Report from the President

REPORT FROM THE PRESIDENT

Economic, financial, and technological developments presented the Bank with many challenges and much uncertainty in 1999. Though well into the ninth year of cyclical expansion, U.S. economic activity remained brisk, bringing jobs and an improved standard of living not only to the educated and skilled, but also to many who are less well off. Meanwhile, inflation remained subdued and the net worth of households and businesses continued to climb.

Throughout the year, however, the uncertain effects of Y2K induced businesses, as well as financial market participants and institutions, to direct resources toward contingency planning, computer system testing and remediation, and investment in new technologies. Driven more by caution than the likelihood of breakdowns in critical computer systems, some individuals and institutions took extraordinary steps to build up liquidity around year-end, complicating the execution of monetary policy and the provision of currency by the Bank to depository institutions.

The improving economic and financial conditions in much of the world, together with the cyclical expansion in the United States and Y2K preparations, set the tone for much of the Bank's work in 1999. Yet continuing stresses, particularly in Asia and Latin America, presented several areas of the Bank with major challenges. Throughout the year, we monitored developments and looked for possible systemic risks emanating from abroad, and we used our technical expertise in support of crisis management in several countries. In addition, we strengthened our approach to financial supervision to reflect changes in the structure and functions of banking organizations, the passage of landmark banking legislation, and major trends in the global business environment.

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. Although major challenges remain as the Bank seeks to become more integrated, flexible, and efficient, several strategic initiatives undertaken in 1999 have already yielded significant rewards. These initiatives were intended to:

- enhance the Bank's role in financial supervision and policy formulation by strengthening our ability to identify and respond to emerging trends and public policy issues affecting the banking and financial sectors;

- integrate financial and economic theory more effectively into the daily operations of the Domestic Open Market Desk and improve understanding of how changes in the economy and financial system affect the transmission of monetary policy;

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Years of complex planning and coordination by staff throughout the Bank paid off richly as the century date change weekend passed without any serious computer system disruptions, security infractions, or service interruptions.

- provide leadership in the development of safe, efficient, and internationally linked payment systems and in the formulation and implementation of payment system policy, law, and technology; and

- broaden and deepen the Bank's network of international relationships.

Because of these initiatives, which will continue in 2000, the Bank is better able to foster collaboration among its policy, operations, and support areas; respond flexibly to changing conditions; and reallocate resources to meet new or changing priorities. At the same time, the initiatives are helping the Bank to become more outward looking in its policies and operations and to provide stronger practical leadership in the central banking community and the private sector. As a consequence, I am confident that the Bank's reputation as the preeminent center of excellence in central banking policy and practice and as a vital link between the public and private sectors will be further enhanced.

MEETING THE Y2K CHALLENGE

Years of complex planning and coordination by staff throughout the Bank paid off richly as the century date change weekend passed without any serious computer system disruptions, security infractions, or service interruptions. This achievement reflected the dedication of the scores of Bank employees who worked intensively since 1997 to prepare the Bank for the century date change, as well as substantial collaboration with vendors and many outside organizations.

Our staff completed certification of most of the Bank's systems in 1998. However, throughout 1999, we continued to cooperate with other supervisory authorities, government agencies, payment clearing and settlement houses, and official international organizations to develop and coordinate test plans, contingency plans, and event management plans. Directed by the Y2K office, individual areas undertook contingency planning and drills across functional areas, conducted scenario walk-throughs, and took part in two full-day Systemwide event simulation exercises. To ensure that certified systems would remain ready, the Bank put in place change control and Y2K compliance recertification programs.

I applaud all of the staff whose work during the century rollover period helped to make the Bank and the financial system more reliable, secure, and stable.

A key aspect of the Bank's role as a banking supervisor entailed reviewing the Y2K preparedness of the banks we examine. Early in 1999, we initiated discussions with the major market participants to assess key business risks arising from Y2K issues, including the impact on liquidity, credit exposures, and market risk; these discussions also brought to the fore other issues that needed to be addressed, including supervisory policy, Federal Reserve System readiness, public sector actions, and public perceptions. Beyond these "due diligence" discussions, we conducted in-depth business line reviews of major organizations, and we completed all phases of the System's supervisory program for all institutions, including follow-ups with banks in less than satisfactory condition.

