

## Facing Change and Managing Risk

*Change and risk are words that are inextricably linked, and nowhere is this more evident than in the financial system. As markets grow more complex, as technology advances, as customers demand more services, the financial system must adapt to meet the needs of this ever-changing environment. Every step of the way, we must consider how to balance risk with the benefits and necessity of progress.*



Anthony M. Santomero, President

The Philadelphia Fed's 2005 annual report, "Facing Change, Managing Risk," examines this concept in detail. After all, as stewards of the financial system, it is the responsibility of the Federal Reserve System to navigate these changes, helping to ensure a thriving and prosperous economy for our nation.

This particular annual report is special to me because it covers my last year as president of the Federal Reserve Bank of Philadelphia. I have been part of this Bank for nearly six years, including two years as a voting member of the Federal Open Market Committee. I am honored to have had the opportunity to lead such a prestigious institution as the Philadelphia Fed and to have worked with so many talented and dedicated people.

### Leading Change

Our Bank has adapted to the changing times and has emerged as an even stronger and more vital institution. When I took office, my vision was for the Philadelphia Bank to be known as an important center of central bank knowledge and capability. I believe this vision has been

achieved in ways that have touched on virtually every aspect of the Fed. In my final message as president, I would like to share with you some highlights of the Philadelphia Bank's accomplishments here in our District as well as in the Federal Reserve System.

The Philadelphia Fed has long been a System leader in providing financial services to depository institutions. This is perhaps most evident in check operations. In 2005, we further solidified our position of strength when the Philadelphia Fed was selected to

become a System consolidation site for check processing, absorbing New York's East Rutherford Operations Center, known as EROC. The Federal Reserve System chose Philadelphia based on its overall productivity and efficiency, its ability to handle the total check volume of both Districts, and its proximity to New York financial institutions. This new responsibility will mean additional equipment and space renovations to accommodate the increased workload. Furthermore, in the second half of 2006, we expect to create a substantial number of new positions to help process the additional volume.

The Philadelphia Fed has also played a key role in providing financial services to the U.S. Treasury. We are now one of only two sites in the System that clear government-issued checks, and we have been actively engaged in modernizing the way the federal government makes these payments.

At the same time, we have been involved in the ongoing monitoring of the nation's financial and payment systems. Studies produced here and throughout the Federal Reserve System have emphasized the remarkable evolution taking place in U.S. payments. Later in this book, First Vice President Bill Stone elaborates on just how pervasive payment changes have become.

We have advanced the System's knowledge of evolving payments mechanisms as the first Federal Reserve Bank to establish a dedicated Payment Cards Center. In 2005, the Center produced papers and conducted conferences and workshops on a number of important topics to provide meaningful insights into developments in consumer credit and payments.

Indeed, we are a palpable presence in the research and policy arena, which is perhaps most visible to the general public in our annual Philadelphia Fed Policy Forum. In 2005, we looked at "Fiscal Imbalance: Problems, Solutions, and Implications." As in past years, the event brought together leading academics, policymakers, and market economists for debate and discussion of relevant macroeconomic and monetary policy issues.

## Managing Risk

In central bank administration, 2005 was an important year as well. Over the past several years we have carved out a role in the "knowledge and information" sector of the Fed's infrastructure. We now lead the System in the challenging area of Enterprise Risk Management (ERM). Our Bank's ERM group, as well as our well-regarded accounting professionals, has furthered our reputation as an extremely efficient, high-quality organization with a strong focus on controls and risk management. In 2005, we developed a relationship with the central bank of Spain, which wants to implement an ERM program. As a result of this contact, our chief financial officer has been asked to co-chair a consortium of central banks—from Europe and elsewhere—that will meet annually to discuss common risk-management concerns.

In an environment of high loan growth in 2005, our Supervision, Regulation and Credit (SRC) Department continued working with banks to ensure that credit quality

"Tony Santomero is an accomplished leader and talented economist. We at the Federal Reserve have greatly benefited from his perspective and keen insights. He has been a valued voice of wisdom at our meeting table. We will miss him."

