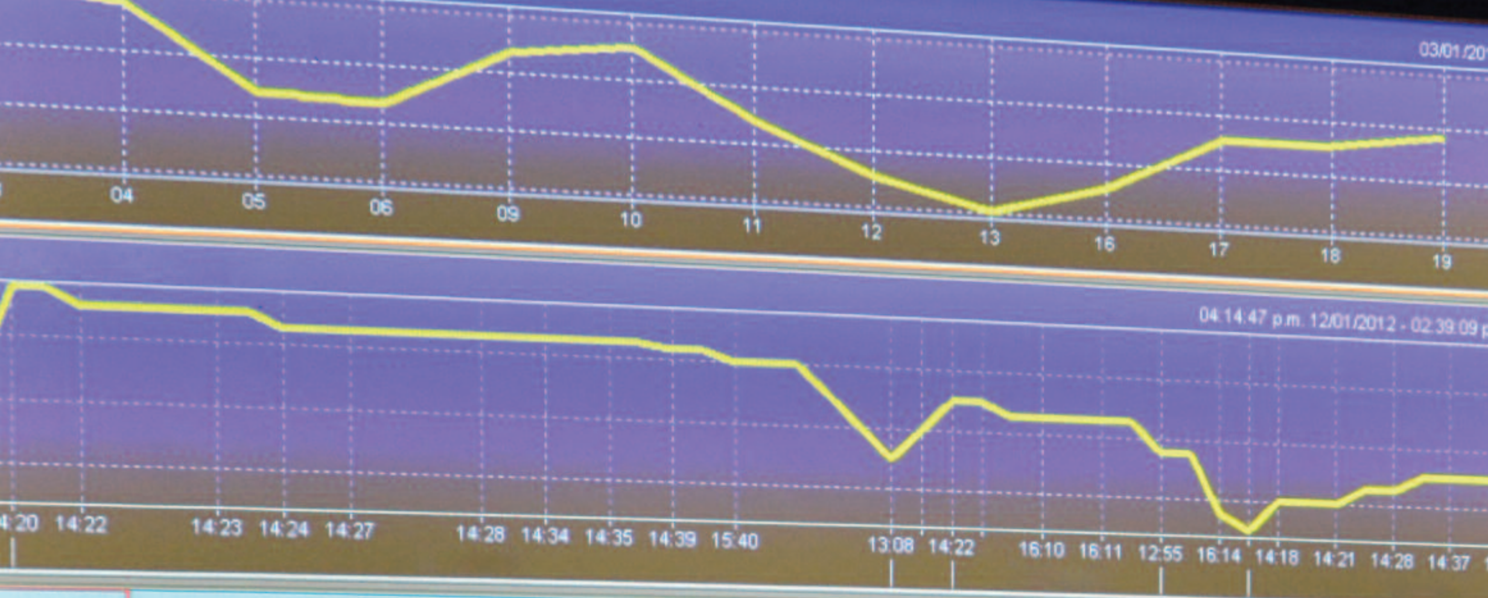

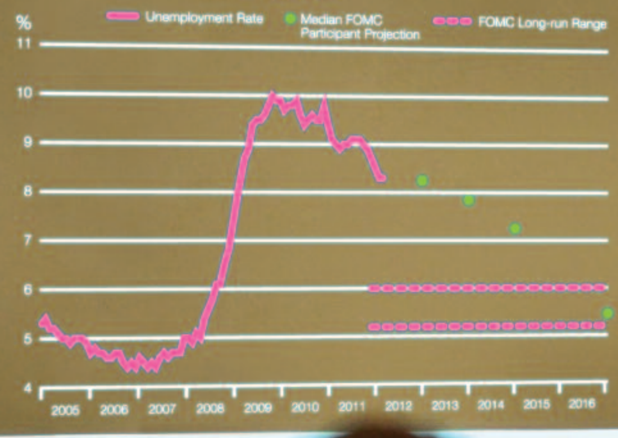

THE CASE FOR MORE ACCOMMODATION

2011 **Federal Reserve Bank of Chicago**
Annual Report

A Discussion with President ***Charles Evans***

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Sources for cover charts: *Haver Analytics and the Minutes of the Federal Open Market Committee.*

LETTER FROM THE PRESIDENT

As head of the Federal Reserve Bank of Chicago, it is my pleasure to offer the Bank's annual report for 2011. As the nation's central bank, the Federal Reserve is charged by Congress with promoting price stability and maximum employment. This is often called our dual mandate and guides our decision-making in the monetary policy-making process.

I strongly advocated a highly accommodative monetary policy stance throughout 2011 and have continued to do so this year. The main essay in this annual report, titled "The Case for Accommodation," explains my thinking on the subject. It also features answers to questions about policy that I frequently receive as I travel throughout the five states of the Seventh Federal Reserve District as well as the rest of the country. I hope you find the essay useful and thought-provoking in furthering your understanding of the work of this Reserve Bank and the Federal Reserve System as a whole.

As always, the success of the Federal Reserve Bank of Chicago depends on the important work of the talented people who make up our staff. I also would like to recognize the dedicated individuals who comprise our boards of directors, both here in Chicago and at our Branch in Detroit. A special note of thanks goes out to two Detroit Branch board members who retired at the end of the year: Tim Manganello, Chairman and CEO of BorgWarner in Auburn Hills, Michigan, who served for six years, five as chairman, and Mark Gaffney, President of the Michigan AFL-CIO, Lansing, Michigan, who served for a total of nearly 12 years on both the Detroit and Chicago Boards.

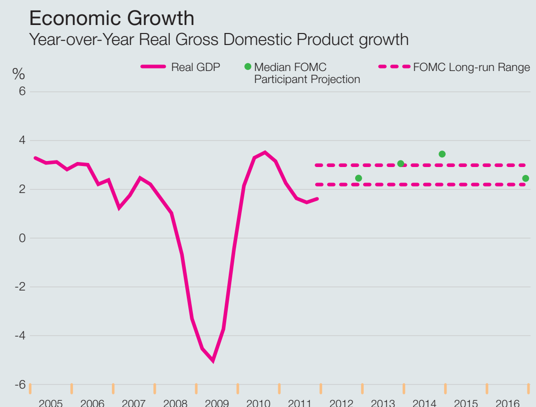
Together, these individuals contributed greatly to our goal of fostering financial stability in 2011, and as 2012 progresses we look forward to continued success in promoting the health and well-being of our U.S. economy.

Left to right: *Chicago Board of Directors Deputy Chairman Thomas Wilson, Chicago Board of Directors Chairman William Foote, Federal Reserve Board Chairman Ben Bernanke, Federal Reserve Bank of Chicago First Vice President Gordon Werkema and Federal Reserve Bank of Chicago President Charles Evans.*

Charles L. Evans
President and Chief Executive Officer
March 20, 2012

THE ECONOMY AND MONETARY POLICY IN 2011*

The U.S. economy continued to recover in 2011, though at a slower pace than in 2010. Real gross domestic product (GDP) grew only 1.7 percent over the course of the year and at an uneven rate: Growth was anemic during the first three quarters of the year and then picked up during the fall and winter months. Real GDP growth in 2012 is projected to be roughly on par with the potential rate of output for the economy, according to the median of the projections of Federal Open Market Committee (FOMC) participants.



As of the January 24-25, 2012 meeting, the FOMC expected real gross domestic product (GDP) growth to gradually increase over the next two years.

Source: Haver Analytics and the Minutes of the Federal Open Market Committee.

Over the course of 2011 and early 2012, the unemployment rate fell by nearly 1 percentage point. While this is welcome news, unemployment remains well above the range that encompasses the FOMC participants' views of its longer-run natural rate. Furthermore, with growth expected to be only moderately above potential in the next few years, it could be some time before the unemployment rate declines to a level consistent with the employment side of the Federal Reserve's dual mandate.

Looking at the price stability side of the mandate, the Personal Consumption Expenditures (PCE) price index ended the year 2.7 percent higher than in the fourth quarter of 2010. However, excluding volatile food and energy prices, core PCE inflation was up only 1.8 percent over the same period. With long-run inflation expectations stable and elevated resource slack continuing to exert some downward pressure on prices, the FOMC projections expect that inflation over the

This essay reflects information available as of March 15, 2012.

medium-run will be at or below the Committee's long-run goal of 2 percent for total PCE inflation.

To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the FOMC expects to maintain a highly accommodative stance for monetary policy for some time. In particular, at its January 2012 meeting, the Committee indicated that it anticipates that economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run – were likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.

THE ECONOMY

After rising at a moderate 2.4 percent annual rate of growth in the second half of 2010, real GDP grew at a sluggish annual rate of 0.4 percent in the first quarter of 2011, reflecting declines in government spending and net exports, as well as weaker gains in consumption and investment. Growth in the second and third quarters of the year remained slow, coming in at annual rates of 1.3 percent and 1.8 percent, respectively. Growth increased to 3.0 percent in the final quarter of 2011, in large part due to an increase in inventory accumulation.

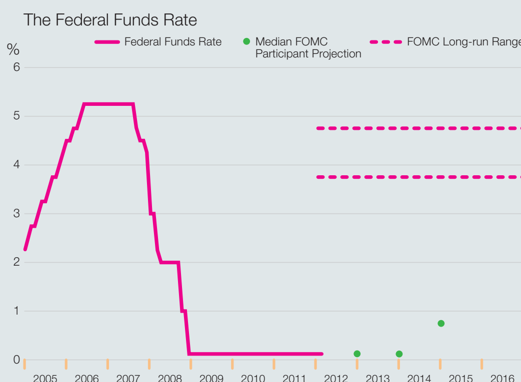
Business investment continued to improve in 2011, though not quite as strongly as in 2010. Purchases of new equipment and software continued to increase. For the first time in three years, the annual growth rate of investment in nonresidential structures was positive, boosted in part by a further increase in expenditures on drilling and extraction of petroleum and natural gas. In general, U.S. manufacturing is expanding – boosted by the recovery in the domestic automotive sector, as well as international trade. However, the recent weakness in Europe and other parts of the world remains a source of concern going forward.

Growth in consumer spending also slowed in 2011, with much of the weakness occurring in the first half of the year. The modest pickup in growth in the second half of the year came primarily from purchases of durable goods, as vehicle sales rebounded sharply following the spring supply chain disruptions that followed the natural disasters in Japan. In contrast, spending on nondurables and services was uncharacteristically weak. The housing market showed signs of improvement. For the first time since 2005, residential investment increased over the course of the year. However, the level of activity remains quite low.

The labor market showed signs of improvement in 2011. Additions to nonfarm payrolls averaged 153,000 new jobs per month – a total of 1.84 million jobs in 2011. This pace picked up in early 2012 as job gains averaged over 250,000 for the first two months of the year. Likewise, initial claims for unemployment insurance reached their lowest levels since early 2008, and the unemployment rate declined by over 1 percentage point to 8.3 percent in February 2012. There is still work to do, however: The economy remains at a net loss of 5.3 million jobs since the cyclical peak in December 2007.

Monetary Policy Tools

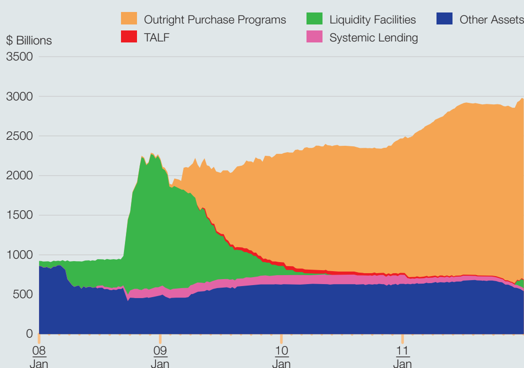
The Federal Funds Rate



As of the January 24-25, 2012 meeting, the FOMC projected the Federal Funds Rate to remain near zero until late 2014.

Source: Haver Analytics and the Minutes of the Federal Open Market Committee.

The Federal Reserve's Assets



Additional large-scale asset purchases and reinvestment of principal repayments of earlier purchases led the overall size of the Federal Reserve's balance sheet to approach $3.0 trillion by the end of 2011.

Source: Haver Analytics.

MONETARY POLICY

With a considerable amount of slack left in the economy, the FOMC left its traditional policy instrument, the federal funds rate, unchanged at a level between zero and 0.25 percent in 2011. However, as growth remained weak, in August the FOMC provided additional forward guidance on the path of the funds rate, altering the language in its policy statement from saying that economic conditions were likely to warrant exceptionally low levels of the federal funds rate for an "extended period" to indicating that the length of the period would likely be through mid-2013. This period was then revised again in January 2012 to be likely at least through late 2014.

Nontraditional monetary policies also played a role in the FOMC's response to weaker economic conditions in 2011. The FOMC's purchases of $600 billion in long-term assets, announced at its November 2010 meeting, continued through the first half of the year until completion in June 2011. During the second half of the year, financial markets experienced some tightening, largely over concerns about European sovereign debt. To help reduce some of this strain and promote dollar liquidity, the Fed extended its swap facilities with the Bank of Canada, Bank of England, European Central Bank, Bank of Japan, and Swiss National Bank and lowered the rate for these transactions.

The FOMC also enacted a number of policies directed toward lowering longer-term borrowing costs. In September 2011, the FOMC began to re-orient its balance sheet to longer-term securities by selling $400 billion of Treasury securities with remaining maturities of three years or less and then purchasing an equal amount of securities with remaining maturities of six to 30 years. This process is expected to reach completion by June 2012. During the same meeting, the FOMC also announced that in order to support conditions in mortgage markets, it would reinvest principal repayments from its holdings of agency debt and agency mortgage-backed securities (MBS) in further agency MBS instead of in Treasury securities.

PROMOTING CORPORATE SOCIAL RESPONSIBILITY

A Corporate Social Responsibility Council was created at the Chicago Fed in 2011 to take a holistic approach toward integrating ongoing work in the areas of economic and financial education, work force and supplier diversity and inclusion, and community and economic development and outreach programs.

ENVIRONMENTALISM

The Bank has worked aggressively toward creating a "green" culture by promoting environmental awareness and practices. Part of the process is pursuing for the Chicago Fed headquarters building a special certification that signifies it as a high performance green building in key areas of human and environmental health.

VOLUNTEERISM

The Chicago Fed actively encourages employees at Chicago headquarters and the Detroit and Des Moines offices to take part in community-based volunteer activities throughout the Seventh Federal Reserve District.

REGIONAL ECONOMIC OUTREACH

In addition to taking part in hundreds of speaking events and meetings throughout the Midwest in 2011, the Bank's regional economists expanded their ongoing business roundtable discussions to include one in northwest Michigan and one focused on manufacturing with representatives from across the Midwest. Special conferences focused on rising farmland values, state budgetary stress, and the rise of electronic content in autos.

ECONOMIC EDUCATION

The Chicago Fed focuses on three programming areas: professional development for educators, in-kind and technical support for local education-based organizations, and experiential programs for students. In 2011, more than 200 educators attended sessions, and our educator-targeted blog received over 28,000 unique visitors.

FINANCIAL EDUCATION

Money Smart Weeks are the foundation of the Chicago Fed's efforts to educate consumers to make informed choices about their personal finances. Each year, the Bank helps coordinate these Money Smart Weeks, in which roughly 1500 partner organizations put on more than 2000 free classes on a broad array of personal finance topics.

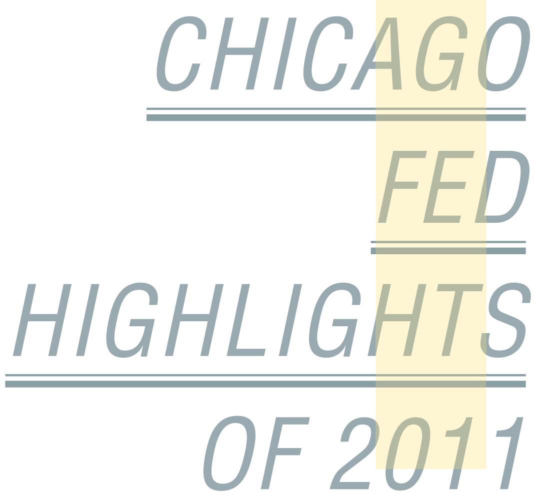
EMPLOYEE DIVERSITY AND INCLUSION/ SUPPLIER DIVERSITY

The report to Congress is available at http://www.chicagofed.org/digital_assets/others/utilities/about_us/csr/2011_omwi_ar.pdf.

The Chicago Fed recently submitted to the U.S. Congress a comprehensive report on continued progress in promoting diversity and inclusion in the purchase of products and services, hiring, and creating development opportunities for staff members. It also looks at financial and economic education efforts in the Seventh Federal Reserve District.

COMMUNITY AND ECONOMIC DEVELOPMENT

A variety of programs and research projects were carried out to address issues affecting economically disadvantaged and redeveloping communities as well as low- and moderate-income individuals throughout the Seventh District (see Highlights on page 6).



