



STABILITY IN TIMES OF CHANGE

A PERSONAL REFLECTION ON
THIRTEEN YEARS IN OFFICE

By President & CEO Michael H. Moskowitz

OUR MISSION

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

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

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OUR VISION

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

On the Cover: Completed in 1922, the Federal Reserve Bank of Chicago’s front facade, with its Corinthian colonnades rising 65 feet, was designed to produce “the impression of dignity and strength, in harmony with the power and purpose of the institution,” according to a newspaper of the day.

MESSAGE FROM THE PRESIDENT

THE ECONOMY AND MONETARY POLICY Real gross domestic product, or real GDP — our broadest measure of economic output — increased at an annual rate of 3.1 percent in 2006. However, over the past few quarters, growth has been averaging close to 2 percent. At the Federal Reserve Bank of Chicago, our estimate of the economy’s potential growth rate — that is, the rate of growth it can sustain over time given its labor and capital resources — is just a bit under 3 percent. As such, by this standard, economic growth over the last few quarters has been somewhat below potential. However, even though overall growth has been below our estimate of potential, labor markets have continued to tighten; the unemployment rate fell from 5 percent in late 2005 to an average of about 4½ percent in early 2007.

Such tightening resource pressures, as well as high energy and commodity prices, likely contributed to faster increases in prices. As a result, inflation ran too high. The Fed’s preferred measure of inflation is the price index for personal consumption expenditures excluding food and energy, also known as core PCE. Over the four quarters of 2006, core PCE prices increased 2.2 percent, about the same pace as in 2005. By contrast, I prefer that, over time, inflation run between 1 and 2 percent — the range I consider to be most compatible with the Fed’s goal of price stability.

Given the relatively high level of resource utilization in the first half of 2006, the Federal Open Market Committee (FOMC) continued removing policy accommodation at a measured pace. The FOMC raised the target federal funds rate from 4¼ percent at the beginning of the year to 5¼ percent after its June meeting. With the pace of growth moderating in the second half of the year, but with inflation still running too high, the FOMC left the stance of policy unchanged through the rest of 2006 and the beginning of 2007.

For the balance of 2007, economic growth likely will average modestly below potential, but I expect that growth will return to near potential in 2008. The below-potential growth this year would be consistent with slight increases in the unemployment rate and other measures of resource slack, but the magnitude of the increases would likely be small.

Core inflation should gradually come down, moving closer to the levels I view as being consistent with price stability. Still, there is a risk that inflation could remain stubbornly high for a couple reasons. First, the economy appears to be operating in the neighborhood of its potential level of output. The unemployment rate is low, growth in compensation per hour has moved up some over the past year, and productivity growth has slowed. Together, these have resulted in an acceleration in unit labor costs. Second, inflation has run at or above 2 percent for the past three years. With inflation at such a high level for such a long period of time, we have to recognize the risk that inflation expectations could become



*Michael Moskow,
President and
CEO of the
Federal Reserve Bank
of Chicago*

stuck in a range that would not be conducive to price stability. To date, inflation expectations appear to be contained, but that is not something we can take for granted. The longer inflation runs above levels consistent with effective price stability, the greater the danger that expectations of future inflation will settle in above those levels as well.

Taking all of these factors into account, my assessment is that the risk of inflation remaining too high in 2007 is greater than the risk of growth falling too low. Of course, whether policy will need to be adjusted and the degree of any adjustment will depend on the incoming data and how that data influences our forecast of the economy.

LOOKING BACK After 13 years as president of the Federal Reserve Bank of Chicago, I will retire on August 31, 2007. In this year’s annual report, I reflect upon my tenure at the Bank, and in particular, on my impressions of the most important developments in the Federal Reserve’s core responsibilities of monetary policy, bank supervision and regulation, and the payments system.

In addition, I would be remiss if I did not say how tremendously rewarding my work at the Chicago Fed has been, primarily because of the opportunity over the years to work with such dedicated and talented staff members and directors.

Of special note are the seven individuals who served as chairman of our Board of Directors during my years at the Chicago Fed: Richard Cline; Robert Healey (deceased); Lester McKeever, Jr.; Arthur Martinez; Robert Darnall; James Farrell and Miles White. Each has made significant contributions to the Chicago Fed and the Federal Reserve System.

I would also like to thank the many directors who served the Chicago Fed and its Detroit Branch during my tenure (listed on page 17) as well as the three individuals who completed their service as directors last year. They are:

- James Farrell, former chairman of Glenview, Ill.-based Illinois Tool Works. Jim served as chairman of the board from 2004 to 2005.
- William A. Osborn, the chairman and CEO of Northern Trust Corporation and the Northern Trust Company.
- Mindy C. Meads, currently the president and chief merchandising officer of Aeropostale, Inc., and formerly the president and CEO of Lands’ End Inc.

I am very grateful for their counsel and help in running our operation efficiently and productively. On a related note, I would like to recognize the following people who joined our board this year. They are:

- William C. Foote, chairman and CEO of Chicago-based USG Corporation.
- Dennis J. Kuester, chairman and CEO, Marshall & Ilsley Corporation, Milwaukee, Wisconsin.
- Ann D. Murtlow, president and CEO, Indianapolis Power & Light Company, Indianapolis, Indiana, and vice president, AES Corporation.

In closing, I would like to emphasize how much I have enjoyed serving the Federal Reserve Bank of Chicago and the residents of the Seventh Federal Reserve District. I am proud of our accomplishments and value the relationships that I have been able to form with people throughout Chicago and the Midwest. I also am proud of the tremendous strides we have made in fulfilling our varied responsibilities. With the continued dedication of our staff and directors, I am confident that the Bank will remain in very strong condition in the years ahead.



MICHAEL H. MOSKOW
PRESIDENT AND CHIEF EXECUTIVE OFFICER
MAY 15, 2007

ECONOMIC RESEARCH AND PROGRAMS

- Chicago Fed economists provided support throughout the year to the president and board members to help them carry out their monetary policy responsibilities.
- Research Department members prepared eight special policy briefings, including presentations on topics such as the long-run trends in housing markets and inflation dynamics.
- Twenty-seven working papers were produced, and 25 previously written papers were accepted for publication in top-tier scholarly journals.
- The Research and Consumer and Community Affairs (CCA) areas held 41 conferences.
- Research reports were presented in *Economic Perspectives*, *Ag Letter*, *Profitwise News and Views*, and *Fed Letter*, including 12 special issues of *Fed Letter*.
- Department economists gave 49 paper presentations to academic audiences and presented 129 speeches and lectures to a variety of audiences.
- Policy conferences and forums were held on financial access for immigrants, rural economic development, community development finance, access to financial services, and foreclosure prevention.

FINANCIAL INSTITUTION SUPERVISION AND REGULATION

- Supervision and Regulation continued to focus on improving core supervisory functions by promoting staff development and a collaborative work culture as well as improving risk assessment and operational processes.
- The department’s primary 2006 focus was on enhancing the quality of risk resolution work.
- More than 1100 examinations, inspections and off-site reviews were conducted.
- The department focused strategic efforts on streamlining processes for low-risk organizations and activities and making improvements in examination processes.
- New procedures were implemented for examining banks with low-risk information technology operations.

FINANCIAL SERVICES

- Check processing successfully met all cost, productivity and sales targets and played a leadership role in supporting, selling and implementing Check 21 products.
- Cash Services successfully met all unit cost, productivity and quality targets.
- 2006 marked the first full year in the new Detroit Cash facility, featuring multiple machine rooms, state-of-the-art technology, increased capacity, and a strengthened control environment.

- The Des Moines check-processing operation remains among the top in the Federal Reserve System.
- The Midway check-processing center improved its efficiency, increasing both productivity and quality.
- Cash and check continued to maintain internal quality controls throughout the year.

CUSTOMER RELATIONS AND SUPPORT OFFICE (CRSO)

- The CRSO successfully completed the migration of FedLine Advantage and converted the more than 8,600 remaining customers off of the DOS-based FedLine platform.
- National Marketing and Sales continued strong performance and played a critical role in achieving outstanding results in 2006.
- The CRSO developed a new customized Check 21 Value Calculator and online resource center for customers and issued the first quarterly National Customer Satisfaction Survey.

OTHER ACTIVITIES

- A new Financial Markets Group was created to study financial markets and the clearing and settlement operations that support these markets, with particular focus on Chicago derivatives exchanges and clearinghouses.
- Money Smart Weeks held in Chicago, Michigan, Indiana and Wisconsin involved more than 500 partner organizations and featured more than 1300 events providing financial education to consumers throughout the Seventh Federal Reserve District.
- Executives from around the Federal Reserve System gathered in Chicago twice during the year for the Senior Leadership Conference, featuring thought-provoking activities and presentations.
- The process began to identify the successor to Chicago Fed President Michael H. Moskowitz, who will retire at the end of August of 2007.
- The bank better managed operational risks and controls.

STABILITY IN TIMES OF CHANGE

By President & CEO Michael H. Moskow

SINCE JOINING THE CHICAGO FED IN 1994, I have witnessed significant changes in our financial and economic system, as well as in the way the Federal Reserve carries out its responsibilities. One thing of which I am certain is that the financial system, and the Fed's role in supporting it, will continue to evolve. With that in mind, I would like to offer my perspectives on some of the major developments in monetary policy, the nation's payments system, and bank supervision and regulation over the last 13 years.

Some of the more significant developments include the acceleration in productivity in the late 1990s, the risk of deflation in 2003, transformations in the banking industry, and the growth and rapid acceptance of electronic payments. Much of what we have learned from these and other events can and should shape our monetary, supervisory, and regulatory policies going forward. These lessons also will help position the Fed to anticipate and effectively respond to whatever challenges lie ahead.

MONETARY POLICY

At the time of my arrival at the Federal Reserve Bank of Chicago in September of 1994, the U.S. economy was well into two very important transitions. The first was the shift from a high or moderate-inflation economy to one with relatively low and stable inflation. Core PCE inflation, which measures the percent change in the price index for Personal Consumption Expenditures, excluding food and energy, had fallen from staggering double-digit rates in the late 1970s and early 1980s to just 2½ percent in 1994.

The second transition, referred to by economists as “The Great Moderation,” had begun in the mid-1980s, but we were just beginning to recognize it in 1994. This period was the evolution to a low-volatility economy, in which fluctuations in real economic activity were much smaller than they had been in the 30 years prior to the mid-1980s.

In many important ways, these two transitions made the policymaking environment easier during my years at the helm of the Chicago Fed. While some challenges remained in the pursuit of price stability when I started, the inflation issues the Federal Open Market Committee (FOMC) has faced since then have been less severe than those confronted by the Paul Volcker-led Fed in 1979. In addition, since 1994 the FOMC has faced relatively smaller cyclical fluctuations in growth than it had in the past.

But the FOMC during the last 13 years still has had to react to a number of important and difficult challenges: the Asian financial crisis, the Russian debt default, unusual asset price movements (such as equities in the late 1990s and housing in the mid-2000s), Y2K, 9/11, the acceleration in productivity, and the risk of deflation. All of these issues generated policy questions that did not fit neatly into any familiar textbook framework. Instead, they required new approaches and new ways of thinking.