— Former Chairman  
Alan Greenspan

The Philadelphia  
Fed is an  
organization  
with a powerful  
niche in  
public service  
and a stellar  
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credibility.

was never compromised. As the banking industry becomes more complex and competitive, the tenets of capital adequacy and risk management are more important than ever before. At the Philadelphia Fed, we recognize this and have established a unit in SRC to analyze retail credit risk. Now the System has charged us with developing the strategy for implementing this part of the new Basel II capital requirements. We are also home to the System's Subcommittee on Credit, Reserves, and Risk Management, known as SCRRM. Our Bank has led the way here by coordinating System policies to supply depository institutions with needed liquidity, implement new discount window policies, and direct the upgrade of supporting System technology.

### **Sharing Knowledge**

As important as it is to have knowledge and expertise, it is just as important to share it. Therefore, we have made strong contributions to our community and our country in the area of economic outreach. In 2005, our Bank offered a number of programs to promote knowledge and share resources concerning personal finance and the U.S. economy.

We produced the educational consumer video, "Buried by Debt: The Dangers of Borrowing," which offers at-risk consumers real-life examples of lending abuses and offers tips to avoid falling victim to such abuses. Philadelphia is a System leader in economic education and has developed financial literacy curriculums used both locally and nationally. In addition, our programs to promote financial literacy, improve access to credit, end predatory lending, and foster urban development continue to make a real difference in our District's communities.

Indeed, not only has the Bank become an even more important part of the Philadelphia community but also of economic policy discussions in our District. Our participation in these discussions has affirmed the Philadelphia Fed's expertise in monetary policy.

### **Board of Directors**

Of course, all of this would not be possible without the leadership and support of our board of directors, who guide us in all our accomplishments. It is only fitting that we recognize our debt to them for their service. These nine individuals play an important role in keeping us in touch with our District and by performing the oversight role of directors everywhere.

We offer our sincere thanks to two members of our board who have completed their terms of service with us: Robert E. Chappell, chairman and CEO of The Penn Mutual Life Insurance Company, and Kenneth R. Shoemaker, president and CEO of Orrstown Bank. Each was a valuable contributor to our board and helped immeasurably in our attempts to maintain close contacts with all sectors within the District.

We offer special thanks to our outgoing chairman of the board, Ron Naples. His leadership, keen insights into the regional, national, and global economy, and his corporate governance skills will be missed—as will his good humor.

I am pleased to report that Doris M. Damm, president and CEO of ACCU Staffing Services, has been appointed chairman of the board of directors, and William F. Hecht,

chairman and CEO of PPL Corporation, has been appointed deputy chairman of the board of directors. I leave my position with the knowledge that the Bank's board has strong leaders at the top.

At the same time, we welcome our newest board members and look forward to their counsel and guidance. John G. Gerlach, president and CEO of Pocono Community Bank; Audrey S. Oswell, president and CEO of Resorts Atlantic City; and Charles P. Pizzi, president and CEO of Tasty Baking Company, joined the board on January 1, 2006. On behalf of all of us here at the Philadelphia Fed, I thank our board for its valuable contributions.

Let me also acknowledge the contribution of Bruce L. Hammonds, president and CEO of MBNA Corporation, who has completed his term as a member of the Federal Advisory Council (FAC), and welcome Ted T. Cecala, chairman and CEO of Wilmington Trust Company, who has been appointed to represent the Third District on the FAC.

### Closing Thoughts

The world has changed a great deal in just the first few years of this new millennium and so, too, has the Philadelphia Reserve Bank. We are strongly connected to the financial industry and engaged in our community. We have increased our visibility in our District on many fronts. We contribute to and lead many System initiatives. I am confident this tradition of excellence will carry on as the Philadelphia Fed continues to be a high-quality provider of financial services and a leader in the Federal Reserve System.

As part of the nation's central bank, the Philadelphia Fed is an organization with a powerful niche in public service and a stellar reputation for quality and credibility. Our Bank will continue to move forward under its new leadership and will remain steadfastly committed to the strength and growth of the Third District's economy.

In closing, I would like to express my gratitude for having had the pleasure of national service in a truly outstanding institution and for the opportunity to work under Alan Greenspan, a Chairman who was universally regarded as America's and the world's finest central banker. At the same time, I applaud the President's choice of Ben Bernanke as the 14<sup>th</sup> Chairman of the Board of Governors. The Federal Reserve is in good hands.



Anthony M. Santomero  
President  
March 2006

“President Santomero has made significant contributions to the Bank, the Federal Reserve System, and our region. We will miss his outstanding leadership and knowledge. We have full confidence in the leadership team Tony helped build that will continue to manage the Bank .”

— Ronald J. Naples  
2005 Chairman, Board of Directors