

Mission

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

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

Annual Report 2003

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Putting *Money in Motion*: Telling Our Story

The Federal Reserve Bank of Philadelphia has literally been putting money in motion since it opened in 1914. But many people have not had the opportunity to fully understand what we do and why.

With the debut of our permanent exhibit, “Money in Motion,” in July 2003, we opened our doors to the public to help clarify the Fed’s role in the financial system throughout its history. Using cutting edge technology and innovative concepts, we’ve made learning about the Fed fun and entertaining.

But the theme for this year’s annual report refers to more than the exhibit. Our story is also told through changes taking place in the check arena and a new \$20 bill redesigned for additional security.

Please read on to see how the Federal Reserve has evolved along with the financial services industry.

President's Message

The Federal Reserve has literally been “putting money in motion” for 90 years. We have come a long way from the simplicity of our origins as facilitator of the payments system. Today, as the central bank of the United States, the Federal Reserve is at the center of a complex and ever-changing financial system.

As our mission evolves in concept and scope, always foremost in our minds is that our institution is built on integrity and efficiency and wields vast influence over our nation's economy. We recognize the magnitude of our responsibilities, we take our stewardship seriously, and we work diligently to reach and exceed our goals.

Despite the Fed's rich and intriguing past, its story, and in particular that of the Federal Reserve Bank of Philadelphia, has not been well known. Now, with our *Money in Motion* exhibit, we are working to change that.

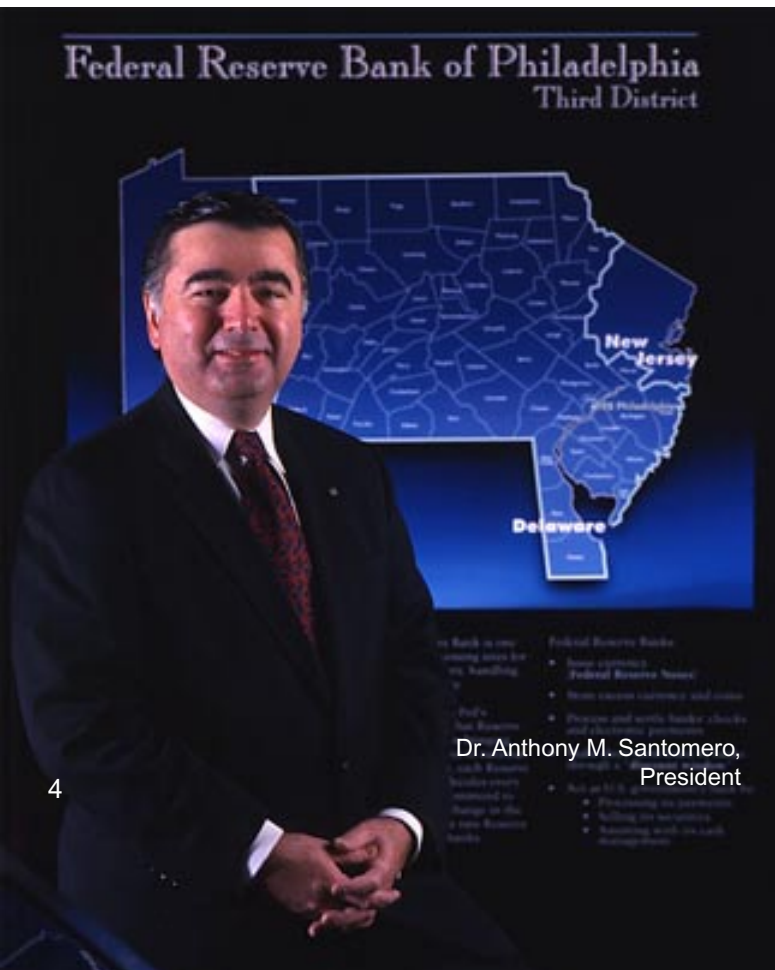
Money in Motion: The Exhibit Tells Our Story

The Federal Reserve works as a stage manager for the financial system—critical to its smooth operation but entirely behind the scenes. Particularly since the events of 9/11, when the Federal Reserve proved instrumental in maintaining stability

in financial markets, consumers need and want a better understanding of what the Fed does and why we do it.

For the Philadelphia Fed in particular, providing a historical context for the role of central banking seems quite appropriate, given our city's standing as the birthplace of both our nation and banking. Indeed, the buildings that were home to the first and second Bank of the United States are in close proximity to our own building on Independence Mall.

Money in Motion, our new financial and historical exhibit, was born of the notion that people of all ages should possess a solid understanding of money and finance.



Since opening to great fanfare in July 2003, the exhibit has told the story of central banking in the United States as it has never been told before. As we trace our roots through the exhibit, we provide a powerful reminder of the ingenuity, the political battles, and the colorful cast of characters that brought our nation's central bank to life.

Money in Motion: Change Abounds at the Fed

While the exhibit itself is a physical manifestation of the Federal Reserve's activities, there have also been many changes in the details of our work. In fact, 2003 was a year that involved intense change in our Reserve Bank on a number of fronts.

First, it marked our conversion to a new check processing platform. This transition was driven primarily by the need to install a uniform national platform for financial services across the Federal Reserve System. Also, a standardized platform facilitates our move toward the more modern payments system emerging out of recent legislation. Known as "Check 21," this act facilitates the use of new technology in check payments, creating a more efficient system of check collection and processing. First Vice President Bill Stone provides more details on this exciting new technology in a later section of this report.

This year also marked the introduction of the new \$20 bill. In addition to their new look and color, the new notes are safer, smarter, and more secure than ever before. The Treasury plans to issue a new \$50 bill this fall, and we are working hard to build awareness about currency authenticity and to combat counterfeiters.

Meanwhile, as credit cards, debit cards, and other new methods of payment become more popular and pervasive, the Philadelphia Fed's Payment Cards Center continues its work to provide meaningful insights into this emerging sector of the financial services industry.

Our economic education initiatives are yet another element of the ongoing efforts by the Federal Reserve Bank of Philadelphia to open its doors and help the public understand what we do. Around our District, we're helping young people understand the workings of the economy and the financial system. We're helping low- and moderate-income communities protect people from unscrupulous business practices and evaluate risks and alternatives. And we hold seminars and workshops here at the Bank to teach the importance of economic and financial education.

The Federal Reserve works as a stage manager for the financial system—critical to its smooth operation but entirely behind the scenes.

The economic recovery is gaining traction, and we look forward to solid expansion in 2004, with GDP growing at a healthy pace and job growth accelerating as we move through the year.

Money in Motion: The Economy in Motion

A key part of the Federal Reserve's mission is to ensure the robust health of the U.S. economy. Our Research Department advances this effort through its in-depth analyses of the economy and innovative research on policy issues. The department's contributions to economic policymaking were supported by our third annual Policy Forum, which was held last fall and focused on "Managing the Recovery in Uncertain Times." The event brought together widely recognized experts from around the world to discuss the central policy issues that emerged during the ongoing recovery.

At the Philadelphia Fed, our outlook for this economic recovery is bright. The economic recovery is gaining traction, and we look forward to solid expansion in 2004, with GDP growing at a healthy pace and job growth accelerating as we move through the year. Meanwhile, inflation should remain subdued.

For the longer term, changes in technology and the globalization of markets will continue to present the U.S. economy with new challenges and new opportunities. By responding as we always have—with ingenuity and innovation—we will ensure continued improvement in living standards both here and around the world.

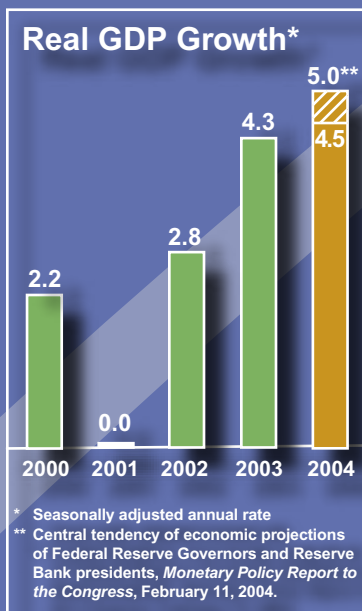
The Third District's economy weathered the recent business cycle reasonably well, and our region's economy continues to evolve along with the nation's. Looking ahead, we are well positioned to take advantage of the ongoing economic expansion.

