

---

# Financial Statements

**Report of Independent Auditors**  
PricewaterhouseCoopers LLP

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

We have completed an integrated audit of the Federal Reserve Bank of New York's 2006 financial statements, and of its internal control over financial reporting as of December 31, 2006 and an audit of its 2005 financial statements in accordance with the generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

**Financial Statements**

We have audited the accompanying statements of condition of the Federal Reserve Bank of New York (the "Bank") as of December 31, 2006 and 2005, 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 generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our 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*, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2006 and 2005, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

## Internal Control over Financial Reporting

Also, in our opinion, management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that the Bank maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Bank maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the COSO. The Bank's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Bank's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

**PRICEWATERHOUSECOOPERS LLP**

March 12, 2007  
New York, New York

**STATEMENTS OF CONDITION**  
as of December 31, 2006, and December 31, 2005  
(in millions)

ASSETS	2006	2005
Gold certificates	\$ 4,139	\$ 4,357
Special drawing rights certificates	874	874
Coin	47	47
Items in process of collection	70	625
Securities purchased under agreements to resell	40,750	46,750
U.S. government securities, net	290,039	297,481
Investments denominated in foreign currencies	5,707	5,514
Accrued interest receivable	2,528	2,353
Bank premises and equipment, net	259	255
Federal Reserve System prepaid pension benefit costs	1,183	2,728
Other assets	117	107
<b>Total assets</b>	<b>\$345,713</b>	<b>\$361,091</b>
<b>LIABILITIES AND CAPITAL</b>		
<b>Liabilities:</b>		
Federal Reserve notes outstanding, net	\$285,126	\$283,673
Securities sold under agreements to repurchase	10,961	12,096
<b>Deposits:</b>		
Depository institutions	6,609	6,389
U.S. Treasury, general account	4,708	4,573
Other deposits	240	206
Deferred credit items	111	797
Interest on Federal Reserve notes due to U.S. Treasury	650	362
Interdistrict settlement account	29,471	45,332
Accrued benefit costs	285	200
Other liabilities	98	93
<b>Total liabilities</b>	<b>338,259</b>	<b>353,721</b>
<b>Capital:</b>		
Capital paid-in	3,727	3,685
Surplus (including accumulated other comprehensive loss of \$1,567 million at December 31, 2006)	3,727	3,685
<b>Total capital</b>	<b>7,454</b>	<b>7,370</b>
<b>Total liabilities and capital</b>	<b>\$345,713</b>	<b>\$361,091</b>

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

## STATEMENTS OF INCOME

for the years ended December 31, 2006, and December 31, 2005  
(in millions)

	<u>2006</u>	<u>2005</u>
<b>Interest income:</b>		
Interest on U.S. government securities	\$13,280	\$11,402
Interest on securities purchased under agreements to resell	1,240	848
Interest on investments denominated in foreign currencies	103	81
Interest on loans to depository institutions	2	1
<b>Total interest income</b>	<b><u>14,625</u></b>	<b><u>12,332</u></b>
<b>Interest expense:</b>		
Interest expense on securities sold under agreements to repurchase	505	327
<b>Net interest income</b>	<b><u>14,120</u></b>	<b><u>12,005</u></b>
<b>Other operating income (loss):</b>		
Income from services	66	66
Compensation received for services provided	37	43
Reimbursable services to government agencies	85	73
Foreign currency gains (losses), net	331	(767)
Other income	64	60
<b>Total other operating income (loss)</b>	<b><u>583</u></b>	<b><u>(525)</u></b>
<b>Operating expenses:</b>		
Salaries and other benefits	363	343
Occupancy expense	53	45
Equipment expense	25	23
Compensation paid for services costs incurred	29	—
Assessments by the Board of Governors	188	179
Other expenses	180	161
<b>Total operating expenses</b>	<b><u>838</u></b>	<b><u>751</u></b>
Net income before net periodic pension expense	13,865	10,729
Net periodic pension expense (credit)	57	(10)
<b>Net income prior to distribution</b>	<b><u>\$13,808</u></b>	<b><u>\$10,739</u></b>
<b>Distribution of net income:</b>		
Dividends paid to member banks	221	215
Transferred to surplus	1,609	255
Payments to U.S. Treasury as interest on Federal Reserve notes	11,978	10,269
<b>Total distribution</b>	<b><u>\$13,808</u></b>	<b><u>\$10,739</u></b>

