later check deposit deadlines to improve the availability of funds to its customers. Similarly, the reliability of interdistrict check transportation was greatly improved through expanded use of direct commercial shipments and charter air service. This resulted in improved credit availability and substantially reduced float to depositors.

As part of a Systemwide program, the Bank implemented the Large-Dollar Return Item Notification Service associated with an amendment to Regulation J, which established new notification requirements for the return of dishonored checks of $2,500 or more. This enhancement provides the payor institution with the opportunity to notify (through the Fedwire network) the institution where the check was first deposited that a large dollar item is being returned. Moreover, in an effort to improve service quality and to increase operational efficiency, the Bank is developing automated systems to replace obsolete equipment used to process return-items and checks rejected by high-speed sorters. Based on the success of a 1985 pilot project which automated the low speed check processing operation, the Bank will expand this automation program to check processing service centers throughout the Twelfth District in 1986.

The Twelfth District also is a principal participant in a Systemwide effort to explore new procedures and technologies related to check safekeeping and image processing. Safekeeping of checks could result in substantial cost-savings over the current system in which all checks are returned to their makers. The Bank is currently working with other Federal Reserve System representatives to manage the development of a demonstration safekeeping system that would enable the U.S. Treasury to retrieve check images using digital image technology rather than microfilm. Management is particularly interested in exploring digital image processing as a cost-effective and reliable means of storing and retrieving check-initiated payment instructions.

Funds Transfer

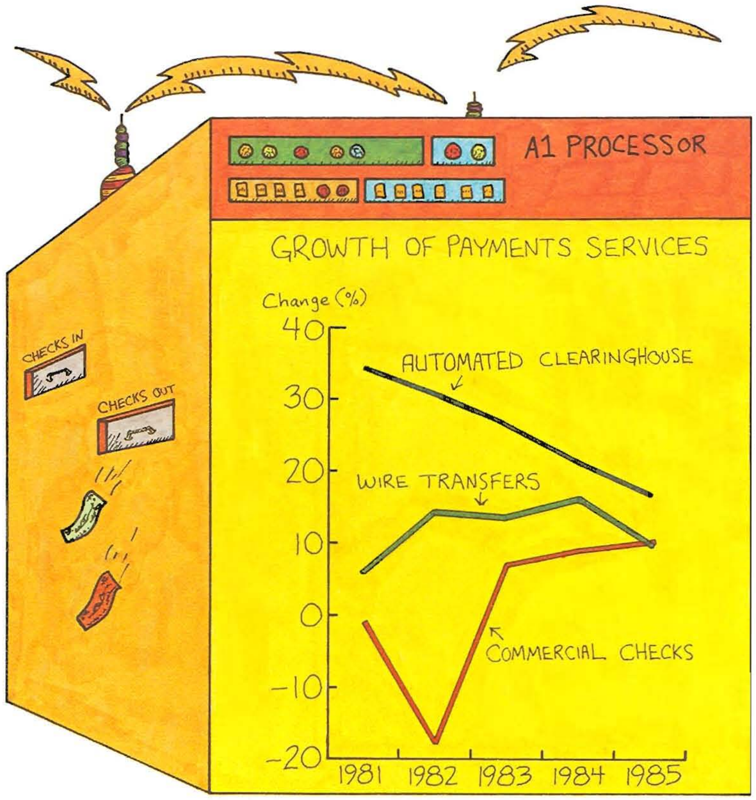
Use of the Bank's Funds Transfer service (Fedwire) continued to grow at a healthy rate in 1985. A major step was taken during the year to improve this service by installing a new processing system that eventually will be used by all Reserve Banks across the country. This new automated system provides customers with improved security. Its flexibility will enable all Reserve Banks to add enhancements to this service.

Another enhancement to the Bank's funds transfer service is the extension of Fedwire operating hours, effective January 1, 1986. An earlier opening hour and a later interdistrict third party closing hour will provide additional processing time for West Coast financial institutions and allow them to manage their intra-day funds positions better.

FedLine Service

FedLine is a family of products that provides electronic access to Bank services via a microcomputer electronically linked to this Bank's computer. *FedLine* was introduced in 1982 to allow a wider range of depository institutions direct access to the Bank's funds transfer service. The *FedLine* funds transfer service continues to be highly attractive, with the number of customers growing from 800 to nearly 950 in 1985. In 1983, a second service was introduced, called *FedLine Cash,* which allows customers to place orders for currency and coin. It also has proven successful with approximately 400 customers now using this product.

