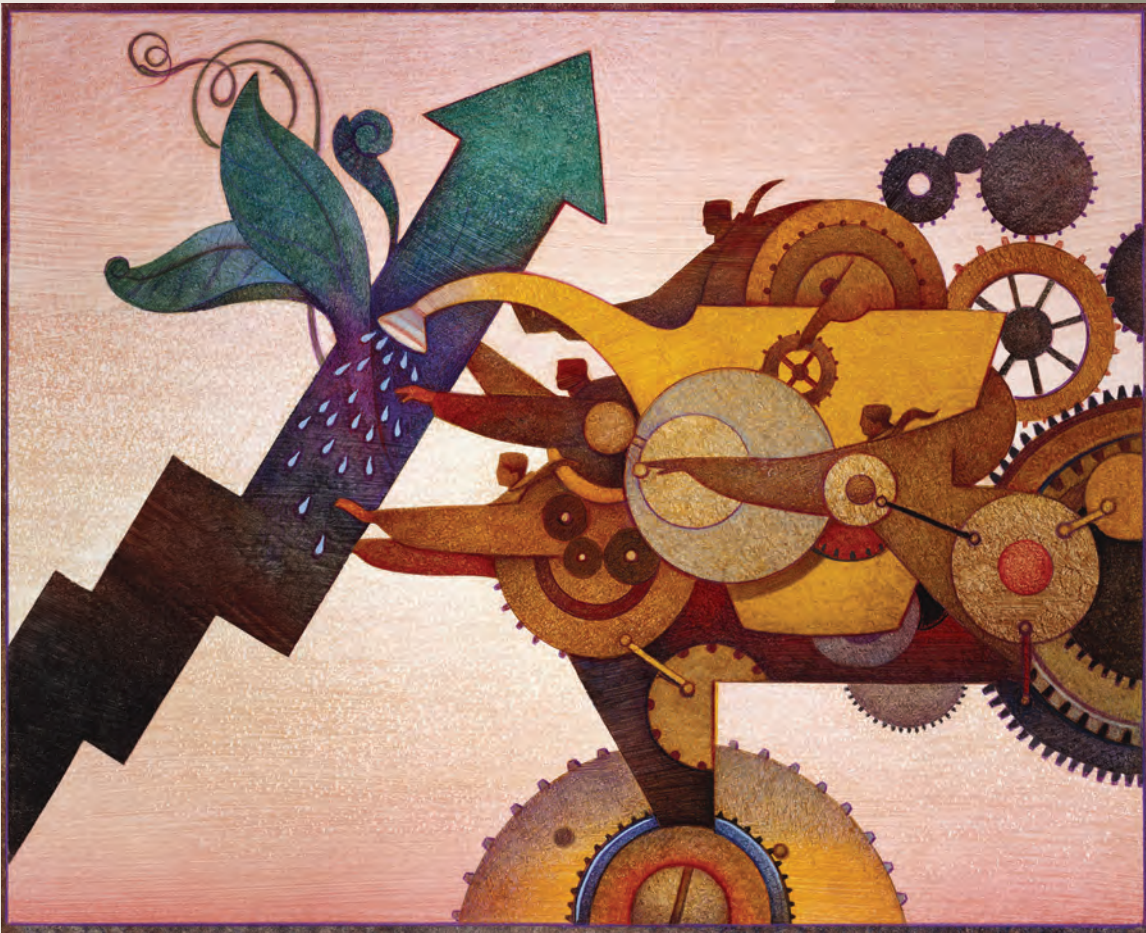


FEDERAL RESERVE BANK
of CLEVELAND



Annual Report 2011

Maximum employment:
what we know (and don't know) about

THE LABOR MARKET

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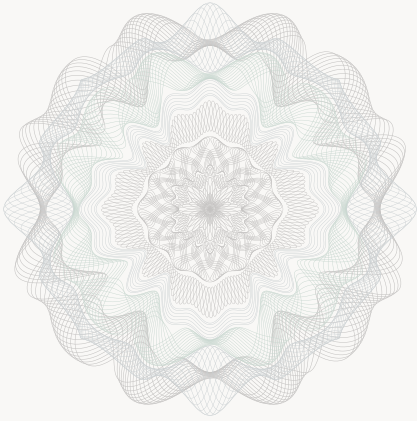



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The Federal Reserve System is responsible for formulating and implementing U.S. monetary policy. It also supervises certain banks and other financial institutions and provides financial services to depository institutions and the federal government.

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, DC, 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).



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First Vice President and Chief Operating Officer

Sandra Pianalto
President and Chief Executive Officer

Alfred M. Rankin Jr.
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Richard K. Smucker
Deputy Chairman, Board of Directors



The Federal Reserve has a dual mandate to promote stable prices and maximum employment, and we take a balanced approach in fulfilling these objectives. Early in 2010, and again early last year, economic growth seemed poised to accelerate, only to disappoint. At times, inflation appeared likely to move either too far above or too far below our long-term objective of 2 percent. Needless to say, conducting monetary policy in this environment remains quite challenging.

In last year's annual report essay, I focused on the price stability aspect of the Federal Reserve's dual mandate. I explained why price stability is essential to achieving maximum economic growth. In this annual report essay, I consider economic growth from another perspective—that of the labor market.

In my essay and in related articles by the Federal Reserve Bank of Cleveland's Research staff, we identify some of the salient features of today's employment situation. These insights underpin my view that the current stance of monetary policy puts us on the right path for meeting our dual mandate of maximum employment and stable prices over the long term.



At the Federal Reserve Bank of Cleveland, 2011 was a year of change and progress. The Office of Minority and Women Inclusion made many strides in its first full year of operation. As directed by Congress, the Office formalizes efforts that have been underway at this Bank for several years: It is responsible for all matters relating to diversity in management, employment, and business activities.

In the fourth quarter, our Bank welcomed a new first vice president and chief operating officer, Gregory Stefani. Beginning on page 22, Greg introduces the operations section of this report: the 2011 Innovation Update. He explains that although the Pittsburgh Branch of the Cleveland Fed will no longer issue and redeem savings bonds in partnership with the U.S. Treasury, the Bank continues to work with the Treasury to provide wide-ranging, efficient electronic payments and debt management services to benefit customers across the nation.

President's Foreword

After four years of crisis, recession, and uncertainty, U.S. businesspeople are expressing a sense of greater confidence and cautious optimism. Yet our economy still faces some serious headwinds. Housing markets remain in distress, state and local governments are still adjusting to budget pressures, and European financial markets continue to pose downside risks.

The officers and staff of the Federal Reserve Bank of Cleveland are committed to serving our region and nation through the Bank's three major functions: monetary policy, supervision and regulation, and financial services. In these efforts, we are enriched by the guidance and insights provided by our boards of directors in Cleveland, Pittsburgh, and Cincinnati, as well as by our advisory councils across the District.

I especially want to thank the directors who completed their terms of service on our boards in 2011. I am grateful to **Charlotte Martin**, president and CEO of Great Lakes Bankers Bank in Worthington, Ohio, who spent five years on our Cincinnati board of directors before joining the Cleveland board in 2009. Her contributions and counsel have been noteworthy throughout her tenure on our boards.

James Anderson, retired president and advisor to the Cincinnati Children's Hospital Medical Center, stepped down after six years of service as chairman of our Cincinnati board, which is a significant commitment of time and talent. Jim's business expertise and deep history in medical services have helped us better understand both the healthcare industry and the economy of the southern part of our District, and we are indebted to him for those contributions.

Also retiring from our Cincinnati board is **Janet Reid**, managing partner and director of Global Novations, LLC in Cincinnati, following two terms as a director. Janet brought us key guidance on the service sector, both regionally and nationally. Her vision and understanding of workplace trends has greatly enhanced our view of the labor market.

Thanks also go to **Sunil Wadhvani**, chairman and co-founder of iGATE Corporation in Pittsburgh, who served two terms as a Pittsburgh director and chaired the Pittsburgh board for the past three years. Sunil brought significant insights on emerging technologies nationally and globally, and his energy and commitment have been invaluable.

Howard W. Hanna III, chairman and CEO of Howard Hanna Real Estate Services, also retired from our Pittsburgh board after five years of service. His expertise in housing markets helped guide us through a turbulent time for that sector, and his boundless energy and optimism in spite of those challenges were much appreciated.

Finally, I am grateful to **James Rohr**, chairman and CEO of the PNC Financial Services Group, Pittsburgh, who ably served as the Bank's representative on the Federal Advisory Council in 2011.



The employees of the Federal Reserve Bank of Cleveland continue to advance our Bank's vision of promoting financial stability and prosperity in our neighborhoods, region, and country. Whether by conducting research that contributes to sound monetary policy, by supervising and regulating banks to ensure they operate in a safe and sound manner, or by providing financial services to banking institutions and the U.S. government to help the payments system function smoothly and efficiently, our employees embody the best characteristics of a private entity serving the public interest.

As I enter my 10th year as president and CEO of the Federal Reserve Bank of Cleveland, I am proud to lead an organization devoted to excellence, thought leadership, and innovation. I sincerely thank the Bank's officers and staff for their efforts in positioning our Bank for continued success.



Sandra Pianalto
President and Chief Executive Officer



Maximum employment:
what we know (and don't know) about

THE LABOR MARKET

By Sandra Pianalto, President and CEO

Developing issues in the labor market are clouding the outlook for both the unemployment rate and the natural rate of unemployment over the next few years. Both rates at their current levels clearly argue for providing an accommodative monetary policy, as long as inflation remains consistent with the Federal Open Market Committee's price stability objective.

During the next few years, I expect that our economy will continue to grow, that unemployment will decline, and that inflation will average about 2 percent. Monetary policy will need to be adjusted in response to incoming data that may prompt economists to re-evaluate the outlook. In particular, I am closely watching developments in several highly uncertain features of the labor market. These include trends in job matching, unemployment durations, labor market participation, and wages.

THE DUAL MANDATE

The Federal Reserve Act mandates that monetary policy be set to achieve stable prices over the long run as well as maximum sustainable employment. I do not view these objectives as competing with one another because over the longer run, price stability is essential to achieving maximum sustainable employment.

In last year's Federal Reserve Bank of Cleveland annual report essay, I wrote about inflation and monetary policy, suggesting that the Federal Open Market Committee (FOMC) could enhance its monetary policy framework by establishing a specific numerical objective for its stable prices mandate. My reasoning was that ultimately, inflation is a monetary phenomenon, and its trend can be controlled by the central bank.

Others supported that view as well, and in January 2012, the FOMC established an objective for stable prices of 2 percent inflation over the longer term. Over the past three years (which is just enough time to include the offsetting high and low inflation periods around the recession and recovery), inflation has averaged 1.5 percent. I expect inflation to stay close to the FOMC's 2 percent objective over the next few years, in line with projections from most professional forecasters. So I think it is fair to say that the FOMC has been effectively fulfilling its mandate for stable prices.

In its statement of longer-run objectives in January 2012, the FOMC also acknowledged that "the maximum level of employment is largely determined by nonmonetary factors." But these questions remain: how to put the concept of "full employment" into practical use, and how monetary policy should promote it.

The underperformance of the U.S. labor market is one of the most defining aspects of the nation's recovery from the financial crisis and severe recession. More than 12.5 million people are unemployed today, almost three years after the end of the recession. That's more than the number of people out of work at the deepest points of any recession since World War II. As if the sheer numbers are not grim enough, the average length of unemployment spells also stands at a record high.

We clearly have not satisfied our maximum employment mandate—the unemployment rate remains quite high, and unemployment spells are still too long. So in this year's essay, I focus on the labor market in relation to monetary policy.

In my view, the FOMC's highly accommodative monetary policy has put the economy on a path toward achieving our maximum employment objective. However, as is the case with many policy issues, I have relatively more confidence in some facets of today's labor market and less confidence in others. Because of these labor market "unknowns," I want to keep an open mind and be prepared to make policy adjustments if the outlook changes.

THE "NATURAL RATE" AND TODAY'S UNEMPLOYMENT

Let's start with one aspect of the labor market that I am relatively confident about: Today's labor market is far from full employment. As intuitive as the term "full employment" might seem, economists tend to think of the labor market from a broader perspective, one that includes both labor demand and labor supply. More often, we ask how low the *unemployment* rate could go and stay steady if the economy had fully adjusted to any disturbances (such as recessions). This level of unemployment is the concept I refer to as the "natural rate of unemployment."

In this framework, zero unemployment is just not possible because people are always entering and returning to the workforce, people are always leaving jobs and searching for new ones, and some businesses fail or contract while others start up or expand. Because it takes some time to search for a job, at any given time there will be people who are looking for work and thus unemployed. These labor market frictions are always present and keep the natural rate of unemployment above zero. I find this concept of the natural rate fairly appealing and use it in my thinking about labor market dynamics and monetary policy.

Unfortunately, putting a specific number on the concept of the natural rate of unemployment is technically difficult, and economists have different estimates for this rate. Moreover, the natural rate of unemployment can shift up or down with changes in demographics, technology, the skill level of the labor force, and regulations, among other factors. In January 2012, FOMC participants had a range of estimates for the natural rate of unemployment between 5 and 6 percent. My staff and I currently estimate this rate at somewhere around 6 percent (see side essay, page 12). The difference between the current unemployment rate of 8.1 percent and the natural rate of 6 percent translates into roughly 3.5 million people. We have a long way to go.

GETTING BACK TO THE NATURAL RATE

It seems remarkable that the unemployment rate should be this high nearly three years after the trough of the recession. And yet, I still don't expect the unemployment rate to reach 6 percent for another four years or so. Why is it going to take so long?

First, we fell into such a deep hole to begin with. We lost almost 9 million jobs during the recession (beyond the roughly 6.5 million people already unemployed). Since employment began to recover, we have regained only about 3 million of the lost jobs. Even if we continue to generate around 200,000 jobs each month (the average gain in the first four months of 2012), ongoing population growth implies that it would still be four years before we reached 6 percent unemployment. And that estimate assumes that the many people who stopped looking for work in the recession will not return to the labor force. If they do return, as they usually do when times get better, we will need to create millions of additional jobs to get back to full employment. So thus far, we have climbed only partway out of a very deep hole.

Second, our economy is generating job openings very slowly. Output growth has been weak over the recovery and looks likely to stay moderate over the next several quarters. The only real solution to the unemployment problem is to increase the number of job openings through more growth in the economy. Typically, our economy needs to grow at a rate of 2 percent just to accommodate new people who join the workforce and to keep the unemployment rate from rising. Unfortunately, the economy grew at less than 2 percent in each of the first three quarters of 2011 and then picked up to 3 percent in the fourth quarter—still not enough total growth to see significant

progress on employment last year. This year's growth started out at 2.2 percent in the first quarter, which has produced only moderate gains in job openings.

Finally, there are reasons to think our economy is matching workers to job openings at a slower pace than in the past. This matching process may be permanently slower and less dynamic for several reasons. It could be that demand for more specialized skills—those requiring higher levels of education and training—makes it harder for employers to find candidates who meet the necessary requirements. Businesses create and destroy jobs all the time. This churning process causes some unemployment but also creates new employment opportunities. There is some evidence that this churning process has been slowing, and labor market adjustments have been slowing along with it (see side essay, page 14).

In sum, we generated a *lot* of unemployment in the recession, we are not generating job openings very quickly in the recovery, and employers may be taking longer to fill the open positions than they used to. While each of these three reasons helps to explain why it may take quite some time to reach maximum employment, none of them necessarily implies that the natural rate of unemployment has increased, although it may have. If there is any good news in all of this, it is that U.S. economic history supports the prospect that workers will eventually shift industries and get the training they need to meet the demands of the workplace.



The only real solution to the unemployment problem is to increase the number of job openings through more growth in the economy.

OPEN LABOR MARKET QUESTIONS

While I have confidence in some aspects of the labor market, I have less confidence in others. I am closely monitoring several “unknowns” in the labor market where conditions are historically unusual. How the labor market will perform over the next few years deserves careful analysis.

One issue we are following closely at the Federal Reserve Bank of Cleveland is the job-matching process, which is central to the economic models we use to estimate the natural rate of unemployment. These estimates can shift up or down over time in response to changes in the underlying trends in job-finding and job-separation rates. The process of matching workers to jobs appears to have slowed, but it is difficult to judge how much of this change will prove to be permanent versus a transitory response to our recent deep recession.

The slowdown in the job-finding rate (which would tend to raise the natural rate of unemployment) has been partially offset by a decline in the job-separation rate (which acts to lower the natural rate). While recent shifts in these rates over the course of the recovery have implied only a small increase in the natural rate of unemployment, further shifts in these rates could more substantially raise or lower the natural rate. Even without a shift in the natural rate, slower job-finding rates (offset by a reduced job-separation rate) would still slow the economy’s adjustment toward a lower unemployment rate (again, see side essay, page 12).

A second aspect of labor market performance that is not so clearly understood is whether the long spells of unemployment that many individuals are experiencing—some exceeding two years—will have lasting impacts on their employability and lifetime earnings. We have reasons to be concerned about the job-finding outlook for these individuals (see side essay, page 18). Although some people do find work after a year or more of unemployment, a long unemployment spell does lessen the likelihood of finding a job, and the number of people with more than a year of unemployment is unprecedented. We also know from previous experience that these individuals often have reduced income levels for many years after they find work again, perhaps because their skills are fundamentally less valuable in their new work. If the adjustment of workers to new sectors were to slow, productivity in turn would be adversely affected. This is an important concern, given that productivity is ultimately the source of economic prosperity.

A third, less-well-understood aspect of labor market conditions is the reintegration back into the labor force of people who have stopped looking for work and those who are currently underemployed (see side essay, page 20). We know that a lot of people have moved out of the full-time labor force, and we know that long-term economic growth depends on their return. But we don’t know the outcome if these individuals were to re-enter the full-time labor force suddenly—it could, for example, increase the challenges of those currently unemployed and cause the unemployment rate to decline more slowly than currently projected.

←-----
If the adjustment of workers to new sectors were to slow, productivity in turn would be adversely affected. This is an important concern, given that productivity is ultimately the source of economic prosperity.
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To assess this risk, my staff used a forecasting model to analyze labor force participation and its trend. Based on past recovery patterns, a pickup in participation would likely be associated with *better* GDP growth. Historically, periods with stronger GDP growth have been associated with people being drawn into the labor force, and the higher GDP growth rates during these periods have been sufficient to keep the unemployment rate declining gradually. That finding would be an attractive possibility. It suggests that there is an economic upside to the re-entrance of a large number of people back into the labor force. But precisely how the extraordinary number of people out of the labor market or on reduced hours responds to improving conditions represents an important unknown.

Finally, although wage growth looks to be moderate over the next few years, it is critical to keep our eye on how wage patterns develop. To date, larger gains seem isolated to narrow occupations with exceptionally strong demand relative to the number of available workers. However, if demand grew beyond these relatively focused occupations and skills without being easily filled by unemployed workers, we could see broader pressure on overall wage growth. At some point in each of the past expansions, wages have headed higher, but at this point we do not see convincing evidence that wage acceleration is looming. Reports from our business contacts tend to emphasize subdued wages, with little pressure on firms’ pricing decisions.

