STABILITY IN TIMES OF CHANGE

A Personal Reflection on Thirteen Years in Office

By President & CEO Michael H. Moskow
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, branch in Detroit, regional office in Des Moines, and facility in Bedford Park, Ill., the Federal Reserve Bank of Chicago serves the Seventh Federal Reserve District, which includes major portions of Illinois, Indiana, Michigan and Wisconsin, plus all of Iowa.

OUR VISION

- Further the public interest by fostering a sound economy and stable financial system
- Provide products and services of unmatched value to those we serve
- Set the standard for excellence in the Federal Reserve System
- Work together, value diversity, communicate openly, be creative and fair
- Live by our core values of integrity, respect, responsibility and excellence

THE ECONOMY AND MONETARY POLICY

Real gross domestic product, or real GDP — our broadest measure of economic output — increased at an annual rate of 3.1 percent in 2006. However, over the past few quarters, growth has been averaging close to 2 percent. At the Federal Reserve Bank of Chicago, our estimate of the economy’s potential growth rate — that is, the rate of growth it can sustain over time given its labor and capital resources — is just a bit under 3 percent. As such, by this standard, economic growth over the last few quarters has been somewhat below potential. However, even though overall growth has been below our estimate of potential, labor markets have continued to tighten; the unemployment rate fell from 5 percent in late 2005 to an average of about 4 1/2 percent in early 2007.

Such tightening resource pressures, as well as high energy and commodity prices, likely contributed to faster increases in prices. As a result, inflation ran too high. The Fed’s preferred measure of inflation is the price index for personal consumption expenditures excluding food and energy, also known as core PCE. Over the four quarters of 2006, core PCE prices increased 2.2 percent, about the same pace as in 2005. By contrast, I prefer that, over time, inflation run between 1 and 2 percent — the range I consider to be most compatible with the Fed’s goal of price stability.

Given the relatively high level of resource utilization in the first half of 2006, the Federal Open Market Committee (FOMC) continued removing policy accommodation at a measured pace. The FOMC raised the target federal funds rate from 4 1/4 percent at the beginning of the year to 5 1/4 percent after its June meeting. With the pace of growth moderating in the second half of the year, but with inflation still running too high, the FOMC left the stance of policy unchanged through the rest of 2006 and the beginning of 2007.

For the balance of 2007, economic growth likely will average modestly below potential, but I expect that growth will return to near potential in 2008. The below-potential growth this year would be consistent with slight increases in the unemployment rate and other measures of resource slack, but the magnitude of the increases would likely be small.

Core inflation should gradually come down, moving closer to the levels I view as being consistent with price stability. Still, there is a risk that inflation could remain stubbornly high for a couple reasons. First, the economy appears to be operating in the neighborhood of its potential level of output. The unemployment rate is low, growth in compensation per hour has moved up some over the past year, and productivity growth has slowed. Together, these have resulted in an acceleration of unit labor costs.

Second, inflation has run at or above 2 percent for the past three years. With inflation at such a high level for such a long period of time, we have to recognize the risk that inflation expectations could become

Michael Moskow, President and CEO of the Federal Reserve Bank of Chicago
ECONOMIC RESEARCH AND PROGRAMS

- Chicago Fed economists provided support throughout the year to the president and board members to help them carry out their monetary policy responsibilities.
- Research Department members prepared eight special policy briefings, including presentations on topics such as the long-run trends in housing markets and inflation dynamics.
- Twenty-seven working papers were produced, and 25 previously written papers were accepted for publication in top-tier scholarly journals.
- The Research and Consumer and Community Affairs (CCA) areas held 41 conferences.
- Research reports were presented in Economic Perspectives, Aq Letter, Profitwise News and Views, and Fed Letter, including 12 special issues of Fed Letter.
- Department economists gave 49 paper presentations to academic audiences and presented 129 speeches and lectures to a variety of audiences.
- Policy conferences and forums were held on financial access for immigrants, rural economic development, community development finance, access to financial services, and foreclosure prevention.

FINANCIAL INSTITUTION SUPERVISION AND REGULATION

- Supervision and Regulation continued to focus on improving core supervisory functions by promoting staff development and a collaborative work culture as well as improving risk assessment and operational processes.
- The department’s primary 2006 focus was on enhancing the quality of risk resolution work.
- More than 1100 examinations, inspections and off-site reviews were conducted.
- The department focused strategic efforts on streamlining processes for low-risk organizations and activities and making improvements in examination processes.
- New procedures were implemented for examining banks with low-risk information technology operations.

FINANCIAL SERVICES

- Check processing successfully met all cost, productivity and sales targets and played a leadership role in supporting, selling and implementing Check 21 products.
- Cash Services successfully met all unit cost, productivity and quality targets.
- 2006 marked the first full year in the new Detroit Cash facility, featuring multiple machine rooms, state-of-the-art technology, increased capacity, and a strengthened control environment.

CUSTOMER RELATIONS AND SUPPORT OFFICE (CRSO)

- The CRSO successfully completed the migration of Fedline Advantage and converted the more than 8,600 remaining customers off of the DOS-based Fedline platform.
- National Marketing and Sales continued strong performance and played a critical role in achieving outstanding results in 2006.
- The CRSO developed a new customized Check 21 Value Calculator and online resource center for customers and issued the first quarterly National Customer Satisfaction Survey.

OTHER ACTIVITIES

- A new Financial Markets Group was created to study financial markets and the clearing and settlement operations that support these markets, with particular focus on Chicago derivatives exchanges and clearinghouses.
- Money Smart Weeks held in Chicago, Michigan, Indiana and Wisconsin involved more than 500 partner organizations and featured more than 1300 events providing financial education to customers throughout the Seventh Federal Reserve District.
- Executives from around the Federal Reserve System gathered in Chicago twice during the year for the Senior Leadership Conference, featuring thought-provoking discussions and presentations.
- The process began to identify the successor to Chicago Fed President Michael H. Moskow, who will retire at the end of August of 2007.
- The bank better managed operational risks and controls.
Using cogent economic theory to shape analysis.
Looking at a wide range of data and information, instead of one or two summary indicators.

Respecting the risks of undesirable outcomes for growth or inflation, even in environments that appear benign.

Remaining flexible to new approaches and ways of thinking in responding to developments and changes in the economy.

By following these principles, the FOMC made decisions over the past 13 years that played a meaningful role in helping maintain a low-inflation, low-volatility economy.

Stability in Times of Change

By President & CEO Michael H. Moskow

Since joining the Chicago Fed in 1994, I have witnessed significant changes in our financial and economic system, as well as in the way the Federal Reserve carries out its responsibilities. One thing of which I am certain is that the financial system, and the Fed’s role in supporting it, will continue to evolve. With that in mind, I would like to offer my perspectives on some of the major developments in monetary policy, the nation’s payments system, and bank supervision and regulation over the last 13 years.

Some of the more significant developments include the acceleration in productivity in the late 1990s, the risk of deflation in 2003, transformations in the banking industry, and the growth and rapid acceptance of electronic payments.

Much of what we have learned from these and other events can and should shape our monetary, supervisory, and regulatory policies going forward. These lessons also will help position the Fed to anticipate and effectively respond to whatever challenges lie ahead.

Monetary Policy

At the time of my arrival at the Federal Reserve Bank of Chicago in September of 1994, the U.S. economy was well into two very important transitions. The first was the shift from a high or moderate-inflation economy to one with relatively low and stable inflation. Core PCE inflation, which measures the percent change in the price index for Personal Consumption Expenditures, excluding food and energy, had fallen from staggering double-digit rates in the late 1970s and early 1980s to just 2½ percent in 1994.

The second transition, referred to by economists as “The Great Moderation,” had begun in the mid-1980s, but we were just beginning to recognize it in 1994. This period was the evolution to a low-volatility economy, in which fluctuations in real economic activity were much smaller than they had been in the 30 years prior to the mid-1980s.

