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President's Message

The theme for our 2004 annual report is "Sharing Our Knowledge." Knowledge is integral to everything we do as individuals and as a society. Each of us accumulates knowledge, and we use and share it as part of every purposeful activity in which we engage. Our organizations and institutions do likewise.

As the nation's central bank, the Federal Reserve provides a financial environment that fosters sustained economic growth and a financial system that is reliable and accessible to all. In pursuit of these objectives, we often share our knowledge, and we do so enthusiastically, because the more knowledgeable we make our constituencies – be they consumers, bankers, educators, the public at large, or our own employees – the closer we can come to achieving our goals.

All across the country, the Federal Reserve System is playing a valuable role in educating young people about the financial system and its role in a market economy.

In this opening letter, I will give you a quick overview of the ways in which the Federal Reserve Bank of Philadelphia endeavors to share its knowledge and the rationale behind those efforts. The essays that follow will convey to you the texture and substance of our programs. Along the way you will meet some of the many people at the Bank involved in their development and delivery. I hope you will find these efforts and the impact they are having as exciting as I do.

As an economist and a former professor, I am doubly aware of the value of economic education. When people know how to assess economic costs and benefits, they make better decisions about how much to spend, where to invest, and what career to pursue. When voters understand the fundamental workings of the economy, they support better public policy choices, both in their local community and for the nation. In short, well-informed economic decisions and well-understood economic policies are the building blocks for success in a market economy and a democratic society.

As president of this Bank, I see every day how sharing knowledge helps the Federal Reserve achieve its mandated mission – as monetary authority, as bank regulator, and as payments system provider.

For instance, by helping people understand the cross-currents affecting the economy and articulating the value of a stable price environment, we at the Fed strengthen the public mandate for a monetary policy that promotes full employment and sustainable economic growth. Moreover, by maintaining an open dialogue with academia, civic leaders, and the business community, we advance our collective knowledge about the economy, and hopefully, we make better policy decisions ourselves.

As a regulator, the Federal Reserve is responsible for promoting safe and sound practices in the banking industry. Over time, industry conditions change, new laws are enacted, and new regulations are written.

By keeping the bankers in our District up-to-date on these developments, we help them adapt more readily to changing standards. The Fed also oversees the industry's compliance with many consumer protection laws. Here we aim to educate not only the financial institutions but the consumers themselves about their protections under the law. Sharing our knowledge with both sides and building a common understanding are surely the best ways to ensure that the law achieves its intended purpose.

The Federal Reserve is also responsible for maintaining a reliable and efficient payments system. This is an area where new information technology is driving tremendous change. Consumers and businesses are rapidly relinquishing paper transactions – handling cash or writing checks – in favor of electronic ones, swiping a card or logging on to a computer. The challenge for the Fed is to preserve the reliability we have all come to expect from paper-based payments without diminishing the convenience that the new electronic forms of payment offer. Again, sharing our knowledge is an important part of meeting the challenge. The Fed aims to keep both financial institutions and their customers up-to-date on developments in electronic payments, including current standards for processing transactions, disclosure of fees, protection from fraud, and recourse in the event of an error. The Fed also keeps legislators up-to-date on payments technology, so that they can establish standards that provide both reasonable safeguards and ample opportunity to innovate.

So sharing our knowledge helps us achieve our mission in all its dimensions. But how do we actually go about sharing this knowledge?

Reaching Our Constituencies

When it comes to providing economic education to the individual, we have developed a three-part approach. First, we support programs that help young people learn more about economics at school. Second, we support programs that help adults get the back-

The wisdom and leadership of our Board of Directors are of inestimable value in guiding the Bank through changing times.

Federal Reserve Bank of Philadelphia President Anthony M. Santomero (center right) with (left to right) Doris Damm, Deputy Chairman, Board of Directors; Ron Naples, Chairman, Board of Directors; and Federal Reserve Bank of Philadelphia First Vice President William H. Stone, Jr.

ground they need to handle their immediate economic and financial decisions. Third, we offer programs that help the public at large understand the ever-changing structure of the U.S. economy.

Supporting economic education for school-age children is at the core of our efforts because we recognize that broad-based economic education now will translate into a society of more financially literate adults in the future. Unfortunately, the basic concepts of economics and finance often receive only cursory treatment in many schools. Sometimes, they are excluded altogether. As a consequence, graduates enter adulthood ill-equipped to make good life choices about their careers or their personal finances. This situation has led the Bank to focus on programs that integrate economics and finance more fully into school curricula at all levels. We also provide teachers with presentations and seminars to enhance their own background in these subjects and with classroom materials and training on their use. By working with schools and teachers, the Philadelphia Fed can leverage its knowledge resources and have a substantial impact.

We are not alone in this effort. All across the country, the Federal Reserve System is playing a valuable role in educating young people about the financial system and its role in a market economy. Each Federal Reserve Bank has its own economic education specialists and tailors its programs to the needs and resources of the District it serves. With our Bank situated on Independence Mall in the heart of historic Philadelphia, we offer the visiting public "Money in Motion," a history-based look at central banking in the U.S. By partnering with area educators, we are now leveraging the exhibit as an educational resource for area students.

The Bank also has been active in bringing economic education and financial literacy to adults across the District. Financial literacy is a person's best defense against financial fraud and abuse, and so we seek to offer people financial education before they fall victim to unscrupulous business practices. Like any good inoculation program, financial education is most effective if it is targeted at the most vulnerable among us. In this case, the most vulnerable are older people, people in low- and moderate-income communities, and those with a poor credit history. We provide both literature to consumers themselves and curricula to those who counsel and instruct them.

Financial education is most effective if it is targeted at the most vulnerable among us.

As a regulator, the Fed specifies the information that financial institutions must provide in the disclosure forms they give their customers. But these disclosures are useful only if consumers can read and understand them. So we think supporting financial literacy is an essential element of our approach to effective regulation.

But our posture is not a purely defensive one, geared to protect the consumer from harm. Over the long term, we hope to help all consumers master the basics of money management, empowering them to take control of their financial futures. An example of our success in this endeavor is our faith-based financial education initiatives, which have been quite effective in making inroads in communities around our District.

Yet our young and at-risk populations are not the only ones that need education. In today's rapidly changing world, education is becoming a life-long process for virtually everyone. Recognizing that the Bank has a part to play in that process, we have expanded our efforts to keep the public up-to-date on changes in the financial landscape. We are continually enhancing our "Money in Motion" exhibit. For instance, in 2004 the new $50 bill made its debut. We held several events to educate the public about currency authenticity and to point out the security features of the new bill. In addition, we produced brochures on consumer credit topics such as identity theft and credit card fraud.

Networking with the Research Community

Our research economists maintain close ties with a number of the major colleges and universities in our area. Many of our economists are engaged in the national and international academic scene, as well. And we often host prominent scholars for a semester or more of research and interaction here in the Bank. This rich network of knowledge-sharing helps advance the frontiers of economic science.

Engaging the Banking Community

The Philadelphia Fed also made a significant investment in educating the banking community during 2004. In October, the payment system took an important step forward with the enactment of the Check Clearing for the 21st Century Act. Check 21, as it is known, establishes the legal structure necessary to enable the transition from paper to electronic check processing. To take full advantage of this new opportunity, the Federal Reserve launched an aggressive program to move all retail payments to electronics. To engage the banking community in this effort, the Bank actively shared its knowledge about the implications of Check 21 with District banking leaders and kept them informed about the evolution of Federal Reserve payments processing throughout 2004.

