

making change

The Federal Reserve Bank
of St. Louis

1997 ANNUAL REPORT

REINVENTING THE FEDERAL RESERVE

THE FEDERAL RESERVE BANK OF ST. LOUIS

The Federal Reserve Bank of St. Louis is one of 12 regional Reserve Banks, which together with the Board of Governors make up the nation's central bank. The Fed carries out U.S. monetary policy, regulates certain depository institutions, provides wholesale-priced services to banks and acts as fiscal agent for the U.S. Treasury. The St. Louis Fed serves the Eighth Federal Reserve District, which includes all of Arkansas, eastern Missouri, southern Indiana, southern Illinois, western Kentucky, western Tennessee and northern Mississippi. Branch offices are located in Little Rock, Louisville and Memphis.

Enabling the economy to achieve maximum sustainable growth

THIS IS THE CORE MISSION OF THE FEDERAL RESERVE.

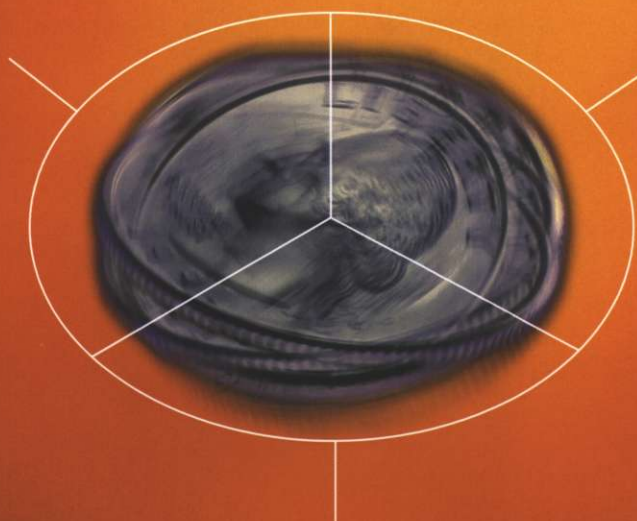
Just like private enterprise, the Fed continues to evolve, adapting to change and reinventing itself to stay in step with the times.

MONETARY POLICY **Page 4**

To wring double-digit inflation out of the economy, the Fed increased its emphasis on price stability and communicated its policy decisions more openly.

BANK SUPERVISION **Page 6**

To more effectively supervise a changing banking landscape, the Fed shifted from one-size-fits-all to customized bank examinations focused on risk.



FINANCIAL SERVICES **Page 10**

Through a revamped financial services management structure and consolidated automation systems, the Fed aggressively promotes electronic payments.

Chairman's Message

MAKING CHANGE – REINVENTING THE FEDERAL RESERVE

The last 20 years have been a period of remarkable change for the Federal Reserve System. To some, this may be a revelation. Although most of us are familiar with the reengineering success stories of American business, the tale of how the Federal Reserve has retooled in the face of tremendous market change is subject to little fanfare. That is because, to a great extent, changes at the Fed have been transparent to the public.

Most of what the Fed does – regulate banks, conduct monetary policy and oversee the payments system – affects the economy profoundly. Sweeping, unpredictable changes in the Fed's operations could lead to uncertainty in financial markets and produce undesirable effects throughout our economic system. So, while the private sector captures headlines with pronouncements of rapid restructuring and dramatic changes in purpose or tactics, the Fed quietly makes deliberate but incremental moves to adjust to – or stay ahead of – the evolving marketplace.

These incremental moves are the subject of this year's annual report. On the following pages, you will see that the Fed acts, within the confines of its structure, in a manner similar to the private sector. It is continually analyzing its own operations and methods, and making adjustments when necessary to keep on top of its game: ensuring a steadily growing economy. In this regard, the Fed must be effective at both anticipating and reacting to changes in the marketplace, while maintaining public confidence in the workings of the economy. It is not an easy task.

Before we begin, however, I'd first like to thank several of my retiring colleagues on the boards of this Bank and its Branches for their years of distinguished service. It has been my privilege to serve this organization with Sandra B. Sanderson from the St. Louis board, Robert D. Nabholtz Jr. and Lee Frazier from Little Rock, John A. Williams and Thomas E. Spragens Jr. from Louisville, and Lewis F. Mallory Jr. from Memphis.



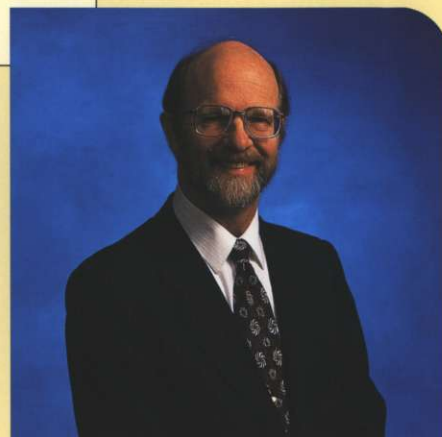
WILLIAM POOLE took office as president and chief executive officer of the St. Louis Fed on March 23, 1998. Prior to joining the Fed, Poole was the Herbert H. Goldberger Professor of Economics at Brown University. He was a member of the Council of Economic Advisers during the first Reagan Administration, an adjunct scholar at the CATO Institute since 1985 and a member of the Shadow Open Market Committee over that same period. He was also a member and later a senior advisor for the Brookings Panel on Economic Activity from 1970 to 1990 and held several positions at various Federal Reserve offices. He holds M.B.A. and Ph.D. degrees from the University of Chicago.

I especially want to thank Tom Melzer for his 12 years as president and chief executive officer of the St. Louis Fed. He ably served this Bank, its region and the nation's economy through his unparalleled leadership, integrity and professionalism. Tom's disarming manner and calm, reasoned approach won him respect throughout the Federal Reserve System and from all who had the opportunity to work with him.

At the same time, we are extremely fortunate that William Poole has recently joined the Bank to replace Tom. Getting his start on the staff of the Federal Reserve Board in 1964, Bill brings his distinguished career as an academic scholar and economist full circle in his new role as president. I am confident Bill will provide strong continuity and innovative evolution to the monetarist tradition that is the hallmark of the St. Louis Fed.

A handwritten signature in black ink, reading "John F. McDonnell".

