

Federal Reserve Bank of Kansas City



2001 Annual Report

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“...our three complementary mission areas, and the structure of the System itself, serve to foster the stability, integrity, and efficiency of local, national, and world financial and payments systems...”

Trust & Confidence

Our vision guides our missions

The Federal Reserve Bank of Kansas City's vision statement focuses on the principles of “Trust and Confidence.” It is a simple but important statement that took on special meaning as the Federal Reserve worked with the financial and business communities, and the American people, during the tragic events of September 2001. Our Annual Report this year attempts to better explain this statement – first, in the context of the events around September 11 and, second, in the context of this Reserve Bank's changing role as one of twelve Banks and the Board of Governors making up the Federal Reserve System.

The Federal Reserve System's mission centers on the fulfillment of three central bank responsibilities: monetary policy, supervision, and financial and Treasury services. The provision of these services is what Jerry Corrigan, the former president of the Federal Reserve Banks of Minneapolis and New York, likes to call “the trilogy of central bank responsibilities.” While often viewed as separate and unique, these mission areas are, in fact, complementary and assist the Federal Reserve to achieve the highest level of performance in fulfilling its public policy role. This becomes particularly evident during times of crisis, when individuals across business lines share and manage information.



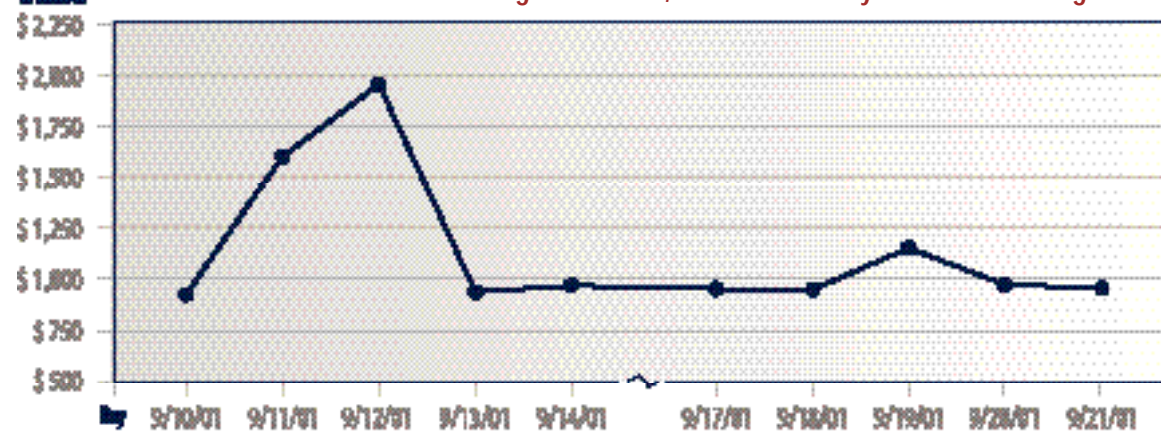
*Thomas M. Hoenig
President and Chief Executive Officer*

The Federal Reserve's Response to the Events of September 11

The events of September 11 produced outcomes that are unspeakable in their effects on human life. They also illustrate how our three complementary mission areas, and the structure of the System itself, serve to foster the stability, integrity, and efficiency of local, national, and world financial and payments systems, and promote confidence in these systems throughout the world.

10th District Loans and Other Assets

Includes assets denominated in foreign currencies, revalued monthly at market exchange rates.



