

Integrity. Efficiency. Accessibility. These are the three major objectives the Federal Reserve Banks strive to meet in the U.S. monetary and financial system. During the past year, perhaps nothing demonstrated the significance of that mission more clearly than the Federal Reserve's response to the events of September 11. The System's prompt and decisive actions to support the economy during the national crisis included the central bank's three primary functions: monetary policy, banking supervision and regulation, and financial services.

September 11 also underscored the necessity—for both the Federal Reserve and depository institutions—of contingency planning, a lesson we learned well from our preparations for the century date change. When Y2K turned out to be far less troublesome than feared, some questioned whether all the diligent preparation had been worthwhile. In retrospect, we discovered this groundwork allowed us to respond immediately to an unthinkable disaster and to preserve the public's confidence in our financial system.

By joining forces to keep cash, checks, and electronic payments moving—and by providing record-breaking levels of discount window lending—the Cleveland Reserve Bank ensured that Fourth District financial institutions had access to all the liquidity they needed during the week of September 11 and afterward. The Bank's staff worked tirelessly with their counterparts in other Federal Reserve Districts, with the Board of Governors, and with other financial institution regulators to help avert a systemic financial crisis.

Our response to September 11:

Integrity of people and operations...

efficiency through innovative liquidity solutions...

accessibility through frequent customer communication on all levels.

We Are the Central Bank

The Federal Reserve System wears many hats: monetary policy practitioner, payments system participant, fiscal agent for the U.S. Treasury, and banking supervisor, to name just a few. Although the System has begun to consolidate some of its functions over the past several years to increase efficiency and to better serve the needs of the marketplace, our primary role remains unchanged: We are the nation's central bank. Depository institutions depend on the Fed to do whatever is necessary to support the economy and to act as the nation's lender of last resort.

Chris Moore, senior vice president and head of the Fourth District's discount window and supervision and regulation functions, brings a unique perspective to the events of September 11. He was sitting in a joint meeting of the Fed's discount window officers at the Federal Reserve Bank of New York—just three blocks away from the World Trade Center—when the Twin Towers were struck that morning. "Once we determined that our colleagues were safe, all of us shared an instinctive response," he explains. "We are the central bank. We know we have work to do to support the financial system."

With normal channels of borrowing and payments disrupted, the Fed's monetary policy tools, including open market operations, discount window lending, and other credit facilities, took on historic importance. Federal Reserve Board Vice Chairman Roger Ferguson issued a simple but far-reaching directive early that day: "The Federal Reserve is open and the discount window is available for meeting liquidity needs."

This one-line statement bolstered confidence in the banking and financial sectors that liquidity would be available to help them meet their customers' needs.

Federal Reserve Bank of Cleveland President Jerry Jordan added further clarity for Fourth District staff: "In responding to this crisis, don't think of yourself just as representatives of our Bank, but as central bankers for our nation."

The Board of Governors' *Monetary Policy Report* to Congress on February 27, 2002, noted that direct dislocations in U.S. financial markets had made it difficult for the reserve market to channel funds where they were needed most, creating a surge in the effective demand for reserves. The Fed accommodated this increased demand in a number of ways, beginning with discount window lending, extending to securities lending and bilateral loans of reserves among market participants, and ending with open market operations as the market for reserves began to normalize.

The upshot was the largest single week of lending activity in central bank history, including the three largest loans in Fourth District history. The Bank's Credit Risk Management Department, which is responsible for responding to liquidity needs, provided support through District lending (daylight and overnight credit), expanded hours of operation, and continuous communication with Fourth District depository institutions.

A Real-World Example of Theory

The Fourth District also played a critical role in fulfilling the Fed’s vital payments services responsibilities. Electronic payments staff—handling Fedwire® funds and securities transfers, automated clearinghouse, and electronic access—routinely contacted bank customers as the securities and funds areas extended closing times until late in the evening.

Employees were in frequent communication with the Fed’s Wholesale Payments Product Office, which directs the System’s day-to-day electronic transfer activities, as it shifted operations from New York to its contingency site. “Our staff got a real-world example of the theory of central banking,” says Suzanne Howe, vice president in charge of electronic payments.

