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MISSION

The Federal Reserve Bank of Philadelphia is one of 12 regional Reserve Banks in the United States that, together with the Board of Governors in Washington, D.C., make up the Federal Reserve System – the nation's central bank. The System's primary role is to ensure a sound financial system and a healthy economy.

To foster this goal, the Federal Reserve Bank of Philadelphia helps formulate and implement monetary policy, supervises banks and bank holding companies, and provides financial services to depository institutions and the federal government. The Philadelphia Fed serves the Third District, which is composed of eastern Pennsylvania, southern New Jersey, and Delaware.

"STRATEGY FOR CHANGING TIMES" is more than the theme of this year's annual report. It is a basic tenet for how we do business. What worked yesterday may not be as effective tomorrow. The current business environment requires adaptation and flexibility to prepare for future needs. At the Federal Reserve Bank of Philadelphia, we adhere to a strategy that reveres stability yet allows for change, seeks innovation yet inspires confidence.

This year's annual report theme, "Strategy for Changing Times," outlines our moves to strengthen our overall position. We trust you will find "Strategy for Changing Times" informative. As always, our strategy begins with our president…

Dr. Anthony M. Santomero, President

Our strategies evolve, but our focus on excellence remains constant.

OUR STRATEGY is straight

The year 2002 was a challenging one for our country, filled with financial uncertainty and geopolitical turmoil. Economically, the rise from recession was slower and more difficult than initially anticipated. Indeed, the future course of the economy is still very much on everyone's mind.

Times such as these challenge the Federal Reserve in all its dimensions — as monetary policymaker, as regulator, and as payments provider. I am proud of the contributions the Philadelphia Reserve Bank makes to meet those challenges.

Our strategy for facing these trying times is straightforward: to learn and to lead. Though simple, it serves us well as a "Strategy for Changing Times."

TO LEARN

The cornerstone of our strategy is to continue to build upon our knowledge of the financial services industry and the economy at large. Rapid change is a fact of life; so we constantly strive to develop new knowledge and new capacity to ensure financial system integrity and economic stability.

One example is the recent establishment of the Payment Cards Center. The Center engages in intense study of evolving techniques in retail payments. Use of credit cards, debit cards, and other new methods of payment is growing rapidly, and the Center provides meaningful insights into payments innovations and the issues they raise.

To help build knowledge and capability in the regulatory arena, we recently began a project to quantify the impact of growth in retail credit on the overall safety and soundness of the financial system. This project leverages the expertise we developed in our extensive analysis of consumer credit risk and the credit card industry concentrated in our District.

As part of our effort to build knowledge as monetary policymakers, we held our second annual Policy Forum last year. The Forum brought together central bankers and policy experts from around the world to debate the value of international coordination in setting domestic monetary policy.

processing network that positions the Fed to continue delivering check services at reasonable prices to its customers all across the country.

On the more technical side, the Bank continues to lead System efforts to combat check fraud. In partnership with both industry groups and the U.S. Treasury, we are finding ways to turn new technologies into workable solutions to this serious problem.

Behind the scenes, our Bank also helps the Federal Reserve System maintain and enhance the application of technology to its business processes. We oversee the System's infrastructure for e-mail, videoconferencing, collaborative systems, and important aspects of information security.

forward: to learn and to lead

TO LEAD

As we increase our knowledge, we increase our capacity and propensity to lead. The Philadelphia Fed has taken a leadership role in a number of important Federal Reserve System initiatives, as well as pursuing some initiatives of its own here in the District.

This past year, our Bank had the opportunity to help develop and implement major changes in the Fed's discount window facility. These changes make it easier for banks in sound financial condition to obtain short-term loans from the Federal Reserve.

We also contributed to a broad review of the Fed's check clearing operations that led to a substantial restructuring and consolidation of processing sites. The result is a more efficient

In 2002, we also expanded our outreach to consumers of financial services in the District. Educational programs developed and promoted by the Philadelphia Fed help consumers make better financial decisions. In low- and moderate-income communities — often targets of unscrupulous business practices — we help people understand risks and evaluate alternatives. In District classrooms, we help young people understand the workings of the economy and the financial system in which they are just beginning to participate.

STRATEGY FOR CHANGING TIMES

Through learning and leadership, we will do our part to advance the Fed's mission of fostering a sound financial system and a healthy economy.

In addition, we started a new project to broaden our public outreach, taking advantage of our unique location on Independence Mall. Our financial exhibit, Money in Motion, will open in July 2003. Using technology and interactive displays, visitors will learn about the country's financial history, as well as the history of the Federal Reserve System and its unique role in the nation's economy.

LOOKING AHEAD

As we move into 2003, I am optimistic about the future. I see this year as one in which the economic recovery gains momentum, positioning our nation for a period of sustained economic expansion. Indeed, the ultimate drivers of healthy growth — technology, productivity, and globalization — are very much in place. Despite near-term uncertainty, people have confidence in our economy's long-term potential. Indeed, this confidence itself bolsters growth and ensures our ability to reach that potential.

The future of the Third District economy is equally promising. Over the past several decades, our District has evolved into a microcosm of the national economy, and it now tracks national economic developments quite closely. So, I expect our region to be a full participant in the national economic expansion that lies ahead.

The banks of the Third District are positioned to support that growth. They fared well through the recession and the early stages of this recovery. Through prudent risk management and responsiveness to shifting customer demands, they have performed admirably in very challenging times. I am confident they have the capacity to meet District demands for credit and other financial services in the months and years ahead.

Here at the Philadelphia Fed, we look forward to the new challenges and new opportunities changing times will bring. Through learning and leadership, we will do our part to advance the Fed's mission of fostering a sound financial system and a healthy economy.

BOARD OF DIRECTORS

Recent events remind us about the important role that boards of directors play in guiding organizations. Reserve Bank boards of directors not only oversee the operations of the Reserve Bank, but they also contribute to the formulation of Fed policy on behalf of the District. It is a responsibility they take seriously and perform admirably. So, I want to acknowledge recent changes to the board of directors of the Federal Reserve Bank of Philadelphia:

Glenn A. Schaeffer, president emeritus of the Pennsylvania Building and Construction Trades Council, has been appointed chairman of the board, and Ronald J. Naples, chairman and CEO of Quaker Chemical Corporation, was appointed deputy chairman.

We are grateful for the guidance provided by two directors who completed their terms of service last year: our former chairman, Charisse R. Lillie, partner at Ballard Spahr Andrews & Ingersoll, and Frank Kaminski, Jr., chairman, president, and CEO of Atlantic Central Bankers Bank.

We welcome our two new board members: Garry L. Maddox, CEO of A. Pomerantz & Company, and Kenneth R. Shoemaker, president and CEO of Orrstown Bank. We look forward to the insights they will surely provide.

In addition, Rufus A. Fulton, Jr., chairman and CEO of Fulton Financial Corporation, has been reappointed to represent the Third District on the Federal Advisory Council to the Board of Governors.

On behalf of all of us here at the Philadelphia Fed, I thank them for their leadership and their commitment to public service.

CLOSING THOUGHTS

In closing, and in light of our country's continued state of heightened security awareness, it is important to stress that we stand ready to maintain the integrity of the financial system — to supply liquidity, assist financial institutions in need, and maintain the payments system.

As part of the Federal Reserve System, the Philadelphia Fed is an organization with a clear calling to public service. We remain a high quality provider of central bank services and continue our quest to be broadly recognized as an important center of central bank knowledge and capability.

As the year 2002 so clearly demonstrated, times change and our strategies must evolve. But our focus on excellence remains constant. Looking ahead, we will continue to foster an environment of strength and growth for our region's economy. ■

Anthony M. Santomero
President
April 2003

CHANGING TIMES demand new

As the financial environment evolves and new technologies emerge, the Federal Reserve focuses on the most efficient and effective ways to fulfill its missions. First Vice President Bill Stone offers his insights on the evolution of the Federal Reserve System and the Philadelphia Fed's key role.

SPECIALIZATION AND EFFICIENT USE OF RESOURCES

Each of the 12 Reserve Banks in the Federal Reserve System expends great effort on issues concerning national monetary policy. Each Reserve Bank also does specialized research unique to its regional environment. For example, Philadelphia area researchers are more interested in factors influencing the health-care industry and payment card providers because of the predominance of these activities in the District.

Financial institutions, too, have specialized and expanded into new financial vehicles. From a supervision and regulation perspective, uniform expertise is not required in every Federal Reserve District. Rather, sharing expertise across District lines ensures we are using resources effectively to best serve our financial institutions.

