FEDERAL RESERVE BANK OF ST. LOUIS

2003 ANNUAL REPORT

Branching Out

"The St. Louis Fed's value to its branch communities is more than bricks and mortar. It's the Bank's intellectual contributions that make the most important difference."

William Poole

PRESIDENT AND CEO
FEDERAL RESERVE BANK OF ST. LOUIS

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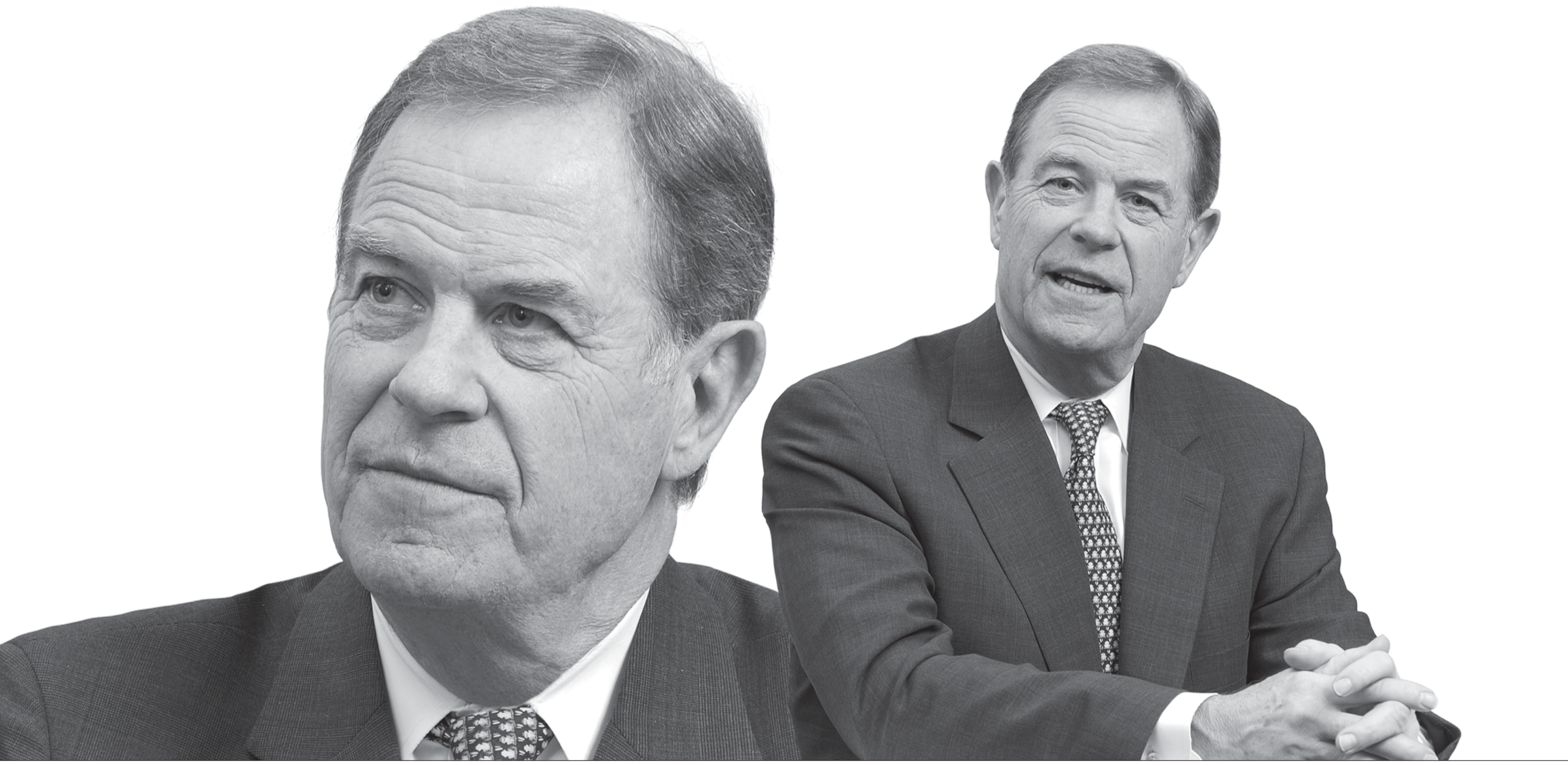
William Poole
PRESIDENT AND CEO

President's Message

In response to dramatic shifts in the payment landscape, the Federal Reserve in 2003 made some tough decisions regarding the offices in which it will continue to process checks. In the Eighth District, such decisions have had a ripple effect, prompting us to shut down our operational role in cash processing and vacate branch buildings in Little Rock and Louisville. By the end of 2004, the Little Rock and Louisville branches will no longer process any form of payment.

For an institution like the Fed, these changes were seismic. If you searched for a single word to sum up what the Fed is all about, the word stability would do a pretty good job. Our primary mission is to maintain price stability. Stability also defines the Fed's goals since 1913 for supervising and regulating the nation's banking system, as well as safeguarding the nation's payments system. Finally, our employees have always regarded the Fed as a stable place to come to work each day.

In the wake of decisions that will reduce staff in Little Rock and Louisville to fewer than 10 each, we have pondered the question: What's a Fed branch for anyway? Have branch offices served



Walter L. Metcalfe Jr.
CHAIRMAN

their time? The essay in this annual report answers the latter question with a resounding no.

We will detail the critical significance of the St. Louis Fed's regional presence in cities around its district. Simply put, we cannot afford to lose or lessen the importance of the network of economic information-gathering resources we've established, the critical input we get from our branch boards of directors on the regional economy, and the one-on-one relationships we've nurtured among the region's bankers, teachers, community development agencies and university professors.   Indeed, we plan to expand these networks, as this report will discuss.

Our renewed efforts will result in a greater public and intellectual presence in branch cities than we've had. Even as we reduce our role as an employer of workers, we expect to be increasing our visibility in the community.

Our new branch direction marks a new era. At the same time, we should not forget the tremendous contributions of the employees who are leaving us. Our employees in Little Rock and Louisville are some of the finest in the Federal Reserve System, and we will miss them. They routinely have led the System in measures of productivity and cost recovery, and I am saddened by the decisions that have cost them their jobs. As we say goodbye to these employees during the second half of 2004, I will do my best to pay tribute to their dedication, excellence and customer service, for they deserve whatever thanks we can give them.

William Poole

William Poole

Branching Out

The St. Louis Fed's Three Branches Expand Beyond Bricks and Mortar.

The first thing they'll have to do is order new business cards. That's because their titles will change from "branch manager" to "senior branch executive." And that is just the first of a multitude of changes the Federal Reserve Bank of St. Louis' three branch managers will encounter in the second half of 2004. New title. New mission. New era.



▲ Future Greenspans? High school students opine about the state of the economy in the Fed Challenge, a competition in which students participate in a mock Federal Open Market Committee meeting in front of a panel of judges. At its three branches, the St. Louis Fed will increase its involvement in these types of outreach events.

Indeed, everything will change in the Eighth District's Little Rock, Louisville and Memphis branches starting later this year. If you live in these communities, expect to read, see and hear more about the Fed's expanded role in a number of local initiatives. One might envision this involvement manifesting itself in a number of ways:

- Robert Hopkins, Little Rock senior branch executive, welcoming attendees to a Fed-sponsored urban planning conference;
- Tom Boone, Louisville senior branch executive, addressing high school seniors about the Federal Reserve's role in monetary policy and the payments system;
- Martha Perine Beard, Memphis senior branch executive, making TV and radio appearances to discuss economic and banking trends affecting the Mid-South;
- a St. Louis Fed economist appearing at a chamber of commerce luncheon to present her research on employment trends in the community;
- a Fed-sponsored speaker's program attracting high-profile business leaders from around the country; or
- more meetings between lenders and community development groups—meetings that are mediated by local Fed representatives and that address key issues related to credit access.

"I think those of us in the Eighth District branches have a great opportunity in our communities to make our presence felt more broadly than ever before," Boone says.

Following a year in which national and local consolidation decisions led the Bank to change the role of its branches dramatically, the St. Louis Fed will draw upon its intellectual capital in areas such as community affairs, economic education, research and monetary policy to increase its contributions to the branch cities and surrounding regions.

This annual report will examine the decisions that prompted the St. Louis Fed to redefine the traditional role of its branches to focus more on outreach and less on operations. In addition, it will review the evolving functions of the branch offices since their inception. Finally, it will discuss in greater detail the branches' new and expanded responsibilities and functions.

CHECK: THE TRANSITION FROM PAPER TO ELECTRONICS

What the Federal Reserve announced on Feb. 6, 2003, is the type of news that has become commonplace in most of the business world. At the Fed, however, it was a jolting, paradigm-shifting event. The Fed announced a consolidation of its check operations, resulting in the elimination of 1,300 positions by the end of 2004.

Smaller consolidations in the past, in response to market conditions, had resulted in some degree of employment shrinkage at the Fed. A sweeping, nationwide wave of job cuts, however, was not something common to the Fed or its employees.

To understand why the Fed is consolidating from 45 check-processing sites to 32 and streamlining its check-adjustment functions from 43 locations to 12 is to understand the decline of checks themselves.[1] It is nothing short of precipitous.

Even though checks remain the most popular form of retail payment outside of cash, they make up only 60 percent of all noncash retail payments today compared with 85 percent in 1979. Federal Reserve studies suggest that roughly 40 billion checks were written in the United States in 2002, down from about 50 billion in 1995. Federal Reserve banks handle about 16.5 billion of these checks annually, and this volume is expected to decline as well. But the bad news for the Fed's check operations is actually evidence of success given the Fed's long-standing push for more electronic payments.