IMPLICATIONS FOR MONETARY POLICY

Maximum employment and stable prices are often discussed as if they are completely independent of one another—in other words, that monetary policy determines long-run inflation, while nonmonetary factors drive the natural rate of unemployment. Although this independence holds over the longer term, over shorter periods it is quite likely that inflation can affect labor market conditions and labor market conditions can affect the inflation rate. For example, if employers and employees expect higher inflation, firms may raise prices and grant wage hikes. Or, if wages are expected to hold steady, firms may see little reason to raise prices.

Wages are prices, too—the price of labor. Trends in wages are unusually persistent and can strongly affect business pricing decisions. I believe that wage trends contain reliably useful information about inflationary pressures over the medium run. Wage growth is clearly positive for the economy when accompanied by gains in labor productivity. Absent those gains, sustained wage growth can signal inflation pressures.

Subdued wage growth has already been playing a critical role in restraining the growth in core inflation during the past few years. Research at my Bank notes a clear connection between high unemployment periods associated with recessions and slower wage growth. The recession brought down wage growth from around 3.5 percent per year to less than 2 percent (see side essay, page 16). Following past recessions, wage levels typically remained low for quite some time, which has again been our current experience.

Because it implies little increase in the cost of producing goods and providing services, a low and stable wage growth trend should help to support a moderate inflation rate. Services are all about the costs of labor—whether those services are provided by a doctor, a hair stylist, an accountant, or a landscaper. Soft wage growth figures have been a significant factor holding down my inflation outlook.

With wages increasing only very slowly, and my outlook for inflation to remain stable, why not ease monetary conditions further to speed the decline in the unemployment rate? That logic is too simple. The average inflation rate of 1.5 percent

during the past three years already reflects the moderate wage growth during that period. But even with moderate wage growth, there were episodes when the inflation rate rose above the FOMC's 2 percent long-term objective. Recent employment cost data show no trend toward even lower wage growth despite the elevated unemployment rates, so my outlook builds in continuing moderate wage growth rather than significantly greater downward pressure on inflation.

This outlook has important connections to how I see monetary policy. Given today's relatively high unemployment rate, I think monetary policy should remain accommodative. My outlook for unemployment and inflation is consistent with the federal funds rate staying low for some time. However, further policy accommodation in the context of my current outlook could result in more upward pressure on inflation, putting the FOMC's objective for stable prices at risk.



TOWARD FULL EMPLOYMENT

My research staff and I will be following these and other labor market issues, applying what we learn to our forecasting process. Between each FOMC meeting, we are also focused on evaluating incoming data, confirming or clarifying those data with business contacts and others, and most important, updating my economic outlook. Monetary policy is a forward-looking endeavor, but it relies heavily on previous economic relationships in the data and lessons learned from both good and poor decisions.

The past has also taught me that as a general rule, it makes sense for monetary policy to respond gradually to changes in incoming information, particularly when economic and financial conditions are unusually uncertain. Monetary policy involves economic analysis, informed estimates, and many judgment calls.

Americans have waited a painfully long time for a return to normal levels of unemployment. I believe that monetary policy is doing what it can to support progress toward maximum employment while continuing to maintain long-run price stability, which itself is essential to maximum economic growth. I remain committed to ensuring that we fulfill our dual mandate.

TODAY'S UNEMPLOYMENT, IN DEPTH

Cleveland Fed Research staff identifies some of the salient features of today's employment situation

The natural rate of unemployment remains around 6 percent



Job creation has slowed, but so has job destruction



Wage growth remains subdued



Finding work is taking longer than ever



Excess slack exists in today's labor market



The natural rate of unemployment remains around 6 percent

Murat Tasci, Research Economist

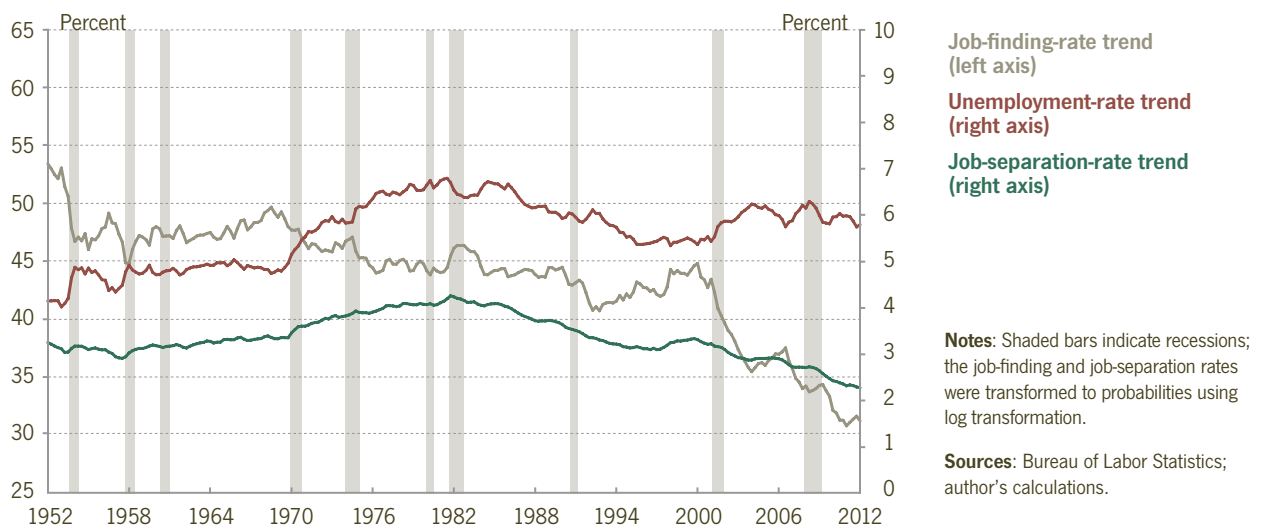
Our research on workers losing and gaining jobs strongly suggests that the long-term unemployment rate has not shifted permanently higher. Rather, labor markets are just adjusting more slowly because of lackluster leading economic growth and low labor market turnover.

Some people think that the unemployment rate will permanently remain as high as it has been recently, arguing that individuals are unemployed because their skills no longer meet the needs of employers looking to hire—a “mismatch” narrative. Other people think unemployment will eventually move lower as the economy continues to recover. The narrative here is that high unemployment mainly reflects the overall weak recovery. These two stories for today’s elevated unemployment rate have very different implications for monetary policy.

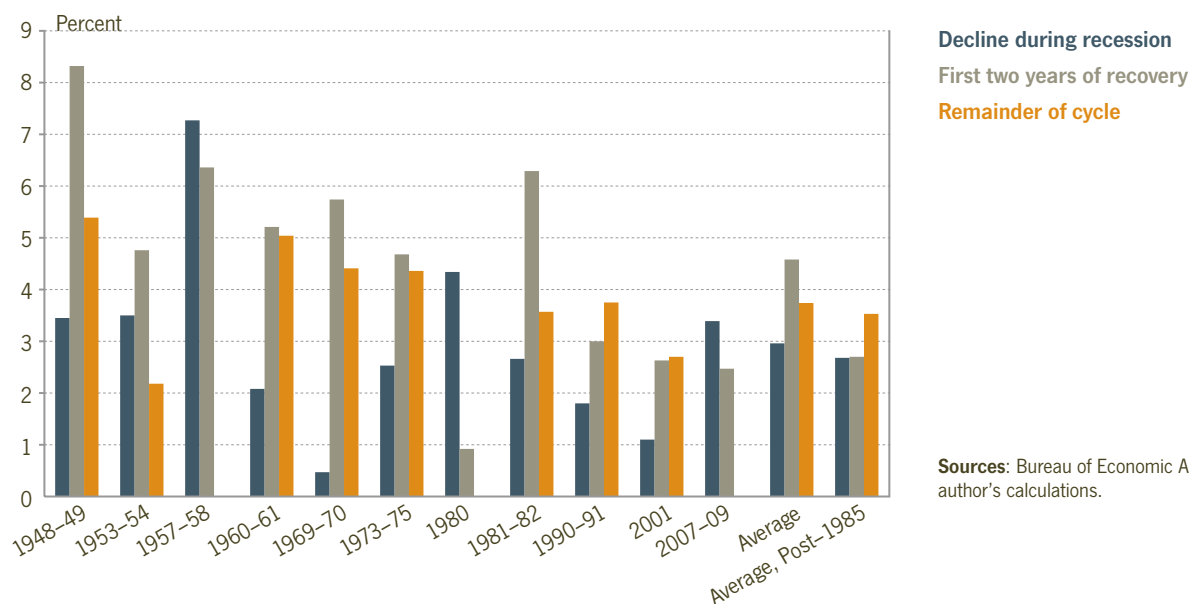
Which story to believe—is the labor market just structurally different than it used to be, with different skills in demand? Or is it mainly a matter of weak labor demand?

To answer these questions, economists estimate the natural rate of unemployment, compare it to the current level, and infer slack from the difference in the two rates. However, measuring the long-term trend of the unemployment rate that would occur without further shocks to the economy is not a simple task.

Worker Flows and the Unemployment Rate



GDP Growth Rates at Different Parts of the Business Cycle



At the Federal Reserve Bank of Cleveland, we use the fact that the unemployment rate can be expressed as a combination of the flows of workers into and out of unemployment. Using this relationship, the natural rate of unemployment is the product of long-term trends in worker turnover.

The Great Recession did significantly affect the short-term flows—job-separation rates increased, while job-finding ones did the opposite. But this has not changed our estimates of long-term trends in these flows or, thus, our view of the *long-term* trend in the unemployment rate. The sharp rise in flows out of unemployment and the decline in worker flows into employment are fully consistent with the depth of the recession and the gradual recovery.

In our model, the long-term job-finding rate has declined greatly over the past decade, but it has been offset by the long-term decline in the separation rate. This implies a relatively stable long-term trend in the unemployment rate. Indeed, the long-term trend in unemployment rates estimated from our model has remained between 5.5 and 6 percent over the past decade or so, even during the depths of the Great Recession.

The model interprets today's elevated rate as temporary: It reflects the prolonged aftereffects of the deep recession that have stunted economic growth. Moreover, the model suggests that the unemployment rate should move down over time and converge to its natural rate in the long run as the effects of the shocks that led to the recession diminish.

If the natural rate of unemployment has not risen, why has the labor market recovery been so sluggish?

First, the pace of job turnover has been slowing. A more dynamic labor market speeds up the adjustment process, moving the economy forward more quickly. However, worker flows now stand at historic lows—and have been trending down for several decades. Thus, the reshuffling process is not as dynamic as it has been in the past, slowing the convergence in the unemployment rate toward the long-term trend. This low level of labor turnover explains, in part, the relatively muted rebounds we have seen in labor markets over the past three cycles.

Second, the overall strength of the recovery, as measured by GDP growth, has been the weakest in the post-World War II era. A weak economy leads to weak job creation and to slow improvement in cyclical unemployment.

At this point, there is little evidence that the trends in labor market flows will change markedly over the near term. It will still take unemployed workers longer to find new jobs, and the rate of people leaving their jobs will remain low. But the slack that we see today in the labor market should be reduced if the economy continues to make substantive progress.



Job creation has slowed, but so has job destruction

Guhan Venkatu, Economist

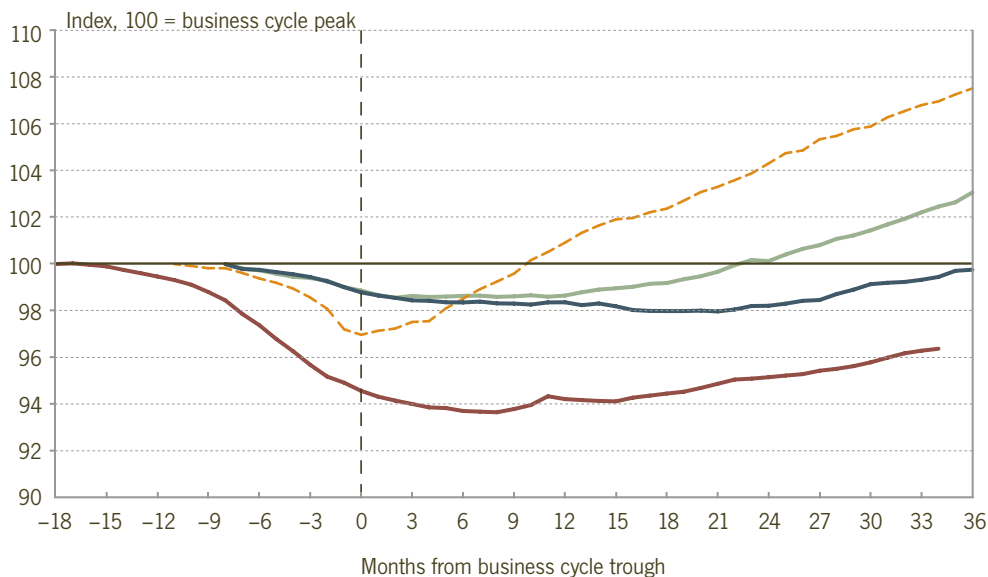
The pace of job creation and job destruction has fallen in recent decades. This might suggest a new normal of slow employment growth during recoveries.

Although the pace of job gains has been slow during the current recovery, in many ways the current trajectory is not all that surprising. Other recent recoveries also proceeded slowly.

While all recoveries in the post–World War II period until 1990 had generated enough jobs in their first 12 months to recover the jobs lost in the prior recession, no matter how severe that recession had been, the 1990–91 recession broke that pattern. And the term “jobless recovery” was introduced to the American vocabulary.

Many wondered whether the underlying structure of the U.S. economy had changed, possibly shifting from a more manufacturing-intensive employment base to one dominated by the service sector. Others implicated a move by employers away from temporary layoffs toward more permanent workforce reductions, consistent with the introduction of new technologies into their operations. No consensus explanation has emerged, but the sluggish employment growth that once seemed like a peculiarity of the recovery in the 1990s now seems typical.

Payroll Employment



Average, post-WWII business cycles before 1990^a

1990

2001

2007

^a Average includes eight cycles and is computed only when at least four cycles are available.

Source: Bureau of Labor Statistics.

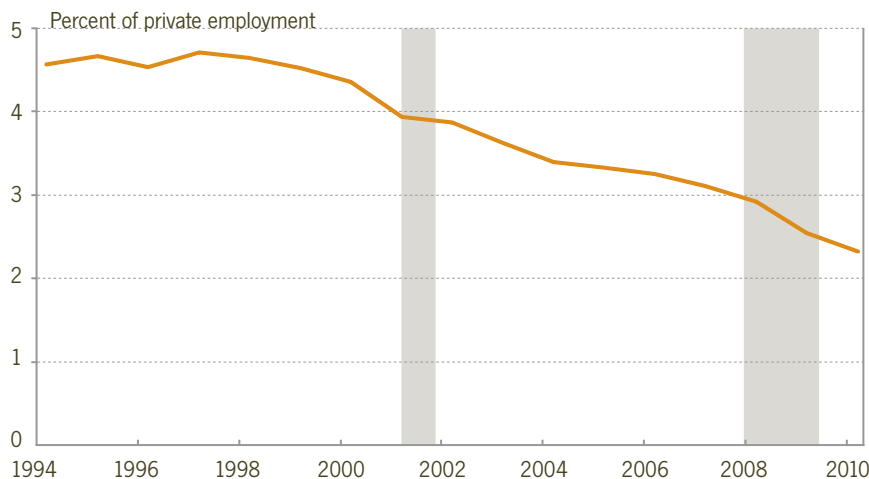
Gross Job Flows, Average Annual Rate as a Percentage of Total U.S. Employment

	GROSS JOB FLOWS				NET JOB GROWTH
	Creation		Destruction	Reallocation ^a	
	Total	Startups			
1980s	18.2	3.5	16.2	34.4	2.0
1990s	16.7	3.0	14.8	31.5	1.9
2000s	15.8	2.6	14.9	30.7	0.9

a. Reallocation is the sum of gross job creation and destruction.

Source: John Haltiwanger, Ron Jarmin, and Javier Miranda. 2011. "Historically Large Decline in Job Creation from Startup and Existing Firms in the 2008–2009 Recession." Kauffman Foundation, Business Dynamics Statistics Briefing (March).

Jobs Created by New Businesses



Notes: Establishments less than one year old; shaded bars indicate recessions.

Source: Bureau of Labor Statistics.

To be sure, all recoveries are unique. But is there something in the way the U.S. labor market now functions that may make employment recoveries more protracted than they once were? One possibility is that the labor market simply isn't as dynamic as it used to be, slowing its recoveries.

The U.S. economy generates an almost staggering number of new jobs every year—generally on the order of 15 to 20 percent of existing employment, with a slightly smaller proportion of jobs lost. However, this churning, as economists call it, has slowed over time.

The Census Bureau shows a small but significant decline in gross job gains since the 1980s. The United States has gone from generating new jobs at an annual pace roughly equal to about 18 percent of existing employment in the 1980s, to 17 percent by the 1990s, and then to less than 16 percent during the 2000s. We also see this decline in dynamism of job creation from new firms.

According to the Bureau, new-firm job creation followed a pattern similar to the overall movement in gross job gains.

In the 1980s, startups created jobs at an average rate of about 3.5 percent of existing employment, but the comparable figures for the 1990s and 2000s were 3 and 2.6 percent, respectively. Labor Department data show a similar and sharper decline in jobs created by businesses less than a year old. The number of jobs created by these new businesses fell from 4.1 million in 1994 to 2.5 million in 2010.

This decline in job creation and job destruction is consistent with the patterns of job-finding and job-separation rates explored on pages 12–13 of this report. Both the job-finding and job-separation rates of workers have also fallen over the past several decades.

What is important to recall, however, is that this slowing in job and worker flows does not mean a rise in the natural rate of unemployment. Rather, it is consistent with a world where it takes longer for the labor market to adjust back to full employment levels. And it may mean that we all need to get accustomed to longer, slower employment recoveries.



Wage growth remains subdued

Mark Schweitzer,
Senior Vice President and Director of Research

Kyle Fee,
Senior Research Analyst

Compensation has been growing moderately since the recession despite higher increases in the cost of benefits. Wages, the largest subcomponent of compensation, have been growing more slowly, suggesting that they are not putting much upward pressure on inflation.

Expanding wages are central to rising living standards, but only when accompanied by rising productivity. Looking at wage and productivity growth also reveals insights about inflationary trends. Conceptually, when wage growth exceeds the growth in the productivity of the workforce, it puts upward pressure on other prices. This makes wage pressures a strong predictive element for medium-term inflation forecasts. So what's been happening to wages and, more generally, overall compensation (which includes the cost of employer-provided benefits)?

One measure that shows underlying compensation trends is the Employment Cost Index, or ECI. The benefits of using the

ECI to inform policy decisions are threefold: construction, volatility, and flexibility. The ECI is *constructed* as a price index with a fixed set of occupations that represent the typical U.S. workforce. Thus, it provides a consistent apples-to-apples comparison of compensation patterns over time. In addition, the ECI is less *volatile* and not subject to significant revisions, as is the case with some other compensation measures. Finally, the ECI's total compensation series can be broken out into wages/salaries *and* benefits. That makes it possible to disentangle the movements to determine what is driving overall compensation growth.