In providing services to the financial community and the U.S. Treasury, we have found that not all aspects of a service can be provided efficiently on a local basis. This is particularly true with changes in technology and the reduced reliance on paper transactions and documents.

William H. Stone, Jr., First Vice President

An example of this is the Fed's participation in the ownership of government securities by individuals. U.S. Treasury securities are often purchased by consumers through TreasuryDirect[SM], the first Systemwide consolidation of services, which found its home at the Philadelphia Fed back in the mid-1980s. Holding these securities in book-entry form made maintaining accounts at a single site a logical option.

Payments activities have also been in transition. As large-dollar payments and automated clearinghouse payments have become more electronic, geographic proximity has become less important. This consolidated processing brings significant improvements in efficiency.

strategies for quality and efficiency

CHANGES IN CHECK INFRASTRUCTURE

During the early 1970s check payments were being influenced by a strong set of demands. Faster funds availability led to an expansion in Federal Reserve facilities as regional check processing centers opened to offer later deposit deadlines and improved funds availability. Despite predictions of their demise, check payments increased at a brisk pace.

Then, the mid-1980s ushered in electronic means for banks to provide information about check payments prior to processing the physical paper. Customers gained the advantage of earlier quality information, while banks avoided the demands of expensive additional processing equipment.

In the late 1990s, image processing furthered the decline in reliance on the physical check. In addition, the accelerating growth of electronic payments has led to declines in check volumes. Consequently, the Federal Reserve is re-examining its check infrastructure and reducing the number of processing sites.

The changes in check infrastructure are still limited by geographic constraints. Check service levels must be maintained, and the requirements for physical delivery of checks, although lessening, are still the primary limiting factor. Passage of the Check Truncation Act would open many additional opportunities for innovation in check processing and remove many of the geographic restraints. Banks would then be able to truncate — or stop the flow of — checks, process them electronically, and create machine-readable substitute checks that would be the legal equivalent of the original checks. The act, now in Congress waiting consideration, would remove certain legal impediments and would enhance the efficiency of the payments system.

OPPORTUNITIES FOR LEADERSHIP

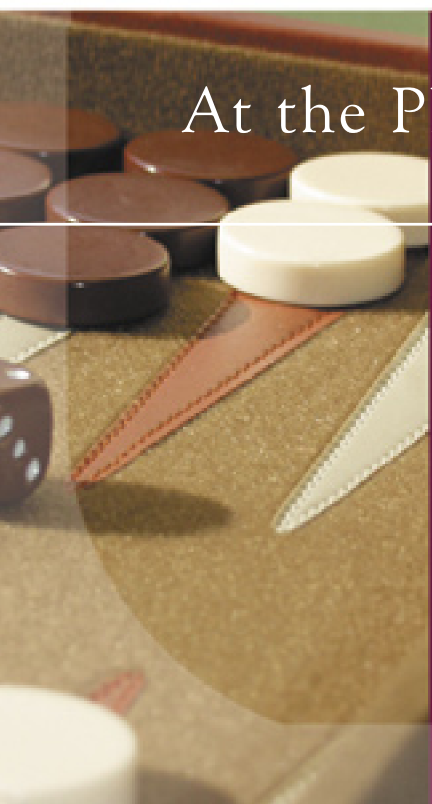
When consolidation and centralization take place, they offer the opportunity for leadership and capitalization on special capabilities. This has been the case for a number of Fed services, such as collateral management for financial institutions and special payments applications for the U.S. Treasury.

Within the Federal Reserve System, the Philadelphia Fed has an outstanding reputation for leading System projects and an impressive portfolio of current leadership assignments. For example, we have earned a central role in the Fed's technology initiatives through our oversight of the planning, implementation, and functional enhancements to the shared technology — or Groupware — for the entire Federal Reserve System. Philadelphia also was asked to provide analysis on how to improve the effectiveness and efficiency of information security across our distributed processing platforms.

As the largest single Fed site for check processing and also one of the most sophisticated and efficient operations in the System, Philadelphia is a major source of innovation and leadership. Philadelphia was asked to lead the effort and make recommendations on check infrastructure, leading to the decisions announced in early 2003. We are currently engaged in research for the System and the U.S. Treasury to combat check fraud. In addition, we are working to develop a new check information and reconcilement system for the U.S. Treasury.

At the Philadelphia Fed, we take advantage of change to leverage our strengths, pursue leadership opportunities, and share our capabilities with the entire Fed System. When financial institutions access the services of their regional Reserve Bank, they do so with the confidence that the full arsenal of Fed resources and capabilities is behind them. This way, the power of sharing best practices is put to use to deliver superior, high quality customer service.

Our goal is to continue to provide the highest quality service in the most efficient and effective manner possible. We at the Federal Reserve Bank of Philadelphia are committed to quality, innovation, and responsiveness. We will strive to make strategic investments that allow us to contribute to the System and serve our Third District stakeholders. ■



At the Philadelphia Fed

We take advantage of change to leverage our strengths, pursue leadership opportunities, and share our capabilities with the entire Fed System.

OPERATING STATISTICS

In 2002, Philadelphia's total volume of commercial checks processed decreased 4 percent. Conversely, the dollar value of transactions increased 4 percent. Beginning in January 2002, the Bank started phasing in its newly assumed responsibility for processing all government checks for the First, Second, Third, and Fourth Federal Reserve Districts.

The Philadelphia Bank continued to be a major processor of cash in the Federal Reserve System in 2002. The volume of currency processed increased 3 percent while the related dollar value increased 12 percent, both attributable to normal growth. The substantial decrease in coin processed was the result of the August 2002 elimination of some processing of lower denominations of coin. The substantial decrease in food coupons processed was a result of the consolidation of this function in January 2002.

In 2002, both the number and value of loans to depository institutions were lower than in the previous year.

	2002 Volume	2002 Dollar Value	2001 Volume	2001 Dollar Value
SERVICES TO DEPOSITORY INSTITUTIONS				
Check processing:				
U.S. government	52.8 million checks	$64.5 billion	40.9 million checks	$37.1 billion
Commercial checks	1,282.6 million checks	$2,594.7 billion	1,339.8 million checks	$2,501.3 billion
Cash operations:				
Currency processed	2,116.7 million notes	$41.2 billion	2,053.8 million notes	$36.8 billion
Coin processed	23.8 thousand bags	$16.4 million	52.5 thousand bags	$29.9 million
Loans to depository institutions	68 loans	$210.3 million	96 loans	$503.3 million
SERVICES TO U.S. TREASURY				
Food coupons processed	551 thousand coupons	$2.8 million	6.4 million coupons	$34.3 million

Note: Because of the consolidation of Federal Reserve System wire transfer of funds and electronic book-entry transfer operations to other Federal Reserve offices, related statistics are no longer shown here.

CHANGING TIMES mean improved

As our nation's central bank, the Federal Reserve is responsible for the integrity of the financial system and views risk management as a key element of bank supervision. Mike Collins, senior vice president, Supervision, Regulation and Credit, tells how Philadelphia is establishing advanced approaches to quantifying retail credit risk.

As a regulator and supervisor of financial institutions, the Fed must expand its knowledge of the broad financial industry to ensure its integrity and stability. The Philadelphia Fed is leading a Systemwide effort to develop a supervisory framework to evaluate bank practices in retail credit risk management, including internal risk rating systems.

This project, which will enhance the Federal Reserve's ability to assess banking organizations' retail credit risk quantification methods, responds to gaps in the Basel II framework. Basel is a landmark international agreement on bank capital standards and risk-based regulation. Until quite recently, bank and supervisory resources have concentrated on credit risk modeling of commercial and industrial portfolios, with fewer resources devoted to understanding risk in the retail credit area, which includes such common consumer instruments as mortgages, credit cards, and auto loans.

However, despite the emphasis on the commercial side, retail credit is a substantial part of the risk borne by the banking industry. Recognizing this, the industry has begun to develop more sophisticated credit-scoring models for measuring retail risk.

DEVELOPING RETAIL CREDIT RISK MODELS

The revolution in information and communications technology has led to the emergence of consumer credit-scoring models as a mainstay technique. As a result, we now have more efficient means to slot individual loans into appropriate risk classes. This has led to greater potential for risk-based pricing and targeted marketing in retail lending; however, there is much ground still to be covered.

While the sophistication of automated credit scoring has increased, only recently have some institutions put resources into advanced methods of retail portfolio credit risk modeling. Additionally, quantifying the risk in retail portfolios places an even greater premium on a bank's ability to accurately differentiate the credit quality of borrowers. It also requires an acute understanding of the contributions of retail credit to both risk and return. For example, problems in accurately predicting performance in sub-prime portfolios proved detrimental to some institutions' overall level of risk, as we have seen in 2002.