It is useful to consider two of these experiences in more detail — the **acceleration in productivity** growth and the **risk of deflation**. They exemplify how, when making difficult decisions in unusual circumstances, it is important to follow sound policy-making principles, including:

- Looking at a wide range of data and information, instead of one or two summary indicators.
- Using cogent economic theory to shape analysis.
- Respecting the risks of undesirable outcomes for growth or inflation, even in environments that appear benign.
- Remaining flexible to new approaches and ways of thinking in responding to developments and changes in the economy.

By following these principles, the FOMC made decisions over the past 13 years that played a meaningful role in helping maintain a low-inflation, low-volatility economy.

THE PRODUCTIVITY ACCELERATION

Productivity — the amount of output the economy can produce with an hour’s worth of work — is the fundamental determinant of our standard of living. That is because new technologies that generate productivity growth provide strong incentives for firms to invest and because, over time, increases in productivity eventually translate into increases in workers’ wages, salaries, and benefits. After two decades of sluggish increases, productivity growth picked up sharply in the second half of the 1990s, and as a result, output surged. Notwithstanding, it was difficult to judge whether the increase in productivity growth was permanent or temporary.

In determining the appropriate stance for monetary policy, the FOMC was well aware of the risks of making a mistake. If we set policy based on the assumption that the productivity surge was permanent, and it turned out to be transitory, we risked providing too much liquidity and generating inflationary pressures. If we instead set policy thinking the increase was temporary, and it turned out to be permanent, we would not have provided adequate liquidity to fund productive investments and hence would have stifled non-inflationary growth. So it was important to make the best assessment possible.

As we now know, the higher rate of growth was long-lasting. Much has been written about the Fed’s — and particularly former Chairman Alan Greenspan’s — insights into recognizing the permanent nature of the productivity pickup. An important part of the analysis was looking beyond the top-line growth numbers. Much of the surge in economic activity was coming in high-technology areas. By studying what was happening in these sectors, our best assessment was that the gains would be long-lived. Furthermore, we were observing very benign inflation numbers, a sign that productive resources were not being strained. In response, we raised the nominal federal funds rate target only 50 basis points between January, 1996 and June, 1998 — much less than if we had simply stuck to the previous benchmarks regarding long-run sustainable growth and unemployment.



Productivity growth picked up sharply in the second half of the 1990s.

The lessons of economic theory also shaped our decision-making. Regardless of which productivity scenario may have been correct, theory indicated higher real interest rates were warranted. If the productivity increases were transitory, higher real rates were needed to contain inflationary pressures. This would require raising nominal rates. If the gains were permanent, the return to investment would be higher, and thus higher real rates were necessary to equilibrate saving and investment. In this latter case, some of the increase in real rates would occur through a drop in the inflation premium built into nominal interest rates. And, as it turned out, though we increased the nominal funds rate only slightly, the real federal funds rate rose about 1¼ percentage points between early 1996 and mid-1998, largely because inflation declined.

Overall, monetary policy was relatively successful over this period. Real GDP growth averaged about 4 percent in the second half of the 1990s, a full percentage point faster than over the previous 25 years. In addition, core PCE inflation ended the decade at 1½ percent, a rate I view as being consistent with price stability.

THE RISK OF DEFLATION The other experience I want to discuss occurred in 2003. Growth in real activity was sluggish, the pace of job growth was subdued, and according to the data we had in hand at the time, core inflation had fallen to below 1 percent. There was a concern that the inflation rate would actually fall below zero, resulting in deflation — a decline in the overall price level. The concern no longer seemed so far-fetched, considering that Japan was at the time in the midst of a prolonged deflation spell. Some commentators even discussed a deflationary spiral, in which the increased real value of debt obligations would lead to a self-reinforcing cycle of defaults, wealth erosion, and a marked contraction in economic activity.

Looking at broader economic data helped put the issue into perspective. The term “deflation” naturally made people focus on the serious downward-price spiral that occurred in the U.S. during the Great Depression. But the performance of the U.S. economy during the 19th century, as well as a number of international experiences, reminded us that solid economic expansion and deflation can co-exist. Once again, economic theory offered an explanation: If productivity growth remains healthy, investment projects can earn large positive real rates of return even if prices are falling, and hence there is no threat of a default cycle.

However, economic theory also reminded us that deflation could pose a special problem for monetary policy. Nominal interest rates cannot go below zero because no one will lend funds without receiving some positive return. If the economy is weak, then businesses may not be able to generate large real returns to investment. And the lower the inflation rate, the smaller the inflation premium built into nominal interest rates. So deflation raises the likelihood that nominal short-term interest rates could fall to zero during some period when the central bank would like to lower interest rates to stimulate a sluggish economy. Given the weakness in the real economy in late 2002 and early 2003, the FOMC took seriously the issue of nominal interest rates falling to zero. In fact, Fed researchers investigated various alternative means for providing monetary stimulus in the event that short-term interest rates hit zero.

Our response to the deflation, or “unwelcomed disinflation,” threat was to lower the nominal federal funds target to 1 percent, a very low level by historical standards. As we moved into the second half of 2003, output growth recovered smartly, labor markets firmed, and inflation moved up from its very low levels without the Fed having to undertake any unusual alternative financial market interventions. However, we took one important additional step: Starting in August, 2003, we communicated our willingness to keep the funds rate low for a “considerable period” and continued using that phrase in FOMC statements for the next several meetings. This communication, and our later statement that the FOMC could “be patient in removing its policy accommodation,” may have produced some added stimulus to the economy by helping keep medium-term interest rates lower than they otherwise would have been.

The 2003 deflation risk served another important role: It sharpened our thinking about the conduct of monetary policy when the economy is operating in the neighborhood of price stability. We were not worrying about deflation as part of policy discussions when I joined the Fed, but given the defeat of high inflation, it is now an important consideration in the discussion of how best to pursue monetary policy.

BANK SUPERVISION AND REGULATION

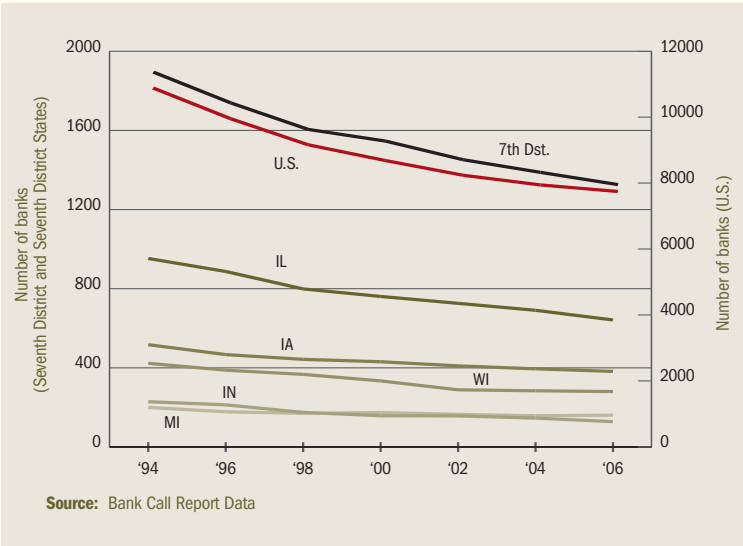
The structure of the banking industry and approaches to bank supervision have changed dramatically during my tenure at the Chicago Fed. Banks have become larger and more complex, and banking risks have become more diverse and dynamic. Bank risk management has become more complicated and sophisticated, and so bank supervision, like monetary policy, has required new approaches and new ways of thinking to remain effective.

INDUSTRY STRUCTURE The U.S. has historically been unique in the structure of its banking industry. By almost any measure — number of banks, banks per capita, or banks per square mile — the U.S. has been more “banked” than any other country in the world. This has been the result, in part, of the geography and demographics of the U.S., characterized by many lightly populated rural areas, each having at least one bank. Another major force was the set of restrictions imposed on geographic expansion. Since the 1920s, the expansion of banking and branching had been left to the states to determine, and a number of them, particularly in the Midwest, opted to restrict expansion significantly. This resulted in the proliferation of single-office banks providing banking services in local communities.

With the advances in information technology (particularly computer systems), credit databases, and risk-management techniques, these geographic legal limitations became highly restrictive in the 1970s and 1980s. Policy makers increasingly realized that broader geographic expansion could create potential efficiency gains for banks and consumers. As a result, the restrictions began to be lifted, first within state boundaries as branching laws were liberalized, then across state borders via regional compacts between states. Finally, shortly after I joined the Fed, the Riegle-Neal Interstate Banking and Branching Efficiency Act was passed, beginning a process of much broader interstate expansion. Thus, geographic deregulation initiated a significant shift in the landscape of U.S. banking.

The chart above shows the change in the number of banks in the U.S. over the last 13 years, while the chart on the next page shows the change in the number of bank branches. Nationally, the number of banks decreased nearly 29%. Most closed as the result of unassisted mergers and acquisitions rather than failures. This stands in stark contrast to the late 1980s, when failures averaged about 400 per year. Distributed by size, a large majority of the decline occurred among community banks (banks with less than \$1 billion in assets).

In the Seventh Federal Reserve District, the trend has been somewhat similar, though the declines in Illinois, Indiana, and Wisconsin have slightly exceeded the national trends. This is, in part, because each of these states was relatively late in relaxing its geographic restrictions.



Total number of banks in U.S., Seventh District and Seventh District States

While the number of banks in most areas declined over this time period, the number of branches serving bank customers significantly increased, by over 16% nationally. This contrast has been most obvious in Illinois, where the number of banks has declined by more than 32%, but the number of branches has increased by more than 43%. Many students of the industry predicted these changes, as Illinois had one of the most restrictive state banking laws regulating geographic expansion.

Of course, the passage of Riegle-Neal and the liberalization of state branching laws were not the only major developments affecting the structure of the banking industry. The Gramm-Leach-Bliley Act of 1999 removed most of the long-standing restrictions against affiliations between commercial banks and investment banks imposed by the Glass-Steagall Act in 1933. The act allowed for the creation of financial holding companies, which are now permitted to engage in a full range of financial activities, such as securities underwriting and dealing, insurance underwriting and selling, and merchant banking, through holding-company affiliates of commercial banks. This is as long as the commercial banks

are sufficiently capitalized and meet other qualifications. Though the individual affiliate activities are regulated by the appropriate functional regulator (such as the SEC, state insurance authorities, and the federal banking agencies), the Federal Reserve serves as the “umbrella supervisor” for the financial holding company.

CHALLENGES FOR COMMUNITY BANKING With these changes in the banking landscape, some have questioned the future viability of community banks. The concern is that the

very nature of the industry has changed so significantly that small community banks will no longer be able to compete with large money-center or regional banks.

Essentially, two different banking models have evolved in the U.S. Larger banks emphasize a low-margin, commodity-based production process using state-of-the-art information technologies, including scoring models and standardized processes. The emphasis is on the processing of easily quantifiable “hard information,” so the most viable competitors in this market will be the banks that do this most efficiently.

Community banks take a different approach that stresses relationship banking. This is typically a higher-cost, higher-margin process that emphasizes the relationship with customers and the processing of less-quantifiable “soft information,” such as management quality and strength of character. The most viable organizations in this model are the banks that can most efficiently extract and interpret this soft information.

