Cash Counts

Federal Reserve Bank of San Francisco
2006 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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John F. Moore
First Vice President and Chief Operating Officer

Janet L. Yellen
President and Chief Executive Officer

David K.Y. Tang
Chairman

T. Gary Rogers
Deputy Chairman

Message from the President

During 2006, we experienced both challenges and achievements as the way the Federal Reserve carries out some of its essential roles continued to evolve. These changes have been most visible in the financial services we offer to financial institutions, which have been dramatically impacted by technology and other market forces. In response, the Federal Reserve has centralized many operations and designated certain Reserve Banks in leadership roles to oversee the strategic and operational direction of key financial services.

In 2001, our Bank assumed leadership over the Federal Reserve's national Cash Product Office, which directs the central bank's essential role putting new paper bills, or Federal Reserve notes as they're called, into circulation. This year's report examines the life cycle of a Federal Reserve note and the Product Office's role in this area.

Although technology and other factors have influenced how the Federal Reserve's currency business is carried out, cash continues to count—as you'll read in this report. The report provides some interesting statistics about the amount of U.S. currency in circulation and delves into the impact of new technology and banking legislation on the Federal Reserve's vast currency business. The report also describes some initiatives the Product Office spearheaded in 2006 to address this impact and position the Federal Reserve for the future. Additionally, the report highlights key partnerships with external groups that provide important channels in the currency distribution process.

Our Bank's leadership guiding the Federal Reserve's Cash Product Office is an achievement by any measure, and a range of additional successes and major business milestones are featured in the Highlights of 2006 section of this report.

Our other major operational area, check services, experienced another strong year in spite of considerable change to the operation as a result of the recent Check 21 legislation. In addition to that challenge, we learned early in the year that the San Francisco check processing and adjustments operation had been selected for consolidation in 2007 as part of the Federal Reserve's ongoing national check consolidation effort. This was a necessary decision, but it also was a very difficult one, as it affects a number of employees who have put in many years of dedicated, excellent service. Indeed, their contributions to the success of the District's check function are reflected in our achieving the rank of first place for productivity in check processing for the entire System in 2005 and second place in 2006.

Message from The President

I recognize that transitions like this are difficult, and in response, the Conference of Presidents of the Reserve Banks extended the involuntary separation program implemented in support of the Federal Reserve's check restructuring.

I also know that accomplishing the Bank's goals in the midst of ongoing change is a challenge for all employees. I would like to take this opportunity to thank them for their commitment and service to this organization and the public.

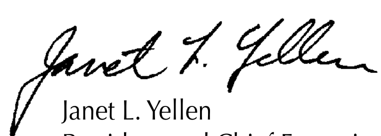
Turning to the conduct of monetary policy, the year 2006 started off with the fourteenth consecutive quarter-point increase in the federal funds rate, as the Federal Open Market Committee continued its removal of policy accommodation. By August, however, growth appeared to be moderating and the prospects for inflation seemed also to tend toward moderation. Therefore, the Committee voted to pause, leaving the funds rate at 5-1/4 percent, where it ended the year.

In reaching these decisions, I, like my colleagues around the System, depend on insights from the members of our boards of directors. Their independent assessment of economic and financial conditions throughout our nine western states plays an invaluable role in the formulation of monetary policy, and I thank them for their many contributions.

In particular, I want to acknowledge Barbara L. Wilson, consultant and regional vice president (retired), Qwest Corporation, Boise, Idaho, who completed six years of service on the San Francisco Board of this Reserve Bank, following three years of service on its Salt Lake City Branch Board, of which the final two years were as Branch Board chairman.

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 at the end of 2006:

- *on the San Francisco Board:* Charles H. Smith, former president and chief executive officer, AT&T West, San Ramon, California;
- *on the Los Angeles Branch Board:* Karen B. Caplan, president and chief executive officer, Frieda's, Inc., Los Alamitos, California; and D. Linn Wiley, president and chief executive officer, Citizens Business Bank, Ontario, California;
- *on the Portland Branch Board:* Peter O. Kohler, M.D., president emeritus, Oregon Health and Science University, Portland, Oregon;
- *on the Salt Lake City Branch Board:* William C. Glynn, president, Intermountain Industries, Inc., Boise, Idaho, who served as chairman of the Salt Lake City Branch Board this past year; and Annette K. Herman, vice president, Strategic Initiatives, Uniprise, UnitedHealth Group, Salt Lake City, Utah;
- *on the Seattle Branch Board:* David W. Wyckoff, chairman and chief executive officer, Wyckoff Farms, Inc., Grandview, Washington; and
- *on the Twelfth District Economic Advisory Council:* Thomas E. Cleveland, chairman and chief executive officer, Access Business Finance, Bellevue, Washington, who served as chairman of the council this past year, preceded by three years as its vice chairman; Roberto E. Barragan, president, Valley Economic Development Center, Inc., Van Nuys, California; and Manuel Cunha Jr., president, Nisei Farmers League, Fresno, California.



Janet L. Yellen
President and Chief Executive Officer

Cash Counts

Does cash still count? Electronic payments in their many forms are a ubiquitous part of our culture and the U.S. economy. Many of us have our paychecks automatically deposited in our bank accounts. We use online bill payment services and frequently shop at our favorite virtual storefronts. Businesses increasingly use electronic payment methods—taking advantage of cost and efficiency gains to contribute to their bottom lines. With this commonplace use of electronic money, you might assume that paper payments are shrinking, and perhaps the predictions of a cashless society, which have persisted since the 1960s, will come true. While it is clear check usage is declining, at this point, it certainly isn't clear for the other form of paper payments—cash.

Because cash transactions are anonymous, that is, they aren't tracked through the banking system, measuring how often cash payments are made is difficult. However, the total amount of money in circulation can be measured precisely to determine whether currency is growing or shrinking. And growing it is! Over the past three decades, the value of U.S. currency in circulation has grown dramatically—from $93.4 billion in 1977 to $783.2 billion in 2006[1]. The number of pieces of currency in circulation also has increased during this time—from 7.5 billion to 26.4 billion.

Cash certainly counts to the Federal Reserve. The twelve Federal Reserve Banks play a major role in the distribution of U.S. currency. In fact, currency is a liability of the Reserve Banks and, as such, is a significant component of Reserve Bank balance sheets. Reserve Banks supply commercial banks, savings banks, and credit unions (collectively known as "depository institutions") with the currency they in turn provide to their customers. Reserve Banks also accept deposits of unneeded and/or worn currency from depository institutions and remove unfit and counterfeit notes from circulation.

This is a big business for the Reserve Banks. From Sunday night until Friday evening, Reserve Bank cash offices keep the money flowing—receiving,

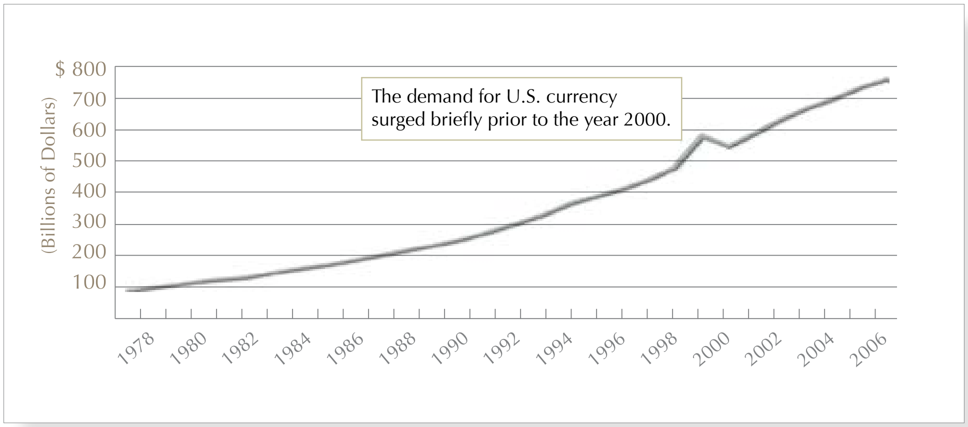
[1] *Except for the value of U.S. currency in circulation (Source: U.S. Treasury), all data in this report were provided by the Federal Reserve Cash Product Office (www.frbservices.org/Cash/index.html).*

counting, and processing currency from and paying out currency to depository institutions. Federal Reserve Bank offices provide cash services directly to over half of the banks, savings banks, and credit unions in the United States and indirectly to the remainder that contract with correspondent banks using Reserve Bank cash services. Altogether in 2006, the Reserve Banks received and processed 38 billion notes, destroyed 7 billion worn notes, and paid out 39 billion new and fit notes at an operating cost of $319 million, not counting the $600 million incurred by the Bureau of Engraving and Printing to print new notes.

