

TRANSITIONS *and* ACCOMPLISHMENTS

Transitions and Accomplishments aptly describe 2006 at the Federal Reserve Bank of Philadelphia. Last year, we welcomed a new president, Charles I. Plosser. We were also involved in a considerable endeavor: consolidating the check processing operations of the Federal Reserve Bank of New York's East Rutherford Operations Center (EROC) into Philadelphia. But we didn't stop there. We also completed and implemented two other major projects: the Treasury Check Information System (TCIS) and the Collateral Management System (CMS). All three of these major undertakings were successful thanks to our talented and dedicated employees. This annual report presents the teamwork, talent, and effort that helped achieve these "Transitions and Accomplishments" — all of which support the Federal Reserve's mission to ensure an efficient and effective payments system and a stable financial environment.



TRANSITIONS *and* ACCOMPLISHMENTS

The year 2006 was marked by operational successes and major changes at the Philadelphia Fed, but leadership was the most important transition the Bank experienced. Charles I. Plosser became the Bank's 10th chief executive in August of last year. In his first annual report message as president, he talks about his background, his philosophy of leadership, and his goals for the Federal Reserve Bank of Philadelphia.

This is my first annual report message to you as president of the Federal Reserve Bank of Philadelphia. I joined the Bank last August, after spending nearly 30 years as a professor of economics and more than a decade as a business school dean at the University of Rochester. The opportunity to lead such a high-caliber institution as the Philadelphia Fed while retaining my economic roots is truly, for me, the best of both worlds.

My interest in central banking and the Federal Reserve System has spanned my career. As an academic, I had

monetary policy and more broadly to the mission of the Federal Reserve. It is a privilege I greatly value.

Goals for the Bank

One of my goals as president of the Bank is to maintain and enhance Philadelphia's leadership role in the Federal Reserve System and the Third Federal Reserve District. I believe that if we here at the Philadelphia Fed want to be leaders, we must be innovators. Innovation is the best path to ensuring our reputation as one of the outstanding Banks in the Federal Reserve System. What is the best way to

These transitions and accomplishments are examples of how far our Bank can reach when we empower our employees to implement ideas, give them flexibility, and encourage them to be creative.

the opportunity to analyze and critique the actions of the Federal Reserve and other central banks with an outsider's perspective. People often ask me if my views have changed now that I am on the inside. Truthfully, they have not. Economic science helps us understand the way the world works, and good economic analysis should be independent of one's vantage point. What has changed is that now I have the privilege to contribute in a meaningful way to

become innovators? I believe it boils down to three main elements.

First, we must focus on hiring and retaining talented employees and equipping them with the skills and flexibility they need to be successful innovators. Second, we must create an environment that empowers employees to use their talents. A key component of empowerment is delegating

decision-making. Delegating responsibility — and accountability — also builds skills and develops future leaders. Third, we need the appropriate infrastructure to support innovation. Infrastructure means more than just physical capital. More broadly, supporting and encouraging a decentralized organization is an important part of developing the right infrastructure. If we have these three elements in place, we will encourage innovation and we will be

accomplished some truly remarkable things. I have no doubt that together we will continue to succeed in carrying out the Fed's mission: conducting the nation's monetary policy, ensuring a sound and accessible banking system, and maintaining public confidence in all forms of payments.

Board Contributions

In my time here, I have quickly gained a keen

Innovation is the best path to ensuring our reputation as one of the outstanding Banks in the Federal Reserve System.

well positioned to seize opportunities for leadership when they come along.

Our Accomplishments, Our Future

Of course, we have already been innovative here in Philadelphia. The list of accomplishments in 2006 supports that statement. The three major undertakings of last year, which you will read about elsewhere in this annual report, speak to the abilities and creativity of our employees.

In fact, I am deeply impressed by the dedication and integrity exhibited by the staff of this outstanding institution. Thanks to them, this Bank has

appreciation for the contribution of our Board of Directors. Throughout all our transitions and accomplishments, their support is always highly valued.

We offer our sincere gratitude to two members of our Board who have completed their service with us: Audrey S. Oswald, former president and CEO of Resorts Atlantic City, and Eugene W. Rogers, CEO and director of Newfield National Bank. Their advice and guidance on our Board will be missed.

We are pleased to report that Doris M. Damm, president and CEO of ACCU Staffing Services,

has been re-appointed chairman of the Board of Directors, and William F. Hecht, retired chairman, president, and CEO of PPL Corporation, has been re-appointed deputy chairman of the Board of Directors.

We also welcome our newest Board members and look forward to their insights and counsel. Michael F. Camardo, retired executive vice president of Lockheed Martin Information & Technology Services, and Aaron L. Groff, Jr., chairman, president, and CEO of Ephrata National Bank, both joined our Board in 2007, bringing a wealth of experience.

Let me also recognize that the Board has re-appointed Ted Cecala, chairman and CEO of Wilmington Trust Company, to represent the Third District on the Federal Advisory Council in 2007.

Concluding Thoughts

The transitions and accomplishments detailed in this annual report are examples of how far our Bank can reach when we empower our employees to implement ideas, give them flexibility, and encourage them to be creative. Supporting such an environment is essential to our goal of enhancing our capabilities and contributions to the mission of the Federal Reserve and firmly establishing the Philadelphia Reserve Bank as a center of excellence.

Again, I want to say how pleased I am to be part of the Philadelphia Fed community. I look with great anticipation toward building on the momentum already so capably begun here, and I look forward to working with our many constituents throughout the Third District.

Charles I. Plosser
President
April 2007

OUR MISSION *and* RESPONSIBILITIES

First Vice President Bill Stone shares his perspective on how three major projects allowed the Philadelphia Fed to capitalize on its areas of strength and pursue leadership opportunities that benefit not only the financial system but the Bank, the Federal Reserve System, and the Treasury.

Since the creation of the Federal Reserve in 1913, its mission and responsibilities have evolved. The Fed has learned that its actions have significant effects on the financial system and overall economy.

While all areas of the Federal Reserve's mission — monetary policy, bank supervision and regulation, and payments — have changed dramatically since 1913, the biggest changes in recent years have been in the payments system. Payments have been part of the Fed's core activities since the beginning, and they are the largest component of Federal Reserve operations. Moreover, this is an area in which the Fed faces both intense competitive pressure from the marketplace and the forces of technological change that have been a hallmark of the past several decades.

That is why three major System projects implemented by the Philadelphia Fed in 2006 are of special importance. Full details on each of these are presented later in this report.



William H. Stone, Jr.
First Vice President

EROC Consolidation

On August 18, 2006, the Philadelphia Fed — home to one of the Federal Reserve's largest check processing centers — absorbed New York's East Rutherford Operations Center (EROC) in the largest System

consolidation yet in the Fed's check restructuring efforts. In many ways, this consolidation was a significant undertaking for the System and the Bank.

"This is part of the evolutionary process as check volumes decline," says Stone. He goes on to explain that changes in the payments system, driven by the industry's ongoing shift to electronic forms of payment, have necessitated consolidations among the Fed's check processing operations. In each of the past several years, the Federal Reserve's Retail Payments

to move EROC's operations here. In addition, Philadelphia's geographic proximity to New York made it the logical candidate for consolidation with EROC. EROC staffers were instrumental in helping the Bank prepare for and implement the consolidation. Staff from other Reserve Banks and the Federal Reserve's Retail Payments Office also played important roles in the consolidation.

Stone attributes much of the decision to the Bank's painstaking preparations. "We had positioned our-

Given the complexity of this particular consolidation and that it was the largest to date, we are particularly proud it was executed so smoothly.

Office has made recommendations for restructuring the Fed's check processing infrastructure. "This restructuring allows us to fulfill our traditional role of payments processor while at the same time maintaining efficiency in this new environment. These consolidations bring about substantial cost savings and are consistent with the System's direction for fewer Reserve Bank locations involved in the check business," explains Stone.