**STATEMENTS OF CHANGES IN CAPITAL**  
for the years ended December 31, 2006, and December 31, 2005  
(in millions)

	Capital Paid-In	Surplus			Total Capital
		Net Income Retained	Accumulated Other Comprehensive Loss	Total Surplus	
<b>Balance at January 1, 2005</b> (68.6 million shares)	\$3,430	\$3,430	\$ —	\$3,430	\$6,860
Net change in capital stock issued (5.1 million shares)	255	—	—	—	255
Transferred to surplus	—	255	—	255	255
<b>Balance at December 31, 2005</b> (73.7 million shares)	\$3,685	\$3,685	\$ —	\$3,685	\$7,370
Net change in capital stock issued (0.8 million shares)	42	—	—	—	42
Transferred to surplus	—	1,609	—	1,609	1,609
Adjustment to initially apply FASB Statement No. 158	—	—	(1,567)	(1,567)	(1,567)
<b>Balance at December 31, 2006</b> (74.5 million shares)	<u>\$3,727</u>	<u>\$5,294</u>	<u>\$(1,567)</u>	<u>\$3,727</u>	<u>\$7,454</u>

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

# FEDERAL RESERVE BANK OF NEW YORK

## *Notes to Financial Statements*

### 1. STRUCTURE

The Federal Reserve Bank of New York (“Bank”) is part of the Federal Reserve System (“System”) and one of the twelve Reserve Banks (“Reserve Banks”) created by Congress under the Federal Reserve Act of 1913 (“Federal Reserve Act”), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branch in Buffalo serve the Second Federal Reserve District, which includes the state of New York; the twelve northern counties of New Jersey; Fairfield County, Connecticut; the Commonwealth of Puerto Rico; and the U.S. Virgin Islands.

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

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

## 2. OPERATIONS AND SERVICES

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

The FOMC, in the conduct of monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and annually issues authorizations and directives to the Bank for its execution of transactions. The Bank is authorized and directed by the FOMC to conduct operations in domestic markets, including the direct purchase and sale of U.S. government securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The Bank executes these open market transactions at the direction of the FOMC and holds the resulting securities, with the exception of securities purchased under agreements to resell, 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 Bank to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System’s central bank responsibilities. The Bank is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange (“FX”) and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The Bank is authorized and directed by the FOMC to maintain reciprocal currency arrangements (“FX swaps”) with two central banks and “warehouse” foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (“ESF”) through the Reserve Banks. In connection with its foreign currency activities, the Bank may enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The Bank controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

Although the Reserve Banks are separate legal entities, in the interests of greater efficiency and effectiveness they collaborate in the delivery of certain operations and services. The collaboration takes the form of centralized operations and product or service offices that have responsibility for the delivery of certain services on behalf of the Reserve Banks. Various operational and management models are used and are supported by service agreements between the Reserve Bank providing the service and the other eleven Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, the Reserve Banks are billed for services provided to them by another Reserve Bank.

Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include the management of the SOMA, Wholesale Payments Product Office, application development work and centralized business administration functions for wholesale payments services, and two national information technology competency centers dealing with incident response and remote access.

During 2005, the Federal Reserve Bank of Atlanta (“FRBA”) was assigned the overall responsibility for managing the Reserve Banks’ provision of check services to depository institutions, and, as a result, recognizes total System check revenue on its Statements of Income. Because the other eleven Reserve Banks incur costs to provide check services, a policy was adopted by the Reserve Banks in 2005 that required that the FRBA compensate the other Reserve Banks for costs incurred to provide check services. In 2006, this policy was extended to the ACH services, which are managed by the FRBA, as well as to Fedwire funds transfer and securities transfer services, which are managed by the Bank. The FRBA and the Bank compensate the other Reserve Banks for the costs incurred to provide these services. Compensation paid by the Bank for Fedwire funds transfer and securities transfer services is reported as a component of “Compensation paid for services costs incurred” in the Statements of Income, and the Bank would have reported \$38 million as compensation paid had this policy been in place in 2005 for Fedwire funds transfer and securities transfer services. Compensation received by the Bank for costs incurred in providing check and ACH services is reported by the Bank as a component of “Compensation received for services provided” in the Statements of Income, and the Bank would have reported \$44 million as compensation received had this policy been in place in 2005 for ACH services.

