
Report from the President

REPORT FROM THE PRESIDENT

Every year presents new challenges for the Bank, and 1997 was no exception. I believe the Bank performed exceptionally well in meeting those challenges, particularly in fulfilling its most important responsibility, the implementation of monetary policy. By most measures, the economy's performance in 1997—with declining inflation, low unemployment, and steady job and output growth—was its best in several decades. Over the course of the year, short-term interest rates remained stable and long-term rates declined. This favorable economic and financial environment helped to strengthen business investment, the housing sector, and sales of big-ticket items; strength in these sectors, in turn, contributed significantly to improved fiscal conditions and a buoyant stock market.

The Bank engages in a broad range of market surveillance and information-gathering activities as part of its policy responsibilities. These efforts are designed to keep Federal Reserve policymakers up to date about developments in financial markets, banking, emerging markets, and the regional economy. In the latter part of 1997, a major focus of the Bank's market surveillance efforts was the monitoring and assessment of the evolving financial situation in Asia and its potential impact on domestic and foreign markets and institutions. Bank staff provided valuable support to policymakers, including extensive

analyses of developments in Thailand, Indonesia, Korea, and other countries.

Toward year-end, as the full dimensions of Korea's financial problems were beginning to become clear, a consensus emerged that an international program of support—from both the private and the public sectors—would be required to address the immediate liquidity problems of Korea's banks, thereby providing Korea with needed time to resolve its structural problems. To further this goal, the Bank organized several meetings in December with leading investment firms, commercial banks, and public sector officials to help lay the groundwork for governmental and private sector actions. Since then, we have directed our efforts toward helping to reestablish and maintain financial stability in Korea. These efforts, and several other initiatives during the year involving bank supervision, monetary policy implementation, and the rapid evolution of the payments system, were evidence of the continued leadership of this Bank in crucial central banking issues.

I am particularly proud of the research, analysis, and operational support that the Bank's staff provided in meeting both the domestic and the international challenges of 1997. This work demonstrated once again the knowledge, professional skill, and dedication to public service of the men and women who work at the Bank.

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CONTRIBUTING TO THE PUBLIC POLICY DEBATE

A major goal we established for the Bank at the beginning of the year was to expand the contribution of Bank research to the public's understanding of issues affecting the regional, national, and global economies. This research made a difference in 1997. We produced more than 100 articles and papers and delivered nearly 600 speeches and presentations to outside groups on a truly impressive range of issues.

The Bank also contributed to an improved understanding of compelling urban economic matters. We held a conference in New Jersey on affordable housing, conducted training sessions in upstate New York communities on how to interpret Community Reinvestment Act data, and provided a number of public forums for the discussion of urban reinvestment issues. We also produced comprehensive reports profiling the distribution of affordable housing loans in Westchester County, New York, and in Bergen County, New Jersey.

During the year, the Bank continued to broaden its role as a facilitator of discussion and analysis of important public policy issues by convening major conferences and colloquia. A highlight of these activities was the November conference "Excellence in Education: Views on Improving American Education," which brought together top academic researchers in education and members of the education community to explore strategies for improving the quality of public school education. In support of that theme, I spoke before numerous audiences in 1997 to encourage

businesses, government, and educational establishments to take leadership roles in integrating new technologies into school curricula and operations, with the aim of transforming schools into modern establishments of learning, skill development, and critical thinking. Promoting public discussion of this critical issue will be a continuing goal of this Bank in the years to come.

Our staff also played a prominent part in the development of key international supervisory policies. Staff provided considerable support to the efforts of the Basle Committee on Banking Supervision on a wide range of banking issues and to efforts by the G-10 Committee on Payment and Settlement Systems to understand potential risks in the global payments system.

In June, the Bank hosted a conference addressing legal issues raised by the European Monetary Union, scheduled to take place on January 1, 1999. The conference, which was attended by nearly 300 lawyers, bankers, and other interested parties, fostered a frank discussion of the many challenges and opportunities that the introduction of the new European currency, the Euro, will pose for U.S. banks.

ASSISTING FOREIGN CENTRAL BANKS AND INTERNATIONAL ORGANIZATIONS

The Bank maintains extensive relations with foreign central banks and governments. These have included, since 1916, gold storage services that have made the New York Fed the largest known depository of monetary gold in the world.