For the consolidation to be successful, it was imperative that the New York and Philadelphia Fed check processing sites be able to work together to provide a nearly seamless transition in service to customers. Philadelphia's reputation as a high-quality and efficient operation played a key role in the decision

to be able to take on System consolidations. When the time came, we were ready for the opportunity. Given the complexity of this particular consolidation and that it was the largest to date, we are particularly proud it was executed so smoothly. The EROC consolidation has become the System benchmark for the successful implementation of a large-scale consolidation," Stone reports.

Stone sums up the success of the project in two words: "dedicated staff." He continues, "The most important component of this restructuring was, without doubt, our Retail Payments staff. Our staff rose to the challenge, and I was proud to see their dedication and teamwork. They understood and focused on the importance of this consolidation as a

determinant of our future success. Individuals across the Bank came together to reach our goals.”

In addition to good planning and hard work, the project’s success relied heavily on Retail Payments’ ability to meet customers’ needs throughout the transition. “This required early communication with customers whose service would be affected and a thorough understanding and ongoing analysis of customer service issues throughout the process,” says Stone.

Before absorbing EROC’s check volume, Philadelphia had been processing nearly 3.5 million checks per day. Following the merger, daily volumes averaged over 5 million. The Philadelphia Fed has long been a leader in the System with a premier check operation, but this new responsibility meant additional employees, equipment, and space renovations to accommodate the increased workload. These changes required support and cooperation from departments across the organization. Building staff worked hard to prepare and reconfigure the physical space. Human Resources recruited and trained new employees and guided them through the hiring process. Protection officers did background checks and supplied employee badges. Among the new staff were some transfers from the EROC facility who knew the business and customers and whose efforts were invaluable in helping to smooth the transition. Additional EROC staff worked in Philadelphia through the first several weeks of the consolidation.

Collateral Management System

The Collateral Management System (CMS) software redevelopment project was another bright spot in a year of operational success stories. The Philadelphia Fed was asked to re-engineer the CMS on behalf of the

Federal Reserve System’s Subcommittee on Credit, Reserves, and Risk Management (SCRRM). This System initiative, which allows straight-through processing of collateral, successfully implements portal technology and includes an automated interface that addresses the needs of the Fed’s depository institutions.

The Philadelphia Fed was assigned this project not only because it ran the system being replaced by the CMS but also because Bank staff had the specialized skills best suited to the task. Stone elaborates, “We were able to bring an understanding of the business requirements for a collateral management system as well as expert knowledge of how the system operates. And importantly, we could bring together the technical expertise to build such a system.”

This initiative involved the conversion of the existing CMS to a System standard technology and allowed the Bank to use the Federal Reserve’s intranet as a way to deliver service. Essentially, the goal of the project was to convert the CMS from a client-server-based application to a web browser application. This provides more seamless user access, alleviates redundancy, and reduces costs.

Treasury Check Information System

In 2001, the U.S. Treasury asked the Philadelphia Fed to modernize and improve the outdated application used for its check processing and reconciliation system. This check processing and reconciliation system is essentially the Treasury’s checkbook — a vast system that tracks all government checks issued and paid and handles claims that arise when checks aren’t received or when a check was sent erroneously.

The Treasury sought out the Philadelphia Reserve

Bank to assist in developing sophisticated programming tools that would create a new and more efficient means to reconcile Treasury checks. The Bank was charged with this monumental task based on its strong relationship with the Treasury, its excellent track record in other Treasury joint initiatives, and its proven expertise in check processing. The Bank's

225 million check payments and 600,000 claims a year and stores data for up to at least seven years. That means TCIS will allow online retrieval of information on more than 1.5 billion check payments and 4 million check claims over a seven-year period.

TCIS ensures the highest levels of financial integ-

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long working relationship with the Treasury helped simplify the overall development effort, which provided the Treasury with such benefits as improved automation and the elimination of paper-based operations.

Philadelphia produced a very strong proposal for taking existing technology, integrating it into a very critical area of Treasury operations, and then determining what software to develop to make it work in the Treasury's environment. Stone explains, "The final result was the successful creation of a product that addresses a critical business need and automates the reconciliation of the Treasury's checkbook."

The Bank worked closely with the Treasury's Financial Management Service to develop the final product: the Treasury Check Information System (TCIS). This fully web-enabled infrastructure records and reconciles the worldwide issuance and payment of U.S. Treasury checks. Currently, TCIS processes more than

225 million check payments and 600,000 claims a year and stores data for up to at least seven years. That means TCIS will allow online retrieval of information on more than 1.5 billion check payments and 4 million check claims over a seven-year period.

Changing Environment, Certain Future

The three System projects successfully completed by the Philadelphia Fed last year bring to light the changing operations environment within the Federal Reserve.

"Both CMS and TCIS may involve additional opportunities for us as the projects expand. Furthermore, the success of the EROC consolidation positions us well for further consolidations into 2008 and beyond." Stone concludes, "We are leveraging successes, strengthening our processes, and proving our project management skills. This is a testament to the credibility of our work and will allow us to build ever-stronger capabilities in the future."

PREPARING *for* CONSOLIDATION

In May 2005, the Philadelphia Fed announced that the Federal Reserve System’s Conference of Presidents had approved the recommendation of the Retail Payments Office (RPO) to move check processing from New York to Philadelphia.

Although the final consolidation of the New York Fed’s East Rutherford Operations Center (EROCC) took place in mid-2006, the story actually began a year earlier. What happened between the announcement of the decision to merge and the final consolidation date — August 18, 2006 — demonstrates that an undertaking of this size involves the cooperation of many people and departments.

The department and employees most directly affected by the consolidation were, of course, those in the Bank’s Retail Payments Department. While changes to the physical plant were underway (see story on page 16), the department hired and trained new staff, installed new equipment, dealt with software issues, and tested the Bank’s ability to handle the in-

creased volume of checks. Employees did whatever was necessary to make the transition a success: putting in extra hours, working weekends, and learning new skills. Also, throughout this transition, Retail Payments staff still had to process the Bank’s normal daily check volume.

In short, for employees in this area, 2006 was a year of changes and challenges. Below we highlight some of the key staff and components of this multi-faceted undertaking.

Hiring New Staff

Lisa Irwin, manager, HR Support, Retail Payments, notes that to handle the increased workload, the department needed many different types of expertise: sorter operators, data prep staff, and shipping clerks. Management decided to start the hiring process early — in March 2006 — so employees would be up to speed by August.

Originally, Retail Payments planned to hire about 60 new employees; however, the department hired almost 100 new workers, both temporary and permanent. The Bank also made offers of employment

May 2005

Philadelphia Fed announces merger of East Rutherford Operations Center’s (EROCC) check processing with Philadelphia’s

August 2005

Facilities Management starts renovations on fifth-floor checks area

November 2005

Work begins on reconfiguring loading dock area

December 2005

Retail Payments starts to relocate sorters and other equipment

January 2006

Fifth-floor renovations completed

to displaced EROC workers, 10 of whom accepted positions and moved to Philadelphia.

Moving and Installing Equipment

Mike Penhollow, check operations coordinator, oversaw the installation of new medium- and high-speed sorters and the relocation of existing ones. To accommodate the consolidation, the Philadelphia Fed increased the number of high-speed sorters from 15 to 21 and the number of medium-speed sorters from eight to 10.

Penhollow and his crew started moving equipment in December 2005. It took approximately four months to get new and existing sorters in place. All of the machines needed for Check 21 processing had to be relocated as well.

Dealing with Software Concerns

Less obvious to the casual observer was the behind-the-scenes work of the data migration team, under manager Pete Milkovits. This group reviewed EROC’s file structures to see how they fit into the Philadelphia environment and created new sort patterns for EROC checks. Moreover, they had to determine how EROC’s deadlines fit in with Philadelphia’s.



Wanda Preston (left), Check Adjustments Officer, and Lisa Irwin, Manager, HR Support, Retail Payments

Over the course of many visits to northern New Jersey, Philadelphia’s data migration team worked closely with EROC’s operations and technical staff to iron out problems and discuss issues concerning customer databases and services. In fact, the Philadelphia Fed created test files that mirrored formats used by East Rutherford. Over a three-month period, the banks served by EROC tested these files to ensure their systems were compatible before the final cutover.

