

# THE FEDERAL RESERVE BANK OF ST. LOUIS ANNUAL REPORT 2002



# ALTHOUGH OUR FINANCIAL SYSTEM HAS WEATHERED THESE STORMS— WE'D BE WISE TO KEEP IN MIND THE OFT-STATED WARNING: during the latest wave of cri-

ses may not apply in the future.



William Poole
President and CEO

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Chairman

# A MESSAGE FROM OUR PRESIDENT

THE ST. LOUIS FED TRADITION-ALLY ANCHORS ITS ANNUAL REPORT WITH AN ESSAY ON A TOPIC THAT'S IMPORTANT TO THOSE WHO CARE ABOUT OUR NATION'S ECONOMY. This year is no exception. The subject is financial stability—always worth talking about but particularly timely now, what with the shocks that we've endured of late: terrorist attacks, war, accounting scandals and volatile markets, to name a few.

Although our financial system has weathered these storms—and many more before them—we'd be wise to keep in mind the oft-stated warning:
Past performance is no guarantee of future results. The steps we took to protect our credit and payment mechanisms during the latest wave of crises may not apply in the future.
Different problems require different solutions. We should

start thinking about these problems and solutions now—before some vulnerability surfaces out of the blue and bites us. A few of the threats to our financial system are very well-known, such as the funding shortages facing Social Security and Medicare. Others are beginning to catch the public's eye, such as the troubling dominance of the home mortgage market by Fannie Mae and Freddie Mac. If either of these giants were to stumble, the entire housing market would fall into disarray. Other possible threats may be harder to get a handle on, but we must still try.

For those who think the protectors of our financial system will always prevail, this essay will provide a reminder of when the United States had a reputation for financial *in*stability.

Looking today at Japan, one can see that such instability

can recur, even in a country that has a long-term track record of stability like ours.

We hope that this essay spurs discussion about the vital need for vigilance on the subject of financial stability.

Elsewhere in this report, we summarize our year—a good one for the St. Louis Fed, in almost all regards. This book also contains a new section, called "By the Numbers."

Through important, unusual or just interesting numbers, we will tell you a bit more about who we are at the St. Louis Fed and what we do. I hope you enjoy it.

William Poole



CONSECUTIVE YEAR OF FINANCIAL

have not damaged the roots of the U.S. TURBULENCE IN THE UNITED STATES.

financial system—the banking sector.





# FINANCIAL STABILITY WELL-ROOTED IN U.S.

2002 MARKED THE THIRD CONSECUTIVE YEAR OF FINANCIAL TURBULENCE IN THE UNITED STATES. In early 2000, investors lost faith in technology stocks and later in other stocks, ushering in what has turned out to be a long bear market in equities. In March 2001, the economy entered its first recession in a decade. Then, in September 2001, terrorists attacked New York City and Washington, D.C. After these shocks, one might have expected a calmer 2002. Instead, last year brought new challenges in the form of sensational accounting and investment-banking scandals, large corporate bankruptcies, and historically high levels of stockand bond-market volatility.

Yet, three consecutive years of turbulence have not damaged the roots of the U.S. financial system—the banking sector. Commercial banks and thrifts have proven financially robust indeed, quite profitable—during this period. Creditworthy households and businesses continue to enjoy uninterrupted access to credit, while the payments system functions as smoothly as ever. Steady performance is important because access to credit and to a functioning payments system are the twin hallmarks of financial stability.

Although financial market turbulence did spread to the banking system in the 19th and early 20th centuries in the United States and sometimes still does in other economies around the globe, our financial system has stood immune and stable for decades.

Why?

#### THE SEEDS OF STABILITY

FINANCIAL STABILITY RARELY COMES UP IN DAILY CONVERSATION PRECISELY BECAUSE THE U.S. FINANCIAL SYSTEM HAS PROVEN SO STABLE SINCE THE 1930s. Stability implies widespread reliance on the financial system and its parts to function smoothly—as, for example, when we expect a 24-hour ATM machine to dispense cash on demand, when we assume a gas pump will accept a debit card without fail, when we anticipate that online

lenders will refinance mortgages without a hassle or when we trust our money to an unfamiliar bank without a second thought.

To the Federal Reserve, the term has a more precise meaning: Financial stability refers to the smooth, uninterrupted operation of both credit and payment mechanisms. In practice, financial stability means that all credit-worthy borrowers can obtain funds at reasonable rates and that all monetary payments and securities transactions will settle accurately and promptly. Because extending credit and executing payments are two core commercial banking functions, it should come as no surprise that the Fed's mandate to promote financial stability is carried out largely through policies designed to preserve the health of individual banks and the integrity of interbank networks.

The Fed plays an important role in maintaining both economic and financial stability. Using monetary policy, the Fed exerts a stabilizing influence on the economy as a whole, working primarily through interest-rate channels that influence borrowing and lending decisions. The Fed also relies on lender-of-last-resort (discount window)

and payments-systems policies to calm financial markets after a shock. Finally, the Fed monitors many U.S. financial institutions to make sure that they are run in a safe-and-sound manner. All of these responsi-

#### **Financial stability**

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AND PROMPTLY.

bilities interact to stabilize the banking system, thereby preserving its ability to extend credit and to serve as the backbone of the payments system.<sup>1</sup>

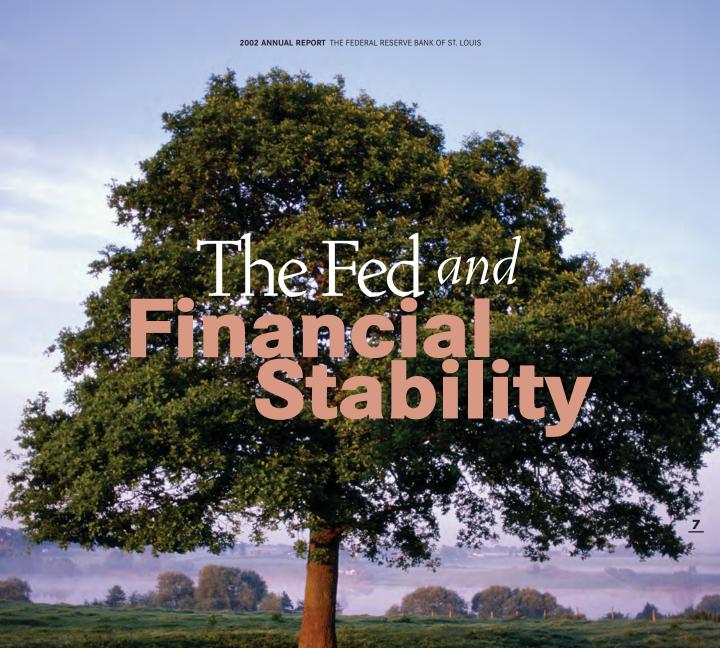
#### **UPROOTING STABILITY**

HISTORICALLY, FINANCIAL
INSTABILITY—A TEMPORARY
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TIME DESPITE THE BEST
EFFORTS OF MARKET PARTICIPANTS AND POLICY-MAKERS.
To be sure, the U.S. financial

system was perhaps most notable among advanced economies for its instability as late as the 1930s. *Caveat emptor* was the operative rule because banks failed as frequently as any other kind of business. System-wide collapses, albeit temporary, were not unknown.

Business and financial cycles did not originate in the United States, of course. Adam Smith, the Scotsman who is now known as the father of modern economics, long ago distilled the essential dynamics of a modern economy as an inevitable, recurring sequence of "overtrading," followed by "negligence and profusion," culminating in "revulsion and discredit."2 What was unusual about the U.S. financial system is how long it took to temper the "overtrading-negligencerevulsion" cycle. England experienced only one banking crisis after 1866—when the Bank of England first intervened successfully as a lender of last resort. Meanwhile, serious banking disruptions struck the United States in 1873, 1884, 1890, 1893, 1907, 1914, and most tragically, 1930-33.3 Crashes of the stock market

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The 12 Federal Reserve banks serve as the banking system's lender of last resort.

CASUAL OBSERVERS MAY THINK THE FEDERAL RESERVE'S ROLE IN THE ECONOMY IS EXCLUSIVELY TO PROMOTE MACROECONOMIC STABILITY—INCLUDING PRICE STABILITY, MAXIMUM SUSTAINABLE ECONOMIC GROWTH AND LOW LONG-TERM INTEREST RATES. While certainly an important and challenging task, the Fed's mandate actually is broader and includes the goal of promoting financial stability of the banking system. This dual mandate makes sense because macroeconomic and financial stability are mutually reinforcing—for better and for worse.

The 12 Federal Reserve banks serve as the banking system's lender of last resort, the safety valve that depressurizes

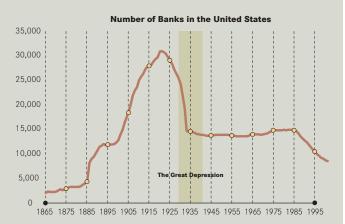
sudden spikes in the demand for liquidity, such as occurred in the aftermath of Sept. 11. This episode showed clearly that, when commercial banks and thrifts have emergency access to liquidity at the central bank's discount window, disruptions to the credit and payment mechanisms can be avoided even under the direst circumstances. The Federal Reserve also serves as lead supervisor for thousands of financial holding companies, bank holding companies and many state-chartered banks in the United States. This front-line contact with financial institutions equips the Fed to play a role in financial policy-making and provides a source of timely information for monetary policy deliberations.

and collapses of major financial institutions were even more frequent. These episodes contributed to a widespread belief that the U.S. financial system—and particularly the banking system—was inherently unstable.

