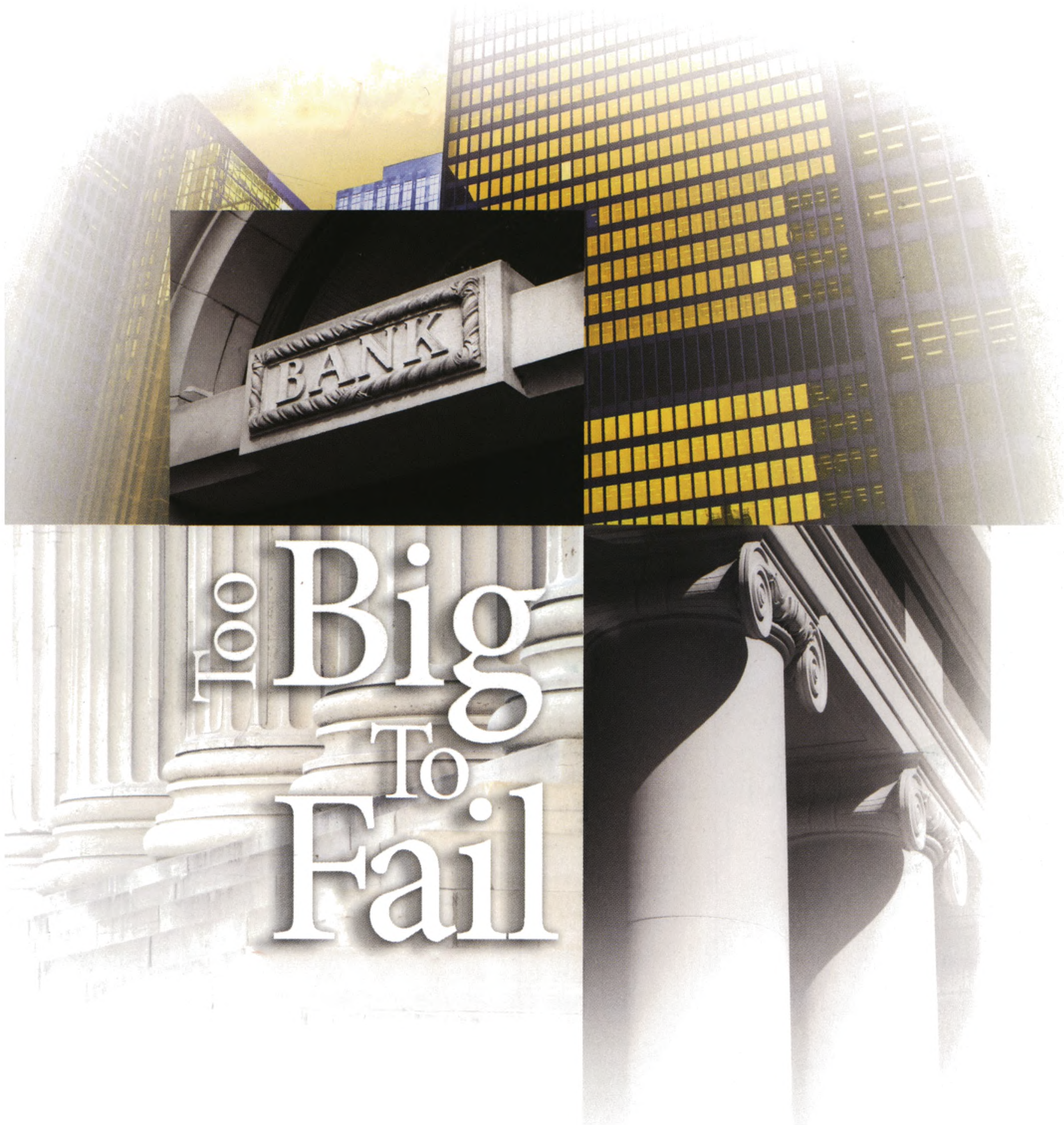
Managing the Expanded Safety Net



Federal Reserve Bank of Minneapolis 2007 Annual Report

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The Region
Federal Reserve Bank of Minneapolis
P.O. Box 291
Minneapolis, MN 55480-0291
E-mail: letters@mpls.frb.org
Web: minneapolisfed.org

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Message from the President

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I fully support the extraordinary steps taken by the Federal Reserve in response to the collapse of Bear Stearns in March 2008. As Federal Reserve officials have testified, Bear Stearns' bankruptcy could have triggered significant doubt about the viability of other investment banks. Bankruptcy could also have imposed potentially large costs on a myriad of firms with financial exposure to Bear Stearns. More importantly, this shock to the financial sector could have spilled over to the rest of the economy. It was on this basis—as lender-of-last-resort with responsibility to address systemic risk to the economy—that the Federal Reserve took its actions.

However, the Federal Reserve's response has a potentially significant cost. The uninsured creditors of other large financial firms may now have heightened expectations of receiving government support if these firms get into trouble. That is, they may perceive that the government will view their firm, also, as systemically important and therefore "too big to fail (TBTF)." Such expectations need to be addressed by policymakers because they encourage financial firms to take on more risk than they otherwise would, and this increased risk-taking, all else equal, makes future financial and economic instability more likely.

Moreover, this expansion of the safety net came when TBTF was already a problem. Indeed, we have been warning about an increasing TBTF threat for much of the past five years, recommending a management framework and specific steps to address it and urging that policymakers act when times are good in financial markets and for financial institutions. Now policymakers have another chance to examine our recommendations to better manage the safety net. In that vein, the accompanying 2007 *Annual Report* essay discusses these recommendations, explaining why they respond effectively to the TBTF problem confronting policymakers.

Gary H. Stern
President

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Managing the Expanded Safety Net

Gary H. Stern AND Ron J. Feldman*
PRESIDENT SENIOR VICE PRESIDENT

In this essay, we first briefly explain why the government's response to the 2007–08 financial turmoil, although justified, expanded the safety net and exacerbated the existing too big to fail (TBTF) problem. A larger TBTF problem is costly, having the capability to sow the seeds of future financial crises, which means we should begin now to develop a new approach to manage TBTF.

We believe recommendations we had already crafted to address TBTF would effectively address the safety net expansion and position policymakers to respond more effectively to "the next Bear Stearns." We describe the recommendations briefly and explain their relevance in today's environment in the second half of the essay. Because our approach and recommendations are spelled out in our 2004 book, *Too Big To Fail: The Hazards of Bank Bailouts*, we conclude with excerpts from it summarizing our arguments in a bit more detail.

A Wider Safety Net, A Larger TBTF Problem

The Federal Reserve's expansion of the safety net was not subtle or implied. The Federal Reserve took on risk normally borne by private parties when it supported JPMorgan Chase's purchase of Bear Stearns. The Federal Reserve also opened the discount window to select investment banks (i.e., primary dealers).

One could describe the former action as one-time and the latter program as temporary. But such a characterization obscures the message these actions send. Through these efforts, the Federal Reserve sought to limit the collateral damage or spillovers caused by the failure of a large financial firm. And these spillovers can take many forms. In a simple example, the failure of a large financial

*The authors thank David Fettig, Art Rolnick, Phil Strahan, Dick Todd, David Torregrossa, and Niel Willardson for their comments.

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firm means that other large financial firms might not have loans paid back or otherwise receive funds owed to them by the failing entity. In another case, the failure of a large financial firm could prevent it from providing critical services to financial market participants such as clearing and settlement of financial transactions. In both examples, the shock to financial firms could impair their normal operations, which could injure their customers and the rest of the economy. If the threat of such spillovers presented itself again, and spillovers frequently define a financial crisis, many large-firm creditors would anticipate another extraordinary action or resurrection of a special lending program.

To be sure, Bear Stearns' equity holders—including many employees of the firm—took significant financial losses. This was an appropriate outcome. And doesn't this action sufficiently curtail expectations of government support in the future and thus fix whatever problem such expectations create? The short answer is no. The long answer requires a brief summary of why we care about safety net expansion and TBTF in the first place.

The bigger the government safety net, the more the government shifts risk from creditors of financial firms to taxpayers. With less to lose, creditors have less incentive to monitor financial firms and to discipline risk-taking. Consider an extreme but simple case where nominally uninsured depositors at the largest U.S. commercial banks come to expect complete government support if their bank fails. These depositors have essentially no reason to pull their funds even if these banks take on so much risk that they doom themselves to failure.

Now, this dulling of the depositors' senses has the welcome effect in our example of stopping runs on the largest banks. Such runs can spread into panics and significant economic downturns. The prevention of such ill effects, as noted, motivated the Federal Reserve's safety net expansion and is the reason government support during a crisis should never be categorically ruled out.

But the same stickiness of deposits has a major downside, which is the point of our example. The large bank that fleeing depositors would otherwise close remains open to continue or increase its risky bets. If it does not get lucky, the bank's losses actually grow. In this way, the safety net encourages risk-taking that exposes society to increasing losses, with their associated instability.

Of equal concern, TBTF wastes society's resources. Financial firms allocate capital, and when they work well, they ensure that high-return projects are funded. But excessive government support warps that allocation process, sending too much money to higher-risk projects.

We focused deliberately on depositors in our example; we could have mentioned other short- or long-term holders of interest-bearing investments, insured or uninsured. For it is the reduced vigilance of depositors and other debt holders—lulled by implied government support—that leads large financial institutions to take on too much risk and underlies TBTF. Policymakers face a TBTF problem even if equity holders fully expect to suffer large losses upon failure of the firm in question.

