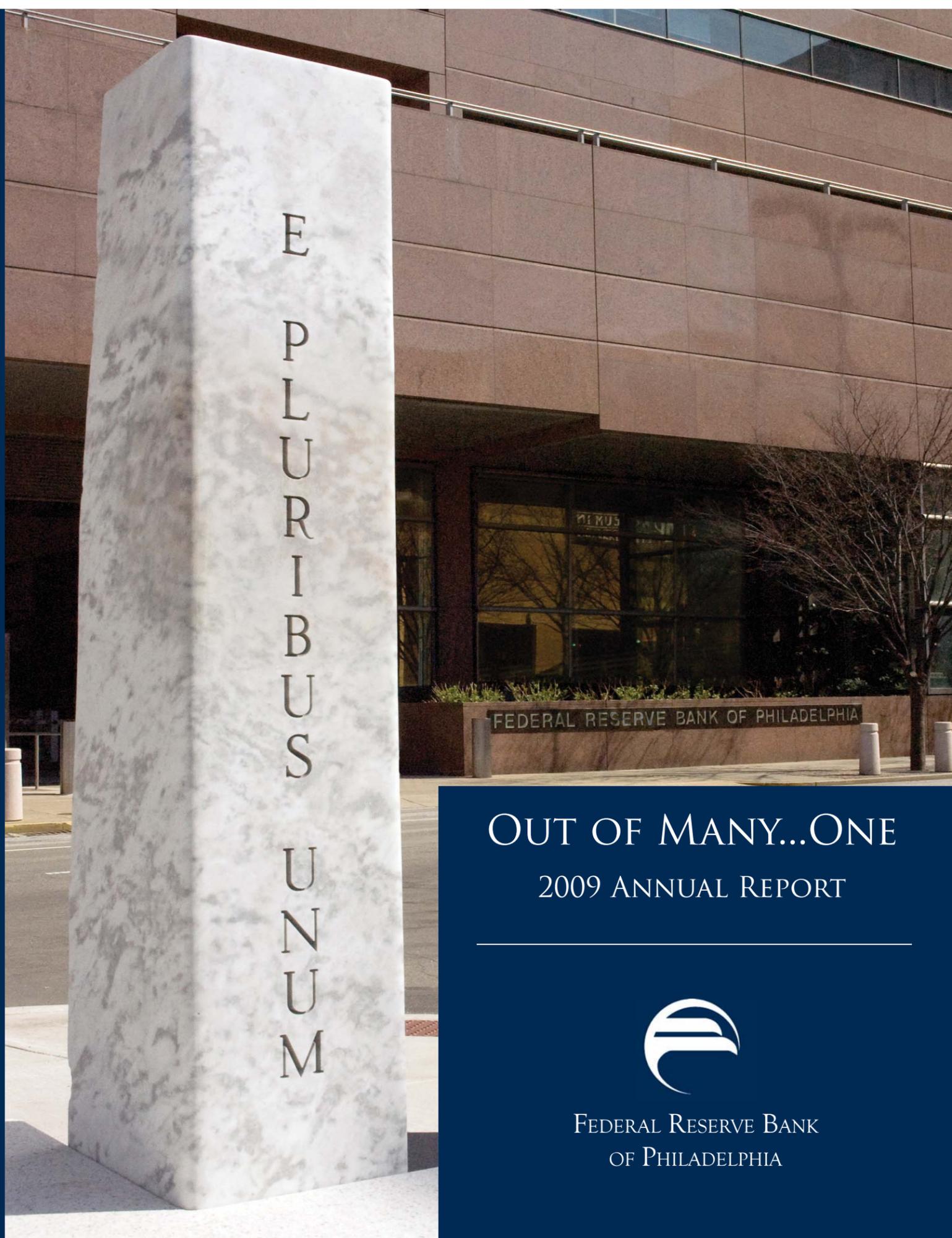


FEDERAL RESERVE BANK OF PHILADELPHIA ANNUAL REPORT 2009



OUT OF MANY..ONE
2009 ANNUAL REPORT



FEDERAL RESERVE BANK OF PHILADELPHIA

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www.philadelphiafed.org



FEDERAL RESERVE BANK
OF PHILADELPHIA

OUT OF MANY...ONE

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PRESIDENT'S MESSAGE

The theme of this year's annual report, "Out of Many...One," may sound familiar. The Latin translation, "E Pluribus Unum," is the motto found on the Great Seal of the United States. It indicates that out of many states, a single nation emerged — a nation founded just a few blocks from the Philadelphia Fed in Independence Hall.

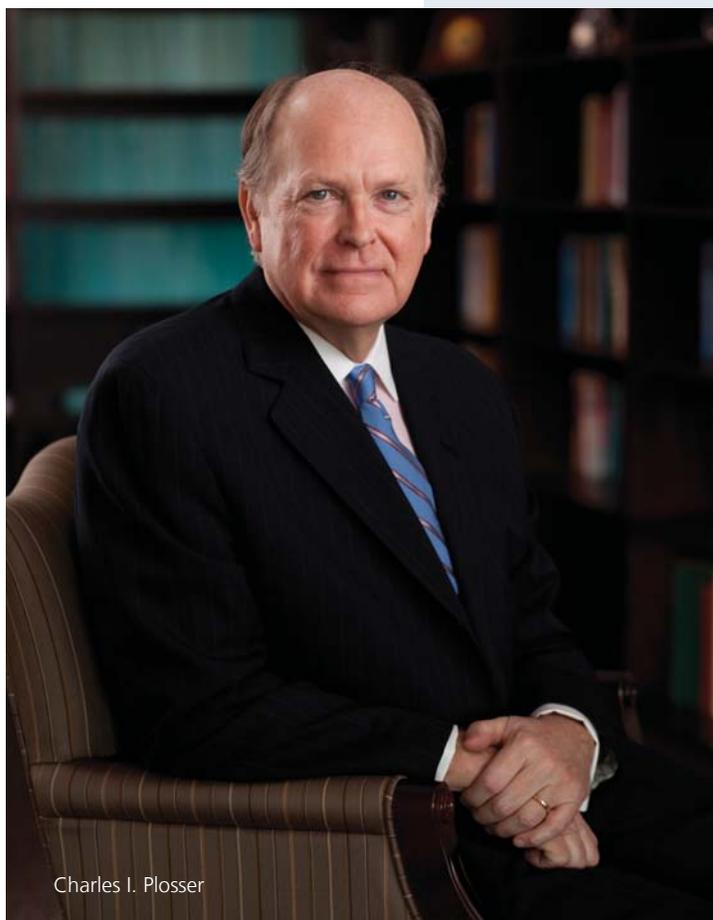
In today's dynamic economic environment, "Out of Many...One" is also particularly apt. It reflects the idea that out of many markets and sectors, we are one economy. It also applies to our decentralized central bank structure: 12 regional Reserve Banks around the nation and a Board of Governors in Washington form one central bank — the Federal Reserve. Although individual Federal Reserve policymakers have different perspectives and often articulate diverse views, they work together to set one monetary policy for the nation.

Throughout last year, I talked about the need to preserve the foundational structure of the Federal Reserve as we consider financial regulatory reform. In this year's essay, "The Importance of a Regional and Independent Federal Reserve," I discuss how this decentralized structure and independence from short-term

political pressures help the Fed pursue the goals that Congress has set for the central bank. Almost a century ago, Congress established the structure of the Federal Reserve to balance the interests of Main Street and Wall Street, and to balance the power of the public sector in Washington and the private sector throughout our great and vast nation. These checks and balances remain just as important today.

Other articles in this year's annual report describe the many ways people in our Bank have helped fulfill the mission Congress has defined for the Fed: conducting monetary policy, supervising financial institutions, supporting an efficient payment system, and serving as a "bankers' bank" to depository institutions and as the bank of the U.S. government.

One highlight of the year was the vital role played by Philadelphia's Supervision, Regulation and Credit (SRC) Department during the Supervisory Capital Assessment Program (SCAP), which was popularly known as the large banks' stress test. SCAP involved an in-depth analysis of 19 of the largest bank holding companies against a common set of assumptions. To my mind, the value was not to focus solely on these largest institutions but to dem-



Charles I. Plosser

onstrate the value of a macro-prudential approach that can be incorporated into oversight of a broader class of financial institutions. (See page 22.)

Philadelphia's SRC also supported the Fed in another important way during 2009 by helping bankers understand and follow new regulations and consumer compliance issues. On behalf of the Federal Reserve System, SRC produces the quarterly *Consumer Compliance Outlook*, a newsletter distributed to state member banks and bank holding companies supervised by the Fed's 12 Reserve Banks. This newsletter also reaches interested credit unions, savings and loan institutions, law firms, and consulting firms. (See page 29.)

This annual report also tells how our Research Department contributed to a better understanding of economic trends during a tumultuous year. (See page 30.) For instance, the Philadelphia Fed's monthly Business Outlook Survey of Third District manufacturers has been widely viewed as a gauge of the direction of the national economy. Many economists and forecasters followed the index as it turned positive at mid-year. The report also describes some of the department's other work, such as the Real-Time Data Research Center's quarterly Survey of Professional Forecasters and the Aruoba-Diebold-Scotti business conditions index, and the regional section's state coincident indexes. Our staff economists also conduct research in varied subject areas, including monetary and regulatory policy, banking and financial markets, payments, and the regional economy.

The Bank's Community Affairs Department has worked to address the mortgage crisis through its biennial "Reinventing Older Communities" conference and through workshops with lenders and housing counselors. The department also participated in the Fed's Mortgage Outreach and Research Efforts (MORE) program. One of MORE's goals is to improve data collection related to housing and credit markets, which, in turn, will help us find ways to mitigate the impact of the mortgage crisis on individuals and communities. (See page 34.)

In addition, Community Affairs also engages in outreach, educational, and technical assistance activities to help financial institutions, community-based organizations, government entities, and the public understand and address financial services issues affecting low- and moderate-income people and communities. It also offers a number of economic education programs.

Our final story marks the end of an era as the Philadelphia Fed closed its check processing operations in December 2009. (See page 37.) I want to express my sincere gratitude to our Retail Payments staff, who worked diligently throughout several consolidations in recent years as our economy shifted from paper to electronic check processing.

To my mind, the value was not to focus solely on these largest institutions but to demonstrate the value of a macro-prudential approach that can be incorporated into oversight of a broader class of financial institutions.

Board of Directors

On behalf of the entire Bank, I offer all of our directors my sincere thanks for giving their time and perspectives in serving on the Board of Directors of the Philadelphia Fed. Reserve Bank directors help keep this nation's central bank connected with the concerns of Main Street, and they therefore play a key role in providing balance in the conduct of monetary policy in the United States.

In particular, I thank William F. Hecht, retired president and CEO of PPL Corporation, and Garry L. Maddox, president and CEO of A. Pomerantz & Company, who both completed their terms of service in 2009. I am grateful for their years of distinguished service to the Federal Reserve Bank of Philadelphia and will miss their valuable insights and wise counsel.

I am pleased that board member Charles P. Pizzi, president and CEO of Tasty Baking Company, has been appointed chairman of the Board of Directors and that Jeremy Nowak, president and CEO of The Reinvestment Fund, has been appointed deputy chairman. Their dedication and leadership will no doubt prove invaluable to our Bank in the years ahead.

At the beginning of 2010, the Bank also welcomed its newest board members: Deborah M. Fretz, president, CEO, and director of Sunoco Logistics, and James E. Nevels, chairman of the Swarthmore Group. I look forward to the contributions of their experience and expertise. In addition, Aaron L. Groff, Jr., chairman, president, and CEO of the Ephrata National Bank, one of the three bankers on our nine-member board, was re-elected.

Closing Thoughts

I am proud to present this annual report and share how the Philadelphia Fed has played one part, out of many, to help support the recovery of financial markets and the national economy. The Philadelphia Fed, in cooperation with its 11 regional counterparts and the Board of Governors, has worked tirelessly to ensure a sound financial system and an effective monetary policy. We will continue to support, through a strong and independent central bank, a healthy and robust American economy.

I look forward to working with you in the year ahead.



Charles I. Plosser

President and Chief Executive Officer

June 2010

CHALLENGES AND CHANGES

BY WILLIAM H. STONE, JR., FIRST VICE PRESIDENT

Last year presented yet another set of challenges and changes for the Federal Reserve Bank of Philadelphia. The aftermath of a global financial crisis, the ongoing restructuring of check processing within the Federal Reserve System, and the continuing pursuit to remain innovative even through a period of turmoil — all tested our resourcefulness and creativity. Yet, these challenges also created opportunities for our employees to make significant contributions to the Federal Reserve System, Third District constituents, and the community at large.

The 2009 annual report includes articles that will describe many of these contributions, including several that I would like to highlight.

Check Consolidation

By the end of 2009, the Philadelphia Fed had reached the end of a seven-year journey as the Federal Reserve adapted its operations to accommodate the ongoing shift from paper checks to electronic payments. For the past few years, Philadelphia has served as one of four main consolidation sites as the Fed reduced retail payment operations from 45 sites in 2003 to a single site for electronic check processing in Atlanta and a single site for paper check processing in Cleveland.

In 2009, Philadelphia staff completed the consolidation of the Baltimore branch's check processing operations into Philadelphia's operations, and in December, our staff helped transfer all paper check processing for much of the northeastern United States to the national processing site in Cleveland.

Although this transition supports the Fed's mission to promote an efficient and reliable payment system, we also recognize that this consolidation affects employees. Consequently, we hired an outplacement firm to help affected employees find new jobs — both inside and outside the Bank. We appreciate the hard work of our staff and their dedication to ensuring a smooth transition for our customers right up through the last day of check processing here.

PhillyFedCARES

Philadelphia Fed employees have a strong spirit of volunteerism, and our Bank has a long tradition of sup-



William H. Stone, Jr.

*Several years ago,
the Bank added
an important word,
innovator, to its
vision statement:
“The Federal Reserve
Bank of Philadelphia
will be widely
recognized as a
leader and
innovator in central
bank knowledge
and service.”*

porting worthwhile causes. During 2009, we developed a strategic initiative to coordinate and support Bank-wide volunteer efforts. This initiative, PhillyFedCARES, will initially help us focus on causes that aid in the welfare and education of children throughout the Third District while continuing to support our current charitable activities.

In January 2010, we conducted our first PhillyFedCARES Day of Service, in which employees and their families worked together to spruce up a local elementary school. Good citizens make good employees. I am proud to say that many of our employees have gotten involved in PhillyFedCARES, contributing their time and skills to the communities we serve.

Innovation Forum

Several years ago, the Bank added an important word, innovator, to its vision statement: “The Federal Reserve Bank of Philadelphia will be widely recognized as a leader and innovator in central bank knowledge and service.” That role as innovator requires an ongoing commitment by those involved in day-to-day operations to explore the innovations that can most directly improve our organization’s overall performance.

Therefore, in 2009, the Bank launched the Innovation Forum. This employee forum creates a marketplace for ideas and gives employees the opportunity to contribute to the creative process. Its goal is to cultivate ideas that will advance the work of the Philadelphia Fed, building our business and providing opportunities for leadership, both in the Bank and in the Federal Reserve System.

In fact, our Innovation Forum has already prompted a new venture that the Philadelphia Fed will lead on behalf of the Federal Reserve: the Consumer and Securities Data Warehouse (CSDW) project. Issues pertaining to consumer credit were central to the recent financial crisis, and the CSDW project will help the Fed gather and analyze data about consumer credit as well as securities based on consumer debt.

The project will build on lessons learned in the Fed’s ongoing Mortgage Outreach and Research Efforts (MORE), which included collaborating on analyzing large, robust data sets of consumer mortgage data. The CSDW should help us with similar analyses of consumer credit data, which will help Fed researchers, supervisors, and policymakers study the overall markets.

The Innovation Forum also highlighted ongoing initiatives to ensure that our operations are “going green” wherever possible. In 2009, we implemented a pilot program to cut our Reserve Bank’s energy consumption. We’ve installed more energy-efficient lighting and have taken measures to ensure improved energy efficiency in all major equipment.

In fact, our new off-site screening facility, which officially opened in December 2009, incorporates a number of environmentally sound features. The building,

designed to enhance the security and safety of our employees and operations, is topped with a “green” roof with living plants that absorb rainwater run-off and insulate the building.

Cash Processing Upgrades

In the Cash Services Department, we completed a successful upgrade of our high-speed currency sorters and software, which help us both improve our capabilities and reduce our costs.

This upgrade was instrumental to our cash business, a highly complex operation with stringent controls and requirements. This new network helps extend the useful life of our existing sorters and provides the technology platform for future enhancements.

Video Conferencing

Nearly a decade ago, the Philadelphia Fed was tasked with evaluating the System’s video conferencing service and implementing a strategy to enhance its value. Today, Philadelphia manages a video conferencing network that reaches across the nation to support the entire Federal Reserve System. In 2009, usage was up almost 10 percent, to more than 2.5 million minutes — more than 40,000 hours of video conferences — which saved participants time and travel to traditional meetings.

The latest in video conferencing technology — telepresence — uses large screens and specially configured rooms to allow meetings in which participants have all the benefits of a face-to-face event. The video conferencing team first piloted the technology at the Board of Governors in Washington and at the Richmond, Dallas, and New York Feds. The team is now overseeing the installation of telepresence rooms in other Reserve Banks. One of the best outcomes is the greater networking and exchange of ideas during these turbulent times, all without the added travel.

As our technology continues to evolve, the team continues to look for new ways to expand the service. Next, we will work to bring video conferencing right to the desktop.

Summary

These are just a few of the highlights of a full year at the Philadelphia Fed. More information about the Bank’s accomplishments can be found in the Bank Highlights section on pages 40-43.

Despite the challenges and changes we faced, the Philadelphia Fed’s 2009 achievements demonstrate our ability to leverage our strengths in order to contribute to the smooth functioning of the payment system and the economy and to encourage and support our employees and constituencies even — or perhaps especially — in tough economic times.

OUT OF MANY...ONE

THE IMPORTANCE OF A REGIONAL AND INDEPENDENT FEDERAL RESERVE

Proposals that reshuffle the regulatory landscape and attempt to make the Federal Reserve, and thus monetary policy, more political miss the mark of meaningful reform.

BY CHARLES I. PLOSSER

In the aftermath of the global financial crisis and accompanying recession, some people have asked whether the governance and structure of the Federal Reserve System should be overhauled. In this essay, I explain why I believe the system that Congress established nearly 100 years ago still serves the public interest and why some proposed changes to its structure would pose serious risks to the health of our economy.¹

Over the past two years, the Fed has taken extraordinary and unprecedented actions to respond to the financial crisis. Now, as the economy begins to recover, the debate has turned to ways to prevent the next crisis, and it is entirely appropriate that we address the critical issues of moral hazard and firms deemed too big to fail. In doing so, though, we must guard against implementing regulatory reforms that have unintended consequences. To avoid harming the economy, we must refrain from undermining the Fed's ability to achieve its congressional mandates of price stability with maximum employment and sustainable economic growth, as well as the Fed's ability to foster financial stability.

In particular, proposals that reshuffle the regulatory landscape and attempt to make the Federal Reserve, and thus monetary policy, more political miss the mark of meaningful reform. (See "A Way Toward Real Reform" on page 17.) In fact, they would weaken the Fed's independence and the prospects that the Fed can carry out its mandates to achieve price stability and promote sustainable economic growth. Let me explain why.