### 3. SIGNIFICANT ACCOUNTING POLICIES

Accounting principles for entities with the unique powers and responsibilities of the nation’s central bank have not been formulated by accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and

practices that it considers to be appropriate for the nature and function of a central bank, which differ significantly from those of the private sector. These accounting principles and practices are documented in the “Financial Accounting Manual for Federal Reserve Banks” (“Financial Accounting Manual”), which is issued by the Board of Governors. All of the Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual and the financial statements have been prepared in accordance with the Financial Accounting Manual.

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

In addition, the Bank has elected not to present a Statement of Cash Flows because the liquidity and cash position of the Bank are not a primary concern given the Bank’s unique powers and responsibilities. A Statement of Cash Flows, therefore, would not provide any additional meaningful information. Other information regarding the Bank’s activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

The preparation of the financial statements in conformity with the Financial Accounting Manual requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of con-

tingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

a. **Gold and Special Drawing Rights Certificates**

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

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

SDR certificates are issued by the International Monetary Fund (“Fund”) to its members in proportion to each member’s quota in the Fund at the time of issuance. SDR certificates serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks’ SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon each Reserve Bank’s Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2006 or 2005.

#### b. Loans to Depository Institutions

Depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Bank. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Outstanding loans are evaluated for collectibility. 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 and determination by the Board of Governors. There were no outstanding loans to depository institutions at December 31, 2006 and 2005.

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

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

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

#### d. Securities Purchased under Agreements to Resell, Securities Sold under Agreements to Repurchase, and Securities Lending

The Bank may engage in tri-party purchases of securities under agreements to resell (“tri-party agreements”). Tri-party agreements are conducted with two commercial custodial banks that manage the clearing and settlement of collateral. Collateral is held in excess of the contract amount. Acceptable collateral under tri-party agreements primarily includes U.S. government securities; pass-through mortgage securities of the Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association; STRIP securities

of the U.S. government; and “stripped” securities of other government agencies. The tri-party agreements are accounted for as financing transactions, with the associated interest income accrued over the life of the agreement.

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

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

Activity related to securities sold under agreements to repurchase and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from the annual settlement of interdistrict clearings. Securities purchased under agreements to resell are allocated to the Bank and not allocated to the other Reserve Banks.

#### e. FX Swap Arrangements and Warehousing Agreements

FX swap arrangements are contractual agreements between two parties, the Bank and an authorized foreign central bank, to exchange specified currencies, at a specified price, on a specified date. 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 the foreign currencies it may need to intervene to support the dollar and give the authorized foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the FX swap arrangements can be initiated by either party acting as drawer, and must be agreed to by the drawee party. The FX swap arrangements are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. The Bank will generally invest the foreign currency received under an FX swap arrangement in interest-bearing instruments.

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

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

#### f. Bank Premises, Equipment, and Software

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

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

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

#### g. Interdistrict Settlement Account

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

#### h. Federal Reserve Notes

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

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

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

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

“Federal Reserve notes outstanding, net” in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the currency issued to the Bank but not in circulation, of \$56,821 million and \$43,521 million at December 31, 2006 and 2005, respectively.

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

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

#### j. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. These shares are nonvoting with a par value of \$100 and may not be transferred or hypothecated. As a member bank's capital and surplus

changes, its holdings of Reserve Bank stock must be adjusted. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. By law, each Reserve Bank is required to pay each member bank an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

#### k. Surplus

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

Accumulated other comprehensive income is reported as a component of surplus in the Statements of Condition and the Statements of Changes in Capital. The balance of accumulated other comprehensive income is comprised of expenses, gains, and losses related to defined benefit pension plans and other postretirement benefit plans that, under accounting principles, are included in comprehensive income but excluded from net income. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 8, 9, and 10.

