Report from the President

REPORT FROM THE PRESIDENT

During 1998, the Federal Reserve Bank of New York faced an unusually large number of difficult and complex challenges. Economic and financial developments abroad, particularly in emerging market economies, as well as domestic financial market volatility and the fast pace of financial sector restructuring, complicated the execution of monetary policy and created major supervisory challenges. At the same time, the Bank's intensifying focus on improved productivity and efficiency resulted in the modification and upgrading of many of its operations.

By year's end, the Bank had recorded an impressive list of achievements in fulfilling its public policy missions and providing services to its customers. However, in 1999 and beyond, we must continue to improve the efficiency of our operations and find new cost-effective ways to reach our goals. In doing so, management will rely heavily on the expertise and technical know-how of the Bank's officers and staff, whose dedication to public service is the Bank's greatest strength.

SUSTAINING ECONOMIC GROWTH

Monetary policymakers faced a complex and sometimes conflicting array of economic and financial issues in 1998. Already in the eighth year of uninterrupted expansion, the U.S. economy got off to a strong start, showing sizable gains in consumer spending, increased housing market activity, and tight labor markets in many regions. Under these conditions, a resurgence in inflation could not be ruled out. By the second half of the year, however, economic and financial problems abroad had begun to restrain some sectors of the economy and heighten uncertainty in financial markets. While overall GDP growth remained very healthy, export-competitive U.S. manufacturing slowed. Losses in financial markets made lenders and investors more cautious about taking risks; risk spreads on debt instruments widened, and liquidity in some markets dried up.

In September, October, and again in November, the Federal Open Market Committee reduced short-term interest rates to cushion the domestic economy against the weakening foreign economies and the less accommodative conditions in U.S. financial markets. These actions helped to stabilize the financial markets and to ensure continued robust growth in output, income, and employment. Meanwhile, inflation and interest rates remained low, and investor confidence largely returned.

Responsibility for carrying out the policy decisions of the Federal Open Market Committee rests with the Bank's Markets Group. Through open market operations and administration of the discount window, the Markets Group influences conditions in the markets for money and credit. From time to time, the Domestic Open Market Desk

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modifies its procedures to improve the effectiveness of its operations and the functioning of the markets in which it operates. In 1998, modifications in operating procedures helped to lessen the impact of open market operations on the prices of U.S. Treasury securities and to enhance price discovery in the market for Treasury securities. These modifications, adopted with the approval of the Federal Open Market Committee, were generally welcomed by the primary dealers with which the Desk does business.

SYSTEMIC RISKS AND BANK SUPERVISION

Economic and financial turbulence abroad during 1998 increased the risks faced by U.S. financial institutions, particularly those with large direct foreign exposures or a number of loans to highly leveraged institutions. Around midyear, deteriorating financial and currency market conditions in several countries resulted in sizable losses by some U.S. hedge funds and other institutions. Then, on August 17, the Russian government announced an effective devaluation of the ruble and a debt moratorium, undermining investor confidence around the world. Over the subsequent days and weeks, already fragile equity and debt markets became increasingly volatile and uncertain.

In September, as president of the Bank, I was faced with a number of difficult decisions when the potential bankruptcy of a very large hedge fund, Long Term Capital Management (LTCM), threatened to disrupt financial market and economic activity. At the request of some financial firms, the Bank hosted meetings of leading financial firms with a strong interest in seeking a solution to LTCM's problems.

At a meeting on September 23, representatives from seventeen firms examined possible private-sector actions that could protect their firms against the effects of LTCM's potential bankruptcy. At the end of the day, the firms agreed to a consortium approach that ultimately involved fourteen banks and securities firms in a recapitalization of LTCM, with three firms contributing smaller amounts than the other eleven. The recapitalization of LTCM was purely a private-sector solution involving an investment of new equity by LTCM's creditors and counterparties. No public money was spent or committed.

On October 1, Chairman Greenspan and I testified before the House Banking Committee about LTCM's problems and the events that led to the formation of the private-sector consortium. At the hearing, I also highlighted three issues requiring close attention by banks and supervisors—the adequacy of banks' credit analysis processes, the effectiveness of exposure measurement methodologies, and the role of stress testing of counterparty credit exposures. The near-collapse of LTCM underscored the need for lenders to recognize and manage the risks of interacting with highly leveraged institutions (HLIs)—risks to creditors and, under certain market conditions, to the financial system as a whole. In addition, the LTCM situation highlighted the blurring of the distinctions between the regulated and the unregulated segments of the financial marketplace.