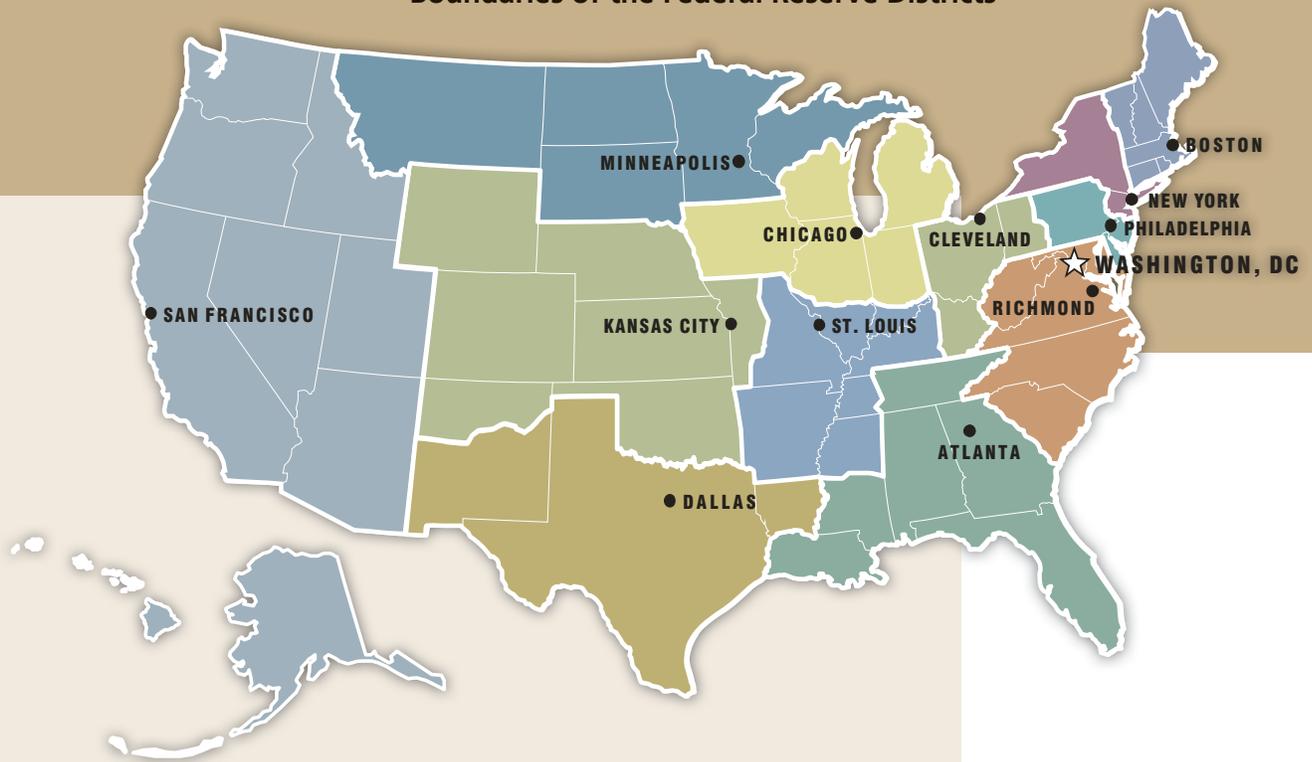
Federal Reserve Structure and Governance

First, it is important to understand the structure and governance of the Federal Reserve System, which has enhanced its effectiveness for nearly a century. The structure is often misunderstood. Yet, I believe history helps us understand why we have a regional and independent central bank.

Just blocks away from the Federal Reserve Bank of Philadelphia stand the historic buildings that once housed the First and Second Banks of the United States. Both

¹ This essay is based on several recent writings and speeches by the author, including the following: Charles I. Plosser, "A Look Back Shows Valid Reasons for the Current System," *Philadelphia Inquirer*, August 16, 2009; Charles I. Plosser, "Demystifying the Federal Reserve," speech at Lafayette College, Easton, PA, September 29, 2009; and Charles I. Plosser, "The Federal Reserve System: Balancing Independence and Accountability," speech to the World Affairs Council, Philadelphia, February 17, 2010.

Boundaries of the Federal Reserve Districts



failed because they became embroiled in politics and lacked the balance and independence needed to serve our vast and diverse country. (See “The First and Second Banks of the United States: The Historical Basis for a Decentralized Fed” on pages 10-11.) When President Woodrow Wilson signed the Federal Reserve Act into law in 1913, it included an ingenious compromise — a decentralized central banking system.

The Fed’s unique structure helped overcome political and public opposition that stemmed from fears that the central bank would be dominated either by political interests in Washington or by financial interests in New York. Americans have long been suspicious of the concentration of authority. A decentralized central bank allowed Congress to spread authority for central bank policy throughout the nation.

Congress established the Federal Reserve System by chartering 12 regional Reserve Banks, overseen by a Board of Governors in Washington, to provide checks and balances — between centralization and decentralization, between the public and private sectors, and between Wall Street and Main Street — all to ensure that policy decisions are balanced and independent. (See “Federal Reserve System Structure and Governance: A Balance of Power” on pages 20-21.)

The regional structure of the Federal Reserve System also helps the Federal Open Market Committee, or FOMC, to set more effective monetary policy. Congress gave votes on the FOMC to the seven Governors in Washington, along with five

(continued on page 12)

THE FIRST AND SECOND BANKS OF THE UNITED STATES: THE HISTORICAL BASIS FOR A DECENTRALIZED FED

Those considering the future of the Federal Reserve would do well to revisit the past. In Philadelphia's historic Old City, a short walk from the Philadelphia Fed, you will find the vestiges of two earlier attempts at a central bank.



Following the Revolutionary War, the newly formed nation of the United States sought a way to re-establish commerce, repay war debt, restore the value of currency, and lower inflation. One of our Founding Fathers — Alexander Hamilton, the first Secretary of the Treasury — devised a plan to accomplish these goals. His idea? Create a national bank that would issue paper money, provide a safe place for public funds, offer banking facilities for commercial transactions, and act as the government's fiscal agent.

Many people opposed the idea. They believed that a national bank was unconstitutional and would place too much power in the hands of the federal government. Despite the opposition, Hamilton prevailed, and Congress created the Bank of the United States (often called the First Bank), granting it a 20-year charter. Although not a central bank in the modern sense, the First Bank was the nation's first attempt at central banking. It opened in 1791 and closed in 1811, when Congress failed to renew its charter.

However, by early 1815, much like at the end of the Revolutionary War, the U.S. found itself heavily in debt after fighting the War of 1812 and struggling with soaring prices and devalued money from ris-

ing inflation. Furthermore, with no national bank, the government had difficulty borrowing money and making payments. Many people felt that the solution to the country's problems lay in establishing another national bank. After much debate and opposition, Congress established the second Bank of the United States (the Second Bank), which, like its predecessor, had a 20-year charter. Opening in 1816, the Second Bank closed in 1836, when Congress failed to override President Andrew Jackson's veto of the reauthorization of the Second Bank.

Like the First Bank, the Second Bank was the victim of a distrust of centralized power. More important, both banks became entangled in politics and failed

First Bank of the United States



MANY..ONE | OUT OF MANY..ONE | OUT OF MANY..ONE | OUT OF MANY..ONE

to find the balance and independence necessary to serve our vast and diverse country.*

It was almost 80 years before the nation was ready to try again.

By 1913, many Americans accepted the fact that the nation needed a central bank as a means of stabilizing the currency and the financial system. The country had been rocked with financial panics on a regular basis since the Civil War. The Panic of 1907 led Congress to establish a commission to consider ways to mitigate such financial crises.

There were two competing views. The bankers, mainly from New York, and some politicians in Washington favored a strong central bank with the power to issue currency and support the efficient functioning of the payment system. This institution was to be governed by the bankers themselves. The Wall Street crowd at the time thought that this institution should be located in New York.

However, many Americans were suspicious of having such a strong central entity. In addition, many citizens did not want to vest a lot of power in an institution controlled so heavily by the “special interests” in New York — at the time referred to as the “money trusts” — or in politically charged Washington. Moreover, the country was geographically

* For more information, see *History of Central Banking*, Federal Reserve Bank of Philadelphia, 2009, and *The First Bank of the United States: A Chapter in the History of Central Banking*, Federal Reserve Bank of Philadelphia, 2009.



Second Bank of the United States

diverse, and the economic needs of its different parts varied.

When President Woodrow Wilson signed the Federal Reserve Act into law in 1913, it included an ingenious compromise — a decentralized central banking system. This unique structure helped overcome political and public opposition that stemmed from fears that this new central bank would be dominated either by political interests in Washington or by financial interests in New York.

Over the years, the conduct of monetary policy has changed, and most of the authority for setting policy is now vested in the Federal Open Market Committee (FOMC), which is made up of the seven members of the Board of Governors and the presidents of the 12 Reserve Banks. This change was detailed in the Banking Act of 1935, which amended the Federal Reserve Act and created the FOMC as we know it today.

Nearly a century ago, there were valid reasons for creating an independent and decentralized central bank, with a network of regional Reserve Banks, rather than one based solely in the nation’s political or financial capital. Those reasons remain valid today.



(continued from page 9)

of the 12 presidents of the regional Reserve Banks. As the president of the Philadelphia Fed, I receive a lot of information about business and financial conditions in the Third District, which includes Delaware, the southern half of New Jersey, and the eastern two-thirds of Pennsylvania. I also reach out more broadly to contacts in the national and international business communities. In addition, here in Philadelphia, our Research Department collects survey data from around the District and the nation and constructs indexes of economic activity. The results are published in a number of publications. The most recognized and frequently cited are our Business Outlook Survey, our Survey of Professional Forecasters, and our coincident indexes for the 50 states. (See “Providing Reliable Information on the Economy” on page 30.) I use all of this information, along with incoming data on the national economy, when I prepare for meetings of the FOMC, held typically every six to eight weeks in Washington.

At those FOMC meetings, I share what I have gathered as I express my views about the economy, just as I hear the perspectives of other Fed presidents and Governors. It is the aggregation of those diverse views on the state of the economy and proposed policy actions that shape the FOMC’s monetary policy decisions, so that our nation’s monetary policy reflects the most up-to-date and comprehensive picture of the economy. The information from the Reserve Bank Districts, in its detail and timeliness, is often invaluable in understanding how our economy is evolving.²

In formulating policies, it is valuable to hear perspectives on the economy and policy from throughout the country — not just from Wall Street or Washington, but also from Philadelphia and the other Districts of our uniquely decentralized central bank. The diverse and independent voices that are represented in the making of monetary policy result in a stronger and more effective institution and better policies. As the famous American journalist Walter Lippmann once said: “Where all men think alike, no one thinks very much.”

By bringing an independent view and a regional Main Street perspective to Washington, the 12 Reserve Bank presidents help maintain a balanced and richer decision-making process, improving policy and economic outcomes on behalf of the entire country.

² See the Federal Reserve Bank of Philadelphia’s booklet, “A Day in the Life of the FOMC,” January 2008.



Independence in a Decentralized System

Congress wanted a central bank that was both decentralized and independent within government in order to shelter it from short-term political influences. To help reinforce the central bank's independence, Congress established the Fed to be self-funding, meaning that the Fed receives no government appropriations from Congress. In fact, the System turns over any excess earnings on its portfolio of securities and loans above the cost of its operations to the U.S. Treasury. In 2009, that amounted to about \$46 billion returned to the Treasury.

To further preserve the Fed's political independence, Federal Reserve Bank employees, officers, and directors are generally restricted from engaging in political activities.

However, independence does not mean that the central bank is unaccountable for its policies, nor does it mean that the Federal Reserve sets its own goals. Congress sets the Fed's monetary policy goals. The Federal Reserve Act states that the Fed should conduct monetary policy to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Since moderate long-term interest rates generally result when prices are stable and the economy is operating at full employment, it is often said that Congress has given the Fed a dual mandate.

What central bank independence means is that Congress has left the decisions of how best to achieve this mandate to Fed policymakers, free from short-term political interference. As former Fed Vice Chairman Alan Blinder has explained, Congress knew the temptation to interfere with monetary policy was great and that such interference would be detrimental to society. So, Congress tied its own hands, just as Ulysses had himself tied to the mast of his ship as it sailed past the beautiful and tempting, but deadly, Sirens.³

Many people may wonder why in a democratic society we leave monetary policy decisions in the hands of nonelected policymakers who can act with independence. There are two very good reasons for this structural independence for the central bank.

The first and most important reason is to separate the authority of those in government responsible for making the decisions to spend and tax from those responsible for printing the money. This lessens the temptation for the fiscal authority to use the printing press to fund its public spending, which would substitute a hidden tax of future inflation for taxes or spending cuts.

This can be especially important when governments face huge deficits and may be tempted to use the monetary printing press to improperly fund fiscal needs.

³ Alan S. Blinder, "Is Government Too Political?" *Foreign Affairs*, 76 (November/December 1997), pp. 115-26.

The Federal Reserve Act states that the Fed should conduct monetary policy to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

*The mere threat
that monetary policy
might become
politicized can damage
the nation's credibility.
It can raise fears of
inflation that send
interest rates higher
and currencies falling.*

The fiscal authorities should not think of the central bank as a source of funds or a piggy bank they can use simply to avoid the difficult choices of cutting spending or raising taxes.

History is replete with examples in which central banks became agents for a nation's fiscal policy or a means for a political party to remain in power. Just in the 20th century, think of the hyperinflation experiences in Germany and Hungary; think of Italy before the euro; think of the numerous financial crises in Latin America or the current economic chaos in Argentina and Zimbabwe, to name just a few. The consequences of using the printing press as a substitute for spending restraint are dire — higher inflation, currency crises, and economic instability.

Here in the U.S. there have also been periods where fiscal demands and monetary policy became too intertwined. For example, in the late 1960s and early 1970s, the Fed came under pressure from the Treasury and the administration to support the funding of the Great Society programs and the Vietnam War. As a result, the Fed became reluctant to raise interest rates to restrain inflationary pressures. This failure of the Fed to exert its independence sowed the seeds of the Great Inflation in the 1970s. As unemployment rose in response to the disruptions caused by the oil shocks in that decade, the Fed remained reluctant to raise rates sufficiently in the face of rising inflation. Thus, the failure to keep monetary policy sufficiently independent led the Fed to forsake its mandate for price stability, which resulted in more than a decade of economic instability.

More than ever before, we live today in a world of highly mobile capital and financial markets that are constantly assessing the credibility of governments and their central banks to maintain price and economic stability. In such a world, the mere threat that monetary policy might become politicized can damage the nation's credibility. It can raise fears of inflation that send interest rates higher and currencies falling.

A Long-Term Perspective

The second reason central bank independence is important is that monetary policy affects the economy with sometimes long and variable lags, but elected politicians, and even the public, often have shorter time horizons. Monetary policy actions taken today will not have their full effect on the economy for at least several quarters and perhaps as long as several years. That is why monetary policy choices must focus on the intermediate to long term and anticipate what the economy might look like over the next one to three years.

Moreover, there can be a conflict between what monetary policy may be able to achieve over the short term versus its impact over the long term. For example, sustained monetary policy easing, achieved by lowering interest rates, is often perceived to have beneficial effects on employment and output in the near term. Yet such effects are temporary at best and are highly unpredictable. Moreover, in the long term such a policy is likely to result in higher rates of inflation and higher nominal interest rates. On the other hand, a tightening of policy to re-

strain inflation will first show up in declines in employment and output; only later will those effects be reversed and inflation fall. This pattern engenders an inflationary bias in policy if policymakers become too short-term oriented. Delegating the decision-making to an independent central bank that can focus on long-term policy goals is a way of limiting the temptation for short-term gains at the expense of the future.

Independence will be even more important for the Fed going forward. During the recent crisis, the Fed took extraordinary measures. At some point, however, the Fed must unwind this support, increase short-term interest rates, and drain some of the money it has pumped into the economy during the recession. The Fed must have the independence to take these actions without short-term political interference if it is to achieve Congress's dual mandate.

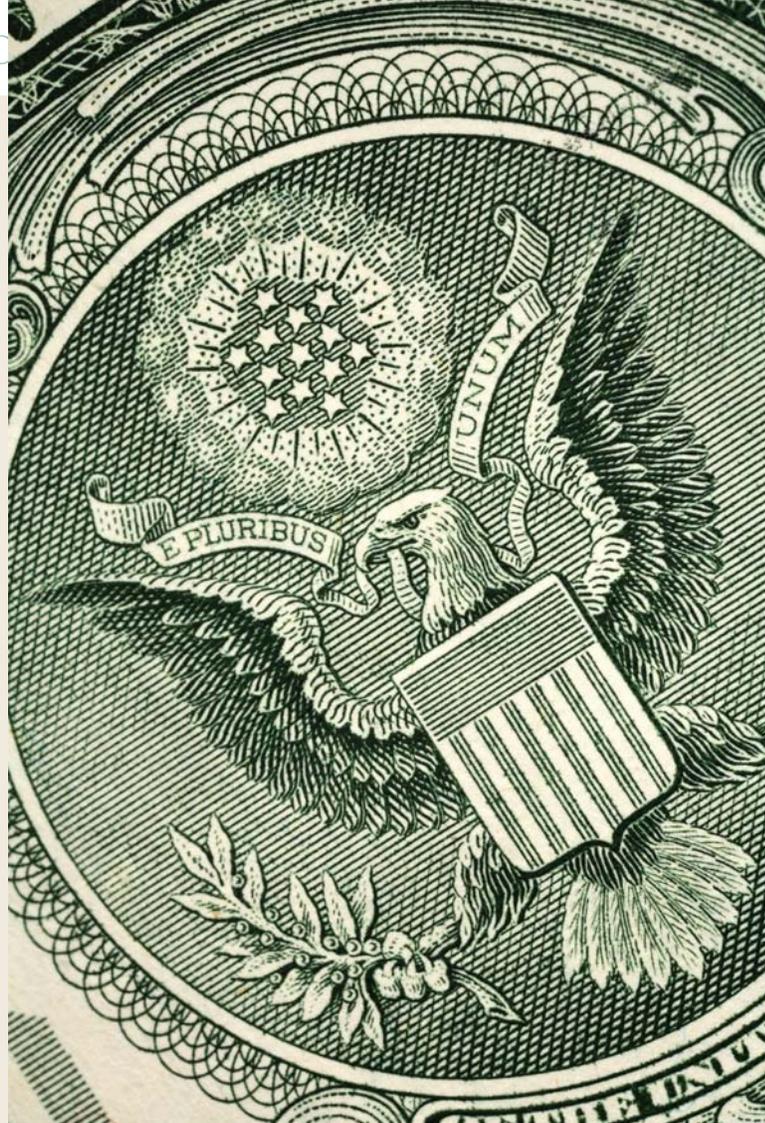
Instead of seeking to preserve or enhance the central bank's independence, however, some reform proposals would politicize the governance of the 12 Reserve Banks by making the New York Fed president, or even other Reserve Bank presidents, political appointees. Other proposals would change the roles and responsibilities of the Fed.

Such changes would weaken the regional and decentralized structure of the Federal Reserve System and lead to a more centralized and political institution, which would yield less effective policymaking. Were regional Reserve Bank presidents to become political appointees, they would be more attuned to the political process in Washington that selected them, rather than having a public interest in the broad economic health of the nation and the Reserve Districts in which they reside.

Any shift in power in Washington and New York at the expense of the other Reserve Banks would undermine the delicate balance of our uniquely decentralized central bank and lead to a central bank that is more interested in politics and Wall Street than in the economic health of Main Street. Such a shift in the focus of the central bank would be a loss for the country and our economic well-being.