#### l. Interest on Federal Reserve Notes

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

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

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

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

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

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

The Board of Governors assesses the Reserve Banks to fund its operations based on each Reserve Bank's capital and surplus balances as of December 31 of the previous year. The Board of Governors also assesses each Reserve Bank for the expenses incurred for the U.S. Treasury to issue and retire Federal Reserve notes based on each Reserve Bank's share of the number of notes comprising the System's net liability for Federal Reserve notes on December 31 of the previous year.

o. **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 \$5 million for each of the years ended December 31, 2006 and 2005, and are reported as a component of "Occupancy expense." In 2005, the Bank received a \$2.7 million real estate credit related to prior period taxes for leased property that the Bank no longer occupies.

p. **Restructuring Charges**

In 2003, the Reserve Banks began the restructuring of several operations, primarily check, cash, and U.S. Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in some locations. These restructuring activities continued in 2004 through 2006.

Note 11 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 impairment of certain of the Bank's assets are discussed in Note 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the Bank. Costs and liabilities associated with enhanced postretirement benefits are discussed in Note 9.

q. **Implementation of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans**

The Bank initially applied the provisions of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Statements of Condition, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard require applying the provisions as of the end of

the year of initial implementation with no retrospective application. The incremental effects on the line items in the Statement of Condition at December 31, 2006, were as follows (in millions):

	Before Application of Statement 158	Adjustments	After Application of Statement 158
Federal Reserve System prepaid pension benefit costs	\$ 2,675	\$ (1,492)	\$ 1,183
<b>Total assets</b>	<b>\$347,205</b>	<b>\$ (1,492)</b>	<b>\$345,713</b>
Accrued benefit costs	210	75	285
<b>Total liabilities</b>	<b>\$338,184</b>	<b>\$ 75</b>	<b>\$338,259</b>
Surplus	5,294	(1,567)	3,727
<b>Total capital</b>	<b>\$ 9,021</b>	<b>\$ (1,567)</b>	<b>\$ 7,454</b>

#### 4. U.S. GOVERNMENT SECURITIES, SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL, SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE, AND SECURITIES LENDING

The Bank, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 37.013 percent and 39.653 percent at December 31, 2006 and 2005, respectively.

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

	2006	2005
Par value:		
U.S. government:		
Bills	\$102,532	\$107,568
Notes	148,927	150,730
Bonds	36,838	36,809
<b>Total par value</b>	<b>288,297</b>	<b>295,107</b>
Unamortized premiums	3,224	3,494
Unaccreted discounts	(1,482)	(1,120)
<b>Total allocated to the Bank</b>	<b>\$290,039</b>	<b>\$297,481</b>

At December 31, 2006 and 2005, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was \$294,584 million and \$304,329 million, respectively, as determined by reference to quoted prices for identical securities.

The total of the U.S. government securities, net, held in the SOMA was \$783,619 million and \$750,202 million at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, the fair value of the U.S. government securities held in the SOMA, excluding accrued interest, was \$795,900 million and \$767,472 million, respectively, as determined by reference to quoted prices for identical securities.

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

At December 31, 2006 and 2005, the total contract amount of securities sold under agreements to repurchase was \$29,615 million and \$30,505 million, respectively, of which \$10,961 million and \$12,096 million were allocated to the Bank. The total par value of the SOMA securities that were pledged for securities sold under agreements to repurchase at December 31, 2006 and 2005 was \$29,676 million and \$30,559 million, respectively, of which \$10,984 million and \$12,118 million was allocated to the Bank. The contract amounts for securities purchased under agreements to resell and securities sold under agreements to repurchase approximate fair value.

