Annual

Federal Reserve Bank of Cleveland

Report

2006

The Federal Reserve System is responsible for formulating and implementing U.S. monetary policy. It also supervises banks and bank holding companies and provides financial services to depository institutions and the federal government.

The Federal Reserve Bank of Cleveland is one of 12 regional Reserve Banks in the United States that, together with the Board of Governors in Washington, D.C., comprise the Federal Reserve System.

The Federal Reserve Bank of Cleveland, including its branch offices in Cincinnati and Pittsburgh, serves the Fourth Federal Reserve District (Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky).

It is the policy of the Federal Reserve Bank of Cleveland to provide equal employment opportunity for all employees and applicants without regard to race, color, religion, sex, national origin, age, or disability.

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Annual Report

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President's Foreword

Resilience defined the U.S. economy in 2006. Despite risks posed by inflation and the housing sector, the economy continued to expand at a steady pace, creating millions of new jobs and maintaining a relatively low unemployment rate.

Nevertheless, within one of the wealthiest and most productive nations in the world, millions of our citizens continue to live in poverty. The U.S. poverty rate has stalled for the past 30 years and remains among the highest of all developed countries today.

Poverty imposes significant costs: the personal costs faced by those who live in poverty, and the national costs associated with poverty's consequences. People who grow up in poverty tend to acquire fewer job skills, earn less money, and experience worse health than those who are better off. Poor people also tend to live at the margins of our financial system, sometimes paying more for financial services than necessary and finding it difficult to accumulate savings.

Poverty saps the strength from communities as well as from people. In cities that are already coping with the stresses of industrial transformation, poverty is yet another obstacle to community development. Civic leaders struggle to provide housing, health care, and family assistance to their poorest residents. Sadly, too, children make up the largest share of people living in poverty today. They—and we—will live with the social and economic consequences of their deprivation for decades to come.

This year's *Annual Report* essay reviews the persistence of poverty in America and suggests some reasons why the economy's rising tide has failed to lift all boats. In the end, we encourage civic leaders and policymakers to consider the crucial difference that better education and skill building can make in reducing poverty. Not surprisingly, the sooner children enjoy positive educational experiences, the greater the benefits for both them and society.

This essay is the latest in the Bank's ongoing research efforts to better understand the role that education, innovation, and human capital play in driving long-term economic growth.

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Our research function is among many areas of the Bank that contributed to advancing our strategic objectives of leadership in thought and deed, operational excellence, and external focus in 2006.

Leadership in thought and deed challenges employees to help shape the policies, strategies, and practices of the Federal Reserve System. In 2006, the Bank's staff provided strong support in the areas of research, payments, banking supervision, and eGovernment assistance to the U.S. Treasury.

(L-R) R. Chris Moore, first vice president and chief operating officer;
Sandra Pianalto, president and chief executive officer;
Charles E. Bunch, chairman; and Tanny B. Crane, deputy chair.

In 2006, the Bank also made great strides in our strategic objective of operational excellence. The Bank's Cash and Check functions experienced significant growth, and our eGovernment and Treasury Retail Securities areas continued to maintain the highest levels of customer service and support.

Our third strategic objective, external focus, saw considerable progress as well, highlighted by the first full year of operation for our new Learning Center and Money Museum. More than 10,000 children and adults toured this facility to learn more about what gives money value. The Operational Highlights section of this report provides greater detail on all of these achievements.

The Bank's boards of directors and advisory councils in Cleveland, Cincinnati, and Pittsburgh provided outstanding support in guiding our success during the past year.

I am particularly indebted to our retiring chairman, Charles E. Bunch (chairman and CEO, PPG Industries), for his 10 years of outstanding service to the Federal Reserve Bank of Cleveland. His strong leadership—first as director and chairman of our Pittsburgh board and then as director, deputy chair, and chairman of our Cleveland board—has helped our Bank achieve remarkable growth and innovation during a decade of significant change.

I also extend my appreciation to another longtime director, Stephen P. Wilson (chairman, president, and CEO, Lebanon Citizens National Bank). His nine years of service on the Cincinnati and Cleveland boards, including leadership on two board committees, have been marked by both lively debate and informed counsel.

Thanks also go to Charles Whitehead (retired president, Ashland Inc. Foundation) for six years of service on the Cincinnati board; and to James I. Mitnick (senior vice president, Turner Construction Company) and Kristine N. Molnar (executive vice president, WesBanco Bank) for six years of service on the Pittsburgh board. These three branch directors served in various leadership capacities on our board committees, and their insights have been invaluable.

The Federal Reserve Bank of Cleveland has defined a challenging strategic direction to drive our success in 2007 and beyond. To achieve our goals in thought leadership, operational excellence, and external focus, we depend on the brainpower, skills, and dedication of more than 1,500 employees in Cleveland, Cincinnati, and Pittsburgh.

Our Bank's officers and staff are the bedrock of all of our Bank's efforts to innovate and grow, and I offer them my heartfelt appreciation.

It is my continuing privilege to lead the Federal Reserve Bank of Cleveland.

Sandra Pianalto

Sandra Pianalto
President and Chief Executive Officer

As part of his "war on poverty" initiative, President Lyndon Johnson visited with families in rural areas of the Fourth Federal Reserve District. In April 1964, he spoke with Tom Fletcher of Inez, Kentucky. Mr. Fletcher's family of 10 earned only $400 in 1963. Today, the situation in many rural counties has improved considerably, but poverty remains a persistent problem both in the Fourth District and across the nation.

Understanding the Persistence of Poverty

More than 40 years ago, Americans witnessed a pivotal moment in political history as President Lyndon Johnson declared an "unconditional war on poverty in America."[1] Had they known that the next few decades would bring unprecedented growth in output per person, those Americans might have reasonably assumed that by the beginning of the twenty-first century, the war on poverty would have been won.

Of course, they would have been wrong. Despite a variety of programs designed to lessen poverty—and some real successes over the years—the latest data indicate that more than 12 percent of U.S. residents still live below the poverty line *(see box on page 8 for official definition of poverty).* The Fourth Federal Reserve District itself contains two cities that currently rank among the top 10 poorest major cities in America: Cleveland and Cincinnati.[2]

The persistence of poverty over the past few decades has led to many new initiatives to better understand the causes and consequences of poverty, including recent efforts by the Federal Reserve System and the Federal Reserve Bank of Cleveland *(see box on page 10).*

Defining Poverty

To understand exactly *who* falls into the category of "poor," we turn to the U.S. Census Bureau. The bureau publishes annual poverty statistics based on established thresholds and adjusts them for inflation each year using the Consumer Price Index. For 2006, a family of four was considered in poverty if its annual income fell below $20,444. For a couple under age 65, the poverty threshold was $13,500, and for an individual living alone, it was $10,488.

The official definition of poverty has changed little since 1969, when the Bureau of the Budget accepted thresholds set forth by Mollie Orshansky, a statistician at the Social Security Administration. Having grown up in poverty herself, Orshansky spent her career advocating for children's welfare. In 1958, she set out to estimate the incidence of childhood poverty in order to make these children and their families more visible to the decision makers involved in developing policies and programs for the poor.

Mollie Orshansky developed the first U.S. poverty thresholds in the 1960s—formulas that are still in place for defining poverty today.

By 1964, Orshansky had perfected a formula for determining poverty thresholds. Using the "economy food plan" she had helped to develop while working at the U.S. Department of Agriculture, she estimated the minimum cost of food for families of various sizes. Applying the ratio of food expenditures to after-tax income from the 1955 Household Food Consumption Survey, Orshansky created a detailed matrix of poverty thresholds. The Bureau of the Budget adopted these thresholds (with minor revisions) as the federal government's official definition of poverty in 1969.

Today, the thresholds are used for statistical purposes to quantify Americans living in poverty. Poverty *guidelines*, a simplified version of the federal poverty thresholds, are typically used for administrative purposes, such as determining financial eligibility for certain federal programs. These guidelines are issued annually in the Federal Register by the Department of Health and Human Services.

Sources: Cassidy (2006); Fisher (1997); U.S. Department of Commerce, Bureau of the Census; Social Security Administration; and U.S. Department of Health and Human Services.

Poverty imposes punishing effects on individuals, families, and communities:

- Studies show a link between poverty and health, including a higher prevalence of chronic illnesses, more frequent and severe disease complications, and increased demands and costs for health-care services.[3]
- Poverty is linked to increased rates of teenage pregnancy, which can cause these children to face greater health-care and education challenges.
- Schooling outcomes are affected by poverty. Research shows that increases in income directly raise test performance results for students, even after controlling for other changes.[4]
- Poverty can also affect crime. In a recent social experiment that relocated families from poor to less-poor areas, violent criminal activity fell among the relocated residents.[5]

Unfortunately, poverty seems as entrenched as ever in our society. In this essay, we address three major questions:

- Why have 40 years of steady real economic growth failed to eliminate poverty?
- Why haven't antipoverty programs eliminated poverty?
- What can we learn from substantial shifts in poverty within the Fourth Federal Reserve District over the past few decades?

We know that our results will not be the final word on this longstanding issue. Every society faces a tradeoff between practicing benevolence through direct transfers and promoting incentives to engage in work and create wealth. We suggest that programs

1. Johnson (1965).
2. Schweitzer and Rudick (2007).
3. Woolf, Johnson, and Geiger (2006).
4. Dahl and Lochner (2005).
5. Ludwig, Duncan, and Hirschfield (2001).

encouraging the production of human capital through education and training may be the most fruitful approach to fighting the battle against poverty. This approach may also be the most self-sustaining for future generations.

As with all important research topics, a major part of the effort is finding and refining *new* questions that need to be answered. Still, we hope that this essay leads to a better understanding of the issues that have kept poverty rates high and the policies that may help end the war on poverty.