Aside from developments in payments, our bank supervision and regulation staff offered a number of programs to brief Third District bankers on recent changes in the law and to discuss emerging trends in the financial services industry.

Building Our Knowledge

We are pleased to share our knowledge and contribute to the continual learning process of our constituencies. But we too must be continual learners if we are to pursue our mission effectively. Recognizing this, our Bank has been quite active in developing educational programs, not only for our own staff members but for our colleagues across the entire Federal Reserve System. Our Professional Education Program (PEP) and its partner, ePEP, combine traditional classroom and technology-based instruction to provide a high quality "blended learning" experience for all business lines throughout the System. Through this program, we help the Federal Reserve build the knowledge it needs to meet the challenges of a changing world.

> The Philadelphia Bank has been quite active in developing educational programs, not just for its own employees but for the entire Federal Reserve System.

I am proud of all of the contributions to education and knowledge sharing that the Philadelphia Fed makes. I believe they make a difference in our District's communities, in the financial services industry, and across the Fed System. As I said at the outset, I believe they serve us well in the pursuit of our mandated mission. As you read this report, I hope you come to share my perspective.

Board of Directors

In the context of this year's report, it is particularly fitting that we recognize the contribution of our Board of Directors, who share their knowledge with us so generously. Their wisdom and leadership are of inestimable value in guiding the Bank through these changing times.

I am pleased to report that Ronald J. Naples, chairman and CEO of Quaker Chemical Corporation, has been reappointed chairman of the Board of Directors, and Doris M. Damm, president and CEO of ACCU Staffing Services, has been reappointed deputy chairman of the Board of Directors for 2005. In addition, P. Coleman Townsend, chairman and CEO of Townsends, Inc., has been re-elected to a second three-year term.

We greatly look forward to the counsel and guidance of our newest Board member, Wayne R. Weidner, chairman of National Penn Bank. At the same time, we offer our sincere thanks to Walter E. Daller, Jr., chairman, president, and CEO of Harleysville National Corporation, who completed his term of service on our Board of Directors. His insights will be missed.

I would also like to acknowledge the contribution of Rufus A. Fulton, Jr., chairman and CEO of Fulton Financial Corporation. We had the pleasure of his service for three years on our Board (1997-2000), and he represented the District admirably on the Federal Advisory Council (FAC) from 2001 to 2004. In his stead, we are also pleased to announce that Bruce L. Hammonds, president and CEO of MBNA Corporation, has been appointed to represent the Third District on the FAC. On behalf of all of us here at the Philadelphia Fed, I thank our Board members for their thoughtful insights and commitment to public service.

A Closing Thought

Before closing, I will mention that Philadelphia's role in the monetary policy decision-making process is now somewhat more pronounced because 2005 is a voting year for Philadelphia on the Federal Open Market Committee (FOMC). As many of you know, the FOMC consists of 12 Federal Reserve Bank presidents and the seven members of the Board of Governors and sets the course for monetary policy. While all Fed presidents attend and contribute to the discussions, only five vote on the final decision. The voting schedule is dictated by the Federal Reserve Act and is done on a rotating schedule of one-year terms. So expect the Philadelphia Reserve Bank to be even more closely watched in the year ahead.

At times like this, I especially appreciate the strong support I receive from the Third District business community, our Board of Directors, our Research Department, and the Bank's advisory councils, as well as from all of the employees who keep us in touch with the Third District.

Anthony M. Santomero
President
April 2005

Introduction

Sharing knowledge with its many constituencies allows the Federal Reserve Bank of Philadelphia to contribute to the economic vitality of the Third District and the nation.

Members of the Pennsylvania Governor's Institute for the Social Studies came to the Bank to learn about resources for teaching economics in the primary grades.

Promoting Economics and Personal Finance

The Federal Reserve's primary role is to ensure a sound financial system and a healthy economy. However, keeping the financial system and economy sound is easier when consumers are financially literate.

Andrew T. Hill, Ph.D.
Economic Education Specialist
Community Affairs Department

To help consumers become more aware of money matters, the Federal Reserve System and the Federal Reserve Bank of Philadelphia have renewed their commitment to teaching the public about economics and personal finance. The Philadelphia Fed plays a strong role in carrying out this commitment in the Third District through the work of economic education specialists such as Andrew Hill in the Bank's Community Affairs Department. Over the past several years, Hill has helped to develop several new programs and expand existing ones.

What's New

One big undertaking in 2004 involved developing a curriculum to go with the Philadelphia Fed's permanent exhibit, "Money in Motion." The curriculum comprises six lessons aimed at different levels: grades three through five, grades six through eight, and high school. The lessons provide classroom activities that prepare students to visit the exhibit, to get the most out of the exhibit while they're here, and to follow up once they're back in the classroom.

Also in 2004, the Bank began a series of evening courses that helped teachers learn how to integrate economics and personal finance into their teaching of reading, writing, and math. This program, "Economics in Children's Literature," showed a group of mostly primary-school educators how to incorporate such lessons using many of the children's books already in their curriculums.

In addition, for five days in July, 37 teachers came to the Philadelphia Fed to attend a course called "Making Sense of Money and Banking." Modeled after a similar program at the St. Louis Fed, "Making Sense" shows teachers how to incorporate lessons about economics and the Federal Reserve System into their social studies, consumer science, and business curriculums. The teachers received professional development credit and a binder of curriculum materials.

Existing Programs

The Bank also continued to offer long-standing programs in 2004. The "Hot Topics in Economics" seminar, which is in its seventh year, invites teachers to come to the Bank one evening for three short presentations on topics related to economic and personal finance issues. For example, the 2004 program included talks by various Bank staff on exchange rates, health-care costs, and the outlook for the economy.

A program of even longer standing is the Topical Seminar Series, which has been held for 21 years in Delaware. This five-night series is sponsored by the University of Delaware's Center for Economic Education and Entrepreneurship. The concluding night of the series is devoted to a speaker from the Philadelphia Fed, who, last year, made a presentation on the history of central banking.

Of course, throughout the year, Hill and other staff members in Community Affairs are kept busy with many other presentations and conferences. For example, in 2004, the Bank hosted the Pennsylvania Governor's School for Global Entrepreneurship for the third year, welcomed teachers from the Pennsylvania Governor's Institute for the Social Studies, and participated in the Chamber of Commerce of Southern New Jersey's annual Summer Institute for Teachers.

In the past year, the Federal Reserve System has renewed its commitment to teaching the public about economics and personal finance.

For the past two years the Bank has been a partner in "Money Talks," a five-day summer course for Delaware teachers who want to learn how to teach personal finance in kindergarten through grade 12. Partners in this endeavor are the Delaware Bankers Association and Citigroup.

One very successful program over the past few years has been "Keys to Financial Success," which was developed in partnership with the University of Delaware's Center for Economic Education and Entrepreneurship, the Delaware Bankers Association, and Community Credit Counseling Services of Maryland and Delaware. Originally done as a pilot in a Newark, Delaware, high school in the 2001-02 school year, "Keys" has now grown to 24 high schools in the First State. Recently, a high school in Bristol, Pennsylvania, adopted the program, and the Bank's economic education specialists are working to expand "Keys" in the Commonwealth. They're also hoping to start a "Keys" program in New Jersey.

At the state level, the Philadelphia Fed's economic education specialists attend the annual meetings of the New Jersey Education Association. At the national level, they participate in a number of conferences, including those of the National Council on Economic Education and the National Council on Social Studies. Events such as these offer an opportunity to talk to teachers around the Third District and the nation and let them know about free resources available from the Fed.

