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Why the partnership between the U.S. Treasury
and the Federal Reserve is good for government, and for you

Federal Reserve Bank of St. Louis | **2004 Annual Report**

"The best way to describe the partnership is a long-term, symbiotic relationship that leverages the strengths of both organizations to focus on a common mission."

Don Hammond
Fiscal Assistant Secretary
U.S. Department of the Treasury

a **message** from the president

William Poole
President and CEO

president's message

Readers of our 2003 annual report will recall our essay detailing a major change in philosophy for the Federal Reserve Bank of St. Louis. We presented a new mission for our branch offices, one focusing more on intellectual leadership and less on operational functions. Last year's report proved that the Federal Reserve System and the St. Louis Fed in particular face the same challenges as many private businesses: run a tighter ship, do more with less and leverage your strengths.

This final point—leveraging strengths in order to bring the greatest possible value to customers—sums up why in this year's report we write about the symbiotic relationship between the Federal Reserve and the U.S. Treasury. Furthermore, we discuss how a key leadership role granted to the Eighth District helps to ensure that the Treasury can continue to count on the Fed as a dependable, dedicated partner.

Our Bank was privileged in 2001 to be chosen as the System's Treasury relationship office, representing all Reserve banks. The assignment means that St. Louis is the central point of contact for all Federal Reserve products, services and objectives relating to the Treasury. The Fed's commitment to the agency breaks down to approximately 1,600 employees nationwide providing more than $400 million worth of services annually.

For many years prior to 2001, the St. Louis Fed was a proud provider of Treasury-related offerings. Thus, upon accepting leadership responsibility, we were supremely confident that the knowledge and experience ingrained within our staff—led by First Vice President LeGrande Rives, Senior Vice President Dave Sapenaro and Vice President Judie Courtney—would be something our Treasury colleagues would find valuable.

president'smessage

Teaming up with the Treasury is nothing new for the Federal Reserve. The role of fiscal agent and depository of the Treasury was officially assigned to the Fed in 1915, shortly after the central bank was created. What *is* new is the type of work the Fed has performed for the Treasury over the past five to 10 years.

In the early years, Reserve banks accepted taxes and customs duties, held deposits for the Treasury, cleared Treasury checks and redeemed Treasury coupons. World Wars I and II witnessed the Fed's involvement in issuing, servicing and redeeming bonds to defray the costs of the conflicts, with U.S. savings bonds continuing as a popular Treasury offering to this day. The relationship between the two organizations continued to evolve over the years, with emerging technologies like the automated clearinghouse network for electronic payments resulting in product and service advancements on a larger scale.

Since the end of the 1990s, however, the pace of change has quickened. The Treasury has expanded efforts to produce more convenient, reliable and secure services that are good for both the federal government and the general public. Whether we're talking about new forms of Internet payment, stored-value cards or government direct payment programs, it's safe to say that the past 10 years have brought more technological change and challenges than the previous 80 years combined.

For the St. Louis Fed, the daily task of managing and coordinating the Reserve banks' many contributions to the Treasury is a momentous challenge unto itself. I invite you to read our 2004 annual report and learn how, in so many ways and with the St. Louis Fed's guidance, the Federal Reserve is committed to helping the Treasury achieve its strategic objectives.

William Poole

William Poole

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WHY THE PARTNERSHIP BETWEEN THE U.S. TREASURY AND THE FEDERAL RESERVE IS GOOD FOR GOVERNMENT, AND FOR YOU

March 2, 2005

On this late winter's day, there is no obvious connection among the four. Nina is an 84-year-old great-grandmother in Denver; Patricia owns a chain of computer-repair shops in New Orleans; Andy is a proud, young father in Jefferson City, Mo.; and Vince is a U.S. Army first lieutenant on duty in Kuwait. As they go about their business today, however, one link does emerge.

Nina had been receiving her Social Security check in the mail at the beginning of every month for nearly 20 years. Then, less than a year ago, as Nina's health began to decline, her grandson convinced her that switching to direct deposit would reduce some stress in her life. This morning, as a foot of freshly fallen snow greets Denverites, she calls her grandson to thank him for his advice. Rather than making the difficult trek to the bank to deposit her check, Nina sits comfortably at home while her money sits safely and securely in her account.

In New Orleans, Patricia is caught in a more desirable blizzard of sorts. Her computer-repair business is booming. She arrives at her office at 6:30 a.m. to prepare for a meeting with her five store managers at 8. On the agenda is the subject of adding to staff to keep up with customer demand. Ten minutes before her managers arrive, Patricia realizes she still has enough time to complete another task on her jam-packed to-do list. Her quarterly federal tax payment is due later in the week. She logs on to the Electronic Federal Tax Payment System (EFTPS) web site, enters her information and sends instructions to have her payment transferred from her bank account on the due date. With seven minutes remaining before the meeting begins, Patricia steps away to refill her coffee cup.

As first-time father Andy enjoys breakfast with his 3-year-old son, Zach, he smiles, seeing how engrossed the boy is playing with his toy cars. It suddenly occurs to Andy that, soon enough, the time will come when Zach will be old

It costs the government 62 cents more per payment to issue a check rather than pay electronically.

enough to do more than merely imagine being behind the wheel. As his dad had done for him, Andy wants to one day help his son pay for his first car. He decides that today is the day to start saving for it by choosing a safe investment with steady growth prospects. Later at work, a colleague recommends a web site to Andy that would enable him to directly purchase U.S. savings bonds and give them to his son when Zach is ready to pick out something he can drive in a lane that's a bit wider than the kitchen table.

Halfway across the globe, Vince has been leading his platoon through relentless training missions for over a month, in preparation for deployment in Iraq. This afternoon, however, he is able to break away and head into town to purchase a hand-woven Kuwaiti dress for his sister, who will turn 40 later in the month. Before he leaves, Vince first stops by the currency exchange office on the base to obtain Kuwaiti currency. Later, he mails the present from the base post office. For both transactions, Vince uses his Army EagleCash stored-value card, which he had preloaded with funds from his bank account several days earlier.

The common thread running through the lives of Nina, Patricia, Andy and Vince is perhaps one that only the U.S. Department of the Treasury and the Federal Reserve can fully appreciate. But appreciate it they do. These two formidable organizations are working in tandem to push innovative, electronic mechanisms for government payments, collections

The Fed's relationship as the Treasury's fiscal agent has taken on extraordinary significance over the past decade.

The Federal Reserve manages an application that offsets debt against payment files, yielding in excess of $20 billion in government delinquent debt to date.

and savings options for the public. The Fed's long-standing relationship as the Treasury's fiscal agent has taken on extraordinary significance over the past decade, as technological advancements in society have increased the likelihood of the Treasury's ultimate goal: 100 percent electronic financial transactions. The electronic payment revolution is resulting in improved efficiencies for the federal government, greater convenience for consumers and cost-savings for both parties.

This annual report examines the critical, but little understood, role that the Fed serves for the Treasury and the central role played by the Federal Reserve Bank of St. Louis in particular.