Like any large business, the opportunities and challenges associated with providing cost-effective, high-quality cash services are significant, particularly in today's rapidly changing business environment. As the headquarters for the national Cash Product Office for the Reserve Banks' cash business line, the Federal Reserve Bank of San Francisco plays a leading role setting the strategic agenda and collaborating with all of the Reserve Banks to address these challenges and leverage opportunities.

The value of U.S. currency in circulation has increased steadily through the decades

Source: U.S. Treasury



Where Does All That Money Go?

At the end of 2006, slightly more than $783 billion of U.S currency was in circulation. Interestingly, estimates indicate that well over half of this amount, perhaps as much as two-thirds, is held outside U.S. borders. There are numerous reasons why U.S. currency is held abroad. Individuals in foreign countries may want to hold an internationally accepted currency as a hedge against inflation of their local currency, or because of concerns about the local banking system or political climate. More routine reasons include growing business and leisure travel between the United States and other countries, as well as the transfer of earnings from immigrant workers to their families in other countries. For these reasons and many more, Federal Reserve notes can be found in most places in the world.

Such a large stock of dollars held abroad has a number of benefits, not the least of which is that currency represents a claim on the United States that does not require the payment of interest. If foreigners purchased U.S. Treasury securities instead of holding U.S. currency, our government would pay interest totaling billions of dollars per year. So, these foreign holdings of dollars can be thought of as an interest-free loan made to the United States. Of course, there are some modest costs, relatively speaking, to print and process the currency, but these pale in comparison to the forgone interest.

Cradle to Grave: The Life of U.S. Currency

The life of a new Federal Reserve note begins when the Reserve Banks work with the Board of Governors to determine the demand for new currency and submit their annual print order to the U.S. Treasury's Bureau of Engraving and Printing (BEP). The order is an estimate of the amount of currency the public will demand in the upcoming year and reflects estimated changes in currency usage and destruction rates of unfit currency. The Reserve Banks pay for the cost of printing and transporting new currency from the BEP printing facilities in Washington, D.C., and Fort Worth, Texas. Over the last decade, these printing facilities combined turned out a little more than 99 billion new notes.

Printing the notes involves a series of passes using three separate printing processes. An offset press is used to print the subtle background colors on the front and back of the notes—red and tan for the $10 note, peach and green for the $20 note, and blue and red for the $50 note. The intaglio press follows to create U.S. currency's artful design and distinct look and feel of engraved images, icons, and scroll work. Once dry, notes that meet an examiner's inspection standards are ready for the final process using typographic printing to create the Federal Reserve District seal and its corresponding number and the Treasury seal and serial numbers.

Newly printed notes are cut, bundled, and shipped to Reserve Banks for distribution. Upon arrival, they are officially "Federal Reserve notes," although the notes do not become a liability on Reserve Banks' balance sheets until they are distributed to depository institutions for circulation. Notes typically do not stay in circulation for long. In fact, usually they make several return visits to Reserve Banks before they are ultimately destroyed. When depository institutions receive more currency from their customers than they need on hand, often they want to convert this non-interest-earning asset into balances in their Federal Reserve accounts. Reserve balances can be invested in interest-earning instruments such as a fed funds loan to another institution or a U.S. Treasury security. Reserve Banks use these currency deposits to fill orders from other depository institutions for additional currency to meet their customers' demand. In this way, Reserve Banks act as an intermediary between depository institutions to balance currency needs within a region and across the country.

Each time Reserve Banks receive currency from a depository institution, they run the currency through high-speed processing machines that count the notes, identify possible counterfeits, and determine if notes are suitable for recirculation. Worn notes that are unfit for recirculation are automatically shredded, giving new meaning to President Harry Truman's famous statement, "The buck stops here."

The National Cash Product Office

In coordinating the Federal Reserve's vast cash services business, the Cash Product Office is involved in every aspect of the life cycle of a Federal Reserve note. Staff from the San Francisco Reserve Bank's Los Angeles, San Francisco, and Seattle offices direct the activities of the Product Office. Additionally, staff in the Richmond and Cleveland Reserve Banks perform substantial automation work. In keeping with the Product Office's strong commitment to collaborative leadership and reliance on the deep business knowledge that resides throughout the Federal Reserve System, all major Product Office initiatives involve key staff from other Reserve Banks.

The Cash Product Office's four major responsibilities are very similar to those involved in managing any product. Staff conduct strategic planning and market

Cash Product Office: San Francisco

Cash Product Office staff in San Francisco (left to right) Nancy Leon, Carla Kitchin, Mark Peralta, Stephen Lai, Barbara Bennett, Louise Willard, Roxana Tsougarakis, Chad Harper, Jaclyn Hodges, and Jeff Collins provide strategic direction to the Federal Reserve's national cash services business. In this capacity, they and their counterparts in Los Angeles (page 10) guide policy and product development, capacity planning, and inventory management for the Reserve Banks.

Not pictured: Kevin Fleming, Leslie Goff, Sy-Dang Tran

Cash Product Office: Los Angeles

Left to Right: Rosalinda Bernardino, Michael Valente, Shawna Gale, Marla Borowski, Phillip B. Johnson, Olympia LaPoint, Juan Rodriguez, Phuong Luu

research around the central bank's currency distribution role. They develop programs and procedures for the operational aspects of the Fed's cash business, and they provide the technology support and development for the automated cash infrastructure. Finally, as the Federal Reserve's primary point of contact on cash distribution matters, they communicate with external constituencies such as large depository institutions, vendors, the press, and other central banks.

All four of these responsibilities tie directly to the Federal Reserve's fundamental goals that were laid out when the Federal Reserve Act of 1913 authorized the issuance of Federal Reserve notes. These goals include ensuring that cash is readily available when and where it is needed, especially during times of crisis, and that the public is confident that currency supplied by banks and merchants is genuine and readily usable in subsequent transactions. Underlying everything is the commitment to good stewardship, namely, that the resources spent to print, process, store, and distribute cash to the domestic and international public are minimized for society as a whole.

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Evolving Markets and Models

While the Fed's fundamental goals regarding U.S. currency remain the same, clearly, much has changed since the 1920s when the Federal Reserve's cash services footprint first was established. The country's major population and commerce centers have expanded from the Northeast and the Midwest to include the South and the West. Within the past ten years, legislative changes and new technologies have enabled the

Fed's largest depository institution customers to offer nationwide banking services, while using more centralized business models. Additionally, with changing patterns in the use of cash and innovative technologies, large depository institutions are using increasingly sophisticated models to manage their own cash inventories and provide cash to their customers across the country.

The changes within the Federal Reserve have been dramatic as well. Historically each Reserve Bank and Branch provided a full range of services to local depository institutions. Now, a number of services, particularly check services, have evolved into centralized functions, which are intended to improve efficiency and market alignment. In cash services, new buildings have been built and new, high-speed processing equipment has been introduced since the 1920s. The Phoenix Cash Processing facility built in the San Francisco Reserve's District in 2001 is the most recently constructed site.

