

PRESIDENT'S MESSAGE

In last year's annual report, I said we cannot take prosperity for granted. On September 11, 2001, this statement gained new meaning. As unimaginable events unfolded before our eyes, we trusted in the organizational design of the Federal Reserve System and the effectiveness of our crisis management plans. The Fed's actions following the attacks illustrate just how this structure responds to a national need. Now, more than ever before, the Fed is looked upon as a bastion of stability.

Reflecting on 2001, we see a year of progress and of challenges for the Federal Reserve Bank of Philadelphia. Our progress was evident in the expansion of the Bank's role in both our Third District communities and in the Federal Reserve System. Among our challenges were those shared by all — an economic slowdown and a national crisis. But above all, we remain committed to the long-term health of our region's and nation's economies. In this year's annual report, we share insights from the various Philadelphia Fed people who, in the aftermath of September 11, were instrumental in our ability to maintain "Stability in a Crisis."

ROLE OF THE FED & CRISIS MANAGEMENT

The Federal Reserve's mission is to provide money and credit conditions that foster maximum sustainable economic and job growth in an environment of price stability. This mission is achieved through three important and intertwined functions: conducting the nation's monetary policy, supervising and regulating banking operations, and providing and maintaining an effective and efficient payments system. One issue, however, remains paramount — maintaining public confidence in the nation's financial and economic system. This was never more evident than on September 11.

Our response was a coordinated effort across all three of our areas of responsibility. From keeping the payments system operating, to providing access to credit, to implementing monetary policy, the Fed proved vital in upholding the integrity of our financial system. We were able to simultaneously feel the pulse of financial activity across the country, operate in multiple locations, and



coordinate efforts to ensure financial stability.

Throughout the crisis, Fed operations continued. Employees at the Philadelphia Fed did a tremendous job in responding to a national tragedy. The dedication of Philadelphia Fed employees allowed us to remain open and operating in the aftermath of the attacks and ensured that the payments system was functional throughout the crisis. I commend all our Bank employees for their hard work and long hours during this especially troubling time for our nation.

STRATEGIC GOALS — 2002 AND BEYOND

Looking beyond the literal interpretation of our roles, we must strive to build our capabilities and achieve our goals. Doing so demands vision. At the Federal Reserve Bank of Philadelphia, our vision is to be known as an

important center of central bank knowledge and capability. Our strategy for 2002 and beyond is to be a high quality provider of central bank knowledge and services with emphasis on efficiency, innovation, and strong financial controls.

To achieve our goals, we must expand our knowledge of the broader financial services industry. Barriers into this industry have been eliminated for many nonbank and bank participants. With the emergence of new entrants, new vehicles for retail payments have emerged as well. The Payment Cards Center was created to address these issues and serve as a source of knowledge and expertise on this important segment of the financial system. Established in early 2001, the Center provides meaningful insights into the industry through an agenda of research and analysis, forums, and conferences that will encourage a dialogue incorporating industry, academic, and public-sector perspectives.

We must also continue to expand our outreach to academia, the financial services industry, and the community. This will be accomplished through monetary policy research, increased regional involvement, and Community and Consumer Affairs initiatives. Working with partners, we already have implemented a successful pilot financial literacy program in a Delaware high school. Next, we plan to expand financial literacy throughout the region.

Furthering our outreach efforts in 2001, our Bank had the privilege of hosting on separate occasions Chairman Alan Greenspan and Vice Chairman Roger Ferguson from the Board of Governors to speak to business leaders in our District. Another notable visitor to speak at our Bank was Lawrence Lindsey, President Bush's Assistant for Economic Policy, who offered insight on the effects of Bush's tax cuts on the economy.

The Philadelphia Reserve Bank is committed to enhancing its role as a prominent System leader. As a first-tier Bank in terms of quality, efficiency, and controls, Philadelphia is poised to be an integral part of the leadership process. In 2001, we acquired the SCRRM (Subcommittee

on Credit, Reserves, and Risk Management) office, which oversees discount window operating procedures on a System-wide basis. We have also earned a central role in the Fed's technology initiatives through our Groupware Leadership Center. This office coordinates desktop standards for the entire System.

The Philadelphia Fed held its inaugural Policy Forum last fall. This effort brought together a group of highly respected academics, policymakers, and market economists

for a discussion of current macroeconomic research and its implications for monetary policy. The event, which garnered extensive media coverage, was considered a tremendous success.

As the leader in check processing, the Philadelphia Fed

actively seeks innovative solutions for improving its business. Our initiatives have included the development of check imaging to enhance the efficiency of the payments system, as well as a pilot program of sophisticated techniques to combat check fraud. Philadelphia also helps manage federal check payments. We are currently developing and managing checkbook software applications for the federal government. In addition, we serve as a primary collection point for U.S. Treasury checks.

THE ROAD TO RECOVERY

Looking forward, I see 2002 as a turnaround year for the economy. Thanks to the progress we have made in recent years, the Greater Philadelphia region will recover along with the nation. As I reported to you a year ago, activity in our region has continued to expand in such key sectors as business services, construction, and tourism. We also continue to build on our reputation as a center for pharmaceutical research and production, health care, and higher education. In both our region and the nation, we hope to see a healthy pace of sustained growth by year-end 2002. But first, our challenge is to manage the current period of economic weakness with an eye to the future. Our flexible markets, entrepreneurial spirit, well-educated work force, and major advances in information technology provide a

OUR VISION IS TO BE BROADLY RECOGNIZED AS AN IMPORTANT CENTER OF CENTRAL BANK KNOW- LEDGE AND CAPABILITY.

sound foundation for the long-term growth of productivity, employment, and standards of living. While consumer and business behavior will significantly affect the progress of our economy in the near-term, the longer-term prospects for the U.S. economy remain sound.

BOARD OF DIRECTORS

The thoughtful insights provided by our Board of Directors allowed us to accomplish a great deal in 2001, and we are truly grateful for their valuable contributions. I am pleased to report that Charisse R. Lillie, partner at Ballard Spahr Andrews & Ingersoll, has been re-appointed chairman of the Board of Directors, and Glenn A. Schaeffer, president of the Pennsylvania Building and Construction Trades Council, has been re-appointed deputy chairman.

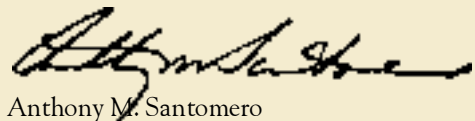
We offer our sincere thanks to those who completed their terms of service on our Board of Directors: Rufus Fulton, chairman, president, and CEO of Fulton Financial Corporation, and Howard Cosgrove, chairman and CEO of Conectiv. Mr. Fulton has been appointed to represent the Third District on the Federal Advisory Council during 2002.

We look forward to the insight and guidance of our newest Board members: Walter E. Daller, Jr., chairman, president, and CEO of Harleysville National Corporation, and P. Coleman Townsend, Jr., chairman and CEO of Townsends, Inc.

SOME CLOSING THOUGHTS

Philadelphia's role in the monetary policy decision-making process became more pronounced in 2002, as our Bank now votes on the Federal Open Market Committee (FOMC). The FOMC consists of 12 Federal Reserve Bank presidents and the seven members of the Board of Governors and sets the course for monetary policy. While all Fed presidents attend and contribute to the discussions, only five vote. This is done on a rotating schedule of one-year terms.

Last year was a testament to the Philadelphia Fed's strength and dedication to progress. Going forward, we continue to expand our efforts to provide the Third District community with the most up-to-date economic information and research. As a responsible steward of the District's economic health, we maintain our focus on helping our region to grow and prosper. Now, we move forward — confident that our region's economy, like our nation's, is enormously resilient.



