

THE FED AT WORK

2004 ANNUAL REPORT
FEDERAL RESERVE BANK OF SAN FRANCISCO



The Federal Reserve Bank of San Francisco is one of twelve regional Federal Reserve Banks across the U.S. that, together with the Board of Governors in Washington, D.C., serve as our nation's central bank.

The Twelfth Federal Reserve District includes the nine western states—Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington—and American Samoa, Guam, and the Northern Mariana Islands. Branches are located in Los Angeles, Portland, Salt Lake City, and Seattle, with a cash facility in Phoenix. The largest District, it covers 35 percent of the nation's landmass, ranks first in the size of its economy, and is home to approximately 20 percent of the nation's population.

COVER PHOTO *(left to right):* JEFF JONES RENEE COURTOIS ANDREA DAVIS
Statistics *Public Information* *Public Information*

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SHEILA D. HARRIS
Deputy Chairman (2004)

JANET L. YELLEN
President

GEORGE M. SCALISE
Chairman

JOHN F. MOORE
First Vice President

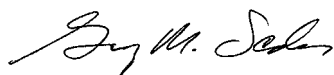
Not Pictured:
DAVID K. Y. TANG
Deputy Chairman (2005)

NOTE FROM THE CHAIRMAN

THE YEAR 2004 MARKED A MAJOR TRANSITION in leadership for the Twelfth District. We said goodbye to President and Chief Executive Officer Robert Parry after 18 years of service. I think I can speak for everyone who worked with Bob when I say we all appreciated Bob's dedication and commitment and the contribution he made both to our Reserve Bank and the Federal Reserve System.

During 2004, we also welcomed Dr. Janet Yellen as the new head of the Federal Reserve Bank of San Francisco. Janet, who took office in June, was appointed after an extensive, nationwide search. She brings an extraordinary combination of expertise and experience to the position. Although she is new to our Reserve Bank, she is not new to the Federal Reserve System, in that she served as a Governor from August 1994 through February 1997. She also was Chair of President Clinton's Council of Economic Advisers and has an extensive and well-recognized academic career.

Janet already has developed a solid rapport with the many constituencies throughout our region and with employees as well. It has been a pleasure to work with her during the past six months, and I look forward to working with her in the future.



George M. Scalise

MESSAGE FROM THE PRESIDENT

THIS IS MY FIRST ANNUAL REPORT as the president and chief executive officer of the Federal Reserve Bank of San Francisco. I am honored to have been chosen for this role and to follow in the footsteps of my predecessor, Robert T. Parry, who left an exceptional foundation to build upon through his contributions to monetary policy, to the San Francisco Reserve Bank, and to the Federal Reserve System.

Representing a District that comprises nearly 20 percent of the national economy is a privilege. Since coming here in June 2004, I have spent a lot of time listening and learning—getting to know the people and seeing the operations. I have met some remarkable people who are dedicated to serving the broad public interest. This dedication reflects an essential mission of the Federal Reserve, which is to promote the well-being of American households.

Although I am in a new role, I am not new to the Federal Reserve, since I previously served as a Governor. This is a very interesting time to be returning. It is a time of change. Some of the most dramatic changes impacting what we do involve the move toward electronic payments in the financial services industry. Soon after I stepped into my new role, the Federal Reserve announced additional consolidations of check operations nationwide to address the accelerating shift away from the use of paper checks to electronic payments. Looking ahead, this shift, together with consolidations in the banking industry, are serving as a catalyst for the Federal Reserve to rethink how it will continue to perform its essential roles and maintain the benefits of its regional structure within a more centralized business environment.

The Federal Reserve is a complex organization, and many Americans understand very little about how it carries out its duties and impacts their lives, let alone how it is evolving in the changing environment. Yet, this understanding can contribute significantly to public well-being and to the Federal Reserve's policy goals as well. The Federal Reserve has been long committed to enhancing public understanding of its activities, the economy, and the financial system through a variety of outreach programs and educational materials.

As part of our outreach strategy, we opened new educational exhibits at our San Francisco headquarters and at our Los Angeles Branch during 2004. These comprehensive exhibits provide the backdrop for this year's essay, "The Fed at Work." The essay describes the Federal Reserve's fundamental roles: conducting monetary policy, supervising and regulating banks, maintaining the stability of the financial system, and providing services for financial institutions. At their core, all of these roles are carried out to enhance public well-being.

The report also looks at some milestones that took place during the year in our business areas that underscore the fact that, while the institution's roles have not changed—how we do our work has. Accomplishing our goals, especially within this changing environment, attests to the talent and commitment of the people who work at the Federal Reserve Bank of San Francisco. I would like to thank employees for their hard work and dedication.

I also would like to extend my thanks and appreciation to our Twelfth District directors for their invaluable counsel during 2004. The directors' independent assessment of economic and financial conditions throughout our nine western states is critical to the formulation of monetary policy.

In particular, I acknowledge the many contributions of Sheila D. Harris, director, Arizona Department of Housing, Phoenix, Arizona, who completed six years of service to this Reserve Bank, the last one and one-half years as deputy chairman of the board.

In addition, I would like to express my sincere thanks and appreciation to the other directors and Advisory Council members who concluded their terms of service during 2004:

- on the San Francisco Board: Jay Harris, Wallis Annenberg Chair in Journalism and Communications, Annenberg School for Communication, University of Southern California, Los Angeles, California;
- on the Los Angeles Branch Board: William Jones, chairman, president, and chief executive officer, CityLink Investment Corporation, San Diego, California, who served as chairman of the Los Angeles Branch Board the last four years; and Russell Goldsmith, chairman and chief executive officer, City National Bank, Beverly Hills, California;
- on the Salt Lake City Branch Board: Curtis Harris, chairman, president, and chief executive officer, Barnes Banking Company, Kaysville, Utah;
- on the Seattle Branch Board: Peter van Oppen, chairman and chief executive officer, Advanced Digital Information Corporation, Redmond, Washington;
- as Twelfth District member of the Federal Advisory Council: Michael O'Neill, chairman, president, and chief executive officer (retired), Bank of Hawaii Corporation, Honolulu, Hawaii; and
- on the Twelfth District Advisory Council: Paula Collins, chief executive officer, WDG Ventures, Inc., San Francisco, California; and Ed Mayne, president, Utah AFL-CIO, West Valley, Utah.



Janet L. Yellen

THE FED AT WORK

central bank: Principal monetary authority of a nation, which performs several key functions, including issuing currency and regulating the supply of money and credit in the economy.¹

You are part of the nation's \$11.7 trillion U.S. economy.² Every time you buy a pair of shoes, invest in mutual funds, save for your child's education, or borrow to buy a house or to start a business, you are making an economic decision. And so are billions of other Americans, foreigners, firms, and governments.

And while all of these people, firms, and institutions are making economic decisions, the people at the Federal Reserve, called "the Fed" for short, are working to help everyone make these decisions in a stable, predictable economic environment. This means setting monetary policy to keep inflation low and to promote maximum sustainable employment and output. It means supervising and regulating the banking system, which plays a critical role allocating resources, pooling capital, and funding and fostering economic growth. And, it means providing vital financial services, including processing checks and electronic funds, for individuals, businesses, and the U.S. government, and distributing coins and currency, making sure the supply is safe and dependable. Twenty-four hours every day, the American economy never stops moving, and the Fed's job is to help keep it that way. To see how, take a closer look at the Fed at work.



ANDREW MCCALLUM
Economic Research

GOLNAZ MOTIEY
Economic Research

INDEPENDENT YET ACCOUNTABLE

Our Nation's Central Bank

As our nation's central bank, the Fed manages the supply of money and credit in the economy and is responsible for keeping the financial system safe and the banking system sound. The Federal Reserve was established by an act of Congress in 1913 and consists of the Board of Governors in Washington, D.C., and twelve District Banks. San Francisco is headquarters for the Twelfth Federal Reserve District. Branches are located in Los Angeles, Portland, Salt Lake City, and Seattle, with a cash facility in Arizona.

