Driving the Future: The Auto Industry at a Crossroads

Federal Reserve Bank of Chicago 2002 Annual Report
Centered primarily in the Midwest region served by the Federal Reserve Bank of Chicago, the automotive industry is a major factor in the overall U.S. economy.

Our 2002 annual report examines how this key industry is dealing with major issues that affect its role in the nation and region.
The year 2002, following the events of 9/11, was marked by increased geopolitical risk and greater uncertainty in the economy. American business also was profoundly shaken by accounting improprieties and failures in corporate governance that resulted in the collapse of several major companies—adversely affecting employees and shareholders. This had a chilling effect, making many firms hesitant to hire or to invest. Further, to the extent that general uncertainty depressed the stock market, the dent in household wealth was most likely a negative factor for consumer spending.

But, even under these circumstances, the economy held up remarkably well—with real GDP rising 2.9 percent over the year, and with inflation remaining low and well contained. (Real GDP is the broadest measure of national output adjusted for inflation.) One benefit of the low inflation was that it allowed monetary policy to maintain an accommodative stance. Indeed, the Federal Open Market Committee lowered its federal funds rate target to 1\(\frac{1}{4}\) percent—the lowest the actual federal funds rate has been in 41 years. This helped bolster demand throughout the economy.

In addition, household incomes continued to rise throughout 2002. Fiscal policy helped in this regard. But, importantly, growth in real household income has been supported by strong gains in productivity. Indeed, the fact that the outlook for productivity—a major determinant of growth in real wages and real corporate profits over time—has remained strong, suggests that economic fundamentals are still sound.

Midwest auto industry plays key role in national economy

A notable player in the economy's performance last year was the auto sector—based largely in the Seventh Federal Reserve District served by the Chicago Fed, which includes most of Illinois, Indiana, Michigan and Wisconsin, plus all of Iowa. Motor vehicle output alone accounts for more than 3 percent of GDP. Over the year 2002, it increased 9.1 percent compared with overall economic growth of 2.9 percent. Even more significant, when the economy was virtually flat in 2001, motor vehicle output was up 5.6 percent.

This performance provided a substantial lift to a struggling economy. In doing so, it ran counter to the industry's record in prior economic slowdowns. That is to say, when the overall economy slowed down, the auto sector traditionally slowed even more.

Whether recent behavior is the beginning of a new trend is one of many timely questions we address in this year's annual report, entitled "Driving the Future: The Auto Industry at a Crossroads." A four-part essay, focusing on the role of the auto industry nationally and in our region, begins on page 3.
**Impact of shift to electronic payments**

Another important development is that consumers and businesses have been substituting electronic payments—made through debit cards, credit cards and the Internet—for paper checks. This development is good news for the nation’s payments system, and something the Federal Reserve has actively encouraged. But it’s accelerated a decline in the volume of checks processed by the Reserve Banks, forcing us to make changes to recover the costs of payment services, as we’re required to do by law.

Over the next two years, the 12 Reserve Banks will increase efficiency nationwide by reducing the number of check processing sites from 45 to 32 and the number of offices processing check adjustments from 43 to 12. Three Seventh District offices—Indianapolis, Milwaukee and Peoria—will be consolidated into other sites. Unfortunately, this means that positions are being eliminated throughout our District and the System. These decisions reflect the need to address these challenges as a System to position us most effectively for the future.

**2002 results were commendable**

Despite declining check volumes, Seventh District Financial Services contributed the second-highest check net revenue to the System in 2002 and significantly increased our local net revenue performance over 2001. In Detroit, we will be building a new branch facility that will address current and future needs by improving security, vault space and check processing efficiency. We’ve also been busy developing stronger customer relationships that tailor specific products to specific customers. In a notable success, our Des Moines office made the largest single sale of check services in the System’s history.

Economic Research had another outstanding year in its efforts to produce timely, independent and innovative policy-relevant research. A significant 2002 achievement was the December opening of the Chicago Census Research Data Center, located at the Chicago Fed. The center is a joint partnership between the United States Census Bureau and a consortium of institutions including the Bank. It will enable researchers with projects approved by the Census Bureau to study a variety of important economic questions using highly detailed census data while safeguarding confidentiality.

In 2002, Supervision and Regulation sharpened its focus on core bank supervisory responsibilities in response to a more challenging business environment with more complex institutions to supervise. This included increasing staff levels and working to strengthen their expertise.

Overall, we continued to manage District costs to align them with revenue in both the short and long term. We lowered costs significantly through controlling expenses, resizing and realigning staff, and matching support services with demand.

We also implemented measures to ensure the continuity of Bank operations in an emergency situation and enhance the security and safety of our people. A business continuity office was created, and protection officers were certified under the new federal law enforcement authority.

Throughout these challenging times, senior management has communicated with employees frequently to discuss key issues and solicit their ideas for new and better ways to conduct business.

**Appreciation for our employees and directors**

When times are tough, it’s especially important to reiterate how much we appreciate our staff. Employees have demonstrated great flexibility, and we are grateful for their willingness to adapt further as our organization changes.

We also appreciate the support of our directors, whose advice and counsel are invaluable as we fine-tune our strategy to meet new challenges.

During 2002, we also welcomed three new directors: Miles White, chairman and chief executive officer of Abbott Laboratories, joined the Chicago Fed board; and Bob Churchill, chairman and chief executive officer of Citizens National Bank, and Irvin Reid, president of Wayne State University, joined the Detroit Branch board.

Working together as a dedicated team of employees, officers and directors, we improved results in 2002 and have set the stage for stronger performance in 2003 and beyond.

MICHAEL H. MOSKOW
PRESIDENT AND CHIEF EXECUTIVE OFFICER
MARCH 3, 2003
Does the automotive industry still drive the U.S. business cycle?
How does recent performance of the auto industry affect the near-term outlook?
How vulnerable is the auto industry supply chain?
Will the Midwest remain the auto industry's center?
Does the automotive industry still drive the U.S. business cycle?

The auto industry in the United States employs more than 1.3 million workers, and is so large that gross motor vehicle output alone represents more than 3 percent of the U.S. economy. The sector encompasses large auto assembly plants as well as supplier plants that feed the assembly locations everything from raw materials, such as steel and glass, to pre-assembled subcomponents, such as dashboards and seats.

The vast majority of production facilities are concentrated in the so-called auto corridor. This is a region extending south from Michigan along interstate highways 65 and 75, with fingers reaching up to Ontario and down to Mexico. The Chicago Fed District alone, located at the hub of the auto region, is home to 35 percent of the production of light vehicles, which include cars, minivans, pickup trucks and sport utility vehicles, or SUVs. In other words, light vehicle production is twice as concentrated as manufacturing in general in this district. (See chart Seventh District Shares of U.S. Totals).