John F. McDonnell
Chairman of the Board



Monetary Policy

MONETARY POLICY EMPHASIZES PRICE STABILITY

SINCE 1980, THE STORY OF MONETARY POLICY IS ESSENTIALLY THE TALE OF A DRAMATIC DROP IN INFLATION. FROM DOUBLE-DIGIT HEIGHTS IN THE LATE 1970s AND EARLY 1980s, AND AN AVERAGE OF MORE THAN 3.5 PERCENT DURING THE EARLY 1990s, INFLATION CHECKED IN AT JUST 1.7 PERCENT OVER THE 12 MONTHS ENDING DECEMBER 1997. WHILE CONVENTIONAL WISDOM HAS HELD THAT LOWER INFLATION CAN BE ACHIEVED ONLY AT THE EXPENSE OF LOWER EMPLOYMENT AND ECONOMIC GROWTH, THE TRANSITION TO LOW INFLATION IN THE 1990s HAS BEEN ACCOMPANIED BY SUBSTANTIAL REAL GROWTH, DECLINING INTEREST RATES AND AN UNEMPLOYMENT RATE AT A QUARTER-CENTURY LOW. HOW WAS THIS SUCCESS ACHIEVED?

AN INCREASED EMPHASIS ON PRICE STABILITY

Success in monetary policy came about because of an increased focus on price stability, sustained over the entire period after 1980. Given their experience with high inflation, many central banks around the world have come to realize that low inflation promotes sustainable economic growth. High and variable inflation, on the other hand, distorts the economy's signals about price movements and puts upward pressure on nominal interest rates, as lenders demand compensation for expected inflation and the risk associated with inflation uncertainty.

How the Federal Reserve implements its low-inflation strategy has changed in response to dramatic changes in financial innovation and deregulation over the past two decades. The Fed's chief policymaking body, the Federal Open Market Committee (FOMC), employs a variety of indicators, including monetary aggregates, reserve aggregates and interest rates, to gauge the impact of its policies on the nation's economy. Given the lag between Fed actions and their effect on inflation, monetary policy must be forward-looking and, thus, is most effective when it is preemptive.

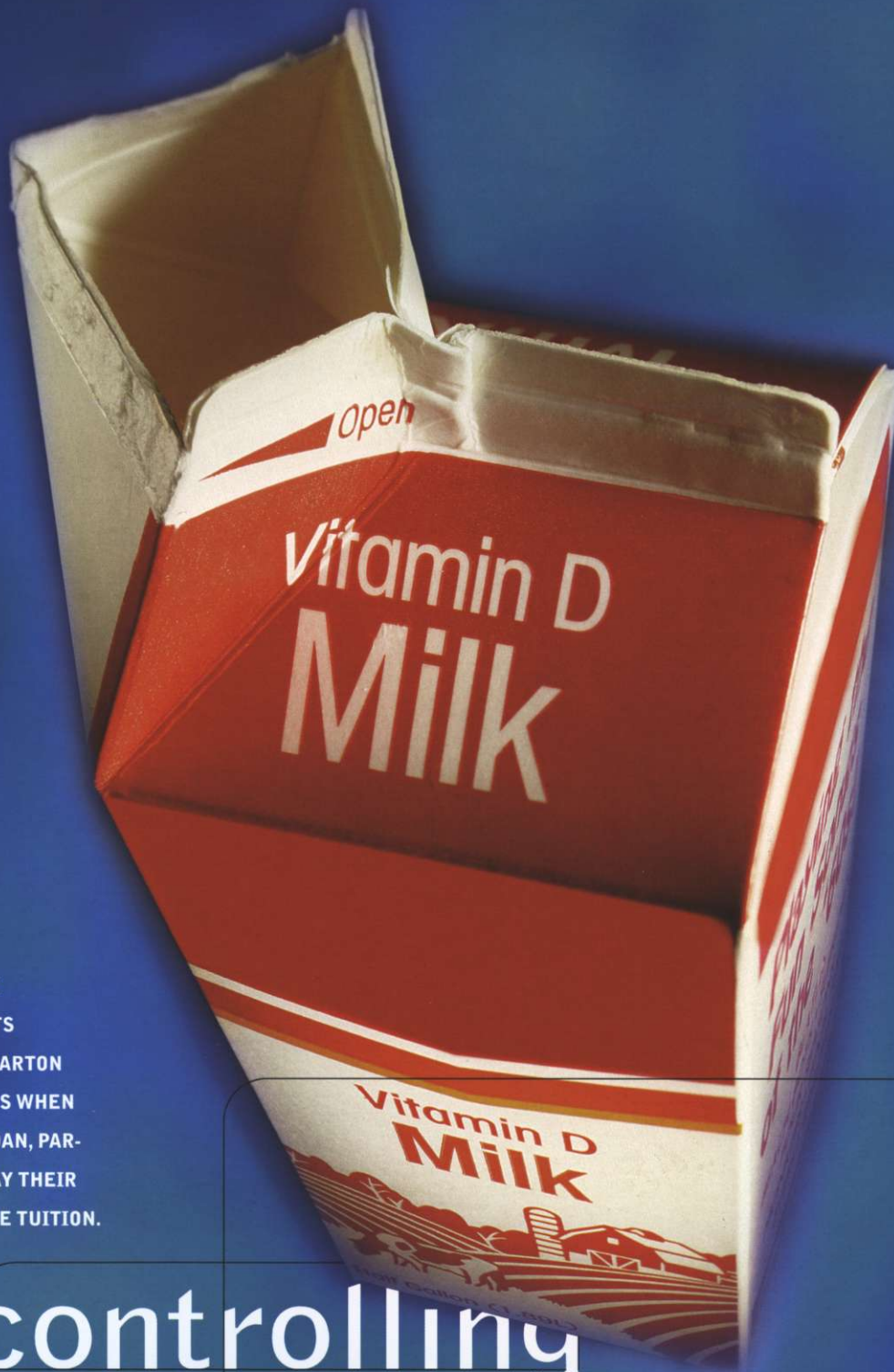
To increase an understanding of the preemptive nature of its policies, the Fed has taken steps to conduct monetary policy more openly. In 1994, the FOMC began announcing its policy decisions immediately after making them; in 1995, it began to announce a target level for the federal funds rate; and in 1997, it began including this target in its policy directive. In addition, the Fed now uses the Internet to disseminate economic information, both policy-related and educational.

Ultimately, efforts to broaden public understanding of the Fed's goals and objectives, along with continued innovation in the strategies that drive monetary policymaking, will play a critical part in prolonging our current monetary policy successes. Making the Fed's strategy clear and its performance measurable are key to establishing credibility for a long-term policy that seeks to foster sustained economic growth and increasing standards of living for all Americans.