The remarkable 19th- and early 20th-century instability of the U.S. banking system was, in many ways, homegrown. Because the U.S. Constitution prohibited states from taxing interstate commerce or printing money, they turned in large part to taxes on state-chartered banks to cover their expenditures.<sup>4</sup> Many of the restrictions on geographical and product expansion in banking date from this period. To maximize tax revenues from banks, states restricted competition.

As a result, the United
States ended up with a very
large number of small, undiversified institutions that were vulnerable to local economic as well as national financial shocks. Depositors, aware of this vulnerability, rationally responded to such shocks by "running" their banks. Bank panics, in turn, depressed the real economy by reducing the available supply of credit to business firms and preventing

#### Instability in 1920s, 1930s Slashed Number of Banks in U.S.



BEFORE THE GREAT DEPRESSION, the number of banks steadily rose. States had allowed relatively free entry into banking then. Restrictions on geographic expansion meant that the expanding national economy required more banks. But in the 1920s, the numbers began to fall. Many agricultural areas, along with the banks that served them, were hit hard by falling agriculture prices and overall deflation. Some people thought that the failure of hundreds of banks each year during the 1920s without a nationwide financial crisis meant that our system was immune to collapse. The 1930s showed otherwise. The number of bank failures increased during the early 1930s until deposit insurance and the other New Deal reforms "froze" into place the system that existed as of 1934. The total number of banks began to fall again about 1985 because of failures and mergers.

DATA SOURCES: **1865-1933**: White, Eugene. *The Regulation and Reform of the American Banking System, 1900-1929*. Princeton, N.J.: Princeton University Press, 1983. **1934-2001**: Federal Deposit Insurance Corp., Historical Statistics on Banking, Washington, D.C., 2003.

businesses and households from making payments.

Financial instability amplified economic instability to create a self-reinforcing downward spiral. Before 1914, no central bank existed in the United States to help break the vicious cycle. A demand for the government to provide deposit insurance arose

as a means to keep small banks competitive with larger banks that could offer greater safety. Many states responded with programs for local banks. Typically, the insurance was voluntary, and its price did not rise much with bank risk. These design flaws ultimately bankrupted the states' reserve funds

and, more importantly, kept the state-run programs from exerting a stabilizing influence on the financial system.<sup>5</sup>

What forced fundamental change on the U.S. financial system, of course, was the Great Depression. Between 1930 and 1933, roughly 9,000 U.S. banks failed—some 30 percent of the nation's total. Today, many economists believe that the collapse of the banking system transformed a garden-variety recession into an economic calamity. Bank failures destroyed deposits in droves (or froze them as the failed banks were resolved), causing the available money supply to drop by one-third. Bank failures also destroyed valuable lending relationships, further contributing to the depth and length of the Depression. Between 1929 and 1933, the unemployment rate soared to 25 percent from 3 percent, not falling back into the single digits until the 1940s. Sadly, the Federal Reserve—created in 1914 in part to ensure that financial shocks would not spark financial instability made things worse in the early 1930s by tightening monetary policy to defend the gold standard rather than injecting liquidity to contain the banking panic. This financial, economic and social catastrophe convinced a sufficient majority of business and political leaders of the day that the hitherto lightly regulated financial system was inherently and intolerably unstable.

# ROOT-AND-BRANCH REFORM

THE NEW DEAL WAS A MAS-SIVE POLICY RESPONSE TO THE ECONOMIC CALAMITY. In the financial sector, the response took the form of strict bank chartering requirements, narrowly drawn activity restrictions across all types of financial institutions, price controls (such as interest-rate ceilings), federal deposit insurance, new government financial institutions (such as the Reconstruction Finance Corp. and the Federal National Mortgage Association, or "Fannie Mae") and a restructured Federal Reserve System. Although many warned of the inhibiting effects of government intervention, the risk of not attempting root-and-branch reform of the financial system appeared even greater. And while a revisionist school of thought today questions the wisdom of many New

Deal financial reforms, the circumstantial evidence suggests that these reforms have contributed to our success in avoiding bouts of financial instability during the past seven decades.

The United States has suffered no instances of generalized financial instability since the 1930s despite the fact that shocks to financial markets have been no less frequent than in earlier eras. A partial list of shocks since the Depression includes World War II and the Korean War, the Cuban missile crisis, the Penn Central commercial-paper crisis, two OPEC oil shocks, the 1974 and 1987 stock market crashes, and the regionally devastating energy and real estate lending cycles of the 1980s, culminating in the failure of thousands of bank and thrift institutions. Most recently, corporate accounting scandals, large corporate bankruptcies and stock market volatility have shaken investor and consumer confidence. Yet, none of these events produced economy-wide financial instability. Why?

Federal deposit insurance the keystone of the New Deal reforms—largely explains the disappearance of financial instability. When designing the

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The National Banking Acts of 1863 and 1864. Created a national bank charter and the Office of the Comptroller of the Currency to regulate nationally chartered banks. These acts tried unsuccessfully to drive state-chartered banks out of business.

1873, 1884, 1890, 1893, 1907, 1914, 1930-33

Major banking disruptions.



"It certainly is a great mistake for people to draw their money out of the banks in the way they are doing and put it away where it will do no good. All this money is thus taken out of the channels of business, which at the present time need all the cash that can possibly be obtained."

"It is due their action in withdrawing accounts from solvent institutions."
"And what is the remedy?"
"There is but one, and that is for the people to settle dwn and become reasonable. The government and the financies.



The Federal Reserve Act of 1913 was signed by President Woodrow Wilson. Created the Federal Reserve System. This was the first central bank in the United States, although its structure and functioning were quite decentralized.

1927

The McFadden Act of 1927. In effect, barred interstate banking and branching by requiring national banks to follow the same laws that applied to state banks.



The Great Depression 1929-1939. Nearly 30 percent of banks fail. Unemployment hits 25 percent.



Early 1930s: Fed tightens monetary policy to defend gold standard rather than injecting liquidity to contain banking panic.



The Banking Acts of 1933 (Glass-Steagall) and 1935 (part of FDR's New Deal reforms, which stretched out throughout the 1930s). Created federal deposit insurance for commercial banks (FDIC) and savings institutions (FSLIC). Separated commercial banking from investment banking and insurance underwriting. Restructured the Federal Reserve System, focusing more authority in Washington. Created the Federal Open Market Committee (FOMC). Created a true central bank with a unified decision-making structure.

1956, 1970

The Bank Holding Company Acts of 1956 and 1970.

Defined and created regulation for bank holding companies, an organizational form with little economic rationale other than to arbitrage regulation. The Federal Reserve was given authority to regulate bank holding companies, regardless of the charter(s) held by banks owned by the holding companies.



1970: Penn Central commercialpaper crisis, which threatened to draw the Fed (via the discount window) into a non-banking financial crisis. The Fed refused a request by the Nixon administration to lend money to a non-bank.



When Franklin National Bank of Long Island, N.Y., failed in October 1974, it was the largest bank failure to date. Franklin had \$5 billion in assets. Federal Reserve discount-window lending to Franklin peaked at \$1.8 billion just six days before the bank's failure. Noting "the severe deterioration of confidence at home and abroad that would have resulted from an abrupt failure," the Fed was inadvertently laying the groundwork for a "too-big-to-fail" policy, which later would hamper efforts to instill market discipline in banking.



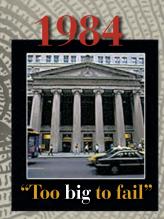
**1973-74:** Worst bear market since the Great Depression.

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The S&L crisis of the late 1970s and 1980s. By the time all the doors were closed and depositors paid off, the crisis cost U.S. taxpayers at least \$150 billion.

The Depository Institutions
Deregulation and Monetary
Control Act (DIDMCA) of 1980.
Abolished Regulation Q, which put
ceilings on deposit interest rates.
Broadened access by banks to the
Federal Reserve's discount window
and extended reserve requirements
to all depository institutions.



1984: "Too big to fail" is inadvertently acknowledged as policy by the Comptroller of the Currency when it says Continental Illinois and 10 other major banks cannot be allowed to fail for fear of bringing the entire financial system down.



1989

The Financial Institutions
Reform, Recovery, and
Enforcement Act (FIRREA)
of 1989. Tightened regulation
of commercial banks and savings institutions. Appropriated
funds and created governmentsponsored entities to administer the resolution (bailout) of
the savings and loans' insolvent
deposit-insurance corporation
(FSLIC). Moved deposit insurance of savings institutions to
the FDIC.



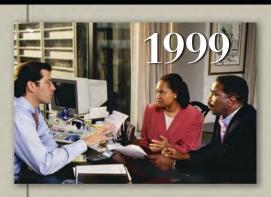
The Federal Deposit Insurance Corp. Improvement Act (FDICIA) of 1991. Made changes to the FDIC and to the deposit insurance provided to depository institutions. Addressed the "too-big-tofail" problem by specifying how systemically important depository institutions could be treated when insolvent.