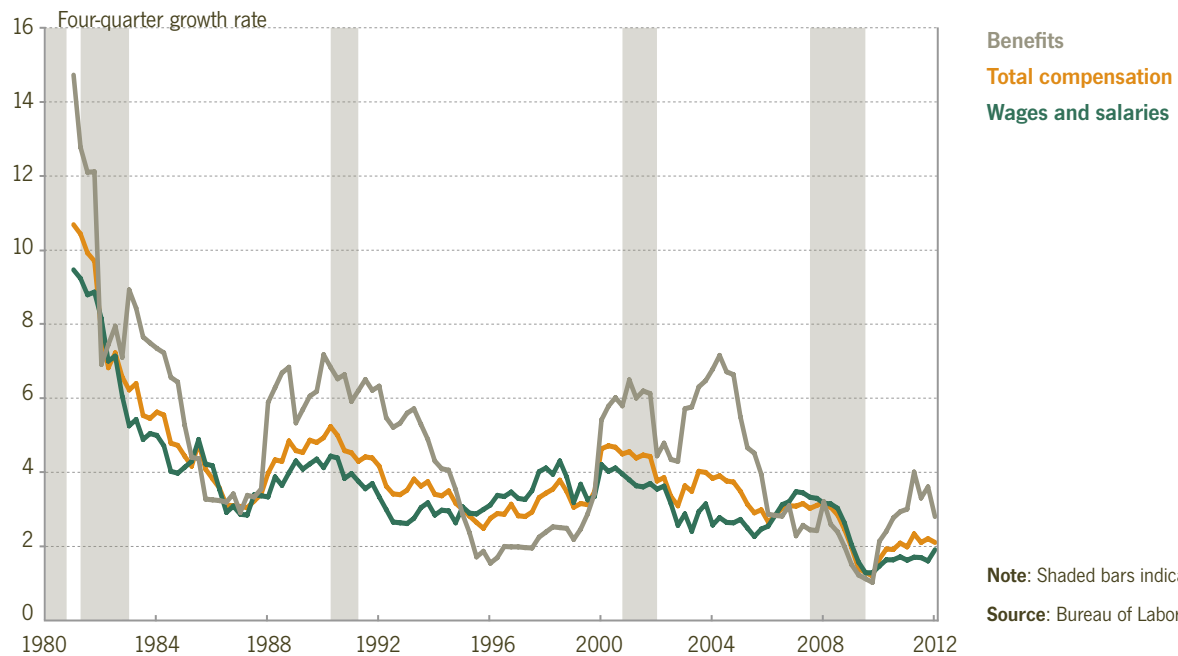
Recent trends in the ECI point to subdued compensation growth. Over the past year, total compensation for private workers is up 2.1 percent, while wages and salaries are up 1.9 percent. A striking feature of the recent trend is that compensation growth has consistently remained below its prerecession levels. During the last business cycle, compensation growth was as high as 4 percent before it fell to 1.2 percent and then stabilized slightly above 2 percent, where it has remained for the past seven quarters. In fact, this pattern has occurred after each of the recessions in which ECI data are available.

lower levels following each recession. During the last recession, wage and salary growth fell from just below 4 percent to less than 2 percent, and has remained there.

In sum, much of the recent upward movement in compensation growth has been driven from benefits and not from wages and salaries. Given recent productivity rates, which have averaged 2.2 percent over the expansion, it is hard to argue that there is any meaningful inflationary pressure coming from wages.

A quick look at the split of compensation into its components highlights three points. First, wages have a much tighter relationship with overall compensation growth than benefits. Second, benefits growth can be subject to large movements that may not be part of the business cycle, leading to some prolonged shifts in the overall compensation series; this appears to be the case currently. Third, wage growth has fallen even more reliably after each recession and has remained at

Employment Cost Index (ECI)





Finding work is taking longer than ever

Timothy Dunne, Vice President and Economist

The recession and weak recovery have greatly increased the share of long-term unemployed workers in the U.S. labor force—with more than 30 percent remaining jobless for upward of a year. How the long-term unemployed reintegrate into the labor market is one of big question marks in the wake of the Great Recession.

One of the deepest scars the Great Recession has left on the American economy takes shape in the unemployment rate: It has remained above 8 percent for almost three years.

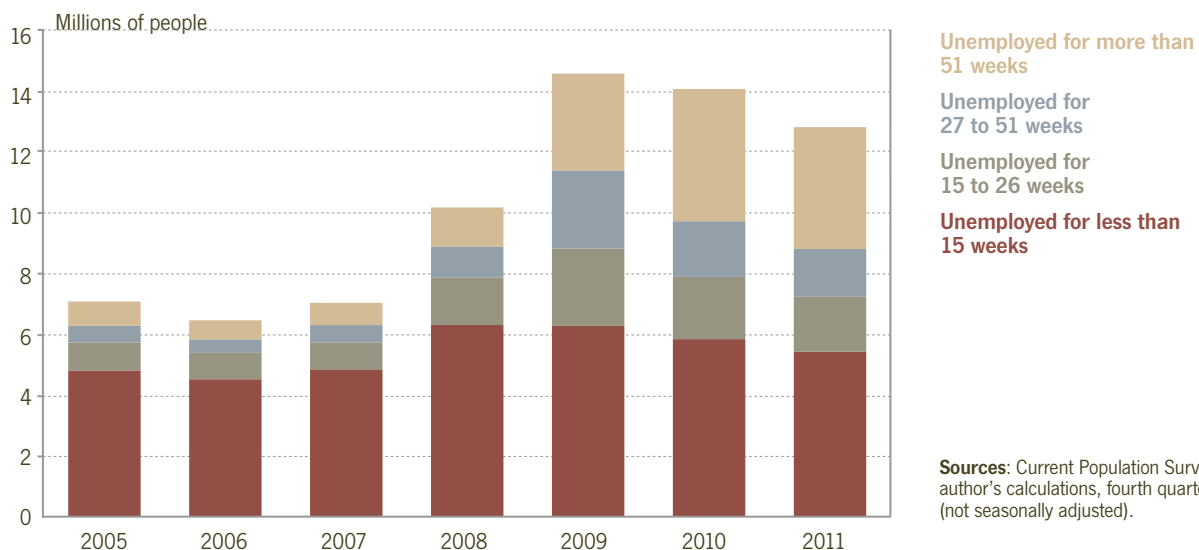
Part of the reason for this stubbornly high rate is that over the past two years, more than 30 percent of the unemployed have been jobless for more than a year. This represents more than 4 million long-term unemployed—three times the number of long-term unemployed seen in 2006 and 2007—and a much higher level or proportion than seen in previous post-World War II recessions.

The growth in the number of people experiencing long-term unemployment raises several questions. Here are some of the big ones:

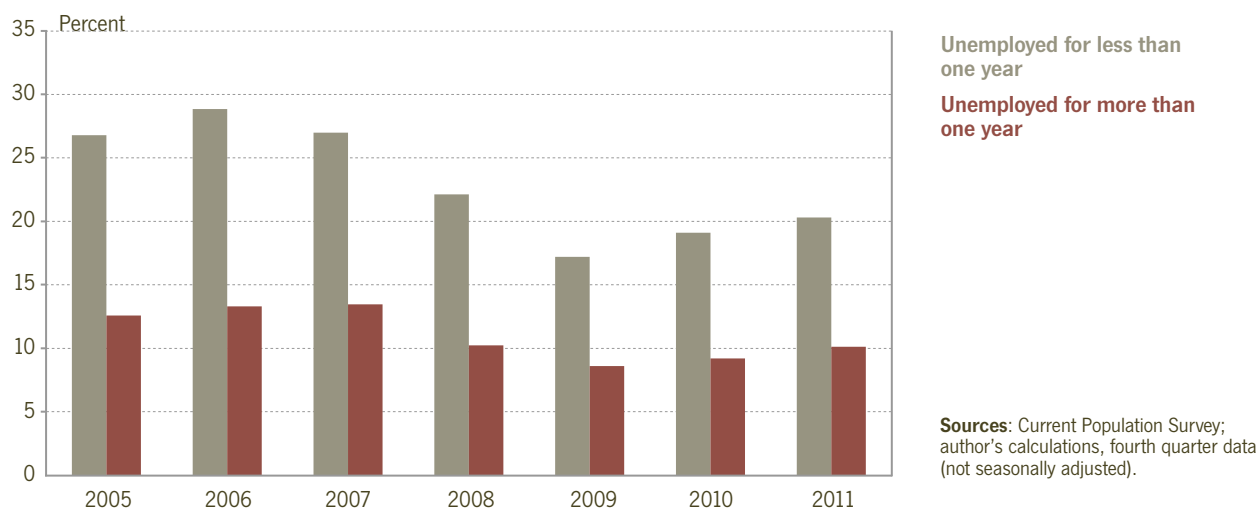
Why has long-term unemployment risen?

One potential reason is demographics. In particular, older workers have longer durations of unemployment, and the share of older workers in the labor force has grown. But changes in demographics explain only a small rise in the incidence of long-term unemployment in the last business cycle.

Unemployed by Unemployment Duration



Re-employment Rates by Unemployment Duration



Another potential reason is the availability of unemployment benefits. In 1983, unemployment benefits were capped at 42 weeks. In 2009, they were raised to 99 weeks. Several studies have reported that increases in unemployment compensation likely raised the unemployment rate over the past few years because of the incentive for people to remain jobless. But these studies also find that the increases have not been large enough to explain much of today's lengthy unemployment durations.

The most important reason for lengthy unemployment spells, and perhaps the most obvious, is that the economy has grown too slowly to create many new jobs. Economic growth since the end of the recession has averaged only 2.5 percent—the weakest post-World War II recovery on record—and has lent little support to job creation. Re-employment rates (the proportion of the unemployed who find a job in a given month) have stayed relatively low compared to pre-recession figures, greatly lengthening unemployment spells.

Who are the long-term unemployed?

In a word, everybody. Men and women experience more or less the same unemployment durations. Roughly 30 percent of unemployed men and women in the last quarter of 2011 were unemployed for a year or more. Somewhat surprisingly, this pattern also holds true across education groups.

However, it is important to remember that education still matters a lot in determining whether a person is unemployed. For example, people without a high school degree had an unemployment rate of nearly 14 percent at the end of 2011, while those with a bachelor's degree or higher had an unemployment rate of 4 percent.

Finally, long-term unemployment generally rises with age. As mentioned previously, this reflects the fact that re-employment rates are generally lower for older workers, extending unemployment spells.

What are the broader implications of long-term unemployment?

Long-term unemployment exacerbates the problems inherent in unemployment itself—declines in income, increasing probabilities of home foreclosure, loss of health insurance, and so on. And extended spells of unemployment can have even longer-term consequences; the long-term unemployed generally suffer large and persistent losses in wages when they do return to work.

Economists are concerned that the labor market skills of the long-term unemployed either degrade as a person spends more time in unemployment or are no longer well-suited to the current job market. Down the road, economists will look at whether re-employment rates of the long-term unemployed stay low compared to those of the more recently unemployed. If such a divergence occurs, this might be viewed as evidence of “structural mismatch” in the labor market.

Moreover, spells of long-term unemployment can influence more than labor market outcomes. Recent research shows that the long-term unemployed have more health problems, in large part because their economic prospects are diminished. Clearly, the U.S. economy and the labor market in particular will continue to live with the scarring effects of the Great Recession well into the future.



Excess slack exists in today's labor market

Daniel Hartley, Research Economist

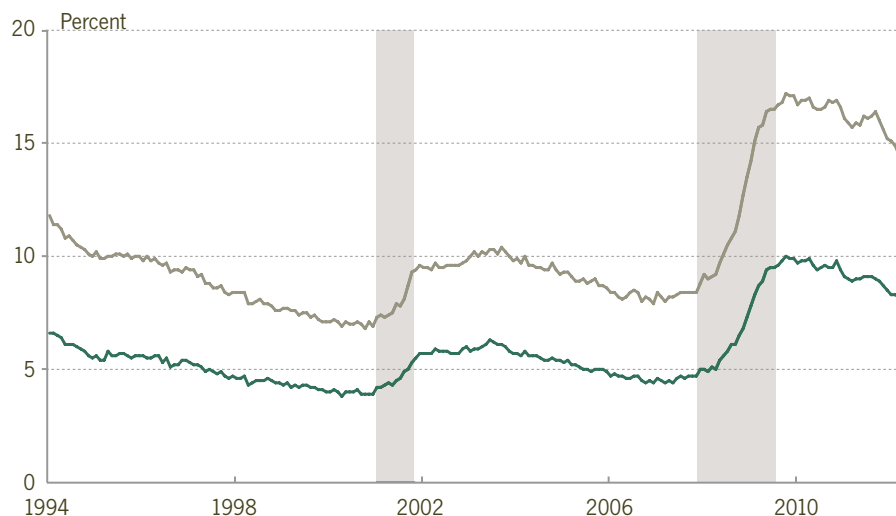
To really understand what's happening in the labor market, you need to look at more than the official unemployment rate. A number of broader measures of labor utilization describe labor market conditions more fully. What these alternative measures tell us is that there is a lot of slack in the labor market.

While economists use the unemployment rate as a standard gauge of the labor market's health, it is not a perfect measure. It does not tell us if we are fully tapping the country's pool of available labor.

First, the standard definition of unemployed workers excludes people who would like to work but have not actively searched for a job over the prior four weeks. They are considered out of

the labor force and are sometimes referred to as discouraged or marginally attached workers. However, it is important to recognize that many people who become newly employed in a month were not actually out of the labor force in the prior month. So there is a significant amount of available labor in the pool of individuals not in the labor force that could and would enter the labor market if conditions improved.

Unemployment Rate

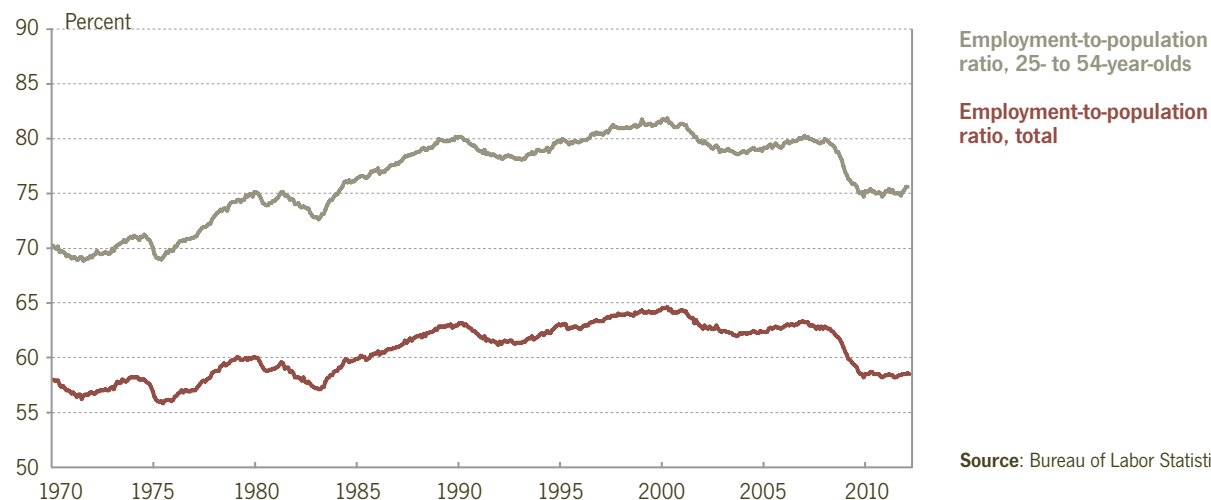


U-6, the broadest measure of labor underutilization
 U-3, the official unemployment rate

Note: Shaded bars indicate recessions.

Source: Bureau of Labor Statistics.

Employment-to-Population Ratio



Second, people in part-time jobs who would like to work full time are not captured in the standard definition. These people are effectively underemployed, although not unemployed. While the Bureau of Labor Statistics does not make adjustments to its official unemployment rate to incorporate these situations, it does produce several alternative measures of labor utilization that do incorporate them.

The unemployment rate known as U-6 (really!) is the broadest measure of labor underutilization. It includes those workers who would like a job but are no longer actively searching for one, as well as people who are working part time but would rather be working full time. This broad measure of labor underutilization rose from 8.2 percent in 2007 to 17 percent at its peak in 2009, and has since fallen to 14.5 percent.

This means that right now, roughly 22.7 million Americans want a job and do not have one *or* have a part-time job and would like a full-time position. A comparatively low 12.5 million individuals are included in the official (U-3) unemployment rate.

A look inside these numbers reveals that most of the difference between the official unemployment rate and this alternative definition is attributable to the part-time-worker category. There are 7.8 million part-time workers who would prefer and are available to work full time. Another 2.4 million people are out of the labor force and would like a job but have not searched in the prior four weeks.

The employment-to-population ratio is another useful measure for describing labor market conditions. This ratio measures total employment relative to the adult population. Since the start of the Great Recession, we have seen a large decline in this ratio, falling by almost 5 percentage points. We are now in territory last seen in the late 1970s and early 1980s, when women's labor force participation rates were much lower.

The employment-to-population ratio hasn't budged much from 58.5 percent since 2009. What this means is that the recent employment growth has only kept up with the growth in the adult population—holding the ratio roughly constant.

Although we should not expect the employment-to-population ratio to fully recover to its pre-Great Recession level because of our aging workforce, we should expect some cyclical rebound. The same patterns hold when looking at the employment-to-population ratio for prime age workers (ages 25 to 54)—little to no recovery.

The overarching conclusion is that all of these alternative measures of labor utilization show high amounts of labor slack in the economy. This sends a strong signal that we still have a relatively long way to go before the labor market recovers.



2011 Innovation Update: **OPERATIONS IN MOTION**

The Federal Reserve Bank of Cleveland continues to transition from an organization previously grounded in operating activities to one that is becoming increasingly focused on knowledge-based contributions.

Gregory L. Stefani



Message from the First Vice President

This past November, I accepted the position of first vice president and chief operating officer of the Federal Reserve Bank of Cleveland. While I am new to the role, I am not new to the Cleveland Fed—I have been with the organization for nearly three decades and have formed many lasting relationships with employees and stakeholders during my time here. I've also observed considerable change within the organization throughout that period, especially over the past several years.

To remain successful, organizations must proactively adapt to a changing environment. The Federal Reserve Bank of Cleveland is no different and is in a period of transition itself. In December 2011, for example, we said goodbye to one of the Bank's longtime functions, Treasury Retail Securities (TRS). Since 1985, the employees of our Bank's Pittsburgh Branch issued and redeemed savings bonds, served customers, and provided Legacy Treasury Direct services, among other responsibilities—and they did so with innovation, commitment, and integrity. We served as one of two locations in the Federal Reserve System that provided TRS services until the U.S. Treasury consolidated all TRS business lines into the Federal Reserve Bank of Minneapolis in 2011. For all of the exemplary customer service and dedication that our TRS employees provided, I thank them.

Despite our Bank's loss, western Pennsylvania remains an important part of the Fourth Federal Reserve District, and our work there will continue. Business and community leaders from the area are vital contributors to our understanding of the economic and financial climate of the region. We remain committed to the region and will continue to retain the Pittsburgh Branch presence, although in a different building, to carry out our responsibilities.