In addition to the impact of its size and scope, the auto industry also influences the national economy because it traditionally accounts for a disproportionate share of the economy’s fluctuations. Autos—along with other big-ticket items such as appliances, computers and furniture—are examples of what economists term “durable goods.” The long-term nature of these goods allows consumers to put off their purchase during hard times.

Auto industry and economic trends

The relationship of the U.S. economy to the auto industry has been so entwined that it often was said, “If the economy sneezes, Detroit catches cold.” Indeed, if the economy slows down, for whatever reason, the auto sector typically slows down to a larger extent. Similarly, if the economy is doing well, the auto sector does even better as a general rule. Expansions or contractions in the economy translate into larger swings in the durable goods sector, which, in turn, magnify the swings of the overall economy.

Yet fluctuations in the auto sector have moderated noticeably in the past 15 years. Most likely this reflects longer-term structural changes, such as the arrival of lean manufacturing in the auto industry.

Lean manufacturing helps smooth cyclicality

Lean manufacturing is the term for the current best-practice approach to setting up and running a manufacturing facility. Pioneered in Japan, it has been implemented widely since the mid-1980s. It operates on the premise of a so-called pull system, whereby the flow of materials and products through the various stages of production is triggered by the customer.

Because the process is driven by demand, inventories within the production system—that is, within the assembly plant as well as at the supplier plants—have been pared
down to the bare minimum. Now, whenever sales slow or accelerate, that signal gets fed back through the entire production chain faster because inventories no longer cushion the impact.

While this might increase short-term production volatility, it also tends to reduce long-term fluctuations in output. The tighter linkage between demand and production avoids the excess inventory buildup common in earlier years. This mitigates the drastic production cutbacks often required in the past when driving down excessive inventory levels.

Furthermore, today's assembly plants are more flexible than they used to be. A state-of-the-art facility can produce multiple models of a car or light truck—generally based on a single chassis—on the same assembly line. This ability to adjust the output mix quickly at individual plants reduces output swings in the auto sector (see chart U.S. Real GDP and Motor Vehicle Production) by better aligning production with the composition of demand.

As it strives to incorporate the best practices in design, manufacturing and distribution, the auto industry remains a vital sector that helps drive the U.S. economy. In fact, over the four quarters of 2002, motor vehicle output increased 9.1 percent compared with overall real GDP growth of 2.9 percent.

Even more significant, vehicle output was up 5.6 percent in 2001, when the economy went through a sizable slowdown, increasing only 0.1 percent. In this instance, the auto sector ran counter to its traditional performance and moderated the magnitude of the downturn. Whether this scenario is repeated in the future remains to be seen.
How does recent performance of the auto industry affect the near-term outlook?

Early in 2001, prior to 9/11, light vehicle sales were projected to reach 16.7 million units, a level that would have represented the fourth-best sales year on record. Following 9/11, auto showroom traffic fell dramatically. The industry was deeply concerned about a sizeable drop in consumer spending that could hit the durable goods sector, including autos, particularly hard.

Given this changed environment, auto manufacturers—led by General Motors and its patriotic “Keep America Rolling” advertising campaign—introduced the simple marketing concept of zero-percent financing to the American public. The new financing option drove light vehicle sales to a record level in the fourth quarter of 2001. This extraordinary quarter boosted vehicle sales for all of 2001 to 17 million units, resulting in the second-best year ever for vehicle sales (see chart Auto and Light Truck Sales in U.S.).

Industry works to avoid fall-off after banner year
In the wake of such a strong showing in 2001, analysts expected light vehicle sales to fall to the mid-15 million unit level in 2002. At the end of 2001 there was widespread uncertainty regarding the underlying strength of
the economy, especially for the first half of 2002. In addition, analysts thought that a large share of the strong fourth-quarter sales of 2001 reflected purchases that otherwise would have been made in 2002.

However, for a number of reasons, the industry wanted to mitigate this potential downtrend. Faced with a cost structure for labor, plant and equipment that varied little with output, it was less expensive to produce vehicles and market them with heavy incentives than to shut down plants.

A combination of the availability of low market interest rates and the need to keep factories humming inspired the auto industry to move boldly. In addition, some automakers were concerned about market share losses to imports and foreign nameplates produced in the United States. Over the past five years, market share of light vehicles for the Big Three automakers—GM, Ford and DaimlerChrysler—had fallen by more than 10 percentage points.

Together, these factors prompted the industry to push sales actively. Led by GM, the firms took aggressive steps in 2002—including even more generous incentives—to keep consumers coming into their dealers’ showrooms (see chart Marketing Incentives for Light Vehicles in U.S.).

Near-record auto sales help boost economy
Thus the marketing strategies pursued by automakers during 2002 spurred consumers to continue purchasing new vehicles. Sales totaled 16.7 million units in 2002, slightly lower than in 2001 and more than a million units above what had been expected. This made 2002 the fourth-best selling year for light vehicle sales. By helping to power auto and light truck sales to near-record levels, the marketing strategies gave a major lift to a struggling U.S. economy.

Outlook for 2003
Looking ahead, industry observers anticipate sales declining in 2003. However, the decline is expected to be rather moderate as automakers continue to use incentives to smooth production. The severity of the decline will depend on geopolitical uncertainties as well as changes in oil and gas prices. In addition, some analysts are concerned that the escalating level of marketing incentives offered to consumers during the last year has boosted recent sales at the expense of future sales.

At the same time, vehicles continue to be more affordable. It now takes just under 20 weeks of median family income to purchase an automobile. That represents the fewest weeks since 1978.

In light of these factors, forecasters who participated at the Federal Reserve Bank of Chicago’s Economic Outlook Symposium in December 2002 project light vehicle sales during 2003 of 16.5 million units, which would be just slightly below 2002 levels. If realized, this would make 2003 the fifth-best year for vehicle sales.

Source: Ward’s Automotive Yearbook

Auto and Light Truck Sales in U.S.
Millions of units

Source: Ward’s Automotive Yearbook

Marketing Incentives for Light Vehicles in U.S.
Sales price discount plus reduced financing costs, average per vehicle, in dollars

Source: J.D. Power and Associates
How vulnerable is the auto industry supply chain?

From Henry Ford’s introduction of the auto assembly line over a century ago, to the adoption of Japanese manufacturing techniques in the 1980s, automobile production has been evolving continuously. Most crucial today is a tight organization of the supply chain—the way producers of parts are connected to the assembly of the final product.

