

MESSAGE FROM THE PRESIDENT AND FIRST VICE PRESIDENT

The year 2001 brought with it tragedy, change, and economic uncertainty. It is impossible to reflect on the past year of activities in our Bank and in the economy without recalling the terror and destruction that befell this country on September 11. Just as our attention had focused on that Tuesday morning's business, it was quickly diverted to news of the horrific events that separated this day from any day before it. Within minutes, our attention shifted to securing the safety of our employees and maintaining public trust in the country's financial system.

Although the Bank maintains aggressive contingency plans developed by thinking the unthinkable, it is with the hope that there will never be a need to activate them. On September 11, the unthinkable became reality. In the hours and days that followed, staff across the Fifth District responded in a manner that makes us very proud. Despite a natural desire to comfort family and mourn with fellow citizens, our people rallied to support essential Federal Reserve operations. We will be forever grateful for their dedication and commitment.

Stability Maintained in the U.S. Financial System

Our Bank played a significant role in helping the Federal Reserve System stabilize the nation's financial markets and avert a liquidity crisis. Staff in Loans, Supervision and Regulation, Reserve Accounts, Cash, and Check Processing Departments worked around the clock. The Bank provided substantial funds through discount window loans and check-processing services. The volume of loans requested was unprecedented. On September 12, discount window loans at the Richmond Fed totaled \$10.9 billion, about 25 percent of the credit extended by the System that day. In comparison, \$94 million in loans were made a week earlier.

It took collaboration and teamwork throughout the District and the Fed nationally to meet the challenge of September 11. One small electronic payments team at the Richmond Office provided backup for colleagues at the New York Fed. Within moments after the World Trade Center attacks, this team took over the monitoring of critical large dollar funds and securities transfer services. Any interruption of these critical payments services obviously would have severely disrupted not only the financial system but also the broader economy.

Others manned Bank facilities and their perimeters. Security staff worked 12-hour shifts and continuously tightened procedures to keep fellow employees safe. Still others took to the road to deliver checks to branch offices and banks around the District after air transportation was grounded, and many employees worked extended shifts to process the enormous backlog of checks deposited by banks.

As the tragedy unfolded in New York City and Washington, we learned firsthand that, in a crisis, our ability to communicate well with our customers and the public is paramount. Internally, constant communication among our officers and staff provided a vital network for handling the situation. It also unified us, strengthened us, and enabled us to contribute effectively to the Fed's overall effort to help our country work through this especially difficult period in our recent history.

The crisis last fall was not the only time during the year that our emergency preparedness was tested. On July 18 a fire in a Baltimore railway tunnel forced most of the city's nearby businesses to close because of the fumes and other potential dangers. While our Baltimore Office is located close to the tunnel, staff remained on hand to maintain payment activities and other operations without disruption.

Changes in the Bank and the District

Every day, our staff is dedicated to improving service and increasing efficiency in carrying out the Bank's business. In this spirit, the Bank reorganized many of its operations along functional lines in the spring of 2001. Overall, we expect the reorganization to reduce costs and enable us to serve our customers better. In particular, the functional management structure will help the Bank better support the Fed System's Check Modernization Project, an effort to standardize and reengineer the nation's check processing infrastructure over the next several years.

These improvements were extremely important in 2001 as the structure of our District's banking industry also changed. With the merger of Charlotte-based First Union Corporation and Winston-Salem-based Wachovia Corporation, the Fifth District became headquarters for two of the nation's four largest banking organizations. As a result, the District now ranks second nationally in total bank holding company assets owned. Accommodating these large banking organizations requires us to focus on retaining and attracting staff with a broad range of experience and specialized skills to supervise the more complex and sophisticated activities of these institutions.

A Year of Economic Challenges

The Fed faced the extraordinary challenge of deciding how to respond with monetary policy in the aftermath of the September 11 attacks. Yet the year had already been challenging from a policy perspective since the evolving economic slowdown was a significant departure from the rapid growth of the late 1990s.