The Riegle-Neal Interstate Bank Branching Act of 1994. Permitted interstate branching by all commercial banks. States subsequently passed laws to permit state-chartered banks to branch across state lines.

1998

1998: Long-Term Capital Management, a hedge fund, collapses, pushing the world's financial system to the brink of collapse.



The Financial Modernization Act (Gramm-Leach-Bliley) of 1999. Repealed much, but not all, of the Glass-Steagall Act that had separated commercial banking from investment banking and insurance underwriting. Created the financial holding company designation to permit financial organizations to engage in different financial activities within the same corporate entity. Reaffirmed the role of the Federal Reserve as the lead (or "umbrella") supervisor of complex financial institutions (both bank holding companies and financial holding companies). Preserved the role of functional supervisors at the subsidiary level to oversee each line of financial business separately.



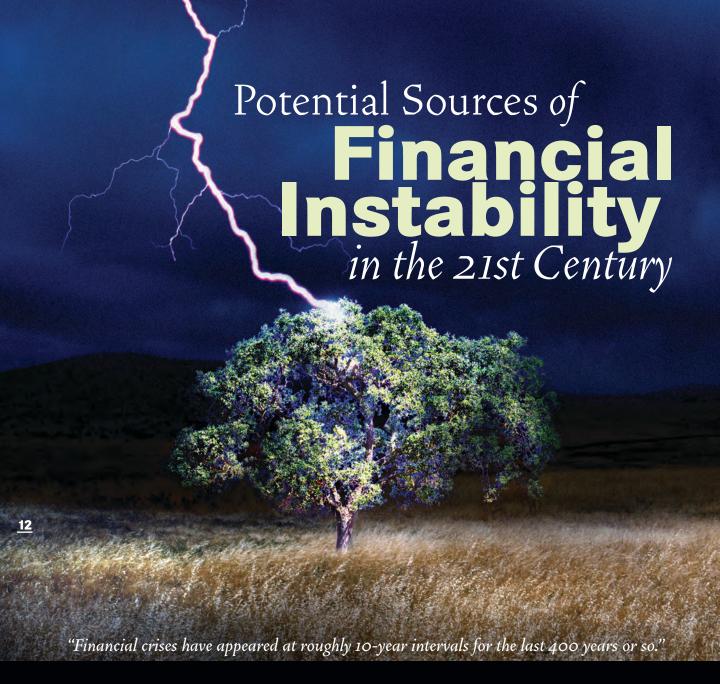
**2000:** Stock market meltdown begins.

2001

Sept. 11, 2001: Terrorists attack New York City and Washington, D.C. New York Stock Exchange closes for four days, the longest interruption of trading since 1914. Federal Reserve undertakes extraordinary measures to protect the payments system.

Financial stability is maintained.





IS A RETURN TO FINANCIAL INSTABILITY LIKELY? In 1984, Charles Kindleberger, an eminent economic historian, suggested that financial turbulence was unavoidable: "Financial crises have appeared at roughly 10-year intervals for the last 400 years or so." The years after 1984 have witnessed, if anything, even more financial crises around the world. Yet, the United States has successfully avoided disruptions of credit and payments mechanisms. Will our record hold? What threats to financial stability exist today?

To answer these questions, it pays to think about the type of economic or financial crisis that could cause an outbreak of financial instability. The International Monetary Fund provides a quarterly update on trouble spots in the global economy and in the financial systems of major countries. The report summarizing risks to global economic and financial stability entering 2003 pointed to a long list of problems:

 An excessive amount of corporate leverage and excess production capacity in some sectors.

- Deterioration in the financial condition of households, posing a risk that consumer spending could slow sharply.
- Heightened risk aversion among investors in financial markets, depressing asset prices.
- High levels of volatility in major equity and credit markets.
- Bank losses—both financial losses on loans and losses of reputation from questionable business practices.
- Diminished access to international capital markets by borrowers in emerging markets.

The March 2003 report also pointed to the huge size and ambiguous legal status of Fannie Mae and Freddie Mac, two government sponsored enterprises (GSEs), as discussed elsewhere in this essay.

Any one or a combination of these risk factors could strike an undercapitalized, poorly regulated banking system and precipitate financial instability somewhere in the world during 2003. But given the resilience of our banking system in the last three years, it appears unlikely that financial instability will visit the United States any time soon.

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program, Congress sought to avoid the problems that brought down the state systems. For example, Congress insisted that all national banks and members of the Federal Reserve System accept coverage thereby preventing larger, and typically stronger, banks from opting out. The nationwide scope of the program reduced the likelihood that a geographic or industry shock would bankrupt the reserve fund. In the worst case, the federal treasury could be called upon to bolster the fund. These improvements over the state-run programs kept financial turbulence from provoking banking panics. No longer did a financial shock such as the failure of a major financial institution—spell trouble for a small depositor. Nationwide bank panics became the stuff of newsreels, not CNN.

# OTHER WEAKNESSES SURFACE

ALTHOUGH FEDERAL DEPOSIT
INSURANCE DID MUCH TO
STABILIZE THE U.S. BANKING
SYSTEM, IT CONTAINED
STRUCTURAL FLAWS that
would later come back to haunt

policy-makers and, ironically, test the robustness of the post-Depression financial system. Specifically, the flat-rate premium structure—a design flaw in the state-run systems as well—promoted imprudent risktaking, thereby contributing to the savings and loan debacle of the 1980s. With flat-rate premiums, troubled thrifts could take on risky activities, knowing that deposit insurance would cost no more than before and that the government would bear most of any resulting losses. These perverse incentives resulted in billions of dollars of loans to support projects of dubious value and, ultimately, in thousands of failures with enormous cost to taxpavers.

To be sure, flat-rate premiums were not the only cause of the thrift debacle. Policyinduced incentives to take on interest-rate risk, inadequate supervision of risk-taking and poorly designed legislative responses contributed as well.8 New Deal programs that were aimed at stabilizing the mortgage market encouraged thrifts to lengthen the maturity of their assets, while deposit insurance allowed thrifts to shorten their liabilities. The resulting mismatch increased

the interest rate risk exposure of the industry and ate away capital during the period of higher and more volatile interest rates in the late 1960s, 1970s and early 1980s.

Congress responded to the developing crisis by deregulating thrift asset portfolios—a sensible move for a strongly capitalized industry, but an illadvised policy for a weakly capitalized one. With little of their own wealth to lose, some undercapitalized thrift owners gladly took on risky investments. Congress also raised the deposit insurance ceiling, thereby shielding thrifts from market discipline because a greater portion of their funding became insensitive to risk. Underfunded thrift supervisors, who operated under intense political and lobbying pressure, sanctioned the use of accounting gimmicks to give thrifts more leeway to avoid recognizing losses, presumably so that they could grow out of their problems. In many cases, however, these gimmicks simply gave thrift managers more time to experiment with new, even riskier investments, thereby compounding the cost of the eventual cleanup. Despite an ultimate loss to taxpayers of

roughly \$150 billion, the federal deposit insurance system—and what is more important, the banking system—did not break. Through it all, the public never lost confidence in depository institutions because the insurance was fully backed by the federal government. Because the credit and payment mechanisms remained intact, the thrift crisis did not degenerate into a vicious cycle of financial and economic instability. The role of federal insurance cannot be overemphasized: In the mid-1980s and early 1990s, state-insured depository institutions in Maryland, Ohio and Rhode Island were destroyed by panicked deposit withdrawals. Such panics could have become national rather than localized phenomena if no federal deposit insurance system had existed.

No doubt, other factors help account for the financial stability of the 1980s and 1990s. Unlike the early 1930s, monetary policy during and after the S&L crisis took explicit account of the condition of the banking system. Government-sponsored enterprises—Fannie Mae, Freddie Mac and the Federal Home Loan Banks—stepped in with commercial banks to

replace thrift institutions as the primary conduits for channeling funds to households desiring mortgages.

#### **A NEW SEASON**

EVEN THOUGH THE NEW DEAL REFORMS HELPED US SUR-VIVE THE THRIFT DEBACLE, THE HIGH PRICE PAID TO PRO-TECT THE FINANCIAL SYSTEM, IN TERMS OF TAXPAYER **FUNDS AND RESOURCE** MISALLOCATION, DICTATED A RE-EVALUATION. This re-evaluation pointed to five important lessons. First, it became clear that mechanisms should be in place to encourage faithful and timely disclosure of financial condition. Second, a new method was needed for pricing deposit insurance, whereby the explicit price of deposit insurance plus the implicit price imposed by bank supervisors would mimic the private sector's risk-sensitive approach to pricing. Third, wherever possible, market discipline must reinforce pressure from deposit-insurance premiums and bank supervisors to contain risk. Fourth, financial firms must maintain adequate capital to promote market discipline and to provide a cushion

against mistakes and unforeseen portfolio losses. Finally, bank supervisors must receive adequate funding and remain shielded from political pressures.