The maturity distribution of U.S. government securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase, that were allocated to the Bank at December 31, 2006, was as follows (in millions):

	U.S. Government Securities (Par Value)	Securities Purchased under Agreements to Resell (Contract Amount)	Securities Sold under Agreements to Repurchase (Contract Amount)
Within 15 days	\$ 15,023	\$40,750	\$10,961
16 days to 90 days	66,953	—	—
91 days to 1 year	68,522	—	—
Over 1 year to 5 years	82,974	—	—
Over 5 years to 10 years	25,037	—	—
Over 10 years	29,788	—	—
<b>Total allocated to the Bank</b>	<b><u>\$288,297</u></b>	<b><u>\$40,750</u></b>	<b><u>\$10,961</u></b>

At December 31, 2006 and 2005, U.S. government securities with par values of \$6,855 million and \$3,776 million, respectively, were loaned from the SOMA, of which \$2,537 million and \$1,497 million, respectively, were allocated to the Bank.

#### 5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

The Bank's allocated share of investments denominated in foreign currencies was approximately 27.864 percent and 29.132 percent at December 31, 2006 and 2005, respectively.

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

	<u>2006</u>	<u>2005</u>
European Union euro:		
Foreign currency deposits	\$1,739	\$1,580
Securities purchased under agreements to resell	617	562
Government debt instruments	1,135	1,038
Japanese yen:		
Foreign currency deposits	725	762
Government debt instruments	1,491	1,572
<b>Total allocated to the Bank</b>	<b><u>\$5,707</u></b>	<b><u>\$5,514</u></b>

At December 31, 2006 and 2005, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was \$5,694 million and \$5,525 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as a central bank, to meet its financial obligations and responsibilities.

Total System investments denominated in foreign currencies were \$20,482 million and \$18,928 million at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, the fair value of the total System investments denominated in foreign currencies, including accrued interest, was \$20,434 million and \$18,965 million, respectively.

The maturity distribution of investments denominated in foreign currencies that were allocated to the Bank at December 31, 2006, was as follows (in millions):

	<u>European Euro</u>	<u>Japanese Yen</u>	<u>Total</u>
Within 15 days	\$1,214	\$ 725	\$1,939
16 days to 90 days	662	336	998
91 days to 1 year	681	617	1,298
Over 1 year to 5 years	934	538	1,472
Over 5 years to 10 years	—	—	—
Over 10 years	—	—	—
<b>Total allocated to the Bank</b>	<b><u>\$3,491</u></b>	<b><u>\$2,216</u></b>	<b><u>\$5,707</u></b>

At December 31, 2006 and 2005, there were no open foreign exchange contracts.

At December 31, 2006 and 2005, the warehousing facility was \$5,000 million, with no balance outstanding.

## 6. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	<u>2006</u>	<u>2005</u>
Bank premises and equipment:		
Land	\$ 20	\$ 20
Buildings	245	224
Building machinery and equipment	67	60
Construction in progress	10	19
Furniture and equipment	<u>160</u>	<u>160</u>
Subtotal	502	483
Accumulated depreciation	<u>(243)</u>	<u>(228)</u>
<b>Bank premises and equipment, net</b>	<b><u>\$259</u></b>	<b><u>\$255</u></b>
<b>Depreciation expense,</b>		
<b>    for the year ended December 31</b>	<b><u>\$ 26</u></b>	<b><u>\$ 24</u></b>

The Bank leases space to outside tenants with remaining lease terms ranging from seven to eleven years. Rental income from such leases was \$2 million for the years ended December 31, 2006 and 2005, and is reported as a component of “Other income.” Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2006, are as follows (in millions):

	<u>Rental Leases</u>
2007	\$ 2
2008	2
2009	2
2010	2
2011	2
Thereafter	<u>6</u>
<b>Total</b>	<b><u>\$16</u></b>

The Bank had capitalized software assets, net of amortization, of \$40 million and \$33 million at December 31, 2006 and 2005, respectively. Amortization expense was \$9 million and \$6 million for the years ended December 31, 2006 and 2005, respectively. Capitalized software assets are reported as a component of “Other assets” and the related amortization is reported as a component of “Other expenses.”

Assets impaired as a result of the Bank's restructuring plan, as discussed in Note 11, include equipment. Asset impairment losses of \$1 million for the period ending December 31, 2005, was determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses." The Bank had no impairment losses in 2006.

