# 92nd Annual Report 2005

Board of Governors of the Federal Reserve System

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*Board of Governors of the Federal Reserve System*

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# *Letter of Transmittal*

Board of Governors of the Federal Reserve System
Washington, D.C.

June 2006

The Speaker of the House of Representatives:

Pursuant to the requirements of section 10 of the Federal Reserve Act, I am pleased to submit the ninety-second annual report of the Board of Governors of the Federal Reserve System.

This report covers operations of the Board during calendar year 2005.

Sincerely,

Ben Bernanke
*Chairman*

# *Overview of the Federal Reserve*

As the nation's central bank, the Federal Reserve System has numerous, varied responsibilities:

- conducting the nation's monetary policy by influencing monetary and credit conditions in the economy
- supervising and regulating banking institutions, to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets
- providing financial services to depository institutions, the U.S. government, and foreign official institutions

The Federal Reserve is a federal system composed of a central, governmental agency—the Board of Governors—and twelve regional Federal Reserve Banks. The Board of Governors, located in Washington, D.C., is made up of seven members appointed by the President of the United States and supported by a staff of about 1,800. In addition to conducting research, analysis, and policymaking related to domestic and international financial and economic matters, the Board plays a major role in the supervision and regulation of the U.S. banking system and administers most of the nation's laws regarding consumer credit protection. It also has broad oversight responsibility for the nation's payments system and the operations and activities of the Federal Reserve Banks.

The Federal Reserve Banks, which combine public and private elements, are the operating arms of the central banking system. They carry out a variety of System functions, including operating a nationwide payments system; distributing the nation's currency and coin; under authority delegated by the Board of Governors, supervising and regulating bank holding companies and state-chartered banks that are members of the System; serving as fiscal agents of the U.S. Treasury; and providing a variety of financial services for the Treasury, other government agencies, and other fiscal principals.

A major component of the Federal Reserve System is the Federal Open Market Committee (FOMC), which is made up of the members of the Board of Governors, the president of the Federal Reserve Bank of New York, and presidents of four other Federal Reserve Banks, who serve on a rotating basis. The FOMC establishes monetary policy and oversees open market operations, the main tool used by the Federal Reserve to influence overall monetary and credit conditions. The FOMC sets the federal funds rate, but the Board has sole authority over changes in reserve requirements and must approve any change in the discount rate initiated by a Reserve Bank.

Two other groups play roles in the functioning of the Federal Reserve System: depository institutions, through which monetary policy operates, and advisory councils, which make recommendations to the Board of Governors and the Reserve Banks regarding the System's responsibilities. ■

# Contents

## Monetary Policy and Economic Developments

3 MONETARY POLICY AND THE ECONOMIC OUTLOOK
5 Monetary Policy, Financial Markets, and the Economy in 2005 and Early 2006
7 Economic Projections for 2006 and 2007

9 ECONOMIC AND FINANCIAL DEVELOPMENTS IN 2005 AND EARLY 2006
9 The Household Sector
12 The Business Sector
15 The Government Sector
18 The External Sector
20 The Labor Market
22 Prices
24 U.S. Financial Markets
28 International Developments

33 MONETARY POLICY REPORT OF JULY 2005
33 Monetary Policy and the Economic Outlook
36 Economic and Financial Developments in 2005

## Federal Reserve Operations

57 BANKING SUPERVISION AND REGULATION
58 Scope of Responsibilities for Supervision and Regulation
59 Supervision for Safety and Soundness
67 Supervisory Policy
77 Supervisory Information Technology
78 Staff Development
80 Regulation of the U.S. Banking Structure
84 Enforcement of Other Laws and Regulations
85 Federal Reserve Membership

87 CONSUMER AND COMMUNITY AFFAIRS
87 Implementation of Statutes Designed to Inform and Protect Consumers
92 Supervision for Compliance with Consumer Protection and Community Reinvestment Laws
103 Consumer Complaints
104 Advice from the Consumer Advisory Council
107 Promotion of Community Economic Development in Historically Underserved Markets
111 Outreach Activities

113 FEDERAL RESERVE BANKS
113 Developments in Federal Reserve Priced Services
118 Developments in Currency and Coin
118 Developments in Fiscal Agency and Government Depository Services
122 Electronic Access to Reserve Bank Services
122 Information Technology
124 Examinations of the Federal Reserve Banks
124 Income and Expenses
125 Holdings of Securities and Loans
126 Volume of Operations
126 Federal Reserve Bank Premises
128 Pro Forma Financial Statements for Federal Reserve Priced Services

133 THE BOARD OF GOVERNORS AND THE GOVERNMENT PERFORMANCE AND RESULTS ACT
133 Strategic Plan, Performance Plan, and Performance Report
133 Mission
133 Goals and Objectives

137 FEDERAL LEGISLATIVE DEVELOPMENTS
137 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005
141 Post-Employment Restrictions on Senior Examiners

## *Records*

145 RECORD OF POLICY ACTIONS OF THE BOARD OF GOVERNORS
145 Regulation D (Reserve Requirements of Depository Institutions)
145 Regulation E (Electronic Fund Transfers)
145 Regulation H (Membership of State Banking Institutions in the Federal Reserve System) and Regulation Y (Bank Holding Companies and Change in Bank Control)
146 Regulation J (Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers through Fedwire) and Regulation CC (Availability of Funds and Collection of Checks
146 Regulation V (Fair Credit Reporting) and Regulation FF (Obtaining and Using Medical Information in Connection with Credit)
147 Regulation BB (Community Reinvestment)
147 Regulation DD (Truth in Savings)
148 Post-Employment Restrictions for Senior Examiners
148 Rules Regarding Equal Opportunity
148 Policy Statements and Other Actions
149 Discount Rates in 2005

153 MINUTES OF FEDERAL OPEN MARKET COMMITTEE MEETINGS
153 Authorization for Domestic Open Market Operations
155 Domestic Policy Directive
155 Authorization for Foreign Currency Operations
156 Foreign Currency Directive
157 Procedural Instructions with Respect to Foreign Currency Operations
158 Meeting Held on February 1–2, 2005
170 Meeting Held on March 22, 2005
179 Meeting Held on May 3, 2005
187 Meeting Held on June 29–30, 2005
195 Meeting Held on August 9, 2005
201 Meeting Held on September 20, 2005
208 Meeting Held on November 1, 2005
215 Meeting Held on December 13, 2005

223 LITIGATION
223 Litigation under the Financial Institutions Supervisory Act
223 Other Actions

## *Federal Reserve System Organization*

227 BOARD OF GOVERNORS

230 FEDERAL OPEN MARKET COMMITTEE

231 ADVISORY COUNCILS TO THE BOARD OF GOVERNORS
231 Federal Advisory Council
232 Consumer Advisory Council
233 Thrift Institutions Advisory Council

234 FEDERAL RESERVE BANKS AND BRANCHES
234 Officers of the Banks and Branches
235 Conference of Chairmen
235 Conference of Presidents
236 Conference of First Vice Presidents
236 Directors of the Banks and Branches

253 MEMBERS OF THE BOARD OF GOVERNORS, 1913–2005

## *Statistical Tables*


258 1. Federal Reserve Open Market Transactions, 2005

262 2. Federal Reserve Bank Holdings of U.S. Treasury and Federal Agency Securities, December 31, 2003–2005

263 3. Federal Reserve Bank Interest Rates on Loans to Depository Institutions, December 31, 2005

264 4. Reserve Requirements of Depository Institutions, December 31, 2005

265 5. Banking Offices and Banks Affiliated with Bank Holding Companies in the United States, December 31, 2004 and 2005

266 6. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items
- A. Year-End 1984–2005 and Month-End 2005
- B. Year-End 1918–1983

274 7. Principal Assets and Liabilities of Insured Commercial Banks, by Class of Bank, June 30, 2005 and 2004

275 8. Initial Margin Requirements under Regulations T, U, and X

276 9. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 2005 and 2004

280 10. Income and Expenses of the Federal Reserve Banks, by Bank, 2005

284 11. Income and Expenses of the Federal Reserve Banks, 1914–2005

290 12. Operations in Principal Departments of the Federal Reserve Banks, 2002–2005

291 13. Number and Annual Salaries of Officers and Employees of the Federal Reserve Banks, December 31, 2005

292 14. Acquisition Costs and Net Book Value of the Premises of the Federal Reserve Banks and Branches, December 31, 2005


## *Federal Reserve System Audits*


295 AUDITS OF THE FEDERAL RESERVE SYSTEM

297 BOARD OF GOVERNORS FINANCIAL STATEMENTS

311 FEDERAL RESERVE BANKS COMBINED FINANCIAL STATEMENTS

325 OFFICE OF INSPECTOR GENERAL ACTIVITIES

326 GOVERNMENT ACCOUNTABILITY OFFICE REVIEWS

328 MAPS OF THE FEDERAL RESERVE SYSTEM

333 INDEX

# *Monetary Policy and Economic Developments*

# *Monetary Policy and the Economic Outlook*

The U.S. economy delivered a solid performance in 2005 despite a further sharp increase in energy prices and devastating hurricanes that claimed many lives, destroyed homes and businesses, and displaced more than 1 million persons. Real gross domestic product is estimated to have risen a little more than 3 percent over the four quarters of 2005 even though growth slowed significantly in the fourth quarter as a result of storm-related disruptions and other factors that are likely to prove transitory. The increase in real GDP in 2005 was sufficient to add 2 million new jobs, on net, to employers' payrolls and to further reduce slack in labor and product markets. As in 2004, overall consumer price inflation was boosted by the surge in energy prices. Core consumer price inflation (as measured by the price index for personal consumption expenditures excluding the direct effects of movements in food and energy prices) picked up early in the year, but it subsequently eased and totaled less than 2 percent over the year as a whole. The dollar appreciated against most major currencies in 2005, and, with domestic demand expanding strongly, the U.S. current account deficit widened further.

In 2005, energy prices were up substantially for a second year in a row. Crude oil costs climbed further, on net, and prices of refined petroleum products and natural gas came under additional upward pressure for a time after supplies were curtailed by hurricane damage to production facilities in the Gulf Coast region. As a result, households in the United States faced steep increases in gasoline and home heating expenses, and many firms were likewise burdened with rising energy costs.

The resilience of the U.S. economy in the face of these major shocks likely reflects, in part, improvements in energy efficiency over the past several decades. A number of other factors also helped to keep economic activity moving forward in 2005. For one, the rapid gain in real estate values in the past few years, in combination with the rise in stock prices since 2002, has encouraged households to sustain their spending through a period of relatively weak growth in real income. For another, credit conditions remained supportive for businesses last year, facilitating a brisk expansion of capital spending. In addition, labor productivity has been on a strong uptrend in recent years, which has fostered substantial growth in the economy's productive capacity and no doubt lifted households' and businesses' assessments of their long-term income prospects.

In light of elevated inflation pressures and shrinking margins of unutilized resources, and with short-term interest rates relatively low, the Federal Open Market Committee (FOMC) continued to remove monetary policy accommodation gradually in 2005, raising the target

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NOTE: The discussion here and in the next chapter consists of the text, tables, and selected charts from the Monetary Policy Report submitted to the Congress on February 15, 2006, pursuant to section 2B of the Federal Reserve Act; the complete set of charts is available on the Board's web site, at www.federalreserve.gov/boarddocs/hh.

Other materials in this annual report related to the conduct of monetary policy include the minutes of the 2005 meetings of the Federal Open Market Committee (see the "Records" section) and statistical tables 1–4 (at the back of this report).

federal funds rate 25 basis points at each of its eight meetings. This cumulative policy firming of 2 percentage points was substantially greater than market participants had expected at the start of the year. But each action was anticipated by the time of the meeting at which it was taken, as the Committee's communications, policy strategy, and responses to incoming economic data appear to have been well understood. At its meeting in January 2006, the FOMC increased the target federal funds rate another 25 basis points, bringing it to 4½ percent. The Committee indicated that possible increases in resource utilization as well as elevated energy prices had the potential to add to inflation pressures and that, as a result, some further policy tightening may be needed.

The U.S. economy should continue to perform well in 2006 and 2007. To be sure, higher energy prices will probably exert some restraint on activity for a while longer. But so long as energy price increases slow, as is suggested by futures prices, this restraint should diminish as 2006 progresses. In addition, economic activity should receive some impetus from post-hurricane recovery efforts. Although progress to date has been uneven in the affected regions, the reopening of facilities shut down by the hurricanes is already being reflected in a rebound in industrial production. Federal assistance will buttress rebuilding activity in coming quarters.

More broadly, the major factors that contributed to the favorable performance of the U.S. economy in 2005 remain in place. Long-term interest rates are low, and conditions in corporate credit markets are generally positive. The household sector is also in good financial shape overall and should stay so even if—as expected—the housing sector cools. In addition, the improved outlook for economic growth abroad bodes well for U.S. exports. However, the effects of the cumulative tightening in monetary policy should keep the growth in aggregate output close to that of its longer-run potential.

Core inflation is likely to remain under some upward pressure in the near term from rising costs as the pass-through of higher energy prices runs its course. But those cost pressures should wane as the year progresses. Moreover, strength in labor productivity should continue to damp business costs more generally. With little evidence to date that resource utilization has put appreciable upward pressure on prices, and with longer-run inflation expectations continuing to be well anchored, core inflation should remain contained in 2006 and 2007.

Nonetheless, significant risks attend this economic outlook. Some of the uncertainty is centered on the prospects for the housing sector. On the one hand, some observers believe that home values have moved above levels that can be supported by fundamentals and that some realignment is warranted. Such a realignment—if abrupt—could materially sap household wealth and confidence and, in turn, depress consumer spending. On the other hand, if home values continue to register outsized increases, the accompanying increment to household wealth would stimulate aggregate demand and raise resource utilization further. With the economy already operating in the neighborhood of its productive potential, this higher resource utilization would risk adding to inflation pressures. Another major source of uncertainty is the price of energy, which continues to be buffeted by concerns about future supply disruptions. Additional steep increases in the price of energy would intensify cost pressures and weigh on economic activity.

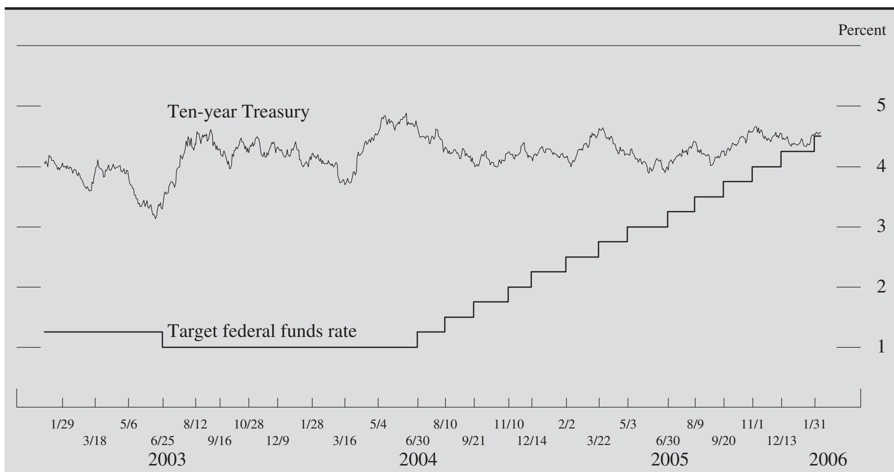
## Monetary Policy, Financial Markets, and the Economy in 2005 and Early 2006

The year 2005 opened with the target federal funds rate at 2¼ percent, a level that Federal Reserve policymakers judged to be quite accommodative. During the first few months of the year, output appeared to be growing at a solid pace despite rising energy prices. Improving labor market conditions and favorable financing terms were providing considerable support to consumer outlays and homebuilding activity, while reasonably bright sales prospects and strong profitability were buoying business investment. Pressures on inflation appeared to be mounting, however, partly owing to increasing energy prices. Measures of inflation compensation derived from securities markets were on the rise as well. In these circumstances, the Committee firmed policy 25 basis points at both its February and March meetings and signaled that, if economic conditions progressed as anticipated, it would need to continue to remove policy accommodation gradually to keep inflation pressures contained.

In the spring, policymakers perceived some signs of softness in spending, which they attributed in part to the earlier step-up in energy prices. Nonetheless, the federal funds rate was still relatively low, and robust underlying growth in productivity was providing ongoing support to economic activity. Accordingly, the Committee anticipated some strengthening of activity, and it reduced policy accommodation further in May by lifting the target federal funds rate another quarter percentage point, to 3 percent.

In the event, the signs of softness proved transitory. Incoming data suggested that output, employment, and spending were growing moderately through midyear. Inflation expectations seemed to be well contained, but pressures on inflation remained elevated. With the stance of policy still accommo-

Selected Interest Rates, 2003–06




NOTE: The data are daily and extend through February 8, 2006. The ten-year Treasury rate is the constant-maturity yield based on the most actively traded securities. The dates on the horizontal axis are those of FOMC meetings.

SOURCE: Department of the Treasury and the Federal Reserve.

dative, the Committee added another 25 basis points to the target federal funds rate at both its June and August meetings.

Subsequently, the devastation caused by Hurricane Katrina increased uncertainty about the vitality of the economic expansion in the near term. The destruction in the Gulf Coast region, the associated dislocation of economic activity—including considerable disruption of energy production—and the accompanying further boost to energy prices were expected to impose some restraint on spending, production, and employment in the near term. Although the region had been dealt a severe blow, the Committee did not see these developments as posing a more persistent threat to the overall economic expansion. Consequently, it decided to firm policy another 25 basis points at its September meeting.

Over the following weeks, the Gulf Coast region absorbed further setbacks from Hurricanes Rita and Wilma. The growth of economic activity dipped for a time—hiring slowed, consumer spending softened, and confidence declined. At the same time, however, soaring energy prices fed through to top-line consumer price inflation and pushed some survey measures of inflation expectations upward. With employment and growth expected to be supported by accommodative financial conditions, the FOMC continued the process of policy tightening at its November meeting.

By December, incoming data indicated that the overall expansion remained on track, although recovery from the damage in the hurricane-affected areas would apparently require considerable time. The Committee judged that possible increases in resource utilization as well as elevated energy prices had the potential to add to inflation pressures. Accordingly, policy was firmed another 25 basis points, bringing the target federal funds rate to 4¼ percent. In the accompanying statement, monetary policy was no longer characterized as "accommodative" because the federal funds rate had been boosted substantially and was now within the broad range of values that, in the judgment of the Committee, might turn out to be consistent with output remaining close to its potential. Indeed, because policy actions over the previous eighteen months had significantly reduced the degree of monetary accommodation, Committee members thought that the outlook for their near-term policy actions was becoming considerably less certain. In such an environment, policy decisions would increasingly depend on incoming data and their implications for future economic growth and inflation. Nonetheless, the Committee indicated that some further measured policy firming was likely to be needed to keep the risks to the attainment of its goals of sustainable economic growth and price stability roughly in balance.

Over the period leading up to the January 2006 meeting, incoming data on economic activity were uneven. The advance estimate of real GDP pointed to a slowing in the growth of output in the fourth quarter, but the underlying strength in consumer and business spending suggested that the economic expansion remained on solid footing. With the potential for added pressures on inflation still evident, the FOMC raised the target federal funds rate another 25 basis points, bringing its level to 4½ percent. In its statement after the meeting, the Committee indicated that some further policy firming may be necessary and again noted that it would respond to changes in economic prospects as needed.

## Economic Projections for 2006 and 2007

In conjunction with the FOMC meeting in January, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, provided economic projections for 2006 and 2007. The central tendency of the FOMC participants' forecasts for the increase in real GDP is about 3½ percent over the four quarters of 2006 and 3 percent to 3½ percent in 2007. The civilian unemployment rate is expected to lie between 4¾ percent and 5 percent in the fourth quarter of 2006 and to remain in that area in 2007. As for inflation, the FOMC participants expect that the price index for personal consumption expenditures excluding food and energy (core PCE) will rise about 2 percent in 2006 and between 1¾ percent and 2 percent in 2007. ■

Economic Projections of Federal Reserve Governors and Reserve Bank Presidents for 2006 and 2007

Percent

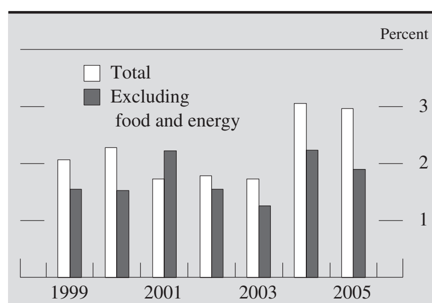
| Indicator | Memo: 2005 actual | 2006 | | 2007 | |
|---|---|---|---|---|---|
| | | Range | Central tendency | Range | Central tendency |
| *Change, fourth quarter to fourth quarter*[1] | | | | | |
| Nominal GDP | 6.2 | 5¼–6½ | 5½–6 | 5–6 | 5–5¾ |
| Real GDP | 3.1 | 3¼–4 | About 3½ | 3–4 | 3–3½ |
| PCE price index excluding food and energy | 1.9 | 1¾–2½ | About 2 | 1¾–2 | 1¾–2 |
| *Average level, fourth quarter* | | | | | |
| Civilian unemployment rate | 5.0 | 4½–5 | 4¾–5 | 4½–5 | 4¾–5 |

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

# *Economic and Financial Developments in 2005 and Early 2006*

The economic expansion remained firmly entrenched in 2005, although the growth of real GDP late in the year was apparently restrained by the effects of the hurricanes and by sharp drops in some volatile categories of spending. In the labor market, payroll employment rose moderately for a second year in a row, and the unemployment rate declined further. As in 2004, headline inflation was boosted appreciably by soaring energy prices; however, core inflation remained subdued. In 2005, financial market conditions were once again supportive of growth, with long-term market interest rates low and credit spreads and risk premiums narrow.

Change in PCE Chain-Type Price Index, 1999–2005



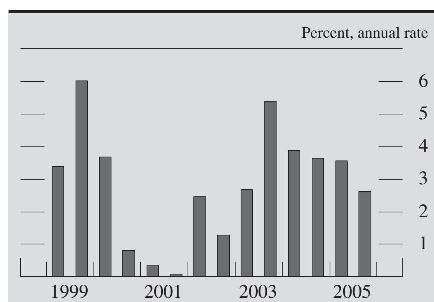

NOTE: The data are for personal consumption expenditures (PCE).
SOURCE: Department of Commerce, Bureau of Economic Analysis.

## The Household Sector

### Consumer Spending

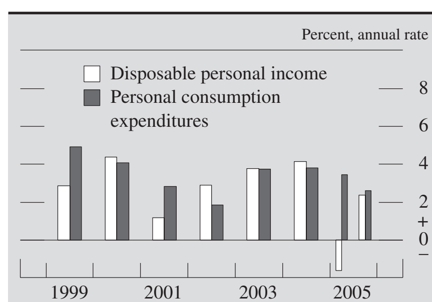
Consumer spending had gathered considerable steam in 2003 and 2004 and remained vigorous in 2005. Higher energy prices last year continued to siphon off household purchasing power, and short-term interest rates moved up; nevertheless, spending was again bolstered by an improving labor market and rising household wealth.

Change in Real GDP, 1999–2005




NOTE: Here and in subsequent charts, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Change in Real Income and Consumption, 1999–2005




SOURCE: Department of Commerce, Bureau of Economic Analysis.

Real personal consumption expenditures (PCE) had posted back-to-back increases of 3¾ percent in 2003 and 2004 and continued to rise at about that pace over the first three quarters of 2005; in the fourth quarter, PCE growth slowed to an annual rate of just 1 percent as consumer outlays for motor vehicles slackened after a surge prompted by last summer's "employee discount" programs. For 2005 as a whole, sales of light vehicles (cars, vans, sport-utility vehicles, and pickup trucks) totaled nearly 17 million units, about the same as the annual figure for 2004. Real spending on consumer goods other than motor vehicles was robust in 2005, with substantial gains almost across the board; a notable exception was real spending on gasoline, which was up only modestly for a second year in a row as prices at the pump soared. Real expenditures on services rose moderately in 2005, as a sizable further increase in outlays for medical care was partly offset by a relatively small gain in outlays for energy services.

Excluding the estimated effects of the one-time special dividend payment that Microsoft made in December 2004, disposable personal income (DPI)—that is, personal income less personal current taxes—rose about 1½ percent in real terms in 2005, considerably less than in 2003 and 2004. Although aggregate wages and salaries advanced moderately last year and some other major types of nominal income posted notable gains, the increases in real terms were eroded by the rise in energy prices. In addition, personal tax payments rose faster last year than did personal income as measured in the national income and product accounts (NIPA). In the second half of the year, the growth of real DPI was volatile, mainly because of the hurricanes. Rental income and proprietors' income were pulled down in the third quarter as a result of uninsured losses on residential and business property. Real DPI snapped back in the fourth quarter as income in these hurricane-affected categories rebounded from the exceptionally low levels in the third quarter.

Although the run-up in energy prices restrained the growth of real DPI in 2005, its effect on overall spending appears to have been largely offset by other factors. In particular, sharp increases in household wealth since 2002 have provided many households with the resources and inclination to sustain their spending through a period of relatively weak growth of real income. Household net worth, which typically feeds through to spending over several quarters, posted sizable gains in 2003 and 2004, and it rose further in 2005 as house values continued to climb and as stock prices moved modestly higher. At the end of the third quarter (the most recent period for which complete data on wealth are available), the ratio of household net worth to disposable income stood at 5.65, well above its long-run average level of 4.75. Meanwhile, surveys by the Michigan Survey Research Center (SRC) and the Conference Board suggest that, apart from the first few months after the hurricanes, consumer confidence was about at the favorable levels that had prevailed in 2004. All in all, personal outlays exceeded disposable income in 2005. As a result, the personal saving rate, which had dropped below 2 percent in 2004, fell further in 2005, ending the year at negative ½ percent.

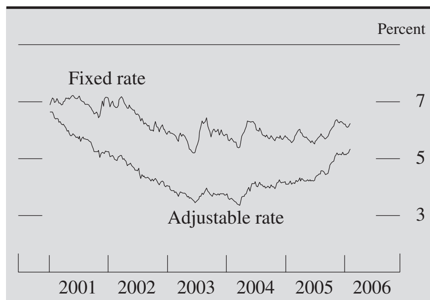
## Residential Investment

Activity in the housing sector remained torrid through much of 2005. By the end of the year, however, a few tentative signs of cooling had begun to appear. In the single-family sector, starts of new

units dipped in December after a string of exceptionally strong months; still, they totaled 1.7 million for the year as a whole—6½ percent above the already rapid pace in 2004. Starts in the multifamily sector totaled 350,000 in 2005, a pace similar to that of the preceding three years. Real expenditures on residential structures—which include outlays not only for new construction but also for additions and alterations as well as commissions paid to real estate agents—rose nearly 8 percent in 2005, the fourth large yearly increase in a row.

Sales of both new and existing homes set records in 2005, although they, like housing starts, seem to have lost some steam late in the year. Rates on thirty-year fixed-rate mortgages were in the neighborhood of 5¾ percent for much of the year, but they rose in the autumn. Since October, they have averaged close to 6¼ percent, at the upper end of the narrow range that has prevailed since 2003 but still fairly low by historical standards. Rates on adjustable-rate mortgages have been trending up since early 2004. The softening of home sales in recent months has contributed to an updrift in the stock of unsold new and existing homes. As of December, the stock of unsold new homes was equal to nearly five months of supply when measured at that month's sales pace. Between 1998 and 2004, the stock of unsold new homes had averaged about four months of supply.

Mortgage Rates, 2001–06




NOTE: The data, which are weekly and extend through February 8, 2006, are contract rates on thirty-year mortgages.
SOURCE: Federal Home Loan Mortgage Corporation.

Measures of house prices that attempt to control for shifts in the quality and composition of homes sold show that prices continued to rise rapidly through the third quarter of 2005, though partial data for the fourth quarter point to some slowing. Notably, the purchase-only version of the repeat-transactions price index for existing homes, which is published by the Office of Federal Housing Enterprise Oversight and tracks sales of the same houses over time, rose 11 percent over the year ending in the third quarter (the latest available data), once again outstripping the increases in household incomes and rents. The Census Bureau's constant-quality price index for new homes, which controls for changes in the composition of sales by geography, home size, and other readily observable characteristics, had also shown sizable increases through the third quarter, but it decelerated sharply in the fourth quarter and was up just 4¾ percent over 2005 as a whole; in 2004, this measure had risen 8½ percent.

## Household Finance

Household debt expanded about 10½ percent at an annual rate over the first three quarters of last year, roughly the same brisk pace as had been registered in 2004. Home-mortgage debt continued to grow rapidly, as homeowners took advantage of the further sizable increases in house prices last year. The use of alternative mortgage products spread further in 2005, in part because rising home values generally made house purchases less affordable. Last May federal regulators issued guid-

ance promoting sound risk-management practices to financial institutions with home equity lending programs. Mortgage-related borrowing likely took the place of some funding with consumer credit, which expanded only modestly again last year. Overall, the expansion in household debt outpaced the growth in disposable personal income, and the financial obligations ratio moved up to a level close to the peak that it had reached earlier this decade. However, the relatively low readings on most measures of loan delinquencies last year indicate that most households were not struggling to meet their obligations.

A large number of households filed for bankruptcy in the weeks leading up to October 17, the date when a new bankruptcy law took effect. The law was designed in part to diminish the ability of households to discharge their debts through chapter 7 filings. After the new law became effective, filings fell sharply to a level significantly below the average of recent years, and they have since remained low. This suggests that, to avoid the new rules, some households accelerated filings they would have undertaken eventually even under the old law. The spike in bankruptcies appears to have induced a jump in charge-offs of consumer loans in the fourth quarter.

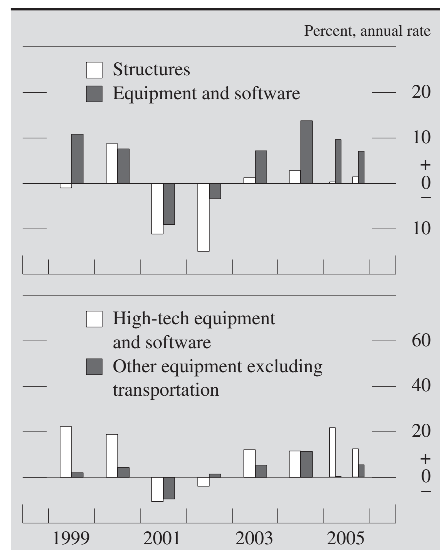
## The Business Sector

### Fixed Investment

Real business fixed investment rose 6½ percent in 2005. Real spending on equipment and software (E&S) posted an increase of more than 8 percent after rising nearly 14 percent in 2004. The broadly based growth in E&S spending last year was supported by favorable fundamentals: appreciable growth in final sales, ample financial resources in the corporate sector, and supportive conditions in financial markets.

Real investment in high-technology equipment rose 17 percent in 2005, as further declines in prices provided a substantial incentive for firms to step up their outlays on such items; the increase was 5 percentage points faster than in 2003 and 2004 and about in line with the average annual gain over the past twenty-five years. Spending on communications equipment was exceptionally strong last year, as telecom service providers rolled out major new fiber-optic systems and third-generation wireless gear. Business spending for computing equipment rose roughly 30 percent in real terms, a pace close to its historical average, while spending on software posted its largest increase in several years.

Change in Real Business Fixed Investment, 1999–2005




NOTE: High-tech equipment consists of computers and peripheral equipment and communications equipment.

SOURCE: Department of Commerce, Bureau of Economic Analysis.

Although aircraft investment remained depressed as domestic airlines continued to grapple with overcapacity and soaring fuel prices, the other major categories of E&S spending outside the high-tech area did well in 2005. Business outlays on motor vehicles rose markedly, with the demand for heavy trucks especially strong. Investment in equipment other than high-tech and transportation goods—a broad category that accounts for nearly half of E&S spending when measured in nominal terms—barely rose in real terms over the first half of 2005. Investment in this category sped up after midyear, to increase moderately over the year as a whole.

Apart from the drilling and mining sector, where investment has strengthened in response to higher energy prices, outlays for nonresidential construction have yet to gain much traction. Spending on office and commercial structures has been essentially flat since 2003; construction of manufacturing facilities leveled out in 2005 after having firmed in late 2004; and investment in the power and communications sector moved down further last year. However, vacancy rates have continued to reverse some of the run-up that occurred between 2000 and 2003, and some industry reports suggest that an upturn in building activity is in train.

## Inventory Investment

After having been exceptionally restrained earlier in the economic expansion, inventory investment picked up sharply in 2004, and the higher pace of accumulation extended into early 2005. The step-up in accumulation, which provided considerable impetus to industrial production for a time, brought stocks into better alignment with sales and set the stage for a subsequent downswing in inventory investment. Inventories in the motor vehicle sector were drawn down in both the second and third quarters, though accumulation resumed in the fourth quarter after last summer's surge in sales cleared out dealers' lots. Apart from motor vehicles, real stockbuilding slowed sharply over the course of the year and, according to the advance NIPA estimate, came to a halt in the fourth quarter. At year-end, inventories seemed to be in reasonable alignment with sales, even taking into account the downward trend in inventory-sales ratios that has resulted from the ongoing improvement in supply-chain management.

## Corporate Profits and Business Finance

With profits posting further solid gains in 2005 and ample liquid assets on corporate balance sheets, nonfinancial businesses were able to finance much of their capital expenditures out of internal funds, pay record sums to shareholders in the form of share buybacks, and still maintain strong balance sheets. Nonetheless, elevated merger and acquisition activity and the considerable rise in share buybacks boosted the pace of business borrowing. Short-term borrowing rose significantly, driven by financing from banks. The issuance of long-term debt remained moderate overall, but debt related to commercial mortgages continued to expand rapidly. Indicators of corporate credit quality generally remained favorable.

Corporate profits continued to grow strongly in 2005. The ratio of before-tax profits of domestic nonfinancial corporations to that sector's gross value added rose to more than 12 percent, near its 1997 peak. Gains in earnings were fairly widespread, with profits in the petroleum and gas industries especially strong. In the fourth quarter of 2005,

operating earnings per share for S&P 500 firms appear to have been nearly 14 percent above their level four quarters earlier.

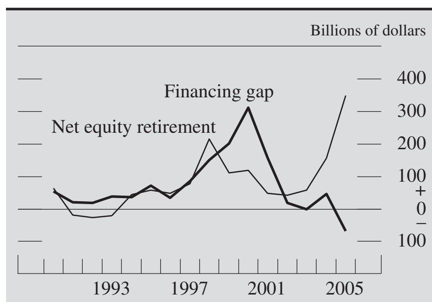
Gross equity issuance remained modest in 2005, while net equity issuance sank into deeply negative territory as corporations retired shares at a rapid pace. Both a jump in cash-financed mergers and a record-setting level of share repurchases were spurred by the strong growth of profits as well as by the substantial liquidity that firms had built up in recent years.

Net corporate bond issuance was subdued in 2005, as modest growth in nominal capital expenditures, strong cash positions, and robust profits apparently limited the demand for such financing. However, commercial-mortgage debt grew rapidly last year. Gross issuance of commercial-mortgage-backed securities likely reached a record pace in the fourth quarter.

Short-term borrowing by businesses rose smartly in 2005, as business lending by both large and small commercial banks surged. Throughout the year, respondents to the Senior Loan Officer Opinion Surveys indicated that their institutions had further eased standards and terms for lending to businesses and that the demand for such loans had continued to strengthen. Most respondents attributed the stronger demand to borrowers' increased need to finance inventories, accounts receivable, and investment in plant and equipment; a substantial fraction of respondents to some surveys also pointed to a pickup in merger and acquisition activity. By contrast, outstanding commercial paper declined last year.

Readings on credit quality for nonfinancial companies generally remained favorable in 2005 despite some pockets of distress. The amount of corporate debt that was downgraded by Moody's Investors Service last year exceeded the amount that was upgraded, mainly as a result of the high-profile downgrades of the debt of General Motors and Ford. After trending down over the first three quarters of last year, the six-month trail-

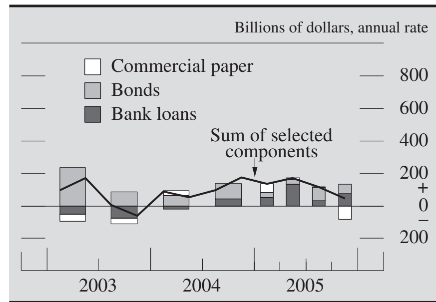
Financing Gap and Net Equity Retirement at Nonfinancial Corporations, 1990–2005




Note: The data are annual; the observations for 2005 are based on partially estimated data. The financing gap is the difference between capital expenditures and internally generated funds. Net equity retirement is the difference between equity retired through share repurchases, domestic cash-financed mergers, or foreign takeovers of U.S. firms and equity issued in public or private markets, including funds invested by venture capital partnerships.

Source: Federal Reserve Board, flow of funds data.

Selected Components of Net Financing for Nonfinancial Corporate Businesses, 2003–05




Note: The data for the components excluding bonds are seasonally adjusted. The data for the sum of selected components are quarterly; 2005:Q4 is estimated.

Source: Federal Reserve Board; Securities Data Company; and Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

ing bond default rate moved up in the fall, most notably because of the bankruptcies of Delta Air Lines, Northwest Airlines, Delphi, and Calpine. However, these bankruptcies were widely anticipated and had little effect on other measures of aggregate credit quality. The credit quality of commercial mortgage debt also appeared to remain robust during 2005; delinquency rates on commercial mortgages held by banks and on those pooled into securities trended down on balance over last year, while delinquencies on mortgages held by insurance companies remained low.

## The Government Sector

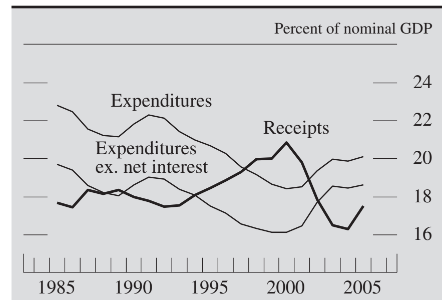
### Federal Government

The deficit in the federal unified budget narrowed appreciably in fiscal year 2005. Although outlays continued to rise rapidly, receipts rose even faster; as a consequence, the deficit fell to $318 billion, roughly $100 billion less than the deficit in fiscal 2004. The latest projections from the Administration and the Congressional Budget Office, however, point to a deterioration in the unified budget position in fiscal 2006, in part because of the start of the Medicare drug benefit and the need to pay for post-hurricane reconstruction and relief.

Nominal federal spending rose nearly 8 percent in fiscal 2005 and stood at about 20 percent of GDP—virtually the same as in 2003 and 2004 but 1½ percentage points above the recent low in fiscal 2000. Defense spending rose 8½ percent after three years of double-digit increases; outlays for nondefense discretionary programs moved up further as well, in part because of higher spending for education and for disaster relief. (Spending on disaster relief in fiscal 2005, which ended on September 30, was primarily for needs that emerged before Hurricane Katrina.) As for the major health programs, Medicare outlays continued to climb. Medicaid spending rose relatively slowly, mainly because it had been boosted during much of fiscal 2004 by the temporary increase in the federal share of the program's costs included in the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). Net interest payments, which had declined steadily from 1998 to 2003 and had increased only moderately in 2004, were up significantly in fiscal 2005 as short-term interest rates rose. Thus far in fiscal 2006, outlays have continued to rise rapidly, in part because of heavy spending for flood insurance payouts and other hurricane-related disaster relief. According to the NIPA, real federal expenditures on consumption and gross investment, the part of government spending that is a component of real GDP, increased 1¼ percent over the four quarters of calendar year 2005.

Federal receipts rose 14½ percent in fiscal 2005; as a ratio to GDP, they stood at 17½ percent—more than 1 percentage point higher than in 2004. Cor-

Federal Receipts and Expenditures, 1985–2005




Note: The receipts and expenditures data are on a unified-budget basis and are for fiscal years (October through September); GDP is for the four quarters ending in Q3.

Source: Office of Management and Budget.

porate payments rose nearly 50 percent, lifted by the robust profits of 2004 and 2005 and the termination of the partial-expensing tax incentive at the end of calendar 2004. Individual income taxes increased nearly 15 percent; nonwithheld taxes rose especially rapidly because of both substantial strength in nonwage taxable incomes (including capital gains) and certain features of JGTRRA that altered the timing of tax payments in a way that temporarily reduced the level of collections in 2004. Social insurance taxes rose in line with wages and salaries.

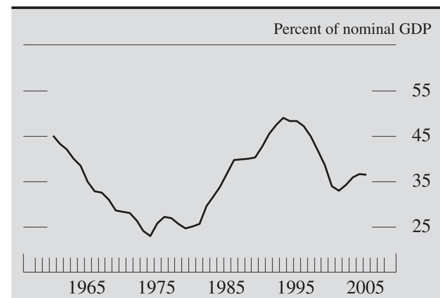
Mirroring the narrowing of the unified deficit, federal saving (essentially, the unified surplus or deficit adjusted to conform to the accounting practices followed in the NIPA) improved from negative 3½ percent of GDP in calendar 2004 to negative 2½ percent in the first half of 2005. However, the beneficial effect of the smaller deficit in terms of national saving was essentially offset by a sharp decline in personal saving. Measured net of estimated depreciation, national saving in the first half of 2005 was equal to just 1½ percent of GDP, about the same as in 2004 and well below the recent highs of more than 6 percent of GDP in the late 1990s. In the third quarter, net saving was dragged down by sizable hurricane-related reductions in both federal and nonfederal net saving; excluding these one-time factors, net saving in the third quarter would have been roughly the same as it was in the first half of the year. If not reversed over the longer haul, persistent low levels of saving will necessitate either slower capital formation or continued heavy borrowing from abroad, either of which would hamper the ability of the nation to cope with the retirement needs of the baby-boom generation and would retard the growth of the standard of living.

## Federal Borrowing

Borrowing by the Treasury moderated somewhat in calendar year 2005—federal debt rose 7 percent last year after increasing 9 percent in 2004. Much of the improvement reflected the surge in tax receipts noted earlier. As a result, the amount of Treasury bills outstanding contracted on net in 2005, and Treasury sales of coupon securities declined. As was widely anticipated, the Treasury announced in August that it would resume regular semiannual issuance of a thirty-year nominal bond. The first such auction, held on February 9, 2006, was well received, with a high level of participation from indirect bidders. The Treasury expects issuance of the thirty-year bond to help stabilize the average maturity of outstanding marketable Treasury debt, which declined from a high of about seventy months at the end of 2000 to fifty-three months at the end of 2005.

Federal debt held by the public as a percentage of nominal GDP was steady during 2005 and stood at about 36 percent at the end of the third quarter. The federal debt ceiling did not need to be

Federal Government Debt Held by the Public, 1960–2005




NOTE: The final observation is for 2005:Q3. For previous years, the data for debt are as of year-end, and the corresponding values for GDP are for Q4 at an annual rate. Excludes securities held as investments of federal government accounts.

SOURCE: Federal Reserve Board, flow of funds data.

raised last year, but the Treasury has announced that it expects that the debt will reach its statutory ceiling in February 2006.

The appetite for Treasury securities among foreign investors remained strong in the aggregate in 2005. The proportion of outstanding Treasury securities held by foreign investors is estimated to have climbed to slightly more than 45 percent in the third quarter of 2005, a record. Data from the Treasury International Capital reporting system suggest that net purchases of Treasury securities by foreign private investors jumped last year, whereas such purchases by foreign official institutions slowed significantly amid upward pressure on the foreign exchange value of the dollar.

## State and Local Governments

The fiscal positions of state and local governments continued to improve in 2005. Strong growth in income and retail sales boosted revenues, as did rising property values. And although the sector continued to grapple with higher medical costs and pressures to restore funding to programs that had been cut back earlier in the decade, states and localities generally kept a tight rein on current outlays. On a NIPA basis, net saving by state and local governments—which is broadly similar to the surplus in an operating budget—turned positive in the first half of 2005 after having been negative between 2002 and 2004, and it would have remained positive in the third quarter in the absence of the hurricanes. The sizable revenue gains reported by many states in fiscal 2005, which ended on June 30 in all but four states, appear to have extended into fiscal 2006. Even so, some governments are still struggling with strained fiscal situations, and some face significant structural imbalances in their budgets that likely will be exacerbated in coming years by the need to provide pensions and health care to a growing number of retired employees. In addition, the jurisdictions in the Gulf Coast region confront the dual challenge of substantial post-hurricane demands and diminished flows of tax revenues.

According to the NIPA, real expenditures on consumption and gross investment by state and local governments rose 1¼ percent in 2005. Real outlays for current consumption were up only about 1 percent for a second year, in part because of the relatively slow pace of hiring. Real investment expenditures also registered a small gain.

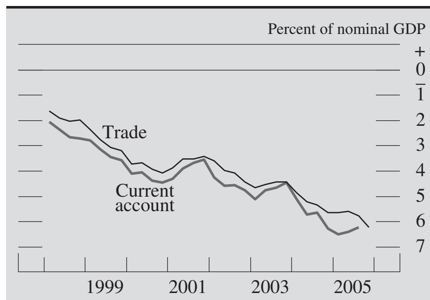
## State and Local Government Borrowing

Borrowing by state and local governments picked up in 2005. Gross issuance of municipal securities was brisk, as the relatively low level of longer-term market interest rates spurred advance refundings of outstanding securities. The bulk of new capital issues last year reportedly was earmarked for education-related projects. Credit quality in the state and local sector generally remained favorable in 2005. Notable exceptions were the obligations of numerous municipal issuers in Michigan, which were downgraded last year largely as a consequence of the difficulties of GM and Ford. In addition, the obligations of a number of issuers in the regions that were hit by last year's hurricanes were downgraded in the fourth quarter, and some bonds from these areas remain on watch. Despite these isolated troubles, rating upgrades of municipal bonds slightly outpaced downgrades in 2005.

## The External Sector

The U.S. current account deficit widened further in 2005. At an annual rate, it came in at just under $800 billion, or about 6¼ percent of nominal GDP, in the first three quarters (the latest available data). As in the past, a substantial portion of the widening of the current account deficit came from a larger deficit on trade of goods and services, but a decrease in net investment income also worsened the external account. Net investment income edged into negative territory in the second quarter of 2005 for the first time in the post-World War II period. Unilateral transfer payments to foreigners dropped sharply on net in the third quarter because of a surge in receipts from foreign insurance companies for damage caused by the hurricanes, leading to a slight narrowing of the deficit from the previous quarter. The trade data through December showed that the U.S. trade deficit widened further in the fourth quarter of 2005, to about $790 billion at an annual rate. This increase suggests that the fourth-quarter current account deficit, yet to be reported, will also widen substantially.

U.S. Trade and Current Account Balances, 1998–2005




NOTE: The data are quarterly. The current account data extend through 2005:Q3, and the trade data extend through 2005:Q4.

SOURCE: Department of Commerce.

### International Trade

Real exports of goods and services continued the solid pace of expansion registered in both 2003 and 2004; they rose an estimated 5¾ percent in 2005, supported by robust foreign economic activity. Export growth was rapid in the first half of the year, spurred by the depreciation of the dollar in previous years; it then slowed in the second half of the year, in part owing to the dollar's appreciation since the beginning of 2005. For the year as a whole, exports of capital goods posted solid growth. Exports of aircraft performed especially well despite an interruption of their production in September because of a strike at Boeing. Exports of industrial supplies were hampered late in the year by the effects of the hurricanes on production and shipping in the Gulf Coast region. By destination, exports to Canada and Mexico grew rapidly in 2005, those to Western Europe also increased, but exports to Japan were relatively weak. Exports of services rose about 3 percent in 2005 in real terms.

Prices of exported goods increased at an annual rate of 2¾ percent in 2005, a bit below the rate of increase in 2004. Prices decelerated in the second and third quarters as the dollar strengthened and as pressures on prices of agricultural exports and other nonfuel commodities ebbed. Prices accelerated again in the fourth quarter, when a sharp rise in the prices of oil and metals drove up prices for many nonagricultural industrial supplies.

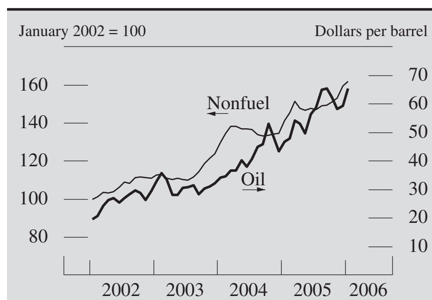
After expanding at a double-digit pace in 2004, real imports of goods and services decelerated to about 4½ percent in 2005, even as U.S. GDP growth remained robust. Although overall growth of non-oil imports was slower last year than in 2004, capital goods imports continued strong. The hurri-

canes affected several categories of imports. Despite a contraction of domestic oil consumption, real imports of oil expanded to offset reduced production in the Gulf Coast region. Chemicals imports also registered strong gains toward year-end amid hurricane-related losses in domestic production. Real imports of services moved up only 2¼ percent in 2005, a substantial cooling from their 2004 pace.

Prices of imported goods excluding oil and natural gas increased at an annual rate of 1½ percent in 2005, down from a rate of 2¾ percent in 2004. Prices decelerated in midyear as the dollar appreciated and nonfuel commodity prices steadied. However, import prices accelerated in the fourth quarter of 2005, led by higher prices for chemicals, metals, and building materials. In global commodity markets, prices of metals increased an average of 30 percent in 2005, a surge that reflected both robust global demand and limited increases in supply.

A key event in 2005 was the substantial increase in the price of crude oil. The spot price of West Texas intermediate (WTI) crude oil climbed from about $43 per barrel at the start of 2005 to a peak of about $70 per barrel in late August, at the time of Hurricane Katrina. The spot price then edged down as production revived in the Gulf of Mexico and as above-average temperatures in the United States reduced oil demand. After falling to below $60 per barrel by late November, oil prices moved up to an average of about $65 per barrel for January, in part on concerns about possible disruptions of foreign supply. However, oil prices have declined so far in February. Growing conviction among traders that oil-market conditions would remain tight in future years pushed the price of the far-dated NYMEX oil futures contract (currently for delivery in 2012) from an average of $38 per barrel for January 2005 to about $61 per barrel for January 2006.

Prices of Oil and of Nonfuel Commodities, 2002–06




NOTE: The data are monthly and extend through January 2006. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices.

SOURCE: For oil, the Commodity Research Bureau; for nonfuel commodities, International Monetary Fund.

Although the rate of growth in world oil consumption slowed in 2005 from its torrid pace of 2004, spare production capacity among OPEC members remained limited, at an estimated level of only about 1 million barrels per day. With the perception that additional capacity would be slow to come on line, oil markets were highly sensitive to news about fluctuations in supply and demand. Market participants' concerns about crude oil supply were heightened by production difficulties in Iraq and by the resumption of nuclear activities in Iran, both posing risks to the stability of Middle East supply. Elsewhere, production problems in Nigeria stemming from social unrest and a marked slowdown in the growth of Russian production also kept upward pressure on oil prices throughout the year.

Domestic crude oil supply was severely hampered by last year's hurricanes, which were the most damaging in the history of the U.S. energy industry. At the peak of the disruption, all U.S.

crude oil production in the Gulf of Mexico (about 28 percent of total U.S. production) and 88 percent of U.S. natural gas production there (about 17 percent of total U.S. production) were shut in. At the end of January 2006, 25 percent of Gulf oil production remained shut in, and cumulative lost production in the Gulf stood at about 22 percent of the average annual output from that region. Refinery outages, which peaked after Hurricane Rita at more than one-fourth of total U.S. refining capacity, caused sharp increases in the prices of refined products. Retail gasoline prices in the United States jumped to more than $3 per gallon in early September, briefly crimping gasoline demand and, in turn, demand for crude oil. Petroleum product prices returned to pre-hurricane levels within a few weeks as imports soared and refineries resumed operations, but they began to rise again in December and January.

### The Financial Account

In 2005, foreign official financial inflows slowed from their extraordinary pace of 2004 but remained sizable. Most of these official inflows took the form of purchases of U.S. long-term government and private securities for reserve accumulation, primarily by Asian central banks. The slowdown in foreign official inflows last year was more than offset, however, by an increase in foreign private purchases of U.S. securities. Most of this pickup was concentrated in bonds, as in 2004, but foreign private purchases of U.S. equities also increased somewhat. Foreign direct investment flows into the United States continued to be strong in 2005, with the average pace during the first three quarters a bit higher than in 2004.

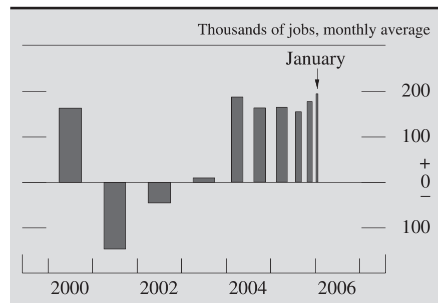
U.S. residents' net purchases of foreign securities remained brisk last year, near the levels recorded in 2003 and 2004, with smaller purchases of foreign bonds offset by larger purchases of foreign equities. By contrast, U.S. direct investment flows abroad slowed markedly during the first half of 2005 and turned negative in the third quarter. This unusual pattern reflected responses to the partial tax holiday provided in the 2004 Homeland Investment Act, which allowed firms to repatriate at a preferential tax rate previous years' earnings that had been reinvested in their foreign affiliates.

## The Labor Market

### Employment and Unemployment

Conditions in the labor market continued to improve, on balance, in 2005, although many individuals lost jobs in the aftermath of the hurricanes. Nonfarm payroll employment rose 175,000 per month, on average, through August, the same as the average monthly increase in 2004. Net hiring then slowed sharply in September and October, as job losses in the Gulf Coast region largely offset moderate increases in payrolls elsewhere in the nation. In November and December, monthly job growth

Net Change in Payroll Employment, 2000–06




NOTE: Nonfarm business sector.
SOURCE: Department of Labor, Bureau of Labor Statistics.

was uneven, but it averaged 250,000, and hiring remained brisk in January. The reemployment of many of those who lost jobs because of the hurricanes appears to have provided a modest lift to overall hiring in recent months. However, others affected by the storms apparently have not found new jobs yet, and the unemployment rate among evacuees seems to have remained quite high.

Employment gains were widespread by industry in 2005. As in 2004, hiring was especially strong at firms supplying professional and business services and in health care. The construction industry also continued to exhibit a good deal of vigor, spurred by the booming housing sector. Employment in retail trade and in food services rose fairly briskly in the first half of the year, but it was held down in the second half by job losses in the Gulf Coast region. In the manufacturing sector, employment was essentially flat for a second year after three years of steep declines. In the government sector, state and local payrolls continued to rise modestly, while civilian employment in the federal government was about unchanged.

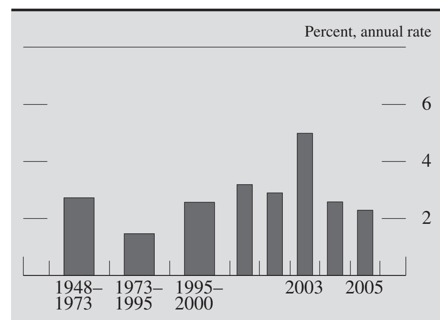
After hovering around 5½ percent during the second half of 2004, the unemployment rate fell, on net, over the first three months of 2005. During the remainder of the year, it fluctuated in a narrow range around 5 percent. In January 2006, it decreased to 4.7 percent. The labor force participation rate, which had dropped noticeably between 2000 and 2004, edged up, on net, in 2005. The participation rate in January 2006 was 66 percent, well below the high of 67¼ percent reached in early 2000 but not far from its trend, which has been declining in recent years as a consequence of demographic forces.

Other indicators also pointed to a gradual improvement in labor market conditions over the course of 2005. Initial claims for unemployment insurance drifted lower, and the job openings rate moved up. At year-end, the Conference Board reported that a larger proportion of respondents to its monthly survey thought that jobs were plentiful than thought that jobs were hard to get.

## Productivity and Labor Costs

Labor productivity in the nonfarm business sector continued to advance in 2005. Last year's increase in output per hour of 2¼ percent was noticeably below the average annual gain over the preceding four years. But taking the longer view, growth in labor productivity over the past five years has averaged 3¼ percent per year, nearly ¾ percentage point faster than the already impressive gains posted between 1995 and 2000. Productivity appears to have received considerable impetus in recent years from a number of factors, including the rapid pace of technological change and the growing ability of firms to use information and other technology to improve the efficiency of their operations. Increases in the amount of capital per worker, especially high-tech capital, have also helped to spur productivity

Change in Output per Hour, 1948–2005




Note: Nonfarm business sector.
Source: Department of Labor, Bureau of Labor Statistics.

growth over the past few years, although apparently by less than was the case during the capital spending boom in the late 1990s.

Increases in hourly labor compensation were moderate in 2005 even though overall consumer prices rose relatively rapidly for a second year and the downward pressure on wages from labor market slack diminished. As measured by the employment cost index (ECI) for private nonfarm businesses, hourly compensation increased 3 percent last year, ¾ percentage point less than in 2004. The wages and salaries component of the ECI rose just 2½ percent, the same as in 2004, while the cost of providing benefits rose 4 percent after two years of increases in the area of 6½ percent to 7 percent. Much of the deceleration in benefits costs was in employers' contributions to retirement plans, which had increased markedly in 2003 and 2004 as firms ratcheted up their contributions to defined-benefit plans to cover earlier declines in the market value of the plans' assets. Health insurance costs rose 6½ percent in 2005, the smallest increase since the late 1990s.

According to preliminary data, compensation per hour in the nonfarm business (NFB) sector—an alternative measure of compensation developments derived from the data in the NIPA—rose 3¼ percent in 2005, about the same rise as in the ECI. In 2004, NFB compensation had risen nearly 6 percent; a fourth-quarter surge in the value of stock option exercises, which are excluded from the ECI, likely contributed to that increase. The preliminary estimate for NFB compensation in 2005 reflects the apparent reversal of some of the late-2004 upswing in compensation, though it is subject to revision when more-detailed information becomes available later this year. In any event, the deceleration in hourly compensation last year held the increase in unit labor costs to 1 percent. Unit labor costs had risen more than 3 percent in 2004 after having been close to flat over the preceding three years.

## Prices

Headline inflation continued to be boosted by soaring energy prices in 2005, while core inflation—which excludes the direct effects of movements in food and energy prices—remained subdued. The PCE chain-type price index rose 3 percent for the second year in a row. The increase in core PCE prices, which in 2004 had ticked up to 2¼ percent, remained high in early 2005 by recent standards. Core PCE inflation subsequently subsided and came in a shade below 2 percent for the year as a whole. The market-based component of the core PCE price index—which excludes prices that must be imputed because they cannot be observed in market transactions and that often move erratically—rose 1¾ percent in 2005, unchanged from its pace in 2004.

Alternative Measures of Price Change, 2003–05

Percent

| Price measure | 2003 | 2004 | 2005 |
|---|---|---|---|
| *Chain-type* | | | |
| Gross domestic product (GDP) | 2.0 | 2.9 | 3.0 |
| Gross domestic purchases | 2.0 | 3.4 | 3.4 |
| Personal consumption expenditures (PCE) | 1.7 | 3.1 | 3.0 |
| Excluding food and energy | 1.3 | 2.2 | 1.9 |
| Market-based PCE excluding food and energy | 1.0 | 1.7 | 1.7 |
| *Fixed-weight* | | | |
| Consumer price index | 1.9 | 3.4 | 3.7 |
| Excluding food and energy | 1.2 | 2.1 | 2.1 |

NOTE: Changes are based on quarterly averages of seasonally adjusted data.

SOURCE: For chain-type measures, Department of Commerce, Bureau of Economic Analysis; for fixed-weight measures, Department of Labor, Bureau of Labor Statistics.

A similar pattern is evident in the core consumer price index, which rose about 2 percent in both 2004 and 2005, and in broad NIPA price measures such as the price index for GDP, which was up about 3 percent in both years.

The PCE price index for energy rose roughly 20 percent in 2005 for the second year in a row. The nearly 25 percent increase in gasoline prices in 2005 largely reflected the effects of the continuing surge in crude oil prices on retail energy prices. Gasoline prices recorded some dramatic spikes—notably in the spring and after the hurricanes—when disruptions at refineries depleted inventories and pushed up the margin of the retail price over the already-elevated cost of the associated crude oil. After peaking at more than $3 per gallon in early September, gasoline prices fell sharply over the balance of 2005 as demand moderated, refinery capacity in the Gulf Coast region came back on line, and imports surged. In January 2006, gasoline prices turned up in response to higher crude oil costs, and they are now running about 50 cents per gallon higher than they were in January 2005.

Consumer prices for natural gas rose more than 35 percent in 2005, with most of the increase coming in the second half of the year. Prices started to move up around midyear and then skyrocketed in September and October after Hurricanes Katrina and Rita curtailed production in the Gulf of Mexico. Most of the shut-in production was restored by late 2005, and inventories remained ample for a normal heating season, but spot natural gas prices held at elevated levels through mid-December. They have since plummeted in response to unseasonably warm weather in much of the nation but are still far above their levels of a year ago. Reflecting higher input costs, PCE electricity prices rose 10 percent in 2005 after a much smaller rise in 2004.

Consumer food prices rose about 2 percent in 2005 after slightly larger increases in 2003 and 2004. Food prices received some upward pressure late in the year. Crop damage from Hurricane Wilma temporarily pushed up the prices of some fruits and vegetables, and beef prices were boosted by the resumption of some exports to Pacific Rim countries after the lifting in early December of an extended ban (which was subsequently reinstated in January 2006). But, in general, the higher production of several livestock products and a bumper harvest of grains helped to limit increases in retail food prices to about the rate of core inflation.

The broad contours of core inflation in 2005 were about the same as those in 2004. Prices of core goods, which had declined in 2002 and 2003, were about flat for a second year. Prices of core services decelerated a bit—from about 3 percent in 2004 to 2¾ percent in 2005. The deceleration was concentrated in some nonmarket categories—in particular, prices of financial services provided by banks without explicit charge, foreign travel by U.S. residents, and life and motor vehicle insurance—that had posted large increases in 2004. With the notable exception of airfares, which picked up in 2005 after having fallen in 2004, prices in other market-based categories of services rose about as fast as they had in 2004.

The run-up in energy prices in 2005 boosted the cost of producing other goods and services—especially for energy-intensive items, including chemicals, plastics, and nitrogenous fertilizers. In addition, prices of other commodities such as lumber and a variety of metals, which had soared in 2004 in response to the strengthening of economic activity worldwide, moved up

further in early 2005. Many of those prices slackened in the spring and summer as industrial production softened, but they turned up again in the fall. All told, however, the higher input costs left only a small mark on the prices of core goods and services. A major reason is that the robust upward trend in labor productivity helped to hold labor costs in check and gave firms scope to absorb cost increases.

Near-term inflation expectations have come under some upward pressure over the past year, but recent readings have been close to those at the beginning of 2005. Apart from an energy-related spurt to 4½ percent in early autumn, the Michigan SRC measure of households' median expectation for inflation over the next twelve months has been in the neighborhood of 3 percent to 3¼ percent since March 2005 after hovering in the area of 2¾ percent to 3 percent in late 2004 and early 2005. In January 2006, it stood at 3 percent. The Michigan SRC measure of the median expectation for inflation over the next five to ten years was also running a bit above 3 percent in late 2005, but it dipped to 2.9 percent in January of this year, a reading similar to those in 2004 and in the first eight months of 2005. Other indicators likewise suggest that longer-run inflation expectations have remained well contained. According to the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years remained at 2½ percent in 2005, as they have since 1998. In addition, inflation compensation, as measured by the spread of yields on nominal Treasury securities over their inflation-protected counterparts, fell a bit, on balance, in 2005.

## U.S. Financial Markets

U.S. financial markets withstood some strains in 2005, most notably a large cumulative upward revision to the expected path of monetary policy, sharp increases in energy prices, troubles in the auto and airline sectors, and three major hurricanes. Longer-term market interest rates remained low, corporate risk spreads stayed relatively narrow by historical standards, and equity prices advanced modestly. Banks continued to ease standards and terms on loans to businesses, and bank lending to businesses surged. Overall, debt growth in the business sector picked up, and the expansion of household debt remained quite brisk, but federal borrowing dropped back. The M2 monetary aggregate grew moderately.

### Interest Rates

The FOMC lifted the target federal funds rate a total of 2 percentage points in 2005, nearly 1 percentage point more than market participants had anticipated at the start of the year. Over the first half of 2005, short- and intermediate-term interest rates rose in line with the gradual firming in the stance of monetary policy, but longer-term interest rates moved lower on balance. For a time early in the year, rising oil prices and incoming data showing higher-than-expected inflation appeared to lift policy expectations as well as interest rates at intermediate- and longer-term horizons. The minutes of the December 2004 FOMC meeting, released on January 4, 2005, and the FOMC's conditioning of its risk assessment on "appropriate monetary policy action" after its March 2005 meeting were read as indicating more concern among Committee mem-

bers about inflation pressures than investors had anticipated. The ten-year Treasury yield moved up after Chairman Greenspan's semiannual congressional testimony in February 2005, as investors reportedly focused on his remark that the low level of long-term interest rates at that time was a "conundrum." However, the subsequent release of weaker-than-expected data on consumer spending, consumer sentiment, and output led investors to mark down again their anticipated path for monetary policy and caused intermediate-term Treasury yields to retreat somewhat on balance during the second quarter, while the ten-year Treasury yield declined sharply.

On balance over the second half of the year, investors became more confident that the economic expansion had substantial momentum, and the expected path of policy and nominal Treasury yields moved considerably higher. Economic data that came in over the summer months suggested more strength in spending and output than investors had been anticipating. However, in response to the devastation caused by Hurricane Katrina in August and the subsequent landfall of two additional major storms, investors marked down sharply their expectations for the path of monetary policy, predominantly at longer horizons, and nominal Treasury yields dipped. Those declines in yields proved temporary, though, as incoming data in the weeks after the hurricanes indicated that output had been expanding briskly before the storms hit and that the resulting disruptions to economic activity would probably be less severe than investors had initially feared. In addition, a drop in some energy prices might have contributed to an upgrading of the economic outlook. Over the remaining three months of the year, data on spending and production generally appeared robust, and investors raised their expectations for the path of monetary policy a bit more.

Interest Rates on Selected Treasury Securities, 2003–06

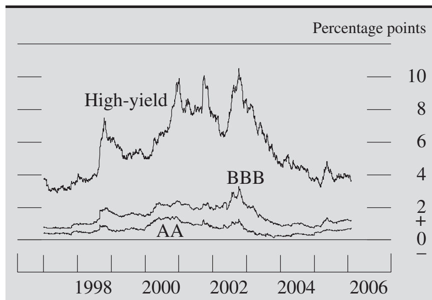
NOTE: The data are daily and extend through February 8, 2006.
SOURCE: Department of the Treasury.

On net in 2005, the yield on the two-year nominal Treasury note rose about 135 basis points, whereas the yield on the ten-year Treasury note increased only about 15 basis points. As a result, longer-horizon forward rates extended their decline that had begun around the middle of 2004, the onset of the current tightening cycle. Although the reasons for this large cumulative drop are not entirely clear, this general pattern was also evident last year in other major industrialized economies, where longer-term interest rates mainly declined. One possibility is that higher energy prices might have led investors to trim their assessment of the cumulative amount of monetary policy restraint required over the longer run that would be consistent with sustainable economic growth. Investors also appeared to become less uncertain about the outlook and so might have become more willing to accept smaller risk premiums on long-term securities. Another possible expla-

nation is that long-term inflation expectations have fallen and have become more firmly anchored. As measured by the spread between yields on nominal Treasury securities and their inflation-protected counterparts, inflation compensation fell a bit more than 30 basis points at the ten-year horizon over 2005. Finally, it is possible that an excess of global saving over planned investment has lowered real longer-term interest rates.

In the corporate bond market, risk spreads widened modestly in 2005, but the generally healthy state of corporate balance sheets and the robust growth of profits kept spreads low by historical standards. Spreads in the auto sector were an exception, however, as the troubles that emerged in the spring at GM and Ford and the bankruptcy of Delphi last fall boosted spreads sharply in this sector. The bankruptcies of two major airlines and the revelation of apparent accounting fraud at Refco, a large derivatives broker, did not appear to have a material effect on broad corporate risk spreads.

Spreads of Corporate Bond Yields over Comparable Off-the-Run Treasury Yields, 1997–2006




Note: The data are daily and extend through February 8, 2006. The high-yield index is compared with the five-year Treasury yield, and the BBB and AA indexes are compared with the ten-year Treasury yield.

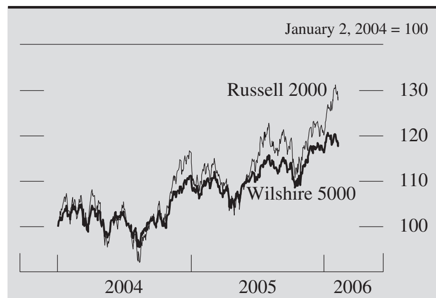
Source: Merrill Lynch AA and BBB indexes and Merrill Lynch Master II high-yield index.

To date in 2006, amid uneven incoming economic data, investors' expectations for the path of the target federal funds rate have edged up, as have intermediate- and longer-term nominal Treasury rates. However, spreads on investment-grade corporate securities have changed little, whereas those on speculative-grade issues have declined somewhat.

## Equity Markets

Share values, as measured by the Wilshire 5000 index, rose about 4½ percent in 2005. Higher energy prices and expectations for tighter monetary policy damped equity prices at times during the year, but these downward pressures were offset by continued strong corporate earnings growth and largely upbeat news on the economy. The response of stock prices to the hurricanes was generally muted—low longer-term interest rates and the prospect of additional fiscal stimulus apparently offset concerns that yet-higher energy prices might trim economic growth. On net last year, energy-related stocks registered substantial gains in response to the rise in the price of oil. To date in 2006, major equity indexes have risen modestly amid

Stock Price Indexes, 2004–06




Note: The data are daily and extend through February 8, 2006.

Source: Frank Russell Company; Dow Jones Indexes.

largely positive news about fourth-quarter earnings.

Volatilities of equity prices implied by prices on options contracts on both the S&P 500 and Nasdaq 100 indexes remained low over most of 2005, apparently owing to perceptions of only modest near-term macroeconomic risk. However, the spread between the twelve-month forward earnings–price ratio for S&P 500 firms and an estimate of the real long-term Treasury yield—a measure of the long-term equity risk premium—widened a bit last year and is now in the upper part of its range of the past two decades. Arithmetically, the widening in this spread can be attributed to a decline in the measure of the real long-term Treasury yield; the measure of the earnings yield on the S&P 500 changed little on balance last year.

## Debt and Financial Intermediation

The total debt of the domestic nonfinancial sectors expanded an estimated 9 percent in 2005, about the same pace as in 2004. However, the composition of debt growth differed somewhat from the previous year: Borrowing by nonfinancial businesses picked up in 2005 while federal borrowing dropped back. The growth of debt of the household sector remained brisk, driven by the rapid expansion of mortgages.

Commercial bank credit expanded 10½ percent in 2005, a bit faster than the brisk pace registered in 2004. Growth of commercial and industrial loans jumped to 13½ percent, the fastest pace in more than two decades. As noted, senior loan officers reported in quarterly surveys that they had eased terms and standards on such loans last year. They attributed the easing to an improved economic outlook and more-aggressive competition from other banks and nonbank lenders. They also reported that loan demand had strengthened. Real estate lending by banks was brisk again last year, though it cooled somewhat in the fourth quarter in the wake of the backup in longer-term interest rates. Consumer loans on banks' books expanded rapidly during the first quarter of 2005 but then less so over the balance of the year, in part because some households substituted lower-cost mortgage credit for consumer loans.

Measures of bank profitability in 2005 fell back a bit from the very high levels posted in 2003 and 2004 but remained robust by historical standards. Profitability was restrained by vigorous competition and downward pressure on net interest margins from increases in market interest rates, but it was supported by excellent asset quality and reductions in noninterest expenses relative to assets. Banks' provisioning for loan losses over the first three quarters of last year was lower, on average, than in 2004, even with the increase in provisioning in the third quarter owing to the prospective surge in personal bankruptcies and to the hurricanes.

Mortgage market assets held by government-sponsored enterprises declined in 2005, as Fannie Mae reduced its mortgage portfolio about 20 percent and the rate of portfolio increase by Freddie Mac was somewhat below the rate of growth of residential mortgage debt in general. The reduction at Fannie Mae occurred partly in response to regulatory concerns about the adequacy of its capitalization. These concerns increased substantially after the company revealed in late 2004 that it had improperly accounted for certain derivative transactions. Fannie Mae's share price dropped about 30 percent last year, and Freddie Mac's declined about 10 percent. Yield spreads on both firms' debt over comparable-maturity Treasury securities were little changed on net.

### The M2 Monetary Aggregate

M2 rose 4 percent in 2005, a pace significantly slower than the growth in nominal income and the lowest annual rate of expansion in about a decade.[1] As is typical in a period of rising rates, the opportunity cost of holding M2 assets increased significantly over the course of the year, as changes in rates on liquid deposits lagged those in market yields. Consequently, growth in liquid deposits almost came to a halt following double-digit expansion during the previous several years. Some offset was provided by a rapid increase in small time deposits, rates on which remained better aligned with short-term market rates. After having contracted sharply in the past couple of years, shares of retail money market mutual funds were about flat, on net, as the return on such balances improved in line with short-term interest rates. Hurricane relief efforts likely added a little to the growth of M2 last year: Funds provided by the federal government to displaced households and funds advanced by insurance companies probably buoyed M2 over the last four months of 2005, as did a rise in the use of currency in the affected areas.

## International Developments

Foreign economic activity remained strong in 2005, as the global economy displayed resilience in the face of sizable increases in energy prices. Manufacturing and trade expanded in most industrial and emerging economies. As in 2004, global economic growth in 2005 was driven importantly by strong demand from the United States and China, but domestic demand picked up in a number of other countries as well. The run-up in prices of crude oil and other commodities over 2005 appeared to have had only a modest effect on measures of inflation in most countries.

Cumulative changes in monetary policy in foreign industrial economies during 2005 varied in direction and, in contrast to the United States, were mostly small. The European Central Bank, which had maintained its main policy interest rate at 2 percent since the middle of 2003, tightened 25 basis points late in 2005, citing a need to keep inflation expectations in check. The Bank of England, after tightening 100 basis points in 2004, lowered its policy rate 25 basis points in August 2005, as the U.K. housing market had cooled and as the growth of household spending and business investment had slowed. The Bank of Canada raised its target for the overnight rate a total of 100 basis points in the latter part of 2005 and the beginning of 2006, stating that the Canadian economy was operating again at full capacity. The Bank of Japan did not depart in 2005 from its policy of quantitative easing, as it continued to provide large amounts of bank reserves to keep short-term interest rates near zero. However, in the second half of the year, amid growing evidence that an end to consumer price deflation might be near, Bank of Japan officials began to discuss publicly the possibility of ending the policy in 2006.

Ten-year sovereign yields in the euro area and Canada have declined 15 to 20 basis points on net since the beginning of 2005, and ten-year U.K. sovereign yields have dropped 35 basis points. Over the same period, Japanese ten-year sovereign yields have risen about 15 basis points, somewhat less

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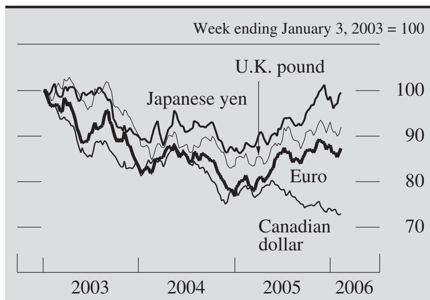
1. The Board announced in November that in March 2006 it would cease compilation and publication of data on the M3 monetary aggregate; publication of M3 was judged to be no longer generating sufficient benefit in the analysis of the economy or of the financial sector to justify the costs of publication.

than U.S. Treasury yields of the same maturity. Despite higher energy prices, long-term inflation expectations appear to have remained well contained abroad. In Europe, Canada, and Japan, the differences between ten-year nominal and inflation-indexed bond yields currently are little changed from their levels at the start of 2005.

Our broadest measure of the nominal trade-weighted exchange value of the dollar has risen 2½ percent on net since the beginning of 2005. The dollar likely was supported by the FOMC's significant cumulative policy tightening, only part of which had been anticipated by market participants at the start of 2005. The dollar's overall appreciation was driven by its sharp gains against the currencies of several major industrial countries; the dollar depreciated on average against the currencies of the United States' other important trading partners. Since the start of 2005, the dollar has appreciated about 15 percent versus the euro and the Japanese yen, and 10 percent against the British pound. A notable exception to this pattern is the Canadian dollar, against which the U.S. dollar has depreciated 4 percent since early 2005. With respect to currencies of other important trading partners, the dollar has depreciated 6 percent against the Mexican peso, 17 percent versus the Brazilian *real*, and 7 percent against the Korean won.

U.S. Dollar Exchange Rate against Selected Major Currencies, 2003–06




NOTE: The data are weekly and are in foreign currency units per dollar. The last observation for each series is the average of February 6 through February 8, 2006.

SOURCE: Bloomberg L.P.

Equity prices have risen substantially in most foreign industrial and emerging-market countries since early 2005; these prices have been supported by the continued global economic expansion and by interest rates that, in most countries, have remained well below historical averages. Rising commodity prices have buoyed share prices of firms in the energy and mining sectors, and share prices in the technology sector have also increased sharply. Since the beginning of 2005, headline equity indexes, measured in local currencies, have risen about 20 percent on net in the United Kingdom, 30 percent in the euro area, and 45 percent in Japan. In the United States, by contrast, equity prices have increased only modestly over the same period.

## Industrial Economies

After expanding at an annual rate of 5¼ percent in the first half of 2005, Japanese real GDP growth declined to 1 percent in the third quarter, largely because of slower inventory accumulation. Throughout the year, the most important source of support to economic growth was domestic demand, which was lifted by improvements in corporate profitability and labor market conditions. The unemployment rate declined sharply during 2005, ending the year at just under 4½ percent. The rate of deflation in core consumer prices subsided considerably in 2005; in fact, from December 2004 to December 2005, core prices posted a 0.1 percent increase. However, the GDP deflator continued to fall at a slow rate.

Economic growth in the euro area remained weak in the first half of 2005, at around a 1½ percent annual rate. Growth picked up to 2½ percent in the third quarter, spurred by stronger exports, especially by Germany. However, weakness in household spending persisted. The area-wide unemployment rate fell slightly over the year, to 8¼ percent near year-end, although employment only edged up. For the sixth straight year, euro-area inflation remained just above the ECB's medium-term goal of less than (but close to) 2 percent.

The rate of growth of real GDP in the United Kingdom slowed from 3¼ percent in 2004 to 1¾ percent in 2005. The slowdown was marked by a substantial deceleration of both private and government consumption. Labor markets remained tight, however; the unemployment rate of 2.9 percent in December was up only slightly from the twenty-year low of 2.6 percent recorded in January 2005. Consumer price inflation over the twelve months ending in December 2005 was 2 percent, in line with the central bank's official target. In contrast to the substantial run-up in real estate prices of 2004, housing price increases in 2005 were small.

Canadian economic growth was solid again in 2005. Recovering from a slow first quarter that featured a sharp but temporary pullback in exports, real GDP growth rebounded to around 3½ percent in the second and third quarters. For a second straight year, strong domestic demand underpinned growth, but net exports also made a positive contribution to growth late in the year. Employment made gains, although not as large as in the previous three years, and the unemployment rate touched a thirty-year low of 6.4 percent at year's end. After spiking in the third quarter on rising gasoline prices, consumer price inflation settled back toward 2 percent, the midpoint of the Bank of Canada's inflation target range.

## Emerging-Market Economies

Growth of real GDP in China remained vigorous in 2005, supported again by robust domestic demand and exports. Both personal consumption and investment expenditures continued to grow rapidly during the year. Export growth also remained strong through most of the year, while import growth slowed. As a result, the Chinese trade surplus more than tripled and exceeded $100 billion. Consumer price inflation in 2005 was low in comparison with the previous year, when higher food prices had caused inflation to surge; the twelve-month change in consumer prices finished the year at just over 1½ percent.

On July 21, China revalued the renminbi 2.1 percent versus the dollar and announced that henceforth it would manage the value of its currency with reference to a basket of foreign currencies. Since the July revaluation, the exchange value of the renminbi versus the dollar has risen about ½ percent. Chinese authorities also have implemented some reforms of the financial system that are intended to facilitate further exchange rate flexibility, including the introduction of an over-the-counter trading system in the domestic foreign exchange market. China's foreign exchange reserves increased more than $200 billion in 2005; the pace of reserve accumulation did not change appreciably after the revaluation of the renminbi in July.

In other emerging-market nations in Asia, economic activity also picked up substantially in 2005, driven by the growth of domestic demand and exports. Despite the global rise of energy costs,

consumer price inflation generally remained contained. Equity indexes registered large increases in a number of Asian countries, led in many cases by gains in share prices of technology firms. In particular, Korean equity prices have risen about 45 percent since early 2005. Several countries in the region added to their holdings of foreign exchange reserves over the period, but in all cases far less than China did.

After a solid performance in 2004, the Mexican economy slowed in the first quarter of 2005 and contracted in the second quarter because of weaker exports to the United States and a sharp drop in agricultural production. However, the Mexican economy recovered in the second half of the year, as agricultural and manufacturing production bounced back. Aggressive tightening of monetary policy from early 2004 to March 2005 seemed to be successful in restraining inflationary pressures: Consumer price inflation declined from more than 5 percent at the end of 2004 to a bit less than 4 percent in January 2006, within the central bank's target range of 2 percent to 4 percent. The soft economy and an improved outlook for inflation led the Bank of Mexico to begin easing policy in August 2005, and the central bank has continued to ease since then. High oil revenues boosted the public-sector surplus, and yield spreads of Mexican sovereign debt over U.S. Treasuries declined to record lows.

In Brazil, growth in economic activity was moderate in the first half of 2005, and some indicators point to a slowing over the second half. Nonetheless, risk spreads of Brazilian sovereign debt declined over the course of the year to their lowest levels since 1997, the *real* appreciated strongly, and stock prices rose sharply. Concerns over inflation kept monetary policy very tight for most of the year, but the central bank began easing in September, and the policy rate was reduced a total of 250 basis points, to 17¼ percent, by January. In late December, Brazil paid in full its debt to the International Monetary Fund (IMF), using a portion of its foreign exchange reserves.

In Argentina, the economic recovery continued last year, driven in part by increases in consumption and investment. After more than three years in default, the government completed a debt swap, restructuring $80 billion in bonds and obtaining a participation rate of 76 percent. Early this year, Argentina also paid in full its IMF obligations out of its foreign exchange reserves. ■

# *Monetary Policy Report of July 2005*

## Monetary Policy and the Economic Outlook

The U.S. economy continued to expand at a solid pace over the first half of 2005 despite the restraint imposed on aggregate demand by a further rise in crude oil prices. Household spending trended up, propelled by rising wealth and income and by low interest rates, and business outlays received ongoing support from favorable financial conditions, rising sales, and increased profitability. Moreover, the earlier declines in the foreign exchange value of the dollar shifted some domestic and foreign demand toward U.S. producers. Overall, the economic expansion was sufficient to create jobs at roughly the same pace as in late 2004 and to lower the unemployment rate further over the first half of this year.

Higher oil prices boosted retail prices of a broad range of consumer energy products and, as a result, continued to hold up the rate of overall consumer price inflation in the first half of 2005. In addition, the rise in energy prices this year, coupled with increases in the prices of some other commodities, imported goods, and industrial materials, put upward pressure on the costs of many businesses. A portion of these costs was passed on to consumers, which contributed to a higher rate of inflation in core consumer prices (that is, total prices excluding the food and energy components, which are volatile). As measured by the price index for personal consumption expenditures excluding food and energy, core inflation increased from an annual rate of 1½ percent in 2004 to about 2 percent between the fourth quarter of 2004 and May 2005. While survey measures of near-term inflation expectations have edged up this year, surveys, as well as readings from financial markets, suggest that expected inflation at longer horizons has remained contained.

With financial conditions advantageous for households and firms, a solid economic expansion in train, and some upward pressure on inflation, the Federal Open Market Committee (FOMC) continued to remove policy accommodation at a measured pace over the first half of the year, raising the intended federal funds rate an additional 1 percentage point, to 3¼ percent, by the end of June. At the most recent FOMC meeting, the Committee judged that policy remained accommodative. With appropriate monetary policy, however, the upside and downside risks to output and inflation were viewed as balanced, and the Committee underscored its commitment to respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The fundamental factors that supported the U.S. economy in the first half of 2005 should continue to do so over the remainder of 2005 and in 2006. In the household sector, the combination of further gains in employment, favorable borrowing terms, and generally healthy balance sheets should keep consumer spending and residential investment on an upward path. In the business sector,

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NOTE: The discussion in this chapter consists of the text and tables from the Monetary Policy Report submitted to the Congress on July 20, 2005; the charts from that report (as well as earlier reports) are available on the Board's web site, at www.federalreserve.gov/boarddocs/hh.

expanding sales, the low cost of capital, and the replacement or upgrade of aging equipment and software should help to maintain increases in capital spending. And, although economic performance has been uneven across countries, continued growth overall in the economies of U.S. trading partners should sustain the demand for U.S. exports. In contrast, ongoing increases in imports will likely continue to subtract from the growth of U.S. gross domestic product. In addition, high energy prices remain a drag on aggregate demand both here and abroad, though this drag should lessen over time if prices for crude oil level out in line with quotes in futures markets.

Despite the upward pressure on costs and prices over the past year or so, core consumer price inflation is likely to remain contained in 2005 and 2006. Longer-run inflation expectations are still well anchored, and because businesses are adding to their stocks of capital and are continuing to find ways to use their capital and work forces more effectively, structural productivity will likely rise at a solid pace over the foreseeable future. In addition, barring a further increase in oil prices, the boost that higher energy costs have given to core inflation should wane in coming quarters, while the recent appreciation of the dollar, as well as the deceleration in global materials prices, will likely reduce the impetus to inflation from rising import prices.

Of course, substantial uncertainties surround this economic outlook. A further sharp rise in crude oil prices would have undesirable consequences for both economic activity and inflation, and the possibility that housing prices, at least in some locales, have moved above levels that can be supported by fundamentals remains a concern. As another example, if the recent surge in measured unit labor costs were to prove more persistent than currently appears likely, the outlook for inflation would be adversely affected. Economic growth and inflation will also be shaped importantly by the evolution of the imbalance in the U.S. current account.

## The Conduct of Monetary Policy over the First Half of 2005

Despite increases in the federal funds rate totaling 1¼ percentage points in 2004, monetary policy was still judged to be accommodative at the start of 2005. At the time of the February FOMC meeting, the available information indicated that the economy had expanded at a robust pace through the end of 2004 and retained considerable momentum. Accordingly, the Committee voted to raise its target for the federal funds rate from 2¼ percent to 2½ percent and to make minimal changes to the text of the accompanying statement. The statement reiterated that "the Committee believes that policy accommodation can be removed at a pace that is likely to be measured." Members noted, however, that this forward-looking language was clearly conditioned on economic developments and therefore would not stand in the way of either a pause or a step-up in policy firming depending on events.

By March, the data were pointing to a further solid gain in activity during the first quarter, fueled especially by continued increases in consumption expenditures and residential investment. In addition, private nonfarm payrolls were posting widespread advances, and slack in resource utilization appeared to be diminishing. The Committee voted at its March meeting to raise the federal funds rate another 25 basis points, to 2¾ percent. In view of the rise in prices of energy and other commodities and recent elevated readings on inflation in

core consumer prices, the Committee altered the text of the policy statement to note the pickup in inflationary pressures. The Committee also decided to modify the assessment of the balance of risks to make it explicitly conditional on an assumption of "appropriate" monetary policy, so as to underscore that maintaining balanced risks would likely require continued removal of policy accommodation.

The evidence that had accumulated by the spring pointed to some moderation in the pace of activity. Retail spending flattened out for a time, likely in response to higher energy prices, and the growth of capital spending dropped back from its elevated pace of late last year. Nonetheless, with long-term interest rates still quite low and with employment and profits continuing to rise, economic activity appeared to retain considerable momentum, suggesting that the softness would be short lived. Against this backdrop, the FOMC decided to raise the federal funds rate another 25 basis points at its May meeting and to make few changes to the text of the accompanying statement.

In the weeks after the May meeting, incoming indicators supported the view that the underlying pace of activity was not faltering. The information that the Committee reviewed at the time of the June FOMC meeting showed that consumer spending and business investment had turned up, on balance, and that demand for housing continued to be strong. With economic activity remaining firm and crude oil prices ratcheting higher, the FOMC voted to raise the funds rate an additional 25 basis points, to 3¼ percent, and to make only minimal changes to the text of the accompanying statement. This action brought the cumulative increase in the target federal funds rate since June 2004 to 2¼ percentage points.

## Economic Projections for 2005 and 2006

In conjunction with the FOMC meeting at the end of June, the members of the Board of Governors and the Federal Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, were asked to provide economic projections for 2005 and 2006. In general, Federal Reserve policymakers expect the economy to continue to expand at a moderate pace and core inflation to remain roughly stable over this period. The central tendency of the FOMC participants' forecasts for the increase in real (that is, inflation adjusted) GDP is 3½ percent over the

Economic Projections for 2005 and 2006

Percent

| Indicator | Federal Reserve Governors and Reserve Bank presidents | |
|---|---|---|
| | Range | Central tendency |
| | 2005 | |
| *Change, fourth quarter to fourth quarter*[1] | | |
| Nominal GDP | 5–6¼ | 5½–5¾ |
| Real GDP | 3–3¾ | 3½ |
| PCE price index excluding food and energy | 1½–2¼ | 1¾–2 |
| *Average level, fourth quarter* | | |
| Civilian unemployment rate | 5–5¼ | 5 |
| | 2006 | |
| *Change, fourth quarter to fourth quarter*[1] | | |
| Nominal GDP | 5–6 | 5¼–5½ |
| Real GDP | 3¼–3¾ | 3¼–3½ |
| PCE price index excluding food and energy | 1½–2½ | 1¾–2 |
| *Average level, fourth quarter* | | |
| Civilian unemployment rate | 5 | 5 |

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

four quarters of 2005 and 3¼ percent to 3½ percent in 2006. The civilian unemployment rate is expected to average 5 percent in both the fourth quarter of 2005 and the fourth quarter of 2006. FOMC participants project that the chain-type price index for personal consumption expenditures excluding food and energy will increase between 1¾ percent and 2 percent both this year and next.

## Economic and Financial Developments in 2005

The economic expansion entered 2005 on a solid footing and was led by ongoing increases in consumption, residential investment, and business spending on equipment and software. Although the pace of expansion slowed somewhat in the early spring, activity has picked up again more recently. On average, real GDP appears to have increased a little less rapidly over the first half of 2005 than in the second half of 2004, a reflection in part of reduced fiscal stimulus and the drag on economic activity from higher energy prices. Industrial production has also risen more slowly so far this year than in 2004: The increase totaled 3 percent at an annual rate between December 2004 and June 2005, down from 5 percent during the previous six months. Nevertheless, the economic expansion has been sufficient to gradually absorb slack in labor and product markets. Nonfarm payroll employment has continued to increase, and the unemployment rate has moved down further since the beginning of the year, to 5 percent in June. Similarly, the rate of capacity utilization in the manufacturing sector stood at 78.4 percent in June, up from 77.9 percent at the end of 2004 and just a little below its long-term historical average.

Rising energy prices continued to boost consumer price inflation in the first half of 2005. With consumer energy prices having climbed more than 13 percent at an annual rate so far this year, the price index for personal consumption expenditures (PCE) increased at an annual rate of about 2½ percent between the fourth quarter of 2004 and May 2005, the same pace as in 2004. Meanwhile, the core PCE price index rose at an annual rate of about 2 percent in the first half of 2005, up from 1½ percent in 2004.

### The Household Sector

#### *Consumer Spending*

Consumer spending continued to move higher in the first half of this year, though not as rapidly as in the second half of 2004. After increasing at an average annual rate of 4½ percent in the third and fourth quarters of last year, real personal consumption expenditures rose at a 3½ percent rate in the first quarter and appear to have advanced at a roughly similar pace in the second quarter. Household spending this year has been supported by rising employment and household wealth as well as by the low level of interest rates. However, higher costs for consumer energy products have eroded households' purchasing power.

Sales of light motor vehicles, which had been buoyed in the second half of last year by a variety of sales inducements, dropped back in the first quarter after many of the inducements expired. However, sales firmed again in the second quarter to an average annual pace of more than 17 million units, a level similar to that in the fourth quarter of last year. Underlying demand for light motor vehicles has remained relatively strong, though sales likely have also

been boosted recently by sizable price discounts.

Excluding motor vehicles, consumer spending posted strong gains in early 2005, flattened out in March, and picked up again in the spring. On a quarterly average basis, the rate of increase in non-auto spending appears to have stepped down in the second quarter, largely because of a deceleration in outlays for consumer goods. Meanwhile, real outlays for services rose at an annual rate of about 3 percent in the first quarter, and the available data point to an increase of about the same magnitude in the second quarter.

If the effect of Microsoft's $32 billion special dividend payment in December 2004 is excluded from the calculation, real disposable personal income (that is, after-tax income adjusted for inflation) rose at an annual rate of about 2 percent between the fourth quarter of 2004 and May 2005, a slower pace than in 2004. Although increases in employment and earnings pushed up wage and salary income over the first half of 2005, the rise in real income was damped to some degree by the energy-driven increase in consumer prices. Higher energy prices also appear to have weighed on consumer confidence for much of this year. Surveys by both the Michigan Survey Research Center (SRC) and the Conference Board indicate that household sentiment edged down through the early spring, though readings from these surveys turned up again more recently.

Household wealth appears to have increased a bit faster than nominal disposable income over the first half of this year; the small increase in the wealth-to-income ratio comes on the heels of substantial increases in 2003 and 2004. Although stock prices have changed little, on net, thus far this year, home prices have continued to rise sharply. Because changes in wealth influence consumer spending with a lag, both the earlier and the more-recent increases in household net worth have supported consumption this year. As wealth increased and interest rates remained quite low, the personal saving rate edged down to just ½ percent of disposable income in April and May. Over the previous two decades, the personal saving rate averaged close to 5 percent.

### *Residential Investment*

Activity in the housing market continued at a strong pace in the first half of 2005. Real expenditures on residential structures increased at an annual rate of 11½ percent in the first quarter and appear to have posted another gain in the second quarter. In the single-family sector, starts of new units averaged 1.69 million at an annual rate between January and June—nearly 4 percent above the pace posted over the second half of 2004. Similarly, starts of multifamily units averaged 360,000 over the first six months of 2005, about 3¼ percent higher than in the previous six months.