Before the creation of the Fed, the country experienced uneven economic growth and frequent depressions and financial panics. A severe banking crisis in 1907 convinced the Congress of the need for a central bank to manage the nation's money supply and to watch over the banking system.

The Congress structured the Fed to be independent within the government—that is, the Fed is accountable to the Congress and its goals for economic performance are set by law. It reports to the Congress on its finances and is subject to government audit and review. Fed officials report regularly to the Congress on monetary policy, regulatory policy, and a variety of other issues, and they meet with senior Administration officials to discuss Federal Reserve and federal government economic programs.

However, the Fed's policy actions are insulated from day-to-day political pressures. This reflects the conviction that the people who control the country's money supply should be independent of the people who frame the government's spending decisions.

What features make the Fed “independent within government”? To provide for some separation from congressional spending decisions, the Fed covers its own operating expenses, primarily from interest earnings on its portfolio of securities. The U.S. President appoints the seven members of the Board

of Governors to 14-year terms, with confirmation by the Senate. These appointments are staggered to reduce the chance of a U.S. President “loading” the Board with appointees. To separate Board members' terms from the political election cycle, their terms are longer than those of elected officials.

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The appointment process for Reserve Bank presidents is another factor that contributes to the Fed's independence. District directors, who appoint Reserve Bank presidents for their regions, are not chosen by politicians but are selected to represent a cross-section of interests within the region including those of depository institutions and nonfinancial businesses, labor, and the public.

LOW INFLATION, HIGH EMPLOYMENT, STRONG ECONOMY

Monetary Policy

U.S. monetary policy affects all kinds of economic and financial decisions made in this country—whether to buy a house or a new car, whether to expand a business or invest in a start-up, and whether to put savings in a bank, in bonds, or the stock market, for example. And, because the U.S. is the largest economy in the world, its monetary policy also has significant economic and financial effects on other countries.

Monetary policy involves influencing short-term interest rates and the supply of money and credit to promote basic goals established by the Congress: “stable” prices and “maximum” sustainable economic output and employment. “Price stability” is often



Standing (left to right):

REUVEN GLICK

MARK SPIEGEL

SANDRA NAYLOR

Seated (left to right):

MICHELE CAVALLO

DIEGO VALDERRAMA

CENTER FOR PACIFIC BASIN STUDIES

taken to mean that inflation is low enough that it does not play a significant role in economic decisionmaking. “Maximum” sustainable economic output and employment mean economic output and employment grow at a pace consistent with the economy’s maximum long-run ability to expand while maintaining price stability.

The FOMC

The Federal Open Market Committee (FOMC) directs the Fed’s monetary policy. The Committee, which typically meets eight times per year in Washington, D.C., to vote on a policy direction, has twelve voting members: the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and four of the other Reserve Bank presidents, who serve on a rotating basis. Regardless of their

voting status, all Reserve Bank presidents contribute to FOMC discussions.

When making monetary policy, the FOMC can’t control inflation or influence economic output and employment directly. Instead, it affects them indirectly, mainly by raising or lowering a short-term interest rate called the federal funds rate, or simply, the “funds rate.” A change to the funds rate affects many other kinds of interest rates and financial conditions throughout the country—for example, it influences the overall “cost,” or interest rate, for borrowing money for everyone: individuals, businesses, and the government, alike.

At FOMC meetings, the Committee votes on an explicit target for the funds rate. Before voting, the Committee examines a wide variety of economic data.

To get a sense of economic conditions and how a change in monetary policy will affect the economy, the Committee examines data on consumer, business, and government spending, as well as international trade, labor markets, and financial market conditions. The Committee also evaluates forecasts of likely future economic performance. Reserve Bank presidents discuss conditions shaping their regions, as well.

Primary Monetary Policy Tool

Most often, the FOMC influences the funds rate through its primary monetary policy tool—conducting open market operations in the market for bank reserves known as the federal funds market. This is the market where banks lend money to one another, usually overnight, to cover temporary shortfalls. By law, banks are required to hold a percentage of deposits as reserves; excess reserves above the requirement can be lent to other banks. With millions of daily transactions, some banks need to borrow money temporarily to acquire needed transactions' balances, while others find themselves with excess money they wish to lend. The funds rate is the interest rate banks charge each other for overnight borrowing.

Open market operations, which involve the buying or selling of government securities for the Fed's portfolio, are used to affect the supply of reserves in the banking system. The New York Reserve Bank's Trading Desk carries out this complex task for the FOMC. The Desk conducts open market operations frequently, even daily, to hit the funds rate target set by the FOMC. To carry out a particular operation, the Desk contacts dealers trading in U.S. Treasury and federal agency securities. When the Desk buys securities, it credits the reserve account of the dealer's bank. This increases the bank's reserves and the supply of reserves in the entire banking system. With a greater supply of reserves available for lending, the funds rate falls. When the Desk sells securities, it debits the reserve account of the dealer's bank, which has

the opposite effect. A lower supply of reserves in the banking system pushes up the funds rate.

The Federal Reserve also sets the discount rate—the interest rate charged to banks that borrow reserves directly from Reserve Banks at what is called the “discount window.”

The Desk conducts open market operations frequently, even daily, to hit the funds rate target set by the FOMC.

Reserve Banks' board of directors set the discount rate for each District, subject to “review and determination” by the Board of Governors. Since January 2003, the discount rate has been set 1 percent higher than the fed funds rate target. Setting the discount rate higher than the funds rate helps to keep banks from turning to this source before they have exhausted other less expensive alternatives. With the discount rate set in response to FOMC decisions on the funds rate, the discount rate does not directly affect the stance of monetary policy.

SAFE AND SOUND

Banking Supervision and Regulation

As a bank supervisor and regulator, the Fed works with other financial authorities to promote a safe, sound, and competitive banking system and to make sure consumers are treated fairly in their financial dealings. In its supervisory role, the Fed monitors and examines banks and other types of financial institutions to assess their financial conditions and their compliance with relevant laws and regulations.³ Banks the Fed monitors include state-chartered banks that are members of the Fed, bank holding companies (organizations that own one or more banks), and various international banking operations. As a regulator, the Fed writes and issues regulations and guidelines governing the structure and conduct of banks.



JOSE ALONSO
MARY HAMMOND

Managing Risk

Banks assume certain financial risks when providing loans and services to their customers. Evaluating a bank's ability to manage these risks appropriately is a cornerstone of the examination process. Fed examiners evaluate a bank's risk levels related to six factors, together called a "CAMELS" rating: capital, assets, management, earnings, liquidity, and sensitivity to interest rate fluctuations.

When evaluating a bank, Fed examiners particularly focus on the effectiveness of the bank's own internal processes for identifying, measuring, monitoring, and controlling the risk of financial loss. Examiners also check for compliance with banking laws and regulations and coordinate their exams with other supervisory agencies. As part of ongoing monitoring, banks

submit periodic reports to the Fed. This helps examiners identify deteriorating financial profiles early on and monitor developing trends in the banking industry.

Protecting and Educating Consumers

The Congress has given the Fed the authority to write, interpret, and implement consumer-protection laws. These laws cover not only banks, but also other businesses, including finance companies, mortgage brokers, retailers, and automobile dealers. They ensure consumers receive comprehensive information and fair treatment in their financial transactions. The Fed also examines banks for compliance with these laws and operates a program consumers can turn to with complaints about financial misdealings involving banks the Fed regulates. Because informed consumers

contribute to the Fed's policy goals and a sound economy, Reserve Banks around the country educate consumers about personal finance and economic literacy through workshops, publications, and the web.