St. Louis

Initiative:

How do we ensure that the recent success of monetary policy in reducing inflation endures? The St. Louis Fed has argued that monetary policy be "anchored" to a price level objective. For several years, we have advocated that the FOMC publicly commit to a specific inflation or price level objective, as well as a time frame for achieving it. At the same time, because an accurate measure of the growth of money is critical in assessing monetary policy's effectiveness, we revised our measures of the adjusted monetary base and adjusted reserves to reflect the increased importance of interbank settlement as a factor affecting the amount of deposits that banks hold at the Federal Reserve.



CONSUMERS NOTICE
INFLATION'S EFFECTS
WHEN THEY BUY A CARTON
OF MILK, BORROWERS WHEN
THEY TAKE OUT A LOAN, PAR-
ENTS WHEN THEY PAY THEIR
CHILDREN'S COLLEGE TUITION.

controlling inflation

THE FED ACTS PREEMPTIVELY
TO KEEP A PERSISTENT RISE
IN OVERALL PRICES FROM
HAMPERING ECONOMIC GROWTH.

Bank Supervision

FED EXAMINERS RESPOND TO A CHANGING INDUSTRY

FOR SEVERAL YEARS NOW, THE ENTIRE BANKING INDUSTRY HAS FACED THE CHALLENGE OF RESPONDING TO TECHNOLOGICAL CHANGES AND FINANCIAL INNOVATION. TECHNOLOGY HAS BOTH LOWERED THE COSTS AND TIME NEEDED TO BRING NEW PRODUCTS TO MARKET AND INCREASED THE EFFICIENCY WITH WHICH INFORMATION IS COLLECTED AND TRANSACTIONS ARE PROCESSED. AS A RESULT, BANK CUSTOMERS CAN NOW GET LOAN APPROVALS OVER THE PHONE OR AT AUTOMATED LOAN MACHINES; INVESTORS CAN BUY AND SELL STOCKS AT HOME OVER THEIR PCs; AND CONSUMERS CAN SHOP ON THE INTERNET.

The nature of competition in the banking industry also has been altered through an unprecedented number of bank consolidations. Computers and the Internet are removing geographic barriers that have traditionally separated many domestic and international markets. And artificial barriers – such as the laws that have restricted bank growth across state lines – are coming down as well.

Supervising banks in this environment is a challenge. The risks inherent in rapidly changing markets are often difficult to pinpoint. When financial markets evolved more slowly, and the composition of a bank's asset and liability structure was relatively static, a periodic snapshot of a bank's condition, obtained through an on-site examination, was an effective means of overseeing an institution's stability.

Today, however, evaluating a bank's condition at a single point in time – using only traditional accounting techniques and balance sheet analysis – is no longer effective. For this reason, the Federal Reserve developed a new framework known as risk-based supervision.

SHIFTING THE FOCUS TO RISK

Risk-based supervision presumes that a bank's own management is in the best position to monitor the institution's exposure to risk. To verify management's capability in this regard, the

Fed's bank examiners must address several issues: Does the bank's management have the expertise to effectively oversee its business strategy? Does management have the internal controls to adequately monitor the bank's activity? Is there a contingency plan to mitigate loss in a worst-case scenario? Risk-based supervision attempts to identify weak banking practices early on so that emerging problems can be contained and remedied, and losses minimized.

The same advances in technology that have changed banking services and competition have enhanced the Fed's ability to conduct risk-based exams. Risk-based supervision enables examiners to shape each review to fit the institution. The examiner may identify areas requiring analysis during a planning period so that on-site examination resources match the areas requiring review. Further, examination data from each bank can be provided to the examiner electronically so that review areas can be analyzed and targeted before the examiner ever enters the institution. New technology also permits particular areas of the bank – such as a securities portfolio – to be assessed entirely off-site.

Once on-site, the examiners continue to evaluate aspects of a bank's operations, like the credit quality of the loan portfolio, as they have traditionally. However, the overall emphasis of the examination is very different. Where the



A SMOKE ALARM
MONITORS THE AIR
IN YOUR HOME. ITS
SIGNAL IS AN ADVANCE
WARNING THAT YOU MAY
BE AT RISK.

monitoring risk

FED EXAMINERS MONITOR THE BANKING
INDUSTRY. THEIR EXAMINATION IDENTIFIES
AREAS OF RISK THAT COULD AFFECT A BANK'S
SAFETY AND SOUNDNESS.

primary means of determining the institution's financial and operating condition used to rely heavily on transaction testing, the assessment is now focused largely on assessing ongoing risk management processes, such as how well these processes address banking risks.

The bottom line is whether the institution's ability to manage risk is commensurate with the level of risk it has taken on in its business practices. This assessment is accomplished in a much less disruptive manner than ever before. Examiners are able to reduce the time they spend reviewing low-risk activities and emphasize instead those areas with higher risk. Examinations no longer employ a one-size-fits-all approach; they are tailored to the institution's business lines, risk profile, operating philosophy and size.

INCREASING COOPERATION AMONG REGULATORS

The Fed applies federal banking law to bank holding companies and member state chartered banks – financial institutions with a wide range of sizes, business activities, sophistication and markets. Complicating this task is the recent passage of interstate branching legislation. The legislation eliminated laws that, for generations, prevented banks from branching across state lines and has prompted bank

expansion and reorganizations. As a regulator with supervision responsibility on both sides of the dual (federal and state) banking system, the Fed has led initiatives to broaden cooperative agreements with other regulators. While achieving a more consistent partnership with state authorities and other federal regulators, this cooperation also controls the regulatory burden placed on banking organizations. The goal is to make these supervisory efforts seamless by conducting coordinated examinations with more joint resources and expertise, and providing consistent direction to banking organizations that are overseen by multiple regulators.

The Fed's concern for banking safety and soundness extends beyond its domestic borders, too. As a central bank, the Fed is concerned with systemic risk in banking and economic systems – that is, the risk that a banking failure or financial crisis will spread through financial markets, causing widespread failures. In this regard, the Fed has worked with international regulators to build strategies that promote sound banking practices worldwide. For example, the Basle Committee on Bank Supervision, an organization of supervisory authorities and central banks from around the world, has adopted the Fed's model for risk-based supervision.