On the day of the Fed's check announcement, Cathy Minehan, president and CEO of the Federal Reserve Bank of Boston and, at the time, chair of the Fed's Financial Services Policy Committee, explained: "Nationwide, consumers and businesses have made a significant shift in how they make payments, substituting electronic payments for checks. This development is good news for the nation's payments system, and the Federal Reserve has strongly supported this shift. But declining check volumes are requiring the Reserve banks to make changes in their check operations to address the challenges posed by the changing market. The changes we are announcing today will help us meet these challenges."

In light of the increased popularity of electronic payments at the expense of check growth, the Federal Reserve had no choice but to take action. Because the Fed has a goal to recover its check costs (as stipulated in the Monetary Control Act of 1980), Reserve banks must continually balance rev-

[1] Check adjustments refers to the part of the check-processing operation in which errors are resolved.

enue and expenditures in its financial services. With check volumes declining across the nation, however, the Federal Reserve System has missed its cost-recovery targets in recent years. The Fed's Check Re-engineering Initiative was launched to get the cost recovery effort back on track.

The initiative is expected to reduce the Fed's operating costs for check services by about $60 million in 2005 and about $300 million over the next five years. The Eighth District is projected to save $5 million annually.

THE IMPACT ON THE EIGHTH DISTRICT

The ramifications of the Fed's check announcement were more severe in the Eighth Federal Reserve District than in most other districts in the Fed System. As a result of the decision, the following actions will occur:

- In Little Rock, all of Check Operations will shut down, with processing moving to the Memphis office in July 2004;

- In Louisville, all of Check Operations will shut down. In August 2004, Check processing will move to Cincinnati, and Check adjustments will move to Cleveland.

- In Memphis, Check processing will expand with the addition of Little Rock's check volume.

- St. Louis will maintain its check-processing function.

- Management of Check adjustments in Little Rock, Memphis and St. Louis will be consolidated in Memphis.

About 160 Check employees, mainly in Little Rock and Louisville, will lose their jobs once the consolidations are complete. Their departure has nothing to do with performance. As St. Louis Fed President Bill Poole and First Vice President LeGrande Rives were quick to point out, the decision was primarily "a fact of geography." The city of Louisville sits only 100 miles from Cincinnati. Little Rock is only 120 miles from Memphis.

"We are not blessed in the Eighth District with a branch infrastructure that supports the kinds of changes we've seen," Rives says. "When these branches were established, it probably made sense to have branches that were only 120 miles apart, in terms of transportation, the banking environment, the way checks were handled. ... But, obviously, a lot has changed in terms of technology, transportation, economic conditions and population growth. When you look at these changes since the 1920s and where the population is now, it becomes very difficult for us to maintain operations at branches that are only 120 miles apart."

TAKING IT ONE STEP FURTHER

For some Federal Reserve offices that are losing their Check operations—Little Rock and Louisville among them—the announcement would translate into the exodus of the majority of staff. At the time of the decision in early 2003, Little Rock and Louisville each employed about 130 people, roughly two-thirds of whom worked in the Check Department. The remaining operation function, Cash processing, employs far fewer people than Check. Other employees work in support functions such as protection, building maintenance, food services and housekeeping. Each branch also has a Community Affairs representative.

With the absence of the main revenue generator, Check, the cost of running the Little Rock and Louisville branches would be shouldered almost entirely by Cash. To avoid shifting these costs to the U.S. Treasury and to maintain the efficiency of operations, the District made the following Cash restructuring decisions in July 2003:

▲ Check and Cash consolidations will result in the closure of the St. Louis Fed's buildings in Louisville (top) and Little Rock (bottom), though the Fed will maintain a presence in both cities.

- Cash operations and support services, including protection, building and food services, would close in the Little Rock and Louisville branches in late 2004.

- The night shift Cash operation in Louisville would move to Memphis on Jan. 1, 2004.

Reflecting the reduced staffing, the Bank will also sell the Little Rock and Louisville buildings. A small staff consisting of a senior branch executive, community affairs representatives, economic education specialists and support staff will be working in leased space and maintaining contact with local banks, organizations and officials. In addition, each branch will continue to have its own board of directors to gather regional economic information.

Rives says: "We considered all kinds of alternatives that could possibly either put in new operations or shore up how we distributed costs at those branches. And, really, none of them made good economic sense.

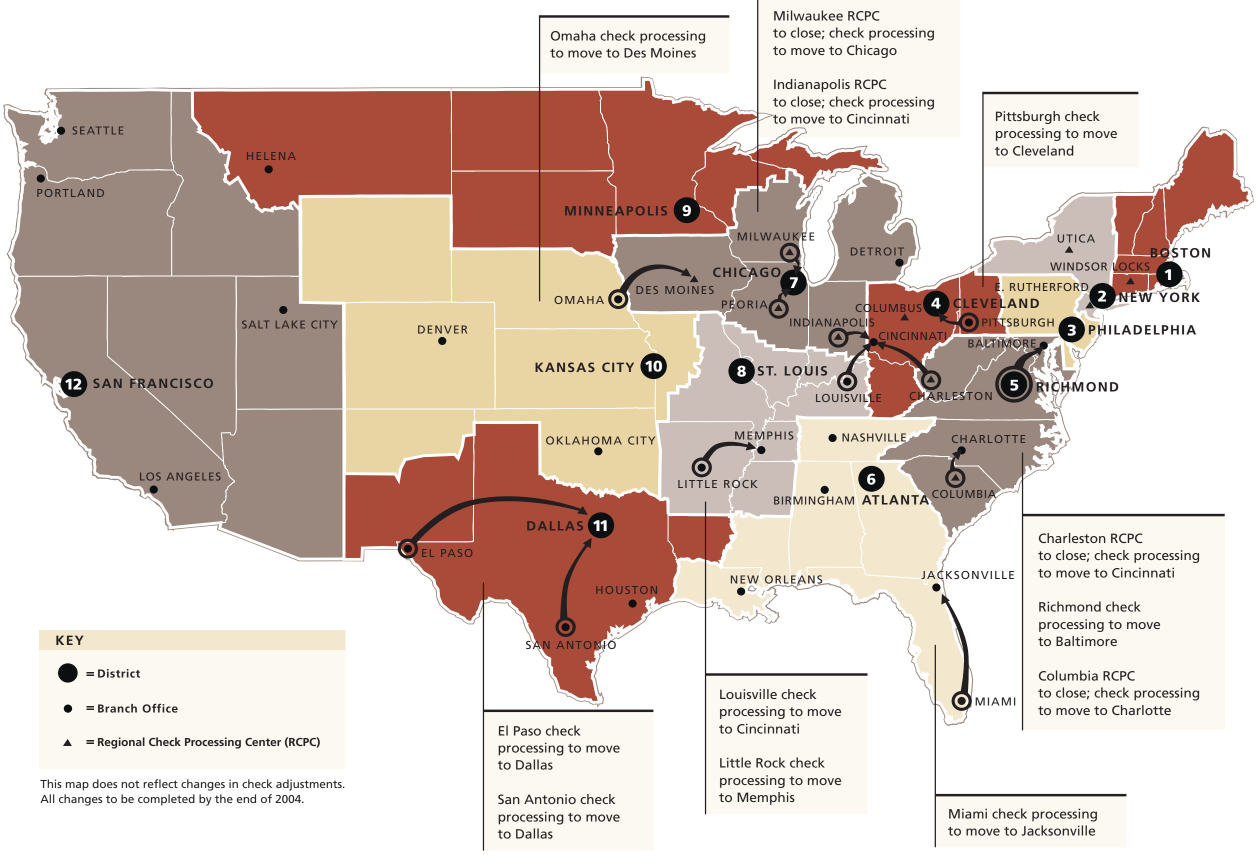
"We asked ourselves, 'Is there anything on the horizon that would make the answer different two years from now, or five years from now?' And the answer was, 'no.'"

ORIGINS OF THE EIGHTH DISTRICT

The St. Louis Fed, importantly, is not closing its Little Rock and Louisville branches. The current events represent the latest in the evolution of the Eighth District branches, albeit the most dramatic changes in the nearly 90-year history of the three branches.

To learn how the branches came into existence, one must go back nearly a century to the creation of the Eighth District. When the Federal Reserve Act was enacted in 1913, St. Louis was the fourth-largest city in the United States. In addition to being a major railroad hub, St. Louis was the world's largest fur market, the nation's third-largest manufacturing city, a major

CHANGES IN THE FEDERAL RESERVE SYSTEM'S CHECK–PROCESSING LOCATIONS



livestock market, a brewing center, a leading distributor of dry goods, as well as a leading banking center.

The Federal Reserve Act called for between eight and 12 Reserve districts. Competition among cities was fierce. A total of 37 cities made formal pitches to the Federal Reserve Bank Organizing Committee. Because of St. Louis' size and economic significance to the nation, city representatives were confident that St. Louis would be selected. What concerned officials more was the size of the territory St. Louis would be granted. They sought to be awarded one of the four largest regional banks, hoping for all or parts of 12 states to be within its boundaries, according to one newspaper report.

In the book *A Foregone Conclusion: The Founding of the Federal Reserve Bank of St. Louis,* the St. Louis contingent was said to be pushing for "a long north-and-south axis to ensure a balance of economic interests. The cotton-belt bankers from Tennessee through Arkansas, Mississippi and Louisiana to Texas, with their heavy seasonal demands for credit, should press the Organizing Committee to give St. Louis a self-sufficient district with a variety of economic interests, such as mining and manufacturing, and enough banking resources to absorb seasonal credit demands."

Within the large territory St. Louis envisioned for its district, eight other cities also were seeking selection: Kansas City, Memphis, New Orleans, Indianapolis, Nashville, Dallas, Houston and Fort Worth. In an attempt at gentle persuasion, those hoping to land a Reserve bank in St. Louis sent a letter to bankers in many of these cities to inform them that there would more than likely be 10 to 15 branches in a St. Louis district, each with local control through a seven-member board.