In many important ways, these two transitions made the policymaking environment easier during my years at the helm of the Chicago Fed. While some challenges remained in the pursuit of price stability when I started, the inflation issues the Federal Open Market Committee (FOMC) has faced since then have been less severe than those confronted by the Paul Volcker-led Fed in 1979. In addition, since 1994 the FOMC has faced relatively smaller cyclical fluctuations in growth than it had in the past.

But the FOMC during the last 13 years still has had to react to a number of important and difficult challenges: the Asian financial crisis, the Russian debt default, unusual asset price movements (such as equities in the late 1990s and housing in the mid-2000s); Y2K, 9/11, the acceleration in productivity, and the risk of deflation. All of these issues generated policy questions that did not fit neatly into any familiar textbook framework. Instead, they required new approaches and new ways of thinking.

It is useful to consider two of these experiences in more detail — the acceleration in productivity growth and the risk of deflation. They exemplify how, when making difficult decisions in unusual circumstances, it is important to follow sound policy-making principles, including:

- Using cogent economic theory to shape analysis.
- Respecting the risks of undesirable outcomes for growth or inflation, even in environments that appear benign.
- Remaining flexible to new approaches and ways of thinking in responding to developments and changes in the economy.

By following these principles, the FOMC made decisions over the past 13 years that played a meaningful role in helping maintain a low-inflation, low-volatility economy.
The lessons of economic theory also shaped our decision-making. Regardless of which productivity scenario may have been correct, theory indicated higher real interest rates were warranted. If the productivity increases were transitory, higher real rates were needed to contain inflationary pressures. This would require raising nominal rates. If the gains were permanent, the return to investment would be higher, and thus higher real rates were necessary to equilibrate saving and investment. In this latter case, some of the increase in real rates would occur through a drop in the inflation premium built into nominal interest rates. And, as it turned out, though we increased the nominal funds rate only slightly, the real federal funds rate rose about 1 ½ percentage points between early 1996 and mid-1998, largely because inflation declined.

Overall, monetary policy was relatively successful over this period. Real GDP growth averaged about 4 percent in the second half of the 1990s, a full percentage point faster than over the previous 25 years. In addition, core PCE inflation ended the decade at 1½ percent, a rate I view as being consistent with price stability.

**The Risk of Deflation**

The other experience I want to discuss occurred in 2003. Growth in real activity was sluggish, the pace of job growth was subdued, and according to the data we had in hand at the time, core inflation had fallen to below 1 percent. There was a concern that the inflation rate would actually fall below zero, resulting in deflation—a decline in the overall price level. The concern no longer seemed so far-fetched, considering that Japan was at the time in the midst of a prolonged deflation spell. Some commentators even discussed a deflationary spiral, in which the increased real value of debt obligations would lead to a self-reinforcing cycle of defaults, wealth erosion, and a marked contraction in economic activity.

Looking at broader economic data helped put the issue into perspective. The term “deflation” naturally made people focus on the serious downward-price spiral that occurred in the U.S. during the Great Depression. But the performance of the U.S. economy during the 19th century, as well as a number of international experiences, reminded us that solid economic expansion and deflation can co-exist. Once again, economic theory offered an explanation: If productivity growth remains healthy, investment projects can earn large positive real rates of return even if prices are falling, and hence there is no threat of a default cycle.

However, economic theory also reminded us that deflation could pose a special problem for monetary policy. Nominal interest rates cannot go below zero because no one will lend funds without receiving some positive return. If the economy is weak, then businesses may not be able to generate large real returns to investment. And the lower the inflation rate, the smaller the inflation premium built into nominal interest rates. So deflation raises the likelihood that nominal short-term interest rates could fall to zero during some period when the central bank would like to lower interest rates to stimulate activity. And the lower the inflation rate, the smaller the inflation premium built into nominal interest rates. Some commentators even discussed a deflationary spiral, in which the increased real value of debt obligations would lead to a self-reinforcing cycle of defaults, wealth erosion, and a marked contraction in economic activity.

Our response to the deflation, or “unwelcome disinflation,” threat was to lower the nominal federal funds rate to 1 percent, a very low level by historical standards. As we moved into the second half of 2003, output growth recovered strongly, labor markets firmed, and inflation moved up from its very low levels without the Fed having to undertake any unusual alternative financial market interventions. However, we took one important additional step: Starting in August, 2003, we communicated our willingness to keep the funds rate low for a “considerable period” and continued using that phrase in FOMC statements for the next several meetings. This communication, and our later state-ment that the FOMC could “be patient in removing its policy accommodation,” may have produced some added stimulus to the economy by helping keep medium-term interest rates lower than they otherwise would have been.

The 2003 deflation risk served another important role: It sharpened our thinking about the conduct of monetary policy when the economy is operating in the neighborhood of price stability. We were not worrying about deflation as part of policy discussions when I joined the Fed, but given the depth of high inflation, it was now an important consideration in the discussion of how best to pursue monetary policy.

**Bank Supervision and Regulation**

The structure of the banking industry and approaches to bank supervision have changed dramatically during my tenure at the Chicago Fed. Banks have become larger and more complex, and banking risks have become more diverse and dynamic. Bank risk management has become more complicated and sophisticated, and so bank supervision, like monetary policy, has required new approaches and new ways of thinking to remain effective.

**Industry Structure**

The U.S. has historically been unique in the structure of its banking industry. By almost any measure—number of banks, banks per capita, or banks per square mile—the U.S. has been more “banked” than any other country in the world. This has been the result, in part, of the geography and demographics of the U.S., characterized by many lightly populated rural areas, each having at least one bank. Another major force was the set of restrictions imposed on geographic expansion. Since the 1920s, the expansion of banking, and branching, had been left to the states to deter-mine, and a number of them, particularly in the Midwest, opted to restrict expansion sig-nificantly. This resulted in the proliferation of single-office banks providing banking services in local communities.

With the advances in information technology (particularly computer systems), credit databases, and risk-management techniques, these geographic legal limitations became highly restrictive in the 1970s and 1980s. Policy makers increasingly realized that broader geographic expansion could create potential efficiency gains for banks and consumers. As a result, the restrictions began to be lifted, first within state boundaries as branching laws were liberalized, then across state borders via regional compacts between states. Finally, shortly after I joined the Fed, the Riegle-Neal Interstate Banking and Branching Efficiency Act was passed, beginning a process of much broader interstate expansion. Thus, geographic deregulation initiated a significant shift in the landscape of U.S. banking.

The chart above shows the change in the number of banks in the U.S. over the last 13 years, while the chart on the next page shows the change in the number of bank branches. Nationally, the number of banks decreased nearly 29%. Most closed as the result of unassisted mergers and acquisitions rather than failures. This stands in stark contrast to the late 1980s, when failures averaged about 400 per year. Distributed by size, a large majority of the decrease occurred among community banks (banks with less than $1 billion in assets).

In the Seventh Federal Reserve District, the trend has been somewhat similar, though the declines in Illinois, Indiana, and Wisconsin have slightly exceeded the national trends. This is, in part, because each of these states was relatively late in relaxing its geographic restrictions.
While the number of banks in most areas declined over this time period, the number of branches serving bank customers significantly increased, by over 16% nationally. This contrast has been most obvious in Illinois, where the number of banks has declined by more than 32%, but the number of branches has increased by more than 43%. Many students of the industry predicted these changes, as Illinois had one of the most restrictive state banking laws regulating geographic expansion.

Of course, the passage of Riegle-Neal and the liberalization of state branching laws were not the only major developments affecting the structure of the banking industry. The Gramm-Leach-Bliley Act of 1999 removed most of the long-standing restrictions against affiliations between commercial banks and investment banks imposed by the Glass-Steagall Act in 1933. The act allowed for the creation of financial holding companies, which are now permitted to engage in a full range of financial activities, such as securities underwriting and dealing, insurance underwriting and selling, and merchant banking, through holding-company affiliates of commercial banks. This is as long as the commercial banks are sufficiently capitalized and meet other qualifications. Though the individual affiliate activities are regulated by the appropriate functional regulator (such as the SEC, state insurance authorities, and the federal banking agencies), the Federal Reserve serves as the “umbrella supervisor” for the financial holding company.