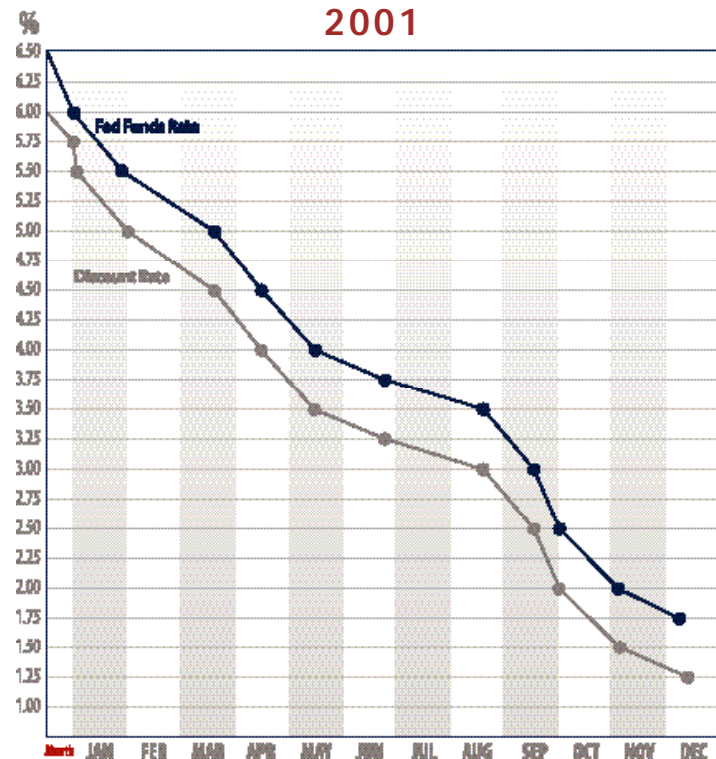
Monetary Policy and the Provision of Liquidity

Following September 11, the Federal Reserve acted quickly to supply funds necessary to meet the extraordinary demand for liquidity and to assist banks whose ability, or whose customers' ability, to receive and send payments had been disrupted. Discount window borrowing on September 12 was \$45.6 billion; a week earlier it had been \$195 million. In addition, the day after the attacks the Open Market Desk at the New York Fed injected \$38 billion of liquidity into the market through overnight repurchase agreements, and by Friday, September 14, the desk had injected a record \$81.25 billion. Since the demand for dollar liquidity is global, the Federal Reserve established

or expanded currency exchange lines of credit with other central banks around the world to ensure that foreign banks operating in the United States had sufficient access to U.S. dollars to enable them to operate without undue disruption.

Before the reopening of the stock markets on September 17, the Federal Open Market Committee (FOMC) lowered the federal funds rate target, and the Board of Governors, with recommendations from the Reserve Banks, lowered the discount rate by 50 basis points. Additionally, the FOMC reaffirmed its commitment to supply unusually large volumes of liquidity to the financial markets, as needed, until more normal market functioning could be restored.

Federal Reserve Rate Moves 2001



Mission

mission 1

Monetary Policy

Our mission is to formulate and implement monetary policy that promotes financial stability and sustainable economic growth for the nation; price stability fosters these goals. Price stability leads to an environment that allows businesses and consumers to plan with confidence, encourages growth and business investment, and leads to an increased capacity to produce goods and services.



To counter the negative economic effects of the terrorist attacks – and the continuing economic weakness that had begun before the attacks – the FOMC lowered rates 50 basis points on October 2 and November 6, and 25 basis points on December 11. The result was a 1³/₄ percent federal funds rate target – the lowest in forty years, and a 1¹/₄ percent discount rate – the lowest since the 1940s. At the beginning of the year, the funds rate target stood at 6¹/₂ percent. At year-end it was 1³/₄ percent.