Since the LTCM episode, senior supervisory staff from the Bank have contributed importantly to the Working Group on Highly Leveraged Institutions, an international effort to analyze the risks posed by HLIs, to assess banks' risk management practices with respect to such institutions, and to evaluate potential responses to those risks. Formed by the Basle Committee on Banking Supervision, which I chair, the Working Group prepared a major report in 1998 that examined these issues and offered guidance on sound practices in dealing with HLIs. The Working Group's report, released in January 1999, will serve as an important basis for work with supervisory authorities around the world.

As a supervisor of banks, the Federal Reserve helps to ensure that banks operate safely and soundly by engaging in lending, investment, and other activities that do not subject depositors' funds to undue risks or weaken the public's confidence in the banking and financial systems. Beginning in 1997, bank examinations by supervisory authorities became more risk-focused, taking into account how banks measure and manage risks in their loan and investment portfolios. In 1998, bank supervision staff joined with staff of the Board of Governors in developing a framework for supervising large, diversified financial services companies. In addition, the Bank made good progress in moving to a "continuous supervision" model that will allow us to better monitor the condition of the largest institutions on an ongoing basis. In the years ahead, we will refine this approach further and implement it more broadly as part of the Bank's overall supervision model.

Financial sector consolidation, exemplified by mergers involving a number of very large, diversified financial companies, has created major challenges for the Bank's staff. As a supervisory authority, we review applications for mergers, acquisitions, and branch additions in order to ensure that the banks involved will continue to serve the needs and convenience of the communities in which they do business. In 1998, the Bank received two applications for mergers that had significant implications for the banking and financial systems—the application by the Travelers Group to become a bank holding company by acquiring Citicorp and the application for the merger of Union Bank of Switzerland with Swiss Bank Corporation. In reviewing these applications, bank supervisory staff examined thousands of pages of data, analysis, commentaries, and supporting documents to determine how each merger would affect competition, pricing, employment, and the availability of financial services to local communities.

With public interest in the proposed mergers becoming unusually intense, the Bank held a two-day hearing in June on the Travelers-Citicorp merger; 115 people testified on the proposal. The merger of the two Swiss banking companies, in turn, attracted intense political interest stemming from claims about the banks' handling of the assets of Holocaust victims. By year's end, both mergers received Federal Reserve approval.

In the years ahead, the Bank will continue its efforts to improve methods of risk measurement and management, with a particularly strong focus on the regulation and supervision of banks with offices and activities that cross national borders.

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MAINTAINING SECURE AND RELIABLE PAYMENTS SYSTEMS

The Bank plays a unique role in the nation's payments systems. It serves as the Federal Reserve's operating arm in the government securities and foreign exchange markets, while also providing a large share of the electronic funds transfer, book-entry securities transfer, and settlement services used daily by financial institutions and the U.S. Treasury.

In 1998, the Federal Reserve System's Wholesale Payments Product Office (WPPO), located at the New York Fed, lowered fees for Fedwire funds transfer and book-entry securities services for the third consecutive year. In addition, the WPPO made substantial progress toward implementing a new multilateral net settlement service that will be offered in 1999. For the year, transfers of funds and securities over the Federal Reserve's Fedwire system averaged more than $2 trillion a day; about two-thirds of that volume involved transfers that originated in the Federal Reserve's Second District. Despite a number of technical adjustments to the system, our Fedwire operations functioned all year without any service disruptions.

Productivity and efficiency in our check-processing operations, a source of some concern in recent years, improved in 1998, though we did not achieve Federal Reserve System standards for some key quality measures. While more needs to be done to meet these standards and reduce check-processing costs, several achievements can be cited. For example, we initiated a multiyear plan that had among its main components the retraining of staff and greater flexibility in the deployment of resources. The volume of processed and return items increased modestly, despite a 10 percent reduction in staff. As a result, cost recovery in the check area improved to within half a percentage point of our target,

We also implemented a strategy to accelerate the move from paper check to electronic payments processing by image-enabling all of the Bank's high-speed sorters. Gains were made in encouraging banks to accept electronic payments and to advance electronic check presentment, though we need to make more progress toward this end in 1999. Working in partnership with several of the District's large banks, our Utica facility will serve as the site for a System-wide pilot program in check imaging.