And policymakers faced a TBTF problem even before recent safety net expansions; the

[1] See Stern and Feldman (2004). Mishkin (2006) provides a detailed summary and critique of our book. Analysis published after the book including, but not limited to, Morgan and Stiroh (2005), Rime (2005), and Deng et al. (2007) continues to find evidence of a TBTF problem. For Moody's related assessment of the likelihood that select large banks in the United States would receive government support, see American Banker (2007). Acharya and Yorulmazer (2007) discuss a phenomenon somewhat similar to TBTF.

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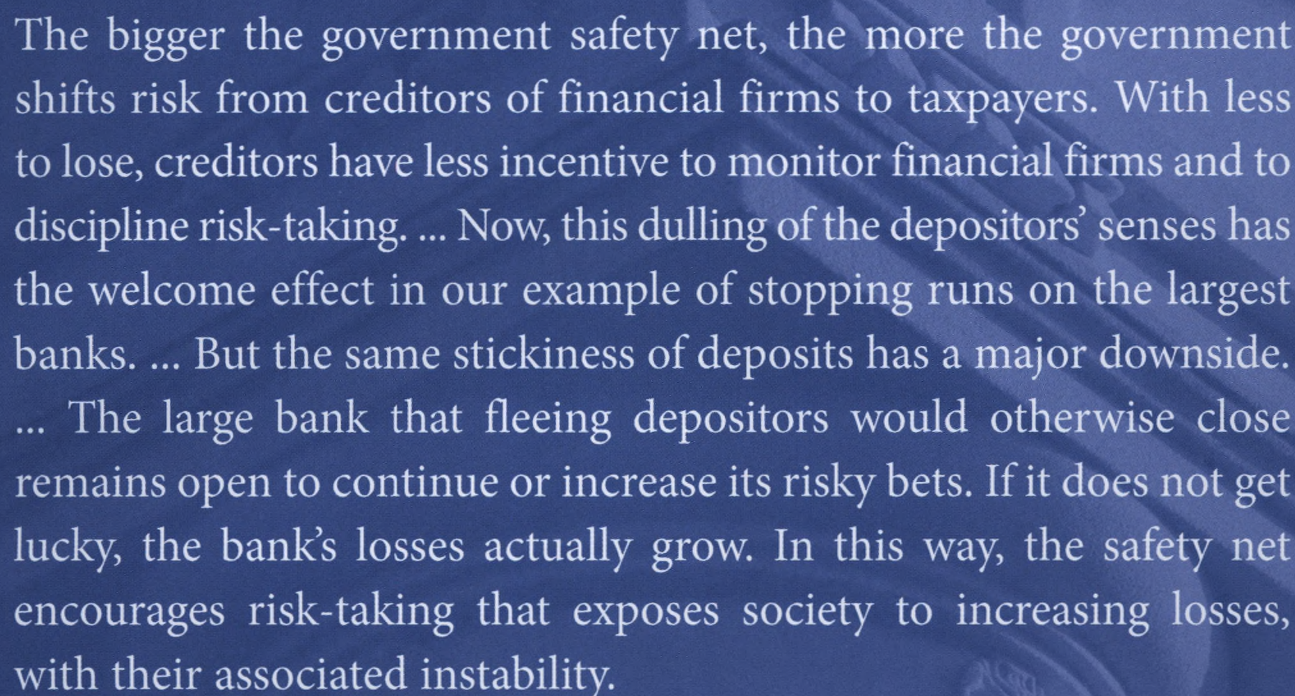

TBTF problem we described in 2004 has grown since then.[1] Some very large banks and financial firms (e.g., Countrywide Financial) faced significant pressure during the 2007–08 market disturbance. Reporting on these cases, sometimes months before the run on Bear Stearns, had at times explicitly raised the specter of government support. The initial rescue in 2007 and later nationalization of Northern Rock in 2008 by the British government may have contributed to the speculation. Nationalization occurred in a country viewed, like the United States, as having a low propensity to support uninsured creditors and involved a financial institution that supervisors did not apparently treat as if it posed significant systemic risk.

Our concern about the preexisting TBTF problem led us to suggest policy reforms, as detailed in our book. We now turn to summarizing our approach, explaining why it applies to the current situation and why it is preferable to other options.

Managing the Safety Net, Addressing the TBTF Problem

While safety net expansion has increased TBTF concerns, the essence of the problem and underlying cause of TBTF have not changed since 2004: Policymakers support large-bank creditors to contain or eliminate spillover effects, but the support creates an incentive for too much risk-taking in the future. Our approach is straightforward. If spillovers lead to government support, then policymakers who want to reduce creditors' expectations of such support should enact reforms that make spillovers less threatening. Reforms that fail to address this fundamental issue will not change policymaker behavior and will not

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convince creditors that they face real risk of loss. We provide more details on this approach in excerpted summaries from our book following this section.

So what should policymakers do to address concerns over spillovers? We recommend a three-pronged approach (again, a few more details follow in the excerpts with many more details in the book itself). Policymakers should

- reduce their uncertainty about the potential magnitude and cost of spillovers through tools like failure simulation. This "disaster" preparation could either directly lead to more informed actions that reduce spillovers or provide sufficient information to policymakers such that they can reduce support for creditors more confidently. Recent progress in addressing potential sources of instability also fall under this approach. For example, the Federal Reserve Bank of New York played an important role in an effort to improve the processing and settlement of certain derivative transactions while the Federal Deposit Insurance Corporation is taking steps to facilitate large-bank resolution absent extraordinary government support.[2]

- augment policies that manage the losses one firm's failure imposes on its counterparties. Policymakers would be more willing to let large firms fail if they thought the fallout would be constrained. Closing firms while they still have some capital left is one example of this approach (although we recommend modifications to the current "prompt closure" regime).

- enhance payments system reforms that limit the exposure that payment processing creates for financial firms. The goal of these reforms is to limit the chance that through the payments system, one firm's failure puts the solvency of other firms in doubt.

For each of the three strategies, we recommend that policymakers broadly communicate the actions they've taken to reduce expectations of bailouts. We detail the form and benefits of potential communication elsewhere, but the basic point is simple.[3] Creditors will not realize that the spillover threats have declined and will not change behavior unless informed through effective communication.

Put together, this approach offers at least the potential for a positive cycle. Policymakers limit the need for government support by managing underlying sources of instability. Reduced expectations of government support lead to less risk-taking and greater stability.

Our approach contrasts with some other alternatives policymakers might adopt. Some observers suggest that policymakers try to manage the expanded safety net, for example, by extending rules that procedurally make it more difficult for policymakers to support creditors. For example, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires on-the-record support from a variety of policymakers before the FDIC can provide extraordinary support to bank creditors (FDICIA subjected such extraordinary support to other reviews and reforms as well). Policymakers might apply these strictures before providing support to creditors of any financial firm.

While we do not oppose expanding the types of firms covered under the FDICIA regime, we doubt the changes would materially reduce the support provided to large-firm creditors. Why? These procedural changes do not reduce the underlying rea-

[2] These two examples are discussed in Stern and Feldman (2006).
[3] See Stern (2007) and Stern and Feldman (2005a, b).

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Policymakers should

- ☐ reduce their uncertainty about the potential magnitude and cost of spillovers.
- ☐ augment policies that manage the losses one firm's failure imposes on its counterparties.
- ☐ enhance payments system reforms that limit the exposure that payment processing creates for financial firms.

son policymakers provided support in the first place. Consider that the intervention with Bear Stearns involved the type of on-the-record voting and consultations across agencies that FDICIA would mandate.

Pledges of "no bailouts" from policymakers or general prohibitions against bailouts are even less credible unless accompanied by action. And such prohibitions and related jawboning are unwise. Policymakers will face circumstances where, even accounting for distortions to future behavior, the provision of government support has benefits exceeding costs.

Observers also suggest that enhanced supervision, or regulations like those found in Basel II, might curtail the risk-taking of financial firms. While supervision and regulation have an important role to play, these tools may not adequately curtail the risk-taking encouraged by TBTF. Supervisors with discretion, for example, cannot easily limit firm risk-taking before the damage is done. Minimum capital rules also seem one step too slow; that is, regulators cannot readily institute capital rules that link minimum capital levels to current bank risk-taking.

None of this is to suggest that our recommendations are beyond reproach. Some of the specific recommendations we made in 2004 deserve a second look given the events of 2007 and 2008. For example, we suggested that policymakers consider implementing a form of "coinsurance" for uninsured creditors, whereby such creditors must take some loss if their financial firm becomes insolvent. While our proposal differs from the use of coinsurance for insured depositors in England, some observers attribute part of the Northern Rock crisis to this feature, suggesting it deserves reconsideration.

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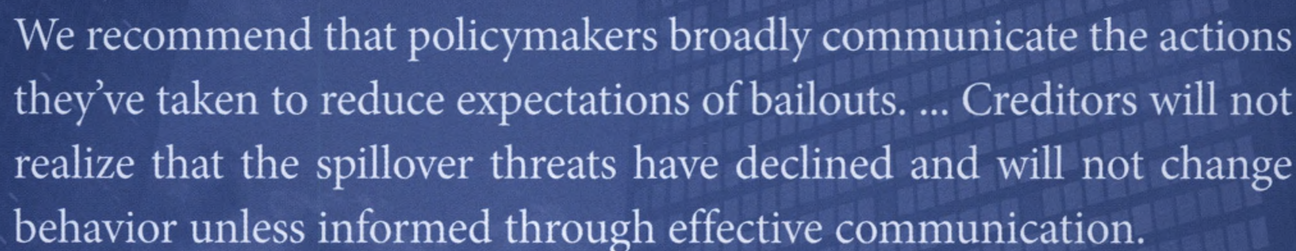

We recommend that policymakers broadly communicate the actions they've taken to reduce expectations of bailouts. ... Creditors will not realize that the spillover threats have declined and will not change behavior unless informed through effective communication.