As the expansion unfolds, monetary policy will begin returning to a more neutral stance. Likewise, the stage will be set for fiscal policy to pursue a more balanced posture. However, both these policy changes are likely to occur only slowly and in response to the acceleration of growth. In short, the U.S. economy is on the right path—a path of sustained growth with low inflation—and that is a good place to be.

Board of Directors

As always, we are truly grateful for the valuable contributions of all who assisted us in the past year. Special thanks go to our Board of Directors. Their role is critical to putting money in motion. Their broad experience and keen acumen allowed us to accomplish a great deal in 2003.

I am pleased to report the following election results:



Ronald J. Naples, chairman and CEO of Quaker Chemical Corporation, has been appointed Chairman of the Board, and Doris M. Damm, president and CEO of ACCU Staffing Services, was appointed Deputy Chairman.

We look forward to the insight and guidance of our newest Board members: William F. Hecht, chairman, president, and CEO of PPL Corporation, and Eugene W. Rogers, CEO and director of Newfield National Bank.

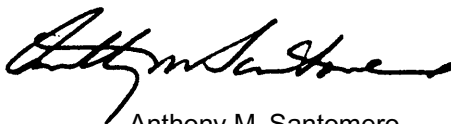
In addition, Rufus A. Fulton, Jr., chairman and CEO of Fulton Financial Corporation, has been reappointed to represent the Third District on the Federal Advisory Council to the Board of Governors.

Finally, we wish to offer our sincere thanks to those who completed their terms of service on our Board of Directors: our former Chairman Glenn A. Schaeffer, president emeritus of the Pennsylvania Building and Construction Trades Council, and Robert J. Vanderslice, president and COO of Pennsville National Bank.

Closing Thoughts

In closing, I want to point out that 2004 marks the 90th anniversary of an important date in central banking history. On November 16, 1914, the nation's 12 Federal Reserve Banks opened their doors for business. At the time, the Federal Reserve Bank of Philadelphia operated out of a modest two-room office at 4th and Chestnut streets. Ninety years have brought tremendous change. Throughout 2004, we will celebrate this milestone and honor the progressiveness of our forefathers in their classic example of addressing competing concerns—a decentralized central bank that successfully balances private and public interests.

We hope you enjoy this year's annual report, "Putting Money in Motion: Telling Our Story." It expresses the spirit in which we pursue new initiatives to strengthen our role as a central bank. Likewise, it explains the origins of our core convictions and commitments. But most important, it demonstrates our focus on helping our region continue to grow and prosper.



Anthony M. Santomero
President
April 2004

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Money in Motion Opens at the Philadelphia Fed



The day after Federal Reserve Chairman Alan Greenspan's visit, the new *Money in Motion* exhibit opened to the public. The first day drew 125 people. Since then, we're proud to report that *Money in Motion* has attracted more than 15,000 visitors.

The Bank's new permanent exhibit, *Money in Motion*, continues to garner rave reviews from employees, visitors, and the media. It took the efforts of nearly 100 employees, a design firm, and other vendors over the course of almost two years to make it happen.

Like all good productions, *Money in Motion* had a series of rehearsals. Several groups were invited to preview the exhibit before it went "prime time." The Bank's officers and managers, Bank employees and their families, and the press were asked to celebrate the installation of the exhibit and test it out. The official unveiling by Fed Chairman Alan Greenspan on July 2, 2003, was the culmination of the activities leading up to the exhibit's public debut on July 3.

The Bank's officers and managers got first crack at the exhibit. They were generally impressed with the professional design of the exhibit elements, particularly the many interactive features. President Santomero noted that the exhibit is consistent with the Bank's strategic goal of engaging the Philadelphia community. He added, "The exhibit is what we envisioned. It puts Philadelphia's role in central banking in context."

Sunday, June 22, was earmarked for Family Day. Hundreds of employees brought spouses, children, and grandchildren to see *Money in Motion*. Typical responses from employees included one from Ray Smith, Treasury Services, who declared the exhibit "very classy, top shelf." Sheila Harris, Records Management, called it "very interesting; great for schools and kids."

Next, we invited regional business reporters to the Bank for a "sneak peek." They explored each of the exhibit's elements, and Public Affairs staff members were on hand to answer their questions.

"Among the displays are powerful reminders of a history of central banking in this country that had its origins in [a] classic edifice on Third Street in Philadelphia."

—Alan Greenspan



Greenspan told the assembly that it was particularly appropriate for the Philadelphia Reserve Bank to install this exhibit, given Philadelphia's "key part in our country's founding...and in the development of banking in the U.S."



Finally, on July 2, 2003, Federal Reserve Chairman Alan Greenspan made the journey to Philadelphia to officially open *Money in Motion*.

Hundreds of invited guests from the region's business and financial services community, Bank officers, and reporters from local print and electronic media crammed into Eastburn Court, the Bank's main lobby, to hear the Chairman's remarks. As cameras clicked and recorders whirred, Greenspan told the assembly that it was particularly appropriate for the Philadelphia Reserve Bank to install this exhibit, given Philadelphia's "key part in our country's founding, and especially given the historic significance of this neighborhood for the development of banking in the U.S."

Greenspan was referring to the Bank's location in the heart of the city's historic district. The Federal Reserve Bank of Philadelphia's current home at 6th and Arch streets is near the Liberty Bell, Independence Hall, and the new National Constitution Center, which opened July 4, 2003. The Bank also lies just a few blocks from the sites of its central banking predecessors: the first Bank of the United States and the second Bank of the United States.

The Chairman's remarks offered a capsule of the history of central banking. He concluded with these words: "The current structure of the Federal Reserve System and the wide recognition of the value of political independence to ensure the effective administration of our nation's monetary policy reflect, in part, the understanding by our System's founders of our early central banking history. Among the displays of the *Money in Motion* exhibit are powerful reminders of a history of central banking in this country that had its origins in that classic edifice on Third Street in Philadelphia" [a reference to the first Bank of the United States]. Before his speech, Greenspan took a private tour of *Money in Motion*. Upon completing it, he remarked, "Good exhibit. Even better than I expected." ■

Telling the Fed’s Story Through *Money in Motion*

Four elements of the *Money in Motion* exhibit—“In & Out,” “Eye on the Money,” “Swipe It,” and “Moving Money at Near Light Speed”—inform visitors about some of the activities of the Federal Reserve Bank of Philadelphia and the Federal Reserve System and the various ways in which the Fed puts money in motion.

“In & Out” and “Eye on the Money”

In telling the public what the Fed does, we knew it was important to explain our role in the payments system. That’s why we’ve included the 25-foot tower of shredded money, which dominates the “In & Out” portion of the exhibit. This tower brings home the fact that the Philadelphia Fed alone shreds \$20 million in unfit currency on an average day.

In the exhibit, we also explain that circulated notes—used money—come in from local financial institutions that have too much currency on hand, or that need to increase the amount of money they must hold on deposit with the Fed. The Fed counts the money and replaces worn or torn bills with new money. Worn or torn notes are automatically routed to stainless steel blades on the Fed’s high-speed currency shredders, which crosscut notes into confetti-like shreds. New money is printed by the Bureau of Engraving and Printing in Washington, D.C., and Fort Worth, Texas, and issued by the Federal Reserve Banks to financial institutions.

The Fed distributes both new and circulated bills to meet the

The Fed distributes both new and circulated bills to meet the demand for currency from financial institutions.





demand for currency from financial institutions in the Third Federal Reserve District. A related exhibit element, "Eye on the Money," tracks the journey of newly printed and circulated money within the Federal Reserve Bank of Philadelphia.

