

## Operational Highlights

**A**s the nation's central bank, the Federal Reserve's chief objectives are to promote sustained, long-term economic growth and to foster a sound and efficient financial system. This charge is particularly salient today, as our payments system undergoes significant change: Market demands and new technologies are spurring the rapid development of new electronic delivery channels. As a result, the Federal Reserve is making investments in research and technology to both modernize paper payments and ensure the stability and effectiveness of electronic payments.

The U.S. payments system has witnessed a surge of innovation in recent years—and a great deal of that innovation is occurring right here in the Fourth Federal Reserve District. The Federal Reserve Bank of Cleveland, which has long been known for its hard work, creativity, and ability to get the job done, is partnering with the U.S. Treasury, industry groups, and financial institutions on projects throughout the Federal Reserve System that are helping to improve the infrastructure of our payments system and bringing electronic payments to market.

## Modernizing the Check Factory

Although paper checks may be on the decline, they're certainly not a thing of the past. Consumers continue to favor checks because they are convenient, familiar, universally accepted, and offer simple record keeping. According to the most recent Federal Reserve estimates, roughly 40 billion checks—60 percent of all noncash payments—are still written in the United States each year.

But the work of processing checks is costly and labor intensive. For that reason, the Federal Reserve has sought out ways to improve the efficiency of its check operations—to modernize its factory, so to speak. In 2003, the Federal Reserve completed its four-year Check Modernization initiative, which overhauled the systems and infrastructure for processing checks. The Cleveland Bank's Retail Payments Office, working in partnership with the Federal Reserve Bank of Atlanta, led the development and implementation of this ambitious project, which was completed on time and within budget.

Check Modernization has standardized check processing across Federal Reserve offices nationwide, implemented common software for processing and researching check adjustments, delivered Web-based services to financial institutions, and created a national archive and retrieval system for check images. The Cleveland Office is home to one of two national check image archive sites, where the Bank stores approximately 250 million images every month for financial institutions across the country.

In addition to the operational efficiencies and flexibility afforded by Check Modernization, the improvements will allow the Fed to develop and roll out new products more quickly and cost-effectively.

## Responding to a Changing Market for Check Services

While the Check Modernization initiative has dramatically improved the Fed's infrastructure for check payment processing and the quality of service it provides to depository institutions, market forces cannot be ignored: The use of checks is declining, and that has had a significant impact on Federal Reserve operations. For this reason, the Federal Reserve System announced in early 2003 that it would reduce the number of check processing locations nationwide from 45 to 32. Additionally, the System will reduce the number of sites that perform check adjustments to 12 regional locations. The move will allow the Fed to continue providing high-quality check services while maintaining efficient, cost-effective operations.

What does this mean for the Fourth Federal Reserve District? In late 2003, the Cleveland Office took on the check processing volume of its Pittsburgh branch, which no longer performs check activities. Throughout 2004, the Bank's check operations in Cincinnati will absorb the work of three check offices in Indianapolis, Louisville, and Charleston, making it one of the largest check processing sites in the System. In addition, the Cleveland Office will take on check adjustments from five offices in our District and others.

As we make these changes, financial institutions can be assured that the Federal Reserve Bank of Cleveland will continue its tradition of high-quality check services and superior customer service.

## Clearing the Way

The nation's check collection system is also getting a boost from a law enacted in late 2003, the Check Clearing for the 21st Century Act—"Check 21" for short. The legislation, which will become effective in October 2004, promises to foster innovation and efficiency in the payments system by reducing some of the impediments to check truncation.

Under the new law, financial institutions will be able to collect and return checks by using digital images and electronic check information to create substitute paper checks that will be the legal equivalent of the original check.

For banks, Check 21 will mean greater efficiency, lower check handling and transportation costs, and the ability to broaden deposit options for customers. Plus, financial institutions will be able to take full advantage of electronic check collection and return capabilities, giving customers an attractive alternative to the current paper-based system.

The Cleveland Fed, working on behalf of the System's Retail Payments Office, is once again taking a leadership role by preparing for the requirements of Check 21, designing a new suite of products and services, and overseeing the project's implementation.