Transforming Communities

Like individual consumers, communities depend on fair access to credit and a full range of financial services to thrive. Reserve Banks offer educational and technical assistance to banks, government agencies, and community groups in their regions to encourage collaboration for community development through

such programs as affordable housing projects and first-time savings accounts to help low-income populations meet financial goals.

Under the Community Reinvestment Act (CRA) of 1977, banks receive a special rating as part of the bank examination process for meeting the needs of low-to-moderate income geographical regions and people. The Fed also considers a bank's CRA performance when ruling on a bank merger or acquisition application or a request to form a bank holding company. This helps ensure federally insured financial institutions provide fair and equal access to credit in all of the

SCOTT TURNER

COMMUNITY AFFAIRS



markets they serve. Consumers and community groups have opportunities to give feedback on a bank's community reinvestment record during CRA examinations and the application process.

THE FLOW OF MONEY

Financial Services

Financial services keep money moving—from buyers to sellers, from employers to staff, and from lenders to borrowers, in the forms of electronic funds, checks, and cash. As our nation's money manager, the Fed is positioned at the center of the financial system to assess and control risk and keep these vital payments systems running smoothly.

One way the Fed keeps the nation's financial wheels rolling is by serving as the banker's bank. Reserve Banks process electronic payments and checks for banks and store their excess cash. Reserve Banks also distribute new coins and currency through banks and destroy currency that is no longer fit for circulation. As the U.S. government's bank, the Fed maintains the U.S. Treasury's bank account and processes government checks, postal money orders, U.S. savings bonds, government securities, and federal tax deposits.

Electronic Funds

In 2004, transactions averaging more than \$1.8 trillion per day passed over the Fed's electronic funds transfer system, called Fedwire.⁴ This represents more than 494,000 daily funds transfers, averaging \$3.8 million each. Banks and other financial institutions with accounts at the Fed use the Fedwire network to handle large-dollar, time-critical payments such as securities and fed funds transfers between banks and real estate transactions on behalf of their customers. These electronic funds transfers are real-time, irrevocable transactions. The Treasury and other federal agencies also use Fedwire to collect and disburse funds.

The Fed's automated clearinghouse (ACH) is used to process routine, lower-dollar electronic payments such as direct deposits of paychecks, automatic bill payments, and government payments, such as Social Security checks and tax refunds. In 2004, the Fed's ACH processed 7.4 billion payments, worth \$15.5 trillion.⁵ This represents an average payment of \$2,500.

Checks

Although you may be one of the many consumers who leaves the checkbook at home, millions of Americans continue to write checks every day. The Fed handles one-third of them, with Reserve Banks using high-speed processing machines that sort up to 100,000 paper checks per hour, operating nearly twenty-four hours per day, seven days per week.



BILL KIMBEL

THERESE WILLIAMS

ELMER STOKES
ALEX TORRES

CASH SERVICES



More and more these days, the check you write may be converted to some type of electronic transaction during processing. In fact, the number of electronic payment transactions in the United States now exceeds check payments according to a Fed survey published in 2004.⁶ Electronic payments consist of such payment methods as debit cards, credit cards, and ACH transactions. This means, for example, your monthly mortgage check may be converted to an ACH transaction, replacing the need to clear the paper check. Or the cashier at your local department store may scan your check to create an ACH transaction, voiding the check at the store.

Coins and Currency

Add up all of the coins and currency dropped into vending machines and cash registers, and that's a lot

of money changing hands every day. Reserve Banks play an important role making sure enough coins and currency are in circulation to meet the public's demand in their districts. Demand varies depending on the time of year and the level of economic activity. For example, the demand for cash increases during the holidays at the end of the year. On a larger scale, the Fed makes sure enough coins and currency are on hand to prepare for unforeseen events that could disrupt the flow of money in the banking system.

Reserve Banks work with the U.S. Mint and the U.S. Bureau of Engraving and Printing to determine how many coins and how much currency are produced and distributed around the country. The U.S. Mint decides how many coins to make each year in part through the use of sophisticated forecasting models at the Fed and the Mint. From its production facilities

in Philadelphia and Denver, the Mint sends coins to Reserve Banks and more than 180 coin terminals it has contracted with nationwide. Reserve Banks order new paper bills from the U.S. Bureau of Engraving and Printing, in Washington, D.C., and Fort Worth, Texas.

Exactly how does new cash get into circulation? Reserve Banks put new money into circulation through commercial banks. Banks store excess coins and currency in local Fed vaults and maintain cash balances in reserve accounts. Reserve Banks verify amounts received, weighing coins and using high-speed machines to process currency. Sorting over 70,000 notes per hour, the machines verify amounts and denominations, remove counterfeits, and shred worn currency. In 2004, Reserve Banks shredded almost \$91 billion worth of currency.⁷ Reserve Banks send counterfeit bills to the U.S. Secret Service for investigation. Money that is in good shape is stored. When banks request money, Reserve Banks ship this “fit” money, along with new coins and currency, to meet demand. On an average day in 2004, Federal Reserve Banks delivered \$2.7 billion worth of bills and \$25.3 million worth of coins to America’s banks.⁸

MAINTAINING STABILITY

When a crisis or an economic shock threatens to disrupt the financial system, the Fed needs to respond quickly and decisively to restore stability. Through its discount window, the Fed makes temporary loans to banks to ensure that a shortage of funds at one institution does not disrupt the flow of money and credit, or “liquidity,” throughout the banking system.

Typically, the Fed provides credit at the discount window to banks to help them adjust to temporary changes in their deposits or loan portfolios and to cover seasonal or emergency credit needs. When a more severe shock hits, such as the events of September 11, 2001 (or 9/11), borrowing at the discount window is one of a number of important

tools the Fed uses to inject liquidity into the economy. On September 12, 2001, the day after the attacks, the Fed lent a record \$46 billion at its discount window, compared to a daily average of \$54 million on a normal business day in 2001.⁹

Typically, the Fed provides credit at the discount window to banks to help them adjust to temporary changes in their deposits or loan portfolios and to cover seasonal or emergency credit needs.

During severe shocks, the Fed also can provide liquidity in the check-clearing process to offset imbalances in the flow of payments between banks. “Float” is the term used to describe the amount of money Reserve Banks credit to depositing banks that hasn’t been debited from the accounts of check writers. When 9/11 hit, the Fed continued to clear checks under normal schedules, despite being unable to collect from paying banks around the country. As a result, the Fed incurred close to \$23 billion in float on September 12—about 30 times the historical daily average.¹⁰

When a shock hits, U.S. banks aren’t the only concern. The Fed needs to make sure that foreign financial institutions have sufficient dollars on hand to enable individuals, businesses, and foreign governments to meet financial obligations. “Swap lines” allow foreign central banks to exchange their currencies for U.S. dollars. This is another tool the Fed used following 9/11 when it entered into swap agreements with the European Central Bank and the Bank of England and augmented an existing agreement with the Bank of Canada.

The stock market crash of 1987 and the Continental Illinois National Bank failure in 1984 are two different types of shocks from the past that illustrate the Fed’s role in maintaining the stability of the financial

system. When the stock market plunged more than 20 percent on what came to be called “Black Monday,” October 19, 1987, the Fed rapidly provided liquidity to help stabilize the financial markets. To calm the public and prevent panic selling that might have worsened the crisis, the Fed quickly announced its readiness to provide credit, just as it did during the 9/11 crisis.

