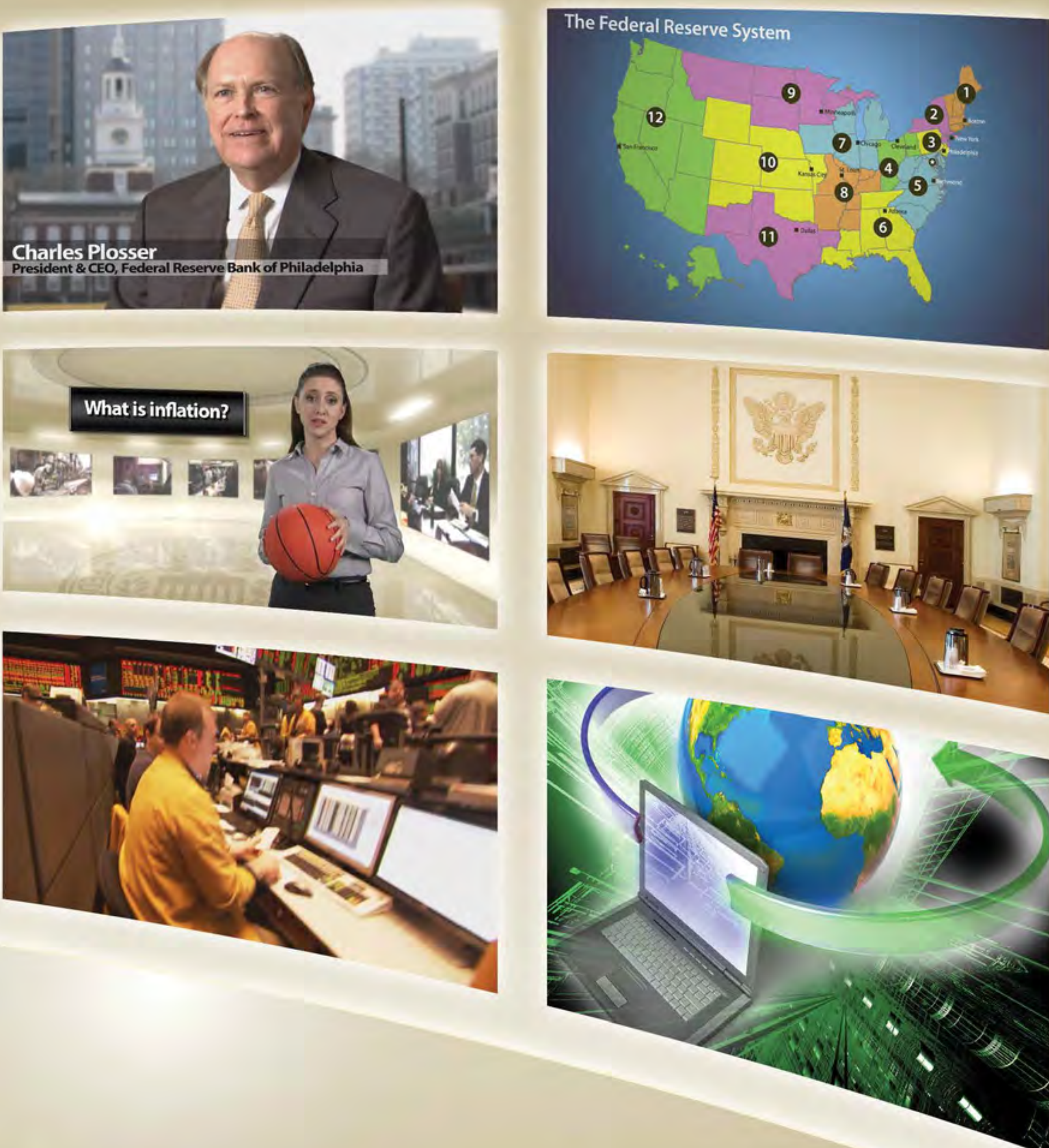
Federal Reserve Bank of Philadelphia
2012 Annual Report



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CHARLES I. PLOSSER

PRESIDENT'S MESSAGE

UNDERSTANDING THE FEDERAL RESERVE, ITS ROLE, AND ITS LIMITATIONS

This year's annual report, entitled *The Federal Reserve and You*, highlights a new educational video about our nation's central bank, which is the culmination of more than three years of work by staff at the Federal Reserve Bank of Philadelphia, in partnership with Federal Reserve System colleagues.

The cover article, "The Making of *The Federal Reserve and You*," provides the behind-the-scenes story and describes how the video's chapters explain the Federal Reserve's key roles in our nation's payments system, in conducting monetary policy, and in the supervision and regulation of banking institutions. The video, which is available on DVD or from our website, also includes chapters on the basics of money and banking and the history of U.S. central banking. While the primary audience is high school students, we expect that consumers and community and business groups will find this resource helpful in understanding the Federal Reserve, why it was created, and how it touches the lives of all Americans.

I believe it is also important to understand the limitations of our role as a central bank. In this year's essay, "Fiscal Policy and Monetary Policy: Restoring the Boundaries," I describe the differences between fiscal and monetary policy, and why it is important to have a bright line separating them. Unfortunately, over the past few years, the global financial crisis and sustained fiscal imbalances in many countries have blurred that line. Asking monetary policy to take on fiscal responsibilities undermines the discipline of the fiscal authorities, the independence of the central bank, and our ability to achieve the goals of monetary policy assigned to the central bank.

The annual report includes a message from First Vice President Blake Prichard and Bank Highlights of our accomplishments during 2012. I especially note our work on key Federal Reserve System projects, such as the work on model validation for the Comprehensive Capital Analysis and Review (CCAR), mandated by the

Dodd-Frank Act. Researchers in the Payment Cards Center helped study debit card interchange fees at the Board of Governors. The Philadelphia Fed and the Kansas City Fed continue to staff and manage a System resource – Risk Assessment, Data Analysis, and Research (RADAR) – which helps optimize the use of data to identify and monitor financial risks. And economists in our Research Department studied the use of dynamic stochastic general equilibrium (DSGE) models in monetary policymaking and provided other important staff work to the Federal Open Market Committee.

Our Bank also hosted 18 major conferences and seminars last year to share research with the public, including the biennial "Reinventing Older Communities" conference featured in the Bank Highlights section of this report.

BOARD OF DIRECTORS AND ADVISORY COUNCILS

The citizens who serve on the Bank's board of directors and advisory councils have a unique insight into the many roles that we play in the economy. I am grateful for the continued advice and counsel of the nine citizens who serve on the board. In 2012, Jeremy Nowak, president of J Nowak and Associates, LLC, and James E. Nevels, chairman and founder of The Swarthmore Group, completed their first years as chairman and deputy chairman, respectively. Both were reappointed to these roles in 2013. Also in 2013, we welcomed David R. Hunsicker, chairman, president, and CEO of New Tripoli Bank, and Rosemary Turner, president of the United Parcel Service's (UPS) Chesapeake District, to the board. They replace Deborah M. Fretz, retired president and CEO of Sunoco Logistics, and Aaron L. Groff, Jr., chairman, president, and CEO of Ephrata National Bank, who completed their terms in 2012. I thank them both for their service and advice.

The Economic Advisory Council (EAC) includes representatives from diverse industries, manufacturers, as well as nonprofits in the Third District. In 2012, we welcomed Michael Araten, president and CEO, the Rodon Group and K'NEX Brands; Thomas J. Doll, president, COO, and CFO of Subaru of America, Inc.; Bill Polacek, president and CEO, JWF Industries and JWF Defense Systems, LLC, in Johnstown; and M. Shawn Puccio, senior vice president of finance, Saint-Gobain Corporation.

In 2012, we also appointed Richard A. Grafmyre, president and CEO of Jersey Shore State Bank, and Gerald L. Reeves, president, CEO, and director of Sturdy Savings Bank, to the Community Depository Institutions Advisory Council (CDIAC), which includes representatives from commercial banks, thrift institutions, and credit unions in the Third District. In addition, Dennis D. Cirucci, president, CEO, and director of Alliance Bancorp Inc. and Alliance Bank, was selected from our CDIAC to serve on the Federal Reserve Board's CDIAC with his peers from around the Federal Reserve System.

I also thank Bharat Masrani, president and CEO of TD Bank, N.A., for his continued service as the Third District's representative to the Federal Advisory Council, which meets quarterly with the Board of Governors in Washington, D.C.

Finally, I offer my sincere thanks to the talented and dedicated employees at the Philadelphia Fed. I am proud of their many contributions to the Bank, to the Federal Reserve System, and to the community. If you really want to understand *The Federal Reserve and You,* know that people here and around the System all share a common commitment to public service that helps support a sound economy. We look forward to working with you in the year ahead.

Charles Plosser

Charles I. Plosser
President and Chief Executive Officer
June 2013

FIRST VICE PRESIDENT'S MESSAGE

STRONG, STABLE PERFORMANCE ON A THREE-LEGGED STOOL

D. Blake Prichard, First Vice President and Chief Operating Officer

We sometimes represent the scope of Federal Reserve duties by a three-legged stool — a metaphor for a seat whose stability depends on the strength of each leg. In 2012, all three legs — financial services, bank supervision, and monetary policy — got their exercise, and the outlook is for continued strong performance in all functions.

In our financial services role, the Federal Reserve announced a new strategic plan for financial services to expand our role to foster integrity, efficiency, and accessibility to financial services. The strategic plan describes a partnership with industry to promote faster payments delivery and notification from initiation of payments to completion or "fulfillment," bringing greater certainty to many transactions. The plan recognizes the significant collaboration that has occurred with industry leaders to evolve the U.S. payments system from a paper-based to a nearly all-electronic system with nearly 100 percent of checks now collected digitally. The plan continues a focus on secure financial transactions with efforts to coordinate resources in defending against cyber-attacks.

In supervision, we have seen continued improvement in banking conditions and in the health and strength of our nation's financial institutions. Our staff performed essential work in validating models for the 2012 Comprehensive Capital Analysis and Review (CCAR), the so-called "stress tests" of top banking institutions. These tests provided an objective assessment of the capability of these institutions to weather possible economic downturns yet remain strong and viable.

Finally, in monetary policy, the Bank's economists continue to play a key role in contributing to monetary policy through analysis of regional and national conditions. Our research publications and analyses are delivered to business and academic forums everywhere and are archived on our website to inform consumers, businesses, and academics.

Our foundation and our commitment are strong to continue the legacy of service built over nearly a century. We look ahead to celebrating that century of service as we approach that milestone in 2013.

Please read more details in the Bank Highlights section that follows.

BLAKE PRICHARD

BANK HIGHLIGHTS

IMPROVING URBAN RESILIENCY THROUGH COMMUNITY DEVELOPMENT

How older industrial cities can become resilient communities was the focus of the Federal Reserve Bank of Philadelphia's fifth biennial Reinventing Older Communities conference. Community development leaders from nonprofits, banks, foundations, government agencies, and businesses from 24 states, the District of Columbia, Puerto Rico, and Canada attended.

Conference attendees heard from some of the nation's leading practitioners and researchers and toured workforce development sites in Philadelphia's Kensington neighborhood, economic revitalization projects in Chester, PA, and waterfront development along the Delaware River. Speakers probed why some cities, rather than others, are resilient. Among those addressing the question of urban resiliency were Charles I. Plosser, president and CEO of the Federal Reserve Bank of Philadelphia; Jeremy Nowak, president of J Nowak and Associates, LLC and chairman of the board of directors of the Philadelphia Fed; and Shaun Donovan, secretary of the U.S. Department of Housing and Urban Development.

"In Philadelphia's Shadow: Small Cities in the Third Federal Reserve District," a special report written by Alan Mallach, a visiting scholar at the Philadelphia Fed, was released at the conference. The report described 13 small formerly industrial cities in the District and conditions that contributed to their decline and recovery.

From left, Erin Mierzwa, department manager, and Theresa Y. Singleton, vice president and community affairs officer, in the Community Development Studies and Education Department, led the planning for the conference.

HIGHLIGHTING MACROECONOMICS, REGIONAL ANALYSIS, AND REAL-TIME DATA

The **Research Department** organized several significant workshops and conferences, including the 10th annual Philadelphia Workshop on Macroeconomics, which was jointly sponsored with the University of Pennsylvania's Economics Department, the Penn Institute for Economic Research, and the International Economic Review. It also held the sixth annual Macroeconomics Across Time and Space conference in partnership with the National Bureau of Economic Research. And the department coorganized a conference on monetary policy, inflation, and international linkages at the Deutsche Bundesbank's training center in Eltville, Germany. The Research Department also convened the annual conference of the System's Committee on Regional Analysis and worked with Princeton University's Woodrow Wilson School to hold the fourth annual Conference on Urban and Regional Economics. The Research Department collaborated with the Payment Cards Center and the Supervision, Regulation & Credit Department on a conference on improving data and analysis for financial stability.

PROMOTING NEW TOOLS, THE ROLE OF RESEARCH, AND FINANCIAL PROTECTION

Conferences convened by Bank departments in 2012 included an annual meeting of System Payments Analysts hosted by the **Payment Cards Center** (PCC) in June. The meeting featured new collaborative tools developed by the PCC, presentations by researchers from the Consumer Financial Protection Bureau, and a presentation on the role of research in the Federal Reserve Financial Services' new strategic plan. The PCC also hosted a conference on consumer financial protection regulations attended by 80 representatives from commercial banks, credit card companies, academia, nonprofits specializing in consumer financial education, policy-making entities, and the Federal Reserve System. In addition, the PCC introduced a new section of the Bank's website that features the research and expertise of the entire Bank on topics related to consumer credit and payments.

Participants in the July 2012 "Making Sense of Money and Banking" five-day program.

PROMOTING FINANCIAL LITERACY IN THE CLASSROOM

The Bank also convened a number of professional development programs for educators, including its annual "Making Sense of Money and Banking" program, as well as "Making Sense of Money and Banking 2," which was offered to primary and secondary school teachers who had attended "Making Sense of Money and Banking" courses since 2004. Another 48 educators participated in the Bank's "Entrepreneurship and You," an after-school professional development program that focuses on the framework for teaching entrepreneurship and economics topics in the classroom.

