Inside:
Home foreclosures
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Era of checks

BUILDING FOR THE FUTURE
Kansas City Fed moves into new headquarters
RURAL SNAPSHOTs: A look back at 2007 gives a glimpse of 2008
Ethanol and export demands as well as strong farm gains have been promising, but it’s rising production costs that will determine rural America’s prosperity this year.

INDUSTRIAL LOAN COMPANIES: Commercial businesses face head-on opposition to entering the banking sector
Current law leaves ILCs as the only option for businesses like Wal-Mart and Home Depot to open a bank, but this possibility causes uproar.

REPAIRING THE DAMAGE: A combination of factors led to the nationwide foreclosure surge
The onslaught may continue through the next few years, but help is available for homeowners in distress.

2007 ANNUAL REPORT
Listings of officers, directors and advisory councils, and financial reports for the Federal Reserve Bank of Kansas City.

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Moving forward, remembering the past

The Federal Reserve Bank of Kansas City recently completed the move to our new headquarters at 1 Memorial Drive. For employees, this obviously has been a very exciting, and historic, time. But, as excited as we are about our future, it is also natural at times like this to reflect on the past.

When the Federal Reserve Bank of Kansas City opened for business on Nov. 16, 1914, it operated out of about 8,500 square feet of office space in the R.A. Long Building on the northwest corner of 10th and Grand streets. In those early days, a handful of employees conducted the Bank’s business primarily out of lobby offices, although a few had to venture to a small filing room on the building’s then-skyscraping 15th floor.

Soon, more space was needed.

Within three years, the Bank had employees working on five floors of the Long Building, as well as in two other downtown Kansas City structures. With business growth showing no signs of slowing, Bank officials took the first steps toward the construction of the building that would be the Bank’s home for nearly a century downtown at 925 Grand Blvd.

They built with an eye to the future. When employees moved in on Nov. 16, 1921, they filled only about half of the building’s 21 stories. The rest of the space in what was then the city’s tallest structure was leased to outside tenants. A few of those tenants were especially notable: Harry Truman worked there after leaving the White House and before the opening of his library and museum in nearby Independence, Mo. The FBI was also based there at the time of the Union Station massacre.

Although these tenants certainly brought some excitement to the building, and to the lives of Bank employees, gradually the Bank began to grow. By the early 1970s, the last of the tenants left and Bank operations filled all 21 floors.

Through the years, the building that employees referred to as simply “925” served us well and will remain an important connection to our history.

There were, however, challenges. The U-shaped floor plates designed to circulate air in an era before air conditioning, were not well suited for the operations and offices of a modern Federal Reserve Bank. To address office space concerns, in 1976 we moved some employees into a building just north of 925 Grand. In 2000, we moved some of our staff into leased offices nearby at One Kansas City Place and a second group of employees moved into leased offices there in 2001.

In recent years, these types of challenges, coupled with our continued growth, had a very real impact on the efficiency of our operations.

1 Memorial Drive

On July 1, we will officially open to the public our new headquarters along Kansas City’s Main Street.

Like its predecessor, this structure was built with an eye to the future. State-of-the-art technology combined with a location that is easily accessible from anywhere in the United States have the Federal Reserve Bank of Kansas City well-positioned to serve the Federal Reserve System and the banks of the Tenth District.

There will certainly be efficiencies and opportunities that will come from working in an environment designed for the 21st century. Technology is remaking all businesses and industries, and banking is no exception—you only need to look as far as your next transaction where you are perhaps more likely to pull out a
debit card instead of a checkbook. As innovation increases, both in speed and significance, our new building positions the Federal Reserve Bank of Kansas City to quickly respond to developments that affect the banks we serve in the Tenth Federal Reserve District. Technology also is changing the way we do business within the network of regional Banks that make up the Federal Reserve System. As the System’s newest facility, we are well prepared for the future.

Our new home also provides a unique opportunity for the public. A 3,000-square-foot visitors center explains how the nation’s financial system functions, from the individual consumer and their bank through the nation’s largest financial institutions and, of course, the role of the Federal Reserve. Visitors also will learn about the Federal Reserve’s monetary policy mission and the Federal Open Market Committee. Especially of interest to the public, we believe, will be the opportunity to look into a cash vault—with its storage capacity equal to nearly 100 railcars—to see how our cash operations work.

The building is the first Federal Reserve facility constructed after the tragedy of 9/11. As such, our security meets all of the Federal Reserve’s understandably stringent requirements. However, unlike at 925 Grand where we had to retrofit an existing structure to these new security standards, incorporating these features into new construction results in a building that we believe will be easily accessible to the public.

We are especially pleased that a significant portion of the taxes generated by our new building will be used to help fund projects in our new neighborhood along Main Street and in nearby Penn Valley Park through an innovative use of tax increment financing. And we are proud to be a part of the ongoing development in the Liberty Memorial area and of the urban rebirth that is taking place in Kansas City’s core.

But for all the excitement and all the history we are making, these are also bittersweet times for some of our long-time employees, myself included.

The building at 925 Grand was the oldest building still in use in the Federal Reserve System. Despite all of its shortcomings, the building was home for a large part of many of our professional lives.

As with any move, we brought some parts of our previous home with us, including the brass seal from the lobby floor, a Tommy gun used by the early guards and two pairs of the art deco elevator doors. You can read about some of these items, and some other projects related to our new building, on Page 28 of this issue of TEN. You will also be able to see many of these pieces when our new building opens to the public.

We are proud that the 925 building will remain a Kansas City landmark. For generations it has served the city and the Tenth Federal Reserve District well. We look forward to continuing to serve the region for the generations to come from our new home at 1 Memorial Drive. I invite you to visit us here soon.

THOMAS M. HOENIG, PRESIDENT
FEDERAL RESERVE BANK OF KANSAS CITY

SPRING 2008 • TEN
The Federal Reserve Bank of Kansas City offers resources for students, teachers and the public.

Visit us online @

www.KansasCityFed.org
to learn more about personal finance programs, school-based programs and contests for students, such as the Essay Contest.

or

www.FederalReserveEducation.org
for free personal financial and economic education resources including publications and classroom-ready materials.
A look back at 2007 gives a glimpse of 2008
ut, it’s rising production costs that will determine how prosperous rural America will be this year, say Jason Henderson, an economist, and Maria Akers, an assistant economist, both at the Federal Reserve Bank of Kansas City’s Omaha Branch. Henderson is also the Branch executive for the Omaha office.

Henderson and Akers examined the rural economy in 2007 and its prospects for 2008. They researched the booming farm economy, steady expansion on Main Street, and future opportunities and limitations.

“The rural economy appears poised to post another year of economic gains,” Henderson says. “Ethanol demand and export activity likely will contribute to robust farm incomes. On Main Street, similar to the national economy, activity has slowed, but may rebound by the end of 2008.”

The stage is set in rural America for a profitable 2008—on and off the farm. Vibrant ethanol and export demand as well as a strong farm forecast are promising economic opportunities.
“Rural America basked in a bright economic outlook in 2007,” Akers says.

Net farm incomes unexpectedly reached a record high—$87.5 billion, according to the USDA. Producers used increased profits to strengthen their financial conditions, such as pay off debts. They also boosted investments in equipment and land, and values have increased as a result. Main Street businesses, too, reaped some of the benefit of this higher farm spending.

Crops

Increased crop profits in rural America last year were mostly the result of corn and wheat, according to Henderson and Akers’ research. Easing droughts led to increased production while heightened export and ethanol demand led to high selling prices. Crop inventories worldwide have been lean; ethanol demand alone accounted for 24 percent of the record U.S. corn crop and exports rose by 15 percent.

U.S. wheat exports surged nearly 30 percent, pushing inventories to a record low. And although U.S. soybean production and exports declined, total foreign trade projections increased 6 percent.

Meanwhile, subsidies are shrinking (at $12.1 billion down from $15.7 billion), which is “a big concern because of the cost of production,” says farmer Dan Watermeier.

Expenses were way up for Watermeier’s large, family-owned farm in Syracuse, Neb., which includes corn, wheat, soybeans and alfalfa. “Fertilizer, machinery and anything petroleum” greatly affects the bottom line, he says. Still, 2007 was a good year and Watermeier predicts he’ll fare well this year, too.

Livestock

Thinking back on 2007, Neal Haverkamp marks it with an “F.” Not for failure by any means, but rather “feed, fuel and fertilizer.”

These rising costs significantly affect his family’s livestock business, Haverkamp Brothers Inc., just outside the small town of Bern, Kan. He oversees Nemaha Valley Angus Inc., the cattle operation of the business, while several of his 10 siblings run the row crop and swine components.

Last year “wasn’t bad” as far as profitability, but Haverkamp says he offsets soaring expenses by locking in low feed prices, mixing corn with cheaper components, cutting back on fertilizer and the like.

Across rural America, higher feed costs trimmed livestock producers’ profits, Akers says. Feed costs increased almost 23 percent, according to the USDA.

For the industry overall in 2007:
• cattle feedlots operated in the red for most of the year;
• hog profits declined significantly;
• price-cost margins for poultry producers fell sharply.
Haverkamp points to the increasing demand for corn-based ethanol as the primary factor driving the price hike.

Generally, growing livestock demand has helped offset rising production costs, Akers says. Gains were driven largely by export demand, with the biggest emerging in the dairy sector. Gross revenues increased 17 percent, but by the end of 2007, producers still were struggling to post profits.

For Nemaha Valley Angus, this may lead to a short-term increase in slaughter, and a long-term decrease in overall beef production, Haverkamp says. And expansion isn’t likely any time soon.

“Once we see costs rise,” he says, “we seldom see them go back down.”

Business

While the nonfarm rural economy slowed along with the nation, rural areas still experienced steady economic growth last year, though the gains were not evenly distributed across geographic regions.

“Main Street activity was buoyed by strong activity in energy and high-skilled services,” Henderson says.

The rural unemployment rate remained lower than metro unemployment rates. Rural businesses may have been challenged to find and retain high-skilled workers or find lower-skilled workers at existing wages. Overall, businesses added jobs at a modest pace last year.

“Natural resource industries, namely mining and energy, saw the largest nonfarm growth in employment and earnings for rural America,” Henderson says. “Despite industry-specific lulls in employment, rural incomes rose and economic prospects remained positive for Main Street businesses as 2007 ended.”

Loren Kucera, director of the Nebraska Business Center at Wayne State College, says the rural business sector was profitable last year, especially in ethanol, manufacturing and farm equipment industries.

Some sectors, however, such as convenience stores and non-chain restaurants, have seen a drop-off in business.

For Myrna and Jerry Higgins, owners of Higgins Hardware in Plattsmouth, Neb., 2007 was average compared to the other 30 or so years that they’ve owned the shop. The couple says profitability seems to mirror that of other sectors in rural America.

They can pinpoint certain factors that will affect business, such as prolonged bad weather, which keeps people away, or the current housing slump, which prompts homeowners to tackle improvement projects around the house rather than move into a new one. So far this year, they’ve seen both scenarios.

Sectors of rural employment

increases include:
• education
• health care
• professional and business services (accounting, architecture, engineering)
• tourism
• financial activities and information
• distribution and transportation

decreases include:
• retail
• government
• manufacturing
“Both farm and nonfarm businesses are facing higher input costs, which could take some of the luster off emerging opportunities,” Henderson says. “But stronger export activity and rising ethanol mandates could offset these expenses and greatly benefit the rural economy in 2008.”

The private sector and the Federal Reserve both forecast national economic growth to soften this year. The forecasts, however, anticipate renewed strength in the second half of 2008. If the rural economy continues to track the national economy, Main Street activity could experience a rebound at this time.

**Housing effects**

Nationwide, the combination of declining home values, resetting interest rates on adjustable rate mortgages and more loans issued to higher-risk applicants resulted in a dramatic increase in foreclosure rates beginning in 2006. As of mid-2007, the share of mortgages entering into foreclosure reached an all-time high. Some estimates predict 3 million homeowners will default on their mortgages by mid-2009 with two-thirds of those resulting in foreclosure.

National housing market woes spread to rural communities, but didn’t affect residents as negatively as in urban communities.

Through most of last year, rural building...
permits fell sharply, although these declines were less than the nearly 50 percent decline in metro housing permits. The demand for affordable new home construction brings new home buyers and developers to rural communities, but in a weak housing market this demand decreases.

For Myrna and Jerry Higgins, a drop in construction means less business from both commercial and private contractors who come to their Nebraska hardware shop for supplies.

Despite initial job cutbacks, the rural construction industry rebounded and even added jobs as 2007 progressed. Much of the demand seemed to be in commercial construction rather than homes.

Research shows higher energy costs have a disproportionately larger impact on rural households than urban households, with gasoline especially—rural households spent nearly 22 percent more in 2006 than urban households. With higher gas prices and longer commutes, rural communities that surround metro areas could face more limited housing demand that could be a potential economic drag this year, Akers says.

Export activity
Exports play a large role in the rural economy, especially agriculture, which may give rural America a boost. Although a decline in the value of the dollar can mean higher import prices...
on goods purchased by rural customers, a weaker dollar can spur exports as it did last year.

Since 2003, the dollar has fallen 30 percent against the Euro and the Canadian dollar. Like manufactured exports, agricultural exports also strengthened, accelerating as 2008 neared. This was driven by increases in both the price of exported goods and the quantity shipped. Low global crop inventories are also supporting U.S. exports this year.

“Future agricultural export growth will not only be supported by a weaker dollar that makes U.S. goods more competitive in foreign markets, but also by income gains in foreign countries that buy U.S. products,” Henderson says.

Haverkamp, of Nemaha Valley Angus Inc., is optimistic his exports will grow in Japan specifically. After years of intermittent bans first prompted in 2003 by a mad cow disease risk, American beef is once again allowed into the country. With the ban lifted, U.S. beef exports soared last year. In the past, Asian countries, and Japan in particular, have accounted for a large share of the multibillion dollar U.S. beef export industry.

“China is a big factor as well,” Haverkamp says. “Maybe this year the pace (of exports) will pick up.”

**Ethanol**

Perhaps most telling of its expectations, Renova Energy is making modifications to increase production at its 15-year-old Wyoming Ethanol facility, and building another that’s twice as large in neighboring Idaho.

“Demand for ethanol is good…. There will definitely be a market” throughout 2008 and beyond, says Jim Glancey, senior vice president of Renova, the parent company of Wyoming Ethanol, which produces annually 10 million

One lesson from 2007 is that ethanol is still a policy-driven industry.
gallons of corn-based ethanol and a byproduct for livestock feed in the small town of Torrington.

But that’s not to say there aren’t concerns in the industry. On the heels of a successful 2007—overall ethanol production surged 32 percent above the previous year—profit opportunities in 2008 might be affected by higher production costs and lower selling prices, Akers says.

“Corn prices are a challenge at all times,” Glancey acknowledges.