As we press on in 2012, I see the Cleveland Fed further evolving to meet the opportunities of the changing environment. We continue to transition from an organization previously grounded in operating activities to one that is becoming increasingly focused on knowledge-based contributions. Whether it includes providing innovative technology solutions in payments and debt management for the U.S. Treasury and other federal agencies, contributing to strategies and tools that help promote financial stability, or advancing policies and analysis that speed the recovery of the housing market and ultimately promote economic growth, our organization will continue to remain an active contributor to the overall mission of the Federal Reserve System.

Gregory L. Stefani
First Vice President and Chief Operating Officer



Fielding customer phone calls is a 24-hour, seven-day-a-week job for Pay.gov representatives, shown here at the Cleveland Fed.

THE CONSUMER'S FED

For nearly a century, the employees of the Federal Reserve System have provided financial services to the U.S. Treasury, government agencies, and ultimately, the American public. With the evolution of technology, payments systems, and consumer preferences, an inconspicuous relationship between Fed employees and you, the consumer, was born—and you may not even know it.

Let's start with the big picture: If the largest corporate entity in the world is the United States (as many financial experts attest), then the U.S. Treasury—the steward of the nation's economic and financial systems—is certainly one of the single most important players in the global economy.

The Treasury's operations reach virtually everyone, everywhere—from the U.S. economy to foreign governments and central banks, world financial markets, and customers all around the globe. An institution as large, complex, and influential as this needs an agent to manage its bank accounts, collect and disburse funds for the federal government, deliver efficient fiscal services, and perform behind-the-scenes support for its daily operations.

This is where we, the Federal Reserve System, step in. While we are known for monetary policy, much of our work focuses on helping consumers find more efficient ways of accessing government services—and how we accomplish this might surprise you.

SERVING CUSTOMERS ACROSS THE NATION

You may not recognize the names “eGovernment” or “Treasury Retail Securities,” but you've probably heard of what these Federal Reserve Bank of Cleveland functions support: payments and debt management for the Treasury. And even if those aspects of the financial system are off your radar screen, eGov and TRS (as employees refer to them) most likely touch you in some way.

Services provided by these two functions have a broad consumer reach. For instance, have you applied for a passport recently? If so, an eGov employee processed that payment for you. Do you watch TV? Someone in eGov facilitated your favorite station's licensing fee. Have you bought savings bonds or secured an FHA home loan as a first-time borrower? Our employees helped make those transactions possible, too—and many others.

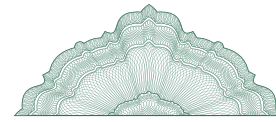
Recently, both eGov and TRS have undergone significant enhancements, driven primarily by advancements in technology, the Treasury's evolving needs, and shifting consumer preferences. While these enhancements can change the way we perform our services, our goal hasn't changed: to make government more efficient while improving consumer experiences. Whether we are processing student loans, nuclear regulatory fees, or a donation to the Disaster Relief Fund, we always keep in mind whom we ultimately serve — the American people.

A WELL-OILED MACHINE

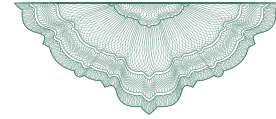
The Federal Reserve Bank of Cleveland exclusively leads, manages, and operates the eGov function. Housed and staffed entirely within the Cleveland Fed, eGov is responsible for two areas within the Treasury's Collections and Cash Management Modernization (CCMM) initiative. One visible side is Paygov, the Treasury's online platform for nontax payments made to federal agencies and one of the faces of the initiative for Treasury customers. Working behind the scenes is the Debit Gateway, the Treasury's system for settling all check and electronic (ACH) payments made to those agencies. The Treasury's goals for CCMM? To eliminate redundancy, improve speed and efficiency, and ultimately save the Treasury millions of dollars annually.

Technology must keep pace with shifts in consumer preferences. Whether you're a military veteran or a college student or both, you might find yourself rapidly abandoning cash and checks in favor of paperless transactions. With Paygov, the channel through which your VA medical care copayment or student loan passes, you can directly pay fees, fines, and taxes, as well as initiate other payments—such as purchasing commemorative coins or a gift from a U.S. Embassy—online.

For more than a decade, customers have used Paygov to make secure electronic payments to federal government agencies directly from their bank accounts and credit and debit cards.



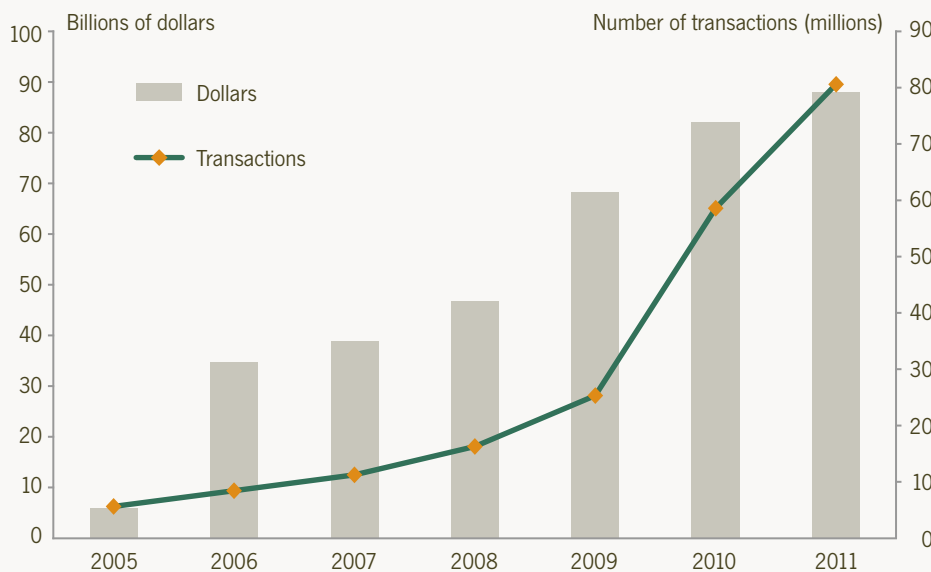
IN 2011, PAY.GOV PROCESSED A 47 PERCENT HIGHER TRANSACTION VOLUME THAN IN 2010, AND MORE SIGNIFICANT GROWTH IS ANTICIPATED.



Cleveland Fed technicians support the portal 24 hours a day, seven days a week, and any customer—be it a hiker who needs a back-country use permit or a small-business owner with a monthly SBA loan payment—can contact a member of the support team directly for assistance in making online payments, resolving password issues, locating forms, or checking on the status of a payment. eGov's analysts and technicians work with government agencies to ensure that all their transactions are processed quickly and accurately, while an application security team protects their privacy.

In 2011, Paygov collected more than 80 million payment items worth more than \$88 billion for 162 government agencies, including the Departments of Education and Veterans Affairs, the Small Business Administration, the National Park Service, Customs and Border Protection, and many more. The portal processed a 47 percent higher transaction volume than in 2010, and more significant growth is anticipated.

The Rise of Pay.gov



Source: Federal Reserve Bank of Cleveland.

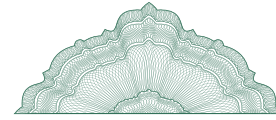
A GATEWAY TO GREATER EFFICIENCY

Unlike Pay.gov, the support provided by the Debit Gateway is mostly invisible to its customers. Even so, it's highly likely that your IRS payment or national park cabin reservation fee, to name just two, has passed—or will soon pass—through the gateway.

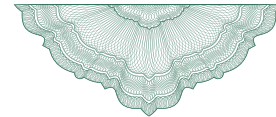
By late 2013, every check and automated clearinghouse (ACH) payment to the federal government is projected to pass through the Debit Gateway. Payments can be made in various ways, and the Debit Gateway determines the most efficient way to collect the payment and what form it should take, eventually streamlining all payments into a single system. This system allows multiple types of payments to be processed and settled quickly, economically, and on a much larger scale.

The Debit Gateway was launched in 2010 and became the first new application implemented as part of the Treasury's strategic vision for the future of collections. The Cleveland Fed's behind-the-scenes work on the platform has satisfied the Treasury's requirements for greater versatility and efficiency by offering an extensive enterprise for settlement services (the processes that ensure electronic payments reach their intended destinations—one of which could be your bank account).

In 2011, the system processed more than 126 million transactions totaling \$161 billion and some change—approximately 32 percent greater volume than in 2010, and accounting for 36 percent of total payments made to the U.S. government that year. By 2013, the Debit Gateway is projected to process 72 percent of all payments to the federal government.



IN 2011, THE DEBIT GATEWAY PROCESSED
MORE THAN 126 MILLION TRANSACTIONS
TOTALING \$161 BILLION AND SOME CHANGE—
APPROXIMATELY 32 PERCENT GREATER
VOLUME THAN IN 2010.



A CUSTOMER-FOCUSED CONSOLIDATION

Anyone familiar with savings bonds or Treasury bills is also familiar with the other work the Federal Reserve does for the Treasury—helping to facilitate the sale of retail securities to individuals, institutions, and government agencies so the federal government has enough money to operate: otherwise known as debt management. From 1985 to 2011, TRS at the Pittsburgh Branch of the Cleveland Fed was integral to this work: It continually sought and implemented operational efficiencies for the retail program to improve the overall customer service experience.

The retail securities business is a customer-focused one, and Pittsburgh Branch employees have historically been on the front lines. Just in 2011, for example, the TRS operations employees processed customer orders resulting in the issuance of 1.2 million savings bonds, managed the flow of millions of redeemed savings bonds, and, with impeccable quality and accuracy, fielded 240,000 customer calls and serviced thousands of transactions.

In 2011, the Pittsburgh Branch was one of only two offices providing processing services for Treasury Retail Securities. To focus on the electronic future, decrease program costs for the Treasury, and reduce the expense to taxpayers, the two sites were consolidated into one by the end of 2011, with the Pittsburgh Branch transferring its work to the main office of the Federal Reserve Bank of Minneapolis. In addition to lowering program costs, the consolidation streamlined infrastructure and reinforced a uniform customer experience for retail investors. Up until their final day of service for the Treasury, Fourth District TRS employees maintained the highest level of dedication to the public by exceeding the Treasury's service-level objectives for operational and customer service commitments.



eGov employees at the Cleveland Fed convene daily to collaborate on Debit Gateway software updates.

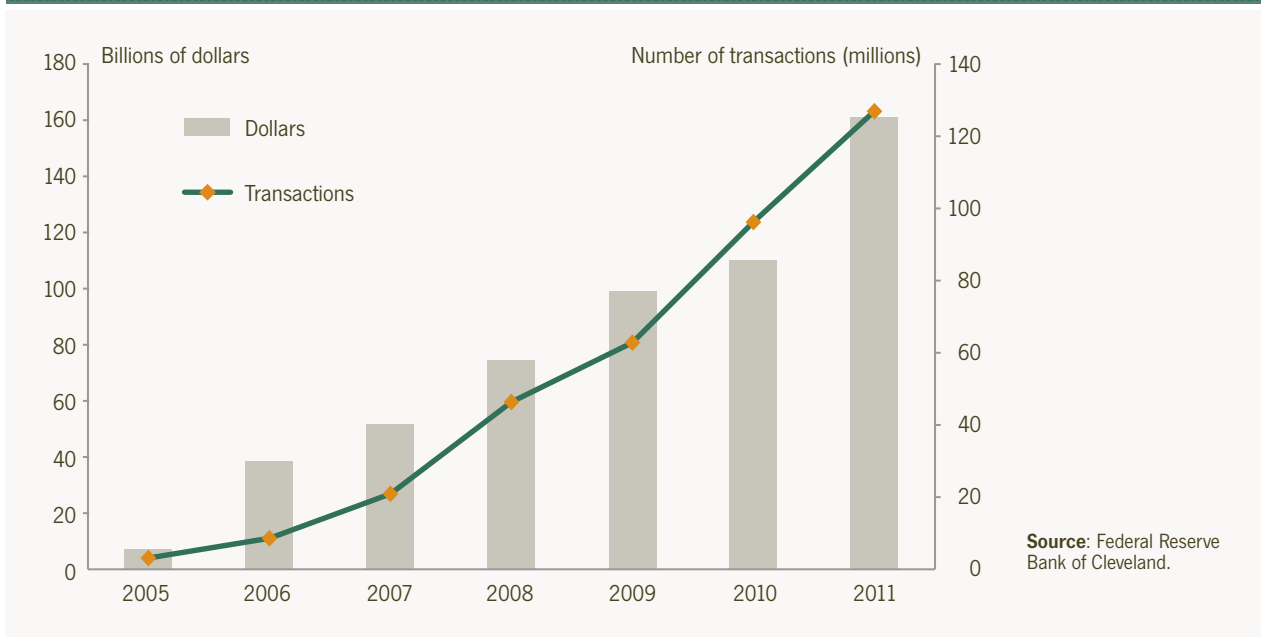
**IMPROVING CUSTOMER SERVICE—
NOW AND IN THE FUTURE**

As the financial services industry grows progressively high-tech (as of January 1, 2012, for example, you can no longer buy paper savings bonds at financial institutions), the Treasury will require even more agility, innovation, and responsiveness from employees of the Federal Reserve and all of the other agencies that support its vast operations. The Federal Reserve will continue to play a critical role in developing and executing the Treasury’s all-electronic initiative by collaborating on a

comprehensive e-commerce strategy, which will include expanded billing services as well as the development of customer-focused online banking and mobile payments applications.

While planning for this next generation of fiscal support is just getting underway, Cleveland Fed employees eagerly look toward the future and what’s on the horizon: additional opportunities to anticipate and serve the complex, ever-changing needs of the Treasury and its customers, and improve the experiences of consumers like you.

The Rise of the Debit Gateway



Officers and Consultants, Boards of Directors, and Advisory Councils

FEDERAL RESERVE BANK *of* CLEVELAND

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and Chief Operating Officer*

Mark S. Sniderman
*Executive Vice President
and Chief Policy Officer*
Economic Research,
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 Check Operations

Nadine M. Wallman
Vice President
 Large Bank Supervision,
 Applications

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Assistant Vice President
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 COSO

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 Infrastructure Support

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 Business Process Management

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 Financial Services Policy Committee

Jerrold L. Newlon
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 and Capital Review

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 Office of the Corporate Secretary

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Assistant Vice President and
Assistant General Auditor
 Audit

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Assistant Vice President
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 Minority and Women Inclusion

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Assistant Vice President
 Risk Supervision

Michael Vangelos
Assistant Vice President
 Information Security,
 Business Continuity

Carolyn M. Williams
Assistant Vice President
 Law Enforcement Unit

Boards of Directors

Federal Reserve Banks each have a main office board of nine directors. Directors supervise the Bank's budget and operations and make recommendations on the discount rate on primary credit. Those directors who are not commercial bankers appoint the Bank's president and first vice president, subject to the Board of Governors' approval.

In addition, directors provide the Federal Reserve System with a wealth of information on economic conditions. This information is used by the Federal Open Market Committee and the Board of Governors in reaching decisions about monetary policy.

Class A directors are elected by and represent Fourth District member banks. Class B directors are also elected by Fourth District member banks and represent diverse industries within the District. Class C directors are selected by the Board of Governors and also represent the wide range of businesses and industries in the Fourth District. Two Class C directors are designated as chairman and deputy chairman of the board.

The Cincinnati and Pittsburgh branch offices each have a board of seven directors who are appointed by the Board of Governors and the Board of Directors of the Federal Reserve Bank of Cleveland.

Terms for all directors are generally limited to two three-year terms to ensure that the individuals who serve the Federal Reserve System represent a diversity of backgrounds and experience.

Cleveland Board of Directors

As of December 31, 2011

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Chairman
Chairman, President,
and Chief Executive Officer
NACCO Industries, Inc.
Cleveland, Ohio

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Deputy Chairman
Chief Executive Officer
The J.M. Smucker Company
Orrville, Ohio

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Christopher M. Connor
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C. Daniel DeLawder
Chairman and Chief Executive Officer
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*Chairman, President,
and Chief Executive Officer*
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Harold Keller
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Ohio Capital Corporation
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Columbus, Ohio

Charlotte W. Martin
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Chairman and Chief Executive Officer
The PNC Financial Services
Group, Inc.
Pittsburgh, Pennsylvania



Harold Keller, Alfred M. Rankin Jr., Susan Tomasky, C. Daniel DeLawder, Tilmon F. Brown, Paul G. Greig, Richard K. Smucker, Charlotte W. Martin, Christopher M. Connor

Cincinnati Board of Directors

As of December 31, 2011

32

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Chairman
Advisor to the President
Cincinnati Children's Hospital
Medical Center
Cincinnati, Ohio

Donald E. Bloomer
President and Chief Executive Officer
Citizens National Bank
Somerset, Kentucky

Daniel B. Cunningham
President and Chief Executive Officer
The Long-Stanton Group
Cincinnati, Ohio

Gregory B. Kenny
President and Chief Executive Officer
General Cable Corporation
Highland Heights, Kentucky

Austin W. Keyser
*Midwest Senior Field
Representative*
AFL-CIO
McDermott, Ohio

Janet B. Reid
Managing Partner and Director
Global Novations, LLC
Cincinnati, Ohio

Peter S. Strange
Chairman
Messer, Inc.
Cincinnati, Ohio



Gregory B. Kenny, Austin W. Keyser, Peter S. Strange, Donald E. Bloomer, James M. Anderson, Daniel B. Cunningham, Janet B. Reid

Pittsburgh Board of Directors

As of December 31, 2011

Sunil T. Wadhvani
Chairman
Chairman and Co-founder
iGATE Corporation
Pittsburgh, Pennsylvania

Todd D. Brice
President and Chief Executive Officer
S&T Bancorp, Inc.
Indiana, Pennsylvania

Howard W. Hanna III
Chairman and Chief Executive Officer
Howard Hanna Real Estate Services
Pittsburgh, Pennsylvania

Glenn R. Mahone
Partner and Attorney at Law
Reed Smith LLP
Pittsburgh, Pennsylvania

Petra Mitchell
President
Catalyst Connection
Pittsburgh, Pennsylvania

Grant Oliphant
President and Chief Executive Officer
The Pittsburgh Foundation
Pittsburgh, Pennsylvania

Robert A. Paul
Chairman and Chief Executive Officer
Ampco-Pittsburgh Corporation
Pittsburgh, Pennsylvania



Robert A. Paul, Petra Mitchell, Grant Oliphant, Sunil T. Wadhvani, Howard W. Hanna III, Todd D. Brice, Glenn R. Mahone

Business Advisory Councils

As of December 31, 2011

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 Cincinnati, Cleveland, Dayton, Erie, Lexington, Pittsburgh, and Wheeling—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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CINCINNATI

Charles H. Brown

Vice President of Accounting and Finance
Toyota Motor Engineering and
Manufacturing, North America, Inc.
Erlanger, Kentucky

Robert W. Buechner, Esq.