Anthony M. Santomero
President

April 2002

3 MAIN ROLES OF THE FEDERAL RESERVE

CONDUCTING MONETARY POLICY

- Is the role most visible to the general public
- Refers to the Fed controlling money supply, regulating economy, and controlling inflation
- Set with consideration for current national economic conditions; not determined by fixed ideology
- Requires constant vigilance so economy flourishes and growth is sustained

SUPERVISING AND REGULATING BANKING OPERATIONS

- Promotes the safety and soundness of District financial institutions
- Examines and supervises financial institutions in our geographic District
- Coordinates across Districts to also oversee all subsidiaries and parent holding companies
- Provides liquidity through discount window operations

MAINTAINING AN EFFECTIVE PAYMENTS SYSTEM

- Effective operation of U.S. payments system essential to a healthy economy
- Largest component of Fed operations
- Central to people's ability to make payments quickly and easily
- Philadelphia is largest check processing site in System, with an average of 5 million checks a night

OVERALL PERSPECTIVE

A key element in the Federal Reserve's mission is to maintain the stability of the financial system and contain any systemic risk that may arise in financial markets. In times of economic crisis, the strength of the financial system depends upon the effective response of the Federal Reserve System. In the following, First Vice President Bill Stone discusses the Bank's crisis management efforts.

PREPARING FOR THE UNEXPECTED

"Federal Reserve Banks respond to a crisis situation exactly the way our original founders had envisioned. We come to the aid of the country at crucial times and work hard to keep the payments system functioning. Preparedness for the unexpected is integral to our role in the economy.

"The Fed is a 24-hour-a-day operation. Times of crisis are no exception. As a critical component of the structure of the U.S. economy, the Fed stands prepared to supply liquidity and assist banking institutions when the financial

system has been disrupted. The Fed achieves this ambitious goal through a concerted effort among its Reserve Banks and the Board of Governors. The Districts comprise a nationwide network of both centralized and decentralized operations, through which sophisticated linkages ensure the safety and soundness of the entire system.

"We invest a tremendous amount of resources into our contingency planning efforts. These plans are frequently reassessed to ensure they are current, functional, and effective. They are then tested and retested to guarantee the continuity of our business.

"Our experienced Philadelphia Fed staff has seen the Bank through financial crises and natural disasters and is always prepared to take the necessary measures to uphold our infrastructure and sustain our operations. The near meltdown at Three Mile Island and Hurricane Agnes taught us the importance of being prepared to preserve the integrity of the banking system. Though September 11 was something quite different, the procedures for contingency planning still applied. Our extensive preparation for Y2K also benefited our efforts following the attacks. It was one reason the Federal Reserve was able to act quickly on September 11 – supplying needed funds for liquidity and assisting banking institutions whose ability, or customers' ability, to send and receive payments had been disrupted.

"On the morning of September 11, we had to take immediate action. We knew we had to coordinate efforts across all areas of responsibility. Later in this report, you will learn specifically how each of our major functional areas responded to the crisis.

"Our first order of business on September 11 was to keep the payments system operating as close to normal as possible. Cash and currency deliveries continued throughout the day, and special requests from any depository with

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WILLIAM H. STONE JR.
FIRST VICE PRESIDENT

an unexpected need were handled expeditiously. We accommodated banks by crediting them according to normal schedules despite the fact that the airport shutdown kept us from moving checks by air and adhering to normal clearing schedules. Fedwire – our service that allows for electronic funds transfer – stayed open late into the night. In addition, we stood ready to hold open the Automated Clearing House, an electronic system used to process transfers for financial institutions nationwide.

“Another important component was ensuring banks could meet the credit needs of their customers without undue concern about liquidity or capital positions. We increased bank reserve positions through both open market operations, which are the primary means of affecting the overall supply of reserves, and the discount window, the Fed’s lending function. Moreover, we were able to maintain an open dialogue with customers throughout the crisis. While we were working to mitigate concerns by contacting select District financial institutions, many of our customers were simultaneously calling our customer service area seeking assistance. Our close proximity to New York also put us in a supporting role to provide logistical support to the New York Fed. In fact, some New York Fed employees worked out of temporary offices in our facility.”

CONTROLLING THE CRISIS

“While the Federal Reserve Bank of Philadelphia did its part to maintain stability in the region’s banking system, plans were also unfolding on a national, System-wide level. The Board of Governors held daily conference calls with all 12 Federal Reserve Banks to aid in the coordination

of System efforts. We also received frequent bulletins and intelligence briefings from the FBI to allow us to procure information in the timeliest manner possible.

“During the crisis, our priority was reassuring the public of the soundness of the banking system and providing liquidity where necessary. On September 11, the Board of Governors issued a press release to reassure the financial services industry and the public that the Federal Reserve was open and operating and that the discount window was available to meet liquidity needs. In situations arising from the attacks, we encouraged financial institutions, where appropriate, to provide their customers reasonable relief, such

DURING THE CRISIS, OUR PRIORITY WAS REASSURING THE PUBLIC OF THE SOUNDNESS OF THE BANKING SYSTEM AND PROVIDING LIQUIDITY WHERE NECESSARY.

as waiving late payment fees, extending loan terms, restructuring debt obligations, and easing credit terms. In conjunction with other federal banking agencies, we also indicated our willingness to accommodate banks if increased extension of customer credit caused a temporary decline in capital ratios.

“In anticipation of the potential economic implications of the attacks, the Federal Open Market Committee took prompt action to ease monetary policy. In the three months following September 11, short-term interest rates were cut four times for a total of 175 basis points.

“While the Fed’s monetary policy actions were its most publicized responses to the situation, our early actions to keep payments moving and the banking system liquid were equally important for maintaining public confidence. To those who have read economic history, the real story of the aftermath of September 11 was the ability of the financial system to remain functional and liquid without concerns of crisis, panic, or lack of liquidity.”

FEDERAL RESERVE RESPONSE TO SEPTEMBER 11

***T**hese statistics illustrate the Fed's quick and effective response to the September 11 crisis. But beyond the numbers, the clear message is that Fed business continued as usual. We remained open and operating in the aftermath of the attacks to ensure the continuation of vital payment services including electronic transfers, check processing, and currency distribution.*

- On September 5, System discount window borrowing totaled \$195 million. On September 12, the day after the attack, it peaked at a record \$45.6 billion.



The Philadelphia Fed (shown above), along with the entire Federal Reserve System, helped to maintain stability during the crisis.

- Also on September 12, the Open Market Desk at the Federal Reserve Bank of New York injected \$38 billion in liquidity into the financial system.
- To facilitate the functioning of financial markets and provide liquidity in dollars, the Federal Reserve established or expanded swap lines totaling \$90 billion with the European Central Bank, Bank of Canada, and Bank of England.
- The Open Market Desk facilitated the clearing process in the government securities markets by liberalizing its rules for securities lending. In the strained, post-crisis marketplace, the Open Market Desk's lending expanded from a pre-September daily average of approximately \$1.5 billion to over \$8 billion a day in the week following the attacks.
- To further help the U.S. economy, following the attacks the Fed eased monetary policy four times during the remainder of 2001 for a total of 175 basis points – bringing the federal funds rate to a 40-year low of 1.75 percent.

CHECKS

On a normal day, the Philadelphia Fed, the largest processor of checks in the Federal Reserve System, clears approximately 5 million checks.

Although other forms of payments continue to make inroads against checks, we are far from achieving a checkless society.

So what happens when there's a crisis? Blake Prichard, senior vice president, Retail Payment Services, talked about disruptions to services and how the System and the Philadelphia Fed handled the events of September 11 and their aftermath. Here's his account.