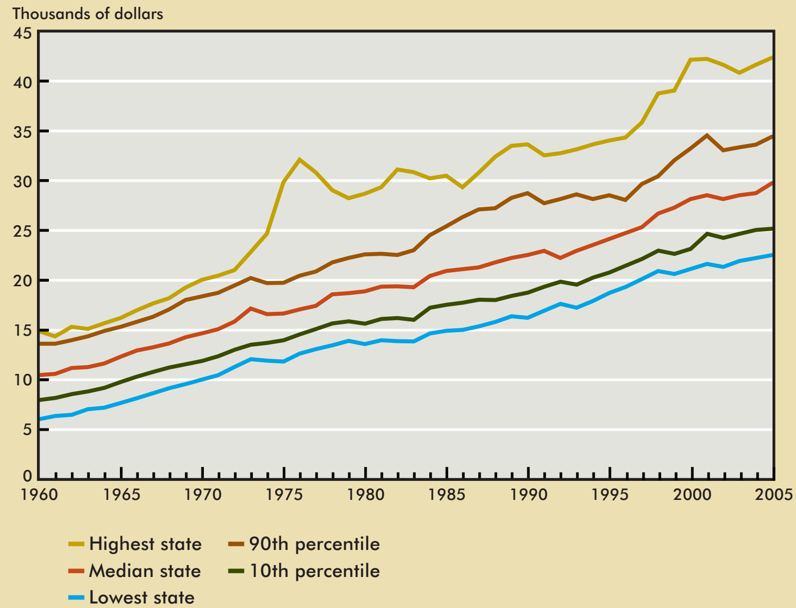
Why Hasn't Economic Growth Eliminated Poverty?

U.S. economic growth over the past half-century has been staggering in historical terms. Even after adjusting for inflation, per capita income for the median state has grown from about $10,000 per year in 1960 to roughly $30,000 in 2005 (*see figure 1*). Although per capita income still differs across the states, even the state with the lowest per capita income in the early 1960s saw its income nearly triple over the next 45 years.

In the United States, for an average individual, one hour of work in 2005 bought more than twice as many goods as it did in 1960. Over the long term, small percentage changes in annual income growth lead to large changes in overall income levels. For example, suppose two individuals earned the average household income of $3,815 in 1950. The individual whose income grew at a 1 percent annualized rate would make about $6,600 in 2005, while the individual whose income grew at a 3 percent annualized rate would make about $19,400—roughly three times the former amount.

Although the growth in real income has been impressive, the gains have not reached everyone. As many observers have commented, the difference between the "haves" and the "have-nots" has grown substantially over the past 30 years or so.

Figure 1 Real Per Capita Income Growth of U.S. States



Note: Percentiles represent state per capita income levels. For example, the 90th percentile state is the fifth-highest-income state, while the 10th percentile state is the fifth-lowest-income state.

Sources: Authors' calculations and U.S. Department of Commerce, Bureau of Economic Analysis.

As shown in figure 2, income inequality has clearly increased in the United States over the past few decades. This figure depicts the growth rates of real wages between 1962 and 2005 at different points of the income distribution.[6] An upward-sloping line indicates that high earners (at the upper end of the income distribution) saw much larger increases than those who earned less (at the lower end of the income distribution).

Individuals at different points of the income distribution change; we know that relatively few of today's workers were working in 1962. But today's lowest-income workers earn only slightly more in real terms than did the lowest-income earners in 1962. At the low end of the income distribution (5th percentile), real incomes have increased just $1,100 over the past four decades, to $13,500 in 2005.

6. For the purposes of this example, wages and income both refer to annual labor income of full-time workers. Our methodologies follow Juhn, Murphy, and Pierce (1993).

Federal Reserve Keeps a Spotlight on Poverty

The Community Affairs function of the Federal Reserve System is dedicated to supporting the System's economic growth objectives by promoting community development and fair and impartial access to credit. Each of the 12 Federal Reserve Banks, along with the Board of Governors, has a Community Affairs Office that works to address issues threatening community reinvestment and asset accumulation, particularly among low- and moderate-income communities.

Here in the Fourth District, poverty is an issue not just in urban areas like Cleveland and Cincinnati but also in smaller cities and rural areas. By keeping a spotlight on poverty, Community Affairs believes we will move toward a more in-depth understanding of the issue.

Dr. William Julius Wilson, professor and director of the Joblessness and Urban Poverty Research Program at Harvard University, gave the keynote address at the Federal Reserve Bank of Cleveland's 2006 Community Development Policy Summit.

In June 2006, the Federal Reserve Bank of Cleveland focused its annual Community Development Policy Summit on concentrated poverty. The goal was to examine this issue from a community development perspective, versus the more traditional social services approach. The conference drew policymakers, bankers, researchers, and community development practitioners from across the region, all eager to share experiences, insights, and ideas.

President Sandra Pianalto explained in her opening address why the Federal Reserve is so dedicated to the analysis of poverty:

> *We are committed to the goals of community development. Our Community Affairs program helps us fulfill one of our most important public policy mandates—to enforce fair-lending regulations that protect consumers in the financial marketplace. We also believe that understanding the issues behind concentrated poverty will help us better assess overall economic performance.*

In addition, the Community Affairs offices across the Federal Reserve System have teamed with the Brookings Institution on a study of concentrated poverty. This study is looking at the causes and consequences of concentrated poverty in a variety of communities (rural and urban, immigrant and nonimmigrant, minority and nonminority) nationwide. The Federal Reserve strongly believes that a deeper understanding of this phenomenon will help public and private entities better integrate community reinvestment activities with traditional social services activities.

Note: Conference proceedings for the Federal Reserve Bank of Cleveland's 2006 Community Development Policy Summit are available online at *www.clevelandfed.org/CommAffairs/Conf2006/June/Index.cfm.*

The story is very different among upper-income earners (*see table 1*). Forty years of annual real income gains above 1 percent have accumulated into significantly higher real earnings: $110,000 in 2005 versus $67,200 in 1962 for the top 5 percent of earners (95th percentile). These substantial differences reveal that much of the average income gains seen nationally have been realized by relatively high earners.

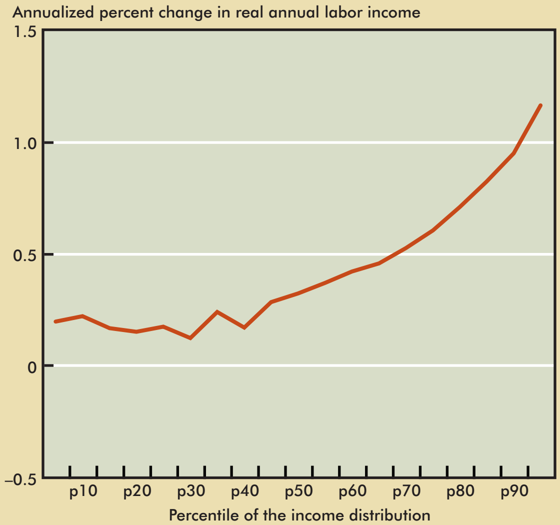
Unfortunately, no one is entirely certain about what causes income inequality. Some researchers believe that increased globalization may contribute to inequality through immigration. Others cite the importance of international trade patterns, outsourcing, and changing institutions, such as the long-term decline in union membership.

One prominent theory behind income inequality is what economists refer to as "skill-biased" technological change. That is, workers who acquire the appropriate skills can take advantage of new technologies and increase their wages, while unskilled workers cannot. In fact, research has documented that large bursts in technological advances—for example, during the Industrial Revolution that began in the eighteenth century or perhaps in today's Information Age—lead to greater income inequality.[7] Increasing inequality, then, may be a natural outcome of the labor market in response to changing fundamentals underlying the supply and demand of labor.

A logical way for workers to combat these labor market forces and increase their incomes is to acquire additional education and skills. The strength of this theory is evident in table 1, which lists real annual income by educational attainment at different points in the income distribution. In 1962, a high-school dropout who was the median earner for that group (the 50th percentile) earned $29,100 annually. However, a college graduate at the same percentile earned $44,000 annually.

7. Greenwood (1999).

Figure 2 Real Wage Growth Across the Income Distribution, 1962-2005



Note: Labor income includes income from wages and salaries. Figure is computed for full-time, full-year workers who are not self-employed. Percentiles are listed in ascending order of the income distribution. For example, p10 indicates the point at which only 10 percent of the working population earns less than these workers, while p90 indicates the point at which 90 percent of the working population earns less than these workers.

Sources: Authors' calculations; U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Labor, Bureau of Labor Statistics, Current Population Survey.

Table 1 Real Annual Income, 1962

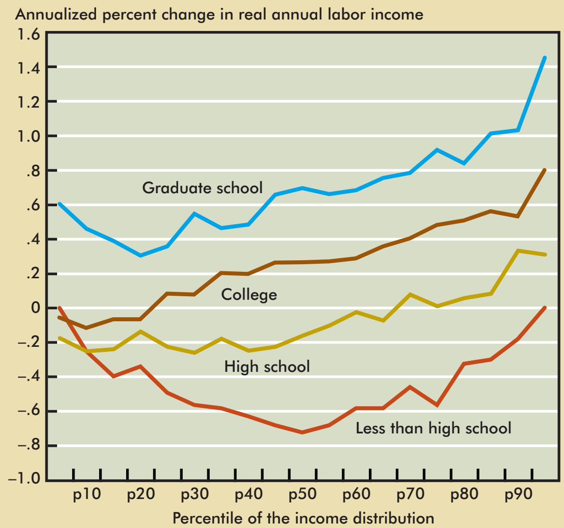
	5th Percentile Wage Earner	50th Percentile Wage Earner	95th Percentile Wage Earner
High-School Dropout	$ 10,100	$ 29,100	$ 54,900
High-School Graduate	$ 13,400	$ 32,300	$ 63,400
College Graduate	$ 20,100	$ 44,000	$ 97,000
Graduate School	$ 19,400	$ 48,500	$ 109,900
All	$ 12,400	$ 32,300	$ 67,200

Real Annual Income, 2005

	5th Percentile Wage Earner	50th Percentile Wage Earner	95th Percentile Wage Earner
High-School Dropout	$ 10,000	$ 21,200	$ 54,600
High-School Graduate	$ 12,400	$ 30,000	$ 72,000
College Graduate	$ 19,500	$ 49,000	$ 136,000
Graduate School	$ 25,000	$ 65,000	$ 203,500
All	$ 13,500	$ 37,300	$ 110,000

Sources: Authors' calculations; U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Labor, Bureau of Labor Statistics, Current Population Survey.

