MESSAGE FROM THE PRESIDENT

Every annual report, in essence, is a summary of how an organization is meeting the challenges, achieving results, and delivering on its commitments to stakeholders. This year's annual report theme, "Meeting the Challenges," highlights the work of the Federal Reserve Bank of Philadelphia in an extraordinary year of challenges.

Throughout 2008, the Federal Reserve has taken unprecedented actions in both monetary policy and its lending operations to address a deteriorating economy and a growing financial crisis in the U.S. and around the world. The powerful combination of events — beginning with troubles in the housing market and culminating in a global credit crisis — prompted these extraordinary responses from the nation's central bank.

In this year's essay, "Principles of Sound Central Banking," I share my perspectives on the principles that should guide the central bank's monetary policy. They include: 1) setting clear and explicit objectives, 2) committing to a systematic approach over time — even when it seems expedient to abandon course, 3) communicating with transparency about policies and actions to the public, and 4) ensuring the independence of the central bank. I believe these same principles can guide the Federal Reserve's actions to promote greater financial stability.

In the pages that follow, starting with First Vice President Bill Stone's letter, we also describe how the Philadelphia Fed has played an instrumental role in meeting the challenges of 2008. Among our many accomplishments, the Philadelphia Fed worked closely with the U.S. Treasury in a number

by Charles I. Plosser, President and CEO

of ways from processing fiscal stimulus checks in the first half of the year to assisting the District's financial institutions with applications for capital infusions late in the year.

Other feature articles describe how the Philadelphia Fed's Supervision, Regulation and Credit (SRC) Department is adapting to changes in the banking industry and regulation in response to the crisis. We also explain the extraordinary actions taken by our discount window operations in lending to the District's depository institutions. By law, a central bank lends against good collateral, and the Philadelphia Fed's Collateral Management System application helps keep track of $5 trillion in collateral on behalf of the entire Federal Reserve System.

You will also learn about the ongoing efforts of our Community Affairs Department to address one of the consequences of the crisis: the high rate of mortgage foreclosures. Finally, you will read how our Research staff kept pace with increased demands for policy and economic analyses during a period of rapid change.

A CONTINUING VOICE IN POLICY

During 2008, the Philadelphia Fed was a voting member of the Federal Open Market Committee (FOMC), the Federal Reserve's monetary policy-making body. The FOMC includes all of the Fed Governors in Washington, D.C., as well as the 12 Reserve Bank presidents. Yet, by law, only five of the Reserve Bank presidents vote each year with the Governors. Having served in such a crucial role during this challenging year was an extraordinary experience.

Although I will not vote again until 2011, all Reserve Bank presidents participate equally in the FOMC's analysis and deliberations. Giving each president a seat at the FOMC table brings a valuable diversity of views to monetary policy decisions. Throughout the coming year, I will continue to be an active voice at the FOMC table and in my outreach within the Third District and the broader economic community of ideas.

BOARD OF DIRECTORS

As we met the challenges of 2008 head-on, we were grateful for the valuable insights provided by our board of directors. Their guidance provided us with timely perspectives on our region's economy and wise counsel to our operations. We offer sincere gratitude to John G. Gerlach, president of Pocono Community Bank, who has completed his term of service on our board.

We are pleased to report that William F. Hecht, retired chairman, president, and CEO of PPL Corporation, has been reappointed chairman of the

As we met the challenges of 2008 head-on, we were grateful for the valuable insights provided by our board of directors.

board of directors. Charles P. Pizzi, president and CEO of Tasty Baking Company, has been reappointed deputy chairman.

At the beginning of 2009, we also welcomed our newest board member, Frederick (Ted) C. Peters, president and CEO of Bryn Mawr Trust Company. His experience and expertise will contribute much to our board in the years ahead.

I am also pleased to announce that in June 2008, the Philadelphia Fed established its Economic Advisory Council. This new body, which replaces our former council structure, includes representatives from the tourism, health-care, retail, and food industries, as well as organized labor. The council's 14 members reflect our District's diverse economic base and represent a broader geographic area than the previous council structure.

THANKS TO OUR EMPLOYEES

Finally, I want to offer my sincere thanks to the dedicated employees of the Philadelphia Fed, who are working together as never before to lead the Bank and its stakeholders during this period of economic difficulty. The pages of this annual report highlight only a handful of their remarkable stories of service.

Special recognition goes to Philadelphia's Retail Payments employees, who have served admirably through several major consolidations of check processing as our economy continues the rapid move toward electronic payments. Philadelphia has been one of four main consolidation sites over the past two years. In November 2008, the Federal Reserve System announced plans to consolidate into one location in Cleveland for paper check processing and one site in Atlanta for electronic check processing. Philadelphia will continue to serve as a regional processing site until check processing moves to Cleveland by the end of 2009. While change is always difficult, our people continue to meet the challenge with professionalism and dedication, recognizing that our work here will help ensure a strong and stable payments system.

All of us at the Philadelphia Fed look forward to our region's — and our nation's — economic recovery and will continue to work with our many constituents throughout the Third District in the year ahead.

Charles I. Plosser
President and Chief Executive Officer
May 2009

THE PHILADELPHIA FED: PERFORMANCE AND EFFICIENCY

by William H. Stone, Jr., First Vice President

Throughout a tumultuous 2008, the Federal Reserve Bank of Philadelphia showed its ability to meet the challenges of our times in how we responded to the nation's financial crisis and in our pursuit of the Philadelphia Fed's vision to be widely recognized as a leader and innovator in central bank knowledge and service.

