



Cover: Detail from bronze doorway, main entrance, Federal Reserve Bank of Chicago

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# 1977 ANNUAL REPORT Federal Reserve Bank of Chicago

To our stockholders:

Current earnings for 1977 climbed to \$1,085,843,394, an increase of 7.3 percent over the previous year. The increase resulted from renewed demand for loans from the bank, growth in the bank's securities portfolio, and a modest rise in market interest rates.

Income after current expenses was \$1,006,473,635, an increase of 7.7 percent. Thus, current net earnings in 1977 amounted to 92.7 percent of total revenues, up slightly from 92.4 percent in 1976.

This improvement in the bank's performance was achieved primarily through continued vigorous efforts on the part of management to control costs and improve productivity. Consequently, even though volume increased in most of the bank's major activities, operating expenses for 1977 were up only 2 percent from the previous year.

primarily as a result of unfavorable developments in foreign exchange markets, the rise in net earnings after all additions and deductions was somewhat less than the rise in current earnings--about 4.5 percent. Nonetheless, with net earnings of \$971,509,141, for 1977, the bank was able to pay its stockholders a dividend for the 62nd consecutive year, or, in other words, in every year since the second full year of the bank's operation.

The earnings outlook for the coming year is, as always, dependent largely upon developments in the U.S. economy. Stockholders can rest assured, however, that bank management will continue to seek opportunities to improve Wouldn't any bank be proud to send its stockholders a letter describing such extraordinary performance? Operating expenses total only 7.3 percent of operating income compared with an 87.6 percent ratio for all insured commercial banks in the United States for 1976! Net earnings amount to almost 90 percent of total current earnings versus a 12.4 percent profit margin for all banks! That kind of earnings performance means remarkable rates of return as well. All banks in 1976 earned (before taxes) about 1 percent on assets and 14 percent on capital. The figures reported in that letter represent a 4.6 percent return on assets and an incredible 619 percent return on capital!

Could such performance be possible? The figures cited are real. They are derived directly from the 1977 condition and earnings statements of the Federal Reserve Bank of Chicago (pages 12 and 13 of this report). Year after year Chicago Fed financial statements indicate "performance" ratios that would be the envy of any "for-profit" enterprise.

But while the figures are authentic they are not a true indication of this institution's performance. Profits are only *incidental to*, not an *objective of*, Reserve Bank operations.

Unfortunately, however, the average citizen finds it difficult to regard "profits" which for the Chicago Fed approach the billion dollar level as incidental, unimportant or insignificant. As a result, Reserve Bank profitability is a source of confusion for many and, quite frankly, a source of irritation for a few.

This confusion is especially unfortunate today in light of current debate concerning the structure and operation of the Federal Reserve System. Of particular significance in this regard are questions being raised concerning: (1) the central bank's independence, which in large part rests on its ability to finance operations from its own earnings, and (2) the use of such earnings to pay interest on member bank reserves.

Obviously, misunderstanding concerning Reserve Bank profits inhibits constructive debate of such questions. Therefore, Federal Reserve profitability has been chosen as the focus of this year's annual report of the Federal Reserve Bank of Chicago. In particular, two questions underlie the discussion: first, what is the source of Reserve Bank earnings, and second, if profits are not a managerial objective, what are the determining factors of management decisions?

## The source of Federal Reserve earnings

At first glance Federal Reserve financial statements are strikingly similar to those of a private commercial bank. Although one would have to admit to some major disparities in relative proportions (such as capital to assets, loans to deposits and investment income to total income), most asset, liability and income items are the same.

For both commercial and Federal Reserve Banks, their principal assets are loans and securities. The liability side of their balance sheets both show "customer" deposits-member bank reserve accounts in the case of the Fed. And earnings statements for both show that income is derived primarily from interest on security holdings and loans.

Given this overall similarity it is easy to assume that Federal Reserve profits are generated in the same way as commercial bank earnings. But the truth of the matter is that the processes are exactly opposite.