THE PHILADELPHIA FED'S PROJECT

Given the recent developments in the retail sector, regulators must gain a greater understanding of current industry practices and areas for potential improvement. The Philadelphia Fed has distinguished itself as an expert hub of emerging industry issues and a vital resource in identifying and implementing industry best practices. Consequently, we have the important System responsibility to expand the Fed's knowledge of advanced approaches to quantifying retail credit risk. Our efforts focus on three main goals:

First, we document existing policies and practices among institutions capable of effectively measuring retail credit risk. Toward this goal, we have joined with other U.S. regulators in conducting interviews at several large banking organizations. These interviews help us identify current practices in evaluating retail credit risk and improve our knowledge of current industry practices. We are using this information to compare banks' current practices with the Basel II proposal for an internal

Michael E. Collins, Senior Vice President and Lending Officer

practices and increased responsibilities

ratings-based (IRB) approach to retail credit.

Our second goal is to analyze the reliability of current practices and assess their weaknesses or gaps. That way, we can spot problems supervisors need to address in assessing internal risk and capital adequacy in the retail credit area.

Our third goal is to identify major analytical issues in quantifying retail credit risk and to generate relevant research. In this way, we can identify priority policy issues for the Federal Reserve and other banking regulators and make recommendations on how to tackle them. Philadelphia's work is the beginning of a necessary and important long-term effort in the retail credit arena.

Throughout 2003, Philadelphia will develop a research agenda on retail credit risk quantification. We are now preparing research analyzing strengths and weaknesses of existing retail risk quantification standards at large U.S. banks. Our findings will be presented at various forums to educate the industry on these issues. We will also lead efforts of the Federal Reserve System and other U.S. banking regulators to develop training curricula for supervisory staff on IRB standards and examination guidance.

Constructive dialogue between financial institutions and their regulators means standards progress and practices improve. With more experience and better information, risk parameters will change and models will get stronger and more efficient. Rather than a uniform regulatory standard, financial institutions will develop their own assessments and procedures that accurately capture retail credit risk. ■

While technology has brought about innovations in the financial services industry, it has also enabled more sophisticated methods of fraud. Consequently, we need increasingly sophisticated technology to detect fraud. That's why the Retail Payments Office (RPO) asked Philadelphia to lead an investigation into ways to prevent check fraud. Arun Jain, vice president, Retail Payments, talked about the Bank's role in two pilot programs.

Since Philadelphia has a close working relationship with the Treasury Department, it made sense for us to jointly undertake this project. Furthermore, Treasury checks are a major target for fraud.

Basically, detecting check fraud has two facets: the application of fraud-prevention technology and machines that can read new security features. Right now, there are four types of technologies in this area: laser ink, two-dimensional barcodes, seal encoding, and digital watermarking. Our pilot programs involved these last two technologies. Initially, we used test checks from the Treasury. The seal encoding pilot used production checks issued by the Federal Reserve Bank of Philadelphia for Treasury-related payments, and the digital watermarking pilot used simulated test checks.

Seal encoding technology conceals information (for example, the dollar amount, account number, payee name, or issue date) within the body of the check in order to detect altered or counterfeit checks. It's similar to two-dimensional barcoding, but not as visible. (See sidebar.) For instance, you can hide data in a corporate logo on a check. Someone looking at the check may not see a difference, but the right detection software can read the hidden information and match it to what is on the magnetic ink character recognition (MICR) line that's printed on the bottom of a check. The pilot showed that seal encoding works in some situations, but not all.

The second pilot applied a digital watermark to the body of the check. The idea is that photocopiers and high-resolution scanners won't pick up and subsequently print the watermark, thus making it harder for counterfeiters to copy checks.

CHANGING TIMES mean new ways

High speed sorters such as this one process checks using magnetic ink character recognition.

One advantage here is that digital watermarking can cover a wide area of the check. Since checks can be mishandled and mutilated, it's better to have the fraud-detection feature in more than one part of the check. One problem with both of these technologies is that good checks are sometimes flagged as altered or counterfeit, and it costs both time and money to verify the so-called false positive checks.

RESULTS

Working with other Reserve Banks, we tested seal encoding and digital watermarking on both IBM and Unisys sorters. That way, we could note differences between the types of sorters.

of detecting fraud

These pilots involved true research and development work. Although these technologies are used for fraud detection in other industries, we are trying to validate their applicability in the checks arena. Cost/benefit analyses will be important determinants of which technologies are finally adopted.

Our initial report of the outcome will go to the RPO and Treasury. Subsequently, we'll share the outcome with the banking industry. The results for these various pilot programs will determine if Treasury is ready to adopt one or both of these technologies.

Our goal is to aid the banking industry by helping to develop new methods for reducing fraud, which costs the industry — and consumers — millions of dollars every year. ■

Chemical Inks and Two-Dimensional Barcodes

Chemical Inks. The idea behind chemical inks is to invent a process that places an invisible mark on a check that cannot be reproduced and is manufactured only in secure printing arrangements.

Testing for the chemical ink would be accomplished via special scanning devices licensed by the technology owner. Low-cost scanners would shine a special ultra-violet or laser light spectrum onto the paper to test for reflection from the chemicals. Checks expected to have this invisible chemical ink would be considered genuine if the test is positive and assumed to be counterfeit if the test fails.

Two-Dimensional Barcodes. Two-dimensional barcodes are the modern equivalent of the universal product code (UPC) found on most products in grocery stores and other retail outlets. But unlike the long, varying-width lines that code eight to 12 digits of product code data, 2-D barcodes can carry a payload of hundreds of bytes of data.

Low-cost digital scanners and decoding software would be used to test the 2-D barcode. Existing digital scanners on high-speed check-processing equipment could be used to test for the existence of a 2-D barcode and to compare it with the MICR line at the bottom of the check and visual data.

CHANGING TIMES mean new Paper to Electronic Payments

Over the past decade, consumers have moved away from paper forms of payment — checks and cash — to payment cards and other electronic methods. Acknowledging this shift in consumers' behavior, the Philadelphia Fed established the Payment Cards Center to serve as a source of expertise on this important segment of the financial system. The Center's director, Peter Burns, elaborated on the Center's mission and achievements to date.

Although cash and checks remain popular methods of payment, consumers are turning more frequently to electronic methods, such as credit cards, debit cards, smart cards, stored-value cards, and other emerging payment technologies. In fact, since 1979, consumer electronic payments have grown from approximately 5 billion transactions a year to about 30 billion. The pace of change is further accelerating as consumers become increasingly comfortable with these new payment mechanisms.

USING NEW PAYMENT METHODS

After cash and checks, credit cards are probably the most familiar method of payment and the payment vehicle of choice for many consumers. Right now, about 80 percent of Americans use credit cards, and most carry several different cards in their wallets. At the same time, use of debit cards, which are directly linked to consumers' bank accounts, is growing even faster than credit cards. Simultaneously, banks, retailers, and other businesses are experimenting with various other electronic payment vehicles that add convenience and efficiency to the retail payments arena.

Migration from paper to electronic payments will drive investments in product development, operations, technology, marketing, and business infrastructure.

HIGHLIGHTS IN 2002

To carry out its mandate to monitor trends in the industry and provide insights into this evolving field, the Payment Cards Center has launched a variety of projects over the past two years.

In 2002, we held a series

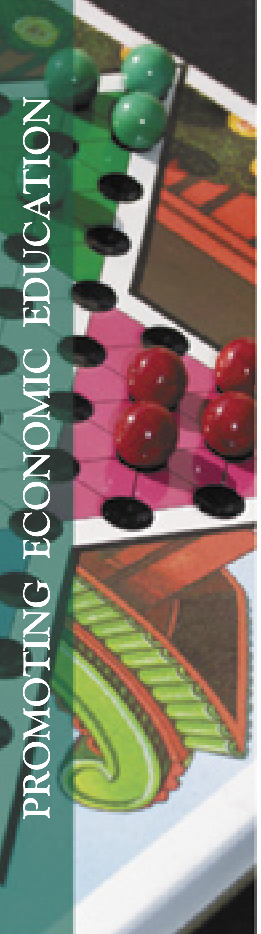
Jeanne M. Hogarth (left), program manager, and Marianne A. Hilgert, research assistant, Consumer Policies Section, Board of Governors of the Federal Reserve System, participated in the Payment Cards Center's workshop "Voting with Your Feet: Consumers' Problems with Credit Cards and Exit Behaviors."

ways of making payments

of workshops featuring industry experts on a wide range of topics, including the role of credit reporting agencies, financial privacy, and credit risk management practices. We also co-sponsored three major conferences: one with the Bank's Research Department, one with the Wharton Financial Institutions Center, and one with the Electronic Funds Transfer Association's E-Commerce Payments Council. These conferences brought together representatives from the academic, industry, and policy communities to debate critical issues in consumer payments.