Liquidity Provision during the September 11 Crisis

Activity	Fourth District	Federal Reserve System
Discount window lending	<ul style="list-style-type: none"> ■ \$5.3 billion lent on September 12 ■ Monthly lending information not available 	<ul style="list-style-type: none"> ■ \$45.5 billion lent on September 12 ■ \$82 billion in total lending for the week ending September 12 (compared with \$755 million for the month of August 2001)
Overnight overdrafts	<ul style="list-style-type: none"> ■ Negligible overnight overdraft activity 	<ul style="list-style-type: none"> ■ \$4 billion in overnight overdrafts on September 12 (compared with \$9 million for the month of August 2001)
Daylight credit	<ul style="list-style-type: none"> ■ Average daily daylight credit utilization peaked at \$21.7 billion on September 12 (compared with \$19.8 billion for the month of August 2001) 	<ul style="list-style-type: none"> ■ Average daily daylight credit utilization peaked at \$150.1 billion on September 14 (compared with \$92.9 billion for the month of August 2001)

SOURCES: Board of Governors of the Federal Reserve System, Federal Reserve Statistical Release H.4.1, September 13, 2001; and Stacy Panigay Coleman, “The Evolution of the Federal Reserve’s Intraday Credit Policies,” *Federal Reserve Bulletin*, February 2002, pp. 79–84.

The extended hours devoted to funds and securities transfers led to nearly round-the-clock operations for accounting systems and staff. “We pushed the limits of our systems but were successful because we made critical decisions and implemented them quickly,” notes Darell Wittrup, vice president.

Finally, the Retail Payments Office (RPO) in Cleveland assumed a significant leadership role during the week of September 11 as it partnered with the Atlanta Reserve Bank to manage check operations for the Fed’s 45 processing offices nationwide. With airline traffic halted for three days, the RPO and Reserve Banks kept paper checks moving by devising an interim ground transport network to swap check processing work among nearby offices. During frequent communications with customers, marketing staff outlined our policy of providing credit for all checks deposited at the Reserve Banks, despite the need to incur billions of dollars in check float.

How did the financial community respond to all of these extraordinary efforts? Consider the words of one stakeholder, Kenneth A. Guenther, president and chief executive officer of Independent Community Bankers of America, who commented: “The Federal Reserve’s response on September 11 ensured a fully functioning payments system when the private sector could not.... The Fed’s dual roles [as provider of services and regulator of the payments system] are an essential element of the ongoing homeland security of the United States.”

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The following section presents an overview of the Bank's 2001 operational achievements in each of its major areas of responsibility: economic research and monetary policy; the supervision and regulation of banking organizations; and the provision of payments services to banking institutions and the U.S. Treasury.

Economic Research and Monetary Policy Economic policymakers understand the importance of anticipating and preparing for change in today's global economy. As 2001 unfolded, first with deteriorating economic conditions and then with the shocks brought by September 11, the ability to add insight and value to public discourse on policy issues gained new importance.

The Research Department continued to pursue its goals of being a respected contributor to strategic thinking about System policy issues and promoting constructive discourse of those issues in the public domain. Research staff published articles and papers on monetary, economic, and banking topics in the Bank's annual report and its *Economic Commentary* and *Economic Review* series, as well as other respected academic journals.

One of the Federal Reserve Bank of Cleveland's key strategic initiatives has been the formation of the Central Bank Institute. The Institute was established to promote greater understanding of the monetary policy, supervisory, and payments aspects of central banking through research and communications among central bank practitioners and academic economists. Academics and representatives from central banks around the world participated in a major conference in Cleveland and several workshops sponsored by the Central Bank Institute.

Efforts to leverage the Bank's reputation and expertise in economic research and monetary policy were intensified in 2001. The Bank is recognized as a leader in the area of inflation and inflation expectation measurement, Social Security policy, and the role of the central bank.

Public outreach remains a key objective of the Federal Reserve Bank of Cleveland, and the public tour program and speakers bureau continue to be the cornerstones of that program. Although the tour program was suspended after September 11, more than 4,300 visitors toured the Cleveland, Cincinnati, and Pittsburgh offices in 2001, and Fourth District staff delivered more than 40 speeches.

