19 ANNUAL

FEDERAL RESERVE BANK of CLEVELAND

REPORT 93

The Federal Reserve System is responsible for formulating and implementing U.S. monetary policy. It also supervises banks and bank holding companies, and provides financial services to depository institutions and the federal government.

The Federal Reserve Bank of Cleveland is one of 12 regional Reserve Banks in the United States that, together with the Board of Governors in Washington, D.C., comprise the Federal Reserve System.

The Federal Reserve Bank of Cleveland, its two branches in Cincinnati and Pittsburgh, and its Columbus Office serve the Fourth Federal Reserve District. The Fourth District includes Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky.

The year 1993 will no doubt be remembered as a turning point, a time when major directions — economic and political, international, national, and local — were changed and the future was embraced.

(standing) G. Watts Humphrey, Jr., A. William Reynolds, Sandra Pianalto (seated) Jerry L. Jordan

This is evident in the U.S. economy, as households and businesses at last seem ready to make the necessary investments to ensure a more prosperous, stable future. The imbalances caused by excessive personal and corporate debt, by overcapacity in real estate, and by downsizing to improve productivity and world competitiveness continue to be corrected. Though many have argued that the ongoing recovery has not been strong enough or fast enough, the growth is real and has been accomplished without the devastating surge in inflation that often accompanies economic upturns.

Given that one of the few contributions a central bank can make to a nation's economic progress is to maintain price stability, I would have wished to see a much lower inflation rate than even the relatively modest 3 percent we experienced in 1993. Surveys and current research indicate that households and businesses expect inflation to continue and that they are skeptical about the Federal Reserve's resolve in taking the necessary steps to contain it. In my remarks to bankers, policymakers, and academics last year, I emphasized that the central bank remains committed to reestablishing trust in the purchasing power of the dollar, which is crucial to maximizing and fulfilling the productive capacity of this nation.

Certainly, the economy and the banking institutions of the Fourth Federal Reserve District — which includes the state of Ohio, the western third of Pennsylvania, the northern panhandle of West Virginia, and the eastern half of Kentucky — continue to fare well. During the recession and early in the current expansion, this region did not suffer the same degree of decline as had been the tradition for the so-called Rust Belt. We can attribute our success to the fact that, over the last decade, we improved our productivity and developed a more balanced industrial mix.

The region's stable economy during the past two years and our increased presence in foreign markets attest to the gains we have made. After decades of painful economic restructuring and conservative banking investment, I believe that we are now poised to regain our historic position as the country's economic leader.

BANKING EXCELLENCE

In fact, our banking institutions are already leading the nation. Judged by capitalization levels, return on assets, return on equity, and loan loss reserves, our banks are the strongest in the country and among the best in the world. I have had the opportunity to meet with the chief executive officers of nearly every commercial bank in this District over the last 18 months as well as with the top management of several of the region's thrift institutions, and I cannot help but feel fortunate to be working with such a dynamic group.

Because of the confidence I have in our District's banking leadership, early in 1993 I publicly proposed that the industry and its regulators begin a whole new approach to bank regulation. This approach would allow market forces to discipline banks, rather than using the costly and often counterproductive regulatory apparatus now in place.

My recommendations include public disclosure of regulatory risk ratings, adoption of market-value accounting systems to provide a more accurate picture of a bank's financial condition, and incentives to encourage banks to maintain high levels of capital. Furthermore, especially well-run, well-capitalized organizations should be given the opportunity to consolidate more easily or to develop more efficient corporate structures, rather than having to react to restrictive regulations and negative incentives when making business decisions.

Regulations imposed with even the best of intentions entail substantial costs, many of which are unintended. Indeed, the entire economy is harmed to the extent that regulation lowers the efficiency of the financial system and, therefore, the real growth potential of the economy. These proposals reflect my belief that market forces are powerful and efficient regulators and that we must unleash our institutions' potential for success in order to compete in the world's financial services marketplace.

COMPETITIVE CHALLENGES

Increasing competition will surely change the face of the financial services industry. The strategies that were successful in a highly regulated environment will almost certainly need to change as banks compete in more open markets. The Federal Reserve System itself, with its pivotal role in the nation's payments system, has been challenged by many of the same forces that are confronting depository financial institutions. Several years ago, the leadership of this District recognized the necessity of improving our efficiency, of providing customer-driven, price-competitive services, and of developing quality in everything we do. In 1993, we began to reap significant benefits from these efforts by placing first among the twelve Federal Reserve Districts in unit cost efficiency.

Our top ranking is a particularly important milestone for this District: It is the first time in the seventeen years since the Federal Reserve System began using unit cost as a measure of efficiency that we have been ranked number one.