"Several times in the past, the Fed System has had to respond to emergencies. These problems involved individual Federal Reserve Banks or their Branches. For example, flooding on the Mississippi, Missouri, and Raccoon rivers put the St. Louis Fed and the Des Moines office of the Chicago Fed in jeopardy. When Hurricane Andrew ravaged southern Florida, the Miami Branch of the Atlanta Fed was knocked out for a time. Similarly, Hurricane Hugo impaired activity at both the Regional Check Processing Center in Columbia, South Carolina, and the Charlotte Branch of the Richmond

Fed. In these instances we participated in System-wide conference calls to decide how we could offer mutual support.

"But the events of September 11 eclipsed anything by far. That day, of course, the FAA grounded all flights in the U.S., an unprecedented move. Although the Federal Reserve and all the private check-collection arrangements rely significantly on both regional and national air transportation, we had no contingency plans for that. So we instantly began to put together plans to overcome such a problem."



ON SEPTEMBER 11, WITHOUT AIR TRANSPORTATION, WE HAD NO CHOICE BUT TO DEVISE A SYSTEM OF GROUND TRANSPORTATION. WE PUT TOGETHER A FAIRLY SOPHISTICATED NETWORK OF VEHICLES TO MOVE CHECKS OUT OF PHILADELPHIA.

D. BLAKE PRICHARD

SENIOR VICE PRESIDENT

PLANNING TRANSPORTATION

"On September 11, without air transportation, we had no choice but to devise a system of ground transportation. We put together a fairly sophisticated network of vehicles to move checks out of Philadelphia. We made arrangements with all the adjacent Districts to continue to move checks. Normally, we would ship checks to a Fed office only if those checks were going to be processed there: New York's checks would go to New York for processing, and

Baltimore's to Baltimore. But because of the extraordinary circumstances, we loaded a big truck with checks for New York; Utica; Windsor Locks, Connecticut; and Boston. We drove the truck to the New York Fed's processing center in North Jersey and dropped off not only New York's checks but Utica's as well. New York then took care of getting checks to Utica, since Utica is part of the New York Fed. Then we drove to Windsor Locks, Connecticut, and gave them both their own checks plus Boston's. The Connecticut processing center took the responsibility of moving checks to Boston.

"At each stop, we also loaded the truck with checks destined for Philadelphia. In that way, we brought back all the checks from New England and from the Second District (New York) for processing. That took care of the Northeast corridor.

"Simultaneously, we sent a truck to western Pennsylvania and made arrangements with the Pittsburgh Branch of the Cleveland Fed to ship all the checks that belonged to its Cincinnati and Columbus offices. Likewise, we supplemented a truckload of checks for Baltimore with checks for all offices of the Richmond and Atlanta Feds. Richmond then took care of forwarding the checks to their respective destinations, going as far south as Florida.

"Simply stated, we were collecting almost all of our checks east of the Mississippi, though days later than normal. But at least checks were moving. However, we

were unable to get anything to or beyond Chicago, and nothing was coming here from Chicago or further west. This situation persisted from September 11 to the weekend, when air transportation resumed."

PROCESSING AN AVALANCHE OF CHECKS

"That weekend, with transportation more or less under control, our check operations area received an avalanche of checks. We're

almost—but not quite—a 24/7 operation. But we supplemented our operations to ensure that we'd have enough additional manpower to process whatever volume came in. People worked in-

credible amounts of overtime. In fact, our unit worked continuously through the weekend to keep up with the flood of checks.

"Let me give you an order of magnitude for Philadelphia: Our average daily volume is about 5 million checks, and we're the single largest check processor in the System. During the height of the crisis, we processed 9.4 million checks a day. That's close to 11.4 million 'item passes' because checks often have to go through the sorter more than once. The dollar value was over \$12 billion; on a normal day we present about \$6 billion in checks."

WORKING WITH OUR CUSTOMERS

"We worked closely with our local banks. The biggest banks didn't want to get one big presentment on Monday morning. So, we made courtesy shipments to

PEOPLE WORKED INCREDIBLE AMOUNTS OF OVERTIME. IN FACT, OUR UNIT WORKED CONTINUOUSLY THROUGH THE WEEKEND TO KEEP UP WITH THE FLOOD OF CHECKS.

them throughout the weekend. PNC, Mellon, Citibank, and others got checks as they became available. Consequently, operations at those banks ran smoother.

“In addition, the Federal Reserve System agreed to accept checks from any financial institution. Normally, the System clears about one-third of all checks written. But for a while, we were handling a significantly larger percentage. By doing this, the Fed provided significant liquidity and predictability to the banking industry. Most banks were surprised by this action. Ultimately, though, they realized it was the Fed being the Fed: bringing stability during a crisis.

“In fact, throughout the crisis, the Federal Reserve Banks took the position of extending credit to check depositors regardless of the Fed’s ability to physically collect checks. This action provided certainty of credit to financial institutions at a time when the larger payments system was under significant stress. This mea-

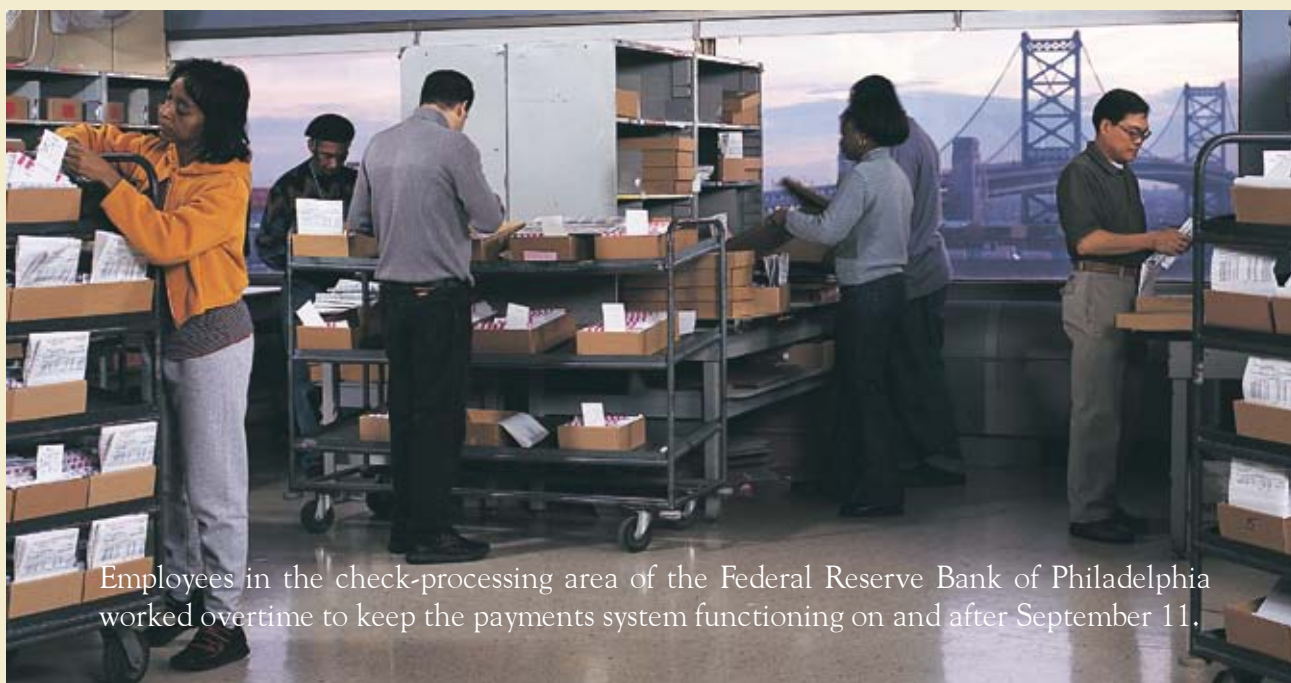
sure of liquidity went a long way toward allowing depositors to manage their financial positions and helped to avoid a ripple effect caused by other liquidity concerns.”