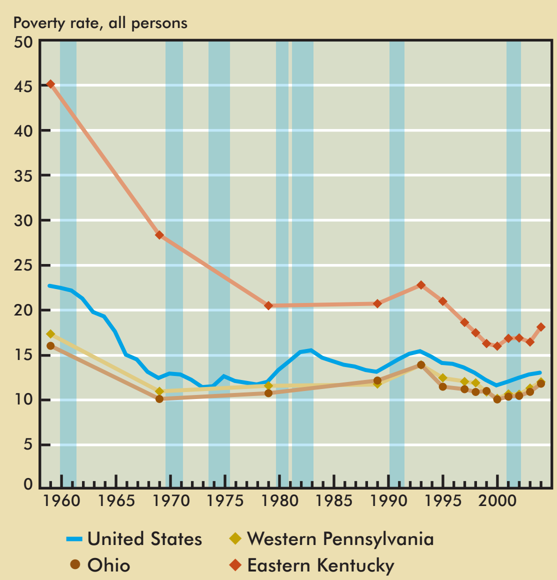
Figure 3 Real Wage Growth by Educational Attainment, 1962-2005



Note: Labor income includes income from wages and salaries. Figure is computed for full-time, full-year workers who are not self-employed. Percentiles are listed in ascending order of the income distribution. For example, p10 indicates the point at which only 10 percent of the working population earns less than these workers, while p90 indicates the point at which 90 percent of the working population earns less than these workers.

Sources: Authors' calculations; U.S. Department of Commerce, Bureau of the Census; and U.S. Department of Labor, Bureau of Labor Statistics, Current Population Survey.

Figure 4 U.S. and Fourth District Poverty Rates, 1959-2004



Note: Blue bars indicate recessionary periods.

Source: Authors' calculations based on U.S. Department of Commerce, Bureau of the Census, decennial census data and Small Area Income and Poverty Estimates Program.

The earnings gap between the more and less educated has been growing wider since the 1960s, as shown in figure 3. Wages of workers with graduate degrees have been growing faster than for those who hold only a four-year college degree. The trend is similar for college versus high-school graduates, and for high-school graduates versus high-school dropouts. Indeed, the wage picture is comparatively bleak for high-school dropouts. Not only did their wages fall in comparison to their higher-educated peers, but for many high-school dropouts, their own real wages actually fell over time.

What is most troublesome about the rise in income inequality is not that the rich have gotten richer, but that those at the lowest part of the income distribution have made such little progress in terms of real wage growth.

Why Haven't Antipoverty Programs Eliminated Poverty?

President Johnson noted in 1964 that the war on poverty was "not going to be a short or easy struggle," but initially it looked like the United States was gaining some ground.

The 1960s saw a lot of progress on poverty, as shown in figure 4. In less than 15 years, poverty was cut in half—from more than 22 percent in 1959 to just over 11 percent in 1973. Then the decline seemed to stop cold. Since 1973, U.S. poverty rates have hovered between 11 and 15 percent. Data for 2005 indicate that 12.6 percent of U.S. residents live below the poverty line. Although poverty rates typically move with the state of the economy—declining during expansions and rising during recessions—the persistence of high poverty rates is still surprising for an economy that has boosted average incomes nearly threefold since 1960.

Recognizing that economic growth has been insufficient to lift all citizens out of poverty, the United States provides assistance for the less fortunate among our fellow citizens. Federal and state governments offer support for poor families through a wide range of programs:

- Means-tested transfers, commonly known as welfare, require people to meet specific income standards and are provided through programs such as food stamps and Temporary Assistance for Needy Families (TANF), formerly known as Aid to Families with Dependent Children.
- The U.S. tax code has been written to provide some support for low-income families—for example, through progressive income tax rates and the Earned Income Tax Credit.
- Social insurance has no income requirements but provides general benefits that help low-income households—Social Security and Medicare, for example.

While means-tested transfer payments have declined in real terms, real social insurance spending has increased from less than 6 percent to more than 9 percent of real GDP over the past 35 years, driven largely by increases in Social Security and Medicare benefits (*see figure 5*).

One reason why means-tested programs have not eliminated poverty is that they are not large enough to move all family incomes above the poverty line. For example, after existing cash benefits are accounted for, the average difference between a family's income and its poverty threshold in 2005 was $8,125. As a result, about $120 billion in cash transfers—or 4 percent of the federal budget—would be needed annually to lift families and other poor individuals out of poverty.[8]

However, another reason why means-tested programs do not reduce the official poverty rate is that many of them rely on in-kind transfers and are not really a direct transfer of income, which would be counted in the official poverty definition (*see box at right*). This is true for programs such as Medicaid, food stamps,

8. Authors' calculations based on Congressional Budget Office data (2006).

Alternative Measures of Poverty

Social scientists are engaged in a vigorous debate about how to measure poverty. Official U.S. statistics use a pre-tax income definition that has changed little over time. Critics of the current measure say it does not measure the economic well-being of the poor for a number of reasons. First, pre-tax income fails to accurately measure the economic resources available to a family because it excludes noncash benefits such as food stamps, medical and housing assistance, and the Earned Income Tax Credit, but includes payroll and income taxes. The Census Bureau publishes a set of alternative measures of poverty income that adjust for taxes paid and noncash benefits received. Incorporating these adjustments into the poverty rate calculation typically reduces the poverty rate by 2 to 3 percentage points a year, a sizable reduction.

Second, the official statistics use a specific Consumer Price Index series (CPI-U) to adjust incomes for inflation. This series does not contain all of the improvements that have been made in measuring consumer price inflation over the past several decades. According to Meyer and Sullivan, poverty statistics constructed using an alternative price index published by the Bureau of Labor Statistics (CPI-U-RS) show a marked reduction in the U.S. poverty rate versus the official statistics.

Finally, some social scientists argue that the poverty yardstick should be based on what families consume rather than on their income levels. Using a consumption metric offers a number of benefits. For example, it can better capture the ability of families who suffer a job loss to maintain their standard of living by borrowing or by tapping into savings. Income surveys, such as the one used to measure poverty rates, often underreport transfer payments that families obtain through government assistance programs. These payments are particularly important for low-income families. Empirically, consumption-based poverty indices generally paint a more optimistic view of the progress on poverty than do the official statistics, particularly for elderly Americans.

Sources: Dalaker (2005), Johnson (2004), and Meyer and Sullivan (2006).

The Role of Public Programs in Balancing Household Budgets

Families who fall beneath the poverty threshold vary widely in their spending needs, income levels, and eligibility for public assistance. Who qualifies for help—and how much help they qualify for—also varies from state to state depending on how federal programs are implemented. These variances can make it difficult to evaluate the overall effectiveness of antipoverty programs.

Fortunately, the National Center for Children in Poverty at Columbia University has developed a Family Resource Simulator, a web-based tool that simulates the impact of federal and state support (for example, Earned Income Tax Credits, child-care subsidies, health-care coverage, food stamps, and housing assistance) on family budgets. The Family Resource Simulator can calculate how much a family needs to cover its basic budget, demonstrate the effects of various programs, and help identify and simulate policy alternatives that might better meet the needs of low-wage workers and their families.

Using the Family Resource Simulator, we can analyze the circumstances of both a low-income single mother with a young child and a low-income two-parent household with two children. (For this example, we will assume these families live in Pittsburgh.) While the simulations show how a poor household can manage to make ends meet, the expenses shown here are minimal. Many poor households have additional expenses (such as car payments, debt payments, and health needs) that are not included in these simulations. Still, the simulations illustrate the important role of public programs in helping low-income families meet their financial obligations.

Family Resource and Expense Simulation, 2003

	Single mother earning $500/month with a young child	Single mother earning $1,000/month with a young child	Married couple earning $600/month with two children	Married couple earning $1,200/month with two children
Resources				
Earnings	$ 500	$ 1,000	$ 600	$ 1,200
Federal Earned Income Tax Credit (EITC)	$ 170	$ 212	$ 240	$ 350
Temporary Assistance for Needy Families (TANF)	$ 66	$ 0	$ 197	$ 0
Food stamps	$ 259	$ 167	$ 405	$ 306
Total Resources	**$ 995**	**$ 1,379**	**$ 1,442**	**$ 1,856**
Expenses				
Rent and utilities*	$ 151	$ 275	$ 209	$ 336
Food	$ 284	$ 284	$ 574	$ 574
Child care*	$ 22	$ 43	$ 22	$ 0
Health insurance*	$ 0	$ 190	$ 0	$ 316
Transportation	$ 136	$ 182	$ 191	$ 182
Other necessities	$ 243	$ 243	$ 321	$ 321
Payroll and income taxes	$ 53	$ 94	$ 64	$ 95
Total Expenses	**$ 889**	**$ 1,311**	**$ 1,381**	**$ 1,824**
Resources minus Expenses	**$ 106**	**$ 68**	**$ 61**	**$ 32**

* These costs are significantly offset by Section 8 housing, child care, and health insurance benefits.
Note that the results assume that in the two-parent family, the second parent is not employed and therefore the family has no child-care costs. When the family receives TANF cash assistance, however, both parents are required to participate in work activity, and the family has child-care expenses.