The Federal Deposit Insurance Corp. Improvement Act of 1991 (FDICIA) constituted a significant step in the right direction. The act beefed up supervision by mandating safetyand-soundness exams at least every 18 months, prompt corrective action, risk-based deposit insurance premiums and least-cost failure resolution. Frequent exams improved the flow of information between bankers and supervisors so that emerging problems could be addressed quickly and decisively. Prompt corrective action, which mandates specific supervisory responses to deteriorating bank capital, guaranteed that emerging problems would be addressed quickly and decisively—thereby keeping supervision insulated from politically motivated tampering. Risk-based premiums, which currently range from 0 to 27 cents annually per \$100 of deposits, increased the cost of deposit insurance coverage as bank risk rises, thereby making deposit insurance more like private insurance. Finally, leastcost resolution, which forces the FDIC to clean up failures in the least costly way for the deposit insurance fund, shifted more of the losses to uninsured depositors. Greater loss exposure increases investors' incentive to demand higher interest rates from riskier institutions—an illustration of market discipline. The consensus view so far seems to be that FDICIA has reduced the chances of another thrift-type depositinsurance meltdown.

FDICIA brought one more important change—it scaled back the so-called "too big to fail" protection for large banks. In May 1984, concerns about "systemic risk" (another term for financial instability) led regulators to shield all creditors of Continental Illinois from losses when the bank became insolvent. That September, the Comptroller of the Currency formalized the policy in congressional testimony by announcing that the 11 largest national banks were too big to fail. The equity markets immediately priced a reduction in risk into the publicly traded securities of all large banking organizations. That is, market participants came to believe that the failure of a large bank

was unlikely; so, the potential damage one bank's failure might cause for other banks also diminished. As a consequence of implied federal protection,

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of course, market pressure on all large banks to contain risk was reduced.

FDICIA curbed too-big-tofail protection by requiring the consent of the Secretary of the Treasury, along with two-thirds majorities of the Board of Governors of the Federal Reserve and the directors of the FDIC, before an institution could be given an exemption from normal procedures for resolution. To be sure, regulatory resolve has yet to be tested in a crisis; so, we do not know if the claim by regulators that no bank is too big to fail is, indeed, true. The consensus view among market participants appears to be that uninsured creditors of large banks

now face greater default risk than before FDICIA, which is the intent of the law. Genuine risk exposure ensures that market discipline will reinforce supervisory efforts to maintain the safety and soundness of large banks.

Why the banking sector has fared so well during the recent economic slowdown can be explained in part by the retooling of policy following the thrift crisis, along with:

- other changes in regulation that permitted greater bank diversification across product lines and geographic markets,
- the strengthening of capital requirements under the Basel Capital Accord,
- technological advances in risk management, such as asset securitization, and
- better risk management by banks.

For the banking sector as a whole, return on assets remains comfortably above the traditional 1 percent benchmark for strong earnings. Bank failures numbered more than 100 every year between 1985 and 1991, but since 1995, they have not exceeded 11 in any year. The average commercial bank's equity capital ratio stood at 6.4 percent of assets at the end of

1990, but had risen to 9.2 percent of assets by the end of

One other stabilizing aspect of the supervisory framework is worth mentioning. The Federal Reserve's role as supervisor of all financial holding companies, bank holding companies and some state-chartered banks contributes to financial stability in two ways. First and foremost, the Fed's supervisory role yields critical feedback about ongoing developments in the financial sector and in the non-financial economy. This feedback puts the Fed in a better position to carry out its function as lender of last resort. Second, and somewhat under-appreciated, the Fed's status as being "independent inside the government" puts some distance between the political process and bank supervision. The Fed shares supervisory responsibility at the federal level with the Office of the Comptroller and the FDIC; each state also has a supervision department.

The Fed's independence helps guarantee that competition among state and federal regulators, which can do much to improve efficiency and reduce regulatory burden, does not compromise the integrity of the supervisory process.

# THREATS ON THE HORIZON

WE HAVE LEARNED FROM LONG AND PAINFUL EXPERI-ENCE THAT THE BEST SAFE-**GUARD AGAINST FINANCIAL** INSTABILITY IS A CAREFULLY DESIGNED PRIVATE-PUBLIC PARTNERSHIP. Yet, as a result of rapid financial innovation as well as profit-driven incentives to avoid regulation, a thriving set of non-bank financial entities has emerged in the United States and many other nations. These lightly regulated entities are not allowed to offer deposits, but compete with banks on other fronts. Prominent nonbank financial entities today include investment banks, mutual funds, finance companies, the "financial conglomerates" permitted by the Gramm-Leach-Bliley Act of 1999 and financially oriented government sponsored enterprises (GSEs). Because these institutions have grown rapidly, they have become important players in the financial system. Yet, because we do not have many centuries of experience with non-bank financial institutions as we do for banks, we do not really know what risks they potentially pose to the financial

system. As important, they are not federally insured and do not have access to the Federal Reserve discount window.

Two of these entities— Fannie Mae and Freddie Macmerit special attention because of their size and dominance in the housing finance market in the United States. These two housing GSEs are so massive in size and are growing so fast that any significant disruption at one or both of the enterprises necessarily would impact a large number of other financial institutions and non-financial entities.9 The securities issued and guaranteed by the housing GSEs are widely held in the United States and abroad, notably by commercial banks. 10 U.S. households depend on Fannie and Freddie to obtain capital-market rates for home mortgage borrowing. A large number of players in the interest-rate derivatives market (including commercial banks) count one or both enterprises among their most important counterparties. Illiquidity caused by concerns about enterprise viability, not to mention outright default, could disrupt commercial banks' liquidity management and other



# Fannie and Freddie Troubling Dominance

JAL REPORT THE FEDERAL RESERVE BANK OF ST. LO

Their direct debt—over \$1.5 trillion—is about 40 percent as much as the publicly held debt of the Treasury.

FANNIE MAE (FORMERLY KNOWN AS THE FEDERAL NATIONAL MORTGAGE ASSOCIATION, OR FNMA) AND FREDDIE MAC (FORMERLY KNOWN AS THE FEDERAL HOME LOAN MORTGAGE CORP., OR FHLMC) TOGETHER OWN OR GUARANTEE ABOUT 45 PERCENT OF ALL RESIDENTIAL MORTGAGE DEBT, UP FROM ABOUT 25 PERCENT IN 1990." In their primary market niche of so-called "conforming mortgages"—prime quality fixed-rate single-family mortgages—Fannie and Freddie enjoy a market share of about 75 percent, up from about 50 percent a decade ago. The U.S. housing market has been strong throughout the 1990s and into the 2000s, in part due to the ability of these housing GSEs to provide uninterrupted access by households to the competitive interest rates available in international capital markets.

As the secondary mortgage market has grown, so have the direct debt obligations of Fannie and Freddie. Direct debt obliga-

tions of the two enterprises (i.e., excluding mortgage-backed securities) presently exceed \$1.5 trillion, roughly 40 percent as much as the publicly held debt of the U.S. Treasury.

Mortgage-backed securities issued and guaranteed by Fannie and Freddie of about the same amount are held by investors of many types. U.S. commercial banks held about \$900 billion of housing-GSE securities (13 percent of banks' total assets) on Sept. 30, 2002, up from about \$400 billion at the end of 1993 (11 percent of total assets). Meanwhile, community banks alone (those banks with less than \$500 million of assets) held \$130 billion of housing-GSE securities on Sept. 30, 2002 (16 percent of total assets), a bit more than at the end of 1993 (15 percent of total assets). To manage interest-rate risk, Fannie and Freddie together have become the largest end-users of interest-rate derivatives in the world.

continued from Page 16

financial institutions and markets in unpredictable ways.

The collapse of the hedge fund Long-Term Capital Management (LTCM) in 1998 illustrates how disruptive a single large player's demise can be, especially in the global derivatives markets. Federal Reserve intervention, which encouraged a capital infusion and an orderly wind-ing-up of LTCM's business, prevented much greater financial turbulence.

Housing GSEs also operate with an ambiguous status in the market. Participants in capital markets clearly perceive a significant credit-quality benefit attached to GSE status, as reflected in the very tight interest-rate spreads that GSE obligations enjoy over Treasury securities. Yet, the housing GSEs have no legal right to call upon the federal government to provide financial support beyond a trivial line of credit. If market participants were to abruptly downgrade the credit quality of GSE-issued or GSEguaranteed securities, the resulting repricing and loss of wealth by securities holders could unleash substantial portfolio reallocations and widespread market volatility.

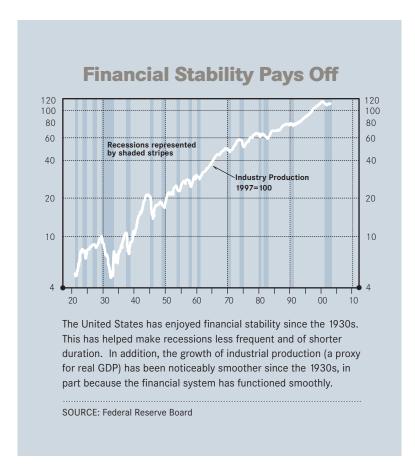
The fact that we have avoided FINANCIAL INSTABILITY FOR 70 YEARS IS, UNFORTUNATELY, NO GUARANTEE THAT WE WILL BE AS LUCKY DURING THE NEXT SEVEN DECADES.