As with the distribution of the newly designed $100 and $50 banknotes in 1996 and 1997, the Bank played a major role in the introduction of the new $20 banknote in 1998. During the year, the Bank distributed more U.S. currency than any other Federal Reserve facility. We strengthened our leadership in the international distribution of U.S. banknotes by expanding contractual agreements with four depository institutions to warehouse currency and distribute it from five extended custodial inventory (ECI) sites in three European cities. The ECI program promotes the use and recirculation of the new-design banknotes internationally, facilitates the repatriation of old-series notes, and improves the collection of information on currency flows.

In the provision of fiscal services, the Bank added another government agency, the General Services Administration, to the International Direct Deposit (IDD) program. It also expanded IDD to Australia and arranged for two commercial banks to provide IDD services to twenty-five additional countries. Further, we expanded our role as fiscal agent for some government-sponsored and international agencies by assuming System-wide responsibility for the elimination of canceled agency securities. Our Buffalo Branch remained the nation's most productive facility in the processing of U.S. savings bond applications and continued to lower the direct costs of this operation. The Branch also developed and implemented a personal-computer-based tracking system for savings bond transactions at all five Federal Reserve consolidated processing sites.

Overall, the Bank exceeded its cost-recovery target for priced services, with a recovery rate of almost 110 percent. This success was driven primarily by strong revenue performance in book-entry transfers.

READINESS FOR THE CENTURY DATE CHANGE

Completion of testing and certification of all computer hardware and software for Y2K compliance ranks among the Bank's most important achievements of the year. This important effort, overseen by a new Y2K office established in July, required meticulous planning and cooperation from every area of the Bank. The new office coordinates the Bank's Y2K efforts with those of the Board and the other Federal Reserve Banks.

In 1997, we assessed the Y2K problem and concluded that without more intensive attention to the problem, some financial institutions in the United States and abroad would not be able to complete their Y2K testing and certification in time for the century date change. To improve both Y2K readiness and public awareness in 1998, the Bank took part in numerous conferences and briefings on Y2K issues and strategies in the United States and abroad and shared information on Y2K preparedness with other public and private sector organizations. In addition, the Wholesale Payments Product Office coordinated wholesale services forums on Y2K, provided information on test support, and created a work group to develop contingency plans for the wholesale services.

As part of our international efforts in this area, we maintained communications with other central banks to inform them of the nature of our Y2K preparations and to help them develop their strategies for dealing with the problem. Along with others in the Federal Reserve System, we are working with the Global 2000 Coordinating Committee, a private organization of more than 200 international banks from thirty-seven countries, to provide guidance to banks on Y2K best practices for testing and contingency planning. Further, we developed close working relationships on Y2K issues with private sector groups such as the New York Clearing House and the Securities Industry Association.

As of year-end 1998, our efforts to test and remediate the Bank's mission-critical systems were largely completed. Significantly, all of our

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critical payments system applications, including the funds transfer and book-entry systems linked to commercial banks, tested successfully. In addition, during the year, we completed the bulk of Y2K testing and remediation of the Bank's personal computer hardware and standard software, application server hardware and environmental software, and other office automation systems.

As the century date change approaches, one unresolved issue is the extent of the public's demand for currency. To meet a potentially large demand in 1999 and 2000, the Federal Reserve System has stored additional currency at each of its cash-distribution facilities. The Bank's cash facility at the East Rutherford Operations Center (EROC) will be fully prepared to meet the currency needs of all depository institutions in the Second District.

