

FACING CHANGE, MANAGING RISK

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Facing Change and Managing Risk

Change and risk are words that are inextricably linked, and nowhere is this more evident than in the financial system. As markets grow more complex, as technology advances, as customers demand more services, the financial system must adapt to meet the needs of this ever-changing environment. Every step of the way, we must consider how to balance risk with the benefits and necessity of progress.



Anthony M. Santomero, President

The Philadelphia Fed's 2005 annual report, "Facing Change, Managing Risk," examines this concept in detail. After all, as stewards of the financial system, it is the responsibility of the Federal Reserve System to navigate these changes, helping to ensure a thriving and prosperous economy for our nation.

This particular annual report is special to me because it covers my last year as president of the Federal Reserve Bank of Philadelphia. I have been part of this Bank for nearly six years, including two years as a voting member of the Federal Open Market Committee. I am honored to have had the opportunity to lead such a prestigious institution as the Philadelphia Fed and to have worked with so many talented and dedicated people.

Leading Change

Our Bank has adapted to the changing times and has emerged as an even stronger and more vital institution. When I took office, my vision was for the Philadelphia Bank to be known as an important center of central bank knowledge and capability. I believe this vision has been

achieved in ways that have touched on virtually every aspect of the Fed. In my final message as president, I would like to share with you some highlights of the Philadelphia Bank's accomplishments here in our District as well as in the Federal Reserve System.

The Philadelphia Fed has long been a System leader in providing financial services to depository institutions. This is perhaps most evident in check operations. In 2005, we further solidified our position of strength when the Philadelphia Fed was selected to

become a System consolidation site for check processing, absorbing New York's East Rutherford Operations Center, known as EROC. The Federal Reserve System chose Philadelphia based on its overall productivity and efficiency, its ability to handle the total check volume of both Districts, and its proximity to New York financial institutions. This new responsibility will mean additional equipment and space renovations to accommodate the increased workload. Furthermore, in the second half of 2006, we expect to create a substantial number of new positions to help process the additional volume.

The Philadelphia Fed has also played a key role in providing financial services to the U.S. Treasury. We are now one of only two sites in the System that clear government-issued checks, and we have been actively engaged in modernizing the way the federal government makes these payments.

At the same time, we have been involved in the ongoing monitoring of the nation's financial and payment systems. Studies produced here and throughout the Federal Reserve System have emphasized the remarkable evolution taking place in U.S. payments. Later in this book, First Vice President Bill Stone elaborates on just how pervasive payment changes have become.

We have advanced the System's knowledge of evolving payments mechanisms as the first Federal Reserve Bank to establish a dedicated Payment Cards Center. In 2005, the Center produced papers and conducted conferences and workshops on a number of important topics to provide meaningful insights into developments in consumer credit and payments.

Indeed, we are a palpable presence in the research and policy arena, which is perhaps most visible to the general public in our annual Philadelphia Fed Policy Forum. In 2005, we looked at "Fiscal Imbalance: Problems, Solutions, and Implications." As in past years, the event brought together leading academics, policymakers, and market economists for debate and discussion of relevant macroeconomic and monetary policy issues.

Managing Risk

In central bank administration, 2005 was an important year as well. Over the past several years we have carved out a role in the "knowledge and information" sector of the Fed's infrastructure. We now lead the System in the challenging area of Enterprise Risk Management (ERM). Our Bank's ERM group, as well as our well-regarded accounting professionals, has furthered our reputation as an extremely efficient, high-quality organization with a strong focus on controls and risk management. In 2005, we developed a relationship with the central bank of Spain, which wants to implement an ERM program. As a result of this contact, our chief financial officer has been asked to co-chair a consortium of central banks—from Europe and elsewhere—that will meet annually to discuss common risk-management concerns.

In an environment of high loan growth in 2005, our Supervision, Regulation and Credit (SRC) Department continued working with banks to ensure that credit quality

"Tony Santomero is an accomplished leader and talented economist. We at the Federal Reserve have greatly benefited from his perspective and keen insights. He has been a valued voice of wisdom at our meeting table. We will miss him."

— Former Chairman
Alan Greenspan

The Philadelphia
Fed is an
organization
with a powerful
niche in
public service
and a stellar
reputation for
quality and
credibility.

was never compromised. As the banking industry becomes more complex and competitive, the tenets of capital adequacy and risk management are more important than ever before. At the Philadelphia Fed, we recognize this and have established a unit in SRC to analyze retail credit risk. Now the System has charged us with developing the strategy for implementing this part of the new Basel II capital requirements. We are also home to the System's Subcommittee on Credit, Reserves, and Risk Management, known as SCRRM. Our Bank has led the way here by coordinating System policies to supply depository institutions with needed liquidity, implement new discount window policies, and direct the upgrade of supporting System technology.

Sharing Knowledge

As important as it is to have knowledge and expertise, it is just as important to share it. Therefore, we have made strong contributions to our community and our country in the area of economic outreach. In 2005, our Bank offered a number of programs to promote knowledge and share resources concerning personal finance and the U.S. economy.

We produced the educational consumer video, "Buried by Debt: The Dangers of Borrowing," which offers at-risk consumers real-life examples of lending abuses and offers tips to avoid falling victim to such abuses. Philadelphia is a System leader in economic education and has developed financial literacy curriculums used both locally and nationally. In addition, our programs to promote financial literacy, improve access to credit, end predatory lending, and foster urban development continue to make a real difference in our District's communities.

Indeed, not only has the Bank become an even more important part of the Philadelphia community but also of economic policy discussions in our District. Our participation in these discussions has affirmed the Philadelphia Fed's expertise in monetary policy.

Board of Directors

Of course, all of this would not be possible without the leadership and support of our board of directors, who guide us in all our accomplishments. It is only fitting that we recognize our debt to them for their service. These nine individuals play an important role in keeping us in touch with our District and by performing the oversight role of directors everywhere.

We offer our sincere thanks to two members of our board who have completed their terms of service with us: Robert E. Chappell, chairman and CEO of The Penn Mutual Life Insurance Company, and Kenneth R. Shoemaker, president and CEO of Orrstown Bank. Each was a valuable contributor to our board and helped immeasurably in our attempts to maintain close contacts with all sectors within the District.

We offer special thanks to our outgoing chairman of the board, Ron Naples. His leadership, keen insights into the regional, national, and global economy, and his corporate governance skills will be missed—as will his good humor.

I am pleased to report that Doris M. Damm, president and CEO of ACCU Staffing Services, has been appointed chairman of the board of directors, and William F. Hecht,

chairman and CEO of PPL Corporation, has been appointed deputy chairman of the board of directors. I leave my position with the knowledge that the Bank's board has strong leaders at the top.

At the same time, we welcome our newest board members and look forward to their counsel and guidance. John G. Gerlach, president and CEO of Pocono Community Bank; Audrey S. Oswell, president and CEO of Resorts Atlantic City; and Charles P. Pizzi, president and CEO of Tasty Baking Company, joined the board on January 1, 2006. On behalf of all of us here at the Philadelphia Fed, I thank our board for its valuable contributions.

Let me also acknowledge the contribution of Bruce L. Hammonds, president and CEO of MBNA Corporation, who has completed his term as a member of the Federal Advisory Council (FAC), and welcome Ted T. Cecala, chairman and CEO of Wilmington Trust Company, who has been appointed to represent the Third District on the FAC.

Closing Thoughts

The world has changed a great deal in just the first few years of this new millennium and so, too, has the Philadelphia Reserve Bank. We are strongly connected to the financial industry and engaged in our community. We have increased our visibility in our District on many fronts. We contribute to and lead many System initiatives. I am confident this tradition of excellence will carry on as the Philadelphia Fed continues to be a high-quality provider of financial services and a leader in the Federal Reserve System.

As part of the nation's central bank, the Philadelphia Fed is an organization with a powerful niche in public service and a stellar reputation for quality and credibility. Our Bank will continue to move forward under its new leadership and will remain steadfastly committed to the strength and growth of the Third District's economy.

In closing, I would like to express my gratitude for having had the pleasure of national service in a truly outstanding institution and for the opportunity to work under Alan Greenspan, a Chairman who was universally regarded as America's and the world's finest central banker. At the same time, I applaud the President's choice of Ben Bernanke as the 14th Chairman of the Board of Governors. The Federal Reserve is in good hands.



Anthony M. Santomero
President
March 2006

“President Santomero has made significant contributions to the Bank, the Federal Reserve System, and our region. We will miss his outstanding leadership and knowledge. We have full confidence in the leadership team Tony helped build that will continue to manage the Bank .”

— Ronald J. Naples
2005 Chairman, Board of Directors

Santomero's Reflections on Greenspan and Bernanke

Alan Greenspan

How did Alan Greenspan accomplish so much? Everyone wants to know the answer to this and there is no shortage of explanations. But from my vantage point the answer is rather clear.

Alan Greenspan is first and foremost an extraordinary economist. As a professional economic forecaster, he has an uncanny ability to project our economy's course. His almost total recall of even the most obscure statistics is unparalleled. As a result, he has shown the most remarkable ability to adapt to the pervasive, ongoing changes in the economy while still standing strong against inflation.

