

# Annual Report 2010

FEDERAL RESERVE BANK  
*of* CLEVELAND

The Federal Reserve System is responsible for formulating and implementing U.S. monetary policy. It also supervises banks and bank holding companies and provides financial services to depository institutions and the federal government.

The Federal Reserve Bank of Cleveland is one of 12 regional Reserve Banks in the United States that, together with the Board of Governors in Washington, DC, comprise the Federal Reserve System. The Federal Reserve Bank of Cleveland, including its branch offices in Cincinnati and Pittsburgh, serves the Fourth Federal Reserve District (Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky).

It is the policy of the Bank to provide equal employment opportunity for employees and applicants without regard to race, color, religion, sex, national origin, age, disability, genetic information, or sexual orientation.

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## President's Foreword

To most Americans, inflation tends to be an abstract concept. Then suddenly, as gas and food prices strain their weekly budgets, it becomes a topic of everyday conversation. At the Federal Reserve, we constantly monitor the impact of price movements on underlying inflation trends, and we adjust monetary policy accordingly.

My policy decisions as president and CEO of the Federal Reserve Bank of Cleveland are motivated by the dual mandate of price stability and maximum employment. These are the objectives that Congress has given the Federal Reserve.

For a long time, many observers doubted the central bank's ability to pursue the dual mandate successfully. Some believed there was a tradeoff between low inflation and high unemployment. Those doubts have faded over the past 30 years as the public has come to see that both employment growth and price stability can be sustained over long periods of time.

In this year's annual report essay, I discuss why now may be an opportune time for the Federal Reserve to be more explicit about its inflation objective. An explicit objective is not only consistent with the Federal Reserve's dual mandate, but could improve our capacity for fulfilling it. Moreover, an explicit objective is a natural step in the evolution of Federal Reserve communications. The existence of an explicit numerical inflation objective has the potential to make policy decisions more transparent and policy-makers more accountable. In times of volatile commodity price changes, the existence of an explicit inflation objective could go a long way toward reassuring the public about our commitment to controlling inflation.

In separate essays in this annual report, our Bank's economists address specific questions about inflation in the context of the dual mandate. Taken as a whole, these essays are the latest in the Federal Reserve Bank of Cleveland's efforts to better connect the work we do to the economic well-being of Americans.



The officers and staff of the Federal Reserve Bank of Cleveland are committed to serving our region and nation through the Bank's three major functions: monetary policy, banking supervision and regulation, and payment services. As we do our work, we are enriched by the guidance and insights provided by our boards of directors in Cleveland, Pittsburgh, and Cincinnati, as well as by our business, consumer, and community banking advisory councils across the District.

I would especially like to thank the following directors who completed their terms of service on our boards in 2010:

- Roy Haley, chairman of Wesco International, Inc. in Pittsburgh, who spent four years as chairman of our Pittsburgh board before joining the Cleveland board in 2007.

- James Rohr, chairman and CEO of the PNC Financial Services Group, Pittsburgh, who served three years as a Cleveland director.
- Les Vinney, chairman of Cleveland HeartLab, who served as a Cleveland director for six years.
- Margaret Irvine Weir, president of NexTier Bank in Butler, Pennsylvania, who served more than three years on our Pittsburgh board.

I am grateful to Paul Poston, director of the Great Lakes District of NeighborWorks® America, Cincinnati, who served the Cincinnati board with distinction. Sadly, we lost Mr. Poston to cancer in late 2010. His expertise in housing policy, his commitment to community, and most of all his kindness will be sorely missed.


I am also grateful for the leadership of Henry L. Meyer III, chairman and CEO of KeyCorp in Cleveland, who completed three years as the Bank's representative on the Federal Advisory Council in 2010.



I wish to express my thanks to Dale Roskom, who joined the Federal Reserve Bank of Cleveland as first vice president and chief operating officer in early 2010. Dale's leadership and energy are already making a difference. Finally, I would like to express my sincere appreciation to all Bank officers and staff for their dedicated service during the past year. Working collaboratively as well as with our external stakeholders, the Bank's employees in Cleveland, Pittsburgh, and Cincinnati have fostered innovation in the nation's payments system, have ably served the U.S. Treasury, and have championed policies that promote economic growth, price stability, and strength in the nation's banking and financial systems. This commitment to excellence, efficiency, innovation, and sound public policy has empowered the Bank in pursuing its vision: to promote financial stability and prosperity in our neighborhoods, region, and country.



Sandra Pianalto  
President and Chief Executive Officer



In 2011 and in the coming years, the Federal Reserve will always strive to fulfill its **DUAL MANDATE** of price stability and maximum employment.

# PRICE STABILITY

## *Why We Seek It and How Best to Achieve It*



**By Sandra Pianalto**

*President and Chief Executive Officer  
Federal Reserve Bank of Cleveland*

In 2010, the unemployment rate fell, the pace of foreclosures declined, and the stock market rallied.

Still, as a Federal Reserve policymaker, I am far from satisfied. Too many Americans are still hurting—many are out of work, many have seen the values of their homes plummet, and many see little hope of restoring their nest eggs for retirement.

If these conditions are not challenging enough, we now have another issue to contend with: Inflation concerns are mounting. On this developing front, I want to be crystal clear: In 2011 and in the coming years, the Federal Reserve will always strive to fulfill its dual mandate of price stability and maximum employment.

This annual report is dedicated to the topic of inflation in the context of our dual mandate. We offer a collection of frequently asked questions that we hear today about inflation and the inflation outlook, together with answers from our Research Department economists. These short articles review recent movements in inflation, explain how we develop our inflation forecast, and put the Federal Reserve's job in a global context, among other topics.

In the next several pages, however, I want to give you my own views on controlling inflation in the context of the Federal Reserve's dual mandate. In doing so, I want to make two key points.

First, it is important to understand that the Federal Reserve's commitment to price stability is entirely consistent with promoting maximum employment. In fact, it is a necessary part of creating the economic conditions that permit jobs to flourish over time.

Second, now may be an opportune time for the Federal Reserve to adopt an explicit numerical inflation objective. The events of the past year—including a new round of monetary stimulus and the recent spike in commodity prices—have underscored the potential benefits of a numerical inflation objective. Most Americans probably are not even aware that the Federal Open Market Committee (FOMC) has no such explicit objective—or what having one would entail.

As I will explain, putting a number on our inflation objective could enhance our communication capabilities with the public, make the monetary policy formulation process more transparent, and increase the Federal Reserve's accountability. As a result, monetary policy will be better able to achieve both price stability and maximum employment.



Conceptually, **PRICE STABILITY** can be thought of as an inflation rate low enough and predictable enough that inflation does not prominently enter into decisions by firms and consumers.

## The Dual Mandate: Why Price Stability Is Consistent with Maximum Employment

Conceptually, price stability can be thought of as an inflation rate low enough and predictable enough that inflation does not prominently enter into decisions by firms and consumers. For example, to maximize economic efficiency, firms must be confident enough about the general level of prices in the future to be willing to make long-term agreements with their suppliers and customers (although relative prices do, of course, need to change over time). Individuals need the same confidence to plan for retirement.

To many Americans, the costs of excessive inflation are familiar from the 1970s, a decade in which consumer price inflation averaged 8 percent per year. (By comparison, consumer price inflation since then has averaged close to 3 percent.)<sup>1</sup>

Let's break down the negative impacts of high inflation into four areas:

- First, sustained high inflation erodes the purchasing power of people on fixed incomes. Over the years, retirement savings can decrease in value if inflation unexpectedly rises.
- Second, high inflation can lead consumers and firms to spend time and money managing its consequences. For example, consumers will devote more time tending to cash balances, and firms will change their posted prices more frequently.
- Third, high inflation muddies the information on supply and demand reflected in prices, leading to inefficient spending decisions. For instance, with substantial inflation, a business will find it more difficult to determine if an increase in the price of a new machine for its production line reflects inflation in the overall price level or an increase in the price of the machine relative to some other production input, such as steel. As a result, the firm could misjudge the price change and make a poor decision.
- Finally, because many components of federal and state tax codes are not indexed to the cost of living, high inflation creates adverse tax effects that can lead consumers and firms to take actions they would otherwise not take.

<sup>1</sup> Data cited in this annual report reflect updates through April 30, 2011.



Very low inflation creates different challenges. When inflation is very low, as it has been recently, the Federal Reserve's ability to ease monetary policy is constrained if the federal funds rate cannot be reduced further. That is why after cutting the target for the federal funds rate to essentially zero in December 2008, the FOMC had to take the unusual step of making large-scale asset purchases of longer-term Treasury securities, agency debt, and agency mortgage-backed securities. Although the strategy was unusual, its purpose was the same as more traditional policy easing: to activate the conventional channels of monetary stimulus to the economy. It would be preferable, though, to be able to employ more traditional policy tools, with which we have more experience and with which the public is more familiar.

In an environment of very low inflation and interest rates, monetary policy can become hamstrung in its ability to promote stronger economic activity. The experiences of Japan in the last two decades point to the real danger of low inflation—deflation, which occurs when the overall price level falls as inflation rates turn negative for extended periods. Deflation is more likely when an already-weak economy deteriorates further.

Declining price levels might sound like a good thing—allowing consumers to buy more of some goods. But sustained deflation can have profoundly negative effects on the real economy. When prices are expected to continue to fall, many consumers and firms will delay purchases while waiting for lower prices. Deflation also lowers wages as well as prices, and debts don't decrease in nominal terms, so actual debt burdens are higher. Deflation can also create or worsen problems in the financial system. It reduces the value of collateral, which makes borrowing more difficult. This dynamic is especially relevant in a period following a severe financial crisis, when asset values have fallen and credit channels have already been impaired. For these reasons, Japan's deflation is widely thought to have hampered that nation's monetary policy and economy since the early 1990s.

Inflation that is high or too low is bad enough—but uncertain and variable inflation introduces additional problems. One consequence of variability is that unexpected changes in inflation redistribute wealth between borrowers and lenders. For example, if inflation proves higher than expected, a borrower can pay a lender back with dollars that buy less than they would have otherwise. If inflation proves to be lower than expected, the lender benefits at the expense of the borrower. As a result of these uncertainties, lenders incorporate an inflation risk premium in

interest rates, essentially making borrowing more expensive on average than it normally would be. This risk premium reduces borrowing for productive purposes, such as capital spending by firms. Finally, uncertainty about future inflation can reduce the willingness of firms to enter into long-term contracts that contribute to an efficient economic system.

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### **Inflation that is high or too low is bad enough—but uncertain and variable inflation introduces additional problems.**

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Seen this way, the Federal Reserve's objective of price stability is fully complementary with its objective of maximum employment. The maintenance of price stability avoids problems that can arise with either very low or excessively high inflation. As a result, price stability helps to maximize economic efficiency through a multitude of channels, from interest rates to the provision of credit. Monetary policy promotes the fastest sustainable rate of economic growth by minimizing the many economic distortions that inevitably arise because of deviations from price stability.

## **How a Numerical Objective for Price Stability Could Help Monetary Policy**

Over the course of the business cycle, monetary policy affects inflation, employment, and long-term interest rates. Over longer periods, monetary policy is the sole determinant of the average rate of inflation—but is only one of many factors affecting employment and long-term interest rates. Put another way, in the long run, inflation is a monetary phenomenon (to paraphrase the late Milton Friedman), while trends in employment and long-term interest rates depend on other forces, including demographics and the productivity of the nation's stock of factories and machinery. As a corollary, central banks such as the Federal Reserve can reasonably be expected to achieve a pre-specified numerical inflation objective over time, but not so for unemployment.

In fact, many other central banks around the world do have explicit numerical objectives for inflation to anchor their definitions of price stability. The Federal Reserve does not. At present, the closest the Federal Reserve comes to stating an explicit inflation objective is in the quarterly economic projections of the FOMC in which its participants indicate their current estimate of the rate to which inflation would converge under “appropriate monetary policy” and in the absence of additional shocks.

FOMC members have raised the idea of establishing a numerical objective several times over the years. Ben Bernanke, for example, spoke about the potential utility of an explicit inflation objective in improving economic outcomes back in 2003, when he was a member of the Board of Governors but not yet its chairman.

I think it is an opportune time for the FOMC to establish an explicit inflation objective. The potential benefits are large and, in my mind, likely to help foster the Federal Reserve’s objectives of price stability and maximum employment. Specifically, I favor establishing a 2 percent inflation objective. In the interest of economic stability, and to provide some flexibility to respond to shocks, our intention would be to move as close as possible to this target annually. In the event of shocks to the economy that push inflation away from this target, the goal would be to set policy so that inflation converges back to 2 percent over the medium term, a period of perhaps two to four years, depending on the size of the shocks.

The potential merits of a stated inflation objective seem particularly large at the moment, given the array of challenges bearing down on the economy so far in 2011. Consider, for example, that even though underlying inflation today is still at a low level, people disagree about where it is heading. Even professional forecasters differ more with one another about the longer-run inflation outlook now than they did before the recession.<sup>2</sup>

Why the uncertainty? On the one hand, with unemployment very high and wages increasing very slowly, underlying inflation could remain subdued. Working in the other direction, recent increases in energy and other commodity prices are putting upward pressure on inflation. Although these pressures have not spilled over into consumer prices more generally, it is possible that they could.

## A Sampling of Central Banks with Inflation Targets

Country	Targeting adoption date	Target (%) <sup>a</sup>
New Zealand	March 1990	1.0–3.0
Canada	February 1991	2.0
United Kingdom	October 1992	2.0
Czech Republic	January 1998	2.0
Euro Area	January 1999	< 2.0
Brazil	June 1999	4.5
Mexico	January 2001	3.0
Norway	March 2001	2.5
Peru	January 2002	2.0
Romania	August 2005	3.0
Japan	March 2006	0–2.0
Ghana	May 2007	8.5

a. Some banks use different measures.

Sources: Federal Reserve Bank of Boston; Federal Reserve Bank of Cleveland.

<sup>2</sup> Underlying inflation was only 1.2 percent in the 12 months ended in March 2011, as measured by the Cleveland Federal Reserve’s median Consumer Price Index.

Although I trust that the FOMC will act as needed to preserve price stability, the perceived threat of inflation is very real in many people's minds. They see the expansion of the Federal Reserve's balance sheet, the federal government's immense borrowing needs, and rising global commodity prices as all potentially contributing to rapidly rising inflation. If those concerns intensified so strongly that broad measures of longer-term inflation expectations escalated, actual inflation could rise in the absence of an appropriate response from the Federal Reserve.

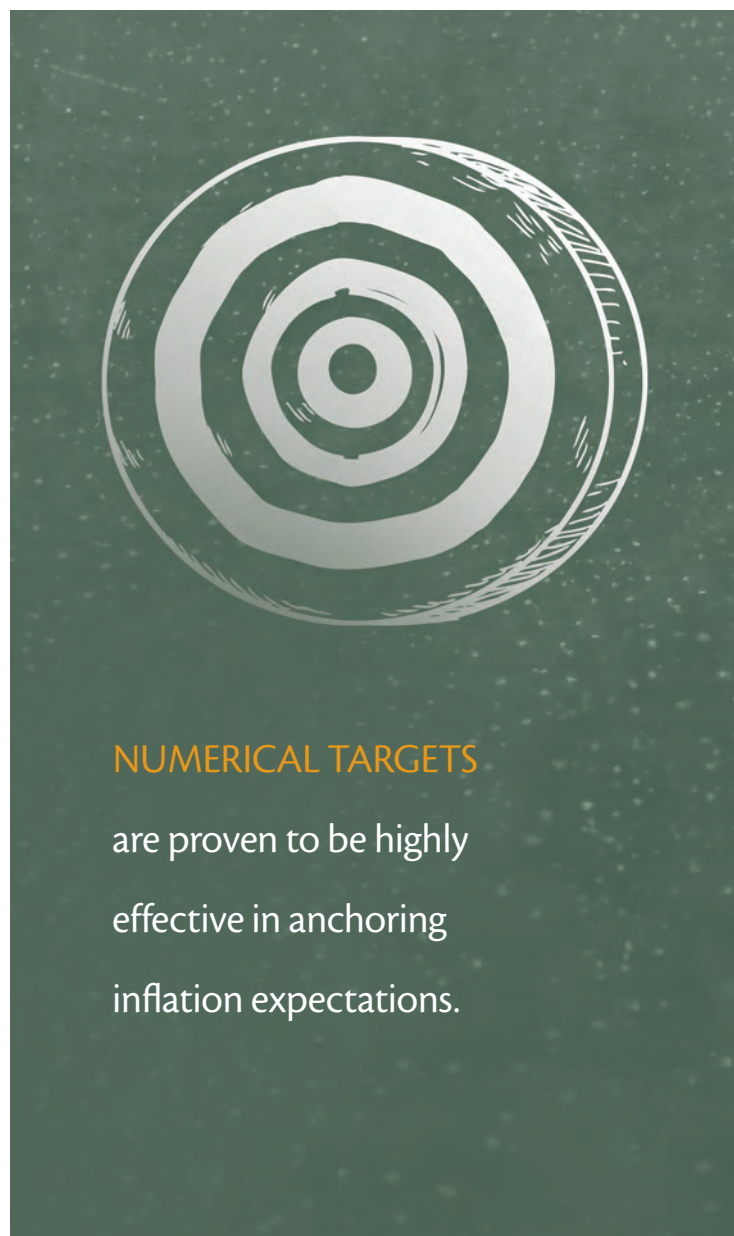
Economic theory tells us that rising long-term inflation expectations (one of the key determinants of the actual inflation trend) could push inflation higher. For example, expectations of a pickup in inflation could lead firms to boost their prices to reflect those expectations, contributing to a rise in inflation this year.