In 1985, two new services were added to the *FedLine* family. *FedLine Update Checks* provides customers with detailed accounting information on the current day's check processing activity. Five hundred customers already are using this new service. The *FedLine Update Statements* service followed, providing electronic access to the previous day's Statement of Account early in the following morning. Over 300 customers now are using this service as well.



Automated Clearing House

The Bank's Automated Clearing House (ACH) service, which provides for the exchange and delivery of electronic payments, is undergoing tremendous growth and change in response to market needs. The number of transactions processed in the Twelfth District in 1985 grew more than 16 percent over 1984. At the same time, the Bank worked closely with representatives of Calwestern ACH as it prepared to begin operation as a private sector processor late in the year.

Installation of new standardized ACH software throughout the Federal Reserve System improved processing efficiency and provided the foundation for enhancements to the ACH service planned for 1986. Within the Twelfth District, much of 1985 was spent developing and testing new products to be introduced in early 1986 which will enable customers to originate and receive ACH transactions, or send ACH returns, electronically. Through these new products, customers of all sizes can have a direct electronic ACH connection with the Federal Reserve.

Cash Transportation and Securities Services

In 1985, the Bank's objectives for cash transportation services focused on improved service levels and cost effectiveness, with particular attention paid to institutions at remote distances from a Reserve Bank office. Toward this end, plans were completed late in the year to establish a cash terminal in Phoenix which will improve access and service levels to those customers and contain the rise in cash transportation costs.

In 1985, this Bank provided, on a priced basis, a variety of securities services to financial institutions in the Twelfth District, including safekeeping and transferring of book-entry securities and collection of noncash items. In October, however, the U.S. Treasury determined that the Reserve Banks should provide U.S. Treasury securities services as fiscal agents of the United States, rather than offering them as priced services. Moreover, in an effort to improve the efficiency of the noncash collection service, which involves the collection of maturing municipal notes and bonds and interest coupons, the Securities Services staffs of this Bank and the Federal Reserve Bank of Minneapolis participated in a year-long pilot program aimed at consolidating this service in Minneapolis.

GOVERNMENTAL SERVICES

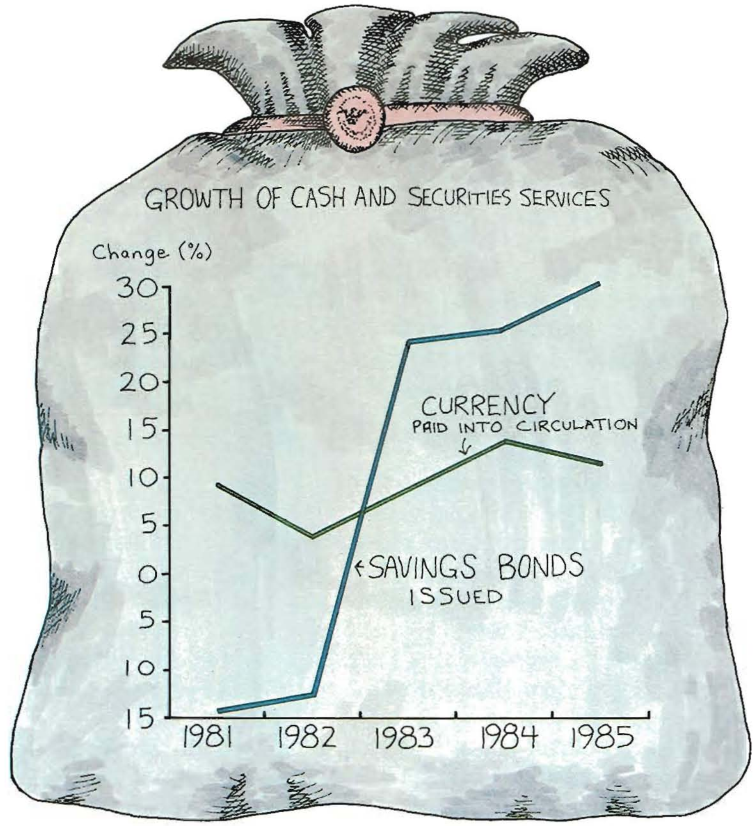
The Federal Reserve Bank of San Francisco is an important provider of fiscal and financial services to the United States Government and to the public on behalf of the U.S. Government. The primary fiscal services provided to the United States Treasury include the issuing, servicing and redemption of government securities and savings bonds, and the distribution of cash and coin to depository institutions. Additional financial services provided to government agencies include check collection and funds transfers, and the processing of electronic payments and food coupons. Major activities in 1985 supported the System's efforts to provide more efficient, better quality and increasingly automated payment services to the U.S. Treasury, which is the single largest user of Federal Reserve payments services.