In many ways, this financial crisis has drawn attention to the professionalism of some of the operations at the Philadelphia Fed that may not always be highly visible. Yet, when the time came, Philadelphia Fed staff met the challenge.

This was certainly true in the Bank's Collateral Management System (CMS) and discount window lending operations. In most years, lending at the Philadelphia Fed is a small part of our overall operations. Yet, the team led by Vish Viswanathan, vice president and discount officer, stepped up to the challenge of managing exponentially higher loan volumes in 2008.

Treasury Services has a Central Business Administration Function (CBAF) that maintains the CMS, which manages and monitors roughly $5 trillion in collateral on behalf of the Federal Reserve System. The team provided expertise and guidance – often at all hours of the night and on weekends – to ensure that the CMS could adapt to new collateral procedures for the Fed's new lending facilities. CMS's web-based portal also had to be available around the clock because financial institutions relied on the expertise of the Fed's credit risk management community to support the implementation of new collateral programs and answer questions about complex processing issues.

Another Philadelphia-based system that proved invaluable during the crisis was our Treasury Check Information System (TCIS). TCIS made necessary enhancements to accommodate the influx of more than 75 million additional check payments resulting from the early 2008 stimulus package. The team in Philadelphia also implemented a Treasury check verification application to mitigate fraud. TCIS, which was developed by the Philadelphia Fed in conjunction with the U.S. Treasury, is a web-enabled infrastructure that records and reconciles Treasury checks. It ensures the highest levels of financial integrity, significantly improves the processing of Treasury transactions, and reduces losses resulting from counterfeit checks.

The Philadelphia Fed also lent its expertise to the Board of Governors and other Federal Reserve Banks throughout the crisis. Staff in our Supervision, Regulation and Credit (SRC) Department played an important role in reviewing the activi-

ties and portfolios of the government-sponsored enterprises Fannie Mae and Freddie Mac (see page 20). SRC staff also led a business group working with colleagues in Kansas City to develop a new database to help the Fed research and report on U.S. mortgage conditions. In fact, our SRC staff as a whole did a remarkable job in processing applications from financial institutions for capital infusions through the Treasury's program.

CHECK CONSOLIDATION AND RESTRUCTURING

Apart from the financial crisis, the most significant change in the financial landscape has been the continuing shift away from paper checks to electronic payments. As a result, the Fed has reduced its check-processing infrastructure over the past six years to better match the declining volume of paper checks being processed nationwide.

In Philadelphia, the process began in 2006, when the Bank absorbed the check-processing function of the Federal Reserve Bank of New York's East Rutherford Operations Center. During 2008, Philadelphia continued to serve as one of four main consolidation sites, assuming check-processing operations from the New York Fed's Utica, N.Y. office and the Federal Reserve Bank of Boston's location in Windsor Locks, Conn. The Philadelphia Fed also closed its check adjustments operations, which moved to other check adjustment centers in the System.

In November 2008, the Federal Reserve System announced plans to accelerate the consolidations and ultimately move to just one location for paper check processing in Cleveland and one in Atlanta for electronic processing. As a result, Philadelphia's check-processing operations will move to Cleveland by the end of 2009.

Philadelphia has demonstrated leadership and expertise as one of the four consolidation sites. Our check processing operation has also made major changes in workflow in the last year to handle an increasing number of electronic checks, including the addition of high-speed printers for substitute check printing. While meeting the challenges of change is often difficult, we greatly appreciate the hard work and dedication of everyone involved. We also know that this process supports the Federal Reserve's mission to promote the long-term efficiency and integrity of the payments system.

The Fed is a 24-hour-a-day operation. Part of our responsibility is to plan for contingencies to ensure it remains working. In 2008, the Philadelphia Fed moved to a new District relocation facility in New Jersey, one that will serve as Philadelphia's main relocation point and as a secondary site for the New York Fed.

During 2008, we also made progress on several projects to enhance the security and safety of our operations. As we announced in last year's annual report, the Philadelphia Fed is constructing a 6,300-square-foot screening facility across from the Bank's 7th Street entrance. This new facility, which we expect to open in late 2009, will allow our Law Enforcement officers to conduct inspections of vehicles away from the main Bank building and out of the flow of traffic.

Throughout what was arguably one of the toughest years in our Bank's history, the Philadelphia Fed met the challenge by contributing to important Bank and System initiatives. In addition to the projects mentioned here, you can read more about our achievements in 2008 in the Bank Highlights section (see page 32).

All of these achievements have demonstrated that the people at the Philadelphia Fed can adapt to change and continue to show strong performance and maintain efficient operations. This is a testament to our employees' expertise, skills, and experience. These attributes will allow us to further expand our capabilities in the future, as we contribute to the System and serve our Third District stakeholders.

PRINCIPLES OF SOUND CENTRAL BANKING

by Charles I. Plosser

By any measure, 2008 was an extraordinary year. The economic turmoil that began in housing two years ago swelled into a financial tsunami, which roiled the economy over the course of the year. That turmoil has not been confined to the U.S. Slowing economic growth and the deepening credit crisis have affected the global economy and prompted historic actions by policymakers in the U.S. and around the world. The crisis has led to fundamental changes in the financial landscape, prompting debates about the central bank's roles and responsibilities and the appropriate approach to conducting policy.