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HELPING THE COMMUNITY

Throughout 1998, the Bank continued to facilitate the establishment of strong working relationships between financial institutions and organizations concerned about community development. In fulfilling that mission, the Bank conducted nearly 150 outreach meetings throughout the Second District. Collaborating with other regulatory agencies, the Bank's Office of Regional and Community Affairs hosted a series of small group meetings to provide technical assistance to bankers on issues relating to investments that qualify for Community Reinvestment Act credit. The Bank also convened forums on community development and the need for lenders to provide more loans to small businesses and greater access to home mortgages for low- and middle-income households. During the year, the Bank continued to oversee the Long Island Home Purchase Process Initiative, a multiyear effort begun in 1996 to identify and reduce barriers to home ownership, particularly among low- and middle-income individuals.

The Bank also expanded its core economic education programs. Participation in the Fed Challenge competition spread widely within the Second District and elsewhere in the System, involving students from more than 300 schools nationally. In addition, the Bank conducted dozens of seminars and workshops for educators to promote better understanding of economic issues and the Federal Reserve System. Working with representatives from financial and nonfinancial organizations, educational associations, and government officials, the Bank led an effort to preserve economics as a required course in New York State high schools. Further, we collaborated with education leaders in Puerto Rico to train high school social studies teachers in economics. This three-year effort will culminate in the introduction of economics in the Puerto Rican high school curriculum by 2001, and in an economics competition designed to foster active learning and critical thinking by students about economic issues.

Worldwide demand for the Bank's publications continues to grow. In 1998, the Bank filled orders for more than 2.6 million publications; about one-fifth of the publication orders were placed electronically over the Bank's web site. In addition, we produced and installed an electronic version of the *Catalog of Public Information Materials* to facilitate web-site ordering of Federal Reserve System education and information materials.

CONTRIBUTING TO THE PUBLIC POLICY DEBATE

During the year, the Bank made substantial contributions to public policy discussions by publishing a sizable body of original research and taking part in major conferences around the world. Research staff published numerous papers in the Bank's *Economic Policy Review* and *Current Issues in Economics and Finance* series, and placed about eighty papers in academic journals and other scholarly volumes.

Working with colleagues in foreign countries, Bank staff contributed to the Triennial Foreign Exchange and Derivatives Survey and served as members of various working groups under the auspices of the Bank for International Settlements. In addition, the Bank took part in projects for the Basle Supervisors' Research Task Force and provided technical assistance to central banking organizations around the world. Bank staff made important contributions to several Federal Reserve System initiatives, such as the Intercountry Exposure Review Committee and the Enhanced Supervisory Program for Foreign Banking Organizations.

To stimulate public discussion and analysis of important policy issues, the Bank organized the conferences "Financial Services at the Crossroads: Capital Regulation in the Twenty-First Century" and "The Consolidation of the Financial Services Industry." We also cosponsored the conferences "Topics in Empirical International Economics" and "Intranational Macroeconomics" and helped to organize briefings on the economic outlook for New Jersey and Long Island. In addition, Bank staff developed and cosponsored the first annual "National Economics Conference for Educators," which provided professional development for high school teachers from all parts of the country. Throughout 1998, we convened focus group discussions with the heads of small- and medium-sized firms in the tristate region to identify incentives and disincentives for the growth of business in the Second District. In 1999, we will continue to look at this issue as well as at the economic, financial, and social roots of the widening income disparity among demographic groups.

As part of its efforts to stabilize international financial markets, the Bank took part in policy consultations with U.S. government officials, international financial institutions, and sovereign authorities. Bank staff participated in and facilitated discussions among public- and private-sector leaders, in the United States and abroad, that helped several nations to address financial shocks. The Bank also provided technical assistance overseas, both directly and in cooperation with official international organizations.

In the fall, the Bank hosted its twenty-third annual central banking seminar for central bankers from sixty countries. Participants in the seminar gained a better understanding of the Federal Reserve and of U.S. financial markets and shared perspectives on central bank operations. Following the formal three-week seminar, we conducted a series of specialized one-week courses for foreign central bankers

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on bank supervision, U.S. monetary policy, foreign exchange policy, and operations management.

Bank officials took part in forums around the world as speakers on economic, financial, and supervisory matters. One important message conveyed in those speeches was the need for better and more timely information that would allow investors, lenders, and supervisors to make more accurate and thorough risk assessments. Officials also discussed the need for new risk management and stress testing approaches and for new methods to evaluate capital adequacy. Further, the Bank advocated development of a capital framework in which internationally active banks from around the world with similar risk profiles and levels of sophistication would face similar capital requirements.