As in 2004, the demand for housing during the first half of 2005 was supported by rising employment and income and by low mortgage rates. Rates on thirty-year fixed-rate mortgages have fluctuated between 5½ percent and 6 percent in recent months and are currently near the low end of that range. In addition, demand reportedly has been boosted by a rise in purchases of second homes—either as vacation units or as investments—and by the greater availability of less-conventional financing instruments. These financing instruments, including interest-only mortgages and adjustable-rate mortgages that allow borrowers a degree of flexibility in the size of their monthly

payments, have enabled some households to buy homes that would otherwise have been unaffordable. As a result, both new and existing home sales have remained remarkably robust this year, and both were at or near record levels in May.

The strong demand for housing has continued to push up home prices this year. Although rates of house price appreciation were a little slower in the first quarter of this year than in 2004, the repeat-transactions price index for existing homes (limited to purchase-transactions only), which is published by the Office of Federal Housing Enterprise Oversight and partially adjusts for changes in the quality of homes sold, was nonetheless up 10 percent relative to its year-earlier level. Price appreciation has been especially sharp over the past year in some large metropolitan areas, including Las Vegas, Miami, San Francisco, and New York, but rapid increases in home prices have been observed in other areas as well. In many of these locales, recent price increases have far exceeded the increases in rents and household incomes.

### *Household Finance*

Supported by rising house prices and continued economic expansion, household debt increased at an annual rate of about 9¼ percent in the first quarter of 2005. This advance was paced by a rise in mortgage debt of 10½ percent at an annual rate. However, even that rapid rise in mortgage debt represented a slight deceleration from the torrid pace in 2004, a development in line with the small slowdown in the pace of house price appreciation. Despite the increase in mortgage debt, net housing wealth rose. Refinancing activity has remained subdued, as rates on fixed-rate mortgages are a little above levels at which many households would currently find refinancing to be attractive.

Consumer credit expanded at an annual rate of about 4½ percent over the first quarter of the year and was about unchanged in April and May. The growth of consumer credit has continued to be restrained by substitution toward home equity debt as a means to finance household expenditures.

Measures of household credit quality have remained favorable. Delinquency rates on credit card debt and auto loans have continued to decline from already low levels. The pace of bankruptcy filings has run a little higher than at the same time last year; however, that pace has probably been boosted by a rush to file before the new rules in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 take effect in October. Reflecting the rapid pace of household debt growth, the ratio of household financial obligations to disposable personal income has edged up from a year earlier, though this ratio remains a bit below the peak level reached in late 2002.

## The Business Sector

### *Fixed Investment*

After posting a robust gain in the second half of 2004, real business fixed investment rose at a more moderate pace over the first half of 2005, as the rate of increase in expenditures on equipment and software (E&S) dropped back and outlays for nonresidential structures remained lackluster. Nonetheless, economic and financial conditions appear to be supportive of capital spending: Sales and corporate profits have continued to increase, businesses have ample liquid assets at their disposal, and financial market participants appear willing

to finance new investment projects at favorable terms.

Real E&S spending rose at an annual rate of 6 percent in the first quarter after having advanced at an 18 percent pace in the second half of 2004. Led by large increases in purchases of computers and communications equipment, spending on high-tech equipment posted a sizable gain in the first quarter. In contrast, outlays for transportation equipment dropped back early in the year because of a small decline in business expenditures on motor vehicles and a sharp drop in aircraft purchases after a surge in the fourth quarter of 2004. Investment in equipment other than high-tech and transportation goods, a category that accounts for about 40 percent of E&S in nominal terms, also edged down in the first quarter after registering a sizable gain in the second half of last year. The types of equipment in this category of investment tend to be sensitive to trends in business sales, but the timing of business spending may have been influenced by the provisions of the partial-expensing tax incentive, which encouraged capital spending to be pulled forward in advance of the incentive's expiration at the end of 2004.

More-recent indicators of E&S spending point to another moderate rise in investment in the second quarter. In particular, outlays for transportation equipment appear to have turned up, on net, as a step-up in purchases of aircraft more than offset a further decline in business spending on motor vehicles. At the same time, the evidence on high-tech spending has been mixed: Real spending on computers appears to have registered another large gain in the second quarter, while the rate of increase in outlays for communications equipment apparently fell back. Indicators of spending on equipment other than transportation and high tech have looked more favorable recently, as shipments and imports for this broad category increased noticeably, on balance, in April and May. In addition, unfilled orders for such equipment remain at high levels.

Real nonresidential construction continued at a low level in the first half of this year, but fundamentals are starting to show signs of improvement. The construction of office buildings and industrial facilities has been restrained for some time by elevated vacancy rates, weak demand, and higher costs for construction materials. However, vacancy rates in these sectors have recently turned down, and construction outlays for these types of buildings appear to have edged higher, on net, so far this year. Commercial building—which includes retail outlets and warehouses—also appears to have increased this year, in part because of strong growth in the construction of large retail stores. Meanwhile, investment in the drilling and mining sector has trended up, on balance, over the past year, as higher prices for natural gas boosted the demand for new drilling rigs.

### *Inventory Investment*

As in 2004, businesses accumulated inventories at an appreciable pace early this year. Outside the motor vehicle industry, nonfarm inventories increased at an annual rate of $66 billion in real terms in the first quarter of 2005. The rapid rate of inventory accumulation late last year and early in 2005 appears primarily to have been the result of efforts by firms to replenish stocks that had been depleted by the strong pace of sales in 2003 and 2004; apart from firms in a limited number of sectors, such as steel and paper, most businesses do not appear to be holding excess stocks, even taking into account the downward

trend in inventory–sales ratios that has resulted from the improvement in supply-chain management capabilities. The rebuilding of inventories in most industries appears to have been largely completed, and the available data for April and May point to a noticeable step-down in the pace of stockbuilding. Indeed, in recent surveys, businesses have been reporting that they and their customers are increasingly comfortable with current levels of stocks, whereas in 2004 and early 2005, many were still characterizing inventory positions as too lean.

One important exception to this characterization is the motor vehicle industry, for which dealer stocks—especially of light trucks—were high by historical standards in recent months. In response, several major motor vehicle manufacturers reduced production in the second quarter, and, more recently, some have introduced price discounts on many 2005 models. These efforts appear to have helped, in that inventories of light vehicles at the end of June fell to sixty-five days of supply, a level more in line with historical norms.

### *Corporate Profits and Business Finance*

Corporate profits have continued to rise so far this year, though at a slower pace than in 2003 and 2004. Earnings per share for S&P 500 firms in the first quarter of 2005 were up about 13 percent since the same time last year, a pace in line with the profit figures reported in the national income and product accounts (NIPA). The ratio of before-tax profits of nonfinancial corporations to that sector's gross value added was about flat in the first quarter after having moved up in 2003 and 2004. In the first half of this year, the petroleum and gas industries benefited from higher oil prices, but corporate earnings in the automobile sector declined sharply.

Given continued strong corporate profits and the accompanying strength in cash flow, nonfinancial firms' demand for external financing to fund capital expenditures has remained somewhat subdued. Net equity issuance has stayed negative so far this year, and share retirements have been boosted by considerable stock buybacks and cash-financed merger and acquisition activity. Gross corporate bond issuance has been limited, and the proceeds have been used mainly to pay down existing debt. Short-term debt financing, however, continued to pick up in the first half of 2005. Both commercial and industrial loans and commercial paper expanded at a brisk pace that was likely in part the result of firms' need to fund the rapid rate of inventory accumulation earlier in the year. The Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices conducted in April 2005 indicated that demand for business loans had strengthened over the previous three months and that substantial fractions of banks had eased standards and terms on these loans. In response to special questions regarding longer-term changes in lending practices, most banks reported that standards on business loans were somewhat tighter, but that terms were somewhat easier, than they had been in 1996 and 1997.

Indicators of credit quality in the nonfinancial business sector have stayed generally very strong amid continued growth of profits and corporate balance sheets that remain flush with liquid assets. Both the default rate on outstanding corporate bonds and the delinquency rate on business loans stand at the low end of their historical ranges. However, the automobile sector has been an exception to the pattern of solid corpo-

rate credit quality. All three major credit rating agencies downgraded the debt of both Ford and General Motors this year in response to disappointing earnings news. General Motors' debt now has a below-investment-grade rating from both Standard & Poor's and Fitch, though it is still rated as investment-grade by Moody's. Ford retains an investment-grade rating with all the rating agencies except Standard & Poor's.

Expansion of commercial-mortgage debt continued apace in the first half of the year and was accompanied by record issuance of commercial-mortgage-backed securities. Likely because of that heavy issuance, spreads of yields on commercial-mortgage-backed securities over those on comparable-maturity Treasuries have turned up recently, but these spreads remain relatively low. The credit quality of commercial-mortgage debt remains quite strong, as delinquency rates on holdings of commercial mortgages at banks and insurance companies and on loans that back mortgage securities have been declining from already low levels.

## The Government Sector

### *Federal Government*

The deficit in the federal unified budget narrowed over the past year. Over the twelve months ending in June, the unified budget recorded a deficit of $336 billion, $99 billion less than during the comparable period last year. Both revenues and outlays rose faster than did nominal GDP over this period, but the rise in receipts was especially strong. Even at its lower level, the deficit was still equal to about 2¾ percent of nominal GDP.

Nominal federal receipts during the twelve months ending in June were 14 percent higher than during the same period a year earlier and reached 17 percent of nominal GDP. Revenues were boosted by a large increase in corporate receipts that was driven by the strength of corporate profits. In addition, individual income and payroll taxes rose nearly 12 percent, twice as fast as the growth of household income. However, some of this rise was due to the features of the Jobs and Growth Tax Relief Reconciliation Act of 2003 that altered the timing of tax payments in a way that temporarily reduced the level of tax collections last year.

Nominal federal outlays during the twelve months ending in June were 7 percent higher than during the same period a year ago and stood at 20 percent of nominal GDP. Spending for national defense continued to trend up at a rapid clip, and outlays for Medicare also posted a sizable increase. In addition, federal net interest payments, boosted both by higher interest rates and by the higher level of federal debt, rose more than 13 percent over this period. Real federal expenditures for consumption and investment—the part of government spending that is a component of real GDP—increased at an annual rate of just ½ percent in the first calendar quarter of 2005 after having risen 4 percent in 2004. Although defense spending changed little in real terms in the first quarter, it has risen considerably in recent years and is likely to increase further in coming quarters. Nondefense spending in the first quarter edged up in line with its recent trend, and enacted legislation is consistent with its continuing to rise at a subdued pace.

The deficit in the federal budget has depressed national saving in the past few years. The narrowing of the deficit of late has lessened this reduction in national saving from a little more than 3 percent of nominal GDP in 2003 and 2004 to roughly 2 percent in the first

quarter of 2005. Even so, as business and personal saving rates changed little, on average, over the past year, net national saving rose to just 3¼ percent of nominal GDP in the first quarter, well below the long-term historical average of about 7 percent and below recent levels of net domestic investment. If not reversed, such a low level of net national saving will necessitate either slower capital formation or continued heavy borrowing from abroad. The pressures on national saving will intensify greatly with the retirement of the baby-boom generation and the associated increases in Social Security and Medicare benefit payments.

*Federal Borrowing*

Because of the need to finance the sizable federal budget deficit, federal debt held by the public expanded at a seasonally adjusted annual rate of 13¾ percent in the first quarter of the year. The ratio of this debt to nominal GDP increased to more than 37 percent for the first time since 2000. The average maturity of outstanding marketable Treasury debt has been declining for several years and reached fifty-three months at the end of the first quarter of 2005, down from about seventy months in 2000. However, in the May mid-quarter refunding statement, the Treasury announced that it was considering reintroducing regular issuance of a thirty-year nominal bond in February 2006, a move that would presumably slow or arrest this downtrend.

Indicators of demand for Treasury securities by foreign investors have been mixed so far this year; demand by foreign official institutions seems to have moderated, but demand by foreign private investors appears to have remained robust. Indirect bidders at Treasury auctions—which include foreign official institutions that place bids through the Federal Reserve Bank of New York—have been awarded an average of 33 percent of coupon securities issued at auctions held so far this year, down from 42 percent in 2004. Treasury securities held in custody at the Federal Reserve Bank of New York on behalf of foreign official institutions have grown only about $25 billion so far this year after an increase of more than $200 billion in 2004. Data from the Treasury International Capital System also suggest an ebbing of demand for Treasury securities from foreign official investors during the first five months of the year. These data, however, indicate that foreign private investors have continued to accumulate Treasury securities at a rapid pace.

*State and Local Governments*

The fiscal positions of states and localities have improved this year. Ongoing gains in income and consumer spending, along with sharp increases in property values, have continued to boost tax receipts. Although many jurisdictions have increased their spending moderately, some are also using the additional revenues to rebuild reserve funds. On a NIPA basis, net saving by state and local governments equaled $34 billion at an annual rate in the first quarter (roughly ¼ percent of nominal GDP), double the 2004 average. In addition, virtually all states registered surpluses in their general fund budgets in fiscal year 2005, which ended on June 30 for all but four states. Nevertheless, lingering fiscal concerns are still evident in some jurisdictions; these concerns are related primarily to rising Medicaid costs, the termination of temporary federal grants that were appropriated in fiscal year 2004, and pressures to restore funding to programs—such as elementary and sec-

ondary education—that were cut back earlier in the decade.

Real consumption and investment spending by state and local governments edged down in the first quarter of 2005 after having changed little in 2004. Real outlays for consumption items increased at an annual rate of less than ½ percent, a reflection of some slowing in the pace of hiring. Nominal spending on investment rose at a moderate rate in the first quarter, but because construction costs escalated, investment spending declined a little in real terms.

### *State and Local Government Borrowing*

State and local government debt held by the public expanded at a rapid pace in the first quarter of the year, rising at a seasonally adjusted annual rate of 16¼ percent, up from 5½ percent in the fourth quarter of last year. However, much of this borrowing was for the advance refunding of existing debt, as state and local governments continued to take advantage of low long-term interest rates. A significant portion of the proceeds of these advance refundings were invested in U.S. Treasury instruments tailored to meet the cash management needs of municipal governments. In addition, financing of transportation- and education-related projects boosted issuance of long-term municipal bonds for new capital.

The credit quality of municipal borrowers improved last year, and this trend has generally continued so far in 2005, as upgrades of municipal bonds by Standard & Poor's continued to outpace downgrades.

## The External Sector

The U.S. current account deficit expanded in the first quarter of 2005 to $780 billion at an annual rate, or about 6.4 percent of nominal GDP. The deficit in trade in goods continued to widen, increasing $17 billion from the previous quarter. The deficit on net unilateral transfers also widened in the first quarter, largely because of an increase in government grants. In contrast, the surplus on trade in services rose $7 billion, and the surplus on net investment income rose $2 billion.

### *International Trade*

Real exports of goods and services accelerated in the first quarter of 2005 to an annual rate of about 9 percent, roughly twice as fast as the rate in the second half of last year. The dollar's decline in recent years has raised the competitiveness of U.S. relative prices and has continued to provide a mounting boost to exports. Support from foreign economic activity, though still substantial, moderated after the first half of 2004 as growth abroad slowed. Increases in exports of U.S. goods were widespread across major U.S. trading partners, with the exception of Japan, and were concentrated in capital goods and consumer goods. Real exports of services rose at an annual rate of about 13¼ percent.

Real imports of goods and services rose at an annual rate of about 9½ percent in the first quarter, a pace similar to the average in 2004. The growth of real oil imports ebbed after surging late last year. Increases in imports of non-oil goods were widespread across categories. The expiration of the Multifibre Arrangement and the resulting elimination of quotas shifted the source of some U.S. textile and apparel imports among U.S. trading partners, but these events appear to have had a limited effect on the overall level of imports of these goods. Real imports of services reversed

their fourth-quarter decline, posting a gain of 7 percent at an annual rate, as some travel-related expenditures and also royalties and license fees recovered from a very weak fourth quarter.

Boosted by substantial increases in the prices of primary commodities and industrial supplies, prices of total exports rose at an annual rate of 4¼ percent in the first quarter. Prices of U.S. agricultural exports rebounded in the first quarter after good harvests in the second half of 2004 had caused prices to fall sharply. The available data for the second quarter point to continued increases in export prices.

Prices of imported non-oil goods rose at an annual rate of 3¾ percent in the first quarter, almost 1½ percentage points faster than in the second half of 2004. Prices of material-intensive items, such as industrial supplies and foods, steadily increased in the last quarter of 2004 and in the first quarter of 2005. In part, this rise reflected higher prices for nonfuel primary commodities, as strength in global demand for many commodities outstripped a slow expansion of supply. Prices for finished goods, such as consumer goods and many kinds of capital goods, also turned noticeably higher. Available data for the second quarter show that the increases in prices of both material-intensive and finished goods have slowed.

The spot price of West Texas intermediate (WTI) crude oil began 2005 near $43 per barrel, but it climbed above $50 per barrel in late February and breached $60 per barrel in late June. The increase in the spot price of WTI largely reflects several global factors: continued strong demand for oil, limited spare production capacity, and concerns about the reliability of supply from some foreign sources. In contrast to the market outlook during last October's peak in oil prices, futures contracts indicate that market participants now expect oil prices to remain near their current high levels, a view consistent with the belief that demand will remain strong and production will have difficulty keeping pace. The price of the far-dated NYMEX oil futures contract (currently for delivery in December 2011) rose from about $38 per barrel as of last October to about $56 per barrel in late June.

OPEC spare production capacity appears to be near historical lows, with only Saudi Arabia able to increase production substantially. Many other OPEC producers are either pumping close to capacity or encountering production problems. Venezuela and Indonesia cannot meet their production quotas, and Iraqi production this year has averaged less than in 2004. In addition, several governments have moved to increase their control of the energy industry as oil prices have risen. Russian oil production, which had provided most of the growth in non-OPEC supply over the previous five years, has stagnated since last September amid the partial nationalization of Yukos, formerly Russia's largest oil company. Venezuela has also increased the taxes and royalty payments of foreign oil firms.

### *The Financial Account*

Foreign official inflows, which accounted for more than half of all net financial inflows to the United States in 2004, slowed significantly in the first quarter but showed signs of renewed strength in April and May. In contrast, private inflows moderated in April and May after having increased substantially in the preceding six months. As has been the case for several years, the U.S. current account has been financed primarily by foreign purchases of U.S. debt securities. U.S. residents' purchases of

foreign securities increased after a temporary lull in the fourth quarter and have been more heavily weighted toward purchases of equities.

Net direct investment outflows in the first quarter were well below their levels in the fourth quarter; direct investment into the United States was roughly unchanged, but U.S. direct investment abroad fell back after a surge in new equity late last year. There is little evidence to date that U.S. companies have repatriated earnings from their foreign subsidiaries using the temporarily reduced tax rate available under the American Jobs Creation Act of 2004. However, there are indications that these remittances may pick up in the second half of this year.

## The Labor Market

### *Employment and Unemployment*

Labor markets have continued to improve this year, albeit at an uneven pace from month to month. On average, nonfarm payroll employment expanded roughly 180,000 per month over the first half of 2005, about the same pace as in the fourth quarter of 2004. At the same time, the civilian unemployment rate, which had declined from 5¾ percent to just below 5½ percent over 2004, continued to move down. The jobless rate stood at 5 percent in June, the lowest level since September 2001.

The increases in payrolls over the first half of 2005 were relatively widespread across industries. Particularly sizable gains were registered at providers of health-care services and leisure and hospitality services and at establishments that provide business services, such as professional and technical assistance and administrative and support services (a category that includes temporary help). In addition, construction employment continued to climb at a steady pace, a reflection of the buoyant residential housing market and increased spending on infrastructure by state and local governments. In contrast, manufacturing employment continued to trend down, as cutbacks in industries that produce wood products, furniture, and a variety of nondurable goods more than offset hiring at producers of fabricated metals and machinery. Employment in retail trade has advanced at a moderate pace this year. Increases in employment at state and local governments slowed somewhat in the first half of this year from the pace in the second half of last year, and federal civilian employment changed little.

The gradual rise in job opportunities appears to be attracting some potential workers back into the labor market. The labor force participation rate, which had declined noticeably between 2000 and 2004, edged up over the first half of 2005. Nevertheless, the participation rate in June, at 66 percent, remained well below the high of 67¼ percent reached in early 2000. To some extent, both the high level of the participation rate in 2000 and the more recent decline are likely related to cyclical developments in the economy: The tight labor markets of the late 1990s, perhaps coupled with the introduction of work requirements for many welfare recipients, undoubtedly drew additional people into the labor force at that time, while the subsequent recession and slow recovery in the labor market have discouraged many job seekers in recent years. However, the downtrend in the aggregate participation rate also appears to be associated with structural developments that seem likely to limit future increases. For example, the large baby-boom cohorts are now entering ages at which labor force participation rates typically drop off sharply. And, in con-

trast to patterns observed in previous decades, participation rates for women between 25 and 54 years of age no longer appear to be trending up.

*Productivity and Labor Costs*

Gains in labor productivity have slowed, on balance, in recent quarters. According to currently published data, output per hour in the nonfarm business sector rose 2½ percent over the year ending in the first quarter of 2005, down from the 5½ percent pace registered in the comparable period a year earlier. A deceleration in productivity is not unusual as an economic expansion matures and as businesses—which become increasingly confident about future prospects for sales—step up their pace of hiring. In addition, the recent slowdown in productivity growth was from the unusually rapid average rate that prevailed between 2002 and early 2004. That elevated rate likely reflected both an atypical reluctance to hire—as employers reacted to a succession of economic and geopolitical shocks—and newfound efficiencies brought about by the better use of high-tech capital purchased by businesses in earlier years and by organizational changes implemented to maintain profitability when the economy was relatively weak. As the impetus from these influences has waned, productivity growth has fallen back.

Measures of labor compensation for recent quarters suggest that the remaining slack in labor markets continued to restrain increases in base wage rates but that large increases in some of the more flexible components of worker pay and for some types of employer-provided benefits added to labor costs. In particular, compensation per hour in the nonfarm business sector, which is based on the data from the national income and product accounts, rose 7 percent over the four quarters ending in the first quarter of this year, having registered a particularly large bulge in the final quarter of 2004. Much of this sharp rise may be the result of the exercise of a large number of stock options late last year, a development perhaps induced by an increase in equity prices that boosted the number of options that were "in the money" and by a proposed change in accounting regulations that led some companies to accelerate the vesting of options that had been previously granted. In addition, the strong performance of profits in 2004 may have been associated with sizable nonproduction bonus payments at the end of last year.

A more modest rate of increase in hourly compensation is indicated by the employment cost index (ECI), which is based on a quarterly survey of private nonfarm establishments conducted by the Bureau of Labor Statistics and which excludes income received from the exercise of stock options. In particular, the ECI measure of hourly compensation rose 3½ percent over the twelve months ending in March 2005, about ½ percentage point less than the increases over the preceding two years. The wages and salaries component of the ECI was up just 2½ percent over the twelve months ending in March, a pace similar to that in the preceding year, while employer costs for benefits increased 5¾ percent, a bit below the pace of the previous year but a sizable gain nonetheless. Part of the outsized rise in benefit costs stemmed from the need by many companies to rebuild their defined-benefit pension assets to make up for earlier losses in those plans. In addition, health insurance costs have continued to rise more rapidly than wages, although the 7½ percent increase in these costs over the year ending in March of this year was down from the double-digit rates of growth in 2002 and 2003.

The acceleration in the nonfarm business measure of hourly compensation, coupled with the deceleration in productivity, has contributed to a noticeable pickup in unit labor costs in recent quarters. In particular, unit labor costs rose 4¼ percent over the four quarters ending in the first quarter of 2005 after having declined 1 percent over the preceding four quarters. However, to the extent that the acceleration in compensation was the result of a temporary bulge in stock option exercises in late 2004, unit labor costs should moderate significantly this year. Moreover, the implications of such a spike in unit labor costs for price inflation are probably minimal, at least as judged by previous spikes of this nature. For example, the sharp rise in unit labor costs in 2000 had little or no subsequent effect on price inflation.

## Prices

Higher energy prices continued to show through to overall consumer price inflation this year. The chain-type price index for personal consumption expenditures rose at an annual rate of about 2½ percent between the fourth quarter of 2004 and May 2005, a rate of increase similar to that over the four quarters of 2004. Within that total, core PCE prices accelerated over that period to an annual rate of about 2 percent, from 1½ percent in 2004. However, data for the consumer price index (CPI), which are available through June, suggest that core inflation has moderated in recent months; the core CPI rose at an annual rate of 1¼ percent in the three months ending in June after having increased at a 3¼ percent pace over the first three months of this year.

The PCE price index for energy, which moved up more than 18 percent in 2004, increased at an annual rate of nearly 14 percent between the fourth quarter of 2004 and May 2005, having been pushed higher by a further run-up in crude oil prices. Gasoline prices climbed especially rapidly between February and April, when higher crude costs were accompanied by a significant widening in retail margins. Although these margins subsequently dropped back, retail gasoline prices in June were still nearly 10 percent above their level at the end of last year, and they moved up further in early July. Electricity prices also rose sharply over the first half of 2005 because of higher input costs for electricity generation.

Consumer food prices increased at an annual rate of about 2½ percent over the first half of 2005, a bit less than in 2004. Prices for fruits and vegetables dropped back early in the year, as supplies recovered from the damage associated with last year's succession of hurricanes. Although these prices turned up a little in the spring, they remain below their fourth-quarter levels. In contrast, meat prices rose at an annual rate of 3 percent over the first half of the year; relatively strong domestic demand has lifted prices despite increases in the number of cattle being fed for slaughter and ample supplies of other meats and poultry. Prices

Alternative Measures of Price Change

Percent

| Price measure | 2003 to 2004 | 2004 to 2005 |
|---|---|---|
| *Chain-type (Q1 to Q1)* | | |
| Gross domestic product (GDP) | 1.7 | 2.4 |
| Gross domestic purchases | 1.7 | 2.8 |
| Personal consumption expenditures (PCE) | 1.7 | 2.2 |
| Excluding food and energy | 1.4 | 1.6 |
| Market-based PCE excluding food and energy | 1.3 | 1.7 |
| *Fixed-weight (Q2 to Q2)* | | |
| Consumer price index | 2.9 | 2.9 |
| Excluding food and energy | 1.8 | 2.2 |

NOTE. Changes are based on quarterly averages of seasonally adjusted data.

for beef were also influenced by a variety of trade restrictions associated with concerns about mad cow disease: Both the full resumption of imports from Canada (which would tend to push down prices) and the resumption of exports to other important trading partners (which would tend to push up prices) were delayed. Prices of food away from home, for which labor costs are more important than raw food costs, rose at an annual rate of about 3½ percent over the first half of this year, a little higher than the recent trend.

The pickup in core PCE inflation this year is due both to the sharp run-up in energy prices and to higher prices for other intermediate materials; these developments have raised production and distribution costs for a wide range of domestically produced goods and services. In addition, the decline in the exchange value of the dollar into early 2005 continued to push up prices of core nonfuel imports this year, both for items used in the domestic production of other goods and services and for items sold directly to consumers. Partially offsetting these influences have been the gains in productivity, which have enabled firms to absorb a portion of the higher costs. Moreover, although the price of crude oil remains high, prices for some other industrial materials have decelerated or edged down of late: The *Journal of Commerce* industrial price index—which excludes energy items—has fallen 6 percent since the beginning of April, while the producer price index for core intermediate materials rose at an annual rate of just 1¼ percent in the second quarter of this year after having increased at roughly a 7 percent pace, on average, in the preceding few quarters.

Measures of shorter-term inflation expectations have edged higher this year, while those of longer-term expectations have held steady or moved lower. Most notably, the Michigan SRC survey indicates that households' median expectations for inflation over the next twelve months have ranged between 3 percent and 3¼ percent in recent months, up from just under 3 percent at the beginning of the year. In contrast, households' median expectations for inflation over the next five to ten years, at a little under 3 percent, are similar to readings in recent years. The latest Survey of Professional Forecasters likewise shows that inflation is expected to average 2½ percent over the next ten years, a figure unchanged since 2001. Readings of longer-term inflation compensation from financial markets show a more pronounced decline: Inflation compensation as measured by the spread of the yield on nominal Treasury securities over their indexed counterparts for the period five to ten years ahead has fallen about 50 basis points since the end of 2004.

## U.S. Financial Markets

Financial market conditions remained generally accommodative during the first half of 2005, as Treasury and private interest rates stayed low. Risk spreads on speculative-grade debt had become very tight by the end of the first quarter, but they subsequently rose, on balance, after the downgrades of Ford and General Motors; current levels suggest more-typical compensation for default risk. Banks continued easing terms and standards on lending to businesses. The pace of business borrowing, which had been sluggish, picked up last year and remained fairly robust in the first half of 2005. Nevertheless, strong corporate profits and the large stockpile of liquid assets already on firms' balance sheets continued to limit their demand for external financing. Debt of

the federal government, of state and local governments, and of households continued to expand briskly. Broad equity price indexes were little changed on net; higher oil prices boosted share prices in the energy sector but weighed on other stocks.

*Interest Rates*

The FOMC boosted the intended federal funds rate 25 basis points at each of its four meetings in the first half of the year. Judging from federal funds futures quotes, these policy actions had all been widely anticipated by investors for some time before each meeting. Since the start of the year, rates on interest rate futures contracts that will expire at the end of 2005 have moved up about 60 basis points in response to evidence of robust economic growth and concerns about the possible emergence of inflationary pressures. Two-year nominal Treasury yields have risen about 80 basis points over that period, reflecting both the firming of policy expectations and actual monetary policy tightening.

Nevertheless, ten-year nominal Treasury yields have edged down so far this year and are now about 60 basis points below their level just before the FOMC meeting in June 2004. Moreover, this fall in long-term yields is a global phenomenon: Long-term yields have declined in most foreign industrialized economies, in several cases by more than in the United States. From the term structure of interest rates, the ten-year Treasury yield can be decomposed into a series of ten consecutive one-year forward rates. The last of these—the one-year forward rate ending ten years hence—now stands about 160 basis points below its level just before the June 2004 FOMC meeting.

Several potential explanations have been offered for the decline in long-term yields and distant-horizon forward rates in the United States since mid-2004. Among these is the possibility that long-term inflation expectations have fallen and become more firmly anchored. Indeed, longer-term inflation compensation, measured by the spread between the yields on ten-year Treasury inflation-protected securities and their nominal counterparts, has fallen about 30 basis points over this period. A second possible explanation is investors' willingness to accept smaller risk premiums on long-term securities amid declining macroeconomic and interest rate uncertainty. The volatility of short-term interest rates and Treasury yields implied by option prices has indeed declined to historically low levels. A third possibility is that several factors have spurred an excess of global saving over planned investment, such as rising incomes in countries with high saving rates, the desire by the aging citizens of many industrialized countries to save for retirement, and apparently diminished investment prospects in many industrialized and developing economies.

Spreads of yields on investment-grade corporate debt over those on comparable-maturity Treasury securities fell during the first quarter of 2005, and risk spreads on high-yield corporate debt reached very low levels. However, in March, news about difficulties in the domestic motor vehicle industry apparently became a focal point for a revision of investors' assessment of risks. Further revelations of accounting irregularities in the insurance industry also seem to have made investors somewhat charier of risk. As a result, risk spreads on corporate bonds and credit default swaps have widened; speculative-grade bond spreads are now about 50 basis points higher than at the start of the year.

*Equity Markets*

Broad equity price indexes fell modestly in the first quarter, but they rebounded and are now little changed, on net, since the start of 2005. Thus far this year, stock prices have been buoyed by continued strong profits and low long-term interest rates, but higher oil prices and a few high-profile earnings disappointments have weighed on share prices outside the energy sector. The forward earnings–price ratio held about steady despite the fall in real interest rates. Equity price volatility implied by quotes on stock options declined, as the implied volatility on the S&P 500 index dropped to a record low level of less than 11 percent.

Net inflows into equity mutual funds were moderate in the first half of 2005, down from the rapid pace during the same period last year. These flows likely followed the pattern set by share prices, which surged about 30 percent in 2003, rose about 10 percent in 2004, and have been flat so far this year.

*Debt and Financial Intermediation*

The aggregate debt of the domestic nonfinancial sectors expanded at an annual rate of about 10 percent in the first quarter of 2005, up from an 8¼ percent pace in the fourth quarter of 2004, mainly because of faster growth of federal government debt and state and local government debt. The mix of household and business debt growth has shifted modestly since the same time last year. Household debt decelerated, though it continued expanding at a rapid pace, and the growth of business-sector debt picked up even though ample internal funding continued to limit firms' need for external financing.

Commercial bank credit expanded at an annual rate of 13 percent in the first quarter of 2005. Financing secured by residential real estate, including home mortgages, home equity loans, and mortgage-backed securities, extended its long, robust expansion. In May, the Federal Reserve Board and other federal agencies that regulate depository institutions issued guidance on sound underwriting and effective credit-risk-management practices for home equity lending. Recently there has been increased use of potentially riskier types of mortgages, including adjustable-rate and interest-only loans, which could pose challenges to both lenders and borrowers. Business loans, which had begun to grow in 2004 after several years of runoffs, accelerated to a 15 percent annual rate of growth in the first quarter of 2005, supported in part by strong demand for short-term financing to fund rising accounts receivable, inventories, and merger and acquisition activity.

Credit market assets held by government-sponsored enterprises declined in the first quarter of this year, as Freddie Mac and Fannie Mae reduced their outright holdings of mortgage-backed securities.

*The M2 Monetary Aggregate*

In the first half of 2005, M2 grew at a 2½ percent annual rate—probably slower than nominal GDP and down from a 5¼ percent pace last year. Slower growth in liquid deposits—likely a consequence of their rising opportunity cost—accounted for most of this deceleration. Yields on retail money market mutual funds rose noticeably in the first half but continued to lag interest rates on market instruments, and assets in these funds continued their prolonged runoff. Small time deposits, whose yields have better kept pace with rising market interest rates, rose briskly during

the same period. Currency expanded at a slow rate, apparently a reflection in large measure of weak demand from abroad. On net, the velocity of M2 is estimated to have moved up in the first half at a somewhat slower pace than would be expected from the historical relationship between money, income, and opportunity cost.

## International Developments

Foreign economic activity has expanded a bit less rapidly this year than in the second half of 2004, as measured by an export-weighted average of growth among U.S. trading partners. The pace of expansion in the industrial economies has generally increased, but, with the important exception of China, this increase has been offset by moderating growth in many developing economies. Inflation has remained well contained in most countries.

The stance of monetary policy has not changed this year in most major foreign economies. The European Central Bank has held its policy rate constant since June 2003, and both the Bank of England and the Bank of Canada have kept policy rates unchanged after having raised them in the latter half of 2004. The Bank of Japan has maintained its commitment to a policy of quantitative easing until deflation ends, but in late May it made what it described as a technical change to allow temporary deviations below the target range for reserve accounts if banks' demand for funds is too weak to satisfy the target. Reserve account balances temporarily fell below ¥30 trillion, the lower end of the target, in early June. Monetary policy has also remained unchanged in most emerging Asian economies; however, several Latin American monetary authorities have continued tightening cycles that began last year in efforts to restrain inflationary pressures.

After having edged up during the first three months of this year, long-term interest rates in the major foreign industrial economies have fallen and now stand below their levels at the start of the year. As in the United States, the decline in foreign long-term interest rates continues a trend that began in mid-2004. However, long-term rates in the major foreign industrial economies have fallen more than rates in the United States this year. The decline in European long-term rates occurred amid weak economic news and a shift away from market expectations of a policy rate increase. In contrast, long-term rates in Canada and the United Kingdom have trended down despite policy rate increases in the second half of last year by both countries' central banks, though market perceptions that the Bank of England may cut rates have recently increased. Although the decline in Japanese rates last year was consistent with both the weak performance of the economy and the persistence of deflation, long-term rates fell further this year despite solid growth in the first quarter.

As foreign interest rates have fallen in recent months, the value of the dollar has risen. Most of this rise has been against the currencies of the major industrial countries; the dollar is largely unchanged against the currencies of the United States' other important trading partners. The dollar has appreciated about 12 percent against the euro and about 9 percent against the yen and sterling since the start of the year. Some of the appreciation against the euro occurred after voters in France and the Netherlands rejected the proposed constitution for the European Union by unexpectedly large margins in May.

European, British, and Canadian stock indexes have risen more than

8 percent since the start of the year. The rise in European stock prices is notable because indicators of economic activity have been fairly weak. In contrast, Japanese stock prices are now little changed after having reversed first-quarter gains. Equity prices in the majority of emerging markets began the year on a strong note but reversed course late in the first quarter and currently stand close to their January levels. Despite these swings, intraday volatility has remained subdued in most equity markets.

*Industrial Economies*

Real GDP in Japan increased at an annual rate of nearly 5 percent in the first quarter of 2005, bouncing back from last year's recession. Personal consumption spending reversed its recent declines, pushing the household saving rate down further. Private investment also rose sharply after having grown tepidly in the second half of 2004. In contrast, the external sector made a small negative contribution to GDP, as imports rose modestly but exports fell. While Japanese manufacturers of high-tech goods reduced their levels of inventories from last year's peak, inventory stocks of firms outside the high-tech sector increased, perhaps because of the slowdown in exports. The labor market has steadily improved: The unemployment rate has reached a seven-year low, and the ratio of job offers to job applicants is at a twelve-year high. Despite the pickup in economic activity and continuing inflation in wholesale prices, consumer price deflation has worsened slightly. The GDP price deflator returned to a year-over-year rate of deflation of more than 1 percent after having temporarily registered a more modest decline in the fourth quarter of 2004.

The pace of activity in the euro area appears to have slowed after a stronger start to the year. Real GDP grew at a 2 percent annual rate in the first quarter, as private consumption rose moderately and both households and firms switched expenditures away from imports and toward domestically produced goods. Both Germany and Spain grew at rates above the area average in the first quarter. In contrast, real GDP in both Italy and the Netherlands declined, while French growth was slower than in most of 2004. Measures of activity point toward slower growth in the euro area in the second quarter. Retail sales, which had risen in the first quarter, were roughly flat, on average, in April and May. The trade balance fell in April, threatening a main engine of growth, though the recent rise in the dollar against the euro should help stimulate export demand going forward. Twelve-month consumer price inflation edged up in June to just above the European Central Bank's target ceiling of 2 percent for inflation over the medium term. The European Central Bank's measure of core inflation, which excludes energy and unprocessed foods, has eased since January to an annual rate comfortably below 2 percent.

Consumer spending in the United Kingdom increased only modestly in the first quarter, slowing real GDP growth to 1½ percent. Nevertheless, the labor market remains tight, as unemployment is at its lowest levels since the mid-1970s and real earnings continue to trend up. The twelve-month rate of consumer price inflation ticked up in June to the Bank of England's target of 2 percent. In its May *Inflation Report*, the Bank of England forecast that inflation would temporarily rise but stay near the target over a two-year period. House prices have been fairly stable this year,

and household net mortgage borrowing has also been subdued.

Growth in Canada remains moderate. Continuing a pattern that has largely held for the past two years, private consumption and investment demand rose in the first quarter while net exports fell. Activity in the second quarter appears to have been solid. Data on housing starts indicate that construction spending grew further, and the merchandise trade surplus improved in April, as exports rose and imports decreased slightly. Twelve-month consumer price inflation fell in May to about 1½ percent after having averaged slightly above 2 percent in the first quarter. The Bank of Canada's measure of core inflation has stayed below 2 percent throughout this year.

*Emerging-Market Economies*

Chinese real GDP continues to rise rapidly following strong growth in 2004. Economic expansion has been led by investment, exports, and, more recently, a surge in domestic production of goods that had previously been imported. Investment expenditure has remained vigorous despite the government's attempts early last year to slow its rate of increase. Import growth slowed in the first quarter, but the rise of exports was unabated, leading to a significant widening of the trade surplus. Although recent attention has focused on China's exports of textiles, export growth has remained strong across most major categories of goods. The slowdown in imports has also been broadly based. Despite China's strong rate of economic expansion, consumer price inflation fell to less than 3 percent in the first quarter and has remained low, as declining food prices have offset modest increases in nonfood prices.

Economic developments in other Asian emerging-market economies have varied. Hong Kong maintained its strong performance. As in China, growth in Hong Kong has been driven by both investment and exports. Export growth has also played an important role in supporting growth in most of the other countries in this region, but domestic demand, particularly inventory investment, has declined in many economies so far this year. Inflation has risen slightly, reflecting higher food and energy prices, but remains well contained and under 3 percent in most countries.

The Mexican economy has slowed so far this year, as demand for its manufacturing exports has weakened and monetary tightening has tempered investment and consumption demand. The Bank of Mexico has left monetary policy unchanged since March, but its tightening over the preceding twelve months raised short-term interest rates 500 basis points. Twelve-month consumer price inflation has fallen from its levels of late last year but still stands above the Bank of Mexico's target range of 2 percent to 4 percent. After having risen in the second half of last year, core inflation has also trended down in recent months.

Economic growth in most South American economies has also slowed compared with the pace of activity at the end of 2004. Brazil's real GDP rose at only a 1¼ percent annual rate in the first quarter, as both private consumption and investment declined in the wake of the Brazilian central bank's decision to begin raising its policy rate in the second half of 2004 to counter inflationary pressures. Exports, which rose rapidly and outpaced imports, provided the only bright spot. Twelve-month inflation has remained above 7 percent, and the central bank has continued to raise

its policy rate this year. Argentina has gradually recovered from its 2001 crisis, but real GDP sharply decelerated in the first quarter. The unemployment rate, which had steadily fallen over the past few years, also edged up slightly. Twelve-month consumer price inflation appears to have stabilized after having been pushed up by food price increases earlier in the year, but it still lies above the central bank's unofficial target range of 5 percent to 8 percent. The Argentine government recently completed the final settlement of its debt exchange but has not yet resolved the treatment of the remaining investors (holders of roughly one-fourth of all defaulted government bonds) who rejected the agreement. ■

# *Federal Reserve Operations*

# *Banking Supervision and Regulation*

The Federal Reserve has supervisory and regulatory authority over a wide range of financial institutions and activities. It works with other federal and state supervisory authorities to ensure the safety and soundness of financial institutions and the stability of the financial markets.

In 2005, U.S. banking organizations reported record earnings and maintained strong asset quality. However, banking organizations also faced some challenges during the year. Throughout the year, a flattening yield curve placed pressure on bank net interest margins, necessitating adjustments to balance-sheet positions and interest-rate risk management strategies at many institutions. In September, banking organizations in several Gulf Coast states faced extraordinary challenges in the aftermath of Hurricanes Katrina and Rita. For the most part, the banking organizations supervised by the Federal Reserve in the affected areas resumed operations expeditiously. The Federal Reserve and the other federal banking agencies encouraged banking organizations to be flexible in responding to the needs of borrowers and other customers in communities and regions affected by the disasters. At year-end, the ramifications of the hurricanes on banking organizations had not been fully quantified. The federal banking agencies continue to work with the banking organizations in the affected regions as they deal with the after-effects of the storms.

During the latter half of the year, personal bankruptcy filings rose sharply as a result of consumers accelerating their filings before the effective date of the 2005 amendments to the Bankruptcy Code. These filings temporarily increased loan losses—particularly within credit card portfolios—but had little effect on the industry's sound loan quality. The number of consumer bankruptcy filings is expected to diminish in 2006.

Rapid growth in home equity lines of credit, nontraditional residential mortgages, and commercial real estate loans raised some supervisory concerns in 2005 and led the federal banking agencies to issue or propose guidance on sound risk-management practices for these lines of business. Nevertheless, delinquencies in these and most other loan segments remained low, and nonperforming asset ratios reached very low levels during the year.

While banks and supervisors have traditionally ranked credit and market risks as top concerns, in recent years these risks often have been overshadowed by compliance and other operational risks. Some of the largest banking organizations have experienced rapid growth and significantly expanded their products and services, heightening supervisory concern about whether these organizations' compliance risk management practices are keeping pace. One significant area of concern for supervisors is compliance with anti-money-laundering laws and regulations. In 2005, the Federal Reserve, in conjunction with the other federal banking agencies and the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN), issued the *Bank Secrecy Act/Anti–Money Laundering (BSA/AML) Examination Manual* to help strengthen

enforcement of these laws and further promote consistent examination approaches among supervisors.

Federal Reserve staff continue to devote considerable effort to revising domestic and international capital standards. In 2006, the U.S. banking agencies expect to issue a notice of proposed rulemaking (NPR) setting forth their views and seeking public comment with respect to the U.S. implementation of the Basel II capital accord, an international agreement among banking supervisors that was issued in June 2004.[1] The Federal Reserve is also working with the other federal banking agencies to develop supervisory guidance for both examiners and the banking industry.

The U.S. banking organizations expect that only a small number of large, internationally active U.S. banking organizations will be subject to the Basel II framework. The vast majority of banking organizations are expected to remain on the existing risk-based capital framework (Basel I). To update Basel I and mitigate some of the consequences of the differences between Basel I and Basel II, the federal banking agencies in October jointly published an advance notice of proposed rulemaking that contains proposed revisions to Basel I that would enhance its risk sensitivity.

## Scope of Responsibilities for Supervision and Regulation

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies, including financial holding companies formed under the authority of the 1999 Gramm-Leach-Bliley Act, and state-chartered commercial banks that are members of the Federal Reserve System. In overseeing these organizations, the Federal Reserve seeks primarily to promote their safe and sound operation, including their compliance with laws and regulations.[2]

The Federal Reserve also has responsibility for the supervision of all Edge Act and agreement corporations; the international operations of state member banks and U.S. bank holding companies; and the operations of foreign banking companies in the United States.

The Federal Reserve exercises important regulatory influence over entry into the U.S. banking system and the structure of the system through its administration of the Bank Holding Company Act, the Bank Merger Act (with regard to state member banks), the Change in Bank Control Act (with regard to bank holding companies and state member banks), and the International Banking Act. The Federal Reserve is also responsible for imposing margin requirements on securities transactions. In carrying out these responsibilities, the Federal Reserve coordinates its supervisory activities with the other federal banking agencies, state agencies, functional regulators, and the bank regulatory agencies of other nations.

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1. The agreement, titled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," was developed by the Basel Committee on Banking Supervision, which is made up of representatives of the central banks or other supervisory authorities of thirteen countries. The November 2005 updated version is available on the web site of the Bank for International Settlements (www.bis.org).

2. The Board's Division of Consumer and Community Affairs coordinates the Federal Reserve's supervisory activities with regard to compliance with consumer protection and civil rights laws. Those activities are described in the chapter "Consumer and Community Affairs." Compliance with other banking laws and regulations, which is treated in this chapter, is the responsibility of the Board's Division of Banking Supervision and Regulation and the Federal Reserve Banks, whose examiners also check for safety and soundness.

## Supervision for Safety and Soundness

To promote the safety and soundness of banking organizations, the Federal Reserve conducts on-site examinations and inspections and off-site surveillance and monitoring. It also undertakes enforcement and other supervisory actions.

### Examinations and Inspections

The Federal Reserve conducts examinations of state member banks, the U.S. branches and agencies of foreign banks, and Edge Act and agreement corporations. In a process distinct from examinations, it conducts inspections of bank holding companies and their nonbank subsidiaries. Preexamination planning and on-site review of operations are integral parts of the overall effort to ensure the safety and soundness of banking organizations. Whether an examination or an inspection is being conducted, the review of operations entails (1) an assessment of the quality of the processes in place to identify, measure, monitor, and control risks; (2) an assessment of the quality of the organization's assets; (3) an evaluation of management, including an assessment of internal policies, procedures, controls, and operations; (4) an assessment of the key financial factors of capital, earnings, liquidity, and sensitivity to market risk; and (5) a review for compliance with

State Member Banks and Holding Companies, 2001–2005

| Entity/Item | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|
| *State member banks* | | | | | |
| Total number | 907 | 919 | 935 | 949 | 970 |
| Total assets (billions of dollars) | 1,318 | 1,275 | 1,912 | 1,863 | 1,823 |
| Number of examinations | 783 | 809 | 822 | 814 | 816 |
| By Federal Reserve System | 563 | 581 | 581 | 550 | 561 |
| By state banking agency | 220 | 228 | 241 | 264 | 255 |
| *Top-tier bank holding companies* | | | | | |
| Large (assets of more than $1 billion) | | | | | |
| Total number | 394 | 355 | 365 | 329 | 312 |
| Total assets (billions of dollars) | 10,261 | 8,429 | 8,295 | 7,483 | 6,905 |
| Number of inspections | 501 | 500 | 454 | 439 | 413 |
| By Federal Reserve System[1] | 496 | 491 | 446 | 431 | 409 |
| On site | 457 | 440 | 399 | 385 | 372 |
| Off site | 39 | 51 | 47 | 46 | 37 |
| By state banking agency | 5 | 9 | 8 | 8 | 4 |
| Small (assets of $1 billion or less) | | | | | |
| Total number | 4,760 | 4,796 | 4,787 | 4,806 | 4,816 |
| Total assets (billions of dollars) | 890 | 852 | 847 | 821 | 768 |
| Number of inspections | 3,420 | 3,703 | 3,453 | 3,726 | 3,486 |
| By Federal Reserve System | 3,233 | 3,526 | 3,324 | 3,625 | 3,396 |
| On site[2] | 170 | 186 | 183 | 264 | 730 |
| Off site | 3,063 | 3,340 | 3,141 | 3,361 | 2,666 |
| By state banking agency | 187 | 177 | 129 | 101 | 90 |
| *Financial holding companies* | | | | | |
| Domestic | 591 | 600 | 612 | 602 | 567 |
| Foreign | 38 | 36 | 32 | 30 | 23 |

1. For large bank holding companies subject to continuous, risk-focused supervision, includes multiple targeted reviews.

2. In 2002, the supervisory program for small bank holding companies was revised, resulting in more inspections being performed off-site versus on-site. See text section "Bank Holding Companies" for more information.

applicable laws and regulations. The table provides information on the examinations and inspections conducted by the Federal Reserve during the past five years.

To manage the supervisory process, the Federal Reserve follows a risk-focused approach that seeks to focus supervisory resources on (1) those business activities posing the greatest risk to banking organizations and (2) the organizations' management processes for identifying, measuring, monitoring, and controlling risks. The key features of the supervision program for large complex banking organizations (LCBOs) are (1) identifying those LCBOs that are judged, on the basis of their shared risk characteristics, to present the highest level of supervisory risk to the Federal Reserve System, (2) maintaining continual supervision of these organizations so that the Federal Reserve's assessment of each organization's condition is current, (3) assigning to each LCBO a supervisory team composed of Reserve Bank staff members who have skills appropriate for the organization's risk profile (the team leader is the central point of contact, has responsibility for only one LCBO, and is supported by specialists skilled in evaluating the risks of LCBO business activities and functions), and (4) promoting System-wide and interagency information-sharing through automated systems.

For other banking organizations, the risk-focused supervision program provides that examination procedures should be tailored to each bank's size, complexity, and risk profile. Examinations entail both off-site and on-site work, including planning, pre-examination visits, detailed documentation, and examination reports tailored to the scope and findings of the examination.

### *State Member Banks*

At the end of 2005, 907 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve System. These banks represented approximately 12 percent of all insured U.S. commercial banks and held approximately 15 percent of all insured commercial bank assets in the United States. The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination of these banks is required at least once a year, although certain well-capitalized, well-managed organizations having assets of less than $250 million may be examined once every eighteen months. The Federal Reserve conducted 563 exams of state member banks in 2005.

### *Bank Holding Companies*

At year-end 2005, a total of 5,860 U.S. bank holding companies were in operation, of which 5,154 were top-tier bank holding companies. These organizations controlled 6,160 insured commercial banks and held approximately 96 percent of all insured commercial bank assets in the United States.

Federal Reserve guidelines call for annual inspections of large bank holding companies as well as smaller companies that have significant nonbank assets. In judging the financial condition of the subsidiary banks owned by holding companies, Federal Reserve examiners consult examination reports prepared by the federal and state banking authorities

that have primary responsibility for the supervision of those banks, thereby minimizing duplication of effort and reducing the burden on banking organizations. Small, noncomplex bank holding companies—those that have consolidated assets of $1 billion or less—are subject to a special supervisory program that was implemented in 1997 and modified in 2002.[3] The program permits a more flexible approach to the supervision of these companies. In 2005, the Federal Reserve conducted 496 inspections of large bank holding companies and 3,233 inspections of small, noncomplex bank holding companies.

### *Financial Holding Companies*

Under the Gramm-Leach-Bliley Act, bank holding companies that meet certain capital, managerial, and other requirements may elect to become financial holding companies and thereby engage in a wider range of financial activities, including full-scope securities underwriting, merchant banking, and insurance underwriting and sales. The statute streamlines the Federal Reserve's supervision of all bank holding companies, including financial holding companies, and sets forth parameters for the relationship between the Federal Reserve and other regulators. The statute also differentiates between the Federal Reserve's relations with regulators of depository institutions and its relations with functional regulators (that is, regulators for insurance, securities, and commodities firms).

As of year-end 2005, 591 domestic bank holding companies and 38 foreign banking organizations had financial holding company status. Of the domestic financial holding companies, 39 had consolidated assets of $15 billion or more; 115, between $1 billion and $15 billion; 82, between $500 million and $1 billion; and 355, less than $500 million.

3. Refer to SR Letter 02-01 for a discussion of the factors considered in determining whether a bank holding company is complex or noncomplex (www.federalreserve.gov/boarddocs/srletters/).

## Anti-Money-Laundering Examinations

The U.S. Department of the Treasury regulations (31 CFR 103) implementing the Bank Secrecy Act (BSA) generally require banks and other types of financial institutions to file certain reports and maintain certain records that are useful in criminal or regulatory proceedings.

The BSA and separate Board regulations require banking organizations supervised by the Board to file reports on suspicious activity related to possible violations of federal law, including money laundering, terrorist financing, and other financial crimes. In addition, BSA and Board regulations require that banks develop written programs on BSA/anti-money-laundering (AML) compliance and that the programs be formally approved by bank boards of directors. An institution's compliance program must (1) establish a system of internal controls to ensure compliance with the BSA, (2) provide for independent compliance testing, (3) identify individuals responsible for coordinating and monitoring day-to-day compliance, and (4) provide training for personnel as appropriate.

The Federal Reserve is responsible for examining its supervised institutions for compliance with various anti-money-laundering laws and regulations. During examinations of state member banks and U.S. branches and agencies of foreign banks and, when appropriate,

inspections of bank holding companies, examiners review the institution's compliance with the BSA and determine whether adequate procedures and controls to guard against money laundering are in place.

## Quantitative Risk Management

To better coordinate the System's existing advanced risk-management and risk-measurement efforts, the division created a quantitative risk management group in early 2005. This new group will focus on Basel II quantification and validation, and will play a broader role by helping the System set priorities on the allocation of quantitative resources, identifying important issues at both systemic and institutional levels, collaborating on original research and data analysis with colleagues in the Federal Reserve's economic research divisions, and generally providing input on quantitative matters. In 2005, the group participated in the fourth Basel II Quantitative Impact Study (QIS-4) and other interagency efforts, participated in Basel Committee on Banking Supervision (Basel Committee) working groups and projects, and assisted with quantitative training for examiners and other staff.

## Business Continuity

In 2005, the Federal Reserve continued its efforts to strengthen the resilience of the U.S. financial system in the event of unexpected disruptions. Throughout the year, the Federal Reserve monitored financial institutions' progress toward implementing the sound practices identified in the April 2003 "Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System," a joint publication with the Office of the Comptroller of the Currency (OCC) and the Securities and Exchange Commission (SEC), which specifies 2005–06 implementation dates. The agencies also provided some guidance to help firms that are implementing the sound practices verify their efforts. In addition, the agencies continue to closely coordinate efforts to ensure a consistent supervisory approach for business-continuity practices.

## Specialized Examinations

The Federal Reserve conducts specialized examinations of banking organizations in the areas of information technology, fiduciary activities, transfer agent activities, and government and municipal securities dealing and brokering. The Federal Reserve also conducts specialized examinations of certain entities, other than banks, brokers, or dealers, that extend credit subject to the Board's margin regulations.

### *Information Technology Activities*

In recognition of the importance of information technology to safe and sound operations in the financial industry, the Federal Reserve reviews the information technology activities of supervised banking organizations as well as certain independent data centers that provide information technology services to these organizations. All safety and soundness examinations are expected to include a review of information technology risks and activities. During 2005, the Federal Reserve was the lead agency in 2 examinations of large, multiregional data processing servicers examined in cooperation with the other federal banking agencies.

### *Fiduciary Activities*

The Federal Reserve has supervisory responsibility for organizations that

together hold more than $26 trillion of assets in various fiduciary or custodial capacities. During on-site examinations of fiduciary activities, an organization's compliance with laws, regulations, and general fiduciary principles and potential conflicts of interest are reviewed; its management and operations, including its asset- and account-management, risk-management, and audit and control procedures, are also evaluated. In 2005, Federal Reserve examiners conducted 119 on-site fiduciary examinations.

### *Transfer Agents and Securities Clearing Agencies*

As directed by the Securities Exchange Act of 1934, the Federal Reserve conducts specialized examinations of those state member banks and bank holding companies that are registered with the Board as transfer agents. Among other things, transfer agents countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. On-site examinations focus on the effectiveness of an organization's operations and its compliance with relevant securities regulations. During 2005, the Federal Reserve conducted on-site examinations at 24 of the 77 state member banks and bank holding companies that were registered as transfer agents. In 2005, the Federal Reserve also examined 1 state member limited-purpose trust company acting as a national securities depository.

### *Government and Municipal Securities Dealers and Brokers*

The Federal Reserve is responsible for examining state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with Department of the Treasury regulations governing dealing and brokering in government securities. Twenty-eight state member banks and 7 state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2005, the Federal Reserve conducted 9 examinations of broker-dealer activities in government securities at these organizations. These examinations are generally conducted concurrently with the Federal Reserve's examination of the state member bank or branch.

The Federal Reserve is also responsible for ensuring that both state member banks and bank holding companies that act as municipal securities dealers comply with the Securities Act Amendments of 1975. Municipal securities dealers are examined pursuant to the Municipal Securities Rulemaking Board's rule G-16 at least once every two calendar years. Of the 22 entities that dealt in municipal securities during 2005, 7 were examined during the year.

### *Securities Credit Lenders*

Under the Securities Exchange Act of 1934, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. As part of its general examination program, the Federal Reserve examines the banks under its jurisdiction for compliance with the Board's Regulation U. In addition, the Federal Reserve maintains a registry of persons other than banks, brokers, and dealers who extend credit subject to Regulation U. The Federal Reserve may conduct specialized examinations of these lenders if they are not already subject to supervision by the Farm Credit Administration, the National Credit Union Administration, or the Office of Thrift Supervision (OTS).

At the end of 2005, 628 lenders other than banks, brokers, or dealers were registered with the Federal Reserve. Other federal regulators supervised 216 of these lenders, and the remaining 412 were subject to limited Federal Reserve supervision. On the basis of regulatory requirements and annual reports, the Federal Reserve exempted 181 lenders from its on-site inspection program. The securities credit activities of the remaining 231 lenders were subject to either biennial or triennial inspection. Eighty inspections were conducted during the year, compared with 55 in 2004.

## Enforcement Actions and Special Examinations

The Federal Reserve has enforcement authority over the banking organizations it supervises and their affiliated parties. Enforcement actions may be taken to address unsafe and unsound practices or violations of any law or regulation. Formal enforcement actions include cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties. In 2005, the Federal Reserve completed 64 formal enforcement actions. Civil money penalties totaling $40.2 million were assessed. All civil money penalties, as directed by statute, are remitted either to the Department of the Treasury or to the Federal Emergency Management Agency. Enforcement orders, which are issued by the Board, and written agreements, which are executed by the Reserve Banks, are made public and posted on the Board's web site (www.federalreserve.gov/boarddocs/enforcement).

In addition to formal enforcement actions, the Reserve Banks completed 95 informal enforcement actions in 2005. Informal enforcement actions include memoranda of understanding and board of directors resolutions. Information about these actions is not available to the public.

## Surveillance and Off-Site Monitoring

The Federal Reserve uses automated screening systems to monitor the financial condition and performance of state member banks and bank holding companies between on-site examinations. This analysis helps to direct examination resources to institutions that exhibit higher risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities.

Since 1994, the Federal Reserve's screening systems have included a set of two models that together are known as the System to Estimate Examination Ratings (SEER). These models use econometric techniques to estimate, for each bank, a supervisory rating and probability of failure using the supervisory information and financial data banks report on their Reports of Condition and Income (Call Reports). During 2005, the Federal Reserve completed an initiative to enhance the SEER models; this effort resulted in a new off-site monitoring tool known as the Supervision and Regulation Statistical Assessment of Bank Risk model. The new model is scheduled for implementation in early 2006. To supplement these screens that use financial and supervisory data, the Federal Reserve also monitors various market data, including equity prices, debt spreads, agency ratings, and measures of expected default frequency, to gauge market perceptions of the risk in banking organizations.

The Federal Reserve also prepares quarterly Bank Holding Company Performance Reports (BHCPRs) for use in monitoring and inspecting supervised

banking organizations. The reports contain, for individual bank holding companies, financial statistics and comparisons with peer companies. BHCPRs are compiled from data provided by large bank holding companies in quarterly regulatory reports (FR Y-9C and FR Y-9LP). BHCPRs are made available to the public on the National Information Center web site, which can be accessed at www.ffiec.gov.

During 2005, the surveillance function implemented two major upgrades to its web-based Performance Report Information and Surveillance Monitoring (PRISM) application. PRISM is a querying tool used by Federal Reserve analysts to access and display financial, surveillance, and examination data. In the analytical module, users can customize the presentation of institutional financial information drawn from Call Reports, Uniform Bank Performance Reports, FR Y-9 statements, BHCPRs, and other regulatory reports. In the surveillance module, users can generate reports summarizing the results of System surveillance screens for banks and bank holding companies. The upgrades enhanced the range of regulatory data available for queries, expanded the number of surveillance screens, added new search options, and improved the user interface.

The Federal Reserve works through the Federal Financial Institutions Examination Council (FFIEC) Task Force on Surveillance Systems to coordinate surveillance activities with the other federal banking agencies.[4]

4. The member agencies of the FFIEC are the Federal Reserve Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

## International Activities

The Federal Reserve supervises the foreign branches and overseas investments of member banks, Edge Act and agreement corporations, and bank holding companies and also the investments by bank holding companies in export trading companies. In addition, it supervises the activities that foreign banking organizations conduct through entities in the United States, including branches, agencies, representative offices, and subsidiaries.

### *Foreign Operations of U.S. Banking Organizations*

To examine the international operations of state member banks, Edge Act and agreement corporations, and bank holding companies, the Federal Reserve generally conducts its examinations or inspections at the U.S. head offices of these organizations—where the ultimate responsibility for their foreign offices lies. Examiners also visit the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to evaluate the organizations' efforts to implement corrective measures or to test their adherence to safe and sound banking practices. Examinations abroad are conducted with the cooperation of the supervisory authorities of the countries in which they take place; when appropriate, the examinations are coordinated with the OCC.

At the end of 2005, 55 member banks were operating 748 branches in foreign countries and overseas areas of the United States; 34 national banks were operating 693 of these branches, and 21 state member banks were operating the remaining 55. In addition, 16 nonmember banks were operating 20 branches in foreign countries and overseas areas of the United States.

*Edge Act and Agreement Corporations*

Edge Act corporations are international banking organizations chartered by the Board to provide all segments of the U.S. economy with a means of financing international business, especially exports. Agreement corporations are similar organizations, state chartered or federally chartered, that enter into an agreement with the Board to refrain from exercising any power that is not permissible for an Edge Act corporation.

Sections 25 and 25A of the Federal Reserve Act grant Edge Act and agreement corporations permission to engage in international banking and foreign financial transactions. These corporations, most of which are subsidiaries of member banks, may (1) conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions, and (2) make foreign investments that are broader than those permissible for member banks.

At year-end 2005, 70 banking organizations, operating 9 branches, were chartered as Edge Act or agreement corporations. These corporations are examined annually.

*U.S. Activities of Foreign Banks*

The Federal Reserve has broad authority to supervise and regulate the U.S. activities of foreign banks that engage in banking and related activities in the United States through branches, agencies, representative offices, commercial lending companies, Edge Act corporations, commercial banks, and certain nonbank companies. Foreign banks continue to be significant participants in the U.S. banking system.

As of year-end 2005, 183 foreign banks from 54 countries were operating 220 state-licensed branches and agencies (of which 8 were insured by the Federal Deposit Insurance Corporation) as well as 50 branches licensed by the OCC (of which 4 had FDIC insurance). These foreign banks also directly owned 12 Edge Act and agreement corporations and 2 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 67 U.S. commercial banks.

Altogether, the U.S. offices of these foreign banks at the end of 2005 controlled approximately 18 percent of U.S. commercial banking assets. These foreign banks also operated 73 representative offices; an additional 52 foreign banks operated in the United States solely through a representative office.

State-licensed and federally licensed branches and agencies of foreign banks are examined on-site at least once every eighteen months, either by the Federal Reserve or by a state or other federal regulator. In most cases, on-site examinations are conducted at least once every twelve months, but the period may be extended to eighteen months if the branch or agency meets certain criteria.

In cooperation with the other federal and state banking agencies, the Federal Reserve conducts a joint program for supervising the U.S. operations of foreign banking organizations. The program has two main parts. One part addresses the examination process for those foreign banking organizations that have multiple U.S. operations and is intended to ensure coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each organization to assess its general ability to support its U.S. operations and to determine what risks, if any, the organization poses through its U.S. operations. Together, these two processes provide critical information to U.S. supervisors in a logical, uniform, and timely man-

ner. The Federal Reserve conducted or participated with state and federal regulatory authorities in 338 examinations in 2005.

### Technical Assistance

In 2005, the Federal Reserve continued to provide technical assistance on bank supervisory matters to foreign central banks and supervisory authorities. Technical assistance involves visits by Federal Reserve staff members to foreign authorities as well as consultations with foreign supervisors who visit the Board or the Reserve Banks. Technical assistance in 2005 was concentrated in Latin America, Asia, and former Soviet bloc countries. The Federal Reserve, along with the OCC, FDIC, and Department of the Treasury, was also an active participant in the newly launched Middle East and North Africa (MENA) Financial Regulators' Training Initiative, which is part of the U.S. government's Middle East Partnership Initiative.

During the year, the Federal Reserve offered training courses exclusively for foreign supervisory authorities in Washington, D.C., and in a number of foreign jurisdictions. System staff also took part in technical assistance and training missions led by the International Monetary Fund, the World Bank, the Inter-American Development Bank, the Asian Development Bank, the Basel Committee, and the Financial Stability Institute.

The Federal Reserve is also an associate member of the Association of Supervisors of Banks of the Americas (ASBA), an umbrella group of bank supervisors from countries in the Western Hemisphere. The group, headquartered in Mexico, promotes communication and cooperation among bank supervisors in the region; coordinates training programs throughout Latin America, with the help of national banking supervisors and international agencies; and aims to help members develop banking laws, regulations, and supervisory practices that conform to international best practices. For the past three years, a Federal Reserve official has served as chairman of the board of directors of ASBA; the Federal Reserve also contributes significantly to ASBA's organizational management and to its training and technical assistance activities.

## Supervisory Policy

The Federal Reserve's supervisory policy function is responsible for developing guidance for examiners and banking organizations as well as regulations for banking organizations under the Federal Reserve's supervision. Staff members participate in international supervisory forums, such as the Basel Committee and the International Accounting Standards Board (IASB), and provide support for the work of the FFIEC.

### Capital Adequacy Standards

During 2005, the Federal Reserve, OCC, FDIC, and OTS continued to draft proposed revisions to their risk-based capital adequacy regulations to reflect the June 2004 international agreement on capital adequacy for banking organizations, commonly known as Basel II. The agencies also issued an advance notice of proposed rulemaking (ANPR) on potential changes to the Basel I framework; these proposed changes would affect banking organizations not subject to Basel II. Further, the agencies issued joint interagency guidance on capital requirements for asset-backed commercial paper (ABCP) programs, and they are developing a proposal to revise the

capital requirements for trading book positions subject to the market risk capital rule. In addition, the Federal Reserve adopted a final rule on the treatment of trust preferred securities in the tier 1 capital of bank holding companies.

*Risk-Based Capital Standards for Certain Internationally Active Banking Organizations*

During 2005, the agencies continued to prepare for the U.S. implementation of Basel II. In early 2006, the U.S. banking agencies expect to make available a notice of proposed rulemaking (NPR) setting forth their views on Basel II and seeking public comment on the U.S. plan for implementing the agreement.

The agencies expect that only a small number of large, internationally active U.S. banking organizations will be required to use the Basel II framework. In April, the agencies announced preliminary results from the fourth quantitative impact study (QIS-4), which evaluated the potential impact of implementing Basel II at the approximately thirty banking organizations that participated in the study. The preliminary results of QIS-4 showed a larger overall decline and a greater dispersion in regulatory capital requirements than had been originally expected. QIS-4 results also indicated that participating institutions have additional work to do to complete the systems and processes they need to have in place before Basel II is implemented. Partly as a result of concerns identified in the analysis of QIS-4 results, the agencies announced on September 30 additional prudential safeguards and a one-year delay in the timeline for Basel II implementation in the United States.

The NPR will maintain the basic minimum risk-based capital ratio format of regulatory capital divided by risk-weighted assets, with the minimum for tier 1 capital set at 4 percent and the minimum for total qualifying capital set at 8 percent. The components of tier 1 and total qualifying capital have been adjusted to an unexpected-loss basis consistent with the denominator. The primary difference between the current rules and the proposed Basel II rule is the internal-ratings-based methodologies Basel II uses to calculate risk-weighted assets; the proposed rule also contains the Basel II advanced measurement approach for operational risk. Banking organizations using the methods set forth in the NPR would also be subject to certain public disclosure requirements to foster transparency and market discipline. All banking organizations, including those using the internal-ratings-based approach for credit risk and the advanced measurement approach for operational risk, would continue to be subject to the tier 1 leverage ratio requirement and the market risk capital rule, if applicable, as well as the prompt corrective action rules.

*Risk-Based Capital Standards for Banking Organizations Not Subject to Basel II*

On October 20, the agencies issued for public comment an ANPR that considers modifications to the existing risk-based capital framework, or Basel I, which would continue to apply to banking organizations not subject to Basel II. The changes seek to enhance the risk sensitivity of Basel I by increasing the number of risk-weight categories, permitting greater use of external ratings as an indicator of credit risk for externally rated exposures, expanding the types of guarantees and collateral that may be recognized, and modifying the risk weights associated with residential mortgages. The ANPR also discusses

approaches that would change the credit-conversion factor for certain types of commitments, assign a risk-based capital charge to certain securitizations with early-amortization provisions, and assign a higher risk weight to loans that are 90 days or more past due or in nonaccrual status and to certain commercial real estate exposures. The agencies are also considering modifying the risk weights on certain other retail and commercial exposures. The comment period for the ANPR will end in January 2006.

### *Asset-Backed Commercial Paper Programs*

On August 4, the agencies issued "Interagency Guidance on the Eligibility of Asset-Backed Commercial Paper Program Liquidity Facilities and the Resulting Risk-Based Capital Treatment." The guidance reiterates the agencies' position that the primary function of an eligible ABCP liquidity facility should be to provide liquidity—not to enhance credit. The guidance clarifies (1) the application of the asset-quality test set forth in the agencies' risk-based capital rules for determining the eligibility of an ABCP liquidity facility and (2) the resulting risk-based capital treatment of such a facility for banking organizations. An eligible liquidity facility must have an asset-quality test that precludes funding against assets that are 90 days or more past due, in default, or below investment grade. This test implies that the banking organization providing the ABCP liquidity facility should not be exposed to the credit risk associated with such assets. The guidance clarifies that an ABCP liquidity facility meets the asset-quality test if, at all times throughout the transaction, (1) the liquidity provider has access to certain types of acceptable credit enhancements that support the liquidity facility and (2) the notional amount of such credit enhancements exceeds the amount of underlying assets that are 90 days or more past due, defaulted, or below investment grade that the liquidity provider may be obligated to fund under the facility.

### *Other Capital Issues*

In March, the Board adopted a final rule that allows for the continued inclusion of trust preferred securities in the tier 1 capital of bank holding companies, subject to stricter quantitative limits and clearer qualitative standards. The final rule revised the quantitative limits applied to the aggregate amount of certain core capital elements that may be included in tier 1 capital and revised the qualitative standards for capital instruments included in regulatory capital, consistent with long-standing Board policies.

Board staff members are working with the other agencies to develop a proposal to implement a revised, more risk-sensitive methodology for determining the capital charge for positions subject to the market risk capital rule. The proposal will address the issues identified in the July 2005 paper "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects," which was published by the Basel Committee and the International Organization of Securities Commissioners (IOSCO).

The Board's staff also conduct supervisory analyses of innovative capital instruments and novel transactions in order to determine the appropriate supervisory and regulatory capital treatment and to identify and address supervisory concerns. These reviews frequently require staff to review the various funding strategies proposed in

## New Bank Secrecy Act/Anti–Money Laundering Examination Manual

*This interagency manual is a significant step toward consistency in the area of anti-money-laundering examination. The new manual promotes a shared understanding of the Bank Secrecy Act and anti-money-laundering regulations and supervisory expectations.*

Susan Schmidt Bies, *Member*, Board of Governors
June 2005

The release of the *Bank Secrecy Act/Anti–Money Laundering Examination Manual* on June 30, 2005, marked an important milestone for the federal banking agencies in their effort to enhance the consistent application of the Bank Secrecy Act (BSA). The five federal financial institutions regulatory agencies[1] developed the new manual, in collaboration with the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). The state banking agencies and Treasury's Office of Foreign Assets Control (OFAC) also contributed to this initiative.

In the manual, the agencies emphasize that banking organizations are responsible for establishing and implementing risk-based policies, procedures, and processes to comply with the BSA and to safeguard their operations from money laundering and terrorist financing. The agencies focus on a banking organization's sound risk assessment so that the banking organization can develop an anti-money-laundering program calibrated to its own risk profile. The agencies further

1. The agencies are the Board of Governors of the Federal Reserve System (Federal Reserve), Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA), Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS).

applications for acquisitions and other transactions that institutions submit to the Federal Reserve.

### Bank-Owned Life Insurance

In 2005, an interagency working group issued "Interagency Interpretations of the Interagency Statement on the Purchase and Risk Management of Life Insurance." The interpretations clarify financial reporting, credit-exposure limits, concentration limits, and the appropriate methods for calculating the amount of insurance a banking organization may purchase.

### Bank Holding Company Rating System

In January, the Federal Reserve adopted a revised bank holding company rating system known as RFI/C(D). The three main components of the system are Risk management, Financial condition, and potential Impact of the parent company and nondepository subsidiaries (collectively, nondepository entities) on the subsidiary depository institution(s). The fourth component, Depository institution, generally mirrors the primary regulator's assessment of the subsidiary depository institution(s). The revised rating system reflects the shift that has

emphasize that the primary role of the examiner is to evaluate the adequacy of a banking organization's controls and not to second-guess individual, transaction-level decisions.

To promote a greater understanding of the BSA and anti-money-laundering (BSA/AML) requirements outlined in the manual, the Federal Reserve, along with the other federal banking agencies, FinCEN, and the OFAC, participated in a series of outreach events following the manual's release. The events, intended for the banking industry and federal and state banking agency examination staff, consisted of nationwide conference calls, regional outreach meetings, and a simultaneous broadcast via the Internet. More than 23,000 bankers and examiners participated in these sessions, where they also had the opportunity to ask questions and receive feedback on specific issues.

Moving forward, the agencies will ensure that the manual provides the industry and examiners with relevant, up-to-date information. The manual will be revised in response to changes in law or regulation, other guidance, or evolving risks or controls. The agencies will hold periodic discussions with banking industry representatives so that issues related to the manual may be raised. These sessions will be held through the Bank Secrecy Act Advisory Group (BSAAG), which is a public-private partnership sponsored by the Department of the Treasury devoted to evaluating BSA-related matters. Specifically, the meetings will be held through a BSAAG subcommittee on examination issues, co-chaired by the Federal Reserve.

The Federal Reserve recognizes that banking organizations have invested significant resources to comply with the BSA and related regulations in order to deter and detect money laundering and terrorist financing. Both the banking industry and the regulatory agencies share the goal of combating the threats these crimes pose to the U.S. financial system. The Federal Reserve remains committed to ensuring that supervisory expectations for BSA/AML compliance are clearly understood by banking organizations and examiners.

occurred over time in the Federal Reserve's supervisory practices: a shift away from historical analyses of a BHC's financial condition toward more-forward-looking assessments of its risk management and financial factors. One year into the implementation of the new ratings system, Federal Reserve supervisors have found it to be an effective tool for communicating key supervisory points to banking organizations.

## Bank Secrecy Act and Anti–Money Laundering

In June 2005, the FFIEC issued a new examination manual that compiles existing regulatory requirements, supervisory expectations, and sound practices for BSA/AML compliance. To foster consistency, the manual includes the examination procedures that each agency's examiners are expected to follow. (For more information, see the box "New Bank Secrecy Act/Anti–Money Laundering Examination Manual.")

In March and April, the Federal Reserve, FDIC, OCC, OTS, NCUA, and FinCEN issued guidance to clarify the requirements of the BSA/AML regulations for banking organizations that provide banking services to money-services businesses operating in the United States.

## International Guidance on Supervisory Policies

As a member of the Basel Committee, the Federal Reserve in 2005 participated in efforts to revise the international capital regime and to develop international supervisory guidance. The Federal Reserve's goals in these activities are to advance sound supervisory policies for internationally active banking organizations and to improve the stability of the international banking system.

### *Capital Adequacy*

To address issues not fully resolved in the Basel II framework, the Federal Reserve in 2005 continued to participate in a number of Basel Committee working groups, including a joint Basel Committee–IOSCO working group reviewing issues related to counterparty credit risk, double-default effects (reflecting the low probability that both a borrower and its guarantor will default at the same time), and the definition of positions that are subject to a market risk capital requirement.

### *Risk Management*

The Federal Reserve contributed to several supervisory policy papers, reports, and recommendations issued by the Basel Committee during 2005 that were generally aimed at improving the supervision of banking organizations' risk-management practices.[5]

- "Home-Host Information Sharing for Effective Basel II Implementation," issued as a consultative document in November by the Basel Committee, in association with the Core Principles Liaison Group
- "Enhancing Corporate Governance for Banking Organizations," issued in July (to update guidance published in 1999)
- "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects," issued in July by the Basel Committee and IOSCO
- "Compliance and the Compliance Function in Banks," issued in April

### *Core Principles for Effective Banking Supervision*

The Core Principles, developed by the Basel Committee in 1997, have become the de facto international standard for sound prudential regulation and supervision of banks. During 2005, the Federal Reserve participated in a Basel Committee effort to update the Core Principles in light of the significant changes that have occurred in international banking regulation and the experience that has been gained since the principles were last revised in 1999.

### *Joint Forum*

In 2005, the Federal Reserve also continued its participation in the Joint Forum—a group made up of representatives of the Basel Committee, IOSCO, and the International Association of Insurance Supervisors. The Joint Forum is a forum for supervisors to discuss their experiences with financial conglomerates. The Federal Reserve contributed to several supervisory policy

5. Papers issued by the Basel Committee can be accessed via the Bank for International Settlements web site at www.bis.org.

papers, reports, and recommendations issued by the Joint Forum during 2005.[6]

- "High-Level Principles for Business Continuity," issued in December
- "Credit Risk Transfer," issued in March
- "Outsourcing in Financial Services," issued in February

*International Accounting and Disclosure*

The Federal Reserve participates in the Basel Committee's Accounting Task Force (ATF) and represents the Basel Committee at international meetings on accounting, auditing, and disclosure issues affecting global banking organizations. In particular, officials of the Federal Reserve represent the Basel Committee at meetings that address financial instruments accounting and disclosure issues associated with international accounting standards. In addition, an official of the Federal Reserve is a member of the Standards Advisory Council of the IASB.

The IASB issued an amendment in June that reflects extensive Basel Committee and European Central Bank comments. The amended fair value option (FVO) rule in International Accounting Standard (IAS) 39 allows an organization to irrevocably elect, at inception, a fair value measurement for certain financial instruments, with gains and losses from changes in fair value recorded in current earnings. The FVO rule amendment to IAS 39 will become effective January 1, 2006.

During 2005, the Federal Reserve had a key role in the development of ATF's consultative document "Supervisory Guidance on the Use of the Fair Value Option by Banks under International Financial Reporting Standards," issued for public comment in July. The document provides guidance for the prudential supervision of banks in their implementation of the FVO rule under the amended IAS 39.

The Federal Reserve also provided input on ATF's proposed consultative document "Sound Credit Risk Assessment and Valuation for Loans," which was issued for comment in November. The guidance consists of ten principles addressing supervisory expectations for and supervisory evaluations of a banking organization's establishment and support of its loan-loss allowance accounts.

## Response to 2005 Hurricanes

In 2005, the Federal Reserve worked cooperatively with the other federal banking agencies, state banking agencies, and other organizations to determine the operating status of financial institutions located in the areas affected by Hurricanes Katrina, Rita, and Wilma. The agencies encouraged banks to work with consumer and commercial customers experiencing difficulties due to the storms. The agencies promptly released joint guidance on regulatory and reporting issues to assist examiners and banking organizations affected by the hurricanes. In addition, the Federal Reserve, in consultation with the other federal banking agencies, issued responses to questions frequently asked by financial institutions about whether certain BSA provisions applied when providing services to victims of Hurricane Katrina. The agencies also exercised their authority under section 2 of the Deposi-

6. Papers issued by the Joint Forum can be accessed via the Bank for International Settlements web site at www.bis.org.

tory Institutions Disaster Relief Act of 1992 to waive statutory and regulatory appraisal requirements for transactions that involve real property in major disaster areas, when waiving the appraisal requirements would facilitate disaster recovery and would be consistent with safe and sound banking practice.

In an effort to provide the industry and examiners with further guidance on a growing number of hurricane-related issues, the FFIEC established a formal Katrina working group composed of senior supervision officials from each of the FFIEC agencies. The Katrina working group published frequently asked questions (FAQs) and developed examiner guidance that will be issued in early 2006. Because of the severity and scale of Katrina and the other natural disasters in 2005, the working group's efforts are expected to continue into 2006. The Katrina working group has established a user-friendly, web-based "frequently asked questions" forum on the FFIEC's web site (www.ffiec.gov).

## Credit Risk Management

The Federal Reserve works with the other federal banking agencies to develop guidance on credit risk management.

### *Real Estate Appraisals*

In September, the Federal Reserve, FDIC, NCUA, OCC, and OTS issued FAQs on the requirements of the agencies' real estate appraisal regulations and on the October 2003 interagency statement "Independence of Appraisal and Evaluation Functions." The agencies also issued FAQs in March to help institutions comply with the agencies' appraisal regulations and real estate lending requirements when financing residential construction in a tract development.

### *Home Equity Lending*

In May, the Federal Reserve and the other federal financial institutions regulatory agencies issued "Interagency Credit Risk Management Guidance on Home Equity Lending" to promote sound risk management in banks' home equity lending. The guidance addressed the agencies' concerns about the easing of underwriting standards as lenders compete to attract home equity lending business—sometimes by offering products with high loan-to-value ratios, requiring only limited documentation of a borrower's assets and income, using automated valuation models to a greater extent, or relying on loans originated by third parties. The guidance advances sound underwriting standards, controls over third-party originations, a robust collateral-valuation process, and account and portfolio management practices.

### *Nontraditional Mortgage Products*

In December, the Federal Reserve and the other federal financial institutions regulatory agencies issued for public comment "Proposed Interagency Guidance on Nontraditional Mortgage Products." Nontraditional mortgage products typically include payment-option adjustable-rate mortgages and interest-only mortgages. These mortgage products allow for principal-payment deferral and negative amortization. Institutions may also combine these products with other risk-layering practices, such as less stringent underwriting standards, reduced loan documentation, or simultaneous second-lien loans. The proposed interagency guidance emphasizes that an

institution needs to develop and maintain adequate risk-management practices to monitor and control the risk associated with these products. The proposed guidance also contains recommended practices for providing consumers with information about the terms and risks of nontraditional mortgage products. Comments on the proposal are due March 29, 2006.

### *Commercial Real Estate Concentrations*

During 2005, the Federal Reserve and the federal financial institutions regulatory agencies developed proposed interagency guidance, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices." The proposed guidance, to be issued for public comment in January 2006, will respond to the agencies' concerns about rising commercial real estate (CRE) concentrations, particularly at small to medium-sized institutions. This guidance will reinforce the agencies' existing real estate lending guidelines and provide criteria for identifying institutions that have CRE lending concentrations and that should therefore employ heightened risk-management practices. Comments on the proposal are due April 13, 2006.

## Overdraft Protection

In February, the Federal Reserve, FDIC, NCUA, and OCC issued interagency guidance to assist insured depository institutions in the responsible disclosure and administration of overdraft-protection services. The guidance (1) seeks to ensure that institutions adopt adequate policies and procedures to address the credit, operational, and other risks associated with overdraft-protection services; (2) alerts institutions offering these services to the need to comply with all applicable federal and state laws; and (3) sets forth examples of best practices that are currently observed in, or recommended by, the industry.

## Small Bank Holding Company Threshold

In September, the Board requested comment on a proposal to raise the asset-size threshold used to determine whether a bank holding company qualifies for (1) the Board's Small Bank Holding Company Policy Statement and (2) an exemption from the Board's risk-based and leverage capital adequacy guidelines for bank holding companies. The proposal would raise that threshold from $150 million to $500 million in consolidated assets. The proposal would also modify the qualitative criteria used in determining whether a bank holding company that is under the asset-size threshold nevertheless would not qualify for the policy statement or the exemption from the capital guidelines. In addition, the proposal would clarify the treatment under the policy statement of subordinated debt associated with trust preferred securities. Final action on this proposal is expected in early 2006.

## Economic Growth and Regulatory Paperwork Reduction Act of 1996

The Federal Reserve, OCC, FDIC, and OTS are in the process of reviewing agency regulations as required by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). EGRPRA requires that the banking agencies review their regulations every ten years to identify any unnecessary regulatory requirements imposed on insured depository institu-

tions and eliminate these requirements, as appropriate. This review is in addition to the Board's periodic review of each of its regulations.

The agencies met with representatives from the banking industry and from consumer groups around the country to listen to their concerns and to solicit their suggestions for reducing regulatory burden. The agencies have received public comments on several of their regulations and expect to issue a final report in 2006.

## Sarbanes-Oxley Act

During 2005, the Federal Reserve continued to evaluate the effects of the Sarbanes-Oxley Act (SOX) on banking organizations. Federal Reserve accounting staff reviewed material internal control weaknesses and deficiencies at certain public banking organizations and are now drafting supervisory guidance for examiners and inspectors. The guidance will instruct examiners and inspectors to consider internal control information, including findings generated by the requirements of section 404 of SOX, in the overall risk-assessment process.

In addition, an official of the Federal Reserve serves on the Standing Advisory Group of the Public Company Accounting Oversight Board (PCAOB); the group is advising the PCAOB as it develops standards for the external audits of publicly traded companies in the United States. The Federal Reserve also continued in 2005 to work with the FDIC and other federal agencies to consider changes that should be made to the regulations implementing the Federal Deposit Insurance Corporation Improvement Act to promote strong internal controls and consistency with the SOX requirements.

## Bank Holding Company Regulatory Financial Reports

The Federal Reserve requires that U.S. bank holding companies periodically submit reports providing financial and structure information. This information is essential to the supervision of the organizations and the formulation of regulations and supervisory policies. The information is also used in responding to requests from Congress and the public for information on bank holding companies and their nonbank subsidiaries. In addition, foreign banking organizations must periodically submit reports to the Federal Reserve.

The FR Y-9 series of reports provides standardized financial statements for bank holding companies on a consolidated and parent-only basis. The reports are used to detect emerging financial problems, to review performance and conduct pre-inspection analysis, to monitor and evaluate risk profiles and capital adequacy, to evaluate proposals for bank holding company mergers and acquisitions, and to analyze the holding company's overall financial condition. The nonbank subsidiary reports—FRY-11, FR 2314, and FR Y-7N—aid the Federal Reserve in determining the condition of bank holding companies that are engaged in nonbanking activities and in monitoring the volume, nature, and condition of their nonbanking subsidiaries.

In March, several revisions to the FR Y-9C and FR Y-9SP reports were implemented in order to identify private equity merchant banking activity, identify firms providing auditing services to the bank holding company, collect information on subordinated notes payable to trusts issuing trust preferred securities (changes affected the FR Y-9C balance sheet), and collect information on nonvoting equity capital (changes affected

the FR Y-9SP). In September, the FR Y-9C was modified to collect information on purchased impaired loans in response to Statement of Position 03-3 of the American Institute of Certified Public Accountants, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer," and to collect information related to the Government National Mortgage Association (GNMA) optional repurchase program for mortgage loans (rebooked loans backing GNMA securities).

Effective December 31, revisions to the Annual Report of Foreign Banking Organizations (FR Y-7) reorganized the form and instructions, expanded information collected on foreign companies held under the authority of section 2(h)(2) of the Bank Holding Company Act, added language to the confidentiality section, and clarified the instructions pursuant to Regulation K.

In December, a new report was implemented: the Supplement to the Reports of Changes in Organizational Structure (FR Y-10S). In this report, bank holding companies, financial holding companies, and state member banks not owned by bank holding companies report their SEC registration status and whether they are subject to the requirements of section 404 of SOX. They also report their six-digit CUSIP number to help the Federal Reserve compare regulatory data with market data.

### Commercial Bank Regulatory Financial Reports

As the federal supervisor of state member banks, the Federal Reserve, acting in concert with the other federal banking agencies through the FFIEC, requires banks to submit quarterly Call Reports. Call Reports are the primary source of data for the supervision and regulation of banks and for the ongoing assessment of the overall soundness of the nation's banking system. Call Report data, which also serve as benchmarks for the financial information required by many other Federal Reserve regulatory financial reports, are widely used by state and local governments, state banking supervisors, the banking industry, securities analysts, and the academic community.

The Federal Reserve and the other banking agencies under the auspices of the FFIEC have completed the Call Report modernization project. Through the use of new open data exchange standards (known as "eXtensible Business Reporting Language," or XBRL), the new Central Data Repository (CDR) system improves the timeliness and quality of supervisory data and enhances market discipline by ensuring that the public has more timely access to the data. This is the first wide-scale application of XBRL. Enhancements to the data-collection and -disclosure process include requiring banks to submit their Call Report data electronically to the CDR, moving forward the deadline for filing reports, and requiring respondents to validate their data before filing. The effort to set up the CDR was completed and became operational on October 1.

The FFIEC issued for public comment the proposed changes to the 2006 Call Report. The agencies planned to implement some changes effective March 31, 2006, and to defer implementation on other issues until September 30, 2006, and March 31, 2007, pending final interagency approval.

## Supervisory Information Technology

Under the direction of the division's chief technology officer, the supervisory information technology (SIT) function within the division facilitates the management of information technology

across the Federal Reserve System's overall supervision function. SIT works through assigned staff at the Board and the Reserve Banks, as well as through a System-wide committee structure, to ensure that key staff members throughout the System participate in identifying requirements and setting priorities for IT initiatives.

In 2005, the SIT function worked on the following strategic projects and initiatives: (1) refine and institutionalize processes governing IT investments to ensure that all technology investments are aligned with business needs and that accountability for business success is clearly defined and accepted; (2) improve the security of information-sharing technologies and provide for seamless collaboration in interagency efforts; (3) develop a measurement-based management and investment culture; (4) identify opportunities to converge and streamline IT applications, including key administrative systems, to provide consistent and seamless information; (5) develop a foundation for evaluating technologies (such as portals, search engines, and content management tools) to improve access to these systems and to integrate supervisory and management information systems that support both office-based and field staff; (6) enhance the information security framework for the supervisory function; and (7) participate in the selection of a learning management system that will enhance the delivery of online examiner training.

### National Information Center

The National Information Center (NIC) is the Federal Reserve's comprehensive repository for supervisory, financial, and banking structure data and supervisory documents. NIC includes the structure data system; the National Examination Database (NED), which provides supervisory personnel and state banking authorities with access to NIC data; the Banking Organization National Desktop (BOND), an application that facilitates secure, real-time electronic information-sharing and collaboration among federal and state banking regulators for the supervision of banking organizations; and the Central Document and Text Repository, which contains documents supporting the supervisory processes.

During 2005, the NED application was modified to incorporate information from consumer affairs and Community Reinvestment Act examinations, thereby eliminating a separate legacy system. In early 2006, NED will be enhanced to begin collecting important BSA information in an automated format to support the Federal Reserve's enforcement activities.

In 2005, the BOND application was enhanced to improve usability, reduce administrative burden, and increase the effectiveness of management reporting. BOND was also updated to accommodate the new FR Y-10S reporting form (see the section "Bank Holding Company Regulatory Financial Reports"). At year-end 2005, BOND had approximately 2,700 registered users across the Federal Reserve System, the OCC, the FDIC, and eleven state banking departments. In 2005, significant resources were also devoted to the FFIEC Call Report modernization initiative (see the section "Commercial Bank Regulatory Financial Reports").

## Staff Development

The System Staff Development Program trains staff members at the Board, the Reserve Banks, state banking departments, and foreign supervisory authorities. Training is offered at the basic, intermediate, and advanced levels in

Training Programs for Banking Supervision and Regulation, 2005

| Program | Number of sessions conducted | |
|---|---|---|
| | Total | Regional |
| *Schools or seminars conducted by the Federal Reserve* | | |
| Core schools | | |
| Banking and supervision elements | 7 | 5 |
| Operations and analysis | 6 | 5 |
| Bank management | 4 | 2 |
| Report writing | 12 | 12 |
| Management skills | 9 | 7 |
| Conducting meetings with management | 10 | 10 |
| *Other schools* | | |
| Credit risk analysis | 5 | 4 |
| Examination management | 6 | 4 |
| Real estate lending seminar | 3 | 3 |
| Senior forum for current banking and regulatory issues | 3 | 3 |
| Assessing capital adequacy | 1 | 1 |
| Basel II corporate activities | 2 | 1 |
| Basel II operational risk | 1 | 1 |
| Basel II retail activities | 2 | 0 |
| Principles of fiduciary supervision | 2 | 2 |
| Commercial lending essentials for consumer affairs | 1 | 1 |
| Consumer compliance examinations I | 2 | 0 |
| Consumer compliance examinations II | 2 | 2 |
| CRA examination techniques | 2 | 1 |
| CRA risk-focused examination techniques | 3 | 3 |
| Fair lending examination techniques | 2 | 2 |
| Foreign banking organizations seminar | 1 | 1 |
| Information systems continuing education | 4 | 4 |
| Asset liability management (ALM1) | 2 | 2 |
| Asset liability management (ALM2) | 1 | 1 |
| Fundamentals of interest rate risk management | 5 | 5 |
| Trading and operations | 1 | 1 |
| Technology risk integration | 3 | 3 |
| Leadership dynamics | 7 | 6 |
| Fundamentals of fraud | 5 | 5 |
| Information technology seminars [1] | 13 | 13 |
| Seminar for senior supervisors of foreign central banks [2] and ten other international courses | 35 | 27 |
| *Self-study or online learning* [3] | | |
| Orientation (core and specialty) | 0 | 0 |
| Self-study modules (26 modules) | 0 | 0 |
| *Other agencies conducting courses* [4] | | |
| Federal Financial Institutions Examination Council | 70 | 12 |
| The Options Institute | 1 | 1 |

1. Held at Chicago IT Lab.
2. Conducted jointly with the World Bank.
3. Self-study programs do not involve group sessions.
4. Open to Federal Reserve employees.

several disciplines within bank supervision: safety and soundness, information technology, international banking, and consumer affairs. Classes are conducted in Washington, D.C., as well as at Reserve Banks and other locations.