Securities Services

During 1985, the Securities Services staff throughout the Twelfth District prepared for the mid-1986 installation of the new TREASURY DIRECT Account Book-Entry System. Developed by the Federal Reserve Bank of Philadelphia, this U.S. Treasury project will offer domestic issues of marketable notes and bonds exclusively in book-entry form and will complete the Treasury's transition to full book-entry of all issues. TREASURY DIRECT will also provide a new automated system for establishing, maintaining, and servicing accounts for over two million individual investors in marketable government securities throughout the country. The new system includes a direct deposit feature through which interest and redemption payments are transferred electronically and credited to investors' accounts on the day the payment is due.

In line with the move to book-entry securities, the Bank took several steps to improve the efficiency of handling remaining Treasury obligations available in bearer form. In 1985, the Twelfth District consolidated the inventory of unissued Treasury securities stock in San Francisco. This centralization of the remaining issues of Treasury obligations still available in bearer form has reduced costs without diminishing services to the financial community and the public. A similar effort to improve the attractiveness and service of the Bank's savings bond programs fostered a 30 percent increase in the number of bonds issued.

This Reserve Bank also has supported implementation of the Treasury's new program to facilitate the Separate Trading of Registered Interest and Principal of Securities (STRIPS). This marks the first time that the market was given the opportunity to trade separate principal and interest coupons, or "zero-coupon" instruments in book-entry form as direct obligations of the United States. The success of this effort has assisted the



Bureau of the Public Debt to reduce the cost of government financing.

Federal Reserve Banks are the chief agents for relaying Government transfer payments, such as Social Security payments, to individuals. These payments are made primarily through electronic transfers or Treasury checks. Electronic payments through the Automated Clearing House (ACH) and Fedwire continued an upward trend, with Government payments constituting 68 percent of the Twelfth District's ACH volume. Reserve Banks also collect, sort, cancel, and store Treasury checks for safekeeping after circulation. Within the System, the San Francisco Bank is the largest processor of Government checks in the United States, handling over 90 million such checks in 1985.

Cash

Another major government service provided by Reserve Banks is the distribution and recirculation of currency to depository institutions. Cash requirements throughout the Twelfth District were substantial in 1985, despite the growth of alternative payment services. This District, with the second highest cash processing volume in the System, uses high-speed processing machines to count, sort and verify currency deposits. High speed currency machines have dramatically increased the efficiency of processing large volumes of cash and have contributed to higher quality of currency in circulation. An additional unit was installed in the San Francisco Branch during 1985. Looking ahead, the Bank is currently working with other Reserve Banks to develop more efficient and effective "second generation" currency processing equipment.

A new Cash Automation System was designed and developed in 1985. By automating the record-keeping requirements of Cash Services at each branch, this new system will improve operational efficiency and ensure the integrity and auditing needs of cash operations. Following a pilot and test phase of the San Francisco working model, the Cash Automation System will be installed in all branches during 1986.

Senior Management Staff Functions
(From left to right)
Robert I. Gatchell, General Auditor
William V. Ott, Senior Vice President, Computer Services
Louis E. Reilly, Senior Vice President and General Counsel
John L. Scadding, Senior Vice President and Director of Research
Eugene A. Thomas, Senior Vice President, Supervision, Regulation and Credit
Sara K. Garrison, Senior Vice President, Statistical and Data Services
Carl E. Powell, Senior Vice President, Finance and Product Management

Branch Operations
(From left to right)
Angelo S. Carella, Senior Vice President in Charge, Portland Branch
Gerald R. Kelly, Senior Vice President in Charge, Seattle Branch
E. Ronald Liggett, Vice President in Charge, Salt Lake City Branch
Robert M. McGill, Senior Vice President in Charge, Los Angeles Branch
H. Peter Franzel, Senior Vice President, District Operations
David J. Christerson, Vice President in Charge, San Francisco Branch

DIRECTORS

Directors of the Federal Reserve bring management expertise to the task of overseeing Reserve Bank operations. They provide information on key economic developments in various areas of the District, complementing the Bank's internal research. In addition, Board members give advice on the general direction of monetary policy, especially with regard to the Bank's discount rate.

