
# Federal Reserve Bank of San Francisco

2005 Annual Report – Gateway to Asia

## About the Federal Reserve Bank of San Francisco

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.

## Table of Contents




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

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

**George M. Scalise**
Chairman (2005)

**David K.Y. Tang**
Deputy Chairman (2005)
and Chairman (2006)

Not Pictured

**T. Gary Rogers**
Deputy Chairman (2006)

# Message from the President

This year's report looks at Asia and the special connection our District and Reserve Bank have with that part of the world. This is fitting on a number of levels. Most obviously, the global economy increasingly is being shaped by developments in Asia, especially by the rise of China and India, which has captured the world's attention. Because of its location, the Twelfth District serves as America's gateway to Asia, creating strong economic ties and giving us a broad perspective on the region. This important international arena has been a strategic focus for the San Francisco Reserve Bank for many years. Knowledge of the region is critical to understanding trends affecting the Twelfth District and the global economy, as well as the implications for monetary policy and our banking supervision responsibilities.

To advance our commitment to understanding issues, our Bank has two long-established programs devoted to Asia: the Center for Pacific Basin Studies in Economic Research and the Country Analysis Unit in the Banking Supervision area. This report features a series of essays authored by experts from these programs. The first essay provides an overview of current developments in Asia and examines the Twelfth District's economic and banking ties with our Pacific Rim neighbors. The second essay compares the rise of China and India and the challenges they face. Subsequent essays delve into the strategic roles of our own Asia programs and spotlight their areas of expertise with articles covering research related to a series of conferences on the U.S. current account deficit and Asian banking developments in 2005.

Following a long tradition, each year I make at least one trip to Asia. In 2005, I traveled with Federal Reserve Governor Donald Kohn to India, spending time in Mumbai, New Delhi, and Bangalore, which has been called India's "Silicon Valley." We met with senior government and central bank officials, bankers, representatives of U.S. and Indian businesses, academics, and experts from multilateral institutions. These yearly trips advance our broad objective to serve as a repository of expertise on Asia-related economic, banking, and financial issues.

Turning to the operations side of our organization, 2005 was a year of change, challenge, and achievement. The environment in which the Federal Reserve conducts its activities has changed significantly in recent years in response to evolutions in the financial services industry. In 2005, local and national initiatives continued to require workforce restructuring. After processing checks since opening almost 90 years ago, our Salt Lake City and Portland Branches consolidated their processing operations to Denver and Seattle, respectively. In other major transitions, Seattle-Portland check processing moved to leased space and cash operations at the Portland Branch relocated to the Seattle Branch.

In the midst of these transitions, we had numerous achievements. The Portland Branch was selected as one of the Federal Reserve's five check adjustments sites, and our Cash Product Office coordinated the

Federal Reserve's national response to Hurricane Katrina to restore cash services to impacted areas. These and other milestones are chronicled in the Highlights of 2005 section in this report.

I recognize that numerous transitions in 2005 had a significant personal toll for employees, especially for those who were displaced after many years of service. Despite the challenges, they worked with commitment and professionalism. I would like to take this opportunity to acknowledge their dedication and service, as well as the ongoing commitment and contributions of other employees to our organization.

I also would like to extend our thanks and appreciation to our Twelfth District directors for their invaluable counsel during 2005. The directors' independent assessment of economic and financial conditions throughout our nine western states is critical to the formulation of monetary policy.

In particular, I want to acknowledge the many contributions to the Bank and to the Federal Reserve System of retiring Chairman of the Board George M. Scalise, president, Semiconductor Industry Association, San Jose, California. Mr. Scalise completed six years of service to this Reserve Bank, the last two and one-half years serving as its chairman, preceded by two and one-half years as its deputy chairman. In 2005, Mr. Scalise also served as the chairman of the Federal Reserve System's Conference of Chairmen.

In addition, I would like to express my sincere thanks and appreciation to the other directors and advisory council members who concluded their terms of service during 2005:

- *on the San Francisco Board*: Richard C. Hartnack, who was vice chairman, Union Bank of California, N.A., Los Angeles, California, at the time of his service on our board;

- *on the Los Angeles Branch Board:* Sister Diane Donoghue, executive director, Esperanza Community Housing Corporation, Los Angeles, California;

- *on the Portland Branch Board:* Judi A. Johansen, president and chief executive officer, PacifiCorp, Portland, Oregon; and George J. Passadore, Oregon Region chairman, (retired), Wells Fargo Bank, Portland, Oregon;

- *on the Salt Lake City Branch Board:* H. Roger Boyer, chairman, The Boyer Company, Salt Lake City, Utah, who served as chairman of the Salt Lake City Branch Board the last five years;

- *on the Seattle Branch Board:* Mary E. Pugh, president, Pugh Capital Management, Inc., Seattle, Washington; and

- *on the Twelfth District Advisory Council:* Don M. "Duff" Willey, president, Willey Automotive Group, Bountiful, Utah, who served as chairman of the council the last three years, preceded by three years as its vice chairman; Barbara Bry, chief operating officer, Blackbird Ventures, La Jolla, California; and Paul Ecke, III, president, Paul Ecke Ranch, Encinitas, California.

Janet L. Yellen

Janet L. Yellen
President and Chief Executive Officer


MITSUKOSHI
TAMAYA
京セラ
Number
MIKIMOTO
GINZA Matsushima

# Gateway to Asia

The global economy is increasingly shaped by developments in Asia.[1] Home to nearly two-thirds of the world's population, Asia's share of global gross domestic product (GDP) grew to an estimated 35 percent in 2005, from 25 percent in 1990. In contrast, U.S. GDP as a percentage of world GDP has remained fairly constant over the past 15 years, at about 20 percent.

Asia's growing influence in the United States—economically and culturally—is very apparent in the Federal Reserve's Twelfth District. The nine western states form a geographical gateway to Asia, and because of the close ties, can provide insight into Asian economic and financial developments. The Twelfth District is an attractive destination for trade and investment by Asian companies because of its location. Also, the District's geographical position has contributed to a long and rich history of Asian immigration into the region.

Both Asia and the Twelfth District benefit from this growing interdependence. The western states profit from exports to Asia's booming domestic markets, capital from Asian investors, and an inflow of highly skilled professionals. Asia benefits from the Twelfth District's technology centers, educational institutions, and dynamic financial system. As this relationship becomes closer, Asia's significance to the District's economic vitality grows.

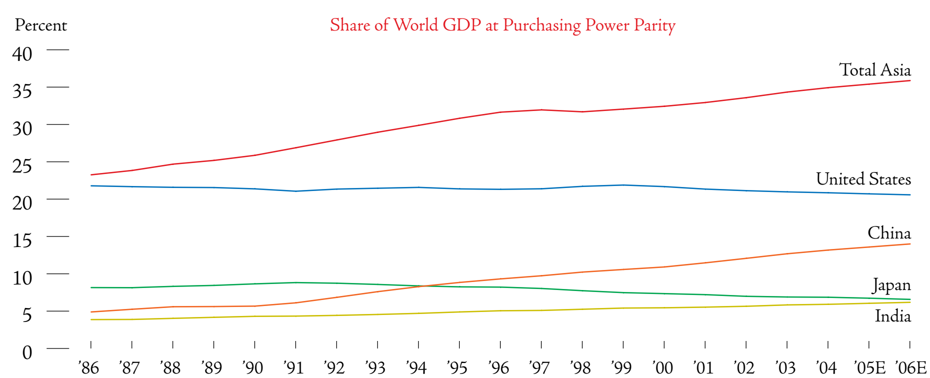
***Three Stories of Asia***

Recent developments in Asia are defined by three stories: the economic recovery in Japan, the rebound from the Asian financial crisis of the late 1990s, and the rise of China's and India's economic importance. In the first story, although Japan has the second largest economy in the world, it has suffered through more than a decade of economic stagnation and steadily weakening corporate and banking sectors. Fortunately, Japan now appears to be exiting from its economic difficulties and experiencing a rebound in property prices, equity markets, and consumer prices.

The second story centers around the countries that suffered most during the Asian financial crisis: Thailand, Indonesia, and South Korea. After the severe financial and economic difficulties that began with the floating of the Thai currency in 1997, these countries implemented a series of structural reforms that have improved the region's economic stability. At present, these three countries each have a solvent, growing banking system and a GDP that exceeds pre-crisis levels.