Another part of "In & Out" is a currency container that displays what more than \$1 million in new \$5 bills looks like when stored in a currency cart. The Philadelphia Fed uses these containers to move large numbers of bills in its vault.

"Swipe It"

Consumers are using payment cards more and more to purchase a variety of items both in brick-and-mortar stores and online. This increased usage has led to rising concern among consumers and in the financial services industry about credit card fraud, identity theft, and the problems associated with mounting personal debts.

The "Swipe It" component of the exhibit teaches visitors about the various forms of credit and debit cards. It provides information on how consumers can protect themselves against credit card fraud and identity theft. It also lets them use a debt calculator to see how long it takes to pay off credit card debt, especially when minimum payments are made. This element also answers some frequently asked questions about credit cards.

"Swipe It" ties in with the work of the Federal Reserve Bank of Philadelphia's Payment Cards Center. This unit, which was established in 2000, provides insight into developments in the payment cards industry. During 2003 the Center produced a number of analytical papers on the subject and hosted a series of conferences that brought together representatives from the industry, academia, and the policy arena.

Increased usage of payment cards has led to rising concern about credit card fraud, identity theft, and the problems associated with mounting personal debts.



Wire transfers can move trillions of dollars—
at near light speed—from one account
to another. Fedwire electronically transfers
approximately \$3 trillion each day.

“Moving Money at Near Light Speed”

In this modern age, moving money can mean more than just the physical processing of checks or cash or using plastic. Wire transfers can move trillions of dollars—at near light speed—from one account to another. That’s the role Fedwire plays in our nation’s payments system.

The Fedwire system is an electronic funds transfer and book-entry securities transfer service. It links the Federal Reserve Banks and approximately 10,000 depository institutions nationwide.

Fedwire electronically transfers approximately \$3 trillion each day. About 60 percent of that total represents payments made by financial institutions acting on behalf of themselves or their customers. The balance is transfers of U.S. government and agency securities.

Fedwire transfers are immediate and not revocable. Although many transfers are for less than \$1,000, the average runs in the millions of dollars. ■

Check Clearing for the 21st Century

“At the Federal Reserve Bank of Philadelphia, we look forward to the opportunities and potential afforded by Check 21. We are working to help banks prepare so they can take full advantage of its benefits and pass them along to their own customers.”

~ First Vice President Bill Stone

By facilitating the use of new technologies, Check 21 will improve the efficiency and reduce the cost of the nation’s check collection system, while providing better services to bank customers. Banks will achieve this by simply replacing original checks with electronically created substitute checks, both of which contain identical payment information. These substitute checks are paper reproductions that are the legal equivalent of the original checks.

Our nation’s check payments system has changed a great deal. Just half a century ago, millions of checks were sorted by hand every day. Then, in the 1960s, mechanical high-speed processing equipment emerged as the most high-tech means to read and sort checks.

But change is constant in the banking industry. What was once touted as the latest technology is considered both costly and labor-intensive in today’s fast-paced world. With around 40 billion checks processed each year, the industry is constantly challenged to become faster and more efficient to keep pace with change.

Despite the fact that check payments in the United States likely peaked in the mid-1990s and have declined gradually since, they still represent approximately half of the nation’s noncash payment transactions. Checks are still the most popular form of retail payments in the U.S. after cash. To stay ahead of the ever-changing industry curve, the Federal Reserve System approached the U.S. Congress in late 2001 with a proposal that promised to bring check payments into the 21st century.

The Check Clearing for the 21st Century Act, also known as Check 21, will take effect on October 28, 2004.

This legislation facilitates the use of new technology in check payments, allowing for a more efficient system of check collection and processing. Under Check 21, financial institutions will be able to create substitute checks, using digital images and electronic check information, which will allow them to collect and return checks more quickly.

Check 21 is part of the broader process of electronic check presentment (ECP), whereby checks are cleared based on information gathered electronically rather than from the actual paper checks. The process is technologically sophisticated, yet quite simple: digital images of checks are transmitted electronically from banks where the checks were deposited to the “paying bank” (the check writer’s bank), central operations center, or other service provider. From there, banks can elect to accept checks forwarded for collection either in electronic form or in the form of a substitute check.

The original checks are truncated, or stopped, before reaching the paying bank. The substitute checks—not the images themselves—serve as the legal equivalent of the original check. For the most part, Check 21 will be transparent to the consumer. However, bank customers who currently receive cancelled checks



First Vice President William H. Stone, Jr. (front) looked over the new check processing machines with (left to right) Assistant Vice President Ronald R. Sheldon, Vice President Arun Jain, and Assistant Vice President John P. Kelly.

Check Out the Benefits of Check 21

More choices:

By taking advantage of electronic check presentment and return capabilities, banks can offer an alternative to today's paper-based system.

Increased efficiencies:

By reengineering their infrastructure with electronics, banks can expedite the collection or return of checks, streamline internal processes, reduce operating costs, and realize greater efficiencies.

Greater innovation:

By providing innovative new services, banks can broaden their deposit options or extend deposit cutoff hours.

back may begin to receive some substitute checks after Check 21 becomes effective. Over time, customers' monthly statements may include only copies of check images or may simply list each transaction.

To prepare for this bold initiative, the Federal Reserve is actively involved in a number of projects focused on analysis, design, and development to ensure the readiness of our operations and to achieve strategic alignment with the financial services industry. The Federal Reserve System recently standardized its check processing platforms nationwide. In addition, Reserve Banks around the country intend to introduce a broad array of new and improved products, services, and solutions, supporting Check 21 and offering customers more options than ever before.

When asked about the future of checks, First Vice President Bill Stone had this to say:

"This new infrastructure for checks will enhance our capabilities and leverage our strengths in the dynamic payments environment. At the Philadelphia Fed, we continue to embrace technology and innovation as we seek ways to enhance our services. These changes will pave the way for new methods of operation, improved efficiency, and cost reduction in the nation's check processing system. The bottom line is better services for bank customers. Most important, it will enable us to more quickly and effectively respond to our customers' needs, which remain, as always, our foremost priority."



Changing Platforms: The Check Standardization Project

Putting money in motion certainly involves processing checks. This was especially evident in 2003, when the Federal Reserve Bank of Philadelphia's Retail Payments area underwent a significant change: the conversion of the check processing platform from Unisys application software and hardware to an IBM-based check processing system.

This "check conversion" is all part of a larger Federal Reserve System effort called the Check Modernization Project, an umbrella term that covers four areas: Check Standardization, Enterprise-wide Adjustments, Image Services System, and Electronic Access and Delivery. Check Standardization is, by far, the largest and most important component, and it's the one that encompasses the conversion of the check processing platform.

Why the switch? Several considerations led the Federal Reserve System to switch platforms. Philadelphia, like the other Reserve Banks, has more national customers now, and they're demanding more uniform services from the Reserve Banks. Because of the variety of platforms in use around the Federal Reserve System, depository institutions weren't getting uniform service and products.

In addition, having a standard processing platform makes it easier to adapt to Check 21, the legislation that provided the impetus for the switch. If the Federal Reserve System had to equip each of 37 offices with new systems, it would take five years to

The change in check processing platforms was driven by the need to have uniformity across the Federal Reserve System and to carry out provisions of Check 21.





(Left to right): Gary Swasey, Joe Basile, and Tom Ballay, of Retail Payments, go over some figures.

Having a common platform will increase efficiency...and allow a more dynamic environment.

implement Check 21. One platform makes it easier to deploy a system nationwide.

Cutting costs is another reason for changing platforms. Now, when something goes wrong with the system, one solution fixes the problem for all of the Reserve Banks. That way, the Fed doesn't have to have software and support experts at

each Reserve Bank, Branch, or regional check processing center.

At the Federal Reserve System level, having a common platform will make some functions easier to perform and increase efficiency. A common platform also allows a more dynamic environment. Restructuring check operations—for example, because of additional bank mergers—will be easier because the infrastructure is already in place. Furthermore, the new setup offers tools the Fed didn't have before, such as an enhanced ability for reconcilements using images of rejected items.