Promoting a Safe and Efficient Payments Mechanism

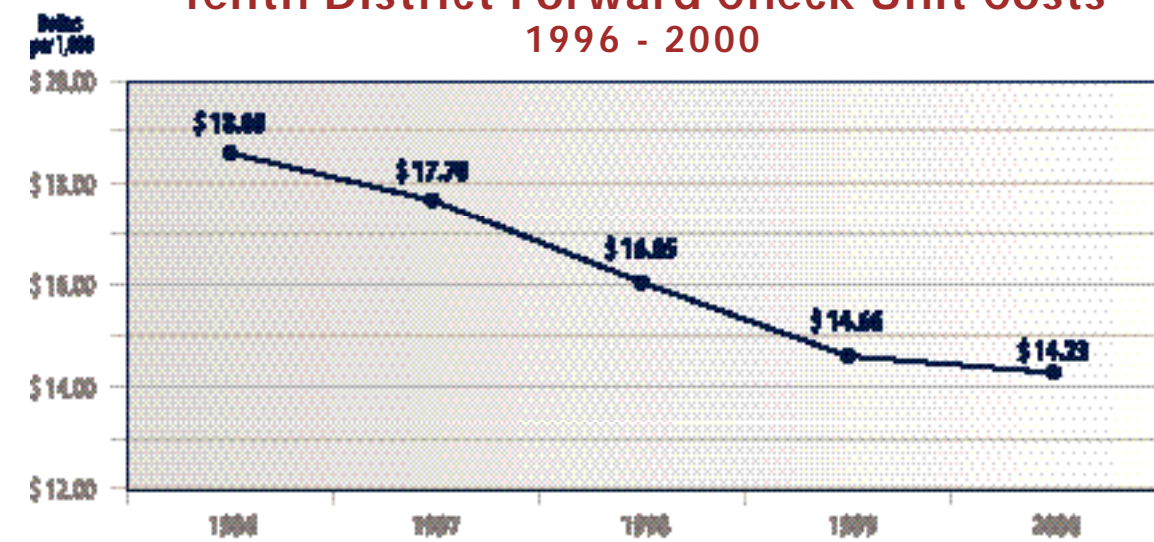
These actions, while substantial, were but one dimension of the Federal Reserve's reaction to September 11. Complementing its monetary and liquidity actions, the Federal Reserve managed its payments activities with a view to keeping the U.S. financial system open and working. Early in the day of September 11, the twelve Reserve Bank presidents and the Board of Governors committed themselves to remaining open and operating to ensure the continuation of vital payment services, such as electronic transactions, currency distribution, and check processing.

10th District Financial Services Statistics 2001

- Approximately 2,200 institutions served
- 1,400 customers with electronic connections
- 980 forward check depositors
- 1,340 Automated Clearinghouse originators
- \$20 billion received and \$22 billion paid out in currency
- 1.4 billion checks processed
- 13.5 million savings bonds printed and mailed
- 187,000 calls to automated voice response service
- 63,500 customer and public phone calls handled every month

The Federal Reserve's electronic payments systems – the Fedwire funds and securities transfer system, and the automated clearinghouse system – remained open and functioning. For several days following the attacks, the Fed extended the normal Fedwire closing time until late into the evening to accommodate banks that experienced operating problems. Right after the attacks there was a moderate increase in demand for currency, not unlike the increased demand that is experienced after natural disasters. Accordingly, throughout the post-attack period, Reserve Banks and depository institutions maintained ample supplies of currency, and demand quickly returned to normal levels.

Tenth District Forward Check Unit Costs 1996 - 2000



Finally, during the week of September 11, each Reserve Bank continued to provide credit for check deposits based on its published schedules. Credit was given even though the Fed could not present many of these checks on normal schedules because of the absence of air transportation.

Providing Supervisory and Regulatory Oversight

Consistent with our third area of responsibility, on September 11 and in the days that followed, the Federal Reserve relied on its supervisory staff to serve as key central points of contact with the nation's largest banking organizations.

This ongoing support assisted the System's effort to ensure that the payment systems continued to function. Also, the Federal Reserve encouraged its state-chartered banks and bank holding companies to work flexibly with borrowers and other customers who were directly or indirectly affected by the attacks. The Fed issued a press release on September 14 encouraging banking organizations to "take prudent steps to make credit available to sound borrowers" and assuring lenders that such actions are consistent with safe and sound banking practices and promote the

public interest. Finally, the Federal Reserve worked closely with law enforcement to disseminate a list of suspected terrorists to all of its banking organizations, asking them to check their account and transaction records against this list and report any positive responses to law enforcement as quickly as possible.

We take a risk-focused approach to supervision that allows us to tailor our process to fit the risk-profile of individual institutions. We are proactive in offering outreach and education to community bank officers and directors to help ensure stronger oversight and identify issues before problems arise.