GETTING BACK TO NORMAL

“Within a week of the crisis, check payments were pretty much back to normal. The only area that lagged was check adjustments. Under the best circumstances, adjustments usually lag processing by several weeks. So, of course, the extraordinary circumstances of those months meant longer lags.

“Reflecting on our response to the crisis, we clearly see the value of our strong national payments system. The Fed met the challenge and provided both the leadership and the operational commitment to overcome adversity and support the economy and the businesses that underlie each check payment.”

[THE FED’S] ACTION PROVIDED CERTAINTY OF CREDIT TO FINANCIAL INSTITUTIONS AT A TIME WHEN THE LARGER PAYMENTS SYSTEM WAS UNDER SIGNIFICANT STRESS.



Employees in the check-processing area of the Federal Reserve Bank of Philadelphia worked overtime to keep the payments system functioning on and after September 11.

SUPERVISION, REGULATION, & CREDIT

Supervision and regulation are among the most critical components of the banking system. The Supervision, Regulation, and Credit Department (SRC) supervises and regulates domestic and foreign operations for financial institutions in eastern Pennsylvania, southern New Jersey, and Delaware, under the jurisdiction of the Federal Reserve Bank of Philadelphia and the Board of Governors.

It is imperative for SRC to maintain public confidence and normal operations at the Bank regardless of existing circumstances. While this objective has been challenged in past crisis situations, it had never been put to the test as on the days following the September 11 terrorist attacks on America.

In the following, Senior Vice President Michael E. Collins recounts SRC's response to the crisis.

A PLAN OF ACTION

"Historically, our supervisory and regulatory framework has played an important role in identifying and anticipating problems before they become crises. An essential ingredient in managing problem institutions is our ability to know what traits of an emerging situation could cause problems. When we are success-

ful, this allows us to help banking organizations maintain safe and sound operations without undertaking undue risk.

"The need for crisis management skills comes into play when we as supervisors do not have advanced warning about potential problems and are instead faced with an urgent crisis situation. This was the case on September 11.

"On that morning, when we realized that these were terrorist attacks on America, SRC immediately began gauging the impact on the financial services industry. Some members of our SRC staff were attending a Subcommittee on Credit, Reserves, and Risk Management meeting at the New York Fed, not far from ground zero. Immediate telephone contact was made to determine if any employees had been affected. After ensuring the safety of our staff, we organized a conference call among key players in SRC to determine a plan of action. Our primary objectives were 1) to manage the technical aspects of the attacks on the banking system and 2) to keep people informed regarding the human aspects of the crisis."



**SRC'S PRIMARY FUNCTION
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PROVIDING LIQUIDITY TO THE
FINANCIAL SYSTEM.**

MICHAEL E. COLLINS

SENIOR VICE PRESIDENT AND
LENDING OFFICER

COMMUNICATION IN A CRISIS

“To gauge the impact of the crisis on the Third District, we contacted select institutions around the region to assess and evaluate their financial condition. This way we were able to identify any high-risk areas in the District and locate potential clearing or settlement bottlenecks. In addition, we immediately took action to analyze the sufficiency of back-up systems. Our preparation for the century date change proved helpful in our analysis.

“Immediate and continuous dialogue with financial institutions communicated our willingness to accommodate special requests in this time of crisis. Issues related to section 23A of the Federal Reserve Act, which covers transactions with affiliates including collateral requirements, quickly began to emerge. The discount window staff was instructed to take an accommodative posture to ensure adequate liquidity and assure institutions that we were open to lend. Also, lending and supervisory inquiries were coming in from financial institutions around the District as banks became apprehensive about whether their normal channels for funding would be available. We acted promptly on these inquiries and gathered intelligence, which allowed us to preempt potential financial difficulties.

“The crisis also warranted extensive communications among banking agencies, including all Federal Reserve Banks, and federal and state regulators. In fact,

the Office of the Comptroller of the Currency sent messages to New York via the Philadelphia Fed, as they were unable to get through to New York.

“Acting as process facilitator proved a crucial aspect of SRC’s role on September 11. We called the New York Fed on behalf of institutions in our District

that expected to receive funds from New York banks. The New York Fed then contacted its institutions to ascertain their ability to conduct business. With offices evacuated and systems down, there was uncertainty about the effective clearing

and settlement of transactions. We were able to provide a source of information to our institutions regarding account activity. Meanwhile, our Credit Risk Management staff worked late into the night addressing settlement issues and completing transactions.”

LENDER OF LAST RESORT

“In the days and weeks following the attacks as intelligence was gathered, we were in constant communication with our institutions to impart real-time policy decisions. As lender of last resort, especially in times of crisis, it is our responsibility to lend to those with no access to credit. We communicated policy directives encouraging institutions to work with customers and not allow the temporary breach of the stringent supervisory framework to impede service. Banks were assured that temporarily inflated balance sheets or temporary declines

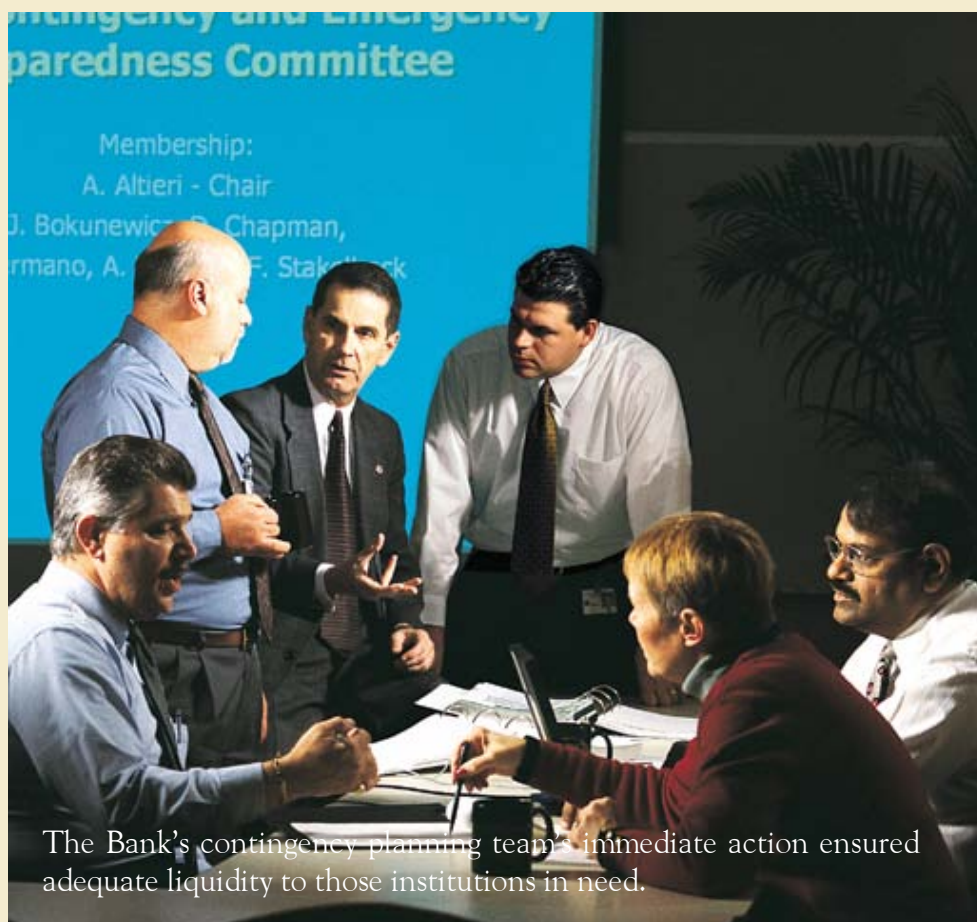
IMMEDIATE AND CONTINUOUS DIALOGUE WITH FINANCIAL INSTITUTIONS COMMUNICATED OUR WILLINGNESS TO ACCOMMODATE SPECIAL REQUESTS IN THIS TIME OF CRISIS.

in capital ratios would not trigger corrective action on our part as regulators. The temporary easing of credit terms and waiving of certain obligations provided the flexibility to ensure adequate liquidity to those institutions in need.”