But while Alan Greenspan is an extraordinary economist, he is also an extraordinary leader. He will be remembered as a consensus builder and a developer of talent. It shows in the strength of the organization and the strong consensus that has been achieved at our monetary policy meetings. Unanimity has been the rule, not the exception, in spite of strong voices and difficult circumstances. This is a testament to his leadership.

Yet, historians will probably most remember Greenspan and the Greenspan era for the changes made to transparency in Fed policymaking over the past decade. This openness has been the defining aspect of monetary policy under Greenspan. Information about the Fed's policy goals, its assessment of the current economic situation, and its strategic direction are increasingly part of the public record.



Former Chairman Alan Greenspan

Ben Bernanke

Chairman Bernanke has close ties to the Philadelphia Bank. He served as a visiting scholar in our Research Department, a participant in our annual Policy Forum, and a neighbor during his time at Princeton.

I came to know Ben quite well when he was on the Board of Governors in 2003 and 2004, and I always appreciated his collegiality and insight. He is scholarly and unassuming — a true intellectual. He is a man of impeccable credentials and sound policy judgment. His reputation is one of intellectual rigor and integrity.

Ben is considered one of the finest monetary economists of our time, with a gift for understanding how economic concepts apply to real world markets. This allows him to neatly bridge the gap between sound ideas and good policies. He questions the status quo and offers fresh interpretations of the data.

As chair of Princeton's Economics Department, Bernanke described his managerial style as "primus inter pares" (first among equals). He has said, "We're all the same rank. I'm just the one sitting in the chair." This approach could also serve him well as Chairman of the FOMC, where all participants contribute to the outcome and policy action.



Chairman Ben Bernanke

The Transition to a New Chairman

By Anthony M. Santomero

The prospect of a new Chairman at the helm of the Federal Reserve has always caused anxiety from Wall Street to Main Street. Here President Anthony Santomero shares his thoughts on the Fed's transition to a new Chairman, bidding farewell to the venerable Alan Greenspan and welcoming a new era under Chairman Ben Bernanke.

The Changing of the Guard

When Alan Greenspan was nominated to replace Paul Volcker as head of the Federal Reserve in June 1987, the world's financial markets collectively held their breath. Skepticism was rampant as to whether Greenspan would be able to do as good a job as Volcker.

A *New York Times* article expressed these concerns, saying:

"The markets had incredible confidence in Paul. Investors saw him as the one guy with the knowledge, guts and skill to stop inflation and hold the system together... Indeed, some economists are saying that one reason there is growing fear of an economic catastrophe is that the Reagan administration let Volcker go, replacing him with the less-experienced and less-well-known Alan Greenspan."

Barron's also opined on the transition, calling Volcker "a legend in his own time," and comparing him to Greenspan, who was "a relatively unknown quantity." Little did they know at the time, they were referring to the man who would come to be known as "the Maestro."



Federal Reserve Chairman Ben Bernanke, former Chairman Paul Volcker, and former Chairman Alan Greenspan at a reception in January 2006.

The Volcker Legacy

Before Greenspan, Paul Volcker earned quite a reputation — for himself and for the Federal Reserve as an institution. When he assumed office in 1979, Volcker also assumed the burden

of double-digit inflation. It was the most sustained period of inflation post-WWII America had ever faced—rising at annual rates of over 10 percent and up to 14 or 15 percent in some months. As Fed Chairman, Volcker devised a strategy that would crush inflation and change the face of central banking.

Rather than follow the Fed's traditional practice of nudging interest rates

up or down, he decided the Fed should focus on controlling the money supply and be committed to slowing monetary growth to beat inflation. To achieve its money growth targets, the Fed would have to allow interest rates to rise, and they rose dramatically. The fed funds rate reached 19 percent in 1981 and held fast despite the ensuing recession.

But the policy proved effective, and within three years, inflation had been tamed. By 1983, Volcker's policy succeeded in bringing the inflation rate down to around 4 percent, and the economy was on the path to a sustained expansion. Volcker was lauded as a genius, and his powerful policy changes earned the Fed an unprecedented level of credibility and prestige.

Greenspan's Tenure

At his confirmation hearing before the Senate Banking Committee, Greenspan spoke of the same Fed goals Volcker had advocated. He too recognized and argued forcefully that to create an environment for solid, sustained economic growth, it was absolutely crucial that the Fed focus on containing inflation.

As the expansion of the 1980s matured, the Chairman remained true to his words. However, only two months after he took office, Greenspan was faced with the biggest stock market crash since the Great Depression. On October 19, 1987—Black Monday—the Dow Jones Industrial Average plummeted nearly 23 percent, its greatest loss ever in percentage terms. Amid widespread fears of a recession, Greenspan acted quickly to provide liquidity to financial markets and calm investors. His quick response



Chairman Bernanke and former Chairman Greenspan at the public swearing-in ceremony on February 6, 2006.

and competent leadership shaped his reputation and earned him high marks from his peers and the public. The Fed's actions under Greenspan helped secure public confidence in future price stability, though not without a period of recession as the new decade began.

It was during the expansion of the 1990s that Chairman Greenspan put his own unique stamp on the conduct of monetary policy. In the first half of the decade, the economy moved from recession to recovery, and the Fed removed the monetary accommodation it had provided. Then, mid-decade, the economy began to boom. Growth accelerated, and unemployment began falling to levels not seen in 30 years. The orthodox monetary policy prescription was to tighten. But Greenspan veered from the orthodox view. He believed that the rules of the game had changed. In a new era of accelerating productivity growth and increased competition, he believed it was possible to run the economy on all cylinders and close to full employment, without undue inflationary pressures. With the Fed ever-vigilant, the expansion went on to become the longest in U.S. history.

Still, Greenspan knew that all was not perfect. In 1996, he gave his famous "irrational exuberance" speech, alluding to concerns about a stock market bubble. When the bubble finally burst and the economy fell into recession, the Federal Reserve responded aggressively. Short-term rates were slashed nearly 5 percent in one year and brought down to a mere 1 percent by 2003. The U.S. financial markets had not seen rates so low in nearly 50 years.

Supported by strong monetary stimulus, the economy proved surprisingly resilient—indeed, more so than most had believed possible. Despite an unprecedented series of disturbances—the declining stock market, a terrorist attack on American soil, two wars, numerous financial scandals, skyrocketing oil prices, and even natural disasters—the economy recovered and again embarked on a path of sustainable expansion. Indeed, under Chairman Greenspan's leadership, the 21st century began with the Fed providing the economy with unprecedented monetary support during a difficult downturn and, at the same time, preserving public confidence in its commitment to long-term price stability.

Alan Greenspan served as Fed Chairman for more than 18 years. The second longest-serving Chairman in the history of the Fed, he was appointed or reappointed by four different Presidents. During his tenure, the U.S. economy achieved both strong growth and stable prices. Inside the Fed, Greenspan, like Volcker, exerted a powerful influence and fundamentally altered the way we think about policymaking.

Bernanke at the Helm

In February 2006, Ben Bernanke succeeded Alan Greenspan as Fed Chairman. Again, there is some apprehension because a relative unknown is following a celebrated success. Again, the incoming Chairman has stated publicly his commitment to pursuing the Fed's fundamental goals, in particular, preserving a stable price environment. If history is a guide, circumstances will

“The Fed’s job is to take away the punch bowl just when the party really gets going.”

*— Former Chairman
William McChesney Martin*

Ben Bernanke is an accomplished scholar in the field of monetary economics and widely recognized as a deep thinker and clear communicator.

challenge the new Chairman to meet that commitment and offer him opportunities to put his own stamp on the conduct of monetary policy.

On a personal level, Chairman Bernanke has the talent and expertise to serve well as the head of the nation's central bank. He is an accomplished scholar in the field of monetary economics, a former Fed Governor and economic advisor to the President, and widely recognized as a deep thinker and clear communicator.

Beyond that, Ben Bernanke has the support of his colleagues on the FOMC in monetary policy matters. All seven Fed Governors and 12 Reserve Bank presidents participate in FOMC meetings, collectively assessing the economy, discussing policy alternatives, and ultimately selecting a policy action.

Among the most powerful allies Chairman Bernanke has in making effective monetary policy is one his predecessor helped to create: greater transparency. Greater openness about monetary policy decisions was a defining aspect of the Greenspan Fed, and it was an important means through which Greenspan built the Fed's reputation and influence.

Prior to 1994, there was no direct communication between the FOMC and the markets. Today, the FOMC issues press releases after each meeting, stating its near-term fed funds target, with an explanation of the action and an indication of the likely future course of policy. The release also summarizes the FOMC's outlook for growth and inflation.

This transparency in monetary policy only enhances its effectiveness. Indeed, the financial markets begin building anticipated policy actions into asset prices even *before* they are actually implemented. Thus, the response to Fed policy in the financial sector, and in the economy as a whole, is swifter, smoother, and stronger than it would otherwise be.

Our new Chairman is a strong supporter of transparency, and, as a Governor, he had often spoken in support of a more open Federal Reserve System. For instance, he has already indicated that he would like to see more consideration of an explicit inflation target. So, indications are that the Fed may well consider additional steps toward transparency under Chairman Bernanke.