Last year also marked the first time in our Bank's 80-year history that we were reviewed by a team of independent auditors rather than by Federal Reserve System officials. We received a very positive report, and our standards and qualities were deemed to be of the same high caliber as those found in the best commercial banks.

We are proud of these accomplishments, but we also see them as turning points. The dynamic environment of the twenty-first century will require an entirely different perspective on how we do business, a perspective that places customer service, quality, and efficiency at the very center of our mission. The management of our District has thus developed a strategic plan for the coming five years that takes a bolder approach to our traditional roles as a provider of payments services, regulator of state-chartered member banks, and decisionmaker in the setting of monetary policy.

As a result, the Fourth District has begun to realign its resources. From introducing progressive, customer-focused employee training programs to enhancing efficiency through wide-ranging automation projects, we are committed to continuously improving our effectiveness. We are guided in these efforts and are assisted in the fulfillment of all our public responsibilities by the considerable experience of our 23 directors and our Small Bank and Small Business Advisory Councils.

I especially want to recognize the contributions of those Cleveland directors who completed their terms of service: Verna K. Gibson (president, Outlook Consulting International, Inc.) and John R. Hodges (retired president, Ohio AFL-CIO). Thanks are also due to the outgoing directors of our two branch offices: Jack W. Buchanan (president, Sphar & Company, Inc.) and Marvin Rosenberg (Partner, Towne Properties Ltd.) of our Cincinnati board, and Frank V. Cahouet (chairman, president, and chief executive officer, Mellon Bank Corporation and Mellon Bank, N.A.) and George A. Davidson, Jr. (chairman and chief executive officer, Consolidated Natural Gas Company) of our Pittsburgh board.

I would also like to express my gratitude to our Federal Advisory Council member, John B. McCoy (chairman and chief executive officer of Banc One Corporation). He has very ably represented the Fourth District on this national council since 1991, and will be replaced in 1994 by Frank Cahouet.

Clearly, to the staff and management of the Federal Reserve Bank of Cleveland and its offices in Cincinnati, Columbus, and Pittsburgh, 1993 was a significant year, one in which each accomplishment seemed to open new vistas. I am grateful to my colleagues here — at every level of our organization — for their contributions, and I look forward to the years ahead.

Jerry L. Jordan

Jerry L. Jordan

The need for ever-increasing efficiency drives the Federal Reserve System in its role as the guardian of the nation's payments system. Since

BUILDING A MORE EFFICIENT PAYMENTS SYSTEM

1913, the Fed has been at the forefront of payments system technology. We have developed national transportation and accounting settlement systems that enable institutions to clear interbank checks more efficiently, helped to design and test state-of-the-art check-processing systems, led the banking industry in setting standards for encoding checks for more efficient processing, and implemented software and hardware to provide value-added services to our customers.

One of the biggest challenges facing participants in the payments system is to eliminate the expensive and time-consuming process of moving paper checks. In response to this challenge, the Fourth District has refined several electronic check products that promise to improve the efficiency of the check-clearing system by taking advantage of existing electronic processing and communications technology.

For example, all of the information necessary to post a check to a customer's account is contained in the MICR line, a machine-readable code printed along the bottom of every check. Yet millions of paper checks are transported across the country each day, from the institution where the check was deposited to the institution on which it was drawn. Why not simply capture the MICR information and transmit it electronically to the payor institution?

The Fourth District has pioneered the effort to provide just such a service so that our customers receive the information they need much sooner. In 1993, we were successful in gaining wider customer acceptance for our electronic check products — a crucial step in reducing reliance on paper items and ultimately improving the efficiency of the payments system. In fact, if payor institutions opt for the District's truncation service, checks do not need to be moved from the Federal Reserve at all: They are simply stored until needed or destroyed.

The next step in reducing the movement of paper is imaging — that is, creating an electronic picture of all components of a check and then "storing" that information in electronic form. In 1993, the District introduced software that provides a foundation for such electronic enhancements. The new item-processing system also allows checks to be sorted and balanced more efficiently, has an increased capacity to process electronic files, is faster, and is compatible with the full range of electronic communications interfaces.

For several years, the Fourth District has led the Federal Reserve System's effort to develop this software, as well as software to speed check adjustments. From the initial research to implementation and testing, a team of District programmers, check-processing professionals, and customer service specialists have worked across departments and offices to bring the latest technology to our customers.

A similar effort took place in 1993, when the Federal Reserve Bank of Cleveland helped Fourth District institutions convert to an all-electronic automated clearinghouse (ACH) environment. Now, customers have access to 25,000 depository institutions nationwide, either directly or through service providers, and have new options in deposit deadlines that allow originators quicker turnaround times in delivering payments.