CHICAGO FED HIGHLIGHTS OF 2011

RESEARCHING ECONOMIC CONDITIONS

- Supporting the policy-making role of President Charles Evans, staff analyzed critical issues concerning national and regional economic policy, the economic recovery, and financial market developments.
- Researchers continued to analyze the potential role of job mismatch in explaining current weakness in labor markets.
- A new Insurance Initiative was established to analyze the role of the insurance industry in the financial sector.
- The new Industrial Cities Initiative focused on researching cities that have successfully maintained or improved their economic well-being after experiencing a major loss in their manufacturing base.
- Research continued on systemic risks to the economy and alternative models for derivatives clearinghouses.
- Best practices for error control in high frequency trading environments were studied.

KEEPING BANKS SAFE

- Banking conditions are stabilizing. More banks are profitable, but the industry still has a considerable volume of problem loans to resolve.
  - Credit Risk Management staff helped coordinate the closing of 13 distressed depository institutions located in the Seventh District.
  - Leveraging lessons learned from the financial crisis, Supervision & Regulation (S&R) contributed to System efforts aimed at improving supervisory programs and processes.
- Continuing previous trends, examination events increased, yet S&R met all targets for delivering timely and accurate reports to the institutions we supervise.
- The impact of the Dodd-Frank Act (DFA) placed additional demands on supervisory resources. S&R added more than 100 people.
  - The Chicago Fed gained supervisory responsibilities for 54 Savings and Loan Holding Companies (SLHCs) and nine Insurance SLHCs.
  - The Act also called for enhanced prudential standards to be put in place for our largest organizations. The Chicago Fed established the Federal Reserve System's Wholesale Credit Risk Center to serve as a resource for the System.
  - The Seventh District contributed 26 people to the first and second Comprehensive Capital Analysis and Review (CCAR), a new DFA requirement to incorporate stress testing in the supervision of the largest banks.

KEEPING PAYMENTS SECURE

- All payment system business lines were able to manage costs to meet full cost recovery in 2011.
- The Customer Relations and Support Office (CRSO) continued to advance strategies to leverage the strategic and economic value of the FedLine network.
- District Cash performed well, adjusting staff levels to meet targets for productivity and work hours.
- District Cash realigned staffing levels and machine production shifts in response to technology-enabled productivity increases and exceeded the Cash Product Office's performance targets.
- Chicago Cash Operations received one of its most favorable Treasury Compliance reviews.

BUILDING RELATIONSHIPS

- The Seventh District designed and led the System Incentive Compensation project, which produced a multi-disciplinary, horizontal review of incentive compensation practices at 25 large, complex banking organizations and helped formulate the DFA rule on this topic.
- Economic Research staff worked closely with the Board of Governors and other Reserve Banks on several key Federal Open Market Committee (FOMC) related efforts.
- District staff participated in the Midwest Interagency Group, which brought together bank, insurance and securities regulators to begin dialogue related to oversight of diverse financial entities and to increase access and cooperation among agencies.
- Addressing community and economic development issues remained a priority throughout the year. One major effort was the Detroit Access to Credit for Small Businesses, which studied how changes in the location of bank branches and other financial service providers affect the availability of credit and access to banking services for small businesses.
- Money Smart Weeks were held in every state in the Seventh District and many cities outside the District, featuring roughly 1500 partner organizations bringing free educational seminars and events to tens of thousands of consumers.
- An iPad app was developed that serves as a useful tool for finding a wide variety of Federal Reserve System information.

"I think the current
unemployment rate is
unacceptably high."

THE CASE FOR MORE ACCOMMODATION

A Discussion with President Charles Evans*

The U.S. is now more than 2-1/2 years into its stop-and-go recovery from the Great Recession. Real GDP growth averaged just 2-1/2 percent in this period, and the unemployment rate is still 8-1/4 percent, more than 3 percentage points higher than when the recession began. To be sure, the recent data have been encouraging. Notably, the unemployment rate has fallen 3/4 percentage point since last summer, and job growth has gained momentum.

These are welcome developments. But even the more optimistic forecasts see GDP growing only moderately above potential in the near term, and no one is expecting a surge in activity over the next couple years that would quickly close resource gaps. In fact, in the projections submitted in January, the central tendency of FOMC participants' forecasts for the unemployment rate at the end of 2014 was still 6.7 to 7.6 percent. This is well above where most participants see the rate eventually stabilizing in the long run, which is between 5.2 and 6.0 percent. At the same time, the outlook for inflation is subdued, with most FOMC participants' forecasts for increases in total PCE prices averaging roughly between 1 and 2 percent over the next three years. Furthermore, private sector long-run inflation expectations are quite well anchored, moderating this source of inflationary pressure.

Congress has mandated the Federal Reserve with setting monetary policy with the aim of achieving the dual goals of maximum employment and stable prices. In view of the unemployment rate outlook, I think it is clear that the Fed has fallen short in achieving its goal of maximum employment. And most FOMC participants see inflation at or below our target of 2 percent even in 2014. So on both elements of our dual mandate, we are missing our policy objectives.[1]

As the central bank in a democratic society, the Federal Reserve is accountable to the public. Accordingly, I believe we have to acknowledge that we are missing our policy mandates, and we need to describe the ways in which we will try to remedy this to achieve our objectives. So I have spent a good deal of time in my public discourse over the past year describing a policy strategy that I think will help us do a better job.

THE ECONOMY IN A LIQUIDITY TRAP

I believe that the disappointingly slow growth and continued high unemployment that we confront today

This essay reflects information available as of March 15, 2012.

[1] *At the January 2012 FOMC meeting, the Federal Reserve for the first time decided on an explicit inflation target—2 percent as measured by the annual change in the price index for personal consumption expenditures. The FOMC did not specify a fixed goal for maximum employment, but noted that the central tendency of FOMC participants' most recent estimates for the rate of unemployment consistent with this goal is 5-1/4 to 6 percent. See "Recent FOMC Communications Initiatives" on page 14.*

reflect the fact that we are in what economists call a "liquidity trap." In normal times, real interest rates — that is, nominal interest rates adjusted for expected inflation — rise and fall to bring desired saving into line with investment and to keep productive resources near full employment. This market dynamic is thwarted in the case of a liquidity trap. A liquidity trap occurs when desired saving increases a great deal but nominal interest rates fall to near zero and can go no lower. Real interest rates become "trapped" because they cannot become low enough to equilibrate saving and investment. That is where we seem to be now: Short-term, risk-free nominal interest rates are close to zero, and actual real rates are modestly negative, but they are still not low enough to return economic activity to its potential.

A liquidity trap presents a clear and present danger of a prolonged period of economic weakness — today that means a risk of repeating the experience of the U.S. in the 1930s or that of Japan over the past 20 years.

The important point for policy is that we need not resign ourselves to such an outcome. A large body of economic research concludes that economic performance can be vastly improved by employing monetary policies that commit to keeping short-term rates low for a prolonged period. Because of this, I have been advocating such a prolonged period of accommodation.

PROVIDING ACCOMMODATION WITHIN A BALANCED APPROACH TO MONETARY POLICY

While I believe we are in a liquidity trap and favor the prescription of prolonged accommodation, I recognize that my assessment could be wrong. Some have posited that we are in an economic malaise that reflects "structural factors" (such as a job skills mismatch) and that the economy today is actually functioning close to a new, more dismal productive capacity. If this scenario is true, then further monetary accommodation would lead only to rising inflation without much improvement in unemployment. In considering this possibility, I am mindful of the 1970s, when our failure to appreciate the changing structure of the economy led to an overstimulative policy and eventually to stagflation.

Although I do not find this structural impediments scenario compelling, as a prudent policymaker, I must at least consider it as a possibility. Accordingly, I favor a monetary policy strategy that balances the two risks of dismally slow growth on the one hand and rising inflation on the other.

The Fed could sharpen its forward guidance by pledging to keep policy rates near zero until one of two events occurs. The first event would be if the unemployment rate moved below 7 percent. An unemployment rate below this threshold would represent enough meaningful progress toward the natural rate of unemployment that it might be time to lessen policy accommodation.[2]

The second event prompting higher rates would be if inflation rose above a particular threshold even if the unemployment rate remained above 7 percent. This trigger is a safeguard against the possibility that we are wrong and the natural rate of unemployment is higher than 7 percent. If this were so, then the low-rate policy would generate an unexpected increase in inflation, and the trigger would cause us to exit from what would now evidently be excessive policy accommodation. We would not have the desired reductions in unemployment, but then again, monetary policy could do little about it.

I believe that this inflation-safeguard threshold needs to be above our current 2 percent inflation objective. This is consistent with the theoretical work showing that extraction from a liquidity trap requires the central bank, if necessary, to allow inflation to run higher than its target over the medium term. My preferred inflation threshold is a forecast of 3 percent over the medium term. This seems to me to be a risk we should be willing to accept. We would suffer some net policy loss if the expected gains in employment did not materialize. But we certainly have experienced inflation rates near 3 percent in the recent past and have weathered them well. And 3 percent is not even close to the debilitating higher inflation rates we saw in the 1970s or 1980s. Nor is it high enough to unhinge long-run inflation expectations.

Let me also emphasize that under this policy proposal, inflation reaching 3 percent is only a risk and not a certainty. Indeed, simulations of standard models suggest that inflation is likely to remain below 3 percent, even under a policy of extended monetary accommodation.

[2] *Note that if inflation fell to 1 percent (below our 2 percent objective) while unemployment improved to 7 percent, then tightening policy at this point would run counter to the achievement of both our employment and price stability objectives.*

Q&A

with President
Charles Evans*

For monetary policy to be most effective, communication must be both clear and consistent. Furthermore, as a central bank in a democratic society, we have a responsibility to articulate the FOMC's views about the goals for monetary policy and the strategies it will employ to achieve those goals.

I have tried to be clear and open in explaining my policy views to the public, giving my messages about the economic outlook and my preferred policy reaction in numerous speeches and press interviews over the past year. I have received thoughtful and sometimes tough questions at these speaking engagements. Answering these questions has offered me another channel to explain and expand on my thinking. What follows is a sampling of those questions and my edited responses to them, culled from the answers I gave at the time and supplemented with content from speeches covering the topic. The answers have also been updated where necessary to reflect current economic and policy conditions.

THE OUTLOOK FOR THE U.S. ECONOMY

How do you make the argument that the economy needs more accommodation when it looks like it is improving?

We have been disappointed so many times since the expansion began. I am at the point where the normal flow of monthly data is not instrumental in my views on the economy. I had been more optimistic. In 2010, I thought we would achieve escape velocity. It did not happen. In 2011, we saw more of the same slow growth, and real GDP growth in the first half of the year was revised down. The amount of resource slack in the economy is still very large. My forecast for this year is about 2-1/2 percent growth, rising to about 3 percent in 2013. That's not enough to make substantial progress on the labor market and to close the output gap.

**This essay reflects information available as of March 15, 2012.*

If we don't do some of the things that you're prescribing, where does the U.S. economy go?

I hope I'm wrong. I hope the economy takes off and we achieve escape velocity. But if we don't, if the unemployment rate stays high, there are a large number of people whose skills are going to diminish. Their opportunities aren't going to be very strong, and that's going to reduce the potential of our economy to grow. This occurs because growth depends not only on capital accumulation and technology, but also on the skill composition of the work force. If we're not using the work force efficiently and up to workers' skill levels, we're not going to produce as much. That would translate to lower living standards for everybody. So we need to get living standards up through higher growth.

MONETARY POLICY STRATEGY

Can you describe your monetary policy strategy?

Policymakers must ask whether their forecasts are consistent with their medium- and long-term policy objectives and, if not, what then is the best response for monetary policy to influence the trajectory of the economy and inflation in order to meet the FOMC's objectives. In essence, this boils down to looking at how far inflation and unemployment are from the values we see as being consistent with our long-run policy objectives and weighing the relative deviations from our goals, both today and also along the prospective paths over which these deviations are likely to close over time under various policy options. This is often referred to in the macroeconomics trade as flexible inflation targeting.

A central banker who favors a conservative approach to monetary policy can still value deviations in unemployment from the natural rate of unemployment equally with deviations in inflation from its target.[3] Accordingly, an inflation rate of 5 percent versus an inflation goal of 2 percent presents this policymaker with an equal-sized loss as a 9 percent unemployment rate versus a conservative estimate of 6 percent for the natural rate of unemployment. There also is an immediate corollary: If you aren't as riled up over 9 percent unemployment as you would be over 5 percent

[3] *For more information, see Charles Evans, 2011, "The Fed's Dual Mandate Responsibilities and Challenges Facing Monetary Policy," speech delivered on September 7 at the European Economics and Financial Centre, London, United Kingdom, available at http://www.chicagofed.org/ webpages/publications/ speeches/2011/09_07_dual_mandate.cfm.*

inflation, then you either put even less weight on unemployment misses in your loss function or you think that the natural unemployment rate is substantially higher than 6 percent.

Given how poorly we are doing in meeting our employment mandate, I argue that the Fed should seriously consider actions that would add very significant amounts of policy accommodation. Such further policy accommodation would increase the risk that inflation could rise temporarily above our long-term goal of 2 percent. But I do not think that a temporary period of inflation above 2 percent is something to regard with horror. I do not see our 2 percent goal as a cap on inflation. Rather, it is a goal for the average rate of inflation over some period of time. To average 2 percent, inflation could be above 2 percent in some periods and below 2 percent in others. If a 2 percent goal was meant to be a cap on inflation, then policy would result in inflation averaging below 2 percent over time. I do not think this would be a good implementation of a 2 percent goal.

You get tremendous push-back from your colleagues when you say, "It's OK for inflation to run a little bit hotter for a period of time." What's your reaction?

I think that's what flexible inflation targeting means. Don't forget that the unemployment rate is 8-1/4 percent and the natural rate of unemployment is much closer to 6 percent. So, we need to evaluate our policy losses and keep both goals in mind when we formulate policy.

But didn't we try that in the 1970s without success?

I have some worry about repeating the 1970s. What central banker wouldn't? But the circumstances today are really quite different. In terms of sustained, higher inflationary expectations, the situation is much different now. In the 1970s, you had high wage growth and a wage-price spiral. Prices would go up, workers would demand that wages go up to compensate for rising prices, and the two would keep spiraling upwards.

I don't believe today anybody expects that wages are going to increase to the extent that it's going to propel inflation or inflation expectations higher. The state of the labor market is that many people are looking for jobs, thereby creating downward pressure on wages. And the thing is we're always tempted to fight the last war, which in my view is what the 1970s experience represents. I'm much more worried about repeating the 1930s experience or Japan's experience of these past 20 years.

Can you explain why you thought the Fed should have done more when you dissented from the consensus viewpoint twice at FOMC meetings in late 2011?

I think the economy needs more accommodation. I think the current unemployment rate is unacceptably high. We should be much closer to 6 percent or less than that. That's where I think the natural rate of unemployment currently is. So I think we should be doing as much as we can to get there. There is strong accommodation already in place. We've done a lot already, but we are a long way from achieving our goals. Clearing up timing questions would provide even more accommodation.

You have mentioned the desire for a clear framework for setting monetary policy decisions. What does that mean for stating both explicit inflation and unemployment targets?

I strongly supported the adoption of a framework statement by the FOMC that contains both of these elements. I think a framework should include clarifying an explicit inflation objective, as we recently did in stating a 2 percent target. On the unemployment side, I think it's very important that we have some clarification of what's meant by maximum employment, but quantifying a particular goal for that is much more difficult. Maximum employment is affected by so many factors outside the scope of monetary policy, and those factors change over time. But we can provide estimates. FOMC participants' latest projections for the rate unemployment would converge to in the absence of further shocks to the economy are 5-1/4 to 6 percent. So our target should be in that range.

PREFERRED FUTURE COURSE OF MONETARY POLICY

So you think we're going to grow at or even a little bit above trend, but you still think the Fed should take action. What action should it take at this point?

Growth of say, 3 percent, would be a little bit above trend but not nearly enough to make large improvements in the labor market. So I favor being more aggressive in applying accommodative monetary policy. The first step I would take is to clarify the conditions under which we would contemplate removing accommodation. I would say that we will continue to be accommodative as long as the unemployment rate is above 7 percent. We're pretty far from that right now. Seven percent is above what I think is a sustainable unemployment rate. When we get to 7 percent, we'll look at how we're doing. We might decide to provide even more accommodation.

This is all as long as inflation remains contained. By “contained,” I mean inflation potentially above our 2 percent target, but certainly no more than 3 percent over the medium term. If we find that we are bumping up against 3 percent, that would tell us that things aren’t proceeding the way I expect; maybe there’s another impediment and we’re running into structural problems. But I’d like to at least test that.

With all the accommodation already in place, how would additional stimulus encourage business spending and investment?

I think it’s important to get the incentives right. Businesses and households need to reach the point where they find it in their best interests to engage in slightly more risk-oriented investment, so that businesses actually start thinking about growth opportunities. If we keep applying accommodation, we’ll eventually tip the scales on the question of incentives so businesses will want to undertake more investment.

At what point would the FOMC consider additional asset purchases?