The Chairman's Leadership

Looking back, Paul Volcker and Alan Greenspan came to the Fed Chairmanship with a strong sense of the Fed's mission, keen insight into the workings of the economy, and the confidence to act decisively in the face of challenging circumstances. During their tenures, they advanced the Fed's capabilities and instilled strong public confidence.

Sharing their strengths and building on their legacy, Ben Bernanke now leads the way as Fed Chairman. We will all be watching to see how the new leader of the Fed changes the System's approach to monetary policy and builds on its strong legacy.

FACING CHANGE, MANAGING RISK

“Facing Change, Managing Risk” aptly describes the work of the Federal Reserve Bank of Philadelphia in 2005. We have even recently seen change at the highest level as the Federal Reserve System welcomed new Chairman Ben Bernanke. The Philadelphia Bank is expecting to soon have a new president as well.

Without question change has been an integral part of the financial services landscape over the last several years. For the nation’s central bank, managing the risks inherent in this evolution is always a top priority.

In this report, we have highlighted the Philadelphia Reserve Bank’s role in both meeting the needs of the ever-changing banking environment and addressing the associated risks.

Evolution of Payments in the U.S.

By William H. Stone, Jr.

The 2004 Federal Reserve Payments Study asserted that electronic payments, for the first time ever, had trumped paper checks in number of total transactions. First Vice President William Stone discusses the major changes faced by our nation's payments system and shares how the Federal Reserve is managing the risks inherent in this evolution.

The Federal Reserve is highly vested in the evolution of payments. Our role encompasses both the responsibility to maintain the integrity of the payments system and participation in new innovation as a financial services provider.

According to the Fed's most recent study, only about 45 percent of all U.S. noncash retail payments are made by paper check, with payment cards and ACH accounting for much of the remainder. At current growth rates, credit cards and debit cards will *both individually* surpass the paper check in terms of total annual transactions by 2007.

From the early days of banking until quite recently, checks had maintained dominance as our nation's noncash payment of choice. Then, in the early 1970s, the Fed introduced its automated clearinghouse (ACH) and began an evolution of electronic payments that would replace transactions traditionally made via checks. ACH grew quickly by distributing various U.S. Treasury credit payments, such as armed services payrolls and Social Security payments, to name just a few. Commercial bank credit payments, such as direct deposit of employers' pay-



William H. Stone, Jr., First Vice President

rolls, quickly followed, as did other forms of debit and credit payments.

Financial institutions continue to find innovative uses for ACH, spanning a broad range of retail transactions and shifting substantial volumes to this system, primarily at the expense of check

volume. A relatively recent variation even allows merchants to convert paper checks to electronic payments through the ACH at the point of purchase. Another variation, known as ARC, for accounts receivable conversion, allows billers such as utilities and credit card issuers to convert checks that are sent to pay monthly bills. These new uses have increased substantially as of late.

But despite innovations in ACH, the greatest driver of change in our nation's payments system has been payment cards. The credit card was the first ubiquitous consumer-based electronic payments instrument to emerge, and it was the credit card that proved most instrumental in moving payments from paper to electronics at the point of sale. Credit cards began as offline travel and dining cards in the 1960s, grew to become more general-purpose purchasing cards in the 1970s, and then increased vastly in usage in the 1980s.

Technology Boom

In the 1990s, when the technology boom made information processing and telecommunications more powerful and less expensive, credit card companies were poised to gain. Low-cost telecom has made real-time, point-of-service verification of cardholders and their credit availability widespread, speeding transactions and curtailing fraud. Of significance for the future, this technology has made the credit card a viable means of payment for e-commerce as well. We have also seen a rise in Internet person-

to-person payments supported by credit cards. In addition, some banks and other card issuers even offer online consolidated bill payment on their websites.

The second most popular electronic instrument for making retail payments today is the debit card. It arrived on the scene relatively recently—during the 1980s—but its growth in usage has already been dramatic.

Payment Card Growth

At first, the debit card emerged as a result of automated teller machine (ATM) systems, but it then moved beyond being solely a mechanism to access currency. Now, bank customers have the option to simply present the card to the merchants and have their bank account directly debited.

The Fed's payment study found that debit payments had the largest compound annual growth rate, at 24 percent. Indeed, the growing popularity of debit cards seems to be part of a broader phenomenon. Last year, Visa announced that for the first time ever, its global debit transaction volume surpassed its credit transaction volume.

The last decade has marked a clear turning point in our payments system. From that time on, Federal Reserve research has indicated a steady decline in check usage. While the number of checks written remains large, the majority of noncash payments in the U.S. are now initiated electronically. In fact, since their peak a decade ago, checks are not only losing market share,

The greatest driver of change in our nation's payments system has been payment cards.

The Philadelphia Fed has earned the distinction of being the largest producer of substitute checks in the Federal Reserve System.

they are actually declining in absolute volume.

The last few years, in particular, have marked dramatic change for the industry. While the 37 billion checks written in the U.S. in 2003 were down more than 12 percent from their 2001 levels, electronic transactions over that period totaled over 44 billion, representing an increase of roughly 45 percent.

Looking forward, the share of retail transactions handled by cards, both debit and credit, will continue to grow, particularly at the point of sale. In addition, organizations other than banks, especially retailers, will expand their role in the payments system.

But the question remains: How quickly will the move from paper to electronics occur? The transition depends on both the evolution of our payments system's capabilities and consumer acceptance. Consumer habits tend to change gradually. People will only accept a payment structure in which they have the utmost confidence. As a result, the paper check is likely to be with us for some time.

Future of Check Clearing

In the meantime, the Fed has been trying to maximize the efficiencies afforded by electronic processing of payments, whether that transaction is initiated electronically or by paper check. For the latter, the Fed is doing what it can to foster check truncation and electrification as early as possible in the payment process. Under the Check Clearing

for the 21st Century Act, or Check 21, it became even easier to move toward a more electronic check process because banks have additional options for handling image-based payments.

As a provider of financial services, the Fed has been actively engaged in bringing a whole array of new products to market to enable banks to more fully take advantage of Check 21 benefits. Our business has been enhanced in a number of ways to encourage the new image technology the act allows. To cite just a few: We have established an image archive for electronic items; we have modified deposit deadlines and enhanced clearing times; and we have enhanced our ability to produce substitute checks, the intermediate step toward a full image-exchange environment. In fact, the Philadelphia Fed has earned the distinction of being the largest producer of substitute checks in the Federal Reserve System.

Evolution in Efficiency

With the evolution of the payments system accelerating, the Federal Reserve System has made major adjustments to both its physical infrastructure and its payments services. Our program of aggressive electrification of retail payments will facilitate Check 21 and allow us to identify new processing efficiencies. The ongoing shift to electronic payments has also profoundly affected our check processing operations. The Fed currently clears about one-third of all checks written in the U.S. Still, the

number of checks collected annually through the Reserve Banks has fallen nearly 20 percent since 1999, and the decline continues to accelerate.

Consequently, the Fed has had to consolidate its operations, closing down processing sites where appropriate. Yet, we still maintain national service levels by re-routing checks to nearby sites. To illustrate the scale of this effort, consider that two years ago the Fed had 45 check processing sites. By mid-2006 we will be down to 22. This downsizing helps us fill our traditional role of payments processor while at the same time maintaining efficiency in this new environment.

The Philadelphia Fed has been selected to become a System consolidation site for check processing, absorbing New York's East Rutherford Operations Center — known as EROC. The Federal Reserve System chose us based on our overall productivity and efficiency, ability to handle total check volume for both Districts, and our proximity to New York financial institutions. The Philadelphia Fed has long been a leader in the System with a premier check operation, but new responsibility will mean additional employees, equipment, and space renovations to accommodate the increased workload. In the second half of 2006, we expect to create approximately 60 new positions to help process the additional volume. These changes should have positive implications for our

Bank in the future, as this Systemwide leadership role solidifies our position of strength in check processing efficiency.

Future of Electronic Payments

As the check continues to be replaced by more efficient payment types, new technologies continue to help curtail check fraud. The Federal Reserve and, in particular, the Philadelphia Fed have been industry leaders in identifying technology to help reduce fraud in the check payment system. These efforts have constrained the \$5 billion annual fraud losses that burden financial services institutions and their customers.

To address the evolution taking place in the payments system, in 2000, the Philadelphia Fed established its Payment Cards Center. The Center's work has been instrumental in enhancing our understanding of electronic payment vehicles, their use by consumers, and their broader impact on the financial system.

The Federal Reserve System encourages the market to drive checks toward electronics. The Philadelphia Fed will play a key leadership role in managing check payments as they morph into new payment forms. We will also continue to develop our unique expertise in understanding and tracking the payment card industry as new payment vehicles evolve in both market share and complexity.

The Federal Reserve and, in particular, the Philadelphia Fed have been industry leaders in identifying technology to help reduce fraud in the check payment system.

Fed's Role in a Changing Banking Industry

For Supervision, Regulation and Credit, facing change and managing risk are all in a day's work. Senior Vice President and Chief Lending Officer Michael E. Collins talks about the dynamic nature of the banking industry and how the Fed is adapting to changing times.