In these circumstances, the FOMC's adoption of a concrete, explicit numerical objective for inflation could be advantageous. Numerical targets are proven to be highly effective in anchoring inflation expectations. Studies comparing the United States to some other countries with formal inflation targets have found that these explicit objectives help to pin down long-term inflation expectations at the rate the central bank has established as its target.<sup>3</sup> For example, in countries with explicit inflation targets, private-sector forecasters are in greater agreement about the inflation outlook.

I see three main gains from a numerical target, and they are intertwined. First, better-anchored inflation expectations could

**INCREASE THE FEDERAL RESERVE'S ABILITY TO ADJUST MONETARY POLICY TO STABILIZE THE ECONOMY.**

For example, when the economy is weak, the FOMC could have more scope to ease monetary policy without triggering an increase in longer-term inflation expectations that would put upward pressure on inflation. The explicit objective for price stability would help to assure the public that a more expansive monetary policy was a temporary move to stabilize the economy, without any implications for the longer-run inflation objective. Thus, an explicit numerical inflation objective could boost the stability of employment as well as inflation.



## NUMERICAL TARGETS

are proven to be highly effective in anchoring inflation expectations.

<sup>3</sup> See Refet S. Gürkaynak, Andrew T. Levin, and Eric T. Swanson, 2010, "Does Inflation Targeting Anchor Long-Run Inflation Expectations? Evidence from Long-Term Bond Yields in the U.S., U.K., and Sweden," *Journal of the European Economic Association*, 8, 1208-42; Meredith J. Beechey, Benjamin K. Johannsen, and Andrew T. Levin, 2011, "Are Long-Run Inflation Expectations Anchored More Firmly in the Euro Area than in the United States?" *American Economic Journal: Macroeconomics*, 3, 104-29; and Eric T. Swanson, 2006, "Would an Inflation Target Help Anchor U.S. Inflation Expectations?" *FRBSF Economic Letter*, 20.

An explicit numerical objective for inflation could also **ENHANCE THE ACCOUNTABILITY AND TRANSPARENCY OF MONETARY POLICY**. With a numerical objective, the public would know exactly what inflation outcome the FOMC was trying to achieve. The public would then be better able to evaluate the FOMC's performance. The Federal Reserve chairman's semiannual reports to Congress would likely include a discussion of inflation outcomes relative to the objective. Less routinely, one can imagine Congress asking the chairman to testify regarding the reasons why inflation had drifted from the target for an unusual length of time.

Finally, putting a number on the FOMC's inflation objective would **HELP THE FOMC EXPLAIN ITS ACTIONS TO THE PUBLIC**. Suppose, for example, that the members agreed on an inflation objective of 2 percent. Last November, having had such an objective might have allowed the FOMC to better explain the expansion of its purchases of longer-term Treasury securities. I supported the action in part because I saw inflation as simply too low. The underlying rate of inflation was below 1 percent and falling, pulling inflation yet further from the FOMC's implicit objective of 2 percent or a bit less (as suggested by the FOMC's economic projections). I think the FOMC could have been clearer about its motivation to engage in large-scale asset purchases if it had been able to reference its 2 percent inflation objective.

Similarly, looking ahead, I believe that having an explicit numerical objective for inflation would help the FOMC explain its eventual decision to tighten monetary policy. For instance, once the economic recovery is sufficiently far along that the FOMC expects inflation to begin gathering some momentum, I think the timing and magnitude of our actions to tighten policy would be more clearly understood by the public if we could reference a numerical inflation objective. This would be especially useful in the context of the FOMC's already-established practice of publishing its economic projections. Likewise, an explicit objective might put to rest the media trope about inflation "hawks" and "doves," as it would be evident that all members shared the identical objective.

Finally, it is important to clarify that setting an explicit inflation objective is merely a means to an end. It will enhance the Federal Reserve's ability to achieve its dual mandate of price stability and maximum employment. Being explicit about the inflation objective does not change the dual mandate at all. The Federal

Reserve has had to put the dual mandate into practice ever since Congress set forth the broad goals in 1977. I do not see an explicit numerical inflation objective as anything other than another step in that direction—a step based on good economics, our own experience, and the experience of other central banks.



In 1979, Federal Reserve Chairman Paul Volcker led what became one of our signature monetary policy achievements—the “Great Disinflation.” By taming runaway inflation, the Federal Reserve regained the credibility it had lost in the 1970s as the nation’s steward of price stability.

It is time to build on that hard-won credibility. Setting an explicit inflation objective is in keeping with the times, enhancing the Federal Reserve’s openness and accountability at a time when the public is ever-more demanding of—and deserving of—such openness and accountability. It will be good for monetary policy. Most important, it will be good for the economy. ♦

# FAQ

## Frequently Asked Questions About INFLATION...



**Brent Meyer**  
*Senior Economic Analyst*

### How can inflation be considered low when food and gas prices are so high?



**Mehmet Pasaogullari**  
*Research Economist*

**How can inflation be considered low when food and gas prices are so high?** Because there is a difference between inflation and relative price changes. Inflation is a general rise in prices usually measured by tracking the prices of a broad basket of goods and services, such as the Consumer Price Index (CPI). The CPI is a weighted index of a typical consumer's market basket, which includes food and gas prices. Recently, there have been growing price pressures for these items, which highlight the importance of distinguishing between the two concepts.

Over the past year, the overall—or headline—inflation rate has been gradually rising but remains modest by historical standards (the CPI has risen just 2.7 percent). This may come as a surprise to shoppers who have absorbed the swifter increases in some relative prices such as food, gas, and other commodities. It's well understood that rising food and energy prices can put pressure on household budgets, possibly causing painful tradeoffs, especially since it is hard to substitute these items. Households may decide to either cut back on food and gas or curb their spending on other goods and services, which could cause price changes elsewhere in the market basket. Although these tough choices between food, gas, and other goods and services tell us much about the welfare of individuals, they may not reveal much about the path of inflation.

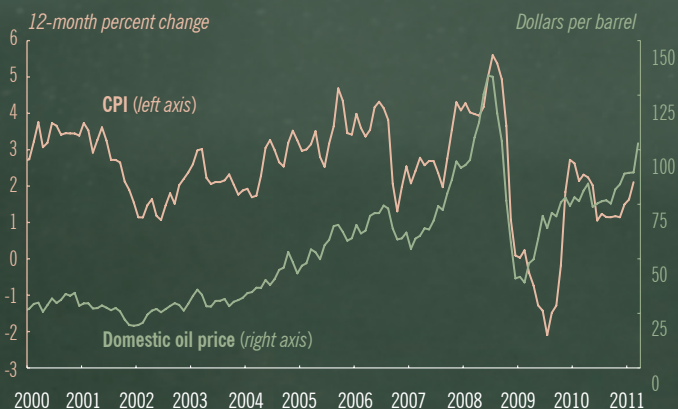
Increasing food and gas prices will affect the headline CPI inflation directly to the extent of their share (roughly 20 percent) in the consumer market basket. These relative price changes

may not be driven by inflation but, more likely, by fundamental factors affecting supply and demand for each particular good. Looking at the price change for one item or group, say gasoline (which is up 27 percent over the past year), doesn't tell you much about how high inflation is—just as infant and toddler apparel prices, which have declined 3.8 percent in the past 12 months, are not an indicator of deflation. Inflation itself affects all prices and wages, not just one or two particular items or markets.

The headline CPI, like all headline inflation measures, is subject to short-term volatility that can arise from several sources: mismeasurement, treatment of seasonal factors, and relative price changes, which have little or nothing to do with inflation. These transitory price fluctuations may cause the CPI to give a misleading monthly signal of the inflation trend.

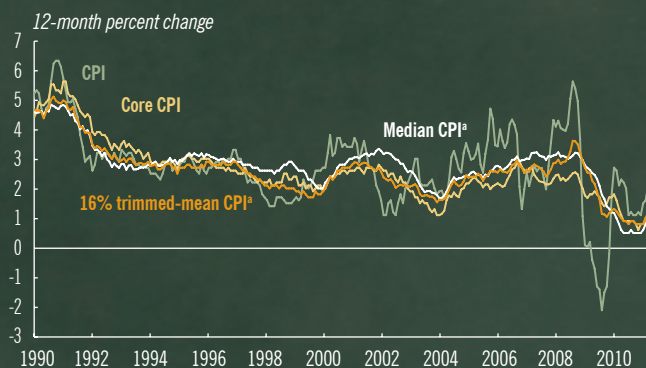
For example, in mid-2008, oil prices spiked, peaking at an average of \$134 a barrel that June. Measured at annualized rates, energy prices in general jumped 102.4 percent that month, which caused the CPI to spike up 11.7 percent, pushing its 12-month change up to 5.0 percent. Five short months later, the bottom fell out on oil and energy prices, causing the year-over-year percent change in the CPI to dip well below zero. This is exactly the kind of volatility that makes it difficult to monitor the headline CPI for changes in the inflation trend. What we need are measures of inflation that extract a signal about future prices.

Figure 1. Inflation and Oil Prices



Sources: U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Bank of Cleveland.

Figure 2. Consumer Price Index



a. Calculated by the Federal Reserve Bank of Cleveland.

Sources: *The Wall Street Journal*; Bureau of Labor Statistics/Haver Analytics.

Price statistics that attempt to distinguish the inflation signal from noise are often called underlying measures of inflation. One well-known underlying inflation statistic excludes food and energy prices from the CPI; this is what most economists refer to as the “core CPI.” Food and energy prices tend to be the most volatile components and regularly cause fluctuations in the CPI that are not characteristic of the inflation trend.

However, the “ex-food and energy” approach does not address transitory price fluctuations in other components of the retail market basket used to construct the CPI, such as mismeasurement and idiosyncratic shocks (excise taxes, inclement weather, and government incentives to reduce the supply of used autos, for example). Further, such an approach may mismeasure inflation if there are long-term movements in food and energy prices relative to other goods and services.

An alternative underlying approach is to eliminate monthly volatile price movements from the CPI through the use of trimmed-mean estimators, which eliminate the most volatile monthly price swings (both increases and decreases). By eliminating high-frequency noise, these measures provide a clearer signal of the inflation trend than either the headline CPI or the core CPI.

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**Price statistics that attempt to distinguish the inflation signal from the noise are often called underlying measures of inflation. The Federal Reserve Bank of Cleveland’s measures of underlying inflation are currently quite low.**

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The Federal Reserve Bank of Cleveland reports two such trimmed-mean measures—the 16 percent trimmed-mean CPI and the median CPI—on a monthly basis. These measures are much less volatile than either the CPI or the core CPI, making them more useful in determining the current inflation trend and in forecasting future inflation, as research here in our Bank and elsewhere shows.<sup>4</sup>

As you can see from figure 2, these measures of underlying inflation are currently quite low. In fact, they are all hovering near post-World War II lows. The median CPI and the core CPI are up just 1.2 percent over the past year. ♦

<sup>4</sup> See Michael F. Bryan, Stephen G. Cecchetti, and Rodney L. Wiggins II, 1997, “Efficient Inflation Estimation,” Working Paper No. 9707, Federal Reserve Bank of Cleveland (August).



**Owen Humpage**  
Senior Economic Advisor

## Can the Federal Reserve control inflation in a global marketplace?

**Can the Federal Reserve control inflation in a global marketplace?** Yes, it can. The growing integration of world markets has by no means diminished the Federal Reserve's ability to control inflation. If anything, the more intense competition associated with global openness complements the FOMC's efforts to achieve price stability. Since 1980, as trade and competition between nations has progressed, the rate of inflation in the United States has fallen precipitously. Even as commodity prices are rising here and internationally, domestic inflation remains firmly under the Federal Reserve's control.

One of the bedrock principles of economics is that trade is mutually beneficial. When one nation profits from trade, it does not necessarily mean the other loses—it is not a zero-sum game. The concept holds when applied to prices. Cross-border competition generally has a favorable impact on the level of consumer prices, whether for steel or software.

Globalization provides firms with access to lower-cost inputs while it reduces firms' ability to mark up prices beyond what is necessary to cover their costs and provide a competitive rate of return. Separately, openness fosters specialization and cross-border technological transfers, both of which reduce prices through productivity gains. International trade also tends to keep wage rates at competitive levels. Moreover, prices and wages that evolve in such competitive environments tend to adjust more flexibly to changes in underlying market conditions than prices and wages that arise in less-competitive situations.

Still, with world commodity prices now on a sharp upward path, and with inflation rising in some developing countries, notably China, many observers wonder if higher import prices will serve as the conduit to growing inflation in the United States. A sharp rise in import prices—particularly in goods like oil that are used in the production of other U.S. goods—can put upward pressure on a broad swath of consumer prices.

These price strains will always prove transitory, provided that the Federal Reserve System does not accommodate them through a monetary expansion.

Increases in the prices of imports and in the prices of domestic goods made with imports have two general impacts on the economy. First, they cause consumers and businesses to switch to cheaper alternatives whenever possible. This substitution effect can cause the prices of the alternative goods to rise, of course, but competition tends to limit their size. Second, the rise in import and related prices reduces the purchasing power of consumers' income, much like a tax. This income effect ultimately limits the scope of price increases—prices can rise only so far before consumers completely stop buying those products, given income constraints—unless, of course, income somehow expands along with the price pressures.

The only way that can happen is for the Federal Reserve to ease monetary policy. In fact, the FOMC often did so in the 1970s, fearing that the income effect from sharply higher imported oil prices would otherwise lower output and employment. The results were disastrous, ushering in the unintended effect of upward spiraling inflation and stagnant growth. Easing monetary policy in an attempt to minimize output losses can convert a broad-based relative price hike into inflation with—at best—uncertain, temporary gains to employment and output. Ultimately, the economy still must adjust to elevated import prices, but having to adjust to a higher rate of inflation on top of relative price increases is a recipe for recession.

Keeping the focus of monetary policy on a low and stable inflation objective, in contrast, allows the economy to adjust to higher relative import prices without the added uncertainty about how and when the central bank will wrench it back out of an inflationary environment. Commodity prices may grab the headlines, but remember: The conduit of inflation is always monetary policy. ♦



**Mark Schweitzer**  
Senior Vice President and  
Director of Research

## Is an explicit inflation objective consistent with a dual mandate?



**Brent Meyer**  
Senior Economic Analyst

**Is an explicit inflation objective consistent with a dual mandate?** It can be. An inflation objective can be implemented even when a central bank has more than one mandate, which the Federal Reserve does—to provide “maximum sustainable employment” in “an environment of stable prices.” In fact, in countries like the United States, where weight is given to variables other than inflation, monetary policy performance may be even more effective than if the central bank had only a single mandate.