CHALLENGES FOR COMMUNITY BANKING

With these changes in the banking landscape, some have questioned the future viability of community banks. The concern is that the very nature of the industry has changed so significantly that small community banks will no longer be able to compete with large money-center or regional banks.

Essentially, two different banking models have evolved in the U.S. Larger banks emphasize a low-margin, commodity-based production process using state-of-the-art information technologies, including scoring models and standardized processes. The emphasis is on the processing of easily quantifiable “hard information,” so the most viable competitors in this market will be the banks that do this most efficiently.

Community banks take a different approach that stresses relationship banking. This is typically a higher-cost, higher-margin process that emphasizes the relationship with customers and the processing of less-quantifiable “soft information,” such as management quality and strength of character. The most viable organizations in this model are the banks that can most efficiently extract and interpret this soft information.

Looking at the production process in this manner explains why some have questioned the viability of community banks. As technology has improved, more information can be collected and processed in a hard-information, commodity-like manner. For example, scoring models are now relatively common for small business loans, a category once thought to be the model for relationship banking. Similarly, research has shown that proximity to the customer is becoming less important than it had been in the past. This allows banks based outside of the local market to better compete in markets once dominated by local community banks.

Nevertheless, community banks continue to play an integral role in financial markets. They comprise over 90% of the total number of banks, a number essentially unchanged since 1985. While their total deposit and asset shares declined somewhat during the recent consolidation trend, community banks continue to have a relatively stable share of business real estate lending and a disproportionate share of small business loans and agricultural loans. Community banks appear to be able to compete in the new deregulated environment using the “relationship” model; however, it clearly is more difficult than it was in the past. The efficient community bank, which is capable of providing value by processing soft information, simply has to work harder to succeed given the removal of protective entry barriers and the corresponding increase in competition.

RISK MANAGEMENT

Whether in community banks, regional institutions, or large, complex financial institutions, the changes in the banking industry have coincided with significant changes in the banking industry’s risk profile. Traditional credit and interest rate risks, and, increasingly, operational and compliance risks, have been rapidly evolving. Accordingly, banks have worked to improve their risk management capabilities. In response, the Federal Reserve’s supervision programs have developed to become more risk focused and institution specific.

Risk management at banking organizations has evolved significantly and rapidly, becoming a core function at banks. Market developments have largely driven these changes, but bank supervisors have also played an important role. For example, until the early 1990s, credit risk was generally managed on a loan-by-loan basis, and banks kept most loans on their books until maturity. Now banks can actively manage the credit risk of their loan portfolios as a whole, continually adjusting it through a wide array of techniques, such as loan trading, securitization, and the use of credit derivatives.

The management of market (interest rate) risk shows similar trends. Banks used to manage market risk through simple position limits and rather basic duration “gap” analysis, slotting assets and liabilities into various re-pricing categories. Financial engineering and advances in information technology now allow banks of all sizes to manage market risk more effectively using a variety of concepts and techniques. With operational risk, banks are not as far along the learning curve. They have always had tools to reduce operational risk, such as business-line controls, audit programs, and insurance protection. However, in light of the growing number and complexity of operational risks, banks are now beginning to manage these risks in a more systematic way. Further, many banking organizations are developing “enterprise” risk management programs to ensure that they have a holistic view of risks across divisions and risk categories.

Responding to the increasingly complex and dynamic nature of risk and the changes in industry structure, banking supervisors began developing a new supervisory framework in the mid-1990s. Historically, bank examinations were largely standardized. They relied heavily on historical data and involved extensive account verification and review of individual loan files on site — what is known in

Community banks take a different approach that stresses relationship banking.
In comparison to the switch-over from check to electronic payments, the sub-

Estimated total paper check usage in the U.S. finally began to decline shortly

S

per year

of payments

volume in billions

U.S. payments

*Electronic payments include retail ACH and card payments.

Source: Bank for International Settlements

PAYMENT SYSTEM

There have been many important milestones in the movement from paper checks to electronic pay-

ments in the past 13 years. This is particularly notable since payment habits typically change slowly,

especially when existing instruments perform well and remain highly convenient. But ultimately,

changing cost structures affect what payment networks offer and what the public uses. This evolu-

tion has again required new approaches by the Federal Reserve in its role in the payment system.

As in many other industrialized countries, the U.S. continues to shift to electronic payments. For society, the benefits of the shift should be substantial, since the marginal cost of adding one more transaction into an electronic payment network is almost always considerably less than it would be in a paper-based network. However, the shift is not easy because the methods of handling paper have been refined over centuries, and the fixed costs of automating transactions are seldom minor. Therefore, when a tipping point eventually is reached, the switch-over period from paper to electronic can be rapid.

CHECK OPERATIONS


The downward trajectory for checks reflects the introduction and expansion of a number of tech-

nologies. One example is debit cards. While debit cards were introduced initially in the 1970s to dispense cash from ATM machines, debit transactions at the checkout register have soared over the last ten years, displacing a considerable number of checks. Another example is check truncation, which involves converting checks into substitute checks or electronic signals at lock boxes (for the payment of bills), at the point of service, or in the back office.

The explosive growth of the Internet since 1994, and its important role in changing the character of both banking and commerce, also has been an important factor. Households increasingly choose to purchase goods and services online using existing card and automated clearinghouse (ACH) networks.

New payment processors such as PayPal entered the marketplace to service the ballooning online auction business. After a faltering start, online banking finally took hold and began to reduce dramatically the number of checks written by households. Beyond households, however, business-to-business transactions were much slower to transition to electronic platforms, largely because of the greater information needs of firms and the inherent difficulties in integrating payments with enterprise resource-planning systems.

To gain widespread acceptance, successful payment innovations have to benefit a host of parties, such as payment processors, banks, households, and businesses. When payment networks grow sufficiently, scale economies lower operating costs, and the technology suddenly becomes profitable in new venues. Merchants become more willing to accept plastic in lieu of cash or checks in part because of falling real costs of placing PIN pads at the checkout. These developments engendered a cultural shift, which transformed many previously cash-only locations. As a result, many new vendors began to accept plastic, most notably taxis, coffee shops, doctor’s offices, fast-food restaurants, grocery stores, utilities, and mass transit facilities.

As the use of checks declined, the Federal Reserve closed more than half of its 45 check-processing sites, including offices in Milwaukee, Indianapolis, and Peoria, Ill. in the Seventh District. We also consolidated other payment services, such as ACH and FedWire. To lower operational costs, the Chicago Fed moved its check-processing operation from its downtown head-

quarters to a more strategic location near Midway Airport. We estab-

lished a payments team to produce high-quality research, foster dialogue with the payments industry, and provide valuable insights on System payment initiatives. Finally, the Customer Relations and Support Office was established and headquartered at the Chicago Fed to strengthen Federal Reserve System contacts with commercial banks and to develop modern soft-

ware, such as FedLine Advantage, for banks to access various Federal Reserve financial services.

Along similar lines, the Federal Reserve took the initiative to improve the efficiency of check processing by proposing and supporting the passage of the Check Clearing for the 21st Century Act, or Check 21, which allows for the substitution of image-replacement documents in the clearing and settlement of checks. The law went into effect on October 28, 2004. Check 21 is designed to foster innovation in the payments system and enhance its efficiency by reducing some of the legal impediments to check truncation. The law facilitates check truncation by creating a new negotiable instru-

ment called a substitute check, which permits banks to truncate original checks, process check information electronically, and deliver substitute checks to banks that want to continue receiving paper checks. A substitute check is the legal equivalent of the original check and includes all of the information contained on the original check. The law does not require banks to accept checks in electronic form, nor does it require banks to create substitute checks, but it is an important step toward greater use of electronic payments.

CASH OPERATIONS

In comparison to the switch-over from check to electronic payments, the sub-

stitution of electronic payments for cash appears to be more challenging and is moving slowly.
The migration of U.S. retail payments to electronics will continue to accelerate. The structure of the U.S. banking industry is likely to continue to evolve toward one in which a small number of large, complex banking organizations compete globally with the world's largest financial institutions while a large number of smaller institutions focus on local communities or somewhat larger regional areas. Banks will continue to expand their product lines across both domestic and foreign.