A commercial bank uses its deposit liabilities to acquire assets. By lending or investing its customers' funds, a bank generates income. But to assume that the Federal Reserve uses member bank deposits to make loans or buy U.S. Government securities which in turn generate its income carries the parallel too far. Whereas from the commercial bank's point of view an increase in its assets results from an increase in its liabilities. Federal Reserve liabilities arise from increases in its assets. And whereas a commercial bank goal is to increase assets in order to increase earnings, the Fed at times deliberately takes action to decrease its assets.

The process through which the acquisition of assets by a Federal Reserve Bank creates its liabilities is illustrated by T-accounts depicting a Reserve Bank loan to a member bank, Reserve Bank assets increase by the amount of the loan, and the proceeds of the loan are simply added, or credited, to the member bank's reserve deposit account. (See Illustration 1.) Clearly, the asset increase—a loan—gives rise to an increase in reserve deposits—a liability.

The purchase of securities by the Fed from a securities dealer has the same effect although the process is less direct. The Fed "pays" for the security by simply crediting the reserve account of the dealer's bank, and the bank in turn credits the demand deposit account of its customer, the securities dealer. (See Illustration 2.)

For the receiving commercial bank a deposit received as a result of this transaction is no different from any other net increase in its deposits: it now has additional funds to lend or invest. But for the commercial banking system as a whole, the transaction is quite distinctive. Had one party to the securities purchase not been the central bank, the increase in deposits at the seller's bank would have been precisely offset by a decrease in deposits at the buyer's bank.

#### Illustration 1

Loans to

#### When a member bank borrows \$100,000 from the Fed

Federal Reserve Bank Member bank Loan payable Member bank Reserve balance member banks + 100 | reserves + 100 at F.R. Bank + 100 to F.R. Bank + 100

#### A closer look at Reserve Bank earnings: the 1977 financial statements of the Federal Reserve Bank of Chicago

Year-to-year changes in the major asset, liability and income items on Reserve Bank financial statements reflect developments in the economy and actions undertaken in support of System monetary objectives. By purchasing securities and making loans to member banks, the Reserve Banks increase member bank reserve deposits and provide a base for expansion in the public's holdings of currency and commercial bank deposits, in accord with the economy's growth needs.

During 1977 this Bank's loans to member banks increased by \$34.5 million and its share of securities held in the System Open Market Account increased by \$1.4 billion, as System monetary policy actions continued to be aimed at providing reserves to the banking system sufficient to finance moderate expansion in the nation's economy with a minimum of inflation. The increase in Reserve Bank credit outstanding was almost entirely absorbed, however, by the payout of currency (Federal Reserve notes outstanding) in response to public demands. Although District member bank deposits increased last year, member bank reserves declined because of a reduction in reserve requirements and shifts of deposits to banks and deposit classes with lower reserve requirements.

Increased interest income from this larger portfolio of loans and securities as well as somewhat higher market interest rates more than offset this Bank's share of losses on sales of securities and foreign exchange losses entailed in currency stabilization operations. Net earnings rose by almost \$42 million, producing a record payment to the U.S. Treasury.

Thus, although it certainly appears otherwise, the Fed does not earn its profits by using the funds of commercial banks to buy securities and make loans. To acquire assets—to purchase securities or otherwise extend credit—

the Federal Reserve does not need to have a single penny of deposits. The very essence of central banking is that increases in central bank assets provide new funds to the banking system: the increases create reserves which in turn support growth in commercial bank deposits and credit. And this is precisely the purpose for which the Federal Reserve increases-or decreases—its assets; not to produce Reserve Bank income but rather to affect the flow of money and credit through the nation's banking system. Reserve Bank profits, although substantial, are incidental. Assets are acquired by the Federal Reserve without regard to the impact the action will have on its profit and loss statement but rather with an eye only to the impact the action will have on the commercial banking system and through it the U.S. economy at large-ultimately on growth, production, employment, and the value of the dollar.