Discussion papers, which offer business analyses of issues related to payment cards, constitute another aspect of our work. These papers, which are available in hard copy, are also posted on the Center's web site, allowing even wider distribution. Furthermore, the Center is committed to supporting academic research on payment-card topics and works with the Bank's Research Department in fulfilling this part of its mission. In addition, the Center's visiting scholars program brings academic researchers to the Bank, usually for one or two academic semesters, so they can pursue their research interests.

This past year, we expanded our programs and honed our expertise. Now it's time to look ahead. In the coming year, we will work to further engage industry practitioners and academic and consumer representatives in our activities and design programs that effectively address their concerns. ■



CHANGING TIMES mean a greater

Easier access to credit and increased instances of predatory lending have created a greater need to educate the public about financial services. To meet this need, the Community Affairs Department at the Philadelphia Fed has expanded its programs in economic education and financial literacy. The department's economic education specialist, Andrew Hill, described some of the new ventures.

Financial literacy is an important topic these days. The headlines tell the story: Americans hold more debt than ever before, personal bankruptcies are at an all-time high, and people continue to fall victim to financial scams and predatory lenders.

The proliferation of check cashing outlets has had an effect. In many low- and moderate-income neighborhoods, these outlets offer convenient locations and hours. People use them in spite of the very high fees they charge. Also, many people in our society have no regular relationship with a financial institution. Consequently, the people who can least afford it are being hit with high fees, and sometimes high interest rates, from tax preparers, check cashing facilities, payday lenders, and rent-to-own furniture stores.

As these problems have become more prevalent, there has been a push to do something about them. In response, the Community Affairs Department has renewed its commitment to increasing financial literacy and has created some new initiatives in economic education.

TEACHING THE TEACHERS

In our economic education program, we want to make people aware of the Federal Reserve System and the workings of the economy in general. We're also developing financial literacy programs that target both young people and low- and moderate-income adults. We want to keep young people from getting into financial trouble and help adults find their way out of it. So we teach them about credit, bank services, and saving. Also, we introduce such economic concepts as the allocation of scarce resources and the idea that a choice they make today may mean giving up something later.

Some states mandate economic education at the high school level; other states voluntarily include it in their curricula. But, unfortunately, many high school teachers are ill-equipped to teach economics and finance. That's where we hope to have an impact. We're following a train-the-trainer model. Rather than being directly involved with students, we're providing significant training to teachers so they can get the message across.

OUR SUCCESSES

To date, our biggest success has been in Delaware, where a financial literacy program introduced in one high school has now spread to seven other schools. Fortunately, we've built strong partnerships with the Delaware Bankers Association, the Consumer Credit Counseling Services of Maryland and Delaware, and the University of

Delaware's Center for Economic Education and Entrepreneurship. Although we lit the fire, our partners did 95 percent of the work.

We're hoping to replicate our Delaware success in Pennsylvania and New Jersey. To that end, we're building relationships with state councils on economic education and with economic education centers at colleges and universities.

COURSES AND OTHER PLANS

This summer, we'll offer teachers a graduate-level course on money and banking. We'll also participate with the University of Delaware and Millersville University in a separate graduate course for teachers.

Other plans include holding workshops and conferences. In fact, we've already hosted several events. Last summer, the department presented day-long programs to students in the Pennsylvania Governor's School for Entrepreneurship and to teachers as part of the Summer Institute of the South Jersey Chamber of Commerce. In October, teachers from Philadelphia and its suburbs came to the Bank for a seminar called "Hot Topics in Economics."

Thus far, our programs have been well received by Third District teachers and consumers. Our efforts also support the Bank's goal of making the Philadelphia Fed known as a center of central bank knowledge and capability. ■

need for economic education

Andrew Hill, economic education specialist, Federal Reserve Bank of Philadelphia, talks to a group of teachers about the importance of economic education.

Having a solid financial base is crucial to the work of the Federal Reserve Bank of Philadelphia. Donna Franco, vice president and chief financial officer, tells why strong internal controls are an essential part of that base.

Strong internal controls are important to the financial soundness and integrity of any organization. But when you're the entity that sets monetary policy and fosters the integrity of the nation's payments system, such controls are vital. The Philadelphia Fed's stability – indeed, that of the Federal Reserve System – is underlined by stringent internal controls.

In fact, we believe the more creative and innovative we want to be, the more crucial these controls are. Bear in mind that many of the initiatives you've read about in this report are possible because strong internal controls are in place.

REINFORCING CONTROLS

How do we reinforce such controls? First, the Bank's senior management sets the tone that is crucial to the control environment. Since strong controls are an integral part of the Bank's strategic direction, there are well-documented policies and procedures in place, which serve as ready references for control questions that arise.

Second, in addition to our own controls, which are guided by the precepts of the Board of Governors in Washington, D.C., we also benefit from periodic reviews by the Board. Having dual controls gives us

C H A N G I N G   T I M E S   m e a n

Donna L. Franco, Vice President and Chief Financial Officer

a definite advantage over other organizations.

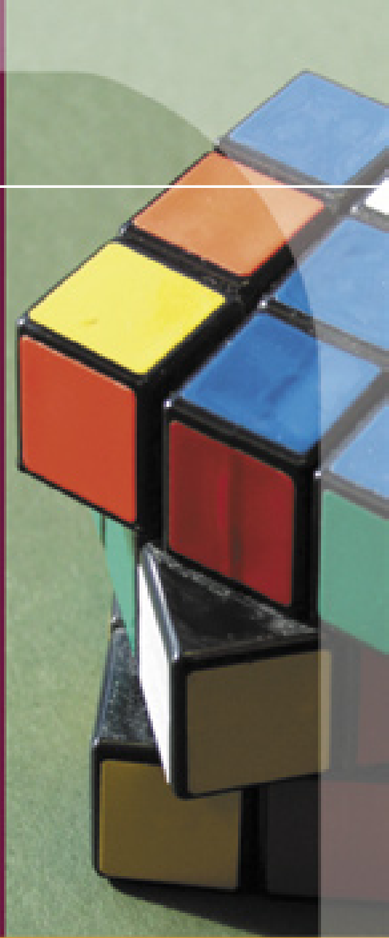
Third, and equally important, is the ongoing cooperation and communication among the various departments at the Bank. For example, the Bank's chief counsel and ethics officer provides valuable insight and support in maintaining the ethical standards so important to strong internal controls.

OTHER RELATIONSHIPS

Furthermore, Audit and Accounting have an important relationship. This liaison is particularly valuable when the Bank goes through its yearly evaluation process, which assesses the effectiveness of the Bank's internal controls. It also comes into play during the year-end financial audit with the Bank's accounting firm.

Internal Control System Components

- Control Environment — sets the tone and serves as a foundation for internal controls
- Risk Assessment — identifies and analyzes relevant risks to achievement of objectives
- Control Activities — includes policies and procedures that help ensure execution of management's directives
- Information and Communication — identifies and captures pertinent information and communicates it to relevant parties
- Monitoring — incorporates ongoing and periodic reviews of quality of internal controls



even stronger controls

Another important area of cooperation is between the Bank's Board of Directors and the Bank's management. Our Board's Budget and Operations Committee receives regular reports and periodic presentations, and we use these opportunities to address financial and operational issues. Similarly, the Audit Committee receives reports on the effectiveness of controls throughout the Bank.

RISK AND QUALITY

Of course, cooperation forms only part of the controls story. Controlling risk and promoting quality are also critical aspects.

On the risk side, a potential pitfall we face as a Federal Reserve Bank is reputational risk. We must be vigilant in all our activities to avoid tarnishing our image. With our reputation intact, we can move forward and take on new strategic initiatives.

Quality is another key feature of strong fundamentals. When an organization lacks quality, it spends too much time and money fixing mistakes. A lot of an organization's success depends on having the right people with the right skills in the right job.