Macroeconomic and financial challenges will undoubtedly continue to emerge. Some of these challenges will be similar to events the U.S. economy has experienced in the past. Others will be new and unique. Many of these new challenges likely will stem from the increasing technological sophistication and complexity of the real economy and of the financial system, others will come from the progressive influence of globalization on trade and international financial flows. All will continue to test the best thinking of the Federal Reserve. For policy to respond successfully to them, we will need to keep in mind the principles of sound policy-making I previously discussed: Study a wide range of data, Analyze problems using cogent economic theory. Respect the risks of undesirable outcomes for growth and inflation. And remain flexible in thinking about changes in the economy and the ways policy should react to them.

The Federal Reserve also has the responsibility of explaining our actions to the public. Over the past decade, we have seen a move from central bank secrecy to central bank transparency, a change that reflects a growing appreciation of the enhanced policy credibility and reduced economic uncertainty that accompany public understanding of the goals and rationales underlying monetary policy decisions. I consider this movement toward greater transparency a very positive development and expect it to continue. The Federal Reserve will continue to adopt and incorporate best practices from the industry and elsewhere to ensure the highest levels of integrity and excellence. In 2006, the Federal Reserve voluntarily chose to meet the rigorous requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (SOX). Like publicly held organizations, through SOX, the Fed strengthened its focus on its system of internal controls over financial reporting and the effective management of risks. For similar reasons, the Federal Reserve System has bolstered its governance structure through service agreements between Reserve Banks, performance metrics, and other mechanisms that enhance the clarity of authority and accountability.

To accomplish this, Reserve Banks are unlikely to remain full-service providers of retail payment services indefinitely. The Reserve Banks will continue encouraging greater use of electronics in the check-collection process as well as offering an array of products and services to take advantage of the opportunities provided by the Check 21 Act. At the same time, there will be an ongoing focus on customers, service levels, and fees, and on cost efficiency in both retail services and Reserve Bank support functions.

The Federal Reserve will continue to contribute to the formulation of payment system policy, particularly with respect to payment system risk issues. In doing so, they will further strengthen their outreach to financial markets, both domestic and abroad, by enhancing the Fed’s role in promoting financial stability, effective crisis management, and the formulation of standards. Ultimately, the Federal Reserve’s role in helping to shape the development of our nation’s payment system will continue to be informed by its unique role as a public policy-making, institution and payments provider.

General-purpose stored-value card trials in the U.S. at the Atlanta Olympics in 1996 and in Manhattan a year later did very little to convince consumers and merchants of their value. Rather, stored-value products have been successful only in relatively limited situations: gift cards, payroll cards, various government benefits, mass transportation, and on university campuses.

Cash itself has undergone several facelifts in the last decade or so. Along with the Federal Reserve, the U.S. Treasury continued to improve the counterfeiting deterrence capabilities of U.S. bank notes. The list of improvements includes adding color to some notes, an enlarged off-center portrait, a watermark, fine-line printing patterns, and color-shifting ink. The counterfeiting threat has global implications because, in value terms at least, half of U.S. banknotes continue to be held outside the United States, particularly as a store of value in several economies with underdeveloped banking systems.

Moving forward, the Federal Reserve must continue to play an important role in fostering a smoothly functioning payments system that is safe, efficient, and accessible. Within that framework, continuing to support the shift from paper to electronic payments is good public policy.
In the midst of tremendous change in the economy and banking and financial systems, the Federal Reserve has been vigilant to retain and build upon a unique attribute and strength — its regional structure and character. Given population shifts in the U.S. since 1913, we would probably implement the geographic structure of Reserve Banks differently if we were to create the Federal Reserve System from scratch today. However, this structure makes our central bank a uniquely American institution, reflecting the importance that we as a society place on local representation, independence, and transparency. It also contributes greatly to the monetary policy-making process.

The 12 regional banks, and their independent Boards of Directors, give the Fed ready access to information from all parts of the country and all sectors of the economy. And the fact that all District Bank presidents serve on the FOMC — and have access to high-quality research performed by their own independent staffs — assures that a variety of voices are heard in the policy-making function. While it is perhaps most notable in the core responsibility of monetary policy, the presence of the Federal Reserve’s regional character helps to inform nearly all aspects of our responsibilities as a central bank, allowing us to bring new insights and ideas to bear on unforeseen problems.

Given these attributes, I remain confident in the ability of the Federal Reserve Banks and the Federal Reserve System to adapt in the face of challenges that lie ahead. In my experience, a hallmark of the Federal Reserve has been and will continue to be the level of commitment and talent associated with the people who make up the institution. At the risk of making a bold prediction, that will never change. As long as we retain these qualities, the System will remain the world’s preeminent central bank.

Federal Reserve Bank of Chicago Research Department Vice Presidents Spencer Krane, Douglas Evanoff and Richard Porter contributed to the development of this essay, as did Supervision & Regulation Senior Vice President Cathy Lemieux and Senior Examiner Steven Van Bever as well as Enterprise Risk Management Assistant Vice President Nate Wuerffel.

Notes:
1 An ACH network is an electronic clearing and settlement system for exchanging electronic transactions among participating depository institutions. Such electronic transactions are substitutes for paper checks and are typically used to make recurring payments such as payroll or labor payments. The Federal Reserve Banks operate an ACH, as do some private sector firms.

2 Fedwire is an electronic funds transfer network operated by the Federal Reserve. Fedwire is usually used to transfer large amounts of funds and U.S. government securities from one institution’s account at the Federal Reserve to another institution’s account. It is also used by the U.S. Department of the Treasury and other federal agencies to collect and disburse funds.

Three new directors joined the Chicago Board in 2007:

WILLIAM C. FOOTE, (left) Chairman and Chief Executive Officer of USG Corporation in Chicago, Illinois, replaced James Farrell, who completed his service on the board at the end of 2006.

DENNIS J. KUESTER, Chairman and Chief Executive Officer of Marsh & McLennan Corporation in Chicago, Illinois, replaced William Dobson, who completed his service on the board at the end of 2006.

ANN T. GAFFNEY, President and Chief Executive Officer of UW Health System in Madison, Wisconsin, replaced Glenn Johnson, who completed his service on the board at the end of 2005.

Notes:
*Valerie Jarrett resigned from the Board of Directors in April of 2007.
**Wendy Blau resigned from the Board of Directors in July of 2006.
Advocacy Councils

FEDERAL ADVISORY COUNCIL SEVENTH DISTRICT REPRESENTATIVE

DENNIS A. JESTER
Marshall & Ilsley Corporation
Milwaukee, Wisconsin

ALFRED M. BIRCHARD
National Bankers Association
Washington, D.C.

JOHN D. FORSYTH
FirstMerit Bank
Chicago, Illinois

JOHN E. HART
Jameson Financial Services
Chicago, Illinois

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago, Illinois

RICHARD E. LEROY
Fifth Third Bank
Cincinnati, Ohio

JOHN R. MAWERS
PNC Bank
Cleveland, Ohio

NORMAN F. RODGERS
FirstMerit Bank
Chicago, Illinois

JANET E. WATKINS-RUSSELL
Morgan Stanley
New York, New York

WILLIAM M. MAGNER, JR.
KPMG Mergers & Acquisitions
Chicago, Illinois

DAVID J. WAGNER
Chicago, Illinois

J. MICHAEL MOORE
FirstMerit Bank
Chicago,
The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2006 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $4.2 million. To ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2006, the Bank did not engage PwC for any material advisory services.
Management's Report on Internal Control Over Financial Reporting

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

March 5, 2007

The management of the Federal Reserve Bank of Chicago ("FRBC") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31st, 2006 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on management judgments and estimates. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the FRBC is responsible for establishing and maintaining effective internal control over financial reporting as it relates to the Financial Statements. Such internal control is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles. The Board of Directors has responsibility for establishing and maintaining effective internal control over financial reporting, and for maintaining effective internal control over financial reporting as it relates to the Financial Statements.