May 2006

Loading dock reconfiguration completed. Retail Payments receives first “live” EROC weekend deposits

May 2006 (cont.)

Retail Payments starts testing ability to handle increased checks volume (25% of anticipated increase)

June 2006

Retail Payments conducts two more tests at 50% and 100% of anticipated increase

July 2006

Retail Payments conducts final test at 100% of anticipated increase

August 2006

Consolidation becomes final on August 18th

Transporting Checks

Another logistical problem that had to be addressed was: How would EROC checks get from the New York area to Philadelphia (inbound checks) and back again (outbound checks)? In particular, Philadelphia needed two transit points for inbound and outbound checks: one for New York City banks and one for EROC's banks outside the city. Charlie McCormack, check operations manager, and Donna Strigari, senior transportation planner, explain that for various reasons, the Retail Payments Office had to find two new transit sites in the New York area. The locations chosen were one site in lower Manhattan, about two miles from the New York Fed, and another in South Hackensack, New Jersey, about five miles from the operations center at East Rutherford.

McCormack points out that consolidation wouldn't change how EROC checks were transported: "All the same runs would be in place, only now they'd leave from Hackensack."

Talking to Customers

Another area involved in the consolidation was Retail Payments' customer service unit. These representatives, along with coordinator Larry O'Toole, deal with day-to-day questions from Philadelphia's financial-institution clients. To prepare for the EROC consolidation, the unit expanded from three to five employees and prepared to field questions from the Bank's new customers in New York. Preparation involved, among other things, dealing with differences in terminology. O'Toole notes that "we had to educate ourselves



(Left to right): Mike Penhollow, Check Operations Coordinator; Pete Milkovits, Check Automation Support Manager; Donna Strigari, Senior Transportation Planner; and Charlie McCormack, Manager, Check Operations

about EROC's terminology, and EROC customers had to become familiar with ours."

Of course, consolidation has meant an increased workload for this group. Since August, calls handled by customer service reps have almost doubled: they've gone from approximately 160 calls a day to 300 — and even more at peak times.



Retail Payments customer service operators (left to right): Sharon Howard, Shelby Coleman, Wylene Bullard, and Joann New. Not shown: Karen McDuffie

Ensuring Quality

Ed McCloskey, senior quality analyst, along with other Check staff, went to East Rutherford fairly early in the consolidation process to review its operations. One purpose of these trips was to spot potential pitfalls before they became major problems.

Of special concern to McCloskey was the quality of the deposits — for example, reject rates and the number of errors per 100,000 items processed. Once Philadelphia had an early opportunity to process EROC's weekend deposits, McCloskey put together a presentation on quality and, with others from Philadelphia, held a series of seminars with EROC customers. As McCloskey puts it, "We gave the Philly perspective on quality to our new customers and told them what types of changes they should expect after the consolidation."

McCloskey also created and distributed job aids, which included signage in the fifth-floor produc-

tion area, handouts for staff members, and workflow charts to help reduce confusion that can lead to mistakes.

Testing Increased Check Volume

Meanwhile, Check staff had to prepare for testing their ability to handle the increased workload. First, though, Retail Payments had to find a large number of test documents. Bill Barker, night-shift manager, explains that the check operations area had to produce enough test documents to simulate a peak processing day — close to 7 million items. To meet its testing needs, the department purchased test checks, borrowed from other Fed offices that had undergone consolidation, and used its Check 21 capabilities to manufacture test checks.

Once the test documents were in hand, Retail Payments scheduled a series of weekend tests. Employees across two shifts staged events just as they



Ed McCloskey (left), Senior Quality Analyst, and Bill Barker, Night-Shift Manager, Retail Payments

would occur in a work situation. Barker notes that the department had to ensure sufficient staffing levels to carry out the tests and process the normal check volume on each shift.

Finally, in May, Check staff tested workload at 25 percent of the anticipated increased volume. In early June, they tested at 50 percent and, in late June, 100 percent. Finally, in July Check staff ran a second 100 percent test, using what they had learned in the late-June test.

After each test was completed, the documents were prepared for the next round. Tight turnarounds — the last two tests were only two weeks apart — made this task a particularly challenging one for employees. But, as was the case all along, Retail Payments staff proved equal to the job. In particular, Barker praises Supervisors Bob Brown, John Hampton, and Dolores McDevitt for managing night-shift

operations while he moved temporarily to days, and Gerri Killebrew and Tracey Hambeau-Fakolujo for all of the effort they put into preparing and testing return items.

Although a third test at 100 percent had been planned for the end of July, management, with the approval of the RPO representatives who were here throughout the transition, decided this test wasn't necessary. The Federal Reserve Bank of Philadelphia was ready to take on the largest consolidation to date in the Federal Reserve System.

Going Live

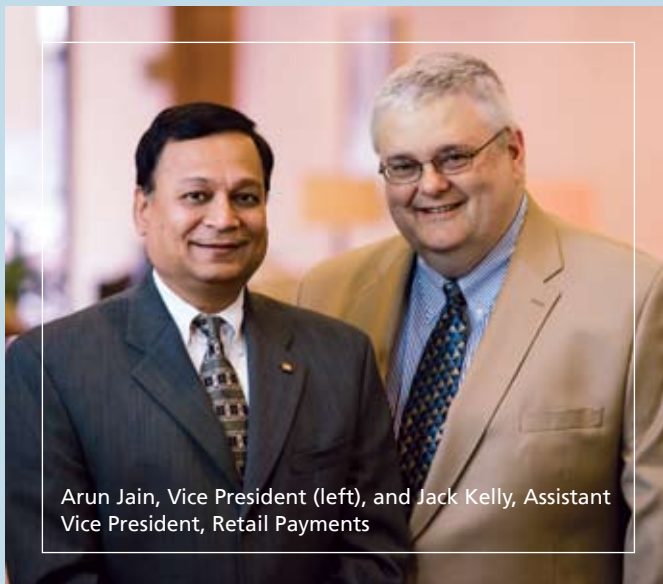
Although the Philadelphia Fed had started to process "live" weekend deposits from EROC in May, the final consolidation took place on August 18.

How did it go? In general, the consolidation was extremely successful. Retail Payments staff were well prepared, and the department had drawn on the expertise of many employees from around the Bank and at EROC. But like any project of this magnitude, the EROC/Philadelphia consolidation was not without its share of unanticipated problems to be solved and new questions to be answered.

As Executive Vice President Blake Prichard summed it up shortly after the final consolidation: "We have been successful thus far because of the expertise, dedication, and attention to detail of our employees and of staff members from other Feds who have assisted us. We've also received help from the Retail Payments Office. We continue to learn from experience as we process the increased volume of checks and provide a wider scope of services to our new customers. The operation gets better and stronger every day, thanks to the dedication of our people."

Coordination and cooperation are essential to completing any project. The merger of EROC with the Philadelphia Fed's check processing was no exception. Arun Jain and Jack Kelly managed the overall consolidation.

Actually, Kelly was involved in the consolidation long before the official announcement was made. About two-and-a-half years ago, Kelly was asked to analyze the impact that absorbing EROC would have on Philadelphia's check operations. The request was motivated by the Retail Payments Office (RPO) initiative to examine the Federal Reserve System's check infrastructure, given declining volumes.



Arun Jain, Vice President (left), and Jack Kelly, Assistant Vice President, Retail Payments

COORDINATING *the* MERGER

Once the decision to merge was made, Kelly, along with Bill Barker, test project manager, helped identify the resources needed to complete the testing for consolidation. Kelly also participated in the workflow analysis and helped revamp the department's scheduling. Perhaps most important of all, Kelly kept Retail Payments managers and supervisors on schedule and focused on the consolidation.