Shareholder
Buechner Haffer Meyers & Koenig
Cincinnati, Ohio

Calvin D. Buford

Partner, Corporate Development
Dinsmore & Shohl LLP
Cincinnati, Ohio

James E. Bushman

President and Chief Executive Officer
Cast-Fab Technologies, Inc.
Cincinnati, Ohio

Christopher C. Cole

Chief Executive Officer
Intelligrated
Mason, Ohio

Carol J. Frankenstein

President
BIO/START
Cincinnati, Ohio

Kay Geiger

Regional President
PNC Bank
Cincinnati, Ohio

Terry Grundy

Director, Community Impact
United Way of Greater Cincinnati
Cincinnati, Ohio

Jose Guerra

President
L5 Source
Cincinnati, Ohio

Jim Huff

President and Chief Executive Officer
HUFF Commercial Group
Ft. Mitchell, Kentucky

Vivian J. Llambi

President
Vivian Llambi & Associates, Inc.
Cincinnati, Ohio

Joseph L. Rippe

Principal
Rippe & Kingston
Cincinnati, Ohio

Carl Satterwhite

President
RCF
Hamilton, Ohio

CLEVELAND

Cedric Beckett

President and Chief Executive Officer
Optimum Supply LLC
Cleveland, Ohio

Maryann Correnti

Chief Financial Officer
Heinen's Fine Foods, Inc.
Warrensville Heights, Ohio

Gary Gajewski

Vice President, Finance
Moen Inc.
North Olmsted, Ohio

Christopher J. Hyland

Chief Financial Officer
Hyland Software Inc.
Westlake, Ohio

Michael Keresman

Chief Executive Officer
Cardinal Commerce Corporation
Mentor, Ohio

Gena Lovett

Director of Manufacturing, Forgings
Cleveland Works,
Alcoa Forgings and Extrusions
Cleveland, Ohio

Rodger W. McKain

Vice President, Government Programs
Rolls-Royce Fuel Cell Systems
(U.S.) Inc.
North Canton, Ohio

Kevin M. McMullen

Chairman and Chief Executive Officer
OMNOVA Solutions Inc.
Fairlawn, Ohio

David Megenhardt

Executive Director
United Labor Agency
Cleveland, Ohio

Michael J. Merle

President and Chief Executive Officer
Ray Fogg Building Methods Inc.
Cleveland, Ohio

Bob Patterson

*Senior Vice President
and Chief Financial Officer*
PolyOne Corporation
Avon Lake, Ohio

DAYTON

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President and Chief Executive Officer
 Greater Dayton Area
 Hospital Association
 Dayton, Ohio

Christopher Che
President and Chief Executive Officer
 Hooven–Dayton Corporation
 Dayton, Ohio

Bruce Feldman
President
 Economy Linen & Towel Service
 Dayton, Ohio

Greg Johnson
Executive Director
 Dayton Metro Housing Authority
 Dayton, Ohio

Larry Klaben
President
 Morris Furniture
 Fairborn, Ohio

Phil Parker
President
 Dayton Area Chamber of Commerce
 Dayton, Ohio

Jennell Ross
President
 Bob Ross Dealerships
 Centerville, Ohio

Michael Shane
Chairman
 Lastar, Inc.
 Moraine, Ohio

Greg Stout
Chief Financial and Operating Officer
 Voss Auto Network
 Dayton, Ohio

Christopher Wallace
Senior Vice President,
Corporate Banking
 PNC Bank
 Dayton, Ohio

Mark Walton
Vice President and CRA Manager
 Fifth Third Bank
 Dayton, Ohio

ERIE

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President
 E. E. Austin and Son, Inc.
 Erie, Pennsylvania

Matthew Baldwin
Vice President
 Baldwin Brothers, Inc.
 Erie, Pennsylvania

Jim Berlin
Chief Executive Officer
 Logistics Plus
 Erie, Pennsylvania

Terrence W. Cavanaugh
President and Chief Executive Officer
 Erie Insurance
 Erie, Pennsylvania

Gary L. Clark
Vice President and Chief
Administrative Officer
 Snap-tite, Inc.
 Erie, Pennsylvania

Joel Deuterma
President and Chief Executive Officer
 Velocity Network
 Erie, Pennsylvania

Martin Farrell
President
 Infinity Resources, Inc.
 Erie, Pennsylvania

William Hilbert Jr.
President
 REDDOG Industries Inc.
 Erie, Pennsylvania

Marsha Marsh
Owner
 Marsha Marsh Real Estate Services
 Erie, Pennsylvania

Chris Scott
Vice President
 Scott Enterprises
 Erie, Pennsylvania

Tim Shuttleworth
President and Chief Executive Officer
 Eriez Magnetics
 Erie, Pennsylvania

Phil Tredway
President and Chief Executive Officer
 Erie Molded Plastics, Inc.
 Erie, Pennsylvania

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President and Chief Executive Officer
United Way of the Bluegrass
Lexington, Kentucky

Paula Hanson
Director of Tax Services
Dean, Dorton, Ford
Lexington, Kentucky

Ed Holmes
President
EHI Consultants
Lexington, Kentucky

Glenn Leveridge
Market President
Central Bank
Winchester, Kentucky

David Magner
Vice President of Operations at Trane
Ingersoll Rand
Lexington, Kentucky

Wayne Masterman
Owner
Port Restaurants, LLC
Lexington, Kentucky

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President
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Lexington, Kentucky

Rebecca S. Mobley
Partner
Turf Town Properties, Inc.
Lexington, Kentucky

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President and Chief Executive Officer
Urban League of Lexington–
Fayette County
Lexington, Kentucky

Robert Quick
President and Chief Executive Officer
Commerce Lexington
Lexington, Kentucky

Kevin Smith
President and Chief Executive Officer
Community Ventures Corporation
Lexington, Kentucky

David Switzer
Executive Director
Kentucky Thoroughbred
Association, Inc.
Lexington, Kentucky

John Taylor
President and Chief Executive Officer
American Founders Bank
Lexington, Kentucky

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*Chair, Department of Economics
and Director, Center for Business and
Economics Research*
University of Kentucky's Gatton
College of Business and Economics
Lexington, Kentucky

Holly Wiedemann
President
AU Associates
Lexington, Kentucky

PITTSBURGH

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President
Homer City Automation
Homer City, Pennsylvania

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President
J D Dunn Company
Sewickley, Pennsylvania

William Fink
President
Paragon Homes, Inc.
Pittsburgh, Pennsylvania

Robert Glimcher
President
Glimcher Group
Pittsburgh, Pennsylvania

Charles Hammel III
President
PITT OHIO
Pittsburgh, Pennsylvania

Anthony M. Helfer
President
United Food and Commercial
Workers Local 23
Canonsburg, Pennsylvania

Kathryn Z. Kalber
President and Executive Director
Marcellus Shale Coalition
Canonsburg, Pennsylvania

John R. Laymon Jr.
President/Owner
JRL Enterprises Inc.
Pittsburgh, Pennsylvania

Dennis Meteny
President and Chief Executive Officer
Cygnus Manufacturing
Company LLC
Saxonburg, Pennsylvania

Stephanie Pashman
Chief Executive Officer
Three Rivers Workforce
Investment Board
Pittsburgh, Pennsylvania

Dominique E. Schinabeck
Chairwoman and President
ACUTRONIC USA Inc.
Pittsburgh, Pennsylvania

Thomas N. Walker III
President
T.N. Walker Inc.
Pittsburgh, Pennsylvania

Doris Carson Williams
President and Chief Executive Officer
African American Chamber of
Commerce of Western Pennsylvania
Pittsburgh, Pennsylvania

WHEELING

John Clarke
Business Representative
International Brotherhood of
Electrical Workers Local #141
Wheeling, West Virginia

John L. Kalkreuth
President
Kalkreuth Roofing
and Sheet Metal, Inc.
Wheeling, West Virginia

Robert Kubovicz
President
United Electric
Wheeling, West Virginia

Joel Mazur
President and Chief Executive Officer
Wheeling Corrugating Company
Wheeling, West Virginia

David H. McKinley
President and Managing Partner
McKinley Carter Wealth Services
Wheeling, West Virginia

Lee C. Paull IV
*Executive Vice President and
Associate Broker*
Paull Associates Insurance/
Real Estate
Wheeling, West Virginia

Richard Riesbeck
President
Riesbeck Food Markets
St. Clairsville, Ohio

Jim Squibb
Chief Executive Officer
Beyond Marketing
Wheeling, West Virginia

Erikka Storch
Chief Financial Officer
Ohio Valley Steel Company
Wheeling, West Virginia

Ronald L. Violi
Principal
R & V Associates
Pittsburgh, Pennsylvania

Community Depository Institutions Advisory Council

As of December 31, 2011

The Community Depository Institutions Advisory Council is composed of representatives from commercial banks, thrift institutions, and credit unions in the Fourth Federal Reserve District.

Council members meet with the Bank president and senior officers at least twice yearly to provide information and insight from the perspective of community depository institutions. These meetings provide anecdotal information that is useful in the formulation of supervisory and monetary policy direction.

The chair of each District Bank's council also has the responsibility of reporting twice yearly to the Federal Reserve Board of Governors in Washington, DC.

Howard T. Boyle, II
*Fourth District CDIA
Representative*
President and Chief Executive Officer
Hometown Bank
Kent, Ohio

Patrick Ferry
Senior Vice President
Members Heritage Federal
Credit Union
Lexington, Kentucky

Christine J. Kunnen
Chief Executive Officer
Cinfed Federal Credit Union
Cincinnati, Ohio

Paul M. Limbert
President and Chief Executive Officer
WesBanco Bank, Inc.
Wheeling, West Virginia

William C. Marsh
*Chairman of the Board, President,
and Chief Executive Officer*
Farmers National Bank
Emlenton, Pennsylvania

James O. Miller
President and Chief Executive Officer
The Citizens Banking Company
Sandusky, Ohio

Robert Oeler
President and Chief Executive Officer
Dollar Bank
Pittsburgh, Pennsylvania

Gary Soukenik
President and Chief Executive Officer
Seven Seventeen Credit Union
Warren, Ohio

Eddie Steiner
President and Chief Executive Officer
CSB Bancorp, Inc.
Millersburg, Ohio

Bick Weissenrieder
Chairman and Chief Executive Officer
Hocking Valley Bank
Athens, Ohio

Charlotte Zuschlag
President and Chief Executive Officer
ESB Financial Corporation
Ellwood City, Pennsylvania



Financial Statements



Auditor Independence

In 2011, the Board of Governors engaged Deloitte & Touche LLP (D&T) to audit the combined and individual financial statements of the Reserve Banks and those of the consolidated LLC entities.¹ In 2011, D&T also conducted audits of internal control over financial reporting for each of the Reserve Banks and the consolidated LLC entities. Fees for D&T's services totaled \$8 million, of which \$2 million was for the audits of the consolidated LLC entities. To ensure auditor independence, the Board of Governors requires that D&T be independent in all matters relating to the audits. Specifically, D&T 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 2011, the Bank did not engage D&T for any non-audit services.

¹ Each LLC will reimburse the Board of Governors for the fees related to the audit of its financial statements from the entity's available net assets.

FEDERAL RESERVE BANK *of* CLEVELAND

Cleveland, OH 44101
216.579.2000
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Management's Report on Internal Control Over Financial Reporting

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

The management of the Federal Reserve Bank of Cleveland (Bank) is responsible for the preparation and fair presentation of the Statements of Condition as of December 31, 2011 and 2010, and the Statements of Income and Comprehensive Income, and Statements of Changes in Capital for the years then ended (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 as set forth in the *Financial Accounting Manual for Federal Reserve Banks* (FAM), and, as such, include some amounts that 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 FAM and include all disclosures necessary for such fair presentation.

The management of the Bank is responsible for establishing and maintaining effective internal control over financial reporting as it relates to the financial statements. The Bank's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with the FAM. The Bank'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 Bank's assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with FAM, and that the Bank's receipts and expenditures are being made only in accordance with authorizations of its management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Bank's assets that could have a material effect on its financial statements.


Even effective internal control, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The management of the Bank assessed its internal control over financial reporting 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 Bank maintained effective internal control over financial reporting.

Federal Reserve Bank of Cleveland
March 20, 2012



Sandra Pianalto
President &
Chief Executive Officer



Gregory L. Stefani
First Vice President &
Chief Operating Officer



Susan M. Steinbrick
Senior Vice President &
Chief Financial Officer

Independent Auditors' Report

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

We have audited the accompanying Statements of Condition of the Federal Reserve Bank of Cleveland ("FRB Cleveland") as of December 31, 2011 and 2010, and the related Statements of Income and Comprehensive Income, and of Changes in Capital for the years then ended, which have been prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System. We also have audited the internal control over financial reporting of the FRB Cleveland as of December 31, 2011, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The FRB Cleveland's management is responsible for these Financial Statements, for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these Financial Statements and an opinion on the FRB Cleveland's internal control over financial reporting 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 and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the Financial Statements included 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, as well as evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

The FRB Cleveland's internal control over financial reporting is a process designed by, or under the supervision of, the FRB Cleveland's principal executive and principal financial officers, or persons performing similar functions, and effected by the FRB Cleveland's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the

preparation of Financial Statements for external purposes in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System. The FRB Cleveland's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the FRB Cleveland; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of Financial Statements in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System, and that receipts and expenditures of the FRB Cleveland are being made only in accordance with authorizations of management and directors of the FRB Cleveland; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the FRB Cleveland's assets that could have a material effect on the Financial Statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As described in Note 4 to the Financial Statements, the FRB Cleveland has prepared these Financial Statements in conformity with accounting principles established by the Board of Governors of the Federal Reserve System, as 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. The effects on such Financial Statements of the differences between the accounting principles established by the Board of Governors of the Federal Reserve System and accounting principles generally accepted in the United States of America are also described in Note 4.

In our opinion, such Financial Statements present fairly, in all material respects, the financial position of the FRB Cleveland as of December 31, 2011 and 2010, and the results of its operations for the years then ended, on the basis of accounting described in Note 4. Also, in our opinion, the FRB Cleveland maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Deloitte + Touche LLP

March 20, 2012

Abbreviations:

ACH	Automated clearinghouse
AMLF	Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
BEP	Benefit Equalization Retirement Plan
Bureau	Bureau of Consumer Financial Protection
FAM	<i>Financial Accounting Manual for Federal Reserve Banks</i>
FASB	Financial Accounting Standards Board
Fannie Mae	Federal National Mortgage Association
Freddie Mac	Federal Home Loan Mortgage Corporation
FOMC	Federal Open Market Committee
FRBA	Federal Reserve Bank of Atlanta
FRBNY	Federal Reserve Bank of New York
GAAP	Accounting principles generally accepted in the United States of America
GSE	Government-sponsored enterprise
IMF	International Monetary Fund
MBS	Mortgage-backed securities
OEB	Office of Employee Benefits of the Federal Reserve System
OFR	Office of Financial Research
SDR	Special drawing rights
SERP	Supplemental Retirement Plan for Select Officers of the Federal Reserve Banks
SOMA	System Open Market Account
STRIP	Separate Trading of Registered Interest and Principal of Securities
TAF	Term Auction Facility
TBA	To be announced
TDF	Term Deposit Facility
TIPS	Treasury Inflation-Protected Securities
TOP	Term Securities Lending Facility Options Program
TRS	Treasury Retail Securities
TSLF	Term Securities Lending Facility

Statements of Condition

As of December 31, 2011 and December 31, 2010 (in millions)

	2011	2010
ASSETS		
Gold certificates	\$ 450	\$ 463
Special drawing rights certificates	237	237
Coin	173	164
System Open Market Account:		
Treasury securities, net	47,279	36,250
Government-sponsored enterprise debt securities, net	2,913	5,197
Federal agency and government-sponsored enterprise mortgage-backed securities, net	22,913	34,135
Foreign currency denominated assets, net	1,925	1,941
Central bank liquidity swaps	7,405	6
Accrued interest receivable	534	484
Bank premises and equipment, net	137	157
Items in process of collection	59	89
Other assets	28	27
Total assets	<u>\$ 84,053</u>	<u>\$ 79,150</u>
LIABILITIES AND CAPITAL		
Federal Reserve notes outstanding, net	\$ 45,046	\$ 38,601
System Open Market Account:		
Securities sold under agreements to repurchase	2,698	2,028
Other liabilities	37	—
Deposits:		
Depository institutions	26,962	18,152
Other deposits	3	4
Interest payable to depository institutions	3	1
Accrued benefit costs	121	133
Deferred credit items	142	410
Accrued interest on Federal Reserve notes	82	26
Interdistrict settlement account	4,966	15,854
Other liabilities	15	7
Total liabilities	<u>80,075</u>	<u>75,216</u>
Capital paid-in	1,989	1,967
Surplus (including accumulated other comprehensive loss of \$11 million and \$37 million at December 31, 2011 and 2010, respectively)	1,989	1,967
Total capital	<u>3,978</u>	<u>3,934</u>
Total liabilities and capital	<u>\$ 84,053</u>	<u>\$ 79,150</u>

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

Statements of Income and Comprehensive Income

For the years ended December 31, 2011 and December 31, 2010 (in millions)

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	2011	2010
INTEREST INCOME		
System Open Market Account:		
Treasury securities, net	1,213	937
Government-sponsored enterprise debt securities, net	89	125
Federal agency and government-sponsored enterprise mortgage-backed securities, net	1,115	1,595
Foreign currency denominated assets, net	18	17
Central bank liquidity swaps	3	1
Total interest income	<u>2,438</u>	<u>2,675</u>
INTEREST EXPENSE		
System Open Market Account:		
Securities sold under agreements to repurchase	1	3
Deposits:		
Depository institutions	55	41
Total interest expense	<u>56</u>	<u>44</u>
Net interest income	<u>2,382</u>	<u>2,631</u>
NON-INTEREST INCOME		
System Open Market Account:		
Treasury securities gains, net	61	—
Federal agency and government-sponsored enterprise mortgage-backed securities gains, net	—	29
Foreign currency gains, net	11	41
Compensation received for service costs provided	25	27
Reimbursable services to government agencies	52	46
Other	4	4
Total non-interest income	<u>153</u>	<u>147</u>
OPERATING EXPENSES		
Salaries and benefits	142	128
Occupancy	16	16
Equipment	7	8
Assessments:		
Board of Governors operating expenses and currency costs	70	64
Bureau of Consumer Financial Protection	18	2
Office of Financial Research	3	1
Other	33	19
Total operating expenses	<u>289</u>	<u>238</u>
Net income prior to distribution	<u>2,246</u>	<u>2,540</u>
Change in prior service costs related to benefit plans	19	(2)
Change in actuarial gains (losses) related to benefit plans	7	(16)
Comprehensive income prior to distribution	<u>\$ 2,272</u>	<u>\$ 2,522</u>
Distribution of comprehensive income:		
Dividends paid to member banks	\$ 118	\$ 115
Transferred to surplus and change in accumulated other comprehensive loss	22	57
Payments to Treasury as interest on Federal Reserve notes	2,132	2,350
Total distribution	<u>\$ 2,272</u>	<u>\$ 2,522</u>

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

Statements of Changes in Capital

For the years ended December 31, 2011 and December 31, 2010 (in millions, except share data)

	Surplus				
	Capital paid-in	Net income retained	Accumulated other comprehensive loss	Total surplus	Total capital
Balance at January 1, 2010 (38,208,062 shares)	\$ 1,910	\$ 1,929	\$ (19)	\$ 1,910	\$ 3,820
Net change in capital stock issued (1,142,322 shares)	57	—	—	—	57
Transferred to surplus and change in accumulated other comprehensive loss	—	75	(18)	57	57
Balance at December 31, 2010 (39,350,384 shares)	\$ 1,967	\$ 2,004	\$ (37)	\$ 1,967	\$ 3,934
Net change in capital stock issued (422,697 shares)	22	—	—	—	22
Transferred from surplus and change in accumulated other comprehensive loss	—	(4)	26	22	22
Balance at December 31, 2011 (39,773,081 shares)	\$ 1,989	\$ 2,000	\$ (11)	\$ 1,989	\$ 3,978

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

1. Structure

The Federal Reserve Bank of Cleveland (Bank) is part of the Federal Reserve System (System) and is one of the 12 Federal 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 serves 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 is exercised by a board of directors. The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors of the Federal Reserve System (Board of Governors) to represent the public, and six directors are elected by member banks. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership. 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.