In this year's annual report essay, I want to focus attention on some of the principles that I believe make for sound and effective central banking. Relying on sound principles to guide policymaking is always useful. But it is particularly important and helpful in times of crisis, when the temptation is to abandon all guiding principles and simply react to the daily challenges based on what seems expedient at the time. I believe that adhering to these principles can enhance the effectiveness of monetary policy in these challenging times and can provide insights into how the central bank can promote greater financial stability.

One of the most significant developments in economic theory during the last quarter of the 20th century was the recognition of the importance of expectations in understanding economic behavior. Expectations about the future play an important role in the economic decisions of both households and businesses. This is particularly evident in financial markets, where expectations about the future play a role not only in investment decisions but also in the valuation of securities. Of course, the public's expectations about future actions by policymakers are also important. Will Congress raise or lower taxes in the future? Will the Federal Reserve ensure that inflation remains low and stable? Expectations about these future policy actions influence the decisions by households and firms today. Moreover, actions taken by policymakers today help inform the public about the likelihood of future policy actions. Thus, policymakers must make decisions with the understanding that those decisions may affect the public's expectations about future decisions — which, in turn, will affect the choices market participants make today.

The recognition of the important role played by expectations leads me to focus on four main principles of sound central banking. These four principles are based on lessons learned from both the theory and the practice of monetary policy.[1] They include:

1

CLEAR OBJECTIVES.

Policymakers should set clear and explicit objectives. These objectives must be realistic and feasible and not just what might be desirable.

2

COMMITMENT TO SYSTEMATIC POLICY.

Policymakers must credibly commit to conducting policy in a systematic — that is, mostly predictable — way over time, even when it seems expedient to do otherwise.

3

TRANSPARENCY.

Policymakers must be as transparent as possible in communicating their policies and actions to the public.

4

INDEPENDENCE.

Experience has shown that central banks operating with a great deal of independence from short-term political pressures deliver better outcomes.

With these guiding principles in mind, let us consider how they apply to the central bank's two main responsibilities: monetary policy and financial stability. These two pillars of central banking are related but different.[2] Monetary policy is responsible for price stability and promoting sustainable economic growth. Financial stability involves promoting an effective and efficient payments system and a robust and healthy financial system that helps support economic growth.

1 CLEAR AND EXPLICIT OBJECTIVES

The first principle of sound central banking is to be clear about the goals and objectives of policy. It makes no sense to seek goals the central bank cannot achieve. In other words, policymakers must be clear about what policy can and cannot do. Given the importance of expectations, we must set reasonable expectations for what a central bank can achieve. We must recognize that over-promising can erode the credibility of a central bank's commitment to meet its goals, whether for monetary policy or financial stability. Saying that monetary policy will achieve an objective it is incapable of delivering is a sure way to lose credibility.

Monetary Policy — Let me expand on this principle in the context of the objectives that Congress has established for the Federal Reserve's monetary policy. The Federal Reserve is charged with conducting monetary policy "so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."[3] These are all desirable goals, yet most economists, myself included, agree that focusing on achieving one of them — stable prices — is the most effective way monetary policy can support the other two.

Moreover, we must remember that sustained inflation or deflation is always a monetary phenomenon and that in a world of paper or fiat money, the central bank has the obligation to preserve the purchasing power of the currency so that the ravages of inflation or deflation do not distort markets.

Maintaining a stable price level allows the economy to function in a more efficient and thus more productive fashion. If people and businesses need not worry that inflation will erode the purchasing power of their money, they need not divert resources from productive activities to conserve their money holdings or to hedge the risks of inflation (or deflation). Stable prices also make it easier for households and businesses to make long-term plans and long-term commitments, since they know what the long-term value of their money will be. Indeed, former Fed Chairman Alan Greenspan suggested that an operational definition of price stability is "an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms."[4]

Price stability also promotes efficiency. Prices give signals about the relative supplies and demands of goods and services in a market economy. With a stable price level, changes in prices can easily be recognized as changes in relative prices. With price signals undistorted by inflation, individuals and businesses are able to make better decisions about where to allocate their resources. Thus, price stability helps a market economy allocate resources efficiently and operate at its peak level of productivity.

Price stability also works to promote moderate long-term interest rates. First, it reduces the level of compensation built into long-term interest rates to make up for the loss of purchasing power due to inflation. Second, it reduces the need for an additional risk premium to compensate for the risk that arises from uncertainty about inflation.

In short, price stability is not only a worthwhile objective in its own right. It is also the most effective way monetary policy can contribute to economic conditions that foster the Federal Reserve's other two objectives: maximum employment and moderate long-term interest rates.

While price stability enhances the economy's ability to achieve its maximum potential growth rate, monetary policy plays no role in determining what that growth rate is. In the long run, the economy's growth rate largely reflects two factors. The first is the growth rate of the labor force, which is determined by demographic factors such as the birth rate, age distribution, and immigration. The second is the growth in the productivity of the labor force, which depends on a number of elements, including both physical and human capital. Monetary policy cannot be used to achieve a long-run growth rate that is inconsistent with these economic fundamentals.

The corollary to this emphasis on price stability is *that monetary policymakers should not commit to what they cannot deliver.* It is not possible for a central bank to achieve a specific rate of real economic growth or unemployment. And it is not desirable to lead the public to believe it is within the central bank's power to do so.

