Report from the President

THE FEDERAL RESERVE BANK OF NEW YORK'S STRATEGIC DIRECTION

In the nearly ten years that I have been president of the Federal Reserve Bank of New York, there have been enormous changes in our economy and our financial system. Earlier annual reports have documented the very substantial accomplishments of the Bank and its staff in meeting challenges in financial markets, bank supervision, financial stability, and the payments system, fields in which the Federal Reserve Bank of New York has long been active.

This annual report of the Federal Reserve Bank of New York focuses on present and future challenges and how we as an institution plan to meet them. To help chart our future path, the Bank's Management Committee, in consultation with the management team, developed a new strategic plan for the Bank in 2002. It is a pleasure to present in this, the final annual report issued under my signature, the Bank's view of the way forward over the next several years.

It has been a great privilege to serve as this Bank's president. As I look back over my tenure, I note that the Bank's most important achievements often take considerable time and require the collaboration of many in the public and private sectors. To cite one example, eight years ago, the New York Foreign Exchange Committee, a private sector body sponsored by the Federal Reserve Bank of New York, published its seminal study on the large and growing risks created by settling huge volumes of foreign exchange. That study was the beginning of a process to solve what was already a twenty-year problem in the markets, one that few thought could be solved. We have now taken the decisive steps to solve it. CLS (Continuous Linked Settlement) Bank began operation in 2002, clearing and settling foreign exchange transactions on an intra-day basis that greatly reduces settlement risk.

To me, this story illustrates all of the elements of good central banking—the adoption of a long-term perspective, commitment to the common good, a fruitful dialogue between public and private sectors, central bank encouragement for private sector initiative, and, when necessary, central bank willingness to tackle what lies beyond the private sector's capacity to change. It is therefore gratifying to see in this annual report that while the list of challenges is still long, the Federal Reserve Bank of New York will remain a crucial and vital force in ensuring that these challenges are met to the benefit of us all.

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THE CORE MISSION OF THE BANK

Despite the extensive changes taking place in our environment, the core mission of the Federal Reserve Bank of New York remains the same: to foster the safety, soundness, and vitality of the economic and financial system in our region and our nation, and thereby to contribute to the well-being of the global system.

Working within the Federal Reserve System and with other public and private sector institutions, the Bank plays a leadership role in:

- executing monetary policy through our Markets Group and contributing to its formulation through the Bank president's roles as vice chairman and permanent member of the Federal Open Market Committee;
- supporting financial stability in the United States and abroad through financial supervision and international consultation and collaboration, including participation in the Basel Committee on Banking Supervision and other committees sponsored by the Bank for International Settlements; and
- fostering a robust and efficient payments system through our operation of Fedwire, the wholesale payments system; our provision of services to financial institutions, the U.S. Treasury, and foreign central banks; and our contribution to payments policy within the Federal Reserve and in international committees.

CHANGES IN THE ENVIRONMENT AND THE CHALLENGES THEY POSE

Many of the challenges now facing the Bank stem from the immense changes that have reshaped our economy and the financial system over the last decade. The first and most obvious of these changes is the remarkable advance in information and communications technologies.

New technology contributed to strong economic growth and low inflation in the 1990s; it continues to foster economic stability today. Businesses have increased their productivity through the introduction of product and service innovations and new methods of production. In addition, improvements in inventory management stemming from technological advances have contributed to lower volatility in economic output.

In 2002, we entered a macroeconomic environment that differs significantly from that of the past several decades. Strong productivity growth accompanied a relatively shallow recession and the subsequent slow recovery; it coincided, too, with very aggressive reductions in inventory and employment and with pressure on profit margins. A bellwether measure of inflation, the core personal consumption expenditure deflator, fell to its lowest level since the 1960s. Faster productivity growth in the United States than abroad also contributed to the emergence of a record current account deficit that approached 5 percent of GDP. These developments challenge us to understand the forces driving our economy and the policy consequences of the high-productivity, low-inflation, and high-current-account-deficit environment we are likely to face for the next several years.