Supply chain based on timely logistics
Within the environment of lean manufacturing, the role of the supply chain is to assure just-in-time delivery of parts and components to the factory door. For example, a producer of car seats receives a signal from the vehicle assembly plant to build the next batch of seats to customer specifications. It does so and loads them onto a trailer truck in a sequence that matches the order of cars coming down the production line. When the seats are delivered to the loading dock at the assembly plant, they are ready to be moved into the production line. As a rule, the elapsed time from notification to delivery is less than eight hours.

While the supply chain for seats is extremely tight, with multiple deliveries each day, it is indicative of the increased role logistics plays in assuring just-in-time pickup and delivery of parts for the assembly facility.

Impact of 9/11 revealed supply chain vulnerability
The North American auto industry, concentrated in the Midwestern U.S. and southwestern Ontario, today represents a tightly integrated production system. What makes it unique, compared with other major sectors of the economy that tightened their supply chains, is that it straddles the border with Canada, the United States’ largest trading partner. Of the $433 billion of U.S. trade with Canada in 2002, nearly one-fourth was automotive equipment.

With assembly and supplier plants located on both sides of the border, intermediate parts and final products cross daily in both directions. In fact, 75 percent of the trade between Michigan and Canada consists of automotive goods. Key land-border crossings for this sector include the Ambassador Bridge and the Detroit-Windsor Tunnel between Detroit, Michigan, and Windsor, Ontario.

Of the $1.2 billion in trade between the United States and Canada daily, approximately 27 percent represents merchandise crossing the Ambassador Bridge which, unlike the tunnel, can accommodate large trucks. In 2001, an average of 4,300 trucks crossed the bridge each day.

The events of September 11, 2001, focused attention on border security. The heavy flow of traffic across the main arteries linking auto industry plants on both sides of the border slowed to a crawl. Initial delays at the border sometimes took 10 hours or more. In response, automakers had to resort to costly alternatives to keep assembly lines moving. Accordingly, questions arose as to whether the auto industry had gone too far in moving toward just-in-time production.

Detroit Border Infrastructure Conference Addresses automotive and other trade issues
The Chicago Fed held a conference at its Detroit Branch in April 2002 to address issues related to border infrastructure. Entitled “Linkages Across the Border—The Great Lakes Economy,” it highlighted integration of the economy of the Great Lakes region, particularly in the auto sector. In view of 9/11, it specifically examined how to prevent the U.S.-Canada border from becoming a stranglehold on regional commerce and trade.

There was general agreement on the importance of a “smart border” approach. This approach includes improved cooperation between the U.S. and Canada, as well as implementation of reforms by both countries to immigration, inspection and traffic management. Such improvements would address a number of practices and regulations that currently impede the flow of goods and services across the border. The ongoing challenge is to develop security solutions that do not impede the viability of the region’s economy.

For more information on this conference, including a conference summary, related articles and related Web sites, please log on to www.chicagofed.org. Click on Midwest Infrastructure Project, and then U.S.-Canadian Border Infrastructure.
In the aftermath, we better understand how vulnerable the auto supply chain really is. Yet a number of efforts have been undertaken to defuse the potential conflict between the viability of international commerce and increased border-security standards. Demands for heightened security have been met with more resources at the border, especially personnel. At the same time, many players in the supply chain have increased inventories in anticipation of possible border delays.

More strategically, better procedures are being developed to achieve a so-called zone of confidence or “smart border.” Many of the proposed improvements to border management seek to sort high-security-risk commerce from low-risk commerce.

Along these lines, extensive simulations are being undertaken to better utilize existing border infrastructure. Efforts are underway in the United States to convert the current customs system from one based on paper to one based on electronic data transfer. In addition, moving physical inspection points away from the border itself is being considered to provide relief from potential congestion.
From its beginning in the late 19th century until today, the U.S. auto industry has been concentrated in the Midwest. The availability of skilled workers as well as necessary raw materials made this manufacturing region a natural hub. During the last 20 years, the auto industry has become more concentrated geographically. For example, assembly plants formerly located on both coasts have been replaced by new plants built in the heart of the country to minimize distribution costs.

In today’s market, production runs for even the best-selling vehicles require only one or two assembly plants. By locating these facilities in the heartland, auto manufacturers are able to distribute finished product to dealers throughout the entire country on a cost-effective basis.

Today’s auto corridor encompasses a fairly compact region that extends from Detroit to Chicago and south to Tennessee, with fingers reaching up to Ontario and down to Mexico. It accommodates closely integrated supply chains particularly well. The region’s transportation infrastructure allows suppliers to serve multiple assembly plants from one location with just-in-time deliveries. A supplier located in Grand Rapids, Michigan, for example, can deliver to Louisville, Kentucky—or any other site within a radius of 450 miles—in a single day.

Competitive challenges facing Midwest dominance in auto industry

Yet, there are challenges to the continued role of the Midwest as the hub of this industry. Most significant, foreign producers are increasing imports from Europe and Asia as well as expanding production in the United States. The increase in imports in the mid-1990s coincided with the rise in the value of the U.S. dollar, which effectively gave foreign producers a cost advantage (see chart Domestic Production Share of U.S. Light Vehicle Sales).

The growth in foreign nameplates’ domestic production capacity has been underway for some time (see chart Foreign Nameplate Share of U.S. Light Vehicle Sales). Honda Motor Co. opened its first U.S. car assembly plant in Ohio more than 20 years ago, followed by other Japanese and European manufacturers.
In 2001, Honda opened an assembly plant in Alabama. Nissan currently is building one in Mississippi, and Toyota recently announced its intention to construct one in Texas. By extending the auto corridor further south and west, such plants could begin shifting the center of gravity within the auto corridor so far south that it would be difficult for a supplier to serve customers at both ends from a single location.

As a result of increased competition in the domestic market, the Big Three’s market share of light vehicle sales declined to 62 percent in 2002 from 68 percent just three years ago and 73 percent six years ago. At the same time, the latest wave of plant building has resulted in sizeable excess production capacity domestically, as foreign producers started entering the fast-growing light truck segment in the United States. Were capacity reductions to follow, the Midwest could bear the brunt of these efforts if they are disproportionately taken by the Big Three. They have a larger share of their plants, especially their car plants, in the region.

**Impact of technological change**

Environmental concerns require the auto industry to continue efforts to reduce harmful emissions and improve fuel economy. Recent innovations include the hybrid car, combining a gasoline-powered combustion engine with a battery-powered electric motor. Today’s models can achieve 20 to 30 more miles per gallon than traditional cars.