As we move further into 2005 and beyond, the Philadelphia Fed will continue to find innovative ways to fulfill its mission in the economic education and financial literacy arena.

Fostering Community Development Initiatives

The Bank's Community Affairs Department has primarily an informational and educational function. As part of this function, the department develops a number of programs and initiatives that identify issues in low- and moderate-income communities.

Marvin M. Smith, Ph.D.
Economic Education Specialist
Community Affairs Department

As part of its mission, the department expands opportunities for low- and moderate-income communities and people by working with lenders, government representatives, and community developers through workshops, seminars, and publications. In this way, Community Affairs helps bankers understand and respond to the credit and deposit needs of underserved communities.

A major issue being addressed is reinventing America's older communities. In 2004, Community Affairs held a national conference with speakers and attendees from across the United States who discussed ways to make existing communities vibrant and competitive again. Some of the topics covered included creating 24/7 downtowns, financing mixed-use and mixed-income projects, and promoting the importance of good schools. The Bank also co-sponsored another conference for practitioners interested in reclaiming vacant properties in their Pennsylvania communities, an important issue for older towns and cities.

In addition, Community Affairs conducts or commissions research on critical community development issues. The Bank co-sponsored a seminar with the New York Fed and Rutgers University at which 60 nationally known academic researchers discussed community development finance strategies. Furthermore, the department has conducted research on rotating credit and savings associations, informal lending arrangements often used by immigrant populations to finance small businesses or consumer purchases.

Volunteers learn how to educate others on the importance of financial education. Pictured with Marvin Smith (center) are some of the volunteers (clockwise from top): Michael Cunningham, New Covenant Church of Philadelphia; Alberta Wilson, Beulah Baptist Church; Diana Lynch, Eastwick United Methodist Church; and Patsy Harris, Enon Tabernacle Baptist Church.

While recognizing the need to highlight community development issues, the Bank also understands the importance of personal financial education for low- and moderate-income and minority people. Financially literate consumers foster a healthy economy. Financial education helps people develop the skills to meet their objectives, including financial stability, homeownership, higher education, or retirement. Consequently, the Philadelphia Fed and the Federal Reserve System have been actively involved for some time in a number of key initiatives to educate the public, particularly those who are low and moderate income, on matters of personal finance.

Working with Churches

Philadelphia meets this challenge by continuing to promote financial education. In particular, the Bank launched a faith-based financial education initiative in 2004. Leading this initiative is Economic Education Specialist Marvin Smith. By forging strong partnerships with faith-based organizations, particularly in minority neighborhoods, the Bank reaches out to communities and provides people with the tools, training, and information to build a better financial future. Smith's programs successfully combine counseling and education to trainers, who can then empower congregants to secure their own financial success.

Smith asks religious leaders to identify volunteers from their congregations to participate in training workshops conducted by Community Affairs. During these "train-the-trainer" workshops, volunteers learn how to teach others about financial matters. These workshops are held at no cost to the house of worship or the participants.

The program curriculum includes subjects such as credit, checking, budgeting, savings, consumer rights, loans, and homeownership. They are also given valuable teaching tips on different learning styles. Congregants who have completed the workshop are able to take a leadership role in providing ongoing financial education within their houses of worship.

Patsy Harris of Enon Tabernacle Baptist Church observed that the Philadelphia Fed "provided an extensive training package we could take back to our churches and share with our membership. We were able to incorporate these training materials into our sessions to help our members be more informed consumers."

Michael Cunningham, director of the New Covenant Church of Philadelphia's Institute for Financial Success, also attended a train-the-trainer workshop at the Philadelphia Fed. Cunningham noted, "The session stimulated participation and gave attendees the confidence to facilitate various financial education workshops within their own congregations." In fact, the New Covenant Church recently launched a homeownership program, which will include credit counseling and loan processing classes taught by graduates of the train-the-trainer workshops.

Continuing Support and Other Programs

But the Philadelphia Fed's efforts do not end with the training workshop. The Bank provides continuing support, communication, and encouragement to its program participants. Once the new instructors have conducted their congregations' financial education classes, they have the opportunity to reconvene with their original training group to share experiences and offer feedback. At that time, the Fed assists them with addressing challenges they have faced and provides any necessary additional information.

The Bank will also hold presentations at an organization's request. For example, Smith coached members of New Covenant Church on how budgeting works and encouraged participants to develop their own budgets. He also addressed about 1,000 clergy and lay representatives from the northeastern United States at a fall 2004 convocation of the African Methodist Episcopal Church.

Educating Bankers In the Third District

Supervising banks is obviously a big part of what the Bank's Supervision, Regulation and Credit (SRC) Department does, but it also conducts several highly successful outreach programs.

Michael E. Collins
Senior Vice President & Lending Officer
Supervision, Regulation & Credit Department

The outreach programs supported by SRC are aimed at maintaining communication channels between the Philadelphia Fed and its depository institutions, keeping Third District bankers informed, helping them comprehend banking regulations and compliance, and soliciting their input and feedback on emerging and existing public policy issues.

Meetings

To keep the lines of communication open, SRC holds meetings throughout the year. These meetings take various forms and are geared to different audiences.

Five times annually, the department holds Bankers' Forums. To make attendance as convenient as possible, SRC splits the locations: two in Philadelphia and three elsewhere in the Third District. The forums give chief executive officers from area banks an opportunity to discuss emerging issues and challenges with SRC staff and their peers. The most important aspect of the Bankers' Forums is hearing concerns directly from bankers, but it also gives SRC a chance to meet with financial institutions outside the examination process. Although these meetings generally focus on discussions about local financial industry issues, in 2004, the Bank Secrecy Act (BSA) and the USA Patriot Act were common themes. The BSA requires banks to file suspicious activity reports on money laundering and certain other crimes. The Patriot Act, in part, reinforces anti-money laundering statutes with an eye to preventing funding of terrorists and their organizations. In discussions, SRC cautioned bankers that, when there is a violation of these laws, the Fed cannot exercise discretion in enforcement actions, since such proceedings are generally mandated by statute.

SRC also sponsors two other annual meetings: a roundtable for certified public accountants who audit banks SRC supervises and a roundtable for banks' chief financial officers and internal auditors. The agenda for these meetings is set by SRC in conjunction with the Federal Reserve's Board of Governors in Washington, DC.

The most important aspect of the Bankers' Forums is hearing concerns directly from bankers, but it also gives SRC a chance to meet with financial institutions outside the examination process.

Publications

Another way SRC keeps bankers abreast of what's happening in the financial services industry is through its quarterly newsletter *SRC Insights* and its companion insert *Compliance Corner*. This publication, which is available in both paper and electronic form, offers a wealth of information to depository institutions. Each issue begins with a commentary from Senior Vice President Mike Collins on topics ranging from trends in enforcement activity, to the changing supervisory landscape, to the impact of the Sarbanes-Oxley Act. Newsletter articles cover subjects such as "phishing" (an Internet scam), Basel II's impact on competition in the U.S. financial services industry, and training for bank directors. Although *SRC Insights* is targeted to the banks SRC supervises, it also contains commentary on guidelines issued by other regulators.

In its publications outreach last year, SRC reached an even broader audience when *The RMA Journal* printed an article by Mike Collins on fraud management techniques. RMA is a professional association that advances the use of sound risk principles in the financial services industry.

Other Initiatives

Enhancing communication with other regulators was also a priority in 2004. To that end, SRC developed and hosted a program with Pennsylvania's Department of Banking to establish good communication between new leadership. In addition, SRC developed and hosted a program with the heads of the banking departments in each of the District's three states to discuss coordination of crisis management activities.