In addition to the 12 Reserve Banks, 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. These functions include participating in formulating and conducting monetary policy; participating in the payment system, including large-dollar transfers of funds, automated clearing-house (ACH) operations, and check collection; distributing coin and currency; performing fiscal agency functions for the U.S. Department of the Treasury (Treasury), certain federal agencies, and other entities; serving as the federal government's bank; providing short-term loans to depository institutions; providing loans to participants in programs or facilities with broad-based eligibility in unusual and exigent circumstances; serving consumers and communities by providing educational materials and information regarding financial consumer protection rights and laws and information on community development programs and activities; and supervising bank holding companies, state member banks, savings and loan holding companies, and U.S. offices of foreign banking organizations pursuant to authority delegated by the Board of Governors. Certain services are provided to foreign and international monetary authorities, primarily by the FRBNY.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which was signed into law and became effective on July 21, 2010, changed the scope of some services performed by the Reserve Banks. Among other things, the Dodd-Frank Act established a Bureau of Consumer Financial Protection (Bureau) as an independent bureau within the System that has supervisory authority over some institutions previously supervised by the Reserve Banks under delegated authority from the Board of Governors in connection with those institutions' compliance with consumer protection statutes; limited the Reserve Banks' authority to provide loans in unusual and exigent circumstances to lending programs or facilities with broad-based eligibility or to designated financial market utilities; and vested the Board of Governors with all supervisory and rule-writing authority for savings and loan holding companies.

The FOMC, in conducting monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and issues authorizations and directives to the FRBNY to execute transactions. The FOMC authorizes and directs the FRBNY to conduct operations in domestic markets, including the direct purchase and sale of Treasury securities, government-sponsored enterprise (GSE) debt securities, federal agency and GSE mortgage-backed securities (MBS), the purchase of these securities under agreements to resell, and the sale of these securities under agreements to repurchase. The FRBNY holds the resulting securities and agreements in a portfolio known as the System Open Market Account (SOMA). The FRBNY is authorized to lend the Treasury securities and federal agency and GSE debt securities that are held in the SOMA.

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes the FRBNY to conduct operations in foreign markets in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC to carry out the System's central bank responsibilities. Specifically, the FOMC authorizes and directs the FRBNY to hold balances of, and to execute spot and forward foreign exchange and securities contracts for, 14 foreign currencies and to invest such foreign currency holdings, while maintaining adequate liquidity. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico in the maximum amounts of \$2 billion and \$3 billion, respectively, and to warehouse foreign currencies for the Treasury and the Exchange Stabilization Fund.

Although the Reserve Banks are separate legal entities, they collaborate on the delivery of certain services to achieve greater efficiency and effectiveness. This collaboration takes the form of centralized operations and product or function 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 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 reimbursed for costs incurred in providing services to other Reserve Banks. Major services provided by the Bank on behalf of the System and for which the costs were not reimbursed by the other Reserve Banks include Treasury Retail Services Technology, Cash Technology, Financial Services Policy Committee, and National Server Management Transition.

3. Financial Stability Activities

The Reserve Banks have implemented the following programs that support the liquidity of financial institutions and foster improved conditions in financial markets.

Large-Scale Asset Purchase Programs and Reinvestment of Principal Payments

On March 18, 2009, the FOMC authorized and directed the FRBNY to purchase \$300 billion of longer-term Treasury securities to help improve conditions in private credit markets. The FRBNY began the purchases of these Treasury securities in March 2009 and completed them in October 2009. On August 10, 2010, the FOMC announced that the Federal Reserve would maintain the level of domestic securities holdings in the SOMA portfolio by reinvesting principal payments from GSE debt securities and federal agency and GSE MBS in longer-term Treasury securities. On November 3, 2010, the FOMC announced its intention to expand the SOMA portfolio holdings of longer-term Treasury securities by an additional \$600 billion and completed these purchases in June 2011. On June 22, 2011, the FOMC announced that the Federal Reserve would maintain its existing policy of reinvesting principal payments from all domestic securities in Treasury securities. On September 21, 2011, the FOMC announced that the Federal Reserve intends to purchase, by the end of June 2012, \$400 billion par value of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less, of which \$133 billion has been purchased and \$134 billion sold as of December 31, 2011. In addition, the FOMC announced that it will maintain its existing policy of rolling over maturing Treasury securities at auction and, rather than reinvesting principal payments from GSE debt securities and federal agency and GSE MBS in Treasury securities, such payments will be reinvested in federal agency and GSE MBS.

The FOMC authorized and directed the FRBNY to purchase GSE debt securities and federal agency and GSE MBS, with a goal to provide support to mortgage and housing markets and to foster improved conditions in financial markets more generally. The FRBNY was authorized to purchase up to \$175 billion in fixed-rate, non-callable GSE debt securities and \$1.25 trillion in fixed-rate federal agency and GSE MBS. Purchases of GSE debt securities began in November 2008, and purchases of federal agency and GSE MBS began in January 2009. The FRBNY completed the purchases of GSE debt securities and federal agency and GSE MBS in March 2010. The settlement of all federal agency and GSE MBS transactions was completed by August 2010. As discussed above, on September 21, 2011, the FOMC announced that the Federal Reserve will begin to reinvest principal payments from its holdings of GSE debt securities and federal agency and GSE MBS in federal agency and GSE MBS.

Central Bank Liquidity Swaps

The FOMC authorized and directed the FRBNY to establish central bank liquidity swap arrangements, which could be structured as either U.S. dollar liquidity or foreign currency liquidity swap arrangements.

In May 2010, U.S. dollar liquidity swap arrangements were re-authorized with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank through January 2011. Subsequently, these arrangements were extended through February 1, 2013. There is no specified limit to the amount that may be drawn by the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank under these swap arrangements; the Bank of Canada may draw up to \$30 billion under the swap arrangement with the FRBNY. In addition to the central bank liquidity swap arrangements, the FOMC has authorized reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico, as discussed in Note 2.

Foreign currency liquidity swap arrangements were authorized with 4 foreign central banks and provided the Reserve Banks with the capacity to offer foreign currency liquidity to U.S. depository institutions. The authorization for these swap arrangements expired on February 1, 2010. In November 2011, as a contingency measure, the FOMC agreed to establish temporary bilateral liquidity swap arrangements with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank so that liquidity can be provided in any of their currencies, if necessary. The swap lines are authorized until February 1, 2013.

Lending to Depository Institutions

The Term Auction Facility (TAF) promoted the efficient dissemination of liquidity by providing term funds to depository institutions. The last TAF auction was conducted on March 8, 2010, and the related loans matured on April 8, 2010.

Lending to Primary Dealers

The Term Securities Lending Facility (TSLF) promoted liquidity in the financing markets for Treasury securities. Under the TSLF, the FRBNY could lend up to an aggregate amount of \$200 billion of Treasury securities held in the SOMA to primary dealers on a secured basis for a term of 28 days. The authorization for the TSLF expired on February 1, 2010.

The Term Securities Lending Facility Options Program (TOP) offered primary dealers the opportunity to purchase an option to draw upon short-term, fixed-rate TSLF loans in exchange for eligible collateral. The program was suspended effective with the maturity of the June 2009 TOP options, and authorization for the program expired on February 1, 2010.

Other Lending Facilities

The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) provided funding to depository institutions and bank holding companies to finance the purchase of eligible high-quality asset-backed commercial paper (ABCP) from money market mutual funds. The Federal Reserve Bank of Boston administered the AMLF and was authorized to extend these loans to eligible borrowers on behalf of the other Reserve Banks. The authorization for the AMLF expired on February 1, 2010.

4. Significant Accounting Policies

Accounting principles for entities with the unique powers and responsibilities of a 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. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* (FAM), which is issued by the Board of Governors. The Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the FAM and the financial statements have been prepared in accordance with the FAM.

Limited differences exist between the accounting principles and practices in the FAM and accounting principles generally accepted in the United States of America (GAAP), due to the unique nature of the Bank's powers and responsibilities as part of the nation's central bank and given the System's unique responsibility to conduct monetary policy. The primary differences are the presentation of all SOMA securities holdings at amortized cost and the recording of SOMA securities on a settlement-date basis. Amortized cost, rather than the fair value presentation, more appropriately reflects the Bank's securities holdings given the System's unique responsibility to conduct monetary policy. Although the application of fair value measurements to the securities holdings may result in values substantially greater or less than their carrying values, these unrealized changes in value 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 before maturity. Decisions regarding securities and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, fair values, earnings, and gains or losses resulting from the sale of such securities and currencies are incidental to open market operations and do not motivate decisions related to policy or open market activities. Accounting for these securities on a settlement-date basis, rather than the trade-date basis required by GAAP, better reflects the timing of the transaction's effect on the quantity of reserves in the banking system. The cost bases of Treasury securities, GSE debt securities, and foreign government debt instruments are adjusted for amortization of premiums or accretion of discounts on a straight-line basis, rather than using the interest method required by GAAP.

In addition, the Bank does not present a Statement of Cash Flows as required by GAAP because the liquidity and cash position of the Bank are not a primary concern given the Reserve Banks' unique powers and responsibilities as a central bank. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income and Comprehensive Income, and Changes in Capital, and the accompanying notes to the financial statements. There are no other significant differences, other than those described above, between the policies outlined in the FAM and GAAP.

Preparing the financial statements in conformity with the FAM requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Unique accounts and significant accounting policies are explained below.

a. Consolidation

The Dodd-Frank Act established the Bureau as an independent bureau within the System, and section 1017 of the Dodd-Frank Act provides that the financial statements of the Bureau are not to be consolidated with those of the Board of Governors or the System. Section 152 of the Dodd-Frank Act established the Office of Financial Research (OFR) within the Treasury. The Board of Governors funds the Bureau and OFR through assessments on the Reserve Banks as required by the Dodd-Frank Act. The Reserve Banks reviewed the law and evaluated the design of and their relationships to the Bureau and the OFR and determined that neither should be consolidated in the Bank's financial statements.

b. Gold and Special Drawing Rights Certificates

The Secretary of the Treasury is authorized to issue gold and special drawing rights (SDR) certificates to the Reserve Banks. Upon authorization, the Reserve Banks acquire gold certificates by crediting equivalent amounts in dollars to the account established for the Treasury. The gold certificates held by the Reserve Banks are required to be backed by the gold owned by the Treasury. The Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the Treasury. At such time, the 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 per fine troy ounce. The Board of Governors allocates the gold certificates among the Reserve Banks once a year based on the average Federal Reserve notes outstanding at each Reserve Bank.

SDR certificates are issued by the International Monetary Fund (IMF) to its members in proportion to each member's quota in the IMF 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 U.S. participation in the SDR system, the Secretary of the Treasury is authorized to issue SDR certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in U.S. dollars are credited to the account established for the Treasury and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the 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 the Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. SDRs are recorded by the Bank at original cost. There were no SDR transactions during the years ended December 31, 2011 and 2010.

c. Coin

The amount reported as coin in the Statements of Condition represents the face value of all United States coin held by the Bank. The Bank buys coin at face value from the U.S. Mint in order to fill depository institution orders.

d. Loans

Loans to depository institutions are reported at their outstanding principal balances, and interest income is recognized on an accrual basis.

Loans are impaired when current information and events indicate that it is probable that the Bank will not receive the principal and interest that are due in accordance with the contractual terms of the loan agreement. Impaired loans are evaluated to determine whether an allowance for loan loss is required. The Bank has developed procedures for assessing the adequacy of any allowance for loan losses using all available information to identify incurred losses. This assessment includes monitoring information obtained from banking supervisors, borrowers, and other sources to assess the credit condition of the borrowers and, as appropriate, evaluating collateral values. Generally, the Bank would discontinue recognizing interest income on impaired loans until the borrower's repayment performance demonstrates principal and interest would be received in accordance with the terms of the loan agreement. If the Bank discontinues recording interest on an impaired loan, cash payments are first applied to principal until the loan balance is reduced to zero; subsequent payments are applied as recoveries of amounts previously deemed uncollectible, if any, and then as interest income.

e. Securities Purchased Under Agreements to Resell, Securities Sold Under Agreements to Repurchase, and Securities Lending

The FRBNY may engage in purchases of securities with primary dealers under agreements to resell (repurchase transactions). These repurchase transactions are settled through a triparty arrangement. In a triparty arrangement, two commercial custodial banks manage the collateral clearing, settlement, pricing, and pledging, and provide cash and securities custodial services for and on behalf of the Bank and counterparty. The collateral pledged must exceed the principal amount of the transaction by a margin determined by the FRBNY for each class and maturity of acceptable collateral. Collateral designated by the FRBNY as acceptable under repurchase transactions primarily includes Treasury securities (including TIPS and STRIP Treasury securities); direct obligations of several federal and GSE-related agencies, including Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac); and pass-through MBS of Fannie Mae, Freddie Mac, and Government National Mortgage Association. The repurchase transactions are accounted for as financing transactions with the associated interest income recognized over the life of the transaction.

The FRBNY may engage in sales of securities under agreements to repurchase (reverse repurchase transactions) with primary dealers and, beginning August 2010, with selected money market funds. The list of eligible counterparties was subsequently expanded to include GSEs, effective in May 2011, and bank and savings institutions, effective in July 2011. These reverse repurchase transactions may be executed through a triparty arrangement as an open market operation, similar to repurchase transactions. Reverse repurchase transactions may also be executed with foreign official and international account holders as part of a service offering. Reverse repurchase agreements are collateralized by a pledge of an amount of Treasury securities, GSE debt securities, and federal agency and GSE MBS that are held in the SOMA. Reverse repurchase transactions are accounted for as financing transactions, and the associated interest expense is recognized over the life of the transaction. These transactions are reported at their contractual amounts as "System Open Market Account: Securities sold under agreements to repurchase" and the related accrued interest payable is reported as a component of "Other liabilities" in the Statements of Condition.

Treasury securities and GSE debt securities held in the SOMA may be lent to primary dealers to facilitate the effective functioning of the domestic securities markets. The amortized cost basis of securities lent continues to be reported as "Treasury securities, net" or "Government-sponsored enterprise debt securities, net," as appropriate, in the Statements of Condition. Overnight securities lending transactions are fully collateralized by Treasury securities that have fair values in excess of the securities lent. The FRBNY charges the primary dealer a fee for borrowing securities, and these fees are reported as a component of "Non-interest income: Other" in the Statements of Income and Comprehensive Income.

Activity related to securities purchased under agreements to resell, securities sold under agreements to repurchase, and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from an annual settlement of the interdistrict settlement account that occurs in the second quarter of each year.

f. Treasury Securities; Government-Sponsored Enterprise Debt Securities; Federal Agency and Government-Sponsored Enterprise Mortgage-Backed Securities; Foreign Currency Denominated Assets; and Warehousing Agreements

Interest income on Treasury securities, GSE debt securities, and foreign currency denominated assets comprising the SOMA is accrued on a straight-line basis. Interest income on federal agency and GSE MBS is accrued using the interest method and includes amortization of premiums, accretion of discounts, and gains or losses associated with principal paydowns. Premiums and discounts related to federal agency and GSE MBS are amortized over the term of the security to stated maturity, and the amortization of premiums and accretion of discounts are accelerated when principal payments are received. Gains and losses resulting from sales of securities are determined by specific issue based on average cost. Treasury securities, GSE debt securities, and federal agency and GSE MBS are reported net of premiums and discounts in the Statements of Condition and interest income on those securities is reported net of the amortization of premiums and accretion of discounts in the Statements of Income and Comprehensive Income.

In addition to outright purchases of federal agency and GSE MBS that are held in the SOMA, the FRBNY enters into dollar roll transactions (dollar rolls), which primarily involve an initial transaction to purchase or sell "to be announced" (TBA) MBS for delivery in the current month combined with a simultaneous agreement to sell or purchase TBA MBS on a specified future date. In 2010, the FRBNY also executed a limited number of TBA MBS coupon swap transactions, which involve a simultaneous sale of a TBA MBS and purchase of another TBA MBS of a different coupon rate. During the year-ended December 31, 2010, the FRBNY's participation in the dollar roll and coupon swap markets furthered the MBS purchase program goals of providing support to the mortgage and housing markets and of fostering improved conditions in financial markets more generally. During

the year-ended December 31, 2011, the FRBNY executed dollar rolls primarily to facilitate settlement. The FRBNY accounts for outstanding commitments under dollar roll and coupon swaps as purchases or sales on a settlement-date basis. Net gains resulting from dollar roll and coupon swap transactions are reported as “Non-interest income: System Open Market Account: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net” in the Statements of Income and Comprehensive Income.

Foreign currency denominated assets, which can include foreign currency deposits, securities purchased under agreements to resell, and government debt instruments, 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 foreign currency denominated assets are reported as “Non-interest income: System Open Market Account: Foreign currency gains, net” in the Statements of Income and Comprehensive Income.

Activity related to Treasury securities, GSE debt securities, and federal agency and GSE MBS, including the premiums, discounts, and realized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of the inter-district settlement account that occurs in the second quarter of each year. Activity related to foreign currency denominated assets, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to the Reserve Banks’ aggregate capital and surplus at the preceding December 31.

Warehousing is an arrangement under which the FOMC has approved the exchange, at the request of the Treasury, of U.S. dollars for foreign currencies held by the Treasury over a limited period. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury for financing purchases of foreign currencies and related international operations. Warehousing agreements are designated as held-for-trading purposes and are valued daily at current market exchange rates. Activity related to these agreements is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to the Reserve Banks’ aggregate capital and surplus at the preceding December 31.

g. Central Bank Liquidity Swaps

Central bank liquidity swaps, which are transacted between the FRBNY and a foreign central bank, can be structured as either U.S. dollar liquidity or foreign currency liquidity swap arrangements.

Central bank liquidity swaps activity, including the related income and expense, is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to the Reserve Banks’ aggregate capital and surplus at the preceding December 31. The foreign currency amounts associated with these central bank liquidity swap arrangements are revalued daily at current foreign currency market exchange rates.

U.S. dollar liquidity swaps

At the initiation of each U.S. dollar liquidity swap transaction, the foreign central bank transfers a specified amount of its currency to a restricted account for the FRBNY in exchange for U.S. dollars at the prevailing market exchange rate. Concurrent with this transaction, the FRBNY and the foreign central bank agree to a second transaction that obligates the foreign central bank to return the U.S. dollars and the FRBNY to return the foreign currency on a specified future date at the same exchange rate as the initial transaction. The Bank’s allocated portion of the foreign currency amounts that the FRBNY acquires are reported as “System Open Market Account: Central bank liquidity swaps” in the Statements of Condition. Because the swap transaction will be unwound at the same U.S. dollar amount and exchange rate that were used in the initial transaction, the recorded value of the foreign currency amounts is not affected by changes in the market exchange rate.