II. A Few Treasury Notes

Although the Federal Reserve dedicates many resources to support the goals of the U.S. Treasury, there are, in fact, many areas of the agency in which the Fed has no involvement at all.

The Treasury Department consists of 12 bureaus and offices, including familiar names like the Internal Revenue Service, the U.S. Mint, and the Bureau of Engraving and Printing. Although the Fed supports many of these areas in some capacity, this report will focus on the two bureaus the Fed provides extensive services to—the Financial Management Service and the Bureau of the Public Debt. We will also discuss the interactions between one of the Treasury's policy-making bodies—the Office of the Fiscal Assistant Secretary—and the Federal Reserve Bank of St. Louis,

which oversees all of the products and services the Reserve banks provide to these three entities of the Treasury.

Financial Management Service

The function of the Financial Management Service (FMS) is to manage the U.S. government's money. The FMS provides centralized collection, payment and reporting services for the government. Every day, the bureau oversees the cash flow of nearly $58 billion into and out of federal accounts.

The FMS collects more than $2.3 trillion each year for the federal government. These payments include individual and corporate income tax deposits, customs duties, fees for government services, fines and loan repayments. On the other side of the ledger, the bureau disburses more than $1.5 trillion each year to more than 100 million individuals through Social Security payments, veteran's benefits, income tax refunds and other federal payments.

The FMS reports that $1.9 trillion of the $2.3 trillion it collects is paid through electronic transactions, nearly 80 percent. As for payments, electronic-related transactions accounted for more than 75 percent in fiscal year 2004.

The stated goal of the FMS is to move toward an all-electronic Treasury for both collection and payments. As we will detail in the next section, the Fed has partnered with the FMS to implement cutting-edge technology that advances the Treasury closer to that objective. So, how close are we to an all-electronic environment? The FMS reports that $1.9 trillion of the $2.3 trillion it collects is through electronic transactions, nearly 80 percent. As for

Three Federal Reserve sites process 250 million Treasury checks per year.

payments, electronic-related transactions accounted for more than 75 percent in fiscal year 2004.

In addition to managing collections and payments, the FMS maintains the federal government's set of accounts and serves as the repository of information for the government's financial position. As part of this responsibility, the FMS assists federal agencies with adopting uniform accounting and reporting standards and systems. The bureau also assures the continuous exchange of financial information among federal agencies, the executive branch's Office of Management and Budget, and financial institutions.

One other main FMS task worth noting is the collection of delinquent debt. The bureau uses a centralized process to collect delinquent debt owed to the U.S. government (e.g., student, mortgage or small business loans, or fines or penalties assessed by federal agencies), as well as income tax debts owed to states and overdue child support payments owed to custodial parents. Since Congress placed debt collection under a single, central authority, the FMS has collected nearly $21 billion in delinquent debts that otherwise would not have been collected.

Bureau of the Public Debt

The public has been familiar with the products of the Bureau of the Public Debt (BPD) since 1917, when the Treasury directed the Federal Reserve banks to issue Liberty Loan bonds and Victory notes to help the government finance World War I. The BPD, whose primary mission is more narrowly defined than that of the FMS, borrows money needed to

operate the government and accounts for the resulting debt.

Each year, the BPD collects about $2 trillion by selling Treasury bills, notes and bonds either at auctions or directly to customers. That figure is boosted by the sale of savings bonds at 40,000 locations throughout the country. The bureau pays interest to investors and eventually redeems the loan when the item matures.

Office of the Fiscal Assistant Secretary

Overseeing the aforementioned two bureaus is the Office of the Fiscal Assistant Secretary (OFAS). This office develops policy on payments, collections, debt financing operations, electronic commerce, government-wide accounting, government investment fund management and other issues. OFAS also performs two mission-critical functions for the Treasury: managing the daily cash position of the government, and producing the cash and debt forecasts used to determine the size and timing of the government's financing operations.

III. The Federal Reserve—Fiscal Agent of Change

In some ways, the Federal Reserve's relationship with the Treasury is as different as the world in general was 90 years ago. Who during Wilsonian times could have imagined a financial environment that eventually would consist of such complex automation and electronification? And who could have envisioned that the Treasury would depend on the Fed

A Commitment That Is Deeper Than the Costs

Although the Federal Reserve and Treasury have always shared common goals, for more than seven decades their relationship was uncommon in a very important way. The Fed's costs for its services to the Treasury were not explicitly reimbursed from 1917 to 1992, at which point Congress enacted legislation to provide money to reimburse the Fed for its services for the Bureau of the Public Debt. A similar law permitted the Financial Management Service and other federal agencies to begin reimbursing Reserve banks for expenses incurred on their behalf beginning in fiscal year 1998.

Both the Fed and the Treasury support the reimbursement of the Fed's fiscal agent services for two reasons: 1. If the federal government did not include in its budget process to Congress the costs incurred by the Reserve banks on the Treasury's behalf, Congress would have trouble determining the true cost to taxpayers of the agencies' operations; and 2. When services are directly reimbursed, the costs are much more transparent. As a result, the services are less likely to be overused and more likely to be used in an efficient manner.

The Treasury in 2004 reimbursed the Reserve banks $385 million. That figure is expected to rise above $400 million in 2005.

to manage these technologies and play a vital role in maintaining high standards of security, efficiency and reliability?

Today, all Federal Reserve districts provide some kind of business line support for the Treasury. What follows is a summary of some of the main tasks and functions the Fed provides for the FMS, BPD and OFAS.

Products and Services for the Financial Management Service

Collection: When the Treasury launched the Electronic Federal Tax Payment System (EFTPS) in 1995, the Federal Reserve was actively involved, helping the Treasury and the IRS implement and market EFTPS to both depository institutions and taxpayers. EFTPS collects $1.6 trillion in taxes for the government annually. Participating taxpayers can elect to go through financial institutions to send an electronic tax payment (via the automated clearinghouse or Fedwire®), or they can enter instructions directly on a web site for their bank account to be debited on the tax due date. The Federal Reserve processes and settles the tax payments and sends related information to the FMS for cash management reporting.

The Fed is also involved in the Treasury Tax and Loan (TT&L) program. TT&L is a system that enables a financial institution to collect federal tax payments from its customers on behalf of the Treasury. The Treasury also invests excess operating funds through the TT&L system at an administratively set rate. Excess funds are also auctioned and placed at a competitive rate to participating financial institutions through a program called the Term Investment Option (TIO). The funds can provide a financial institution with a ready source of liquidity for investment opportunities. Through TT&L

The Fed's savings bonds operations in 1942 climbed to approximately 4,000 employees, or 20 percent of its work force.

and TIO, the Reserve banks provide the Treasury with a safe and efficient way to manage its funds. The Fed invested $2 trillion of government funds in the TT&L program in 2004 and $309 billion in TIO, resulting in over $177 million in earned interest for the U.S. government.