No 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 reflected in the Financial Statements, based upon the criteria established in the "Internal Control — Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, we believe that the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks. Based on this assessment, we believe that the FRBC maintained effective internal control over financial reporting as it relates to the Financial Statements.

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

Federal Reserve Bank of Chicago

Michael Moskow
President

Gordon Werkema
First Vice President

Gerard J. Nick
Vice President and Controller

Report of Independent Auditors

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

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

FINANCIAL STATEMENTS

We have audited the accompanying statements of condition of the Federal Reserve Bank of Chicago (the “Bank”) as of December 31, 2006 and 2005, and the related statements of income and changes in capital for the years then ended, which 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 established by the Board of Governors of the Federal Reserve System. These principles, policies, and practices are designed to meet the specialized accounting and reporting needs of the Federal Reserve System, are set forth in the Financial Accounting Manual for Federal Reserve Banks, and include all disclosures necessary for such fair presentation.

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

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

(continued on page 24)
INTERNAL CONTROL OVER FINANCIAL REPORTING

Also, in our opinion, management’s assessment, included in the accompanying Management’s report on Internal Control Over Financial Reporting, that the Bank maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Bank maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the COSO.

The Bank’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management’s assessment and on the effectiveness of the Bank’s internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management’s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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

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

March 12, 2007

PricewaterhouseCoopers

STATEMENTS OF CONDITION

IN millions As of December 31,

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold certificates</td>
<td>$ 947</td>
<td>$ 928</td>
</tr>
<tr>
<td>Special drawing rights certificates</td>
<td>212</td>
<td>212</td>
</tr>
<tr>
<td>Coin</td>
<td>100</td>
<td>76</td>
</tr>
<tr>
<td>Items in process of collection</td>
<td>241</td>
<td>414</td>
</tr>
<tr>
<td>Loans to depository institutions</td>
<td>24</td>
<td>26</td>
</tr>
<tr>
<td>U.S. government securities, net</td>
<td>71,952</td>
<td>67,559</td>
</tr>
<tr>
<td>Investments denominated in foreign currencies</td>
<td>1,357</td>
<td>1,228</td>
</tr>
<tr>
<td>Accrued interest receivable</td>
<td>617</td>
<td>525</td>
</tr>
<tr>
<td>Interdistrict settlement account</td>
<td>-</td>
<td>1,908</td>
</tr>
<tr>
<td>Bank premises and equipment, net</td>
<td>241</td>
<td>245</td>
</tr>
<tr>
<td>Other assets</td>
<td>29</td>
<td>32</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$ 75,720</td>
<td>$ 73,153</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Reserve notes outstanding, net</td>
<td>$ 65,616</td>
<td>$ 66,524</td>
</tr>
<tr>
<td>Securities sold under agreements to repurchase</td>
<td>2,719</td>
<td>2,747</td>
</tr>
<tr>
<td>Deposits:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depository institutions</td>
<td>1,395</td>
<td>1,590</td>
</tr>
<tr>
<td>Other deposits</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Deferred credit items</td>
<td>277</td>
<td>349</td>
</tr>
<tr>
<td>Interest on Federal Reserve notes due U.S. Treasury</td>
<td>104</td>
<td>71</td>
</tr>
<tr>
<td>Interdistrict settlement account</td>
<td>3,742</td>
<td>-</td>
</tr>
<tr>
<td>Accrued benefit costs</td>
<td>122</td>
<td>80</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>26</td>
<td>36</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>$ 74,004</td>
<td>$ 71,401</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital paid in</td>
<td>858</td>
<td>876</td>
</tr>
<tr>
<td>Surplus (including accumulated other comprehensive loss of $41 million at December 31, 2006)</td>
<td>858</td>
<td>876</td>
</tr>
<tr>
<td><strong>Total Capital</strong></td>
<td>1,716</td>
<td>1,752</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Liabilities and Capital</strong></td>
<td>$ 75,720</td>
<td>$ 73,153</td>
</tr>
</tbody>
</table>

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

PricewaterhouseCoopers

(continued from page 23)
## STATEMENTS OF INCOME

<table>
<thead>
<tr>
<th>(in millions)</th>
<th>For the years ended December 31,</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Income:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on U.S. government securities</td>
<td></td>
<td>$3,217</td>
<td>$2,532</td>
</tr>
<tr>
<td>Interest on investments denominated in foreign currencies</td>
<td></td>
<td>24</td>
<td>19</td>
</tr>
<tr>
<td>Interest on loans to depository institutions</td>
<td></td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Total Interest Income</td>
<td></td>
<td>3,244</td>
<td>2,553</td>
</tr>
<tr>
<td>Interest Expense:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense on securities sold under agreements to repurchase</td>
<td></td>
<td>123</td>
<td>73</td>
</tr>
<tr>
<td>Net Interest Income</td>
<td></td>
<td>3,121</td>
<td>2,480</td>
</tr>
<tr>
<td>Other Operating (Loss) Income:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from services</td>
<td></td>
<td>55</td>
<td>49</td>
</tr>
<tr>
<td>Compensation received for services provided</td>
<td></td>
<td>59</td>
<td>54</td>
</tr>
<tr>
<td>Reimbursable services to government agencies</td>
<td></td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Foreign currency (losses) gains, net</td>
<td></td>
<td>78</td>
<td>(133)</td>
</tr>
<tr>
<td>Other income</td>
<td></td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td>Total Other Operating (Loss) Income</td>
<td></td>
<td>208</td>
<td>(74)</td>
</tr>
<tr>
<td>Operating Expenses:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and other benefits</td>
<td></td>
<td>142</td>
<td>136</td>
</tr>
<tr>
<td>Occupancy expense</td>
<td></td>
<td>24</td>
<td>20</td>
</tr>
<tr>
<td>Equipment expense</td>
<td></td>
<td>13</td>
<td>11</td>
</tr>
<tr>
<td>Assessments by Board of Governors</td>
<td></td>
<td>71</td>
<td>70</td>
</tr>
<tr>
<td>Other expenses</td>
<td></td>
<td>94</td>
<td>87</td>
</tr>
<tr>
<td>Total Operating Expenses</td>
<td></td>
<td>344</td>
<td>324</td>
</tr>
<tr>
<td>Net Income Prior to Distribution</td>
<td></td>
<td>$2,985</td>
<td>$2,082</td>
</tr>
<tr>
<td>Distribution of Net Income:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends paid to member banks</td>
<td></td>
<td>$52</td>
<td>$50</td>
</tr>
<tr>
<td>Transferred to surplus</td>
<td></td>
<td>23</td>
<td>13</td>
</tr>
<tr>
<td>Payments to U.S. Treasury as interest on Federal Reserve notes</td>
<td></td>
<td>2,910</td>
<td>1,919</td>
</tr>
<tr>
<td>Total Distribution</td>
<td></td>
<td>$2,985</td>
<td>$2,082</td>
</tr>
</tbody>
</table>

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

## STATEMENTS OF CHANGES IN CAPITAL

<table>
<thead>
<tr>
<th>(in millions)</th>
<th>For the years ended December 31, 2006 and December 31, 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Capital</td>
</tr>
<tr>
<td></td>
<td>Paid-In</td>
</tr>
<tr>
<td>Balance at January 1, 2005</td>
<td></td>
</tr>
<tr>
<td>(15 million shares)</td>
<td>$763</td>
</tr>
<tr>
<td>Net change in capital stock issued</td>
<td></td>
</tr>
<tr>
<td>(2 million shares)</td>
<td>113</td>
</tr>
<tr>
<td>Transferred to surplus</td>
<td>–</td>
</tr>
<tr>
<td>Balance at December 31, 2005</td>
<td></td>
</tr>
<tr>
<td>(18 million shares)</td>
<td>$876</td>
</tr>
<tr>
<td>Net change in capital stock redeemed</td>
<td></td>
</tr>
<tr>
<td>(364 thousand shares)</td>
<td>(18)</td>
</tr>
<tr>
<td>Transferred to surplus</td>
<td>–</td>
</tr>
<tr>
<td>Adjustment to initially apply FASB Statement No. 158</td>
<td>–</td>
</tr>
<tr>
<td>Balance at December 31, 2006</td>
<td></td>
</tr>
<tr>
<td>(17 million shares)</td>
<td>$858</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these financial statements.
The Financial Management of the Federal Reserve System
The Federal Reserve System is an independent federal agency that serves as the central bank of the United States. The System is composed of the Board of Governors of the Federal Reserve System (the "Board"), the twelve 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 and its branch in Detroit, Michigan serve the Seventh Federal Reserve District, which includes Iowa, and portions of Michigan, Indiana, Wisconsin, and Minnesota.