On the research front, current efforts focus on fuel-cell-powered vehicles. All the major players in the industry, as well as the U.S. government, are pursuing this technology. If successful, fuel cells essentially could eliminate tailpipe emissions.

Such developments are driving fundamental changes that will impact the Midwest, particularly if the industry headquartered there remains dominated by technology related to the internal combustion engine. That is why new initiatives—such as the State of Michigan’s NextEnergy Center launched in 2002 to research alternative fuel sources—are designed to establish the region’s role in developing new technology.
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### Federal Reserve Bank of Chicago Executive Officers

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<tr>
<th>Role</th>
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<tr>
<td>President and Chief Executive Officer</td>
<td>Michael H. Moskow</td>
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<td>Vice President and Chief Operating Officer</td>
<td>Gordon Werkema</td>
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<td>Vice President and Director of Research</td>
<td>William C. Hunter</td>
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<td>Senior Vice President and Economic Advisor</td>
<td>William A. Testa</td>
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<tr>
<td>Vice President and Economic Advisor</td>
<td>Douglas D. Evanoff</td>
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<td>Vice President and Division Leader</td>
<td>Catharine M. Lemieux</td>
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<td>Vice President and Division Leader</td>
<td>Douglas J. Kasl</td>
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<td>Vice President and Division Leader</td>
<td>Mary H. Sherburne</td>
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<td>Vice President and Division Leader</td>
<td>Deborah A. Schneider</td>
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<td>Vice President and Division Leader</td>
<td>Ira R. Zilist</td>
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<tr>
<td>Vice President and Division Leader</td>
<td>Andrei H. Shleifer</td>
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### CENTRAL BANK ACTIVITIES

#### ECONOMIC RESEARCH AND PROGRAMS
- William C. Hunter, Senior Vice President and Director of Research
- William A. Testa, Vice President and Economic Advisor
- Douglas D. Evanoff, Vice President and Economic Advisor
- Daniel G. Sullivan, Vice President and Economic Advisor
- Angela D. Robinson, Senior Vice President
- Kathleen H. Williams, Vice President
- Richard P. Anstee, Senior Vice President
- Kristi L. Zimmermann, Vice President
- Edward J. Green, Senior Vice President and Senior Policy Advisor
- Thomas G. Ciesielski, Vice President

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- Operations: James A. Bluemle, Vice President and Division Leader
- Large Bank Supervision: Richard C. Cahill, Vice President and Division Leader
- Community/Compliance and CRA: Douglas J. Kasl, Vice President and Division Leader
- Risk Analysis: Catharine M. Lemieux, Vice President and Division Leader

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- Cash Operations: Jerome D. Nicolas, Vice President
- Check Processing: Deborah A. Schneider, Vice President
- Check Adjustment and Check Modernization: Mary H. Sherburne, Vice President
- Business Development, Strategy and Support: Barbara J. Feryer, Vice President

### SUPPORT FUNCTIONS
- Audit: Jerome F. John, Senior Vice President and General Auditor
- Corporate Communications: Karen Kane, Senior Vice President and Board Secretary
- G. Douglas Tillet, Vice President
- Finance: Carl E. Vander Wilt, Senior Vice President and Chief Financial Officer
- Loans and Reserves: Gerard J. Nick, Vice President

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- Yurii Skorin, Vice President and Associate General Counsel
- Anna M. Voytovich, Vice President and Associate General Counsel

### PEOPLE PRACTICES
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- Margaret K. Koenigs, Vice President

### STRATEGIC PLANNING AND LEADERSHIP DEVELOPMENT
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- Kathleen H. Williams, Vice President

### TECHNOLOGY AND SUPPORT SERVICES
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- David E. Ritter, Vice President
- Kristi L. Zimmermann, Vice President

As of December 31, 2002
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Chicago, Illinois

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The Insurance Exchange
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Bushman Equipment, Inc.
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National American Business Alliance
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Jan Hayhow
Michigania, Inc.
Okemos, Michigan
Christopher P. LaMothe
Oxford Financial Group, Ltd.
Indianapolis, Indiana
Ritch LeGrand
LeGrand & Company
Sioux City, Iowa
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ILight Technologies
Chicago, Illinois
Jeffrey D. Padden
Public Policy Associates, Inc.
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Richard A. Waller
Security National Bank
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Gaylord, Michigan
David S. Hickman
United Bank & Trust
Tecumseh, Michigan
Joseph F. Salas
CSB Bank
Capac, Michigan

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Stevens Point, Wisconsin
Michael Falbo
State Financial Bank
Hales Corners, Wisconsin
Richard Hansen
Johnson Bank
Racine, Wisconsin
Philip G. Holland
Ixonia State Bank
Ixonia, Wisconsin
David Koppeled
Peoples State Bank
Wausau, Wisconsin
Executive Changes

DIRECTORS
Members of the Federal Reserve Bank of Chicago’s boards of directors are selected to represent a cross section of the Seventh District economy, including consumers, industry, agriculture, the service sector, labor and commercial banks of various sizes.

The Chicago board consists of nine members. Member banks elect three bankers and three nonbankers. The Board of Governors appoints three additional nonbankers and designates the Reserve Bank chair and deputy chair from among its three appointees.

The Detroit Branch has a seven-member board of directors. The Board of Governors appoints three nonbankers and the Chicago Reserve Bank board appoints four additional directors. The Branch board selects its own chair each year, with the approval of the Chicago board. All Reserve Bank and Branch directors serve three-year terms, with a two-term maximum.

Director appointments and elections at the Chicago Reserve Bank and its Detroit Branch effective in 2002 were:
Robert J. Darnall designated chairman
W. James Farrell designated deputy chairman
Miles D. White appointed to a three-year term
James H. Keyes re-elected to a second three-year term
Alan R. Tubbs re-elected to a second three-year term
Timothy D. Leuliette re-designated Branch chairman
Robert E. Churchill appointed to a three-year term as Branch director
Irvin D. Reid appointed to a three-year term as Branch director

At year-end 2002 the following appointments and elections to terms beginning in 2003 were announced:
Robert J. Darnall re-designated chairman
W. James Farrell re-designated deputy chairman
William A. Osborn re-elected to a three-year term
Connie E. Evans re-elected to a second three-year term
Timothy D. Leuliette re-designated Branch chairman
Tommi A. White appointed to a three-year term as Branch director
Edsel B. Ford, II re-appointed to a three-year term as Branch director
Mark T. Gaffney re-appointed to a three-year term as Branch director

ADVISORY COUNCILS
The Federal Advisory Council, which meets quarterly to discuss business and financial conditions with the Board of Governors in Washington, D.C., is composed of one banker from each of the 12 Federal Reserve Districts.