Of course, the switch to a common platform has an impact on the Federal Reserve Banks. A national system certainly means less autonomy for the individual Banks. In Philadelphia's case, historically, we've been known for our quick response to customers. Working with a uniform system could make that harder to do.

Philadelphia was the last Reserve Bank to cut over to the new system. The switchover was designed that way because Philadelphia is the largest check processor in the System, and its check operation is more complex. For example, Philadelphia provides payor bank services, which involves the electronic transmission of check data and certain other services for large corporate customers. Our Delaware banks are the biggest users of this product. The Philadelphia Fed also performs imaging services for several other large customers. Going last allowed Philadelphia to minimize the platform conversion's impact on its customers. It also allowed us to learn from those Reserve Banks that converted before us.

In fact, Philadelphia did its cutover in four distinct phases; all the other Reserve Banks made the switch in a single event. The four phases began on September 18, 2003, and ended on October 30, 2003. Each phase allowed us to use a little bit more of the system.

Besides the advantages to the Federal Reserve, how does the new system benefit the Fed's customers? Because the new system allows the Fed to improve its check imaging services, Fed customers will get better service in that area. In addition, the more efficient, image-based medium-speed platform will work better with return items, thereby cutting down on the number of adjustments.

Also, the IBM-based platform offers the Fed's customers more options. For example, when customers use the new system in conjunction with FedLine for the Web, they'll be able to access check images through the Internet.

All in all, the switch to the new check processing platform means more efficiency and lower costs for the Federal Reserve System and better service for its customers. ■

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The New Color of Money

“Every aspect of the redesign was coordinated through the Reserve Banks. Each followed identical procedures when storing and releasing the new currency.”

~ Michelle Scipione

Cash Officer Michelle Scipione points out new security features on the \$20 bill.



The Federal Reserve Bank of Philadelphia believes its participation in the Series 2004 \$20 outreach campaign will pay off for consumers and businesses in its District.

Before the colorful new notes were distributed to the approximately 300 financial institutions in the Third District, Philadelphia's Cash and Public Affairs departments directed an extensive educational outreach program to introduce the enhanced security features.

Our Cash Department's first forum, which followed the May 2003 unveiling, introduced the new design to the District's 10 largest financial institutions and regional armored carriers. More detailed seminars, open to all customers, followed and involved the United States Secret Service. “Every aspect of the redesign was coordinated throughout the Federal Reserve System,” said Philadelphia Fed Cash Officer Michelle Scipione, who helped develop the procedures as well as the training materials for banks and retailers. “Each of the Federal Reserve Banks distributed the same training materials to customers and followed identical procedures when storing and releasing the new currency,” Scipione explained.

Expanded training made a difference in this campaign. The Philadelphia Fed conducted seminars for Southeastern Pennsylvania Transit Authority (SEPTA) managers and supervisors. During the 1998 currency rollout, the U.S. Treasury and the Fed learned an important lesson when some transit authorities discovered that the new \$20s were not compatible with the older software in their bill-acceptance machines. This time, the Fed worked with businesses and cash machine vendors to prevent any glitches. In fact, the Bureau of Engraving and Printing (BEP) met with vendors as the prototypes of the new \$20 were being designed and also provided them with test notes early in 2003.

The SEPTA training was filmed and featured along with

other new currency programs in a news release videotape distributed by the Treasury that aired on more than 200 stations nationwide when the currency was rolled out. Weeks earlier, advertisements and placements of the new \$20 aired on popular programs such as *Who Wants to Be a Millionaire?*, *America's Funniest Home Videos*, *Jeopardy*, and *Live with Regis and Kelly*, all paid for by the Treasury as part of the \$53 million, five-year currency campaign to build awareness.

"Educating people on how to authenticate currency is crucial," said Bob McCarthy, Philadelphia Fed Public Affairs manager. McCarthy gave interviews and speeches on the currency around the District. He found the public was eager to see the new color of money. Although the remake featured subtle peach and blue background colors and striking eagle icons, McCarthy encouraged consumers to check their currency for the portrait watermark, color-shifting ink, and security thread.

The Public Affairs and Cash departments invited the press to be among the first to see and spend the new \$20s on October 9, 2003, when they were released into circulation. The Federal Reserve Banks' seamless distribution of currency to financial institutions across the country required careful advance planning. Months earlier, each Federal Reserve Bank received and secured large inventories of the new \$20 notes based on their customers' needs. Although all the Federal Reserve Banks released the new \$20s to their customers on the same day (October 9, 2003), most of the public didn't have the bills in their hands until a few days later.

The Federal Reserve System, the U.S. Treasury, the Bureau of Engraving and Printing, and the U.S. Secret Service are coordinating efforts, expanding training, and building awareness about the new currency here and abroad. The Philadelphia Fed will also continue its role in educating its constituencies and maintaining the public's confidence in American currency. ■



(Left to right): Bureau of Engraving and Printing Director Tom Ferguson, Treasury Secretary John W. Snow, Federal Reserve Board Chairman Alan Greenspan, U.S. Treasurer Rosario Marin, and U.S. Secret Service Director W. Ralph Basham unveil the new design for the \$20 bill.

What's Next for U.S. Currency

This fall, the Treasury expects to issue the new \$50 bill, followed by the \$100 in 2005. Designs will be introduced every seven to 10 years to stay ahead of counterfeiters.

Payment Cards Center

The Center was created to address payment card issues and serve as a source of expertise on this emerging sector of the financial services industry.

As credit cards, debit cards, and other new methods of payment become more popular and pervasive, the Philadelphia Fed's Payment Cards Center continues its work to provide meaningful insights into this realm of retail payments.

The Center was created to address payment card issues and serve as a source of expertise on this emerging sector of the financial services industry. By studying innovations in retail payments through research and analysis, workshops, and conferences, the Center encourages dialogue among industry participants, academics, and policymakers. Importantly, the Center's staff draws on the expertise of their Reserve Bank colleagues, from retail risk quantification specialists in Supervision, Regulation and Credit to payments-focused economists in the Research Department.

Here are just a few of the Center's 2003 activities, which shed light on important trends and developments in the payment cards industry.

Conferences

"Asset-Backed Securities and Credit Cards" (December 3, 2003) brought together industry practitioners and the bank regulatory community to explore the role of securitization in the credit card industry and discuss emerging issues.

"Financial Privacy: Perspectives from the Payment Cards Industry" (March 21, 2003) included legal and industry experts who provided insights into the controversy surrounding the financial privacy debate and addressed steps being taken to safeguard personal financial information.

“Innovations at the Point of Sale” (February 27, 2003) highlighted emerging developments, trends, and challenges in consumer payments with a special emphasis on merchants’ perspectives.

Discussion Papers

“Consumer Bankruptcy: How Unsecured Lenders Fare” (November 2003), a discussion paper by Payment Cards Center Industry Specialist Mark Furletti, assesses trends and developments in bankruptcy filings and their impact on unsecured lenders, especially credit card issuers.

“Credit Card Pricing Developments and Their Disclosure” (January 2003), a discussion paper also by Mark Furletti, considers changes in credit card pricing over the past two decades and describes how new technologies, increasing competition, and consumer awareness have influenced card pricing and broadened the availability of unsecured credit.

Research Working Papers

“An Introduction to the Economics of Payment Card Networks” (June 2003), a Research Department working paper by Philadelphia Fed economist Robert Hunt, provides an overview of the economics of the payment card industry, examining the antitrust issues arising from the vast coordination among financial institutions, retailers, and consumers in open payment card networks.

“Credit Card Securitization and Regulatory Arbitrage” (April 2003), a Research Department working paper by Charles Calomiris (Columbia Business School, the National Bureau of Economic Research, and the American Enterprise Institute), and Joseph Mason (Drexel University and Payment Cards Center visiting scholar), explores the motivations and desirability of off-balance-sheet financing of credit card receivables by banks. ■

To learn more about the Center’s conferences and papers, or to obtain more information on other Payment Cards Center activities, please visit our web site at www.phil.frb.org/pcc.