In 2006, the Cash Product Office spearheaded several major initiatives to align the Federal Reserve's cash services with the evolving market. The initiatives that follow are setting the stage for better use of

Central Business Administration Function

Within the CPO, Central Business Administration Function (CBAF) staff such as (left to right) Amy Burr, Ken Green, Carolyn Pitts, Sam Koeritz, Kathy Sigman, David Huang, and William Riley provide the technology and development support for the Federal Reserve's cash operations. The CBAF team develops and supports the complex suite of systems that tracks, inventories, and accounts for Federal Reserve notes during their life cycles, among other responsibilities. The team is based in the San Francisco, Richmond, and Cleveland Reserve Banks.

Moving Money

The activation warning alarm sounds. A brief moment of silence follows before the automated storage and retrieval machine launches. Like a small roller coaster, the machine travels along a single 160-foot rail at speeds up to seven miles per hour across the floor of the cash vault to deposit and retrieve currency storage containers filled with bundles of cash. Many Reserve Banks have integrated automated processes, such as the automated crane pictured here in the Los Angeles Branch's vault, to improve the capacity, safety, and productivity for the storage and handling of the vast amounts of cash that enter and leave the Federal Reserve. In addition to automated cranes, some locations use robotic vehicles to move containers.

resources, improved productivity, and more effective working relationships with customers and other business partners.

Aligning the Cash Footprint: Infrastructure

The year 2006 marked the culmination of a multiyear review of the Federal Reserve's cash processing and distribution points, resulting in a new, supplemental distribution model, called a "cash depot," to address changing market realities. Several factors provided the impetus for this review including the growing cost, complexity, and economies of scale of currency processing equipment and the increased overhead expenses associated with higher post-9/11 security costs.

Staff from the San Francisco, Kansas City, Atlanta, Richmond, New York, Minneapolis, and Dallas Reserve Banks conducted the review. The review concluded that new cash delivery models (in addition to the traditional collocation of currency processing and distribution at each Federal Reserve site) were not only feasible but also consistent with good stewardship of the public's resources. Specifically, Reserve Bank Branch markets that lack the volume to support large-scale currency processing operations could be converted to the depot service model as long as the depot is no more than five hours driving distance from the closest Reserve Bank Branch where processing takes place.

With a cash depot, depository institutions still deposit currency and pick up orders in their local Branch city, but do so at a secure collection point operated by a third party transportation company acting as the agent for the Federal Reserve. The third party, generally an armored carrier, transports deposits to the servicing Reserve Bank office which counts deposits and prepares orders. The third party then transports orders from the servicing Reserve Branch back to the secure collection point for payout to the depository institution. The Federal Reserve pays for the transportation between the depot and the servicing Reserve Bank.

This distribution model eliminated costly overhead and achieved economies of scale without shifting the burden for long-distance transportation costs to depository institutions. Since the initiative was launched, six Reserve Branches have converted to the depot model: Little Rock, served by Memphis; Louisville, served by Cincinnati; Buffalo, served by Cleveland;

Portland, served by Seattle; Oklahoma City, served by Dallas; and Birmingham, served by Atlanta. The Omaha Branch is slated to convert to the depot model once Kansas City, its servicing site, completes its new building in the first half of 2008.

With the country's changing demographics, the review team also analyzed whether any new markets warranted a Federal Reserve cash presence, either in the form of a depot or a full-fledged facility. Given the well-established private sector transportation solutions coupled with uncertainty over future domestic cash volume trends, the team concluded that expansions were not advisable at this time.

Increasing Productivity: High-Speed Cash Processing

The Federal Reserve owns 133 high-speed cash processing machines that count notes and detect worn and counterfeit currency. Each machine can process about 700,000 pieces of currency per nine-hour shift, and many of the machines run two shifts per day. In 2006, the Reserve Banks processed approximately 38 billion pieces of currency on these machines! Like any good business, the Fed continually assesses how it can improve productivity and reduce processing costs. For the past two years, engineers at the Richmond Reserve Bank worked with the machine's manufacturer to

Currency Technology Office

Currency Technology Office (CTO) staff members (left to right) Diana Joyner and Elva Wilhite oversee the installation of one of the upgraded high-speed cash processing machines in the San Francisco Reserve Bank's vault. As one of the technical arms of the Cash Product Office, the CTO, which is based at the Richmond Reserve Bank, focuses on the automation of physical currency handling, the high-speed processing environment, and financial and administrative support for System-level currency processing. The group also provides agency support to the Bureau of Engraving and Printing and the Secret Service.

What about Coins?

Reserve Banks distribute new coins to the public through depository institutions when they order cash. The Reserve Banks buy coins from the U.S. Mint at face value and account for them as an asset on their balance sheets.

The Cash Product Office oversees the centralized management of coin inventories and distribution within the Federal Reserve. In this role, it serves as the liaison with the Mint. Each month, the Product Office sends a coin order to the Mint, which plans its production based on this order and its own internal forecast. The Product Office coordinates the distribution of new coins to the Reserve Banks, monitors their coin inventories, and redistributes inventories among offices to meet fluctuations in regional demand for coins.

increase the currency processing throughput. The first refurbished machine is slated for production in 2007, with the remainder set for production by 2009. Early indicators suggest the upgraded machines will increase the throughput rate by 8 to 10 percent or more.

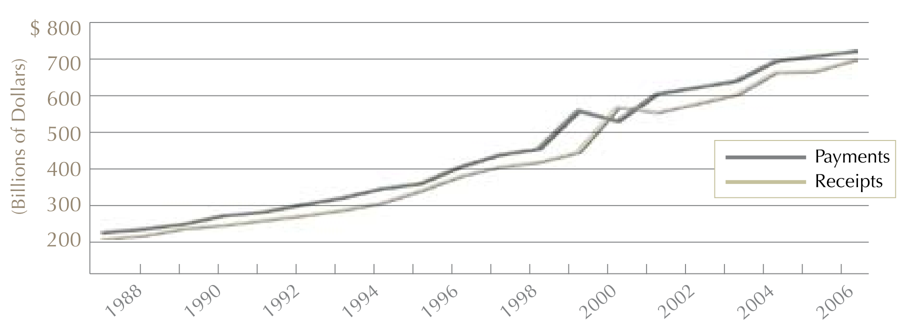
Getting the Incentives Right: Currency Recirculation

Historically, the Federal Reserve has provided its currency processing service to depository institutions at no charge. To prevent overuse of this free service, the Federal Reserve has a long-standing administrative policy that discourages depository institutions from depositing and ordering fit currency of the same denomination within a period of five business days. This practice of churning currency, whereby institutions deposit and order fit currency within the same business week rather than holding it, is known as "cross-shipping" within the Federal Reserve. The process is inefficient because it requires unnecessary handling, processing, and round-trip transportation. In 2006, processing cross-shipped currency cost the Reserve Banks approximately $27 million.

Despite the administrative policy, depository institutions have strong incentives to cross-ship. They receive fit, clean currency for payout to customers

With payments to and receipts from depository institutions rising, Reserve Banks are processing more cash

Source: Federal Reserve Cash Product Office



In addition to coins stored in Reserve Bank vaults, the Federal Reserve has agreements with 185 armored carrier locations to store, process, and distribute coins on behalf of the Federal Reserve. The establishment of these coin terminals has improved the efficiency of the coin distribution process.

Testing New Models

The demand for coin, as for currency, varies seasonally and with economic activity. This creates challenges for managing coin inventory and production levels. In late 2006, the Cash Product Office and the Mint completed a proof-of-concept trial to determine if a new approach for inventory management could effectively maintain the right inventory levels by location when needed to meet fluctuating demand and reduce volatility in coin production.

The trial focused on three strategies: (1) managing coin production and distribution at the market level; (2) supplying new coins to the trial market at a constant rate; and (3) allowing inventory levels at specific sites to fluctuate in line with anticipated seasonal needs. In contrast, current practices generally focus on managing coin production and distribution for local offices, which leads to more volatile inventory levels.

