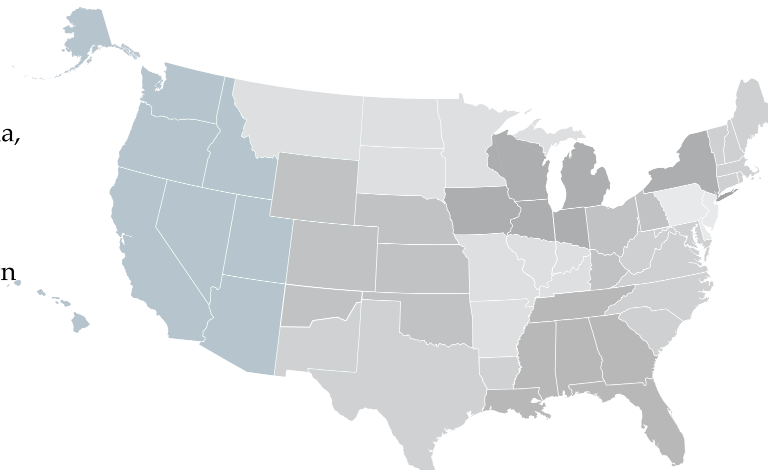
# Financial Turmoil and the Economy

Federal Reserve Bank of San Francisco
2008 Annual Report

The Federal Reserve Bank of San Francisco is one of twelve regional Federal Reserve Banks across the United States that, together with the Board of Governors in Washington, D.C., serve as our nation's central bank.



The Twelfth Federal Reserve District includes the nine western states—Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington—and American Samoa, Guam, and the Northern Mariana Islands. Branches are located in Los Angeles, Portland, Salt Lake City, and Seattle, with a cash facility in Phoenix. The largest District, it covers 35 percent of the nation's landmass, ranks first in the size of its economy, and is home to approximately 20 percent of the nation's population.

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*(Left to Right)*

**John F. Moore**
First Vice President and Chief Operating Officer

**David K.Y. Tang**
Chairman (2008)

**Janet L. Yellen**
President and Chief Executive Officer

**T. Gary Rogers**
Deputy Chairman (2008)
and Chairman (2009)

# Letter from the President

In 2008, the U.S. economy was gripped by what could well be the most severe recession since World War II. The downturn put enormous stresses on the nation's financial system and presented the Federal Reserve with some of the greatest challenges in its history. Federal Reserve policymakers responded forcefully by pushing the central bank's key interest rate close to zero and putting in place an array of unconventional policy initiatives designed to ease conditions in private credit markets. In the new year, the Federal Reserve has broadened and deepened these programs, signaling its commitment to use every tool at its disposal to restore economic growth.

The early part of 2008 saw the effects of a slumping housing market wash over the financial system, threatening the viability of major financial institutions. As the housing downturn deepened and millions of Americans found themselves facing foreclosure, credit markets went into a deep freeze, and consumers and businesses had an increasingly hard time obtaining credit. By the fall, losses at a number of systemically important depository and non-depository financial institutions reached the breaking point. The Federal Reserve took aggressive action to fulfill its role as lender of last resort, easing rates and terms for discount window loans and extending credit in new areas, such as the commercial paper and government-sponsored-agency debt markets. The central bank also worked in tandem with the Treasury Department and other federal agencies to shore up the banking system and check the spread of financial turmoil. Still, the financial crisis took a toll on the real economy, which contracted at the fastest pace in a generation during the fourth quarter of 2008.

The recession has hit this Reserve District especially hard. Unemployment in three District states—Oregon, California, and Nevada—exceeded 10 percent in March of this year, putting them among the seven states with the highest unemployment rates in the nation. Several regions in the Twelfth District experienced some of the nation's most explosive housing booms in the middle of the decade, and now are going through some of the most punishing reversals.

The Federal Reserve Bank of San Francisco is playing a vital part in promoting economic recovery. We are working with District financial institutions to make credit more affordable and more easily available to creditworthy borrowers, and we are playing an integral part in developing and implementing policies that will help put the economy back on its feet and strengthen the banking system.

This report features a series of articles written by the major areas of our Bank that are working to promote economic recovery. The report recaps the economic and financial turmoil that unfolded during 2008 and the policy initiatives and programs the Federal Reserve and this Bank have put in place to combat the crisis. A profile of our Bank's discount window highlights the important role this area is playing as the lender of last resort. Another profile looks at a new policy our Bank implemented during the year to pay interest on bank reserves. This report also examines challenges in the banking industry during the year, both in our District and nationally, and looks at how we are monitoring banks during the crisis and working with them to provide access to Federal Reserve and government programs and to strengthen the banking system. In other banking-related activities, the report examines new research by our Bank that revisits the importance of the Community Reinvestment Act and dispels claims that it contributed to the crisis.

I am fortunate to work with the dedicated economic and banking experts who have provided me with regular briefings and counsel during the financial crisis. Our Bank's strong operational performance in 2008, despite significant challenges, indicates a steadfast commitment by individuals throughout our Bank. In financial services, our Business Development unit ended the year as the number one sales team in the Federal Reserve System. In another example of excellence, the Seattle Branch partnered with the Retail Payments Office to create a new capture/print check processing model for the System and was selected as the beta site to implement the model.

In a major milestone in the history of our Reserve Bank, the Seattle Branch dedicated its new building, capping a multi-year construction project. The Highlights of 2008 section of this report chronicles this and our other significant events and achievements during the year.

In this challenging year, I would like to take this opportunity to thank our staff in all areas of the Bank for their commitment and public service. I also would like to extend my thanks and appreciation to our Twelfth District directors and Economic Advisory Council members for their invaluable service and counsel during the past year. The directors' grassroots input and independent assessment of economic and financial conditions throughout the nine western states that comprise this District are essential to the formulation of monetary policy.

In particular, I would like to acknowledge the many contributions of retiring Chairman of the Board David K.Y. Tang, managing partner, Asia, K&L Gates, Seattle, Washington. Mr. Tang completed six years of service to this Reserve Bank, the last three years serving as its chairman, preceded by a year as its deputy chairman. I also would like to acknowledge Candace H. Wiest, president and chief executive officer, West Valley National Bank, Avondale, Arizona, who completed her service on the Head Office Board at the end of 2008 after serving six years as a director.

In addition, I would like to express my sincere thanks and appreciation to the other directors and Economic Advisory Council members who concluded their terms of service during 2008:

- ***on the Los Angeles Branch Board:*** Peter M. Thomas, managing partner, Thomas & Mack Co., Las Vegas, Nevada;

- ***on the Portland Branch Board:*** Alan V. Johnson, regional president, Wells Fargo Bank, Portland, Oregon; George J. Puentes, president, Don Pancho Authentic Mexican Foods, Inc., Salem, Oregon; and William D. Thorndike, Jr., chairman and president, Medford Fabrication, Medford, Oregon;

- ***on the Salt Lake City Branch Board:*** A. Scott Anderson, president and chief executive officer, Zions Bank, Salt Lake City, Utah; and Deborah S. Bayle, president and chief executive officer, United Way of Salt Lake, Salt Lake City, Utah;

- ***on the Seattle Branch Board:*** James R. Gill, president, Pacific Northwest Title Holding Co., Seattle, Washington; Kenneth M. Kirkpatrick, president, Washington State, U.S. Bank, Seattle, Washington; and H. Stewart Parker, former president and chief executive officer, Targeted Genetics Corporation, Seattle, Washington; and

- ***on the Twelfth District Economic Advisory Council:*** Vivek Paul, former partner, Texas Pacific Group, San Francisco, California.

Janet L. Yellen
President and Chief Executive Officer

# Financial Turmoil and the Economy

## Economic Research

Economic Research, the other areas contributing to this report, and the Legal department are part of an interdepartmental committee the Federal Reserve Bank of San Francisco formed in 2008 to coordinate responses at the highest levels to the crisis. The initial focus on the fallout in the housing and mortgage markets now has expanded to encompass the broader financial crisis. The committee coordinates individual department initiatives and interdepartmental initiatives to address challenges and analyze emerging developments and policy issues related to housing, financial markets, and financial institutions.

*Seated (Left to Right): Simon Kwan, John Krainer, Jose Lopez*
*Standing (Left to Right): Jens Christensen, Fred Furlong, Liz Laderman*

The year 2008 marked a watershed for the modern global financial system and presented the Federal Reserve with some of the greatest challenges in its history. The financial market turmoil that started in the previous year worsened substantially during 2008, and its effect on real economic activity was substantial. Facing the mutually reinforcing combination of the most serious impairment of our financial system and the potentially worst economic downturn since World War II, the Federal Reserve took unprecedented actions as it strived to restore economic growth, job creation, and financial stability, as well as to preserve price stability, an effort that continues in 2009 (see Box 1: Financial Crisis Timeline).

The intensification of the turmoil in financial markets in 2008 was due in part to the marked deterioration in conditions in the housing and residential mortgage markets. As documented in last year's annual report, *The Subprime Mortgage Market: National and Twelfth District Developments*, the end of the credit and housing boom in the second half of 2005 unveiled earlier excesses that eventually led to the swelling of mortgage delinquencies and the eruption of financial market turmoil in August of 2007. In 2008, amid the steepening of house-price depreciation, the economy weakened substantially and the number of mortgage delinquencies climbed even higher.

The buildup of financial stress in 2008 extended far beyond the housing and the residential mortgage markets. In the earlier boom years, asset values in general were inflated in an environment of unusually low risk spreads, heightened reliance on financial leverage, and the proliferation of complex and opaque financial instruments that proved to be fragile under stress. As market forces corrected these excesses, the simultaneous re-pricing of risks, deleveraging, and

During the year, the loss of confidence led to serious impairment and, in some cases, a freezing up of credit flows in key markets.

massive write-downs by financial institutions unleashed powerful forces across financial markets in 2008.

## Market Participants Lose Confidence

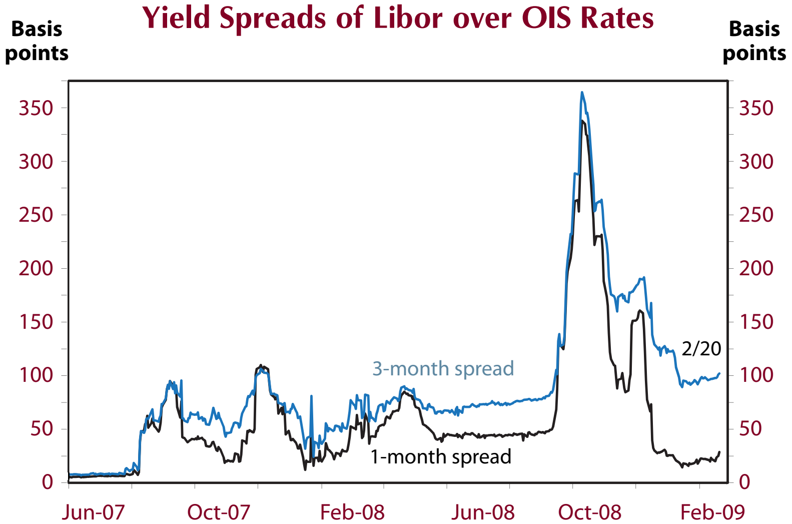
Resolution of the financial crisis is complicated by a profound loss of investor and public confidence in the strength of key financial markets and institutions. The loss of confidence stems in part from uncertainty about the extent of potential financial losses in the face of deteriorating economic conditions and the difficulty of valuing complex financial securities. Confidence is further undermined by the limited disclosure by financial institutions on their portfolio compositions and asset holdings, which makes it difficult to assess their exposure to losses. Many of these institutions are especially vulnerable owing to their very high leverage and heavy reliance on very short-term funding.

During the year, the loss of confidence led to serious impairment and, in some cases, a freezing up of credit flows in key markets. One notable example is the term interbank market—that is, the market in which banks lend to each other for periods longer than overnight. Due to concerns about the ability of borrowers in the interbank market to repay loans and the desire of banks to protect their own capital and liquidity positions, the spreads on term interbank borrowing rates relative to the Overnight Index Swap (OIS) rates—a key measure of funding stress—spiked to uncharted territory following several high profile events during 2008, such as the forced sale of Bear Stearns and the bankruptcy of Lehman Brothers (see Chart 1).[1] Other examples of credit market impairment during the year included the sharp slowdown of commercial

***Serious impairment of the term interbank funding market***

Chart 1

**Yield Spreads of Libor over OIS Rates**

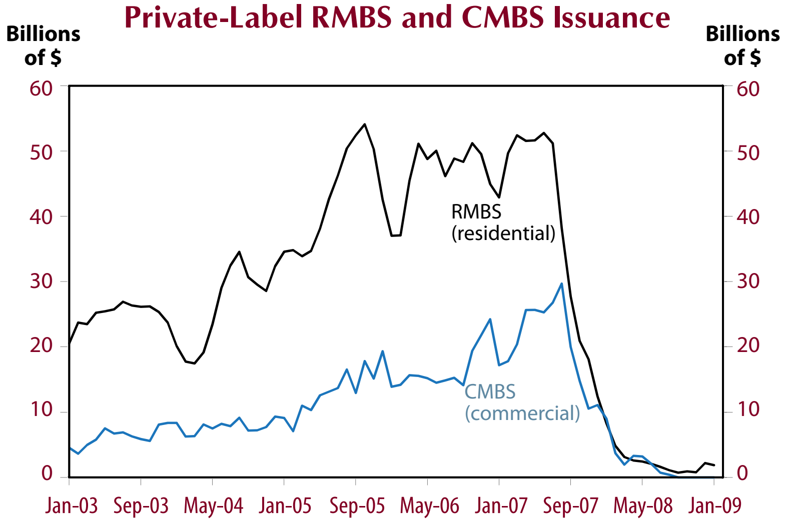



*Libor: London interbank offered rate*

***Private-label mortgage securitization evaporates***

Chart 2

**Private-Label RMBS and CMBS Issuance**



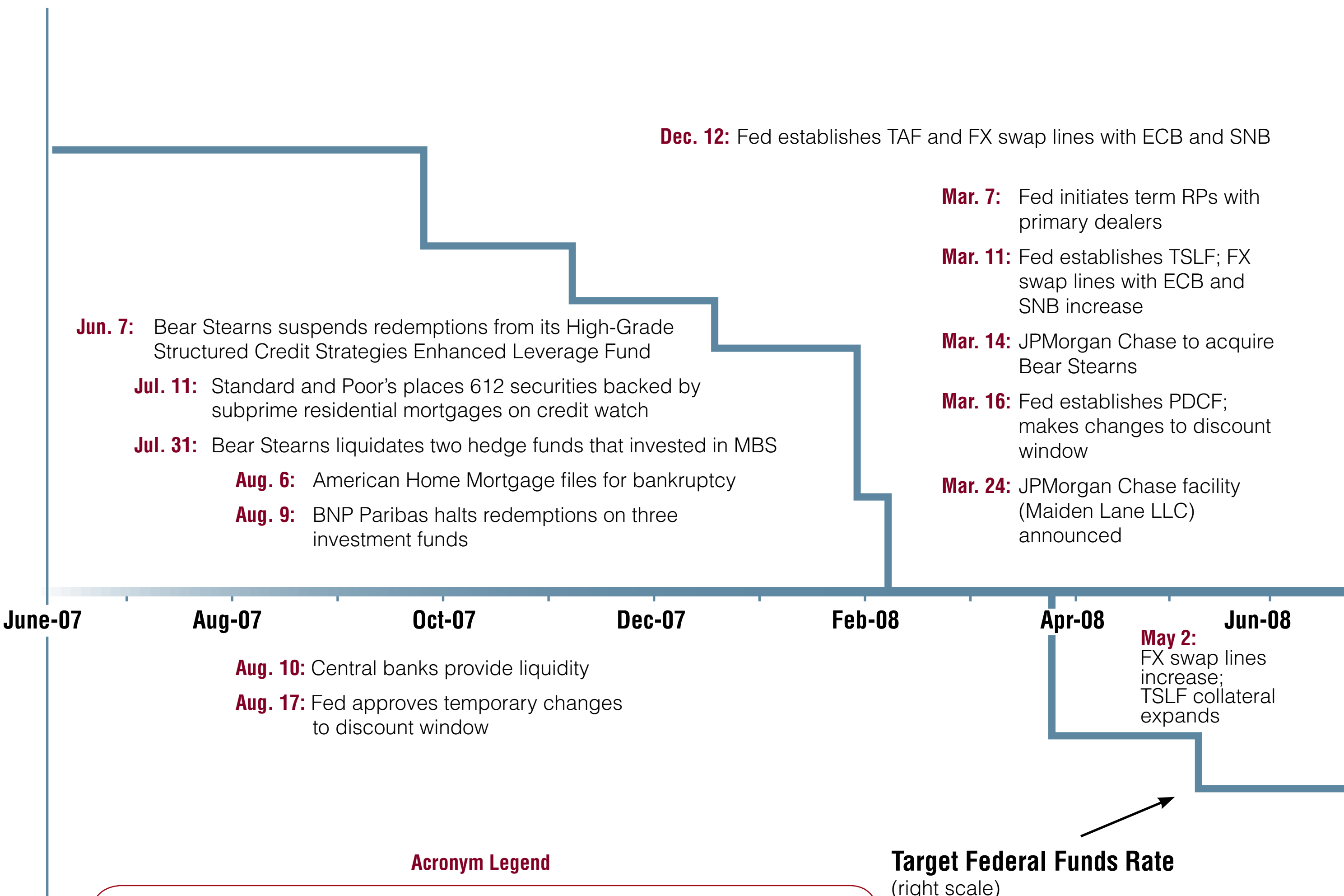

1 *The OIS rate is the fixed leg underlying the derivative contract between two parties swapping overnight federal funds with term federal funds.*

paper issuance after a prominent money market fund "broke the buck"—when its share value fell below one dollar—and the elevated risk spreads on mortgage-backed securities (MBS) that are guaranteed by the two government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, even after they were placed in conservatorship by the federal government.

