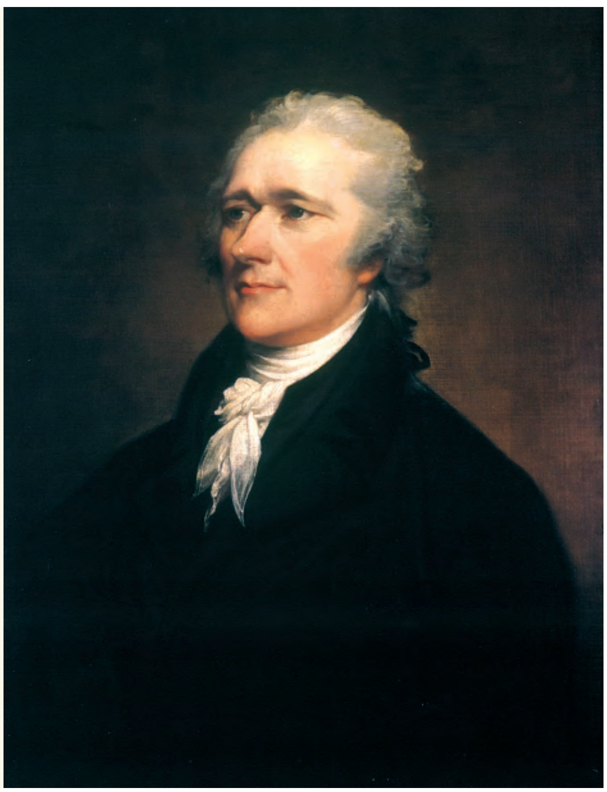
A Depressing Reality

Before the Great Depression, education was one of the top priorities in America. But by 1933, two hundred thousand teachers were unemployed, 2.2 million children were out of school, and two thousand rural schools had failed to open. Even if children were fortunate enough to go to school, class and racial barriers prevented many of them from going to college.

The Rise of Universal Education

Enrollment in prekindergarten through eighth grade at private and public schools rose to 40.0 million children in 2004. Private- and public-college enrollment of undergraduates and grad students hit a record level in 2004 at 17.4 million, and the share of bachelor's degrees obtained by African Americans, Caucasians, and Hispanics have all increased over the years.

Operational Highlights: Even the Treasury Needs a Bank



Alexander Hamilton,
first Secretary of the U.S. Treasury

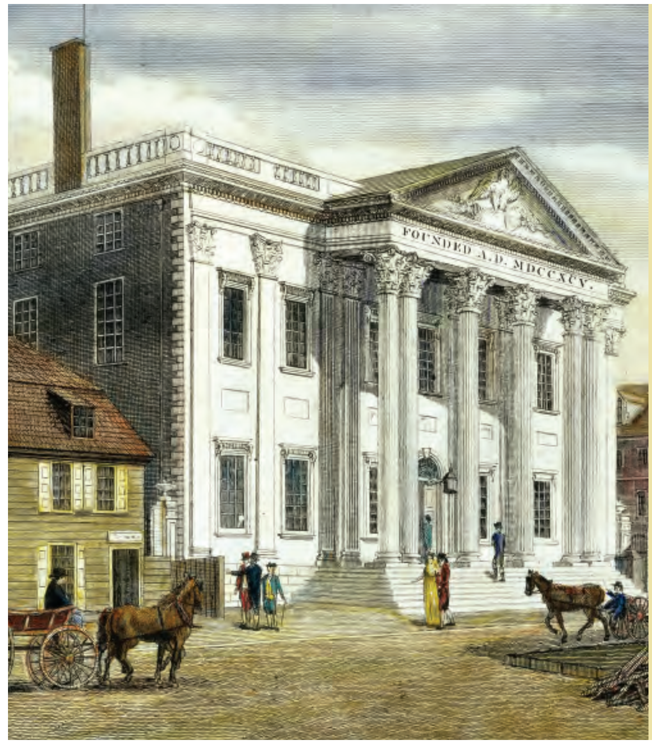
Hamilton's Treasury

When Alexander Hamilton reported to work as the first Secretary of the U.S. Treasury on September 14, 1789, he faced daunting fiscal challenges: The new nation's public credit was in shambles, with the outstanding public debt trading at significant discounts; soldiers in the federal army—in fact, all federal employees—needed their paychecks; and the federal government had no liquid bank balances, relying instead on loans from the Bank of New York and the Bank of North America to begin operations.

Much of Hamilton's attention in that first year was, naturally, focused on policy matters, such as whether the federal government should assume the Revolutionary War debts of the states and whether the nation needed a national bank.