Each year the Chicago Reserve Bank’s board of directors selects a representative to this group. Alan G. McNally, chairman, Harris Bankcorp, Inc., was re-appointed to serve a one-year term beginning January 1, 2003.

Members of the Advisory Council on Agriculture, Labor and Small Business served the third year of their terms in 2002.

Members of the Community Bank Council served the second year of their terms in 2002.

The councils provide a vital communication link between the Bank and these important sectors.

EXECUTIVE OFFICERS
A number of executive changes were made among the Bank’s executive officers during 2002.

The Bank’s board of directors acted on the following senior vice president and vice president promotions during 2002:
Barbara D. Benson to Senior Vice President
Glenn C. Hansen to Senior Vice President
Elizabeth A. Knospe to Senior Vice President and General Counsel
James W. Nelson to Senior Vice President
Angela D. Robinson to Senior Vice President
Michael J. Hoppe to Vice President
Margaret K. Koenigs to Vice President
Ira R. Zilist to Vice President

New vice presidents appointed by the board in 2002 were:
Barbara J. Peryer
Sean Rodriguez
Deborah A. Schneider

The following executive officers retired during 2002:
William H. Gram, Senior Vice President and General Counsel, retired after 36 years of service
John J. Winstead, Jr., Senior Vice President of Supervision and Regulation, retired after 28 years of service
Yvonne H. Montgomery, Vice President, Financial Services Group, retired after 36 years of service
Jean L. Valerius, Vice President and Senior Policy Advisor, Economic Research and Programs, retired after 35 years of service
## Operations Volumes

<table>
<thead>
<tr>
<th></th>
<th>DOLLAR AMOUNT</th>
<th>NUMBER OF ITEMS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CHECK OPERATIONS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Checks, NOWs and Share Drafts Processed</td>
<td>1.8 Trillion</td>
<td>1.5 Trillion</td>
</tr>
<tr>
<td>Fine Sort and Packaged Checks Handled</td>
<td>10.7 Billion</td>
<td>16.8 Billion</td>
</tr>
<tr>
<td>U.S. Government Checks Processed</td>
<td>16.9 Billion</td>
<td>42.4 Billion</td>
</tr>
<tr>
<td><strong>CASH OPERATIONS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency Received and Counted</td>
<td>53.5 Billion</td>
<td>52.9 Billion</td>
</tr>
<tr>
<td>Unfit Currency Destroyed</td>
<td>7.6 Billion</td>
<td>7.3 Billion</td>
</tr>
<tr>
<td>Coin Bags Received and Processed</td>
<td>1.5 Billion</td>
<td>1.6 Billion</td>
</tr>
<tr>
<td><strong>LOANS TO DEPOSITORY INSTITUTIONS</strong></td>
<td>3.6 Billion</td>
<td>15.6 Billion</td>
</tr>
</tbody>
</table>
The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2002 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $1.0 million. In order to ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2002, the Bank did not engage PwC for advisory services.
The management of the Federal Reserve Bank of Chicago ("FRBC") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2002 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the FRBC 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 FRBC 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 FRBC maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Michael Moskow
President and Chief Executive Officer
Gordon Werkema
First Vice President and Chief Operating Officer
Carl Vander Wilt
Senior Vice President and Chief Financial Officer
REPORT OF INDEPENDENT ACCOUNTANTS
TO THE BOARD OF DIRECTORS OF THE FEDERAL RESERVE BANK OF CHICAGO

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

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

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

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

MARCH 3, 2003
CHICAGO, ILLINOIS
REPORT OF INDEPENDENT ACCOUNTANTS
TO THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM AND THE BOARD OF DIRECTORS
OF THE FEDERAL RESERVE BANK OF CHICAGO

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

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

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

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

MARCH 3, 2003
CHICAGO, ILLINOIS
### Federal Reserve Bank of Chicago 2002 Financial Statements

**STATEMENTS OF CONDITION, IN MILLIONS**

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold Certificates</td>
<td>$1,080</td>
<td>$1,028</td>
</tr>
<tr>
<td>Special Drawing Rights Certificates</td>
<td>212</td>
<td>212</td>
</tr>
<tr>
<td>Coin</td>
<td>126</td>
<td>117</td>
</tr>
<tr>
<td>Items in Process of Collection</td>
<td>1,170</td>
<td>526</td>
</tr>
<tr>
<td>Loans to Depository Institutions</td>
<td>7</td>
<td>15</td>
</tr>
<tr>
<td>U.S. Government and Federal Agency Securities, Net</td>
<td>75,212</td>
<td>63,617</td>
</tr>
<tr>
<td>Investments Denominated in Foreign Currencies</td>
<td>1,827</td>
<td>1,333</td>
</tr>
<tr>
<td>Accrued Interest Receivable</td>
<td>642</td>
<td>646</td>
</tr>
<tr>
<td>Interdistrict Settlement Account</td>
<td>—</td>
<td>6,071</td>
</tr>
<tr>
<td>Bank Premises and Equipment, Net</td>
<td>149</td>
<td>136</td>
</tr>
<tr>
<td>Other Assets</td>
<td>38</td>
<td>48</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$80,463</td>
<td>$73,749</td>
</tr>
<tr>
<td><strong>LIABILITIES AND CAPITAL</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Liabilities:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Reserve Notes Outstanding, Net</td>
<td>$56,508</td>
<td>$68,119</td>
</tr>
<tr>
<td>Securities Sold under Agreements to Repurchase</td>
<td>2,482</td>
<td>—</td>
</tr>
<tr>
<td>Deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depository Institutions</td>
<td>3,943</td>
<td>3,498</td>
</tr>
<tr>
<td>Other Deposits</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Deferred Credit Items</td>
<td>997</td>
<td>386</td>
</tr>
<tr>
<td>Interest on Federal Reserve Notes Due U.S. Treasury</td>
<td>123</td>
<td>43</td>
</tr>
<tr>
<td>Interdistrict Settlement Account</td>
<td>14,583</td>
<td>—</td>
</tr>
<tr>
<td>Accrued Benefit Cost</td>
<td>92</td>
<td>88</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>17</td>
<td>25</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>$78,749</td>
<td>$72,163</td>
</tr>
<tr>
<td><strong>Capital:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital Paid-In</td>
<td>857</td>
<td>793</td>
</tr>
<tr>
<td>Surplus</td>
<td>857</td>
<td>793</td>
</tr>
<tr>
<td><strong>Total Capital</strong></td>
<td>$1,714</td>
<td>$1,586</td>
</tr>
<tr>
<td><strong>Total Liabilities and Capital</strong></td>
<td>$80,463</td>
<td>$73,749</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these financial statements.
### STATEMENTS OF INCOME, IN MILLIONS