Here in the Fourth District, we are taking advantage of the potential for using ACH even more efficiently. We have expanded our program to help utilities automatically debit households electronically, a further effort to provide customers with cost-effective, dependable payment services and to stimulate the growth of electronic payments.

Savings Bond Consolidation

The U.S. Treasury, especially through its activities in the Bureau of the Public Debt, is the Federal Reserve System's biggest customer. More than that, the Bureau has an important relationship with our other customers: depository financial institutions throughout the country that participate in marketing and processing Treasury securities and savings bonds. These are certainly reasons enough for the Fourth District to provide a high level of efficiency and customer service to the Bureau.

However, we have gone beyond simply maintaining a good business relationship and have initiated several successful automation and consolidation projects with the Bureau that have revolutionized the way savings bonds are handled. Our Pittsburgh office, in particular, has been at the forefront of streamlining many aspects of savings bond issuance and redemption.

DEVELOPING WORLD-CLASS SERVICE FOR THE WORLD'S LARGEST CUSTOMER

This expertise culminated in the award of several permanent assignments for that facility. It was named as one of five Federal Reserve sites in the country to be a Regional Delivery System (RDS) office for savings bond issuance, as well as a center for exchanges, redemptions, and several other recordkeeping operations. Extensive modifications have already been made to our downtown Pittsburgh building to accommodate the additional operations. By the time consolidation is completed in 1996, staffing will have been increased 50 percent over former levels.

The Pittsburgh facility has also been named as one of two locations in the country to handle the printing and mailing of an estimated 70 million savings bonds annually. Ultimately, the office will service about 60 percent of the Federal Reserve System's volume. At the same time, it will continue to be the only national warehouse for unissued savings bond stock, will provide stock consignment to all issuing agents across the country, and will remain the only national processing site for book-entry savings bonds.

These projects are just a few examples of the Federal Reserve System's ongoing strategy to automate and consolidate the handling of savings bonds and other government debt instruments. In so doing, the Fed saves taxpayers millions of dollars annually and demonstrates that good customer service means taking on the challenges of the world's biggest securities issuer.

Payments System Risk

One of the Federal Reserve System's mandated roles is to maintain the stability and integrity of the nation's payments system, especially as it operates through depository financial institutions. In addition, as the entity that guarantees the settlement of trillions of dollars of payments through wire transfer operations and that advances loans to institutions through the discount window, the Federal Reserve is itself at risk.

In order to maintain an efficient and stable payments system, as well as to monitor the credit risk exposure to District institutions more effectively, the Federal Reserve Bank of Cleveland has reengineered its approach to a variety of information-gathering and analysis activities. During 1993, interrelated operations such as financial surveillance, data collection, administration of collateral for discount window loans, and monitoring of intraday credit risk were consolidated under the same management within the Banking Supervision and Regulation Department.

NEW STRUCTURE STREAMLINES CREDIT RISK MANAGEMENT

This approach has enabled us to manage our risk more efficiently through centralized oversight of institutions' financial conditions, and to coordinate our efforts to inform bankers about new daylight overdraft policies.

With the introduction of the Daylight Overdraft Reporting and Pricing System (DORPS), Federal Reserve Banks — and depository financial institutions themselves — are able to capture much more information about institutions' funding positions on a real-time basis. This development directly supports the Fourth District's supervision strategy: not to eliminate risk in banking, but to help institutions manage risk more effectively in order to ensure a more stable payments system.

Economic Research

In recent years, the Federal Reserve Bank of Cleveland has developed a national reputation for promoting price stability as the primary goal of monetary policy. The Bank's economic researchers, as well as its current and former presidents, have argued persuasively that controlling the price level is the only goal any nation's central bank can realistically achieve through monetary policy. U.S. law currently requires the Federal Reserve to pursue maximum employment growth, moderate long-term interest rates, and price stability. Our Bank's position is that price stability is the means through which the Fed can best help the nation to achieve its ultimate employment and interest-rate objectives.

During 1993, the Bank's researchers contributed to public policy discussions by taking a closer look at how price stability is measured. At issue is the potential error of basing monetary policy decisions on short-term fluctuations in relative prices, rather than on true signals that an overall rise in the level of all price changes (inflation) has occurred.

MEDIAN CPI STUDIES HELP TO FRAME EFFECTIVE MONETARY POLICY DECISIONS

In pursuing this line of inquiry, the Bank has published several studies that examine a variant of the most popular measure of current inflation, the Consumer Price Index (CPI). This alternative, known as the median CPI, shows a stronger correlation with money supply growth than do other price-level measures, making it a better standard for gauging the true inflationary effect of monetary policy. Based on this development, the Fourth District has taken a public policy stance on using the median CPI as a benchmark for monitoring the nation's monetary objectives.