## Household and Business Credit Stifled

The impairment of financial markets severely stifled credit flows to households and businesses. Issuance of private-label MBS, both for residential and commercial mortgages, essentially evaporated (see Chart 2), and the securitization of consumer and business-related loans

Box 1: **Financial Crisis Timeline: Federal Funds Target Rate and Other Policy Actions**

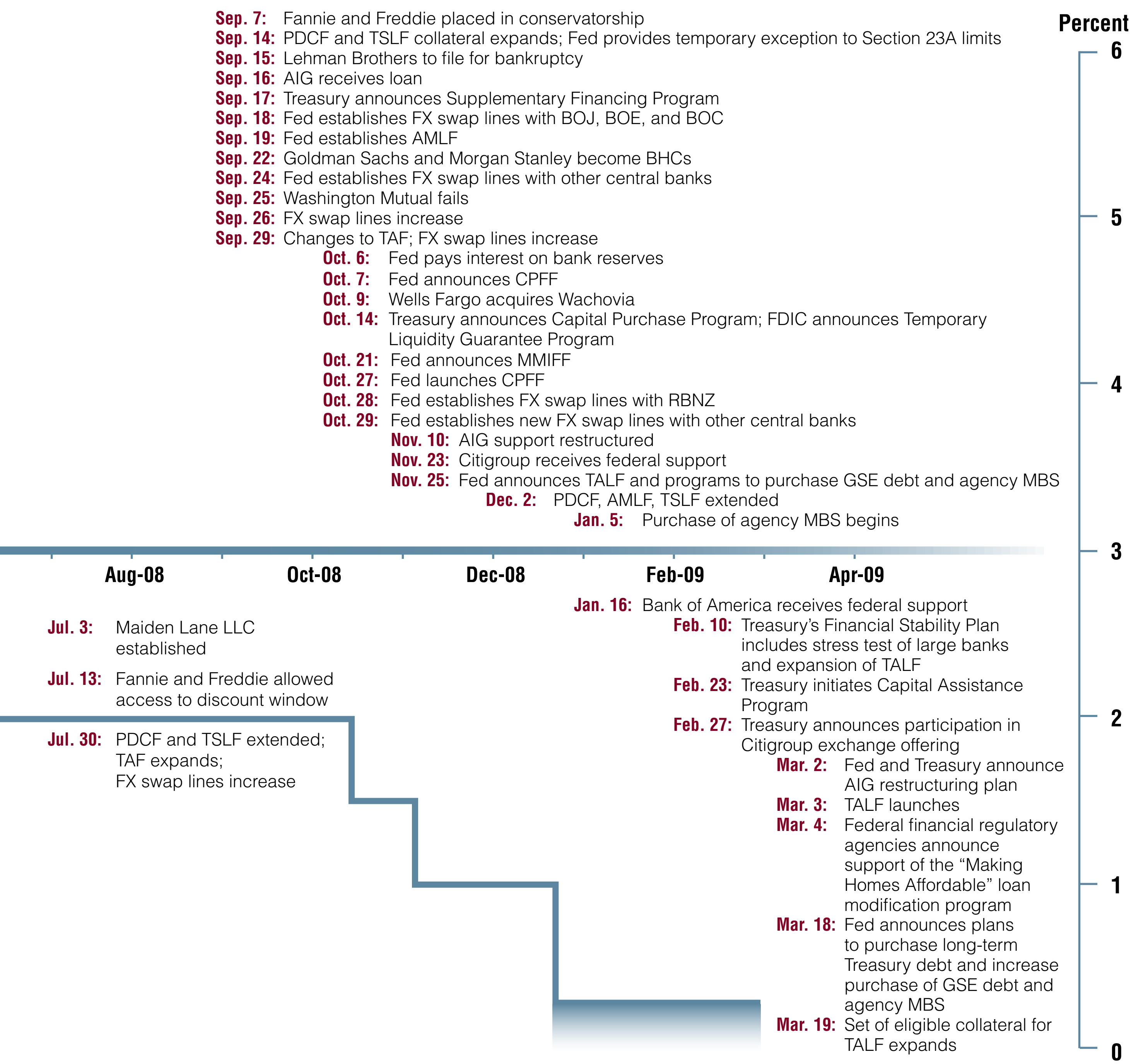



**Acronym Legend**

Asset-Backed Commercial Paper Money Market Fund Liquidity Facility (AMLF)
Bank holding company (BHC)
Bank of Canada (BOC)
Bank of England (BOE)
Bank of Japan (BOJ)
Commercial Paper Funding Facility (CPFF)
European Central Bank (ECB)
Foreign exchange (FX)
Government-Sponsored Enterprise (GSE)
Limited Liability Corporation (LLC)
Money Market Investor Funding Facility (MMIFF)
Mortgage-backed securities (MBS)
Primary Dealer Credit Facility (PDCF)
Reserve Bank of New Zealand (RBNZ)
Repurchase agreements (RPs)
Swiss National Bank (SNB)
Term Asset-Backed Securities Loan Facility (TALF)
Troubled Asset Relief Program (TARP)
Term Auction Facility (TAF)
Term Securities Lending Facility (TSLF)

nose-dived. Commercial banks also severely tightened credit terms and lending standards during 2008. Although lending by commercial banks expanded in 2008, the expansion did not offset contractions in other sources of private funding. On net, credit availability to households and businesses was exceptionally tight.

Our economic system is critically dependent on well-functioning financial markets and sound financial institutions that mediate the flow of credit. The impairment of financial markets and credit flows took a heavy toll on the economy. With the United States officially in a recession during all of 2008, the economy lost about 2.6 million jobs, the worst 12-month period since World War II. This created an adverse feedback



loop—that is, economic deterioration intensified stress in the financial sector, which in turn further squeezed economic activity, creating a mutually reinforcing cycle (see Chart 3).

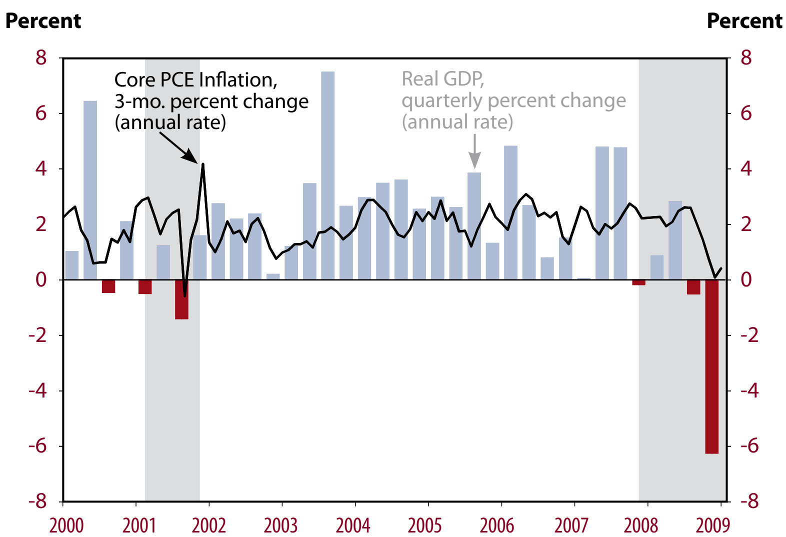
## Policy Actions

An important lesson from both economic theory and history is that policymakers must confront circumstances like these with prompt and aggressive action. Even so, in the first half of 2008, the conduct of monetary policy was complicated by rising commodity prices that pushed up the headline inflation rate. The Federal Open Market Committee (FOMC) nonetheless expected inflationary pressures to subside, and longer-term inflation expectations appeared to be stable. With the serious threat to economic growth from the financial crisis, the FOMC cut the federal funds rate target by roughly five percentage points in the period following the onset of the crisis. In December 2008, the FOMC took the historic step of lowering the federal funds rate essentially to its "zero bound," establishing a target range of 0 to $^1/_4$ percent.

***Adverse feedback loop: financial crisis and severe recession***

Chart 3

**Real GDP Growth and Core PCE Inflation**




*GDP: Gross domestic product*
*PCE: Personal consumption expenditures*

## Expanded Policy Toolbox

Due to the extraordinary stress in financial markets, in addition to lowering the federal funds rate target, the Federal Reserve employed a set of new tools to improve the functioning of credit markets, ease financial conditions, and support economic activity more generally. As early as December 2007, the Federal Reserve established the first of a number of new liquidity and credit facilities, the Term Auction Facility (TAF), to address the dislocation in the term interbank market.[2] This facility was set up as an auction and served as another vehicle for extending discount window loans to depository institutions. Amid the global scope of the financial crisis, the Federal Reserve also supported the provision of U.S. dollar liquidity in foreign markets by vastly expanding its network of currency swap lines with other central banks starting in December of 2007.

These facilities for providing liquidity to depositories are in keeping with the Federal Reserve's traditional role as lender of last resort. However, since the financial crisis also hit nonbank financial institutions and key markets, providing liquidity to depository institutions alone was not sufficient to meet the liquidity and credit demands of the economy. In response, the Federal Reserve employed a number of other new tools, some of which involved using the Fed's authority to make direct purchases of U.S. government agency securities. For others, the Federal Reserve invoked Section 13(3) of the Federal Reserve Act to lend in "unusual and exigent circumstances" to "individuals, partnerships, or corporations" that are "unable to secure adequate credit accommodations from other banking institutions." Under this authority, the Federal Reserve initiated a number of special credit facilities to extend credit to a broader range of counterparties, against a broader set of collateral, and for relatively longer terms (see Box 2: Federal Reserve Bank Credit).

The goals of these policy tools are to promote the dissemination of liquidity, foster the liquidity of key securities, increase the flow of credit to seriously impaired sectors, and lower interest rates in targeted nonbank credit

2 *To further ease liquidity pressures at quarter- and year-end, the Federal Reserve announced the forward auctions of TAF loans on July 30, 2008.*

## Box 2: Federal Reserve Bank Credit

*March 2009*

| Program/Enhancement | Participants | Description | Limit |
|---|---|---|---|
| **Loans to depositories and central banks** | | | |
| Discount Window* [1] | Depository institutions (DIs)[2] | Collateralized, recourse loans [3] | no stated limit |
| Term Auction Facility (TAF) (Dec. 12, 2007)[1] | DIs eligible for primary credit | Collateralized, recourse loans, 28-day and 84-day funding [3] | $900 b |
| Forward TAF (Sept. 29, 2008) | DIs eligible for primary credit | Auction of options on term-lending over year-end [3] | OBS** |
| Foreign exchange (FX) swaps (Dec. 12, 2007) | Central banks[4] | Temporary reciprocal currency swap lines between the Federal Reserve and other central banks to meet the demand for U.S. dollar-denominated funding by foreign DIs | $755 b |
| Asset-Backed Commercial Paper Money Market Fund Liquidity Facility (AMLF) (Sept. 19, 2008) | DIs, bank holding companies, U.S. branches and agencies of foreign banks | Collateralized, nonrecourse loans to purchase highly rated asset-backed commercial paper from money market mutual funds (MMMFs); maturity of funding equal to maturity of collateral pledged [5] | Amount held by MMMFs |
| **Other liquidity and credit market facilities** | | | |
| Repurchase agreements overnight* and term [6] | Primary dealers | Collateralized, overnight and term loans provided via auctions [7] | no stated limit |
| Primary Dealer Credit Facility (PDCF) (Mar. 16,2008) | Primary dealers | Collateralized, recourse, overnight, loans [8] | no stated limit |
| Commercial Paper Funding Facility (CPFF) (Oct. 7, 2008) | Highly rated U.S. commercial paper (CP) issuers and U.S. CP issuers with foreign parents | Loans to Federal Reserve Bank of NY created Special Purpose Vehicle (SPV) investing in CP of eligible participants | no stated limit |
| Money Market Investor Funding Facility (MMIFF) (Oct. 21, 2008) | U.S. 2a-7 MMMFs | Federal Reserve Bank of NY provides senior secured loans to private SPVs that invest in eligible assets issued by designated financial institutions [9] | $540 b [10] |
| Overnight Securities Lending* | Primary dealers | Treasury general collateral (from the Federal Reserve System Open Market Account) available to primary dealers via auction | no stated limit |
| Term Securities Lending Facility (TSLF) (Mar. 11, 2008) | Primary dealers | Treasury general collateral (from the System Open Market Account) available via auction for 28-day maturity [11] | $200 b |
| TSLF Options (TOP) (Sept. 29, 2008) | Primary dealers | Auction of options to borrow Treasury securities from the TSLF | OBS [12] |
| Term Asset-Backed Securities Loan Facility (TALF) (Program announced on Nov. 25, 2008, and launched on Mar. 3, 2009) | Eligible U.S. borrowers holding qualified asset-backed securities[13] (ABS) | Nonrecourse loans of up to three years, fully secured by eligible ABS The U.S. Treasury provides up to $100 billion of credit protection[14] | $1 tr |

*Shading indicates programs established using emergency authority under Section 13.3 of the Federal Reserve Act.*

* Previously established program or facility. ** Off balance sheet.

1. On August 17, 2007, the Federal Reserve reduced to 50 basis points (b.p.) the spread for the primary credit rate over the federal funds target and allowed 30-days loans. On March 17, 2008, the Federal Reserve reduced to 25 b.p. the spread for the primary credit rate over the federal funds target and allowed up to 90-day loans.
2. Eligible institutions are U.S. depository institutions and branches and agencies of foreign banks operating in the U.S.
3. Eligible collateral includes (but is not limited to) U.S. government and agency securities, foreign sovereign debt obligations, municipal and corporate debt, ABS, CP, bank-issued assets, and customer obligations.
4. Programs created with: European Central Bank and Swiss National Bank (December 12, 2007); Bank of Canada, Bank of England, and Bank of Japan (September 18, 2008); Reserve Bank of Australia, Sveriges Riksbank, De Nederlandsche Bank, and Norges Bank (September 24, 2008); Reserve Bank of New Zealand (October 28, 2008); Banco Central do Brasil, Banco de Mexico, Bank of Korea, and Monetary Authority of Singapore (October 29, 2008).
5. Eligible collateral must be rated A1/P1/F1 by at least two of the rating agencies. The funding rate is equal to the Federal Reserve Bank of Boston's primary credit rate.
6. Term repurchase agreements authorized on March 7, 2008.
7. Eligible collateral includes U.S. Treasury securities, direct agency obligations, and agency MBS that are eligible as collateral in open market operations.
8. Eligible collateral includes securities used for tri-party repurchase agreements arranged by the Federal Reserve Bank of NY, as well as all investment-grade corporate securities, municipal securities, MBS and ABS for which a price is available.
9. Eligible assets: U.S. dollar-denominated certificates of deposit, bank notes, and CP, with remaining maturity of 7 to 90 days. Assets must be issued by one of ten designated financial institutions and be rated A1/P1/F1 by at least two of the rating agencies.
10. Maximum holding of the SPV of any single issuer is limited to the maximum amount of paper outstanding by that issuer between January 1, 2008 and August 31, 2008.
11. TSLF conducts Schedule 1 auctions involving exchanges of all securities used in tri-party repos and schedule 2 auctions involving collateral in the schedule 1 auctions plus investment-grade corporate securities, municipal securities, mortgage-backed securities, and ABS.
12. Limit of $150 billion for each auction.
13. Eligible borrowers include business entities that are organized under the laws of the United States or a political subdivision or territory thereof (including such an entity that has a non-U.S. parent company) or U.S. branches or agencies of foreign banks.
14. Eligible collateral includes highly rated ABS backed by certain consumer and business debt and could be expanded to certain assets backed by residential or commercial mortgages. An SPV will be created by the Federal Reserve Bank of New York to purchase any assets acquired through TALF lending with the first $100 billion of funding for the SPV provided by the U.S. Treasury.