As it was for everyone in Retail Payments, 2006 was a busy year for Arun Jain. As the consolidation site manager, he was the primary point of contact with all Federal Reserve entities. In addition, Jain continued to run day-to-day check operations. Jain oversaw the consolidation's many dimensions: customer communications, products and services, transportation, renovations on the fifth floor and loading dock, migration of data, and new equipment. He also ensured that EROC's financial institutions were briefed about changes to deadlines, products, and transportation logistics to minimize the impact on these new customers. Reconfigured software and new equipment also had to be tested.

Another step was assembling teams and assigning specific tasks to each. To keep the teams on target, Jain held weekly or bi-weekly meetings at which each team reported its progress to date. This made it easier to spot bottlenecks in the process and allocate resources to ensure everything stayed on track for the final consolidation. Team leaders also met with Jain to confirm that all of the project's components were in sync. These meetings were critically important to the smooth functioning of the merger.

Before the final cutover, Retail Payments conducted four readiness tests that simulated the consolidated production environment. These tests were crucial to ensuring that workflow, processing capacity, staffing, and the customer service setup were correct.

In the end, the hard work and extra hours put in by Kelly, Jain, and all Retail Payments employees paid off. Federal Reserve colleagues have declared that all future consolidations will be measured against the overwhelming success of the Philadelphia/EROC venture.

ROLE of FACILITIES MANAGEMENT

To accommodate the anticipated increase in check volume from the EROC/Philadelphia consolidation, the Bank's Facilities Management staff had to complete two major projects within a short time frame: reconfigure the loading dock and renovate the check operations space.

Loading Dock

According to Chris Ivanoski, manager, design and construction, the loading dock had not been upgraded since its construction in the 1970s. Federal Reserve security guidelines have changed considerably since then, and the Bank had been planning for some time to reconfigure the loading dock area in order to meet current standards.

The EROC consolidation added a sense of urgency to the project and necessitated significant acceleration of both the design and the construction schedules. The need to accommodate the combined Philadelphia and EROC check volume while still satisfying physical security requirements made the project particularly challenging.

One key element of the work was to raise the level of the Cherry Street driveway and two of the receiving bays by three feet while still allowing the Bank's daily work to go on. To accommodate that need, the Facilities staff constructed a temporary receiving area for



Chris Ivanoski, Manager; Nasrollah Tahmasebi, Supervisor; and Claudia Le, Space Planner, Facilities Management

checks by cutting a new opening in the side of the building in the west courtyard and creating a temporary ramp and a special conveyor-fed x-ray system.

The design work that led to the new loading dock configuration involved extensive collaboration

between Bank staff and outside design firms. The Bank successfully incorporated material-handling techniques that have proved successful at other Reserve Banks, including automated conveyors, a sorting area for incoming checks, and specially designed “transfer rooms” for outbound check shipments, similar to those that have long been used in Cash Services operations.

tions. Essentially, the design team started from scratch, and the result was a radically different configuration.

By August 2005, renovations were underway. To create room to work, the Facilities crew had to move the Settlement area to temporary quarters on the seventh floor. Ivanoski notes that this move was “the only way we could create space to work and not dis-

The new facilities have met or exceeded all expectations.

Construction work started in November 2005 and was substantially completed by May 2006. The new facilities have met or exceeded all expectations.

Check Operations Area

The fifth-floor check operations area also underwent major renovations. Mike Penhollow, check operations coordinator, and Charlie McCormack, manager, check operations, collaborated extensively with Chris Ivanoski and the Facilities Management staff to come up with a plan for the floor that would allow Retail Payments to work more efficiently. As Ivanoski points out, the checks area was still laid out “the same as it was 30 years ago,” yet the department had grown over the years. In fact, the old layout actually impeded the workflow in check processing. For example, over the course of a shift, checks traveled over three-quarters of the floor, from the time they came off the elevator until the time they left the floor for shipment back to banks.

So the design team asked themselves how they could maximize the efficiency of each area of check opera-

rupt operations.” The construction team gutted the entire floor and renovated it one unit at a time. By the time the dust settled, all of the major areas in Retail Payments had been moved to a different spot on the floor: shipping, receiving, medium-speed processing, high-speed processing, and settlement.

Extensive work on the electrical and data communications infrastructure was also necessary. Facilities staff had to change all of the electrical and data feeds for every piece of equipment in the Retail Payments area while also constructing about 5000 square feet of raised flooring and relocating five air conditioners.

Renovations were completed in mid-January 2006. Although Ivanoski is proud of the work of the Facilities team, he shares the credit for a job well done with the Retail Payments staff: “Even though Check employees had to carry out all of their regular duties while the renovations were going on, they nonetheless took the time to help us and tell us their ideas. Communications and coordination were excellent — nothing was done in a vacuum.”

IT TAKES *a* WHOLE BANK

The success of the East Rutherford Operations Center/Philadelphia Fed check processing consolidation involved people throughout the Bank. Here is a brief look at other departments and employees who contributed to the ultimate success of the consolidation.

Customer Relations

This group pitched in to support the EROC consolidation by partnering with EROC's business development staff to conduct seminars for Second District customers, confirming shipping arrangements, updating agreements for various services as needed, and reviewing EROC's products and services and comparing them with those available in Philadelphia. In fact, Bond Kraemer, sales support coordinator, developed a database to make it easier to compare EROC's products with Philadelphia's. Subsequently, the Federal Reserve System's Retail Payments Office made a template for the database part of its repeatable processes manual. Customer Relations staff also kept Third District financial institutions informed about the various stages of the consolidation.

Tom Lombardo, financial services industry relations officer, was responsible for overseeing project reporting. Using the Federal Reserve System's restructuring repeatable processes template as a road map, Lombardo maintained the project plan — taking information from the various consolidation teams, tracking various tasks involved in the consolidation, and gathering empirical measures of the Bank's percentage of readiness. He then used these data to generate reports for the Retail Payments Office and high-level Federal Reserve officials. In essence, Lombardo served as the "face" of the EROC/Philadelphia consolidation project at the System level.

Human Resources (HR)

The Staffing division worked long and hard to interview and hire qualified employees for the EROC consolidation. Senior Staffing Recruiter Michelle Small was the lead recruiter for the project, supported by Paulette Pompey and Marcos Delgado, senior staffing assistants. Staffing Manager Donna Koller worked with the team to make sure that the hiring process went smoothly and that lines of communication were kept open. She joined Retail Payments management on a trip to EROC to interview existing staff there about possibly moving to Philadelphia. HR's Lisa Martino, senior medical administrator, coordinated the medical aspects of the hiring process. Tom Ballay, training specialist, worked with new hires as a facilitator and mentor.

Information Technology Services (ITS)

ITS staff made key contributions to the consolidation project. They had to ensure all of the Retail Payments Department’s wiring and network connectivity needs were met. Since many employees had to be temporarily moved out of the check processing area during renovations, then moved back again, IT employees were kept busy. Ray Capriotti, Ed Harkins, and Willis Ross saw to the timely completion of network and telephone wiring. Office Automa-

Protection

The officers in Protection kept the hiring process moving by fingerprinting new hires and doing background checks. In particular, Officer Vicky Rodriguez coordinated the scheduling and fingerprinting of all new hires — whether they were temporary workers or permanent employees. Rodriguez had to process a larger number of employees than were actually hired, since some potential new hires didn’t make the final cut.

“I am deeply impressed by the dedication and integrity exhibited by the staff of this institution.”

— *Charles I. Plosser*

tion Support staff — John Pietropaulo, Mark Zirpoli, Don Lisbon, and Rob Torney — completed all of the workstation moves and additions, taking care of personal computers for the temporary offices and the renovated checks area. Communications and Technical Support staff — Pete Bittle, Mark Bryant, Len Reingold, Rich Bauer, and Brenda Aldridge — assisted in the installation efforts by providing key technical support for this complex project. Finally, Ron Dorsch and Mike Whitzer managed and coordinated the ITS support efforts, including connectivity for all new and relocated sorters, printers, and other network devices.