Put together, this approach offers at least the potential for a positive cycle. Policymakers limit the need for government support by managing underlying sources of instability. Reduced expectations of government support lead to less risk-taking and more stability.

Our recommendations have received more general critiques as well. Some critics focus on the inability of our recommendations, or any recommendations for that matter, to anticipate the source of the next major disruption. These observers argue that the idiosyncratic nature of each financial disruption means that policymakers can, at best, fight the last war and cannot take steps that limit future spillovers. Who could have foreseen, critics might ask, that losses originating in subprime mortgages would ultimately lead to a freeze in the secured funding markets on which Bear Stearns and others relied?

The manner in which Bear Stearns imploded certainly caught most observers and market participants by surprise. But it was no surprise that a failure of one of the largest U.S. investment banks posed spillover risks or raised TBTF concerns. Indeed, Paul Volcker, in the foreword to our book, raised a similar point.

> The implications of [the TBTF book] ... go beyond the world of commercial banking. Witness the officially encouraged (if not officially financed) rescue a few years ago of Long-Term Capital Management, a large but unregulated, secretive, speculative hedge fund. The fact is the relative importance of commercial banks in the United States has been diminishing steadily. Consequently, the lessons and approaches reviewed in *Too Big To Fail* have wider application.[4]

[4] See Stern and Feldman (2004, ix).

[5] Without implying agreement between our proposal and more recent alternatives, other parties have also suggested that policymakers respond to safety net expansion by focusing on broad stability-related issues. For one example, see Nason (2008).

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Moreover, we do not need to forecast the event that brings down systemically important firms to make progress against TBTF. Instead, we need to consider the spillovers that failure might cause. Would that failure, for example, eliminate the availability of important clearing and settlement services? If so, what can we do today to facilitate continued provision of those services? Would that failure impose large losses on other firms potentially seen as TBTF? If so, what actions today would help policymakers quickly quantify potential exposures and assess counterparties' management of that risk? Of course, this approach is sure to miss some potential spillovers or risks. While not perfect, this approach is superior to efforts that do not focus on spillover potential or which react to instability once a firm fails.[5]

In conclusion, we think the recommendations we made several years ago have stood the test of time. They offer a structure and specific steps that policymakers can take to better manage the safety net and the TBTF problem. Due to its recent expansion, such safety net management should, in our view, take a considerably higher priority with policymakers than it has in the past. R

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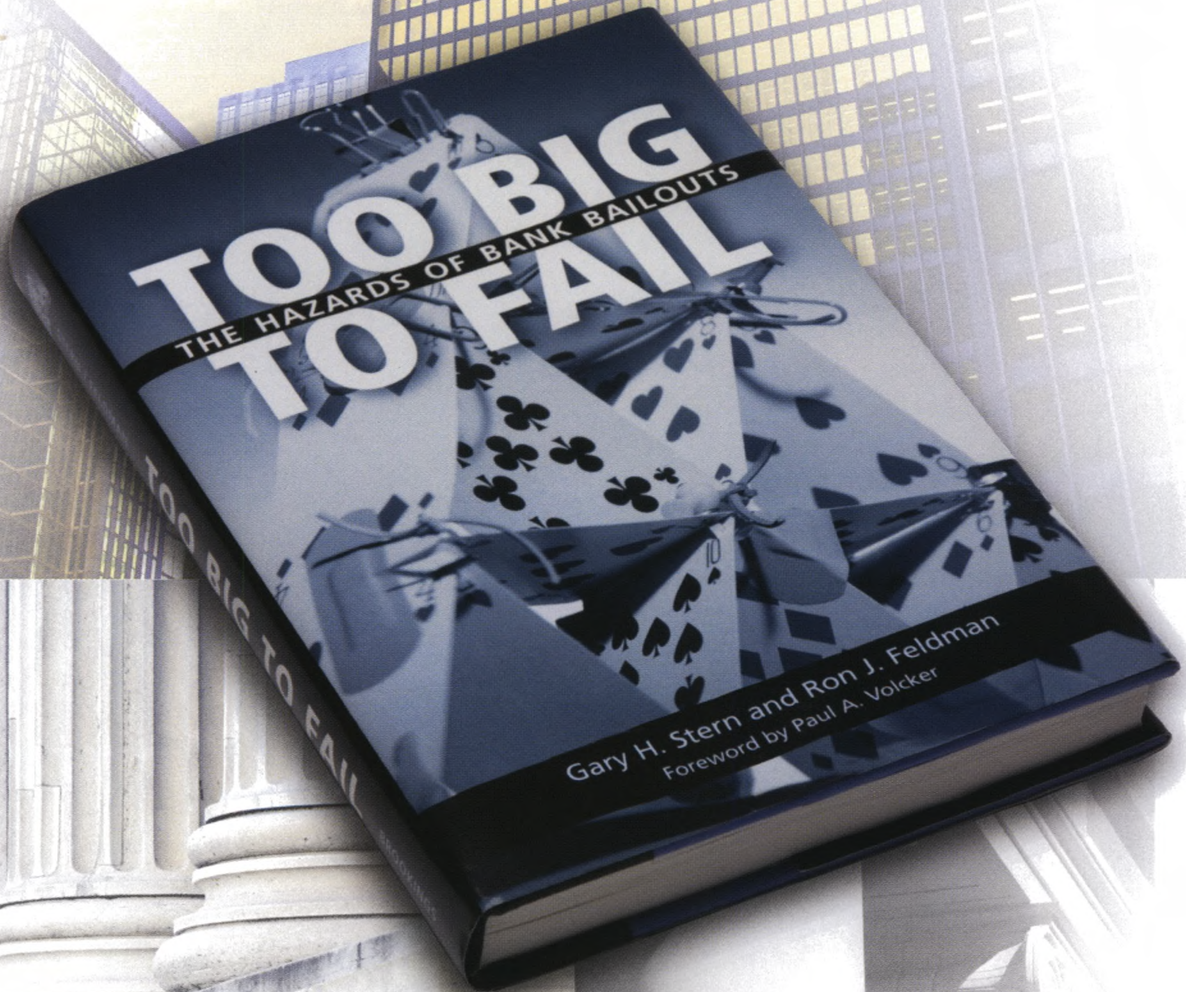

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*Too Big To Fail: The Hazards of Bank Bailouts**

Excerpts from the 2004 book by Gary H. Stern and Ron J. Feldman

EDITOR'S NOTE: The preceding essay in this Annual Report explains the authors' policy recommendations in light of the 2007-08 financial turmoil. This excerpt, from the book's introduction, summarizes the authors' main messages and contrasts their approach with some alternatives.

Despite some progress, our central warning is that *not enough has been done to reduce creditors' expectations of TBTF protection.* Many of the existing pledges and policies meant to convince creditors that they will bear market losses when large banks fail are not credible and therefore are ineffective. Blanket pledges not to bail out creditors are not credible because they do not address the factors that motivate policymakers to protect uninsured bank creditors in the first place. The primary reason why policymakers bail out creditors of large banks is to reduce the chance that the failure of a large bank in which creditors take large losses will lead other banks to fail or capital markets to cease working efficiently.

Other factors may also motivate governments to protect uninsured creditors at large banks. Policymakers may provide protection because doing so benefits them personally, by advancing their career, for example. Incompetent central planning may also drive some bailouts. Although these factors receive some of our attention and are addressed by some of our reforms, we think they are less important than the motivation to dampen the effect of a large bank failure on financial stability.

Despite the lack of definitive evidence on the moral hazard costs and benefits of increased stability generated by TBTF protection, the empirical and anecdotal data, analysis, and our general impression—imperfect as they are—suggest that TBTF protection imposes net costs. *We also argue that the TBTF problem has grown in severity.* Reasons for this increase include growth in the size of the largest

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banks, greater concentration of banking system assets in large banks, the greater complexity of bank operations, and, finally, several trends in policy including a spate of recent bailouts.

Our views are held by some, but other respected analysts come to different conclusions. Some observers believe that the net costs of TBTF protection have been overstated, while others note that some large financial firms have failed without their uninsured creditors being protected from losses. However, even analysts who weigh the costs and benefits differently than we do have reason to support many of our reforms. Some of our recommendations, for example, make policymakers less likely to provide TBTF protection and address moral hazard precisely by reducing the threat of instability. Moreover, our review of cases where bailouts were not forthcoming suggests that policymakers are, in fact, motivated by the factors we cite and that our reforms would push policy in the right direction.

A second camp believes that TBTF protection could impose net costs in theory, but in practice legal regimes in the United States—which other developed countries could adopt—make delivery of TBTF protection so difficult as to virtually eliminate the TBTF problem.

We are sympathetic to the general and as yet untested approach taken by U.S. policymakers and recognize that it may have made a dent in TBTF expectations. In the long run, however, we predict that the system will not significantly reduce the probability that creditors of TBTF banks will receive bailouts. The U.S. approach to too big to fail continues to lack credibility.

Finally, a third camp also recognizes that TBTF protection could impose net costs but believes that there is no realistic solution. This camp argues that policymakers cannot credibly commit to imposing losses on the creditors of TBTF banks. The best governments can do, in their view, is accept the net costs of TBTF, albeit with perhaps more resources devoted to supervision and regulation and with greater ambiguity about precisely which institutions and which creditors could receive ex post TBTF support.

Like the third camp, we believe that policymakers face significant challenges in credibly putting creditors of important banks at risk of loss. A TBTF policy based on assertions of "no bailouts ever" will certainly be breached. Moreover, we doubt that any single policy change will dramatically reduce expected protection. But fundamentally we part company with this third camp. *Policymakers can enact a series of reforms that reduce expectations of bailouts for many creditors at many institutions.* Just as policymakers in many countries established expectations of low inflation when few thought it was possible, so too can they put creditors who now expect protection at greater risk of loss.