The foreign central bank compensates the FRBNY based on the foreign currency amounts it holds for the FRBNY. The Bank’s allocated portion of the amount of compensation received during the term of the swap transaction is reported as “Interest income: System Open Market Account: Central bank liquidity swaps” in the Statements of Income and Comprehensive Income.

Foreign currency liquidity swaps

The structure of foreign currency liquidity swap transactions involves the transfer by the FRBNY, at the prevailing market exchange rate, of a specified amount of U.S. dollars to an account for the foreign central bank in exchange for its currency. The foreign currency amount received would be reported as a liability by the Bank.

h. 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 2 to 50 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, whether developed internally or acquired for internal use, are capitalized based on the purchase cost and the cost of direct services and materials associated with designing, coding, installing, and testing the software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which generally range from two to five years. Maintenance costs related to software are charged to operating expense in the year incurred.

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

i. Interdistrict Settlement Account

At the close of business each day, each Reserve Bank aggregates the payments due to or from other Reserve Banks. These payments result from transactions between the Reserve Banks and transactions that involve depository institution accounts held by other Reserve Banks, such as Fedwire funds and securities transfers and check and ACH transactions. The cumulative net amount due to or from the other Reserve Banks is reflected in the "Interdistrict settlement account" in the Statements of Condition.

j. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes, which are identified as issued to a specific Reserve Bank, must be fully collateralized. All of the Bank's assets are eligible to be pledged as collateral. 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 sold under agreements to repurchase is deducted from the eligible collateral value.

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize outstanding 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 government.

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Bank's currency holdings of \$9,085 million and \$7,304 million at December 31, 2011 and 2010, respectively.

At December 31, 2011 and 2010, all Federal Reserve notes issued to the Reserve Banks were fully collateralized. At December 31, 2011, all gold certificates, all special drawing right certificates, and \$1,018 billion of domestic securities held in the SOMA were pledged as collateral. At December 31, 2011, no investments denominated in foreign currencies were pledged as collateral.

k. Deposits

Depository Institutions

Depository institutions' deposits represent the reserve and service-related balances, such as required clearing balances, in the accounts that depository institutions hold at the Bank. The interest rates paid on required reserve balances and excess balances are determined by the Board of Governors, based on an FOMC-established target range for the federal funds rate. Interest payable is reported as "Interest payable to depository institutions" in the Statements of Condition.

The Term Deposit Facility (TDF) consists of deposits with specific maturities held by eligible institutions at the Reserve Banks. The Reserve Banks pay interest on these deposits at interest rates determined by auction. Interest payable is reported as “Interest payable to depository institutions” in the Statements of Condition. There were no deposits held by the Bank under the TDF at December 31, 2011 and 2010.

Other

Other deposits include foreign central bank and foreign government deposits held at the FRB NY that are allocated to the Bank.

l. Items in Process of Collection and Deferred Credit Items

“Items in process of collection” 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” is the counterpart liability to items in process of collection. 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.

m. 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. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

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. To meet the Federal Reserve Act requirement that annual dividends be deducted from net earnings, dividends are presented as a distribution of comprehensive income in the Statements of Income and Comprehensive Income.

n. Surplus

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in. On a daily basis, surplus is adjusted to equate the balance to capital paid-in. Accumulated other comprehensive income is reported as a component of “Surplus” in the Statements of Condition and the Statements of Changes in Capital. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 12 and 13.

o. Interest on Federal Reserve Notes

The Board of Governors requires the Reserve Banks to transfer excess earnings to the 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 “Payments to Treasury as interest on Federal Reserve notes” in the Statements of Income and Comprehensive Income. The amount due to the Treasury is reported as “Accrued interest on Federal Reserve notes” in the Statements of Condition.

If earnings during the year are not sufficient to provide for the costs of operations, payment of dividends, and equating surplus and capital paid-in, payments to the Treasury are suspended. A deferred asset is recorded that represents the amount of net earnings a Reserve Bank will need to realize before remittances to the Treasury resume. This deferred asset is periodically reviewed for impairment.

p. Income and Costs Related to Treasury Services

When directed by the Secretary of the Treasury, the Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States Government. By statute, the Treasury has appropriations to pay for these services. During the years ended December 31, 2011 and 2010, the Bank was reimbursed for all services provided to the Treasury as its fiscal agent.

q. Compensation Received for Service Costs Provided

The Federal Reserve Bank of Atlanta (FRBA) has overall responsibility for managing the Reserve Banks' provision of check and ACH services to depository institutions and, as a result, recognizes total System revenue for these services in its Statements of Income and Comprehensive Income. Similarly, the FRBNY manages the Reserve Banks' provision of Fedwire funds and securities services and recognizes total System revenue for these services in its Consolidated Statements of Income and Comprehensive Income. The FRBA and the FRBNY compensate the applicable Reserve Banks for the costs incurred to provide these services. The Bank reports this compensation as "Non-interest income: Compensation received for service costs provided" in the Statements of Income and Comprehensive Income.

r. Assessments

The Board of Governors assesses the Reserve Banks to fund its operations, the operations of the Bureau and, for a two-year period following the July 21, 2010, effective date of the Dodd-Frank Act, the OFR. These assessments are allocated to each Reserve Bank based on each Reserve Bank's capital and surplus balances as of December 31 of the prior year for the Board of Governors' operations and as of the most recent quarter for the Bureau and OFR operations. The Board of Governors also assesses each Reserve Bank for the expenses incurred by the Treasury to produce 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 prior year.

During the period prior to the Bureau transfer date of July 21, 2011, there was no limit on the funding provided to the Bureau and assessed to the Reserve Banks; the Board of Governors was required to provide the amount estimated by the Secretary of the Treasury needed to carry out the authorities granted to the Bureau under the Dodd-Frank Act and other federal law. The Dodd-Frank Act requires that, after the transfer date, the Board of Governors fund the Bureau in an amount not to exceed a fixed percentage of the total operating expenses of the System as reported in the Board of Governors' 2009 annual report, which totaled \$4.98 billion. The fixed percentage of total 2009 operating expenses of the System is 10 percent (\$498.0 million) for 2011, 11 percent (\$547.8 million) for 2012, and 12 percent (\$597.6 million) for 2013. After 2013, the amount will be adjusted in accordance with the provisions of the Dodd-Frank Act. The Bank's assessment for Bureau funding is reported as "Assessments: Bureau of Consumer Financial Protection" in the Statements of Income and Comprehensive Income.

The Board of Governors assesses the Reserve Banks to fund the operations of the OFR for the two-year period following enactment of the Dodd-Frank Act; thereafter, the OFR will be funded by fees assessed on bank holding companies and nonbank financial companies that meet the criteria specified in the Dodd-Frank Act.

s. 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, 2011 and 2010, and are reported as a component of "Operating expenses: Occupancy" in the Statements of Income and Comprehensive Income.

t. Restructuring Charges

The Reserve Banks recognize restructuring charges for exit or disposal costs incurred as part of the closure of business activities in a particular location, the relocation of business activities from one location to another, or a fundamental reorganization that affects the nature of operations. Restructuring charges may include costs associated with employee separations, contract terminations, and asset impairments. Expenses are recognized in the period in which the Bank commits to a formalized restructuring plan or executes the specific actions contemplated in the plan and all criteria for financial statement recognition have been met.

Note 14 describes the Bank's restructuring initiatives and provides information about the costs and liabilities associated with employee separations and contract terminations. The costs associated with the impairment of certain Bank assets are discussed in Note 9. 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 12.

u. *Recently Issued Accounting Standards*

In July 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires additional disclosures about the allowance for credit losses and the credit quality of loan portfolios. The additional disclosures include a rollforward of the allowance for credit losses on a disaggregated basis and more information, by type of receivable, on credit quality indicators, including the amount of certain past-due receivables and troubled debt restructurings and significant purchases and sales. The adoption of this update is effective for the Bank for the year ended December 31, 2011, and did not have a material effect on the Bank's financial statements.

In April 2011, the FASB issued ASU 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, which clarifies accounting for troubled debt restructurings, specifically clarifying creditor concessions and financial difficulties experienced by borrowers. This update is effective for the Bank for the year ended December 31, 2012, and is not expected to have a material effect on the Bank's financial statements.

In April 2011, the FASB issued ASU 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*, which reconsidered the effective control for repurchase agreements. This update prescribes when the Bank may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. This determination is based, in part, on whether the Bank has maintained effective control over the transferred financial assets. This update is effective for the Bank for the year ended December 31, 2012, and is not expected to have a material effect on the Bank's financial statements.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income (Topic 220): Presentation of Comprehensive Income*, which requires a reporting entity to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This update eliminates the option to present the components of other comprehensive income as part of the statement of shareholders' equity. The update is intended to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items by presenting the components reported in other comprehensive income. The Bank has adopted the update in this ASU effective for the year ended December 31, 2011, and the required presentation is reflected in the Bank's financial statements.

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*. This update will require a reporting entity to present enhanced disclosures for financial instruments and derivative instruments that are offset or subject to master netting agreements or similar such agreements. This update is effective for the Bank for the year ended December 31, 2013, and is not expected to have a material effect on the Bank's financial statements.

In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. This update indefinitely defers the requirements of ASU 2011-05 related to presentation of reclassification adjustments.

5. Loans

The Bank had no loans outstanding at December 31, 2011 and 2010.

Loans to Depository Institutions

The Bank offers primary, secondary, and seasonal loans to eligible borrowers, and each program has its own interest rate. Interest is accrued using the applicable interest rate established at least every 14 days by the Bank's board of directors, subject to review and determination by the Board of Governors. Primary and secondary loans are extended on a short-term basis, typically overnight, whereas seasonal loans may be extended for a period of up to nine months.

Primary, secondary, and seasonal loans are collateralized to the satisfaction of the Bank to reduce credit risk. Assets eligible to collateralize these loans include consumer, business, and real estate loans; Treasury securities; GSE debt securities; foreign sovereign debt; municipal, corporate, and state and local government obligations; asset-backed securities; corporate bonds; commercial paper; and bank-issued assets, such as certificates of deposit, bank notes, and deposit notes. Collateral is assigned a lending value that is deemed appropriate by the Bank, which is typically fair value reduced by a margin. Loans to depository institutions are monitored daily to ensure that borrowers continue to meet eligibility requirements for these programs. The financial condition of borrowers is monitored by the Bank and, if a borrower no longer qualifies for these programs, the Bank will generally request full repayment of the outstanding loan or, for primary or seasonal loans, may convert the loan to a secondary credit loan. Collateral levels are reviewed daily against outstanding obligations and borrowers that no longer have sufficient collateral to support outstanding loans are required to provide additional collateral or to make partial or full repayment.

Allowance for Loan Loss

At December 31, 2011 and 2010, the Bank did not have any impaired loans and no allowance for loan losses was required. There were no impaired loans during the years ended December 31, 2011 and 2010.

6. Treasury Securities; Government-Sponsored Enterprise Debt Securities; Federal Agency and Government-Sponsored Enterprise Mortgage-Backed Securities; Securities Purchased Under Agreements to Resell; 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 2.701 percent and 3.398 percent at December 31, 2011 and 2010, respectively.

The Bank's allocated share of Treasury securities, GSE debt securities, and federal agency and GSE MBS, net, excluding accrued interest, held in the SOMA at December 31 was as follows (in millions):

	2011				
	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost	Fair value
Bills	\$ 498	\$ —	\$ —	\$ 498	\$ 498
Notes	34,747	724	(33)	35,438	37,531
Bonds	9,688	1,657	(2)	11,343	13,741
Total Treasury securities	\$ 44,933	\$ 2,381	\$ (35)	\$ 47,279	\$ 51,770
GSE debt securities	\$ 2,809	\$ 104	\$ —	\$ 2,913	\$ 3,086
Federal agency and GSE MBS	\$ 22,627	\$ 314	\$ (28)	\$ 22,913	\$ 24,189
	2010				
	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost	Fair value
Bills	\$ 626	\$ —	\$ —	\$ 626	\$ 626
Notes	26,273	477	(26)	26,724	27,340
Bonds	7,807	1,112	(19)	8,900	9,845
Total Treasury securities	\$ 34,706	\$ 1,589	\$ (45)	\$ 36,250	\$ 37,811
GSE debt securities	\$ 5,010	\$ 188	\$ (1)	\$ 5,197	\$ 5,327
Federal agency and GSE MBS	\$ 33,709	\$ 479	\$ (53)	\$ 34,135	\$ 34,859

The total of the Treasury securities, GSE debt securities, and federal agency and GSE MBS, net, excluding accrued interest, held in the SOMA at December 31 was as follows (in millions):

	2011		2010	
	Amortized cost	Fair value	Amortized cost	Fair value
Bills	\$ 18,423	\$ 18,423	\$ 18,422	\$ 18,422
Notes	1,311,917	1,389,429	786,575	804,703
Bonds	419,937	508,694	261,955	289,757
Total Treasury securities	\$ 1,750,277	\$ 1,916,546	\$ 1,066,952	\$ 1,112,882
GSE debt securities	\$ 107,828	\$ 114,238	\$ 152,972	\$ 156,780
Federal agency and GSE MBS	\$ 848,258	\$ 895,495	\$ 1,004,695	\$ 1,026,003

The fair value amounts in the above tables are presented solely for informational purposes. Although the fair value of security holdings can be substantially greater than or less than the recorded value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as the central bank, to meet their financial obligations and responsibilities. The fair value of federal agency and GSE MBS was determined using a model-based approach that considers observable inputs for similar securities; fair value for all other SOMA security holdings was determined by reference to quoted prices for identical securities.

The fair value of the fixed-rate Treasury securities, GSE debt securities, and federal agency and GSE MBS in the SOMA's holdings is subject to market risk, arising from movements in market variables, such as interest rates and securities prices. The fair value of federal agency and GSE MBS is also affected by the expected rate of prepayments of mortgage loans underlying the securities.

The following table provides additional information on the amortized cost and fair values of the federal agency and GSE MBS portfolio at December 31 (in millions):

	2011		2010	
	Amortized cost	Fair value	Amortized cost	Fair value
Distribution of MBS holdings by coupon rate				
Allocated to the Bank:				
3.0%	\$ 36	\$ 36	\$ —	\$ —
3.5%	524	531	11	12
4.0%	4,362	4,586	5,697	5,722
4.5%	10,979	11,647	16,909	17,287
5.0%	4,930	5,204	7,863	8,071
5.5%	1,804	1,892	3,164	3,257
6.0%	247	260	438	454
6.5%	31	33	53	56
Total	\$ 22,913	\$ 24,189	\$ 34,135	\$ 34,859
Total SOMA:				
3.0%	\$ 1,313	\$ 1,336	\$ —	\$ —
3.5%	19,415	19,660	341	352
4.0%	161,481	169,763	167,675	168,403
4.5%	406,465	431,171	497,672	508,798
5.0%	182,497	192,664	231,420	237,545
5.5%	66,795	70,064	93,119	95,873
6.0%	9,152	9,616	12,910	13,376
6.5%	1,140	1,221	1,558	1,656
Total	\$ 848,258	\$ 895,495	\$ 1,004,695	\$ 1,026,003

There were no transactions related to securities purchased under agreements to resell during the years ended December 31, 2011 and 2010. Financial information related to securities sold under agreements to repurchase for the years ended December 31 was as follows (in millions):

	2011	2010
Allocated to the Bank:		
Contract amount outstanding, end of year	\$ 2,698	\$ 2,028
Average daily amount outstanding, during the year	2,066	2,079
Maximum balance outstanding, during the year	3,363	3,071
Securities pledged (par value), end of year	2,325	1,483
Securities pledged (market value), end of year	2,698	2,028
Total SOMA:		
Contract amount outstanding, end of year	\$ 99,900	\$ 59,703
Average daily amount outstanding, during the year	72,227	58,476
Maximum balance outstanding, during the year	124,512	77,732
Securities pledged (par value), end of year	86,089	43,642
Securities pledged (market value), end of year	99,900	59,703

The contract amounts for securities sold under agreements to repurchase approximate fair value. FRBNY executes transactions for the purchase of securities under agreements to resell primarily to temporarily add reserve balances to the banking system. Conversely, transactions to sell securities under agreements to repurchase are executed to temporarily drain reserve balances from the banking system and as part of a service offering to foreign official and international account holders.

The remaining maturity distribution of Treasury securities, GSE debt securities, federal agency and GSE MBS bought outright, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2011, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Over 5 years to 10 years	Over 10 years	Total
Treasury securities (par value)	\$ 439	\$ 732	\$ 2,428	\$ 17,550	\$ 17,555	\$ 6,229	\$ 44,933
GSE debt securities (par value)	67	136	532	1,637	374	63	2,809
Federal agency and GSE MBS (par value) ¹	—	—	—	—	1	22,626	22,627
Securities sold under agreements to repurchase (contract amount)	2,698	—	—	—	—	—	2,698

¹ The par amount shown for Federal agency and GSE MBS is the remaining principal balance of the underlying mortgages.

Federal agency and GSE MBS are reported at stated maturity in the table above. The estimated weighted average life of these securities at December 31, 2011, which differs from the stated maturity primarily because it factors in scheduled payments and prepayment assumptions, is approximately 2.4 years.

The amortized cost and par value of Treasury securities and GSE debt securities that were loaned from the SOMA at December 31 was as follows (in millions):

	Allocated to the Bank			
	Amortized cost		Par value	
	2011	2010	2011	2010
Treasury securities	\$ 408	\$ 769	\$ 378	\$ 750
GSE debt securities	34	57	33	55

	Total SOMA			
	Amortized cost		Par value	
	2011	2010	2011	2010
Treasury securities	\$ 15,121	\$ 22,627	\$ 13,978	\$ 22,081
GSE debt securities	1,276	1,686	1,216	1,610

The FRBNY enters into commitments to buy Treasury and GSE debt securities and records the related securities on a settlement-date basis. As of December 31, 2011, the total purchase price of the Treasury securities under outstanding commitments was \$3,200 million. The total purchase price of outstanding commitments allocated to the Bank was \$86 million. These commitments had contractual settlement dates extending through January 3, 2012. As of December 31, 2011, the fair value of Treasury securities under outstanding purchase commitments was \$3,208 million, of which \$87 million was allocated to the Bank.

The FRBNY enters into commitments to buy and sell federal agency and GSE MBS and records the related securities on a settlement-date basis. As of December 31, 2011, the total purchase price of the federal agency and GSE MBS under outstanding purchase commitments was \$41,503 million, of which \$513 million was related to dollar roll transactions. The total purchase price of outstanding purchase commitments allocated to the Bank was \$1,121 million, of which \$14 million was related to dollar roll transactions. As of December 31, 2011, the total sales price of the federal agency and GSE MBS under outstanding sales commitments was \$4,430 million, all of which was related to dollar roll transactions. The total sales price of outstanding sales commitments allocated to the Bank was \$120 million, all of which was related to dollar roll transactions. These commitments, which had contractual settlement dates extending through February 2012, are for the purchase and sale of TBA MBS for which the number and identity of the pools that will be delivered to fulfill the commitment are unknown at the time of the trade. As of December 31, 2011, the fair value of federal agency and GSE MBS purchases and sales, net under outstanding commitments was \$41,873 million and \$4,473 million, respectively, of which \$1,131 million and \$121 million, respectively, was allocated to the Bank. These commitments are subject to varying degrees of off-balance-sheet market risk and counterparty credit risk that result from their future settlement. The FRBNY requires the posting of cash collateral for commitments as part of the risk management practices used to mitigate the counterparty credit risk.