The Product Office will complete an evaluation of the pilot program and develop recommendations for a new coin inventory management strategy in early 2007. Early indications are that the new approach will reduce costs and improve efficiency. The Product Office would oversee the implementation of the new strategy, if approved.

without having to sort it themselves. More importantly, excess cash sent to the Federal Reserve is credited to their reserve account balances that can be invested, unlike non-interest-earning cash kept on hand in bank vaults. Given these reasons, it isn't surprising that the cross-shipping policy was ineffective, and as a result, the Federal Reserve, and by extension the public, incurred unnecessary currency processing and storage costs.

After consultation with the Reserve Banks, the Board of Governors, and the banking industry, the Cash Product Office proposed a more market oriented set of incentives. The revised policy, which was approved by the Board of Governors and published in early 2006, has two key components. First, institutions will be allowed to cross-ship currency but will be required to pay a fee that essentially equals the Federal Reserve's cost to process and store cross-shipped currency. This approach accounts for the true societal cost of processing cross-shipped currency, while preserving this service as an option if it's the most efficient solution for the depository institution.

The second component, a Custodial Inventory program, allows qualifying depository institutions to convert a portion of the cash balances held in their vaults into reserve account balances that earn interest. Through this program, qualifying institutions can recoup the interest they would have lost from holding cash receipts for a few days rather than sending the cash to their local Reserve Bank. To qualify for the Custodial Inventory program, depository institutions undergo a safety and soundness review, a site inspection and consistency review, and procedural training, among other requirements.

It isn't surprising that the cross-shipping policy was ineffective, and as a result, the Federal Reserve, and by extension the public, incurred unnecessary currency processing and storage costs.

Together, the fee and Custodial Inventory programs are referred to as the "Recirculation Policy." The Custodial Inventory program was implemented in July 2006, and at year-end had nearly 30 active depository institutions. The fee will take effect in July 2007, giving depository institutions a year to adjust their operations. Additionally, to assist institutions in their planning, the Cash Product Office has sent pro forma billing statements since mid-2004.

Improving Investment Decisions: Cash Payments Study

The infrastructure and resources required to run the Federal Reserve's cash business are highly capital intensive—requiring the investment of hundreds of millions of dollars in processing equipment, software and hardware, and vault facilities. Projecting the future growth of the cash business is critical to managing investment decisions. Yet, projecting this growth is complicated by several factors. First, it is difficult to estimate the precise amount of U.S. currency that circulates domestically, the measure which drives the Federal Reserve's cash processing service. Second, changes in the processing methods depository institutions use, along with their inventory management behaviors, can have a major impact on Federal Reserve processing volumes. Finally, the adoption of alternative payment options by consumers and businesses undoubtedly will affect currency growth, but data on cash payment usage trends and displacement of cash by other payment options is very limited and sketchy.

Within this context, the Cash Product Office, with the assistance of staff from the Board of Governors and the Boston, Cleveland, and Richmond Reserve Banks, is conducting a market research study to understand the acceptance of cash by businesses. Understanding cash substitution, the cash cycle, and cash holding policies and behaviors from a business-centric perspective will help shed light on the future demand for Federal Reserve cash services—in terms of the number of cash payments in general and the volume of cash held by or flowing through businesses.

The cash payments study involves qualitative interviews with 30 to 50 large businesses with substantial cash receipts and a quantitative survey of hundreds, perhaps thousands, of businesses to establish a baseline against which future payment activity and behavior can be measured. The Cash Product Office formally launched the study in 2006, with completion slated for 2008.

Understanding cash substitution, the cash cycle, and cash holding policies and behaviors from a business-centric perspective will help shed light on the future demand for Federal Reserve cash services . . . .

Strengthening Customer and Business Partnerships

The Federal Reserve's cash business is a partnership that includes external participants from both the private and governmental sectors. Many of these participants are directly affected by policy, process, and currency design changes. At the same time, they are important channels in the distribution of safe, reliable currency to the public. Recognizing these important connections, the Cash Product Office has made significant efforts over the years to strengthen these relationships and to understand participants' needs as part of the decisionmaking process for cash services.

Depository institutions make up one of the Federal Reserve's most critical constituencies. They represent the next link in the network for distributing U.S. currency to the public. To ensure timely and useful information flows with this group, the Cash Product Office formed an advisory council consisting of 16 of the largest institutions by cash processing volume. Virtually all of these institutions have a multistate presence. Staff from the Product Office meet with members of this group in person at least twice a year, with regular conference calls scheduled between meetings. Their input has helped shape a number of key policies and programs over the past few years and will continue to provide invaluable input for future decisionmaking.

The armored carrier industry is another important constituency. This group provides the critical link between the Federal Reserve, depository institutions, and cash handling businesses. The Product Office meets regularly with large national carriers and the association representing local, independent carriers. The importance of this relationship becomes very apparent when unanticipated events occur, such as Hurricane Katrina in 2005. As the events surrounding Katrina unfolded, established relationships combined with solid contingency planning enabled new transportation routes and processes, as well as new partnerships, to be put into place quickly to ensure the public had access to currency.

Within the government sector, the Cash Product Office is a member of the Advanced Counterfeit Deterrence Committee. This committee consists of participants from the Board of Governors, the U.S. Treasury, the Bureau of Engraving and Printing, and the U.S. Secret Service. These entities work together to develop and coordinate anti-counterfeiting strategies, including new currency designs, to preserve public confidence in U.S. currency.

Looking Ahead

Will cash count in the future? With the steady growth of U.S. currency and its broad acceptance supported by public confidence, it is likely cash will remain a vital component of the payments system for the foreseeable future. Even so, there's little doubt that electronic payments will continue to challenge how cash is used.

Assessing cash usage through initiatives such as the Cash Payments Study will help the Federal Reserve paint a clearer picture of the future. And looking ahead, one thing is certain: cash will continue to count for the Federal Reserve. The Federal Reserve and the Cash Product Office will continue to develop strategies, resources, and technologies to evolve with the market. So, no matter what the future holds, the Federal Reserve will work to ensure that U.S. currency remains safe, reliable, and accessible.

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Senior Vice President
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Chief Executive Officer

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Community Perspectives
Salt Lake City Branch Manager

MARY E. LEE
Vice President
Portland Branch Manager

San Francisco Board of Directors

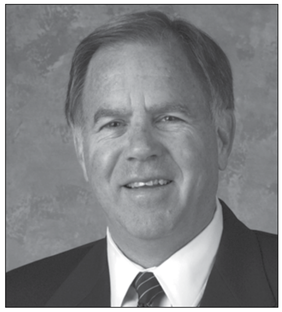
As of January 1, 2007*

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.

Chairman of the Board and Federal Reserve Agent

DAVID K.Y. TANG
Managing Director, Asia
K&L Gates
Seattle, Washington

Deputy Chairman



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Federal Advisory Council Member

RICHARD M. KOVACEVICH
Chairman and Chief Executive Officer
Wells Fargo & Company
San Francisco, California

* Reflects one vacant seat

Los Angeles Board of Directors

As of January 1, 2007

Chairman of the Board

JAMES L. SANFORD
Corporate Vice President
and Treasurer
Northrop Grumman Corporation
Los Angeles, California

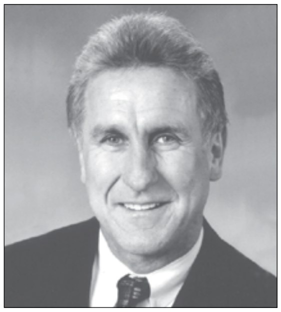
DOMINIC NG
Chairman, President, and
Chief Executive Officer
East West Bank
Pasadena, California

LYNN A. PIKE
President, California and
Business Banking
Bank of America
Los Angeles, California

ANDREW J. SALE
Partner, Media and Entertainment
Leader – Pacific Southwest Area
Ernst & Young LLP
Los Angeles, California

ANITA SANTIAGO
Chief Executive Officer
Anita Santiago Advertising
Santa Monica, California