The productivity gains so evident in U.S. business have also taken place in financial services and thereby dramatically increased global overcapacity in that industry. This development has led to a second major change in the environment: the consolidation of both the banking and the securities industries over the past ten years. In 1992, New York City was home to eight major bank holding companies among the country's top twenty; in 2002, four of the original eight had been absorbed in consolidations. In 1992, there were thirty-nine primary dealers in the government securities markets; by the end of 2002, there were only twenty-two.

At the same time, the tremendous growth of wealth in the 1990s fueled the growth of institutional investors. Understanding how financial firms beyond banks and securities firms operate has become imperative, because the largest insurance companies, mutual funds, hedge funds, and finance companies increasingly rival banks and securities firms not only in their asset size but also in their ability to reshape financial activity. The near failure of Long-Term Capital Management in 1998 illustrated the extent to which financial stability could be threatened by these newly important financial market participants.

The third critical source of change in the last ten years has been the extension of the long wave of globalization. This wave includes the liberalization of capital flows, the expanded reach of U.S. and other major financial institutions through substantial foreign direct investment, and the development of domestic financial markets to complement banking markets in emerging market countries.

Greater globalization and the increased role of markets generally have been beneficial to emerging markets, but these changes in the financial landscape have altered the ways that problems develop and propagate. The 1995 Barings failure and the 1997-98 Asian crisis demonstrated how breakdowns in internal controls and weaknesses in financial structures and corporate governance systems could create crises that reverberated around the world. Understanding what institutional arrangements and policy strategies work well and how problems unfold when institutions and policies falter is yet another important challenge.

These crises also illustrated the power of information, communications, and financial technology to erode market and geographic boundaries in the ordinary course of business. In the United States, the unbundling of financial activities is commonplace: consider, for example, the separate roles of mortgage broker, mortgage bank, mortgage servicer, and mortgage securities holder in a transaction as basic as arranging a home purchase. When the various firms are located in different countries, this unbundling of financial activity poses a great challenge not only to supervision but also potentially to financial stability. In such circumstances, new supervisory tactics, greater market and financial institution transparency, and increased international supervisory cooperation are necessary. In some cases, existing laws need to be reexamined and possibly revised to ensure that market integrity and financial soundness are preserved.

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The fourth source of change—a shift in the nature of competition within financial services—has further blurred the line between financial and nonfinancial firms. In the past, financial competition was about price, service, and new products; it took place largely among firms in the banking and securities industries. Today, competition is likely to be driven by technological innovation and its impact on service quality and cost, and the innovating firms can be located either inside or outside the financial industry.

At the end of the 1990s, as the high-tech bubble was reaching its zenith, the potential competition from Internet providers of financial services seemed formidable, given the apparently low marginal costs of transactions. The subsequent high-tech bust has winnowed the number of such potential competitors substantially, but electronic trading and electronic loan, banking, and payment services have survived and continue to grow in importance in our financial markets. A challenge for us is to understand the implications of these changes for market structure, market performance, and monetary and supervisory policies.

The potential for electronic services to reshape payment and settlement services lends new import to the question of what payment services the Federal Reserve should provide and how it should provide them in the future. Some desirable changes have already been identified. For example, the financial community has expressed interest in shifting to Internet protocols for wholesale payments as a means to increase the information accompanying such payments. Similarly, financial firms have explored the potential for straight-through processing of payments to reduce operational risk and shorten clearance and settlement times. Finally, several new payment arrangements—including the intra-day settlement of cross-border currency transactions provided by CLS Bank since 2002—make use of technological advances to reduce and manage risks in the settlement process.

More broadly, the development of electronic market structures means that in the future we may see more convergence between financial markets and goods and services markets. For example, at the height of the Internet enthusiasm, the method of pricing, buying, and paying for goods and services started to resemble methods used in financial transactions, with auction or exchange mechanisms being used for the purchase of automobile parts, chemicals, and other products. While these innovations were severely blunted by the high-tech collapse, it seems likely that such practices—which could have the benefit of increasing transparency in pricing and reducing costs—will eventually reappear in some more robust form.