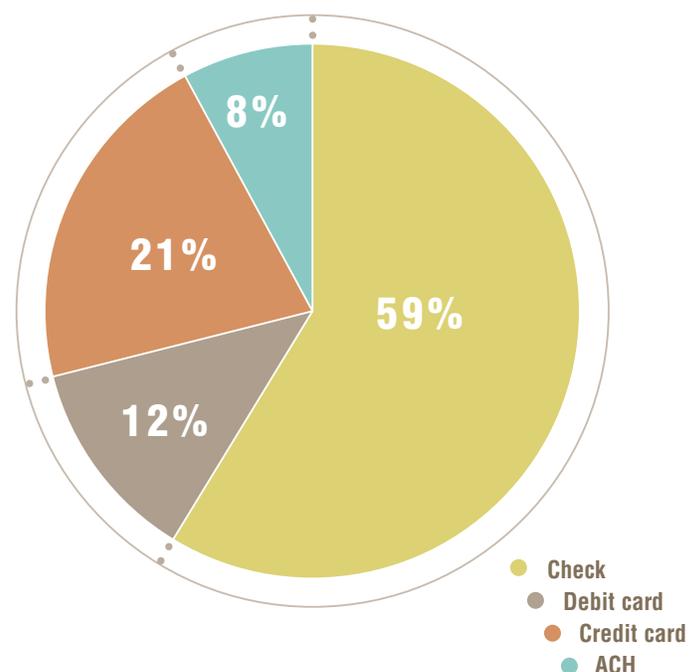
## Transforming Electronic Payments

Even as the Federal Reserve works to make traditional paper payments as efficient as possible, it's clear that electronic payments are driving today's financial services: Electronic payments have increased nearly fivefold over the past two decades. That's why we're putting as much brain power into the future of electronic payments as we are improving existing paper payments. The Fed—and the Cleveland Reserve Bank in particular—is at the center of several exciting initiatives that are paving the way for new payment vehicles.

More and more consumers are choosing to pay bills online because of the convenience, cost savings, and improved security of internet payments. It makes sense, then, for companies to take advantage of the same benefits by actually presenting bills electronically and eliminating the paper bills that consumers receive each month.

In 2003, the Cleveland Fed continued to champion the Electronic Billing Information Delivery System (EBIDS), which aims to deliver summary electronic bills to consumers through their financial institutions using the Fed's ACH network. The Cleveland Bank is taking a leadership role in moving the EBIDS concept into a national pilot program, working in partnership with NACHA (the rules-making body for ACH payments), industry groups, financial institutions, and private companies. EBIDS is expected to complement banks' existing online banking and ACH applications by delivering bill content and supporting the adoption of electronic payments.

The Retail Payments Mix



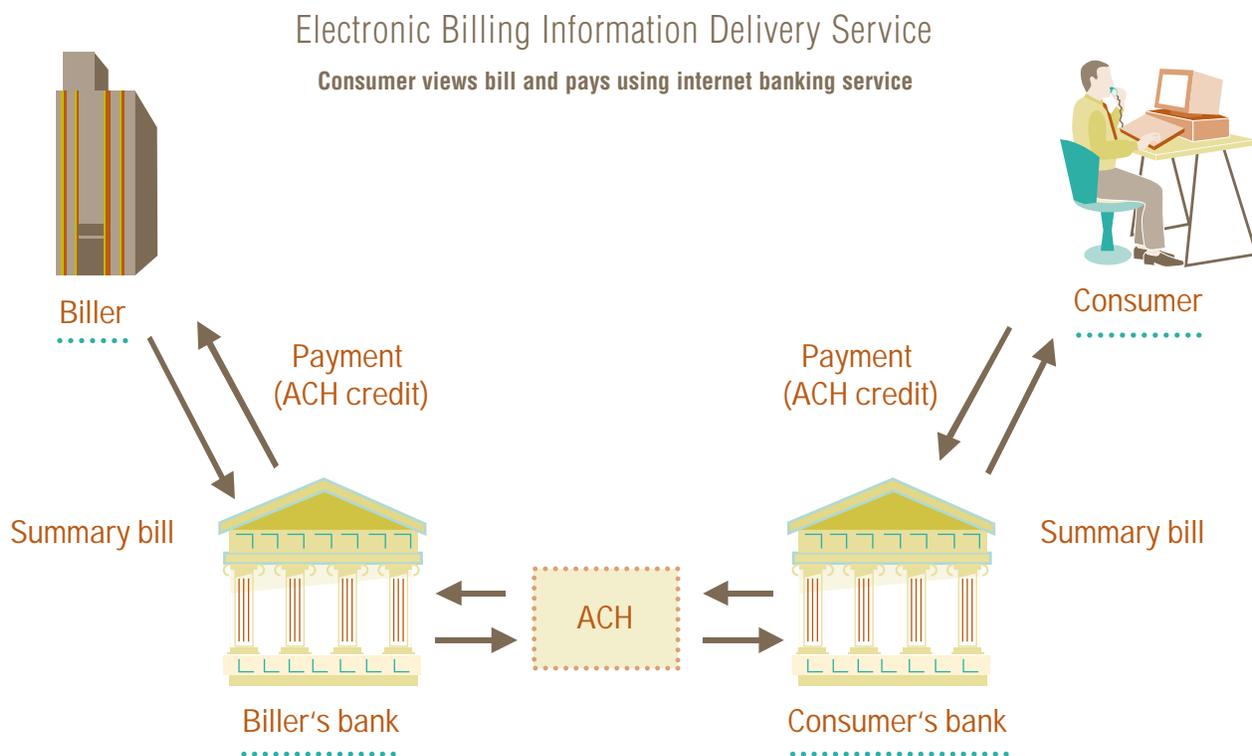
By eliminating the cost and hassle of paperwork, EBIDS promises to be a win-win solution for everyone involved. Consumers can receive and pay more of their bills at a single banking site, and they can easily control the timing and amount of payment. Financial institutions retain their primary role as payments providers, and gain added support for their existing internet banking business. Finally, billers benefit from the reduced costs of processing bills and remittances. Although the EBIDS pilot will focus on consumer bill presentment, industry groups expect the service to have significant business-to-business applications in the future.