BANKING SYSTEM INVESTIGATION

“Once liquidity concerns were addressed, we turned our attention to how the banking system might have been used in the attack. Who was behind the attacks? How were they funded? These were the questions at the forefront of the investigation. We received lists of names from law enforcement officials which we circulated to financial institutions, along with instructions on how to notify the proper authorities if a name from this list was discovered on their accounts.

“This brings us into the realm of money laundering, an area where I am certain we will see immediate and far-reaching policy changes. Proposed legislation would give the Treasury new powers to target foreign countries or banks deemed to present a major money-laundering threat.”



The Bank's contingency planning team's immediate action ensured adequate liquidity to those institutions in need.

OUR UTMOST OBJECTIVE

“Engaging in proactive crisis management presents us with a unique challenge. We are essentially preparing for an event we hope never comes to fruition. But crises do occur, sometimes insignificant like Y2K, sometimes devastating like September 11. Regardless of the issue, we must never lose

THE TEMPORARY EASING OF CREDIT TERMS AND WAIVING OF CERTAIN OBLIGATIONS PROVIDED THE FLEXIBILITY TO ENSURE ADEQUATE LIQUIDITY TO THOSE INSTITUTIONS IN NEED.

sight of the public nature of our work. Operating efficiently, protecting the safety net, and keeping the confidence of our customers is achieved through maintaining the safety and soundness of our financial system. That is, and always has been, our utmost objective.”

SCRRM

(SUBCOMMITTEE ON CREDIT, RESERVES, & RISK MANAGEMENT)

You may never have heard of SCRRM, the Subcommittee on Credit, Reserves, and Risk Management. But this group played an important role on September 11, 2001, and for some weeks thereafter.

SCRRM assists Reserve Bank presidents in developing and implementing policies for managing discount window credit, reserve accounts, and payment system risk. SCRRM also coordinates these functions across Reserve Banks to ensure consistent application of policies across the Federal Reserve System.

Here's an account of the subcommittee's activities on September 11 and afterward from SCRRM Chairman Steve Meyer, vice president and senior economic policy advisor at the Philadelphia Fed.

"On September 11, SCRRM and its task forces happened to be meeting at the New York Fed – three blocks from the World Trade Center. The disruptions to the financial system caused by the terrorist attacks made it necessary for the Fed to provide liquidity through the discount window. They also increased risk in the payment system. SCRRM's role included both supplying liquidity and controlling risk.

"Shortly after the second tower collapsed, SCRRM commandeered a conference phone and got to work. Despite problems with phone lines, we were able to reach the conference bridge at the Minneapolis Fed. Minneapolis staff,

in turn, connected us with discount window and risk management staff at all Reserve Banks, as well as the Board of Governors in Washington, D.C. SCRRM then began collecting information about developments in the financial system, particularly in the interbank markets.

"It soon became apparent that there were major disruptions to the financial system and that some financial institutions had large overdrafts in their reserve accounts as a result. SCRRM instructed staff in each Reserve Bank to contact all large financial institutions in their District to collect information."

FOCUSING ON LIQUIDITY

"Around noon, we contacted Philadelphia Fed President Santomero by phone and summarized what SCRRM had learned. He informed us that Reserve Bank presidents and Federal Reserve Board Vice Chairman Ferguson had been discussing the situation. He confirmed that the Federal



SCRRM PROVIDES A
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SYSTEM.

STEPHEN A. MEYER

SCRRM CHAIRMAN,
VICE PRESIDENT AND
SENIOR ECONOMIC POLICY ADVISOR

Reserve had made a commitment to provide necessary liquidity to the banking system.

"In response, SCRRM instructed staff in each Reserve Bank's discount window function to ask financial institutions to continue providing liquidity to their customers. The Fed, in turn, prepared to give those institutions access to Federal Reserve credit, where necessary, to ensure they had sufficient liquidity to meet their customers' needs. SCRRM also began planning measures to control risks associated with large overdrafts and other extensions of credit.

"At 4:30 pm Federal Reserve Vice Chairman Ferguson joined SCRRM's System-wide conference call. During that call, Vice Chairman Ferguson endorsed SCRRM's approach to controlling the risks associated with large overdrafts. SCRRM continued to monitor developments until 6 pm."

MEETING THE NEXT DAY

"At 10 am on September 12, many SCRRM members assembled in my midtown Manhattan hotel room for another nationwide conference call. We collected final details on discount window loans and overnight overdrafts from September 11, along with information about market disruptions on September 12. We also began planning how to deal with continuing disruptions.

"Returning to Philadelphia that afternoon allowed us to participate in a 5:30 pm conference call with Federal Reserve officials from all parts of the country and all of the Fed's functions. During that call, we learned the effects of the terrorist attacks were even more widespread than had been apparent from New York."

FOLLOWING UP

"For the next week and a half, SCRRM members, other staff in all Reserve Banks' credit and risk management functions, and staff at the Board of Governors shared critical information via late-afternoon conference calls. We held those daily calls until market conditions returned to more-or-less normal.

"More recently, SCRRM has been reviewing contingency plans and contributing to a variety of projects to ensure that the Fed will be able to function in any future emergency. We hope those plans will never be used."

IT SOON BECAME APPARENT THAT THERE WERE MAJOR DISRUPTIONS TO THE FINANCIAL SYSTEM.



The staff of SCRRM's administrative office holds a meeting at its Philadelphia headquarters.

CASH & CUSTOMER SERVICE

If events interfere with the supply of cash, the public and the economy may suffer. Although the events of September 11 didn't have as great an impact on cash operations as they did on checks, Don Doros, executive vice president, offered comments on the Philadelphia Fed's preparedness to meet a cash challenge.

"Late on the morning of September 11, we held discussions here at the Bank about how individual Reserve Banks were responding to events of that day. Since Philadelphia had no evidence of any threat to its operations, we remained open.

"Our customer service staff was kept busy answering phones. Most of our customers seemed to have two main questions: Were we open? Was extra cash available in the event that it was needed? The answer to both questions was yes. As it turned out, a few customers asked for special orders, to meet unusually heavy demand at ATMs. On subsequent days, we received no special orders. We also told customers that we would stay open longer than normal for pickup and delivery of cash. Our norm is 3 pm. But we have some latitude to accept and receive deposits later

than that, and it would not be unusual for us to stay open until 6 pm or 7 pm to accept a deposit. Toward the weekend, we also announced that we would be open on Saturday for emergency orders."



**EVEN IN THIS AGE OF
PAYMENT CARDS,
CASH IS STILL AN
IMPORTANT PART
OF THE ECONOMY.
BANKS NEED CASH TO
MEET DAILY DEMAND,
AND ATMS MUST BE
KEPT STOCKED.**

DONALD F. DOROS

EXECUTIVE VICE PRESIDENT

DEALING WITH A POTENTIAL PROBLEM

"One potential problem did surface. At one point, armored carriers said they would be pulling their trucks off the roads. This threat was troubling for at least a couple of reasons. For one thing, if a bank, in fact, needed currency, it would lack the means of getting it. Another factor involved banks' retail customers. Some retailers use armored carriers to directly pick up deposits. Plus many of these stores don't have the facilities to keep and adequately protect large amounts of cash.

"So you can see that not having armored trucks available would not only affect the relationship between the Fed and the banks it serves, but it would also disrupt the relationships between banks and their customers. We felt we had to address this situation.

"Requests for pickup or deposit of currency come to

us directly from the armored carriers on behalf of the banks that have hired them. Consequently, we've developed a very close relationship with the various armored services.