The third story, which is the topic of many recent headlines, is the rise of China and India. These two

**Asia's rising share of global GDP is largely due to China's strong economic performance**




Source: International Monetary Fund, World Economic Outlook Database countries, with a combined population of 2.3 billion, have exhibited dramatic growth, mainly due to a well-educated, plentiful workforce and a low-cost wage structure. China and India have captured the world's attention with their rapid economic growth rates, burgeoning populations, and significant impacts on global trade. Many analysts predict that, as these two economies continue to grow, they will eventually overtake the economies of Europe and the United States. One study projects that China's economy will surpass the economies of Japan and the United States by the middle of the twenty-first century, while India will overtake the major European economies within the next 20 years.[2] However, the dominance of China and India is by no means assured; both countries face significant socioeconomic hurdles that could derail their progress.

### *Growing Trade*

Trade ties between Asia and the Twelfth District are close. In 2004, 44 percent of all the District's exports went to Asia, approaching twice the national average of 26 percent. Hawaii sent 73 percent of its exports to Asia in 2004, Alaska 68 percent, and California 43 percent. Except for Nevada, every state in the District ships a higher percentage of its exports to Asia than the national average. Merchandise exports from the Twelfth District to Asia consist primarily of information technology (IT) goods, non-high-tech durables such as consumer electronics, and nondurables such as food. Japan is both the largest investor and the largest export market for the District; however, trade with China and India is growing rapidly.

### *The Technology Connection*

The Twelfth District's large IT sector has clearly benefited from a connection to Asia. Highly skilled workers from Asia occupy prominent positions in many IT firms in the District. Indians, Chinese, and Taiwanese have established the most significant presence, especially in Silicon Valley. Similarly, the Twelfth District has influenced Asia's booming IT industry. Many Asians have taken the skills and expertise they acquired in the United States to start companies back home. This is particularly true in Taiwan and China, where Silicon Valley alumni have played important roles in developing the IT industry. Recently, venture capital and private equity firms from the Twelfth District have been financing young IT firms in Asia, with China and India attracting the greatest interest.

Japan is both the largest investor and the largest export market for the District; however, trade with China and India is growing rapidly.

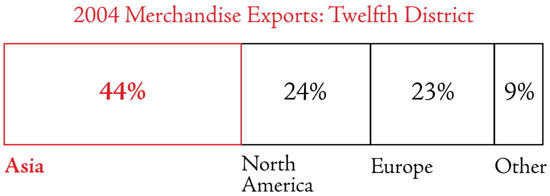
### *Asian Banking Presence*

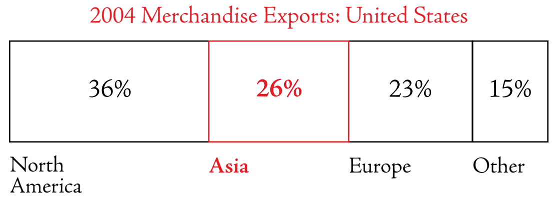
The Federal Reserve Bank of San Francisco takes a special interest in the growing presence of Asian-related banks in the Twelfth District because its banking supervision responsibilities for foreign banks are primarily tied to Asia. Over the past several years, the number of banks catering primarily to local Asian immigrants has increased significantly. These banks help serve the financial needs of individuals and small firms in the local Asian communities in the District. About 45 percent of the country's Asian American-owned banks are headquartered in the Twelfth District; these banks hold $25 billion in assets and account for nearly three-quarters of total Asian American-owned bank assets in the country. Twenty-two of the District's Asian American banks are headquartered in California, four are in Hawaii, and two are in Washington. The District also is home to branches and subsidiaries of 33 banks headquartered in Asia, with local assets of $123 billion. These branches and subsidiaries primarily facilitate transactions for companies in their home countries.

1. For this discussion, Asia is defined as Bangladesh, Bhutan, Cambodia, China, Hong Kong, India, Indonesia, Japan, Lao People's Democratic Republic, Malaysia, Maldives, Myanmar, Nepal, Pakistan, Philippines, Singapore, South Korea, Sri Lanka, Taiwan, Thailand, and Vietnam.

2. Goldman Sachs. 2003. "Dreaming with BRICs: The Path to 2050," *Global Economic Paper No. 99.* October 1.

**Merchandise exports from the Twelfth District to Asia approached twice the national average in 2004**




Sources: U.S. Department of Commerce: Tradestats Express; FRBSF

## India's Silicon Valley

Since Indians and Americans of Indian origin have played a significant role in the development of the Twelfth District's IT industry, it's not surprising that a version of Silicon Valley has formed in India. Centered in the south Indian city of Bangalore, India's IT industry is enjoying rapid growth and making a significant impact on the global technology scene. While other Asian nations have developed large electronics hardware industries, only India boasts a deep, globally competitive software sector.

Staffed by a highly skilled, English-speaking, and low-wage workforce, Indian software firms have enjoyed extraordinary growth. Industry revenues have increased more than fivefold—from $5 billion to $28.5 billion from fiscal year-end 1998 to 2005. While IT revenues account for approximately 4 percent of India's GDP, the IT sector boosts the country's larger economy by creating indirect employment, spurring reform, and increasing investors' interest in India. Subsidiaries and branches of Western-owned multinationals control much of the Indian IT sector, but top Indian-owned firms are growing fast and attracting international recognition. Indian companies also are increasingly opening offices and acquiring firms in the United States.

Prospects for India's IT sector remain bright. Despite problems posed by rapidly rising wages, skilled labor shortages, and weak infrastructure, local firms' capabilities continue to develop. Firms now are moving beyond low value-added services such as coding and programming to offer high-margin consultancy and research and development services in areas such as finance, pharmaceuticals, and technology. One study forecasts Indian IT revenues will continue to boom, rising at a 38 percent compound annual rate to reach $77 billion by 2008.[1] In this scenario, IT's contribution to India's GDP could rise to 20 percent.

1. Carl Dahlman and Anuja Utz. 2005. "India and the Knowledge Economy: Leveraging Strengths and Opportunities." Knowledge for Development Program, World Bank Institute. April.

# A Tale of Two Giants: Comparing China and India

Accounting for 40 percent of the world's population and almost 20 percent of the world's output, China and India are two of Asia's—indeed, the world's—economic giants. In addition to their size, these countries have other traits in common. Both are among the fastest-growing economies in the world, and both are transitioning from heavily state-controlled and regulated economies to more market-based economic systems.

Although both countries are experiencing rapid economic transformations, there are significant differences in the ascent of each region. China's reforms started some 25 years ago in response to the failures of Maoist economic policies. Since then, its economy has recorded a phenomenal average annual growth rate of better than 9 percent. India's reforms began in 1991, triggered by a fiscal budget and balance of payments crisis. Its average annual growth rate over that period has been closer to 6 percent. The sources of this difference in growth performance may be found in some key differences between the two countries. For example, China's higher rate of saving has enabled domestic investment of 35 to 40 percent of its GDP, while India's investment rate is about half that.

China and India have taken different paths to economic growth and development. China's growth strategy, like that of its East Asian neighbors, has involved the expansion of labor-intensive manufacturing, such as textiles and consumer goods, to take advantage of an abundant supply of labor. India's emphasis on protecting workers and small-scale businesses has paradoxically limited the scale of growth of its manufacturing sector. Consequently, the relatively less-regulated service sector has been the growth engine of India's economy. The service sector now accounts for over 50 percent of India's output, much higher than the norm for developing economies. India's most visible example of success is the information technology sector; it has burgeoned because of economic reforms and because of the country's abundance of English-language speakers, strong technical education system, and professional talent with programming and managerial experience.

In terms of global trade, China is a much bigger player—its exports and imports of goods amount to about 50 percent of its GDP, compared to around 20 to 30 percent for India. China has experienced huge foreign direct investment inflows. Until recently, India has been much less interested in attracting foreign capital and therefore, less successful. China spends substantially more on infrastructure than India. China's public finances are in better shape than India's finances: India's consolidated fiscal deficit is running at 8 to 9 percent of GDP, one of the highest among developing countries, against less than 3 percent in China. Compared to India, China's labor market has been much more flexible. Labor can move easily from the agricultural sector to the industrial sector, which allows Chinese manufacturers to keep labor costs low. China's overall education level is higher than that of India, with a much higher literacy rate and a larger percentage of children completing primary school. That said, India has a world-class university system that produces a core of well-educated professionals.