Our Regional Structure Contributed to an Effective Response

Among the Reserve Banks, there can be no doubt that the Federal Reserve Bank of New York did the heavy lifting following the attacks. It is located in the financial center of New York, only three blocks from the World Trade Center site, and the financial institutions affected most directly by the attack were institutions it serves. During the hours and days following the

“... a connection that allows the Federal Reserve System to act in an informed manner and to lead both in times of calm and in times of crisis.”

tragedy, the Federal Reserve Bank of New York remained in operation, and its leadership and staff were responsive, responsible, and demonstrated enormous courage.

The other eleven Banks were affected to varying degrees. Each of them, including the Federal

Reserve Bank of Kansas City, provided credit and liquidity to financial institutions in its region whose payments might have been disrupted. Each Reserve Bank worked with hundreds of financial institutions and individuals in its region to meet their needs and to reassure them that the Federal Reserve was open and that the financial system was working and safe. The twelve Banks acting separately, but in a coordinated fashion, were able to communicate at local and national levels and dealt as well as one might hope with this horrific tragedy. Partly as a result of these efforts, financial markets remained relatively stable, a

key ingredient in a market-based economic system.

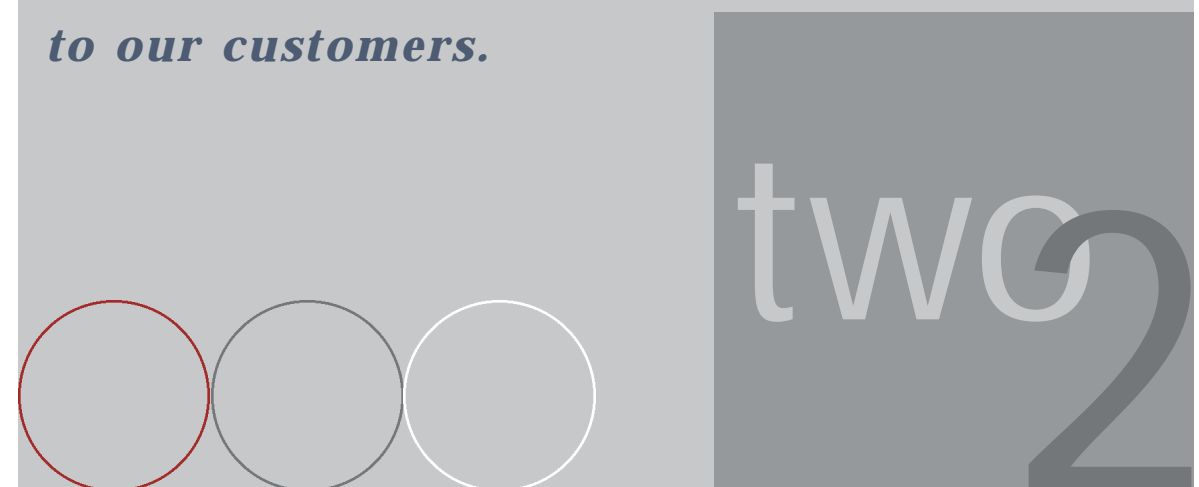
10-Year Treasury Note Constant Maturity Rate 2001