If innovative electronic market structures do in fact take hold, the dividing line between finance and commerce is likely to become increasingly blurred. After three decades of substantial deregulation in financial markets, we will undoubtedly encounter new questions about what activities should be permissible for financial institutions, given their substantial expertise in creating and providing ancillary services to markets, and what type of oversight, if any, is necessary to underpin the integrity of markets adopting financial-market-like structures.

A final key change in the environment has been the sharp rise in service quality, efficiency, and product innovation as a result of intense competition in the financial industry. Technology allows financial institutions to offer a broad customer base the same customized products and services that they previously provided only to high-end customers. Banks have streamlined their operations—including such basic functions as opening a deposit account—at the same time as they have strengthened internal controls. As a result, those banks owned by the ten largest U.S. bank holding companies have seen their efficiency ratio—defined as the ratio of noninterest expense to operating revenues—drop roughly 8 percentage points, to less than 60 percent, over the last ten years.

This tremendous drive toward greater efficiency is another factor behind the consolidation of the U.S. and the global banking systems. Today, we see our relatively local markets for banking transformed into a national market, and our national securities and over-the-counter markets transformed into global markets.

The Federal Reserve System recognizes how important it is to be a part of this drive for efficiency. As a result, the System has been consolidating and restructuring its operations over the last several years. Most recently, it announced a reduction in the number of check-processing locations in the United States. The System's efforts to consolidate its information technology activities have been less visible, but have nonetheless made equally important contributions to the efficiency and resilience of central bank operations. As the Federal Reserve evolves, we at the New York Bank need to actively shape our role within it.

In short, intense competition, new technology, and the drive for efficiency and service quality are transforming the U.S. and global economies and the interactions between financial markets and the economy. The very nature of competition has changed. New technologies challenge the old, and market leadership can change quickly, affecting our operations. Similarly, insight into economic and financial developments advances swiftly, bringing new perspectives to bear on our policy views. In such an environment, investing in people and in technology is crucial if we are to maintain our leadership role.

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A BROAD STRATEGY FOR MEETING THE CHALLENGES WE FACE

Historically, the Federal Reserve Bank of New York has played a unique role in the national and global financial systems. This role stems from our proximity to the U.S. financial markets and the major U.S. financial firms. It also reflects our specialized responsibilities: executing monetary policy, acting as fiscal agent in the securities market for the U.S. Treasury, operating the Fedwire wholesale payments system, and maintaining international correspondent banking relationships with a large majority of the world's central banks. Because of our unique role within the Federal Reserve System, we have been able to contribute to the

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national and international financial policy agenda and to participate in setting the direction of change in the financial system.

As the Federal Reserve increasingly manages its operations on a national basis, the degree of specialization within the Federal Reserve District Banks is likely to increase. At the same time, the Federal Reserve must operate seamlessly in global and national markets from the perspective of its customers, counterparties, and the public. This means we must rethink what we do, how we do it, and how we hand off work from one Reserve Bank to another if we are to maximize our effectiveness both within the Federal Reserve System and with our customers. As we continue the substantial specialized responsibilities we already have, we must now choose among the activities we have in common with other Reserve Banks to retain only those that require our special strengths or have synergies with our major policy and operations roles.

Our strategy in developing our future role has three key elements. The first is to choose those activities that would allow us to build on our comparative advantages. The second is to be able to respond quickly to short- and long-term developments by maintaining a flexible, efficient, and state-of-the-art business and support structure within the Bank. The third is to provide leadership and central bank perspective in all of our interactions with those outside the Bank and at all levels of our organization. Let me discuss each of these in turn.

The first element of the strategy is to concentrate our energies on those activities in which we can excel by virtue of our comparative advantage. In a world where many institutions can produce a service, comparative advantage lies where we are relatively strongest. The central idea is that if we focus our resources on what we do much better than anyone else and let others—inside and outside the Federal Reserve System—focus on activities in which they have a relative edge, the System produces more output at higher average quality and lower average cost.