Protection’s special projects coordinator, Thomas Raggio, played a vital role in making sure all security concerns were addressed during consolidation. In addition to attending weekly meetings, Tom was instrumental in providing critical information about the configuration of the loading dock area to ensure that access was well-controlled but did not impede workflow. He also helped to advise on the placement of screening technologies in the loading dock area. The advice and experience of Assistant Vice President Danny Spriggs were invaluable in devising practical ways to maintain a safe and secure environment during the massive construction projects.

UPDATING *the* SYSTEM'S TECHNOLOGY

The Philadelphia Fed converted a complex centralized system, which tracks more than \$1 trillion in collateral, to a web-based portal platform that has paved the way for portal technology to be implemented throughout the Federal Reserve System.

A team from the Philadelphia Fed was selected to modernize the Collateral Management System (CMS) because of Philadelphia's long-standing expertise in managing the Fed's collateral activities. The team re-engineered the CMS infrastructure, streamlining an elaborate set of monitoring tools used to record securities, commercial paper, and customer notes for financial institutions nationwide. Furthermore, the system's portal technology enables users to access multiple applications in one place, maximizing productivity and minimizing maintenance. CMS is designed to meet the collateral management requirements not only of the Federal Reserve but also of specific programs for the U.S. Treasury.

CMS uses sophisticated methodologies to calculate accurate values for each asset pledged as collateral based on current market prices and characteristics such as asset type, duration, time to maturity, interest rate, and investment grade. Collateral values change regularly based on market conditions, and CMS allows every Reserve Bank from San Francisco to Boston to value collateral based on District-unique circumstances. Analysts can query CMS at any time

to review an institution's collateral portfolio. If institutions pledge securities without market prices, such as customer notes, CMS performs calculations using valuation models that are updated frequently.

Completed in July 2006, this strategic initiative was a three-year undertaking that replaced outdated technology with a web-based platform that enhanced functionality for Federal Reserve users and financial institutions. The project's success can be attributed to the collaboration among Philadelphia's talented team, the Federal Reserve's credit and risk management group, and external partners that were involved in the project from the start.

Thanks to the overhaul of CMS, financial institutions now have an automated system that eliminates manual review and processing of collateral transactions originating through the Depository Trust Company (DTC). CMS has a new electronic link between DTC and the Federal Reserve, which improves Reserve Banks' ability to accept and process pledges of securities other than Treasuries. This is a critical feature of the new system and fulfills a long-standing request from our financial institutions. The Bank's partnership with DTC in establishing this link was one key to the success of the overall project.

"We now offer banks the capability to pledge as much collateral as they need to manage their portfolio. The entire CMS project, especially the DTC interface, is an enormous accomplishment for the Bank and the Federal Reserve System. It is a testa-

ment to the extraordinary working relationship of the business and development teams,” said John D. Ackley, assistant vice president, Treasury Services.

One primary object of the redesigned system was to ensure that it was flexible enough to accommodate changing business needs while supporting current needs. That’s why the team worked closely with all the Reserve Banks to define critical business needs. User groups were involved every step of the way and determined what functions were needed. They also helped to document system requirements, including workflows, screen displays, and report designs.

The Bank conducted extensive testing to keep problems to a minimum. “We executed more than 1,000 test scripts, during many testing phases, to ensure the application met business requirements,” Ackley said.

Users played an integral role in the testing, and representatives from each Federal Reserve participated in the user-acceptance test phase. During the final testing phase, Philadelphia offered on-site and computer-based training to all Reserve Bank users.

The Philadelphia team is responsible for the day-to-day operations of CMS, including management of the application, customer

help desk support, and testing enhancements. However, it is important to recognize that the Philadelphia Fed has a history of expertise in building technology to support collateral management dating back to the 1980s. Then, Philadelphia managed the largest customer safekeeping service in the Federal Reserve System. In the early 1990s, Philadelphia developed a PC-based local area network application to update the older mainframe technology and has continued to take on increasingly extensive leadership roles in the collateral management business line.

But in spite of the project’s success, one thing is certain: Collateral management is a constantly evolving process. Consequently, the Philadelphia team will continue to enhance its reputation as the primary provider of collateral management information to the U.S. Treasury and the Federal Reserve’s credit and risk management community.



Pictured left to right: John Ackley, Assistant Vice President; Marie Tkaczyk, Assistant Vice President; Chris DeYoung, Group Manager, Systems Development; and Bob Mucerino, National Support Service Manager

BALANCING *the* TREASURY'S CHECKBOOK

If you have ever had trouble balancing your checkbook, just imagine the chore the U.S. government faces balancing billions of dollars in checks every day. However, thanks to the Federal Reserve Bank of Philadelphia, the government's job just got easier.

The Philadelphia Fed was chosen for this job because of its expertise and its past success in custom-

izing software for the Treasury. A team from Philadelphia led the U.S. Treasury Financial Management Service's (FMS) conversion from a labor-intensive paper-based check data program to an automated web-based system responsible for recording and reconciling the worldwide issuance and payment of U.S. Treasury checks.

New Features

Called the Treasury Check Information System (TCIS), this new streamlined program features enhanced

software that more easily manages bookkeeping and helps to quickly solve lost and problem check issues. It also maintains payment data for at least seven years, which means that TCIS will allow online retrieval of information on more than 1.5 billion check payments and 4 million check claims over a seven-year period.

TCIS serves more than the Treasury. Nearly 4,000 government users distribute checks through the service, such as the Department of Defense, Social Security, Internal Revenue Service, and many others.

The TCIS project spanned several years as staff from the Bank's Retail Payments and Information Technology departments joined forces to



Clockwise from left: Tom Gibbons, Group Manager, Systems Development; Ann O'Brien, Business Project Manager; Leigh Carasso, Group Manager, Systems Development; Michael Pelle, Lead Technical Specialist; Mona Wells, Lead Technical Specialist; and Gregory Fanelli, Treasury Payments Officer

replace the aging system. The nearly 20-year-old system was becoming costly to maintain and difficult to upgrade, and individuals with extensive knowledge of the system were retiring. Modernizing the mammoth mainframe database system required a comprehensive understanding of the checks business.

The Treasury's Business

It may be surprising to learn that about 99.9 percent of the Treasury's 250 million checks issued and 250 million checks paid balance to the penny. "But there is that outstanding one-tenth of a percent that can add up to millions of dollars," said Ann O'Brien, a project manager. Her assignment was to improve the software reconciliation and claims processing applications.

"The Treasury needed a system where they could quickly view their account and access it at any time. We gave them an electronic system, and no one has to touch a piece of paper," O'Brien said.

An average day in reconciliation may mean that 100 check record discrepancies need to be investigated. For each case there may be 284 possible reasons for the difference and just as many solutions to sort out. "Endless things can happen to a check, and if it happens once, you have to have software to handle it," O'Brien explains.

Encoding errors and machine misreads are among the most common reasons a check ends up in check reconciliation. Previously, dozens of three-digit codes were used to describe the claims. For new employees, finding the correct code was difficult; now it's easier to process. "We substituted words for numbers," O'Brien explained.

Having a large vocabulary is important when the software generates around 600,000 claims each year that must be individually resolved. Of these 600,000 mailed claims, approximately 60,000 are returned and processed by TCIS. TCIS is equipped to place stop payments on checks if people claim they did not receive their check. The entire process is electronic, with letters, e-mails, and outgoing files all within a click-and-pick menu.

TCIS has also improved the amount and speed at which altered or counterfeit checks are found. It leverages the Federal Reserve's image archive, which stores digital images of every Treasury check. "Although the rate of successfully detecting fraudulent checks was high with the Treasury check fraud detection system alone, it has greatly increased due to its linkage with TCIS," said Greg Fanelli, who oversaw the TCIS management team and coordinated activities with the numerous stakeholders.

"One of the challenges in the development process was how to adhere to the complex rules Treasury's claim processing requires. In addition, both the Treasury and the Federal Reserve have robust security requirements that had to be met," Fanelli said.