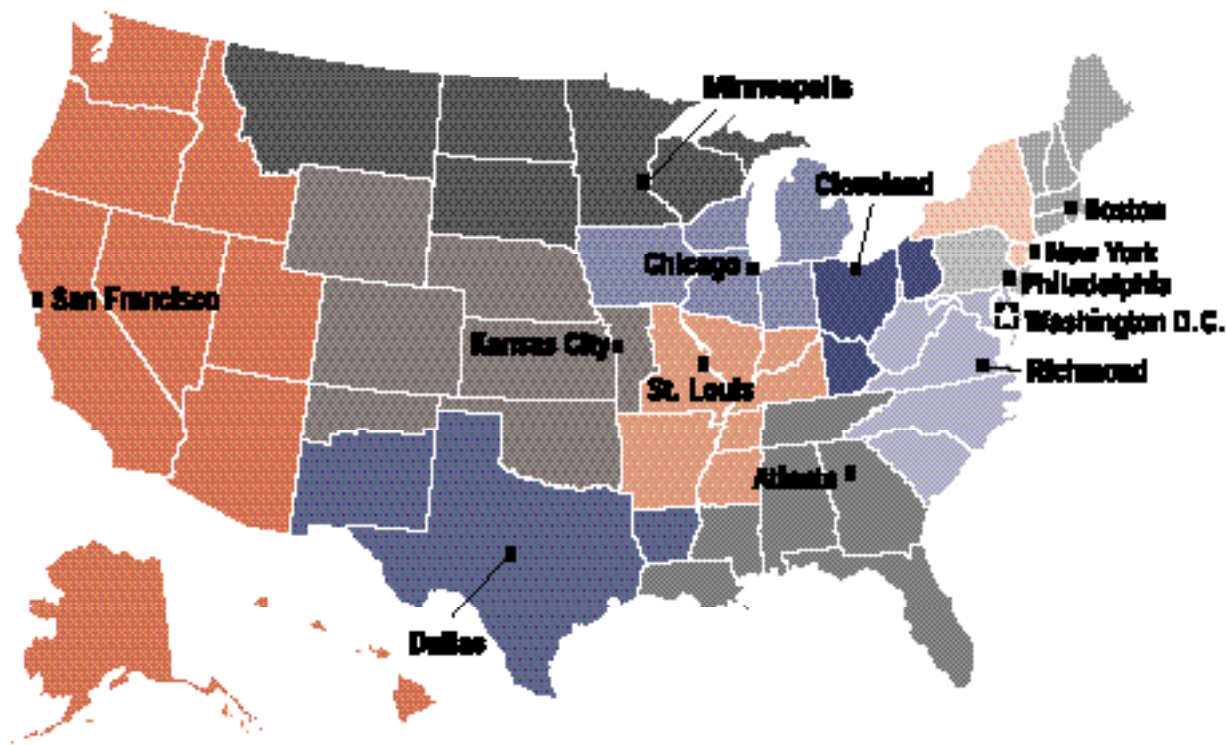


In recapping these events, I hope you have a sense of why I am proud of the Federal Reserve System and why I believe our vision has special meaning. However, the Federal Reserve's ability to engender trust and confidence over time depends on far more than managing a single crisis. It also hinges on each Reserve Bank's continuing involvement with people and activities in its region – a connection that allows the Federal Reserve System to act in an informed manner and to lead both in times of calm and in times of crisis.

Mission
mission 2
Financial Services

Our mission is to foster the integrity, efficiency, and accessibility of U.S. dollar payments and settlement systems in support of U.S. financial stability and economic growth in a global context. As both leaders and participants in the payments system, we strive to promote the public interest by reducing system risks while providing high-quality, innovative financial services to our customers.





The Structure of the Federal Reserve System

It is important to note that the very structure of the Federal Reserve System is engineered to instill trust among U.S. citizens, by dispersing power and assuring a local dimension to central bank activities. This structure also supports our three mission areas and allows us to operate effectively even under adverse conditions.

During the past several years, the Federal Reserve has been viewed favorably by a majority of the American people. But as the Fed has pursued its long-term mandate of stable prices and sustainable growth, this positive view has not always been the case in the past, and it will not always be the case in the future. In addition, there are people who simply are suspicious of and object to having a single, independent central bank of the United States.

Such uneasiness about central banks certainly also existed in 1913 when Congress chartered the Federal Reserve, and it was a principal factor in the decision to organize the Federal Reserve as a System of twelve separately chartered Banks. Indeed, the Fed's founders thought it was especially important to build a network of regional Reserve Banks in order to diffuse power and provide a mechanism for obtaining independent views on economic and financial events. By being attentive to local as well as national issues, these Banks would serve to instill confidence about the Federal Reserve in communities across the country.

Paul Warburg, one of the original architects of the Federal Reserve System, said it best in his book, titled *The Federal Reserve System: Reflections and Recollections*

One of the striking points of strength of the Reserve System lies in its weakness. This paradox means that the strength of a system of regional banks consists in engendering in the minds of people a comfortable feeling of protection against the dangers of an autocratic central administration.