China doesn't have the edge in everything. India has a more developed legal system, including more protection of intellectual property rights. India's financial system also is in better shape than China's system. Although both countries have been hampered by the involvement of state-owned banks in directed lending, nonperforming loans are a much smaller problem in India. India's bond and equity markets also are much more efficient.

Each country is seeking to find the right balance of political and economic liberalization to fulfill long-run growth possibilities.

What challenges do China and India face? Each country is seeking to find the right balance of political and economic liberalization to fulfill long-run growth possibilities. Since 1979, China has followed a "full steam ahead" process of economic reform that has emphasized growth, even at the risk of major social upheavals. The country is simultaneously trying to manage the transition from a one-party state to a more popular and responsive political regime that many believe is necessary to deal with China's increasingly sophisticated economy and society. Compared to China, India has followed a more cautious and gradual reform process. India's current coalition government, led by the Indian National Congress Party, is attempting to perform a difficult balancing act of maintaining the progress of economic reform while keeping its promise to reduce the grinding poverty that still afflicts the majority of its population. To close the gap with China, India must address infrastructure problems and make its labor markets more flexible.

# Federal Reserve Bank of San Francisco Asia Programs

Because of the strong ties between the Twelfth District and Asia, the Federal Reserve Bank of San Francisco has a strategic interest in following and analyzing economic and financial developments in Asia. This contributes to a better understanding of the District's economy and developments that shape the implementation of the Federal Reserve's monetary policy and supervision and regulation of banks. Two programs within the Bank monitor Asia: the Economic Research department's Center for Pacific Basin Studies and Banking Supervision and Regulation's Country Analysis Unit.

## Center for Pacific Basin Studies

The Center for Pacific Basin Studies was established within the Federal Reserve Bank of San Francisco's Economic Research department in 1990; it is the oldest such regional research center in the Federal Reserve System. Its origins date back to 1974, when the Bank initiated its Pacific Basin Program to concentrate on economic issues related to this important international region with close ties to the Twelfth District. The center's mission is to promote cooperation among central banks in the region and enhance public understanding of major Pacific Basin monetary and economic policy issues. The center's staff members conduct basic research and support the Bank's president in the conduct of policy by providing briefings on international economic conditions.

In addition to providing policy support and conducting scholarly conferences in 2005, the center pursued a number of other activities. These included the annual Senior Policymaker Seminar, which the center organizes jointly with the World Bank for leading policymakers from emerging nations in the Pacific Basin and beyond. The center also maintained an extensive visiting scholar program, bringing in economists from the San Francisco Bay Area and other regions to work on Pacific Basin policy issues. In 2006, the center will inaugurate an "Asian visiting scholar" program, aimed at bringing in top visiting scholars from Asia to conduct Pacific Basin research at the Federal Reserve Bank of San Francisco. Information about the center and its research can be found at www.frbsf.org/economics/pbc/index.html.

## Center for Pacific Basin Studies

Front Row, from Left

**Reuven Glick** **Thien Nguyen** **Sylvia Papa** **Mark Spiegel**

Back Row, from Left

**Michele Cavallo** **Ann Lucas** **Diego Valderama** **Jessica Wesley**


## Center for Pacific Basin Studies Takes On the U.S. Current Account Deficit

The U.S. current account balance, which reflects its balance on trade in goods and services, investment income, and unilateral transfers, has deteriorated significantly over the last 15 years. In 1991, it was in surplus. Since then, the current account balance has swelled to a deficit that in 2005 equaled more than 6 percent of GDP, the highest such ratio in at least 40 years. In 2005, the Center for Pacific Basin Studies took on the controversial issue of the large and growing U.S. current account deficit in two scholarly conferences. Exploring this topic was of particular interest both because of its implications for the U.S. economy and because of the important role Asia plays in it, as the United States has traditionally run a large bilateral current account deficit with countries in that region. For example, the bilateral trade deficit with Asia in 2004 accounted for roughly 44 percent of the overall U.S. trade deficit.

In the past, other countries faced worsening borrowing terms, in the form of either reduced borrowing opportunities or increased interest charges, when their current account deficit reached around 5 percent of GDP. By that standard, some would argue that the United States is overdue for such adjustments, which may be accompanied by a fall in the value of the dollar.

This position has been contested by a group of economists who argue that the current pattern is caused by unique conditions, and that continued large U.S. trade deficits need not necessarily lead to a large dollar devaluation. Instead, they envision an environment where the large U.S. current account deficit can continue to be financed by an accumulation of dollar reserves by foreign governments, particularly those in Asia, where a number of national governments have accumulated large stocks of U.S. Treasuries. These economists assert that Asian nations will be willing to accumulate ever-increasing stocks of U.S. assets to maintain export growth in an informal arrangement that mirrors the Bretton Woods system of fixed exchange rates that prevailed internationally in the mid-twentieth century.

Two of the leading proponents of this argument, Michael Dooley of U.C. Santa Cruz and Peter Garber of Deutsche Bank, presented their viewpoints at a symposium sponsored by the Center for Pacific Basin Studies and U.C. Berkeley's Clausen Center for International Business and Policy entitled, "Revived Bretton Woods System: A New Paradigm for Asian Development?" in February 2005. The symposium provided an opportunity for Dooley and Garber to discuss these issues with other experts in the field, a number of whom contended that the U.S. current account deficit is unsustainable for an extended period.[1]

The question of the U.S. current account deficit was revisited in the Center for Pacific Basin Studies annual conference, "External Imbalances and Adjustment in the Pacific Basin," held in September 2005. The conference included a number of scholarly papers examining the U.S. current account deficit and its implications for the U.S. economy going forward, with special attention placed on the prominent role of Asian nations in both the trade and financial issues associated with the large U.S. external imbalances. In one paper, Maurice Obstfeld of U.C. Berkeley and Kenneth Rogoff of Harvard University argued that a major devaluation of the dollar would be required to bring the U.S. current account into balance. In another, Hélène Rey of Princeton University and Pierre-Olivier Gourinchas of U.C. Berkeley argued that the United States would accumulate capital gains in its net international investment position as a result of dollar devaluation, which would mitigate the magnitude of devaluation necessary to achieve current account balance. Other papers also considered issues raised by the continued U.S. current account deficits.[2]

These economists assert that Asian nations will be willing to accumulate ever-increasing stocks of U. S. assets to maintain export growth in an informal arrangement that mirrors the Bretton Woods system of fixed exchange rates that prevailed internationally in the mid-twentieth century.

Going forward, the Center for Pacific Basin Studies will continue to serve as an international resource for research on issues relevant to the Pacific Basin, even potentially controversial topics, such as the role of Asian nations in the U.S. current account deficit. Such topics are crucial to the center's long-standing mission of promoting the understanding of major monetary and economic policy issues in the region.

1. For the symposium agenda and copies of papers presented, see www.frbsf.org/economics/conferences/0502/index.html.

2. For the conference agenda and copies of papers presented, see www.frbsf.org/economics/conferences/0509/agenda.pdf.

## Banking Supervision and Regulation: Country Analysis Unit

The Banking Supervision and Regulation department's Country Analysis Unit closely analyzes Asian financial sector developments to support the Reserve Bank's oversight of the U.S. branches and subsidiaries of 22 Asian banks. Because conditions in home markets can affect these banks' abilities to support their U.S. operations, Reserve Bank staff monitor not only the financial strength of Asian parent banks, but also the quality of Asian bank regulatory systems and the potential impact of broader economic, political, and social trends.

Although much of this research is used internally for supervisory purposes, the unit conducts some activities to benefit the public, in recognition of the tremendous interest in Asian economic and financial developments. The unit's staff deliver presentations to local conferences, and the unit sponsors a speaker series—"The Asia Financial Forum"—that allows local bankers, businesspeople, and regulators to meet specialists outside of the Federal Reserve who focus on Asia. In addition, the unit's *Asia Focus* publication offers concise analyses of selected issues of importance to Asian banks. In 2005, *Asia Focus* examined consumer finance in Japan, foreign investment in Chinese banks, bank reforms in India, and China's housing market. Past and current issues of *Asia Focus* can be found at www.frbsf.org/publications/banking.