> The current events represent the latest in the evolution of the Eighth District branches, albeit the most dramatic changes in the nearly 90-year history of the three branches.

Eighteen banks signed the letter, which was sent to their correspondent banks. The bankers said that in a 12-state district headquartered in St. Louis, "every point could be served more satisfactorily through the branches of the St. Louis Reserve Bank than through smaller banks or through banks located in districts not so diversified. It is the evident and proper intent of the law to allow the free use of branches so that all privileges could be carried near to all the people, no matter where the district bank be located."

In January 1914, St. Louis made its case to Organizing Committee members William G. McAdoo, the secretary of the Treasury, and David Houston, the secretary of Agriculture. In an ambitious proposal—though one scaled back from the previously reported version—Festus Wade, president of the St. Louis Clearing House Association, presented St. Louis as "District Five" of a Federal Reserve consisting of eight districts.

When the Organizing Committee made its announcement on April 2, 1914, 12 districts—the maximum allowed by the Federal Reserve Act—were created, with St. Louis named as head office of the Eighth District. The inclusion of districts headquartered in Kansas City and Dallas cut into the west and southwest areas that St. Louis desired for its district. Mainly, that included Texas, Oklahoma and western Missouri. The Eighth District's size, nearly 150,000 square miles, was the fourth smallest among all districts, behind Philadelphia, New York and Boston.

ALONG CAME THE BRANCHES

The notion of 10 to 15 branches sprinkled throughout the St. Louis Federal Reserve District never materialized. But within four years of the St. Louis Fed's swinging open its doors in November 1914, three branches were established. They were located in Little Rock, Louisville and Memphis.

Louisville was the first branch to open, in December 1917. The St. Louis Fed's Board of

LOUIS, FRIDAY MORNING, JANUARY 23, 1914—SIXTEEN PAGES. PRI

McADOO'S SPEECH FAVORS ST. LOUIS

Gives Distinct Impression that U S. Reserve Bank Here Is Certain

SIX HUNDRED ATTEND B. M. L. BANQUET

Archbishop Glennon's Clear Voice Leads in Singing "My Old Kentucky Home" and National Anthem.

Secretary of the Treasury William G. McAdoo, in an address at the annual banquet of the Business Men's League at the Planters' Hotel last night, conveyed the distinct impression that he favors St. Louis as one of the cities for the establishment of a federal reserve bank.

At the dinner, attended by 600, all of the banks in St. Louis and many in the surrounding territory, ...

Excerpts from Address of Secretary McAdoo

POLITICS will have no place in deciding where reserve banks will be located.

The choice will be made from a national viewpoint.

There will be no panic in wake of new currency law.

There will be no destruction.

There will be no inflation of credit, but a legitimate expansion.

$4,000,000 TAKEN IN BY LOCAL RESERVE BANK OPENING DAY

Floral Offerings Are So Numerous Rooms Resemble a Greenhouse.

It was "all coming in and nothing going out" on the opening day of the Federal Reserve Bank of St. Louis, on the fourth floor of the Boatmen's Bank Building, yesterday, when $2,000,000 in crackly new $5 and $10 Reserve Bank notes and about $2,000,000 in deposits of reserves were received and locked away in steel caches. None of the notes was put into circulation. Rediscounting of commercial paper is expected to begin about Thursday.

A visitor at the opening hour, 10 o'clock—and there were many visitors—imagined himself in a Shaw's Garden greenhouse as he walked through the series of offices belonging to William McC. Martin, chairman; Rolla Wells, governor; W. W. Hoxton, Walter W. Smith and C. E. French, cashier.

Huge vases of flowers from friends were everywhere. All that was lacking was the earthy odor of a greenhouse.

Shortly before 10 Giboney Houck, cashier of the First National Bank of Cape Girardeau, Mo., arrived with $10,000 in gold and was the first out-of-town banker to deposit reserves after the bank opened. He is the son of Louis Houck, railroad builder.

During the luncheon hour dozens of St. Louis bankers stepped in to look around.

About 800 Eastern Missouri bankers are expected to attend a group meeting in St. Louis to-day. Some of them probably will visit the Reserve Bank.

$10,000,000 in Reserves Expected.

French estimated the deposits of reserves at above $1,000,000. A late afternoon count showed $787,000. About 25 per cent was in gold, 15 per cent in gold certificates and the rest in lawful money.

French predicted that between $10,000,000 and $14,000,000 will be received from bankers in the first installment of reserves

RESERVE BANKS ARE OPENED, USHERING IN FINANCIAL FREEDOM

Warburg Says Event Marks Economic Fourth of July for Nation.

SPECIAL DISPATCH TO THE GLOBE-DEMOCRAT.

WASHINGTON, November 16.—With many evidences of zeal on the part of officials responsible for its administration, the federal reserve currency system began operation this morning with the opening of the twelve reserve banks.

The announcement of this opening was made by Secretary of the Treasury McAdoo shortly after 8 o'clock, by which time he had signed telegraphic notices addressed to all member banks that their reserve banks were open for business and that the reserve requirements of the new law had become effective. No formal ceremony marked the opening at the Treasury Department.

Immediately after these notices had been signed, Secretary McAdoo sent telegrams to the reserve banks authorizing them to announce to member banks that they were formally opened and personal messages of congratulations to the reserve agents and governors of the twelve banks. Before 5 o'clock this afternoon responses had been received from all of the reserve bank officials addressed, reciprocating the congratulations extended by Mr. McAdoo and announcing that the banks had opened.

The Reserve Board already has before it plans for widening the banks' field of operations and increasing their store of cash.

The board has under consideration the deposit of a large part of the loose cash now in the treasury and the transfer of most of the government funds now deposited in national banks. Secretary McAdoo has power to make these changes, but so far has not reached a decision.

Time Deposits Defined.

▲ Following a visit by William G. McAdoo and the rest of the Federal Reserve Bank Organizing Committee in early 1914, optimism ran high in St. Louis.

▶ The Federal Reserve Bank of St. Louis opened for business on Nov. 16, 1914, with six officers and 17 other employees.

Branch Function Consolidations

1970s	1980s	1990s	2000s
Credit Discount Savings Bonds	Wire Transfer of Funds	ACH Book-Entry Securities Payroll	Accounting/ Purchasing

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Check Processing
(Little Rock to Memphis, Louisville to Cincinnati)

Check Adjustments
(Little Rock to Memphis, Louisville to Cleveland)

Cash Processing
(Little Rock to Memphis, Louisville to Cincinnati)

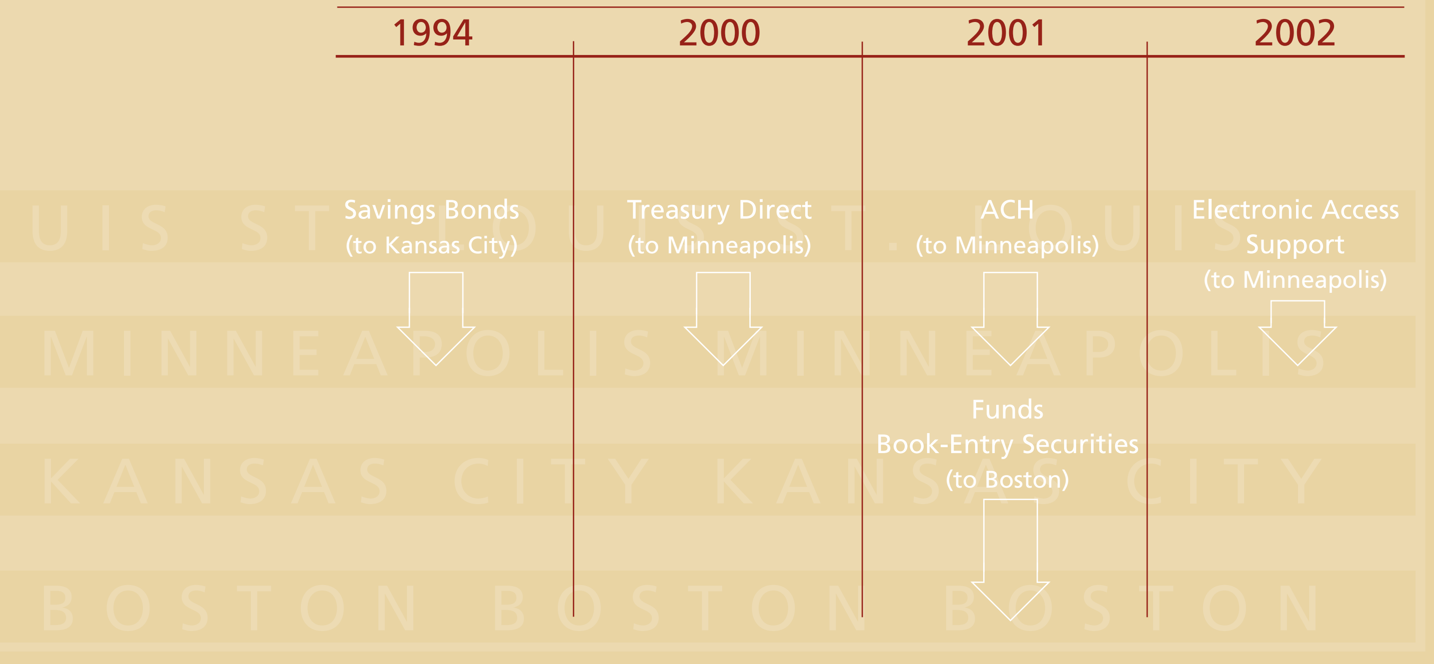
* Since the 1970s, branch consolidation has been on a one-way track. Major functions that each branch used to perform have merged to St. Louis (except where noted).

Directors heard arguments from the Louisville Clearing House Association for the establishment of a branch in Louisville back in September 1916. Not until the following summer did the board approve the establishment of the branch. The Memphis Clearing House Authority petitioned the Bank to establish a branch in that city in the spring of 1918. The St. Louis Board approved the request in June 1918. Just a few weeks later, the directors approved a request from Arkansas bankers to establish a branch in Little Rock.