A SHRINKING UNIVERSE

Bank consolidations also have forced the Fed to restructure the examination process. Banks today face intense competitive pressures, not only from other banking firms but also from nonbanks, such as insurance companies and securities firms. As banks look for ways to lower costs and expand services, they have increasingly chosen to merge with other banks. Technology has played an important role by enabling banking organizations to integrate systems faster and on a broader scale than was possible a few years ago.

Since 1980, this merger pace has reduced the number of independent commercial banks by 40 percent, resulting in a landscape increasingly divided between large multiregional and money-center banks, and small community-based banks. Examination planning and procedures have evolved to accommodate these changes in the industry's structure and complexity. The resulting supervisory structure needs to be both flexible enough to adjust to a rapidly changing financial environment and rational enough to address the inherent differences and risk exposures in large and small banking organizations.

THE MULTIDIMENSIONAL EXAMINER

At the heart of the new risk-focused examination process is a skilled examiner. And, just as the supervision process has been revamped to address the realities of today's banking environment, so have examiners' skills. In a previous era, the typical examiner was well grounded in the principles of accounting. Today, examiners must bring a host of broad financial and business skills to the table. They are expected to be multidimensional professionals – problem solvers, mediators, communicators and negotiators – and must complete a five-year training program at the Fed before gaining a commission as a certified bank examiner. Armed with laptops instead of adding machines, examiners must employ the same technology that is transforming the industry they're supervising. Today, for example, they must be prepared to evaluate strategies that may be as cutting-edge as establishing a "virtual" bank on the Internet, or as complex as creating an interest rate risk management program that employs derivatives.

New challenges, as always, are in the offing. Two of note are the current debates in Congress on how to dismantle Depression-era laws that have separated commercial banking from the securities industry, and on the expansion of banking powers so that banks can better compete with the growing number of nonbank financial service providers.

A perennial challenge for bank regulators, however, concerns how to strike the appropriate balance of regulatory oversight without overly interfering with market innovation – since the former ensures prudent industry practices and the latter serves the public's demand for financial services. The Fed is working continually to achieve this balance by ensuring that its supervisory framework remains flexible, comprehensive and efficient, and that it continues to respond to the realities of an industry in transition.

St. Louis

Initiative:

The St. Louis Fed led two major technology initiatives for the Federal Reserve System's Banking Supervision and Regulation area. The St. Louis staff provided leadership for the development of the National Examination Database (NED). Implemented in late 1997, NED is the System's principle source of supervisory information and is utilized by all Fed Districts, the Board of Governors and numerous State Banking Departments. St. Louis also significantly enhanced the Home Mortgage Disclosure Act (HMDA) and Community Reinvestment Act (CRA) software used by some 10,000 financial institutions nationally to report their compliance with the HMDA and CRA regulations.

Financial Services

THE FED PROMOTES AN ELECTRONIC PAYMENTS SYSTEM

RARELY DO THE HEADLINES CAPTURE NEWS ABOUT ONE OF THE FED'S OTHER CRITICAL RESPONSIBILITIES: OVERSEEING THE NATION'S PAYMENTS SYSTEM. THAT IS A GOOD THING. IT MEANS THE SYSTEM OF COMPLEX TECHNOLOGICAL AND FINANCIAL ARRANGEMENTS THAT WE USE TO TRANSFER VALUE AMONG THOUSANDS OF U.S. FINANCIAL INSTITUTIONS IS OPERATING SAFELY AND WITHOUT INTERRUPTION—HELPING TO ENSURE THAT PUBLIC CONFIDENCE IN OUR SYSTEM REMAINS STRONG.

Our payments system has not always enjoyed this high degree of confidence. In the 19th and early 20th centuries, a series of financial shocks battered the nation's economy.

A particularly severe crisis in 1907 was made worse when the system used to clear and settle check payments broke down. In response, Congress chartered the Federal Reserve System in 1913 and gave the Fed the authority to establish a national check-clearing system to improve the stability of the payments system. Today, the Fed supports confidence in the payments system by guaranteeing the large-dollar payments financial institutions make to each other over the Fed's electronic transfer system, Fedwire®. And, should a financial crisis arise, the Fed can quickly inject cash into the banking system to maintain liquidity.

The payment services the Fed provides have expanded well beyond its founding check-clearing mandate. The Fed offers a variety of services – primarily Fedwire funds transfers and securities transfers, check processing and the automated clearinghouse (ACH) transactions – to financial institutions for clearing and settling of paper and electronic

payments. In 1996, the Fed processed \$464 trillion worth of payments in these services.