## Country Analysis Unit

Left to Right

Richard Naylor | Richard Lung | Susan Chan | Birgit Baxendale | Daniel Fineman | Linda True | Gongpil Choi | Nkechi Carroll

Not Pictured

Arlene Mayeda

## 2005: A Big Year for Asian Banks

This past year saw momentous changes in Asia's banking sector. In China, there was an unprecedented number of investments in local banks by foreign firms. In India, the state-dominated financial sector recognized the potential of the country's vast middle class and sparked a consumer credit expansion. In Japan, seven years of contracting credit ended as bank loans finally started expanding. Across the region, 2005 also will be remembered for the enthusiasm of the consumer, with retail banking driving growth broadly across many Asian banking sectors.

### *China Gold Rush*

China's banking sector saw the most dramatic developments in the region. Before last year, Chinese banks attracted relatively little international attention. The government had been trying to find foreign buyers for minority stakes in the so-called Big Four state-owned commercial banks,[1] but global banks showed little interest given the high risk of purchasing noncontrolling shares in highly troubled lenders.

In 2005, foreign banks began to acquire sizeable stakes in large Chinese banks as a more favorable regulatory environment took hold and investors increasingly recognized the potential of the Chinese banking market. In June, Bank of America agreed to pay $3 billion for 9 percent of the third-largest lender, China Construction Bank, and in August, Royal Bank of Scotland struck a deal to buy 10 percent of second-ranked Bank of China for $3 billion. Over the summer, Goldman Sachs and other investors began negotiations to take a 10 percent stake in top lender Industrial and Commercial Bank of China. The consortium eventually agreed to pay $3.8 billion.

Encouraged by the successful sale of large strategic stakes, two of the top five mainland banks successfully listed in Hong Kong. In June, China's fifth-largest bank, the Bank of Communications, launched a $2 billion initial public offering (IPO) on the Hong Kong stock market, and in October, China Construction Bank conducted one of the ten largest IPOs in world history for over $9 billion. By then, foreigners had struck deals worth $16.5 billion for buying stakes in Chinese banks, or close to 95 percent of the market value of all five mainland banks listed at the end of 2004.

The share sales are of great importance for both the buyers and the sellers. On the Chinese side, the capital injections are shoring up weak balance sheets and providing the funds for future growth. More importantly, buyers are expected to provide the technical expertise to improve lending practices, risk management, and corporate governance. For foreign banks, the acquisitions provide access to the fast-growing Chinese banking market and with it, Chinese consumers. Residential mortgage lending to individual households has grown by over 30 percent in each of the past two years, but represented a relatively low 12 percent of China's GDP as of year-end 2004. There is potential for further growth in this area as per capita income in China rises.

### *India's Emergence*

A rapid increase in bank lending has paralleled India's emergence as a regional economic power. Traditionally, Indian banks have kept 40 percent or more of their total assets in low-risk government bonds and lent relatively little, largely to well-connected corporate borrowers. Over the past year, some Indian banks began shifting their preferences for both bonds and corporate lending. India's large middle class is experiencing rapid income growth as the economy expands, and banks are looking to tap that underserved market. Total credit growth reached 33 percent by the middle of 2005, with consumer lending growing

especially rapidly. Outstanding credit card receivables increased an estimated 49 percent in the fiscal year to March 2005, and mortgages, car lending, and personal loans grew as well. Although the pace of lending has raised asset quality concerns, India's consumer lending market looks set for continued strong growth.

***Japan's Revival***

As Japan's economy rebounded from recession in 2005, its banks also recovered from a decade of poor performance. After several years of writing off bad loans from the real estate and stock market bubbles of the 1980s, a number of banks finally started lending again. In August 2005, the banking system achieved positive year-on-year lending growth for the first month since early 1999. In the late 1990s, the government provided banks tens of billions of dollars in capital injections. Bolstered by stronger balance sheets and rising profitability, the banks now are repaying those public funds. If the trends of the past year continue, banks could reemerge as an engine of economic growth and help Japan's revival deepen and mature.

***The Rise of Retail Banking***

Throughout Asia, banks in 2005 increased their focus on consumer lending and retail banking. In part, the trend arose from a reaction to the years preceding the financial crisis when banks lent excessively to corporate customers and neglected individual consumers. But the shift also highlights the growing maturity and sophistication of the region's financial institutions. Asian banks face challenges in realigning lending practices and risk management systems with the new retail emphasis, but the best growth opportunities clearly lie with the Asian consumer, and increased consumer lending should help lead to more sustainable and better balanced economic growth.

1. China's Big Four banks are the Agricultural Bank of China, the Bank of China, China Construction Bank, and the Industrial and Commercial Bank of China, which together held 53 percent of total Chinese banking assets as of December 2005.

# Board of Directors

## San Francisco Headquarters (as of January 1, 2006)

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

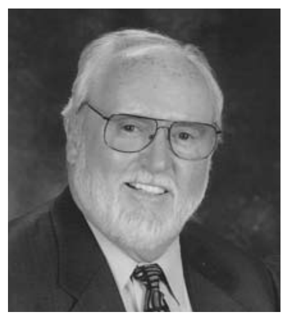
**David K.Y. Tang**
Partner
Preston Gates & Ellis LLP
Seattle, Washington

### Deputy Chairman

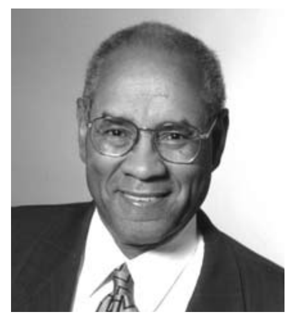
**T. Gary Rogers**
Chairman and
Chief Executive Officer
Dreyer's Grand Ice Cream
Holdings, Inc.
Oakland, California

**Karla S. Chambers**
Vice President and Co-Owner
Stahlbush Island Farms, Inc.
Corvallis, Oregon

**Richard W. Decker, Jr.**
Chairman and Co-Founder
Belvedere Capital Partners LLC
San Francisco, California



**Jack McNally**
Principal
JKM Consulting
Sacramento, California



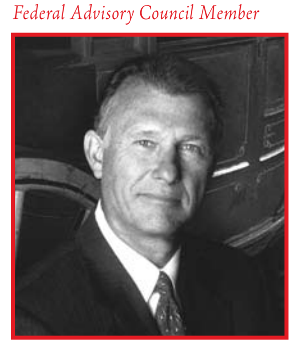
**Charles H. Smith**
President and Chief Executive Officer
AT&T West
San Ramon, California

**Candace H. Wiest**
President
Inland Empire National Bank
Riverside, California

**Kenneth P. Wilcox**
President and
Chief Executive Officer
Silicon Valley Bank
Santa Clara, California

**Barbara L. Wilson**
Consultant and Regional
Vice President (Retired)
Qwest Corporation
Boise, Idaho

*Federal Advisory Council Member*



**Richard M. Kovacevich**
Chairman, President, and
Chief Executive Officer
Wells Fargo & Company
San Francisco, California

# Board of Directors

## Los Angeles Branch (as of January 1, 2006)

### Chairman of the Board

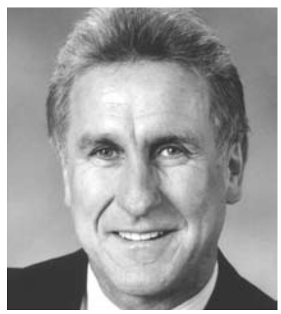
**James L. Sanford**
Corporate Vice President
and Treasurer
Northrop Grumman Corporation
Los Angeles, California

**Karen B. Caplan**
President and
Chief Executive Officer
Frieda's, Inc.
Los Alamitos, California

**Dominic Ng**
Chairman, President, and
Chief Executive Officer
East West Bank
San Marino, California

**Anita Santiago**
President
Anita Santiago Advertising
Los Angeles, California

**Ann E. Sewill**
Vice President and
California Director
Enterprise Community Partners
Los Angeles, California



**Peter M. Thomas**
Managing Director
Thomas & Mack Co.
Las Vegas, Nevada

**D. Linn Wiley**
President and
Chief Executive Officer
Citizens Business Bank
Ontario, California

# Board of Directors

## Portland Branch (as of January 1, 2006)

### 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

**Peter O. Kohler**
President
Oregon Health and
Science University
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.**
President
Medford Fabrication
Medford, Oregon