Before any of the branches could begin functioning, final approval was needed from the Federal Reserve Board in Washington, D.C. Once granted, the St. Louis Board could authorize the branches to perform formal functions, which it did during board meetings in September 1918. The branches' powers were heavy on the operational side and included clearing checks, processing cash and handling credit applications and wire transfers. The seven branch functions and duties spelled out were:

1. To receive from any member or clearing member bank in its territory for collection and credit with it checks drawn on any bank on the par list of the Federal Reserve banks.

* The consolidation trend does not always stop once a function moves to St. Louis. In recent years, some operations have left the St. Louis office as the Federal Reserve nationalizes more and more financial services.



2. To receive from any member or clearing member bank or Federal Reserve bank or branch thereof for collection and credit with or through the head office checks on any bank in its territory on the par list of the Federal Reserve banks.

3. To receive from any member or clearing member bank in its territory for collection and credit when paid, notes, drafts, coupons and other legitimate collection items.

4. To receive from any member or clearing member bank or Federal Reserve bank or branch thereof for collection and credit when paid with or through the head office, notes, drafts, coupons and other legitimate collection items which are payable within its territory.

5. To receive and pass on applications for redis-count and transmit such applications to the head office for approval.

6. To receive and make wire transfers for the mem-ber and clearing member banks in its territory.

7. To receive and transmit by wire to the head office for their approval and advice of rate of dis-count, all applications of member or clearing mem-ber banks to buy or sell mail transfers.

ROLE OF THE BRANCHES: HELPING TO KEEP THE STOOL STEADY

The Federal Reserve is often referred to as a three-legged stool, performing functions and offering expertise in three distinct areas:

- MONETARY POLICY – Basing its decisions on hard data and anecdotal evidence, the Fed acts to keep the level of overall prices stable and the economy growing at a sustainable rate without igniting inflation.

- SUPERVISION AND REGULATION OF FINANCIAL INSTITUTIONS – The Fed is one of several regulators monitoring the banking industry. Fed examiners identify areas of risk that could affect a bank's safety and soundness, and ensure compliance with consumer regulations.

- PROVIDING FINANCIAL SERVICES – A component of the Fed's mission is to foster the integrity, efficiency and accessibility of the payments system. To support its mission, the Fed offers financial services to banks and the U.S. government to encourage competition, innovation and efficiency in the marketplace.

Since the early days of the Eighth District, the Little Rock, Louisville and Memphis branches have played a significant role in the monetary policy and financial services arenas while supervision and regulation functions have been carried out through the St. Louis office.

MONETARY POLICY: A branch's contribution to the monetary policy leg of the stool comes primarily from its board of directors. The Federal Reserve Act stipulates that each Reserve bank branch be operated by a board whose members possess the same qualifications as directors of the head office. The seven directors who serve on each branch board represent the interests of agriculture, commerce, industry, labor and consumers. Current branch board members in the Eighth District hail from sectors of the economy as diverse as banking, academia, health care, manufacturing and affordable housing.

Like the St. Louis board, each branch board generally meets monthly. The directors report on the latest developments in the local economy, and those reports are shared with the Bank president and Bank economists. The president then weighs this information with hard data before attending meetings of the Federal Open Market Committee (FOMC). The FOMC, which determines the target level of the federal funds rate, meets eight times a year to review economic and financial conditions, determine the appropriate stance of monetary policy and assess the risks to its long-run goals of price stability and sustainable economic growth.

St. Louis Fed President Bill Poole regards as critical the anecdotal information provided by sources like board members because it is more timely than formal data such as Gross Domestic Product (GDP) or unemployment statistics. Quantitative measurements that are released monthly or quarterly tend to lag current economic conditions.

"Anecdotal information helps us to see what is going on in the economy almost as it is happening," Poole says. "Also, because it is collected from the people who are actually making day-to-day decisions, it helps us to understand why trends in the data are occurring."

As an example, Poole describes the case of a branch director who in the summer of 2000 reported that loan demand at his bank was falling and that other firms in his area were beginning to experience problems. At the time, the economy seemed to be growing rapidly, and nearly all forecasts indicated that rapid growth would continue. Reports of this sort surfaced throughout the rest of 2000 and into 2001, helping the Fed to get ahead of the recession by lowering its federal funds rate target in early 2001, even though current GDP data suggested that the economy was still growing.

> The directors report on the latest developments in the local economy, and those reports are shared with the Bank president and Bank economists.

Poole also notes that while most of the anecdotal information collected by the Fed supplements other information at the Fed's disposal, the anecdotal reports at times become the primary source of information. Tried and true standard data are not reliable guides whenever history has not recorded a pattern for how the economy is likely to respond. The Sept. 11, 2001, terrorist attacks, for example, had immediate and dramatic economic consequences, but nothing in history could be used to predict the consequences of such an event. The Fed was able to use its network of contacts to get a good idea of the sectors that were affected the most, weeks before any formal data were available.

Poole says: "We found out very quickly that the Fed's injection of liquidity into the banking system had been successful, in that few banks reported having liquidity problems despite the near-complete shutdown of financial markets. We also found that retail sales came to a halt in the two to three days after the attacks but surged back to near-normal levels by the weekend and that manufacturers in the District were anticipating that they would be reducing their output by an average of 10 percent.

"All of this information was vital in the weeks immediately following the attacks, when the Fed had to react very quickly while navigating the uncharted waters of September and October. Indeed, based on anecdotal reports and experience, but without any substantial amount of formal data applying to the period after Sept. 11, the FOMC cut the intended federal funds rate on Sept. 17 and again on Oct. 2."

Information from directors and sources is compiled and shared with the public in a special report—informally called the Beige Book—which is issued about two weeks before each FOMC meeting.

FINANCIAL SERVICES: Fewer than 30 employees were on hand to open each of the St. Louis Fed's three branches. Quickly and steadily, however, the need for more workers and larger facilities at each branch became obvious to accommodate the branches' main function, providing financial services to depository institutions.

The Louisville Branch moved into a new building less than two years after opening its doors. The Branch stayed in growth mode for many years to come: taking over check clearing on city banks from the Louisville Clearing House Association in 1920; installing machines for counting currency in 1928; taking over the issuance and redemption of Defense Bonds (later known as War Bonds and Savings Bonds) from the St. Louis office in the 1940s; moving again into its current building in 1958; and installing an electronic check-handling system in the 1960s.

In Memphis, the Branch's employees moved to expanded offices in 1920. During the decade, the Branch grew to serve 61 banks in eastern Arkansas, northern Mississippi and western Tennessee. Business growth necessitated the construction of a new two-story building before the end of the decade. Even though a third story was added in 1944, by the mid-'60s the building became increasingly inadequate to serve the needs of Memphis financial institutions. In 1972, the Branch moved to a new, four-story downtown building from which it continues to serve more than 400 financial institutions in its zone.

The Little Rock Branch exhibited similar growth since its inception. On the first day the Branch opened in January 1919, clerks processed 750 checks. By December, the quantity had grown to more than 12,000 daily. Employees moved to a new building in 1925 and would stay there for 42 years. With the number of member banks rising to 67 and check volume surging, the Branch moved into its current building in 1967.

Employment at each branch peaked at more than 200 in the early 1970s. Trends such as interstate banking and advancements in technology hastened the movement toward consolidated financial services among Reserve banks. Since then, branch functions have gradually been consolidated, culminating with the check and cash announcements of 2003. (See chart on page 14.)

In 1980, Congress passed the Monetary Control Act, which required the Fed to begin charging for its financial services. The act also opened the Fed's services to all depository financial institutions. Previously, only member banks had direct access to Fed services.

"The Monetary Control Act was clearly a watershed event," says Karl Ashman, senior vice president, Administration, and Little Rock branch manager between 1990 and 1995.

Louisville Branch Manager Tom Boone adds, "From an operations perspective, the Monetary Control Act pushed us into the real world. Not only did we quickly and dramatically improve our efficiency and productivity, but we also began thinking strategically in terms of competing for business."

Now, in the midst of another historic turn of events, the St. Louis Fed prepares to begin a new chapter.

A NEW FED IN TOWN

Barring consumers en masse holstering their debit and credit cards, logging off banking and commercial web sites, and canceling their direct payment accounts, the large check-processing operations employing scores of people will never return to Little Rock and Louisville. Consumers have made it clear: They are increasingly comfortable with electronic forms of payment. What's more, recent legislation like Check 21 is expected to push the electronic payments trend further. (See sidebar on page 21.)

What is not certain at this point is how successful the District's new branch model will become. Can offices that once employed more than 200 people make viable contributions to their communities and the Fed with drastically reduced staffs?

Mary Karr, senior vice president of Legal, Public and Community Affairs, is in charge of the effort to establish a new model for an Eighth District branch office. If history is a barometer, Karr believes the transition will be a success:

"The St. Louis Fed has a great tradition of conducting research that supports monetary policy decisions," Karr says. "We are excited to build on that reputation as we strengthen our intellectual presence in our branches. Shifting our focus from operations will give us an opportunity to be more visible in programs designed to increase the public's understanding of monetary policy and the economy."

Little Rock Branch Manager Robert Hopkins is fully aware that his branch is about to sail in uncharted waters.

"For the Little Rock and Louisville offices, outreach is going to be the primary mission," Hopkins says. "Memphis will still have a huge operations facility, so that branch will be important regardless of what happens on the outreach side."