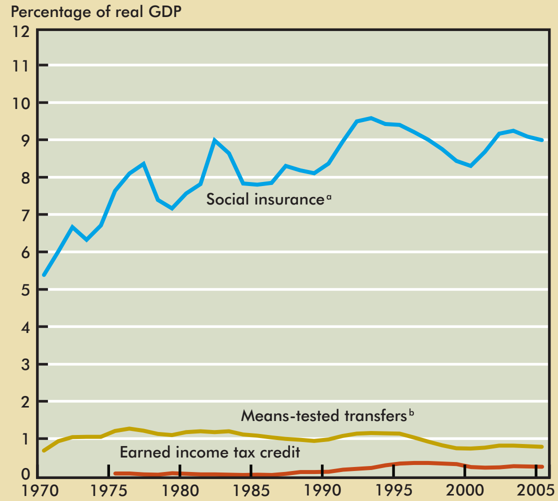
Source: Columbia University, National Center for Children in Poverty.

housing assistance, Head Start subsidies, and school nutrition programs. Each of these programs provides important benefits, but they are provided as goods or services (rather than cash) for low-income families who meet additional requirements. Of the transfer programs, only TANF raises the reported income levels of families, thus directly lowering the poverty gap (*see box on page 14*).

Programs that are not viewed as welfare also make a big difference for poor households. The major U.S. social insurance programs—Social Security, Medicare, unemployment insurance, workers' compensation, and disability insurance—can affect poverty rates as well. Social Security, while not structured to be an antipoverty program, redistributes a large amount of money from workers to retired families and is associated with a precipitous decline in poverty rates among the elderly. Medicare provides benefits, including hospital insurance and supplementary medical insurance. It covers almost all people over age 65 and eligible people under age 65. Roughly half of Medicare benefits are granted to families and individuals who would otherwise be poor.[9]

Public policy debate often centers on the incentives that accompany means-tested transfer programs. Researchers, politicians, and the public alike have voiced concern that welfare policies should be designed to avoid creating a disincentive for poor people to work. Means-tested programs have always struggled to reflect a balance between concern and efficiency. These programs have been repeatedly reined in or reformed over the years, most recently by the Welfare Reform Act of 1996 (*see figure 5*). The Act has certainly been effective in moving people off the welfare rolls by shifting people toward work.[10]

Figure 5 Social Insurance and Antipoverty Spending, 1970-2005



a. Social insurance includes Old-Age Survivors Insurance benefit payments, Medicare, unemployment insurance, workers' compensation, disability insurance, Medicaid, and Supplemental Security Income.

b. Means-tested transfers include Temporary Assistance for Needy Families (and its predecessor, Aid to Families with Dependent Children), food stamps, housing aid, school food programs, Head Start, and Special Supplemental Nutrition Program for Women, Infants, and Children.

Sources: Danzinger and Haveman (2001); Sengupta, Reno, and Burton (2004); U.S. Social Security Administration; Office of Management and Budget; Congressional Budget Office; U.S. Department of Health and Human Services; U.S. Department of Agriculture, Food and Nutrition Service; U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; and authors' calculations.

It remains to be seen whether the income that poor people earn from working will be enough to elevate their families out of poverty without the assistance of transfer programs. In the 10 years following the 1996 reform, however, poverty rates have largely moved with the performance of the economy rather than showing a trend either up or down.

An important alternative to traditional welfare programs has also evolved: the Earned Income Tax Credit (EITC). The EITC is a tax code provision that lowers the taxes of low-income workers so that some families receive tax refunds even though they paid no income taxes. Federal EITC spending totaled about $35 billion in 2006, accounting for roughly 0.3 percent of real GDP.[11] The EITC provides post-tax earnings, so it does not affect the official definition of poverty, but for working families it offers substantial added financial resources.

9. Danzinger and Haveman (2001).

10. Blank (2000).

11. Office of Management and Budget (2006).

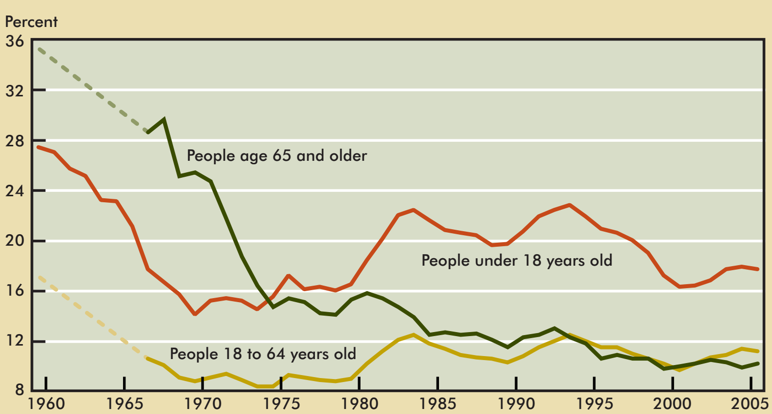
The Changing Face of Poverty

The Census Bureau monitors progress on the war on poverty for three age groups: children, adults, and senior citizens. Over the past five decades, the age distribution of poverty has shifted significantly.

Helped in part by Social Security reforms, senior citizens have experienced the greatest gains in the war on poverty. Their poverty rate has fallen by nearly three-quarters since 1959. However, it is important to keep in mind that the poverty rate is set at three times the cost of food and adjusted for inflation. It does not take into consideration rising medical expenses and may not fully represent the daily struggles that all senior citizens, especially those living in poverty, face.

Children and adults have also benefited from falling poverty rates, which have declined by more than one-third since 1959. But today, children form the group with the highest poverty rate, with 17.6 percent of our nation's children belonging to poor families in 2005. Children have been the poorest age category since 1974.

Poverty Rates by Age Groups



Note: Full age breakdowns are available annually after 1966.

Source: U.S. Department of Commerce, Bureau of the Census.

Research has linked the increase in EITC spending to a reduction in welfare dependence and an increase in labor force participation rates.[12] Although the 1996 welfare reforms lowered direct payments to households, poverty rates continued to fall until the 2001 recession. This outcome could be linked in part to the beneficial effects of the EITC.

Finally, many proposals have been advanced at both the federal and state level to increase the minimum wage, which intuitively might be expected to lower poverty. However, recent research suggests that raising the minimum wage may actually *increase* the number of poor families because the resulting loss in employment would likely exceed the number of people lifted out of poverty.[13]

What Can We Learn from Poverty Trends within the Fourth Federal Reserve District?

While the national poverty rate has been relatively constant, the composition of poverty has changed.[14]

- The poverty rate of Americans age 65 and older declined well into the 1990s (*see box at left*); however, rising child poverty rates have offset this decline. Today, the people in our society who are most likely to be poor are children.
- Poverty is more common in some household types, such as single-parent households. Increasing numbers of single-parent families and households composed of unrelated individuals have contributed to the stubbornness of high poverty rates.
- Minorities experience higher poverty rates, although the time pattern for poverty among minority groups largely follows the national poverty pattern of a sharp decline from 1959 to 1973 and then relatively steady levels.

12. Wirtz (2003).
13. Neumark and Wascher (2001).
14. Burtless and Smeeding (2001).

- Finally, poverty rates and population have both declined in rural areas (*see box at right*).

Some of these broad national patterns are also apparent within the Fourth Federal Reserve District, which includes Ohio, eastern Kentucky, western Pennsylvania, and the northern panhandle of West Virginia.[15] Changes in poverty have been uneven across our region, and this pattern can help us determine which programs seem to be most effective in the long battle against poverty.

Many of the Fourth District counties that had the highest poverty rates in both 1959 and 2004 had small populations. Then, as now, many of these counties were located in eastern Kentucky. However, a large fraction of the poor now live in the major urban counties of the District. The five most populous counties (Cuyahoga, Ohio; Allegheny, Pennsylvania; Franklin, Ohio; Hamilton, Ohio; and Summit, Ohio) accounted for almost a third (32 percent) of the poor population in the District in 2004. This is not surprising, because these counties accounted for a similar fraction (30 percent) of the total population of the District. However, in 1959, just 26 percent of the District's poor lived in these counties, when these counties made up a larger share (36 percent) of the overall population.

Clearly, the biggest geographic shift in the incidence of poverty has been away from the rural portions of the District and toward the metropolitan areas. Poverty rates among rural and nonrural counties are now far more similar than they were nearly 50 years ago.

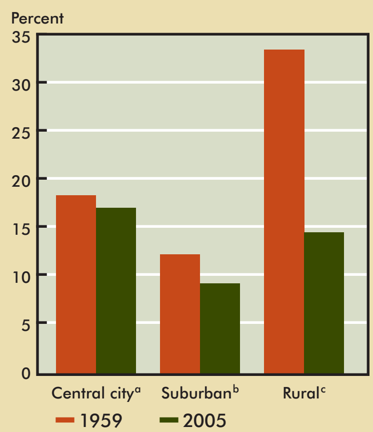
15. We do not include counties for West Virginia in the Fourth District due to the small number of observations in the data.

Where Poverty Lives

Over the past half-century, the distribution of our population has changed considerably. In 1959, the American population was fairly evenly split among central cities, suburbs, and rural areas. Today, central cities are still home to about one-third of the population. Rural areas have dropped to about 16 percent, while the suburbs now hold claim to more than half of American citizens.