The first steps for credibly putting creditors of important financial institutions at risk of loss have little to do with too big to fail per se. Where needed, countries should create or reinforce the rule of law, property rights, and the integrity of public institutions. Incorporating the costs of too big to fail into the policymaking process is another important reform underpinning effective management of TBTF expectations. Appointment of leaders who are loath to, or at least quite cautious about, providing TBTF bailouts is also a conceptually simple but potentially helpful step. Better public accounting for TBTF costs and concern

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about the disposition of policymakers could restrain the personal motivations that might encourage TBTF protection.

With the basics in place, policymakers can take on TBTF expectations more credibly by directly addressing their fear of instability. We recommend a number of options in this regard. One class of reforms tries to reduce the likelihood that the failure of one bank will spill over to another or to reduce the uncertainty that policymakers face when confronted with a large failing bank. These reforms include, among other options, simulating large bank failures and supervisory responses to them, addressing the concentration of payment system activity in a few banks, and clarifying the legal and regulatory framework to be applied when a large bank fails.

Other types of reforms include reducing the losses imposed by bank failure in the first place and maintaining reforms that reduce the exposure between banks that is created by payments system activities. These policies can be effective, in our view, in convincing public policymakers that, if they refrain from a bailout, spillover effects will be manageable. Such policies therefore encourage creditors to view themselves at risk of loss and thus improve market discipline of erstwhile TBTF institutions.

We are less positive about other reforms. A series of reforms that effectively punish policymakers who provide bailouts potentially also could address personal motivational factors. However, we are not convinced that these reforms are workable and believe that they give too much credence to personal motivations as a factor to explain bailouts. The establishment of a basic level of supervision and regulation (S&R) of banks should help to restrict risk-taking, although we view S&R as having important limitations.

Finally, policymakers have a host of other available options once they have begun to address too big to fail more effectively. For example, policymakers could make greater use of discipline by creditors at risk of loss. Bank supervisors could rely more heavily on market signals in their assessment of bank risk-taking. Deposit insurers could use similar signals to set their premiums.

EDITOR'S NOTE: This excerpt, from the book's conclusion, recaps the key points from the book and offers some more details about the authors' proposals.

Three Bottom Lines

FIRST, the TBTF problem has not been solved, is getting worse, and leads, on balance, to wasted resources.

SECOND, although expectations of bailouts by uninsured creditors at large banks cannot be eliminated, they can be reduced and better managed through a credible commitment to impose losses. Policymakers can establish credible commitments by addressing and reducing the motivation for bailouts.

THIRD, although other reforms could help to establish a credible commitment, policymakers should give highest priority to reforms limiting the chance that one bank's failure will threaten the solvency of other banks.

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We now provide supporting points for these conclusions.

The Problem

—Even though they are not entitled to government protection, uninsured creditors of a large or systemically important bank believe they will be shielded from at least part of the loss in the event of bank failure.

—Anticipation of government protection warps the amount and pricing of funding that creditors provide a TBTF bank, which, in turn, leads banks to take excessive risk and make poor use of financial capital. The costs of poor resource use resulting from TBTF guarantees appear to be quite high. We believe these costs exceed the benefits of TBTF coverage in most cases, but even those who weigh the costs and benefits differently should be able to support many of our reforms.

—Expectations of TBTF coverage have likely grown and become more strongly held because more banks are now "large" and because a smaller group of banks controls a greater share of banking assets and provides key banking services. In addition, banks have become increasingly complex, making it more difficult for policymakers to predict the fallout from bank failure and to refuse to provide subsequent coverage to uninsured creditors.

—Reforms over the last decade aiming to limit TBTF protection, including those adopted in the United States, are unlikely to be effective in the long run (although they have yet to be tested and may have made a dent in TBTF expectations).

Commitment as the Solution

—In order to change the expectations of bailouts, policymakers must convince uninsured creditors that they will bear losses when large banks fail; changes in policy toward the uninsured must involve a credible commitment.

—A credible commitment to impose losses must be built on reforms directly reducing the incentives that lead policymakers to bail out uninsured creditors.

—Reforms that forbid coverage for the uninsured are not credible because they do not address underlying motivations and are easily circumvented.

—Policymakers have considerable experience in establishing credible commitments in the setting of monetary policy. The experience of monetary policy over the last two decades demonstrates the feasibility of reducing long-held expectations, such as those likely held by uninsured creditors of large banks.

Specific Motivations and Reforms

—The most important motivation for bailouts is to prevent the failure of one bank from threatening other banks, the financial sector, and overall economic performance. To reduce that motivation, we recommend that policymakers in developed countries take three general steps: enact policies and procedures that would reduce their uncertainty about the potential for spillovers; implement policies that directly limit creditor losses or allocate losses such that market discipline increases without an excessive increase in instability; and consider or follow up on payment system reforms that reduce the threat of spillovers.

—Reforms that reduce policymaker uncertainty include the following: increase supervisory planning

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for, and simulation of, a large bank failure; undertake targeted efforts that reduce the likelihood and cost of failure for banks dominating payment markets; make legal and regulatory adjustments that clarify the treatment of bank creditors at failure; and provide liquidity more rapidly to uninsured creditors.

—Reforms that could address concerns of excessive creditor loss include the following: close institutions before they can impose large losses; require banks in a weak position to increase the financial cushion to absorb losses; impose rules that require creditors to absorb at least some loss when their bank fails (for example, requiring coinsurance); and allow for select coverage of the nominally uninsured while, in general, making it more likely that creditors will suffer losses.

—Although payment system reforms are quite complex in implementation, they are fairly straightforward in concept. One type of reform would eliminate or significantly limit the amount that banks owe each other through the payment system. A second type of reform would establish methods by which a bank owed funds by a failing institution could offset losses (for example, by seizing collateral). R

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2007 Operations Report

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Message from the First Vice President

In the coming years, the Federal Reserve System faces significant challenges and uncertainties as it seeks to fulfill its mission to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payments systems. Financial market developments, declining paper check volumes, continued financial industry consolidation, security concerns, and the pace of technological change will all pose challenges for the Federal Reserve in carrying out its responsibilities.

In response to these challenges, the Federal Reserve Bank of Minneapolis remains focused on effectively executing its strategic plan, which is directed at ensuring all System objectives are met while also maximizing the Bank's operational efficiency and quality of service delivery. In addition, the Bank continues to seek opportunities to make important System contributions and pursue new business activities. In 2007, the Bank's many achievements demonstrate our effectiveness in executing our strategic plan and building on our strengths.

❑ Overall, Bank performance was strong in 2007. Bank expenses were below budgeted levels after adjusting for unplanned costs related to the System decisions to consolidate the Minneapolis check and the Federal Reserve–Electronic Tax Application operations. Revenue for priced services exceeded plan. Most efficiency measures in the check and cash operations were better than plan, and the Bank met nearly all quality measures. The Board of Governors 2007 Review noted that all areas examined were well controlled.

❑ The Bank continued to lead the Financial Services Policy Committee (the Federal Reserve System's payments policymaking arm) and the Financial Services Council effectively, as evidenced by meeting their respective high priority objectives. The Bank received favorable feedback on its leadership from other Reserve Banks and the Product and Support Offices.

❑ The Bank pursued several initiatives as part of its continuing commitment to advance research and economic and financial literacy, as well as to increase awareness of community development issues. Policy contributions included publication of a number of scholarly articles by the Bank's economists and advisers. In addition, the Research department published a book of groundbreaking papers titled *Great Depressions of the Twentieth Century*.

❑ Challenges in 2007 included the consolidation of the Helena Branch check operations into Denver and the decision to consolidate the Minneapolis check operations into Cleveland in 2009. Helena successfully transitioned to a substitute check print operation in October 2007, and efforts are well under way for the Minneapolis consolidation, with particular emphasis on providing assistance to the affected staff.

❑ FedACH launched phase one of a multiyear initiative to modernize its core payments software and processing platform using distributed technologies. Accomplishments included business process model-

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2007 by the Numbers

In 2007, the Federal Reserve Bank of Minneapolis processed:

- 10.6 billion ACH (Automated Clearing House) payments worth approximately $18.4 trillion. FedACH is a nationwide system, developed and operated by Minneapolis staff on behalf of the entire Federal Reserve System, which provides the electronic exchange of debits and credits.
- 825 million check items worth $1.2 trillion; 52 percent of the items were received electronically.
- $10.3 billion of excess currency deposited by financial institutions, destroyed $939 million of worn and torn currency, and shipped $11.7 billion of currency to financial institutions.
- Forms, tenders, account maintenance and other customer transactions for 365,000 active Legacy Treasury Direct accounts for individuals holding Treasury securities totaling $70 billion, and 3.7 million savings bond purchase requests worth $2.0 billion, as one of two Treasury Retail Securities sites in the Federal Reserve System.
- 219,000 transaction items worth more than $519 billion through FR-ETA (Federal Reserve-Electronic Tax Application), a same-day payment mechanism, hosted by the Minneapolis Fed, for businesses paying federal taxes via their financial institutions.

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ing, technology research, and staff training. Also, FedACH assumed new line management responsibility for Atlanta-based Customer Operations Sites and CBAFs, which mirror operations in Minneapolis.

☐ The Supervision, Regulation, and Credit (SRC) Division provided effective oversight of the District's only large complex banking organization and devoted considerable supervisory resources to areas of highest risk. SRC complied with all System policies and guidelines and had no material shortcomings in meeting reporting deadlines or internal metrics for ongoing operations. Three operations reviews conducted by the Board of Governors were favorable, and there were no findings on SRC's Credit, Payments System Risk, and Reserves operations.