Another innovative initiative the Fed manages for the Treasury is Pay.gov, an Internet portal that some federal agencies make available to the public for activities such as submitting information via forms and authorizing electronic payments to agencies. Pay.gov is available for a variety of payments, from a camping license fee required by some national parks to businesses that lease government buildings. The Federal Reserve operates the computer application for the web site and manages the vendors that perform technical support. Pay.gov in 2004 processed nearly 306,000 transactions from 73 agencies for approximately $409 million. Since its inception nearly five years ago, Pay.gov has processed slightly over 2 million transactions for approximately $14.2 billion. The Treasury expects the site to increase in popularity as agencies rely on the Internet to process financial transactions.

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Payments: In the effort to convert all of its payments from paper to electronic, the Treasury has found an experienced partner in the Federal Reserve. The Fed has been offering electronic services to commercial banks for decades. After the Air Force built a similar system to pay its service men and women in the mid-1960s, the Fed in the early 1970s was one of the developers of the commercial automated clearinghouse (ACH). The ACH is a nationwide system for electronic transfer of funds now used by almost all financial institutions in the United States. Sending money to someone through the ACH process is also known as direct deposit or electronic deposit.

The Reserve banks' central clearing application for transmitting and receiving ACH payments is called FedACH℠, which is what the Treasury uses to make approximately 81 percent of all Social Security benefit payments, 98 percent of all Treasury disbursed federal salary payments and some one-time payments, such as federal tax refunds. The other Fed system the Treasury uses to make payments is the Fedwire® Funds Service, which provides immediate settlement for large-dollar payments that must be settled on the same day they are originated.

Reserve banks also participate and support other payments services used by federal agencies, including:

- **Grant payments:** The Treasury's Internet-based Automated Standard Application for Payments (ASAP) was developed and is operated by the Reserve banks. ASAP allows individuals and organizations that receive federal grant payments to submit payment requests via the Internet (ASAP.gov) and to later receive the payments electronically. After a request is submitted on ASAP.gov, it is forwarded to a related computer application at a Reserve bank, which reviews the request, compares it with the parameters established by the granting agency and initiates the payment. ASAP initiated nearly $400 billion in payments in 2003.

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The Paper Chase:
Going, Going, but Not Gone

With all of the emphasis on electronic forms of payment, one might think that paper payments have gone the way of the Macarena. Not quite. The Federal Reserve in 2004 processed nearly 229 million Treasury checks with a cumulative dollar value of $277 billion. It costs the government 62 cents more per payment to issue a check rather than pay electronically.

The Fed also processes postal money orders for the U.S. Postal Service. Postal money orders are prepaid drafts drawn against the Postal Service's account with the Treasury. Individuals purchase them with cash and use them as they do checks. The Reserve banks processed 186 million postal money orders in 2003, a decline from 226 million in 1999.

Paper is also dwindling on the collection side. But while only 5 percent of total business and individual tax dollars (or about $76 billion) were paid by check in 2003, that still amounted to more than 11 million checks.

Treasury checks now include sophisticated encryption features that are validated at Reserve banks to enhance fraud-detection efforts.

- **Intra-governmental payments:** About 300 government agencies pay one another using a computer application that electronically transfers information and funds. This service, which the Fed developed at the Treasury's request, reduced the need for paper invoices and agency-to-agency checks.

- **Vendor payments:** The Treasury in 2003 directed the Reserve banks to manage the Internet Payment Platform. In this pilot program, three federal agencies and their commercial vendors used a central web site to exchange purchase orders and invoices and to initiate ACH payments. The Treasury has decided to proceed with a permanent Internet payment program and has asked the Fed for further support.

- **Military stored-value cards:** By mid-2004, approximately 108,000 stored-value cards were issued to U.S. military personnel. The Reserve banks' role is to maintain detailed transaction and accounting records for the Treasury, to maintain card balances, to pay participating merchants via the ACH, and to develop and maintain related computer applications. The Reserve banks also have developed kiosks for several military bases abroad to allow military service personnel to transfer funds from their bank accounts onto their stored-value cards.

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Products and Services for the Bureau of the Public Debt

Like the Financial Management Service, the Bureau of the Public Debt is interested in deploying emerging technologies to achieve its objectives. One example of how the Fed is helping achieve this is through a computer application it developed that makes Treasury auctions run more smoothly. The Treasury sells marketable securities like Treasury bills, notes, bonds and inflation-protected securities to investors through periodic auctions. The application the Fed developed compares all bids submitted in an auction, assists the Treasury in determining the lowest acceptable price offered and then calculates the amount to be awarded to each bidder.

The highly automated process enables the Treasury to announce its auction results to the public electronically, usually within two minutes of the auction's closing. This shortened time frame allows the Treasury and the Reserve banks to decrease the risk to bidders of changes in market conditions that can occur between the close of bidding and the announcement of results. The Reserve banks in 2003 supported 202 auctions and processed bids totaling almost $8.2 trillion.

Another important system that the Fed operates is the Fedwire Securities Service. This service initiates transactions when interest payments are due on securities for the Treasury or other entities (e.g., Fannie Mae or Freddie Mac), as well as in instances when the Treasury redeems, or buys back, securities from current owners and retires the debt. The Fedwire Securities Service is also a safekeeping system for certain book-entry securities, meaning that it consists of an electronic vault that stores records of book-entry securities holdings by account holder. In late 2004, the system held

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The public holds approximately $4.5 trillion of the $7.6 trillion total public debt.

Striving To Make
Pulp Fiction

Most people have begun to accept electronic payments as a fast, convenient and—most important—secure form of payment. But a hardcore segment of the population remains unconvinced.

Seeking answers as to why the paper-loyalists are reluctant to change, the St. Louis Fed, on behalf of the FMS, formally surveyed federal benefit check recipients in 2004. On one hand, it's impressive that 78 percent of federal benefit recipients received their payments electronically via direct deposit in 2003. And while this figure easily beats the 1996 rate of 56 percent, the conversion rate has slowed in recent years to less than 1 percent a year. The 22 percent that the Treasury and the Fed are trying to bring into the fold receive about 170 million checks per year from the government.

In the survey, information from more than 4,000 people who receive federal benefit payments was collected to better understand why some have not signed up for direct deposit.[1] The survey showed that the barriers to direct deposit can be grouped into four general categories:

- Informational – includes those who don't understand how direct deposit works;
- Emotional – includes those who just prefer to receive checks;
- Inertia – includes those who are receptive to electronic payments, but need to be motivated to sign up; and
- Mechanical – includes those who don't have bank accounts and, in some cases, don't want bank accounts.

With baby boomers preparing to retire in droves over the next decade, the Treasury is examining options for increasing direct deposit participation. From September 2004 to March 2005, the St. Louis Fed, on behalf of the Treasury, conducted a pilot marketing program called "Go Direct" in cities in Illinois, Tennessee and Texas, as well as in Puerto Rico. Go Direct used a combination of community outreach, direct mail and various media channels to bring messages about the benefits of direct deposit using trusted sources in the community.

[1]A research report summarizing the survey is available at www.frbservices.org (click on Treasury Services) and www.fms.treas.gov/eft (click on Reports & Statistics).

The Treasury's Perspective

The following is excerpted from a discussion with the three key Treasury officials who work on a regular basis with the Federal Reserve. The St. Louis Fed's Treasury Relations and Support Office (TRSO) oversees the Fed's overall relationship with the Treasury.