THE BOTTOM LINE

So what's the bottom line? The Bank makes sure that all employees recognize their responsibilities in maintaining strong internal controls in their areas. Controls are a part of our normal routine — not a once-a-year checklist that we complete.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Robert E. Chappell (4)
Federal Reserve Bank of Philadelphia Board of Directors member since 2000. Member Budget and Operations and Personnel committees. Chairman and Chief Executive Officer of Penn Mutual Life Insurance Company. Member Insurance Federation of Pennsylvania and Taxation and Financial Services Steering Committee for American Council of Life Insurance. Serves on boards of Glatfelter, Quaker Chemical Corporation, South Chester Tube Company, LOMA, and Wharton Financial Institutions Center at University of Pennsylvania.

Walter E. Daller, Jr. (9)
Federal Reserve Bank of Philadelphia Board of Directors member since January 2002. Member Budget and Operations and Personnel committees. Chairman, President & CEO of Harleysville National Corporation. Chairman of Harleysville National Bank and Trust Company. Member of Board of Directors of Independent Community Bankers of America and TCM Bank of Tampa, Florida. Serves on boards of North Penn United Way, Lower Salford Historical Society, Muhlenberg House, Montgomery County Lands Trust, and Perkiomen Valley Watershed. Previously served as Federal Reserve Bank of Philadelphia's representative to Federal Advisory Council.

Doris M. Damm (3)
Federal Reserve Bank of Philadelphia Board of Directors member since January 2001. Member Audit and Personnel committees. President and Chief Executive Officer of ACCU Staffing Services. Other affiliations include Cerebral Palsy of New Jersey, Cherry Hill Economic Development Council, Our Lady of Lourdes Medical Center, Our Lady of Lourdes Foundation, and Cherry Hill Regional Chamber of Commerce.

Frank Kaminski, Jr. (1)
Federal Reserve Bank of Philadelphia Board of Directors member since 2000. Member Audit and Research and External Affairs committees. Chairman of Atlantic Central Bankers Bank. Professional affiliations include Pennsylvania Bankers Association, Independent Bankers Association of America, Pennsylvania Association of Community Bankers, and Bankers Bank Council.

Charisse R. Lillie (6)
Chairman, Federal Reserve Bank of Philadelphia Board of Directors. Board member since 1996. Chairman of litigation department of law firm of Ballard Spahr Andrews & Ingersoll, LLP. Member of Labor and Employment Law Group of firm's litigation department. Chair of American Bar Association Commission on Racial and Ethnic Diversity. Serves on numerous boards, including Juvenile Law Center, Friends Select School, Franklin Institute, and Leadership, Inc.

Ronald J. Naples (2)
Federal Reserve Bank of Philadelphia Board of Directors member since January 2001. Member Audit and Research and External Affairs committees. Chairman and Chief Executive Officer of Quaker Chemical Corporation. Chairman of the Board of the University of the Arts. Serves on boards of Glatfelter, Philadelphia Museum of Art, Franklin Institute, Foreign Policy Research Institute, Rock School of the Pennsylvania Ballet, and Greater Philadelphia First.

Glenn A. Schaeffer (7)
Deputy Chairman, Federal Reserve Bank of Philadelphia Board of Directors. Board member since 1998. Member Budget and Operations and Research and External Affairs committees. President Emeritus Pennsylvania Building and Construction Trades Council, Harrisburg. Co-founder Capital Area Labor Management Committee. Coordinator, Capital Area Labor Management Construction Partnership Coordination Project. Member of Executive Committee of Pennsylvania AFL-CIO, Governor's Committee on Economic Development through Labor Management, Pennsylvania Prevailing Wage Advisory Board, and Keystone Commission on Education and Employment in the 21st Century. Serves on Capital Blue Cross board.

P. Coleman Townsend, Jr. (8)
Federal Reserve Bank of Philadelphia Board of Directors member since January 2002. Member Budget and Operations and Personnel committees. Chairman and CEO of Townsends, Inc. Member of Board of Trustees of University of Delaware and Winterthur Museum. Serves on Council of Advisors for Delaware Center for Horticulture, Lehman Art Center Advisory Committee, Liberty Mutual Advisory Committee, and Board of Overseers for Delaware College of Art and Design.

Robert J. Vanderslice (5)
Federal Reserve Bank of Philadelphia Board of Directors member since January 2001. Member Audit and Research and External Affairs committees. President and Chief Operating Officer of Pennsville National Bank. Vice President of Penn Bancshares, Inc. Professional affiliations include Federal Reserve Relations Committee of New Jersey Bankers Association, Pennsville Economic Development Coalition, Penns Grove Rotary Club, and Salem County Chamber of Commerce.

2002 BUSINESS COUNCIL

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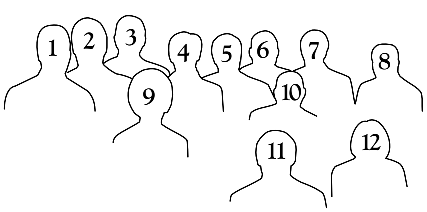
John K. Ball (11), Chairman, President & CEO
R.M. Shoemaker Co., West Conshohocken, PA

Lynn Banta (12), Owner
Twin Stacks Development Co. Inc., Dallas, PA

Michael F. Camardo (6), Executive Vice President
Lockheed Martin Technology, Cherry Hill, NJ

Chloe R. Eichelberger (9), Owner,
President & CEO
Chloe Eichelberger Textiles, Inc., York, PA

David J. Freschman (8), President
Delaware Innovation Fund, Wilmington, DE



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Sandra F. Holsonback,* Director
Small Business Development Center
Lehigh University, Bethlehem, PA

Dennis E. Klima (2), President & CEO
Bayhealth Inc., Dover, DE

Warren B. Matthews (3), M.D., President
Wyncote Family Medicine, Wyncote, PA

John Milligan (10), President
Milligan & Company LLC, Philadelphia, PA

Mitchell L. Morgan (7), President
Morgan Properties, King of Prussia, PA

Audrey S. Oswell (4), President & COO
Resorts Atlantic City, Atlantic City, NJ

Jeffrey J. Trester (5), Director and Co-CEO
PriceSCAN.com, Inc., Malvern, PA

William L. Wilson (1), Principal-in-Charge
Synterra, Philadelphia, PA

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Thomas J. Bisko,* President
The Quakertown National Bank, Quakertown, PA

Joseph E. Chippie,* President & CEO
First National Bank of Wyoming, Wyoming, DE

Thomas W. Cook,* Executive Vice President & CEO
The Bank of Landisburg, Landisburg, PA

John G. Gerlach (1), President & CEO & Director
Pocono Community Bank, Stroudsburg, PA

CHAIRMAN
Robert H. King (6), President,
Sterling Bank, Mount Laurel, NJ

William Leandri (4), President & CEO
Luzerne National Bank, Luzerne, PA

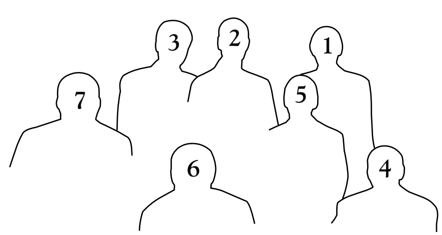
George W. Nise (7), President & CEO
Beneficial Savings Bank, Philadelphia, PA

John W. Ord (5), President & CEO
Peoples National Bank, Hallstead, PA

Frederick C. (Ted) Peters II (2), President & CEO
The Bryn Mawr Trust Company, Bryn Mawr, PA

Patrick M. Ryan (3), President and CEO
The Yardville National Bank, Hamilton, NJ

Wayne R. Weidner,* Chairman, President & CEO
National Penn Bancshares, Inc., Boyertown, PA



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2002 CREDIT UNION COUNCIL

Paula M. Albanese (5), President
Diamond State FCU, New Castle, DE

Barbara Arrowsmith (1), Manager
New Castle County Delaware Employees FCU
New Castle, DE

CHAIRMAN
Jo Ann Broderick,* President
First Commonwealth FCU, Lehigh Valley, PA

L. Edward Brzozowski (2), President
MON-OC FCU, Toms River, NJ

Dennis Flickinger (4), President & CEO
First Capital FCU, York, PA

John LaRosa (8), COO & Treasurer
Police and Fire FCU, Philadelphia, PA

James F. McCaw,* President & CEO
K of C FCU, Philadelphia, PA

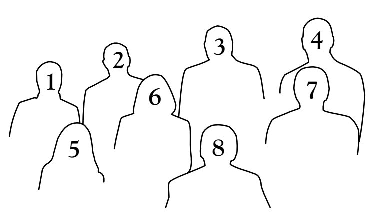
Thomas A. Phillips (3), General Manager
Lakehurst Naval FCU, Lakehurst, NJ