☐ The Bank was awarded responsibility for maintaining and enhancing the System's Technology Project Standards. Bank staff also led a key portion of the Information Technology Cost Allocation Study effort. SRC partnered with the Customer Contact Center to develop and implement Federal Reserve Consumer Help, a System resource center for consumers who have questions or concerns about banking-related matters.

☐ The Bank is the host site for the Learning Management Support Office (LMSO), which has responsibility for implementing and supporting FedLearn. Implementation of FedLearn was successfully completed on schedule and within the approved budget. All Reserve Banks and business lines use FedLearn for course administration and to deliver eLearning. The LMSO was also selected to deploy FedLearn at the Board.

The Bank's success in 2007 is a result of the diligence and strong commitment to excellence by our employees and Board of Directors. Together we will continue to effectively implement our strategic plan, build on our strengths, and address the many challenges we face while also carrying out the Federal Reserve System's mission to foster stability, integrity, and efficiency in the nation's monetary, financial, and payments systems.

James M. Lyon

First Vice President

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Helena Branch Board of Directors

Lawrence R. Simkins
CHAIR

Dean Folkvord
VICE CHAIR

Seated (from left): Joy Ott, John Franklin; standing (from left): Dean Folkvord, Timothy Bartz, Lawrence Simkins

Appointed by the Federal Reserve Bank of Minneapolis

Joy N. Ott
REGIONAL PRESIDENT AND CHIEF EXECUTIVE OFFICER
Wells Fargo Bank Montana NA
Billings, Montana

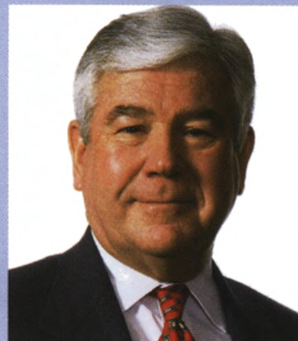
John L. Franklin
PRESIDENT AND CHIEF EXECUTIVE OFFICER
First Bank of Sidney
Sidney, Montana

Timothy J. Bartz
CHIEF EXECUTIVE OFFICER
Anderson ZurMuehlen & Co. PC
Helena, Montana

Appointed by the Board of Governors of the Federal Reserve System

Lawrence R. Simkins
PRESIDENT
Washington Corporations
Missoula, Montana

Dean Folkvord
GENERAL MANAGER AND CHIEF EXECUTIVE OFFICER
Wheat Montana Farms and Bakery
Three Forks, Montana



Federal Advisory Council Member

Lyle Knight
PRESIDENT AND CHIEF OPERATING OFFICER
First Interstate Bank
Billings, Montana

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Minneapolis Board of Directors

Frank L. Sims
CHAIR

James J. Hynes
DEPUTY CHAIR

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(elected by member banks to represent member banks)

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PRESIDENT
First National Bank of Mahnomen
Mahnomen, Minnesota

John H. Hoeven Jr.
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
First Western Bank & Trust
Minot, North Dakota

Thomas W. Scott
CHAIRMAN
First Interstate BancSystem Inc.
Billings, Montana

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PRESIDENT AND CHIEF EXECUTIVE OFFICER
Shur-Co
Yankton, South Dakota

Todd L. Johnson
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
Reuben Johnson & Son Inc. & Affiliated Cos.
Superior, Wisconsin

Randy Peterson
FACILITY DIRECTOR
Lake Superior State University
Sault Ste. Marie, Michigan

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Twin City Pipe Trades Service Association
St. Paul, Minnesota

Jake Marvin
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
Marvin Windows and Doors
Warroad, Minnesota

Frank L. Sims
CORPORATE VICE PRESIDENT, TRANSPORTATION
Cargill Inc.
Wayzata, Minnesota

Seated (from left): James Hynes, Randy Peterson, Thomas Scott, Frank Sims; standing (from left): John Hoeven, Peter Haddeland, William Shorma, Todd Johnson, Jake Marvin

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Advisory Council on Small Business and Labor

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(CHAIRMAN)
EXECUTIVE ADMINISTRATOR
Twin City Pipe Trades Service Association
St. Paul, Minnesota

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Business Banking
Home Federal Bank
Sioux Falls, South Dakota

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CHIEF EXECUTIVE OFFICER
Duemelands Commercial Properties
Bismarck, North Dakota

Rolin Erickson
PRESIDENT
Montana Resources LLP
Butte, Montana

Kim Hamilton
OWNER
White Winter Winery
Iron River, Wisconsin

Sarah Harris
PRINCIPAL
Eberhardt Advisory LLC
Minneapolis, Minnesota

Harry Lerner
CHIEF EXECUTIVE OFFICER
Lerner Publishing Group
Minneapolis, Minnesota

Keith Moyle
VICE PRESIDENT AND GENERAL MANAGER
Upper Peninsula Power Co.
Ishpeming, Michigan

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MagStar Technologies Inc.
Hopkins, Minnesota

G. Bradley Schlossman
CHIEF EXECUTIVE OFFICER
West Acres Development
Fargo, North Dakota

Nancy Straw
PRESIDENT AND CHIEF EXECUTIVE OFFICER
West Central Initiative
Fergus Falls, Minnesota

Seated (from left): Kim Hamilton, Harry Lerner, G. Bradley Schlossman, Nancy Straw, David Brown; standing (from left): Keith Moyle, Sarah Harris, Jon Reissner, Rolin Erickson, James Hynes, Skip Duemeland

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Three Forks, Montana

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OWNER
Highland Valley Farm
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Joel Dick
VICE PRESIDENT AND CHIEF OPERATING OFFICER
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PRESIDENT
F.H.C. Inc.
Oakes, North Dakota

G. C. "Tucker" Hughes
PRESIDENT
Hughes & Sons Cattle Co.
Stanford, Montana

William Kaul
VICE PRESIDENT
Great River Energy
Elk River, Minnesota

Duane Kroll
OWNER
Kroll Farm
Royalton, Minnesota

Jeff Lakner
OWNER
Lakner Farms
Wessington, South Dakota

Maurice Reiner
PRESIDENT, YANKTON MARKET
First National Bank of South Dakota
Yankton, South Dakota

Rodney Schmidt
DISTRICT MANAGER
Bayer Crop Science
Lakeville, Minnesota

Claire Seefeldt
VICE PRESIDENT
First National Bank
Milnor, North Dakota

Seated (from left): William Kaul, Richard Dale, Joel Dick; standing (from left): Maurice Reiner, Duane Kroll, Claire Seefeldt, Jeff Lakner, Stephen Hansen, Dean Folkvord, Tucker Hughes

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Federal Reserve Bank of Minneapolis

Senior Management

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PRESIDENT

James M. Lyon
FIRST VICE PRESIDENT

Duane A. Carter
SENIOR VICE PRESIDENT AND EQUAL EMPLOYMENT OPPORTUNITY OFFICER

Creighton R. Fricek
SENIOR VICE PRESIDENT AND CORPORATE SECRETARY

Arthur J. Rolnick
SENIOR VICE PRESIDENT AND DIRECTOR OF RESEARCH

Claudia S. Swendseid
SENIOR VICE PRESIDENT

Niel D. Willardson
SENIOR VICE PRESIDENT AND GENERAL COUNSEL

Seated (from left): James Lyon, Arthur Rolnick, Duane Carter; standing (from left): Creighton Fricek, Gary Stern, Claudia Swendseid, Niel Willardson

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VICE PRESIDENT

David G. Fettig
VICE PRESIDENT

Michael Garrett
VICE PRESIDENT

Linda M. Gilligan
VICE PRESIDENT AND GENERAL AUDITOR

Matthew D. Larson
VICE PRESIDENT

Frederick L. Miller
VICE PRESIDENT

Kinney G. Misterek
VICE PRESIDENT

Marie R. Munson
VICE PRESIDENT

Paul D. Rimmereid
VICE PRESIDENT AND CHIEF FINANCIAL OFFICER

Susan K. Rossbach
VICE PRESIDENT AND DEPUTY GENERAL COUNSEL

Richard M. Todd
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VICE PRESIDENT

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Warren E. Weber
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ASSISTANT VICE PRESIDENT

Walter A. Cox
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Barbara G. Coyle
ASSISTANT VICE PRESIDENT

James T. Deusterhoff
ASSISTANT VICE PRESIDENT AND DISCOUNT OFFICER

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ASSISTANT VICE PRESIDENT

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Jacqueline G. King
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Tamra J. Wheeler
ASSISTANT VICE PRESIDENT

John E. Yanish
ASSISTANT VICE PRESIDENT

Helena Branch Officer

R. Paul Drake
VICE PRESIDENT AND BRANCH MANAGER

December 31, 2007

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Auditor Independence

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2007 was Deloitte & Touche LLP (D&T). Fees for these services totaled $4.7 million. To ensure auditor independence, the Board of Governors requires that D&T be independent in all matters relating to the audit. 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 2007, the Bank did not engage D&T for any material advisory services.

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Federal Reserve Bank of Minneapolis

2007 Financial Statements

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Federal Reserve Bank of Minneapolis

90 Hennepin Avenue, P.O. Box 291
Minneapolis, Minnesota 55480-0291

Phone 612 204-5000

March 20, 2008

To the Board of Directors
Federal Reserve Bank of Minneapolis
90 Hennepin Avenue, P.O. Box 291
Minneapolis, MN 55480

The management of the Federal Reserve Bank of Minneapolis ("FRBM") is responsible for the preparation and fair presentation of the Statement of Condition, Statements of Income and Comprehensive Income, and Statement of Changes in Capital as of December 31, 2007 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on management judgments and estimates. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

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

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

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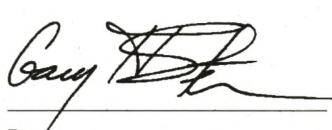
The management of the FRBM assessed its internal control over financial reporting reflected in the Financial Statements, based upon the criteria established in the "Internal Control—Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, we believe that the FRBM maintained effective internal control over financial reporting as it relates to the Financial Statements.