Looking at the production process in this manner explains why some have questioned the viability of community banks. As technology has improved, more information can be collected and processed in a hard-information, commodity-like manner. For example, scoring models are now relatively common for small business loans, a category once thought to be the model for relationship banking. Similarly, research has shown that proximity to the customer is becoming less important than it had been in the past. This allows banks based outside of the local market to better compete in markets once dominated by local community banks.

Nevertheless, community banks continue to play an integral role in financial markets. They comprise over 90% of the total number of banks, a number essentially unchanged since 1985. While their total deposit and asset shares declined somewhat during the recent consolidation trend, community banks continue to have a relatively stable share of business real estate lending and a disproportionate share of small business loans and agricultural loans. Community banks appear to be able to compete in the new deregulated environment using the “relationship” model; however, it clearly is more difficult than it was in the past. The efficient community bank, which is capable of providing value by processing soft information, simply has to work harder to succeed given the removal of protective entry barriers and the corresponding increase in competition.

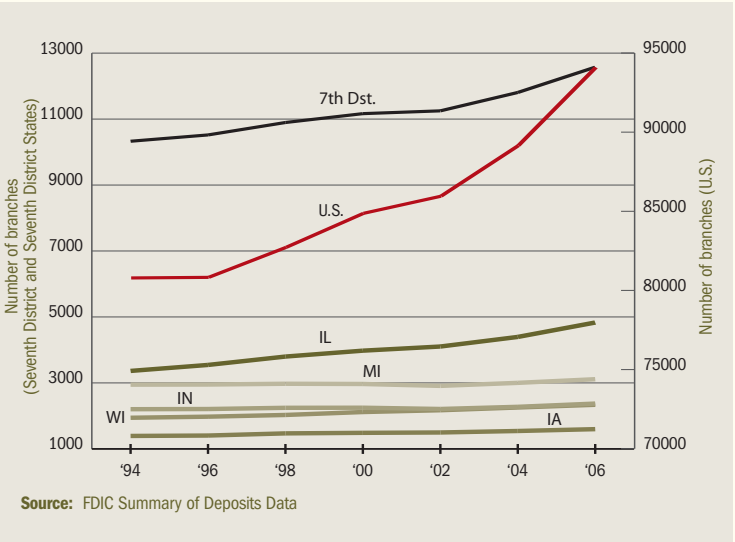
RISK MANAGEMENT Whether in community banks, regional institutions, or large, complex financial institutions, the changes in the banking industry have coincided with significant changes in the banking industry’s risk profile. Traditional credit and interest rate risks, and, increasingly, operational and compliance risks, have been rapidly evolving. Accordingly, banks have worked to improve their risk management capabilities. In response, the Federal Reserve’s supervision programs have developed to become more risk focused and institution specific.

Risk management at banking organizations has evolved significantly and rapidly, becoming a core function at banks. Market developments have largely driven these changes, but bank supervisors have also played an important role. For example, until the early 1990s, credit risk was generally managed on a loan-by-loan basis, and banks kept most loans on their books until maturity. Now banks can actively manage the credit risk of their loan portfolios as a whole, continually adjusting it through a wide array of techniques, such as loan trading, securitization, and the use of credit derivatives.

The management of market (interest rate) risk shows similar trends. Banks used to manage market risk through simple position limits and rather basic duration “gap” analysis, slotting assets and liabilities into various re-pricing categories. Financial engineering and advances in information technology now allow banks of all sizes to manage market risk more effectively using a variety of concepts and techniques.

With operational risk, banks are not as far along the learning curve. They have always had tools to reduce operational risk, such as business-line controls, audit programs, and insurance protection. However, in light of the growing number and complexity of operational risks, banks are now beginning to manage these risks in a more systematic way. Further, many banking organizations are developing “enterprise” risk management programs to ensure that they have a holistic view of risks across divisions and risk categories.

Responding to the increasingly complex and dynamic nature of risk and the changes in industry structure, banking supervisors began developing a new supervisory framework in the mid-1990s. Historically, bank examinations were largely standardized. They relied heavily on historical data and involved extensive account verification and review of individual loan files on site — what is known in



Total number of bank branches in U.S., Seventh District and Seventh District States



Community banks take a different approach that stresses relationship banking.

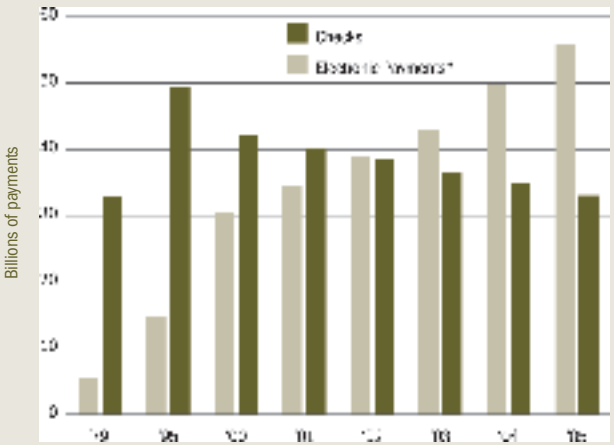
the industry as “transaction testing.” In contrast, the new risk-focused supervisory framework involves directing examination resources toward the areas of greatest risk at each bank. As a result, off-site risk assessment and examination planning are critical. Risk-focused supervision also is more forward-looking than the old approach, focusing on the management practices and controls banks use (such as board oversight, policies and procedures, and management information systems) to deal with current and future risks. Transaction testing has assumed a lesser role, though it is still important in determining the effectiveness of policies and the integrity of banks’ internal credit ratings.

PAYMENT SYSTEM

There have been many important milestones in the movement from paper checks to electronic payments in the past 13 years. This is particularly notable since payment habits typically change slowly, especially when existing instruments perform well and remain highly convenient. But ultimately,

changing cost structures affect what payment networks offer and what the public uses. This evolution has again required new approaches by the Federal Reserve in its role in the payment system.

As in many other industrialized countries, the U.S. continues to shift to electronic payments. For society, the benefits of the shift should be substantial, since the marginal cost of adding one more transaction into an electronic payment network is almost always considerably less than it would be in a paper-based network. However, the shift is not easy because the methods of handling paper have been refined



Source: Bank for International Settlements
*Electronic payments include retail ACH and card payments.

over centuries, and the fixed costs of automating transactions are seldom minor. Therefore, when a tipping point eventually is reached, the switch-over period from paper to electronic can be rapid.

CHECK OPERATIONS Estimated total paper check usage in the U.S. finally began to decline shortly after I began at the Chicago Fed. By 2003, estimated electronic payment transactions in the United States exceeded check payments.

The downward trajectory for checks reflects the introduction and expansion of a number of technologies. One example is debit cards. While debit cards were introduced initially in the 1970s to dispense cash from ATM machines, debit transactions at the checkout register have soared over the last ten years, displacing a considerable number of checks. Another example is check truncation, which involves converting checks into substitute checks or electronic signals at lock boxes (for the payment of bills), at the point of service, or in the back office.

The explosive growth of the Internet since 1994, and its important role in changing the character of both banking and commerce, also has been an important factor. Households increasingly choose to purchase goods and services online using existing card and automated clearinghouse (ACH) networks.¹ New payment processors such as PayPal entered the marketplace to service the ballooning online auction business. After a faltering start, online banking finally took hold and began to reduce dramatically the number of checks written by households. Beyond households, however, business-to-business

transactions were much slower to transition to electronic platforms, largely because of the greater information needs of firms and the inherent difficulties in integrating payments with enterprise resource-planning systems.

To gain widespread acceptance, successful payment innovations have to benefit a host of parties, such as payment processors, banks, households, and businesses. When payment networks grow sufficiently, scale economies lower operating costs, and the technology suddenly becomes profitable in new venues. Merchants become more willing to accept plastic in lieu of cash or checks in part because of falling real costs of placing PIN pads at the checkout. These developments engendered a cultural shift, which transformed many previously cash-only locations. As a result, many new vendors began to accept plastic, most notably taxicabs, coffee shops, doctor’s offices, fast-food restaurants, grocery stores, utilities, and mass transit facilities.

As the use of checks declined, the Federal Reserve closed more than half of its 45 check-processing sites, including offices in Milwaukee, Indianapolis, and Peoria, Ill. in the Seventh District. We also consolidated other payment services, such as ACH and FedWire.² To lower operational costs, the Chicago Fed moved its check-processing operation from its downtown headquarters to a more strategic location near Midway Airport. We established a payments team to produce high-quality research, foster dialogue with the payments industry, and provide valuable insights on System payment initiatives. Finally, the Customer Relations and Support Office was established and headquartered at the Chicago Fed to strengthen Federal Reserve System contacts with commercial banks and to develop modern software, such as FedLine Advantage, for banks to access various Federal Reserve financial services.

Along similar lines, the Federal Reserve took the initiative to improve the efficiency of check processing by proposing and supporting the passage of the Check Clearing for the 21st Century Act, or Check 21, which allows for the substitution of image-replacement documents in the clearing and settlement of checks. The law went into effect on October 28, 2004. Check 21 is designed to foster innovation in the payments system and enhance its efficiency by reducing some of the legal impediments to check truncation. The law facilitates check truncation by creating a new negotiable instrument called a substitute check, which permits banks to truncate original checks, process check information electronically, and deliver substitute checks to banks that want to continue receiving paper checks. A substitute check is the legal equivalent of the original check and includes all of the information contained on the original check. The law does not require banks to accept checks in electronic form, nor does it require banks to create substitute checks, but it is an important step toward greater use of electronic payments.

CASH OPERATIONS In comparison to the switch-over from check to electronic payments, the substitution of electronic payments for cash appears to be more challenging and is moving slowly.



U.S. payments volume in billions of payments per year

Merchants increasingly have become more willing to accept plastic in place of cash or checks.

General-purpose stored-value card trials in the U.S. at the Atlanta Olympics in 1996 and in Manhattan a year later did very little to convince consumers and merchants of their value. Rather, stored-value products have been successful only in relatively limited situations: gift cards, payroll cards, various government benefits, mass transportation, and on university campuses.

Cash itself has undergone several facelifts in the last decade or so. Along with the Federal Reserve, the U.S. Treasury continued to improve the counterfeiting deterrence capabilities of U.S. bank notes. The list of improvements includes adding color to some notes, an enlarged off-center portrait, a watermark, fine-line printing patterns, and color-shifting ink. The counterfeiting threat has global implications because, in value terms at least, half of U.S. banknotes continue to be held outside the United States, particularly as a store of value in several economies with underdeveloped banking systems.

Moving forward, the Federal Reserve must continue to play an important role in fostering a smoothly functioning payments system that is safe, efficient, and accessible. Within that framework, continuing to support the shift from paper to electronic payments is good public policy.

LESSONS LEARNED AND THE FED OF THE FUTURE

I have discussed a number of unique challenges in the macroeconomy and banking and financial systems the Fed faced since 1994. Using these experiences as a guide, I believe we can reasonably anticipate a number of developments in the future.

CHALLENGES AHEAD Macroeconomic and financial challenges will undoubtedly continue to emerge. Some of these challenges will be similar to events the U.S. economy has experienced in the past. Others will be new and unique. Many of these new challenges likely will stem from the increasing technological sophistication and complexity of the real economy and of the financial system; others will come from the progressive influence of globalization on trade and international financial flows. All will continue to test the best thinking of the Federal Reserve.