## 7. COMMITMENTS AND CONTINGENCIES

At December 31, 2006, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from seven to approximately seventeen 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 \$16 million and \$11 million for the years ended December 31, 2006 and 2005, respectively. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2006, are as follows (in millions):

	Operating
2007	\$ 5
2008	5
2009	6
2010	6
2011	6
Thereafter	101
<b>Future minimum rental payments</b>	<b><u>\$129</u></b>

At December 31, 2006, there were no other material commitments or long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks, each of the Reserve Banks has agreed to bear, on a per-incident basis, a pro rata share of losses in excess of 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 the agreement at December 31, 2006 or 2005.

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

## 8. RETIREMENT AND THRIFT PLANS

### Retirement Plans

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

The System Plan is a multi-employer plan with contributions funded by the participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors, 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 Bank acts as a sponsor of the System Plan and the costs associated with the Plan are not redistributed to other participating employers.

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

	<u>2006</u>	<u>2005</u>
Estimated actuarial present value of projected benefit obligation at January 1	\$4,785	\$4,524
Service cost-benefits earned during the period	134	123
Interest cost on projected benefit obligation	278	263
Actuarial loss	132	125
Contributions by plan participants	3	3
Special termination benefits	3	6
Benefits paid	(254)	(259)
Plan amendments	66	—
<b>Estimated actuarial present value of projected benefit obligation at December 31</b>	<b><u>\$5,147</u></b>	<b><u>\$4,785</u></b>

Following is a reconciliation showing the beginning and ending balances of the System Plan assets, the funded status, and the prepaid pension benefit costs (in millions):

	<u>2006</u>	<u>2005</u>
Estimated fair value of plan assets at January 1	\$ 5,868	\$5,887
Actual return on plan assets	713	237
Contributions by the employer	—	—
Contributions by plan participants	3	3
Benefits paid	(254)	(259)
<b>Estimated fair value of plan assets at December 31</b>	<b><u>\$ 6,330</u></b>	<b><u>\$5,868</u></b>
<b>Funded status</b>	<b><u>\$ 1,183</u></b>	\$1,083
Unrecognized prior service cost		149
Unrecognized net actuarial loss		1,496
<b>Prepaid pension benefit costs</b>		<b><u>\$2,728</u></b>
Amounts included in accumulated other comprehensive loss are shown below:		
Prior service cost	\$ (191)	
Net actuarial loss	(1,301)	
<b>Total accumulated other comprehensive loss</b>	<b><u>\$(1,492)</u></b>	

Prepaid pension benefit costs are reported as “Federal Reserve System prepaid pension benefit costs” in the Statements of Condition.

The accumulated benefit obligation for the System Plan, which differs from the estimated actuarial present value of projected benefit obligation because it is based on current rather than future compensation levels, was \$4,522 million and \$4,162 million at December 31, 2006 and 2005, respectively.

The weighted-average assumptions used in developing the pension benefit obligation for the System Plan as of December 31 are as follows:

	2006	2005
Discount rate	6.00%	5.75%
Rate of compensation increase	4.50%	4.50%

Net periodic benefit expenses are actuarially determined using a January 1 measurement date. The weighted-average assumptions used in developing net periodic benefit expenses for the System Plan for the years at January 1 were as follows:

	2006	2005
Discount rate	5.75%	5.75%
Expected asset return	8.00%	8.25%
Rate of compensation increase	4.50%	4.25%

Discount rates reflect yields available on high-quality corporate bonds that would generate the cash flows necessary to pay the plan’s benefits when due. The expected long-term rate of return on assets was based on a combination of methodologies including the System Plan’s historical returns, surveys of what other plans’ expected rates of return are, building a projected return for equities and fixed-income investments based on real interest rates, inflation expectations and equity risk premiums, and surveys of expected returns in equity and fixed-income markets.