Accountability and Transparency

Being independent, though, does not mean the Fed is unaccountable. The Fed is ultimately accountable to Congress and the American people. Having been granted the independence required to implement effective monetary policy on



Recognizing that the Federal Reserve is ultimately accountable to the American people, the Fed has steadily improved transparency about its actions in recent years.

behalf of the country, the Fed has an obligation to explain its policy decisions to the public. Communicating the Fed's actions helps establish the central bank's credibility and reaffirm its commitment to achieving its mission, which in turn generates better policymaking. Transparency allows Congress and the public to better understand the Fed's policy actions and to hold the Fed accountable for the outcomes.

Recognizing that the Federal Reserve is ultimately accountable to the American people, the Fed has steadily improved transparency about its actions in recent years. For example, the Federal Open Market Committee issues a statement after each meeting, detailed minutes three weeks later, and quarterly economic projections of participants. Verbatim transcripts of FOMC meetings are available after five years.⁴ The Fed Chairman testifies to Congress on monetary policy at least twice each year and frequently appears before House and Senate committees to answer questions. In addition, Reserve Banks help increase transparency by communicating economic and monetary policy objectives through educational outreach, speeches by Bank officials, and discussions with the boards of directors and local constituents.

Each year the Fed provides Congress and the public with detailed financial statements audited by an outside independent public accounting firm. The Fed also publishes a balance sheet on a weekly basis and has recently added monthly and quarterly data to increase its level of transparency.

I am keenly aware of the importance of transparency, so I fully support the Fed's efforts to improve and enhance its disclosures surrounding the unusual policy programs we have implemented in response to the crisis. Failure to do so can harm our credibility and reputation, undermining the public trust and the Fed's ability to achieve its objectives.

The Fed's budget and operations are subject to considerable oversight. Internal audit departments, which report directly to the Banks' boards of directors, regularly audit the Reserve Banks' operations. Staff at the Board of Governors also oversees the Reserve Banks' operations throughout the System. The Government Accountability Office (GAO) also conducts frequent audits of many of the Fed's functions, including the financial services provided to the U.S. Treasury and other government agencies, and the Fed's supervisory and regulatory functions.⁵

What Congress correctly decided in 1978, though, is to exempt monetary policy decisions, including open market and discount window operations, from GAO re-

(continued on page 18)

⁴ See the website of the Board of Governors of the Federal Reserve: www.federalreserve.gov/monetarypolicy/fomc_historical.htm

⁵ For more information on GAO audits of Federal Reserve operations and exemptions, see Ben Bernanke, "The Right Reform for the Fed," *Washington Post*, November 27, 2009.

Empirical research over the past 30 years has shown that countries with independent central banks have lower rates of inflation, on average, and generally better economic performance.

view to avoid politicizing monetary policy and jeopardizing the independence of the central bank. Recent proposals to remove this exemption for monetary policy would allow any legislator to demand that the GAO audit the Fed's monetary policy decisions. To be clear, this "audit" does not refer to the usual accounting sense of the term, since the Fed's financial statements and controls are already subject to extensive outside audits by the GAO and a public accounting firm. Rather, this proposal is an attempt to reduce the independence of the central bank and influence policy through the threat of a political action. The GAO could be ordered to investigate a monetary policy decision whenever any member of Congress opposes a decision to change interest rates. These "policy audits" would undermine the Fed's credibility as well as its ability to conduct monetary policy in the best interests of the American public.

Such policy audits would also reverse a trend of the past three decades in which many countries have increased the degree of independence of central bank monetary policymaking from short-term political influences. Empirical research over the past 30 years has shown that countries with independent central banks have lower rates of inflation, on average, and generally better economic performance.⁶

Reforms to Strengthen Independence and Transparency

Rather than seek ways to politicize the Fed, we should seek ways to ensure its independence from short-term political pressures while reducing the temptation to use the central bank as an inappropriate tool for conducting fiscal policy.

Several actions could be taken to support these goals. I would like to emphasize two that I believe are particularly important.

First, the Federal Reserve should conduct monetary policy using a portfolio that contains only Treasury securities, preferably concentrated in bills and short-term coupon bonds. This would contribute to preserving the Fed's independence by limiting activities that could be perceived as crossing the line from monetary policy into the realm of fiscal policy. The Federal Reserve's purchases of mortgage-backed securities were a direct intervention into housing finance and thus can be viewed as a form of fiscal policy. In order to return the composition of the Fed's portfolio to all-Treasuries, I would support the Fed's beginning to sell the agency mortgage-backed securities from its portfolio as the economic recovery gains strength and monetary policy begins to normalize. Returning to an all-Trea-

⁶ See, for example, Alberto Alesina and Lawrence H. Summers, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," *Journal of Money, Credit and Banking*, 25 (May 1993), pp. 151-62; and Alex Cukierman, "Central Bank Independence and Monetary Policymaking Institutions – Past, Present, and Future," *European Journal of Political Economy*, 24 (December 2008), pp. 722-36. This relationship appears to be less robust for developing countries. See, for example, Iftekhar Hasan and Loretta J. Mester, "Central Bank Institutional Structure and Effective Central Banking: Cross-Country Empirical Evidence," *Comparative Economic Studies*, 50 (December 2008), pp. 620-45, and Christopher Crowe and Ellen Meade, "Central Bank Independence and Transparency: Evolution and Effectiveness," *European Journal of Political Economy*, 24 (December 2008), pp. 763-77.

suries portfolio would promote a clearer distinction between monetary policy and fiscal policy and help uphold the Fed's independence.

The second suggestion is to eliminate or curtail the Fed's 13(3) lending authority.⁷ This section of the Federal Reserve Act allows the Fed to lend to corporations, individuals, and partnerships under "unusual and exigent circumstances." I believe the fiscal authorities should do emergency lending and that the Fed be involved

only upon the written request of the Treasury. Any non-Treasury securities or collateral acquired by the Fed under such lending should be promptly swapped for Treasury securities to make it explicitly clear that the responsibility for fiscal policy lies with the Treasury and Congress, not with the Federal Reserve. To codify this arrangement, I have advocated for a new Fed-Treasury Accord, similar to the 1951 accord that restored Fed independence after World War II.⁸ This new accord would eliminate the ability of the Fed to engage in bailouts of individual firms or sectors and place such accountability where it rightly belongs — with the fiscal authorities.

Conclusion

The most severe financial crisis since the Great Depression has prompted the call for financial reforms. History tells us that crises invariably lead to reforms, and as we struggle to find the right reforms to respond to this crisis, we should avoid "quick fixes" that may have unintended consequences that impair the Federal Reserve's ability to achieve the monetary policy goals set by Congress.

Above all, we must preserve the independence and regional nature of our Federal Reserve System against proposals that would threaten to politicize or centralize power. Failure to do so could impede the Fed's ability to meet its objectives for sound monetary policy to ensure price stability and maximum sustainable economic growth. The Fed's regional governance, independence, and current responsibilities are all important for achieving these objectives.



⁷ For more information, see the Federal Reserve Act, Section 13: Powers of Federal Reserve Banks, [federalreserve.gov/aboutthefed/section13.htm](https://www.federalreserve.gov/aboutthefed/section13.htm).

⁸ See Charles I. Plosser, "Ensuring Sound Monetary Policy in the Aftermath of Crisis," speech at the U.S. Monetary Policy Forum, New York, February 27, 2009.

FEDERAL RESERVE SYSTEM STRUCTURE AND GOVERNANCE: A BALANCE OF POWER

The Board of Governors of the Federal Reserve

Governance:

- Seven Governors are appointed by the President and confirmed by the Senate, and so are directly connected to the political process.
- The Governors represent the public sector.
- They serve 14-year terms to insulate them from short-term political pressures and to encourage a long-term perspective on the economy and the financial system.^a

- The Chairman and Vice Chairman of the Board of Governors are appointed by the President and confirmed by the Senate to four-year terms.

Duties:

- Oversees the 12 Federal Reserve Banks and their budgets.
- Sets depository reserve requirements and approves requests for discount rate changes made by the Reserve Banks.
- Issues regulations on financial safety and soundness and consumer protection.
- Leads the Fed's supervision and regulation of bank holding companies, domestic and foreign operations of financial holding companies, and state-chartered banks that are members of the Federal Reserve System. (Staffs at the 12 Reserve Banks responsible for supervising financial institutions in their District operate under delegated authority from the Board of Governors.)

^a A Governor can finish out a previous appointee's term prior to serving his or her own full term.



ASSESSING THE STRENGTH OF THE NATION'S BANKS

“The scope and scale were unprecedented. The rigorous review of loan portfolios, investment securities, trading positions, and off-balance-sheet commitments provided a window into our largest institutions.”

In early 2009, the Federal Reserve Bank of Philadelphia played an integral role in conducting a comprehensive banking stress test to assess the strength of the country's largest banking organizations and to determine how well the financial system was prepared to survive a challenging economic downturn.

Led by the Federal Reserve Board of Governors, this exhaustive effort enlisted more than 150 examiners, economists, and analysts from the Fed and other federal bank supervisors to conduct the stress test, officially named the Supervisory Capital Assessment Program (SCAP).

The 19 bank holding companies with assets of more than \$100 billion were required to participate in this exercise. Collectively, these complex companies hold two-thirds of the assets and more than half of the loans nationwide.

SCAP's purpose was to measure how much additional capital — if any — each institution would need to withstand potential losses under more adverse economic conditions. SCAP employed both a baseline economic scenario and a hypothetically more adverse scenario in its assessment.

In fact, the Philadelphia Fed's Research Department had a role in helping design the severe economic scenarios for SCAP. Working with the Fed's Board of Governors, Philadelphia used its quarterly Survey of Professional Forecasters to elicit information about measures of uncertainty in the forecasters' projections. It was important to create a hypothetical “what if” forecast, which called for economic conditions — growth, unemployment, and the housing market — to be severe but plausible.

“The stress test was important in assuring the public that banks would remain viable if economic conditions worsened. Public confidence plays such a vital role in the banking system, and this test was critical to helping calm the markets and restore public confidence,” said Michael E. Collins, executive vice president and lending officer in the Supervision, Regulation and Credit Department (SRC).

Testing Process

Stress testing isn't new to the banking industry. A bank's management continually conducts stress tests based on its asset size, portfolio composition, and risk characteristics to help establish effective internal risk systems. The testing process should be integrated into the bank's risk culture, yet remain flexible to adapt to new and emerging issues. Its results should reveal the bank's strengths and weaknesses in favorable and unfavorable economic conditions.

Although SCAP shares similarities with a bank's internal stress test, this financial exam was unique.

"The scope and scale were unprecedented. The rigorous review of loan portfolios, investment securities, trading positions, and off-balance-sheet commitments provided a window into our largest institutions, which are key players in our financial system. The results will be important in assessing future capital adequacy," Collins said.

SRC's Role

The Philadelphia Fed's retail credit risk function within SRC dedicated six specialists to the SCAP tests. Todd Vermilyea, vice president of retail risk and bank surveillance in SRC, oversaw Philadelphia's efforts and helped manage multiple challenges.

"We had to overcome significant data, logistic, and deadline challenges to produce a comprehensive and consistent set of results," Vermilyea said of his team.

The group — Vermilyea, Jose J. Canals-Cerda, Ali Cannoni, Larry Cordell, Eddy Hsiao, and Andrew Kish — each worked on different teams and collaborated with colleagues inside and outside the Federal Reserve. They worked in tandem with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

Challenges in Testing

In what may seem an unusual approach, experienced examiners and staff were assigned to evaluate firms for which they possessed limited first-hand knowledge to make certain that outcomes were unbiased. In this regard, Canals-Cerda and Cordell were assigned to analyze losses on retail credit products for several firms.



Front to back: Todd Vermilyea, Larry Cordell, Eddy Hsiao, Jose Canals-Cerda, Andy Kish, and Ali Cannoni

“Independent views, ranging from economists’ loan loss models to examiners’ detailed conversations with bank managers, were a hallmark of this financial examination,” Vermilyea said. These outside experts worked closely with on-site examiners, who had detailed knowledge of each of the institutions. Collaboration among these groups was essential given the very tight time frame.

As they pored over hundreds of pages of bank reports, supervisors worked together in identifying weaknesses in models, obtaining missing information, and recalculating over-optimistic assumptions. Their objective was to produce consistent results, a difficult task given the differences in the way the institutions reported and presented their data.

The Philadelphia Fed took a lead role in analyzing off-balance-sheet positions. Weaknesses in accounting for off-balance-sheet vehicles were being addressed in a new set of Financial Accounting Standards set to take effect in 2010. Given that the stress test forecast losses through 2010, the analysis of off-balance-sheet exposures had to reflect both the institutions’ overall exposures and the impact of these accounting changes. Andy Kish, who was on assignment at the Federal Reserve Board of Governors during the stress test, designed a model to estimate these off-balance-sheet losses. Kish worked closely with accounting expert Hsiao to ensure that the model was consistent with the proposed changes in accounting rules.

Kish also assisted in the SCAP evaluation of credit card losses. Credit card loans are concentrated in the country’s biggest banks and historically have much higher loss rates, carrying more risk than auto or mortgage loans, he said.

“It was an invigorating time and meaningful work to understand the issues during a low point in the financial market. The stress test was a key turning point in the financial crisis, and the test’s outcome gave the market confidence,” Kish said.

Ali Cannoni, who joined the Bank’s retail risk function about three weeks before the stress test began, was enthusiastic about her role. She previously spent almost two years in the Bank’s Financial Statistics Department, which honed her skills in reviewing bank data and graphical analysis. And now she was tasked with reviewing larger and more complex institutions.

“The banks’ data and the materials they submitted tell a story,” Cannoni explained. It was her job to keep track of the stories through every change to multiple spreadsheets representing hundreds of billions of dollars in off-balance-sheet positions.

Test Results

What did this stringent stress test reveal about the banking industry? The results showed that 10 of the 19 institutions required \$185 billion to ensure adequate capital cushions to absorb losses if the economy were to deteriorate as the adverse hypothetical case suggested. They had 30 days to develop a plan to raise capital (to be approved by supervisors) and were required to implement their plans in six months.

When regulators released the results on May 7, 2009, they also reported that the 10 banks needing capital had already either raised or were contractually committed to raising \$110 billion in capital, leaving \$75 billion to be raised. By the November 2009 deadline, the 10 banks had increased their Tier 1 common equity by more than \$77 billion. They accomplished this primarily by issuing new common equity, converting existing preferred equity to common equity, and selling businesses or portfolios of assets.

Future Implications

The banks' actions to shore up their capital positions helped reassure the financial markets. In March, Fed Governor Daniel K. Tarullo discussed the lessons learned from last year's stress test and how it fostered this reassurance. Most market participants accepted the test as credible, he said, adding that the result bolstered confidence because it helped the market understand that our largest banks could withstand severe economic conditions during a very uncertain time.

The stress test has also demonstrated the benefits of using benchmarking to common standards, highlighted the value in collaborative efforts, and provided a detailed view of the health of the banking system.

"The Federal Reserve System has indicated it will incorporate ideas from the stress test's cross-firm approach but will also retain the traditional supervisory exam process, which relies on examiners' insights at the firm level," Collins said. "Stress testing has evolved from focusing on narrow business lines to encompassing the broader business strategies of the institution," he added. Collins said that he has seen the value of employing a more holistic approach to the supervisory process for the institutions in Philadelphia's District.

What did Philadelphia learn from its role in the stress test? "We have integrated the knowledge and wisdom gained from the stress test into our supervisory approach. Our experience also reinforced that we must continue investing in talented staff with the skills to monitor and mitigate the complex issues in our banking system," Collins said.

The results showed that 10 of the 19 institutions required \$185 billion to ensure adequate capital cushions to absorb losses if the economy were to deteriorate as the adverse hypothetical case suggested.

EXAMINING BANKS, SERVING THE NATION'S FINANCIAL SYSTEM

The Philadelphia Fed's bank examiners provide local knowledge and keen insight that help the Federal Reserve achieve its goal of financial stability. They play a vital role in ensuring that the banks in eastern Pennsylvania, southern New Jersey, and Delaware are pursuing safe and sound business practices and complying with regulations that protect consumers.

Some 160 staff members in the Bank's Supervision, Regulation and Credit Department have supervisory responsibility for 130 bank holding companies and state member banks in the Philadelphia Fed's Third District. Their work helps the Philadelphia Fed assess each bank's risk management systems, financial condition, compliance with laws and regulations, training programs, and internal controls.

Examiners possess unique knowledge of an individual institution's operations, an understanding of the firm's management strategy, and an awareness of the economic environment. And they use their business acumen to ensure that banks build robust risk systems and comply with consumer laws, both of which promote a strong, safe, and sound financial system.

The examiners' knowledge of the local economic environment and their familiarity with local financial institutions enhance their effectiveness as bank supervisors. For example, while commercial real estate values have presented a problem for banks nationally, markets differ widely across local areas. Understanding these differences is critical to evaluating the condition of community banks that

operate primarily within a local market. Similarly, understanding how a particular bank manages its risk enables examiners to better focus on key risks that may affect the bank's consumer compliance and financial soundness.

This local knowledge of a bank's operations and its risk profile helps to identify business trends, underlying economic risks, and emerging regulatory concerns. Further, local insights about the banking environment add to the mosaic of information that Philadelphia Fed President Charles Plosser shares with colleagues on the Federal Open Market Committee (FOMC), the Federal Reserve's main body for monetary policymaking.



William Lang (left) and Michael Collins

DISCOUNT WINDOW REFLECTS CHANGING CREDIT CONDITIONS

An important goal of the Federal Reserve's bank supervision activities is to ensure that banking organizations can meet the credit needs of communities. As the nation continues to recover from a severe recession, many people have expressed concern about the ability of small businesses and consumers to obtain credit.

Banks are the primary source of credit for small businesses, and community banks play a particularly important role in extending credit to small businesses. In turn, small businesses play a key role in economic growth and job creation. Yet, it remains difficult for them to receive and renew credit in the current environment.

"We are working very hard to see that our banking organizations strengthen their financial condition and enhance their management systems so they are able to operate in a safe and sound manner while meeting the needs of businesses and consumers," said William W. Lang, senior vice president and chief examinations officer in the Supervision, Regulation and Credit Department.

"Our examiners' deep knowledge of our banking organizations and the communities they serve helps us to be more effective in accomplishing this task," Lang said.

While businesses and consumers continue to face challenging credit conditions, there have been some positive signs in the tri-state region. During 2009, commercial banks based in the Third District were able to increase their loans to small businesses. Many banks have increased their potential capacity to lend by raising additional capital. In fact, Third District banks raised \$688.7 million in 2009 and \$748 million in the first quarter of 2010.

Throughout the crisis, regulators have urged lenders to make prudent decisions and continue lending to creditworthy borrowers. The Fed also accompanied this guidance with training programs for its supervisory staff and state examiners and with outreach to the broader banking community to ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound small business borrowers.

The 12 regional Federal Reserve Banks play a key role as part of the nation's central bank by serving as lender of last resort and making short-term loans to solvent financial institutions against acceptable collateral. Sometimes such loans are needed simply because the ebb and flow of business may bring more withdrawals than deposits on a given day. In other cases, emergency loans are needed, perhaps after flash floods in a small locale, or major disasters such as Hurricane Katrina, or even after the terrorist attacks of September 11, 2001. The Fed has also served as lender of last resort when other inter-bank markets have stopped because of a deep recession or financial crisis.