This does not mean monetary policy should ignore changes in broad economic conditions. The best strategy is to set policy consistent with controlling inflation over the intermediate term. By keeping inflation stable when shocks occur, monetary policy can foster the conditions that enable households and businesses to make the necessary adjustments to return the economy to its long-term growth path. Depending on the nature of the shock, though, this new growth path may be lower, higher, or the same as its previous growth path. However, monetary policy itself does not determine this sustainable path.

Consequently, monetary policy should be managed in a way that yields the best economic outcome given the environment at the time. As long as inflation and expectations about inflation are well anchored at a level consistent with price stability, the target federal funds rate should fall with market rates when the economy weakens and increase as market rates rise when the economy strengthens. Yet, this systematic approach should not be confused with a desire for active management of the real economy.

Unfortunately, what the public has come to expect of monetary policy, and central banking more generally, has risen considerably over the years. Indeed, there seems to be a view that monetary policy is the solution to most, if not all, economic ills. Not only is this not true, it is a dangerous misconception and runs the risk of setting up expectations that monetary policy can achieve objectives it cannot attain. To ensure the credibility of monetary policy, we should *never ask monetary policy to do more than it can do.* Monetary policy's objectives should be not only clear but also realistic and feasible.

To ensure the credibility of monetary policy, we should never ask monetary policy to do more than it can do. Monetary policy's objectives should be not only clear but also realistic and feasible.

Thus, in order to clarify the central bank's mission, many countries have passed legislation that spells out specific objectives, often clearly assigning the central bank the task of maintaining a stable price level or a low level of inflation. Some governments have defined what level of inflation the central bank should target. In other countries, the central bank itself has adopted an inflation target. In so doing, these countries have helped to recognize what a central bank can and cannot do. I am in favor of the Fed setting an inflation target for this reason, as I'll discuss in the next section.

Financial Stability — Setting clear and explicit objectives for a central bank's financial stability goals is more difficult and less well understood.

We first must be clear about what we mean by financial stability. Central banks cannot and should not prevent all types of financial instability. Indeed, the economy benefits when financial institutions and markets take on and manage risk. That means inevitably some firms will fail. As my friend the economist Allan Meltzer has said, "Capitalism without failure is like religion without sin. It doesn't work."[5] The goal of government oversight should not be to try to prevent every financial failure. Instead, the objective should be to reduce the systemic risks that such a failure may create.

Systemic risk generally refers to the risk that problems at one financial institution will spill over to a broad set of otherwise healthy institutions, thereby posing a threat to the integrity of the financial system and perhaps the economy as a whole. When the financial system works well, financial intermediaries fulfill a useful role in bearing and managing the liquidity risk that arises from funding long-term assets with short-term liabilities. In most cases, this process works well. However, if depositors and other liability holders suddenly demand large withdrawals, an intermediary may be forced to sell long-term assets at prices well below their value if they were held to maturity. This can quickly transform an illiquidity problem into a solvency dilemma, eventually leading to the firm's failure. Such failures have the potential to cascade among counterparties, ultimately leading to a major breakdown of borrowing and lending. Lack of transparency about risk and the value of assets, imperfect or asymmetric information, and uncertainty about exposures can all help fuel such financial contagion.

Because of the complexity and interconnectivity of financial markets, we have found that the failure of a major counterparty, whether a bank or a nonbank, has the potential to severely disrupt many other financial institutions, their customers, and other markets.

To address the systemic risk that has arisen since mid-2007, the Fed has taken historic actions to promote financial stability by expanding its role as lender of last resort. Starting in late 2007, the Fed expanded its existing discount window operations and created an alphabet soup of new facilities (see *The Expanding Fed Toolbox*, next page) to help the credit markets function more effectively. Some of these actions required the Fed to invoke a special provision of the Federal Reserve Act — referred to as Section 13(3) — that gives the Fed the authority to lend to any individual, partnership, or corporation in "unusual and exigent circumstances."[6]

Consider how much has changed: Prior to this crisis, the Fed lent only to depository financial institutions — that is, banks, savings and loans, savings banks, and credit unions — and such lending was typically overnight. During this financial crisis, we have made loans to primary securities dealers, investment banks, a global insurance company, and to industrial and financial companies that issue commercial paper. These lending arrangements have been for terms of as long as 90 days or even as long as 10 years in the case of the financing provided in the Bear Stearns acquisition.

Prior to this crisis, Fed lending typically amounted to less than 1 percent of total Fed assets. By the end of 2008, lending had grown to nearly 50 percent of total Fed assets.

However, the Fed has not been as clear or explicit about the goals and objectives of its financial stability policy as it has been with its monetary policy goals. In today's financial system, we must devise new and clearer objectives for central bank lending. If the goal is to protect the financial system against systemic risk, we must clearly define such risk and articulate in advance the circumstances and terms under which we will lend and to whom.

THE EXPANDING FED TOOLBOX*

To address the financial crisis, the Federal Reserve has added three sets of tools:

A. Lending to financial institutions: These tools provide short-term liquidity to banks and other financial institutions and are closely tied to the central bank's role as the lender of last resort.