In addition, the experiences of other countries that have worked with an explicit numerical objective for many years suggest that a flexible inflation targeting regime may actually be more effective than a strict rule, even if price stability is the primary concern. By “flexible,” we mean that the central bank identifies factors that could cause it not to raise interest rates in response to high inflation. Often the factors may indicate that the headline, or overall, inflation increase is expected to be temporary.

New Zealand and Norway are two countries whose experiences in implementing inflation targets illustrate that a flexible inflation targeting regime works well, especially when central banks have additional goals. Both countries are small, open economies: New Zealand trades substantially with Asian markets and, as an exporter of agricultural goods, is very sensitive to exchange-rate movements. Norway—a major oil exporter—is heavily exposed to fluctuations in oil prices, which cause economic variability above and beyond exchange-rate volatility. These sources of added volatility make setting appropriate monetary policy even more challenging than in the United States, and thus make these two countries interesting case studies.

**New Zealand:** The Reserve Bank of New Zealand (RBNZ) started pursuing a strict inflation target in 1990 with the sole purpose of price stability. It established a “hard” annual percent target range in its CPI of 0 to 2 percent. At the time, the RBNZ reacted so aggressively to inflation rates above its target range that it was rumored its governor would lose his job should the RBNZ fail to deliver on its promise. (An effective credibility mechanism!) Unfortunately, such hawkish policy, instead of leading to greater stability, was associated with a volatile period for interest rates, exchange rates, and output.

In response, the RBNZ and the government of New Zealand slowly edged away from a strict regime, becoming more flexible in the approach toward inflation targeting over time. In fact, the RBNZ’s mandate now reads, “In pursuing its price stability objective, the Bank . . . shall seek to avoid unnecessary instability in output, interest rates, and the exchange rate.” In a way, this change made the RBNZ’s objective closer to the Federal Reserve’s dual mandate.

Figure 3 illustrates New Zealand’s flexibility, as the RBNZ has at times either held or cut its main policy tool—the official cash rate (OCR)—even when the annual trend in inflation was above its stated target range. Greater flexibility has likely contributed to reduced macroeconomic volatility, but the RBNZ has still been successful at lowering inflation back into its target range following significant economic shocks. While increasing flexibility does come with the risk of losing credibility, survey measures of inflation expectations have remained within the RBNZ’s target range, evidence that expectations remain anchored.



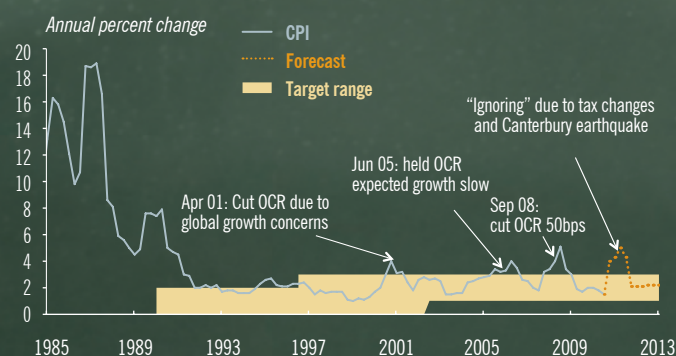
**Norway:** The Norges Bank (the central bank of Norway) has operated a “flexible inflation targeting regime” for the past 10 years. Under this set of rules, weight is given to stability in inflation, employment, and output (similar to the Federal Reserve’s current dual mandate). The Norges Bank’s operational target for inflation is an annual CPI inflation rate of 2.5 percent over the medium term. Should inflation deviate from its target as a result of a shock to the economy, the specific length of time it will take for inflation to return to its target will depend on the type of shock that buffeted the economy.

With such flexibility, a central bank needs to communicate its policy in a transparent and credible manner, lest the public lose faith in the bank’s ability to deliver on its promises. The Norges Bank does this by publicly announcing policy objectives, providing its assessment of current economic conditions, and releasing its forecasts for macroeconomic variables such as GDP and inflation.

Norway has experienced significant shocks to its economy. For example, in January 2003, its headline CPI—which has been and continues to be more volatile than many other developed countries—jumped to above 5 percent, largely due to a spike in the relative price of household electricity stemming from supply issues, only to fall below zero a year later. But despite these episodes, the Norges Bank has succeeded at returning inflation to its targeted level. Relative price swings do make it hard to get an accurate reading on inflation, and even harder to communicate to the public. However, since the Norges Bank adopted an explicit inflation target in 2001, the longer-term (three-year) trend in inflation has been relatively well anchored near 2.5 percent.

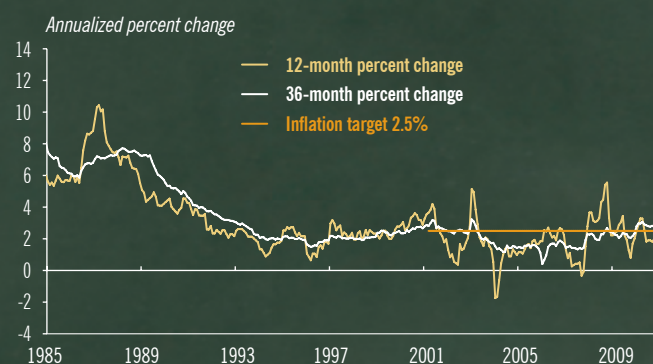
Judging from the experiences of these two countries, moving to an explicit numerical inflation objective can be consistent with the Federal Reserve’s dual mandate. Indeed, these two countries show that when inflation expectations are well anchored, the central bank can be freer to take short-term stabilization actions, if the public does not fear inflation. ♦

Figure 3. New Zealand’s CPI



Sources: Statistics New Zealand; Reserve Bank of New Zealand.

Figure 4. Norway’s CPI



Source: Statistics Norway/Haver Analytics.



## How can the Federal Reserve keep all the money it's been "printing" from developing into runaway inflation?



**John Carlson**  
*Vice President and Economist*

### How can the Federal Reserve keep all the money it's been "printing" from developing into runaway inflation?

The short answer is that the Federal Reserve is unwaveringly committed to price stability and has the tools to fight inflation at every turn. The slightly longer answer follows.

Let's start by revisiting the motivation for the Federal Reserve's "money printing," which has resulted in a balance sheet that is more than 2½ times larger than it was before the financial crisis. The Federal Reserve's balance sheet now contains assets of almost \$3 trillion, a record high that amounts to about \$9,600 per U.S. resident. When people talk about all the money the Federal Reserve is printing, that's what they mean.

The increase in assets served two key purposes. One was to support market functioning. The other was to lower longer-term interest rates.

As the nation's lender of last resort, the Federal Reserve is responsible for providing backstop lending. When private credit markets panicked and dried up in the fall of 2008, the financial system likewise froze. The Federal Reserve accomplished its backstop role by expanding access to credit facilities for a broad array of financial institutions—including investment banks and money market mutual funds—and by purchasing an increasing array of assets, including mortgage-backed securities and commercial paper (figure 5). The increased lending served its purpose: it stabilized markets, restored credit flows, and supported the economic recovery.

Most assets associated with the emergency lending programs have now rolled off the balance sheet. The more persistent components were those intended to lower longer-term interest rates. This program began in November 2008 with an FOMC policy directive to make large-scale purchases of a range of

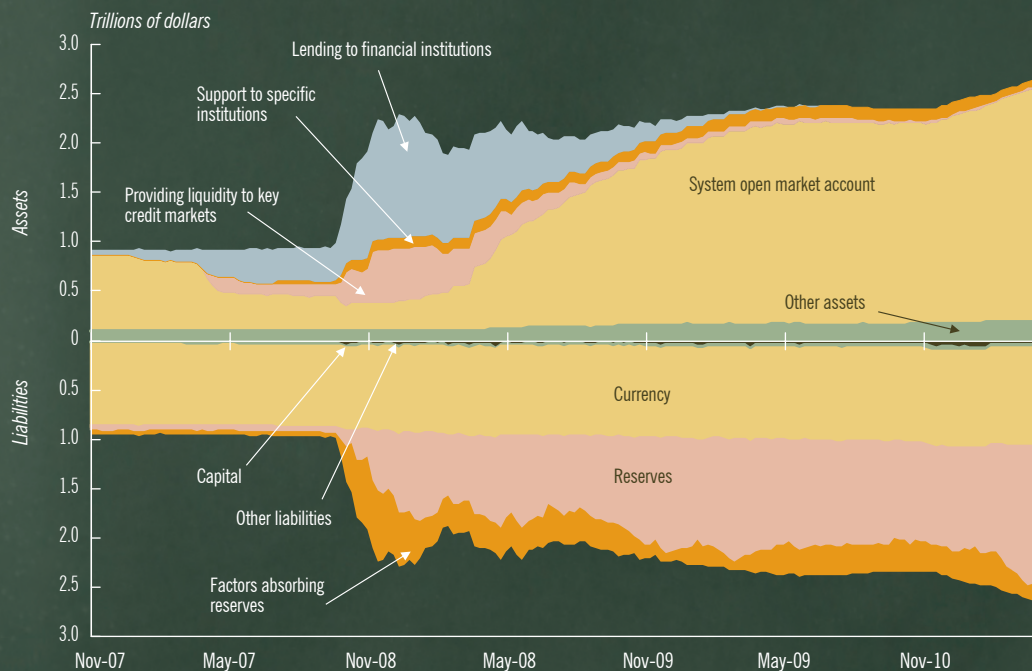
longer-term securities. The large-scale asset purchase program (LSAP) was expanded in March 2009 and continued after the economy began to grow in June 2009. Indeed, the FOMC ordered another round of purchases in November 2010 as economic indicators suggested a weaker-than-expected recovery and the potential for menacingly low inflation. This most recent effort is commonly called Quantitative Easing 2 (QE2) and has received no shortage of attention in the press.

LSAP was a departure from the conventional Federal Reserve policy tool of targeting the interest rates paid on overnight borrowings between banks—known as the federal funds rate. With the funds rate hitting the zero bound—when the FOMC lowered the federal funds rate target to between zero and ¼ percent in December 2008—there was no more room to go lower. But the goal of each tool, whether conventional or unconventional, is the same: to provide monetary stimulus for generating a sustainable expansion of economic activity.

In effect, the asset purchases have been funded by the creation of bank reserves. It is this large supply of bank reserves (composed almost entirely of excess reserves) that has some analysts worried about the potential for an increase in inflation.<sup>5</sup> Excess reserves, like currency, are immediate money, meaning they can be spent instantly. Thus, analysts who are concerned about inflationary pressures see the surge in excess reserves as a case of "printing money."

Unlike Federal Reserve notes, which are actually printed and largely held by individuals, excess reserves remain idle and essentially exist only as entries on banks' balance sheets. Nevertheless, some fear that excess reserves could allow banks to expand credit dramatically, and that could lead to inflationary pressures. Understanding this dynamic, the Federal Reserve began developing an exit strategy well before LSAP was fully implemented.

Figure 5. Federal Reserve's Balance Sheet



Source: Federal Reserve Board.

As part of the exit strategy, Chairman Ben Bernanke has emphasized that the FOMC remains unwaveringly committed to low and stable inflation, and that it “has the tools to be able to smoothly and effectively exit from the current highly accommodative policy stance at the appropriate time.”<sup>6</sup>

Congress gave the Federal Reserve one of the most important exit strategy tools in 2008 with the authority to pay interest on reserve balances at Federal Reserve Banks. This authority allows the Federal Reserve to put upward pressure on short-term rates and thus to tighten monetary policy even if bank reserves remain high. Banks won't want to trade with one another at or below the rate by keeping their reserves on deposit at the Federal Reserve.

In addition, the Federal Reserve has developed other tools that will allow it to absorb reserves, immobilizing them as needed to allow a smooth withdrawal of policy accommodation when conditions warrant. Finally, the Federal Reserve could also tighten policy by redeeming or selling securities in the open market. ♦

<sup>5</sup> Excess reserves consist of reserves over and above the levels that banks are required to keep on deposit at the Federal Reserve.

<sup>6</sup> Testimony before the Committee on the Budget, U.S. House of Representatives, Washington, DC, February 9, 2011.



**Joseph Haubrich**  
*Vice President and Economist*

## How do we know when people are worried about inflation?

**How do we know when people are worried about inflation?** One way to gauge opinions on future inflation is to ask people directly, and several well-respected surveys do just that. The Reuters/University of Michigan Surveys of Consumers ask the proverbial “man on the street” how much he thinks prices will change in general terms, not relative to any statistic. Others, such as the Survey of Professional Forecasters or Blue Chip Economic Indicators, ask market professionals about specific measures, including their predictions for the CPI.

Another way to quantify inflation expectations is to see if people put their money where their mouth is. Several financial contracts linked to inflation provide a sense of what “the market” expects on the inflation front.

The most commonly used measure of inflation expectations of this type is the “break-even inflation rate” derived from the interest rates on two different types of Treasury securities. One type of Treasury bond, Treasury Inflation Protected Securities (TIPS), pays back more money if prices rise, and in that way protects against inflation. Traditional, or nominal, Treasury bonds do not—if the bond has a face value of \$10,000, it will deliver \$10,000 at maturity. A TIPS of equal face value, by contrast, will pay \$11,000 if inflation runs at 10 percent over the life of the bond. Because one bond is protected against inflation and the other is not, the difference in their interest rates gives the measure of expected inflation at which an investor would “break even” no matter which option was chosen.

Another way to gauge expectations is with something called an inflation swap. Here, two investors (or counterparties) agree to a trade: One side pays a fixed, certain interest rate, and the other agrees to pay whatever the inflation rate ends up being. So the

fixed payment should indicate the investor’s expected inflation. In that sense, it is directly comparable to the break-even rate from TIPS.

Plotted on graphs in figures 6 and 7, TIPS and inflation swaps show remarkably similar patterns, though liquidity and other differences between the instruments mean that they do not match exactly. After a large drop to abnormally low levels in the summer of 2010, expectations steadily increased back to levels somewhat above where they were in early 2010.

The problem with these indicators is that both the TIPS- and swaps-based measures overstate inflation expectations. Both include a risk premium for inflation along with a measure of expected inflation. That’s because investors demand a bit of insurance to account for the fact that inflation might differ from what they expect.

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### Another way to quantify inflation expectations is to see if people put their money where their mouth is.

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A measure developed at the Federal Reserve Bank of Cleveland uses a hybrid model that includes both financial data and survey measures of inflation to remove this bias. It delivers a purer measure of inflation expectations and can also extract inflation expectations at a variety of horizons. Shown in figure 8, this measure shows a fairly contained level of inflation at many horizons, with expectations generally staying below 2 percent for many years. ♦

Figure 6. Five-Year Break-Even Inflation Rate, TIPS



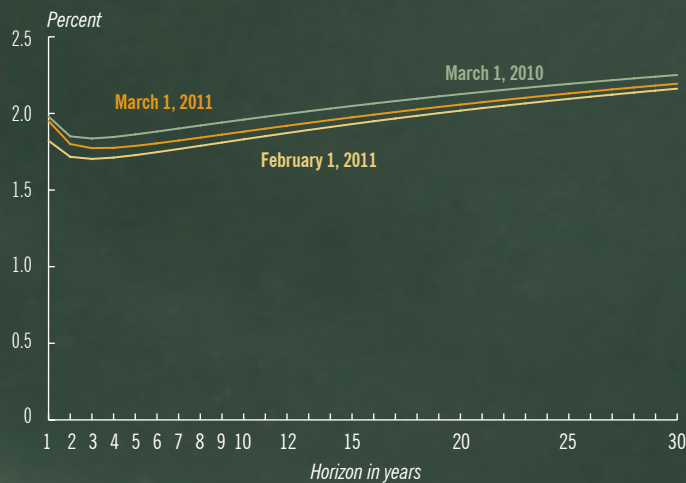
**Note:** Calculated using TIPS break-even inflation rates.  
**Source:** Federal Reserve Board.

Figure 7. Five-Year Break-Even Inflation Rate, Swaps



**Note:** Calculated using inflation swaps.  
**Source:** Bloomberg.

Figure 8. Expected Inflation Yield Curve



**Source:** Federal Reserve Bank of Cleveland.

## Will rising commodity prices lead to rising inflation?



**Kenneth Beauchemin**  
*Senior Research Economist*

**Will rising commodity prices lead to rising inflation?** Not necessarily. While the recent commodity price shock does pose an upward risk to underlying inflation, we expect the effect to be small and transitory.