Other obstacles may include building market-based demand (rather than demand emerging from government mandates alone), transportation issues and a potential restructuring of the ethanol industry, Akers says. As ethanol reached mandatory levels, production has slowed and several plants under construction were put on hold.

But, a recently established mandate could spark another cycle of expansion in ethanol production. The Renewable Fuels Standard requires 9 billion gallons of renewable fuels (not limited to just ethanol) to be produced this year, with a progressive increase to 36 billion gallons by 2022. Ethanol production would, however, taper as mandated levels are reached.

“One lesson from 2007 is that ethanol is still a policy-driven industry,” Henderson says, “and government policy, in the form of mandates and subsidies, will drive profitability going forward.”

Rural profits

Several key sectors to the rural economy posted solid gains heading into 2008, Henderson and Akers say, including mining, rural construction, high-skilled services, tourism and manufacturing.

Kucera, of the Nebraska Business Development Center, says the facets of rural America are often dependent on each other. If one sector has a good year, others very well may too.

“If farmers make money, they’re going to spend it. They’re going to buy farm implements or that new truck or go out to eat,” Kucera says. “I think everything looks positive for ’08.”

Henderson and Akers agree.

“Although, ethanol demand and export activity may support robust farm incomes and profits on Main Street,” Henderson says, “it’s these rising production costs that will determine rural America’s 2008 prosperity.”

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

“WILL RURAL PROSPERITY PREVAIL IN 2008?”
By Jason Henderson and Maria Akers
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.
Industrial Loan Companies

Commercial businesses face head-on opposition to entering the banking sector
About 10 years ago, Flying J opened Transportation Alliance Bank, which offers personal banking services such as checking and savings accounts, retirement and investment options, debit and credit cards, and even leasing and financing. It’s the only bank that focuses solely on trucking and therefore understands the industry’s needs, according to the company. Keeter’s drivers are able to get pay advances while on the road through Flying J. Keeter, in turn, directly pays Transportation Alliance Bank.

Transportation Alliance Bank is not a bank in the traditional sense, but is an Industrial Loan Company, or ILC. ILCs are state-chartered institutions based in seven states around the country. A growing number operate via the Internet and other nontraditional means rather than from a brick-and-mortar storefront. ILCs have nearly all the
same powers as banks, with one big difference: They can be owned by commercial companies, such as General Electric, BMW or Toyota.

Although ILCs aren’t new to the financial industry, Wal-Mart and Home Depot’s recent attempts to open and acquire an ILC, respectively, are causing a stir, say Ken Spong and Eric Robbins, both policy economists at the Federal Reserve Bank of Kansas City. Spong and Robbins recently examined this blend of banking and commerce. They researched ILCs’ legal framework, re-emergence, forms of ownership, business conducted and related public policy issues.

In recent years, both Fry’s Electronics and Target created ILCs with hardly an eyebrow raised. But with more than 3,000 stores and supercenters and millions of financial transactions each week, Wal-Mart’s massive presence crossing over into the banking sector has many critics.

In response, the Federal Deposit Insurance Corporation (FDIC) placed a moratorium on commercial firms opening or acquiring ILCs. Before the moratorium ended, both Wal-Mart and Home Depot withdrew their applications. (Wal-Mart also had previously tried to buy a bank in Oklahoma and an existing ILC in California.)

The withdrawal of these two applications relieves pressure on the FDIC and Congress, which has been working to clarify ILC ownership rules as the banking industry pushes for restrictions. The U.S. Senate Banking Committee is working on a bill, but the prospects for this legislation are uncertain.

Current law leaves ILCs as the only option for commercial firms to enter into banking. Without new legislation, commercial companies, including Wal-Mart, could apply again. Both Ford and Chrysler have ILC applications pending with the FDIC.

In general, points of opposition to commercially owned ILCs include potential conflicts of interest, competitive concerns, safety and soundness issues, and implications for federal deposit insurance and similar protectors. Bankers say this type of ownership is a threat to the system should those companies or their banks fail. Advocates say ILC activities are conducted and supervised in a sound manner, and furthermore better serve niche groups.

“Our review of operations of ILCs owned by large financial and commercial firms shows a record of sound performance, innovative approaches and strong parent company support,” Spong says. “But an important issue raised by the broader ownership of ILCs is how far public authorities should go in extending the federal safety net.”

**Background**

ILCs first emerged in the early 1900s to provide small loans to industrial workers. A few decades later commercial banks and others took over, leaving ILCs a small segment of the consumer lending market.

Within the last decade or so, though, ILCs have re-emerged, allowing commercial and financial firms to offer banking services without being subject to ownership restrictions that apply to other depository institutions.

“This growth likely is driven by business and financial factors—ILCs allow commercial businesses to offer deposit services and financing to their customers, clients or dealers,” Robbins says. “An auto manufacturer, for example, can use ILC lending to help support its car sales. ILCs also can attract and retain customers for the parent company.”

ILCs generally are authorized to perform a full range of credit services and other standard banking activities, but not all states allow ILCs to offer demand deposit accounts, such
ILCs only hold about 1.8 percent of all insured depository institutions’ assets. These ILCs typically operate with capital levels at or above banking industry averages. The five largest ILCs each hold nearly $20 billion or more in total assets and, when combined, account for about 71 percent of all ILC assets.

There are three general categories of ILCs:

Traditional: Owned by individuals, or bank or thrift organizations; focus on providing credit and deposit products. Thirty-seven ILCs have traditional ownership, the largest of which is Fremont Investment & Loan, with nearly $13 billion in assets.

Financial services: Owned by securities firms (Morgan Stanley Bank, Goldman Sachs Bank USA), insurance companies (USAA Savings Bank) or credit card companies (American Express Centurion Bank); most offer deposit or credit products to customers of the parent company. These ILCs now make up the vast majority of ILC business. Merrill Lynch Bank, which has $67 billion in total assets, is the largest ILC.

Commercial: Owned by businesses; most offer a range of financial services that support the parent company. Fifteen ILCs are owned by commercial companies, many of which are automotive companies.

GMAC Automotive Bank has become the largest commercial ILC with almost $20 billion in total assets. Much of its lending now consists of residential mortgages.

As of early 2007, there were 58 ILCs. Forty-five have Utah or California charters; the others are located in Colorado, Hawaii, Indiana, Minnesota or Nevada.

ILCs under financial or commercial ownership

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<th>ILC</th>
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<td>Merrill Lynch Bank USA</td>
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<td>UBS Bank USA</td>
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<td>Capmark Bank</td>
<td>Capmark Financial Group/GMAC</td>
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<td>Lehman Brothers Commercial Bank</td>
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<td>BMW Bank of North America</td>
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<td>GE Capital Financial Inc.</td>
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<td>Advanta Bank Corporation</td>
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<td>Pitney Bowes Bank Inc.</td>
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<td>Transportation Alliance Bank</td>
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<td>EnerBank</td>
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<td>First Electronic Bank</td>
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as checking or savings accounts. Nor do some states welcome commercial ownership of ILCs. California, for example, passed a law in 2002 prohibiting as much after Wal-Mart's attempt there. There are, however, many "traditional" type ILCs in California.

ILCs customarily operate under their own regulatory and supervisory system (state chartered and examined by state authorities), but oversight is similar to that of state-chartered banks. Legislation in the late '80s made all ILCs eligible for federal deposit insurance, which would require these ILCs to be supervised by the FDIC.

Under federal law, ILC owners avoid restrictions on conducting commercial activities that apply to banking organizations, as well as consolidated supervision that applies to bank and thrift holding companies. But, this law also closes other avenues some commercial firms had used to get into banking.

"Some ILC owners face one less layer of regulation compared to other companies that own depository institutions," Robbins says. "This puts ILCs in a unique position within the financial system."

The debate

The Bollingers are probably the very type of customer Flying J had in mind when the company established its Transportation Alliance Bank a decade ago.

David and Kristal, a Kansas City-based husband and wife truck-driving team, often visit the truck stops when on the road. And now they bank there, too.

"It's easier and more convenient," Kristal says.

The young newlyweds drive together (along with pets Buddy and Tigger), alternating 10-hour shifts as they traverse from the Midwest to the East Coast,

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**WAL-MART’S ATTEMPTS TO CREATE A BANK OF SORTS** (known as an ILC) to process its customers’ electronic payments has strong opposition even though other commercial businesses have ILCs.
and sometimes into Canada. The Bollingers can be away from home for months at a time, but because their paychecks are deposited directly into their accounts with Transportation Alliance Bank, David and Kristal say accessing and managing their finances isn’t a hassle while on the road. They each have a card that can be used as debit or credit, which is their primary form of payment.

It’s this type of existing customer base of the parent companies that ILCs hope to also snag as banking customers. And it’s this crossover that opponents say is unfair.

“If they break down the wall between banking and commerce, then we should be able to sell tomatoes,” says Guy Berry, president of American Heritage Bank, a small community bank in Sapulpa, Okla.

Others echo Berry’s sentiment, though Spong and Robbins say recent attention on ILCs doesn’t raise new issues in the banking and commerce ILC debate.

“Many of the public policy concerns now at the heart of the ILC debate have been part of a long-standing discussion on whether banking and commerce should be mixed, and what role commercial firms should have in the financial sector,” Robbins says.

Wal-Mart’s ILC proposal was to process electronic payments (debit, credit and check images) made by its customers—not traditional bank-like services such as deposits or withdrawals. By using its own bank, Wal-Mart would have kept fractions of a cent from these transactions that would’ve added up to $5 million to $10 million a year, and meant lower prices for consumers, according to the company. Critics say this could lead to Wal-Mart using its ILC charter—and extensive network of stores—to establish retail banking operations in communities everywhere.

Opponents argue allowing this type of ownership would open the flood gates, encouraging companies to establish extensive retail banking networks, lend directly to their customer bases and upset the competitive balance in some local banking markets.

As far as overall performance, ILCs owned by financial firms and commercial companies generally have been successful in serving specialized customer bases. High earnings levels can be in part attributed to limited staffing, minimal office facilities and reliance on the parent company to generate business.

“Consequently, whether this performance record will continue likely depends on the success of the parent companies in their main lines of business,” Spong says.

Wal-Mart already has entered the banking industry abroad with its Banco Wal-Mart de Mexico Adelante. The corporation has nearly 1,000 supercenters, restaurants and Sam’s Clubs in Mexico, and is the second chain to open banking operations there. In the United States, Wal-Mart is now leasing space to existing banks to open branches inside the stores.

In comparison, Target Bank was chartered in late 2004. With $14.2 million in assets, it is relatively small. It operates from one office in Utah that isn’t publicly accessible and primarily issues private label credit cards to business owners for use in Target stores. Target Bank doesn’t accept retail deposits but funds much of its lending through a line of credit and deposits from the parent company to ensure compliance with federal banking laws.

If they break down the wall between banking and commerce, then we should be able to sell tomatoes.
Issues to consider

“The operations of ILCs currently owned by businesses may provide a clue to what might be expected if other, large retailers were allowed to set up their own ILCs,” Robbins says. “Are there conflicts of interest that might be detrimental to the ILC, its customers, or safety and soundness?”

Spong and Robbins say increased entry and continued growth in the ILC industry by commercial firms raises a number of issues, including:

• soundness: Because commercial organizations owning ILCs can avoid the consolidated supervision placed on banks and thrifts, opponents say ILCs could be vulnerable to risks that develop in other areas of the organization. Many have said these ILCs and their parent companies are operating with a “supervisory blind spot” and should be subject to the same supervisory framework as bank and thrift organizations, although such oversight could be costly and pose difficulties for supervisors, Spong says.

• conflict of interest: In a few cases, commercially and financially owned ILCs might sacrifice their own interests in favor of the parent company or its customers. Examples include lending to an affiliate or its customers at a favorable rate or without regard to creditworthiness in order to directly boost business, or refusing to lend to competitors of the parent company. However, laws, regulations and the marketplace itself can help control many possible conflicts, Robbins says.

As an example, provisions of the Federal
Reserve Act limit the amount of transactions that can take place between an ILC and its parent company, and require these transactions to have comparable terms to transactions with unrelated parties.

Because ILC loans to affiliate organizations are secured and deposits of ILC customers can’t be used to fund these transactions, they are safe, says George Sutton, legal counsel for the Utah Association of Financial Services, a proponent of ILCs.

It’s the regulatory efforts that ensure there is no adverse influence on the ILC from its parent company, Sutton says.

• competitive effects: Most commercial ILCs serve specialized customer bases and have not attempted to establish a network of retail banking offices. There is some belief, though, that competition would be harmed by the emergence of large, commercially owned ILCs, but in some instances, the entry of commercial or financial firms’ ILCs has increased competition.

Berry, of American Heritage Bank, says banking and commerce should be segregated because it gives large commercial entities an unfair size and regulatory advantage over community banks.

“If an ILC comes in (communities in Oklahoma), it will wipe out hundreds of banks,” Berry says, adding he doesn’t think American Heritage, a $500 million asset bank with a presence in 10 small towns statewide, would “be able to survive this onslaught. … Some of us will make it; most of us will fail.”

However, Sutton argues banks won’t be displaced, but rather ILC presence would create a more diverse financial industry.

• federal safety net: Commercial and financial ILC ownership could lead to a further extension of the federal safety net, which includes deposit insurance, access to Federal Reserve credit and other regulatory tools. The primary purpose of this safety net is to prevent financial panics and protect small depositors. With commercial and financial ILC ownership, funding and lending activities formerly conducted in private capital markets are being shifted into ILCs protected by the federal safety net. This raises the question of how far that safety net should be extended, and how it should be most fairly used, Spong says.

“There are no quick and easy answers to these supervisory and safety net questions,” Robbins says, “but they play a role in determining how the entire financial system should be structured and supervised.”

Spong adds, “The ILCs owned by commercial and financial companies have helped add innovation and competition to the marketplace, but many questions still remain about how the ILC industry should be structured.”

Although Paul Keeter spent nearly two decades in the cab of his big rig and for the past 13 years has run the carrier service Keeter Enterprises LLC, he’s not convinced any sector necessarily needs specialized banking—just good customer service.

Keeter works with Transportation Alliance Bank to accommodate some of his truck drivers who use those services, but does the majority of his own banking with a small financial institution that has a local branch in Boulder.

It’s not affiliated specifically with trucking, but “they’re interested in our business,” Keeter says.

BY BYRE STEEVES, SENIOR WRITER

FURTHER RESOURCES

“INDUSTRIAL LOAN COMPANIES: A GROWING INDUSTRY SPARKS A PUBLIC POLICY DEBATE”
By Kenneth Spong and Eric Robbins
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.
Not long after making the final mortgage payment on the house she bought in 1970 for $15,500, Mary Kelly needed another, even larger, loan.

The home, filled with a lifetime of comforts and 30 years of memories, where she raised her three children, where her grandchildren and great-grandchildren come to visit and where she hosts her fellow community group members, also has a shifting foundation needing $20,000 in repairs.

Eighty years old, long retired from nursing and living on a fixed income, Mary went to a mortgage broker to get a loan.