Describe the relationship between the Treasury and the Federal Reserve.

DH: The best way to describe the partnership is a long-term, symbiotic relationship that leverages the strengths of both organizations to focus on a common mission.

VZ: I would characterize it as a principal-agent relationship in which the official roles of principal and agent are largely irrelevant because of the Federal Reserve's and Treasury's commitment to work together on Treasury fiscal programs.

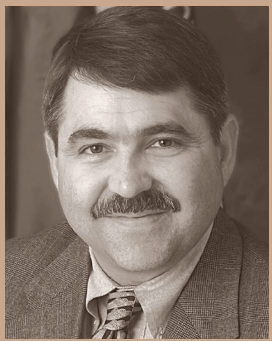
DH: If you talk to people outside the relationship, they can't tell where the Treasury stops and the Federal Reserve begins. It is truly seamless to external people.

DG: I think the current relationship is the best that I've seen in my career. The TRSO has a large part to do with that. In fact, I think it's the biggest single factor. The TRSO brings a business mentality and interest in getting things done while at the same time asking good, difficult questions.

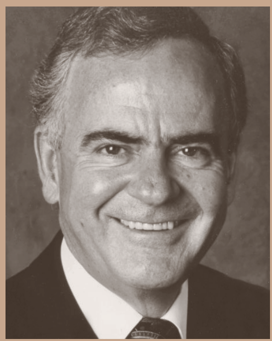
VZ: In addition, the TRSO has added an advocacy component. Within the Federal Reserve System, they have become an advocate and educator about the Treasury's programs. People know what we do. They know that things aren't handled behind the curtain; they're out there on the table.

How does the Treasury decide when it wants the Federal Reserve involved in a function or project?

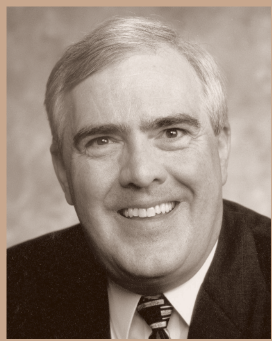
DG: The expertise that the Federal Reserve has in the area of payments is, to me, a natural fit when we look at, for example, modernizing our payments system. We look at



Don Hammond,
Fiscal Assistant Secretary



Dick Gregg,
Financial Management Service Commissioner



Van Zeck,
Bureau of the Public Debt Commissioner

what the Federal Reserve has that can complement the expertise that we have at the Treasury, whether it's in dealing with an issue or developing a new system. We are also looking at whether there is a cultural match, meaning, we look at the Fed's senior leadership and determine if they seem on board with what we are trying to do.

VZ: With the Federal Reserve, there's a certain sense of stability and a comfort level culturally and technologically. This allows us to focus on the best of the best way to get something done, as opposed to being held somewhat captive to other more structured and rigid processes. So, the flexibility of our relationship with the Federal Reserve enables us to concentrate on things that maybe we wouldn't have been even able to get to if we were putting everything out for bid and dealing with a new partner for every project that came along.

DH: I think that is highlighted when you look at things that are not standardized commercial processes. If you look at the work that we have given to the Fed versus our work that is out in the commercial sector, the commercial work is a commodity, meaning we are looking for someone to help us apply a known process. That's a straightforward relationship to manage. We involve the Fed for things that are a little more fluid and innovative.

What is the future of the relationship? Will the growth of electronic payments and issuance of debt instruments necessitate an even deeper relationship? If and when the time comes when 100 percent of transactions are electronic, will the partnership have a new focus and purpose?

DH: I can't imagine a fundamental change in the relationship looking forward from what we have today. Aspects of it will certainly be changed as the environment changes, but the relationship itself is well-positioned to deal with the future.

DG: On that point, when we first talked to the Fed about supporting us on stored-value cards, it was a bit different for all of us. But the more we thought about it, we realized that this is still related to payments and really very much in line with what we've been doing. And that's what will continue to happen: Our missions probably won't change that much, but the nature of how we perform those missions will make for different products.

VZ: Like anyone else, if you can do things at different locations and achieve efficiencies, you try to do that. So, to the extent that we have more opportunities to work more efficiently, I'll expect we'll rise to the challenge. Sometimes it's hard to think what's beyond all-electronic. I don't know that I know. But I think there probably is something beyond all-electronic, and it may have more to do with customer relationships and the speed with which information is available. I think controls and security are going to become increasingly more of interest. The Federal Reserve and the Treasury will continue to innovate and find ways to deliver better services, but do it in a way that both organizations are comfortable with.

Are there times when the Treasury and the Fed differ on strategies and tactics? If so, how are those situations resolved?

DH: Obviously, there are differences. And you would hope for differences, frankly, because everyone brings different perspectives and experiences. If you didn't have differences from time to time, you'd wonder what the nature of the relationship was. From my standpoint, these types of things get resolved professionally and in a business-like manner.

DG: The important thing is that people at the Federal Reserve are willing to provide their perspectives, and that's key. If you don't have that, then what you have is one side feeling constrained from providing the very expertise and insight that we are looking for.

VZ: Hopefully, there's a sense that when we are asking for something or suggesting a direction, there's more to it than just the edict or directive—that there is a willingness to explain to the Fed why we want to do it. That indicates our respect for the relationship.

The Fed's reimbursable services have gone up over the past few years, even as some operations (e.g., TreasuryDirect and savings bonds) have been consolidated. What are the reasons for the increases? Are the Fed's costs expected to level off at some point or keep increasing due to initiatives like software development and new applications?

DG: The reason they've been increasing is that we've been asking the Fed to do more. The development of the TWAI (Treasury Web Application Infrastructure) and the number of very large development initiatives we have under way are expensive. I expect that the costs are going to increase more over the next few years. But I would hope to see them start leveling off in two or three years, and then I would also hope to see them change direction even as we add more work.

VZ: In Public Debt, we're trying to get more focused on tightening our costs, particularly our costs per unit. As we do that, we are making very sure we know where the bureau's costs are coming from and where the Fed's costs are coming from.

Even as electronic payments have taken hold so quickly, are you surprised that there is a hard-core group that remains so difficult to convert? How do you convince these people that electronic forms of payment are easy and secure?

DH: I continue to be ever increasingly surprised in places where I never thought there would be resistance. I saw a study recently that reported that 58 percent of employers in the United States do payroll by hand. When you hear something like this, it gives you an idea of some of the uphill climb we still have in terms of universal acceptance of electronics.

DG: In many respects, from my perspective, consumers have been well ahead of industry and banking. Individuals have been a lot more receptive to innovation. I think there is another 10 percent of the general public out there that we can pretty easily get if we had some kind of semi-hard mandate. But there is also a segment without bank accounts who will continue to get checks until the next generation comes along with people who don't know what a check is.

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$28.5 trillion worth of securities in safekeeping.