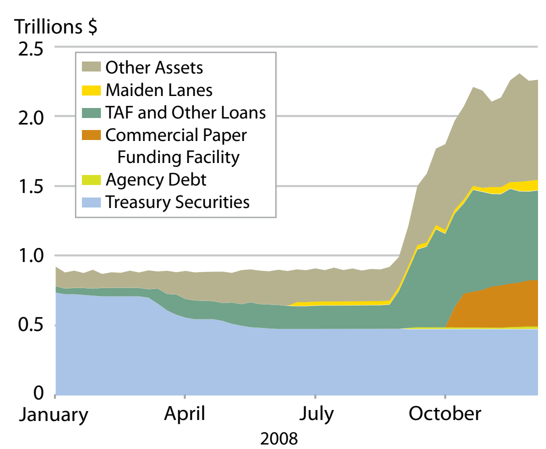
Discount Window Programs	TAF Term Auction Facility	TSLF Term Securities Lending Facility	PDCF Primary Dealer Credit Facility	Reciprocal Currency Arrangements
Primary, secondary, and seasonal lending to depository institutions; rates have been lowered since the crisis began	*Dec. 12, 2007* Auctions for 28-day term loans to primary credit-eligible depository institutions *July 30, 2008* Fed introduces 84-day TAF loans	*March 11, 2008* Allows primary dealers to borrow Treasury securities in exchange for less liquid assets	*March 16, 2008* Overnight loans to primary dealers, the broker-dealers that trade with the Open Market Desk	*Dec. 12, 2007* Currency swaps with select foreign central banks that can lend the funds to foreign financial institutions ease conditions in global markets
Term Discount Window Programs *Aug. 17, 2007* Traditional overnight loans expanded to 90 days		**TSLFO Term Securities Lending Facility Options Program** *July 30, 2008* Allows primary dealers to buy options to borrow from TSLF		

* Adapted from Board of Governors of the Federal Reserve System, "Credit and Liquidity Programs and the Balance Sheet," www.federalreserve.gov/monetarypolicy/bst.htm

Program name: **Bold**; Date program was announced: *italics*; Program description: regular text

In general, we should avoid giving the Fed overly broad mandates, missions, or goals with respect to financial stability that conflict with the one goal that is uniquely the responsibility of a central bank: price stability. In times such as these, we must remember that instability in the general level of prices — whether inflation or deflation — is itself a significant source of financial instability. Consequently, we must make sure that in trying to cure one source of financial instability, we do not sow the seeds of another.

FIGURE 1
Composition of the Fed's Balance Sheet in 2008



Note: Maiden Lanes, TAF and Other Loans, and CPFF account for 46 percent of balance sheet.

Source: Federal Reserve Board of Governors H.4.1 statistical release

2 COMMITMENT TO A SYSTEMATIC APPROACH

The second principle for sound central banking is that policymakers must go beyond just stating their objectives — words are not enough. Policymakers must also make credible those commitments to achieve their policy goals and take actions that are consistent with them.[7]

As mentioned above, expectations about the future play a crucial role in all sorts of decisions that people and businesses make today. If the central bank does not deliver on its stated objectives or takes actions inconsistent with those objectives, businesses and households will need to adjust their decisions in light of this unexpected policy outcome. The central bank's failure to deliver thus leads to unnecessary economic volatility.

If a central bank is to avoid contributing to economic instability, it must not only articulate its goals, it must also make a credible commitment to take actions that will deliver on the stated objectives. Gaining the public's confidence that central banks are committed to their policy objectives and to their plans for achieving them is not an easy task. In democratic societies, it is

B. **Lending directly to key credit markets:** These tools provide liquidity directly to borrowers and investors.

AMLF ABCP Money Market Mutual Fund Liquidity Facility	CPFF Commercial Paper Funding Facility	MMIFF Money Market Investor Funding Facility	TALF Term Asset-Backed Securities Loan Facility
Sept. 19, 2008 Assists money funds that hold high-quality asset-backed commercial paper (ABCP)	*Oct. 7, 2008* Provides liquidity backstop to U.S. issuers of commercial paper	*Oct. 21, 2008* Supports private-sector program to provide liquidity to money market mutual fund investors	*Nov. 25, 2008* Supports the issuance of asset-backed securities (ABS) collateralized by consumer, small business, and various other types of loans

C. **Purchases of longer-term securities**: These tools support the functioning of credit markets by open market purchases of longer-term securities for the Fed's portfolio.

GSE Debt	GSE MBS	Long-Term Treasuries
Sept. 19, 2008 Fed agrees to purchase debt issued by Fannie Mae, Freddie Mac, and Federal Home Loan Banks *Nov. 25, 2008* Fed expands the program to $100 billion *March 18, 2009* Fed increases program up to $200 billion	*Nov. 25, 2008* Fed agrees to purchase up to $500 billion in mortgage-backed securities *March 18, 2009* Fed expands purchases up to $1.25 trillion of agency mortgage-backed securities	*March 18, 2009* Fed agrees to purchase up to $300 billion in longer-term Treasuries

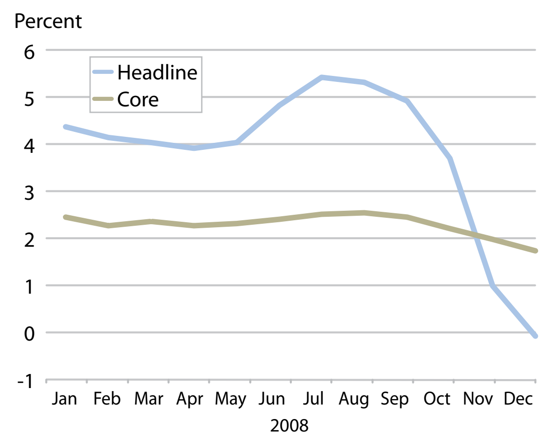
not possible to obtain complete commitment. But there are a variety of ways that governments and central banks have used to make their commitments more credible to the public.