The broker told Mary it would be easier for her to get approved for a larger loan than a smaller one, recommending $40,000. At first she was told her interest rate would be around 6 percent, but when it came time to sign, it was in the double digits. Then she and her daughter, Ann, a teacher, had trouble understanding the other terms and conditions of the contract, but neither could get clarification.

“They were rushing us,” says Ann, 47, who lives with her mother in Kansas City, Mo. “(The broker) told us we had to sign that day.”

They did.
A combination of factors led to the nationwide foreclosure surge.

Mary Kelly, right, and her daughter, Ann, walked away from a predatory loan that ultimately could have caused them to lose their home. They received another loan for the expensive repairs.
Feeling uneasy, Mary remembered a seminar on predatory lending she had attended at church. She knew help was available and took the contract to a local nonprofit, where a lawyer reviewed it.

“Legal Aid (of Western Missouri) told us this was a bad loan,” Ann says.

“I was outraged,” Mary remembers.

Because the contract had a three-day walk-out period, Mary was able to go to her credit union for a new loan. Eventually, her pension would not have been enough to make the monthly payments on the first loan.

“We would’ve lost our home,” Ann says.

Unfortunately, many homeowners across the country already have and others will—some estimates predict 3 million homeowners will default on their mortgages by mid-2009, with two-thirds of those resulting in foreclosure.

Mary Kelly’s experience is just one of many scenarios leading to foreclosure. A variety of other causes—including declining home values, resetting interest rates on adjustable-rate mortgages (ARMs) and more loans issued to higher-risk applicants—combined to result in a dramatic increase in foreclosure rates. As of mid-2007, the share of mortgages entering into foreclosure reached an all-time high.

“This unprecedented foreclosure surge was created by a perfect storm of events,” says Kelly Edmiston, senior economist at the Federal Reserve Bank of Kansas City.

Edmiston and Roger Zalneraitis, a research associate also at the Kansas City Fed, recently examined the foreclosure rise in both the United States and the Tenth Federal Reserve District, which is western Missouri, Nebraska, Oklahoma, Kansas, Wyoming, Colorado and northern New Mexico.

They researched current trends in foreclosure rates; foreclosure circumstances and its process; the relationship of factors that resulted in the current spike; and likely outcomes in the next few years.

In the District, the foreclosure situation is mixed—overall rates are slightly lower than the national average, but those on ARMs are higher than the national average. Many low- and

What happens during

Foreclosure

Some homeowners just walk away from their home and mortgages when faced with negative net equity. But generally, a foreclosure is the result of an inability to make mortgage payments without equity to be able to sell the home.

Foreclosure is a two-step process. First, the homeowner defaults on his or her mortgage, usually from a combination of low or no equity and a trigger event, such as a job loss or serious illness.

Then, the lender forecloses on the home. Laws governing mortgage foreclosures can differ from state to state. Foreclosure costs and rates can be affected by whether a state has statutory redemption (time after foreclosure when the borrower can redeem the property by paying balances, interests and fees) and whether it allows deficiency judgments, which allow the lender to recover funds that remain unpaid after the foreclosure sale.

Those involved:

Borrowers
Subprime borrowers don’t qualify for prime loans because of weak credit history.

Mortgage Brokers
Originated most subprime loans; assess borrowers’ creditworthiness and submit approved loan applications.

Lenders
Fund the loans; often sell loans through a trust to an underwriter.

Underwriters
Often Freddie Mac, Fannie Mae or private; package loans into securities and sell to investors.
moderate-income communities seem to be in significant foreclosure distress.

Edmiston and Zalneraitis’ research shows the current and looming situation is the result of three merging factors:

• The share of subprime mortgages (loans made to borrowers with weak credit) increased substantially in recent years;
• Foreclosure rates for ARMs, especially subprime ARMs, increased considerably;
• High loan-to-value originations coupled with stagnant or falling home prices.

This means borrowers who obtained a subprime mortgage and couldn't make the payments when the initial rate increased, in many cases, couldn't sell their home at a price that exceeded what they owed.

"Any one condition would cause an increase in the foreclosure rate," Edmiston says. "The confluence of these three factors, however, has caught a large number of homeowners in unsustainable financial situations with few options other than defaulting on their mortgages. Unfortunately, this is likely to continue, and worsen, before it gets better."

Background

"The foreclosure rate has a natural ebb and flow," Zalneraitis says, "depending largely on economic conditions and the state of the housing market."

Before 2002, foreclosure rates hadn't really declined for any extended period of time. Heightened foreclosure rates in the 1980s likely were the result of high interest rates, weak real estate markets and regional energy gluts.

After leveling off, foreclosures started to rise again in 1995, spiking to a record high in 2002 as a result of the 2001 recession. Rates settled back to levels seen in the mid-90s until the current surge began in early 2006.

"Since then, the number of new foreclosures each quarter has been at unprecedented levels, and the foreclosure inventory is near its all-time high," Zalneraitis says.

At 1.7 percent, the U.S. foreclosure rate is high but has not affected all areas of the country equally. The highest foreclosure rates are in hurricane-stricken Louisiana and Mississippi, and the upper Midwest. Michigan, Ohio and Indiana have suffered economic difficulties in the manufacturing sector in addition to the same basic foreclosure issues as the rest of the country, where overall the economy is strong and unemployment is low.

In contrast, the Pacific Northwest has foreclosure rates of less than half the national average, and rates generally are below the national average in the Southwest and Northeast.

The increase in foreclosures has been concentrated largely among ARMs, and especially subprime ARMs. Both 2005 and 2006 were record years for subprime lending and the origination of nontraditional mortgages, such as ARMs, Alt-A mortgages (made to borrowers with nontraditional circumstances) and Option ARMs (borrower sets payment terms; usually results in negative amortization).

"These nontraditional loans, many of which are subprime, will continue to reset through 2009, so the worst of the foreclosure problem may be yet to come," Zalneraitis says.

The confluence

Soaring foreclosure rates usually result from poor economic conditions, such as recessions, which drive up unemployment and reduce personal income, making mortgage payments more difficult. These periods of especially high foreclosures also are associated with stagnant or declining home prices.

The dramatic spike in foreclosures that began in 2006 is unusual because the country's
economy overall had been strong—income growth was solid and unemployment rates were low, Edmiston says.

Edmiston and Zalneraitis explain the three factors that combined to lead to this sharp increase in foreclosure rates.

**Subprime borrowers:** Federal legislation in 1980 eliminated interest rate ceilings and made subprime lending possible. This allowed lenders to raise interest rates to compensate for the risk posed by borrowers who don’t qualify for prime mortgages. But it wasn’t until the 1990s when subprime lending became common. Developments in securitization allowed lenders to pool the loans and allocate risks to investors willing to bear them.

Meanwhile, from 2000 to 2003, average interest rates on conventional loans fell dramatically and mortgage originations skyrocketed. But as interest rates started to regain ground in 2004, many mortgage brokers moved aggressively into the still-untapped subprime market in an effort to maintain business.

“With real estate markets booming, these brokers found many willing customers who formerly had little or no access to mortgage financing,” Zalneraitis says. “There also were many investors starved for the high yields subprime mortgages could bring. A major market quickly developed.”

Subprime mortgages swelled from $335 billion in 2003 to $600 billion in 2006; more than one-third of all mortgages were nonprime.

Because subprime loans have higher foreclosure rates than prime loans, this increase alone would lead to an increase in foreclosures.

**Nontraditional mortgages:** “Given the run-up in home prices in the early part of the decade, an increasingly larger share of mortgages originated during the last few years have been nontraditional mortgages,” Edmiston says.

These types of loans often reset to significantly higher payments within a few years, after initially hooking borrowers with teaser rates.

Consumer education is the key to prevention, but help is available for those in need, says Ariel Cisneros, senior community affairs advisor at the Kansas City Fed’s Denver Branch.

As part of its mission to spur economic growth through community development, which includes financial education, asset building and entrepreneurship, the Fed dedicates its resources to foreclosure prevention and consumer assistance, Cisneros says. In addition to economic research, the Kansas City Fed hosts events to initiate community collaboration and is part of a Colorado taskforce and statewide hotline, which was formed by 25 counseling agencies to work with individual homeowners and resolve foreclosure issues.

There is a nationwide hotline (888-995-HOPE) that can put homeowners in touch with local resources.

Not only can foreclosure be detrimental for the homeowner and family, the neighborhood and community also can be affected if homes become abandoned and deteriorate—crime can increase, property values may fall, tax revenues can decrease and lenders might shy away from urban lending, Cisneros says.

“It’s a domino effect and it keeps going,” says MaryEllen De los Santos, a housing counseling coordinator with the Adams County [Colo.] Housing Authority. “It’s going to affect the whole community.”

The organization’s No. 1 goal is to prevent homelessness, followed by preventing foreclosure either through selling the home or working with the lender to refinance or prepay, if possible. Staff is working now to get information to those who will have their rates reset in the coming months.

“If we get them early enough, and get the ball rolling,” De los Santos says, “a lot of people can be saved.”
ARMs usually have lower interest rates than fixed-rate mortgages and are attractive to homeowners intending to stay in their homes for only five to seven years—the length of time the borrower can get a low fixed rate before it becomes variable. If the loan isn’t repaid in that initial fixed-rate time period, the monthly payments can increase substantially, especially in a time of rising interest rates as seen in 2003 to 2006.

Edmiston and Zalneraitis estimate payments on traditional, prime ARMs for a $200,000 mortgage could have increased nearly 40 percent during this period. For subprime ARMs, payments could jump as much as 120 percent, depending on the type of ARM.

Not surprisingly, subprime mortgages are more likely to default than prime mortgages. For instance, data from mid-2007 show 6.9 percent of subprime mortgages were in foreclosure compared to less than 1 percent of prime mortgages, according to Edmiston and Zalneraitis’ research. Even more dramatic, they say, the foreclosure rate for subprime ARMs in particular increased from 4.7 percent in mid-2006 to 10.4 percent in mid-2007.

"Increases in short-term interest rates and payment resets on nontraditional mortgages likely are responsible for much of the increase in the foreclosure rates of ARMs," Edmiston says. “However, many subprime ARMs also have defaulted before they reset.”

Underwriting standards, especially for state-regulated mortgage brokers, have been lenient until recently, which added to the foreclosure problem. Even if underwriting standards had been stricter, many of these loans likely would have been foreclosed upon after the payment reset.

**Home prices:** Beginning in 2001 through 2005 (when prices stagnated), homes appreciated drastically—53 percent—but personal income increased by only 20 percent.

“Homeownership became less affordable,” Zalneraitis says. “Many would-be homeowners found themselves priced out of the housing market.”

This prompted some borrowers to turn to nontraditional mortgage products to achieve “the American dream.”

If borrowers could sell their homes or refinance mortgages when unable to make payments, the foreclosure problem would not be as severe as it has become, Edmiston says.

But the high loan-to-value mortgages, coupled with stagnant or falling home prices, have meant homeowners may not have enough equity to sell or refinance their homes when unable to pay higher mortgage payments. This can be attributed to high loan-to-value ratios (in some cases, no money down), equity extraction, and a stabilization or decline in home prices, which has occurred in the last two years, according to the National Association of Realtors and the Office of Federal Housing Enterprise Oversight.

**Effects in the District**

When the Rucker family defaulted on their mortgage, the interest rate had reset, again, and Michael Rucker had just received bad news from the doctors, again.

A second tumor was discovered in Michael’s brain. Seizures have long prevented him from holding a job, and his radiation and chemotherapy treatments often keep his wife and sole household earner, Angela, away from work. This time she was out for nearly three weeks.

The family had purchased their Thornton, Colo., home in 2003. It was their first—Michael’s disability payments covered the down payment, but with each rate reset, Angela’s paycheck couldn’t stretch quite far enough.

“If I would’ve known they were going to reset as much as they did, we would’ve done something different,” Angela says. The lender “said, ‘Can’t you catch up?’ I said, ‘No. I can’t.’ It’s not that easy.”

Their mortgage company suggested the family sell the home. But the couple, their two children and infant grandson had nowhere else to go. In danger of entering foreclosure, Angela contacted the Adams County Housing
As is the case nationally, foreclosures in the Tenth Federal Reserve District—western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico—increased significantly from 2006 to 2007, from about 1.2 percent to 1.5 percent of all outstanding mortgages. Nationwide, the rate has increased from 1.1 percent to 1.7 percent.

The relatively modest foreclosure rates in most District states can be attributed to the smaller share of adjustable-rate and subprime mortgages than the nation. In this region, housing prices are generally affordable.

Subprime loans make up roughly 12 percent of all outstanding mortgages in the District, compared to more than 13 percent nationally.

Oklahoma and Colorado show higher rates than the country (likely because of high nontraditional loans and high homes prices).

Wyoming has one of the lowest rates nationwide, likely from the energy sector boom there.

New Mexico had declining rates, likely due to a strong real estate market, but foreclosures are rising now.

Kansas rates have remained unchanged.

Oklahoma, Kansas and Nebraska are among the 10 most affordable states to live in.

Missouri foreclosure rates are rising rapidly after a period of low rates.

Nebraska and Kansas rural economies have fared well, which has a positive impact on housing.

Source: RealtyTrac and U.S. Census data
Authority, which helps distressed homeowners work with their lender, offers financial education and often provides financial assistance to those in the county, which also includes part of Denver.

The Ruckers now have a fixed-rate mortgage of 6.625 percent, are caught up on their payments and not likely to default again, Angela says.

“It been a learning experience,” she says.

Edmiston and Zalneraitis identify two areas particularly affected by the foreclosure problem: markets where housing is unaffordable, and low- and moderate-income communities.

In low- and moderate-income communities, many borrowers have low credit scores or unsteady employment and are therefore high-risk and only eligible for subprime loans. Most often, foreclosure rates in the District are highest in cities and suburban counties rather than rural areas. Low- and moderate-income areas are being hit the hardest.

In areas where homes prices are high, buyers who thought purchasing a home was a “sure thing” often resorted to ARMs and nontraditional mortgages in hopes that home prices would continue rising indefinitely, or long enough to sell or refinance if needed. For example, home prices in California increased more than 20 percent per year from 2004 to early 2006, but by mid-2007 had decreased 1.4 percent. Foreclosures there have increased almost four-fold since the beginning of 2006.

Mike Stanford has seen among the best and the worst in the District. First State Bancorporation, of which he is president and CEO, is based in Albuquerque, where the state’s foreclosure rates are actually declining, and has branches in Colorado, where foreclosures rates are higher than the national average.

Colorado, Stanford says, was ripe for an inordinate amount of subprime lending. Cheap housing was enticing and ample, especially in bedroom communities of large metros such as Denver. New Mexico, though, has a good balance of supply and demand for both new and existing housing. There also is less subprime activity as a result of stiffer licensing requirements, Stanford says.

He is optimistic for Colorado’s recovery because of strong job and industry growth there.