Federal Reserve Bank of Minneapolis



By

Gary H. Stern
President

By

James M. Lyon
First Vice President

By

Paul D. Rimmereid
Chief Financial Officer

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Deloitte.

Deloitte & Touche LLP
400 One Financial Plaza
120 South Sixth Street
Minneapolis, MN 55402-1844
USA

Tel: +1 612 397 4000
Fax: +1 612 397 4450
www.deloitte.com

Report of Independent Auditors

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

We have audited the accompanying statement of condition of the Federal Reserve Bank of Minneapolis ("FRB Minneapolis") as of December 31, 2007 and the related statements of income and comprehensive income and changes in capital for the year 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 FRB Minneapolis as of December 31, 2007, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB Minneapolis's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management Assertion*. Our responsibility is to express an opinion on these financial statements and an opinion on FRB Minneapolis's internal control over financial reporting based on our audit. The financial statements of FRB Minneapolis for the year ended December 31, 2006 were audited by other auditors whose report, dated March 12, 2007, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with the 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 audit 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, and 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 audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

FRB Minneapolis's internal control over financial reporting is a process designed by, or under the supervision of, FRB Minneapolis's principal executive and principal financial officers, or persons performing similar functions, and effected by FRB Minneapolis'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

Member of
Deloitte Touche Tohmatsu

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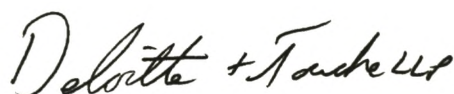
external purposes in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System. FRB Minneapolis's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of FRB Minneapolis; (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 FRB Minneapolis are being made only in accordance with authorizations of management and directors of FRB Minneapolis; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of FRB Minneapolis'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 3 to the financial statements, FRB Minneapolis 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 3.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of FRB Minneapolis as of December 31, 2007, and the results of its operations for the year then ended, on the basis of accounting described in Note 3. Also, in our opinion, FRB Minneapolis maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.



March 20, 2008

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Federal Reserve Bank of St. Louis

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Suite 1400
225 South Sixth Street
Minneapolis MN 55402
Telephone (612) 596 6000
Facsimile (612) 373 7160

Report of Independent Auditors

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

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

We conducted our audit in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 3, these financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of the Federal Reserve System, are set forth in the *Financial Accounting Manual for Federal Reserve Banks* which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2006, and the results of its operations for the year then ended, on the basis of accounting described in Note 3.

March 12, 2007

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Federal Reserve Bank of Minneapolis

STATEMENTS OF CONDITION

(in millions)

	December 31, 2007	December 31, 2006
Assets		
Gold certificates	$ 203	$ 211
Special drawing rights certificates	30	30
Coin	45	31
Items in process of collection	98	219
Loans to depository institutions	3	22
Securities purchased under agreements to resell	928	-
U.S. government securities, net	14,877	15,930
Investments denominated in foreign currencies	851	380
Accrued interest receivable	127	137
Interdistrict settlement account	2,140	-
Bank premises and equipment, net	122	130
Other assets	20	19
Total assets	$ 19,444	$ 17,109
Liabilities and Capital		
Liabilities		
Federal Reserve notes outstanding, net	$ 16,429	$ 14,893
Securities sold under agreements to repurchase	877	602
Deposits		
Depository institutions	1,104	455
Other deposits	1	1
Deferred credit items	222	288
Interest on Federal Reserve notes due to U.S. Treasury	38	16
Interdistrict settlement account	-	237
Accrued benefit costs	55	60
Other liabilities	8	5
Total liabilities	18,734	16,557
Capital		
Capital paid-in	355	276
Surplus (including accumulated other comprehensive loss of $1 million and $12 million at December 31, 2007 and 2006, respectively)	355	276
Total capital	710	552
Total liabilities and capital	$ 19,444	$ 17,109

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

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Federal Reserve Bank of Minneapolis

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(in millions)

	For the years ended December 31, 2007	December 31, 2006
Interest income		
Interest on U.S. government securities	$ 777	$ 721
Interest on securities purchased under agreements to resell	28	-
Interest on investments denominated in foreign currencies	10	7
Interest on loans to depository institutions	2	3
Total interest income	817	731
Interest expense		
Interest expense on securities sold under agreements to repurchase	34	27
Net interest income	783	704
Other operating income		
Compensation received for services provided	79	74
Reimbursable services to government agencies	29	26
Foreign currency gains, net	34	22
Other income	1	1
Total other operating income	143	123
Operating expenses		
Salaries and other benefits	105	98
Occupancy expense	12	11
Equipment expense	7	7
Assessments by the Board of Governors	20	18
Other expenses	43	41
Total operating expenses	187	175
Net income prior to distribution	739	652
Change in funded status of benefit plans	11	-
Comprehensive income prior to distribution	**$ 750**	**$ 652**
Distribution of comprehensive income		
Dividends paid to member banks	$ 19	$ 15
Transferred to surplus and change in accumulated other comprehensive loss	79	43
Payments to U.S. Treasury as interest on Federal Reserve notes	652	594
Total distribution	**$ 750**	**$ 652**

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

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Federal Reserve Bank of Minneapolis

STATEMENTS OF CHANGES IN CAPITAL

(in millions)

	For the years ended December 31, 2007 and December 31, 2006				
		Surplus			
	Capital Paid-In	Net Income Retained	Accumulated Other Comprehensive Loss	Total Surplus	Total Capital
Balance at January 1, 2006 (4.9 million shares)	$ 245	$ 245	$ -	$ 245	$ 490
Net change in capital stock issued (0.6 million shares)	31	-	-	-	31
Transferred to surplus	-	43	-	43	43
Adjustment to initially apply SFAS No. 158	-	-	(12)	(12)	(12)
Balance at December 31, 2006 (5.5 million shares)	$ 276	$ 288	$ (12)	$ 276	$ 552
Net change in capital stock issued (1.6 million shares)	79	-	-	-	79
Transferred to surplus and change in accumulated other comprehensive loss	-	68	11	79	79
Balance at December 31, 2007 (7.1 million shares)	$ 355	$ 356	$ (1)	$ 355	$ 710

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

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Notes to Financial Statements

1. STRUCTURE

The Federal Reserve Bank of Minneapolis ("Bank") is part of the Federal Reserve System ("System") and one of the twelve Reserve Banks ("Reserve Banks") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act"), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branch in Helena, Montana, serve the Ninth Federal Reserve District, which includes Minnesota, Montana, North Dakota, South Dakota, and portions of Michigan and Wisconsin.

In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a board of directors. The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors of the Federal Reserve System ("Board of Governors") to represent the public, and six directors are elected by member banks. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership in the System. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

The System also consists, in part, of the Board of Governors and the Federal Open Market Committee ("FOMC"). The Board of Governors, an independent federal agency, is charged by the Federal Reserve Act with a number of specific duties, including general supervision over the Reserve Banks. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York ("FRBNY"), and on a rotating basis four other Reserve Bank presidents.

2. OPERATIONS AND SERVICES

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

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The FOMC, in the conduct of monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and annually issues authorizations and directives to the FRBNY for its execution of transactions. The FRBNY is authorized and directed by the FOMC to conduct operations in domestic markets, including the direct purchase and sale of U.S. government securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY executes these open market transactions at the direction of the FOMC and holds the resulting securities and agreements in the portfolio known as the System Open Market Account ("SOMA").

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange ("FX") and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements ("FX swaps") with four central banks and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks. In connection with its foreign currency activities, the FRBNY may enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

Although the Reserve Banks are separate legal entities, in the interests of greater efficiency and effectiveness they collaborate in the delivery of certain operations and services. The collaboration takes the form of centralized operations and product or 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 Bank providing the service and the other eleven Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, the Reserve Banks are billed for services provided to them by another Reserve Bank.

Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include application development and centralized business administration functions for FedACH payment services, the Electronic Access Customer Contact Center, the Financial Services Policy Committee, and the FedMail and FedPhone Leadership Center.

3. SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and practices that it considers to be appropriate for the nature and function of a central bank, which differ significantly from those of the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* ("Financial Accounting Manual"), which is issued

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by the Board of Governors. All of the Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual and the financial statements have been prepared in accordance with the Financial Accounting Manual.

Differences exist between the accounting principles and practices in the Financial Accounting Manual and generally accepted accounting principles in the United States ("GAAP"), primarily due to the unique nature of the Bank's powers and responsibilities as part of the nation's central bank. The primary difference is the presentation of all securities holdings at amortized cost, rather than using the fair value presentation required by GAAP. U.S. government securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Amortized cost more appropriately reflects the Bank's securities holdings given the System's unique responsibility to conduct monetary policy. While the application of current market prices to the securities holdings may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio may involve transactions that result in gains or losses when holdings are sold prior to maturity. Decisions regarding securities and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such securities and currencies are incidental to the open market operations and do not motivate decisions related to policy or open market activities.

In addition, the Bank has elected not to present a Statement of Cash Flows because the liquidity and cash position of the Bank are not a primary concern given the Reserve Banks' unique powers and responsibilities. A Statement of Cash Flows, therefore, would not provide additional meaningful information. 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. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

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

a. *Gold and Special Drawing Rights Certificates*

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

Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. The gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged, and the Reserve Banks' gold certificate accounts

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

SDR certificates are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDR certificates serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates somewhat like gold certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in dollars are credited to the account established for the U.S. Treasury and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2007 or 2006.

b. *Loans to Depository Institutions*

Depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Bank. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. The Bank offers three discount window programs to depository institutions: primary credit, secondary credit, and seasonal credit, each with its own interest rate. Interest is accrued using the applicable discount rate established at least every fourteen days by the board of directors of the Reserve Bank, subject to review and determination by the Board of Governors.