The Federal Reserve System, in other words, is a product of this country's populist roots, with its inherent suspicion of "big" institutions. This uneasiness, while currently somewhat dormant, is as real today as it was nearly ninety years ago. If, for whatever reason, the System's structure were dismantled or seriously altered, the resulting weakening of the System's connections to the community, loss of regional directors with local oversight, and reduction in the System's effectiveness in communicating with the broad populace of the United States would provide substance to such uneasiness. And, in my opinion, we would likely see a significant decline in the Federal Reserve System's ability to successfully meet its three core mission areas – monetary policy, supervision, and financial services.

Fragmented but Whole

There is a final reason for this unique structure that goes beyond politics and public opinion – operational effectiveness. Jared Diamond, the Pulitzer Prize-winning author of *Guns, Germs, and Steel*, said it best when he noted, "History tells us that authority should be neither too centralized nor too diffuse. Organizations, from business to states, function best when they are optimally fragmented." So it is with the Federal Reserve System. It is fragmented across the United States and yet, when necessary, its components can function as one organization with a single purpose and a loyal, effective cadre of people who know their jobs and communities.

10th District Boards of Directors and Advisory Councils

Boards of Directors
Confer on economic and banking developments and advise the Bank on its operations and policies.

Economic Advisory Council
Provides the Bank with perspectives on economic conditions and business issues.

Community Development Advisory Council
Supplies information about community economic development issues and needs.

Financial Services Customer Advisory Council
Identifies current and emerging issues in payments services and provides information on payments system trends.

Credit Union Customer Advisory Council
Encourages discussion of issues specific to credit unions.

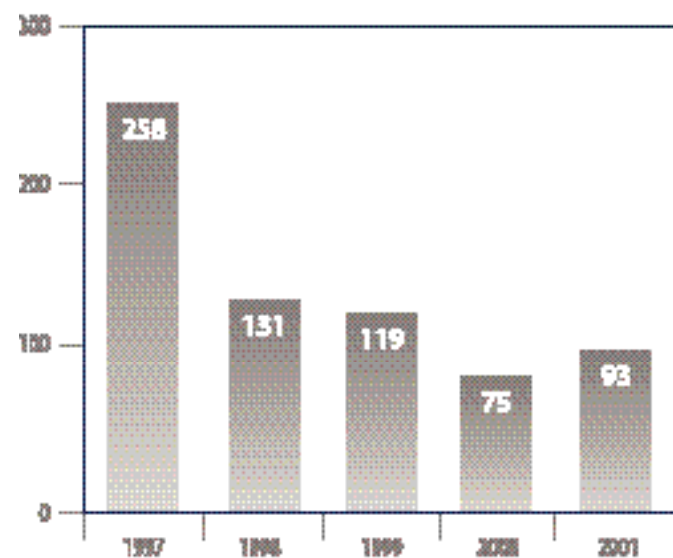
We must continue to examine how the information economy will alter the structure of financial, product, and labor markets.

We must also address the key policy challenges that arise in the information economy.

Changing Times Require the Federal Reserve to Change

In saying all this, of course, I acknowledge that times and situations change and that if the Federal Reserve is to maintain the public trust, it must change as well. Indeed, how the Federal Reserve prepares for the future will be one of its greatest challenges in the coming years and will determine its level of success.

Automated Clearinghouse Originators
New 10th District Customers



As the Federal Reserve goes about the process of change, it must do so in a manner that carefully balances goals that are enormously complex and sometimes competing. It must hold its vision dear, appreciate its trio of central bank responsibilities, and respect its decentralized structure and role as the central bank of the United States. But it also must balance these priorities with the need to adopt new ways of operating, embrace new technology, and be sensitive to cost pressures affecting all modern institutions.