During the year, the public showed increasing interest in the disposition of Nazi gold assets, particularly gold that might have belonged to Holocaust victims. The issue is an important one for the Bank, which holds about \$23 million worth of gold for the Tripartite Gold Commission (TGC). The TGC was formed after World War II to receive and distribute gold recovered by the Allies from the Nazis; this gold was believed to be monetary gold belonging to countries invaded by the Nazis. I decided early on that we should make full public disclosure of the Bank's gold records and institute a comprehensive search of the Bank's files. In carrying out this goal, we sent thousands of pages of documents to the National Archives. We also helped prepare parts of the U.S. government report on this complex issue.

Another aspect of our relations with foreign central banks involves technical assistance. We provided assistance to banking supervisors in a number of countries during the year and hosted numerous visits from foreign regulatory officials and market risk specialists. We also worked with foreign central banks to focus international attention on the need to reduce risk in global payment and settlement systems. Bank staff made many presentations on this issue in central bank forums and conferences around the world.

ENSURING A SAFE AND SOUND FINANCIAL SYSTEM

Ensuring stability in domestic and international financial markets and promoting the smooth functioning of the global payments system are ongoing challenges, and I believe the Bank

performed exceedingly well in meeting them in 1997. During the year, we strengthened lines of communication and relationships with supervisors from foreign countries. Our efforts included active participation in the development of core principles for supervising global banks and for sharing information among national supervisory authorities. We also helped to develop market risk capital standards and the regulatory approach to evaluating specific risk models that formed the basis of an amendment to the Basle Capital Accord. Looking to the future, Bank staff identified a range of issues for consideration in establishing twenty-first-century capital standards for financial institutions. Early in 1998, we hosted a conference with distinguished speakers from around the world that contributed to the progress being made on this issue.

During the year, Bank staff developed a set of supervisory policies and procedures to guide banks as they adjust their automated systems to deal with the century date change—that is, correct posting of entries starting on January 1, 2000. At the same time, Bank staff worked diligently to prepare all of the Bank's computers and systems for the century date change.

We also helped develop a new rating system for trust activities and wrote a “sound practices” paper for private banking. This paper established a standard for private banking operations and provided a framework for the development of formal “know-your-customer” banking rules and new Federal Reserve procedures for examining private banking activities.

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Progress was also made in 1997 on the multiyear effort to shift the focus of the Bank's examinations of depository institutions from balance-sheet reviews to assessment of the strengths and weaknesses of internal controls, procedures, and systems banks have in place for managing risk. To this end, the Bank reorganized its bank supervision and regulation area, establishing a number of specialty teams to focus on current risks within the banking industry. In addition, the Bank helped develop new guidelines for examiners in evaluating banks' risk controls and procedures.

PROVIDING SECURE AND RELIABLE PAYMENTS SERVICES

The challenge of maintaining effective oversight of banking activities was heightened in 1997 by a historic change in the federal regulation of banks. A 1994 federal law authorizing banks to operate branches across state lines finally took effect in July. To implement interstate branching, the Federal Reserve decided that a depository institution needs to have an account with only one Reserve Bank, regardless of the number of branches and states in which the institution does business. To bring this regulatory change about, the Bank's legal staff worked with Federal Reserve System colleagues to rewrite virtually all of the contractual terms and conditions under which Reserve Banks make loans and provide banking services. The Systemwide changes in interstate banking regulations helped to position the Federal Reserve to be more responsive to banks as these institutions pursue business opportunities over broader geographic areas.

The Bank has a unique role in the nation's payments system. We not only serve as the Federal Reserve's operating arm in the government securities and foreign exchange markets, but we also provide a large share of the electronic funds transfer, book-entry securities transfer, and settlement services that commercial banks and the U.S. Treasury rely on each day.

During the year, we transferred most of our automated payments systems and applications to the Federal Reserve's centralized processing facility at the East Rutherford Operations Center (EROC) in New Jersey. This transfer was the last part of the Federal Reserve's transition to mainframe computer consolidation. At the same time, as the developer of the Fedwire software application for the Federal Reserve Banks, this Bank introduced a new electronic funds transfer format and expanded funds transfer operations to eighteen hours a day. The extended operating hours provide opportunities to reduce settlement risk, particularly in foreign exchange markets, by creating overlapping operating hours among major financial centers. In addition, we worked closely with the Treasury Department to issue the federal government's new inflation-indexed security and to provide the Treasury with improved automated systems for conducting dealer auctions and processing government securities sales.

In 1997, the U.S. monetary authorities continued the issuance of redesigned currency with the release of a new \$50 banknote. As the principal international currency distribution center, this Bank took the lead in distributing

the new notes overseas, as we did in 1996 with the new \$100 banknote. Among the actions we took on that occasion to ensure smooth distribution of the new notes abroad was the creation, in conjunction with the private sector, of several distribution facilities that would provide a ready supply of new notes in Europe. In 1997, we expanded our distribution program in Europe and initiated a study to determine the feasibility of establishing similar facilities in Southeast Asia.