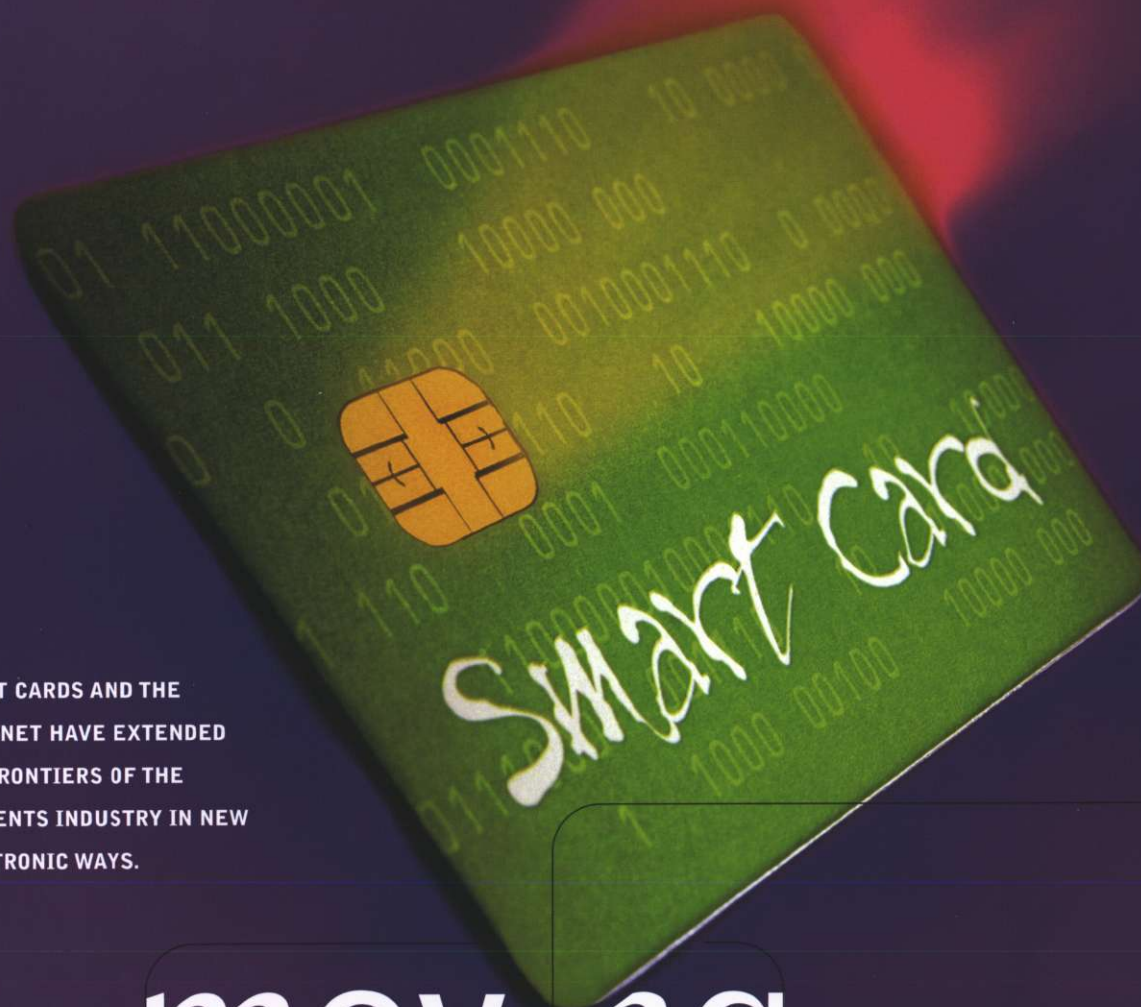
Prior to the passage of the Depository Institutions Deregulation and Monetary Control Act (MCA) in 1980, only banks that were members of the Federal Reserve System had access to these services – services the Fed provided free of charge. The MCA radically redefined the Fed's relationship with its member banks and its participation in the payments system. The MCA required the Fed to open access to its payment services to all U.S. depository institutions and to charge fees for these services, thereby making the Fed compete with private clearing systems. It must recover, in the long run, all costs associated with providing payments services – including imputed costs like taxes that would be incurred, the cost of capital, and profits that would be earned – had the services been provided by the private sector.

Thus, the MCA imposed the same market discipline on Reserve Banks that private-sector firms face. To remain viable providers of financial services, Reserve Banks must meet the market's benchmark for quality and price.

St. Louis

Initiative:

As part of the Fed's role as fiscal agent, or bank, for the U.S. government, the St. Louis Fed is responsible for developing, maintaining and enhancing two important systems that enhance the U.S. Treasury's cash management capabilities. First is the Treasury Investment Program (TIP) software, currently under development, which will replace the Fed's current system that invests corporate tax payment funds with financial institutions, so the funds earn interest until the Treasury withdraws them. Second is the CASH TRACK software, implemented in 1998, which provides real-time account balance information to the Treasury, so it can more efficiently manage its daily funds position.



SMART CARDS AND THE
INTERNET HAVE EXTENDED
THE FRONTIERS OF THE
PAYMENTS INDUSTRY IN NEW
ELECTRONIC WAYS.

moving money

THE FED PROVIDES ITS OWN ELECTRONIC
PAYMENT SERVICES – INCLUDING ACH
AND FEDWIRE® – AND SUPPORTS INNOVATIONS
LIKE ELECTRONIC CHECK PRESENTMENT
IN THE RETAIL PAYMENTS ARENA.

THE FSPC – REINVENTING THE MANAGEMENT OF FINANCIAL SERVICES

The financial services provided by the 12 Reserve Banks enable depository institutions to, in turn, enhance their services to customers and businesses. To better coordinate the Banks' development and implementation of financial services under the FSPC's national umbrella, certain Reserve Banks serve as product and function offices for the entire Fed system. The current structure consists of the following assignments:

RETAIL PAYMENTS – The Federal Reserve Bank of Atlanta directs the System's retail services, which consist primarily of check processing and the ACH.

WHOLESALE PAYMENTS – The Federal Reserve Bank of New York oversees wholesale services, which include Fedwire funds and securities transfer, and net settlement.

CASH AND FISCAL SERVICES – The Federal Reserve Bank of Philadelphia coordinates the programs that the Fed administers on behalf of the U.S. Treasury. These include: cash distribution and processing; Treasury bill, note and bond auction services; federal tax deposit processing; and savings bond issuance and redemption.

SUPPORT SERVICES – The Federal Reserve Bank of San Francisco provides support activities to all Reserve Banks, including accounting services, local Reserve Bank automation and electronic connection products.

FEDERAL RESERVE AUTOMATION SERVICES (FRAS) – Headquartered at the Federal Reserve Bank of Richmond, FRAS operates the consolidated network of Reserve Bank mainframe data processing systems and data communications.

BUSINESS DEVELOPMENT – Housed at the Federal Reserve Bank of Chicago, this office oversees product and service developments, and coordinates marketing and customer relationships.

The St. Louis Fed completed three years of service to the FSPC in 1997. Thomas C. Melzer, who resigned as the Bank's president in January 1998, served as the FSPC's first chairman from 1994 to 1997. During this time, the St. Louis Fed also provided support to the committee as its general counsel and national communications office. Cathy E. Minehan, president of the Boston Fed, now chairs the committee.

REORGANIZING FINANCIAL SERVICES

In light of the changes brought about by the MCA and in recognition of the forces, like interstate banking and technological changes, that are reshaping the financial industry, the Fed set out to reinvent its management of financial services. This recognition resulted in the creation of the Financial Services Policy Committee (FSPC). The FSPC sets the strategic direction for Fed financial services nationwide. Under the FSPC umbrella, individual Reserve Banks serve as product and function offices for the entire System (see sidebar above). This restructuring transformed a regional approach to payments system innovation and delivery into one that is truly national.

The FSPC's primary objective is maintaining payments system efficiency, integrity and accessibility. This

objective is accomplished by focusing on improvements in the Reserve Banks' automated systems and operating environments. Since the FSPC's debut, the Fed's ability to respond to customer needs in a changing environment has improved in a number of ways. One example is the account structure the Fed implemented in 1998 in response to the Riegle-Neal Interstate Banking and Branching Efficiency Act, which allows state-chartered banks to open out-of-state branches. Anticipating this significant change in the banking landscape, the Reserve Banks developed a single account structure for their customers that accommodates institutions operating in multiple states and Fed Districts. This allowed financial institutions with accounts at multiple Reserve Banks to consolidate them into a single account at their "home" Fed bank.