The Federal Reserve System also participates in training offered by the FFIEC and by certain other regulatory agencies. The System's involvement includes developing and implementing basic and advanced training in relation to various emerging issues as well as in specialized areas such as international banking, information technology, municipal securities dealing, capital

Results of First Proficiency and Second Proficiency Examinations, 2005

| Result | First proficiency | Second proficiency | | |
|---|---|---|---|---|
| | | Safety and soundness | Consumer affairs | Information technology |
| Passed | 155 | 65 | 18 | 2 |

markets, payment systems risk, white-collar crime, and real estate lending. In addition, the System co-hosts the World Bank Seminar for supervisors from developing countries.

In 2005, the Federal Reserve trained 3,296 students in System schools, 946 in schools sponsored by the FFIEC, and 11 in other schools, for a total of 4,253, including 266 representatives of foreign central banks and supervisory agencies (see the table on the preceding page). The number of training days in 2005 totaled 18,441.

The System gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program, 473 state examiners were trained—267 in Federal Reserve courses, 203 in FFIEC programs, and 3 in other courses.

A staff member seeking an examiner's commission is required to take a first proficiency examination as well as a second proficiency examination in one of the following three specialty areas: safety and soundness, consumer affairs, or information technology. In 2005, 155 examiners passed the first proficiency examination (see Results of Examinations table). In the second proficiency examination, 65 examiners passed the safety and soundness examination, 18 examiners passed the consumer affairs examination, and 2 examiners passed the information technology examination. The average pass rate for the first proficiency examination was 79 percent. The average pass rate for the second proficiency examinations was 78 percent.

## Regulation of the U.S. Banking Structure

The Federal Reserve administers several federal statutes that apply to bank holding companies, financial holding companies, member banks, and foreign banking organizations—the Bank Holding Company Act, the Bank Merger Act, the Change in Bank Control Act, the Federal Reserve Act, and the International Banking Act. In administering these statutes, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of the U.S. banking system at the local, regional, and national levels; the international operations of domestic banking organizations; or the U.S. banking operations of foreign banks. The proposals include bank holding company formations and acquisitions, bank mergers, and other transactions involving bank or nonbank firms. In 2005, the Federal Reserve acted on 1,283 proposals, which represented 3,442 individual applications filed under the five administered statutes.

### Bank Holding Company Act

Under the Bank Holding Company Act, a corporation or similar legal entity must obtain the Federal Reserve's approval before forming a bank holding com-

pany through the acquisition of one or more banks in the United States. Once formed, a bank holding company must receive Federal Reserve approval before acquiring or establishing additional banks. The act also identifies the nonbanking activities permissible for bank holding companies; depending on the circumstances, these activities may or may not require Federal Reserve approval in advance of their commencement.

When reviewing a bank holding company application or notice that requires prior approval, the Federal Reserve may consider the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant's ability to make available to the Federal Reserve information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home-country supervisor. In 2005, the Federal Reserve acted upon 512 applications filed by bank holding companies to acquire a bank or a nonbank firm, or to otherwise expand their activities.

Bank holding companies generally may engage in only those nonbanking activities that the Board has previously determined to be closely related to banking under section 4(c)(8) of the Bank Holding Company Act. Since 1996, the act has provided an expedited prior-notice procedure for certain permissible nonbank activities and for acquisitions of small banks and nonbank entities. Since that time, the act has also permitted well-run bank holding companies that satisfy certain criteria to commence certain other nonbank activities on a de novo basis without first obtaining Federal Reserve approval.

A bank holding company may repurchase its own shares from its shareholders. When the company borrows money to buy the shares, the transaction increases the company's debt and decreases its equity. The Federal Reserve may object to stock repurchases by bank holding companies that fail to meet certain standards, including the Board's capital adequacy guidelines. In 2005, the Federal Reserve reviewed 6 stock-repurchase proposals by bank holding companies.

The Federal Reserve also reviews elections from bank holding companies seeking financial holding company status under the authority granted by the Gramm-Leach-Bliley Act. Bank holding companies seeking financial holding company status must file a written declaration with the Federal Reserve. In 2005, 35 domestic financial holding company declarations and 3 foreign bank declarations were approved.

## Bank Merger Act

The Bank Merger Act requires that all proposals involving the merger of insured depository institutions be acted on by the appropriate federal banking agency. The Federal Reserve has primary jurisdiction if the institution surviving the merger is a state member bank. Before acting on a merger proposal, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of the existing and combined organizations, the convenience and needs of the communities to be served, and the competitive effects of the proposed merger. It

also considers the views of certain other agencies regarding the competitive factors involved in the transaction. In 2005, the Federal Reserve approved 58 merger applications under the act.

When the FDIC, OCC, or OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors related to the proposal. By using standard terminology in assessing competitive factors in merger proposals, the four agencies have sought to ensure consistency in administering the Bank Merger Act. The Federal Reserve submitted 472 reports on competitive factors to the other agencies in 2005.

## Change in Bank Control Act

The Change in Bank Control Act requires individuals and certain other parties that seek control of a U.S. bank or bank holding company to obtain approval from the appropriate federal banking agency before completing the transaction. The Federal Reserve is responsible for reviewing changes in the control of state member banks and bank holding companies. In its review, the Federal Reserve considers the financial position, competence, experience, and integrity of the acquiring person; the effect of the proposed change on the financial condition of the bank or bank holding company being acquired; the effect of the proposed change on competition in any relevant market; the completeness of the information submitted by the acquiring person; and whether the proposed change would have an adverse effect on the federal deposit insurance funds. As part of the process, the Federal Reserve may contact other regulatory or law enforcement agencies for information about relevant individuals. In 2005, the Federal Reserve approved 111 changes in control of state member banks and bank holding companies.

## Federal Reserve Act

Under the Federal Reserve Act, a member bank may be required to seek prior Federal Reserve approval before expanding its operations domestically or internationally. State member banks must obtain Federal Reserve approval to establish domestic branches, and all member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals to establish domestic branches, the Federal Reserve considers, among other things, the scope and nature of the banking activities to be conducted. When reviewing proposals for foreign branches, the Federal Reserve considers, among other things, the condition of the bank and the bank's experience in international banking. In 2005, the Federal Reserve acted on new and merger-related branch proposals for 2,435 domestic branches, and granted prior approval for the establishment of 5 new foreign branches.

State member banks must also obtain Federal Reserve approval to establish financial subsidiaries. These subsidiaries may engage in activities that are financial in nature or incidental to financial activities, including securities and insurance agency–related activities. In 2005, 2 applications for financial subsidiaries were approved.

## Overseas Investments by U.S. Banking Organizations

U.S. banking organizations may engage in a broad range of activities overseas. Many of the activities are conducted

indirectly through Edge Act and agreement corporation subsidiaries. Although most foreign investments are made under general consent procedures that involve only after-the-fact notification to the Federal Reserve, large and other significant investments require prior approval. In 2005, the Federal Reserve approved 43 proposals for significant overseas investments by U.S. banking organizations. The Federal Reserve also approved 11 applications to make additional investments through an Edge Act or agreement corporation, 3 applications to establish an Edge Act or agreement corporation, and 2 applications to extend the corporate existence of an Edge Act corporation.

## International Banking Act

The International Banking Act, as amended by the Foreign Bank Supervision Enhancement Act of 1991, requires foreign banks to obtain Federal Reserve approval before establishing branches, agencies, commercial lending company subsidiaries, or representative offices in the United States.

In reviewing proposals, the Federal Reserve generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home-country supervisor. It also considers whether the home-country supervisor has consented to the establishment of the U.S. office; the financial condition and resources of the foreign bank and its existing U.S. operations; the managerial resources of the foreign bank; whether the home-country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information concerning its operations and activities will be made available to the Federal Reserve, if deemed necessary to determine and enforce compliance with applicable law; whether the foreign bank has adopted and implemented procedures to combat money laundering and whether the home country of the foreign bank is developing a legal regime to address money laundering or is participating in multilateral efforts to combat money laundering; and the record of the foreign bank with respect to compliance with U.S. law. In 2005, the Federal Reserve approved 10 applications by foreign banks to establish branches, agencies, or representative offices in the United States.

## Public Notice of Federal Reserve Decisions

Certain decisions by the Federal Reserve that involve an acquisition by a bank holding company, a bank merger, a change in control, or the establishment of a new U.S. banking presence by a foreign bank are made known to the public by an order or an announcement. Orders state the decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are made public; they are subsequently reported in the Board's weekly H.2 statistical release and in the *Federal Reserve Bulletin*. The H.2 release also contains announcements of applications and notices received by the Federal Reserve upon which action has not yet been taken. For each pending application and notice, the related H.2A contains the deadline for comments. The Board's web site (www.federalreserve.gov) provides information on orders and announcements as well as a guide for U.S. and foreign banking organizations

submitting applications or notices to the Federal Reserve.

## Enforcement of Other Laws and Regulations

The Federal Reserve's enforcement responsibilities also extend to financial disclosures by state member banks, securities credit, and extensions of credit to executive officers.

### Financial Disclosures by State Member Banks

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the SEC. At the end of 2005, 18 state member banks were registered with the Board under the Securities Exchange Act of 1934.

### Securities Credit

Under the Securities Exchange Act, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. The Board's Regulation T limits the amount of credit that may be provided by securities brokers and dealers when the credit is used to trade debt and equity securities. The Board's Regulation U limits the amount of credit that may be provided by lenders other than brokers and dealers when the credit is used to purchase or carry publicly held equity securities if the loan is secured by those or other publicly held equity securities. The Board's Regulation X applies these credit limitations, or margin requirements, to certain borrowers and to certain credit extensions, such as credit obtained from foreign lenders by U.S. citizens.

Several regulatory agencies enforce the Board's securities credit regulations. The SEC, the National Association of Securities Dealers, and the national securities exchanges examine brokers and dealers for compliance with Regulation T. With respect to compliance with Regulation U, the federal banking agencies examine banks under their respective jurisdictions; the Farm Credit Administration, the NCUA, and the OTS examine lenders under their respective jurisdictions; and the Federal Reserve examines other Regulation U lenders.

Extensions of Credit by State Member Banks to their Executive Officers, 2004 and 2005

| Period | Number | Amount (dollars) | Range of interest rates charged (percent) |
|---|---|---|---|
| *2004* | | | |
| October 1–December 31 | 479 | 53,340,000 | 0.0–20.8 |
| *2005* | | | |
| January 1–March 31 | 414 | 54,737,000 | 0.0–21.2 |
| April 1–June 30 | 530 | 117,416,000 | 0.0–20.6 |
| July 1–September 30 | 504 | 56,969,000 | 0.0–21.6 |
| October 1–December 31 | 485 | 57,422,000 | 0.0–18.0 |

Source. Call Reports.

### Extensions of Credit to Executive Officers

Under section 22(g) of the Federal Reserve Act, a state member bank must include in its quarterly Call Report information on all extensions of credit by the bank to its executive officers since the date of the preceding report. The accompanying table summarizes this information for 2005.

## Federal Reserve Membership

At the end of 2005, 2,698 banks were members of the Federal Reserve System and were operating 52,639 branches. These banks accounted for 37 percent of all commercial banks in the United States and for 72 percent of all commercial banking offices. ▪

# *Consumer and Community Affairs*

Among the Federal Reserve's responsibilities in the areas of consumer and community affairs are

- writing and interpreting regulations to implement federal laws that protect and inform consumers;
- supervising state member banks to ensure their compliance with the regulations;
- investigating complaints from the public about state member bank compliance with regulations; and
- promoting community development in historically underserved markets.

These responsibilities are carried out by the members of the Board of Governors, the Board's Division of Consumer and Community Affairs, and the consumer and community affairs staff of the Federal Reserve Banks.

## Implementation of Statutes Designed to Inform and Protect Consumers

The Board of Governors writes regulations to implement federal laws involving consumer financial services and fair lending. The Board revises and updates these regulations to address the introduction of new products and technologies, to implement legislative changes to existing laws, and to address problems consumers may encounter in their financial transactions. To interpret and clarify the regulations, Board staff issues commentaries and other guidance.

During 2005, the Board, with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA), issued joint guidance on overdraft-protection programs. The guidance is intended to help insured depository institutions responsibly administer and provide appropriate disclosures for these programs. To improve the uniformity and adequacy of information consumers receive about overdraft-protection services, the Board also issued final rules amending its Truth in Savings Act regulation (Regulation DD) and the associated commentary. The Board, FDIC, and OCC jointly revised certain provisions of their rules implementing the Community Reinvestment Act (CRA). In addition, the Board amended its regulation implementing the Electronic Fund Transfer Act (Regulation E) to address the regulation's coverage of electronic check conversion services; a separate interim final rule under Regulation E dealt with payroll card accounts. The Board issued final rules with the FDIC, NCUA, OCC, and Office of Thrift Supervision (OTS) to implement provisions of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act) that govern the use of medical information in connection with credit-eligibility determinations. Furthermore, the Board raised the threshold that triggers additional requirements under the Home Ownership and Equity Protection Act (HOEPA) and raised the exemption threshold for depository institutions required to collect data under the Home Mortgage Disclosure Act (HMDA).

## Interagency Guidance on Overdraft-Protection Programs

In February, the Board issued guidance jointly with the FDIC, NCUA, and OCC on overdraft-protection programs at insured depository institutions. These services, sometimes referred to as "bounced-check protection" or "courtesy overdraft protection," pay customer's checks or allow other overdrafts when a customer has insufficient funds in his or her account. Typically, an overdraft-protection program is an automated service provided to transaction account customers as an alternative to a traditional overdraft line of credit.

In June 2004, the agencies published for comment proposed interagency guidance on overdraft-protection programs, in response to concerns about the marketing, disclosure, and implementation of these programs. The final guidance responds to comments the agencies received from consumer and community groups, individual consumers, depository institutions, trade associations, vendors offering overdraft-protection products, other industry representatives, and state agencies.[1]

The final joint guidance has three primary sections: Safety and Soundness Considerations, Legal Risks, and Best Practices. The safety and soundness discussion seeks to ensure that financial institutions offering overdraft-protection programs have adequate policies and procedures to address the credit, operational, and other risks associated with these programs. The legal risks discussion alerts institutions to the importance of complying with all applicable federal and state laws, and it advises institutions to have legal counsel review their overdraft-protection programs—before implementation—to ensure the overall compliance of the programs. The best practices section addresses the marketing and communication of overdraft-protection programs as well as disclosures and other operational aspects of these programs.

1. In 2004, the agencies, along with the OTS, produced a consumer publication, "Protecting Yourself from Overdraft and Bounced-Check Fees," which is available in English and Spanish. Both versions are available on the Board's consumer information web site (www.federalreserve.gov/consumers.htm).

## Amendments to Regulation DD (Truth in Savings)

In May, the Board published final amendments to Regulation DD, which implements the Truth in Savings Act, and to the regulation's official staff commentary. The amendments address concerns about the uniformity and adequacy of information provided to consumers when they overdraw their deposit accounts, and some of the amendments specifically address overdraft-protection programs, which are offered by many depository institutions.

To address concerns about the marketing of overdraft services, the Board expanded the regulation's prohibition against misleading advertisements to cover institutions' communications with current customers about their existing accounts. The Board also revised the staff commentary to the regulation to provide examples of misleading advertisements for overdraft-protection services. To help consumers distinguish overdraft-protection services from the traditional lines of credit offered by an institution, the final rule requires that institutions promoting the payment of overdrafts include, in their advertisements, certain disclosures about the terms of the service.

In addition, the final rule includes provisions to enhance the uniformity and adequacy of the cost disclosures

institutions provide to consumers about overdraft and returned-item fees. Institutions that promote the payment of overdrafts in an advertisement must separately disclose, on their periodic statements, the total dollar amount imposed on the account for paying overdrafts and the total dollar amount of fees charged for returning items unpaid. These disclosures must be provided for the statement period and for the calendar year to date, for any account to which the advertisement applies. To help institutions comply with this requirement, the staff commentary provides specific examples of when an institution is promoting the payment of overdrafts in an advertisement. The final rule also requires institutions to state, in their account-opening disclosures, the categories of transactions for which an overdraft fee may be imposed, for example, by specifying that fees are imposed for overdrafts created by checks, ATM withdrawals, or other electronic transactions, as applicable.

The amendments to Regulation DD become effective on July 1, 2006.

## Community Reinvestment Act Rules

In July, the Board, FDIC, and OCC approved a joint final rule to revise certain provisions of their rules implementing the Community Reinvestment Act (CRA). (Regulation BB is the Board's CRA regulation.) The revised rules are intended to reduce regulatory burden on community banks and make CRA evaluations more effective tools for encouraging banks to meet community development needs.

The final rules raise the small bank asset-size threshold from less than $250 million in assets to less than $1 billion in assets without regard to holding company affiliation. Accordingly, the new rules reduce data collection and reporting burden for "intermediate small banks" (banks with assets at least $250 million and less than $1 billion) and, at the same time, encourage these banks to engage in meaningful community development lending, investment, and services.

Under the new rules, intermediate small banks will no longer need to collect and report CRA loan data. Nevertheless, examiners will continue to evaluate bank lending activity during their CRA examinations of intermediate small banks and will disclose those results in the public evaluation. Intermediate small banks will be evaluated under two separately rated tests: (1) the small bank lending test and (2) a new, flexible community development test that includes an evaluation of community development loans, investments, and services in light of the community's needs and the bank's capacity. Satisfactory ratings are required on both tests to obtain an overall satisfactory CRA rating.

For banks of any size, the new rules expand the definition of community development to include activities that revitalize or stabilize designated disaster areas and distressed or underserved rural areas. By doing so, the agencies seek to recognize banks' community development efforts in these areas and encourage further efforts in other rural areas. The rules also clarify when a bank's (or its affiliate's) discrimination or other illegal credit practices will adversely affect an evaluation of its CRA performance. The joint final rule became effective September 1, 2005.

## FACT Act Rules on Medical Information

In November, the Board, FDIC, NCUA, OCC, and OTS issued final rules under

the Fair Credit Reporting Act (FCRA). (The Board's rules are Regulation V and Regulation FF.) The rules create exceptions to the statutory prohibition against creditors' obtaining or using medical information in connection with their credit-eligibility determinations. The final rules also address the sharing of medically related information among affiliates.

Section 411 of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act) amended the FCRA to provide that a creditor may not obtain or use medical information in connection with any determination of a consumer's eligibility, or continued eligibility, for credit, except as permitted by regulations. The FACT Act requires the agencies to prescribe regulations that permit creditors to obtain and use medical information for credit-eligibility purposes when necessary and appropriate to protect legitimate operational, transactional, risk-management, and other needs. The final rules permit creditors to obtain and use medical information that is typically considered in credit underwriting. Under the final rules, all creditors can rely upon the exceptions for obtaining and using medical information.

Section 411 of the FACT Act also amended the FCRA to limit the ability of creditors and others to share medically related information among their affiliates, except as permitted by the statute or by regulation or order. The final rules specify the circumstances in which certain creditors may share medically related information among affiliates without becoming consumer reporting agencies, which are subject to additional requirements.

Final rules will become effective April 1, 2006.

## Amendments to Regulation E (Electronic Fund Transfers)

In December, the Federal Reserve Board announced final amendments to Regulation E, which implements the Electronic Fund Transfer Act. The amendments clarify the responsibilities of parties involved in electronic check conversion transactions and require that consumers receive written notification in advance of these transactions. Additional revisions to the regulation's official staff commentary provide guidance on preauthorized transfers from consumers' accounts, error resolution, and disclosures at ATMs.

Among other provisions, the final rule specifies that merchants and other payees that convert consumers' check payments into electronic fund transfers must provide the consumer with a notice and obtain his or her authorization for the electronic fund transfer. Merchants and other payees must also notify consumers that

- if a check is converted to an electronic fund transfer, funds may be debited from their accounts as soon as the same day that payment is received and

- the check will not be returned to them by their financial institution.

Revisions to the official staff commentary on Regulation E clarify the error resolution obligations of financial institutions and clarify the disclosure obligations of ATM operators with respect to the fees they charge a consumer for initiating an electronic fund transfer or for using an ATM to make a balance inquiry.

The mandatory compliance date for the final rule is January 1, 2007.

*Interim Final Rule Governing Payroll Cards*

In December, the Board adopted a separate interim final rule on payroll card accounts. Under the interim final rule, payroll card accounts that are established to provide salary, wages, or other employee compensation on a recurring basis are accounts covered by Regulation E. The interim final rule grants flexibility to financial institutions that must provide account transaction information to payroll card users. The interim final rule will become effective July 1, 2007.

## Other Regulatory Actions

The Board also took the following regulatory actions during 2005:

- In March, the Board and the other federal financial regulatory agencies adopted in final form, without change, joint interim rules making technical changes to the agencies' regulations implementing the Community Reinvestment Act (CRA). The joint interim rules had been published for comment in July 2004. (Regulation BB is the Board's CRA regulation.) The changes conform the CRA regulations to changes in (1) the Standards for Defining Metropolitan and Micropolitan Statistical areas, published by the U.S. Office of Management and Budget; (2) the census tracts designated by the U.S. Bureau of the Census; and (3) the Board's Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). The joint final rule did not make substantive changes to the requirements of the CRA regulations.
- In August, the Board amended the official staff commentary to Regulation Z to raise from $510 to $528 the total dollar amount of points and fees that triggers additional requirements for certain mortgage loans under the Home Ownership and Equity Protection Act (HOEPA). As prescribed by that statute, the increased amount (effective January 1, 2006) reflects changes in the consumer price index.
- In December, the Board amended the official staff commentary to Regulation C to raise to $35 million the exemption threshold for depository institutions required to collect data in 2006 under HMDA. As prescribed by that statute, the increased threshold reflects changes in the consumer price index.

## Economic Effects of the Electronic Fund Transfer Act

As required by the Electronic Fund Transfer Act (EFTA), the Board monitors what effects the act has on compliance costs for financial institutions, as well as the benefits of the act to consumers.

According to data from the most recent triennial Survey of Consumer Finances (conducted in 2004), approximately 91 percent of U.S. families that year used or had access to one or more EFT services, for example, automated teller machine (ATM) services, debit card services, or direct deposit or payment services—up from approximately 88 percent in 2001. The 2004 Survey of Consumer Finances also reported that approximately 74 percent of U.S. families had an ATM card. In 2004, the number of ATM transactions per month averaged approximately 919 million, and the number of installed ATMs rose about 3 percent from 2003, to 383,000.

About 71 percent of U.S. families had funds deposited directly into their checking or savings account by direct deposit in 2004. Use of the service appears even more common in the public sector; during fiscal year 2005, approximately 76 percent of all government payments were made using EFT, including 81 percent of Social Security payments, 99 percent of federal salary and retirement payments, and 49 percent of federal income tax refunds.

About 59 percent of U.S. families had debit cards in 2004; consumers can use these cards at merchant terminals to pay for purchases. Approximately 17.6 billion debit card transactions took place in 2004, an increase of approximately 9 percent from the previous year's volume. Direct payment appears to be the least widely used EFT payment mechanism. About 47 percent of U.S. families had payments automatically deducted from their accounts in 2004.

The incremental costs associated with the EFTA are difficult to quantify because it is difficult to determine how industry practices would have evolved in the absence of statutory requirements. The benefits of the EFTA are also difficult to measure, as they cannot be isolated from consumer protections that would have been provided in the absence of regulation. The available evidence suggests no serious consumer problems with EFTA. (See ''Agency Reports on Compliance with Consumer Protection Laws'' later in this chapter.)

## Supervision for Compliance with Consumer Protection and Community Reinvestment Laws

### Activities Related to the Community Reinvestment Act

The Community Reinvestment Act (CRA) requires that the Board and other banking agencies encourage financial institutions to help meet the credit needs of the local communities in which they do business, consistent with safe and sound business practices. To carry out this mandate, the Federal Reserve

- examines state member banks to assess their compliance with the CRA;
- analyzes applications for mergers and acquisitions by state member banks and bank holding companies in relation to CRA performance; and
- disseminates information on community development techniques to bankers and the public through community affairs offices at the Reserve Banks.

#### *Examinations for Compliance with the CRA*

The Federal Reserve assesses and rates the CRA performance of state member banks in the course of examinations conducted by staff at the twelve Reserve Banks. During the 2005 reporting period, the Reserve Banks conducted 163 CRA examinations. Of the banks examined, 35 were rated ''outstanding'' in meeting community credit needs, 127 were rated ''satisfactory,'' none was rated ''needs to improve,'' and 1 was rated as being in ''substantial noncompliance.''[2]

#### *Analysis of Applications for Mergers and Acquisitions in Relation to the CRA*

During 2005, the Board of Governors considered applications for several significant banking mergers, including the application by Citigroup, Inc., New York, New York, to acquire First Ameri-

2. The 2005 reporting period was July 1, 2004, through June 30, 2005.

can Bank, Bryan, Texas. The Board approved Citigroup's application in March, after considering information from ongoing examinations of Citigroup, publicly disclosed investigations, and domestic and foreign financial supervisory authorities, in addition to confidential information on Citigroup's compliance with anti-money-laundering laws. Citigroup acknowledged some deficiencies in its compliance and internal controls for the areas being investigated and stated that it had developed plans to address those weaknesses. The Board noted the improvements Citigroup had made to parts of its compliance structure; the Board also expected that the company would fully implement its plan to enhance oversight of its operations. To that end, the Board further expected that Citigroup would not undertake significant expansion during this implementation period.

Several other significant applications are listed below.

- An application by Wells Fargo & Co., San Francisco, California, to acquire First Community Capital Corporation, Houston, Texas, was approved in June.

- An application by Capital One Financial Corporation (Capital One), McLean, Virginia, to acquire Hibernia Bancorporation, New Orleans, Louisiana, was approved in August. The Board considered information on pending lawsuits or investigations undertaken by the attorneys general of Minnesota and West Virginia relating to Capital One's marketing of its credit cards.

- An application by Bank of America Corporation, Charlotte, North Carolina, to acquire MBNA Corporation, Wilmington, Delaware, was approved in December. A total of thirteen comments were submitted in opposition to the application.

The public submitted comments on each of these applications. Most of the commenters expressed concerns that an institution's lending to lower-income communities and minority populations was insufficient or that the institution failed to address the convenience and needs of affected communities. Many of the comments referenced the new pricing information on residential mortgage loans that was required to be reported for 2004 Home Mortgage Disclosure Act (HMDA) data; the new data raised concerns that minority applicants were more likely than nonminority applicants to receive high-cost mortgages.[3] Other commenters raised concerns about potentially predatory lending practices by subprime and payday lenders, as well as the potential adverse effects of branch closings.

In total, the Board acted on twenty-three bank and bank holding company applications that involved protests by members of the public concerning the CRA performance of insured depository institutions. The Board also reviewed twenty-nine applications involving other issues related to CRA, fair lending, or compliance with consumer credit protection laws.[4]

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3. "High-cost mortgages" refers to mortgage loans whose annual percentage rates (APRs) are 3 percent or more over the yield on comparable Treasury securities on first liens, and 5 percent or more over that yield on subordinate liens. Interest rate spreads that exceed these two thresholds are required to be reported under Regulation C, which implements the Home Mortgage Disclosure Act (HMDA).

4. In addition, four applications involving consumer compliance issues were withdrawn.

## Other Consumer Compliance Activities

The Division of Consumer and Community Affairs supports and oversees the supervisory efforts of the Federal Reserve Banks to ensure that consumer protection laws and regulations are fully and fairly enforced. Division staff provides guidance and expertise to the Reserve Banks on consumer protection regulations, examination and enforcement techniques, examiner training, and emerging issues. They develop and update examination policies, procedures, and guidelines, as well as review Reserve Bank supervisory reports and work products. They also participate in interagency activities that promote uniformity in examination principles and standards.

Examinations are the Federal Reserve's primary means of enforcing compliance with consumer protection laws. During the 2005 reporting period, the Reserve Banks conducted 239 consumer compliance examinations—220 of state member banks and 19 of foreign banking organizations (FBO).[5]

The Board periodically issues guidance for Reserve Bank examiners on consumer protection laws and regulations. In addition to updating examination procedures for a number of regulations in concert with the other federal financial institution regulatory agencies, the Board issued guidance that Federal Reserve consumer compliance examiners are to use when evaluating cases that may involve any pattern or practice of flood insurance violations.

5. The foreign banking organizations examined by the Federal Reserve are organizations operating under section 25 or 25A of the Federal Reserve Act (Edge Act and agreement corporations) and state-chartered commercial lending companies owned or controlled by foreign banks. These institutions are not subject to the Community Reinvestment Act and typically engage in relatively few activities that are covered by consumer protection laws.

### *Fair Lending*

The Board has a responsibility to ensure that the banks under its jurisdiction comply with the federal fair lending laws—the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. The ECOA prohibits all creditors from discriminating against any applicant, in any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex, marital status, or age. In addition, creditors may not discriminate against an applicant because the applicant receives income from a public assistance program or has exercised, in good faith, any right under the Consumer Credit Protection Act. As provided by the ECOA, the Board enacted Regulation B to fully implement the act and periodically reviews that regulation and modifies it as needed. Congress assigned responsibility for administrative enforcement of the ECOA to the Board for banks under its jurisdiction, to other regulators for creditors that they regulate, and to the Federal Trade Commission for all other creditors.

The Fair Housing Act covers credit for the purchase, construction, improvement, repair, or maintenance of a dwelling. Under the act, it is unlawful for a creditor to deny any form of financial assistance, or discriminate in fixing the amount, interest rate, or any other terms or conditions of any financial assistance, on the basis of race, color, religion, national origin, handicap, familial status, or sex.

The ECOA also obligates the Board and other agencies with enforcement responsibilities under the act to refer any pattern or practice of ECOA violations to the Department of Justice (DOJ). When a violation of the ECOA

also violates the Fair Housing Act, the matter may be referred to the Department of Housing and Urban Development. To promote consistency in how fair lending issues are analyzed throughout the System, Division of Consumer and Community Affairs staff coordinate the investigation of potential fair lending violations with Reserve Bank staff and develop recommendations for the division director regarding whether referral is necessary or appropriate.

During 2005, division staff received and analyzed five reports from Reserve Banks regarding possible referral matters. Three of these reports dealt with potentially discriminatory underwriting standards—two involved potential discrimination on the basis of applicants' marital status and one involved potential discrimination on the basis of an applicant's sex. In one report, a bank's apparent discriminatory loan-pricing practices affected borrowers on the basis of their marital status. The fifth report involved discriminatory redlining on the basis of race. In one of the cases, the Board determined that a referral was not warranted; one case was referred to DOJ; and three cases are pending.

Since 1994, the Federal Reserve has used a two-stage statistical regression program to help assess fair lending compliance by high-volume mortgage lenders. The program uses reported HMDA data for a stage one analysis to identify banks having significant disparities in their loan-denial rates for loan applications submitted by black and Hispanic applicants and those submitted by white applicants; the program then targets these banks for a stage two analysis that considers extensive additional information taken from a sample of a bank's loan files. As a result of 2002 amendments to Regulation C and the receipt of expanded HMDA data for 2004, the regression program has been modified. Differences among groups of loan applicants are now identified using two additional criteria: (1) the incidence of higher-priced lending and (2) differences in the mean spread paid by borrowers who obtained higher-priced loans. The modified statistical program, like the denial-rate review, can target lenders for a more intensive fair lending review that would include the collection and assessment of additional loan-level information, such as credit scores and debt-to-income and loan-to-value ratios.

### *Flood Insurance*

The National Flood Insurance Act imposes certain requirements on loans secured by buildings or mobile homes located in, or to be located in, areas determined to have special flood hazards. Under the Federal Reserve's Regulation H, which implements the act, state member banks in general are prohibited from making, extending, increasing, or renewing any such loan unless the building or mobile home and any personal property securing the loan are covered by flood insurance for the term of the loan. The act requires the Federal Reserve to impose civil money penalties when it finds a pattern or practice of violations of the regulation. The civil money penalties are payable to the Federal Emergency Management Agency for deposit into the National Flood Mitigation Fund.

During 2005, the Board imposed civil money penalties on ten state member banks. The penalties, which were assessed via consent orders, totaled $219,810.

### *Coordination with Other Federal Banking Agencies*

The member agencies of the Federal Financial Institutions Examination

Council (FFIEC) develop uniform examination principles, standards, procedures, and report formats.[6] In 2005, the FFIEC revised examination procedures for the Fair Credit Reporting Act (FCRA) to reflect amendments to the FCRA by the Fair and Accurate Credit Transactions Act (the FACT Act). The FFIEC also issued examination procedures on the Federal Communications Commission's telemarketing rules and its CAN-SPAM Act (Controlling the Assault of Non-Solicited Pornography and Marketing Act). The new procedures address the requirements each of these rules lays out for electronic communications with consumers. Finally, the Board, OCC, and FDIC issued examination procedures for reviewing the Community Reinvestment Act (CRA) performance of intermediate small banks. Following the issuance of new CRA regulations last year, these agencies also published for comment proposed questions and answers on their new regulations.

The FFIEC issues guidance to the agencies' consumer compliance examination staff and to supervised financial institutions. The agencies issued final guidance on overdraft-protection programs (see "Interagency Guidance on Overdraft-Protection Programs" earlier in this chapter). In addition, the Board, OCC, and FDIC issued new templates for preparing CRA performance evaluations for intermediate small banks; these agencies also revised the existing templates in order to reflect the amended definition of community development that now applies to all banks, as the term is defined in the new CRA regulations. Finally, the Board, OCC, and FDIC updated the host-state loan-to-deposit ratios used to determine compliance with section 109 of the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994.

6. The FFIEC member agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union Administration.

## Training for Bank Examiners

Ensuring that financial institutions comply with laws that protect consumers and encourage community reinvestment is an important part of the bank examination and supervision process. As the number and complexity of consumer financial transactions grow, training for examiners of the state member banks under the Federal Reserve's supervisory responsibility becomes even more important. The consumer affairs curriculum is composed of six courses focused on various consumer protection laws, regulations, and examining concepts. In 2005, these courses were offered in ten sessions to more than 190 consumer compliance examiners and System staff members.

Board and Reserve Bank staff regularly review the consumer affairs curriculum, updating subject matter and adding new elements as appropriate. During 2005, staff conducted a curriculum review of the Commercial Lending Essentials for Consumer Affairs course to incorporate different instructional methods (for example, an expanded case study). This course provides consumer compliance examiners with a basic understanding of how a loan officer underwrites and prices commercial loans.

In addition to providing core training, the examiner curriculum emphasizes the importance of continuing professional development (CPD). Opportunities for continuing development include special projects and assignments, self-study programs, rotational assignments,

the opportunity to instruct at System schools, and mentoring programs.

## Reporting on Home Mortgage Disclosure Act Data

The Home Mortgage Disclosure Act (HMDA), enacted by Congress in 1975, requires most mortgage lenders located in metropolitan areas to collect data about their housing-related lending activity, report the data annually to the government, and make the data publicly available. In 1989, Congress expanded the data required by HMDA to include information about loan applications that did not result in a loan origination, as well as information about the race, sex, and income of applicants and borrowers. Since 1989, mortgage markets have changed dramatically as information technology has improved, permitting more-efficient and more-accurate risk assessment and management. These developments have made it feasible for institutions to lend to higher-risk borrowers, albeit at prices commensurate with the higher risk. In the past, many of the borrowers who now receive higher-priced loans were often denied lower-priced credit.

Although a positive development, the growth of the subprime market has also raised public policy concerns. One concern is whether consumers who obtain higher-priced loans are sufficiently informed about the loan options available to them, allowing them to shop effectively and protect themselves from unfair or deceptive lending practices. This concern has contributed to an ongoing debate about how adequate and effective proposed or existing mortgage lending disclosures and limitations are in protecting consumers from abuse. In addition, the wider range of loan prices available in today's marketplace has raised concerns about whether price variations reflect, even in part, unlawful discrimination rather than legitimate risk- and cost-related factors.

In response to these concerns, the Federal Reserve updated Regulation C, the regulation that implements HMDA. The revisions, which were effective in 2004, required lenders to collect price information for loans they originated in the higher-priced segment of the home loan market. Lenders report the number of percentage points (if any) by which a loan's annual percentage rate (known as the "APR") exceeds a threshold; the threshold is 3 percentage points above the yield on comparable Treasury securities for first-lien loans, and 5 percentage points above that yield for junior-lien loans. Loans with rates above this threshold are referred to as "higher-priced loans." The HMDA data collected in 2004 and released to the public in 2005 provide the first publicly available loan-level data about loan prices.

An article published by Federal Reserve staff in the Summer 2005 issue of the *Federal Reserve Bulletin* uses the 2004 data to describe the market for higher-priced loans and patterns of lending across loan products, geographic markets, and borrowers and neighborhoods of different races and incomes.[7] Relatively few lenders account for most higher-priced originations. In 2004, only 500 of the 8,850 reporting home lenders made 100 or more higher-priced loans; the 10 home lenders with the largest volume accounted for about 40 percent of all such loans. Higher-priced lending is also concentrated by price: in 2004 the vast majority of higher-priced loans had annual percentage rates within 1 or 2 percentage points of the reporting thresholds. Furthermore, a relatively

7. The complete article is available at www.federalreserve.gov/pubs/bulletin/2005/05index.htm.

small share of loan originations are higher-priced loans—16 percent in 2004.

The prevalence of higher-priced lending varies widely, however. First, it varies by product type. For example, 15.5 percent of first-lien refinance loans were higher-priced in 2004 compared with 27.4 percent of comparable junior-lien loans. Manufactured-home loans show the greatest incidence of higher pricing across all loan products, a result consistent with the elevated credit risk associated with such lending. Second, higher-priced lending varies widely by geography. Most of the metropolitan areas with the greatest incidence of higher-priced lending are in the southern region of the country (in many metropolitan areas in the South and Southwest, 30 to 40 percent of homebuyers who obtained conventional loans in 2004 received higher-priced loans), whereas metropolitan areas with the lowest incidence are much more dispersed. Third, the incidence of higher-priced borrowing varies greatly among borrowers of different races and ethnicities (see related box "2004 HMDA Data and Fair Lending"). All of these patterns are expected to be the subject of further research.

## Agency Reports on Compliance with Consumer Protection Laws

The Board reports annually on compliance with consumer protection laws by entities supervised by federal agencies. This section summarizes data collected from the twelve Federal Reserve Banks, the FFIEC member agencies, and other federal enforcement agencies.[8]

8. Because the agencies use different methods to compile the data, the information presented here supports only general conclusions. The 2005 reporting period was July 1, 2004, through June 30, 2005.

### *Regulation B (Equal Credit Opportunity)*

The FFIEC agencies reported that 85 percent of the institutions examined during the 2005 reporting period were in compliance with Regulation B, compared with 88 percent for the 2004 reporting period. The most frequent violations involved failure to take one or more of the following actions:

- collect information for monitoring purposes about the race, ethnicity, and sex of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- notify a credit applicant of the action taken on his or her loan request within the time frames specified in the regulation
- provide a written notice of denial or other adverse action to a credit applicant that contains the specific reason for the adverse action, along with other required information

During this reporting period, the OTS issued two cease-and-desist orders against savings associations for their alleged violations of the ECOA and Regulation B, as well as other consumer regulations. For these violations, the associations paid civil money penalties that totaled $17,500. The other FFIEC agencies did not issue any formal enforcement actions relating to Regulation B during the reporting period.

The Federal Trade Commission (FTC) entered into one settlement with a mortgage corporation for its alleged violations of the ECOA and Regulation B, as well as other statutes. The defendants were required to pay consumer restitution for their alleged violations of the Truth in Lending Act (see the discussion under Regulation Z).

## 2004 HMDA Data and Fair Lending

The 2004 HMDA data included, for the first time, information on "higher-priced loans," or loans whose pricing (interest rates and fees) exceeded certain thresholds. An analysis of this new data offers some insights about where higher-priced lending is more prevalent and what types of borrowers are more likely to receive a higher-priced loan. While these statistics alone cannot explain the reasons why higher-priced lending was concentrated in some geographic areas or among some borrowers, the 2004 data are still an important tool for fair lending enforcement.

The incidence of higher-priced borrowing—the proportion of borrowers who obtain higher-priced loans—varies widely by race and ethnicity. In 2004, blacks and Hispanics were much more likely than non-Hispanic whites to receive higher-priced loans, and Asians were less likely than non-Hispanic whites to receive such loans. For example, 32 percent of black borrowers, and 20 percent of Hispanic borrowers, received higher-priced home purchase loans, but only 9 percent of non-Hispanic white borrowers did. In other words, black homebuyers received higher-priced loans more than three times as often as non-Hispanic white homebuyers, and Hispanic homebuyers received higher-priced loans more than two times as often. In general, differences of this magnitude persist across borrowers with different income levels and across neighborhoods with different median incomes (for example, low-income versus middle-income). The differences in the incidence of higher-priced loans shrink minimally when individual borrowers are matched by, for example, their income, the amount of their loan, and the location of the property being financed—which are the principal loan-pricing factors reported in the HMDA data.

In large part, the differences in what groups of borrowers were more likely to receive a higher-priced loan reflect the segmentation of the home loan market. That is, a major reason that black and Hispanic borrowers were much more likely than non-Hispanic white borrowers to obtain higher-priced mortgage loans is the fact that black and Hispanic borrowers were much more likely to obtain mortgage loans from institutions that specialize in higher-priced lending.

Some, perhaps much, of the market segmentation and the related price differences for mortgages are the result of differences in legitimate price-determining factors, such as a borrower's credit risk. Credit risk is typically measured by a borrower's credit score, his or her debt-to-income ratio, the loan-to-value ratio, and other information. But the HMDA data do not include this type of information. Therefore, the data do not yield any conclusions about the reasons behind racial and ethnic differences in the incidence of higher-priced lending; the data also cannot be used to prove (or disprove) the legitimacy of any speculated reasons for these differences.

Notwithstanding the limitations of the HMDA loan-pricing data, the data can be used to improve enforcement of the laws that prohibit racial and ethnic discrimination in mortgage lending: the Federal Reserve and the other agencies that enforce these laws can use the data as a screening tool to determine which institutions' pricing practices warrant scrutiny. For example, Board staff used the 2004 data to determine (1) which lenders exhibited a highly statistically significant difference in their higher-priced lending to black and Hispanic borrowers, on the one hand, and to non-Hispanic white borrowers, on the other, and (2) when that difference could not be explained by a difference in borrower income, loan amount, or property location. Board staff shared statistical reports about the identified lenders with the relevant state and federal agencies, who can use the data, as appropriate, in their fair lending enforcement and supervision efforts.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA), the Department of Transportation, the Securities and Exchange Commission (SEC), the Small Business Administration, and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise. The FCA's examination activities revealed that most Regulation B violations involved either creditors' providing inadequate statements of specific reasons for denial or creditors' failure to request or provide information for government-monitoring purposes. As reported by the SEC, the National Association of Securities Dealers, Inc., (NASD) found that one of its member firms could not produce evidence that its customers were notified about the denial of their applications for margin accounts. In addition, a different NASD firm could not demonstrate that it sent required annual margin disclosure statements to its customers. However, none of these other agencies initiated any formal enforcement actions relating to Regulation B during 2005.

*Regulation E*
*(Electronic Fund Transfers)*

The FFIEC agencies reported that approximately 95 percent of the institutions examined during the 2005 reporting period were in compliance with Regulation E, which is comparable to the level of compliance for the 2004 reporting period. The most frequent violations involved failure to comply with the following requirements:

- determine whether an error occurred within ten business days of receiving a notice of error from a consumer
- report the results of an error investigation to the consumer within three business days
- give the consumer provisional credit for the amount of the alleged error when the investigation cannot be completed within 10 business days

The OTS issued one cease-and-desist order for violations of a number of consumer regulations, including Regulation E. The savings association paid a civil money penalty of $10,000 for the violations. The other FFIEC agencies and the SEC did not issue any formal enforcement actions relating to Regulation E during the period.

*Regulation M*
*(Consumer Leasing)*

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2005 reporting period were in compliance with Regulation M, which is comparable to the level of compliance for the 2004 reporting period. The few violations noted involved failure to adhere to specific disclosure requirements. The FFIEC agencies did not issue any formal enforcement actions relating to Regulation M during the period.

*Regulation P*
*(Privacy of Consumer Financial Information)*

The FFIEC agencies reported that 97 percent of the institutions examined during the 2005 reporting period were in compliance with Regulation P, compared with 96 percent for the 2004 reporting period. The most frequent violations involved failure to comply with the following requirements:

- provide a clear and conspicuous initial privacy notice to customers that accurately reflects the institution's privacy policies and practices, not later than when the customer relationship is established

- provide a clear and conspicuous annual privacy notice to customers

- disclose the institution's information-sharing practices in initial, annual, and revised privacy notices

The OCC issued a civil money penalty of $180,000 to a mortgage company subsidiary of a national bank for its failure to properly and securely dispose of confidential customer information. The OTS issued one cease-and-desist order to a former institution-affiliated party for violations of Regulation P and another consumer regulation. The individual paid a civil money penalty of $2,000 for the violations. The other FFIEC agencies did not issue any formal enforcement actions relating to Regulation P during the reporting period.

*Regulation Z*
*(Truth in Lending)*

The FFIEC agencies reported that 80 percent of the institutions examined during the 2005 reporting period were in compliance with Regulation Z, compared with 84 percent for the 2004 reporting period. The most frequent violations involved failure to take one or more of the following actions:

- accurately disclose the finance charge in closed-end credit transactions

- accurately disclose the annual percentage rate (APR) in closed-end credit transactions

- on certain residential mortgage transactions, provide a good faith estimate of the required disclosures before consummation, or not later than three business days after receipt of the loan application

In addition, 93 banks supervised by the Federal Reserve and the FDIC were required, under the Interagency Enforcement Policy on Regulation Z, to reimburse a total of approximately $591,000 to consumers for understating the annual percentage rate or the finance charge in their consumer loan disclosures.

The OCC entered into a formal agreement with a bank and its mortgage company subsidiary for violations of the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Federal Trade Commission Act. The subsidiary was required to reimburse borrowers who were harmed and was directed to set aside at least $14 million to fund these reimbursements.

The OCC also issued a prohibition and cease-and-desist order, as well as a civil money penalty of $20,000, against a former bank vice president for making tax lien loans that violated the Home Ownership Equity Protection Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Federal Trade Commission Act. The OCC had previously ordered the bank to reimburse affected customers and had issued a cease-and-desist order against the company that marketed, originated, and serviced the loans.

The OTS issued five cease-and-desist orders for violations of a number of consumer regulations, including Regulation Z, during the reporting period. Three of the banks paid civil money penalties totaling $18,900. The FDIC issued one cease-and-desist order for violations of a number of consumer regulations, including Regulation Z. The

other FFIEC agencies did not issue any formal enforcement actions relating to Regulation Z during the reporting period.

The FTC settled charges against an individual defendant and a group of mortgage brokers for their alleged violations of the Truth in Lending Act and Regulation Z, the Federal Trade Commission Act, and other statutes. Under the consent judgment, the individual defendant will cease making misrepresentations about home mortgage refinancing offers and cease future violations of Regulation Z. The defendant was also required to pay $128,300 in consumer restitution. In another case, the FTC settled charges, through a stipulated order, against a mortgage corporation for its alleged violations of the Truth in Lending Act and Regulation Z, the Federal Trade Commission Act, and other statutes. The stipulated order requires the defendant to pay $750,000 in consumer restitution; the order also set up a $350,000 performance fund to be used if the defendant fails to comply with the order. In addition, the order bars the defendant from making or servicing any home-secured loans and includes other injunctions.

The FTC continued litigation against a mortgage broker and its principals for their alleged violations of the Truth in Lending Act, Regulation Z, and the Federal Trade Commission Act, in connection with advertisements for extremely low mortgage rates. In 2004, the court entered a stipulated preliminary injunction against the defendants. In 2005, the court held the defendant's chief executive officer in civil contempt of that order; he was subsequently arrested under a bench warrant. The court released this individual after he paid $275,000 in sanctions and agreed to pay $400,000 in consumer restitution, among other terms. Litigation is ongoing in this case.

The FTC settled charges against a finance company, seven related companies, and their principals for their alleged violations of the Truth in Lending Act and Regulation Z, the Federal Trade Commission Act, and other statutes. The final order shut down the companies and permanently bars them and their principals from participating in any lending or direct-deposit business and from offering or selling ancillary products. The FTC will receive a $10.5 million claim in the consolidated bankruptcy case against the companies, 50 percent of the assets in receivership, and two suspended judgments totaling approximately $674,000. Finally, the FTC continues litigation against two related companies and their officers for their alleged violations of the Truth in Lending Act, Regulation Z, and the Federal Trade Commission Act. The companies are alleged to have engaged in misrepresentation about merchandise refunds and, when consumers were owed refunds, to have failed to promptly credit their credit card accounts.

The FCA's examination and enforcement activities revealed that most Regulation Z violations involved inadequate or incorrect disclosures for closed-end credit. The other agencies that enforce Regulation Z—the Department of Transportation and the Grain Inspection, Packers, and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise.

### *Regulation AA (Unfair or Deceptive Acts or Practices)*

The FFIEC agencies reported that more than 99 percent of the institutions examined during the 2005 reporting

period were in compliance with Regulation AA, which is comparable to the level of compliance for the 2004 reporting period. No formal enforcement actions relating to Regulation AA were issued during the reporting period.

*Regulation CC*
*(Availability of Funds and Collection of Checks)*

The FFIEC agencies reported that 93 percent of institutions examined during the 2005 reporting period were in compliance with Regulation CC, which is comparable to the level of compliance for the 2004 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved the failure to take one or more of the following actions:

- make available on the next business day the lesser of $100 or the aggregate amount of checks deposited that are not subject to next-day availability
- follow special procedures when invoking the exception for large-dollar deposits
- provide required information when placing an exception hold on an account

The OTS issued one cease-and-desist order for violations of a number of consumer regulations, including Regulation CC. The other FFIEC agencies did not issue any formal enforcement actions related to Regulation CC during the reporting period.

*Regulation DD*
*(Truth in Savings)*

The FFIEC agencies reported that 91 percent of institutions examined during the 2005 reporting period were in compliance with Regulation DD, compared with 92 percent for the 2004 reporting period. Among the institutions not in full compliance, the most frequently cited violations involved the following actions:

- using the phrase "annual percentage yield" in an advertisement without disclosing required additional terms and conditions for customer accounts
- providing account disclosures that did not contain all required information
- failing to provide timely maturity notification for time deposits

The OTS issued one cease-and-desist order for violations of a number of consumer regulations, including Regulation DD. The other FFIEC agencies did not issue any formal enforcement actions related to Regulation DD during the reporting period.

## Consumer Complaints

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agency complaints that involve other creditors and businesses. Each Reserve Bank investigates complaints against state member banks in its District. In 2005, the Federal Reserve received 460 consumer complaints about regulated practices by state member banks—complaints were received by mail, by telephone, in person, and electronically via the Internet.

### Complaints against State Member Banks

Of the 460 complaints about regulated practices, 78 percent involved consumer

loans: 5 percent alleged discrimination on a basis prohibited by law (race, color, religion, national origin, sex, marital status, age, the fact that the applicant's income comes from a public assistance program, or the fact that the applicant has exercised a right under the Consumer Credit Protection Act), and 73 percent concerned other credit-related practices, such as credit card disclosures, preapproved solicitations, and billing error resolution. Seventeen percent of the complaints involved disputes about interest on deposits and other deposit account practices, including electronic fund transfers; the remaining 5 percent concerned disputes about trust services or other practices. (See tables.)

In 95 percent of the complaints against state member banks regarding regulated practices that were investigated in 2005, the banks had correctly handled the customer's account. The remaining 5 percent of the complaints against state member banks resulted in a finding that the bank had violated a consumer protection regulation. The most common violations involved real estate loans, deposit accounts, and electronic fund transfers.

Consumer Complaints against State Member Banks, by Classification, 2005

| Classification | Number |
|---|---|
| Regulation B (Equal Credit Opportunity) | 29 |
| Regulation C (Home Mortgage Disclosure Act) | 0 |
| Regulation E (Electronic Fund Transfers) | 30 |
| Regulation H (Bank Sales of Insurance) | 2 |
| Regulation M (Consumer Leasing) | 0 |
| Regulation P (Privacy of Consumer Financial Information) | 4 |
| Regulation Q (Payment of Interest) | 0 |
| Regulation Z (Truth in Lending) | 187 |
| Regulation BB (Community Reinvestment) | 2 |
| Regulation CC (Expedited Funds Availability) | 18 |
| Regulation DD (Truth in Savings) | 37 |
| Fair Credit Reporting Act | 96 |
| Fair Debt Collection Practices Act | 40 |
| Fair Housing Act | 2 |
| Flood Insurance | 3 |
| Regulations T, U, and X | 4 |
| Real Estate Settlement Procedures Act | 6 |
| **Total** | **460** |

### *Unregulated Practices*

As required by section 18(f) of the Federal Trade Commission Act, the Board continued to monitor complaints about banking practices that are not subject to existing regulations and to focus on those that concern possible unfair or deceptive practices. In 2005, the Board received more than 1,300 complaints against state member banks that involved unregulated practices. The categories that received the most complaints involved checking accounts and credit cards. Consumers most frequently complained about insufficient funds charges and procedures (95 complaints); other issues concerned interest rates and terms on credit cards (95), customer service (83), and fraud (57). The remainder of the complaints concerned a wide range of unregulated practices involving credit cards, including banks' refusals to close accounts when requested to do so by customers, the amounts banks charge for late payments, and the unsolicited offers banks send to consumers.

### *Complaint Referrals to HUD*

In accordance with a memorandum of understanding between HUD and the federal bank regulatory agencies, in 2005 the Federal Reserve referred three complaints to HUD that alleged state member bank violations of the Fair Housing Act.

## Advice from the Consumer Advisory Council

The Board's Consumer Advisory Council—whose members represent consumer and community organizations,

Complaints against State Member Banks that Involve Regulated Practices, 2005

| Subject of complaint | All complaints | | Complaints involving violations | |
|---|---|---|---|---|
| | Number | Percent | Number | Percent |
| **Total** | **460** | **100** | **22** | **5** |
| Loans | | | | |
| Discrimination alleged | | | | |
| Real estate loans | 5 | 1 | 0 | 0 |
| Credit cards | 11 | 2 | 0 | 0 |
| Other loans | 7 | 1 | 0 | 0 |
| Other type of complaints | | | | |
| Real estate loans | 42 | 9 | 7 | 17 |
| Credit cards | 257 | 56 | 3 | 1 |
| Other loans | 38 | 8 | 2 | 5 |
| Deposits | 50 | 11 | 4 | 8 |
| Electronic fund transfers | 26 | 6 | 4 | 15 |
| Trust services | 1 | 1 | 0 | 0 |
| Other | 23 | 5 | 2 | 9 |

the financial services industry, academic institutions, and state agencies—advises the Board of Governors on matters concerning laws and regulations that the Board administers and on other issues related to consumer financial services. Council meetings are held three times a year and are open to the public. (For a list of members of the council, see the section "Federal Reserve System Organization.")

In 2005, the council met in March, June, and October. In March, council members discussed the Board's proposed amendments to Regulation E, which implements the Electronic Fund Transfer Act (EFTA). Members focused on proposed revisions to cover payroll cards as "accounts" under Regulation E; the revisions would require financial institutions to provide written periodic statements to consumers who use payroll cards. Some members asserted that providing written periodic statements to these consumers posed operational problems for lenders, because payroll card users are often not bank customers. Other members believed that payroll cards are a major monetary asset for many unbanked consumers—and consumers should receive periodic statements for these accounts, regardless of any statement-delivery or other concerns.

In March and June, the council discussed the advance notice of proposed rulemaking (ANPR) to revise Regulation Z, which implements the Truth in Lending Act (TILA). Members commented on the current content and format of disclosures for credit card accounts and also pointed out that competition between credit card companies has led to consumers being offered complicated and confusing products that they may not understand. Members commented on the disclosure table known as the "Schumer box," which is provided with credit card applications and solicitations. Although including a Schumer box on credit card applications and solicitations has been a successful way for lenders to disclose the associated fees, the design and format of the box could still be improved. Members also discussed whether the TILA amendments included in the Bankruptcy Abuse and Prevention and Consumer

Protection Act of 2005 should be implemented as part of the ongoing regulatory review of Regulation Z. All members agreed that developing the Bankruptcy Act TILA disclosures in conjunction with the review of Regulation Z would be beneficial.

The Home Mortgage Disclosure Act (HMDA) was a topic of discussion at both the March and October meetings. In March, council members discussed revisions to Regulation C (HMDA's implementing regulation) that require federally insured depository and for-profit nondepository lenders to collect, report, and publicly disclose loan-price data for certain higher-priced home mortgage loans. Many lenders and community groups expressed concerns about the release and interpretation of the new HMDA data. They emphasized that the Federal Reserve System's community affairs staff could promote a better understanding of the data by supporting education efforts and starting a dialogue between lenders and community groups. In October, members noted that the new HMDA pricing data show a higher incidence of higher-priced lending among minorities; members also believed that more research on opportunities for reaching underserved individuals, including low-income and minority borrowers, is needed.

The proposed revisions to the financial agencies' regulations implementing the Community Reinvestment Act (CRA) were discussed at the March and June meetings. Members' comments primarily focused on community development in rural areas. Prior to July 19, 2005, the CRA rules considered community development in rural areas as eligible for CRA credit if the activities targeted low- or moderate-income census tracts or populations. However, rural areas are frequently categorized as middle-income tracts because of the uneven distribution of income levels within those census tracts. Members generally agreed that, in rural areas, the definition of community development should be expanded to be more responsive to the community development needs of those areas, regardless of their overall income levels. Members also focused on the community development test for branching services; they did not agree with the proposed rule change that would eliminate CRA credit for branching by banks with assets of between $250 million and $1 billion. They believed that a branching test should be required for intermediate small banks under the revised CRA proposal.

In June, council members from financial institutions discussed the scope and variety of recent information security breaches involving customer information, and they explored the challenges of finding solutions for safeguarding customer information. Members generally agreed that federal regulation (1) is needed to address information security problems on a national basis and (2) should cover entities beyond financial institutions. Entities that are not subject to regulatory oversight should be required to meet federal guidelines for establishing security programs and providing notice to customers and law enforcement agencies when breaches occur.

In October, pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), members provided comments on consumer protection laws and regulations that may have become outdated, unnecessary, or unduly burdensome. Members commented on the rules governing the asset-size exemption for reporting HMDA data, TILA's provisions addressing the right to rescind certain mortgage loan transactions, the Gramm-Leach-Bliley Act (GLB Act) requirements for

sending annual privacy notices, and the CRA rule requiring federal regulators' prior approval for establishing branches. Members agreed that the requirements for HMDA reporting and TILA's right-of-rescission rules were important and should be retained without change. Members suggested that the rules concerning GLB Act privacy notices and the CRA notice requirements for establishing branches could be simplified.

Nontraditional mortgage loan products were also discussed at the October meeting. During the past two years, the number of consumers obtaining nontraditional mortgages, such as payment-option adjustable-rate mortgages or interest-only mortgages, has significantly increased. Council members noted that these products are complex; require extensive education on the part of consumers, as well as extensive disclosures by lenders; and are often offered without considering sound underwriting criteria for the loan. Members expressed concern that some lenders do not provide consumers with disclosures that explain the full range of risks involved in repaying the loan. Members highlighted the need for more-extensive consumer financial education, which should be balanced with clear disclosures from lenders, understandable and less complex products, and underwriting standards that assess borrowers' suitability for nontraditional loan products. Hurricane Katrina was another topic of discussion at the October meeting. Members discussed a wide range of issues connected with the impact of the hurricane, commending the performance of the Federal Reserve and the other bank regulatory agencies in addressing immediate issues. However, members noted that the Gulf Coast region now needs long-term rebuilding and revitalization strategies to supplement the shorter-term "piecemeal" responses that occurred immediately after the disaster. Members encouraged the Federal Reserve Board to take a leadership role in bringing federal policymakers together for a dialogue about long-term goals and solutions.

## Promotion of Consumer Education and Community Economic Development in Historically Underserved Markets

In 2005, the community affairs function within the Federal Reserve System supported several initiatives to promote community economic development and fair access to credit for low- and moderate-income communities and populations. The function continued to focus on financial literacy and education, the sustainability of community development organizations, policies to help low-income individuals build their assets, and community economic development. Activities included conducting research, publishing newsletters and articles, sponsoring conferences and seminars, and supporting the dissemination of information to both general and targeted audiences.

As a decentralized function, the Community Affairs Offices (CAOs) at the Board and each of the twelve Reserve Banks design activities in response to the needs of communities in the regions they serve. At the Reserve Banks, CAOs focus on providing information and promoting awareness of investment opportunities to financial institutions, government agencies, and organizations that serve low- and moderate-income communities and populations; the Board's CAO engages in activities and explores issues that have public policy implications.

Promoting well-educated and informed consumers is vital to supporting

consumer protection and efficient financial market operations. Accordingly, the Board has a long-standing commitment to providing consumers with information that helps them know their rights and responsibilities in relation to financial services, including how they can use disclosures to shop and compare products and providers. The Federal Reserve maintains a consumer information web site (www.federalreserve.gov/consumers.htm) that includes educational materials related to the Board's consumer regulations. In 2005, the consumer publication "How to File a Consumer Complaint about a Bank" was substantially revised and updated to reflect the current marketplace.

Last year, Board staff continued to be involved with an interagency working group drafting a national strategy for financial education. The working group was created to fulfill the legislative mandate of the Financial Literacy and Education Commission (the commission), established by the Fair and Accurate Credit Transactions Act (the FACT Act). The thirteen-agency working group, led by Treasury Department staff, is charged with developing a national strategy to promote basic financial literacy and education. The working group has sought the participation of government, private, nonprofit, and public institutions in this effort. In 2005, Board staff submitted comments to Treasury Department staff, who are writing the final strategy. Board staff also worked with the other agencies to update the www.MyMoney.gov web site; the update links the web site to the Federal Reserve's consumer education materials. The globalization of the financial services industry has made financial education an international, as well as a national, concern. In November, Board staff shared insights on financial education and consumer protection regulation at a conference hosted by the European Credit Research Institute in Belgium, and at the Third International Forum on Financial and Consumer Protection and Education in Malaysia.

Recognizing the importance of providing access to consumer and financial education to its employees, the Board offered several informational seminars in conjunction with its Workplace Financial Education Task Force, chaired by the director of the Division of Consumer and Community Affairs. Four programs were offered in 2005: identity theft, alternative and interest-only mortgage loans, credit reports, and an orientation to money and finances for Take Your Sons and Daughters to Work Day. Staff also assisted in the design and launch of a tax resources web site on the Board's intranet.

Board staff continued to be involved in national financial education initiatives throughout the year. The division's director serves as an adviser to the board of Operation HOPE, a national nonprofit organization dedicated to delivering financial education programs to low-income populations with a particular focus on communities suffering from natural disasters. Currently, a member of the Board of Governors serves on the board of directors of NeighborWorks America (the trade name of the Neighborhood Reinvestment Corporation). Community Affairs staff participate in strategic planning for the NeighborWorks Center for Homeownership Education and Counseling, with the objective of developing national standards for financial counseling and training to promote homeownership among low- and moderate-income populations. To further support consumers' informed decision making about mortgage credit, Board staff developed an information brochure describing the implications of interest-only loans, a popular product in high-cost housing markets. The bro-

chure describes the rate and payment adjustments inherent in the terms of these loans. Board and Reserve Bank staff also continued to support the Conference of Mayors' financial education program, Dollar Wi$e. In various cities throughout the country, the program seeks to increase the awareness of the importance of personal financial management. Membership in the campaign doubled in 2005, with seventy-one cities now participating.

The CAOs at the Reserve Banks remained active in financial education initiatives during 2005. The Federal Reserve Bank of Kansas City actively promoted workplace financial education by convening employers in Kansas City and Denver to discuss the advantages of providing financial education to employees. In partnership with the Atlanta Reserve Bank, Kansas City staff also published a brochure identifying the characteristics of an effective financial education program (www.kc.frb.org/comaffrs/Workshops/FEbrochure.pdf). The Oklahoma City Branch of the Kansas City Reserve Bank collaborated with the Oklahoma Jump$tart Coalition to host a conference of local financial-education service providers and community members to identify strategies for expanding financial education throughout the state. In an effort to expand the scope of the regional financial education collaboratives it has helped establish in key cities in the Fourth District, the Cleveland Reserve Bank hosted a conference that underscored effective strategies for measuring success and conducting research on financial education.

Complementing the System's financial education efforts, various CAOs partnered with CFED, a national nonprofit organization formerly known as the Corporation for Enterprise Development, to host a series of events delving into asset-building and wealth-accumulation strategies for lower-income individuals. The San Francisco, New York, Boston, and Philadelphia Reserve Banks cohosted two conferences with CFED in San Francisco and New York that highlighted private-sector innovations as well as local and national policies that facilitate and encourage savings and investment among lower-income consumers. In addition, the Board and the Richmond Reserve Bank cohosted a forum of national research and policy experts to discuss opportunities for improving asset-building among lower-income populations.

Building on prior years' efforts to help community development financing organizations grow and survive, the Federal Reserve System and the Aspen Institute collaborated on a series of conferences. Research by the Aspen Institute, a national research and leadership development organization, was the foundation for conference discussions about the industry and how to increase its impact. One event, sponsored by the Chicago Reserve Bank, explored various business models that have led to successful community development finance programs. Another event, cohosted by the Boston Reserve Bank, explored whether socially responsible investments can be used to fund community development institutions and help them operate more effectively. Board staff also participated in an international conference, sponsored by the Social Enterprise Initiative at Harvard Business School, on effective business strategies for serving lower-income populations. Staff presented a case study of a community development financial institution, highlighting the role banking regulation and policy had in motivating private investment in these institutions, as well as the business strategies these

institutions adopted to respond to the credit and financial services needs of their lower-income markets.

The System's CAOs remain committed to increasing research and data on community economic development. In 2005, the System hosted its biennial community development research conference, "Promises and Pitfalls: As Consumer Finance Options Multiply, Who Is Being Served and at What Cost?" The Research and Community Affairs staffs at the Board and the Cleveland Reserve Bank collaborated on the event. Papers presented at the conference assessed the impact that consumer behavior, alternative financial services providers, financial education, and other factors have on consumers' access to and experiences with the financial sector. In one paper, System staff studied data from focus groups with Mexican immigrants who remitted money to family members in Mexico. Those results are being used to help immigrants connect with the banking system and thereby increase market efficiencies for both financial institutions and consumers. The results are also being used in interagency efforts to educate consumers about the remittance channels available to them. A call for papers for the System's 2007 research conference has been issued. The 2007 conference will address the effectiveness of the Community Reinvestment Act (CRA) in promoting access to and encouraging community and economic development, in light of the dramatic changes that have occurred in the financial services industry in the thirty years since the CRA was enacted.[9]

In addition to participating in the System research conference, several CAOs at Reserve Banks have expanded their programs to include research and data collection. The Boston Reserve Bank launched a series of community economic development papers that offer in-depth coverage of current community economic development issues. The Boston Bank also created a new series of data resources on the socioeconomic characteristics of lower-income communities in New England (www.bos.frb.org/commdev/index.htm). The New York Reserve Bank published research on whether stored-value cards are an effective electronic payment tool for unbanked consumers; the Bank also published a paper on using the earned income tax credit to encourage savings and banking system participation by unbanked consumers (www.ny.frb.org/regional/commdev.html). To bridge the gap between community economic development theory and practice, the San Francisco Reserve Bank launched a new community development journal that features articles and commentary by researchers, policymakers, and practitioners (www.sf.frb.org/publications/community/). Research by Board staff on the financial education programs offered to military personnel by the Department of Defense (DoD) continued. Staff collected data from recipients of the DoD's financial education program as support for a longitudinal study to assess the impact of DOD's programs on the financial management behavior of the recipients.

Finally, Board staff undertook efforts to help the public understand and use the new Home Mortgage Disclosure Act (HMDA) data. Public interest in HMDA data increased significantly in 2005, with the release of previously uncollected data on the pricing of home mortgage loans. To address potential concerns and questions about the new HMDA data, Board staff

9. The web site for the 2005 conference (including conference papers), as well as the 2007 call for papers, can be accessed at www.federalreserve.gov/community.htm.

worked collaboratively with other agencies to develop questions and answers about the insights and limitations the new data provide. (See the Board's March 31, 2005, press release at www.federalreserve.gov/newsevents.htm.) These questions and answers were designed to both help interested parties use the data objectively and to discourage individuals and groups from forming conclusions about mortgage lending patterns that are not supported by the data.

## Outreach Activities

The Board engages in outreach activities throughout the year to provide information to the public about the Board's responsibilities, to facilitate understanding of changes in banking regulations and their impact on banks and consumers, to promote community development and consumer education, and to foster discussion of public policy issues. Board staff periodically meet with financial institutions, community groups, and other members of the public in formal and informal settings. The Board sponsors and participates in meetings, conferences, and seminars for the general public and targeted audiences. This year, the Board again participated in the Congressional Black Caucus Foundation's 2005 annual legislative conference, which provides a national forum for examining strategies and viable solutions to public policy issues facing African Americans. Board staff distributed consumer education materials provided by the Federal Reserve System and used the opportunity to inform conference attendees about the Federal Reserve and its multifaceted responsibilities. ■

# Federal Reserve Banks

In addition to contributing to the setting of national monetary policy and supervising and regulating banks and other financial entities (discussed in preceding chapters), the Federal Reserve Banks operate a nationwide payments system, distribute the nation's currency and coin, and serve as fiscal agents and depositories for the United States.

## Developments in Federal Reserve Priced Services

In operating a nationwide payments system, the Federal Reserve Banks provide numerous services to depository institutions, including collecting and processing checks, operating an automated clearinghouse service, transferring funds and securities, and providing settlement services. The Reserve Banks charge fees for providing these "priced services."

The Monetary Control Act of 1980 requires that the Federal Reserve establish fees for priced services provided to depository institutions so as to recover, over the long run, all direct and indirect costs actually incurred as well as the imputed costs that would have been incurred, including financing costs, taxes, and certain other expenses, and the return on equity (profit) that would have been earned if a private business firm had provided the services. The imputed costs and imputed profit are collectively referred to as the private-sector adjustment factor (PSAF).[1] Over the past ten years, the Reserve Banks have recovered 98.4 percent of their priced services costs, including the PSAF (table). In 2005, the Board approved changes, to be effective in 2006, to the method for calculating the target return on equity measure in the PSAF.

Overall, the price index for priced services increased 8.4 percent from 2004 to 2005. Revenue from priced services amounted to $901.0 million, other income was $93.7 million, and costs were $834.7 million, resulting in net income from priced services of $160.0 million. In 2005, the Reserve Banks recovered 106.1 percent of total costs of $937.7 million, including the PSAF.[2]

### Commercial Check Collection Service

In 2005, operating expenses and imputed costs for the Reserve Banks' commercial check collection service totaled $688.6 million, of which $39.0 million was attributable to the transportation of commercial checks

1. In addition to income taxes and the return on equity, the PSAF is made up of three imputed costs: interest on debt, sales taxes, and assessments for deposit insurance by the Federal Deposit Insurance Corporation (FDIC). Board of Governors assets and personnel costs that are related to priced services are also allocated to priced services; in the pro forma statements at the end of this chapter, Board expenses are included in operating expenses and Board assets are part of long-term assets.

2. Financial data reported throughout this chapter—revenue, other income, cost, net revenue, and income before taxes—can be linked to the pro forma statements at the end of this chapter. *Other income* is revenue from investment of clearing balances net of earnings credits, an amount termed net income on clearing balances. *Total cost* is the sum of operating expenses, imputed costs (interest on debt, interest on float, sales taxes, and the FDIC assessment), imputed income taxes, and the targeted return on equity.

Priced Services Cost Recovery, 1996–2005

Millions of dollars except as noted

| Year | Revenue from services[1] | Operating expenses and imputed costs[2] | Targeted return on equity | Total costs | Cost recovery (percent)[3] |
|---|---|---|---|---|---|
| 1996 | 815.9 | 746.4 | 42.9 | 789.3 | 103.4 |
| 1997 | 818.8 | 752.8 | 54.3 | 807.1 | 101.5 |
| 1998 | 839.8 | 743.2 | 66.8 | 809.9 | 103.7 |
| 1999 | 867.6 | 775.7 | 57.2 | 832.9 | 104.2 |
| 2000 | 922.8 | 818.2 | 98.4 | 916.6 | 100.7 |
| 2001 | 960.4 | 901.9 | 109.2 | 1,011.1 | 95.0 |
| 2002 | 918.3 | 891.7 | 92.5 | 984.3 | 93.3 |
| 2003 | 881.7 | 931.3 | 104.7 | 1,036.1 | 85.1 |
| 2004 | 914.6 | 842.6 | 112.4 | 955.0 | 95.8 |
| 2005 | 994.7 | 834.7 | 103.0 | 937.7 | 106.1 |
| 1996–2005 | 8,934.6 | 8,238.4 | 841.4 | 9,080.0 | 98.4 |

NOTE: Here and elsewhere in this chapter, components may not sum to totals or yield percentages shown because of rounding.

1. For the ten-year period, includes revenue from services of $8,606.3 million and other income and expense (net) of $328.3 million.

2. For the ten-year period, includes operating expenses of $7,585.1 million, imputed costs of $341.4 million, and imputed income taxes of $312.0 million.

3. Revenue from services divided by total costs.

between Reserve Bank check-processing centers. Revenue amounted to $740.3 million, of which $42.9 million was attributable to estimated revenues derived from the transportation of commercial checks between Reserve Bank check-processing centers, and other income was $77.1 million. The resulting net income was $128.7 million. Check service revenue in 2005 increased $20.6 million from 2004, largely because of price increases and a slower-than-anticipated reduction of check-processing volume.

The Reserve Banks handled 12.2 billion checks in 2005, a decrease of 12.3 percent from the 13.9 billion checks handled in 2004 (table). The decline in Reserve Bank check volume is consistent with nationwide trends away from the use of checks and toward greater use of electronic payment methods.[3] Overall, the price index for check services increased 10.2 percent from 2004.

In response to the continuing decline in check volume, the Reserve Banks in 2005 continued to reduce check service operating costs through a combination of measures, including closing some check-processing sites and increasing capacity at others. Checks that once would have been processed in Birmingham are now processed in Atlanta. Detroit check processing has been consolidated to Cleveland; Salt Lake City to Denver; Portland to Seattle; and Houston and Oklahoma City to Dallas.

Of all the checks presented by the Reserve Banks to paying banks in 2005, 25.2 percent (approximately 3.1 billion checks) were presented electronically, compared with 23.1 percent in 2004. The Banks captured images of 11.8 percent of the checks they col-

3. The Federal Reserve System's retail payments research suggests that the number of checks written in the United States has been declining since the mid-1990s. For details, see Federal Reserve System, "The 2004 Federal Reserve Payments Study: Analysis of Noncash Payments Trends in the United States, 2000–2003" (December 2004). (www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf)

Activity in Federal Reserve Priced Services, 2003–2005
Thousands of items

| Service | 2005 | 2004 | 2003 | Percent change | |
|---|---|---|---|---|---|
| | | | | 2004 to 2005 | 2003 to 2004 |
| Commercial check | 12,195,301 | 13,904,382 | 15,805,894 | −12.3 | −12.0 |
| Funds transfer | 135,227 | 128,270 | 125,936 | 5.4 | 1.9 |
| Securities transfer | 9,235 | 9,208 | 10,071 | .3 | −8.6 |
| Commercial ACH | 7,338,950 | 6,486,091 | 5,588,381 | 13.1 | 16.1 |
| Noncash | 117 | 211 | 280 | −44.5 | −24.7 |

NOTE. Activity in *commercial check* is the total number of commercial checks collected, including processed and fine-sort items; in *funds transfer* and *securities transfer*, the number of transactions originated online and offline; in *commercial ACH,* the total number of commercial items processed; and in *noncash*, the number of items on which fees were assessed.

lected, an increase from 10.4 percent in 2004. In 2005 the Banks presented approximately 241.5 million substitute checks, or 2.0 percent of the total number of checks they collected. (For more information on substitute checks, see the box "The First Full Year of Check 21.")

## Commercial Automated Clearinghouse Services

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled $72.1 million in 2005. Revenue from ACH operations totaled $79.3 million and other income totaled $8.2 million, resulting in net income of $15.2 million. The Banks processed 7.3 billion commercial ACH transactions (worth $12.8 trillion), an increase of 13.1 percent from 2004. Overall, the price index for ACH services decreased 1.1 percent from 2004.

In 2005 the Reserve Banks conducted a pilot program of an ACH risk-management service that will be available to all depository institutions in 2006. The service will help originating institutions manage operational, credit, and third-party risk associated with originating ACH payments.

## Fedwire Funds and National Settlement Services

Reserve Bank operating expenses and imputed costs for the Fedwire Funds and National Settlement Services totaled $55.3 million in 2005. Revenue from these operations totaled $61.0 million and other income amounted to $6.3 million, resulting in net income of $12.1 million.

### *Fedwire Funds Service*

The Fedwire Funds Service allows participants to draw on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions that maintain accounts at the Banks. In 2005, the number of Fedwire funds transfers originated by depository institutions increased 5.4 percent from 2004, to approximately 135.2 million. The average daily value of Fedwire funds transfers in 2005 was $2.1 trillion.

### *National Settlement Service*

Private clearing arrangements that exchange and settle transactions may use the Reserve Banks' National Settle-

## The First Full Year of Check 21

The United States is in the midst of significant change in the way payments are made. At one time, most noncash payments were made by paper check. Evidence of major change was seen in the results of the Federal Reserve's most-recent payments research, which found that in 2003, for the first time ever, businesses and consumers made more payments electronically (by debit and credit card, for example) than by paper check. The declining use of checks is only a part of the ongoing change within the payments system, however. The way in which checks are collected is changing as well, as a result of the Check Clearing for the 21st Century Act (commonly referred to as Check 21). Before implementation of the act in 2004, laws governing check collection allowed a paying bank to require that the original check be physically presented for payment. Check 21 was designed to facilitate the electronic processing of checks, with the goal of making check collection faster, more efficient, and less costly.

Under Check 21, while a paying bank may demand that presentment be in the form of a paper check, it may no longer require that the *original* check be presented. Instead, paying banks must accept a "substitute check," a special paper copy of an original check that can be processed in the same way as the original check. By authorizing this new, legally equivalent negotiable instrument, Check 21 facilitates, through the action of market forces, the adoption of check truncation and the electronic collection of checks.[1] As banks increasingly send and receive checks electronically, they will be able to reduce their

1. Check truncation is the removal of an original check from the check-collection system and the collection, instead, of a substitute check or, by agreement, information contained on the original check's magnetic ink character recognition (MICR) line, including the paying bank's routing number, the check writer's account number, the check serial number, and the amount of the check. Additional consumer information on Check 21 is available at www.federalreserve.gov/consumers.htm. Banking industry educational and reference material on Check 21 is available at www.ffiec.gov/exam/check21/default.htm.

ment Service to settle their transactions. This service is provided to approximately fifty-five local and national private arrangements, primarily check clearinghouse associations but also other types of arrangements. In 2005, the Reserve Banks processed slightly more than 440,000 settlement entries for these arrangements.

### Fedwire Securities Service

The Fedwire Securities Service allows participants to electronically transfer securities issued by the U.S. Treasury, federal government agencies, government-sponsored enterprises, and certain international organizations to other participants in the United States.[4] Reserve Bank operating expenses and imputed costs for providing this service totaled $17.4 million in 2005. Revenue from the service totaled $19.3 million, and other income totaled

4. The expenses, revenues, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and certain international organizations. The Treasury Department assesses fees on depository institutions for some of the transfer, account maintenance, and settlement services for U.S. Treasury securities provided by the Reserve Banks. For details, see the section "Debt Services" later in this chapter.

infrastructure for processing paper checks and the cost of physically transporting original paper checks from the bank where they were deposited to the banks that pay them.

The Federal Reserve Banks have been leaders within the payments industry in making use of the authority granted by Check 21. They began offering Check 21 services as soon as the law became effective in October 2004. The services allow for the deposit of digital check images with the Reserve Banks and the truncation of paper-check deposits by the Reserve Banks. The check images are transmitted to the Reserve Bank closest to the paying bank, thereby eliminating the need to physically transport paper checks between the Banks. The receiving Reserve Bank either prints substitute checks from the check images for presentment to the paying bank or, if the paying bank accepts electronic presentment, provides the check information electronically.

Across the industry, banks have begun to take advantage of the opportunities created by Check 21. More than 500 depository institution customers were using Federal Reserve Check 21 services by year-end 2005. In December 2005, peak daily volume processed by the Reserve Banks exceeded 3 million substitute checks valued at more than $19 billion.

As with many significant operational and technological changes, adoption of the new check-processing methods made possible by Check 21 has been gradual. To fully realize the benefits of a faster, more efficient, less costly, and more resilient check-collection system envisioned when Check 21 was enacted, the banking industry will need to make changes to its current systems to support the exchange of digital check images. As technology improves and scale economies are realized, the cost of collecting checks electronically will decrease relative to the cost of collecting paper checks, and this decrease should eventually spur greater adoption of Check 21 technologies across the banking industry.

$2.0 million, resulting in net income of $3.8 million. Approximately 9.2 million transfers of Treasury and other securities were processed by the service during the year, almost unchanged from 2004. In 2005, the surcharge for offline transfers increased from $28 to $33.

## Noncash Collection Service

At year-end 2005, the Reserve Banks withdrew from the noncash collection service, which collected and processed municipal bearer bonds and coupons issued by state and local governments (referred to as "noncash" items), because of a declining volume of coupons and bonds presented for collection. The service processed slightly fewer than 117,000 noncash transactions in 2005, representing a 44.5 percent decline in volume from 2004. Operating expenses and imputed costs for noncash operations totaled $1.1 million in 2005, and revenue and other income totaled $1.2 million, resulting in net income of approximately $0.1 million.

## Float

The Federal Reserve had daily average debit float of $133.4 million in 2005, compared with credit float of $76.4 million in 2004.[5]

5. Credit float occurs when the Reserve Banks receive settlement for items prior to providing credit to the depositing institution, and debit float occurs when the Reserve Banks credit the depositing institution prior to receiving settlement.

## Developments in Currency and Coin

The Federal Reserve Banks distribute the nation's currency (in the form of Federal Reserve notes) and coin through depository institutions and receive currency and coin from circulation. As currency flows into the Reserve Banks, the Banks inspect the notes and destroy those that are unfit for recirculation.

The Reserve Banks received 37.2 billion Federal Reserve notes from circulation in 2005, a 0.9 percent decrease from 2004, and made payments of 38.5 billion notes into circulation, a 1.6 percent increase from 2004. They received 56.1 billion coins from circulation in 2005, a 0.8 percent increase from 2004, and made payments of 72.1 billion coins into circulation, a 6.9 percent increase from 2004.[6]

Because many depository institutions overuse Reserve Bank cash-processing services, the Board in 2003 requested comment on a policy of providing incentives to encourage depository institutions to recirculate fit currency to their customers rather than return it to the Federal Reserve for processing. Under the policy, the Federal Reserve would establish a custodial inventory program that allows depository institutions to transfer a portion of their cash holdings to the books of a Reserve Bank. Reserve Banks would charge fees to institutions that, within a one-week period, deposited fit currency and reordered currency of the same denomination within the same Reserve Bank office's service area. The Reserve Banks conducted a custodial inventory proof-of-concept program in 2004 to test the effectiveness of a program that supports the proposed policy and evaluated the program in 2005. The Reserve Banks believe that a permanent custodial inventory program, together with recirculation fees, would provide incentives to depository institutions to recirculate currency.

Study of the proposed policy's potential effects on the quality of currency in circulation continues. In 2005, the Federal Reserve worked with vending industry representatives to determine the effect of quality variance on machines' ability to accept currency. The Federal Reserve is also developing a technical definition of currency that is "fit for commerce" and a Reserve Bank program to monitor and control the quality of currency in circulation. The Board is expected to consider approval of a final recirculation policy in early 2006.

The Reserve Banks also continue to study cost-effective alternatives to the existing infrastructure for providing cash services. Earlier studies resulted in the elimination of cash operations at the Little Rock, Louisville, Buffalo, and Portland (Oregon) offices and the replacement of these offices with cash depots. In a cash depot arrangement, armored carrier facilities serve as collection and distribution points for depository institutions' currency deposits and orders. The deposits and orders are transported to and from a nearby Reserve Bank by armored carrier.

## Developments in Fiscal Agency and Government Depository Services

As fiscal agents and depositories for the federal government, the Federal Reserve Banks provide services related to the federal debt, help the Treasury collect funds owed to the federal government, process electronic and check payments for the Treasury, maintain the Treasury's bank account, and invest excess Treasury balances. The Reserve Banks

6. Percentages reflect restatements of previously reported data.

Expenses of the Federal Reserve Banks for Fiscal Agency and Depository Services, 2003–2005

Thousands of dollars

| Agency and service | 2005 | 2004 | 2003 |
|---|---|---|---|
| DEPARTMENT OF THE TREASURY | | | |
| *Bureau of the Public Debt* | | | |
| Treasury retail securities | | | |
| Savings bonds | 59,624.0 | 72,385.1 | 66,403.7 |
| TreasuryDirect and Treasury coupons | 26,879.2 | 30,872.7 | 33,013.5 |
| Treasury securities safekeeping and transfer | 6,055.8 | 6,267.0 | 4,836.3 |
| Treasury auction | 17,553.5 | 17,159.5 | 16,802.6 |
| Computer infrastructure development and support | 2,575.5 | 5,935.1 | 7,836.7 |
| Other services | 1,806.5 | 1,709.8 | 1,460.7 |
| Total | 114,494.5 | 134,329.1 | 130,353.4 |
| *Financial Management Service* | | | |
| Payment services | | | |
| Government check processing | 20,988.0 | 24,245.4 | 25,624.7 |
| Automated clearinghouse | 5,709.5 | 5,352.9 | 6,253.9 |
| Fedwire funds transfers | 109.4 | 111.6 | 187.3 |
| Other payment-related services | 49,366.0 | 33,646.9 | 23,630.8 |
| Collection services | | | |
| Tax and other revenue collections | 39,736.0 | 34,248.4 | 29,782.9 |
| Other collection-related services | 14,354.2 | 12,922.8 | 12,532.6 |
| Cash management services | 40,496.7 | 21,835.8 | 18,227.8 |
| Computer infrastructure development and support | 67,703.3 | 52,673.3 | 24,575.3 |
| Other services | 2,332.2 | 6,931.6 | 6,666.2 |
| Total | 240,795.4 | 191,968.6 | 147,481.5 |
| *Other Treasury* | | | |
| Total | 15,726.7 | 15,106.1 | 13,913.5 |
| Total, Treasury | 371,016.6 | 341,403.7 | 291,748.5 |
| OTHER FEDERAL AGENCIES | | | |
| Department of Agriculture | | | |
| Food coupons | 2,642.4 | 4,519.0 | 7,791.4 |
| U.S. Postal Service | | | |
| Postal money orders | 7,647.8 | 7,774.6 | 10,959.5 |
| Other agencies | | | |
| Other services | 14,870.2 | 16,104.0 | 16,508.2 |
| Total, other agencies | 25,160.4 | 28,397.5 | 35,259.2 |
| Total reimbursable expenses | 396,177.0 | 369,801.2 | 327,007.7 |

also provide limited fiscal agency and depository services to other entities.

The total cost of providing fiscal agency and depository services to the Treasury and other entities in 2005 amounted to $396.2 million, compared with $369.8 million in 2004 (table). Treasury-related costs were $371 million in 2005, compared with $341.4 million in 2004, an increase of 8.7 percent. The cost of providing services to other entities was $25.2 million, compared with $28.4 million in 2004. In 2005, as in 2004, the Treasury and other entities reimbursed the Reserve Banks for the costs of providing these services.

The most-significant development in the provision of fiscal agency services in 2005 was the Reserve Banks' consolidation of customer service and back-office operations that support the Treasury's retail securities programs, through which retail investors purchase and hold marketable Treasury securities and savings bonds. As the Treasury replaced paper processes in retail securities with more-efficient electronic processes, fewer operations sites were

needed. The consolidation to two sites was completed in October 2005. The Banks expect that annual operating costs for retail securities operations will decline considerably in 2006 because of lower personnel costs.

## Debt Services

The Reserve Banks auction, provide safekeeping for, and transfer Treasury securities. Reserve Bank operating expenses for these activities totaled $23.6 million in 2005, a slight increase from 2004. The Banks processed 245,000 tenders for Treasury securities, compared with 156,000 in 2004. They originated 12.6 million transfers of Treasury securities in 2005, an 18.6 percent increase from 2004.

The Reserve Banks also operate computer applications and provide customer service and back-office support for the Treasury's retail securities programs, including Treasury securities and savings bonds. Reserve Bank operating expenses for these activities were $86.5 million in 2005, compared with $103.3 million in 2004.

In addition, the Reserve Banks operate Treasury Direct, a program that allows investors to purchase and hold Treasury securities directly with the Treasury instead of through a broker. The program held $68.1 billion (par value) of Treasury securities as of December 31, 2005. Because the program was designed for investors who plan to hold their securities to maturity, it does not provide transfer services. Investors may, however, sell their securities for a fee through Sell Direct, a program operated by one of the Reserve Banks. Approximately 14,000 securities worth $874.8 million were sold through Sell Direct in 2005, compared with 15,000 securities worth $673.3 million in 2004. Fees associated with the sale of securities through Sell Direct totaled $566,000, an increase of 12.2 percent from the more than $504,000 in fees collected in 2004.

The Banks printed and mailed more than 32 million savings bonds in 2005, a 9.6 percent decrease from 2004. They issued more than 3 million Series I (inflation indexed) bonds and 12.6 million Series EE bonds. Reissued or exchanged bonds accounted for the remaining bonds printed. The Banks processed about 3.5 million redemption, reissue, and exchange transactions, a 9.6 percent decrease from 2004.

## Payments Services

The Reserve Banks process both electronic and check payments for the Treasury. Reserve Bank operating expenses for processing government payments totaled $76.2 million in 2005, compared with $63.4 million in 2004. The Banks processed 981 million ACH payments for the Treasury, an increase of 4.4 percent from 2004, and more than 849,000 Fedwire funds transfers. They also processed 214.8 million paper government checks, a decline of 8.3 percent from 2004. In addition, the Banks issued more than 206,000 fiscal agency checks, a decrease of 25.9 percent from 2004.

In addition to processing payments, the Reserve Banks operate several programs to help the Treasury increase the use of electronic payments. One such program, the Automated Standard Application for Payment, enables recipients of federal grants to request payments using the Internet. This application processed $423.8 billion in Fedwire funds transfers and ACH payments in 2005, compared with $404.7 billion in

2004. Another such program, the stored-value card program, provides salary and benefit payments to military personnel, via a smart card, for use at military bases. In 2005, the Banks worked with the Treasury to plan a web-based application to allow federal agencies and vendors to exchange purchase orders and invoices and initiate ACH payments electronically. The operating costs for these three programs totaled $19.7 million in 2005, compared with $15.4 million in 2004.

## Collection Services

The Reserve Banks support several Treasury programs to collect funds owed the federal government. Reserve Bank operating expenses related to these programs totaled $54.1 million in 2005, compared with $47.2 million in 2004. The Banks operate the Federal Reserve Electronic Tax Application (FR-ETA) as an adjunct to the Treasury's Electronic Federal Tax Payment System (EFTPS). EFTPS allows businesses and individual taxpayers to pay their taxes electronically. It uses the automated clearinghouse (ACH) to collect funds, so tax payments must be scheduled at least one day in advance. Some business taxpayers, however, do not know their tax liability until the tax due date. FR-ETA allows these taxpayers to use EFTPS by providing a same-day electronic federal tax payment alternative. FR-ETA collected $409.2 billion for the Treasury in 2005, compared with $344.8 billion in 2004.

In addition, the Reserve Banks operate Pay.gov, a Treasury program that allows members of the public to pay for goods and services offered by the federal government over the Internet. They also operate the Treasury's Paper Check Conversion and Electronic Check Processing programs, whereby checks written to government agencies are converted into ACH transactions at the point of sale or at lockbox locations. In 2005, the Reserve Banks originated more than 2.6 million ACH transactions through these programs, a 36 percent increase from the 1.9 million originated in 2004.

## Cash Management Services

The Treasury maintains its bank account at the Reserve Banks and invests the funds it does not need for current payments with qualified depository institutions through the Treasury Tax and Loan (TT&L) program, which the Reserve Banks operate. Reserve Bank operating expenses related to this program totaled $40.5 million in 2005, compared with $21.8 million in 2004. The investments either are callable on demand or are for a set term. In 2005, the Reserve Banks placed a total of $8.8 billion in immediately callable investments and $574.1 billion in term investments. The rate for term investments is set at auction; the Reserve Banks held 104 such auctions in 2005, compared with 45 auctions in 2004. In 2005, the Treasury's income from the TT&L program was $597.4 million.

## Services Provided to Other Entities

The Reserve Banks provide fiscal agency and depository services to other domestic and international entities when required to do so by the Secretary of the Treasury or when required or permitted to do so by federal statute. The majority of the work is securities-related.

## The Federal Reserve System's Response to Hurricane Katrina

The damage from Hurricane Katrina's strike along the Gulf Coast on August 29, 2005, and the subsequent flooding of much of New Orleans when levees were breached, seriously affected the banking system's ability to provide financial services at a time when individuals and businesses needed access to their funds. Some depository institutions were flooded and unable to open. Others in the Gulf Coast region that were not severely damaged and might have opened were unable to do so because of interruptions to utility services or a shortage of employees. The transportation of cash for distribution to the public was impeded, and the process of presenting and collecting checks was disrupted.