Oklahoma’s foreclosure rate also has been above the national average, according to Edmiston and Zalneraitis’ research, which can negatively impact housing-related businesses, such as construction.

P.B. Odom III, principal of P.B. Odom III Land Development Companies in Oklahoma City, saw a 17 percent decrease in new residential construction in 2007 from the year prior. He knows there’s been a larger impact on others. Still, Odom thinks Oklahoma is fairing well compared to the East and West Coasts.

“I think it’s going to get worse” through 2009 or 2010, Odom says. “In our business, we know these times are coming. We don’t like it. But we weather the storm.”

In our business, we know these times are coming. We don’t like it. But we weather the storm.

“RISING FORECLOSURES IN THE UNITED STATES: A PERFECT STORM”
By Kelly D. Edmiston and Roger Zalneraitis
www.KansasCityFed.org/TEN

Comments/Questions are welcome and should be sent to teneditors@kc.frb.org.
Building for the Future

Kansas City Fed moves into new headquarters
The building at 1 Memorial Drive replaces the Bank’s original facility at 925 Grand Blvd., which, until the time of the move, was the oldest building in use by the Federal Reserve System. Bank operations outgrew the former building in the mid-1970s when some staff was moved to office space nearby. Additional staff was moved to another downtown location in 2000, and a final group moved in 2001.

In comparison to the 367,000 square feet at 925 Grand, the Bank’s new home offers about 600,000 square feet of space spread throughout 14 stories. The new building will help improve the efficiency of the Bank’s operations and offer new opportunities to serve both the Tenth Federal Reserve District and the entire Federal Reserve System. You can learn more about our history and the new building by reading the President’s Message starting on Page 1 in this issue of TEN.

Some other facts about the new building:
- The cash vault has 540,000 cubic feet of storage capacity and is equal to four stories in height.
- Guarding that much currency requires a lot of security. As a part of their jobs, the Bank’s law enforcement officers will rely on a network of nearly 700 cameras.
- The building has 372 miles of cable, or enough to attach a television at the Bank’s Oklahoma City Branch to an outlet at the headquarters in Kansas City.
- It also has 832 miles of copper wire—enough to roll from Kansas City through Denver, spanning across the entire Tenth Federal Reserve District from east to west.
- Of the 75 or so firms involved in the project as contractors, suppliers and consultants, more than 60 are businesses based within the seven states of the Tenth Federal Reserve District, which are Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and New Mexico.
- The new building was designed by Henry N. Cobb of the architectural firm Pei Cobb Freed & Partners with work also done locally by Ellerbe Beckett. The project manager was J.E. Dunn Construction.

Heritage
The new Bank headquarters will feature several items connected to the Bank’s history.

The Bank seals: The brass seal, which was previously embedded in the center of the lobby floor at the 925 Grand building, has been moved to the new building and can be seen on a lobby wall. Additionally, the large seals which hung on the south and east sides of the Bank’s former parking garage along McGee Street now hang on the exterior of the new headquarters.
The Spirits: Artist Henry Hering designed two relief sculptures, the Spirits of Commerce and Industry, to adorn the front of the 925 Grand building when it opened in 1921. At the new building, visitors coming to the front entrance pass between two large three-dimensional sculptures that artist Tuck Langland based on Hering’s designs. Nearby, a fountain features three jets, each one representing one of the Bank's three mission areas: monetary policy, supervision and risk management, and financial and treasury services.

Elevator doors: One of the more unique features of the 925 Grand building were the distinctive art deco elevator doors featuring an eagle and the 10-J designation signifying the Tenth Federal Reserve District (“J” is the 10th letter of the alphabet). Two sets of the 925 Grand elevators doors are on display in the corridor outside the Liberty Room, where the Bank plans to host events, including its Economic Forums program, bank regulatory updates and educator workshops.

The Truman Coin Collection: The roughly 450-piece coin collection is prominently displayed in the lobby. The collection features coins issued under every president and is on loan to the Bank from the Harry S. Truman Presidential Library and Museum in Independence, Mo. The exhibit continues the Bank’s connection to Truman, who, after leaving the White House, leased office space in the 925 Grand building until the Truman Library opened in 1957. You can read more about Truman’s connection to the Bank in the Winter 2006 edition of TEN, available online at KansasCityFed.org/TEN.

The heritage exhibit: Several prominent items from the Bank’s history are on display in the Bank’s Money Museum and visitors center, including the trowel used to set the cornerstone at 925 Grand. Also on display is a Tommy gun once used by the Bank’s security staff who were stationed in a turret above the lobby.

The heritage case is just one of the displays in the new building’s 3,000-square-foot visitors center and Money Museum, which features the history and structure of the Federal Reserve as well as interactive exhibits about banking and the economy.

Tours that include the visitors center, as well as the opportunity to look into the massive vault and watch the Bank’s cash operations, are free. Reservations are necessary for groups numbering from six to 60 and can be made by calling (816) 881-2683 or at KansasCityFed.org.

In addition to the Bank’s history, the Bank also recognizes the history of its new location. Bricks from St. Mary’s Hospital, which previously occupied the site, along with the chapel bell and the cornerstone that was a part of the structure, have been incorporated into a memorial near the sidewalk along Main Street.

The Bank’s move served as a catalyst for two projects related to the Bank’s history that will make their debut this summer.

A book about the Bank’s history will be published in June. The hardcover, illustrated book tells of the Bank’s founding in Kansas City through the stories of those involved, and the Bank’s early history including the construction of the former headquarters at 925 Grand.

The book will be available in The
Vault, the Fed’s gift shop located in the lobby.

Kansas City Public Television station KCPT will premier the documentary “10-J: The History of the Federal Reserve Bank of Kansas City” at 8 p.m., June 10 and again at 8 p.m., June 12. The hour-long film explains the history of the Federal Reserve, including why the founders decided the nation needed a central bank with a unique “decentralized” structure, as well as the early history of the Kansas City Bank and the Tenth District. The documentary features interviews with business people from throughout the District as well as historians, including Carnegie Mellon University’s Allan Meltzer, who is the leading Federal Reserve historian. The documentary tells the story of the Bank’s Branch offices in Denver, Oklahoma City and Omaha. The program will be offered to public television stations throughout the country. Check local PBS listings for details.

By Tim Todd, Editor

Comments/questions are welcome and should be sent to teneditors@kc.frb.org.
"Sorry, no checks accepted."

Notices denying check writers seem ubiquitous these days, posted at the cash registers of eateries and shops alike. A literal sign of the times, perhaps, but one that’s driven by consumers, who more frequently reach for their debit and credit cards in lieu of their checkbooks.

Although check use peaked about 10 years ago, electronic payments are rapidly taking over and all but completely replacing checks. Electronic payments now make up more than two-thirds of all noncash payments. Since 2003 check payments nationwide have declined 6.4 percent per year, according to a 2007 Payments Study conducted by the Federal Reserve System.

“Consumers are simply writing fewer checks in favor of faster, more convenient electronic methods,” says Rich Rasdall, first vice president of the Federal Reserve Bank of Kansas City. “This shift is certainly affecting the payments system, which must adjust accordingly.”

Because check volume is dropping so significantly, the Federal Reserve’s check processing sites around the country are being consolidated and remaining sites are changing the way they operate. Additionally, relatively new legislation known as Check 21, coupled with industry advancements, are prompting financial institutions to clear customers’ checks electronically rather than by manual methods that traditionally have been relied upon.

For consumers and banks alike, this means faster, more efficient payments and processing. And for the payments system, this means
making adjustments ranging from manpower to operations.

“We are seeing an electronic evolution,” Rasdall says. “While checks may never become completely obsolete, perpetual change in the payments system is inevitable—and is already well under way.”

**Evolution of checks**

Check volume at the Kansas City Fed, which is the headquarters for the Tenth Federal Reserve District, was at its height in 2002. At that time, staff processed an average of 1.8 million paper checks a day from banks around the region. But just one year later, the volume began declining significantly and by mid-2007, roughly half that amount was processed. Even more drastic, the average daily volume of paper checks processed in January was just 451,000, or roughly 25 percent of the amount processed in its peak.

“Until this decade, consumers hadn’t fully accepted the electronic payments system,” Rasdall says. “But by 2003, the number of all electronic payments had surpassed the number of check payments.”

Electronic payments grew 12.4 percent per year from 2003 to 2006, according to the study. The value of these payments has also steadily increased. Debit card payments now exceed credit card payments, and card payments in general make up more than half of all noncash payments.

As a result of this shift in consumer behavior, the Federal Reserve System has consolidated its 45 check processing sites around the country to 17 sites. Further consolidation is planned and by 2010, there will be four locations: Philadelphia, Cleveland, Atlanta and Dallas. Each will serve as a regional, full-service check processing site at least through 2011. Three “print only” sites will dispatch substitute checks (legal images of the originals), down
from about 21 sites currently. Scaled back or closed sites all will print substitute checks and some will electronically capture paper checks and transmit the images to the fully operational sites.

Further consolidation in the future is a possibility, Rasdall says.

Around the country, the Federal Reserve said it would cut 1,740 jobs from its 3,300-employee unit, whose main task is to help banks clear checks. In Kansas City, the Fed stopped processing paper checks in April and consolidated those operations into the Dallas Fed. The restructure coincided with the Kansas City Fed’s move to its new headquarters, and eliminated 93 check processing-related jobs. Electronic processing and substitute check printing operations remain in the Tenth District.

At the Kansas City Fed’s three Branches, checks operations were closed in Oklahoma City and Omaha in 2005 and 2004, respectively, while processing in Denver is scheduled to transition to a “capture and print” site in 2009.

“Reducing staff is certainly the most difficult aspect of this move away from checks,” says Barbara Pacheco, senior vice president of financial services at the Federal Reserve Bank of Kansas City. “Each office in the District has always been successful in meeting its objectives and other challenges through the years, but consolidation is simply necessary as the need to clear paper checks decreases.”

Technology has changed the need for labor.

“The Federal Reserve System and our District are well-positioned to manage these changes, which are inevitable,” Pacheco says. “Every day, more and more paper checks are converted to electronics.”

Check 21

Now, when a customer deposits a check it’s no longer necessary for the bank to physically transport that check to the paying bank to clear it.

The Check Clearing for the 21st Century Act, or Check 21, implemented in 2004, makes the substitute check the legal equivalent of an original check. This authorizes financial institutions to use images when processing customers’ checks. For all financial institutions that accept digital images instead of the original checks, the manual handling and physical transportation needed to clear the billions of paper checks each year is eliminated. Electronically processing not only makes clearing checks more efficient, it also saves money as courier and fuel costs continue to rise, says Korie Miller, assistant vice president of financial services at the Federal Reserve Bank of Kansas City.

Every day, more and more paper checks are converted to electronics.
After a dramatic drop in volume, the Kansas City office stopped processing checks in April and consolidated those operations with the Dallas Fed. Payments are increasingly becoming electronic worldwide.

There is no deadline and image processing under Check 21 is voluntary, although eventually all banks will need to comply in order to do business. However, the rapid adoption of Check 21 has surprised the Kansas City Fed.

As of January:
• Electronic images made up 76 percent of all District deposit volume. For the Federal Reserve System, electronic images made up 62 percent of deposit volume processed.
• The District sends electronically 41 percent of its outbound volume; the Federal Reserve System sends out electronically 40 percent.

“We’re looking at 60 percent of Tenth District depositors using Check 21,” Miller says. “It’s much more than we originally projected. By 2009, we’re estimating 90 percent.”

Miller attributes this “positive snowball effect” to good business sense. Because much of the District is rural, geographic isolation demands the efficiency of Check 21, she says. But that’s not to say the largest banks aren’t jumping on board, too.

“It’s not really feasible for any bank not to adopt Check 21,” Miller says. “Check 21 is something better for bankers, the payments industry and consumers. ... It’s not if a bank uses image exchange, it’s when.”

Future of payments

As part of its mission, the Federal Reserve monitors payments, emerging methods and significant innovations.

Innovation is making transactions cheaper and easier to carry out, whether they are established payments methods, such as checks or debit and credit cards, or new and emerging methods, says Stuart Weiner, vice president, economist and director of payments research at the Kansas City Fed.

“The United States has seen an increase in new types of payments in recent years,” Weiner says, citing paying via mobile device, contactless credit and debit cards, and pre-paid stored-value cards.

Even as check use continues to decline, it is likely there will still always be a need to write checks. Check 21 makes that process efficient.

“The future is going to be largely electronic,” Weiner says. “There’s no doubt about that.”

And the Fed will be a part of this.

“We want to promote the efficiency and effectiveness of the payments system,” Pacheco says. “That’s our job.”

Further Resources

“The 2007 Federal Reserve Payments Study”
www.KansasCityFed.org/TEN
**Financial Fitness Week**

Kansas City area groups are coordinating efforts for a week-long campaign to encourage better financial health.

Financial Fitness Week begins April 27. Its goals include providing consumers with a range of events and resources tied to financial awareness and sound financial decision-making, as well as elevating the importance among consumers, policymakers, employers, educators and social service organizations, says Gigi Wolf, an economic education specialist with the Federal Reserve Bank of Kansas City.

Additionally, this is an opportunity for area financial education providers to showcase their services, educational events and products, which increase a group’s visibility and outreach within the community, Wolf says.

Part of the Federal Reserve’s mission is to increase the understanding of economics and personal finance. Financial Fitness Week, in Kansas City and similar events at the Denver, Oklahoma City, and Omaha Branches, is just one initiative throughout the year in an effort to do so. There are many ways for groups and individuals to be involved in Financial Fitness Week activities.

For more information, visit KansasCityFed.org/FitnessWeek.

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**Bank Anniversaries**

The following banks in the Tenth Federal Reserve District are celebrating one, five, 10, 20 or more years as Federal Reserve members in April, May or June.