Real, or relative, commodity prices are determined by the Commodity Research Bureau's (CRB) spot price index of all commodities divided by the core consumer price index. They include crude oil, metals, crops, and the like, and their spike has been quite pronounced over the past year. Since the early 2000s, in fact, real commodity prices have generally moved higher (see figure 9).

Inflation in the near- to medium term, in particular the underlying inflation trends that help guide monetary policy, depends on a variety of forces, including inflation expectations and the behavior of economic activity. (Over the long term, monetary policy determines the trend of inflation.) For a more satisfying explanation of why we expect only small and transitory effects from the recent commodity price shock, we need to delve just a little deeper into the economy's structure to examine the role of commodity prices in production costs.

In the mature and diverse economy of the United States, the total number of goods produced far exceeds those that are sold to consumers as "final" output. The prices for the items in the CPI published by the Bureau of Labor Statistics (BLS), for example, represent only a small fraction of prices posted and paid in the economy.

In addition to consumer prices, there are also the prices for "intermediate" goods—the industrial materials fashioned from raw commodities that trade on global markets. But do

the prices of intermediate goods exist in a realm completely separate from consumer prices?

Certainly not, as a time-honored textbook example makes clear: Consider a loaf of bread on a supermarket shelf that sells for \$2.00. In the first stage of production, a farmer produces the wheat required to produce the loaf and sells it to the flour mill for \$0.60. The mill converts the wheat to flour and sells it to the bakery for \$1.30. In the process, the mill has added \$0.70 of value to the farmer's wheat. Subsequently, the bakery produces the loaf and sells it to the grocer for \$1.80 (in what is commonly called a wholesale transaction), adding \$0.50 of value to the bread. Finally, the consumer purchases the bread for \$2.00 (the retail transaction), which means that the retailer has added \$0.20 in value.

This final transaction's price is the only one that would enter into an index of consumer prices (such as the CPI). The rest—all prices determined in intermediate transactions—contribute to the various measures of producer prices compiled by the BLS.

We take away from this example the simple notion that consumer prices reflect the prices of all intermediate materials used in production. In our little example, wheat is considered a commodity, flour an intermediate material, and bread on the grocer's shelf the final output.

But this simple story disguises the contribution of a universal and critical input to production: the labors of men and women that transform raw and intermediate materials into materials that are useful in the next stage of production. Also, the value added by labor in each stage of production—from the farmer toiling in the fields to the cashier ringing up your bread—turns out to be far greater than the cost of materials. Furthermore,

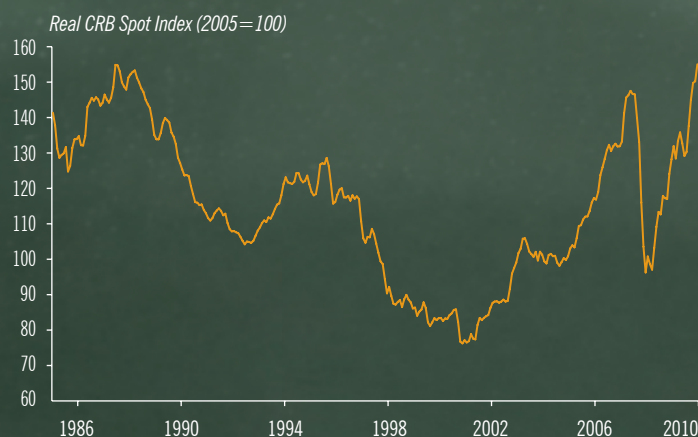
when the relative price of a material rises, firms can often substitute for a cheaper alternative. Substituting labor for materials is not so straightforward. So what has been happening to labor costs? Figure 10 charts the recent growth in unit labor costs (the labor cost of producing a single unit of output), and it has been anemic. While strong world demand for commodities coupled with substantial supply disruptions have driven commodity prices much higher over the past year or so, weak labor market conditions in the United States coupled with strong productivity growth have led to concurrently falling unit labor costs and historically low readings of underlying inflation. With the unemployment rate at historically high levels, we do not expect resurgent labor compensation growth anytime soon.

A commodity price shock also has its own implications for economic activity and labor demand, particularly if that commodity is crude oil and energy commodities more generally. Given that substitutes for fossil-fuel-generated energy are nearly nil in just about any production process one can imagine, the natural response of a profit-maximizing firm to higher energy prices is to limit production, thereby reducing the demand for labor and suppressing market wages in the process. So, higher commodity prices act as a catalyst for both higher inflation, as businesses pass through higher production costs, and lower inflation, as compensation growth falls.

How do we sort out these complicated and opposing forces to determine whether rising commodity prices will lead to rising inflation? At the Cleveland Federal Reserve, we recently developed a historically based forecasting model to evaluate the question. The main experiment simulated a commodity price shock of similar scale to the one experienced in 2007 and 2008. The model showed only a small increase in the core CPI, about 0.3 percentage point at the worst point of the shock, and some dampening of economic activity.

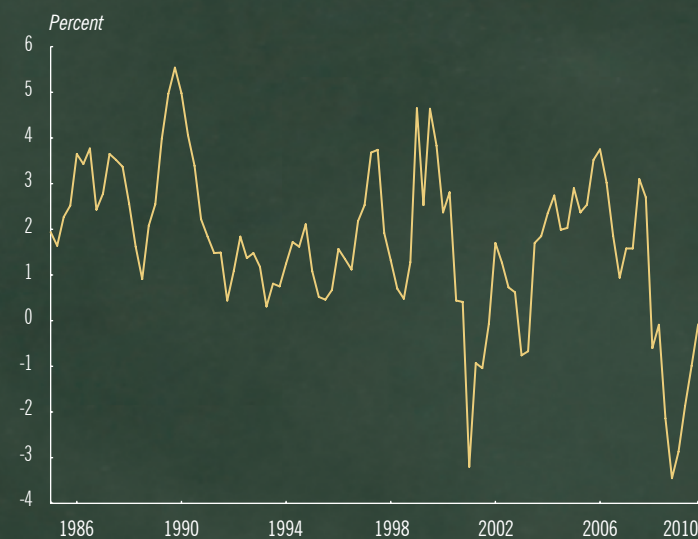
Even though changes in commodity prices can quickly hit consumer pocketbooks, their ability to bring about a sustained inflation is less robust. For commodity price shocks to generate inflation, they must rise faster than the overall level of prices for a protracted period. In that event, stable inflation expectations could be placed in jeopardy, raising the risk of a sustained inflationary period—and a tougher monetary policy environment. ♦

### Figure 9. Real Commodity Prices Since 1986



Source: Commodity Research Bureau.

### Figure 10. Unit Labor Costs



Source: U.S. Department of Labor, Bureau of Labor Statistics.



**John Carlson**  
*Vice President and Economist*



**Owen Humpage**  
*Senior Economic Advisor*

## Isn't pursuing a low and stable inflation rate going to cost the economy jobs?

Isn't pursuing a low and stable inflation rate going to cost the economy jobs? On the contrary: Low and stable inflation is an essential ingredient for growing jobs. It can help promote maximum employment by eliminating uncertainty about the evolution of monetary policy and by allowing relative prices to act as clear signals to consumers.

It's true that monetary policy has been highly stimulative for the past couple of years, which could risk creating higher inflation while creating higher employment. At first glance, it might appear that efforts to place more policy focus on low and stable inflation could cost jobs. In fact, many believe that we must have higher inflation to have lower unemployment—this is the premise of the Phillips curve, which shaped economic debate for much of the last part of the 20th century.

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**The lower the inflation rate, the lower the unemployment rate—contrary to what many economists had once thought to be the case.**

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When monetary policy attempts to raise employment above a level consistent with stable inflation, however, consumers, businesses, and wage earners eventually catch on and begin to anticipate the inflationary effects of the policy on all prices and wages. Producers of goods discover that they can increase their profit margins by raising prices at the cost of lower levels of

output and therefore demand fewer employees. So any tradeoff between inflation and unemployment eventually breaks down, resulting in permanently higher inflation, but no lasting gains in employment.

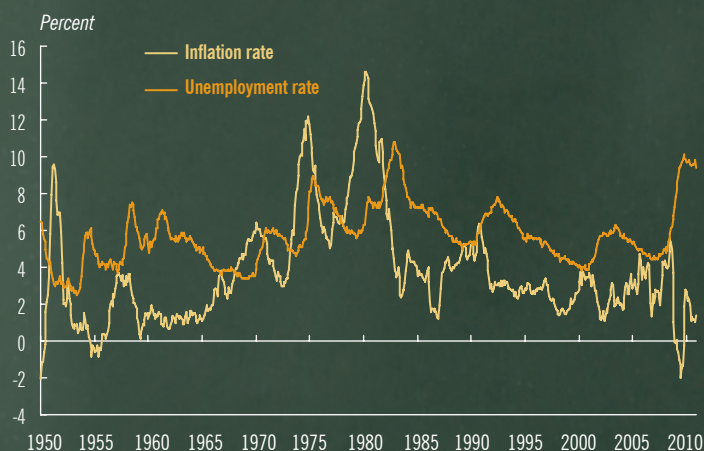
Attempts to maintain a level of unemployment below the economy's full employment rate also create uncertainty about the implications of such a policy for the relative prices of goods and services. Thus, such policies interfere with efficient spending choices by adding noise to price-setting decisions, and hence to the signals consumers need to make their best choices.

The overall correlation between inflation and the unemployment rate since 1950 is weak, but it is nonetheless significant and positive—not negative as a permanent tradeoff would indicate. In other words, the lower the inflation rate, the lower the unemployment rate—contrary to what many economists had once thought to be the case. But the data also suggest that, over short periods, monetary policy can be used to bring employment in line with full employment levels, provided inflation expectations remain stable.

Consider the 1970s: Excessively stimulative monetary policy during this decade persistently failed to account for accelerating inflation and its ultimate effect on inflation expectations. As illustrated in figure 11, both inflation and unemployment rose throughout the decade. After this dismal experience, many central banks set numerical objectives for inflation in the



Figure 11. U.S. Inflation and Unemployment Rate



**Note:** Inflation rate given as an annualized percent.

**Source:** U.S. Department of Labor, Bureau of Labor Statistics.



neighborhood of 2 percent per year. This objective is broadly accepted as being most consistent with maximum levels of employment; 2 percent is a low enough target level to be credible with the objective of price stability. Such credibility in turn creates an environment in which monetary policymakers can aggressively ease to offset the negative consequences of shocks that threaten economic stability. And, as figure 11 also shows, since

the 1980s, both U.S. inflation and unemployment have trended lower until the 2007-09 recession.

To the extent that the recent policy measures to produce low and stable inflation help speed economic activity and employment to their potential levels, such policies would, if anything, add—not cost—jobs. ♦

## 2010 OPERATIONAL HIGHLIGHTS

*As 2010 ushered in sweeping reforms to the U.S. financial regulatory structure, the Federal Reserve Bank of Cleveland geared up to implement the impending changes. At the same time, the Bank reaffirmed its commitment to excellence in core responsibilities, including central banking, financial and Treasury services, banking supervision and regulation, and outreach. Guiding these efforts were the Bank's refreshed strategic goals: financial system stability, economic growth, and payments transformation.*



## Contributions to Regional and National Policy Issues



Vice President and Community Affairs Officer Ruth Clevenger, 2010 President's Award recipient, is shown here with President and CEO Sandra Pianalto and First Vice President and COO Dale Roskom.

Throughout 2010, the Bank advanced its work on housing policy and neighborhood stabilization through applied research and leadership of System and District policy summits. The **Community Development** function worked proactively to recognize and respond to the housing and foreclosure issues emerging in the Fourth District.

Led by Vice President and Community Affairs Officer Ruth Clevenger, Community Development expanded the Bank's collaboration with nonprofit organizations, government agencies, academics, and other Reserve Banks. These efforts yielded a national vacant property conference showcasing a presentation of the Bank's Neighborhood Stabilization Program research.

The function also provided key insights into the development of a Community Reinvestment Act (CRA) proposal, contributing early versions of the language and approach to the proposal that was put out for public comment, and collaborated frequently with Research and Supervision staff to design public outreach programs. Throughout the financial crisis and its aftermath, the team maintained strong communication channels with its stakeholders, hosting conferences and small group meetings throughout the District to address issues concerning housing policy.

Community Development has become widely regarded as a leader in the Federal Reserve System for its expertise on housing issues associated with vacant and abandoned properties and for its proactive outreach efforts. As a result, the Federal Reserve Bank of Cleveland became one of two Reserve Banks to lead a Systemwide initiative on how to deal with distressed properties, which led to a significant conference held at the Federal Reserve Board.

For her leadership, commitment, and ability to deliver results in addressing the aftereffects of the financial crisis, Clevenger was awarded one of two 2010 President's Awards, the Bank's highest employee honor.

The **Community Development** function has become widely regarded as a leader in the Federal Reserve System for its expertise on housing issues.

## Achievements in Payments Operations



The Bank's Debit Gateway team received a 2010 President's Award for successfully streamlining business processes that resulted in significant savings for the U.S. Treasury and the Federal Reserve.

The Bank continued to play a crucial role in supporting the U.S. Treasury's efforts to further streamline its electronic payments processes by successfully implementing the Debit Gateway. The Debit Gateway project consolidated the processing of check and ACH debit transactions into a single centralized system that resulted in greater efficiency.

Over the course of 15 months, the Debit Gateway team—comprised of members of the Bank's **eGovernment** function—successfully designed, tested, and implemented two significant software releases. By second quarter 2010, the Debit Gateway was successfully launched, and payment processing began. The system processes more than 250 million transactions totaling over \$2 trillion annually.

The successful implementation was an important milestone for both the Cleveland Fed and the Treasury. A highly visible project, the Debit Gateway became the first new application to be integrated as part of the Treasury's strategic vision, and signifies the future of collections.

For their efforts in streamlining business processes and continuing to provide critical services and support to the Treasury, the Debit Gateway team was awarded the second of the Bank's 2010 President's Awards. The eGovernment Department also received the Treasury's highest performance rating for the third consecutive year.

The **Debit Gateway** became the first new application to be integrated as part of the Treasury's strategic vision, and signifies the future of collections.



## Innovations in Public Outreach



Todd Morgano, assistant vice president in Public Affairs, was presented with the 2010 Chris Moore Spirit of Innovation Award for developing and executing the Drawing Board concept.

The Bank's public outreach initiatives focused on such issues as small business lending, housing finance, and systemic risk. In 2010, key messages from the Bank's research were shared more broadly across communication channels and media outlets and were widely cited in the press. In particular, the Bank's work on inflation, the median CPI, Federal Reserve balance sheet developments, and economic trends received considerable public attention.

Realizing the public's desire to better understand the complex economic issues confronting them every day, the **Public Information** function saw a unique opportunity to provide those sought-after answers while delivering key Bank messages in a creative way. Working cross-functionally with the **Research** function, the team—led by Assistant Vice President Todd Morgano—developed the Drawing Board, a series of videos comprised of “really bad drawings and real simple explanations.”

The first installment in the series featured the Federal Reserve Bank of Cleveland's proposal for regulating systemically important institutions. A comprehensive media campaign that targeted both traditional and social media channels was launched, which garnered significant attention from national and local media for the video. Another video in the series, which focused on Federal Reserve independence, drew critical acclaim from the media. Both videos continue to be viewed regularly on YouTube.

The Drawing Board series and media campaign conveyed the Bank's key messages clearly and accurately using common-sense language, which allowed the Fed to reach new audiences. For pioneering this new dimension of the Bank's communications strategy, Morgano was presented with the 2010 Chris Moore Spirit of Innovation Award. The annual award, which honors the legacy of the Bank's late first vice president, recognizes a commitment to innovation through the implementation of creative ideas that contribute to the Bank's strategic goals.



Find the Drawing Board series at [www.clevelandfed.org/drawingboard](http://www.clevelandfed.org/drawingboard).