Box 2 (continued): **Federal Reserve Bank Credit**

*March 2009*

| Program/Enhancement | Participants | Description | Limit |
|---|---|---|---|
| **Federal Reserve U.S. Treasury and agency securities held directly** | | | |
| U.S. Treasury Securities* | Primary dealers | Open market purchases from primary dealers | no stated limit |
| GSE direct obligations (Nov. 25, 2008)[15] | Primary dealers | Federal Reserve Bank of NY makes purchases of direct GSE obligation from primary dealers | $200 b |
| Federal agency MBS (Nov. 25, 2008)[15] | Selected asset managers | Purchases of agency MBS conducted by asset managers selected via a competitive process | $1.25 t |
| **Federal Reserve Direct Financial Assistance Facilities** | | | |
| Maiden Lane LLC [16] (July 3, 2008) | Federal Reserve Bank of NY established the LLC to acquire selected assets of Bear Stearns in connection with the acquisition by JP Morgan Chase. | Nonrecourse loan to the LLC | $29 b |
| AIG credit (Sept. 16, 2008)[17] | Federal Reserve Bank of NY established the LLC to acquire assets of AIG. | Loans guaranteed by AIG assets | [17] |
| Maiden Lane II LLC (Nov. 10, 2008) | Federal Reserve Bank of NY established the LLC to acquire residential MBS from AIG's U.S. securities lending collateral portfolio. | Nonrecourse loan to the LLC | $22.5 b |
| Maiden Lane III LLC (Nov. 10, 2008) | Federal Reserve Bank of NY established the LLC to acquire multisector collateralized debt obligations on which AIG has written credit default swap contracts. | Nonrecourse loan to the LLC | $30 b |
| Citigroup (Nov. 23, 2008) | Citigroup | Treasury and FDIC provide protection against a pool of Citigroup's asset; Federal Reserve to provide a nonrecourse loan to "backstop" residual risk in Citigroup's asset pool | OBS** [18] |
| Bank of America Corp. (BAC) (Jan. 16, 2009) | Bank of America Corp. | Treasury and FDIC provide protection against a pool of BAC assets; Federal Reserve to provide a nonrecourse loan to "backstop" residual risk in BAC's asset pool | OBS** [19] |

*Shading indicates programs established using emergency authority under Section 13.3 of the Federal Reserve Act.*

* Previously established program or facility. ** Off balance sheet.

15. Purchases of direct obligations of, and obligations fully guaranteed as to principal-interest by, any U.S. government agencies, under the direction of the FOMC, are permitted under section 14(b) of the Federal Reserve Act. Explicit programs to purchase direct obligations of GSEs Fannie Mae, Freddie Mac, and Federal Home Loan Banks and MBS backed by housing agencies (Fannie Mae, Freddie Mac, and Ginnie Mae) were announced on November 25, 2008.
16. Limited Liability Corporation.
17. Terms were modified on November 10, 2008, and on March 2, 2009. Based on latter modification, the revolving credit facility is to be reduced from $60 billion to no less than $25 billion. In return for the reduction in the revolving credit facility, the Federal Reserve Bank of NY will get preferred interest in two SPVs created to hold common shares of two life insurance subsidiaries of AIG. The Federal Reserve Bank of New York is authorized to make up to $8.5 billion in new loans to SPVs established by domestic life insurance subsidiaries of AIG.
18. Asset pool is valued at $306 billion.
19. Asset pool is valued at $118 billion.

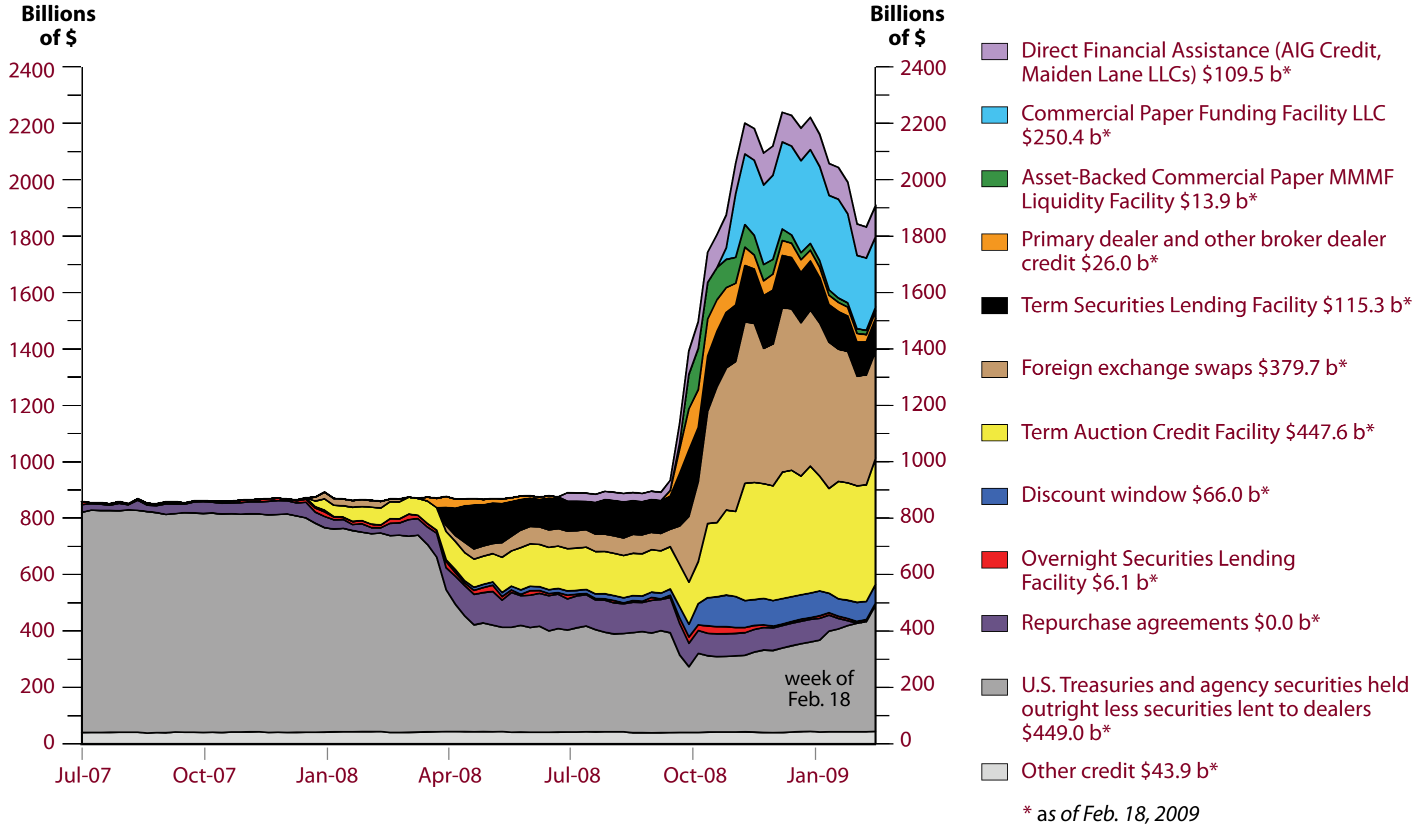
markets. For primary dealers, these tools provide access to collateralized loans from the Federal Reserve and the option to borrow Treasury securities.[3] For others, these measures provide liquidity for money market securities held by money market mutual funds, support the extension of credit to highly rated issuers of commercial paper, and enable the Federal Reserve to purchase both the direct obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks and agency MBS to help lower mortgage interest rates. The Term Asset-Backed Securities Loan Facility (TALF), which was launched in early 2009, is directed at supporting the particularly hard-hit asset-backed securities market, which is instrumental to the flow of credit for consumer loans, student loans, business loans, and certain mortgages that are not eligible for inclusion in securities guaranteed by the housing GSEs.

Finally, a number of tools made possible under the Federal Reserve's emergency powers involve targeted financial assistance to preserve the stability of systemically critical financial institutions. For example, these include the credit facilities established by the Federal Reserve Bank of New York in connection with the acquisition of Bear Stearns by JPMorgan Chase and the efforts to stabilize insurance giant American International Group (AIG).

***Fed turns to unconventional policy tools***

Chart 4

**Federal Reserve Bank Credit**




3 *The Federal Reserve Bank of New York trades U.S. government securities and other selected securities with designated primary dealers, which include banks and securities broker-dealers.*

## The Fed's Growing Balance Sheet

The implementation of these policy tools has substantially changed the composition and, since mid-September 2008, the size of the Federal Reserve System's balance sheet (see Chart 4).[4] The Federal Reserve's balance sheet expanded rapidly toward the latter part of 2008 with the deterioration in financial market conditions that led to the failure of Lehman Brothers, followed by the near collapse of AIG, the "run" on prime money market funds, the severe dislocations in commercial paper markets, and the general flight to quality by investors seeking the safety of Treasury securities.[5] At the beginning of 2009, Federal Reserve Bank credit reached about $2.3 trillion, compared with about $900 billion prior to the start of the financial turmoil.

It is difficult to assess the effects of individual facilities on particular markets, let alone the impact on overall financial conditions. Along with the Federal Reserve initiatives, the federal government undertook a number of efforts to support financial markets, including the Treasury Department's Troubled Asset Relief Program, the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program, and the placement of Fannie Mae and Freddie Mac in conservatorship. These programs were designed to work with the Federal Reserve initiatives to mitigate the effects of the dislocation in financial markets. Indeed, there are signs that stress in financial markets eased from the crescendo reached in mid-September 2008. The improvement was evident in lower risk spreads in commercial paper markets (see Chart 5) and in a narrowing of the spreads on the term Libor relative to the OIS rates (see Chart 1), though the latter remained somewhat elevated. In other markets targeted by the Federal Reserve initiatives, risk premiums on GSE-backed MBS moved lower in late 2008 and early 2009, helping to bring down interest rates on conforming mortgages.

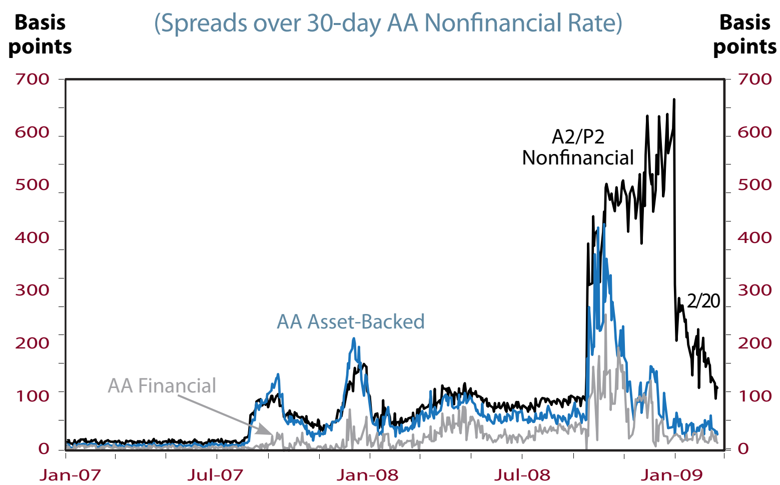
Looking forward, the use of the Federal Reserve's balance sheet to restore financial stability and economic growth has become even more important, with the federal funds rate close to zero at the beginning of 2009. In addition, the Federal Reserve's communications to the public about its policy formulation will be vital in the period ahead. ■

***Signs of improvement in commercial paper market***

Chart 5

**Commercial Paper Risk Spreads**

(Spreads over 30-day AA Nonfinancial Rate)




4 *The Treasury's Special Funding Program and the authorization of the Federal Reserve to pay interest on reserves allowed the Federal Reserve to expand its balance sheet while separately pursuing monetary policy actions directed at affecting the level of the federal funds rate.*

5 *The federal government also took extraordinary actions at the time by guaranteeing the shares of money market mutual funds, at the same time as the Federal Depository Insurance Corporation guaranteed senior unsecured debt of depository institutions and their holding companies and provided full deposit insurance coverage for non-interest-bearing transaction accounts.*

# With Markets in Turmoil, Twelfth District Banks Relied on Discount Window for Funding in 2008

The Federal Reserve's discount window has long served as an important safety valve in the financial system, providing overnight loans to financial institutions to cover temporary changes in deposits and loan portfolios during the normal course of business and supplying liquidity to financial markets during systemic stress. Over the course of the current crisis, this role expanded beyond conventional boundaries when the Federal Reserve introduced new lending facilities through the discount window to provide liquidity and credit to dysfunctional markets. To supplement the new lending programs and further encourage borrowing from the discount window, the Federal Reserve also cut the discount rate, which is the primary credit rate charged to financial institutions for overnight loans.

The Term Auction Facility (TAF), introduced in December 2007 and expanded in 2008, is administered through the discount windows at all Reserve Banks. Through the auctions, depository institutions borrow from the Federal Reserve for a fixed term against the same collateral accepted by the discount window's primary credit program. The rate is determined at auction, subject to a minimum set by the Federal Reserve.

The Federal Reserve Bank of New York oversees the majority of the other discount window lending facilities that were introduced in 2008, such as the Term Securities Lending Facility, which provides liquidity in the U.S. Treasury and other securities markets, and the Commercial Paper Funding Facility, which provides liquidity to short-term funding markets for U.S. issuers of commercial paper.

Since January 2003, primary credit had been targeted at 100 basis points above the Federal Open Market Committee's (FOMC) target federal funds rate. As the financial picture weakened, the FOMC reduced the federal funds target eight times in 2008. The Federal Reserve also narrowed the primary credit spread above the federal funds rate target to $1/4$ percentage point, resulting in a discount rate of .50 percent by year-end. Equally important, the Federal Reserve lifted the 30-day term limit for primary credit to 90 days.

### Credit and Risk Management

The Federal Reserve Bank of San Francisco's Credit and Risk Management staff oversee the discount window. The group nearly doubled in size from late 2007 through year-end 2008 to process the unprecedented volume of collateral pledges and loans and to monitor troubled institutions. Given the high volume, the group coordinated the on-site inspections of collateral, receipt of daily liquidity reports for troubled institutions, and review of collateral proposals, among other activities, with assistance from the Banking Supervision and Regulation and Legal departments.

*Seated (Left to Right): Steve Fung, Pedro Romero, Ivette Cisneros-Iriarte, David Xu*
*Standing (Left to Right): Rick Miller, Don Lieb, Erin Klein*
*Not Pictured: Javier Jerez*

Following the introduction of TAF and the cut in the primary credit rate, activity skyrocketed at the Federal Reserve Bank of San Francisco's discount window in 2008. At the start of the year, the auctions offered $30 billion with 28-day maturities. As credit markets tightened further in 2008, the auctions became a permanent fixture on a biweekly schedule, with the addition of 84-day maturity loans and an increase in the amount auctioned to $150 billion.

During 2008, with no other stable source of funding available, many institutions in the Twelfth District turned to the discount window. At the end of 2007, 190 institutions with relationships with the Twelfth District's discount window had pledged $72.8 billion of collateral toward loans. Six months later, the number increased to 207 depository institutions with collateral pledges of $98.8 billion. By the end of 2008, 305 institutions had established relationships with the District's discount window, pledging $173.5 billion in collateral to support their liquidity needs.