Policymakers, for example, can earn a reputation for delivering on their objectives by acting in a consistent way that convinces the public their stated commitment is credible. To maintain that credibility or reputation, policymakers must continue to act in a way that is consistent with their goals. If they deviate from those goals or act in a way that is inconsistent with them, policymakers run the risk of losing credibility.

Monetary Policy — In the U.S., the Federal Reserve has built a reputation during the past 25 years for having a commitment to keeping inflation low and stable, a commitment that has contributed to economic stability. But that reputation can be lost if we do not continue to act in a way that is consistent with it. From my perspective, reputational capital is always tenuous — it is hard to acquire but easy to lose and so it must be protected.

In the spring and summer of 2008, there was great concern that rising headline inflation rates, due to rapid and dramatic increases in the prices of oil and other commodities, would lead to rising inflation expectations, which in turn would contribute to a more persistent rise in inflation rates. The public began to question the Fed's resolve to maintain price stability. In response to this concern, I and other members of the Federal Open Market Committee (FOMC) continued to remind the public that the FOMC was committed to maintaining price stability and would resist any unanchoring of inflation expectations. None of us wanted to repeat the period of the late 1970s and early 1980s, when we saw that an unanchoring of inflation expectations made it more difficult and more costly to reduce inflation once it became too high.

FIGURE 2
Headline and Core CPI Inflation in 2008
(12-month percent change)



Source: Bureau of Labor Statistics

It is just as important that expectations remain well anchored in the face of falling energy prices. Significant declines in gasoline and fuel oil prices in the last few months of 2008, for instance, led to declines in the consumer price index (CPI). This prompted some commentators to suggest that the U.S. is facing a threat of persistent deflation, as it did in the Great Depression or as Japan faced during the 1990s. I am not particularly concerned about the possibility of persistent deflation. When oil and commodity prices stabilize, the negative rates of inflation we have seen in the CPI are likely to disappear. Moreover, I am confident that the FOMC is committed to maintaining price stability.

Nonetheless, we must act to ensure that expectations of deflation do not take root, just as we must act to ensure that expectations of higher inflation do not emerge. The failure to maintain well-anchored inflation expectations can wreak havoc with the real economy, foster unnecessary volatility, and make it more difficult for the Fed to deliver on its mandate to keep the economy growing with maximum employment and price stability.

As indicated earlier, some governments and central banks have adopted institutional mechanisms to make their stated commitments more credible to the public, including specific objectives in terms of a stable price level or a low level of inflation. Such clearly articulated objectives become a form of institutional commitment, not just the choice of a specific individual or a committee whose membership may change over time. As such, they strengthen the institution's credibility regarding its commitment.

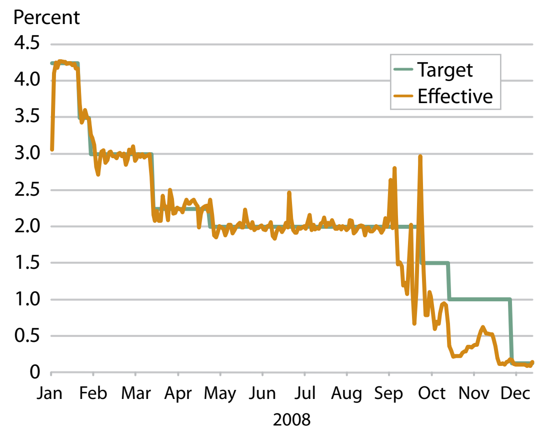
Other economists and I have long proposed establishing an explicit inflation target as one way to signal the FOMC's commitment to price stability and to help anchor expectations.[8] A public commitment to a numerical inflation target over an intermediate horizon is a clear and feasible goal for monetary policy and is consistent with the Federal Reserve's mandates. Such an inflation target would not only help prevent inflation expectations from rising to undesirable levels, but it would also help prevent expectations from falling to undesirable levels. It would offer greater clarity and transparency in communicating our monetary objectives for price stability and would give us a target that we could credibly commit to meet over time.

Of course, adopting an inflation target is not enough. A central bank must also act in a way that is consistent with that target. Words alone are not enough to make commitments credible. The central bank must articulate systematic or mostly predictable policies that help communicate and provide information as to how the objectives will be achieved if policymakers hope to reduce policy-induced uncertainty.

Some central banks have experimented with adopting rules — or at least they have engaged in rule-like behavior. Some rules involve having the central bank's policy interest rate respond to changes in either money growth or certain financial or exchange rate conditions. Other rules involve adjusting the policy interest rate in response to deviations of inflation from some target as well as to deviations of output (or economic growth) from its long-term trend or some measure of potential. In a March 2008 speech, I argued that research has suggested that simple rules such as variations on the Taylor rule appear to perform quite well in a wide range of economic models.[9] This implies that using simple rules as a guide to setting policy is a useful way to make monetary policy more systematic and predictable.