## Response to Financial Regulatory Reform

With the passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act in July 2010, several Federal Reserve System banking supervision practices were revised to focus on strengthening processes for systemically important and large banking organizations. The Bank’s **Supervision and Regulation** function successfully incorporated these changes and enhanced its large-bank capital assessment processes. The Bank also piloted elements of its enterprise risk management framework at a large District banking organization.

The **Office of Minority and Women Inclusion (OMWI)** was established consistent with the parameters outlined in the Dodd–Frank Act. Although the legislation is new, the Bank’s commitment to diversity and inclusion is not. OMWI supports the Bank’s existing efforts to foster a more inclusive work environment, build a workforce that is representative of our

communities and is consistent with the applicable job market, and promote the Bank as an organization that values a collaborative and diverse environment.

To support OMWI’s goals, the **Contracts and Procurement** function expanded its supplier diversity program. **Human Resources** reviewed its recruiting practices to confirm that diverse slates of candidates are considered for Fourth District employment opportunities. The **Community Relations** function incorporated additional diversity and inclusion practices into its strategic plan for education and outreach efforts, expanding the concept of community and allowing the Bank to engage more diverse stakeholders.



Office of Minority and Women Inclusion

In all of their endeavors, employees continued working toward the Federal Reserve Bank of Cleveland's renewed vision of promoting financial stability and prosperity in our neighborhoods, region, and country.



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## Auditor Independence

In 2010, the Board of Governors engaged Deloitte & Touche LLP (D&T) for the audits of the individual and combined financial statements of the Reserve Banks and the consolidated financial statements of the limited liability companies (LLCs) that are associated with Federal Reserve actions to address the financial crisis and are consolidated in the financial statements of the Federal Reserve Bank of New York. Fees for D&T's services are estimated to be \$8.0 million, of which approximately \$1.6 million were for the audits of the LLCs.<sup>1</sup> To ensure auditor independence, the Board of Governors requires that D&T be independent in all matters relating to the audit. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of Reserve Banks, or in any other way impairing its audit independence. In 2010, the Bank did not engage D&T for any non-audit services.

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



# FEDERAL RESERVE BANK *of* CLEVELAND

Cleveland, OH 44101 | 216.579.2000 | [www.clevelandfed.org](http://www.clevelandfed.org)

## Management's Report on Internal Control Over Financial Reporting

To the Board of Directors of the Federal Reserve Bank of Cleveland:

The management of the Federal Reserve Bank of Cleveland (FRBC) is responsible for the preparation and fair presentation of the Statements of Condition as of December 31, 2010 and 2009, and the Statements of Income and Comprehensive Income, and Statements of Changes in Capital for the years then ended (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 as set forth in the *Financial Accounting Manual for Federal Reserve Banks* (FAM), and, as such, include some amounts that are based on management judgments and estimates. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies, and practices documented in the FAM and include all disclosures necessary for such fair presentation.

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

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

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

Federal Reserve Bank of Cleveland

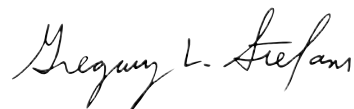
March 22, 2011



Sandra Pianalto  
President &  
Chief Executive Officer



Dale Roskom  
First Vice President &  
Chief Operating Officer



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Chief Financial Officer



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## Independent Auditors' Report

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

We have audited the accompanying Statements of Condition of the Federal Reserve Bank of Cleveland ("FRB Cleveland") as of December 31, 2010 and 2009, and the related Statements of Income and Comprehensive Income, and of Changes in Capital for the years then ended, which have been prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System. We also have audited the internal control over financial reporting of the FRB Cleveland as of December 31, 2010, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The FRB Cleveland's management is responsible for these Financial Statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on these Financial Statements and an opinion on the FRB Cleveland's internal control over financial reporting based on our audits.

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

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

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

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

In our opinion, such Financial Statements present fairly, in all material respects, the financial position of the FRB Cleveland as of December 31, 2010 and 2009, and the results of its operations for the years then ended, on the basis of accounting described in Note 4. Also, in our opinion, the FRB Cleveland maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

The logo for Deloitte & Touche LLP, featuring the company name in a stylized, cursive script.

March 22, 2011

## Abbreviations

<b>ACH</b>	Automated clearinghouse
<b>AMLF</b>	Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility
<b>ASC</b>	Accounting Standards Codification
<b>BEP</b>	Benefit Equalization Retirement Plan
<b>Bureau</b>	Bureau of Consumer Financial Protection
<b>Dodd–Frank Act</b>	The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010
<b>ESF</b>	Exchange Stabilization Fund
<b>FAM</b>	<i>Financial Accounting Manual for Federal Reserve Banks</i>
<b>FASB</b>	Financial Accounting Standards Board
<b>Fannie Mae</b>	Federal National Mortgage Association
<b>Freddie Mac</b>	Federal Home Loan Mortgage Corporation
<b>FOMC</b>	Federal Open Market Committee
<b>FRBA</b>	Federal Reserve Bank of Atlanta
<b>FRBNY</b>	Federal Reserve Bank of New York
<b>GAAP</b>	Accounting principles generally accepted in the United States of America
<b>GSE</b>	Government-sponsored enterprise
<b>IMF</b>	International Monetary Fund
<b>MBS</b>	Mortgage-backed securities
<b>OEB</b>	Office of Employee Benefits of the Federal Reserve System
<b>OFR</b>	Office of Financial Research
<b>SDR</b>	Special drawing rights
<b>SERP</b>	Supplemental Retirement Plan for Select Officers of the Federal Reserve Banks
<b>SFAS</b>	Statement of Financial Accounting Standards
<b>SOMA</b>	System Open Market Account
<b>STRIP</b>	Separate Trading of Registered Interest and Principal of Securities
<b>TAF</b>	Term Auction Facility
<b>TBA</b>	To be announced
<b>TDF</b>	Term Deposit Facility
<b>TIPS</b>	Treasury Inflation-Protected Securities
<b>TSLF</b>	Term Securities Lending Facility
<b>TOP</b>	Term Securities Lending Facility Options Program

## Statements of Condition

As of December 31, 2010 and December 31, 2009 (in millions)

	2010	2009
<b>ASSETS</b>		
Gold certificates	\$ 463	\$ 467
Special drawing rights certificates	237	237
Coin	164	154
Items in process of collection	89	182
Loans:		
Depository institutions	—	753
System Open Market Account:		
Treasury securities, net	36,250	31,842
Government-sponsored enterprise debt securities, net	5,197	6,612
Federal agency and government-sponsored enterprise mortgage-backed securities, net	34,135	36,305
Foreign currency denominated assets, net	1,941	1,861
Central bank liquidity swaps	6	757
Accrued interest receivable	484	499
Bank premises and equipment, net	157	162
Other assets	27	24
Total assets	<u>\$ 79,150</u>	<u>\$ 79,855</u>
<b>LIABILITIES AND CAPITAL</b>		
Federal Reserve notes outstanding, net	\$ 38,601	\$ 37,387
System Open Market Account:		
Securities sold under agreements to repurchase	2,028	3,071
Other liabilities	—	24
Deposits:		
Depository institutions	18,152	15,198
Other deposits	4	4
Interest payable to depository institutions	1	2
Accrued benefit costs	133	108
Deferred credit items	410	422
Accrued interest on Federal Reserve notes	26	23
Interdistrict settlement account	15,854	19,789
Other liabilities	7	7
Total liabilities	<u>75,216</u>	<u>76,035</u>
Capital paid-in	1,967	1,910
Surplus (including accumulated other comprehensive loss of \$37 million and \$19 million at December 31, 2010 and 2009, respectively)	1,967	1,910
Total capital	<u>3,934</u>	<u>3,820</u>
Total liabilities and capital	<u>\$ 79,150</u>	<u>\$ 79,855</u>

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

## Statements of Income and Comprehensive Income

For the years ended December 31, 2010 and December 31, 2009 (in millions)

	2010	2009
<b>INTEREST INCOME</b>		
Loans:		
Depository institutions	\$ —	\$ 18
System Open Market Account:		
Treasury securities, net	937	896
Government-sponsored enterprise debt securities, net	125	80
Federal agency and government-sponsored enterprise mortgage-backed securities, net	1,595	804
Foreign currency denominated assets, net	17	22
Central bank liquidity swaps	1	158
Total interest income	2,675	1,978
<b>INTEREST EXPENSE</b>		
System Open Market Account:		
Securities sold under agreements to repurchase	3	4
Deposits:		
Depository institutions	41	65
Total interest expense	44	69
Net interest income	2,631	1,909
<b>NON-INTEREST INCOME</b>		
System Open Market Account:		
Federal agency and government-sponsored enterprise mortgage-backed securities gains, net	29	35
Foreign currency gains, net	41	16
Compensation received for service costs provided	27	35
Reimbursable services to government agencies	46	48
Other income	4	8
Total non-interest income	147	142
<b>OPERATING EXPENSES</b>		
Salaries and benefits	128	130
Occupancy	16	16
Equipment	8	10
Assessments:		
Board of Governors operating expenses and currency costs	64	52
Bureau of Consumer Financial Protection and Office of Financial Research	3	—
Other	19	24
Total operating expenses	238	232
Net income prior to distribution	2,540	1,819
Change in funded status of benefit plans	(18)	(3)
Comprehensive income prior to distribution	\$ 2,522	\$ 1,816
Distribution of comprehensive income:		
Dividends paid to member banks	\$ 115	\$ 100
Transferred to surplus and change in accumulated other comprehensive loss	57	358
Payments to Treasury as interest on Federal Reserve notes	2,350	1,358
Total distribution	\$ 2,522	\$ 1,816

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

## Statements of Changes in Capital

For the years ended December 31, 2010 and December 31, 2009 (in millions, except share data)

	Surplus					Total capital
	Capital paid-in	Net income retained	Accumulated other comprehensive loss	Total surplus		
Balance at January 1, 2009 (31,041,908 shares)	\$ 1,552	\$ 1,568	\$ (16)	\$ 1,552	\$ 3,104	
Net change in capital stock issued (7,166,154 shares)	358	—	—	—	358	
Transferred to surplus and change in accumulated other comprehensive loss	—	361	(3)	358	358	
Balance at December 31, 2009 (38,208,062 shares)	\$ 1,910	\$ 1,929	\$ (19)	\$ 1,910	\$ 3,820	
Net change in capital stock issued (1,142,322 shares)	57	—	—	—	57	
Transferred to surplus and change in accumulated other comprehensive loss	—	75	(18)	57	57	
Balance at December 31, 2010 (39,350,384 shares)	\$ 1,967	\$ 2,004	\$ (37)	\$ 1,967	\$ 3,934	

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

## Notes to Financial Statements

### 1. Structure

The Federal Reserve Bank of Cleveland (Bank) is part of the Federal Reserve System (System) and is one of the 12 Federal Reserve Banks (Reserve Banks) created by Congress under the Federal Reserve Act of 1913 (Federal Reserve Act), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank serves the Fourth Federal Reserve District, which includes Ohio and portions of Kentucky, Pennsylvania, and West Virginia.

In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a board of directors. The Federal Reserve Act specifies the composition of the board of directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as chairman and deputy chairman, are appointed by the Board of Governors of the Federal Reserve System (Board of Governors) to represent the public, and six directors are elected by member banks. Banks that are members of the System include all national banks and any state-chartered banks that apply and are approved for membership. 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.

In addition to the 12 Reserve Banks, the System also consists, in part, of the Board of Governors and the Federal Open Market Committee (FOMC). The Board of Governors, an independent federal agency, is charged by the Federal Reserve Act with a number of specific duties, including general supervision over the Reserve Banks. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York (FRBNY), and, on a rotating basis, four other Reserve Bank presidents.

## 2. Operations and Services

The Reserve Banks perform a variety of services and operations. These functions include participating in formulating and conducting monetary policy; participating in the payment system, including large-dollar transfers of funds, automated clearinghouse (ACH) operations, and check collection; distributing coin and currency; performing fiscal agency functions for the U.S. Department of the Treasury (Treasury), certain Federal agencies, and other entities; serving as the federal government's bank; providing short-term loans to depository institutions; providing loans to individuals, partnerships, and corporations in unusual and exigent circumstances; serving consumers and communities by providing educational materials and information regarding financial consumer protection rights and laws and information on community development programs and activities; and supervising bank holding companies, state member banks, and U.S. offices of foreign banking organizations. Certain services are provided to foreign and international monetary authorities, primarily by the FRBNY.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which was signed into law and became effective on July 21, 2010, changed the scope of some services performed by the Reserve Banks. Among other things, the Dodd-Frank Act establishes a Bureau of Consumer Financial Protection (Bureau) as an independent bureau within the Federal Reserve System that will have supervisory authority over some institutions previously supervised by the Reserve Banks under delegated authority from the Board of Governors in connection with those institutions' compliance with consumer protection statutes; limits the Reserve Banks' authority to provide loans in unusual and exigent circumstances to lending programs or facilities with broad-based eligibility; and vests the Board of Governors with all supervisory and rule-writing authority for savings and loan holding companies.

The FOMC, in conducting monetary policy, establishes policy regarding domestic open market operations, oversees these operations, and issues authorizations and directives to the FRBNY to execute transactions. The FOMC authorizes and directs the FRBNY to conduct operations in domestic markets, including the direct purchase and sale of Treasury securities, Federal agency and government-sponsored enterprise (GSE) debt securities, Federal agency and GSE mortgage-backed securities (MBS), the purchase of these securities under agreements to resell, and the sale of these securities under agreements to repurchase. The FRBNY holds the resulting securities and agreements in a portfolio known as the System Open Market Account (SOMA). The FRBNY is authorized to lend the Treasury securities and Federal agency and GSE debt securities that are held in the SOMA.

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes the FRBNY to conduct operations in foreign markets in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC to carry out the System's central bank responsibilities. Specifically, the FOMC authorizes and directs the FRBNY to hold balances of, and to execute spot and forward foreign exchange and securities contracts for, 14 foreign currencies and to invest such foreign currency holdings, while maintaining adequate liquidity. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico and to "warehouse" foreign currencies for the Treasury and the Exchange Stabilization Fund (ESF).

Although the Reserve Banks are separate legal entities, they collaborate in the delivery of certain services to achieve greater efficiency and effectiveness. This collaboration takes the form of centralized operations and product or function offices that have responsibility for the delivery of certain services on behalf of the Reserve Banks. Various operational and management models are used and are supported by service agreements between the Reserve Banks. In some cases, costs incurred by a Reserve Bank for services provided to other Reserve Banks are not shared; in other cases, the Reserve Banks are reimbursed for costs incurred in providing services to other Reserve Banks. Major services provided by the Bank on behalf of the System and for which the costs were not reimbursed by the other Reserve Banks include National Check Adjustments, Treasury Retail Services Technology, Cash Technology, Retail Payments Office, Financial Services Policy Committee, National Check Automation Services, and National Server Management Transition.

## 3. Financial Stability Activities

The Reserve Banks have implemented the following programs that support the liquidity of financial institutions and foster improved conditions in financial markets.

### Large-Scale Asset Purchase Programs

The FOMC authorized and directed the FRBNY to purchase \$300 billion of longer-term Treasury securities to help improve conditions in private credit markets. The FRBNY began the purchases of these Treasury securities in March 2009 and completed them in October 2009.



On August 10, 2010, the FOMC announced that the Federal Reserve will maintain the level of domestic securities holdings in the SOMA portfolio by reinvesting principal payments from GSE debt securities and Federal agency and GSE MBS in longer-term Treasury securities. On November 3, 2010, the FOMC announced its intention to expand the SOMA portfolio holdings of longer-term Treasury securities by an additional \$600 billion by June 2011. The FOMC will regularly review the pace of these securities purchases and the overall size of the asset purchase program and will adjust the program as needed to best foster maximum employment and price stability.

The FOMC authorized and directed the FRBNY to purchase GSE debt securities and Federal agency and GSE MBS, with a goal to provide support to mortgage and housing markets and to foster improved conditions in financial markets more generally. The FRBNY was authorized to purchase up to \$175 billion in fixed-rate, non-callable GSE debt securities and \$1.25 trillion in fixed-rate Federal agency and GSE MBS. Purchases of GSE debt securities began in November 2008, and purchases of Federal agency and GSE MBS began in January 2009. The FRBNY completed the purchases of GSE debt securities and Federal agency and GSE MBS in March 2010. The settlement of all Federal agency and GSE MBS transactions was completed by August 2010.