Another area in SRC, the Consumer Compliance/Community Reinvestment Act (CC/CRA) unit, contributes significantly to SRC's outreach initiatives. Last year, the unit developed a CD-ROM training module on the Home Mortgage Disclosure Act, entitled "HMDA: Understanding the Changes to Regulation." The CC/CRA unit also conducted a training session on consumer regulations for the National Credit Union Administration and, with the Bank's Retail Payments Department, participated in several Check 21 initiatives. This unit also conducts outreach to community groups and fields consumer complaints.

Visiting Scholar Jan Brueckner of the University of California-Irvine meets with members of the Bank's Research Department to discuss his latest research.

Teaching Others About the Economy: Research's Role

The Research Department plays many different roles within the Bank and the Federal Reserve System. We talked with Philadelphia Fed Director of Research Loretta J. Mester to find out what Research does to promote the Bank's education efforts.

Loretta J. Mester, Ph.D.
Senior Vice President &
Director of Research
Research Department

Q: Tell us about the Research Department's educational roles.

LJM: The department does many different things to educate its various constituencies. Our main responsibility is to brief President Santomero in preparation for Federal Open Market Committee (FOMC) meetings. But we also try to educate the public on current economic conditions and economic research.

Our economists give speeches on the economic outlook. They also write articles for the department's flagship publication, *Business Review*.

We also talk to reporters to help them better understand various aspects of the economy. In turn, they can better explain the economy to their readers.

Of course, we also work to advance knowledge within the economics profession by disseminating our research worldwide.

Q: What is the department's role in preparing President Santomero for the FOMC?

LJM: Our economists brief President Santomero on current economic conditions, and we develop forecasts of the economy and discuss the risks to those forecasts. We analyze forecasts from others as well. We point out different options for monetary policy and the reasoning behind those options. Preparation for the briefings is quite lengthy and entails gathering and analyzing data and applying various economic models to the current economic situation to develop appropriate policy recommendations.

Q: How does the *Business Review* fit into Research's educational role? Isn't the material highly technical?

LJM: The work our economists do is often highly technical. However, in the *Business Review*, we distill the technical material into a form that is accessible to educated lay readers. We want readers to understand economic issues, but not necessarily all of the technical details.

We should note that our *Review* differs from those of many of the other Reserve Banks. Our *Business Review* articles are aimed at an educated lay audience — people who are interested in economic issues but who are not economists. One way we measure our success in this area is by the number of requests we get to include *Business Review* articles in reading materials for college courses and books of readings that accompany textbooks. And we've been highly successful on that front.

Q: What about the department's other publications? How is the information gleaned from your economic surveys used?

LJM: Our surveys are used in current analysis of the national and regional economy. For example, the Survey of Professional Forecasters and the Livingston Survey report measures of inflation expectations, along with forecasts of other economic variables. These measures of expectations are important variables in setting monetary policy, and they're also used as a data source in economic research.

The department's Business Outlook Survey (BOS) of regional manufacturers is used for regional analysis. Because it comes out earlier than other measures of the national economy, the information in the BOS is also used as an early forecast of trends in the national economy.

Q: Do your reports literally move markets?

LJM: They can. The BOS has been known to move markets. Traders read the survey immediately upon its release, and movement in the markets is sometimes attributed to survey results that have come out differently than market participants expected.

Q: Can you tell us about the department's conferences and forums?

LJM: The Research Department sponsors several conferences a year that span the various interests of the Bank's research efforts. Since 2001, we've been hosting the Policy Forum, a large macroeconomic conference that brings together policymakers, academics, market economists, and members of the press. The Policy Forum's participants discuss relevant issues that the Federal Open Market Committee will need to deal with in the coming years.

> The annual Policy Forum brings together policymakers, academics, market economists, and members of the press.

We also co-sponsor a macroeconomics workshop each year with the University of Pennsylvania's Economics Department.

In 2005, we will have several events. In April, we will hold a conference on immigration. In June, we'll be co-hosting a conference in Berlin, Germany, on "Bank Relationships, Credit Extension, and the Macroeconomy." Our co-sponsors are the German Institute for Economic Research and the *Journal of Financial Intermediation*. In September, we will co-sponsor a conference on issues in consumer credit and payments with the Bank's Payment Cards Center.

These conferences serve several purposes. They inform us about cutting-edge research on the conference topic and bring together researchers with common interests, which can spur collaborations. They also advance the research agenda on these topics by illuminating which questions remain open.

Q: How is your department's research disseminated to other institutions?

LJM: The web is the premier medium through which we disseminate early versions of our research. Since the web is a global instrument, our economics colleagues around the world have access to our papers. But even before the final working paper is produced, economists have been exchanging ideas by presenting seminars at other institutions and conferring with colleagues. In addition, we sponsor our own seminar series and visiting scholar program, through which we bring in other economists to discuss their research.

In effect, economists "vet" their work by presenting it to other economists. We also send our papers to academic and Fed libraries and post them to online databases such as the Social Sciences Research Network. Ultimately, we revise our work based on the feedback gleaned from presenting and discussing our work, and then submit papers to academic journals. This starts another round of revisions as authors respond to referees' comments before the work is finally published in the journal.

Q: How does the Bank's Research Department help the Philadelphia region?

LJM: Over the years, we've helped various institutions in the area by supplying data, reviewing their analysis, and offering policy advice. In 2004, our chief regional economist attended the Mayor's Economic Summit to discuss the economic future of Philadelphia.

We produce articles on the region, either as stand-alone reports or as part of our *Business Review*, which contain information about some aspect of the local economy. Various city organizations have used this information in their policy discussions.

Over the years, the Research Department has helped various institutions in the area by supplying data, reviewing their analysis, and offering policy advice.

Q: Is any of your work international in nature?

LJM: Economics itself is international in scope. As I mentioned earlier, our research is disseminated through the web, both on the Bank's own web site and on various databases. Some of our economists focus on topics such as international economics and trade.

We have set up economist exchange programs with both the Bank of Sweden and Bank of Canada. Their economists come to the Philadelphia Fed for a week or so, and we then send one of our economists to their central bank for a week. This helps create closer ties among central bank staff, who often are researching similar types of economic questions. It also enables our economists to gain a broader perspective of world economic conditions.

Q: Do the other 11 Reserve Banks' Research Departments work the same way?

LJM: Our general goals are very similar. Certainly, briefing a Reserve Bank's president for the FOMC is a critical function of all Research departments in the System. Of course, regional knowledge is the unique item each Reserve Bank president brings to the FOMC meetings.

Some System departments emphasize different areas of interest, depending on their location. For example, Reserve Banks in the Midwest may do more research on agriculture-related economic issues. Some departments may emphasize shorter term current analysis, while others emphasize longer term research. Most of the Reserve Banks, including our own, have a mix of these activities.

Making Check Processing More Efficient: Check 21

The Check Clearing for the 21st Century Act, also called Check 21, fosters innovation and efficiency in the payments system. On October 28, 2004, this important new legislation took effect.

Anthony Scafide, Assistant Vice President, and Tom Lombardo, Manager, both in Customer Relations

The essence of the law is that it allows a substitute check, created from an electronic image, to serve as the legal equivalent of the check itself. In doing so, it eliminates a significant legal barrier to check truncation and electronification of check processing. A collecting bank can create an electronic image of a check, transmit the image to the paying bank's location, and then present the paying bank with a paper reproduction or with the electronic image itself.