# Board of Directors

## Salt Lake City Branch (as of January 1, 2006)

### Chairman of the Board

**William C. Glynn**
President
Intermountain Industries, Inc.
Boise, Idaho

**A. Scott Anderson**
President and
Chief Executive Officer
Zions First National Bank
Salt Lake City, Utah

**Gary L. Crocker**
Chairman of the Board
Merrimack Pharmaceuticals
Salt Lake City, Utah

**Annette K. Herman**
Vice President,
Strategic Initiatives Uniprise
UnitedHealth Group
Salt Lake City, Utah

**Clark D. Ivory**
Chief Executive Officer
Ivory Homes, Ltd.
Salt Lake City, Utah

**Michael M. Mooney**
President and
Chief Executive Officer
Farmers & Merchants State Bank
Boise, Idaho

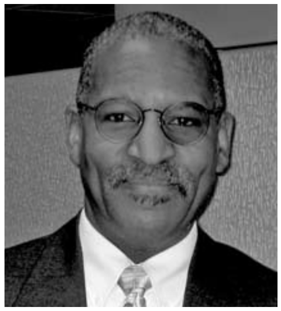
**Deborah B. Nielsen**
President and
Chief Executive Officer
United Way of Salt Lake
Salt Lake City, Utah

# Board of Directors

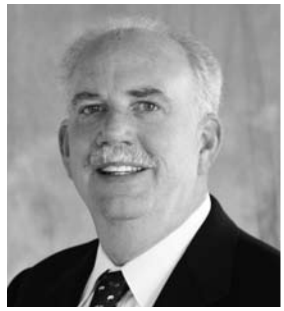
## Seattle Branch (as of January 1, 2006)

### Chairman of the Board

**Mic R. Dinsmore**
Chief Executive Officer
Port of Seattle
Seattle, Washington



**James R. Gill**
President
Pacific Northwest Title
Holding Company
Seattle, Washington

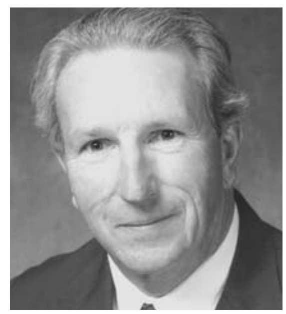


**Kenneth M. Kirkpatrick**
President, Washington State
U.S. Bank
Seattle, Washington

**Blake W. Nordstrom**
President
Nordstrom, Inc.
Seattle, Washington

**H. Stewart Parker**
President and
Chief Executive Officer
Targeted Genetics Corporation
Seattle, Washington

**Helvi K. Sandvik**
President
NANA Development Corp.
Anchorage, Alaska



**David W. Wyckoff**
Chairman and
Chief Executive Officer
Wyckoff Farms, Inc.
Grandview, Washington

# Twelfth District Advisory Council

(as of January 1, 2006)

Chairman

**Thomas E. Cleveland**
Chairman and
Chief Executive Officer
Access Business Finance
Bellevue, Washington

Vice Chairman

**Stephen M. Brophy**
President
Page Land & Cattle Company
Phoenix, Arizona

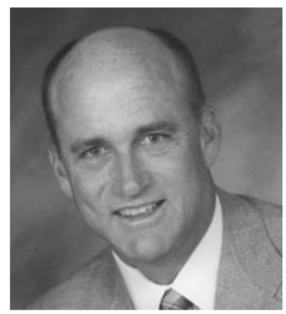
**Roberto E. Barragan**
President
Valley Economic Development
Center, Inc.
Van Nuys, California

**Grace Evans Cherashore**
President and
Chief Executive Officer
Evans Hotels
San Diego, California

**Manuel Cunha, Jr.**
President
Nisei Farmers League
Fresno, California

**Jack Gleason**
ComPlan Advisors LLC
Scottsdale, Arizona

**Cathy Luke**
President
Loyalty Enterprises, Ltd.
Honolulu, Hawaii



**Roderick C. Wendt**
President and
Chief Executive Officer
JELD-WEN, inc.
Klamath Falls, Oregon

# Highlights of 2005

## First Quarter

- Board of Governors approves proposal to expedite consolidation of Portland Branch Cash Services to the Seattle Branch at year-end 2005.
- Economic Research holds annual "Fiscal and Monetary Policy" macro conference.

## Second Quarter

- As part of the Federal Reserve's Check Restructuring Initiative, Salt Lake City Branch Check Processing consolidates to the Denver Branch—after processing checks at the Branch since 1918.
- Cash Product Office announces phase one cash infrastructure changes to continue cash processing at the Salt Lake City Branch and to convert to contracted cash depots in Portland, Oregon, Birmingham, Alabama, and Oklahoma City, Oklahoma.

## Third Quarter

- Seattle Branch Check Processing moves to leased facility to maximize cost savings and workflow efficiencies related to the fourth quarter consolidation of Portland Branch Check Processing to the Seattle Branch.
- Portland Branch selected as one of the Federal Reserve's five national Regional Check Adjustments sites.

## Third Quarter (continued)

- Seattle Branch holds groundbreaking ceremony at the site of the new Seattle Branch building, slated to open in the fourth quarter 2007 in Renton, Washington.
- Cash Product Office coordinates Federal Reserve's national response to Hurricane Katrina to reestablish cash services to the hurricane-affected areas.
- Public Information releases the video-based curriculum, *Open & Operating: The Federal Reserve Responds to September 11,* to high schools nationwide.

## Fourth Quarter

- Portland Branch Check Processing consolidates to the Seattle Branch check processing facility, after processing checks at the Branch since 1917.
- The Center for the Study of Innovation and Productivity in Economic Research holds "Productivity Growth: Causes and Consequences" conference.
- New cash depot facility opens in Portland with the consolidation of Portland Cash Services to the Seattle Branch.
- Twelfth District Check Processing is first in productivity ranking among all Federal Reserve check processing offices in 2005.

# Executive Committee

Standing, from Left

**Mark L. Mullinix**
Executive Vice President
District Finance
National Cash Product Manager

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

**John F. Moore**
First Vice President and
Chief Operating Officer
National Cash Product Director

**Terry S. Schwakopf**
Executive Vice President
Banking Supervision and
Regulation, District Public
Information, Communicating
Arts, and Office of the Secretary

Sitting, from Left

**John P. Judd**
Executive Vice President and
Director of Research

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

## Branch Managers

| Los Angeles | Salt Lake City | Portland | Seattle |
|---|---|---|---|
| **Mark L. Mullinix** | **Andrea P. Wolcott** | **Mary E. Lee** | **Mark A. Gould** |
| Executive Vice President | Group Vice President | Vice President | Senior Vice President |