But Hamilton also devoted considerable attention to the day-to-day financial business of the government. In that first year, the federal government's revenues consisted almost entirely of the $4.4 million earned in customs receipts, of which 55 percent was spent on debt service and another 15 percent on the military. But how could the federal government reliably and efficiently collect revenues from all customs and land sales across a land mass of 900,000 square miles, an area larger than any European state of the period save the Russian Empire? How could the Treasury combine funds from borrowings, note issues, and taxes to meet its daily obligations? And how could the Treasury assure the many creditors of the new nation, foreign and domestic, that the obligations owed them would be paid in full and on time?

Hamilton addressed those challenges by running the Treasury the way he knew how—like a business enterprise. Hamilton was among the few founding fathers with substantial commercial business experience, having worked for several years in a thriving St. Croix trading enterprise before coming to the American colonies in 1772. In his state papers, Hamilton emphasized the importance of paying the government's bills on time, collecting revenues in an efficient manner, and maintaining cordial relationships with creditors and other stakeholders.[1]



First Bank of the United States, Philadelphia, 1799

With 27 employees, the Treasury was the largest department in the new government, but it did not have sufficient national reach or commercial expertise to efficiently execute its day-to-day operations. The Treasury needed a *fiscal agent* with a national presence to make payments, collect funds owed to the government, and manage relationships with the government's creditors. The Bank of the United States—our nation's first central bank—began serving in 1791 as the Treasury's first fiscal agent, a role that the Federal Reserve System continues to play today.

1 Hamilton's state papers, *Report on Public Credit* (January 9, 1790) and *Report on a National Bank* (December 13, 1790), are particularly instructive in this area.

Savings bonds

Liberty Loan bonds

The Federal Reserve as Fiscal Agent

The Federal Reserve Act was signed into law in December 1913. Toward the end of 1914, the 12 Federal Reserve Banks opened for business, but they only gradually took on the fiscal agency role. In 1915 and 1916, the Reserve Banks were designated as depositories to maintain the Treasury's bank account, facilitating nationwide collection and disbursement of funds for the federal government. In 1917, Reserve Banks began handling an unprecedented volume of securities processing associated with the Liberty Loan bonds and Victory Notes issued to finance U.S. involvement in World War I. In 1921, the Treasury closed its network of regional offices, which dated to the mid-1840s. The duties of those offices to hold collateral for government funds held on deposit at commercial banks and to distribute the nation's currency and coin were transferred to the Federal Reserve.

The partnership between the Treasury and the Federal Reserve continued to grow in succeeding decades, with the Reserve Banks assuming an increasing share of the back-office duties involved in day-to-day Treasury operations. Among the Federal Reserve's fiscal agency activities today are collecting and holding balances due the Treasury; making and receiving payments for the federal government using checks, Automated Clearinghouse (ACH), and wire transfers; printing, issuing, and retiring U.S. savings bonds; managing the relationship between the Treasury and its creditors, i.e., purchasers of government securities; and processing U.S. postal money orders. In 2005, the Federal Reserve spent $376 billion, or nearly 15 percent of its total spending, on Treasury support.

Using the Federal Reserve as its fiscal agent has provided the Treasury with an alternative to operating a national financial institution of its own. Like Alexander Hamilton, who moved most of the Treasury's payment processing to the Bank of the United States, today's Treasury has outsourced much of its daily payment and debt-processing activities to the Federal Reserve.

Technology and Consolidation

The Treasury's relationship with the Federal Reserve Banks is a "dynamic partnership based on common goals of delivery of high quality service and efficiency of operations."[2] The Treasury and the Reserve Banks have used technology and consolidation to cut costs and improve the delivery of services to millions of U.S. citizens.

Services such as Treasury securities and savings bond processing, which, as recently as 1990, were provided by all 35 main offices and branches in the Federal Reserve System, have now been consolidated into just two locations. Treasury check services, which were handled in 45 Federal Reserve check-processing locations until 1990, have also been consolidated into two offices.

The Treasury and the Federal Reserve have migrated to straight-through processing of some activities, using the Internet, telecommunications, and data processing technology as more efficient and cost-effective substitutes for manual processing. By using ACH to convert checks to electronic payments, certain types of check clearing that used to take two or three weeks can now be done overnight, lowering the cost of clearing and of after-the-fact exceptions processing. By using the Internet, consumers can conduct business with the Treasury and federal agencies 24/7.

Straight-through processing illustrates one of the most remarkable accomplishments of the Treasury/Federal Reserve collaboration: the transition from a system dominated by paper processing to one with a large electronic component. The Federal Reserve Bank of Cleveland has played an important role in that evolution.

Transactions Converted from Paper to Electronics

Category	*1970*	*2005*
Federal payments made electronically	0%	79%
Savings bond applications received electronically	0%	65%

The Cleveland Bank's Role in Supporting the U.S. Treasury

In the 1980s, the Federal Reserve Bank of Cleveland's role in providing fiscal agency services to the Treasury was much like those of the other 11 Reserve Banks. However, by 2005, the Cleveland Reserve Bank had become one of the largest providers of Treasury services in terms of staff levels, comprising 27 percent of the System's total.