Diana L. Roberts,* President & CEO
Hershey FCU, Hershey, PA

C. Kipp Stecher,* President & CEO
AmeriChoice FCU, Mechanicsburg, PA

Judith M. Supplee (6), President & CEO
Keystone FCU, West Chester, PA

Virginia F. Williams (7), CEO
FAA Technical Center FCU, Northfield, NJ



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CURRENT OFFICERS

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President

William H. Stone, Jr.
First Vice President

Donald F. Doros
Executive Vice President

Richard W. Lang
Executive Vice President

Michael E. Collins
Senior Vice President and
Lending Officer

Loretta J. Mester
Senior Vice President and
Director of Research

John B. Shaffer
Senior Vice President and
General Auditor

Milissa M. Tadeo
Senior Vice President
Human Resources and
Treasury Services

John G. Bell
Vice President
Financial Statistics

Robert J. Bucco
Vice President
Wholesale Product Office

Peter P. Burns
Vice President and
Director
Payment Cards Center

Theodore M. Crone
Vice President and
Economist

Dean Croushore
Vice President and
Economist

John J. Deibel
Vice President and Chief
Administrative Officer
Supervision, Regulation
and Credit

Patrick L. Donahue
Vice President
Customer Relations

Michael Dotsey
Vice President and Senior
Economic Policy Advisor

William Evans, Jr.
Vice President
Information Technology
Services

Donna L. Franco
Vice President and
Chief Financial Officer

Joanna H. Frodin
Vice President
Supervision, Regulation
and Credit

Faith P. Goldstein
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Arun K. Jain
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Henry T. Kern
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Cash Services

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Purchasing,
Transportation, and
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Supervision, Regulation
and Credit

Edward M. Mahon
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General Counsel

Stephen A. Meyer
Vice President and
Senior Economic Policy
Advisor

Mary DeHaven Myers
Vice President and
Community Affairs
Officer

A. Reed Raymond, III
Vice President
Supervision, Regulation
and Credit

Richard A. Sheaffer
Vice President
Treasury Services

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Vice President and
Corporate Secretary

Vish P. Viswanathan
Vice President and
Discount Officer
Supervision, Regulation
and Credit

Eileen P. Adezio
Assistant Vice President
Supervision, Regulation
and Credit

Shirley L. Coker
Assistant Vice President
and Counsel

William L. Gaunt
Assistant Vice President
Supervision, Regulation
and Credit

Stephen G. Hart
Assistant Vice President
Human Resources

Mary Ann Hood
Assistant Vice President
Human Resources

Howard M. James, Jr.
Assistant Vice President
Supervision, Regulation
and Credit

John P. Kelly
Assistant Vice President
Retail Payment Services

Elisabeth V. Levins
Assistant Vice President
Supervision, Regulation
and Credit

Alice Kelley Menzano
Assistant Vice President
Information Technology
Services

Patrick M. Regan
Assistant Vice President
and Information Security
Officer

Anthony T. Scafide, Jr.
Assistant Vice President
Customer Relations

Ronald R. Sheldon
Assistant Vice President
Retail Payment Services

Marie Tkaczyk
Assistant Vice President
Information Technology
Services

Richard A. Valente
Assistant Vice President
and Assistant General
Auditor

Bernard M. Wennemer
Assistant Vice President
Supervision, Regulation
and Credit

Anthony J. White
Assistant Vice President
Customer Relations

Michael P. Zamulinsky
Assistant Vice President
Supervision, Regulation
and Credit

Mitchell S. Berlin
Research Officer and
Economist

Aileen C. Boer
Research Support Officer

Donna L. Brenner
Budget Officer and
Assistant Secretary
Accounting Services

Michael T. Doyle
Business Planning and
Analysis Officer

Linda K. Kirson
Office Automation
Support Officer
Information Technology
Services

Joseph L. McCann
Administrative Services
and Security Officer

Edward C. Morrison
Operations Officer
Information Technology
Services

Michelle M. Scipione
Cash Services Officer

Stephen J. Smith
Assistant Counsel

Includes promotions through March 2003

STATEMENT OF AUDITOR INDEPENDENCE

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2002 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $1.0 million. In order to ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2002, the Bank did not engage PwC for advisory services.

CONTENTS

LETTER TO DIRECTORS

FEDERAL RESERVE BANK
OF PHILADELPHIA

Office of the President

Federal Reserve Bank of Philadelphia
Ten Independence Mall
Philadelphia, PA 19106-1574

215-574-6432
215-574-3412 (fax)
www.phil.frb.org

March 3, 2003

To the Board of Directors

The management of the Federal Reserve Bank of Philadelphia 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, 2002 (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 ("Manual"), and as such, include amounts, some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the Federal Reserve Bank of Philadelphia 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 an effective process of internal controls, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements.

The management of the Federal Reserve Bank of Philadelphia assessed its process of 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, we believe that the Federal Reserve Bank of Philadelphia maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Federal Reserve Bank of Philadelphia

by ____________
Anthony M. Santomero, President

by ____________
William H. Stone, First Vice President

by ____________
Donna L. Franco, Chief Financial Officer

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Two Commerce Square, Suite 1700
2001 Market Street
Philadelphia PA 19103-7042
Telephone (267) 330 3000
Facsimile (267) 330 3300

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors of the
Federal Reserve Bank of Philadelphia:

We have examined management's assertion that the Federal Reserve Bank of Philadelphia ("FRB - Philadelphia") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the financial statements as of December 31, 2002, based on criteria described in "Internal Control - Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission included in the accompanying Management's Assertion. FRB - Philadelphia's management is responsible for maintaining effective internal control over financial reporting and the safeguarding of assets as they relate to the financial statements. Our responsibility is to express an opinion on the assertion based on our examination.

Our examination was conducted in accordance with attestation 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 performing 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 FRB - Philadelphia maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the financial statements as of December 31, 2002, is fairly stated, in all material respects, based on criteria described in "Internal Control - Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

PricewaterhouseCoopers LLP

March 3, 2003
Philadelphia, Pennsylvania

REPORT OF INDEPENDENT ACCOUNTANTS

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Two Commerce Square, Suite 1700
2001 Market Street
Philadelphia PA 19103-7042
Telephone (267) 330 3000
Facsimile (267) 330 3300

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Governors of The Federal Reserve System
and the Board of Directors of The Federal Reserve
Bank of Philadelphia:

We have audited the accompanying statements of condition of The Federal Reserve Bank of Philadelphia (the "Bank") as of December 31, 2002 and 2001, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of The Federal Reserve System. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 3, the financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of The Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of The Federal Reserve System, are set forth in the "Financial Accounting Manual for Federal Reserve Banks" and constitute a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2002 and 2001, and results of its operations for the years then ended, in conformity with the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

March 3, 2003
Philadelphia, Pennsylvania

STATEMENTS OF CONDITION

As of December 31, 2002 and December 31, 2001 (in millions)

	2002	2001
ASSETS		
Gold certificates	$ 430	$ 454
Special drawing rights certificates	83	83
Coin	61	44
Items in process of collection	494	526
U.S. government and federal agency securities, net	24,576	23,071
Investments denominated in foreign currencies	510	481
Accrued interest receivable	210	234
Bank premises and equipment, net	73	70
Other assets	96	91
Total assets	**$ 26,533**	**$ 25,054**
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	$ 18,624	$ 21,773
Securities sold under agreements to repurchase	811	–
Deposits:		
Depository institutions	577	413
Other deposits	3	2
Deferred credit items	556	100
Interest on Federal Reserve notes due U.S. Treasury	47	29
Interdistrict settlement account	5,391	2,239
Accrued benefit costs	51	51
Other liabilities	7	5
Total liabilities	26,067	24,612
Capital:		
Capital paid-in	233	221
Surplus	233	221
Total capital	**466**	**442**
Total liabilities and capital	**$ 26,533**	**$ 25,054**

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF INCOME

For the years ended December 31, 2002 and December 31, 2001 (in millions)

	2002	2001
Interest income:		
Interest on U.S. government and federal agency securities	$ 984	$ 1,219
Interest on investments denominated in foreign currencies	8	11
Total interest income	**992**	**1,230**
Interest expense:		
Interest expense on securities sold under agreements to repurchase	1	–
Net interest income	**991**	**1,230**
Other operating income:		
Income from services	46	47
Reimbursable services to government agencies	20	20
Foreign currency gains (losses), net	62	(47)
U.S. government securities gains, net	3	13
Other income	3	4
Total other operating income	**134**	**37**
Operating expenses:		
Salaries and other benefits	81	79
Occupancy expense	9	9
Equipment expense	13	13
Assessments by Board of Governors	21	24
Other expenses	29	32
Total operating expenses	**153**	**157**
Net income prior to distribution	$ 972	$ 1,110
Distribution of net income:		
Dividends paid to member banks	$ 14	$ 14
Transferred to (from) surplus	12	(7)
Payments to U.S. Treasury as interest on Federal Reserve notes	946	1,103
Total distribution	**$ 972**	**$1,110**

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF CHANGES IN CAPITAL

For the years ended December 31, 2002 and December 31, 2001 (in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 2001 (4.6 million shares)	$ 228	$ 228	$ 456
Net income transferred from surplus	–	(7)	(7)
Net change in capital stock redeemed (0.2 million shares)	(7)	–	(7)
Balance at December 31, 2001 (4.4 million shares)	$ 221	$ 221	$ 442
Net income transferred to surplus	–	12	12
Net change in capital stock issued (0.2 million shares)	12	–	12
Balance at December 31, 2002 (4.6 million shares)	$ 233	$ 233	$ 466

The accompanying notes are an integral part of these financial statements.