Today, the rapid changes and operational advantages facilitated by technology have led the

Federal Reserve to focus on harvesting these advantages for itself. This has resulted in an enormous Systemwide focus on the issues of operational scale and cost containment. Because technology, especially communication technology, requires significant capital investments in equipment and software, the need to capture economies of scale is real and appropriate. From nearly every perspective, the drive toward efficiency is unrelenting and understood as necessary within the Federal Reserve System.

Mission

mission 3

Supervision & Regulation

Our mission is to promote the safety and soundness of the nation's banking and financial systems by ensuring compliance with applicable laws and regulations, while encouraging institutions to meet the credit needs of all segments of their communities. Consistently carrying out this mission inspires public trust and confidence in our ability to ensure the availability of credit in any situation.



Our System project leadership allows us to coordinate efficiencies while retaining our District's individuality.

Check Standardization Project - Central Check User Support, Central Implementation Team, and Payor Bank Services Software Development

PeopleSoft Nationally Provided Support Service

Customer Relations Support Office

Consolidated On-Line Customer Support for Funds Transfer and Book-Entry Securities Services

FederalReserveEducation.org Development

Large Complex Banking Organization (LCBO) Coordination

If the Federal Reserve fails to seek out better and more efficient ways to operate, it will soon find itself unable to deliver services effectively and will be legitimately subject to criticism. However, as I have said elsewhere, we must be thoughtful as we pursue lower costs. There are other long-term implications that follow if the Federal Reserve allows itself to be driven only by cost factors.

While the Federal Reserve is committed to providing services in an efficient manner, it must also remain aware that, foremost, it is a "central bank" – not a commercial bank. As such, its principal obligation is to deliver value in the form of financial stability and reliability, and, at times, it must look beyond factors such as cost or market share. For example, if consolidating operations to achieve economies of scale involves a loss of local flexibility, the result may be a significant trade-off in performance levels or the ability to react to local events such as the September 11 crisis. Would the response and outcome have been as exceptional if the Federal Reserve were a monolithic organization? I don't believe so.

Organizational Models for Managing Processes

So, what should we do in these circumstances? How do we, as a central bank, act responsibly in bringing value to the public domain? We must constantly remind ourselves of our vision and carefully balance the need to be efficient and the political realities within which we operate against the demands that our vision and mission areas require over the long run.

Organizational models are emerging that may help us to better understand and balance such trade-offs. These models are geared toward managing processes, such as the Federal Reserve's wholesale and retail payments operations, across business lines and regions.

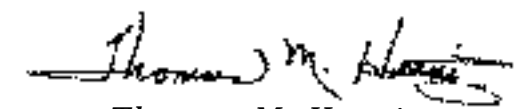
In these models, the operation is assigned an "owner" – for example, one Reserve Bank. The owner has significant authority over how the Systemwide operation is conducted, and leads design and budget development for that activity. The other regional banks are expected to help develop and then follow the agreed design for the process or product. Because the local Reserve Banks are familiar with their constituencies, they each have a clear responsibility to identify unique regional issues during the design process. In the end, the regional Reserve Banks and the operation owner must work as partners to ensure success.

This is the model that the Federal Reserve System is adopting as it carries out certain aspects of its core missions. The goal is to remain responsive to our regional responsibilities while delivering services on a national scale, at reasonable costs, under normal and sometimes stressful circumstances. In other words, the goal is to preserve the best of the old, adapt to the new, and ultimately fulfill our three responsibilities in a way that adds value to the national financial and market economy.

Conclusion

Well-advised monetary policy, innovative financial services, and consistent supervision are all essential to our vision of a central bank that inspires trust and confidence in our customers and the public. These parties trust that our core services are available and that our money and financial system runs well, under the most normal or the most difficult of circumstances. We must inspire confidence that all parties have a voice and are served by a regional organization that works effectively on a national scale.

Finally, the Federal Reserve Bank of Kansas City's Annual Report this year reflects our strong sense of our importance as a regional institution – though, I would like to think, with the right degree of objectivity. In the final analysis, we are proud of our unique structure, of our Federal Reserve System heritage, and of the way we serve the financial industry, our community, and the nation.



Thomas M. Hoenig