As part of our financial literacy efforts, Bank staff trained 35 teachers, 14 of whom represented majority-minority schools, to teach the "Keys to Financial Success" course. These 14 teachers reach an estimated 1,025 students per year. In all, teachers from 24 school districts in Delaware, New Jersey, Pennsylvania, and Virginia participated.

BANK HIGHLIGHTS

RESEARCHING COMMUNITY DEVELOPMENT ISSUES

The Bank launched a new publication entitled *Cascade Focus*, which summarizes research on issues related to community development in low- and moderate-income (LMI) communities and fair and impartial access to credit in underserved markets. On the Bank's external website, the **Community Development Studies and Education Department** also released a Community Development Data Dashboard, which provides insights into housing and economic trends in LMI communities in the District and the nation.


December 2012

CASCADE FOCUS

Affordability and Availability of Rental Housing in the Third Federal Reserve District: 2012[1]

By Keith Wardrip, Thomas Hylands, and Joshua Strazanac

Highlights

The Bank also convened several events for community development leaders, including two events in Philadelphia and Reading on small business lending in collaboration with the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the U.S. Small Business Administration. In addition, an event brought together anchor institutions in Chester, PA, in collaboration with Widener University and the U.S. Department of Housing and Urban Development's Office of University Partnerships, to discuss the role of such anchor institutions in economic and community development.

LENDING HELPING HANDS IN THE COMMUNITY

During 2012, the **PhillyFedCARES** program held a number of volunteering events that took employees out into the community. The program organized two "Days of Caring," during which 20 employees worked with MANNA (Metropolitan Area Neighborhood Nutrition Alliance), located in Center City Philadelphia (top). Employee volunteers also assisted the Andrew Jackson elementary school by painting iron fences and flower planters, sorting over 2,000 books in the school library, and planting employee-donated bushes and plants (center and bottom).

Approximately 50 Bank employees participated in the 9/11 Heroes Run in Fairmount Park, sponsored by the Travis Manion Foundation, a nonprofit organization that supports veterans and their families, as well as the families of fallen service members. PhillyFedCARES is an employee voluntarism group that organizes many community service projects and activities to provide opportunities to Bank staff to serve others.

EXPANDING OUTREACH TO STUDENTS AND VETS

The Bank expanded outreach to historically black colleges and universities and women's colleges within the Third District by attending on-campus career fairs and campus events and hosting an event at the Bank for key administrators from an area women's college to share information about the summer internship program.

The Bank continues to support the Philadelphia Youth Network and WorkReady Philadelphia by participating in such events as "Connect the Dots," a networking event for Philadelphia high school students and business leaders, and the "Extreme Interview Expo 2012," an event focused on helping high school students practice interviewing techniques to prepare for the workforce.

The **Procurement** staff participated in the Greater Philadelphia Chamber of Commerce "Vetwork Your Business" event aimed at veteran-owned businesses and services, especially those owned by disabled veterans. Staff also sponsored outreach to minority- and women-owned businesses to provide resources to support successful bid proposals to expand their businesses.

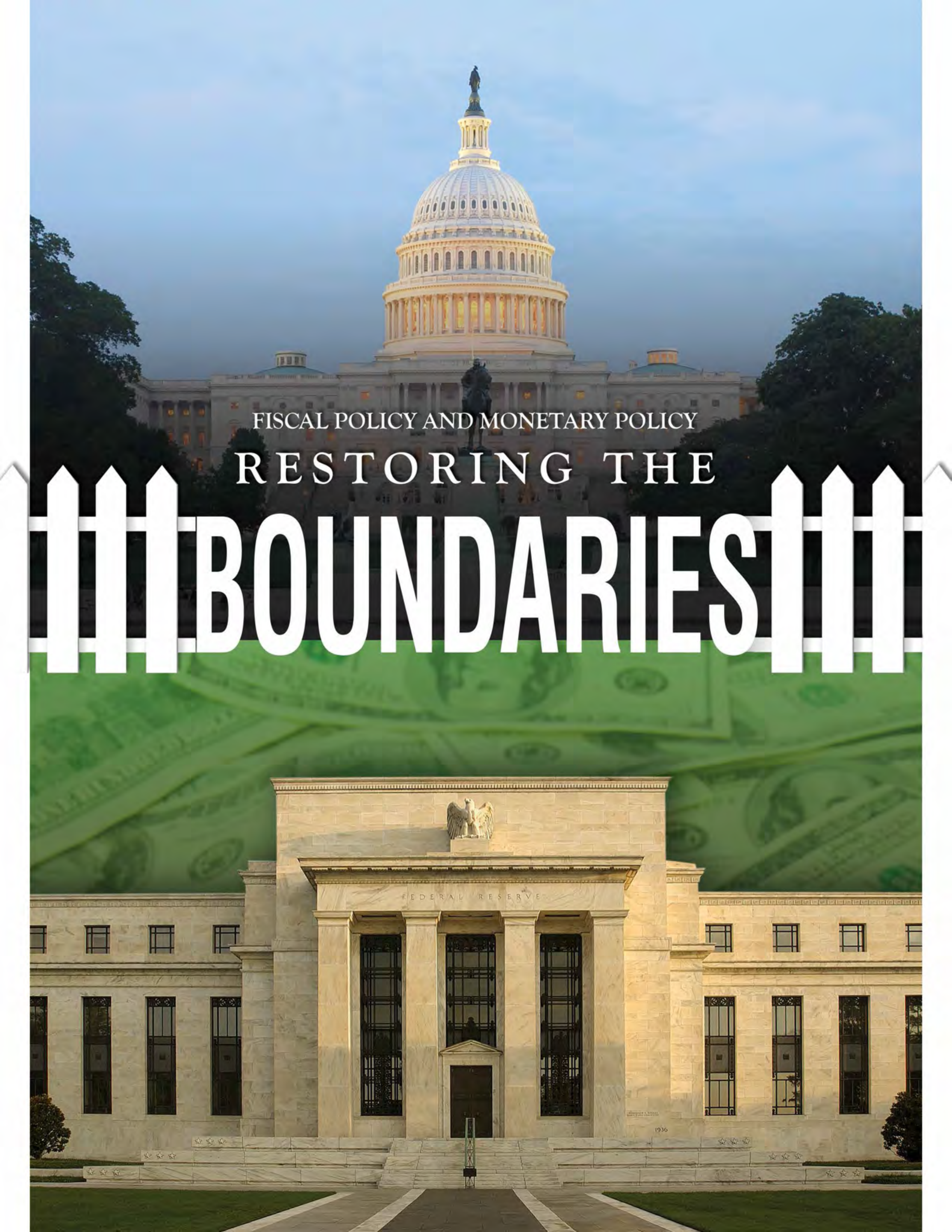
SHARING KNOWLEDGE, COLLECTING DATA

Supervision, Regulation & Credit staff provided major contributions to the Fed's Stress Testing Model Symposium, which brought together over 250 participants, including many experts from industry, academia, and the Fed. The conference highlighted our Bank's leadership in model validation and consumer credit modeling used in Comprehensive Capital Analysis and Review (CCAR), mandated for the nation's largest banks by the Dodd-Frank Act.

The Bank led development of a new quarterly publication and website, *Community Banking Connections,* on behalf of the Federal Reserve System. Both the website and publication provide important regulatory and supervisory guidance that is specifically directed to community banks. The Bank continues to publish *Consumer Compliance Outlook*, a quarterly publication that focuses on consumer compliance issues. In addition, the Bank plays a leadership role in the System's Partnership for Progress program, which provides minority-owned and de novo financial institutions with information and resources.

The Risk Assessment, Data Analysis, and Research (RADAR) team began to collect and manage account-level data on credit cards and mortgages from the largest banks. The monthly files, which include more than a half billion credit card accounts with $600 billion in balances and more than 45 million mortgage loans totaling more than $7 billion, help the Federal Reserve monitor financial stability.

The business technology group established the Supervision Team Site Support Office (STSSO) to develop and implement technology solutions for all Federal Reserve bank examiners. Electronic team site workspaces allow examiners to share information and collaborate more effectively and efficiently.


FISCAL POLICY AND MONETARY POLICY
RESTORING THE
BOUNDARIES
FEDERAL RESERVE

FISCAL POLICY AND MONETARY POLICY: RESTORING THE BOUNDARIES

By Charles I. Plosser

The policy choices made during and after the global recession that started in 2007 have created daunting fiscal challenges for our country and many others around the world. These fiscal challenges also have profound implications for monetary policy. Although the interplay between monetary and fiscal policy is not a new topic, in this year's annual report essay, I would like to share some thoughts about the appropriate relationship between the two, and why it is important to restore the bright boundaries between fiscal and monetary policy.[1]

FISCAL IMBALANCES

During the past several years, we have witnessed the ongoing saga of governments, both in Europe and in the U.S., struggling with large deficits and soaring public debt. For the most part, these challenges are self-inflicted. They are the result of governments choosing fiscal policies that they knew would be unsustainable in the long run. Financial market participants remain skeptical about whether the political process can come to grips with the problems. So far, this skepticism appears to be wholly justified. Neither the European nor the American political process has developed credible and sustainable plans to finance public spending. Instead, politicians continue to engage in protracted debates over who will bear the burden of the substantial adjustments needed to put fiscal policies back on a sustainable path. In my view, these prolonged debates impede economic growth, in part, due to the uncertainty they impose on consumers and businesses. Moreover, the longer the delay in developing credible plans, the more costly it becomes for the respective economies.

Given the magnitude of the fiscal shortfalls, the way in which the political process restores fiscal discipline will have profound implications for years to come. Will there be higher taxes on investments by the private sector that risk reducing productive capacity and output in the future? Will there be higher taxes on labor that discourage work effort or hiring? Will there be cutbacks in government expenditures on defense or basic research that might force significant resource reallocations and affect a wide array of industry sectors? Will there be cutbacks on entitlements that could

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[1] This essay is based on a speech by the author, Plosser (2012). The views expressed here are the author's and not necessarily those of the Federal Reserve Board or the Federal Open Market Committee.

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affect health care, social insurance, and other aspects of our safety net? Or will a viable fiscal plan combine various types of tax increases and spending cuts?

These are important questions that involve hard choices and trade-offs between efficiency and equity. Yet, until fiscal authorities choose a path, uncertainty encourages firms to defer hiring and investment decisions and complicates the financial planning of individuals and businesses. The longer it takes to reach a resolution on a credible, sustainable plan to reduce future deficits and limit the ratio of public debt to gross domestic product, or GDP, the more damage is done to the economy in the near term.

Some observers say cyclical factors and the magnitude of the recent global recession caused the current fiscal crisis. It is certainly true that the policy choices made by governments to deal with the financial crisis and ensuing recession have caused a significant deterioration in fiscal balances and debt levels in many countries. However, the underlying trends that are at the root of unsustainable fiscal deficits in many countries, including the U.S., have been in place and known for some time. In the U.S., for example, the major long-run drivers of the structural deficit at the federal level are entitlements such as health care and Social Security.[2]

Thus, even after cyclical effects play out, many countries will continue to have large structural budget deficits. In this sense, the financial crisis and recession have simply exacerbated the underlying problems and perhaps moved up the day of reckoning. In

[2] In other countries and jurisdictions, such as those at the state and local levels, pension and entitlement commitments also account for a significant source of the growth in commitments and thus are central to the fiscal problems.

some cases, such as Greece, that day has come. In light of these realities, market participants have begun to question the solvency of governments and their ability to honor their sovereign debt obligations in the absence of deep structural reforms. In Europe, the doubts have greatly complicated the political problems as various countries debate the question of "who pays" for the anticipated bad debts of individual countries. Here, too, the protracted nature of the political debate creates uncertainty, which undermines economic growth and exacerbates the crisis.

THE INTERACTION OF MONETARY POLICY AND FISCAL POLICY

So what does this have to do with monetary policy? Well, it turns out, a great deal. It is widely understood that governments can finance expenditures through taxation, debt – that is, future taxes – or printing money. In this sense, monetary and fiscal policy are intertwined through the government budget constraint. Nevertheless, there are good reasons to prefer an arrangement that provides a fair degree of separation between the functions and responsibilities of central banks and those of the fiscal authorities. For example, in a world of fiat currency, central banks are generally assigned the responsibility for establishing and maintaining the value or purchasing power of the nation's monetary unit of account. Yet, that task can be undermined or completely subverted if fiscal authorities independently set their budgets in a manner that ultimately requires the central bank to finance government expenditures with significant amounts of seigniorage in lieu of tax revenues or debt.[3]

[3] See Sargent and Wallace (1981).

The ability of the central bank to maintain price stability can also be undermined when the central bank itself ventures into the realm of fiscal policy.

Imagine a situation in which public debt levels are high and rising. Now stretch your mind even more and imagine that fiscal policymakers are reluctant to make the hard choices of cutting expenditures or increasing taxes. Of course, neither of these assumptions requires much imagination. Indeed, history and our daily newspapers provide numerous examples. Unless governments are constrained institutionally or constitutionally, they often resort to the printing press to try to escape their budget problems. Yet, we all understand that this option is a recipe for creating substantial inflation.[4] Indeed, history shows that it is often a path toward hyperinflation.[5]

Awareness of these long-term consequences of excessive money creation is the reason that over the past 60 years, country after country has moved to establish and

[4] Inflation, of course, is also a tax. It is a hidden tax on holding nominal assets, and when it is unanticipated, it can have significant consequences that redistribute wealth from creditors to debtors. The near-term effects of money creation often appear to be positive, while the undesirable consequences become apparent only over time. While money creation results in lower nominal interest rates and perhaps a modest boost to real activity in the short run, over time, it results in higher inflation and higher nominal interest rates and ultimately requires painful efforts to restore price stability.

[5] Some notable examples include Germany, Hungary, and Austria after World War I, and Hungary and Greece after World War II. More recently, countries from South and Central America have had episodes of hyperinflation, including Argentina, Bolivia, Brazil, Peru, Mexico, and Nicaragua. Zimbabwe is the most recent example, with a period of hyperinflation that ended with currency reform in 2008.