**Helping Government Work Better**

One of the Fed’s chief responsibilities is to act as the fiscal agent for the U.S. government. Like most organizations, the U.S. Treasury Department has set ambitious goals to reduce its costs and improve the efficiency of government financial operations. Two key

parts of that goal are ensuring the efficient operation of the current savings bond and TreasuryDirect businesses, and the transition to an electronic environment for government transactions with the public.

The Federal Reserve Bank of Cleveland has long operated the largest, most efficient, and most innovative site for processing savings bonds on behalf of the Treasury’s Bureau of Public Debt. In late 2003, the Treasury announced it would reduce the number of Federal Reserve sites providing Treasury retail securities services from nine to two. The Cleveland Fed’s Pittsburgh Office was chosen to be one of only two Reserve Banks doing this work. The multiyear transition—which the Cleveland Bank is leading on the System’s behalf—will require the Pittsburgh Office to reestablish its TreasuryDirect functions and expand its savings bond operation.



The Treasury's decision was based on its long-term goal to move to an electronic processing environment—with the new Web-based TreasuryDirect system at the center. This new system represents a different way of doing business for the Bureau of Public Debt: It allows investors to purchase savings bonds (and eventually marketable securities) online and hold them as book-entry securities. The system is expected to decrease the number of paper transactions processed and provide greater convenience and flexibility for investors.

When you think of your interactions with government agencies, “convenient” and “efficient” may not be the words that immediately come to mind. But thanks in part to the Government Paperwork Elimination Act—a federal law that requires agencies to accept forms electronically—that's beginning to change. That act is one component of a governmentwide move to “electronify” services.

For several years, the Federal Reserve Bank of Cleveland has worked closely with the Treasury's Financial Management Service, which is responsible for government payments and collections, to help reengineer the government's collections process. One result, Pay.gov, gives individuals and corporations a fast, safe, and convenient way to complete and submit forms to government agencies and make payments online. For example, the Federal Trade Commission uses Pay.gov to collect fees from telemarketers who purchase the national Do Not Call list, and the National Park Service uses the system to process camping permits and collect fees.

The Pay.gov project is a model for how the Fed works collaboratively to foster innovation and efficiency in the payments system: Over the course of several years, the Cleveland Bank has partnered with the Treasury, on whose behalf it works, and with more than a dozen

federal agencies sponsored by the Financial Management Service. In 2003, use of Pay.gov continued to rise: By year-end, it supported 17 federal agencies and processed nearly half a million transactions (totaling \$3.8 billion), an increase of nearly 200 percent over 2002.

In addition to its work on Pay.gov, the Cleveland Reserve Bank has partnered with the Treasury's Financial Management Service to develop and implement a second electronic payments initiative, Paper Check Conversion. The service, known as PCC, converts paper checks presented at the point of sale at government and military locations worldwide into electronic debits. It is an innovative, highly automated system that improves the collection, reconciliation, and reporting processes for federal agencies.

PCC is deployed at military bases overseas and at government agencies in the United States. In 2003, Federal Reserve staff responded to the Treasury's request for rapid deployment at several military bases in the Middle East during the months preceding the war in Iraq—an effort recognized by both the Assistant Secretary of the Army and the Assistant Secretary of the Treasury. By the end of 2003, Paper Check Conversion supported 40 agencies at 170 locations around the world, processing more than 740,000 transactions totaling \$391 million.

### Where To?

The pace of change and innovation in financial services isn't likely to slow down any time soon—and that's a good thing. The innovation that's taking place in our industry today means growth and prosperity tomorrow. By embracing change and remaining open to the possibilities that technology is bringing us, we all benefit. Although our environment may be uncertain, one thing is for sure: The Federal Reserve remains committed to ensuring the safety, soundness, and efficiency of the nation's payments system today and in the future.