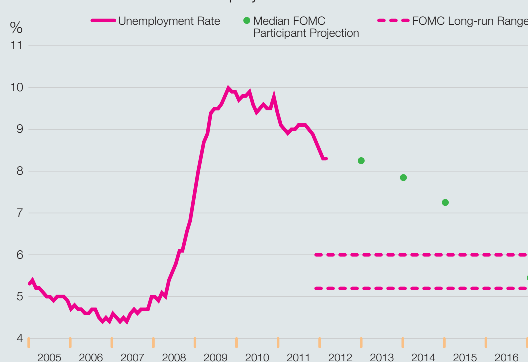
I think that the state of the economy is such that, all else being equal, it would be a good idea for the Fed to undertake more asset purchases. But before doing so, I think we should first clarify our language on forward guidance. Then we should monitor very closely what progress is being made towards our goals, asking, “How quickly is the economy accelerating and bringing unemployment down? How is the economy responding?” And then, only if we think that there’s not enough progress being made, I would consider providing additional accommodation through more asset purchases.

Can you explain how more asset purchases would help lower the unemployment rate or create growth?

These purchases are aimed at directly influencing longer-maturity interest rates; lower long-term rates, in turn, should stimulate spending by households and businesses. The purchases also play an important and useful communications role — they signal our commitment to keeping short-term rates low for an extended period of time.[4]

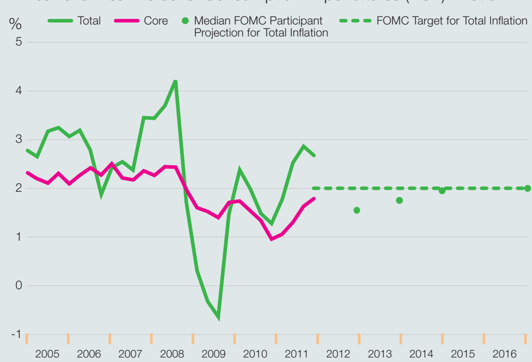
Consider a metric for interest rates, the well-known Taylor Rule, which captures how monetary policy typically adjusts to output gaps and deviations in inflation from target. At the time of our second set of asset purchases (in November 2010), the Taylor Rule would have called for the federal funds rates to be something like –4 percent, well below the zero lower bound at which the funds rate is still trapped. Our large-scale asset purchases have provided additional stimulus, but by most estimates, not enough that it would be equivalent to bringing the federal funds rate down to the Taylor Rule prescriptions.[5] So, in the absence of other accommodative policy actions, there is an argument for having another large-scale asset purchase program.

Unemployment Rate
Percent of labor force unemployed



As of the January 24-25, 2012 meeting, the FOMC expected that it will likely be some time before the unemployment rate enters a range consistent with the maximum employment mandate of the Fed.

Inflation
Year-over-Year Personal Consumption Expenditures (PCE) Inflation



As of the January 24-25, 2012 meeting, the FOMC expected inflation to remain below its mandate-consistent level until 2015.

Source for both charts: Haver Analytics and the Minutes of the Federal Open Market Committee.

[4] *Charles Evans, 2011, “Making Sense of Monetary Policy,” speech delivered on May 19 at the Global Corporate Treasurer Forum, Chicago, Illinois, available at http://www.chicagofed.org/webpages/publications/speeches/2011/05_19_global_corporate_treasurers.cfm.*

[5] *Charles Evans, 2011, “The Fed’s Dual Mandate Responsibilities: Maintaining Credibility during a Time of Immense Economic Challenges,” speech delivered on October 17 at the Michigan Council on Economic Education, Michigan Economic Dinner, Detroit, Mich., available at http://www.chicagofed.org/webpages/publications/speeches/2011/10_17_11_mcee.cfm.*

RECENT FOMC COMMUNICATIONS INITIATIVES

In July 2011, FOMC Chairman Ben Bernanke reconstituted the FOMC Subcommittee on Communications and asked it to study proposals to increase monetary policy transparency. I served on the Subcommittee, which was chaired by Governor Janet Yellen and also included Governor Sarah Raskin and Philadelphia Fed President Charles Plosser. The Subcommittee worked on two major communications initiatives that were adopted by the entire FOMC and rolled out to the public at the January 2012 FOMC meeting. The first was a framework statement of our monetary goals and strategies, and the second was the publication of FOMC participants' projections for the future path of appropriate policy. I believe that these latest communications efforts are an important step in further increasing our transparency and accountability to the public. Importantly, they reaffirm our commitment to both legs of our dual mandate and they further describe the ways in which we will seek to achieve these objectives.

THE FRAMEWORK STATEMENT

The framework statement clarifies how the FOMC interprets its statutory responsibilities for facilitating maximum employment and price stability, in terms of measurable and achievable economic goals over the longer run. We say that the FOMC considers a rate of inflation of 2 percent over the long run as being consistent with the price stability leg. There are two important ingredients: Our explicit inflation objective is 2 percent; and this is to be achieved over the long run. As recently as 2005, many FOMC participants preferred to describe a range of inflation outcomes as being consistent with our inflation mandate instead of stating it as a single number. Our current statement narrows our objective to 2 percent. It also presents this as an average that we aim to achieve over the long run, in recognition of the obvious fact that inflation may deviate from this goal from time to time owing to economic challenges, conflicts in achieving the dual mandate objectives, and difficulties in the policy transmission channels.

The statement also notes that maximum employment is largely determined by nonmonetary factors, which are difficult to measure and may change over time. Hence, we cannot and do not specify a fixed, time-invariant goal for it. But FOMC participants can provide their current assessments of goal variables related to the achievement of maximum employment. We do so using the central tendency of FOMC participants' projections for the rate that unemployment would converge to in the absence of further shocks to the economy. As of January 2012, this rate is 5-1/4 to 6 percent.

The statement also indicates that policy will seek to mitigate deviations in inflation and unemployment from these longer-run goals and addresses the weighting of relevant costs and benefits when trying to close these gaps. Namely, if the policy prescriptions for achieving the inflation and unemployment goals are in conflict, we will take a balanced approach in promoting the economy's return to each goal, taking into account the size of the deviations and the relative speeds at which convergence can be expected.

Just about every major central bank around the world publishes something akin to such a framework statement. In one way, the Fed's is different because, unlike other countries, we have a dual mandate, so our framework explicitly addresses goals for both inflation and the real side of the economy (as reflected in employment). But just about every central bank with a single price stability mandate also says that it will avoid undue disruptions to the real side of the economy when pursing its inflation goal. Indeed, some are quite clear about following a flexible inflation targeting strategy.

POLICY PROJECTIONS

The forecasts for growth, the unemployment rate, and inflation that FOMC participants have been submitting since 1979 have always been conditioned on each participant's views of the future path of policy most likely to foster outcomes consistent with our dual mandate

responsibilities — what we refer to as the appropriate path for policy. As of January 2012, our quarterly Summary of Economic Projections (SEP) now includes the projected paths for the federal funds rate and qualitative information about the balance sheet that make up these views.

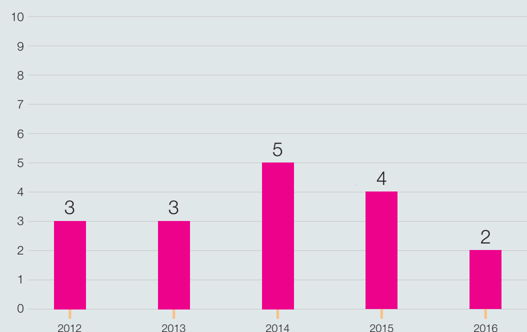
I believe this move significantly enhances policy accountability. For example, suppose inflation were running higher than we would like, and the economic projections in the SEP showed it coming down over the next couple of years. In the absence of policy projections, the public would not know whether the FOMC thought inflation would simply come down on its own or whether it thought that a monetary tightening would be required to reduce inflationary pressures. The inclusion of participants' policy projections will help communicate such judgments.

Furthermore, households and businesses will be able to make better informed decisions if they have a clearer notion of future policy rates; the potential for reduced uncertainty could also lower the risk premium embedded in longer-term interest rates. Now, clearly, our forecasts of what rates are going to be three years from now will often be wrong — and sometimes by a good deal. Some say this means our projections are worthless or, even worse, will cause people to under-weight interest-rate risk in making economic decisions. I disagree. The accuracy of the early forecasts we write down is not as important as the fact that the public can observe how these forecasts change over time. As the economy is hit by shocks or the data come in contrary to expectations, we will update our forecasts for both the economic variables and the policy rate. As we do, households and businesses will be able to learn more about the monetary policy reaction function. And this knowledge will help them make better informed decisions.

Another criticism we heard the day the projections were published was that they seemed to be inconsistent with the FOMC policy statement released a couple of hours earlier. The statement indicated that the Committee thought economic conditions were likely to warrant exceptionally low levels for the federal funds rate at least through late 2014, but six of the 17 policy projections anticipated a fed funds rate of 1-1/2 percent or higher at the end of that year. Well, by the next day, the markets had figured it out; the projections are made by all FOMC participants, while the statement reflects the policy views agreed upon at the meeting by the voting members of the Committee. We all come into the meeting with our own projections, but we then do have a real debate: All of the participants exchange ideas and argue points of view, and then the voters on the Committee come to a consensus and make a collective policy decision. The information regarding the federal funds rate in the SEP does not substitute for this formal decision of the voting members of the FOMC.

Appropriate Timing of Policy Firming

The number of FOMC participants who projected in January of 2012 that the initial increase in the target federal funds rate (from its current range of 0 to 1/4 percent) would appropriately occur in the specified calendar year.



Source: Minutes of the Federal Open Market Committee.

That said, the diversity of views is a fact of life. Policymakers may well make different judgments about the appropriate stance of monetary policy in the particular economic circumstances of the moment. These communications initiatives cannot eliminate these differences of opinion. But they further discipline the parameters of our discussions, clarify the judgments that underlie our policy decisions, and enhance transparency and the public's ability to evaluate current monetary policy and compare it with alternative approaches.

Senior Vice President and Senior Research Advisor Spencer Krane and Economist and Senior Policy Specialist Ellen Rissman contributed to the development of these essays.

First Vice President Gordon Werkema leads the Federal Reserve office that operates the electronic FedLine network, which financial institutions use to access Federal Reserve Bank payment services – more than 71 million payments daily worth almost $4 trillion. Werkema also oversees national sales and marketing of these services.

Federal Reserve Banks

THE FOUNDATION OF THE U.S. PAYMENT SYSTEM

By **Gordon Werkema**
First Vice President and Chief Operating Officer

Consumers, businesses, retailers and governments – as well as the depository institutions that service them – do not have to look too far to see that the payment system is changing rapidly. Non-bank service providers have been jumping into the payment service business. The choice of payment instruments and channels keeps growing. Payment options – including prepaid cards, debit cards, credit cards, stored-value systems, smart phone apps, checks and cash – bombard consumers. And financial incentives abound for service providers, prompting them to steer consumers toward certain types of payment methods and away from others.

With its finger on the pulse of the U.S. payment system, the Reserve Bank Financial Services team is facing these changes head-on. Our national sales and marketing teams closely monitor payment activity and customer needs, and the Board of Governors and various Reserve Banks publish useful research documenting changes in the use of different payment instruments. We also stay very close to the industry by partnering with other payments organizations. For example, this past year we collaborated with NACHA to establish formats, rules and procedures for international ACH payments.

Overall, what we continue to learn from our own efforts and through industry partnerships is that large non-bank companies and service providers – as well as smaller start-up companies – are innovating rapidly in payment services and competing to provide the best solutions for end-users. This drive to innovation reflects the market-driven approach to payment services in the U.S., where multiple banks, service providers, technology companies and the Reserve Banks are in the competitive mix.

Through these periods of change, the Reserve Banks have stood firm as the foundation of the U.S. payment system. For almost 100 years, the role of the Reserve Banks has been to operate a national payment clearing and settlement network, guided by the goals of integrity, efficiency and accessibility. We have not strayed from these goals, and we stand committed to helping financial institutions maintain stability, both in our role as system operator and as an industry thought leader. Summarized below are some accomplishments in 2011 that highlight this commitment.

INTEGRITY

A key attribute of payment system integrity is operating reliable and secure networks, with effective risk management and controls, especially in systemically important systems.

In recent years, the commitment to integrity has expanded to include a focus on resilience and data security, including preparedness for business disruptions such as malicious attacks, natural disasters or network outages. The Federal Reserve Banks are strategically

investing in technology and infrastructure designed to enhance security and reliability. We also have initiatives underway to modernize our funds transfer and securities-processing platforms, check, ACH and electronic access. These improvements will scale our systems for the future processing needs. Enhancing the security of our payments network is requiring ongoing investment in industry-leading approaches for identity and access management, encryption, and intrusion detection.

EFFICIENCY

The Reserve Banks continue to focus on maximizing efficiency within our operations by encouraging even greater use of electronic clearing. We also believe some of the greatest opportunities lie in facilitating straight-through processing for financial institutions and their customers, both business and consumer. Over the past several years, the Federal Reserve Banks have worked with the industry to identify barriers to moving business-to-business (B2B) transactions to electronic payments. We have taken a number of actions to address these obstacles with enhancements to virtually all of our payment services. Some of the key advances include more sophisticated risk management and electronic data interchange (EDI) related services for ACH as well as implementation of an updated Fedwire funds transfer format that supports notification services and remittance information using an internationally recognized format standard. Educating financial institutions and corporations about these innovations and how they address B2B payment requirements is important.

Opportunities for greater clearing speed and efficiency exist for ACH payments as well, both for domestic and international payments. The Federal Reserve Banks' FedACH® SameDay Service introduced a significant change to ACH debit originations and helped to set in motion the industry effort to design an expedited ACH credit origination clearing and settlement model. Same-day clearing puts ACH on par with electronic check, debit and credit transactions from a settlement timing perspective, but at a lower clearing cost and with less risk. With the growth of cross-border commerce, tremendous opportunities also exist to speed international payments, reduce exceptions, lower costs and provide greater certainty and transparency to international payments clearing. Today, the Reserve Banks' FedGlobal® ACH Payments network provides low-cost ACH credit payments clearing to 35 countries, as well as debit payments to Canada, with expansion of the network under consideration.

ACCESSIBILITY

Accessibility is the ability of all depository institutions to use Fed services. We offer services across our entire product suite that are competitively priced and help ensure widespread access. Our FedLine® services provide flexible options so that financial institutions can access the types of services they need at a price they can afford. Customers who aren't able or choose not to invest in sophisticated payments capabilities internally can take advantage of an array of clearing, risk management, information and reporting services we offer. This fuels a competitive marketplace for payments services and benefits end users.

The Reserve Banks supplement our operator role with research and development-like events that benefit the industry at large. For example, the Chicago Fed last year hosted a symposium on Immediate Funds Transfer (IFT) for general-purpose payments. It highlighted systems that are up and running in other countries and asked whether IFT-like attributes would be beneficial for the U.S. payments system as well. We also sponsored a conference on remote payments fraud, which brought industry participants together to discuss strategies to help reduce this type of fraud.

Part of our role as a thought leader in the payments system is to develop meaningful partnerships with various industry associations, system operators, bankers, academics, and legislators, as well as our own System Product Offices. Through forums such as focus groups and conferences, we can keep in close touch with industry developments about how to deliver better customer service.

As we look beyond the current state of change, the Fed finds itself at a crossroads. Our vision is to understand new ways that our payment and clearing network can bring benefits to all end-users of the payments system – in the U.S. and globally. We gain this understanding only through partnership with the private sector, as we have always done. In doing so, we commit to consider the needs of the smallest credit union to the largest bank. In that way, we will continue to be the foundation of the U.S. payment system.

Contributing to the development of this essay were Kirstin Wells, Assistant Vice President, Financial Markets Group, and Cyndi Pijarowski, Assistant Vice President, Customer Relations and Support Office.