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maintain independent central banks. Without the protections afforded by independence, the temptation of governments to exploit the printing press in the absence of fiscal discipline is just too great. Thus, it is simply good governance and wise economic policy to maintain a healthy separation between those responsible for tax and spending policy and those responsible for money creation.

But it is equally important that independent central banks be constrained from using their own authority to engage in activities that enter the realm of fiscal policy or distort private markets.[6]

There are several ways to place limits on central banks so that the boundaries between monetary and fiscal policy remain clear:[7]

First, the central bank can be given a narrow mandate, such as price stability. In fact, this has been a prominent trend during the last 25 years. Many major central banks now have price stability as their sole or primary mandate.

Second, the central bank can be restricted as to the type of assets it can hold on its balance sheet. This limits its ability to engage in credit policies or resource allocations that rightfully belong under the purview of the fiscal authorities or the private marketplace.

Third, the central bank can conduct its monetary policy in a more systematic or rule-like manner, which limits the scope for discretionary actions that might violate the boundaries between monetary and fiscal policy. Examples include Milton Friedman's suggestion to have money growth rise at a constant rate, or rules suggested by John Taylor that relate changes in a central bank's policy rate to the deviation of inflation from its target and output from its potential level. Such approaches to systematic policy can be a commitment device that limits discretionary behavior and thus helps to solve time-consistency problems.

THE BREAKDOWN OF THE ACCEPTED BOUNDARIES

Unfortunately, over the past few years, the combination of a financial crisis and sustained fiscal imbalances has led to a substantial breakdown in the institutional framework and the accepted barriers between monetary and fiscal policy. The pressure has come from both sides. Governments are pushing central banks to exceed their monetary boundaries and central banks are stepping into areas not previously viewed as acceptable for an independent central bank. Let me offer some examples to illustrate these pressures.

First, despite the well-known benefits of maintaining stable prices, there have

[6] See Plosser (2010) for further discussion on the risks of unconstrained policy tools and the necessity of commitment devices.

[7] Sargent (2010) has a thoughtful and insightful discussion on these and related issues.

been calls in many countries to abandon this commitment and create higher inflation to devalue outstanding nominal government and private debt. Such an inflation tax would transfer wealth from those who have lent money, in good faith, to the borrowers. I am deeply skeptical of such a strategy. In my view, inflation is a blunt and inappropriate instrument for assigning winners and losers from profligate fiscal policy or excessive borrowing by private individuals and firms. Forced redistributions of this kind, if undertaken at all, should be done through the political process and by the fiscal authorities, not through the backdoor by the central bank by way of inflationist policies. As a monetary policymaker, I do not want to be complicit in such a strategy. Moreover, history has shown that once inflation is unleashed, it is not always easy to bring it back down, especially if the central bank loses the public's confidence and damages the credibility of its commitment to price stability. Thus, proposals to use inflation to fix the debt overhang problem are nothing more than a call for debt monetization to solve a problem that is fundamentally fiscal in nature.

Pressure on central banks is also showing up through other channels. In some circles, it has become fashionable to invoke lender-of-last-resort arguments as a reason for central banks to lend to "insolvent" organizations, either failing businesses or, in some cases, failing governments. Such arguments go beyond the well-accepted principles established by Walter Bagehot, who wrote in his 1873 classic Lombard Street that central bankers could limit systemic risk in a banking crisis by "lending freely at a penalty rate against good collateral." Such a call to widen the lender-of-last-resort role is a perversion of one of central banking's core concepts. It is a fig leaf to conceal the process of monetizing the sovereign debt of those countries that are insolvent due to their inability to manage their fiscal affairs. Monetary policy should not be used to solve a fiscal crisis.

Unfortunately, from my perspective, breaching the boundaries is not confined to the fiscal authorities asking central banks to do their heavy lifting. The Fed and other central banks have also undertaken actions that have blurred the distinction between monetary policy, credit policy, and fiscal policy. These steps were undertaken with the sincere belief that they were absolutely necessary to address the challenges posed by the financial crisis.

For example, early in the financial crisis the Fed established credit facilities to support particular asset classes, such as commercial paper and asset-backed securities. Then it began purchasing housing

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When the Fed engages in targeted credit programs that seek to alter the allocation of credit across markets, I believe it is engaging in fiscal policy…

agency mortgage-backed securities (MBS) and agency debt to increase the availability and reduce the cost of credit in the housing sector. In September 2012, the Fed began a new round of MBS purchases, buying $40 billion in agency MBS per month, in part to support mortgage markets. The Fed is currently also purchasing $45 billion per month of longer-term Treasury securities. When the Fed engages in targeted credit programs that seek to alter the allocation of credit across markets, I believe it is engaging in fiscal policy and has breached the traditional boundaries established between the fiscal authorities and the central bank. Indeed, some of these actions have generated pointed criticisms of the Fed.

I view the breakdown of the traditional institutional arrangements as dangerous and fraught with longer-term risks. While it is popular to view such blurring of the boundaries as appropriate "cooperation" or "coordination" between the monetary and fiscal authorities, the boundaries were established for good reasons and we ignore them at our own peril.

I believe that central banks need to think hard about how and when they exercise this important role. We need to have a well-articulated and systematic approach to such actions. Otherwise, our actions will exacerbate moral hazard and encourage excessive risk-taking, thus sowing the seeds for the next crisis.

RESTORING THE BOUNDARIES

Once a central bank ventures into fiscal policy, it is likely to find itself under increasing pressure from the private sector, financial markets, or the government to use its balance sheet to substitute for other fiscal decisions. Such actions by a central bank can create their own form of moral hazard, as markets and governments come to see central banks as instruments of fiscal policy, thus undermining incentives for fiscal discipline. This pressure can threaten the central bank's independence in conducting monetary policy and thereby undermine monetary policy's effectiveness in achieving its mandate.

I have long argued for a bright line between monetary policy and fiscal policy, for the independence of the central bank, and for the central bank to have clear and transparent objectives. I have also stressed the importance of a systematic approach to monetary policy that serves to limit discretionary actions by the central bank. Furthermore, I have proposed a new accord between the Treasury and the central bank that would severely limit, if not eliminate, the central bank's ability to lend to private individuals and firms outside of the discount window mechanisms.[8] I have noted that decisions to grant subsidies to particular market segments should rest with the fiscal authorities – in the U.S., this means Congress and the Treasury Department – and not with the central bank. Thus, the new accord would limit the Fed to an all-Treasuries portfolio, except for those assets held as collateral for traditional discount window operations.

[8] See Plosser (2009) and Plosser (2010).

Should the fiscal authority ask the central bank to engage in lending outside of its normal operations, the fiscal authority should exchange government securities for the nongovernment assets that would accumulate on the central bank's balance sheet as a result. This type of swap would ensure that the full authority and responsibility for fiscal matters remained with the Treasury and Congress and the Fed's balance sheet remained essentially all Treasuries.

Congress has mandated the goals of monetary policy to promote price stability, maximum employment, and moderate long-term interest rates. Asking monetary policy to take on ever more fiscal responsibilities undermines the discipline of the fiscal authorities and the independence of the central bank. Central banks and monetary policy are not and cannot be real solutions to the unsustainable fiscal paths many countries currently face. The only real answer rests with the fiscal authorities' ability to develop credible commitments to sustainable fiscal paths. It is a difficult and painful task to be sure, but a monetary solution is a bridge to nowhere at best, and the road to perdition at worst – a world of rising and costly inflation and a weakening of fiscal discipline.

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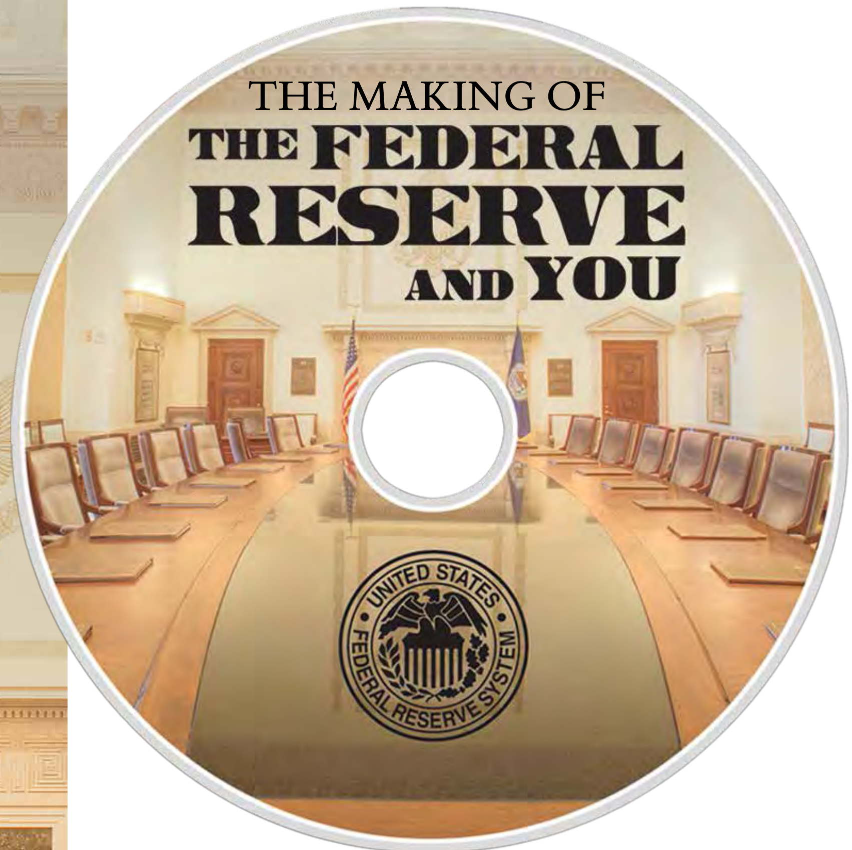


A FRESH APPROACH TO ECONOMIC EDUCATION

Educating the public about what the Federal Reserve is and does, and why we do what we do, is one of our fundamental duties. If we don't explain our essential role, who will?

Yet, it is a daunting challenge to explain the complex issues that led to the formation of the Federal Reserve and the complex processes it manages to seek the positive economic outcomes we all desire. Accepting this challenge led to a fresh approach in the making of *The Federal Reserve and You* interactive video.

The new video replaces a 12-year-old videotape called *The Fed Today*, but rather than producing another short linear film, the team chose to rethink the way video was used in the classroom. The result is a more interactive tool, with a menu-driven DVD and a matching video streaming website.

The Federal Reserve and You brings to life the important responsibilities of the Federal Reserve System and its essential role in the American and global economy. It is structured to have broad appeal, and its modular functionality enables a wide range of viewers — from high school students and teachers to consumers and business professionals — to tailor the use of the video to their own educational needs.

Whether the public, teachers, or students need a 24-minute overview of the Federal Reserve System, a two-minute primer on a specific aspect of monetary policy, or two and a half hours of material for a semester-long class, *The Federal Reserve and You* fits the bill.

LEVERAGING EDUCATIONAL EXPERTISE

Economic education is nothing new for the Philadelphia Fed. The Bank's economic education team, which is part of the Community Development Studies and Education Department, has a long history of working with educators. It holds several daylong and weeklong teacher-training programs annually and produces a wide range of educational materials and lesson plans, specifically for K-12 classrooms, on economics and personal finance.

"We strive to follow best practices in the field of economic education," said Andrew T. Hill, Ph.D., economic education advisor at the Philadelphia Fed. "Video continues to be one of the most effective teaching tools inside and outside the classroom, and its influence is growing as interactive video and online video streaming make video content more accessible — and more powerful — than ever."

Hill explained that the Philadelphia Fed had been responsible for distribution of VHS and DVD copies of the 13-minute video made in 1999, *The Fed Today*, which was hosted by former broadcast journalist Charles Osgood. While the video provided an overview of the Federal Reserve, it was missing the depth and details required to fully understand the functions of the Fed that affect our lives each day. A new video was needed to reflect the changes in the Federal Reserve and monetary policy in recent years and to help educators better meet state and national academic content standards.

So, Hill and his team seized the opportunity to spearhead a new educational video about the Federal Reserve System. Hill proposed a multiyear project to create the interactive video and led the effort from conception through distribution.

While the Bank's economic education team assumed full responsibility for the video's creation, the project's goal was to represent all of the Fed. To achieve this, the team engaged Federal Reserve System economic education colleagues to arrange interviews with Chairman Bernanke and other leaders from the Board of Governors in Washington and Reserve Banks across the country to contribute their perspectives and commentary. The video also draws on footage and photos from other Reserve Banks. Accordingly, the end product is a tool that can be broadly used across the country.

Right: Andrew Hill, economic education advisor, led the team that worked to produce the video.

Below: Stills from the video highlight the interviews and animations included in it.

"The interviews with the many leaders from across the System were integral in ensuring a well-balanced final product that serves teachers, students, individuals, and organizations nationwide. *The Federal Reserve and You* will, no doubt, become a useful resource for economic education across the country," said Hill.

The video includes an overview of the Federal Reserve and a full chapter on money and banking, including basic information that consumers need, which helps the public better understand the role of the Fed.

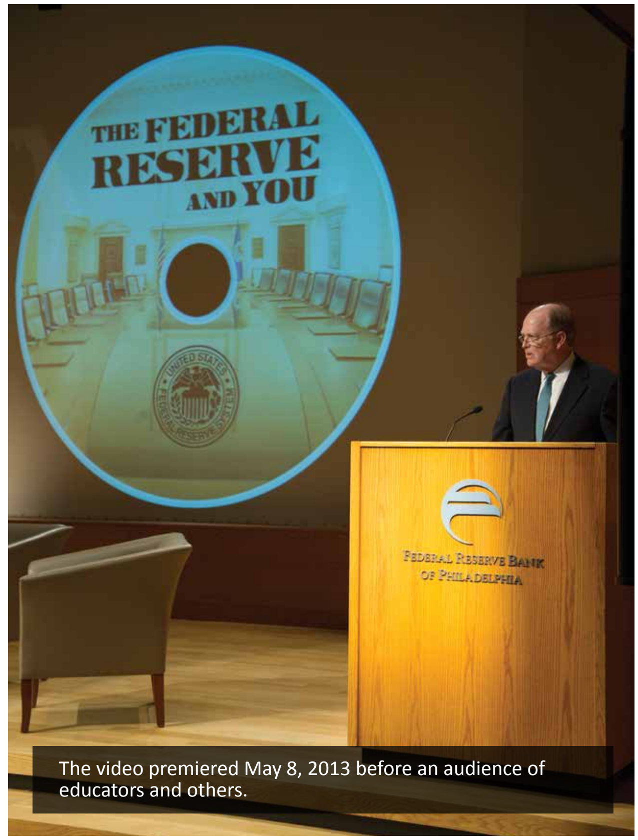
The video also includes a full chapter on the history of U.S. central banking, which fits well with Philadelphia's role as the home of the First and Second Banks of the United States and reminds viewers of the essential role a central bank plays in modern economies. The buildings that housed these two early attempts at central banking are just blocks away from the Philadelphia Fed.

