

2002 FINANCIAL REPORTS

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.



December 31, 2002

To the Board of Directors:

The management of the Federal Reserve Bank of San Francisco (FRB-SF) 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 FRB-SF 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 FRB-SF 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. Based on this assessment, we believe that FRB-SF maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Federal Reserve Bank of San Francisco

by *Robert T. Parry*

Robert T. Parry
President

by *John F. Moore*

John F. Moore
First Vice President

by *Mark Mullinix*

Mark Mullinix
Principal Financial Officer

REPORT OF INDEPENDENT ACCOUNTANTS



To the Board of Directors of the Federal Reserve Bank of San Francisco:

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

PricewaterhouseCoopers LLP

March 3, 2003
San Francisco, California

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 San Francisco:

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

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

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

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

PricewaterhouseCoopers LLP

March 3, 2003
San Francisco, California

FEDERAL RESERVE BANK OF SAN FRANCISCO

Statements of Condition

As of December 31, 2002 and 2001 (in millions)

	2002		2001
Assets			
Gold certificates	\$ 1,046	\$	1,136
Special drawing rights certificates	234		234
Coin	111		144
Items in process of collection	2,608		267
Loans to depository institutions	5		-
U.S. government and federal agency securities, net	54,835		56,590
Investments denominated in foreign currencies	1,833		1,673
Accrued interest receivable	468		575
Bank premises and equipment, net	233		229
Other assets	36		36
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Total assets	\$ 61,409	\$	60,884
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Liabilities and Capital			
Liabilities:			
Federal Reserve notes outstanding, net	\$ 52,772	\$	49,314
Securities sold under agreements to repurchase	1,810		-
Deposits:			
Depository institutions	2,273		2,129
Other deposits	4		5
Deferred credit items	2,584		489
Interest on Federal Reserve notes due U.S. Treasury	104		53
Interdistrict settlement account	43		7,226
Accrued benefit costs	69		68
Other liabilities	14		8
	<hr/>		
Total liabilities	59,673		59,292
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Capital:			
Capital paid-in	868		796
Surplus	868		796
	<hr/>		
Total capital	1,736		1,592
	<hr/>		
Total liabilities and capital	\$ 61,409	\$	60,884
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The accompanying notes are an integral part of these financial statements.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Statements of Income

For the years ended December 31, 2002 and 2001 (in millions)

	2002	2001
Interest income:		
Interest on U.S. government and federal agency securities	\$ 2,258	\$ 3,050
Interest on investments denominated in foreign currencies	30	37
Interest on loans to depository institutions	-	1
Total interest income	2,288	3,088
Interest expense:		
Interest expense on securities sold under agreements to repurchase	1	-
Net interest income	2,287	3,088
Other operating income (loss):		
Income from services	98	96
Reimbursable services to government agencies	20	20
Foreign currency gains (losses), net	224	(162)
U.S. government securities gains, net	7	32
Other income	7	11
Total other operating income (loss)	356	(3)
Operating expenses:		
Salaries and other benefits	194	177
Occupancy expense	18	17
Equipment expense	24	25
Assessments by Board of Governors	56	67
Other expenses	64	74
Total operating expenses	356	360
Net income prior to distribution	\$ 2,287	\$ 2,725
Distribution of net income:		
Dividends paid to member banks	\$ 50	\$ 48
Transferred to surplus	72	4
Payments to U.S. Treasury as interest on Federal Reserve notes	2,165	2,673
Total distribution	\$ 2,287	\$ 2,725

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

FEDERAL RESERVE BANK OF SAN FRANCISCO

Statements of Changes in Capital For the years ended December 31, 2002 and 2001 (in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 2001 (16 million shares)	\$ 792	\$ 792	\$ 1,584
Net income transferred to surplus	–	4	4
Net change in capital stock issued (0 million shares)	4	–	4
Balance at December 31, 2001 (16 million shares)	796	796	1,592
Net income transferred to surplus	–	72	72
Net change in capital stock issued (1 million shares)	72	–	72
Balance at December 31, 2002 (17 million shares)	\$ 868	\$ 868	\$ 1,736