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Chairman, President
and Chief Executive Officer
The Allstate Corporation
Northbrook, Illinois

Nelda J. Connors
Chief Executive Officer
Pine Grove Holdings, LLC
Chicago, Illinois

Stephen J. Goodenow
Chairman and Chief Executive Officer
Bank Midwest
Spirit Lake, Iowa

Mark C. Hewitt
President and Chief Executive Officer
Clear Lake Bank & Trust Company
Clear Lake, Iowa

Jeffrey A. Joerres
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Indianapolis, Indiana

Frederick H. Waddell
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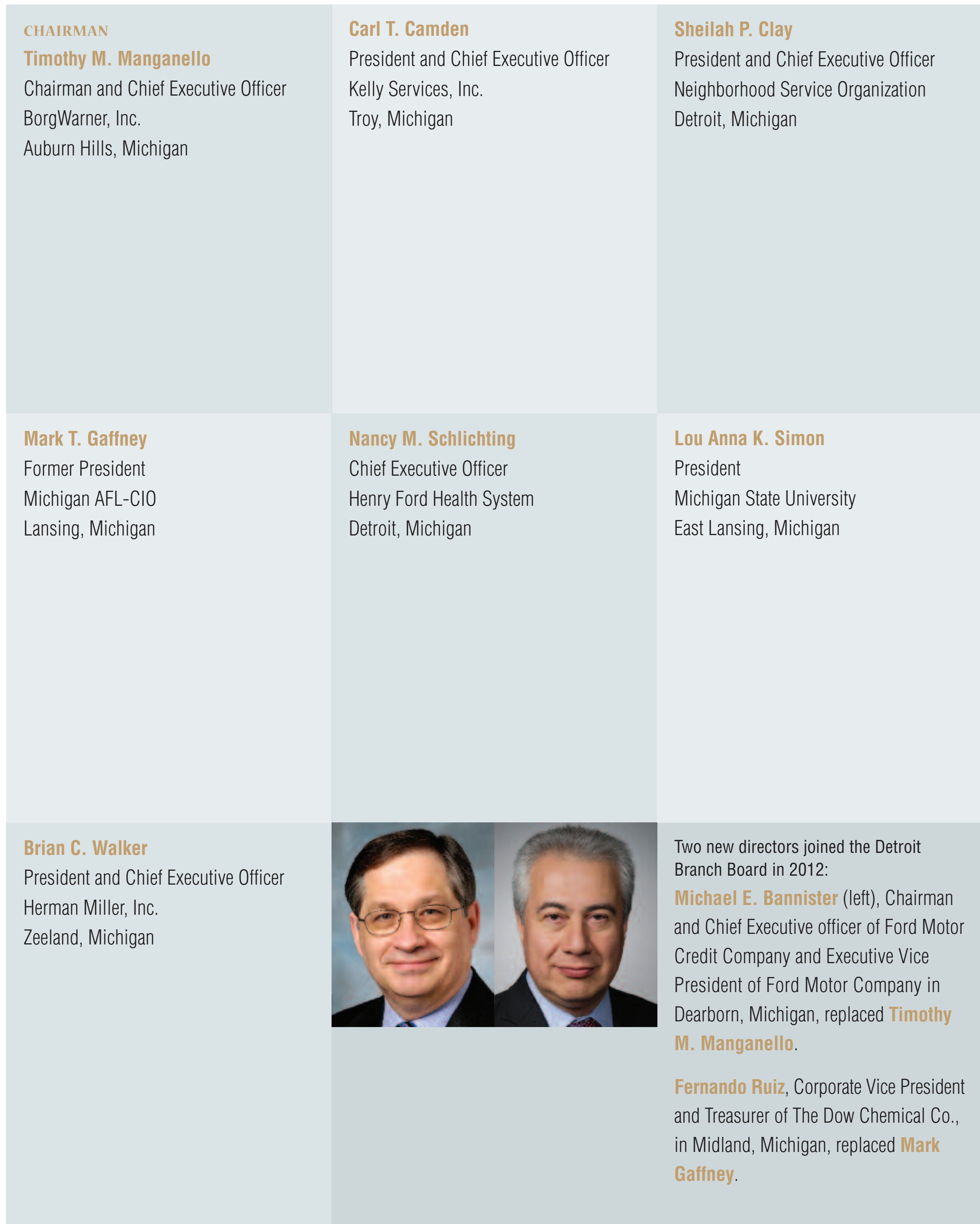
Northern Trust Corporation and
The Northern Trust Company
Chicago, Illinois

BOARD of DIRECTORS

Federal Reserve Bank of Chicago – Detroit Branch



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Auburn Hills, Michigan

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President and Chief Executive Officer
Kelly Services, Inc.
Troy, Michigan

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Detroit, Michigan

Mark T. Gaffney
Former President
Michigan AFL-CIO
Lansing, Michigan

Nancy M. Schlichting
Chief Executive Officer
Henry Ford Health System
Detroit, Michigan

Lou Anna K. Simon
President
Michigan State University
East Lansing, Michigan

Brian C. Walker
President and Chief Executive Officer
Herman Miller, Inc.
Zeeland, Michigan

Two new directors joined the Detroit Branch Board in 2012:

Michael E. Bannister (left), Chairman and Chief Executive officer of Ford Motor Credit Company and Executive Vice President of Ford Motor Company in Dearborn, Michigan, replaced **Timothy M. Manganello**.

Fernando Ruiz, Corporate Vice President and Treasurer of The Dow Chemical Co., in Midland, Michigan, replaced **Mark Gaffney**.

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Chief Executive Officer

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Chief Operating Officer

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Executive Vice President
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(CRSO) and Information Technology

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Legal, Board of Directors, Risk Management,
Business Continuity, Human Resources,
and Internal Communications

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Internal Audit

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Supervision and Regulation

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Associate Director of Research and
Director of Financial Markets Group

Daniel G. Sullivan
Executive Vice President and
Director of Research
Economic Research and Programs

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EEO Officer and Director of OMWI
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Office of Diversity and Inclusion

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District Operations, Administrative Services,
Law Enforcement, and Detroit Branch

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Senior Vice President and
Senior Research Advisor

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Macroeconomic Policy Research

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Microeconomic Policy Research

Daniel R. Aaronson
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Senior Research Advisor

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Large and Foreign Banks

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Large Specialized Institutions

James Nelson
Senior Vice President

Risk Specialists

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Regional Banking, Small Thrifts and Technology Group

Douglas J. Kasl
Vice President

Applications, Enforcement, QM, and Talent

Pamela S. Rieger
Vice President

Compliance

Julie Williams
Vice President

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Executive Vice President
and Product Manager

Electronic Access

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Senior Vice President

Todd Aadland
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National Sales and Marketing

Sean Rodriguez
Senior Vice President

Shonda Clay
Vice President and
Regional Sales Director

Michael J. Hoppe
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National Account Manager

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Officer, and Director of OMWI

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Jerome E. Julian
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General Counsel, Ethics
Officer and District Board
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Human Resources and
Internal Communications

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Vice President and
Associate General Counsel

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Senior Vice President and
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SEVENTH DISTRICT ADVISORY COUNCIL ON AGRICULTURE, SMALL BUSINESS AND LABOR

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Challenger, Gray & Christmas, Inc.
Chicago

Diane Cullinan Oberhelman
Chairman & Founding Partner
Cullinan Properties, Ltd.
Peoria

Joel Hertz
Chairman
Hertz Farm Management
Monticello

ILLINOIS

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President & CEO
North American Tool Corp.
South Beloit

Jorge Ramirez
President
Chicago Federation of Labor
Chicago

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Crystal Lake

Whitney Smith
Program Manager
The Joyce Foundation
Chicago

Siva Yam
President
United States of America -China Chamber of Commerce (USCCC)
Chicago

Harold Force
President & CEO
Force Construction Company, Inc.
Columbus

INDIANA

IOWA

MICHIGAN

Nancy Guyott
President
Indiana State AFL-CIO
Indianapolis

David Howell
Owner
Howell Farms
Middletown

Scott Peterson
President, Harbor Group
CFO, Interstates Companies
Sioux Center

Ken D. Sagar
President
Iowa Federation of Labor AFL-CIO
Des Moines

Dave Armstrong
Chief Executive Officer
GreenStone Farm Credit Services
East Lansing

Scott Z. Goldstein
President
National Default Exchange (NDeX)
Farmington Hills

MICHIGAN

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Chairman & CEO
James Group International, Inc.
Detroit

Birgit Klohs
President & CEO
The Right Place, Inc.
Grand Rapids

Cathy McClelland
President & CEO
McClelland & Associates
Southfield

Donald Snider
Senior Vice President
Urban Economic Development
Michigan Economic Development Corp.
Detroit

David J. Lubar
President
Lubar & Co.
Milwaukee

Carol Maria
President
Wisconsin Business Development (WBD) Service Company
Waukesha

ADVISORY COUNCILS

Standing from left to right: William M. Farrow III, Steven M. Eldred, Timothy G. Marshall, Jeff Plagge, David M. Findlay, Micah R. Bartlett, David W. Heeter, Michael L. Scudder. *Sitting from left to right:* Jean M. Trainor, Catherine J. Tierney, Sandra Jelinksi, Barrie G. Christman.

Community Depository Institution Advisory Council (CDIAC)

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Urban Partnership Bank
Chicago

Michael L. Scudder
President and
Chief Executive Officer
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Chairman of the Board and
Chief Executive Officer
First Midwest Bank
Itasca

IOWA

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Jeff Plagge
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Chief Executive Officer
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Warsaw

David W. Heeter
Chief Executive Officer
MutualBank
Muncie

MICHIGAN

Sandra Jelinski
President and
Chief Executive Officer
Lake Michigan Credit Union
Grand Rapids

Timothy G. Marshall
President and
Chief Executive Officer
Bank of Ann Arbor
Ann Arbor

EXECUTIVE CHANGES

DIRECTORS

Members of the Federal Reserve Bank of Chicago's boards of directors are selected to represent a cross section of the Seventh District economy, including consumers, industry, agriculture, the service sector, labor and banks of various sizes.

The Chicago board consists of nine members. Seventh District member banks elect three bankers and three non-bankers. The Board of Governors appoints three additional non-bankers and designates the Reserve Bank chair and deputy chair from among its three appointees.

The Detroit Branch has a seven-member board of directors. The Board of Governors appoints three non-bankers, and the Chicago Reserve Bank board appoints four additional directors. The Chicago board designates one of the Board of Governors appointees as chair of the Detroit Board. Reserve Bank and Branch directors may serve three-year terms, with a maximum of two full terms.

Director appointments and elections at the Chicago Reserve Bank and its Detroit Branch effective in 2011 were:

William C. Foote was re-appointed to a one-year term as Chicago board chairman.

Thomas J. Wilson was re-appointed to a three-year term as a Chicago director and re-appointed to a one-year term as Chicago board deputy chairman. (Mr. Wilson resigned from the Board in October).

Mark C. Hewitt was re-elected to a three-year term as a Chicago director.

Ann D. Murtlow was re-elected to a three-year term as a Chicago director.

Nelda J. Connors was elected in June to serve an unexpired term as a Chicago director.

Carl T. Camden was re-appointed to a three-year term as a Detroit Branch director.

Nancy M. Schlichting was appointed to a three-year term as a Detroit Branch director.

Timothy M. Manganello was re-appointed to a one-year term as Detroit Branch board chairman.

The following appointments and elections for 2012 were announced:

Fernando Ruiz was appointed in February to serve an unexpired term as a Detroit Branch director.

William C. Foote was re-appointed to a one-year term as Chicago board chairman.

Jeffrey A. Joerres was re-appointed to a three-year term as a Chicago director and appointed to a one-year term as Chicago board deputy chairman.

Frederick H. Waddell was re-elected to a three-year term as a Chicago director.

Nelda J. Connors was re-elected to a three-year term as a Chicago director.

Michael E. Bannister was appointed to a three-year term as a Detroit Branch director.

Brian C. Walker was re-appointed to a three-year term as a Detroit Branch director.

Carl T. Camden was appointed to a one-year term as Detroit Branch board chairman.

FEDERAL ADVISORY COUNCIL REPRESENTATIVE

The Federal Advisory Council, which meets quarterly to discuss business and financial conditions with the Board of Governors in Washington, D.C., is composed of one person from each of the 12 Federal Reserve Districts. Each year the Chicago Reserve Bank's board of directors selects a representative to this group.

David W. Nelms, Chairman and Chief Executive Officer of Discover Financial Services in Riverwoods, Illinois, served one-year terms in 2010 and 2011 as the Federal Advisory Council representative for the Seventh Federal Reserve District. He was selected to serve a third one-year term in 2012.

EXECUTIVE CHANGES

Bill Barouski Executive Vice President, Customer Relations and Support Office (CRSO) and Information Technology (IT), assumed the role of the Federal Reserve System's Chief Information Security Officer (CISO).

The Bank's Board of Directors acted on the following promotion during 2011:

Richard Heckinger to Vice President and Senior Policy Advisor, Financial Markets Group.

OPERATIONS VOLUMES

	DOLLAR AMOUNT		NUMBER OF ITEMS	
	2011	2010	2011	2010
CHECK AND ELECTRONIC PAYMENTS				
Checks, NOWs, & Share Drafts Processed	—	—	—	—
Legacy Images Captured	—	—	—	—
Check 21 Images Presented	—	—	651.8 Million	799.1 Million
Check 21 IRD* Printed	—	—	7.5 Million	54.9 Million
Check 21 Items Received	832.3 Billion	1.1 Trillion	685.7 Million	963.6 Million
CASH OPERATIONS				
Currency Counted	43.7 Billion	41.5 Billion	2.9 Billion	3.1 Billion
Unfit Currency Destroyed	4.0 Billion	4.4 Billion	335.1 Million	474.0 Million
Coin Bags Paid and Received	1.7 Billion	1.8 Billion	3.4 Million	3.5 Million
Number of Notes Paid and Received	109.5 Billion	105.1 Billion	6.9 Billion	7.1 Billion
LOANS TO DEPOSITORY INSTITUTIONS				
Total Loans Made During Year	1.1 Billion	7.0 Billion	0.7 Thousand	1.2 Thousand

**Image Replacement Documents*

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Auditor Independence

In 2011, the Board of Governors engaged Deloitte & Touche LLP (D&T) to audit the combined and individual financial statements of the Reserve Banks and those of the consolidated LLC entities.[1] In 2011, D&T also conducted audits of internal control over financial reporting for each of the Reserve Banks and the consolidated LLC entities. Fees for D&T's services totaled $8 million, of which $2 million was for the audits of the consolidated LLC entities. To ensure auditor independence, the Board of Governors requires that D&T be independent in all matters relating to the audits. Specifically, D&T 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 2011, the Bank did not engage D&T for any non-audit services.

[1]Each LLC will reimburse the Board of Governors for the fees related to the audit of its financial statements from the entity's available net assets.

Management's Report on Internal Control Over Financial Reporting

March 20, 2012

To the Board of Directors

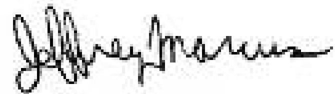
The management of the Federal Reserve Bank of Chicago (FRBC) is responsible for the preparation and fair presentation of the Statements of Condition as of December 31, 2011 and 2010, and the Statements of Income and Comprehensive Income, and Statements of Changes in Capital for the years then ended (the 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 as set forth in the *Financial Accounting Manual for Federal Reserve Banks* (FAM), and, as such, include some amounts that are based on management judgments and estimates. To our knowledge, the financial statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the FAM and include all disclosures necessary for such fair presentation.

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

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

The management of the FRBC assessed its internal control over financial reporting based upon the criteria established in the *"Internal Control – Integrated Framework"* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, we believe that the FRBC maintained effective internal control over financial reporting.

Federal Reserve Bank of Chicago



by Charles L. Evans
President

by Gordon Werkema
First Vice President

by Jeffrey Marcus
Vice President and Controller

Independent Auditors' Report

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

We have audited the accompanying Statements of Condition of the Federal Reserve Bank of Chicago ("FRB Chicago") as of December 31, 2011 and 2010, and the related Statements of Income and Comprehensive Income, and of Changes in Capital for the years then ended, which have been prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System. We also have audited the internal control over financial reporting of the FRB Chicago as of December 31, 2011, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The FRB Chicago's management is responsible for these Financial Statements, for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these Financial Statements and an opinion on the FRB Chicago's internal control over financial reporting based on our audits.

We conducted our audits in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Financial Statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the Financial Statements included examining, on a test basis, evidence supporting the amounts and disclosures in the Financial Statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

The FRB Chicago's internal control over financial reporting is a process designed by, or under the supervision of, the FRB Chicago's principal executive and principal financial officers, or persons performing similar functions, and effected by the FRB Chicago's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of Financial Statements for external purposes in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System. The FRB Chicago's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the FRB Chicago; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of Financial Statements in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System, and that receipts and expenditures of the FRB Chicago are being made only in accordance with authorizations of management and directors of the FRB Chicago; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the FRB Chicago's assets that could have a material effect on the Financial Statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Member of
Deloitte Touche Tohmatsu Limited

As described in Note 4 to the Financial Statements, the FRB Chicago has prepared these Financial Statements in conformity with accounting principles established by the Board of Governors of the Federal Reserve System, as set forth in the *Financial Accounting Manual for Federal Reserve Banks*, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The effects on such Financial Statements of the differences between the accounting principles established by the Board of Governors of the Federal Reserve System and accounting principles generally accepted in the United States of America are also described in Note 4.