The potential threat to financial stability posed by the housing GSEs has not gone unnoticed. The housing GSEs' federal regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), recently published an extensive study analyzing the systemic-risk implications posed by Fannie Mae and Freddie Mac. 13 The report concluded that the immediate risks of financial-solvency issues at either Fannie or Freddie—and hence, the risk they pose for financial stability—were quite small because these enterprises are very strong financially and are well-regulated by OFHEO. The agency also believes it likely that other financial institutions, such as large banks, could quickly fill any void created by the pullback of Fannie or Fred-die from the mortgage market due to financial problems they might encounter.

Nevertheless, OFHEO concluded that the chance of such a systemic disruption could not be ruled out and that further research is warranted. For, though a Fannie or Freddie insolvency is unlikely, the ramifications for financial markets and some financial institutions should insolvency occur particularly if it occurred abruptly, say, as a result of uncovering an accounting fraud—would be profound, to say the least. A more likely event is not outright insolvency of one or both of the enterprises, but some disruption to the liquidity of the markets in which their fixed-income securities trade—the agency market or the mortgage-backed security (MBS) market. Such a "liquidity event" could stress the banking system because banks are relying more and more on agency securities and MBS as secondary liquidity reserves.

# AS UNPREDICTABLE AS THE WEATHER

SUDDEN SHOCKS—INCLUD-ING DRAMATIC REVALUATIONS OF CURRENCIES, STOCK MARKET CORRECTIONS OR TERRORIST EVENTS—are facts of life in modern economies.



Economic disturbances such as recessions and lending cycles appear to be unavoidable as well. Without prudent policy, these shocks and disturbances, if severe or concentrated enough in time, could translate into a financial crisis that critically damages the banking sector. This, in turn, could severely disrupt credit and payment mechanisms—that is, create financial instability.

Extensive government intervention into the financial sector of the U.S. economy—federal deposit insurance, the Federal Reserve System's multifaceted role as promoter of macroeco-

nomic and financial stability, and other financial regulations—has short-circuited this damaging feedback loop since the 1930s. To be sure, private-sector risk management practices have improved, but it is no accident that the New Deal financial reforms described in this essay have coincided with the longest uninterrupted stretch of financial stability in U.S. history.

Even though no bouts of financial instability have occurred in the United States since the 1930s, we know its reappearance is not outside the realm of possibility. The burst-

ing of Japan's "bubble economy" of the 1980s has crippled its banking sector. Indeed, Japan has avoided profound financial instability only by massive ad hoc government interventions that well may bring long-lasting negative consequences, such as an unsustainable amount of government debt issued to support the banks. Moreover, many less-developed economies have succumbed to macroeconomic and financial instability of the type that bedeviled the U.S. economy during the 19th and early 20th centuries.

As we move into the 21st century, we must build on our successes and learn from our own and other countries' mistakes. In practice, this means paying careful attention to the incentives created by our banking policies. The fact that we have avoided financial instability for 70 years is, unfortunately, no guarantee that we will be as lucky during the next seven decades. In addition to continuous updating of financial supervisory practice and regulation, constant vigilance by government regulators—the public's watchdogs-will be required. \*

- 1 The Federal Reserve served as a stabilizing force on several fronts in the unsettled post-Sept. 11 environment. The Federal Reserve Bank of St. Louis 2001 Annual Report described in detail the Fed's contributions to maintaining financial stability. http://www.stlouisfed.org/publications/ar/2001/default.html.
- 2 Smith, Adam. An Inquiry into the Nature and the Causes of the Wealth of Nations. New York: Modern Library, 1776 (1937 edition), p. 700.
- 3 Gorton, Gary. "Banking Panics." The New Palgrave Dictionary of Money and Finance, p. 147. New York: The Stockton Press, 1992.
- 4 Sylla, Richard; Legler, John B.; and Wallis, John J. "Banks and State Public Finance in the New Republic: The United States, 1790-1860." *Journal of Economic History*, 1987, Vol. 47, pp. 391-403.
- 5 For a brief history of the state-chartered deposit insurance systems, see Mark D. Vaughan and David C. Wheelock, "Deposit Insurance Reform...ls It Déjà Vu All over Again?" Federal Reserve Bank of St. Louis, *The Regional Economist*, October 2002, pp. 5-9.
- 6 Kindleberger, Charles P. "Financial Crises." A Financial History of Western Europe, p. 269. London: George Allen & Unwin, 1984.
- 7 International Monetary Fund. Global Financial Stability Report: Market Developments and Issues. Washington, D.C.: IMF, December 2002 and March 2003. www.imf.org/external/ pubs/ft/GFSR.
- 8 For an overview of the thrift crisis, see
  David H. Pyle, "The U.S. Savings and Loan
  Crisis," in *Handbooks in Operations*Research and Management Science,
  Vol. 9, edited by R.A. Jarrow, et al.,
  Amsterdam, North Holland, 1995.
- 9 The third housing GSE is the Federal Home Loan Bank System. Because its structure and operations are quite different, we do not discuss it here.

- 10 Direct debt obligations of Fannie, Freddie or the Federal Home Loan Bank System are termed "agency securities." Securitized pools of mortgages guaranteed against default by Fannie or Freddie are termed "mortgage-backed securities," or MBS.
- 11 Falcon Jr., Armando. Statement before the Bond Market Association, New York, Feb. 4, 2003. http://www.ofheo.gov/ docs/speeches/bmspeech2403.pdf.
- by the housing GSEs as near-perfect substitutes for Treasury securities to serve as secondary liquidity reserves. The share of banks' total securities holdings accounted for by housing-GSE securities increased from 49 to 72 percent between the end of 1993 and late 2002. Substitution of GSE for Treasury securities raises banks' interest earnings slightly, at the risk of some illiquidity if GSE securities markets were to become unsettled and illiquid for some reason.
- 13 Office of Federal Housing Enterprise

  Oversight. "Systemic Risk: Fannie Mae,
  Freddie Mac and the Role of OFHEO,"
  a report transmitted to the Congress
  pursuant to 12 U.S.C. 4513, Sec. 1313 (e),
  February 2003, http://www.ofheo.gov/docs/reports/sysrisk.pdf.

# THE FEDERAL RESERVE BANK OF ST. LOUIS ANNUAL REPORT 2002 THE YEAR IN REVIEW



## 2002 WAS A YEAR OF WHICH

# Looking at the most basic barometer of success, ALL OF US AT THE ST. LOUIS FED

our expenses came in under budget and our financial CAN BE TRULY PROUD.

services local net revenue exceeded expectations.



Mary Karr

**LeGrande Rives** 

Julie Stackhouse

Robert Rasche

Karl Ashman

Dave Sapenaro

William Poole

Hank Bourgaux

MANAGEMENT COMMITTEE

# A MESSAGE FROM MANAGEMENT

2002 WAS A YEAR OF WHICH ALL OF US AT THE ST. LOUIS FED CAN BE TRULY PROUD. We accomplished our goals—and, in many cases, did more than we set out to do—in helping the Federal Reserve System fulfill its primary responsibilities: setting and carrying out monetary policy, regulating and supervising member financial institutions, and providing financial services to banks and to the federal government.

However, the Federal
Reserve's success in converting paper payments to electronics will result in consolidated operations and a significant change in the way we operate.
Recently, the Federal Reserve
System announced that it would eliminate jobs because of the decline in the nation's check usage. For decades, processing checks has been

one of our main businesses. At the same time, we've been encouraging check writers to switch to electronic forms of payment. Why? Electronic payments make for a moreefficient payments system one of our primary responsibilities. Because the public has now begun a fundamental shift to electronic payments, we need fewer locations and people to process checks. Systemwide, 1,300 positions will be eliminated; in the Eighth District, about 170 jobs will be cut by year-end 2004—more than 10 percent of our staff—as the Little Rock and Louisville branches stop processing checks. Never before has the Fed reduced staff to this extent, and we're saddened that we'll lose such dedicated employees. Yet we know these reductions are an unavoidable consequence

of a move that will improve the nation's economy in the long run.

Despite the sobering news of staff reductions, we must recognize the many successes we've had over the past year. These can be measured in a variety of ways: from the numbers on the ledger sheets to the number of outreach efforts, from the quality of our financial services to the valuable research and advice that we provide to our nation's monetary policy-makers.

Looking at the most basic barometer of success, our expenses last year came in under budget and our financial services local net revenue exceeded expectations. Not many businesses can say that for 2002.

In the financial services arena, we're working hard to keep up with our customers'



Bill Poole reads the news before starting another day at the helm of the St. Louis Fed.

demands. For example, we've modernized all check-related systems as the Fed has moved to a single system for the entire nation; the Eighth District was the first Reserve bank in the System to complete this effort. Our cash operations—counting, sorting and storing currency, along with replacing the wornout bills—have also become more efficient. As a result, we ended 2002 as No. 2 in productivity among the 12 Fed districts in cash operations. The Federal Reserve System has also recognized our track record in processing food coupons at our Memphis Branch— Memphis now has responsibility for processing food coupons for the western half of the United States.

Even as we picked up additional System responsibilities, we gave up some financial services work to other Feds

to create common practices, to produce economies of scale and to reduce expenses. For example, our electronic access support was shifted in 2002 to the Minneapolis Fed. We also pursued joint ventures with other Feds; the business development departments of the St. Louis and Cleveland Feds were recently merged—a first for the System—to save money and provide better service to customers across the two districts.