Many investors who generally hold their Treasury securities until maturity participate in a Fed-operated system known as *TreasuryDirect*. The Reserve banks issue confirmation notices and account statements to the *TreasuryDirect* account holders and credit interest and principal payments to their account with their depository institutions. *TreasuryDirect* investors can perform their transactions on the Internet or by telephone. As of December 2004, *TreasuryDirect* maintained almost 714,000 accounts, holding a total of $61.7 billion of Treasury securities.

Each year, consumers purchase more than 40 million savings bonds and redeem nearly 5 million.

U.S. savings bonds are a long-standing staple of the Treasury's offerings to the public. As of September 2004, $204 billion in savings bonds—representing 4.7 percent of the federal public debt—was outstanding. Each year, consumers purchase more than 40 million savings bonds and redeem nearly 5 million. While the Fed is not the only outlet for issuing, servicing and redeeming savings bonds, it is a primary provider of this service for the BPD.

Products and Services for the Office of the Fiscal Assistant Secretary

The St. Louis Fed in 1998 helped develop a centralized application called CASH TRACK that provides data to OFAS for use in its daily cash management activities. CASH TRACK collects payment and receipt data from government agencies, financial institutions and Federal Reserve banks and reports the activities to the Treasury. It also tracks historical data, which is used to forecast outlay and receipt activity for cash management and debt management purposes.

IV. St. Louis Steps Up

By now, we've learned that the Federal Reserve's work for the Treasury is vast, varied and voluminous. With Reserve banks across the country performing many unrelated operations, it is essential that one office serve as a centralized headquarters to coordinate and manage all of the work. In 2001, the Federal Reserve Bank of St. Louis' formal proposal to assume this role was approved by the Federal Reserve's governing body for financial services, the Financial Services Policy Committee.

The St. Louis Fed's Treasury Relations and Support Office (TRSO) now has about four years under its belt serving as the liaison between the Fed and the Treasury. The desire to become the Treasury's relationship office was not a fleeting hope. The idea was a Bank strategic objective for several years running before the Fed rotated the office to St. Louis.

Prior to being awarded the office, the St. Louis Fed served as a provider of Treasury services through modernizing the Treasury Tax and Loan function and through implementing CASH TRACK. Today, the St. Louis Fed still employs a large staff whose mission is to support Treasury services such as CASH TRACK, the Treasury Investment Program, tax collections and web development services to agencies for collecting funds and reporting information.

"Our objective was to expand our Bank's role as a key and trusted business partner of the Treasury," said LeGrande Rives, first vice president of the St. Louis Fed and the leader of the bid to obtain the TRSO. "In addition to mentioning our past successes in our proposal, we strongly emphasized the need to identify strategic initiatives and opportunities that benefit both organizations, while ensuring that all Treasury-related Fed initiatives are successfully completed."

The TRSO's responsibilities fall into three major categories: 1. relationship management; 2. strategic consulting; and 3. oversight of Fed initiatives in support of the Treasury's strategic directions.

Relationship Management: As the Treasury's chief advocate within the Federal Reserve System, the TRSO ensures that the Treasury's strategic direction and specific initiatives are understood by all relevant Fed System officials. At the same time, officials identify any System initiatives that may affect the Treasury and incorporate the Treasury's interests into the System's planning, decision-making and scheduling. St. Louis is also the focal point within the Fed System for the resolution of policy and operational issues. To keep the relationship between the Fed and the Treasury strong, the TRSO stays in constant contact with the FMS, BPD and OFAS.

Strategic Consulting: The TRSO consults with the Treasury as a think tank would—immersing itself in information about the Treasury's strategic needs related to fiscal and payment-related activities. If the TRSO identifies any potential gaps between strategic direction and work being pursued by the Treasury and/or the Fed System, it looks to surface ideas for products and services that could fill these gaps. In this capacity, the TRSO also seeks out ways to share expertise and lessons learned between the Treasury and the Federal Reserve banks.

"Our objective was to expand our Bank's role as a key and trusted business partner of the Treasury."

LeGrande Rives

First Vice President

Federal Reserve Bank of St. Louis

Oversight of Fed Initiatives for the Treasury: The TRSO is responsible for the completion—on time and within budget—of all fiscal projects the Fed performs for the Treasury. For payments-related projects that fall under the domain of other Federal Reserve product offices, the TRSO provides oversight primarily by monitoring progress on each project's key interim deadlines, costs and status of outstanding issues. The TRSO hosts a number of regular meetings and conference calls to keep Fed System Treasury groups informed about any updates.

The TRSO is responsible for the completion—on time and within budget—of all fiscal projects the Fed performs for the Treasury.

V. Conclusion: Benefits for All

It is not hyperbole to state that the movement to electronic forms of payment has saved the federal government billions of dollars over the years. Without such staggering amounts saved, the government would look to taxpayers to make up the difference.

Indeed, with the Fed's help, not only is the government saving more money, it is earning additional money on those savings through programs like the Term Investment Option. And the Fed is helping the Treasury collect money that may never have been recovered through systems developed for collecting delinquent debt.

With the Fed's help, not only is the government saving more money, it is earning additional money on those savings.

Individuals are benefiting from the Treasury/Fed partnership as well, thanks to the many innovative methods described in this report. The Treasury and the Federal Reserve continue striving to persuade the remaining holdouts to take advantage of doing business electronically and join people like Nina, Patricia, Andy and Vince—the four hypothetical, though representative, examples described at the beginning of this essay. Whereas some people have made the transition from paper to electronics with great confidence, others have done so with a degree of hesitation and trepidation. But, once converted, nearly everyone has benefited from the convenience, reliability and security that electronic payments and processing offer.

There is no doubt that the electronic payments movement is on a one-way course. In fact, the Fed confirmed that electronic payment transactions in the United States exceeded check payments for the first time in 2003. The number of total electronic payment transactions, including nongovernment transactions, totaled 44.5 billion in 2003, while the number of checks paid totaled 36.7 billion.

With so much momentum on their side and a nearly century-old partnership defined by common objectives, the Treasury and the Federal Reserve will continue to work together to achieve the goals that make sense—and cents—for both the federal government and the public.

President Franklin D. Roosevelt placed the first order for a $500 Series E Savings Bond in a radio broadcast on April 30, 1941.

eighth district **boards** of directors

Thank You
Retiring Board Members

We bid farewell and express our gratitude to those members of the Eighth District boards of directors who retired in 2004. Our appreciation and best wishes go out to the following:

Little Rock
Lawrence A. Davis Jr.
Everett Tucker III

Louisville
David H. Brooks
Maria G. Hampton

Memphis
Gregory M. Duckett
Walter L. Morris Jr.
Tom A. Wright

St. Louis
J. Stephen Barger
Bert Greenwalt
Charles W. Mueller
Bradley W. Small

Federal Advisory Council Member
David W. Kemper

We also extend our deepest sympathies to the family and friends of Thomas W. Smith, Louisville board member, who passed away in 2004.

FEDERAL RESERVE BANK OF ST. LOUIS
LITTLE ROCK BRANCH
STEPHENS BUILDING, 111 CENTER ST., SUITE 1000
LITTLE ROCK, AR 72201

STEPHEN M. ERIXON
Chairman

CEO
Baxter Regional Medical Center
Mountain Home, Ark.