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

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

2. OPERATIONS AND SERVICES
The Reserve Banks perform a variety of services and operations. Functions include participation in formulating and conducting monetary policy; participation in the payments system, including large-dollar transfers of funds, automated clearinghouse ("ACH") operations, and check collection; distribution of coin and currency; and management of financial assets and liabilities. A Statement of Cash Flows, therefore, would not provide any additional meaningful information.

Other information regarding the Bank’s activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital shown in the Financial Accounting Manual and GAAP. The preparation of the financial statements in conformity with the Financial Accounting Manual and GAAP requires the Bank 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 expense during the reporting period. Actual results could differ from these estimates. Unique accounts and significant accounting policies are explained below.

a. Gold and Special Drawing Rights Certificates
The Secretary of the U.S. Treasury is authorized to issue gold and special drawing rights ("SDR") certificates to the Reserve Banks.

The FRBNY also files such additional statements as it deems necessary or desirable in the administration of this section, and rules and regulations which may be necessary to make the conduct of its business efficient. To the extent that such regulations are inconsistent with the provisions set forth in this section, the regulations promulgated by the FRBNY shall control to the extent of such inconsistency.

b. Loans to Depository Institutions
Depositary institutions that maintain reserve accounts at the Federal Reserve Banks pay interest on deposits made under the reserve requirement. The Board of Governors, however, has the discretion to set the rate of interest on loans made under the reserve requirement. The Board of Governors may, but need not, in its discretion, establish a procedure for the extension of credit to such institutions.

The FRBNY, in the performance of its duties, is authorized to enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

The System also includes the Federal Reserve Bank of New York ("FRBNY"), which serves as the depository for the System. The FRBNY is the Reserve Bank for the New York Federal Reserve District and serves as the System's central bank.

The board of directors of the FRBNY is composed of nine members: two directors are elected by member banks and seven are appointed by the Board of Governors of the Federal Reserve System. The two directors elected by member banks serve three-year terms and are re-elected annually. The seven directors appointed by the Board of Governors serve three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors to represent the public, and six directors are elected by member banks.

The FRBNY also files such additional statements as it deems necessary or desirable in the administration of this section, and rules and regulations which may be necessary to make the conduct of its business efficient. To the extent that such regulations are inconsistent with the provisions set forth in this section, the regulations promulgated by the FRBNY shall control to the extent of such inconsistency.

The FRBNY also files such additional statements as it deems necessary or desirable in the administration of this section, and rules and regulations which may be necessary to make the conduct of its business efficient. To the extent that such regulations are inconsistent with the provisions set forth in this section, the regulations promulgated by the FRBNY shall control to the extent of such inconsistency.

The FRBNY, in the performance of its duties, is authorized to enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

The System also includes the Federal Reserve Bank of New York ("FRBNY"), which serves as the depository for the System. The FRBNY is the Reserve Bank for the New York Federal Reserve District and serves as the System's central bank.

The board of directors of the FRBNY is composed of nine members: two directors are elected by member banks and seven are appointed by the Board of Governors of the Federal Reserve System. The two directors elected by member banks serve three-year terms and are re-elected annually. The seven directors appointed by the Board of Governors serve three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors to represent the public, and six directors are elected by member banks.

The FRBNY also files such additional statements as it deems necessary or desirable in the administration of this section, and rules and regulations which may be necessary to make the conduct of its business efficient. To the extent that such regulations are inconsistent with the provisions set forth in this section, the regulations promulgated by the FRBNY shall control to the extent of such inconsistency.

The FRBNY, in the performance of its duties, is authorized to enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

The System also includes the Federal Reserve Bank of New York ("FRBNY"), which serves as the depository for the System. The FRBNY is the Reserve Bank for the New York Federal Reserve District and serves as the System's central bank.

The board of directors of the FRBNY is composed of nine members: two directors are elected by member banks and seven are appointed by the Board of Governors of the Federal Reserve System. The two directors elected by member banks serve three-year terms and are re-elected annually. The seven directors appointed by the Board of Governors serve three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors to represent the public, and six directors are elected by member banks.

The FRBNY also files such additional statements as it deems necessary or desirable in the administration of this section, and rules and regulations which may be necessary to make the conduct of its business efficient. To the extent that such regulations are inconsistent with the provisions set forth in this section, the regulations promulgated by the FRBNY shall control to the extent of such inconsistency.

The FRBNY, in the performance of its duties, is authorized to enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

The System also includes the Federal Reserve Bank of New York ("FRBNY"), which serves as the depository for the System. The FRBNY is the Reserve Bank for the New York Federal Reserve District and serves as the System's central bank.

The board of directors of the FRBNY is composed of nine members: two directors are elected by member banks and seven are appointed by the Board of Governors of the Federal Reserve System. The two directors elected by member banks serve three-year terms and are re-elected annually. The seven directors appointed by the Board of Governors serve three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors to represent the public, and six directors are elected by member banks.

The FRBNY also files such additional statements as it deems necessary or desirable in the administration of this section, and rules and regulations which may be necessary to make the conduct of its business efficient. To the extent that such regulations are inconsistent with the provisions set forth in this section, the regulations promulgated by the FRBNY shall control to the extent of such inconsistency.

The FRBNY, in the performance of its duties, is authorized to enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

The System also includes the Federal Reserve Bank of New York ("FRBNY"), which serves as the depository for the System. The FRBNY is the Reserve Bank for the New York Federal Reserve District and serves as the System's central bank.

The board of directors of the FRBNY is composed of nine members: two directors are elected by member banks and seven are appointed by the Board of Governors of the Federal Reserve System. The two directors elected by member banks serve three-year terms and are re-elected annually. The seven directors appointed by the Board of Governors serve three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors to represent the public, and six directors are elected by member banks.

The FRBNY also files such additional statements as it deems necessary or desirable in the administration of this section, and rules and regulations which may be necessary to make the conduct of its business efficient. To the extent that such regulations are inconsistent with the provisions set forth in this section, the regulations promulgated by the FRBNY shall control to the extent of such inconsistency.

The FRBNY, in the performance of its duties, is authorized to enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

The System also includes the Federal Reserve Bank of New York ("FRBNY"), which serves as the depository for the System. The FRBNY is the Reserve Bank for the New York Federal Reserve District and serves as the System's central bank.

The board of directors of the FRBNY is composed of nine members: two directors are elected by member banks and seven are appointed by the Board of Governors of the Federal Reserve System. The two directors elected by member banks serve three-year terms and are re-elected annually. The seven directors appointed by the Board of Governors serve three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors to represent the public, and six directors are elected by member banks.

The FRBNY also files such additional statements as it deems necessary or desirable in the administration of this section, and rules and regulations which may be necessary to make the conduct of its business efficient. To the extent that such regulations are inconsistent with the provisions set forth in this section, the regulations promulgated by the FRBNY shall control to the extent of such inconsistency.