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

Notes to Financial Statements

1. Structure

The Federal Reserve Bank of San Francisco (“Bank”) is part of the Federal Reserve System (“System”) created by Congress under the Federal Reserve Act of 1913 (“Federal Reserve Act”) which established the central bank of the United States. The System consists of the Board of Governors of the Federal Reserve System (“Board of Governors”) and twelve Federal Reserve Banks (“Reserve Banks”). The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branches in Los Angeles, California, Portland, Oregon, Salt Lake City, Utah, and Seattle, Washington, serve the Twelfth Federal Reserve District, which includes Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, Washington, and the commonwealths or territories of American Samoa, Guam, and the Northern Mariana Islands. Other major elements of the System are the Federal Open Market Committee (“FOMC”) and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York (“FRBNY”) and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state chartered bank that applies and is approved for membership in the System.

Board of Directors

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

2. Operations and Services

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

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, matched sale-purchase transactions, the purchase of securities under 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.

Notes to Financial Statements

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: Statistics and Reserves, Enterprise Wide Adjustments, Cash Product Office, Check Standardization, and National Information Center - Central Operations.

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 prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

Gold Certificates

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

Notes to Financial Statements

Special Drawing Rights Certificates

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

Loans to Depository Institutions

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

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

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

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

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

Notes to Financial Statements

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

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

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

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

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

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

Notes to Financial Statements

Balances of U.S. government and federal agency securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currencies, 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.

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.

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 Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank. In accordance with the Federal Reserve Act, gold certificates, special drawing rights certificates, U.S. government and federal agency securities, repurchase agreements, 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. Repurchase agreements 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 \$14,359 million, and \$20,372 million at December 31, 2002 and 2001, respectively.

Notes to Financial Statements

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.

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.

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.

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 8.580 percent and 10.075 percent at December 31, 2002 and 2001, respectively.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Notes to Financial Statements

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

	2002	2001
Par value:		
Federal agency	\$ 1	\$ 1
U.S. government:		
Bills	19,449	18,343
Notes	25,558	26,793
Bonds	8,994	10,444
Total par value	54,002	55,581
Unamortized premiums	923	1,139
Unaccreted discounts	(90)	(130)
Total allocated to Bank	\$ 54,835	\$ 56,590

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):

Maturities of Securities Held	Par Value		Total
	U.S. Government Securities	Federal Agency Obligations	
Within 15 days	\$ 2,355	\$ —	\$ 2,355
16 days to 90 days	13,232	—	13,232
91 days to 1 year	12,169	1	12,170
Over 1 year to 5 years	14,822	—	14,822
Over 5 years to 10 years	4,573	—	4,573
Over 10 years	6,850	—	6,850
Total	\$ 54,001	\$ 1	\$ 54,002

As mentioned in Note 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 \$23,188 million were outstanding, of which \$1,810 million and \$2,366 million, respectively, were allocated to the Bank. At December 31, 2001, MSP transactions involving U.S. government securities with a par value of \$21,098 million were outstanding, of which \$1,810 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 \$158 million and \$740 million were allocated to the Bank.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Notes to Financial Statements

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 10.839 percent and 11.491 percent at December 31, 2002 and 2001, respectively.

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

	2002		2001
European Union Euro:			
Foreign currency deposits	\$ 605	\$	528
Government debt instruments including agreements to resell	357		310
Japanese Yen:			
Foreign currency deposits	194		217
Government debt instruments including agreements to resell	668		611
Accrued interest	9		7
Total	\$ 1,833	\$	1,673

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

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

Maturities of Investments Denominated in Foreign Currencies

Within 1 year	1,692
Over 1 year to 5 years	98
Over 5 years to 10 years	43
Over 10 years	—
Total	\$ 1,833

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

At December 31, 2002 and 2001, the warehousing facility was \$5,000 million, with zero balance outstanding.