'The mistaken notion that the Federal Reserve uses the funds member banks are legally required to deposit with it to earn huge profits underlies some arguments

that the Fed should use its profits to pay interest on member bank reserve accounts. While the above points out that this line of reasoning is not correct, the aim here is not to suggest that the payment of interest on reserves is inappropriate or unwarranted. The payment of interest on reserves would tend to compensate for the fact that the legal requirement, and therefore, the burden of membership, does not fall equitably on all banks.

#### **Illustration 2**

#### When the Fed buys \$100,000 of U.S. Government securities

Federal Reserve Bank

Member bank

# Reserve Bank profits and the management challenge

To say that Reserve Banks face any kind of management challenge may sound strange. After all, what could be simpler than managing a very profitable not-for-profit institution?

Since profits are not an objective. management is not expected to maximize them. And management hardly has to worry about financial resources since Reserve Bank revenues far exceed needs in terms of the cost of operations. Consider, for example, that current earnings of the Chicago Fed for 1977 exceeded \$1 billion while current expenses were less than \$80 million. In other words, during 1977 the Chicago Fed used only about \$1 out of every \$14 of its income to cover the cost of operations, and it has been many decades since management has had to worry whether revenues would fall short of expenses.

Furthermore, no precise legal constraints apply to how much or how little a Reserve Bank can spend on operations. Current law and regulations place only two specific fiscal requirements on a Reserve Bank: it must

pay an annual dividend to member bank stockholders (by statute equal to 6 percent of paid-in capital), and it must set aside an amount sufficient to equalize its capital surplus account with its paid-in capital account. Whatever remains of Reserve Bank earnings after these small payments and after expenses is turned over to the U.S. Treasury each year, technically as interest on Federal Reserve notes.

With no challenge to maximize profits, no fears that earnings will not cover expenses, and no precise legal restrictions on spending, Reserve Bank management would appear to have little need or incentive to apply management methods similar to those that are successful in private business.

But, in reality, the absence of a profit discipline does not mean that the Fed has no "bottom line," that there are no constraints. Clearly, Reserve Bank management is accountable—responsible for completing the tasks assigned the central bank in the most effective and most efficient manner possible.

# The challenge and the strategy

The Reserve Bank management task is actually complicated by the fact that objectives cannot be stated in terms such as profit targets, growth rates, sales or returns on investments. Were such objectives relevant, management would be provided with explicit guides for both allocating resources and measuring performance.

Since profits, investment return and similar measures cannot be applied to a Reserve Bank, what factors can be used to answer the questions that face management of any organization? How should resources be allocated? How much should be spent on one Reserve Bank operation versus another? Should more—or less—be spent on all

simultaneously? Is a significant capital investment warranted—such as would be entailed in automating an activity or establishing regional offices to process checks? What level of service should the Fed provide in any of its various activities—that is, in providing a facility for check collection, in issuing currency and coin, in serving as the government's bank, in supervising and regulating commercial bank activities, and so forth?

To an extent, answers to such questions may be obvious, even though based more often on subjective judgments than objective measures. Take service levels within the Fed's cash issuing function, for example.

The Federal Reserve has responsibility for assuring that the public has at all times enough currency and coin to conduct its business free of interruptions caused by shortages of cash. Reserve Banks, therefore, transport cash to member banks in whatever amounts and denominations they request.

But many levels of service are possible-especially from the standpoint of the Federal Reserve's capacity to "foot the bill." Comparable service could be provided to nonmember banks. Deliveries could be made to any banking office, including all branches, or only to selected offices. Currency shipments could be scheduled on demand or on a restricted basis, such as weekly or monthly. Coin could be provided in wrappers or in bulk form. A cash dispensing service could even be provided directly to the general public. What level of service is appropriate for the Federal Reserve to provide within its cash issuing function? In each of the Fed's various areas of responsibility,

how much of the public's resources should be spent by the Fed in providing service to the public?