Among the most daunting challenges faced by the Bank were those confronting the Markets Group. Working with staff at the Board of Governors, and with the approval of the Federal Open Market Committee (FOMC), the Domestic Open Market Desk introduced a number of innovative measures to offset potential reserve deficiencies that threatened to disrupt the money and capital markets. Throughout the spring and summer, there was widespread concern that participants in the financial markets would be less willing to maintain normal levels of trading and market intervention around the century date change and that such reluctance could interfere with the efficient allocation of credit. In this environment, the Desk recognized that it would probably need to transact large repurchase agreements (RPs), which would exacerbate a possible shortage of Treasury collateral stemming from a surge in investor demand.

To stabilize the money and capital markets and bolster the confidence of market participants, the Bank's Markets Group established a temporary standby financing facility through the auction of options on RPs. The options were designed to encourage primary dealers to continue to make markets and undertake normal intermediation in securities markets—two activities that are needed for the Desk to arrange open market operations. Starting in October, the Desk conducted seven weekly auctions of options with a total value of $480 billion, none of which were exercised.

In addition to creating the standby liquidity facility, the Desk also took the following steps:

- The maximum maturity of RPs and matched sale-purchase transactions was extended from sixty days to ninety days.

- A temporary expansion of the securities that could be used as collateral on the Desk's RPs was approved through April 2000. The principal effect of this step was the inclusion of pass-through mortgage-backed securities and stripped securities.

- Triparty settlement arrangements were set up with two clearing banks, the Chase Manhattan Bank and the Bank of New York, for valuing and accepting delivery of collateral on RPs. This action involved negotiating legal agreements and establishing procedures to oversee the work of the two custodians and to monitor the collateral being pledged.

- As reserve deficiencies deepened in the days leading up to the century date change, the Desk arranged a series of forward RPs, a type of operation rarely used before.

In a parallel effort, the Board of Governors established a special liquidity facility that provided banks with additional flexibility in obtaining advances at the discount window.

No one can say with certainty how the markets would have behaved had the Bank and the Federal Reserve System as a whole taken less aggressive actions during the final months of 1999. However, the relative calm in the markets and the positive perceptions of the public as the end of the year approached attest

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Another Y2K concern involved the means by which the Federal Reserve would meet the expected year-end surge in the public's demand for currency. The Treasury Department and the Board of Governors turned to this Bank to establish an overseas strategic inventory location (SIL) program for housing U.S. currency to meet potential demands. During 1999, we established SIL cash depots in Europe, Asia, and South America as well as several others in the United States and Puerto Rico. By the fourth quarter of 1999, Federal Reserve cash facilities around the country had received a total of about $50 billion in currency beyond their normal seasonal requirements for distribution to banks.

Toward the end of the year, banks raised sharply the amount of currency held in their vaults. Through the overseas SIL program, we were able to supply global markets with more than $4 billion in Y2K contingency currency. In December alone, the New York Fed paid into circulation some $20 billion in currency, a record for a single month.

Owing in part to a rigorous public campaign to provide factual information, the public's demand for currency fell far short of the worst-case scenarios, leaving banks with large amounts of vault cash. Consequently, early in 2000, our Cash department faced the significant challenge of managing the rapid redepositing of excess cash by banks.

LEADERSHIP IN PAYMENTS

A major objective for 1999 was to provide leadership in developing safe, efficient, and internationally linked payment systems and to maintain the Bank as a center of payment system policy, technology, and efficiency in market operations. This effort, led by Jamie Stewart, the Bank's first vice president, came about in a period of great uncertainty about the future of wholesale and retail payment systems. Major changes in technology, the structure of the financial system, the composition of products and delivery systems, and the expectations of customers have forced the Bank to reassess its roles in the payment system as a provider of services and a supervisor of banks. As this reassessment proceeds, Jamie and I are committed to helping the Bank take advantage of opportunities to become more efficient, reduce cost, and improve service to our customers. We also intend to continue to gather information from public- and private-sector sources that will give us a better understanding of how banks are adapting to changes in payment practices and a clearer understanding of the payment services the public wants from banks.