For policy to respond successfully to them, we will need to keep in mind the principles of sound policy-making I previously discussed: Study a wide range of data. Analyze problems using cogent economic theory. Respect the risks of undesirable outcomes for growth and inflation. And remain flexible in thinking about changes in the economy and the ways policy should react to them.

The Federal Reserve also has the responsibility of explaining our actions to the public. Over the past decade, we have seen a move from central bank secrecy to central bank transparency, a change that reflects a growing appreciation of the enhanced policy credibility and reduced economic uncertainty that accompany public understanding of the goals and rationales underlying monetary policy decisions. I consider this movement toward greater transparency a very positive development and expect it to continue.

EVOLUTION OF BANKING INDUSTRY The structure of the U.S. banking industry is likely to continue to evolve toward one in which a small number of large, complex banking organizations compete globally with the world's largest financial institutions while a large number of smaller institutions focus on local communities or somewhat larger regional areas. Banks will continue to expand their product lines across the spectrum of financial activities, and other financial institutions will increasingly offer traditional banking services. Technological advances will facilitate increasingly sophisticated banking products and services. At the same time, the implementation of the Basel II Capital Accord in the U.S. will spur further development of risk management practices of financial institutions.

The evolution of the banking industry will require the Federal Reserve to continue to improve its supervision techniques, tailoring them to the needs and challenges posed by the different types of banking institutions. At the core of our supervisory responsibilities will be the Federal Reserve's ability to identify and understand the swiftly changing risks and risk management practices of banking organizations. To carry out their supervisory tasks, the Reserve Banks must continue to improve their capacity to evaluate the quality of these risk management practices. To obtain a complete picture of industry risks and risk

management practices, we will need to continue to share insights across Districts and with other regulators, both domestic and foreign.

PAYMENT SYSTEM The migration of U.S. retail payments to electronics will continue to accelerate. Payment system developments will require the Fed to continue to adapt to lower demand for paper-based processing services and higher demand for electronic payment services.

To accomplish this, Reserve Banks are unlikely to remain full-service providers of retail payment services indefinitely. The Reserve Banks will continue encouraging greater use of electronics in the check-collection process as well as offering an array of products and services to take advantage of the opportunities provided by the Check 21 Act. At the same time, there will be an ongoing focus on customers, service levels, and fees, and on cost efficiency in both retail services and Reserve Bank support functions.

The Reserve Banks also will continue to contribute to the formulation of payment system policy, particularly with respect to payment system risk issues. In doing so, they will further strengthen their outreach to financial markets, both domestic and abroad, by enhancing the Fed's role in promoting financial stability, effective crisis management, and the formulation of standards. Ultimately, the Federal Reserve's role in helping to shape the development of our nation's payment system will continue to be informed by its unique role as a public policy-making institution and payments provider.

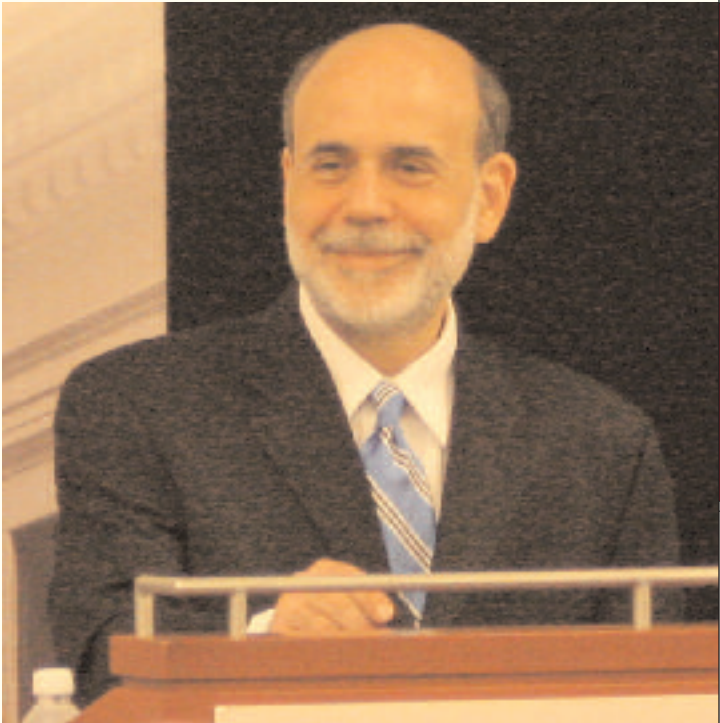
INCORPORATING BEST PRACTICES

I would note that, in many ways, the Federal Reserve System has already made great strides to prepare for these future challenges in the economy,

banking and payments system. Across its responsibilities, the Federal Reserve has adopted industry best practices, managed its responsibilities holistically, and worked to retain and build upon its distinctive strengths. These attributes are likely to sustain the central bank in the years to come.

The Federal Reserve will continue to adopt and incorporate best practices from the industry and elsewhere to ensure the highest levels of integrity and excellence. In 2006, the Federal Reserve voluntarily chose to meet the rigorous requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (SOX). Like publicly held organizations, through SOX, the Fed strengthened its focus on its system of internal controls over financial reporting and the effective management of risks. For similar reasons, the Federal Reserve System has bolstered its governance structure through service agreements between Reserve Banks, performance metrics, and other mechanisms that enhance the clarity of authority and accountability.

Across the System, Federal Reserve Banks increasingly strive to provide a common face to customers and stakeholders. Responding to changes in the payments system, the System consolidated a number of business and support functions such as payments processing locations (notably in the paper check



Federal Reserve Board Chairman Ben Bernanke, shown here at the Chicago Fed, succeeded Alan Greenspan in 2006.

infrastructure), statistical reporting functions, marketing and some sales activities, and information technology support and infrastructure. The System also further coordinated its activities in supervising financial institutions. At the same time, we improved the coordination and collaboration between Reserve Banks, the Board of Governors, and other entities. These moves improve the efficiency and effectiveness of our payments products and central bank responsibilities, and ensure we deliver more seamless interaction and services to customers and stakeholders.

OUR REGIONAL STRUCTURE In the midst of tremendous change in the economy and banking and financial systems, the Federal Reserve has been vigilant to retain and build upon a unique attribute and strength — its regional structure and character. Given population shifts in the U.S. since 1913, we would probably implement the geographic structure of Reserve Banks differently if we were to create the Federal Reserve System from scratch today. However, this structure makes our central bank a uniquely American institution, reflecting the importance that we as a society place on local representation, independence, and transparency. It also contributes greatly to the monetary policy-making process.

The 12 regional banks, and their independent Boards of Directors, give the Fed ready access to information from all parts of the country and all sectors of the economy. And the fact that all District Bank presidents serve on the FOMC — and have access to high-quality research performed by their own independent staffs — assures that a variety of voices are heard in the policy-making function. While it is perhaps most notable in the core responsibility of monetary policy, the presence of the Federal Reserve’s regional character helps to inform nearly all aspects of our responsibilities as a central bank, allowing us to bring new insights and ideas to bear on unforeseen problems.

Given these attributes, I remain confident in the ability of the Federal Reserve Banks and the Federal Reserve System to adapt in the face of challenges that lie ahead. In my experience, a hallmark of the Federal Reserve has been and will continue to be the level of commitment and talent associated with the people who make up the institution. At the risk of making a bold prediction, that will never change. As long as we retain these qualities, the System will remain the world’s preeminent central bank.

Federal Reserve Bank of Chicago Research Department Vice Presidents Spencer Krane, Douglas Evanoff and Richard Porter contributed to the development of this essay, as did Supervision & Regulation Senior Vice President Cathy Lemieux and Senior Examiner Steven Van Bever as well as Enterprise Risk Management Assistant Vice President Nate Wuerffel.

Notes:

¹ An ACH network is an electronic clearing and settlement system for exchanging electronic transactions among participating depository institutions. Such electronic transactions are substitutes for paper checks and are typically used to make recurring payments such as payroll or loan payments. The Federal Reserve Banks operate an ACH, as do some private sector firms.

² Fedwire is an electronic funds transfer network operated by the Federal Reserve. Fedwire is usually used to transfer large amounts of funds and U.S. government securities from one institution’s account at the Federal Reserve to another institution’s account. It is also used by the U.S. Department of the Treasury and other federal agencies to collect and disburse funds.



CHAIRMAN
MILES D. WHITE
Chairman and
Chief Executive Officer
Abbott
Abbott Park, Illinois



DEPUTY CHAIRMAN
JOHN A. CANNING, JR.
Chairman and
Chief Executive Officer
Madison Dearborn
Partners, LLC
Chicago, Illinois



MARK T. GAFFNEY
President
Michigan AFL-CIO
Lansing, Michigan



VALERIE B. JARRETT*
President and
Chief Executive Officer
The Habitat Company
Chicago, Illinois



MICHAEL L. KUBACKI
Chairman, President and
Chief Executive Officer
Lake City Bank and
Lakeland Financial Corp.
Warsaw, Indiana



MINDY C. MEADS**
Former President and
Chief Executive Officer
Lands’ End, Inc.
Dodgeville, Wisconsin



WILLIAM A. OSBORN
Chairman and
Chief Executive Officer
Northern Trust Corp. and
The Northern Trust Co.
Chicago, Illinois



JEFF PLAGGE
Chairman,
Chief Executive Officer
and President
Midwest Heritage Bank
Clive, Iowa



W. JAMES FARRELL
Retired Chairman and
Chief Executive Officer
Illinois Tool Works, Inc.
Glenview, Illinois



THREE NEW DIRECTORS JOINED THE CHICAGO BOARD IN 2007:

WILLIAM C. FOOTE, (left) Chairman and Chief Executive Officer of USG Corporation in Chicago, Illinois, replaced James Farrell, who completed his service on the board at the end of 2006.

DENNIS J. KUESTER, Chairman and Chief Executive Officer of Marshall & Ilsley Corporation in Milwaukee, Wisconsin, replaced William Osborn, who completed his service on the board at the end of 2006.

ANN D. MURTLow, President and Chief Executive Officer of Indianapolis Power and Light Company in Indianapolis, Indiana, and Vice President, AES Corporation, replaced Mindy Meads.