In 2009, the Philadelphia Fed was still lending to banks through the discount window far above pre-crisis levels. In 2009, the Philadelphia Fed's discount window made 1,295 loans to depository institutions, including primary, secondary, seasonal, and term auction facility loans. Total cumulative daily loan value was nearly \$7.4 trillion, compared with 437 loans valued at \$2.3 trillion in 2008.

In the first half of 2009, the discount window made 610 loans valued at \$6 trillion, followed by 685 loans valued at \$1.3 trillion to end the year. In November 2009, the Federal Reserve Board, recognizing improvements in financial markets, reduced the maximum maturity of primary credit loans at the discount window for depository institutions to 28 days from 90 days, effective January 14, 2010, and subsequently returned the term to the traditional overnight lending as of March 18, 2010. The Term Auction Facility was suspended in March 2010 because conditions in the wholesale funding markets were improving.

“So while many bankers tell us that Federal Reserve examiners are analytical and tough, few tell us that they are unfair or uninformed about what’s going on in the local economy.”

Ultimately, the challenge for banking supervision is the need to ensure safety and soundness without dampening the competitive spirit. “I think it’s important to make sure that when risks are taken, the bank has strong corporate governance in place because even excellent supervision cannot supplant the bank’s overall management,” explained Executive Vice President and Lending Officer Michael E. Collins.

“Our goal is not to stop banks from taking any risk, since this would prevent banks from serving their critical role in our economy. Balancing these objectives appropriately requires skill, experience, and judgment,” Collins observed.

Evolving Environment for Examiners

The specialized knowledge of the Fed’s examiners is invaluable because it gives the Fed a window into the nation’s economy, banking system, and financial markets. The depth and breadth of resources allows the Fed to see developing trends and growing weaknesses that go beyond looking at firm-specific or geographic issues and focus on imbalances building in the industry or the broader economy that could affect these firms.

Collins, who began his career as a bank examiner at the Philadelphia Fed more than 30 years ago, has witnessed sweeping changes toward this macro-prudential approach in supervisory practices. He noted that supervisory tactics now focus on a continuous evaluation of a bank’s condition and rely more on stress tests and the expanded use of market data and forward-looking assessments.

Examiners complete a rigorous training regimen focused on one of two distinct disciplines: safety and soundness or consumer compliance. Specialized training for each includes on-site instruction, classroom work, and several levels of competency tests spanning a three- to five-year period, depending on the examiner’s intended specialty. Once employees receive an examiner’s commission, they embark on a continuous learning track to enhance their credentials. They also work extensively with an experienced team of examiners before they advance to lead a team on their own.

Although there is no one model or personality preferred for examiners, those who hold this position share common goals and similar backgrounds. Some examiners hold degrees in accounting, finance, or law, and all are expected to demonstrate an ability to think critically, communicate effectively, and negotiate skillfully.

These analytical skills serve them well in the field. In fact, Federal Reserve Chairman Ben Bernanke said in a recent speech, “So while many bankers tell us that Federal Reserve examiners are analytical and tough, few tell us that they are unfair or uninformed about what’s going on in the local economy. We believe that this kind of response speaks to the effectiveness of our supervisory program for community banks, and we take pride in the professionalism and quality of our community bank examiners.”*

* Ben S. Bernanke, “Preserving a Role for Community Banking,” speech at the Independent Bankers of America National Convention, Orlando, FL, March 20, 2010.

CONSUMER COMPLIANCE OUTLOOK: AN AUTHORITATIVE SOURCE FOR FINANCIAL INSTITUTIONS

In recent years, the Federal Reserve Bank of Philadelphia has recognized the need for an authoritative source of information to help financial institutions comply with consumer protection laws and regulations. In response, the Philadelphia Fed's Supervision, Regulation and Credit Department (SRC) launched *Consumer Compliance Outlook*® in May 2008.

Why Philadelphia? The magazine traces its roots to *Compliance Corner*, a section in the Bank's *SRC Insights* that was devoted exclusively to consumer compliance issues. As the insert gained popularity and compliance issues continued to become more important, SRC realized that a larger and more comprehensive newsletter with nationwide distribution was needed.

"The timing of this publication was perfect. There was a wealth of things to write about in the consumer compliance world. There was an audience, there was a need, and we had the talent and expertise here in Philadelphia to serve that need," said Connie Wallgren, assistant vice president, SRC.

Although *Outlook's* roots lie in the Philadelphia Fed, the publication is a System-wide effort. Philadelphia chairs the publication's Advisory Board, which also includes officers from the Minneapolis, Richmond, and San Francisco Federal Reserve Banks. This collaborative effort has been very successful. Recently, the System's Consumer Compliance Management Group (CCMG), consisting of Reserve Bank officers with responsibility for compliance, voted *Outlook* as the CCMG's most successful initiative of the last five years.

Now in its second year, *Consumer Compliance Outlook* has increased online subscriptions to more than 3,500 nationwide. Since the second quarter of 2008, both electronic and hard-copy subscriptions (which are sent to state member banks and bank holding companies) have increased significantly. Banks, credit unions, and savings and loan institutions make up 90 percent of the magazine's electronic readership. In addition, *Outlook* has received several requests to reprint articles.

Ultimately, *Outlook's* goal is "to help protect consumers by educating bankers about the compliance requirements for the consumer protection laws and regulations with which they must comply," explained Ken Benton, senior consumer regulations specialist, SRC.



Standing: Ken Benton and Robin Myers.
Seated: Connie Wallgren

PROVIDING RELIABLE INFORMATION ON THE ECONOMY

The BOS's more timely measures of activity in the local manufacturing sector often serve as indicators of changes in the national economic picture.

In 2009, policymakers, consumers, and other market participants sought reliable information about the state of the economy. In particular, they were looking for signs that the recovery from the severe recession was underway. The Research Department's surveys and indexes played a significant part in providing the needed economic information.

Business Outlook Survey

One main source of information was the Business Outlook Survey (BOS), a monthly compilation that tracks developments in the Third District's manufacturing sector by gathering information on such variables as new orders, shipments, inventories, employment, prices paid and received, unfilled orders, and delivery times.

According to Michael Trebing, senior economic analyst, the BOS's closely watched general activity index has generally dipped into negative territory and returned to positive readings remarkably close to the start and end dates of past recessions. The National Bureau of Economic Research (NBER) is the arbiter of such business cycle dates; however, it makes those determinations with significant lags. The BOS's more timely measures of activity in the local manufacturing sector often serve as indicators of changes in the national economic picture.

In the most recent recession, the BOS's general activity index went below zero in December 2007 — the date the NBER eventually marked as the start of the current recession. The number reached zero in August 2009 and turned positive again the following month. "The BOS is a serious barometer of both the regional and the national economy," said Trebing, who noted that on or near the third Thursday of the month — the survey's release date — he gets phone calls and e-mail from analysts, economists, and forecasters from around the world.

Policymakers also watch the survey because it provides significant information about the economy in the Third District and reflects conditions in the national manufacturing sector. Why does a survey of manufacturing firm executives in Delaware, southern New Jersey, and eastern Pennsylvania get so much attention? There are several key reasons:

- The manufacturing sector is more sensitive to changes in the business cycle, and therefore, changes in this sector can serve as an indicator of cyclical fluctuations in the whole economy as they develop.
- Also, manufacturers in this District are a diverse group, mirroring the nation's manufacturing sector, and many of these firms serve national markets or

have plants in other parts of the country. In addition, some of the respondent firms manufacture goods that are used as inputs for other firms that operate in the national market.

- Furthermore, data for the survey results are collected over the first two weeks of the month, so the survey provides an early reading of that month’s manufacturing data. This early reading leads many analysts to use the BOS numbers to predict the results of the monthly Institute for Supply Management’s (ISM) survey, which measures manufacturing activity at the national level. The ISM survey is usually released about two weeks after the BOS.

About 10 years ago, the BOS began to include special questions on topics related to current events in the economy, such as how the recession was affecting capacity utilization, or the economic impact of key events such as the September 11th terrorist attacks and Hurricane Katrina.

Coincident Indexes

Market participants are not just interested in how the national economy is faring. The economic fortunes of the individual states are also important when business owners, government officials, or households make decisions.

To help track economic activity at the state level, the Research Department’s regional section has developed monthly coincident indexes for each of the 50 states. The indexes summarize current economic conditions based on four variables: nonfarm payroll employment, average hours worked in manufacturing, the unemployment rate, and wage and salary disbursements. They provide information about the states’ individual business cycles, which are not necessarily in sync with the national business cycle.

Public interest in the coincident indexes increased in 2009 as users turned to these regional



Left to right: Keith Sill, Jason Novak, Tom Stark, and Mike Trebing

The national economy and the statistics that track it are really just aggregations of many smaller and unique economies. By studying the state coincident indexes, an analyst can see important trends that may predict national movements.

indexes to gauge their states' performance during the recession. The indexes offered a look at the recession from different vantage points: Indexes for coastal states with overheated housing markets showed substantial declines in economic activity, while the Plains states had less severe downturns. While our indexes suggest that some states are likely to have continued stress in 2010, they are pointing to improved activity in several other states.

"The national economy and the statistics that track it are really just aggregations of many smaller and unique economies. By studying the state coincident indexes, an analyst can see important trends that may predict national movements," said Jason Novak, senior economic analyst.

Survey of Professional Forecasters

The Real-Time Data Research Center in the Bank's Research Department is responsible for administering and compiling the results of the Survey of Professional Forecasters (SPF), a quarterly survey of forecasters from around the country. It's the oldest quarterly survey of macroeconomic forecasters in the U.S.

The SPF asks participants to project the course of 24 economic variables, including gross domestic product (GDP), inflation, and unemployment. The survey also asks its participants to indicate the degree of uncertainty in their projections: Knowing the uncertainty of a forecast can sway an economic policy decision.

"For example, a projection of strong growth paired with a strong degree of certainty could lead to a decision that is radically different from one made when that same forecast is paired with a strong degree of uncertainty," said Thomas Stark, assistant director and manager in the Real-Time Data Research Center.

In fact, in 2009, the Research Department, in conjunction with the Board of Governors, added questions to the survey to elicit further information about measures of uncertainty in the forecasters' projections. As explained by Federal Reserve Governor Daniel Tarullo in congressional testimony, the information collected with these questions helped to provide the Federal Reserve System with "better assessments of the likelihood of severe macroeconomic outcomes." The forecasts collected in the SPF were then used to help design the economic scenarios for the Supervisory Capital Assessment Program, or stress test, conducted by the Fed and other federal bank regulatory agencies in 2009. The questions were so useful that the Philadelphia Fed decided to keep them in the 2010 surveys to help the Federal Reserve System in its banking supervision and monetary policy work.

Like the other surveys and indexes produced by the Research Department, the SPF can offer early signs of the economy's direction. In fact, the SPF was hinting that all was not right in the economy as early as 2006. "Late in 2006 the survey's well-known measure of the risk of a downturn in real GDP — the anxious index — began to signal increasing levels of risk," said Stark. "This was a year

ahead of the peak in the expansion and two years ahead of the NBER's December 1, 2008, announcement that the peak had occurred in December 2007. The index continued to signal rising risk levels over the period leading up to the beginning of the recession. More recently, the anxious index has retreated to levels that are consistent with the early stages of a recovery."

Aruoba-Diebold-Scotti Business Conditions Index

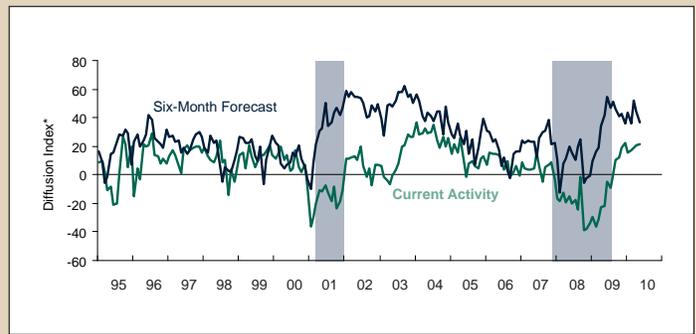
In January 2009, the Real-Time Data Research Center began publishing the ADS business conditions index, which tracks real business conditions using real-time data based on indicators such as weekly initial jobless claims, monthly payroll employment, and quarterly real GDP. Named for its developers (economists Boragan Aruoba, Frank Diebold, and Chiara Scotti), the ADS summarizes economic conditions using a blend of high-frequency and low-frequency information.

"We receive a large amount of data about the economy over time — things like industrial production, retail sales, unemployment data, and GDP. And these data come out at different times — weekly, monthly, and quarterly. The ADS summarizes a subset of that mixed-frequency data to provide information on the state of the economy. It gives us a snapshot of the economy in real time," said Keith Sill, assistant vice president and the center's director.

Summary

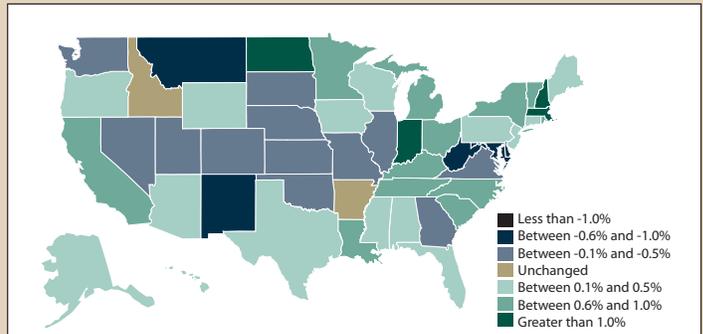
Together, the Business Outlook Survey, the coincident indexes, the SPF, and the ADS — along with the other surveys, indexes, and analyses produced by the Research Department — contribute substantially to satisfying the ongoing demand for current and forward-looking information about the economy.

Current and Future General Activity Indexes (January 1995 to May 2010)

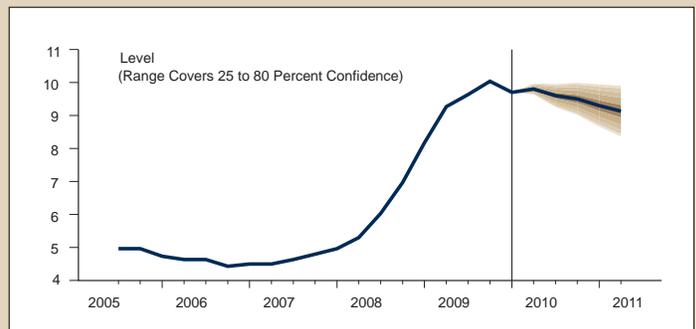


* Percentage of respondents indicating an increase minus percentage indicating a decrease.

State Coincident Indexes: Three-Month Change (March 2010)

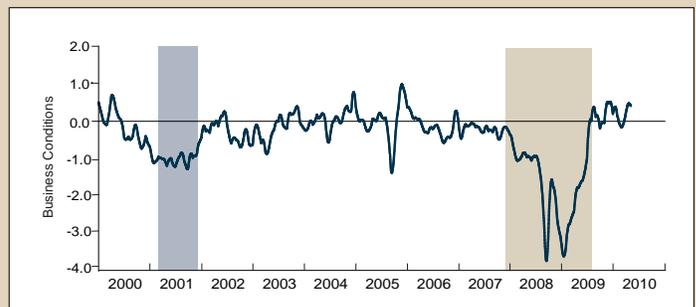


Survey of Professional Forecasters: Unemployment Rate History, Forecast, and Ranges for the SPF of 2010:02



The vertical line marks the last historical quarter known by the panelists when they made their projections. The survey's consensus projection appears to the right of the vertical line. The range is based on the survey's historical forecast record over the period since 1985.

Aruoba-Diebold-Scotti Business Conditions Index (1/1/2000 - 5/08/2010)



The ADS Index using the latest data available as of May 14, 2010. Blue shading indicates historical NBER-designated recessions. Tan shading indicates the recent recession, designated by the NBER to have started in December 2007 but not yet designated by the NBER to have ended (as of the date of creation of this figure). We end it in July 2009, which appears likely conditional on information presently available, but we use tan as a reminder that our dating is not official.

SUPPORTING CONSUMERS, COLLABORATING WITH COLLEAGUES

In 2009, the Federal Reserve System's Conference of Presidents continued to work on the Mortgage Outreach and Research Efforts (MORE). MORE's goal is to encourage a coordinated and collective understanding of mortgage delinquencies and foreclosures and their impact on communities.

Speaking at the December 10, 2009, Mortgage Foreclosure Policy Conference, Federal Reserve Governor Elizabeth A. Duke said, "At the Board of Governors in Washington, and at the regional Federal Reserve Banks across the country, we are providing data and bringing together different parties from the private, public, and nonprofit sectors to encourage strategies for refinance, loan modification, short sales, and other alternatives to prevent foreclosures." The knowledge of many, brought together as one, can have considerable impact on the nation's response to the mortgage crisis.

Several Philadelphia Fed departments are supporting the MORE initiative. Research; Supervision, Regulation and Credit; and the Payment Cards Center (PCC), along with Community Affairs, have pooled their resources to develop research papers, host conferences, and provide information for the Bank's website to help consumers and communities affected by foreclosures.

Conference on "Understanding the Housing and Mortgage Markets: What Data Do We Have? What Data Do We Need?"

This conference, co-sponsored by Community Affairs and the PCC, focused on issues such as the types of data currently available and their shortcomings, the data elements most critical for understanding the mortgage and housing markets, and a range of other topics that must be considered in developing better databases. Panelists included users of state and local data and government officials who have been involved in efforts to improve the quality of these data.

Although Community Affairs fosters public-private partnerships that result in increased affordable housing and community development, the mortgage market was a new area of research for the PCC. But both areas recognized the strong links between the mortgage crisis and other consumer credit markets and the value in collaborating on this joint project. Harriet Newburger, community development research advisor, Community Affairs Department, explained the need for such an event: "The lack of readily accessible data on the mortgage market negatively affected the ability to predict how severe the mortgage crisis and its spillovers would be. It has also hampered efforts to alleviate the effects of the crisis."



Harriet Newburger (left)
and Erin Mierzwa

Many of the lessons learned at this event have already contributed to changes in the way the Federal Reserve System uses and shares mortgage-related data for the purposes of risk assessment, foreclosure mitigation, and research.

Pennsylvania's Lowest-Income Renters Have the Greatest Needs

Nearly 85 percent of Pennsylvania's extremely low-income (ELI) renter households spend more than 30 percent of their income on housing and 69 percent spend more than 50 percent. There is also a severe shortage of affordable and available rental housing across the state for ELI renters. These findings and more are reported in a study conducted last year by Erin Mierzwa, community development specialist, Community Affairs, and Kathryn P. Nelson, an affordable housing consultant, along with Harriet Newburger, also in Community Affairs.

The study is particularly relevant because approximately 30 percent of all Pennsylvania households are renters with access to a limited supply of available and affordable housing. The study provides local policymakers with solid data they can use to help develop local rental housing strategies.

Concentrated Poverty and Atlantic City's Future

In 2008, Community Affairs offices in the Federal Reserve System, including the Philadelphia Fed, undertook a joint research project with the Brookings Institution's Metropolitan Policy Program that examined 16 American communities characterized by extreme poverty. The Philadelphia Fed's part of this System-wide study concentrated on several census tracts within Atlantic City, New Jersey. The report highlighted the workforce paradox of plentiful jobs co-existing with high rates of poverty and unemployment. The researchers also identified concerns that residents have about their neighborhoods and their future status in Atlantic City.