These conditions presented challenges to the Federal Reserve, which is charged with distributing the nation's currency and coin and provides check-collection services to depository institutions. In the Gulf Coast region, the Federal Reserve conducts these operations through the New Orleans Branch of the Atlanta Federal Reserve Bank. The New Orleans Branch building was not flooded and sustained only minor damage from the hurricane. Only a few essential employees were able to remain in the building, however, so the Branch was unable to provide services as usual. Nonetheless, even before Hurricane Katrina struck, the Branch implemented its contingency operations plans by relocating certain essential employees from New Orleans to the Atlanta Bank's Birmingham, Alabama, Branch, and it quickly began providing services to depository institutions through other Federal Reserve offices. Recognizing that depository institutions faced gasoline shortages and could incur high costs to obtain cash from offices outside New Orleans, the Atlanta and Dallas Reserve Banks arranged for armored carriers to transport cash into the affected areas.

To further support recovery efforts, the Atlanta Reserve Bank also opened drop-off points for check deposits a few days after the hurricane. These deposits were then transported to the Bank's Atlanta office

## Electronic Access to Reserve Bank Services

The Federal Reserve Banks have been using a DOS-based platform, FedLine, to provide services and information to about seven thousand depository institution end points, mainly small and medium-sized institutions. A more-efficient replacement delivery channel, FedLine Advantage, which uses Internet web technologies to provide financial institutions with access to such critical payment systems as Fedwire Funds Service, Fedwire Securities Service, and FedACH Services, has been developed. Migration to FedLine Advantage began in 2005 and will be completed in 2006.

## Information Technology

In 2005, the Federal Reserve Banks completed projects to standardize local area network components and telephone private branch exchange systems and to implement reduced-cost wide area network telecommunications services. An initiative is now under way to strengthen information security controls across the System.

In partnership with the agencies that make up the Financial and Banking Information Infrastructure Committee, the Federal Reserve continued in 2005 to sponsor clearing and settlement utilities, key financial institutions, and key market participants in the national secu-

for processing. Staff from other Federal Reserve offices—and, subsequently, relocated New Orleans employees—have continued to process checks in Atlanta. The Atlanta Bank provided credit for deposited checks drawn on depository institutions in the New Orleans area even though it was initially unable to present checks to those institutions for collection, and it did not return the checks that it could not present. During the crisis, the number of checks drawn on New Orleans area institutions that cleared through the Federal Reserve rose significantly as checks that would normally have cleared through other channels were redirected through the Federal Reserve.

As depository institutions in the affected area began operating at contingency locations, the Atlanta Reserve Bank contacted those institutions to gather information on their situation, particularly on their liquidity and their ability to process payments. Reestablishing contact with depository institutions—an effort on which the Federal Reserve worked closely with other regulatory agencies—was critical, as some institutions had difficulty restoring their operations and were unable to retrieve their ACH (automated clearinghouse) files, which contained information on payroll, Social Security, and other credit payments that their customers needed in this time of crisis.

The Board also worked with key government finance and banking regulatory agencies to devise a strategy for restoring vital telecommunications services to affected institutions. The Board served as the central point of contact for management of the overall restoration effort under the Telecommunications Service Priority (TSP) program—a federal program that identifies and prioritizes those telecommunications services essential to national security and emergency preparedness.[1] Most institutions that were assigned high TSP priority had some measure of telecommunications services available within a matter of days.

1. The TSP program is administered by the National Communications System (NCS), an interagency group of federal departments and agencies that plans for and coordinates national security and emergency preparedness telecommunications, especially during crises.

rity and emergency preparedness programs offered by the Department of Homeland Security's National Communications System, which coordinates activities to ensure that critical telecommunications services are prepared to meet natural disasters and national emergencies. The Board's role in implementing one of these programs—the Telecommunications Service Priority program—to help restore telecommunications services to financial institutions in Mississippi and Louisiana in the wake of Hurricane Katrina and the subsequent flooding in New Orleans is described in the accompanying box.

In response to recommendations in the 2004 report of the Financial Services Task Force of the President's National Security Telecommunications Advisory Committee, the Federal Reserve in 2005 partnered with the Alliance for Telecommunications Industry Solutions (ATIS) on a collaborative project. The team assessed the ability to track changes in the way telecommunications circuits are routed to customer locations and determined that there is currently no commercially viable product that can be adopted to automate this process. The greater the number of carriers involved in providing services, the more difficult it becomes to track such changes. A diverse network provides more protection against disruption of service during contingencies, however, because diver-

sity lessens the risk of a single point of failure. A report on this initiative, the National Diversity Assurance Initiative, was released in February 2006.

## Examinations of the Federal Reserve Banks

Section 21 of the Federal Reserve Act requires the Board of Governors to order an examination of each Federal Reserve Bank at least once a year. The Board engages a public accounting firm to perform an annual audit of the combined financial statements of the Reserve Banks (see the section ''Federal Reserve Banks Combined Financial Statements''). The accounting firm also audits the annual financial statements of each of the twelve Banks. The Reserve Banks use the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in assessing their internal controls over financial reporting, including the safeguarding of assets. In 2005, the Reserve Banks further enhanced their assessments under the COSO framework, strengthening the key control assertion process, consistent with the requirements of the Sarbanes–Oxley Act of 2002. Within this framework, management of each Reserve Bank provides an assertion letter to its board of directors annually confirming adherence to COSO standards, and a public accounting firm certifies management's assertion and issues an attestation report to the Bank's board of directors and to the Board of Governors.

The firm engaged for the audits of the individual and combined financial statements of the Reserve Banks for 2005 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $4.6 million. To ensure auditor independence, the Board requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2005, the Reserve Banks did not engage PwC for non-audit services.

The Board's annual examination of the Reserve Banks includes a wide range of off-site and on-site oversight activities conducted by the Division of Reserve Bank Operations and Payment Systems. Division personnel monitor the activities of each Reserve Bank on an ongoing basis and conduct on-site reviews based on the division's risk-assessment methodology. The 2005 examinations also included assessing the efficiency and effectiveness of the internal audit function. To assess compliance with the policies established by the Federal Reserve's Federal Open Market Committee (FOMC), the division also reviews the accounts and holdings of the System Open Market Account at the Federal Reserve Bank of New York and the foreign currency operations conducted by that Bank. In addition, PwC audits the schedule of participated asset and liability accounts and the related schedule of participated income accounts at year-end. The FOMC receives the external audit reports and the report on the division's examination.

## Income and Expenses

The accompanying table summarizes the income, expenses, and distributions of net earnings of the Federal Reserve Banks for 2004 and 2005.

Income in 2005 was $30,729 million, compared with $23,540 million in 2004. Expenses totaled $3,633 million ($2,677 million in operating expenses, $213 million in earnings

Income, Expenses, and Distribution of Net Earnings of the Federal Reserve Banks, 2005 and 2004

Millions of dollars

| Item | 2005 | 2004 |
|---|---|---|
| Current income | 30,729 | 23,540 |
| Current expenses | 2,890 | 2,239 |
| Operating expenses [1] | 2,677 | 2,123 |
| Earnings credits granted | 213 | 116 |
| Current net income | 27,840 | 21,301 |
| Net additions to (deductions from, – ) current net income | –3,577 | 918 |
| Assessments by the Board of Governors | 743 | 776 |
| For expenditures of Board | 266 | 272 |
| For cost of currency | 477 | 504 |
| Net income before payments to Treasury | 23,520 | 21,443 |
| Dividends paid | 781 | 582 |
| Transferred to surplus | 1,272 | 2,783 |
| Payments to Treasury [2] | 21,468 | 18,078 |

1. Includes net periodic pension credit of $11 million in 2005 and $37 million in 2004.

2. Interest on Federal Reserve notes.

credits granted to depository institutions, $266 million in assessments for expenditures by the Board of Governors, and $477 million for the cost of new currency). Revenue from priced services was $901 million. The profit and loss account showed a net loss of $3,577 million. The loss was due primarily to unrealized losses on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled $781 million, $199 million more than in 2004; the increase reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to the U.S. Treasury in the form of interest on Federal Reserve notes totaled $21,468 million in 2005, up from $18,078 million in 2004; the payments equal net income after the deduction of dividends paid and of the amount necessary to equate the Reserve Banks' surplus to paid-in capital.

In the "Statistical Tables" section of this report, table 10 details the income and expenses of each Reserve Bank for 2005 and table 11 shows a condensed statement for each Bank for the years 1914 through 2005; table 9 is a statement of condition for each Bank, and table 13 gives number and annual salaries of officers and employees for each. A detailed account of the assessments and expenditures of the Board of Governors appears in the section "Board of Governors Financial Statements."

## Holdings of Securities and Loans

The Federal Reserve Banks' average daily holdings of securities and loans during 2005 amounted to $761,509 million, an increase of $41,862 million from 2004 (table). Holdings of U.S. government securities increased $41,801 million, and holdings of loans increased $61 million. The average rate of interest earned on the Reserve Banks' holdings of government securities increased to 3.80 percent, from 3.11 percent in 2004, and the average rate of interest earned on loans increased to 3.49 percent, from 1.74 percent.

Securities and Loans of the Federal Reserve Banks, 2003–2005

Millions of dollars except as noted

| Item and year | Total | U.S. government securities[1] | Loans[2] |
|---|---|---|---|
| *Average daily holdings*[3] | | | |
| 2003 | 683,438 | 683,294 | 144 |
| 2004 | 719,647 | 719,494 | 153 |
| 2005 | 761,509 | 761,295 | 214 |
| *Earnings*[4] | | | |
| 2003 | 22,598 | 22,597 | 1 |
| 2004 | 22,347 | 22,344 | 3 |
| 2005 | 28,966 | 28,959 | 7 |
| *Average interest rate (percent)* | | | |
| 2003 | 3.31 | 3.31 | 1.00 |
| 2004 | 3.11 | 3.11 | 1.74 |
| 2005 | 3.80 | 3.80 | 3.49 |

1. Includes federal agency obligations.
2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.
3. Based on holdings at opening of business.
4. Earnings have not been netted with the interest expense on securities sold under agreements to repurchase.

## Volume of Operations

Table 12 in the "Statistical Tables" section shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 2002 through 2005.

## Federal Reserve Bank Premises

In 2005, construction was completed on new buildings for the Dallas Federal Reserve Bank's Houston Branch and the Chicago Bank's Detroit Branch, and construction began on the Kansas City Bank's new headquarters building after the Board approved the project's final design. Design work continued, and site preparation work began, for the San Francisco Bank's new Seattle Branch building. The multiyear renovation program at the New York Bank's headquarters building continued, as did facility renovation projects at several Reserve Bank offices to accommodate the consolidation of check activities.

Security enhancement programs continue at several facilities. One such project is an ongoing external perimeter security improvement project at the Boston Bank. Another is taking place at the St. Louis Bank, where, as part of a long-term facility redevelopment program, construction of a new pedestrian entrance screening vestibule was completed and design work for an addition to the Bank's headquarters building continued. The St. Louis Bank also completed the purchase and renovation of a building to be used as a business-continuity relocation facility. In addition, the Richmond Bank completed renovation of a building to be used as a relocation site for critical staff and initiated construction of additional security improvements to the building. The Dallas Bank completed the purchase of property behind its headquarters building for the construction of a remote vehicle screening and shipping/receiving facility.

Also during 2005, the Board approved the Richmond Bank's purchase of property adjacent to its headquarters building for construction of a new parking garage, and the sales of the

New York Bank's Buffalo Branch and the Kansas City Bank's headquarters building were finalized. Efforts to sell the Chicago Bank's Detroit Branch building, the St. Louis Bank's Little Rock Branch building, and the San Francisco Bank's Seattle and Portland Branch buildings continued, as did efforts by the Dallas Bank to sell excess land at its Houston Branch and to lease excess space in the Branch building.

Administrative activities for the Buffalo, Louisville, and Little Rock Branches were moved to leased facilities. Check operations formerly conducted at the San Francisco Bank's Seattle and Portland Branches were consolidated and relocated to a leased facility near the Seattle airport. The Portland Branch cash operation was relocated to the current Seattle Branch building until the new building is completed.

Although utility services were interrupted, the Atlanta Bank maintained the security and building systems operations of its New Orleans Branch building during Hurricane Katrina. Because the building sits several feet above flood level, it was not damaged by flooding.

Table 14 in the "Statistical Tables" section of this report details the acquisition costs and net book value of the Federal Reserve Banks and Branches. ■

# Pro Forma Financial Statements for Federal Reserve Priced Services

## Pro Forma Balance Sheet for Priced Services, December 31, 2005 and 2004

Millions of dollars

| Item | 2005 | | 2004 | |
|---|---|---|---|---|
| *Short-term assets* (Note 1) | | | | |
| Imputed reserve requirements on clearing balances | 993.2 | | 1,115.7 | |
| Imputed investments | 8,626.4 | | 9,691.9 | |
| Receivables | 77.0 | | 75.8 | |
| Materials and supplies | 1.3 | | 1.9 | |
| Prepaid expenses | 25.6 | | 31.8 | |
| Items in process of collection | 5,934.4 | | 6,107.1 | |
| Total short-term assets | | 15,657.7 | | 17,024.1 |
| *Long-term assets* (Note 2) | | | | |
| Premises | 424.5 | | 471.8 | |
| Furniture and equipment | 156.1 | | 152.8 | |
| Leases, leasehold improvements, and long-term prepayments | 88.5 | | 107.9 | |
| Prepaid pension costs | 796.8 | | 795.4 | |
| Total long-term assets | | 1,465.9 | | 1,528.0 |
| Total assets | | 17,123.6 | | 18,552.1 |
| *Short-term liabilities* | | | | |
| Clearing balances and balances arising from early credit of uncollected items | 10,703.2 | | 11,909.5 | |
| Deferred-availability items | 5,163.0 | | 5,354.3 | |
| Short-term debt | .0 | | .0 | |
| Short-term payables | 126.2 | | 92.2 | |
| Total short-term liabilities | | 15,992.4 | | 17,355.9 |
| *Long-term liabilities* | | | | |
| Long-term debt | .0 | | .0 | |
| Postretirement/postemployment benefits obligation | 275.0 | | 268.6 | |
| Total long-term liabilities | | 275.0 | | 268.6 |
| Total liabilities | | 16,267.4 | | 17,624.5 |
| Equity | | 856.2 | | 927.6 |
| Total liabilities and equity (Note 3) | | 17,123.6 | | 18,552.1 |

NOTE: Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

## Pro Forma Income Statement for Federal Reserve Priced Services, 2005 and 2004

Millions of dollars

| Item | 2005 | | 2004 | |
|---|---|---|---|---|
| Revenue from services provided to depository institutions (Note 4) | | 901.0 | | 865.9 |
| Operating expenses (Note 5) | | 750.0 | | 800.6 |
| Income from operations | | 150.9 | | 65.3 |
| Imputed costs (Note 6) | | | | |
| Interest on float | 6.1 | | –.1 | |
| Interest on debt | .0 | | .0 | |
| Sales taxes | 11.3 | | 11.6 | |
| FDIC insurance | .0 | 17.4 | .0 | 11.4 |
| Income from operations after imputed costs | | 133.5 | | 53.8 |
| Other income and expenses (Note 7) | | | | |
| Investment income | 292.7 | | 156.8 | |
| Earnings credits | –199.0 | 93.7 | –108.1 | 48.7 |
| Income before income taxes | | 227.2 | | 102.5 |
| Imputed income taxes (Note 6) | | 67.3 | | 30.6 |
| Net income | | 160.0 | | 72.0 |
| MEMO: Targeted return on equity (Note 6) | | 103.0 | | 112.4 |

NOTE: Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

## Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2005

Millions of dollars

| Item | Total | Commercial check collection | Fedwire funds | Fedwire securities | Commercial ACH | Noncash services |
|---|---|---|---|---|---|---|
| Revenue from services (Note 4) | 901.0 | 740.3 | 61.0 | 19.3 | 79.3 | 1.1 |
| Operating expenses (Note 5) | 750.0 | 619.0 | 49.3 | 15.5 | 65.1 | 1.1 |
| Income from operations | 150.9 | 121.3 | 11.7 | 3.8 | 14.1 | .0 |
| Imputed costs (Note 6) | 17.4 | 15.5 | .9 | .3 | .6 | .0 |
| Income from operations after imputed costs | 133.5 | 105.7 | 10.9 | 3.4 | 13.5 | .0 |
| Other income and expenses, net (Note 7) | 93.7 | 77.1 | 6.3 | 2.0 | 8.2 | .1 |
| Income before income taxes | 227.2 | 182.9 | 17.2 | 5.4 | 21.6 | .1 |
| Imputed income taxes (Note 6) | 67.3 | 54.1 | 5.1 | 1.6 | 6.4 | .0 |
| Net income | 160.0 | 128.7 | 12.1 | 3.8 | 15.2 | .1 |
| MEMO: Targeted return on equity (Note 6) | 103.0 | 82.0 | 7.9 | 2.9 | 10.0 | .2 |

NOTE: Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

# FEDERAL RESERVE BANKS

## Notes to Pro Forma Financial Statements for Priced Services

### (1) Short-Term Assets

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as non-earning balances maintained at a Reserve Bank; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. Another portion of the clearing balances is used to finance short-term and long-term assets. The remainder of clearing balances is assumed to be invested in a portfolio of investments, shown as imputed investments.

Receivables are (1) amounts due the Reserve Banks for priced services and (2) the share of suspense-account and difference-account balances related to priced services.

Materials and supplies are the inventory value of short-term assets.

Prepaid expenses include salary advances and travel advances for priced-service personnel.

Items in process of collection is gross Federal Reserve cash items in process of collection (CIPC) stated on a basis comparable to that of a commercial bank. It reflects adjustments for intra-System items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; adjustments for items associated with nonpriced items, such as those collected for government agencies; and adjustments for items associated with providing fixed availability or credit before items are received and processed. Among the costs to be recovered under the Monetary Control Act is the cost of float, or net CIPC during the period (the difference between gross CIPC and deferred-availability items, which is the portion of gross CIPC that involves a financing cost), valued at the federal funds rate.

### (2) Long-Term Assets

Consists of long-term assets used solely in priced services, the priced-services portion of long-term assets shared with nonpriced services, and an estimate of the assets of the Board of Governors used in the development of priced services. Effective Jan. 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). Accordingly, the Reserve Banks recognized a credit to expenses for the qualified pension plan of $1.3 million in 2005 and a credit to expenses of $7.5 million in 2004 with a corresponding increase in this asset account.

### (3) Liabilities and Equity

Under the matched-book capital structure for assets, short-term assets are financed with short-term payables and clearing balances. Long-term assets are financed with long-term liabilities and clearing balances. As a result, no short- or long-term debt is imputed. Other short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of accrued postemployment, postretirement, and nonqualified pension benefits costs and obligations on capital leases.

Equity is imputed at 5 percent of total assets based on the Federal Deposit Insurance Corporation's definition of a well-capitalized institution for deposit insurance premium purposes.

### (4) Revenue

Revenue represents charges to depository institutions for priced services and is realized from each institution through one of two methods: direct charges to an institution's account or charges against its accumulated earnings credits.

### (5) Operating Expenses

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were $6.6 million in 2005 and $7.6 million in 2004. The net credit to expenses under SFAS 87 (see note 2) that includes the nonqualified pension expense of $1.0 million in 2005 is reflected in operating expenses.

The income statement by service reflects revenue, operating expenses, and imputed costs. Certain corporate overhead costs not closely related to any particular priced service are allocated to priced services in total based on an expense-ratio method, but are allocated among priced services based on management decision. Corporate overhead was allocated among the priced services during 2005 and 2004 as follows (in millions):

| | 2005 | 2004 |
|---|---|---|
| Check | 29.4 | 33.5 |
| ACH | 3.7 | 3.4 |
| Fedwire funds | 2.6 | 2.5 |
| Fedwire securities | 1.3 | 1.3 |
| Noncash services | .1 | .1 |
| Total | 37.1 | 40.8 |

### (6) Imputed Costs

Imputed costs consist of income taxes, return on equity, interest on debt, sales taxes, the FDIC assessment, and interest on float. Many imputed costs are derived from the private-sector adjustment factor (PSAF) model, which uses bank holding companies as the proxy for a private-sector firm. The cost of debt and the effective tax rate from the PSAF model are used to impute debt and income taxes. The after-tax rate of return on equity is used to impute the profit that would have been earned had the services been provided by a private-sector firm.

Interest is imputed on the debt assumed necessary to finance priced-service assets; however, no debt was imputed in 2005 or 2004. The sales taxes and FDIC assessment that the Federal Reserve would have paid had

it been a private-sector firm are also among the components of the PSAF.

Interest on float is derived from the value of float to be recovered, either explicitly or through per-item fees, during the period. Float costs include costs for checks, book-entry securities, noncash collection, ACH, and funds transfers.

Float cost or income is based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each service to the total expenses for all services less the total shipping expenses for all services.

The following list shows the daily average recovery of actual float by the Reserve Banks for 2005 in millions of dollars:

| | |
|---|---|
| Total float | 134.3 |
| Unrecovered float | 11.9 |
| Float subject to recovery | 122.5 |
| Sources of recovery of float | |
| Income on clearing balances | 12.3 |
| As-of adjustments | −1.0 |
| Direct charges | 837.7 |
| Per-item fees | −728.4 |

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for cash items in process of collection, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges refer to float that is created by interterritory check transportation and the observance of non-standard holidays by some depository institutions. Such float may be recovered from the depository institutions through adjustments to institution reserve or clearing balances or by billing institutions directly. Float recovered through direct charges and per-item fees is valued at the federal funds rate; credit float recovered through per-item fees has been subtracted from the cost base subject to recovery in 2005.

### (7) Other Income and Expenses

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances for 2004 and 2005 represents the average coupon-equivalent yield on three-month Treasury bills plus a constant spread, based on the return on a portfolio of investments. In both years, the return is applied to the *total* clearing balance maintained, adjusted for the effect of reserve requirements on clearing balances. Expenses for earnings credits granted to depository institutions on their clearing balances are derived by applying a discounted average coupon-equivalent yield on three-month Treasury bills to the *required* portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.

# *The Board of Governors and the Government Performance and Results Act*

The Government Performance and Results Act of 1993 (GPRA) requires that federal agencies, in consultation with Congress and outside stakeholders, prepare a strategic plan covering a multiyear period and submit an annual performance plan and performance report. Although the Federal Reserve is not covered by the GPRA, the Board of Governors voluntarily complies with the spirit of the act.

## Strategic Plan, Performance Plan, and Performance Report

The Board's strategic plan in the GPRA format, which is prepared biennially and covers a four-year period, articulates the Board's mission, sets forth major goals for the period, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. It also addresses issues that cross agency jurisdictional lines, identifies key quantitative measures of performance, and discusses performance evaluation. The most recent strategic plan, covering the period 2004–08, was made public in August 2004. (A strategic plan covering the period 2006–09 is scheduled for release in late spring 2006.)

The Board's performance plan, which is prepared biennially and covers a two-year period, sets forth specific targets for some of the performance measures identified in the strategic plan and describes the operational processes and resources needed to meet those targets; it also discusses data validation and verification of results. The most recent performance plan, covering the period 2004–05, was made public in August 2004. The equivalent document for 2006–07, in the form of a performance budget, will be released in 2006.

The most recent performance report, covering the period 2002–03, was made public in August 2004. The report indicates that the Board generally met its goals for 2002–03. A performance report covering 2004–05 will be released in 2006.

These documents—the strategic and performance plans and the performance report—are available on the Board's web site, at www.federalreserve.gov/boarddocs/rptcongress. The Board's mission statement and a summary of the Federal Reserve's goals and objectives, as set forth in the most recently released strategic and performance plans, are given below.

## Mission

The mission of the Board is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance.

## Goals and Objectives

The Federal Reserve has six primary goals with interrelated and mutually reinforcing elements:

### Goal

To conduct monetary policy that promotes the achievement of maximum

sustainable long-term growth and the price stability that fosters that goal

*Objectives*

- Stay abreast of recent developments and prospects in the U.S. economy and financial markets, and in those abroad, so that monetary policy decisions will be well informed.
- Enhance our knowledge of the structural and behavioral relationships in the macroeconomic and financial markets, and improve the quality of the data used to gauge economic performance, through developmental research activities.
- Implement monetary policy effectively in rapidly changing economic circumstances and in an evolving financial market structure.
- Contribute to the development of U.S. international policies and procedures, in cooperation with the U.S. Department of the Treasury and other agencies.
- Promote understanding of Federal Reserve policy among other government policy officials and the general public.

## Goal

To promote a safe, sound, competitive, and accessible banking system and stable financial markets

*Objectives*

- Promote overall financial stability, manage and contain systemic risk, and identify emerging financial problems early so that crises can be averted.
- Provide a safe, sound, competitive, and accessible banking system through comprehensive and effective supervision of U.S. banks, bank and financial holding companies, foreign banking organizations, and related entities. At the same time, remain sensitive to the burden on supervised institutions.
- Provide a dynamic work environment that is challenging and rewarding. Enhance efficiency and effectiveness, while remaining sensitive to the burden on supervised institutions, by addressing the supervision function's procedures, technology, resource allocation, and staffing issues.
- Promote compliance by domestic and foreign banking organizations supervised by the Federal Reserve with applicable laws, rules, regulations, policies, and guidelines through a comprehensive and effective supervision program.

## Goal

To effectively implement federal laws designed to inform and protect the consumer, to encourage community development, and to promote access to banking services in historically underserved markets

*Objectives*

- Take a leadership role in shaping the national dialogue on consumer protection in financial services, addressing the rapidly emerging issues that affect today's consumers, strengthening consumer compliance supervision programs when required, and remaining sensitive to the burden on supervised institutions.
- Promote, develop, and strengthen effective communications and collaborations within the Board, the Federal Reserve Banks, and other agencies and organizations.
- Increase public understanding of consumer protection and community

development and the Board's role in these areas through increased outreach and by developing programs that address the information needs of consumers and the financial services industry.
- Develop a staff that is highly skilled, professional, innovative, and diverse, providing career development opportunities to ensure the retention of highly productive staff and recruiting highly qualified and skilled employees.
- Promote an efficient and effective work environment by aligning business functions with appropriate work processes and implementing solutions for work products and processes that can be handled more efficiently through automation.

## Goal

To foster the integrity, efficiency, and accessibility of U.S. payment and settlement systems

*Objectives*

- Develop sound, effective policies and regulations that foster payment system integrity, efficiency, and accessibility. Support and assist the Board in overseeing U.S. dollar payment and securities settlement systems by assessing their risks and risk-management approaches against relevant policy objectives and standards.
- Conduct research and analysis that contributes to policy development and increases the Board's and others' understanding of payment system dynamics and risk.

## Goal

To provide high-quality professional oversight of Reserve Banks

*Objective*

- Produce high-quality assessments and oversight of Federal Reserve System strategies, projects, and operations, including adoption of technology to the business and operational needs of the Federal Reserve. The oversight process and outputs should help Federal Reserve management foster and strengthen sound internal control systems, efficient and reliable operations, effective performance, and sound project management and should assist the Board in the effective discharge of its oversight responsibilities.

## Goal

To foster the integrity, efficiency, and effectiveness of Board programs

*Objectives*

- Oversee a planning and budget process that clearly identifies the Board's mission, results in concise plans for the effective accomplishment of operations, transmits to the staff the information needed to attain objectives efficiently, and allows the public to measure our accomplishments.
- Develop appropriate policies, oversight mechanisms, and measurement criteria to ensure that the recruiting, training, and retention of staff meet Board needs.
- Establish, encourage, and enforce a climate of fair and equitable treatment for all employees regardless of race, creed, color, national origin, age, or sex.
- Provide financial management support needed for sound business decisions.
- Provide cost-effective and secure information resource management services to Board divisions, support divi-

sional distributed-processing requirements, and provide analysis on information technology issues to the Board, Reserve Banks, other financial regulatory institutions, and central banks.

- Efficiently provide safe, modern, and secure facilities and necessary support for activities conducive to efficient and effective Board operations. ■

# Federal Legislative Developments

## Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

On April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Bankruptcy Act of 2005). Title IX of the act contains provisions designed to reduce systemic risk in the banking system and the financial markets when parties to certain types of financial transactions become bankrupt or insolvent, by allowing expeditious termination or netting of certain types of financial transactions. In addition, the Bankruptcy Act of 2005 makes several important amendments to the Truth in Lending Act.

### Financial Contract Provisions

*Treatment of Swaps and QFCs*

The Bankruptcy Act of 2005 amends the definitions of several terms that appear in the Federal Deposit Insurance Act (FDI Act) and the Federal Credit Union Act (FCUA) to make them consistent with the definitions in the Bankruptcy Code and to reflect the enactment of the Commodity Futures Modernization Act of 2000 (CFMA). Of particular importance, the act updates the definition of "swap agreement" to include types of transactions that have recently entered the market. Under the FDI Act, the FCUA, and the Bankruptcy Code, swap agreements are eligible for termination, liquidation, acceleration, offset, and netting. The amended definition includes combinations of the listed agreements or transactions and permits contractual netting across economically similar transactions that are the subject of recurring dealings in swap agreements.

In addition, the Bankruptcy Act of 2005 clarifies that the FDI Act and the FCUA expressly protect rights under securities agreements, arrangements, or other credit enhancements related to qualified financial contracts (QFCs). The act also clarifies that no provision of federal or state law relating to the avoidance of preferential or fraudulent transfers may be invoked to avoid a transfer made in connection with any QFC of an insured depository institution in conservatorship or receivership, absent actual fraudulent intent on the part of the transferee.

*Cross-Product Netting*

The Bankruptcy Act of 2005 also promotes cross-product netting through master agreements for QFCs. The act specifies that under the FDI Act and the FCUA, a master agreement for one or more securities contracts, commodity contracts, forward contracts, repurchase agreements, or swap agreements is to be treated as a single QFC, but only with respect to the underlying agreements that are themselves QFCs. This provision ensures that cross-product netting pursuant to a master agreement, or pursuant to an umbrella agreement for separate master agreements between the same parties, will be enforceable under the FDI Act and the FCUA. Cross-product netting permits the netting of a wide variety of financial transactions between two participants, thereby maximizing the present and potential future risk-reducing benefits

of the netting arrangement between the parties.

The Bankruptcy Act of 2005 similarly promotes cross-product netting through amendments to the Bankruptcy Code. The act adds definitions for "master netting agreement" and "master netting agreement participant" to the Bankruptcy Code in order to protect the termination and close-out netting provisions of cross-product master agreements between parties. These agreements may be used (1) to document a wide variety of securities contracts, commodity contracts, forward contracts, repurchase agreements, and swap agreements or (2) as umbrella agreements for separate master agreements between the same parties, each of which is used to document a discrete type of transaction. The act also adds a new section 561 to the Bankruptcy Code designed to expressly protect the contractual rights of a master netting agreement participant to enforce any rights of termination, liquidation, acceleration, offset, or netting under a master netting agreement.

### *"Financial Participants" under the Bankruptcy Code*

The Bankruptcy Act of 2005 adds a new definition for "financial participant" and allows such market participants to close out and net agreements with insolvent entities under the Bankruptcy Code. These changes are designed to limit the potential effect of insolvencies on major market participants. "Financial participant" is defined by the act to include entities having contracts of a total gross dollar value of not less than $1 billion in notional or actual principal amount outstanding or having gross mark-to-market positions of not less than $100 million (aggregated across counterparties). Clearing organizations are also expressly included in the definition and may take advantage of these expanded protections. This amendment is intended to further the goal of promoting the clearing of derivatives and other transactions as a way of reducing systemic risk. The act also makes several amendments to the Bankruptcy Code to reflect current market practice and to conform certain definitions to the FDI Act.

### *FDICIA Netting Protections*

The Bankruptcy Act of 2005 also extends the protections afforded to netting arrangements by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). FDICIA provides that a netting arrangement will be enforced pursuant to its terms, notwithstanding the failure of a party to the agreement. The act extended FDICIA's protections of netting arrangements to

- multilateral clearing organizations,
- uninsured national and state member banks,
- foreign banks and their branches and agencies,
- netting arrangements governed by the laws of a foreign country, and
- netting arrangements between clearing organizations.

### *Authority of FDIC and NCUAB*

The Bankruptcy Act of 2005 provides that no provision of law may be construed to limit the power of the FDIC or the National Credit Union Administration Board (NCUAB) to transfer, or to disaffirm or repudiate, any QFC in accordance with its powers under the

FDI Act or the FCUA, respectively. Moreover, the act denies enforcement of "walkaway" clauses in QFCs. The act defines a walkaway clause as a provision that, after calculation of the value of a party's position or an amount due to or from one of the parties upon termination, liquidation, or acceleration of the QFC, either (1) does not create a payment obligation for the party or (2) extinguishes a payment obligation of the party in whole or in part solely because of the party's status as a nondefaulting party.

The Bankruptcy Act of 2005 also amends the FDIA and the FCUA to expand the receivership authority of the FDIC and the NCUAB, respectively, to permit transfers of QFCs to "financial institutions." The amendment allows the FDIC and the NCUAB, when acting as receiver for an insolvent depository institution, to transfer QFCs to a nondepository financial institution, provided the transferee institution is not subject to bankruptcy or insolvency proceedings. In transferring QFCs, the receiver may not split the QFCs and related interests between the depository institution in default and a particular counterparty; rather, either the receiver must transfer all such QFCs to a single person or it may not transfer any of the QFCs for that particular counterparty. The act's amendments also permit transfers to an eligible financial institution that is a non-U.S. person, or the branch or agency of a non-U.S. person, or a U.S. financial institution that is not an FDIC-insured institution if, following the transfer, the contractual rights of the parties would be enforceable substantially to the same extent as under the FDI Act and the FCUA. The act similarly limits the disaffirmance and repudiation authorities of the FDIC and NCUAB with respect to QFCs so as to make those authorities consistent with the agencies' transfer authority. The act requires that a conservator or receiver must either disaffirm or repudiate all QFCs between the depository institution in default and a particular counterparty or disaffirm or repudiate none of such QFCs. This requirement limits the ability of the FDIC and the NCUAB to "cherry pick" the QFCs between a depository institution in default and a particular counterparty. The amendment is consistent with the FDIC's policy not to repudiate or disaffirm QFCs selectively. The unified treatment is fundamental to the reduction of systemic risk.

The Bankruptcy Act of 2005 also limits the enforcement of rights of termination, liquidation, or netting that arise solely because of the insolvency of a depository institution or that are based on the "financial condition" of the institution in receivership or conservatorship. However, any payment, delivery, or other performance-based default, or a breach of a representation or covenant putting in question the enforceability of the agreement, will not be deemed to be based solely on the financial condition of the institution. The amendment does not prevent counterparties from taking all actions permitted and recovering all damages authorized upon repudiation of any QFC by a conservator or receiver.

The Bankruptcy Act of 2005's amendments also permit the FDIC and the NCUAB to transfer QFCs of a failed depository institution to a bridge bank or a depository institution organized by the FDIC or NCUAB for which a conservator is appointed either (1) immediately upon the organization of such institution or (2) at the time of a purchase and assumption transaction between the FDIC or NCUAB and the institution. These institutions are not to be considered financial institutions that are ineligible to receive transfers of QFCs under the FDI Act.

## TILA Amendments

The Bankruptcy Act of 2005 also includes several provisions that amend the Truth in Lending Act (TILA). These provisions deal principally with open-end (revolving) credit accounts and require new disclosures on periodic statements and on credit card applications and solicitations. The Board is required to issue regulations implementing most of the new provisions, and the new provisions generally will not become effective until twelve months after the regulations are finalized.

### *Minimum-Payment Warnings*

The Bankruptcy Act of 2005 requires creditors to provide, on each periodic statement for open-end credit, a clear and conspicuous disclosure that making only the minimum payment will increase the interest the consumer pays and the time it takes to repay the balance. The statute also requires that the disclosure include

- a hypothetical example of how long it would take to pay off a specified balance with a 17 percent annual percentage rate and
- a toll-free telephone number that consumers can call to obtain an estimate of how long it will take to pay off their own balance if only minimum payments are made.

The Bankruptcy Act of 2005 contains an exemption from these disclosure requirements for a creditor that maintains a toll-free telephone number for the purpose of providing customers with the actual number of months that it will take to repay the customer's outstanding balance. To standardize the information provided to consumers, the act directs the Board to develop a "table" that creditors may use in responding to consumers. The Board and the FTC must establish their own toll-free telephone numbers for use by customers of small banks and non-depository institution creditors, respectively.[1]

### *Introductory Rate Offers*

Credit card issuers that offer discounted introductory interest rates are required, under the Bankruptcy Act of 2005, to disclose clearly and conspicuously on the application or solicitation for the credit card the expiration date of the offer, the rate that will apply after that date, and an explanation of how the introductory rate could be lost (for example, by making a late payment).

### *Internet Solicitations*

The act requires that credit card offers on the Internet must include the same disclosure table—commonly known as the "Schumer box"—that now is required to be included in applications or solicitations for credit cards that are sent by direct mail.

### *Late Fees*

For open-end credit, the Bankruptcy Act of 2005 requires creditors to disclose, on each periodic statement, the earliest date on which a late payment fee may be charged, as well as the amount of the fee.

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1. The Board is required to operate its toll-free telephone number for two years, while the FTC must operate its toll-free telephone number indefinitely.

*High Loan-to-Value Mortgage Credit*

For home-secured credit that may exceed the home's fair market value, the act requires creditors to disclose in the application and in advertisements that the interest on the portion of the loan that exceeds the home's fair market value is not tax deductible.

*Account Termination*

Creditors are prohibited under the Bankruptcy Act of 2005 from terminating an open-end credit account before its expiration date solely because the consumer has not incurred finance charges on the account.

## Post-Employment Restrictions on Senior Examiners

In December 2004, Congress imposed a new federal post-employment restriction applicable to senior examiners of the federal banking agencies, as part of the Intelligence Reform Act.[2] Under this provision, an officer or employee of a federal banking agency or a Federal Reserve Bank who acts as the "senior examiner" for a particular depository institution may not, within one year after terminating employment with the agency or Reserve Bank, knowingly accept compensation as an officer, director, employee, or consultant from that depository institution or any company (including a bank holding company) that controls the depository institution. A similar post-employment restriction is imposed on an officer or employee who acts as the senior examiner of a particular bank holding company or savings and loan holding company; in these circumstances, the post-employment restrictions apply to relationships with the bank holding company or savings and loan holding company and any depository institution subsidiary of the holding company. These post-employment restrictions are in addition to any other conflict of interest and ethics rules and restrictions that may apply to examiners under applicable federal law or the internal codes of conduct established by the agency or Reserve Bank.

Under the statute, an officer or employee of an agency or a Reserve Bank is considered to be the "senior examiner" of a particular depository institution or depository institution holding company only if the examiner has "continuing, broad responsibility" for the examination or inspection of that depository institution or holding company. In addition, to be subject to these new post-employment restrictions, the officer or employee must have served as the senior examiner for the relevant institution or holding company for two or more months during the final twelve months of his or her employment with the agency or Reserve Bank. If a senior examiner violates the one-year post-employment restrictions, the appropriate agency must initiate proceedings to impose an order of removal and prohibition or a civil money penalty on the former senior examiner, and may seek both remedies.

In November 2005, the Board and the other federal banking agencies jointly adopted rules implementing these new post-employment restrictions. *See* 70 FR 69,633 (November 17, 2005). ■

2. Codified at section 10(k) of the FDI Act.

*Records*

# Record of Policy Actions of the Board of Governors

## Regulation D
Reserve Requirements of Depository Institutions

[Docket No. R-1236]

*On October 4, 2005*, the Board approved amendments to reflect the annual indexing of the low reserve tranche and of the reserve requirement exemption for use in 2006 reserve requirement calculations. The amendments increase the 3 percent low reserve tranche for net transaction accounts to $48.3 million (from $47.6 million in 2005) and the reserve requirement exemption to $7.8 million (from $7 million in 2005).

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn.

## Regulation E
Electronic Fund Transfers

[Docket Nos. R-1210, R-1234, and R-1247]

*On December 30, 2005*, the Board approved amendments to clarify the responsibilities of parties in transactions involving electronic check conversion and to require that consumers receive written notification in advance of these transactions. The Board also revised the regulation's official staff commentary to provide guidance on preauthorized transfers from consumers' accounts, error resolutions, and disclosures at ATMs. The amendments are effective February 9, 2006, and compliance is mandatory by January 1, 2007.

In addition, the Board approved an interim final rule with request for comment that applies the regulation to payroll card accounts established to distribute employee salaries, wages, or other compensation on a recurring basis. The interim final rule is effective July 1, 2007.

Votes for these actions: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn.

## Regulation H
Membership of State Banking Institutions in the Federal Reserve System

## Regulation Y
Bank Holding Companies and Change in Bank Control

[Docket No. R-1193]

*On February 28, 2005*, the Board approved amendments to the risk-based capital standards for bank holding companies to allow the continued inclusion of trust preferred securities in tier 1 capital, under stricter quantitative limits and qualitative standards. The amendments also revise (1) quantitative limits for the aggregate amount of trust preferred securities and other restricted core capital elements included in tier 1 capital and (2) qualitative standards for capital instruments included in regulatory capital. The amendments are effective

NOTE: Full texts of the policy actions are available via the "Reading Rooms" on the Board's FOIA web page and on request from the Board's Freedom of Information Office.

April 11, 2005, with a transition period for the new quantitative limits ending March 31, 2009.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

[Docket No. OP-1155]

*On March 21, 2005*, the Board, acting with the other federal banking and thrift regulatory agencies, approved the Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and for Customer Notice. The guidance, which builds on the Interagency Guidelines Establishing Information Security Standards, provides that financial institutions should implement a response program for security breaches involving customer information. As part of their response program, institutions should notify their customers when they determine that misuse of customer information has occurred or is reasonably possible. The guidance is effective March 29, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

## Regulation J
Collection of Checks
and Other Items by
Federal Reserve Banks and
Funds Transfers through Fedwire

## Regulation CC
Availability of Funds and
Collection of Checks

[Docket No. R-1226]

*On November 21, 2005*, the Board approved amendments defining "remotely created checks"—checks created by a seller or creditor with the account holder's authorization but without the account holder's handwritten signature on the check. Such checks are typically used to purchase goods or pay bills by telephone. The Board also approved amendments shifting liability for unauthorized remotely created checks from the paying bank to the depositary bank (in most cases the bank for the seller or creditor that created and deposited the check). The amendments are effective July 1, 2006.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies and Olson. Absent and not voting: Governor Kohn.

## Regulation V
Fair Credit Reporting

## Regulation FF
Obtaining and
Using Medical Information
in Connection with Credit

[Docket No. R-1188]

*On November 14, 2005*, the Board, acting with the other federal bank, thrift, and credit union regulatory agencies, approved interagency rules implementing restrictions in the Fair and Accurate Credit Transactions Act on creditors' use and sharing of medical information. The rules permit creditors (1) to obtain and use consumers' medical information in connection with credit determinations when necessary and appropriate for legitimate purposes, consistent with congressional intent to restrict the use of such information for inappropriate purposes, and (2) to share medical information among affiliates under limited circumstances without becoming credit reporting agencies. The amendments, which are substantially similar to interim final rules published by the

agencies on June 10, 2005, are effective April 1, 2006.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn.

## Regulation BB
Community Reinvestment

[Docket No. R-1205]

*On March 2, 2005*, the Board, acting with the other federal bank and thrift regulatory agencies, approved interagency amendments to conform with changes by the Office of Management and Budget in the standards for defining metropolitan and micropolitan statistical areas, by the U.S. Bureau of the Census in designating census tracts, and by the Board in Regulation C (Home Mortgage Disclosure). The amendments, which are identical to the interim final rules published by the agencies on July 8, 2004, are effective March 28, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

[Docket No. R-1225]

*On July 18, 2005*, the Board approved amendments under the Community Reinvestment Act (CRA) to reduce regulatory burden on intermediate small banks (banks with assets between $250 million and $1 billion) and to more effectively encourage bank investment in community development. The amendments exempt intermediate small banks from certain data collection and reporting requirements and provide for the evaluation of those banks' CRA performance under the small-bank lending test and a new, flexible community development test. The amendments also expand the definition of "community development" to include bank activities in underserved or distressed middle-income rural areas as well as in designated disaster areas. Finally, they clarify the effect of illegal credit practices on a bank's CRA performance rating. The amendments, which are identical to amendments to their regulations adopted by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, are effective September 1, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, and Kohn.

## Regulation DD
Truth in Savings

[Docket No. R-1197]

*On May 19, 2005*, the Board approved amendments to the regulation and its official staff commentary to improve the uniformity and adequacy of information provided to consumers when they overdraw their deposit accounts. The amendments, in part, address a specific service, commonly referred to as "bounced-check protection" or "courtesy overdraft protection," that pays checks and allows other transactions in accounts that have insufficient funds. They also (1) expand the regulation's prohibition against misleading advertisements, to address concerns about the marketing of this service, and (2) require additional disclosures about fees and other terms for overdraft services in such materials as advertisements and periodic account statements. The amendments are effective July 1, 2006.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Gov-

ernors Gramlich, Bies, Olson, Bernanke, and Kohn.

## Post-Employment Restrictions for Senior Examiners

[Docket No. R-1230]

*On November 10, 2005*, the Board, acting with the other federal bank and thrift regulatory agencies, approved new interagency rules implementing post-employment restrictions on certain senior examiners contained in the Intelligence Reform and Terrorism Prevention Act. The rules provide that a senior examiner employed by one of the agencies or a Federal Reserve Bank may not knowingly accept compensation, as an employee, officer, director, or consultant, from a depository institution or holding company that he or she examined, or from certain related entities, for one year after leaving the employment of the agency or Reserve Bank. The rules are effective December 17, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn.

## Rules Regarding Equal Opportunity

[Docket No. OP-1239]

*On November 2, 2005*, the Board approved an interim final rule with request for comment to clarify the limitations on access to sensitive information by employees who are not U.S. citizens. The interim final rule is effective November 8, 2005.

Votes for this action: Chairman Greenpan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn.

## Policy Statements and Other Actions

### Overdraft Protection Programs

[Docket No. OP-1198]

*On February 17, 2005*, the Board, acting with the other federal bank and credit union regulatory agencies, approved joint guidance on overdraft protection programs to help depository institutions in the disclosure and administration of their overdraft-protection services.

Votes for this action: Chairman Greenspan and Governors Gramlich, Bies, Olson, Bernanke, and Kohn. Absent and not voting: Vice Chairman Ferguson.

### Reserve Bank Withdrawal from Noncash Collection Service

[Docket No. OP-1214]

*On February 28, 2005*, the Board approved the withdrawal of the Federal Reserve Banks from the noncash collection service, which involves collecting and processing definitive municipal securities issued by state and local governments. The service was terminated in light of declining volume, expected under-recovery of costs in future years, and the availability of alternative service providers and substitutable services. Withdrawal is effective December 30, 2005; items will be accepted for deposit until September 30.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn.

### Information Security Standards

[Interagency Compliance Guide]

*On November 29, 2005*, the Board, acting with the other federal bank and thrift

regulatory agencies, approved publication of a Small-Entity Compliance Guide to help financial institutions comply with the Interagency Guidelines Establishing Information Security Standards. The guide summarizes in plain language the obligations of financial institutions to protect customer information and illustrates how certain provisions of the interagency security guidelines apply in specific situations.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn.

## Discount Rates in 2005

Under the Federal Reserve Act, the boards of directors of the Federal Reserve Banks must establish rates on loans to depository institutions at least every fourteen days, subject to review and determination by the Board of Governors.

### Primary Credit Rate

Primary credit is the Federal Reserve's main lending program. Primary credit is made available with minimal administration for very short terms as a backup source of liquidity to depository institutions that, in the judgment of the lending Federal Reserve Bank, are in generally sound financial condition. Primary credit is extended at a rate above the federal funds rate target set by the Federal Open Market Committee (FOMC).

During 2005, the Board approved eight increases in the primary credit rate, bringing the rate from 3¼ percent to 5¼ percent. The Board reached its determinations on the primary credit rate recommendations of the Reserve Bank boards of directors in conjunction with the FOMC's decisions to raise the target federal funds rate from 2¼ percent to 4¼ percent and related economic and financial developments. The U.S. economy delivered a solid performance in 2005 despite a further sharp increase in energy prices and devastating hurricanes. The increase in GDP in 2005 was sufficient to further reduce slack in labor and product markets. Core consumer price inflation picked up early in the year, but it subsequently eased and totaled less than 2 percent over the year as a whole. In light of these conditions, the Board and FOMC raised the structure of policy rates at a measured pace. Monetary policy developments are reviewed more fully in other parts of this report (see the section "Monetary Policy and Economic Developments" and the minutes of FOMC meetings held in 2005).

### Secondary and Seasonal Credit Rates

Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit. The secondary credit rate is set at a spread above the primary credit rate. In 2005, the spread was set at 50 basis points.

Seasonal credit is available to smaller depository institutions to meet liquidity needs that arise from regular swings in their loans and deposits. The rate on seasonal credit is calculated every two weeks as an average of selected money-market yields, typically resulting in a rate close to the federal funds rate target.

At year-end, the secondary and seasonal credit rates were 5¾ percent and 4.35 percent, respectively.

### Votes on Discount Rate Changes

About every two weeks during 2005, the Board approved proposals by the twelve Reserve Banks to maintain the formulas

for computing the secondary and seasonal credit rates. Details on the eight actions by the Board to approve changes in the primary credit rate are provided below.

*February 2, 2005.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 3½ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective February 3, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn. Votes against this action: None.

*March 22, 2005.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 3¾ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective March 23, 2005. The Board also approved identical actions subsequently taken by the directors of the Federal Reserve Banks of Kansas City, effective March 23, 2005, and Dallas, effective March 24, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, Bernanke, and Kohn. Votes against this action: None.

*May 3, 2005.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 4 percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective May 4, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, and Kohn. Votes against this action: None.

*June 30, 2005.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 4¼ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective July 1, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Gramlich, Bies, Olson, and Kohn. Votes against this action: None.

*August 9, 2005.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 4½ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective August 10, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Gov-

ernors Bies, Olson, and Kohn. Votes against this action: None.

*September 20, 2005.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Richmond, Chicago, Minneapolis, Kansas City, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 4¾ percent. The Board also approved identical actions subsequently taken by the directors of the Federal Reserve Banks of St. Louis, effective September 21, 2005, and Cleveland, Atlanta, and Dallas, effective September 22, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn. Votes against this action: None.

*November 1, 2005.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 5 percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective November 2, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn. Votes against this action: None.

*December 13, 2005.* Effective this date, the Board approved actions taken by the directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and San Francisco to raise the rate on discounts and advances under the primary credit program by ¼ percentage point, to 5¼ percent. The same increase was approved for the Federal Reserve Bank of St. Louis, effective December 14, 2005.

Votes for this action: Chairman Greenspan, Vice Chairman Ferguson, and Governors Bies, Olson, and Kohn. Votes against this action: None. ■

# *Minutes of Federal Open Market Committee Meetings*

The policy actions of the Federal Open Market Committee, contained in the minutes of its meetings, are presented in the Annual Report of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each policy action, and that it shall include in its annual report to Congress a full account of such actions.

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a summary of the information and discussions that led to the decisions. The descriptions of economic and financial conditions are based solely on the information that was available to the Committee at the time of the meetings.

Members of the Committee voting for a particular action may differ among themselves as to the reasons for their votes; in such cases, the range of their views is noted in the minutes. When members dissent from a decision, they are identified in the minutes and a summary of the reasons for their dissent is provided.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market operations, the Federal Reserve Bank of New York operates under instructions from the Federal Open Market Committee that take the form of an Authorization for Domestic Open Market Operations and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Federal Reserve Bank of New York operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 2005. Changes in the instruments during the year are reported in the minutes for the individual meetings.

## Authorization for Domestic Open Market Operations

### In Effect January 1, 2005

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal

Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $12.0 billion during the period commencing with the opening of business on the day following such a meeting and ending with the close of business on the day of the next such meeting;

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account;

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding. The Federal Reserve Bank of New York shall set a minimum lending fee consistent with the objectives of the program and apply reasonable limitations on the total amount of a specific issue that may be auctioned and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York and accounts maintained at the Federal Reserve Bank of New York as fiscal agent of the United States pursuant to Section 15 of the Federal Reserve Act, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 65 business days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of

pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

## Domestic Policy Directive

### In Effect January 1, 2005[1]

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 2¼ percent.

## Authorization for Foreign Currency Operations

### In Effect January 1, 2005

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Canadian dollars
Danish kroner
Euro
Pounds sterling
Japanese yen
Mexican pesos
Norwegian kroner
Swedish kronor
Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding $25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

| Foreign bank | Amount of arrangement (millions of dollars equivalent) |
|---|---|
| Bank of Canada | 2,000 |
| Bank of Mexico | 3,000 |

1. Adopted by the Committee at its meeting on December 14, 2004.

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account ("Manager"), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

## Foreign Currency Directive

### In Effect January 1, 2005

1. System operations in foreign currencies shall generally be directed at countering dis-

orderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

## Procedural Instructions with Respect to Foreign Currency Operations

### In Effect January 1, 2005

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of

(i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

## Meeting Held on February 1–2, 2005

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, February 1, 2005, at 1:30 p.m. and continued on Wednesday, February 2, 2005, at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Guynn, Lacker, Mses. Pianalto and Yellen, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

Ms. Holcomb, First Vice President, Federal Reserve Bank of Dallas

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter,[2] Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Evans, Howard, Madigan, Oliner, Rolnick, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Slifman and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Clouse, Reifschneider,[3] and Whitesell, Deputy Associate Directors, Divisions of Monetary Affairs, Research and Statistics, and Monetary Affairs, respectively, Board of Governors

Messrs. Elmendorf,[3] English, Faust,[3] and Leahy,[3] Assistant Directors, Divisions of Research and Statistics, Monetary Affairs, International Finance, and International Finance, respectively, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

2. Attended Tuesday's session only.

3. Attended portion of meeting relating to special topic of a numerical definition of the price-stability objective for monetary policy.

Messrs. Bassett, Lebow,[4] Ms. Lindner,[3] Messrs. Rudd,[3] Tetlow,[3] and Wood,[4] Senior Economists, Divisions of Monetary Affairs, Research and Statistics, Reasearch and Statistics, Reasearch and Statistics, Research and Statistics, and International Finance, respectively, Board of Governors

Mr. Durham,[4] Economist, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Moore, First Vice President, Federal Reserve Bank of Cleveland

Mr. Judd, Executive Vice President, Federal Reserve Bank of San Francisco

Messrs. Eisenbeis, Fuhrer, Goodfriend, Hakkio, and Rasche, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Richmond, Kansas City, and St. Louis, respectively

Messrs. Altig, Dotsey, Ms. Hargraves, and Mr. Wynne, Vice Presidents, Federal Reserve Banks of Cleveland, Philadelphia, New York, and Dallas, respectively

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 2005 had been received and that these individuals had executed their oaths of office.

4. Attended portion of meeting related to the economic outlook.

The elected members and alternate members were as follows:

Timothy F. Geithner, President of the Federal Reserve Bank of New York, with Christine M. Cumming, First Vice President, Federal Reserve Bank of New York as alternate.

Anthony M. Santomero, President of the Federal Reserve Bank of Philadelphia, with Jeffrey M. Lacker, President of the Federal Reserve Bank of Richmond, as alternate.

Michael H. Moskow, President of the Federal Reserve Bank of Chicago, with Sandra Pianalto, President of the Federal Reserve Bank of Cleveland, as alternate.

Jack Guynn, President of the Federal Reserve Bank of Atlanta as alternate, voting pending the election of the President of the Federal Reserve Bank of Dallas.

Gary H. Stern, President of the Federal Reserve Bank of Minneapolis, with Janet L. Yellen, President of the Federal Reserve Bank of San Francisco, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were selected to serve until the selection of their successors at the first regularly scheduled meeting after December 31, 2005, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

| | |
|---|---|
| Alan Greenspan | Chairman |
| Timothy F. Geithner | Vice Chairman |
| Vincent R. Reinhart | Secretary and Economist |
| Deborah J. Danker | Deputy Secretary |
| Michelle A. Smith | Assistant Secretary |

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|---|---|
| Scott G. Alvarez | General Counsel |
| Thomas C. Baxter, Jr. | Deputy General Counsel |
| Karen H. Johnson | Economist |
| David J. Stockton | Economist |

Thomas A. Connors, Charles L. Evans, David H. Howard, Brian F. Madigan, Loretta J. Mester, Stephen D. Oliner, Arthur J. Rolnick, Harvey Rosenblum, Joseph S. Tracy, and David W. Wilcox, Associate Economists

As customarily occurs at the first regularly scheduled meeting of the year, the Committee reviewed a range of organizational items, covered below.

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account.

By unanimous vote, Dino Kos was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.[5]

By unanimous vote, the Authorization for Foreign Currency Operations was reaffirmed in the form shown below.

## Authorization for Foreign Currency Operations (Reaffirmed February 1, 2005)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

| | |
|---|---|
| Canadian dollars | Mexican pesos |
| Danish kroner | Norwegian kroner |
| Euro | Swedish kronor |
| Pounds sterling | Swiss francs |
| Japanese yen | |

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding $25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

5. Secretary's note: Advice subsequently was received that the selection of Mr. Kos as Manager was satisfactory to the board of directors of the Federal Reserve Bank of New York.

| Foreign bank | Amount of arrangement (millions of dollars equivalent) |
|---|---|
| Bank of Canada | 2,000 |
| Bank of Mexico | 3,000 |

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account (“Manager”), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3G(1) of the Board of Governors’ Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

By unanimous vote, the Foreign Currency Directive was reaffirmed in the form shown below.

## Foreign Currency Directive (Reaffirmed February 1, 2005)

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency ("swap") arrangements with selected foreign central banks.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under IMF Article IV.

By unanimous vote, the Procedural Instructions with Respect to Foreign Currency Operations were reaffirmed in the form shown below.

## Procedural Instructions with Respect to Foreign Currency Operations (Reaffirmed February 1, 2005)

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account ("Manager"), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and

about any operations that are not of a routine character.

By unanimous vote, the Authorization for Domestic Open Market Operations was amended and approved in the form shown below. The amendment involved removing from paragraph 1(a) the reference to the limit on the amount by which the System Open Market Account holdings of securities can change between FOMC meetings. This limit had become outdated, as it had been superseded by other, more effective mechanisms for the Committee to oversee Desk operations.

## Authorization for Domestic Open Market Operations (Amended February 1, 2005)

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement;

(b) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account.

(c) To sell U.S. Government securities and obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States to dealers for System Open Market Account under agreements for the resale by dealers of such securities or obligations in 65 business days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes the Federal Reserve Bank of New York to lend on an overnight basis U.S. Government securities held in the System Open Market Account to dealers at rates that shall be determined by competitive bidding. The Federal Reserve Bank of New York shall set a minimum lending fee consistent with the objectives of the program and apply reasonable limitations on the total amount of a specific issue that may be auctioned and on the amount of securities that each dealer may borrow. The Federal Reserve Bank of New York may reject bids which could facilitate a dealer's ability to control a single issue as determined solely by the Federal Reserve Bank of New York.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York and accounts maintained at the Federal Reserve Bank of New York as fiscal agent of the United States pursuant to Section 15 of the Federal Reserve Act, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities in 65 business

days or less on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(b), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and such foreign, international, and fiscal agency accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

4. In the execution of the Committee's decision regarding policy during any intermeeting period, the Committee authorizes and directs the Federal Reserve Bank of New York, upon the instruction of the Chairman of the Committee, to adjust somewhat in exceptional circumstances the degree of pressure on reserve positions and hence the intended federal funds rate. Any such adjustment shall be made in the context of the Committee's discussion and decision at its most recent meeting and the Committee's long-run objectives for price stability and sustainable economic growth, and shall be based on economic, financial, and monetary developments during the intermeeting period. Consistent with Committee practice, the Chairman, if feasible, will consult with the Committee before making any adjustment.

By unanimous vote, the Committee made several amendments to its rules, statements, and resolutions, including to align the starting dates of Committee membership terms of Presidents with those of Committee officers, and to authorize the Secretary of the Committee, with the concurrence of the General Counsel, to make technical changes to the rules in the future.

By unanimous vote, the Committee amended its Program for Security of FOMC Information on February 1, 2005, to reflect an updating and streamlining of the document.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period December 14, 2004 to February 1, 2005. By unanimous vote, the Committee ratified these transactions.

At this meeting the Committee engaged in a broad-ranging discussion of the pros and cons of formulating a numerical definition of the price-stability objective of monetary policy. A staff presentation on the topic included a review of the potential costs and benefits of introducing such a definition as well as of other countries' experiences. In the subsequent discussion, meeting participants uniformly agreed that price stability provided the best environment for maximizing sustainable economic growth in the long run, but expressed a range of views on whether it would be helpful for the Committee to articulate a specific numerical definition for the Federal Reserve's price-stability objective—either a single figure or a range. Those who believed such a move would be on balance beneficial cited, for example, its usefulness as an anchor for long-term inflation expectations, as a vehicle for enhanced clarity of Committee deliberations, and as an additional tool for communications. Several of those who saw greater potential drawbacks were concerned that such a shift might appear to be inconsistent with the Committee's dual mandate of fostering maximum employment as well as price stability or that it might inappropriately bias or constrain policy at times; in any case, with inflation expectations well-contained over recent years, the benefits

of announcing a specific inflation objective were not likely to be large. The Committee decided to defer further discussion.

The information reviewed at this meeting suggested that the economy expanded at a solid pace in recent months. Consumer spending and the housing market continued to exhibit strength, and business fixed investment grew robustly in the fourth quarter. The pace of inventory accumulation picked up and industrial production accelerated. The labor market showed further signs of improvement. Core consumer prices rose moderately over the past few months, and measures of inflation expectations remained well-anchored.

Moderate increases in payroll employment during November and December pushed the average monthly advance in the quarter well above that of the third quarter. Employment gains were fairly widespread, with hiring in business services, health care, financial activities, and wholesale trade more than offsetting continued sluggishness in manufacturing and a seasonally adjusted decline in retail services during December. Surveys of employers' hiring plans and job openings pointed to continued moderate gains in employment early this year. The average workweek during the fourth quarter was unchanged from the third quarter, and as a result aggregate hours decelerated despite the pickup in employment growth. The unemployment rate held steady at 5.4 percent in December.

Industrial activity accelerated noticeably during the fourth quarter. The pickup of industrial production in December owed largely to increased motor vehicle assemblies and a turnaround in the output of utilities associated with cold weather across the northeast. Production of high-tech goods slowed slightly in the fourth quarter. Available weekly physical product data suggested that manufacturing production would increase moderately in January. Capacity utilization continued to climb through the end of the year but remained below its longer-run average.

Real consumer spending expanded briskly in December and in the fourth quarter as a whole, with retail sales exhibiting widespread strength across categories. Expenditures on consumer services also continued to post solid increases. A surge in light vehicle sales in December pulled the average rate of sales during the fourth quarter slightly above the third-quarter pace. Real disposable personal income increased at a rapid rate at the end of the year—boosted in part by the special dividend payment by Microsoft; excluding this payment, real disposable personal income rose at a more moderate rate. Measures of consumer confidence remained favorable and consistent with sustained increases in spending.

Residential housing activity remained buoyant in the fourth quarter. A rebound in single-family housing starts in December from a disappointing November brought the fourth quarter pace about in line with that earlier in the year. Sales of new and existing homes slipped some late in the year but remained robust. Mortgage rates had changed little since August and continued to support demand. Construction activity in the multifamily sector weakened a bit in November and December, but indicators of underlying demand pointed to a rebound in starts in January.

Business fixed investment continued to be bolstered by favorable fundamentals, including sustained expansion of business output, the flush cash position of many firms, readily available credit, and a still-favorable cost of capital. Equipment and software spending grew at a solid rate in the fourth quarter,

though not quite as briskly as in the third quarter owing to a deceleration in spending outside the high-tech sector. By contrast, investment in nonresidential structures had edged down in recent months, with expenditures only for drilling and mining operations showing some strength amid flat outlays for manufacturing facilities and a decline in spending on office buildings.

Nonfarm inventories increased a bit more in the fourth quarter than they had in the third quarter. The buildup of inventories was widespread across manufacturers, wholesalers, and retailers as well as across stages of production. Motor vehicle inventories were an exception, as motor vehicle manufacturers sought to reduce stocks of unsold light vehicles. The aggregate inventory–sales ratio outside of motor vehicles likely edged up in the fourth quarter but remained within the range that had prevailed since the middle of last year.

The most recent data suggested that the U.S. international trade deficit widened in the fourth quarter as a result of a broad-based decline in exports of goods and increase in imports of oil and consumer goods. The expansion in economic activity in the major foreign industrialized economies appeared to remain sluggish in the fourth quarter, but the growth of real GDP in Latin America and emerging Asia likely stepped up.

Core consumer prices decelerated over the past few months, while overall consumer prices were buffeted by movements in energy prices. The rate of increase in core prices in the twelve months ending in December was somewhat higher than the very low rate that prevailed during the year-earlier period; the overall index also accelerated, with about half of its advance accounted for by a sharp rise in energy prices. Measures of inflation expectations were little changed over the intermeeting period. With regard to labor costs, the employment cost index decelerated in the fourth quarter; the slowdown was attributable to wages, which gained only slightly, while benefit costs rose a bit faster than in the third quarter.

At its meeting on December 14, 2004, the Federal Open Market Committee decided to increase its target for the federal funds rate 25 basis points to 2¼ percent. In its announcement of this decision, the Committee indicated that the upside and downside risks to the attainment of both sustainable growth and price stability were roughly equal. The Committee also noted that output appeared to be growing at a moderate pace and labor market conditions continued to improve gradually, while inflation and inflation expectations remained well-contained. As a result, the Committee again judged that policy accommodation could be removed at a pace that was likely to be measured, although the path of policy would depend importantly on evolving economic prospects.

The Committee's decision at its December meeting to increase the federal funds rate had been fully anticipated in financial markets, and reaction to the attendant statement was muted. The release of the minutes of the December meeting on January 4, however, triggered a significant upward revision in the anticipated path of monetary policy: Investors apparently read them as expressing more widespread concern among Committee members about inflation pressures than had been the case previously. Market participants viewed the generally favorable incoming data on economic activity as consistent with their expectations of firmer policy. Interest rates on intermediate-term Treasury securities rose in response to the revision to policy expectations, but longer-term yields were little changed over

the intermeeting period. As yields on inflation-indexed Treasury securities rose roughly in line with their nominal counterparts, longer-term inflation compensation remained about unchanged. Risk spreads on corporate bonds were stable at relatively low levels, consistent with favorable indicators of corporate credit quality. Broad stock indexes declined a bit over the intermeeting period. In foreign exchange markets, the dollar ended the period little changed on a trade-weighted basis, appreciating against the major European currencies but falling vis-à-vis other important trading partners.

M2 grew moderately in recent months, its expansion restrained by rising opportunity costs associated with monetary policy tightening. Because changes in interest rates on liquid deposits typically lag those in market interest rates, the growth of that component slowed in the second half of 2004. By contrast, growth of small time deposits, whose yields closely track market rates, picked up. Currency growth was about flat in December.

In the staff forecast prepared for this meeting, the economy was seen as likely to expand at a pace a little above that of its longer-run potential over this year and next, while hiring was expected to firm some more, resulting in a further decrease in the unemployment rate. Household spending was projected to grow at a fairly solid rate, supported by higher employment and somewhat lower energy prices but damped somewhat by lessened stimulus from gains in wealth and the need for households to rebuild savings. After a temporary dip in the level of business investment this quarter related to the expiration of the partial-expensing tax provision, investment outlays were seen as likely to resume vigorous growth in response to steadily rising sales, strong corporate balance sheets, supportive financial conditions, and an ongoing need to replace or upgrade aging equipment and software. Real net exports were projected to be roughly stable for several quarters, held up by the lagged effect of the lower foreign exchange value of the dollar and some strengthening in foreign demand. Measures of total consumer price inflation were expected to decline over the forecast horizon as energy prices receded, while core inflation was seen as remaining stable in the staff forecast. Tendencies for core inflation to increase because of slightly higher trend unit labor costs and a narrowing margin of resource slack were expected to be offset by the waning contribution of elevated prices for energy and imported goods.

In their discussion of the economic outlook, the meeting participants regarded incoming data since the last meeting as supporting their expectations that, with the further removal of monetary accommodation, GDP would likely grow at a moderate pace consistent with a gradual reduction of remaining economic slack, and inflation would probably continue to be low. Domestic demand had stayed strong through the fourth quarter and should continue to be bolstered by favorable financial conditions. Recent data indicated low and stable rates of core consumer inflation and apparently well-anchored inflation expectations. Against this backdrop, the risks to the outlook for both output and inflation relative to the Committee's goals appeared to remain well-balanced.

In preparation for the Federal Reserve's semi-annual report to the Congress on the economy and monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and core con-

sumer price inflation for the years 2005 and 2006. As part of its continuing effort to improve its communications, the Committee had earlier decided to add one year to the forecast period so as to make the projections more useful to the public. The forecasts of the rate of expansion in real GDP were concentrated in the upper part of a 3½ to 4 percent range for 2005; for 2006 the forecasts were in a slightly lower range of 3¼ to 3¾ percent, with a central tendency at 3½ percent. These rates of growth were associated with a civilian unemployment rate in the range of 5 to 5½ percent and a central tendency of 5¼ percent in the fourth quarter of 2005 and 5 to 5¼ percent in the fourth quarter of 2006. The rate of inflation, as measured by the core PCE price index, was expected to remain fairly stable, with forecasts concentrated in the lower portion of a 1½ to 2 percent range for both this year and next.

In their comments about developments in key sectors of the economy, meeting participants noted that, relative to several months ago, many firms now seemed somewhat more confident about the economic outlook. The anticipation of increased sales relative to existing production capacity and also desires to upgrade technology and improve competitiveness were leading firms to increase spending on equipment and software. Gains in capital spending had been quite strong last year, and while some of that spending might have been motivated by the year-end expiration of the partial-expensing provisions of the tax code, participants had seen little evidence to date that there would be a significant slowdown in the growth of spending in the early part of 2005. Low longer-term interest rates on corporate borrowing—reflecting in part narrow credit risk spreads—along with strong corporate profitability and improved balance sheets were continuing to support fairly brisk growth of capital expenditures. Low longer-term nominal interest rates were partly attributable to well-contained inflation expectations, but low real interest rates, along with slight declines in equity prices so far this year, might reflect lingering caution on the part of businesses about the outlook. Nevertheless, narrow credit spreads and risk premiums, along with abundant liquidity in financing markets, suggested that markets now assigned fairly low odds to significant downside risks.

Solid income gains, low interest rates, and consumer confidence were seen by participants as helping to sustain strong growth of household spending. Some firms had reported that holiday sales were higher than a year earlier and better than expected, while auto sales had responded strongly to incentives in December. The current low measured saving rate seemed mostly explainable by the strength of expected income gains, low interest rates, and the increase in household wealth resulting from the rise in equity and housing prices. Although the saving rate might well drift up over the next couple of years, participants generally thought it likely that consumer spending would continue growing at a strong pace. However, a marked slowing in home price appreciation and possible increases in longer-term interest rates, which would raise financing costs and reduce opportunities to extract equity from homes through refinancings and home equity loans, were seen as downside risks to the prospects for consumption spending and for housing construction.

Several participants mentioned that the low level of measured national saving, which implied a continued need for foreign financing of U.S. investment, and imbalances in the external sector imparted additional uncertainty to

the longer-term economic outlook. The extent to which the federal budget deficit would decline over coming years was an open question. As regards the current account balance, some participants noted that the sharp drop in net exports in November probably reflected transitory factors in large part, as well as reported measurement errors. However, there has been little hard evidence as yet of a strengthening in the growth of spending in our foreign trading partners or of substantial effects on net exports from previous dollar declines. As a result, the external imbalance seemed likely to remain elevated, with a high level of uncertainty surrounding the prospects for and path of adjustment.

A number of participants noted continued modest gains in employment, though some commented that, based on anecdotal information, job growth seemed to have picked up of late. The increase in aggregate demand was expected to be sufficient over coming quarters to allow the rate of unemployment to continue to edge lower even as more people return to the labor force. Participants noted considerable uncertainty about the sustainable rate of resource utilization and about structural productivity growth. One participant suggested that, given the range of uncertainty, output might already be at or close to potential. Others commented that recent studies did not on balance support a conclusion that structural labor market shifts had caused resource slack to be lower than commonly estimated and that the flat pattern of growth in wages and compensation suggested an absence of pressures in labor markets. However, unit labor costs had accelerated over 2004 owing to a tapering off in productivity growth. If that slowing reflected a moderation in structural productivity growth and if firms believed that the associated increases in the growth rate of labor costs were permanent, these cost pressures might be passed through to consumer prices fairly quickly to preserve profit margins. While participants generally felt that the pace of underlying productivity growth remained robust, careful attention would need to be paid to developments regarding unit labor costs and profit margins.

Despite some pickup in costs, participants thought that the rate of core inflation likely would remain low and stable, assuming further removal of policy accommodation. Elevated price markups and profits, as well as slack in resource use, had helped absorb cost increases and put downward pressure on inflation and would likely continue to do so. Indeed, core inflation measures had eased off, both in the latest readings and on balance over the second half of 2004 relative to the first half. However, several participants suggested the possibility of an upward skew to the distribution of inflation outcomes, especially if there were appreciable further declines in the foreign exchange value of the dollar or in structural productivity growth; already some participants were hearing anecdotal reports from firms of an increased ability to pass cost increases through to product prices, perhaps because of increasing confidence in the outlook for the economic expansion.

In the Committee's discussion of policy for the intermeeting period, all of the members favored raising the target for the federal funds rate by 25 basis points to 2½ percent at this meeting. All members judged that a further quarter-point firming in the target federal funds rate was appropriate in light of current overall accommodative financial conditions and the continuing outlook for solid economic growth and diminished slack in resource utilization. A higher nominal federal funds rate was seen as needed

to contain risks of increased cost and price pressures, but even with this action, the real federal funds rate was generally seen as remaining below levels that might reasonably be associated with maintaining a stable inflation rate over the medium run. The pace of policy moves at upcoming meetings, however, would depend on incoming data.

With regard to the Committee's announcement to be released after the meeting, members concurred that overall economic prospects were similar to those prevailing at the time of the December meeting and that consequently the statement should be altered only to the minor extent required to reflect recent economic developments. They concurred that the statement should note that output appeared to be growing at a moderate pace despite the rise in energy prices, that labor market conditions continued to improve gradually, and that inflation and longer-term inflation expectations remained well-contained. They also agreed again to characterize the risks to sustainable growth and price stability as balanced. All members agreed that the FOMC statement for this meeting should again indicate that policy accommodation could be removed at a pace that was likely to be measured but that the Committee would respond to changes in economic prospects as needed to maintain price stability.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate at an average of around 2½ percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee perceives the upside and downside risks to the attainment of both sustainable growth and price stability for the next few quarters to be roughly equal. With underlying inflation expected to be relatively low, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

> Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs. Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, Santomero, and Stern. Vote against this action: None. Mr. Guynn voted as alternate member.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 22, 2005.

The meeting adjourned at 12:35 p.m. on February 2, 2005.

## Notation Vote

By notation vote completed on December 31, 2004, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on December 14, 2004.

Vincent R. Reinhart
Secretary

## Meeting Held on March 22, 2005

A meeting of the Federal Open Market Committee was held in the offices of

the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, March 22, 2005, at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Mr. Bernanke
Ms. Bies
Mr. Ferguson
Mr. Gramlich
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Santomero
Mr. Stern

Ms. Cumming, Messrs. Guynn and Lacker, Mses. Pianalto and Yellen, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

Ms. Holcomb, First Vice President, Federal Reserve Bank of Dallas

Mr. Reinhart, Secretary and Economist
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Evans, and Madigan, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Kamin and Slifman, Associate Directors, Divisions of International Finance and Research and Statistics, respectively, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Messrs. English and Leahy, Assistant Directors, Divisions of Monetary Affairs and International Finance, respectively, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Nelson, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Carpenter, Senior Economist, Division of Monetary Affairs, Board of Governors

Messrs. Kumasaka and Luecke, Senior Financial Analysts, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Judd, Executive Vice President, Federal Reserve Bank of San Francisco

Messrs. Eisenbeis, Fuhrer, Goodfriend, Hakkio, Rasche, Sniderman, and Steindel, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Boston, Richmond, Kansas City, St. Louis, Cleveland, and New York, respectively

Mr. Elsasser, Vice President, Federal Reserve Bank of New York

The Manager of the System Open Market Account reported on recent

developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period February 2, 2005, through March 21, 2005. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that the economy was expanding at a solid pace in the first quarter of the year. Employment was improving. Consumer spending still appeared to be growing briskly, and residential construction expenditures continued to move higher. Business spending on equipment and software showed notable gains early in the quarter, and industrial production increased moderately in the first two months of the year. Consumer prices moved higher in January after being unchanged in December.

The labor market continued to improve in February. Private nonfarm payrolls grew at a solid pace, and these gains were widespread across industries. Of particular note, manufacturing employment, which had been declining, edged higher. On balance, surveys of employers and of households pointed to firming labor demand. With the average workweek unchanged, aggregate hours increased moderately in February. Although the unemployment rate in February ticked back up to its December level, the set of available information on the labor market suggested that resource slack was diminishing.

Industrial production posted a moderate gain in February, led by a surge in motor vehicle production. Production of high-tech equipment rose, with the increase in output of communications equipment far outpacing sluggish growth of computer production. Production of consumer goods, both durable and nondurable, also rose. In contrast, the production of non-high-tech business equipment edged down, and the output of construction and business supplies and materials dropped back. Mining output edged up, but the output of utilities fell for a second consecutive month amid a generally warm winter.

Supported by strong income gains and higher wealth, consumer spending had increased at a robust rate in the last quarter of 2004 and appeared to be on track to post another strong advance in the first quarter of the year. Apart from purchases of motor vehicles, which stepped down early this year after a year-end surge, the increases in outlays had been broad based. On average, real disposable income increased at a vigorous pace in December and January, well above that seen over most of last year. Increases in equity prices and in house values pushed up the wealth-to-income ratio in the fourth quarter, and the saving rate remained low by historical standards.

Activity in the housing market continued to expand early this year. Starts of single-family homes in January and February were well above their fourth-quarter pace, although indicators of future production pointed to some slowing. Similarly, in the multifamily sector, starts increased substantially in the first two months of the year but appeared poised to moderate this month. Although both new and existing home sales declined somewhat in January, demand continued to be supported by low mortgage rates.

Business spending on equipment and software increased sharply in the fourth quarter and, excluding motor vehicles, appeared to be growing briskly in the first quarter. The expiration at the end of

2004 of the special tax provisions that permitted partial expensing of investment expenditures seemed not to be retarding capital spending. Presumably contributing to the vigor of capital spending were further increases in business output, strong cash positions of corporations, and an attractive cost of capital amid generally low interest rates. Shipments and orders for high-tech equipment remained strong in January. Outside the high-tech sector, shipments posted a sizable and broad-based increase in January, and the rising backlog of orders pointed to further gains in the near future. Spending on nonresidential construction was subdued, as it had been for some time.

Increased inventory accumulation contributed significantly to the rise in economic output in the fourth quarter of last year and appeared likely to make an additional contribution in the first quarter of this year. In January, manufacturers' book-value inventories increased at nearly twice the rate seen in the fourth quarter, while wholesale and retail inventories about kept pace with the advance in the previous quarter. The rapid buildup in inventories left the inventory-to-sales ratio unchanged rather than on the downtrend of recent years. However, the available evidence suggested that firms generally were not uncomfortable with their inventory positions.

The U.S. international trade deficit widened in January, primarily reflecting a surge in imported non-oil goods and services. After a general slowdown in the fourth quarter of last year, indicators for major foreign industrial countries revealed a broad pickup in economic growth in the first quarter, with industrial production rising in Japan and the major euro-area countries. Meanwhile, consumer price inflation across most industrial economies remained subdued. Among the emerging-market economies, indicators of economic activity were mixed.

Consumer prices edged higher in January after having been flat in December. Core consumer prices rose a bit faster than overall prices, with price increases widespread across commodities and services. Consumer energy prices fell in January but turned back up in February and early March. For the twelve-month period ended in January, overall consumer prices were boosted significantly by higher oil prices, but core consumer price inflation over the same period was fairly subdued. A survey measure of near-term inflation expectations moved up in early March, but long-term expectations had changed little since the end of last year. Producer prices and commodity indexes were broadly higher in January, with the exception of prices for core crude materials. With regard to labor costs, average hourly earnings rose slowly over January and February. Over the preceding year, compensation costs increased moderately, contributing to a small rise in unit labor costs.

At its February meeting, the Committee decided to increase the target federal funds rate 25 basis points, to 2½ percent. In its accompanying statement, the Committee indicated that the upside and downside risks to the attainment of both sustainable growth and price stability were roughly equal. In addition, the Committee noted that the economy appeared to be growing at a moderate rate despite increases in energy prices, that labor market conditions continued to improve gradually, and that inflation and inflation expectations remained well contained. As a consequence, the Committee again judged that policy accommodation could be removed at a pace that was likely to be measured, although the path of policy would

depend importantly on evolving economic prospects.

The Committee's decision to change the target rate was universally anticipated by market participants, as was the tenor of the statement. As a result, the reaction in financial markets was muted. Over the intermeeting period, however, the Chairman's semiannual testimony on monetary policy, higher oil prices, and incoming data that showed a pickup in price inflation led market participants to mark up their expectations for the trajectory of the target federal funds rate. Consistent with the upward revision to policy expectations, yields on Treasury securities rose significantly. Some of the increase in nominal rates likely owed to higher inflation expectations, as inflation compensation, measured from the spread between Treasury nominal debt and comparable inflation-indexed securities, rose. However, staff analysis suggested that the increases were concentrated over the next few years and that long-term inflation expectations were little changed. Risk spreads on most corporate bonds narrowed on balance, significantly so for speculative-grade debt, amid generally strong corporate balance sheets and good credit performance. Broad stock market indexes edged up over the intermeeting period. In foreign exchange markets, the trade-weighted value of the dollar depreciated slightly, with the declines widespread against the currencies of industrialized countries other than Japan.

M2 growth slowed in the first two months of the year, as the opportunity cost of holding money rose with monetary policy tightening. Rates paid on liquid deposits were little changed, but those on small time deposits tracked market rates more closely. As a result, growth in liquid deposits was depressed, while that of small time deposits was vigorous. Flows into equity and bond funds picked up in the first two months of the year. In the staff forecast prepared for this meeting, the economy was seen as likely to expand at a rate above the growth of potential this year and next, led by strong business demand for equipment and software. Consequently, labor markets were expected to continue to firm and the unemployment rate to decline gradually. In light of the robust expansion of capital spending thus far this year, the outlook for business investment spending was revised up appreciably, as more of the strength over the latter part of 2004 was attributed to underlying demand and less to the effects of the partial-expensing tax provision. Steadily rising sales, an ongoing need to replace and upgrade software and equipment, and favorable financing costs were all expected to continue to buoy business spending this year and next. Household spending, supported by rising disposable income and, to a lesser degree, by increasing wealth, was projected to expand at a solid rate. Net exports were seen as exerting less of an arithmetic drag on economic growth than in 2004. Measures of overall consumer price inflation were expected to be lower this year than last and to step down again next year as energy prices retreated. Inflation in core consumer prices was seen as being boosted a bit by the effects of higher import and energy costs in the near term but still largely contained by continued strong growth in underlying labor productivity and remaining slack in resource markets.

In their discussion of current conditions and the economic outlook, many participants said that circumstances had changed from those anticipated at the time of the Committee's meeting in early February. In particular, incoming data and anecdotal information indicated that economic activity had appre-

ciably more forward momentum than previously perceived and that inflation pressures could be intensifying. While underlying inflation appeared to have moved up only modestly and nearly all participants thought that core and total inflation going forward would be relatively low, they had become less certain of that outlook for the next few quarters.

Many participants noted that the most recent data and business commentary indicated that investment was running considerably stronger in the first quarter of the year than had previously been anticipated. Underlying trends in capital spending appeared to be more robust than had earlier been recognized, perhaps partly in response to unusually supportive financial conditions, and that strength was thought likely to carry forward. Business contacts were more confident about economic prospects, and that confidence was bolstering firms' willingness to invest. Anecdotal information suggested that firms were investing in part to expand capacity and in part to boost productivity and lower costs. Some investment was being prompted by a need to replace equipment that was becoming obsolete, in part because of the higher level of energy prices. Increased demand was reported for a wide variety of categories of capital goods, ranging from several types of heavy equipment, including trucks, farm machinery, and construction equipment, to software and high-tech equipment. Nonresidential construction, however, remained soft in many regions, damped by relatively high vacancy rates for office buildings and other commercial real estate.

Spending on housing and consumer goods and services was also seen as underpinning economic expansion. With single-family housing starts at record levels, residential investment expenditures apparently continued to be spurred by relatively low interest rates. A few participants cited some evidence of speculative activity in the housing market in several regions. However, recent house price developments were mixed, with reports of incipient softness in some markets, including high-end properties, and overall house price inflation was seen as likely to slow in coming quarters. Consumer expenditures were expected to continue to advance at a solid pace, buoyed by strong gains in personal income, although high energy prices could exert some restraint on spending. The possibility of an appreciable rise in the personal saving rate, which was near its historical low, represented another possible downside risk to consumer spending. The recent sharp slowing in motor vehicle sales, which appeared to be related in part to the paring of purchase incentives and perhaps also to the high level of energy prices, raised some concerns about the expansion of economic activity in some regions.

Some participants mentioned that expansion abroad was apparently strengthening early this year, particularly in emerging-market economies. This development, in turn, was likely to help support U.S. exports. Several participants noted that past declines in the foreign exchange value of the dollar were contributing to U.S. economic activity. Tourism from abroad, for example, was being spurred by relative currency values. At the same time, though, it was recognized that growth in U.S. domestic demand would likely continue to be met in part by imports, tending to trim the increase in domestic output.

U.S. industrial activity was increasing steadily, pushing capacity utilization higher. Production was expanding in a broad range of manufacturing categories, notably including high-tech and

defense industries. Business contacts indicated that the high level of energy prices was spurring coal mining activity. Drilling for oil and gas was also increasing, although extraction was said to be crimped in some instances by a scarcity of experienced rig hands as well as spot shortages of certain key production inputs, such as drilling pipe.

Around the nation, labor markets conditions were reported to be stable to improving, and meeting participants perceived that slack in labor markets was gradually diminishing. In general, business executives indicated that labor was readily available, although again workers with certain skills and in certain occupations, such as trucking, were becoming increasingly difficult to hire. Some commented that the failure of labor force participation to rise as expected as the expansion gained momentum likely portended somewhat weaker labor force growth than previously anticipated; such a development, at the margin, would tend to reduce the expansion of potential output. Still, pressures on prices stemming from labor costs seemed well contained and were expected to remain damped in coming quarters. National data and anecdotal information suggested that wages generally continued to increase moderately. However, health-care expenses were a persistent source of pressure on costs.

Growth in unit labor costs had continued to be held down by growth of output per hour worked, which had continued to perform surprisingly well. Although productivity growth had slowed from the extraordinarily rapid pace that prevailed earlier in the expansion, data for the fourth quarter of 2004, as well as preliminary indications for the first quarter of this year, suggested that gains from efficiency remained substantial. Participants remarked that many business executives were seeking further advances in productivity through organizational improvements as well as through investment in equipment and software. Regarding the latter, some evidence suggested that rapid technological progress was being sustained, which would continue to drive down the cost of many forms of productive capital and thus boost returns on investment. Moreover, the stronger picture of capital spending that had emerged of late boded well for the performance of productivity going forward. Still, considerable uncertainty persisted about longer-run prospects for productivity growth, unit labor costs, and cost pressures on profits and prices.

Meeting participants commented in particular detail on the inflation situation. They noted with some concern the recent elevated readings on inflation in prices of core personal consumption expenditures, the producer price index, and indicators of prices at earlier stages of production, as well as the sizable further increase in energy prices. Nonetheless, many participants stated that they expected total inflation to diminish and any rise in core consumer inflation to be limited. One source of upward pressure on inflation had been the rise in energy prices, and it seemed reasonable to expect that these prices would level out or even decline mildly, as built into futures prices. Unit labor costs were still being held down by moderate wage growth and rising productivity. Indeed, a few saw a distinct possibility of further positive productivity surprises, representing a downside risk to the inflation outlook. Moreover, the markup of prices over costs in nonfarm businesses remained quite high, and firms would likely be pressed by competition to absorb a portion of any step-up in the growth of unit labor costs, at least if that acceleration were limited in extent and duration. In addition, prices of many

non-energy commodities had risen in recent weeks, but such inputs constituted a relatively small fraction of overall business costs, and, partly for that reason, in the past commodity prices had demonstrated little predictive content for broad inflation rates. While short-term inflation expectations had risen somewhat, longer-term inflation expectations remained well contained. And lastly, monetary policy would be aimed at preserving price stability.

Still, many participants indicated that their uncertainty about the intensity of inflation pressures had risen in response to recent developments and that, in particular, the distribution of possible inflation outcomes was now tilted a little to the upside. Although monthly statistical releases could be quite volatile, the recent data showing consumer inflation a little above previous expectations were of concern. Also, anecdotal indications of price increases were becoming more common across a number of industries. Some business executives reportedly believed that, with aggregate demand expanding robustly and the lower foreign exchange value of the dollar putting upward pressure on import prices, a degree of "pricing power" had returned. Moreover, the recent rebound in spot crude oil prices, and especially the substantial advance in prices of crude oil futures contracts for delivery well into the future, suggested that a significant unwinding of higher energy costs might not be in prospect. Several participants indicated that, in current circumstances, they viewed an upside surprise to inflation as potentially more harmful than an equivalent downside surprise, partly because such an outcome could well impart additional upward momentum to inflation expectations.

In the Committee's discussion of monetary policy for the intermeeting period, all of the members favored boosting the target for the federal funds rate by 25 basis points to 2¾ percent at this meeting. Monetary conditions evidently were still quite accommodative, economic activity appeared to have more momentum than had previously been perceived, and, while core inflation most probably would stay low, pressures on inflation seemed to have risen. Prospects for legislative action to apply significant fiscal restraint were unclear, even as the expansion became increasingly well established and private demand proved strong and resilient. Although the required amount of cumulative tightening may have increased, members noted that an accelerated pace of policy tightening did not appear necessary at this time, as a degree of economic slack apparently remained, productivity growth would probably continue to damp increases in unit labor costs and prices, and inflation would most likely continue to be contained. In these circumstances, Committee members judged that the measured removal of policy accommodation was appropriate for now.

In discussing the announcement to be released after the meeting, members agreed that it was appropriate to acknowledge the recent evolution in the inflation situation by indicating that "though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident. The rise in energy prices, however, has not notably fed through to core consumer prices." Regarding the risks to sustainable growth and price stability, members discussed a proposal to make the Committee's assessment explicitly conditional on an assumption of appropriate monetary policy so as to underscore that maintaining balanced risks would require policy action. It was noted that the Committee's assessment

of balanced risks over the past nine months—a period in which monetary policy had been steadily tightened—necessarily had to be interpreted as based implicitly on an assumption that policy accommodation would be removed. A number of members believed that formulaic language by its nature was too rigid to reflect evolving economic circumstances in a satisfactory manner, especially when developments were subtle or complex, and some of these members believed that the risk assessment should be discontinued. All the members ultimately approved making the risk assessment in the policy announcement following this meeting explicitly conditional on appropriate policy.

Members also focused on the issue of whether to reiterate the judgment expressed in the Committee's recent statements that ". . . policy accommodation can be removed at a pace that is likely to be measured." Some expressed the view that such language could constrain future policy inappropriately; while these concerns were not new, they were now felt to be more pressing, as the odds that the Committee might need to step up the pace of policy firming were thought to have increased. Members noted, however, that the existing "measured pace" language was clearly conditional on the economy evolving in a way that promised a gradual return to high levels of resource utilization and on inflation remaining low, and thus believed that the wording did not rule out either picking up the pace of firming or pausing in the process of removing policy accommodation should circumstances warrant. They also noted that the language had not precluded a notable increase in medium- and longer-term interest rates over the intermeeting period as markets extended the expected gradual increase in policy rates. Some discomfort was expressed with language that related so explicitly to the likely trajectory of future policy action. But it was also averred that the Committee should, to the extent possible, provide information that would help the public anticipate the probable course of monetary policy; providing such information would tend to increase the effectiveness of monetary policy. More generally, members recognized that the Committee's statement would need to evolve over time.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 2¾ percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan, Geithner, Bernanke, Ms. Bies, Messrs.

Ferguson, Gramlich, Guynn, Kohn, Moskow, Olson, Santomero, and Stern. Vote against this action: None. Mr. Guynn voted as alternate member .

It was agreed that the next meeting of the Committee would be held on Tuesday, May 3, 2005. The meeting adjourned at 1:25 p.m.

## Notation Vote

By notation vote completed on February 22, 2005, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on February 1–2, 2005.

Vincent R. Reinhart
Secretary

## Meeting Held on May 3, 2005

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 3, 2005 at 9:00 a.m.

*Present:*
Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Fisher[6]
Mr. Gramlich
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Guynn and Lacker, Mses. Pianalto and Yellen, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Evans, and Madigan, Ms. Mester, Messrs. Oliner, Rosenblum, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Freeman, Slifman, and Struckmeyer, Associate Directors, Divisions of International Finance, Research and Statistics, and Research and Statistics, respectively, Board of Governors

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

Messrs. English and Leahy, Assistant Directors, Divisions of Monetary Affairs and International Finance, respectively, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

6. Secretary's note: Advice had been received that Richard W. Fisher had been elected by the directors of the Federal Reserve Banks of Atlanta, Dallas, and St. Louis, as a member of the Federal Open Market Committee for the period commencing April 4, 2005, and that he had executed his oath of office.

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Brady, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Lyon, First Vice President, Federal Reserve Bank of Minneapolis

Messrs. Eisenbeis, Goodfriend, Hakkio, Rasche, Rudebusch, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Atlanta, Richmond, Kansas City, St. Louis, San Francisco, and Cleveland, respectively

Mr. Elsasser, Ms. Little, and Messrs. Peach and Todd, Vice Presidents, Federal Reserve Banks of New York, Boston, New York, and Minneapolis, respectively

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

By unanimous vote, the Committee voted to extend for one year beginning in mid-December 2005 the reciprocal currency ("swap") arrangements with the Bank of Canada and the Banco de Mexico. The arrangement with the Bank of Canada is in the amount of $2 billion equivalent and that with the Banco de Mexico in the amount of $3 billion equivalent. Both arrangements are associated with the Federal Reserve's participation in the North American Framework Agreement of 1994. The vote to renew the System's participation in the swap arrangements maturing in December was taken at this meeting because of the provision that each party must provide six months prior notice of an intention to terminate its participation.