Many companies use the term outreach to mean charitable contributions or employee volunteerism. What the Fed means by outreach is different. Indeed, while plans for expanded outreach in the St. Louis Fed's branch cities continue to evolve, the outlines of the effort are already taking shape:

EXPANDED EMPHASIS ON MONETARY POLICY: The St. Louis Fed will deepen its knowledge of economic developments across the District, with the effort

▲ The St. Louis Fed will be more visible in its branch communities, hosting events similar to this recent urban revitalization conference in East St. Louis, Ill., which attracted acclaimed speakers to address how distressed cities can reverse their fortunes.

managed from the four District offices. Equally important, the Bank will increase its efforts to communicate policy issues to improve general understanding of how policy is made and its effects on the economy.

EXPANDED RESEARCH INTO REGIONAL ECONOMIC ISSUES: To further aid in monetary policy research, the St. Louis Fed will hire additional economists who will specialize in studying regional issues affecting the District and later present their findings to academic, business and community audiences.

EXPANDED ECONOMIC EDUCATION PROGRAMS: These programs demystify the Fed and explain money, banking and the Fed in simple language for teachers and their students. With dedicated economic education staff members located at a branch, the St. Louis Fed will be able to work more effectively with teachers and students in the branch cities. The Fed has a tremendous range of resources available for use by teachers and students.

EXPANDED COMMUNITY AFFAIRS PROGRAMS: The Bank's Community Affairs Office links lenders with community development organizations. By facilitating partnerships within communities, employees in this department foster dialogue and understanding on issues such as the Community Reinvestment Act, economic development, affordable housing, and fair and equal access to credit. Community Affairs publishes numerous materials on these topics and also hosts or sponsors forums throughout the District. The St. Louis Fed will expand Community Affairs' role in all three branches by increasing staff and sponsoring additional programs.

THE ADDITION OF A SUPERVISORY PRESENCE IN MEMPHIS: Experienced examiners will relocate to Memphis from St. Louis. Julie Stackhouse, the St. Louis Fed's senior vice president over Banking Supervision and Regulation, plans for the operation to grow to about 10 members over time.

Stackhouse says, "Our reason for establishing this satellite office is simple: We want to become more accessible. I believe we can be more effective as a Mid-South banking supervisor if we establish a physical presence in Memphis."

A COMMITTED AND PROFESSIONALLY DIVERSE BOARD OF DIRECTORS AT EACH BRANCH: Maintaining a strong board is perhaps the most critical piece of the new branch model, for the District will need engaged directors to make these ideas successful. Hopkins, for one, is optimistic that business and community leaders will continue to want to serve on a branch board, saying, "I think the directors are tied to the Federal Reserve System more than they are to these large buildings."

All of the evidence presented here indicates that the St. Louis Fed's branches had momentum in several areas of outreach and monetary policy, even before last year's decisions were made. An intellectual presence at each branch was already in place, co-existing as an essential element of a branch's makeup, along with operational services. By the end of 2004, however, an intellectual presence will be what remains in two of the three branches.

"Time will tell as to whether we'll be successful," Hopkins says. "It depends on what we do and how we do it."

Check 21: The Check Stops Here

To enhance efficiency and foster innovation in the payments system, the Federal Reserve System sponsored the Check Clearing for the 21st Century Act (Check 21), which will go into effect Oct. 28, 2004. Check 21 facilitates the use of check electronification to help promote a more efficient system of check collection and processing. It also reduces legal impediments to check truncation that exist under current law.

It works like this: Currently, when you deposit a check at your bank, the bank must present the original paper check to the paying bank, unless there is an agreement in place between the banks. Under Check 21, the paying bank is also required to accept presentment of a substitute check—a paper reproduction of the original check that contains an image of the front and back of the original check, including its magnetic ink character recognition (MICR) information.

As a result of Check 21, banks may choose to truncate original paper checks, process and deliver checks electronically, and print substitute checks at a location near the paying bank for presentment. The act does not require banks to accept checks in electronic form, nor does it require banks to create substitute checks. But it does require banks to accept substitute checks, which will serve as the legal equivalent to the original check.

How quickly banks will adopt all of the provisions of Check 21 is unknown. While all banks will need to ensure they can process substitute checks, they will need to determine whether they can make a business case for investing in the systems and processes necessary to implement check electronification. Some banks will quickly see the advantages for their business, while for other banks it may not make sense immediately.

Overall check volumes have declined over the past several years. About 40 billion checks continue to be written annually in the United States, and the Federal Reserve processes 16.5 billion of those checks. So while checks may be in decline, it is clear they are not going away overnight.

What Check 21 may mean for the Federal Reserve banks is fewer checks to process and reduced costs associated with the relatively slow and expensive check transportation network. The act may also result in an increased share of check-processing resources devoted to receiving, sorting and delivering check data and images electronically.

Says Timothy C. Brown, vice president, Check, at the St. Louis Fed: "This legislation facilitates check electronification while allowing consumers and businesses to continue using paper checks. With Check 21, we can accelerate the check-clearing process, reduce some of the risks associated with ground and air transportation, and reduce operating costs."

As the Eighth District's

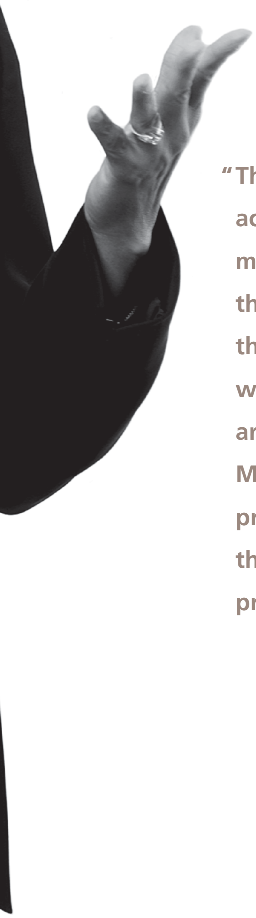
"Change is always a challenge, and the extent to which we are reducing our physical presence will be a very difficult transition. But on the other side of that transition, I see opportunities to make our presence felt in a very positive and meaningful way. For example, by opening new dialogues and forging new partnerships in our communities, we will be able to improve the exchange of economic information and, I hope, make some inroads in promoting economic education and financial literacy."

Tom Boone
LOUISVILLE

branch managers prepare for major changes to their offices' roles and responsibilities, they share their thoughts on the challenges that lie ahead:

"The redesigned mission of the Little Rock Branch affords us the opportunity to expand our existing relationships with bankers, educators and other business leaders across the state, making relevant contributions to economic research, education and community service. We at Little Rock look forward to building on our years of service to the people of Arkansas."

Robert Hopkins
LITTLE ROCK



"The Memphis office will be challenged to achieve some very aggressive productivity measures. Overnight, we will leap from being the smallest to the largest operations office in the District. Our operations in Check and Cash will double. Memphis' employees, however, are eager to face the challenge. Although the Memphis office will have a strong operations presence, I am excited about the expansion that will occur with regard to our intellectual presence in the community."

Martha Perine Beard
MEMPHIS

LITTLE ROCK

Scott T. Ford
Chairman

PRESIDENT AND CEO
ALLTEL CORP.
LITTLE ROCK, ARKANSAS

Everett Tucker III
CHAIRMAN
MOSES TUCKER REAL ESTATE INC.
LITTLE ROCK, ARKANSAS

David R. Estes
PRESIDENT AND CEO
FIRST STATE BANK
LONOKE, ARKANSAS

Board of Directors

Lawrence A. Davis Jr.
CHANCELLOR
UNIVERSITY OF ARKANSAS AT PINE BLUFF
PINE BLUFF, ARKANSAS

Sonja Yates Hubbard
CEO
E-Z MART STORES INC.
TEXARKANA, TEXAS

Raymond E. Skelton
REGIONAL PRESIDENT
U.S. BANK
NORTH LITTLE ROCK, ARKANSAS

Stephen M. Erixon
CEO
BAXTER REGIONAL MEDICAL CENTER
MOUNTAIN HOME, ARKANSAS

LOUISVILLE

Cornelius A. Martin
Chairman

PRESIDENT AND CEO
MARTIN MANAGEMENT GROUP
BOWLING GREEN, KENTUCKY

David H. Brooks
CHAIRMAN AND CEO
STOCK YARDS BANK & TRUST CO.
LOUISVILLE, KENTUCKY

Thomas W. Smith
PRESIDENT
THOMAS W. SMITH & ASSOCIATES INC.
DANVILLE, KENTUCKY

Board of Directors

Maria Gerwing Hampton
PRESIDENT
THE HOUSING PARTNERSHIP INC.
LOUISVILLE, KENTUCKY

Norman E. Pfau Jr.
PRESIDENT AND CEO
GEO. PFAU'S SONS CO. INC.
JEFFERSONVILLE, INDIANA

Gordon B. Guess
CHAIRMAN, PRESIDENT AND CEO
THE PEOPLES BANK
MARION, KENTUCKY

Marjorie Z. Soyugenc
EXECUTIVE DIRECTOR AND CEO
WELBORN FOUNDATION
EVANSVILLE, INDIANA

MEMPHIS

Meredith B. Allen
Chairman

VICE PRESIDENT, MARKETING
STAPLE COTTON COOPERATIVE ASSOCIATION
GREENWOOD, MISSISSIPPI

Walter L. Morris Jr.
PRESIDENT
H&M LUMBER CO. INC.
WEST HELENA, ARKANSAS

Tom A. Wright
CHAIRMAN AND CEO
ENTERPRISE NATIONAL BANK
MEMPHIS, TENNESSEE

Board of Directors

Gregory M. Duckett
SENIOR V.P. AND CORPORATE COUNSEL
BAPTIST MEMORIAL HEALTH CARE CORP.
MEMPHIS, TENNESSEE

Russell Gwatney
PRESIDENT
GWATNEY COMPANIES
MEMPHIS, TENNESSEE

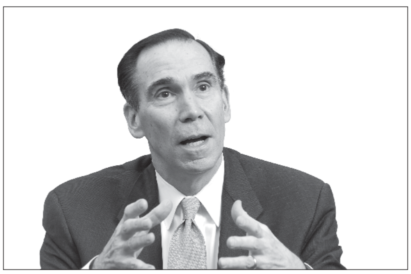
James A. England
CHAIRMAN, PRESIDENT AND CEO
DECATUR COUNTY BANK
DECATURVILLE, TENNESSEE