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In carrying out our payment system initiative, New York Fed staff at the System's Wholesale Payments Product Office (WPPO) introduced an enhanced net settlement service intended to facilitate clearing arrangements by providing improved settlement finality and increased operational efficiency. In 1999, some sixteen arrangements took advantage of the new system, which will be phased in nationwide this year and next. The WPPO also led the System in continued service streamlining and consolidation initiatives designed to reduce the costs of providing wholesale services and the fees charged to customers. For example, in 1999, the fees for on-line Fedwire funds transfers were reduced for the third consecutive year and those for Fedwire book-entry securities transfers were reduced for the second consecutive year.

The WPPO also introduced a new price structure for wholesale services that modernizes and simplifies pricing, responds to the different characteristics of customers, and encourages the efficient use of services. Further, the Office implemented efforts to use new tools and techniques in the delivery of wholesale services without introducing unacceptable risk to the core payment services. One such effort was the deployment of a new Fedwire participant directory on the Internet. Banks and private corporations use the highly automated directory to access accurate and up-to-date Fedwire message routing information.

In the financial services area, the Bank provided leadership in directing a number of strategic Federal Reserve initiatives to improve the efficiency of the payment system. Most notably, considerable attention and resources were committed in 1999 to moving check processing from paper to electronics, expanding the global network for distributing U.S. currency overseas, and ensuring the Y2K readiness of the electronic payment systems that serve as the spinal cord of the nation's financial system.

Early in 1999, the Bank was asked by the Board of Governors to lead a multiyear, Systemwide initiative to advance the banking industry's movement from paper check processing to electronics. The first phase of this initiative was to demonstrate the technical capabilities, speed, and reliability of new technology that processes and transmits the electronic image of checks instead of the checks themselves. This was a demanding and formidable challenge. Previously, no Reserve Bank had adapted high-speed imaging technology fully to its paper-based check operations, and the project management team that we brought together from our Check and Automation staffs had to meet a tight schedule because of the Federal Reserve's moratorium on technological changes as the century date change approached.

In September, we successfully completed this demonstration, or "proof of concept," at our Utica office. The new technology not only met the demanding performance specifications we established, but it was put into production on schedule and on budget through the application of stringent project management techniques. In December, the Board of Governors approved the second phase of the check imaging initiative, authorizing the Bank to introduce the new technology fully at our Utica office. In subsequent phases, our check operations at East Rutherford will also obtain the new technology, making the Bank the first in the System with full high-speed imaging capabilities at both of its check offices.

We view check imaging as a "bridge" technology with the potential to accelerate the replacement of paper transactions with more efficient, end-to-end electronic transactions. With the image capabilities we are building, we believe we can significantly advance this strategic objective. Not inconsequentially, we will also be able to meet pent-up demand for imaging services from scores of New York area banks that want to convert customers' checks

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into image items. Moreover, we plan to maximize the internal operating efficiencies that image processing permits to reengineer our check reconcilement and adjustment operations. These process changes should enable banks using our imaging services to capture efficiencies in their own back-office check operations.

The Bank in 2000 will face the challenge of providing continuing leadership in the check imaging initiative. In that spirit, we will contribute staff resources and operational expertise to a complementary Systemwide initiative to standardize check operating platforms across all Reserve Banks. This latter initiative, which is expected to take three years to complete, will better enable the Reserve Banks to meet the check processing needs of the nation's largest commercial banks, which are increasingly operating across many regions of the country.

In our cash operations, the Bank's leadership in international currency distribution helped to facilitate the smooth functioning of global banknote markets in 1999. We expanded the extended custodial inventory (ECI) program by establishing two new ECI sites in Hong Kong and one new site in Buenos Aires. Through the ECI program, which the Bank operates on behalf of the Treasury Department and the Federal Reserve System, we house some of our currency in cash depots at banks abroad in order to facilitate currency distribution. With ECIs now operating in Europe, Asia, and South America, we have created a true global network that enables us to manage the international distribution of U.S. currency more effectively. It is estimated that two-thirds of U.S. currency is in circulation outside the United States.

One of the collateral benefits of the program is the increased speed with which our ECI partners can supply U.S. currency to markets experiencing financial disruptions. Another is that the ECIs have proved enormously helpful in gathering information on U.S. currency flows abroad and on international counterfeiting. In recognition of its growing expertise in this area, the Bank was asked during the year to coordinate—for the Treasury, Secret Service, and the Federal Reserve—the 1999 audit of international currency flows, an initiative mandated by Congress to improve America's money-laundering detection capabilities.