(Left to right): Oliver Ireland, attorney, Morrison & Foerster; Peter Swire, professor of law, the Moritz College of Law, Ohio State University; Andy Navarrete, associate general counsel, Capital One; and Bill Brooks, chief privacy officer, MBNA, participate in a panel discussion during a Payment Cards Center symposium on privacy issues in the payment card industry.

Federal Reserve Bank of Philadelphia

Board of Directors

Robert E. Chappell (5)

Board member since 2000. Member, Budget and Operations and Personnel committees. Chairman and CEO of Penn Mutual Life Insurance Company. Member, Insurance Federation of Pennsylvania, Taxation and Financial Services Steering Committee for American Council of Life Insurance. Serves on boards of Quaker Chemical Corporation, South Chester Tube Company, LOMA, and Wharton Financial Institutions Center at the University of Pennsylvania.

Walter E. Daller, Jr. (4)

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

Doris M. Damm (3)

Board member since January 2001. Member, Budget and Operations and Personnel committees. President and Chief Executive Officer of ACCU Staffing Services. Other affiliations include Cerebral Palsy of New Jersey, Cherry Hill Economic Development Council, Our Lady of Lourdes Medical Center, Our Lady of Lourdes Foundation, and Cherry Hill Regional Chamber of Commerce.

Garry L. Maddox (6)

Board member since January 2003. Member, Audit and Research and External Affairs committees. CEO of A. Pomerantz & Company. Founding President of World Wide Concessions, Inc. Corporate Marketing Representative, Philadelphia Phillies Organization. Partner of Aramark, Food and Beverage Concession at the Airport. Founder & Executive Director of LPGA Urban Youth Golf Program of Greater Atlantic City, Founder & President of the Youth Golf & Academics Program. Serves on boards of the Boys and Girls Clubs of Camden County, Greater Philadelphia Chamber of Commerce, Chamber of Commerce of Southern New Jersey, Fairmount Park Commission, Philadelphia Sports Congress, and the Corporate Alliance for Drug Education. Director Emeritus of the Philadelphia Child Guidance Center. Member of the Board of Governors of the National Adoption Center.

Ronald J. Naples (2)

Deputy Chairman, Federal Reserve Bank of Philadelphia Board of Directors. Board member since January 2001. Member, Audit and Research and External Affairs committees. Chairman and Chief Executive Officer of Quaker Chemical Corporation. Chairman of the Board of the University of the Arts. Serves on boards of Glatfelter, Philadelphia Museum of Art, Franklin Institute, Foreign Policy Research Institute, Rock School of the Pennsylvania Ballet, and American Red Cross - Southeastern Pennsylvania Chapter.

Glenn A. Schaeffer (1)

Chairman, Federal Reserve Bank of Philadelphia Board of Directors. Board member since 1998. President Emeritus, Pennsylvania Building and Construction Trades Council in Harrisburg. Co-founder, Capital Area Labor Management Committee. Coordinator, Capital Area Labor Management Construction Partnership Coordination Project. Serves on the board of Capital Blue Cross.

Kenneth R. Shoemaker (9)

Board member since January 2003. Member, Audit and Research and External Affairs committees. President and CEO of Orrstown Bank, President and CEO of Orrstown Financial Services. Member, Pennsylvania Bankers Association. Chairman of the Council of Trustees of Shippensburg University. Serves on boards of Cumberland Valley School of Music and the Carlisle Regional Medical Center. Founding President of the Mainstreet Non-Profit Redevelopment Corporation.

P. Coleman Townsend, Jr. (8)

Board member since January 2002. Member, Budget and Operations and Personnel committees. Chairman and CEO of Townsends, Inc. Member of the Board of Trustees of the University of Delaware, Winterthur Museum, and Christiana Care. Serves on the Council of Advisors for Delaware Center for Horticulture, Lehman Art Center Advisory Committee, Liberty Mutual Advisory Committee, and the Board of Overseers for Delaware College of Art and Design.

Robert J. Vanderslice (7)

Board member since January 2001. Member, Audit and Research and External Affairs committees. President and COO of Pennsville National Bank, Vice President of Penn Bancshares, Inc. Serves on the board of Memorial Hospital of Salem County. Professional affiliations: Pennsville Economic Development Commission, Penns Grove Rotary Club, Salem County Technical and Vocational School Advisory Board, Salem County Community College Foundation, and Salem County Chamber of Commerce.



Federal Reserve Bank of Philadelphia Councils

2003 Business Council

CHAIRMAN

John K. Ball (2)
Chairman, President, &
CEO
R.M. Shoemaker Co.
West Conshohocken, PA

Lynn Banta (8)
Owner
Twin Stacks
Development Co. Inc.
Dallas, PA

Michael F. Camardo*
Executive Vice President
Lockheed Martin
Technology
Cherry Hill, NJ

Douglass C. Henry, Jr. (4)
CEO
Henry Molded Products
Lebanon, PA

Dennis E. Klima (1)
President & CEO
Bayhealth Inc.
Dover, DE

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

Mitchell L. Morgan (9)
President
Morgan Properties
King of Prussia, PA

Albert Morrison, III (7)
Chairman, President, &
CEO
Burnham Holdings
Lancaster, PA

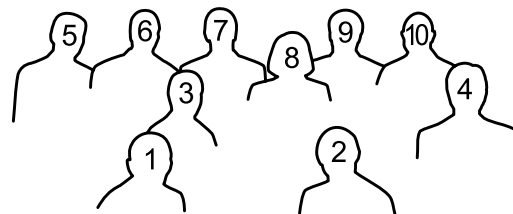
Audrey S. Oswell*
President & COO
Resorts Atlantic City
Atlantic City, NJ

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

William L. Wilson (6)
Principal-in-Charge
Synterra
Philadelphia, PA

Mark S. Stellini (3)
President & CEO
InfoSystems
Wilmington, DE

* Not Shown



2003 Community Bank Council

Joseph E. Chippie (2)

President & CEO
First National Bank of
Wyoming
Wyoming, DE

Robert E. Forse (5)

Chairman, President, &
CEO
Woodlands Bank
Williamsport, PA

Mark D. Gainer (3)

President & CEO
Union National
Community Bank
Mt. Joy, PA

Aaron L. Groff (7)

Chairman, President, &
CEO
Ephrata National Bank
Ephrata, PA

George W. Nise (8)

President & CEO
Beneficial Savings Bank
Philadelphia, PA

John W. Ord*

President & CEO
Peoples National Bank
Hallstead, PA

CHAIRMAN

Frederick C. (Ted)

Peters II (1)
Chairman, President, &
CEO
The Bryn Mawr Trust
Company
Bryn Mawr, PA

Eugene W. Rogers (4)

CEO
Newfield National Bank
Newfield, NJ

Patrick M. Ryan*

President and CEO
The Yardville National
Bank
Hamilton, NJ

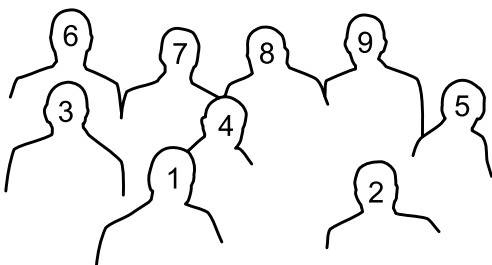
William F. Snell (9)

President & CEO
Farmers and Merchants
Trust Co.
Chambersburg, PA

Wayne R. Weidner (6)

Chairman, President, &
CEO
National Penn
Bancshares, Inc.
Boyertown, PA

* Not Shown



Federal Reserve Bank of Philadelphia Councils

2003 Credit Union Council

CHAIRMAN

Paula M. Albanese (1)
President
Diamond State FCU
New Castle, DE

Barbara Arrowsmith*
Manager
New Castle County
Delaware Employees
FCU
New Castle, DE