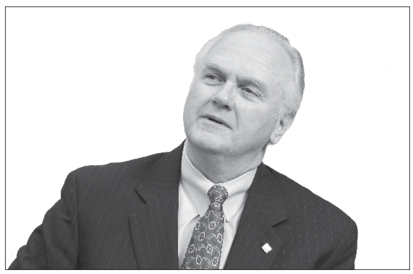
David P. Rumbarger Jr.
PRESIDENT AND CEO
COMMUNITY DEVELOPMENT FOUNDATION
TUPELO, MISSISSIPPI

ST. LOUIS

Walter L. Metcalfe Jr.
Chairman

CHAIRMAN
BRYAN CAVE LLP
ST. LOUIS, MISSOURI





Lewis F. Mallory Jr.
CHAIRMAN AND CEO
NATIONAL BANK OF COMMERCE
STARKVILLE, MISSISSIPPI

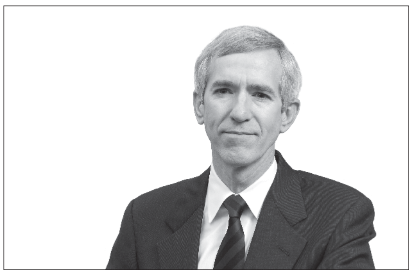
Lunsford W. Bridges
PRESIDENT AND CEO
METROPOLITAN NATIONAL BANK
LITTLE ROCK, ARKANSAS

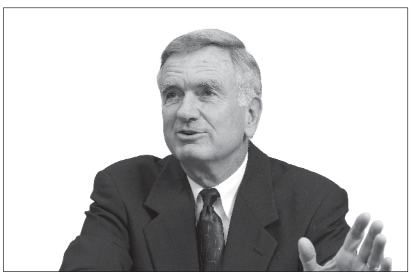
Board of Directors

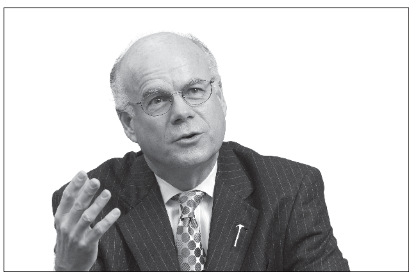
Gayle P.W. Jackson
Deputy Chairman
MANAGING DIRECTOR
FONDELEC CLEAN ENERGY GROUP INC.
ST. LOUIS, MISSOURI

Bert Greenwalt
PARTNER
GREENWALT CO.
HAZEN, ARKANSAS

Bradley W. Small
PRESIDENT AND CEO
THE FARMERS AND MERCHANTS NATIONAL BANK
NASHVILLE, ILLINOIS







Charles W. Mueller
AMEREN CORP.
ST. LOUIS, MISSOURI

J. Stephen Barger
EXECUTIVE SECRETARY-TREASURER
KENTUCKY STATE DISTRICT COUNCIL
OF CARPENTERS
FRANKFORT, KENTUCKY

A. Rogers Yarnell II
PRESIDENT
YARNELL ICE CREAM CO. INC.
SEARCY, ARKANSAS

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 2003. Our appreciation and best wishes go out to:

Vick M. Crawley FROM THE LITTLE ROCK BOARD,

Frank J. Nichols FROM THE LOUISVILLE BOARD,

E.C. Neelly III FROM THE MEMPHIS BOARD AND

Robert L. Johnson FROM THE ST. LOUIS BOARD.

The Economic Outlook

Through the Eyes of Our Board Members

WHAT CHALLENGES DOES YOUR ORGANIZATION OR INDUSTRY FACE IN 2004 AND BEYOND?

"Challenges that face the banking industry, inclusive of our organization, continue to be the shrinking margin due to the competitive nature in the commercial lending arena, plus the unprecedented low interest rates. It is also very difficult to gather deposits due to lack of attractive rates and the availability of alternative investments that currently exist."

Raymond E. Skelton, REGIONAL PRESIDENT
U.S. BANK, NORTH LITTLE ROCK, ARKANSAS

"The energy industry's emphasis today is on going back to basics—investing in bread-and-butter energy distribution assets and building financial strength. While more than 85 percent of all customers surveyed express strong satisfaction with our service, my utility company and the entire industry must respond to customer demand for even higher levels of service quality—near-flawless energy delivery—in the face of constrained resources. Our focus must continue to be on diversifying our fuel sources, employing technology to keep our operations clean and efficient, and relentlessly cutting costs where we can."

Charles W. Mueller
AMEREN CORP., ST. LOUIS, MISSOURI

"The ability to consistently grow earning assets will remain a challenge to banks in areas that do not provide a steady supply of good loans. Sensitivity to interest rate risk can be an added challenge to these banks when funds are placed into extended investment portfolio maturities to generate more profitable margins."

Lewis F. Mallory Jr., CHAIRMAN AND CEO
NATIONAL BANK OF COMMERCE, STARKVILLE, MISSISSIPPI

"I am in the philanthropic world. … Our challenge in 2004 and the future is to keep to our missions and assure our communities that the investments we make through grants to improve the quality of life are effective, and that we are accountable in how we use these funds."

Marjorie Z. Soyugenc, EXECUTIVE DIRECTOR AND CEO
WELBORN FOUNDATION, EVANSVILLE, INDIANA

"Our greatest challenge will be getting accurate market information from China, which has become the major customer for our product. Our industry is having to shift from a U.S. market to an export market, primarily China."

Meredith Baird Allen, VICE PRESIDENT, MARKETING
STAPLE COTTON COOPERATIVE ASSOCIATION,
GREENWOOD, MISSISSIPPI

"Small and/or independent banks face the same old challenges—primarily, training new personnel and retaining experienced personnel in this era of advanced technology and specialization."

Gordon B. Guess, CHAIRMAN, PRESIDENT AND CEO,
THE PEOPLES BANK, MARION, KENTUCKY

"The confidence of builders in Louisville metro is high. A strong housing market and stable interest rates will result in healthy choice and pricing options for first-time home buyers. However, in the affordable housing arena, the challenge of delivering attractive mortgage products, with fair and affordable rates and fees, will be great. First-time home buyers, as well as those homeowners who have earned equity, will continue to be offered subprime mortgage packages that may not be in their long-term interest."

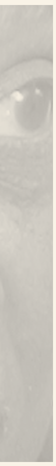
Maria Gerwing Hampton, PRESIDENT
THE HOUSING PARTNERSHIP INC., LOUISVILLE, KENTUCKY

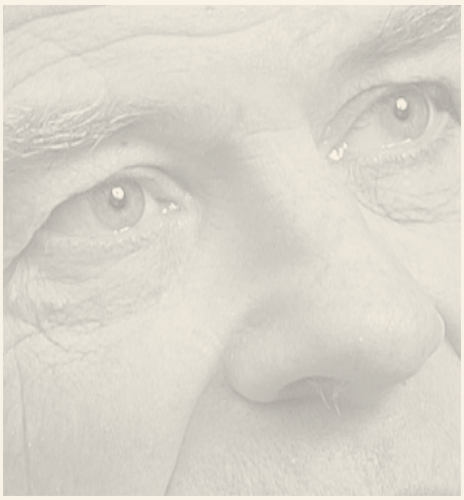
"I think that the greatest challenge to the banking industry will come from nonbank financial institutions. Community banks in particular will continue to face strong competition from credit unions. Community banks will also find it difficult to keep up with new technology trends and will have trouble in continuing to find new products to increase noninterest income."

James A. England, CHAIRMAN, PRESIDENT AND CEO
DECATUR COUNTY BANK, DECATURVILLE, TENNESSEE

"The construction industry will be impacted by the budget deficits faced by state, local and federal legislative bodies. Highways, bridges, water and sewage treatment facilities and government offices funded by federal, state and local tax dollars make up a large percentage of dollars spent on construction. Construction projects are normally the first items to be cut during budget crunches. The impact will be felt in the next few years."

J. Stephen Barger, EXECUTIVE SECRETARY-TREASURER
KENTUCKY STATE DISTRICT COUNCIL OF CARPENTERS
FRANKFORT, KENTUCKY





"Over the course of the next few years, the overall automobile market in the United States should increase. With the number of new drivers that will come of driving age from the 'Y Generation' and longer life spans, some are predicting that annual sales could reach 20 million units within the next five years. The effects of this should have an impact over the short run looking ahead in 2004. However, the industry as a whole is suffering from the loss of pricing power and the high cost of incentives, which will remain the biggest obstacles facing the automobile market."

Russell Gwatney, PRESIDENT
GWATNEY COMPANIES, MEMPHIS, TENNESSEE

ARE THERE ANY NEW TRENDS OR BUSINESS PROCESSES THAT YOU EXPECT WILL HAVE A MAJOR IMPACT ON YOUR ORGANIZATION OR INDUSTRY IN THE NEAR FUTURE?

"The most immediate impact to my industry will be the impact of Check 21. I believe new alliances will be made in the banking industry, and small banks will need to unite and be nimble in the market in order to compete. I further believe that five years from now, the banking landscape will look nothing like it does today."

Bradley W. Small, PRESIDENT AND CEO
THE FARMERS AND MERCHANTS NATIONAL BANK
NASHVILLE, ILLINOIS

"Driven by changes in consumer preference and innovations in food production and processing technology, the structure of agriculture is evolving from one of small independent farmers producing for open markets into a vertically coordinated agribusiness system. The transformation will significantly impact food manufacturers, consumers and farmers. Consumers will benefit from a wider selection of food products and possibly lower prices. Farmers may gain or lose depending on their size, location and skill in negotiating with integrated food companies."