One important characteristic of simple rules is that they can be more easily explained to the public. That makes it easier for the public and for financial market participants to form expectations about policy. Simple rules could enhance the credibility of monetary policy, help anchor expectations, and better align the public's expectations with the central bank's intentions. Adopting simple rules would make policy more systematic and predictable,

FIGURE 3
Fed Funds Rate Target vs. Effective Rate in 2008



Source: Federal Reserve Board of Governors H.15 statistical release

which would minimize policy surprises and the detrimental effects often caused by such surprises.

Financial Stability — During the past year, the Fed has taken steps to limit the systemic risks caused by the potential failure of several large financial institutions. The decisions were always made based on the risks to the financial markets, not the desire to preserve individual institutions. Yet, the old "rules of the game" were out of date. We had to improvise. Consequently, we had no choice but to generate some uncertainty.

Indeed, the financial problems at Bear Stearns, AIG, and Lehman Brothers elicited different responses. When serious funding problems led to the prospect that Bear Stearns might go bankrupt and potentially bring down many other financial firms and disrupt important pieces of the payment system, the Federal Reserve, in consultation with the Treasury, invoked its emergency powers as lender of last resort to allow for a more orderly resolution of the firm's problems. A private-sector buyer (JPMorganChase), with Fed assistance, then purchased Bear Stearns. When AIG and Lehman faced severe funding problems, the Fed and the Treasury again attempted to find private-sector solutions to avoid the imminent failure of these firms. None was forthcoming. The judgment was made that given the nature of AIG's financial obligations, its disorderly collapse would severely threaten financial stability. Therefore, the Federal Reserve provided an emergency credit line to facilitate an orderly resolution. In the case of Lehman, the Fed and Treasury declined to commit public funds, since Lehman's problems had been known to the market for some time.

In hindsight, some have criticized these decisions. However, at the time, each decision was a reasonable judgment based on systemic risk. Yet, these actions did lead to uncertainty about how nonbank financial failures would be handled, and arguably, this uncertainty contributed to the stress in the markets.

One way to alleviate uncertainty is to arrive at more predictable guidelines for our lending and intervention policies. Achieving greater clarity about the criteria by which the Fed will lend to banks or nonbanks in order to prevent systemic risk concerns will improve the Fed's decision-making and the understanding in the marketplace, thus reducing instability and uncertainty.

We should also establish alternative resolution mechanisms that are more predictable and systematic in their approach. One of the lessons from the current financial crisis is that, for policymakers, bankruptcy is not an attractive option for a failing institution that poses systemic risk. In fact, the underlying rationale of bankruptcy law is maximizing the payoffs to the firm's creditors, which in some cases could exacerbate systemic risk. Although state insurance regulators do have special procedures for the orderly liquidation of regulated insurance companies that fail, their focus is on paying off policyholders and claimants. Their procedures are not intended to address systemic risk.

Since bankruptcy proceedings do not normally make provisions for systemic risk, we have long had a specialized regimen for dealing with bank failures. The Federal Deposit Insurance Corporation (FDIC) may consider systemic concerns in a failing bank's resolution and has the authority to act as a receiver for a failed commercial bank and run a bridge bank for up to five years. However, there is no similar mechanism for the orderly liquidation of most nonbank financial firms that pose systemic risk. Policymakers are thus left with one of two outcomes: (1) very costly failures; or (2) very costly interventions to avoid the failure.

One alternative resolution mechanism might follow the one used by the FDIC. That is, extend some type of "bridge-bank" authority to regulators of nonbank financial firms that pose systemic risk. It is not clear to me whether centralizing that type of bridge authority in one regulatory body — whether it is the FDIC, the Office of the Comptroller of the Currency, the Fed, or the Securities and Exchange Commission — would be optimal. Certainly, that is an issue for further study. However, I do not believe that the Fed is the appropriate institution for such a role because of the potential conflicts of interest between monetary policy and the resolution of a single institution. Thus, I think this bridge-bank authority should not be the responsibility of the Federal Reserve.

We can look to banking for other examples of systematic policy approaches. For instance, the prompt corrective action provisions of the 1991 FDIC Improvement Act (FDICIA) provide an example of a systematic approach that is required when a bank gets into trouble and is at risk of failing. Trigger points are specified for when bank regulators must take action to deal with the bank's problems. Because Congress embodied these provisions in legislation, regulators are more insulated from near-term political pressures and constrained to behave more systematically. This gives the regulators a degree of political independence and the markets more clarity.

3 TRANSPARENCY

The third principle simply stresses that policymakers should be clear and trans-

TIMELINE TO TRANSPARENCY

In recent years, the FOMC has sought to improve transparency about its policymaking. Today, the central bank is quite explicit in setting out the objectives of policy and its views on the outlook for the economy. Here are some significant milestones:

76 77 78 80 81 82 84 85 86 87 88 89 90 91

1975

The Federal Reserve presents testimony twice each year to Congress on the conduct of monetary policy.

1979

The FOMC releases the first semiannual economic projections.

1983

The Federal Reserve publishes the first "Beige Book," which summarizes economic conditions in each Federal Reserve District.

1994

The FOMC begins to release a statement disclosing changes in the federal funds rate target.

parent in communicating their policy and actions to the public. At one level, transparency is simply a part of making credible commitments. Central bankers must clearly articulate to the public their objectives and their plans to achieve those objectives, as well as explaining those occasions when they have reason to deviate from their plans.