David W. Clendaniel (10)
President & CEO
Dover FCU
Dover, DE

Eileen Crean (11)
President & CEO
CUMCO FCU
Vineland, NJ

John LaRosa (6)
COO & Treasurer
Police and Fire FCU
Philadelphia, PA

**Louise P. Lingenfelter
(8)**
President & CEO
UGI Employees FCU
Wyomissing, PA

Robert L. Marquette (7)
President & CEO
Members 1st FCU
Mechanicsburg, PA

James F. McCaw (2)
President & CEO
K of C FCU
Philadelphia, PA

Thomas A. Phillips (9)
General Manager
Lakehurst Naval FCU
Lakehurst, NJ

Diana L. Roberts (5)
President & CEO
Hershey FCU
Hershey, PA

Judith M. Supplee (3)
President & CEO
Keystone FCU
West Chester, PA

Virginia F. Williams (4)
CEO
FAA Technical Center
FCU
Northfield, NJ



* Not Shown



Operating Statistics

In 2003, Philadelphia's total volume of commercial checks processed decreased by 3 percent and the dollar value of transactions decreased by 5 percent. A significant increase in U.S. government check volume was experienced in 2003, attributable to Philadelphia's assuming responsibility, on a phased basis beginning in January 2002, for processing all government checks for the First, Second, Third, Fourth, and a portion of the Fifth Federal Reserve Districts.

The Philadelphia Bank continued to be a major processor of cash in the Federal Reserve System in 2003. The volume of cur-

rency processed increased by 4 percent while the related dollar value increased 3 percent, both attributable to normal growth. With the August 2002 elimination of coin weighing (with the exception of dollar coins) for greater operational efficiency, the volume measurement was changed from bags weighed to bags processed in both years. Because we gained a large customer in 2003, there was an 88 percent increase in processed coin volume and a 79 percent increase in processed coin value.

In 2003, both the number and value of loans to depository institutions were higher than in the previous year.

SERVICES TO DEPOSITORY INSTITUTIONS

	2003 Volume	2003 Dollar Value	2002 Volume	2002 Dollar Value
Check processing:				
U.S. Government	81.9 million checks	\$100.0 billion	52.8 million checks	\$64.5 billion
Commercial checks	1,239.6 million checks	\$2,457.1 billion	1,282.6 million checks	\$2,594.7 billion
Cash operations:				
Currency processed	2,212.0 million notes	\$43.0 billion	2,116.7 million notes	\$41.2 billion
Coin processed	430.9 thousand bags	\$204.6 million	229.1 thousand bags	\$114.1 million
Loans to depository institutions	99 loans	\$308.3 million	68 loans	\$210.3 million

Note: Because of the consolidation of Federal Reserve System food coupon operations to other Federal Reserve offices, related statistics are no longer shown here.

Federal Reserve Bank of Philadelphia

Current Officers

Anthony M. Santomero
President

William H. Stone, Jr.
First Vice President

Donald F. Doros
Executive Vice President

Richard W. Lang
Executive Vice President

Michael E. Collins
Senior Vice President
and Lending Officer

Loretta J. Mester
Senior Vice President and
Director of Research

John B. Shaffer
Senior Vice President and
General Auditor

Milissa M. Tadeo
Senior Vice President
Cash Services and Treasury
Services

John G. Bell
Vice President
Financial Statistics

Robert J. Bucco
Vice President
Wholesale Product Office

Peter P. Burns
Vice President and Director
Payment Cards Center

Theodore M. Crone
Vice President and Economist

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

Patrick L. Donahue
Vice President
Customer Relations

Michael Dotsey
Vice President and Senior
Economic Policy Advisor

Richard A. Elliott
Vice President
Facilities, Records, and
Document Services

Donna L. Franco
Vice President and
Chief Financial Officer

Faith P. Goldstein
Vice President
Public Affairs

Mary Ann Hood
Vice President
Human Resources

Arun K. Jain
Vice President
Retail Payment Services

Henry T. Kern
Vice President
Cash Services

William W. Lang
Vice President
Supervision, Regulation and
Credit

Edward M. Mahon
Vice President and General
Counsel

Stephen A. Meyer
Vice President and
Senior Economic Policy
Advisor

Mary DeHaven Myers
Vice President and
Community Affairs Officer

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

Patrick M. Regan
Vice President
Information Technology
Services

Richard A. Sheaffer
Vice President
Treasury Services

Herbert E. Taylor
Vice President and
Corporate Secretary

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

Kei-Mu Yi
Vice President and Economist

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

Mitchell S. Berlin
Assistant Vice President and
Economist

Shirley L. Coker
Assistant Vice President and
Counsel

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

Stephen G. Hart
Assistant Vice President
Human Resources

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

John P. Kelly
Assistant Vice President
Retail Payment Services

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

Alice Kelley Menzano
Assistant Vice President
Information Technology
Services

Camille M. Ochman
Assistant Vice President
Treasury Services

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

Ronald R. Sheldon
Assistant Vice President
Retail Payment Services

Eric A. Sonnheim
Assistant Vice President
Supervision, Regulation and
Credit

Marie Tkaczyk
Assistant Vice President
Information Technology
Services

Richard A. Valente
Assistant Vice President and
Assistant General Auditor

Constance H. Wallgren
Assistant Vice President
Supervision, Regulation and
Credit

Anthony J. White
Assistant Vice President
Customer Relations

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

Aileen C. Boer
Research Support Officer

Donna L. Brenner
Budget and Procurement
Officer

Maryann T. Connelly
Assistant Counsel

Michael T. Doyle
Business Planning and
Analysis Officer

Suzanne W. Furr
Wholesale Product Officer

Linda K. Kirson
Office Automation
Support Officer
Information Technology
Services

Joseph L. McCann
Administrative Services
and Security Officer

Michelle M. Scipione
Cash Services Officer

Stephen J. Smith
Assistant Counsel

Statement of Auditor Independence

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2003 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$1.4 million. To ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2003, the Bank did not engage PwC for advisory services.

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35	Statements of Income
36	Statements of Changes in Capital
37	Notes to Financial Statements

Letter to Directors



FEDERAL RESERVE BANK
OF PHILADELPHIA

January 8, 2004

To the Board of Directors

The management of the Federal Reserve Bank of Philadelphia is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2003 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the Federal Reserve Bank of Philadelphia is responsible for maintaining an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements. Such internal controls are designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of reliable Financial Statements. This process of internal controls contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in the process of internal controls are reported to management, and appropriate corrective measures are implemented.

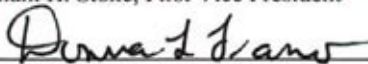
Even an effective process of internal controls, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements.

The management of the Federal Reserve Bank of Philadelphia assessed its process of internal controls over financial reporting including the safeguarding of assets reflected in the Financial Statements, based upon the criteria established in the "Internal Control -- Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, we believe that the Federal Reserve Bank of Philadelphia maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Federal Reserve Bank of Philadelphia

by 
Anthony M. Santomero, President

by 
William H. Stone, First Vice President

by 
Donna L. Franco, Chief Financial Officer

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, included in the accompanying Management 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, 2003, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB Philadelphia's management is responsible for maintaining effective internal control over financial reporting and safeguarding of assets as they relate to the financial statements. Our responsibility is to express an opinion on management's assertion based on our examination.

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

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of 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 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, 2003 is fairly stated, in all material respects, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

This report is intended solely for the information and use of management and the Board of Directors and Audit Committee of FRB Philadelphia, and any organization with legally defined oversight responsibilities and is not intended to be and should not be used by anyone other than these specified parties.

March 1, 2004

Report of Independent Auditors



REPORT OF INDEPENDENT AUDITORS

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

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, 2003 and 2002, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of The Federal Reserve System. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2003 and 2002, and results of its operations for the years then ended, in conformity with the basis of accounting described in Note 3.

A handwritten signature in black ink, appearing to read "PricewaterhouseCoopers LLP".