Q: How is the banking industry faring in today's economy?

Collins: In 2005, the industry delivered strong performance, smoothly adapting from a benign economic environment to one of rising interest rates and stronger growth. Throughout this transition, the nation's financial institutions have been able to successfully deal with changing circumstances while still generating healthy profits. Going forward, we believe the U.S. banking industry is well positioned to support a thriving and prosperous U.S. economy.

Our banking system is truly the nexus of our economy. It supports a dynamic and competitive financial services market while still encouraging innovation and responsiveness. The industry's central role in allocating resources, pooling capital, and funding economic growth has continued to grow and change as its complexity evolves. Technological advances, combined with new products and markets, have changed the financial services landscape, creating opportunities and challenges for both financial institutions and industry supervisors.



Michael E. Collins, Senior Vice President
and Lending Officer

Q: So, adapting to change is an important aspect of the banking business. How does this affect SRC?

Collins: Our supervisory practices have become geared more toward evaluation of risk management and less toward point-in-time financial assessments.

Supervision itself is a preventative and collaborative practice, intended to be flexible and designed to identify and assess risk. Our approach to supervision focuses on a bank's systems, policies, and internal controls. This helps us ensure that appropriate procedures are in place to contain risk and, importantly, that bank management adheres to them. Our goal is to ensure public confidence and a sound banking and financial system.

Regulation, on the other hand, is largely responsive. Regulation typically grows from fraud and abuse, disruptive technologies, and rapidly evolving social trends. It establishes rules and directives, with due consideration to past events, and should be an ongoing process aligned with strategy.

In both supervision and regulation, we always strive to avoid unintended consequences and excessive burden. Supervisory processes and regulations and guidelines undergo periodic evaluation to ensure their continued effectiveness. We believe governance is a fluid process, which should encompass best practices and guidance.

Q: How do you balance your supervisory and regulatory duties while still encouraging banks to sort out their own best practices?

Collins: Given the increasing scale and diversity of financial institutions and the rapid pace of change, it is important for supervision and regulation to try to mirror the discipline the market itself would impose.

Markets are remarkably resilient and have an inherent capacity to sort

out shocks and risks, ideally with minimal regulatory involvement. Effective market discipline gives banks strong incentives to conduct their business in a safe, sound, and efficient manner.

However, since we can never exactly duplicate the market's discipline, we must depend on supervisory guidance, rules, and procedures to ensure safety and soundness in our institutions. Also, financial institutions may not always objectively consider the broader implications of their decisions on other stakeholders in the marketplace. So, it is incumbent upon the Fed and other regulatory agencies to work with financial institutions and help them achieve optimal outcomes without stifling their innovation.

Q: Credit risk has historically been the leading cause of bank failures. What is the industry doing to protect assets and ensure against undue credit risk?

Collins: Imbalances and undue risk can build on a bank's balance sheet as a result of the growth in nontraditional mortgage products, the rise in commercial real estate concentrations, and the increased use of leverage. We expect institutions with higher risk profiles to have more robust risk management systems. As such, institutions increasingly manage risk on a portfolio basis, conducting stress testing and using secondary markets to mitigate risk. They also price for risk to ensure a balanced risk-reward equation. Such risk-based pricing is consistent with expanding access to credit.

Banks are willing to take on riskier loans because they can hedge away

Supervision
itself is a
preventative and
collaborative
practice,
intended to
be flexible and
designed to
identify and
assess risk.

Our supervisory practices have adapted to a changing banking industry, becoming geared more toward evaluation of risk management.

some risk by issuing asset-backed securities. These markets are sophisticated and complex, allowing many individual investors to purchase a portion of the loans, which have been “bundled” for diversification purposes. The situation is win-win. The bank is rendered less vulnerable to the risk of the original loans, and the investors are willing to bear that risk for the chance to earn higher potential returns.

While we recognize that credit concentrations can be effectively managed, excessive levels may expose an institution to high credit loss volatility and, when unchecked, can be an unsafe and unsound strategy. Banks have implemented in-house limits and strengthened their oversight of concentrations by improving portfolio stratification. Nevertheless, regulators have released draft guidance related to commercial real estate concentrations given the historic adverse impact on the industry.

Q: What is the Fed's position on the use of more exotic instruments, such as interest-only loans?

Collins: The Fed understands the need for innovation in the financial services industry to ensure we have a vibrant banking system. Innovation is good, but, as with anything new, we must be careful about how these instruments are used. We must also ensure that the public is sufficiently financially literate to choose and use these instruments properly.

Of course, despite these solutions, the competitive drive to win customers should not supersede the discipline of

prudent lending and adherence to good credit fundamentals.

It is incumbent upon bankers making these loans to ensure that borrowers have the capacity to repay them, thereby sustaining the expansion of homeownership these products make possible. This is an area of increasing sensitivity in regulatory circles, largely because of the newness of these types of products. Risk management procedures must consider the unique nature of these new loan types. Borrowers must be able to sustain their investment and repay these new loans. And underwriters must have systems in place to ensure that they will.

Q: What is the Fed doing to protect consumers?

Collins: As an agency charged with banking supervision and regulation, the Fed has a responsibility to ensure that banks follow safe and sound management practices and serve all segments of their community. People must have access to a sound banking system where their money can be invested productively with minimal risk.

The Federal Reserve writes regulations to implement many of the major consumer protection laws. These include the Truth in Lending Act, which ensures consumers receive adequate information about credit, and the Truth in Savings Act, which requires banks to disclose certain information about deposit accounts. The Federal Reserve also has responsibility for reviewing banks' compliance with its regulations. In addition, the Federal Reserve responds to inquiries and investigates complaints

from the public regarding the institutions it supervises and refers other inquiries/complaints to the appropriate regulatory agency.

Q: What is the purpose of the new Bank Secrecy Act manual?

Collins: The new interagency Bank Secrecy Act examination manual, released in June, was a collaborative effort of the federal banking agencies and the U.S. Department of the Treasury's Financial Crimes Enforcement Network. It introduces no new rules or guidance, but rather it is a compilation of existing regulatory requirements, supervisory expectations, and sound practices designed to ensure that the banking system is not used to finance illicit activities.

Sound Bank Secrecy Act/anti-money laundering risk management enables an organization to identify risks and better direct resources to safeguard its operations from money laundering or terrorist financing.

Q: Why do you think the industry has continued toward consolidation?

Collins: The trend toward nationwide banking and the desire to leverage investments in technology have contributed to banks' desire to consolidate. In addition, some consolidation activity has been the result of competitive changes that allowed financial institutions to cross lines of business and break into new markets. In turn, such activity has imposed significant change on the industry.

Consolidation can improve efficiency and scale while still allowing the benefits of local banking. Through branch networks, institutions build not only their reputation and brand but also the ability to expand distribution channels and delivery networks. However, despite ongoing consolidation among larger institutions, there continues to be a steady level of requests for new bank charters, which indicates that strong consumer and investor demand for community banks still exists.

The vast array of opportunities and risks likely means there will be no pre-eminent model for the successful banking organization of the future. Rather, several models will likely thrive and survive. The proper execution of the model and unparalleled attention to customers will determine its success.

Q: What is the status of Basel II?

Collins: Capital adequacy is an ongoing concern for bank supervisors. The U.S. is striving to implement the proposed international regulatory framework of Basel II by 2009. This framework will better align regulatory capital with risks and represent a vast change in how banks determine capital adequacy. Under its advanced approaches, banks will be required to adopt more formal, quantitative risk measures and risk management procedures. Essentially, Basel II strengthens the link between regulatory capital and risk management.

Now, more than ever before, capital adequacy, risk management, and effective supervision are of critical importance to maintaining a safe and sound financial system.

Preventing Check Fraud

Paper checks are still a major player in the payment system, and managing risk includes finding ways to prevent check fraud. Here's what the Philadelphia Fed is doing in this area.

Estimates of check fraud's cost to consumers, merchants, and the financial services industry range from \$5 billion to \$10 billion a year. Whatever the actual number, check fraud is a costly and growing problem in the United States and around the world.

In 2005, the Philadelphia Fed undertook several efforts to prevent check fraud, such as promoting the exchange of technologies and data throughout the payments system. The Bank also encouraged collaboration in the financial services industry to address certain challenges. But before we talk about that, some history is in order.

For many years, the Federal Reserve Bank of Philadelphia, along with the Treasury, tested technologies that would help the financial services industry deter check fraud. The Treasury made a logical partner because it issues approximately 250 million checks a year for payments such as Social Security benefits and tax refunds.

In 2003, after testing several technologies, the Philadelphia Fed and the Treasury adopted one for use with Treasury checks. This application allows the Treasury to encrypt a code on each check at the time of issue. The code describes the dollar amount, the date of



Blake Prichard, Executive Vice President

issue, the account number, and so forth, and it is invisible to the human eye. But when the check is digitally imaged, this technology survives the imaging and allows the hidden data to be compared against the information written on the check, then confirms whether the check is genuine. The Philadelphia Fed found it to be effective in identifying altered

checks and payment and processing errors. Today, all Treasury checks include this technology.