The information received at this meeting suggested that the growth of economic activity had unexpectedly moderated during the first quarter from the rapid pace seen during the second half of 2004. Gains in private payroll employment over the first quarter were similar to the average for the second half of 2004 but weakened in March, and manufacturing production rose only a little, on balance, over February and March. Consumers appeared to have turned somewhat cautious in their spending, likely a reflection of higher energy prices. Housing starts fell in March after a sustained stretch of very high readings, but home sales continued at a rapid rate throughout the quarter. Growth of capital spending, while strong in the first quarter, was down from the brisk rates of previous quarters. Sharp increases in energy prices pushed up headline inflation, and core measures were also somewhat elevated. Labor costs, however, advanced at a moderate rate. Employment continued to expand in March, although the increase was less than the strong advance in February. Employment declined in manufacturing, retail trade, and temporary help services, but most other sectors registered gains. The average workweek remained

at its recent level, and aggregate hours posted a small gain. The unemployment rate moved down to 5.2 percent in March. Also suggesting a gradual erosion of slack in labor markets were surveys indicating that some employers were finding some jobs requiring special skills harder to fill and that households were experiencing increases in job availability. Nevertheless, survey measures of expected conditions in labor markets softened somewhat in the early months of the year, and the labor market participation rate remained low in March.

Industrial production continued to expand in the first quarter, but the pace was slower than in the final months of 2004. Gains were restrained by a decline in manufacturing output, particularly for motor vehicles and parts, and by a reduction in energy generation at utilities, which was held down by unseasonably warm weather early in the year. Mining output, however, accelerated, as did production in the business equipment and defense and space equipment industries. Capacity utilization in manufacturing edged up on average in the first quarter, but moved down in March and remained a bit below its thirty-year average.

Consumer spending advanced solidly in the first quarter despite some slowing in automobile sales. However, much of that strength was registered early in the quarter, and spending in March was subdued. Measures of consumer confidence declined in the early months of the year but remained well above the lows of two years ago. Other factors underlying consumer spending also remained favorable: Real wages and salaries continued to rise, and the ratio of wealth to income remained high, although it was down a bit because of a decline in equity prices. The personal saving rate stayed low over the first quarter of the year.

Housing starts slowed in March, after exceptional strength in the prior two months. However, a substantial increase in the level of permits in March suggested that starts likely turned back up in April. A similar pattern was observed in the multifamily sector. The thirty-year mortgage rate in the first quarter stayed in a range around its average level for the past two years. Sales of existing homes were rapid throughout the quarter, and sales of new homes rose to another record level in March. House prices continued to rise rapidly over the first quarter, although recent data suggested some slowing.

Growth of business spending on equipment and software moderated substantially in the first quarter from the very high rates of last year, but appeared to retain considerable momentum; strong gains occurred in all major categories except motor vehicles. This performance reflected favorable underlying fundamentals, including solid growth in business output, strong retained earnings, high levels of liquid assets, and favorable borrowing conditions in the form of low interest rates and narrow risk spreads in bond and loan markets. At the same time, construction of nonresidential structures remained quite subdued. Over the first quarter, outlays for manufacturing facilities picked up a bit, but those for office buildings stayed low despite some declines in the office vacancy rate, and spending on commercial structures fell.

Nonfarm inventories accumulated in the first two months of the year at a much faster rate than in the preceding quarter, prompting a small increase in inventory–sales ratios. Inventory gains were especially strong early in the quarter and were concentrated in the manufacturing sector.

The U.S. international trade deficit widened in February as exports held

steady. The value of imported oil jumped sharply, and nonoil imports also rose. Economic indicators for major foreign industrial countries suggested some slowing of growth late in the quarter after a pickup earlier in the year. In Japan, industrial production rose briskly in January before falling back; the euro-area industrial sector evidenced a similar pattern. By contrast, economic activity in China and other developing countries showed greater buoyancy. Consumer price inflation abroad remained subdued.

U.S. consumer price inflation firmed in recent months as energy prices rose sharply. Core consumer prices also rose a bit more rapidly recently, but the increase over the twelve months ending in March was little different than over the year-earlier period. According to survey information, expectations of near-term inflation picked up in March, consistent with the increase in energy prices. As for labor costs, the employment cost index for private industry decelerated over the first quarter from an already moderate pace. The slowing occurred in both the wages and salaries component and the benefits component and was fairly widespread across industry groups.

At its March meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 2¾ percent. In its accompanying statement, the Committee expressed its perception that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. The Committee also noted that economic output continued to grow at a solid pace despite the rise in energy prices and that labor market conditions continued to improve gradually. While pressures on inflation had picked up in recent months and pricing power was more evident, longer-term inflation expectations remained well contained. In these circumstances, the Committee believed that policy accommodation could be removed at a pace that would likely be measured but noted that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The FOMC's decision in March to raise the intended level of the federal funds rate 25 basis points was fully anticipated by the market, as were its retention in the accompanying statement of the "measured pace" language and its assessment that the risks to price stability and sustainable economic growth were balanced. Interest rates, however, rose, reportedly in response to the statement's references to increased price pressures and to more evident pricing power as well as to the Committee's conditioning of its risk assessment on "appropriate monetary policy action." Interest rates rose further the next day following the release of a larger-than-expected increase in the CPI for February. Over subsequent weeks, however, these increases were more than reversed by weaker-than-expected data on consumer spending, consumer sentiment, and output. Further downward pressure on interest rates was exerted by the market's response to the release of the minutes of the March meeting, as attention focused on the reference to Committee members' judgment that an accelerated path of policy tightening was not necessary at that time. Despite generally good first-quarter earnings reports, equity indexes moved down considerably in response to the signs of weaker economic growth. In foreign exchange markets, the dollar rose on balance, apparently due, in part, to disappointing news on employment and output abroad.

M2 expanded in March and April at about the same sluggish pace as it did earlier in the year. The growth of M2 continued to be restrained by increases in its opportunity cost resulting from rising short-term interest rates. Rates paid on its liquid components particularly lagged increases in market rates.

Partly in response to the receipt of weaker-than-expected data for spending and output in the first quarter, the staff marked down somewhat its forecast of economic growth for 2005 and 2006. Even so, the economy was seen as retaining considerable momentum, and growth was expected to pick up some after the first quarter, paced by business spending on equipment and software. Consumption expenditures were seen as likely to expand at a moderate rate and residential investment to slow. With exports forecast to expand a bit more rapidly than imports, the arithmetic net drag on the economy from trade was expected to lessen. Fiscal policy was expected to provide a more moderate impetus to growth this year and next, following the substantial boost estimated for earlier years. Although economic growth was projected to run a bit above the staff's estimate of the economy's potential, the unemployment rate was projected to hold around its current level with improvements in job prospects expected to lure more workers back into the labor force. Inflation was projected to edge lower over the rest of the year and into 2006, reflecting the attenuation of the impact of higher energy prices and the effects of a slowed rate of growth of import prices and remaining slack in resource markets.

In their discussion of current conditions and the economic outlook, meeting participants observed that incoming data over the intermeeting period hinted at possible upside risks for inflation and downside risks for economic growth. Earlier increases in energy prices seemed to be an important factor contributing to an uptick in core inflation and a slower pace of economic activity. With energy prices leveling out more recently, however, and the behavior of compensation suggesting a lack of pressure in labor markets, underlying inflation appeared to remain contained. The weakness in spending was widespread and could not be completely dismissed, but it had appeared only very recently and could be a product of the inherent noisiness of high-frequency economic data. On balance, economic fundamentals including low interest rates, robust underlying productivity growth, and strengthened business balance sheets were expected to support economic growth at a pace sufficient to gradually eliminate remaining slack in resource utilization. Although the economic outlook generally seemed favorable, there was also broad recognition of greater uncertainty attending the outlook for both inflation and output growth.

Capital expenditures advanced briskly over the first quarter, but at a pace significantly below that registered over the latter half of last year. To some extent, businesses probably had pulled capital outlays forward from this year into 2004 to benefit from the partial-expensing tax provision that expired at year-end, but the unexpected weakness in capital goods orders for February and March seemed hard to attribute to this factor alone. In addition, the prolonged period of elevated spot energy prices, the sense supported by futures markets that these higher prices may persist for some time, and the heightened uncertainty about energy prices going forward, together may have left businesses less confident about the future and wary of longer-term commitments such as expanding plant capacity or taking on new workers. A less buoyant and less certain

economic outlook seemed apparent in financial markets as well, where equity prices had fallen and risk spreads had widened. On balance, though, these financial developments did not appear to signal the onset of a sharp retrenchment in investors' willingness to bear risk, and capital expenditures were seen as likely to remain quite robust, spurred by strong economic fundamentals that included elevated profits, opportunities to raise efficiency by utilizing new technologies, a low cost of capital, and strong corporate balance sheets. Indeed, a substantial weakening in business investment in an environment with such favorable fundamentals would be at odds with the historical record.

Incoming data for the household sector were viewed as mixed. Higher gasoline prices seemed to be sapping consumer confidence and consumer spending. The pace of consumption growth had fallen off appreciably toward the end of the first quarter, and some participants worried about the potential for continued sluggishness in consumer spending if increasingly cautious households sought to raise their saving rate rapidly. On balance, though, strong income growth and low interest rates augured well for household spending. Although housing starts had dropped of late, home sales and other indicators of activity in the residential real estate market remained at very high levels. House price appreciation was expected to moderate over coming quarters, but a number of local real estate markets were still regarded as "hot," with signs of possible speculative excesses in some areas.

The deceleration in final sales over the first quarter had been accompanied by a sizable accumulation of businesses inventories. The available data suggested that stocks had accumulated in a variety of industries, but particularly in the motor vehicle sector where the inventory of new autos had moved appreciably higher. Although difficult to judge, the inventory buildup was not regarded as likely to have major implications for aggregate manufacturing beyond some modest production cutbacks in the current quarter.

A relatively high proportion of demand had continued to be met by imports. Some concern was expressed that incoming data suggested weaker growth in some of our major trading partners, which posed a downside risk to forecasts for U.S. exports. Moreover, advances in domestic income were expected to contribute to brisk growth in imports. Looking ahead, the U.S. economy was expected to continue to run quite substantial current account deficits, although the impact of past dollar depreciation should work to boost exports and slow the rise in imports to some extent.

Recent energy price developments garnered considerable attention. Declines in energy prices in recent weeks were viewed as welcome, but participants noted that far-dated futures prices for oil remained quite elevated and that persistently high energy prices could trigger a range of deleterious effects on the economy. High energy prices appeared to be taking a toll on household and business confidence and might be beginning to crimp corporate profits. In some cases, firms seemed to be more successfully passing on energy costs to their customers. Indeed, some portion of recent elevated inflation readings probably represented, at least partly, such pass-through effects from higher energy costs. However, while pass-through effects could leave the overall price level higher, their impact on inflation should fade over time, as long as inflation expectations remain well contained. Still, considerable uncertainty surrounded the degree of pass-through

from energy prices to core consumer prices, and pass-through effects might be more pronounced when energy price increases were perceived as more likely to be permanent. Persistently high energy prices were mentioned as a factor that could trim the level of potential output to a small degree over time, possibly contributing to additional upward pressure on consumer prices at the margin.

Participants voiced concerns about recent price trends; they expected inflation to remain contained but also perceived that the risks to that inflation outlook now might be skewed somewhat to the upside. Core measures of price inflation had moved up over recent quarters and particularly so over the last few months. A discernable upcreep was apparent in survey measures of short- and, to a limited extent, long-term inflation expectations over recent months. Moreover, there were risks that the relative stability of long-term survey measures of inflation expectations could simply reflect lags in households' perceptions of changing economic prospects. The success that some businesses seemed to be encountering in passing through cost increases raised the possibility that competitive pressures and resource slack were exerting somewhat less restraint on inflation than had been anticipated.

However, available indicators of wages and benefits had registered only modest growth, suggesting to many that some slack in labor markets persisted. Moreover, market measures of inflation compensation had ebbed in recent weeks, and survey measures of long-term inflation expectations, albeit a touch higher of late, remained in the broad range of recent years. Along with energy prices, import and materials prices apparently had contributed to the recent uptick in inflation, and pressures on inflation stemming from these three sources were expected to lessen over coming quarters. On balance, measures of core inflation were thought likely to remain in check over the remainder of this year and next.

In the Committee's discussion of monetary policy for the intermeeting period, all members favored raising the target federal funds rate 25 basis points to 3 percent at this meeting. Although downside risks to sustainable growth had become more evident, most members regarded the recent slower growth of economic activity as likely to be transitory. In this regard, the ability of the U.S. economy to withstand significant shocks over recent years buttressed the view that policymakers should not overreact to a comparatively small number of disappointing indicators, especially when economic fundamentals appeared to remain quite supportive of continued solid expansion. To be sure, the Committee had raised its federal funds rate target appreciably over the past year, and, in the view of a few members, a larger-than-expected moderation of aggregate demand in response to this cumulative policy action could not be ruled out. However, all members regarded the stance of policy as accommodative and judged that the current level of short-term rates remained too low to be consistent with sustainable growth and stable prices in the long run. Against the backdrop of the recent uptick in core inflation and in some measures of inflation expectations, members agreed that they should continue along the course of removing policy accommodation at a measured pace conditional on the outlook for inflation and economic growth.

In discussing the statement to be released after the meeting, members agreed that it was appropriate to acknowledge that rising energy prices

seemed to have spurred an increase in core measures of inflation by dropping the reference from the March statement indicating that "The rise in energy prices, however, has not notably fed through to core consumer prices." They likewise all agreed that mention should be made that, on balance, longer-term inflation expectations remained well contained. Regarding the risks to sustainable growth and price stability, some members noted that the risk assessment conditioned on "appropriate policy" no longer seemed to convey useful information regarding the Committee's economic and policy outlook. Although some members noted that a case could be made that the risks to inflation were now somewhat skewed to the upside and those to sustainable economic growth perhaps to the downside, the most likely outcome remained one of stable prices and sustainable growth, and the Committee agreed that it should retain a balanced assessment of risks conditional on appropriate policy.

For many, heightened economic uncertainty in the current environment implied greater uncertainty about the range of possible policy outcomes and placed a premium on flexibility in setting policy at upcoming meetings. Some members commented that this greater uncertainty called for eliminating or paring back forward-looking language from the statement—if not at this meeting, then fairly soon. In the event, most members viewed the forward-looking language in the statement—including the characterization of the stance of policy as accommodative as well as the judgment that policy accommodation could be removed at a pace that is "likely to be measured"—as a reasonable characterization of the policy stance and its likely evolution over time. Moreover, a number remarked that the language in its current form was clearly conditioned on economic developments and therefore would not stand in the way of either a pause or a step-up in policy firming depending on events. In the end, all members agreed to retain the forward-looking language.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 3 percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan and Geithner, Ms. Bies, Messrs. Ferguson, Fisher, Gramlich, Kohn, Moskow, Olson, Santomero, and Stern. Votes against this action: None. Absent and not voting: Mr. Bernanke

It was agreed that the next meeting of the Committee would be held on Wednesday–Thursday, June 29–30, 2005.

The meeting adjourned at 1:25 p.m.

## Notation Vote

By notation vote completed on April 11, 2005, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on March 22, 2005.

Vincent R. Reinhart
Secretary

## Meeting Held on June 29–30, 2005

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, June 29, 2005 at 2:00 p.m. and continued on Thursday, June 30, 2005 at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Fisher
Mr. Gramlich
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Santomero
Mr. Stern

Ms. Cumming, Messrs. Guynn and Lacker, Mses. Pianalto and Yellen, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Evans, Freeman, and Madigan, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Kamin, Slifman, and Struckmeyer, Associate Directors, Divisions of International Finance, Research and Statistics, and Research and Statistics, respectively, Board of Governors

Messrs. Clouse, Wascher, and Whitesell, Deputy Associate Directors, Divisions of Monetary Affairs, Research and Statistics, and Monetary Affairs, respectively, Board of Governors

Messrs. English, Leahy, and Treacy,[7] Assistant Directors, Divisions of Monetary Affairs, International Finance, and Banking Supervision and Regulation, respectively, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Wright,[8] Section Chief, Division of Monetary Affairs, Board of Governors

7. Attended Wednesday's portion of the meeting.
8. Attended Thursday's portion of the meeting.

Messrs. Bowman,[8] Gallin,[7] and Lehnert,[7] Senior Economists, Divisions of International Finance, Research and Statistics, and Research and Statistics, respectively, Board of Governors

Messrs. Doyle[7] and Martin,[7] Economists, Division of International Finance, Board of Governors

Messrs. Kumasaka[7] and Luecke, Senior Financial Analysts, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Eisenbeis and Judd, Executive Vice Presidents, Federal Reserve Banks of Atlanta and San Francisco, respectively

Messrs. Fuhrer, Goodfriend, and Hakkio, Ms. Perelmuter, Messrs. Rasche, Rudebusch,[7] Sniderman, and Williams,[7] Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Kansas City, New York, St. Louis, San Francisco, Cleveland, and San Francisco, respectively

Mr. Peach,[7] Vice President, Federal Reserve Bank of New York

By unanimous vote, the Federal Open Market Committee approved the selection of Richard T. Freeman to serve as associate economist of the Committee until the selection of a successor at the first regularly scheduled meeting after December 31, 2005.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

At this meeting the Committee reviewed and discussed staff presentations on the topic of housing valuations and monetary policy. Prices of houses in the United States had risen sharply in recent years, especially in certain areas of the country, to very high levels relative to incomes or rents. In addition to local market factors, a wide range of influences appeared to be supporting home prices, including solid gains in disposable income, low mortgage rates, and financial innovation in the residential mortgage market. Prices might be somewhat above the levels consistent with these underlying factors, but measuring the extent of any overvaluation either nationally or in regional markets posed considerable conceptual and statistical difficulties. Meeting participants noted that the rise in house prices had been accompanied by a modest shift toward potentially riskier types of mortgages, including adjustable-rate and interest-only loans, which could pose challenges to both lenders and borrowers. Nonetheless, financial institutions generally remained in a comfortable capital position, such loans had performed well thus far, much of the associated risk had been transferred to other investors through securitization, and valuations had risen more rapidly than mortgage debt on average—so that loan-to-value ratios had fallen.

The information received at this meeting suggested that the economy was expanding at a moderate pace in the second quarter. Housing activity

remained at a high level, business investment appeared to have improved some after a slowdown of growth in the first quarter, and manufacturing picked up notably in May. Supported by a rebound in motor vehicle purchases, consumer spending appeared on track to post another moderate gain for the quarter. Labor demand continued to expand, and the unemployment rate edged down further in May. Core CPI inflation slowed in April and May, but crude oil prices turned higher again following a decline earlier in the spring.

Averaging through a large gain in April and a more modest increase in May, growth in payroll employment was on par with that over the preceding six months. Payrolls expanded in line with their recent trends in the construction, transportation and utilities, and nonbusiness services sectors, while hiring in financial services slowed a bit, and the manufacturing sector posted further small losses of jobs. The average workweek of production or nonsupervisory workers edged up over the two-month period, helping to boost aggregate hours to the highest level since early 2001. The unemployment rate dipped to 5.1 percent in May. Meanwhile, the labor force participation rate moved up a bit, suggesting that the labor market had strengthened enough to attract some individuals back into the workforce. Survey indicators and the continued relatively low level of initial claims for unemployment insurance also supported the notion of continued improvement in the labor market.

Industrial production declined in April, owing to a dip in utilities output, but widespread gains in manufacturing output in May offset that loss. On net, industrial production was little changed over April and May; capacity utilization generally followed the same pattern as output.

Real personal consumption expenditures appeared to be increasing at a moderate pace this quarter, though a bit below that of the first quarter. Purchases of motor vehicles rebounded smartly after declining in the first quarter. Excluding motor vehicles, however, the expansion of real consumer outlays likely slowed of late, against a backdrop of modest gains in real income. Recent measures of consumer confidence improved from their levels earlier in the spring, when higher gasoline prices and concerns about a slowing in the pace of the economic expansion may have served as restraining influences.

Activity in the housing sector remained robust. Single-family starts averaged more than 1.65 million units at an annual rate in April and May, not much below the very strong first-quarter pace. Sales of both new and existing homes remained at a high level in May. While prices of existing homes continued to increase rapidly, new home prices showed signs of decelerating. Available indicators suggested that, with the ongoing support of low mortgage rates, the housing sector remained strong in June.

Spending on equipment and software registered a solid increase in the first quarter, and the available data suggested that second-quarter spending was continuing at a slightly faster pace. Shipments of nondefense capital goods posted sizable increases in recent months, although gains in orders were more uneven. Broadly speaking, the fundamentals continued to support business investment, with the user cost of capital still low and corporate balance sheets healthy. Outlays for construction of nonresidential structures appeared to have picked up some, but the level of such investment remained subdued. And although spending on commercial structures had moved up in recent months, outlays for office buildings were still at

depressed levels, and expenditures on manufacturing and other facilities were lackluster.

The book value of manufacturing and trade inventories continued to grow in April, but more slowly than in the first quarter. With these increases, the inventory–sales ratio fell back in April after moving up a little in the first quarter.

After reaching a record high relative to GDP in February, the U.S. international trade deficit narrowed in March, but widened again in April. While the value of exports of goods and services increased in both months, the value of imports of goods and services jumped in April, more than offsetting a decline in March. GDP growth in most major foreign industrial economies picked up slightly in the first quarter, but recent economic indicators for the major foreign economies in the second quarter were mixed.

Consumer prices were about unchanged in May after posting large increases in the previous few months. Consumer energy prices, in particular, reversed part of their earlier run-up. Excluding food and energy, inflation appeared to have moderated slightly from its pace in the early part of the year. Despite this moderation, measures of core consumer price inflation over the past year were somewhat above those for the comparable period a year ago. The producer price index rose sharply in April, but dropped back again in May, driven largely by a swing in the food and energy components. According to recent surveys, both near-term and longer-term inflation expectations had changed little over the past two months, and market measures of inflation compensation had moved lower. With regard to labor costs, growth in hourly compensation in the nonfarm business sector in the first quarter was estimated to have slowed some after advancing notably in the fourth quarter; the first quarter increase was broadly similar to those posted during the middle of last year.

At its May meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 3 percent. In its accompanying statement, the Committee expressed its perception that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. The Committee also noted that recent data suggested that the solid pace of spending growth had slowed somewhat, partly in response to the earlier increases in energy prices, but that labor market conditions apparently continued to improve gradually. While pressures on inflation had picked up in recent months and pricing power was more evident, longer-term inflation expectations remained well contained. In these circumstances, the Committee believed that policy accommodation could be removed at a pace that would likely be measured but noted that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The decision at the May FOMC meeting to raise the federal funds rate target 25 basis points, to 3 percent, to maintain an assessment that risks to the goals of price stability and sustained growth were balanced, and to retain the "measured pace" language was widely expected in financial markets. The publication of the minutes three weeks later also contained few surprises for investors and elicited little market reaction. Market expectations for the future path of policy ended the period higher in the near term but lower at longer horizons. Nominal Treasury yields followed the

shift in policy expectations, with near-term yields higher and longer-term yields modestly lower, on net. Spreads on investment-grade corporate bonds were little changed over the intermeeting period, but spreads on speculative-grade bonds contracted notably. Buoyed by the drop in longer-term interest rates and largely upbeat economic news, major equity indexes rose appreciably over the intermeeting period. The positive economic data also seemed to lift the dollar against major foreign currencies, though the dollar's moves against individual currencies varied widely.

M2 edged lower over April and May as the opportunity cost of holding M2 assets rose further. Liquid deposits were especially weak, owing to the slow adjustment of yields paid on these deposits to increases in market rates. Despite the recent softness in M2, its velocity remained quite low relative to its historical relationships with opportunity cost. Bank credit decelerated sharply in April and May from rapid gains posted in the first quarter, as growth in both securities and loans fell.

In the staff forecast prepared for this meeting, the economy was seen as likely to expand this year and next at a rate just above its potential. The effects of reduced monetary and fiscal policy stimulus were expected to be counterbalanced by continued low long-term interest rates and an abatement of energy-related headwinds. Household spending was expected to firm going forward as real income posts solid gains attributable in part to the ongoing improvement in the labor market. Business investment was projected to benefit from the combination of favorable prospects for sales, supportive financial markets, and the ongoing need to replace or upgrade aging equipment and software. A slightly larger portion of domestic demand was expected to be supplied by imports over the forecast period. The forecast for consumer price inflation was revised up, with inflation seen as somewhat higher this year than in 2004, reflecting in part higher import prices and the direct and indirect effects of higher energy prices, and only edging lower next year as these price pressures wane.

In their discussion of current conditions and the economic outlook, many meeting participants noted that incoming data had been reassuring about the strength of the expansion. Following some softer readings earlier in the year, incoming spending and production data over the intermeeting period indicated that the expansion remained firm, led by residential and business investment. In addition, labor market conditions continued to strengthen gradually. The economy evidently had been resilient in the face of rising energy prices, and financial conditions remained accommodative, supporting growth going forward. Increases in core consumer prices had slowed of late, though underlying inflation was still seen by most meeting participants as likely to be modestly higher this year than last, impelled in part by the pass-through of a further rise in energy prices. However, the impetus to inflation from the prices of oil and other commodities was expected to wane, and long-term inflation expectations apparently remained well-anchored. With some limited remaining slack in labor markets likely damping growth in compensation, as well as further withdrawal of policy accommodation, core inflation was expected to remain contained.

In preparation for the Federal Reserve's semiannual report to the Congress on monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of GDP, the rate of unemploy-

ment, and core consumer price inflation for 2005 and 2006. The forecasts of the rate of expansion in real GDP were concentrated in the upper part of a 3 to 3¾ percent range for 2005, and the forecasts for 2006 were concentrated at the lower end of a range of 3¼ to 3¾ percent. These rates of growth were associated with a civilian unemployment rate of 5 to 5¼ percent in the fourth quarter of this year and a rate of 5 percent in the fourth quarter of 2006. Forecasts of the rate of inflation, as measured by the core PCE price index, were mainly near the middle of a 1½ to 2¼ percent range this year and somewhat below the middle of a range of 1½ to 2½ percent next year.

In their comments about developments in key sectors of the economy, meeting participants noted that the fundamentals underlying household spending remained firm. With rising home and equity prices buoying household wealth, consumer expenditures continued to advance. Although the recent surge in energy prices was anticipated to impose some drag for a time, consumption spending was expected to grow about in line with income going forward, in an environment of further gradual improvements in labor markets. Increased speculative activity in housing markets was evident in some parts of the country, but robust demand for new homes owed in large part to the ongoing economic expansion and low long-term interest rates.

Business outlays for capital goods continued to rise, and the outlook for investment spending remained solid, supported by increased sales, low interest rates, robust profits, and strong business balance sheets. Anecdotal reports from industry contacts generally pointed to planned increases in investment spending, though in some regions businesses apparently remained cautious about the outlook. Conditions in the commercial real estate sector, which had been weak for some time, were said to have improved in some parts of the nation.

Several meeting participants expressed some concern about domestic and global imbalances. Large federal budget deficits were expected to persist despite an increase in tax receipts in recent months. These deficits were contributing to a low level of national saving that would, if not corrected over time, ultimately constrain investment and overall economic growth. Moreover, U.S. trade deficits were expected to remain large going forward, reflecting both the low level of U.S. saving and relatively slow growth in some of our trading partners. Uncertainties regarding the nature and timing of the potential correction of these imbalances complicated the assessment of the intermediate-term prospects for the U.S. economy.

In their discussion of developments in asset markets, the participants' comments focused on two related issues: the low level of long-term interest rates and the continued run-up in home prices. Despite substantial cumulative policy tightening over the past year, long-term Treasury yields had moved considerably lower, implying a significant flattening of the yield curve (measured as the spread between long-term and short-term Treasury yields). Lower compensation for inflation accounted for a portion of the decline in longer-term nominal yields, but a larger portion reflected reductions in real yields. Participants cited a variety of factors as possibly contributing to the unusual behavior of long-term rates over this period. For one, investors might have marked down the level of real interest rates seen as likely to be necessary to contain inflation and keep output in line

with potential—perhaps reflecting weak investment demand abroad relative to saving—or even might have come to expect a stretch of sub-par U.S. growth. However, anticipation of slow growth seemed inconsistent with higher stock prices and thin risk spreads in corporate debt markets. The behavior of long-term interest rates could also reflect reduced uncertainty on the part of investors about the economic outlook—as seen in low readings of implied volatility in bond and equity markets. Finally, demands for longer-term U.S. securities by both domestic and foreign investors might have been boosted by special factors. Confidence about the economic outlook and low market interest rates—along with possibly outsized expectations of capital gains in some markets—could also help to account for the high level of home prices the Committee had discussed on the first day of the meeting. It was agreed that considerable uncertainty attended the outlook for both long-term interest rates and home prices.

With regard to any role for monetary policy in responding to possible imbalances in housing or bond markets, meeting participants stressed the importance of the pursuit of their core objectives of price stability and maximum sustainable economic growth. To the extent that an asset price movement threatened the achievement of those objectives, it would of course be taken into consideration in setting policy. However, given the unavoidable uncertainties associated with judgments regarding the appropriate level of and likely future movements in asset prices, a strategy of responding more directly to possible mispricing was seen as very unlikely to contribute, on balance, to the achievement of the Committee's objectives over time.

Participants' views on the inflation outlook were mixed. Thus far in 2005, core consumer price inflation had been higher than most participants had expected at the start of the year, reflecting, at least in part, the pass-through effects of higher energy, commodity, and import prices. While such shocks could be expected to boost inflation temporarily, some participants expressed concern that, with policy still accommodative, the underlying pace of inflation might be in the process of stepping up, perhaps to a level that was at the upper end of the range that they viewed as compatible with the Committee's price stability objective. The degree of slack remaining in labor and resource markets was very uncertain, and unit labor costs in the nonfarm business sector had moved notably higher in recent quarters. Trend unit labor costs could also be boosted by slower growth in structural productivity; while recent evidence was not conclusive, some participants thought the underlying pace of productivity growth might well fall back in coming quarters following the substantial gains seen in recent years. And with higher energy prices already eating into profit margins at firms outside the energy sector, increases in unit labor costs might be more likely to be passed through into prices.

While agreeing that inflation developments had to be watched carefully, other meeting participants emphasized that recent core inflation data had been relatively restrained, and anecdotal reports suggested that pricing power at many firms remained quite limited. Moreover, readings from futures markets suggested that oil prices would likely flatten out, so their effect on inflation should gradually ebb. Similarly, prices of other commodities and imports, which had surged for a time, were now moderating. Survey and market measures of long-term inflation expectations did not suggest that the earlier higher inflation readings were going to persist. Finally, while the

degree of slack in labor markets was uncertain, total labor compensation had probably been boosted temporarily around the turn of the year by special factors, and the recent behavior of a range of other indicators of labor costs appeared consistent with some remaining slack that would likely tend to restrain inflation pressures. Moreover, anecdotal reports of labor market conditions continued to point to shortages of labor only for certain, mostly skilled, occupations.

In the Committee's discussion of monetary policy for this meeting, all members agreed on a 25 basis point increase in the target federal funds rate to 3¼ percent. Economic growth remained firm, while rising energy, and possibly labor, costs threatened to put upward pressure on inflation. Even with this action, the federal funds rate remained below the level members anticipated would prove necessary in the long run to contain inflation pressures and keep output near potential. However, the pace and extent of future policy moves would depend on incoming data.

In considering the statement to be released following this meeting, members concurred that it should note that even with the rise in oil prices, the expansion remained firm and labor markets continued to improve gradually. All also thought that the statement should note the continued pressures on inflation, while mentioning that long-term inflation expectations remained well contained. With policy still seen as accommodative, members agreed that the statement should retain an assessment that the risks to both sustainable economic growth and price stability were balanced, conditional on appropriate policy action. Members also agreed that the statement language indicating that "policy accommodation can be removed at a pace that is likely to be measured" correctly characterized the outlook for policy for now. The members concurred that at this stage in the expansion, with margins of slack resources narrowing and inflation somewhat higher, the Committee needed to be particularly alert to signs of a further increase in inflation. Such an increase could be particularly problematic because it might impart upward momentum to inflation expectations that would be costly to reverse. In any case, additional tightening would probably be necessary, but views differed on the amount of tightening that would likely be required to keep inflation contained and bring output in line with potential. However, members agreed that there was no need to make such an assessment at this time, and that the appropriate pace and degree of cumulative policy adjustment would depend on economic developments going forward. With the forward-looking language in the statement clearly conditioned on the outlook, it was not seen as limiting the Committee's flexibility in responding to such developments.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 3¼ percent.

The vote encompassed approval of the paragraph below for inclusion in the

statement to be released shortly after the meeting:

> The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan and Geithner, Ms. Bies, Messrs. Ferguson, Fisher, Gramlich, Kohn, Moskow, Olson, Santomero, and Stern. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 9, 2005.

The meeting adjourned at 1:25 p.m.

## Notation Vote

By notation vote completed on May 23, 2005, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on May 3, 2005.

Vincent R. Reinhart
Secretary

## Meeting Held on August 9, 2005

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 9, 2005 at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Fisher
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Guynn and Lacker, Mses. Pianalto and Yellen, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors and Madigan, Ms. Mester, Messrs. Rosenblum, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Struckmeyer, Associate Director, Division of Research and Statistics, Board of Governors

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

Messrs. English and Gagnon, and Ms. Liang, Assistant Directors, Divisions of Monetary Affairs, International Finance, and Research and Statistics, respectively, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Wright, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors

Mr. Connolly, First Vice President, Federal Reserve Bank of Boston

Mr. Judd, Executive Vice President, Federal Reserve Bank of San Francisco

Messrs. Hakkio, Rasche, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Kansas City, St. Louis, and Cleveland, respectively

Ms. Mosser and Messrs. Porter, Tallman, and Tootell, Vice Presidents, Federal Reserve Banks of New York, Chicago, Atlanta, and Boston, respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

Mr. Hetzel, Senior Economist, Federal Reserve Bank of Richmond

The Manager of the System Open Market Account reported on recent developments in the foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information received at this meeting suggested that final demand had expanded at a solid pace in the second quarter, led by a surge in net exports and another robust gain in residential investment, while business investment and consumer spending rose at moderate rates. The labor market continued to improve gradually in June and July. Core CPI and PCE prices decelerated in recent months, after notable increases earlier in the year. Crude oil prices continued to rise, reaching record levels in nominal terms over the intermeeting period.

Payroll employment grew in June and July at a pace that was roughly on par with that over the preceding six months. Hiring in the services and construction sectors remained strong, but the manufacturing sector posted further small job losses. With employment increasing and the average workweek of production or nonsupervisory workers unchanged over these two months, aggregate hours continued to firm. The unemployment rate dipped to 5.0 percent in June and held steady at that rate in July. Initial claims for unemployment insurance remained at low levels.

Industrial production picked up in June. A jump in utilities output, apparently owing to unseasonably warm weather, accounted for more than half of the gain. Motor vehicle production also rose a good bit, but the pace of production growth in the high-tech sector was sluggish, reflecting a decline in the output of communications equipment. Overall capacity utilization moved up to its highest level since December 2000.

Real personal consumption expenditures increased at a moderate pace in the second quarter, buoyed by a surge in purchases of motor vehicles that appeared to be due largely to the extension by an automaker of its "employee discount" program to the general pub-

lic. Excluding spending on motor vehicles, the growth of real personal consumption expenditures slowed slightly in the second quarter. Survey measures of consumer confidence continued to be quite favorable in July.

Activity in the housing sector remained robust. In June, starts of single-family homes maintained the strong pace of earlier this year. Both new and existing home sales jumped. Mortgage rates remained low, and house prices apparently continued to rise briskly.

Business spending on equipment and software posted a solid increase in the second quarter, boosted by a surge in outlays for transportation equipment. Excluding this volatile component, business spending on equipment and software decelerated markedly in the second quarter. Spending on nonresidential construction remained subdued. Nonetheless, fundamentals appeared to continue to support business investment, with the user cost of capital still low and corporations experiencing strong cash flows and holding ample liquid assets.

Real nonfarm inventories edged down in the second quarter, after a substantial rise in the first quarter. The strong pace of motor vehicle sales contributed to the runoff of inventories in the second quarter. Outside the automobile sector, real nonfarm inventories continued to rise, but at a much slower pace than earlier in the year. The inventory–sales ratio for the nonfarm business sector declined further from an already low level, continuing its long-term downward trend.

The U.S. international trade deficit narrowed in May as the value of exports of goods and services rose slightly and the value of imports declined, partly reflecting a sharp drop in the value of oil imports. GDP growth in a number of major foreign industrial economies appeared to have slowed a bit in the second quarter.

Consumer prices were about unchanged in June after posting notable increases earlier in the year. Consumer energy prices reversed a small part of their previous run-up, and core consumer inflation remained low. The producer price index was unchanged in June. The annual revisions to the national income and product accounts, which were released in early August, included a substantial upward revision to core PCE inflation for 2004, from 1.6 percent to 2.2 percent, reflecting changes to the nonmarket-based components of the index. Survey measures of near-term inflation expectations edged down in July, and longer-term inflation expectations firmed only a touch. The employment cost index for private industry workers again rose at a modest pace in the second quarter, and increases in compensation per hour in the nonfarm business sector slowed somewhat from the rapid rate of the first quarter.

At its June meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 3¼ percent. In its accompanying statement, the Committee indicated that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. In addition, the Committee noted that the expansion remained firm, that labor market conditions continued to improve gradually, and that, although pressures on inflation had remained elevated, longer-term inflation expectations remained well contained. In these circumstances, the Committee believed that policy accommodation could be removed at a pace that would likely be measured but noted that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The Committee's decision at its June meeting to raise the intended level of the federal funds rate 25 basis points, to maintain an assessment that risks to the goals of price stability and sustained growth were balanced assuming appropriate monetary policy action, and to retain the "measured pace" language was widely expected in financial markets. Over the intermeeting period, however, investors appreciably marked up their expectations for the path of policy, primarily in response to incoming economic data suggesting more strength in spending and output than had been anticipated. Nominal Treasury yields increased in line with the revision to policy expectations. Yields on inflation-indexed Treasury securities rose a touch less than their nominal counterparts, leaving inflation compensation only slightly higher. Spreads on investment-grade corporate bonds were little changed over the intermeeting period, but those on speculative-grade bonds declined markedly, ending the period close to the very low levels reached earlier this year. Major equity indexes advanced, supported by strong corporate earnings reports. The trade-weighted foreign exchange value of the dollar depreciated slightly over the intermeeting period. The People's Bank of China announced a change to its exchange-rate regime, including an immediate 2.1 percent appreciation of the renminbi versus the dollar.

M2 continued to grow sluggishly on balance over June and July. Small time deposits, whose rates of return adjust relatively quickly to changes in market rates, expanded briskly. However, liquid deposits and retail money market mutual funds were little changed on net over these two months. Despite the recent slow growth of M2, its velocity remained low relative to the level that would be expected based on its historical relationship with opportunity cost. The growth of bank credit was restrained in June by a runoff in securities holdings but picked up in July.

In the forecast prepared for this meeting, the staff raised its projection for economic growth over the remainder of 2005 in light of incoming data suggesting greater near-term momentum in aggregate demand. At the same time, however, it trimmed the growth rate forecast for 2006, reflecting the effects of higher energy prices, higher long-term interest rates, and the somewhat slower growth of productive capacity implied by the annual revisions to the national accounts. The output gap was predicted to be essentially closed by the end of this year. Inventory investment was projected to resume contributing to GDP growth over the second half of this year, after the sharp swing toward inventory runoffs in the second quarter. Growth in consumer spending was expected to firm in the third quarter, buoyed by motor vehicle spending, before falling back in the fourth quarter. With housing starts essentially flat, residential investment was projected to decelerate substantially over the remainder of this year. Business investment was predicted to continue to rise at a moderate pace, benefiting from still-accommodative financial conditions and the ongoing need to replace depreciating equipment and software. The recent improvement in the trade balance was expected to be transitory. Notwithstanding recent benign readings on inflation, the forecast for core PCE inflation was raised somewhat, owing in part to the recent further rise in energy prices and, in light of the revisions to historical data, a higher assumed trajectory for the nonmarket component of core PCE prices.

In their discussion of current conditions and the economic outlook, meeting

participants noted that aggregate spending appeared to have picked up in recent months by more than anticipated and that current estimates of slack were narrower than those reviewed at the June meeting. In addition, high and rising energy prices were adding to pressures on overall inflation, and energy price increases probably would feed through, at least temporarily, to core measures of inflation. Nonetheless, core inflation recently had been relatively low and inflation expectations remained well contained. Moreover, participants thought that some slowing in final sales was likely later this year as net exports resumed their decline and purchases of automobiles fell back with the expiration of special discount programs. In these circumstances, it appeared that, for now, continued removal of policy accommodation at a measured pace still would likely be sufficient to keep inflation contained, but participants also recognized that the pace and cumulative extent of policy adjustment going forward would depend importantly on economic developments.

In the household sector, the path for spending was expected to be bolstered in the near term by still-low interest rates, solid growth in disposable income, and ongoing increases in wealth. However, elevated energy prices were seen as likely to be a significant drag on consumption and, on net, household spending was expected to advance at a moderate pace. Housing sales and construction activity generally remained strong across the country, but meeting participants noted anecdotal evidence of some cooling in housing markets in certain areas. And at least some banks were reportedly beginning to apply somewhat tighter standards in real estate lending and becoming more cautious in their promotion of nontraditional mortgage products. Participants generally anticipated that the pace of home price appreciation would slow over time, though the timing and extent of that slowing, as well as its implications for consumer spending, were quite uncertain.

Participants indicated that business investment had been evolving roughly in line with their expectations. Strong fundamentals, including low interest rates, wide profit margins, and a high level of liquid assets, were seen as supporting expenditures on software and equipment going forward. Inventory investment declined in the second quarter, with much of the falloff concentrated in the motor vehicle industry, where sales had been boosted sharply by the introduction of special discount programs. Inventories now seemed to be coming in line with the trend in final demand and were anticipated to expand along with sales later this year.

Participants viewed the increases in market interest rates over the intermeeting period as an appropriate response to the stronger economic outlook. A few participants voiced concerns that still-low interest rates and insufficient recognition by investors of the dependency of the Committee’s policy expectations on economic data were continuing to foster an inappropriate degree of risk-taking in financial markets. Another participant mentioned, however, that recent sluggish growth of the monetary aggregates suggested that the stance of policy was not overly accommodative. Moreover, with a higher proportion of mortgages now tied to short-term rates, it was noted that increases in short-term rates could have a somewhat larger-than-usual effect on spending. On balance, current financial conditions, which embedded expectations of future policy tightening, were generally seen as likely to be consistent with sustained moderate economic growth and containment

of pressures on inflation in coming quarters.

Regarding the federal budget, a recent narrowing of the deficit was noted, but the improvement appeared to be attributable to cyclical factors and to increases in the level of tax collections that were not likely to be repeated. Few signs were evident that greater fiscal discipline in the budget process would emerge any time soon. As a result, federal deficits were expected to continue to act as a considerable drain on national saving over the longer run.

Although net exports had been significantly higher over the second quarter than had been expected, participants did not see this development as signaling the beginning of a sustained improvement in the trade and current account balances. The strong advance in exports and weakness in imports in the second quarter seemed largely attributable to special factors. Continued brisk import growth appeared likely to be sustained for the foreseeable future by gains in domestic demand.

Participants discussed at length the factors affecting costs and prices. Although uncertainties about the underlying pace of productivity increases, trends in labor force participation, and the level of potential output complicated the inflation outlook, higher energy prices and reduced resource slack were seen as pointing to elevated inflation pressures. While recent monthly readings indicated that core inflation had been subdued, a number of participants noted that underlying core inflation appeared to be running at a pace around the upper end of the range they viewed as consistent with price stability—an assessment that was reinforced by the recent upward revisions to historical data on core PCE inflation. Participants commented that an increase in inflation from recent rates could have especially adverse effects on longer-run economic performance.

While most participants viewed the risks to inflation as having ticked up over the intermeeting period, many also cited factors that, in concert with the likely continued removal of policy accommodation, would tend to hold inflation pressures in check. For example, few indications had emerged recently that businesses had enjoyed any significant increase in pricing power, and the continuing expansion of global trade was seen as an important factor limiting firms' ability to pass through cost increases. In these circumstances and with markups at relatively high levels, a substantial proportion of any increases in business costs might well be reflected in narrower profit margins. Moreover, the recent relatively low monthly readings on core inflation and modest wage pressures, at least by some measures, suggested that some slack remained in resource utilization. Despite the rise in oil prices and quickening pace of economic activity, both market- and survey-based measures of inflation expectations seemed to remain quite well anchored.

In the Committee's discussion of monetary policy for the intermeeting period, all of the members favored raising the target federal funds rate by 25 basis points to 3½ percent at this meeting. Even with this action, the federal funds rate would remain below the level that members anticipated would prove necessary to contain inflation pressures and keep output near potential, and thus in all likelihood further policy action would be required. However, the pace of future policy moves, although likely to be measured, as well as the extent of those moves, would depend on incoming data.

In discussing the statement to be released after the meeting, members

agreed that it was appropriate to highlight the apparent strengthening in aggregate spending. Policymakers exchanged views on the characterization of labor market conditions in light of recent employment reports and other indicators, but members ultimately concurred that the description of labor markets as ‘‘improving gradually’’ remained appropriate. Members agreed that it was appropriate to acknowledge the recent relatively low monthly rates of core inflation, but also to emphasize that inflation pressures remained elevated. As in past meetings, there was some discussion about the desirability of including forward-looking language in the statement, but members agreed to retain the forward-looking language for now.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 3½ percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

> Votes for this action: Messrs. Greenspan and Geithner, Ms. Bies, Messrs. Ferguson, Fisher, Kohn, Moskow, Olson, Santomero, and Stern. Vote against this action: None. Absent and not voting: Mr. Gramlich.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 20, 2005.

The meeting adjourned at 1:00 p.m.

## Notation Vote

By notation vote completed on July 20, 2005, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on June 29–30, 2005.

Vincent R. Reinhart
Secretary

## Meeting Held on September 20, 2005

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 20, 2005 at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Fisher
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Guynn and Lacker,
Mses. Pianalto and Yellen,
Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Assistant General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Evans, Freeman, and Madigan, Ms. Mester, Messrs. Oliner, Rosenblum, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Slifman and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Messrs. Clouse and Whitesell, Deputy Associate Directors, Division of Monetary Affairs, Board of Governors

Mr. English, Assistant Director, Division of Monetary Affairs, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Durham, Senior Economist, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors

Mr. Rives, First Vice President, Federal Reserve Bank of St. Louis

Mr. Eisenbeis, Executive Vice President, Federal Reserve Bank of Atlanta

Messrs. Elsasser, Fuhrer, Hakkio, Rasche, Sniderman, Weinberg, and Williams, Senior Vice Presidents, Federal Reserve Banks of New York, Boston, Kansas City, St. Louis, Cleveland, Richmond, and San Francisco, respectively

Mr. Potter, Assistant Vice President, Federal Reserve Bank of New York

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that, before the landfall of Hurricane Katrina on the Gulf Coast, expansion of economic activity had been solid, led by robust gains in housing and buoyant consumer spend-

ing. While business investment appeared to be losing some momentum, labor markets continued to improve, and increases in core CPI and PCE prices were modest after notable increases earlier in the year. Only limited data bearing on the likely economic effects of the hurricane were available. Oil and gasoline prices, however, were on the rise, spiking to record levels in the days immediately following the hurricane.

Payroll employment grew at a good pace in August, and the average increase over the most recent three months was largely on par with the advances made since the fourth quarter of last year. Employment gains were widespread across industries, with the exception of the manufacturing sector, which continued to post small job losses. With employment increasing and the average workweek of production or nonsupervisory workers unchanged in August, aggregate hours continued to firm modestly. The unemployment rate dipped to 4.9 percent in August, its lowest level since August 2001. Given the increase in the labor-force participation rate reported for the month, the employment–population ratio rose to its highest level in three years. Initial claims for unemployment insurance jumped in the latest available week, however, as workers in the Gulf Coast region began to file claims.

Industrial production increased only slightly in August; the staff estimated that the curtailment of activity as a result of Hurricane Katrina shaved 0.3 percent from the index. Petroleum refining and crude oil and natural gas extraction were especially hard hit by the storm. The output of utilities declined in August after surging earlier in the summer in response to unseasonably warm weather. Higher production of motor vehicles and parts boosted manufacturing output. After slowing in the second quarter, the pace of production in the high-tech sector accelerated somewhat in recent months, owing to increased output of communications equipment and semiconductors. Overall capacity utilization through August remained close to its highest level since December 2000.

Real personal consumption expenditures, boosted by motor vehicles purchases in response to employee-discount programs, were robust during the summer. Spending on goods outside the automobile sector and on services was moderate. Strong overall spending along with lackluster real income growth put downward pressure on the saving rate. Survey measures of consumer confidence early in August were generally consistent with solid increases in spending, but confidence fell appreciably in the period immediately after the storm.

Activity in the housing sector remained brisk. Starts of new single-family homes in July were slightly above their average level for the first half of the year. New home sales advanced further in July, and existing home sales stayed elevated. Mortgage rates remained low and supported demand. Prices of existing homes again rose briskly, while price appreciation for new homes moderated somewhat.

Although real outlays for equipment and software increased solidly in the second quarter, available data on orders and shipments suggested some softness in the third quarter. Amid continued rapid expansion in business output, favorable financing conditions, and ample cash balances, the fundamentals stayed positive. Real spending on nonresidential construction remained lackluster despite incremental improvements in nonresidential property market conditions this year.

Investment in real nonfarm inventories excluding motor vehicles slowed markedly in the second quarter, and

partial data for July suggested that real stockbuilding continued to be subdued. The slower rate of inventory accumulation suggested that firms had largely completed the stockbuilding that had been prompted by earlier low ratios of inventories to sales.

The U.S. international trade deficit narrowed somewhat in July, as the value of exports of goods and services rose slightly and the value of imports declined. The value of oil imports increased strongly in July but that rise was offset by decreases in imports of services and of non-oil goods. GDP growth in foreign industrial economies picked up, on balance, in the second quarter, but performance across economies was mixed.

Core consumer price inflation remained benign in July and August. However, the surge in energy prices considerably boosted overall consumer price inflation over those months. Gasoline prices in particular rose steeply in August, and survey data pointed to a larger increase in early September. Producer price inflation was subdued. One survey of households in early September indicated that near-term inflation expectations jumped and that longer-term inflation expectations edged higher. With regard to labor costs, the employment cost index for private industry workers rose at a modest pace in the second quarter, and the twelve-month change in this index declined from that of a year earlier. Average hourly earnings rose only moderately over the past twelve months.

At its August meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 3½ percent. In its accompanying statement, the Committee indicated that, with appropriate monetary policy action, the upside and downside risks to the attainment of sustainable growth and price stability should be kept roughly equal. In addition, the Committee noted that, despite high energy prices, aggregate spending appeared to have strengthened, labor market conditions continued to improve gradually, and longer-term inflation expectations remained well contained, although pressures on inflation had stayed elevated. In these circumstances, the Committee believed that policy accommodation could be removed at a pace that would likely be measured but noted that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The Committee's decision at its August meeting was widely expected in financial markets and evoked little price reaction. Over the intermeeting period, however, investors marked down their expectations for the path of policy, partly in response to the devastation caused by Hurricane Katrina. Nominal Treasury yields decreased about in line with the revision to policy expectations. Yields on inflation-indexed Treasury securities fell a bit more than their nominal counterparts, leaving inflation compensation slightly higher. Spreads on investment-grade corporate bonds were little changed over the intermeeting period, but those on speculative-grade bonds increased from very low levels. Major equity indexes appeared to be supported by lower interest rates and posted modest gains despite the increases in energy prices. The trade-weighted foreign exchange value of the dollar depreciated slightly over the intermeeting period.

M2 grew moderately, on balance, in August. Liquid deposits edged higher, but retail money market mutual funds contracted, on net. Small time deposits, whose rates of return adjust relatively quickly to changes in market rates, con-

tinued to expand rapidly. The growth of bank credit surged, as loans expanded briskly.

In the forecast prepared for this meeting, the staff lowered its projection for economic growth over the remainder of 2005 in light of the economic dislocation associated with Hurricane Katrina. At the same time, however, the staff increased the growth rate forecast for 2006 to reflect the boost to economic activity from the rebuilding effort. By 2007, the level of output was expected to move back to the path it would have followed in the absence of the storm. The staff revised upward its forecast of overall inflation for 2005 and of core inflation for 2006, reflecting the effects of higher energy prices, but lowered its projection for overall inflation slightly for 2006. It was recognized that there were considerable near-term uncertainties and that many data series in coming months would be influenced by the effects of the storm.

In their discussion of the economic situation and outlook, meeting participants agreed that output and employment appeared to have been growing at a good pace before Hurricane Katrina's landfall. Business fixed investment had been a little softer than expected, but household spending had been especially strong. Participants agreed that the widespread devastation in the Gulf Coast region and the dislocation of many people would hold down indicators of spending for a time. But they also were of the view that aggregate demand and output would likely rebound before long, fueled in part by private spending to rebuild and outlays by the federal government to assist in the recovery. With growth of the economy expected to recover, meeting participants were concerned that price pressures, which had been elevated before the storm, could climb further, primarily as a result of additional increases in energy prices.

Meeting participants recognized that Hurricane Katrina would have significant effects on the U.S. economy, but the size and timing of those effects were uncertain. Economic activity in the Gulf Coast region would be disrupted by the destruction of capital and the displacement of a large population, perhaps for an extended period. Moreover, damage to infrastructure for extracting and processing oil and natural gas was expected to be substantial, with significant near-term implications for energy prices and the national economy, and the projected track of Hurricane Rita raised additional concerns. In that environment, the prices of crude oil, natural gas, and gasoline likely would remain elevated and subject to considerable volatility, particularly given the limited spare capacity available in energy extraction and refining industries. Participants noted that very substantial rebuilding would probably be underway soon, supported importantly by government programs. The pace at which reconstruction activity would take place, however, was uncertain, as it depended in part on factors that were still difficult to assess, such as how quickly the affected areas could again be made habitable. On balance, participants thought that there would likely be a significant shift in the timing of aggregate economic activity over the next several quarters but probably little effect on the economy's intermediate-term growth prospects. Several participants voiced concern that the effects of the hurricane were likely to add to already considerable pressures on prices.

For the nation as a whole, participants noted that household spending had been fairly robust before the hurricane, supported by strong advances in income and continuing gains in wealth that

reflected in part further large increases in home prices. Most anecdotal information supported the indications from available data that activity in housing markets generally remained brisk. The termination of some inducements to purchase motor vehicles was expected to retard expenditures on consumer durables in the latter part of this year. The reduction in real disposable incomes caused by large increases in consumer energy prices was also anticipated to restrain consumer spending, with business contacts indicating that retail outlets that typically serve lower- and middle-income households could see particular weakness. The reduction in spending as a result of higher energy prices and hurricane-related dislocations could be augmented by a weakening of consumer attitudes. Many of the restraining effects were thought likely to dissipate over time, however. Retail energy prices were likely to retrace at least a portion of the post-hurricane increase, and consumer confidence should rebound. Moreover, demands for consumer durables, as well as housing, would receive support as hurricane victims repaired or replaced lost property, with help from insurance payments and government transfers. Although uncertainties about the outlook for spending had increased, it appeared that, over time, consumption would probably expand at a moderate pace—perhaps a little below the pace of income growth once the increases in house prices slowed to more historically typical rates.

Meeting participants noted that, even prior to the hurricane, business fixed investment had been somewhat weaker than expected. The softness was somewhat puzzling, as sales were growing, business balance sheets appeared quite strong in the aggregate, profitability was high, and financing was readily available and relatively inexpensive for most firms. Although the apparent sluggishness could reflect only short-term fluctuations in volatile data series, some evidence suggested that it may also have stemmed from concern among business executives about the effects of high energy prices. The anecdotal information on commercial real estate markets was mixed, with some districts reporting firming markets while activity elsewhere was said to remain subpar.

With regard to fiscal policy, meeting participants noted that federal outlays would increase sharply in order to assist with recovery and reconstruction efforts in the aftermath of the hurricane. The eventual size of the increment to federal outlays was unclear, but it was likely to be quite large. The substantial step-up in government spending would add to federal deficits that were already large and underscored the worrisome loss of fiscal discipline evident in recent years. The expansion of federal spending implied an increase in fiscal stimulus at a time when the margin of unutilized resources in the overall economy was probably thin.

Participants' concerns about inflation prospects generally had increased over the intermeeting period. The surge in energy prices, in particular, was boosting overall inflation, and some of that increase would probably pass through for a time into core prices. This posed the risk that there could be a more persistent influence on inflation should inflation expectations rise. Indeed, some recent survey evidence on such expectations had been troubling, and widening federal deficits were mentioned as a factor that could further stir inflationary concerns. Measures of labor costs were giving conflicting signals, with some indexes indicating that growth in labor compensation remained relatively low but another showing appreciably more rapid increases. Anecdotal information continued to point to shortages of certain types of labor, such as truck drivers,

and some business contacts reported difficulties in hiring more generally, a development that had prompted some firms to boost wages. Underlying productivity growth to date apparently had remained robust but, at this stage of the business cycle, gains in productivity could not necessarily be counted on to stay strong. The prices of a number of intermediate goods, including a wide range of petrochemical products and building materials, were subject to upward pressure, reflecting high crude oil prices, production disruptions in the energy sector, and elevated demands for materials in anticipation of rebuilding in the Gulf Coast region. Still, core inflation in recent months had been quite damped, and market-based measures of longer-term inflation expectations had risen only modestly of late. It was observed that, after the early 1980s, the pass-through of energy prices into core inflation had been quite limited, suggesting that, in current circumstances, core inflation could stay relatively low and overall inflation would probably drop back if inflation expectations remained contained.

In the Committee's discussion of monetary policy for the intermeeting period, nearly all members favored raising the target federal funds rate 25 basis points to 3¾ percent at this meeting. Although uncertainty had increased, in the Committee's judgment the fundamental factors influencing the longer-term path of the economy probably had not been affected by the hurricane, but the upside risks to inflation appeared to have increased. Even after today's action, the federal funds rate would likely be below the level that would be necessary to contain inflationary pressures, and further rate increases probably would be required. Moreover, the uncertainties about near-term economic prospects resulting from Hurricane Katrina would probably not be reduced materially in coming weeks. Indeed, underlying economic trends would be particularly difficult to assess over the next several months as a result of the direct, and presumably temporary, effects of the storm and its aftermath on the incoming data. A pause in policy tightening at this meeting had the potential to mislead the public both about the Committee's perceptions of the fundamental strength and resilience of the economy and about its commitment to fostering price stability.

In discussing the statement to be released after the meeting, members agreed that it would be appropriate to characterize the macroeconomic effects of Hurricane Katrina, while significant, as essentially temporary. Members also believed that the statement should again note that both monetary policy accommodation and robust underlying productivity growth were continuing to support economic activity. Although energy prices had the potential to add to inflation pressures, and inflation expectations had recently exhibited some signs of increasing, members agreed that the risks to inflation, as well as those to growth, remained essentially balanced under an assumption of appropriate policy action. The Committee also agreed to reiterate its previous expectation that ". . . policy accommodation can be removed at a pace that is likely to be measured." However, some sentiment was expressed to consider changes to forward-looking aspects of the statement at upcoming meetings, in part because of the considerable reduction in monetary policy accommodation that had already been accomplished.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 3¾ percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan and Geithner, Ms. Bies, Messrs. Ferguson, Fisher, Kohn, Moskow, Santomero, and Stern. Vote against this action: Mr. Olson.

Mr. Olson dissented because he preferred that the Committee defer policy action at this meeting, pending the receipt of additional information on the economic effects resulting from the severe shock of Hurricane Katrina.

It was agreed that the next meeting of the Committee would be held on Tuesday, November 1, 2005.

The meeting adjourned at 1:15 p.m.

## Notation Vote

By notation vote completed on August 29, 2005, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on August 9, 2005.

Vincent R. Reinhart
Secretary

## Meeting Held on November 1, 2005

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, November 1, 2005 at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Fisher
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Santomero
Mr. Stern

Messrs. Guynn and Lacker, Mses. Pianalto and Yellen, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Freeman, and Madigan, Ms. Mester, Messrs. Oliner, Rosenblum, Tracy, Rolnick, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Slifman and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Mr. English, Assistant Director, Division of Monetary Affairs, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Nelson, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors

Mr. Werkema, First Vice President, Federal Reserve Bank of Chicago

Mr. Eisenbeis, Executive Vice President, Federal Reserve Bank of Atlanta

Messrs. Fuhrer, Hakkio, Rasche, Rudebusch, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, Kansas City, St. Louis, San Francisco, and Cleveland, respectively

Mr. Krane and Ms. Mucciolo, Vice Presidents, Federal Reserve Banks of Chicago and New York, respectively

Mr. Hetzel, Senior Economist, Federal Reserve Bank of Richmond

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that the economy had a good deal of forward momentum in the third quarter. Although recent hurricanes caused considerable damage and disruption, particularly in the energy sector, economic activity outside the Gulf region appeared to have been well maintained. In September, hiring in other regions remained in line with its pace over the preceding twelve months, and excluding the estimated effects of the hurricanes and a strike by Boeing machinists, industrial production increased briskly. In addition, residential construction remained buoyant. Consumer spending, however, showed some signs of weakening. Although consumer spending was strong for the third quarter as a whole, it softened in September, and survey measures of consumer confidence slumped noticeably. Despite the large increase in consumer energy prices since midyear, core price inflation was restrained through September.

Hurricane Rita caused further disruption to energy production in the Gulf area, which had not yet fully recovered from Hurricane Katrina. Energy production in October was still below pre-hurricane levels, although progress had been made in reopening shut-down energy facilities. Rising imports, along with more-subdued consumption of

gasoline and other petroleum products, helped to offset the effect on energy prices of some of the output losses in refined products. In addition, to address the low level of gasoline inventories and more-immediate retail demands, domestic refiners sharply increased the share of gasoline in their output of total refined product. Wholesale and retail gasoline prices spiked soon after Rita's landfall but had since declined to pre-hurricane levels. Spot prices for natural gas soared with the hurricanes and remained at elevated levels.

Payroll employment fell in September, held down by substantial job losses associated with Hurricane Katrina. Employment in the areas unaffected by the hurricane increased at a rate in line with the average pace over the previous twelve months. The largest employment loss occurred in the leisure and hospitality category, an industry particularly hard hit by the storm. The average workweek was unchanged in September, so with employment lower, aggregate hours declined slightly. The unemployment rate rose 0.2 percentage points to 5.1 percent. The labor force participation rate held steady, but the number of individuals reporting that they had a job but were not at work because of bad weather surged. More recently, weekly data on initial claims for unemployment insurance suggested that the job losses associated with the hurricane were subsiding.

Industrial production fell substantially in September, but excluding the effects of hurricane-related disturbances and the Boeing strike, industrial production was estimated to have risen at a brisk pace. The hurricanes caused the index for oil and natural gas extraction and refining to plummet in September, and they also significantly affected petrochemical production. Manufacturing output fell noticeably in the shipbuilding, food manufacturing, paper, and plywood industries. In the transportation equipment category, motor vehicle production climbed notably, but the machinists' strike at Boeing caused the company to cease nearly all commercial aircraft production during the month. High-tech output—led by strong gains in the production of semiconductors and communications equipment—surged in September. Manufacturing capacity utilization dropped substantially in September, but was still noticeably above its year-earlier level.

Real consumer spending increased at a moderate rate in the third quarter as a whole, although it declined in August and September after having risen substantially earlier in the summer. The softening in spending of late reflected in part the diminishing boost to light vehicle sales from manufacturers' programs offering employee discounts to nonemployees. Spending on other goods and services was also sluggish, likely because of the direct effects of the dislocation of households by the hurricanes, high energy prices, and falling consumer confidence. Consumer sentiment in October, as measured by both the Michigan Survey and the Conference Board's indicator, dropped a little further after plunging in September. The personal saving rate remained slightly negative in September.

Residential construction continued at a robust pace. In September, new single-family homes were started at a rate a bit above their elevated average rate in the first half of the year, and permit issuance jumped to a new high. New home sales remained substantial in August, but they were below July's elevated level. Although they remained low by historical standards, both the thirty-year fixed mortgage rate and the one-year adjustable rate had moved up a bit in recent months and were notably above

the levels seen at the beginning of the year. The average selling price of existing homes rose in the twelve months ending in September at about the same rapid clip as a year earlier, but the average selling price of new homes rose more slowly over the past few months.

Real outlays for equipment and software were sluggish in the summer, but a broad-based pickup in orders for and shipments of nondefense capital goods excluding aircraft in August suggested some firming. Investment fundamentals remained relatively solid, including continued expansion in business sales, a declining cost of capital, and corporate balance sheets that were flush with cash. Surveys of executive sentiment squared well with the fundamentals: Although business leaders expressed some misgivings about the overall macroeconomic environment, their stated capital spending intentions pointed to increasing investment. Vacancy rates for nonresidential properties continued to edge lower, but they remained elevated for office and industrial properties, and real spending on new construction had yet to improve materially.

Business investment in real nonfarm inventories was subdued over the summer. Although inventory-to-sales ratios moved down some in July and August, businesses did not appear dissatisfied with their level of stocks. For example, September results from the Institute for Supply Management survey indicated that respondents viewed their customers' current inventory situation as reasonably well aligned with demand.

The U.S. international trade deficit widened somewhat in August, as a surge in imports of goods and services was partially offset by a sizable gain in exports. The growth in imports reflected both a marked increase in oil imports and a rise in nonoil goods; imports of services were little changed. The increase in exports was driven by higher merchandise exports, although exports of services also advanced a bit. GDP growth in foreign industrial economies appeared to have continued at a moderate pace in the third quarter.

Soaring energy prices have boosted overall measures of consumer price inflation in recent months. However, measures of core consumer price inflation were much more restrained. The twelve-month change in core consumer prices through September was about unchanged from its year-earlier level. One survey of households in October found that expectations for inflation over the coming year rose to a level well above the readings that had prevailed over the spring and summer, presumably in response to rising energy prices. However, median expectations for inflation over the next five to ten years were only a little above the average range reported in recent years. With regard to labor costs, the employment cost index for private industry workers rose at a moderate pace in the third quarter, up somewhat from its second-quarter pace, but the twelve-month change in the index declined from that of a year earlier. Hourly compensation in the nonfarm business sector was estimated to have also risen at a moderate rate in the third quarter.

At its September meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 3¾ percent. In its accompanying statement, the Committee indicated that, with appropriate monetary policy action, the upside and downside risks to the attainment of sustainable growth and price stability should be kept roughly equal. The Committee noted that the widespread devastation in the Gulf region from Hurricane Katrina, the associated dislocation of economic activity, and the boost to

energy prices would set back spending, production, and employment in the near term. However, the Committee judged that these unfortunate developments did not pose a more persistent threat to the overall economy. Rather, monetary policy accommodation, coupled with robust underlying growth in productivity, was providing ongoing support to economic activity. Although higher energy and other costs had the potential to add to inflation pressure, core inflation had been relatively low in the preceding few months and longer-term inflation expectations remained contained. In these circumstances, the Committee believed that policy accommodation could be removed at a pace that would likely be measured but noted that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

With investors putting only small odds on a pause in the tightening cycle following Hurricane Katrina, there was little market reaction to the Committee's decision at the September meeting. However, the expected path for monetary policy shifted up in subsequent weeks, as incoming data indicated that output had been expanding briskly prior to the hurricanes and that the disruptions to economic activity from the hurricanes were likely to be less severe than initially feared. This upward pressure on interest rates may have been amplified by comments from a number of Federal Reserve officials that were read as stressing inflation concerns. Nominal Treasury yields rose in line with the shift in the outlook for monetary policy. Despite a large increase in the overall consumer price index for September, measures of inflation compensation calculated using yields on nominal and inflation-protected Treasury securities were about unchanged over the intermeeting period, although they remained a bit above the levels seen before Hurricane Katrina. As broad indexes of investment- and speculative-grade corporate bond yields moved largely in line with Treasury yields over the period, spreads were little changed. Major stock price indexes fell moderately and the trade-weighted foreign exchange value of the dollar appreciated slightly over the intermeeting period.

Domestic nonfinancial debt appeared to have advanced briskly in the third quarter. Growth in household debt was estimated to have edged down in the third quarter because of a slowing in mortgage debt growth but remained elevated. Household bankruptcies surged in the weeks immediately before bankruptcy reforms went into effect on October 17. The debt of nonfinancial businesses rose in the third quarter at a rate comparable to the increases seen in the first half of the year. Bank loans to businesses continued to advance briskly, and the results of the October Senior Loan Officer Opinion Survey showed some further easing of lending terms and standards for such loans. M2 expanded at a fairly solid rate in September. The increase in September was in part attributable to a boost to currency and liquid deposits resulting from Hurricane Katrina. Growth in nominal output in the third quarter exceeded that of M2, implying a further rise in velocity.

In the forecast prepared for this meeting, the staff continued to project moderate economic growth for the second half of 2005. Output growth was expected to pick up in 2006, as the boost from hurricane-related rebuilding activity more than offset the effects of somewhat tighter financial conditions, and then slow in 2007, as the impetus from rebuilding waned. The near-term forecast again entailed a marked downshift in headline inflation as energy prices fall back consistent with readings from

futures markets. Favorable incoming data led the staff to reduce its forecast for near-term core inflation a bit. The outlook continued to be for core inflation to pick up modestly over coming quarters owing to the lagged effects of higher energy prices but then to return to near current levels in 2007 primarily as the result of the restraining influence of falling energy prices.

In their discussion of the economic situation and outlook, meeting participants saw the economy as continuing to grow at a solid pace, notwithstanding the disruptive effects to economic activity and employment from the hurricanes. However, the near-term outlook continued to be subject to considerable uncertainty given the difficulties in assessing the net effects of the downturn in consumer confidence and the rise in energy prices through the summer, on the one hand, and the rebuilding from hurricane damage, on the other. Although oil and gasoline prices had fallen in recent weeks and core inflation had remained benign, some businesses had reported increased ability to pass through cost increases in the environment of higher headline inflation. On balance, meeting participants remained concerned about heightened inflation pressures.

Meeting participants generally saw accumulating evidence as supporting the view that the disruptions to aggregate economic activity and employment from the hurricanes were likely to be limited and temporary. In areas that had been devastated by the hurricanes, recovery of energy production and the rebuilding of homes and businesses might take longer than had been expected, in part because of a slow return of evacuees. However, in regions just outside those that were most severely damaged, recovery was already well underway, and the pace of economic activity had strengthened, in some cases owing to spending by relocated households. Reconstruction along the Gulf Coast would likely pick up substantially in the next couple of quarters.

In the household sector, spending seemed to have held up fairly well, aside from a drop in purchases of autos. Some participants noted, however, that the erosion of consumer confidence, still-elevated gasoline prices, and the prospect of higher heating bills might augur weakness ahead. The housing market had remained robust, although a slowing in house price gains in some areas and recent declines in home equity lending at banks could be indicating that the long-expected cooling in the housing market was near. Motor vehicle purchases had slowed substantially in October, but that seemed to owe primarily to the end of discount programs that had generated a surge in auto spending over the summer. Over the longer-term, with house price gains moderating and perhaps greater perceived needs to invest for retirement purposes, the household saving rate was likely to rise gradually.

Growth in business investment spending seemed to remain moderate overall, but anecdotal reports suggested that a number of firms had boosted their plans for capital spending. Moreover, construction spending and commercial real estate investment seemed to be picking up in some areas. Significant problems persisted amongst U.S. nameplates in the auto sector, however. The rise in longer-term real interest rates and some widening of private credit spreads in recent months were seen as perhaps having a little restraining effect on the investment outlook.

Economic growth in the near term was likely to be boosted by additional fiscal stimulus, in part to support recovery and rebuilding from the hurricanes. Strong demand from overseas was evidently boosting exports this year by

more than the increase in imports, with the nation's external accounts thereby providing a small net positive contribution to growth in domestic production. Next year, however, the arithmetic contribution to growth from net exports was seen as likely to return to negative territory.

While participants noted some recent favorable data on core inflation and labor costs, upside risks to the outlook for underlying inflation remained a key concern. Wage gains had remained modest relative to continued strong productivity growth, suggesting that labor costs were not putting much upward pressure on prices. Indeed, core inflation continued to be subdued, and in recent weeks gasoline prices had unwound a significant portion of their steep increases. Nevertheless, there was a risk that the large cumulative rise in energy and petroleum product prices through the summer would be transmitted to core consumer prices. A number of firms had been reporting a greater ability to pass through increases in energy and other costs to customers, though evidently more so to other businesses than to consumers. A survey measure of the near-term inflation expectations of households had risen notably, but intermediate- and longer-term inflation expectations implied by Treasury security yields had remained fairly stable. It was noted, however, that longer-term expectations of inflation remained contained in the context of an increase in the extent of additional monetary policy tightening expected in financial markets.

In the Committee's discussion of monetary policy for the intermeeting period, all members favored raising the target federal funds rate 25 basis points to 4 percent at this meeting. The economy seemed to be growing at a fairly strong pace, despite the temporary disruptions associated with the hurricanes, and underlying economic slack was likely quite limited. In that context, all members believed it important to continue removing monetary policy accommodation in order to check upside risks to inflation and keep inflation expectations contained, but noted that policy setting would need to be increasingly sensitive to incoming economic data. Some members cautioned that risks of going too far with the tightening process could also eventually emerge. Nonetheless, all members agreed to indicate at the conclusion of this meeting that a continued measured pace of policy firming remained likely.

In their ongoing discussion of the Committee's communication strategy, participants expressed a variety of perspectives about how the policy statement issued at the end of FOMC meetings might evolve over time. Several aspects of the statement language would have to be changed before long, particularly those related to the characterization of and outlook for policy. Possible future changes in the sentence on the balance of risks to the Committee's objectives were also discussed. Participants noted that any forward-looking elements of the statement should clearly be conditioned on the outlook for inflation and economic growth. For this meeting, members concurred that the current statement structure could be retained, as it accurately conveyed their near-term economic and policy outlook.

In view of the continued rapid pace of observed productivity gains, members agreed that the statement to be released after the meeting should again indicate that robust underlying productivity growth and monetary policy accommodation were supporting the economic expansion. Those influences were expected to be augmented by planned rebuilding and recovery activity in

hurricane-affected areas. While gasoline prices had recently moved lower, the cumulative rise in energy prices and other costs was seen as having the potential to add to inflation pressures. However, core inflation had been subdued in recent months and longer-run inflation expectations remained contained. Against that backdrop, the risks to the objective of price stability, as well as that for sustainable growth, remained in balance, given appropriate monetary policy actions.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 4 percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Votes for this action: Messrs. Greenspan and Geithner, Ms. Bies, Messrs. Ferguson, Fisher, Kohn, Olson, Moskow, Santomero, and Stern. Votes against this action: None

It was agreed that the next meeting of the Committee would be held on Tuesday, December 13, 2005.

The meeting adjourned at 1:15 p.m.

## Notation Vote

By notation vote completed on October 7, 2005, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on September 20, 2005.

Vincent R. Reinhart
Secretary

## Meeting Held on December 13, 2005

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, December 13, 2005 at 9:00 a.m.

*Present:*

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Fisher
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Santomero
Mr. Stern

Ms. Cumming, Messrs. Guynn and Lacker, Mses. Pianalto and Yellen, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Connors, Freeman, and Madigan, Ms. Mester, Messrs. Oliner, Rosenblum, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Messrs. Slifman and Struckmeyer, Associate Directors, Division of Research and Statistics, Board of Governors

Mr. Whitesell, Deputy Associate Director, Division of Monetary Affairs, Board of Governors

Messrs. English and Sheets, Assistant Directors, Divisions of Monetary Affairs and International Finance, respectively, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Zakrajšek, Section Chief, Division of Monetary Affairs, Board of Governors

Mr. Kumasaka, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Fuhrer, Hakkio, Rasche, Sniderman, Weinberg, and Williams, Senior Vice Presidents, Federal Reserve Banks of Boston, Kansas City, St. Louis, Cleveland, Richmond, and San Francisco, respectively

Mr. Cunningham, Ms. Mosser, and Mr. Sullivan, Vice Presidents, Federal Reserve Banks of Atlanta, New York, and Chicago, respectively

Mr. Weber, Senior Research Officer, Federal Reserve Bank of Minneapolis

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

The information reviewed at this meeting suggested that the economy continued to expand at a solid rate in the fourth quarter. Industrial production rebounded, and employment growth appeared to have recovered smartly from the depressing effects of recent hurricanes. Although some scattered signs of cooling of the housing sector had emerged, the pace of construction activity and sales remained brisk. More broadly, spending by consumers and businesses was well maintained. Core consumer price inflation remained subdued, even though some of the increase in energy costs had apparently passed

through to prices of final goods and services.

Private nonfarm payrolls grew rapidly in November after a small gain in October. Construction employment posted another large increase, probably owing in part to hurricane-related activity. Broad-based gains in durable goods industries augmented manufacturing employment, and employment in the related industries of temporary help services and wholesale trade increased as well. With employment rising but the average workweek of production or nonsupervisory workers falling slightly, aggregate hours slipped in November—albeit to a level above that of their third-quarter average. The unemployment rate held steady at 5 percent, and the labor force participation rate was also unchanged. Survey measures of individuals' expectations of future labor market conditions improved in November, largely reversing post-Katrina declines.

Industrial production rebounded in October after having been held down in September by hurricanes and by a strike at Boeing. The resumption of commercial aircraft production boosted manufacturing output and more than offset a fall in the production of motor vehicles and parts. Large output gains in hurricane-affected industries—such as segments of the food, rubber and plastics, and paper industries—also contributed to the increase in manufacturing output. The growth of high-tech output slowed slightly in October, mainly as a result of smaller increases in the production of semiconductors. In contrast, production of communication equipment—particularly data networking equipment—accelerated. With many energy facilities in the Gulf region still closed, output at mines, which is defined to include oil and gas extraction, slipped further in October. Manufacturing capacity utilization moved up again in October and was only a touch below its long-run average.

Real personal consumption expenditures appeared to be increasing solidly over the course of the fourth quarter, led by improvements in the fundamental determinants of consumer spending. Real disposable personal income was bolstered by gains in employment and falling retail energy prices, while continued brisk advances in house prices and the recent strengthening of equity prices contributed importantly to increases in household wealth. Consumer sentiment picked up in November and early December; some survey measures of confidence returned to the range seen during the first half of the year. The personal saving rate—while still slightly negative—moved up in October.

Activity in the housing market remained brisk despite a rise in mortgage interest rates. Starts of new single-family homes dropped back somewhat in October from September's very strong pace, but permit issuance remained elevated. New home sales reached a new high in October, and existing home sales eased off only a little from the high levels recorded during the summer. Other available indicators of housing activity were on the soft side: An index of mortgage applications for purchases of homes declined in November, and builders' ratings of new home sales had fallen off in recent months. In addition, survey measures of homebuying attitudes had declined to levels last observed in the early 1990s.

Real outlays for equipment and software posted a solid gain in the third quarter. Although business purchases of motor vehicles declined in October and November, growth in investment in non-transportation equipment appeared to

have been well maintained in the fourth quarter. Rising business sales, a declining cost of capital, and ample financial resources in the corporate sector continued to foster a favorable environment for capital spending, a sentiment echoed in executive surveys, which generally pointed to widespread increases in planned capital outlays. Real spending on nonresidential construction improved materially in the third quarter, boosted by substantial gains in drilling and mining expenditures.

Real nonfarm inventories ran off in the third quarter as automakers pared their motor vehicle stocks. But even outside the motor vehicle sector, inventory investment was relatively restrained, and partial data for October suggested that real stockbuilding continued to be subdued. The level of stocks appeared reasonably well aligned with sales.

The U.S. international trade deficit reached a new record in September. A surge in imports was accompanied by a fairly sizable drop in exports, part of which was due to a steep falloff in aircraft exports as a result of the strike at Boeing. The jump in the value of imports was driven by strong growth in most categories of goods and, to a lesser extent, growth in services; increases in the dollar value of imports of oil and of industrial supplies—especially natural gas—were particularly strong, a reflection of higher prices. Foreign industrialized economies expanded robustly in the third quarter, and available indicators for the fourth quarter appeared promising, on balance.

Core consumer price inflation was moderate in recent months, although some signs of pass-through of higher energy costs were evident, especially in transportation services. Consumer energy prices had retreated notably from their elevated post-hurricane levels. Wholesale and retail gasoline prices dropped as gasoline inventories rebounded. And spot prices for natural gas fell sharply through mid-November amidst unusually temperate weather, plentiful inventories, and declining prices of competing fuels; unusually cold weather in early December, however, caused spot prices to move back up to their October levels. Presumably in response to falling retail energy prices, one survey of households in November and early December showed a marked retreat in expectations for inflation over the coming year. Longer-term inflation expectations also edged down, but stayed a touch above the narrow range observed in recent years. Although recent increases in energy costs had pushed up producer prices in some sectors, overall producer price inflation remained subdued. With regard to labor costs, the twelve-month change in the employment cost index for private industry workers in September was well below its year-ago increase. Hourly compensation in the nonfarm business sector also appeared to have slowed a bit recently.

At its November meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 4 percent. In its accompanying statement, the Committee indicated that, with appropriate monetary policy action, the upside and downside risks to the attainment of sustainable growth and price stability should be kept roughly equal. The Committee also noted that elevated energy prices and hurricane-related disruptions in economic activity had temporarily depressed output and employment. However, monetary policy accommodation, coupled with robust underlying growth in productivity, was providing ongoing support to economic activity. And although the cumulative rise in energy and other costs had the poten-

tial to add to inflation pressures, core inflation had been relatively low in recent months, and longer-term inflation expectations remained contained. In these circumstances, the Committee believed that policy accommodation could be removed at a pace that was likely to be measured but noted that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

Market participants widely anticipated the Committee's decision at its November meeting, and the policy announcement evoked little reaction in financial markets. Over the intermeeting period, investors marked up slightly their expectations for the path of monetary policy in light of stronger-than-expected data on spending and production. Nominal Treasury yields changed little, on net, but measures of inflation compensation at longer horizons—which are calculated using yields on nominal and inflation-protected securities—declined somewhat. Credit spreads on both investment- and speculative-grade corporate bonds were about unchanged over the intermeeting period. Major equity price indexes posted substantial gains, spurred by the perception that the economy had retained considerable momentum with limited inflation pressures. In foreign exchange markets, the trade-weighted value of the dollar was about unchanged over the intermeeting period.

The expansion of domestic nonfinancial debt appeared to have moderated a little from its brisk third-quarter pace. Consumer credit dipped in October, and nonfinancial firms' net borrowing in the form of bank loans, commercial paper, and bonds was a bit below the third-quarter pace. Household bankruptcies hovered at very low levels in recent weeks after soaring to unprecedented heights just before the implementation of more-stringent bankruptcy rules in mid-October. Hurricane relief payments apparently boosted M2 in October, but that aggregate decelerated in November, partly reflecting the continued rise in the opportunity cost of holding liquid deposits.

The staff forecast prepared for this meeting suggested that growth of economic activity would slow from this year's pace, but remain solid, with output staying near the economy's potential over the next two years. Although hurricane-related rebuilding would boost activity, especially in the near term, this stimulus increasingly would be countered by higher interest rates, the anticipated waning of the positive wealth effect associated with large earlier gains in equity and house prices, and reduced impetus from fiscal policy. Both overall and core consumer price inflation were projected to move higher in the first half of next year, reflecting the effects of higher energy prices, but then to trend lower as those effects ebb.

In their discussion of the economic situation and outlook, meeting participants noted that incoming data over the intermeeting period had been encouraging with regard to both economic growth and inflation. The economic expansion had shown considerable resilience in the face of higher energy prices and hurricane-related disruptions, suggesting greater underlying strength than had been apparent at the time of the November meeting. At the same time, incoming inflation data had been benign, indicating relatively modest pass-through of higher energy prices to core inflation to date; subdued gains in compensation and strong growth in productivity were holding down business costs; and inflation expectations, which had jumped after the hurricanes, had fallen back. Nonetheless, with growth

solid and prices of energy products still well above levels earlier in the year, possible increases in resource utilization had the potential to add to pressures on prices, especially in the absence of some further firming of policy.

In their discussion of major sectors of the economy, meeting participants noted that, while light vehicle sales had slowed in the fall, consumer spending outside the auto sector appeared to have remained vigorous. Holiday sales were said to be off to a good start in many parts of the country. The substantial recovery in measures of consumer confidence after their sharp declines in the aftermath of the hurricanes had reduced meeting participants' concerns about a significant pull-back in spending. Going forward, consumer outlays were expected to be supported by further advances in employment and income.

Meeting participants discussed tentative signs that activity was beginning to slow in the housing sector. Reports from contacts in many parts of the country suggested somewhat less ebullient market conditions, and measures of confidence of homebuyers and builders had fallen back noticeably. A downshift in attitudes regarding the outlook for the housing sector could have significant market effects, in part by damping the demand for houses by investors and speculators. A slowing of house price increases, by restraining the expansion of consumption, and a moderation in the pace of new building were expected to reduce the growth of aggregate demand somewhat in coming quarters. To date, however, the national data on home prices, sales, and construction activity did not suggest a significant weakening in the sector.

Business investment spending had accelerated some since midyear. In part, the pickup may have reflected an increase in business confidence as the economy proved resilient in the face of this year's substantial adverse shocks. Participants noted that the improved performance of investment suggested that the expansion was becoming more balanced, with strengthening business spending potentially offsetting some moderation in the growth of household spending from the elevated rates of recent years.

Economic activity also could be buoyed by developments in other sectors of the economy. Increased federal government outlays were expected to boost output a little next year. Supportive financial conditions and an apparent increase in confidence had contributed to a pickup in growth abroad. Despite possible firming of monetary policy by some foreign central banks and the rise in the foreign exchange value of the dollar owing to global demands for dollar assets, a good portion of the recent strength in foreign economic growth was expected to persist and provide support for U.S. exports.

In their discussion of prices, participants indicated that their concerns about near-term inflation pressures had eased somewhat over the intermeeting period. Recent data suggested that, thus far, indirect effects of elevated energy prices on core inflation had been muted. Moreover, energy prices generally had fallen back on balance since earlier in the fall, and much of the increases in inflation expectations posted in the aftermath of the hurricanes had reversed. Participants noted that robust competition—including that from foreign producers—and further substantial gains in productivity were helping to contain cost and price pressures. Moreover, measures of labor compensation showed only moderate gains while relatively wide profit margins could allow firms to absorb somewhat larger increases in labor and other costs without boosting

prices. Nonetheless, surveys and anecdotal reports suggested that some firms were successfully passing at least a portion of their increased costs on to customers, and many participants remained concerned that elevated energy prices could put pressure on core inflation. Also, in the view of a number of participants, the economy was possibly producing in the neighborhood of its potential, and the persistent strength in spending of late suggested that resource markets could tighten further and inflation pressures build. Under these circumstances, and with policy having been accommodative for some time, inflation expectations could rise if monetary policy were not seen as responding to contain such risks.

In the Committee's discussion of monetary policy for the intermeeting period, all members favored raising the target federal funds rate 25 basis points to 4¼ percent. With spending apparently retaining considerable momentum, and with the indirect effects of increased energy prices still threatening to raise core inflation at least for a time, the Committee thought that additional policy firming at this meeting was appropriate to keep inflation and inflation expectations in check. Committee members generally anticipated that policy would likely need to be firmed further going forward. In that process, the Committee would need to be mindful of the lags in the effect of policy firming on the economy. However, it would also have to take account of the effects of the sustained period of favorable financial conditions on asset prices and aggregate demand as well as the resulting possibility of further increases in resource utilization and pressures on prices. Views differed on how much further tightening might be required. Because the Committee's actions over the past eighteen months had significantly reduced the degree of monetary policy accommodation, members thought that the policy outlook was becoming considerably less certain and that policy decisions going forward would depend to an increased extent on the implications of incoming economic data for future growth and inflation.

The Committee agreed that several changes in the wording of the announcement to be released after today's meeting would be appropriate. The federal funds rate had been boosted substantially, and, in the view of some members, it was now likely within a broad range of values that might turn out to be consistent with output remaining close to potential. In these circumstances, the Committee thought that policy should no longer be characterized as accommodative. Members concurred that the statement should note that the expansion remained solid despite elevated energy prices and hurricane-related disruptions. While inflation and long-term inflation expectations remained contained, the Committee agreed that the announcement should indicate that possible increases in resource utilization, as well as elevated energy prices, had the potential to add to inflation pressures and that "some further measured policy firming is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance." Although future action would depend on the incoming data, this characterization of the outlook for policy was seen by most members as indicating that, given the information now in hand, the number of additional firming steps required probably would not be large. Some members thought that the word "measured" was no longer necessary, but its retention for this meeting was seen as potentially useful to preclude a possible misinterpretation that the Committee now saw a sig-

nificant possibility of adjusting policy in larger increments in the near future. Wording of the announcement along these lines was not expected to have a substantial effect on market expectations for policy, though such effects were especially difficult to judge given the extensive changes being made to the statement. The members agreed that the announcement should end by noting that policy will respond to changes in economic prospects as needed to foster the Committee's objectives.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 4¼ percent.

The vote encompassed approval of the paragraph below for inclusion in the statement to be released shortly after the meeting:

> The Committee judges that some further measured policy firming is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In any event, the Committee will respond to changes in economic prospects as needed to foster these objectives.

> Votes for this action: Messrs. Greenspan and Geithner, Ms. Bies, Messrs. Ferguson, Fisher, Kohn, Olson, Moskow, Santomero, and Stern. Votes against this action: None

It was agreed that the next meeting of the Committee would be held on Tuesday, January 31, 2006.

The meeting adjourned at 1:00 p.m.

## Notation Vote

By notation vote completed on November 21, 2005, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on November 1, 2005.

Vincent R. Reinhart
Secretary

# Litigation

During 2005, the Board of Governors was a party in three lawsuits or appeals filed that year and was a party in ten other cases pending from previous years, for a total of thirteen cases; in 2004, the Board had been a party in a total of seventeen cases. None of the lawsuits or appeals filed in 2005 raised questions under the Bank Holding Company Act. As of December 31, 2005, five cases were pending.

## Litigation under the Financial Institutions Supervisory Act

*Bazy v. Board of Governors*, No. 05-1320 (D.C. Circuit, filed August 12, 2005), was a petition for review of an interlocutory order in an administrative enforcement proceeding. On August 24, 2005, the court dismissed the case on the motion of the petitioner.

*Board of Governors v. Thomas, et al.*, No. 1:04-CV-0777 (N.D. Georgia, filed March 19, 2004), was an injunctive action in which, in 2004, the court ordered eighteen individuals to deposit funds into the court's registry to satisfy civil money penalties the Board was seeking against them in a separate administrative enforcement proceeding. On July 13, 2005, the court granted the Board's motion to dismiss the preliminary injunction issued on the Board's behalf so that the deposited funds could instead be transferred to the United States Bankruptcy Court, Middle District of Florida, Tampa Division, which had issued judgments against the same eighteen defendants in an adversary proceeding brought by the court-appointed trustee.

*Ulrich v. Board of Governors*, No. 03-73854 (9th Circuit, filed October 24, 2003), and *Diehl McCarthy v. Board of Governors*, No. 03-73997 (9th Circuit, filed October 28, 2003), were petitions for review of orders of prohibition issued by the Board on October 15, 2003. On April 27, 2005, the court denied the petitions for review. 129 Fed. App'x. 386 (9th Cir. 2005).

## Other Actions

*Inner City Press/Community on the Move v. Board of Governors*, No. 05-6162 (2nd Circuit, filed November 21, 2005), is an appeal of the district court's order (No. 04-CV-8337, 380 F. Supp. 2d 211 (S.D.N.Y. 2005)) granting in part and denying in part the Board's motion for summary judgment in a Freedom of Information Act case. On December 5, 2005, the Board filed a cross-appeal in the matter.

*Price v. Greenspan*, No. 05-5361 (D.C. Circuit, filed September 29, 2005), is an appeal of an order of the district court (No. 04-CV-0973, 374 F. Supp. 2d 17 (D.D.C. 2005)) dismissing an employment discrimination action.

*Barnes v. Greenspan*, No. 04-CV-1989 (CKK) (D. District of Columbia, filed November 15, 2004), is a case under the Age Discrimination in Employment Act.

*Fakolujo v. Federal Reserve System, et al.*, No. 05-304 (E.D. Pennsylvania, filed October 15, 2004, in the Court of Common Pleas, Philadelphia County, Pa., and removed to federal court on January 21, 2005), was an action for

wrongful denial of insurance claim. The action was dismissed by agreement of the parties on April 15, 2005.

*Jones v. Greenspan*, No. 04-CV-1696 (RMU) (D. District of Columbia, filed October 4, 2004), is an employment discrimination action. On December 13, 2005, the district court granted in part and denied in part the Board's motion to dismiss and for summary judgment.

*Texas State Bank v. United States*, No. 04-5126 (Federal Circuit, filed July 28, 2004), was an appeal from a decision of the United States Court of Federal Claims dismissing an action challenging on constitutional grounds the failure to pay interest on reserve accounts held at Federal Reserve Banks. On September 21, 2005, the court affirmed the lower court's dismissal of the action. 423 F.3d 1370 (Fed. Cir. 2005). The petitioner's request for rehearing and rehearing *en banc* was denied on December 13, 2005.

*Sciba v. Board of Governors*, No. 04-CV-1011 (D. District of Columbia, filed June 21, 2004), was a case brought under the Freedom of Information Act. On September 30, 2005, the court granted the Board's motion for summary judgment.

*Artis v. Greenspan*, No. 01-0400 (D. District of Columbia, filed February 22, 2001), is an employment discrimination action. An identical action, No. 99-2073 (EGS) (D. District of Columbia, filed August 3, 1999), was consolidated with this action on August 15, 2001.