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Location</th>
<th>Years</th>
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<td>Sundance State Bank</td>
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<td>First Nebraska Bank</td>
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<td>First State Bank</td>
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<td>Bank of Hartington</td>
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<td>Bankwest of Kansas</td>
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<td>First State Bank in Temple</td>
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<td>Castle Rock Bank</td>
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<td>Chickasha B&amp;TC</td>
<td>Okla.</td>
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<tr>
<td>First State Bank</td>
<td>Okla.</td>
<td>10</td>
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<tr>
<td>KCB Bank</td>
<td>Mo.</td>
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<td>Cottonwood Valley Bank</td>
<td>Kan.</td>
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<tr>
<td>Heritage Bank</td>
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<tr>
<td>Peoples Bank</td>
<td>Kan.</td>
<td>5</td>
</tr>
<tr>
<td>CoBiz Bank</td>
<td>Colo.</td>
<td>1</td>
</tr>
</tbody>
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Compiled By TEN Staff

Comments/Questions are welcome and should be sent to teneditors@kc.frb.org
2007 Annual Report
Federal Reserve Bank of Kansas City
Management Committee

(From left) Ms. George, Mr. Sellon, Mr. Rasdall, Mr. McBride, Mr. Hoenig, Mr. Dubbert, Ms. Pacheco, Mr. Barkema

Thomas M. Hoenig
President and
Chief Executive Officer

Richard K. Rasdall, Jr.
First Vice President and
Chief Operating Officer

Alan D. Barkema
Senior Vice President

Kelly J. Dubbert
Senior Vice President and
Chief Information Officer

Esther L. George
Senior Vice President

Stephen E. McBride
Senior Vice President

Barbara S. Pacheco
Senior Vice President

Gordon H. Sellon, Jr.
Senior Vice President and
Director of Research
Board Members

Robert A. Funk, Board Chairman;
Chairman of the Board and Chief Executive Officer
Express Personnel Services
Oklahoma City, Oklahoma (Class C)

Lu M. Córdova, Board Deputy Chairman;
Chief Executive Officer, Corlund Industries;
President and General Manager, Almacen Storage Group
Boulder, Colorado (Class C)

Dan L. Dillingham
Chief Executive Officer
Dillingham Insurance
Enid, Oklahoma (Class B, Group 2)

Robert C. Fricke
President and Chief Executive Officer
Farmers & Merchants National Bank
Ashland, Nebraska (Class A, Group 3)

Frank N. Moore (not pictured)
President
Spearhead Ranch Company
Douglas, Wyoming (Class B, Group 3)

Terry L. Moore
President
Omaha Federation of Labor
Omaha, Nebraska (Class C)

Kevin K. Nunnink
Chairman
Integra Realty Resources
Westwood, Kansas (Class B, Group 1)

Mark W. Schifferdecker
President and Chief Executive Officer
Girard National Bank
Girard, Kansas (Class A, Group 2)

Rick L. Smalley
Chief Executive Officer
Dickinson Financial Corporation
Kansas City, Missouri (Class A, Group 1)

Federal Advisory Council Representative
David C. Boyles (not pictured)
Chairman, Columbine Capital Corp.;
Director, Columbine Capital Corp. &
Collegiate Peaks Bank
Buena Vista, Colorado

For an explanation of class and group designations, see Page 47.
Kristy A. Schloss, Board Chairman;
President and Chief Executive Officer
Schloss Engineered Equipment
Aurora, Colorado

Bruce K. Alexander
President and Chief Executive Officer
Vectra Bank Colorado
Denver, Colorado

James A. Helzer (not pictured)
Chairman
Unicover Corporation
Cheyenne, Wyoming

Diane Leavesley
President
Mercy Loan Fund
Denver, Colorado

John D. Pearson
Real Estate Broker and Owner
Pearson Real Estate Company Inc.
Buffalo, Wyoming

Michael R. Stanford (not pictured)
President and Chief Executive Officer
First State Bancorporation
Albuquerque, New Mexico

Thomas Williams
President and Chief Executive Officer
Williams Group L.L.C.
Golden, Colorado
Richard K. Ratcliffe, Board Chairman;
Chairman
Ratcliffe’s Inc.
Weatherford, Oklahoma

Steven C. Agee
President
Agee Energy, L.L.C.
Oklahoma City, Oklahoma

Terry M. Almon
President
Oklahoma Community Capital Corporation
Broken Arrow, Oklahoma

Steve Burrage
Chairman
FirstBank
Antlers, Oklahoma

Michael A. Cawley (not pictured)
President, Chief Executive Officer
The Samuel Roberts Noble Foundation Inc.
Ardmore, Oklahoma

Barry H. Golsen
Board Vice Chairman, President and
Chief Operating Officer
LSB Industries Inc.
Oklahoma City, Oklahoma

Fred M. Ramos
President
RGF Inc.
Oklahoma City, Oklahoma
James A. Timmerman, Board Chairman;
Chief Financial Officer
Timmerman & Sons Feeding Co.
Springfield, Nebraska

Todd S. Adams
Chief Executive Officer
Adams Bank and Trust
Ogallala, Nebraska

Cynthia Hardin Milligan (not pictured)
Dean - College of Business Administration
University of Nebraska - Lincoln
Lincoln, Nebraska

Charles R. Hermes
President
Dutton-Lainson Company
Hastings, Nebraska

Rodrigo Lopez
President and Chief Executive Officer
AmeriSphere Multifamily Finance, L.L.C.
Omaha, Nebraska

Mark A. Sutko
President and Chief Executive Officer
Platte Valley State Bank
Kearney, Nebraska

Lyn Wallin Ziegenbein (not pictured)
Executive Director
Peter Kiewit Foundation
Omaha, Nebraska
Economic Advisory Council

(From left) Mr. Roetheli, Ms. Herda, Mr. Neira, Ms. Johnson, Mr. Liston, Mr. Mead, Mr. DeBruce, Ms. Mowry, Mr. Stout, Mr. Perry

Paul DeBruce
Chief Executive Officer
DeBruce Grain, Inc.
Kansas City, Missouri

Larissa Herda
Chairman, Chief Executive Officer and President
Time Warner Telecom
Littleton, Colorado

Deborah Johnson
Chief Executive Officer
Rick Johnson and Company, Inc.
Albuquerque, New Mexico

Dennis Liston
Financial Secretary
International Brotherhood of Electrical Workers
Kansas City, Missouri

Bradford S. Mead
Attorney at Law
Mead & Mead
Jackson, Wyoming

Barbara Mowry
President and Chief Executive Officer
Silver Creek Systems, Inc.
Westminster, Colorado

Xavier Neira
Vice President of Special Projects
Rooney Holdings, Inc.
Oklahoma City, Oklahoma

Russell Perry
President
Perry Publishing and Broadcasting Company
Oklahoma City, Oklahoma

Tom B. Price (not pictured)
President
UFCW District Local Two, AFL-CIO
Kansas City, Missouri

Joe Roetheli
Chief Executive Officer
Key Companies & Associates
North Kansas City, Missouri

Michael Shaw (not pictured)
President and Owner
Mike Shaw Chevrolet, Buick, Saab
Denver, Colorado

John Stout
Chief Executive Officer
Plaza Belmont Management Group, L.L.C.
Shawnee Mission, Kansas
Community Development Advisory Council

(From left) Ms. Fennell, Ms. Capps, Ms. Dobreff, Mr. Franklin, Ms. Noonan, Ms. Tinney, Ms. Meyer

Linda Capps  
Vice Chairman  
Citizen Potawatomi Nation  
Shawnee, Oklahoma

Erica Dobreff  
President  
Kansas City Equity Fund  
Kansas City, Missouri

Patricia B. Fennell  
Executive Director  
Latino Community Development Agency  
Oklahoma City, Oklahoma

Bernard Franklin  
President  
Penn Valley Community College  
Kansas City, Missouri

Robert Jensen  (not pictured)  
Chief Executive Officer  
Wyoming Business Council  
Cheyenne, Wyoming

Carol Meyer  
President  
Garden City Chamber of Commerce  
Garden City, Kansas

Agnes Noonan  
Executive Director  
WESST Corporation  
Albuquerque, New Mexico

Linda Tinney  
Vice President  
U.S. Bank  
Denver, Colorado

Jeffrey Yost  (not pictured)  
President and Chief Executive Officer  
Nebraska Community Foundation  
Lincoln, Nebraska
Advisory Council on Payments

(From left) Mr. Davidson, Mr. Wyatt, Mr. Oatman, Mr. Hipp, Mr. Copeland, Mr. Connealy, Mr. Reuter, Mr. Champion, Mr. Fosler, Mr. Frank

Kansas City
Tim Connealy
Executive Vice President and Chief Operating Officer
Bank Midwest
Kansas City, Missouri

Lloyd Davidson
President
First Bank Kansas
Salina, Kansas

Steve Hipp
Executive Vice President
INTRUST Bank, N.A.
Wichita, Kansas

Denver
Mark Frank
Senior Vice President
CoBiz Bank, N.A.
Denver, Colorado

James A. Reuter
President
FirstBankData Corporation
Lakewood, Colorado

Oklahoma City
Scott Copeland
Executive Vice President
BancFirst
Oklahoma City, Oklahoma

C.H. Wyatt, Jr.
Vice Chair and President
Rose Rock Bank
El Reno, Oklahoma

Omaha
Craig E. Champion
Senior Vice President
TierOne Bank
Lincoln, Nebraska

Alan L. Fosler
Senior Vice President and Cashier
Union Bank and Trust Company
Lincoln, Nebraska

Russell A. Oatman
Senior Vice President
First National Bank of Omaha
Omaha, Nebraska
Federal Reserve Bank Directors

The Board of Directors of a Federal Reserve Bank is filled through a unique blend of appointed and elected positions. The nine-member panel is divided evenly among three classifications. All directors serve staggered three-year terms.

**CLASS A**

The three Class A directors represent commercial banks that are members of the Federal Reserve System. These directors are bankers who are nominated and elected by member banks within the Tenth Federal Reserve District. This District includes western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico.

Under the Class A category, a director will be elected by a specific group of member banks classified as either 1, 2 or 3. This classification is based on the total amount of capital and surplus for each commercial bank, with Group 1 banks being the largest. Each group within the class elects one director.

For example, Robert C. Fricke, president and chief executive officer of the Farmers & Merchants Bank of Ashland, Neb., is a Class A director, who was elected by, and represents, Group 3 member banks.

**CLASS B**

The three Class B directors represent the public. Class B directors may not be an officer, director or employee of a bank or a bank holding company. However, these directors are also elected by member banks under the same categories as Class A directors. For example, Dan L. Dillingham, chief executive officer of Dillingham Insurance of Enid, Okla., is a Class B director elected by Group 2 member banks.

**CLASS C**

The three Class C directors also represent the public. These directors, however, are appointed by the Board of Governors of the Federal Reserve System.

Like a Class B director, a Class C director may not be an officer, director or employee of a bank or a bank holding company. These directors may not own stock in a bank or a bank holding company. From the Class C directors, the Board of Governors selects one person as chairman and another as deputy chairman.

**SERVING ON THE BOARD**

**Federal Reserve Bank of Kansas City**

Reserve Bank directors meet monthly to oversee the Bank's operations and policies and to confer on economic and banking developments. The directors also provide information on economic conditions within the District as a part of the Bank president’s preparation for Federal Open Market Committee meetings. Among directors’ responsibilities is establishing the Kansas City Fed's discount rate, which is subject to review and determination by the Federal Reserve Board. The directors and their classifications are on Page 40.

**SERVING THE BRANCHES**

**Denver, Oklahoma City and Omaha**

Each Branch of the Federal Reserve Bank of Kansas City also has its own seven-member Board of Directors. Four of these directors are appointed by the Federal Reserve Bank of Kansas City while three are appointed by the Board of Governors. Branch directors serve three-year terms and provide their respective Branch Executives with insight on regional economic conditions as well as offer advice and counsel. Branch directors are on Pages 41-43.
Tenth District
Officers

**Kansas City**
Thomas M. Hoenig
President and Chief Executive Officer

Richard K. Rasdall, Jr.
First Vice President and Chief Operating Officer

Alan D. Barkema
Senior Vice President

Kelly J. Dubbert
Senior Vice President and Chief Information Officer

Esther L. George
Senior Vice President

Barbara S. Pacheco
Senior Vice President

Stephen E. McBride
Senior Vice President

Gordon H. Sellon, Jr.
Senior Vice President and Director of Research

Charles L. Bacon, Jr.
Senior Vice President, General Counsel and Secretary

Craig S. Hakkio
Senior Vice President and Special Advisor on Economic Policy

Josias A. Aleman
Vice President and General Auditor

Larry D. Bailey
Vice President

Todd E. Clark
Vice President and Economist

Denise I. Connor
Vice President

Anita F. Costanza
Vice President

Steven D. Evans
Vice President

Janel K. Frisch
Vice President and Chief Financial Officer

George A. Kahn
Vice President

Kevin L. Moore
Vice President

Dawn B. Morhaus
Vice President

Charles S. Morris
Vice President

Karen A. Pennell
Vice President

Diane M. Raley
Vice President and Public Information Officer

Randy M. Schartz
Vice President

Stacey L. Schrefl
Vice President and Economist

Linda S. Schroeder
Vice President

Veronica R. Sellers
Vice President and Associate General Counsel

Donna J. Ward
Vice President

Stuart E. Weiner
Vice President, Economist and Director Payments System Research

Susan E. Zubradt
Vice President

Stanley R. Beaty
Assistant Vice President

Debra L. Bronston
Assistant Vice President and Equal Employment Opportunity Officer

Harriet I. Chern
Assistant Vice President

Michael R. Childs
Assistant Vice President

Paul S.J. Coquillette
Assistant Vice President and Community Affairs Officer

Kelley D. Courtright
Assistant Vice President

Kristi A. Coy
Assistant Vice President

Kevin J. Craig
Assistant Vice President

Tanya L. Cvetan
Assistant Vice President

Troy A. Davig
Assistant Vice President and Economist

Justin M. Dean
Assistant General Counsel

James R. Deis
Assistant Vice President

Dennis V. Denney
Assistant Vice President

Linda K. Edwards
Assistant Vice President

C. Alan Garner
Assistant Vice President and Economist

Lori D. Haley
Assistant Vice President

Robert L. Hampton
Assistant Vice President

Ann L. Hoelting
Assistant Vice President

Kristofer K. Hogan
Assistant Vice President

Mark C. Horan
Assistant Vice President

James H. Hunter
Assistant Vice President

Lowell C. Jones
Assistant Vice President

William R. Keeton
Assistant Vice President and Economist

W. Todd Mackey
Assistant Vice President and Assistant Secretary

D. Michael Manies
Assistant Vice President

Abigail A. Mayer
Assistant Vice President

Renu A. Mehra
Assistant Vice President

Korie S. Miller
Assistant Vice President

Randall L. Mueller
Assistant Vice President

Todd A. Offenbacker
Assistant Vice President

Annette K. Owens
Assistant Vice President

Wayne M. Powell
Assistant Vice President

Michael R. Steckline
Assistant Vice President

Stephanie L. Stratemeier
Assistant Vice President

Leesa Guyton Thompson
Assistant Vice President

Wilmer R. Ullmann
Associate General Counsel and Ethics Officer

Kathryn A. Webster
Assistant Vice President

Jonathan L. Willis
Assistant Vice President and Economist

Ginger K. Wise
Assistant Vice President

Kristina J. Young
Assistant Vice President

Catherine A. Zeigler
Assistant Vice President

Denver
Mark E. Schweitzer
Vice President, Branch Executive and Economist

Pamela L. Weinstein
Vice President

Megan L. Hruda
Assistant Vice President

Debbie L. Meyers
Assistant Vice President

Dennis J. Stansbury
Assistant Vice President

Oklahoma City
Chad R. Wilkerson
Assistant Vice President, Branch Executive and Economist

Robert W. Toler
Assistant Vice President

Omaha
Jason R. Henderson
Assistant Vice President, Branch Executive and Economist

Kevin A. Drusch
Vice President

D. Rick Lay
Assistant Vice President
The Work of the Federal Reserve
Bank of Kansas City

Employees are involved in a wide range of duties at the Kansas City Fed and its Branches in Denver, Oklahoma City and Omaha.