# Bank Officers & Principals (as of December 31, 2005)

## San Francisco Headquarters

Janet L. Yellen
President and
Chief Executive Officer

John F. Moore
First Vice President and
Chief Operating Officer

John P. Judd
Executive Vice President

Terry S. Schwakopf
Executive Vice President

John S. Hsiao
Senior Vice President and
Chief Information Officer

Glenn D. Rudebusch
Senior Vice President

Susan A. Sutherland
Senior Vice President

John C. Williams
Senior 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

Todd A. Glissman
Group Vice President

Richard B. Hornsby
Group Vice President

Donald R. Lieb
Group Vice President and
Chief Financial Officer

Sharon 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

Randy Balducci
Vice President

Barbara A. Bennett
Vice President

Clifford N. Croxall
Vice President

Mary C. Daly
Vice President

John G. Fernald
Vice President

Beverley-Ann Hawkins
Vice President

Joy K. Hoffmann
Vice President

Michael E. Johnson
Vice President and
Managing Director

Ann Marie Kohlligian
Vice President and
Managing Director

Gopa Kumar
Vice President

Simon H. Kwan
Vice President

Mark M. Spiegel
Vice President

Kevin C. Alecca
Director

Philip A. Aquilino
Director

Thomas A. Ballantyne
Director

Tracy Basinger
Director

Kenneth R. Binning
Director

Richard K. Cabral
Director

James J. Callahan
Director

Jackie C. Hicks
Director

Rick A. Miller
Director

Frederic P. Minardi
Director

Richard A. Naylor, II
Director

Darren S. Post
Director

David E. Reiser
Director

Jack Richards
Director

Philip M. Ryan
Director

Carl M. Segall
Director

David G. Tresmontan
Director

Roxana R. Tsougarakis
Director

Paulette M. Wallace
Director

Mary E. Wujek
Director

Kevin Zerbe
Director

Judith R. W. Goff
Research Publications
Advisor

Eric T. Swanson
Research Advisor

Bharat Trehan
Research Advisor

Robert G. Valletta
Research Advisor

Nancy S. Emerson
Principal

Gerald T. Iseda
Principal

Bonita G. Jones
Principal

Maureen E. O'Byrne
Principal

Mildred J. Powell
Equal Employment
Opportunity Officer

Erik Z. Revai
Associate General Counsel

Peggy L. Speck
Secretary of the Board

Shirley N. Thompson
Associate General Counsel

## Los Angeles Branch

Mark L. Mullinix
Executive Vice President

Roger W. Replogle
Senior Vice President

Deborah Awai
Group Vice President

Marla E. Borowski
Vice President

Warren Howard
Vice President

Rita G. Aguilar
Director

Jose Alonso
Director

Anthony P. Dazzo
Director

Robert C. Johnson
Director

Steven E. Jung
Director

Howard Ng
Director

Robin A. Rockwood
Director

Joel K. Van Zee
Director

Dale L. Vaughan
Director

Dana R. Green
Principal

Richard J. Shershenovich
Principal

## Portland Branch

Mary E. Lee
Vice President

Steven H. Walker
Director

## Salt Lake City Branch

Andrea P. Wolcott
Group Vice President

## Seattle Branch

Mark A. Gould
Senior Vice President

Michael J. Stan
Senior Vice President

Pamela R. Anderson
Director

Lynn M. Jorgensen
Director

## Phoenix Processing Center

Robert E. Kellar, Jr.
Director

# Summary of Operations

| | (volume in thousands) | |
|---|---|---|
| | 2005 | 2004 |
| **Cash Services** | | |
| Currency notes paid into circulation | 6,340,868 | 6,097,331 |
| Food stamp coupons processed* | 0 | 46,714 |
| **Check Services** | | |
| Commercial checks processed | 1,300,371 | 1,516,019 |
| Return items processed | 23,152 | 27,048 |
| **Discounts and Advances** | | |
| Total discounts and transactions** | 367 | 287 |
| Number of financial institutions accommodated** | 81 | 90 |

** Items no longer processed in the Twelfth District*
*** Whole numbers (not in thousands)*

# 2005 Financial Reports

## 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 2005 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $4.6 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 2005, the Bank did not engage PwC for non-audit services.

# Federal Reserve Bank of San Francisco

101 Market Street, San Francisco, CA 94105

March 2, 2006

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, 2005 (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 judgments and estimates of management. 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 maintaining an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements. Such internal controls are designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of reliable Financial Statements. This process of internal controls contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in the process of internal controls are reported to management, and appropriate corrective measures are implemented.

Even an effective process of internal controls, 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.

The management of the FRBSF assessed its process of internal controls over financial reporting including the safeguarding of assets 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 (COSO). Based on this assessment, we believe that the FRBSF maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Federal Reserve Bank of San Francisco

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

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
333 Market Street, San Francisco CA 94105-2119
Telephone (415) 498 5000
Facsimile (415) 498 7100

## Report of Independent Auditors

To the Board of Directors of
the Federal Reserve Bank of San Francisco

We have examined management's assertion, included in the accompanying Management Assertion that the Federal Reserve Bank of San Francisco ("FRBSF") maintained effective internal control over financial reporting and the safeguarding of assets as of December 31, 2005, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRBSF's management is responsible for maintaining effective internal control over financial reporting and safeguarding of assets. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that FRBSF maintained effective internal control over financial reporting and over the safeguarding of assets as of December 31, 2005 is fairly stated, in all material respects, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

This report is intended solely for the information and use of management and the Board of Directors and Audit Committee of FRBSF, and any organization with legally defined oversight responsibilities and is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

March 8, 2006

San Francisco, California

PricewaterhouseCoopers LLP
333 Market Street, San Francisco CA 94105-2119
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 audited the accompanying statements of condition of the Federal Reserve Bank of San Francisco (the "Bank") as of December 31, 2005 and 2004, 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2005 and 2004, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

PricewaterhouseCoopers LLP

March 8, 2006

San Francisco, California

# Statements of Condition

*as of December 31, 2005 and 2004 (in millions)*

| Assets | 2005 | 2004 |
|---|---|---|
| Gold certificates | $ 1,172 | $ 1,055 |
| Special drawing rights certificates | 234 | 234 |
| Coin | 94 | 105 |
| Items in process of collection | 834 | 2,542 |
| Loans to depository institutions | 5 | — |
| U.S. government securities, net | 76,066 | 65,573 |
| Investments denominated in foreign currencies | 2,062 | 2,532 |
| Accrued interest receivable | 591 | 459 |
| Interdistrict settlement account | 19,327 | 4,414 |
| Bank premises and equipment, net | 209 | 216 |
| Other assets | 35 | 37 |
| Total assets | $ 100,629 | $ 77,167 |

| Liabilities and Capital | | |
|---|---|---|
| Liabilities: | | |
| Federal Reserve notes outstanding, net | $ 91,694 | $ 67,831 |
| Securities sold under agreements to repurchase | 3,093 | 2,782 |
| Deposits: | | |
| Depository institutions | 2,153 | 2,244 |
| Other deposits | 4 | 4 |
| Deferred credit items | 830 | 1,599 |
| Interest on Federal Reserve notes due U.S. Treasury | 74 | 56 |
| Accrued benefit costs | 71 | 68 |
| Other liabilities | 12 | 17 |
| Total liabilities | 97,931 | 74,601 |
| Capital: | | |
| Capital paid-in | 1,349 | 1,283 |
| Surplus | 1,349 | 1,283 |
| Total capital | 2,698 | 2,566 |
| Total liabilities and capital | $ 100,629 | $ 77,167 |

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

## Statements of Income

*for the years ended December 31, 2005 and 2004 (in millions)*

| | 2005 | 2004 |
|---|---|---|
| **Interest income:** | | |
| Interest on U.S. government securities | $ 2,775 | $ 1,933 |
| Interest on investments denominated in foreign currencies | 31 | 32 |
| Total interest income | 2,806 | 1,965 |
| **Interest expense:** | | |
| Interest expense on securities sold under agreements to repurchase | 80 | 27 |
| Net interest income | 2,726 | 1,938 |
| **Other operating income (loss):** | | |
| Income from services | — | 78 |
| Compensation received for check services provided | 59 | — |
| Reimbursable services to government agencies | 15 | 16 |
| Foreign currency gains (losses), net | (301) | 145 |
| Other income | 11 | 7 |
| Total other operating income (loss) | (216) | 246 |
| **Operating expenses:** | | |
| Salaries and other benefits | 174 | 178 |
| Occupancy expense | 18 | 17 |
| Equipment expense | 18 | 19 |
| Assessments by Board of Governors | 93 | 99 |
| Other expenses | 65 | 68 |
| Total operating expenses | 368 | 381 |
| Net income prior to distribution | $ 2,142 | $ 1,803 |
| **Distribution of net income:** | | |
| Dividends paid to member banks | $ 80 | $ 72 |
| Transferred to surplus | 66 | 235 |
| Payments to U.S. Treasury as interest on Federal Reserve notes | 1,996 | 1,496 |
| Total distribution | $ 2,142 | $ 1,803 |

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

## Statements of Changes in Capital

*for the years ended December 31, 2005 and 2004 (in millions)*

| | Capital Paid-in | Surplus | Total Capital |
|---|---|---|---|
| Balance at January 1, 2004 (21 million shares) | $ 1,048 | $ 1,048 | $ 2,096 |
| Transferred to surplus | — | 235 | 235 |
| Net change in capital stock issued (5 million shares) | 235 | — | 235 |
| Balance at December 31, 2004 (26 million shares) | 1,283 | 1,283 | 2,566 |
| Transferred to surplus | — | 66 | 66 |
| Net change in capital stock issued (1 million shares) | 66 | — | 66 |
| Balance at December 31, 2005 (27 million shares) | $ 1,349 | $ 1,349 | $ 2,698 |

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

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

## 2. Operations and Services

The System performs a variety of services and operations. Functions include formulating and conducting monetary policy; participating actively in the payments system including large-dollar transfers of funds, automated clearinghouse ("ACH") operations, and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks, and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The System also provides 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. FRBNY is authorized to conduct operations in domestic markets, including direct purchase and sale of U. S. government securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. FRBNY executes these open market transactions and holds the resulting securities, with the exception of securities purchased under agreements to resell, in the portfolio known as the System Open Market Account ("SOMA").