The Fed proposed Check 21 to enable the industry to make check processing more efficient and reliable. Now, banks must consider how to use the new options offered by Check 21 to create shareholder value and improve service quality. The new legislation provides an excellent opportunity for financial institutions to increase their use of image processing in check collection and improve their business operations.

Preparation at the System Level

As preparations to implement Check 21 were underway across the financial services industry, the Federal Reserve System embarked on a year of training-intensive activities to educate Reserve Bank customers on making the most of the opportunities available through the new legislation. Importantly, the Fed also helped them clarify how best to pass those benefits along to their own customers.

In early 2004, experts from the Federal Reserve System made presentations at the Bank Administration Institute's Check 21 Implementation Planning Clinics, which were held around the nation to review the legal aspects of Check 21, provide an overview of Federal Reserve initiatives, and share perspectives on developing and implementing Check 21 plans.

The Federal Reserve also sponsored online Check 21 seminars to support financial institutions' efforts to develop and implement Check 21 strategies. These online seminar topics included an overview of the new Check 21 product suite, information on how to best use the new product suite within financial institutions' business environments, and tools to help assess readiness for Check 21 implementation. Participants, numbering in the thousands, agreed that these online seminars were very informative and highly practical and allowed the Reserve Banks' busy customers to be informed without leaving their offices.

In addition, in Federal Reserve Bank Customer Service locations around the nation, account executives continue to talk to customers, answering questions about Check 21 and helping identify opportunities to leverage technology and evaluate banks' long-term payments processing strategies in light of Check 21.

Preparation in Our District

Education continued at the District level, as each of the 12 Reserve Banks held seminars around their respective regions to help bankers learn to maximize efficiencies under Check 21 and take advantage of Check 21-related opportunities.

In Philadelphia, our District's training began with the 2004 Field Meetings. Each year, Philadelphia Fed officials travel throughout the Third District educating financial institutions on the economic outlook, banking trends and developments, and financial services. Last year, the financial services portion of the meeting focused exclusively on the upcoming implementation of Check 21. These meetings set the stage for further outreach to bankers around the region.

Following the field meetings, Anthony Scafide, assistant vice president, and Tom Lombardo, manager, both of the Philadelphia Fed's Customer Relations Department, presented six open seminars throughout the Third District to provide bankers the opportunity to learn more about Check 21. Upon customers' requests, or when more one-on-one training was needed, Scafide and Lombardo also conducted comprehensive presentations for individual bank customers interested in obtaining more information on Check 21.

The seminars emphasized how financial institutions can enhance their efficiencies and improve customer service. Another important component of the seminars was the introduction of a variety of new and improved products, services, and solutions offered by the Federal Reserve and designed to support banks' best use of the new options under Check 21.

Follow-Up

As a follow-up to the six seminars and to address any outstanding issues bankers were facing, Scafide and Lombardo developed "Keeping Our Promise," a Check 21 town hall meeting focusing on issues dealing with regulation, compliance, operations, and products and pricing. The session allowed an open dialogue between the bankers and relevant experts in each of the topical areas discussed.

It will take some time for the full effects of Check 21 to be realized. The infrastructure of check processing will evolve, generating new check products and services, and new ways to deliver them. The Federal Reserve is committed to working with the financial services industry in this dynamic environment to ensure a smooth transition and to achieve all the efficiencies this new legislation offers.

More information on Check 21 is available at www.frbservices.org or on the Federal Reserve Board of Governors' web site at www.federalreserve.gov. Or you may contact the Federal Reserve Bank of Philadelphia's Customer Service office at (877) 574-1776.

Examiners in the Bank's Supervision, Regulation and Credit Department use a most unusual tool — Philadelphia's Mural Arts Program.

Training Employees For the 21st Century

Training employees is also an important aspect of sharing our knowledge. A well-trained staff makes the Philadelphia Fed better able to serve both its external and internal customers. The Organizational Learning & Development unit has primary responsibility for this task.

Stephen G. Hart
Assistant Vice President
Organizational Learning & Development Division
Human Resources Department

The Federal Reserve Bank of Philadelphia carries out its mission to educate the public in many ways. But members of the public are not the only ones who benefit from Fed education and training. The Bank also trains employees at every level and in a variety of ways to help them become even more effective at their jobs.

Organizational Learning and Development (OL&D), which is part of the Bank's Human Resources Department, has two primary training units. One group concentrates on training within the Bank, and the other, called the Electronic Professional Education Program (ePEP), concentrates on training System-wide. Both units share three primary objectives: match employees' skills to the Bank's or System's strategic focus, be performance driven and results oriented, and have a technological bias.

To meet these objectives, OL&D staff, under the direction of Assistant Vice President Steve Hart, offer a variety of training programs for employees. A quick look at just a few of the items on OL&D's training calendar demonstrates this. For example, last year, OL&D offered courses on building collaborative relationships, learning leadership at work, establishing good client/consultant relationships, and preventing workplace violence.

Active Training

Also this past year, OL&D made a concerted effort to move from passive to active training. Instead of waiting for people to come to them, staff members visited departments to identify training needs. In this new role, the trainers not only customize training to meet departmental needs, but they also expand their roles as organizational development consultants. This new model offers opportunities for the trainers to help managers and officers look at skill development as well as ways to improve a process, develop team effectiveness, or explore the use of alternative management styles.

In addition, the Bank's trainers were busy last year in operations areas, helping employees adjust to the new check processing platform and implementing Check 21. OL&D also got involved in cross-training Check employees. Some OL&D staff members ventured into a new area: developing training materials for special projects. In particular, they worked with a vendor on technical support for the Treasury Check Information System (TCIS) project, a new web-based system for reconcilement and claims processing of Treasury Checks.

ePEP and Blended Learning

The Bank's trainers also oversaw several ePEP programs. Originally, the Professional Education Program involved a full week of training in Federal Reserve System accounting functions. Then the System expanded that model to include Fed employees who work in Cash departments.

But it quickly became evident that one week of training, once a year, wasn't enough. Nor did such a schedule meet the training needs of the various Federal Reserve Banks. So a blended learning model was developed.

To further facilitate the System's training needs, the Philadelphia Fed proposed the idea of continuous learning: No matter what month new employees are hired, they do not have to wait to learn FRS accounting methods. To implement this idea, online models were created. Furthermore, subject matter experts round out these online sessions by sharing their experience via Sametime, a web-based tool that allows employees to attend live virtual training sessions from their desktops.

Another component of blended learning is virtual learning. The Philadelphia Fed and Banks around the System can use video conferencing to "attend" training sessions. While this technology can be used for information sharing, it also allows Fed trainers to hold interactive, collaborative sessions.

A particularly successful ePEP program in 2004 involved training the examiners in Supervision, Regulation and Credit using a most unusual tool—Philadelphia's Mural Arts Program. As part of this course, 60 examiners went through various exercises, all designed to stress the importance of good communication, collaboration, and teamwork. One "experiential exercise" had participants visit some of Center City Philadelphia's murals and reflect on the facts, emotions, and symbols contained in these works of art.

> The most exciting training news in 2004 was the announcement that in 2005 the Bank will offer an on-site bachelor's degree completion program in conjunction with Philadelphia University.

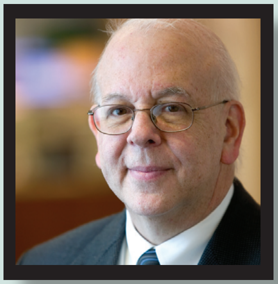
An exercise of this type is particularly useful because examiners are collaborating more in their work. For example, safety and soundness examiners may have to work more closely with community affairs examiners. Thus, it's crucial for them to be able to communicate more effectively.