PROMOTING ELECTRONIC SERVICES

The current management structure provides a vehicle for the Fed to aggressively carry out its long-term strategy: improving the payments system through the use of electronic technology. Several of the Fed's high-priority projects along these lines include:

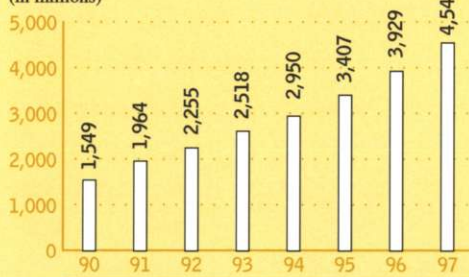
AUTOMATED CLEARINGHOUSE – The Fed's development of the automated clearinghouse (ACH) in the 1970s reflects an early effort to bring electronic technology to retail payments. While acceptance has been slow, businesses and governments are now making greater use of the ACH for recurring payments, like direct deposit of employee paychecks and Social Security payments. Since 1990, ACH transaction volume has increased roughly 16 percent a year, reaching 4.5 billion payments worth over \$12 trillion in 1997 (see chart). This trend will no doubt continue as the federal government relies more heavily on the ACH to achieve its 1999 electronic payment mandate.

ELECTRONIC CHECK PRESENTMENT – Although some 80 percent of the value of all U.S. payments move over large-dollar interbank electronic systems like Fedwire, these transactions make up less than 1 percent of the total number of payments each year. The reason for this lopsided bias is that Americans find that checks are a convenient form of payment. We write the lion's share of the world's checks – some 65 billion per year. And, despite the increased use of electronic forms of retail payment – such as debit cards and the ACH – over the last five years, U.S. check use has continued to grow approximately 2 percent a year. This preference comes with a huge

economic cost: The processing of paper checks is extremely labor intensive, requiring ground and air transportation and the physical handling of millions of checks each day. To bridge the gap between this high cost and Americans' continuing preference for paper checks, the Fed has focused on promoting electronic check presentment (ECP).

ECP allows a bank that's collecting a payment to rush the critical payment information electronically to the paying bank. Whether or not the physical checks are returned to the check writer, the handling and processing costs are reduced. Right now, about 11 percent of all the checks the Fed presents are electronic.

Number of ACH origination and receipt transactions (in millions)



Source: National Automated Clearing House Association

WIRE FUNDS TRANSFER – Two important efficiency improvements were made to the Fedwire funds transfer system in 1997: The format was expanded, and the operating hours were extended. The changes affect both domestic and international payments markets. The format was expanded in response to industry interest in having more complete information about all parties to a funds transfer. It brings added efficiency to processing and posting transfers. The expanded format, which is similar to those used by international funds transfer and information services, permits increased communication across global systems. The operating hours for on-line Fedwire funds transfers were extended from 10 to 18 hours a day, enabling banks to move money earlier in the day and correspond more closely with settlements in international financial markets. The extended hours reduce risk by giving banks more time to settle their international transactions in the same business day.

St. Louis Initiative:

To promote the use of ACH more widely, the St. Louis Fed, along with the Federal Reserve Banks of Chicago and Kansas City and the Mid-America Payment Exchange, formed the Automated Payments Partnership (APP). The alliance is carrying out a three-year, multistate marketing and educational campaign to increase the use of ACH for recurring payments. By promoting ACH's use among corporations, utility firms, governments and financial institutions in a 10-state area, the APP's ultimate goal is to originate 50 million new ACH payments by December 1999.

IMPROVING INTERNAL EFFICIENCY

An effective restructuring of the Fed's financial services management could not have been accomplished without a parallel effort in the systems that support these services. In this regard, the Reserve Banks are nearing completion of a five-year restructuring effort of their mainframe computer systems, enabling electronic payments like fund transfers and ACH to be handled at central sites, rather than at each of the 12 Reserve Banks.

Consolidation has allowed the Banks to launch new nationwide services and enhance existing ones at a lower cost. It also has dramatically improved the Reserve Banks' disaster recovery and information security capabilities, increased the Fed's ability to respond quickly to change, and expanded the central bank's management of payments system risk. Moreover, the consolidation effort gave the Fed a headstart on preparing its computers for the Year 2000. The consolidation process, begun five years ago, required new centralized applications for services like Fedwire funds and securities transfers, and ACH. All were designed with Year 2000 compliance in mind.

The financial services industry has already realized dividends from the Fed's increased efficiencies in processing Fedwire and ACH payments. These dividends include improved software to run these systems and a series of price reductions begun in 1995, which will generate a savings of \$42 million in fees by year-end 1998 for Fed customers.

The Reserve Banks also have improved the efficiency of the other services they provide to banks and the public. The Fed consolidated the number of processing sites for its noncash collection service for maturing coupons and bonds from 27 to one and for savings bond operations from 24 to five. Along with the Treasury, the Fed also has introduced automated processing to the previously paper-based Treasury auction system, thereby improving the accessibility, integrity and timeliness of the Treasury securities auction process. Finally, the Reserve Banks have consolidated the handling of commercial tenders from 13 to three sites using the automated system. Overall, these changes have improved the reliability and security of many Fed services and have enabled the Reserve Banks to respond more quickly to changes in their own business environments and the demands of their business customers.

SETTING A FUTURE COURSE

Some long-standing questions recently have been answered by a group of Federal Reserve officials who took an in-depth look at the Fed's payments system mission and strategies. The group – known as the Committee on the Federal Reserve in the Payments Mechanism, or the Rivlin Committee – performed an unprecedented study of the payment services provided by Reserve Banks to assess the Banks' role in the retail payments arena of the 21st century.

The committee, headed by Alice C. Rivlin, vice chair of the Federal Reserve Board of Governors, included Federal Reserve Governor Edward W. Kelley Jr., Federal Reserve Bank of New York President William J. McDonough and former Federal Reserve Bank of St. Louis President Thomas C. Melzer. As part of its work, the committee, as well as each of the 12 Reserve Banks, held a series of forums in which they received feedback about the Fed's

payments role from representatives of more than 450 banks, clearinghouses and other payment providers. The committee also commissioned internal studies of the Fed's payments strategies.