**Valerie Jarrett resigned from the Board of Directors in April of 2007.
**Mindy Meads resigned from the Board of Directors in July of 2006.*



CHAIRMAN
ROGER A. GREGG
Chairman, President and
Executive Vice President and
Chief Financial Officer
Pulte Homes, Inc.
Bloomfield Hills, Michigan



RALPH W. BABB, JR.
Chairman, President and
Chief Executive Officer
Comerica, Inc.
Detroit, Michigan



LINDA S. LIKELY
Director of Housing and
Community Development
Kent County Community
Development Department
and Housing Commission
Grand Rapids, Michigan



MICHAEL M. MAGEE, JR.
President and
Chief Executive Officer
Independent Bank Corp.
Ionia, Michigan



TIMOTHY M. MANGANELLO
Chairman and
Chief Executive Officer
BorgWarner, Inc.
Auburn Hills, Michigan



IRVIN D. REID
President
Wayne State University
Detroit, Michigan



TOMMI A. WHITE
Chief Executive Officer
ER-One, Inc.
Livonia, Michigan

ADVISORY COUNCILS

FEDERAL ADVISORY
COUNCIL SEVENTH
DISTRICT
REPRESENTATIVE

DENNIS J. KUESTER
Marshall & Ilsley Corporation
Milwaukee, Wisconsin

SEVENTH DISTRICT
ADVISORY COUNCIL

Illinois
MARGARET BLACKSHERE
AFL-CIO of Illinois
Chicago, Illinois

JEFF MARTIN
Bluestem Farm
Mt. Pulaski, Illinois

JIM McCONOUGHNEY
Heartland Partnership
Peoria, Illinois

ALEJANDRO SILVA
Evans Food Group Ltd.
Chicago, Illinois

Indiana
JOHN D. HARDIN, JR.
Hardin Farms
Danville, Indiana

GRANT M. MONAHAN
Indiana Retail Council
Indianapolis, Indiana

Iowa
MARY ANDRINGA
Vermeer Manufacturing Co.
Pella, Iowa

LESLIE SMITH MILLER
Iowa State Savings Bank
Knoxville, Iowa

GARY WELLS
Wells' Dairy, Inc.
LeMars, Iowa

Michigan
CARL T. CAMDEN
Kelly Services, Inc.
Troy, Michigan

CLARENCE NIXON, JR.
CNC Group
Detroit, Michigan

DONALD SNIDER
Paper - Plas Corporation
Detroit, Michigan

Wisconsin
WILLIAM BECKETT
CHRYSPAC
Milwaukee, Wisconsin

ROBERT MARIANO
Roundy's Supermarkets, Inc.
Milwaukee, Wisconsin

DAVID NEWBY
Wisconsin State AFL-CIO
Milwaukee, Wisconsin

The following individuals have served as directors during Michael Moskow's presidency.

BOARD OF DIRECTORS OF THE
FEDERAL RESERVE BANK OF CHICAGO

Class A Directors	Class B Directors	Class C Directors
DAVID W. FOX 1/1/91 - 12/31/97	A. CHARLENE SULLIVAN 1/1/91 - 12/31/96	RICHARD G. CLINE* 1/1/90 - 12/31/95
STEFAN S. ANDERSON 1/1/92 - 12/31/98	THOMAS C. DORR 1/1/92 - 12/31/97	ROBERT M. HEALEY* 1/23/91 - 12/31/96
ARNOLD C. SCHULTZ 1/1/93 - 12/31/99	DONALD J. SCHNEIDER 1/1/93 - 12/31/98	DUANE L. BURNHAM 2/11/92 - 12/31/94
VERNE G. ISTOCK 1/1/97 - 12/31/01	MIGDALIA RIVERA 1/1/97 - 12/31/99	LESTER H. MCKEEVER* 1/1/95 - 12/31/00
ROBERT R. YOHANAN 1/1/98 - 12/31/03	JACK B. EVANS 1/1/98 - 12/31/03	ARTHUR C. MARTINEZ* 2/22/96 - 3/29/02
ALAN R. TUBBS 1/1/99 - 12/31/04	JAMES H. KEYES 1/1/99 - 12/31/04	ROBERT J. DARNALL* 1/1/97 - 12/31/03
WILLIAM A. OSBORN 1/1/01 - 12/31/06	CONNIE E. EVANS 1/1/00 - 12/31/05	W. JAMES FARRELL* 1/1/01 - 12/31/06
MICHAEL L. KUBACKI 1/1/04 - Present	MARK T. GAFFNEY 1/1/04 - PRESENT	MILES D. WHITE* 4/1/02 - Present
JEFF PLAGGE 1/1/05 - Present	MINDY C. MEADS 1/1/05 - 7/31/06	JOHN A. CANNING, JR.** 1/1/04 - Present
DENNIS J. KUESTER 1/1/07 - Present	VALERIE B. JARRETT 1/1/06 - 4/10/07	WILLIAM C. FOOTE 1/1/07 - Present
	ANN D. MURFLOW 1/1/07 - PRESENT	

* Served as both Chairman and Deputy Chairman
** Currently serving as Deputy Chairman

BOARD OF DIRECTORS OF THE DETROIT BRANCH
OF THE FEDERAL RESERVE BANK OF CHICAGO

J. MICHAEL MOORE ¹ 1/1/90 - 12/31/95	TIMOTHY D. LEULIETTE ¹ 11/5/96 - 12/31/03	LINDA S. LIKELY 1/1/04 - Present
NORMAN F. RODGERS 1/1/90 - 12/31/95	IRMA B. ELDER 1/1/97 - 12/31/02	ROGER A. CREGG ¹ 1/1/04 - Present
CHARLES E. ALLEN 1/1/91 - 12/31/96	DENISE ILITCH LITES 1/1/97 - 12/31/99	RALPH W. BABB 1/1/04 - Present
WILLIAM E. ODOM 1/1/91 - 12/31/96	DAVID J. WAGNER 1/1/98 - 12/31/03	MICHAEL M. MAGEE, JR. 1/1/05 - Present
JOHN D. FORSYTH ¹ 1/1/92 - 7/22/96	EDSEL B. FORD II ¹ 1/1/00 - 12/31/05	TIMOTHY M. MANGANELLO ¹ 1/1/06 - Present
FLORINE MARK ¹ 1/1/94 - 12/31/99	MARK T. GAFFNEY 7/27/00 - 12/31/03	
CHARLES R. WEEKS 1/1/94 - 12/31/97	ROBERT E. CHURCHILL 1/1/02 - 12/31/04	
STEPHEN R. POLK 1/1/96 - 12/31/01	IRVIN D. REID 1/1/02 - Present	
RICHARD M. BELL 1/1/96 - 12/31/01	TOMMI A. WHITE 1/1/03 - Present	

¹Served as Chairman of the Detroit Branch

Class A directors are bankers elected by bankers.
Class B directors are non-bankers elected by bankers.
Class C directors are non-bankers appointed by the
Federal Reserve Board of Governors.



MICHAEL H. MOSKOW
President and
Chief Executive Officer



GORDON WERKEMA
First Vice President and
Chief Operating Officer



WILLIAM A. BAROUSKI
Senior Vice President
Customer Relations and
Support Office (CRSO)
and Information Technology



BARBARA D. BENSON
Senior Vice President
Strategy, and People
Practices



CHARLES L. EVANS
Senior Vice President and
Director of Research



GLENN C. HANSEN
Senior Vice President
Detroit Branch,
Office of the Directors and
Corporate Communications



ELIZABETH A. KNOSPE
Senior Vice President,
General Counsel,
Enterprise Risk Management,
Business Continuity, and
Law Enforcement



MARGARET K. KOENIGS
Vice President
and General Auditor



CATHARINE LEMIEUX
Senior Vice President
Supervision and Regulation



DAVID MARSHALL
Senior Vice President
Financial Markets and
Risk Management



ANGELA D. ROBINSON
Senior Vice President
and EEO Officer
Central Bank Services,
Financial Management,
and Administration



ROBERT G. WILEY
Senior Vice President
Financial Services Group
(Cash and Check
Operations)

As of December 31, 2006

MICHAEL H. MOSKOW
President and
Chief Executive Officer

GORDON WERKEMA
First Vice President and
Chief Operating Officer

**ECONOMIC RESEARCH
AND PROGRAMS**

CHARLES L. EVANS
Senior Vice President and
Director of Research

Regional Economics
WILLIAM A. TESTA
Vice President and
Economic Advisor

Banking and Financial Markets
DOUGLAS D. EVANOFF
Vice President and
Economic Advisor

Macroeconomic Policy Research
SPENCER D. KRANE
Vice President and
Economic Advisor

Macroeconomic Policy Research
DANIEL G. SULLIVAN
Vice President and
Economic Advisor

Payments Studies
RICHARD D. PORTER
Vice President

Consumer and Community Affairs
ALICIA WILLIAMS
Vice President

**FINANCIAL MARKETS AND
RISK MANAGEMENT**

DAVID MARSHALL
Senior Vice President

ADRIAN D' SILVA
Vice President

**SUPERVISION AND
REGULATION**

CATHARINE LEMIEUX
Senior Vice President

Operations
DOUGLAS J. KASL
Vice President

Institutions
MARK H. KAWA
Vice President

Risk Specialists
RICHARD C. CAHILL
Vice President

**CUSTOMER RELATIONS
AND SUPPORT OFFICE
(CRSO) AND TECHNOLOGY**

WILLIAM A. BAROUSKI
Senior Vice President

Fedline Services
ELLEN J. BROMAGEN
Vice President and
Program Director

*National Marketing and
Communications*
LAURA J. HUGHES
Vice President and
Program Director

National Sales
SEAN RODRIGUEZ
Vice President and
Program Director

MICHAEL J. HOPPE
Vice President and National
Account Manager

Information Technology
IRA R. ZILIST
Vice President

**FINANCIAL SERVICES
GROUP CHECK AND CASH
OPERATIONS**

ROBERT G. WILEY
Senior Vice President

BRIAN EGAN
Vice President
(Dedicated to the Retail
Payments Office)

CYNTHIA L. RASCHE
Vice President
(Dedicated to the Retail
Payments Office)

MARY H. SHERBURNE
Vice President,
Business Development

JEROME D. NICOLAS
Vice President, Cash Operations

**DETROIT BRANCH, OFFICE
OF THE DIRECTORS,
CORPORATE
COMMUNICATIONS**

GLENN C. HANSEN
Senior Vice President

Corporate Communications
G. DOUGLAS TILLET
Vice President

**CENTRAL BANK SERVICES,
FINANCIAL MANAGEMENT,
AND ADMINISTRATION**

ANGELA D. ROBINSON
Senior Vice President
and EEO Officer

Central Bank Services
VALERIE J. VAN METER
Vice President

Financial Management
JEFFREY MARCUS
Vice President and Controller

GERALD J. NICK
Vice President and Controller

JEFFERY S. ANDERSON
Vice President,
Budget Reporting

Administrative Services
KRISTI L. ZIMMERMANN
Vice President

**STRATEGY AND PEOPLE
PRACTICES**

BARBARA D. BENSON
Senior Vice President

**LEGAL RELATIONS,
ENTERPRISE RISK
MANAGEMENT, & BUSINESS
CONTINUITY**

ELIZABETH A. KNOSPE
Senior Vice President and
General Counsel

YURII SKORIN
Vice President and
Associate General Counsel

KATHY H. SCHREPFER
Vice President, Associate General
Counsel, and Ethics Officer

ANNA M. VOYTOVICH
Vice President and
Associate General Counsel

**OFFICE OF THE GENERAL
AUDITOR**

MARGARET K. KOENIGS
Vice President and
General Auditor

As of December 31, 2006

DIRECTORS

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

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

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

Director appointments and elections at the Chicago Reserve Bank and its Detroit Branch effective in 2006 were:

- Miles D. White was appointed to a one-year term as Chicago board chairman
- John A. Canning, Jr. was re-appointed to a three-year term as Chicago director and appointed to a one-year term as Chicago board deputy chairman
- Roger A. Cregg appointed to a one-year term as Detroit Branch chairman
- William A. Osborn re-elected to serve another year as Chicago director
- Linda S. Likely re-appointed to serve a three-year term as Detroit Branch director
- Tommi A. White re-appointed to serve a second three-year term as Detroit Branch director
- Valerie B. Jarrett was elected to a three-year term as a Chicago director
- Timothy M. Manganello was appointed to a three-year term as a Detroit Branch director

At the end of 2006 the following appointments and elections beginning in 2007 were announced:

- Miles D. White was re-appointed to a one-year term as Chicago board chairman
- John A. Canning, Jr. was re-appointed to a one-year term as Chicago board deputy chairman
- Roger A. Cregg was re-appointed to the Detroit board through 2008
- William C. Foote was appointed to a thee-year term on the Chicago board through 2009

- Dennis J. Kuester was elected to a two-year term on the Chicago board through 2008
- Timothy M. Manganello was appointed to a one-year term as chairman of the Detroit Branch board
- Ann D. Murtlow was elected to a one-year term on the Chicago board

ADVISORY COUNCILS

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

Each year the Chicago Reserve Bank’s board of directors selects a representative to this group. William A. Downe, President and Chief Executive Officer of BMO Financial Group, Chicago, Illinois was selected to be the 2007 representative.