CREATING COMPELLING CONTENT

Hill and the production team also selected two young actors to serve as the on-screen hosts, who walk viewers through the video from start to finish and explain the Fed in simple terms. Modern graphics, detailed animations, historical reenactments, and interviews with leaders from across the Federal Reserve System complement their dialogue, helping viewers to visualize and conceptualize the information. The young hosts help to ensure a more relevant product for high school students, yet they also appeal to a larger audience.

"Despite its complexities, learning about the Federal Reserve does not have to be difficult. With the right presentation tools and delivery format, learning should be engaging, effective, and even fun," said Hill.

Even so, exploring all the important details of various facets of the Fed in easily understandable terms requires hours of explanation, making it essential that the economic education team carefully chart the content and its structure. As a result, *The Federal Reserve and You* is composed of seven chapters:



The video premiered May 8, 2013 before an audience of educators and others.

Chapter 1: The Federal Reserve and You

Capturing the core of the Federal Reserve System, this 24-minute overview explains the Fed's structure and the three areas in which it operates — payments, supervision and regulation of financial institutions, and monetary policy — as well as the two goals of Federal Reserve monetary policy: price stability and maximum employment.

Chapter 2: History of Central Banking in the United States

Historical reenactments bring the nation's monetary and financial history to life as viewers journey through time to explore the creation of the First and Second Banks of the United States, the tumultuous nature of the nation's financial system in the period between 1836 and 1913, the founding of the Federal Reserve, and its operations in key periods, including the Great Depression, the spiraling inflation of the 1970s, and the financial crisis of 2007-2009.

Chapter 3: Money and Banking 101

Encouraging viewers to think critically about the money they use every day, this chapter provides background on the basics of money and banking in the United States and delves into details about the money supply, the fractional reserve banking system, how money is created when banks make loans, the concept of price stability, and the causes and effects of inflation.

Chapter 4: Monetary Policy

This chapter explains how changes in the money supply can affect interest rates, and in turn, national economic goals of economic growth, price stability, and full employment. The discussion also explores the Federal Reserve's monetary policy tools: open market operations, the discount rate, reserve requirements, and interest on reserves.

Chapter 5: The Payments System

This chapter looks at how the nation's payments system facilitates everyday financial transactions and explores cash, checks, and the evolution of electronic payments over the past 20 years. It emphasizes the critical role that the System's Fedwire service plays as the backbone of the U.S. financial system.

Chapter 6: Supervision and Regulation

Why and how does the Federal Reserve supervise and regulate thousands of financial institutions? This content provides important insight into the history and current state of supervision and regulation, including how Congress passes laws that affect financial institutions and how the Federal Reserve, in cooperation with other regulatory agencies, writes rules to implement those laws.

Chapter 7: A Baker's Dozen: 13 Key Questions

This handy Q&A delivers quick answers to 13 questions about the Federal Reserve and economics, from "How does the Federal Reserve work for you?" and "What is GDP?" to "What are government securities?"

A CLOSER LOOK AT MONETARY POLICY

The Federal Reserve and You dedicates nearly 20 minutes to monetary policy. One of the most detailed chapters, it covers the effects of changes in the money supply; price stability; monetary policy goals; the role of the Federal Open Market Committee (FOMC); open market operations; the discount rate; interest on reserves; reserve requirements; and monetary policy during turbulent times.

At a local level, the Bank's Research Department plays a key role in monetary policy by gathering information about the Third District and the economy at large. Their work helps brief President Plosser before each FOMC meeting.

The department also publishes analyses of regional and national economic data, such as the Philadelphia Fed's Business Outlook Survey, a poll of manufacturers in the Third District that has been conducted every month since May 1968. It has become one of the most widely followed regional surveys. Respondents provide data about business activity at their plants, including employment, working hours, new and unfilled orders, shipments, inventories, delivery times, prices paid, and prices received.

Each of these chapters contains various shorter segments that explain specific aspects of the larger topic. The DVD and the streaming video site allow viewers to watch entire chapters or to play one segment at a time. This creates maximum flexibility for teaching and learning about the Federal Reserve. Teachers can easily combine specific content areas from portions of the video or full chapters into their lesson plans at various points in the curriculum.

This flexibility also expands the video's functionality, since it can be used in various academic content areas beyond business or economics. For example, social studies classes can benefit from learning about the history of central banking in the United States, from the establishment of the First Bank, proposed by Alexander Hamilton in 1791, to the financial crisis of 2007-2009. Family and consumer science classes will find value in the segments about money and banking.

Hill added, "We have created a multipurpose video that can be used well beyond the classroom. Individual consumers, consumer groups, and business groups can all use this resource to learn about the Fed."

Top left: Andrew Hill (right), the producer of *The Federal Reserve and You*, and the film's director, Bob Noll (left), interviewed Chairman Ben Bernanke (center) inside the board room of the Board of Governors in Washington, D.C.

Bottom left: Pictured at the premiere of the *The Federal Reserve and You* are (left to right) Andrew Hill; President Charles Plosser; Jimmy Brooks, Jr., actor; Theresa Singleton, vice president, Community Development Studies and Education; Bob Noll; and Milissa Tadeo, senior vice president, Corporate Affairs.

A CLOSER LOOK AT PAYMENTS

The Federal Reserve and You explains how the Federal Reserve plays an important role in various forms of payment, including familiar currency, coin, and paper checks, as well as electronic payments, such as the automated clearing house (ACH) used by businesses and consumers, and the Fedwire services used by financial institutions.

In the Third District, the Philadelphia Fed is advancing its work in payments on several fronts. The currency counting division of the Bank's Cash Services Department continues to execute the national multiyear strategic plan to upgrade all electronic sensors that authenticate currency to keep pace with advancements in technology and the new designs of U.S. currency.

In 2012, the Bank's Payment Cards Center marked its 12th year of promoting a deeper understanding of consumer credit and payments. The center hosts seminars on the use of payment cards and related economic and policy issues and frequently represents the Philadelphia Fed at industry and policy events focused on payments. Combining this industry involvement with extensive research, the center remains a well-respected source of information and insight into payments.

KEEPING CURRENT

The Federal Reserve and You, which has been more than two years in the making, was designed in a segmented format, with production elements that lend themselves to updates in the years to come. Rather than overhaul the entire video as the Fed and the financial landscape continue to evolve, the economic education team can edit or add individual sections of content as the need arises.

The video's online distribution on the Philadelphia Fed's website (www.philadelphiafed.org/the-federal-reserve-and-you) lends itself to accommodating these updates. The video is also available in traditional DVD format. The Philadelphia Fed's economic education team plans a series of approximately 30 lesson plans to accompany the majority of the segments. These lesson plans will also help ensure that the video project remains timely and that teachers have great resources for teaching about money, banking, and the Federal Reserve.

Hill concluded, "*The Federal Reserve and You* will also serve a variety of functions as video material is put to additional uses. For instance, the Philadelphia Fed has already integrated portions of the video about inflation into an element of its Money in Motion exhibit." He added that the project team is embarking on promotional efforts to include social media and other public relations activities to generate awareness of the video, which will help the public understand the role of the Federal Reserve as it approaches its centennial at the end of 2013.

BEHIND THE SCENES

Key team members who worked on the project behind the scenes include (from left): Jim Ely, Todd Zartman, Hilda Guay, Christian Lepore, Melissa Kinney, and Sally Burke.

A CLOSER LOOK AT SUPERVISION AND REGULATION

In the chapter about supervision and regulation, *The Federal Reserve and You* examines how the Federal Reserve works with other federal and state agencies to supervise and regulate the nation's financial institutions. The video explores the history of the Federal Reserve in supervision and regulation, the role of Congress in this area, and how bank examiners do their work.

The Philadelphia Fed has made significant contributions to the Federal Reserve's supervision and regulation initiatives through its work on several System programs. The Bank's supervision and regulation staff led the System's model validation efforts, which help ensure the quality of supervisory models used in stress testing the nation's largest financial institutions.

The Federal Reserve System also continues to rely on the Risk Assessment, Data Analysis, and Research (RADAR) group, which the Philadelphia and Kansas City Feds created to optimize the use of data to monitor financial risks. RADAR consists of a data warehouse, a central facility that stores consumer credit data — including information about credit cards, auto loans, student loans, mortgages, and more — and enables authorized users throughout the System to access this information for bank surveillance and related activities. The Philadelphia Fed supports this tool with a team of experts who ensure the quality of the data, answer questions from analysts throughout the System, and assist bank examiners and Fed market analysts in evaluating the securities positions of financial institutions.

Members of the supervision and regulation staff appearing in the video (from left): Ken Benton, Jennifer McCune, Carole Foley, Barry Cutler, and Christopher Hahne.

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From left: Arun Jain, Donna Franco, Mary Ann Hood, Terry Harris, Jeanne Rentezelas, Charles Plosser, Blake Prichard, William Lang, Loretta Mester, Herb Taylor, Milissa Tadeo.

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Includes promotions through January 2013

OPERATING STATISTICS

In 2012, of the 28 processing offices in the Federal Reserve System, Philadelphia was the sixth largest currency counting office by volume. The overall volume of currency processed was comparable to the volume processed in 2011. The reduction in the value of currency processed reflects an overall change in the mix of notes received by Philadelphia. Most notably, in 2012, there were 82,000 fewer $20-note bundles processed compared with 2011. This volume was replaced with 90,000 bundles of $1 notes.

In 2012, on-site and off-site coin activity declined by 2.3 and 4.9 percent, respectively. Demand for all denominations of coin declined, with the exception of quarters. The long-term storage inventory for quarters was reduced by $23.6 million, or 23,600 bags, from year-end 2011 to year-end 2012.

Discount window lending declined in 2012, as significant excess reserve balances continued to be maintained throughout the year by depository institutions in the District. Lending activity for the year was on par with pre-crisis levels.

SERVICES TO DEPOSITORY INSTITUTIONS

	2012 Volume	2012 Dollar Value	2011 Volume	2011 Dollar Value
Cash operations:				
Currency processed	1,629.3 million notes	$22.7 billion	1,638.2 million notes	$25.2 billion
Coin paid and received on-site	273.5 thousand bags	$151.9 million	280.0 thousand bags	$148.3 million
Coin paid and received off-site	993.9 thousand bags	$769.4 million	1,044.8 thousand bags	$803.4 million
Loans to depository institutions during the year	49 loans	$92.2 million	80 loans	$679.4 million

STATEMENT OF AUDITOR INDEPENDENCE

The Board of Governors engaged Deloitte & Touche LLP (D&T) to audit the 2012 combined and individual financial statements of the Reserve Banks and those of the consolidated LLC entities.[1] In 2012, D&T also conducted audits of internal controls over financial reporting for each of the Reserve Banks, Maiden Lane LLC, Maiden Lane III LLC, and TALF LLC. Fees for D&T's services totaled $7 million, of which $1 million was for the audits of the consolidated LLC entities. To ensure auditor independence, the Board requires that D&T be independent in all matters relating to the audits. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2012, the Bank did not engage D&T for any non-audit services.

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[1] In addition, D&T audited the Office of Employee Benefits of the Federal Reserve System (OEB), the Retirement Plan for Employees of the Federal Reserve System (System Plan), and the Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The System Plan and the Thrift Plan provide retirement benefits to employees of the Board, the Federal Reserve Banks, and the OEB.

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MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

FEDERAL RESERVE BANK OF PHILADELPHIA

March 14, 2013

To the Board of Directors

The management of the Federal Reserve Bank of Philadelphia (Bank) is responsible for the preparation and fair presentation of the Statements of Condition as of December 31, 2012 and 2011, and the Statements of Income and Comprehensive Income, and Statements of Changes in Capital for the years then ended (the financial statements). The financial statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System as set forth in the *Financial Accounting Manual for Federal Reserve Banks* (FAM), and, as such, include some amounts that are based on management judgments and estimates. To our knowledge, the financial statements are, in all material respects, fairly presented in conformity with the accounting principles, policies, and practices documented in the FAM and include all disclosures necessary for such fair presentation.

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

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

The management of the Bank assessed its internal control over financial reporting based upon the criteria established in the "*Internal Control -- Integrated Framework*" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, we believe that the Bank maintained effective internal control over financial reporting.

Charles I. Plosser, President and Chief Executive Officer

D. Blake Prichard, First Vice President

Donna L. Franco, Senior Vice President and Chief Financial Officer

INDEPENDENT AUDITORS' REPORT

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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 financial statements of the Federal Reserve Bank of Philadelphia ("FRB Philadelphia"), which are comprised of the statements of condition as of December 31, 2012 and 2011, and the related statements of income and comprehensive income, and of changes in capital for the years then ended, and the related notes to the financial statements. We also have audited the FRB Philadelphia's internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Management's Responsibility

The FRB Philadelphia's management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles established by the Board of Governors of the Federal Reserve System (the "Board") as described in Note 3 to the financial statements. The Board has determined that this basis of accounting is an acceptable basis for the preparation of the FRB Philadelphia's financial statements in the circumstances. The FRB Philadelphia's management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. The FRB Philadelphia's management is also responsible for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements and an opinion on the FRB Philadelphia's internal control over financial reporting based on our audits. We conducted our audits of the financial statements in accordance with auditing standards generally accepted in the United States of America and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States) ("PCAOB") and we conducted our audit of internal control over financial reporting in accordance with attestation standards established by the American Institute of Certified Public Accountants and in accordance with the auditing standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement and whether effective internal control over financial reporting was maintained in all material respects.