FEDERAL RESERVE BANK OF SAN FRANCISCO

Notes to Financial Statements

6. Bank Premises and Equipment

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

	2002	2001
Bank premises and equipment:		
Land	\$ 24	\$ 24
Buildings	185	179
Building machinery and equipment	41	42
Construction in progress	8	1
Furniture and equipment	133	135
	<hr/> 391	<hr/> 381
Accumulated depreciation	(158)	(152)
	<hr/> \$ 233	<hr/> \$ 229

Depreciation expense was \$19 million and \$20 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 one to six years. Rental income from such leases was \$2 million and \$1 million for the years ended December 31, 2002 and 2001, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2002, were (in millions):

2003	\$ 1.2
2004	.3
2005	.2
2006	.2
2007	.1
Thereafter	—
	<hr/> \$ 2.0

7. Commitments and Contingencies

At December 31, 2002, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately three years. These leases provide for increased 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 \$937 thousand and \$858 thousand for 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 and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2002, were not material.

Under the Insurance Agreement of the Federal Reserve Banks dated 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.

Notes to Financial Statements

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.

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 \$7 million and \$6 million for the years ended December 31, 2002 and 2001, respectively, and are reported as a component of "Salaries and other benefits."

9. Postretirement Benefits Other Than Pensions and Postemployment Benefits

Postretirement benefits other than pensions

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

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

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

		2002		2001
Accumulated postretirement benefit obligation at January 1	\$	38.8	\$	33.4
Service cost-benefits earned during the period		1.0		.7
Interest cost of accumulated benefit obligation		2.6		2.3
Actuarial loss		2.3		.1
Contributions by plan participants		.4		.3
Curtailement loss		.1		—
Special termination loss		.1		—
Benefits paid		(3.9)		(2.2)
Plan amendments (curtailments, special termination benefits)		(2.9)		4.2
		<hr/>		<hr/>
Accumulated postretirement benefit obligation at December 31	\$	38.5	\$	38.8

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Notes to Financial Statements

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

	2002		2001
Fair value of plan assets at January 1	\$ —	\$	—
Actual return on plan assets	—		—
Contributions by the employer	3.5		1.9
Contributions by plan participants	.4		.3
Benefits paid	(3.9)		(2.2)
Fair value of plan assets at December 31	\$ —	\$	—
Unfunded postretirement benefit obligation	\$ 38.5	\$	38.8
Unrecognized prior service cost	5.9		4.3
Unrecognized net actuarial gain	11.0		14.0
Accrued postretirement benefit costs	\$ 55.4	\$	57.1

Accrued postretirement benefit costs are reported as a component of “Accrued benefit costs.”

At December 31, 2002 and 2001, the weighted average discount rate assumptions used in developing the benefit obligation were 6.8 percent and 7.0 percent, respectively.

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

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

	One Percentage Point Increase		One Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	\$ 1.8	\$	(1.7)
Effect on accumulated postretirement benefit obligation	.2		(.2)

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Notes to Financial Statements

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

	2002		2001
Service cost-benefits earned during the period	\$ 1.0	\$.7
Interest cost of accumulated benefit obligation	2.6		2.3
Amortization of prior service cost	(1.0)		(1.4)
Recognized net actuarial loss	(.6)		(.9)
Net periodic postretirement benefit costs	\$ 2.0	\$.7

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

Postemployment benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, and disability benefits. Costs were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 2002 and 2001, were \$13 million and \$12 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 \$3 million and \$2 million, respectively.

The Bank also accrued charges during the year ended December 31, 2002 of about \$7 million for severance benefits associated with voluntary and involuntary separations of almost 250 employees that included separation pay and health benefits.

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 consolidating its check adjustment function at the Portland 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.