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange ("F/X") and securities contracts for nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. In addition, FRBNY is authorized to maintain reciprocal currency arrangements ("F/X swaps") with two central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks. In connection with its foreign currency activities, FRBNY may enter into contracts that contain varying degrees of off-balance-sheet market risk, because they represent contractual commitments involving 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 Reserve Banks are separate legal entities, in the interests of greater efficiency and effectiveness, they collaborate in the delivery of certain operations and services. The collaboration takes the form of centralized competency centers, operations sites, and product or service offices that have responsibility for the delivery of certain services on behalf of the Reserve Banks. Various operational and management models are used and are supported by service agreements between the Reserve Bank providing the service and the other eleven Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, Reserve Banks are billed for services provided to them by another Reserve Bank.

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 Adjustment National Management, Enterprise-wide Adjustments, Check User Research Environment, National Incident Response Team, Cash Services Office, Check Automation Services, Standard Cash Automation and Central Business Application Function, and Internet Technologies-Cash.

Beginning in 2005, the Reserve Banks adopted a new management model for providing check services to depository institutions. Under this new model, the Federal Reserve Bank of Atlanta ("FRBA") has the overall responsibility for managing the Reserve Banks' provision of check services and recognizes total System check revenue on its Statements of Income. FRBA compensates the other eleven Banks for the costs incurred to provide check services. This compensation is reported as Compensation received for check services provided in the Statements of Income. If the management model had been in place in 2004, the Bank would have reported $72 million as compensation received for check services provided and $78 million in check revenue would have been reported by FRB Atlanta rather than the Bank.

## 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 the various accounting standard-setting bodies. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* ("Financial Accounting Manual"), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual and the financial statements have been prepared in accordance with the Financial Accounting Manual.

Differences exist between the accounting principles and practices in the Financial Accounting Manual and those generally accepted in the United States ("GAAP") primarily due to the unique nature of the Bank's powers and responsibilities as part of the nation's central bank. The primary difference is the presentation of all security holdings at amortized cost, rather than using the fair value presentation requirements in accordance with GAAP. Amortized cost more appropriately reflects the Bank's security holdings given its unique responsibility to conduct monetary policy. While the application of current market prices to the securities holdings may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct affect 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 security and foreign currency transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings, and any gains or losses resulting from the sale of such securities and currencies are incidental to the open market operations and do not motivate its activities or policy decisions.

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, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

### Gold and Special Drawing Rights Certificates

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

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

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2005 or 2004.

## Loans to Depository Institutions

All depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in regulations issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Bank. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If loans were ever deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Bank, subject to review by the Board of Governors.

## 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."

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

## U.S. Government 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 carried in the Statements of Condition at their contractual amounts and the related accrued interest is reported as a component of "Other liabilities."

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

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

## Foreign Currency Swaps and Warehousing

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

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

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

## Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from three to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred. Capitalized assets including software, land, building, leasehold improvements, furniture, and equipment are impaired when it is determined that the net realizable value is significantly less than book value and is not recoverable.

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

## Interdistrict Settlement Account

At the close of business each day, each Reserve Bank assembles the payments due to or from other Reserve Banks as a result of the day's transactions that involve depository institution accounts held by other Districts. Such transactions may include funds settlement, check clearing, 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.

## Federal Reserve Notes

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

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

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

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding, reduced by the currency issued to the Bank but not in circulation, of $19,391 million, and $20,570 million at December 31, 2005 and 2004, respectively.

## Items in Process of Collection and Deferred Credit Items

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

## 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 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.

## Surplus

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital. Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

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

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to U.S. Treasury in the following year. This amount is reported as a component of "Payments to U.S. Treasury as interest on Federal Reserve notes."

## 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.

## Assessments by the Board of Governors

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

## 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, 2005 and 2004, respectively, and are reported as a component of "Occupancy expense."

## Restructuring Charges

In 2003, the System began the restructuring of several operations, primarily check, cash, and U.S. Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations. These restructuring activities continued in 2004 and 2005.

Footnote 10 describes the restructuring and provides information about the Bank's costs and liabilities associated with employee separations and contract terminations. The costs associated with the write-down of certain Bank assets are discussed in footnote 6. Costs and liabilities associated with enhanced pension benefits in connection with the restructuring activities for all Reserve Banks are recorded on the books of the FRBNY and those associated with enhanced post-retirement benefits are discussed in footnote 9.

## 4. U.S. Government Securities, Securities 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 10.139 percent and 9.037 percent at December 31, 2005 and 2004, respectively.

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

| | 2005 | 2004 |
|---|---|---|
| ***Par value:*** | | |
| ***U.S. government:*** | | |
| Bills | $ 27,505 | $ 23,765 |
| Notes | 38,542 | 32,609 |
| Bonds | 9,412 | 8,497 |
| Total par value | 75,459 | 64,871 |
| Unamortized premiums | 893 | 850 |
| Unaccreted discounts | (286) | (148) |
| Total allocated to Bank | $ 76,066 | $ 65,573 |

The total of the U.S. government securities, net held in the SOMA was $750,202 million and $725,584 million at December 31, 2005 and 2004, respectively.

At December 31, 2005 and 2004, the total contract amount of securities sold under agreements to repurchase was $30,505 million and $30,783 million, respectively, of which $3,093 million and $2,782 million, were allocated to the Bank. The total par value of the SOMA securities pledged for securities sold under agreements to repurchase at December 31, 2005 and 2004 was $30,559 million and $30,808 million, respectively, of which $3,098 million and $2,784 million was allocated to the Bank.

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, 2005, was as follows (in millions):

| Maturities of Securities Held | U.S. Government Securities (Par value) | Securities Sold Under Agreement to Repurchase (Contract Amount) |
|---|---|---|
| Within 15 days | $ 4,158 | $ 3,093 |
| 16 days to 90 days | 17,467 | |
| 91 days to 1 year | 18,888 | |
| Over 1 year to 5 years | 21,368 | |
| Over 5 years to 10 years | 5,749 | |
| Over 10 years | 7,829 | |
| Total | $ 75,459 | $ 3,093 |

At December 31, 2005 and 2004, U.S. government securities with par values of $3,776 million and $6,609 million, respectively, were loaned from the SOMA, of which $383 million and $597 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 the Bank for International Settlements and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities purchased under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

The Bank's allocated share of investments denominated in foreign currencies was approximately 10.896 percent and 11.848 percent at December 31, 2005 and 2004, respectively.

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

| | 2005 | 2004 |
|---|---|---|
| European Union Euro: | | |
| Foreign currency deposits | $ 591 | $ 720 |
| Securities purchased under agreements to resell | 210 | 254 |
| Government debt instruments | 388 | 468 |
| Japanese Yen: | | |
| Foreign currency deposits | 285 | 182 |
| Government debt instruments | 588 | 908 |
| Total | $ 2,062 | $ 2,532 |

Total System investments denominated in foreign currencies were $18,928 million and $21,368 million at December 31, 2005 and 2004, respectively.

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2005, was as follows (in millions):

| Maturities of Investments Denominated in Foreign Currencies | European Euro | Japanese Yen | Total |
|---|---|---|---|
| Within 15 days | $ 368 | $ 285 | $ 653 |
| 16 days to 90 days | 280 | 74 | 354 |
| 91 days to 1 year | 228 | 110 | 338 |
| Over 1 year to 5 years | 311 | 404 | 715 |
| Over 5 years to 10 years | 2 | — | 2 |
| Over 10 years | — | — | 0 |
| Total | $ 1,189 | $ 873 | $ 2,062 |

At December 31, 2005 and 2004, there were no material open or outstanding foreign exchange contracts.

At December 31, 2005 and 2004, the warehousing facility was $5,000 million with no balance outstanding.