For the years ended December 31, 2002 2001

<table>
<thead>
<tr>
<th>Description</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INTEREST INCOME</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on U.S. Government and Federal Agency Securities</td>
<td>$2,926</td>
<td>$3,403</td>
</tr>
<tr>
<td>Interest on Investments Denominated in Foreign Currencies</td>
<td>29</td>
<td>30</td>
</tr>
<tr>
<td>Interest on Loans to Depository Institutions</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total Interest Income</strong></td>
<td>$2,956</td>
<td>$3,435</td>
</tr>
<tr>
<td><strong>INTEREST EXPENSE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Expense on Securities Sold under Agreements to Repurchase</td>
<td>$2</td>
<td>$–</td>
</tr>
<tr>
<td><strong>Net Interest Income</strong></td>
<td>$2,954</td>
<td>$3,435</td>
</tr>
<tr>
<td><strong>OTHER OPERATING INCOME</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from Services</td>
<td>$107</td>
<td>$110</td>
</tr>
<tr>
<td>Reimbursable Services to Government Agencies</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>Foreign Currency Gains (Losses), Net</td>
<td>$229</td>
<td>$(131)</td>
</tr>
<tr>
<td>U.S. Government Securities Gains, Net</td>
<td>$9</td>
<td>$36</td>
</tr>
<tr>
<td>Other Income</td>
<td>$9</td>
<td>$13</td>
</tr>
<tr>
<td><strong>Total Other Operating Income</strong></td>
<td>$365</td>
<td>$39</td>
</tr>
<tr>
<td><strong>OPERATING EXPENSES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and Other Benefits</td>
<td>$158</td>
<td>$157</td>
</tr>
<tr>
<td>Occupancy Expense</td>
<td>20</td>
<td>20</td>
</tr>
<tr>
<td>Equipment Expense</td>
<td>21</td>
<td>21</td>
</tr>
<tr>
<td>Assessments by Board of Governors</td>
<td>70</td>
<td>65</td>
</tr>
<tr>
<td>Other Expenses</td>
<td>73</td>
<td>80</td>
</tr>
<tr>
<td><strong>Total Operating Expenses</strong></td>
<td>$342</td>
<td>$343</td>
</tr>
<tr>
<td><strong>Net Income Prior to Distribution</strong></td>
<td>$2,977</td>
<td>$3,131</td>
</tr>
<tr>
<td><strong>DISTRIBUTION OF NET INCOME</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends Paid to Member Banks</td>
<td>$49</td>
<td>$43</td>
</tr>
<tr>
<td>Transferred to Surplus</td>
<td>64</td>
<td>162</td>
</tr>
<tr>
<td>Payments to U.S. Treasury as Interest on Federal Reserve Notes</td>
<td>$2,864</td>
<td>$2,926</td>
</tr>
<tr>
<td><strong>Total Distribution</strong></td>
<td>$2,977</td>
<td>$3,131</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these financial statements.
## STATEMENTS OF CHANGES IN CAPITAL, IN MILLIONS

<table>
<thead>
<tr>
<th>For the years ended December 31, 2002 and December 31, 2001</th>
<th>CAPITAL PAID-IN</th>
<th>SURPLUS</th>
<th>TOTAL CAPITAL</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance at January 1, 2001 (12.6 Million Shares)</strong></td>
<td>$632</td>
<td>$632</td>
<td>$1,264</td>
</tr>
<tr>
<td>Net Income Transferred to Surplus</td>
<td>–</td>
<td>161</td>
<td>161</td>
</tr>
<tr>
<td>Net Change in Capital Stock Issued (3.2 Million Shares)</td>
<td>161</td>
<td>–</td>
<td>161</td>
</tr>
<tr>
<td><strong>Balance at December 31, 2001 (15.9 Million Shares)</strong></td>
<td>$793</td>
<td>$793</td>
<td>$1,586</td>
</tr>
<tr>
<td>Net Income Transferred to Surplus</td>
<td>–</td>
<td>64</td>
<td>64</td>
</tr>
<tr>
<td>Net Change in Capital Stock Issued (1.3 Million Shares)</td>
<td>64</td>
<td>–</td>
<td>64</td>
</tr>
<tr>
<td><strong>Balance at December 31, 2002 (17.2 Million Shares)</strong></td>
<td>$857</td>
<td>$857</td>
<td>$1,714</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these financial statements.
1. STRUCTURE
The Federal Reserve Bank of Chicago (“Bank”) is part of the Federal Reserve System (“System”) created by Congress under the Federal Reserve Act of 1913 (“Federal Reserve Act”) which established the central bank of the United States. The System consists of the Board of Governors of the Federal Reserve System (“Board of Governors”) and twelve Federal Reserve Banks (“Reserve Banks”). The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branch in Detroit, Michigan, serve the Seventh Federal Reserve District, which includes Iowa and portions of Michigan, Illinois, Wisconsin and Indiana. 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 is 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 of coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government’s bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, and state member banks; and administering other regulations of the Board of Governors. The Board of Governors’ operating costs are funded through assessments on the Reserve Banks.

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

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

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

Effective January 2001, the System implemented procedures to eliminate the sharing of costs by Reserve Banks for certain services a Reserve Bank may provide on behalf of the System. Major services provided for the System by the Bank, for which the costs will not be redistributed to the other Reserve Banks, include national business development and customer support.
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. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

A. Gold Certificates
The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury’s account is charged and the Reserve Banks’ gold certificate accounts are lowered. The value of gold for purposes of backing the gold certificates is set by law at $42 2/9 a fine troy ounce. The Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2002.

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

C. Loans to Depository Institutions
The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If any loans were deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established by the Board of Governors. Interest and principal payments on loans are reduced from the borrower’s account on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

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

F/X contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.
The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed upon period of time (up to twelve months), at an agreed upon interest rate. These arrangements give the FOMC temporary access to foreign currencies that it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank, and must be agreed to by the drawer. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

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

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

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

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

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

E. Bank Premises, Equipment and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from 2 to 50 years. New assets, major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts. Maintenance, repairs and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the application development stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software.

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.”
Federal Reserve Bank of Chicago Notes to Financial Statements

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

The Federal Reserve notes outstanding, net account represents the Bank’s Federal Reserve notes outstanding, reduced by its currency holdings of $7,397 million and $6,424 million at December 31, 2002 and 2001, respectively.