Bachelor's Degree Program

Perhaps the most exciting training news in 2004 was the announcement that in 2005 the Bank will offer an on-site bachelor's degree completion program in conjunction with Philadelphia University. This opportunity, which will allow employees to obtain an undergraduate degree in Finance or Management, follows close on the heels of the Bank's very successful and well-received associate's degree program, which was offered through the Community College of Philadelphia. Early indications are that this program will prove to be popular with employees.

As the Bank rises to meet the challenges of the 21st century workplace, OL&D will continue to play a major role in ensuring that Bank employees have the skills they need to carry out the Bank's and the System's strategic goals.

Training the Examiners



Ian Harvey
Manager, Staff and Career Development
Supervision, Regulation & Credit Department

Some Philadelphia Fed employees need highly specialized training. One example is bank examiners. What goes into the making of a commissioned bank examiner?

Training takes approximately three years to complete. A quick listing of what assistant examiners undergo includes:

- An orientation program that teaches everything from basics of banking and bank examinations to administrative details.
- An introduction to common operational, analytical, and supervisory techniques for banks, bank and financial holding companies, and foreign banking organizations, focusing on credit, market, liquidity, operational, legal, and reputational risks.
- A 115-hour self-study program in three segments.
- A report writing course and sessions on conducting meetings with management.
- A management skills course that teaches critical thinking, teamwork, negotiation, and listening techniques.
- Courses on fundamentals of interest rate risk management, bank management, and examination management.

Successful completion of training, coupled with demonstrated skills on-the-job, allows an assistant examiner to earn the designation of commissioned examiner. At this stage, in addition to their technical skills, examiners demonstrate analytical rigor, are effective communicators, and possess strong leadership skills.

But it doesn't end there. Federal Reserve examiners' learning continues throughout their careers, as they hone their technical and supervisory skills through on-the-job training and continuing professional development, ensuring that they possess a deeper understanding of the broader financial system.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Federal Reserve Bank of Philadelphia

Board of Directors

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

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

Eugene W. Rogers (4)
Board member since January 2004. Member, Audit and Research and External Affairs committees. CEO of Newfield Bancorp, Inc. and CEO of Newfield National Bank. Director of Atlantic Central Bankers Bank. Member of Kennedy Hospital Advisory Board, and Chairman of South Jersey Community Bankers Association.

Kenneth R. Shoemaker (3)
Board member since January 2003. Chair, Audit Committee and Member, Research and External Affairs Committee. President and CEO of Orrstown Bank; President and CEO of Orrstown Financial Services. Chairman of Council of Trustees of Shippensburg University. Serves on boards of Cumberland Valley School of Music and Carlisle Regional Medical Center. Founding President of Mainstreet Non-Profit Redevelopment Corporation.

P. Coleman Townsend, Jr. (2)
Board member since January 2002. Chair, Research and External Affairs Committee and Member, Budget and Operations Committee. Chairman and CEO of Townsends, Inc. Member of Board of Trustees of University of Delaware, Winterthur Museum, Gardens & Library, The Henlopen Fund, and Historical Society of Delaware. Serves on Council of Advisors for Delaware Center for Horticulture. Active participant on Delaware Art Museum-Collections Committee, Delaware Public Policy Institute, and Delaware Business Roundtable.

Federal Reserve Bank of Philadelphia

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* Not pictured

Federal Reserve Bank of Philadelphia

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Chairman
Aaron L. Groff (8)
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Beneficial Savings Bank
Philadelphia, PA

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of Newtown
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Susquehanna Patriot Bank
Marlton, NJ

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President & CEO
First National Bank of Newport
Newport, PA

* Not pictured

Federal Reserve Bank of Philadelphia

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Discovery FCU
Wyomissing, PA

Virginia F. Williams (9)
CEO
FAA Technical Center FCU
Northfield, NJ

* Not pictured

Operating Statistics

In 2004, Philadelphia's total volume of commercial checks processed decreased 9 percent and the dollar value of transactions decreased 19 percent. Philadelphia continues to be responsible for processing all government checks for the First, Second, Third, Fourth, and a portion of the Fifth Federal Reserve Districts. While the volume of U.S. government checks remained fairly constant, the dollar volume increased 10 percent in 2004.

The Philadelphia Bank continued to be a major processor of cash in the Federal Reserve System in 2004. The volume of currency processed increased 7 percent, while the related dollar value increased 3 percent, both attributable to normal growth. Gaining a large customer in 2004 led to a 76 percent increase in processed coin volume and a 19 percent increase in processed coin value.

In 2004, both the number and value of loans to depository institutions were higher than in the previous year.

SERVICES TO DEPOSITORY INSTITUTIONS

	2004 Volume	2004 Dollar Value	2003 Volume	2003 Dollar Value
Check processing:				
U.S. government	82.0 million checks	$109.6 billion	81.9 million checks	$100.0 billion
Commercial checks	1,129.4 million checks	$2,001.8 billion	1,239.6 million checks	$2,457.1 billion
Cash operations:				
Currency processed	2,358.1 million notes	$44.3 billion	2,212.0 million notes	$43.0 billion
Coin paid and received	756.3 thousand bags	$242.7 million	430.9 thousand bags	$204.6 million
Loans to depository institutions during the year	120 loans	$1,393.6 million	99 loans	$308.3 million

Federal Reserve Bank of Philadelphia

Current Officers

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First Vice President

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Executive Vice President

D. Blake Prichard
Executive Vice President

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Senior Vice President and Lending Officer
Supervision, Regulation and Credit

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Senior Vice President and Director of Research
Research

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

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Vice President
Financial Statistics

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Vice President
Wholesale Product Office

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Vice President and Director
Payment Cards Center

Theodore M. Crone
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Supervision, Regulation and Credit

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Stephen G. Hart
Assistant Vice President
Human Resources

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Assistant Vice President
Check Operations
Retail Payment Services

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Assistant Vice President
Supervision, Regulation and Credit

Alice Kelley Menzano
Assistant Vice President
Information Technology Services

Camille M. Ochman
Assistant Vice President
Treasury Services

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Assistant Vice President
Customer Relations

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Assistant Vice President
Supervision, Regulation and Credit

C. Danny Spriggs
Assistant Vice President
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Marie Tkaczyk
Assistant Vice President
Information Technology Services

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

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Treasury Services

Aileen C. Boer
Research Support Officer
Research

Maryann T. Connelly
Assistant Counsel, Legal

Cynthia L. Course
Enforcement and Information Services & Support Officer
Supervision, Regulation and Credit

Frank J. Doto
Information Technology Officer
Supervision, Regulation and Credit

Suzanne W. Furr
Wholesale Product Officer
Wholesale Product Office

Spyro Karetsos
Enterprise Risk Management Officer
Enterprise Risk Management

Wanda Preston
Check Adjustments Officer
Retail Payment Services

Michelle M. Scipione
Cash Services Officer
Cash Services

Stephen J. Smith
Assistant Counsel, Legal

Includes promotions through February 2005

Statement of Auditor Independence

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2004 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $2.0 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 2004, the Bank did not engage PwC for any material advisory services.