Our previous experience and expertise in financial services have been carried over into the jobs we perform for the U.S. Treasury. For the last two years, the St. Louis Fed has had oversight responsibility for the work done by other Federal Reserve banks for the Treasury. In addition, our District provided some of these Treasury services. For example, we handled more than \$2 trillion in transactions for the Treasury last year, mainly in federal tax payments and investments of available Treasury funds in banks around the country. With our help, these investments earned \$280 million in interest for the U.S. Treasury in 2002. We also helped in 2002 to devise a new investment program that in the pilot phase alone netted

the Treasury an additional \$3 million.

In bank supervision, our staff carried out 91 on-site safety and soundness examinations and inspections last year and continued to use off-site monitoring capabilities to improve our own productivity and to be less intrusive in our examinations. Reports on examinations were processed faster than ever. The department's newly established Center for Online Learning is the System's leader in web-based training for examiners. The center's online courses save time and money for all involved and allow trainees to learn at their own pace.

The economists in our Research Department continue to provide valuable policy advice, which is shared with the Federal Open Market Committee when it meets to set monetary policy. The economists also share their research and expertise with broader District audiences everyone from students to teachers to business executives to government officials. In the past year, the economists have seen more of their work published and have increased the number of speeches they give to outside audiences. They also regularly criss-cross



LeGrande Rives answers questions at one of the employee town halls last year.

the district to meet our constituents and customers, swap ideas and gather information on local and regional economies.

It's not just the economists who are reaching out to the public with expertise and services. Our Community Affairs staff travels the District and beyond, bringing together bankers and those who need credit to help redevelop their communities. The office also shines the spotlight on issues that deserve attention, issues such as predatory lending and financial literacy. Of particular note is the conference we sponsored in fall 2002 on the subject of revitalizing distressed urban areas. Instead of holding such an affair in a destination city at a fancy hotel, the office took the bold move of holding the conference in East St. Louis, III., the exact location that needs and deserves our attention.

Meanwhile, our economic education department is at the forefront in the Fed in training teachers and laymen about the economy, having doubled its goal in attendance at such events last year.

As good stewards of our limited resources, we are always trying to do more with less.

One of our new initiatives in 2002 for saving money was ED—Electronic Distribution.

Instead of printing and mailing regulatory and financial ser-vices information to banks, we now send them via e-mail and the Internet. This move reduced our mailing costs by more than half.

Another major savings will come in the future as a result of our decision not to build a new headquarters building. Instead, we will renovate the building that we've called home for more than 75 years. This decision will require some creativity on the architects' part to give us the added security precautions necessitated by Sept. 11 in our current location. But we won't sacrifice on employee security, as we've already demonstrated. In the past year, we've added protection officers at all four offices, and each of them has now

been trained and certified as a federal law enforcement officer.

Next year at this time, we hope that we can report a similar level of success. And we wish the same for you.

William Poole

President and Chief Executive Officer

W. LeGrande Rives
First Vice President
and Chief Operating Officer

WHAT FOLLOWS IS A COLLECTION

OF NUMBERS THAT SPEAR ON MANY

DIFFERENT LEVELS ABOUT THE ST. LOUIS FED'S WORK AND ABOUT THE PEOPLE...

\$37,611,392,000 1,165,805,000

102,843

# THE ST. LOUIS FED BY THE NUMBERS

AT ANY BANK, SUCCESS IS MEASURED THROUGH NUM-BERS. But not all the important numbers can be found in accountants' financial statements. What follows is a collection of numbers that speak on many different levels about the St. Louis Fed's work and about the people involved with the Bank, whether they are customers, employees or outside parties who are just curious about the Federal Reserve System. You don't have to be an accountant—or auditor—to understand why these numbers are meaningful to us.

■ 1,994 depository institutions—banks, savings & loans, credit unions and holding companies—are located in the Eighth District. These include 75 Fed-supervised state member banks and 624 Fed-supervised holding companies. Last year, four banks and 16 holding companies were started in the District, and there were two failures (one bank and one credit union, neither supervised by the Fed).



- 171 citations in professional journals and elsewhere to the work of Research Division economists.
- 396 loans to depository institutions for a total dollar value of \$974 million.
- 46,120,000 Treasury checks processed, an increase of 64
   percent from the previous year.
- 4 is average number of suspected counterfeit bills found a day in money turned over to the St. Louis office by banks for processing and storing. The bills are turned over to the Secret Service.



1,323

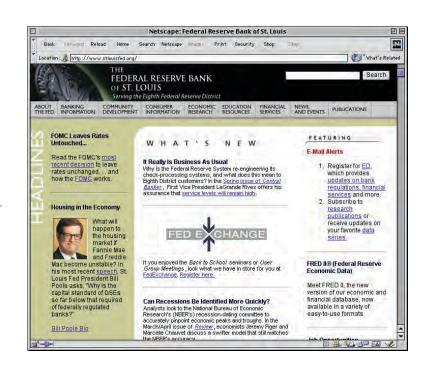
employees in four locations: the home office in St. Louis and the branches in Little Rock, Louisville and Memphis. Of these, 76 were part-time. Total turnover was 8.25 percent.

# \$37,611,399,000

the total dollar value of all currency handled by the St. Louis Fed and paid out. In all, almost 2.4 billion notes were processed. When the cash is received from banks, lightning-quick machines count, validate and bundle notes at the rate of 88,500 an hour.

- Approximately \$1.6 trillion in federal taxes on businesses processed through the Treasury Tax & Loan program for the U.S. Treasury.
- \$280 million in interest earned for the U.S. Treasury through TT&L investments at qualified financial institutions.
- 216,487,000 postal money orders processed.
- 5,500 calls a month handled by Treasury Relations and Systems Support staff members. They deal with more than 10,000 financial institutions nationwide.





- 25 workshops on risk management were facilitated by the Bank's Risk Management Consulting department.
- 34,189 statistical reports from financial institutions and other respondents were processed.

# 102,843 cans of food

donated by St. Louis employees to charity. The annual food drive is now providing half of the food collected by Operation Food Search, the area's largest food bank.

5,435,469 hits

to the newly designed web site from the time it went live in the middle of August until the end of the year.

1,165,805,000 commercial checks processed

(down 0.7 percent from 2001), with a total dollar value of \$696 billion (up 12 percent).

\$1.040 billion

#### \$897 million

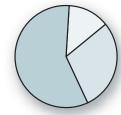
interest on federal securities

#### \$53 million services

\$42 million foreign currency gains

#### \$38 million

reimbursable services to government agencies



\$84 million salaries and benefits

#### \$42 million

other (includes everything from software to travel to some pension costs)

upkeep of the **Board of Governors** 

\$163 million

\$19 million

to our periodicals. In addition to these publications sent out in the mail, we have 3,617 online subscriptions from people who want to do their reading on the computer.

■ 520 depository institutions had a total balance of \$478,795,726 in Fed accounts at year's end. The money represents required reserves and discretionary funds needed for settling transactions.

■ 26,949,000 food coupons

destroyed. That's 28 percent

more than the previous year,

thanks, in large part, to con-

Memphis and Richmond, Va.

solidation of this work in

106,549 subscriptions

≅Regional Econom<u>is</u>t

ntral Banker

29 economic education events held across the District. These included seven high-school students from St. Louis who made it to the Fed Challenge's "final four" in Washington, the highest level attained by any team from our district, and 35 teachers who participated in the weeklong Money and Banking course during the summer for college credit.

■ 1,603 people who attended

The Bank had net income of \$877 million, with \$816 million of that profit turned over to the U.S. Treasury, \$11 million paid out to member banks and \$50 million kept as surplus.

for the year to the FRED (Federal Reserve Economic Data) database, the Internet's mercial web site for The Research Division implemented a new, of FRED in 2002. Hits rose 23 percent from 2001.





9

# THANK YOU RETIRING BOARD MEMBERS

We would like to express our deepest gratitude to those members of our Eighth District boards of directors who retired in 2002.

Our appreciation and best wishes go out to:

Joseph E. Gliessner Jr. from the St. Louis Board,
Cynthia J. Brinkley from the Little Rock Board and
Mike P. Sturdivant Jr. from the Memphis Board.

## LITTLE ROCK

#### BOARD OF DIRECTORS

#### **LEFT OF COLUMN**

A. Rogers Yarnell II

President Yarnell Ice Cream Co. Inc. Searcy, Arkansas David R. Estes

President and CEO First State Bank Lonoke, Arkansas



#### **RIGHT OF COLUMN**

Vick M. Crawley

Chairman

Plant Manager Baxter Healthcare Corporation Mountain Home, Arkansas Lawrence A. Davis Jr.