"Because we've built this close relationship over the years, staff here at the Bank called local carriers directly and urged them to be responsive to their customers' needs. I'm happy to say that by mid-afternoon armored carriers were on the road, and luckily, this did not become a major complication."

MAINTAINING COMMUNICATION

"As events unfolded over the rest of the week, we kept up communications with our customers. Mostly,

they wanted to know the status of Fedwire and check clearing. Another important part of the story is e-mail.

Philadelphia is in the process of taking over monitoring the performance and supporting the infrastructure of e-mail for the Federal Reserve System. But, thus far, the transition is not complete. Nonetheless, we

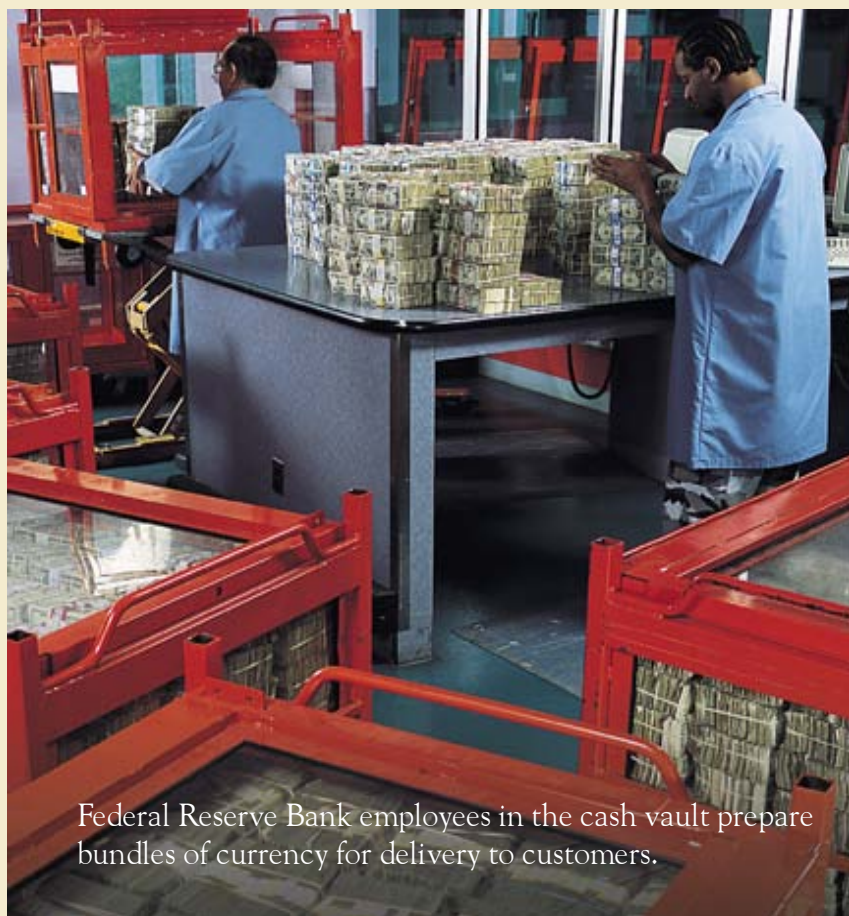
had our people on alert, and we had our back-up facility ready. The good news is that we did not need to use it. E-mail service was maintained and proved to be an effective means of communicating throughout the Federal Reserve System as it did throughout the country. So, for that portion of the e-mail system we're already managing, we did well."

REVIEWING PROCEDURES

"Of course, the events of September 11 have caused the Federal Reserve System to review its contingency plans. Although the System has a considerable amount of contingency plans already, we now have to make sure they're adequate for these new circumstances.

"I think the message in all of this is that we're well prepared to provide cash services to our customers in an emergency. Our operations stayed open, and we were in close contact with our customers. And even though there were no extraordinary demands for currency, had there been, be assured that we would have been able to meet them."

WE'RE WELL PREPARED TO PROVIDE CASH SERVICES TO OUR CUSTOMERS IN AN EMERGENCY.



Federal Reserve Bank employees in the cash vault prepare bundles of currency for delivery to customers.

PUBLIC AFFAIRS

The Public Affairs Department helps to shape the public's understanding and perception of the Federal Reserve through working with the local and national media. During a crisis, our role is to provide relevant, timely information.

"Fifteen minutes after the second airplane crashed into the tower, the first call came into Public Affairs. 'The Fed hasn't evacuated,' the reporter yelled back to the newsroom. It was but the first of many media calls received in the hours and days following the terrorist attacks.

"My first response was to let reporters know that we were open and operating and that the Federal Reserve System stood ready to supply liquidity to any financial institution during this disruption in the markets. This message went on our Bank's web site immediately.

"My colleagues within the Fed Bank network and the Board of Governors quickly scheduled regular communication through e-mail alerts and daily conference calls. Fed Banks with operations that served the entire Fed network spoke on behalf of the System. For example, Atlanta, home to the check relay system, answered check inquiries; San Francisco acted as the source for cash distribution questions, while Boston was contacted regarding retail payments.

"Days were filled talking to officers handling front-burner issues, sitting in on Vice Chairman Ferguson's conference calls, and conferring with colleagues. We followed the same clear crisis communications guidelines that proved successful during Y2K. Individual Fed Banks handled questions about their region but referred national matters to Washington.

"Some reporters' questions were very specific. For example, Washington press wanted to know the whereabouts of Chairman Greenspan. (He was safe in

Switzerland.) In Richmond, the television media wanted to know if the same architect who designed the World Trade Towers had worked on their building. (Yes, it was.) In Philadelphia, the question was if our president had returned from giving a speech in New York the day before. (Yes, he and his staff returned on Monday.)

"Yet from San Francisco to Boston, all my public affairs peers were dealing with many of the same questions: What impact will the attack have on the economy? How are checks being transported if all airplanes are grounded? Was there plenty of cash?

"In Philadelphia, reporters called about rumors of alleged bank runs — unfounded in our District. It became important to convey that the Philadelphia Fed was prepared with plenty of cash, and the Fed stood ready to meet any nationwide unexpected cash demands.

"Our responses were closely coordinated to be consistent. We had to speak with one clear voice.

"We also had to be mindful of having consistent news reports nationwide. One low note was news from the Justice Department that several Fed Banks might have been targets for terrorists. One high note — literally — came from the New York Fed, located in the heart of Wall Street, as it played John Philip Sousa music over its outside speakers.

"From the Liberty Bell to the Golden Gate Bridge, the Federal Reserve System spoke with one strong, clear, reassuring voice during the September 11 crisis."



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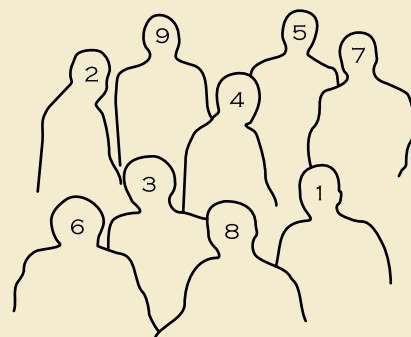
Chairman, Federal Reserve Bank of Philadelphia Board of Directors. Board member since 1996. Partner in law firm of Ballard Spahr Andrews & Ingersoll, LLP. Member of Labor and Employment Law Group of firm's litigation department. Chair of American Bar Association Commission on Racial and Ethnic Diversity.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

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* Not Pictured

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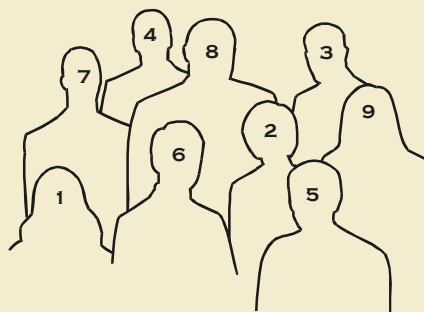
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President & CEO
AmeriChoice FCU
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Judith M. Supplee (9)

President & CEO
Keystone FCU
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* Not Pictured



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Support Officer

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Administrative Services
and Security Officer

Edward Morrison
Operations Officer
Data Processing

Michelle Scipione
Cash Services Officer

Stephen J. Smith
Assistant Counsel

Anthony J. White
Financial Services Officer

Officers list through December 31, 2001, plus 2002 promotions through March

OPERATING STATISTICS

Total commercial check volume increased 2 percent while the dollar value of transactions increased 31 percent. An increase in the number of high dollar value Same Day Settlement deposits resulted in an increase in total dollar value of checks processed. A significant increase in U.S. government check volume was experienced in 2001 because of the issuance of a one-time income tax rebate.