The Seventh District Advisory Council members meet twice a year to provide their views on current business conditions to Chicago Fed President Michael Moskow and other senior officials of the Bank. Input from Council members on regional economic conditions helps contribute to the Federal Reserve System’s formulation of national monetary policy.

EXECUTIVE OFFICERS

The Bank’s board of directors acted on the following senior vice president promotion during 2006:

- David Marshall to Senior Vice President, Financial Markets and Risk Management
- The Bank’s board of directors acted on the following vice president promotions during 2006:
- Adrian D’Silva to Vice President, Financial Markets and Risk Management
- Jeffrey Marcus to Vice President and Controller
- Kathy H. Schrepfer to Vice President, Legal Relations

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2006 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$4.2 million. To ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2006, the Bank did not engage PwC for any material advisory services.

MANAGEMENT’S REPORT ON INTERNAL CONTROL
OVER FINANCIAL REPORTING

To the Board of Directors of the Federal Reserve Bank of Chicago
March 5, 2007

The management of the Federal Reserve Bank of Chicago (“FRBC”) is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31st, 2006 (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 management judgments and estimates. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the FRBC is responsible for establishing and maintaining effective internal control over financial reporting as it relates to the Financial Statements. Such internal control is designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of the Financial Statements in accordance with the Manual. Internal control contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in internal control are reported to management and appropriate corrective measures are implemented.

Even effective internal control, 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. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The management of the FRBC assessed its internal control over financial reporting 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 the FRBC maintained effective internal control over financial reporting as it relates to the Financial Statements.

Management’s assessment of the effectiveness of the FRBC’s internal control over financial reporting as of December 31, 2006, is being audited by PricewaterhouseCoopers LLP, the independent registered public accounting firm which also is auditing the FRBC’s Financial Statements.

Federal Reserve Bank of Chicago



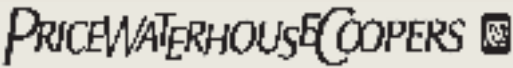
Michael Moskow
President



Gordon Werkema
First Vice President



Gerard J. Nick
Vice President and Controllor



PricewaterhouseCoopers LLP
One North Wacker
Chicago, IL 60606
Telephone (312) 298-2000
Facsimile (312) 298-2001

REPORT OF INDEPENDENT AUDITORS

To the Board of Governors of the Federal
Reserve System and the Board of Directors of the
Federal Reserve Bank of Chicago:

We have completed an integrated audit of the Federal Reserve Bank of Chicago’s 2006 financial statements, and of its internal control over financial reporting as of December 31, 2006 and an audit of its 2005 financial statements in accordance with the generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

FINANCIAL STATEMENTS

We have audited the accompanying statements of condition of the Federal Reserve Bank of Chicago (the “Bank”) as of December 31, 2006 and 2005, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Bank’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 3, these financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of the Federal Reserve System, are set forth in the *Financial Accounting Manual for Federal Reserve Banks* which is 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, 2006 and 2005, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

(continued on page 24)

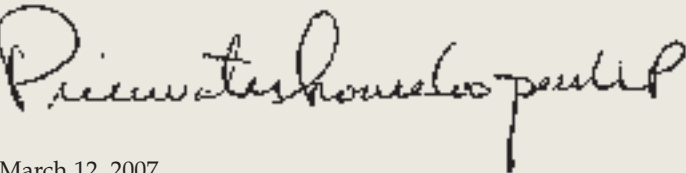
(continued from page 23)

INTERNAL CONTROL OVER FINANCIAL REPORTING

Also, in our opinion, management’s assessment, included in the accompanying Management’s report on Internal Control Over Financial Reporting, that the Bank maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Bank maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Bank’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management’s assessment and on the effectiveness of the Bank’s internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management’s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.



March 12, 2007

2006 FINANCIAL STATEMENTS

STATEMENTS OF CONDITION (in millions)	As of December 31,	2006	2005
Assets			
Gold certificates		\$ 947	\$ 928
Special drawing rights certificates		212	212
Coin		100	76
Items in process of collection		241	414
Loans to depository institutions		24	26
U.S. government securities, net		71,952	67,559
Investments denominated in foreign currencies		1,357	1,228
Accrued interest receivable		617	525
Interdistrict settlement account		-	1,908
Bank premises and equipment, net		241	245
Other assets		29	32
Total Assets		\$ 75,720	\$ 73,153
Liabilities and Capital			
Liabilities:			
Federal Reserve notes outstanding, net		\$ 65,616	\$ 66,524
Securities sold under agreements to repurchase		2,719	2,747
Deposits:			
Depository institutions		1,395	1,590
Other deposits		3	4
Deferred credit items		277	349
Interest on Federal Reserve notes due U.S. Treasury		104	71
Interdistrict settlement account		3,742	-
Accrued benefit costs		122	80
Other liabilities		26	36
Total Liabilities		74,004	71,401
Capital:			
Capital paid-in		858	876
Surplus (including accumulated other comprehensive loss of \$41 million at December 31, 2006)		858	876
Total Capital		1,716	1,752
Total Liabilities and Capital		\$ 75,720	\$ 73,153

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

2006 FINANCIAL STATEMENTS

STATEMENTS OF INCOME (in millions)	For the years ended December 31,	2006	2005
Interest Income:			
Interest on U.S. government securities	\$	3,217	\$ 2,532
Interest on investments denominated in foreign currencies		24	19
Interest on loans to depository institutions		3	2
Total Interest Income		3,244	2,553
Interest Expense:			
Interest expense on securities sold under agreements to repurchase		123	73
Net Interest Income		3,121	2,480
Other Operating (Loss) Income:			
Income from services		55	49
Compensation received for services provided		59	54
Reimbursable services to government agencies		5	5
Foreign currency (losses) gains, net		78	(193)
Other income		11	11
Total Other Operating (Loss) Income		208	(74)
Operating Expenses:			
Salaries and other benefits		142	136
Occupancy expense		24	20
Equipment expense		13	11
Assessments by Board of Governors		71	70
Other expenses		94	87
Total Operating Expenses		344	324
Net Income Prior to Distribution	\$	2,985	\$ 2,082
Distribution of Net Income:			
Dividends paid to member banks	\$	52	\$ 50
Transferred to surplus		23	113
Payments to U.S. Treasury as interest on Federal Reserve notes		2,910	1,919
Total Distribution	\$	2,985	\$ 2,082

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

2006 FINANCIAL STATEMENTS

STATEMENTS OF CHANGES IN CAPITAL (in millions)		For the years ended December 31, 2006 and December 31, 2005			
		Surplus			
	Capital Paid-In	Net Income Retained	Accumulated Other Comprehensive Loss	Total Surplus	Total Capital
Balance at January 1, 2005					
(15 million shares)	\$ 763	\$ 763	\$ -	\$ 763	\$ 1,526
Net change in capital stock issued (2 million shares)	113			-	113
Transferred to surplus	-	113		113	113
Balance at December 31, 2005					
(18 million shares)	\$ 876	\$ 876	\$ -	\$ 876	\$ 1,752
Net change in capital stock redeemed (364 thousand shares)	(18)			-	(18)
Transferred to surplus	-	23		23	23
Adjustment to initially apply FASB Statement No. 158	-		(41)	(41)	(41)
Balance at December 31, 2006					
(17 million shares)	\$ 858	\$ 899	\$ (41)	\$ 858	\$ 1,716

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

NOTES TO FINANCIAL STATEMENTS

1. STRUCTURE

The Federal Reserve Bank of Chicago (“Bank”) is part of the Federal Reserve System (“System”) and one of the twelve Reserve Banks (“Reserve Banks”) created by Congress under the Federal Reserve Act of 1913 (“Federal Reserve Act”), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branch in Detroit, Michigan serve the Seventh Federal Reserve District, which includes Iowa, and portions of Michigan, Illinois, Wisconsin and Indiana.

In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a board of directors. The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors of the Federal Reserve System (“Board of Governors”) to represent the public, and six directors are elected by member banks. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership in the System. 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.

The System also consists, in part, of the Board of Governors and the Federal Open Market Committee (“FOMC”). The Board of Governors, an independent federal agency, is charged by the Federal Reserve Act with a number of specific duties, including general supervision over the Reserve Banks. 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.

2. OPERATIONS AND SERVICES

The Reserve Banks perform a variety of services and operations. Functions include participation in formulating and conducting monetary policy; participation in the payments system, including large-dollar transfers of funds, automated clearinghouse (“ACH”) operations, and check collection; distribution of coin and currency; performance of fiscal agency functions for the U.S. Treasury, certain federal agencies, and other entities; serving as the federal government’s bank; provision of short-term loans to depository institutions; service to the consumer and the community by providing educational materials and information regarding consumer laws; and supervision of bank holding companies, state member banks, and U.S. offices of foreign banking organizations. The Reserve Banks also provide certain services to foreign central banks, governments, and international official institutions.

The FOMC, in the conduct of monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and annually issues authorizations and directives to the FRBNY for its execution of transactions. The FRBNY is authorized and directed by the FOMC to conduct operations in domestic markets, including the direct purchase and sale of U.S. government securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY executes these open market transactions at the direction of the FOMC and holds the resulting securities, with the exception of securities purchased under agreements to resell, 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. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange (“FX”) and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements (“FX swaps”) with two central banks and “warehouse” foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (“ESF”) through the Reserve Banks. In connection with its foreign currency activities, the FRBNY may enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

Although the Reserve Banks are separate legal entities, in the interests of greater efficiency and effectiveness they collaborate in the delivery of certain operations and services. The collaboration takes the form of centralized operations and product or service offices that have responsibility for the delivery of certain services on behalf of the Reserve Banks. Various operational and management models are used and are supported by service agreements between the Reserve Bank providing the service and the other eleven Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, the Reserve Banks are billed for services provided to them by another Reserve Bank.

Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include national business development and customer support.