*Fraternal Order of Police v. Board of Governors*, No. 98-3116 (D. District of Columbia, filed December 22, 1998), was an action seeking a declaratory judgment regarding the Board's labor policy governing Federal Reserve Banks. On July 28, 2005, the district court granted the Board's motion for summary judgment and dismissed the action. 391 F. Supp. 2d 1 (D.D.C. 2005). ▪

# *Federal Reserve System Organization*

# Board of Governors

**December 31, 2005**

## Members

| | Term expires January 31, |
|---|---|
| ALAN GREENSPAN, *Chairman*[1] | 2006 |
| ROGER W. FERGUSON, JR., *Vice Chairman*[1] | 2014 |
| SUSAN S. BIES | 2012 |
| MARK W. OLSON | 2010 |
| DONALD L. KOHN | 2016 |

## Officers

### OFFICE OF BOARD MEMBERS

MICHELLE A. SMITH, *Director*

WINTHROP P. HAMBLEY, *Assistant to the Board and Director for Congressional Liaison*

ROSANNA PIANALTO-CAMERON, *Special Assistant to the Board for Public Information*

DAVID W. SKIDMORE, *Special Assistant to the Board*

LARICKE D. BLANCHARD, *Special Assistant to the Board for Congressional Liaison*

BRIAN J. GROSS, *Special Assistant to the Board for Congressional Liaison*

ROBERT M. PRIBBLE, *Special Assistant to the Board for Congressional Liaison*

### LEGAL DIVISION

SCOTT G. ALVAREZ, *General Counsel*

RICHARD M. ASHTON, *Deputy General Counsel*

KATHLEEN M. O'DAY, *Deputy General Counsel*

STEPHANIE MARTIN, *Associate General Counsel*

ANN MISBACK, *Associate General Counsel*

KATHERINE H. WHEATLEY, *Associate General Counsel*

KIERAN J. FALLON, *Assistant General Counsel*

STEPHEN H. MEYER, *Assistant General Counsel*

PATRICIA A. ROBINSON, *Assistant General Counsel*

CARY K. WILLIAMS, *Assistant General Counsel*

### OFFICE OF THE SECRETARY

JENNIFER J. JOHNSON, *Secretary*

ROBERT DEV. FRIERSON, *Deputy Secretary*

MARGARET M. SHANKS, *Associate Secretary*

### DIVISION OF INTERNATIONAL FINANCE

KAREN H. JOHNSON, *Director*

THOMAS A. CONNORS, *Senior Associate Director*

WILLIAM L. HELKIE, *Senior Adviser*

DALE W. HENDERSON, *Senior Adviser*

RICHARD T. FREEMAN, *Associate Director*

STEVEN B. KAMIN, *Associate Director*

JON W. FAUST, *Assistant Director*

JOSEPH E. GAGNON, *Assistant Director*

MICHAEL P. LEAHY, *Assistant Director*

D. NATHAN SHEETS, *Assistant Director*

RALPH W. TRYON, *Assistant Director*

### DIVISION OF MONETARY AFFAIRS

VINCENT R. REINHART, *Director*

BRIAN F. MADIGAN, *Deputy Director*

DEBORAH J. DANKER, *Special Assistant to the Board*

ATHANASIOS ORPHANIDES, *Adviser*

JAMES A. CLOUSE, *Deputy Associate Director*

WILLIAM C. WHITESELL, *Deputy Associate Director*

CHERYL L. EDWARDS, *Assistant Director*

WILLIAM B. ENGLISH, *Assistant Director*

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1. The designations as Chairman and Vice Chairman expire on June 19, 2008, and October 28, 2007, respectively, unless the service of these members of the Board terminates sooner.

## Board of Governors—Continued

### Division of Research and Statistics

David J. Stockton, *Director*
Patrick M. Parkinson, *Deputy Director*
David W. Wilcox, *Deputy Director*
Myron L. Kwast, *Senior Associate Director*
Stephen D. Oliner, *Associate Director*
Lawrence Slifman, *Associate Director*
Charles S. Struckmeyer, *Associate Director*
Alice Patricia White, *Associate Director*
Glenn B. Canner, *Senior Adviser*
David S. Jones, *Senior Adviser*
Thomas D. Simpson, *Senior Adviser*
S. Wayne Passmore, *Deputy Associate Director*
David L. Reifschneider, *Deputy Associate Director*
Janice Shack-Marquez, *Deputy Associate Director*
William L. Wascher III, *Deputy Associate Director*
Joyce K. Zickler, *Deputy Associate Director*
J. Nellie Liang, *Assistant Director*
Daniel E. Sichel, *Assistant Director*
Mary M. West, *Assistant Director*
Michael S. Cringoli, *Assistant Director and Chief*
Douglas W. Elmendorf, *Assistant Director and Chief*
Michael S. Gibson, *Assistant Director and Chief*
Diana Hancock, *Assistant Director and Chief*
Robin A. Prager, *Assistant Director and Chief*

### Division of Banking Supervision and Regulation

Richard Spillenkothen, *Director*
Stephen M. Hoffman, Jr., *Deputy Director*
Roger T. Cole, *Senior Associate Director*
Michael G. Martinson, *Senior Adviser*
Steven M. Roberts, *Senior Adviser*
Deborah P. Bailey, *Associate Director*
Norah M. Barger, *Associate Director*
Betsy Cross, *Associate Director*
Gerald A. Edwards, Jr., *Associate Director*
Jack P. Jennings, *Associate Director*
Robin L. Lumsdaine, *Associate Director*
Peter J. Purcell, *Associate Director and Chief Technology Officer*
Molly S. Wassom, *Associate Director*
David M. Wright, *Associate Director*
Barbara J. Bouchard, *Deputy Associate Director*
Angela Desmond, *Deputy Associate Director*
James A. Embersit, *Deputy Associate Director*
Charles H. Holm, *Deputy Associate Director*
William C. Schneider, Jr., *Deputy Associate Director*
William G. Spaniel, *Deputy Associate Director*
Stacy Lee Coleman, *Assistant Director*
Jon D. Greenlee, *Assistant Director*
Walt H. Miles, *Assistant Director*
William F. Treacy, *Assistant Director*

### Division of Consumer and Community Affairs

Sandra F. Braunstein, *Director*
Glenn E. Loney, *Deputy Director*
Leonard Chanin, *Associate Director*
Adrienne D. Hurt, *Associate Counsel*
Mary T. Johnsen *Associate Director*
Tonda E. Price, *Associate Director*
Suzanne G. Killian, *Assistant Director*
Sheila F. Maith, *Assistant Director*
James A. Michaels, *Assistant Director*

## *Board of Governors—Continued*

### Division of Reserve Bank Operations and Payment Systems

Louise L. Roseman, *Director*
Jeffrey C. Marquardt, *Deputy Director*
Paul W. Bettge, *Senior Associate Director*
Kenneth D. Buckley, *Associate Director*
Dorothy LaChapelle, *Associate Director*
Jack K. Walton II, *Associate Director*
Gregory L. Evans, *Assistant Director*
Lisa Hoskins, *Assistant Director*
Michael J. Lambert, *Assistant Director*
Jeff J. Stehm, *Assistant Director*

### Office of Staff Director for Management

Stephen R. Malphrus, *Staff Director for Management*
Sheila Clark, *Equal Employment Opportunity Programs Director*
Lynn S. Fox, *Senior Adviser*

### Management Division

H. Fay Peters, *Director*
Darrell R. Pauley, *Deputy Director*
Stephen J. Clark, *Senior Associate Director*
Christine M. Fields, *Associate Director*
Marsha W. Reidhill, *Associate Director*
Billy J. Sauls, *Associate Director*
Donald A. Spicer, *Associate Director*
Charles F. O'Malley, *Assistant Director*
James R. Riesz, *Assistant Director*

### Division of Information Technology

Marianne M. Emerson, *Director*
Maureen T. Hannan, *Deputy Director*
Tillena G. Clark, *Assistant Director*
Geary L. Cunningham, *Assistant Director*
Wayne A. Edmondson, *Assistant Director*
Po Kyung Kim, *Assistant Director*
Susan F. Marycz, *Assistant Director*
Sharon L. Mowry, *Assistant Director*
Raymond Romero, *Assistant Director*
Jill R. Rosen, *Assistant Director*

### Office of Inspector General

Barry R. Snyder, *Inspector General*
Donald L. Robinson, *Deputy Inspector General*
Elizabeth A. Coleman, *Assistant Inspector General*
Laurence A. Froehlich, *Assistant Inspector General*
William L. Mitchell, *Assistant Inspector General*

# *Federal Open Market Committee*

**December 31, 2005**

## Members

Alan Greenspan, *Chairman,* Board of Governors

Timothy F. Geithner, *Vice Chairman,* President, Federal Reserve Bank of New York

Susan S. Bies, Board of Governors

Roger W. Ferguson, Jr., Board of Governors

Richard W. Fisher, President, Federal Reserve Bank of Dallas

Donald L. Kohn, Board of Governors

Michael H. Moskow, President, Federal Reserve Bank of Chicago

Mark W. Olson, Board of Governors

Anthony M. Santomero, President, Federal Reserve Bank of Philadelphia

Gary H. Stern, President, Federal Reserve Bank of Minneapolis

## Alternate Members

Christine M. Cumming, First Vice President, Federal Reserve Bank of New York

Jack Guynn, President, Federal Reserve Bank of Atlanta

Jeffrey M. Lacker, President, Federal Reserve Bank of Richmond

Sandra Pianalto, President, Federal Reserve Bank of Cleveland

Janet L. Yellen, President, Federal Reserve Bank of San Francisco

## Officers

Vincent R. Reinhart, *Secretary and Economist*

Deborah J. Danker, *Deputy Secretary*

Michelle A. Smith, *Assistant Secretary*

Scott G. Alvarez, *General Counsel*

Thomas C. Baxter, Jr., *Deputy General Counsel*

Karen H. Johnson, *Economist*

David J. Stockton, *Economist*

Thomas A. Connors, *Associate Economist*

Charles L. Evans, *Associate Economist*

Richard T. Freeman, *Associate Economist*

Brian F. Madigan, *Associate Economist*

Loretta J. Mester, *Associate Economist*

Stephen D. Oliner, *Associate Economist*

Arthur J. Rolnick, *Associate Economist*

Harvey Rosenblum, *Associate Economist*

Joseph S. Tracy, *Associate Economist*

David W. Wilcox, *Associate Economist*

Dino Kos, *Manager, System Open Market Account*

During 2005 the Federal Open Market Committee held eight regularly scheduled meetings (see “Minutes of Federal Open Market Committee Meetings” in this volume).

# *Federal Advisory Council*

**December 31, 2005**

## Members

District 1—James C. Smith, *Chairman and Chief Executive Officer*, Webster Bank, N.A. and Webster Financial Corporation, Waterbury, Conn.

District 2—Thomas A. Renyi, *Chairman and Chief Executive Officer*, The Bank of New York, N.Y.

District 3—Bruce L. Hammonds *President and Chief Executive Officer*, MBNA Corporation, Wilmington, Del.

District 4—Martin G. McGuinn, *Chairman and Chief Executive Officer*, Mellon Financial Corp., Pittsburgh, Pa.

District 5—G. Kennedy Thompson, *Chairman, President, and Chief Executive Officer*, Wachovia Corporation, Charlotte, N.C.

District 6—Fred L. Green III, *Vice Chairman*, Synovus Financial Corporation, Columbus, Ga.

District 7—Dennis J. Kuester, *President and Chief Executive Officer*, Marshall & Ilsley Corporation, Milwaukee, Wis.

District 8—J. Kenneth Glass, *Chairman, President, and Chief Executive Officer*, First Horizon National Corporation, Memphis, Tenn.

District 9—Jerry A. Grundhofer, *President and Chief Executive Officer*, U.S. Bancorp, Minneapolis, Minn.

District 10—Byron G. Thompson, *Chairman*, Country Club Bank, N.A., Kansas City, Mo.

District 11—Gayle M. Earls, *President and Chief Executive Officer*, TIB—The Independent BankersBank, Dallas, Tex.

District 12—Richard M. Kovacevich, *Chairman, President, and Chief Executive Officer*, Wells Fargo and Company, San Francisco, Calif.

## Officers

Martin G. McGuinn, *President*

Jerry A. Grundhofer, *Vice President*

James E. Annable, *Secretary*

The Federal Advisory Council, which is a statutory body established under the Federal Reserve Act, consults with, and advises, the Board of Governors on all matters within the Board's jurisdiction. It is composed of one representative from each Federal Reserve District, chosen by the Reserve Bank in that District. The Federal Reserve Act requires the council to meet in Washington, D.C., at least four times a year. In 2005, it met on February 10–11, May 5–6, September 1–2, and December 8–9. The council met with the Board on February 11, May 6, September 2, and December 9, 2005.

# Consumer Advisory Council

**December 31, 2005**

## Members

STELLA ADAMS, *Executive Director*, North Carolina Fair Housing Center, Durham, N.C.

DENNIS L. ALGIERE, *Senior Vice President*, The Washington Trust Company, Westerly, R.I.

FAITH L. ANDERSON, *Vice President/Legal Compliance and General Counsel*, American Airlines Federal Credit Union, Fort Worth, Tex.

SUSAN BREDEHOFT, *Senior Vice President/ Compliance Risk Management*, Commerce Bank, N.A., Cherry Hill, N.J.

SHEILA CANAVAN, *Consumer Attorney*, Law Office of Sheila Canavan, Moab, Utah

CAROLYN CARTER, *Attorney*, National Consumer Law Center, Boston, Mass.

MICHAEL COOK, *Vice President*, Wal-Mart Stores, Inc., Bentonville, Ark.

DONALD S. CURRIE, *Executive Director*, Community Development Corporation of Brownsville, Brownsville, Tex.

ANNE DIEDRICK, *Senior Vice President*, JPMorgan Chase Bank, New York, N.Y.

DAN DIXON, *Group Senior Vice President*, World Savings Bank, FSB, Washington, D.C.

HATTIE B. DORSEY, *President and Chief Executive Officer*, Atlanta Neighborhood Development Partnership, Atlanta, Ga.

KURT EGGERT, *Professor of Law and Director of Clinical Legal Education*, Chapman University School of Law, Orange, Calif.

JAMES GARNER, *Senior Vice President and General Counsel*, North American Consumer Finance for Citigroup, Baltimore, Md.

CHARLES GATSON, *Former Vice President*, Midtown Community Development Corporation, Kansas City, Mo.

DEBORAH HICKOK, *Vice President*, MoneyGram Payment Systems, Inc., Ooltewah, Tenn.

W. JAMES KING, *President and Chief Executive Officer*, Community Redevelopment Group, Cincinnati, Ohio

ELSIE MEEKS, *Executive Director*, First Nations Oweesta Corporation, Rapid City, S.D.

BRUCE B. MORGAN, *Chairman, President, and Chief Executive Officer*, Valley State Bank, Roeland Park, Kans.

BENJAMIN ROBINSON III, *President and Chief Executive Officer*, Innovative Risk Solutions, LLC, Charlotte, N.C.

MARY JANE SEEBACH, *Managing Director, Public Affairs*, Countrywide Financial Corporation, Calabasas, Calif.

LISA SODEIKA, *Executive Vice President-Corporate Affairs*, HSBC North America Holdings, Inc., Prospect Heights, Ill.

PAUL J. SPRINGMAN, *Chief Marketing Officer*, Equifax, Atlanta, Ga.

FORREST F. STANLEY, *Senior Vice President and Deputy General Counsel*, KeyBank National Association, Cleveland, Ohio

DIANE THOMPSON, *Supervising Attorney*, Land of Lincoln Legal Assistance Foundation, Inc., East St. Louis, Ill.

ANSELMO VILLARREAL, *Executive Director*, LaCasa de Esperanza, Inc., Waukesha, Wis.

CLINT WALKER, *General Counsel/Chief Administrative Officer*, Juniper Bank, Wilmington, Del.

KELLY K. WALSH, *Former Senior Vice President*, Bank of Hawaii, Honolulu, Hawaii

MARVA E. WILLIAMS, *Senior Vice President*, Woodstock Institute, Chicago, Ill.

## Officers

MARK PINSKY, *Chair*, President and Chief Executive Officer, National Community Capital Association, Philadelphia, Pa.

LORI SWANSON, *Vice Chair*, Solicitor General, Office of the Minnesota Attorney General, St. Paul, Minn.

The Consumer Advisory Council—a statutory body established pursuant to the 1976 amendments to the Equal Credit Opportunity Act—advises the Board of Governors on consumer financial services. Its members, who are appointed by the Board, are academics, state and local government officials, and representatives of the financial services industry and of consumer and community interests. In 2005, the council met with members of the Board on March 17, June 23, and October 27.

# *Thrift Institutions Advisory Council*

**December 31, 2005**

## Members

ELDON R. ARNOLD, *President and Chief Executive Officer*, Citizens Equity First Credit Union (CEFCU), Peoria, Ill.

H. BRENT BEESLEY, *Chairman and Chief Executive Officer*, Heritage Bank, St. George, Utah

CRAIG G. BLUNDEN, *Chairman, President, and Chief Executive Officer*, Provident Savings Bank, FSB, Riverside, Calif.

ALEXANDER R.M. BOYLE, *Vice Chairman*, Chevy Chase Bank, Bethesda, Md.

ROBERT M. COUCH, *President and Chief Executive Officer*, New South Federal Savings Bank, Birmingham, Ala.

JEFFREY H. FARVER, *President and Chief Executive Officer*, San Antonio Federal Credit Union, San Antonio, Tex.

DOUGLAS K. FREEMAN, *Chairman and Chief Executive Officer*, NetBank, Alpharetta, Ga.

CURTIS L. HAGE, *Chairman and Chief Executive Officer*, Home Federal Bank, Sioux Falls, S.D.

DAVID H. HANCOCK, *Chief Executive Officer*, North American Savings Bank, Grandview, Mo.

GEORGE JEFFREY RECORDS, JR., *Chairman and Chief Executive Officer*, MidFirst Bank, Oklahoma City, Okla.

DAVID RUSSELL TAYLOR, *President and Chief Executive Officer*, Rahway Savings Institution, Rahway, N.J.

ROY M. WHITEHEAD, *President and Chief Executive Officer*, Washington Federal Savings, Seattle, Wash.

## Officers

CURTIS L. HAGE, *President*

ROY M. WHITEHEAD, *Vice President*

The Thrift Institutions Advisory Council was established by the Board of Governors to consult with, and advise, the Board on issues pertaining to the thrift industry and on other matters within the Board's jurisdiction. Its members, who are appointed by the Board, represent credit unions, savings and loan associations, and savings banks. In 2005, the council met with the Board on March 4, July 8, and December 2.

# *Federal Reserve Banks and Branches*

**December 31, 2005**

## Officers

| BANK or Branch | Chairman[1] / Deputy Chairman | President / First Vice President | Officer in charge of Branch |
|---|---|---|---|
| BOSTON[2] | Samuel O. Thier | Cathy E. Minehan | |
| | Blenda J. Wilson | Paul M. Connolly | |
| NEW YORK[2] | John E. Sexton | Timothy F. Geithner | |
| | Jerry I. Speyer | Christine M. Cumming | |
| Buffalo | Marguerite D. Hambleton | | Kausar Hamdani |
| PHILADELPHIA | Ronald J. Naples | Anthony M. Santomero | |
| | Doris M. Damm | William H. Stone, Jr. | |
| CLEVELAND[2] | Robert W. Mahoney | Sandra Pianalto | |
| | Charles E. Bunch | Robert Christy Moore | |
| Cincinnati | James M. Anderson | | Barbara B. Henshaw |
| Pittsburgh | Roy W. Haley | | Robert B. Schaub |
| RICHMOND | Thomas J. Mackell, Jr. | Jeffrey M. Lacker | |
| | Theresa M. Stone | Walter A. Varvel | |
| Baltimore | William C. Handorf | | David Beck |
| Charlotte | Michael A. Almond | | Jeffrey S. Kane |
| ATLANTA | David M. Ratcliffe | Jack Guynn | James M. McKee |
| | V. Larkin Martin | Patrick K. Barron | |
| Birmingham | James H. Sanford | | Lee C. Jones |
| Jacksonville | Fassil Gabremariam | | Christopher L. Oakley |
| Miami | Edwin A. Jones, Jr. | | Juan del Busto |
| Nashville | Beth Dortch Franklin | | Melvyn K. Purcell |
| New Orleans | Earl L. Shipp | | Robert J. Musso |
| CHICAGO[2] | W. James Farrell | Michael H. Moskow | |
| | Miles D. White | Gordon R.G. Werkema | |
| Detroit | Edsel B. Ford II | | Glenn Hansen |
| ST. LOUIS | Walter L. Metcalfe, Jr. | William Poole | |
| | Gayle P. W. Jackson | W. LeGrande Rives | |
| Little Rock | Stephen M. Erixon | | Robert A. Hopkins |
| Louisville | Norman E. Pfau, Jr. | | Maria Gerwing Hampton |
| Memphis | Russell Gwatney | | Martha Perine Beard |
| MINNEAPOLIS | Linda Hall Whitman | Gary H. Stern | |
| | Frank L. Sims | James M. Lyon | |
| Helena | Lawrence R. Simkins | | Samuel H. Gane |

## Officers—Continued

| BANK or Branch | Chairman[1]<br>Deputy Chairman | President<br>First Vice President | Officer<br>in charge of Branch |
|---|---|---|---|
| KANSAS CITY | Robert A. Funk<br>Richard H. Bard | Thomas M. Hoenig<br>Richard K. Rasdall | |
| Denver | Thomas Williams | | Pamela L. Weinstein |
| Oklahoma City | Tyree O. Minner | | Dwayne E. Boggs |
| Omaha | James A. Timmerman | | Kevin A. Drusch |
| DALLAS | Ray L. Hunt<br>Patricia M. Patterson | Richard W. Fisher<br>Helen E. Holcomb | |
| El Paso | Ron C. Helm | | Robert W. Gilmer |
| Houston | Lupe Fraga | | Robert Smith III |
| San Antonio | Elizabeth Chu Richter | | D. Karen Diaz |
| SAN FRANCISCO[2] | George M. Scalise<br>David K.Y. Tang | Janet L. Yellen<br>John F. Moore | |
| Los Angeles | James L. Sanford | | Mark L. Mullinix |
| Portland | James H. Rudd | | Mary E. Lee |
| Salt Lake City | H. Roger Boyer | | Andrea P. Wolcott |
| Seattle | Mic R. Dinsmore | | Mark Gould |

1. The chairman of a Federal Reserve Bank serves, by statute, as Federal Reserve agent.
2. Additional offices of these Banks are located at Windsor Locks, Connecticut; Utica at Oriskany, New York; East Rutherford, New Jersey; Columbus, Ohio; Des Moines, Iowa; Midway at Bedford Park, Illinois, and Phoenix, Arizona.

## Conference of Chairmen

The chairmen of the Federal Reserve Banks are organized into the Conference of Chairmen, which meets to consider matters of common interest and to consult with and advise the Board of Governors. Such meetings, also attended by the deputy chairmen, were held in Washington, D.C. on June 1 and 2, November 30, and December 1, 2005.

The members of the executive committee of the Conference of Chairmen during 2005 were George M. Scalise, chair; Walter L. Metcalfe, Jr., vice chair; and John Sexton, member.

On December 1, 2005, the conference elected its executive committee for 2006, naming John E. Sexton as chair; Charles E. Bunch as vice chair; and Robert A. Funk as the third member.

## Conference of Presidents

The presidents of the Federal Reserve Banks are organized into the Conference of Presidents, which meets periodically to consider matters of common interest and to consult with and advise the Board of Governors.

Cathy E. Minehan, president of the Federal Reserve Bank of Boston, served as chair of the conference in 2005, and Anthony M. Santomero, president of the Federal Reserve Bank of Philadelphia, served as vice chair. Michael P. Malone, of the Federal Reserve Bank of Boston, served as secretary, and Herbert E. Taylor, of the Federal Reserve Bank of Philadelphia, served as assistant secretary.

## Conference of First Vice Presidents

The Conference of First Vice Presidents of the Federal Reserve Banks was organized in 1969 to meet periodically for the consideration of operations and other matters.

Walter A. Varvel, first vice president of the Federal Reserve Bank of Richmond, served as chair of the conference in 2005, and Helen E. Holcomb, first vice president of the Federal Reserve Bank of Dallas, served as vice chair. Janice E. Clatterbuck, of the Federal Reserve Bank of Richmond, served as secretary, and Harvey R. Mitchell, of the Federal Reserve Bank of Dallas, served as assistant secretary.

On September 20, 2005, the conference elected Helen E. Holcomb as chair for 2006–07 and James M. Lyon, first vice president of the Federal Reserve Bank of Minneapolis, as vice chair.

## Directors

Each Federal Reserve Bank has a nine-member board: three Class A and three Class B directors, who are elected by the stockholding member banks, and three Class C directors, who are appointed by the Board of Governors.

Class A directors represent the stockholding member banks in each Federal Reserve District. Class B and Class C directors represent the public and are chosen with due, but not exclusive, consideration to the interests of agriculture, commerce, industry, services, labor, and consumers; they may not be officers, directors, or employees of any bank or bank holding company. In addition, Class C directors may not be stockholders of any bank or bank holding company.

For the election of Class A and Class B directors, the member banks of each Federal Reserve District are classified into three groups. Each group, which comprises banks with similar capitalization, elects one Class A director and one Class B director. Annually, the Board of Governors designates one of the Class C directors as chair of the board and Federal Reserve agent of each District Bank, and it designates another Class C director as deputy chair.

Federal Reserve Branches have either five or seven directors, a majority of whom are appointed by the parent Federal Reserve Bank; the others are appointed by the Board of Governors. One of the directors appointed by the Board is designated annually as chair of the board of that Branch in a manner prescribed by the parent Federal Reserve Bank.

The chairs and deputy chairs of the Reserve Bank boards of directors, and the chairs of the Branches, are listed in the preceding table, titled "Officers." The directors of the Banks and Branches are listed in the following table. For each director, the class of directorship, the director's principal organizational affiliation, and the date the director's term expires is shown.

## Directors

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| | DISTRICT 1—BOSTON | |
| Reserve Bank | | |
| *Class A* | | |
| James R. Wood | President and Chief Executive Officer, The First National Bank of Suffield, Suffield, Connecticut | 2005 |
| Peter A. Blyberg | President and Chief Executive Officer, Union Trust Company, Ellsworth, Maine | 2006 |
| Ronald E. Logue | Chairman and Chief Executive Officer, State Street Corporation, Boston, Massachusetts | 2007 |
| *Class B* | | |
| Orit Gadiesh | Chairman, Bain & Company, Inc., Boston, Massachusetts | 2005 |
| Kirk P. Pond | President, Chief Executive Officer, and Chairman, Fairchild Semiconductor International, South Portland, Maine | 2006 |
| Robert K. Kraft | Chairman and Chief Executive Officer, The Kraft Group, Foxborough, Massachusetts | 2007 |
| *Class C* | | |
| Blenda J. Wilson | President and Chief Executive Officer, Nellie Mae Education Foundation, Quincy, Massachusetts | 2005 |
| Lisa M. Lynch | William L. Clayton Professor of International Economic Affairs, The Fletcher School of Law and Diplomacy, Tufts University, Medford, Massachusetts | 2006 |
| Samuel O. Thier, M.D. | Professor of Medicine and Professor of Health Care Policy, Harvard Medical School, Massachusetts General Hospital, Boston, Massachusetts | 2007 |
| | DISTRICT 2—NEW YORK | |
| Reserve Bank | | |
| *Class A* | | |
| Charles V. Wait | President, Chief Executive Officer, and Chairman, The Adirondack Trust Company, Saratoga Springs, New York | 2005 |
| Sanford I. Weill | Chairman, Citigroup Inc., New York, New York | 2006 |
| Jill M. Considine | Chairman and Chief Executive Officer, The Depository Trust Company, New York, New York | 2007 |
| *Class B* | | |
| Marta Tienda | Maurice P. During Professor of Demographic Studies, Princeton University, Princeton, New Jersey | 2005 |
| Denis M. Hughes | President, New York State AFL-CIO, New York, New York | 2006 |
| Richard S. Fuld, Jr. | Chairman and Chief Executive Officer, Lehman Brothers, New York, New York | 2007 |
| *Class C* | | |
| Loretta E. Lynch | Partner, Hogan & Hartson LLP, New York, New York | 2005 |
| Jerry I. Speyer | President and Chief Executive Officer, Tishman Speyer, New York, New York | 2006 |
| John E. Sexton | President, New York University, New York, New York | 2007 |

## Directors—Continued

| BANK OR BRANCH, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| BUFFALO BRANCH | | |
| *Appointed by the Federal Reserve Bank* | | |
| Geraldine C. Ochocinska | Regional Director, Region 9, UAW, Amherst, New York | 2005 |
| Maureen Torrey Marshall | Vice President, Torrey Farms, Inc., Elba, New York | 2006 |
| Peter G. Humphrey | Chairman, President, and Chief Executive Officer, Financial Institutions, Inc., Warsaw, New York | 2006 |
| Emerson L. Brumback | President and Chief Operating Officer, Manufacturers and Traders Trust Company, Buffalo, New York | 2007 |
| *Appointed by the Board of Governors* | | |
| Brian J. Lipke | Chairman and Chief Executive Officer, Gibraltar, Buffalo, New York | 2005 |
| Alphonso O'Neil-White | President and Chief Executive Officer, HealthNow New York Inc., Buffalo, New York | 2006 |
| Marguerite D. Hambleton | President and Chief Executive Officer, AAA Western and Central New York, Williamsville, New York | 2007 |
| | DISTRICT 3—PHILADELPHIA | |
| RESERVE BANK | | |
| *Class A* | | |
| Kenneth R. Shoemaker | President and Chief Executive Officer, Orrstown Bank, Shippensburg, Pennsylvania | 2005 |
| Eugene W. Rogers | Chief Executive Officer, Newfield National Bank, Newfield, New Jersey | 2006 |
| Wayne R. Weidner | Chairman, National Penn Bank, Boyertown, Pennsylvania | 2007 |
| *Class B* | | |
| Robert E. Chappell | Chairman and Chief Executive Officer, Penn Mutual Life Insurance Company, Horsham, Pennsylvania | 2005 |
| Garry L. Maddox | President and Chief Executive Officer, A. Pomerantz & Company, Philadelphia, Pennsylvania | 2006 |
| P. Coleman Townsend, Jr. | Chairman and Chief Executive Officer, Townsends, Inc., Wilmington, Delaware | 2007 |
| *Class C* | | |
| Ronald J. Naples | Chairman and Chief Executive Officer, Quaker Chemical Corporation, Conshohocken, Pennsylvania | 2005 |
| William F. Hecht | Chairman and Chief Executive Officer, PPL Corporation, Allentown, Pennsylvania | 2006 |
| Doris M. Damm | President and Chief Executive Officer, ACCU Staffing Services, Cherry Hill, New Jersey | 2007 |

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| | DISTRICT 4—CLEVELAND | |
| Reserve Bank | | |
| *Class A* | | |
| Bick Weissenrieder | Chairman of the Board and Chief Executive Officer, Hocking Valley Bank, Athens, Ohio | 2005 |
| Stephen P. Wilson | President and Chief Executive Officer, Lebanon Citizens National Bank, Lebanon, Ohio | 2006 |
| Henry L. Meyer III | Chairman of the Board and Chief Executive Officer, KeyCorp, Cleveland, Ohio | 2007 |
| *Class B* | | |
| Tanny B. Crane | President and Chief Executive Officer, Crane Group Company, Columbus, Ohio | 2005 |
| V. Ann Hailey | Executive Vice President and Chief Financial Officer, Limited Brands, Columbus, Ohio | 2006 |
| Les C. Vinney | President and Chief Executive Officer, STERIS Corporation, Mentor, Ohio | 2007 |
| *Class C* | | |
| Phillip R. Cox | President and Chief Executive Officer, Cox Financial Corporation, Cincinnati, Ohio | 2005 |
| Robert W. Mahoney | Retired Chairman and Chief Executive Officer, Diebold, Incorporated, North Canton, Ohio | 2006 |
| Charles E. Bunch | Chairman and Chief Executive Officer, PPG Industries, Inc., Pittsburgh, Pennsylvania | 2007 |
| Cincinnati Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| V. Daniel Radford | Executive Secretary-Treasurer, Cincinnati AFL-CIO Labor Council, Cincinnati, Ohio | 2005 |
| Glenn D. Leveridge | President, Lexington Market, JPMorgan Chase Bank, NA, Lexington, Kentucky | 2005 |
| Charlotte W. Martin | President and Chief Executive Officer, Great Lakes Bankers Bank, Gahanna, Ohio | 2006 |
| James H. Booth | President, Czar Coal Corporation, Lovely, Kentucky | 2007 |
| *Appointed by the Board of Governors* | | |
| James M. Anderson | President and Chief Executive Officer, Cincinnati Children's Hospital Medical Center, Cincinnati, Ohio | 2005 |
| Charles Whitehead | Retired President, Ashland Inc. Foundation, Covington, Kentucky | 2006 |
| Herbert R. Brown | Senior Vice President, Western and Southern Financial Group, Cincinnati, Ohio | 2007 |
| Pittsburgh Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Vacancy | | 2005 |
| Georgiana N. Riley | President and Chief Executive Officer, TIGG Corporation, Bridgeville, Pennsylvania | 2005 |

## Directors—Continued

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| Kristine N. Molnar | Executive Vice President, WesBanco Bank, Inc., Wheeling, West Virginia | 2006 |
| Michael J. Hagan | President and Chief Executive Officer, Iron and Glass Bank, Pittsburgh, Pennsylvania | 2007 |
| *Appointed by the Board of Governors* | | |
| Roy W. Haley | Chairman and Chief Executive Officer, WESCO International, Inc., Pittsburgh, Pennsylvania | 2005 |
| James I. Mitnick | Senior Vice President, Turner Construction Company, Pittsburgh, Pennsylvania | 2006 |
| Robert O. Agbede | President and Chief Executive Officer, ATS-Chester Engineers, Inc., Pittsburgh, Pennsylvania | 2007 |
| | DISTRICT 5—RICHMOND | |
| Reserve Bank | | |
| *Class A* | | |
| Barry J. Fitzpatrick | Chairman, Branch Banking & Trust Co. of Virginia, Falls Church, Virginia | 2005 |
| Ernest J. Sewell | Senior Advisor, FNB Southeast, Greensboro, North Carolina | 2006 |
| Kathleen Walsh Carr | President, Cardinal Bank Washington, Washington, D.C. | 2007 |
| *Class B* | | |
| W. Henry Harmon | President and Chief Executive Officer, Triana Energy, Inc., Charleston, West Virginia | 2005 |
| Kenneth R. Sparks | President and Chief Executive Officer, Ken Sparks Associates LLC, White Stone, Virginia | 2006 |
| Harry M. Lightsey, III | State President—South Carolina, BellSouth, Columbia, South Carolina | 2007 |
| *Class C* | | |
| Thomas J. Mackell, Jr. | Director, National Investment Managers, Inc., Warrenton, Virginia | 2005 |
| Lemuel E. Lewis | Executive Vice President and Chief Financial Officer, Landmark Communications, Inc., Norfolk, Virginia | 2006 |
| Theresa M. Stone | Chief Financial Officer, Jefferson-Pilot Corporation; President, Jefferson-Pilot Communications Company, Greensboro, North Carolina | 2007 |
| Baltimore Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Dyan Brasington | Director, Economic and Workforce Development, Towson University, Towson, Maryland | 2005 |
| Kenneth C. Lundeen | President, C. J. Langenfelder & Son, Inc., Baltimore, Maryland | 2006 |
| Michael L. Middleton | Chairman and President, Community Bank of Tri-County, Waldorf, Maryland | 2006 |

| BANK OR BRANCH, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| Donald P. Hutchinson | President and Chief Executive Officer, SunTrust Bank, Maryland, Baltimore, Maryland | 2007 |
| *Appointed by the Board of Governors* | | |
| Cynthia Collins Allner | Principal, Miles & Stockbridge P.C., Baltimore, Maryland | 2005 |
| William C. Handorf | Professor of Finance, George Washington University, Washington, D.C. | 2006 |
| William R. Roberts | President, Verizon Maryland Inc., Baltimore, Maryland | 2007 |
| CHARLOTTE BRANCH *Appointed by the Federal Reserve Bank* | | |
| Lucy J. Reuben | Visiting Fellow, Duke University, Durham, North Carolina | 2005 |
| Michael C. Miller | Chairman and President, FNB Corp. and First National Bank and Trust Company, Asheboro, North Carolina | 2006 |
| Donald K. Truslow | Chief Risk Officer, Wachovia Corporation, Charlotte, North Carolina | 2006 |
| Barry L. Slider | President and Chief Executive Officer, First South Bancorp, Inc., Spartanburg, South Carolina | 2007 |
| *Appointed by the Board of Governors* | | |
| Michael A. Almond | Counsel, Parker Poe Adams & Bernstein LLP, Charlotte, North Carolina | 2005 |
| Jim Lowry | Dealer Operator (Retired), Crown Automotive, High Point, North Carolina | 2006 |
| Anthony J. DiGiorgio | President, Winthrop University, Rock Hill, South Carolina | 2007 |
| | DISTRICT 6—ATLANTA | |
| RESERVE BANK *Class A* | | |
| Richard G. Hickson | Chairman and Chief Executive Officer, Trustmark Corporation, Jackson, Mississippi | 2005 |
| William G. Smith, Jr. | Chairman, President, and Chief Executive Officer, Capital City Bank Group, Inc., Tallahassee, Florida | 2006 |
| James F. Beall | Chairman, President, and Chief Executive Officer, Farmers & Merchants Bank, Centre, Alabama | 2007 |
| *Class B* | | |
| Egbert L.J. Perry | Chairman and Chief Executive Officer, The Integral Group, LLC, Atlanta, Georgia | 2005 |
| Teri G. Fontenot | President and Chief Executive Officer, Woman's Hospital, Baton Rouge, Louisiana | 2006 |
| Lee M. Thomas | President and Chief Operating Officer, Georgia-Pacific Corporation, Atlanta, Georgia | 2007 |

## Directors—Continued

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| *Class C* | | |
| V. Larkin Martin | Managing Partner, Martin Farm, Courtland, Alabama | 2005 |
| D. Scott Davis | Chief Financial Officer, United Parcel Service, Atlanta, Georgia | 2006 |
| David M. Ratcliffe | Chairman, President, and Chief Executive Officer, Southern Company, Atlanta, Georgia | 2007 |
| Birmingham Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| John H. Holcomb III | Chairman and Chief Executive Officer, Alabama National Bancorporation, Birmingham, Alabama | 2005 |
| Samuel F. Dodson | Business Manager, International Union of Operating Engineers—Local 312, Birmingham, Alabama | 2006 |
| Bobby A. Bradley | Managing Partner, Lewis Properties, LLC and Anderson Investments, LLC, Athens, Alabama | 2006 |
| John B. Barnett III | Monroeville Chairman and President, BankTrust, Monroeville, Alabama | 2007 |
| *Appointed by the Board of Governors* | | |
| James H. Sanford | Chairman of the Board, HOME Place Farms, Inc., Prattville, Alabama | 2005 |
| W. Miller Welborn | President, Welborn and Associates, Inc., Lookout Mountain, Tennessee | 2006 |
| Maryam B. Head | President, Ram Tool and Supply Company, Inc., Birmingham, Alabama | 2007 |
| Jacksonville Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Jerry M. Smith | Chairman of Alachua County Community Board, Capital City Bank, Alachua, Florida | 2005 |
| Robert L. Fisher | President and Chief Executive Officer, MacDill Federal Credit Union, Tampa, Florida | 2006 |
| Ellen S. Titen | President, E.T. Consultants, Winter Park, Florida | 2006 |
| Jack B. Healan, Jr. | President, Amelia Island Plantation Company, Amelia Island, Florida | 2007 |
| *Appointed by the Board of Governors* | | |
| Fassil Gabremariam | President and Founder, US–Africa Free Enterprise Education Foundation, Tampa, Florida | 2005 |
| Linda H. Sherrer | President and Chief Executive Officer, Prudential Network Realty, Jacksonville, Florida | 2006 |
| H. Britt Landrum, Jr. | President and Chief Executive Officer, AmStaff Human Resources, Inc., Pensacola, Florida | 2007 |

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| Miami Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Francis V. Gudorf | President/Executive Director, Jubilee Community Development Corporation, Miami, Florida | 2005 |
| Joseph C. Schwartzel | President, Meridian Broadcasting, Inc., Fort Myers, Florida | 2005 |
| Miriam Lopez | Chairman and Chief Executive Officer, TransAtlantic Bank, Miami, Florida | 2006 |
| Dennis S. Hudson III | Chairman and Chief Executive Officer, Seacoast Banking Corporation of Florida, Stuart, Florida | 2007 |
| *Appointed by the Board of Governors* | | |
| Edwin A. Jones, Jr. | President, Angus Investments, Inc., Port St. Lucie, Florida | 2005 |
| Brian E. Keeley | President and Chief Executive Officer, Baptist Health South Florida, Coral Gables, Florida | 2006 |
| Gay Rebel Thompson | President and Chief Executive Officer, Cement Industries, Inc., Fort Myers, Florida | 2007 |
| Nashville Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Michael B. Swain | Chairman, First National Bank, Oneida, Tennessee | 2005 |
| James W. Spradley, Jr. | President and Chief Executive Officer, Standard Candy Company, Inc., Nashville, Tennessee | 2006 |
| Daniel A. Gaudette | Senior Vice President, North American Manufacturing and Quality Assurance, Nissan North America, Inc., Smyrna, Tennessee | 2006 |
| Ed C. Loughry, Jr. | Chairman and Chief Executive Officer, Cavalry Banking, Murfreesboro, Tennessee | 2007 |
| *Appointed by the Board of Governors* | | |
| Beth Dortch Franklin | Chief Executive Officer, Star Transportation, Inc., Nashville, Tennessee | 2005 |
| David Williams II | Vice Chancellor and General Counsel, Vanderbilt University, Nashville, Tennessee | 2006 |
| Debra K. London | President and Chief Executive Officer, St. Mary's Health System, Knoxville, Tennessee | 2007 |
| New Orleans Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| C.R. Cloutier | President and Chief Executive Officer, MidSouth Bank, Lafayette, Louisiana | 2005 |
| Lawrence E. Kurzius | President, U.S. Consumer Foods, McCormick & Company, Incorporated, Baltimore, Maryland | 2006 |
| Christel C. Slaughter | Partner, SSA Consultants, LLC, Baton Rouge, Louisiana | 2006 |
| David E. Johnson | Chairman and Chief Executive Officer, The First Bancshares, Inc., and The First, A National Banking Association, Hattiesburg, Mississippi | 2007 |

## Directors—Continued

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| *Appointed by the Board of Governors* | | |
| Earl L. Shipp | Global Business Vice President for Oxides and Glycols, The Dow Chemical Company, Midland, Michigan | 2005 |
| Ben Tom Roberts | President, Roberts Brothers Commercial and Property Management, Inc., Realtors, Mobile, Alabama | 2006 |
| Dave Dennis | President and Chief Executive Officer, Specialty Contractors & Assoc., Inc., Gulfport, Mississippi | 2007 |
| | DISTRICT 7—CHICAGO | |
| Reserve Bank | | |
| *Class A* | | |
| William A. Osborn | Chairman and Chief Executive Officer, Northern Trust Corporation and The Northern Trust Company, Chicago, Illinois | 2005 |
| Michael L. Kubacki | Chairman, President, and Chief Executive Officer, Lakeland Financial Corporation, Warsaw, Indiana | 2006 |
| Jeff Plagge | President and Chief Executive Officer, The First National Bank of Waverly, Waverly, Iowa | 2007 |
| *Class B* | | |
| Connie E. Evans | President and Chief Executive Officer, WSEP Ventures, Chicago, Illinois | 2005 |
| Mark T. Gaffney | President, Michigan AFL-CIO, Lansing, Michigan | 2006 |
| Mindy C. Meads | Former President and Chief Executive Officer, Lands' End, Inc., Dodgeville, Wisconsin | 2007 |
| *Class C* | | |
| John A. Canning, Jr. | Chairman and Chief Executive Officer, Madison Dearborn Partners, Inc., Chicago, Illinois | 2005 |
| W. James Farrell | Chairman, Illinois Tool Works, Inc., Glenview, Illinois | 2006 |
| Miles D. White | Chairman and Chief Executive Officer, Abbott Laboratories, Abbott Park, Illinois | 2007 |
| Detroit Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Tommi A. White | Chief Operating Officer, Compuware Corporation, Detroit, Michigan | 2005 |
| Linda S. Likely | Director of Housing & Community Development, Kent County Community Development Department & Housing Commission, Grand Rapids, Michigan | 2005 |
| Ralph W. Babb, Jr. | Chairman, President, and Chief Executive Officer, Comerica Incorporated, Detroit, Michigan | 2006 |
| Michael M. Magee, Jr. | President and Chief Executive Officer, Independent Bank Corporation, Ionia, Michigan | 2007 |
| *Appointed by the Board of Governors* | | |
| Edsel B. Ford II | Board Director, Ford Motor Company, Dearborn, Michigan | 2005 |

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| Roger A. Cregg | Executive Vice President and Chief Financial Officer, Pulte Homes, Inc., Bloomfield Hills, Michigan | 2006 |
| Irvin D. Reid | President, Wayne State University, Detroit, Michigan | 2007 |
| | DISTRICT 8—ST. LOUIS | |
| Reserve Bank | | |
| *Class A* | | |
| Lunsford W. Bridges | President and Chief Executive Officer, Metropolitan National Bank, Little Rock, Arkansas | 2005 |
| David R. Pirsein | President and Chief Executive Officer, First National Bank in Pinckneyville, Pinckneyville, Illinois | 2006 |
| Lewis F. Mallory, Jr. | Chairman and Chief Executive Officer, NBC Capital Corporation, Starkville, Mississippi | 2007 |
| *Class B* | | |
| Vacancy | | 2005 |
| A. Rogers Yarnell, II | President, Yarnell Ice Cream Company, Inc., Searcy, Arkansas | 2006 |
| Paul T. Combs | President, Baker Implement Company, Kennett, Missouri | 2007 |
| *Class C* | | |
| Gayle P.W. Jackson | Managing Director, FondElec Clean Energy Group, Inc., St. Louis, Missouri | 2005 |
| Walter L. Metcalfe, Jr. | Partner, Bryan Cave LLP, St. Louis, Missouri | 2006 |
| Irl F. Engelhardt | Chairman and Chief Executive Officer, Peabody Energy, St. Louis, Missouri | 2007 |
| Little Rock Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| David R. Estes | President and Chief Executive Officer, First State Bank, Lonoke, Arkansas | 2005 |
| Robert A. Young III | Chairman, President, and Chief Executive Officer, Arkansas Best Corporation, Fort Smith, Arkansas | 2005 |
| Raymond E. Skelton | Retired Regional President, U.S. Bank, North Little Rock, Arkansas | 2006 |
| Sharon Priest | Executive Director, The Downtown Partnership, Little Rock, Arkansas | 2007 |
| *Appointed by the Board of Governors* | | |
| Stephen M. Erixon | Chief Executive Officer, Baxter Regional Medical Center, Mountain Home, Arkansas | 2005 |
| Scott T. Ford | President and Chief Executive Officer, ALLTEL Corporation, Little Rock, Arkansas | 2006 |
| Sonja Yates Hubbard | Chief Executive Officer, E-Z Mart Stores, Inc., Texarkana, Texas | 2007 |
| Louisville Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Marjorie Z. Soyugenc | Executive Director and Chief Executive Officer, Welborn Foundation, Evansville, Indiana | 2005 |

## Directors—Continued

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| L. Clark Taylor, Jr. | Chief Executive Officer, Ephraim McDowell Health, Danville, Kentucky | 2005 |
| Gordon B. Guess | Chairman, President, and Chief Executive Officer, The Peoples Bank, Marion, Kentucky | 2006 |
| Steven E. Trager | Chairman and Chief Executive Officer, Republic Bank & Trust Company, Louisville, Kentucky | 2007 |
| *Appointed by the Board of Governors* | | |
| John L. Huber | President and Chief Executive Officer, Louisville Water Company, Louisville, Kentucky | 2005 |
| Norman E. Pfau, Jr. | President and Chief Executive Officer, Geo. Pfau's Sons Company, Inc., Jeffersonville, Indiana | 2006 |
| Cornelius A. Martin | President and Chief Executive Officer, Martin Management Group, Bowling Green, Kentucky | 2007 |
| Memphis Branch *Appointed by the Federal Reserve Bank* | | |
| James A. England | Chairman, President, and Chief Executive Officer, Decatur County Bank, Decaturville, Tennessee | 2005 |
| Levon Mathews | President, Regions Bank, Memphis, Tennessee | 2005 |
| David P. Rumbarger, Jr. | President and Chief Executive Officer, Community Development Foundation, Tupelo, Mississippi | 2006 |
| Thomas G. Miller | President, Southern Hardware Company, Inc., West Helena, Arkansas | 2007 |
| *Appointed by the Board of Governors* | | |
| Meredith B. Allen | Vice President, Marketing, Staple Cotton Cooperative Association, Greenwood, Mississippi | 2005 |
| Russell Gwatney | President, Gwatney Companies, Memphis, Tennessee | 2006 |
| J.W. Gibson II | Owner and Chief Executive Officer, Gibson Companies, Memphis, Tennessee | 2007 |
| | DISTRICT 9—MINNEAPOLIS | |
| Reserve Bank *Class A* | | |
| Robert Dickson | Chairman and Chief Executive Officer, The First National Bank of Fairfax, Fairfax, Minnesota | 2005 |
| Douglas C. Morrison | Chief Financial Officer, Citibank (South Dakota) N.A., Sioux Falls, South Dakota | 2006 |
| John H. Hoeven, Jr. | Chairman, First Western Bank & Trust, Minot, North Dakota | 2007 |
| *Class B* | | |
| Randy Peterson | General Manager, Precision Edge Surgical Products Co., LLC, Sault Ste. Marie, Michigan | 2005 |
| D. Greg Heineman | Chairman, Williams Insurance Agency, Sioux Falls, South Dakota | 2006 |

| BANK OR BRANCH, *Category*<br>Name | Title | Term expires Dec. 31 |
|---|---|---|
| Todd L. Johnson | President and Chief Executive Officer, Reuben Johnson & Son, Inc. & Affiliated Companies, Superior, Wisconsin | 2007 |
| *Class C* | | |
| Linda Hall Whitman | Chief Operating Officer, MinuteClinic, Minneapolis, Minnesota | 2005 |
| James J. Hynes | Executive Administrator, Twin City Pipe Trades Service Association, St. Paul, Minnesota | 2006 |
| Frank L. Sims | Corporate Vice President, Transportation, Cargill, Inc., Wayzata, Minnesota | 2007 |
| HELENA BRANCH | | |
| *Appointed by the Federal Reserve Bank* | | |
| Ronald D. Scott | President and Chief Executive Officer, The First State Bank of Malta, Malta, Montana | 2005 |
| Marilyn F. Wessel | Former Dean and Director, Museum of the Rockies, Bozeman, Montana | 2006 |
| Joy N. Ott | Regional President and Chief Executive Officer, Wells Fargo Bank Montana, N.A., Billings, Montana | 2006 |
| *Appointed by the Board of Governors* | | |
| Lawrence R. Simkins | President, Washington Corporations, Missoula, Montana | 2005 |
| Dean Folkvord | President and Chief Executive Officer, Wheat Montana Farms and Bakery, Three Forks, Montana | 2006 |
| | DISTRICT 10—KANSAS CITY | |
| RESERVE BANK | | |
| *Class A* | | |
| Rick L. Smalley | Chief Executive Officer, Dickinson Financial Corporation, Kansas City, Missouri | 2005 |
| Mark W. Schifferdecker | President and Chief Executive Officer, Girard National Bank, Girard, Kansas | 2006 |
| Robert C. Fricke | President and Chief Executive Officer, Farmers & Merchants National Bank, Ashland, Nebraska | 2007 |
| *Class B* | | |
| Dan L. Dillingham | Chief Executive Officer, Dillingham Insurance, Enid, Oklahoma | 2005 |
| Kevin K. Nunnink | Chairman, Integra Realty Resources, Westwood, Kansas | 2006 |
| Frank Moore | President, Spearhead Ranch Company, Douglas, Wyoming | 2007 |
| *Class C* | | |
| Lu M. Cordova | Chief Executive Officer, Corlund Industries; Chairman, CTEK Angels, Boulder, Colorado | 2005 |
| Robert A. Funk | Chairman and Chief Executive Officer, Express Personnel Services International, Oklahoma City, Oklahoma | 2006 |

## Directors—Continued

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| Richard H. Bard | Chairman and Chief Executive Officer, International Surface Preparation Corporation, Golden, Colorado | 2007 |
| Denver Branch *Appointed by the Federal Reserve Bank* | | |
| Virginia K. Berkeley | President, CoBiz Bank, N.A., Denver, Colorado | 2005 |
| James A. Helzer | President and Chief Executive Officer, Unicover Corporation, Cheyenne, Wyoming | 2006 |
| John D. Pearson | Real Estate Broker/Owner, Pearson Real Estate Co., Inc., Buffalo, Wyoming | 2006 |
| Michael R. Stanford | President and Chief Executive Officer, First State Bancorporation, Albuquerque, New Mexico | 2007 |
| *Appointed by the Board of Governors* | | |
| Kathleen Avila | Managing Member, Avila Retail Development & Management, Albuquerque, New Mexico | 2005 |
| Thomas Williams | President and Chief Executive Officer, Williams Group LLC, Golden, Colorado | 2006 |
| Kristy A. Schloss | President and Chief Executive Officer, Schloss Engineered Equipment, Inc., Aurora, Colorado | 2007 |
| Oklahoma City Branch *Appointed by the Federal Reserve Bank* | | |
| Fred M. Ramos | President, Tulsa Hispanic Chamber of Commerce, Tulsa, Oklahoma | 2005 |
| Richard K. Ratcliffe | Chairman, Ratcliffe's Inc., Weatherford, Oklahoma | 2006 |
| Robert R. Gilbert, III | President and Chief Operating Officer, The F&M Bank & Trust Company, Tulsa, Oklahoma | 2007 |
| Terry M. Almon | President and Chief Executive Officer, Arkansas Valley State Bank, Broken Arrow, Oklahoma | 2007 |
| *Appointed by the Board of Governors* | | |
| Michael J. Packnett | President and Chief Executive Officer, Mercy Health System of Oklahoma, Inc., Oklahoma City, Oklahoma | 2005 |
| Tyree O. Minner | Plant Manager, General Motors Assembly Plant, Oklahoma City, Oklahoma | 2006 |
| J. Larry Nichols | Chairman and Chief Executive Officer, Devon Energy Corporation, Oklahoma City, Oklahoma | 2007 |
| Omaha Branch *Appointed by the Federal Reserve Bank* | | |
| Judith A. Owen | Retired President and Chief Executive Officer, Wells Fargo Bank, Nebraska, Omaha, Nebraska | 2005 |
| Rodrigo Lopez | President and Chief Executive Officer, AmeriSphere Multifamily Finance, LLC, Omaha, Nebraska | 2006 |

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| Michael J. Nelson | Chairman, FirsTier Bank, Kimball, Nebraska | 2006 |
| Cynthia Hardin Milligan | Dean—College of Business Administration, University of Nebraska-Lincoln, Lincoln, Nebraska | 2007 |
| *Appointed by the Board of Governors* | | |
| James A. Timmerman | Chief Financial Officer and Secretary/Treasurer, Timmerman and Sons Feeding Company, Springfield, Nebraska | 2005 |
| Charles R. Hermes | President, Dutton-Lainson Company, Hastings, Nebraska | 2006 |
| Terry L. Moore | President, Omaha Federation of Labor, Omaha, Nebraska | 2007 |
| | DISTRICT 11—DALLAS | |
| Reserve Bank | | |
| *Class A* | | |
| Richard W. Evans, Jr. | Chairman and Chief Executive Officer, Cullen/Frost Bankers, Inc., San Antonio, Texas | 2005 |
| Matthew T. Doyle | Vice Chairman and Chief Executive Officer, Texas First Bank, Texas City, Texas | 2006 |
| David S. Barnard | Chairman and Chief Executive Officer, National Banks of Central Texas, Gatesville, Texas | 2007 |
| *Class B* | | |
| Malcolm Gillis | University Professor and Zingler Professor of Economics, Rice University, Houston, Texas | 2005 |
| Judy Ley Allen | Partner, Allen Investments, Houston, Texas | 2006 |
| Robert A. Estrada | Chairman and Chief Executive Officer, Estrada Hinojosa & Company, Inc., Dallas, Texas | 2007 |
| *Class C* | | |
| Patricia M. Patterson | President, Patterson Investments, Inc., Dallas, Texas | 2005 |
| Anthony R. Chase | Chairman and Chief Executive Officer, ChaseCom, LP, Houston, Texas | 2006 |
| Ray L. Hunt | Chairman, President, and Chief Executive Officer, Hunt Consolidated, Inc., Dallas, Texas | 2007 |
| El Paso Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Pete Cook | President and Chief Executive Officer, First National Bank of Alamogordo, Alamogordo, New Mexico | 2005 |
| Fred J. Loya | Chairman, Fred Loya Insurance, El Paso, Texas | 2005 |
| Gerald J. Rubin | Chairman, President, and Chief Executive Officer, Helen of Troy Limited, El Paso, Texas | 2006 |
| F. James Volk | Regional President, State National Bank, El Paso, Texas | 2007 |
| *Appointed by the Board of Governors* | | |
| Ron C. Helm | Owner, Helm Land and Cattle Company, Van Horn, Texas | 2005 |
| William V. Flores | Provost, New Mexico State University, Las Cruces, New Mexico | 2006 |

## Directors—Continued

| Bank or Branch, *Category*<br>Name | Title | Term expires Dec. 31 |
|---|---|---|
| Cecilia Ochoa Levine | President, MFI International Mfg., LLC, El Paso, Texas | 2007 |
| Houston Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Priscilla D. Slade | President, Texas Southern University, Houston, Texas | 2005 |
| S. Reed Morian | Chairman, President, and Chief Executive Officer, DX Service Company, Inc., Houston, Texas | 2005 |
| Timothy N. Bryan | Chairman and Chief Executive Officer, The First National Bank of Bryan, Bryan, Texas | 2006 |
| Jodie L. Jiles | Senior Vice President, First Albany Capital, Inc., Houston, Texas | 2007 |
| *Appointed by the Board of Governors* | | |
| Lupe Fraga | Chairman and Chief Executive Officer, Tejas Office Products, Inc., Houston, Texas | 2005 |
| Nancy T. Chang | President and Chief Executive Officer, Tanox, Inc., Houston, Texas | 2006 |
| James T. Hackett | President and Chief Executive Officer, Anadarko Petroleum Corporation, Houston, Texas | 2007 |
| San Antonio Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Matt F. Gorges | Chairman and Chief Executive Officer, Valley International Cold Storage, Inc., Harlingen, Texas | 2005 |
| Daniel B. Hastings, Jr. | President and Owner, Daniel B. Hastings, Inc., Laredo, Texas | 2005 |
| Steven R. Vandegrift | Founder and President, SRV Holdings, Austin, Texas | 2006 |
| James D. Goudge | Chairman & Chief Executive Officer, Broadway National Bank, San Antonio, Texas | 2007 |
| *Appointed by the Board of Governors* | | |
| Elizabeth Chu Richter | Chairman and Chief Executive Officer, Richter Architects, Corpus Christi, Texas | 2005 |
| J. Dan Bates | President, Southwest Research Institute, San Antonio, Texas | 2006 |
| Ricardo Romo | President, The University of Texas at San Antonio, San Antonio, Texas | 2007 |
| | DISTRICT 12—SAN FRANCISCO | |
| Reserve Bank | | |
| *Class A* | | |
| Candace Hunter Wiest | President, Inland Empire National Bank, Riverside, California | 2005 |
| Vacancy | | 2006 |
| Richard W. Decker, Jr. | Chairman and Co-Founder, Belvedere Capital Partners, LLC, San Francisco, California | 2007 |

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| *Class B* | | |
| Karla S. Chambers | Vice President, Stahlbush Island Farms, Inc., Corvallis, Oregon | 2005 |
| Barbara L. Wilson | Consultant; and Regional Vice President (Retired), Qwest Communications, Boise, Idaho | 2006 |
| Jack McNally | Principal, JKM Consulting, Sacramento, California | 2007 |
| *Class C* | | |
| George M. Scalise | President, Semiconductor Industry Association, San Jose, California | 2005 |
| T. Gary Rogers | Chairman and Chief Executive Officer, Dreyer's Grand Ice Cream, Inc., Oakland, California | 2006 |
| David K.Y. Tang | Partner, Preston Gates & Ellis LLP, Seattle, Washington | 2007 |
| Los Angeles Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Peter M. Thomas | Managing Partner, Thomas & Mack Company, Las Vegas, Nevada | 2005 |
| D. Linn Wiley | President and Chief Executive Officer, Citizens Business Bank, Ontario, California | 2006 |
| Karen B. Caplan | President and Chief Executive Officer, Frieda's, Inc., Los Alamitos, California | 2006 |
| Dominic Ng | Chairman, President, and Chief Executive Officer, East West Bank, San Marino, California | 2007 |
| *Appointed by the Board of Governors* | | |
| Diane Donoghue | Executive Director, Esperanza Community Housing Corporation, Los Angeles, California | 2005 |
| Anita Santiago | President, Anita Santiago Advertising, Santa Monica, California | 2006 |
| James L. Sanford | Corporate Vice President and Treasurer, Northrop Grumman Corporation, Los Angeles, California | 2007 |
| Portland Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| William D. Thorndike, Jr. | President, Medford Fabrication, Medford, Oregon | 2005 |
| George J. Puentes | President, Don Pancho Authentic Mexican Foods, Inc., Salem, Oregon | 2005 |
| Robert D. Sznewajs | President and Chief Executive Officer, West Coast Bancorp, Lake Oswego, Oregon | 2006 |
| Alan V. Johnson | Regional President for Oregon and Southwest Washington, Wells Fargo Bank, Portland, Oregon | 2007 |
| *Appointed by the Board of Governors* | | |
| Peter O. Kohler | President, Oregon Health & Science University, Portland, Oregon | 2005 |
| Vacancy | | 2006 |

## Directors—Continued

| Bank or Branch, *Category* Name | Title | Term expires Dec. 31 |
|---|---|---|
| James H. Rudd | Chief Executive Officer and Principal, Ferguson Wellman Capital Management, Inc., Portland, Oregon | 2007 |
| Salt Lake City Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| A. Scott Anderson | President and Chief Executive Officer, Zions Bank, Salt Lake City, Utah | 2005 |
| Deborah Bayle Nielsen | President and Chief Executive Officer, United Way of Salt Lake, Salt Lake City, Utah | 2005 |
| Annette K. Herman | Vice President, Strategic Initiatives Uniprise, UnitedHealth Group, Salt Lake City, Utah | 2006 |
| Michael M. Mooney | President and Chief Executive Officer, Farmers & Merchants State Bank, Boise, Idaho | 2007 |
| *Appointed by the Board of Governors* | | |
| H. Roger Boyer | Chairman, The Boyer Company, Salt Lake City, Utah | 2005 |
| William C. Glynn | President, Intermountain Industries, Inc., Boise, Idaho | 2006 |
| Gary L. Crocker | Chairman of the Board, Merrimack Pharmaceuticals, Salt Lake City, Utah | 2007 |
| Seattle Branch | | |
| *Appointed by the Federal Reserve Bank* | | |
| Mary E. Pugh | President, Pugh Capital Management, Inc., Seattle, Washington | 2005 |
| Kenneth M. Kirkpatrick | President, Washington State, U.S. Bank, Seattle, Washington | 2005 |
| Helvi K. Sandvik | President, NANA Development Corp., Anchorage, Alaska | 2006 |
| Blake W. Nordstrom | President, Nordstrom, Inc., Seattle, Washington | 2007 |
| *Appointed by the Board of Governors* | | |
| James R. Gill | President, Pacific Northwest Title Holding Co., Seattle, Washington | 2005 |
| David W. Wyckoff | Chairman and Chief Executive Officer, Wyckoff Farms, Inc., Grandview, Washington | 2006 |
| Mic R. Dinsmore | Chief Executive Officer, Port of Seattle, Seattle, Washington | 2007 |

# *Members of the Board of Governors, 1913–2005*

## Appointed Members

| Name | Federal Reserve District | Date initially took oath of office | Other dates[1] |
|---|---|---|---|
| Charles S. Hamlin | Boston | Aug. 10, 1914 | Reappointed in 1916 and 1926. Served until Feb. 3, 1936.[2] |
| Paul M. Warburg | New York | Aug. 10, 1914 | Term expired Aug. 9, 1918. |
| Frederic A. Delano | Chicago | Aug. 10, 1914 | Resigned July 21, 1918. |
| W.P.G. Harding | Atlanta | Aug. 10, 1914 | Term expired Aug. 9, 1922. |
| Adolph C. Miller | San Francisco | Aug. 10, 1914 | Reappointed in 1924. Reappointed in 1934 from the Richmond District. Served until Feb. 3, 1936.[2] |
| Albert Strauss | New York | Oct. 26, 1918 | Resigned Mar. 15, 1920. |
| Henry A. Moehlenpah | Chicago | Nov. 10, 1919 | Term expired Aug. 9, 1920. |
| Edmund Platt | New York | June 8, 1920 | Reappointed in 1928. Resigned Sept. 14, 1930. |
| David C. Wills | Cleveland | Sept. 29, 1920 | Term expired Mar. 4, 1921. |
| John R. Mitchell | Minneapolis | May 12, 1921 | Resigned May 12, 1923. |
| Milo D. Campbell | Chicago | Mar. 14, 1923 | Died Mar. 22, 1923. |
| Daniel R. Crissinger | Cleveland | May 1, 1923 | Resigned Sept. 15, 1927. |
| George R. James | St. Louis | May 14, 1923 | Reappointed in 1931. Served until Feb. 3, 1936.[3] |
| Edward H. Cunningham | Chicago | May 14, 1923 | Died Nov. 28, 1930. |
| Roy A. Young | Minneapolis | Oct. 4, 1927 | Resigned Aug. 31, 1930. |
| Eugene Meyer | New York | Sept. 16, 1930 | Resigned May 10, 1933. |
| Wayland W. Magee | Kansas City | May 18, 1931 | Term expired Jan. 24, 1933. |
| Eugene R. Black | Atlanta | May 19, 1933 | Resigned Aug. 15, 1934. |
| M.S. Szymczak | Chicago | June 14, 1933 | Reappointed in 1936 and 1948. Resigned May 31, 1961. |
| J.J. Thomas | Kansas City | June 14, 1933 | Served until Feb. 10, 1936.[2] |
| Marriner S. Eccles | San Francisco | Nov. 15, 1934 | Reappointed in 1936, 1940, and 1944. Resigned July 14, 1951. |
| Joseph A. Broderick | New York | Feb. 3, 1936 | Resigned Sept. 30, 1937. |
| John K. McKee | Cleveland | Feb. 3, 1936 | Served until Apr. 4, 1946.[2] |
| Ronald Ransom | Atlanta | Feb. 3, 1936 | Reappointed in 1942. Died Dec. 2, 1947. |
| Ralph W. Morrison | Dallas | Feb. 10, 1936 | Resigned July 9, 1936. |
| Chester C. Davis | Richmond | June 25, 1936 | Reappointed in 1940. Resigned Apr. 15, 1941. |
| Ernest G. Draper | New York | Mar. 30, 1938 | Served until Sept. 1, 1950.[2] |
| Rudolph M. Evans | Richmond | Mar. 14, 1942 | Served until Aug. 13, 1954.[2] |
| James K. Vardaman, Jr. | St. Louis | Apr. 4, 1946 | Resigned Nov. 30, 1958. |
| Lawrence Clayton | Boston | Feb. 14, 1947 | Died Dec. 4, 1949. |
| Thomas B. McCabe | Philadelphia | Apr. 15, 1948 | Resigned Mar. 31, 1951. |
| Edward L. Norton | Atlanta | Sept. 1, 1950 | Resigned Jan. 31, 1952. |
| Oliver S. Powell | Minneapolis | Sept. 1, 1950 | Resigned June 30, 1952. |
| Wm. McC. Martin, Jr. | New York | April 2, 1951 | Reappointed in 1956. Term expired Jan. 31, 1970. |
| A.L. Mills, Jr. | San Francisco | Feb. 18, 1952 | Reappointed in 1958. Resigned Feb. 28, 1965. |
| J.L. Robertson | Kansas City | Feb. 18, 1952 | Reappointed in 1964. Resigned Apr. 30, 1973. |
| C. Canby Balderston | Philadelphia | Aug. 12, 1954 | Served through Feb. 28, 1966. |
| Paul E. Miller | Minneapolis | Aug. 13, 1954 | Died Oct. 21, 1954. |

## Appointed Members—Continued

| Name | Federal Reserve District | Date initially took oath of office | Other dates[1] |
|---|---|---|---|
| Chas. N. Shepardson | Dallas | Mar. 17, 1955 | Retired Apr. 30, 1967. |
| G.H. King, Jr. | Atlanta | Mar. 25, 1959 | Reappointed in 1960. Resigned Sept. 18, 1963. |
| George W. Mitchell | Chicago | Aug. 31, 1961 | Reappointed in 1962. Served until Feb. 13, 1976.[2] |
| J. Dewey Daane | Richmond | Nov. 29, 1963 | Served until Mar. 8, 1974.[2] |
| Sherman J. Maisel | San Francisco | Apr. 30, 1965 | Served through May 31, 1972. |
| Andrew F. Brimmer | Philadelphia | Mar. 9, 1966 | Resigned Aug. 31, 1974. |
| William W. Sherrill | Dallas | May 1, 1967 | Reappointed in 1968. Resigned Nov. 15, 1971. |
| Arthur F. Burns | New York | Jan. 31, 1970 | Term began Feb. 1, 1970. Resigned Mar. 31, 1978. |
| John E. Sheehan | St. Louis | Jan. 4, 1972 | Resigned June 1, 1975. |
| Jeffrey M. Bucher | San Francisco | June 5, 1972 | Resigned Jan. 2, 1976. |
| Robert C. Holland | Kansas City | June 11, 1973 | Resigned May 15, 1976. |
| Henry C. Wallich | Boston | Mar. 8, 1974 | Resigned Dec. 15, 1986. |
| Philip E. Coldwell | Dallas | Oct. 29, 1974 | Served through Feb. 29, 1980. |
| Philip C. Jackson, Jr. | Atlanta | July 14, 1975 | Resigned Nov. 17, 1978. |
| J. Charles Partee | Richmond | Jan. 5, 1976 | Served until Feb. 7, 1986.[2] |
| Stephen S. Gardner | Philadelphia | Feb. 13, 1976 | Died Nov. 19, 1978. |
| David M. Lilly | Minneapolis | June 1, 1976 | Resigned Feb. 24, 1978. |
| G. William Miller | San Francisco | Mar. 8, 1978 | Resigned Aug. 6, 1979. |
| Nancy H. Teeters | Chicago | Sept. 18, 1978 | Served through June 27, 1984. |
| Emmett J. Rice | New York | June 20, 1979 | Resigned Dec. 31, 1986. |
| Frederick H. Schultz | Atlanta | July 27, 1979 | Served through Feb. 11, 1982. |
| Paul A. Volcker | Philadelphia | Aug. 6, 1979 | Resigned August 11, 1987. |
| Lyle E. Gramley | Kansas City | May 28, 1980 | Resigned Sept. 1, 1985. |
| Preston Martin | San Francisco | Mar. 31, 1982 | Resigned April 30, 1986. |
| Martha R. Seger | Chicago | July 2, 1984 | Resigned March 11, 1991. |
| Wayne D. Angell | Kansas City | Feb. 7, 1986 | Served through Feb. 9, 1994. |
| Manuel H. Johnson | Richmond | Feb. 7, 1986 | Resigned August 3, 1990. |
| H. Robert Heller | San Francisco | Aug. 19, 1986 | Resigned July 31, 1989. |
| Edward W. Kelley, Jr. | Dallas | May 26, 1987 | Resigned Dec. 31, 2001. |
| Alan Greenspan | New York | Aug. 11, 1987 | Reappointed in 1992. |
| John P. LaWare | Boston | Aug. 15, 1988 | Resigned April 30, 1995. |
| David W. Mullins, Jr. | St. Louis | May 21, 1990 | Resigned Feb. 14, 1994. |
| Lawrence B. Lindsey | Richmond | Nov. 26, 1991 | Resigned Feb. 5, 1997. |
| Susan M. Phillips | Chicago | Dec. 2, 1991 | Served through June 30, 1998. |
| Alan S. Blinder | Philadelphia | June 27, 1994 | Term expired Jan. 31, 1996. |
| Janet L. Yellen | San Francisco | Aug. 12, 1994 | Resigned Feb. 17, 1997. |
| Laurence H. Meyer | St. Louis | June 24, 1996 | Term expired Jan. 31, 2002. |
| Alice M. Rivlin | Philadelphia | June 25, 1996 | Resigned July 16, 1999. |
| Roger W. Ferguson, Jr. | Boston | Nov. 5, 1997 | Reappointed in 2001. |
| Edward M. Gramlich | Richmond | Nov. 5, 1997 | Resigned August 31, 2005. |
| Susan S. Bies | Chicago | Dec. 7, 2001 | |
| Mark W. Olson | Minneapolis | Dec. 7, 2001 | |
| Ben S. Bernanke | Atlanta | Aug. 5, 2002 | Resigned June 21, 2005. |
| Donald L. Kohn | Kansas City | Aug. 5, 2002 | |

## Appointed Members—Continued

| Name | Term |
|---|---|
| *Chairmen* [3] | |
| Charles S. Hamlin | Aug. 10, 1914–Aug. 9, 1916 |
| W.P.G. Harding | Aug. 10, 1916–Aug. 9, 1922 |
| Daniel R. Crissinger | May 1, 1923–Sept. 15, 1927 |
| Roy A. Young | Oct. 4, 1927–Aug. 31, 1930 |
| Eugene Meyer | Sept. 16, 1930–May 10, 1933 |
| Eugene R. Black | May 19, 1933–Aug. 15, 1934 |
| Marriner S. Eccles | Nov. 15, 1934–Jan. 31, 1948 [4] |
| Thomas B. McCabe | Apr. 15, 1948–Mar. 31, 1951 |
| Wm. McC. Martin, Jr. | Apr. 2, 1951–Jan. 31, 1970 |
| Arthur F. Burns | Feb. 1, 1970–Jan. 31, 1978 |
| G. William Miller | Mar. 8, 1978–Aug. 6, 1979 |
| Paul A. Volcker | Aug. 6, 1979–Aug. 11, 1987 |
| Alan Greenspan | Aug. 11, 1987– [5] |
| *Vice Chairmen* [3] | |
| Frederic A. Delano | Aug. 10, 1914–Aug. 9, 1916 |
| Paul M. Warburg | Aug. 10, 1916–Aug. 9, 1918 |
| Albert Strauss | Oct. 26, 1918–Mar. 15, 1920 |
| Edmund Platt | July 23, 1920–Sept. 14, 1930 |
| J.J. Thomas | Aug. 21, 1934–Feb. 10, 1936 |
| Ronald Ransom | Aug. 6, 1936–Dec. 2, 1947 |
| C. Canby Balderston | Mar. 11, 1955–Feb. 28, 1966 |
| J.L. Robertson | Mar. 1, 1966–Apr. 30, 1973 |
| George W. Mitchell | May 1, 1973–Feb. 13, 1976 |
| Stephen S. Gardner | Feb. 13, 1976–Nov. 19, 1978 |
| Frederick H. Schultz | July 27, 1979–Feb. 11, 1982 |
| Preston Martin | Mar. 31, 1982–Apr. 30, 1986 |
| Manuel H. Johnson | Aug. 4, 1986–Aug. 3, 1990 |
| David W. Mullins, Jr. | July 24, 1991–Feb. 14, 1994 |
| Alan S. Blinder | June 27, 1994–Jan. 31, 1996 |
| Alice M. Rivlin | June 25, 1996–July 16, 1999 |
| Roger W. Ferguson, Jr. | Oct. 5, 1999– |

NOTE. Under the original Federal Reserve Act, the Federal Reserve Board was composed of five appointed members, the Secretary of the Treasury (ex officio chairman of the Board), and the Comptroller of the Currency. The original term of office was ten years; the five original appointed members had terms of two, four, six, eight, and ten years. In 1922 the number of appointed members was increased to six, and in 1933 the term of office was raised to twelve years. The Banking Act of 1935 changed the name to the Board of Governors of the Federal Reserve System and provided that the Board be composed of seven appointed members; that the Secretary of the Treasury and the Comptroller of the Currency continue to serve until Feb. 1, 1936; that the appointed members in office on Aug. 23, 1935, continue to serve until Feb. 1, 1936, or until their successors were appointed and had qualified; and that thereafter the terms of members be fourteen years and that the designation of Chairman and Vice Chairman of the Board be for four years.

1. Date following “Resigned” and “Retired” denotes final day of service.
2. Successor took office on this date.
3. Before Aug. 23, 1935, Chairmen and Vice Chairmen were designated Governor and Vice Governor.
4. Served as Chairman Pro Tempore from February 3, 1948, to April 15, 1948.
5. Served as Chairman Pro Tempore from March 3, 1996, to June 20, 1996.

## Ex Officio Members

| Name | Term |
|---|---|
| *Secretaries of the Treasury* | |
| W.G. McAdoo | Dec. 23, 1913–Dec. 15, 1918 |
| Carter Glass | Dec. 16, 1918–Feb. 1, 1920 |
| David F. Houston | Feb. 2, 1920–Mar. 3, 1921 |
| Andrew W. Mellon | Mar. 4, 1921–Feb. 12, 1932 |
| Ogden L. Mills | Feb. 12, 1932–Mar. 4, 1933 |
| William H. Woodin | Mar. 4, 1933–Dec. 31, 1933 |
| Henry Morgenthau, Jr. | Jan. 1, 1934–Feb. 1, 1936 |
| *Comptrollers of the Currency* | |
| John Skelton Williams | Feb. 2, 1914–Mar. 2, 1921 |
| Daniel R. Crissinger | Mar. 17, 1921–Apr. 30, 1923 |
| Henry M. Dawes | May 1, 1923–Dec. 17, 1924 |
| Joseph W. McIntosh | Dec. 20, 1924–Nov. 20, 1928 |
| J.W. Pole | Nov. 21, 1928–Sept. 20, 1932 |
| J.F.T. O'Connor | May 11, 1933–Feb. 1, 1936 |

# *Statistical Tables*

## 1. Federal Reserve Open Market Transactions, 2005

Millions of dollars

| Type of security and transaction | Jan. | Feb. | Mar. | Apr. |
|---|---|---|---|---|
| U.S. Treasury Securities[1] | | | | |
| *Outright transactions*[2] | | | | |
| Treasury bills | | | | |
| Gross purchases | 0 | 35 | 0 | 0 |
| Gross sales | 0 | 0 | 0 | 0 |
| Exchanges | 62,448 | 66,741 | 78,822 | 63,637 |
| For new bills | 62,448 | 66,741 | 78,822 | 63,637 |
| Redemptions | 0 | 0 | 0 | 0 |
| Others within 1 year | | | | |
| Gross purchases | 0 | 0 | 0 | 0 |
| Gross sales | 0 | 0 | 0 | 0 |
| Maturity shifts | 6,928 | 2,989 | 8,334 | 0 |
| Exchanges | –8,000 | –12,710 | –8,000 | 0 |
| Redemptions | 0 | 333 | 211 | 0 |
| 1 to 5 years | | | | |
| Gross purchases | 0 | 0 | 0 | 1,200 |
| Gross sales | 0 | 0 | 0 | 0 |
| Maturity shifts | –6,928 | 3,180 | –8,334 | 0 |
| Exchanges | 5,000 | 11,498 | 8,000 | 0 |
| 5 to 10 years | | | | |
| Gross purchases | 0 | 0 | 0 | 470 |
| Gross sales | 0 | 0 | 0 | 0 |
| Maturity shifts | 0 | –3,112 | 0 | 0 |
| Exchanges | 0 | 1,212 | 0 | 0 |
| More than 10 years | | | | |
| Gross purchases | 0 | 0 | 0 | 230 |
| Gross sales | 0 | 0 | 0 | 0 |
| Maturity shifts | 0 | –3,058 | 0 | 0 |
| Exchanges | 3,000 | 0 | 0 | 0 |
| All maturities | | | | |
| Gross purchases | 0 | 35 | 0 | 1,900 |
| Gross sales | 0 | 0 | 0 | 0 |
| Redemptions | 0 | 333 | 211 | 0 |
| Net change in U.S. Treasury securities | 0 | –298 | –211 | 1,900 |

For notes see end of table.

1.—Continued

| May | June | July | Aug. | Sept. | Oct. | Nov. | Dec. | Total |
|---|---|---|---|---|---|---|---|---|
| 1,760 | 250 | 0 | 2,751 | 1,992 | 1,023 | 489 | 0 | 8,300 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 70,894 | 91,408 | 68,438 | 66,899 | 87,522 | 68,397 | 65,570 | 80,886 | 871,661 |
| 70,894 | 91,408 | 68,438 | 66,899 | 87,522 | 68,397 | 65,570 | 80,886 | 871,661 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 0 | 0 | 0 | 1,298 | 0 | 500 | 1,096 | 0 | 2,894 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 23,149 | 7,997 | 0 | 26,261 | 7,999 | 11,700 | 14,200 | 0 | 109,557 |
| −26,036 | −6,667 | 0 | −18,253 | −6,585 | −6,551 | −15,297 | 0 | −108,098 |
| 0 | 1,305 | 0 | 757 | 0 | 0 | 189 | 0 | 2,795 |
| 2,295 | 0 | 0 | 1,390 | 3,635 | 1,693 | 1,096 | 0 | 11,309 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| −19,402 | −7,997 | 0 | −20,702 | −7,999 | −11,700 | −11,240 | 0 | −91,121 |
| 23,565 | 6,667 | 0 | 16,781 | 6,585 | 6,551 | 13,077 | 0 | 97,723 |
| 898 | 340 | 0 | 988 | 130 | 0 | 800 | 0 | 3,626 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| −1,277 | 0 | 0 | −2,919 | 0 | 0 | 266 | 0 | −7,041 |
| 2,471 | 0 | 0 | 1,472 | 0 | 0 | 2,221 | 0 | 7,375 |
| 0 | 785 | 0 | 0 | 90 | 902 | 0 | 0 | 2,007 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| −2,471 | 0 | 0 | −2,640 | 0 | 0 | −3,227 | 0 | −11,395 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 3,000 |
| 4,953 | 1,375 | 0 | 6,427 | 5,847 | 4,118 | 3,481 | 0 | 28,136 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 0 | 1,305 | 0 | 757 | 0 | 0 | 189 | 0 | 2,795 |
| 4,953 | 70 | 0 | 5,670 | 5,847 | 4,118 | 3,292 | 0 | 25,341 |

## 1. Federal Reserve Open Market Transactions, 2005—Continued

Millions of dollars

| Type of security and transaction | Jan. | Feb. | Mar. | Apr. |
|---|---|---|---|---|
| FEDERAL AGENCY OBLIGATIONS | | | | |
| *Outright transactions* [2] | | | | |
| Gross purchases | 0 | 0 | 0 | 0 |
| Gross sales | 0 | 0 | 0 | 0 |
| Redemptions | 0 | 0 | 0 | 0 |
| Net change in federal agency obligations | 0 | 0 | 0 | 0 |
| TEMPORARY TRANSACTIONS | | | | |
| *Repurchase agreements* [3] | | | | |
| Gross purchases | 148,500 | 125,250 | 201,500 | 163,500 |
| Gross sales | 152,750 | 120,250 | 204,250 | 167,000 |
| *Reverse repurchase agreements* [4] | | | | |
| Gross purchases | 563,559 | 490,482 | 581,322 | 505,211 |
| Gross sales | 559,501 | 488,781 | 580,402 | 507,649 |
| Net change in temporary transactions | −193 | 6,700 | −1,831 | −5,938 |
| **Total net change in System Open Market Account** | **−193** | **6,402** | **−2,041** | **−4,038** |

NOTE. Sales, redemptions, and negative figures reduce holdings of the System Open Market Account; all other figures increase such holdings. Components may not sum to totals because of rounding.

1. Transactions exclude changes in compensation for the effects of inflation on the principal of inflation-indexed securities. Transactions include the rollover of inflation compensation into new securities.

2. Excludes the effect of temporary transactions—repurchase agreements, matched sale–purchase agreements (MSPs), and reverse repurchase agreements (RRPs).

3. Cash value of agreements, which are collateralized by U.S. government and federal agency securities.

4. Cash value of agreements, which are collateralized by U.S. Treasury securities.

1.—Continued

| May | June | July | Aug. | Sept. | Oct. | Nov. | Dec. | Total |
|---|---|---|---|---|---|---|---|---|
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 186,250 | 173,250 | 201,750 | 200,750 | 187,300 | 145,250 | 140,750 | 223,000 | 2,097,050 |
| 179,000 | 173,500 | 200,750 | 200,750 | 197,050 | 147,000 | 129,500 | 211,500 | 2,083,300 |
| 547,538 | 526,972 | 531,351 | 555,779 | 523,085 | 509,449 | 505,101 | 584,950 | 6,424,797 |
| 546,380 | 527,769 | 532,647 | 554,786 | 523,518 | 508,709 | 508,976 | 585,400 | 6,424,519 |
| 8,408 | −1,047 | –297 | 993 | −10,183 | −1,010 | 7,375 | 11,050 | 14,028 |
| **13,361** | **–977** | **–297** | **6,662** | **–4,336** | **3,108** | **10,667** | **11,050** | **39,369** |

## 2. Federal Reserve Bank Holdings of U.S. Treasury and Federal Agency Securities, December 31, 2003–2005

Millions of dollars

| Description | December 31 | | | Change | |
|---|---|---|---|---|---|
| | 2005 | 2004 | 2003 | 2004 to 2005 | 2003 to 2004 |
| U.S. Treasury Securities | | | | | |
| **Held outright**[1] | **744,215** | **717,816** | **666,665** | **26,399** | **51,151** |
| *By remaining maturity* | | | | | |
| Bills | | | | | |
| 1–90 days | 187,370 | 179,748 | 168,381 | 7,622 | 11,367 |
| 91 days to 1 year | 83,900 | 83,222 | 76,452 | 678 | 6,770 |
| Notes and bonds | | | | | |
| 1 year or less | 128,287[r] | 116,443 | 113,301 | 11,844[r] | 3,142 |
| More than 1 year through 5 years | 210,745[r] | 208,269 | 180,074 | 2,476[r] | 28,195 |
| More than 5 years through 10 years | 56,699[r] | 54,372 | 51,312 | 2,327[r] | 3,060 |
| More than 10 years | 77,215[r] | 75,765 | 77,146 | 1,450[r] | –1,381 |
| *By type* | | | | | |
| Bills | 271,270 | 262,970 | 244,833 | 8,300 | 18,137 |
| Notes | 380,118 | 360,830 | 323,361 | 19,288 | 37,469 |
| Bonds | 92,827 | 94,016 | 98,471 | –1,189 | –4,455 |
| Federal Agency Securities | | | | | |
| **Held outright**[1] | **0** | **0** | **0** | **0** | **0** |
| *By remaining maturity* | | | | | |
| 1 year or less | 0 | 0 | 0 | 0 | 0 |
| More than 1 year through 5 years | 0 | 0 | 0 | 0 | 0 |
| More than 5 years through 10 years | 0 | 0 | 0 | 0 | 0 |
| More than 10 years | 0 | 0 | 0 | 0 | 0 |
| *By issuer* | | | | | |
| Federal National Mortgage Association | 0 | 0 | 0 | 0 | 0 |
| Temporary Transactions | | | | | |
| **Repurchase agreements**[2] | **46,750** | **33,000**[r] | **43,750** | **13,750**[r] | **–10,750**[r] |
| **Matched sale–purchase agreements** | **0** | **0** | **0** | **0** | **0** |
| Foreign official and international accounts | 0 | 0 | 0 | 0 | 0 |
| Dealers | 0 | 0 | 0 | 0 | 0 |
| **Reverse repurchase agreements**[3] | **30,505** | **30,783**[r] | **25,652** | **–278**[r] | **5,131**[r] |
| Foreign official and international accounts | 30,505 | 30,783[r] | 25,652 | –278[r] | 5,131[r] |
| Dealers | 0 | 0 | 0 | 0 | 0 |

NOTE. Components may not sum to totals because of rounding.

1. Excludes the effect of temporary transactions—repurchase agreements, matched sale–purchase agreements (MSPs), and reverse repurchase agreements (RRPs).

2. Cash value of agreements, which are collateralized by U.S. government and federal agency securities.

3. Cash value of agreements, which are collateralized by U.S. Treasury securities.

r. Revised since release of the print version of the Annual Report in June 2006.

## 3. Federal Reserve Bank Interest Rates on Loans to Depository Institutions, December 31, 2005

| Reserve Bank | Primary credit[1] | Secondary credit[2] | Seasonal credit[3] |
|---|---|---|---|
| All Federal Reserve Banks .................. | 5.25 | 5.75 | 4.35 |

1. Primary credit is available for very short terms as a backup source of liquidity to depository institutions that are in generally sound financial condition in the judgment of the lending Federal Reserve Bank.
2. Secondary credit is available in appropriate circumstances to depository institutions that do not qualify for primary credit.
3. Seasonal credit is available to help relatively small depository institutions meet regular seasonal needs for funds that arise from a clear pattern of intra-yearly movements in their deposits and loans. The discount rate on seasonal credit takes into account rates charged by market sources of funds and is reestablished on the first business day of each two-week reserve maintenance period.

## 4. Reserve Requirements of Depository Institutions, December 31, 2005

| Type of deposit | Requirements | |
|---|---|---|
| | Percentage of deposits | Effective date |
| *Net transaction accounts* [1] | | |
| $0 million–$7.8 million [2] | 0 | 12-22-05 |
| More than $7.8 million–$48.3 million [3] | 3 | 12-22-05 |
| More than $48.3 million | 10 | 12-22-05 |
| Nonpersonal time deposits | 0 | 12-27-90 |
| Eurocurrency liabilities | 0 | 12-27-90 |

NOTE. Required reserves must be held in the form of vault cash and, if vault cash is insufficient, also in the form of a deposit with a Federal Reserve Bank. An institution that is a member of the Federal Reserve System must hold that deposit directly with a Reserve Bank; an institution that is not a member of the System can maintain that deposit directly with a Reserve Bank or with another institution in a pass-through relationship. Reserve requirements are imposed on commercial banks, savings banks, savings and loan associations, credit unions, U.S. branches and agencies of foreign banks, Edge corporations, and agreement corporations.

1. Total transaction accounts consists of demand deposits, automatic transfer service (ATS) accounts, NOW accounts, share draft accounts, telephone or preauthorized transfer accounts, ineligible banker's acceptances, and affiliate-issued obligations maturing in seven days or less. Net transaction accounts are total transaction accounts less amounts due from other depository institutions and less cash items in the process of collection.

For a more detailed description of these deposit types, see Form FR 2900 at www.federalreserve.gov/boarddocs/reportforms/.

2. The amount of net transaction accounts subject to a reserve requirement ratio of 0 percent (the "exemption amount" ) is adjusted each year by statute. The exemption amount is adjusted upward by 80 percent of the previous year's (June 30 to June 30) rate of increase in total reservable liabilities at all depository institutions. No adjustment is made in the event of a decrease in such liabilities.

3. The amount of net transaction accounts subject to a reserve requirement ratio of 3 percent is the "low reserve tranche." By statute, the upper limit of the low reserve tranche is adjusted each year by 80 percent of the previous year's (June 30 to June 30) rate of increase or decrease in net transaction accounts held by all depository institutions.

## 5. Banking Offices and Banks Affiliated with Bank Holding Companies (BHCs) in the United States,[1] December 31, 2004 and 2005

| Type of office | Total | Commercial banks[2] | | | | | State-chartered savings banks |
|---|---|---|---|---|---|---|---|
| | | Total | Member | | | Nonmember | |
| | | | Total | National | State | | |
| | **All banking offices** | | | | | | |
| BANKS | | | | | | | |
| **Number, Dec. 31, 2004** | **7,965** | **7,591** | **2,794** | **1,880** | **914** | **4,797** | **374** |
| *Changes during 2005* | | | | | | | |
| New banks | 173 | 165 | 29 | 20 | 9 | 136 | 8 |
| Banks converted into branches | –265 | –253 | –110 | –81 | –29 | –143 | –12 |
| Ceased banking operation[3] | –29 | –20 | –5 | –3 | –2 | –15 | –9 |
| Other[4] | 0 | 2 | –10 | –20 | 10 | 12 | –2 |
| Net change | –121 | –106 | –96 | –84 | –12 | –10 | –15 |
| **Number, Dec. 31, 2005** | **7,844** | **7,485** | **2,698** | **1,796** | **902** | **4,787** | **359** |
| BRANCHES AND ADDITIONAL OFFICES | | | | | | | |
| **Number, Dec. 31, 2004** | **75,272** | **71,931** | **52,329** | **38,985** | **13,344** | **19,602** | **3,341** |
| *Changes during 2005* | | | | | | | |
| New branches | 2,256 | 2,170 | 1,434 | 953 | 481 | 736 | 86 |
| Branches converted from banks | 265 | 257 | 146 | 101 | 45 | 111 | 8 |
| Discontinued[3] | –2,062 | –1,632 | –1,488 | –769 | –719 | –144 | –430 |
| Other[4] | 0 | 250 | 218 | –462 | 680 | 32 | –250 |
| Net change | 459 | 1,045 | 310 | –177 | 487 | 735 | –586 |
| **Number, Dec. 31, 2005** | **75,731** | **72,976** | **52,639** | **38,808** | **13,831** | **20,337** | **2,755** |
| | **Banks affiliated with BHCs** | | | | | | |
| BANKS | | | | | | | |
| **Number, Dec. 31, 2004** | **6,340** | **6,225** | **2,418** | **1,612** | **806** | **3,807** | **115** |
| *Changes during 2005* | | | | | | | |
| BHC-affiliated new banks | 170 | 157 | 35 | 26 | 9 | 122 | 13 |
| Banks converted into branches | –226 | –221 | –98 | –74 | –24 | –123 | –5 |
| Ceased banking operation[3] | –23 | –21 | –9 | –5 | –4 | –12 | –2 |
| Other[4] | 0 | 1 | –9 | –18 | 9 | 10 | –1 |
| Net change | –79 | –84 | –81 | –71 | –10 | –3 | 5 |
| **Number, Dec. 31, 2005** | **6,261** | **6,141** | **2,337** | **1,541** | **796** | **3,804** | **120** |

1. Includes banking offices and BHCs in U.S. territories and possessions.

2. For purposes of this table, banks are entities that are defined as banks in the Bank Holding Company Act, as amended, which is implemented by Federal Reserve Regulation Y. Generally, a bank is any institution that accepts demand deposits and is engaged in the business of making commercial loans or any institution that is defined as an insured bank in section 3(h) of the FDIC Act. Covers entities in the United States and its territories and possessions (affiliated insular areas).