In addition, depository institutions that are eligible to borrow under the Reserve Bank's primary credit program are also eligible to participate in the temporary Term Auction Facility ("TAF") program. Under the TAF program, the Reserve Banks conduct auctions for a fixed amount of funds, with the interest rate determined by the auction process, subject to a minimum bid rate. All advances under the TAF must be fully collateralized.

Outstanding loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established.

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

Interest income on U.S. government securities and investments denominated in foreign currencies comprising the SOMA is accrued on a straight-line basis. Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency gains, net" in the Statements of Income and Comprehensive Income.

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

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

The FRBNY may engage in tri-party purchases of securities under agreements to resell ("tri-party agreements"). Tri-party agreements are conducted with two commercial custodial banks that manage the clearing and settlement of collateral. Collateral is held in excess of the contract amount. Acceptable collateral under tri-party agreements primarily includes U.S. government securities, pass-through mortgage securities of the Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association, STRIP securities of the U.S. Government, and "stripped" securities of other government agencies. The tri-party agreements are accounted for as financing transactions, with the associated interest income accrued over the life of the agreement.

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

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

Activity related to securities sold under agreements to repurchase and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from an annual settlement of the interdistrict settlement account. On February 15, 2007, the FRBNY began allocating to the other Reserve Banks the activity related to securities purchased under agreements to resell.

e. *FX Swap Arrangements and Warehousing Agreements*

FX swap arrangements are contractual agreements between two parties, the FRBNY and an authorized foreign central bank, whereby the parties agree to exchange their currencies up to a prearranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to the foreign currencies it may need to support its international operations and give the authorized foreign central bank temporary access to dollars. Drawings under the FX swap arrangements can be initiated by either party and must be agreed to by the other party. The FX swap arrangements are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. Foreign currencies received pursuant to these agreements

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are reported as a component of "Investments denominated in foreign currencies" in the Statements of Condition.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the U.S. Treasury, U.S. dollars for foreign currencies held by the U.S. Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the U.S. Treasury and ESF for financing purchases of foreign currencies and related international operations.

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

f. *Bank Premises, Equipment, and Software*

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are depreciated over the remaining useful life of the asset or, if appropriate, over the unique useful life of the alteration, renovation, or improvement. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred.

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

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

g. *Interdistrict Settlement Account*

At the close of business each day, each Reserve Bank assembles the payments due to or from other Reserve Banks. These payments result from transactions between Reserve Banks and transactions that involve depository institution accounts held by other Reserve Banks, such as Fedwire funds 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.

h. *Federal Reserve Notes*

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the chairman of the board of directors of each

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Reserve Bank and their designees) to the Reserve Banks upon deposit with such agents of specified classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be at least equal to the sum of the notes applied for by such Reserve Bank.

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

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes issued to all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, Federal Reserve notes are obligations of the United States government. At December 31, 2007, all Federal Reserve notes issued to the Reserve Banks were fully collateralized.

"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 $2,790 million and $2,549 million at December 31, 2007 and 2006, respectively.

i. *Items in Process of Collection and Deferred Credit Items*

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

j. *Capital Paid-in*

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. These shares are nonvoting with a par value of $100 and may not be transferred or hypothecated. As a member bank's capital and surplus changes, its holdings of Reserve Bank stock must be adjusted. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. 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 reflect the Federal Reserve Act requirement that annual dividends are deducted from net earnings, divi-

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dends are presented as a distribution of comprehensive income in the Statements of Income and Comprehensive Income.

k. ***Surplus***

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31 of each year. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital.

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

The Bank initially applied the provisions of SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Statements of Condition, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard required applying the provisions as of the end of the year of initial implementation, and the effect as of December 31, 2006, is recorded as "Adjustment to initially apply SFAS No. 158" in the Statements of Changes in Capital.

l. ***Interest on Federal Reserve Notes***

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

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

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

m. ***Income and Costs Related to U.S. Treasury Services***

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services. During the years ended December 31, 2007 and 2006, the Bank was reimbursed for all services provided to the Department of Treasury.

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n. ***Compensation Received for Services 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 on its Statements of Income and Comprehensive Income. Similarly, the FRBNY manages the Reserve Banks' provision of Fedwire funds and securities transfer services, and recognizes total System revenue for these services on its Statements of Income and Comprehensive Income. The FRBA and FRBNY compensate the other Reserve Banks for the costs incurred to provide these services. The Federal Reserve Bank of Chicago (FRBC) manages the Reserve Banks' provision of electronic access services to depository institutions, recognizes total System revenue for these services on its Statements of Income and Comprehensive Income, and, beginning in 2007, compensates the other Reserve Banks for the costs incurred to provide these services. The Bank reports this compensation as "Compensation received for services provided" in the Statements of Income and Comprehensive Income.

o. ***Assessments by the Board of Governors***

The Board of Governors assesses the Reserve Banks to fund its operations based on each Reserve Bank's capital and surplus balances as of December 31 of the prior year. The Board of Governors also assesses each Reserve Bank for the expenses incurred for the U.S. Treasury to prepare 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.

p. ***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 $3 million for each of the years ended December 31, 2007 and 2006, and are reported as a component of "Occupancy expense."

q. ***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 11 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 of the Bank's assets are discussed in Note 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY.

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r. ***Recently Issued Accounting Standards***

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ("SFAS No. 157"). SFAS No. 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and expands on required disclosures about fair value measurement. SFAS No. 157 is generally effective for the Bank on January 1, 2008, though the effective date of some provisions is January 1, 2009. The provisions of SFAS No. 157 will be applied prospectively and are not expected to have a material effect on the Bank's financial statements.

4. U.S. GOVERNMENT 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 1.995 percent and 2.033 percent at December 31, 2007 and 2006, respectively.

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

	2007	2006
Par value		
U.S. government		
Bills	$ 4,546	$ 5,631
Notes	8,016	8,180
Bonds	2,215	2,023
Total par value	14,777	15,834
Unamortized premiums	159	177
Unaccreted discounts	(59)	(81)
Total allocated to the Bank	$ 14,877	$ 15,930

At December 31, 2007 and 2006, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was $15,506 million and $16,180 million, respectively, as determined by reference to quoted prices for identical securities.

The total of the U.S. government securities, net, held in the SOMA was $745,629 million and $783,619 million at December 31, 2007 and 2006, respectively. At December 31, 2007 and 2006, the fair value of the U.S. government securities held in the SOMA, excluding accrued interest, was $777,141 million and $795,900 million, respectively, as determined by reference to quoted prices for identical securities.

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

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Financial information related to securities purchased under agreements to resell and securities sold under agreements to repurchase for the year ended December 31, 2007, was as follows (in millions):

	Securities Purchased Under Agreements to Resell	Securities Sold Under Agreements to Repurchase
Allocated to the Bank		
Contract amount outstanding, end of year	$ 928	$ 877
Weighted average amount outstanding, during the year	700	695
Maximum month-end balance outstanding, during the year	1,028	877
Securities pledged, end of year	-	879
System total		
Contract amount outstanding, end of year	$ 46,500	$ 43,985
Weighted average amount outstanding, during the year	35,073	34,846
Maximum month-end balance outstanding, during the year	51,500	43,985
Securities pledged, end of year		44,048

At December 31, 2006, the total contract amount of securities sold under agreements to repurchase was $29,615 million, of which $602 million was allocated to the Bank. The total par value of SOMA securities that were pledged for securities sold under agreements to repurchase at December 31, 2006, was $29,676 million, of which $603 million was allocated to the Bank.

The contract amounts for securities purchased under agreements to resell and securities sold under agreements to repurchase approximate fair value.

The maturity distribution of U.S. government securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2007, was as follows (in millions):

	U.S. Government Securities (Par Value)	Securities Purchased Under Agreements to Resell (Contract amount)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	$ 545	$ 928	$ 877
16 days to 90 days	2,987	-	-
91 days to 1 year	3,038	-	-
Over 1 year to 5 years	4,800	-	-
Over 5 years to 10 years	1,635	-	-
Over 10 years	1,772	-	-
Total allocated to the Bank	$ 14,777	$ 928	$ 877

At December 31, 2007 and 2006, U.S. government securities with par values of $16,649 million and $6,855 million, respectively, were loaned from the SOMA, of which $332 million and $139 million, respectively, were allocated to the Bank.

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5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and with the Bank for International Settlements and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities purchased under agreements to resell. These investments are guaranteed as to principal and interest by the issuing foreign governments.

The Bank's allocated share of investments denominated in foreign currencies was approximately 1.799 percent and 1.855 percent at December 31, 2007 and 2006, respectively.

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

	2007	2006
European Union Euro		
Foreign currency deposits	$ 495	$ 116
Securities purchased under agreements to resell	46	41
Government debt instruments	84	75
Japanese Yen		
Foreign currency deposits	50	49
Government debt instruments	103	99
Swiss Franc		
Foreign currency deposits	73	-
Total allocated to the Bank	$ 851	$ 380

At December 31, 2007, the total amount of foreign currency deposits held under FX contracts was $24,381 million, of which $439 million was allocated to the Bank. At December 31, 2006, there were no open foreign exchange contracts.

At December 31, 2007 and 2006, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was $850 million and $379 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as central bank, to meet its financial obligations and responsibilities.

Total System investments denominated in foreign currencies were $47,295 million and $20,482 million at December 31, 2007 and 2006, respectively. At December 31, 2007 and 2006, the fair value of the total System investments denominated in foreign currencies, including accrued interest, was $47,274 million and $20,434 million, respectively.