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

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

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

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

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

4. U.S. GOVERNMENT AND FEDERAL AGENCY SECURITIES
Securities bought outright are held in the SOMA at the FRBNY. An undivided interest in SOMA activity and the related premiums, discounts and income, with the exception of securities purchased under agreements to resell, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings. The settlement, performed in April of each year, equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank’s allocated share of SOMA balances was approximately 11.768% and 11.326% at December 31, 2002 and 2001, respectively.

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

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. government:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bills</td>
<td>26,676</td>
<td>20,621</td>
</tr>
<tr>
<td>Notes</td>
<td>35,056</td>
<td>30,120</td>
</tr>
<tr>
<td>Bonds</td>
<td>12,336</td>
<td>11,740</td>
</tr>
<tr>
<td>Total par value</td>
<td>$74,072</td>
<td>$62,482</td>
</tr>
<tr>
<td>Unamortized premiums</td>
<td>1,266</td>
<td>1,280</td>
</tr>
<tr>
<td>Unaccreted discounts</td>
<td>(124)</td>
<td>(145)</td>
</tr>
<tr>
<td>Total allocated to Bank</td>
<td>$75,212</td>
<td>$63,617</td>
</tr>
</tbody>
</table>

29
Total SOMA securities bought outright were $639,125 million and $561,701 million at December 31, 2002 and 2001, respectively.

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

<table>
<thead>
<tr>
<th>Maturities of Securities Held</th>
<th>Par Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>U.S. Gov't Securities</td>
</tr>
<tr>
<td>Within 15 days</td>
<td>$3,230</td>
</tr>
<tr>
<td>16 days to 90 days</td>
<td>18,149</td>
</tr>
<tr>
<td>91 days to 1 year</td>
<td>16,699</td>
</tr>
<tr>
<td>Over 1 year to 5 years</td>
<td>20,330</td>
</tr>
<tr>
<td>Over 5 years to 10 years</td>
<td>6,272</td>
</tr>
<tr>
<td>Over 10 years</td>
<td>9,396</td>
</tr>
<tr>
<td>Total</td>
<td>$74,069</td>
</tr>
</tbody>
</table>

As mentioned in footnote 3, in December 2002, the FRBNY replaced MSP transactions with securities sold under agreements to repurchase. At December 31, 2002, securities sold under agreements to repurchase with a contract amount of $21,091 million and a par value of $21,098 million were outstanding, of which $2,482 million and $2,483 million, respectively, were allocated to the Bank. At December 31, 2001, MSP transactions involving U.S. government securities with a par value of $23,188 million were outstanding, of which $2,729 million was allocated to the Bank. Securities sold under agreements to repurchase and MSP transactions are generally overnight arrangements.

At December 31, 2002 and 2001, U.S. government securities with par values of $1,841 million and $7,345 million, respectively, were loaned from the SOMA, of which $217 million and $832 million were allocated to the Bank.

5. Investments Denominated in Foreign Currencies

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

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 10.802 percent and 9.158 percent at December 31, 2002 and 2001, respectively.

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

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign currency deposits</td>
<td>603</td>
<td>420</td>
</tr>
<tr>
<td>Government debt instruments including agreements to resell</td>
<td>356</td>
<td>247</td>
</tr>
<tr>
<td>Japanese Yen:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign currency deposits</td>
<td>193</td>
<td>173</td>
</tr>
<tr>
<td>Government debt instruments including agreements to resell</td>
<td>666</td>
<td>487</td>
</tr>
<tr>
<td>Accrued interest</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>$1,827</td>
<td>$1,333</td>
</tr>
</tbody>
</table>

Depreciation expense was $14 million and $15 million for the years ended December 31, 2002 and 2001, respectively.

The Bank leases unused space to outside tenants. Those leases have terms ranging from 1 to 10 years. Rental income from such leases was $3 million for each of the years ended December 31, 2002, and 2001. Future minimum lease payments under non-cancelable agreements in existence at December 31, 2002, were (in millions):

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$2</td>
</tr>
<tr>
<td>2004</td>
<td>$3</td>
</tr>
<tr>
<td>2005</td>
<td>$3</td>
</tr>
<tr>
<td>2006</td>
<td>$3</td>
</tr>
<tr>
<td>2007</td>
<td>$1</td>
</tr>
<tr>
<td>Thereafter</td>
<td>$15</td>
</tr>
</tbody>
</table>

6. Bank Premises and Equipment

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

<table>
<thead>
<tr>
<th>Item</th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank premises and equipment:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$10</td>
<td>$6</td>
</tr>
<tr>
<td>Buildings</td>
<td>137</td>
<td>131</td>
</tr>
<tr>
<td>Building machinery and equipment</td>
<td>21</td>
<td>17</td>
</tr>
<tr>
<td>Construction in progress</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>101</td>
<td>107</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(124)</td>
<td>(127)</td>
</tr>
<tr>
<td>Total</td>
<td>$149</td>
<td>$137</td>
</tr>
</tbody>
</table>

Total investments denominated in foreign currencies were $16,913 million and $14,659 million at December 31, 2002 and 2001, respectively.

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

<table>
<thead>
<tr>
<th>Maturities of Investments Denominated in Foreign Currencies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 1 year</td>
</tr>
<tr>
<td>Over 1 year to 5 years</td>
</tr>
<tr>
<td>Over 5 years to 10 years</td>
</tr>
<tr>
<td>Over 10 years</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

At December 31, 2002 and 2001, there were no open foreign exchange contracts or outstanding F/X swaps.

At December 31, 2002 and 2001, the warehousing facility was $5,000,000, with zero balance outstanding.
7. COMMITMENTS AND CONTINGENCIES
At December 31, 2002, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from 1 to approximately 9 years. These leases provide for increased rentals based upon increases in real estate taxes, operating costs or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $4 million and $3 million for each of the years ended December 31, 2002 and 2001, respectively. Certain of the Bank’s leases have options to renew.

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

<table>
<thead>
<tr>
<th>Operating</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>Thereafter</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$ 2</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>$ 7</td>
</tr>
</tbody>
</table>

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

On September 4, 2001, the Bank sold its Westgate facility for a total of $3 million. The gain of $1 million is reported as a component of “Other income.”