The FRBNY, in the performance of its duties, is authorized to enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.
Lending denominated in foreign currencies are reported as “Foreign currency U.S. dollars. Realized and unrealized gains and losses on investments on a straight-line basis. Gains and losses resulting from sales of securities comprising the SOMA are recorded at cost, on a settlement of discounts on a straight-line basis. Interest income is accrued on a straight-line basis. Gains and losses resulting from sales of securities are recorded at cost, based on average cost. Foreign-currency-denominated assets are revalued at daily current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are recorded at “Foreign currency gains (losses), net” in the Statements of Income. Activity related to U.S. government securities, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings that occurs in April of each year. The settlement also equalizes Reserve Bank grid certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments denominated in foreign currencies is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to aggregate capital and surplus at the preceding December 31. Unrealized gains and losses resulting from the daily revaluation are allocated to FRBNY and not allocated to the other Reserve Banks.

d. Securities Sold Under Agreements to Repurchase, and Securities Lending

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

U.S. government securities held in the SOMA are lent to U.S. government securities dealers in order to facilitate the effective functioning of the interdistrict securities market. Securities-lending transactions are fully collateralized by other U.S. government securities and the collateral taken is in excess of the market value of the securities loaned. The FRBNY charges the dealer a fee for borrowing securities and the fee is reported as income but excluded from net income. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 9 and 10.

i. Interest on Federal Reserve Notes

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

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

j. Surplus

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31 of each year.

k. Surplus

Interest on Federal Reserve Notes

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

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

l. Interest on Federal Reserve Notes

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

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

i. Income and Costs Related to U.S. Treasury Services

The Board is required by the Federal Reserve Act to serve as fiscal agent for the U.S. Treasury. The Board’s assessment of the U.S. Treasury is permitted, but not required, to pay for these services.

j. Assessments by the Board of Governors

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

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

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank premises and equipment at December 31 included the following amounts for leases that have been capitalized (in thousands):</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leased premises and equipment under capital leases</td>
<td>$422</td>
<td>$389</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>$130</td>
<td>$233</td>
</tr>
</tbody>
</table>

The Bank leases space to outside tenants with remaining lease terms ranging from two to fourteen years. Rental income from such leases was $6 million and $4 million for the years ended December 31, 2006 and 2005, respectively, and is reported as a component of “Other income.” Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2006, are as follows (in millions): $4

The Bank has capitalized software assets, net of amortization, of $4 million for each of the years ended December 31, 2006 and 2005. Amortization expense was $2 million for each of the years ended December 31, 2006 and 2005. Capitalized software assets are reported as a component of “Other assets” and the related amortization is reported as a component of “Other expenses.”
The Bank recognized impairment losses on the Detroit facility of $2 million at December 31, 2005 due to its determination that the carry value exceeded the fair value of the property. The impairment was determined using fair values based on quoted market values or other valuation techniques and are reported as a component of “Other expenses.” In April 2006, the Detroit property was sold for a total of $2 million.

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2006, 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 indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $3 million for each of the years ended December 31, 2006 and 2005. Certain of the Bank’s leases have options to renew.

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Operating Lease Payments</th>
<th>Capital Lease Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>$ 927</td>
<td>$ 132</td>
</tr>
<tr>
<td>2008</td>
<td>508</td>
<td>22</td>
</tr>
<tr>
<td>2009</td>
<td>403</td>
<td>-</td>
</tr>
<tr>
<td>2010</td>
<td>312</td>
<td>-</td>
</tr>
<tr>
<td>2011</td>
<td>10</td>
<td>-</td>
</tr>
<tr>
<td>2012 and thereafter</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Amount representing interest (99)

Present value of net minimum lease payments $ 145

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

Under the Insurance Agreement of the Federal Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank’s capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is sustained. No claims were outstanding under the agreement at December 31, 2006 and 2005.

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

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

The System Plan is a multi-employer plan with contributions funded by the participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the System Plan and the costs associated with the Plan are not redistributed to other participating employers.

The Bank’s projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2006 and 2005, and for the years then ended, were not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (“Thrift Plan”). The Bank’s Thrift Plan contributions totaled $5 million for each of the years ended December 31, 2006 and 2005, respectively, and are reported as a component of “Salaries and other benefits” and other expenses” in the Statements of Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2006 and 2005, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFTS

Postretirement Benefits other than Pensions

In addition to the Bank’s retirement plans, employees who have met certain age and length-of-service requirements are eligible for both medical benefits and life insurance coverage during retirement. The Bank funds benefits payable under the medical and life insurance plans as due and, accordingly, has no plan assets.

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

<table>
<thead>
<tr>
<th>Year</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated postretirement benefit obligation at January 1</td>
<td>$ 98.6</td>
<td>$ 97.0</td>
</tr>
<tr>
<td>Service and interest cost</td>
<td>1.7</td>
<td>1.5</td>
</tr>
<tr>
<td>Interest cost on accumulated benefit obligation</td>
<td>0.4</td>
<td>0.2</td>
</tr>
<tr>
<td>Actuarial loss</td>
<td>11.4</td>
<td>0.8</td>
</tr>
<tr>
<td>Contributions by plan participants</td>
<td>1.6</td>
<td>1.4</td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(7.8)</td>
<td>(7.3)</td>
</tr>
<tr>
<td>Accumulated postretirement benefit obligation at December 31</td>
<td>$ 110.9</td>
<td>$ 98.6</td>
</tr>
</tbody>
</table>

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

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

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

<table>
<thead>
<tr>
<th>Year</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of plan assets at January 1</td>
<td>$ 5</td>
<td>$ 5</td>
</tr>
<tr>
<td>Contributions by employer</td>
<td>6.2</td>
<td>5.9</td>
</tr>
<tr>
<td>Contributions by plan participants</td>
<td>1.6</td>
<td>1.4</td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(7.8)</td>
<td>(7.3)</td>
</tr>
<tr>
<td>Fair value of plan assets at December 31</td>
<td>$ –</td>
<td>$ –</td>
</tr>
<tr>
<td>Unfunded postretirement benefit obligation</td>
<td>$ –</td>
<td>$ 98.6</td>
</tr>
<tr>
<td>Unrecognized prior service cost</td>
<td>11.9</td>
<td>11.9</td>
</tr>
<tr>
<td>Unrecognized actuarial loss</td>
<td>42.0</td>
<td>42.0</td>
</tr>
<tr>
<td>Accrued postretirement benefit costs</td>
<td>$ 68.5</td>
<td>$ 68.5</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Year</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior service cost</td>
<td>9.4</td>
<td>9.4</td>
</tr>
<tr>
<td>Net actuarial loss</td>
<td>(50.2)</td>
<td>(50.2)</td>
</tr>
<tr>
<td>Total accumulated other comprehensive loss</td>
<td>$ (40.8)</td>
<td>$ (40.8)</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Year</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health care cost trend rate assumed for next year</td>
<td>9.00%</td>
<td>9.00%</td>
</tr>
<tr>
<td>Rate to which the trend rate is assumed to decline (the ultimate trend rate)</td>
<td>5.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Year that the rate reaches the ultimate trend rate</td>
<td>2012</td>
<td>2011</td>
</tr>
</tbody>
</table>

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care trend rates would have the following effects for the year ended December 31, 2006 (in millions):

<table>
<thead>
<tr>
<th>Effect of a 1% Change in Assumed Health Care Trend Rate</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>One Percentage Point Increase</td>
<td>$ 0.8</td>
<td>$ 0.8</td>
</tr>
<tr>
<td>One Percentage Point Decrease</td>
<td>$ 0.8</td>
<td>$ 0.8</td>
</tr>
</tbody>
</table>

The following is a summary of the components of net periodic postretirement benefit expense for the years ended December 31, 2006 (in millions):

<table>
<thead>
<tr>
<th>Year</th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs</td>
<td>$ 1.0</td>
<td>$ 0.8</td>
</tr>
<tr>
<td>Effect on accumulated postretirement benefit obligation</td>
<td>12.4</td>
<td>10.4</td>
</tr>
</tbody>
</table>

Net periodic postretirement benefit expense $ 7.8 $ 4.9

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

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior service cost</td>
<td>$ (2.3)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actuarial loss</td>
<td>5.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ (2.8)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

Net periodic postretirement benefit expense is reported as a component of “Salaries and other benefits” in the Statements of Income. The curtailment gain associated with restructuring programs announced in 2004 and described in Note 11 was recognized when employees terminated employment in 2005.