In our opinion, such Financial Statements present fairly, in all material respects, the financial position of the FRB Chicago as of December 31, 2011 and 2010, and the results of its operations for the years then ended, on the basis of accounting described in Note 4. Also, in our opinion, the FRB Chicago maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Deloitte & Touche LLP

March 20, 2012

Financial Statements

Abbreviations

ACH	Automated clearinghouse
AMLF	Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility
ASU	Accounting Standards Update
Bureau	Bureau of Consumer Financial Protection
FAM	*Financial Accounting Manual for Federal Reserve Banks*
FASB	Financial Accounting Standards Board
Fannie Mae	Federal National Mortgage Association
Freddie Mac	Federal Home Loan Mortgage Corporation
FOMC	Federal Open Market Committee
FRBA	Federal Reserve Bank of Atlanta
FRBNY	Federal Reserve Bank of New York
GAAP	Accounting principles generally accepted in the United States of America
GSE	Government-sponsored enterprise
IMF	International Monetary Fund
MBS	Mortgage-backed securities
OEB	Office of Employee Benefits of the Federal Reserve System
OFR	Office of Financial Research
SDR	Special drawing rights
SOMA	System Open Market Account
STRIP	Separate Trading of Registered Interest and Principal of Securities
TAF	Term Auction Facility
TBA	To be announced
TDF	Term Deposit Facility
TIPS	Treasury Inflation-Protected Securities
TOP	Term Securities Lending Facility Options Program
TSLF	Term Securities Lending Facility

Financial Statements

Federal Reserve Bank of Chicago Statements of Condition
As of December 31, 2011 and December 31, 2010 (in millions)

	2011	2010
ASSETS		
Gold certificates	$ 854	$ 887
Special drawing rights certificates	424	424
Coin	332	336
Loans to depository institutions	17	79
System Open Market Account:		
Treasury securities, net	103,941	80,434
Government-sponsored enterprise debt securities, net	6,403	11,532
Federal agency and government-sponsored enterprise mortgage-backed securities, net	50,374	75,740
Foreign currency denominated assets, net	657	629
Central bank liquidity swaps	2,529	2
Accrued interest receivable	1,169	1,073
Bank premises and equipment, net	236	240
Items in process of collection	20	40
Other assets	24	22
Total assets	**$ 166,980**	**$ 171,438**
LIABILITIES AND CAPITAL		
Federal Reserve notes outstanding, net	$ 76,931	$ 73,925
System Open Market Account:		
Securities sold under agreements to repurchase	5,933	4,501
Other liabilities	81	-
Deposits:		
Depository institutions	76,731	59,416
Other deposits	36	27
Interest payable to depository institutions	7	6
Accrued benefit costs	166	152
Deferred credit items	56	151
Accrued interest on Federal Reserve notes	170	118
Interdistrict settlement account	5,416	31,780
Other liabilities	17	18
Total liabilities	**165,544**	**170,094**
Capital paid-in	718	672
Surplus (including accumulated other comprehensive loss of $47 and $41 at December 31, 2011 and 2010, respectively)	718	672
Total capital	**1,436**	**1,344**
Total liabilities and capital	**$ 166,980**	**$ 171,438**

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

Financial Statements

Federal Reserve Bank of Chicago Statements of Income and Comprehensive Income
For the years ended December 31, 2011 and December 31, 2010 (in millions)

	2011	2010
INTEREST INCOME		
Loans:		
Loans to Depository institutions	$ -	$ 1
System Open Market Account:		
Treasury securities, net	2,673	2,234
Government-sponsored enterprise debt securities, net	197	299
Federal agency and government-sponsored enterprise mortgage-backed securities, net	2,460	3,807
Foreign currency denominated assets, net	6	6
Central bank liquidity swaps	1	-
Total interest income	**5,337**	**6,347**
INTEREST EXPENSE		
System Open Market Account:		
Securities sold under agreements to repurchase	3	8
Deposits:		
Depository institutions	174	110
Term Deposit Facility	1	-
Total interest expense	**178**	**118**
Net interest income	**5,159**	**6,229**
NON-INTEREST INCOME		
System Open Market Account:		
Treasury securities gains, net	134	-
Federal agency and government-sponsored enterprise mortgage-backed securities gains, net	1	71
Foreign currency gains, net	4	13
Income from services	76	72
Compensation received for service costs provided	21	25
Reimbursable services to government agencies	5	4
Other	8	9
Total non-interest income	**249**	**194**
OPERATING EXPENSES		
Salaries and benefits	175	165
Occupancy	29	28
Equipment	12	11
Compensation paid for service costs incurred	8	9
Assessments:		
Board of Governors operating expenses and currency costs	73	69
Bureau of Consumer Financial Protection	7	1
Office of Financial Research	1	-
Other	77	72
Total operating expenses	**382**	**355**
Net income prior to distribution	**5,026**	**6,068**
Change in prior service costs related to benefit plans	(1)	(2)
Change in actuarial losses related to benefit plans	(5)	(1)
Comprehensive income prior to distribution	**$ 5,020**	**$ 6,065**
Distribution of comprehensive income:		
Dividends paid to member banks	$ 42	$ 38
Transferred to surplus and change in accumulated other comprehensive loss	46	53
Payments to Treasury as interest on Federal Reserve notes	4,932	5,974
Total distribution	**$ 5,020**	**$ 6,065**

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

Financial Statements

Federal Reserve Bank of Chicago Statements of Changes in Capital
For the years ended December 31, 2011 and December 31, 2010 (in millions, except share data)

		Surplus			
	Capital paid-in	Net income retained	Accumulated other comprehensive loss	Total surplus	Total capital
Balance at January 1, 2010 (12,389,881 shares)	**$ 619**	**$ 657**	**$ (38)**	**$ 619**	**$ 1,238**
Net change in capital stock issued (1,049,943 shares)	53	-	-	-	53
Transferred to surplus and change in accumulated other comprehensive loss	-	56	(3)	53	53
Balance at December 31, 2010 (13,439,824 shares)	**$ 672**	**$ 713**	**$ (41)**	**$ 672**	**$ 1,344**
Net change in capital stock issued (913,335 shares)	46	-	-	-	46
Transferred to surplus and change in accumulated other comprehensive loss	-	52	(6)	46	46
Balance at December 31, 2011 (14,353,159 shares)	**$ 718**	**$ 765**	**$ (47)**	**$ 718**	**$ 1,436**

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

Notes to Financial Statements

1. Structure

The Federal Reserve Bank of Chicago is part of the Federal Reserve System (System) and is one of the 12 Federal 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 serves the Seventh Federal Reserve District, which includes Iowa, and portions of Michigan, Illinois, Wisconsin and Indiana.

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

In addition to the 12 Reserve Banks, the System also consists, in part, of the Board of Governors and the Federal Open Market Committee (FOMC). The Board of Governors, an independent federal agency, is charged by the Federal Reserve Act with a number of specific duties, including general supervision over the Reserve Banks. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York (FRBNY), and, on a rotating basis, four other Reserve Bank presidents.

2. Operations and Services

The Reserve Banks perform a variety of services and operations. These functions include participating in formulating and conducting monetary policy; participating in the payment system, including large-dollar transfers of funds, automated clearinghouse (ACH) operations, and check collection; distributing coin and currency; performing fiscal agency functions for the U.S. Department of the Treasury (Treasury), certain federal agencies, and other entities; serving as the federal government's bank; providing short-term loans to depository institutions; providing loans to participants in programs or facilities with broad-based eligibility in unusual and exigent circumstances; serving consumers and communities by providing educational materials and information regarding financial consumer protection rights and laws and information on community development programs and activities; and supervising bank holding companies, state member banks, savings and loan holding companies, and U.S. offices of foreign banking organizations pursuant to authority delegated by the Board of Governors. Certain services are provided to foreign and international monetary authorities, primarily by the FRBNY.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which was signed into law and became effective on July 21, 2010, changed the scope of some services performed by the Reserve Banks. Among other things, the Dodd-Frank Act established a Bureau of Consumer Financial Protection (Bureau) as an independent bureau within the System that has supervisory authority over some institutions previously supervised by the Reserve Banks under delegated authority from the Board of Governors in connection with those institutions' compliance with consumer protection statutes; limited the Reserve Banks' authority to provide loans in unusual and exigent circumstances to lending programs or facilities with broad-based eligibility or to designated financial market utilities; and vested the Board of Governors with all supervisory and rule-writing authority for savings and loan holding companies.

The FOMC, in conducting monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and issues authorizations and directives to the FRBNY to execute transactions. The FOMC authorizes and directs the FRBNY to conduct operations in domestic markets, including the direct purchase and sale of Treasury securities, government-sponsored enterprise (GSE) debt securities, federal agency and GSE mortgage-backed securities (MBS), the purchase of these securities under agreements to resell, and the sale of these securities under agreements to repurchase. The FRBNY holds the resulting securities and agreements in a portfolio known as the System Open Market Account (SOMA). The FRBNY is authorized to lend the Treasury securities and federal agency and GSE debt securities that are held in the SOMA.

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes the FRBNY to conduct operations in foreign markets in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC to carry out the System's central bank responsibilities. Specifically, the FOMC authorizes and directs the FRBNY to hold balances of, and to execute spot and forward foreign exchange and securities contracts for, 14 foreign currencies and to invest such foreign currency holdings, while maintaining adequate liquidity. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico in the maximum amounts of $2 billion and $3 billion, respectively, and to warehouse foreign currencies for the Treasury and the Exchange Stabilization Fund.

Although the Reserve Banks are separate legal entities, they collaborate on the delivery of certain services to achieve greater efficiency and effectiveness. This collaboration takes the form of centralized operations and product or function 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 Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, the Reserve Banks are reimbursed for costs incurred in providing services to other Reserve Banks. Major services provided by the Bank on behalf of the System and for which the costs were not reimbursed by the other Reserve Banks include national business development and customer support.

3. Financial Stability Activities

The Reserve Banks have implemented the following programs that support the liquidity of financial institutions and foster improved conditions in financial markets.

Large-Scale Asset Purchase Programs and Reinvestment of Principal Payments

On March 18, 2009, the FOMC authorized and directed the FRBNY to purchase $300 billion of longer-term Treasury securities to help improve conditions in private credit markets. The FRBNY began the purchases of these Treasury securities in March 2009 and completed them in October 2009. On August 10, 2010, the FOMC announced that the Federal Reserve would maintain the level of domestic securities holdings in the SOMA portfolio by reinvesting principal payments from GSE debt securities and federal agency and GSE MBS in longer-term Treasury securities. On November 3, 2010, the FOMC announced its intention to expand the SOMA portfolio holdings of longer-term Treasury securities by an additional $600 billion and completed these purchases in June 2011. On June 22, 2011, the FOMC announced that the Federal Reserve would maintain its existing policy of reinvesting principal payments from all domestic securities in Treasury securities. On September 21, 2011, the FOMC announced that the Federal Reserve intends to purchase, by the end of June 2012, $400 billion par value of Treasury securities with remaining maturities of 6 years to 30 years and to sell an equal amount of Treasury securities with remaining maturities of 3 years or less, of which $133 billion has been purchased and $134 billion sold as of December 31, 2011. In addition, the FOMC announced that it will maintain its existing policy of rolling over maturing Treasury securities at auction and, rather than reinvesting principal payments from GSE debt securities and federal agency and GSE MBS in Treasury securities, such payments will be reinvested in federal agency and GSE MBS.

The FOMC authorized and directed the FRBNY to purchase GSE debt securities and federal agency and GSE MBS, with a goal to provide support to mortgage and housing markets and to foster improved conditions in financial markets more generally. The FRBNY was authorized to purchase up to $175 billion in fixed-rate, non-callable GSE debt securities and $1.25 trillion in fixed-rate federal agency and GSE MBS. Purchases of GSE debt securities began in November 2008, and purchases of federal agency and GSE MBS began in January 2009. The FRBNY completed the purchases of GSE debt securities and federal agency and GSE MBS in March 2010. The settlement of all federal agency and GSE MBS transactions was completed by August 2010. As discussed above, on September 21, 2011, the FOMC announced that the Federal Reserve will begin to reinvest principal payments from its holdings of GSE debt securities and federal agency and GSE MBS in federal agency and GSE MBS.

Central Bank Liquidity Swaps

The FOMC authorized and directed the FRBNY to establish central bank liquidity swap arrangements, which could be structured as either U.S. dollar liquidity or foreign currency liquidity swap arrangements.

In May 2010, U.S. dollar liquidity swap arrangements were re-authorized with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank through January 2011. Subsequently, these arrangements were extended through February 1, 2013. There is no specified limit to the amount that may be drawn by the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank under these swap arrangements; the Bank of Canada may draw up to $30 billion under the swap arrangement with the FRBNY. In addition to the central bank liquidity swap arrangements, the FOMC has authorized reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico, as discussed in Note 2.

Foreign currency liquidity swap arrangements were authorized with 4 foreign central banks and provided the Reserve Banks with the capacity to offer foreign currency liquidity to U.S. depository institutions. The authorization for these swap arrangements expired on February 1, 2010. In November 2011, as a contingency measure, the FOMC agreed to establish temporary bilateral liquidity swap arrangements with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank so that liquidity can be provided in any of their currencies if necessary. The swap lines are authorized until February 1, 2013.

Lending to Depository Institutions

The Term Auction Facility (TAF) promoted the efficient dissemination of liquidity by providing term funds to depository institutions. The last TAF auction was conducted on March 8, 2010, and the related loans matured on April 8, 2010.

Lending to Primary Dealers

The Term Securities Lending Facility (TSLF) promoted liquidity in the financing markets for Treasury securities. Under the TSLF, the FRBNY could lend up to an aggregate amount of $200 billion of Treasury securities held in the SOMA to primary dealers on a secured basis for a term of 28 days. The authorization for the TSLF expired on February 1, 2010.

The Term Securities Lending Facility Options Program (TOP) offered primary dealers the opportunity to purchase an option to draw upon short-term, fixed-rate TSLF loans in exchange for eligible collateral. The program was suspended effective with the maturity of the June 2009 TOP options, and authorization for the program expired on February 1, 2010.

Other Lending Facilities

The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) provided funding to depository institutions and bank holding companies to finance the purchase of eligible high-quality asset-backed commercial paper (ABCP) from money market mutual funds. The Federal Reserve Bank of Boston administered the AMLF and was authorized to extend these loans to eligible borrowers on behalf of the other Reserve Banks. The authorization for the AMLF expired on February 1, 2010.

4. Significant Accounting Policies

Accounting principles for entities with the unique powers and responsibilities of a nation's central bank have not been formulated by accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and practices that it considers to be appropriate for the nature and function of a central bank. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* (FAM), which is issued by the Board of Governors. The Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the FAM and the financial statements have been prepared in accordance with the FAM.

Limited differences exist between the accounting principles and practices in the FAM and accounting principles generally accepted in the United States of America (GAAP), due to the unique nature of the Bank's powers and responsibilities as part of the nation's central bank and given the System's unique responsibility to conduct monetary policy. The primary differences are the presentation of all SOMA securities holdings at amortized cost and the recording of SOMA securities on a settlement-date basis. Amortized cost, rather than the fair value presentation, more appropriately reflects the Bank's securities holdings given the System's unique responsibility to conduct monetary policy. Although the application of fair value measurements to the securities holdings may result in values substantially greater or less than their carrying values, these unrealized changes in value 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 before maturity. Decisions regarding securities and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, fair values, earnings, and gains or losses resulting from the sale of such securities and currencies are incidental to open market operations and do not motivate decisions related to policy or open market activities. Accounting for these securities on a settlement-date basis, rather than the trade-date basis required by GAAP, better reflects the timing of the transaction's effect on the quantity of reserves in the banking system. The cost bases of Treasury securities, GSE debt securities, and foreign government debt instruments are adjusted for amortization of premiums or accretion of discounts on a straight-line basis, rather than using the interest method required by GAAP.

In addition, the Bank does not present a Statement of Cash Flows as required by GAAP because the liquidity and cash position of the Bank are not a primary concern given the Reserve Banks' unique powers and responsibilities as a central bank. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income and Comprehensive Income, and Changes in Capital, and the accompanying notes to the financial statements. There are no other significant differences, other than those described above, between the policies outlined in the FAM and GAAP.

Preparing the financial statements in conformity with the FAM requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Unique accounts and significant accounting policies are explained below.

a. Consolidation

The Dodd-Frank Act established the Bureau as an independent bureau within the System, and section 1017 of the Dodd-Frank Act provides that the financial statements of the Bureau are not to be consolidated with those of the Board of Governors or the System. Section 152 of the Dodd-Frank Act established the Office of Financial Research (OFR) within the Treasury. The Board of Governors funds the Bureau and OFR through assessments on the Reserve Banks as required by the Dodd-Frank Act. The Reserve Banks reviewed the law and evaluated the design of and their relationships to the Bureau and the OFR and determined that neither should be consolidated in the Bank's financial statements.

Notes to Financial Statements

b. Gold and Special Drawing Rights Certificates

The Secretary of the Treasury is authorized to issue gold and special drawing rights (SDR) certificates to the Reserve Banks. Upon authorization, the Reserve Banks acquire gold certificates by crediting equivalent amounts in dollars to the account established for the Treasury. The gold certificates held by the Reserve Banks are required to be backed by the gold owned by the Treasury. The Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the Treasury. At such time, the Treasury's account is charged, and the Reserve Banks' gold certificate accounts are reduced. The value of gold for purposes of backing the gold certificates is set by law at $42 2/9 per fine troy ounce. The Board of Governors allocates the gold certificates among the Reserve Banks once a year based on the average Federal Reserve notes outstanding at each Reserve Bank.

SDR certificates are issued by the International Monetary Fund (IMF) to its members in proportion to each member's quota in the IMF at the time of issuance. SDR certificates serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for U.S. participation in the SDR system, the Secretary of the Treasury is authorized to issue SDR certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in U.S. dollars are credited to the account established for the Treasury and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the 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 the Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. SDRs are recorded by the Bank at original cost. There were no SDR transactions during the years ended December 31, 2011 and 2010.

c. Coin

The amount reported as coin in the Statements of Condition represents the face value of all United States coin held by the Bank. The Bank buys coin at face value from the U.S. Mint in order to fill depository institution orders.

d. Loans

Loans to depository institutions are reported at their outstanding principal balances, and interest income is recognized on an accrual basis.