Despite the influx of families into the suburbs, the poverty rate of suburban areas is, and has consistently been, the lowest of the three residential categories. Also heartening is the pattern in rural areas, where the poverty rate has been cut by more than half since 1959.

Poverty Rates by Residential Group



But the poverty rate in our central cities has remained almost steady since 1959, now standing at 17 percent—the highest rate among the three locations.

Poverty was and continues to be unevenly distributed across communities.

a. Central city refers to areas characterized as central or principal cities.

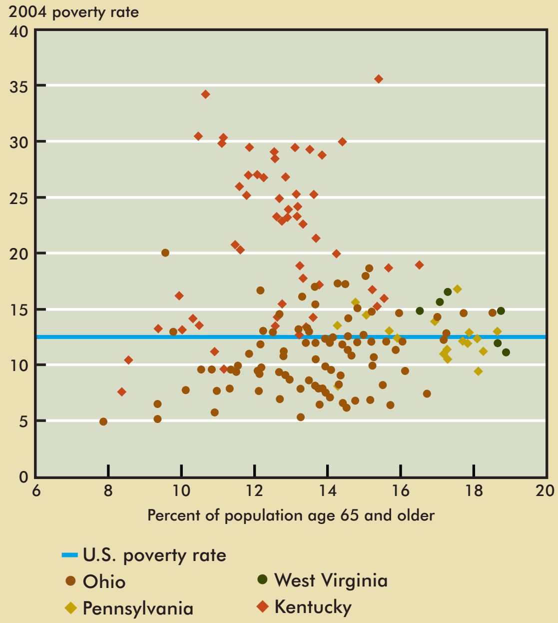
b. Suburban refers to areas within the Metropolitan Statistical Area (MSA), but outside the central or principal city.

c. Rural refers to non-metropolitan areas or areas outside of MSAs.

Census Bureau statistical areas change over time as new areas are recognized to have reached the minimum required city or urbanized area population, and as counties (or cities and towns in New England) are added to existing areas when new decennial census data show them to qualify. Terminology and methodology have also changed over time.

Source: U.S. Department of Commerce, Bureau of the Census.

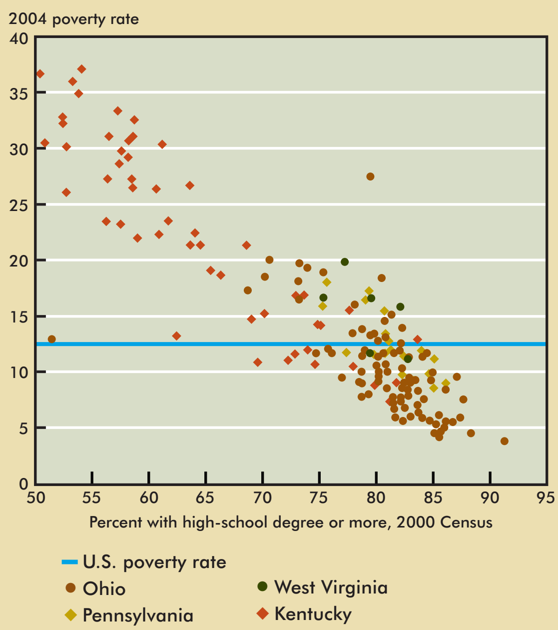
Figure 6 Fourth District County Poverty Rates and Share of Residents Age 65 and Older



Note: Plotted points signify Fourth District counties.

Source: Authors' calculations based on U.S. Department of Commerce, Bureau of the Census, Small Area Income and Poverty Program data.

Figure 7 Fourth District County Poverty Rates and Share of High-School Graduates



Note: Plotted points signify Fourth District counties.

Source: Authors' calculations based on U.S. Department of Commerce, Bureau of the Census, Small Area Income and Poverty Program data.

It turns out that age patterns have little impact on county differences within the Fourth District. Figure 6 depicts the 2004 poverty rates of Fourth District counties versus the fraction of the population age 65 and older. We see no strong pattern connecting age and poverty rates in these counties. Historically, age has mattered quite a lot, but poverty among the elderly is little different from poverty among other adults—due mainly to expanded transfers to older citizens through Social Security.

However, county poverty rates can be predicted very accurately by knowing one important fact about the residents: educational attainment. Figure 7 indicates a striking relationship between county poverty rates and education. With the exception of a few outliers, the Fourth District counties lie along a downward-sloping line: Places where more people lack a high-school diploma have higher poverty rates. These results suggest that lower high-school attainment is likely to be a key factor keeping poverty high in eastern Kentucky counties (orange diamond). Even so, these counties have made a great deal of progress, moving from an average of 24 percent of adults holding at least a high-school degree in 1960 to more than 70 percent by 2000.

The relationship between participation in the labor force (persons who are either working or looking for work) and poverty is also quite strong. Figure 8 illustrates that counties with higher labor force participation rates (the number of participants divided by the population above age 16) are associated with lower poverty rates. Of course, education levels and labor force participation rates are related. Increased education levels are associated with higher levels of participation in the labor market, along with higher earnings when working.

After studying several other interesting variables that could help explain underlying differences (such as the age composition of the population, the unemployment rate, and minority status), we find that labor force participation and education remain the most important determinants of county poverty rates. However, the effect of high-school completion is approximately twice as large as the effect of labor force participation rates and is statistically more reliable.

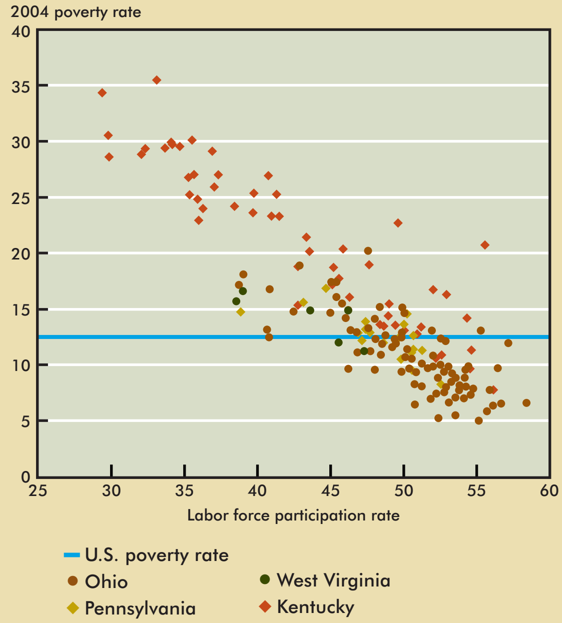
The result relating education and poverty is encouraging, but it remains preliminary. In further research, it will be important to develop models that establish a causal relationship from education to poverty rates. Otherwise, people might be led to support public policies that would address an outcome of high poverty rather than a cause. It is certainly true that high school completion rates reflect a variety of family and individual circumstances, as well as the quality of local schools. Nonetheless, the importance of human capital in driving long-term economic growth suggests the need to develop policies that encourage education and skill acquisition.

Helping to Break the Cycle of Poverty

Just as poverty has been persistent, analysis of policy options has been ongoing for decades. The challenge is to develop more permanent solutions that not only help those in poverty but also provide the incentive to boost human capital. For instance, a simple solution for eliminating poverty is to make direct transfers to the poor. By moving about $120 billion annually to Americans below the poverty line, the U.S. government could effectively move the official poverty rate to near zero. However, such a program would do little, if anything, to improve the human capital and educational outcomes that might instead lessen the incidence of poverty in the first place.

General income growth has not proven enough to eliminate poverty. In his speech declaring war on poverty, President Johnson listed education as one of the solutions. Concerns about both inequality and poverty point to the need to boost education levels, as evidenced by the declining real income for high-school dropouts over the past 40 years. Given the strong link between education and income, it seems natural to believe that for many citizens in poverty, furthering their education may be a promising avenue.

Figure 8 Fourth District County Poverty Rates and Labor Force Participation



Note: Plotted points signify Fourth District counties.

Source: Authors' calculations based on U.S. Department of Commerce, Bureau of the Census, Small Area Income and Poverty Program data.

Boosting high-school graduation rates will likely require a broad range of policies. Education remains a local policy concern, and results continue to vary substantially from one school district to the next. From an educator's perspective, poverty represents a challenge rather than an effect: It has been clearly established that living in poverty reduces the educational outcomes of children.[16]

Successful education requires the interaction of a ready student with a prepared school and a supportive community. If communities are to raise the educational attainment levels of their children, they will need to move beyond the status quo and examine new strategies.

16. Corcoran (2001).

Moving to Opportunity

Does moving from a high-poverty neighborhood to a low-poverty neighborhood improve economic, health, and social outcomes for families? The U.S. Department of Housing and Urban Development undertook an experiment in 1994 to find the answer.

Families from more than 4,000 public-assistance households in Baltimore, Boston, Chicago, Los Angeles, and New York were randomly selected over a three-year period (1994–97). The control group received no new assistance, but continued to be eligible for public housing. The treatment group received a Section 8 voucher that could be used only in neighborhoods with a poverty rate of less than 10 percent, and they also received mobility counseling.

In 2002, data were collected on outcomes from five key areas: economic self-sufficiency, mental health, physical health, risky behavior, and education.

The results of the experiment surprised researchers. Earnings and employment differed little for adults in the control and treatment groups, while mental health outcomes improved for those who moved. Female teenagers benefited most: Those who moved to lower-poverty neighborhoods engaged in less risky behavior, experienced improved mental health, and achieved higher academic performance. However, male teenagers generally fared worse along a range of social and health dimensions compared with the control group. This outcome ran exactly opposite to the researchers' hypothesis that male youths would benefit most by moving away from high-poverty neighborhoods often plagued with drug- and gang-related problems.