Blake Prichard, executive vice president, Retail Payments, points out that an important aspect of this partnership between the Philadelphia Fed and the Treasury is that “none of this would have happened without the perceptive leadership here at the Bank and the industry focus that has long been emphasized by top management at Treasury.”

Role of Check 21

Another motivation for implementing such new technology was Check 21. This law allows a substitute check, created from an electronic image, to serve as the legal equivalent of the check itself. A collecting bank can create an electronic image of a check, transmit the image to the paying bank’s location, and then present the paying bank with a paper reproduction or with the electronic image.

Philadelphia Fed management anticipated that this law would bring special concerns: Once banks started electronic imaging of checks and truncating the original paper checks, how could the industry adapt to the loss of the anti-check fraud features on the originals? The concern was that Check 21 might unwittingly invite greater check fraud unless the industry could find new technologies that would render fraud prevention measures “image survivable.”

That’s why the Philadelphia Fed addressed this issue well in advance of Check 21’s implementation. The technology chosen by the Philadelphia Fed and the Treasury has solved this “survival” problem. Now, Prichard states, “Using this technology, we detect fraudulent

checks almost every day in this Bank.”

Recent Events

In 2005, the Bank took the next steps in fighting check fraud: promoting standards for the exchange of check fraud technologies and encouraging the broad adoption of these standards throughout the payments system. Prichard notes, however, that “the Fed doesn’t plan to impose standards. Rather, we support efforts to create new technologies, and we want the marketplace to evaluate them.”

To further support the development of new technologies, the Bank joined forces with the Financial Services Technology Consortium (FSTC), a research organization based in New York. FSTC encourages collaboration among various players in the financial services industry to find solutions to challenges facing the industry.

The Bank and FSTC launched a project to create interoperability standards for fraud detection applications. Right now, if one bank uses, say, bar codes to verify a check’s authenticity, it may not be able to verify a check issued by a bank that relies on other types of check fraud technologies. An interoperable system would allow any financial institution—and eventually merchants and others—to verify a check regardless of who issued it and what type of security measures were used. One of the biggest benefits is that fraudulent checks will be intercepted much earlier in the payments stream.

In 2006 and beyond, the Philadelphia Fed will continue to support efforts to develop new and better ways to detect fraudulent checks.

In 2006 and beyond, the Philadelphia Fed will continue to support efforts to develop new and better ways to detect fraudulent checks.

Managing Risk at the Bank and Across the System

When you're the nation's central bank, effectively managing risk throughout the organization is a top priority. Indeed, managing risk from a broader perspective has become a hot topic both inside and outside the Fed.

Managing risk is not a new concept for companies and corporations. However, lately, risk management has taken on a new aspect: incorporating risk management principles across the entire organization. Donna Franco, chief financial officer at the Philadelphia Fed, puts it this way: "Corporations have been managing risk for many years. What ERM adds is an organization-wide view." A large institution like the Federal Reserve System is no exception. Like other organizations, the Fed is subject to operational, credit, market, strategic, and reputational risks. To deal with risk issues, the System developed an ERM framework several years ago, and two years ago, the Federal Reserve Bank of Philadelphia established the Enterprise Risk Management (ERM) Department.

The Philadelphia Fed's and the System's involvement with ERM dates back to 2002, when the general auditor of the



Donna Franco, Chief Financial Officer, and Spyro Karetos, Assistant Vice President, Enterprise Risk Management

Philadelphia Reserve Bank led a System work group that produced a white paper that became the basis for implementing ERM in the Federal Reserve System.

Why is managing risk at a broader

level so important? The interconnected nature of the Fed is one reason. If a risk-related issue arises at one Reserve Bank, it may well have implications for the other Reserve Banks.

Spyro Karetzos, assistant vice president, Enterprise Risk Management, notes that sometimes company managers and officers have made decisions about risk-taking informally. By formalizing the decision-making process, Karetzos says, ERM “increases the awareness of risk and the potential impact certain decisions may have.” Furthermore, he says, it allows managers and others to understand a decision’s effect not just on one business area but on other stakeholders as well.

Other Aspects of ERM

Another valuable aspect of ERM, Karetzos observes, is that “it compels entities to develop a common language. Having everyone use the same terminology to talk about risk reduces the need to ‘translate’ risk concepts.” Karetzos adds that a formal ERM program also gives organizations a tool for monitoring risk: “Initially, a company may determine the amount of risk associated with a certain action. But ERM gives you ways to monitor your actual risk level *after* you’ve carried out the decision. It’s really a system of checks and balances.”

One good feature about the System’s ERM framework is its flexibility, Karetzos says. It provides standards that allow a Systemwide perspective, but each Bank’s ERM processes can be customized to fit that Bank’s culture.

Other Reserve Banks also have ERM programs, and one goal is to share

best practices across the System. One venue for doing so is the System’s annual ERM meeting, which Philadelphia has hosted for the past three years. Importantly, at the 2005 meeting, it was clear that a “community of interest” has emerged within the Federal Reserve. One piece of evidence is that these meetings no longer rely on outside speakers to fill the agenda; presenters now come from within the System in addition to external presenters.

For the Philadelphia Bank, sharing ERM ideas sometimes means moving beyond the Fed’s walls and even beyond U.S. borders. In August 2005, Karetzos published an article on the topic in the *RMA Journal*, a publication of the Risk Management Association. ERM has also taken on an international scope. In 2005, the central bank of Spain toured various central banks because it wants to implement an ERM program. As a result of its contact with the Philadelphia Fed, the Banco de España has developed a relationship with the ERM staff here. In early 2006, Franco flew to Madrid to share ideas with her peers from other central banks. She has also been asked to co-chair a consortium of central banks that will meet annually to discuss common risk-management concerns.

Ultimately, ERM is an umbrella that covers an organization’s activities and business lines. ERM also acts as a lens that allows a company to view existing information from a risk perspective. No organization can entirely eliminate risk, Karetzos notes, but “if we know what the risks are and align resources appropriately, we can reduce inherent risks to a level within our tolerance range.”

“If we know what the risks are and align resources appropriately, we can reduce inherent risks to a level within our tolerance range.”

— Spyro Karetzos

Protecting Our Information Systems

Many of the biggest risks facing the Federal Reserve Bank of Philadelphia come from cyberspace. Threats to the security of the Bank's information networks—for example, from the Internet or e-mail—are almost constant. The Information Technology Services Department has primary responsibility for managing the risk posed by these threats.

Fending off attacks from cyberspace may have a “Star Wars” sound to it, but it’s a task that the Bank’s Information Technology Services (ITS) Department deals with every day. According to Pat Regan, vice president, ITS, “The Federal Reserve System takes very seriously the establishment of information security standards for all of the Fed’s technology.”

To protect computer systems from intruders, the Federal Reserve uses intrusion detection technology. According to Regan, the technology “senses” certain types of unauthorized activity and reports it to a group that analyzes the information and, if necessary, takes action.

The Philadelphia Fed also uses technology to look for vulnerabilities in its computing systems. Keith Morales, information security manager, notes that assessing vulnerability is one of the first steps in learning how to protect ourselves.

Regan points out that the security industry has noted a dramatic increase in the number of exposures and the number of computer hacking attempts. He describes the Bank’s information security situation as a “punch/counter-punch” problem. “When we learn of a



Pat Regan, Vice President, ITS, and Keith Morales, Information Security Manager

vulnerability,” he says, “our goal is to fix it before the bad guys can exploit it. But it doesn’t take long before the bad guys have another virus or worm to spread.”

The Philadelphia Fed is also the site for the Federal Reserve System’s Groupware Leadership Center (GLC). The GLC provides e-mail, desktop con-

ferencing, instant messaging, document management, and self-service team website capabilities for almost 20,000 customers across all 12 Reserve Banks. To protect the System's computers, the GLC employs rigorous security safeguards that act as a layer of defense against numerous threats from a variety of sources. Such safeguards include filtering spam, which actually exceeds the total volume of delivered e-mail.

System Architecture

Morales says many of the Bank's information security measures are designed to fit the System's security architecture, which focuses on finding solutions to information security risks. This architecture sets security standards from the standpoint of risk management rather than risk avoidance. "Because we're such a large organization," Morales observes, "we have multiple layers of defenses in place. However, no layer is perfect. So the System's security architecture helps us look at the solutions we have in place and figure out if they're the right ones. The Fed's computer network is so interconnected that a weakness in one area may create weaknesses elsewhere."

Another ITS effort involves the containment of malicious software, or "malware"—for example, spyware or adware that websites download onto computers that connect to them. This effort also encompasses potentially harmful elements distributed through e-mail attachments and embedded links to "bad" websites.

A final factor that helps ITS staff keep computer systems safe is the Bank's own internal audit procedures.

As Regan notes, "We have a high level of security awareness at the Bank. But an important element in protecting the Bank's—and the System's—computer network is training our employees and relying on them to follow security procedures." Internal audits help to ensure that employees develop and use good security habits.