Other liabilities, which are related to federal agency and GSE MBS purchases and sales, includes the FRBNY's obligation to return cash margin posted by counterparties as collateral under commitments to purchase and sell federal agency and GSE MBS. In addition, other liabilities includes obligations that arise from the failure of a seller to deliver securities to the FRBNY on the settlement date. Although FRBNY has ownership of and records its investments in the MBS as of the contractual settlement date, it is not obligated to make payment until the securities are delivered, and the amount included in other liabilities represents the FRBNY's obligation to pay for the securities when delivered. The amount of other liabilities allocated to the Bank and held in the SOMA at December 31 was as follows (in millions):

	Allocated to the Bank		Total SOMA	
	2011		2011	
Cash margin	\$ 34	\$ 1,271		
Obligations from MBS transaction fails	3	97		
Total	\$ 37	\$ 1,368		

During the years ended December 31, 2011 and 2010, the Reserve Banks recorded net gains from federal agency and GSE MBS transactions of \$10 million and \$782 million, respectively, of which \$262 thousand and \$29 million, respectively, were allocated to the Bank. These net gains are reported as "Non-interest income: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net" in the Statements of Income and Comprehensive Income.

Information about transactions related to Treasury securities, GSE debt securities, and federal agency and GSE MBS during the year ended December 31, 2011, is summarized as follows (in millions):

Allocated to the Bank

	Bills	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Balance December 31, 2010	\$ 626	\$ 26,724	\$ 8,900	\$ 36,250	\$ 5,197	\$ 34,135
Purchases ¹	6,938	22,098	4,716	33,752	—	1,138
Sales ¹	—	(3,720)	—	(3,720)	—	—
Realized gains, net ²	—	61	—	61	—	—
Principal payments and maturities	(6,938)	(1,930)	—	(8,868)	(1,289)	(5,661)
Amortization of premiums and discounts	—	(127)	(143)	(270)	(49)	(93)
Inflation adjustment on inflation-indexed securities	—	37	31	68	—	—
Annual reallocation adjustment ³	(128)	(7,705)	(2,161)	(9,994)	(946)	(6,606)
Balance December 31, 2011	\$ 498	\$ 35,438	\$ 11,343	\$ 47,279	\$ 2,913	\$ 22,913

Supplemental information - par value of transactions:

Purchases	\$ 6,938	\$ 21,605	\$ 3,734	\$ 32,277	\$ —	\$ 1,106
Proceeds from sales	—	(3,642)	—	(3,642)	—	—

Total SOMA

	Bills	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Balance December 31, 2010	\$ 18,422	\$ 786,575	\$ 261,955	\$ 1,066,952	\$ 152,972	\$ 1,004,695
Purchases ¹	239,487	731,252	161,876	1,132,615	—	42,145
Sales ¹	—	(137,734)	—	(137,734)	—	—
Realized gains, net ²	—	2,258	—	2,258	—	—
Principal payments and maturities	(239,494)	(67,273)	—	(306,767)	(43,466)	(195,413)
Amortization of premiums and discounts	8	(4,445)	(4,985)	(9,422)	(1,678)	(3,169)
Inflation adjustment on inflation-indexed securities	—	1,284	1,091	2,375	—	—
Balance December 31, 2011	\$ 18,423	\$ 1,311,917	\$ 419,937	\$ 1,750,277	\$ 107,828	\$ 848,258

Supplemental information - par value of transactions:

Purchases	\$ 239,494	\$ 713,878	\$ 127,802	\$ 1,081,174	\$ —	\$ 40,955
Proceeds from sales	—	(134,829)	—	(134,829)	—	—

¹ Purchases and sales are reported on a settlement-date basis and include payments and receipts related to principal, premiums, discounts, and inflation compensation included in the basis of inflation-indexed securities. The amount reported as sales also includes realized gains, net.

² Adjustments for realized gains, net is required because these amounts do not affect the reported amount of the related securities. Excludes gains and losses that result from net settled MBS TBA transactions.

³ Reflects the annual adjustment to the Bank's allocated portion of the related SOMA securities that results from the annual settlement of the interdistrict settlement account, as discussed in Note 4f.

7. Foreign Currency Denominated Assets

The FRBNY holds foreign currency deposits with foreign central banks and the Bank for International Settlements and invests in foreign government debt instruments of Germany, France, and Japan. These foreign government debt instruments are guaranteed as to principal and interest by the issuing foreign governments. In addition, the FRBNY enters into transactions to purchase Euro-denominated government debt securities under agreements to resell for which the accepted collateral is the debt instruments issued by the governments of Belgium, France, Germany, Italy, the Netherlands, and Spain.

The Bank's allocated share of foreign currency denominated assets was approximately 7.418 percent and 7.451 percent at December 31, 2011 and 2010, respectively.

The Bank's allocated share of foreign currency denominated assets, including accrued interest, valued at amortized cost and foreign currency market exchange rates at December 31 was as follows (in millions):

	2011	2010
Euro:		
Foreign currency deposits	\$ 695	\$ 526
Securities purchased under agreements to resell	—	184
German government debt instruments	140	138
French government debt instruments	195	205
Japanese yen:		
Foreign currency deposits	296	289
Japanese government debt instruments	599	599
Total allocated to the Bank	\$ 1,925	\$ 1,941

At December 31, 2011 and 2010, the fair value of foreign currency denominated assets, including accrued interest, allocated to the Bank was \$1,937 million and \$1,953 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 Treasury securities, GSE debt securities, and federal agency and GSE MBS discussed in Note 6, unrealized gains or losses have no effect on the ability of a Reserve Bank, as the central bank, to meet its financial obligations and responsibilities. The fair value is presented solely for informational purposes.

Total Reserve Bank foreign currency denominated assets were \$25,950 million and \$26,049 million at December 31, 2011 and 2010, respectively. At December 31, 2011 and 2010, the fair value of the total Reserve Bank foreign currency denominated assets, including accrued interest, was \$26,116 million and \$26,213 million, respectively.

The remaining maturity distribution of foreign currency denominated assets that were allocated to the Bank at December 31, 2011, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Total
Euro	\$ 397	\$ 218	\$ 157	\$ 258	\$ 1,030
Japanese yen	310	49	233	303	895
Total	\$ 707	\$ 267	\$ 390	\$ 561	\$ 1,925

At December 31, 2011 and 2010, the authorized warehousing facility was \$5 billion, with no balance outstanding.

There were no transactions related to the authorized reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico during the years ended December 31, 2011 and 2010.

There were no foreign exchange contracts related to open market operations outstanding as of December 31, 2011.

The FRBNY enters into commitments to buy foreign government debt instruments and records the related securities on a settlement-date basis. As of December 31, 2011, there were \$216 million of outstanding commitments to purchase Euro-denominated government debt instruments, of which \$16 million was allocated to the Bank. These securities settled on January 4, 2012, and replaced Euro-denominated government debt instruments held in the SOMA that matured on that date. As of December 31, 2011, the fair value of Euro-denominated government debt instruments under outstanding commitments was \$216 million, of which \$16 million was allocated to the Bank.

In connection with its foreign currency activities, the FRBNY may enter into transactions that are subject to varying degrees of off-balance-sheet market risk and counterparty credit risk that result from their future settlement. The FRBNY controls these risks by obtaining credit approvals, establishing transaction limits, receiving collateral in some cases, and performing daily monitoring procedures.

8. Central Bank Liquidity Swaps

U.S. Dollar Liquidity Swaps

The Bank's allocated share of U.S. dollar liquidity swaps was approximately 7.418 percent and 7.451 percent at December 31, 2011 and 2010, respectively.

The total foreign currency held under U.S. dollar liquidity swaps in the SOMA at December 31, 2011 and 2010, was \$99,823 million and \$75 million, respectively, of which \$7,405 million and \$6 million, respectively, was allocated to the Bank.

The remaining maturity distribution of U.S. dollar liquidity swaps that were allocated to the Bank at December 31 was as follows (in millions):

	2011			2010	
	Within 15 days	16 days to 90 days	Total	Within 15 days	
Euro	\$ 2,549	\$ 3,789	\$ 6,338	\$ 6	
Japanese yen	670	368	1,038	—	
Swiss franc	24	5	29	—	
Total	\$ 3,243	\$ 4,162	\$ 7,405	\$ 6	

Foreign Currency Liquidity Swaps

There were no transactions related to the foreign currency liquidity swaps during the years ended December 31, 2011 and 2010.

9. Bank Premises, Equipment, and Software

Bank premises and equipment at December 31 were as follows (in millions):

	2011	2010
Bank premises and equipment:		
Land and land improvements	\$ 10	\$ 10
Buildings	175	172
Building machinery and equipment	59	62
Furniture and equipment	48	54
Subtotal	292	298
Accumulated depreciation	(155)	(141)
Bank premises and equipment, net	\$ 137	\$ 157
Depreciation expense, for the years ended December 31	\$ 11	\$ 11

The Bank leases space to outside tenants with remaining lease terms ranging from one to thirteen years. Rental income from such leases was \$2 million for each of the years ended December 31, 2011 and 2010, and is reported as a component of “Non-interest income: Other” in the Statements of Income and Comprehensive Income. Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2011, are as follows (in millions):

2012	\$	2
2013		1
2014		1
2015		2
2016		1
Thereafter		8
Total	\$	15

The Bank had capitalized software assets, net of amortization, of \$12 million and \$9 million at December 31, 2011 and 2010, respectively. Amortization expense was \$2 million for each of the years ended December 31, 2011 and 2010. Capitalized software assets are reported as a component of “Other assets” in the Statements of Condition and the related amortization is reported as a component of “Operating expenses: Other” in the Statements of Income and Comprehensive Income.

As a result of the Bank’s restructuring plan discussed in Note 14, the Bank has determined that it will vacate the Pittsburgh branch facility. The Bank recorded an impairment loss of \$12 million during the year ended December 31, 2011, to adjust the recorded amount of related building and land, building machinery and equipment, and land improvements to fair value. Fair values were based on appraisals and other valuation techniques. A portion of the impairment loss in the amount of \$10 million is reported as a component of “Operating expenses: Other” and the remaining amount of \$2 million is reported as a component of “Operating expenses: Occupancy” in the Statements of Income and Comprehensive Income. The Bank had no impairment losses in 2010.

10. Commitments and Contingencies

Conducting its operations, the Bank enters into contractual commitments, normally with fixed expiration dates or termination provisions, at specific rates and for specific purposes.

At December 31, 2011, the Bank was obligated under a noncancelable lease for premises and equipment with a remaining term of one year. The lease provides for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indexes.

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 \$358 thousand and \$355 thousand for the years ended December 31, 2011 and 2010, respectively.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with terms of one year or more, at December 31, 2011, were not material.

At December 31, 2011, there were no material unrecorded unconditional purchase commitments or obligations in excess of one year.

Under the Insurance Agreement of the Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a share of certain losses in excess of 1 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 of a Reserve Bank’s capital paid-in 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, 2011 and 2010.

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 legal actions and claims will be resolved without material adverse effect on the financial position or results of operations of the Bank.

11. 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 employees of the Reserve Banks, Board of Governors, and Office of Employee Benefits of the Federal Reserve System (OEB) participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). Under the Dodd-Frank Act, newly hired Bureau employees are eligible to participate in the System Plan and transferees from other governmental organizations can elect to participate in the System Plan. In addition, employees at certain compensation levels participate in the Benefit Equalization Retirement Plan (BEP) and certain Reserve Bank officers participate in the Supplemental Retirement Plan for Select Officers of the Federal Reserve Banks (SERP).

The System Plan provides retirement benefits to employees of the Reserve Banks, Board of Governors, OEB, and certain employees of the Bureau. The FRBNY, on behalf of the System, recognizes the net asset or net liability and costs associated with the System Plan in its consolidated financial statements. During the year ended December 31, 2011, certain costs associated with the System Plan were reimbursed by the Bureau. During the year ended December 31, 2010, costs associated with the System Plan were not reimbursed by other participating employers.

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2011 and 2010, and for the years then ended, were not material.

Thrift Plan

Employees of the Bank participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Bank matches 100 percent of the first 6 percent of employee contributions from the date of hire and provides an automatic employer contribution of 1 percent of eligible pay. The Bank's Thrift Plan contributions totaled \$5 million for each of the years ended December 31, 2011 and 2010, and are reported as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

12. Postretirement Benefits Other Than Retirement Plans and Postemployment Benefits

Postretirement Benefits Other Than Retirement Plans

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 the beginning and ending balances of the benefit obligation (in millions):

	2011	2010
Accumulated postretirement benefit obligation at January 1	\$ 117.7	\$ 93.7
Service cost benefits earned during the period	5.8	4.2
Interest cost on accumulated benefit obligation	6.5	5.5
Net actuarial loss	4.5	18.0
Curtailment gain	(6.9)	—
Contributions by plan participants	0.9	0.7
Benefits paid	(5.0)	(4.7)
Medicare Part D subsidies	0.3	0.3
Plan amendments	(19.4)	—
Accumulated postretirement benefit obligation at December 31	\$ 104.4	\$ 117.7

At December 31, 2011 and 2010, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 4.50 percent and 5.25 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):

	2011	2010
Fair value of plan assets at January 1	\$ —	\$ —
Contributions by the employer	3.8	3.7
Contributions by plan participants	0.9	0.7
Benefits paid	(5.0)	(4.7)
Medicare Part D subsidies	0.3	0.3
Fair value of plan assets at December 31	\$ —	\$ —
Unfunded obligation and accrued postretirement benefit cost	\$ 104.4	\$ 117.7

Amounts included in accumulated other comprehensive loss are shown below:

Prior service cost	\$ 19.4	\$ 0.1
Net actuarial loss	(31.0)	(37.1)
Total accumulated other comprehensive loss	\$ (11.6)	\$ (37.0)

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:

	2011	2010
Health-care cost trend rate assumed for next year	7.50%	8.00%
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	2017	2017

Assumed health-care cost trend rates have a significant effect on the amounts reported for health-care plans. A 1 percentage point change in assumed health-care cost trend rates would have the following effects for the year ended December 31, 2011 (in millions):

	1 percentage point increase	1 percentage point decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	\$ 2.3	\$ (1.9)
Effect on accumulated postretirement benefit obligation	15.0	(12.2)

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

	2011	2010
Service cost-benefits earned during the period	\$ 5.8	\$ 4.2
Interest cost on accumulated benefit obligation	6.5	5.5
Amortization of prior service cost	—	(1.4)
Amortization of net actuarial loss	3.6	1.7
Net periodic postretirement benefit expense	<u>\$ 15.9</u>	<u>\$ 10.0</u>

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Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2012 are shown below:

Prior service cost	\$ (3.6)
Net actuarial loss	2.1
Total	<u>\$ (1.5)</u>

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2011 and 2010, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.25 percent and 5.75 percent, respectively.

Net periodic postretirement benefit expense is reported as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

A curtailment gain associated with restructuring programs that are described in Note 14 was recognized in net income in the year ended December 31, 2011, related to employees who terminated employment during 2011.

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 are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit expense.

Federal Medicare Part D subsidy receipts were \$343 thousand and \$259 thousand for the years ended December 31, 2011 and 2010, respectively. Expected receipts in 2012, related to benefits paid in the years ended December 31, 2011 and 2010, are \$79 thousand.

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

	Without subsidy	With subsidy
2012	\$ 5.6	\$ 5.2
2013	5.7	5.3
2014	5.9	5.5
2015	6.0	5.5
2016	6.4	5.9
2017–2021	35.6	31.6
Total	<u>\$ 65.2</u>	<u>\$ 59.0</u>

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, 2011 and 2010, were \$13.9 million and \$12.1 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 2011 and 2010 operating expenses were \$3.6 million and \$0.9 million, respectively, and are recorded as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

13. Accumulated Other Comprehensive Income and 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 retirement plans
Balance at January 1, 2010	\$ (19)
Change in funded status of benefit plans:	
Amortization of prior service cost	(2)
Change in prior service costs related to benefit plans	(2)
Net actuarial loss arising during the year	(18)
Amortization of net actuarial loss	2
Change in actuarial loss related to benefit plans	(16)
Change in funded status of benefit plans— other comprehensive loss	(18)
Balance at December 31, 2010	\$ (37)
Change in funded status of benefit plans:	
Prior service costs arising during the year	19
Change in prior service costs related to benefit plans	19
Net actuarial gain arising during the year	3
Amortization of net actuarial loss	4
Change in actuarial gain related to benefit plans	7
Change in funded status of benefit plans— other comprehensive loss	26
Balance at December 31, 2011	\$ (11)

Additional detail regarding the classification of accumulated other comprehensive loss is included in Note 12.

14. Business Restructuring Charges

In 2011, the U.S. Treasury announced a restructuring initiative to consolidate the Treasury Retail Securities (TRS) operations located in the Bank's Pittsburgh branch into the Federal Reserve Bank of Minneapolis. In coordination with the TRS restructuring in Pittsburgh, the Bank announced the restructuring of support and overhead functions at the branch and the sale of the Pittsburgh branch facility. Additional announcements in 2011 included the consolidation of paper check processing into the Federal Reserve Bank of Atlanta.

The Bank had no business restructuring charges in 2010.

Additional announcements prior to 2010 included restructuring plans associated with Check Operations and Electronic Treasury Financial Services.

Following is a summary of financial information related to the restructuring plans (in millions):

	2011 restructuring plans	2009 and prior restructuring plans	Total
<i>Information related to restructuring plans as of December 31, 2011:</i>			
Total expected costs related to restructuring activity	\$ 10.0	\$ 2.1	\$ 12.1
Expected completion date	2011	2010	
<i>Reconciliation of liability balances:</i>			
Balance at January 1, 2010	\$ —	\$ 0.1	\$ 0.1
Adjustments	—	(0.1)	(0.1)
Balance at December 31, 2010	\$ —	\$ —	\$ —
Employee separation costs	10.9	—	10.9
Adjustments	(0.8)	—	(0.8)
Payments	(4.0)	—	(4.0)
Balance at December 31, 2011	\$ 6.1	\$ —	\$ 6.1

Employee separation costs are primarily severance costs for identified staff reductions associated with the announced restructuring plans. Separation costs that are provided under terms of ongoing benefit arrangements are recorded based on the accumulated benefit earned by the employee. Separation costs that are provided under the terms of one-time benefit arrangements are generally measured based on the expected benefit as of the termination date and recorded ratably over the period to termination. Restructuring costs related to employee separations are reported as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

Adjustments to the accrued liability are primarily due to changes in the estimated restructuring costs and are shown as a component of the appropriate expense category in the Statements of Income and Comprehensive Income.

Restructuring costs associated with the impairment of certain Bank assets, including software, buildings, leasehold improvements, furniture, and equipment, are discussed in Note 9. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 11. Costs associated with enhanced postretirement benefits are disclosed in Note 12.

15. Subsequent Events

There were no subsequent events that require adjustments to or disclosures in the financial statements as of December 31, 2011. Subsequent events were evaluated through March 20, 2012, which is the date that the Bank issued the financial statements.

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