SCOTT T. FORD

President and CEO
ALLTEL Corp.
Little Rock

SONJA YATES HUBBARD

CEO
E-Z Mart Stores Inc.
Texarkana, Texas

little rock board of directors

ROBERT A. YOUNG III

Chairman, President and CEO

Arkansas Best Corp.

Fort Smith, Ark.

DAVID R. ESTES

President and CEO

First State Bank

Lonoke, Ark.

RAYMOND E. SKELTON

Little Rock

SHARON PRIEST

Executive Director

The Downtown Partnership

Little Rock

FEDERAL RESERVE BANK OF ST. LOUIS
LOUISVILLE BRANCH
NATIONAL CITY TOWER, 101 S. FIFTH ST., SUITE 1920
LOUISVILLE, KY 40202

NORMAN E. PFAU JR.

Chairman

President and CEO

Geo. Pfau's Sons Co. Inc.

Jeffersonville, Ind.

CORNELIUS A. MARTIN

President and CEO

Martin Management Group

Bowling Green, Ky.

louisvilleboard of directors

L. CLARK TAYLOR JR.

CEO

Ephraim McDowell Health

Danville, Ky.

MARJORIE Z. SOYUGENC

Executive Director and CEO

Welborn Foundation

Evansville, Ind.

GORDON B. GUESS

Chairman, President and CEO

The Peoples Bank

Marion, Ky.

STEVEN E. TRAGER

Chairman and CEO

Republic Bank & Trust Co.

Louisville

FEDERAL RESERVE BANK OF ST. LOUIS
MEMPHIS BRANCH
200 N. MAIN ST.
MEMPHIS, TN 38103

RUSSELL GWATNEY

Chairman

President

Gwatney Companies

Memphis

MEREDITH B. ALLEN

Vice President, Marketing

Staple Cotton Cooperative Association

Greenwood, Miss.

J. W. GIBSON II

Owner and CEO

Gibson Companies

Memphis

memphis board of directors

LEVON MATHEWS

President

Regions Bank

Memphis

JAMES A. ENGLAND

Chairman, President and CEO

Decatur County Bank

Decaturville, Tenn.

DAVID P. RUMBARGER JR.

President and CEO

Community Development Foundation

Tupelo, Miss.

THOMAS G. MILLER

President

Southern Hardware Co. Inc.

West Helena, Ark.

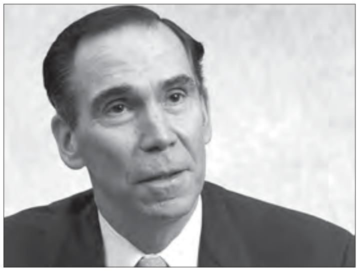
FEDERAL RESERVE BANK OF ST. LOUIS
ONE FEDERAL RESERVE BANK PLAZA
BROADWAY AND LOCUST STREET
ST. LOUIS, MO 63102

WALTER L. METCALFE JR.
Chairman

Partner
Bryan Cave LLP
St. Louis

GAYLE P. W. JACKSON
Deputy Chairman

Managing Director
FondElec Clean Energy Group Inc.
St. Louis



LEWIS F. MALLORY JR.

Chairman and CEO
NBC Capital Corp.
Starkville, Miss.

LUNSFORD W. BRIDGES

President and CEO
Metropolitan National Bank
Little Rock

st.louis board of directors

DAVID R. PIRSEIN

President and CEO

First National Bank in Pinckneyville

Pinckneyville, Ill.

A. ROGERS YARNELL II

President

Yarnell Ice Cream Co. Inc.

Searcy, Ark.

PAUL T. COMBS

President

Baker Implement Co.

Kennett, Mo.

IRL F. ENGELHARDT

Chairman and CEO

Peabody Energy

St. Louis

WILLIAM POOLE
President and CEO

LEGRANDE RIVES
First Vice President

KARL ASHMAN
Senior Vice President

MARY KARR
Senior Vice President

ROBERT RASCHE
Senior Vice President

DAVE SAPENARO
Senior Vice President

JULIE STACKHOUSE
Senior Vice President

amessagefrommanagement

The Federal Reserve Bank of St. Louis enjoys a tradition of excellent performance. That tradition continued in 2004, a year of unprecedented change. Cash and check operations in Little Rock and Louisville were consolidated into the Memphis and Cincinnati branch locations, respectively. Overall, District check net revenue exceeded Bank goals. In fact, the Bank met or exceeded every key objective that it had targeted last year, while finishing below its planned expense budget by $3 million, or 2 percent.

The Branching Out initiative took root in 2004 as the District began looking at new ways to meet community needs in our branch cities by concentrating more attention on programs related to community affairs, economic education, regional research and monetary policy.

Our employees continued to focus on four Bank-wide initiatives: risk management, customer service, staff development and employee communications. The Bank began these initiatives in 1999-2000 to improve performance and increase our System leadership responsibilities. Improvement in these areas is continuing.

What follows are highlights of the Bank's 2004 accomplishments:

Financial Services

- Exceeded the local check net revenue commitment of $10.4 million by $1.4 million.
- Outperformed cash high-speed processing productivity target of 75 bundles per hour and unit costs of $5.65 for high-speed processing and $2.75 for paying and receiving.
- Completed the pre-implementation phase of Check 21.
- Established outsourced cash depots in Little Rock and Memphis.

U.S. Treasury Support

- Completed 11 of 13 high-priority Treasury objectives.
- Initiated a pilot marketing program to convert paper beneficiary payments to electronic payments.
- Enhanced the Treasury Web Application Infrastructure (TWAI) and shifted 16 web applications to the infrastructure.
- Expanded the Financial Management Service's electronic payments and collection programs.

Public Affairs and Community Affairs

- Co-sponsored an international urban planning conference in Louisville.

- Launched a community development speaker series in Little Rock.
- Co-sponsored a money and banking summer course for educators.
- Co-sponsored an education conference for Mississippi teachers.
- Revamped the format for District Dialogue programs with bankers and other business and community leaders.

Research/Monetary Policy Performance

- Staff economists completed 34 working papers, published 16 articles in the Bank's *Review* and spoke at an average of six public events per month.
- Established the Business and Economics Research Group (BERG) in the Eighth District.
- Implemented the Federal Reserve Archival System for Economic Research (FRASER).
- With 27.9 million hits, Federal Reserve Economic Data (FRED) web traffic nearly doubled in 2004.

Banking Supervision, Credit and Center for Online Learning

- Met all examination and inspection mandates.
- Opened a satellite supervision office in Memphis.
- Provided internal e-learning consulting and development services for the Federal Reserve System, and developed a course for bank directors.
- Chaired the Desktop Services Business Steering Group and the Subcommittee on Credit, Reserves and Risk Management Systems Task Force.

Administrative Services

- Completed capital improvement projects, including: opening a new remote screening facility and renovating a parking garage. Began construction of a pedestrian plaza and screening vestibule.
- Opened a new District business continuity recovery facility in December. Added a secure area for check deliveries and a new screening vestibule in Memphis.