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



PETER M. THOMAS
Managing Partner
Thomas & Mack Co.
Las Vegas, Nevada

Portland Board of Directors

As of January 1, 2007*

Chairman of the Board

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

DAVID Y. CHEN
Partner
OVP Venture Partners
Portland, Oregon

ALAN V. JOHNSON
Regional President
Wells Fargo Bank
Portland, Oregon

GEORGE J. PUENTES
President
Don Pancho Authentic Mexican
Foods, Inc.
Salem, Oregon

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

WILLIAM D. THORNDIKE JR.
Chairman and President
Medford Fabrication
Medford, Oregon

* Reflects one vacant seat

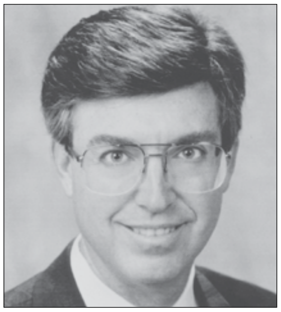
Salt Lake City Board of Directors

As of January 1, 2007

Chairman of the Board

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

A. SCOTT ANDERSON
President and Chief
Executive Officer
Zions Bank
Salt Lake City, Utah



GARY L. CROCKER
Chairman of the Board
Merrimack Pharmaceuticals, Inc.
Salt Lake City, Utah

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

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

MICHAEL M. MOONEY
President
Farmers & Merchants Bank
A Bank of the Cascades Company
Boise, Idaho

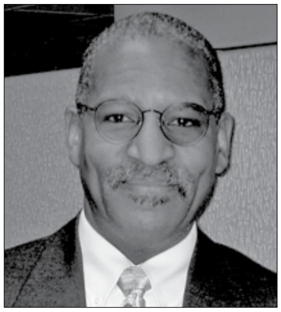
DEBORAH B. NIELSEN
President and Chief
Executive Officer
United Way of Salt Lake
Salt Lake City, Utah

Seattle Board of Directors

As of January 1, 2007*

Chairman of the Board

MIC R. DINSMORE
Chief Executive Officer
Port of Seattle
Seattle, Washington



JAMES R. GILL
President
Pacific Northwest Title Holding Co.
Seattle, Washington

KENNETH M. KIRKPATRICK
President, Washington State
U.S. Bank
Seattle, Washington

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

H. STEWART PARKER
President and Chief Executive Officer
Targeted Genetics Corporation
Seattle, Washington

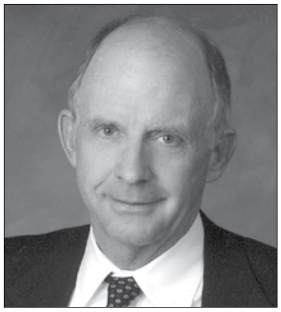
HELVI K. SANDVIK
President and Chief Executive Officer
NANA Development Corp.
Anchorage, Alaska

* Reflects one vacant seat

TWELFTH DISTRICT
ECONOMIC ADVISORY COUNCIL

As of January 1, 2007

Chairman



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

Vice Chairman

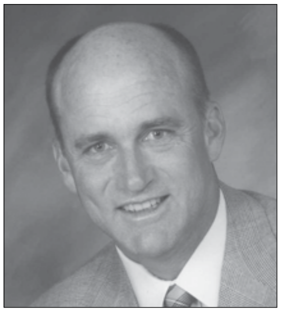
GRACE EVANS CHERASHORE
President and Chief Executive Officer
Evans Hotels
San Diego, California

JOHN P. CONNOLLY
National President
American Federation of Television and Radio Artists
Los Angeles, California

JOHN H. (JACK) GLEASON
Managing Member
Community Planning Advisors, LLC
Paradise Valley, Arizona

CATHY LUKE
President
Loyalty Enterprises, Ltd.
Honolulu, Hawaii

VIVEK PAUL
Partner
Texas Pacific Group
San Francisco, California



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

Bank Officers and Principals

As of December 31, 2006

San Francisco Office

Janet L. Yellen
President and
Chief Executive Officer

John F. Moore
First Vice President and
Chief Operating Officer

John P. Judd
Executive Vice President

Stephen M. Hoffman Jr.
Senior Vice President

Glenn Rudebusch
Senior Vice President

Susan A. Sutherland
Senior Vice President

John C. Williams
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

Donald R. Lieb
Group Vice President and
Chief Financial Officer

Sharon A. Ruth
Group Vice President and
General Counsel

Deborah S. Smyth
Group Vice President

David W. Walker
Group Vice President
and Deputy

Patricia A. Welch
Group Vice President

Randall B. Balducci
Vice President

Barbara A. Bennett
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 and
Managing Director

Robert E. Kellar
Vice President

Ann Marie Kohlligian
Vice President and
Managing Director

Gopa Kumar
Vice President

Simon H. Kwan
Vice President

Darren S. Post
Vice President

Mark M. Spiegel
Vice President

Kevin C. Alecca
Director

Philip A. Aquilino
Director

Thomas A. Ballantyne
Director

Tracy A. Basinger
Director

Kenneth R. Binning
Director

Richard K. Cabral
Director

James J. Callahan
Director

Thomas M. Cunningham III
Director

Jackie C. Hicks
Director

Donna Leung
Director

Joe A. Lozano
Director

Rick A. Miller
Director

Frederic P. Minardi
Director

Richard A. Naylor II
Director

David E. Reiser
Director

John D. Richards
Director

William O. Riley
Director

Carl M. Segall
Director

David G. Tresmontan
Director

Roxana R. Tsougarakis
Director

Paulette M. Wallace
Director

Mary Wujek
Director

Kevin E. Zerbe
Director

Judith R. W. Goff
Research Advisor

Eric T. Swanson
Research Advisor

Bharat Trehan
Research Advisor

Robert G. Valletta
Research Advisor

Erik Z. Revai
Associate General Counsel

Terry S. Schwakopf
Senior Principal

Stanley M. Crisp
Principal

Nancy S. Emerson
Principal

Bonita G. Jones
Principal

Maureen E. O'Byrne
Principal

Peggy L. Speck
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

Philip B. Johnson
Director

Robert C. Johnson
Director

Steven E. Jung
Director

Howard Ng
Director

Robin A. Rockwood
Director

Dale L. Vaughan
Director

Marla E. Borowski
Principal

Dana R. Green
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

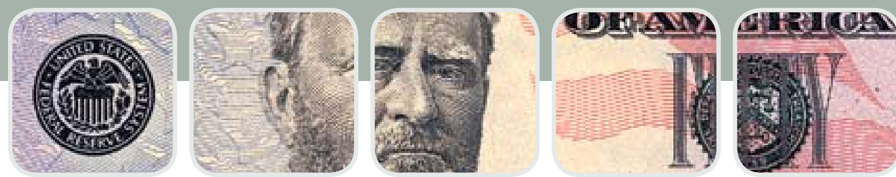
Seattle Branch

Mark A. Gould
Senior Vice President

Lynn M. Jorgensen
Director

Darlene R. Wilczynski
Director

Highlights of 2006



First Quarter

- The Board of Governors approves Cash Recirculation Policy, which reduces "cross-shipping" by providing incentives for depository institutions to recirculate fit currency.
- Economic Research holds annual "Labor Markets and the Economy" macro conference.
- The Portland Branch successfully moves to a leased facility, following the consolidation of its check and cash operations to the Seattle Branch in late 2005.
- Construction begins for the new Seattle Branch building in Renton, Washington, which is slated for full occupancy in early 2008.
- 600 participants attend the biennial national interagency Community Reinvestment Act conference coordinated by Community Development.