During the year, as relationships and collateral pledges with the discount window rose, lending activity spiked. In 2007, the District's discount window originated 283 loans totaling $3.6 billion, principally from the primary credit program. In the first half of 2008, following the cut in the primary credit rate and the expansion of the term limits for TAF, the number of loans more than tripled, with the discount window generating 903 loans totaling $79.3 billion. The latter part of year continued to set new records for the number and value of advances made. By year-end 2008, Twelfth District's discount window had extended 3,190 loans totaling $389.3 billion, the highest loan volume in the Federal Reserve System.

The Twelfth District's discount window also monitored a significantly greater number of troubled institutions during the year as the crisis intensified. Consequently, staff implemented a broad range of traditional and innovative risk controls to manage credit risk exposure at each institution. For example, some banks with impaired capital levels were no longer eligible for TAF funds, long-term borrowing, and intraday overdraft ceilings. Additionally, certain banks were required to post transactions in real-time to their Federal Reserve accounts to ensure they monitored their balances throughout the day. ■

## San Francisco Fed Leads Early Rollout of Interest Payments on Bank Reserves

One rapid response to the financial crisis came from the San Francisco Fed's Statistics Division. With only three weeks of lead time, the Division implemented a new policy to pay interest on reserve balances depository institutions hold in accounts at the Federal Reserve. The change, which took effect in October 2008, provided the Federal Reserve with a tool designed to let it expand new lending facilities while achieving its federal funds interest rate target for monetary policy.

### *What is the link between paying interest on bank reserves and monetary policy?*

Prior to the payment of interest on reserves, banks typically lent excess balances (above required reserves) in the overnight federal funds market to earn interest. By paying interest on bank reserves, the Fed now provides an incentive for institutions to hold these excess balances in reserve accounts at the Fed, and the interest rate paid on reserves tends to set a floor on the interest rate available in the funds market. Thus, the Fed may be able to maintain its monetary policy target rate for federal funds even as it expands excess reserves through new lending facilities.

Although the Financial Services Regulatory Relief Act of 2006 had already authorized interest payments, the change wasn't scheduled to begin until October 1, 2011. Congress approved the accelerated schedule with the passage the Emergency Economic Stabilization Act of 2008.

Banks are required to hold a portion of customer deposits in Federal Reserve accounts. As the manager of the computer system used by all Reserve Banks to calculate these reserve requirements, the Statistics Division led the integration of the new policy to pay interest on both required and excess reserve balances. San Francisco also serves as headquarters for the central bank's national Reserve Resource Center, which provided reserve administration expertise for the transition.

To meet the accelerated schedule, technical specialists within the Statistics Division modified one of the central bank's largest and most complex computer systems within a narrow window of just three weeks. Nearly 7,000 institutions—ranging from depository institutions and trusts to U.S. branches and agencies of foreign banks—became eligible to earn interest on their reserve balances.

## Statistics

The computer system managed by the Statistics Division that is used to calculate reserve balances and interest payments also is the central application for the collection, analysis, and reporting of many types of economic and financial data. Statistics staff and their colleagues at other Reserve Banks provide guidance to depository institutions regarding reporting requirements and continually screen institutions to ensure they comply with requirements. Inside the Federal Reserve, this data contributes to monetary policy decisions, and a large portion is used to evaluate the safety and soundness of depository institutions and assess their compliance with banking regulations.

*Seated (Left to Right): Marilyn Jio, Michael Fernandez, Mohamed Sadiq, Freda Choi, Nancy Henthorne*
*Standing (Left to Right): Lynn Hart, Dorret Dobbs-Hunte, Tom Grybinas, Mark Tanaka, Mark Frappier, Jonathan Kayes, Jeannette Cormier, Peter Miller, Jordon Lum, Huaixi Li, Gregory Canosio, Ai-Ling Wu*
*Not Pictured: Frank De Castro, Leo Shebalin, Susan Wong, Annie Yee*

Although the software code to pay interest on reserve balances already existed, it dated back to 2001 when the Board of Governors first considered the change. Over the three-week implementation period, technical specialists matched the software's reserve balance and interest calculations with current processes and updated and tested the program in conjunction with the Federal Reserve's accounting system that posts interest payments to the accounts of financial institutions.

During this time, analysts from the Reserve Resource Center worked side by side with technical specialists—providing expertise on reserve administration, creating test strategies, and reviewing results. As part of a national effort coordinated through the Federal Reserve Bank of New York, the center's analysts worked with reserve analysts from the other Reserve Banks to evaluate the impact on existing reserve processes and develop detailed workflow diagrams to map out the new process. New operational procedures were put in place for interest accruals and payments, as well as for complicated reserve processes, such as mergers and data revisions.

The implementation of interest payments on bank reserves significantly boosted excess balances held with the Federal Reserve. In early October 2008, excess reserves held at the Federal Reserve Bank of San Francisco totaled $4 billion. By year-end 2008, the total skyrocketed to almost $106 billion. Nationally, excess balances held at all Reserve Banks totaled $136 billion in early 2008. By year-end, they reached $799 billion. ■

# A Tough Year for the Banking Industry

## Banking Supervision and Regulation

Banking Supervision and Regulation staff assess the impact of the economic and financial environment on the banking industry and, since the crisis began, have been facilitating institutions' access to government and Federal Reserve relief programs. Supervisory staff's perspectives on banking conditions and the industry's risk management capabilities help Credit and Risk Management staff manage the increased activity at the discount window and contribute to monetary policy decisions and policy responses to the crisis.

*Seated (Left to Right): Kathleen Brown, Pat Loncar, Josephine Chan*
*Standing (Left to Right): Michele Magidoff, Jeff Plaskett, Elisa Johnson, Tom Cunningham, Joe Lozano*

The year 2008 was the most challenging one in decades for the nation's banking industry. As a whole, the industry's $16.1 billion annual profit was the lowest since 1990, mostly because of sharply higher expenses for bad loans. Some banks didn't survive the year. In fact, failures and assistance transactions among institutions insured by the Federal Deposit Insurance Corporation (FDIC) nationwide reached a 15-year high of 30, with the assets of these institutions totaling $1.7 trillion. In addition, by year-end 2008, 252 institutions were on the FDIC's "problem list"—those with the worst supervisory ratings—up dramatically from 76 at year-end 2007.

Banking organizations with significant exposure to the housing sector—typically through residential mortgages, home construction loans, or investments in related securities—experienced the greatest deterioration in financial performance. Asset quality and profits at these institutions suffered severely when home mortgage borrowers, building contractors, and land developers couldn't make loan payments and when the value of mortgage-related securities plummeted.

Moreover, turmoil in financial markets and shaken confidence among depositors created funding problems across a broad range of banking organizations, even for those without investments in the housing sector. Some banking companies couldn't maintain the stable deposit base they needed to sustain their operations, and the breakdown in financial markets forced institutions that relied on those markets to scramble for alternative funding, which sometimes was available only at a very high price.

### Banking Performance in the Twelfth District

While several of the Twelfth District's banking organizations have significant mortgage lending operations, many more provided construction financing to support the housing boom that occurred over the past several

*. . . turmoil in financial markets and shaken confidence among depositors created funding problems across a broad range of banking organizations, even for those without investments in the housing sector.*

years. In fact, quite a few of the District's community banks are concentrated in lending or other activities related to the housing sector. When residential real estate markets started to sour in 2007, the performance of those banks began to suffer. With the broader weakening of the economy and financial market turmoil in 2008, loan quality and earnings deterioration escalated, and some banks faced a liquidity crisis when nervous customers started to draw down deposits or close their accounts altogether.

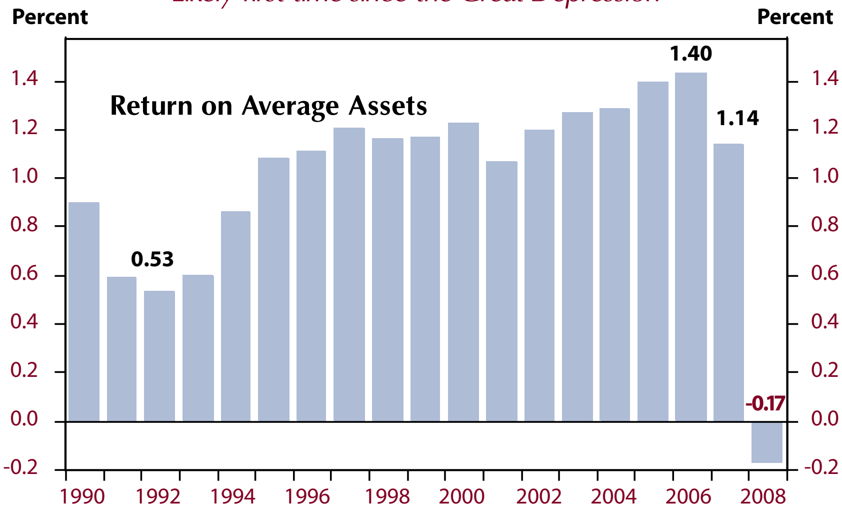
## Adjusting Supervisory Programs

The Federal Reserve Bank of San Francisco's Division of Banking Supervision and Regulation promotes the safety and soundness of the banking system and upholds compliance with regulations. The Division's risk-focused supervision program emphasizes credit, market, liquidity, operational, reputational, and legal risks in the region's banking organizations. At year-end 2008, the Division's portfolio of institutions included 240 bank holding companies, 45 state-chartered banks that are members of the Federal Reserve, and the U.S. operations of foreign banking organizations from 24 different countries. Division staff supervise these institutions through a combination of on-site examinations (conducted in the institutions' offices) and off-site work (conducted at the Reserve Bank). Examples of activities include evaluating risk management processes and internal controls, monitoring financial performance and relevant market conditions, reviewing loan documentation and internal management reports, meeting with an institution's management to discuss identified issues, evaluating applications to expand operations, and initiating supervisory enforcement actions for troubled institutions. The Division closely coordinates its supervisory activity with the appropriate banking agencies and other regulatory bodies.

Starting in late 2007, faced with sharply deteriorating banking conditions in the

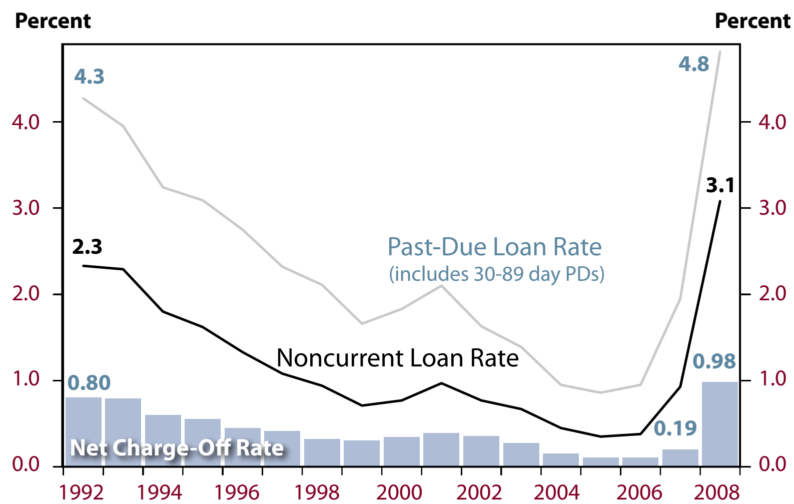
### On Average, District Banks Slipped into the Red in 2008

*Likely first time since the Great Depression*




*All commercial banks excluding those less than 3 years old; averages adjusted for outliers*

### District Loan Quality Metrics Are Worse Than Peaks of Prior Downturn in 1992




*All commercial banks excluding those less than 3 years old; averages adjusted for outliers* region, the Division made several adjustments to the supervisory program. Most significantly, many bank examinations were accelerated or extended where problems were developing rapidly. Additionally, supervisory staff intensified activities to complement examinations including enhancing off-site monitoring and real-time on-site funding and liquidity monitoring. Staff also worked closely with the FDIC to monitor and develop resolutions for troubled banks. In addition, the Division communicated to the banking industry the critical importance of strong funding and liquidity risk management and capital planning in the current environment. Industry consolidation resulted in another significant program change, as the largest banking organization in the District's portfolio completed a major acquisition that substantially expanded its presence across the country.

## Implementing Governmental Programs to Combat the Financial Crisis

As a supervisor of banking organizations, the Division is playing a critical role helping financial institutions take advantage of Federal Reserve and governmental support programs during the financial crisis. Such programs include not only the Federal Reserve's various lending facilities, but also the U.S. Treasury's Troubled Asset Relief Program (TARP), the FDIC's Temporary Liquidity Guarantee Program (TLGP), and elements of the Treasury's Financial Stability Plan.

For TARP, which offers infusions of capital to qualified institutions, the Division worked on the U.S. Treasury's behalf to guide many District banking companies through the application process. Some received capital in 2008, while processing continued for others into 2009. For TLGP, which provides the FDIC's guarantee on certain debt instruments and non-interest-bearing transaction accounts, the Division counseled institutions about participation in the program and consulted with the FDIC as it reviewed requests for exceptions to rules and guarantee limits.

For the U.S. Treasury's Financial Stability Plan, announced in February 2009, Division staff are participating in the comprehensive stress test of the country's largest banking organizations. The stress test is intended to enhance overall financial stability by ensuring that these institutions have enough capital to withstand a more severe decline in the economy than projected. In addition, the Division will support the Treasury's Capital Assistance Program, which is expected to be similar to the TARP process discussed earlier.

## Looking Ahead

As problems that began in the housing sector spilled over into the broader economy, so have banking performance weaknesses related to housing spread into other lines of bank business including commercial real estate, corporate, and consumer lending. Commercial real estate weakness is a particular concern for the Twelfth District because most banks have lending concentrations in that sector. Recessionary effects normally take some time to work their way through loan portfolios—and because financial markets are not yet fully functioning, the lag this time around could be even longer. Going forward, the Division will continue to support the banking industry's recovery by working with individual organizations to address governance and risk management challenges and by facilitating use of policy tools designed to repair the financial system. ■

# A Closer Look at the Community Reinvestment Act of 1977

The turmoil in the financial markets has prompted questions about whether the Community Reinvestment Act (CRA) played a role in causing the subprime crisis. New research by the Federal Reserve's Board of Governors and the Federal Reserve Bank of San Francisco indicates these claims are unsubstantiated. Even so, the sweeping changes in the financial services industry in the past 30 years suggest it may be time to review the CRA within a broader reexamination of the bank regulatory environment. Through its research, analysis, and outreach, the Federal Reserve Bank of San Francisco's Community Development department is bringing together a wide range of experts to consider the future of the CRA and how best to ensure access to credit in low- and moderate-income communities.

## Community Development

Through research, education, and collaborative outreach with financial institutions, community groups, and government entities, Community Development staff are working to help hard-hit communities avoid foreclosure and address economic development issues during the crisis. In putting together the report, *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act,* *(Left to Right) Ian Galloway, David Erickson, and John Olson* worked closely with colleagues at the Federal Reserve Bank of Boston and the Federal Reserve Board of Governors, as well as with experts in both the financial services and community development industries.

## The Community Reinvestment Act

To understand what an evolving CRA might look like, it's important to consider the history of the regulation and the impact it has had on lower-income communities. Congress enacted the CRA in 1977 in response to concerns about "redlining," a practice by which banks denied credit to lower-income communities—areas outlined in red on a map—without regard to an individual borrower's creditworthiness. Since its passage, the CRA has encouraged federally insured banks and thrifts to meet the credit needs of all the communities they serve, including low- and moderate-income neighborhoods and borrowers, consistent with safe and sound banking practices. Regulators consider a bank's CRA record in determining whether to approve its application to merge with or acquire other depository institutions.