Chancellor University of Arkansas at Pine Bluff Pine Bluff, Arkansas Ravmond E. Skelton

Regional President U.S. Bank North Little Rock, Arkansas

#### **NOT PICTURED**

**Everett Tucker II** 

Chairman Moses Tucker Real Estate Inc. Little Rock, Arkansas Scott T. Ford

President and CEO ALLTEL Corporation Little Rock, Arkansas

# LOUISVILLE BOARD OF DIRECTORS

#### LEFT OF COLUMN

#### David H. Brooks

Chairman and CEO Stock Yards Bank & Trust Co. Louisville, Kentucky

#### Marjorie Z. Soyugenc

Executive Director and CEO Welborn Foundation Evansville, Indiana

#### Thomas W. Smith

President
Thomas W. Smith &
Associates Inc.
Danville, Kentucky



#### **RIGHT OF COLUMN**

## Norman E. Pfau Jr. Chairman

President and CEO
Geo. Pfau's Sons
Company Inc.
Leffersonville Indiana

#### Maria Gerwing Hampton

President
The Housing Partnership Inc.
Louisville, Kentucky

#### Cornelius A. Martin

President and CEO Martin Management Group Bowling Green, Kentucky

#### Frank J. Nichols

Chairman, President and CEO Community Financial Services Inc. Benton, Kentucky

#### MEMPHIS BOARD OF DIRECTORS

#### **LEFT OF COLUMN**

#### Russell Gwatney

President Gwatney Companies Memphis, Tennessee

#### Meredith B. Aller

Vice President, Marketing Staple Cotton Cooperative Association Greenwood, Mississippi

#### James A. England

Chairman, President and CEO Decatur County Bank Decaturville, Tennessee



#### **RIGHT OF COLUMN**

## Gregory M. Duckett Chairman

Senior Vice President and Corporate Counsel Baptist Memorial Health Care Corporation Memphis, Tennessee

#### Tom A. Wright

Chairman, President and CEO Enterprise National Bank Memphis, Tennessee

#### Walter L. Morris Ir.

President H&M Lumber Co. Inc. West Helena, Arkansas

#### E.C. Neelly III

Management Consultant First American National Bank Iuka, Mississippi

# ST. LOUIS BOARD OF DIRECTORS

#### **LEFT OF COLUMN**

#### Lewis F. Mallory Jr.

Chairman and CEO National Bank of Commerce Starkville, Mississippi

#### **Bert Greenwalt**

Partner Greenwalt Company Hazen, Arkansas

#### J. Stephen Barger

Executive Secretary-Treasurer Kentucky State District Council of Carpenters Frankfort, Kentucky

### Charles W. Mueller Chairman

Chairman and CEO Ameren Corporation St Louis, Missouri



#### **RIGHT OF COLUMN**

#### Gayle P.W. Jackson

Managing Director FondElec Clean Energy Group Inc. St. Louis, Missouri

#### Lunsford W. Bridges

President and CEO Metropolitan National Bank Little Rock, Arkansas

#### Robert L. Johnson

Chairman and CEO Johnson Bryce Inc. Memphis, Tennessee

#### Bradley W. Small

President and CEO The Farmers and Merchants National Bank Nashville, Illinois

#### NOT PICTURED

Walter L. Metcalfe Jr. Deputy Chairman

Chairman Bryan Cave LLP St. Louis, Missouri

# FINANCIAL STATEMENTS

## THE FEDERAL RESERVE BANK OF ST. LOUIS FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2001 AND 2002

THE FIRM ENGAGED BY THE BOARD OF GOVERNORS FOR THE AUDITS OF THE INDIVIDUAL AND COMBINED FINANCIAL STATEMENTS OF THE RESERVE BANKS FOR 2002 WAS PRICEWATERHOUSECOOPERS LLP (PWC). FEES FOR THESE SERVICES TOTALED \$1.0 MILLION. IN ORDER TO ENSURE AUDITOR INDEPENDENCE, THE BOARD OF GOVERNORS REQUIRES THAT PWC BE INDEPENDENT IN ALL MATTERS RELATING TO THE AUDIT. SPECIFICALLY, PWC MAY NOT PERFORM SERVICES FOR THE RESERVE BANKS OR OTHERS THAT WOULD PLACE IT IN A POSITION OF AUDITING ITS OWN WORK, MAKING MANAGEMENT DECISIONS ON BEHALF OF THE RESERVE BANKS, OR IN ANY OTHER WAY IMPAIRING ITS AUDIT INDEPENDENCE. IN 2002, THE BANK DID NOT ENGAGE PWC FOR ADVISORY SERVICES.

## To the Board of Directors:

The management of the Federal Reserve Bank of St. Louis ("FRBSTL") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2002 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the FRBSTL 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 FRBSTL 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 FRBSTL 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 St. Louis

William Poole, President and Chief Executive Officer

W. LeGrande Rives, First Vice President and Chief Operating Officer

Marilyn K Corona, Principal Financial Officer

## REPORT OF INDEPENDENT ACCOUNTANTS

#### To the Board of Directors of the Federal Reserve Bank of St. Louis:

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

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

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

In our opinion, management's assertion that the FRB maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the financial statements as of December 31, 2002, is fairly stated, in all material respects, based on criteria described in "Internal Control-Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission.

March 3, 2003

St. Louis, Missouri

Tricewaterhouse Coopers LLP

# To the Board of Governors of The Federal Reserve System and the Board of Directors of The Federal Reserve Bank of St. Louis:

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

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

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

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

March 3, 2003

St. Louis, Missouri

Tricewaterhouse Coopers LLP

298

\$22,239

398

24,537

\$

## FEDERAL RESERVE BANK OF ST. LOUIS | STATEMENTS OF CONDITION (IN MILLIONS)

(	As	of Dec	cember 31,
	2002		2001
ASSETS			
Gold certificates	\$ 346	\$	343
Special drawing rights certificates	71		71
Coin	59		58
Items in process of collection	695		215
Loans to depository institutions	11		3
U.S. government and federal agency securities, net	22,726		20,245
Investments denominated in foreign currencies	343		291
Accrued interest receivable	194		206
Interdistrict settlement account	-		721
Bank premises and equipment, net	66		67
Other assets	26		19
TOTAL ASSETS	\$ 24,537	\$	22,239
LIABILITIES AND CAPITAL			
Liabilities:			
Federal Reserve notes outstanding, net	\$ 18,914	\$	21,435
Securities sold under agreements to repurchase	750		-
Deposits:			
Depository institutions	480		344
Other deposits	5		1
Deferred credit items	345		79
Interest on Federal Reserve notes due U.S. Treasury	30		22
Interdistrict settlement account	3,554		-
Accrued benefit costs	57		55
Other liabilities	4		5
TOTAL LIABILITIES	 24,139		21,941
Capital:	100		140
Capital paid-in	199		149
Surplus	199		149

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

TOTAL CAPITAL

TOTAL LIABILITIES AND CAPITAL

.....

## FEDERAL RESERVE BANK OF ST. LOUIS | STATEMENTS OF INCOME (IN MILLIONS)

(IN MILLIONS)	For the	years end	ed Dece	ember 31, 2001
Interest income:				
Interest on U.S. government and federal agency securities Interest on investments denominated in foreign currencies	\$	897 5	\$	1,082 7
TOTAL INTEREST INCOME		902		1,089
Other operating income:				
Income from services		53		54
Reimbursable services to government agencies		38		26
Foreign currency gains (losses), net		42		(30)
U.S. government securities gains, net		3		12
Other income		2		3
TOTAL OTHER OPERATING INCOME		138		65
Operating expenses:				
Salaries and other benefits		84		80
Occupancy expense		8		8
Equipment expense		10		10
Assessments by Board of Governors		19		18
Other expenses		42		35
TOTAL OPERATING EXPENSES	\$	163	\$	151

50 816		983
50		- 11
		11
11	\$	9
877	\$	1,003
	11	11 \$

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

FEDERAL RESERVE BANK OF ST. LOUIS | STATEMENTS OF CHANGES IN CAPITAL

## for the years ended December 31, 2002 and December 31, 2001

	(IN MILLIONS)	Capital	Paid-in	Surplus	Tot	al Capital
Balance at January 1, 2001 (2.8 million shares) Net income transferred to surplus Net change in capital stock issued		\$	138	\$ 138 11	\$	276 11
(0.2 million shares)			11			11
Balance at December 31, 2001 (3.0 million shares)		\$	149	\$ 149	\$	298
Net income transferred to surplus  Net change in capital stock issued				50		50
(1.0 million shares)			50			50
Balance at December 31, 2002 (4.0 million shares)		\$	199	\$ 199	\$	398

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

## FEDERAL RESERVE BANK OF ST. LOUIS | NOTES TO FINANCIAL STATEMENTS

## 1. STRUCTURE

The Federal Reserve Bank of St. Louis ("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 and its branches in Little Rock, Louisville and Memphis, serve the Eighth Federal Reserve District, which includes Arkansas, and portions of Illinois, Indiana, Kentucky, Mississippi, Missouri and Tennessee. Other major elements of the System are the Federal Open Market Committee ("FOMC") and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York ("FRBNY") and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state chartered bank that applies and is approved for membership in the System.

#### **Board of Directors**

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

## 2. OPERATIONS AND SERVICES

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

of Governors' operating costs are funded through assessments on the Reserve Banks.

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

#### 3. SIGNIFICANT ACCOUNTING POLICIES

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

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

Effective January 2001, the System implemented procedures to eliminate the sharing of costs by Reserve Banks for certain services a Reserve Bank may provide on behalf of the System. Major services provided for the System by the Bank, for which the costs will not be redistributed to the other Reserve Banks, include operation of the Treasury Relations and Support Office and Treasury Relations and Systems Support Department, which provide services to the U.S. Treasury. These services include: relationship management, strategic consulting, and oversight for fiscal and payments related projects for the Federal Reserve System; and operational support for the Treasury's tax collection, cash management and collateral monitoring.