Organizational Initiatives

- Continued rolling out Enterprise Risk Management (ERM) to all financial reporting areas in 2004, including an online Risk Awareness Training program.
- Administered the third Bank-wide communications survey since 1999. The results showed steady improvement in the internal communications environment.
- Continued the Customer Service Awareness program, which includes goals for key operations.
- Expanded the Bank's Staff Development program to include a leadership series.

financial statements

For the years ended December 31, 2004 and 2003

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.

To the Board of Directors:

March 10, 2005

The management of the Federal Reserve Bank of St. Louis ("the Bank") 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 the 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 Bank 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 Bank 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 (COSO). Based on this assessment, we believe that the Bank 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 St. Louis

William Poole

WILLIAM POOLE,
President and Chief Executive Officer

William J Rives

W. LEGRANDE RIVES,
First Vice President and Chief Operating Officer

Marilyn K. Corona

MARILYN K. CORONA,
Vice President, Chief Financial Officer

To the Board of Directors of the Federal Reserve Bank of St. Louis:

We have examined management's assertion, included in the accompanying Management Assertion, that the Federal Reserve Bank of St. Louis ("FRB St. Louis") 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. FRB St. Louis' 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 FRB St. Louis 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 FRB St. Louis, 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.

PricewaterhouseCoopers LLP

MARCH 16, 2005

To the Board of Governors of The Federal Reserve System and the Board of Directors of The Federal Reserve Bank of St. Louis:

We have audited the accompanying statements of condition of the Federal Reserve Bank of St. Louis (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 these 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 described in Note 3, these financial statements were prepared in conformity with the accounting principles, policies and practices established by the Board of Governors of the Federal Reserve System. These principles, policies and practices, which were designed to meet the specialized accounting and reporting needs of the Federal Reserve System, are set forth in the Financial Accounting Manual for Federal Reserve Banks 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, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

MARCH 16, 2005

STATEMENTS OF CONDITION

(in millions)

	AS OF DECEMBER 31, 2004	2003
ASSETS		
Gold certificates	$ 325	$ 331
Special drawing rights certificates	71	71
Coin	36	53
Items in process of collection	348	341
Loans to depository institutions	2	-
U.S. government securities, net	21,317	21,254
Investments denominated in foreign currencies	551	472
Accrued interest receivable	149	159
Interdistrict settlement account	1,401	-
Bank premises and equipment, net	85	67
Other assets	41	31
TOTAL ASSETS	$ 24,326	$ 22,779
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve Notes outstanding, net	$ 22,187	$ 19,283
Securities sold under agreements to repurchase	904	807
Deposits:		
Depository institutions	479	509
Other deposits	3	3
Deferred credit items	197	308
Interest on Federal Reserve notes due U.S. Treasury	21	13
Interdistrict settlement account	-	1,330
Accrued benefit costs	54	59
Other liabilities	9	11
TOTAL LIABILITIES	23,854	22,323
Capital:		
Capital paid-in	236	228
Surplus	236	228
TOTAL CAPITAL	472	456
TOTAL LIABILITIES AND CAPITAL	$ 24,326	$ 22,779

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

FEDERAL RESERVE BANK OF ST. LOUIS

STATEMENTS OF INCOME

(in millions)

	AS OF DECEMBER 31, 2004	2003
Interest income:		
Interest on U.S. government securities	$ 657	$ 727
Interest on investments denominated in foreign currencies	7	6
TOTAL INTEREST INCOME	664	733
Interest expense:		
Interest expense on securities sold under agreements to repurchase	9	7
Net interest income	655	726
Other operating income:		
Income from services	40	44
Reimbursable services to government agencies	91	60
Foreign currency gains, net	31	64
Other income	2	2
TOTAL OTHER OPERATING INCOME	164	170
Operating expenses:		
Salaries and other benefits	82	94
Occupancy expense	9	9
Equipment expense	9	8
Assessments by Board of Governors	23	24
Other expenses	86	66
TOTAL OPERATING EXPENSES	209	201
Net income prior to distribution	$ 610	$ 695
Distribution of net income:		
Dividends paid to member banks	$ 13	$ 13
Transferred to surplus	8	29
Payments to U.S. Treasury as interest on Federal Reserve notes	589	653
TOTAL DISTRIBUTION	$ 610	$ 695

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

FEDERAL RESERVE BANK OF ST. LOUIS

STATEMENTS OF CHANGES IN CAPITAL

for the years ended December 31, 2004, and December 31, 2003

(in millions)

	CAPITAL PAID-IN	SURPLUS	TOTAL CAPITAL
Balance at January 1, 2003			
(4.0 million shares)	$ 199	$ 199	$ 398
Transferred to surplus		29	29
Net change in capital stock issued			
(0.6 million shares)	29		29
Balance at December 31, 2003			
(4.6 million shares)	$ 228	$ 228	$ 456
Transferred to surplus		8	8
Net change in capital stock issued			
(0.1 million shares)	8		8
Balance at December 31, 2004			
(4.7 million shares)	$ 236	$ 236	$ 472

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

NOTE 1

STRUCTURE

The Federal Reserve Bank of St. Louis ("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 Little Rock, Louisville and Memphis serve the Eighth Federal Reserve District, which includes Arkansas, and portions of Illinois, Indiana, Kentucky, Mississippi, Missouri and Tennessee. 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.

NOTE 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.

NOTE 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 for the System by the Bank, for which the costs will not be redistributed to the other Reserve Banks, include operation of the Treasury Relations and Support Office and the Treasury Relations and Systems Support Department, which provide services to the U.S. Treasury. These services include: relationship management, strategic consulting, and oversight for fiscal and payments related projects for the Federal Reserve System; and operational support for the Treasury's tax collection, cash management and collateral monitoring.

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. Unique accounts and significant accounting policies are explained below.

A. 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.

B. 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, 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.

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

D. 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 interestbearing instruments.

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 $1.9 million was allocated to the Bank. The effect of this change was not material; therefore, it was included in the 2003 interest income.

E. 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 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.

F. 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."

G. 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 $2,819 million, and $3,961 million at December 31, 2004 and 2003, respectively.

H. 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 (FASB) 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.

I. 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 the 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."

J. 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.

K. 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 $477 thousand and $420 thousand for the years ended December 31, 2004 and 2003, respectively, and are reported as a component of "Occupancy expense."

L. 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.

NOTE 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 2.938 percent and 3.146 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
PAR VALUE:		
U.S. government:		
Bills	$ 7,726	$ 7,703
Notes	10,601	10,173
Bonds	2,762	3,098
TOTAL PAR VALUE	21,089	20,974
Unamortized premiums	276	308
Unaccreted discounts	(48)	(28)
TOTAL ALLOCATED TO BANK	**$ 21,317**	**$ 21,254**

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 Agreements to Repurchase (Contract amount)
Within 15 days	$ 900	$ 904
16 days to 90 days	5,240	-
91 days to 1 year	5,007	-
Over 1 year to 5 years	6,119	-
Over 5 years to 10 years	1,597	-
Over 10 years	2,226	-
TOTAL	**$ 21,089**	**$ 904**

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 $194 million and $139 million were allocated to the Bank.