IMPROVING THE OPERATION OF THE MARKETS

New technologies, the increasing interaction of domestic and foreign markets, and dramatic growth in trading volumes make it necessary for us to continuously reassess our strategies and practices in the implementation of monetary policy. Thus, an ongoing challenge we face is to integrate financial and economic theory with day-to-day operations and to improve the flexibility, reliability, and efficiency of our market operations.

The Bank's Markets Group has responsibility for implementing the nation's monetary and foreign exchange policies. During 1999, the Group took a number of steps to improve the timeliness, transparency, and effectiveness of its actions—steps that complemented the Bank's innovative actions to offset Y2K-related reserve deficiencies and bolster the confidence of market participants and the public.

In April, the Domestic Open Market Desk began to enter the market to execute open market operations at about 9:30 a.m., one hour earlier than previously. This step allowed the Desk to arrange its operations at a time of day when financing markets are typically more active and liquid. Further, in an effort to increase the transparency of monetary policy implementation, the Desk expanded the information it discloses publicly immediately after each operation to include data on the total volume of propositions submitted (in addition to information on total accepted propositions, which was already routinely released), the weighted average rate on accepted propositions, the high and low rates submitted, and the stop-out rate.

To promote stability and efficiency in the government securities market, the Markets Group, with the approval of the FOMC, expanded a program to lend securities to dealers. Under this program, the Federal Reserve lends U.S. government securities held in the system open market account to the market through daily auctions, helping to facilitate settlement of hard-to-find securities and ease tightness in the market for specific issues. In addition, to improve the efficiency of the Treasury auction process, we implemented an Internet-based process for the submission of bids that replaced paper-based submissions.

Staff from the Markets Group and the credit and risk management, fiscal, and legal areas collaborated in 1999 to expand the number of depository institutions having access to the discount window and to increase the range of collateral banks could pledge. Under new policies instituted in 1999, banks can pledge as collateral certificates of deposit, deposit notes, and various collateralized obligations. In addition, staff established procedures that give banks additional flexibility in pledging collateral owned by affiliates or subsidiaries.

The Markets Group also rebalanced the foreign currency portfolios of the Treasury's exchange stabilization fund and the system open market account. Although these two accounts have historically been roughly equal in size and composition, a number of factors caused them to diverge during the late 1990s, complicating investment of the two portfolios. Through a series of trades between the stabilization fund and the system open market account, and with an unrelated transaction involving the International Monetary Fund, our foreign exchange market staff equalized the size of the two portfolios and brought the holdings of yen and euros into balance.

The Markets Group and the Bank's Research and Market Analysis Group (RMAG) worked together to identify ways to enhance open market operations and the Bank's surveillance of the economy and the financial markets. One joint undertaking, which will continue in 2000, is to renew the Bank's understanding of the transmission of monetary policy, especially in light of technology-led changes in aggregate supply, the buildup of wealth in the household sector, and changing patterns of international production, trade, and capital flows.

As part of this effort, RMAG sponsored a conference late in the year that focused on the impact of federal budget surpluses on the economy and financial markets. Discussions

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of expected changes in the market for Treasury securities were particularly important. Implementation of monetary policy through open market operations mainly involves the purchase or sale of Treasury securities by the Domestic Open Market Desk. Thus, budget surpluses projected to accumulate over the next several years at least, and the potential for a related decline in the supply of Treasury securities, could present the Desk with new challenges in its efforts to influence growth in the nation's money supply and to promote financial market stability.

RMAG also completed new research that focused on the prospects for inflation and potential long-term strains and vulnerabilities in the U.S. economy. In addition, RMAG developed new statistical techniques to improve measurement of the risks inherent in forecasting economic growth and inflation. The Bank's research staff published a total of sixty articles in the *Economic Policy Review*, *Staff Reports,* and *Current Issues in Economics and Finance*. By the end of 1999, more than 800 papers were published or were forthcoming in outside journals, scholarly volumes, or practitioner-oriented publications. Efforts were also under way to disseminate published research electronically and to reduce production and mailing costs by streamlining mailing lists for print publications.