During 2005, the Federal Reserve Bank of Atlanta (“FRBA”) was assigned the overall responsibility for managing the Reserve Banks’

provision of check services to depository institutions, and, as a result, recognizes total System check revenue on its Statements of Income. Because the other eleven Reserve Banks incur costs to provide check services, a policy was adopted by the Reserve Banks in 2005 that required that the FRBA compensate the other Reserve Banks for costs incurred to provide check services. In 2006 this policy was extended to the ACH services, which are managed by the FRBA, as well as to Fedwire funds transfer and securities transfer services, which are managed by the FRBNY. The FRBA and the FRBNY compensate the other Reserve Banks for the costs incurred to provide these services. This compensation is reported as a component of “Compensation received for services provided”, and the Bank would have reported \$64 million as compensation received for services provided had this policy been in place in 2005 for ACH, Fedwire funds transfer, and securities transfer services.

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 accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and practices that it considers to be appropriate for the nature and function of a central bank, which differ significantly from those of 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 of the Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual and the financial statements have been prepared in accordance with the Financial Accounting Manual.

Differences exist between the accounting principles and practices in the Financial Accounting Manual and generally accepted accounting principles in the United States (“GAAP”), primarily due to the unique nature of the Bank’s powers and responsibilities as part of the nation’s central bank. The primary difference is the presentation of all securities holdings at amortized cost, rather than using the fair value presentation required by GAAP. Amortized cost more appropriately reflects the Bank’s securities holdings given its unique responsibility to conduct monetary policy. While the application of current market prices to the securities holdings 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 Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio may involve transactions that result in gains or losses when holdings are sold prior to maturity. Decisions regarding securities and foreign currency 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 securities and currencies are incidental to the open market operations and do not motivate decisions related to policy or open market activities.

In addition, the Bank has elected not to present a Statement of Cash Flows because the liquidity and cash position of the Bank are not a primary concern given the Bank’s unique powers and responsibilities. A Statement of Cash Flows, therefore, would not provide any

additional meaningful information. Other information regarding the Bank’s activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

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, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Unique accounts and significant accounting policies are explained below.

a. Gold and Special Drawing Rights Certificates

The Secretary of the U.S. Treasury is authorized to issue gold and special drawing rights (“SDR”) certificates to the Reserve Banks.

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. The 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 reduced. The value of gold for purposes of backing the gold certificates is set by law at \$42 2/9 a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based on the average Federal Reserve notes outstanding in each Reserve Bank.

SDR certificates 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. SDR certificates 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. When SDR certificates are issued to the Reserve Banks, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks’ SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon each Reserve Bank’s Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2006 or 2005.

b. Loans to Depository Institutions

Depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Bank. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Outstanding loans are evaluated for collectibility, and currently all are considered

collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Bank, subject to review and determination by the Board of Governors.

c. U.S. Government Securities and Investments Denominated in Foreign Currencies

U.S. government securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis. Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as “Foreign currency gains (losses), net” in the Statements of Income.

Activity related to U.S. government securities, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings that occurs in April of each year. The settlement also equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments denominated in foreign currencies is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to aggregate capital and surplus at the preceding December 31.

d. Securities Sold Under Agreements to Repurchase, and Securities Lending

Securities sold under agreements to repurchase are accounted for as financing transactions and the associated interest expense is recognized over the life of the transaction. These transactions are reported in the Statements of Condition at their contractual amounts and the related accrued interest payable is reported as a component of “Other liabilities”.

U.S. government securities held in the SOMA are lent to U.S. government securities dealers in order to facilitate the effective functioning of the domestic securities market. Securities-lending transactions are fully collateralized by other U.S. government securities and the collateral taken is in excess of the market value of the securities loaned. The FRBNY charges the dealer a fee for borrowing securities and the fees are reported as a component of “Other income”.

Activity related to securities sold under agreements to repurchase and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from the annual settlement of interdistrict clearings. Securities purchased under agreements to resell are allocated to FRBNY and not allocated to the other Reserve Banks.

e. FX Swap Arrangements and Warehousing Agreements

FX swap arrangements are contractual agreements between two parties, the FRBNY and an authorized foreign central bank, to exchange specified currencies, at a specified price, on a specified date. The par-

ties agree to exchange their currencies up to a prearranged 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 the foreign currencies it may need to intervene to support the dollar and give the authorized foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the FX swap arrangements can be initiated by either party acting as drawer, and must be agreed to by the drawee party. The FX swap arrangements are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an FX swap arrangement in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the U.S. Treasury, U.S. dollars for foreign currencies held by the U.S. 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 U.S. Treasury and ESF for financing purchases of foreign currencies and related international operations.

FX swap arrangements and warehousing agreements are revalued daily at current market exchange rates. Activity related to these agreements, with the exception of the unrealized gains and losses resulting from the daily revaluation, is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to aggregate capital and surplus at the preceding December 31. Unrealized gains and losses resulting from the daily revaluation are allocated to FRBNY and not allocated to the other Reserve Banks.

f. 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 the estimated useful lives of the assets, which range from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are depreciated over the remaining useful life of the asset or, if appropriate, over the unique useful life of the alteration, renovation, or improvement. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred.

Costs incurred for software during the application development stage, either developed internally or acquired for internal use, are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years. Maintenance costs related to software are charged to expense in the year incurred.

Capitalized assets including software, buildings, leasehold improvements, furniture, and equipment are impaired when events or changes in circumstances indicate that the carrying amount of assets or asset groups is not recoverable and significantly exceeds their fair value.

g. Interdistrict Settlement Account

At the close of business each day, each Reserve Bank assembles the payments due to or from other Reserve Banks. These payments result from transactions between Reserve Banks and transactions that

involve depository institution accounts held by other Reserve Banks, such as Fedwire funds transfer, check collection, security transfer, and ACH operations. The cumulative net amount due to or from the other Reserve Banks is reflected in the “Interdistrict settlement account” in the Statements of Condition.

h. 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 and their designees) to the Reserve Banks upon deposit with such agents of specified 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 at least equal to the sum of the notes applied for by such Reserve Bank.

Assets eligible to be pledged as collateral security include all of the Bank’s assets. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, for which the collateral value is equal to the par value of the securities tendered. The par value of securities pledged for securities sold under agreements to repurchase is deducted.

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes issued to all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, Federal Reserve notes are obligations of the United States and are backed by the full faith and credit of the United States government.

“Federal Reserve notes outstanding, net” in the Statements of Condition represents the Bank’s Federal Reserve notes outstanding, reduced by the currency issued to the Bank but not in circulation, of \$14,202 million and \$10,216 million at December 31, 2006 and 2005, respectively.

i. Items in Process of Collection and Deferred Credit Items

“Items in process of collection” in the Statements of Condition primarily represents amounts attributable to checks that have been deposited for collection and that, as of the balance sheet date, have not yet been presented to the paying bank. “Deferred credit items” are the counterpart liability to items in process of collection, and the amounts in this account arise from deferring credit for deposited items until the amounts are collected. The balances in both accounts can vary significantly.

j. 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. These shares are non-

voting with a par value of \$100 and may not be transferred or hypothecated. As a member bank’s capital and surplus changes, its holdings of Reserve Bank stock must be adjusted. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. By law, each Reserve Bank is required to pay each member bank 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.

k. Surplus

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31 of each year. 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.

Accumulated other comprehensive income is reported as a component of surplus in the Statements of Condition and the Statements of Changes in Capital. The balance of accumulated other comprehensive income is comprised of expenses, gains, and losses related to defined benefit pension plans and other postretirement benefit plans that, under accounting principles, are included in comprehensive income but excluded from net income. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 9 and 10.

l. Interest on Federal Reserve Notes

The Board of Governors requires the Reserve Banks to transfer excess earnings to the U.S. Treasury as interest on Federal Reserve notes, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. This amount is reported as a component of “Payments to U.S. Treasury as interest on Federal Reserve notes” in the Statements of Income and is reported as a liability in the Statements of Condition. Weekly payments to the U.S. Treasury may vary significantly.

In the event of losses or an increase in capital paid-in at a Reserve Bank, payments to the U.S. Treasury are suspended and earnings are retained until the surplus is equal to the capital paid-in.

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to the U.S. Treasury in the following year.

m. Income and Costs Related to U.S. 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.

n. Assessments by the Board of Governors

The Board of Governors assesses the Reserve Banks to fund its operations based on each Reserve Bank’s capital and surplus balances as of December 31 of the previous year. The Board of Governors also assesses each Reserve Bank for the expenses incurred for the U.S. Treasury to issue and retire Federal Reserve notes based on each Reserve Bank’s share of the number of notes comprising the System’s net liability for Federal Reserve notes on December 31 of the previous year.

o. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank’s real property taxes were \$4 million and \$3 million for the years ended December 31, 2006 and 2005, respectively, and are reported as a component of “Occupancy expense”.

p. Restructuring Charges

In 2003, the Reserve Banks began the restructuring of several operations, primarily check, cash, and U.S. Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in some locations. These restructuring activities continued in 2004 through 2006.

Note 11 describes the restructuring and provides information about the Bank’s costs and liabilities associated with employee separations and contract terminations. The costs associated with the impairment of certain of the Bank’s assets are discussed in Note 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY. Costs and liabilities associated with enhanced post-retirement benefits are discussed in Note 9.

q. Implementation of FASB Statement No. 158, Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans

The Bank initially applied the provisions of FASB Statement No. 158, Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Statements of Condition, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard require applying the provisions as of the end of the year of initial implementation with no retrospective application. The incremental effects on the line items in the Statement of Condition at December 31, 2006, were as follows (in millions):

	Before Application of Statement 158	Adjustment	After Application of Statement 158
Accrued benefit costs	81	41	122
Total liabilities	\$73,963	\$41	\$74,004
Surplus	899	(41)	858
Total capital	\$1,757	\$(41)	\$1,716

4. U.S. GOVERNMENT SECURITIES, SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE, AND SECURITIES LENDING

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank’s allocated share of SOMA balances was approximately 9.182 percent and 9.005 percent at December 31, 2006 and 2005, respectively.

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

	2006	2005
Par value:		
U.S. government:		
Bills	\$25,436	\$24,429
Notes	36,945	34,231
Bonds	9,139	8,360
Total par value	71,520	67,020
Unamortized premiums	800	794
Unaccreted discounts	(368)	(255)
Total allocated to Bank	\$71,952	\$67,559

At December 31, 2006 and 2005, the fair value of the U.S. government securities allocated to the Bank excluding accrued interest was \$73,079 million and \$69,114 million, respectively, as determined by reference to quoted prices for identical securities.

The total of the U.S. government securities, net, held in the SOMA was \$783,619 million and \$750,202 million at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, the fair value of the U.S. government securities held in the SOMA excluding accrued interest was \$795,900 million and \$767,472 million, respectively, as determined by reference to quoted prices for identical securities.

Although the fair value of security holdings can be substantially greater or less than the carrying value at any point in time, these unrealized gains or losses have no effect on the ability of a Reserve Bank, as a central bank, to meet its financial obligations and responsibilities, and should not be misunderstood as representing a risk to the Reserve Banks, their shareholders, or the public. The fair value is presented solely for informational purposes.

At December 31, 2006 and 2005, the total contract amount of securities sold under agreements to repurchase was \$29,615 million and \$30,505 million, respectively, of which \$2,719 million and \$2,747 million were allocated to the Bank. The total par value of the SOMA securities that were pledged for securities sold under agreements to repurchase at December 31, 2006 and 2005 was \$29,676 million and \$30,559 million, respectively, of which \$2,725 million and \$2,752 million was allocated to the Bank. The contract amount for securities sold under agreements to repurchase approximates fair value.