An audit of the financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the FRB Philadelphia's preparation and fair presentation of the financial

INDEPENDENT AUDITORS' REPORT - PAGE 2

statements in order to design audit procedures that are appropriate in the circumstances. An audit of the financial statements also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. An audit of internal control over financial reporting involves obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Definition of Internal Control Over Financial Reporting

The FRB Philadelphia's internal control over financial reporting is a process designed by, or under the supervision of, the FRB Philadelphia's principal executive and principal financial officers, or persons performing similar functions, and effected by the 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. The 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 the FRB Philadelphia; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the accounting principles established by the Board, and that receipts and expenditures of the FRB Philadelphia are being made only in accordance with authorizations of management and directors of the FRB Philadelphia; and (3) provide reasonable assurance regarding prevention or timely detection and correction of unauthorized acquisition, use, or disposition of the FRB Philadelphia's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Control Over Financial Reporting

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 and corrected 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.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the FRB Philadelphia as of December 31, 2012 and 2011, and the results of its operations for the years then ended in accordance with the basis of accounting described in Note 3 to the financial statements. Also, in our opinion, the FRB Philadelphia maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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Basis of Accounting

We draw attention to Note 3 to the financial statements, which describes the basis of accounting. The FRB Philadelphia has prepared these financial statements in conformity with accounting principles established by the Board, as set forth in the *Financial Accounting Manual for Federal Reserve Banks,* which is a 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 and accounting principles generally accepted in the United States of America are also described in Note 3 to the financial statements. Our opinion is not modified with respect to this matter.

Deloitte & Touche LLP

March 14, 2013

ABBREVIATIONS:

ACH	Automated clearinghouse
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
BEP	Benefit Equalization Retirement Plan
Bureau	Bureau of Consumer Financial Protection
FAM	*Financial Accounting Manual for Federal Reserve Banks*
FASB	Financial Accounting Standards Board
Fannie Mae	Federal National Mortgage Association
Freddie Mac	Federal Home Loan Mortgage Corporation
FOMC	Federal Open Market Committee
FRBA	Federal Reserve Bank of Atlanta
FRBNY	Federal Reserve Bank of New York
GAAP	Accounting principles generally accepted in the United States of America
GSE	Government-sponsored enterprise
IMF	International Monetary Fund
MBS	Mortgage-backed securities
OEB	Office of Employee Benefits of the Federal Reserve System
OFR	Office of Financial Research
SDR	Special drawing rights
SERP	Supplemental Retirement Plan for Select Officers of the Federal Reserve Banks
SOMA	System Open Market Account
TBA	To be announced
TDF	Term Deposit Facility

STATEMENTS OF CONDITION

As of December 31, 2012 and December 31, 2011 (in millions)

	2012	2011
ASSETS		
Gold certificates	$ 437	$ 432
Special drawing rights certificates	210	210
Coin	141	160
Loans to depository institutions	2	-
System Open Market Account:		
Treasury securities, net (of which $302 million and $518 million is lent as of December 31, 2012 and 2011, respectively)	59,808	59,958
Government-sponsored enterprise debt securities, net (of which $23 million and $44 million is lent as of December 31, 2012 and 2011, respectively)	2,627	3,694
Federal agency and government-sponsored enterprise mortgage-backed securities, net	31,416	29,058
Foreign currency denominated assets, net	2,166	2,514
Central bank liquidity swaps	771	9,669
Other investments	1	-
Accrued interest receivable	626	677
Bank premises and equipment, net	87	87
Items in process of collection	-	53
Other assets	27	29
Total assets	**$ 98,319**	**$106,541**
LIABILITIES AND CAPITAL		
Federal Reserve notes outstanding, net	$ 43,262	$ 39,763
System Open Market Account:		
Securities sold under agreements to repurchase	3,543	3,422
Other liabilities	105	47
Deposits:		
Depository institutions	30,547	30,250
Other deposits	17	8
Interest payable to depository institutions	4	4
Accrued benefit costs	115	101
Deferred credit items	-	109
Accrued interest on Federal Reserve notes	29	78
Interdistrict settlement account	16,451	28,084
Other liabilities	14	9
Total liabilities	**94,087**	**101,875**
Capital paid-in	2,116	2,333
Surplus (including accumulated other comprehensive loss of $33 million and $25 million at December 31, 2012 and 2011, respectively)	2,116	2,333
Total capital	**4,232**	**4,666**
Total liabilities and capital	**$ 98,319**	**$106,541**

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

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

For the years ended December 31, 2012 and December 31, 2011 (in millions)

	2012	2011
INTEREST INCOME		
System Open Market Account:		
Treasury securities, net	$ 1,550	$ 1,336
Government-sponsored enterprise debt securities, net	88	94
Federal agency and government-sponsored enterprise mortgage-backed securities, net	1,051	1,184
Foreign currency denominated assets, net	12	24
Central bank liquidity swaps	21	4
Other investments	1	-
Total interest income	2,723	2,642
INTEREST EXPENSE		
System Open Market Account:		
Securities sold under agreements to repurchase	5	1
Deposits:		
Depository institutions	91	122
Term Deposit Facility	1	1
Total interest expense	97	124
Net interest income	2,626	2,518
NON-INTEREST INCOME (LOSS)		
System Open Market Account:		
Treasury securities gains, net	442	77
Federal agency and government-sponsored enterprise mortgage-backed securities gains, net	8	-
Foreign currency translation (losses) gains, net	(96)	15
Compensation received for service costs provided	2	1
Reimbursable services to government agencies	39	35
Other	2	4
Total non-interest income	397	132
OPERATING EXPENSES		
Salaries and benefits	112	105
Occupancy	14	14
Equipment	9	10
Assessments:		
Board of Governors operating expenses and currency costs	76	79
Bureau of Consumer Financial Protection	31	22
Office of Financial Research	-	4
Other	46	34
Total operating expenses	288	268
Net income before interest on Federal Reserve notes expense remitted to Treasury	2,735	2,382
Interest on Federal Reserve notes expense remitted to Treasury	2,812	2,473
Net loss	(77)	(91)
Change in prior service costs related to benefit plans	1	1
Change in actuarial losses related to benefit plans	(9)	(2)
Total other comprehensive loss	(8)	(1)
Comprehensive loss	**$ (85)**	**$ (92)**

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

STATEMENTS OF CHANGES IN CAPITAL

For the years ended December 31, 2012 and December 31, 2011 (in millions, except share data)

		Surplus			
	Capital paid-in	Net income retained	Accumulated other comprehensive income (loss)	Total surplus	Total capital
Balance at December 31, 2010 (51,384,156 shares)	$ 2,569	$ 2,593	$ (24)	$ 2,569	$ 5,138
Net change in capital stock redeemed (4,721,638 shares)	(236)	-	-	-	(236)
Comprehensive income:					
Net loss	-	(91)	-	(91)	(91)
Other comprehensive loss	-	-	(1)	(1)	(1)
Dividends on capital stock	-	(144)	-	(144)	(144)
Net change in capital	(236)	(235)	(1)	(236)	(472)
Balance at December 31, 2011 (46,662,518 shares)	$ 2,333	$ 2,358	$ (25)	$ 2,333	$ 4,666
Net change in capital stock redeemed (4,338,127 shares)	(217)	-	-	-	(217)
Comprehensive income:					
Net loss	-	(77)	-	(77)	(77)
Other comprehensive loss	-	-	(8)	(8)	(8)
Dividends on capital stock	-	(132)	-	(132)	(132)
Net change in capital	(217)	(209)	(8)	(217)	(434)
Balance at December 31, 2012 (42,324,391 shares)	$ 2,116	$ 2,149	$ (33)	$ 2,116	$ 4,232

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 12 Federal Reserve Banks (Reserve Banks) created by Congress under the Federal Reserve Act of 1913 (Federal Reserve Act), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank serves the 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 payment 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 participants in programs or facilities with broad-based eligibility in unusual and exigent circumstances; serving consumers and communities by providing educational materials and information regarding financial consumer protection rights and laws and information on community development programs and activities; and supervising bank holding companies, state member banks, savings and loan holding companies, U.S. offices of foreign banking organizations, and designated financial market utilities pursuant to authority delegated by the Board of Governors. 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 issues authorizations and directives to the FRBNY to execute transactions. The FOMC authorizes and directs the FRBNY to conduct operations in domestic markets, including the direct purchase and sale of Treasury securities, government-sponsored enterprise (GSE) debt securities, federal agency and GSE mortgage-backed securities (MBS), the purchase of these securities under agreements to resell, and the sale of these securities under agreements to repurchase. The FRBNY holds the resulting securities and agreements in a portfolio known as the System Open Market Account (SOMA). The FRBNY is authorized and directed to lend the Treasury securities and federal agency and GSE debt securities that are held in the SOMA.

To counter disorderly conditions in foreign exchange markets or to meet other needs specified by the FOMC to carry out the System's central bank responsibilities, the FOMC has authorized and directed the FRBNY to execute spot and forward foreign exchange transactions in 14 foreign currencies, to hold balances in those currencies, and to invest such foreign currency holdings, while maintaining adequate liquidity. The FOMC has also authorized the FRBNY to maintain reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico in the maximum amounts of $2 billion and $3 billion, respectively, and to warehouse foreign currencies for the Treasury and the Exchange Stabilization Fund.

Because of the global character of funding markets, the System has at times coordinated with other central banks to provide temporary liquidity. In May 2010, the FOMC authorized and directed the FRBNY to establish temporary U.S. dollar liquidity swap arrangements with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank through January 2011. Subsequently, the FOMC authorized and directed the FRBNY to extend these arrangements through February 1, 2013. In December, 2012, the FOMC authorized and directed the FRBNY to extend these arrangements through February 1, 2014. In addition, in November 2011, as a contingency measure, the FOMC authorized the FRBNY to establish temporary bilateral foreign currency liquidity swap arrangements, with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank so that liquidity can be provided to U.S. institutions in any of their currencies if necessary. In December 2012, the FOMC authorized the FRBNY to extend these temporary bilateral foreign currency liquidity swap arrangements through February 1, 2014.

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

3. SIGNIFICANT ACCOUNTING POLICIES

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

NOTES TO FINANCIAL STATEMENTS

Limited differences exist between the accounting principles and practices in the FAM and accounting principles generally accepted in the United States of America (GAAP), due to the unique nature of the Bank's powers and responsibilities as part of the nation's central bank and given the System's unique responsibility to conduct monetary policy. The primary differences are the presentation of all SOMA securities holdings at amortized cost and the recording of all SOMA securities on a settlement-date basis. Amortized cost, rather than the fair value presentation, more appropriately reflects the Bank's securities holdings given the System's unique responsibility to conduct monetary policy. Although the application of fair value measurements to the securities holdings may result in values substantially greater or less than their carrying values, these unrealized changes in value have no direct effect on the quantity of reserves available to the banking system or on the ability of the Reserve Banks, as the central bank, to meet their financial obligations and responsibilities. Both the domestic and foreign components of the SOMA portfolio may involve transactions that result in gains or losses when holdings are sold before maturity. Decisions regarding securities and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, fair values, earnings, and gains or losses resulting from the sale of such securities and currencies are incidental to open market operations and do not motivate decisions related to policy or open market activities. Accounting for these securities on a settlement-date basis, rather than the trade-date basis required by GAAP, better reflects the timing of the transaction's effect on the quantity of reserves in the banking system. The cost bases of Treasury securities, GSE debt securities, and foreign government debt instruments are adjusted for amortization of premiums or accretion of discounts on a straight-line basis, rather than using the interest method required by GAAP. SOMA securities holdings are evaluated for credit impairment periodically.

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

The presentation of "Dividends on capital stock" and "Interest on Federal Reserve notes expense remitted to Treasury" in the Statements of Income and Comprehensive Income for the year ended December 31, 2011 has been revised to conform to the current year presentation format. In addition, the presentation of "Comprehensive income" and "Dividends on capital stock" in the Statements of Changes in Capital for the year ended December 31, 2011 have been revised to conform to the current year presentation format. The revised presentation of "Dividends on capital stock" and "Interest on Federal Reserve notes expense remitted to Treasury" better reflects the nature of these items and results in a more consistent treatment of the amounts presented in the Statements of Income and Comprehensive Income and the related balances presented in the Statements of Condition. As a result of the change to report "Interest on Federal Reserve Notes expense remitted to Treasury" as an expense, the amount reported as "Comprehensive income" for the year ended December 31, 2011 has been revised. Significant accounts and accounting policies are explained below.

NOTES TO FINANCIAL STATEMENTS

a. Consolidation

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) established the Bureau of Consumer Financial Protection (Bureau) as an independent bureau within the System that has supervisory authority over some institutions previously supervised by the Reserve Banks in connection with those institutions' compliance with consumer protection statutes. Section 1017 of the Dodd-Frank Act provides that the financial statements of the Bureau are not to be consolidated with those of the Board of Governors or the System. Section 152 of the Dodd-Frank Act established the Office of Financial Research (OFR) within the Treasury. The Board of Governors funds the Bureau and OFR through assessments on the Reserve Banks as required by the Dodd-Frank Act. The Reserve Banks reviewed the law and evaluated the design of and their relationships to the Bureau and the OFR and determined that neither should be consolidated in the Bank's financial statements.

b. Gold and Special Drawing Rights Certificates

The Secretary of the Treasury is authorized to issue gold and special drawing rights (SDR) certificates to the Reserve Banks. Upon authorization, the Reserve Banks acquire gold certificates by crediting equivalent amounts in dollars to the account established for the Treasury. The gold certificates held by the Reserve Banks are required to be backed by the gold owned by the Treasury. The Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the Treasury. At such time, the Treasury's account is charged, and the Reserve Banks' gold certificate accounts are reduced. The value of gold for purposes of backing the gold certificates is set by law at $42 2/9 per fine troy ounce. Gold certificates are recorded by the Banks at original cost. The Board of Governors allocates the gold certificates among the Reserve Banks once a year based on each Reserve Bank's average Federal Reserve notes outstanding during the preceding calendar year.