In 2001, the Bank continued to be a major processor of cash in the Federal Reserve System. Increases

in the volume of currency processed were attributable to additional capacity resulting from the installation of two currency counting rooms. The substantial increase in coin processed was the result of unusually large deposits from one of our large cash customers.

While the number of loans to depository institutions in 2001 was lower than in the previous year, the average size of the loans was higher.

	2001 Volume	2001 Dollar Value	2000 Volume	2000 Dollar Value
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SERVICES TO DEPOSITORY INSTITUTIONS

Wire Transfer of Funds	8.2 million transfers	\$27.3 trillion	7.7 million transfers	\$25.3 trillion
Check processing:				
U.S. Government	40.9 million checks	\$37.1 billion	31.1 million checks	\$32.5 billion
Commercial checks	1,339.8 million checks	\$2,501.3 billion	1,314.5 million checks	\$1,913.4 billion
Cash operations:				
Currency processed	2,053.8 million notes	\$36.8 billion	1,659.0 million notes	\$35.6 billion
Coin processed	52.5 thousand bags	\$29.9 million	19.7 thousand bags	\$9.6 million
Loans to depository institutions	96 loans	\$503 million	183 loans	\$545 million

SERVICES TO U.S. TREASURY

Electronic book-entry transfers	48,000 transfers	\$170 billion	47,000 transfers	\$138 billion
Food coupons processed	6.4 million coupons	\$34.3 million	6.3 million coupons	\$31.3 million

Note: Because of consolidation of Federal Reserve System ACH operations in 2001, ACH statistics are no longer shown here.

Financial Report

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32	Notes to Financial Statements

LETTER TO DIRECTORS



FEDERAL RESERVE BANK
OF PHILADELPHIA

January 11, 2002

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

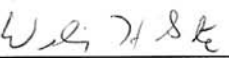
The management of the Federal Reserve Bank of Philadelphia is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2001 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks, and as such, include amounts, some of which are based on judgments and estimates of management.

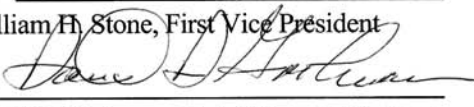
The management of the Federal Reserve Bank of Philadelphia is responsible for maintaining an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements. Such internal controls are designed to provide reasonable assurance 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, the management of the Federal Reserve Bank of Philadelphia believes 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.

By 
Anthony M. Santomero, President

By 
William H. Stone, First Vice President

By 
David D. Gathman, Chief Financial Officer

REPORT OF INDEPENDENT ACCOUNTANTS



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, 2001, included in the accompanying Management's Assertion. The assertion is the responsibility of FRB Philadelphia's management. Our responsibility is to express an opinion on the assertions based on our examination.

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants, and accordingly, included obtaining an understanding of the internal control over financial reporting, testing, and evaluating the design and operating effectiveness of the internal control, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that the 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, 2001, is fairly stated, in all material respects, based upon criteria described in "Internal Control - Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

March 4, 2002
Philadelphia, Pennsylvania

REPORT OF INDEPENDENT ACCOUNTANTS



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, 2001 and 2000, and the related statements of income and changes in capital for the years then ended. 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, 2001 and 2000, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

March 4, 2002
Philadelphia, Pennsylvania

STATEMENTS OF CONDITION

As of December 31, 2001 and December 31, 2000 (in millions)

ASSETS	2001	2000
Gold certificates	\$ 454	\$ 414
Special drawing rights certificates	83	83
Coin	44	52
Items in process of collection	526	384
Loans to depository institutions	—	2
U.S. government and federal agency securities, net	23,071	21,596
Investments denominated in foreign currencies	481	486
Accrued interest receivable	234	251
Interdistrict settlement account	—	1,353
Bank premises and equipment, net	70	72
Other assets	91	91
Total assets	\$ 25,054	\$ 24,784
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	\$ 21,773	\$ 23,114
Deposits:		
Depository institutions	413	702
Other deposits	2	3
Deferred credit items	100	404
Interest on Federal Reserve notes due U.S. Treasury	29	44
Interdistrict settlement account	2,239	—
Accrued benefit costs	51	51
Other liabilities	5	10
Total liabilities	24,612	24,328
Capital:		
Capital paid-in	221	228
Surplus	221	228
Total capital	442	456
Total liabilities and capital	\$ 25,054	\$ 24,784

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

STATEMENTS OF INCOME

For the years ended December 31, 2001 and December 31, 2000 (in millions)

	2001	2000
Interest income:		
Interest on U.S. government and federal agency securities	\$ 1,219	\$ 1,211
Interest on investments denominated in foreign currencies	11	8
Total interest income	1,230	1,219
Other operating income:		
Income from services	47	43
Reimbursable services to government agencies	20	23
Foreign currency losses, net	(47)	(44)
U.S. government securities gains (losses), net	13	(3)
Other income	4	3
Total other operating income	37	22
Operating expenses:		
Salaries and other benefits	79	74
Occupancy expense	9	9
Equipment expense	13	11
Cost of unreimbursed Treasury services	—	4
Assessments by Board of Governors	24	23
Other expenses	32	39
Total operating expenses	157	160
Net income prior to distribution	\$ 1,110	\$ 1,081
Distribution of net income:		
Dividends paid to member banks	\$ 14	\$ 13
Transferred to (from) surplus	(7)	145
Payments to U.S. Treasury as interest on Federal Reserve notes	1,103	923
Total distribution	\$ 1,110	\$ 1,081

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

STATEMENTS OF CHANGES IN CAPITAL

for the years ended December 31, 2001 and December 31, 2000 (in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 2000 (4.0 million shares)	\$ 199	\$ 200	\$ 399
Net income transferred to surplus	—	145	145
Surplus transfer to the U.S. Treasury	—	(117)	(117)
Net change in capital stock issued (0.6 million shares)	29	—	29
Balance at December 31, 2000 (4.6 million shares)	\$ 228	\$ 228	\$ 456
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

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

1. ORGANIZATION

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. 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.

Structure

The Bank in Philadelphia serves the Third Federal Reserve District, which includes Delaware and portions of New Jersey and Pennsylvania. In accordance with the Federal Reserve Act, supervision and control of the Bank are exercised by a Board of Directors. 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

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, 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 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. Data for 2001 reflects the adoption of this policy. Major services provided for the System by this bank, for which the costs will not be redistributed to the other Reserve Banks, include: Collateral Management System, Electronic Cash Letter development, Groupware Leadership Center, Office of Cash Fiscal Services, 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 and 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. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

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.

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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 amounts 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 2001.

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 any loans were 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 Board 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.

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.

Matched sale-purchase transactions are accounted for as separate sale and purchase transactions. Matched sale-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.

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.

Foreign exchange (“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.

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. However, decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, 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

NOTES TO FINANCIAL STATEMENTS

on the sales of U.S. government and federal agency securities are reported as “U.S. government securities gains (losses), net.” Foreign-currency-denominated assets are revalued daily at current 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 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 loaned, investments denominated in foreign currency, interest income, 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 FRBNY and not to other Reserve Banks.