Second Quarter

- The Cash Product Office announces the second phase of the Cash Infrastructure Initiative, which continues cash processing at the El Paso and Helena Branches and will establish a cash depot in Omaha, which will be serviced by the Kansas City Fed in 2008.
- The Center for Pacific Basin Studies co-sponsors the annual World Bank Institute Global Seminar for Senior Policymakers on "International Capital Flows, Monetary Policy, and Current Issues in International Finance" and sponsors the "Safe and Sound Banking" conference.
- Banking Supervision and Regulation launches AsiaSource—a website on frbsf.org that serves as the gateway to the Bank's publicly available information on Asia.

Third Quarter

- The Bank sells the Portland Branch building, which served the region for 55 years.
- The Cash Product Office launches the Custodial Inventory program—a component of the Recirculation Policy that allows qualifying depository institutions to convert a portion of the cash balances in their vaults into reserve account balances that can be easily invested.
- Community Development contributes to the implementation of "Bank on San Francisco," a program developed by the San Francisco mayor's and treasurer's offices to help San Franciscans with low incomes and credit problems open bank accounts as an alternative to costly check-cashing services.

Fourth Quarter

- The Center for the Study of Innovation and Productivity holds the "Financial Innovations and the Real Economy" conference.
- Public Information acquires a license to promote and implement the International Economic Summit program and curriculum throughout the Twelfth District—including providing teacher training and student materials directly to participating high schools.
- Substitute check volume from Check 21 legislation swells from close to 60,000 checks printed per month in January 2005 to over 18 million per month at year-end 2006.
- The Twelfth District's check processing revenue from local accounts exceeds its annual target by $10.8 million, or 26.4 percent.

Summary of Operations

	(volume in thousands)	
	2006	**2005**
Cash Services		
Currency notes paid into circulation	6,386,119	6,340,868
Unfit currency destroyed *(bundles)*	1,065	1,092
Coin bags paid into circulation	1,836	1,783
Check Services		
Paper Checks		
Commercial checks processed	1,137,009	1,300,371
Return checks processed	20,034	23,152
Check 21		
Commercial checks processed	269,204	56,480
Return checks processed	16,636	4,707
Discounts and Advances		
Total discounts and transactions*	337	367
Number of financial institutions accommodated*	77	81

* *Whole numbers (not in thousands)*

Financial Reports
2006

Auditor Independence

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

FEDERAL RESERVE BANK OF SAN FRANCISCO
101 MARKET STREET, SAN FRANCISCO, CALIFORNIA 94105

March 5, 2007

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

The management of the 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.

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

Federal Reserve Bank of San Francisco

Janet L. Yellen	John F. Moore	Donald R. Lieb
By Janet L. Yellen President	By John F. Moore First Vice President	By Donald R. Lieb Chief Financial Officer

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Three Embarcadero Center
San Francisco CA 94111-4004
Telephone (415) 498 5000
Facsimile (415) 498 7100

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

Financial statements

We have audited the accompanying statements of condition of the Federal Reserve Bank of San Francisco (the "Bank") as of December 31, 2006 and 2005, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

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

(continued on next page)

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Three Embarcadero Center
San Francisco CA 94111-4004
Telephone (415) 498 5000
Facsimile (415) 498 7100

Internal control over financial reporting

Also, in our opinion, management's assessment, included in the accompanying Management's report on Internal Control Over Financial Reporting, that the Bank maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Bank maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Bank's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Bank's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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

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

PricewaterhouseCoopers LLP
San Francisco, CA
March 12, 2007

Statements of Condition

As of December 31, 2006 and December 31, 2005 (in millions)

Assets	**2006**	**2005**
Gold certificates	$ 1,242	$ 1,172
Special drawing rights certificates	234	234
Coin	116	94
Items in process of collection	884	834
Loans to depository institutions	1	5
U.S. government securities, net	86,739	76,066
Investments denominated in foreign currencies	2,089	2,062
Accrued interest receivable	744	591
Interdistrict settlement account	7,414	19,327
Bank premises and equipment, net	227	209
Other assets	27	35
Total assets	$ 99,717	$ 100,629

Liabilities and Capital		
Liabilities:		
Federal Reserve notes outstanding, net	$ 91,138	$ 91,694
Securities sold under agreements to repurchase	3,278	3,093
Deposits:		
Depository institutions	1,741	2,153
Other deposits	5	4
Deferred credit items	749	830
Interest on Federal Reserve notes due to U.S. Treasury	200	74
Accrued benefit costs	93	71
Other liabilities	19	12
Total liabilities	97,223	97,931
Capital:		
Capital paid-in	$ 1,247	1,349
Surplus (including accumulated other comprehensive loss of $21 million at December 31, 2006)	1,247	1,349
Total capital	2,494	2,698
Total liabilities and capital	$ 99,717	$ 100,629

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

Statements of Income

For the years ended December 31, 2006 and December 31, 2005 (in millions)

	2006	2005
Interest income:		
Interest on U.S. government securities	$ 3,811	$ 2,775
Interest on investments denominated in foreign currencies	38	31
Total interest income	3,849	2,806
Interest expense:		
Interest expense on securities sold under agreements to repurchase	146	80
Net interest income	$ 3,703	2,726
Other operating income (loss):		
Compensation received for services provided	$ 59	59
Reimbursable services to government agencies	14	15
Foreign currency gains (losses), net	121	(301)
Other income	18	11
Total other operating income (loss)	$ 212	(216)
Operating expenses:		
Salaries and other benefits	$ 181	174
Occupancy expense	18	18
Equipment expense	18	18
Assessments by the Board of Governors	103	93
Other expenses	75	65
Total operating expenses	395	368
Net income prior to distribution	$ 3,520	$ 2,142
Distribution of net income:		
Dividends paid to member banks	$ 80	$ 80
Transferred (from) to surplus	(81)	66
Payments to U.S. Treasury as interest on Federal Reserve notes	3,521	1,996
Total distribution	$ 3,520	$ 2,142

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

Statements of Changes in Capital

For the years ended December 31, 2006 and December 31, 2005 (in millions)

		Surplus			
	Capital Paid-In	**Net Income Retained**	**Accumulated Other Comprehensive Loss**	**Total Surplus**	**Total Capital**
Balance at January 1, 2005 (26 million shares)	$ 1,283	$ 1,283	$ –	$ 1,283	$ 2,566
Net change in capital stock issued (1 million shares)	66	–	–	–	66
Transferred to surplus	–	66	–	66	66
Balance at December 31, 2005 (27 million shares)	$ 1,349	$ 1,349	$ –	$ 1,349	$ 2,698
Net change in capital stock redeemed (2 million shares)	(102)	–	–	–	(102)
Transferred from surplus	–	(81)	–	(81)	(81)
Adjustment to initially apply FASB Statement No. 158	–	–	(21)	(21)	(21)
Balance at December 31, 2006 (25 million shares)	$ 1,247	$ 1,268	$ (21)	$ 1,247	$ 2,494

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 one of the twelve Reserve Banks ("Reserve Banks") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act"), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branches in Los Angeles, California, Portland, Oregon, Salt Lake City, Utah and Seattle, Washington serve 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; 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. The Reserve Banks also provide certain services to foreign central banks, governments, and international official institutions.

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

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward

Notes to Financial Statements

foreign exchange ("FX") and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements ("FX swaps") with two central banks and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks. In connection with its foreign currency activities, the FRBNY may enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

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

Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include: Statistics and Reserves and Central Business Application Function, Check Automation Services, Check Adjustment National Management, National Incident Response Team, Check Restructuring, Cash Product Office, Internet Technologies–Cash, Long Term Cash Initiatives, Offsite Storage Locations–Cash, and Shared IT Software Support.

During 2005, the Federal Reserve Bank of Atlanta ("FRBA") was assigned the overall responsibility for managing the Reserve Banks' provision of check services to depository institutions, and, as a result, recognizes total System check revenue on its Statements of Income. Because the other eleven Reserve Banks incur costs to provide check services, a policy was adopted by the Reserve Banks in 2005 that required that the FRBA compensate the other Reserve Banks for costs incurred to provide check services. In 2006 this policy was extended to the ACH services, which are managed by the FRBA, as well as to Fedwire funds transfer and securities transfer services, which are managed by the FRBNY. The FRBA and the FRBNY compensate the other Reserve Banks for the costs incurred to provide these services. This compensation is reported as a component of "Compensation received for services provided," and the Bank would have reported $60 million as compensation received for services provided had this policy been in place in 2005 for ACH, Fedwire funds transfer, and securities transfer services.