When one of the country’s biggest banks, Continental Illinois National Bank, failed, the shock could have rippled through the financial system, jeopardizing many smaller banks with deposits at the large institution. To stop the spread of instability and protect consumers and the banking system, the Fed temporarily loaned \$5 billion to Continental Illinois, giving the Fed and the bank time to work together and with other regulators to resolve the situation.¹¹

That’s the Fed at work. Since its creation in 1913, the Fed has promoted the public interest by providing a stable, safe U.S. monetary and financial system. To learn more about the Fed at work, read the publications listed below, which, along with the new exhibits in the San Francisco headquarters and Los Angeles Branch, were used in the writing of this report. Find these and other educational and technical resources about the Fed and the economy at www.frbsf.org.

- ***The Federal Reserve: In Brief***
- ***The Federal Reserve System: Purposes and Functions***
- ***U.S. Monetary Policy: An Introduction***



MARTA POSADA
Administrative Services

RICHARD BYRNE
Human Resources

Endnotes

¹ *U.S. Monetary Policy: An Introduction*, Federal Reserve Bank of San Francisco (January 2004), www.frbsf.org/publications/federalreserve/monetary/index.html.

² As of fourth quarter 2004; Source: Bureau of Economic Analysis, www.bea.gov.

³ For convenience, this report refers to all banks and other types of financial institutions the Federal Reserve and other financial agencies supervise as “banks.”

⁴ Source: Federal Reserve Board, Fedwire Funds Service, Annual Data, www.federalreserve.gov/paymentsystems/fedwire/fedwirefundstrfann.htm.

⁵ Source: Federal Reserve Board, Automated Clearinghouse Operations, Annual Data, www.federalreserve.gov/paymentsystems/fedach/achyearly.htm.

⁶ “Federal Reserve Studies Confirm Electronic Payments Exceed Check Payments for the First Time,” Financial Services Policy Committee Press Release (December 6, 2004), www.frbservices.org/Retail/pdf/PR2004PaymentResearch.pdf.

⁷ Federal Reserve System, Cash Product Office.

⁸ Federal Reserve System, Cash Product Office.

⁹ Sources: Federal Reserve Bank of New York 2001 Annual Report (p. 8); Federal Reserve Bank of San Francisco.

¹⁰ Source: Christopher J. Neely. “The Federal Reserve’s Response to the September 11 Attacks,” *The Regional Economist*, Federal Reserve Bank of St. Louis (January 2002).

¹¹ Source: Federal Reserve Bank of San Francisco.

EXECUTIVE COMMITTEE



Standing from left:

SUSAN A. SUTHERLAND
*Senior Vice President
District Business Continuity, Equal Employment
Opportunity, Human Resources, Legal, and Statistics*

JANET L. YELLEN
President and Chief Executive Officer

JOHN F. MOORE
*First Vice President and Chief Operating Officer
National Cash Product Director*

JOHN P. JUDD
Executive Vice President and Director of Research

Sitting from left:

MARK L. MULLINIX
*Executive Vice President
District Finance, Information Technology
National Cash Product Manager*

TERRY S. SCHWAKOPF
*Executive Vice President
Banking Supervision and Regulation,
District Public Information,
Communicating Arts, and Office of the Secretary*

SUMMARY OF OPERATIONS

	(volume in thousands)	
	2004	2003
Cash Services		
Currency notes paid into circulation	6,097,331	5,830,472
Food stamp coupons processed	46,714	222,166
Check Services		
Commercial checks processed	1,516,019	1,743,501
Return items processed	27,048	33,602
Discounts and Advances		
Total discounts and transactions*	287	350
Number of financial institutions accommodated*	90	75

* *Whole numbers (not in thousands)*

BRANCH MANAGERS



PORTLAND
RICHARD B. HORNSBY
Group Vice President

SEATTLE
MARK A. GOULD
Group Vice President

SALT LAKE CITY
ANDREA P. WOLCOTT
Group Vice President

Not Pictured:
LOS ANGELES
MARK L. MULLINIX
Executive Vice President

BANK OFFICERS AND PRINCIPALS

As of December 31, 2004

San Francisco Office

Janet L. Yellen President and Chief Executive Officer	Teresa M. Curran Group Vice President	Mary C. Daly Vice President	Tracy Basinger Director	Darren S. Post Director	Nancy S. Emerson Principal
John F. Moore First Vice President and Chief Operating Officer	Fred T. Furlong Group Vice President	Lee C. Dwyer Vice President	Barbara A. Bennett Director	David E. Reiser Director	Gerald T. Iseda Principal
John P. Judd Executive Vice President	Reuven Glick Group Vice President	Beverley-Ann Hawkins Vice President	Kenneth R. Binning Director	Philip M. Ryan Director	Bonita G. Jones Principal
Terry S. Schwakopf Executive Vice President	Todd A. Glissman Group Vice President	Joy K. Hoffmann Vice President	Richard K. Cabral Director	Carl M. Segall Director	Gopa Kumar Principal
John S. Hsiao Senior Vice President and Chief Information Officer	Donald R. Lieb Group Vice President	Michael E. Johnson Vice President and Managing Director	James J. Callahan Director	David G. Tresmontan Director	Maureen E. O'Byrne Principal
Michael J. Murray Senior Vice President	Sharon Ruth Group Vice President and General Counsel	Ann Marie Kohlligian Vice President and Managing Director	Clifford N. Croxall Director	Roxana R. Tsougarakis Director	Mildred J. Powell Principal
John H. Parrish Senior Vice President and General Auditor	Deborah S. Smyth Group Vice President	Simon H. Kwan Vice President	Ellen M. Hamilton Director	Paulette M. Wallace Director	Erik Z. Revai Principal and Associate General Counsel
Glenn D. Rudebusch Senior Vice President	David W. Walker Group Vice President	Mark M. Spiegel Vice President	Jackie C. Hicks Director	Mary E. Wujek Director	Peggy L. Speck Principal and Secretary of the Board
Susan A. Sutherland Senior Vice President	Patricia A. Welch Group Vice President	Libby Wood Vice President	Rick A. Miller Director	Judith R. W. Goff Research Publications Advisor	Shirley N. Thompson Principal and Associate General Counsel
John C. Williams Senior Vice President	Bonnie R. Allen Vice President and Managing Director	Randy Balducci Director	Frederic P. Minardi Director	Bharat Trehan Research Advisor	Kevin Zerbe Principal
		Thomas A. Ballantyne Director	Richard A. Naylor, II Director	Robert G. Valletta Research Advisor	

Los Angeles Branch

Mark L. Mullinix Executive Vice President	Marla E. Borowski Vice President	Jose Alonso Director	Steven E. Jung Director	Dale L. Vaughan Director
Roger W. Replogle Senior Vice President	Warren Howard Vice President	Anthony P. Dazzo Director	Robin A. Rockwood Director	Dana R. Green Principal
Deborah Awai Vice President	Robert Zavala, Jr. Vice President	Robert C. Johnson Director	Joel K. Van Zee Director	Richard J. Shershenovich Principal

Portland Branch

Richard B. Hornsby Group Vice President	Steven H. Walker Director
Mary E. Lee Director	

Salt Lake City Branch

Andrea P. Wolcott Group Vice President	Jed W. Bodily Director
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Seattle Branch

Michael J. Stan Senior Vice President	Pamela R. Anderson Director
Mark A. Gould Group Vice President	Lynn M. Jorgensen Director

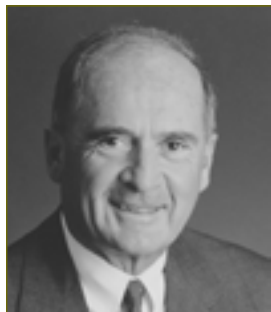
Phoenix Processing Center

Robert E. Kellar, Jr. Director

SAN FRANCISCO BOARD OF DIRECTORS

As of January 1, 2005

Chairman of the Board and Federal Reserve Agent



George M. Scalise
President
Semiconductor Industry Association
San Jose, California

Deputy Chairman



David K. Y. Tang
Partner
Preston Gates & Ellis LLP
Seattle, Washington

Boards of directors of the Reserve Banks and Branches provide the Federal Reserve System with a wealth of information on economic conditions in every corner of the nation. This information, along with other sources, is used by the Federal Open Market Committee and the Board of Governors when reaching decisions about monetary policy.