The larger System report piqued the Community Affairs staff's interest in Atlantic City and led them to take a closer look. The result was *Atlantic City: Past as Prologue*, a fuller study that covers the growth and decline of Atlantic City and the conditions in the city since casino gambling was legalized in 1978 as a "unique tool of urban redevelopment." The research team consisted of Harriet Newburger and John Wackes, both in Community Affairs, and Anita Sands, ARI Planning and Research, Inc.

A presentation of the study's findings to Atlantic City officials and other interested parties has led to a number of initiatives, including collaboration between the Atlantic City school system and Wells Fargo Bank on a program to promote financial literacy (the bank chose Atlantic City as its East Coast site for rolling out

Nearly 85 percent of Pennsylvania's extremely low-income (ELI) renter households spend more than 30 percent of their income on housing and 69 percent spend more than 50 percent.

the program) and development of a course at Atlantic City's Stockton College based on the report.

Other Efforts to Help Consumers

Community Affairs also hosted several events on the "Making Home Affordable" loan program, foreclosure scams, and mortgage foreclosure diversion programs. These meetings were organized by the department in conjunction with the Greater Philadelphia Urban Affairs Coalition's Foreclosure Prevention Task Force and the Financial Education Network, a group of financial educators. The goal of the meetings was to help housing, credit counseling, and other nonprofits, financial institutions, and government agencies understand the programs that are available to help borrowers avoid foreclosure.

In addition, the Federal Reserve Board of Governors developed "5 Tips," a public service campaign to give consumers the basic information they need to recognize and avoid foreclosure prevention scams. The Philadelphia Fed supported the campaign by distributing tip sheets to all branches of the Free Library of Philadelphia; offices of the Special Supplemental Nutrition Program for Women, Infants, and Children; and military bases located in the Third District. The Bank also promoted the tip sheets on its website and made copies available to employees.

BANKING ON COLLABORATION



In 2005, the Philadelphia Fed created the Program in Consumer Credit and Payments (PCCP), an interdepartmental initiative to analyze a broad range of issues related to consumers' use of payment instruments and credit. The program

is coordinated by the Payment Cards Center (PCC), which combines its resources with those of the Research, Community Affairs, and Supervision, Regulation and Credit (SRC) departments. In light of the financial crisis, there has not been a better time for bank staff to work together to better understand and address issues affecting millions of consumers.

In 2009, the PCCP launched a series of interactive web pages on the Bank's intranet to facilitate this collaboration. In addition to a calendar of events, the web pages have a sortable library with links to papers, articles, speeches, and presentations. The pages also allow members to recommend or discuss papers or events, e-mail the entire PCCP member list, or query

other members. Collaborative tools such as these provide employees with the means to work together more effectively and efficiently.

Another development was the creation of a consumer credit data analysis function. This function is housed in the PCC but supports researchers elsewhere in the Bank who are working with large and complex micro data sets on consumer credit and payments.

One outgrowth of the PCCP is an increase in published research by staff from a number of departments and an increase in joint programming on timely issues. For example, in 2009, the PCC and the Community Affairs Department organized a conference on data limitations that interfere with our understanding of mortgage and real estate markets and the efforts required to overcome those limitations. The PCC and SRC co-sponsored a workshop on advances in mortgage risk models. In addition, the PCC and the Research Department held the fifth biennial conference on Recent Developments in Consumer Credit and Payments.

REACHING THE END OF AN ERA IN CHECK PROCESSING

On December 11, 2009, the Philadelphia Fed successfully completed its role in the multi-year restructuring of paper check-processing operations within the Federal Reserve System. As of that date, all paper check-processing operations here migrated to the Cleveland Fed, ending nearly a century of processing paper checks in Philadelphia.

In 2003, the Federal Reserve Banks announced plans to significantly reduce the System's 45 locations for processing checks, as consumers, businesses, and banks grew less dependent on cancelled paper checks. The Check Clearing for the 21st Century Act of 2003, popularly known as Check 21, promoted the greater use of electronic processing of check images rather than the return of an actual check. This legislation, plus greater use of electronic payments, led to a major reduction in the number of paper checks processed throughout the industry. Today's consumers are more apt to pay by debit or credit card for their "in person purchases" and are increasingly relying on Internet purchases and online banking and bill paying.

In November 2008, the Federal Reserve accelerated the restructuring of its national check processing and announced it would consolidate to a single location for paper check processing in Cleveland and a single location for electronic check processing in Atlanta. On February 26, 2010, the Atlanta Fed moved its paper check-processing operations to Cleveland to complete the restructuring.

For the past few years, Philadelphia had been one of four main consolidation sites during the check-restructuring project. In 2006, the Bank completed the first transition by assuming the check-processing operations of the New York Fed's main office. During 2008, Philadelphia assumed check-processing operations from the New York Fed's Utica, N.Y. office and the Boston Fed's location in Windsor Locks, Conn. Finally, Philadelphia consolidated the check-processing function of the Richmond Fed's Baltimore branch in April 2009, before it began planning to transfer operations to Cleveland.

Over the past decade, the Philadelphia Fed's check-processing operations made major changes in workflow to handle an increasing number of electronic checks, including the addition of high-speed printers for printing substitute checks. Philadelphia retains a small team to convert electronic check images to print for depository institutions in its territory that have not yet converted their operations to receive check images electronically.

Today's consumers are more apt to pay by debit or credit card for their "in person purchases" and are increasingly relying on Internet purchases and online banking and bill paying.



Through most of its check-processing history, the Philadelphia Fed was the largest and most innovative check-processing office. Philadelphia made major contributions to advance automated check-processing software developments and offer value-added services to its customers. Check operations peaked in 1999 with an average daily check-processing volume exceeding 4.5 million checks, representing more than \$7 billion in value. At the time, the Federal Reserve System cleared about a third of more than 42 billion checks written annually.

Check Processing in Philadelphia



1910s

In 1917, the Bank reports a daily average of 37,500 checks, totaling \$23.7 million. Checks are sorted by hand on tabletops.

1920s

By 1922, the Bank processes an average of 200,000 checks a day. In 1928, a County Clearinghouse Plan features one-day check clearing to help eliminate check-kiting in the areas outside the city clearinghouse zone.

1940s

The Bank introduces the IBM 803, a mechanical sorting machine about the size of an industrial washing machine and almost as noisy. In 1944, the Bank processes more than 186 million checks, with about a quarter of the volume directly connected to the war effort.



1950s

The industry develops a magnetic ink character recognition (MICR) system for encoding check data, so data could be read electronically.

1960s

In 1961, the Bank installs the first computer-controlled check processing system, CHIPS (Check Handling Information Processing System). By 1964, the Bank is processing 1 million checks a day.



"We salute the hundreds of Federal Reserve Bank of Philadelphia employees and officers who contributed to an efficient check-processing operation through the years, and we especially thank the staff who served with distinction through this challenging period of restructuring," said Arun Jain, senior vice president, who oversaw the department's work.

The successful completion of check restructuring is the latest milestone on a journey to provide the nation with an efficient payment system, as shown on the accompanying timeline of nearly a century of check processing in Philadelphia.

1970s

In 1974, the Bank implements a regionalization plan to provide improved services to distant Pennsylvania banks, with other banks handled by the City-Delaware-New Jersey region. By 1975, the Bank is processing approximately 2.5 million checks a day.

1980s

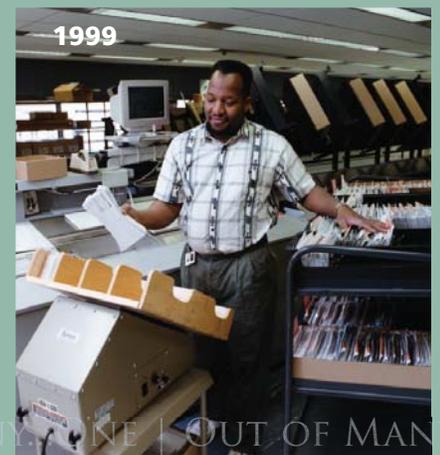
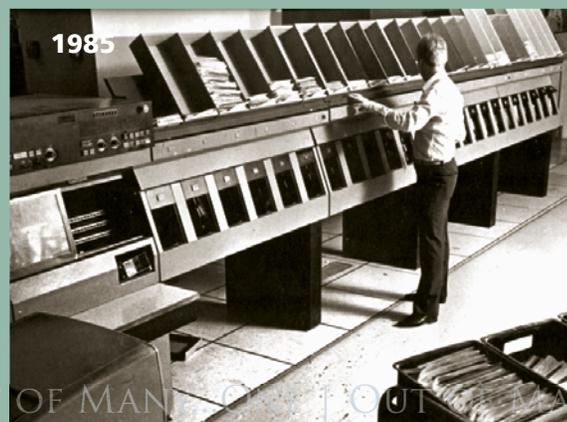
In 1980, the Monetary Control Act requires the Fed to charge depository institutions for financial services, including check processing, which prompts the drive for greater efficiencies. In 1984, the Bank installs five high-speed IBM 3890 MICR readers/sorters, which are capable of sorting 2,000 checks a minute. Meanwhile, businesses expand the use of automated clearinghouse (ACH) electronic payments.

1990s

In 1993, nearly 90 percent of the nation's payment transactions still involve checks, but ACH and payment cards are growing quickly. By the mid-1990s, the Bank is leading the Federal Reserve System's efforts to standardize check-processing equipment and software platforms. It also converts from a District-unique application to the centralized FedACH system for electronic payments.

2000s

In 2001, the Bank clears 1.4 billion checks out of a total of about 42 billion written that year. In 2006, Philadelphia assumes the role of a key consolidation site for check-processing operations. On December 11, 2009, the Philadelphia Fed sorts its last check as operations move to the Cleveland Fed.



2009 BANK HIGHLIGHTS



Audit

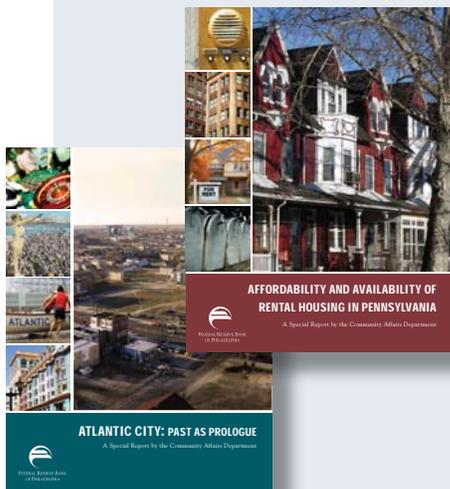
The Audit Department hosted a two-day symposium entitled “The R.I.S.K. Environment: Responsibility, Innovation, Strategies, and Knowledge.” The symposium provided Bank staff with continued professional development through information sharing and interaction with Bank, professional, and community leaders. Approximately 30 participants heard speakers from the Bank, Cotton & Company, the Federal Bureau of Investigation, and other Reserve Banks and Federal Reserve Information Technology. In addition, Philadelphia Fed director Ted Peters, chairman and chief executive officer, Bryn Mawr Trust Company, discussed the role of the Audit Committee. The department also hosted a visiting senior information technology auditor from the Bank of Lithuania to observe an information technology audit in process. The visitor had attended the department’s Regional Workshop on Internal Audit of Central Banks and Financial Sector Regulatory Authorities. Since that time, the department has engaged in discussions regarding opportunities for sharing best practices between the two Audit departments.

Cash Services

In 2009, the currency counting division completed a major upgrade to the eight high-speed currency-processing machines. This effort included both software and hardware updates with many technological advances for throughput and efficiency. Each upgrade required rigorous testing and significant retraining of staff and management. Also, Cash led several work groups to improve operational planning in the areas of cash training, business continuity, and the receipt and destruction of contaminated currency.

Community Affairs

The department continued to support the Federal Reserve System’s Mortgage Outreach and Research Efforts by hosting a conference for regulators and academic researchers on data requirements for better understanding housing and credit markets. In addition, department staff collaborated with staff at the Board of Governors to create a questionnaire for all 12 Reserve Banks to survey recipients about their use of federal Neighborhood Stabilization Program funds. Other accomplishments include the publication of *Atlantic City: Past as Prologue*; *The Affordability and Availability of Rental Housing in Pennsylvania*; and *Alternative Financial Service Providers and the Spatial Void Hypothesis: The Case of New Jersey and Delaware*. The department’s longitudinal study of the effectiveness of homeownership counseling continued with 897 participants. The department’s economic education staff reached over 700 teachers with courses designed to help K-12 school teachers understand economic concepts, the Federal Reserve System, monetary policy, and personal financial education. Furthermore, economic education staff developed six new lessons with the St. Louis Fed for use in the classroom.



Enterprise Risk Management

Philadelphia’s ERM officer provided System leadership by co-chairing the International Operational Risk Working Group conference and led presentations on risk reporting and business continuity. The department officer also made a presentation at a business continuity program sponsored by the Center for Latin American Monetary Studies. In addition, the

department introduced the Innovation Forum, a program designed to encourage employees to think innovatively and to share their ideas with the Bank population.

Facilities Management

The Facilities Management Department oversaw the completion of construction for the Bank's off-site screening facility. The new building, which officially opened in October 2009, is used for screening general delivery trucks, check courier vehicles, and armored carriers before the vehicles proceed to the main Bank building. The department also continued its efforts to make the Bank more environmentally friendly, in particular through a pilot program to replace all of the fluorescent light fixtures in the Bank with energy-efficient ones.



Financial Management Services (FMS)

Staff in FMS chaired several System groups, including the COSO Coordinators Group, the Cost Accounting Group, the Enterprise Risk Management Group, and the Government Entity Accounting Reporting System Management Steering Group. FMS also acted as trustee chair for the Accounting Professional Education Program. In her role as chair of the Enterprise Risk Management Group, the Bank's chief financial officer led an effort to review and develop recommendations to enhance the System's original enterprise risk management framework, which was developed in 2004.

Financial Statistics

In 2009, Financial Statistics staff continued to provide superior analysis to ensure the accuracy and quality of incoming data used by Federal Reserve policymakers responding to credit market disruptions and changing economic conditions. Many staff members made important contributions to the Federal Reserve System's Statistics and Reserves Technology Modernization Project, to management and enhancement of existing technology applications and business processes, and to System-level training initiatives.

Human Resources

Human Resources continued its leadership of the strategic effort to implement a talent management program. In 2009, work focused on educating employees about the new core competency model. To support the talent management program, HR introduced a new e-performance module. HR developed an employment brand identity for the Bank by creating an onboarding Internet site for use by potential new hires. The department also expanded its participation in diversity recruiting fairs. All functions within HR supported the downsizing of operations in Retail Payments by providing counseling services, outplacement support, job search workshops, and other transition support services. HR partnered with other departments to develop a Bank-wide community service and volunteer initiative. The mission of this effort, called PhillyFedCARES, is to recognize and publicize the individual and group volunteer efforts of Bank employees.



Information Technology Services

IT Services managed scores of internal Bank projects, supporting most business lines, and provided significant support to the Federal Reserve System and the Treasury. Major IT leadership assignments included enhancements to collateral management systems, software quality assurance services for major projects throughout the Federal Reserve System, and a proposal to rework the architecture of the Federal Reserve's network infrastructure (for voice, data, and video). A Bank-wide wireless system was implemented to comple-

2009 BANK HIGHLIGHTS



ment the traditional local area network (LAN) connections. The Groupware Leadership Center (GLC) actively supported the development and promotion of a national IT Services strategic plan and deployed major new releases of collaboration technologies, including e-mail and integrated instant messaging, team workplace sites, and enterprise social networking. An important new video conferencing technology called telepresence was piloted at the Board of Governors and the Richmond, Dallas, and New York Feds. The video conferencing team is overseeing installation of telepresence rooms at other Reserve Banks.

Law Enforcement

The Law Enforcement Department has integrated the off-site screening facility into its security operations. It has also completed a major renovation and technology upgrade of the department's control center and video surveillance security system.

Legal

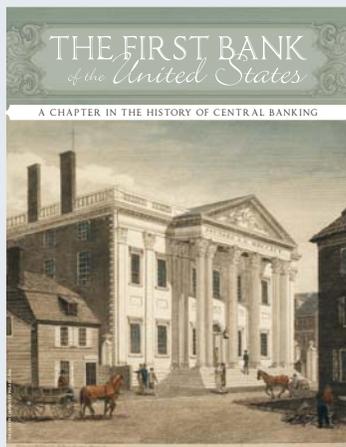
The Bank's general counsel continued to chair the System's Subcommittee of Ethics Officers, which provides information, guidance, and support to the ethics programs of all the Reserve Banks. As chair, the general counsel worked with other Reserve Bank attorneys on drafting new financial disclosure forms to be used by the presidents and economists with regular and ongoing access to Class I FOMC information. The general counsel also headed a work group of Reserve Bank attorneys that organized a training session open to all Reserve Bank attorneys. A department officer continues to provide legal support to the System's Groupware Leadership Center. Another officer serves as the legal liaison to the System's Workers' Compensation Coalition. A third officer is working with Board attorneys on a System-wide litigation project.

Payment Cards Center

The Payment Cards Center organized three important meetings in 2009. The first, co-sponsored with the Bank's Community Affairs Department, brought together participants from the academic, government, nonprofit, and for-profit sectors to discuss the need for better collection and dissemination of housing- and mortgage-related data for the purposes of supervision, mitigation, and state-of-the-art research. The second examined the current state of the credit counseling industry as it attempts to respond to the financial crisis and the rapid growth of for-profit debt-settlement companies. The third, co-sponsored with the Bank's Research Department, brought together 75 scholars to discuss the latest research on consumer credit and payments. In addition, the center welcomed a new director in 2009.

Public Affairs

The Public Affairs Department published *The First Bank of the United States: A Chapter in the History of Central Banking*, a booklet that will be used by teachers using the Bank's economic education programs nationwide. The department also helped promote Community Affairs' work in support of the System's Mortgage Outreach and Research Efforts (MORE). In addition to gaining publicity in traditional media, the Public Affairs team placed the Bank's 2005 video, "Buried by Debt: The Dangers of Borrowing," as streaming video on the Bank's website and on YouTube. The department also began a



multi-year project to redesign the Bank's intranet to incorporate tighter integration with the Groupware Leadership Center's collaboration tools. Public Affairs also welcomed more than 31,000 people to the "Money in Motion" exhibit in 2009.

Research

In January, the Research Department helped to organize a meeting on regulatory reform that brought together academic experts on financial regulation with Federal Reserve presidents and Governors. The director of research spent four months at the Board of Governors as a visiting Reserve Bank officer in the Division of Monetary Affairs. Department staff provided assistance to the city of Philadelphia and the Greater Philadelphia Chamber of Commerce on budget and economic analysis, to the U.S. Bureau of Labor Statistics and Statistics Canada on measuring rents and intangible assets, and to the European Central Bank on conducting business surveys. The department appointed a full-time director for its Real-Time Data Research Center. The Survey of Professional Forecasters, which is produced by the center, provided forecasts used in the Supervisory Capital Assessment Program (the so-called stress test) and center staff worked with staff at the Board to add questions to a survey that will aid in bank supervision. Research continued to produce a number of business surveys, including the Business Outlook Survey, which is used as an indicator of regional as well as national manufacturing activity. (See page 30.) The department sponsored the eighth Philadelphia Fed Policy Forum, and Research staff organized several conferences that covered such topics as international trade, macroeconomics and monetary economics, quantitative macroeconomics, and consumer credit and payments.