Bert Greenwalt, PARTNER
GREENWALT CO., HAZEN, ARKANSAS

"Both consolidation and expansion in the banking industry create activity in the commercial real estate sector. The merger and acquisition of larger old-line banks has opened the door for the formation of new community banks. The former often puts space/property on the market, and the latter often takes it. This trend should continue."

Everett Tucker III, CHAIRMAN
MOSES TUCKER REAL ESTATE INC., LITTLE ROCK, ARKANSAS

MANAGEMENT COMMITTEE

FROM LEFT TO RIGHT

Karl Ashman
Mary Karr
Hank Bourgaux
LeGrande Rives
William Poole
Robert Rasche
Julie Stackhouse
Dave Sapenaro

A Message from Management

As this year's annual report clearly illustrates, the Federal Reserve Bank of St. Louis is undergoing considerable change. A new model for how we operate our branches is just one indication—though a significant one—that the phrase business as usual no longer applies to the Eighth District.

Thus, for 2004 we deemed it necessary to write a new vision statement for the Bank, which reads: **The Federal Reserve Bank of St. Louis will be recognized as a leader in shaping the future of the Fed's business and support functions, and as a benchmark provider of services among Federal Reserve banks.** Looking back on 2003, we are encouraged to see that in many aspects, we are already fulfilling these critical roles.

Many of our employees—like those who support the Fed's important relationship with the U.S. Treasury—exhibit leadership on a daily basis. As home to the Treasury Relations and Support Office, the St. Louis Fed oversees the full range of projects and services that Reserve banks around the country provide to the Treasury. In addition, the District continued its leadership and operational support of the Treasury's cash management, tax collection and collateral monitoring business. Year-end feedback from Treasury senior executives indicated a high level of satisfaction with our performance at both the District and System level.

The District's Banking Supervision and Regulation Division displayed leadership in a number of areas. Division management either chairs or participates on several critical System-level committees and work groups. On behalf of the Federal Reserve System, the consumer compliance function developed a web site to train bankers on significant changes to Regulation C. The web site received national acclaim across the banking community. The Center for Online Learning, one of the division's unique offerings, continued to grow as the System leader in web-based training, resulting in a savings in time and money for learners.

Our Research Division continued to be a leader in the electronic transmission of economic data and Bank-related information via the Internet. After 38 years, the printing of U.S. Financial Data was discontinued and successfully transitioned to electronic distribution. Federal Reserve Electronic Data (FRED) traffic increased 79 percent over 2002, and the Research function's web pages received 18.8 million hits during 2003, a 65 percent increase over 2002. St. Louis Research economists realized substantial increases in productivity last year, with 43 articles published or accepted for publication in refereed journals, 20 more than in 2002. Also, Bank economists made 118 presentations at System meetings, professional conferences and university-sponsored seminars, double the amount from 2002.

In partnership with the Fourth Federal Reserve District, the Bank pioneered the first regional approach to financial services sales and marketing. This endeavor resulted in a savings of approximately $2 million in the two districts as productivity was improved and redundancies eliminated. The collaborative approach may serve as a template for similar sales and marketing consolidations in other districts.

Continuing to place a high priority on the Bank's public presence, the Community Affairs Office sponsored 42 meetings for District audiences on topics such as serving immigrant markets, community investment opportunities and personal financial education. Our economic education efforts drew more than 900 people to 34 events throughout the year. The Bank's tour program attracted 255 groups for a total attendance of 5,359. The St. Louis Fed led a System work group to create a single web page from which visitors can link directly to all regional and national Fed web sites, as well as other selected Fed resources. The page is located at www.federalreserveonline.org

To explain what it means to be a benchmark provider of services, one need only look at the Bank's Check and Cash departments. During a year of uncertainty, these departments performed in an outstanding manner. All four District check operations areas met their net revenue, cost and productivity targets. Cash exceeded its bundles-per-hour target, as well as the System average.

In Treasury services, the District achieved 18 of 19 operational/service quality measures in 2003, and a formal customer satisfaction survey conducted in late 2002 showed that 94 percent of Treasury Tax and Loan (TT&L) customers are "very satisfied" or "satisfied" with the District's services.

Our bank examiners met nearly all examination, inspection and applications processing mandates. The Credit/Payments Risk and Statistics function achieved all of its operating mandates, even during a year in which the functions were reorganized to realize efficiencies and enhance cross-functional communications and staff development. Staff members in these areas participated in new outreach programs to educate bankers on reporting requirements, account management practices and new credit facilities.

In 2004, the District's primary challenge will be the check and cash consolidation efforts and the concurrent efforts to implement a new model for the branch offices. At the same time, District management will continue to look for opportunities to assume System leadership responsibilities while striving to remain a benchmark provider of services.

In order to meet System security requirements and add some additional office space, last spring we announced a multiyear, multimillion-dollar strategy to renovate and expand our existing downtown St. Louis office. In addition to the extensive security improvements, we will add 54,000 square feet of office space by 2007.

The St. Louis Fed is poised to face a set of challenges never encountered before. Our staff's continued high level of performance indicates that we are well- positioned to meet the expectations and needs of the System, our customers and our constituents.

William Poole
PRESIDENT AND CEO

W. LeGrande Rives
FIRST VICE PRESIDENT AND COO

FEDERAL RESERVE BANK OF ST. LOUIS

FINANCIAL STATEMENTS

For the years ended December 31, 2003 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 2003 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $1.4 million. To ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2003, the Bank did not engage PwC for advisory services.

MARCH 1, 2004

To the Board of Directors:

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

The management of the Bank 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 Bank 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 Bank 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 CEO

W. LeGrande Rives
FIRST VICE PRESIDENT AND COO

Marilyn K. Corona
VICE PRESIDENT, CFO

REPORT OF INDEPENDENT ACCOUNTANTS

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

We have examined management's assertion, included in the accompanying Management Assertion, that The Federal Reserve Bank of St. Louis ("FRB STL") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the financial statements as of December 31, 2003, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB STL's management is responsible for maintaining effective internal control over financial reporting and safeguarding of assets as they relate to the financial statements. Our responsibility is to express an opinion on management's assertion based on our examination.

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

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

In our opinion, management's assertion that FRB STL maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the financial statements as of December 31, 2003, is fairly stated, in all material respects, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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

PricewaterhouseCoopers LLP

MARCH 1, 2004

REPORT OF INDEPENDENT AUDITORS

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, 2003 and 2002, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of The Federal Reserve System. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these 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 described in Note 3, these financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of The Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of The Federal Reserve System, are set forth in the Financial Accounting Manual for Federal Reserve Banks and constitute a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

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

PricewaterhouseCoopers LLP

MARCH 1, 2004

FEDERAL RESERVE BANK OF ST. LOUIS

STATEMENTS OF CONDITION

(in millions)

	AS OF DECEMBER 31, 2003	2002
ASSETS		
Gold certificates	$ 331	$ 346
Special drawing rights certificates	71	71
Coin	53	59
Items in process of collection	341	695
Loans to depository institutions	-	11
U.S. government and federal agency securities, net	21,254	22,726
Investments denominated in foreign currencies	472	343
Accrued interest receivable	159	194
Bank premises and equipment, net	67	66
Other assets	31	26
TOTAL ASSETS	**$ 22,779**	**$ 24,537**
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	$ 19,283	$ 18,914
Securities sold under agreements to repurchase	807	750
Deposits:		
Depository institutions	509	480
Other deposits	3	5
Deferred credit items	308	345
Interest on Federal Reserve notes due U.S. Treasury	13	30
Interdistrict settlement account	1,330	3,554
Accrued benefit costs	59	57
Other liabilities	11	4
TOTAL LIABILITIES	22,323	24,139
Capital:		
Capital paid-in	228	199
Surplus	228	199
TOTAL CAPITAL	**456**	**398**
TOTAL LIABILITIES AND CAPITAL	**$ 22,779**	**$ 24,537**

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

FEDERAL RESERVE BANK OF ST. LOUIS

STATEMENTS OF INCOME

(in millions)

	FOR THE YEARS ENDED DECEMBER 31, 2003	2002
Interest income:		
Interest on U.S. government and federal agency securities	$ 727	$ 897
Interest on investments denominated in foreign currencies	6	5
TOTAL INTEREST INCOME	**733**	**902**
Interest expense:		
Interest expense on securities sold under agreements to repurchase	7	-
Net interest income	726	902
Other operating income:		
Income from services	44	53
Reimbursable services to government agencies	60	38
Foreign currency gains, net	64	42
U.S. government securities gains, net	-	3
Other income	2	2
TOTAL OTHER OPERATING INCOME	**170**	**138**
Operating expenses:		
Salaries and other benefits	94	84
Occupancy expense	9	8
Equipment expense	8	10
Assessments by Board of Governors	24	19
Other expenses	66	42
TOTAL OPERATING EXPENSES	**201**	**163**
Net income prior to distribution	$ 695	$ 877
Distribution of net income:		
Dividends paid to member banks	$ 13	$ 11
Transferred to surplus	29	50
Payments to U.S. Treasury as interest on Federal Reserve notes	653	816
TOTAL DISTRIBUTION	**$ 695**	**$ 877**

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, 2003 and December 31, 2002

(in millions)

	CAPITAL PAID-IN	SURPLUS	TOTAL CAPITAL
Balance at January 1, 2002			
(3.0 million shares)	$ 149	$ 149	$ 298
Net income transferred to surplus		50	50
Net change in capital stock issued			
(1.0 million shares)	50		50
Balance at December 31, 2002			
(4.0 million shares)	$ 199	$ 199	$ 398
Net income transferred to surplus		29	29
Net change in capital stock issued			
(0.6 million shares)	29		29
Balance at December 31, 2003			
(4.6 million shares)	$ 228	$ 228	$ 456

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

NOTE 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.