In the area of economic education, the Bank again sponsored the Fed Challenge competition, in which teams of high school students participate in mock Federal Open Market Committee deliberations. Participation in the program, which entails extensive study of current economic conditions and monetary policymaking, increased 25 percent in 2001. The Bank also sponsored an exhibit on Alexander Hamilton at the Cleveland Office.

Supervision and Regulation Changes in the operations and credit quality of the bank holding companies and community banks supervised by the Federal Reserve Bank of Cleveland continue to present challenges and opportunities for the Bank's Supervision and Regulation Department. Prominent among these forces are emerging technologies, industry consolidation, and legal changes in the financial services arena. As the economy slowed in 2001, the quality of banks' loan portfolios reflected weaknesses and resulting strains on earnings.

The concept of risk-based supervision has gained currency as a way to address these issues. In 2001, the Bank's supervision and regulation function formed a Risk Committee to identify and monitor emerging trends in the financial services and legal environment and to direct resources to the areas of highest risk. The consumer affairs function has been recognized as a System leader in the development of comprehensive Community Reinvestment Act/compliance risk profiles for medium and large bank holding companies. The Bank also hosted a roundtable for community bankers to promote a better understanding of the issues and risks associated with liquidity and funding.

The Bank continued to refine its supervisory program for large, complex banking organizations. Dedicated teams that had been established to monitor and direct supervisory activities for these companies were improved by adding staff with key competencies matching the business profiles of the companies supervised.

Efforts to improve the effectiveness of knowledge management activities continue to be an important strategic goal for improving internal efficiency and facilitating communications. SuperLink (patent applied for), a cornerstone technology tool, was further enhanced to provide staff with easy, just-in-time access to the information they need. Other initiatives to explore emerging knowledge management technology tools and to promote a knowledge management culture will yield dividends in the future.

The Bank highly values communication, outreach programs, and training efforts for community bankers and the public. Therefore, the function sponsored workshops on proposed changes to the Home Mortgage Disclosure Act, the Home Owners Equity Protection Act, the Gramm-Leach-Bliley Act, and the Community Reinvestment Act.

The Federal Reserve Bank of Cleveland is a strong advocate of fair lending and community economic development. In support of these goals, the Bank's community affairs staff participated on a number of boards and coalitions for which their public policy, regulatory, or facilitation expertise provided value. The Bank also helped to develop a statewide coalition of rural microenterprise organizations and organized several rural housing conferences.

Payments Services The Federal Reserve Bank of Cleveland continued its tradition of strong financial performance combined with responsive and innovative solutions to marketplace and customer needs. Each functional area—retail payments, fiscal agency, cash, and electronic payments—met or exceeded all major Federal Reserve System quality measures, service objectives, and efficiency targets in 2001.

Retail Payments The Federal Reserve Bank of Cleveland offers two retail payments services: check processing and automated clearinghouse (ACH). Both areas performed exceedingly well in 2001 while undertaking major consolidation and standardization initiatives. The Bank maintained highly efficient operations, achieving the lowest unit cost in the System for retail payments. On the financial side, the check function exceeded its local net revenue target (the difference between revenue generated in the Fourth District and the Bank's total operating and float costs). The function also met profitability targets while maintaining low unit costs.

In check processing, the Bank devoted significant energy to preparing for conversions to the System's new nationwide standard software platform for check processing and FedImageSM Services in 2002. At the same time, two highly innovative and strategic products were developed: cash management perfect presentment and power encode. In ACH, the Bank consolidated its backroom operations to the Federal Reserve Bank of Atlanta, with no impact on customers.

Partnering with the Federal Reserve Bank of Atlanta, the Cleveland Fed's Retail Payments Office (RPO) completed its second full year of managing the Check Modernization initiative. This massive four-year effort will standardize check processing at all 45 Reserve Bank offices, adopt common software for processing and researching check adjustment cases, create a national archive and retrieval system for check images, and deliver check services to customers online using the new FedLine[®] for the Web platform. In 2001, the RPO achieved several milestones as each of the four Check Modernization components (Check Standardization, Enterprise-Wide Adjustments, FedImage Services, and FedLine for the Web—Check Services) either moved into production or completed testing.