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As of December 31, 1993

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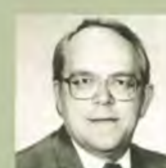
Apple Creek, Ohio



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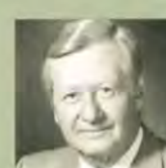

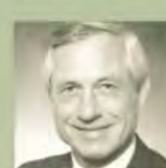

STATEMENT OF CONDITION

		For years ended December 31 1993	1992
ASSETS	Gold certificate account	$ 701,000,000	$ 658,000,000
	Special drawing rights certificate account	556,000,000	556,000,000
	Coin	21,234,140	25,995,434
	Loans and securities:		
	Loans to depository institutions	-0-	-0-
	Federal agency obligations bought outright	311,578,704	340,680,714
	U.S. government securities:		
	Bills	10,772,433,990	8,924,796,483
	Notes	8,872,000,411	7,438,416,401
	Bonds	2,658,156,406	2,205,304,963
	Total U.S. government securities	$ 22,302,590,807	$ 18,568,517,847
	Total loans and securities	$ 22,614,169,511	$ 18,909,198,561
	Cash items in process of collection	274,834,436	442,406,029
	Bank premises	37,373,597	35,939,937
	Other assets	1,800,816,531	1,682,967,122
	Interdistrict settlement account	−3,321,205,721	1,420,144,348
	TOTAL ASSETS	$ 22,684,222,494	$ 23,730,651,431
LIABILITIES	Federal Reserve notes	$ 20,161,201,280	$ 21,679,962,723
	Deposits:		
	Depository institutions	1,556,106,868	1,340,703,323
	Foreign	8,020,300	8,451,200
	Other deposits	14,204,742	14,900,693
	Total deposits	$ 1,578,331,910	$ 1,364,055,216
	Deferred availability cash items	339,713,652	220,326,754
	Other liabilities	157,918,052	113,869,638
	TOTAL LIABILITIES	$ 22,237,164,894	$ 23,378,214,331
CAPITAL ACCOUNTS	Capital paid in	$ 223,528,800	$ 176,218,550
	Surplus	223,528,800	176,218,550
	TOTAL CAPITAL ACCOUNTS	$ 447,057,600	$ 352,437,100
	TOTAL LIABILITIES AND CAPITAL ACCOUNTS	$ 22,684,222,494	$ 23,730,651,431

INCOME AND EXPENSES

		For years ended December 31	
		1993	*1992*
CURRENT INCOME	Interest on loans	$ 181	$ 51,177
	Interest on government securities	1,105,592,400	1,083,681,615
	Earnings on foreign currency	72,384,137	127,851,245
	Income from services	44,464,874	43,856,164
	All other income	229,592	284,196
	Total current income	$ 1,222,671,184	$ 1,255,724,397
CURRENT EXPENSES	Current operating expenses	$ 79,232,490	$ 74,893,149
	Cost of earnings credits	10,756,840	7,166,749
	CURRENT NET INCOME	$ 1,132,681,854	$ 1,173,664,499
PROFIT AND LOSS	Additions to current net income		
	Profit on foreign exchange transactions	$ 15,319,310	$ -0-
	Profit on sales of government securities	2,556,007	7,605,686
	All other additions	2,776,384	4,203
	Total additions	$ 20,651,701	$ 7,609,889
	Deductions from current net income		
	Loss on foreign exchange transactions	$ -0-	$ 65,585,542
	All other deductions	33,032,393	10,279
	Total deductions	$ 33,032,393	$ 65,595,821
	Net additions or deductions	$ 12,380,692	$ 57,985,932
	Cost of Unreimbursable Treasury Services	1,685,403	1,751,906
	Assessments by Board of Governors		
	Expenditures	8,215,500	7,795,200
	Federal Reserve currency costs	23,192,101	18,485,886
	Total assessments by Board of Governors	33,093,004	28,032,992
	NET INCOME AVAILABLE FOR DISTRIBUTION	$ 1,087,208,158	$ 1,087,645,575
DISTRIBUTION OF NET INCOME	Dividends paid	$ 12,010,618	$ 10,100,417
	Payments to U.S. Treasury (interest on Federal Reserve notes)	1,027,887,290	1,062,482,358
	Transferred to surplus	47,310,250	15,062,800
	Total distributed	$ 1,087,208,158	$ 1,087,645,575

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This annual report was prepared by the Public Affairs and Bank Relations Department and the Research Department, Federal Reserve Bank of Cleveland.

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