ENHANCING FINANCIAL SUPERVISION

One of the Bank's most important initiatives in 1999 focused on enhancing its role in financial supervision and policy formulation. Globalization and consolidation in the banking industry, particularly through mergers, as well as the breakdown of distinctions among types of financial services providers, necessitated the rethinking of many of our regulatory and supervisory practices. Meanwhile, changes in the business strategies of banks and the signing into law of the Gramm-Leach-Bliley Act added new challenges to the work of the financial supervisors. Under the terms of the Gramm-Leach-Bliley Act, the Federal Reserve serves as the umbrella supervisor for the financial holding companies allowed to engage in the full range of financial activities.

In 1999, the Bank directed substantial resources over many months toward understanding and managing changes in the financial system. We began discussions with Federal Reserve Board staff and initiated several research projects to help us rethink our approach to analyzing the competitive impact of banking mergers and acquisitions. We also established an interdisciplinary Risk Council, composed of analysts from many areas of the Bank, to identify emerging risks for global banking organizations and to guide the development of the Bank's supervisory responses to these risks. The Council's initial projects focused on the implications of the Internet and e-commerce, the likely effects of a significant economic downturn, and the impact of selected business strategies on risks facing banks.

The Bank also took several steps to advance the supervision of large, complex banking organizations. These steps included establishing dedicated teams to monitor and direct the supervision of large banks, conducting more continuous supervision, increasing the use of comparative statistics for examination planning and institution monitoring, and improving coordination with staff elsewhere in the Federal Reserve System. Meanwhile, we achieved a solid understanding of the risk management and control structure at the corporate level and established mechanisms for ongoing interaction with banks' own risk managers. Further, we strengthened relationships with functional regulators (particularly the insurance supervisors) that will be useful in carrying out our future supervisory responsibilities. Building on this progress, we must continue to refine our supervisory programs for large banking institutions.

As a supervisory authority, the Bank reviews applications for mergers, acquisitions, and branch additions to ensure that the banks involved continue to serve the needs and convenience of the communities in which they do business. In 1999, the Bank reviewed two applications for mergers of foreign and domestic banking organizations that had significant implications for the banking system—Deutsche Bank's acquisition of Bankers Trust and HSBC's acquisition of Republic National Bank. Both mergers reflected the continuing trend toward consolidation in the banking industry, particularly among banks with offices and activities that cross borders. Meanwhile, an increased number of e-banking-related applications in 1999 reflected the growing importance of electronic banking.

The Federal Reserve Bank of New York continued to play a critical role in support of my work as chairman of the Basel Committee on Banking Supervision. During 1999, I led an international effort to update the 1988 Basel Capital Accord. While the 1988 agreement proved extremely valuable in boosting bank capital in many countries, the New York Fed and others have been convinced for some time that key elements of the Accord need substantial revision. In particular, the broad-brush approach to credit risk embodied in the 1988 Accord has led to capital ratios that are less meaningful for many internationally active banks and has encouraged transactions driven solely by the desire to arbitrage capital ratios.

I announced the release of the Basel Committee's proposals for a revision of the Accord in June 1999, with comments due by March 31, 2000. The proposals, written with substantial input from New York Fed staff, present a capital adequacy framework that rests on three pillars. The first pillar would focus on minimum capital requirements, adjusted to be more sensitive to risk. The second pillar would emphasize the role of banks in assessing their own capital needs in excess of regulatory minimums and the role of supervisors in reviewing the efforts of banks to achieve the right balance of capital relative to risk. The third pillar of the new framework would stress the role of market discipline in maintaining prudent capital ratios and therefore would encourage increased disclosure of the relevant financial indicators.

While the proposals and their underlying objectives were generally well received, many challenges remain before the new Accord can be finalized. In the meantime, the Federal Reserve Bank of New York will continue to be actively involved with the efforts of the Basel

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Committee to achieve a consensus on the best way to proceed.

Work by our banking supervision and regulation staff to better understand industry practices, share findings and insights, and provide new guidance contributes significantly to Federal Reserve System supervisory policy and practice. During 1999, our supervisory staff researched loan loss reserve methodologies in support of interagency efforts to provide guidance to the industry on requirements affecting reserves for impaired assets. In addition, supervisory staff, in collaboration with the Bank's research economists, began developing a supervisory framework to assess the adequacy of the internal capital allocation systems of banks.