In addition to the endeavors listed above, Philadelphia's ITS Department is involved with many other ongoing projects related to information security. For example, the Bank is leading an initiative to look at how the Fed handles compliance with legislation such as the Federal Information Security Management Act (FISMA). FISMA defines what actions federal agencies need to take to be deemed appropriately secure. Morales says, "It's the government's version of the Federal Reserve's security architecture and risk management." So although the Reserve Banks are not federal agencies, the Board of Governors and the U.S. Treasury are; so any systems developed for use by the Board or the Treasury need to comply with FISMA. Mike Ram, senior information security consultant, is playing a leadership role supporting some of the Fed's initiatives with FISMA.

Ultimately, Morales summarizes the Bank's security position this way: "The Fed wants security at an appropriate level. We're not trying to build 80-foot walls around *all* of our computer systems. But it may be appropriate to have 300-foot walls around Fedwire, which is a significant part of our nation's payment system."

To protect the Fed's computers, the GLC employs rigorous security safeguards that act as a layer of defense against numerous threats from a variety of sources.

Helping Consumers Make Better Financial Decisions

Since the early 1980s, the Community Affairs Department has helped financial institutions understand the credit needs of low- and moderate-income people and communities. As a result, these people and communities have experienced a significant increase in their ability to build wealth and access credit, particularly for homeownership or home repair.

In 2005, the Community Affairs Department offered a variety of programs to help students and adult consumers become more knowledgeable about personal finance and the U.S. economy. One major project was creating a video about lending abuses. In “Buried by Debt: The Dangers of Borrowing,” people tell true stories about how they were taken in by unscrupulous lenders and contractors.

Why a Video?

The idea for the video first surfaced in November 2003 when 11 ministers from large congregations throughout Philadelphia were meeting at the Bank to launch a financial education program for their congregants. “We asked the ministers what we could do to help them reach their communities,” says Dede Myers, vice president and community affairs officer. “They told us that many of their congregants were victims of unscrupulous lenders and asked if we could produce a video that would help educate people about lending practices.”

Myers and Marvin M. Smith, community development research advisor, set the process in motion. According to



Dede Myers, Vice President and Community Affairs Officer

Smith, “The challenge was to make a video that would still be useful five years from now. We started by doing background research to discover the most

common problems people encountered. We focused on balloon loans, unreasonably high interest rates, loan flipping, prepayment penalties, and contractor schemes.”

To make the video, Community Affairs enlisted the help of Irv Ackelsberg and Brian Mildenberg, two attorneys who have had a lot of experience handling consumer credit cases. In fact, they asked several of their clients to be in the video. Smith recalls that it took a lot of convincing to get the local residents to appear. But, finally, they understood that by participating in the video, they could help others avoid some of the problems they had experienced.

How the Video Was Used

The resulting 14-minute tape has been in great demand by various audiences. More than 3,000 copies were distributed in 2005, including a Spanish version. The department posted information about the video and an order form on its website, which resulted in many requests. Furthermore, other Federal Reserve Banks have asked for copies to distribute to their constituencies, as well.

To help the Bank’s staff, Community Affairs also offered employees on all shifts a chance to see the video. Smith and a cred-

it or housing counselor attended all the showings and encouraged employees to ask questions. The sessions were very popular and lasted nearly 90 minutes.

Other Efforts

To further help employees, Community Affairs also offered a five-week homeownership program, and several of the participants have since bought houses. Other consumer education projects included offering a training session for faith-based organizations and providing space and staff support for quarterly meetings of the Financial Education Support Network of Southeastern Pennsylvania.

Additional endeavors by the department’s economic education unit involved enhancing the curriculum of an existing financial literacy program, which had met with great success in Delaware, and promoting it to teachers in Pennsylvania and New Jersey. The unit also held a number of financial education seminars for teachers around the Third District.



“The challenge was to make a video that would still be useful five years from now. We started by discovering the most common problems people encounter.”

— Marvin M. Smith



Standing left to right: Kenneth Shoemaker, Wayne Weidner, Garry Maddox, and Coleman Townsend. Seated left to right: William Hecht, Robert Chappell, Ronald Naples, Eugene Rogers, and Doris Damm.

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Board member since January 2003. Chair, Audit Committee and Member, Research and External Affairs Committee. President and CEO of Orrstown Bank, President and CEO of Orrstown Financial Services. Chairman of Council of Trustees of Shippensburg University. Serves on boards of Cumberland Valley School of Music, Carlisle Regional Medical Center and Pennsylvania Bankers Association. Founding President of Mainstreet Non-Profit Redevelopment Corporation.

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Board member since January 2002. Chair, Research and External Affairs Committee and Member, Audit Committee. 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. Advisory Board Member for Liberty Mutual and Lehman Art Center - Brooks School. Active participant on Delaware Art Museum Collections Committee.

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Board member since January 2005. Member, Budget and Operations and Research and External Affairs committees. Chairman National Penn Bank. Chairman & CEO of National Penn Bancshares. Serves as a director of National Penn Investors Trust Company, Link Financial Services, Penn 1st Financial Services, National Penn Life Insurance Company, NPB Delaware, and Hawk Mountain Council Boy Scouts of America.

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Standing left to right: Melinda Holman, David Wenger, Robert Gronlund, Daniel Blaschak, and Kenneth Tuckey. Seated left to right: Rodman Ward, Reneé Amooore, Mark Stellini, Douglass Henry, and Eric May.

* Not pictured

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Clockwise left to right: Allan Dennison, Peter Zimmerman, Robert Forse, Aaron Groff, John Adonizio, and Mark Huntley.

* Not pictured

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Clockwise standing from left: Maurice Dawkins, Edwin Williams, Larry Miller, Robert Marquette, and Eileen Crean. Clockwise seated from bottom left: Alfreda Earnest, Dorothy Fox, Louise Lingenfelter, James Everhart, and Larry Stoner.

* Not pictured

Executive Committee

FEDERAL RESERVE BANK OF PHILADELPHIA



The Bank's Executive Committee consists of the president, first vice president, and the key senior officers who report directly to them. They meet regularly to discuss important issues facing the Bank or the Federal Reserve System. Pictured clockwise from left are Milissa Tadeo, Senior Vice President; Michael Collins, Senior Vice President; Blake Prichard, Executive Vice President; Richard Lang, Executive Vice President; Anthony Santomero, President; and William Stone, First Vice President.

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Executive Vice President

D. Blake Prichard
Executive Vice President

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Senior Vice President
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Supervision, Regulation and
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Credit

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Supervision, Regulation and
Credit

C. Danny Spriggs
Assistant Vice President
Protection

Marie Tkaczyk
Assistant Vice President
Information Technology
Services

Todd Vermilyea
Assistant Vice President
Supervision, Regulation and
Credit

Constance H. Wallgren
Assistant Vice President
Supervision, Regulation and
Credit

Aileen C. Boer
Research Support Officer
Research

Maryann T. Connelly
Assistant Counsel
Legal

Gregory Fanelli
Treasury Payments Officer
Retail Payments

Suzanne W. Furr
Wholesale Product Officer
Wholesale Product Office

Wanda Preston
Check Adjustments Officer
Retail Payment Services

Includes promotions through March 2006

Operating Statistics

FEDERAL RESERVE BANK OF PHILADELPHIA

In 2005, Philadelphia's total volume of commercial checks processed decreased 14 percent and the dollar value of transactions increased 13 percent. The volume of U.S. government checks increased 4 percent in 2005, but the dollar value decreased 6 percent. In November, the Philadelphia Bank permanently assumed the processing of U.S. government checks previously processed in Atlanta due to arrangements made in the wake of Hurricane Katrina.

The Philadelphia Bank continued to be a major processor of cash in the Federal Reserve System in 2005. While the volume of currency processed remained fairly constant in 2005, due to the processing of a significantly higher proportion of ones, the actual dollar value of currency processed decreased by 19 percent. In 2005, one of our larger customers began depositing coin directly to an off-site terminal; therefore, the volume of coin bags processed declined by 22 percent and the processed coin value decreased by 7 percent.

In 2005, both the number and value of loans to depository institutions were lower than in the previous year.

SERVICES TO DEPOSITORY INSTITUTIONS

	2005 Volume	2005 Dollar Value	2004 Volume	2004 Dollar Value
<i>Check processing:</i>				
Commercial checks	969.0 million checks	\$2,256.4 billion	1,129.4 million checks	\$2,001.8 billion
U.S. government	84.9 million checks	\$103.2 billion	82.0 million checks	\$109.6 billion
<i>Cash operations:</i>				
Currency processed	2,351.4 million notes	\$36.1 billion	2,358.1 million notes	\$44.3 billion
Coin paid and received	587.8 thousand bags	\$225.5 million	756.3 thousand bags	\$242.7 million
<i>Loans to depository institutions during the year</i>	110 loans	\$823.6 million	120 loans	\$1,393.6 million

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 2005 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$4.6 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 2005, the Bank did not engage PwC for any material advisory services.

Financial Reports

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Letter to Directors

FEDERAL RESERVE BANK OF PHILADELPHIA



FEDERAL RESERVE BANK
OF PHILADELPHIA

March 2, 2006

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, 2005 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

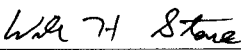
The management of the FRBP is responsible for maintaining an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements. Such internal controls are designed to provide reasonable assurance to management and to the Board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


Even an effective process of internal controls, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements.