The maturity distribution of U.S. government securities bought outright, and securities sold under agreements to repurchase, that were allocated to the Bank at December 31, 2006, was as follows (in millions):

	U.S. Gov’t Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	\$ 3,727	\$ 2,719
16 days to 90 days	16,609	
91 days to 1 year	16,999	
Over 1 year to 5 years	20,584	
Over 5 years to 10 years	6,211	
Over 10 years	7,390	
Total allocated to the Bank	\$71,520	\$ 2,719

At December 31, 2006 and 2005, U.S. government securities with par values of \$6,855 million and \$3,776 million, respectively, were loaned from the SOMA, of which \$629 million and \$340 million, respectively, were allocated to the Bank.

5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and with 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 issuing foreign governments.

The Bank’s allocated share of investments denominated in foreign currencies was approximately 6.626 percent and 6.486 percent at December 31, 2006 and 2005, respectively.

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

	2006	2005
<i>European Union Euro:</i>		
Foreign currency deposits	\$ 413	\$ 352
Securities purchased under agreements to resell	147	125
Government debt instruments	270	231
<i>Japanese Yen:</i>		
Foreign currency deposits	172	170
Government debt instruments	355	350
Total allocated to the Bank	\$ 1,357	\$ 1,228

At December 31, 2006 and 2005, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was \$1,354 million and \$1,230 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as a central bank, to meet its financial obligations and responsibilities.

Total System investments denominated in foreign currencies were \$20,482 million and \$18,928 million at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, the fair value of the total System investments denominated in foreign currencies, including accrued interest, was \$20,434 million and \$18,965 million, respectively.

The maturity distribution of investments denominated in foreign currencies that were allocated to the Bank at December 31, 2006, was as follows (in millions):

	European Euro	Japanese Yen	Total
Within 15 days	\$ 289	\$ 172	\$ 461
16 days to 90 days	157	80	\$ 237
91 days to 1 year	162	147	\$ 309
Over 1 year to 5 years	222	128	\$ 350
Over 5 years to 10 years	–	–	\$ –
Over 10 years	–	–	\$ –
Total allocated to the Bank	\$ 830	\$ 527	\$ 1,357

At December 31, 2006 and 2005, there were no material open foreign exchange contracts.

At December 31, 2006 and 2005, the warehousing facility was \$5,000 million, with no balance outstanding.

6. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	2006	2005
Bank premises and equipment:		
Land	\$ 14	\$ 12
Buildings	231	223
Building machinery and equipment	31	31
Construction in progress	7	12
Furniture and equipment	65	67
Subtotal	348	345
Accumulated depreciation	(107)	(100)
Bank premises and equipment, net	\$ 241	\$ 245
Depreciation expense, for the year ended December 31	\$ 16	\$ 12

Bank premises and equipment at December 31 included the following amounts for leases that have been capitalized (in thousands):

	2006	2005
Leased premises and equipment under capital leases	\$ 622	\$ 622
Accumulated depreciation	(492)	(389)
Leased premises and equipment under capital leases, net	\$ 130	\$ 233

The Bank leases space to outside tenants with remaining lease terms ranging from two to fourteen years. Rental income from such leases was \$6 million and \$4 million for the years ended December 31, 2006 and 2005, respectively, and is reported as a component of “Other income”. Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2006, are as follows (in millions):

2007	\$ 4
2008	4
2009	4
2010	4
2011	4
Thereafter	24
Total	\$ 44

The Bank has capitalized software assets, net of amortization, of \$4 million for each of the years ended December 31, 2006 and 2005. Amortization expense was \$2 million for each of the years ended December 31, 2006 and 2005. Capitalized software assets are reported as a component of “Other assets” and the related amortization is reported as a component of “Other expenses”.

The Bank recognized impairment losses on the Detroit facility of \$2 million at December 31, 2005 due to its determination that the carry value exceeded the fair value of the property. The impairment was determined using fair values based on quoted market values or other valuation techniques and are reported as a component of “Other expenses.” In April 2006, the Detroit property was sold for a total of \$2 million.

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2006, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from one to approximately five years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was \$3 million for each of the years ended December 31, 2006 and 2005. 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 remaining terms of one year or more, at December 31, 2006 are as follows (in thousands):

	Operating	Capital
2007	\$ 927	\$ 132
2008	508	22
2009	401	–
2010	403	–
2011	312	–
Thereafter	10	–
Future minimum rental payments	\$ 2,561	154
Amount representing interest		(9)
Present value of net minimum lease payments		\$ 145

At December 31, 2006, there were no other material commitments or long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks, 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 the agreement at December 31, 2006 or 2005.

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 three 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”). Employees at certain compensation levels participate in the Benefit Equalization Retirement Plan (“BEP”) and certain Reserve Bank officers participate in the Supplemental Employee Retirement Plan (“SERP”).

The System Plan is a multi-employer plan with contributions funded by the participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the System Plan and the costs associated with the Plan are not redistributed to other participating employers.

The Bank’s projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2006 and 2005, and for the years then ended, were 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 \$5 million for each of the years ended December 31, 2006 and 2005, respectively, and are reported as a component of “Salaries and other benefits” in the Statements of Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2006 and 2005, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

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.

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

	2006	2005
Accumulated postretirement benefit obligation at January 1	\$ 98.6	\$ 97.0
Service cost-benefits earned during the period	1.7	1.5
Interest cost on accumulated benefit obligation	5.4	5.2
Actuarial loss	11.4	0.8
Contributions by plan participants	1.6	1.4
Benefits paid	(7.8)	(7.3)
Accumulated postretirement benefit obligation at December 31	\$ 110.9	\$ 98.6

At December 31, 2006 and 2005, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 5.50 percent, respectively.

Discount rates reflect yields available on high-quality corporate bonds that would generate the cash flows necessary to pay the plan’s benefits when due.

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):

	2006	2005
Fair value of plan assets at January 1	\$ –	\$ –
Contributions by the employer	6.2	5.9
Contributions by plan participants	1.6	1.4
Benefits paid	(7.8)	(7.3)
Fair value of plan assets at December 31	\$ –	\$ –
Unfunded postretirement benefit obligation	\$ –	\$ 98.6
Unrecognized prior service cost		11.9
Unrecognized net actuarial loss		(42.0)
Accrued postretirement benefit costs		\$ 68.5

Amounts included in accumulated other comprehensive loss are shown below (in millions):		
Prior service cost		9.4
Net actuarial loss		(50.2)
Total accumulated other comprehensive loss	\$ (40.8)	

Accrued postretirement benefit costs are reported as a component of “Accrued benefit costs” in the Statements of Condition.

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

	2006	2005
Health care cost trend rate assumed for next year	9.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2012	2011

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2006 (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	\$ 1.0	\$ (0.8)
Effect on accumulated postretirement benefit obligation	12.4	(10.4)

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

	2006	2005
Service cost-benefits earned during the period	\$ 1.7	\$ 1.5
Interest cost on accumulated benefit obligation	5.4	5.2
Amortization of prior service cost	(2.5)	(2.4)
Recognized net actuarial loss	3.2	2.8
Total periodic expense	7.8	7.1
Curtailment gain	–	(2.2)
Net periodic postretirement benefit expense	\$ 7.8	\$ 4.9

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2007 are shown below (in millions):		
Prior service cost	\$ (2.3)	
Actuarial loss	5.1	
Total	\$ (2.8)	

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2006 and 2005, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.50 percent and 5.75 percent, respectively.

Net periodic postretirement benefit expense is reported as a component of “Salaries and other benefits” in the Statements of Income.

The curtailment gain associated with restructuring programs announced in 2004 and described in Note 11 was recognized when employees terminated employment in 2005.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 established a prescription drug benefit under Medicare (“Medicare Part D”) and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. The benefits provided under the Bank’s plan to certain participants are at least actuarially equivalent to the Medicare Part D prescription drug benefit. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial (gain) in the accumulated postretirement benefit obligation.

There were no receipts of federal Medicare subsidies in the year ended December 31, 2006. Expected receipts in the year ending December 31, 2007, related to payments made in the year ended December 31, 2006, are \$530 thousand.

Following is a summary of expected postretirement benefit payments (in millions):

	Without Subsidy	With Subsidy
2007	\$ 7.5	\$ 6.8
2008	7.8	7.1
2009	8.2	7.5
2010	8.5	7.7
2011	8.8	7.9
2012-2016	47.1	41.8
Total	\$ 87.9	\$ 78.8

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and

dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2006 and 2005 were \$10 million and \$11 million, respectively. This cost is included as a component of “Accrued benefit costs” in the Statements of Condition. Net periodic postemployment benefit expense included in 2006 and 2005 operating expenses were \$299 thousand and \$(314) thousand, respectively, and are recorded as a component of “Salaries and other benefits” in the Statements of Income.

10. ACCUMULATED OTHER COMPREHENSIVE INCOME

Following is a reconciliation of beginning and ending balances of accumulated other comprehensive loss (in millions):

	Amount Related to Postretirement Benefits other than Pensions
Balance at December 31, 2005	\$ –
Adjustment to initially apply FASB Statement No. 158	(41)
Balance at December 31, 2006	\$ (41)

Additional detail regarding the classification of accumulated other comprehensive loss is included in Note 9.

11. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004 and 2006, additional consolidation and restructuring initiatives were

announced in the check and check adjustment operations, respectively. These actions resulted in the following business restructuring charges (in millions):

	Year-ended 12/31/2006				
	Total Estimated Costs	Accrued Liability 12/31/05	Total Charges and Adjustments	Total Paid	Accrued Liability 12/31/06
Employee separation	\$ 7.9	\$ 0.1	\$ 0.9	\$ –	\$ 1.0
Total	\$ 7.9	\$ 0.1	\$ 0.9	\$ –	\$ 1.0

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 328, including 28 staff reductions related to restructuring announced in 2006. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of “Salaries and other benefits” in the Statements of Income.

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced restructuring plans are not material.

The Bank anticipates substantially completing its announced plans by 2008.

OPERATIONS VOLUMES FEDERAL RESERVE BANK OF CHICAGO

	Dollar Amount		Number of Items	
	2006	2005	2006	2005
Check and Electronic Payments				
Checks, Negotiable Orders of Withdrawal (NOW) and Share Drafts Processed	1.5 Trillion	1.5 Trillion	1.2 Billion	1.4 Billion
Legacy Images Captured	–	–	110.6 Million	116.2 Million
Check 21 Images Presented	–	–	41.2 Million	3.6 Thousand
Check 21 Image Replacement Documents (IRD) Printed	–	–	144.2 Million	23.5 Million
Check 21 Items Received	734.6 Billion	215.9 Billion	233.6 Million	32.1 Million
Cash Operations				
Currency Received and Counted	56.6 Billion	52.7 Billion	4.0 Billion	3.7 Billion
Unfit Currency Destroyed	5.9 Billion	5.6 Billion	674.0 Million	583.1 Million
Coin Bags Paid and Received	1.7 Billion	1.8 Billion	3.9 Million	4.3 Million
Number of Notes Paid and Received	140.2 Billion	128.7 Billion	9.4 Billion	8.5 Billion
Loans to Depository Institutions				
Total Loans Made During Year	1.5 Billion	1.4 Billion	1.5 Thousand	1.4 Thousand

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