The CRA has changed the way banks and thrifts serve low- and moderate-income communities and consumers. Research on the impact of the regulation has found that the CRA has increased knowledge about lending and investment opportunities in lower-income areas and fostered competition among banks in these neighborhoods, thereby generating larger volumes of lending from diverse sources and adding liquidity to the market.[1] By one estimate, between 1993 and 1998, depository institutions covered by the CRA and their affiliates made nearly $620 billion in home mortgage, small business, and community development loans to

1 *William Apgar, and Mark Duda. 2003. "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges." FRBNY Economic Policy Review. June, pp. 169-191. www.newyorkfed.org/research/epr/03v09n2/0306apga.pdf*

low- and moderate-income borrowers and communities.[2] Moreover, studies also have found that lending to lower-income individuals and communities has been nearly as profitable as, and performed similarly to, other types of lending by CRA-covered institutions.[3] Perhaps equally important has been the role of the CRA in helping to build the institutional infrastructure for community development by investing in nonprofits and community development financial institutions, and by strengthening the capacity of local organizations to develop affordable housing, promote small businesses, and deliver financial education and other asset-building programs.[4]

The Federal Reserve Bank of San Francisco's Community Development department has long worked with banks in the Twelfth Federal Reserve District to identify CRA opportunities in low- and moderate-income communities. CRA officers, with their expertise in community development finance and understanding of local credit needs, are essential partners in efforts to expand access to financial services to underserved communities.

Banks also have been key stakeholders in the department's foreclosure prevention activities, for example, by helping to fund borrower outreach events and by working with housing counselors at nonprofits to improve the loan modification process. In the latter half of 2008, the Community Development department worked with local jurisdictions to create neighborhood stabilization plans for communities with high concentrations of foreclosures. Many banks also participated in local task forces that developed strategies to convert foreclosed homes into affordable housing.

## The CRA and the Subprime Crisis

The CRA recently has been criticized for supposedly helping precipitate the financial crisis by encouraging subprime lending. New research by the Federal Reserve's Board of Governors and the Federal Reserve Bank of San Francisco suggests these claims are largely unfounded.

The Board's analysis of 2006 mortgage data found that about 60 percent of high-cost loans, which have the highest delinquency and foreclosure rates, went to higher-income borrowers or neighborhoods that aren't targeted by the CRA. In fact, only 6 percent of all high-cost loans in 2006 were made by CRA-regulated institutions or their affiliates to lower-income borrowers or neighborhoods in their CRA assessment areas, the local geographies that are the primary focus for CRA evaluation.[5]

In addition, a research paper published by the Federal Reserve Bank of San Francisco examined the performance of loans made by CRA-regulated institutions in California. Strikingly, the analysis found that loans originated by lenders regulated under the CRA were "significantly less likely to be in foreclosure" than those originated by independent mortgage companies that weren't covered by the CRA.[6] Indeed, loans made by CRA-regulated institutions within their assessment areas were half as likely to go into foreclosure as loans made by independent mortgage companies, casting considerable doubt on the argument that the

2 *Michael S. Barr. 2005. "Credit Where it Counts: The Community Reinvestment Act and Its Critics," New York University Law Review. May, 80:2 p. 566. www3.law.nyu.edu/journals/lawreview/issues/vol80/no2/NYU202.pdf*

3 *Board of Governors of the Federal Reserve System. 2000. The Performance and Profitability of CRA-Related Lending pp. 1-99. www.federalreserve.gov/BoardDocs/Surveys/CRAloansurvey/cratext.pdf*

4 *David Erickson. 2009. The Housing Policy Revolution: Networks and Neighborhoods. Urban Institute Press, Washington, D.C.*

5 *Randall S. Kroszner. "The Community Reinvestment Act and the Recent Mortgage Crisis." Speech delivered at Confronting Concentrated Poverty Policy Forum, Board of Governors of the Federal Reserve System, Washington, D.C., December 3, 2008. www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm*

6 *Elizabeth Laderman, and Carolina Reid. 2008. "Lending in Low- and Moderate-Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown," FRBSF Community Development Working Paper. 05-08. www.frbsf.org/publications/community/wpapers/2008/wp08-05.pdf*

regulation contributed to the subprime mortgage crisis.

## A Reexamination of the CRA

Yet, this research also suggests a need to reexamine the CRA and its relevance for the current banking environment, which has changed dramatically since the law's passage more than three decades ago. But what should a revised CRA look like? To explore this question, the Federal Reserve Bank of San Francisco's Community Development department, in collaboration with the Federal Reserve Bank of Boston, published *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*[7] in early 2009. The report includes essays by the leading thinkers on the future of the CRA, including bankers, academics, former regulators, and leaders of community-based organizations. It offers a broad range of ideas designed to stimulate discussion on the future of financial regulations affecting low- and moderate-income communities. The report raises important questions: Should other types of financial institutions such as nonbank lenders and insurance companies have similar obligations to help meet the financial needs of the communities in which they are chartered? In an era of bank consolidations and Internet banking, is the geographic focus of the CRA, which is based on a local assessment area, still meaningful? What market inequalities and inefficiencies still exist, and can the CRA address these issues?

None of these questions is easily answered. The Federal Reserve Bank of San Francisco's Community Development department will continue to engage a wide range of stakeholders in a discussion of the future of the CRA to help contribute to a stronger financial services industry—one that not only provides access to credit in a safe, responsible, and equitable way, but also continues its strong tradition of improving the well-being of low-income families and communities. ■

7 *"Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act" is available online at www.frbsf.org/publications/community/CRA/index.html.*

*As of January 1, 2009*

# Executive Committee

*(Left to Right)*

Gerald C. Tsai
Associate General Counsel and Principal
Legal
Executive Committee Secretary

Susan A. Sutherland
Senior Vice President
District Business Continuity
Human Resources
Legal
Equal Employment Opportunity
Statistics

Mark A. Gould
Senior Vice President
and Chief Information Officer
Cash Product Office
Seattle Branch Manager

Sharon A. Ruth
Group Vice President and General Counsel
Legal

Mark L. Mullinix
Executive Vice President
Cash Product Office
Accounting
Credit and Risk Management
Enterprise Risk Management
Los Angeles Branch Manager

Roger W. Replogle
Senior Vice President
District Cash
District Check Operations and Administration
Police Services
Facilities
Customer Support

John F. Moore
First Vice President and Chief Operating Officer

John P. Judd
Advisor to the President

Janet L. Yellen
President and Chief Executive Officer

Stephen M. Hoffman Jr.
Senior Vice President
Banking Supervision and Regulation

John C. Williams
Executive Vice President and Director of Research
Economic Research

Glenn D. Rudebusch
Senior Vice President and Associate Director of Research
Economic Research

Deborah S. Smyth
Group Vice President
Information and Technology Services
Infrastructure Services and Administration
Executive Committee Advisor

# Branch Managers

*(Left to Right)*

Mary E. Lee
Vice President
Portland Branch Manager

Mark A. Gould
Senior Vice President
Seattle Branch Manager

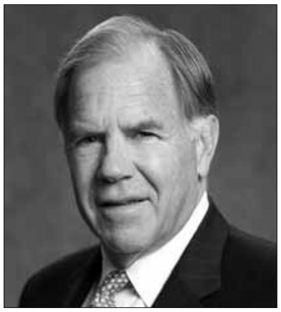
Andrea P. Wolcott
Group Vice President
Salt Lake City Branch Manager

Mark L. Mullinix
Executive Vice President
Los Angeles Branch Manager

# San Francisco Head Office Board of Directors

As of January 1, 2009

Chairman of the Board
and Federal Reserve Agent



T. GARY ROGERS
Chairman of the Board
Levi Strauss & Co.
San Francisco, California

Deputy Chairman

DOUGLAS W. SHORENSTEIN
Chairman and
Chief Executive Officer
Shorenstein Properties LLC
San Francisco, California

Boards of directors of the Reserve Banks and Branches provide the Federal Reserve System with a wealth of information on economic conditions in every corner of the nation. This information, along with other sources, is used by the Federal Open Market Committee and the Board of Governors when reaching decisions about monetary policy.

DANN H. BOWMAN
President and
Chief Executive Officer
Chino Commercial Bank, N.A.
Chino, California

KARLA S. CHAMBERS
Vice President and Co-Owner
Stahlbush Island Farms, Inc.
Corvallis, Oregon

ARNOLD T. GRISHAM
President and
Chief Executive Officer
Alta Alliance Bank
Oakland, California

WILLIAM D. JONES
President and
Chief Executive Officer
CityLink Investment Corporation
San Diego, California

BLAKE W. NORDSTROM
President
Nordstrom, Inc.
Seattle, Washington

KENNETH P. WILCOX
President and
Chief Executive Officer
SVB Financial Group
Santa Clara, California

PATRICIA E. YARRINGTON
Vice President and
Chief Financial Officer
Chevron Corporation
San Ramon, California

Federal Advisory
Council Member

RUSSELL GOLDSMITH
Chairman and
Chief Executive Officer
City National Bank
Beverly Hills, California

# Los Angeles Branch Board of Directors

As of January 1, 2009

Chairman of the Board

ANDREW J. SALE
Partner
Ernst & Young LLP
Los Angeles, California

GRACE EVANS CHERASHORE
President and
Chief Executive Officer
Evans Hotels
San Diego, California

ERIC L. HOLOMAN
President
Magic Johnson Enterprises
Los Angeles, California

DOMINIC NG
Chairman, President, and
Chief Executive Officer
East West Bank
Pasadena, California

JAMES L. SANFORD
Consultant
Northrop Grumman Corporation
Los Angeles, California

ANN E. SEWILL
President, California Foundation
Land Trust
California Community Foundation
Los Angeles, California

KEITH E. SMITH
President and
Chief Executive Officer
Boyd Gaming Corporation
Las Vegas, Nevada

# Portland Branch Board of Directors

As of January 1, 2009

Chairman of the Board

JAMES H. RUDD
Chief Executive Officer
and Principal
Ferguson Wellman Capital
Management, Inc.
Portland, Oregon

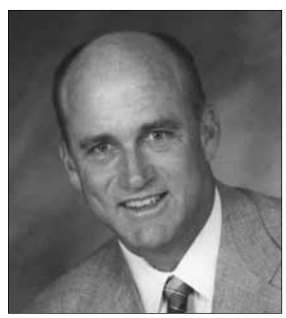
DAVID Y. CHEN
Managing Director
Equilibrium Capital Group LLC
Portland, Oregon

PEGGY Y. FOWLER
Chief Executive Officer
and President
Portland General Electric
Portland, Oregon

ROGER W. HINSHAW
President, Oregon and
SW Washington
Bank of America Oregon, N.A.
Portland, Oregon

JUDITH A. JOHANSEN
President
Marylhurst University
Marylhurst, Oregon

ROBERT D. SZNEWAJS
President and
Chief Executive Officer
West Coast Bancorp
Lake Oswego, Oregon



RODERICK C. WENDT
President and
Chief Executive Officer
JELD-WEN, inc.
Klamath Falls, Oregon

# Salt Lake City Branch Board of Directors

As of January 1, 2009

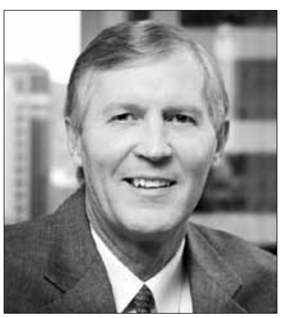
Chairman of the Board

CLARK D. IVORY
Chief Executive Officer
Ivory Homes, Ltd.
Salt Lake City, Utah

CAROL CARTER
President and
Chief Executive Officer
Industrial Compressor
Products, Inc.
Park City, Utah

EDWIN E. DAHLBERG
President and
Chief Executive Officer
St. Luke's Health System
Boise, Idaho

ANNETTE HARDER
President
Herman Consulting LLC
Park City, Utah



ROBERT A. HATCH
President and
Chief Executive Officer
Wells Fargo Bank Utah
Salt Lake City, Utah

SCOTT L. HYMAS
Chief Executive Officer
RC Willey
Salt Lake City, Utah

MICHAEL M. MOONEY
President, Idaho Region
Bank of the Cascades
Boise, Idaho

# Seattle Branch Board of Directors

As of January 1, 2009

Chairman of the Board

HELVI K. SANDVIK
President
NANA Development Corporation
Anchorage, Alaska

WILLIAM S. AYER
Chairman, President, and
Chief Executive Officer
Alaska Air Group
Seattle, Washington

RICHARD A. GALANTI
Executive Vice President and
Chief Financial Officer
Costco Wholesale Corporation
Issaquah, Washington

STAN W. McNAUGHTON
Chairman, Chief Executive Officer,
and President
PEMCO Mutual Insurance
Seattle, Washington

CAROL K. NELSON
President and
Chief Executive Officer
Cascade Financial Corporation
Everett, Washington

# Twelfth District Economic Advisory Council

As of January 1, 2009

Chairman

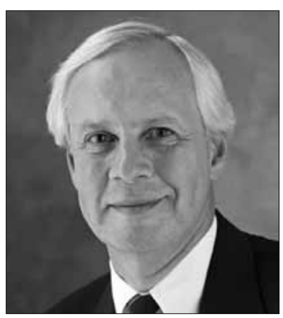
STEPHEN M. BROPHY
President
Page Land & Cattle Co.
Phoenix, Arizona

SUSAN DESMOND-HELLMANN
M.D., M.P.H.
President, Product Development
Genentech, Inc.
South San Francisco, California

JOHN H. GLEASON
Managing Member
Community Planning
Advisors LLC
Scottsdale, Arizona

RICK R. HOLLEY
President and
Chief Executive Officer
Plum Creek Timber Co., Inc.
Seattle, Washington

MARY F. KAISER
President
California Community
Reinvestment Corporation
Glendale, California



HENRY L. KOTKINS, JR.
Chairman and
Chief Executive Officer
Skyway Luggage Company
Seattle, Washington

CATHY LUKE
President
Loyalty Enterprises, Ltd.
Honolulu, Hawaii

# Bank Officers and Principals

As of January 1, 2009

## San Francisco Head Office

Janet L. Yellen
President and
Chief Executive Officer

John F. Moore
First Vice President and
Chief Operating Officer

John P. Judd
Advisor to the President

John C. Williams
Executive Vice President
and Director of Research

Stephen M. Hoffman Jr.
Senior Vice President

Glenn D. Rudebusch
Senior Vice President

Susan A. Sutherland
Senior Vice President

Clifford N. Croxall
Group Vice President

Teresa M. Curran
Group Vice President
and Deputy

Lee C. Dwyer
Group Vice President
and General Auditor

Fred T. Furlong
Group Vice President

Reuven Glick
Group Vice President

Joy K. Hoffmann
Group Vice President

Richard B. Hornsby
Group Vice President

Gopa Kumar
Group Vice President

Donald R. Lieb
Group Vice President and
Chief Financial Officer

Darren S. Post
Group Vice President

Sharon A. Ruth
Group Vice President
and General Counsel

Deborah S. Smyth
Group Vice President

David W. Walker
Group Vice President
and Deputy

David M. Wright
Group Vice President
and Deputy

Randall B. Balducci
Vice President

Tracy A. Basinger
Vice President

Barbara A. Bennett
Vice President

Kenneth R. Binning
Vice President

Stanley M. Crisp
Vice President

Mary C. Daly
Vice President

John G. Fernald
Vice President

Beverley-Ann Hawkins
Vice President and
Equal Employment Officer

Warren Howard
Vice President

Michael E. Johnson
Vice President

Robert E. Kellar
Vice President

Ann Marie Kohlligian
Vice President

Simon H. Kwan
Vice President

William O. Riley
Vice President

Peggy L. Speck
Vice President and
Secretary of the Board

Mark M. Spiegel
Vice President

Kevin E. Zerbe
Vice President

Kevin C. Alecca
Director

Thomas A. Ballantyne
Director

Richard K. Cabral
Director

James J. Callahan
Director

Sharon E. Chow
Director

Thomas M. Cunningham III
Director

Dawn D. Hennings
Director

Jackie C. Hicks
Director

Philip D. Jasienczyk
Director

Rick A. Miller
Director

David J. Moore
Director

David G. Tresmontan
Director

Scott C. Turner
Director

Paulette M. Wallace
Director

Susan T. Wong
Director

Mary Wujek
Director

Judith R. W. Goff
Research Advisor

Bart Hobijn
Research Advisor

Sylvain Leduc
Research Advisor

Zheng Liu
Research Advisor

Jose A. Lopez
Research Advisor

Eric T. Swanson
Research Advisor

Bharat Trehan
Research Advisor

Robert G. Valletta
Research Advisor

Erik Z. Revai
Senior Principal

Nancy S. Emerson
Principal

Joe A. Lozano
Principal

Frederic P. Minardi
Principal

Maureen E. O'Byrne
Principal

David E. Reiser
Principal

## Los Angeles Branch

Mark L. Mullinix
Executive Vice President

Roger W. Replogle
Senior Vice President

Deborah Awai
Group Vice President

Rita G. Aguilar
Director

Jose Alonso
Director

Anthony P. Dazzo
Director

Dana R. Green
Director

Philip B. Johnson
Director

James LeVoir
Director

Howard Ng
Director

Robin A. Rockwood
Director

Dale L. Vaughan
Director

Marla E. Borowski
Principal

Richard J. Shershenovich
Principal

## Portland Branch

Mary E. Lee
Vice President

Steven H. Walker
Director

## Phoenix Processing Center

Gary E. Darby
Vice President

## Salt Lake City Branch

Andrea P. Wolcott
Group Vice President

## Seattle Branch

Mark A. Gould
Senior Vice President

Lynn M. Jorgensen
Director

Darlene R. Wilczynski
Director

# Highlights of 2008

## 1st Quarter

- Seattle Branch dedicates new building following multi-year construction and a successful move to the new Branch in Renton, Washington.
- Federal Reserve Community Perspectives Program hosts the first of five Regional Bankers Forums targeting chief executive officers, presidents, and board members of the Twelfth District's banks to provide information about national and regional economic conditions, banking developments, and the Federal Reserve's programs and financial services.
- Community Development hosts the 2008 National Interagency Community Reinvestment Conference—attended by more than 700 representatives from financial institutions, government agencies, and nonprofits around the country.
- Federal Reserve Bank of San Francisco, Board of Governors, and Federal Reserve Bank of New York partner with People's Bank of China in a cultural exchange of artwork by employees.