The Bank is responsible for the management of the Federal Reserve System's Wholesale Payments Product Office, which coordinates efforts throughout the System to maintain the Federal Reserve's funds transfer and book-entry systems as the nation's premier large-value payment mechanisms. In 1997, the Product Office, which is headed by the Bank's First Vice President, Ernest Patrikis, worked with leading participants in the funds and securities markets to develop a coordinated approach to century date change testing and to establish a new, uniform settlement service nationwide.

A high priority in the financial services area in 1997 was to follow through on aggressive multiyear initiatives aimed at reorganizing work processes to improve operating efficiency and reduce the unit cost of our payments services. Although we made headway in cash, fiscal, and electronic payments services, we ran into unanticipated problems in the check area. The 1996 closing of our Jericho office and the consolidation of our downstate check-processing operations at EROC presented us

with significant operational challenges. We are moving aggressively to improve check operations, with a particular focus on achieving high quality and efficiency.

STRENGTHENING INTERNAL OPERATING EFFICIENCY

During the year, Bank staff at all levels continued to work toward improved efficiency in all Bank operations and services through reengineering and restructuring. Reengineering, as we apply the concept at the Bank, involves not only structural change, but also a change in the mind-set of our managers—a presumption that all of the Bank's operations can be carried out more effectively and at lower cost.

With the help of an outside consulting firm, we put every aspect of our check operations under a microscope to determine how each process could be improved. We also instituted changes in the cash and fiscal areas, where work flows were rearranged and automated, and in the markets area, where we consolidated our foreign and domestic trading desks and began overhauling our trading and back office systems. I am particularly pleased that our reengineering efforts and investment in technology helped to lower the Bank's administrative support and overhead costs in 1997 as a percent of total Bank expenses.

In 1997, we also made progress on an effort to move paper-based data reporting and internal information distribution to electronics. A software application for electronic data submissions using Internet technology was developed during the year and piloted successfully.

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The Bank will be the central site for the Systemwide development of this application in 1998. We also created an Intranet with numerous special-purpose sites and sites for areas throughout the Bank, and developed Internet sites for the Federal Reserve's Payments Systems Risk Committee and the Wholesale Payments Product Office.

We further positioned the Bank for productivity gains over the years ahead by reaching a milestone in the Bank's long-term space strategy. A twenty-five-year lease was signed for the top thirteen floors of 33 Maiden Lane, a building adjacent to 59 Maiden Lane, where the Bank currently leases space. After renovations are completed, staff currently working at 59 Maiden Lane will begin moving to the neighboring building. The move will allow us to provide staff with more modern quarters and to provide the Bank with better conference, training, and meeting rooms.

The challenge of improving operational efficiency throughout the Federal Reserve System helped bring about the establishment of the Rivlin Committee in 1996. In 1997, this committee—of which I am a member—undertook to review the Federal Reserve's role in the payments system. Bank staff were instrumental in preparing the report that summarized the Committee's review. The report concluded that the Federal Reserve should maintain a major role in the nation's check collection and automated clearinghouse systems while working collaboratively with private sector organizations to promote more efficient electronic modes of payment and settlement. We reached this conclusion after holding a series of nation-

wide meetings, hearings, and forums with bankers, vendors, and other major participants in the nation's retail payments system to make certain we took into consideration the concerns of all those involved.

THE CHALLENGE OF MANAGING CHANGE

To cope with developments in banking and financial markets, we have had to take a hard look at how the Bank performs, how staff is managed, and how the Bank deals with change. To meet this challenge more effectively, I began a "core values" project last year aimed at improving the overall management of the Bank. In its initial stages, this project has involved peer review assessments of how the Bank's senior managers handle their interactions with one another and with the officers and staff who work with them. I believe that the initiatives that flow from our work on core values will enable the Bank to operate even more effectively and efficiently in the years to come.

We also instituted a change in the way we look at our internal controls and the oversight of the Bank. In August, the presidents of all of the Reserve Banks voted to adopt a new, rigorous, internationally recognized framework for evaluating and managing internal controls. The framework, established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is designed to ensure that an organization's financial reports are accurate and reliable, that internal operations are conducted effectively and efficiently, and that internal operations comply with applicable laws and regulations. Shortly after this vote,

and in support of the Systemwide initiative scheduled to commence in 1998, I committed this Bank to apply the COSO framework immediately to the preparation of the Bank's year-end financial statements. A team of senior officers was established to oversee this effort, which required a methodical assessment of risks and a detailed evaluation of the strengths and weaknesses of the Bank's financial control systems.