**ADMINISTRATIVE SERVICES**
Administrative Services performs a variety of duties to keep the internal operations of the Federal Reserve Bank of Kansas City running smoothly on a daily basis. Functions include maintaining the facilities; providing a safe and secure environment; developing and implementing human resources strategies to meet the evolving needs of the Fed’s workforce and environment; developing the budget; and providing accurate financial accounting and reporting. Additionally, the division performs services on behalf of the Federal Reserve System, such as providing human resources information systems and billing users of Federal Reserve System services. Facilities Management, Protection, Business Continuity, Human Resources, Accounting, Financial Management, Human Resources Technology Center and the Billing Operations Site are included in this division, which employs 320 people.

**AUDIT**
Audit serves as an independent and objective evaluator of the Tenth Federal Reserve District’s performance. This division reports on the soundness of the Kansas City Fed’s operations to the Board of Directors, senior management and the Board of Governors. This division employs 24 people.

**INFORMATION TECHNOLOGY**
The Information Technology Division consists of three functions: information technology services and support to local and select System business areas; technical support for System check processing services; and technology project management for the U.S. Treasury. This division employs about 270 people.

**LEGAL**
The Legal Department serves as the Kansas City Fed’s counsel. It provides advice to management and the Board of Directors; represents the Kansas City Fed in administrative and judicial proceedings; helps the Kansas City Fed comply with applicable law; counsels employees concerning the Kansas City Fed’s Code of Conduct; and helps educate employees on legal issues. This division employs six people.

**FINANCIAL SERVICES**
Financial Services works to provide Kansas City Fed customers with products and services that assist them in carrying out their daily business. Through Cash Services, Wholesale Operations, and Customer Relations and Support, the division helps distribute coin and currency; provides secure and quick transfers of funds and securities between banks; and supports customer needs. This division employs 204 people.

**REGIONAL, PUBLIC AND COMMUNITY AFFAIRS**
The division’s two primary responsibilities are research and communications. The division’s economists track developments in the District’s economy and present their findings to senior management as part of the Kansas City Fed’s monetary policy deliberations. Through publications, media relations, electronic communication and programs, Public Affairs works to explain the Fed’s purpose and functions. Community Affairs promotes economic development through fair and impartial access to credit throughout the District. This division employs about 54 people.

**ECONOMIC RESEARCH**
This division conducts research on macroeconomics and monetary policy; banking and financial markets; the payments system; and other issues of importance to the Kansas City Fed and the Federal Reserve System. Through publications and presentations, staff members communicate the results of this research to policymakers, other researchers and the general public. Economic Research employs 46 people.

**SUPERVISION AND RISK MANAGEMENT**
Supervision and Risk Management is responsible for regulating bank holding companies and state-chartered member banks in the District. Staff members conduct examinations of these institutions to ensure a safe and sound banking system. In addition, the division works to make sure consumers are treated fairly in their dealings with banks and reviews applications by banking organizations seeking to acquire another institution, open a branch, change ownership or conduct other activities. The division also makes advances to depository institutions through the Fed’s discount window and studies financial industry trends. This division employs 255 people.

**DISTRICT CHECK OPERATIONS (RETAIL PAYMENTS)**
Check Operations is responsible for all aspects of paper and electronic check processing for financial institutions that are Fed customers. Although the Federal Reserve System is streamlining check operations because of declining volume, operations include a small substitute check printing operation and a check adjustments function in Kansas City, along with a full-service check operation at the Denver Branch. As of March 2008, this area employed 193 people.
To the Board of Directors

The management of the Federal Reserve Bank of Kansas City (the “Bank”) is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statements of Income and Comprehensive Income, and Statement of Changes in Capital as of December 31, 2007 (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 Bank is responsible for establishing and maintaining effective internal control over financial reporting as it relates to the Financial Statements. Such internal control is designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of the Financial Statements in accordance with the Manual. Internal control contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in internal control are reported to management and appropriate corrective measures are implemented.

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

The management of the Bank 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 Bank maintained effective internal control over financial reporting as it relates to the Financial Statements.

Thomas M. Hoenig, President
Richard K. Rasdall, Jr., First Vice President
Janel K. Frisch, Vice President, Chief Financial Officer
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 Kansas City:

We have audited the accompanying statement of condition of the Federal Reserve Bank of Kansas City (“FRB Kansas City”) as of December 31, 2007 and the related statements of income and comprehensive income and changes in capital for the year then ended, which have been prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System. We also have audited the internal control over financial reporting of FRB Kansas City as of December 31, 2007, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB Kansas City’s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on FRB Kansas City’s internal control over financial reporting based on our audit. The financial statements of FRB Kansas City for the year ended December 31, 2006 were audited by other auditors whose report, dated March 12, 2007, expressed an unqualified opinion on those statements.

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

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

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

As described in Note 3 to the financial statements, FRB Kansas City has prepared these financial statements in conformity with accounting principles established by the Board of Governors of the Federal Reserve System, as set forth in the *Financial Accounting Manual for Federal Reserve Banks*, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The effects on such financial statements of the differences between the accounting principles established by the Board of Governors of the Federal Reserve System and accounting principles generally accepted in the United States of America are also described in Note 3.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of FRB Kansas City as of December 31, 2007, and the results of its operations for the year then ended, on the basis of accounting described in Note 3. Also, in our opinion, FRB Kansas City maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

March 20, 2008
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 Kansas City:

We have audited the accompanying statement of condition of the Federal Reserve Bank of Kansas City (the “Bank”) as of December 31, 2006, and the related statements of income and changes in capital for the year then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Bank’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

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

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

March 12, 2007
FEDERAL RESERVE BANK OF KANSAS CITY

STATEMENTS OF CONDITION  [in millions]
As of December 31, 2007 and 2006

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold certificates</td>
<td>$335</td>
<td>$324</td>
</tr>
<tr>
<td>Special drawing rights certificates</td>
<td>66</td>
<td>66</td>
</tr>
<tr>
<td>Coin</td>
<td>72</td>
<td>62</td>
</tr>
<tr>
<td>Items in process of collection</td>
<td>215</td>
<td>560</td>
</tr>
<tr>
<td>Loans to depository institutions</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>Securities purchased under agreements to resell</td>
<td>1,505</td>
<td>-</td>
</tr>
<tr>
<td>U.S. government securities, net</td>
<td>24,137</td>
<td>22,946</td>
</tr>
<tr>
<td>Investments denominated in foreign currencies</td>
<td>544</td>
<td>271</td>
</tr>
<tr>
<td>Accrued interest receivable</td>
<td>206</td>
<td>197</td>
</tr>
<tr>
<td>Interdistrict settlement account</td>
<td>5,239</td>
<td>4,733</td>
</tr>
<tr>
<td>Bank premises and equipment, net</td>
<td>298</td>
<td>174</td>
</tr>
<tr>
<td>Other assets</td>
<td>19</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$32,643</td>
<td>$29,352</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>LIABILITIES AND CAPITAL</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Reserve notes outstanding, net</td>
<td>$30,104</td>
<td>$27,053</td>
</tr>
<tr>
<td>Securities sold under agreements to repurchase</td>
<td>1,424</td>
<td>867</td>
</tr>
<tr>
<td>Deposits:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depository institutions</td>
<td>449</td>
<td>546</td>
</tr>
<tr>
<td>Other deposits</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Deferred credit items</td>
<td>157</td>
<td>435</td>
</tr>
<tr>
<td>Interest on Federal Reserve notes due to U.S. Treasury</td>
<td>43</td>
<td>31</td>
</tr>
<tr>
<td>Accrued benefit costs</td>
<td>45</td>
<td>46</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>31</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>32,255</td>
<td>29,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital paid-in</td>
<td>194</td>
<td>176</td>
</tr>
<tr>
<td>Surplus (including accumulated other comprehensive loss of $2 million and $6 million at December 31, 2007 and 2006, respectively)</td>
<td>194</td>
<td>176</td>
</tr>
<tr>
<td><strong>Total capital</strong></td>
<td>388</td>
<td>352</td>
</tr>
<tr>
<td><strong>Total liabilities and capital</strong></td>
<td>$32,643</td>
<td>$29,352</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these financial statements.
# Federal Reserve Bank of Kansas City
## Statements of Income and Comprehensive Income (in millions)

For the years ended December 31, 2007 and 2006

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Interest income:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on U.S. government securities</td>
<td>$1,218</td>
<td>$1,022</td>
</tr>
<tr>
<td>Interest on securities purchased under agreements to resell</td>
<td>45</td>
<td>-</td>
</tr>
<tr>
<td>Interest on investments denominated in foreign currencies</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Interest on loans to depository institutions</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Total interest income</td>
<td>1,271</td>
<td>1,028</td>
</tr>
<tr>
<td><strong>Interest expense:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense on securities sold under agreements to repurchase</td>
<td>53</td>
<td>39</td>
</tr>
<tr>
<td>Net interest income</td>
<td>1,218</td>
<td>989</td>
</tr>
<tr>
<td><strong>Other operating income:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compensation received for services provided</td>
<td>81</td>
<td>71</td>
</tr>
<tr>
<td>Reimbursable services to government agencies</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>Foreign currency gains, net</td>
<td>21</td>
<td>16</td>
</tr>
<tr>
<td>Other income</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Total other operating income</td>
<td>116</td>
<td>100</td>
</tr>
<tr>
<td><strong>Operating expenses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and other benefits</td>
<td>124</td>
<td>114</td>
</tr>
<tr>
<td>Occupancy expense</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Equipment expense</td>
<td>10</td>
<td>9</td>
</tr>
<tr>
<td>Assessments by the Board of Governors</td>
<td>27</td>
<td>21</td>
</tr>
<tr>
<td>Other expenses</td>
<td>47</td>
<td>54</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>215</td>
<td>206</td>
</tr>
<tr>
<td>Net income prior to distribution</td>
<td>1,119</td>
<td>883</td>
</tr>
<tr>
<td>Change in funded status of benefit plans</td>
<td>4</td>
<td>-</td>
</tr>
<tr>
<td>Comprehensive income prior to distribution</td>
<td>$1,123</td>
<td>$883</td>
</tr>
<tr>
<td><strong>Distribution of comprehensive income:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends paid to member banks</td>
<td>$11</td>
<td>$11</td>
</tr>
<tr>
<td>Transferred to surplus and change in accumulated other comprehensive loss</td>
<td>18</td>
<td>7</td>
</tr>
<tr>
<td>Payments to U.S. Treasury as interest on Federal Reserve notes</td>
<td>1,094</td>
<td>865</td>
</tr>
<tr>
<td>Total distribution</td>
<td>$1,123</td>
<td>$883</td>
</tr>
</tbody>
</table>

*The accompanying notes are an integral part of these financial statements.*
# Statements of Changes in Capital

(in millions)

For the years ended December 31, 2007 and 2006

<table>
<thead>
<tr>
<th>Surplus</th>
<th>Capital Paid-In</th>
<th>Net Income Retained</th>
<th>Accumulated Other Comprehensive Loss</th>
<th>Total Surplus</th>
<th>Total Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at January 1, 2006</td>
<td>$ 175</td>
<td>$ 175</td>
<td>$ -</td>
<td>$ 175</td>
<td>$ 350</td>
</tr>
<tr>
<td>(3.5 million shares)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Net change in capital stock issued (0.0 million shares)

| Transferred to surplus | - | 7 | - | 7 | 7 |
| Adjustment to initially apply SFAS No. 158 | - | - | (6) | (6) | (6) |

Balance at December 31, 2006

(3.5 million shares)

| Balance at December 31, 2006 | $ 176 | $ 182 | $ (6) | $ 176 | $ 352 |
| (3.5 million shares) | | | | | |

Net change in capital stock issued (0.4 million shares)

| Transferred to surplus and change in accumulated other comprehensive loss | - | 14 | 4 | 18 | 18 |

Balance at December 31, 2007

(3.9 million shares)

| Balance at December 31, 2007 | $ 194 | $ 196 | $ (2) | $ 194 | $ 388 |
| (3.9 million shares) | | | | | |

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

The Federal Reserve Bank of Kansas City (“Bank”) is part of the Federal Reserve System (“System”) and one of the twelve Reserve Banks (“Reserve Banks”) created by Congress under the Federal Reserve Act of 1913 (“Federal Reserve Act”), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branches in Denver, Colorado; Oklahoma City, Oklahoma; and Omaha, Nebraska, serve the Tenth Federal Reserve District, which includes Colorado, Kansas, Nebraska, Oklahoma, Wyoming, and portions of Missouri and New Mexico.

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

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

2. OPERATIONS AND SERVICES

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

The FOMC, in the conduct of monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and annually issues authorizations and directives to the FRBNY for its execution of transactions. The FRBNY is authorized and directed by the FOMC to conduct operations in domestic markets, including the direct purchase and sale of U.S. government securities, the purchase of securities under agreements to resell, the sale of securities under agreements to
repurchase, and the lending of U.S. government securities. The FRBNY executes these open market
transactions at the direction of the FOMC and holds the resulting securities and agreements in the
portfolio known as the System Open Market Account ("SOMA").

In addition to authorizing and directing operations in the domestic securities market, the FOMC
authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in
order to counter disorderly conditions in exchange markets or to meet other needs specified by the
FOMC in carrying out the System's central bank responsibilities. The FRBNY is authorized by the
FOMC to hold balances of, and to execute spot and forward foreign exchange ("FX") and securities
contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate
liquidity is maintained. The FRBNY is authorized and directed by the FOMC to maintain reciprocal
currency arrangements ("FX swaps") with four central banks and "warehouse" foreign currencies for
the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks. In connection
with its foreign currency activities, the FRBNY may enter into transactions that contain varying
degrees of off-balance-sheet market risk that result from their future settlement and counter-party
credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction
limits, and performing daily monitoring procedures.

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

Major services provided on behalf of the System by the Bank, for which the costs were not redistributed
to the other Reserve Banks, include the Customer Relations and Support Office/Customer Contact
Center, Human Resources Technology Center, and Billing Operations Site.

3. SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

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

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

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

SDR certificates are issued by the International Monetary Fund (“Fund”) to its members in proportion to each member’s quota in the Fund at the time of issuance. SDR certificates serve as a
supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates somewhat like gold certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks’ SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon each Reserve Bank’s Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2007 or 2006.

b. Loans to Depository Institutions

Depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Bank. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. The Bank offers three discount window programs to depository institutions: primary credit, secondary credit, and seasonal credit, each with its own interest rate. Interest is accrued using the applicable discount rate established at least every fourteen days by the board of directors of the Reserve Bank, subject to review and determination by the Board of Governors.