We can conclude from this study that housing mobility in itself does not appear to be an effective antipoverty strategy—at least over a five-year time horizon. We can also conclude that neighborhoods *do* have an effect on the social aspects of residents' lives, but in ways that we do not yet completely understand.

Sources: Kling (2006) and Kling, Liebman, and Katz (2007).

Research has pointed to some potential reforms to consider. For example, early child-care and education programs provide opportunities to address the physical, intellectual, and educational needs of young people living in poverty. In a Federal Reserve Bank of Cleveland *Economic Commentary*, Clive Belfield laid out the costs and benefits of early-childhood programs for Ohio, which have been connected to substantial gains for disadvantaged children.[17] The recent literature on compulsory schooling changes shows that even among those students most likely to drop out, adding more months of school boosts their income possibilities, potentially lowering poverty. Retaining and graduating challenged high-school students is critical; however, the research in this area has yet to establish any definitive program recommendations.[18]

Encouragingly, the past decade has witnessed a period of tremendous experimentation in education. One study conducted by the U.S. Department of Housing and Urban Development even attempted to discover whether physical moves from low- to higher-income neighborhoods and schools could help improve outcomes for poor families. The "moving to opportunity" experiment revealed that the effects of community are complicated, but they do exist (*see box at left*).

A careful rethinking of the weapons used in the battle against poverty can help the nation devise new strategies. Over the years, concerns about incentive effects have generally limited the role of transfer programs. Ultimately, the balance between helping the poor through transfer programs and by encouraging work must be decided through the political process. Further success, we argue, might be achieved through programs that bolster high-school completion, higher education levels, and the greater acquisition of skills.

17. Belfield (2005).

18. The Federal Reserve Bank of Cleveland's 2004 Education and Economic Development conference looked at several education initiatives. For more information, see *www.clevelandfed.org/research/conferences/2004/november/index.cfm*.

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2006 Operational Highlights

In 2006, the Federal Reserve Bank of Cleveland continued to manage operational growth while advancing its strategic objectives of leadership in thought and deed, operational excellence, and external focus.[1]

Leadership in Thought and Deed

The Bank's strategy to provide leadership in both thought and deed challenges employees to leverage their intellectual and operational expertise and relationships to shape the policies, strategies, and practices of the Federal Reserve System.

- The **eGovernment** function, in partnership with the Treasury Relations and Support Office, provided significant support to the U.S. Treasury through projects such as the Treasury's Collection and Cash Management Modernization initiative. In 2006, the Department of Defense recognized the Bank's exceptional contributions to the rapid deployment of scanners at major military sites. The U.S. Treasury also commended the function's extraordinary efforts to implement software changes that enabled the migration of U.S. Customs ACH transaction processing through the Pay.gov project.
- The **Cash** function contributed to the Federal Reserve System's Cash Product Office by serving on Future Cash Application Project teams and the Cash Quality work group. Cleveland served as a pilot site for the National Coin Inventory Management project, led the Cash Infrastructure and Depot Procedures Review Team, and assisted two other Reserve Banks as they prepared for their depot conversions.
- The **Retail Payments Office** managed operational restructuring and automation of check services and supported product management, development, and pricing. Cleveland staff continued to identify strategies to facilitate the transition to a more electronic check-processing environment.

1. To learn more about the Bank's role in payments, see the Operational Highlights section of the Federal Reserve Bank of Cleveland's 2005 *Annual Report*.

- The **Payments System Research Group** collaborated with Federal Reserve and industry experts on key payments issues and special projects. The group continued to provide leadership to the Electronic Billing Information Delivery System (EBIDS) task force pilot. EBIDS is a market-based approach to enhancing the payments system by eliminating barriers to the adoption of electronic bill presentment and payment and by creating solutions for enrollment, account change, and identity management.
- **Research** continued its focus on inflation and the role that innovation, education, and human capital play in strengthening economic performance and long-term economic growth. Research staff contributed numerous articles, policy discussion papers, working papers, and economic commentaries to advance thinking about monetary policy, price measurement, and long-term economic growth.
- **Supervision and Regulation, Credit Risk Management,** and **Statistics and Analysis** contributed to a variety of initiatives. Supervision continued its District umbrella supervision initiative in conjunction with the Office of the Comptroller of the Currency. Credit Risk Management provided support and leadership of national application development and led the effort to automate the transfer of securities to and from the Depository Trust Company. Statistics and Analysis contributed to Federal Reserve System efforts to modernize call report processes and, as a result, a staff member received the Outstanding Accomplishment Award from the Federal Financial Institutions Examination Council.

Nine eGovernment employees received a prestigious award from the U.S. Treasury in April 2006 for successfully developing, testing, and upgrading software used by the Treasury to collect customs payments. Several individuals from the Treasury and the U.S. Customs and Border Protection departments also received the award.

Operational Excellence

The Bank's operational excellence strategy requires a commitment to achieve the highest levels of operational efficiency and effectiveness.

- **Check** performance was strong in a year of continued consolidation and rapid transition from paper to electronics. The Cleveland and Cincinnati offices accommodated significant growth in Check 21 volume, processing the largest percentage of Check 21 transactions in the Federal Reserve System. The Bank was one of only two Federal Reserve Banks in the nation to meet all key internal financial, productivity, and quality measures.
- The **Cash** function successfully consolidated Buffalo Cash depot operations, which contributed to a 55 percent increase in paying and receiving volume in the Cleveland office. As part of this consolidation, three additional coin terminals were implemented.
- The **eGovernment** function continued to expand operations and successfully implemented the U.S. Treasury's Rapid Application Development methodology for Pay.gov.
- **Treasury Retail Securities** improved operations by implementing Payroll for the Internet and the EZ Clear Libra system, acquiring additional printing capacity for savings bonds. The operation completed the release of Gulf Coast Recovery Bonds, which supported the recovery efforts in areas devastated by hurricanes Katrina, Rita, and Wilma.
- **Supervision and Regulation** established a risk team framework to enhance its supervisory processes and completed the first phase of its Basic Training Program and Examination Simulator initiative.
- **Financial Management** exceeded targets for National Billing customer satisfaction, met all service-level agreements, and actively contributed to the future direction for software development.
- **Information Technology** sponsored the Federal Reserve System's Server and Storage Leadership Team and led the administration of the Systemwide information technology customer satisfaction survey.

Jeff Davis, Procter & Gamble's director of New Business Development, spoke at the Bank's conference on Universities, Innovation, and Economic Growth in November 2006.

Scott Ferguson, intermediate Check processor, was one of nearly 350 employees in the Cleveland and Cincinnati offices who helped the Check function to accommodate significant operational growth and meet all key internal quality measures.

- **Information Security** hosted a highly successful conference on web security, which heightened Federal Reserve System awareness of information security improvement opportunities.
- **Drive 4th**, a new cultural change initiative, kicked off a multiyear effort to transform the Bank's culture to better support external focus and thought leadership initiatives.

External Focus

The Bank's external focus strategy promotes an understanding of the Federal Reserve and its mission through active and visible engagement with financial institutions, the U.S. Treasury, and the public.

- **Research** strengthened its role as a source of information and analysis on national and regional economic issues. Research staff hosted or sponsored numerous events throughout the year, including a conference on Universities, Innovation, and Economic Growth.
- **Community Affairs** sponsored numerous programs, seminars, and workshops to foster a dialogue on issues that affect community reinvestment strategies in low- and moderate-income neighborhoods and to promote a better understanding of regulatory issues. Cleveland's 2006 policy summit examined specific poverty issues and the role that community development practitioners play in meeting the challenges associated with concentrated poverty.
- **Public Information** provided several well-received educational outreach programs to promote understanding of the Federal Reserve's mission and key initiatives. The Fed Challenge, Essays in Economics, and Great Minds Think events offered District students and educators an opportunity to learn about the economy, personal finance, and critical thinking. The Bank also co-sponsored the Ohio Council on Economic Education's Economics Challenge competition.
- The **Learning Center and Money Museum** hosted more than 10,000 visitors during its first year of operation. See the following two pages for facts, figures, and photos.

In March 2006, the Pittsburgh office printed the first Gulf Coast Recovery Bond to help rebuild the hurricane-devastated Gulf Coast region. The Information Technology Department assisted in responding to this urgent request from the U.S. Treasury.

Financial Management's National Billing Team exceeded targets for customer satisfaction, met all service-level agreements, and assisted in software development.

Surround Yourself with Money

Meeting the challenge of operating in today's economy is much easier if we have a working knowledge of how our economy functions and how it affects us. That is why economic education is such a critical component of the Federal Reserve's mission.

(Chairman Ben Bernanke, July 2006)

Visitors to the Federal Reserve Bank of Cleveland's new Learning Center and Money Museum are surrounded by money—whether gazing up at the historic currency "growing" on the Money Tree, discovering how compound interest works on the Savings Staircase, or learning about the unique currency of the Yap islands. While experiencing these and more than 25 other exhibits, guests are invited to think about why U.S. currency has value and how that value is maintained.

The Learning Center's Savings Staircase illustrates how compound interest helps saved money grow.

Federal Reserve Board of Governors Chairman Ben Bernanke visits the Learning Center with Bank Vice President and Economist Michael Bryan.

In its first year of operation, the Learning Center welcomed more than 10,000 visitors. It is a cornerstone of the Bank's community and education outreach efforts. By fostering an appreciation of what gives money value and the role of the central bank in maintaining that value, the Learning Center is helping to increase public understanding of the Bank and the Federal Reserve System.