Loans are impaired when current information and events indicate that it is probable that the Bank will not receive the principal and interest that are due in accordance with the contractual terms of the loan agreement. Impaired loans are evaluated to determine whether an allowance for loan loss is required. The Bank has developed procedures for assessing the adequacy of any allowance for loan losses using all available information to identify incurred losses. This assessment includes monitoring information obtained from banking supervisors, borrowers, and other sources to assess the credit condition of the borrowers and, as appropriate, evaluating collateral values. Generally, the Bank would discontinue recognizing interest income on impaired loans until the borrower's repayment performance demonstrates principal and interest would be received in accordance with the terms of the loan agreement. If the Bank discontinues recording interest on an impaired loan, cash payments are first applied to principal until the loan balance is reduced to zero; subsequent payments are applied as recoveries of amounts previously deemed uncollectible, if any, and then as interest income.

e. Securities Purchased Under Agreements to Resell, Securities Sold Under Agreements to Repurchase, and Securities Lending

The FRBNY may engage in purchases of securities with primary dealers under agreements to resell (repurchase transactions). These repurchase transactions are settled through a triparty arrangement. In a triparty arrangement, two commercial custodial banks manage the collateral clearing, settlement, pricing, and pledging, and provide cash and securities custodial services for and on behalf of the Bank and counterparty. The collateral pledged must exceed the principal amount of the transaction by a margin determined by the FRBNY for each class and maturity of acceptable collateral. Collateral designated by the FRBNY as acceptable under repurchase transactions primarily includes Treasury securities (including TIPS and STRIP Treasury securities); direct obligations of several federal and GSE-related agencies, including Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac); and pass-through MBS of Fannie Mae, Freddie Mac, and Government National Mortgage Association. The repurchase transactions are accounted for as financing transactions with the associated interest income recognized over the life of the transaction.

The FRBNY may engage in sales of securities under agreements to repurchase (reverse repurchase transactions) with primary dealers and, beginning August 2010, with selected money market funds. The list of eligible counterparties was subsequently expanded to include GSEs, effective in May 2011, and bank and savings institutions, effective in July 2011. These reverse repurchase transactions may be executed through a triparty arrangement as an open market operation, similar to repurchase transactions. Reverse repurchase transactions may also be executed with foreign official and international account holders as part of a service offering. Reverse repurchase agreements are collateralized by a pledge of an amount of Treasury securities, GSE debt securities, and federal agency and GSE MBS that are held in the SOMA. Reverse repurchase transactions are accounted for as financing transactions, and the associated interest

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expense is recognized over the life of the transaction. These transactions are reported at their contractual amounts as "System Open Market Account: Securities sold under agreements to repurchase" and the related accrued interest payable is reported as a component of "Other liabilities" in the Statements of Condition.

Treasury securities and GSE debt securities held in the SOMA may be lent to primary dealers to facilitate the effective functioning of the domestic securities markets. The amortized cost basis of securities lent continues to be reported as "Treasury securities, net" or "Government-sponsored enterprise debt securities, net," as appropriate, in the Statements of Condition. Overnight securities lending transactions are fully collateralized by Treasury securities that have fair values in excess of the securities lent. The FRBNY charges the primary dealer a fee for borrowing securities, and these fees are reported as a component of "Non-interest income: Other" in the Statements of Income and Comprehensive Income.

Activity related to securities purchased under agreements to resell, securities sold under agreements to repurchase, and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from an annual settlement of the interdistrict settlement account that occurs in the second quarter of each year.

f. Treasury Securities; Government-Sponsored Enterprise Debt Securities; Federal Agency and Government-Sponsored Enterprise Mortgage-Backed Securities; Foreign Currency Denominated Assets; and Warehousing Agreements

Interest income on Treasury securities, GSE debt securities, and foreign currency denominated assets comprising the SOMA is accrued on a straight-line basis. Interest income on federal agency and GSE MBS is accrued using the interest method and includes amortization of premiums, accretion of discounts, and gains or losses associated with principal paydowns. Premiums and discounts related to federal agency and GSE MBS are amortized over the term of the security to stated maturity, and the amortization of premiums and accretion of discounts are accelerated when principal payments are received. Gains and losses resulting from sales of securities are determined by specific issue based on average cost. Treasury securities, GSE debt securities, and federal agency and GSE MBS are reported net of premiums and discounts in the Statements of Condition and interest income on those securities is reported net of the amortization of premiums and accretion of discounts in the Statements of Income and Comprehensive Income.

In addition to outright purchases of federal agency and GSE MBS that are held in the SOMA, the FRBNY enters into dollar roll transactions (dollar rolls), which primarily involve an initial transaction to purchase or sell "to be announced" (TBA) MBS for delivery in the current month combined with a simultaneous agreement to sell or purchase TBA MBS on a specified future date. In 2010, the FRBNY also executed a limited number of TBA MBS coupon swap transactions, which involve a simultaneous sale of a TBA MBS and purchase of another TBA MBS of a different coupon rate. During the year-ended December 31, 2010, the FRBNY's participation in the dollar roll and coupon swap markets furthered the MBS purchase program goals of providing support to the mortgage and housing markets and of fostering improved conditions in financial markets more generally. During the year-ended December 31, 2011, the FRBNY executed dollar rolls primarily to facilitate settlement. The FRBNY accounts for outstanding commitments under dollar roll and coupon swaps as purchases or sales on a settlement-date basis. Net gains (losses) resulting from dollar roll and coupon swap transactions are reported as "Non-interest income: System Open Market Account: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net" in the Statements of Income and Comprehensive Income.

Foreign currency denominated assets, which can include foreign currency deposits, securities purchased under agreements to resell, and government debt instruments, 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 foreign currency denominated assets are reported as "Non-interest income: System Open Market Account: Foreign currency gains, net" in the Statements of Income and Comprehensive Income.

Activity related to Treasury securities, GSE debt securities, and federal agency and GSE MBS, including the premiums, discounts, and realized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of the interdistrict settlement account that occurs in the second quarter of each year. Activity related to foreign currency denominated assets, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to the Reserve Banks' aggregate capital and surplus at the preceding December 31.

Warehousing is an arrangement under which the FOMC has approved the exchange, at the request of the Treasury, of U.S. dollars for foreign currencies held by the Treasury over a limited period. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury for financing purchases of foreign currencies and related international operations. Warehousing agreements are designated as held-for-trading purposes and are valued daily at current market exchange rates. Activity related to these agreements is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to the Reserve Banks' aggregate capital and surplus at the preceding December 31.

g. Central Bank Liquidity Swaps

Central bank liquidity swaps, which are transacted between the FRBNY and a foreign central bank, can be structured as either U.S. dollar liquidity or foreign currency liquidity swap arrangements.

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Central bank liquidity swaps activity, including the related income and expense, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to the Reserve Banks' aggregate capital and surplus at the preceding December 31. The foreign currency amounts associated with these central bank liquidity swap arrangements are revalued daily at current foreign currency market exchange rates.

U.S. dollar liquidity swaps

At the initiation of each U.S. dollar liquidity swap transaction, the foreign central bank transfers a specified amount of its currency to a restricted account for the FRBNY in exchange for U.S. dollars at the prevailing market exchange rate. Concurrent with this transaction, the FRBNY and the foreign central bank agree to a second transaction that obligates the foreign central bank to return the U.S. dollars and the FRBNY to return the foreign currency on a specified future date at the same exchange rate as the initial transaction. The Bank's allocated portion of the foreign currency amounts that the FRBNY acquires are reported as "System Open Market Account: Central bank liquidity swaps" in the Statements of Condition. Because the swap transaction will be unwound at the same U.S. dollar amount and exchange rate that were used in the initial transaction, the recorded value of the foreign currency amounts is not affected by changes in the market exchange rate.

The foreign central bank compensates the FRBNY based on the foreign currency amounts it holds for the FRBNY. The Bank's allocated portion of the amount of compensation received during the term of the swap transaction is reported as "Interest income: System Open Market Account: Central bank liquidity swaps" in the Statements of Income and Comprehensive Income.

Foreign currency liquidity swaps

The structure of foreign currency liquidity swap transactions involves the transfer by the FRBNY, at the prevailing market exchange rate, of a specified amount of U.S. dollars to an account for the foreign central bank in exchange for its currency. The foreign currency amount received would be reported as a liability by the Bank.

h. Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 2 to 50 years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are depreciated over the remaining useful life of the asset or, if appropriate, over the unique useful life of the alteration, renovation, or improvement. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred.

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

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

i. Interdistrict Settlement Account

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

j. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes, which are identified as issued to a specific Reserve Bank, must be fully collateralized. All of the Bank's assets are eligible to be pledged as collateral. The collateral value is equal to the book value of the collateral tendered with the exception of securities, for which the collateral value is equal to the par value of the securities tendered. The par value of securities sold under agreements to repurchase is deducted from the eligible collateral value.

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

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Bank's currency holdings of $11,962 million and $12,147 million at December 31, 2011 and 2010, respectively.

Notes to Financial Statements

At December 31, 2011 and 2010, all Federal Reserve notes issued to the Reserve Banks were fully collateralized. At December 31, 2011, all gold certificates, all special drawing right certificates, and $1,018 billion of domestic securities held in the SOMA were pledged as collateral. At December 31, 2011, no investments denominated in foreign currencies were pledged as collateral.

k. Deposits

Depository Institutions

Depository institutions' deposits represent the reserve and service-related balances, such as required clearing balances, in the accounts that depository institutions hold at the Bank. The interest rates paid on required reserve balances and excess balances are determined by the Board of Governors, based on an FOMC-established target range for the federal funds rate. Interest payable is reported as "Interest payable to depository institutions" in the Statements of Condition.

The Term Deposit Facility (TDF) consists of deposits with specific maturities held by eligible institutions at the Reserve Banks. The Reserve Banks pay interest on these deposits at interest rates determined by auction. Interest payable is reported as "Interest payable to depository institutions" in the Statements of Condition. There were no deposits held by the Bank under the TDF at December 31, 2011 and 2010.

Other

Other deposits include foreign central bank and foreign government deposits held at the FRBNY that are allocated to the Bank.

l. Items in Process of Collection and Deferred Credit Items

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

m. 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. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

By law, each Reserve Bank is required to pay each member bank an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. To meet the Federal Reserve Act requirement that annual dividends be deducted from net earnings, dividends are presented as a distribution of comprehensive income in the Statements of Income and Comprehensive Income.

n. Surplus

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in. On a daily basis, surplus is adjusted to equate the balance to capital paid-in. Accumulated other comprehensive income is reported as a component of "Surplus" in the Statements of Condition and the Statements of Changes in Capital. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 12 and 13.

o. Interest on Federal Reserve Notes

The Board of Governors requires the Reserve Banks to transfer excess earnings to the Treasury as interest on Federal Reserve notes after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. This amount is reported as "Payments to Treasury as interest on Federal Reserve notes" in the Statements of Income and Comprehensive Income. The amount due to the Treasury is reported as "Accrued interest on Federal Reserve notes" in the Statements of Condition.

If earnings during the year are not sufficient to provide for the costs of operations, payment of dividends, and equating surplus and capital paid-in, payments to the Treasury are suspended. A deferred asset is recorded that represents the amount of net earnings a Reserve Bank will need to realize before remittances to the Treasury resume. This deferred asset is periodically reviewed for impairment.

p. Income and Costs Related to Treasury Services

When directed by the Secretary of the Treasury, the Bank is required by the Federal Reserve Act to serve as fiscal agent and depositary of the United States Government. By statute, the Treasury has appropriations to pay for these services. During the years ended December 31, 2011 and 2010, the Bank was reimbursed for all services provided to the Treasury as its fiscal agent.

q. Compensation Received for Service Costs Provided and Compensation Paid for Service Costs Incurred

The Federal Reserve Bank of Atlanta (FRBA) has overall responsibility for managing the Reserve Banks' provision of check and ACH services to depository institutions and, as a result, recognizes total System revenue for these services

in its Statements of Income and Comprehensive Income. The FRBNY manages the Reserve Banks' provision of Fedwire funds and securities services and recognizes total System revenue for these services in its Consolidated Statements of Income and Comprehensive Income. Similarly, the Bank has overall responsibility for managing the Reserve Banks' provision of electronic access services to depository institutions and, as a result, recognizes total System revenue for these services in its Statements of Income and Comprehensive Income. The FRBA, the FRBNY, and the Bank compensate the applicable Reserve Banks for the costs incurred to provide these services. Compensation received by the Bank for providing check, ACH, and Fedwire funds and securities services is reported as "Compensation received for service costs provided" in the Statements of Income and Comprehensive Income. Compensation paid by the Bank for electronic access services is reported as "Compensation paid for service costs incurred" in the Statements of Income and Comprehensive Income.

r. Assessments

The Board of Governors assesses the Reserve Banks to fund its operations, the operations of the Bureau and, for a two-year period following the July 21, 2010 effective date of the Dodd-Frank Act, the OFR. These assessments are allocated to each Reserve Bank based on each Reserve Bank's capital and surplus balances as of December 31 of the prior year for the Board of Governors' operations and as of the most recent quarter for the Bureau and OFR operations. The Board of Governors also assesses each Reserve Bank for the expenses incurred by the Treasury to produce 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 prior year.

During the period prior to the Bureau transfer date of July 21, 2011, there was no limit on the funding provided to the Bureau and assessed to the Reserve Banks; the Board of Governors was required to provide the amount estimated by the Secretary of the Treasury needed to carry out the authorities granted to the Bureau under the Dodd-Frank Act and other federal law. The Dodd-Frank Act requires that, after the transfer date, the Board of Governors fund the Bureau in an amount not to exceed a fixed percentage of the total operating expenses of the System as reported in the Board of Governors' 2009 annual report, which totaled $4.98 billion. The fixed percentage of total 2009 operating expenses of the System is 10 percent ($498.0 million) for 2011, 11 percent ($547.8 million) for 2012, and 12 percent ($597.6 million) for 2013. After 2013, the amount will be adjusted in accordance with the provisions of the Dodd-Frank Act. The Bank's assessment for Bureau funding is reported as "Assessments: Bureau of Consumer Financial Protection" in the Statements of Income and Comprehensive Income.

The Board of Governors assesses the Reserve Banks to fund the operations of the OFR for the two-year period following enactment of the Dodd-Frank Act; thereafter, the OFR will be funded by fees assessed on bank holding companies and nonbank financial companies that meet the criteria specified in the Dodd-Frank Act.

s. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were $3 million for each of the years ended December 31, 2011 and 2010, respectively, and are reported as a component of "Operating expenses: Occupancy" in the Statements of Income and Comprehensive Income.

t. Restructuring Charges

The Reserve Banks recognize restructuring charges for exit or disposal costs incurred as part of the closure of business activities in a particular location, the relocation of business activities from one location to another, or a fundamental reorganization that affects the nature of operations. Restructuring charges may include costs associated with employee separations, contract terminations, and asset impairments. Expenses are recognized in the period in which the Bank commits to a formalized restructuring plan or executes the specific actions contemplated in the plan and all criteria for financial statement recognition have been met.

Note 14 describes the Bank's restructuring initiatives and provides information about the costs and liabilities associated with employee separations and contract terminations. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY. Costs and liabilities associated with enhanced postretirement benefits are discussed in Note 12.

The Bank had no significant restructuring activities in 2011 and 2010.

u. Recently Issued Accounting Standards

In July 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2010-20, *Receivables* (Topic 310): *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires additional disclosures about the allowance for credit losses and the credit quality of loan portfolios. The additional disclosures include a rollforward of the allowance for credit losses on a disaggregated basis and more information, by type of receivable, on credit quality indicators, including the amount of certain past-due receivables and troubled debt restructurings and significant purchases and sales. The adoption of this update is effective for the Bank for the year ended December 31, 2011, and did not have a material effect on the Bank's financial statements.

In April 2011, the FASB issued ASU 2011-02, *Receivables* (Topic 310): *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, which clarifies accounting for troubled debt restructurings, specifically clarifying creditor concessions and financial difficulties experienced by borrowers. This update is effective for the Bank for the year ended December 31, 2012, and is not expected to have a material effect on the Bank's financial statements.

In April 2011, the FASB issued ASU 2011-03, *Transfers and Servicing* (Topic 860): *Reconsideration of Effective Control for Repurchase Agreements*, which reconsidered the effective control for repurchase agreements. This update prescribes when the Bank may or may not recognize a sale upon the transfer of financial assets subject to repurchase agreements. This determination is based, in part, on whether the Bank has maintained effective control over the transferred financial assets. This update is effective for the Bank for the year ended December 31, 2012, and is not expected to have a material effect on the Bank's financial statements.

In June 2011, the FASB issued ASU 2011-05, *Comprehensive Income* (Topic 220): *Presentation of Comprehensive Income*, which requires a reporting entity to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This update eliminates the option to present the components of other comprehensive income as part of the statement of shareholders' equity. The update is intended to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items by presenting the components reported in other comprehensive income. The Bank has adopted the update in this ASU effective for the year ended December 31, 2011, and the required presentation is reflected in the Bank's financial statements.