In total, Bank staff gave more than 1,000 speeches and talks to a total audience of about 60,000 persons. An additional 28,000 visitors from around the world toured the Bank and listened to presentations about the Federal Reserve, the economy, and the banking and financial systems.

INTERNAL OPERATIONS AND CHALLENGES

In the past several years, the Bank has directed substantial resources toward the acquisition and use of technologies to improve efficiency in information processing, operations, and communications, while upgrading the quality and reliability of the services provided to depository institutions. Along these lines, the Bank closed EROC's computer contingency center and completed the transfer of mainframe computer operations from our head office and EROC to the Federal Reserve's centralized automation facility. Further, staff at the Wholesale Payments Product Office managed the consolidation of all Fedwire offline processing at two national sites and oversaw the completion of the migration of the National Book-Entry System to the Federal Reserve's centralized automation facility, a major milestone in the System's multiyear project to consolidate its mainframe automation.

The Bank also built support for the installation of a new phone system at our Utica facility and reengineered intradistrict communications capabilities, resulting in increased bandwidth as well as reduced annual operating costs. In addition, we continued to improve the security of our web-based communications by installing a public cryptography infrastructure. After completing a security evaluation of the Bank's public web site, the International Computer Security Association awarded the Bank formal certification for having a web server configured in accordance with industry best practices.

All areas of the Bank will be challenged to introduce other cost-effective technologies and systems that promote efficiency, productivity gains, and improved customer service. We must accelerate our efforts to reduce the volume of paper-based reports, not only within the Bank but also in our transactions with Bank customers. Accordingly, we will encourage depository institutions during 1999 to sign up for electronic receipt of circulars, a move that could substantially reduce the Bank's printing costs. Further, we will encourage depository institutions and other users of Bank services to submit electronically all data and reports, tenders for Treasury securities, subscriptions for publications, and various other documents.

One reflection of management's intensifying focus on efficiency has been our dedication to improving the Bank's internal control environment. In 1997, the Bank adopted an internationally recognized framework for evaluating the adequacy of internal controls over financial reporting. The framework was developed in the 1980s by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, a group composed largely of accounting industry associations. Following the successful application of the COSO framework to the Bank's financial reporting objectives and controls in 1997, we expanded the Bank's COSO focus in 1998 by undertaking a rigorous evaluation of the broad operational objectives and controls adopted by business management and staff in our priced services areas. These initial operation-focused assessments will be completed in early 1999 and updated continuously thereafter.

The challenge of making the Bank an even stronger institution will require the dedication, expertise, and creativity of every employee at every level of the Bank. In our Human Resources area, we must focus more than ever on remaining an employer of choice. With labor markets tight, the Bank is dedicated to implementing human resource policies and programs designed to create an environment that encourages innovation and creativity, motivates and rewards achievement, and fosters career development for all members of the staff.

Responsibility for directing many of our efficiency- and productivity-enhancement efforts will fall to the Bank's very able management team. On January 12, 1999, I announced that Jamie B. Stewart, Jr., would join the Bank as its eighth first vice president. Jamie has had a distinguished twenty-seven-year career in banking, most recently as vice chairman of the Mellon Bank Corporation and Mellon Bank, N.A., where he was responsible for wholesale banking and cash-management activities. As the chief operating officer of the Bank, Jamie will be able to direct his strong managerial experience and substantial knowledge of banking operations toward making the Bank more efficient and effective in the delivery of services to its customers.

January 20, 1999

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, 1998 (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 an effective process of internal controls over financial reporting, including 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. This process of internal controls contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in the process of 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, including 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 an effective process of internal controls over financial reporting, including the safeguarding of assets as they relate to the Financial Statements.

William J. McDonough
President

Report of Independent Accountants
PricewaterhouseCoopers 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 ("FRBNY") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the Financial Statements as of December 31, 1998, 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 over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control, 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, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control 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 FRBNY maintained an effective internal control over financial reporting and over the safeguarding of assets as they relate to the Financial Statements as of December 31, 1998, is fairly stated, in all material respects, based upon criteria described in "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

PricewaterhouseCoopers LLP

New York, New York
March 5, 1999