March 1, 2004

Statements of Condition

As of December 31, 2003 and December 31, 2002 (in millions)

	2003	2002
ASSETS		
Gold certificates	\$ 380	\$ 430
Special drawing rights certificates	83	83
Coin	37	61
Items in process of collection	493	494
U.S. government and federal agency securities, net	21,121	24,576
Investments denominated in foreign currencies	552	510
Accrued interest receivable	158	210
Interdistrict settlement account	905	-
Bank premises and equipment, net	80	73
Other assets	97	96
Total assets	\$ 23,906	\$ 26,533
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	\$ 21,347	\$ 18,624
Securities sold under agreements to repurchase	802	811
Deposits:		
Depository institutions	719	577
Other deposits	2	3
Deferred credit items	451	556
Interest on Federal Reserve notes due U.S. Treasury	9	47
Interdistrict settlement account	-	5,391
Accrued benefit costs	52	51
Other liabilities	7	7
Total liabilities	23,389	26,067
Capital:		
Capital paid-in	258	233
Surplus	259	233
Total capital	517	466
Total liabilities and capital	\$ 23,906	\$ 26,533

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

Statements of Income

For the years ended December 31, 2003 and December 31, 2002 (in millions)

	2003	2002
Interest income:		
Interest on U.S. government and federal agency securities	\$ 742	\$ 984
Interest on investments denominated in foreign currencies	7	8
	<hr/>	<hr/>
Total interest income	749	992
Interest expense:		
Interest expense on securities sold under agreements to repurchase	7	1
	<hr/>	<hr/>
Net interest income	742	991
Other operating income:		
Income from services	40	46
Reimbursable services to government agencies	20	20
Foreign currency gains, net	75	62
U.S. government securities gains, net	-	3
Other income	3	3
	<hr/>	<hr/>
Total other operating income	138	134
Operating expenses:		
Salaries and other benefits	84	81
Occupancy expense	9	9
Equipment expense	13	13
Assessments by Board of Governors	36	21
Other expenses	29	29
	<hr/>	<hr/>
Total operating expenses	171	153
Net income prior to distribution	<hr/> \$ 709	<hr/> \$ 972
Distribution of net income:		
Dividends paid to member banks	\$ 15	\$ 14
Transferred to surplus	26	12
Payments to U.S. Treasury as interest on Federal Reserve notes	668	946
	<hr/>	<hr/>
Total distribution	\$ 709	\$ 972

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

Statements of Changes in Capital

For the years ended December 31, 2003 and December 31, 2002 (in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 2002 (4.4 million shares)	\$ 221	\$ 221	\$ 442
Net income transferred to surplus	-	12	12
Net change in capital stock issued (0.2 million shares)	12	-	12
	<hr/>	<hr/>	<hr/>
Balance at December 31, 2002 (4.6 million shares)	\$ 233	\$ 233	\$ 466
Net income transferred to surplus	-	26	26
Net change in capital stock issued (0.6 million shares)	25	-	25
	<hr/>	<hr/>	<hr/>
Balance at December 31, 2003 (5.2 million shares)	\$ 258	\$ 259	\$ 517
	<hr/>	<hr/>	<hr/>

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

Notes to Financial Statements

1. Structure

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

Board of Directors

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

2. Operations and Services

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

Notes to Financial Statements

costs are funded through assessments on the Reserve Banks.

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

3. Significant Accounting Policies

Accounting principles for entities with the unique powers and responsibilities of the nation’s central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with 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 because 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. A Statement of Cash Flows, therefore, would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

Each Reserve Bank provides services on behalf of the System for which costs are not shared. Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include: Collateral Management System, Electronic Cash Letter System,

Notes to Financial Statements

Groupware Leadership Center, Subcommittee on Credit, Reserves, and Risk Management Administration Office, and Treasury Direct Central Business Administration Function.

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

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 on average Federal Reserve notes outstanding in each District.

b. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2003 or 2002.

c. Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the

Notes to Financial Statements

Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Boards of Directors of the Reserve Banks, subject to review by the Board of Governors. Loans to depository institutions are reported as "Other assets."

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

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account ("SOMA"). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. Such authorizations are reviewed and approved annually by the FOMC.

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

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

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

The FRBNY, on behalf of the Reserve Banks, maintains renewable,

Notes to Financial Statements

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 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 that 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 may result in gains or losses when holdings are sold prior to maturity. Decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government and federal agency securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis and is reported as "Interest on U.S. government and federal agency securities" or "Interest on investments denominated in foreign currencies," as appropriate. Income earned on securities lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Gains and losses

Notes to Financial Statements

on the sales of U.S. government and federal agency securities are reported as “U.S. government securities gains, net.” Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as “Foreign currency gains, net.” Foreign currencies held through F/X swaps, when initiated by the counter-party, and warehousing arrangements are revalued daily with the unrealized gain or loss reported by the FRBNY as a component of “Other assets” or “Other liabilities,” as appropriate.

Balances of U.S. government and federal agency securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currency, interest income and expense, securities lending fee income, amortization of premiums and discounts on securities bought outright, gains and losses on sales of securities, and realized and unrealized gains and losses on investments denominated in foreign currencies, excluding those held under an F/X swap arrangement, are allocated to each Reserve Bank. 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.

In 2003, additional interest income of \$61 million, representing one day’s interest on the SOMA portfolio, was accrued to reflect a change in interest accrual methods, of which \$2 million was allocated to the Bank. Interest accruals and the amortization of premiums and discounts are now recognized beginning the day that a security is purchased and ending the day before the security matures or is sold. Previously, accruals and amortization began the day after the security was purchased and ended on the day that the security matured or was sold. The effect of this change was not material; therefore, it was included in the 2003 interest income.

e. Bank Premises, Equipment, and Software

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

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

Notes to Financial Statements

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

g. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In 2003, the Federal Reserve Act was amended to expand the assets eligible to be pledged as collateral security to include all Federal Reserve Bank assets. Prior to the amendment, only gold certificates, special drawing rights certificates, U.S. government and federal agency securities, securities purchased under agreements to resell, loans to depository institutions, and investments denominated in foreign currencies could be pledged as collateral. 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 par value of securities pledged for securities sold under agreements to repurchase is similarly deducted. The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. The Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks in order to satisfy their obligation of providing sufficient collateral for outstanding Federal Reserve notes. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding reduced by its currency holdings of \$8,288 million, and \$6,893 million at December 31, 2003 and 2002, 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

Notes to Financial Statements

the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of \$100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

i. Surplus

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

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

j. Income and Costs related to Treasury Services

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

Beginning January 1, 1998, the reimbursement process for all Reserve Banks was centralized at the Bank that included the transfer of each Reserve Bank's Treasury reimbursement receivable to the Bank. The centralized portion of the Bank's reimbursement receivable, reported in "Other assets," totaled \$74 million and \$73 million at December 31, 2003 and 2002, respectively. The centralized portion of the Bank's Costs of unreimbursed Treasury services, reported in "Other expense," totaled \$69 thousand at December 31, 2003.

k. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were \$2 million for both years ended December 31, 2003 and 2002, and are reported as a component of "Occupancy expense."

l. Recent Accounting Developments

In May 2003, the Financial Accounting Standards Board issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150, which will become applicable for the Bank in 2004, establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and imposes certain additional disclosure requirements. When adopted, there may be situations in which the Bank has not yet processed a member bank's application

Notes to Financial Statements

to redeem its Reserve Bank stock. In those situations, this standard requires that the portion of the capital paid-in that is mandatorily redeemable be reclassified as debt.

m. 2003 Restructuring Charges

In 2003, the System restructured several operations, primarily in the check and cash services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations.

Footnote 10 describes the restructuring and provides information about the Bank's costs and liabilities associated with employee separations and contract terminations. Costs and liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8 and those associated with the Bank's enhanced postretirement benefits are disclosed in footnote 9.

4. U.S. Government and Federal Agency Securities

Securities bought outright are held in the SOMA at the FRBNY. An undivided interest in SOMA activity and the related premiums, discounts, and income, with the exception of securities purchased under agreements to resell, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings. The settlement, performed in April of each year, equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 3.126 percent and 3.845 percent at December 31, 2003 and 2002, respectively.