With more than 6,500 square feet, the Learning Center houses two classrooms and many hands-on exhibits, including interactive games, videos, and informational displays that encourage visitors to discover and explore. Visitors learn about inflation, bartering, and the role of the Fed in the nation's economy. The Learning Center's goal is to spark discussions about money, saving and investing, and how our economy operates.

The Learning Center and Money Museum makes learning fun by presenting concepts through learning activities based on education benchmarks. The activities and exhibit content were planned well before construction began, allowing time for professional educators to evaluate them. The Center receives ongoing evaluation and expert advice on its continued operations from the Learning Center Advisory Council, a group of education and museum specialists.

If You Build It...

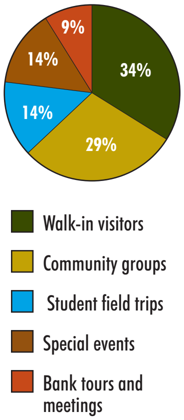
Our 10,000 guests included students, teachers, parents, and tourists. Just about half of the Center's student visitors were from urban school districts. The pie chart at right gives more information on the kinds of guests the Center attracted in its first year.

In addition to on-site visitors, broadcast and print stories in local and national outlets have reached a potential audience of over 3.5 million, increasing public awareness of this new facility. Articles and programs focused on the museum's grand opening and its first special exhibition: *The Color of Money: Depictions of Slavery in Confederate and Southern States' Currency*.

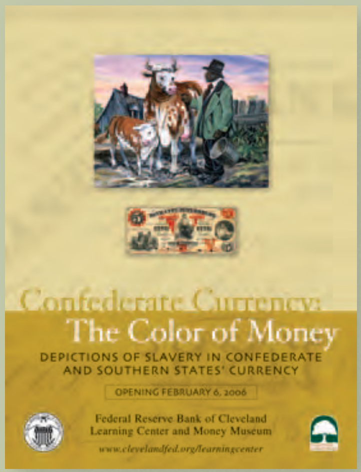
You're Invited

If you would like to surround yourself with money while pondering what makes it valuable, consider a visit to the Learning Center and Money Museum. For more information on visiting, check the Bank's website at *www.clevelandfed.org/learningcenter*.

Learning Center and Money Museum Visitors



Hands-on exhibits encourage visitors to discover and explore.



The Learning Center's first special exhibition was a success, increasing daily average attendance at the facility by nearly 30 percent.

Federal Reserve Bank of Cleveland

Financial Statements

◆ Auditor Independence

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

March 5, 2007

To the Board of Directors of the Federal Reserve Bank of Cleveland:

The management of the Federal Reserve Bank of Cleveland ("FRBC") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 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 condition, 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 Cleveland

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President & Chief Executive Officer

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First Vice President &
Chief Operating Officer

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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 Cleveland:

We have completed an integrated audit of the Federal Reserve Bank of Cleveland's (the "Bank") 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 Cleveland (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.

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.

PricewaterhouseCoopers LLP

March 12, 2007

Comparative Financial Statements

Statements of Condition

(*in millions*)

	December 31, 2006	December 31, 2005
ASSETS		
Gold certificates	$ 446	$ 453
Special drawing rights certificates	104	104
Coin	73	55
Items in process of collection	451	820
U.S. government securities, net	33,836	31,692
Investments denominated in foreign currencies	1,570	1,712
Accrued interest receivable	290	247
Interdistrict settlement account	—	833
Bank premises and equipment, net	186	185
Other assets	62	73
Total assets	**$ 37,018**	**$ 36,174**
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	$ 29,807	$ 31,457
Securities sold under agreements to repurchase	1,279	1,289
Deposits:		
Depository institutions	954	658
Other deposits	4	7
Deferred credit items	405	581
Interest on Federal Reserve notes due to U.S. Treasury	29	78
Interdistrict settlement account	2,264	—
Accrued benefit costs	88	65
Other liabilities	14	11
Total liabilities	**34,844**	**34,146**
Capital:		
Capital paid-in	1,087	1,014
Surplus (including accumulated other comprehensive loss of $22 million at December 31, 2006)	1,087	1,014
Total capital	**2,174**	**2,028**
Total liabilities and capital	**$ 37,018**	**$ 36,174**

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

Statements of Income

(*in millions*)

	For the year ended December 31, 2006	For the year ended December 31, 2005
Interest income:		
Interest on U.S. government securities	$ 1,512	$ 1,191
Interest on investments denominated in foreign currencies	29	25
Total interest income	**1,541**	**1,216**
Interest expense:		
Interest expense on securities sold under agreements to repurchase	58	34
Net interest income	**1,483**	**1,182**
Other operating income (loss):		
Compensation received for services provided	68	60
Reimbursable services to government agencies	60	55
Foreign currency gains (losses), net	91	(243)
Other income	4	5
Total other operating income (loss)	**223**	**(123)**
Operating expenses:		
Salaries and other benefits	112	106
Occupancy expense	16	15
Equipment expense	14	11
Assessments by the Board of Governors	46	50
Other expenses	80	64
Total operating expenses	**268**	**246**
Net income prior to distribution	**$ 1,438**	**$ 813**
Distribution of net income:		
Dividends paid to member banks	$ 63	$ 65
Transferred to (from) surplus	95	(51)
Payments to U.S. Treasury as interest on Federal Reserve notes	1,280	799
Total distribution	**$ 1,438**	**$ 813**

Statements of Changes in Capital

For the years ended December 31, 2006 and December 31, 2005

(*in millions*)

		Surplus			
	Capital Paid-In	Net Income Retained	Accumulated Other Comprehensive Loss	Total Surplus	Total Capital
Balance at January 1, 2005 (21.3 million shares)	$ 1,065	$ 1,065	$ —	$ 1,065	$ 2,130
Net change in capital stock redeemed (1.0 million shares)	(51)	—	—	—	(51)
Transferred from surplus	—	(51)	—	(51)	(51)
Balance at December 31, 2005 (20.3 million shares)	$ 1,014	$ 1,014	$ —	$ 1,014	$ 2,028
Net change in capital stock issued (1.4 million shares)	73	—	—	—	73
Transferred to surplus	—	95	—	95	95
Adjustment to initially apply FASB Statement No. 158	—	—	(22)	(22)	(22)
Balance at December 31, 2006 (21.7 million shares)	$ 1,087	$ 1,109	$ (22)	$ 1,087	$ 2,174

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

Notes to Financial Statements

1. STRUCTURE

The Federal Reserve Bank of Cleveland ("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 branches in Cincinnati and Pittsburgh serve the Fourth Federal Reserve District, which includes Ohio and portions of Kentucky, Pennsylvania, and West Virginia.

In accordance with the Federal Reserve Act, supervision and control of the Bank are exercised by a board of directors. The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors 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 Check Automation Services, Retail Payments Office, National Check Adjustments, Treasury Retail Services Technology, Check 21 Software, Cash Technology, Check Restructuring Projects, National Billing Operations, and Audit Application Competency Center Services.

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 $61 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. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

a. Gold 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. 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. There were no outstanding loans to depository institutions at December 31, 2006 and 2005.

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 parties 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 $6,709 million and $5,081 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 nonvoting 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 $2 million for each of the years ended December 31, 2006 and 2005, 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 postretirement 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 Statements of Condition at December 31, 2006, were as follows (in millions):

	Before Application of Statement 158	Adjustments	After Application of Statement 158
Accrued benefit costs	$ 66	$ 22	$ 88
Total liabilities	$ 34,822	$ 22	$ 34,844
Surplus	$ 1,109	$ (22)	$ 1,087
Total capital	$ 2,196	$ (22)	$ 2,174

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 4.318 percent and 4.225 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	$ 11,961	$ 11,460
Notes	17,374	16,058
Bonds	4,298	3,921
Total par value	33,633	31,439
Unamortized premiums	376	372
Unaccreted discounts	(173)	(119)
Total allocated to the Bank	$ 33,836	$ 31,692

At December 31, 2006 and 2005, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was $34,367 million and $32,422 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 $1,279 million and $1,289 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 $1,281 million and $1,291 million were 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. Government Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	$ 1,752	$ 1,279
16 days to 90 days	7,811	–
91 days to 1 year	7,994	–
Over 1 year to 5 years	9,680	–
Over 5 years to 10 years	2,921	–
Over 10 years	3,475	–
Total allocated to the Bank	$ 33,633	$ 1,279

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 $296 million and $160 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 7.663 percent and 9.043 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
European Union Euro:		
Foreign currency deposits	$ 478	$ 491
Securities purchased under agreements to resell	170	174
Government debt instruments	312	322
Japanese Yen:		
Foreign currency deposits	200	237
Government debt instruments	410	488
Total allocated to the Bank	$ 1,570	$ 1,712

At December 31, 2006 and 2005, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was $1,566 million and $1,715 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	$ 334	$ 199	$ 533
16 days to 90 days	182	93	275
91 days to 1 year	187	170	357
Over 1 year to 5 years	257	148	405
Total allocated to the Bank	$ 960	$ 610	$ 1,570

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	$ 9	$ 8
Buildings	172	170
Building machinery and equipment	51	49
Construction in progress	5	3
Furniture and equipment	71	70
Subtotal	$ 308	$ 300
Accumulated depreciation	(122)	(115)
Bank premises and equipment, net	$ 186	$ 185
Depreciation expense, for the year ended December 31	$ 13	$ 11

The Bank leases space to outside tenants with remaining lease terms ranging from one to eight years. Rental income from such leases was $1 million for each of the years ended December 31, 2006 and 2005, 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	$ 1
2008	1
2009	1
2010	1
2011	1
Thereafter	2
Total	$ 7

The Bank has capitalized software assets, net of amortization, of $34 million and $39 million at December 31, 2006 and 2005, respectively. Amortization expense was $18 million and $12 million for the years ended December 31, 2006 and 2005, respectively. Capitalized software assets are reported as a component of "Other assets" and the related amortization is reported as a component of "Other expenses." Obsolete software assets of $2 million and $1 million were written off for the years ended December 31, 2006 and 2005, respectively. The majority of the write-offs were reimbursed by the Department of the Treasury.