Head Office

Chairman of the Board and Federal Reserve Agent
Alan C. Furth
Vice Chairman
Santa Fe Southern Pacific Corporation
and President, Southern Pacific Company
San Francisco, California

Deputy Chairman
Fred W. Andrew
President
Apex Orchards, Inc.
Bakersfield, California

Carolyn S. Chambers
President and Chief Executive Officer
Chambers Cable Com., Inc.
Eugene, Oregon

Rayburn S. Dezember
Chairman, President and Chief Executive Officer
Central Pacific Corporation
and Chairman, American National Bank
Bakersfield, California

Spencer F. Eccles
Chairman, President and Chief Executive Officer
First Security Corporation
Salt Lake City, Utah

Donald J. Gehb
President and Chief Executive Officer
Alameda Bancorporation and
Alameda First National Bank
Alameda, California

John C. Hampton
President
Willamina Lumber Company
Portland, Oregon

Togo W. Tanaka
Chairman
Gramercy Enterprises, Inc.
Los Angeles, California

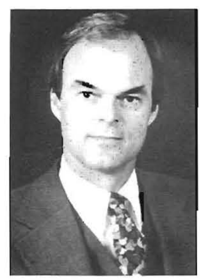
George H. Weyerhaeuser
President and Chief Executive Officer
Weyerhaeuser Company
Tacoma, Washington


Furth


Andrew


Chambers


Dezember


Eccles


Gehb


Hampton


Tanaka


Weyerhaeuser

Federal Advisory Council Member
G. Robert Truex, Jr.
Chairman
Rainier Bancorporation and
Rainier National Bank
Seattle, Washington

Los Angeles

Chairman of the Board
Richard C. Seaver
President
Hydril Company
Los Angeles, California

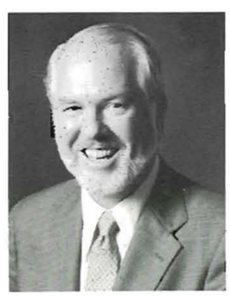
Thomas R. Brown, Jr.
Chairman of the Board
Burr-Brown Corporation
Tucson, Arizona

Howard C. McCrady
Chairman of the Board
Valley National Bank
of Arizona
Phoenix, Arizona

Robert R. Dockson
Chairman of the Board
CalFed, Inc.
Los Angeles, California

Harvey J. Mitchell
President and Chief Executive Officer
Escondido National Bank
Escondido, California

Lola McAlpin-Grant
Attorney
Inglewood, California

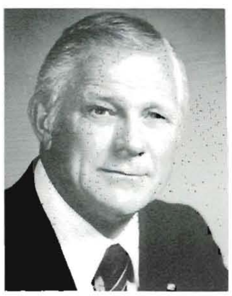


William L. Tooley
Chairman
Tooley & Company,
Investment Builders
Los Angeles, California

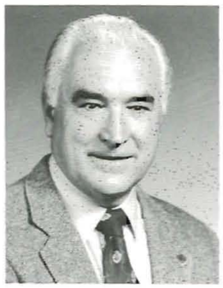
Portland

Chairman of the Board
Paul E. Bragdon
President
Reed College
Portland, Oregon

Herman C. Bradley, Jr.
President and Chief Executive Officer
Tri-County Banking Company
Junction City, Oregon



G. Johnny Parks
Former Northwest Regional Director
International Longshoremen's &
Warehousemen's Union
Portland, Oregon



John A. Elorriaga
Chairman and Chief Executive Officer
United States
National Bank of Oregon
Portland, Oregon

Sandra A. Suran
Partner in Charge
Peat, Marwick, Mitchell & Co.
Beaverton, Oregon

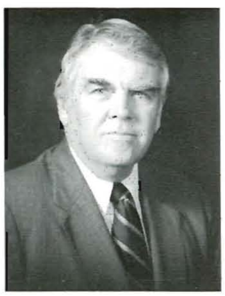
William S. Naito
Vice President
Norcrest China Company
Portland, Oregon

G. Dale Weight
Chairman and Chief Executive Officer
Benjamin Franklin Savings and
Loan Association
Portland, Oregon

Salt Lake City

Chairman of the Board
Don M. Wheeler
President
Wheeler Machinery Company
Salt Lake City, Utah

Gerald R. Christensen
President
First Federal Savings
& Loan Association
Salt Lake City, Utah



Fred C. Humphreys
Chairman, and
Chief Executive Officer
The Idaho First National Bank
and Moore Financial Group
Boise, Idaho

Lela M. Ence
Executive Director
University of Utah
Alumni Association
Salt Lake City, Utah

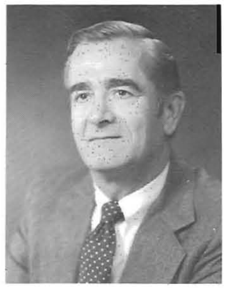
Robert N. Pratt
President
Moriah Enterprises, Inc.
Bountiful, Utah

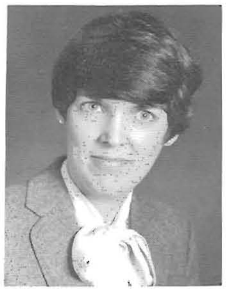
Albert C. Gianoli
President and Chairman of the Board
The First National Bank of Ely
Ely, Nevada