The Federal Reserve Bank of New York's comparative advantages are considerable. They stem from our special historical place within the Federal Reserve System and our location in one of the world's leading financial centers and greatest cities. These two factors cannot really be separated, so entwined is our historical role with our location.

Our comparative advantages start with our people. Especially after a year of observing corporate governance problems in the private sector, we appreciate even more the steadfast integrity of our staff and their deep commitment to public service. Although we share with the Federal Reserve System a highly talented and committed workforce, what gives our Bank a comparative advantage is our ability to draw on a highly diverse labor market, which is important for our national and international presence, and on New York City's concentration of professionals with financial expertise.

The Federal Reserve Bank of New York has always had considerable expertise in financial markets, especially in the foreign exchange and government securities markets in which we operate. We have also developed special insight into wholesale payments and settlement systems, not only through our close contacts with banks and securities firms but also through our activities as the operator of Fedwire payment and securities settlement services and as a supervisor of securities depositories and custody operations.

Our history and our special responsibilities have also led to long-standing and strong relationships with the U.S. Treasury, foreign central banks and monetary authorities, multilateral organizations, and private financial institutions. Because of these relationships, we have often been able to speak with representatives on both sides of a contentious issue. Our extensive contacts have made it possible for us to facilitate dialogue and contribute to the resolution of problems.

A further source of comparative advantage is our ability to act impartially, in both our operations and our contributions to policy debates. Historically, we have been a highly collegial organization with a multidisciplinary approach to problem solving that draws on expertise from all areas of the Bank. Some of our finest work, including our response to the terrorist attacks of September 11, 2001, reflects our ability to bring together staff with different skills and perspectives to forge solutions to problems. We share this reputation for impartial thinking and collaborative action, to be sure, with the entire Federal Reserve System.

The second key element of our strategy for the future is flexibility. We are prepared to alter our way of doing business and our tactics as we see new developments. This flexibility rests on the responsiveness of our infrastructure. For example, since September 11, 2001, we, along with the rest of the Federal Reserve System, have devoted many resources to increasing the resiliency of our infrastructure and working with the private sector to achieve comparable gains in the resiliency of individual firms and financial markets more broadly.

To improve our ability to respond, all central support areas of the Bank have been applying widely used management techniques to assess customer needs, benchmark performance and costs against those of peer organizations, and seek enhancements to service quality and cost effectiveness. For example, in our building services area, a benchmarking exercise last year allowed the area to identify ways to bring the provision of services into line with market practices while matching the price of lower cost providers outside the Bank. Our Corporate Group has adopted e-business methods to replace paper processing with Intranet transactions in areas such as human resources and financial management. These methods have improved efficiency and enhanced customer service throughout the Bank.

The development of management techniques like these not only makes us part of the economy-wide revolution in business management, but also allows us to manage our resources well and be fiscally responsible. Our efforts have led to very low growth in costs—2.3 percent on an average annual basis—over the last six years. During this period, the number of employees has fallen by 20 percent.

These efforts often have tangible results for our customers. We have been able to reduce the average price of Fedwire every year since 1996; the average Fedwire charge is now one-third

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what it was in 1996. The check processing area met all its 2002 financial targets by implementing a sustained efficiency and quality program. We have expanded our capacity in the international distribution of cash and enhanced our ability to meet contingency needs. We are making major investments in our web site in order to increase access to the Bank's expertise through expanded content and a new design. Internally, our efforts have also enabled us to direct our financial resources to the people and systems crucial to our core mission.

The third element of our strategy going forward is leadership. We see building the leadership skills of our staff at all levels as critical to ensuring the Bank's ability to sustain its unique roles in the future. In a rapidly changing world, we need people who can identify new developments, understand their ramifications for public policy and the central bank, and propose courses of action. As the financial system becomes increasingly global and expands to include many players besides banks and securities firms, we need staff who can interact with a widening range of financial and public sector institutions.

During the last two years, the Bank has introduced a broad-based leadership program. Its goal is to develop the Bank's staff to be leaders who are strategic, innovative, and inclusive and who also possess strong communication, delegation, and feedback skills. We also recognize how important it is today to be a "learning" institution. Learning includes the benchmarking reviews we have undertaken in all areas of the Bank to understand and act on the changing context of our activities and the potential to improve performance. It also includes in-depth studies of evolving markets and institutions in our financial system and of important policy issues of our day.