The assertion of compliance with COSO's demanding criteria for financial reporting that appears in this *Annual Report* represents the successful outcome of our implementation effort. I am pleased that the Bank was able to take a leadership position in implementing this framework for financial reporting integrity.

PROMOTING BETTER UNDERSTANDING OF MONEY, BANKING, AND FINANCIAL ISSUES

We made a commitment in 1997 to expand our economic education programs, with an emphasis on giving students and teachers more opportunities to learn interactively about economics, finance, and monetary policy. One of these programs, The Fed Challenge, was extended to more than 150 schools in four Federal Reserve Districts and culminated in an interdistrict competition at the Board of Governors. Another program, the Econ Explorers Club, was introduced in approximately 200 elementary and middle school classes in New York and New Jersey and will be extended to hundreds of additional classes in 1998. Bank staff took part in a variety of school-to-career programs intended to ease students' transition into the workplace.

Hundreds of teachers, principals, assistant principals, and academic administrators participated in the Bank's workshops and seminars in 1997. A new "Partners for Leadership" management training program for New York City school principals was started during the year. We processed orders for more than 2.4 million Bank publications, opened an interactive educational exhibit about money and the Federal Reserve in our main lobby, and improved and expanded the Bank's web pages. We also introduced a regional economy website for those interested in monitoring Second District economic trends.

POSITIONING FOR THE CHALLENGES AHEAD

In the year ahead, a major priority for us in the bank supervision area will be the full implementation of the risk-focused examination process. To ensure success in this effort, management will give substantial attention not only to the effective planning and consistent application of the approach across banking organizations, but also to the development and retention of the high-quality staff required by this new approach. A quality assurance program was established in 1997 to monitor progress in implementing the risk-focused examination approach uniformly, and banks are now being interviewed about their experience with these exams to determine how the process might be improved further.

The financial services areas will face continued pressure to do more with fewer resources. The reduction of overhead and support costs will be a prime objective as we try to improve operating efficiency and reduce unit

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costs. I believe, for example, that our check area is much better positioned to meet these challenges today than it was a year ago, largely because of its 1997 efforts to implement a methodology for generating continuous improvement. Similarly, we face an ongoing need to structure organizational arrangements and work processes to increase productivity and cost efficiency. In the international arena, perhaps our biggest challenge will be to stay on

top of developments around the world and work effectively with policymakers and market participants to improve the prospects for global financial and economic stability.

I am confident that the Bank's management team, supported by the Bank's staff, will meet these challenges with great skill and resourcefulness.

January 9, 1998

To the Board of Directors of the
Federal Reserve Bank of New York:

The management of the Federal Reserve Bank of New York (FRBNY) is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 1997 (the “Financial Statements”). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks, and as such, include amounts, some of which are based on judgments and estimates of management.

The management of the FRBNY is responsible for maintaining effective internal controls over financial reporting and the safeguarding of assets as they relate to the Financial Statements. Such internal controls are designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of reliable Financial Statements. These internal controls contain self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in internal controls are reported to management, and appropriate corrective measures are implemented.

Even effective internal controls, no matter how well designed, have inherent limitations—including the possibility of human error and costs versus benefits considerations—and therefore can provide only reasonable assurance with respect to the preparation of reliable Financial Statements.

The management of the FRBNY assessed its internal controls over financial reporting and the safeguarding of assets reflected in the Financial Statements, based upon the criteria established in the “Internal Control—Integrated Framework” issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, the management of the FRBNY believes that the FRBNY maintained effective internal controls over financial reporting and the safeguarding of assets as they relate to the Financial Statements.



President
Federal Reserve Bank of New York



First Vice President
Federal Reserve Bank of New York

Report of Independent Accountants
Coopers & Lybrand L.L.P.

To the Board of Directors of the
Federal Reserve Bank of New York:

We have examined management's assertion that the Federal Reserve Bank of New York (the "Reserve Bank") maintained an effective internal control structure over financial reporting and over the safeguarding of assets as they relate to the Financial Statements as of December 31, 1997, included in the accompanying Management's Assertion.

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that the Reserve Bank maintained an effective internal control structure over financial reporting and over the safeguarding of assets as they relate to the Financial Statements as of December 31, 1997, is fairly stated, in all material respects, based upon criteria established in "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Coopers & Lybrand L.L.P.

New York, New York
February 20, 1998