SDRs are issued by the International Monetary Fund (IMF) to its members in proportion to each member's quota in the IMF at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for U.S. participation in the SDR system, the Secretary of the Treasury is authorized to issue SDR certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in U.S. dollars are credited to the account established for the Treasury and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR certificate transactions occur, the Board of Governors allocates the SDR certificates among the Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding calendar year. SDR certificates are recorded by the Banks at original cost. There were no SDR certificate transactions during the years ended December 31, 2012 and 2011.

c. Coin

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

d. Loans

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

NOTES TO FINANCIAL STATEMENTS

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

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

The FRBNY may engage in purchases of securities with primary dealers under agreements to resell (repurchase transactions). These repurchase transactions are settled through a triparty arrangement. In a triparty arrangement, two commercial custodial banks manage the collateral clearing, settlement, pricing, and pledging, and provide cash and securities custodial services for and on behalf of the FRBNY and counterparty. The collateral pledged must exceed the principal amount of the transaction by a margin determined by the FRBNY for each class and maturity of acceptable collateral. Collateral designated by the FRBNY as acceptable under repurchase transactions primarily includes Treasury securities (including Treasury Inflation-Protected Securities and Separate Trading of Registered Interest and Principal of Securities Treasury securities); direct obligations of several federal and GSE-related agencies, including Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac); and pass-through MBS of Fannie Mae, Freddie Mac, and Government National Mortgage Association. The repurchase transactions are accounted for as financing transactions with the associated interest income recognized over the life of the transaction. These transactions are reported at their contractual amounts as "System Open Market Account: Securities purchased under agreements to resell" and the related accrued interest receivable is reported as a component of "Other assets" in the Statements of Condition.

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

Treasury securities and GSE debt securities held in the SOMA may be lent to primary dealers to facilitate the effective functioning of the domestic securities markets. The amortized cost basis of securities lent continues to be reported as "Treasury securities, net" and "Government-sponsored enterprise debt securities, net," as appropriate, in the Statements

NOTES TO FINANCIAL STATEMENTS

of Condition. Overnight securities lending transactions are fully collateralized by Treasury securities that have fair values in excess of the securities lent. The FRBNY charges the primary dealer a fee for borrowing securities, and these fees are reported as a component of "Non-interest income (loss): Other" in the Statements of Income and Comprehensive Income.

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

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

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

In addition to outright purchases of federal agency and GSE MBS that are held in the SOMA, the FRBNY enters into dollar roll transactions (dollar rolls), which primarily involve an initial transaction to purchase or sell "to be announced" (TBA) MBS for delivery in the current month combined with a simultaneous agreement to sell or purchase TBA MBS on a specified future date. During the years ended December 31, 2012 and 2011, the FRBNY executed dollar rolls primarily to facilitate settlement of outstanding purchases of federal agency and GSE MBS. The FRBNY accounts for dollar roll transactions as purchases or sales on a settlement-date basis. In addition, TBA MBS transactions may be paired off or assigned prior to settlement. Net gains resulting from dollar roll transactions are reported as "Non-interest income (loss): System Open Market Account: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net" in the Statements of Income and Comprehensive Income.

Foreign currency denominated assets, which can include foreign currency deposits, securities purchased under agreements to resell, and government debt instruments, are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Foreign currency translation gains and losses that result from the daily revaluation of foreign currency denominated assets are reported as "Non-interest income (loss): System Open Market Account: Foreign currency translation (losses) gains, net" in the Statements of Income and Comprehensive Income.

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

NOTES TO FINANCIAL STATEMENTS

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

g. Central Bank Liquidity Swaps

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

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

U.S. dollar liquidity swaps

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

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

Foreign currency liquidity swaps

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

h. Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 2 to 50 years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are depreciated over the remaining useful life of the asset or, if appropriate, over the unique useful life of the alteration, renovation, or improvement. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred.

NOTES TO FINANCIAL STATEMENTS

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

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

i. Interdistrict Settlement Account

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

An annual settlement of the interdistrict settlement account occurs in the second quarter of each year. As a result of the annual settlement, the balance in each Bank's interdistrict settlement account is adjusted by an amount equal to the average balance in the account during the previous twelve month period ended March 31. An equal and offsetting adjustment is made to each Bank's allocated portion of SOMA assets and liabilities.

j. Federal Reserve Notes

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

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

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Bank's currency holdings of $4,304 million and $6,177 million at December 31, 2012 and 2011, respectively.

At December 31, 2012 and 2011, all Federal Reserve notes issued to the Reserve Banks were fully collateralized. At December 31, 2012, all gold certificates, all special drawing rights certificates, and $1,110 billion of domestic securities held

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in the SOMA were pledged as collateral. At December 31, 2012, no investments denominated in foreign currencies were pledged as collateral.

k. Deposits

Depository Institutions

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

The Term Deposit Facility (TDF) consists of deposits with specific maturities held by eligible institutions at the Reserve Banks. The Reserve Banks pay interest on these deposits at interest rates determined by auction. Interest payable is reported as a component of "Interest payable to depository institutions" in the Statements of Condition. There were no deposits held by the Bank under the TDF at December 31, 2012 and 2011.

Other

Other deposits include the Bank's allocated portion of foreign central bank and foreign government deposits held at the FRBNY.

l. Items in Process of Collection and Deferred Credit Items

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

m. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to six 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 six percent on the paid-in capital stock. This cumulative dividend is paid semiannually.

n. Surplus

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in. On a daily basis, surplus is adjusted to equate the balance to capital paid-in. Accumulated other comprehensive income is reported as a component of "Surplus" in the Statements of Condition and the Statements of Changes in Capital. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 9 and 10.

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o. Interest on Federal Reserve Notes

The Board of Governors requires the Reserve Banks to transfer excess earnings to the Treasury as interest on Federal Reserve notes after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. This amount is reported as "Interest on Federal Reserve notes expense remitted to Treasury" 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. See Note 12 for additional information on interest on Federal Reserve notes.

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

p. Income and Costs Related to Treasury Services

When directed by the Secretary of the Treasury, the Bank is required by the Federal Reserve Act to serve as fiscal agent and depositary of the United States Government. By statute, the Treasury has appropriations to pay for these services. During the years ended December 31, 2012 and 2011, the Bank was reimbursed for all services provided to the Treasury as its fiscal agent.

The Bank seeks reimbursement from the Treasury and other government agencies on behalf of all Reserve Banks of costs of performing fiscal agency functions. Each Reserve Bank transfers its Treasury reimbursement receivable to the Bank. The reimbursement receivable is reported in "Other assets" and totaled $1 million and $2 million at December 31, 2012 and 2011, respectively. There were no unreimbursed Treasury services costs during the years ended December 31, 2012 and 2011.

q. Compensation Received for Service Costs Provided

The Federal Reserve Bank of Atlanta (FRBA) has overall responsibility for managing the Reserve Banks' provision of check and ACH services to depository institutions, the FRBNY has overall responsibility for managing the Reserve Banks' provision of Fedwire funds and securities services, and the Federal Reserve Bank of Chicago has overall responsibility for managing the Reserve Banks' provision of electronic access services to depository institutions. The Reserve Bank that has overall responsibility for managing these services recognizes the related total System revenue in its Statements of Income and Comprehensive Income. The Bank is compensated for costs incurred to provide these services and reports this compensation as "Non-interest income (loss): Compensation received for service costs provided" in its Statements of Income and Comprehensive Income.

r. Assessments

The Board of Governors assesses the Reserve Banks to fund its operations, the operations of the Bureau and, for a two-year period following the July 21, 2010 effective date of the Dodd-Frank Act, the OFR. These assessments are allocated to each Reserve Bank based on each Reserve Bank's capital and surplus balances. The Board of Governors also assesses each Reserve Bank for expenses related to producing, issuing, and retiring 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.

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

The Board of Governors assessed the Reserve Banks to fund the operations of the OFR for the two-year period ended July 21, 2012, following enactment of the Dodd-Frank Act; thereafter, the OFR is funded by fees assessed on bank holding companies and nonbank financial companies that meet the criteria specified in the Dodd-Frank Act.

s. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were $2 million for each of the years ended December 31, 2012 and 2011 and are reported as a component of "Operating expenses: Occupancy" in the Statements of Income and Comprehensive Income.

t. Restructuring Charges

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

Note 11 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 2012 and 2011.

u. Recently Issued Accounting Standards

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

In April 2011, the FASB issued ASU 2011-03, *Transfers and Servicing* (Topic 860): *Reconsideration of Effective Control for*

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Repurchase Agreements, which reconsidered the effective control for repurchase agreements. This update prescribes when the Bank may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. This determination is based, in part, on whether the Bank has maintained effective control over the transferred financial assets. This update is effective for the Bank for the year ended December 31, 2012, and did not have a material effect on the Bank's financial statements.

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

In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income* (Topic 220): *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05.* This update indefinitely deferred the requirements of ASU 2011-05, which required an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective net income line items. Subsequently, in February 2013, the FASB issued ASU 2013-02, *Comprehensive Income* (Topic 220): *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income,* which established an effective date for the requirements of ASU 2011-05 related to reporting of significant reclassification adjustments from accumulated other comprehensive income. These presentation requirements of ASU 2011-05 are effective for the Bank for the year ending December 31, 2013, and will be reflected in the Bank's 2013 financial statements.

In January 2013, the FASB issued ASU 2013-01, *Balance Sheet* (Topic 210): *Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. This update clarifies that the scope of ASU 2011-11 applies to derivatives accounted for in accordance with Topic 815. This update is effective for the Bank for the year ending December 31, 2013, and is not expected to have a material effect on the Bank's financial statements.

4. LOANS

Loans to Depository Institutions

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

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

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ing 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.

Loans to depository institutions were $2 million as of December 31, 2012 with a remaining maturity within 15 days. The Bank had no loans outstanding as of December 31, 2011.

At December 31, 2012 and 2011, the Bank did not have any loans that were impaired, past due, or on non-accrual status, and no allowance for loan losses was required. There were no impaired loans during the years ended December 31, 2012 and 2011.

5. SYSTEM OPEN MARKET ACCOUNT

a. Domestic Securities Holdings

The FRBNY conducts domestic open market operations and, on behalf of the Reserve Banks, holds the resulting securities in the SOMA.

During the years ended December 31, 2012 and 2011, the FRBNY continued the purchase of Treasury securities and federal agency and GSE MBS under the large-scale asset purchase programs authorized by the FOMC. In August 2010, the FOMC announced that the Federal Reserve would maintain the level of domestic securities holdings in the SOMA portfolio by reinvesting principal payments from GSE debt securities and federal agency and GSE MBS in longer-term Treasury securities. In November 2010, the FOMC announced its intention to expand the SOMA portfolio holdings of longer-term Treasury securities by an additional $600 billion and completed these purchases in June 2011. In September 2011, the FOMC announced that the Federal Reserve would reinvest principal payments from the SOMA portfolio holdings of GSE debt securities and federal agency and GSE MBS in federal agency and GSE MBS. In June 2012, the FOMC announced that it would continue the existing policy of reinvesting principal payments from the SOMA portfolio holdings of GSE debt securities and federal agency and GSE MBS in federal agency and GSE MBS, and suspended the policy of rolling over maturing Treasury securities into new issues at auction. In September 2012, the FOMC announced that the Federal Reserve would purchase additional federal agency and GSE MBS at a pace of $40 billion per month and maintain its existing policy of reinvesting principal payments from its holdings of agency debt and federal agency and GSE MBS in federal agency and GSE MBS. In December 2012, the FOMC announced that the Federal Reserve would purchase longer-term Treasury securities at a pace of $45 billion per month after its program to extend the average maturity of its holdings of Treasury securities is completed at the end of 2012.

During the years ended December 31, 2012 and 2011, the FRBNY also continued the purchase and sale of SOMA portfolio holdings under the maturity extension programs authorized by the FOMC. In September 2011, the FOMC announced that the Federal Reserve would extend the average maturity of the SOMA portfolio holdings of securities by purchasing $400 billion par value of Treasury securities with maturities of six to thirty years and selling or redeeming an equal par amount of Treasury securities with remaining maturities of three years or less by the end of June 2012. In June 2012, the FOMC announced that the Federal Reserve would continue through the end of 2012 its program to extend the average maturity of securities by purchasing $267 billion par value of Treasury securities with maturities of six to thirty years and selling or redeeming an equal par amount of Treasury securities with maturities of three and a quarter years or less by the end of 2012. In September 2012, the FOMC announced it would continue its program to extend the average maturity of its holdings of securities as announced in June 2012.

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The Bank's allocated share of activity related to domestic open market operations was 3.306 percent and 3.426 percent at December 31, 2012 and 2011, respectively.

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

	2012			
	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost
Bills	$ -	$ -	$ -	$ -
Notes	36,707	1,075	(23)	37,759
Bonds	18,372	3,681	(4)	22,049
Total Treasury securities	$ 55,079	$ 4,756	$ (27)	$ 59,808
GSE debt securities	$ 2,538	$ 89	$ -	$ 2,627
Federal agency and GSE MBS	$ 30,633	$ 806	$ (23)	$ 31,416

	2011			
	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost
Bills	$ 631	$ -	$ -	$ 631
Notes	44,065	918	(42)	44,941
Bonds	12,287	2,102	(3)	14,386
Total Treasury securities	$ 56,983	$ 3,020	$ (45)	$ 59,958
GSE debt securities	$ 3,562	$ 132	$ -	$ 3,694
Federal agency and GSE MB	S $28,696	$ 398	$ (36)	$ 29,058

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

NOTES TO FINANCIAL STATEMENTS

There were no material transactions related to securities purchased under agreements to resell during the years ended December 31, 2012 and 2011. Financial information related to securities sold under agreements to repurchase for the years ended December 31 was as follows (in millions):

	Allocated to the Bank		Total SOMA	
	2012	2011	2012	2011
Contract amount outstanding, end of year	$ 3,543	$ 3,422	$ 107,188	$ 99,900
Average daily amount outstanding, during the year	3,069	2,294	91,898	72,227
Maximum balance outstanding, during the year	4,051	4,265	122,541	124,512
Securities pledged (par value), end of year	3,092	2,949	93,547	86,089
Securities pledged (market value), end of year	3,543	3,422	107,188	99,900

The remaining maturity distribution of Treasury securities, GSE debt securities, federal agency and GSE MBS bought outright, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2012, and 2011 was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Over 5 years to 10 years	Over 10 years	Total
December 31, 2012:							
Treasury securities (par value)	$ -	$ -	$ 1	$ 12,512	$ 28,509	$ 14,057	$ 55,079
GSE debt securities (par value)	52	92	502	1,746	68	78	2,538
Federal agency and GSE MBS (par value)[1]	-	-	-	-	78	30,555	30,633
Securities sold under agreements to repurchase (contract amount)	3,543	-	-	-	-	-	3,543
December 31, 2011:							
Treasury securities (par value)	$ 557	$ 929	$ 3,079	$ 22,256	$ 22,263	$ 7,899	$ 56,983
GSE debt securities (par value)	85	172	675	2,076	474	80	3,562
Federal agency and GSE MBS (par value)[1]	-	-	-	1	1	28,694	28,696
Securities sold under agreements to repurchase (contract amount)	3,422	-	-	-	-	-	3,422

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

Federal agency and GSE MBS are reported at stated maturity in the table above. The estimated weighted average life of these securities, which differs from the stated maturity primarily because it factors in scheduled payments and prepayment assumptions, was approximately 3.3 and 2.4 years as of December 31, 2012, and 2011, respectively.