The management of the FRBP assessed its process of internal controls over financial reporting including the safeguarding of assets reflected in the Financial Statements, based upon the criteria established in the "Internal Control -- Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, we believe that the FRBP maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Federal Reserve Bank of Philadelphia

by 
Anthony M. Santomero, President

by 
William H. Stone, First Vice President

by 
Donna L. Franco, Chief Financial Officer

Report of Independent Accountants

FEDERAL RESERVE BANK OF PHILADELPHIA



PricewaterhouseCoopers LLP
1800 Tysons Boulevard
McLean, VA 22102-4261
Telephone (703) 918 3000
Facsimile (703) 918 3100

Report of Independent Accountants

To the Board of Directors of the
Federal Reserve Bank of Philadelphia

We have examined management's assertion, included in the accompanying Management Assertion, that the Federal Reserve Bank of Philadelphia ("FRBP") maintained effective internal control over financial reporting and the safeguarding of assets as of December 31, 2005, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRBP's management is responsible for maintaining effective internal control over financial reporting and safeguarding of assets. Our responsibility is to express an opinion on management's assertion based on our examination.

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

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

In our opinion, management's assertion that FRBP maintained effective internal control over financial reporting and over the safeguarding of assets as of December 31, 2005 is fairly stated, in all material respects, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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

A stylized, handwritten signature of PricewaterhouseCoopers LLP in black ink. The signature is written in a cursive, flowing style that mimics the company's logo.

March 8, 2006
Washington D.C.

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 audited the accompanying statements of condition of the Federal Reserve Bank of Philadelphia (the "Bank") as of December 31, 2005 and 2004, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2005 and 2004, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

A handwritten signature in black ink that reads "PRICEWATERHOUSECOOPERS LLP". The signature is written in a cursive, stylized font.

March 8, 2006
Washington D.C.

Statements of Condition

FEDERAL RESERVE BANK OF PHILADELPHIA

As of December 31, 2005 and December 31, 2004 (in millions)

	2005	2004
ASSETS		
Gold certificates	\$ 432	\$ 382
Special drawing rights certificates	83	83
Coin	34	56
Items in process of collection	586	360
Loans to depository institutions	-	5
U.S. government securities, net	26,613	21,581
Investments denominated in foreign currencies	473	624
Accrued interest receivable	207	151
Interdistrict settlement account	6,148	4,007
Bank premises and equipment, net	75	76
Interest on Federal Reserve notes due from U.S. Treasury	29	-
Other assets	103	74
Total assets	\$ 34,783	\$ 27,399
LIABILITIES AND CAPITAL		
Liabilities:		
Federal Reserve notes outstanding, net	\$ 31,296	\$ 24,725
Securities sold under agreements to repurchase	1,082	916
Deposits:		
Depository institutions	485	603
Other deposits	4	1
Deferred credit items	363	490
Interest on Federal Reserve notes due U.S. Treasury	-	27
Accrued benefit costs	43	42
Other liabilities	22	7
Total liabilities	33,295	26,811
Capital:		
Capital paid-in	744	294
Surplus	744	294
Total capital	1,488	588
Total liabilities and capital	\$ 34,783	\$ 27,399

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, 2005 and December 31, 2004 (in millions)

	2005	2004
Interest income:		
Interest on U.S. government securities	\$ 958	\$ 662
Interest on investments denominated in foreign currencies	7	8
Total interest income	965	670
Interest expense:		
Interest expense on securities sold under agreements to repurchase	28	9
Net interest income	937	661
Other operating income (loss):		
Income from services	-	38
Compensation received for check services provided	25	-
Reimbursable services to government agencies	25	21
Foreign currency gains (losses), net	(70)	36
Other income	5	3
Total other operating income (loss)	(15)	98
Operating expenses:		
Salaries and other benefits	81	73
Occupancy expense	10	10
Equipment expense	11	13
Assessments by the Board of Governors	34	34
Other expenses	37	27
Total operating expenses	173	157
Net income prior to distribution	\$ 749	\$ 602
Distribution of net income:		
Dividends paid to member banks	\$ 31	\$ 17
Transferred to surplus	450	35
Payments to U.S. Treasury as interest on Federal Reserve notes	268	550
Total distribution	\$ 749	\$ 602

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, 2005 and December 31, 2004 (in millions)

	Capital Paid-in	Surplus	Total Capital
Balance at January 1, 2004 (5.2 million shares)	\$ 258	\$ 259	\$ 517
Transferred to surplus	-	35	35
Net change in capital stock issued (0.7 million shares)	36	-	36
Balance at December 31, 2004 (5.9 million shares)	\$ 294	\$ 294	\$ 588
Transferred to surplus	-	450	450
Net change in capital stock issued (9.0 million shares)	450	-	450
Balance at December 31, 2005 (14.9 million shares)	\$ 744	\$ 744	\$ 1,488

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

Notes to Financial Statements

1. Structure

The Federal Reserve Bank of Philadelphia (“Bank”) is part of the Federal Reserve System (“System”) and 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 are exercised by a Board of Directors. The Federal Reserve Act specifies the composition of the Board of Directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. 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 of the Federal Reserve System (“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 System performs a variety of services and operations. Functions include formulating and conducting monetary policy; participating actively in the payments system including large-dollar transfers of funds, automated clearinghouse (“ACH”) operations, and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government’s bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks, and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The System also provides 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. FRBNY is authorized to conduct operations in domestic markets, including 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. FRBNY executes these open market transactions 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 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 (“F/X”) and securities contracts for nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. In addition, FRBNY is authorized to maintain reciprocal currency arrangements (“F/X swaps”) with 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, FRBNY may enter into contracts that contain varying degrees of off-balance-sheet market risk, because they represent contractual commitments involving future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

Although 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 competency centers, operations sites, 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, 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, and Treasury Direct Central Business Administration Function.

Beginning in 2005, the Reserve Banks adopted a new management model for providing check services to depository institutions. Under this new model, the Federal Reserve Bank of Atlanta (“FRBA”) has the overall responsibility for managing the Reserve Banks’ provision of check services and recognizes total System check revenue on its Statements of Income. FRBA compensates the other eleven Banks for the costs incurred to provide check services. This compensation is reported as “Compensation received for check services provided” in the Statements of Income. If the management model had been in place in 2004, the Bank would have reported \$29 million as compensation received for check services provided and \$38 million in check revenue would have been reported by FRB Atlanta rather than the Bank.

3. Significant Accounting Policies

Accounting principles for entities with the unique powers and responsibilities of the nation’s central bank have not been formulated by the various accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared

with the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* ("Financial Accounting Manual"), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual 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 those generally accepted 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 security holdings at amortized cost, rather than using the fair value presentation requirements in accordance with GAAP. Amortized cost more appropriately reflects the Bank's security 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 security 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 its activities or policy decisions.

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

The preparation of the financial statements in conformity with the Financial Accounting Manual requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, 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. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged, and the Reserve Banks' gold certificate accounts are lowered. The value of gold for purposes of backing the gold certificates is set by law at \$42 2/9 a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based on the average Federal Reserve notes outstanding in each Reserve Bank.

Special drawing rights (“SDRs”) are issued by the International Monetary Fund (“Fund”) to its members in proportion to each member’s quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks’ SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2005 or 2004.

b. Loans to Depository Institutions

All 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. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Bank, subject to review by the Board of Governors.

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.”

Activity related to U.S. government securities, including the related 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 equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments in foreign-currency-denominated assets 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. U.S. Government 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 carried in the Statements of Condition at their contractual amounts and the related accrued interest is reported as a component of “Other liabilities.”

U.S. government securities held in the SOMA are lent to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements 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 or bank a fee for borrowing securities and the fees are reported as a component of "Other Income" in the Statements of Income.

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

e. Foreign Currency Swaps and Warehousing

F/X swap arrangements are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to the foreign currencies it may need to intervene to support the dollar and give the counterparty temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either FRBNY or the counterparty (the drawer) and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. FRBNY will generally invest the foreign currency received under an F/X swap 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.

Foreign currency swaps 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 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 estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred. Capitalized assets including software, building, leasehold improvements, furniture, and equipment are impaired when it is determined that the net realizable value is significantly less than book value and is not recoverable.

Costs incurred for software, either developed internally or acquired for internal use, during the application development stage are capitalized based on the cost of direct services and materi-

als 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.

g. Interdistrict Settlement Account

At the close of business each day, each Reserve Bank assembles the payments due to or from other Reserve Banks as a result of the day's transactions that involve depository institution accounts held by other Districts. Such transactions may include funds settlement, check clearing, 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) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank.

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

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

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding, reduced by the currency issued to the Bank but not in circulation, of \$6,130 million, and \$7,973 million at December 31, 2005 and 2004, respectively.

i. Items in Process of Collection and Deferred Credit Items

The balance in the "Items in process of collection" line in the Statements of Condition primarily represents amounts attributable to checks that have been deposited for collection by the payee depository institution and, as of the balance sheet date, have not yet been collected from the payor depository institution. 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 fluctuate and vary significantly from day to day.