After completing its 15-month study in January 1998, the Committee recommended that the Fed pursue two broad objectives. First, it should remain a provider of both check collection and ACH services, with the explicit goal of enhancing the efficiency, effectiveness and convenience of both systems while, at the same time, ensuring access for all depository institutions. Second, it should play a more active role, working closely and collaboratively with providers and users of the payments system, both to enhance the efficiency of check and ACH services and to help evolve strategies for moving to the next generation of payment instruments.

reinvention with a purpose

As we have seen, the Fed has reinvented itself in the face of tremendous technological and environmental change. Indeed, this practice of reinvention is hardly new to the Fed; it has evolved and adapted to market changes throughout its history. In a sense, the Federal Reserve System was reinvented from the start, the result of a 1913 political compromise that sought to mitigate the political and public distrust for government-run banks, which had brought an end to the country's two previous attempts at central banking. Its balance of public and private missions, centralized and decentralized operations, independence from politics, and accountability to the public is unique in American history.

But structure alone does not guarantee future success. Nor should it. Public expectations are high for an institution whose mission is to enhance the nation's economic well being. And, ultimately, the Fed has embraced

an even broader public policy mission than is detailed in this report. Through its economic education programs and its community affairs activities, and as a corporate citizen, the Federal Reserve seeks to foster a more widespread understanding of how to achieve the maximum sustainable growth for our economy.

The future legacy of the Fed rests firmly on its ability to adapt and innovate, while not losing sight of its commitment to the public interest. The Fed must continue to reinvent itself and keep up with the times. At the same time, it must carefully gauge the effect of any reengineering effort, considering the impact on its operations, on the economy and on its ability to fulfill its public policy mission. Simply put, achieving efficiency at the expense of damaging public confidence in the Fed's ability to conduct monetary policy, protect the payments system or regulate banking organizations is not an option.

FINANCIAL DATA

Statement of Condition (in millions)

	December 31, 1997	December 31, 1996
Assets		
Gold certificates	\$ 401	\$ 474
Special drawing rights certificates	340	419
Coin	15	29
Items in process of collection	93	666
Loans to depository institutions	4	29
U.S. government and federal agency securities, net	17,286	18,470
Investments denominated in foreign currencies	424	476
Accrued interest receivable	163	166
Bank premises and equipment, net	50	47
Other assets	10	9
Total assets	\$18,786	\$20,785
Liabilities and Capital		
Liabilities:		
Federal Reserve notes, net deposits:	\$16,422	\$16,769
Depository institutions	1,244	718
Other deposits	5	4
Deferred credit items	252	292
Statutory surplus transfer due U.S. Treasury	27	32
Interdistrict settlement account	534	2,694
Accrued benefit cost	46	44
Other liabilities	7	6
Total liabilities	\$18,537	\$20,559
Capital:		
Capital paid-in	\$ 127	\$ 114
Surplus	122	112
Total capital	\$ 249	\$ 226
Total liabilities and capital	\$18,786	\$20,785

FINANCIAL DATA

Statement of Income (in millions)

	December 31, 1997	December 31, 1996
Interest Income		
Interest on U.S. government securities	\$1,052	\$1,100
Interest on foreign currencies	9	11
Interest on loans to depository institutions	2	1
Total interest income	\$1,063	\$1,112
Other Operating Income (loss)		
Income from services	\$ 38	\$ 36
Reimbursable services to government agencies	11	9
Foreign currency losses, net	(65)	(41)
Government securities gains, net	1	1
Other income	0	1
Total other operating income (loss)	\$ (15)	\$ 6
Operating Expenses		
Salaries and other benefits	\$ 60	\$ 58
Occupancy expense	6	6
Equipment expense	6	6
Cost of unreimbursed Treasury services	2	2
Assessments by Board of Governors	19	23
Other expenses	43	37
Total operating expenses	\$ 136	\$ 132
Net income available for distribution	\$ 912	\$ 986
Distribution of Income		
Dividends paid to member banks	\$ (7)	\$ (6)
Payments to U.S. Treasury	(892)	(964)
Transferred to surplus	13	16
Surplus January 1	112	98
Statutory surplus transferred to Treasury, October 1	(3)	(2)
Surplus, December 31	\$ 122	\$ 112

Copies of full financial statements complete with footnotes are available by contacting the Public Affairs Department of the Federal Reserve Bank of St. Louis, Post Office Box 442, St. Louis, Missouri 63166.

FINANCIAL DATA

Operating Statistics

	Number Handled		Dollar Amount (millions)	
	1997	1996	1997	1996
Services to Depository Institutions				
Check Services:				
U.S. government checks	24,937,000	27,997,000	\$ 20,346	\$ 23,136
Postal money orders	203,693,000	205,751,000	26,464	25,831
Commercial	889,178,000	772,722,000	447,523	424,068
ACH commercial items originated	132,877,974	*	271,629	*
U.S. government coupons paid	5,104	6,462	2	3
Currency received and counted	926,091,000	897,807,000	12,751	12,436
Wire transfer of funds	4,224,846	4,007,146	6,189,319	5,932,532
Loans to depository institutions	681	577	981	1,597
Services to U.S. Treasury				
Transfer of government securities	152,705	150,865	252,714	277,722
Food stamps redeemed	223,239,000	268,116,000	1,081	1,342

* Prior-year comparison not meaningful because of change in method of data collection.

Boards of Directors

St. Louis Directors

Chairman

John F. McDonnell

St. Louis, Missouri

Deputy Chairman

Susan S. Elliott

President and Chief Executive Officer
Systems Service Enterprises, Inc.
St. Louis, Missouri

Douglas M. Lester

President and Chief Executive Officer
Sea Change Corporation
Bowling Green, Kentucky

W. D. Glover

Chairman and Chief Executive Officer
First National Bank of Eastern Arkansas
Forrest City, Arkansas

Michael A. Alexander

Chairman of the Board and President
The First National Bank of Mount Vernon
Mount Vernon, Illinois

Joseph E. Gliessner, Jr.

Executive Director
New Directions Housing Corporation
Louisville, Kentucky

Robert L. Johnson

Chairman and Chief Executive Officer
Johnson Bryce, Inc.
Memphis, Tennessee

Richard E. Bell

President and Chief Executive Officer
Riceland Foods, Inc.
Stuttgart, Arkansas

Veo Peoples, Jr.