Assets impaired as a result of the Bank's restructuring plan, as discussed in Note 11, include building machinery and equipment. Asset impairment losses are determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses." Asset impairment losses for the period ending December 31, 2006, were immaterial. The Bank had no impairment losses in 2005.

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 three 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 $1 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 terms of one year or more, at December 31, 2006, were not material.

At December 31, 2006, the Bank, acting on its own behalf, had other commitments and long-term obligations extending through the year 2008 with a remaining amount of $7 million. As of December 31, 2006, commitments of $50 million were recognized. Purchases of $11 million and $17 million were made against these commitments during 2006 and 2005, respectively. These commitments represent Electronic Treasury Financial Services and facilities-related expenditures, and have only fixed components. The fixed payments for the next five years under these commitments are as follows (in millions):

	Fixed Commitment
2007	$ 6
2008	1
2009	—
2010	—
2011	—

At December 31, 2006, the Bank, acting on behalf of the Reserve Banks, had contractual commitments extending through the year 2011 with a remaining amount of $27 million. As of December 31, 2006, commitments of $69 million were recognized. Purchases of $27 million and $22 million were made against these commitments during 2006 and 2005, respectively. It is estimated that the Bank's allocated share of these commitments will be $16 million. These commitments represent Check software and hardware, including license and maintenance fees, and have only fixed components. The fixed payments for the next five years under these commitments are as follows (in millions):

	Fixed Commitment
2007	$ 11
2008	9
2009	6
2010	1
2011	—

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 $4 million for each of the years ended December 31, 2006 and 2005, 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	$ 59.2	$ 66.3
Service cost benefits earned during the period	2.2	1.6
Interest cost on accumulated benefit obligation	3.5	3.1
Actuarial loss (gain)	17.5	(9.0)
Contributions by plan participants	0.4	0.3
Benefits paid	(3.6)	(3.1)
Accumulated postretirement benefit obligation at December 31	$ 79.2	$ 59.2

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	3.2	2.8
Contributions by plan participants	0.4	0.3
Benefits paid	(3.6)	(3.1)
Fair value of plan assets at December 31	$ –	$ –
Unfunded postretirement benefit obligation	$ 79.2	$ 59.2
Unrecognized prior service cost		10.2
Unrecognized net actuarial loss		(13.7)
Accrued postretirement benefit cost		$ 55.7
Amounts included in accumulated other comprehensive loss are shown below (in millions):		
Prior service cost	$ 8.0	
Net actuarial loss	(30.2)	
Total accumulated other comprehensive loss	$ (22.2)	

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	$ 1.1	$ (0.9)
Effect on accumulated postretirement benefit obligation	11.0	(9.0)

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	$ 2.2	$ 1.6
Interest cost on accumulated benefit obligation	3.5	3.1
Amortization of prior service cost	(2.3)	(2.3)
Recognized net actuarial loss	1.0	0.4
Net periodic postretirement benefit expense	$ 4.4	$ 2.8

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense (credit) in 2007 are shown below (in millions):

Prior service cost	$ (2.3)
Actuarial loss	3.0
Total	$ 0.7

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 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 loss 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 $200 thousand.

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

	Without Subsidy	With Subsidy
2007	$ 3.5	$ 3.2
2008	3.9	3.5
2009	4.2	3.8
2010	4.6	4.2
2011	5.0	4.5
2012–2016	30.4	27.3
Total	$ 51.6	$ 46.5

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, disability benefits, and self-insured workers' compensation expenses. The accrued postemployment benefit costs recognized by the Bank at December 31, 2006 and 2005, were $7.7 million and $8.7 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 $200 thousand and $1.2 million, 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	(22)
Balance at December 31, 2006	$ (22)

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

11. BUSINESS RESTRUCTURING CHARGES

In 2004, the Bank announced plans for restructuring to streamline operations and reduce costs in Check processing. These actions resulted in the following business restructuring charges (in millions):

			Year ended December 31, 2006		
	Total Estimated Costs	Accrued Liability December 31, 2005	Total Charges	Total Paid	Accrued Liability December 31, 2006
Employee separation	$ 0.8	$ 0.9	$ (0.1)	$ 0.8	$ –
Other	0.4	–	0.4	0.2	0.2
Total	$ 1.2	$ 0.9	$ 0.3	$ 1.0	$ 0.2

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 54. 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. Other costs include the continuation of a noncancelable lease agreement and associated facility maintenance and are shown as a component of "Occupancy expense."

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 substantially completed its announced plans in February 2006.

Federal Reserve Banks each have a board of nine directors. Directors supervise the Bank's budget and operations, make recommendations on the primary credit rate and, with the Board of Governors' approval, appoint the Bank's president, first vice president, and officers.

Class A directors are elected by and represent the interests of Fourth District member banks. Class B directors also are elected by member banks but represent the public interests of agriculture, commerce, industry, services, labor, and consumers. Class C directors are selected by the Board of Governors and also represent these public interests.

Directors serve for three years. Two Class C directors are designated by the Board of Governors as chairman and deputy chairman of the board. Directorships generally are limited to two successive terms to ensure that the individuals who serve the Federal Reserve System represent a diversity of backgrounds and experience.

The Cincinnati and Pittsburgh branch offices each have a board of seven directors who serve three-year terms. Board members are appointed by the Federal Reserve Bank of Cleveland or the Board of Governors.

Federal Reserve Bank of Cleveland

Officers and Consultants

As of December 31, 2006

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R. Chris Moore
First Vice President
and Chief Operating Officer

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Senior Vice President
Supervision and Regulation,
Credit Risk Management, Statistics and Analysis

Lawrence Cuy
Senior Vice President
Financial Management Services, Strategic Planning,
Information Technology, Risk Management

Robert W. Price
Senior Vice President
Retail Payments Office,
National Check Automation and Operations,
National Product Development

Susan G. Schueller
Senior Vice President
and General Auditor
Audit

Samuel D. Smith
Senior Vice President
Cash, Treasury Retail Securities,
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Payments System Research

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Research, Economic Policy and Strategy

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Legal, Ethics Officer

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Research

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Vice President
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Research

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Business Continuity

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Treasury Electronic Check Processing

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Budget, Procurement, Strategic Planning, Risk Management

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Credit Risk Management, Statistics and Analysis

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Information Security, Business Continuity

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Supervision and Regulation

Cleveland Board of Directors

As of December 31, 2006

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Chairman and Chief Executive Officer
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Pittsburgh, Pennsylvania

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Deputy Chair
President and Chief Executive Officer
Crane Group Company
Columbus, Ohio

V. Ann Hailey
Executive Vice President,
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Limited Brands
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KeyCorp
Cleveland, Ohio

Alfred M. Rankin, Jr.
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Chief Executive Officer
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Lebanon, Ohio

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Federal Advisory Council Representative
Chairman and Chief Executive Officer
Fifth Third Bancorp
Cincinnati, Ohio

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Cincinnati Board of Directors

As of December 31, 2006

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President and Chief Executive Officer
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Medical Center
Cincinnati, Ohio

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Czar Coal Corporation
Lovely, Kentucky

Herbert R. Brown
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Western & Southern Financial Group
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Managing Partner
Global Lead Management Consulting
Cincinnati, Ohio

Charles Whitehead
Retired President
Ashland Inc. Foundation
Covington, Kentucky

James M. Anderson, Herbert R. Brown, James H. Booth, Charlotte W. Martin, Charles Whitehead, Janet B. Reid, and Glenn D. Leveridge.

Pittsburgh Board of Directors

As of December 31, 2006

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Chairman and Chief Executive Officer
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Pittsburgh, Pennsylvania

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Chester Engineers, Inc.
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Senior Vice President
Turner Construction Company
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Kristine N. Molnar
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Wheeling, West Virginia

Georgiana N. Riley
President and Chief Executive Officer
TIGG Corporation
Bridgeville, Pennsylvania

Sunil T. Wadhwani
Chief Executive Officer
and Co-founder
iGATE Corporation
Pittsburgh, Pennsylvania

James I. Mitnick, Sunil T. Wadhwani, Georgiana N. Riley, Michael J. Hagan, Roy W. Haley, Kristine N. Molnar, and Robert O. Agbede.

Business Advisory Councils

As of December 31, 2006

Business Advisory Council members are a diverse group of Fourth District businesspeople who advise the president and senior officers on current business conditions.

Each council–in Cleveland, Cincinnati, and Pittsburgh–meets with senior Bank leaders at least twice yearly. These meetings provide anecdotal information that is useful in the consideration of monetary policy direction and economic research activities.

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Warren, Ohio

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Chief Financial Officer
Hyland Software, Inc.
Westlake, Ohio

Gary A. Lesjak
Chief Financial Officer
The Shamrock Companies Inc.
Westlake, Ohio

Rodger W. McKain
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Cincinnati

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Pittsburgh

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TriLogic Corporation
Canonsburg, Pennsylvania

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Campos Inc.
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Reneé S. Frazier
Senior Vice President and
Executive Officer
VHA Pennsylvania
Pittsburgh, Pennsylvania

Dawn Fuchs
President
Weavertown Environmental Group
Carnegie, Pennsylvania

D. Michael Hartley
Chairman and Chief Executive Officer
Standard Bent Glass Corporation
Renfrew, Pennsylvania

John L. Kalkreuth
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