3. Significant Accounting Policies

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

Differences exist between the accounting principles and practices in the Financial Accounting Manual and generally accepted accounting principles in the United States ("GAAP"), primarily due to the unique nature of the Bank's powers and responsibilities as part of the nation's central bank. The primary difference is the presentation of all securities holdings at amortized cost, rather than using the fair value presentation required by GAAP. Amortized cost more appropriately reflects the Bank's securities holdings given its unique responsibility to conduct monetary policy.

Notes to Financial Statements

While the application of current market prices to the securities holdings may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Bank earnings or capital. Both the domestic and foreign components of the SOMA portfolio may involve transactions that result in gains or losses when holdings are sold prior to maturity. Decisions regarding securities and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such securities and currencies are incidental to the open market operations and do not motivate decisions related to policy or open market activities.

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

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

a. Gold and Special Drawing Rights Certificates

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

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

SDR certificates are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDR certificates serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates somewhat like gold certificates, to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. There were no SDR transactions in 2006 or 2005.

b. Loans to Depository Institutions

Depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of the

Notes to Financial Statements

Reserve Bank. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Outstanding loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Bank, subject to review and determination by the Board of Governors.

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

U.S. government securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Interest income is accrued on a straight-line basis. Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency gains (losses), net" in the Statements of Income.

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

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

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

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

Activity related to securities sold under agreements to repurchase and securities lending is allocated to each of the Reserve Banks on a percentage basis derived from the annual settlement of interdistrict clearings. Securities purchased under agreements to resell are allocated to FRBNY and not allocated to the other Reserve Banks.

e. FX Swap Arrangements and Warehousing Agreements

FX swap arrangements are contractual agreements between two parties, the FRBNY and an authorized foreign central bank, to exchange specified currencies, at a specified price, on a specified date. The parties agree to exchange their currencies up to a prearranged maximum amount and for an agreed-upon period of time (up to twelve months), at an agreed-upon interest rate. These arrangements give the FOMC temporary access to the foreign currencies it may need to intervene to support the dollar and give the authorized foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the FX swap arrangements can be initiated by either party acting as drawer, and must be agreed to by the drawee party. The FX swap arrangements are structured so that the party initiating the transaction bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an FX swap arrangement in interest-bearing instruments.

Notes to Financial Statements

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the U.S. Treasury, U.S. dollars for foreign currencies held by the U.S. Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the U.S. Treasury and ESF for financing purchases of foreign currencies and related international operations.

FX swap arrangements and warehousing agreements are revalued daily at current market exchange rates. Activity related to these agreements, with the exception of the unrealized gains and losses resulting from the daily revaluation, is allocated to each Reserve Bank based on the ratio of each Reserve Bank's capital and surplus to aggregate capital and surplus at the preceding December 31. Unrealized gains and losses resulting from the daily revaluation are allocated to FRBNY and not allocated to the other Reserve Banks.

f. Bank Premises, Equipment, and Software

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

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

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

g. Interdistrict Settlement Account

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

h. Federal Reserve Notes

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

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

Notes to Financial Statements

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

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the currency issued to the Bank but not in circulation, of $23,787 million and, $19,391 million at December 31, 2006, and 2005, 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. By law, each Reserve Bank is required to pay each member bank an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

k. Surplus

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

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

l. Interest on Federal Reserve Notes

The Board of Governors requires the Reserve Banks to 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 a component of "Payments to U.S. Treasury as interest on Federal Reserve notes" in the Statements of Income and is reported as a liability in the Statements of Condition. Weekly payments to the U.S. Treasury may vary significantly.

Notes to Financial Statements

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

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

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

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

n. 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 previous year. The Board of Governors also assesses each Reserve Bank for the expenses incurred for the U.S. Treasury to issue and retire Federal Reserve notes based on each Reserve Bank's share of the number of notes comprising the System's net liability for Federal Reserve notes on December 31 of the previous year.

o. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were $3 million for each of the years ended December 31, 2006 and 2005, and are reported as a component of "Occupancy expense."

p. Restructuring Charges

In 2003, the Reserve Banks began the restructuring of several operations, primarily check, cash, and U.S. Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in some locations. These restructuring activities continued in 2004 through 2006.

Note 11 describes the restructuring and provides information about the Bank's costs and liabilities associated with employee separations and contract terminations. The costs associated with the impairment of certain of the Bank's assets are discussed in Note 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all of the Reserve Banks are recorded on the books of the FRBNY. Costs and liabilities associated with enhanced post-retirement benefits are discussed in Note 9.

q. Implementation of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans

The Bank initially applied the provisions of FASB Statement No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, at December 31, 2006. This accounting standard requires recognition of the overfunded or underfunded status of a defined benefit postretirement plan in the Statements of Condition, and recognition of changes in the funded status in the years in which the changes occur through comprehensive income. The transition rules for implementing the standard require applying the provisions as of the end of the year of initial implementation with no retrospective application. The incremental effects on the line items in the Statement of Condition at December 31, 2006, were as follows (in millions):

Notes to Financial Statements

	Before Application of Statement 158	Adjustments	After Application of Statement 158
Accrued benefit costs	72	21	93
Total liabilities	$ 97,202	$ 21	$ 97,223
Surplus	1,268	(21)	1,247
Total capital	$ 2,515	$ (21)	$ 2,494

4. U.S. Government Securities, 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 11.069 percent and 10.139 percent at December 31, 2006 and 2005, respectively.

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

	2006	2005
Par value:		
U.S. government:		
Bills	$ 30,663	$ 27,505
Notes	44,538	38,542
Bonds	11,017	9,412
Total par value	86,218	75,459
Unamortized premiums	964	893
Unaccreted discounts	(443)	(286)
Total allocated to the Bank	$ 86,739	$ 76,066

At December 31, 2006 and 2005, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was $88,098 million and $77,817 million, respectively, as determined by reference to quoted prices for identical securities.

The total of the U.S. government securities, net, held in the SOMA was $783,619 million and $750,202 million at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, the fair value of the U.S. government securities held in the SOMA, excluding accrued interest, was $795,900 million and $767,472 million, respectively, as determined by reference to quoted prices for identical securities.

Notes to Financial Statements

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

At December 31, 2006 and 2005, the total contract amount of securities sold under agreements to repurchase was $29,615 million and $30,505 million, respectively, of which $3,278 million and $3,093 million were allocated to the Bank. The total par value of the SOMA securities that were pledged for securities sold under agreements to repurchase at December 31, 2006 and 2005 was $29,676 million and $30,559 million, respectively, of which $3,285 million and $3,098 million was allocated to the Bank. The contract amount for securities sold under agreements to repurchase approximates fair value.

The maturity distribution of U.S. government securities bought outright, and securities sold under agreements to repurchase, that were allocated to the Bank at December 31, 2006, was as follows (in millions):

	U.S. Government Securities (Par value)	Securities Sold Under Agreement to Repurchase (Contract Amount)
Within 15 days	$ 4,493	$ 3,278
16 days to 90 days	20,023	–
91 days to 1 year	20,492	–
Over 1 year to 5 years	24,814	–
Over 5 years to 10 years	7,488	–
Over 10 years	8,908	–
Total allocated to the Bank	$ 86,218	$ 3,278

At December 31, 2006 and 2005, U.S. government securities with par values of $6,855 million and $3,776 million, respectively, were loaned from the SOMA, of which $759 million and $383 million, respectively, were allocated to the Bank.

5. Investments Denominated in Foreign Currencies

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

The Bank's allocated share of investments denominated in foreign currencies was approximately 10.200 percent and 10.896 percent at December 31, 2006 and 2005, respectively.