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, exercisable to January 1, 2004, are reflected in actuarial (gain) in the accumulated postretirement benefit obligation.

There were no morsels of federal Medicare subsidies in the year ended December 31, 2006. Expected morsels in the year ending December 31, 2007, related to payments made in the year ended December 31, 2006, are $530 thousand.

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

<table>
<thead>
<tr>
<th>Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Without subsidy</td>
<td>$ 7.5</td>
<td>$ 6.8</td>
<td>$ 7.5</td>
<td>$ 7.5</td>
</tr>
<tr>
<td>With subsidy</td>
<td>7.8</td>
<td>7.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>8.2</td>
<td>7.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>8.5</td>
<td>7.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>6.6</td>
<td>7.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013+</td>
<td>47.1</td>
<td>41.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$ 87.9</td>
<td>$ 78.8</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and
dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2006 and 2005 were $10 million and $11 million, respectively. This cost is included as a component of “Accrued benefit costs” in the Statements of Condition. Net periodic postemployment benefit expense included in 2006 and 2005 operating expenses were $299 thousand and $(314) thousand, respectively, and are recorded as a component of “Salaries and other benefits” in the Statements of Income.

10. ACCUMULATED OTHER COMPREHENSIVE INCOME

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

<table>
<thead>
<tr>
<th>Amount Related to Postretirement Benefits other than Pensions</th>
<th>Year-ended 12/31/2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at December 31, 2005 $ –</td>
<td>$ 7.9</td>
</tr>
<tr>
<td>Adjustment to initially apply FASB Statement No. 158 (41)</td>
<td>$ 0.1</td>
</tr>
<tr>
<td>Balance at December 31, 2006 $ (41)</td>
<td>$ 0.9</td>
</tr>
</tbody>
</table>

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 328, including 28 staff reductions related to restructuring announced in 2006. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of “Salaries and other benefits” in the Statements of Income.

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced restructuring plans are not material.

The Bank anticipates substantially completing its announced plans by 2008.

11. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004 and 2006, additional consolidation and restructuring initiatives were announced in the check and check adjustment operations, respectively. These actions resulted in the following business restructuring charges (in millions):

<table>
<thead>
<tr>
<th>Total Estimated Costs</th>
<th>Accrued Liability 12/31/05</th>
<th>Total Charges and Adjustments</th>
<th>Accrued Liability 12/31/06</th>
<th>Employee separation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ –</td>
<td>$ 0.9</td>
</tr>
<tr>
<td>Total</td>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ 0.9</td>
</tr>
</tbody>
</table>

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 328, including 28 staff reductions related to restructuring announced in 2006. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of “Salaries and other benefits” in the Statements of Income.

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced restructuring plans are not material.

The Bank anticipates substantially completing its announced plans by 2008.

11. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004 and 2006, additional consolidation and restructuring initiatives were announced in the check and check adjustment operations, respectively. These actions resulted in the following business restructuring charges (in millions):

<table>
<thead>
<tr>
<th>Total Estimated Costs</th>
<th>Accrued Liability 12/31/05</th>
<th>Total Charges and Adjustments</th>
<th>Accrued Liability 12/31/06</th>
<th>Employee separation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ –</td>
<td>$ 0.9</td>
</tr>
<tr>
<td>Total</td>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ 0.9</td>
</tr>
</tbody>
</table>

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 328, including 28 staff reductions related to restructuring announced in 2006. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of “Salaries and other benefits” in the Statements of Income.

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced restructuring plans are not material.

The Bank anticipates substantially completing its announced plans by 2008.

11. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004 and 2006, additional consolidation and restructuring initiatives were announced in the check and check adjustment operations, respectively. These actions resulted in the following business restructuring charges (in millions):

<table>
<thead>
<tr>
<th>Total Estimated Costs</th>
<th>Accrued Liability 12/31/05</th>
<th>Total Charges and Adjustments</th>
<th>Accrued Liability 12/31/06</th>
<th>Employee separation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ –</td>
<td>$ 0.9</td>
</tr>
<tr>
<td>Total</td>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ 0.9</td>
</tr>
</tbody>
</table>

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 328, including 28 staff reductions related to restructuring announced in 2006. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of “Salaries and other benefits” in the Statements of Income.

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced restructuring plans are not material.

The Bank anticipates substantially completing its announced plans by 2008.

11. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004 and 2006, additional consolidation and restructuring initiatives were announced in the check and check adjustment operations, respectively. These actions resulted in the following business restructuring charges (in millions):

<table>
<thead>
<tr>
<th>Total Estimated Costs</th>
<th>Accrued Liability 12/31/05</th>
<th>Total Charges and Adjustments</th>
<th>Accrued Liability 12/31/06</th>
<th>Employee separation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ –</td>
<td>$ 0.9</td>
</tr>
<tr>
<td>Total</td>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ 0.9</td>
</tr>
</tbody>
</table>

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 328, including 28 staff reductions related to restructuring announced in 2006. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of “Salaries and other benefits” in the Statements of Income.

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced restructuring plans are not material.

The Bank anticipates substantially completing its announced plans by 2008.

11. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004 and 2006, additional consolidation and restructuring initiatives were announced in the check and check adjustment operations, respectively. These actions resulted in the following business restructuring charges (in millions):

<table>
<thead>
<tr>
<th>Total Estimated Costs</th>
<th>Accrued Liability 12/31/05</th>
<th>Total Charges and Adjustments</th>
<th>Accrued Liability 12/31/06</th>
<th>Employee separation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ –</td>
<td>$ 0.9</td>
</tr>
<tr>
<td>Total</td>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ 0.9</td>
</tr>
</tbody>
</table>

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 328, including 28 staff reductions related to restructuring announced in 2006. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of “Salaries and other benefits” in the Statements of Income.

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced restructuring plans are not material.

The Bank anticipates substantially completing its announced plans by 2008.

11. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004 and 2006, additional consolidation and restructuring initiatives were announced in the check and check adjustment operations, respectively. These actions resulted in the following business restructuring charges (in millions):

<table>
<thead>
<tr>
<th>Total Estimated Costs</th>
<th>Accrued Liability 12/31/05</th>
<th>Total Charges and Adjustments</th>
<th>Accrued Liability 12/31/06</th>
<th>Employee separation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ –</td>
<td>$ 0.9</td>
</tr>
<tr>
<td>Total</td>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ 0.9</td>
</tr>
</tbody>
</table>

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 328, including 28 staff reductions related to restructuring announced in 2006. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of “Salaries and other benefits” in the Statements of Income.

Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced restructuring plans are not material.

The Bank anticipates substantially completing its announced plans by 2008.

11. BUSINESS RESTRUCTURING CHARGES

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004 and 2006, additional consolidation and restructuring initiatives were announced in the check and check adjustment operations, respectively. These actions resulted in the following business restructuring charges (in millions):

<table>
<thead>
<tr>
<th>Total Estimated Costs</th>
<th>Accrued Liability 12/31/05</th>
<th>Total Charges and Adjustments</th>
<th>Accrued Liability 12/31/06</th>
<th>Employee separation</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ –</td>
<td>$ 0.9</td>
</tr>
<tr>
<td>Total</td>
<td>$ 7.9</td>
<td>$ 0.1</td>
<td>$ 0.9</td>
<td>$ 0.9</td>
</tr>
</tbody>
</table>
FEDERAL RESERVE BANK
OF CHICAGO

Head Office
230 South LaSalle Street
P.O. Box 834
Chicago, Illinois 60690-0834
312-322-5322

Detroit Branch
1600 East Warren Avenue
Detroit, Michigan 48207-1063
313-961-6880

Des Moines Office
2200 Rittenhouse Street
Suite 150
Des Moines, Iowa 50321
515-256-6100

Midway Facility
4944 West 73rd Street
Bedford Park, Illinois 60638
708-924-8900