We are well aware that we must build the next generation of central bank leaders and that developing the breadth of perspective traditionally associated with senior central bankers has become more challenging as the world has become more interconnected and work has become more specialized. As a result, we have been working to provide our staff with continuing opportunities to broaden their knowledge of policy issues through a variety of initiatives, including small intergroup policy roundtables, speaker programs that bring in business leaders and policymakers, and short seminars. Recognizing the importance of career planning, we are also working with staff to help them sharpen their core specialization while developing breadth and depth of expertise. To this end, we are establishing multidisciplinary project teams and increasing the opportunities for rotations within the Bank. The Bank Supervision Group, in particular, has developed a very effective job mobility program that creates substantial opportunities every year for examiners, policy analysts, and operations support staff to move to different positions in that Group.

KEY BUSINESS IMPERATIVES NOW AND IN THE FUTURE

I have outlined some of the key challenges we face and our broad strategy for addressing them. What are the points of emphasis in our primary business areas over the next few years?

In the area of *monetary policy*, we are providing leadership in adapting monetary operations to changing financial markets and market mechanisms. To that end, we are making a substantial investment in understanding market developments, especially through the use of multidisciplinary teams to study rapidly expanding markets, changing market mechanisms, and new financial instruments. We are also developing new analytical tools to help us manage the portfolio of the System Open Market Account and to meet the needs of our fiscal agency client, the U.S. Treasury. At the same time, we will continue to provide analysis of key strategic questions for monetary operations, including the implications of the System's fast-growing portfolio, the operational challenges of a low-inflation environment, and the identification of techniques for sustaining financial system liquidity in adverse circumstances.

In analyzing the economy, we face the challenge of assessing the nature and extent of achievable economic stability and the ways in which monetary policy can contribute to stability in a transformed U.S. and global economy. The abrupt onset of the 2001 recession has prompted us to develop better "real-time" information about the economy. The combination of a low-inflation environment and a burgeoning U.S. current account deficit poses special challenges in interpreting economic and financial conditions going forward. Through the examination of issues such as these, we are seeking to build our reputation for balanced, dispassionate analysis of monetary policy issues in both a national and an international context.

In the years ahead, we also want to sharpen our focus on economic developments in the communities that make up the Second District. As the banking system and the Federal Reserve consolidate their operations, it is essential that the Bank find new ways to deepen its understanding of the region. That understanding rests to a great extent on direct, person-to-person contacts with bankers, businesspeople, and community representatives. These contacts are especially important in meeting the intentions of the Federal Reserve's founders that all regions be represented in the formulation of monetary policy.

In the area of *financial supervision*, we plan to advance the continuous supervision model the Federal Reserve System has adopted to critically assess the performance of supervised institutions. We intend to make that assessment while providing significant value to the institutions we supervise, limiting the burden of regulation and supervision, and dealing firmly with the problems that are uncovered. As a special area of emphasis, we plan to continue our leadership role in evaluating how risks are measured, managed, and controlled, and how banking, securities, and insurance risks can be addressed in a common framework.

On the international level, the Basel Committee on Banking Supervision, which I have had the great honor to chair since 1998, has developed principles for sound and effective banking supervision and continues to add to its guidance on minimum and advanced supervisory practices. Its proposed revisions to

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the Basel Capital Accord call for these principles to be applied to all internationally active banks within a more dynamic and risk-based framework that draws on banks' management processes. The revised Accord is intended to align regulatory capital requirements more closely with underlying risks and to provide banks and their supervisors with a range of options for the assessment of capital adequacy. Our Bank Supervision Group will have a major role in overseeing the implementation of the new capital standards by larger U.S. banks in the next several years.

The need for banks to have a more dynamic, risk-based framework to assess capital adequacy is critical given the rapidly changing competitive landscape in financial services, including the increasing presence of nontraditional competitors alongside banks and securities firms. In addition to influencing the competitive environment in financial services, large globally active institutional investors and nontraditional competitors are often important counterparties of banks and securities firms.