Retail Payments

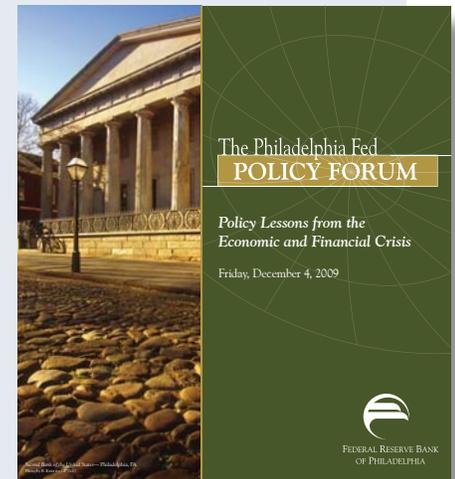
Philadelphia's Retail Payments Department successfully consolidated the check-processing operations of the Richmond Fed's Baltimore office to Philadelphia. The department then completed the move of paper check-processing operations from Philadelphia to Cleveland at year-end, ceasing check-sorting operations after more than 90 years of service. High-speed printing of image replacement documents and shipping to thousands of endpoints from Virginia to Maine continue.

Supervision, Regulation and Credit Department (SRC)

SRC provided active leadership in the Supervisory Capital Assessment Program (also called stress test; see page 22). The department also collaborated with staff at the Board of Governors to develop additional questions for the Quinquennial Survey of Finance Companies and supported the Board by providing quarterly briefings on the state of the credit card market. In addition, two SRC officers assumed high-profile assignments and assisted System efforts pertaining to compliance and Treasury issues. Department staff held a series of Directors' Workshops, hosted its annual All-Staff Conference, and organized and hosted the Partnership for Progress annual meeting, "Keeping Minority Institutions Viable." The department provides ongoing leadership for *Consumer Compliance Outlook*[®], a consumer protection publication for the Federal Reserve System, which saw a material rise in subscriptions in 2009.

Treasury Services

In 2009, the Bank's Treasury Services Department provided guidance to the Federal Reserve System on collateral management issues and introduced important enhancements to the Collateral Management System, including the daily pricing of collateral holdings. The department also provided leadership in developing requirements for implementation of the Payment System Risk (PSR) policies.



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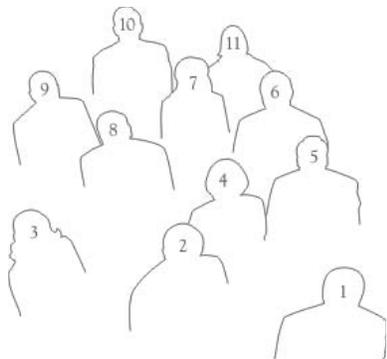
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David Wenger

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SENIOR STAFF



The Bank's senior staff consists of Charles I. Plosser (1), President; William H. Stone, Jr. (2), First Vice President; and other key senior officers: Michael E. Collins (6), Executive Vice President and Lending Officer; Richard W. Lang (8), Executive Vice President; Loretta J. Mester (4), Senior Vice President; D. Blake Prichard (10), Executive Vice President; Donna Franco (11), Senior Vice President and Chief Financial Officer; Mary Ann Hood (7), Senior Vice President; Arun Jain (5), Senior Vice President; William W. Lang (9), Senior Vice President; and Milissa Tadeo (3), Senior Vice President.

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Executive Vice President

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Mary Ann Hood
Senior Vice President & EEO
Officer
Human Resources

Arun K. Jain
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Retail Payments

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Examinations Officer
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Financial Services Industry
Relations Officer & Assistant
Secretary
Customer Relations

Keith Morales
Information Technology Services
Officer
Information Technology Services

Wanda Preston
Supervision, Regulation & Credit
Officer
Supervision, Regulation & Credit

Gregory Ramick
Wholesale Product Office
Officer
Wholesale Product Office

Gail L. Todd
Credit Officer
Supervision, Regulation & Credit

*Includes promotions through
March 2010*

OPERATING STATISTICS

In 2009, Philadelphia's total volume of commercial checks processed decreased 67 percent, and the dollar value of transactions decreased 73 percent. These decreases were the result of the general decline in check processing in the nation's payment system due to the increased use of Check 21 image exchange by financial institutions. As of December 11, 2009, Philadelphia's paper check operation was consolidated into the Cleveland check operation. This marked the completion of over 90 years of paper check processing by Philadelphia within the Federal Reserve System. Philadelphia has now made the transition to a substitute check print and distribution site for 2010.

The volume of commercial checks received as Check 21 electronic images increased 5 percent in 2009. The total paper and electronic items processed declined nationwide due to continued declines in check writing. At this stage, increases in electronic volume are the result of more institutions, particularly credit unions and smaller community banks, using Check 21 image exchange rather than depositing paper checks. However, the overall Check 21 dollars processed in 2009 declined 12 percent because some large correspondent institutions with large dollar value transactions exchanged images directly with other correspondents via clearinghouse arrangements.

In August 2008, all government check volume was consolidated at the St. Louis Reserve Bank. As a result, Phila-

delphia did not have any government check volume to report in 2009.

In 2009, Philadelphia continued to be a major processor of cash in the Federal Reserve System, although the volume of currency processed decreased 5 percent because of improvements in financial institutions' cash-handling practices. Because the Bank processed a greater proportion of smaller denomination notes, the actual dollar value of currency processed decreased by a more significant margin (18 percent). In 2009, the volume of coin bags processed on site increased 13 percent, and the value of processed coin increased 15 percent because of an overabundance of coin in the District resulting from the 11th year of the State Quarters program, during which the U.S. Territories were added to the program, and the issuance of new commemorative coins.

In 2009, discount window lending increased significantly, both in the number of loans and the value of loans advanced by the Reserve Bank. The financial turbulence and the tightening of liquidity in the economy resulted in many depository institutions relying on the discount window as a source of funds to meet their liquidity needs. In addition to the normal lending programs (i.e., primary credit), financial institutions also took advantage of the new lending programs introduced by the Federal Reserve, such as the Term Auction Facility (TAF).

SERVICES TO DEPOSITORY INSTITUTIONS

	2009 Volume	2009 Dollar Value	2008 Volume	2008 Dollar Value
Check services:				
Commercial checks –				
Paper processed	182.1 million checks	\$300.0 billion	554.8 million checks	\$1,094.3 billion
Check 21 received	1.2 billion checks	\$2,198.0 billion	1.2 billion checks	\$2,509.1 billion
U.S. government checks	-	-	40.9 million checks	\$47.7 billion
Cash operations:				
Currency processed	1,702.7 million notes	\$23.7 billion	1,793.2 million notes	\$29.0 billion
Coin paid and received	459.0 thousand bags	\$215.1 million	404.9 thousand bags	\$187.5 million
Loans to depository institutions during the year	1,295 loans	\$7,369.0 billion	437 loans	\$2,264.8 billion

STATEMENT OF AUDITOR INDEPENDENCE

In 2009, the Board of Governors engaged Deloitte & Touche LLP (D&T) for the audits of the individual and combined financial statements of the Reserve Banks and the consolidated financial statements of the limited liability companies (LLCs) that are associated with Federal Reserve actions to address the financial crisis and are consolidated in the financial statements of the Federal Reserve Bank of New York. Fees for D&T's services are estimated to be \$9.6 million, of which approximately \$2.0 million were for the audits of the LLCs.* 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 Reserve Banks, or in any other way impairing its audit independence. In 2009, the Bank did not engage D&T for any non-audit services.

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

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LETTER TO DIRECTORS



FEDERAL RESERVE BANK
OF PHILADELPHIA

April 21, 2010

To the Board of Directors

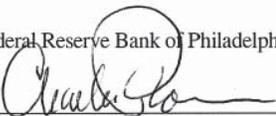
The management of the Federal Reserve Bank of Philadelphia ("FRBP") is responsible for the preparation and fair presentation of the Statements of Condition, Statements of Income and Comprehensive Income, and Statements of Changes in Capital as of December 31, 2009 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and, as such, include some amounts that are based on management judgments and estimates. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

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

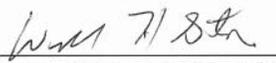
Even effective internal control, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements. Also, projections of any evaluation of effectiveness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

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

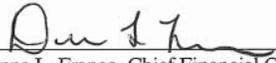
Federal Reserve Bank of Philadelphia

by 

Charles I. Plosser, President

by 

William H. Stone, First Vice President

by 

Donna L. Franco, Chief Financial Officer



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INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying statements of condition of the Federal Reserve Bank of Philadelphia ("FRB Philadelphia") as of December 31, 2009 and 2008 and the related statements of income and comprehensive income, and changes in capital for the years then ended, which have been prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System. We also have audited the internal control over financial reporting of FRB Philadelphia as of December 31, 2009, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB Philadelphia'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's report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on FRB Philadelphia's internal control over financial reporting based on our audits.

We conducted our audits in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, 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 audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

FRB Philadelphia's internal control over financial reporting is a process designed by, or under the supervision of, FRB Philadelphia's principal executive and principal financial officers, or persons performing similar functions, and effected by FRB Philadelphia's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System. FRB Philadelphia'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 Philadelphia; (2) provide

Member of
Deloitte Touche Tohmatsu

REPORT OF INDEPENDENT AUDITORS

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 Philadelphia are being made only in accordance with authorizations of management and directors of FRB Philadelphia; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of FRB Philadelphia's assets that could have a material effect on the financial statements.

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

As described in Note 4 to the financial statements, FRB Philadelphia has prepared these financial statements in conformity with accounting principles established by the Board of Governors of the Federal Reserve System, as set forth in the *Financial Accounting Manual for Federal Reserve Banks*, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The effects on such financial statements of the differences between the accounting principles established by the Board of Governors of the Federal Reserve System and accounting principles generally accepted in the United States of America are also described in Note 4.

In our opinion, such financial statements present fairly, in all material respects, the financial position of FRB Philadelphia as of December 31, 2009 and 2008, and the results of its operations for the years then ended, on the basis of accounting described in Note 4. Also, in our opinion, FRB Philadelphia maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.



April 21, 2010

STATEMENTS OF CONDITION

As of December 31, 2009 and December 31, 2008 (in millions)

	2009	2008
ASSETS		
Gold certificates	\$ 450	\$ 453
Special drawing rights certificates	210	83
Coin	165	137
Items in process of collection	51	237
Prepaid interest on Federal Reserve notes	284	-
Loans to depository institutions	1,735	38,629
System Open Market Account:		
Securities purchased under agreements to resell	-	3,493
Treasury securities, net	12,504	21,021
Government-sponsored enterprise debt securities, net	2,596	905
Federal agency and government-sponsored enterprise mortgage-backed securities, net	14,256	-
Investments denominated in foreign currencies	2,776	2,438
Central bank liquidity swaps	1,128	54,424
Accrued interest receivable	197	377
Interdistrict settlement account	35,084	-
Bank premises and equipment, net	92	85
Other assets	53	56
Total assets	\$ 71,581	\$ 122,338
LIABILITIES AND CAPITAL		
Federal Reserve notes outstanding, net	\$ 32,831	\$ 36,205
System Open Market Account:		
Securities sold under agreements to repurchase	1,206	3,858
Other liabilities	9	-
Deposits:		
Depository institutions	31,597	10,565
Other deposits	5	4
Deferred credit items	220	515
Accrued interest on Federal Reserve notes	-	7
Interdistrict settlement account	-	66,458
Interest due to depository institutions	3	2
Accrued benefit costs	93	79
Other liabilities	13	15
Total liabilities	65,977	117,708
Capital paid-in	2,802	2,315
Surplus (including accumulated other comprehensive loss of \$30 million and \$24 million at December 31, 2009 and 2008, respectively)	2,802	2,315
Total capital	5,604	4,630
Total liabilities and capital	\$ 71,581	\$ 122,338

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

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

For the years ended December 31, 2009 and December 31, 2008 (in millions)

	2009	2008
INTEREST INCOME		
Loans to depository institutions	\$ 60	\$ 55
System Open Market Account:		
Securities purchased under agreements to resell	1	83
Treasury securities	488	1,120
Government-sponsored enterprise debt securities	39	5
Federal agency and government-sponsored enterprise mortgage-backed securities	356	-
Investments denominated in foreign currencies	32	62
Central bank liquidity swaps	231	356
Total interest income	1,207	1,681
INTEREST EXPENSE		
System Open Market Account:		
Securities sold under agreements to repurchase	3	32
Depository institution deposits	46	9
Total interest expense	49	41
Net interest income	1,158	1,640
NON-INTEREST INCOME:		
System Open Market Account:		
Treasury securities gains	-	166
Federal agency and government-sponsored enterprise mortgage-backed securities gains, net	5	-
Foreign currency gains, net	29	135
Compensation received for services provided	26	40
Reimbursable services to government agencies	32	32
Other income	7	37
Total non-interest income	99	410
OPERATING EXPENSES:		
Salaries and other benefits	104	101
Occupancy expense	13	12
Equipment expense	11	13
Assessments by the Board of Governors	72	66
Other expenses	28	38
Total operating expenses	228	230
Net income prior to distribution	1,029	1,820
Change in funded status of benefit plans	(6)	(5)
Comprehensive income prior to distribution	\$ 1,023	\$ 1,815
Distribution of comprehensive income:		
Dividends paid to member banks	\$ 151	\$ 127
Transferred to surplus and change in accumulated other comprehensive loss	487	502
Payments to Treasury as interest on Federal Reserve notes	385	1,186
Total distribution	\$ 1,023	\$ 1,815

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

STATEMENTS OF CHANGES IN CAPITAL

For the years ended December 31, 2009 and December 31, 2008 (in millions, except share data)

	Surplus				Total capital
	Capital paid-In	Net income retained	Accumulated other comprehensive loss	Total surplus	
Balance at January 1, 2008 (36,266,586 shares)	\$ 1,813	\$ 1,832	\$ (19)	\$ 1,813	\$ 3,626
Net change in capital stock issued (10,034,575 shares)	502	-	-	-	502
Transferred to surplus and change in accumulated other comprehensive loss	-	507	(5)	502	502
Balance at December 31, 2008 (46,301,161 shares)	\$ 2,315	\$ 2,339	\$ (24)	\$ 2,315	\$ 4,630
Net change in capital stock issued (9,737,906 shares)	487	-	-	-	487
Transferred to surplus and change in accumulated other comprehensive loss	-	493	(6)	487	487
Balance at December 31, 2009 (56,039,067 shares)	\$ 2,802	\$ 2,832	\$ (30)	\$ 2,802	\$ 5,604

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

NOTES TO FINANCIAL STATEMENTS

1. STRUCTURE

The Federal Reserve Bank of Philadelphia (“Bank”) is part of the Federal Reserve System (“System”) and is one of the twelve Federal Reserve Banks (“Reserve Banks”) created by Congress under the Federal Reserve Act of 1913 (“Federal Reserve Act”), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank serves the Third Federal Reserve District, which includes Delaware and portions of New Jersey and Pennsylvania.

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

In addition to the 12 Reserve Banks, the System also consists, in part, of the Board of Governors and the Federal Open Market Committee (“FOMC”). The Board of Governors, an independent federal agency, is charged by the Federal Reserve Act with a number of specific duties, including general supervision over the Reserve Banks. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York (“FRBNY”), and, on a rotating basis, four other Reserve Bank presidents.

2. OPERATIONS AND SERVICES

The Reserve Banks perform a variety of services and operations. These functions include participating in formulating and conducting monetary policy; participating in the payments system, including large-dollar transfers of funds, automated clearinghouse (“ACH”) operations, and check collection; distributing coin and currency; performing fiscal agency functions for the U.S. Department of the Treasury (“Treasury”), certain Federal agencies, and other entities; serving as the federal government’s bank; providing short-term loans to depository institutions; providing loans to individuals, partnerships, and corporations in unusual and exigent circumstances; serving consumers and communities by providing educational materials and information regarding financial consumer protection rights and laws and information on community development programs and activities; and supervising bank holding companies, state member banks, and U.S. offices of foreign banking organizations. Certain services are provided to foreign and international monetary authorities, primarily by the FRBNY.

The FOMC, in conducting monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and annually issues authorizations and directives to the FRBNY to execute transac-

tions. The FOMC authorizes and directs the FRBNY to conduct operations in domestic markets, including the direct purchase and sale of Treasury securities, Federal agency and government-sponsored enterprise (“GSE”) debt securities, Federal agency and GSE mortgage-backed securities (“MBS”), the purchase of these securities under agreements to resell, and the sale of these securities under agreements to repurchase. The FRBNY executes these transactions at the direction of the FOMC and holds the resulting securities and agreements in a portfolio known as the System Open Market Account (“SOMA”). The FRBNY is authorized to lend the Treasury securities and Federal agency and GSE debt securities that are held in the SOMA.

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes the FRBNY to execute operations in foreign markets in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC to carry out the System’s central bank responsibilities. Specifically, the FOMC authorizes and directs the FRBNY to hold balances of, and to execute spot and forward foreign exchange and securities contracts for, fourteen foreign currencies and to invest such foreign currency holdings, while maintaining adequate liquidity. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements (“FX swaps”) with two central banks and to “warehouse” foreign currencies for the Treasury and the Exchange Stabilization Fund (“ESF”). The FRBNY is also authorized and directed by the FOMC to maintain U.S. dollar currency liquidity swap arrangements with fourteen central banks. The FOMC has also authorized the FRBNY to maintain foreign currency liquidity swap arrangements with four foreign central banks.

Although the Reserve Banks are separate legal entities, they collaborate in the delivery of certain services to achieve greater efficiency and effectiveness. This collaboration takes the form of centralized operations and product or function offices that have responsibility for the delivery of certain services on behalf of the Reserve Banks. Various operational and management models are used and are supported by service agreements between the Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, the Reserve Banks are reimbursed for costs incurred in providing services to other Reserve Banks. Major services provided by the Bank on behalf of the System and for which the costs were not reimbursed by the other Reserve Banks include Collateral Management System, Electronic Cash Letter System, Groupware Leadership Center, Treasury Check Information Services Central Business Administration Function, and Treasury Direct Central Business Administration Function.

3. FINANCIAL STABILITY ACTIVITIES

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

Expanded Open Market Operations and Support for Mortgage-Related Securities

The Single-Tranche Open Market Operation Program allows primary dealers to initiate a series of 28-day term repurchase transactions while pledging Treasury securities, Federal agency and GSE debt securities, and Federal agency and GSE MBS as collateral.

The Federal Agency and GSE Debt Securities and MBS Purchase Program provides support to the mortgage

NOTES TO FINANCIAL STATEMENTS

and housing markets and fosters improved conditions in financial markets. Under this program, the FRBNY purchases housing-related GSE debt securities and Federal agency and GSE MBS. Purchases of housing-related GSE debt securities began in November 2008 and purchases of Federal agency and GSE MBS began in January 2009. The FRBNY is authorized to purchase up to \$200 billion in fixed rate, non-callable GSE debt securities and up to \$1.25 trillion in fixed rate Federal agency and GSE MBS. The activities of both of these programs are allocated to the other Reserve Banks.

Central Bank Liquidity Swaps

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

U.S. dollar liquidity swap arrangements were authorized with fourteen foreign central banks to provide liquidity in U.S. dollars to overseas markets. Such arrangements were authorized with the following central banks: the Reserve Bank of Australia, the Banco Central do Brasil, the Bank of Canada, Danmarks Nationalbank, the Bank of England, the European Central Bank, the Bank of Japan, the Bank of Korea, the Banco de Mexico, the Reserve Bank of New Zealand, Norges Bank, the Monetary Authority of Singapore, the Sveriges Riksbank, and the Swiss National Bank. The maximum amount that could be drawn under these swap arrangements varied by central bank. The authorization for these swap arrangements expired on February 1, 2010.