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

8. RETIREMENT AND THRIFT PLANS
Retirement Plans
The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank’s employees participate in the Retirement Plan for Employees of the Federal Reserve System (“System Plan”) and the Benefit Equalization Retirement Plan (“BEP”) and certain Bank officers participate in a Supplemental Employee Retirement Plan (“SERP”). The System Plan is a multi-employer plan with contributions fully funded by participating employers. No separate accounting is maintained of assets contributed by the participating employers. The Bank’s projected benefit obligation and net pension costs for the BEP at December 31, 2002 and 2001 and for the SERP at December 31, 2002, and for the years then ended, are not material.

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

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 cost is actuarially determined using a January 1 measurement date.

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

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated</td>
<td></td>
<td></td>
</tr>
<tr>
<td>postretirement</td>
<td>$75.2</td>
<td>$70.1</td>
</tr>
<tr>
<td>benefit obligation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>at January 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Service cost</td>
<td>1.7</td>
<td>1.5</td>
</tr>
<tr>
<td>benefits earned</td>
<td></td>
<td></td>
</tr>
<tr>
<td>during the period</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest cost of</td>
<td>5.7</td>
<td>5.4</td>
</tr>
<tr>
<td>accumulated</td>
<td></td>
<td></td>
</tr>
<tr>
<td>benefit obligation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actuarial loss</td>
<td>11.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Contributions by</td>
<td>0.4</td>
<td>0.3</td>
</tr>
<tr>
<td>plan participants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(4.2)</td>
<td>(4.1)</td>
</tr>
<tr>
<td>Plan amendments,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>acquisitions,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>foreign currency</td>
<td></td>
<td></td>
</tr>
<tr>
<td>exchange rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>changes, business</td>
<td></td>
<td></td>
</tr>
<tr>
<td>combinations,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>divestitures,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>curtailments,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>settlements,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>special terminations</td>
<td></td>
<td></td>
</tr>
<tr>
<td>termination benefits</td>
<td>(4.6)</td>
<td>(8.0)</td>
</tr>
<tr>
<td>Accumulated</td>
<td>$85.2</td>
<td>$75.2</td>
</tr>
<tr>
<td>postretirement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>benefit obligation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>at December 31</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

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 $5.8 million and $4.7 million for the years ended December 31, 2002 and 2001, respectively, and are reported as a component of “Salaries and other benefits.”
Following is a reconciliation of the beginning and ending balance of the plan assets, the unfunded postretirement benefit obligation, and the accrued postretirement benefit cost (in millions):

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of plan assets at January 1</td>
<td>$ –</td>
<td>$ –</td>
</tr>
<tr>
<td>Actual return on plan assets</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Contributions by employer</td>
<td>3.8</td>
<td>3.7</td>
</tr>
<tr>
<td>Contributions by plan participants</td>
<td>0.4</td>
<td>0.3</td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(4.2)</td>
<td>(4.0)</td>
</tr>
<tr>
<td>Fair value of plan assets at December 31</td>
<td>$ –</td>
<td>$ –</td>
</tr>
<tr>
<td>Unfunded postretirement benefit obligation</td>
<td>$ 85.2</td>
<td>$ 75.2</td>
</tr>
<tr>
<td>Unrecognized prior service cost</td>
<td>21.1</td>
<td>18.6</td>
</tr>
<tr>
<td>Unrecognized net actuarial gain</td>
<td>(27.1)</td>
<td>(17.1)</td>
</tr>
<tr>
<td>Accrued postretirement benefit cost</td>
<td>$ 79.2</td>
<td>$ 76.7</td>
</tr>
</tbody>
</table>

Accrued postretirement benefit cost is reported as a component of “Accrued benefit cost.”

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

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

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

<table>
<thead>
<tr>
<th></th>
<th>One Percentage Point Increase</th>
<th>One Percentage Point Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effect on aggregate of service and interest cost components of net periodic postretirement benefit cost</td>
<td>$ 1.4</td>
<td>$ (1.1)</td>
</tr>
<tr>
<td>Effect on accumulated postretirement benefit obligation</td>
<td>12.9</td>
<td>(10.3)</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service cost-benefits earned during the period</td>
<td>$ 1.7</td>
<td>$ 1.5</td>
</tr>
<tr>
<td>Interest cost of accumulated benefit obligation</td>
<td>5.7</td>
<td>5.4</td>
</tr>
<tr>
<td>Amortization of prior service cost</td>
<td>(2.1)</td>
<td>(1.3)</td>
</tr>
<tr>
<td>Recognized net actuarial loss</td>
<td>1.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Net periodic postretirement benefit cost</td>
<td>$ 6.9</td>
<td>$ 5.8</td>
</tr>
</tbody>
</table>

Net periodic postretirement benefit cost is reported as a component of “Salaries and other benefits.”

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 2002 and 2001, were $12 million and $11 million, respectively. This cost is included as a component of “Accrued benefit costs.” Net periodic postemployment benefit costs included in 2002 and 2001 operating expenses were $2 million for each year.

10. SUBSEQUENT EVENT

In January 2003, the System announced plans to restructure its check collection operations. The restructuring plans include streamlining the check management structure, reducing staff, decreasing the number of check-processing locations, and increasing processing capacity in other locations. The restructuring, which is expected to begin in 2003 and conclude by the end of 2004, will result in the Bank discontinuing its check operations at the Milwaukee, Peoria and Indianapolis offices, increasing its check processing capacity at the Chicago (Midway) and Des Moines offices, and consolidating its check adjustment function at the Detroit office.

At this time, the Reserve Banks have not developed detailed estimates of the cost of the restructuring plan in the aggregate or for the individual Reserve Banks affected.
OUR MISSION

The Federal Reserve Bank of Chicago is one of 12 regional Reserve Banks across the United States that, together with the Board of Governors in Washington, D.C., serve as the nation’s central bank. The role of the Federal Reserve System, since its establishment by an act of Congress passed in 1913, has been to foster a strong economy, supported by a stable financial system.

To this end, the Federal Reserve Bank of Chicago participates in the formulation and implementation of national monetary policy, supervises and regulates state-member banks, bank holding companies and foreign bank branches, and provides financial services to depository institutions and the U.S. government. Through its head office in Chicago, branch in Detroit, regional offices in Des Moines, Indianapolis and Milwaukee, and facility in Peoria, the Federal Reserve Bank of Chicago serves the Seventh Federal Reserve District, which includes major portions of Illinois, Indiana, Michigan and Wisconsin, plus all of Iowa.

OUR VISION

• Further the public interest by fostering a sound economy and stable financial system
• Provide products and services of unmatched value to those we serve
• Set the standard for excellence in the Federal Reserve System
• Work together, value diversity, communicate openly, be creative and fair
• Live by our core values of integrity, respect, responsibility and excellence