### Central Bank Liquidity Swaps

The FOMC authorized and directed the FRBNY to establish central bank liquidity swap arrangements, which could be structured as either U.S. dollar liquidity or foreign currency liquidity swap arrangements. U.S. dollar liquidity swap arrangements were authorized with 14 foreign central banks to provide liquidity in U.S. dollars to overseas markets. The authorization for these swap arrangements expired on February 1, 2010. In May 2010, U.S. dollar liquidity swap arrangements were reestablished with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan, and the Swiss National Bank; these arrangements will expire on August 1, 2011.

Foreign currency liquidity swap arrangements provided the Reserve Banks with the capacity to offer foreign currency liquidity to U.S. depository institutions. The authorization for these swap arrangements expired on February 1, 2010.

### Lending to Depository Institutions

The Term Auction Facility (TAF) promoted the efficient dissemination of liquidity by providing term funds to depository institutions. The last TAF auction was conducted on March 8, 2010, and the related loans matured on April 8, 2010.

### Lending to Primary Dealers

The Term Securities Lending Facility (TSLF) promoted liquidity in the financing markets for Treasury securities. Under the TSLF, the FRBNY could lend up to an aggregate amount of \$200 billion of Treasury securities held in the SOMA to primary dealers on a secured basis for a term of 28 days. The authorization for the TSLF expired on February 1, 2010.

The Term Securities Lending Facility Options Program (TOP) offered primary dealers the opportunity to purchase an option to draw upon short-term, fixed-rate TSLF loans in exchange for eligible collateral. The program was suspended effective with the maturity of the June 2009 TOP options, and authorization for the program expired on February 1, 2010.

### Other Lending Facilities

The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) provided funding to depository institutions and bank holding companies to finance the purchase of eligible high-quality asset-backed commercial paper (ABCP) from money market mutual funds. The Federal Reserve Bank of Boston administered the AMLF and was authorized to extend these loans to eligible borrowers on behalf of the other Reserve Banks. The authorization for the AMLF expired on February 1, 2010.

## 4. Significant Accounting Policies

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

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

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

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

#### *a. Consolidation*

The Dodd-Frank Act established the Bureau as an independent bureau within the Federal Reserve System, and section 1017 of the Dodd-Frank Act provides that the financial statements of the Bureau are not to be consolidated with those of the Board of Governors or the Federal Reserve System. Section 152 of the Dodd-Frank Act established the Office of Financial Research (OFR) within the Treasury. The Board of Governors funds the Bureau and OFR through assessments on the Reserve Banks as required by the Dodd-Frank Act. The Bank reviewed the law and evaluated the design of and its relationship to the Bureau and the OFR and determined that neither should be consolidated in the Bank's financial statements.

#### *b. Gold and Special Drawing Rights Certificates*

The Secretary of the Treasury is authorized to issue gold and special drawing rights (SDR) certificates to the Reserve Banks. Upon authorization, the Reserve Banks acquire gold certificates by crediting equivalent amounts in dollars to the account established for the Treasury. The gold certificates held by the Reserve Banks are required to be backed by the gold owned by the Treasury. The Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the Treasury. At such time, the Treasury's account is charged, and the Reserve Banks' gold certificate accounts are reduced. The value of gold for purposes of backing the gold certificates is set by law at \$42 2/9 per fine troy ounce. The Board of Governors allocates the gold certificates among the Reserve Banks once a year based on the average Federal Reserve notes outstanding at each Reserve Bank.

SDR certificates are issued by the International Monetary Fund (IMF) to its members in proportion to each member's quota in the IMF at the time of issuance. SDR certificates serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for U.S. participation in the SDR system, the Secretary of the Treasury is authorized to issue SDR certificates to the Reserve Banks. When SDR certificates are issued to the Reserve Banks, equivalent amounts in U.S. dollars are credited to the account established for the Treasury and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among the Reserve Banks based upon each Reserve Bank's Federal Reserve notes outstanding at the end of the preceding year. SDRs are recorded by the Bank at original cost. In 2009, the Treasury issued \$3 billion in SDR certificates to the Reserve Banks, of which \$133 million was allocated to the Bank. There were no SDR transactions in 2010.

*c. Coin*

The amount reported as coin in the Statements of Condition represents the face value of all United States coin held by the Bank. The Bank buys coin at face value from the U.S. Mint in order to fill depository institution orders.

*d. Loans*

Loans to depository institutions are reported at their outstanding principal balances, and interest income is recognized on an accrual basis.

Loans are impaired when current information and events indicate that it is probable that the Bank will not receive the principal and interest that is due in accordance with the contractual terms of the loan agreement. Impaired loans are evaluated to determine whether an allowance for loan loss is required. The Bank has developed procedures for assessing the adequacy of any allowance for loan losses using all available information to identify incurred losses. This assessment includes monitoring information obtained from banking supervisors, borrowers, and other sources to assess the credit condition of the borrowers and, as appropriate, evaluating collateral values. Generally, the Bank would discontinue recognizing interest income on impaired loans until the borrower's repayment performance demonstrates principal and interest would be received in accordance with the terms of the loan agreement. If the Bank discontinues recording interest on an impaired loan, cash payments are first applied to principal until the loan balance is reduced to zero; subsequent payments are applied as recoveries of amounts previously deemed uncollectible, if any, and then as interest income.

*e. Securities Purchased Under Agreements to Resell, Securities Sold Under Agreements to Repurchase, and Securities Lending*

The FRBNY may engage in purchases of securities with primary dealers under agreements to resell (repurchase transactions). These repurchase transactions are settled through a tri-party arrangement. In a tri-party arrangement, two commercial custodial banks manage the collateral clearing, settlement, pricing, and pledging, and provide cash and securities custodial services for and on behalf of the Bank and counterparty. The collateral pledged must exceed the principal amount of the transaction by a margin determined by the FRBNY for each class and maturity of acceptable collateral. Collateral designated by the FRBNY as acceptable under repurchase transactions primarily includes Treasury securities (including TIPS and STRIP Treasury securities); direct obligations of several Federal agency and GSE-related agencies, including Fannie Mae and Freddie Mac; and pass-through MBS of Fannie Mae, Freddie Mac, and Ginnie Mae. The repurchase transactions are accounted for as financing transactions with the associated interest income recognized over the life of the transaction. Repurchase transactions are reported at their contractual amount as "System Open Market Account: Securities purchased under agreements to resell," and the related accrued interest receivable is reported as a component of "Accrued interest receivable" in the Statements of Condition.

The FRBNY may engage in sales of securities under agreements to repurchase (reverse repurchase transactions) with primary dealers and, beginning August 2010, with selected money market funds, as an open market operation. These reverse repurchase transactions may be executed through a tri-party arrangement, similar to repurchase transactions. Reverse repurchase transactions may also be executed with foreign official and international account holders as part of a service offering. Reverse repurchase agreements are collateralized by a pledge of an amount of Treasury securities, GSE debt securities, and Federal agency and GSE MBS that are held in the SOMA. Reverse repurchase transactions are accounted for as financing transactions, and the associated interest expense is recognized over the life of the transaction. These transactions are reported at their contractual amounts as "System Open Market Account: Securities sold under agreements to repurchase," and the related accrued interest payable is reported as a component of "Other liabilities" in the Statements of Condition.

Treasury securities and GSE debt securities held in the SOMA may be lent to primary dealers to facilitate the effective functioning of the domestic securities markets. Overnight securities lending transactions are fully collateralized by Treasury securities that have fair values in excess of the securities lent. The FRBNY charges the primary dealer a fee for borrowing securities, and these fees are reported as a component of "Other income" in the Statements of Income and Comprehensive Income.

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

*f. Treasury Securities; Government-Sponsored Enterprise Debt Securities; Federal Agency and Government-Sponsored Enterprise Mortgage-Backed Securities; Foreign Currency Denominated Assets; and Warehousing Agreements*

Interest income on Treasury securities, GSE debt securities, and foreign currency denominated assets comprising the SOMA is accrued on a straight-line basis. Interest income on Federal agency and GSE MBS is accrued using the interest method and includes amortization

of premiums, accretion of discounts, and gains or losses associated with principal paydowns. Premiums and discounts related to Federal agency and GSE MBS are amortized over the term of the security to stated maturity, and the amortization of premiums and accretion of discounts are accelerated when principal payments are received. Paydown gains and losses represent the difference between the principal amount paid and the amortized cost basis of the related security. Gains and losses resulting from sales of securities are determined by specific issue based on average cost. Treasury securities, GSE debt securities, and Federal agency and GSE MBS are reported net of premiums and discounts on the Statements of Condition and interest income on those securities is reported net of the amortization of premiums and accretion of discounts on the Statements of Income and Comprehensive Income.

In addition to outright purchases of Federal agency and GSE MBS that are held in the SOMA, the FRBNY entered into dollar roll transactions (dollar rolls), which primarily involve an initial transaction to purchase or sell “to be announced” (TBA) MBS for delivery in the current month combined with a simultaneous agreement to sell or purchase TBA MBS on a specified future date. The FRBNY also executed a limited number of TBA MBS coupon swap transactions, which involve a simultaneous sale of a TBA MBS and purchase of another TBA MBS of a different coupon rate. The FRBNY’s participation in the dollar roll and coupon swap markets furthers the MBS purchase program goal of providing support to the mortgage and housing markets and fostering improved conditions in financial markets more generally. The FRBNY accounts for outstanding commitments under dollar roll and coupon swaps on a settlement-date basis. Based on the terms of the FRBNY dollar roll and coupon swap transactions, transfers of MBS upon settlement of the initial TBA MBS transactions are accounted for as purchases or sales in accordance with FASB ASC Topic 860 (ASC 860), *Transfers and Servicing*, and the related outstanding commitments are accounted for as sales or purchases upon settlement. Net gains (losses) resulting from dollar roll and coupon swap transactions are reported as “Non-interest income: System Open Market Account: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net” in the Statements of Income and Comprehensive Income.

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 foreign currency denominated assets are reported as “Foreign currency gains, net” in the Statements of Income and Comprehensive Income.

Activity related to Treasury securities, GSE debt securities, and Federal agency and GSE MBS, including the premiums, discounts, and realized gains and losses, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of the interdistrict settlement account that occurs in April of each year. Activity related to foreign currency denominated assets, including the premiums, discounts, and realized and unrealized gains and losses, is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to aggregate capital and surplus at the preceding December 31.

Warehousing is an arrangement under which the FOMC has approved the exchange, at the request of the Treasury, of U.S. dollars for foreign currencies held by the Treasury over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury for financing purchases of foreign currencies and related international operations. Warehousing agreements are designated as held-for-trading purposes and are valued daily at current market exchange rates. Activity related to these agreements is allocated to each Reserve Bank based on the ratio of each Reserve Bank’s capital and surplus to aggregate capital and surplus at the preceding December 31.

#### g. *Central Bank Liquidity Swaps*

Central bank liquidity swaps, which are transacted between the FRBNY and a foreign central bank, can be structured as either U.S. dollar liquidity or foreign currency liquidity swap arrangements.

Central bank liquidity swaps activity, including the related income and expense, 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. The foreign currency amounts associated with these central bank liquidity swap arrangements are revalued at current foreign currency market exchange rates.

#### *U.S. Dollar Liquidity Swaps*

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

The foreign central bank compensates the FRBNY based on the foreign currency amounts it holds for the FRBNY. The FRBNY recognizes compensation during the term of the swap transaction and reports it as "Interest income: Central bank liquidity swaps" in the Statements of Income and Comprehensive Income.

#### Foreign Currency Liquidity Swaps

The structure of foreign currency liquidity swap transactions involves the transfer by the FRBNY, at the prevailing market exchange rate, of a specified amount of U.S. dollars to an account for the foreign central bank in exchange for its currency. The foreign currency amount received would be reported as a liability by the Bank.

#### h. Interdistrict Settlement Account

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

#### i. Bank Premises, Equipment, and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over the estimated useful lives of the assets, which range from 2 to 50 years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are depreciated over the remaining useful life of the asset or, if appropriate, over the unique useful life of the alteration, renovation, or improvement. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred.

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

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

#### j. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes, which are identified as issued to a specific Reserve Bank, must be fully collateralized. All of the Bank's assets are eligible to be pledged as collateral. The collateral value is equal to the book value of the collateral tendered with the exception of securities, for which the collateral value is equal to the par value of the securities tendered. The par value of securities sold under agreements to repurchase is deducted from the eligible collateral value.

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

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Bank's currency holdings of \$7,304 million and \$7,535 million at December 31, 2010 and 2009, respectively.

At December 31, 2010 and 2009, all Federal Reserve notes issued to the Reserve Banks were fully collateralized. At December 31, 2010, all gold certificates, all special drawing right certificates, and \$925 billion of domestic securities held in the SOMA were pledged as collateral. At December 31, 2010, no investments denominated in foreign currencies were pledged as collateral.

### k. *Deposits*

#### **Depository Institutions**

Depository institutions' deposits represent the reserve and service-related balances in the accounts that depository institutions hold at the Bank. The interest rates paid on required reserve balances and excess balances are determined by the Board of Governors, based on an FOMC-established target range for the federal funds rate. Interest payable is reported as "Interest payable to depository institutions" on the Statements of Condition.

The Term Deposit Facility (TDF) consists of deposits with specific maturities held by eligible institutions at the Reserve Banks. The Reserve Banks pay interest on these deposits at interest rates determined by auction. Interest payable is reported as "Interest payable to depository institutions" on the Statements of Condition. There were no deposits held by the Bank under the TDF at December 31, 2010.

#### **Other**

Other deposits include foreign central bank and foreign government deposits held at the FRBNY that are allocated to the Bank.

### l. *Items in Process of Collection and Deferred Credit Items*

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

### m. *Capital Paid-in*

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

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

### n. *Surplus*

The Board of Governors requires the Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31 of each year. Accumulated other comprehensive income is reported as a component of "Surplus" in the Statements of Condition and the Statements of Changes in Capital. Additional information regarding the classifications of accumulated other comprehensive income is provided in Notes 12 and 13.

### o. *Interest on Federal Reserve Notes*

The Board of Governors requires the Reserve Banks to transfer excess earnings to the Treasury as interest on Federal Reserve notes after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in. This amount is reported as "Payments to Treasury as interest on Federal Reserve notes" in the Statements of Income and Comprehensive Income. The amount due to the Treasury is reported as "Accrued interest on Federal Reserve notes" in the Statements of Condition.

If earnings during the year are not sufficient to provide for the costs of operations, payment of dividends, and equating surplus and capital paid-in, payments to the Treasury are suspended. A deferred asset is recorded that represents the amount of net earnings a Reserve Bank will need to realize before remittances to Treasury resume. This deferred asset is periodically reviewed for impairment.

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

*p. Income and Costs Related to Treasury Services*

When directed by the Secretary of the Treasury, the Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States Government. By statute, the Treasury has appropriations to pay for these services. During the years ended December 31, 2010 and 2009, the Bank was reimbursed for substantially all services provided to the Treasury as its fiscal agent.

*q. Compensation Received for Service Costs Provided*

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

*r. Assessments*

The Board of Governors assesses the Reserve Banks to fund its operations and the operations of the Bureau and, for a two-year period, the OFR. These assessments are allocated to each Reserve Bank based on each Reserve Bank's capital and surplus balances as of December 31 of the prior year for the Board of Governor's operations and as of the most recent quarter for the Bureau and OFR operations. The Board of Governors also assesses each Reserve Bank for the expenses incurred by the Treasury to produce and retire Federal Reserve notes based on each Reserve Bank's share of the number of notes comprising the System's net liability for Federal Reserve notes on December 31 of the prior year.