The components of net periodic pension benefit expense (credit) for the System Plan for the years ended December 31 are shown below (in millions):

	<u>2006</u>	<u>2005</u>
Service cost-benefits earned during the period	\$134	\$123
Interest cost on projected benefit obligation	278	263
Amortization of prior service cost	23	24
Amortization of actuarial loss	75	49
Expected return on plan assets	<u>(460)</u>	<u>(476)</u>
Net periodic pension expense/(credit)	50	(17)
Special termination benefits	<u>3</u>	<u>6</u>
<b>Total periodic pension expense/(credit)</b>	<b><u>\$ 53</u></b>	<b><u>\$(11)</u></b>
Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic pension benefit expense in 2007 are shown below:		
Prior service cost	\$ 29	
Actuarial loss	<u>66</u>	
<b>Total</b>	<b><u>\$ 95</u></b>	

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

	<u>Expected Benefit Payments</u>
2007	\$ 260
2008	270
2009	281
2010	294
2011	306
2012-2016	<u>1,764</u>
<b>Total</b>	<b><u>\$3,175</u></b>

The Federal Reserve System's pension plan weighted-average asset allocations at December 31 by asset category are as follows:

	<u>2006</u>	<u>2005</u>
Equities	64.3%	66.2%
Fixed-income	34.4%	31.7%
Cash	1.3%	2.1%
<b>Total</b>	<b><u>100.0%</u></b>	<b><u>100.0%</u></b>

The System's Committee on Investment Performance ("CIP") contracts with investment managers who are responsible for implementing the System Plan's investment policies. The managers' performance is measured against a trailing 36-month benchmark of 60 percent of a market-value-weighted index of predominantly large capitalization stocks trading on the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers Automated Quotation National Market System and 40 percent of a broadly diversified investment-grade fixed-income index (rebalanced monthly). The managers invest plan funds within CIP-established guidelines for investment in equities and fixed-income instruments. Equity investments can range between 40 percent and 80 percent of the portfolio. Investments, however, cannot be concentrated in particular industries and equity securities holdings of any one company are limited. Fixed-income securities must be investment grade and the effective duration of the fixed-income portfolio must remain within a range of 67 percent and 150 percent of a broadly diversified investment-grade fixed-income index. CIP guidelines prohibit margin, short sale, foreign exchange, and commodities trading as well as investment in bank, bank holding company, savings and loan, and government securities dealers stocks. In addition, investments in non-dollar-denominated securities are prohibited; however, a small portion of the portfolio can be invested in American Depositary Receipts/Shares and foreign-issued dollar-denominated fixed-income securities.

Contributions to the System Plan may be determined using different assumptions than those required for financial reporting. The System does not expect to make a cash contribution during 2007.

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2006 and 2005, and for the years then ended, were 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 \$14 million and \$13 million for the years ended December 31, 2006 and 2005, respectively, and are reported as a component of "Salaries and other benefits" in the Statements of Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2006 and 2005, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

## 9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

### Postretirement Benefits Other than Pensions

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

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

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

	<u>2006</u>	<u>2005</u>
Accumulated postretirement benefit obligation at January 1	\$200.1	\$197.8
Service cost-benefits earned during the period	4.4	3.4
Interest cost on accumulated benefit obligation	11.6	10.3
Actuarial loss/(gain)	42.4	(0.9)
Contributions by plan participants	1.4	1.1
Benefits paid	(12.0)	(11.6)
Plan amendments	—	—
<b>Accumulated postretirement benefit obligation at December 31</b>	<b><u>\$247.9</u></b>	<b><u>\$200.1</u></b>

At December 31, 2006 and 2005, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 5.50 percent, respectively.

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

Following is a reconciliation of the beginning and ending balances of the plan assets, the unfunded postretirement benefit obligation, and the accrued postretirement benefit costs (in millions):

	<u>2006</u>	<u>2005</u>
Fair value of plan assets at January 1	\$ —	\$ —
Contributions by the employer	10.6	10.5
Contributions by plan participants	1.4	1.1
Benefits paid	(12.0)	(11.6)
<b>Fair value of plan assets at December 31</b>	<u>\$ —</u>	<u>\$ —</u>
<b>Unfunded postretirement benefit obligation</b>	<u>\$247.9</u>	\$200.1
Unrecognized prior service cost		25.3
Unrecognized net actuarial loss		(58.1)
<b>Accrued postretirement benefit cost</b>		<u>\$167.3</u>
Amounts included in accumulated other comprehensive loss are shown below:		
Prior service cost	\$ 20.0	
Net actuarial loss	(95.2)	
<b>Total accumulated other comprehensive loss</b>	<u>\$ (75.2)</u>	

Unfunded postretirement benefit obligation and accrued postretirement benefit costs are reported as a component of “Accrued benefit costs” in the Statements of Condition.