Notwithstanding these significant accomplishments in the arena of supervisory practice and policy, we recognized that changes in the organizational structure of the supervision group could improve the consistency of our supervisory approaches across similar institutions, the development of our staff's expertise, and the linkage between policy and the conduct of supervisory activities.

To meet these goals, we undertook a fundamental reassessment of our organization and adopted a new structure and staffing model. Although implementation and transition procedures have been laid out, successfully implementing the plan and ensuring that the expected improvements are achieved remain a formidable challenge. Our challenge is intensified by the need to adjust to our new role as the umbrella supervisor under Gramm-Leach-Bliley, which will require establishing new relationships with other supervisors.

Finally, we continue to face the important task of attracting, developing, and retaining supervisory staff with the expertise we need—an issue that assumes greater importance in light of the increasing size and complexity of the organizations for which we will be responsible, either as the primary regulator or the umbrella supervisor. Efforts to improve skills development and staff retention will again be top priorities in 2000.

In 1999, the Bank set out to broaden and deepen its network of international relationships.

STRENGTHENING INTERNATIONAL RELATIONSHIPS

In 1999, the Bank set out to broaden and deepen its network of international relationships. The Emerging Markets and International Affairs Group successfully built on its unique position and relationships within the domestic and international financial community and maintained an ongoing dialogue with key players in both the official and the private sectors. These efforts supported the Bank's active role throughout the year in monitoring, analyzing, and ameliorating emerging market pressures and in contributing to related policy discussions.

The Group also put strong emphasis on improving the training and information available to central bankers from all over the world. Our annual multiweek seminar for central bankers provided training to participants from seventy-five countries. The Bank also hosted week-long courses on a wide range of central banking subjects in the spring and the fall. In addition, we structured customized activities for more than 100 central bankers, allowing us to provide training and internships to representatives from countries strategically important to the Bank.

Communications with bankers and central bankers were quite extensive during the year. In addition to our usual contacts, we conducted training surveys, published three issues of a newsletter on central banking issues, and responded to requests from international account holders for information about this Bank's Y2K compliance. The Bank continued its luncheon and meeting series with the managers of New York offices of foreign banks and hosted meetings for other international groups. In addition, we arranged a number of meetings with the New York financial community to foster a productive dialogue between the public and the private sectors on pressing issues in the emerging markets.

The Bank's network of relationships was strengthened by its ongoing engagement with the international financial community on a range of practical issues and proposals. For instance, we deepened our relationships with foreign central banks and monetary authorities through collaborative projects and contributed to several bilateral and multilateral work groups. New York Fed staff led two interagency groups working on improvements in the collection of foreign banking and portfolio investment data and on ways to reduce reporting burdens.

As a service to official international organizations and to governments and central banks around the world, the Federal Reserve Bank of New York maintains custodial accounts containing gold, funds, securities, and other assets. In 1982, Iran initiated a legal action against the Bank that alleged breaches in our obligations with respect to Iranian funds we held. Those funds had been frozen by an executive order signed by President Carter during the hostage crisis. Specifically, Iran sought to recover $200 million based on its claim that the Bank did not pay adequate interest on the funds it held during the period in question. In 1999, following a complicated and contentious hearing, the Iran-United States tribunal at the Hague ruled in favor of the Bank, and Iran received nothing. In ruling on Iran's claim, Judge Mosk of the United States stated that the "award establishes that the [Bank] acted honorably and appropriately despite difficult international and domestic conditions."

LOOKING OUTWARD

The major initiatives undertaken by the Bank in 1999 will help to strengthen its leadership, not only within the Federal Reserve System but also among central banks around the world. However, to maximize the benefits from these initiatives, we must do a better job than ever before of using all channels of information, both inside and outside the Bank, to learn about and understand the concerns of market participants, customers, and the public we serve.

In 1999, for example, our unique network of international relationships continued to position the Bank to make important contributions to the management and resolution of emerging market crises. Similarly, the success of our Markets Group in calming financial markets by writing options and taking other unprecedented steps prior to the century date change was derived largely from our outward-looking approach to policy. Stated simply, we were plugged into the markets, had the right information, and devised a program that addressed the needs and concerns of market participants.

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To remain outward looking in our approach, . . . we must also stay closely involved with the people and firms that reside and do business in our District.