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet* (Topic 210): *Disclosures about Offsetting Assets and Liabilities*. This update will require a reporting entity to present enhanced disclosures for financial instruments and derivative instruments that are offset or subject to master netting agreements or similar such agreements. This update is effective for the Bank for the year ended December 31, 2013, and is not expected to have a material effect on the Bank's financial statements.

In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income* (Topic 220): *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. This update indefinitely defers the requirements of ASU 2011-05 related to presentation of reclassification adjustments.

5. Loans

The remaining maturity distribution of loans outstanding at December 31, 2011, and total loans outstanding at December 31, 2010, was as follows (in millions):

	2011		2010
	Within 15 days	Total	Total
Loans to depository institutions	$ 17	$ 17	$ 79

Loans to Depository Institutions

The Bank offers primary, secondary, and seasonal loans to eligible borrowers, and each program has its own interest rate. Interest is accrued using the applicable interest rate established at least every 14 days by the Bank's board of directors, subject to review and determination by the Board of Governors. Primary and secondary loans are extended on a short-term basis, typically overnight, whereas seasonal loans may be extended for a period of up to nine months.

Primary, secondary, and seasonal loans are collateralized to the satisfaction of the Bank to reduce credit risk. Assets eligible to collateralize these loans include consumer, business, and real estate loans; Treasury securities; GSE debt securities; foreign sovereign debt; municipal, corporate, and state and local government obligations; asset-backed securities; corporate bonds; commercial paper; and bank-issued assets, such as certificates of deposit, bank notes, and deposit notes. Collateral is assigned a lending value that is deemed appropriate by the Bank, which is typically fair value reduced by a margin. Loans to depository institutions are monitored daily to ensure that borrowers continue to meet eligibility requirements for these programs. The financial condition of borrowers is monitored by the Bank and, if a borrower no longer qualifies for these programs, the Bank will generally request full repayment of the outstanding loan or, for primary or seasonal loans, may convert the loan to a secondary credit loan. Collateral levels are reviewed daily against outstanding obligations and borrowers that no longer have sufficient collateral to support outstanding loans are required to provide additional collateral or to make partial or full repayment.

Allowance for Loan Loss

At December 31, 2011 and 2010, the Bank did not have any impaired loans and no allowance for loan losses was required. There were no impaired loans during the years ended December 31, 2011 and 2010.

6. Treasury Securities; Government-Sponsored Enterprise Debt Securities; Federal Agency and Government-Sponsored Enterprise Mortgage-Backed Securities; Securities Purchased Under Agreements to Resell; 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 5.939 percent and 7.539 percent at December 31, 2011 and 2010, respectively.

The Bank's allocated share of Treasury securities, GSE debt securities, and federal agency and GSE MBS, net, excluding accrued interest, held in the SOMA at December 31 was as follows (in millions):

2011	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost	Fair value
Bills	$ 1,094	$ -	$ -	$ 1,094	$ 1,094
Notes	76,390	1,592	(73)	77,909	82,512
Bonds	21,300	3,643	(5)	24,938	30,209
Total Treasury securities	$ 98,784	$ 5,235	$ (78)	$ 103,941	$ 113,815
GSE debt securities	$ 6,176	$ 228	$ (1)	$ 6,403	$ 6,784
Federal agency and GSE MBS	$ 49,746	$ 690	$ (62)	$ 50,374	$ 53,179

2010	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost	Fair value
Bills	$ 1,389	$ -	$ -	$ 1,389	$ 1,389
Notes	58,295	1,060	(58)	59,297	60,663
Bonds	17,323	2,468	(43)	19,748	21,844
Total Treasury securities	$ 77,007	$ 3,528	$ (101)	$ 80,434	$ 83,896
GSE debt securities	$ 11,117	$ 417	$ (2)	$ 11,532	$ 11,819
Federal agency and GSE MBS	$ 74,794	$ 1,063	$ (117)	$ 75,740	$ 77,347

The total of the Treasury securities, GSE debt securities, and federal agency and GSE MBS, net, excluding accrued interest, held in the SOMA at December 31 was as follows (in millions):

	2011		2010	
	Amortized cost	Fair value	Amortized cost	Fair value
Bills	$ 18,423	$ 18,423	$ 18,422	$ 18,422
Notes	1,311,917	1,389,429	786,575	804,703
Bonds	419,937	508,694	261,955	289,757
Total Treasury securities	$ 1,750,277	$ 1,916,546	$ 1,066,952	$ 1,112,882
GSE debt securities	$ 107,828	$ 114,238	$ 152,972	$ 156,780
Federal agency and GSE MBS	$ 848,258	$ 895,495	$ 1,004,695	$ 1,026,003

The fair value amounts in the above tables are presented solely for informational purposes. Although the fair value of security holdings can be substantially greater than or less than the recorded value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as the central bank, to meet their financial obligations and responsibilities. The fair value of federal agency and GSE MBS was determined using a model-based approach that considers observable inputs for similar securities; fair value for all other SOMA security holdings was determined by reference to quoted prices for identical securities.

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The fair value of the fixed-rate Treasury securities, GSE debt securities, and federal agency and GSE MBS in the SOMA's holdings is subject to market risk, arising from movements in market variables, such as interest rates and securities prices. The fair value of federal agency and GSE MBS is also affected by the expected rate of prepayments of mortgage loans underlying the securities.

The following table provides additional information on the amortized cost and fair values of the federal agency and GSE MBS portfolio at December 31 (in millions):

	2011		2010	
Distribution of MBS holdings by coupon rate	Amortized cost	Fair value	Amortized cost	Fair value
Allocated to the Bank:				
3.0%	$ 78	$ 79	$ -	$ -
3.5%	1,153	1,168	26	27
4.0%	9,589	10,081	12,640	12,695
4.5%	24,138	25,605	37,518	38,356
5.0%	10,838	11,441	17,446	17,908
5.5%	3,967	4,161	7,020	7,228
6.0%	543	571	973	1,008
6.5%	68	73	117	125
Total	$ 50,374	$ 53,179	$ 75,740	$ 77,347
Total SOMA:				
3.0%	$ 1,313	$ 1,336	$ -	$ -
3.5%	19,415	19,660	341	352
4.0%	161,481	169,763	167,675	168,403
4.5%	406,465	431,171	497,672	508,798
5.0%	182,497	192,664	231,420	237,545
5.5%	66,795	70,064	93,119	95,873
6.0%	9,152	9,616	12,910	13,376
6.5%	1,140	1,221	1,558	1,656
Total	$ 848,258	$ 895,495	$ 1,004,695	$ 1,026,003

There were no transactions related to securities purchased under agreements to resell during the years ended December 31, 2011 and 2010. Financial information related to securities sold under agreements to repurchase for the years ended December 31 was as follows (in millions):

	2011	2010
Allocated to the Bank:		
Contract amount outstanding, end of year	$ 5,933	$ 4,501
Average daily amount outstanding, during the year	4,554	4,955
Maximum balance outstanding, during the year	7,394	8,411
Securities pledged (par value), end of year	5,112	3,290
Securities pledged (market value), end of year	5,933	4,501
Total SOMA:		
Contract amount outstanding, end of year	$ 99,900	$ 59,703
Average daily amount outstanding, during the year	72,227	58,476
Maximum balance outstanding, during the year	124,512	77,732
Securities pledged (par value), end of year	86,089	43,642
Securities pledged (market value), end of year	99,900	59,703

The contract amounts for securities sold under agreements to repurchase approximate fair value. FRBNY executes transactions for the purchase of securities under agreements to resell primarily to temporarily add reserve balances to the banking system. Conversely, transactions to sell securities under agreements to repurchase are executed to temporarily drain reserve balances from the banking system and as part of a service offering to foreign official and international account holders.

Notes to Financial Statements

The remaining maturity distribution of Treasury securities, GSE debt securities, federal agency and GSE MBS bought outright, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2011, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Over 5 years to 10 years	Over 10 years	Total
Treasury securities (par value)	$ 965	$ 1,610	$ 5,339	$ 38,582	$ 38,595	$ 13,693	$ 98,784
GSE debt securities (par value)	148	298	1,170	3,599	822	139	6,176
Federal agency and GSE MBS (par value)[1]	-	-	-	1	2	49,743	49,746
Securities sold under agreements to repurchase (contract amount)	5,933	-	-	-	-	-	5,933

[1] The par amount shown for Federal agency and GSE MBS is the remaining principal balance of the underlying mortgages.

Federal agency and GSE MBS are reported at stated maturity in the table above. The estimated weighted average life of these securities at December 31, 2011, which differs from the stated maturity primarily because it factors in scheduled payments and prepayment assumptions, is approximately 2.4 years.

The amortized cost and par value of Treasury securities and GSE debt securities that were loaned from the SOMA at December 31 was as follows (in millions):

Allocated to the Bank	Amortized cost		Par value	
	2011	2010	2011	2010
Treasury securities	$ 898	$ 1,706	$ 830	$ 1,665
GSE debt securities	76	127	72	121

Total SOMA	Amortized cost		Par value	
	2011	2010	2011	2010
Treasury securities	$ 15,121	$ 22,627	$ 13,978	$ 22,081
GSE debt securities	1,276	1,686	1,216	1,610

The FRBNY enters into commitments to buy Treasury and GSE debt securities and records the related securities on a settlement-date basis. As of December 31, 2011, the total purchase price of the Treasury securities under outstanding commitments was $3,200 million. The total purchase price of outstanding commitments allocated to the Bank was $190 million. These commitments had contractual settlement dates extending through January 3, 2012. As of December 31, 2011, the fair value of Treasury securities under outstanding purchase commitments was $3,208 million, of which $190 million was allocated to the Bank.

The FRBNY enters into commitments to buy and sell federal agency and GSE MBS and records the related securities on a settlement-date basis. As of December 31, 2011, the total purchase price of the federal agency and GSE MBS under outstanding commitments was $41,503 million, of which $513 million was related to dollar roll transactions. The total purchase price of outstanding purchase commitments allocated to the Bank was $2,465 million, of which $30 million was related to dollar roll transactions. As of December 31, 2011, the total sales price of the federal agency and GSE MBS under outstanding sales commitments was $4,430 million, all of which was related to dollar roll transactions. The total sales price of outstanding sales commitments allocated to the Bank was $263 million, all of which was related to dollar roll transactions. These commitments, which had contractual settlement dates extending through February 2012, are for the purchase and sale of TBA MBS for which the number and identity of the pools that will be delivered to fulfill the commitment are unknown at the time of the trade. As of December 31, 2011, the fair value of federal agency and GSE MBS purchases and sales, net under outstanding commitments was $41,873 million and $4,473 million, respectively of which $2,487 million and $266 million, respectively, was allocated to the Bank. These commitments are subject to varying degrees of off-balance-sheet market risk and counterparty credit risk that result from their future settlement. The FRBNY requires the posting of cash collateral for commitments as part of the risk management practices used to mitigate the counterparty credit risk.

Other liabilities, which are related to federal agency and GSE MBS purchases and sales, includes the FRBNY's obligation to return cash margin posted by counterparties as collateral under commitments to purchase and sell federal agency and GSE MBS. In addition, other liabilities includes obligations that arise from the failure of a seller to deliver securities to the FRBNY on the settlement date. Although the FRBNY has ownership of and records its investments in the MBS as of the contractual settlement date, it is not obligated to make payment until the securities are delivered, and the amount included

in other liabilities represents the FRBNY's obligation to pay for the securities when delivered. The amount of other liabilities allocated to the Bank and held in the SOMA at December 31 was as follows (in millions):

	Allocated to the Bank		Total SOMA	
	2011	2010	2011	2010
Cash margin	$ 75	$ -	$ 1,271	$ -
Obligations from MBS transaction fails	6	-	97	-
Total	$ 81	$ -	$ 1,368	$ -

During the years ended December 31, 2011 and 2010, the Reserve Banks recorded net gains from federal agency and GSE MBS transactions of $10 million and $782 million, respectively, of which $1 million and $71 million, respectively, were allocated to the Bank. These net gains are reported as "Non-interest income: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net" in the Statements of Income and Comprehensive Income.

Information about transactions related to Treasury securities, GSE debt securities, and federal agency and GSE MBS during the year ended December 31, 2011, is summarized as follows (in millions):

Allocated to the Bank

	Bills	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Balance December 31, 2010	$ 1,389	$ 59,297	$ 19,748	$ 80,434	$ 11,532	$ 75,740
Purchases[1]	15,300	48,815	10,401	74,516	-	2,503
Sales[1]	-	(8,179)	-	(8,179)	-	-
Realized gains, net[2]	-	134	-	134	-	-
Principal payments and maturities	(15,301)	(4,254)	-	(19,555)	(2,847)	(12,485)
Amortization of premiums and discounts	1	(280)	(315)	(594)	(109)	(204)
Inflation adjustment on inflation-indexed securities	-	81	69	150	-	-
Annual reallocation adjustment[3]	(295)	(17,705)	(4,965)	(22,965)	(2,173)	(15,180)
Balance December 31, 2011	$ 1,094	$ 77,909	$ 24,938	$ 103,941	$ 6,403	$ 50,374
Supplemental information-par value of transactions:						
Purchases	$ 15,301	$ 47,728	$ 8,237	$ 71,266	$ -	$ 2,432
Proceeds from sales	-	(8,007)	-	$ (8,007)	-	-

Total SOMA

	Bills	Notes	Bonds	Total Treasury securities	GSE debt securities	Federal agency and GSE MBS
Balance December 31, 2010	$ 18,422	$ 786,575	$ 261,955	$ 1,066,952	$ 152,972	$ 1,004,695
Purchases[1]	239,487	731,252	161,876	1,132,615	-	42,145
Sales[1]	-	(137,734)	-	(137,734)	-	-
Realized gains, net[2]	-	2,258	-	2,258	-	-
Principal payments and maturities	(239,494)	(67,273)	-	(306,767)	(43,466)	(195,413)
Amortization of premiums and discounts	8	(4,445)	(4,985)	(9,422)	(1,678)	(3,169)
Inflation adjustment on inflation-indexed securities	-	1,284	1,091	2,375	-	-
Balance December 31, 2011	$ 18,423	$ 1,311,917	$ 419,937	$ 1,750,277	$ 107,828	$ 848,258
Supplemental information-par value of transactions:						
Purchases	$ 239,494	$ 713,878	$ 127,802	$ 1,081,174	$ -	$ 40,955
Proceeds from sales	-	(134,829)	-	(134,829)	-	-

[1] Purchases and sales are reported on a settlement-date basis and include payments and receipts related to principal, premiums, discounts, and inflation compensation included in the basis of inflation-indexed securities. The amount reported as sales also includes realized gains, net.
[2] Adjustments for realized gains, net is required because these amounts do not affect the reported amount of the related securities. Excludes gains and losses that result from net settled MBS TBA transactions.
[3] Reflects the annual adjustment to the Bank's allocated portion of the related SOMA securities that results from the annual settlement of the interdistrict settlement account, as discussed in Note 4f.

7. Foreign Currency Denominated Assets

The FRBNY holds foreign currency deposits with foreign central banks and the Bank for International Settlements and invests in foreign government debt instruments of Germany, France, and Japan. These foreign government debt instruments are guaranteed as to principal and interest by the issuing foreign governments. In addition, the FRBNY enters into transactions to purchase Euro-denominated government debt securities under agreements to resell for which the accepted collateral is the debt instruments issued by the governments of Belgium, France, Germany, Italy, the Netherlands, and Spain.

The Bank's allocated share of foreign currency denominated assets was approximately 2.534 percent and 2.416 percent at December 31, 2011 and 2010, respectively.

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

	2011	2010
Euro:		
Foreign currency deposits	$ 237	$ 170
Securities purchased under agreements to resell	-	60
German government debt instruments	48	45
French government debt instruments	67	66
Japanese yen:		
Foreign currency deposits	101	94
Japanese government debt instruments	204	194
Total allocated to the Bank	$ 657	$ 629

At December 31, 2011 and 2010, the fair value of foreign currency denominated assets, including accrued interest, allocated to the Bank was $662 million and $633 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to Treasury securities, GSE debt securities, and federal agency and GSE MBS discussed in Note 6, unrealized gains or losses have no effect on the ability of a Reserve Bank, as the central bank, to meet its financial obligations and responsibilities. The fair value is presented solely for informational purposes.

Total Reserve Bank foreign currency denominated assets were $25,950 million and $26,049 million at December 31, 2011 and 2010, respectively. At December 31, 2011 and 2010, the fair value of the total Reserve Bank foreign currency denominated assets, including accrued interest, was $26,116 million and $26,213 million, respectively.

The remaining maturity distribution of foreign currency denominated assets that were allocated to the Bank at December 31, 2011, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Total
Euro	$ 136	$ 74	$ 54	$ 88	$ 352
Japanese yen	106	17	79	103	305
Total	$ 242	$ 91	$ 133	$ 191	$ 657

At December 31, 2011 and 2010, the authorized warehousing facility was $5 billion, with no balance outstanding.