## 6. Bank Premises, Equipment, and Software

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

| | Useful Life Range (in years) | 2005 | 2004 |
|---|---|---|---|
| Bank premises and equipment: | | | |
| Land | N/A | $ 29 | $ 29 |
| Buildings | 1-45 | 189 | 189 |
| Building machinery and equipment | 1-20 | 44 | 44 |
| Construction in progress | N/A | 6 | 2 |
| Furniture and equipment | 1-18 | 116 | 126 |
| Subtotal | | 384 | 390 |
| Accumulated depreciation | | (175) | (174) |
| Bank premises and equipment, net | | $ 209 | $ 216 |
| Depreciation expense, for the years ended | | $ 15 | $ 16 |

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 lease terms ranging from one to 7 years. Rental income from such leases was $1 million for each of the years ended December 31, 2005 and 2004, respectively. Future minimum lease payments under noncancelable agreements in existence at December 31, 2005, were (in millions):

| | |
|---|---|
| 2006 | $ 0.9 |
| 2007 | 0.2 |
| 2008 | — |
| 2009 | — |
| 2010 | — |
| Thereafter | — |
| | $ 1.1 |

The Bank has capitalized software assets, net of amortization, of $8 million and $10 million at December 31, 2005 and 2004, respectively. Amortization expense was $5 million for each of the years ended December 31, 2005 and 2004, respectively. Capitalized software assets are reported as a component of "Other assets" and related amortization is reported as a component of "Other expenses."

Assets impaired either as a result of the Bank's restructuring plan, as discussed in footnote 10 include building, building machinery and equipment, processing equipment, furniture, and other assets. Asset impairment losses of $326 thousand and $13 million for the periods ending December 31, 2005 and 2004, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

## 7. Commitments and Contingencies

At December 31, 2005, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately 8 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 $475 thousand and $593 thousand for the years ended December 31, 2005 and 2004, respectively. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with terms of one year or more, at December 31, 2005, were (in millions):

| | Operating |
|---|---|
| 2006 | $ 0.6 |
| 2007 | 0.6 |
| 2008 | 0.7 |
| 2009 | 0.8 |
| 2010 | 0.6 |
| Thereafter | 1.1 |
| | $ 4.4 |

At December 31, 2005, there were no other material commitments and long-term obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks, each Reserve Bank 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 such agreement at December 31, 2005 or 2004.

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

## 8. Retirement and Thrift Plans

### Retirement Plans

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

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve 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 benefit obligation and net pension costs for the BEP and the SERP at December 31, 2005 and 2004, and for the years then ended, are not material.

### Thrift Plan

Employees of the 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 $6 million and $7 million for the years ended December 31, 2005 and 2004, respectively, and are reported as a component of "Salaries and other benefits." The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2005 and 2004, 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):

| | 2005 | 2004 |
|---|---|---|
| Accumulated postretirement benefit obligation at January 1 | $ 62.5 | $ 57.9 |
| Service cost-benefits earned during the period | 1.5 | 1.4 |
| Interest cost of accumulated benefit obligation | 3.1 | 3.6 |
| Actuarial (gain)/loss | (3.6) | 10.8 |
| Special termination loss | — | 0.5 |
| Contributions by plan participants | 1.1 | 1.0 |
| Benefits paid | (5.1) | (4.2) |
| Plan amendments | — | (8.5) |
| Accumulated postretirement benefit obligation at December 31 | $ 59.5 | $ 62.5 |

At December 31, 2005 and 2004, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.50 percent and 5.75 percent, respectively.

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

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

| | 2005 | 2004 |
|---|---|---|
| Fair value of plan assets at January 1 | $ — | $ — |
| Actual return on plan assets | — | — |
| Contributions by the employer | 4.0 | 3.2 |
| Contributions by plan participants | 1.1 | 1.0 |
| Benefits paid | (5.1) | (4.2) |
| Fair value of plan assets at December 31 | $ 0.0 | $ 0.0 |
| Unfunded postretirement benefit obligation | $ 59.5 | $ 62.5 |
| Unrecognized prior service cost | 6.7 | 8.3 |
| Unrecognized net actuarial loss | (13.4) | (17.4) |
| Accrued postretirement benefit costs | $ 52.8 | $ 53.4 |

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs."

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

| | 2005 | 2004 |
|---|---|---|
| Health care cost trend rate assumed for next year | 9.00% | 9.00% |
| Rate to which the cost trend rate is assumed to decline (the ultimate trend rate) | 5.00% | 4.75% |
| Year that the rate reaches the ultimate trend rate | 2011 | 2011 |

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2005 (in millions):

| | One Percentage Point Increase | One Percentage Point Decrease |
|---|---|---|
| Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs | $ (0.1) | $ — |
| Effect on accumulated postretirement benefit obligation | (0.4) | 0.1 |

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

| | 2005 | 2004 |
|---|---|---|
| Service cost-benefits earned during the period | $ 1.5 | $ 1.4 |
| Interest cost of accumulated benefit obligation | 3.1 | 3.6 |
| Amortization of prior service cost | (1.6) | (1.4) |
| Recognized net actuarial loss | 0.4 | 0.4 |
| Total periodic expense | 3.4 | 4.0 |
| Curtailment (gain) loss | — | (3.5) |
| Special termination loss | — | 0.5 |
| Net periodic postretirement benefit costs | $ 3.4 | $ 1.0 |

At January 1, 2005 and 2004, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.75 percent and 6.25 percent, respectively.

Net periodic postretirement benefit costs are reported as a component of "Salaries and other benefits."

A plan amendment that modified the credited service period eligibility requirements created curtailment gains. The recognition of special termination losses is primarily the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10. The curtailment gain associated with restructuring programs announced in 2003 was recognized when employees left the Bank in 2004.

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

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

| Expected Benefit Payments | Without Subsidy | With Subsidy |
|---|---|---|
| 2006 | $ 4.3 | $ 3.9 |
| 2007 | 4.4 | 4.0 |
| 2008 | 4.5 | 4.0 |
| 2009 | 4.6 | 4.1 |
| 2010 | 4.8 | 4.2 |
| 2011-2015 | 25.4 | 21.6 |
| Total | $ 48.0 | $ 41.8 |

### Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2005 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2005 and 2004, were $16 million and $14 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2005 and 2004 operating expenses were $4 million for each year and are recorded as a component of "Salaries and other benefits."

## 10. Business Restructuring Charges

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including staff reductions in various functions of the Bank. In 2004 and 2005, additional consolidation and restructuring initiatives were announced in the Check and Cash operations. These actions resulted in the following business restructuring charges (in millions):

| | Total Estimated Costs | Accrued Liability December 31, 2004 | Total Charges | Total Paid | Accrued Liability December 31, 2005 |
|---|---|---|---|---|---|
| Employee separation | $ 5.5 | $ 2.5 | $ 0.5 | $ 1.7 | $ 1.3 |
| Other | 0.1 | — | 0.1 | 0.1 | — |
| Total | $ 5.6 | $ 2.5 | $ 0.6 | $ 1.8 | $ 1.3 |

Employee separation costs are primarily severance costs related to identified staff reductions of approximately $5.6 million, including 32 and 166 staff reductions related to restructuring announced in 2005 and 2004, respectively. These costs are reported as a component of "Salaries and other benefits." Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Other expenses."

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

Future costs associated with the restructuring that are not estimable are not recognized as liabilities.

The Bank anticipates substantially completing its announced plans by 2006.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## Acknowledgements

**Writers**
Susan Chan, Daniel Fineman, Reuven Glick, Mark Spiegel

**Managing Editor**
Lyndi Beale

**Production Coordinator**
Ed Espiritu

**Design**
Curran & Connors, Inc./www.curran-connors.com

**Photography**
Kathryn MacDonald Photography/www.macdonaldphoto.com (pages 2, 15, 19, 30, 31)

**Cover Photo**
Steve Baxter

Thank you to the following people for their contributions to the production of the 2005 annual report: Javier Jerez, Kathy Laird, Richard Lung, Richard Naylor, Maureen O'Byrne, Luis Pacas, Peggy Speck, Anita Todd, Edwina Wong, Allen Young.

View and order this report online at www.frbsf.org/publications/federalreserve/annual/index.html.

Federal Reserve Bank of San Francisco 2005 Annual Report
Gateway to Asia


San Francisco Headquarters
101 Market Street
San Francisco, California 94105
(415) 974-2000

Los Angeles Branch
950 South Grand Avenue
Los Angeles, California 90015
(213) 683-2300

Portland Branch
1500 SW First Avenue, Suite 100
Portland, Oregon 97201
(503) 276-3000

Salt Lake City Branch
120 South State Street
Salt Lake City, Utah 84111
(801) 322-7900

Seattle Branch
1015 Second Avenue
Seattle, Washington 98104
(206) 343-3600

Phoenix Processing Center
1550 North 47th Avenue
Phoenix, Arizona 85043
(602) 477-7700