Foreign currency liquidity swap arrangements provided the Reserve Banks with the capacity to offer foreign currency liquidity to U.S. depository institutions. Such arrangements were authorized with the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank. The maximum amount that could be drawn under the swap arrangements varied by central bank. The authorization for these swap arrangements expired on February 1, 2010.

Lending to Depository Institutions

The Term Auction Facility ("TAF") promotes the efficient dissemination of liquidity by providing term funds to depository institutions. Under the TAF, Reserve Banks auction term funds to depository institutions against any collateral eligible to secure primary, secondary, and seasonal credit less a margin, which is a reduction in the assigned collateral value that is intended to provide the Banks additional credit protection. All depository institutions that are considered to be in generally sound financial condition by their Reserve Bank and that are eligible to borrow under the primary credit program are eligible to participate in TAF auctions. All loans must be collateralized to the satisfaction of the Reserve Banks.

Lending to Primary Dealers

The Term Securities Lending Facility ("TSLF") promoted liquidity in the financing markets for Treasury securities. Under the TSLF, the FRBNY could lend up to an aggregate amount of \$200 billion of Treasury securities held in the SOMA to primary dealers secured for a term of 28 days. Securities were lent to primary dealers through a competitive single-price auction and were collateralized, less a margin, by a pledge of other securities, including Treasury securities, municipal securities, Federal agency and GSE MBS, non-agency AAA/Aaa-rated private-label residential MBS, and asset-backed securities ("ABS"). The authorization for the TSLF expired on February 1, 2010.

The Term Securities Lending Facility Options Program (“TOP”) offered primary dealers, through a competitive single-price auction, to purchase an option to draw upon short-term, fixed-rate TSLF loans in exchange for eligible collateral. The program enhanced the effectiveness of the TSLF by ensuring additional liquidity during periods of heightened collateral market pressures, such as around quarter-end dates. The program was suspended effective with the maturity of the June 2009 TOP options and the program authorization expired on February 1, 2010.

Other Lending Facilities

The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (“AMLF”) provided funding to depository institutions and bank holding companies to finance the purchase of eligible high-quality asset-backed commercial paper (“ABCP”) from money market mutual funds. The program assisted money market mutual funds that hold such paper to meet the demands for investor redemptions and to foster liquidity in the ABCP market and money markets more generally. The Federal Reserve Bank of Boston (“FRBB”) administered the AMLF and was authorized to extend these loans to eligible borrowers on behalf of the other Reserve Banks. All loans extended under the AMLF were non-recourse and were recorded as assets by the FRBB and if the borrowing institution settles to a depository account in the Third Federal Reserve District, the funds were credited to the depository institution account and settled between the Reserve Banks through the inter-district settlement account. The credit risk related to the AMLF was assumed by the FRBB. The authorization for the AMLF expired on February 1, 2010.

4. SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of a nation’s central bank have not been formulated by accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and practices that it considers to be appropriate for the nature and function of a central bank. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* (“Financial Accounting Manual” or “FAM”), which is issued by the Board of Governors. The Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the FAM and the financial statements have been prepared in accordance with the FAM.

Limited differences exist between the accounting principles and practices in the FAM and 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 SOMA securities holdings at amortized cost rather than the fair value presentation required by GAAP. Treasury securities, GSE debt securities, Federal agency and GSE MBS, and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis rather than the trade-date basis required by GAAP. The cost basis of Treasury securities, GSE debt securities, and foreign government debt instruments is 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. Accounting for these securities on a settlement-date basis more appropriately reflects the timing of the transaction’s effect on the quantity of reserves in the banking system. Although the application of fair value measurements to the securities holdings may result in values substantially

NOTES TO FINANCIAL STATEMENTS

above or below their carrying values, these unrealized changes in value have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio may involve transactions that result in gains or losses when holdings are sold 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, fair values, earnings, and 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. 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 FAM and GAAP.

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

A. GOLD AND SPECIAL DRAWING RIGHTS CERTIFICATES

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

Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the Treasury. The gold certificates held by the Reserve Banks are required to be backed by the gold of the Treasury. The Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the Treasury. At such time, the Treasury's account is charged, and the Reserve Banks' gold certificate accounts are reduced. The value of gold for purposes of backing the gold certificates is set by law at \$42 2/9 per fine troy ounce. The Board of Governors allocates the gold certificates among the Reserve Banks once a year based on the average Federal Reserve notes outstanding in each Reserve Bank.

SDR certificates are issued by the International Monetary Fund (the "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 U.S. participation in the SDR system, the Secretary of the Treasury is authorized to issue SDR certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in U.S. dollars are credited to the account established for the Treasury and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direc-

NOTES TO FINANCIAL STATEMENTS

tion of the Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among the Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2008, and in 2009 the Treasury issued \$3 billion in SDR certificates to the Reserve Banks, of which \$127 million was allocated to the Bank.

B. LOANS TO DEPOSITORY INSTITUTIONS

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

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

C. SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL, SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE, AND SECURITIES LENDING

The FRBNY may engage in purchases of securities with primary dealers under agreements to resell ("repurchase transactions"). These repurchase transactions are typically executed through a tri-party arrangement ("tri-party transactions"). Tri-party transactions are conducted with two commercial custodial banks that manage the clearing, settlement, and pledging of collateral. The collateral pledged must exceed the principal amount of the transaction. Acceptable collateral under tri-party repurchase transactions primarily includes Treasury securities; pass-through mortgage securities of Fannie Mae, Freddie Mac, and Ginnie Mae; STRIP Treasury securities; and "stripped" securities of Federal agencies. The tri-party transactions are accounted for as financing transactions with the associated interest income accrued over the life of the transaction. Repurchase transactions are reported at their contractual amount as "System Open Market Account: Securities purchased under agreements to resell" in the Statements of Condition and the related accrued interest receivable is reported as a component of "Accrued interest receivables."

The FRBNY may engage in sales of securities with primary dealers under agreements to repurchase ("reverse repurchase transactions"). These reverse repurchase transactions may be executed through a tri-party arrangement, similar to repurchase transactions. Reverse repurchase transactions may also be executed with foreign official and international accounts. Reverse repurchase transactions are accounted for as financing transactions, and the associated interest expense is recognized over the life of the transaction. These trans-

NOTES TO FINANCIAL STATEMENTS

actions are reported at their contractual amounts in the Statements of Condition and the related accrued interest payable is reported as a component of "Other liabilities."

Treasury securities and GSE debt securities held in the SOMA are lent to primary dealers to facilitate the effective functioning of the domestic securities market. Overnight securities lending transactions are fully collateralized by other Treasury securities. TSLF transactions are fully collateralized with investment-grade debt securities, collateral eligible for tri-party repurchase agreements arranged by the FRBNY, or both. The collateral taken in both overnight and term securities lending transactions is in excess of the fair value of the securities lent. The FRBNY charges the primary dealer a fee for borrowing securities, and these fees are reported as a component of "Other income." In addition, TOP fees are reported as a component of "Other income."

Activity related to securities purchased under agreements to resell, securities sold under agreements to repurchase, and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from an annual settlement of the interdistrict settlement account that occurs in April each year. The settlement also equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District.

D. TREASURY SECURITIES; GOVERNMENT-SPONSORED ENTERPRISE DEBT SECURITIES; FEDERAL AGENCY AND GOVERNMENT-SPONSORED ENTERPRISE MORTGAGE-BACKED SECURITIES; INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES; AND WAREHOUSING AGREEMENTS

Interest income on Treasury securities, GSE debt securities, and investments denominated in foreign currencies comprising the SOMA is accrued on a straight-line basis. Interest income on Federal agency and GSE MBS is accrued using the interest method and includes amortization of premiums, accretion of discounts, and paydown gains or losses. Paydown gains or losses result from scheduled payment and prepayment of principal and represent the difference between the principal amount and the carrying value of the related security. Gains and losses resulting from sales of securities are determined by specific issue based on average cost.

In addition to outright purchases of Federal agency and GSE MBS that are held in the SOMA, the FRBNY enters into dollar roll transactions ("dollar rolls"), which primarily involve an initial transaction to purchase or sell "to be announced" ("TBA") MBS combined with an agreement to sell or purchase TBA MBS on a specified future date. The FRBNY's participation in the dollar roll market furthers the MBS Purchase Program goal of providing support to the mortgage and housing markets and fostering improved conditions in financial markets. The FRBNY accounts for outstanding commitments to sell or purchase TBA MBS on a settlement-date basis. Based on the terms of the FRBNY dollar roll transactions, transfers of MBS upon settlement of the initial TBA MBS transactions are accounted for as purchases or sales in accordance with FASB ASC Topic 860 (ASC 860), *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*, (previously SFAS 140), and the related outstanding commitments are accounted for as sales or purchases upon settlement.

Activity related to Treasury securities, GSE debt securities, and Federal agency and GSE MBS, including the premiums, discounts, and realized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of the 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, including the premiums, dis-

NOTES TO FINANCIAL STATEMENTS

counts, and realized and unrealized gains and losses, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31.

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 or losses, net" in the Statements of Income and Comprehensive Income.

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

Warehousing agreements are designated as held-for-trading purposes and are valued daily at current market exchange rates. Activity related to these agreements is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31.

E. CENTRAL BANK LIQUIDITY SWAPS

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

Activity related to U.S. dollar and foreign currency swap transactions, including the related income and expense, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. Similar to investments denominated in foreign currencies, the foreign currency amounts associated with these central bank liquidity swap arrangements are revalued at current foreign currency market exchange rates.

U.S. dollar liquidity swaps

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

The foreign central bank compensates the FRBNY based on the foreign currency amounts held for the FRBNY. The FRBNY recognizes compensation during the term of the swap transaction and reports it as "Interest income: Central bank liquidity swaps" in the Statements of Income and Comprehensive Income.

NOTES TO FINANCIAL STATEMENTS

Foreign currency liquidity swaps

At the initiation of each foreign currency liquidity swap transaction, the FRBNY will transfer, at the prevailing market exchange rate, a specified amount of U.S. dollars to an account for the foreign central bank in exchange for its currency. The foreign currency amount received would be reported as a liability by the Bank. Concurrent with this transaction, the FRBNY and the foreign central bank agree to a second transaction that obligates the FRBNY to return the foreign currency and the foreign central bank to return the U.S. dollars on a specified future date. The FRBNY compensates the foreign central bank based on the foreign currency transferred to the FRBNY. For each foreign currency swap transaction with a foreign central bank it is anticipated that the FRBNY will enter into a corresponding transaction with a U.S. depository institution in order to provide foreign currency liquidity to that institution. No foreign currency liquidity swap transactions occurred in 2008 or 2009.

F. INTERDISTRICT SETTLEMENT ACCOUNT

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

G. 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, whether developed internally or acquired for internal use, are capitalized based on the purchase cost and the cost of direct services and materials associated with designing, coding, installing, and testing the software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which 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 and an adjustment is recorded when events or changes in circumstances indicate that the carrying amount of assets or asset groups is not recoverable and significantly exceeds the assets' fair value.

H. FEDERAL RESERVE NOTES

Federal Reserve notes are the circulating currency of the United States. These notes, which are identified as issued to a specific Reserve Bank, must be fully collateralized. Assets eligible to be pledged as collateral secu-

NOTES TO FINANCIAL STATEMENTS

riety 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 outstanding Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes issued to all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, Federal Reserve notes are obligations of the United States government. At December 31, 2009 and 2008, 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 \$5,591 million and \$5,013 million at December 31, 2009 and 2008, 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. 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 be deducted from net earnings, dividends 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. Accumulated other comprehensive income is reported as a com-

NOTES TO FINANCIAL STATEMENTS

ponent 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 other postretirement benefit plans that, under GAAP, 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 12 and 13.

L. INTEREST ON FEDERAL RESERVE NOTES

The Board of Governors requires the Reserve Banks to transfer excess earnings to the Treasury as interest on Federal Reserve notes after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. This amount is reported as "Payments to U.S. Treasury as interest on Federal Reserve notes" in the Statements of Income and Comprehensive Income. The amount due to the Treasury is reported as "Accrued interest on Federal Reserve notes" in the Statements of Condition. If overpaid during the year, the amount is reported as "Prepaid interest on Federal Reserve notes" in the Statements of Condition. Payments are made weekly to the Treasury.

In the event of losses or an increase in capital paid-in at a Reserve Bank, payments to the 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 Treasury in the following year.

M. INTEREST ON DEPOSITORY INSTITUTION DEPOSITS

On October 9, 2008, the Reserve Banks began paying interest to depository institutions on qualifying balances held at the Banks. The interest rates paid on required reserve balances and excess balances are determined by the Board of Governors, based on an FOMC-established target range for the effective federal funds rate.

N. INCOME AND COSTS RELATED TO TREASURY SERVICES

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States Government. By statute, the Department of the Treasury has appropriations to pay for these services. During the years ended December 31, 2009 and 2008, the Bank was reimbursed for substantially all services provided to the Department of the Treasury as its fiscal agent.

The Treasury and other government agencies reimbursement process for all Reserve Banks is centralized at the Bank. Each Reserve Bank transfers its Treasury reimbursement receivable to the Bank. The reimbursement receivable is reported in "Other assets" and totaled \$30 million and \$34 million at December 31, 2009 and 2008, respectively. There was no cost of unreimbursed Treasury services at December 31, 2009. The cost of unreimbursed Treasury services is reported in "Other expense" and was immaterial at December 31, 2008.

O. 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 services and recognizes total System revenue for these services on its Consolidated Statements of Income and Comprehensive Income. The FRBA and the FRBNY compensate the applicable Reserve Banks for the costs incurred to provide these services. The Bank reports this compensation as “Compensation received for services provided” in the Statements of Income and Comprehensive Income.

P. 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 by the Treasury to produce and retire Federal Reserve notes based on each Reserve Bank’s share of the number of notes comprising the System’s net liability for Federal Reserve notes on December 31 of the prior year.

Q. TAXES

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank’s real property taxes were \$2 million for each of the years ended December 31, 2009 and 2008 and are reported as a component of “Occupancy expense.”

R. RESTRUCTURING CHARGES

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

Note 14 describes the Bank’s restructuring initiatives and provides information about the costs and liabilities associated with employee separations and contract terminations. 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.

The Bank had no significant restructuring activities in 2009.

NOTES TO FINANCIAL STATEMENTS

S. RECENTLY ISSUED ACCOUNTING STANDARDS

In February 2008, FASB issued FSP SFAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (codified in FASB ASC Topic 860 (ASC 860), *Transfers and Servicing*). ASC 860 requires that an initial transfer of a financial asset and a repurchase financing that was entered into contemporaneously with, or in contemplation of, the initial transfer be evaluated together as a linked transaction unless certain criteria are met. These provisions of ASC 860 are effective for the Bank's financial statements for the year beginning on January 1, 2009 and have not had a material effect on the Bank's financial statement. The requirements of this standard have been reflected in the accompanying footnotes.

In June 2009, FASB issued SFAS 166, *Accounting for Transfers of Financial Assets – an amendment to FASB Statement No. 140*, (codified in ASC 860). The new guidance modifies existing guidance to eliminate the scope exception for qualifying special purpose vehicles ("SPVs") and clarifies that the transferor must consider all arrangements of the transfer of financial assets when determining if the transferor has surrendered control. These provisions of ASC 860 are effective for the Bank's financial statements for the year beginning on January 1, 2010, and earlier adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Bank's financial statements.

In May 2009, FASB issued SFAS No. 165, *Subsequent Events* (codified in FASB ASC Topic 855 (ASC 855), *Subsequent Events*), which establishes general standards of accounting for and disclosing events that occur after the balance sheet date but before financial statements are issued or are available to be issued. ASC 855 sets forth (i) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements; (ii) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements; and (iii) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date, including disclosure of the date through which an entity has evaluated subsequent events and whether that represents the date the financial statements were issued or were available to be issued. The Bank adopted ASC 855 for the period ended December 31, 2009 and the required disclosures are reflected in Note 15.

In June 2009, the FASB issued SFAS No. 168, *The Statement of Financial Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles"* (SFAS 168). SFAS 168 establishes the FASB ASC as the source of authoritative accounting principles recognized by the FASB to be applied by non-governmental entities in the preparation of financial statements in conformity with GAAP. The ASC does not change current GAAP, but it introduces a new structure that organizes the authoritative standards by topic. SFAS 168 is effective for financial statements issued for periods ending after September 15, 2009. As a result, both the ASC and the legacy standard are referenced in the Bank's financial statements and footnotes.

NOTES TO FINANCIAL STATEMENTS

5. LOANS

The loan amounts outstanding at December 31 were as follows (in millions):

	2009	2008
Primary, secondary, and seasonal credit	\$ 122	\$ 329
TAF	1,613	38,300
Loans to depository institutions	\$ 1,735	\$ 38,629

Loans to depository institutions

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

Primary, secondary, and seasonal credit lending is collateralized to the satisfaction of the Bank to reduce credit risk. Assets eligible to collateralize these loans include consumer, business, and real estate loans; Treasury securities; GSE debt securities; foreign sovereign debt; municipal, corporate, and state and local government obligations; ABS; corporate bonds; commercial paper; and bank-issued assets, such as certificates of deposit, bank notes, and deposit notes. Collateral is assigned a lending value that is deemed appropriate by the Bank, which is typically fair value or face value reduced by a margin.

Depository institutions that are eligible to borrow under the Bank's primary credit program are also eligible to participate in the 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. TAF loans are extended on a short-term basis, with terms ranging from 28 to 84 days. All advances under the TAF program must be collateralized to the satisfaction of the Bank. Assets eligible to collateralize TAF loans include the complete list noted above for loans to depository institutions. Similar to the process used for primary, secondary, and seasonal credit, a lending value is assigned to each asset that is accepted as collateral for TAF loans reduced by a margin.

Loans to depository institutions are monitored on a daily basis to ensure that borrowers continue to meet eligibility requirements for these programs. The financial condition of borrowers is monitored by the Bank and, if a borrower no longer qualifies for these programs, the Bank will generally request full repayment of the outstanding loan or, for primary and seasonal credit lending, may convert the loan to a secondary credit loan.

Collateral levels are reviewed daily against outstanding obligations and borrowers that no longer have sufficient collateral to support outstanding loans are required to provide additional collateral or to make partial or full repayment.

NOTES TO FINANCIAL STATEMENTS

The remaining maturity distributions of loans outstanding at December 31 were as follows (in millions):

	2009		2008	
	Primary, secondary, and seasonal credit	TAF	Primary, secondary, and seasonal credit	TAF
Within 15 days	\$ 118	\$ 1,613	\$ 319	\$ 7,550
16 days to 90 days	4	-	10	30,750
Total loans	\$ 122	\$ 1,613	\$ 329	\$ 38,300

At December 31, 2009 and 2008, the Bank did not have any impaired loans and no allowance for loan losses was required.

6. TREASURY SECURITIES; GOVERNMENT-SPONSORED ENTERPRISE DEBT SECURITIES; FEDERAL AGENCY AND GOVERNMENT-SPONSORED ENTERPRISE MORTGAGE-BACKED SECURITIES; SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL; SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE; AND SECURITIES LENDING

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 1.551 percent and 4.366 percent at December 31, 2009 and 2008, respectively.