There were no transactions related to the authorized reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico during the years ended December 31, 2011 and 2010.

There were no foreign exchange contracts related to open market operations outstanding as of December 31, 2011.

The FRBNY enters into commitments to buy foreign government debt instruments and records the related securities on a settlement-date basis. As of December 31, 2011, there were $216 million of outstanding commitments to purchase Euro-denominated government debt instruments, of which $5 million was allocated to the Bank. These securities settled on January 4, 2012, and replaced Euro-denominated government debt instruments held in the SOMA that matured on that date. As of December 31, 2011, the fair value of Euro-denominated government debt instruments under outstanding commitments was $216 million of which $5 million was allocated to the Bank.

In connection with its foreign currency activities, the FRBNY may enter into transactions that are subject to varying degrees of off-balance-sheet market risk and counterparty credit risk that result from their future settlement. The FRBNY controls these risks by obtaining credit approvals, establishing transaction limits, receiving collateral in some cases, and performing daily monitoring procedures.

8. Central Bank Liquidity Swaps

U.S. Dollar Liquidity Swaps

The Bank's allocated share of U.S. dollar liquidity swaps was approximately 2.534 percent and 2.416 percent at December 31, 2011 and 2010, respectively.

The total foreign currency held under U.S. dollar liquidity swaps in the SOMA at December 31, 2011 and 2010, was $99,823 million and $75 million, respectively, of which $2,529 million and $2 million, respectively, was allocated to the Bank.

The remaining maturity distribution of U.S. dollar liquidity swaps that were allocated to the Bank at December 31 was as follows (in millions):

			2011		2010
	Within 15 days	16 days to 90 days	Total	Within 15 days	Total
Euro	870	1,294	2,164	2	2
Japanese yen	229	126	355	-	-
Swiss franc	8	2	10	-	-
Total	$ 1,107	$ 1,422	$ 2,529	$ 2	$ 2

Foreign Currency Liquidity Swaps

There were no transactions related to the foreign currency liquidity swaps during the years ended December 31, 2011 and 2010.

9. Bank Premises, Equipment, and Software

Bank premises and equipment at December 31 were as follows (in millions):

	2011	2010
Bank premises and equipment:		
Land and land improvements	$ 17	$ 17
Buildings	268	261
Building machinery and equipment	36	36
Construction in progress	9	9
Furniture and equipment	68	65
Subtotal	398	388
Accumulated depreciation	(162)	(148)
Bank premises and equipment, net	$ 236	$ 240
Depreciation expense, for the years ended December 31	$ 20	$ 18

The Bank leases space to outside tenants with remaining lease terms ranging from one to nine years. Rental income from such leases was $6 million and $7 million for the years ended December 31, 2011 and 2010, respectively, and is reported as a component of "Non-interest income: Other" in the Statements of Income and Comprehensive Income. Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2011, are as follows (in millions):

2012	$ 4
2013	4
2014	7
2015	5
2016	5
Thereafter	10
Total	$ 35

The Bank had capitalized software assets, net of amortization, of $2 million and $3 million at December 31, 2011 and 2010, respectively. Amortization expense was $1 million for each of the years ended December 31, 2011 and 2010, respectively. Capitalized software assets are reported as a component of "Other assets" in the Statements of Condition and the related amortization is reported as a component of "Operating expenses: Other" in the Statements of Income and Comprehensive Income.

10. Commitments and Contingencies

Conducting its operations, the Bank enters into contractual commitments, normally with fixed expiration dates or termination provisions, at specific rates and for specific purposes.

At December 31, 2011, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from one to approximately five years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indexes.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance, and maintenance when included in rent), net of sublease rentals, was $1 million for each of the years ended December 31, 2011 and 2010, respectively.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2011, are as follows (in thousands):

	Operating leases
2012	$ 484
2013	175
2014	174
2015	169
2016	169
Thereafter	14
Future minimum rental payments	$ 1,185

At December 31, 2011, there were no material unrecorded unconditional purchase commitments or obligations in excess of one year.

Under the Insurance Agreement of the Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a share of certain losses in excess of 1 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 of a Reserve Bank's capital paid-in to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2011 and 2010.

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 legal actions and claims will be resolved without material adverse effect on the financial position or results of operations of the Bank.

11. 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 employees of the Reserve Banks, Board of Governors, and Office of Employee Benefits of the Federal Reserve System (OEB) participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). Under the Dodd-Frank Act, newly hired Bureau employees are eligible to participate in the System Plan and transferees from other governmental organizations can elect to participate in the System Plan. In addition, employees at certain compensation levels participate in the Benefit Equalization Retirement Plan and certain Reserve Bank officers participate in the Supplemental Retirement Plan for Select Officers of the Federal Reserve Banks.

The System Plan provides retirement benefits to employees of the Reserve Banks, Board of Governors, OEB, and certain employees of the Bureau. The FRBNY, on behalf of the System, recognizes the net asset or net liability and costs associated with the System Plan in its consolidated financial statements. During the year ended December 31, 2011, certain costs associated with the System Plan were reimbursed by the Bureau. During the year ended December 31, 2010, costs associated with the System Plan were not reimbursed by other participating employers.

Thrift Plan

Employees of the Bank participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Bank matches 100 percent of the first 6 percent of employee contributions from the date of hire and provides an automatic employer contribution of 1 percent of eligible pay. The Bank's Thrift Plan contributions totaled $7 million for each of the years ended December 31, 2011 and 2010, respectively, and are reported as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

12. Postretirement Benefits Other Than Retirement Plans and Postemployment Benefits

Postretirement Benefits Other Than Retirement Plans

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.

Notes to Financial Statements

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 the beginning and ending balances of the benefit obligation (in millions):

	2011	2010
Accumulated postretirement benefit obligation at January 1	$ 133.9	$ 126.0
Service cost benefits earned during the period	3.4	3.2
Interest cost on accumulated benefit obligation	6.8	7.1
Net actuarial loss	8.3	4.9
Special termination benefits loss	-	0.3
Contributions by plan participants	2.3	2.0
Benefits paid	(9.2)	(10.2)
Medicare Part D subsidies	0.7	0.6
Accumulated postretirement benefit obligation at December 31	$ 146.2	$ 133.9

At December 31, 2011 and 2010, the weighted-average discount rate assumptions used in developing the post-retirement benefit obligation were 4.50 percent and 5.25 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):

	2011	2010
Fair value of plan assets at January 1	$ -	$ -
Contributions by the employer	6.2	7.6
Contributions by plan participants	2.3	2.0
Benefits paid	(9.2)	(10.2)
Medicare Part D subsidies	0.7	0.6
Fair value of plan assets at December 31	$ -	$ -
Unfunded obligation and accrued postretirement benefit cost	$ 146.2	$ 133.9
Amounts included in accumulated other comprehensive loss are shown below:		
Prior service cost	$ 1.8	$ 2.6
Net actuarial loss	(48.4)	(43.5)
Total accumulated other comprehensive loss	$ (46.6)	$ (40.9)

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs" in the Statements of Condition.

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

	2011	2010
Health-care cost trend rate assumed for next year	7.50%	8.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2017	2017

Assumed health-care cost trend rates have a significant effect on the amounts reported for health-care plans. A 1 percentage point change in assumed health-care cost trend rates would have the following effects for the year ended December 31, 2011 (in millions):

	1 percentage point increase	1 percentage point decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 1.7	$ (1.4)
Effect on accumulated postretirement benefit obligation	20.0	(16.4)

Notes to Financial Statements

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

	2011	2010
Service cost-benefits earned during the period	$ 3.4	$ 3.2
Interest cost on accumulated benefit obligation	6.8	7.1
Amortization of prior service cost	(0.8)	(2.2)
Amortization of net actuarial loss	3.4	3.9
Total periodic expense	12.8	12.0
Special termination benefits loss	-	0.3
Net periodic postretirement benefit expense	$ 12.8	$ 12.3

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2012 are shown below:

Prior service cost	$ (0.7)
Net actuarial loss	4.2
Total	$ 3.5

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2011 and 2010, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.25 percent and 5.75 percent, respectively.

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

The recognition of special termination benefit losses is primarily the result of enhanced retirement benefits provided to employees during the restructuring described in Note 14.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 established a prescription drug benefit under Medicare (Medicare Part D) and a federal subsidy to sponsors of retiree health-care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. The benefits provided under the Bank’s plan to certain participants are at least actuarially equivalent to the Medicare Part D prescription drug benefit. The estimated effects of the subsidy are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic post-retirement benefit expense.

Federal Medicare Part D subsidy receipts were $524 thousand and $562 thousand in the years ended December 31, 2011 and 2010, respectively. Expected receipts in 2012, related to benefits paid in the years ended December 31, 2011 and 2010, are $318 thousand.

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

	Without subsidy	With subsidy
2012	$ 8.4	$ 7.8
2013	8.7	8.1
2014	8.9	8.2
2015	9.0	8.2
2016	9.2	8.3
2017-2021	48.5	42.8
Total	$ 92.7	$ 83.4

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined and include the cost of medical and dental insurance, survivor income, disability benefits, and self-insured workers’ compensation expenses. The accrued postemployment benefit costs recognized by the Bank at December 31, 2011 and 2010, were $13 million. This cost is included as a component of “Accrued benefit costs” in the Statements of Condition. Net periodic postemployment benefit expense included in 2011 and 2010 operating expenses were $1 million and $235 thousand, respectively, and are recorded as a component of “Operating expenses: Salaries and benefits” in the Statements of Income and Comprehensive Income.

13. Accumulated Other Comprehensive Income And Other Comprehensive Income

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

	Amount related to postretirement benefits other than retirement plans	
Balance at January 1, 2010	$	(37.7)
Change in funded status of benefit plans:		
Amortization of prior service cost		(2.2)
Change in prior service costs related to benefit plans		(2.2)
Net actuarial loss arising during the year		(4.9)
Amortization of net actuarial loss		3.9
Change in actuarial losses related to benefit plans		(1.0)
Change in funded status of benefit plans-other comprehensive loss		(3.2)
Balance at December 31, 2010	$	(40.9)
Change in funded status of benefit plans:		
Amortization of prior service cost		(0.8)
Change in prior service costs related to benefit plans		(0.8)
Net actuarial loss arising during the year		(8.3)
Amortization of net actuarial loss		3.4
Change in actuarial losses related to benefit plans		(4.9)
Change in funded status of benefit plans-other comprehensive loss		(5.7)
Balance at December 31, 2011	$	(46.6)

Additional detail regarding the classification of accumulated other comprehensive loss is included in Note 12.

14. Business Restructuring Charges

The Bank had no business restructuring charges in 2011 or 2010.

Before 2010, the Reserve Banks announced the acceleration of their check restructuring initiatives to align the check processing infrastructure and operations with declining check processing volumes. The new infrastructure consolidated operations into two regional Reserve Bank processing sites; one in Cleveland, for paper check processing, and one in Atlanta, for electronic check processing.

Following is a summary of financial information related to the restructuring plans (in thousands):

	2007 restructuring plans	
Information related to restructuring plans as of December 31, 2011:		
Total expected costs related to restructuring activity	$	4,991
Estimated future costs related to restructuring activity		-
Expected completion date		2008
Reconciliation of liability balances:		
Balance at January 1, 2010	$	1,199
Employee separation costs		32
Adjustments		89
Payments		(883)
Balance at December 31, 2010	$	437
Adjustments		(327)
Payments		(94)
Balance at December 31, 2011	$	16

Employee separation costs are primarily severance costs for identified staff reductions associated with the announced restructuring plans. Separation costs that are provided under terms of ongoing benefit arrangements are recorded based on the accumulated benefit earned by the employee. Separation costs that are provided under the terms of one-time benefit arrangements are generally measured based on the expected benefit as of the termination date and recorded ratably over the period to termination. Restructuring costs related to employee separations are reported as a component of "Operating expenses: Salaries and benefits" in the Statements of Income and Comprehensive Income.

Adjustments to the accrued liability are primarily due to changes in the estimated restructuring costs and are shown as a component of the appropriate expense category in the Statements of Income and Comprehensive Income.

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 11. Costs associated with enhanced postretirement benefits are disclosed in Note 12.

15. Subsequent Events

There were no subsequent events that require adjustments to or disclosures in the financial statements as of December 31, 2011. Subsequent events were evaluated through March 20, 2012, which is the date that the Bank issued the financial statements.

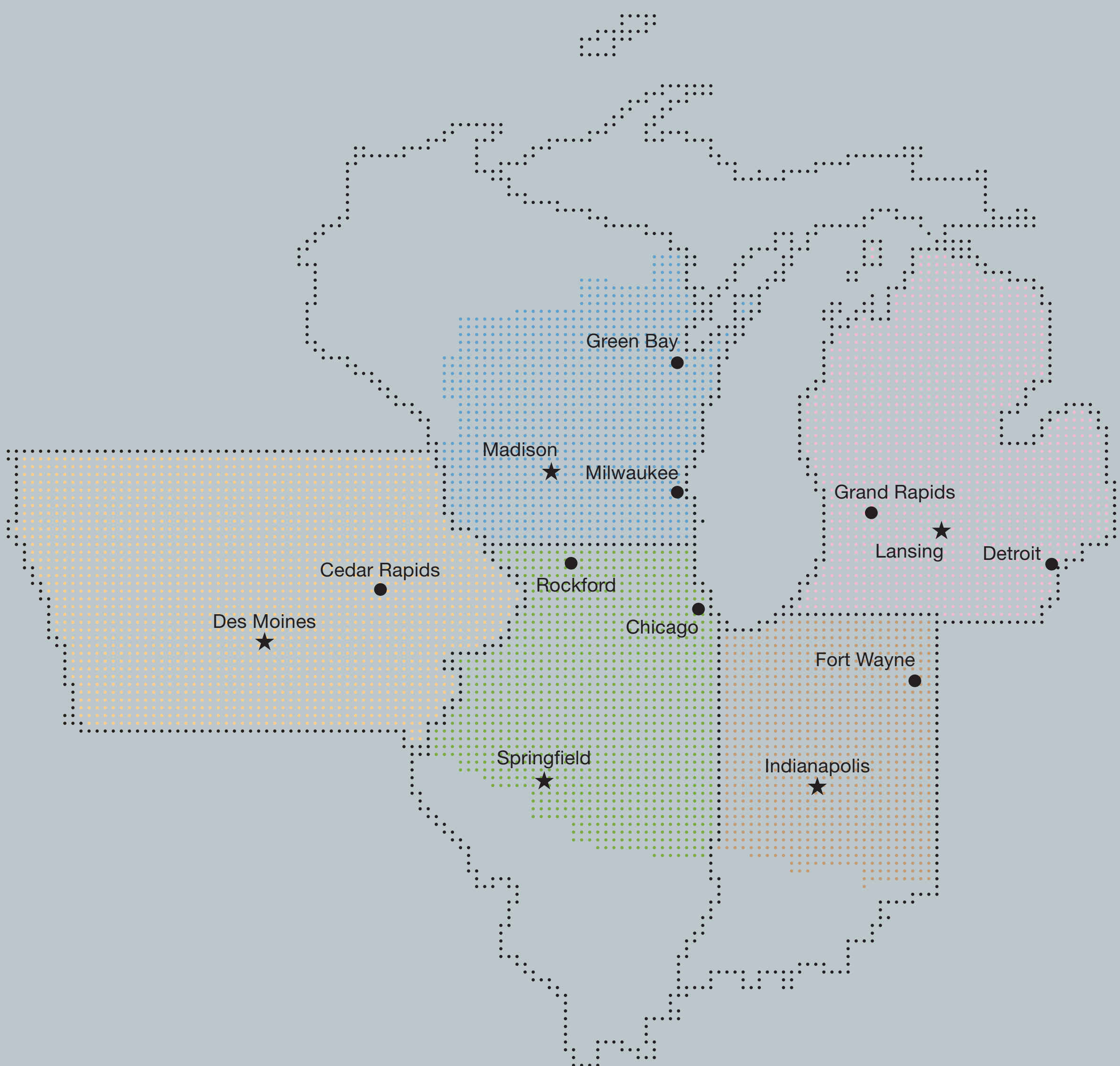
OUR MISSION

The Federal Reserve Bank of Chicago is one of 12 regional Reserve Banks across the United States that, together with the Board of Governors in Washington, D.C., serve as the nation's central bank. The role of the Federal Reserve System, since its establishment by an act of Congress passed in 1913, has been to foster a strong economy, supported by a stable financial system.

To this end, the Federal Reserve Bank of Chicago participates in the formulation and implementation of national monetary policy; supervises and regulates state-member banks, bank holding companies and foreign bank branches; and provides financial services to depository institutions and the U.S. government. Through its head office in Chicago and branch in Detroit, the Federal Reserve Bank of Chicago serves the Seventh Federal Reserve District, which includes most of Illinois, Indiana, Michigan and Wisconsin, plus all of Iowa.

OUR VISION

We serve the public interest by fostering a strong economy and promoting financial stability. We accomplish this with talented and innovative people working within a collaborative and inclusive culture.



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