An examination of current Reserve Bank activities would reveal that a general principle that guides management in answering this question has evolved. Within each major function that Congress has assigned the Federal Reserve, sufficient resources should be spent to provide that level of service which is essential to assure the smooth operation of the financial system. On the other hand, it is unnecessary, and therefore unwarranted, for the Federal Reserve to commit resources to services which are adequately provided by the private sector. The Federal Reserve was not chartered to compete in the private marketplace. So long as the marketplace provides service on an equitable and efficient basis to all potential users, the Fed should not interfere in its operation. To put it more simply, each Federal Reserve Bank should do and should spend no morebut certainly no less—than it takes to accomplish the major objectives of the Federal Reserve Act within its District.

This general principle, although difficult to quantify and apply, represents for Reserve Bank management what profits are for managers of private enterprises: namely, a standard for both allocating resources and measuring performance. Once the general principle has been applied in the decisionmaking process, Reserve Bank management can then look to more precise tools, comparable to those employed by private enterprises, to increase operational effectiveness and efficiency. This sequence provides a Reserve Bank with a means and with a strategy for meeting its management challenge.

# Managing for the 70s and beyond

A few examples of Chicago Reserve Bank operational developments and management programs might help to illustrate how this management process works.

During the 1970s major resource commitments have been necessary in order for the Chicago Fed to meet increased public demands in a number of areas of the Bank's activity. In the payments mechanism area, for example, the establishment of regional check processing centers and increased automation of operations have been necessary to process a continuously expanding volume of work and to maintain timeliness. Similarly, in the area of supervision and regulation, new programs, requiring additional staff, have had to be developed and implemented, not only to carry out new legislated responsibilities in the areas of consumer credit protection and bank holding company regulation, but to provide adequate supervision of an increasingly complicated and sophisticated commercial banking system as well.

Once the need for such resource commitments has been recognized, however, these and other areas of operation can be scrutinized for opportunities to maximize effectiveness and efficiency. To accomplish this a number of management programs and techniques have been employed during recent years.

To name but a few, a "management by objectives" program was first introduced at the Chicago Fed in 1973 to identify corporate goals and new initiatives that could be undertaken at all levels of management. A new Federal Reserve accounting system was developed and installed, providing unit cost and comparative performance information for all Federal Reserve offices. The usefulness of "zero-base" budgeting is being studied, and to this end the Chicago Fed's Research, Bank Relations and Public Information departments prepared special 1978 budgets incorporating these techniques on a test-pilot basis. Overall, as in private industry, terms such as "operations reviews," "performance evaluations" and "cost-effectiveness analyses" have become the bywords and tools of Reserve Bank management.

And as in private industry, there is a sense in which a Reserve Bank can and ought to view itself as something akin to a profit-maximizing firm. At the least, a Reserve Bank must recognize its responsibility for minimizing the cost of providing adequate service to the public. This is the challenge that Reserve Bank management must face. And so long as the Federal Reserve identifies public needs first and then charts the best course for meeting them, it can meet the challenge, no matter what new demands may be made of the central bank in the future.

# Summary of operations

	Dollar amount		Nun	Number	
	1977	1976	1977	1976	
Classics and collection annuations					
Clearing and collection operations  Commercial bank checks collected 906	4 billion	798.8 billion	2.0 billion	1.8 billion	
	5.8 billion	42.2 billion		104.2 million	
	3.1 billion	0.9 billion	3013 1111111011	3.2 million	
	7.1 trillion	6.0 trillion		3.4 million	
Corporate and municipal bonds,		010 11111101	3.7 111111011	3.1	
coupons and other noncash items					
	1.8 billion	1.9 billion	13 538.5 thous.	567.5 thous.3	
Currency and related operations					
Currency received and counted	7.1 billion	6.8 billion	n 894.3 million	890.8 million	
	1.2 billion	1.2 billion		271.7 million	
Coin received and counted 21		229.5 million		1.8 billion	
Food stamps received and processed . 87	3.1 million	938.5 million	n 226.0 million	244.7 million	
Loans to member banks					
0,	6.3 billion	2.6 billion	_,	560	
Banks accommodated	_	<del>-</del>	209	114	
Services to U.S. Treasury					
Marketable Government securities					
issued, serviced and redeemed:  Definitive securities	40 hillian	21.3 billion	n <sup>3</sup> 326.7 thous.	750.6 thous.3	
Book entry securities		626.4 billion		267.3 thous. <sup>3</sup>	
U.S. savings bonds issued,	4.5 DIIIIOII	020.4 0111101	200.0 111003.	207.5 (11003.	
	3.7 billion	3.6 billion	n 60.2 million	55.6 million	
Federal taxes processed <sup>2</sup> 4		41.4 billion	0012 1111111011	4.4 million	
Member bank "service" operations					
Safekeeping of securities:		227 20 1 2427			
Definitive, balance December 31 8		7.7 billion		1.6 million	
Book entry, balance December 31 42	2.3 billion	37.6 billion	n³ —	_	
Securities purchased and sold	1 2 L:II:	1.1 billion	42.4.4	11 6 44	
for member banks	1.3 billion	1.1 DIIIIO	12.4 thous.	11.6 thous.	