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 upon average Federal Reserve notes outstanding in each District.

## b. Special Drawing Rights Certificates

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

## c. Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Boards of Directors of the Reserve Banks, subject to review by the Board of Governors. Reserve Banks retain the option to impose a surcharge above the basic rate in certain circumstances.

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

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

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

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

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

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

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

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

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

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

Balances of U.S. government and federal agency securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currency, interest income and expense, securities lending fee income, amortization of premiums and discounts on securities bought outright, gains and losses on sales of securities, and realized and unrealized gains and losses on investments denominated in foreign currencies, excluding those held under an F/X swap arrangement, are allocated to each Reserve Bank. Income from securities lending transactions undertaken by the FRBNY are also allocated to each Reserve Bank. Securities purchased under agreements to resell and unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to the FRBNY and not to other Reserve Banks.

## e. Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from 2 to 50 years. New assets, major alterations, renovations and improve-

ments are capitalized at cost as additions to the asset accounts. Maintenance, repairs and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the application development stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software.

#### f. Interdistrict Settlement Account

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

## g. Federal Reserve Notes

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

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding, reduced by its currency holdings of \$3.088 million and \$2.586 million at December 31, 2002 and December 31, 2001, respectively.

#### h. Capital Paid-in

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

### i. Surplus

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

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

## j. Income and Costs related to Treasury Services

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

#### k. Taxes

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

## 4. U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES

Securities bought outright are held in the SOMA at the FRBNY. An undivided interest in SOMA activity and the related premiums, discounts and income, with the exception of securities purchased under agreements to resell, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings. The settlement, performed in April of each year, equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 3.556 percent and 3.604 percent at December 31, 2002 and 2001, respectively.

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

	2002	2001
PAR VALUE:		
U.S. government:		
Bills	\$ 8,060	\$ 6,563
Notes	10,592	9,585
Bonds	3,728	3,736
TOTAL PAR VALUE	 22,380	19,884
Unamortized premiums	383	407
Unaccreted discounts	(37)	(46)
TOTAL ALLOCATED TO BANK	\$ 22,726	\$ 20,245

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

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

TOTAL	\$ 22,380	-	\$ \$22,380
Over 10 years	2,839	_	2,839
Over 5 years to 10 years	1,895		1,895
Over 1 year to 5 years	6,143	-	6,143
91 days to 1 year	5,044	-	5,044
16 days to 90 days	5,483	-	5,483
Within 15 days	\$ 976	\$ -	\$ 976
MATURITIES OF SECURITIES HELD		G	
	U.S. Government Securities	0 ,	Total
		PAR VALUE	

As mentioned in footnote 3, in December 2002, the FRBNY replaced MSP transactions with securities sold under agreements to repurchase. At December 31, 2002, securities sold under agreements to repurchase with a contract amount of \$21,091 million and a par value of \$21,098 million were outstanding, of which \$750 million and \$750 million, respectively, were allocated to the Bank. At December 31, 2001, MSP transactions involving U.S. government securities with a par value of \$23,188 million were outstanding, of which \$836 million was allocated to the Bank. Securities sold under agreements to repurchase and MSP transactions are generally overnight arrangements.

At December 31, 2002 and 2001, U.S. government securities with par values of \$1,841 million and \$7,345 million, respectively, were loaned from the SOMA, of which \$65 million and \$265 million were allocated to the Bank.

## 5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 2.030 percent and 2.001 percent at December 31, 2002 and 2001, respectively.

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

	2002	2001
European Union Euro:		
Foreign currency deposits	\$ 113	\$ 92
Government debt instruments including	67	54
Agreement to resell		
Japanese Yen:		
Foreign currency deposits	36	38
Government debt instruments including	125	106
Agreement to resell		 
Accrued interest	2	1
TOTAL	\$ 343	\$ 291

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

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

TOTAL	\$ 343
Over 10 years	-
Over 5 years to 10 years	8
Over 1 year to 5 years	18
Within 1 year	\$ 317
MATURITIES OF INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES	

At December 31, 2002 and 2001, there were no open foreign exchange contracts or outstanding F/X swaps. At December 31, 2002 and 2001, the warehousing facility was \$5,000 million, with zero balance outstanding.

## 6. BANK PREMISES AND EQUIPMENT

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

MATURITIES OF INVESTMENTS DENIGNALIZATED IN FOREIGN OURDENGLES

	2002	2001
BANK PREMISES AND EQUIPMENT:		
Land	\$ 4	\$ 4
Buildings	50	46
Building machinery and equipment	18	16
Construction in progress	-	1
Furniture and equipment	57	56
	129	123
Accumulated depreciation	(63)	(56)
BANK PREMISES AND EQUIPMENT, NET	\$ 66	\$ 67

Depreciation expense was \$8.9 million and \$8.6 million for the years ended December 31, 2002 and 2001, respectively. Future minimum payments under agreements in existence at December 31, 2002 were immaterial.

## 7. COMMITMENTS AND CONTINGENCIES

At December 31, 2002, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from 1 to approximately 4 years. These leases provide for increased rentals based upon increases in real estate taxes, operating costs or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was \$1 million for each of the years ended December 31, 2002 and 2001. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2002, were (in thousands):

	OPER/	ATING
2003	\$	240
2004		64
2005		64
2006		48
2007		-
Thereafter		-
	\$	416

At December 31, 2002, other commitments and long-term obligations in excess of one year were \$0.

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

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

## 8. RETIREMENT AND THRIFT PLANS

## **Retirement Plans**

The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve

System ("System Plan") and the Benefit Equalization Retirement Plan ("BEP") and certain Bank officers participate in a Supplemental Employee Retirement Plan ("SERP"). The System Plan is a multi-employer plan with contributions fully funded by participating employers. No separate accounting is maintained of assets contributed by the participating employers. The Bank's projected benefit obligation and net pension costs for the BEP at December 31, 2002 and 2001 and the SERP at December 31, 2002, and for the years then ended, are not material.

#### Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled \$3 million and \$2 million for the years ended December 31, 2002 and 2001, 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):

	2002	2001
Accumulated postretirement benefit obligation at January 1	\$ 45.4	\$ 42.9
Service cost-benefits earned during the period	0.8	1.0
Interest cost of accumulated benefit obligation	2.9	3.5
Actuarial loss (gain)	(1.1)	9.5
Contributions by plan participants	0.1	0.1
Benefits paid	(2.5)	(2.2)
Plan Amendment/Settlement	0.2	(9.4)
ACCUMULATED POSTRETIREMENT BENEFIT OBLIGATION AT DECEMBER 31	\$ 45.8	\$ 45.4

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

	2002	2001
Fair value of plan assets at January 1 Contributions by the employer Contributions by plan participants Benefits paid	\$ - 2.4 0.1 (2.5)	\$ - 2.2 0.1 (2.3)
FAIR VALUE OF PLAN ASSETS AT DECEMBER 31	\$ -	\$ -
Unfunded postretirement benefit obligation Unrecognized prior service cost Unrecognized net actuarial loss	\$ 45.8 9.0 (3.5)	\$ 45.4 10.0 (4.6)
ACCRUED POSTRETIREMENT BENEFIT COSTS	\$ 51.3	\$ 50.8

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

At December 31, 2002 and 2001, the weighted average discount rate assumptions used in developing the benefit obligation were 6.75 percent and 7.0 percent, respectively.

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

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

	One Pe	ercentage	One Pe	rcentage
	Point	Increase	Point Decrease	
Effect on aggregate of service and interest cost components				
of net periodic postretirement benefit costs	\$	0.2	\$	0.2
Effect on accumulated postretirement benefit obligation		4.0		4.5

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

NET PERIODIC POSTRETIREMENT BENEFIT COSTS	\$ 2.9	\$ 4.5
Amortization of prior service cost	(0.8)	(0.1)
Interest cost of accumulated benefit obligation	2.9	3.5
Service cost-benefits earned during the period	\$ 0.8	\$ 1.1
	2002	2001

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

#### Postemployment benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 2002 and 2001, were \$5 million and \$4 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2002 and 2001 operating expenses were \$1 million for each year.

## 10. SUBSEQUENT EVENT

In January 2003, the System decided to restructure its check collection operations. The restructuring plans include streamlining the check management structure, reducing staff, decreasing the number of check-processing locations, and increasing processing capacity in other locations. The restructuring, which is expected to begin in 2003 and conclude by the end of 2004, will result in the Bank discontinuing its check operations at the Little Rock and Louisville offices, increasing its check processing capacity at the Memphis office, and consolidating its check adjustment function at the St. Louis or Memphis office.

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The Federal Reserve Bank of St. Louis is one of 12 regional Reserve banks, which, together with the Board of Governors, make up the nation's central bank. The Fed carries out U.S. monetary policy, regulates certain depository institutions, provides wholesale-priced services to banks and acts as fiscal agent for the U.S. Treasury. The St. Louis Fed serves the Eighth Federal Reserve District, which includes all of Arkansas, eastern Missouri, southern Indiana, southern Illinois, western Kentucky, western Tennessee and northern Mississippi.

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Franklin National Bank photograph on Page 10:

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