NOTES TO FINANCIAL STATEMENTS

1. STRUCTURE

The Federal Reserve Bank of Philadelphia ("Bank") is part of the Federal Reserve System ("System") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act") which established the central bank of the United States. The System consists of the Board of Governors of the Federal Reserve System ("Board of Governors") and twelve Federal Reserve Banks ("Reserve Banks"). The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank in Philadelphia serves the Third Federal Reserve District, which includes Delaware and portions of New Jersey and Pennsylvania. Other major elements of the System are the Federal Open Market Committee ("FOMC") and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York ("FRBNY") and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state chartered bank that applies and is approved for membership in the System.

Board of Directors

In accordance with the Federal Reserve Act, supervision and control of the Bank are exercised by a Board of Directors. The Federal Reserve Act specifies the composition of the Board of Directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. Of the six elected by member banks, three represent the public and three represent member banks. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

2. OPERATIONS AND SERVICES

The System performs a variety of services and operations. Functions include: formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse ("ACH") operations and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies and state member banks; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, matched sale-purchase transactions, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY is also authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange ("F/X") and securities contracts in, nine foreign currencies, maintain reciprocal currency arrangements ("F/X swaps") with various central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks.

3. SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared to the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* ("Financial Accounting Manual"), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual.

The financial statements have been prepared in accordance with the Financial Accounting Manual. Differences exist between the accounting principles and practices of the System and accounting principles generally accepted in the United States of America ("GAAP"). The primary differences are the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP, and the accounting for matched sale-purchase transactions as separate sales and purchases, rather than secured borrowings with pledged collateral, as is generally required by GAAP. In addition, the Bank has elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included as the liquidity and cash position of the Bank are not of primary concern to the users of these financial statements. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. Therefore, a Statement of Cash Flows would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

Effective January 2001, the System implemented procedures to eliminate the sharing of costs by Reserve Banks for certain services a Reserve Bank may provide on behalf of the System. Major services provided for the System by the Bank, for which the costs will not be redistributed to the other Reserve Banks, include: Collateral Management System, Electronic Cash Letter System, Groupware Leadership Center, Subcommittee on Credit Reserves and Risk Management Administrative Office, Treasury Direct Central Business Administration Function.

The preparation of the financial statements in conformity with the Financial Accounting Manual requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Unique accounts and significant accounting policies are explained below.

NOTES TO FINANCIAL STATEMENTS

a. Gold Certificates

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged and the Reserve Banks' gold certificate accounts are lowered. The value of gold for purposes of backing the gold certificates is set by law at $42 2/9 a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based upon average Federal Reserve notes outstanding in each District.

b. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDRs, at the direction of the U.S. Treasury, for the purpose of financing SDR certificate acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2002.

c. Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Boards of Directors of the Reserve Banks, subject to review by the Board of Governors. Reserve Banks retain the option to impose a surcharge above the basic rate in certain circumstances. There were no outstanding loans to depository institutions at December 31, 2002 and 2001, respectively.

d. U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account

("SOMA"). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. Such authorizations are reviewed and approved annually by the FOMC.

In December 2002, the FRBNY replaced matched sale-purchase ("MSP") transactions with securities sold under agreements to repurchase. MSP transactions, accounted for as separate sale and purchase transactions, are transactions in which the FRBNY sells a security and buys it back at the rate specified at the commencement of the transaction. Securities sold under agreements to repurchase are treated as secured borrowing transactions with the associated interest expense recognized over the life of the transaction.

The FRBNY has sole authorization by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements on behalf of the System, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires FRBNY to take possession of collateral in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by FRBNY on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

F/X contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed upon period of time (up to twelve months), at an agreed upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank, and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases of foreign currencies and related international operations.

NOTES TO FINANCIAL STATEMENTS

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts which contain varying degrees of off-balance sheet market risk, because they represent contractual commitments involving future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that can result in gains or losses when holdings are sold prior to maturity. Decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis and is reported as "Interest on U.S. government and federal agency securities" or "Interest on investments denominated in foreign currencies," as appropriate. Income earned on securities lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses on the sales of U.S. government and federal agency securities are reported as "U.S. government securities gains, net". Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as Foreign currency gains (losses), net. Foreign currencies held through F/X swaps, when initiated by the counter-party, and warehousing arrangements are revalued daily, with the unrealized gain or loss reported by the FRBNY as a component of "Other assets" or "Other liabilities," as appropriate.

Balances of U.S. government and federal agency securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currency, interest income and expense, securities lending fee income, amortization of premiums and discounts on securities bought outright, gains and losses on sales of securities, and realized and unrealized gains and losses on investments denominated in foreign currencies, excluding those held under an F/X swap arrangement, are allocated to each Reserve Bank. Income from securities lending transactions undertaken by the FRBNY are also allocated to each Reserve Bank. Securities purchased under agreements to resell and unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to the

NOTES TO FINANCIAL STATEMENTS

FRBNY and not to other Reserve Banks.

e. Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from 2 to 50 years. New assets, major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the application development stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software.

f. Interdistrict Settlement Account

At the close of business each day, all Reserve Banks and branches assemble the payments due to or from other Reserve Banks and branches as a result of transactions involving accounts residing in other Districts that occurred during the day's operations. Such transactions may include funds settlement, check clearing and ACH operations, and allocations of shared expenses. The cumulative net amount due to or from other Reserve Banks is reported as the "Interdistrict settlement account."

g. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In accordance with the Federal Reserve Act, gold certificates, special drawing rights certificates, U.S. government and federal agency securities, securities purchased under agreements to resell, loans to depository institutions, and investments denominated in foreign currencies are pledged as collateral for net Federal Reserve notes outstanding. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, whose collateral value is equal to the par value of the securities tendered, and securities purchased under agreements to resell, which are valued at the contract amount. The par value of securities pledged for securities sold under agreements to repurchase is similarly deducted. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. The Reserve Banks have entered into an agreement which provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks in order to satisfy their obligation of providing sufficient collateral for outstanding Federal Reserve notes. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding, reduced by its currency holdings of $6,893 million, and $6,562 million at December 31, 2002 and December 31, 2001, respectively.

h. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank's capital and surplus changes, its holdings of the Reserve Bank's stock must be adjusted. Member banks are those state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of $100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

i. Surplus

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

In the event of losses or a substantial increase in capital, payments to the U.S. Treasury are suspended until such losses are recovered through subsequent earnings. Weekly payments to the U.S. Treasury may vary significantly.

j. Income and Costs related to Treasury Services

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services. Beginning January 1, 1998, the reimbursement process for all Reserve Banks was centralized at the Bank that included the transfer of each Reserve Bank's Treasury reimbursement receivable to the Bank. The centralized portion of the Bank's reimbursement receivable, reported in "Other assets," totaled $73 million and $70 million at December 31, 2002 and 2001, respectively.

k. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property, which are reported as a component of "Occupancy expense."

4. U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES

Securities bought outright are held in the SOMA at the FRBNY. An undivided interest in SOMA activity and the related premiums, discounts and income, with the exception of securities purchased under agreements to resell, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings. The settlement, performed in April of each year, equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 3.845 percent and 4.107 percent at December 31, 2002 and 2001, respectively.

The Bank's allocated share of securities held in the SOMA at December 31, that were bought outright, was as follows (in millions):

	2002	2001
Par value:		
U.S. government:		
Bills	$ 8,717	$ 7,479
Notes	11,455	10,923
Bonds	4,031	4,258
Total par value	**24,203**	**22,660**
Unamortized premiums	414	464
Unaccreted discounts	(41)	(53)
Total allocated to Bank	**$ 24,576**	**$ 23,071**

Total SOMA securities bought outright were $639,125 million and $561,701 million at December 31, 2002 and 2001, respectively.