We intend to deepen our knowledge of these influential participants in the financial system to understand more fully both the nature of banks' exposures to other market players and the business environment of the banking system. We also see the need to assess the legal and supervisory frameworks that apply to banks and to these other major market participants to determine how well these frameworks support financial stability and an effective financial system and to propose changes as necessary.

In the area of *international financial stability*, we are promoting efforts to devise and implement strategies to foster long-term stability in the global economy, with a special emphasis on using our in-depth understanding of the international financial system. We believe that more attention needs to be devoted to the strategies and institutional settings that work best in the emerging market countries to foster internal economic and financial stability and access to external financial markets. Identifying these potential strategies and institutional reforms is a primary focus of our work, along with enhancing our ability to monitor international capital flows and financial markets important to emerging market countries. We are contributing to the current discussion of new approaches to resolving instances of institutional, sovereign, or market distress—including strategies to strengthen economic, market, and legal frameworks—in order to achieve better outcomes to potentially disruptive situations.

In the area of *payment, treasury, and central bank services*, we see the potential for great change in wholesale payment and settlement services. We intend to lead in developing and implementing the next generation of Fedwire payment, securities settlement, and related services for our Bank and central bank customers. A starting point for that effort is to conduct in-depth studies of what the users of the Fedwire system and central bank correspondents will need from the Federal Reserve in the future. We see an unusual opportunity to take advantage of new technology, and we have already begun to develop Internet protocols for our wholesale payment services.

We also see a need to pursue a broader discussion in the financial community about the shape of the future wholesale payments and settlement system. The private sector—through projects of the Group of Thirty, our Payments System Risk Advisory Committee, and the Securities Industry Association—has identified some desirable features of a future system. Moreover, key elements of a more truly global payments system are falling into place, including the successful launch of CLS Bank and progress in the cross-border recognition of collateral agreements. We therefore see an opportunity to identify common ground in the various views of the future wholesale payments system and to begin the resolution of important outstanding issues. We believe that creating greater clarity about future payment arrangements will be important to private sector institutions as they make investments in the coming years.

As the dialogue on payments progresses, it will be imperative to think through the potential benefits and risks posed by the use of new technologies in payment and securities settlement services. As part of the Federal Reserve's oversight role, we seek not only to assess the soundness of changing arrangements in the financial markets and in the payments and financial businesses but also to evaluate how risk management in the financial business needs to evolve to limit systemic risk. We must also be careful to apply to our own operations those insights we develop regarding sound financial practices and effective risk management.

In all our payment services, our goal is to meet the high service and quality expectations of our customers at the lowest reasonable cost and to be in a position to do so in good and in adverse circumstances. We see these goals as critical to remaining competitive and achieving key performance targets within the Federal Reserve. We also see the importance of fulfilling the Federal Reserve's commitment to shift from paper-based to electronic services. We strive to provide the most effective and efficient services possible to the U.S. Treasury, which has successfully led the way in adopting electronic and Internet-based services.

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I would like to conclude by recognizing the many talented and supportive individuals with whom I have had the great pleasure to work these past ten years. I leave the Federal Reserve Bank of New York with great pride in the institution and the people who serve it.

February 28, 2003

To the Board of Directors of the
Federal Reserve Bank of New York:

The management of the Federal Reserve Bank of New York ("FRBNY") 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 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 FRBNY 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 FRBNY 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 FRBNY maintained an effective process of internal controls over financial reporting, including the safeguarding of assets as they relate to the Financial Statements.

William J. McDonough	Jamie B. Stewart, Jr.	Suzanne Cutler
President	First Vice President	Principal Financial Officer

Report of Independent Accountants
PricewaterhouseCoopers L.L.P.

To the Board of Directors of the
Federal Reserve Bank of New York:

We have examined management's assertion that the Federal Reserve Bank of New York ("FRBNY") 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. FRBNY'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 FRBNY 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
New York, New York