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As part of the System's Check Modernization Project, the Bank has entered into a Systemwide contract with PricewaterhouseCoopers LLP (PwC) for management advisory services. Expenditures for these services during the year 2001 totaled \$0.7 million. The term of this contract extends to 2003 with total expected payments in future years of \$1.8 million. PwC is also engaged by the Board of Governors of the Federal Reserve System to audit the individual and combined financial statements of the Reserve Banks for 2001. Fees for these services totaled \$1.3 million. In order to ensure auditor independence, the Board requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Bank or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks or in any other way impairing its audit independence. The Bank's board of directors believes that the advisory services do not directly affect the preparation of the financial statements audited by PwC and are not incompatible with the services provided by PwC as an independent auditor.

Fiscal Agency Innovation was the hallmark of fiscal agency activities in 2001. The Cleveland Fed took a lead role in developing two new electronic payments initiatives for the U.S. Treasury, *Pay.gov* and Paper Check Conversion, both of which will be enhanced and implemented at new sites over the next few years. *Pay.gov* will use state-of-the-art payments technology to authorize and settle government payments over the Internet. Paper Check Conversion will allow the Treasury to move checks into the more efficient automated clearinghouse. The Bank's fiscal agency function was designated as the System's lead operating site for these two initiatives. The Bank's savings bonds function is the largest of the five processing sites nationwide as well as the most efficient, evidenced by its lowest unit cost in the System.

Cash The Fourth District's cash function led the Federal Reserve System's implementation of the Standard Cash Application, which automates cash accounting, control, and reporting functions nationwide. The Cleveland Bank served as a secondary installation site for the application and as the home of the Cash System Support function. The Bank's cash function ranked first in the System in productivity (measured by bundles of currency processed per hour), performed under budget, and maintained low unit cost (fourth-highest rank in the System).

Electronic Payments Data collected by the Federal Reserve System suggest that over the past 20 years, retail payments have been steadily migrating to electronic alternatives as consumers, businesses, and financial institutions seek greater efficiency and cost-effectiveness. American consumers and businesses make 80 billion retail payments each year, nearly 50 billion by check and 30 billion using electronic instruments such as credit cards, debit cards, and ACH. Since 1979, checks have declined from about 85 percent of noncash payments to approximately 60 percent today.

The Federal Reserve Bank of Cleveland is responding to this trend by interacting with customers to better understand financial institutions' needs and by supporting those needs through initiatives such as the national consolidation of ACH operations and the addition of Ginnie Mae securities to the National Book-Entry System. The Bank continues to support the Direct Payment Program, which encourages consumers to pay their utility bills automatically through ACH. The Bank is also developing an electronic bill presentment and payment service that uses ACH as the delivery and payment method.

Quality Improvements The Bank's strategic vision—to become the best example of a private enterprise serving the public interest—has been the foundation for our strategic direction over the past several years. This vision, along with the four accompanying corporate goals—efficiency and effectiveness, customer culture, alignment, and leadership—has guided the Bank in meeting the needs of customers and stakeholders. The Bank continues to employ the balanced scorecard in all functional areas to track performance against objectives.

In 2001, significant time and effort were devoted to developing a multiyear strategic plan that will ensure the Bank's continued effectiveness in monetary policy and economic research, banking supervision, and payments services in light of the rapidly changing environment in which we operate. The Bank's updated vision, mission, strategic objectives, and corporate goals will be unveiled in 2002.

To further strengthen our service-oriented, customer-focused culture, the Bank formed a Customer Satisfaction Department, which is responsible for managing all of the elements associated with establishing the Bank as a preferred service provider to customers. In addition, the Bank implemented help desks at all offices and refocused the role of account executives to respond more effectively to customer needs. The Bank's 2001 customer survey indicated dramatic improvement in customer service initiatives, with 84 percent of our customers classified as "truly loyal."