Karla S. Chambers
Vice President and Co-Owner
Stahlbush Island Farms, Inc.
Corvallis, Oregon



Richard W. Decker, Jr.
Chairman and Co-Founder
Belvedere Capital Partners LLC
San Francisco, California



Richard C. Hartnack
Vice Chairman
Union Bank of California, N.A.
Los Angeles, California



Jack McNally
Principal
JKM Consulting
Sacramento, California



T. Gary Rogers
Chairman and Chief
Executive Officer
Dreyer's Grand Ice Cream
Holdings, Inc.
Oakland, California



Candace H. Wiest
President
Inland Empire National Bank
Riverside, California



Barbara L. Wilson
Consultant and Regional
Vice President (Retired)
Qwest Corporation
Boise, Idaho



Richard M. Kovacevich
Chairman, President, and Chief
Executive Officer
Wells Fargo & Company
San Francisco, California

Federal Advisory Council Member

LOS ANGELES BOARD OF DIRECTORS

As of January 1, 2005

Chairman of the Board



James L. Sanford
Corporate Vice President
and Treasurer
Northrop Grumman Corporation
Los Angeles, California



Karen Caplan
President and Chief
Executive Officer
Frieda's, Inc.
Los Alamitos, California



Sister Diane Donoghue
Executive Director
Esperanza Community
Housing Corporation
Los Angeles, California



Dominic Ng
Chairman, President, and
Chief Executive Officer
East West Bank
San Marino, California



Anita Santiago
President
Anita Santiago Advertising
Santa Monica, California



Peter M. Thomas
Managing Director
Thomas and Mack Co.
Las Vegas, Nevada



D. Linn Wiley
President and Chief
Executive Officer
Citizens Business Bank
Ontario, California

PORTLAND BOARD OF DIRECTORS

As of January 1, 2005

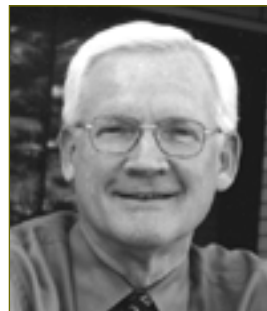
Chairman of the Board



James H. Rudd
Chief Executive Officer
and Principal
Ferguson Wellman Capital
Management, Inc.
Portland, Oregon



Judi Johansen
President and Chief
Executive Officer
PacifiCorp
Portland, Oregon



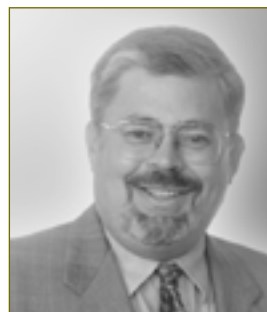
Peter O. Kohler
President
Oregon Health and
Science University
Portland, Oregon



George Passadore
Oregon Region Chairman (Retired)
Wells Fargo Bank
Portland, Oregon



Robert D. Sznewajs
President and Chief
Executive Officer
West Coast Bancorp
Lake Oswego, Oregon



William D. Thorndike, Jr.
President
Medford Fabrication
Medford, Oregon

SALT LAKE CITY BOARD OF DIRECTORS

As of January 1, 2005

Chairman of the Board



H. Roger Boyer
Chairman
The Boyer Company
Salt Lake City, Utah



A. Scott Anderson
President and Chief
Executive Officer
Zions First National Bank
Salt Lake City, Utah



Gary L. Crocker
Chairman and Chief
Executive Officer
AnzenBio, LLC
Salt Lake City, Utah



William C. Glynn
President
Intermountain Industries, Inc.
Boise, Idaho



Annette K. Herman
President and Chief
Executive Officer
UnitedHealthcare
Salt Lake City, Utah



Michael M. Mooney
President and Chief
Operating Officer
Farmers & Merchants State Bank
Boise, Idaho

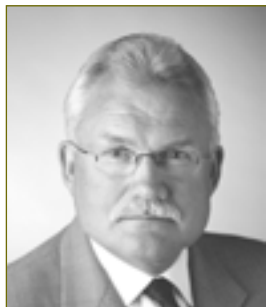


Deborah B. Nielsen
President and Chief
Executive Officer
United Way of Salt Lake
Salt Lake City, Utah

SEATTLE BOARD OF DIRECTORS

As of January 1, 2005

Chairman of the Board



Mic R. Dinsmore
Chief Executive Officer
Port of Seattle
Seattle, Washington



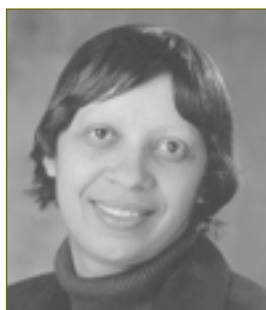
James R. Gill
President
Pacific Northwest Title
Holding Company
Seattle, Washington



Kenneth M. Kirkpatrick
President, Washington State
U.S. Bank
Seattle, Washington



Blake W. Nordstrom
President
Nordstrom, Inc.
Seattle, Washington



Mary E. Pugh
President
Pugh Capital Management, Inc.
Seattle, Washington



Helvi K. Sandvik
President
NANA Development Corp.
Anchorage, Alaska



David W. Wyckoff
Chairman and Chief
Executive Officer
Wyckoff Farms, Inc.
Grandview, Washington

TWELFTH DISTRICT ADVISORY COUNCIL

As of January 1, 2005

Chairman



Duff Willey
President
Willey Automotive Group
Bountiful, Utah

Vice Chairman



Thomas E. Cleveland
Chairman and Chief Executive Officer
Access Business Finance
Bellevue, Washington



Roberto Barragan
President
Valley Economic
Development Center, Inc.
Van Nuys, California



Stephen M. Brophy
President
Page Land & Cattle Co.
Phoenix, Arizona



Barbara Bry
Chief Operating Officer
Voice of San Diego
San Diego, California



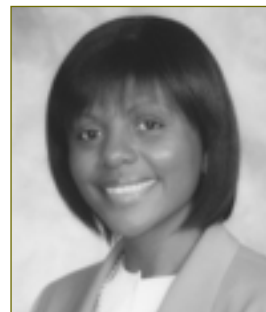
Manuel Cunha, Jr.
President
Nisei Farmers League
Fresno, California



Paul Ecke, III
Chairman and Chief Executive Officer
Paul Ecke Ranch
Encinitas, California



Jack H. Gleason
ComPlan Advisors LLC
Scottsdale, Arizona



Denice A. Young, CPA
President
Young Consulting Group
and Real Estate Services
Torrance, California

2004 FINANCIAL REPORTS

Auditor Independence

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2004 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$2.0 million. To ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2004, the Bank did not engage PwC for any material advisory services.

FEDERAL RESERVE BANK OF SAN FRANCISCO
101 MARKET STREET, SAN FRANCISCO, CALIFORNIA 94105

March 2, 2005

To the Board of Directors:

The management of the Federal Reserve Bank of San Francisco (FRBSF) is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2004 (the “Financial Statements”). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the *Financial Accounting Manual for Federal Reserve Banks* (“Manual”) and, as such, include amounts some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies, and practices documented in the Manual and include all disclosures necessary for such fair presentation.

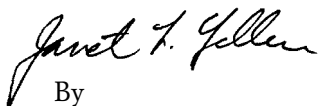
The management of the FRBSF is responsible for maintaining an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements. Such internal controls are designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of reliable Financial Statements. This process of internal controls contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in the process of internal controls are reported to management, and appropriate corrective measures are implemented.