## 2nd Quarter

- Statistics and Reserves (STAR) team selected to lead the development of modernizing the current STAR application that supports the central bank's economic data collection, reporting system, and reserves administration used by all Federal Reserve Banks and the Board of Governors.
- Economic Research hosts the "Applied Micro Summer Conference," and its Center for the Study of Innovation and Productivity hosts a symposium on "Research on the Effects of Fiscal Stimulus."
- Banking Supervision and Regulation hosts "The Changing Landscape: Asia's Role in Global Finance" attended by senior policymakers, bankers, academics, and market participants from the United States, Asia, and Europe.

## 3rd Quarter

- Community Development sponsors 14 meetings for regional stakeholders to support foreclosure prevention and neighborhood stabilization, and hosts "Stabilizing Communities: Addressing the Negative Impact of Foreclosures in Los Angeles," one of five Federal Reserve System forums on foreclosure.
- Seattle Branch implements the Federal Reserve System's first capture/print check processing model, the beta site for all Reserve Banks.

## 4th Quarter

- The Cash Product Office completes phase one of the Currency and Coin Handling Environment, a multi-year enhancement to the cash automation and management information systems used by Federal Reserve Banks across the country to manage cash operations.
- The Federal Reserve Bank of Kansas City's Regional Check Adjustments Site consolidates to the Portland Branch's Regional Check Adjustments Site. Additionally, the Portland Branch integrates customer support calls for all of the Federal Reserve's Check Adjustments Sites into its National Customer Support Center and begins integrating customer support calls for all Check Operations.
- Business Development exceeds the Twelfth District's Check Services revenue target for the year by 6.6 percent—achieving the best revenue performance of any sales unit in the Federal Reserve System.
- Federal Reserve Bank of San Francisco launches the *GreenLife* Initiative in all offices to support environmentally friendly practices already in place and new projects related to energy conservation, building infrastructure, recycling, and transportation.

# Summary of Operations

| | (volume in thousands) | |
|---|---|---|
| | **2008** | **2007** |
| **Cash Services** | | |
| Currency notes paid into circulation | 6,225,879 | 6,320,967 |
| Unfit currency destroyed (bundles) | 977 | 1,053 |
| Coin bags paid into circulation | 1,810 | 1,865 |
| **Check Services** | | |
| *Paper Checks* | | |
| Commercial checks processed | 268,662 | 665,818 |
| Return checks processed | 7,694 | 11,573 |
| *Check 21* | | |
| Commercial checks processed | 1,117,340 | 1,156,676 |
| Return checks processed | 25,336 | 30,205 |
| **Discounts and Advances** | | |
| Total discounts and transactions* | 3,190 | 283 |
| Number of financial institutions accommodated* | 199 | 90 |

** Whole numbers (not in thousands)*

# Financial Reports

2008

## Auditor Independence

In 2008, the Board of Governors engaged Deloitte & Touche LLP (D&T) for the audits of the individual and combined financial statements of the Reserve Banks. Fees for D&T's services are estimated to be $10.2 million. Approximately $2.7 million of the estimated total fees were for the audits of the limited liability companies (LLCs) that are associated with recent Federal Reserve actions to address the financial crisis, and are consolidated in the financial statements of the Federal Reserve Bank of New York.[1] To ensure auditor independence, the Board of Governors requires that D&T be independent in all matters relating to the audit. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of Reserve Banks, or in any other way impairing its audit independence. In 2008, the Bank did not engage D&T for any non-audit services.

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

Federal Reserve Bank of San Francisco
101 Market Street, San Francisco, California 94105

April 2, 2009

To the Board of Directors:

The management of the Federal Reserve Bank of San Francisco ("FRBSF") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statements of Income and Comprehensive Income, and Statement of Changes in Capital as of December 31, 2008 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on management judgments and estimates. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies, and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the FRBSF is responsible for establishing and maintaining effective internal control over financial reporting as it relates to the Financial Statements. Such internal control is designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of the Financial Statements in accordance with the Manual. Internal control contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in internal control are reported to management and appropriate corrective measures are implemented.

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

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

Federal Reserve Bank of San Francisco

Janet L. Yellen John F. Moore Donald R. Lieb

| | | |
|---|---|---|
| By Janet L. Yellen<br>President | By John F. Moore<br>First Vice President | By Donald R. Lieb<br>Chief Financial Officer |

Deloitte.

**Deloitte & Touche LLP**
50 Fremont Street
San Francisco, CA 94105-2230
USA

Tel: +1 415 783 4000
Fax: +1 415 783 4329
www.deloitte.com

# Report of Independent Auditors

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

We have audited the accompanying statements of condition of the Federal Reserve Bank of San Francisco ("FRB SF") as of December 31, 2008, and 2007 and the related statements of income and comprehensive income and changes in capital for the years then ended, which have been prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System. We also have audited the internal control over financial reporting of FRB SF as of December 31, 2008, based on criteria established in *Internal Control–Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB SF's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management's Assertion*. Our responsibility is to express an opinion on these financial statements and an opinion on FRB SF's internal control over financial reporting based on our audits.

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

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

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of FRB SF as of December 31, 2008 and 2007, and the results of its operations for the years then ended, on the basis of accounting described in Note 4. Also, in our opinion, FRB SF maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Deloitte & Touche LLP

April 2, 2009

# Statements of Condition

## As of December 31, 2008 and December 31, 2007 (in millions)

| | 2008 | 2007 |
|---|---|---|
| **Assets** | | |
| Gold certificates | $ 1,249 | $ 1,286 |
| Special drawing rights certificates | 234 | 234 |
| Coin | 252 | 165 |
| Items in process of collection | 199 | 522 |
| Loans to depository institutions | 49,143 | 2,031 |
| System Open Market Account: | | |
| Securities purchased under agreements to resell | 8,849 | 5,355 |
| U.S. government, Federal agency, and government-sponsored enterprise securities, net | 55,548 | 85,871 |
| Investments denominated in foreign currencies | 1,815 | 1,864 |
| Central bank liquidity swaps | 40,517 | 1,982 |
| Interdistrict settlement account | 49,257 | – |
| Bank premises and equipment, net | 249 | 258 |
| Accrued interest receivable | 767 | 736 |
| Other assets | 47 | 26 |
| Total assets | $ 208,126 | $ 100,330 |
| | | |
| **Liabilities and Capital** | | |
| Federal Reserve notes outstanding, net | $ 87,018 | $ 86,459 |
| System Open Market Account: | | |
| Securities sold under agreements to repurchase | 9,773 | 5,066 |
| Deposits: | | |
| Depository institutions | 107,779 | 1,823 |
| Other deposits | 3 | 3 |
| Deferred credit items | 495 | 353 |
| Interest on Federal Reserve notes due to U.S. Treasury | 23 | 161 |
| Interdistrict settlement account | – | 3,651 |
| Accrued benefit costs | 99 | 90 |
| Other liabilities | 38 | 24 |
| Total liabilities | 205,228 | 97,630 |
| Capital paid-in | 1,449 | 1,350 |
| Surplus (including accumulated other comprehensive loss of $16 million and $13 million at December 31, 2008 and 2007, respectively) | 1,449 | 1,350 |
| Total capital | 2,898 | 2,700 |
| Total liabilities and capital | $ 208,126 | $ 100,330 |

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

## Statements of Income and Comprehensive Income

For the years ended December 31, 2008 and December 31, 2007 (in millions)

| | 2008 | 2007 |
|---|---|---|
| ***Interest income:*** | | |
| Loans to depository institutions | $ 308 | $ 2 |
| System Open Market Account: | | |
| Securities purchased under agreements to resell | 211 | 162 |
| U.S. government, Federal agency, and government-sponsored enterprise securities | 2,878 | 4,407 |
| Investments denominated in foreign currencies | 46 | 45 |
| Central bank liquidity swaps | 265 | 3 |
| Total interest income | 3,708 | 4,619 |
| ***Interest expense:*** | | |
| System Open Market Account: | | |
| Securities sold under agreements to repurchase | 83 | 192 |
| Depository institution deposits | 62 | – |
| Total interest expense | 145 | 192 |
| Net interest income | 3,563 | 4,427 |
| ***Non-interest income:*** | | |
| System Open Market Account: | | |
| U.S. government, Federal agency, and government-sponsored enterprise securities gains, net | 428 | – |
| Foreign currency gains, net | 97 | 147 |
| Compensation received for services provided | 56 | 69 |
| Reimbursable services to government agencies | 12 | 13 |
| Other income | 96 | 14 |
| Total non-interest income | 689 | 243 |
| ***Operating expenses:*** | | |
| Salaries and other benefits | 199 | 197 |
| Occupancy expense | 20 | 19 |
| Equipment expense | 17 | 17 |
| Assessments by the Board of Governors | 99 | 112 |
| Other expenses | 61 | 74 |
| Total operating expenses | 396 | 419 |
| Net income prior to distribution | 3,856 | 4,251 |
| Change in funded status of benefit plans | (3) | 8 |
| Comprehensive income prior to distribution | $ 3,853 | $ 4,259 |
| ***Distribution of comprehensive income:*** | | |
| Dividends paid to member banks | $ 84 | $ 77 |
| Transferred to surplus and change in accumulated other comprehensive loss | 99 | 103 |
| Payments to U.S. Treasury as interest on Federal Reserve notes | 3,670 | 4,079 |
| Total distribution | $ 3,853 | $ 4,259 |

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

## Statements of Changes in Capital

For the years ended December 31, 2008 and December 31, 2007 (in millions, except share data)

| | | Surplus | | | |
|---|---|---|---|---|---|
| | Capital Paid-In | Net Income Retained | Accumulated Other Comprehensive Loss | Total Surplus | Total Capital |
| Balance at January 1, 2007 (25 million shares) | $ 1,247 | $ 1,268 | $ (21) | $ 1,247 | $ 2,494 |
| Net change in capital stock issued (2 million shares) | 103 | – | – | – | 103 |
| Transferred to surplus and change in accumulated other comprehensive loss | – | 95 | 8 | 103 | 103 |
| Balance at December 31, 2007 (27 million shares) | $ 1,350 | $ 1,363 | $ (13) | $ 1,350 | $ 2,700 |
| Net change in capital stock issued (2 million shares) | 99 | – | – | – | 99 |
| Transferred to surplus and change in accumulated other comprehensive loss | – | 102 | (3) | 99 | 99 |
| Balance at December 31, 2008 (29 million shares) | $ 1,449 | $ 1,465 | $ (16) | $ 1,449 | $ 2,898 |

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

# Notes to Financial Statements

## 1. Structure

The Federal Reserve Bank of San Francisco ("Bank") is part of the Federal Reserve System ("System") and is one of the twelve Reserve Banks ("Reserve Banks") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act"), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank serves the Twelfth Federal Reserve District, which includes Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, Washington and the commonwealths or territories of American Samoa, Guam and the Northern Mariana Islands.

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

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

## 2. Operations and Services

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

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

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets 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 and securities contracts for, fourteen foreign currencies and to invest such foreign currency holdings, ensuring adequate liquidity is maintained. The FRBNY is also authorized and directed by the FOMC to maintain reciprocal currency arrangements with fourteen central banks and to "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks.

# Notes to Financial Statements

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

Major services provided by the Bank on behalf of the System and for which the costs were not reimbursed by the other Reserve Banks include Statistics and Reserves, Currency and Coin Handling Environment, National Incident Response Team, Standard Cash Automation and CBAF, Cash Product Office, EnterpriseWide Information Security Operations and Coordination, National Cash Operations Management, Supervision and Regulation National Information Center – Central Operations, Long Term Cash Initiatives, and Offsite Storage Locations – Cash.

## 3. Recent Financial Stability Activities

The Federal Reserve has implemented a number of programs designed to support the liquidity of financial institutions and to foster improved conditions in financial markets. These new programs, which are set forth below, have resulted in significant changes to the Bank's financial statements.

***Expanded Open Market Operations and Support for Mortgage-Related Securities***

The Single-Tranche Open Market Operation Program, created on March 7, 2008, allows primary dealers to initiate a series of term repurchase transactions that are expected to accumulate up to $100 billion in total. Under the provisions of the program, these transactions are conducted as 28-day term repurchase agreements for which primary dealers pledge U.S. Treasury and agency securities and agency Mortgage-Backed Securities ("MBS") as collateral. The FRBNY can elect to increase the size of the term repurchase program if conditions warrant. The repurchase transactions are reported as "System Open Market Account: Securities purchased under agreements to resell" in the Statements of Condition.

The GSE and Agency Securities and MBS Purchase Program was announced on November 25, 2008. The primary goal of the program is to provide support to the mortgage and housing markets and to foster improved conditions in financial markets. Under this program, the FRBNY will purchase the direct obligations of housing-related GSEs and MBS backed by the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and the Government National Mortgage Association ("Ginnie Mae"). Purchases of the direct obligations of housing-related GSEs began in November 2008 and purchases of GSE and agency MBS began in January 2009. There were no purchases of GSE and agency MBS during the period ended December 31, 2008. The program was initially authorized to purchase up to $100 billion in GSE direct obligations and up to $500 billion in GSE and agency MBS. In March 2009, the FOMC authorized FRBNY to purchase up to an additional $750 billion of GSE and agency MBS and up to an additional $100 billion of GSE direct obligations.

The FRBNY holds the resulting securities and agreements in the SOMA portfolio and the activities of both programs are allocated to the other Reserve Banks.

***Central Bank Liquidity Swaps***

The FOMC authorized the FRBNY to establish temporary reciprocal currency swap arrangements (central bank liquidity swaps) with the European Central Bank and the Swiss National Bank on December 12, 2007 to help provide liquidity in U.S. dollars to overseas markets. Subsequently, the FOMC authorized reciprocal currency swap arrangements with additional foreign central banks. Such arrangements are now authorized with the following central banks: the Reserve Bank of Australia, the Banco Central do Brasil, the Bank of Canada, Danmarks Nationalbank, the Bank of England, the European Central Bank, the Bank of Japan, the Bank of Korea, the Banco de Mexico, the Reserve Bank of New Zealand, Norges Bank, the Monetary Authority of Singapore, Sveriges Riksbank, and the Swiss National Bank. The activity related to the program is allocated to the other Reserve Banks. The maximum amount of borrowing permissible under the swap arrangements varies by central bank. The central bank liquidity swap arrangements are authorized through October 30, 2009.