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 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 Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

In the event of losses or an increase in capital paid-in 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. Weekly payments to the U.S. Treasury may vary significantly.

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

l. 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 its Treasury reimbursement receivable to the Bank. The reimbursement receivable is reported in "Other assets" and totaled \$67 million and \$53 million at December 31, 2005 and 2004, respectively. The cost of unreimbursed Treasury services, is reported in "Other expense" and totaled \$19 thousand and \$10 thousand at December 31, 2005 and 2004, respectively.

m. 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. 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.

n. 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 both years ended December 31, 2005 and 2004 and are reported as a component of "Occupancy expense."

o. Restructuring Charges

In 2003, the System began the restructuring of several operations, primarily check, cash, and U.S. Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations. These restructuring activities continued in 2004 and 2005.

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 3.547 percent and 2.974 percent at December 31, 2005 and 2004, respectively.

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

	2005	2004
Par value:		
U.S. government:		
Bills	\$ 9,623	\$ 7,822
Notes	13,484	10,732
Bonds	3,293	2,796
Total par value	26,400	21,350
Unamortized premiums	313	280
Unaccreted discounts	(100)	(49)
Total allocated to Bank	\$ 26,613	\$ 21,581

The total of the U.S. government securities, net held in the SOMA was \$750,202 million and \$725,584 million at December 31, 2005 and 2004, respectively.

At December 31, 2005 and 2004, the total contract amount of securities sold under agreements to repurchase was \$30,505 million and \$30,783 million, respectively, of which \$1,082 million and \$916 million, were allocated to the Bank. The total par value of the SOMA securities pledged for securities sold under agreements to repurchase at December 31, 2005 and 2004 was \$30,559 million and \$30,808 million, respectively, of which \$1,084 million and \$916 million was allocated to the Bank.

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, 2005, was as follows (in millions):

Maturities of Securities Held	U.S. Government Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	\$ 1,455	\$ 1,082
16 days to 90 days	6,111	-
91 days to 1 year	6,608	-
Over 1 year to 5 years	7,476	-
Over 5 years to 10 years	2,011	-
Over 10 years	2,739	-
Total	\$ 26,400	\$ 1,082

At December 31, 2005 and 2004, U.S. government securities with par values of \$3,776 million and \$6,609 million, respectively, were loaned from the SOMA, of which \$134 million and \$197 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 the Bank for International Settlements and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities purchased under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

The Bank's allocated share of investments denominated in foreign currencies was approximately 2.497 percent and 2.923 percent at December 31, 2005 and 2004, respectively.

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

	2005	2004
<i>European Union Euro:</i>		
Foreign currency deposits	\$ 136	\$ 178
Securities purchased under agreements to resell	48	62
Government debt instruments	89	115
<i>Japanese Yen:</i>		
Foreign currency deposits	65	45
Government debt instruments	135	224
Total	\$ 473	\$ 624

Total System investments denominated in foreign currencies were \$18,928 million and \$21,368 million at December 31, 2005 and 2004, respectively.

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2005, was as follows (in millions):

Maturities of Investments

Denominated in Foreign Currencies	European Euro	Japanese Yen	Total
Within 15 days	\$ 85	\$ 65	\$ 150
16 days to 90 days	64	17	81
91 days to 1 year	52	25	77
Over 1 year to 5 years	71	93	164
Over 5 years to 10 years	1	-	1
Total	\$ 273	\$ 200	\$ 473

At December 31, 2005 and 2004, there were no material open or outstanding foreign exchange contracts.

At December 31, 2005 and 2004, 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):

	Useful Life Range (in Years)	2005		2004	
Bank premises and equipment:					
Land	N/A	\$ 3		\$ 3	
Buildings	1-21	78		74	
Building machinery and equipment	1-19	12		12	
Construction in progress	N/A	1		2	
Furniture and equipment	1-10	66		65	
Subtotal		\$ 160		\$ 156	
Accumulated depreciation		(85)		(78)	
Bank premises and equipment, net		\$ 75		\$ 76	
Depreciation expense, for the years ended		\$ 10		\$ 9	

The Bank leases space to an outside tenant with a lease term of 5 years. Rental income from such lease was \$1 million for both years ended December 31, 2005 and 2004. Future minimum lease payments under the noncancelable agreement in existence at December 31, 2005, were (in millions):

2006	\$	1
2007		1
2008		1
2009		1
2010		1
		<hr/>
	\$	5
		<hr/>

The Bank has capitalized software assets, net of amortization, of \$10 million and \$8 million at December 31, 2005 and 2004, respectively. Amortization expense was \$1 million for both years ended December 31, 2005 and 2004. Capitalized software assets are reported as a component of "Other assets" and related amortization is reported as a component of "Other expenses."

Assets impaired either as a result of the Bank's restructuring plan, as discussed in footnote 10, or the Bank's decision to increase efficiency, included equipment. Asset impairment losses of \$466 thousand for the period ending December 31, 2005 was determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses." The Bank had no impairment losses in 2004.

7. Commitments and Contingencies

At December 31, 2005, the Bank was obligated under noncancelable leases for premises and equipment with terms of approximately one year. 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 both years ended December 31, 2005 and 2004. 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, 2005, were not material.

At December 31, 2005, the Bank, acting on behalf of the Reserve Banks, had a contractual commitment extending through the year 2008 totaling \$7 million. As of December 31, 2005, \$7 million of this commitment was recognized. This commitment represents software licenses and maintenance. The fixed payments under this commitment are \$2 million for both years 2006 and 2007.

Under the Insurance Agreement of the Federal Reserve Banks, each Reserve Bank has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the

total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 2005 or 2004.

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

8. Retirement and Thrift Plans

Retirement Plans

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

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve 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 benefit obligation and net pension costs for the BEP and the SERP at December 31, 2005 and 2004, and for the years then ended, are not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled \$3 million for both years ended December 31, 2005 and 2004 and are reported as a component of "Salaries and other benefits." The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2005 and 2004, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

9. Postretirement Benefits Other Than Pensions and Postemployment Benefits

Postretirement Benefits Other Than Pensions

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

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

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

	2005	2004
Accumulated postretirement benefit obligation at January 1	\$ 41.9	\$ 50.4
Service cost-benefits earned during the period	1.0	1.1
Interest cost of accumulated benefit obligation	2.4	2.4
Actuarial (gain) loss	3.2	(5.5)
Contributions by plan participants	1.0	0.8
Benefits paid	(3.3)	(2.8)
Plan amendments	-	(4.5)
	<hr/>	<hr/>
Accumulated postretirement benefit obligation at December 31	\$ 46.2	\$ 41.9

At December 31, 2005 and 2004, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.50 percent and 5.75 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):

	2005	2004
Fair value of plan assets at January 1	\$ -	\$ -
Actual return on plan assets	-	-
Contributions by the employer	2.3	2.0
Contributions by plan participants	1.0	0.8
Benefits paid	(3.3)	(2.8)
	<hr/>	<hr/>
Fair value of plan assets at December 31	\$ -	\$ -
	<hr/>	<hr/>
Unfunded postretirement benefit obligation	\$ 46.2	\$ 41.9
Unrecognized prior service cost	6.2	7.5
Unrecognized net actuarial loss	(15.3)	(13.1)
	<hr/>	<hr/>
Accrued postretirement benefit costs	\$ 37.1	\$ 36.3

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

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

	2005	2004
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 %	4.75 %
Year that the rate reaches the ultimate trend rate	2011	2011

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2005 (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	\$ 0.4	\$ (0.4)
Effect on accumulated postretirement benefit obligation	4.3	(4.2)

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

	2005	2004
Service cost-benefits earned during the period	\$ 1.0	\$ 1.1
Interest cost of accumulated benefit obligation	2.4	2.4
Amortization of prior service cost	(1.3)	(1.7)
Recognized net actuarial loss	1.0	0.4
Total periodic expense	\$ 3.1	\$ 2.2
Curtailment gain	-	(7.7)
Net periodic postretirement benefit costs (credit)	\$ 3.1	\$ (5.5)

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2005 and 2004, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.75 percent and 6.25 percent, respectively.

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

A plan amendment that modified the credited service period eligibility requirements created curtailment gains in 2004.

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 by the Bank's plan to certain participants are at least actuarially equivalent to the Medicare Part D prescription drug benefit. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial gain in the accumulated postretirement benefit obligation and in actuarial loss in the net periodic postretirement benefit costs.

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

Expected benefit payments:	Without Subsidy	With Subsidy
2006	\$ 2.8	\$ 2.5
2007	2.9	2.5
2008	3.0	2.6
2009	3.1	2.6
2010	3.2	2.7
2011-2015	17.5	14.5
Total	\$ 32.5	\$ 27.4

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2005 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, 2005 and 2004 were \$5 million and \$6 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2005 and 2004 operating expenses were \$20 thousand and (\$1) million, respectively and are recorded as a component of "Salaries and other benefits."

10. Business Restructuring Charges

In 2005, the System announced plans for consolidation and restructuring to streamline operations and reduce costs, including consolidation of operations and staff reductions in various functions of several Banks. The Bank's costs associated with the restructuring were not material.