Even an effective process of internal controls, 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.

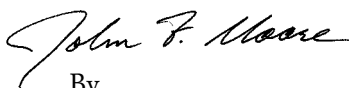
The management of the FRBSF assessed its process of internal controls over financial reporting including the safeguarding of assets reflected in the Financial Statements, based upon the criteria established in the *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on this assessment, we believe the FRBSF maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Federal Reserve Bank of San Francisco



By
Janet L. Yellen
President



By
John F. Moore
First Vice President



By
Mark Mullinix
Principal Financial Officer



PricewaterhouseCoopers LLP

333 Market Street
San Francisco CA 94105-2119
Telephone (415) 498 5000
Facsimile (415) 498 7100

Report of Independent Auditors

To the Board of Governors of the Federal Reserve System
and the Board of Directors of the Federal Reserve Bank of San Francisco

We have audited the accompanying statements of condition of the Federal Reserve Bank of San Francisco (the "Bank") as of December 31, 2004 and 2003, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2004 and 2003, and results of its operations for the years then ended, in conformity with the basis of accounting described in Note 3.

A handwritten signature in dark ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

March 16, 2005
San Francisco, California

**PricewaterhouseCoopers LLP**

333 Market Street
 San Francisco CA 94105-2119
 Telephone (415) 498 5000
 Facsimile (415) 498 7100

Report of Independent Auditors

To the Board of Directors of
 The Federal Reserve Bank of San Francisco

We have examined management's assertion, included in the accompanying Management Assertion, that the Federal Reserve Bank of San Francisco ("FRBSF") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the financial statements as of December 31, 2004, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRBSF's management is responsible for maintaining effective internal control over financial reporting and safeguarding of assets as they relate to the financial statements. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that FRBSF maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the financial statements as of December 31, 2004 is fairly stated, in all material respects, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

This report is intended solely for the information and use of management and the Board of Directors and Audit Committee of FRBSF, and any organization with legally defined oversight responsibilities and is not intended to be and should not be used by anyone other than these specified parties.

March 16, 2005
 San Francisco, California

Statements of Condition

As of December 31, 2004 and 2003 (in millions)

Assets	2004	2003
Gold certificates	\$ 1,055	\$ 963
Special drawing rights certificates	234	234
Coin	105	84
Items in process of collection	2,542	2,689
Loans to depository institutions	–	20
U.S. government securities, net	65,573	54,278
Investments denominated in foreign currencies	2,532	2,058
Accrued interest receivable	459	406
Interdistrict settlement account	4,414	11,391
Bank premises and equipment, net	216	234
Other assets	37	38
Total assets	<u>\$ 77,167</u>	<u>\$ 72,395</u>
Liabilities and Capital		
<i>Liabilities:</i>		
Federal Reserve notes outstanding, net	\$ 67,831	\$ 63,868
Securities sold under agreements to repurchase	2,782	2,061
<i>Deposits:</i>		
Depository institutions	2,244	1,957
Other deposits	4	3
Deferred credit items	1,599	2,296
Interest on Federal Reserve notes due U.S. Treasury	56	29
Accrued benefit costs	68	69
Other liabilities	17	16
Total liabilities	<u>74,601</u>	<u>70,299</u>
<i>Capital:</i>		
Capital paid-in	1,283	1,048
Surplus	1,283	1,048
Total capital	<u>2,566</u>	<u>2,096</u>
Total liabilities and capital	<u>\$ 77,167</u>	<u>\$ 72,395</u>

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

Statements of Income

For the years ended December 31, 2004 and 2003 (in millions)

	2004	2003
<i>Interest income:</i>		
Interest on U.S. government securities	\$ 1,933	\$ 1,826
Interest on investments denominated in foreign currencies	32	27
Total interest income	1,965	1,853
<i>Interest expense:</i>		
Interest expense on securities sold under agreements to repurchase	27	18
Net interest income	1,938	1,835
<i>Other operating income:</i>		
Income from services	78	81
Reimbursable services to government agencies	16	16
Foreign currency gains, net	145	280
Other income	7	8
Total other operating income	246	385
<i>Operating expenses:</i>		
Salaries and other benefits	178	186
Occupancy expense	17	18
Equipment expense	19	22
Assessments by Board of Governors	99	99
Other expenses	68	54
Total operating expenses	381	379
Net income prior to distribution	\$ 1,803	\$ 1,841
<i>Distribution of net income:</i>		
Dividends paid to member banks	\$ 72	\$ 55
Transferred to surplus	235	180
Payments to U.S. Treasury as interest on Federal Reserve notes	1,496	1,606
Total distribution	\$ 1,803	\$ 1,841

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

Statements of Changes in Capital

For the years ended December 31, 2004 and 2003 (in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 2003 (17 million shares)	\$ 868	\$ 868	\$ 1,736
Transferred to surplus	—	180	180
Net change in capital stock issued (4 million shares)	180	—	180
Balance at December 31, 2003 (21 million shares)	1,048	1,048	2,096
Transferred to surplus	—	235	235
Net change in capital stock issued (5 million shares)	235	—	235
Balance at December 31, 2004 (26 million shares)	\$ 1,283	\$ 1,283	\$ 2,566

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

Notes to Financial Statements

1. Structure

The Federal Reserve Bank of San Francisco (“Bank”) is part of the Federal Reserve System (“System”) created by Congress under the Federal Reserve Act of 1913 (“Federal Reserve Act”) which established the central bank of the United States. The System consists of the Board of Governors of the Federal Reserve System (“Board of Governors”) and twelve Federal Reserve Banks (“Reserve Banks”). The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branches in Los Angeles, California, Portland, Oregon, Salt Lake City, Utah, and Seattle, Washington serve the Twelfth Federal Reserve District, which includes Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, Washington, and the commonwealths or territories of American Samoa, Guam, and the Northern Mariana Islands. Other major elements of the System are the Federal Open Market Committee (“FOMC”) and the Federal Advisory Council. 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. Banks that are members of the System include all national banks and any state-chartered bank that applies and is approved for membership in the System.

Board of Directors

In accordance with the Federal Reserve Act, supervision and control of the Bank are exercised by a Board of Directors. The Federal Reserve Act specifies the composition of the Board of Directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. Of the six elected by member banks, three represent the public and three represent member banks. 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.

2. Operations and Services

The System performs a variety of services and operations. Functions include formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse (“ACH”) operations, and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government’s bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies and state member banks; and administering other regulations of the Board of Governors. The Board of Governors’ operating costs are funded through assessments on the Reserve Banks.

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY is also authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange (“F/X”) and securities contracts in, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. In addition, FRBNY is authorized to maintain reciprocal currency arrangements (“F/X swaps”) with various central banks, and “warehouse” foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (“ESF”) through the Reserve Banks.

Notes to Financial Statements

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 the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* ("Financial Accounting Manual"), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual.

The financial statements have been prepared in accordance with the Financial Accounting Manual. Differences exist between the accounting principles and practices of the System and accounting principles generally accepted in the United States of America ("GAAP"). The primary difference is the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP. In addition, the Bank has elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included because the liquidity and cash position of the Bank are not of primary concern to the users of these financial statements. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. A Statement of Cash Flows, therefore, would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

Each Reserve Bank provides services on behalf of the System for which costs are not shared. Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include: National Incident Response Team, Statistics and Reserves, Enterprise Wide Adjustments, Cash Product Office, Check Standardization, Check Restructuring, and National Information Center – Central Operations.

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

Gold Certificates

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

Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. 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 United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time,

Notes to Financial Statements

equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2004 or 2003.

Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Bank. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Bank, subject to review by the Board of Governors.

U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies

The FOMC has designated the FRBNY to execute open market transactions on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account ("SOMA"). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. Such authorizations are reviewed and approved annually by the FOMC.