2 Bureau of the Public Debt. 2003. *Public Debt Strategic Plan 2003–2008. www.publicdebt.treas.gov/oa/oastrategicplan.pdf*, accessed April 3, 2006.

A number of factors contributed to the Cleveland Bank's role in providing Treasury services:

- Transfer of activities from the Treasury to the Federal Reserve, such as the processing of redeemed bonds, which was moved from the Treasury's office in Parkersburg, West Virginia, to the Federal Reserve Bank of Cleveland's Pittsburgh Branch in 1999
- Consolidation of Treasury services once performed in all Federal Reserve Districts into progressively fewer offices, such as the consolidation of Treasury securities and savings bond servicing into the Pittsburgh and Minneapolis Federal Reserve offices in 2005
- Treasury efforts to move services from commercial banks and other private-sector providers into the Federal Reserve, such as the *Over-the-Counter Paper Check Conversion to ACH* program that is now centralized in the Cleveland office
- Initiatives chosen by the U.S. Treasury to be sourced from the Federal Reserve, especially those that were placed in the Fourth District for production and day-to-day management, such as the *Pay.gov* program, which Web-enables and makes electronic many Treasury and other federal collection transactions that were once done with paper

CASH AND CHECK OPERATIONS

Fiscal agency functions were not the only Federal Reserve operations to be affected by consolidations in recent years. In 2004, the Federal Reserve Bank of Cleveland's Cincinnati office began processing cash for financial institutions in the Federal Reserve's Louisville territory. In 2006, the Bank's Cleveland office is scheduled to absorb the cash activities of the Federal Reserve office in Buffalo, New York.

Check-processing volume in the Fourth District has grown from an average of 6.3 million checks per day in 2002—before consolidation began—to 7.6 million in 2005, despite a 38 percent decline in overall check volume in the Federal Reserve System. The Cleveland Bank's Cincinnati office, in addition to serving its own territory, now clears checks for territories once served by the Charleston, Indianapolis, and Louisville Federal Reserve offices. In mid-2005, the Cleveland office absorbed the check-processing operation of the Federal Reserve's Detroit office, and in early 2006, Cleveland and Cincinnati will absorb all check processing from the Cleveland Bank's Columbus office.

Federal Reserve check-processing operations are also being impacted by Check 21, which became effective in October 2004. The volume of checks being converted to images or to substitute checks rose rapidly throughout 2005. By year's end, such checks represented approximately 5 percent of the number, and roughly 20 percent of the dollar value, of checks processed by the Federal Reserve.

Treasury Retail Securities

The Treasury Retail Securities Department, housed in Cleveland's Pittsburgh Branch, led the System's effort to consolidate savings bond and Treasury-Direct operations into the Federal Reserve's Pittsburgh and Minneapolis offices. The Treasury expects the consolidation to result in $30 million in annual savings for U.S. taxpayers.

In 2005, the Pittsburgh office processed 5.7 million savings bond applications, printed and mailed 32 million bonds, and redeemed 48 million bonds. Also, as part of its fiscal agency activities, Pittsburgh managed the Treasury's book-entry and payroll savings bond programs and its TreasuryDirect bond and note-purchasing program.

eGovernment

The eGovernment function, housed in Cleveland, is responsible for the conversion of paper checks—received over the counter and at government-contracted lockbox operations—to ACH debits and Check 21 clearings. These paper-check-conversion programs reduce the Treasury's clearing costs and its exposure to risk from bounced checks.

The programs have grown significantly in the past year: The Cleveland office currently receives over-the-counter check images from a total of 463 government sites on six continents and U.S. Navy ships at sea. In 2005, the Cleveland office handled 1.9 million over-the-counter payments worth $1.75 billion. Lockbox paper-check conversion, launched in 2005, involved 415,000 transactions worth $456 million.

The eGovernment function also administers the Pay.gov program, which involves collections management for 87 federal agencies, which themselves manage 208 separate federal programs. Pay.gov handles payments received over the Web; the hosting of electronic versions of paper forms, which can be completed on the Web; and the electronic presentment of bills for federal services, which can be executed there. Pay.gov offers consumers and businesses electronic access to information and transaction processing, while reducing the Treasury's operating costs.

The U.S. Treasury anticipates that $30 billion in transactions will move across Pay.gov in 2006, including $24 billion associated with the Customs and Border Protection Service.

Principles That Stand the Test of Time

Alexander Hamilton could not possibly have fore-seen the way technology would transform Treasury operations or the role that the Federal Reserve System would play in that transformation. But Hamilton would no doubt recognize the business principles that guided the process: timeliness, efficiency, and customer service.