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

	<u>2006</u>	<u>2005</u>
Health care cost trend rate assumed for next year	9.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2012	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, 2006 (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	\$2.6	\$(2.1)
Effect on accumulated postretirement benefit obligation	31.0	(25.8)

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

	<u>2006</u>	<u>2005</u>
Service cost-benefits earned during the period	\$ 4.4	\$ 3.4
Interest cost on accumulated benefit obligation	11.6	10.3
Amortization of prior service cost	(5.3)	(5.3)
Amortization of actuarial loss	5.3	2.9
<b>Total periodic expense</b>	<b><u>16.0</u></b>	<b><u>11.3</u></b>
Curtailment	—	—
Special termination benefits	—	—
<b>Net periodic postretirement benefit expense</b>	<b><u>\$ 16.0</u></b>	<b><u>\$ 11.3</u></b>
Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2007 are shown below:		
Prior service cost	\$ (5.2)	
Actuarial loss	10.9	
<b>Total</b>	<b><u>\$ 5.7</u></b>	

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2006 and 2005, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.50 percent and 5.75 percent, respectively.

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

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

There were no receipts of federal Medicare subsidies in the year ended December 31, 2006. Expected receipts in the year ending December 31, 2007, related to payments made in the year ended December 31, 2006, are \$1 million.

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

	Expected Benefit Payments	
	Without Subsidy	With Subsidy
2007	\$ 13.8	\$ 12.8
2008	14.9	13.8
2009	16.1	14.9
2010	17.0	15.8
2011	17.9	16.6
2012-2016	97.2	88.8
<b>Total</b>	<b>\$176.9</b>	<b>\$162.7</b>

#### Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2006 and 2005, were \$30 million. This cost is included as a component of “Accrued benefit costs” in the Statements of Condition. Net periodic postemployment benefit expenses included in 2006 and 2005 operating expenses were \$4 million and \$5 million, respectively, and are recorded as a component of “Salaries and other benefits” in the Statements of Income.

## 10. ACCUMULATED OTHER COMPREHENSIVE INCOME

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

	Amount Related to Defined Benefit Retirement Plan	Amount Related to Postretirement Benefits Other than Pensions	Total Accumulated Other Comprehensive Loss
Balance at December 31, 2005	\$ —	\$ —	\$ —
Adjustment to initially apply FASB Statement No. 158	(1,492)	(75)	(1,567)
<b>Balance at December 31, 2006</b>	<b>\$(1,492)</b>	<b>\$(75)</b>	<b>\$(1,567)</b>

Additional detail regarding the classification of accumulated other comprehensive loss is included in Notes 8 and 9.

## 11. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of operations and staff reductions in various functions of the Bank. In 2005, additional consolidation and restructuring initiatives were announced in the check and cash operations. These actions resulted in the following business restructuring charges (in millions):

	Total Estimated Costs	Accrued Liability 12/31/2005	Year Ended 12/31/2006		Accrued Liability 12/31/2006
			Total Charges	Total Paid	
Employee separation	\$8	\$4	\$—	\$4	\$—
<b>Total</b>	<b>\$8</b>	<b>\$4</b>	<b>\$—</b>	<b>\$4</b>	<b>\$—</b>

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 90 related to restructuring announced in 2005. Costs related to staff reductions for the year ended December 31, 2005, are reported as a component of “Salaries and other benefits” in the Statements of Income.

Restructuring costs associated with the impairment of certain Bank assets, including software, buildings, leasehold improvements, furniture, and equipment, are discussed in Note 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the Bank as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

The Bank substantially completed its announced plans in 2006.