The maturity distribution of U.S. government and federal agency securities bought outright, which were allocated to the Bank at December 31, 2002, was as follows (in millions):

Maturities of Securities Held	Par value Total
Within 15 days	$ 1,055
16 days to 90 days	5,930
91 days to 1 year	5,455
Over 1 year to 5 years	6,643
Over 5 years to 10 years	2,050
Over 10 years	3,070
Total	**$ 24,203**

As mentioned in footnote 3, in December 2002, the FRBNY replaced MSP transactions with securities sold under agreements to repurchase. At December 31, 2002, securities sold under agreements to repurchase with a contract amount of $21,091 million and a par value of $21,098 million were outstanding, of which $811 million and $811 million, respectively, were allocated to the Bank. At December 31, 2001, MSP transactions involving U.S. government securities with a par value of $23,188 million were outstanding, of which $952 million was allocated to the Bank. Securities sold under agreements to repurchase and MSP transactions are generally overnight arrangements.

At December 31, 2002 and 2001, U.S. government securities with par values of $1,841 million and $7,345 million, respectively, were loaned from the SOMA, of which $71 million and $302 million were allocated to the Bank.

5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and the Bank for International Settlements, and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities purchased under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 3.015 percent and 3.305 percent at December 31, 2002 and 2001, respectively.

The Bank's allocated share of investments denominated in foreign currencies, valued at current foreign currency market exchange rates at December 31, was as follows (in millions):

	2002	2001
European Union Euro:		
Foreign currency deposits	$ 168	$ 152
Government debt instruments including agreements to resell	99	89
Japanese Yen:		
Foreign currency deposits	54	62
Government debt instruments including agreements to resell	186	176
Accrued interest	3	2
Total	**$ 510**	**$ 481**

Total investments denominated in foreign currencies were $16,913 million and $14,559 million at December 31, 2002 and 2001, respectively.

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2002, was as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies

Within 1 year	$ 471
Over 1 year to 5 years	27
Over 5 years to 10 years	12
Total	**$ 510**

At December 31, 2002 and 2001, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 2002 and 2001, the warehousing facility was $5,000 million, with zero balance outstanding.

6. BANK PREMISES AND EQUIPMENT

A summary of bank premises and equipment at December 31 is as follows (in millions):

	2002	2001
Bank premises and equipment:		
Land	$ 2.6	$ 2.5
Buildings	66.2	65.8
Building machinery and equipment	10.8	9.6
Construction in progress	1.3	.5
Furniture and equipment	63.6	59.1
	144.5	137.5
Accumulated depreciation	(72.0)	(67.8)
Bank premises and equipment, net	$ 72.5	$ 69.7

Depreciation expense was $9 million for both years ended December 31, 2002 and 2001.

The Bank leases unused space to an outside tenant. This lease has a term of 2 years. Rental income from such lease was $1 million for both years ended December 31, 2002 and 2001. Future minimum lease payments under the noncancelable agreement in existence at December 31, 2002 were $3 million for years 2003 through 2004.

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2002, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from 1 to approximately 3 years. These leases provide for increased rentals based upon increases in real estate taxes, operating costs or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $1 million and $658 thousand for the years ended December 31, 2002 and 2001, respectively. Certain of the Bank's leases have options to renew. The Bank has no capital leases.

Future minimum rental payments under noncancelable operating leases with terms of one year or more, at December 31, 2002, were $560 thousand, $300 thousand, and $50 thousand for the years 2003, 2004, and 2005, respectively.

At December 31, 2002, the Bank has no other commitments and long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks dated as of March 2, 1999, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 2002 or 2001.

The Bank is involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position or results of operations of the Bank.

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan") and the Benefit Equalization Retirement Plan ("BEP") and certain Bank officers participate in a Supplemental Employee Retirement Plan ("SERP"). The System Plan is a multi-employer plan with contributions fully funded by participating employers. No separate accounting is maintained of assets contributed by the participating employers. The Bank's projected benefit obligation and net pension costs for the BEP at December 31, 2002 and 2001 and for the SERP at December 31, 2002, and for the years then ended, are not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $3 million for each of the years ended December 31, 2002 and 2001 and are reported as a component of "Salaries and other benefits."

9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement benefits other than pensions

In addition to the Bank's retirement plans, employees who have met certain age and length of service requirements are eligible for both medical benefits and life insurance coverage during retirement.

The Bank funds benefits payable under the medical and life insurance plans as due and, accordingly, has no plan assets. Net postretirement benefit costs are actuarially determined using a January 1 measurement date.

Following is a reconciliation of beginning and ending balances of the benefit obligation (in millions):

	2002	2001
Accumulated postretirement benefit obligation at January 1	$ 37.2	$ 33.4
Service cost-benefits earned during the period	0.7	0.7
Interest cost of accumulated benefit obligation	2.2	2.4
Actuarial loss (gain)	(2.6)	2.1
Contributions by plan participants	0.2	0.3
Benefits paid	(2.4)	(1.5)
Plan amendments (curtailments, special termination benefits)	(0.2)	(0.2)
Accumulated postretirement benefit obligation at December 31	$ 35.1	$ 37.2

Following is a reconciliation of the beginning and ending balance of the plan assets, the unfunded postretirement benefit obligation, and the accrued postretirement benefit costs (in millions):

	2002	2001
Fair value of plan assets at January 1	$ –	$ –
Actual return on plan assets	–	–
Contributions by the employer	2.2	1.2
Contributions by plan participants	0.2	0.3
Benefits paid	(2.4)	(1.5)
Fair value of plan assets at December 31	$ –	$ –
Unfunded postretirement benefit obligation	$ 35.1	$ 37.2
Unrecognized initial net transition asset (obligation)	–	–
Unrecognized prior service cost	14.3	16.0
Unrecognized net actuarial gain (loss)	(6.2)	(8.9)
Accrued postretirement benefit costs	$ 43.2	$ 44.3

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs."

At December 31, 2002 and 2001, the weighted average discount rate assumptions used in developing the benefit obligation were 6.75 percent and 7.00 percent, respectively.

For measurement purposes, a 9.0 percent annual rate of increase in the cost of covered health care benefits was assumed for 2003. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.0 percent by 2008, and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2002 (in millions):

	One Percentage Point Increase	One Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 0.3	$ (0.3)
Effect on accumulated postretirement benefit obligation	3.0	(3.4)

The following is a summary of the components of net periodic postretirement benefit costs for the years ended December 31 (in millions):

	2002	2001
Service cost-benefits earned during the period	$ 0.7	$ 0.7
Interest cost of accumulated benefit obligation	2.2	2.4
Amortization of prior service cost	(1.9)	(1.8)
Recognized net actuarial loss	0.1	0.2
Net periodic postretirement benefit costs	$ 1.1	$ 1.5

Net periodic postretirement benefit costs are reported as a component of "Salaries and other benefits."

Postemployment benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 2002 and 2001, were $7 million for both years. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2002 and 2001 operating expenses were $1 million for both years.

10. SUBSEQUENT EVENT

In January 2003, the System announced plans to restructure its check collection operations. The restructuring plans include streamlining the check management structure, reducing staff, decreasing the number of check-processing locations, and increasing processing capacity in other locations. The restructuring, which is expected to begin in 2003 and conclude by the end of 2004, will have no significant effect on the Bank. At this time, the Reserve Banks have not developed detailed estimates of the cost of the restructuring plan in the aggregate or for the individual Reserve Banks affected.

The Federal Reserve Bank of Philadelphia's web site is our electronic front door. A visit to our site allows you to keep up with the latest information on the regional and national economy and consumer issues. You can also find links to employment opportunities, educational and consumer resources, and the latest consumer and research publications from the Federal Reserve Bank of Philadelphia. Our new e-mail service notifies you of web updates for subscription topics you choose, including circular letters, news releases, speeches, Payment Cards Center information, and more. Visit us at www.phil.frb.org to learn more.

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KEY FEDERAL RESERVE BANK OF PHILADELPHIA PHONE NUMBERS

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Community Affairs
215-574-6458

Financial Statistics/Regulatory Reporting
215-574-6455

Human Resources
215-574-6150

Library & Research Center
215-574-6540

Payment Cards Center
215-574-7220

Public Affairs
215-574-6113

Research
215-574-6448

Supervision, Regulation and Credit
215-574-6480

Consumer Complaints
1-800-372-1220

Treasury Services
215-574-4332