3. Institutions that no longer meet the Regulation Y definition of bank.

4. Interclass changes and sales of branches.

## 6A. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1984–2005 and Month-End 2005

Millions of dollars

| Period | Factors supplying reserve funds | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Federal Reserve Bank credit outstanding | | | | | | Gold stock | Special drawing rights certificate account | Treasury currency outstanding[3] |
| | Securities held outright[1] | Repurchase agreements[2] | Loans | Float | Other Federal Reserve assets | Total | | | |
| 1984 | 167,612 | 2,015 | 3,577 | 833 | 12,347 | 186,384 | 11,096 | 4,618 | 16,418 |
| 1985 | 186,025 | 5,223 | 3,060 | 988 | 15,302 | 210,598 | 11,090 | 4,718 | 17,075 |
| 1986 | 205,454 | 16,005 | 1,565 | 1,261 | 17,475 | 241,760 | 11,084 | 5,018 | 17,567 |
| 1987 | 226,459 | 4,961 | 3,815 | 811 | 15,837 | 251,883 | 11,078 | 5,018 | 18,177 |
| 1988 | 240,628 | 6,861 | 2,170 | 1,286 | 18,803 | 269,748 | 11,060 | 5,018 | 18,799 |
| 1989 | 233,300 | 2,117 | 481 | 1,093 | 39,631 | 276,622 | 11,059 | 8,518 | 19,628 |
| 1990 | 241,431 | 18,354 | 190 | 2,566 | 39,880 | 302,421 | 11,058 | 10,018 | 20,402 |
| 1991 | 272,531 | 15,898 | 218 | 1,026 | 34,524 | 324,197 | 11,059 | 10,018 | 21,014 |
| 1992 | 300,423 | 8,094 | 675 | 3,350 | 30,278 | 342,820 | 11,056 | 8,018 | 21,447 |
| 1993 | 336,654 | 13,212 | 94 | 963 | 33,394 | 384,317 | 11,053 | 8,018 | 22,095 |
| 1994 | 368,156 | 10,590 | 223 | 740 | 33,441 | 413,150 | 11,051 | 8,018 | 22,994 |
| 1995 | 380,831 | 13,862 | 135 | 231 | 33,483 | 428,543 | 11,050 | 10,168 | 24,003 |
| 1996 | 393,132 | 21,583 | 85 | 5,297 | 32,222 | 452,319 | 11,048 | 9,718 | 24,966 |
| 1997 | 431,420 | 23,840 | 2,035 | 561 | 32,044 | 489,901 | 11,047 | 9,200 | 25,543 |
| 1998 | 452,478 | 30,376 | 17 | 1,009 | 37,692 | 521,573 | 11,046 | 9,200 | 26,270 |
| 1999 | 478,144 | 140,640 | 233 | 407 | 34,799 | 654,223 | 11,048 | 6,200 | 28,013 |
| 2000 | 511,833 | 43,375 | 110 | 795 | 36,896 | 593,009 | 11,046 | 2,200 | 31,643 |
| 2001 | 551,685 | 50,250 | 34 | 698 | 36,885 | 639,552 | 11,045 | 2,200 | 33,017 |
| 2002 | 629,416 | 39,500 | 40 | 832 | 38,574 | 708,363 | 11,043 | 2,200 | 34,597 |
| 2003 | 666,665 | 43,750 | 62 | 211 | 40,214 | 750,901 | 11,043 | 2,200 | 35,475 |
| 2004 | 717,819 | 33,000 | 43 | 927 | 42,161 | 793,950 | 11,045 | 2,200 | 36,434 r |
| 2005 | 744,215 | 46,750 | 72 | 891 | 39,319 | 831,247 | 11,043 | 2,200 | 36,610 |

For notes see end of table.

6A.—Continued

| Factors absorbing reserve funds | | | | | | | | Reserve balances with Federal Reserve Banks [6] |
|---|---|---|---|---|---|---|---|---|
| Currency in circulation | Reverse repurchase agreements [4] | Treasury cash holdings [5] | Deposits with Federal Reserve Banks, other than reserve balances | | | Required clearing balances | Other Federal Reserve liabilities and capital | |
| | | | Treasury | Foreign | Other | | | |
| 183,796 | 0 | 513 | 5,316 | 253 | 867 | 1,126 | 5,952 | 20,693 |
| 197,488 | 0 | 550 | 9,351 | 480 | 1,041 | 1,490 | 5,940 | 27,141 |
| 211,995 | 0 | 447 | 7,588 | 287 | 917 | 1,812 | 6,088 | 46,295 |
| 230,205 | 0 | 454 | 5,313 | 244 | 1,027 | 1,687 | 7,129 | 40,097 |
| 247,649 | 0 | 395 | 8,656 | 347 | 548 | 1,605 | 7,683 | 37,742 |
| 260,456 | 0 | 450 | 6,217 | 589 | 1,298 | 1,618 | 8,486 | 36,713 |
| 286,963 | 0 | 561 | 8,960 | 369 | 242 | 1,960 | 8,147 | 36,698 |
| 307,756 | 0 | 636 | 17,697 | 968 | 1,706 | 3,946 | 8,113 | 25,467 |
| 334,701 | 0 | 508 | 7,492 | 206 | 372 | 5,897 | 7,984 | 26,182 |
| 365,271 | 0 | 377 | 14,809 | 386 | 397 | 6,332 | 9,292 | 28,619 |
| 403,843 | 0 | 335 | 7,161 | 250 | 876 | 4,196 | 11,959 | 26,593 |
| 424,244 | 0 | 270 | 5,979 | 386 | 932 | 5,167 | 12,342 | 24,444 |
| 450,648 | 0 | 249 | 7,742 | 167 | 892 | 6,601 | 13,829 | 17,923 |
| 482,327 | 0 | 225 | 5,444 | 457 | 900 | 6,679 | 15,500 | 24,159 |
| 517,484 | 0 | 85 | 6,086 | 167 | 1,605 | 6,781 | 16,354 | 19,525 |
| 628,359 | 0 | 109 | 28,402 | 71 | 1,261 | 7,482 | 17,256 | 16,545 |
| 593,694 | 0 | 450 | 5,149 | 216 | 1,382 | 6,332 | 17,962 | 12,713 |
| 643,301 | 0 | 425 | 6,645 | 61 | 820 | 8,525 | 17,083 | 8,953 |
| 687,518 | 21,091 | 367 | 4,420 | 136 | 1,152 | 10,533 | 18,977 | 12,008 |
| 724,194 | 25,652 | 321 | 5,723 | 162 | 717 | 11,828 | 19,793 | 11,230 |
| 754,877 [r] | 30,783 | 270 | 5,912 | 80 | 1,285 | 9,963 | 26,378 | 14,080 |
| 794,084 | 30,505 | 202 | 4,573 | 83 | 2,144 | 8,652 | 30,466 | 10,391 |

## 6A. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1984–2005 and Month-End 2005—Continued

Millions of dollars

| Period | Factors supplying reserve funds | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Federal Reserve Bank credit outstanding | | | | | | Gold stock | Special drawing rights certificate account | Treasury currency out-standing [3] |
| | Securities held outright [1] | Repurchase agreements [2] | Loans | Float | Other Federal Reserve assets | Total | | | |
| 2005 | | | | | | | | | |
| Jan. | 717,869 | 28,750 | 71 | 1,277 | 42,094 | 790,061 | 11,042 | 2,200 | 36,434 |
| Feb. | 717,492 | 33,750 | 114 | 3 | 39,547 | 790,906 | 11,042 | 2,200 | 36,546 |
| Mar. | 717,326 | 31,000 | 52 | −1,025 | 40,327 | 787,680 | 11,041 | 2,200 | 36,545 |
| Apr. | 719,350 | 27,500 | 105 | −1,160 | 41,882 | 787,676 | 11,041 | 2,200 | 36,545 |
| May | 724,471 | 34,750 | 160 | −950 | 38,704 | 797,135 | 11,042 | 2,200 | 36,545 |
| June | 724,722 | 34,500 | 235 | −936 | 39,685 | 798,206 | 11,041 | 2,200 | 36,615 |
| July | 724,699 | 35,500 | 273 | −1,205 | 40,781 | 800,048 | 11,041 | 2,200 | 36,429 |
| Aug. | 730,380 | 35,500 | 336 | 741 | 38,292 | 805,248 | 11,041 | 2,200 | 36,429 |
| Sept. | 736,360 | 25,750 | 910 | −312 | 38,974 | 801,682 | 11,041 | 2,200 | 36,429 |
| Oct. | 740,595 | 24,000 | 159 | 345 | 39,909 | 805,008 | 11,041 | 2,200 | 36,429 |
| Nov. | 744,168 | 35,250 | 86 | 886 | 37,351 | 817,741 | 11,041 | 2,200 | 36,540 |
| Dec. | 744,215 | 46,750 | 72 | 891 | 39,319 | 831,247 | 11,043 | 2,200 | 36,610 |

6A.—Continued

| Factors absorbing reserve funds | | | | | | | | Reserve balances with Federal Reserve Banks[6] |
|---|---|---|---|---|---|---|---|---|
| Currency in circulation | Reverse repurchase agreements[4] | Treasury cash holdings[5] | Deposits with Federal Reserve Banks, other than reserve balances | | | Required clearing balances | Other Federal Reserve liabilities and capital | |
| | | | Treasury | Foreign | Other | | | |
| 746,746 | 26,726 | 269 | 4,971 | 121 | 313 | 8,944 | 26,932 | 24,715 |
| 751,631 | 25,026 | 263 | 4,673 | 86 | 282 | 8,670 | 27,776 | 22,286 |
| 754,637 | 24,106 | 284 | 5,219 | 139 | 235 | 9,514 | 27,862 | 15,470 |
| 752,786 | 26,544 | 258 | 3,585 | 126 | 318 | 9,025 | 28,846 | 15,975 |
| 761,384 | 25,386 | 275 | 5,538 | 105 | 274 | 8,851 | 29,255 | 15,854 |
| 764,713 | 26,183 | 237 | 4,373 | 103 | 250 | 8,278 | 29,095 | 14,830 |
| 762,035 | 27,480 | 252 | 5,064 | 83 | 297 | 8,674 | 30,326 | 15,508 |
| 765,723 | 26,487 | 262 | 5,650 | 81 | 265 | 8,717 | 30,748 | 16,985 |
| 766,482 | 26,920 | 237 | 4,381 | 96 | 295 | 8,864 | 31,015 | 13,063 |
| 768,130 | 26,180 | 211 | 5,712 | 88 | 315 | 8,781 | 31,820 | 13,440 |
| 780,223 | 30,055 | 204 | 4,634 | 82 | 255 | 8,754 | 31,865 | 11,450 |
| 794,084 | 30,505 | 202 | 4,573 | 83 | 2,144 | 8,652 | 30,466 | 10,391 |

NOTE. Components may not sum to totals because of rounding.

1. Includes U.S. Treasury and federal agency securities. U.S. Treasury securities contain securities lent to dealers and are fully collateralized by other U.S. Treasury securities. Federal agency securities are included at face value.

2. Cash value of agreements, which are collateralized by U.S. Treasury and federal agency securities.

3. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see "Currency and Coin in Circulation," *Treasury Bulletin*.

4. Cash value of agreements, which are collateralized by U.S. Treasury securities.

5. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

6. Excludes required clearing balances and adjustments to compensate for float.

r. Revised.

## 6B. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918–1983

Millions of dollars

| Period | Factors supplying reserve funds | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Federal Reserve Bank credit outstanding | | | | | | | Gold stock[6] | Special drawing rights certificate account | Treasury currency out-standing[7] |
| | Securities held outright[1] | Repur-chase agree-ments[2] | Loans | Float[3] | All other[4] | Other Federal Reserve assets[5] | Total | | | |
| 1918 | 239 | 0 | 1,766 | 199 | 294 | 0 | 2,498 | 2,873 | ... | 1,795 |
| 1919 | 300 | 0 | 2,215 | 201 | 575 | 0 | 3,292 | 2,707 | ... | 1,707 |
| 1920 | 287 | 0 | 2,687 | 119 | 262 | 0 | 3,355 | 2,639 | ... | 1,709 |
| 1921 | 234 | 0 | 1,144 | 40 | 146 | 0 | 1,563 | 3,373 | ... | 1,842 |
| 1922 | 436 | 0 | 618 | 78 | 273 | 0 | 1,405 | 3,642 | ... | 1,958 |
| 1923 | 80 | 54 | 723 | 27 | 355 | 0 | 1,238 | 3,957 | ... | 2,009 |
| 1924 | 536 | 4 | 320 | 52 | 390 | 0 | 1,302 | 4,212 | ... | 2,025 |
| 1925 | 367 | 8 | 643 | 63 | 378 | 0 | 1,459 | 4,112 | ... | 1,977 |
| 1926 | 312 | 3 | 637 | 45 | 384 | 0 | 1,381 | 4,205 | ... | 1,991 |
| 1927 | 560 | 57 | 582 | 63 | 393 | 0 | 1,655 | 4,092 | ... | 2,006 |
| 1928 | 197 | 31 | 1,056 | 24 | 500 | 0 | 1,809 | 3,854 | ... | 2,012 |
| 1929 | 488 | 23 | 632 | 34 | 405 | 0 | 1,583 | 3,997 | ... | 2,022 |
| 1930 | 686 | 43 | 251 | 21 | 372 | 0 | 1,373 | 4,306 | ... | 2,027 |
| 1931 | 775 | 42 | 638 | 20 | 378 | 0 | 1,853 | 4,173 | ... | 2,035 |
| 1932 | 1,851 | 4 | 235 | 14 | 41 | 0 | 2,145 | 4,226 | ... | 2,204 |
| 1933 | 2,435 | 2 | 98 | 15 | 137 | 0 | 2,688 | 4,036 | ... | 2,303 |
| 1934 | 2,430 | 0 | 7 | 5 | 21 | 0 | 2,463 | 8,238 | ... | 2,511 |
| 1935 | 2,430 | 1 | 5 | 12 | 38 | 0 | 2,486 | 10,125 | ... | 2,476 |
| 1936 | 2,430 | 0 | 3 | 39 | 28 | 0 | 2,500 | 11,258 | ... | 2,532 |
| 1937 | 2,564 | 0 | 10 | 19 | 19 | 0 | 2,612 | 12,760 | ... | 2,637 |
| 1938 | 2,564 | 0 | 4 | 17 | 16 | 0 | 2,601 | 14,512 | ... | 2,798 |
| 1939 | 2,484 | 0 | 7 | 91 | 11 | 0 | 2,593 | 17,644 | ... | 2,963 |
| 1940 | 2,184 | 0 | 3 | 80 | 8 | 0 | 2,274 | 21,995 | ... | 3,087 |
| 1941 | 2,254 | 0 | 3 | 94 | 10 | 0 | 2,361 | 22,737 | ... | 3,247 |
| 1942 | 6,189 | 0 | 6 | 471 | 14 | 0 | 6,679 | 22,726 | ... | 3,648 |
| 1943 | 11,543 | 0 | 5 | 681 | 10 | 0 | 12,239 | 21,938 | ... | 4,094 |
| 1944 | 18,846 | 0 | 80 | 815 | 4 | 0 | 19,745 | 20,619 | ... | 4,131 |
| 1945 | 24,252 | 0 | 249 | 578 | 2 | 0 | 15,091 | 20,065 | ... | 4,339 |
| 1946 | 23,350 | 0 | 163 | 580 | 1 | 0 | 24,093 | 20,529 | ... | 4,562 |
| 1947 | 22,559 | 0 | 85 | 535 | 1 | 0 | 23,181 | 22,754 | ... | 4,562 |
| 1948 | 23,333 | 0 | 223 | 541 | 1 | 0 | 24,097 | 24,244 | ... | 4,589 |
| 1949 | 18,885 | 0 | 78 | 534 | 2 | 0 | 19,499 | 24,427 | ... | 4,598 |
| 1950 | 20,725 | 53 | 67 | 1,368 | 3 | 0 | 22,216 | 22,706 | ... | 4,636 |
| 1951 | 23,605 | 196 | 19 | 1,184 | 5 | 0 | 25,009 | 22,695 | ... | 4,709 |
| 1952 | 24,034 | 663 | 156 | 967 | 4 | 0 | 25,825 | 23,187 | ... | 4,812 |
| 1953 | 25,318 | 598 | 28 | 935 | 2 | 0 | 26,880 | 22,030 | ... | 4,894 |
| 1954 | 24,888 | 44 | 143 | 808 | 1 | 0 | 25,885 | 21,713 | ... | 4,985 |
| 1955 | 24,391 | 394 | 108 | 1,585 | 29 | 0 | 26,507 | 21,690 | ... | 5,008 |
| 1956 | 24,610 | 305 | 50 | 1,665 | 70 | 0 | 26,699 | 21,949 | ... | 5,066 |
| 1957 | 23,719 | 519 | 55 | 1,424 | 66 | 0 | 25,784 | 22,781 | ... | 5,146 |
| 1958 | 26,252 | 95 | 64 | 1,296 | 49 | 0 | 27,755 | 20,534 | ... | 5,234 |
| 1959 | 26,607 | 41 | 458 | 1,590 | 75 | 0 | 28,771 | 19,456 | ... | 5,311 |

For notes see end of table.

6B.— Continued

| Factors absorbing reserve funds | | | | | | | | Member bank reserves[9] | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Currency in circulation | Treasury cash holdings[8] | Deposits with Federal Reserve Banks, other than reserve balances | | | Other Federal Reserve accounts[5] | Required clearing balances | Other Federal Reserve liabilities and capital[5] | With Federal Reserve Banks | Currency and coin[10] | Required[11] | Excess[11, 12] |
| | | Treasury | Foreign | Other | | | | | | | |
| 4,951 | 288 | 51 | 96 | 25 | 118 | 0 | 0 | 1,636 | 0 | 1,585 | 51 |
| 5,091 | 385 | 51 | 73 | 28 | 208 | 0 | 0 | 1,890 | 0 | 1,822 | 68 |
| 5,325 | 218 | 57 | 5 | 18 | 298 | 0 | 0 | 1,781 | 0 | 0 | 0 |
| 4,403 | 214 | 96 | 12 | 15 | 285 | 0 | 0 | 1,753 | 0 | 1,654 | 99 |
| 4,530 | 225 | 11 | 3 | 26 | 276 | 0 | 0 | 1,934 | 0 | 0 | 0 |
| 4,757 | 213 | 38 | 4 | 19 | 275 | 0 | 0 | 1,898 | 0 | 1,884 | 14 |
| 4,760 | 211 | 51 | 19 | 20 | 258 | 0 | 0 | 2,220 | 0 | 2,161 | 59 |
| 4,817 | 203 | 16 | 8 | 21 | 272 | 0 | 0 | 2,212 | 0 | 2,256 | –44 |
| 4,808 | 201 | 17 | 46 | 19 | 293 | 0 | 0 | 2,194 | 0 | 2.250 | –56 |
| 4,716 | 208 | 18 | 5 | 21 | 301 | 0 | 0 | 2,487 | 0 | 2,424 | 63 |
| 4,686 | 202 | 23 | 6 | 21 | 348 | 0 | 0 | 2,389 | 0 | 2,430 | –41 |
| 4,578 | 216 | 29 | 6 | 24 | 393 | 0 | 0 | 2,355 | 0 | 2,428 | –73 |
| 4,603 | 211 | 19 | 6 | 22 | 375 | 0 | 0 | 2,471 | 0 | 2,375 | 96 |
| 5,360 | 222 | 54 | 79 | 31 | 354 | 0 | 0 | 1,961 | 0 | 1,994 | –33 |
| 5,388 | 272 | 8 | 19 | 24 | 355 | 0 | 0 | 2,509 | 0 | 1,933 | 576 |
| 5,519 | 284 | 3 | 4 | 128 | 360 | 0 | 0 | 2,729 | 0 | 1,870 | 859 |
| 5,536 | 3,029 | 121 | 20 | 169 | 241 | 0 | 0 | 4,096 | 0 | 2,282 | 1,814 |
| 5,882 | 2,566 | 544 | 29 | 226 | 253 | 0 | 0 | 5,587 | 0 | 2,743 | 2,844 |
| 6,543 | 2,376 | 244 | 99 | 160 | 261 | 0 | 0 | 6,606 | 0 | 4,622 | 1,984 |
| 6,550 | 3,619 | 142 | 172 | 235 | 263 | 0 | 0 | 7,027 | 0 | 5,815 | 1,212 |
| 6,856 | 2,706 | 923 | 199 | 242 | 260 | 0 | 0 | 8,724 | 0 | 5,519 | 3,205 |
| 7,598 | 2,409 | 634 | 397 | 256 | 251 | 0 | 0 | 11,653 | 0 | 6,444 | 5,209 |
| 8,732 | 2,213 | 368 | 1,133 | 599 | 284 | 0 | 0 | 4,026 | 0 | 7,411 | 6,615 |
| 11,160 | 2,215 | 867 | 774 | 586 | 291 | 0 | 0 | 12,450 | 0 | 9,365 | 3,085 |
| 15,410 | 2,193 | 799 | 793 | 485 | 256 | 0 | 0 | 13,117 | 0 | 11,129 | 1,988 |
| 20,499 | 2,303 | 579 | 1,360 | 356 | 339 | 0 | 0 | 12,886 | 0 | 11,650 | 1,236 |
| 25,307 | 2,375 | 440 | 1,204 | 394 | 402 | 0 | 0 | 14,373 | 0 | 12,748 | 1,625 |
| 28,515 | 2,287 | 977 | 862 | 446 | 495 | 0 | 0 | 15,915 | 0 | 14,457 | 1,458 |
| 28,952 | 2,272 | 393 | 508 | 314 | 607 | 0 | 0 | 16,139 | 0 | 15,577 | 562 |
| 28,868 | 1,336 | 870 | 392 | 569 | 563 | 0 | 0 | 17,899 | 0 | 16,400 | 1,499 |
| 28,224 | 1,325 | 1,123 | 642 | 547 | 590 | 0 | 0 | 20,479 | 0 | 19,277 | 1,202 |
| 27,600 | 1,312 | 821 | 767 | 750 | 106 | 0 | 0 | 16,568 | 0 | 15,550 | 1,018 |
| 27,741 | 1,293 | 668 | 895 | 565 | 714 | 0 | 0 | 17,681 | 0 | 16,509 | 1,172 |
| 29,206 | 1,270 | 247 | 526 | 363 | 746 | 0 | 0 | 20,056 | 0 | 19,667 | 389 |
| 30,433 | 1,270 | 389 | 550 | 455 | 777 | 0 | 0 | 19,950 | 0 | 20,520 | –570 |
| 30,781 | 761 | 346 | 423 | 493 | 839 | 0 | 0 | 20,160 | 0 | 19,397 | 763 |
| 30,509 | 796 | 563 | 490 | 441 | 907 | 0 | 0 | 18,876 | 0 | 18,618 | 258 |
| 31,158 | 767 | 394 | 402 | 554 | 925 | 0 | 0 | 19,005 | 0 | 18,903 | 102 |
| 31,790 | 775 | 441 | 322 | 426 | 901 | 0 | 0 | 19,059 | 0 | 19,089 | –30 |
| 31,834 | 761 | 481 | 356 | 246 | 998 | 0 | 0 | 19,034 | 0 | 19,091 | –57 |
| 32,193 | 683 | 358 | 272 | 391 | 1,122 | 0 | 0 | 18,504 | 0 | 18,574 | –70 |
| 32,591 | 391 | 504 | 345 | 694 | 841 | 0 | 0 | 18,174 | 310 | 18,619 | –135 |

## 6B. Reserves of Depository Institutions, Federal Reserve Bank Credit, and Related Items, Year-End 1918–1983—Continued

Millions of dollars

| Period | Factors supplying reserve funds | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Federal Reserve Bank credit outstanding | | | | | | | Gold stock [6] | Special drawing rights certificate account | Treasury currency outstanding [7] |
| | Securities held outright [1] | Repurchase agreements [2] | Loans | Float [3] | All other [4] | Other Federal Reserve assets [5] | Total | | | |
| 1960 | 26,984 | 400 | 33 | 1,847 | 74 | 0 | 29,338 | 17,767 | . . . | 5,398 |
| 1961 | 30,478 | 159 | 130 | 2,300 | 51 | 0 | 31,362 | 16,889 | . . . | 5,585 |
| 1962 | 28,722 | 342 | 38 | 2,903 | 110 | 0 | 33,871 | 15,978 | . . . | 5,567 |
| 1963 | 33,582 | 11 | 63 | 2,600 | 162 | 0 | 36,418 | 15,513 | . . . | 5,578 |
| 1964 | 36,506 | 538 | 186 | 2,606 | 94 | 0 | 39,930 | 15,388 | . . . | 5,405 |
| 1965 | 40,478 | 290 | 137 | 2,248 | 187 | 0 | 43,340 | 13,733 | . . . | 5,575 |
| 1966 | 43,655 | 661 | 173 | 2,495 | 193 | 0 | 47,177 | 13,159 | . . . | 6,317 |
| 1967 | 48,980 | 170 | 141 | 2,576 | 164 | 0 | 52,031 | 11,982 | . . . | 6,784 |
| 1968 | 52,937 | 0 | 186 | 3,443 | 58 | 0 | 56,624 | 10,367 | . . . | 6,795 |
| 1969 | 57,154 | 0 | 183 | 3,440 | 64 | 2,743 | 64,584 | 10,367 | . . . | 6,852 |
| 1970 | 62,142 | 0 | 335 | 4,261 | 57 | 1,123 | 67,918 | 10,732 | 400 | 7,147 |
| 1971 | 69,481 | 1,323 | 39 | 4,343 | 261 | 1,068 | 76,515 | 10,132 | 400 | 7,710 |
| 1972 | 71,119 | 111 | 1,981 | 3,974 | 106 | 1,260 | 78,551 | 10,410 | 400 | 8,313 |
| 1973 | 80,395 | 100 | 1,258 | 3,099 | 68 | 1,152 | 86,072 | 11,567 | 400 | 8,716 |
| 1974 | 84,760 | 954 | 299 | 2,001 | 999 | 3,195 | 92,208 | 11,652 | 400 | 9,253 |
| 1975 | 92,789 | 1,335 | 211 | 3,688 | 1,126 | 3,312 | 102,461 | 11,599 | 500 | 10,218 |
| 1976 | 100,062 | 4,031 | 25 | 2,601 | 991 | 3,182 | 110,892 | 11,598 | 1,200 | 10,810 |
| 1977 | 108,922 | 2,352 | 265 | 3,810 | 954 | 2,442 | 118,745 | 11,718 | 1,250 | 11,331 |
| 1978 | 117,374 | 1,217 | 1,174 | 6,432 | 587 | 4,543 | 131,327 | 11,671 | 1,300 | 11,831 |
| 1979 | 124,507 | 1,660 | 1,454 | 6,767 | 704 | 5,613 | 140,705 | 11,172 | 1,800 | 13,083 |
| 1980 | 128,038 | 2,554 | 1,809 | 4,467 | 776 | 8,739 | 146,383 | 11,160 | 2,518 | 13,427 |
| 1981 | 136,863 | 3,485 | 1,601 | 1,762 | 195 | 9,230 | 153,136 | 11,151 | 3,318 | 13,687 |
| 1982 | 144,544 | 4,293 | 717 | 2,735 | 1,480 | 9,890 | 63,659 | 11,148 | 4,618 | 13,786 |
| 1983 | 159,203 | 1,592 | 918 | 1,605 | 418 | 8,728 | 172,464 | 11,121 | 4,618 | 15,732 |

NOTE. For a description of figures and discussion of their significance, see *Banking and Monetary Statistics, 1941–1970* (Board of Governors of the Federal Reserve System, 1976), pp. 507–23.

Components may not sum to totals because of rounding.

1. In 1969 and thereafter, includes securities loaned—fully guaranteed by U.S. government securities pledged with Federal Reserve Banks—and excludes securities sold and scheduled to be bought back under matched sale–purchase transactions. On September 29, 1971, and thereafter, includes federal agency issues bought outright.

2. On December 1, 1966, and thereafter, includes federal agency obligations held under repurchase agreements.

3. In 1960 and thereafter, figures reflect a minor change in concept; see *Federal Reserve Bulletin*, vol. 47 (February 1961), p. 164.

4. Principally acceptances and, until August 21, 1959, industrial loans, the authority for which expired on that date.

5. For the period before April 16, 1969, includes the total of Federal Reserve capital paid in, surplus, other capital accounts, and other liabilities and accrued dividends, less the sum of bank premises and other assets, and is reported as "Other Federal Reserve accounts"; thereafter, "Other Federal Reserve assets" and "Other Federal Reserve liabilities and capital" are shown separately.

6. Before January 30, 1934, includes gold held in Federal Reserve Banks and in circulation.

7. Includes currency and coin (other than gold) issued directly by the Treasury. The largest components are fractional and dollar coins. For details see "Currency and Coin in Circulation," *Treasury Bulletin*.

6B.—Continued

| Factors absorbing reserve funds | | | | | | | | Member bank reserves[9] | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Currency in circulation | Treasury cash holdings[8] | Deposits with Federal Reserve Banks, other than reserve balances | | | Other Federal Reserve accounts[5] | Required clearing balances | Other Federal Reserve liabilities and capital[5] | | | | |
| | | Treasury | Foreign | Other | | | | With Federal Reserve Banks | Currency and coin[10] | Required[11] | Excess[11, 12] |
| 32,869 | 377 | 485 | 217 | 533 | 941 | 0 | 0 | 17,081 | 2,544 | 18,988 | 637 |
| 33,918 | 422 | 465 | 279 | 320 | 1,044 | 0 | 0 | 17,387 | 2,544 | 18,988 | 96 |
| 35,338 | 380 | 597 | 247 | 393 | 1,007 | 0 | 0 | 17,454 | 3,262 | 20,071 | 645 |
| 37,692 | 361 | 880 | 171 | 291 | 1,065 | 0 | 0 | 17,049 | 4,099 | 20,677 | 471 |
| 39,619 | 612 | 820 | 229 | 321 | 1,036 | 0 | 0 | 18,086 | 4,151 | 21,663 | 574 |
| 42,056 | 760 | 668 | 150 | 355 | 211 | 0 | 0 | 18,447 | 4,163 | 22,848 | −238 |
| 44,663 | 1,176 | 416 | 174 | 588 | −147 | 0 | 0 | 19,779 | 4,310 | 24,321 | −232 |
| 47,226 | 1,344 | 1,123 | 135 | 563 | −773 | 0 | 0 | 21,092 | 4,631 | 25,905 | −182 |
| 50,961 | 695 | 703 | 216 | 747 | −1,353 | 0 | 0 | 21,818 | 4,921 | 27,439 | −700 |
| 53,950 | 596 | 1,312 | 134 | 807 | 0 | 0 | 1,919 | 22,085 | 5,187 | 28,173 | −901 |
| 57,903 | 431 | 1,156 | 148 | 1,233 | 0 | 0 | 1,986 | 24,150 | 5,423 | 30,033 | −460 |
| 61,068 | 460 | 2,020 | 294 | 999 | 0 | 0 | 2,131 | 27,788 | 5,743 | 32,496 | 1,035 |
| 66,516 | 345 | 1,855 | 325 | 840 | 0 | 0 | 2,143 | 25,647 | 6,216 | 32,044 | 98[12] |
| 72,497 | 317 | 2,542 | 251 | 1,419[13] | 0 | 0 | 2,669 | 27,060 | 6,781 | 35,268 | −1,360 |
| 79,743 | 185 | 2,113 | 418 | 1,275[13] | 0 | 0 | 2,935 | 25,843 | 7,370 | 37,011 | −3,798 |
| 86,547 | 483 | 7,285 | 353 | 1,090 | 0 | 0 | 2,968 | 26,052 | 8,036 | 35,197 | −1,103[14] |
| 93,717 | 460 | 10,393 | 352 | 1,357 | 0 | 0 | 3,063 | 25,158 | 8,628 | 35,461 | −1,535 |
| 103,811 | 392 | 7,114 | 379 | 1,187 | 0 | 0 | 3,292 | 26,870 | 9,421 | 37,615 | −1,265 |
| 114,645 | 240 | 4,196 | 368 | 1,256 | 0 | 0 | 4,275 | 31,152 | 10,538 | 42,694 | −893 |
| 125,600 | 494 | 4,075 | 429 | 1,412 | 0 | 0 | 4,957 | 29,792 | 11,429 | 44,217 | −2,835 |
| 136,829 | 441 | 3,062 | 411 | 617 | 0 | 0 | 4,671 | 27,456 | 13,654 | 40,558 | 675 |
| 144,774 | 443 | 4,301 | 505 | 781 | 0 | 117 | 5,261 | 25,111 | 15,576 | 42,145 | −1,442 |
| 154,908 | 429 | 5,033 | 328 | 1,033 | 0 | 436 | 4,990 | 26,053 | 16,666 | 41,391 | 1,328 |
| 171,935 | 479 | 3,661 | 191 | 851 | 0 | 1,013 | 5,392 | 20,413 | 17,821 | 39,179 | −945 |

8. Coin and paper currency held by the Treasury, as well as any gold in excess of the gold certificates issued to the Reserve Bank.

9. In November 1979 and thereafter, includes reserves of member banks, Edge Act corporations, and U.S. agencies and branches of foreign banks. On November 13, 1980, and thereafter, includes reserves of all depository institutions.

10. Between December 1, 1959, and November 23, 1960, part was allowed as reserves; thereafter, all was allowed.

11. Estimated through 1958. Before 1929, data were available only on call dates (in 1920 and 1922 the call date was December 29). Since September 12, 1968, the amount has been based on close-of-business figures for the reserve period two weeks before the report date.

12. For the week ending November 15, 1972, and thereafter, includes $450 million of reserve deficiencies on which Federal Reserve Banks are allowed to waive penalties for a transition period in connection with bank adaptation to Regulation J as amended, effective November 9, 1972. Allowable deficiencies are as follows (beginning with first statement week of quarter, in millions): 1973—Q1, $279; Q2, $172; Q3, $112; Q4, $84; 1974—Q1, $67; Q2, $58. The transition period ended with the second quarter of 1974.

13. For the period before July 1973, includes certain deposits of domestic nonmember banks and foreign-owned banking institutions held with member banks and redeposited in full with Federal Reserve Banks in connection with voluntary participation by nonmember institutions in the Federal Reserve System program of credit restraint.

As of December 12, 1974, the amount of voluntary nonmember bank and foreign-agency and branch deposits at Federal Reserve Banks that are associated with marginal reserves is no longer reported. However, two amounts are reported: (1) deposits voluntarily held as reserves by agencies and branches of foreign banks operating in the United States and (2) Eurodollar liabilities.

14. Adjusted to include waivers of penalties for reserve deficiencies, in accordance with change in Board policy, effective November 19, 1975.

. . . Not applicable.

## 7. Principal Assets and Liabilities of Insured Commercial Banks,[1] by Class of Bank, June 30, 2005 and 2004

Millions of dollars, except as noted

| Item | Total | Member banks | | | Nonmember banks |
|---|---|---|---|---|---|
| | | Total | National | State | |
| | 2005 | | | | |
| ASSETS | | | | | |
| Loans and investments | 6,255,126 | 4,893,231 | 3,885,313 | 1,007,918 | 1,361,895 |
| Loans, gross | 4,714,324 | 3,691,084 | 2,955,338 | 735,746 | 1,023,240 |
| Net | 4,712,455 | 3,689,964 | 2,954,473 | 735,490 | 1,022,492 |
| Investments | 1,540,802 | 1,202,147 | 929,975 | 272,172 | 338,655 |
| U.S. Treasury and federal agency securities | 300,767 | 182,541 | 120,644 | 61,897 | 118,226 |
| Other | 1,240,035 | 1,019,606 | 809,331 | 210,275 | 220,430 |
| Cash assets, total | 262,667 | 209,058 | 172,000 | 37,058 | 53,608 |
| LIABILITIES | | | | | |
| Deposits, total | 4,844,823 | 3,692,187 | 2,941,844 | 750,342 | 1,152,636 |
| Interbank | 80,342 | 66,527 | 55,023 | 11,504 | 13,816 |
| Other transaction | 703,015 | 504,561 | 396,603 | 107,958 | 198,454 |
| Other nontransaction | 4,061,466 | 3,121,099 | 2,490,219 | 630,880 | 940,367 |
| Equity capital | 871,715 | 700,401 | 570,411 | 12,989 | 171,314 |
| Number of banks | 7,528 | 2,764 | 1,861 | 903 | 4,764 |
| | 2004 | | | | |
| ASSETS | | | | | |
| Loans and investments | 5,788,806 | 4,567,709 | 3,321,077 | 1,246,632 | 1,221,097 |
| Loans, gross | 4,267,991 | 3,381,763 | 2,481,333 | 900,430 | 886,228 |
| Net | 4,266,475 | 3,380,928 | 2,480,744 | 900,183 | 885,547 |
| Investments | 1,520,816 | 1,185,946 | 839,744 | 346,202 | 334,869 |
| U.S. Treasury and federal agency securities | 333,738 | 212,361 | 122,041 | 90,320 | 121,376 |
| Other | 1,187,078 | 973,585 | 717,703 | 255,882 | 213,493 |
| Cash assets, total | 271,104 | 218,068 | 156,194 | 61,874 | 53,037 |
| LIABILITIES | | | | | |
| Deposits, total | 4,460,713 | 3,419,602 | 2,442,681 | 976,921 | 1,041,111 |
| Interbank | 68,721 | 54,897 | 37,078 | 17,819 | 13,824 |
| Other transaction | 682,017 | 493,695 | 344,248 | 149,447 | 188,322 |
| Other nontransaction | 3,709,976 | 2,871,010 | 2,061,355 | 809,655 | 838,966 |
| Equity capital | 721,218 | 576,854 | 419,827 | 157,027 | 144,364 |
| Number of banks | 7,677 | 2,885 | 1,955 | 930 | 4,792 |

NOTE. Data are domestic assets and liabilities (except for those components reported on a consolidated basis only). Components may not sum to totals because of rounding.

1. Includes U.S.-insured commercial banks located in the United States but not U.S.-insured commercial banks operating in U.S. territories or possessions.

## 8. Initial Margin Requirements under Regulations T, U, and X

Percent of market value

| Effective date | Margin stocks | Convertible bonds | Short sales, T only[1] |
|---|---|---|---|
| 1934, Oct. 1 | 25–45 | . . . | . . . |
| 1936, Feb. 1 | 25–55 | . . . | . . . |
| Apr. 1 | 55 | . . . | . . . |
| 1937, Nov. 1 | 40 | . . . | 50 |
| 1945, Feb. 5 | 50 | . . . | 50 |
| July 5 | 75 | . . . | 75 |
| 1946, Jan. 21 | 100 | . . . | 100 |
| 1947, Feb. 1 | 75 | . . . | 75 |
| 1949, Mar. 3 | 50 | . . . | 50 |
| 1951, Jan. 17 | 75 | . . . | 75 |
| 1953, Feb. 20 | 50 | . . . | 50 |
| 1955, Jan. 4 | 60 | . . . | 60 |
| Apr. 23 | 70 | . . . | 70 |
| 1958, Jan. 16 | 50 | . . . | 50 |
| Aug. 5 | 70 | . . . | 70 |
| Oct. 16 | 90 | . . . | 90 |
| 1960, July 28 | 70 | . . . | 70 |
| 1962, July 10 | 50 | . . . | 50 |
| 1963, Nov. 6 | 70 | . . . | 70 |
| 1968, Mar. 11 | 70 | 50 | 70 |
| June 8 | 80 | 60 | 80 |
| 1970, May 6 | 65 | 50 | 65 |
| 1971, Dec. 6 | 55 | 50 | 55 |
| 1972, Nov. 24 | 65 | 50 | 65 |
| 1974, Jan. 3 | 50 | 50 | 50 |

NOTE. These regulations, adopted by the Board of Governors pursuant to the Securities Exchange Act of 1934, limit the amount of credit to purchase and carry "margin securities" (as defined in the regulations) when such value is collateralized by securities. Margin requirements on securities are the difference between the market value (100 percent) and the maximum loan value of collateral as prescribed by the Board. Regulation T was adopted effective October 1, 1934; Regulation U, effective May 1, 1936; and Regulation X, effective November 1, 1971. The former Regulation G, which was adopted effective March 11, 1968, was merged with Regulation U, effective April 1, 1998.

1. From October 1, 1934, to October 31, 1937, the requirement was the margin "customarily required" by the brokers and dealers.

## 9. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 2005 and 2004

Millions of dollars

| Item | Total | | Boston | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| ASSETS | | | | |
| Gold certificate account | 11,039 | 11,041 | 510 | 494 |
| Special drawing rights certificate account | 2,200 | 2,200 | 115 | 115 |
| Coin | 686 | 728 | 31 | 19 |
| *Loans* | | | | |
| To depository institutions | 72 | 43 | 2 | 1 |
| Securities purchased under agreements to resell (triparty) | 46,750 | 33,000 | 0 | 0 |
| *U.S. Treasury securities* | | | | |
| Bought outright[1] | 744,215 | 717,819 | 38,076 | 33,707 |
| Held under repurchase agreements | 0 | 0 | 0 | 0 |
| Total loans and securities | 791,036 | 750,863 | 38,078 | 33,708 |
| Items in process of collection | 6,834 | 7,964 | 368 | 457 |
| Bank premises | 1,827 | 1,778 | 112 | 99 |
| *Other assets* | | | | |
| Denominated in foreign currencies[2] | 18,928 | 21,368 | 2,405 | 1,083 |
| Other[3] | 18,579 | 19,004 | 792 | 1,182 |
| Interdistrict settlement account | 0 | 0 | –3,268 | 2,979 |
| **Total assets** | **851,130** | **814,946** | **39,143** | **40,136** |
| LIABILITIES | | | | |
| Federal Reserve notes outstanding (issued to Bank) | 906,511 | 848,370 | 38,971 | 38,054 |
| Less: Notes held by Federal Reserve Bank | 148,152 | 128,933 | 4,424 | 4,137 |
| Federal Reserve notes, net | 758,359 | 719,437 | 34,548 | 33,917 |
| Securities sold under agreements to repurchase | 30,505 | 30,783 | 1,561 | 1,445 |
| *Deposits* | | | | |
| Depository institutions | 19,043 | 24,043 | 622 | 1,050 |
| U.S. Treasury, general account | 4,573 | 5,912 | 0 | 0 |
| Foreign, official accounts | 83 | 80 | 5 | 2 |
| Other[4] | 2,168 | 1,288 | 1,068 | 2 |
| Total deposits | 25,867 | 31,323 | 1,695 | 1,054 |
| Deferred credit items | 5,943 | 7,038 | 488 | 578 |
| Other liabilities and accrued dividends[5] | 4,019 | 2,821 | 218 | 151 |
| **Total liabilities** | **824,693** | **791,402** | **38,510** | **37,145** |
| CAPITAL ACCOUNTS | | | | |
| Capital paid in | 13,536 | 11,914 | 317 | 1,638 |
| Surplus | 12,901 | 11,630 | 317 | 1,353 |
| **Total liabilities and capital accounts** | **851,130** | **814,946** | **39,143** | **40,136** |
| FEDERAL RESERVE NOTE STATEMENT | | | | |
| Federal Reserve notes outstanding | 906,511 | 848,370 | ... | ... |
| Less: Held by Banks not subject to collateralization | 148,152 | 128,933 | ... | ... |
| **Collateralized Federal Reserve notes** | **758,359** | **719,437** | ... | ... |
| *Collateral for Federal Reserve notes* | | | | |
| Gold certificate account | 11,039 | 11,041 | ... | ... |
| Special drawing rights certificate account | 2,200 | 2,200 | ... | ... |
| Other eligible assets | 0 | 0 | ... | ... |
| U.S. Treasury and federal agency securities | 745,120 | 706,196 | ... | ... |
| **Total collateral** | **758,359** | **719,437** | ... | ... |

For notes see end of table.

9.—Continued

| New York | | Philadelphia | | Cleveland | | Richmond | |
|---|---|---|---|---|---|---|---|
| 2005 | 2004 | 2005 | 2004 | 2005 | 2004 | 2005 | 2004 |
| 4,357 | 4,651 | 432 | 382 | 453 | 452 | 836 | 819 |
| 874 | 874 | 83 | 83 | 104 | 104 | 147 | 147 |
| 47 | 42 | 34 | 56 | 55 | 52 | 66 | 62 |
| 0 | 0 | 0 | 5 | 0 | 0 | 1 | 0 |
| 46,750 | 33,000 | 0 | 0 | 0 | 0 | 0 | 0 |
| 295,107 | 311,256 | 26,401 | 21,350 | 31,439 | 30,673 | 56,796 | 54,557 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 341,857 | 344,256 | 26,401 | 21,354 | 31,439 | 30,673 | 56,797 | 54,558 |
| 625 | 407 | 586 | 360 | 820 | 814 | 225 | 341 |
| 207 | 196 | 53 | 53 | 158 | 157 | 153 | 144 |
| 5,514 | 4,905 | 473 | 624 | 1,712 | 1,757 | 3,454 | 5,009 |
| 8,740 | 9,176 | 672 | 530 | 718 | 966 | 1,341 | 1,337 |
| –45,332 | –24,125 | 6,148 | 4,007 | 833 | –495 | 8,521 | –420 |
| **316,889** | **340,381** | **34,883** | **27,449** | **36,293** | **34,479** | **71,540** | **61,996** |
| 327,194 | 335,998 | 37,426 | 32,698 | 36,539 | 34,511 | 69,647 | 64,991 |
| 43,521 | 35,347 | 6,130 | 7,973 | 5,081 | 5,408 | 11,887 | 12,275 |
| 283,673 | 300,651 | 31,296 | 24,725 | 31,457 | 29,103 | 57,759 | 52,716 |
| 12,096 | 13,348 | 1,082 | 916 | 1,289 | 1,315 | 2,328 | 2,340 |
| 6,389 | 11,388 | 485 | 603 | 658 | 1,272 | 3,182 | 1,645 |
| 4,573 | 5,912 | 0 | 0 | 0 | 0 | 0 | 0 |
| 55 | 57 | 1 | 1 | 4 | 2 | 7 | 7 |
| 523 | 527 | 4 | 28 | 82 | 2 | 146 | 169 |
| 11,539 | 17,884 | 490 | 632 | 743 | 1,277 | 3,336 | 1,820 |
| 797 | 651 | 363 | 490 | 581 | 505 | 509 | 544 |
| 1,414 | 988 | 164 | 99 | 196 | 149 | 359 | 280 |
| **309,519** | **333,522** | **33,395** | **26,861** | **34,266** | **32,349** | **64,291** | **57,700** |
| 3,685 | 3,430 | 744 | 294 | 1,013 | 1,065 | 3,942 | 2,148 |
| 3,685 | 3,430 | 744 | 294 | 1,013 | 1,065 | 3,307 | 2,148 |
| **316,889** | **340,381** | **34,883** | **27,449** | **36,293** | **34,479** | **71,540** | **61,996** |
| . . . | . . . | . . . | . . . | . . . | . . . | . . . | . . . |
| . . . | . . . | . . . | . . . | . . . | . . . | . . . | . . . |
| . . . | . . . | . . . | . . . | . . . | . . . | . . . | . . . |
| . . . | . . . | . . . | . . . | . . . | . . . | . . . | . . . |
| . . . | . . . | . . . | . . . | . . . | . . . | . . . | . . . |
| . . . | . . . | . . . | . . . | . . . | . . . | . . . | . . . |
| . . . | . . . | . . . | . . . | . . . | . . . | . . . | . . . |
| . . . | . . . | . . . | . . . | . . . | . . . | . . . | . . . |

## 9. Statement of Condition of the Federal Reserve Banks, by Bank, December 31, 2005 and 2004—Continued

Millions of dollars

| Item | Atlanta | | Chicago | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| ASSETS | | | | |
| Gold certificate account | 945 | 894 | 928 | 924 |
| Special drawing rights certificate account | 166 | 166 | 212 | 212 |
| Coin | 89 | 82 | 76 | 111 |
| *Loans* | | | | |
| To depository institutions | 7 | 8 | 27 | 14 |
| Securities purchased under agreements to resell (triparty) | 0 | 0 | 0 | 0 |
| *U.S. Treasury securities* | | | | |
| Bought outright[1] | 57,576 | 48,408 | 67,020 | 64,660 |
| Held under repurchase agreements | 0 | 0 | 0 | 0 |
| Total loans and securities | 57,583 | 48,415 | 67,047 | 64,674 |
| Items in process of collection | 1,281 | 637 | 414 | 559 |
| Bank premises | 232 | 276 | 211 | 157 |
| *Other assets* | | | | |
| Denominated in foreign currencies[2] | 830 | 1,181 | 1,228 | 2,232 |
| Other[3] | 1,276 | 1,076 | 1,386 | 1,374 |
| Interdistrict settlement account | 10,086 | 9,939 | 1,908 | 225 |
| **Total assets** | **72,489** | **62,666** | **73,408** | **70,469** |
| LIABILITIES | | | | |
| Federal Reserve notes outstanding (issued to Banks) | 84,653 | 74,144 | 76,740 | 72,517 |
| Less: Notes held by Federal Reserve Banks | 19,039 | 17,376 | 10,216 | 9,046 |
| Federal Reserve notes, net | 65,614 | 56,768 | 66,524 | 63,470 |
| Securities sold under repurchase agreements | 2,360 | 2,076 | 2,747 | 2,773 |
| *Deposits* | | | | |
| Depository institutions | 1,626 | 1,722 | 1,591 | 1,762 |
| U.S. Treasury, general account | 0 | 0 | 0 | 0 |
| Foreign, official accounts | 2 | 2 | 3 | 3 |
| Other[4] | 13 | 56 | 72 | 246 |
| Total deposits | 1,641 | 1,780 | 1,665 | 2,011 |
| Deferred credit items | 763 | 796 | 349 | 421 |
| Other liabilities and accrued dividends[5] | 326 | 214 | 371 | 267 |
| **Total liabilities** | **70,704** | **61,634** | **71,656** | **68,942** |
| CAPITAL ACCOUNTS | | | | |
| Capital paid in | 892 | 516 | 876 | 763 |
| Surplus | 892 | 516 | 876 | 763 |
| **Total liabilities and capital accounts** | **72,489** | **62,666** | **73,408** | **70,469** |

NOTE. Components may not sum to totals because of rounding.

1. Includes securities loaned—fully guaranteed by U.S. Treasury securities pledged with Federal Reserve Banks—and excludes securities purchased under agreements to resell.

2. Valued daily at market exchange rates.

3. The System total includes depository institution overdrafts of $2 million for 2005 and $1 million for 2004.

9.—Continued

| St. Louis | | Minneapolis | | Kansas City | | Dallas | | San Francisco | |
|---|---|---|---|---|---|---|---|---|---|
| 2005 | 2004 | 2005 | 2004 | 2005 | 2004 | 2005 | 2004 | 2005 | 2004 |
| 327 | 325 | 212 | 218 | 318 | 302 | 549 | 525 | 1,172 | 1,055 |
| 71 | 71 | 30 | 30 | 66 | 66 | 98 | 98 | 234 | 234 |
| 43 | 36 | 22 | 22 | 61 | 48 | 68 | 93 | 94 | 105 |
| 0 | 2 | 16 | 13 | 11 | 1 | 3 | 0 | 5 | 0 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 23,094 | 21,089 | 15,543 | 15,657 | 21,050 | 18,863 | 36,654 | 32,729 | 75,459 | 64,871 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 23,094 | 21,090 | 15,560 | 15,669 | 21,060 | 18,864 | 36,657 | 32,729 | 75,464 | 64,871 |
| 217 | 348 | 339 | 512 | 591 | 653 | 535 | 334 | 834 | 2,542 |
| 70 | 68 | 119 | 123 | 84 | 82 | 261 | 257 | 165 | 168 |
| 379 | 551 | 409 | 835 | 246 | 392 | 217 | 267 | 2,062 | 2,532 |
| 524 | 487 | 338 | 351 | 441 | 416 | 786 | 716 | 1,563 | 1,395 |
| 2,010 | 1,401 | 38 | –969 | 2,422 | 1,584 | –2,693 | 1,461 | 19,327 | 4,414 |
| **26,735** | **24,377** | **17,067** | **16,790** | **25,290** | **22,408** | **36,477** | **36,479** | **100,916** | **77,316** |
| 28,096 | 25,006 | 17,854 | 16,370 | 27,832 | 24,535 | 50,474 | 41,146 | 111,084 | 88,401 |
| 3,494 | 2,819 | 2,789 | 1,982 | 5,016 | 4,497 | 17,163 | 7,503 | 19,391 | 20,570 |
| 24,602 | 22,187 | 15,065 | 14,387 | 22,816 | 20,038 | 33,311 | 33,643 | 91,694 | 67,831 |
| 947 | 904 | 637 | 671 | 863 | 809 | 1,502 | 1,404 | 3,093 | 2,782 |
| 482 | 479 | 388 | 473 | 655 | 721 | 811 | 684 | 2,154 | 2,244 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 1 | 1 | 1 | 1 | 1 | 1 | 0 | 0 | 4 | 4 |
| 108 | 27 | 25 | 115 | 22 | 32 | 31 | 26 | 74 | 57 |
| 591 | 507 | 414 | 590 | 678 | 753 | 843 | 710 | 2,232 | 2,305 |
| 151 | 197 | 353 | 548 | 457 | 409 | 303 | 301 | 830 | 1,599 |
| 156 | 111 | 107 | 85 | 128 | 92 | 212 | 152 | 369 | 234 |
| **26,447** | **23,906** | **16,576** | **16,281** | **24,941** | **22,101** | **36,172** | **36,209** | **98,218** | **74,751** |
| 144 | 236 | 245 | 254 | 175 | 153 | 153 | 135 | 1,349 | 1,283 |
| 144 | 236 | 245 | 254 | 175 | 153 | 153 | 135 | 1,349 | 1,283 |
| **26,735** | **24,377** | **17,067** | **16,790** | **25,290** | **22,408** | **36,477** | **36,479** | **100,916** | **77,316** |

4. Includes international organization deposits of $125 million for 2005 and $144 million for 2004.

5. Includes exchange-translation account reflecting the monthly revaluation at market exchange rates of foreign exchange commitments.

. . . Not applicable.

## 10. Income and Expenses of the Federal Reserve Banks, by Bank, 2005

Thousands of dollars

| Item | Total | Boston | New York | Philadelphia | Cleveland |
|---|---|---|---|---|---|
| CURRENT INCOME | | | | | |
| Loans | 7,453 | 438 | 1,217 | 75 | 234 |
| U.S. Treasury securities | 28,958,637 | 1,409,356 | 12,249,381 | 957,863 | 1,190,864 |
| Foreign currencies | 282,772 | 34,326 | 81,081 | 7,149 | 25,400 |
| Priced services | 900,959 | 0 | 66,264 | 0 | 0 |
| Compensation received for check services provided[1] | 483,381 | 45,065 | 43,001 | 25,090 | 60,225 |
| Other | 96,154 | 3,045 | 57,582 | 1,975 | 2,682 |
| **Total** | **30,729,357** | **1,492,230** | **12,498,525** | **992,152** | **1,279,405** |
| CURRENT EXPENSES | | | | | |
| Salaries and other personnel expenses | 1,345,171 | 72,098 | 275,567 | 63,784 | 81,748 |
| Retirement and other benefits | 398,173 | 16,139 | 76,046 | 18,703 | 23,990 |
| Net periodic pension costs[2] | –7,183 | 148 | –9,736 | 162 | 292 |
| Fees | 110,156 | 2,487 | 8,916 | 1,306 | 7,347 |
| Travel | 58,849 | 2,314 | 7,512 | 1,993 | 3,778 |
| Software expenses | 123,740 | 3,752 | 13,512 | 4,206 | 16,626 |
| Postage and other shipping costs | 91,465 | 1,446 | 4,637 | 1,508 | 4,871 |
| Communications | 39,198 | 2,193 | 2,799 | 469 | 724 |
| Materials and supplies | 44,739 | 2,358 | 8,459 | 3,052 | 3,795 |
| *Building expenses* | | | | | |
| Taxes on real estate | 32,431 | 4,993 | 4,885 | 1,563 | 2,163 |
| Property depreciation | 88,592 | 4,862 | 14,495 | 3,891 | 6,919 |
| Utilities | 37,424 | 3,640 | 7,954 | 2,914 | 2,376 |
| Rent | 37,165 | 822 | 11,421 | 314 | 386 |
| Other | 34,872 | 1,255 | 6,495 | 1,716 | 2,848 |
| *Equipment* | | | | | |
| Purchases | 25,873 | 1,476 | 3,328 | 1,051 | 1,703 |
| Rentals | 5,173 | 231 | 1,908 | 366 | 311 |
| Depreciation | 91,517 | 3,894 | 9,801 | 5,641 | 4,576 |
| Repairs and maintenance | 78,727 | 4,639 | 8,656 | 4,289 | 5,019 |
| Earnings-credit costs | 212,773 | 9,994 | 71,225 | 16,036 | 15,719 |
| Compensation paid for check services costs incurred[1] | 483,381 | 0 | 0 | 0 | 0 |
| Other | 68,829 | 27,839 | 51,092 | 9,703 | 12,429 |
| Recoveries | –88,186 | –12,108 | –10,514 | –3,176 | –2,696 |
| Expenses capitalized[3] | –26,794 | –430 | –9,330 | –1,994 | 0 |
| **Total** | **3,286,085** | **154,040** | **559,127** | **137,497** | **194,924** |
| Reimbursements | –396,540 | –20,265 | –72,912 | –25,397 | –55,008 |
| Net expenses | 2,889,544 | 133,775 | 486,215 | 112,100 | 139,916 |

For notes see end of table.

10.—Continued

| Richmond | Atlanta | Chicago | St. Louis | Minneapolis | Kansas City | Dallas | San Francisco |
|---|---|---|---|---|---|---|---|
| 43 | 220 | 1,813 | 881 | 1,365 | 628 | 88 | 451 |
| 2,143,162 | 2,106,639 | 2,531,655 | 860,958 | 593,462 | 781,316 | 1,359,392 | 2,774,590 |
| 52,691 | 12,633 | 19,171 | 5,782 | 6,477 | 3,789 | 3,263 | 31,011 |
| 0 | 785,660 | 49,035 | 0 | 0 | 0 | 0 | 0 |
| 39,736 | 0 | 54,319 | 21,659 | 30,954 | 55,727 | 48,605 | 59,001 |
| 5,674 | 4,793 | 5,567 | 2,259 | 1,199 | 1,540 | 2,588 | 7,251 |
| **2,241,306** | **2,909,945** | **2,661,560** | **891,539** | **633,457** | **843,000** | **1,413,936** | **2,872,303** |
| 178,932 | 127,470 | 107,750 | 72,595 | 69,431 | 88,102 | 73,578 | 134,117 |
| 64,877 | 37,363 | 28,427 | 22,602 | 19,249 | 21,027 | 28,512 | 41,238 |
| 242 | 274 | 148 | 213 | 189 | 160 | 210 | 514 |
| 54,937 | 7,355 | 5,518 | 13,694 | 1,865 | 1,667 | 2,547 | 2,516 |
| 7,673 | 7,532 | 6,180 | 3,667 | 2,692 | 4,379 | 3,332 | 7,797 |
| 51,773 | 4,279 | 4,455 | 5,156 | 3,214 | 3,577 | 5,157 | 8,033 |
| 3,928 | 55,031 | 4,180 | 2,091 | 2,850 | 2,540 | 2,680 | 5,703 |
| 23,912 | 1,502 | 1,320 | 1,108 | 1,239 | 1,011 | 1,312 | 1,610 |
| 4,755 | 5,326 | 3,378 | 2,162 | 1,737 | 2,413 | 3,522 | 3,782 |
| 2,055 | 2,232 | 2,631 | 545 | 2,721 | 1,286 | 4,297 | 3,061 |
| 8,195 | 11,451 | 9,239 | 5,103 | 4,661 | 4,022 | 7,109 | 8,645 |
| 3,600 | 3,040 | 1,785 | 1,910 | 1,827 | 1,141 | 3,630 | 3,606 |
| 15,135 | 876 | 2,536 | 1,602 | 243 | 2,759 | 767 | 305 |
| 3,894 | 3,618 | 4,923 | 1,028 | 1,568 | 938 | 4,169 | 2,420 |
| 5,124 | 2,432 | 813 | 1,364 | 2,302 | 2,687 | 1,526 | 2,067 |
| 793 | 612 | 378 | 206 | 27 | 50 | 121 | 171 |
| 34,995 | 7,817 | 4,294 | 3,138 | 2,509 | 3,597 | 4,028 | 7,226 |
| 18,081 | 9,609 | 6,734 | 2,407 | 2,197 | 3,046 | 4,830 | 9,222 |
| 31,683 | 11,035 | 19,750 | 3,585 | 4,056 | 6,245 | 4,042 | 19,404 |
| 0 | 483,381 | 0 | 0 | 0 | 0 | 0 | 0 |
| –251,340 | 14,042 | 41,067 | 74,996 | 21,616 | 17,763 | 33,827 | 15,795 |
| –28,720 | –2,870 | –7,433 | –4,522 | –1,132 | –3,461 | –6,699 | –4,855 |
| –3,150 | 0 | –267 | –6,903 | –1,600 | –527 | –1,008 | –1,587 |
| **231,374** | **793,405** | **247,807** | **207,746** | **143,462** | **164,421** | **181,491** | **270,790** |
| –27,886 | –17,557 | –5,085 | –111,621 | –24,484 | –10,518 | –11,118 | –14,689 |
| 203,489 | 775,848 | 242,722 | 96,125 | 118,978 | 153,903 | 170,373 | 256,101 |

## 10. Income and Expenses of the Federal Reserve Banks, by Bank, 2005—Continued

Thousands of dollars

| Item | Total | Boston | New York | Philadelphia | Cleveland |
|---|---|---|---|---|---|
| PROFIT AND LOSS | | | | | |
| Current net income | 27,839,813 | 1,358,455 | 12,012,310 | 880,052 | 1,139,488 |
| *Additions to and deductions from (–) current net income*[4] | | | | | |
| Other additions | 933 | 25 | 99 | 3 | 1 |
| Losses on foreign exchange transactions | –2,723,131 | –313,128 | –766,723 | –69,819 | –242,721 |
| Interest expense on reverse repurchase agreements | –808,808 | –40,649 | –327,177 | –27,694 | –34,253 |
| Other deductions | –45,875 | –1 | –545 | –5 | –2 |
| **Total deductions** | **–3,577,814** | **–353,778** | **–1,094,445** | **–97,518** | **–276,976** |
| Net addition to or deduction from (–) current net income | –3,576,881 | –353,753 | –1,094,347 | –97,515 | –276,974 |
| Cost of unreimbursed Treasury services | 22 | 0 | 3 | 19 | 0 |
| *Assessments by Board* | | | | | |
| Board expenditures[5] | 265,742 | 24,617 | 77,166 | 6,600 | 23,959 |
| Cost of currency | 477,087 | 28,344 | 101,397 | 27,030 | 26,020 |
| Net income before payment to U.S. Treasury | 23,520,080 | 951,741 | 10,739,398 | 748,889 | 812,534 |
| Dividends paid | 780,863 | 50,819 | 214,923 | 30,700 | 64,845 |
| Payments to U.S. Treasury (interest on Federal Reserve notes) | 21,467,545 | 1,937,102 | 10,268,863 | 268,048 | 798,844 |
| Transferred to/from surplus | 1,271,672 | –1,036,180 | 255,612 | 450,140 | –51,155 |
| Surplus, January 1 | 11,629,504 | 1,353,004 | 3,429,567 | 293,908 | 1,064,625 |
| Surplus, December 31 | 12,901,176 | 316,824 | 3,685,179 | 744,048 | 1,013,470 |

NOTE: Components may not sum to totals because of rounding.

1. Beginning in 2005, the Reserve Banks adopted a new management model for providing check services to depository institutions. The Federal Reserve Bank of Atlanta compensates the other eleven Banks for the costs incurred to provide check services.

2. Reflects the effect of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). The System Retirement Plan for employees is recorded on behalf of the System on the books of the Federal Reserve Bank of New York, resulting in a decrease in expenses of $10,652 thousand. The expenses related to the Retirement Benefit Equalization Plan and the Supplemental Employee Retirement Plan are recorded by each Federal Reserve Bank.

3. Includes expenses for labor and materials capitalized and depreciated or amortized as charges to activities in the periods benefited.

4. Includes reimbursement from the U.S. Treasury for uncut sheets of Federal Reserve notes, gains and losses on the sale of Reserve Bank buildings, counterfeit currency that is not charged back to the depositing institution, and stale Reserve Bank checks that are written off.

5. For additional details, see the chapter "Board of Governors Financial Statements."

10.—Continued

| Richmond | Atlanta | Chicago | St. Louis | Minneapolis | Kansas City | Dallas | San Francisco |
|---|---|---|---|---|---|---|---|
| 2,037,817 | 2,134,097 | 2,418,838 | 795,414 | 514,479 | 689,098 | 1,243,563 | 2,616,201 |
| 0 | 279 | 49 | 427 | 0 | 9 | 6 | 35 |
| –519,271 | –124,274 | –193,661 | –56,998 | –66,356 | –37,711 | –31,662 | –300,808 |
| –61,671 | –60,845 | –72,841 | –24,810 | –17,054 | –22,527 | –39,198 | –80,089 |
| –6 | –39,568 | –979 | –2 | –1 | –4,630 | –136 | 0 |
| **–580,949** | **–224,687** | **–267,481** | **–81,810** | **–83,410** | **–64,868** | **–70,996** | **–380,897** |
| –580,949 | –224,408 | –267,432 | –81,383 | –83,410 | –64,858 | –70,990 | –380,862 |
| 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 57,140 | 13,260 | 17,373 | 4,722 | 5,639 | 3,419 | 3,068 | 28,779 |
| 42,101 | 58,604 | 52,210 | 17,653 | 12,652 | 16,897 | 29,984 | 64,197 |
| 1,357,628 | 1,837,825 | 2,081,824 | 691,656 | 412,777 | 603,924 | 1,139,520 | 2,142,364 |
| 198,386 | 41,652 | 50,279 | 15,403 | 14,946 | 9,708 | 8,788 | 80,414 |
| 0 | 1,419,942 | 1,918,743 | 767,897 | 406,905 | 572,526 | 1,113,058 | 1,995,617 |
| 1,159,242 | 376,231 | 112,802 | –91,644 | –9,073 | 21,689 | 17,674 | 66,333 |
| 2,148,210 | 515,935 | 763,499 | 235,644 | 254,396 | 153,068 | 134,953 | 1,282,696 |
| 3,307,452 | 892,166 | 876,301 | 144,000 | 245,322 | 174,757 | 152,628 | 1,349,029 |

## 11. Income and Expenses of the Federal Reserve Banks, 1914–2005

Thousands of dollars

| Federal Reserve Bank and period | Current income | Net expenses | Net additions or deductions (–)[1] | Assessments by Board of Governors | |
|---|---|---|---|---|---|
| | | | | Board expenditures | Costs of currency |
| *All Banks* | | | | | |
| 1914–15 | 2,173 | 2,018 | 6 | 302 | . . . |
| 1916 | 5,218 | 2,082 | –193 | 192 | . . . |
| 1917 | 16,128 | 4,922 | –1,387 | 238 | . . . |
| 1918 | 67,584 | 10,577 | –3,909 | 383 | . . . |
| 1919 | 102,381 | 18,745 | –4,673 | 595 | . . . |
| 1920 | 181,297 | 27,549 | –3,744 | 710 | . . . |
| 1921 | 122,866 | 33,722 | –6,315 | 741 | . . . |
| 1922 | 50,499 | 28,837 | –4,442 | 723 | . . . |
| 1923 | 50,709 | 29,062 | –8,233 | 703 | . . . |
| 1924 | 38,340 | 27,768 | –6,191 | 663 | . . . |
| 1925 | 41,801 | 26,819 | –4,823 | 709 | . . . |
| 1926 | 47,600 | 24,914 | –3,638 | 722 | 1,714 |
| 1927 | 43,024 | 24,894 | –2,457 | 779 | 1,845 |
| 1928 | 64,053 | 25,401 | –5,026 | 698 | 806 |
| 1929 | 70,955 | 25,810 | –4,862 | 782 | 3,099 |
| 1930 | 36,424 | 25,358 | –93 | 810 | 2,176 |
| 1931 | 29,701 | 24,843 | 311 | 719 | 1,479 |
| 1932 | 50,019 | 24,457 | –1,413 | 729 | 1,106 |
| 1933 | 49,487 | 25,918 | –12,307 | 800 | 2,505 |
| 1934 | 48,903 | 26,844 | –4,430 | 1,372 | 1,026 |
| 1935 | 42,752 | 28,695 | –1,737 | 1,406 | 1,477 |
| 1936 | 37,901 | 26,016 | 486 | 1,680 | 2,178 |
| 1937 | 41,233 | 25,295 | –1,631 | 1,748 | 1,757 |
| 1938 | 36,261 | 25,557 | 2,232 | 1,725 | 1,630 |
| 1939 | 38,501 | 25,669 | 2,390 | 1,621 | 1,356 |
| 1940 | 43,538 | 25,951 | 11,488 | 1,704 | 1,511 |
| 1941 | 41,380 | 28,536 | 721 | 1,840 | 2,588 |
| 1942 | 52,663 | 32,051 | –1,568 | 1,746 | 4,826 |
| 1943 | 69,306 | 35,794 | 23,768 | 2,416 | 5,336 |
| 1944 | 104,392 | 39,659 | 3,222 | 2,296 | 7,220 |
| 1945 | 142,210 | 41,666 | –830 | 2,341 | 4,710 |
| 1946 | 150,385 | 50,493 | –626 | 2,260 | 4,482 |
| 1947 | 158,656 | 58,191 | 1,973 | 2,640 | 4,562 |
| 1948 | 304,161 | 64,280 | –34,318 | 3,244 | 5,186 |
| 1949 | 316,537 | 67,931 | –12,122 | 3,243 | 6,304 |
| 1950 | 275,839 | 69,822 | 36,294 | 3,434 | 7,316 |
| 1951 | 394,656 | 83,793 | –2,128 | 4,095 | 7,581 |
| 1952 | 456,060 | 92,051 | 1,584 | 4,122 | 8,521 |
| 1953 | 513,037 | 98,493 | –1,059 | 4,100 | 10,922 |
| 1954 | 438,486 | 99,068 | –134 | 4,175 | 6,490 |
| 1955 | 412,488 | 101,159 | –265 | 4,194 | 4,707 |
| 1956 | 595,649 | 110,240 | –23 | 5,340 | 5,603 |
| 1957 | 763,348 | 117,932 | –7,141 | 7,508 | 6,374 |
| 1958 | 742,068 | 125,831 | 124 | 5,917 | 5,973 |
| 1959 | 886,226 | 131,848 | 98,247 | 6,471 | 6,384 |

For notes see end of table.

11.—Continued

| Dividends paid | Payments to U.S. Treasury | | Transferred to surplus (section 13b) | Transferred to surplus (section 7) |
|---|---|---|---|---|
| | Statutory transfers [2] | Interest on Federal Reserve notes | | |
| 217 | ... | ... | ... | ... |
| 1,743 | ... | ... | ... | ... |
| 6,804 | 1,134 | ... | ... | 1,134 |
| 5,541 | ... | ... | ... | 48,334 |
| 5,012 | 2,704 | ... | ... | 70,652 |
| | | | | |
| 5,654 | 60,725 | ... | ... | 82,916 |
| 6,120 | 59,974 | ... | ... | 15,993 |
| 6,307 | 10,851 | ... | ... | –660 |
| 6,553 | 3,613 | ... | ... | 2,546 |
| 6,682 | 114 | ... | ... | –3,078 |
| 6,916 | 59 | ... | ... | 2,474 |
| 7,329 | 818 | ... | ... | 8,464 |
| 7,755 | 250 | ... | ... | 5,044 |
| 8,458 | 2,585 | ... | ... | 21,079 |
| 9,584 | 4,283 | ... | ... | 22,536 |
| | | | | |
| 10,269 | 17 | ... | ... | –2,298 |
| 10,030 | ... | ... | ... | –7,058 |
| 9,282 | 2,011 | ... | ... | 11,021 |
| 8,874 | ... | ... | ... | –917 |
| 8,782 | ... | ... | –60 | 6,510 |
| 8,505 | 298 | ... | 28 | 607 |
| 7,830 | 227 | ... | 103 | 353 |
| 7,941 | 177 | ... | 67 | 2,616 |
| 8,019 | 120 | ... | –419 | 1,862 |
| 8,110 | 25 | ... | –426 | 4,534 |
| | | | | |
| 8,215 | 82 | ... | –54 | 17,617 |
| 8,430 | 141 | ... | –4 | 571 |
| 8,669 | 198 | ... | 50 | 3,554 |
| 8,911 | 245 | ... | 135 | 40,327 |
| 9,500 | 327 | ... | 201 | 48,410 |
| 10,183 | 248 | ... | 262 | 81,970 |
| 10,962 | 67 | ... | 28 | 81,467 |
| 11,523 | 36 | 75,284 | 87 | 8,366 |
| 11,920 | ... | 166,690 | ... | 18,523 |
| 12,329 | ... | 193,146 | ... | 21,462 |
| | | | | |
| 13,083 | ... | 196,629 | ... | 21,849 |
| 13,865 | ... | 254,874 | ... | 28,321 |
| 14,682 | ... | 291,935 | ... | 46,334 |
| 15,558 | ... | 342,568 | ... | 40,337 |
| 16,442 | ... | 276,289 | ... | 35,888 |
| 17,712 | ... | 251,741 | ... | 32,710 |
| 18,905 | ... | 401,556 | ... | 53,983 |
| 20,081 | ... | 542,708 | ... | 61,604 |
| 21,197 | ... | 524,059 | ... | 59,215 |
| 22,722 | ... | 910,650 | ... | –93,601 |

## 11. Income and Expenses of the Federal Reserve Banks, 1914–2005—Continued

Thousands of dollars

| Federal Reserve Bank and period | Current income | Net expenses | Net additions or deductions (–)[1] | Assessments by Board of Governors | |
|---|---|---|---|---|---|
| | | | | Board expenditures | Costs of currency |
| 1960 | 1,103,385 | 139,894 | 13,875 | 6,534 | 7,455 |
| 1961 | 941,648 | 148,254 | 3,482 | 6,265 | 6,756 |
| 1962 | 1,048,508 | 161,451 | –56 | 6,655 | 8,030 |
| 1963 | 1,151,120 | 169,638 | 615 | 7,573 | 10,063 |
| 1964 | 1,343,747 | 171,511 | 726 | 8,655 | 17,230 |
| 1965 | 1,559,484 | 172,111 | 1,022 | 8,576 | 23,603 |
| 1966 | 1,908,500 | 178,212 | 996 | 9,022 | 20,167 |
| 1967 | 2,190,404 | 190,561 | 2,094 | 10,770 | 18,790 |
| 1968 | 2,764,446 | 207,678 | 8,520 | 14,198 | 20,474 |
| 1969 | 3,373,361 | 237,828 | –558 | 15,020 | 22,126 |
| 1970 | 3,877,218 | 276,572 | 11,442 | 21,228 | 23,574 |
| 1971 | 3,723,370 | 319,608 | 94,266 | 32,634 | 24,943 |
| 1972 | 3,792,335 | 347,917 | –49,616 | 35,234 | 31,455 |
| 1973 | 5,016,769 | 416,879 | –80,653 | 44,412 | 33,826 |
| 1974 | 6,280,091 | 476,235 | –78,487 | 41,117 | 30,190 |
| 1975 | 6,257,937 | 514,359 | –202,370 | 33,577 | 37,130 |
| 1976 | 6,623,220 | 558,129 | 7,311 | 41,828 | 48,819 |
| 1977 | 6,891,317 | 568,851 | –177,033 | 47,366 | 55,008 |
| 1978 | 8,455,309 | 592,558 | –633,123 | 53,322 | 60,059 |
| 1979 | 10,310,148 | 625,168 | –151,148 | 50,530 | 68,391 |
| 1980 | 12,802,319 | 718,033 | –115,386 | 62,231 | 73,124 |
| 1981 | 15,508,350 | 814,190 | –372,879 | 63,163 | 82,924 |
| 1982 | 16,517,385 | 926,034 | –68,833 | 61,813 | 98,441 |
| 1983 | 16,068,362 | 1,023,678 | –400,366 | 71,551 | 152,135 |
| 1984 | 18,068,821 | 1,102,444 | –412,943 | 82,116 | 162,606 |
| 1985 | 18,131,983 | 1,127,744 | 1,301,624 | 77,378 | 173,739 |
| 1986 | 17,464,528 | 1,156,868 | 1,975,893 | 97,338 | 180,780 |
| 1987 | 17,633,012 | 1,146,911 | 1,796,594 | 81,870 | 170,675 |
| 1988 | 19,526,431 | 1,205,960 | –516,910 | 84,411 | 164,245 |
| 1989 | 22,249,276 | 1,332,161 | 1,254,613 | 89,580 | 175,044 |
| 1990 | 23,476,604 | 1,349,726 | 2,099,328 | 103,752 | 193,007 |
| 1991 | 22,553,002 | 1,429,322 | 405,729 | 109,631 | 261,316 |
| 1992 | 20,235,028 | 1,474,531 | –987,788 | 128,955 | 295,401 |
| 1993 | 18,914,251 | 1,657,800 | –230,268 | 140,466 | 355,947 |
| 1994 | 20,910,742 | 1,795,328 | 2,363,862 | 146,866 | 368,187 |
| 1995 | 25,395,148 | 1,818,416 | 857,788 | 161,348 | 370,203 |
| 1996 | 25,164,303 | 1,947,861 | –1,676,716 | 162,642 | 402,517 |
| 1997 | 26,917,213 | 1,976,453 | –2,611,570 | 174,407 | 364,454 |
| 1998 | 28,149,477 | 1,833,436 | 1,906,037 | 178,009 | 408,544 |
| 1999 | 29,346,836 | 1,852,162 | –533,557 | 213,790 | 484,959 |
| 2000 | 33,963,992 | 1,971,688 | –1,500,027 | 188,067 | 435,838 |
| 2001 | 31,870,721 | 2,084,708 | –1,117,435 | 295,056 | 338,537 |
| 2002 | 26,760,113 | 2,227,078 | 2,149,328 | 205,111 | 429,568 |
| 2003 | 23,792,725 | 2,462,658 | 2,481,127 | 297,020 | 508,144 |
| 2004 | 23,539,942 | 2,238,705 | 917,870 | 272,331 | 503,784 |
| 2005 | 30,729,357 | 2,889,544 | –3,576,903 | 265,742 | 477,087 |
| **Total, 1914–2005** | **672,479,214** | **50,083,413** | **4,200,642** | **4,403,787** | **8,340,050** |

11.—Continued

| Dividends paid | Payments to U.S. Treasury | | Transferred to surplus (section 13b) | Transferred to surplus (section 7) |
|---|---|---|---|---|
| | Statutory transfers [2] | Interest on Federal Reserve notes | | |
| 23,948 | . . . | 896,816 | . . . | 42,613 |
| 25,570 | . . . | 687,393 | . . . | 70,892 |
| 27,412 | . . . | 799,366 | . . . | 45,538 |
| 28,912 | . . . | 879,685 | . . . | 55,864 |
| 30,782 | . . . | 1,582,119 | . . . | −465,823 |
| 32,352 | . . . | 1,296,810 | . . . | 27,054 |
| 33,696 | . . . | 1,649,455 | . . . | 18,944 |
| 35,027 | . . . | 1,907,498 | . . . | 29,851 |
| 36,959 | . . . | 2,463,629 | . . . | 30,027 |
| 39,237 | . . . | 3,019,161 | . . . | 39,432 |
| 41,137 | . . . | 3,493,571 | . . . | 32,580 |
| 43,488 | . . . | 3,356,560 | . . . | 40,403 |
| 46,184 | . . . | 3,231,268 | . . . | 50,661 |
| 49,140 | . . . | 4,340,680 | . . . | 51,178 |
| 52,580 | . . . | 5,549,999 | . . . | 51,483 |
| 54,610 | . . . | 5,382,064 | . . . | 33,828 |
| 57,351 | . . . | 5,870,463 | . . . | 53,940 |
| 60,182 | . . . | 5,937,148 | . . . | 45,728 |
| 63,280 | . . . | 7,005,779 | . . . | 47,268 |
| 67,194 | . . . | 9,278,576 | . . . | 69,141 |
| 70,355 | . . . | 11,706,370 | . . . | 56,821 |
| 74,574 | . . . | 14,023,723 | . . . | 76,897 |
| 79,352 | . . . | 15,204,591 | . . . | 78,320 |
| 85,152 | . . . | 14,228,816 | . . . | 106,663 |
| 92,620 | . . . | 16,054,095 | . . . | 161,996 |
| 103,029 | . . . | 17,796,464 | . . . | 155,253 |
| 109,588 | . . . | 17,803,895 | . . . | 91,954 |
| 117,499 | . . . | 17,738,880 | . . . | 173,771 |
| 125,616 | . . . | 17,364,319 | . . . | 64,971 |
| 129,885 | . . . | 21,646,417 | . . . | 130,802 |
| 140,758 | . . . | 23,608,398 | . . . | 180,292 |
| 152,553 | . . . | 20,777,552 | . . . | 228,356 |
| 171,763 | . . . | 16,774,477 | . . . | 402,114 |
| 195,422 | . . . | 15,986,765 | . . . | 347,583 |
| 212,090 | . . . | 20,470,011 | . . . | 282,122 |
| 230,527 | . . . | 23,389,367 | . . . | 283,075 |
| 255,884 | 5,517,716 | 14,565,624 | . . . | 635,343 |
| 299,652 | 20,658,972 | 0 | . . . | 831,705 |
| 343,014 | 17,785,942 | 8,774,994 | . . . | 731,575 |
| 373,579 | . . . | 25,409,736 | . . . | 479,053 |
| 409,614 | . . . | 25,343,892 | . . . | 4,114,865 |
| 428,183 | . . . | 27,089,222 | . . . | 517,580 |
| 483,596 | . . . | 24,495,490 | . . . | 1,068,598 |
| 517,705 | . . . | 22,021,528 | . . . | 466,796 |
| 582,402 | . . . | 18,078,003 | . . . | 2,782,587 |
| 780,863 | . . . | 21,467,545 | . . . | 1,271,672 |
| **7,867,522** | **44,113,958** | **544,876,281** | **–4** | **16,994,848** [3] |

## 11. Income and Expenses of the Federal Reserve Banks, 1914–2005—Continued

Thousands of dollars

| Federal Reserve Bank and period | Current income | Net expenses | Net additions or deductions (–)[1] | Assessments by Board of Governors | |
|---|---|---|---|---|---|
| | | | | Board expenditures | Costs of currency |
| *Aggregate for each Bank, 1914–2005* | | | | | |
| Boston | 36,048,784 | 3,274,732 | –15,082 | 199,880 | 487,911 |
| New York | 234,942,446 | 7,766,643[4] | 1,007,889 | 1,086,518 | 2,674,482 |
| Philadelphia | 24,861,783 | 2,655,034 | 102,829 | 176,550 | 345,554 |
| Cleveland | 40,972,417 | 3,108,697 | 263,458 | 320,387 | 489,061 |
| Richmond | 51,911,304 | 4,345,043 | 478,516 | 588,205 | 685,503 |
| Atlanta | 36,743,133 | 5,665,930 | 321,649 | 329,983 | 594,893 |
| Chicago | 81,895,577 | 6,204,504 | 658,528 | 505,921 | 954,188 |
| St. Louis | 23,099,813 | 2,495,102 | 72,461 | 111,872 | 304,452 |
| Minneapolis | 11,417,989 | 2,418,425 | 134,715 | 134,873 | 143,849 |
| Kansas City | 24,386,940 | 3,235,577 | 134,127 | 142,889 | 304,514 |
| Dallas | 30,724,517 | 3,260,617 | 386,879 | 214,756 | 412,630 |
| San Francisco | 75,474,511 | 5,653,109 | 654,672 | 591,953 | 943,014 |
| **Total** | **672,479,214** | **50,083,413** | **4,200,642** | **4,403,787** | **8,340,050** |

NOTE. Components may not sum to totals because of rounding.

. . . Not applicable.

1. For 1987 and subsequent years, includes the cost of services provided to the Treasury by Federal Reserve Banks for which reimbursement was not received.

2. Represents transfers made as a franchise tax from 1917 through 1932; transfers made under section 13b of the Federal Reserve Act from 1935 through 1947; and transfers made under section 7 of the Federal Reserve Act for 1996 and 1997.

11.—Continued

| Dividends paid | Payments to U.S. Treasury | | Transferred to surplus (section 13b) | Transferred to surplus (section 7) |
|---|---|---|---|---|
| | Statutory transfers [2] | Interest on Federal Reserve notes | | |
| 389,053 | 2,579,504 | 28,598,628 | 135 | 503,858 |
| 1,954,667 | 17,307,161 | 200,612,873 | –433 | 4,548,425 |
| 327,412 | 1,312,118 | 19,261,492 | 291 | 886,161 |
| 586,203 | 2,827,043 | 32,604,787 | –10 | 1,299,708 |
| 1,163,247 | 3,083,928 | 38,208,638 | –72 | 4,315,327 |
| 552,880 | 2,713,230 | 26,021,551 | 5 | 1,186,310 |
| 864,400 | 4,593,811 | 68,177,052 | 12 | 1,254,217 |
| 199,102 | 1,833,837 | 17,981,385 | –27 | 246,550 |
| 241,764 | 416,227 | 7,806,113 | 65 | 391,389 |
| 237,538 | 1,249,703 | 19,059,475 | –9 | 291,380 |
| 338,852 | 1,510,802 | 25,081,323 | 55 | 292,361 |
| 1,012,405 | 4,686,594 | 61,462,963 | –17 | 1,779,161 |
| **7,867,522** | **44,113,958** | **544,876,281** | **–4** | **16,994,848** [3] |

3. The $16,994,848 thousand transferred to surplus was reduced by direct charges of $500 thousand for charge-off on Bank premises (1927), $139,300 thousand for contributions to capital of the Federal Deposit Insurance Corporation (1934), $4 thousand net upon elimination of section 13b surplus (1958), and $106,000 thousand (1996), $107,000 thousand (1997), and $3,752,000 thousand (2000) transferred to the Treasury as statutorily required; and was increased by transfer of $11,131 thousand from reserves for contingencies (1955), leaving a balance of $12,901,176 thousand on December 31, 2005.

4. This amount is reduced by $2,664,656 thousand for expenses of the System Retirement Plan. See note 2, table 10.

## 12. Operations in Principal Departments of the Federal Reserve Banks, 2002–2005

| Operation | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|
| *Millions of pieces (except as noted)* | | | | |
| Currency processed | 36,463 | 36,242 | 34,832 | 34,208 |
| Currency destroyed | 6,551 | 6,748 | 7,375 | 8,363 |
| Coin received[1] | 56,080 | 55,655 | 48,138 | **43,445** |
| Checks handled | | | | |
| U.S. government checks | 215 | 234 | 267 | 289 |
| Postal money orders | 176 | 187 | 198 | 216 |
| Other | 12,195 | 13,904 | 15,806 | 16,587 |
| Government securities transfers | 22 | 20 | 20 | 17 |
| Transfer of funds | 132 | 125 | 123 | 115 |
| Automated clearinghouse transactions | | | | |
| Commercial | 7,339 | 6,486 | 5,588 | 4,986 |
| Government | 964 | 941 | 914 | 883 |
| Food stamps redeemed | 1 | 48 | 287 | 500 |
| *Millions of dollars* | | | | |
| Currency processed | 639,832 | 625,127 | 584,915 | 565,302 |
| Currency destroyed | 83,187 | 90,943 | 101,338 | 92,511 |
| Coin received[1] | 5,412 | 5,403 | 4,879 | **4,579** |
| Checks handled | | | | |
| U.S. government checks | 250,865 | 277,649 | 308,055 | 307,627 |
| Postal money orders | 28,395 | 29,045 | 29,197 | 30,161 |
| Other | 14,379,874 | 14,287,740 | 15,431,625 | 15,033,298 |
| Government securities transfers | 368,896,819 | 313,425,252 | 267,644,194 | 228,907,121 |
| Transfer of funds | 518,546,592 | 469,898,863 | 436,706,269 | 405,761,750 |
| Automated clearinghouse transactions | | | | |
| Commercial | 12,801,914 | 12,543,907 | 13,951,600 | 13,135,350 |
| Government | 3,156,556 | 2,913,189 | 2,810,283 | 2,711,384 |
| Food stamps redeemed | 2 | 239 | 1,510 | 2,543 |

1. Amounts in bold are restatements due to the inclusion of coin activity at Federal Reserve off-site coin terminals.

13. Number and Annual Salaries of Officers and Employees of the Federal Reserve Banks, December 31, 2005

| Federal Reserve Bank (including Branches) | President[1] | Other officers | | Employees | | | Total | |
|---|---|---|---|---|---|---|---|---|
| | Salary (dollars)[2] | Number | Salaries (dollars)[2] | Number: Full-time | Number: Part-time | Salaries (dollars)[2] | Number | Salaries (dollars)[2] |
| Boston[3] | 355,600 | 62 | 10,095,965 | 927 | 98 | 59,160,815 | 1,088 | 69,612,380 |
| New York | 327,800 | 271 | 50,656,321 | 2,594 | 54 | 196,934,336 | 2,920 | 247,918,457 |
| Philadelphia | 293,700 | 53 | 7,735,500 | 912 | 36 | 48,862,872 | 1,002 | 56,892,072 |
| Cleveland | 249,000 | 60 | 8,780,700 | 1,481 | 36 | 70,106,859 | 1,578 | 79,136,559 |
| Richmond | 262,800 | 69 | 9,771,300 | 1,629 | 67 | 91,936,492 | 1,766 | 101,970,592 |
| Atlanta | 355,600 | 77 | 12,185,600 | 1,917 | 41 | 101,452,089 | 2,036 | 113,993,289 |
| Chicago[3] | 355,600 | 84 | 12,367,949 | 1,325 | 57 | 81,933,636 | 1,467 | 94,657,185 |
| St. Louis | 295,700 | 73 | 10,227,500 | 972 | 54 | 51,984,088 | 1,100 | 62,507,288 |
| Minneapolis | 355,600 | 43 | 6,221,000 | 1,164 | 121 | 60,410,547 | 1,329 | 66,987,147 |
| Kansas City | 323,800 | 73 | 10,761,200 | 1,237 | 47 | 66,213,955 | 1,358 | 77,298,955 |
| Dallas | 262,800 | 54 | 7,838,405 | 1,199 | 25 | 60,943,991 | 1,279 | 69,045,196 |
| San Francisco | 310,700 | 73 | 12,606,008 | 1,626 | 30 | 106,306,340 | 1,730 | 119,223,048 |
| Federal Reserve Information Technology | ... | 36 | 5,432,900 | 700 | 3 | 56,009,962 | 739 | 61,442,862 |
| Office of Employee Benefits | ... | 7 | 1,412,100 | 34 | 0 | 2,721,309 | 41 | 4,133,409 |
| **Total** | **3,748,700** | **1,035** | **166,092,448** | **17,717** | **669** | **1,054,977,290** | **19,433** | **1,224,818,438** |

1. The policies governing the salaries of Federal Reserve Bank presidents were revised in 2005. Under the revised policies, appointment salaries are normally 85 percent of the midpoint of the salary range (an 85 compa-ratio), with the exception of the appointment salary of the New York Reserve Bank president, which is normally set at a 95 compa-ratio. The Board has discretion to approve a higher appointment salary if requested by a Reserve Bank's board of directors.

On January 1 of each year, each president receives a salary increase equal to the percentage increase in the midpoint of his or her salary range. In addition, on every third-year anniversary of his or her initial appointment (through year 9), each president receives a salary increase that results in a higher compa-ratio, as follows: year 3, 95 (for the New York Bank, 105); year 6, 105 (New York, 115); year 9, 115 (New York, 125).

There continue to be tiered salary ranges for Reserve Bank presidents, reflecting differences in the costs of labor in the head-office cities. Currently, the New York and San Francisco Banks are in tier 1, which has a midpoint of $345,000; the Boston, Philadelphia, Richmond, Atlanta, Chicago, Minneapolis, and Dallas Banks are in tier 2, which has a midpoint of $309,200; and the Cleveland, St. Louis, and Kansas City Banks are in tier 3, which has a midpoint of $281,600. The Board reviews Reserve Bank officer salary ranges and the placement of individual Reserve Banks in the salary tiers annually.

2. Annualized salary liability based on salaries in effect on December 31, 2005.

3. Data for 2004 have been corrected, as follows: For the Boston Reserve Bank, employee annual salaries, $57,177,807; total annual salaries, $66,461,907. For the Chicago Reserve Bank, number of full-time employees, 1,471; number of part-time employees, 60; total number of employees, 1,624; employee annual salaries, $86,707,060; total annual salaries, $100,031,698.

... Not applicable.