During the period prior to the Bureau transfer date of July 21, 2011, there is no fixed limit on the funding that can be provided to the Bureau and that is assessed to the Reserve Banks; the Board of Governors must provide the amount estimated by the Secretary of the Treasury needed to carry out the authorities granted to the Bureau under the Dodd-Frank Act and other federal law. After the transfer date, the Dodd-Frank Act requires the Board of Governors to fund the Bureau in an amount not to exceed a fixed percentage of the total operating expenses of the Federal Reserve System as reported in the Board of Governors' 2009 annual report. The fixed percentage of total operating expenses of the System is 10% for 2011, 11% for 2012, and 12% for 2013. After 2013, the amount will be adjusted in accordance with the provisions of the Dodd-Frank Act.

The Board of Governors assesses the Reserve Banks to fund the operations of the OFR for the two-year period following enactment of the Dodd-Frank Act; thereafter, the OFR will be funded by fees assessed on certain bank holding companies.

*s. 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 \$2 million for each of the years ended December 31, 2010 and 2009, and are reported as a component of "Operating expenses: Occupancy" in the Statements of Income and Comprehensive Income.

*t. Restructuring Charges*

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

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

The Bank had no significant restructuring activities in 2010 and 2009.

#### u. Recently Issued Accounting Standards

In June 2009, FASB issued Statement of Financial Accounting Standards (SFAS) 166, *Accounting for Transfers of Financial Assets – an amendment to FASB Statement No. 140*, (codified in ASC 860). The new standard revises the criteria for recognizing transfers of financial assets as sales and clarifies that the transferor must consider all arrangements when determining if the transferor has surrendered control. The adoption of this accounting guidance was effective for the Bank for the year beginning on January 1, 2010, and did not have a material effect on the Bank's financial statements.

In July 2010, the FASB issued Accounting Standards Update 2010-20, *Receivables* (Topic 310), which requires additional disclosures about the allowance for credit losses and the credit quality of loan portfolios. The additional disclosures include a rollforward of the allowance for credit losses on a disaggregated basis and more information, by type of receivable, on credit quality indicators, including the amount of certain past due receivables and troubled debt restructurings and significant purchases and sales. The adoption of this accounting guidance is effective for the Bank on December 31, 2011, and is not expected to have a material effect on the Bank's financial statements.

## 5. Loans

Loans outstanding at December 31, 2010 and 2009, were as follows (in millions):

	2010	2009
Primary, secondary, and seasonal credit	\$ —	\$ 1
TAF	—	752
Loans to depository institutions	\$ —	\$ 753

### Loans to Depository Institutions

The Bank offers primary, secondary, and seasonal credit to eligible borrowers, and each program has its own interest rate. Interest is accrued using the applicable interest rate established at least every 14 days by the Bank's board of directors, subject to review and determination by the Board of Governors. Primary and secondary credit are extended on a short-term basis, typically overnight, whereas seasonal credit may be extended for a period of up to nine months.

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

Depository institutions that are eligible to borrow under the Bank's primary credit program were eligible to participate in the TAF program. Under the TAF program, the Reserve Banks conducted auctions for a fixed amount of funds, with the interest rate determined by the auction process, subject to a minimum bid rate. TAF loans were extended on a short-term basis, with terms ranging from 28 to 84 days. All advances under the TAF program were collateralized to the satisfaction of the Bank. All TAF loan principal and accrued interest was fully repaid.

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

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



### Allowance for Loan Loss

At December 31, 2010 and 2009, the Bank did not have any impaired loans and no allowance for loan losses was required. There were no impaired loans during the years ended December 31, 2010 and 2009.

## 6. Treasury Securities; Government-Sponsored Enterprise Debt Securities; Federal Agency and Government-Sponsored Enterprise Mortgage-Backed Securities; Securities Purchased Under Agreements to Resell; Securities Sold Under Agreements to Repurchase; and Securities Lending

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 3.398 percent and 3.951 percent at December 31, 2010 and 2009, respectively.

The Bank's allocated share of Treasury securities, GSE debt securities, and Federal agency and GSE MBS, excluding accrued interest, held in the SOMA at December 31 was as follows (in millions):

	2010				
	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost	Fair value
Bills	\$ 626	\$ —	\$ —	\$ 626	\$ 626
Notes	26,273	477	(26)	26,724	27,340
Bonds	7,807	1,112	(19)	8,900	9,845
Total Treasury securities	\$ 34,706	\$ 1,589	\$ (45)	\$ 36,250	\$ 37,811
GSE debt securities	\$ 5,010	\$ 188	\$ (1)	\$ 5,197	\$ 5,327
Federal agency and GSE MBS	\$ 33,709	\$ 479	\$ (53)	\$ 34,135	\$ 34,859

	2009				
	Par	Unamortized premiums	Unaccreted discounts	Total amortized cost	Fair value
Bills	\$ 728	\$ —	\$ —	\$ 728	\$ 728
Notes	22,453	259	(39)	22,673	23,035
Bonds	7,500	966	(25)	8,441	9,115
Total Treasury securities	\$ 30,681	\$ 1,225	\$ (64)	\$ 31,842	\$ 32,878
GSE debt securities	\$ 6,316	\$ 297	\$ (1)	\$ 6,612	\$ 6,615
Federal agency and GSE MBS	\$ 35,888	\$ 478	\$ (61)	\$ 36,305	\$ 36,122

The total of the Treasury securities, GSE debt securities, and Federal agency and GSE MBS, net, excluding accrued interest, held in the SOMA at December 31 was as follows (in millions):

	2010		2009	
	Amortized cost	Fair value	Amortized cost	Fair value
Bills	\$ 18,422	\$ 18,422	\$ 18,423	\$ 18,423
Notes	786,575	804,703	573,877	583,040
Bonds	261,955	289,757	213,672	230,717
Total Treasury securities	\$ 1,066,952	\$ 1,112,882	\$ 805,972	\$ 832,180
GSE debt securities	\$ 152,972	\$ 156,780	\$ 167,362	\$ 167,444
Federal agency and GSE MBS	\$ 1,004,695	\$ 1,026,003	\$ 918,927	\$ 914,290

The fair value amounts in the above tables are presented solely for informational purposes. Although the fair value of security holdings can be substantially greater than or less than the recorded value at any point in time, these unrealized gains or losses have no effect on the ability of the Reserve Banks, as the central bank, to meet their financial obligations and responsibilities. The fair value of Federal agency and GSE MBS was determined using a model-based approach that considers observable inputs for similar securities; fair value for all other SOMA security holdings was determined by reference to quoted prices for identical securities.

The fair value of the fixed-rate Treasury securities, GSE debt securities, and Federal agency and GSE MBS in the SOMA's holdings is subject to market risk, arising from movements in market variables, such as interest rates and securities prices. The fair value of Federal agency and GSE MBS is also affected by the rate of prepayments of mortgage loans underlying the securities.

The following table provides additional information on the amortized cost and fair values of the Federal agency and GSE MBS portfolio at December 31, 2010 and 2009 (in millions):

Distribution of MBS holdings by coupon rate	2010		2009	
	Amortized cost	Fair value	Amortized cost	Fair value
Allocated to the Bank:				
3.5%	\$ 11	\$ 12	\$ 15	\$ 15
4.0%	5,697	5,722	6,721	6,548
4.5%	16,909	17,287	17,160	17,053
5.0%	7,863	8,071	7,721	7,760
5.5%	3,164	3,257	4,084	4,132
6.0%	438	454	502	510
6.5%	53	56	102	104
Total	\$ 34,135	\$ 34,859	\$ 36,305	\$ 36,122
SOMA:				
3.5%	\$ 341	\$ 352	\$ 363	\$ 365
4.0%	167,675	168,403	170,119	165,740
4.5%	497,672	508,798	434,352	431,646
5.0%	231,420	237,545	195,418	196,411
5.5%	93,119	95,873	103,379	104,583
6.0%	12,910	13,376	12,710	12,901
6.5%	1,558	1,656	2,586	2,644
Total	\$ 1,004,695	\$ 1,026,003	\$ 918,927	\$ 914,290

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

	Securities purchased under agreements to resell		Securities sold under agreements to repurchase	
	2010	2009	2010	2009
Allocated to the Bank:				
Contract amount outstanding, end of year	\$ —	\$ —	\$ 2,028	\$ 3,071
Average daily amount outstanding, during the year	—	137	2,079	2,647
Maximum balance outstanding, during the year	—	3,034	3,071	3,395
Securities pledged (par value), end of year	—	—	1,483	3,076
SOMA:				
Contract amount outstanding, end of year	\$ —	\$ —	\$ 59,703	\$ 77,732
Average daily amount outstanding, during the year	—	3,616	58,476	67,837
Maximum balance outstanding, during the year	—	80,000	77,732	89,525
Securities pledged (par value), end of year	—	—	43,642	77,860

The contract amounts for securities purchased under agreements to resell and securities sold under agreements to repurchase approximate fair value. The FRBNY executes transactions for the purchase of securities under agreements to resell primarily to temporarily add reserve balances to the banking system. Conversely, transactions to sell securities under agreements to repurchase are executed primarily to temporarily drain reserve balances from the banking system.

The remaining maturity distribution of Treasury securities, GSE debt securities, Federal agency and GSE MBS bought outright, and securities sold under agreements to repurchase that were allocated to the Bank at December 31, 2010, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Over 5 years to 10 years	Over 10 years	Total
Treasury securities (par value)	\$ 333	\$ 843	\$ 1,843	\$ 14,936	\$ 11,346	\$ 5,405	\$ 34,706
GSE debt securities (par value)	38	470	968	2,414	1,040	80	5,010
Federal agency and GSE MBS (par value)	—	—	—	1	1	33,707	33,709
Securities sold under agreements to repurchase (contract amount)	2,028	—	—	—	—	—	2,028

Federal agency and GSE MBS are reported at stated maturity in the table above. The estimated weighted average life of these securities at December 31, 2010, which differs from the stated maturity primarily because the weighted average life factors in prepayment assumptions, is approximately 4.2 years.

The par value of Treasury and GSE debt securities that were loaned from the SOMA at December 31, was as follows (in millions):

	Allocated to the Bank		Total SOMA	
	2010	2009	2010	2009
Treasury securities	\$ 750	\$ 810	\$ 22,081	\$ 20,502
GSE debt securities	55	44	1,610	1,108

Other liabilities, which are related to purchases of Federal agency and GSE MBS, arise from the failure of a seller to deliver securities to the FRBNY on the settlement date. Although the Bank has ownership of and records its investments in the MBS as of the contractual settlement date, it is not obligated to make payment until the securities are delivered, and the amount reported as other liabilities represents the Bank's obligation to pay for the securities when delivered. Total other liabilities held in the SOMA were \$601 million at December 31, 2009, of which \$24 million was allocated to the Bank. There were no other liabilities held in the SOMA at December 31, 2010.

The FRBNY enters into commitments to buy Treasury and GSE debt securities and records the related securities on a settlement-date basis. There were no commitments to buy Treasury and GSE debt securities as of December 31, 2010.

The FRBNY enters into commitments to buy Federal agency and GSE MBS and records the related MBS on a settlement-date basis. There were no commitments to buy or sell Federal agency or GSE MBS as of December 31, 2010.

During the years ended December 31, 2010 and 2009, the Reserve Banks recorded net gains from dollar roll and coupon swap related transactions of \$782 million and \$879 million, respectively, of which \$29 million and \$35 million, respectively, was allocated to the Bank. These net gains are reported as "Non-interest income: Federal agency and government-sponsored enterprise mortgage-backed securities gains, net" in the Statements of Income and Comprehensive Income.

## 7. Foreign Currency Denominated Assets

The FRBNY holds foreign currency deposits with foreign central banks and the Bank for International Settlements and invests in foreign government debt instruments. These foreign government debt instruments are guaranteed as to principal and interest by the issuing foreign governments. In addition, the FRBNY enters into transactions to purchase Euro-denominated government debt securities under

agreements to resell for which the accepted collateral is the debt instruments issued by the governments of Belgium, France, Germany, Italy, the Netherlands, and Spain.

The Bank's allocated share of foreign currency denominated assets was approximately 7.451 percent and 7.364 percent at December 31, 2010 and 2009, respectively.

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

	2010	2009
Euro:		
Foreign currency deposits	\$ 526	\$ 545
Securities purchased under agreements to resell	184	191
Government debt instruments	343	363
Japanese yen:		
Foreign currency deposits	289	251
Government debt instruments	599	511
Total allocated to the Bank	\$ 1,941	\$ 1,861

At December 31, 2010 and 2009, the fair value of foreign currency denominated assets, including accrued interest, allocated to the Bank was \$1,953 million and \$1,876 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the Treasury securities, GSE debt securities, and Federal agency and GSE MBS discussed in Note 6, unrealized gains or losses have no effect on the ability of a Reserve Bank, as the central bank, to meet its financial obligations and responsibilities. The fair value is presented solely for informational purposes.

Total Reserve Bank foreign currency denominated assets were \$26,049 million and \$25,272 million at December 31, 2010 and 2009, respectively. At December 31, 2010 and 2009, the fair value of the total Reserve Bank foreign currency denominated assets, including accrued interest, was \$26,213 million and \$25,480 million, respectively.

The remaining maturity distribution of foreign currency denominated assets that were allocated to the Bank at December 31, 2010, was as follows (in millions):

	Within 15 days	16 days to 90 days	91 days to 1 year	Over 1 year to 5 years	Total allocated to the Bank
Euro	\$ 404	\$ 224	\$ 151	\$ 274	\$ 1,053
Japanese yen	306	42	181	359	888
Total allocated to the Bank	\$ 710	\$ 266	\$ 332	\$ 633	\$ 1,941

At December 31, 2010 and 2009, the authorized warehousing facility was \$5.0 billion, with no balance outstanding.

There were no transactions related to the authorized reciprocal currency arrangements with the Bank of Canada and the Bank of Mexico during the years ended December 31, 2010 and 2009.

There were no foreign exchange contracts outstanding as of December 31, 2010.

The FRBNY enters into commitments to buy foreign government debt instruments and records the related securities on a settlement-date basis. As of December 31, 2010, there were \$209 million of outstanding commitments to purchase Euro-denominated government debt instruments, of which \$16 million was allocated to the Bank. These securities settled on January 4, 2011, and replaced Euro-denominated government debt instruments held in the SOMA that matured on that date.

In connection with its foreign currency activities, the FRBNY may enter into transactions that are subject to varying degrees of off-balance-sheet market risk and counterparty credit risk that result from their future settlement. The FRBNY controls these risks by obtaining credit approvals, establishing transaction limits, receiving collateral in some cases, and performing daily monitoring procedures.

## 8. Central Bank Liquidity Swaps

### U.S. Dollar Liquidity Swaps

The Bank's allocated share of U.S. dollar liquidity swaps was approximately 7.451 percent and 7.364 percent at December 31, 2010 and 2009, respectively.

The total foreign currency held under U.S. dollar liquidity swaps in the SOMA at December 31, 2010 and 2009, was \$75 million and \$10,272 million, respectively, of which \$6 million and \$757 million, respectively, was allocated to the Bank. All of the U.S. dollar liquidity swaps outstanding at December 31, 2010, were transacted with the European Central Bank and had remaining maturity distributions of less than 15 days.

### Foreign Currency Liquidity Swaps

There were no transactions related to the foreign currency liquidity swaps during the years ended December 31, 2010 and 2009.

## 9. Bank Premises, Equipment, and Software

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

	2010	2009
Bank premises and equipment:		
Land and land improvements	\$ 10	\$ 10
Buildings	172	171
Building machinery and equipment	62	60
Furniture and equipment	54	53
Subtotal	298	294
Accumulated depreciation	(141)	(132)
Bank premises and equipment, net	\$ 157	\$ 162
Depreciation expense, for the years ended December 31	\$ 11	\$ 12

The Bank leases space to outside tenants with remaining lease terms ranging from one to fourteen years. Rental income from such leases was \$2 million and \$1 million for the years ended December 31, 2010 and 2009, respectively, and is reported as a component of "Other income" in the Statements of Income and Comprehensive Income. Future minimum lease payments that the Bank will receive under noncancelable lease agreements in existence at December 31, 2010, are as follows (in millions):

2011	\$ 2
2012	2
2013	1
2014	1
2015	1
Thereafter	6
Total	\$ 13

The Bank had capitalized software assets, net of amortization, of \$9 million and \$6 million at December 31, 2010 and 2009, respectively. Amortization expense was \$2 million and \$3 million for the years ended December 31, 2010 and 2009, respectively. Capitalized software assets are reported as a component of "Other assets" in the Statements of Condition and the related amortization is reported as a component of "Operating expenses: Other" in the Statements of Income and Comprehensive Income.