<sup>&</sup>lt;sup>1</sup>Includes postal money orders.

<sup>&</sup>lt;sup>2</sup>Number count for items processed changed in last quarter 1976 from tax deposit forms to transmittal letters which represent multiple deposit forms.

<sup>3</sup>Revised.

# Statement of condition

(in thousands of dollars)

	As of December 31	
	1977	1976
Assets		
Gold certificate account	1,735,954	1,704,081
Interdistrict settlement account	89,375	570,496
Special drawing rights	400.000	400 000
certificate account	198,000	190,000
Coin	24,371	36,278
Loans and securities:		
Loans secured by U.S. Government		
securities	41,575	7,020
Other loans	_	_
Federal agency securities	1,282,151	1,087,925
U.S. Government securities	16,166,456	14,935,629
Total loans and securities	17,490,182	16,030,574
Cash items in process of collection	1,366,649	1,182,956
Bank premises	15,686	15,715
Other assets	261,533	238,751
Total assets	21,181,750	19,968,851
Liabilities		
Federal Reserve notes	15,427,599	13,895,922
Deposits:		
Member bank reserves	3,591,303	3,713,914
U.S. Treasury—general account	704,511	824,742
Foreign	41,355	36,062
Other	90,167	222,489
Total deposits	4,427,336	4,797,207
Deferred availability cash items	834,240	837,098
Other liabilities	178,509	142,708
Total liabilities	20,867,684	19,672,935
Capital accounts Capital paid in	157,033	147,958
Surplus	157,033	147,958
Total capital	314,066	295,916
Total liabilities and capital	21,181,750	19,968,851

# Statement of earnings

(in thousands of dollars)

	Year ending December 31	
	1977	1976
Current earnings:	2.762	639
Interest on loans to member banks	2,763	1,006,357
Interest on Government securities	1,082,419	1,000,337
Interest on investments of	422	4,320
foreign currencies	239	251
		1,011,567
Total current earnings	1,085,843	1,011,30/
Courant evacances		
Current expenses: Operating expenses	79,726	78,053
Cost of Federal Reserve currency	7,370	6,009
	87,096	84,062
Total current expenses  Less reimbursement for certain	07,030	01,002
fiscal agency and other expenses	7,726	7,291
Current net expenses	79,370	76,771
Current net expenses	73,370	, 0,, , .
Current net earnings	1,006,473	934,796
Additions to (or deductions from)		
current net earnings:		
Net profit (or loss) on sales	(7,994)	5,111
of securities	(7,334)	3,111
exchange transactions	(21,958)	(3,836)
Assessment for expenses of	(,)	
Board of Governors	(7,153)	(6,365)
All other—net	2,141	154
Net additions (or deductions)	(34,964)	(4,936)
Net earnings before payments to	074 500	020.000
U.S. Treasury	971,509	929,860
Distribution of net earnings:		
Dividends paid	9,144	8,661
Payments to U.S. Treasury (as interest		
on Federal Reserve notes)	953,290	915,095
Transferred to surplus	9,075	6,104
	971,509	929,860

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