### *Lending to Depository Institutions*

The temporary Term Auction Facility ("TAF") program was created on December 12, 2007. The goal of the TAF is to help promote the efficient dissemination of liquidity, which is achieved by the Reserve Banks injecting term funds through a broader range of counterparties and against a broader range of collateral than open market operations. Under the TAF program, Reserve Banks auction term funds to depository institutions against a wide variety of collateral. All depository institutions that are judged to be in generally sound financial condition by their Reserve Bank and that are eligible to borrow under the primary credit program are eligible to participate in TAF auctions. All advances must be fully collateralized. The loans are reported as "Loans to depository institutions" in the Statements of Condition.

### *Lending to Primary Dealers*

The Term Securities Lending Facility ("TSLF") was created on March 11, 2008, to promote the liquidity in the financing markets for U.S. Treasuries and other collateral. Under the TSLF, the FRBNY will lend up to an aggregate amount of $200 billion of U.S. Treasury securities to primary dealers secured for a term of 28 days. Securities loans are collateralized by a pledge of other securities, including federal agency debt, federal agency residential mortgage-backed securities, and non-agency AAA/Aaa-rated private-label residential mortgage-backed securities, and are awarded to primary dealers through a competitive single-price auction. The TSLF is authorized through October 30, 2009. The fees related to these securities lending transactions are reported as a component of "Non-interest income (loss): Other income" in the Statements of Income and Comprehensive Income.

The Term Securities Lending Facility Options Program ("TOP"), created on July 30, 2008, offers primary dealers the option to draw upon short-term, fixed-rate TSLF loans in exchange for eligible collateral. The options are awarded through a competitive auction. The program is intended to enhance the effectiveness of the TSLF by ensuring additional securities liquidity during periods of heightened collateral market pressures, such as around quarter-end dates. TOP auction dates are determined by the FRBNY, and the program authorization ends concurrently with the TSLF.

### *Other Lending Facilities*

The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF"), created on September 19, 2008, is a lending facility that provides funding to U.S. depository institutions and bank holding companies to finance the purchase of high-quality asset-backed commercial paper ("ABCP") from money market mutual funds under certain conditions. The program is intended to assist money market mutual funds that hold such paper to meet the demands for investor redemptions and to foster liquidity in the ABCP market and money markets more generally. The Federal Reserve Bank of Boston ("FRBB") administers the AMLF and is authorized to extend these loans to eligible borrowers on behalf of the other Reserve Banks. All loans extended under the AMLF are recorded as assets by the FRBB and, if the borrowing institution settles to a depository account in the Twelfth Reserve District, the funds are credited to the institution's depository account and settled between the Banks through the interdistrict settlement account. The credit risk related to the AMLF is assumed by the FRBB. The FRBB is authorized to finance the purchase of commercial paper through October 30, 2009.

## 4. Significant Accounting Policies

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

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

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

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

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

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

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

SDR certificates are issued by the International Monetary Fund (the "Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDR certificates serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for U.S. participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates somewhat like gold certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among the Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2008 or 2007.

***b. Loans to Depository Institutions***

Loans are reported at their outstanding principal balances net of commitment fees. Interest income is recognized on an accrual basis. Loan commitment fees are generally deferred and amortized on a straight-line basis over the commitment period, which is not materially different from the interest method.

Outstanding loans are evaluated to determine whether an allowance for loan losses is required. The Bank has developed procedures for assessing the adequacy of the allowance for loan losses that reflect the assessment of credit risk considering all available information. This assessment includes monitoring information obtained from banking supervisors, borrowers, and other sources to assess the credit condition of the borrowers.

# Notes to Financial Statements

Loans are considered to be impaired when it is probable that the Bank will not receive principal and interest due in accordance with the contractual terms of the loan agreement. The amount of the impairment is the difference between the recorded amount of the loan and the amount expected to be collected, after consideration of the fair value of the collateral. Recognition of interest income is discontinued for any loans that are considered to be impaired. Cash payments made by borrowers on impaired loans are applied to principal until the balance is reduced to zero; subsequent payments are recorded as recoveries of amounts previously charged off and then to interest income.

***c. 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 Fannie Mae, Freddie Mac, and Ginnie Mae; STRIP securities of the U.S. government; and "stripped" securities of other government agencies. The tri-party agreements are accounted for as financing transactions and the associated interest income is accrued over the life of the agreement.

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

U.S. government securities held in the SOMA are lent to U.S. government securities dealers to facilitate the effective functioning of the domestic securities market. Overnight securities lending transactions are fully collateralized by other U.S. government securities. Term securities lending transactions are fully collateralized with investment-grade debt securities, collateral eligible for tri-party repurchase agreements arranged by the Open Market Trading Desk, or both. The collateral taken in both overnight and term securities lending transactions is in excess of the fair value of the securities loaned. The FRBNY charges the primary dealer a fee for borrowing securities, and these fees are reported as a component of "Other income."

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

***d. U.S. Government, Federal Agency, and Government-Sponsored Enterprise Securities; Investments Denominated in Foreign Currencies; and Warehousing Agreements***

Interest income on U.S. government, Federal agency, and GSE securities and investments denominated in foreign currencies comprising the SOMA is accrued on a straight-line basis. Gains and losses resulting from sales of securities are determined by specific issue 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" in the Statements of Income and Comprehensive Income.

Activity related to U.S. government, Federal agency, and GSE securities, including the premiums, discounts, and realized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of the interdistrict settlement account that occurs in April of each year. The settlement also equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding in each District. Activity related to investments denominated in foreign currencies, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31.

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.

Warehousing agreements are designated as held for trading purposes and are valued daily at current market exchange rates. Activity related to these agreements is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31.

*e. Central Bank Liquidity Swaps*

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

The foreign central bank pays interest to the FRBNY based on the foreign currency amounts held by the FRBNY. The FRBNY recognizes interest income during the term of the swap agreement and reports the interest income as a component of "Interest income: Central bank liquidity swaps" in the Statements of Income and Comprehensive Income.

Activity related to these swap transactions, including the related interest income, 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. Similar to other investments denominated in foreign currencies, the foreign currency holdings associated with these central bank liquidity swaps are revalued at current foreign currency market exchange rates and allocated to the other Reserve Banks. Because the swap arrangement will be unwound at the same exchange rate that was used in the initial transaction, the obligation to return the foreign currency is also revalued at current foreign currency market exchange rates and is recorded in a currency exchange valuation account by the FRBNY. This revaluation method eliminates the effects of the changes in the market exchange rate. As of December 31, 2008, the FRBNY began allocating this currency exchange valuation account to the Bank and, as a result, the reported amount of central bank liquidity swaps reflects the Bank's allocated portion at the contract exchange rate.

*f. Interdistrict Settlement Account*

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

*g. Bank Premises, Equipment, and Software*

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

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

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

# Notes to Financial Statements

***h. Federal Reserve Notes***

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the chairman of the board of directors of each Reserve Bank and their designees) to the Reserve Banks upon deposit with such agents of specified classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be at least equal to the sum of the notes applied for by such Reserve Bank.

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

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the outstanding Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes issued to all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, Federal Reserve notes are obligations of the United States government. At December 31, 2008 and 2007, all Federal Reserve notes issued to the Reserve Banks were fully collateralized.

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Bank's currency holdings of $26,219 million and $25,719 million at December 31, 2008 and 2007, respectively.

***i. Items in Process of Collection and Deferred Credit Items***

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

***j. Capital Paid-in***

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

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

***k. Surplus***

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

Accumulated other comprehensive income is reported as a component of surplus in the Statements of Condition and the Statements of Changes in Capital. The balance of accumulated other comprehensive income is comprised of expenses, gains, and losses related to other postretirement benefit plans that, under accounting standards, are included in other comprehensive income, but excluded from net income. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 12 and 13.

# Notes to Financial Statements

*l. Interest on Federal Reserve Notes*

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

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

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

*m. Interest on Depository Institution Deposits*

Beginning October 9, 2008, the Reserve Banks began paying interest to depository institutions on qualifying balances held at the Banks. Authorization for payment of interest on these balances was granted by Title II of the Financial Services Regulatory Relief Act of 2006, which had an effective date of 2011. Section 128 of the Emergency Economic Stabilization Act of 2008, enacted on October 3, 2008, made that authority immediately effective. The interest rates paid on required reserve balances and excess balances are based on an FOMC-established target range for the effective federal funds rate.

*n. Income and Costs Related to U.S. Treasury Services*

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury has appropriations to pay for these services. During the years ended December 31, 2008 and 2007, the Bank was reimbursed for all services provided to the Department of the Treasury as its fiscal agent.

*o. Compensation Received for Services Provided*

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

*p. Assessments by the Board of Governors*

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

*q. Taxes*

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property and, in some states, sales taxes on construction-related materials. The Bank's real property taxes were $4 million and $3 million for the years ended December 31, 2008 and 2007, respectively, and are reported as a component of "Occupancy expense."

*r. Restructuring Charges*

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

Note 14 describes the Bank's restructuring initiatives and provides information about the costs and liabilities associated with employee separations and contract terminations. The costs associated with the impairment of certain of the Bank's assets are discussed in Note 9. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY.

***s. Recently Issued Accounting Standards***

In September 2006, FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"), which established a single authoritative definition of fair value and a framework for measuring fair value, and expands the required disclosures for assets and liabilities measured at fair value. SFAS 157 was effective for fiscal years beginning after November 15, 2007, with early adoption permitted. The Bank adopted SFAS 157 effective January 1, 2008. The provisions of this standard have no material effect on the Bank's financial statements.

In February 2007, FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115" ("SFAS 159"), which provides companies with an irrevocable option to elect fair value as the measurement for selected financial assets, financial liabilities, unrecognized firm commitments, and written loan commitments that are not subject to fair value under other accounting standards. There is a one-time election available to apply this standard to existing financial instruments as of January 1, 2008; otherwise, the fair value option will be available for financial instruments on their initial transaction date. SFAS 159 reduces the accounting complexity for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently, and it eliminates the operational complexities of applying hedge accounting. The Bank adopted SFAS 159 effective January 1, 2008. The provisions of this standard have no material effect on the Bank's financial statements.

In February 2008, FASB issued FASB Staff Position ("FSP") FAS 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions." FSP FAS 140-3 requires that an initial transfer of a financial asset and a repurchase financing that was entered into contemporaneously with, or in contemplation of, the initial transfer be evaluated together as a linked transaction under SFAS 140 "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," unless certain criteria are met. FSP FAS 140-3 is effective for the Bank's financial statements for the year beginning on January 1, 2009 and earlier adoption is not permitted. The provisions of this standard will not have a material effect on the Bank's financial statements.

## 5. Loans

The loan amounts outstanding to depository institutions at December 31 were as follows (in millions):

| | 2008 | 2007 |
|---|---|---|
| Primary, secondary, and seasonal credit | $ 4,338 | $ 330 |
| TAF | 44,805 | 1,701 |
| Total loans to depository institutions | $ 49,143 | $ 2,031 |

***Loans to Depository Institutions***

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

Primary, secondary, and seasonal credit lending is collateralized to the satisfaction of the Bank to reduce credit risk. Assets eligible to collateralize these loans include consumer, business, and real estate loans, U.S. Treasury securities, Federal agency securities, GSE obligations, foreign sovereign debt obligations, municipal or corporate obligations, state and local government obligations, asset-backed securities, corporate bonds, commercial paper, and bank-issued assets, such as certificates of deposit, bank notes, and deposit notes. Collateral is assigned a lending value deemed appropriate by the Bank, which is typically fair value or face value reduced by a margin.

Depository institutions that are eligible to borrow under the Bank's primary credit program are also eligible to participate in the temporary TAF program. Under the TAF program, the Reserve Banks conduct auctions for a fixed amount of funds, with the interest rate determined by the auction process, subject to a minimum bid rate. TAF loans are extended on a short-term basis, with terms of either 28 or 84 days. All advances under the TAF must be fully collateralized. Assets eligible to collateralize TAF loans include the complete list noted above for loans to depository institutions. Similar to the process used for primary, secondary, and seasonal credit, a lending value is assigned to each asset accepted as collateral for TAF loans.

Loans to depository institutions are monitored on a daily basis to ensure that borrowers continue to meet eligibility requirements for these programs. The financial condition of borrowers is monitored by the Bank and, if a borrower no longer qualifies for these programs, the Bank will generally request full repayment of the outstanding loan or may convert the loan to a secondary credit loan.

Collateral levels are reviewed daily against outstanding obligations and borrowers that no longer have sufficient collateral to support outstanding loans are required to provide additional collateral or to make partial or full repayment.

The maturity distribution of loans outstanding at December 31, 2008, was as follows (in millions):

| | Primary, secondary, and seasonal credit | TAF |
|---|---|---|
| Within 15 days | $ 3,542 | $ 19,530 |
| 16 days to 90 days | 796 | 25,275 |
| Total loans | $ 4,338 | $ 44,805 |

***Allowance for Loan Losses***

At December 31, 2008 and 2007, no loans were considered to be impaired and the Bank determined that no allowance for loan losses was required.

# Notes to Financial Statements

## 6. U.S. Government, Federal Agency, and Government-Sponsored Enterprise Securities; Securities Purchased Under Agreements to Resell; Securities Sold Under Agreements to Repurchase; and Securities Lending

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 11.061 percent and 11.517 percent at December 31, 2008 and 2007, respectively.

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

| | 2008 | 2007 |
|---|---|---|
| *U.S. government securities:* | | |
| Bills | $ 2,038 | $ 26,239 |
| Notes | 37,030 | 46,271 |
| Bonds | 13,574 | 12,783 |
| Federal agency and GSE securities | 2,180 | – |
| Total par value | 54,822 | 85,293 |
| Unamortized premiums | 890 | 920 |
| Unaccreted discounts | (164) | (342) |
| Total allocated to the Bank | $ 55,548 | $ 85,871 |

At December 31, 2008 and 2007, the fair value of the U.S. government, Federal agency, and GSE securities allocated to the Bank, excluding accrued interest, was $62,653 million and $89,500 million, respectively, as determined by reference to quoted prices for identical securities.

The total of the U.S. government, Federal agency, and GSE securities, net, held in the SOMA was $502,189 million and $745,629 million at December 31, 2008 and 2007, respectively. At December 31, 2008 and 2007, the fair value of the U.S. government, Federal agency, and GSE securities held in the SOMA, excluding accrued interest, was $566,427 million and $777,141 million, respectively, as determined by reference to quoted prices for identical securities.

Although the fair value of security holdings can be substantially greater than or less than the recorded value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as central bank, to meet their financial obligations and responsibilities and do not represent a risk to the Reserve Banks, their shareholders, or the public. The fair value is presented solely for informational purposes.

# Notes to Financial Statements

Financial information related to securities purchased under agreements to resell and securities sold under agreements to repurchase for the years ended December 31, 2008 and 2007, were as follows (in millions):

| | Securities purchased under agreements to resell | | Securities sold under agreements to repurchase | |
|---|---|---|---|---|
| | **2008** | **2007** | **2008** | **2007** |
| ***Allocated to the Bank:*** | | | | |
| Contract amount outstanding, end of year | $ 8,849 | $ 5,355 | $ 9,773 | $ 5,066 |
| Weighted average amount outstanding, during the year | 10,733 | 4,039 | 7,241 | 4,013 |
| Maximum month-end balance outstanding, during the year | 13,163 | 5,931 | 10,902 | 5,066 |
| Securities pledged, end of year | | | 8,727 | 5,073 |
| ***System total:*** | | | | |
| Contract amount outstanding, end of year | $ 80,000 | $ 46,500 | $ 88,352 | $ 43,985 |
| Weighted average amount outstanding, during the year | 97,037 | 35,073 | 65,461 | 34,846 |
| Maximum month-end balance outstanding, during the year | 119,000 | 51,500 | 98,559 | 43,985 |
| Securities pledged, end of year | | | 78,896 | 44,048 |

The contract amounts for securities purchased under agreements to resell and securities sold under agreements to repurchase approximate fair value.