Signs of weakness had been increasingly apparent throughout much of the year in some economic sectors such as manufacturing. The number of jobs in District factories had been declining since the fall of 2000, but the losses accelerated after the terrorist attacks. In all, 120,000 District manufacturing jobs were lost in 2001, many in traditional industries such as textiles, apparel, and furniture.

Despite economic weakness, jobs in the District's non-manufacturing sector generally grew during the first three quarters of 2001. During the week of September 11, however, business and retail activity came to a virtual standstill. Many lost jobs when District airports closed and air travel ceased for a week or more. Because of its proximity to Washington, Reagan National airport did not reopen until early October. Not only were the airlines affected, but jobs related to travel, hotel, food services, and tourist activities were also lost. Not surprisingly, jobs in the non-manufacturing sector declined in the fourth quarter. Moreover, weaker overall economic conditions throughout the year in District states caused state governments to fall short of anticipated tax revenues, which generated substantial budgetary challenges. Despite these difficulties, by the end of 2001 many District businesspeople were optimistic that an economic upturn would

materialize in the region as well as the nation in 2002.

The events of September 11 highlighted the importance of our relationships with the business community throughout the District. We routinely consult with our directors at all three of our offices, our advisory council members, and our other business contacts regarding current business conditions and the outlook. We relied even more heavily on them in the aftermath of September 11 to keep us abreast of emerging developments. Published statistics and databases simply could not provide us with the up-to-the-minute information we needed to deal effectively with the crisis. We thank our contacts for all their assistance during that time and throughout the year.

Two Directors Conclude Their Terms

We would especially like to thank retiring directors Jim Culberson and Craig Ruppert for their important contributions this year and in earlier years. Jim served on the Richmond board from 1999 through 2001. He had previously served as a director of our Charlotte Office from 1985 through 1990. While on the Richmond board, Jim shared his extensive banking experience with us, which made him a key contributor to the Bank's Financial and Strategic Planning Committee during his term. He also served as a member of the Committee on Research, Public Affairs, and Community Affairs for those three years and chaired the Committee in 2000 and in 2001.

Craig served two three-year terms on the Richmond board from 1996 through 2001. He was a member of the Committee on Buildings through both terms, and was chairman of the Committee for five years. In that capacity, he provided valuable insights while overseeing the security enhancements to the Richmond Office. He was also a member of the Executive Committee; the Committee on Research, Public Affairs, and Community Affairs; and the Committee on Financial and Strategic Planning.

Financial Privacy Examined

In light of the many extraordinary events in 2001, it is easy to lose sight of more routine but nonetheless important issues that were evolving in banking. Among

the most significant were the proposed changes in the way financial institutions treat information regarding their customers. In late 1999, the Gramm-Leach-Bliley Act was passed to modernize the way financial institutions are regulated. Among other things, the Act imposed new regulations on financial firms' sharing of customer information with outside companies.

According to the financial privacy provisions of Gramm-Leach-Bliley, which took effect in mid-2001, if a financial institution shares nonpublic customer information with third parties, it is required to give its customers an opportunity to "opt out." Privacy advocates have argued for a stricter "opt-in" provision that would require financial institutions to get explicit consent from consumers before sharing personal information about them. State legislators in some states have proposed even tighter regulations on sharing information within affiliated companies.

In "The Economics of Financial Privacy," Jeff Lacker, Senior Vice President and Director of Research, takes a look at the opt-out and opt-in debate from an economist's perspective. Fundamentally, the issue centers around the proper allocation of "rights" in a contractual relationship — a customer's right to privacy versus the right of a financial institution to share its information. The answer economics provides is that whether regulations allocate the rights in accord with opt-out or opt-in is irrelevant. Under an opt-out standard, banks could pay customers to refrain from opting out, while under an opt-in standard, banks could pay customers for their information. In either regime, the market should deliver an appropriate balance between consumers' desire for privacy and the economic value of information sharing.

Interestingly enough, the debate is ongoing and fervent. Jeff's article analyzes the debate and concludes that it is unnecessary.

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