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

	2009						
	Treasury securities			Total Treasury securities	GSE debt securities	Federal agency and GSE MBS	
	Bills	Notes	Bonds				
Par	\$ 286	\$ 8,817	\$ 2,945	\$ 12,048	\$ 2,480	\$ 14,092	
Unamortized premiums	-	101	380	481	116	188	
Unaccreted discounts	-	(15)	(10)	(25)	-	(24)	
Total amortized cost	\$ 286	\$ 8,903	\$ 3,315	\$ 12,504	\$ 2,596	\$ 14,256	
Fair Value	\$ 286	\$ 9,045	\$ 3,579	\$ 12,910	\$ 2,598	\$ 14,184	

NOTES TO FINANCIAL STATEMENTS

2008						
Treasury securities						
	Bills	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Par	\$ 804	\$ 14,617	\$ 5,358	\$ 20,779	\$ 861	\$ -
Unamortized premiums	-	12	294	306	45	-
Unaccreted discounts	-	(37)	(27)	(64)	(1)	-
Total amortized cost	\$ 804	\$ 14,592	\$ 5,625	\$ 21,021	\$ 905	\$ -
Fair Value	\$ 804	\$ 15,618	\$ 7,398	\$ 23,820	\$ 911	\$ -

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

2009						
Treasury securities						
	Bills	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Amortized Cost	\$ 18,423	\$ 573,877	\$ 213,672	\$ 805,972	\$ 167,362	\$ 918,927
Fair Value	18,423	583,040	230,717	832,180	167,444	914,290

2008						
Treasury securities						
	Bills	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Amortized Cost	\$ 18,422	\$ 334,217	\$ 128,810	\$ 481,449	\$ 20,740	\$ -
Fair Value	18,422	357,709	169,433	545,564	20,863	-

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

NOTES TO FINANCIAL STATEMENTS

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

The following table provides additional information on the amortized cost and fair values of the Federal agency and GSE MBS portfolio at December 31, 2009 (in millions):

Distribution of MBS holdings by coupon rate	Amortized cost	Fair value
Allocated to the Bank:		
4.0%	\$ 2,639	\$ 2,571
4.5%	6,738	6,697
5.0%	3,032	3,047
5.5%	1,604	1,622
6.0%	197	200
Other ¹	46	47
Total	\$ 14,256	\$ 14,184
System total:		
4.0%	\$ 170,119	\$ 165,740
4.5%	434,352	431,646
5.0%	195,418	196,411
5.5%	103,379	104,583
6.0%	12,710	12,901
Other ¹	2,949	3,009
Total	\$ 918,927	\$ 914,290

¹ Represents less than one percent of the total portfolio

NOTES TO FINANCIAL STATEMENTS

Financial information related to securities purchased under agreements to resell and securities sold under agreements to repurchase for the years ended December 31, 2009 and 2008, was as follows (in millions):

	Securities purchased under agreements to resell		Securities sold under agreements to repurchase	
	2009	2008	2009	2008
Allocated to the Bank:				
Contract amount outstanding, end of year	\$ -	\$ 3,493	\$ 1,206	\$ 3,858
Average daily amount outstanding, during the year	158	3,774	1,644	2,416
Maximum month-end balance outstanding, during the year	-	5,196	3,352	4,303
Securities pledged, end of year			1,208	3,445
System total:				
Contract amount outstanding, end of year	\$ -	\$ 80,000	\$ 77,732	\$ 88,352
Average daily amount outstanding, during the year	3,616	86,227	67,837	55,169
Maximum month-end balance outstanding, during the year	-	119,000	77,732	98,559
Securities pledged, end of year			77,860	78,896

The Bank has revised its disclosure of securities purchased under agreements to resell and securities sold under agreements to repurchase from a weighted average calculation, disclosed in 2008, to the simple daily average calculation, disclosed above. The previously reported System total 2008 weighted average amount outstanding for securities purchased under agreements to resell was \$97,037 million of which \$4,237 million was allocated to the Bank. The previously reported System total 2008 weighted average amount outstanding for securities sold under agreements to repurchase was \$65,461 million of which \$2,858 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.

NOTES TO FINANCIAL STATEMENTS

The remaining maturity distribution of Treasury securities, GSE debt securities, Federal agency and GSE MBS bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2009 was as follows (in millions):

	Treasury securities (Par value)	GSE debt securities (Par value)	Federal agency and GSE MBS (Par value)	Securities purchased under agreements to resell (Contract amount)	Securities sold under agreements to repurchase (Contract amount)
Within 15 days	\$ 180	\$ 1	\$ -	\$ -	\$ 1,206
16 days to 90 days	447	47	-	-	-
91 days to 1 year	788	334	-	-	-
Over 1 year to 5 years	5,071	1,542	-	-	-
Over 5 years to 10 years	3,316	524	-	-	-
Over 10 years	2,246	32	14,092	-	-
Total allocated to the Bank	\$ 12,048	\$ 2,480	\$ 14,092	\$ -	\$ 1,206

Federal agency and GSE MBS are reported at stated maturity in the table above. The estimated weighted average life of these securities at December 31, 2009, which differs from the stated maturity primarily because it factors in prepayment assumptions, is approximately 6.4 years.

At December 31, 2009 and 2008, Treasury securities and GSE debt securities with par values of \$21,610 million and \$180,765 million, respectively, were loaned from the SOMA, of which \$335 million and \$7,892 million, respectively, were allocated to the Bank.

At December 31, 2009, the total of other investments was \$5 million, of which the Bank's allocated share was immaterial. Other investments consist of cash and short-term investments related to the Federal agency and GSE MBS portfolio.

At December 31, 2009, the total of other liabilities was \$601 million, of which \$9 million was allocated to the Bank. These other liabilities, which are related to purchases of Federal agency and GSE MBS, arise from the failure of a seller to deliver securities to the FRBNY on the settlement date. Although the Bank has ownership of and records its investments in the MBS securities as of the contractual settlement date, it is not obligated to make payment until the securities are delivered, and the amount reported as other liabilities represents the Bank's obligation to pay for the securities when delivered.

The FRBNY enters into commitments to buy Federal agency and GSE MBS and records the related MBS on a settlement-date basis. As of December 31, 2009, the total purchase price of the Federal agency and GSE MBS under outstanding commitments was \$160,099 million, of which \$32,838 million was related to dollar roll transactions. The amount of outstanding commitments allocated to the Bank was \$2,484 million, of which \$509 million was related to dollar roll transactions. These commitments, which had contractual settlement dates extending through March 2010, are primarily for the purchase of TBA MBS for which the

NOTES TO FINANCIAL STATEMENTS

number and identity of the pools that will be delivered to fulfill the commitment are unknown at the time of the trade. These commitments are subject to market and counterparty risks that result from their future settlement. As of December 31, 2009, the fair value of Federal agency and GSE MBS under outstanding commitments was \$158,868 million, of which \$2,465 million was allocated to the Bank. During the year ended December 31, 2009, the Reserve Banks recorded net gains from dollar roll related sales of \$879 million, of which \$5 million was allocated to the Bank. These net gains are reported as "Non-Interest Income: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net" in the Statements of Income and Comprehensive Income.

7. 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. These investments are guaranteed as to principal and interest by the issuing foreign governments. In addition, the FRBNY enters into transactions to purchase foreign-currency-denominated government-debt securities under agreements to resell for which the accepted collateral is the debt instruments issued by the governments of Belgium, France, Germany, Italy, the Netherlands, and Spain.

The Bank's allocated share of investments denominated in foreign currencies was approximately 10.984 percent and 9.829 percent at December 31, 2009 and 2008, respectively.

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

	2009	2008
Euro:		
Foreign currency deposits	\$ 812	\$ 547
Securities purchased under agreements to resell	285	401
Government debt instruments	542	453
Japanese yen:		
Foreign currency deposits	374	342
Government debt instruments	763	695
Total allocated to the Bank	\$ 2,776	\$ 2,438

At December 31, 2009 and 2008, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was \$2,799 million and \$2,459 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

NOTES TO FINANCIAL STATEMENTS

interest, approximates fair value. Similar to the Treasury securities, GSE debt securities, and Federal agency and GSE MBS discussed in Note 6, unrealized gains or losses have no effect on the ability of a Reserve Bank, as the central bank, to meet its financial obligations and responsibilities. The fair value is presented solely for informational purposes.

Total Reserve Bank investments denominated in foreign currencies were \$25,272 million and \$24,804 million at December 31, 2009 and 2008, respectively. At December 31, 2009 and 2008, the fair value of the total Reserve Bank investments denominated in foreign currencies, including accrued interest, was \$25,480 million and \$25,021 million, respectively.

The remaining maturity distribution of investments denominated in foreign currencies that were allocated to the Bank at December 31, 2009 was as follows (in millions):

	Euro	Japanese yen	Total
Within 15 days	\$ 666	\$ 398	\$ 1,064
16 days to 90 days	275	51	326
91 days to 1 year	265	260	525
Over 1 year to 5 years	433	428	861
Total allocated to the Bank	\$ 1,639	\$ 1,137	\$ 2,776

At December 31, 2009 and 2008, the authorized warehousing facility was \$5 billion, with no balance outstanding.

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

8. CENTRAL BANK LIQUIDITY SWAPS

U.S. Dollar Liquidity Swaps

The Bank's allocated share of U.S. dollar liquidity swaps was approximately 10.984 percent and 9.829 percent at December 31, 2009 and 2008, respectively.

At December 31, 2009 and 2008, the total Reserve Bank amount of foreign currency held under U.S. dollar liquidity swaps was \$10,272 million and \$553,728 million, respectively, of which \$1,128 million and \$54,424 million, respectively, was allocated to the Bank.

NOTES TO FINANCIAL STATEMENTS

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

	2009			2008		
	Within 15 days	16 days to 90 days	Total	Within 15 days	16 days to 90 days	Total
Australian dollar	\$ -	\$ -	\$ -	\$ 983	\$ 1,261	\$ 2,244
Danish krone	-	-	-	-	1,475	1,475
Euro	715	-	715	14,838	13,798	28,636
Japanese yen	60	-	60	4,707	7,354	12,061
Korean won	-	-	-	-	1,017	1,017
Mexican peso	353	-	353	-	-	-
Norwegian krone	-	-	-	216	592	808
Swedish krona	-	-	-	983	1,474	2,457
Swiss franc	-	-	-	1,889	585	2,474
U.K. pound	-	-	-	12	3,240	3,252
Total	\$ 1,128	\$ -	\$ 1,128	\$ 23,628	\$ 30,796	\$ 54,424

Foreign Currency Liquidity Swaps

There were no transactions related to the foreign currency liquidity swaps during the years ended December 31, 2008 and 2009.

9. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	2009	2008
Bank premises and equipment:		
Land	\$ 8	\$ 7
Buildings	102	92
Building machinery and equipment	16	15
Construction in progress	1	1
Furniture and equipment	70	68
Subtotal	197	183
Accumulated depreciation	(105)	(98)
Bank premises and equipment, net	\$92	\$85
Depreciation expense, for the years ended December 31	\$ 11	\$ 11

NOTES TO FINANCIAL STATEMENTS

The Bank leases space to an outside tenant with a remaining lease term of one year. Rental income from such leases was \$1 million for each of the years ended December 31, 2009 and 2008 and is reported as a component of "Other income" in the Statements of Income and Comprehensive Income. Future minimum lease payments that the Bank will receive under the noncancelable lease agreement in existence at December 31, 2009 are \$2 million for the year 2010.

The Bank had capitalized software assets, net of amortization, of \$6 million and \$5 million at December 31, 2009 and 2008, respectively. Amortization expense was \$2 million for each of the years ended December 31, 2009 and 2008. Capitalized software assets are reported as a component of "Other assets" in the Statements of Condition and the related amortization is reported as a component of "Other expenses" in the Statements of Income and Comprehensive Income.

10. COMMITMENTS AND CONTINGENCIES

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

At December 31, 2009, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from 1 to approximately 10 years. One equipment lease provides for increased rental payments based upon increases in operating quantity.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance, and maintenance when included in rent), net of sublease rentals, was \$1 million for each of the years ended December 31, 2009 and 2008. Certain of the Bank's leases have options to renew. The Bank has no capital leases.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2009 are as follows (in thousands):

	Operating leases
2010	\$ 503
2011	478
2012	484
2013	433
2014	445
Thereafter	1,938
Future minimum rental payments	\$ 4,281

At December 31, 2009, there were no material unrecorded unconditional purchase commitments or obligations in excess of one year.

NOTES TO FINANCIAL STATEMENTS

Under the Insurance Agreement of the Federal Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio 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, 2009 or 2008.

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.

11. RETIREMENT AND THRIFT PLANS

Retirement Plans

The Bank currently offers three defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the employees of the Reserve Banks, Board of Governors, and Office of Employee Benefits of the Federal Reserve System ("OEB") participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan"). In addition, employees at certain compensation levels participate in the Benefit Equalization Retirement Plan ("BEP") and certain Reserve Bank officers participate in the Supplemental Retirement Plan for Select Officers of the Federal Reserve Bank ("SERP").

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

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2009 and 2008, and for the years then ended, were not material.

Thrift Plan

Employees of the Bank participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank matches employee contributions based on a specified formula. For the year ended December 31, 2008 and for the first three months of the year ended December 31, 2009, the Bank matched 80 percent of the first 6 percent of employee contributions for employees with less than five years of service and 100 percent of the first 6 percent of employee contributions for employees with five or more years of service. Effective April 1, 2009, the Bank matches 100 percent of the first 6 percent of employee contributions from the date of hire and provided an automatic employer contribution of one percent of eligible pay. The Bank's Thrift Plan contributions totaled \$4 million and \$3 million for the years ended December 31, 2009 and 2008, respectively, and are reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income.

12. POSTRETIREMENT BENEFITS OTHER THAN RETIREMENT PLANS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Retirement Plans

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

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

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

	2009	2008
Accumulated postretirement benefit obligation at January 1	\$ 72.5	\$ 62.9
Service cost benefits earned during the period	1.8	2.0
Interest cost on accumulated benefit obligation	4.4	4.2
Net actuarial loss	3.4	8.7
Curtailment gain	-	(2.4)
Contributions by plan participants	1.3	1.4
Benefits paid	(4.6)	(4.6)
Medicare Part D subsidies	0.4	0.3
Plan amendments	4.5	-
Accumulated postretirement benefit obligation at December 31	\$ 83.7	\$ 72.5

At December 31, 2009 and 2008, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 6.00 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.

NOTES TO FINANCIAL STATEMENTS

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):

	2009	2008
Fair value of plan assets at January 1	\$ -	\$ -
Contributions by the employer	2.9	2.9
Contributions by plan participants	1.3	1.4
Benefits paid	(4.6)	(4.6)
Medicare Part D subsidies	0.4	0.3
Fair value of plan assets at December 31	\$ -	\$ -
Unfunded obligation and accrued postretirement benefit cost	\$ 83.7	\$ 72.5
Amounts included in accumulated other comprehensive loss are shown below:		
Prior service cost	\$ (3.4)	\$ 2.3
Net actuarial loss	(26.6)	(26.3)
Deferred curtailment gain	-	0.4
Total accumulated other comprehensive loss	\$ (30.0)	\$ (23.6)

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:

	2009	2008
Health care cost trend rate assumed for next year	7.50%	7.50%
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	2015	2014

NOTES TO FINANCIAL STATEMENTS

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, 2009 (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	\$ -	\$ (0.1)
Effect on accumulated postretirement benefit obligation	0.6	(1.9)

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

	2009	2008
Service cost for benefits earned during the period	\$1.8	\$2.0
Interest cost on accumulated benefit obligation	4.4	4.2
Amortization of prior service cost	(1.2)	(1.3)
Amortization of net actuarial loss	3.0	2.9
Total periodic expense	8.0	7.8
Curtailment (gain)/loss	(0.4)	0.1
Net periodic postretirement benefit expense	\$7.6	\$7.9

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2010 are shown below:

Prior service cost	\$(0.1)
Net actuarial loss	2.9
Total	\$2.8

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2009 and 2008, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 6.00 percent and 6.25 percent, respectively.

NOTES TO FINANCIAL STATEMENTS

Net periodic postretirement benefit expense is reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income. A net curtailment gain/loss associated with restructuring programs that are described in Note 14 was recognized in net income in the year ended December 31, 2009, related to employees who terminated employment during 2009. A deferred curtailment gain was recorded in 2008 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 are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit expense.

Federal Medicare Part D subsidy receipts were \$0.6 million and \$0.3 million in the years ended December 31, 2009 and 2008, respectively. Expected receipts in 2010, related to benefits paid in the years ended December 31, 2009 and 2008, are \$0.1 million.

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

	Without subsidy	With subsidy
2010	\$ 4.8	\$ 4.4
2011	5.3	4.8
2012	5.6	5.1
2013	6.0	5.4
2014	6.3	5.7
2015 - 2019	36.1	32.3
Total	\$ 64.1	\$ 57.7

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. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, disability benefits, and self-insured workers' compensation expenses. The accrued postemployment benefit costs recognized by the Bank at December 31, 2009 and 2008 were \$7 million and \$5 million, respectively. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2009 and 2008 operating expenses were \$3.3 million and \$0.4 million, respectively, and are recorded as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income.

NOTES TO FINANCIAL STATEMENTS

13. ACCUMULATED OTHER COMPREHENSIVE INCOME AND OTHER COMPREHENSIVE INCOME

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

	Amount related to postretirement benefits other than pensions
Balance at January 1, 2008	\$ (19)
Change in funded status of benefit plans:	
Net actuarial loss arising during the year	(7)
Amortization of prior service cost	(1)
Amortization of net actuarial loss	3
Change in funded status of benefit plans - other comprehensive loss	(5)
Balance at December 31, 2008	\$ (24)
Change in funded status of benefit plans:	
Prior service costs arising during the year	(5)
Net actuarial loss arising during the year	(3)
Amortization of prior service cost	(1)
Amortization of net actuarial loss	3
Change in funded status of benefit plans - other comprehensive loss	(6)
Balance at December 31, 2009	\$ (30)

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

14. BUSINESS RESTRUCTURING CHARGES***2008 Restructuring Plans***

In 2008, the Reserve Banks announced the acceleration of their check restructuring initiatives to align the check processing infrastructure and operations with declining check processing volumes. The new infrastructure consolidates operations into two regional Reserve Bank processing sites; in Cleveland, for paper check processing, and Atlanta, for electronic check processing.

NOTES TO FINANCIAL STATEMENTS

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

	2008 restructuring plans	
<i>Information related to restructuring plans as of December 31, 2009:</i>		
Total expected costs related to restructuring activity	\$	3.7
Expected completion date		2009
<i>Reconciliation of liability balances:</i>		
Balance at January 1, 2008	\$	-
Employee separation costs		2.8
Other costs		0.3
Adjustments		(0.2)
Balance at December 31, 2008	\$	2.9
Other costs		0.2
Adjustments		0.6
Payments		(1.4)
Balance at December 31, 2009	\$	2.3

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

Other costs include retention benefits and outplacement services and are shown as a component of "Salaries and other benefits" and "Other expenses" in the Statements of Income and Comprehensive Income.

Adjustments to the accrued liability are primarily due to changes in the estimated restructuring costs and are shown as a component of the appropriate expense category in the Statements of Income and Comprehensive Income. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 11.

15. SUBSEQUENT EVENTS

There were no subsequent events that require adjustments to or disclosures in the financial statements as of December 31, 2009. Subsequent events were evaluated through April 21, 2010, which is the date that the Bank issued the financial statements.

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