In addition, depository institutions that are eligible to borrow under the Reserve Bank’s primary credit program are also eligible to participate in the temporary Term Auction Facility (“TAF”) program. Under the TAF program, the Reserve Banks conduct auctions for a fixed amount of funds, with the interest rate determined by the auction process, subject to a minimum bid rate. All advances under the TAF must be fully collateralized.

Outstanding loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established.

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

Interest income on U.S. government securities and investments denominated in foreign currencies comprising the SOMA is accrued on a straight-line basis. Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as “Foreign currency gains (losses), net” in the Statements of Income and Comprehensive 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 the interdistrict settlement account that occurs in April of each year. The settlement also equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments denominated in foreign currencies is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to aggregate capital and surplus at the preceding December 31.
d. Securities Purchased Under Agreements to Resell, Securities Sold Under Agreements to Repurchase, and Securities Lending

The FRBNY may engage in tri-party purchases of securities under agreements to resell ("tri-party agreements"). Tri-party agreements are conducted with two commercial custodial banks that manage the clearing and settlement of collateral. Collateral is held in excess of the contract amount. Acceptable collateral under tri-party agreements primarily includes U.S. government securities, pass-through mortgage securities of the Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association, STRIP securities of the U.S. Government, and "stripped" securities of other government agencies. The tri-party agreements are accounted for as financing transactions, with the associated interest income accrued over the life of the agreement.

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

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

Activity related to securities sold under agreements to repurchase and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from an annual settlement of the interdistrict settlement account. On February 15, 2007 the FRBNY began allocating to the other Reserve Banks the activity related to securities purchased under agreements to resell.

e. FX Swap Arrangements and Warehousing Agreements

FX swap arrangements are contractual agreements between two parties, the FRBNY and an authorized foreign central bank, whereby the parties agree to exchange their currencies up to a prearranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to the foreign currencies it may need to support its international operations and give the authorized foreign central bank temporary access to dollars. Drawings under the FX swap arrangements can be initiated by either party and must be agreed to by the other party. The FX swap arrangements are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. Foreign currencies received pursuant to these agreements are reported as a component of "Investments denominated in foreign currencies" in the Statements of Condition.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the U.S. Treasury, U.S. dollars for foreign currencies held by the U.S. Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the U.S. Treasury and ESF for financing purchases of foreign currencies and related international operations.
FX swap arrangements and warehousing agreements are revalued daily at current market exchange rates. Activity related to these agreements, with the exception of the unrealized gains and losses resulting from the daily revaluation, is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to aggregate capital and surplus at the preceding December 31. Unrealized gains and losses resulting from the daily revaluation are recorded by FRBNY and not allocated to the other Reserve Banks.

f. Bank Premises, Equipment, and Software

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

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

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

g. Interdistrict Settlement Account

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

h. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the chairman of the board of directors of each Reserve Bank and their designees) to the Reserve Banks upon deposit with such agents of specified classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be at least equal to the sum of the notes applied for by such Reserve Bank.
Assets eligible to be pledged as collateral security include all of the Bank’s assets. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, for which the collateral value is equal to the par value of the securities tendered. The par value of securities pledged for securities sold under agreements to repurchase is deducted.

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes issued to all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, Federal Reserve notes are obligations of the United States government. At December 31, 2007, all Federal Reserve notes issued to the Reserve Banks were fully collateralized.

“Federal Reserve notes outstanding, net” in the Statements of Condition represents the Bank’s Federal Reserve notes outstanding, reduced by the Bank’s currency holdings of $3,212 million and $3,717 million at December 31, 2007 and 2006, respectively.

i. Items in Process of Collection and Deferred Credit Items

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

j. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. These shares are nonvoting with a par value of $100 and may not be transferred or hypothecated. As a member bank’s capital and surplus changes, its holdings of Reserve Bank stock must be adjusted. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

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

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

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

The Bank initially applied the provisions of SFAS No. 158, Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Statements of Condition, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard required applying the provisions as of the end of the year of initial implementation, and the effect as of December 31, 2006 is recorded as “Adjustment to initially apply SFAS No. 158” in the Statements of Changes in Capital.

l. Interest on Federal Reserve Notes

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

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

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

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

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services. During the years ended December 31, 2006 and 2007, the Bank was reimbursed for all services provided to the Department of the Treasury.
n. Compensation Received for Services Provided

The Federal Reserve Bank of Atlanta ("FRBA") has overall responsibility for managing the Reserve Banks’ provision of check and ACH services to depository institutions, and, as a result, recognizes total System revenue for these services on its Statements of Income and Comprehensive Income. Similarly, the FRBNY manages the Reserve Banks’ provision of Fedwire funds and securities transfer services, and recognizes total System revenue for these services on its Statements of Income and Comprehensive Income. The FRBA and FRBNY compensate the other Reserve Banks for the costs incurred to provide these services. The Federal Reserve Bank of Chicago ("FRBC") manages the Reserve Banks’ provision of electronic access services to depository institutions, recognizes total System revenue for these services on its Statements of Income and Comprehensive Income, and, beginning in 2007, compensates the other Reserve Banks for the costs incurred to provide these services. The Bank reports this compensation as “Compensation received for services provided” in the Statements of Income and Comprehensive Income.

o. Assessments by the Board of Governors

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

p. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank’s real property taxes were $201 thousand and $1 million for the years ended December 31, 2007 and 2006, respectively, and are reported as a component of “Occupancy expense.”

q. Restructuring Charges

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

Note 11 describes the Bank’s restructuring initiatives and provides information about the costs and liabilities associated with employee separations and contract terminations. The costs associated with the impairment of certain of the Bank’s assets are discussed in Note 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY.
r. Recently Issued Accounting Standards

In September, 2006, the FASB issued SFAS No. 157, Fair Value Measurements (“SFAS No. 157”). SFAS No. 157 establishes a single authoritative definition of fair value, sets out a framework for measuring fair value, and expands on required disclosures about fair value measurement. SFAS No. 157 is generally effective for the Bank on January 1, 2008, though the effective date of some provisions is January 1, 2009. The provisions of SFAS No. 157 will be applied prospectively and are not expected to have a material effect on the Bank’s financial statements.

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

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank’s allocated share of SOMA balances was approximately 3.237 percent and 2.928 percent at December 31, 2007 and 2006, respectively.

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

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Par value:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. government:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bills</td>
<td>$ 7,375</td>
<td>$ 8,112</td>
</tr>
<tr>
<td>Notes</td>
<td>13,006</td>
<td>11,782</td>
</tr>
<tr>
<td>Bonds</td>
<td>3,593</td>
<td>2,914</td>
</tr>
<tr>
<td><strong>Total par value</strong></td>
<td>23,974</td>
<td>22,808</td>
</tr>
<tr>
<td>Unamortized premiums</td>
<td>259</td>
<td>255</td>
</tr>
<tr>
<td>Unaccreted discounts</td>
<td>(96)</td>
<td>(117)</td>
</tr>
<tr>
<td><strong>Total allocated to the Bank</strong></td>
<td>$ 24,137</td>
<td>$ 22,946</td>
</tr>
</tbody>
</table>

At December 31, 2007 and 2006, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was $25,157 million and $23,306 million, respectively, as determined by reference to quoted prices for identical securities.

The total of the U.S. government securities, net, held in the SOMA was $745,629 million and $783,619 million at December 31, 2007 and 2006, respectively. At December 31, 2007 and 2006, the fair value of the U.S. government securities held in the SOMA, excluding accrued interest, was $777,141 million and $795,900 million, respectively, as determined by reference to quoted prices for identical securities.
Although the fair value of security holdings can be substantially greater or less than the recorded value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as central bank, to meet their financial obligations and responsibilities, and should not be misunderstood as representing a risk to the Reserve Banks, their shareholders, or the public. The fair value is presented solely for informational purposes.

Financial information related to securities purchased under agreements to resell and securities sold under agreements to repurchase for the year ended December 31, 2007 was as follows (in millions):

<table>
<thead>
<tr>
<th></th>
<th>Securities Purchased Under Agreements to Resell</th>
<th>Securities Sold Under Agreements to Repurchase</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Allocated to the Bank:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contract amount outstanding, end of year</td>
<td>$1,505</td>
<td>$1,424</td>
</tr>
<tr>
<td>Weighted average amount outstanding, during the year</td>
<td>1,135</td>
<td>1,128</td>
</tr>
<tr>
<td>Maximum month-end balance outstanding, during the year</td>
<td>1,667</td>
<td>1,424</td>
</tr>
<tr>
<td>Securities pledged, at end of year</td>
<td>1,426</td>
<td></td>
</tr>
<tr>
<td><strong>System total:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contract amount outstanding, end of year</td>
<td>$46,500</td>
<td>$43,985</td>
</tr>
<tr>
<td>Weighted average amount outstanding, during the year</td>
<td>35,073</td>
<td>34,846</td>
</tr>
<tr>
<td>Maximum month-end balance outstanding, during the year</td>
<td>51,500</td>
<td>43,985</td>
</tr>
<tr>
<td>Securities pledged, end of year</td>
<td>44,048</td>
<td></td>
</tr>
</tbody>
</table>

At December 31, 2006, the total contract amount of securities sold under agreements to repurchase was $29,615 million, of which $867 million was allocated to the Bank. The total par value of SOMA securities that were pledged for securities sold under agreements to repurchase at December 31, 2006 was $29,676 million, of which $869 million was allocated to the Bank.

The contract amounts for securities purchased under agreements to resell and securities sold under agreements to repurchase approximate fair value.
The maturity distribution of U.S. government securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2007, was as follows (in millions):

<table>
<thead>
<tr>
<th></th>
<th>U.S. Government Securities (Par value)</th>
<th>Securities Purchased Under Agreements to Resell (Contract amount)</th>
<th>Securities Sold Under Agreements to Repurchase (Contract amount)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 15 days</td>
<td>$883</td>
<td>$1,505</td>
<td>$1,424</td>
</tr>
<tr>
<td>16 days to 90 days</td>
<td>4,847</td>
<td></td>
<td></td>
</tr>
<tr>
<td>91 days to 1 year</td>
<td>4,929</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Over 1 year to 5 years</td>
<td>7,787</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Over 5 years to 10 years</td>
<td>2,653</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Over 10 years</td>
<td>2,875</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total allocated to the Bank</td>
<td>$23,974</td>
<td>$1,505</td>
<td>$1,424</td>
</tr>
</tbody>
</table>

At December 31, 2007 and 2006, U.S. government securities with par values of $16,649 million and $6,855 million, respectively, were loaned from the SOMA, of which $539 million and $201 million, respectively, were allocated to the Bank.

5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

The Bank’s allocated share of investments denominated in foreign currencies was approximately 1.151 percent and 1.321 percent at December 31, 2007 and 2006, respectively.
The Bank’s allocated share of investments denominated in foreign currencies, including accrued interest, valued at foreign currency market exchange rates at December 31, was as follows (in millions):

<table>
<thead>
<tr>
<th>Currency</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Euro</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign currency deposits</td>
<td>$316</td>
<td>$83</td>
</tr>
<tr>
<td>Securities purchased under agreements to resell</td>
<td>29</td>
<td>29</td>
</tr>
<tr>
<td>Government debt instruments</td>
<td>54</td>
<td>54</td>
</tr>
<tr>
<td><strong>Japanese Yen</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign currency deposits</td>
<td>32</td>
<td>34</td>
</tr>
<tr>
<td>Government debt instruments</td>
<td>66</td>
<td>71</td>
</tr>
<tr>
<td><strong>Swiss Franc</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign currency deposits</td>
<td>47</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total allocated to the Bank</strong></td>
<td>$544</td>
<td>$271</td>
</tr>
</tbody>
</table>

At December 31, 2007, the total amount of foreign currency deposits held under FX contracts was $24,381 million, of which $281 million was allocated to the Bank. At December 31, 2006, there were no material open foreign exchange contracts.

At December 31, 2007 and 2006, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was $544 million and $270 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as central bank, to meet its financial obligations and responsibilities.

Total System investments denominated in foreign currencies were $47,295 million and $20,482 million at December 31, 2007 and 2006, respectively. At December 31, 2007 and 2006, the fair value of the total System investments denominated in foreign currencies, including accrued interest, was $47,274 million and $20,434 million, respectively.
The maturity distribution of investments denominated in foreign currencies that were allocated to the Bank at December 31, 2007, was as follows (in millions):

<table>
<thead>
<tr>
<th></th>
<th>European</th>
<th>Japanese</th>
<th>Swiss</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Euro</td>
<td>Yen</td>
<td>Franc</td>
<td></td>
</tr>
<tr>
<td>Within 15 days</td>
<td>$58</td>
<td>$34</td>
<td>$-</td>
<td>$92</td>
</tr>
<tr>
<td>16 days to 90 days</td>
<td>265</td>
<td>5</td>
<td>47</td>
<td>317</td>
</tr>
<tr>
<td>91 days to 1 year</td>
<td>32</td>
<td>23</td>
<td>-</td>
<td>55</td>
</tr>
<tr>
<td>Over 1 year to 5 years</td>
<td>44</td>
<td>36</td>
<td>-</td>
<td>80</td>
</tr>
<tr>
<td>Over 5 years to 10 years</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Over 10 years</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total allocated to the Bank</td>
<td>$399</td>
<td>$98</td>
<td>$47</td>
<td>$544</td>
</tr>
</tbody>
</table>

At December 31, 2007 and 2006, the authorized warehousing facility was $5,000 million, with no balance outstanding.

6. **BANK PREMISES, EQUIPMENT, AND SOFTWARE**

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

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank premises and equipment:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$45</td>
<td>$36</td>
</tr>
<tr>
<td>Buildings</td>
<td>16</td>
<td>17</td>
</tr>
<tr>
<td>Building machinery and equipment</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Construction in progress</td>
<td>217</td>
<td>114</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>71</td>
<td>55</td>
</tr>
<tr>
<td>Subtotal</td>
<td>355</td>
<td>228</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(57)</td>
<td>(54)</td>
</tr>
<tr>
<td>Bank premises and equipment, net</td>
<td>$298</td>
<td>$174</td>
</tr>
<tr>
<td>Depreciation expense, for the year ended December 31</td>
<td>$5</td>
<td>$5</td>
</tr>
</tbody>
</table>
The Bank is constructing a new building to replace the head office in Kansas City. At December 31, 2007, approximately $38 million of costs associated with the acquisition of land and site preparation for the new building are included in Land, and approximately $217 million of costs associated with the construction of the new building are included in Construction in progress.

The Bank leases space to outside tenants with remaining lease terms ranging from one to four years. Rental income from such leases was not material for the years ended December 31, 2007 and 2006. Future minimum lease payments that the Bank will receive under noncancelable agreements in existence at December 31, 2007 were not material.

The Bank has capitalized software assets, net of amortization, of $6 million and $4 million at December 31, 2007 and 2006, respectively. Amortization expense was $1 million for each of the years ended December 31, 2007 and 2006. Capitalized software assets are reported as a component of “Other assets” in the Statements of Condition and the related amortization is reported as a component of “Other expenses” in the Statements of Income and Comprehensive Income.