## 14. Acquisition Costs and Net Book Value of the Premises of the Federal Reserve Banks and Branches, December 31, 2005

Thousands of dollars

| Federal Reserve Bank or Branch | Acquisition costs | | | | Net book value | Other real estate[3] |
|---|---|---|---|---|---|---|
| | Land | Buildings (including vaults)[1] | Building machinery and equipment | Total[2] | | |
| BOSTON | 27,081 | 121,666 | 27,090 | 175,837 | 112,296 | . . . |
| NEW YORK | 20,103 | 242,759 | 60,251 | 323,113 | 206,967 | . . . |
| Buffalo | 0 | 0 | 0 | 0 | 0 | . . . |
| PHILADELPHIA | 2,561 | 78,924 | 12,117 | 93,602 | 53,461 | . . . |
| CLEVELAND | 4,386 | 123,627 | 24,766 | 152,780 | 114,863 | . . . |
| Cincinnati | 2,541 | 29,487 | 11,575 | 43,602 | 23,093 | . . . |
| Pittsburgh | 1,658 | 20,117 | 12,531 | 34,307 | 20,093 | . . . |
| RICHMOND | 22,637 | 86,413 | 38,210 | 147,260 | 101,465 | . . . |
| Baltimore | 6,482 | 29,286 | 5,815 | 41,584 | 24,499 | . . . |
| Charlotte | 3,130 | 30,582 | 6,842 | 40,554 | 27,368 | . . . |
| ATLANTA | 22,735 | 147,904 | 16,065 | 186,704 | 169,033 | . . . |
| Birmingham | 5,347 | 10,939 | 1,439 | 17,725 | 11,623 | . . . |
| Jacksonville | 1,730 | 20,603 | 3,741 | 26,074 | 17,153 | 48 |
| Miami | 4,254 | 19,381 | 4,618 | 28,252 | 18,738 | . . . |
| Nashville | 603 | 5,585 | 3,648 | 9,836 | 5,232 | . . . |
| New Orleans | 3,785 | 9,437 | 5,218 | 18,439 | 10,418 | . . . |
| CHICAGO | 4,512 | 158,996 | 18,962 | 182,470 | 115,395 | 2,744 |
| Detroit | 7,132 | 76,585 | 11,845 | 95,562 | 95,376 | . . . |
| ST. LOUIS | 8,396 | 59,903 | 12,217 | 80,516 | 54,736 | . . . |
| Little Rock | 0 | 0 | 0 | 0 | 0 | 4,657 |
| Louisville | 0 | 0 | 0 | 0 | 0 | . . . |
| Memphis | 2,472 | 13,935 | 5,164 | 21,571 | 15,704 | . . . |
| MINNEAPOLIS | 15,666 | 104,426 | 13,851 | 133,943 | 109,389 | . . . |
| Helena | 2,890 | 9,716 | 943 | 13,549 | 9,898 | . . . |
| KANSAS CITY | 28,771 | 24,389 | 0 | 53,160 | 53,160 | . . . |
| Denver | 3,511 | 12,255 | 4,502 | 20,268 | 12,135 | . . . |
| Oklahoma City | 433 | 8,186 | 2,629 | 11,248 | 3,438 | . . . |
| Omaha | 7,165 | 11,770 | 2,437 | 21,371 | 15,429 | . . . |
| DALLAS | 32,135 | 110,203 | 23,572 | 165,911 | 122,878 | 1,702 |
| El Paso | 262 | 3,426 | 1,553 | 5,241 | 1,875 | . . . |
| Houston | 22,938 | 100,629 | 8,236 | 131,802 | 130,085 | 7,204 |
| San Antonio | 826 | 7,351 | 3,089 | 11,266 | 6,285 | . . . |
| SAN FRANCISCO | 20,122 | 93,921 | 22,238 | 136,280 | 82,133 | . . . |
| Los Angeles | 6,306 | 69,935 | 13,009 | 89,249 | 58,544 | . . . |
| Portland | 1,287 | 8,764 | 2,532 | 12,584 | 6,375 | . . . |
| Salt Lake City | 1,294 | 4,680 | 1,680 | 7,654 | 3,276 | . . . |
| Seattle | 380 | 17,220 | 4,545 | 22,145 | 14,913 | 8,205 |
| **Total** | **295,531** | **1,872,998** | **386,930** | **2,555,460** | **1,827,324** | **24,560** |

NOTE. Components may not sum to totals because of rounding.

1. Includes expenditures for construction at some offices, pending allocation to appropriate accounts.

2. Excludes charge-offs of $17,699 thousand before 1952.

3. Covers acquisitions for banking-house purposes and Bank premises formerly occupied and being held pending sale.

. . . Not applicable.

# *Federal Reserve System Audits*

# *Audits of the Federal Reserve System*

The Board of Governors, the Federal Reserve Banks, and the Federal Reserve System as a whole are all subject to several levels of audit and review. The Board's financial statements, and its compliance with laws and regulations affecting those statements, are audited annually by an outside auditor retained by the Board's Office of Inspector General. The Office of Inspector General also audits and investigates the Board's programs and operations, as well as those Board functions delegated to the Reserve Banks.

The Reserve Banks' financial statements are audited annually by an independent outside auditor retained by the Board of Governors. In addition, the Reserve Banks are subject to annual examination by the Board. As discussed in the chapter "Federal Reserve Banks," the Board's examination includes a wide range of ongoing oversight activities conducted on and off site by staff of the Board's Division of Reserve Bank Operations and Payment Systems.

Federal Reserve operations are also subject to review by the Government Accountability Office. ■

# *Board of Governors Financial Statements*

The financial statements of the Board for 2005 and 2004 were audited by KPMG LLP, independent auditors.

**KPMG LLP**
2001 M Street, NW
Washington, DC 20036

**Independent Auditors' Report on Financial Statements**

To the Board of Governors of the Federal Reserve System:

We have audited the accompanying balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2005 and 2004, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Board's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Board of Governors of the Federal Reserve System, at December 31, 2005 and 2004, and the results of its operations, and its cash flows, for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued reports dated May 31, 2006, on our consideration of the Board's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in assessing the results of our audits.

KPMG LLP

May 31, 2006

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

# BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

## BALANCE SHEETS

| | As of December 31, 2005 | As of December 31, 2004 |
|---|---|---|
| **ASSETS** | | |
| **CURRENT ASSETS** | | |
| Cash | $ 45,970,435 | $ 60,107,292 |
| Accounts receivable | 3,345,446 | 1,696,480 |
| Prepaid expenses and other assets | 2,728,486 | 4,015,067 |
| Total current assets | 52,044,367 | 65,818,839 |
| **NONCURRENT ASSETS** | | |
| Property and equipment, net (Note 3) | 155,441,553 | 149,028,686 |
| Art collections (Note 2) | | |
| Total noncurrent assets | 155,441,553 | 149,028,686 |
| Total assets | $207,485,920 | $214,847,525 |
| **LIABILITIES AND CUMULATIVE RESULTS OF OPERATIONS** | | |
| **CURRENT LIABILITIES** | | |
| Accounts payable and accrued liabilities | $ 16,906,350 | $ 13,891,861 |
| Accrued payroll and related taxes | 4,860,572 | 4,552,039 |
| Accrued annual leave | 15,456,484 | 14,195,910 |
| Capital lease payable (current portion) | 270,167 | 250,794 |
| Unearned revenues and other liabilities | 783,711 | 467,664 |
| Total current liabilities | 38,277,284 | 33,358,268 |
| **LONG-TERM LIABILITIES** | | |
| Capital lease payable (non-current portion) | 406,188 | 675,271 |
| Accumulated retirement benefit obligation (Note 4) | 813,497 | 594,169 |
| Accumulated postretirement benefit obligation (Note 5) | 6,237,290 | 5,789,566 |
| Accumulated postemployment benefit obligation (Note 6) | 5,111,365 | 5,308,565 |
| Total long-term liabilities | 12,568,340 | 12,367,571 |
| Total liabilities | 50,845,624 | 45,725,839 |
| **CUMULATIVE RESULTS OF OPERATIONS** | | |
| Working capital | 14,037,250 | 32,711,365 |
| Unfunded long-term liabilities | (12,162,152) | (11,692,300) |
| Net investment in property and equipment | 154,765,198 | 148,102,621 |
| Total cumulative results of operations | 156,640,296 | 169,121,686 |
| Total liabilities and cumulative results of operations | $207,485,920 | $214,847,525 |

See accompanying notes to financial statements.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

STATEMENTS OF REVENUES AND EXPENSES
AND CHANGES IN CUMULATIVE RESULTS OF OPERATIONS

| | For the years ended December 31, | |
|---|---|---|
| | 2005 | 2004 |
| BOARD OPERATING REVENUES | | |
| Assessments levied on Federal Reserve Banks for Board operating expenses and capital expenditures | $265,742,100 | $272,331,500 |
| Other revenues (Note 7) | 8,520,342 | 8,336,581 |
| Total operating revenues | 274,262,442 | 280,668,081 |
| BOARD OPERATING EXPENSES | | |
| Salaries | 174,523,825 | 166,797,724 |
| Retirement and insurance | 31,847,951 | 30,850,441 |
| Contractual services and professional fees | 24,695,564 | 24,835,904 |
| Depreciation and net losses on disposals | 12,954,506 | 12,445,708 |
| Utilities | 9,065,329 | 8,273,801 |
| Travel | 7,794,483 | 7,088,444 |
| Software | 6,052,617 | 6,302,695 |
| Postage and supplies | 7,169,829 | 6,116,355 |
| Repairs and maintenance | 3,361,179 | 3,954,263 |
| Printing and binding | 1,973,594 | 1,944,552 |
| Other expenses (Note 7) | 7,304,955 | 6,515,129 |
| Total operating expenses | 286,743,832 | 275,125,016 |
| RESULTS OF OPERATIONS | (12,481,390) | 5,543,065 |
| ISSUANCE AND REDEMPTION OF FEDERAL RESERVE NOTES | | |
| Assessments levied on Federal Reserve Banks for currency costs | 477,087,471 | 503,784,304 |
| Expenses for currency printing, issuance, retirement, and shipping | 477,087,471 | 503,784,304 |
| CURRENCY ASSESSMENTS OVER (UNDER) EXPENSES | 0 | 0 |
| TOTAL RESULTS OF OPERATIONS | (12,481,390) | 5,543,065 |
| CUMULATIVE RESULTS OF OPERATIONS, Beginning of year | 169,121,686 | 163,578,621 |
| CUMULATIVE RESULTS OF OPERATIONS, End of year | $156,640,296 | $169,121,686 |

See accompanying notes to financial statements.

## BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

## STATEMENTS OF CASH FLOWS

| | For the years ended December 31, | |
|---|---|---|
| | 2005 | 2004 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| RESULTS OF OPERATIONS | $(12,481,390) | $ 5,543,065 |
| Adjustments to reconcile results of operations to net cash provided by (used in) operating activities: | | |
| Depreciation and net losses on disposals | 12,954,506 | 12,445,708 |
| Increase in assets: | | |
| Accounts receivable, prepaid expenses, and other assets | (362,385) | (1,846,076) |
| Increase (decrease) in liabilities: | | |
| Accounts payable and accrued liabilities | 3,014,489 | (1,455,529) |
| Accrued payroll and related taxes | 308,533 | (504,608) |
| Accrued annual leave | 1,260,574 | 766,917 |
| Unearned revenues and other liabilities | 316,047 | 76,966 |
| Accumulated retirement benefit obligation | 219,328 | (1,432) |
| Accumulated postretirement benefit obligation | 447,724 | 467,513 |
| Accumulated postemployment benefit obligation | (197,200) | 358,673 |
| Net cash provided by operating activities | 5,480,226 | 15,851,197 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Proceeds from disposals | 2,850 | 4,005 |
| Capital expenditures | (19,370,223) | (11,715,861) |
| Net cash used in investing activities | (19,367,373) | (11,711,856) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Capital lease payments | (249,710) | (211,703) |
| Net cash used in financing activities | (249,710) | (211,703) |
| NET INCREASE (DECREASE) IN CASH | (14,136,857) | 3,927,638 |
| CASH BALANCE, Beginning of year | 60,107,292 | 56,179,654 |
| CASH BALANCE, End of year | $ 45,970,435 | $ 60,107,292 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | |
| Capital lease obligations incurred | $ 0 | $ 190,538 |

See accompanying notes to financial statements.

# BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEARS ENDED
DECEMBER 31, 2005 AND 2004

## (1) Structure

The Federal Reserve System was established by Congress in 1913 and consists of the Board of Governors (Board), the Federal Open Market Committee, the twelve regional Federal Reserve Banks, the Federal Advisory Council, and the private commercial banks that are members of the System. The Board, unlike the Reserve Banks, was established as a federal government agency and is supported by Washington DC based staff numbering approximately 1,800, as it carries out its responsibilities in conjunction with other components of the Federal Reserve System.

The Board is required by the Federal Reserve Act to report its operations to the Speaker of the House of Representatives. The Act also requires the Board, each year, to order a financial audit of each Federal Reserve Bank and to publish each week a statement of the financial condition of each such Reserve Bank and a consolidated statement for all of the Reserve Banks. Accordingly, the Board believes that the best financial disclosure consistent with law is achieved by issuing separate financial statements for the Board and for the Reserve Banks. Therefore, the accompanying financial statements include only the results of operations and activities of the Board. Combined financial statements for the Federal Reserve Banks are included in the Board's annual report to the Speaker of the House of Representatives.

## (2) Significant Accounting Policies

*Basis of Accounting*—The financial statements have been prepared on the accrual basis of accounting.

*Revenues*—Assessments for operating expenses and additions to property are based on expected cash needs. Amounts over or under assessed due to differences between actual and expected cash needs flow in to or out of "Cumulative Results of Operations" during the year.

*Issuance and Redemption of Federal Reserve Notes*—The Board incurs expenses and assesses the Federal Reserve Banks for currency printing, issuance, retirement, and shipping of Federal Reserve Notes. These assessments and expenses are separately reported in the statements of revenues and expenses because they are passed through Board accounts and are not Board operating transactions.

*Property and Equipment*—The Board's property, buildings, 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 3 to 10 years for furniture and equipment and from 10 to 50 years for building equipment and structures. Upon the sale or other disposition of a depreciable asset, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized.

*Art Collections*—The Board has collections of works of art, historical treasures, and similar assets. These collections are maintained and held for public exhibition in furtherance of public service. Proceeds from any sales of collections are used to acquire other items for collections. As permitted by Statement of Financial Accounting Standards Number 116, *Accounting for Contributions Received and Contributions Made,* the cost of collections purchased by the Board is charged to expense in the year purchased and donated collection items are not recorded. The value of the Board's collections has not been determined.

*Estimates*—The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Reclassifications*—Certain 2004 amounts have been reclassified to conform with the 2005 presentation.

## (3) Property and Equipment

The following is a summary of the components of the Board's property and equipment, at cost, net of accumulated depreciation.

| | As of December 31, | |
|---|---|---|
| | 2005 | 2004 |
| Land | $ 18,640,314 | $ 18,640,314 |
| Buildings and improvements | 135,152,735 | 132,891,551 |
| Furniture and equipment | 39,926,270 | 44,450,522 |
| Software | 12,990,050 | 12,207,125 |
| Construction in process | 13,928,149 | 4,380,259 |
| | 220,637,518 | 212,569,771 |
| Less accumulated depreciation | (65,195,965) | (63,541,085) |
| Property and equipment, net | $155,441,553 | $149,028,686 |

Furniture and equipment includes $1,230,000 each year for capitalized leases as of December 31, 2005 and 2004. Accumulated depreciation includes $612,000 and $356,000 for capitalized leases as of December 31, 2005 and 2004, respectively. The Board paid interest related to these capital leases in the amount of $83,000 and $104,000 for 2005 and 2004, respectively.

Construction in process includes costs incurred in 2005 and 2004 for long-term security projects and building enhancements.

The future minimum lease payments required under the capital leases and the present value of the net minimum lease payments as of December 31, 2005, are as follows:

| | Year ending December 31 | Amount |
|---|---|---|
| | 2006 | $ 417,358 |
| | 2007 | 416,274 |
| | 2008 | 138,279 |
| Total minimum lease payments | | 971,911 |
| Less: Amount representing maintenance included in total amounts above | | (207,125) |
| Net minimum lease payments | | 764,786 |
| Less: Amount representing interest | | (88,431) |
| Present value of net minimum lease payments | | 676,355 |
| Less: Current maturities of capital lease obligations | | (270,167) |
| Long-term capital lease obligations | | $ 406,188 |

(4) Accumulated Retirement Benefits

The following information provides disclosure requirements contained in Statement of Financial Accounting Standards No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*.

Substantially all of the Board's employees participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). The System Plan is a multi-employer plan which covers employees of the Federal Reserve Banks, the Board, and the Office of Employee Benefits.

Employees of the Board who became employed prior to 1984 are covered by a contributory defined benefits program under the System Plan. Employees of the Board who became employed after 1983 are covered by a non-contributory defined benefits program under the System Plan. Contributions to the System Plan are actuarially determined and funded by participating employers. Based on actuarial calculations, it was determined that employer funding contributions were not required for the years 2005 and 2004, and the Board was not assessed a contribution for these years. Because the plan is part of a multi-employer plan, information as to vested and nonvested benefits, as well as plan assets, as it relates solely to the Board, is not readily available.

A relatively small number of Board employees participate in the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). These defined benefit plans are administered by the U.S. Office of Personnel Management, which determines the required employer contribution levels. The Board's contributions to these plans totaled $324,000 and $330,000 in 2005 and 2004, respectively. The Board has no liability for future payments to retirees under these programs and is not accountable for the assets of the plans.

Employees of the Board may also participate in the Federal Reserve System's Thrift Plan. Board contributions to members' accounts are based upon a fixed percentage of each member's basic contribution and were $8,617,000 and $8,314,000 in 2005 and 2004, respectively.

Effective January 1, 1996, Board employees covered under the System Plan are also covered under a Benefits Equalization Plan (BEP). Benefits paid under the BEP are limited to those benefits that cannot be paid from the System Plan due to limitations imposed by Sections 401(a)(17), 415(b), and 415(e) of the Internal Revenue Code of 1986. Activity for the BEP for 2005 and 2004 is summarized in the following table:

| | 2005 | 2004 |
|---|---|---|
| *Change in projected benefit obligation* | | |
| Benefit obligation at beginning of year | $ 140,953 | $ 74,956 |
| Service cost | 193,209 | 23,239 |
| Interest cost | 35,964 | 6,170 |
| Plan participants' contributions | 0 | 0 |
| Plan amendments | 0 | 0 |
| Actuarial (gain)/loss | 168,027 | 36,588 |
| Benefits paid | (1,814) | 0 |
| Benefit obligation at end of year | $ 536,339 | $ 140,953 |
| *Change in plan assets* | | |
| Fair value of plan assets at beginning of year | $ 0 | $ 0 |
| Actual return on plan assets | 0 | 0 |
| Employer contributions | 1,814 | 0 |
| Plan participants' contributions | 0 | 0 |
| Benefits paid | (1,814) | 0 |
| Fair value of plan assets at end of year | $ 0 | $ 0 |
| *Reconciliation of funded status at end of year* | | |
| Funded status | $ (536,339) | $ (140,953) |
| Unrecognized net actuarial (gain)/ loss | (15,728) | (177,773) |
| Unrecognized prior service cost | (701,125) | (817,732) |
| Unrecognized net transition obligation | 439,695 | 542,289 |
| Retirement benefit liability | $ (813,497) | $ (594,169) |
| *Information for pension plans with an accumulated benefit obligation in excess of plan asset:* | | |
| Projected benefit obligation | $ 536,339 | $ 140,953 |
| Accumulated benefit obligation | 278,252 | 33 |

| | 2005 | 2004 |
|---|---|---|
| *Weighted-average assumptions used to determine benefit obligation as of December 31* | | |
| Discount rate | 5.75% | 5.75% |
| Rate of compensation increase | 4.50% | 4.25% |
| *Components of net periodic benefit cost* | | |
| Service cost—benefits earned during the period | $ 193,209 | $ 23,239 |
| Interest cost on projected benefit obligation | 35,964 | 6,170 |
| Expected return on plan assets | 0 | 0 |
| Amortization of prior service cost | (116,607) | (116,607) |
| Amortization of (gains)/losses | 5,982 | (16,828) |
| Amortization of initial (asset)/obligation | 102,594 | 102,594 |
| Net periodic benefit cost (credit) | $ 221,142 | $ (1,432) |
| *Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31* | | |
| Discount rate | 5.75% | 6.25% |
| Rate of compensation increase | 4.25% | 4.00% |

(5) Accumulated Postretirement Benefits

This following information provides disclosure requirements contained in Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

The Board provides certain life insurance programs for its active employees and retirees. Activity for 2005 and 2004 is summarized in the following table:

| | 2005 | 2004 |
|---|---|---|
| *Change in benefit obligation* | | |
| Benefit obligation at beginning of year | $ 8,404,552 | $ 7,166,146 |
| Service cost | 217,421 | 203,229 |
| Interest cost | 437,320 | 443,043 |
| Plan participants' contributions | 0 | 0 |
| Plan amendments | (196,970) | 0 |
| Actuarial (gain)/loss | (304,006) | 845,851 |
| Benefits paid | (284,485) | (253,717) |
| Benefit obligation at end of year | $ 8,273,832 | $ 8,404,552 |

| | 2005 | 2004 |
|---|---|---|
| *Change in plan assets* | | |
| Fair value of plan assets at beginning of year | $ 0 | $ 0 |
| Actual return on plan assets | 0 | 0 |
| Employer contribution | 284,485 | 253,717 |
| Plan participants' contributions | 0 | 0 |
| Benefits paid | (284,485) | (253,717) |
| Fair value of plan assets at end of year | $ 0 | $ 0 |
| *Reconciliation of funded status at end of year* | | |
| Funded status | $(8,273,832) | $(8,404,551) |
| Unrecognized net actuarial (gain)/loss | 2,145,920 | 2,537,211 |
| Unrecognized prior service cost | (109,378) | 77,774 |
| Prepaid/(accrued) postretirement benefit liability | $(6,237,290) | $(5,789,566) |
| *Components of net periodic cost for year* | | |
| Service cost | $ 217,421 | $ 203,229 |
| Interest cost | 437,320 | 443,043 |
| Amortization of prior service cost | (9,818) | 6,073 |
| Amortization of (gains)/losses | 87,286 | 68,885 |
| Total net periodic cost | $ 732,209 | $ 721,230 |

The liability and costs for the postretirement benefit plan were determined using discount rates of 5.75 percent as of December 31, 2005 and 2004. Unrecognized losses of $2,145,920 as of December 31, 2005 and $2,537,211 as of December 31, 2004 result from changes in the discount rate used to measure the liabilities. Under Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, the Board may have to record some of these unrecognized losses in operations in future years. The assumed salary trend rate for measuring the increase in postretirement benefits related to life insurance was an average of 4.25 percent.

The above accumulated postretirement benefit obligation is related to the Board sponsored life insurance programs. The Board has no liability for future payments to employees who continue coverage under the federally sponsored life and health programs upon retiring. Contributions for active employees participating in federally sponsored health programs totaled $8,933,000 and $8,223,000 in 2005 and 2004, respectively.

(6) Accumulated Postemployment Benefit Plan

This following information provides disclosure requirements contained in Statement of Financial Accounting Standards No. 112, *Employers' Accounting for Postemployment Benefits*.

The Board provides certain postemployment benefits to eligible former or inactive employees and their dependents during the period subsequent to employment but prior to retirement. Costs were projected using the same discount rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Board for the years ended December 31, 2005 and 2004, were $155,800 and $733,000, respectively.

(7) Other Revenues and Other Expenses

The following are summaries of the components of Other Revenues and Other Expenses.

| | For the years ended December 31, | |
|---|---|---|
| | 2005 | 2004 |
| *Other revenues* | | |
| Data processing revenue | $3,788,217 | $3,984,610 |
| Rent | 2,433,833 | 2,332,089 |
| Subscription revenue | 782,743 | 787,053 |
| Reimbursable services to other agencies | 664,755 | 673,730 |
| Board sponsored conferences | 250,650 | 0 |
| Miscellaneous | 600,144 | 559,099 |
| Total other revenues | $8,520,342 | $8,336,581 |
| *Other expenses* | | |
| Tuition, registration, and membership fees | $2,573,028 | $2,048,610 |
| Contingency operations | 956,476 | 782,052 |
| Public transportation subsidy | 691,264 | 800,724 |
| Subsidies and contributions | 656,150 | 635,336 |
| Meals and representation | 518,640 | 377,963 |
| Equipment and facilities rental | 336,342 | 307,999 |
| Administrative law judges | 268,228 | 492,155 |
| Security investigations | 184,880 | 286,711 |
| Former employee related payments | 319,461 | 205,627 |
| Miscellaneous | 800,486 | 577,952 |
| Total other expenses | $7,304,955 | $6,515,129 |

(8) Commitments and Contingencies

*Leases*

The Board has entered into several operating leases to secure office, training, and warehouse space for remaining periods ranging from one to four years. In addition, the Board has entered into an agreement with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, through the Federal Financial Institutions Examination Council (the "Council") to fund a portion of enhancements for a central data repository project through 2013.

Mimimum annual payments under the operating leases having an initial or remaining noncancelable lease term in excess of one year are $71,991 for 2006.

Rental expenses under the operating leases were $157,000 in 2005 and $156,000 in 2004.

*Benefit Obligations*

The Board is subject to potential liabilities for a supplemental benefit for certain employees that participate in CSRS and who meet certain other criteria. Based on information currently available, the exact amount of the additional pension liability as of December 31, 2005 is unknown. It is management's opinion that the additional liability, if any, will not have a materially adverse effect on the financial statements.

*Litigation*

The Board is subject to contingent liabilities which include litigation cases. These contingent liabilities arise in the normal course of operations and their ultimate disposition is unknown. Based on information currently available to management, it is management's opinion that the expected outcome of these matters, individually or in the aggregate, will not have a materially adverse effect on the financial statements. Management believes the Board has substantial defenses and that the likelihood of an adverse judgement is small.

One action pending in the United States District Court for the District of Columbia under Title VII of the Civil Rights Act of 1964, as amended, alleges discrimination on behalf of a class of African American secretaries at the Board. The case is a successor to an earlier lawsuit that was dismissed for failure to exhaust administrative remedies. Following a period of discovery on the issue of exhaustion of administrative remedies, the Board has moved to dismiss the action; that motion is pending. Should the case proceed beyond the motion to dismiss the Board believes it has substantial defenses and intends to defend the case vigorously.

Seven additional matters alleging employment discrimination are currently pending administrative resolution or have been resolved recently and could be the subject of an administrative appeal or a judicial action. The chances that any of these cases will result in court litigation cannot reasonably be estimated at this time. In five of these cases, there has not yet been an investigative report. Therefore, management is unable at this time to determine the potential for a materially adverse effect on the financial statements. Management believes the likelihood of an unfavorable outcome in the remaining two cases is remote.

(9) Federal Financial Institutions Examination Council

The Board is one of the five member agencies of the Council, and currently performs certain management functions for the Council. The five agencies which are represented on the Council are the Board, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision. The Board's financial statements do not include financial data for the Council. Activity related to the Board and Council for 2005 and 2004 is summarized in the following table:

| | 2005 | 2004 |
|---|---|---|
| *Board paid to the Council:* | | |
| Assessments for operating expenses of the Council | $ 83,811 | $ 112,020 |
| Central Data Repository | 1,096,062 | 326,640 |
| Uniform Bank Performance Report | 202,666 | 199,230 |
| Total Board paid to the Council | $1,382,539 | $ 637,890 |
| *Council paid to the Board:* | | |
| Data processing related services | 3,572,816 | 3,360,055 |
| Administrative services | 175,000 | 133,500 |
| Total Council paid to the Board | $3,747,816 | $3,493,555 |

(10) Federal Reserve Banks

The Board performs certain functions for the Reserve Banks in conjunction with its responsibilities for the Federal Reserve System, and the Federal Reserve Banks provide certain administrative functions for the Board. Activity related to the Board and Reserve Banks for 2005 and 2004 is summarized in the following table:

| | 2005 | 2004 |
|---|---|---|
| *Board paid to the Reserve Banks:* | | |
| Assessments for employee benefits | $ 2,072,595 | $ 2,151,078 |
| Data processing and communication | 2,106,850 | 1,920,996 |
| Contingency site | 956,476 | 1,481,452 |
| Total Board paid to the Reserve Banks | $ 5,135,921 | $ 5,553,526 |
| *Reserve Banks paid to the Board:* | | |
| Assessments for currency costs | $477,087,471 | $503,784,304 |
| Assessments for operating expenses of the Board | 265,742,100 | 272,331,500 |
| Data processing | 516,433 | 686,312 |
| Total Reserve Banks paid to the Board | $743,346,004 | $776,802,116 |

**KPMG LLP**
2001 M Street, NW
Washington, DC 20036

**Independent Auditors' Report on Internal Control over Financial Reporting**

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2005 and 2004, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows for the years then ended, and have issued our report thereon dated May 31, 2006. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

In planning and performing our 2005 audit, we considered the Board's internal control over financial reporting by obtaining an understanding of the Board's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards*. The objective of our audit was not to provide assurance on the Board's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Board's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected.

In our 2005 audit, we noted certain matters, discussed in Exhibit I, involving the internal control over financial reporting and its operation that we consider to be a reportable condition. However, the reportable condition is not believed to be a material weakness. Management's responses to our findings are also included in Exhibit I.

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

We also noted certain additional matters that we reported to the management of the Board in a separate letter dated May 31, 2006.

This report is intended solely for the information and use of the Board and its management, the Office of Inspector General, the Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

May 31, 2006

Exhibit I

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Reportable Condition
December 31, 2005

**Improvement Is Needed in Internal Controls over Financial Reporting**

Management is responsible for developing and maintaining effective internal controls to provide assurance that the Board has the ability to record, process, summarize, and report financial data consistent with the assertions of management in its financial statements.

The following paragraphs discuss weaknesses noted in the Board's internal control over financial reporting that could adversely affect the Board's ability to produce accurate and timely financial statements.

*Controls over Accounts Payable and Accrued Liabilities*

During our audit, we noted that the Board recorded material post closing entries amounting to $1,957,836 to reduce liabilities, prepayments, and the related expenses as of December 31, 2005. Issues we identified that resulted in post closing entries included:

- Recording transactions as liabilities and prepaid expenses, although the Board did not receive the related goods/services prior to December 31, 2005.
- Recording transactions in both accounts payable and accrued liabilities. Therefore, these liabilities were duplicated in the financial statements.
- Recording transactions based on incorrect supporting documents or estimates provided by the operating divisions that differed significantly from the actual invoices.

We also noted that the Board received an invoice from the General Services Administration (GSA) in April 2006 for $275,100 that might include some expenses for steam provided in 2005. The Board recorded an accrual for $50,000 at December 31, 2005. However, management is unable to determine if an additional accrual is required for 2005 as the invoices received from GSA during 2005 and 2006 did not provide sufficient details on the billing period.

*Control of Census Data*

During our audit, we coordinated with the Office of Inspector General (OIG) to perform an analysis of the accuracy of the census data used by the Board's actuary in the pension benefit liability and noted that there were discrepancies between the Board's Human Resources database and the data used by the actuary. We noted that the Board has not established controls to verify the accuracy of the underlying data used by the actuary in the pension liability calculation.

Specifically, we noted the following:

- Of the 176 employees included in the Benefits Equalization Plan (BEP) liability:
  - One individual was retired and covered under the CSRS plan; accordingly he/she should not have been included in the BEP population. Also, the gender of the individual was reported incorrectly.
  - One individual was covered under the FERS plan and therefore does not qualify for the BEP.
  - One individual was included twice in the BEP calculation.
  - Two individuals did not have retirement service credit dates in PeopleSoft.
  - Sixteen individuals had incorrect service credit dates in the data used by the actuary.
  - For two individuals, the total pay used in the actuarial calculations was incorrect because their variable pay amounts were not included.
- The 930 employees included by the actuary in the Board Postretirement Welfare Benefits Plan (BEGLI) calculation included two retired individuals who should not have been in the active file.
- Of the 1,777 employees included in the

Board Postemployment Benefit Plan (Long-term disability):

— Three individuals who retired prior to January 1, 2005 were incorrectly included in the actuarial liability calculations.

— Thirty individuals in the Board Plan had differences over 30 days that related to incorrect service credit dates.

We also noted that the actuary incorrectly included variable pay in the calculations for long-term disability.

*Recommendations:*

We recommend that the Board:

1. Establish policies and procedures for processing year-end accounts payables and accruals to include the requirements for management to review and approve all entries and supporting documents before they are recorded. Management should also perform a review of the year-end accounts payable listings and subsequent disbursements to ensure that the transactions reported at year end are appropriately stated. Further, a reconciliation of the GSA account should be performed timely, to identify any discrepancies on the invoices received.
2. Confirm the data used by the actuary in the pension liability calculation prior to recording the entries in the general ledger.
3. Implement recommendations made by the OIG in their report titled "*Evaluation of Service Credit Computations.*" This would include performing periodic reconciliations of the census data between the Board's system and the data used by the actuary; reducing or eliminating the number of data transcriptions; requiring automated verifications for all census data transmissions; and updating the existing service credit form to clearly document all prior government service.

*Management Response*

1. Concur. Management will strengthen its procedures for review and approval of year-end transactions for accounts payables and year-end accruals. In addition to strengthening our procedures, organizational changes have been made to enhance supervision in this area and additional resources will be devoted to this time-sensitive process. Accounting staff will provide additional training for division staff responsible for reporting year-end accruals and approval of accruals will require more senior staff approval both in the divisions and Accounting.

2. & 3. Concur. We support the recommendation and work is underway to enhance controls over these data. Management is working with the Office of Employee Benefits, the Federal Reserve's actuary, and the Federal Reserve's pension administrator to ensure data accuracy and the presence of appropriate controls over the exchange of census data among the various entities. The Office of Inspector General will review the work of the group and, where appropriate, provide comments to management on internal control issues. This same group is working to implement fully the recommendations provided by the Office of Inspector General in its report titled *Evaluation of Service Credit Computations*, and management has directed the pension administrator to implement appropriate changes to its automated systems and supporting processes.

**KPMG LLP**
2001 M Street, NW
Washington, DC 20036

**Independent Auditors' Report on Compliance and Other Matters**

To the Board of Governors of the Federal Reserve System:

We have audited the balance sheets of the Board of Governors of the Federal Reserve System (the Board) as of December 31, 2005 and 2004, and the related statements of revenues and expenses and changes in cumulative results of operations, and cash flows, for the years then ended, and have issued our report thereon dated May 31 2006. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

The management of the Board is responsible for complying with laws, regulations, and contracts applicable to the Board. As part of obtaining reasonable assurance about whether the Board's 2005 financial statements are free of material misstatement, we performed tests of the Board's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to the Board. However, providing an opinion on compliance with laws, regulations, and contracts was not an objective of our audit and, accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

This report is intended solely for the information and use of the Board and its management, the Office of Inspector General, the Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

May 31, 2006

KPMG LLP, a U.S. limited liability partnership, is the U.S. member firm of KPMG International, a Swiss cooperative.

# *Federal Reserve Banks Combined Financial Statements*

The combined financial statements of the Federal Reserve Banks were audited by PricewaterhouseCoopers LLP, independent auditors, for the years ended December 31, 2005 and 2004.

REPORT OF INDEPENDENT AUDITORS

To the Board of Governors of the Federal Reserve System
and the Board of Directors of the Federal Reserve Banks:

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

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

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

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

March 23, 2006
Washington, D.C.

PricewaterhouseCoopers LLP

# FEDERAL RESERVE BANKS
# COMBINED STATEMENTS OF CONDITION
## December 31, 2005 and 2004

(in millions)

| Assets | 2005 | 2004 |
|---|---|---|
| Gold certificates | $ 11,039 | $ 11,041 |
| Special drawing rights certificates | 2,200 | 2,200 |
| Coin | 686 | 728 |
| Items in process of collection | 5,930 | 6,233 |
| Loans to depository institutions | 72 | 43 |
| Securities purchased under agreements to resell | 46,750 | 33,000 |
| U.S. government securities, net | 750,202 | 725,584 |
| Investments denominated in foreign currencies | 18,928 | 21,368 |
| Accrued interest receivable | 5,874 | 5,104 |
| Bank premises and equipment, net | 2,252 | 2,216 |
| Other assets | 3,394 | 3,350 |
| Total assets | $847,327 | $810,867 |
| **Liabilities and Capital** | | |
| Liabilities | | |
| Federal Reserve notes outstanding, net | $758,359 | $719,437 |
| Securities sold under agreements to repurchase | 30,505 | 30,783 |
| Deposits | | |
| Depository institutions | 19,043 | 24,043 |
| U.S. Treasury, general account | 4,573 | 5,912 |
| Other deposits | 393 | 332 |
| Deferred credit items | 5,039 | 5,306 |
| Interest on Federal Reserve notes due U.S. Treasury | 1,784 | 329 |
| Accrued benefit costs | 913 | 891 |
| Other liabilities | 281 | 290 |
| Total liabilities | 820,890 | 787,323 |
| Capital | | |
| Capital paid-in | 13,536 | 11,914 |
| Surplus | 12,901 | 11,630 |
| Total capital | 26,437 | 23,544 |
| Total liabilities and capital | $847,327 | $810,867 |

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

# FEDERAL RESERVE BANKS
## COMBINED STATEMENTS OF INCOME
### for the years ended December 31, 2005 and 2004

(in millions)

| | 2005 | 2004 |
|---|---|---|
| **Interest income** | | |
| Interest on U.S. government securities | $28,959 | $22,344 |
| Interest on investments denominated in foreign currencies | 283 | 269 |
| Interest on loans to depository institutions | 7 | 3 |
| Total interest income | 29,249 | 22,616 |
| **Interest expense** | | |
| Interest expense on securities sold under agreements to repurchase | 809 | 303 |
| Net interest income | 28,440 | 22,313 |
| **Other operating (loss) income** | | |
| Income from services | 901 | 866 |
| Reimbursable services to government agencies | 396 | 370 |
| Foreign currency (losses) gains, net | (2,723) | 1,230 |
| Other income | 131 | 89 |
| Total other operating (loss) income | (1,295) | 2,555 |
| **Operating expenses** | | |
| Salaries and other benefits | 1,709 | 1,604 |
| Occupancy expense | 228 | 222 |
| Equipment expense | 198 | 245 |
| Assessments by the Board of Governors | 743 | 776 |
| Other expenses | 747 | 578 |
| Total operating expenses | 3,625 | 3,425 |
| Net income prior to distribution | $23,520 | $21,443 |
| **Distribution of net income** | | |
| Dividends paid to member banks | $ 781 | $ 582 |
| Transferred to surplus | 1,271 | 2,783 |
| Payments to U.S. Treasury as interest on Federal Reserve notes | 21,468 | 18,078 |
| Total distribution | $23,520 | $21,443 |

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

FEDERAL RESERVE BANKS
COMBINED STATEMENTS OF CHANGES IN CAPITAL
for the years ended December 31, 2005 and 2004

(in millions)

| | Capital paid-in | Surplus | Total capital |
|---|---|---|---|
| Balance at January 1, 2004 (176 million shares) | $ 8,847 | $ 8,847 | $17,694 |
| Transferred to surplus | . . . | 2,783 | 2,783 |
| Net change in capital stock issued (61 million shares) | 3,067 | . . . | 3,067 |
| Balance at December 31, 2004 (238 million shares) | $11,914 | $11,630 | $23,544 |
| Transferred to surplus | . . . | 1,271 | 1,271 |
| Net change in capital stock issued (32 million shares) | 1,622 | . . . | 1,622 |
| Balance at December 31, 2005 (270 million shares) | $13,536 | $12,901 | $26,437 |

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

## Notes to the Combined Financial Statements of the Federal Reserve Banks

### (1) Structure

The twelve Federal Reserve Banks (Reserve Banks) are part of the Federal Reserve System (System) 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.

In accordance with the Federal Reserve Act, supervision and control of each Reserve 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, and six directors are elected by member banks. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership in the System. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

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

### (2) Operations and Services

The System performs a variety of services and operations. Functions include formulating and conducting monetary policy; participating actively in the payments system, including large-dollar transfers of funds, automated clearinghouse (ACH) operations, and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies and other entities; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks, and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The Systm also provides certain services to foreign central banks, governments, and international official institutions.

In performing fiscal agency functions for the U.S. Treasury, seven Reserve Banks provide U.S. securities direct purchase and savings bond processing services. In March 2004, the U.S. Treasury provided an implementation plan for consolidating the provision of these services at two Reserve Banks. The costs for the associated restructuring for the affected Banks have been included in footnote 10.

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

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

transactions. The FRBNY is authorized to conduct operations in domestic markets, including direct purchase and sale of U.S. government securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY executes these open market transactions and holds the resulting securities, with the exception of securities purchased under agreements to resell, in the portfolio known as the System Open Market Account (SOMA).

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs 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 (F/X) and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is authorized to maintain reciprocal currency arrangements (F/X swaps) with two central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund (ESF) through the Reserve Banks. In connection with its foreign currency activities, the FRBNY may enter into contracts that contain varying degrees of off-balance-sheet market risk, because they represent contractual commitments involving future settlement and counterparty credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

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

Beginning in 2005, the Reserve Banks adopted a new management model for providing check services to depository institutions. Under this new model, the Federal Reserve Bank of Atlanta (FRBA) has the overall responsibility for managing the Reserve Banks' provision of check services and recognizes total System check revenue on its Statements of Income. FRBA compensates the other eleven Banks for the costs incurred to provide check services.

(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 various accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* (*Financial Accounting Manual*), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the *Financial Accounting Manual* and the financial statements have been prepared in accordance with the *Financial Accounting Manual*.

Differences exist between the accounting principles and practices in the *Financial Accounting Manual* and those generally accepted in the United States (GAAP) primarily due to the unique nature of the Reserve Banks' powers and responsibilities as part of the nation's central bank. The primary difference is the presentation of all security holdings at amortized cost, rather than using the fair value presentation requirements in accordance with GAAP. Amortized cost more appropriately reflects the Reserve Banks' security holdings given their 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 Reserve Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio may involve transactions that result in gains or losses when holdings are sold prior to maturity. Decisions regarding security and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such securities and currencies are incidental to the open market operations and do not motivate these activities or policy decisions.

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

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

## Notes to the Combined Financial Statements of the Federal Reserve Banks—Continued

(A) *Gold and Special Drawing Rights Certificates*

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

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

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

(B) *Loans to Depository Institutions*

All depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of each of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of each of the Reserve Banks, subject to review and determination by the Board of Governors.

(C) *U.S. Government Securities and Investments Denominated in Foreign Currencies*

U.S. government securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis. Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency (losses) gains, net."

Activity related to U.S. government securities, including the related premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings that occurs in April of each year. The settlement equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments in foreign-currency-denominated assets is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31.

(D) *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 carried in the Statements of Condition at their contractual amounts and the related accrued interest is reported as a component of "Other liabilities."

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

Activity related to U.S. government securities sold under agreements to repurchase and securities lending is allocated to each Reserve Bank on a percentage basis derived from the annual settlement of interdistrict clear-

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

ings. Securities purchased under agreements to resell are allocated to the FRBNY and not to the other banks.

(E) *Foreign Currency Swaps and Warehousing*

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

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the U.S. Treasury, U.S. dollars for foreign currencies held by the U.S. Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the U.S. Treasury and ESF for financing purchases of foreign currencies and related international operations.

Foreign currency swaps and warehousing agreements are revalued daily at current market exchange rates. Activity related to these agreements, with the exception of the unrealized gains and losses resulting from the daily revaluation, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. Unrealized gains and losses resulting from the daily revaluation are allocated to the FRBNY and not to the other Reserve Banks.

(F) *Bank Premises, Equipment, and Software*

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred. Capitalized assets, including software, buildings, leasehold improvements, furniture, and equipment are impaired when it is determined that the net realizable value is significatly less than book value and is not recoverable.

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

(G) *Federal Reserve Notes*

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank.

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

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

The "Federal Reserve notes outstanding, net" account represents Federal Reserve notes outstanding, reduced by the currency issued to the Reserve Banks but not in circulation, of $148,152 million and $128,933 million at December 31, 2005 and 2004, respectively.

At December 31, 2005 all Federal Reserve notes outstanding were fully collateralized. All gold certificates, all special drawing rights certificates, and $745,120 million of domestic securities and securities purchased under agreements to resell were pledged as collateral. At December 31, 2005 no loans or investments denominated in foreign currencies were pledged as collateral.

(H) *Items in Process of Collection and Deferred Credit Items*

The balance in the "Items in process of collection" line in the Statements of Condition primarily represents amounts that are attributable to checks deposited for collection by a depository institution and that, as of the balance sheet date, have not yet been collected from the payor depository institution. Deferred credit items are the counterpart liability to items in process of collection, and the amounts in this account arise from deferring credit for deposited items until the amounts are collected. The balances in both accounts can fluctuate and vary significantly from day to day.

## Notes to the Combined Financial Statements of the Federal Reserve Banks—Continued

(I) *Capital Paid-In*

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

(J) *Surplus*

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

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

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

(K) *Income and Costs Related to U.S. Treasury Services*

The Reserve Banks are required by the Federal Reserve Act to serve as fiscal agents and depositories of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

(L) *Assessments by the Board of Governors*

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

(M) *Taxes*

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. Real property taxes were $32 million and $33 million for the years ended December 31, 2005 and 2004, respectively, and are reported as a component of "Occupancy expense."

(N) *Restructuring Charges*

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

Footnote 10 describes the restructuring and provides information about the Reserve Banks' costs and liabilities associated with employee separations and contract terminations. The costs associated with the write-down of certain Reserve Bank assets are discussed in footnote 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all Reserve Banks are recorded on the books of the FRBNY and those associated with enhanced post-retirement benefits are discussed in footnote 9.

### (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.

Total securities held in the SOMA at December 31 were as follows (in millions):

| | 2005 | 2004 |
|---|---|---|
| Par value | | |
| U.S. government | | |
| Bills | $271,270 | $262,970 |
| Notes | 380,118 | 360,832 |
| Bonds | 92,827 | 94,017 |
| Total par value | 744,215 | 717,819 |
| Unamortized premiums | 8,813 | 9,405 |
| Unaccreted discounts | (2,826) | (1,640) |
| Total | $750,202 | $725,584 |

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 held in the SOMA at December 31, 2005, was as follows (in millions):

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

| Maturities of securities held | U.S. government securities (Par value) | Securities purchased under agreements to resell (Contract amount) | Securities sold under agreements to repurchase (Contract amount) |
|---|---|---|---|
| Within 15 days | $ 41,010 | $46,750 | $30,505 |
| 16 days to 90 days | 172,264 | ... | ... |
| 91 days to 1 year | 186,283 | ... | ... |
| Over 1 year to 5 years | 210,745 | ... | ... |
| Over 5 years to 10 years | 56,699 | ... | ... |
| Over 10 years | 77,214 | ... | ... |
| Total | $744,215 | $46,750 | $30,505 |

At December 31, 2005 and 2004, U.S. government securities with par values of $3,776 million and $6,609 million, respectively, were loaned from the SOMA.

At December 31, 2005 and 2004, securities sold under agreements to repurchase with a contract amount of $30,505 million and $30,783 million, respectively, were outstanding. At December 31, 2005 and 2004, securities sold under agreements to repurchase with a par value of $30,559 million and $30,808 million, respectively, were outstanding.

(5) INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

Total investments denominated in foreign currencies, including accrued interest, and valued at current foreign currency market exchange rates at December 31, were as follows (in millions):

| | 2005 | 2004 |
|---|---|---|
| European Union euro | | |
| Foreign currency deposits | $ 5,424 | $ 6,079 |
| Securities purchased under agreements to resell | 1,928 | 2,142 |
| Government debt instruments | 3,561 | 3,947 |
| Japanese yen | | |
| Foreign currency deposits | 2,618 | 1,540 |
| Government debt instruments | 5,397 | 7,660 |
| Total | $18,928 | $21,368 |

The maturity distribution of investments denominated in foreign currencies at December 31, 2005, was as follows (in millions):

| Maturities of investments denominated in foreign currencies | European euro | Japanese yen | Total |
|---|---|---|---|
| Within 15 days | $ 3,379 | $2,617 | $ 5,996 |
| 16 days to 90 days | 2,574 | 679 | 3,253 |
| 91 days to 1 year | 2,089 | 1,007 | 3,096 |
| Over 1 year to 5 years | 2,855 | 3,712 | 6,567 |
| Over 5 years to 10 years | 16 | ... | 16 |
| Total | $10,913 | $8,015 | $18,928 |

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

At December 31, 2005 and 2004, the warehousing facility was $5,000 million, with no balance outstanding.

(6) BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

| | Remaining useful life (range in years) | 2005 | 2004 |
|---|---|---|---|
| Bank premises and equipment | | | |
| Land | N/A | $ 295 | $ 274 |
| Buildings | 1–50 | 1,787 | 1,631 |
| Building machinery and equipment | 1–20 | 387 | 373 |
| Construction in progress | N/A | 86 | 202 |
| Furniture and equipment | 1–19 | 1,162 | 1,200 |
| Subtotal | | $3,717 | $3,680 |
| Accumulated depreciation | | (1,465) | (1,464) |
| Bank premises and equipment, net | | $2,252 | $2,216 |
| Depreciation expense, for the years ended | | $ 175 | $ 179 |

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

| | 2005 | 2004 |
|---|---|---|
| Bank premises and equipment | $10 | $11 |
| Accumulated depreciation | (5) | (6) |
| Capitalized leases, net | $ 5 | $ 5 |

Certain of the Reserve Banks lease space to outside tenants with initial or remaining lease terms from 1 to 20 years. Rental income from such leases was $23 million and $21 million for the years ended December 31, 2005 and 2004, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2005, were (in millions):

## Notes to the Combined Financial Statements of the Federal Reserve Banks—Continued

| | |
|---|---|
| 2006 | $ 21 |
| 2007 | 17 |
| 2008 | 16 |
| 2009 | 15 |
| 2010 | 14 |
| Thereafter | 60 |
| Total | $143 |

The Reserve Banks have capitalized software assets, net of amortization, of $162 million and $170 million at December 31, 2005 and 2004, respectively. Amortization expense was $55 million and $56 million for the years ended December 31, 2005 and 2004, respectively. Capitalized software assets are reported as a component of "Other assets" and related amortization is reported as a component of "Other expenses."

Several Reserve Banks have impaired assets as a result of the System's restructuring plans, as discussed in footnote 10. Impaired assets include software, buildings, leasehold improvements, furniture, and equipment. Asset impairment losses related to the check and cash restructurings of $50 million and $21 million for the periods ending December 31, 2005 and 2004, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

### (7) Commitments and Contingencies

At December 31, 2005, the Reserve Banks were obligated under noncancelable leases for premises and equipment with initital or remaining terms ranging from 1 to 18 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 $40 million and $70 million for the years ended December 31, 2005 and 2004, respectively. Certain of the Reserve Banks' leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with terms of one year or more, at December 31, 2005, were (in millions):

| | Operating |
|---|---|
| 2006 | $ 11 |
| 2007 | 10 |
| 2008 | 8 |
| 2009 | 8 |
| 2010 | 7 |
| Thereafter | 109 |
| | $153 |

At December 31, 2005, the Reserve Banks had other commitments and long-term obligations extending through the year 2017 with a remaining amount of $397 million. As of December 31, 2005, commitments of $185 million were recognized. Purchases of $144 million and $124 million were made against these commitments during 2005 and 2004, respectively. These commitments are for goods and services to maintain currency machines, for software licenses and maintenance, for services related to check processing equipment and transportation, and have variable and fixed components. The variable portion of the commitments is for additional services above fixed contractual service limits. The fixed payments for the next five years under these commitments are (in millions):

| | Fixed commitment |
|---|---|
| 2006 | $50 |
| 2007 | 52 |
| 2008 | 38 |
| 2009 | 32 |
| 2010 | 27 |

The Reserve Banks are 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 Reserve Banks.

### (8) Retirement and Thrift Plans

#### *Retirement Plans*

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

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

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

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

| | 2005 | 2004 |
|---|---|---|
| Estimated actuarial present value of projected benefit obligation at January 1 | $4,524 | $3,930 |
| Service cost—benefits earned during the period | 123 | 116 |
| Interest cost on projected benefit obligation | 263 | 245 |
| Actuarial loss | 125 | 457 |
| Contributions by plan participants | 3 | 3 |
| Special termination benefits loss | 6 | 20 |
| Benefits paid | (259) | (247) |
| Estimated actuarial present value of projected benefit obligation at December 31 | $4,785 | $4,524 |

Following is a reconciliation showing the beginning and ending balance of the System Plan assets, the funded status, and the prepaid pension benefit costs (in millions):

| | 2005 | 2004 |
|---|---|---|
| Estimated fair value of plan assets at January 1 | $5,887 | $5,703 |
| Actual return on plan assets | 237 | 428 |
| Contributions by the employer | . . . | . . . |
| Contributions by plan participants | 3 | 3 |
| Benefits paid | (259) | (247) |
| Estimated fair value of plan assets at December 31 | $5,868 | $5,887 |
| Funded status | $1,083 | $1,362 |
| Unrecognized prior service cost | 149 | 173 |
| Unrecognized net actuarial loss | 1,496 | 1,182 |
| Prepaid pension benefit costs | $2,728 | $2,717 |

Prepaid pension benefit costs are reported as a component of "Other assets."

The accumulated benefit obligation for the System Plan was $4,162 million and $3,894 million at December 31, 2005 and 2004, respectively.

The weighted-average assumptions used in developing the pension benefit obligation for the System Plan as of December 31 are as follows:

| | 2005 | 2004 |
|---|---|---|
| Discount rate | 5.75% | 5.75% |
| Rate of compensation increase | 4.50% | 4.25% |

Net periodic benefit costs are actually determined using a January 1 measurement date. The weighted-average assumptions used in developing net periodic benefit cost for the System Plan for the years at January 1 are as follows:

| | 2005 | 2004 |
|---|---|---|
| Discount rate | 5.75% | 6.25% |
| Expected asset return | 8.25% | 8.25% |
| Rate of compensation increase | 4.25% | 4.00% |

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.

Expected return on assets was based on a combination of methodologies including the System Plan's historical returns, surveys of what other plans' expected rates of return are, building a projected return for equities and fixed income investments based on real interest rates, inflation expectations and equity risk premiums, and, finally, surveys of expected returns in equity and fixed income markets.

The components of net periodic pension benefit credit for the System Plan for the years ended December 31 are shown below (in millions):

| | 2005 | 2004 |
|---|---|---|
| Service cost—benefits earned during the period | $ 123 | $ 116 |
| Interest cost on projected benefit obligation | 263 | 245 |
| Amortization of prior service cost | 24 | 24 |
| Recognized net loss | 49 | 20 |
| Expected return on plan assets | (476) | (462) |
| Net periodic pension benefit credit | (17) | (57) |
| Special termination benefits | 6 | 20 |
| Net periodic pension benefit credit | $ (11) | $ (37) |

The recognition of special termination benefits is the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10.

Following is a summary of expected benefit payments excluding enhanced retirement benefits (in millions):

| | Expected benefit payments |
|---|---|
| 2006 | $ 236 |
| 2007 | 242 |
| 2008 | 247 |
| 2009 | 253 |
| 2010 | 261 |
| 2011–2015 | 1,498 |
| Total | $2,737 |

The Federal Reserve System's pension plan weighted-average asset allocations at December 31, by asset category, are as follows:

| | 2005 | 2004 |
|---|---|---|
| Equities | 65.9% | 67.5% |
| Fixed income | 32.0% | 30.0% |
| Cash | 2.1% | 2.5% |
| Total | 100.0% | 100.0% |

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

The System's Committee on Investment Performance (CIP) contracts with investment managers who are responsible for implementing the System Plan's investment policies. The managers' performance is measured against a trailing 36-month benchmark of 60 percent of a market value weighted index of predominantly large capitalization stocks trading on the New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers Automated Quotation National Market System and 40 percent of a broadly diversified investment-grade fixed income index (rebalanced monthly). The managers invest Plan funds within CIP-established guidelines for investment in equities and fixed income instruments. Equity investments can range between 40 percent and 80 percent of the portfolio. Investments, however, cannot be concentrated in particular industries and equity security holdings of any one company are limited. Fixed income securities must be investment grade and the effective duration of the fixed income portfolio must remain within a range of 67 percent and 150 percent of a broadly diversified investment-grade fixed income index. CIP guidelines prohibit margin, short sale, foreign exchange, and commodities trading as well as investment in bank, bank holding company, savings and loan, and government securities dealers stocks. In addition, investments in non-dollar denominated securities are prohibited; however, a small portion of the portfolio can be invested in American Depositary Receipts/Shares and foreign-issued dollar denominated fixed income securities.

The Federal Reserve System does not expect to make a cash contribution to the System Plan during 2006.

The Reserve Banks' projected benefit obligation and net pension costs for the BEP and the SERP at December 31, 2005 and 2004, and for the years then ended, are not material.

*Thrift Plan*

Employees of the Reserve Banks may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Reserve Banks' Thrift Plan contributions totaled $63 million for each of the years ended December 31, 2005 and 2004, and are reported as a component of "Salaries and other benefits." The Reserve Banks match employee contributions based on a specified formula. For the years ended December 31, 2005 and 2004, the Reserve Banks matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

(9) POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

*Postretirement Benefits Other Than Pensions*

In addition to the Reserve Banks' 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 Reserve Banks fund benefits payable under the medical and life insurance plans as due and, accordingly, have no plan assets.

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

| | 2005 | 2004 |
|---|---|---|
| Accumulated postretirement benefit obligation at January 1 | $869 | $942 |
| Service cost—benefits earned during the period | 32 | 19 |
| Interest cost of accumulated benefit obligation | 49 | 52 |
| Actuarial loss | 45 | 10 |
| Curtailment gain | . . . | (2) |
| Special termination loss | . . . | 1 |
| Contributions by plan participants | 11 | 9 |
| Benefits paid | (59) | (50) |
| Plan amendments | . . . | (112) |
| Accumulated postretirement benefit obligation at December 31 | $947 | $869 |

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

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

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

| | 2005 | 2004 |
|---|---|---|
| Fair value of plan assets at January 1 | $ . . . | $ . . . |
| Contributions by the employer | 48 | 42 |
| Contributions by plan participants | 11 | 8 |
| Benefits paid | (59) | (50) |
| Fair value of plan assets at December 31 | $ . . . | $ . . . |
| Unfunded postretirement benefit obligation | $947 | $869 |
| Unrecognized net curtailment gain | . . . | 5 |
| Unrecognized prior service cost | 105 | 128 |
| Unrecognized net actuarial loss | (277) | (247) |
| Accrued postretirement benefit costs | $775 | $755 |

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

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

| | 2005 | 2004 |
|---|---|---|
| Health care cost trend rate assumed for next year | 9.00% | 9.00% |
| Rate to which the cost trend rate is assumed to increase (the ultimate trend rate) | 5.00% | 4.75% |
| Year that the rate reaches the ultimate trend rate | 2011 | 2011 |

NOTES TO THE COMBINED FINANCIAL STATEMENTS OF THE FEDERAL RESERVE BANKS—CONTINUED

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2005 (in millions):

| | One percentage point increase | One percentage point decrease |
|---|---|---|
| Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs | $ 11 | $(10) |
| Effect on accumulated postretirement benefit obligation | 103 | (86) |

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

| | 2005 | 2004 |
|---|---|---|
| Service cost—benefits earned during the period | $ 32 | $ 19 |
| Interest cost of accumulated benefit obligation | 49 | 52 |
| Amortization of prior service cost | (21) | (17) |
| Recognized net actuarial loss | 13 | 8 |
| Total periodic expense | 73 | 62 |
| Curtailment gain | (5) | (86) |
| Special termination loss | . . . | 1 |
| Net periodic postretirement benefit costs (credit) | $ 68 | $(23) |

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

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

The 2005 service cost contains an adjustment by one Reserve Bank that resulted from a review of plan terms and assumptions. A plan amendment that modified the credited service period eligibility requirements created curtailment gains. The recognition of special termination losses is primarily the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 established a prescription drug benefit under Medicare (Medicare Part D) and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. The benefits provided by the Reserve Banks' 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 costs.

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

| | Without subsidy | With subsidy |
|---|---|---|
| 2006 | $ 54 | $ 49 |
| 2007 | 57 | 52 |
| 2008 | 59 | 53 |
| 2009 | 62 | 56 |
| 2010 | 64 | 58 |
| 2011–2015 | 351 | 308 |
| Total | $647 | $576 |

*Postemployment Benefits*

The Reserve Banks offer benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2005, measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Reserve Banks at December 31, 2005 and 2004, were $124 million and $128 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2005 and 2004 operating expenses were $14 million and $17 million, respectively, and are recorded as a component of "Salaries and other benefits."

## 10. BUSINESS RESTRUCTURING CHARGES

In 2003, several Reserve Banks announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Banks. In 2004 and 2005, additional consolidation and restructuring initiatives were announced in the check, cash, savings bonds, marketing, purchasing, and Treasury operations. These actions resulted in the following business restructuring charges (in millions):

| | Total estimated costs |
|---|---|
| Employee separation | $60 |
| Contract termination | 1 |
| Total | $61 |

| | Accrued liability 12/31/04 | Total charges | Total paid | Accrued liability 12/31/05 |
|---|---|---|---|---|
| Employee separation | $28 | $6 | $(17) | $17 |
| Contract termination | 1 | . . . | (1) | . . . |
| Total | $29 | $6 | $(18) | $17 |

Adjustments due to unrecognized accrued liabilities were offset against total charges. Without these offsets, total charges would have been $11 million in 2005.

Total employee separation costs are primarily severance costs related to staff reductions of approximately 2,411, including 348 and 945 staff reductions related to restructuring announced in 2005 and 2004, respectively. These costs are reported as a component of ‘‘Salaries and other benefits.’’ Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of ‘‘Other expenses.’’

Restructing costs associated with the write-downs of certain Reserve Bank assets, including software, buildings, leasehold improvements, furniture, and equipment are discussed in footnote 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8. Costs associated with enhanced postretirement benefits are disclosed in footnote 9.

Future costs associated with the announced restructuring plans are estimed at $3 million.

The Reserve Banks anticipate substantially completing their announced plans in 2007.

# *Office of Inspector General Activities*

The Board's Office of Inspector General (OIG) functions in accordance with the Inspector General Act of 1978, as amended. In addition to retaining an independent auditor each year to audit the Board's financial statements, the OIG plans and conducts audits, inspections, evaluations, and investigations of the Board's programs and operations and its delegated functions at the Federal Reserve Banks. The OIG also reviews existing and proposed legislation and regulations for economy and efficiency. It recommends policies, and conducts and supervises activities, that promote economy and efficiency and prevent and detect waste, fraud, and abuse in Board and Board-delegated programs and operations, and in activities administered or financed by the Board. The OIG keeps the Congress and the Chairman of the Board fully informed about serious abuses and deficiencies and about the status of any corrective actions.

During 2005, the OIG completed eleven audits, reviews, and other assessments and conducted a number of follow-up reviews to evaluate action taken on earlier recommendations. Some of these projects resulted in multiple reports. The OIG also closed seven investigations and performed numerous legislative and regulatory reviews.

Audits, Reviews, and Assessments Completed during 2005

| Report title | Month issued |
| --- | --- |
| Review of Configuration Management (Restricted Report) | January |
| Review of the Board's Workers' Compensation Program | March |
| Audit of the FFIEC's Financial Statements (Year Ended December 31, 2004) | March |
| Audit of the Board's Financial Statements (Year Ended December 31, 2004) | April |
| Audit of the Board's Fixed Asset Management Process | May |
| Review of Board's Implementation of Software Security Reviews | May |
| Review of the Bank of Ephraim Failure | August |
| Evaluation of Service Credit Computations (Internal Report) | August |
| Agreed Upon Procedures Engagement Regarding Certain Personnel-Related Controls (Internal Report) | August |
| Audit of the Supervision and Regulation Function's Efforts to Implement Requirements of the Federal Information Security Management Act | September |
| Audit of the Board's Information Security Program | October |

# *Government Accountability Office Reviews*

Under the Federal Banking Agency Audit Act (Public Law 95–320), most Federal Reserve System operations are under the purview of the Government Accountability Office (GAO). In 2005, the GAO completed five reports on selected aspects of Federal Reserve operations (table). In addition, five projects concerning the Federal Reserve were in various stages of completion at year-end (table). The Federal Reserve also provided information to the GAO during the year on numerous other GAO investigations.

The reports are available directly from the GAO.

Reports Completed during 2005

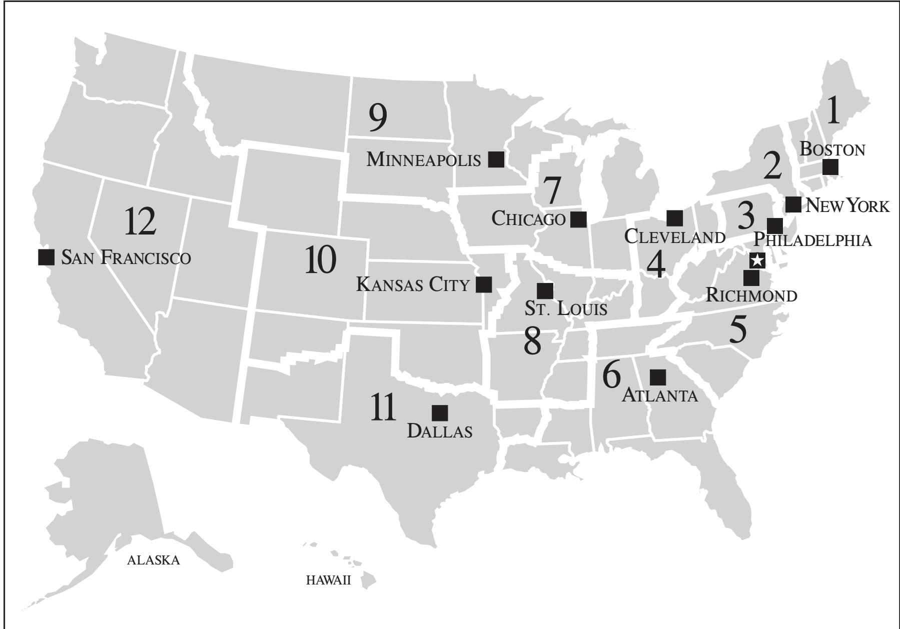
| Report title | Report number | Month issued (2005) |
|---|---|---|
| USA Patriot Act: Additional Guidance Could Improve Implementation of Regulations Related to Customer Identification and Information Sharing Procedures | GAO-05-412 | May |
| Information Security Practices: Financial Market Organizations Have Taken Steps to Protect against Electronic Attacks, But Could Take Additional Actions | GAO-05-679R | June |
| Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority | GAO-05-621 | September |
| Financial Audit: Bureau of the Public Debt's Fiscal Years 2005 and 2004 Schedules of Federal Debt | GAO-06-l69 | November |
| International Remittances: Information on Products, Costs, and Consumer Disclosures | GA0-06-204 | November |

Projects Active at Year-End 2005

| Subject of project | Month initiated |
|---|---|
| Bank Secrecy Act examinations | January 2004 |
| Sections 330 and 361of the USA Patriot Act | September 2005 |
| Diversity in the financial services sector | October 2005 |
| Lending practices associated with alternative mortgage products | November 2005 |
| Consolidated supervision of financial institutions | November 2005 |

# *Maps of the Federal Reserve System*

# The Federal Reserve System




LEGEND

*Both pages*

- ■ Federal Reserve Bank city
- ✪ Board of Governors of the Federal Reserve System, Washington, D.C.

*Facing page*

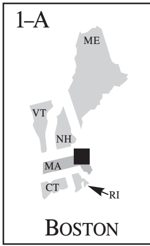
- • Federal Reserve Branch city
- — Branch boundary

NOTE

The Federal Reserve officially identifies Districts by number and by Reserve Bank city (shown on both pages) and by letter (shown on the facing page).

In the 12th District, the Seattle Branch serves Alaska, and the San Francisco Bank serves Hawaii.

The System serves commonwealths and territories as follows: The New York Bank serves the Commonwealth of Puerto Rico and the U.S. Virgin Islands; the San Francisco Bank serves American Samoa, Guam, and the Commonwealth of the Northern Mariana Islands. The maps show the boundaries within the System as of year-end 2005.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NH
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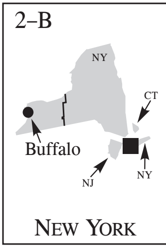
BOSTON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Buffalo
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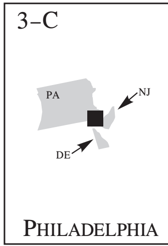
NEW YORK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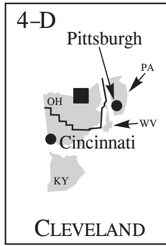
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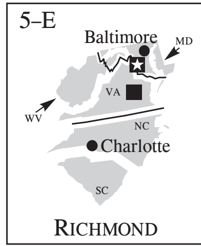
PA
OH
WV
Cincinnati
KY
CLEVELAND


5–E
Baltimore
MD
VA
WV
NC
Charlotte
SC
RICHMOND

6–F
TN
Nashville
Birmingham
AL
MS
GA
LA
Jacksonville
New Orleans
FL
Miami
ATLANTA

7–G
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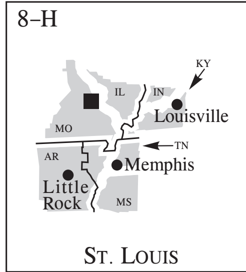
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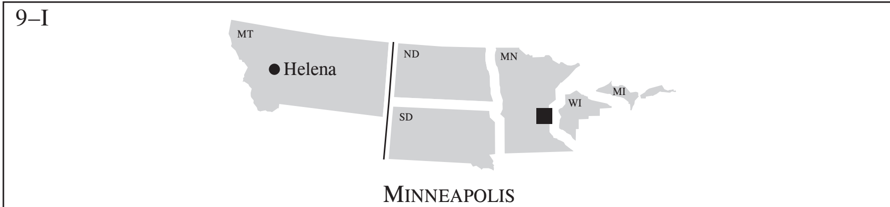
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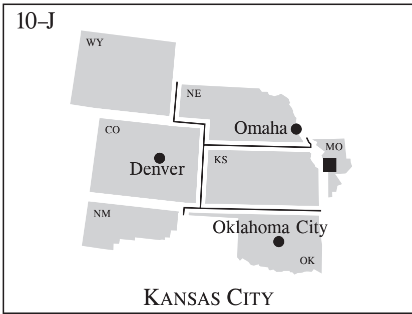
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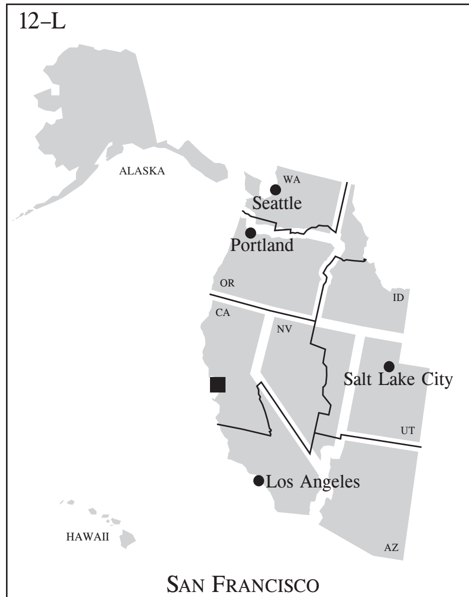
Oklahoma City
OK
KANSAS CITY


12–L
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WA
Seattle
Portland
OR
ID
CA
NV
Salt Lake City
UT
Los Angeles
HAWAII
AZ
SAN FRANCISCO

11–K
TX
NM
LA
El Paso
Houston
San Antonio
DALLAS

# *Index*

# Index

**Accounting Task Force (ATF),** 73
Agreement corporations, examinations of, 58, 59, 65–66
Anti–money laundering (AML)
  *Bank Secrecy Act/Anti–Money Laundering (BSA/AML) Examination Manual,* 57–58, 70–71
  Examinations, 61–62
Applications, notices, and proposals, 80–84, 92–93
Asset-backed commercial paper (ABCP) programs, 69
Assets and liabilities
  Board of Governors, 298
  Commercial banks, 274
  Federal Reserve Banks, 276–79, 312
Association of Supervisors of Banks of the Americas (ASBA), 67
ATM (automated teller machine) use, 90, 91
Auditors' reports, 297, 306–7, 310, 311
Audits, reviews, and assessments
  of Board of Governors, 295, 297–310, 325
  of Federal Reserve Banks, 124, 295, 311–24, 325
  of Federal Reserve System, 295, 325, 326
  by Government Accountability Office, 326
  by Office of Inspector General, 325
Automated clearinghouse services, Federal Reserve Banks, 115, 290
Availability of Funds and Collection of Checks (Regulation CC), 103, 146

**Balance sheets**
  Board of Governors, 298
  Federal Reserve priced services, 128
Bank examiner training, 78–80, 96–97
Bank holding companies
  Banks affiliated with, 265
  Capital standards, 69
  Inspections of, 59, 60–61
  Number of, 59
  Rating system, 70–71
  Regulatory financial reports, 76–77
Bank holding companies—Continued
  Small holding company threshold, 75
  Surveillance and off-site monitoring of, 64–65
Bank Holding Companies and Change in Bank Control (Regulation Y), 145–46
Bank Holding Company Act, 58, 80–81
Bank Holding Company Performance Reports (BHCPRs), 64–65
Banking Organization National Desktop (BOND), 78
Banking organizations, U.S. (*See also* Bank holding companies *and* Commercial banks)
  Capital standards, 67–70
  Examinations and inspections of, 59–61
  Foreign operations, 65, 68, 82–83
  Number of, 265
  Regulation of, 80–84
  Risk-focused supervision of, 60
Bank Merger Act, 58, 81–82
Bank of America Corporation, acquisition, 93
Bank-owned life insurance, 70
Bankruptcy Abuse Prevention and Consumer Protection Act, 38, 57, 105–6, 137–41
Bank Secrecy Act Advisory Group (BSAAG), 71
*Bank Secrecy Act/Anti–Money Laundering (BSA/AML) Examination Manual,* 57–58, 70–71
Bank Secrecy Act (BSA), examinations, 61–62
Basel Committee on Banking Supervision, 62, 67, 72–73
Basel I framework, implementation, 58, 68–69
Basel II framework, implementation, 58, 62, 68–69, 72
Board of Governors (*See also* Federal Reserve System)
  Assets and liabilities of, 298
  Audits, reviews, and assessments of, 295, 297–310, 325
  Consumer Advisory Council, 104–7, 232
  Decisions, public notice, 83–84

Board of Governors—Continued
Ex officio members, 256
Federal Advisory Council, 231
FFIEC activities, 65, 74, 77, 80, 95–96
Financial statements of, 297–310
Government Performance and Results Act, 133–36
Inspector General, Office of, audits, reviews, and assessments, 325
Litigation, 223–24
Members and officers, 227–29, 253–56
Outreach activities, 111
Policy actions, 145–51
Thrift Institutions Advisory Council, 233
BOND (Banking Organization National Desktop), 78
Branches (*See* Federal Reserve Banks)
Business continuity, 62
Business investment, profits, and finance, 12–15, 38–41

**Call Reports,** 64, 77
CAN-SPAM Act, 96
Capital accounts, Federal Reserve Banks, 276–79, 312
Capital One Financial Corporation, acquisition, 93
Capital standards, 67–70, 72
Cash flows, Board of Governors, 300
Cash management services, Federal Reserve Banks, 121
Central Document and Text Repository (CDTR), 78
Change in Bank Control Act, 58, 82
Check Clearing for the 21st Century Act (Check 21), 116–17
Check collection and processing, Federal Reserve Banks, 113–15, 290
Citigroup, Inc., merger, 92–93
Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers through Fedwire (Regulation J), 146
Collection services for federal government, Federal Reserve Banks, 121
Combined financial statements, Federal Reserve Banks, 311–24
Commercial banks
Assets and liabilities of, 274
Number of, 265
Regulatory financial reports, 77
Commercial paper, asset-backed, programs, 69
Commercial real estate (CRE), 75
Committee of Sponsoring Organizations of the Treadway Commission (COSO), 124
Community Affairs Offices (CAOs), 107, 109–10
Community affairs (*See* Consumer and community affairs)
Community economic development, 107–11
Community Reinvestment Act (CRA)
Applications, analysis in relation to, 92–93
Effectiveness of, 110
Examinations for compliance with, 92
Review of, 106
Rules revisions, 87, 89, 91, 106
Community Reinvestment (Regulation BB), 89, 91, 106, 147
Compliance examinations, 92, 94
Condition statements, Federal Reserve Banks, 276–79, 312
Consumer Advisory Council, 104–7, 232
Consumer and community affairs
Community economic development, 107–11
Consumer Advisory Council advice, 104–7
Consumer complaints, 103–4, 105
Consumer financial education, 107–11
Consumer protection and community reinvestment laws, 87–103
Outreach activities, 111
Consumer complaints, 103–4, 105
Consumer Credit Protection Act, 94
Consumer Leasing (Regulation M), 100
Consumer price index (CPI), 22–23, 47
Consumer prices, 22–23, 47–48
Consumer protection laws
Agency reports on compliance with, 98–103
Implementation of, 87–92
Supervision for compliance with, 92–98
Consumer spending, 9–10, 36–37
Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act, 96
Core Principles for banking supervision, 72
Corporate profits, 13–15, 40–41
CPI (consumer price index), 22–23, 47

Credit, extensions to bank executive officers, 84–85
Credit risk management, 74–75
Currency and coin, operations and developments in, 118, 290
Current account, U.S., 18, 43

**Debt**
Corporate, 14–15, 40–41
Domestic nonfinancial sectors, 27, 50
Government, 16, 17, 42, 43
Household, 11–12, 38
Debt services for federal government, Federal Reserve Banks, 120
Depository Institutions Disaster Relief Act, 73–74
Depository institutions (*See also* Commercial banks)
Interest rates on loans by Federal Reserve Banks, 263
Reserve requirements, 264
Reserves of, 266–73
Depository services to federal government, Federal Reserve Banks, 118–21
Deposits
Commercial banks, 274
Federal Reserve Banks, 267, 269, 271, 273
Directors, Federal Reserve Banks and Branches, 236–52
Disclosures by state member banks, 84
Discount rates (*See also* Interest rates), 149–51
Disposable personal income (DPI), 10, 37
Dollar exchange rate, 29, 51
Dollar Wi$e financial education program, 109

**ECI (employment cost index),** 22, 46
Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA), 75–76, 106
Economies, foreign, 28–31, 51–54
Economy, U.S.
Business sector, 12–15, 38–41
Debt, 27, 50
External sector, 18–20, 43–45
Financial markets, 5–6, 24–28, 48–51
Government sector, 15–17, 41–43
Household sector, 9–12, 36–38
Interest rates, 5, 24–26, 49
Labor market, 20–22, 45–47
Economy, U.S.—Continued
M2 monetary aggregate, 28, 50–51
Outlook and projections, 3–4, 7, 33–34, 35–36
Prices, 19–20, 22–24, 44, 47–48
Edge Act corporations, examinations of, 58, 59, 65–66
Education, consumer financial, 107–11
Electronic access to Federal Reserve Bank services, 122
Electronic Federal Tax Payment System (EFTPS), 121
Electronic Fund Transfer Act (EFTA), 87, 90–92, 105
Electronic Fund Transfers (Regulation E), 87, 90–91, 100, 105, 145
Emerging-market economies, 30–31, 53–54
Employment, 20–21, 45–46
Employment cost index (ECI), 22, 46
Energy prices, 19–20, 23–24, 44, 48
Enforcement actions
Federal Reserve System, 64
Other federal agencies, 98, 100–103
Equal Credit Opportunity Act (ECOA), 94–95
Equal Credit Opportunity (Regulation B), 94, 98, 100
Equal opportunity rules, 148
Equity markets and prices, 26–27, 50
Examinations and inspections
Anti–money laundering, 61–62
Bank holding companies, 59, 60–61
Community Reinvestment Act, compliance with, 92
Consumer protection laws, compliance with, 94–96
Edge Act and agreement corporations, 58, 59, 65–66
Federal Reserve Banks, 124
Fiduciary activities, 62–63
Financial holding companies, 61
Foreign banks, 66–67
Information technology activities, 62
International banking activities, 65–67
Securities clearing agencies, 63
Securities credit lenders, 63–64
Securities dealers and brokers, government and municipal, 63
State member banks, 59, 60, 65
Transfer agents, 63

Examiners
Post-employment restrictions on, 141, 148
Training, 78–80, 96–97
Expenses (*See* Income and expenses)
Exports, 18, 43–44
External sector, developments in, 18–20, 43–45

**Fair and Accurate Credit Transactions Act (FACT Act),** 87, 89–90, 96
Fair Credit Reporting Act (FCRA), 96
Fair Credit Reporting (Regulation V), 90, 146
Fair Housing Act, 94–95
Fair lending laws, compliance with, 94–95, 98, 99
Fair value option (FVO) rule, 73
Federal Advisory Council, members and officers, 231
Federal agency securities and obligations
Commercial bank holdings, 274
Federal Reserve Bank holdings, 266, 268, 270, 272
Federal Deposit Insurance Corporation Improvement Act, 60, 76, 138
Federal Financial Institutions Examination Council (FFIEC), 65, 74, 77, 79, 80, 95–96
Federal funds rate, 3–4, 5–6, 33, 34–35, 169–70, 177–79, 185–86, 194–95, 200–201, 207–8, 214–15, 221–22
Federal government
Federal Reserve Bank services to, 118–21
Spending, receipts, and borrowing, 15–17, 41–42
Federal Open Market Committee (FOMC)
Authorizations, 153–55, 155–56, 160–61, 163–64
Domestic policy directives, 155, 170, 178–79, 186, 194–95, 201, 207–8, 215, 222
Foreign currency directives and procedural instructions, 156–58, 162–63
Meetings, minutes of, 153–222
Members and officers, 230
Notation votes, 170, 179, 187, 195, 201, 208, 215, 222
Federal Open Market Committee—Continued
System Open Market Account, 154–57, 160–64, 171–72, 180, 188, 196, 202, 209, 216
Federal Reserve Act, 82
Federal Reserve Banks
Assessments by Board of Governors, 284, 286, 288
Assets and liabilities of, 276–79, 312
Audits, reviews, and assessments of, 124, 295, 311–24, 325
Automated clearinghouse services, 115, 290
Branches of, 234–35
Capital accounts, 276–79, 312
Chairmen, Conference of, 235
Credit outstanding, 266, 268, 270, 272
Deposits, 267, 269, 271, 273
Directors of, 236–52
Discount rates, 149–51
Electronic access to services, 122
Examinations of, 124
Examiners, post-employment restrictions on, 141, 148
Examiner training, 78–80, 96–97
FedLine Advantage, 122
Financial statements of, combined, 311–24
First Vice Presidents, Conference of, 236
Fiscal agency services, 118–21
Government depository services, 118–21
Income and expenses of, 124–25, 280–89
Information technology developments, 122–24
Interest rates on loans to depository institutions, 263
Noncash collection service, 117, 148
Officers and employees, number and salaries of, 291
Officers of (list), 234–35
Operations, volume of, 290
Payments to U.S. Treasury, 125, 282–83
Premises of, 126–27, 292
Presidents, Conference of, 235
Priced services, 113–17, 128–31
Reserve balances, 267, 269, 271, 273
Salaries of officers and employees, 291
Securities and loans, holdings of, 125–26, 262, 266, 268, 270, 272
Statements for priced services, 128–31
Statements of changes in capital, 314

Federal Reserve Banks—Continued
 Statements of condition, 276–79, 312
 Statements of income, 313
Federal Reserve Electronic Tax Application (FR-ETA), 121
Federal Reserve System (*See also* Board of Governors *and* Federal Reserve Banks), 67
 Audits, reviews, and assessments of, 295, 325, 326
 Banking structure, U.S., regulation of, 80–84
 Basel Committee activities, 62, 67, 72–73
 Consumer protection responsibilities, 87–96
 Decisions, public notice of, 83–84
 Enforcement actions, 64
 Hurricanes, response to, 57, 73–74, 107, 122–23
 Maps of, 328–29
 Membership, 85
 Safety and soundness responsibilities, 58–67
 Supervisory information technology, 77–78
 Supervisory policy, 67–77
 Surveillance and off-site monitoring, 64–65
 Technical assistance, 67
 Training and staff development, 78–80, 96–97
Federal sector, developments in, 15–17, 41–42
Federal tax payments, 121
FedLine Advantage, 122
Fedwire Funds Service, 115
Fedwire Securities Service, 116–17
FFIEC (Federal Financial Institutions Examination Council), 65, 74, 77, 79, 80, 95–96
Fiduciary activities, supervision of, 62–63
Finance
 Business, 13–15, 40–41
 Household, 11–12, 38
Financial account, U.S., 20, 44–45
Financial Crimes Enforcement Network (FinCEN), 57, 70–71
Financial education, consumer, 107–11
Financial holding companies, 61
Financial Institutions Supervisory Act, 223
Financial intermediation, 27, 50
Financial markets, 5–6, 24–28, 48–51
Financial statements
 Board of Governors, 297–310
 Federal Reserve Banks, combined, 311–24
 Federal Reserve priced services, 128–31
First American Bank, merger, 92–93
First Community Capital Corporation, acquisition, 93
Fiscal agency services, Federal Reserve Banks, 118–21
Float, 117, 266, 268, 270, 272
Flood insurance, 95
FOMC (*See* Federal Open Market Committee)
Foreign banks, U.S. activities of, 66–67
Foreign currency operations
 Authorization for conduct of, 155–56, 160–61
 Directives, 156–57, 162
 Procedural instructions for, 157–58, 162–63
Foreign economies, 28–31, 51–54
Foreign operations of U.S. banking organizations, 65, 68, 82–83
Foreign trade, 18–20, 43–44

**GDP (gross domestic product),** 7, 9, 16, 35–36, 41–42
Gold stock, 266, 268, 270, 272
Government
 Federal, spending, receipts, and borrowing, 15–17, 41–42
 Federal Reserve Bank services to, 118–21
 State and local, spending, receipts, and borrowing, 17, 42–43
Government Accountability Office (GAO), 326
Government National Mortgage Association (GNMA), 77
Government Performance and Results Act (GPRA), 133–36
Government securities dealers and brokers, examination of, 63
Gramm-Leach-Bliley Act, 58, 61, 81, 106–7

**Hibernia Bancorporation, acquisition,** 93
Home equity lending (*See also* Household sector), 74
Homeland Investment Act, 20

Home Mortgage Disclosure Act (HMDA), 87, 91, 93, 95, 97–99, 106–7, 110–11
Home Mortgage Disclosure (Regulation C), 91, 95, 106
Home Ownership and Equity Protection Act (HOEPA), 87, 91
Household sector, developments in, 9–12, 36–38
Housing and Urban Development, Department of, complaint referrals, 104
Hurricane damage and response, 57, 73–74, 107, 122–23,

**Imports,** 18–19, 43–44
Income and expenses
  Board of Governors, 299
  Federal Reserve Banks, 124–25, 280–89
  Federal Reserve priced services, 129
Industrial economies, 29–30, 52–53
Inflation, 3–4, 7, 9, 22–24, 33–35, 47–48
Information security standards, 148–49
Information technology
  Developments in, 122–24
  Federal Reserve examination of, 62
  Supervisory, 77–78
Inspections (*See* Examinations and inspections)
Inspector General, Office of (OIG), 325
Insured commercial banks (*See* Commercial banks)
Interest rates (*See also* Discount rates *and* Federal funds rate), 5, 24–26, 49, 263
International Accounting Standards Board (IASB), 67, 73
International Banking Act, 58, 83
International banking activities, supervision of, 65–67, 68, 72–73
International Organization of Securities Commissioners (IOSCO), 69, 72
International trade, 18–20, 43–44
Investment
  Business sector, 12–13, 38–40
  Overseas, by U.S. banking organizations, 82–83
  Residential, 10–11, 37–38

**Jobs and Growth Tax Relief Reconciliation Act (JGTRRA),** 15–16, 41
Joint Forum, 72–73
Jump$tart Coalition, 109

**Labor market,** 20–22, 45–47
Large complex banking organizations (LCBOs), supervision of, 60
Legislation, federal, 137–41
Liabilities (*See* Assets and liabilities)
Life insurance, bank-owned, 70
Litigation involving Board of Governors
  Artis, 224
  Barnes, 223
  Bazy, 223
  Diehl McCarthy, 223
  Fakolujo, 223–24
  Fraternal Order of Police, 224
  Inner City Press/Community on the Move, 223
  Jones, 224
  Price, 223
  Sciba, 224
  Texas State Bank, 224
  Thomas, 223
  Ulrich, 223
Loans
  Federal Reserve Bank holdings, 125–26, 266, 268, 270, 272
  Insured commercial bank holdings, 274
  State member banks to executive officers, 84–85
Local governments, 17, 42–43

**Maps, Federal Reserve System,** 328–29
Margin requirements, 275
MBNA Corporation, acquisition, 93
Medical information, 89–90, 146–47
Member banks (*See also* State member banks)
  Assets and liabilities, 274
  Examination of foreign operations, 65
  Number of, 265
  Reserves, 271, 273
Members and officers
  Board of Governors, 227–29, 253–56
  Consumer Advisory Council, 232
  Federal Advisory Council, 231
  Federal Open Market Committee, 230
  Federal Reserve Banks and Branches, 234–35
  Thrift Institutions Advisory Council, 233
Membership of State Banking Institutions in the Federal Reserve System (Regulation H), 145

Middle East and North Africa (MENA) Financial Regulators' Training Initiative, 67
Monetary aggregate (M2), 28, 50–51
*Monetary Policy Reports to the Congress*
February 2006, 3–31
July 2005, 33–54
Monetary policy (*See also* Federal Open Market Committee), 3–6, 33–35
Money-laundering prevention, 61–62, 70–71
Mortgage interest rates, 11, 37–38
Mortgage products, nontraditional, 74–75, 107
Municipal securities dealers and brokers, examination of, 63
MyMoney.gov, 108

**National Examination Database (NED),** 78
National Flood Insurance Act, 95
National Information Center (NIC), 78
National Settlement Service, 115–16
Noncash collection service, Federal Reserve Banks, 117, 148
Nonmember banks, assets and liabilities, 274
Notes, Federal Reserve (*See also* Currency and coin), 276–79

**Obtaining and Using Medical Information in Connection with Credit (Regulation FF),** 90, 146–47
Office of Foreign Assets Control (OFAC), 70–71
Office of Inspector General (OIG), 325
Officers (*See* Members and officers)
Oil prices (*See* Energy prices)
Open market operations
Authorization for conduct of, 153–55, 163–64
Volume of transactions, 258–61
Overdraft-protection services, 75, 88–89, 148

**Pay.gov,** 121
Payments services, Federal Reserve Banks, 120–21
Payroll card accounts, 91, 105
PCE (personal consumption expenditures), 10, 36
Performance Report Information and Surveillance Monitoring (PRISM), 65
Policy actions
Board of Governors, 145–51
Federal Open Market Committee, 153–222
Premises, Federal Reserve Banks and Branches, 126–27, 292
Priced services, Federal Reserve Banks, 113–17, 128–31
Prices
Consumer, 22–23, 47–48
Energy, 19–20, 23–24, 44, 48
Equity, 26–27, 50
Primary credit rate, 149
PRISM (Performance Report Information and Surveillance Monitoring), 65
Privacy of Consumer Financial Information (Regulation P), 100–101
Private-sector adjustment factor (PSAF), 113
Productivity, 21–22, 46–47
Profits, corporate, 13–15, 40–41
Public Company Accounting Oversight Board (PCAOB), 76
Public notice, Federal Reserve decisions, 83–84

**Qualified financial contracts (QFCs),** 137–39
Quantitative Impact Study (QIS-4), 62, 68
Quantitative risk management, 62

**Real estate appraisals,** 74
Regulations
B, Equal Credit Opportunity, 94, 98, 100
C, Home Mortgage Disclosure, 91, 95, 106
D, Reserve Requirements of Depository Institutions, 145
E, Electronic Fund Transfers, 87, 90–91, 100, 105, 145
H, Membership of State Banking Institutions in the Federal Reserve System, 145
J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers through Fedwire, 146
M, Consumer Leasing, 100
P, Privacy of Consumer Financial Information, 100–101
V, Fair Credit Reporting, 90, 146

Regulations—Continued
- Y, Bank Holding Companies and Change in Bank Control, 145–46
- Z, Truth in Lending, 91, 101–2, 105–7
- AA, Unfair or Deceptive Acts or Practices, 102–3
- BB, Community Reinvestment, 89, 91, 106, 147
- CC, Availability of Funds and Collection of Checks, 103, 146
- DD, Truth in Savings, 88–89, 103, 147–48
- FF, Obtaining and Using Medical Information in Connection with Credit, 90, 146–47

Reports of Condition and Income (Call Reports), 64, 77
Repurchase agreements, Federal Reserve Banks, 266, 268, 270, 272
Reserve requirements, depository institutions, 264
Reserve Requirements of Depository Institutions (Regulation D), 145
Residential investment, 10–11, 37–38
Revenue (*See* Income and expenses)
Reverse repurchase agreements, Federal Reserve Banks, 267, 269
Riegle Community Development and Regulatory Improvement Act, 60
Risk-focused supervision, Federal Reserve System, 60, 68–69
Risk management, 62, 72, 74–75

**Salaries, Federal Reserve Bank officers and employees,** 291
Sarbanes-Oxley Act (SOX), 76
Savings bonds, 119
Secondary and seasonal credit rates, 149
Securities credit, 63–64, 84
Securities (*See also* Treasury securities)
- Clearing agencies, examination of, 63
- Credit lenders, examination of, 63–64
- Government and municipal, examination of dealers and brokers, 63

SEER (System to Estimate Examination Ratings), 64
Small bank holding company threshold, 75
Special drawing rights certificate account, 266, 268, 270, 272
Staff development, Federal Reserve, 78–80, 96–97
State and local governments, 17, 42–43
State member banks (*See also* Member banks)
- Complaints against, 103–4, 105
- Examinations of, 59, 60, 65
- Extensions of credit to executive officers, 84–85
- Financial disclosures, 84
- Number of, 59, 265
- Surveillance and off-site monitoring of, 64–65

Stocks
- Margin requirements, 275
- Price indexes, 26, 50

Supervision and regulation responsibilities, Federal Reserve System, 57–85, 92–96
Supervisory information technology (SIT), 77–78
Surveillance and off-site monitoring, 64–65
Swaps, 137, 155, 157–58
System Open Market Account (SOMA) (*See* Federal Open Market Committee *and* Open market operations)
System to Estimate Examination Ratings (SEER), 64

**Tax collection, electronic,** 121
Technical assistance to foreign banking authorities, 67
Thrift Institutions Advisory Council, 233
Trade, international, 18–20, 43–44
Training and development, Federal Reserve staff, 78–80, 96–97
Transfer agents, examination of, 63
Treasury, U.S. Department of the (*See also* Treasury securities)
- Cash holdings, 267, 269, 271, 273
- Currency outstanding and in circulation, 266–73
- Payments processed for, 120–21
- Payments to, by Federal Reserve Banks, 125, 282–83

Treasury Direct, 120
Treasury securities
- Commercial bank holdings, 274
- Federal Reserve Bank holdings, 125–26, 262, 266, 268, 270, 272
- Interest rates on, 25–26, 49
- Open market transactions, 258–59
- Repurchase and reverse repurchase agreements, 266–73

Treasury Tax and Loan (TT&L) program, 121
Truth in Lending Act (TILA), 105–7, 140
Truth in Lending (Regulation Z), 91, 101–2, 105–7
Truth in Savings (Regulation DD), 88–89, 103, 147–48

**Unemployment,** 7, 20–21, 45–46
Unfair or Deceptive Acts or Practices (Regulation AA), 102–3

**Wells Fargo & Co., acquisition,** 93
West Texas intermediate (WTI) prices, 19, 44