TCIS' developers had to recognize that more and more checks are being processed electronically since the implementation of the Check Clearing for the 21st Century Act, or Check 21. Check 21, which became effective October 2004, makes it easier for banks to electronically collect check images instead of physically transferring paper checks. Additionally, unique requirements were needed to accommodate several users, such as the U.S. Department of Defense and the U.S. Social Security Administration.

The development team knew that customizing an accounting module for TCIS would be a huge challenge. “But it was a vital part of the system and took years to refine,” said Tom Gibbons, a project manager.

Once the major software components were completed, the final hurdle was ensuring that the system would successfully integrate with related applications at Treasury. Integration, testing, data migration, performance tests, and stress tests all took months of coordinated effort among the Fed

didn’t get their checks. In fact, with one easy click on the computer, people can see the check and who endorsed it, helping to quickly resolve simple problems of miscommunication over missing check claims.

Completing the Conversion

The final phase required the team to work long hours and weekends to see their project to completion. An elaborate plan comprising several hundred steps was devised and tested five times to prepare for a smooth conversion.

An elaborate plan comprising several hundred steps was devised and tested five times to prepare for a smooth conversion.

team, the FMS team, the Fed’s information technology staff, and contractors who operate the Treasury Web Application Infrastructure (TWA) on behalf of the Fed and the Treasury.

Impressive Results

The final results of TCIS were impressive. “There is just no comparison between the old and new systems,” Gibbons said. “For example, the new system has more databases online allowing users to have real-time access rather than waiting one to two days to get archived data,” he explained.

“You key in a serial number and it pulls in the check image right then and there,” said Ronald Cymbor, a director of the Treasury’s Financial Processing Division. Cymbor adds that this real-time access to files also benefits agencies because they can quickly research issues for people who report in person that they

Then on May 24, 2006, the first of 27.5 million Treasury records were transferred to the new system. Nearly 40 stakeholders from the Federal Reserve, government agencies, and vendors saw it to completion. TCIS was online for business on June 5, 2006. “Everyone gave us their all. It was a flawless conversion,” Fanelli said.

Team members agree that the new system will undergo another real-world stress test when the U.S. Treasury starts issuing IRS refunds this year. Then the amount of outgoing checks will nearly double, and related claims will increase as well.

But even outside of tax season, Philadelphia’s team is certain the new system will deliver the highest level of financial integrity. In fact, they are confident TCIS provides superior standards of reliability to take us to the next decade.

OPERATING STATISTICS

Federal Reserve Bank of Philadelphia

In 2006, Philadelphia’s total volume of commercial checks processed increased 5 percent and the dollar value of transactions increased 34 percent, as a result of assuming processing from the East Rutherford Operations Center in the third quarter. The volume of U.S. government checks increased 1 percent in 2006 and the dollar value increased 2 percent.

The Philadelphia Reserve Bank continued to be a major processor of cash in the Federal Reserve System in 2006. While the volume of currency processed decreased 5 percent in 2006 because

the Bank processed a greater number of larger denominations, the actual dollar value of currency processed increased 7 percent. In 2006, an additional off-site terminal was opened; therefore, the volume of coin bags processed on site declined 7 percent. The processed coin value increased 5 percent as a result of processing higher denomination coin bags.

In 2006, both the number and value of loans to depository institutions were significantly lower than in the previous year.

SERVICES TO DEPOSITORY INSTITUTIONS

	2006 Volume	2006 Dollar Value	2005 Volume	2005 Dollar Value
Check processing:				
Commercial checks	1,020.3 million checks	\$3,019.9 billion	969.0 million checks	\$2,256.4 billion
U.S. Government	85.9 million checks	\$105.4 billion	84.9 million checks	\$103.2 billion
Cash operations:				
Currency processed	2,236.5 million notes	\$38.6 billion	2,351.4 million notes	\$36.1 billion
Coin paid and received	549.0 thousand bags	\$236.8 million	587.8 thousand bags	\$225.5 million
Loans to depository institutions during the year	75 loans	\$86.3 million	110 loans	\$823.6 million

BOARD of DIRECTORS

Federal Reserve Bank of Philadelphia

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Chairman, Federal Reserve Bank of Philadelphia Board of Directors. Board member since January 2001. President and Chief Executive Officer of ACCU Staffing Services. Director of Our Lady of Lourdes Medical Center. Member of the Advisory Board and Foundation Board of Rutgers University School of Business, Camden. Panelist for the Rutgers Quarterly Economic Outlook Panel. Member of the Women's Business Enterprise National Council.

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Board member since January 2003. Member Audit and Personnel Committees. President and CEO of A. Pomerantz & Company. Founding President of World Wide Concessions, Inc. Founder and Executive Director of PGA Urban Youth Golf Program of Greater Atlantic City. Founder and President of Youth Golf and Academics Program. Serves on boards of Boys and Girls Club of Camden County, Corporate Alliance for Drug Education, Greater Philadelphia Chamber of Commerce, Fairmount Park Commission, Neumann College, Philadelphia Sports Congress, Operation Good Neighbor, and Shippensburg University. Director Emeritus of Philadelphia Child Guidance Center. Member of Board of Governors of National Adoption Center.

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Board member since January 2006. Member Budget and Operations and Research and External Affairs Committees. President and CEO of Tasty Baking Company. Chairman of the Allegheny West Foundation. Serves on the Boards of Drexel University, Independence Blue Cross, Greater Philadelphia Chamber of Commerce, Philadelphia Stock Exchange, Brandywine Realty Trust, and Grocery Manufacturers of America.

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Board member since January 2004. Member of Budget and Operations and Research and External Affairs Committees. Director and CEO of Newfield Bancorp, Inc., Director and CEO of Newfield National Bank, and Director and Vice President of FNBN Investment Corp. Director of Atlantic Central Bankers Bank. Member of Kennedy Hospital Advisory Board and New Jersey Bankers Association. Serves as Chairman of the South Jersey Community Bankers Association.

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Board member since January 2002. Member Audit and Research and External Affairs Committees. Chairman and CEO of Townsends, Inc. Member of Board of Trustees of University of Delaware and Winterthur Museum. Member Winterthur Museum Garden, Collections and Library Committees. Serves on the Council of Advisors for Delaware Center of Horticulture and the Advisory Board for Lehman Art Center - Brooks School. Active participant on Delaware Art Museum Collections Committee.

Wayne R. Weidner

Board member since January 2005. Member Budget and Operations and Personnel Committees. Chairman National Penn Bancshares, Inc. Serves as a director of National Penn Bancshares, Inc., National Penn Bank, National Penn Investors Trust Company, Penn 1st Financial Services, and Hawk Mountain Council Boy Scouts of America.



Standing left to right: Eugene Rogers, Wayne Weidner, Coleman Townsend, Garry Maddox, and John Gerlach. Seated left to right: Charles Pizzi, Doris Damm, and William Hecht.

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Standing left to right: Robert Gronlund, David Wenger, Rodman Ward, and Eric May. Seated left to right: Keith Campbell, Reneé Amooore, and Daniel Blaschak. Not shown: Melinda Holman and Kenneth Tuckey

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Standing left to right: Michael Quick, Allan Dennison, John Parry, and Donna Coughey. Seated left to right: Mark Huntley and Peter Zimmerman. Not shown: John Adonizio and Thomas Bracken

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Standing left to right: Maurice Dawkins, Larry Miller, Jeff March, and Larry Stoner. Seated left to right: Edwin Williams, Alfreda Earnest, and James Everhart. Not shown: Dorothy Fox

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Customer Relations

Wanda Preston
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Patrick Turner
IT Services Officer
Information Technology
Services

STATEMENT *of* AUDITOR INDEPENDENCE

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2006 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$4.2 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 2006, the Bank did not engage PwC for any material advisory services.