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

	2003	2002
Par value:		
U.S. government:		
Bills	\$ 7,654	\$ 8,717
Notes	10,110	11,455
Bonds	3,079	4,031
	<hr/>	<hr/>
Total par value	20,843	24,203
Unamortized premiums	306	414
Unaccreted discounts	(28)	(41)
	<hr/>	<hr/>
Total allocated to Bank	\$ 21,121	\$ 24,576
	<hr/>	<hr/>

Notes to Financial Statements

The total of SOMA securities bought outright was \$675,569 million and \$639,125 million at December 31, 2003 and 2002, respectively.

As noted in footnote 3, the FRBNY replaced MSP transactions with securities sold under agreements to repurchase in December 2002. At December 31, 2003 and 2002, securities sold under agreements to repurchase with a contract amount of \$25,652 million and \$21,091 million, respectively, were outstanding, of which \$802 million and \$811 million were allocated to the Bank. At December 31, 2003 and 2002, securities sold under agreements to repurchase with a par value of \$25,658 million and \$21,098 million, respectively, were outstanding, of which \$802 million and \$811 million were allocated to the Bank.

The maturity distribution of U.S. government securities bought outright and securities sold under agreements to repurchase, that were allocated to the Bank at December 31, 2003, was as follows (in millions):

Maturities of Securities Held	U.S. Government Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	\$ 1,492	\$ 802
16 to 90 days	4,357	-
91 days to 1 year	5,130	-
Over 1 year to 5 years	5,848	-
Over 5 years to 10 years	1,604	-
Over 10 years	2,412	-
Total	\$ 20,843	\$ 802

At December 31, 2003 and 2002, U.S. government securities with par values of \$4,426 million and \$1,841 million, respectively, were loaned from the SOMA, of which \$138 million and \$71 million were allocated to the Bank.

5. Investments Denominated in Foreign Currencies

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

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X

Notes to Financial Statements

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 2.778 percent and 3.015 percent at December 31, 2003 and 2002, respectively.

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

	2003	2002
<i>European Union Euro:</i>		
Foreign currency deposits	\$ 191	\$ 168
Government debt instruments including agreements to resell	114	99
<i>Japanese Yen:</i>		
Foreign currency deposits	41	54
Government debt instruments including agreements to resell	204	186
<i>Accrued interest</i>	2	3
Total	\$ 552	\$ 510

Total investments denominated in foreign currencies were \$19,868 million and \$16,913 million at December 31, 2003 and 2002, respectively.

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2003, was as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies

Within 1 year	\$ 507
Over 1 year to 5 years	36
Over 5 years to 10 years	9
Total	\$ 552

At December 31, 2003 and 2002, there were no outstanding F/X swaps or material open foreign exchange contracts.

At December 31, 2003 and 2002, the warehousing facility was \$5,000 million, with no balance outstanding.

Notes to Financial Statements

6. Bank Premises, Equipment, and Software

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

	2003	2002
Bank premises and equipment:		
Land	\$ 3	\$ 3
Buildings	72	66
Building machinery and equipment	11	11
Construction in progress	1	1
Furniture and equipment	71	64
	<hr/>	<hr/>
Subtotal	\$ 158	\$ 145
Accumulated depreciation	(78)	(72)
	<hr/>	<hr/>
Bank premises and equipment, net	\$ 80	\$ 73
	<hr/>	<hr/>
Depreciation expense, for the years ended	\$ 9	\$ 9
	<hr/>	<hr/>

The Bank leases unused space to an outside tenant. This lease has a term of 2 years. Rental income from such lease was \$1 million for both years ended December 31, 2003 and 2002. Future minimum lease payments under the noncancelable agreement in existence at December 31, 2003, were \$2 million for years 2004 through 2005.

The Bank has capitalized software assets, net of amortization, of \$6 million and \$5 million at December 31, 2003 and 2002, respectively. Amortization expense was \$1 million for both years ended December 31, 2003 and 2002.

A software asset was impaired as a result of the decision to standardize check processing in the System. Asset impairment losses of \$1 million were reported as a component of "Other expenses" for the period ending December 31, 2003.

7. Commitments and Contingencies

At December 31, 2003, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately 3 years. These leases provide for increased rental payments 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

Notes to Financial Statements

\$1 million for both years ended December 31, 2003 and 2002, 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, 2003, were \$540 thousand, \$360 thousand, and \$70 thousand for the years 2004, 2005, and 2006, respectively.

At December 31, 2003, the Bank has no other commitments and long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks dated as of March 2, 1999, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 2003 or 2002.

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"). In addition, certain Bank officers participate in the Supplemental Employee Retirement Plan ("SERP").

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the Plan for the System and the costs associated with the Plan are not redistributed to the Bank. The Bank's projected benefit obligation and net pension costs for the BEP and the SERP at December 31, 2003 and 2002, and for the years then ended, are not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The

Notes to Financial Statements

Bank's Thrift Plan contributions totaled \$3 million for both years ended December 31, 2003 and 2002, 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):

	2003	2002
Accumulated postretirement benefit obligation at January 1	35.1	\$ 37.2
Service cost-benefits earned during the period	0.9	0.7
Interest cost of accumulated benefit obligation	2.7	2.2
Actuarial loss (gain)	13.3	(2.6)
Contributions by plan participants	0.5	0.2
Benefits paid	(2.1)	(2.4)
Plan amendments	-	(0.2)
	<hr/>	<hr/>
Accumulated postretirement benefit obligation at December 31	50.4	\$ 35.1

Notes to Financial Statements

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):

	2003	2002
Fair value of plan assets at January 1	\$ -	\$ -
Actual return on plan assets	-	-
Contributions by the employer	1.6	2.2
Contributions by plan participants	0.5	0.2
Benefits paid	(2.1)	(2.4)
	<hr/>	<hr/>
Fair value of plan assets at December 31	\$ -	\$ -
	<hr/>	<hr/>
Unfunded postretirement benefit obligation	\$ 50.4	\$ 35.1
Unrecognized prior service cost	12.4	14.3
Unrecognized net actuarial loss	(19.0)	(6.2)
	<hr/>	<hr/>
Accrued postretirement benefit costs	\$ 43.8	\$ 43.2
	<hr/>	<hr/>

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

At December 31, 2003 and 2002, the weighted average discount rate assumptions used in developing the benefit obligation were 6.25 percent and 6.75 percent, respectively.

For measurement purposes, a 10.00 percent annual rate of increase in the cost of covered health care benefits was assumed for 2004. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.00 percent by 2011 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, 2003 (in millions):

	One Percentage Point Increase	One Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	\$ 0.2	\$ 0.4
Effect on accumulated postretirement benefit obligation	2.5	4.0

Notes to Financial Statements

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

	2003	2002
Service cost-benefits earned during the period	\$ 0.9	\$ 0.7
Interest cost of accumulated benefit obligation	2.7	2.2
Amortization of prior service cost	(1.9)	(1.9)
Recognized net actuarial loss	0.5	0.1
	<hr/>	<hr/>
Net periodic postretirement benefit costs	<u>\$ 2.2</u>	<u>\$ 1.1</u>

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

The recognition of a special termination loss is the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10. Because the special termination loss is less than \$50 thousand, the amount is not displayed in the tables above.

Following the guidance of the Financial Accounting Standards Board, the Bank elected to defer recognition of the financial effects of the Medicare Prescription Drug Improvement and Modernization Act of 2003 until further guidance is issued. Neither the accumulated postretirement benefit obligation at December 31, 2003 nor the net periodic postretirement benefit cost for the year then ended reflect the effect of the Act on the plan.

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 2003 and 2002 were \$8 million and \$7 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2003 and 2002 operating expenses were \$1 million for both years.

10. Business Restructuring Charges and Asset Impairments

In 2003, the System announced plans for consolidation and restructuring to streamline operations and reduce costs, including consolidation of operations and staff reductions in various functions of several Banks. The Bank's restructuring costs associated with the restructuring are not material.

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