The FRBNY has sole authorization by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements on behalf of the System, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires the FRBNY to take possession of collateral in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the FRBNY on a daily basis, with additional collateral obtained as necessary. The securities lent are accounted for in the SOMA.

F/X contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to foreign currencies it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

Notes to Financial Statements

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

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts that contain varying degrees of off-balance-sheet market risk, because they represent contractual commitments involving future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio from time to time involve transactions that may result in gains or losses when holdings are sold prior to maturity. Decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Securities sold under agreements to repurchase are accounted for as secured borrowing transactions with the associated interest expense recognized over the life of the transaction. Such transactions are settled by FRBNY. Interest income is accrued on a straight-line basis. Income earned on securities lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency gains, net."

Activity related to U.S. government securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currency, excluding those held under an F/X swap arrangement, and deposit accounts of foreign central banks and governments above core balances are allocated to each Reserve Bank. U.S. government securities purchased under agreements to resell and unrealized gains and losses on the revaluation of foreign currency holdings under F/X swaps and warehousing arrangements are allocated to the FRBNY and not to other Reserve Banks.

In 2003, additional interest income of \$61 million, representing one day's interest on the SOMA portfolio, was accrued to reflect a change in interest accrual calculations, of which \$5 million was allocated to the Bank. The effect of this change was not material; therefore, it was included in the 2003 interest income.

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 estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs, and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the

Notes to Financial Statements

application development stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years.

Interdistrict Settlement Account

At the close of business each day, all Reserve Banks and branches assemble the payments due to or from other Reserve Banks and branches as a result of transactions involving accounts residing in other Districts that occurred during the day's operations. Such transactions may include funds settlement, check clearing and ACH operations, and allocations of shared expenses. The cumulative net amount due to or from other Reserve Banks is reported as the "Interdistrict settlement account."

Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank.

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

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes of 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, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding reduced by its currency holdings of \$20,570 million, and \$15,685 million at December 31, 2004 and 2003, respectively.

Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank's capital and surplus changes, its holdings of Reserve Bank stock must be adjusted. Member banks are state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of \$100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

The Financial Accounting Standards Board has deferred the implementation date for SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* for the Bank. When applicable, the Bank will determine the impact and provide the appropriate disclosures.

Notes to Financial Statements

Surplus

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

Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

In the event of losses or an increase in capital paid-in, payments to the U.S. Treasury are suspended and earnings are retained until the surplus is equal to the capital paid-in. Weekly payments to the U.S. Treasury may vary significantly.

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to U.S. Treasury in the following year. This amount is reported as a component of "Payments to U.S. Treasury as interest on Federal Reserve notes."

Income and Costs Related to Treasury Services

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were \$3 million for each of the years ended December 31, 2004 and 2003, and are reported as a component of "Occupancy expense."

Restructuring Charges

In 2003, the System started the restructuring of several operations, primarily check, cash, and treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations. These restructuring activities continued in 2004.

Footnote 10 describes the restructuring and provides information about the Bank's costs and liabilities associated with employee separations and contract terminations. The costs associated with the write-down of certain Bank assets are discussed in footnote 6. Costs and liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY.

Notes to Financial Statements

4. U.S. Government Securities

Securities bought outright are held in the SOMA at the FRBNY. An undivided interest in SOMA activity and the related premiums, discounts, and income, with the exception of securities purchased under agreements to resell, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings that occurs in April of each year. The settlement equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 9.037 percent and 8.034 percent at December 31, 2004 and 2003, respectively.

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

	2004	2003
<i>Par value:</i>		
<i>U.S. government:</i>		
Bills	23,765	19,671
Notes	32,609	25,980
Bonds	8,497	7,912
Total par value	64,871	53,563
Unamortized premiums	850	787
Unaccreted discounts	(148)	(72)
Total allocated to Bank	\$ 65,573	\$ 54,278

The total of the U.S. Government securities, net held in the SOMA was \$725,584 million and \$675,569 million at December 31, 2004 and 2003, respectively.

The maturity distribution of U.S. government securities bought outright and securities sold under agreements to repurchase, that were allocated to the Bank at December 31, 2004, was as follows (in millions):

Maturities of Securities Held	U.S. Government Securities (Par value)	Securities Sold Under Agreement to Repurchase (Contract Amount)
Within 15 days	\$ 2,770	\$ 2,782
16 days to 90 days	16,118	
91 days to 1 year	15,400	
Over 1 year to 5 years	18,822	
Over 5 years to 10 years	4,914	
Over 10 years	6,847	
Total	\$ 64,871	\$ 2,782

At December 31, 2004 and 2003, U.S. government securities with par values of \$6,609 million and \$4,426 million, respectively, were loaned from the SOMA, of which \$597 million and \$356 million were allocated to the Bank.

Notes to Financial Statements

At December 31, 2004 and 2003, securities sold under agreements to repurchase with contract amounts of \$30,783 million and \$25,652 million, respectively, and par values of \$30,808 million and \$25,658 million, respectively, were outstanding. The Bank's allocated share at December 31, 2004 and 2003 was \$2,782 and \$2,061 million, respectively, of the contract amount and \$2,784 million and 2,061 million, respectively, of the par value.

5. Investments Denominated in Foreign Currencies

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

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 11.848 percent and 10.360 percent at December 31, 2004 and 2003, respectively.

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

	2004	2003
<i>European Union Euro:</i>		
Foreign currency deposits	\$ 718	\$ 712
Securities purchased under agreements to resell	254	213
Government debt instruments	455	211
<i>Japanese Yen:</i>		
Foreign currency deposits	182	153
Government debt instruments	908	760
Accrued interest	15	9
Total	<u>\$ 2,532</u>	<u>\$ 2,058</u>

Total system investments denominated in foreign currencies were \$21,368 million and \$19,868 million at December 31, 2004 and 2003, respectively.

Notes to Financial Statements

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2004, was as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	European Euro	Japanese Yen	Total
Within 1 year	\$ 1,064	\$ 1,090	\$ 2,154
Over 1 year to 5 years	356	—	356
Over 5 years to 10 years	22	—	22
Over 10 years	—	—	—
Total	<u>\$ 1,442</u>	<u>\$ 1,090</u>	<u>\$ 2,532</u>

At December 31, 2004 and 2003, there were no material open foreign exchange contracts.

At December 31, 2004 and 2003, the warehousing facility was \$5,000 million, with no balance outstanding.

6. Bank Premises, Equipment and Software

A summary of bank premises and equipment at December 31 is as follows (in millions):

	Maximum Useful Life (in years)	2004	2003
<i>Bank premises and equipment:</i>			
Land	N/A	\$ 29	\$ 24
Buildings	50	189	194
Building machinery and equipment	20	44	44
Construction in progress	N/A	2	5
Furniture and equipment	10	126	137
Subtotal		<u>390</u>	<u>404</u>
Accumulated depreciation		<u>(174)</u>	<u>(170)</u>
Bank premises and equipment, net		<u>\$ 216</u>	<u>\$ 234</u>
Depreciation expense, for the years ended		<u>\$ 16</u>	<u>\$ 18</u>

Capitalized leases that are included in Bank Premises and Equipment at December 31 were not material.

Notes to Financial Statements

The Bank leases unused space to outside tenants. Those leases have terms ranging from one to 10 years. Rental income from such leases was \$1 million for each of the years ended December 31, 2004 and 2003. Future minimum lease payments under noncancelable agreements in existence at December 31, 2004, were (in millions):

2005	\$	0.8
2006		0.8
2007		0.2
2008		—
2009		—
Thereafter		—
	\$	<u>1.8</u>

The Bank has capitalized software assets, net of amortization, of \$10 and \$12 million at December 31, 2004 and 2003, respectively. Amortization expense was \$5 million for each of the years ended December 31, 2004 and 2003.