Statement of Financial Accounting Standards No. 133, as amended and interpreted, became effective on January 1, 2001. For the periods presented, the Reserve Banks had no derivative instruments required to be accounted for under the standard.

e. Bank Premises and Equipment

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. Internally-developed software is capitalized based on the cost of direct materials and services and those indirect costs associated with developing, implementing, 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 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, triparty agree-

ments, 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. 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 Federal Reserve notes reduced by currency held in the vaults of the Bank of \$6,562 million, and \$8,706 million at December 31, 2001 and 2000, 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. 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.

The Consolidated Appropriations Act of 2000 (Public Law 106-113, Section 302) directed the Reserve Banks to transfer to the U.S. Treasury additional surplus funds of \$3,752 million during the Federal Government’s 2000 fiscal year. Federal Reserve Bank of Philadelphia transferred \$117 million to the U.S. Treasury. Reserve Banks were not permitted to replenish surplus for these amounts during fiscal year 2000, which ended September 30, 2000; however, the surplus was replenished by December 31, 2000.

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.

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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. The costs of providing fiscal agency and depository services to the Treasury Department that have been billed but will not be paid are reported as the "Cost of unreimbursed Treasury 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 \$70 million and \$71 million at December 31, 2001 and 2000, respectively. The centralized portion of the Bank's Costs of unreimbursed Treasury services totaled \$77 thousand and \$4 million for the years ended December 31, 2001 and 2000, respectively. Enhancement to the Treasury billing process implemented January 1, 2001 resulted in a significant decrease in the amount of unreimbursed costs.

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, with the exception of securities held under agreements to resell and the related premiums, discounts and income, 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 4.107 percent and 4.165 percent at December 31, 2001 and 2000, respectively.

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

Par value:	2001	2000
Federal agency	\$.4	\$ 5.4
U.S. government:		
Bills	7,478.5	7,444.7
Notes	10,923.2	10,003.5
Bonds	4,257.8	3,864.5
Total par value	22,659.9	21,318.1
Unamortized premiums	464.2	405.5
Unaccreted discounts	(52.8)	(127.8)
Total allocated to Bank	\$ 23,071.3	\$ 21,595.8

Total SOMA securities bought outright were \$561,701 million and \$518,501 million at December 31, 2001 and 2000, respectively.

The maturity distribution of U.S. government and federal agency securities bought outright, which were allocated to the Bank at December 31, 2001, were as follows (in millions):

Maturities of Securities Held	Par value		
	U.S. Government Securities	Federal Agency Obligations	Total
Within 15 days	\$ 438.9	\$ —	\$ 438.9
16 days to 90 days	5,115.6	—	5,115.6
91 days to 1 year	5,365.4	—	5,365.4
Over 1 year to 5 years	6,290.8	0.4	6,291.2
Over 5 years to 10 years	2,190.8	—	2,190.8
Over 10 years	3,258.0	—	3,258.0
Total	\$ 22,659.5	\$ 0.4	\$ 22,659.9

At December 31, 2001 and 2000, matched sale-purchase transactions involving U.S. government securities with par values of \$23,188 million and \$21,112 million, respectively, were outstanding, of which \$952 million and \$879 million were allocated to the Bank. Matched sale-purchase transactions are generally overnight arrangements.

At December 31, 2001 and 2000, U.S. government securities with par values of \$7,345 million and \$2,086 million, respectively, were loaned from the SOMA, of which \$302 million and \$87 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 held 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 3.305 percent and 3.101 percent at December 31, 2001 and 2000, respectively.

NOTES TO FINANCIAL STATEMENTS

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

	2001	2000
European Union Euro:		
Foreign currency deposits	\$ 152	\$ 144
Government debt instruments including		
Agreements to resell	89	85
Japanese Yen:		
Foreign currency deposits	62	85
Government debt instruments including		
Agreements to resell	176	170
Accrued interest	2	2
Total	\$ 481	\$ 486

Total investments denominated in foreign currencies were \$14,559 million and \$15,670 million at December 31, 2001 and 2000, respectively.

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2001, was as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies

Within 1 year	\$ 453
Over 1 year to 5 years	13
Over 5 years to 10 years	15
Total	\$ 481

At December 31, 2001 and 2000, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 2001 and 2000, the warehousing facility was \$5 billion, with zero outstanding.

6. BANK PREMISES AND EQUIPMENT

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

	2001	2000
Bank premises and equipment:		
Land	\$ 2.5	\$ 2.4
Buildings	65.8	63.9
Building machinery and equipment	9.6	9.1
Construction in progress	.5	1.8
Furniture and equipment	59.1	56.8
	137.5	134.0
Accumulated depreciation	(67.8)	(62.5)
Bank premises and equipment, net	\$ 69.7	\$ 71.5

Depreciation expense was \$9 million and \$8 million for the years ended December 31, 2001 and 2000, respectively.

The Bank leases unused space to an outside tenant. This lease has a term of two years. Rental income from such lease was \$1 million for both years ended December 31, 2001 and 2000. Future minimum lease payments under the noncancelable agreement in existence at December 31, 2001 were \$3 million for years 2002 through 2003.

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2001, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from 1 to approximately 2 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 \$658 thousand and \$554 thousand for the years ended December 31, 2001 and 2000, 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, 2001, were \$534 thousand for the years 2002 through 2003.

At December 31, 2001, the Bank has no other commitments and long-term obligations in excess of one year.

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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 1 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, 2001 or 2000.

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"). 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, 2001 and 2000, 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 and \$2 million for the years ended December 31, 2001 and 2000, respectively, 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):

	2001	2000
Accumulated postretirement benefit obligation at January 1	\$ 33.4	\$ 30.3
Service cost-benefits earned during the period	0.7	0.6
Interest cost of accumulated benefit obligation	2.4	2.2
Actuarial loss	2.1	1.5
Contributions by plan participants	0.3	0.2
Benefits paid	(1.5)	(1.4)
Plan amendments, acquisitions, foreign currency exchange rate changes, business combinations, divestitures, curtailments, settlements, special termination benefits	(0.2)	—
Accumulated postretirement benefit obligation at December 31	\$ 37.2	\$ 33.4

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):

	2001	2000
Fair value of plan assets at January 1	\$ —	\$ —
Actual return on plan assets	—	—
Contributions by the employer	1.2	1.2
Contributions by plan participants	0.3	0.2
Benefits paid	(1.5)	(1.4)
Fair value of plan assets at December 31	\$ —	\$ —
Unfunded postretirement benefit obligation	\$ 37.2	\$ 33.4
Unrecognized prior service cost	16.0	17.6
Unrecognized net actuarial gain (loss)	(8.9)	(7.0)
Accrued postretirement benefit costs	\$ 44.3	\$ 44.0

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

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At December 31, 2001 and 2000, the weighted average discount rate assumptions used in developing the benefit obligation were 7.0 percent and 7.5 percent, respectively.

For measurement purposes, a 10.0 percent annual rate of increase in the cost of covered health care benefits was assumed for 2002. 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, 2001 (in millions):

	1 Percentage Point Increase	1 Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	\$ 0.2	\$ (0.3)
Effect on accumulated postretirement benefit obligation	2.4	(3.5)

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

	2001	2000
Service cost-benefits earned during the period	\$ 0.7	\$ 0.6
Interest cost of accumulated benefit obligation	2.4	2.2
Amortization of prior service cost	(1.8)	(1.8)
Recognized net actuarial loss	0.2	0.1
Net periodic postretirement benefit costs	\$ 1.5	\$ 1.1

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 both December 31, 2001 and 2000, were \$7 million. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in both 2001 and 2000 operating expenses were \$1 million.