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LETTER *to* DIRECTORS

Federal Reserve Bank of Philadelphia



FEDERAL RESERVE BANK
OF PHILADELPHIA

March 5, 2007

To the Board of Directors

The management of the Federal Reserve Bank of Philadelphia ("FRBP") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2006 (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 management judgments and estimates. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

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

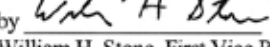
Even effective internal control, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements. Also, projections of any evaluation of effectiveness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

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

Management's assessment of the effectiveness of the FRBP's internal control over financial reporting as of December 31, 2006, is being audited by PricewaterhouseCoopers LLP, the independent registered public accounting firm which also is auditing the FRBP's Financial Statements.

Federal Reserve Bank of Philadelphia

by 
Charles L. Plosser, President

by 
William H. Stone, First Vice President

by 
Donna L. Franco, Chief Financial Officer

REPORT *of* INDEPENDENT AUDITORS

Federal Reserve Bank of Philadelphia



PricewaterhouseCoopers LLP
1800 Tysons Boulevard
McLean, VA 22102-4261
Telephone (703) 918 3000
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Report of Independent Auditors

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

We have completed an integrated audit of the Federal Reserve Bank of Philadelphia's (the "Bank") 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 Philadelphia (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.

Continued on page 36

REPORT of INDEPENDENT AUDITORS

Federal Reserve Bank of Philadelphia

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
McLean, Virginia

STATEMENTS *of* CONDITION

Federal Reserve Bank of Philadelphia

As of December 31, 2006 and December 31, 2005 (in millions)

	2006	2005
ASSETS		
Gold certificates	\$ 463	\$ 432
Special drawing rights certificates	83	83
Coin	53	34
Items in process of collection	649	586
U.S. government securities, net	34,021	26,613
Investments denominated in foreign currencies	1,152	473
Accrued interest receivable	292	207
Interdistrict settlement account	836	6,148
Bank premises and equipment, net	81	75
Interest on Federal Reserve notes due from U.S. Treasury	305	29
Other assets	58	103
	<hr/>	<hr/>
Total assets	\$ 37,993	\$ 34,783
	<hr/> <hr/>	<hr/> <hr/>
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	\$ 31,700	\$ 31,296
Securities sold under agreements to repurchase	1,286	1,082
Deposits:		
Depository institutions	584	485
Other deposits	3	4
Deferred credit items	718	363
Accrued benefit costs	70	43
Other liabilities	12	22
	<hr/>	<hr/>
Total liabilities	34,373	33,295
	<hr/>	<hr/>
Capital:		
Capital paid-in	1,810	744
Surplus (<i>including accumulated other comprehensive loss of \$24 million at December 31, 2006</i>)	1,810	744
	<hr/>	<hr/>
Total capital	3,620	1,488
	<hr/>	<hr/>
Total liabilities and capital	\$ 37,993	\$ 34,783
	<hr/> <hr/>	<hr/> <hr/>

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

STATEMENTS *of* INCOME

Federal Reserve Bank of Philadelphia

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

	2006	2005
Interest income:		
Interest on U.S. government securities	\$ 1,454	\$ 958
Interest on investments denominated in foreign currencies	20	7
	<hr/>	<hr/>
Total interest income	1,474	965
	<hr/>	<hr/>
Interest expense:		
Interest expense on securities sold under agreements to repurchase	56	28
	<hr/>	<hr/>
Net interest income	1,418	937
	<hr/>	<hr/>
Other operating income (loss):		
Compensation received for services provided	32	25
Reimbursable services to government agencies	31	25
Foreign currency gains (losses), net	66	(70)
Other income	3	5
	<hr/>	<hr/>
Total other operating income (loss)	132	(15)
	<hr/>	<hr/>
Operating expenses:		
Salaries and other benefits	90	81
Occupancy expense	11	10
Equipment expense	11	11
Assessments by the Board of Governors	51	34
Other expenses	42	37
	<hr/>	<hr/>
Total operating expenses	205	173
	<hr/>	<hr/>
Net income prior to distribution	\$ 1,345	\$ 749
	<hr/> <hr/>	<hr/> <hr/>
Distribution of net income:		
Dividends paid to member banks	\$ 80	\$ 31
Transferred to surplus	1,090	450
Payments to U.S. Treasury as interest on Federal Reserve notes	175	268
	<hr/>	<hr/>
Total distribution	\$ 1,345	\$ 749
	<hr/> <hr/>	<hr/> <hr/>

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

STATEMENTS *of* CHANGES *in* CAPITAL

Federal Reserve Bank of Philadelphia

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

	SURPLUS				
	Capital Paid-In	Net Income Retained	Accumulated Other Comprehensive Loss	Total Surplus	Total Capital
Balance at January 1, 2005 (5.9 million shares)	\$ 294	\$ 294	\$ -	\$ 294	\$ 588
Net change in capital stock issued (9.0 million shares)	450	-	-	-	450
Transferred to surplus	-	450	-	450	450
Balance at December 31, 2005 (14.9 million shares)	\$ 744	\$ 744	\$ -	\$ 744	\$ 1,488
Net change in capital stock issued (21.3 million shares)	1,066	-	-	-	1,066
Transferred to surplus	-	1,090	-	1,090	1,090
Adjustment to initially apply FASB Statement No. 158	-	-	(24)	(24)	(24)
Balance at December 31, 2006 (36.2 million shares)	\$ 1,810	\$ 1,834	\$ (24)	\$ 1,810	\$ 3,620

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

NOTES *to* FINANCIAL STATEMENTS

Federal Reserve Bank of Philadelphia

1. STRUCTURE

The Federal Reserve Bank of Philadelphia (“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 in Philadelphia serves the Third Federal Reserve District, which includes Delaware and portions of New Jersey and Pennsylvania.

In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a board of directors. The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors of the Federal Reserve System (“Board of Governors”) to represent the public, and six directors are elected by member banks. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership 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 Federal Reserve Bank of New York (“FRBNY”), and on a rotating basis four other Reserve Bank presidents.

2. OPERATIONS AND SERVICES

The Reserve Banks perform a variety of services and operations. 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 FRBNY for its execution of transactions. The FRBNY is authorized and directed by the FOMC to conduct operations

NOTES *to* FINANCIAL STATEMENTS

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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 FRBNY 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 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. The FRBNY 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 FRBNY 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 FRBNY may enter into transactions that contain varying degrees of off-balance-sheet market risk that result from their future settlement and counter-party credit risk. The FRBNY 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 Collateral Management System, Electronic Cash Letter System, Groupware Leadership Center, Subcommittee on Credit, Reserves, and Risk Management Administration Office, Treasury Check Information Services Central Business Administration Function, and Treasury Direct Central Business Administration Function.

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.

NOTES *to* FINANCIAL STATEMENTS

Federal Reserve Bank of Philadelphia

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 FRBNY. The FRBA and the FRBNY compensate the other Reserve Banks for the costs incurred to provide these services. This compensation is reported as a component of "Compensation received for services provided," and the Bank would have reported \$26 million as compensation received for services provided had this policy been in place in 2005 for ACH, Fedwire funds transfer, and securities transfer 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

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Federal Reserve Bank of Philadelphia

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 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 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, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropri-

NOTES *to* FINANCIAL STATEMENTS

Federal Reserve Bank of Philadelphia

ate 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. Loans to depository institutions are reported as “Other Assets.”

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 Sold Under Agreements to Repurchase and Securities Lending

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 FRBNY 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 FRBNY 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 FRBNY and an authorized

NOTES *to* FINANCIAL STATEMENTS

Federal Reserve Bank of Philadelphia

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 prearranged 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 FRBNY 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 FRBNY 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.

NOTES *to* FINANCIAL STATEMENTS

Federal Reserve Bank of Philadelphia

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 \$6,957 million and \$6,130 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.

NOTES *to* FINANCIAL STATEMENTS

Federal Reserve Bank of Philadelphia

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 accu-

mulated other comprehensive income is provided in Notes 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.