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

	Allocated to the Bank		Total SOMA	
	2012	2011	2012	2011
Treasury securities (amortized cost)	$ 302	$ 518	$ 9,139	$ 15,121
Treasury securities (par value)	280	479	8,460	13,978
GSE debt securities (amortized cost)	23	44	697	1,276
GSE debt securities (par value)	22	42	676	1,216

The FRBNY enters into commitments to buy and sell Treasury securities and records the related securities on a settlement-date basis. As of December 31, 2012, there were no outstanding commitments.

The FRBNY enters into commitments to buy and sell federal agency and GSE MBS and records the related securities on a settlement-date basis. As of December 31, 2012, the total purchase price of the federal agency and GSE MBS under outstanding purchase commitments was $118,215 million, of which $10,164 million was related to dollar roll transactions. The total purchase price of outstanding purchase commitments allocated to the Bank was $3,908 million, of which $336 million was related to dollar roll transactions. As of December 31, 2012, there were no outstanding sales commitments for federal agency and GSE MBS. These commitments, which had contractual settlement dates extending through February 2013, are for the purchase of TBA MBS for which the number and identity of the pools that will be delivered to fulfill the commitment are unknown at the time of the trade. These commitments are subject to varying degrees of off-balance-sheet market risk and counterparty credit risk that result from their future settlement. The FRBNY requires the posting of cash collateral for commitments as part of the risk management practices used to mitigate the counterparty credit risk.

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

	Allocated to the Bank		Total SOMA	
	2012	2011	2012	2011
Other investments	$ 1	$ -	$ 23	$ -
Other liabilities:				
Cash margin	$ 102	$ 44	$ 3,092	$ 1,271
Obligations from MBS transaction fails	3	3	85	97
Total other liabilities	$ 105	$ 47	$ 3,177	$ 1,368

NOTES TO FINANCIAL STATEMENTS

Information about transactions related to Treasury securities, GSE debt securities, and federal agency and GSE MBS during the years ended December 31, 2012 and 2011, is summarized as follows (in millions):

	Allocated to the Bank					
	Bills	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Balance December 31, 2010	$ 430	$ 18,369	$ 6,117	$ 24,916	$ 3,572	$ 23,463
Purchases[1]	7,469	21,378	5,008	33,855	-	1,444
Sales[1]	-	(4,718)	-	(4,718)	-	-
Realized gains, net[2]	-	77	-	77	-	-
Principal payments and maturities	(7,469)	(2,128)	-	(9,597)	(1,308)	(6,095)
Amortization of premiums and accretion of discounts, net	-	(141)	(158)	(299)	(51)	(98)
Inflation adjustment on inflation-indexed securities	-	40	35	75	-	-
Annual reallocation adjustment[4]	201	12,065	3,383	15,649	1,481	10,344
Balance December 31, 2011	$ 631	$44,942	$ 14,385	$ 59,958	$ 3,694	$ 29,058
Purchases[1]	4,011	13,316	8,818	26,145	-	14,387
Sales[1]	-	(16,949)	(391)	(17,340)	-	-
Realized gains, net[2]	-	400	42	442	-	-
Principal payments and maturities	4,620)	(2,263)	-	(6,883)	(910)	(10,804)
Amortization of premiums and accretion of discounts, net	-	(183)	(251)	(434)	(38)	(174)
Inflation adjustment on inflation-indexed securities	-	21	35	56	-	-
Annual reallocation adjustment[4]	(22)	(1,525)	(589)	(2,136)	(119)	(1,051)
Balance December 31, 2012	$ -	$ 37,759	$ 22,049	$ 59,808	$ 2,627	$ 31,416
Year ended December 31, 2011						
Supplemental information - par value of transactions:						
Purchases[3]	$ 7,469	$ 20,820	$ 3,937	$ 32,226	$ -	$ 1,403
Sales[3]	-	(4,619)	-	(4,619)	-	-
Year ended December 31, 2012						
Supplemental information - par value of transactions:						
Purchases[3]	$ 4,011	$ 12,815	$ 6,852	$ 23,678	$ -	$ 13,777
Sales[3]	-	(16,443)	(303)	(16,746)	-	-

[1] Purchases and sales are reported on a settlement-date basis and may include payments and receipts related to principal, premiums, discounts, and inflation compensation adjustments to the basis of inflation-indexed securities. The amount reported as sales includes the realized gains and losses on such transactions. Purchases and sales exclude MBS TBA transactions that are settled on a net basis.

[2] Realized gains, net offset the amount of realized gains and losses included in the reported sales amount.

[3] Includes inflation compensation

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

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	Total SOMA					
	Bills	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Balance December 31, 2010	$ 18,422	$ 786,575	$ 261,954	$ 1,066,951	$ 152,972	$ 1,004,695
Purchases[1]	239,487	731,252	161,876	1,132,615	-	42,145
Sales[1]	-	(137,733)	-	(137,733)	-	-
Realized gains, net[2]	-	2,258	-	2,258	-	-
Principal payments and maturities	(239,494)	(67,273)	-	(306,767)	(43,466)	(195,413)
Amortization of premiums and accretion of discounts, net	8	(4,445)	(4,985)	(9,422)	(1,678)	(3,169)
Inflation adjustment on inflation-indexed securities	-	1,283	1,092	2,375	-	-
Balance December 31, 2011	$ 18,423	$1,311,917	$ 419,937	$ 1,750,277	$ 107,828	$ 848,258
Purchases[1]	118,886	397,999	263,991	780,876	-	431,487
Sales[1]	-	(507,420)	(11,727)	(519,147)	-	-
Realized gains, net[2]	-	12,003	1,252	13,255	-	-
Principal payments and maturities	(137,314)	(67,463)	-	(204,777)	(27,211)	(324,181)
Amortization of premiums and accretion of discounts, net	5	(5,460)	(7,531)	(12,986)	(1,138)	(5,243)
Inflation adjustment on inflation-indexed securities	-	643	1,047	1,690	-	-
Balance December 31, 2012	$ -	$1,142,219	$ 666,969	$ 1,809,188	$ 79,479	$ 950,321
Year ended December 31, 2011						
Supplemental information - par value of transactions:						
Purchases[3]	$ 239,494	$ 713,878	$ 127,802	$ 1,081,174	$ -	$ 40,955
Sales[3]	-	(134,829)	-	(134,829)	-	-
Year ended December 31, 2012						
Supplemental information - par value of transactions:						
Purchases[3]	$ 118,892	$ 383,106	$ 205,115	$ 707,113	$ -	$ 413,160
Sales[3]	-	(492,234)	(9,094)	(501,328)	-	-

[1] Purchases and sales are reported on a settlement-date basis and may include payments and receipts related to principal, premiums, discounts, and inflation compensation adjustments to the basis of inflation-indexed securities. The amount reported as sales includes the realized gains and losses on such transactions. Purchases and sales exclude MBS TBA transactions that are settled on a net basis.

[2] Realized gains, net offset the amount of realized gains and losses included in the reported sales amount.

[3] Includes inflation compensation

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b. Foreign Currency Denominated Assets

The FRBNY conducts foreign currency operations and, on behalf of the Reserve Banks, holds the resulting foreign currency denominated assets in the SOMA.

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

The Bank's allocated share of activity related to foreign currency operations was 8.674 percent and 9.686 percent at December 31, 2012 and 2011, respectively.

Information about foreign currency denominated assets, including accrued interest, valued at amortized cost and foreign currency market exchange rates at December 31 was as follows (in millions):

	Allocated to Bank		Total SOMA	
	2012	2011	2012	2011
Euro:				
Foreign currency deposits	$ 774	$ 907	$ 8,925	$ 9,367
Securities purchased under agreements to resell	57	-	659	-
German government debt instruments	189	183	2,178	1,884
French government debt instruments	214	255	2,470	2,635
Japanese yen:				
Foreign currency deposits	308	386	3,553	3,986
Japanese government debt instruments	624	783	7,187	8,078
Total allocated to the Bank	$ 2,166	$ 2,514	$ 24,972	$ 25,950

The remaining maturity distribution of foreign currency denominated assets that were allocated to the Bank at December 31, 2012, and 2011, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Total
December 31, 2012:					
Euro	$ 572	$ 150	$ 188	$ 324	$ 1,234
Japanese yen	330	43	185	374	932
Total	$ 902	$ 193	$ 373	$ 698	$ 2,166
December 31, 2011:					
Euro	$ 518	$ 284	$ 205	$ 338	$ 1,345
Japanese yen	405	64	305	395	1,169
Total	$ 923	$ 348	$ 510	$ 733	$ 2,514

There were no foreign exchange contracts related to open market operations outstanding as of December 31, 2012.

NOTES TO FINANCIAL STATEMENTS

The FRBNY enters into commitments to buy foreign government debt instruments and records the related securities on a settlement-date basis. As of December 31, 2012, there were no outstanding commitments to purchase foreign government debt instruments. During 2012, there were purchases, sales, and maturities of foreign government debt instruments of $4,959 million, $0, and $4,840 million, respectively, of which $436 million, $0, and $426 million, respectively, were allocated to the Bank.

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

At December 31, 2012 and 2011, the authorized warehousing facility was $5 billion, with no balance outstanding.

There were no transactions related to the authorized reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico during the years ended December 31, 2012 and 2011.

c. Central Bank Liquidity Swaps

U.S. Dollar Liquidity Swaps

The Bank's allocated share of U.S. dollar liquidity swaps was approximately 8.674 percent and 9.686 percent at December 31, 2012 and 2011, respectively.

The total foreign currency held under U.S. dollar liquidity swaps in the SOMA at December 31, 2012 and 2011, was $8,889 million and $99,823 million, respectively, of which $771 million and $9,669 million, respectively, was allocated to the Bank**.**

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

	2012			2011		
	Within 15 days	16 days to 90 days	Total	Within 15 days	16 days to 90 days	Total
Euro	$ 151	$ 620	$ 771	$ 3,328	$ 4,948	$ 8,276
Japanese yen	-	-	-	875	480	1,355
Swiss franc	-	-	-	31	7	38
Total	$ 151	$ 620	$ 771	$ 4,234	$ 5,435	$ 9,669

Foreign Currency Liquidity Swaps

There were no transactions related to the foreign currency liquidity swaps during the years ended December 31, 2012 and 2011.

NOTES TO FINANCIAL STATEMENTS

d. Fair Value of SOMA Assets

The fair value amounts presented below are solely for informational purposes. Although the fair value of SOMA security holdings can be substantially greater than or less than the recorded value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as the central bank, to meet their financial obligations and responsibilities.

The fair value of the fixed-rate Treasury securities, GSE debt securities, federal agency and GSE MBS, and foreign government debt instruments in the SOMA's holdings is subject to market risk, arising from movements in market variables such as interest rates and credit risk. The fair value of federal agency and GSE MBS is also affected by the expected rate of prepayments of mortgage loans underlying the securities. The fair value of foreign government debt instruments is affected by currency risk. Based on evaluations performed as of December 31, 2012, there are no credit impairments of SOMA securities holdings as of that date.

NOTES TO FINANCIAL STATEMENTS

The following table presents the amortized cost and fair value of the Treasury securities, GSE debt securities, federal agency and GSE MBS, and foreign currency denominated assets, net, held in the SOMA at December 31 (in millions):

	Allocated to the Bank					
	2012			2011		
	Amortized cost	Fair value	Fair value greater than amortized cost	Amortized cost	Fair value	Fair value greater than amortized cost
Treasury securities:						
Bills	$ -	$ -	$ -	$ 631	$ 631	$ -
Notes	37,759	40,105	2,346	44,941	47,596	2,655
Bonds	22,049	25,162	3,113	14,386	17,426	3,040
GSE debt securities	2,627	2,810	183	3,694	3,913	219
Federal agency and GSE MBS	31,416	32,859	1,443	29,058	30,676	1,618
Foreign currency denominated assets	2,166	2,181	15	2,514	2,530	16
Total SOMA portfolio securities holdings	$ 96,017	$ 103,117	$ 7,100	$ 95,224	$ 102,772	$ 7,548
Memorandum - Commitments for:						
Purchases of Treasury securities	$ -	$ -	$ -	$ 110	$ 110	$ -
Purchases of Federal agency and GSE MBS	3,908	3,914	6	1,422	1,434	12
Sales of Federal agency and GSE MBS	-	-	-	152	153	1
Purchases of foreign government debt instruments	-	-	-	21	21	-

	Total SOMA					
	2012			2011		
	Amortized cost	Fair value	Fair value greater than amortized cost	Amortized cost	Fair value	Fair value greater than amortized cost
Treasury securities:						
Bills	$ -	$ -	$ -	$ 18,423	$ 18,423	$ -
Notes	1,142,219	1,213,177	70,958	1,311,917	1,389,429	77,512
Bonds	666,969	761,138	94,169	419,937	508,694	88,757
GSE debt securities	79,479	85,004	5,525	107,828	114,238	6,410
Federal agency and GSE MBS	950,321	993,990	43,669	848,258	895,495	47,237
Foreign currency denominated assets	24,972	25,141	169	25,950	26,116	166
Total SOMA portfolio securities holdings	$2,863,960	$3,078,450	$ 214,490	$2,732,313	$2,952,395	$ 220,082
Memorandum - Commitments for:						
Purchases of Treasury securities	$ -	$ -	$ -	$ 3,200	$ 3,208	$ 8
Purchases of Federal agency and GSE MBS	118,215	118,397	182	41,503	41,873	370
Sales of Federal agency and GSE MBS	-	-	-	4,430	4,473	43
Purchases of foreign government debt instruments	-	-	-	216	216	-

The fair value of Treasury securities, GSE debt securities, and foreign government debt instruments was determined using pricing services that provide market consensus prices based on indicative quotes from various market participants. The

NOTES TO FINANCIAL STATEMENTS

fair value of federal agency and GSE MBS was determined using a pricing service that utilizes a model-based approach that considers observable inputs for similar securities. The cost basis of foreign currency deposits adjusted for accrued interest approximates fair value. The contract amount for euro-denominated securities sold under agreements to repurchase approximates fair value.