NOTE 2
OPERATIONS AND SERVICES

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

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

NOTE 3
SIGNIFICANT ACCOUNTING POLICIES

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

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

Each Reserve Bank provides services on behalf of the System for which costs are not shared. Major services provided 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 on average Federal Reserve notes outstanding in each District.

B. SPECIAL DRAWING RIGHTS CERTIFICATES

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

C. LOANS TO DEPOSITORY INSTITUTIONS

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

D. U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES AND INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

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

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

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

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

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

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

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

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

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

In 2003, additional interest income of $61 million representing one day's interest on the SOMA portfolio was accrued to reflect a change in interest accrual methods, of which $1.9 million was allocated to the Bank. Interest accruals and the amortization of premiums and discounts are now recognized beginning the day that a security is purchased and ending the day before the security matures or is sold. Previously, accruals and amortization began the day after the security was purchased and ended on the day that the security matured or was sold. The effect of this change was not material; therefore, it was included in the 2003 interest income.

E. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

F. INTERDISTRICT SETTLEMENT ACCOUNT

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

G. FEDERAL RESERVE NOTES

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

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding reduced by its currency holdings of $3,961 million, and $3,088 million at December 31, 2003 and 2002, respectively.

H. CAPITAL PAID-IN

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

I. SURPLUS

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

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

J. INCOME AND COSTS RELATED TO TREASURY SERVICES

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

K. TAXES

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were $420 thousand and $383 thousand for the years ended December 31, 2003 and 2002, respectively, and are reported as a component of "Occupancy expense."

L. RECENT ACCOUNTING DEVELOPMENTS

In May 2003, the Financial Accounting Standards Board issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150, which will become applicable for the Bank in 2004, establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and imposes certain additional disclosure requirements. When adopted, there may be situations in which the Bank has not yet processed a member bank's application to redeem its Reserve Bank stock. In those situations, this standard requires that the portion of the capital paid-in that is mandatorily redeemable be reclassified as debt.

M. 2003 RESTRUCTURING CHARGES

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

Footnote 10 describes the restructuring and provides information about the Bank's costs and liabilities associated with employee separations and contract terminations. The costs associated with the write-down of certain Bank assets are discussed in footnote 6. Costs and liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8 and those associated with the Bank's enhanced postretirement benefits are disclosed in footnote 9.

NOTE 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 3.146 percent and 3.556 percent at December 31, 2003 and 2002, respectively.

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

	2003	2002
PAR VALUE:		
U.S. government:		
Bills	$ 7,703	$ 8,060
Notes	10,173	10,592
Bonds	3,098	3,728
TOTAL PAR VALUE	**20,974**	**22,380**
Unamortized premiums	308	383
Unaccreted discounts	(28)	(37)
TOTAL ALLOCATED TO BANK	**$ 21,254**	**$ 22,726**

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

As noted in footnote 3, the FRBNY replaced MSP transactions with securities sold under agreements to repurchase in December 2002. At December 31, 2003 and 2002, securities sold under agreements to repurchase with a contract amount of $25,652 million and $21,091 million, respectively, were outstanding, of which $807 million and $750 million were allocated to the Bank. At December 31, 2003 and 2002, securities sold under agreements to repurchase with a par value of $25,658 million and $21,098 million, respectively, were outstanding, of which $807 million and $750 million were allocated to the Bank.

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

MATURITIES OF SECURITIES HELD	U.S. Government Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	$ 1,502	$ 807
16 to 90 days	4,384	-
91days to 1 year	5,162	-
Over 1 year to 5 years	5,885	-
Over 5 years to 10 years	1,614	-
Over 10 years	2,427	-
Total	$ 20,974	$ 807

At December 31, 2003 and 2002, U.S. government securities with par values of $4,426 million and $1,841 million, respectively, were loaned from the SOMA, of which $139 million and $65 million were allocated to the Bank.

NOTE 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 2.375 percent and 2.030 percent at December 31, 2003 and 2002, respectively.

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

	2003	2002
European Union Euro:		
Foreign currency deposits	$ 163	$ 113
Government debt instruments including agreements to resell	97	67
Japanese Yen:		
Foreign currency deposits	35	36
Government debt instruments including agreements to resell	175	125
Accrued interest	2	2
TOTAL	**$ 472**	**$ 343**

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

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

MATURITIES OF INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES	
Within 1 year	$ 433
Over 1 year to 5 years	31
Over 5 years to 10 years	8
Over 10 years	-
TOTAL	**$ 472**

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

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

NOTE 6

BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	2003	2002
Bank premises and equipment:		
Land	$ 7	$ 4
Buildings	49	50
Building machinery and equipment	17	18
Construction in progress	7	-
Furniture and equipment	54	57
Subtotal	$ 134	$ 129
Accumulated depreciation	(67)	(63)
BANK PREMISES AND EQUIPMENT, NET	**$ 67**	**$ 66**
DEPRECIATION EXPENSE, FOR THE YEARS ENDED	**$ 8**	**$ 9**

Future minimum payments under agreements in existence at December 31, 2003, were immaterial.

The Bank has capitalized software assets, net of amortization, of $2 million and $4 million at December 31, 2003 and 2002, respectively. Amortization expense was $1 million for each of the years ended December 31, 2003 and 2002, respectively.

Assets impaired as a result of the Bank's restructuring plan, as discussed in footnote 10 include building, furniture and equipment. Asset impairment losses of $7 million for the period ending December 31, 2003 were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other Expenses."

NOTE 7

COMMITMENTS AND CONTINGENCIES

At December 31, 2003, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately three years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $1 million for each of the years ended December 31, 2003 and 2002, respectively. 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, 2003, were (in thousands):

	OPERATING LEASES
2004	$ 451
2005	451
2006	352
2007	-
2008	-
Thereafter	-
	$ 1,254

At December 31, 2003, other commitments and long-term obligations in excess of one year were immaterial.

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

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

NOTE 8

RETIREMENT AND THRIFT PLANS

RETIREMENT PLANS

The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan") and the Benefit Equalization Retirement Plan ("BEP"). In addition, certain Bank officers participate in the Supplemental Employee Retirement Plan ("SERP").

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

THRIFT PLAN

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $3 million for each of the years ended December 31, 2003 and 2002, respectively, and are reported as a component of "Salaries and other benefits."

NOTE 9

POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

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

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

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

	2003	2002
Accumulated postretirement benefit obligation at January 1	$ 45.8	$ 45.4
Service cost-benefits earned during the period	1.2	0.8
Interest cost of accumulated benefit obligation	3.4	2.9
Actuarial (gain) loss	13.5	(1.1)
Curtailment gain	(3.3)	-
Special termination loss	0.1	-
Contributions by plan participants	0.2	0.1
Benefits paid	(2.4)	(2.5)
Plan amendments	-	0.2
ACCUMULATED POSTRETIREMENT BENEFIT OBLIGATION AT DECEMBER 31	**$ 58.5**	**$ 45.8**

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

	2003	2002
Fair value of plan assets at January 1	$ -	$ -
Contributions by the employer	2.2	2.4
Contributions by plan participants	0.2	0.1
Benefits paid	(2.4)	(2.5)
FAIR VALUE OF PLAN ASSETS AT DECEMBER 31	**$ -**	**$ -**
Unfunded postretirement benefit obligation	$ 58.5	$ 45.8
Unrecognized net curtailment gain	1.4	-
Unrecognized prior service cost	6.8	9.0
Unrecognized net actuarial loss	(13.4)	(3.5)
ACCRUED POSTRETIREMENT BENEFIT COSTS	**$ 53.3**	**$ 51.3**

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

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

For measurement purposes, a 10.00 percent annual rate of increase in the cost of covered health care benefits was assumed for 2004. Ultimately, the health care cost trend rate is expected to decrease gradually to 5.0 percent by 2011 and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2003 (in millions):

	ONE PERCENTAGE POINT INCREASE	ONE PERCENTAGE POINT DECREASE
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 0.2	$ (0.4)
Effect on accumulated postretirement benefit obligation	3.5	(5.3)

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

	2003	2002
Service cost-benefits earned during the period	$ 1.2	$ 0.8
Interest cost of accumulated benefit obligation	3.4	2.9
Amortization of prior service cost	(0.8)	(0.8)
Recognized net actuarial loss	0.3	-
Total periodic expense (credit)	$ 4.1	$ 2.9
Special termination loss	0.1	-
Net periodic postretirement benefit costs	$ 4.2	$ 2.9

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

The recognition of a special termination loss is the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10. The curtailment gain, associated with the employee terminations, will be offset by the unrecognized actuarial losses and prior service cost gains. As a result, an unrecognized net curtailment gain will be recorded in 2004 when the affected employees terminate employment.

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

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 2003 and 2002, were $6 million and $5 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2003 and 2002 operating expenses were $1 million for each year.

NOTE 10
RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check, check adjustment and cash operations and staff reductions in various functions of the Bank. These actions resulted in the following business restructuring charges:

Major categories of expense (in millions):

	TOTAL ESTIMATED COSTS	ACCRUED LIABILITY 12/31/02	TOTAL CHARGES	TOTAL PAID	ACCRUED LIABILITY 12/31/03
Employee separation	$ 5.1	$ -	$ 5.1	$ (0.1)	$ 5.0
Contract termination	-	-	-	-	-
Other	0.3	-	0.1	(0.1)	-
TOTAL	**$ 5.4**	**$ -**	**$ 5.2**	**$ (0.2)**	**$ 5.0**

Employee separation costs are primarily severance costs related to reductions of approximately 256 staff and are reported as a component of "Salaries and other benefits." Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Other expenses."

Costs associated with the write-downs of certain Bank assets, including software, buildings, leasehold improvements, furniture, and equipment are discussed in footnote 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8. Costs associated with enhanced postretirement benefits are disclosed in footnote 9.

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2004.

The Bank anticipates substantially completing its announced plans by December 31, 2004.