Assets impaired as a result of the Bank’s restructuring plan, as discussed in Note 11, include land, building, building machinery and equipment, as well as furniture and check equipment. Asset impairment losses of $2 million and $13 million for the periods ending December 31, 2007 and 2006, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of “Other expenses” in the Statements of Income and Comprehensive Income.

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2007, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from one to approximately four 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 $5 million and $4 million for the periods ending December 31, 2007 and 2006, respectively. Certain of the Bank’s leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2007, are as follows (in millions):

<table>
<thead>
<tr>
<th>Year</th>
<th>Operating</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$1.2</td>
</tr>
<tr>
<td>2009</td>
<td>0.2</td>
</tr>
<tr>
<td>2010</td>
<td>0.2</td>
</tr>
<tr>
<td>2011</td>
<td>0.1</td>
</tr>
<tr>
<td>2012</td>
<td>-</td>
</tr>
<tr>
<td>Thereafter</td>
<td>-</td>
</tr>
<tr>
<td>Future minimum rental payments</td>
<td>$1.7</td>
</tr>
</tbody>
</table>
At December 31, 2007, there were no material unrecorded unconditional purchase 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 of a Reserve Bank’s capital paid-in to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2007 or 2006.

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

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

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

The System Plan provides retirement benefits to employees of the Federal Reserve Banks, the Board of Governors, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. The FRBNY, on behalf of the System, recognizes the net asset and costs associated with the System Plan in its financial statements. Costs associated with the System 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, 2007 and 2006, 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 $4 million for each of the years ended December 31, 2007 and 2006, and are reported as a component of “Salaries and other benefits” in the Statements of Income and Comprehensive Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2007 and 2006, 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. POSTRETIRED BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits other than Pensions

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

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

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

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated postretirement benefit obligation at January 1</td>
<td>$38.6</td>
<td>$38.8</td>
</tr>
<tr>
<td>Service cost-benefits earned during the period</td>
<td>1.5</td>
<td>1.0</td>
</tr>
<tr>
<td>Interest cost on accumulated benefit obligation</td>
<td>2.3</td>
<td>1.8</td>
</tr>
<tr>
<td>Net actuarial gain</td>
<td>(2.6)</td>
<td>(0.9)</td>
</tr>
<tr>
<td>Curtailment gain</td>
<td>(1.1)</td>
<td>(0.2)</td>
</tr>
<tr>
<td>Contributions by plan participants</td>
<td>0.9</td>
<td>1.0</td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(3.3)</td>
<td>(2.7)</td>
</tr>
<tr>
<td>Medicare Part D subsidies</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>Plan amendments</td>
<td>-</td>
<td>(0.4)</td>
</tr>
<tr>
<td>Accumulated postretirement benefit obligation at December 31</td>
<td>$36.5</td>
<td>$38.6</td>
</tr>
</tbody>
</table>

At December 31, 2007 and 2006, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 6.25 percent and 5.75 percent, respectively.

Discount rates reflect yields available on high-quality corporate bonds that would generate the cash flows necessary to pay the plan’s benefits when due.
Following is a reconciliation of the beginning and ending balance of the plan assets, the unfunded postretirement benefit obligation, and the accrued postretirement benefit costs (in millions):

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of plan assets at January 1</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>Contributions by employer</td>
<td>2.2</td>
<td>1.5</td>
</tr>
<tr>
<td>Contributions by plan participants</td>
<td>0.9</td>
<td>1.0</td>
</tr>
<tr>
<td>Benefits paid, net of Medicare Part D subsidies</td>
<td>(3.1)</td>
<td>(2.5)</td>
</tr>
<tr>
<td>Fair value of plan assets at December 31</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>Unfunded obligation and accrued postretirement benefit cost</td>
<td>$36.5</td>
<td>$38.6</td>
</tr>
<tr>
<td>Amounts included in accumulated other comprehensive loss are shown below:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prior service cost</td>
<td>$ 3.7</td>
<td>$ 5.7</td>
</tr>
<tr>
<td>Net actuarial loss</td>
<td>(7.2)</td>
<td>(12.2)</td>
</tr>
<tr>
<td>Deferred curtailment gain</td>
<td>1.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Total accumulated other comprehensive loss</td>
<td>$ (2.2)</td>
<td>$ (5.8)</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></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health care cost trend rate assumed for next year</td>
<td>8.00%</td>
<td>9.00%</td>
</tr>
<tr>
<td>Rate to which the cost 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>2013</td>
<td>2012</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 cost trend rates would have the following effects for the year ended December 31, 2007 (in millions):

<table>
<thead>
<tr>
<th>Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs</th>
<th>One Percentage Point Increase</th>
<th>One Percentage Point Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effect on accumulated postretirement benefit obligation</td>
<td>0.1</td>
<td>(0.1)</td>
</tr>
<tr>
<td>Effect on accumulated postretirement benefit obligation</td>
<td>0.2</td>
<td>(0.5)</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service cost-benefits earned during the period</td>
<td>$ 1.5</td>
</tr>
<tr>
<td>Interest cost on accumulated benefit obligation</td>
<td>2.3</td>
</tr>
<tr>
<td>Amortization of prior service cost</td>
<td>(1.4)</td>
</tr>
<tr>
<td>Amortization of net actuarial loss</td>
<td>1.2</td>
</tr>
<tr>
<td>Net periodic postretirement benefit expense</td>
<td>$ 3.6</td>
</tr>
</tbody>
</table>

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2008 are shown below:

| Prior service cost | $ (1.2) |
| Actuarial gain | (0.3) |
| **Total** | **$ (1.5)** |

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2007 and 2006, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.75 percent and 5.50 percent, respectively.

Net periodic postretirement benefit expense is reported as a component of “Salaries and other benefits” in the Statements of Income and Comprehensive Income.
Deferred curtailment gains associated with restructuring programs announced in 2006 and 2007 that are described in Note 11 were recorded in 2006 and 2007 as a component of accumulated other comprehensive loss; the gains will be recognized in future years when the related employees terminate employment.

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

There were no receipts of federal Medicare Part D subsidies in the year ended December 31, 2006. Receipts in the year ending December 31, 2007, related to benefits paid in the years ended December 31, 2006 and 2007, were $0.2 million and $0.2 million, respectively. Expected receipts in 2008, related to benefits paid in the year ended December 31, 2007 are $0.1 million.

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

<table>
<thead>
<tr>
<th></th>
<th>Without Subsidy</th>
<th>With Subsidy</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$2.9</td>
<td>$2.7</td>
</tr>
<tr>
<td>2009</td>
<td>3.1</td>
<td>2.8</td>
</tr>
<tr>
<td>2010</td>
<td>3.4</td>
<td>3.0</td>
</tr>
<tr>
<td>2011</td>
<td>3.6</td>
<td>3.3</td>
</tr>
<tr>
<td>2012</td>
<td>3.7</td>
<td>3.3</td>
</tr>
<tr>
<td>2013 - 2017</td>
<td>20.8</td>
<td>18.1</td>
</tr>
<tr>
<td>Total</td>
<td>$37.5</td>
<td>$33.2</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 were $6 million for each of the years ended December 31, 2007 and 2006. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2007 and 2006 operating expenses were $1 million for both years, and are recorded as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income.
10. ACCUMULATED OTHER COMPREHENSIVE INCOME AND 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></th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at January 1, 2006</td>
<td>$ -</td>
</tr>
<tr>
<td>Adjustment to initially apply SFAS No. 158</td>
<td>(6)</td>
</tr>
<tr>
<td>Balance at December 31, 2006</td>
<td>$ (6)</td>
</tr>
<tr>
<td>Change in funded status of benefit plans:</td>
<td></td>
</tr>
<tr>
<td>Prior service costs arising during the year</td>
<td>(1)</td>
</tr>
<tr>
<td>Net actuarial gain arising during the year</td>
<td>4</td>
</tr>
<tr>
<td>Deferred curtailment gain</td>
<td>1</td>
</tr>
<tr>
<td>Amortization of prior service cost</td>
<td>(1)</td>
</tr>
<tr>
<td>Amortization of net actuarial loss</td>
<td>1</td>
</tr>
<tr>
<td>Change in funded status of benefit plans - other comprehensive income</td>
<td>4</td>
</tr>
<tr>
<td>Balance at December 31, 2007</td>
<td>$ (2)</td>
</tr>
</tbody>
</table>

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

In 2007, the Reserve Banks announced a restructuring initiative to align the check processing infrastructure and operations with declining check processing volumes. The new infrastructure will involve consolidation of operations into four regional Reserve Bank processing sites in Philadelphia, Cleveland, Atlanta, and Dallas.

In 2005 and 2006, the Bank announced restructuring plans to streamline operations and reduce costs, including consolidation of check and cash operations and staff reductions in various other functions of the Bank.

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

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Information related to restructuring plans as of December 31, 2007:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total expected costs related to restructuring activity</td>
<td>$ 3</td>
<td>$ 3</td>
<td>$ 3</td>
<td>$ 9</td>
</tr>
<tr>
<td>Expected completion date</td>
<td>2007</td>
<td>2008</td>
<td>2010</td>
<td></td>
</tr>
<tr>
<td>Reconciliation of liability balances:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balance at January 1, 2006</td>
<td>$ 3</td>
<td>$ -</td>
<td>$ -</td>
<td>$ 3</td>
</tr>
<tr>
<td>Employee separation costs Payments</td>
<td>-</td>
<td>3</td>
<td>-</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>(3)</td>
<td>-</td>
<td>-</td>
<td>(3)</td>
</tr>
<tr>
<td>Balance at December 31, 2006</td>
<td>$ -</td>
<td>$ 3</td>
<td>$ -</td>
<td>$ 3</td>
</tr>
<tr>
<td>Employee separation costs</td>
<td>-</td>
<td>-</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Balance at December 31, 2007</td>
<td>$ -</td>
<td>$ 3</td>
<td>$ 3</td>
<td>$ 6</td>
</tr>
</tbody>
</table>
Employee separation costs are primarily severance costs for identified staff reductions associated with the announced restructuring plans. Separation costs that are provided under terms of ongoing benefit arrangements are recorded based on the accumulated benefit earned by the employee. Separation costs that are provided under the terms of one-time benefit arrangements are generally measured based on the expected benefit as of the termination date and recorded ratably over the period to termination. Restructuring costs related to employee separations are reported as a component of “Salaries and other benefits” in the Statements of Income and Comprehensive Income.

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

12. SUBSEQUENT EVENTS

In March 2008, the Board of Governors announced several initiatives to address liquidity pressures in funding markets and promote financial stability, including increasing the Term Auction Facility (see Note 3b) to $100 billion and initiating a series of term repurchase transactions (see Notes 3d and 4) that may cumulate to $100 billion. In addition, the Reserve Banks’ securities lending program (see Notes 3d and 4) was expanded to lend up to $200 billion of Treasury securities to primary dealers for a term of 28 days, secured by federal agency debt, federal agency residential mortgage-backed securities, agency collateralized mortgage obligations, non-agency AAA/Aaa-rated private-label residential mortgage-backed securities, and AAA/Aaa-rated commercial mortgage-backed securities. The FOMC also authorized increases in its existing temporary reciprocal currency arrangements (see Notes 3e and 5) with specific foreign central banks. These initiatives will affect 2008 activity related to loans to depository institutions, securities purchased under agreements to resell, U.S. government securities, net, and investments denominated in foreign currencies, as well as income and expenses. The effects of the initiatives do not require adjustment to the amounts recorded as of December 31, 2007.
VOLUME OF PRINCIPAL OPERATIONS (UNAUDITED)*

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans and Discounts, Daily Average</td>
<td>$18,305,000</td>
<td>$22,078,000</td>
</tr>
<tr>
<td>Number of Institutions Borrowing</td>
<td>61</td>
<td>74</td>
</tr>
<tr>
<td>Commercial Checks - Paper</td>
<td>$906,509,000,000</td>
<td>$1,099,366,000,000</td>
</tr>
<tr>
<td>Commercial Checks Processed</td>
<td>664,832,000</td>
<td>878,353,000</td>
</tr>
<tr>
<td>Commercial Checks - Check 21</td>
<td>$805,538,000,000</td>
<td>$425,781,000,000</td>
</tr>
<tr>
<td>Commercial Checks Received</td>
<td>426,733,000</td>
<td>177,450,000</td>
</tr>
<tr>
<td>Currency Receipts and Payments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pieces</td>
<td>$42,394,167,000</td>
<td>$47,525,209,000</td>
</tr>
<tr>
<td></td>
<td>2,724,237,000</td>
<td>3,112,862,000</td>
</tr>
<tr>
<td>Coin Receipts and Payments Bags</td>
<td>$207,145,000</td>
<td>$138,556,000</td>
</tr>
<tr>
<td></td>
<td>246,000</td>
<td>243,000</td>
</tr>
</tbody>
</table>

*Numbers are not included in our audited financial statements.

Auditor Independence

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2007 was Deloitte & Touche LLP (D&T). Fees for these services totaled $4.7 million. To ensure auditor independence, the Board of Governors requires that D&T be independent in all matters relating to the audit. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2007, the Bank did not engage D&T for any material advisory services.
The Federal Reserve System

Congress created the Federal Reserve in 1913 to bring financial stability after a number of banking panics. It is the nation’s third central bank. The first, established in 1791, and the second, created in 1816, were each operational for 20 years. In both cases, its charter failed to be renewed and the banks closed.

With the Federal Reserve Act, Congress sought to create a central bank the public would be more likely to support by making it “decentralized” with more local control. This new structure was designed to overcome one of the primary weaknesses of the previous central banks: public distrust of an institution that many felt could potentially be under the control of either government or special interests. The new central bank is a network of 12 regional Federal Reserve Banks, located throughout the country and under the leadership of local boards of directors, with oversight from the Board of Governors in Washington, D.C., a government agency.

The Federal Reserve is considered to be independent within government and broadly insulated from political pressures. While members of the Board of Governors are nominated by the president of the United States and confirmed by the Senate, the Federal Reserve’s regional structure, including local boards of directors and advisory councils, ensures that views from a broad spectrum of the public nationwide contribute to the central bank’s deliberations.

President Woodrow Wilson signed the Federal Reserve Act on Dec. 23, 1913, and the 12 regional Federal Reserve Banks opened on Nov. 16, 1914.

The Federal Reserve Bank of Kansas City

The Federal Reserve Bank of Kansas City and its Branches in Denver, Oklahoma City and Omaha serve the Tenth Federal Reserve District, which encompasses western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico. As a part of the Federal Reserve System, the Bank participates in setting national monetary policy, supervising and regulating numerous commercial banks and bank holding companies, and providing check processing and other services to depository institutions.
Tour
the Kansas City Fed’s Money Museum

Learn about the Federal Reserve’s history, functions and role in the economy.

• Look inside the cash vault
• Check out historical artifacts and new displays on currency
• Shop for Fed merchandise

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