Peoples, LLC
St. Louis, Missouri

Federal Advisory Council Member

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Chairman of the Board
and Chief Executive Officer
Mercantile Bancorporation Inc.
St. Louis, Missouri

Little Rock Directors

Chairman

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Chairman and Chief Executive Officer
World Wide Travel Service Inc.
Little Rock, Arkansas

Diana T. Hueter

President and Chief Executive Officer
St. Vincent Health Systems
Little Rock, Arkansas

Janet M. Jones

President
The Janet Jones Company
Little Rock, Arkansas

Lunsford W. Bridges

President and Chief Executive Officer
Metropolitan National Bank
Little Rock, Arkansas

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President
M. A. Shelton Farming Company
Wabbaseka, Arkansas

Mark Simmons

Chairman
Simmons Foods, Inc.
Siloam Springs, Arkansas

Ross M. Whipple

Chairman and Chief Executive Officer
Horizon Bancorp, Inc.
Arkadelphia, Arkansas

Louisville Directors

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President and Chief Executive Officer
The Reynolds Group, Inc.
Louisville, Kentucky

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Chairman
Service First Warehouse and Distribution, Inc.
Elizabethtown, Kentucky

Debbie Scoppechio

Chairman and Chief Executive Officer
Creative Alliance, Inc.
Louisville, Kentucky

Ronald R. Cyrus

Executive Secretary-Treasurer
Kentucky State AFL-CIO
Frankfort, Kentucky

Larry E. Dunigan

Chairman and Chief Executive Officer
Holiday Management Corp.
Evansville, Indiana

Aubrey W. Lippert

Chairman and Chief Executive Officer
Peoples First Corporation
Paducah, Kentucky

Orson Oliver

President
Mid-America Bank of Louisville & Trust Co.
Louisville, Kentucky

Memphis Directors

Chairman

Carol G. Crawley

Vice President and Regional Manager
Mid-America Apartment Communities, Inc.
Memphis, Tennessee

John V. Myers

President
Better Business Bureau
Memphis, Tennessee

Mike P. Sturdivant, Jr.

Partner
Due West Plantation
Glendora, Mississippi

John C. Kelley

President, Memphis Banking Group
First Tennessee Bank
Memphis, Tennessee

E.C. Neelly III

Chief Executive Officer
First American National Bank
Iuka, Mississippi

Anthony M. Rampley

President and Chief Executive Officer
Arkansas Glass Container Corporation
Jonesboro, Arkansas

Katie S. Winchester

President and Chief Executive Officer
First Citizens National Bank
Dyersburg, Tennessee

Economic Advisory Council/Bank Officers

ECONOMIC ADVISORY COUNCIL

Agricultural

Dr. Bert Greenwalt
Partner
Greenwalt Company Farm
Hazen, Arkansas

Paul Combs
Vice President
Baker Implement Company
Kennett, Missouri

Robert A. Cunningham
Valley Farms
Bigbee Valley, Mississippi

Joseph H. Spalding
Lebanon, Kentucky

Small Business

William A. Haley
President
and Chief Executive Officer
Haley Family Corporation
St. Louis, Missouri

Robert Reynolds
President
Shuler Drilling Company, Inc.
El Dorado, Arkansas

Beverly Robertson
Principal
Trust Marketing
Communications
Consortium, Inc.
Memphis, Tennessee

Gerald W. Clapp, Jr.
Clapp Oldsmobile
Clarksville, Indiana

Ann Ross
President
The Paper Warehouse
St. Louis, Missouri

OFFICERS

St. Louis Office

William Poole
President
and Chief Executive Officer

W. LeGrande Rives
First Vice President
and Chief Operating Officer

Karl W. Ashman
Senior Vice President

Henry H. Bourgaux
Senior Vice President

Joan P. Cronin
Senior Vice President

William G. Dewald
Senior Vice President
and Director of Research

Mary H. Karr
Senior Vice President,
General Counsel
and Secretary

John P. Baumgartner
Vice President

John W. Block
Vice President

Timothy A. Bosch
Vice President

Marilyn K. Corona
Vice President

Cletus C. Coughlin
Vice President

William T. Gavin
Vice President

R. Alton Gilbert
Vice President

N. Lynn Greenwood
Vice President

William C. Leslie
Vice President

Jean M. Lovati
Vice President

Michael J. Mueller
Vice President

Kim D. Nelson
Vice President

Michael D. Renfro
General Auditor

David A. Sapenaro
Vice President

William J. Sneed
Vice President

Randall C. Sumner
Vice President
and Assistant Secretary

Richard G. Anderson
Assistant Vice President

Dennis W. Blase
Assistant Vice President

James B. Bullard
Assistant Vice President

Martin J. Coleman
Assistant Vice President

Judie A. Courtney
Assistant Vice President

Jeffrey M. Dale
Assistant Vice President

Hillary B. Debenport
Assistant Vice President

Edward A. Hopkins
Assistant Vice President

Patricia A. Marshall
Assistant Vice President,
Assistant General Counsel
and Assistant Secretary

Jerome J. McGunnigle
Assistant Vice President

John P. Merker
Assistant Vice President

Kathleen O'Neill Paese
Assistant Vice President

Frances E. Sibley
Assistant Vice President

Steven N. Silvey
Assistant Vice President

Leisa J. Spalding
Assistant Vice President and
Assistant General Auditor

Robert J. Taylor
Assistant Vice President

Daniel L. Thornton
Assistant Vice President

David C. Wheelock
Assistant Vice President

Carl K. Anderson
Supervisory Officer

Barkley E. Bailey
Supervisory Officer

Bernard E. Berns
Public Affairs Officer

Daniel P. Brennan
Public Affairs Officer

Timothy C. Brown
Operations Officer

Diane B. Camerlo
Assistant Counsel

Michael W. DeClue
Supervisory Officer

Michael J. Dueker
Research Officer

Elizabeth A. Hayes
Supervisory Officer

W. Scott McBride
Assistant Counsel

Joseph A. Ritter
Research Officer

Harold E. Slingerland
Credit Officer

Little Rock Branch

Robert A. Hopkins
Vice President
and Branch Manager

Thomas R. Callaway
Assistant Vice President

Andrea S. Eddy
Operations Officer

Louisville Branch

Thomas A. Boone
Vice President
and Branch Manager

Ronald L. Byrne
Vice President

Thomas O. Short
Assistant Vice President

Memphis Branch

Martha Perine Beard
Vice President
and Branch Manager

John G. Holmes
Operations Officer

John W. Mitchell
Operations Officer



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