D. N. "Nick" Rose
President and Chief Executive Officer
Mountain Fuel Supply Company
Salt Lake City, Utah

Seattle

Chairman of the Board
John W. Ellis
President and Chief Executive Officer
Puget Sound Power & Light Company
Bellevue, Washington





Carol Birkholz
Managing Partner
Laventhol & Horwath
Seattle, Washington

John N. Nordstrom
Co-Chairman of the Board
Nordstrom, Inc.
Seattle, Washington

H. H. Larison
President and Chief Executive Officer
Columbia Paint Co.
Spokane, Washington

W. W. Philip
Chairman of the Board and President
Puget Sound National Bank
Tacoma, Washington

Byron I. Mallott
Chief Executive Officer
Sealaska Corporation
Juneau, Alaska

William S. Randall
Chairman, President and Chief
Executive Officer
First Interstate Bank
of Washington, N.A.
Seattle, Washington

Comparative Statement of Account

(Thousands of Dollars)

	December 31, 1985	December 31, 1984
Assets		
Gold certificate account	$ 1,361,000	$ 1,318,000
Special Drawing Rights certificate account	590,000	518,000
Other cash	83,682	94,148
Loans to depository institutions	41,840	23,700
Federal Agency obligations	1,103,353	1,075,682
United States Government securities:		
Bills	11,456,076	9,108,176
Notes	9,071,851	8,364,689
Bonds	3,315,969	2,942,780
Total United States Government Securities	23,843,896	20,415,645
Total loans and securities	24,989,089	21,515,027
Items in process of collection	1,607,278	692,624
Bank premises	128,015	110,613
Operating equipment	27,785	31,319
Other assets:		
Denominated in foreign currencies	1,101,355	589,744
All other	443,219	690,995
Interdistrict Settlement Account	1,333,364	1,368,923
Total assets	31,664,787	26,929,393
Liabilities		
Federal Reserve Notes	24,210,803	21,048,999
Deposits:		
Total depository institutions—reserve accounts	4,979,368	4,412,694
Foreign	23,550	24,600
Other deposits	106,447	57,996
Total deposits	5,109,365	4,495,290
Deferred credit items	1,479,492	517,175
Other liabilities	304,181	356,949
Total liabilities	31,103,841	26,418,413
Capital Accounts		
Capital paid in	280,473	255,490
Surplus	280,473	255.490
Total liabilities and capital accounts	31,664,787	26,929,393

Earnings and Expenses

(Thousands of Dollars)

	December 31, 1985	December 31, 1984
Current Earnings		
Discounts and advances	$ 4,106	$ 6,446
United States Government securities	2,219,340	2,122,735
Foreign currencies	35,859	35,618
Income from services	69,524	63,526
All other	1,740	1,865
Total current earnings	2,330,569	2,230,190
Current Expenses		
Total current expenses	128,391	120,473
Less: reimbursement for certain fiscal agency and other expenses	10,589	8,979
Net expenses	117,802	111,494
Cost of earnings credit	7,711	8,799
Current net earnings	2,205,056	2,109,897
Profit and Loss		
Additions to current net earnings		
Profit on sales of United States Government securities (net)	12,967	6,207
Profit on foreign exchange transactions (net)	189,977	0
Total additions	202,944	6,207
Deductions from current net earnings		
Loss on foreign exchange transactions (net)	0	74,590
All other	1,268	447
Total deductions	1,268	75,037
Net additions (+) deductions (−)	+201,676	−68,830
Assessments by Board of Governors		
Board expenditures	−12,150	−13,406
Federal Reserve currency costs	−21,726	−20,624
Net earnings before payments to the United States Treasury	2,372,856	2,007,037
Dividends paid	16,237	14,816
Payments to the United States Treasury (interest on Federal Reserve notes)	2,331,636	1,977,523
Transferred to surplus	24,983	14,698
Surplus, January 1	255,490	240,792
Surplus, December 31	280,473	255,490

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

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

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

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

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

This report was prepared by the staff of the Federal Reserve Bank of San Francisco: produced by Karen Rusk; graphics designed by William Rosenthal; edited by Barbara Bennett. Assistance provided by Economic Research; Supervision, Regulation and Credit; and Corporate Planning, which coordinated the contributions of District Operations, Computer Services, Finance and Product Management, Statistical and Data Services and Personnel.

FEDERAL RESERVE BANK OF SAN FRANCISCO
P.O. BOX 7702
SAN FRANCISCO, CALIFORNIA 94120