In financial services as well, we concentrated in 1999 on knowing the pricing concerns and service needs of our customers. Throughout the year, we had substantially more contact with our customers, service providers, and vendors by sending representatives into the field and inviting industry leaders to the Bank. In order to reduce the flow of documents to banks in our district, we introduced an electronic system to alert them about newly issued circulars and to facilitate downloading via e-mail.

To remain outward looking in our approach, however, we must also stay closely involved with the people and firms that reside and do business in our District. In 1999, our perspective on the community was greatly enhanced by information we obtained from the members of our advisory councils on small business and agriculture, thrift institutions, and economic and financial education. Guided in part by what we learned from outside sources, the Bank organized a series of informal conferences highlighting strategies for community development investment by bankers and other investors.

In addition, the Bank's outreach efforts included about 100 interviews with bankers, community groups, and government officials, as well as numerous focus groups on housing, economic and community development, youth unemployment, and economic literacy for adults. During 1999, we collaborated with several organizations to improve understanding of the home-buying process, established a Community Development Council consisting of selected individuals from banks, government, and not-for-profit organizations, and helped to form a partnership among banks and nonprofit organizations to provide training and job opportunities to unemployed youths. Further, we extended our community outreach efforts to include discussions of the 1977 Community Reinvestment Act, fair lending, risk-focused examination procedures, and subprime lending.

In 1999, as in past years, activities to promote a better understanding of economics and finance played a major role in the Bank's outward focus. Consistent with this mission, we introduced a series of coincident and leading indicators for the economies of New York and New Jersey that provide early warning signals of business cycle turning points. We also coordinated the second year of a program to train Puerto Rican high school teachers in economics and increased the number of schools and teachers taking part. In addition, the Bank extended its kindergarten through twelfth-grade education programs to include a larger and more diverse group of Second District schools and increased national participation in educational competitions and other programs.

The Bank also coordinated several multiple-day workshops, including the Global Economic Forum, Central Banking Seminar for College Teachers, Fed Challenge Institute, and "In the Shoes of a Fed Policy Maker." For the second consecutive year, the Bank ran the national economics conference for educators in collaboration with the National Council for the Social Studies.

Our outward focus by no means minimized the importance we placed on finding new efficiencies in our internal operations. In 1999, for example, the Bank established a set of policies and guidelines to address a fundamental change in our approach to computing, away from mainframes and toward PCs linked to decentralized servers. This new "change management architecture" will encourage faster adaptation to technological changes by empowering each business area to make decisions about its own technological needs. Consequently, staff throughout the Bank will need to be knowledgeable about the technology in their area and accountable for the effective functioning and creative use of that technology. In effect, each business area will become its own agent of change, comfortable with innovation and more tolerant of ambiguity and risk.

During 1999, efficiencies were also realized from improvements in paperwork management, automation initiatives, changes in internal service levels, and the establishment of a formal review framework for major resource investments. The Bank's total staffing dropped to about 3,800 people in 1999—a decline of more than 2 percent; total operating expenses grew by a modest 3.2 percent, with lower growth rates in support services. These savings have generated sources of internal funding for the Bank's strategic initiatives. A larger share of the Bank's resources is now going to support key endeavors in areas such as monetary policy implementation, financial supervision, payment systems, and international relationships.

The drive for greater efficiency in 1999 complemented our efforts to use the diverse skills of the Bank's staff more fully. In 2000, we plan to increase communication across departments and encourage greater movement of staff among different areas of the Bank—steps that should foster fresh, cross-disciplinary approaches to analysis and problem solving. Similarly, we plan to add flexibility to the Bank's structure by shifting both staff and financial resources more readily within the Bank to meet new or changing priorities. We expect these approaches and more competitive compensation packages to help ensure that the Bank will remain an employer of choice in 2000 and beyond.

Our outward focus by no means minimized the importance we placed on finding new efficiencies in our internal operations.

February 11, 2000

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

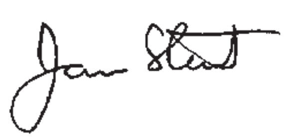
The management of the Federal Reserve Bank of New York (FRBNY) is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 1999 (the "Financial Statements"). The Financial Statements have 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



Jamie B. Stewart, Jr.
First Vice 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, 1999, 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 effective internal control over financial reporting and over the safeguarding of assets as they relate to the Financial Statements as of December 31, 1999, 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
February 29, 2000