The cost basis of securities purchased under agreements to resell, securities sold under agreements to repurchase, and other investments held in the SOMA approximate fair value.

Because the FRBNY enters into commitments to buy Treasury securities, federal agency and GSE MBS, and foreign government debt instruments and records the related securities on a settlement-date basis in accordance with the FAM, the related outstanding commitments are not reflected in the Statements of Condition.

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

	2012		2011	
Distribution of MBS holdings by coupon rate	Amortized cost	Fair value	Amortized cost	Fair value
Allocated to the Bank:				
2.0%	$ 28	$ 28	$ -	$ -
2.5%	1,242	1,248	-	-
3.0%	5,310	5,347	45	46
3.5%	5,937	6,108	665	674
4.0%	4,554	4,825	5,532	5,815
4.5%	8,677	9,328	13,924	14,770
5.0%	4,136	4,371	6,252	6,600
5.5%	1,321	1,382	2,288	2,400
6.0%	186	195	313	329
6.5%	25	27	39	42
Total	$ 31,416	$ 32,859	$ 29,058	$ 30,676
Total SOMA:				
2.0%	$ 845	$ 846	$ -	$ -
2.5%	37,562	37,766	-	-
3.0%	160,613	161,757	1,313	1,336
3.5%	179,587	184,752	19,415	19,660
4.0%	137,758	145,955	161,481	169,763
4.5%	262,484	282,181	406,465	431,171
5.0%	125,107	132,214	182,497	192,664
5.5%	39,970	41,819	66,795	70,064
6.0%	5,642	5,888	9,152	9,616
6.5%	753	812	1,140	1,221
Total	$ 950,321	$ 993,990	$ 848,258	$ 895,495

NOTES TO FINANCIAL STATEMENTS

The following tables present the realized gains and the change in the unrealized gain position of the domestic securities holdings during the year ended December 31, 2012 (in millions):

	Allocated to Bank		Total SOMA	
	Total portfolio holdings realized gains[1]	Fair value changes in unrealized gains[2]	Total portfolio holdings realized gains[1]	Fair value changes in unrealized gains[2]
Treasury securities	$ 442	$ (53)	$ 13,255	$ (1,142)
GSE debt securities	-	(30)	-	(885)
Federal agency and GSE MBS	8	(116)	241	(3,568)
Total	$ 450	$ (199)	$ 13,496	$ (5,595)

[1] Total portfolio holdings realized gains are reported in "Non-interest income (loss): System Open Market Account" in the Statements of Income and Comprehensive Income.

[2] Because SOMA securities are recorded at amortized cost, unrealized gains (losses) are not reported in the Statements of Income and Comprehensive Income.

The amount of change in unrealized gains, net, related to foreign currency denominated assets was an increase of $3 million for the year ended December 31, 2012, of which $206 thousand was allocated to the Bank.

Accounting Standards Codification (ASC) Topic 820 (ASC 820) defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC 820 establishes a three-level fair value hierarchy that distinguishes between assumptions developed using market data obtained from independent sources (observable inputs) and the Bank's assumptions developed using the best information available in the circumstances (unobservable inputs). The three levels established by ASC 820 are described as follows:

- Level 1 – Valuation is based on quoted prices for identical instruments traded in active markets.
- Level 2 – Valuation is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 – Valuation is based on model-based techniques that use significant inputs and assumptions not observable in the market. These unobservable inputs and assumptions reflect the Bank's estimates of inputs and assumptions that market participants would use in pricing the assets and liabilities. Valuation techniques include the use of option pricing models, discounted cash flow models, and similar techniques.

NOTES TO FINANCIAL STATEMENTS

The following tables present the classification of SOMA financial assets at fair value as of December 31 by ASC 820 hierarchy (in millions):

	2012 Level 2	2011 Level 2
Assets:		
Treasury securities	$ 1,974,315	$ 1,916,546
GSE debt securities	85,004	114,238
Federal agency and GSE MBS	993,990	895,495
Foreign government debt instruments	12,003	12,762
Total assets	$ 3,065,312	$ 2,939,041

The SOMA financial assets are classified as Level 2 in the table above because the fair values are based on indicative quotes and other observable inputs obtained from independent pricing services that, in accordance with ASC 820, are consistent with the criteria for Level 2 inputs. Although information consistent with the criteria for Level 1 classification may exist for some portion of the SOMA assets, all securities in each asset class were valued using the inputs that are most applicable to the securities in the asset class. The inputs used for valuing the SOMA financial assets are not necessarily an indication of the risk associated with those assets.

6. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	2012	2011
Bank premises and equipment:		
Land and land improvements	$ 8	$ 8
Buildings	107	104
Building machinery and equipment	23	18
Construction in progress	2	1
Furniture and equipment	55	63
Subtotal	195	194
Accumulated depreciation	(108)	(107)
Bank premises and equipment, net	$ 87	$ 87
Depreciation expense, for the years ended December 31	$ 9	$ 10

NOTES TO FINANCIAL STATEMENTS

The Bank leases space to outside tenants with remaining lease terms ranging from 1 to 12 years. Rental income from such leases was $2 million for each of the years ended December 31, 2012 and 2011 and is reported as a component of "Non-interest income: Other" in the Statements of Income and Comprehensive Income. Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2012, are as follows (in thousands):

2013	$ 2,176
2014	263
2015	279
2016	286
2017	275
Thereafter	1,777
Total	$ 5,056

The Bank had capitalized software assets, net of amortization, of $7 million and $8 million at December 31, 2012 and 2011, respectively. Amortization expense was $2 million for each of the years ended December 31, 2012 and 2011. Capitalized software assets are reported as a component of "Other assets" in the Statements of Condition and the related amortization is reported as a component of "Operating expenses: Other" in the Statements of Income and Comprehensive Income.

7. COMMITMENTS AND CONTINGENCIES

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

At December 31, 2012, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from 1 to approximately 7 years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indexes.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance, and maintenance when included in rent), net of sublease rentals, was $1 million for each of the years ended December 31, 2012 and 2011. 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, 2012, are as follows (in thousands):

	Operating leases
2013	$ 548
2014	554
2015	484
2016	469
2017	480
Thereafter	533
Future minimum rental payments	$ 3,068

NOTES TO FINANCIAL STATEMENTS

At December 31, 2012, there were no material unrecorded unconditional purchase commitments or obligations in excess of one year.

Under the Insurance Agreement of the Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a share of certain losses in excess of 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, 2012 and 2011.

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

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

The Bank currently offers three defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the employees of the Reserve Banks, Board of Governors, and Office of Employee Benefits of the Federal Reserve System (OEB) participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). Under the Dodd-Frank Act, newly hired Bureau employees are eligible to participate in the System Plan and transferees from other governmental organizations can elect to participate in the System Plan. In addition, employees at certain compensation levels participate in the Benefit Equalization Retirement Plan (BEP) and certain Reserve Bank officers participate in the Supplemental Retirement Plan for Select Officers of the Federal Reserve Banks (SERP).

The System Plan provides retirement benefits to employees of the Reserve Banks, Board of Governors, OEB, and certain employees of the Bureau. The FRBNY, on behalf of the System, recognizes the net asset or net liability and costs associated with the System Plan in its consolidated financial statements. During the years ended December 31, 2012 and 2011, certain costs associated with the System Plan were reimbursed by the Bureau.

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2012 and 2011, and for the years then ended, were not material.

Thrift Plan

Employees of the Bank participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Bank matches 100 percent of the first six percent of employee contributions from the date of hire and provides an automatic employer contribution of one percent of eligible pay. The Bank's Thrift Plan contributions totaled $5 million and $4 million for the years ended December 31, 2012 and 2011, respectively, and are reported as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

NOTES TO FINANCIAL STATEMENTS

9. 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 and life insurance benefits 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):

	2012	2011
Accumulated postretirement benefit obligation at January 1	$ 89.5	$ 83.0
Service cost benefits earned during the period	2.8	2.3
Interest cost on accumulated benefit obligation	4.1	4.3
Net actuarial loss	10.9	3.4
Contributions by plan participants	1.9	1.8
Benefits paid	(6.0)	(5.7)
Medicare Part D subsidies	0.4	0.4
Accumulated postretirement benefit obligation at December 31	$ 103.6	$ 89.5

At December 31, 2012 and 2011, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 3.75 percent and 4.50 percent, respectively.

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

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):

	2012	2011
Fair value of plan assets at January 1	$ -	$ -
Contributions by the employer	3.7	3.5
Contributions by plan participants	1.9	1.8
Benefits paid	(6.0)	(5.7)
Medicare Part D subsidies	0.4	0.4
Fair value of plan assets at December 31	$ -	$ -
Unfunded obligation and accrued postretirement benefit cost	$ 103.6	$ 89.5
Amounts included in accumulated other comprehensive loss are shown below:		
Prior service cost	$ (1.2)	$ (1.8)
Net actuarial loss	(32.3)	(23.6)
Total accumulated other comprehensive loss	$ (33.5)	$ (25.4)

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:

	2012	2011
Health-care cost trend rate assumed for next year	7.00%	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	2018	2017

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, 2012 (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	$ (0.3)
Effect on accumulated postretirement benefit obligation	0.8	(6.2)

NOTES TO FINANCIAL STATEMENTS

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

	2012	2011
Service cost-benefits earned during the period	$ 2.7	$ 2.3
Interest cost on accumulated benefit obligation	4.1	4.3
Amortization of prior service cost	0.6	0.3
Amortization of net actuarial loss	2.2	1.6
Net periodic postretirement benefit expense	$ 9.6	$ 8.5

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2013 are shown below:

Prior service cost	$ 0.5
Net actuarial loss	3.1
Total	$ 3.6

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2012 and 2011, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 4.50 percent and 5.25 percent, respectively.

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

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 $350 thousand and $300 thousand in the years ended December 31, 2012 and 2011, respectively. Expected receipts in 2013, related to benefits paid in the years ended December 31, 2012 and 2011, are $288 thousand.

NOTES TO FINANCIAL STATEMENTS

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

	Without subsidy	With subsidy
2013	$ 4.8	$ 4.4
2014	5.1	4.7
2015	5.4	4.9
2016	5.8	5.2
2017	6.1	5.5
2018 - 2022	34.3	30.8
Total	$ 61.5	$ 55.5

Postemployment Benefits

The Bank offers benefits to former or inactive employees. 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, 2012 and 2011 were $6.4 million and $7.0 million, respectively. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense (credit) included in 2012 and 2011 operating expenses were $(98) thousand and $577 thousand, respectively, and are recorded as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

NOTES TO FINANCIAL STATEMENTS

10. ACCUMULATED OTHER COMPREHENSIVE INCOME AND OTHER COMPREHENSIVE INCOME

Following is a reconciliation of beginning and ending balances of accumulated other comprehensive loss as of December 31 (in millions):

	2012	2011
	Amount related to postretirement benefits other than retirement plans	Amount related to postretirement benefits other than retirement plans
Balance at January 1	$ (25.4)	$ (24.0)
Change in funded status of benefit plans:		
Prior service costs arising during the year	-	-
Amortization of prior service cost	0.6	0.4
Change in prior service costs related to benefit plans	0.6	0.4
Net actuarial loss arising during the year	(10.9)	(3.4)
Amortization of net actuarial loss	2.2	1.6
Change in actuarial losses related to benefit plans	(8.7)	(1.8)
Change in funded status of benefit plans - other comprehensive loss	(8.1)	(1.4)
Balance at December 31	$ (33.5)	$ (25.4)

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

11. BUSINESS RESTRUCTURING CHARGES

The Bank had no business restructuring charges in 2012 or 2011.

In years prior to 2011, 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 consolidated paper and electronic check processing at the FRBA. The Bank's liability balance for the check restructuring as of December 31, 2012 and 2011, and the related activity during the years then ended, were not material.

12. DISTRIBUTION OF COMPREHENSIVE INCOME

In accordance with Board policy, Reserve Banks remit excess earnings, after providing for dividends and the amount necessary to equate surplus with capital paid-in, to the U.S. Treasury as interest on Federal Reserve notes. The following table presents the distribution of the Bank's comprehensive income in accordance with the Board's policy for the years ended December 31 (in millions):

	2012	2011
Dividends on capital stock	$ 132	$ 144
Transfer from surplus - amount required to equate surplus with capital paid-in	(217)	(236)
Interest on Federal Reserve notes expense remitted to Treasury	2,812	2,473
Total distribution	$ 2,727	$ 2,381

During the year ended December 31, 2012, the Bank recorded a reduction in the amount of capital paid-in and a corresponding reduction of surplus, which is presented in the above table as "Transfer from surplus – amount required to equate surplus with capital paid-in." The reduction of surplus resulted in an equivalent increase in "Interest on Federal Reserve notes expense remitted to Treasury" and an increase in "Comprehensive loss" for the year ended December 31, 2012.

13. SUBSEQUENT EVENTS

There were no subsequent events that require adjustments to or disclosures in the financial statements as of December 31, 2012. Subsequent events were evaluated through March 14, 2013, which is the date that the Bank issued the financial statements.

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