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The maturity distribution of investments denominated in foreign currencies that were allocated to the Bank at December 31, 2007, was as follows (in millions):

	European Euro	Japanese Yen	Swiss Franc	Total
Within 15 days	$ 90	$ 54	$ -	$ 144
16 days to 90 days	416	7	73	496
91 days to 1 year	50	36	-	86
Over 1 year to 5 years	69	56	-	125
Total allocated to the Bank	$ 625	$ 153	$ 73	$ 851

At December 31, 2007 and 2006, the authorized warehousing facility was $5,000 million with no balance outstanding.

6. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	2007	2006
Bank premises and equipment		
Land	$ 18	$ 18
Buildings	115	114
Building machinery and equipment	15	15
Furniture and equipment	37	39
Subtotal	185	186
Accumulated depreciation	(63)	(56)
Bank premises and equipment, net	$ 122	$ 130
Depreciation expense, for the year ended December 31	$ 7	$ 7

The Bank leases space to an outside tenant with a remaining lease of five years. Rental income from such lease was immaterial for the years ended December 31, 2007 and 2006, and is reported as a component of "Other income." Future minimum lease payments that the Bank will receive under the noncancelable lease agreement in existence at December 31, 2007, are immaterial.

The Bank has capitalized software assets, net of amortization, of $5 million for the years ended December 31, 2007 and 2006. Amortization expense was $2 million and $1 million for the years ended December 31, 2007 and 2006. Capitalized software assets are reported as a component of "Other assets" and the related amortization is reported as a component of "Other expenses."

Assets impaired as a result of the Bank's restructuring plan, as discussed in Note 11, include check equipment. Asset impairment losses of $2 million and $127 thousand for the periods ending December 31, 2007 and 2006, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

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7. COMMITMENTS AND CONTINGENCIES

At December 31, 2007, the Bank was obligated under a noncancelable lease for premises and equipment with a remaining term of six years. This lease provides for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $271 thousand and $273 thousand for the years ended December 31, 2007 and 2006, respectively.

Future minimum rental payments under the noncancelable operating lease net of sublease rentals, with a remaining term of one year or more, at December 31, 2007, were not material.

At December 31, 2007, there were no material unrecorded unconditional purchase commitments or long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of 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, 2007 or 2006.

The Bank is involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position or results of operations of the Bank.

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

The Bank currently offers three defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan"). Employees at certain compensation levels participate in the Benefit Equalization Retirement Plan ("BEP") and certain Reserve Bank officers participate in the Supplemental Employee Retirement Plan ("SERP").

The System Plan provides retirement benefits to employees of the Federal Reserve Banks, the Board of Governors, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. The FRBNY, on behalf of the System, recognizes the net asset and costs associated with the System Plan in its financial statements. Costs associated with the System Plan are not redistributed to other participating employers.

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2007 and 2006, and for the years then ended, were not material.

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Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $4 million and $3 million for the years ended December 31, 2007 and 2006, respectively, and are reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2007 and 2006, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits other than Pensions

In addition to the Bank's retirement plans, employees who have met certain age and length-of-service requirements are eligible for both medical benefits and life insurance coverage during retirement.

The Bank funds benefits payable under the medical and life insurance plans as due and, accordingly, has no plan assets.

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

	2007	2006
Accumulated postretirement benefit obligation at January 1	$ 54.4	$ 41.6
Service cost-benefits earned during the period	2.5	1.7
Interest cost on accumulated benefit obligation	3.1	2.4
Net actuarial (gain) loss	(8.7)	10.4
Curtailment (gain)	(1.4)	
Contributions by plan participants	0.4	0.4
Benefits paid	(2.2)	(2.2)
Medicare Part D subsidies	0.2	0.1
Accumulated postretirement benefit obligation at December 31	$ 48.3	$ 54.4

At December 31, 2007 and 2006, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 6.25 percent and 5.75 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.

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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):

	2007	2006
Fair value of plan assets at January 1	$ -	$ -
Contributions by the employer	1.6	1.7
Contributions by plan participants	0.4	0.4
Benefits paid, net of Medicare Part D subsidies	(2.0)	(2.1)
Fair value of plan assets at December 31	$ -	$ -
Unfunded obligation and accrued postretirement benefit cost	$ 48.3	$ 54.4
Amounts included in accumulated other comprehensive loss are shown below		
Prior service cost	$ 3.4	$ 5.2
Net actuarial loss	(5.4)	(17.2)
Deferred curtailment gain	0.6	-
Total accumulated other comprehensive loss	$ (1.4)	$ (12.0)

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:

	2007	2006
Health care cost trend rate assumed for next year	8.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2013	2012

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2007 (in millions):

	One Percentage Point Increase	One Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 1.0	$ (0.8)
Effect on accumulated postretirement benefit obligation	$ 6.4	$ (5.3)

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

	2007	2006
Service cost-benefits earned during the period	$ 2.5	$ 1.7
Interest cost on accumulated benefit obligation	3.1	2.4
Amortization of prior service cost	(1.1)	(1.1)
Amortization of net actuarial loss	1.6	0.3
Total periodic expense	6.1	3.3
Net periodic postretirement benefit expense	$ 6.1	$ 3.3

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2008 are shown below:

Prior service cost	$ (0.9)
Net actuarial loss	0.1
Total	$ (0.8)

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2007 and 2006, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.75 percent and 5.50 percent, respectively.

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

A deferred curtailment gain was recorded in 2007 as a component of accumulated other comprehensive loss; the gain will be recognized in net income in future years when the related employees terminate employment.

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

There were no receipts of federal Medicare Part D subsidies in the year ended December 31, 2006. Receipts in the year ending December 31, 2007, related to benefits paid in the years ended December 31, 2007 and 2006, were $0.1 million and $0.2 million, respectively. Expected receipts in 2008 related to benefits paid in the year ended December 31, 2007, are $0.1 million.

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

	Without Subsidy	With Subsidy
2008	$ 2.7	$ 2.5
2009	3.0	2.8
2010	3.3	3.1
2011	3.6	3.3
2012	3.8	3.5
2013 - 2017	22.2	19.8
Total	$ 38.6	$ 35.0

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2007 and 2006, were $5 million. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2007 and 2006 operating expenses were $1 million and $2 million, respectively, and are recorded as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income.

10. 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 Pensions
Balance at January 1, 2006	$ -
Adjustment to initially apply SFAS No. 158	(12)
Balance at December 31, 2006	$ (12)
Change in funded status of benefit plans	
Prior service costs arising during the year	$ (1)
Net actuarial gain arising during the year	10
Deferred curtailment gain	1
Amortization of prior service cost	(1)
Amortization of net actuarial loss	2
Change in funded status of benefit plans - other comprehensive income	$ 11
Balance at December 31, 2007	$ (1)

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

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11. BUSINESS RESTRUCTURING CHARGES

2007 Restructuring Plans

In 2007, the Reserve Banks announced a restructuring initiative to align the check processing infrastructure and operations with declining check processing volumes. The new infrastructure will involve consolidation of operations, including the Minneapolis office, into four regional Reserve Bank processing sites in Philadelphia, Cleveland, Atlanta, and Dallas. Additional announcements in 2007 included restructuring plans associated with U.S. Treasury operations.

2006 Restructuring Plans

In 2006, the Reserve Banks announced a restructuring initiative to align the check processing infrastructure and operations with declining check processing volumes. As a result, the Helena branch operations were consolidated to the Denver processing site in 2007.

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

	2006 Restructuring Plans	2007 Restructuring Plans	Total
Information related to restrucuring plans as of December 31, 2007			
Total expected costs related to restructuring activity	$ 1.0	$ 4.7	$ 5.7
Estimated future costs related to restructuring activity	-	0.7	0.7
Expected completion date	2007	2009	
Reconciliation of liability balances			
Balance at January 1, 2006	$ -	$ -	$ -
Employee separation costs	1.0	-	1.0
Payments	-	-	-
Balance at December 31, 2006	$ 1.0	$ -	$ 1.0
Employee separation costs	0.4	4.0	4.4
Adjustments	(0.3)	-	(0.3)
Payments	(0.8)	-	(0.8)
Balance at December 31, 2007	$ 0.3	$ 4.0	$ 4.3

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 "Other liabilities" in the Statements of Condition and "Salaries and other benefits" in the Statements of Income and Comprehensive Income.

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Restructuring costs associated with the impairment of certain check equipment are discussed in Note 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8.

12. SUBSEQUENT EVENTS

In March 2008, the Board of Governors announced several initiatives to address liquidity pressures in funding markets and promote financial stability, including increasing the Term Auction Facility (see Note 3b) to $100 billion and initiating a series of term repurchase transactions (see Notes 3d and 4) that may cumulate to $100 billion. In addition, the Reserve Banks' securities lending program (see Notes 3d and 4) was expanded to lend up to $200 billion of Treasury securities to primary dealers for a term of 28 days, secured by federal agency debt, federal agency residential mortgage-backed securities, agency collateralized mortgage obligations, non-agency AAA/Aaa-rated private-label residential mortgage-backed securities, and AAA/Aaa-rated commercial mortgage-backed securities. The FOMC also authorized increases in its existing temporary reciprocal currency arrangements (see Notes 3e and 5) with specific foreign central banks. These initiatives will affect 2008 activity related to loans to depository institutions, securities purchased under agreements to resell, U.S. government securities, net, and investments denominated in foreign currencies, as well as income and expenses. The effects of the initiatives do not require adjustment to the amounts recorded as of December 31, 2007.

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Accounting Customer Support:
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Cash Services Help Line: 204-5227 or
1-800-553-9656 ext. 5227

Check Customer Service/Adjustments:
1-800-283-2830

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