The Treasury and other government agencies reimbursement process for all Reserve Banks is centralized at the Bank. Each Reserve Bank transfers

NOTES *to* FINANCIAL STATEMENTS

Federal Reserve Bank of Philadelphia

its Treasury reimbursement receivable to the Bank. The reimbursement receivable is reported in "Other assets" and totaled \$29 million and \$67 million at December 31, 2006 and 2005, respectively. The cost of unreimbursed Treasury services is reported in "Other expense" and was immaterial at December 31, 2006 and 2005.

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 \$2 million for each of the years ended December 31, 2006 and 2005 and are reported as a component of "Occupancy expense".

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 capac-

ity in some locations. These restructuring activities continued in 2004 through 2006.

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
Accrued benefit costs	46	24	70
Total liabilities	\$34,349	\$24	\$34,373
Surplus	1,834	(24)	1,810
Total capital	\$3,644	\$(24)	\$3,620

NOTES *to* FINANCIAL STATEMENTS

Federal Reserve Bank of Philadelphia

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

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 4.342 percent and 3.547 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	\$ 12,027	\$ 9,623
Notes	17,469	13,484
Bonds	4,321	3,293
Total par value	33,817	26,400
Unamortized premiums	378	313
Unaccreted discounts	(174)	(100)
Total allocated to the Bank	\$ 34,021	\$ 26,613

At December 31, 2006 and 2005, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was \$34,555 million and \$27,226 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 \$1,286 million and \$1,082 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 \$1,288 million and \$1,084 million was allocated to the Bank. The contract amount for securities sold under agreements to repurchase approximates fair value.

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, 2006, was as follows (in millions):

NOTES *to* FINANCIAL STATEMENTS

Federal Reserve Bank of Philadelphia

	U.S. Government Securities (Par Value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	\$ 1,762	\$ 1,286
16 days to 90 days	7,854	-
91 days to 1 year	8,037	-
Over 1 year to 5 years	9,733	-
Over 5 years to 10 years	2,937	-
Over 10 years	3,494	-
	<hr/>	<hr/>
Total allocated to the Bank	<u>\$ 33,817</u>	<u>\$ 1,286</u>

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 \$298 million and \$134 million, respectively, were allocated to the Bank.

5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and with the Bank for International Settlements and invests in foreign government debt instruments. 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 5.626 percent and 2.497 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):

	2006	2005
European Union Euro:		
Foreign currency deposits	\$ 351	\$ 136
Securities purchased under agreements to resell	125	48
Government debt instruments	229	89
	<hr/>	<hr/>
Japanese Yen:		
Foreign currency deposits	146	65
Government debt instruments	301	135
	<hr/>	<hr/>
Total allocated to the Bank	<u>\$ 1,152</u>	<u>\$ 473</u>

At December 31, 2006 and 2005, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was \$1,150 million and \$474 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 mil-

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lion 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):

	European Euro	Japanese Yen	Total
Within 15 days	\$ 245	\$ 147	\$ 392
16 days to 90 days	134	68	202
91 days to 1 year	137	124	261
Over 1 year to 5 years	189	108	297
Total allocated to the Bank	<u>\$ 705</u>	<u>\$ 447</u>	<u>\$ 1,152</u>

At December 31, 2006 and 2005, there were no material 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):

	2006	2005
Bank premises and equipment:		
Land	\$ 3	\$ 3
Buildings	84	78
Building machinery and equipment	13	12
Construction in progress	1	1
Furniture and equipment	68	66
Subtotal	<u>169</u>	<u>160</u>
Accumulated depreciation	(88)	(85)
Bank premises and equipment, net	<u>\$ 81</u>	<u>\$ 75</u>
Depreciation expense, for the year ended December 31	<u>\$ 9</u>	<u>\$ 10</u>

The Bank leases space to an outside tenant with a remaining lease term of 4 years. Rental income from such leases was \$1 million for each of 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 the noncancelable lease agreement in existence at December 31, 2006, are as follows (in millions):

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2007	\$	1
2008		1
2009		1
2010		1
		<hr/>
Total	\$	4
		<hr/> <hr/>

The Bank has capitalized software assets, net of amortization, of \$8 million and \$10 million at December 31, 2006 and 2005, respectively. Amortization expense was \$3 million and \$1 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 or the Bank's decision to increase efficiency included equipment. Asset impairment losses of \$466 thousand for the period ending December 31, 2005 were 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 1 to approximately 3 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, 2006 and 2005. Certain of the Bank's leases have options to renew. The Bank has no capital leases.

Future minimum rental payments under noncancelable operating leases with terms of one year or more, at December 31, 2006 were not material.

At December 31, 2006, the Bank, acting on behalf of the Reserve Banks, had a contractual commitment extending through the year 2008 with a remaining amount of \$4 million which is included as a component of "Other assets" in the Statement of Condition. This commitment represents software licenses and maintenance. The 2007 fixed payment under this commitment is \$2 million.

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

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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 FRBNY acts as a sponsor of the System Plan and the costs associated with the Plan are not redistributed to other participating employers.

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 \$3 million for each of the years ended December 31, 2006 and 2005 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.

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

	2006	2005
Accumulated postretirement benefit obligation at January 1	\$ 46.2	\$ 41.9
Service cost-benefits earned during the period	1.4	1.0
Interest cost on accumulated benefit obligation	2.8	2.4
Actuarial loss	15.2	3.2
Contributions by plan participants	1.0	1.0
Benefits paid	(3.3)	(3.3)
Plan amendments	(0.2)	-
Accumulated postretirement benefit obligation at December 31	<u>\$ 63.1</u>	<u>\$ 46.2</u>

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 balance of the plan assets, the unfunded postretirement benefit obligation, and the accrued postretirement benefit costs (in millions):

	2006	2005
Fair value of plan assets at January 1	\$ -	\$ -
Contributions by the employer	2.3	2.3
Contributions by plan participants	1.0	1.0
Benefits paid	(3.3)	(3.3)
Fair value of plan assets at December 31	<u>\$ -</u>	<u>\$ -</u>
Unfunded postretirement benefit obligation	<u>\$ 63.1</u>	\$ 46.2
Unrecognized prior service cost		6.2
Unrecognized net actuarial loss		(15.3)
Accrued postretirement benefit cost		<u>\$ 37.1</u>

Amounts included in accumulated other comprehensive loss are shown below (in millions):

Prior service cost	\$ 5.0
Net actuarial loss	(28.8)
Total accumulated other comprehensive loss	<u>\$ (23.8)</u>

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:

	2006	2005
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

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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	\$ 0.3	\$ (0.5)
Effect on accumulated postretirement benefit obligation	4.5	(6.4)

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

	2006	2005
Service cost-benefits earned during the period	\$ 1.4	\$ 1.0
Interest cost on accumulated benefit obligation	2.8	2.4
Amortization of prior service cost	(1.3)	(1.3)
Recognized net actuarial loss	1.6	1.0
Total periodic expense	<u>4.5</u>	<u>3.1</u>
Net periodic postretirement benefit expense	<u>\$ 4.5</u>	<u>\$ 3.1</u>

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2007 are shown below (in millions):

Prior service cost	\$ (1.3)
Net actuarial loss	3.2
Total	<u>\$ 1.9</u>

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 loss in the accumulated postretirement benefit obligation.

There were no receipts of federal Medicare subsidies in the year ended December 31, 2006. Expected

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receipts in the year ending December 31, 2007, related to payments made in the year ended December 31, 2006, are \$.3 million.

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

	Without Subsidy	With Subsidy
2007	\$ 3.5	\$ 3.1
2008	3.8	3.3
2009	4.0	3.5
2010	4.3	3.7
2011	4.5	3.9
2012-2016	26.3	22.5
Total	<u>\$ 46.4</u>	<u>\$ 40.0</u>

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 \$6 million and \$5 million, respectively. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2006 and 2005 operating expenses were \$1 million and \$20 thousand, 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 Postretirement Benefits other than Pensions
Balance at December 31, 2005	\$ -
Adjustment to initially apply FASB Statement No. 158	(24)
Balance at December 31, 2006	<u>\$ (24)</u>

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