Financial Reports

Letter to Directors

FEDERAL RESERVE BANK
OF PHILADELPHIA

March 10, 2005

To the Board of Directors

The management of the Federal Reserve Bank of Philadelphia (“FRBP”) 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, 2004 (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 FRBP 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 FRBP 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 FRBP maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Federal Reserve Bank of Philadelphia

by______________________
Anthony M. Santomero, President

by______________________
William H. Stone, First Vice President

by______________________
Donna L. Franco, Chief Financial Officer

Report of Independent Accountants

PRICEWATERHOUSECOOPERS

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

Report of Independent Accountants

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

We have examined management's assertion, included in the accompanying Management Assertion, that the Federal Reserve Bank of Philadelphia ("FRBP") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the financial statements as of December 31, 2004, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRBP'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 FRBP maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the financial statements as of December 31, 2004 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 FRBP, 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 16, 2005
Philadelphia, Pennsylvania

Report of Independent Auditors

PRICEWATERHOUSECOOPERS

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

Report of Independent Auditors

To the Board of Governors of the Federal Reserve System
and the Board of Directors of the Federal Reserve
Bank of Philadelphia

We have audited the accompanying statements of condition of the Federal Reserve Bank of Philadelphia (the "Bank") as of December 31, 2004 and 2003, 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, 2004 and 2003, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

March 16, 2005
Philadelphia, Pennsylvania

Federal Reserve Bank of Philadelphia

Statements of Condition

As of December 31, 2004 and December 31, 2003 (in millions)

	2004	2003
ASSETS		
Gold certificates	$ 382	$ 380
Special drawing rights certificates	83	83
Coin	56	37
Items in process of collection	360	493
Loans to depository institutions	5	-
U.S. government securities, net	21,581	21,121
Investments denominated in foreign currencies	624	552
Accrued interest receivable	151	158
Interdistrict settlement account	4,007	905
Bank premises and equipment, net	76	80
Other assets	74	97
Total assets	**$ 27,399**	**$ 23,906**
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve Notes outstanding, net	$ 24,725	$ 21,347
Securities sold under agreements to repurchase	916	802
Deposits:		
Depository institutions	603	719
Other deposits	1	2
Deferred credit items	490	451
Interest on Federal Reserve notes due U.S. Treasury	27	9
Accrued benefit costs	42	52
Other liabilities	7	7
Total liabilities	**26,811**	**23,389**
Capital:		
Capital paid-in	294	258
Surplus	294	259
Total capital	**588**	**517**
Total liabilities and capital	**$ 27,399**	**$ 23,906**

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

Federal Reserve Bank of Philadelphia

Statements of Income

For the years ended December 31, 2004 and December 31, 2003 (in millions)

	2004	2003
Interest income:		
Interest on U.S. government securities	$ 662	$ 742
Interest on investments denominated in foreign currencies	8	7
Total interest income	**670**	**749**
Interest expense:		
Interest expense on securities sold under agreements to repurchase	9	7
Net interest income	**661**	**742**
Other operating income:		
Income from services	38	40
Reimbursable services to government agencies	21	20
Foreign currency gains, net	36	75
Other income	3	3
Total other operating income	**98**	**138**
Operating expenses:		
Salaries and other benefits	73	84
Occupancy expense	10	9
Equipment expense	13	13
Assessments by Board of Governors	34	36
Other expenses	27	29
Total operating expenses	**157**	**171**
Net income prior to distribution	$ 602	$ 709
Distribution of net income:		
Dividends paid to member banks	$ 17	$ 15
Transferred to surplus	35	26
Payments to U.S. Treasury as interest on Federal Reserve notes	550	668
Total distribution	**$ 602**	**$ 709**

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

Federal Reserve Bank of Philadelphia

Statements of Changes in Capital

For the years ended December 31, 2004 and December 31, 2003 (in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 2003 (4.6 million shares)	$ 233	$ 233	$ 466
Transferred to surplus	-	26	26
Net change in capital stock issued (0.6 million shares)	25	-	25
Balance at December 31, 2003 (5.2 million shares)	$ 258	$ 259	$ 517
Transferred to surplus	-	35	35
Net change in capital stock issued (0.7 million shares)	36	-	36
Balance at December 31, 2004 (5.9 million shares)	$ 294	$ 294	$ 588

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

Notes to Financial Statements

1. STRUCTURE

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

Board of Directors

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

2. OPERATIONS AND SERVICES

The System performs a variety of services and operations. Functions include formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse ("ACH") operations, and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies and state member banks; and administering other regulations of the Board of Governors. The Board of Governors' operating 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, 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 and to invest such foreign currency holdings ensuring adequate liquidity is maintained. In addition, FRBNY is authorized to maintain reciprocal currency arrangements ("F/X swaps") with various central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks.

3. SIGNIFICANT ACCOUNTING POLICIES

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

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

Each Reserve Bank provides services on behalf of the System for which costs are not shared. Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include: Collateral Management System, Electronic Cash Letter System, Groupware Leadership Center, Subcommittee on Credit, Reserves, and Risk Management Administration Office, and Treasury Direct Central Business Administration Function.

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

a. *Gold Certificates*

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged, and the Reserve Banks' gold certificate accounts are lowered. The value of gold for purposes of backing the gold certificates is set by law at $42 2/9 a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based on average Federal Reserve notes outstanding in each District.

b. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2004 or 2003.

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 Bank. 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 Board of Directors of the Reserve Bank, 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.

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 lent are 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 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. Securities sold under agreements to repurchase are accounted for as secured borrowing transactions with the associated interest expense recognized over the life of the transaction. Such transactions are settled by FRBNY. Interest income is accrued on a straight-line basis. 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. 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.

Activity related to U.S. government securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currency, excluding those held under an F/X swap arrangement, and deposit accounts of foreign central banks and governments above core balances are allocated to each Reserve Bank. U.S. government 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 calculations, of which $2 million was allocated to the Bank. 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 and are amortized over the remaining useful life of the asset. 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.

Assets eligible to be pledged as collateral security include all Federal Reserve Bank assets. 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. To satisfy the obligation to provide sufficient collateral for outstanding 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 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 $7,973 million, and $8,228 million at December 31, 2004 and 2003, 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 Reserve Bank stock must be adjusted. Member banks are 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.

The Financial Accounting Standards Board (FASB) has deferred the implementation date for SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" for the Bank. When applicable, the Bank will determine the impact and provide the appropriate disclosures.

Notes to Financial Statements

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 an increase in capital paid-in, payments to the U.S. Treasury are suspended and earnings are retained until the surplus is equal to the capital paid-in. Weekly payments to the U.S. Treasury may vary significantly.

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to the U.S. Treasury in the following year. This amount is reported as a component of "Payments to U.S. Treasury as interest on Federal Reserve notes".

j. ***Income and Costs related to Treasury Services***

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

Beginning January 1, 1998, the reimbursement process for all Reserve Banks was centralized at the Bank that included the transfer of each Reserve Bank's Treasury reimbursement receivable to the Bank. The centralized portion of the Bank's reimbursement receivable, reported in "Other assets," totaled $53 million and $74 million at December 31, 2004 and 2003, respectively. The centralized portion of the Bank's Costs of unreimbursed Treasury services, reported in "Other expense," totaled $10 thousand at December 31, 2004.

k. ***Taxes***

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were $2 million for both years ended December 31, 2004 and 2003 and are reported as a component of "Occupancy expense."

l. ***Restructuring Charges***

In 2003, the System started the restructuring of several operations, primarily check, cash, and Treasury 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. These restructuring activities continued in 2004.

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.

4. U.S. GOVERNMENT 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 that occurs in April of each year. The settlement equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 2.974 percent and 3.126 percent at December 31, 2004 and 2003, respectively.