Assets impaired as a result of the Bank's restructuring plan, as discussed in footnote 10 include land, building, furniture, and equipment. Asset impairment losses of \$13 million for the period ending December 31, 2004, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

7. Commitments and Contingencies

At December 31, 2004, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately 4 years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was \$593 thousand and \$807 thousand for the years ended December 31, 2004 and 2003, respectively. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2004, were (in millions):

	Operating	Capital
2005	\$ 0.1	\$ 1.3
2006	—	1.3
2007	—	0.4
2008	—	0.1
2009	—	0.1
Thereafter	—	—
	<u>\$ 0.1</u>	<u>3.2</u>
Amount representing interest		(0.2)
Present value of net minimum lease payments		<u>\$ 3.0</u>

Notes to Financial Statements

At December 31, 2004, other commitments and long-term obligations in excess of one year were \$3 million.

At December 31, 2004, the Bank, acting on behalf of the Reserve Banks, had a contractual commitment extending through the year 2007 totaling \$3 million. As of December 31, 2004, \$3 million of the commitment was recognized. Payments of \$1 million were made against the commitment for each of the years 2004 and 2003. It is estimated that the Bank's allocated share of the commitment will be \$3 million. The commitment represents software license fees and maintenance and has variable and fixed components. The variable portion of the commitment is for software maintenance. The fixed payments for the next five years under the commitment are:

	Fixed Commitment
2005	\$ 3.0
2006	0.2
2007	0.1
2008	—
2009	—

Under the Insurance Agreement of the Federal Reserve Banks dated as of March 2, 1999, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 2004 or 2003.

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

8. Retirement and Thrift Plans

Retirement Plans

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

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the Plan for the System and the costs associated with the Plan are not redistributed to the Bank. The Bank's projected benefit obligation and net pension costs for the BEP and the SERP at December 31, 2004 and 2003, and for the years then ended, are not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled \$7 million for each of the years ended December 31, 2004 and 2003 and are reported as a component of "Salaries and other Benefits."

Notes to Financial Statements

9. Postretirement Benefits Other Than Pensions and Postemployment Benefits

Postretirement benefits other than pensions

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

The Bank funds benefits payable under the medical and life insurance plans as due and, accordingly, has no plan assets. Net postretirement benefit costs are actuarially determined using a January 1 measurement date.

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

	2004	2003
Accumulated postretirement benefit obligation at January 1	\$ 57.9	\$ 38.5
Service cost-benefits earned during the period	1.4	1.2
Interest cost of accumulated benefit obligation	3.6	3.1
Actuarial loss	10.8	18.0
Curtailment (gain)/loss	—	—
Special termination loss	0.5	0.1
Contributions by plan participants	1.0	0.5
Benefits paid	(4.2)	(3.5)
Plan amendments	(8.5)	—
Accumulated postretirement benefit obligation at December 31	\$ 62.5	\$ 57.9

At December 31, 2004 and 2003, the weighted average discount rate assumptions used in developing the benefit obligation were 5.75% and 6.25%, respectively.

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):

	2004	2003
Fair value of plan assets at January 1	\$ —	\$ —
Actual return on plan assets	—	—
Contributions by the employer	3.2	3.0
Contributions by plan participants	1.0	0.5
Benefits paid	(4.2)	(3.5)
Fair value of plan assets at December 31	\$ —	\$ —
Unfunded postretirement benefit obligation	\$ 62.5	\$ 57.9
Unrecognized prior service cost	8.3	4.7
Unrecognized net actuarial gain/(loss)	(17.4)	(7.0)
Accrued postretirement benefit costs	\$ 53.4	\$ 55.6

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs."

Notes to Financial Statements

For measurement purposes, the assumed health care cost trend rates at December 31 are as follows:

	2004	2003
Health care cost trend rate assumed for next year	9.00%	10.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	4.75%	5.00%
Year that the rate reaches the ultimate trend rate	2011	2011

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2004 (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	\$ 0.3	\$ (0.3)
Effect on accumulated postretirement benefit obligation	3.1	(2.6)

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

	2004	2003
Service cost-benefits earned during the period	\$ 1.4	\$ 1.2
Interest cost of accumulated benefit obligation	3.6	3.1
Amortization of prior service cost	(1.4)	(1.2)
Recognized net actuarial (gain)/loss	0.4	—
Total periodic expense	4.0	3.1
Curtailment (gain)/loss	(3.5)	—
Special termination loss	0.5	0.1
Net periodic postretirement benefit costs	\$ 1.0	\$ 3.2

At December 31, 2004 and 2003, the weighted average discount rate assumptions used to determine net periodic postretirement benefit obligation were 6.25 percent and 6.75 percent, respectively.

Net periodic postretirement benefit costs are reported as a component of “Salaries and other benefits.”

A plan amendment that modified the credited service period eligibility requirements created curtailment gains. The recognition of special termination losses is primarily the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10.

Notes to Financial Statements

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the “Act”) was enacted in December 2003. The Act 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. Following the guidance of the Financial Accounting Standards Board, the Bank elected to defer recognition of the financial effects of the Act until further guidance was issued in May 2004.

Benefits provided to certain participants are at least actuarially equivalent to Medicare Part D. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit costs.

Following is a summary of the effects of the expected subsidy (in millions):

	2004	
Decrease in the accumulated postretirement benefit obligation	\$	6.6
Decrease in the net periodic postretirement benefit costs		1.0
Expected benefit payments	Without Subsidy	With Subsidy
2005	\$ 4.1	\$ 4.1
2006	4.2	3.9
2007	4.3	3.9
2008	4.3	3.9
2009	4.4	4.0
2010–2014	22.9	20.5
Total	\$ 44.2	\$ 40.3

Postemployment benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2004 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. For 2004, the Bank changed its practices for estimating postemployment costs and used a 5.25 percent discount rate and the same health care trend rates as were used for projecting postretirement costs. Costs for 2003, however, were estimated using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 2004 and 2003, were \$14 million and \$13 million, respectively. This cost is included as a component of “Accrued benefit costs.” Net periodic postemployment benefit costs included in 2004 and 2003 operating expenses were \$4 million and \$2 million, respectively.

10. Business Restructuring Charges and Asset Impairments

In 2003, the Bank announced consolidation and restructuring plans to streamline operations and reduce costs, including staff reductions in various functions of the Bank. In 2004, additional consolidation and restructuring initiatives were announced in the check operations. These actions resulted in the following business restructuring charges:

Major categories of expense (in millions):

	Total Estimated Costs	Accrued Liability December 31, 2003	Total Charges	Total Paid/ Expensed	Accrued Liability December 31, 2004
Employee separation	\$ 5.5	\$ 1.2	\$ 3.8	\$ 2.5	\$ 2.5
Contract termination	—	—	—	—	—
Asset impairment	13.4	—	13.4	13.4	—
Other	—	—	—	—	—
Total	\$ 18.9	\$ 1.2	\$ 17.2	\$ 15.9	\$ 2.5

Employee separation costs are primarily severance costs related to identify staff reductions of approximately 240 staff, including 74 staff reductions related to restructuring announced in 2003. These costs are reported as a component of “Salaries and other benefits.” Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of “Other expenses.” Asset impairment costs include land, building, furniture, and equipment write-downs, which were determined using fair values based on quoted market values or other valuation techniques. These asset impairment costs are reported as a component of “Other expenses.”

Restructuring costs associated with the write-downs of certain Bank assets, including land, buildings, furniture, and equipment are discussed in footnote 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8. Costs associated with enhanced postretirement benefits are disclosed in footnote 9.

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2005.

The Bank anticipates substantially completing its announced plans by 2005.

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