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 $904 million and $807 million, respectively, of the contract amount and $905 million and $807 million, respectively, of the par value.

NOTE 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 2.580 percent and 2.375 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
European Union Euro:		
Foreign currency deposits	$ 156	$ 163
Securities purchased under agreements to resell	55	49
Government debt instruments	99	48
Japanese Yen:		
Foreign currency deposits	40	35
Government debt instruments	198	175
Accrued interest	3	2
TOTAL	**$ 551**	**$ 472**

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

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	$ 232	$ 237	**$ 469**
Over 1 year to 5 years	77	-	**77**
Over 5 years to 10 years	5	-	**5**
Over 10 years	-	-	**-**
TOTAL	**$ 314**	**$ 237**	**$ 551**

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.

NOTE 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
Bank premises and equipment:			
Land	N/A	$ 8	$ 7
Buildings	50	66	49
Building machinery and equipment	20	20	17
Construction in progress	N/A	10	7
Furniture and equipment	10	48	54
Subtotal		$ 152	$ 134
Accumulated depreciation		(67)	(67)
BANK PREMISES AND EQUIPMENT, NET		**$ 85**	**$ 67**
DEPRECIATION EXPENSE, FOR THE YEARS ENDED		**$ 8**	**$ 8**

The Bank leases unused space to outside tenants. This lease has a term of less than one year.

The Bank has capitalized software assets, net of amortization, of $5 million and $2 million at December 31, 2004 and 2003, respectively. Amortization expense was $1 million for each of the years ended December 31, 2004 and 2003, respectively.

Assets impaired as a result of the Bank's restructuring plan, as discussed in footnote 10, include building, furniture and equipment. Asset impairment losses of $7 million for the period ending December 31, 2003, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

Subsequent to December 31, 2004, the facilities in Louisville and Little Rock were vacated on January 18, 2005, and February 22, 2005, respectively, as a result of the Bank's restructuring plan. The facility in Louisville, including associated furnishings, was sold for $4 million on January 31, 2005, and the facility in Little Rock is available for sale.

NOTE 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 five 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 $1 million for each of 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 thousands):

	OPERATING
2005	$ 910
2006	884
2007	461
2008	359
2009	349
Thereafter	15
	$ 2,978

At December 31, 2004, other commitments and long-term obligations in excess of one year were immaterial.

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.

NOTE 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 $3 million for each of the years ended December 31, 2004 and 2003, respectively, and are reported as a component of "Salaries and other benefits."

NOTE 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	$ 58.5	$ 45.8
Service cost-benefits earned during the period	1.1	1.2
Interest cost of accumulated benefit obligation	3.1	3.4
Actuarial (gain)/loss	(2.2)	13.5
Curtailment gain	-	(3.3)
Special termination loss	0.1	0.1
Contributions by plan participants	0.2	0.2
Benefits paid	(2.7)	(2.4)
Plan amendments	(2.5)	-
ACCUMULATED POSTRETIREMENT BENEFIT OBLIGATION AT DECEMBER 31	**$ 55.6**	**$ 58.5**

At December 31, 2004 and 2003, the weighted average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 6.25 percent, 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	$ -	$ -
Contributions by the employer	2.5	2.2
Contributions by plan participants	0.2	0.2
Benefits paid	(2.7)	(2.4)
FAIR VALUE OF PLAN ASSETS AT DECEMBER 31	**$ -**	**$ -**
Unfunded postretirement benefit obligation	$ 55.6	$ 58.5
Unrecognized net curtailment gain	-	1.4
Unrecognized prior service cost	3.8	6.8
Unrecognized net actuarial loss	(11.2)	(13.4)
ACCRUED POSTRETIREMENT BENEFIT COSTS	**$ 48.2**	**$ 53.3**

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

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	7.9	(6.4)

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	$ 1.1	$ 1.2
Interest cost of accumulated benefit obligation	3.1	3.4
Amortization of prior service cost	(0.7)	(0.8)
Recognized net actuarial loss	0.1	0.3
Total periodic expense	$ 3.6	$ 4.1
Curtailment gain	(6.3)	-
Special termination loss	0.1	0.1
NET PERIODIC POSTRETIREMENT BENEFIT COSTS	**$ (2.6)**	**$ 4.2**

At December 31, 2004 and 2003, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs 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. The curtailment gain associated with restructuring programs announced in 2003 was recognized when employees left the Bank in 2004.

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	$ 7.7
Decrease in the net periodic postretirement benefit costs	$ 1.0

Expected benefit payments:

	WITHOUT SUBSIDY	WITH SUBSIDY
2005	$ 2.5	$ 2.5
2006	2.6	2.4
2007	2.8	2.5
2008	2.9	2.6
2009	3.1	2.7
2010-2014	17.7	15.6
TOTAL	**$ 31.6**	**$ 28.3**

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 projected 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 $6 million for each year. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2004 and 2003, operating expenses were $1 million for each year.

NOTE 10

BUSINESS RESTRUCTURING CHARGES

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

Major categories of expense (in millions):

	TOTAL ESTIMATED COSTS	ACCRUED LIABILITY 12/31/03	TOTAL CHARGES	TOTAL PAID	ACCRUED LIABILITY 12/31/04
Employee separation	$ 4.1	$ 5.0	$ (1.0)	$ (3.0)	$ 1.0
Contract termination	-	-	-	-	-
Other	.4	-	.3	(0.3)	-
TOTAL	**$ 4.5**	**$ 5.0**	**$ (0.7)**	**$ (3.3)**	**$ 1.0**

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 175, including 168 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."

Restructuring costs associated with the write-downs of certain Bank assets, including software, buildings, leasehold improvements, 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 March 31, 2005.

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Summary of Key Operation Statistics for Services Provided to Depository Institutions and the U.S. Treasury (The following schedule is unaudited and has been included as supplemental information.)

	NUMBER OF ITEMS		DOLLAR AMOUNT (MILLIONS)	
	2004	2003	2004	2003
Government Checks Processed	73,682,000	78,374,000	89,608	89,051
Postal Money Order Processed	186,918,000	198,320,000	33,973	29,197
Commercial Checks Processed	951,391,000	1,131,023,000	677,151	745,449
Currency Processed	1,098,465,000	1,182,079,000	20,962	19,963
Loans to Depository Institutions	240	200	352	411
Food Coupons Destroyed	1,281,000	30,798,000	4	156

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The Federal Reserve Bank of St. Louis is one of 12 regional Reserve banks, which, together with the Board of Governors, make up the nation's central bank. The Fed carries out U.S. monetary policy, regulates certain depository institutions, provides wholesale-priced services to banks and acts as fiscal agent for the U.S. Treasury. The St. Louis Fed serves the Eighth Federal Reserve District, which includes all of Arkansas, eastern Missouri, southern Indiana, southern Illinois, western Kentucky, western Tennessee and northern Mississippi. Branch offices are located in Little Rock, Louisville and Memphis.

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