The maturity distribution of U.S. government, Federal agency, and GSE securities bought outright, securities purchased under agreements to resell, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2008, was as follows (in millions):

| | U.S. government securities (Par value) | Federal agency and GSE securities (Par value) | Subtotal: U.S. government, Federal agency, and GSE securities (Par value) | Securities purchased agreements to resell (Contract amount) | Securities sold under agreements to repurchase (Contract amount) |
|---|---|---|---|---|---|
| Within 15 days | $ 2,117 | $ 50 | $ 2,167 | $ 4,424 | $ 9,773 |
| 16 days to 90 days | 2,319 | 363 | 2,682 | 4,425 | – |
| 91 days to 1 year | 7,005 | 108 | 7,113 | – | – |
| Over 1 year to 5 years | 19,172 | 1,257 | 20,429 | – | – |
| Over 5 years to 10 years | 10,765 | 402 | 11,167 | – | – |
| Over 10 years | 11,264 | – | 11,264 | – | – |
| Total allocated to the Bank | $ 52,642 | $ 2,180 | $ 54,822 | $ 8,849 | $ 9,773 |

At December 31, 2008 and 2007, U.S. government securities with par values of $180,765 million and $16,649 million, respectively, were loaned from the SOMA, of which $19,995 million and $1,917 million, respectively, were allocated to the Bank.

# Notes to Financial Statements

## 7. Investments Denominated in Foreign Currencies

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and with the Bank for International Settlements and invests in foreign government debt instruments. These investments are guaranteed as to principal and interest by the issuing foreign governments.

The Bank's allocated share of investments denominated in foreign currencies was approximately 7.317 percent and 8.136 percent at December 31, 2008 and 2007, respectively.

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

| | 2008 | 2007 |
|---|---|---|
| ***Euro:*** | | |
| Foreign currency deposits | $ 407 | $ 583 |
| Securities purchased under agreements to resell | 298 | 207 |
| Government debt instruments | 337 | 380 |
| ***Japanese yen:*** | | |
| Foreign currency deposits | 255 | 229 |
| Government debt instruments | 518 | 465 |
| Total allocated to the Bank | $ 1,815 | $ 1,864 |

At December 31, 2008 and 2007, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was $1,831 million and $1,862 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government, Federal agency, and GSE securities discussed in Note 6, unrealized gains or losses have no effect on the ability of a Reserve Bank, as central bank, to meet its financial obligations and responsibilities.

Total System investments denominated in foreign currencies were $24,804 million and $22,914 million at December 31, 2008 and 2007, respectively. At December 31, 2008 and 2007, the fair value of the total System investments denominated in foreign currencies, including accrued interest, was $25,021 million and $22,892 million, respectively.

The maturity distribution of investments denominated in foreign currencies that were allocated to the Bank at December 31, 2008, was as follows (in millions):

| | Euro | Japanese Yen | Total |
|---|---|---|---|
| Within 15 days | $ 556 | $ 255 | $ 811 |
| 16 days to 90 days | 85 | 46 | 131 |
| 91 days to 1 year | 128 | 146 | 274 |
| Over 1 year to 5 years | 273 | 326 | 599 |
| Total allocated to the Bank | $ 1,042 | $ 773 | $ 1,815 |

At December 31, 2008 and 2007, the authorized warehousing facility was $5 billion, with no balance outstanding.

In connection with its foreign currency activities, the FRBNY may enter into transactions that contain varying degrees of off-balance-sheet market risk that result from their future settlement and counter-party credit risk. The FRBNY controls these risks by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

## 8. Central Bank Liquidity Swaps

Central bank liquidity swap arrangements are contractual agreements between two parties, the FRBNY and an authorized foreign central bank whereby the parties agree to exchange their currencies up to a prearranged maximum amount and for an agreed-upon period of time. At the end of that period of time, the currencies are returned at the original contractual exchange rate and the foreign central bank pays interest to the Federal Reserve at an agreed-upon rate. These arrangements give the authorized foreign central bank temporary access to U.S. dollars. Drawings under the swap arrangements are initiated by the foreign central bank and must be agreed to by the Federal Reserve.

The Bank's allocated share of central bank liquidity swaps was approximately 7.317 percent and 8.136 percent at December 31, 2008 and 2007, respectively.

At December 31, 2008 and 2007, the total System amount of foreign currency held under central bank liquidity swaps was $553,728 million and $24,353 million, respectively, of which $40,517 million and $1,982 million, respectively, was allocated to the Bank.

The maturity distribution of central bank liquidity swaps that were allocated to the Bank at December 31 was as follows (in millions):

| | 2008 | | | 2007 |
|---|---|---|---|---|
| | **Within 15 days** | **16 days to 90 days** | **Total** | **16 days to 90 days** |
| Australian dollar | $ 731 | $ 939 | $ 1,670 | $ – |
| Danish krone | – | 1,098 | 1,098 | |
| Euro | 11,047 | 10,272 | 21,319 | 1,651 |
| Japanese yen | 3,504 | 5,475 | 8,979 | – |
| Korean won | – | 757 | 757 | – |
| Norwegian krone | 161 | 441 | 602 | – |
| Swedish krona | 732 | 1,097 | 1,829 | – |
| Swiss franc | 1,406 | 436 | 1,842 | 331 |
| U.K. pound | 9 | 2,412 | 2,421 | – |
| Total | $ 17,590 | $ 22,927 | $ 40,517 | $ 1,982 |

# Notes to Financial Statements

## 9. Bank Premises, Equipment, and Software

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

| | 2008 | 2007 |
|---|---|---|
| ***Bank premises and equipment:*** | | |
| Land | $ 41 | $ 36 |
| Buildings | 225 | 185 |
| Building machinery and equipment | 45 | 43 |
| Construction in progress | 9 | 63 |
| Furniture and equipment | 109 | 115 |
| Subtotal | 429 | 442 |
| Accumulated depreciation | (180) | (184) |
| Bank premises and equipment, net | $ 249 | $ 258 |
| Depreciation expense, for the years ended December 31 | $ 16 | $ 14 |

Capital leases that are included in the Bank Premises and Equipment at December 31 were not material.

The Bank leases space to outside tenants with remaining lease terms ranging from 1 to 9 years. Rental income from such leases was $3 million and $2 million for the years ended December 31, 2008 and 2007, respectively, and is reported as a component of "Other income." Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2008, are as follows (in millions):

| | |
|---|---|
| 2009 | $ 2.1 |
| 2010 | 1.9 |
| 2011 | 1.9 |
| 2012 | 1.9 |
| 2013 | 2.0 |
| Thereafter | 6.3 |
| Total | $ 16.1 |

The Bank has capitalized software assets, net of amortization, of $20 million and $8 million at December 31, 2008 and 2007, respectively. Amortization expense was $2 million for each of the years ended December 31, 2008 and 2007. Capitalized software assets are reported as a component of "Other assets" and the related amortization is reported as a component of "Other expenses."

Assets impaired as a result of the Bank's restructuring plan, as discussed in Note 14, include processing equipment. Asset impairment losses of $3 million for the period ended December 31, 2007, were determined using fair values based on quoted fair values or other valuation techniques and are reported as a component of "Other expenses." The Bank had no impairment losses in 2008.

# Notes to Financial Statements

## 10. Commitments and Contingencies

In the normal course of its operation, the Bank enters into contractual commitments, normally with fixed expiration dates or termination provisions, at specific rates and for specific purposes.

At December 31, 2008, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from 2 to approximately 5 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 $1 million for each of the years ended December 31, 2008 and 2007.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2008, are as follows (in millions):

| | Operating Leases |
|---|---|
| 2009 | $ 0.8 |
| 2010 | 0.7 |
| 2011 | 0.4 |
| 2012 | 0.4 |
| 2013 | 0.4 |
| Thereafter | 0.0 |
| Future minimum rental payments | $ 2.7 |

At December 31, 2008, the Bank, acting on behalf of the Reserve Banks, had unrecorded unconditional purchase commitments extending through the year 2017 with a remaining fixed commitment of $292 million. Purchases of $30 million and $24 million were made against these commitments during 2008 and 2007, respectively. These commitments represent maintenance of currency processing machines and have variable and/or fixed components. The variable portion of the commitment is for machine shifts added or removed during the year. The fixed payments for the next five years under these commitments are as follows (in millions):

| | Fixed Commitment |
|---|---|
| 2009 | $ 7 |
| 2010 | 59 |
| 2011 | 30 |
| 2012 | 30 |
| 2013 | 31 |

Under the Insurance Agreement of the Federal Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio of a Reserve Bank's capital paid-in to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2008 or 2007.

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

# Notes to Financial Statements

## 11. Retirement and Thrift Plans

### *Retirement Plans*

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

The System Plan provides retirement benefits to employees of the Federal Reserve Banks, the Board of Governors, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. The FRBNY, on behalf of the System, recognizes the net asset or net liability and costs associated with the System Plan in its financial statements. Costs associated with the System Plan are not reimbursed by other participating employers.

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2008 and 2007, and for the years then ended, were not material.

### *Thrift Plan*

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2008 and 2007, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service. The Bank's Thrift Plan contributions totaled $7 million for each of the years ended December 31, 2008 and 2007, and are reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income. Beginning in 2009, the Bank will match 100 percent of the first 6 percent of employee contributions from the date of hire and provide an automatic employer contribution of 1 percent of eligible pay.

## 12. Postretirement Benefits Other Than Pensions and Postemployment Benefits

### *Postretirement Benefits Other Than Pensions*

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

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

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

| | **2008** | **2007** |
|---|---|---|
| Accumulated postretirement benefit obligation at January 1 | $ 72.3 | $ 75.2 |
| Service cost-benefits earned during the period | 2.8 | 3.1 |
| Interest cost on accumulated benefit obligation | 4.7 | 4.5 |
| Net actuarial loss (gain) | 4.3 | (5.2) |
| Curtailment gain | (0.3) | (1.1) |
| Contributions by plan participants | 1.4 | 1.3 |
| Benefits paid | (6.0) | (5.7) |
| Medicare Part D subsidies | 0.2 | 0.2 |
| Accumulated postretirement benefit obligation at December 31 | $ 79.4 | $ 72.3 |

At December 31, 2008 and 2007, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 6.00 percent and 6.25 percent, respectively.

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

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

| | 2008 | 2007 |
|---|---|---|
| Fair value of plan assets at January 1 | $ – | $ – |
| Contributions by the employer | 4.4 | 4.2 |
| Contributions by plan participants | 1.4 | 1.3 |
| Benefits paid | (6.0) | (5.7) |
| Medicare Part D subsidies | 0.2 | 0.2 |
| Fair value of plan assets at December 31 | $ – | $ – |
| Unfunded obligation and accrued postretirement benefit cost | $ 79.4 | $ 72.3 |
| Amounts included in accumulated other comprehensive loss are shown below: | | |
| Prior service cost | $ (0.2) | $ (0.4) |
| Net actuarial loss | (16.0) | (12.6) |
| Total accumulated other comprehensive loss | $ (16.2) | $ (13.0) |

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

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

| | 2008 | 2007 |
|---|---|---|
| Health care cost trend rate assumed for next year | 7.50% | 8.00% |
| Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) | 5.00% | 5.00% |
| Year that the rate reaches the ultimate trend rate | 2014 | 2013 |

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, 2008 (in millions):

| | One Percentage Point Increase | One Percentage Point Decrease |
|---|---|---|
| Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs | $ 0.1 | $ (0.2) |
| Effect on accumulated postretirement benefit obligation | 0.7 | (0.9) |

# Notes to Financial Statements

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

| | 2008 | 2007 |
|---|---|---|
| Service cost-benefits earned during the period | $ 2.8 | $ 3.1 |
| Interest cost on accumulated benefit obligation | 4.7 | 4.5 |
| Amortization of prior service cost | (0.2) | (0.5) |
| Amortization of net actuarial loss | 1.0 | 2.0 |
| Net periodic postretirement benefit expense | $ 8.3 | $ 9.1 |

| | |
|---|---|
| Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2009 are shown below: | |
| Net actuarial loss | 1.2 |
| Total | $ 1.2 |

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2008 and 2007, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 6.25 percent and 5.75 percent, respectively.

Net periodic postretirement benefit expense is reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income.

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

Federal Medicare Part D subsidy receipts were $0.2 million for each of the years ended December 31, 2008 and 2007. Expected receipts in 2009, related to benefits paid in the years ended December 31, 2008 and 2007 are $0.1 million.

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

| | Without Subsidy | With Subsidy |
|---|---|---|
| 2009 | $ 5.5 | $ 5.2 |
| 2010 | 5.9 | 5.5 |
| 2011 | 6.3 | 5.9 |
| 2012 | 6.6 | 6.2 |
| 2013 | 6.9 | 6.5 |
| 2014 – 2018 | 37.8 | 34.8 |
| Total | $ 69.0 | $ 64.1 |

### *Postemployment Benefits*

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank was $14 million for each of the years ended December 31, 2008 and 2007. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2008 and 2007 operating expenses were $2 million and $1 million, respectively, and are recorded as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income.

## 13. Accumulated Other Comprehensive Income And Other Comprehensive Income

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

| | Amount Related to Postretirement Benefits other than Pensions |
|---|---|
| Balance at January 1, 2007 | $ (21) |
| Change in funded status of benefit plans: | |
| Net actuarial gain arising during the year | 7 |
| Amortization of prior service cost | (1) |
| Amortization of net actuarial loss | 2 |
| Change in funded status of benefit plans – other comprehensive income | 8 |
| Balance at December 31, 2007 | $ (13) |
| Change in funded status of benefit plans: | |
| Net actuarial loss arising during the year | (4) |
| Amortization of net actuarial loss | 1 |
| Change in funded status of benefit plans – other comprehensive loss | (3) |
| Balance at December 31, 2008 | $ (16) |

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

## 14. Business Restructuring Charges

### *2008 Restructuring Plans*

In 2008, the Reserve Banks announced the acceleration of their check restructuring initiatives to align the check processing infrastructure and operations with declining check processing volumes. The new infrastructure will involve consolidation of operations into two regional Reserve Bank processing sites in Cleveland and Atlanta. Additional announcements in 2008 included restructuring plans associated with the Portland Regional Adjustments Site.

### *2007 Restructuring Plans*

In 2007, the Reserve Banks announced a restructuring initiative to align the check processing infrastructure and operations with declining check processing volumes. Additional announcements in 2007 related to Los Angeles and Seattle branches check consolidation to Dallas.

# Notes to Financial Statements

***2006 and Prior Restructuring Costs***

The Bank incurred various restructuring charges prior to 2007 related to the restructuring of checks and other restructuring programs.

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

| | 2006 and Prior Restructuring Plans | 2007 Restructuring Plans | 2008 Restructuring Plans | Total |
|---|---|---|---|---|
| ***Information related to restructuring plans as of December 31, 2008:*** | | | | |
| Total expected costs related to restructuring activity | $ 6.6 | $ 5.8 | $ 1.6 | $ 14.0 |
| Estimated future costs related to restructuring activity | – | 0.3 | – | 0.3 |
| Expected completion date | 2007 | 2009 | 2008 | |
| ***Reconciliation of liability balances:*** | | | | |
| Balance at January 1, 2007 | $ 1.7 | $ – | $ – | $ 1.7 |
| Employee separation costs | 0.3 | 4.2 | – | 4.5 |
| Adjustments | (0.7) | 0.7 | – | – |
| Payments | (1.2) | – | – | (1.2) |
| Balance at December 31, 2007 | $ 0.1 | $ 4.9 | $ – | $ 5.0 |
| Employee separation costs | – | 1.0 | 1.6 | 2.6 |
| Payments | (0.1) | (1.6) | – | (1.7) |
| Balance at December 31, 2008 | $ – | $ 4.3 | $ 1.6 | $ 5.9 |

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

Adjustments to the accrued liability are primarily due to changes in the estimated restructuring costs and are shown as a component of the appropriate expense category in the Statements of Income and Comprehensive Income. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 11.

## 15. Subsequent Events

In February 2009, the System announced the extension through October 30, 2009, of liquidity programs that were previously scheduled to expire on April 30, 2009. The extension pertains to the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility and the Term Securities Lending Facility. In addition, the temporary reciprocal currency arrangements (swap lines) between the Federal Reserve and other central banks were extended to October 30, 2009.

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|---|---|
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| **Los Angeles Branch** | 950 South Grand Avenue<br>Los Angeles, California 90015<br>(213) 683-2300 |
| **Portland Branch** | 1500 SW First Avenue, Suite 100<br>Portland, Oregon 97201<br>(503) 276-3000 |
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