## 10. Commitments and Contingencies

Conducting its operations, the Bank enters into contractual commitments, normally with fixed expiration dates or termination provisions, at specific rates and for specific purposes.

At December 31, 2010, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms of one year.

Rental expense under operating leases for certain operating facilities and data processing and office equipment (including taxes, insurance, and maintenance when included in rent), net of sublease rentals, was \$355 thousand and \$300 thousand for the years ended December 31, 2010 and 2009, respectively.

Future minimum rental payments under noncancelable operating leases, net of sublease rentals, with remaining terms of one year or more, at December 31, 2010, were not material.

At December 31, 2010, there were no material unrecorded unconditional purchase commitments or obligations in excess of one year.

Under the Insurance Agreement of the Federal Reserve Banks, each of the Reserve Banks has agreed to bear, on a per incident basis, a share of certain losses in excess of 1 percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio of a Reserve Bank's capital paid-in to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2010 or 2009.

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.

## 11. Retirement and Thrift Plans

### Retirement Plans

The Bank currently offers three defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the employees of the Reserve Banks, Board of Governors, and Office of Employee Benefits of the Federal Reserve System (OEB) participate in the Retirement Plan for Employees of the Federal Reserve System (System Plan). In addition, employees at certain compensation levels participate in the Benefit Equalization Retirement Plan (BEP) and certain Reserve Bank officers participate in the Supplemental Retirement Plan for Select Officers of the Federal Reserve Bank (SERP). In addition, under the Dodd-Frank Act, employees of the Bureau can elect to participate in the System Plan. There were no Bureau participants in the System Plan as of December 31, 2010.

The System Plan provides retirement benefits to employees of the Federal Reserve Banks, Board of Governors, and OEB and in the future will provide retirement benefits to certain employees of the Bureau. The FRBNY, on behalf of the System, recognizes the net asset or net liability and costs associated with the System Plan in its consolidated financial statements. During the years ended December 31, 2010 and 2009, costs associated with the System Plan were not reimbursed by other participating employers.

The Bank's projected benefit obligation, funded status, and net pension expenses for the BEP and the SERP at December 31, 2010 and 2009, and for the years then ended, were not material.

### Thrift Plan

Employees of the Bank participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The Bank matches employee contributions based on a specified formula. Effective April 1, 2009, the Bank matches 100 percent of the first 6 percent of employee contributions from the date of hire and provides an automatic employer contribution of 1 percent of eligible

pay. For the first three months of the year ended December 31, 2009, the Bank matched 80 percent of the first 6 percent of employee contributions for employees with less than five years of service and 100 percent of the first 6 percent of employee contributions for employees with five or more years of service. The Bank's Thrift Plan contributions totaled \$5 million for each of the years ended December 31, 2010 and 2009, and are reported as a component of "Salaries and benefits" in the Statements of Income and Comprehensive Income.

## 12. Postretirement Benefits Other Than Retirement Plans and Postemployment Benefits

### Postretirement Benefits Other Than Retirement Plans

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

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

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

	2010	2009
Accumulated postretirement benefit obligation at January 1	\$ 93.7	\$ 86.0
Service cost benefits earned during the period	4.2	3.6
Interest cost on accumulated benefit obligation	5.5	5.2
Net actuarial loss	18.0	2.5
Contributions by plan participants	0.7	0.6
Benefits paid	(4.7)	(4.5)
Medicare Part D subsidies	0.3	0.3
Accumulated postretirement benefit obligation at December 31	\$ 117.7	\$ 93.7

At December 31, 2010 and 2009, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.25 percent and 5.75 percent, respectively.

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

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

	2010	2009
Fair value of plan assets at January 1	\$ —	\$ —
Contributions by the employer	3.7	3.6
Contributions by plan participants	0.7	0.6
Benefits paid	(4.7)	(4.5)
Medicare Part D subsidies	0.3	0.3
Fair value of plan assets at December 31	\$ —	\$ —
Unfunded obligation and accrued postretirement benefit cost	\$ 117.7	\$ 93.7

Amounts included in accumulated other comprehensive loss are shown below:

Prior service cost	\$ 0.1	\$ 1.5
Net actuarial loss	(37.1)	(20.8)
Total accumulated other comprehensive loss	\$ (37.0)	\$ (19.3)

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

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

	2010	2009
Health care cost trend rate assumed for next year	8.00%	7.50%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2017	2015

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A 1 percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2010 (in millions):

	1 percentage point increase	1 percentage point decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	\$ 1.7	\$ (1.4)
Effect on accumulated postretirement benefit obligation	16.1	(13.3)

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

	2010	2009
Service cost-benefits earned during the period	\$ 4.2	\$ 3.6
Interest cost on accumulated benefit obligation	5.5	5.2
Amortization of prior service cost	(1.4)	(2.3)
Amortization of net actuarial loss	1.7	1.4
Net periodic postretirement benefit expense	\$ 10.0	\$ 7.9

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2011 are shown below:

Prior service cost	\$ —
Net actuarial loss	3.3
Total	\$ 3.3

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2010 and 2009, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.75 percent and 6.00 percent, respectively.

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

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

Federal Medicare Part D subsidy receipts were \$0.3 million in each of the years ended December 31, 2010 and 2009. Expected receipts in 2011, related to benefits paid in the years ended December 31, 2010 and 2009, are \$0.1 million.



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

	Without subsidy	With subsidy
2011	\$ 5.2	\$ 4.8
2012	5.6	5.2
2013	5.9	5.5
2014	6.4	5.9
2015	6.9	6.4
2016 – 2020	42.7	39.0
Total	\$ 72.7	\$ 66.8

### Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and dental insurance, survivor income, disability benefits, and self-insured workers' compensation expenses. The accrued postemployment benefit costs recognized by the Bank at December 31, 2010 and 2009, were \$12.1 million and \$12.7 million, respectively. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2010 and 2009 operating expenses were \$0.9 million and \$6.1 million, respectively, and are recorded as a component of "Salaries and benefits" in the Statements of Income and Comprehensive Income.

## 13. Accumulated Other Comprehensive Income and Other Comprehensive Income

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

	Amount related to postretirement benefits other than retirement plans
Balance at January 1, 2009	\$ (16)
Change in funded status of benefit plans:	
Net actuarial loss arising during the year	(2)
Amortization of prior service cost	(2)
Amortization of net actuarial loss	1
Change in funded status of benefit plans - other comprehensive loss	(3)
Balance at December 31, 2009	\$ (19)
Change in funded status of benefit plans:	
Net actuarial loss arising during the year	(18)
Amortization of prior service cost	(2)
Amortization of net actuarial loss	2
Change in funded status of benefit plans - other comprehensive loss	(18)
Balance at December 31, 2010	\$ (37)

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

## 14. Business Restructuring Charges

The Bank had no business restructuring charges in 2010 and 2009.

Additional announcements prior to 2009 included restructuring plans associated with Check Operations and Electronic Treasury Financial Services.

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

	2008 and prior restructuring plans
<b>Information related to restructuring plans as of December 31, 2010:</b>	
Total expected costs related to restructuring activity	\$ 2.1
Expected completion date	2010
<b>Reconciliation of liability balances:</b>	
Balance at January 1, 2009	\$ 1.0
Payments	(0.9)
Balance at December 31, 2009	\$ 0.1
Adjustments	(0.1)
Balance at December 31, 2010	\$ —

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

Adjustments to the accrued liability are primarily due to changes in the estimated restructuring costs and are shown as a component of the appropriate expense category in the Statements of Income and Comprehensive Income.

## 15. Subsequent Events

On February 11, 2011, Treasury informed the Bank that the Treasury Retail Securities operations will be consolidated at the Federal Reserve Bank of Minneapolis. Treasury plans to complete the consolidation by the end of 2011. The Bank is evaluating the consolidation efforts and has not yet determined the effects on the 2011 financial statements. There were no other subsequent events that require adjustments to or disclosures in the financial statements as of December 31, 2010. Subsequent events were evaluated through March 22, 2011, which is the date that the Bank issued the financial statements.

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## Officers and Consultants

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*Assistant Corporate Secretary*  
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Office of the Corporate Secretary

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Supervision and Regulation

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Check Automation Services

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*Assistant Vice President and*  
*Assistant General Auditor*  
Audit

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*Assistant Vice President*  
Diversity and Inclusion,  
Office of Minority and  
Women Inclusion

**Michael Vangelos**

*Assistant Vice President*  
Information Security,  
Business Continuity

Federal Reserve Banks each have a main office board of nine directors. Directors supervise the Bank's budget and operations and make recommendations on the discount rate on primary credit. Also, those directors who are not commercial bankers appoint the Bank's president and first vice president, subject to the Board of Governors' approval.

In addition, directors provide the Federal Reserve System with a wealth of information on economic conditions. This information is used by the Federal Open Market Committee and the Board of Governors in reaching decisions about monetary policy.

Class A directors are elected by and represent Fourth District member banks. Class B directors are also elected by Fourth District member banks and represent diverse industries within the District. Class C directors are selected by the Board of Governors and also represent the wide range of businesses and industries in the Fourth District. Two Class C directors are designated as chairman and deputy chairman of the board.

The Cincinnati and Pittsburgh branch offices each have a board of seven directors who are appointed by the Board of Governors and the Board of Directors of the Federal Reserve Bank of Cleveland.

Terms for all directors are generally limited to two three-year terms to ensure that the individuals who serve the Federal Reserve System represent a diversity of backgrounds and experience.

## Cleveland Board of Directors

As of December 31, 2010



(standing) James E. Rohr, Les C. Vinney, Tilmon F. Brown, Alfred M. Rankin Jr., Richard K. Smucker, Roy W. Haley, C. Daniel DeLawder  
(seated) Susan Tomasky, Charlotte W. Martin



**Henry L. Meyer III**  
*Federal Advisory Council  
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Chairman and  
Chief Executive Officer  
KeyCorp  
Cleveland, Ohio*

**Alfred M. Rankin Jr.**  
*Chairman*

*Chairman, President, and  
Chief Executive Officer  
NACCO Industries, Inc.  
Cleveland, Ohio*

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*Executive Chairman and  
Co-Chief Executive Officer  
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Pittsburgh, Pennsylvania*

**Susan Tomasky**

*President  
AEP Transmission  
Columbus, Ohio*

**Les C. Vinney**

*Chairman  
Cleveland HeartLab  
Cleveland, Ohio*

## Cincinnati Board of Directors

As of December 31, 2010



(standing) Paul R. Poston,\* Daniel B. Cunningham, Donald E. Bloomer, Peter S. Strange, Gregory B. Kenny  
(seated) James M. Anderson, Janet B. Reid

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*Chairman*  
*Advisor to the President*  
Cincinnati Children's Hospital  
Medical Center  
Cincinnati, Ohio

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*President and*  
*Chief Executive Officer*  
Citizens National Bank  
Somerset, Kentucky

**Daniel B. Cunningham**  
*President and*  
*Chief Executive Officer*  
Long-Stanton Manufacturing  
Companies  
Cincinnati, Ohio

**Gregory B. Kenny**  
*President and*  
*Chief Executive Officer*  
General Cable Corporation  
Highland Heights, Kentucky

**Janet B. Reid**  
*Managing Partner and Director*  
Global Novations, LLC  
Cincinnati, Ohio

**Peter S. Strange**  
*Chairman*  
Messer, Inc.  
Cincinnati, Ohio

\* Regrettably, Paul R. Poston, director, Great Lakes District, NeighborWorks® America, Cincinnati, Ohio, passed away in November 2010.



## Pittsburgh Board of Directors

As of December 31, 2010

**Sunil T. Wadhvani**  
*Chairman*  
*Co-founder*  
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Pittsburgh, Pennsylvania

**Todd D. Brice**  
*Chief Executive Officer*  
S&T Bancorp, Inc.  
Indiana, Pennsylvania

**Howard W. Hanna III**  
*Chairman and*  
*Chief Executive Officer*  
Howard Hanna Real Estate Services  
Pittsburgh, Pennsylvania

**Glenn R. Mahone**  
*Partner and Attorney at Law*  
Reed Smith LLP  
Pittsburgh, Pennsylvania

**Petra Mitchell**  
*President*  
Catalyst Connection  
Pittsburgh, Pennsylvania

**Robert A. Paul**  
*Chairman and*  
*Chief Executive Officer*  
Ampco-Pittsburgh Corporation  
Pittsburgh, Pennsylvania



(standing) Howard W. Hanna III, Margaret Irvine Weir,\* Sunil T. Wadhvani, Robert A. Paul, Glenn R. Mahone  
(seated) Todd D. Brice, Petra Mitchell

\*Margaret Irvine Weir, president, NexTier Bank, Butler, Pennsylvania, resigned from the Pittsburgh Board of Directors in November 2010.

## Business Advisory Councils

As of December 31, 2010

*Business Advisory Council members are a diverse group of Fourth District businesspeople who advise the president and senior officers on current business conditions.*

*Each council—in Cincinnati, Cleveland, Dayton, Erie, Lexington, Pittsburgh, and Wheeling—meets with senior Bank leaders at least twice yearly. These meetings provide anecdotal information that is useful in the consideration of monetary policy direction and economic research activities.*

### CINCINNATI

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*Vice President of Accounting and Finance and Secretary*  
Toyota Motor Engineering and Manufacturing, North America, Inc.  
Erlanger, Kentucky

**Robert Buechner, Esq.**

*Buechner Haffer Meyers & Koenig*  
Cincinnati, Ohio

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*Partner, Corporate Development*  
Dinsmore & Shohl LLP  
Cincinnati, Ohio

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Cast-Fab Technologies, Inc.  
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Intelligrated  
Mason, Ohio

**Carol J. Frankenstein**

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BIOSTART  
Cincinnati, Ohio

**Kay Geiger**

*Regional President*  
PNC Bank  
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**Terry Grundy**

*Director, Community Impact*  
United Way of Greater Cincinnati  
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**Jose Guerra**

*President*  
LS Source  
Cincinnati, Ohio

**Jim Huff**

*President and Chief Executive Officer*  
HUFF Commercial Group  
Ft. Mitchell, Kentucky

**Vivian J. Llambi**

*President*  
Vivian Llambi & Associates, Inc.  
Cincinnati, Ohio

**Joseph L. Rippe**

*Principal*  
Rippe & Kingston  
Cincinnati, Ohio

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Hamilton, Ohio

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Cleveland, Ohio

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Hyland Software Inc.  
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*Chief Financial Officer*  
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Cleveland Works, Alcoa Forgings and Extrusions  
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*Vice President, Government Programs*  
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*Chairman and Chief Executive Officer*  
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Fairlawn, Ohio

**Michael J. Merle**

*President and Chief Executive Officer*  
Ray Fogg Building Methods Inc.  
Cleveland, Ohio

**Bob Patterson**

*Senior Vice President and Chief Financial Officer*  
PolyOne Corporation  
Avon Lake, Ohio

**Frederick D. Pond**

*President*  
Ridge Tool Company  
Elyria, Ohio

**Jack H. Schron Jr.**

*President and Chief Executive Officer*  
Jergens Inc.  
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 Chief Executive Officer*  
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 Association  
 Dayton, Ohio

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 Hoover-Dayton Corporation  
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 Economy Linen & Towel Service  
 Dayton, Ohio

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As of December 31, 2010

*The Federal Reserve System's Consumer Advisory Council advises the Federal Reserve's Board of Governors on the exercise of the Board's responsibilities under various consumer financial services laws and on other related matters.*

*The council membership represents interests of consumers, communities, and the financial services industry. Members are appointed by the Board of Governors and serve three-year terms. The council meetings, held three times a year in Washington, DC, are open to the public.*

*The following members represent the Fourth Federal Reserve District on the Consumer Advisory Council:*

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We invite your comments and questions. Please email us at [editor@clev.frb.org](mailto:editor@clev.frb.org).

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