The Bank's allocated share of U.S. Government securities, net held in the SOMA at December 31, was as follows (in millions):

	2004	2003
Par value:		
U.S. government:		
Bills	$ 7,822	$ 7,654
Notes	10,732	10,110
Bonds	2,796	3,079
Total par value	21,350	20,843
Unamortized premiums	280	306
Unaccreted discounts	(49)	(28)
Total allocated to Bank	$ 21,581	$21,121

The total of the U.S. Government securities, net held in the SOMA was $725,584 million and $675,569 million at December 31, 2004 and 2003, respectively.

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, 2004, 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	$ 912	$ 916
16 days to 90 days	5,305	-
91 days to 1 year	5,069	-
Over 1 year to 5 years	6,194	-
Over 5 years to 10 years	1,617	-
Over 10 years	2,253	-
Total	**$ 21,350**	**$ 916**

At December 31, 2004 and 2003, U.S. government securities with par values of $6,609 million and $4,426 million, respectively, were loaned from the SOMA, of which $197 million and $138 million were allocated to the Bank.

At December 31, 2004 and 2003, securities sold under agreements to repurchase with contract amounts of $30,783 million and $25,652 million, respectively, and par values of $30,808 million and $25,658 million, respectively, were outstanding. The Bank's allocated share at December 31, 2004 and 2003 was $916 million and $802 million, respectively, of the contract amount and $916 million and $802 million, respectively, of the par value.

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 2.923 percent and 2.778 percent at December 31, 2004 and 2003, 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):

	2004	2003
European Union Euro:		
Foreign currency deposits	$ 177	$ 191
Securities purchased under agreements to resell	63	57
Government debt instruments	112	57
Japanese Yen:		
Foreign currency deposits	45	41
Government debt instruments	224	204
Accrued interest	3	2
Total	**$ 624**	**$ 552**

Total System investments denominated in foreign currencies were $21,368 million and $19,868 million at December 31, 2004 and 2003, respectively.

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2004, was as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	European Euro	Japanese Yen	Total
Within 1 year	$ 262	$ 269	$ 531
Over 1 year to 5 years	88	-	88
Over 5 years to 10 years	5	-	5
Total	**$ 355**	**$ 269**	**$ 624**

At December 31, 2004 and 2003, there were no material open foreign exchange contracts.

At December 31, 2004 and 2003, the warehousing facility was $5,000 million, with no balance outstanding.

6. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	Maximum Useful Life (in years)	2004	2003
Bank premises and equipment:			
Land	N/A	$ 3	$ 3
Buildings	50	74	72
Building machinery and equipment	20	12	11
Construction in progress	N/A	2	1
Furniture and equipment	10	65	71
Subtotal		**$ 156**	**$ 158**
Accumulated depreciation		(78)	(78)
Bank premises and equipment, net		**$ 76**	**$ 80**
Depreciation expense, for the years ended		**$ 9**	**$ 9**

The Bank leases unused space to an outside tenant. This lease has a term of 2 years. Rental income from such lease was $1 million for both years ended December 31, 2004 and 2003. Future minimum lease payments under the noncancelable agreement in existence at December 31, 2004, were $1 million for years 2005 through 2006.

The Bank has capitalized software assets, net of amortization, of $8 million and $6 million at December 31, 2004 and 2003, respectively. Amortization expense was $1 million for both years ended December 31, 2004 and 2003.

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

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2004, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately 2 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 both years ended December 31, 2004 and 2003. Certain of the Bank's leases have options to renew. The Bank has no capital leases.

Future minimum rental payments under noncancelable operating leases with terms of one year or more, at December 31, 2004, were not material.

At December 31, 2004, the Bank has no other commitments and long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks dated as of March 2, 1999, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 2004 or 2003.

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

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

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

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the Plan for the System and the costs associated with the Plan are not redistributed to the Bank. The Bank's projected benefit obligation and net pension costs for the BEP and the SERP at December 31, 2004 and 2003, 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 both years ended December 31, 2004 and 2003 and are reported as a component of "Salaries and other benefits."

9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits other than Pensions

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

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

Notes to Financial Statements

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

	2004	2003
Accumulated postretirement benefit obligation at January 1	$ 50.4	$ 35.1
Service cost-benefits earned during the period	1.1	0.9
Interest cost of accumulated benefit obligation	2.4	2.7
Actuarial (gain)/loss	(5.5)	13.3
Contributions by plan participants	0.8	0.5
Benefits paid	(2.8)	(2.1)
Plan amendments	(4.5)	-
Accumulated postretirement benefit obligation at December 31	$ 41.9	$ 50.4

At December 31, 2004 and 2003, the weighted average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 6.25 percent, respectively.

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):

	2004	2003
Fair value of plan assets at January 1	$ -	$ -
Actual return on plan assets	-	-
Contributions by the employer	2.0	1.6
Contributions by plan participants	0.8	0.5
Benefits paid	(2.8)	(2.1)
Fair value of plan assets at December 31	$ -	$ -
Unfunded postretirement benefit obligation	$ 41.9	$ 50.4
Unrecognized prior service cost	7.5	12.4
Unrecognized net actuarial gain (loss)	(13.1)	(19.0)
Accrued postretirement benefit costs	$ 36.3	$ 43.8

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

For measurement purposes, the assumed health care cost trend rates at December 31 are as follows:

	2004	2003
Health care cost trend rate assumed for next year	9.00%	10.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	4.75%	5.00%
Year that the rate reaches the ultimate rate	2011	2011

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, 2004 (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	$ 0.6	$ (0.4)
Effect on accumulated postretirement benefit obligation	4.0	(3.2)

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

	2004	2003
Service cost-benefits earned during the period	$ 1.1	$ 0.9
Interest cost of accumulated benefit obligation	2.4	2.7
Amortization of prior service cost	(1.7)	(1.9)
Recognized net actuarial (gain)/loss	0.4	0.5
Total periodic expense	**$ 2.2**	**$ 2.2**
Curtailment (gain)/loss	(7.7)	-
Net periodic postretirement benefit costs	$ (5.5)	$ 2.2

At December 31, 2004 and 2003, the weighted average discount rate assumption used to determine net periodic postretirement benefits costs were 6.25 percent and 6.75 percent, respectively.

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

A plan amendment that modified the credited service period eligibility requirements created curtailment gains.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") was enacted in December 2003. The Act establishes a prescription drug benefit under Medicare ("Medicare Part D") and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. Following the guidance of the Financial Accounting Standards Board, the Bank elected to defer recognition of the financial effects of the Act until further guidance was issued in May 2004.

Benefits provided to certain participants are at least actuarially equivalent to Medicare Part D. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in the actuarial gain in the accumulated postretirement benefit obligation and net periodic postretirement benefit costs.

Following is a summary of the effects of the expected subsidy (in millions):

	2004
Decrease in the accumulated postretirement benefit obligation	$ (6.5)
Decrease in the net periodic postretirement benefit costs	$ (0.9)

Expected benefit payments:	Without Subsidy	With Subsidy
2005	$ 2.4	$ 2.4
2006	2.5	2.2
2007	2.6	2.2
2008	2.6	2.3
2009	2.7	2.3
2010-2014	15.1	12.6
Total	**$ 27.9**	**$ 24.0**

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2004 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. For 2004, the Bank changed its practices for estimating postemployment costs and used a 5.25 percent discount rate and the same health care trend rates as were used for projecting postretirement costs. Costs for 2003, however, 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, 2004 and 2003 were $6 million and $8 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2004 and 2003 operating expenses were ($1) million and $1 million, respectively.

10. BUSINESS RESTRUCTURING CHARGES

In 2004, the System announced plans for consolidation and restructuring plans restructuring to streamline operations and reduce costs, including consolidation of operations and staff reductions in various functions of several Banks. The Bank's costs associated with the restructuring were not material.

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