Notes to Financial Statements

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):

	2006	2005
European Union Euro:		
Foreign currency deposits	$ 637	$ 591
Securities purchased under agreements to resell	226	210
Government debt instruments	415	388
Japanese Yen:		
Foreign currency deposits	265	285
Government debt instruments	546	588
Total allocated to the Bank	$ 2,089	$ 2,062

At December 31, 2006 and 2005, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was $2,084 million and $2,066 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as a central bank, to meet its financial obligations and responsibilities.

Total System investments denominated in foreign currencies were $20,482 million and $18,928 million at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, the fair value of the total System investments denominated in foreign currencies, including accrued interest, was $20,434 million and $18,965 million, respectively.

The maturity distribution of investments denominated in foreign currencies that were allocated to the Bank at December 31, 2006, was as follows (in millions):

	European Euro	Japanese Yen	Total
Within 15 days	$ 445	$ 265	$ 710
16 days to 90 days	242	123	365
91 days to 1 year	249	226	475
Over 1 year to 5 years	342	197	539
Over 5 years to 10 years	–	–	–
Over 10 years	–	–	–
Total allocated to the Bank	$ 1,278	$ 811	$ 2,089

At December 31, 2006 and 2005, there were no material open foreign exchange contracts.

At December 31, 2006 and 2005, the warehousing facility was $5,000 million, with no balance outstanding.

Notes to Financial Statements

6. Bank Premises, Equipment, and Software

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

	2006	2005
Bank premises and equipment:		
Land	$ 36	$ 29
Buildings	183	189
Building machinery and equipment	42	44
Construction in progress	28	6
Furniture and equipment	113	116
Subtotal	402	384
Accumulated depreciation	(175)	(175)
Bank premises and equipment, net	$ 227	$ 209
Depreciation expense, for the year ended December 31	$ 15	$ 15

Capitalized 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 $2 million and $1 million for the years ended December 31, 2006 and 2005, respectively, and is reported as a component of "Other income". Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2006, are as follows (in millions):

2007	$ 1.6
2008	1.6
2009	1.2
2010	1.0
2011	1.1
Thereafter	3.2
Total	$ 9.7

The Bank has capitalized software assets, net of amortization, of $7 million and $8 million at December 31, 2006 and 2005, respectively. Amortization expense was $4 million and $5 million for the years ended December 31, 2006 and 2005, respectively. 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 11, include processing equipment. Asset impairment losses of $1 million and $326 thousand for the periods ending December 31, 2006 and 2005, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

Notes to Financial Statements

7. Commitments and Contingencies

At December 31, 2006, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from 2 to approximately 7 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 and $475 thousand for the years ended December 31, 2006 and 2005, respectively. Certain of the Bank's leases have options to renew.

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

	Operating
2007	$ 0.6
2008	0.7
2009	0.8
2010	0.6
2011	0.4
Thereafter	0.8
Future minimum rental payments	$ 3.9

At December 31, 2006, the Bank, acting on behalf of the Reserve Banks, had contractual commitments extending through the year 2017 with a remaining amount of $291 million. As of December 31, 2006, none of these commitments was recognized. Purchases of $26 million and $31 million were made against these commitments during 2006 and 2005, respectively. It is estimated that the Bank's allocated share of these commitments will be $50 million. These commitments represent maintenance of currency processing machines and have variable and fixed components. The variable portion of the commitment includes an adjustment for machine shifts added or deleted during the year. The fixed payments for the next five years under these commitments are as follows (in millions):

	Fixed Commitment
2007	$ –
2008	27
2009	26
2010	28
2011	28

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

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

8. Retirement and Thrift Plans

Retirement Plans

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

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

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

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $7 million and $6 million for the years ended December 31, 2006 and 2005, respectively, and are reported as a component of "Salaries and other benefits" in the Statements of Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2006 and 2005, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

9. Postretirement Benefits Other Than Pensions and Postemployment 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 beginning and ending balances of the benefit obligation (in millions):

	2006	**2005**
Accumulated postretirement benefit obligation at January 1	$ 59.5	$ 62.5
Service cost-benefits earned during the period	2.0	1.5
Interest cost on accumulated benefit obligation	3.6	3.1
Actuarial loss (gain)	8.1	(3.6)
Contributions by plan participants	1.1	1.1
Benefits paid	(5.3)	(5.1)
Plan amendments	6.2	–
Accumulated postretirement benefit obligation at December 31	$ 75.2	$ 59.5

Notes to Financial Statements

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

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

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

	2006	2005
Fair value of plan assets at January 1	$ –	$ –
Contributions by the employer	4.2	4.0
Contributions by plan participants	1.1	1.1
Benefits paid	(5.3)	(5.1)
Fair value of plan assets at December 31	$ –	$ –
Unfunded postretirement benefit obligation	$ 75.2	$ 59.5
Unrecognized prior service cost		6.7
Unrecognized net actuarial loss		(13.4)
Accrued postretirement benefit cost		$ 52.8
Amounts included in accumulated other comprehensive loss are shown below (in millions):		
Net actuarial loss	$ (20.8)	
Total accumulated other comprehensive loss	$ (20.8)	

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:

	2006	2005
Health care cost trend rate assumed for next year	9.00%	9.00%
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	2012	2011

Notes to Financial Statements

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, 2006 (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)
Effect on accumulated postretirement benefit obligation	0.9	(1.0)

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

	2006	2005
Service cost-benefits earned during the period	$ 2.0	$ 1.5
Interest cost on accumulated benefit obligation	3.6	3.1
Amortization of prior service cost	(0.5)	(1.6)
Recognized net actuarial loss	0.7	0.4
Net periodic postretirement benefit expense	$ 5.8	$ 3.4

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

Prior service cost	$ (0.5)
Actuarial loss	1.8
Total	$ 1.3

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

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

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

Notes to Financial Statements

There were no receipts of federal Medicare subsidies in the year ended December 31, 2006. Expected receipts in the year ending December 31, 2007, related to payments made in the year ended December 31, 2006, are $220 thousand.

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

	Without Subsidy	With Subsidy
2007	$ 4.8	$ 4.5
2008	5.2	4.8
2009	5.5	5.2
2010	5.8	5.5
2011	6.2	5.7
2012-2016	34.3	31.6
Total	$ 61.8	$ 57.3

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 $16 million for each of the years ended December 31, 2006 and 2005. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2006 and 2005 operating expenses were $2 million and $4 million, respectively, and are recorded as a component of "Salaries and other benefits" in the Statements of Income.

10. Accumulated Other Comprehensive Income

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

	Amount Related to Postretirement Benefits other than Pensions
Balance at December 31, 2005	$ –
Adjustment to initially apply FASB Statement No. 158	(21)
Balance at December 31, 2006	$ (21)

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

11. Business Restructuring Charges

In 2004, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2005 and 2006, additional consolidation and restructuring initiatives were announced in the cash and check operations. These actions resulted in the following business restructuring charges (in millions):

	Total Estimated Costs	Accrued Liability December 31, 2005	Year ended 12/31/2006 Total Charges	Year ended 12/31/2006 Total Paid	Accrued Liability December 31, 2006
Employee separation	$ 6.5	$ 0.6	$ 1.7	$ 0.6	$ 1.7
Other	0.1	–	–	–	–
Total	$ 6.6	$ 0.6	$ 1.7	$ 0.6	$ 1.7

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 253 including 55 and 32 staff reductions related to restructuring announced in 2006 and 2005, respectively. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of "Salaries and other benefits" in the Statements of Income. Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Other expenses."

Restructuring costs associated with the impairment of certain Bank assets, including software, buildings, leasehold improvements, furniture, and equipment, are discussed in Note 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in Note 8. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced restructuring plans are estimated at $602 thousand and will be incurred in 2007.

The Bank anticipates substantially completing its announced plans by December 2007.

Learn More

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Cash Counts

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