Another important benefit to transparency is that it increases the central bank's accountability to the public. In a democratic society, it is important that institutions with the delegated authority to act in the public interest be as clear and as transparent as possible regarding their actions. Failing to do so risks the loss of confidence and credibility — two essential ingredients for sound central bank policymaking. As former Fed Vice Chairman Alan Blinder has stressed, central bankers must be as transparent as possible and clearly communicate their views on monetary policy to the public, to whom they must be accountable.[10]

Monetary Policy – One of the benefits of greater transparency is that it can help align the public's view of monetary policy with the central bank's objectives and therefore better align the public's expectations about the economy and inflation.

Although the Federal Reserve is now much more transparent about its monetary policymaking than it was 20 years ago, in my view, central banks in many other countries are ahead of the U.S in this area. Other central banks often provide the public with much more detail about their policy deliberations than we do.

In recent years, the FOMC has improved communications between the Fed and the public. Today, more than ever before, the Fed reports more frequently and more thoroughly on the economy, and the public is well-served by the central bank's explanation of its actions. For example, the FOMC now releases Committee participants' projections for the economy and inflation on a quarterly basis. With more information about the Federal Reserve's outlook, individuals and market participants are able to make economic decisions armed with a better understanding of what the

92 93 95 96 97 98 99 01 03 05 06 08

2000

The FOMC begins releasing a statement after every meeting and starts to include an assessment of the balance of risks to achieving its objectives.

2002

The results of the FOMC roll-call vote are added to the post-meeting statement.

2004

The FOMC speeds up the release of its minutes: Now there is only a three-week lag, instead of waiting until after the next regularly scheduled meeting, which meant a lag of about six weeks.

2007

The FOMC decides to release its economic projections four times a year.

Adapted from "A Day in the Life of the FOMC," Federal Reserve Bank of Philadelphia, 2008.

central bank expects will happen in the economy. Transparency increases the public's understanding of monetary policy, which in turn increases the credibility and effectiveness of monetary policy.

Financial Stability — Transparency is also important in communicating the policy and actions that the central bank takes on financial stability. This is an important part of reducing the uncertainty and making the "rules of the game" clear as the central bank responds to a crisis.

Another reason to ensure clear and transparent communications when policymakers take extraordinary actions to ensure financial stability is that such actions can create moral hazard. Indeed, the mere act of creating the Fed's special lending programs over the course of the past year has created moral hazard. To the extent that market participants now feel more comfortable asking for the central bank's support when they get into trouble, they may be inclined to take on more risk than would otherwise be prudent — thus sowing the seeds for the next crisis.

Intervening too often or expanding too broadly the set of institutions that have access to the central bank's credit facilities not only creates moral hazard but also distorts the market mechanism for allocating credit, thus increasing the probability and severity of a future financial crisis.

Clarifying the criteria under which we will intervene in markets or extend credit, including defining what constitutes the "unusual and exigent" circumstances that form the legal basis for the Fed's nontraditional lending, will be essential if we are to mitigate the moral hazard we have created and reduce uncertainty about future actions.

Of course, announcing the central bank's criteria in advance does not commit it to act as stated in every case, but it does raise the costs of deviating from the criteria. We should be prepared to stay the course once our policy is set and clearly communicate the lending policy and the actions we take in our capacity as lender of last resort.

4 ENSURING THE INDEPENDENCE OF THE CENTRAL BANK

The fourth principle of sound central banking is independence. A central bank's independence has many dimensions; however, it does not mean that central bankers or other policymakers should not be accountable to the public. The importance of transparency and the communication of clearly articulated goals as guiding principles are keys to ensuring the legitimacy of our public institutions.

Monetary Policy – Research has suggested that countries with more independent central banks have benefited from lower rates of inflation, on average, without sacrificing real economic growth.[11]

One of the primary reasons independence is so essential is that monetary policy works with long lags. So, central bankers must take a longer-term view of their policies. This need to take a long-run view is undoubtedly one of the reasons that more central banks around the world have been given greater independence from their nations' treasury departments or finance ministries and the political process. History is replete with examples of the dangers of central banks being used as an arm of a country's fiscal authority. The result is often high levels of inflation.

Freeing central bankers from the short-term pressures that inevitably manifest themselves in the political arena helps monetary policymakers better balance the short- and long-term factors inherent in their decisions. This independence, though, underscores the need for accountability and, therefore, transparency, which further illustrates that these four principles are mutually reinforcing.

Financial Stability – Just as we know that independence leads to more effective monetary policy, free from fiscal and political influence, I believe independence is also vital to a more effective lending or financial stability policy.

To protect this independence, the central bank's lending policies should avoid straying into the realm of allocating credit across firms or sectors of the economy, which I believe is appropriately the purview of the market. The perception that the Federal Reserve is in the business of allocating credit is sure to generate pressure on the Fed from all sorts of interest groups. In my view, if government must intervene in allocating credit, doing so should be the responsibility of the fiscal authority rather than the central bank.

To protect this independence, the central bank's lending policies should avoid straying into the realm of allocating credit across firms or sectors of the economy.

The Fed's extraordinary lending facilities already pose a number of problems that the Fed must confront. As mentioned above, the lending programs have dramatically altered the types of assets on the Fed's balance sheet as well as its size. When financial markets begin to operate normally and the outlook for the economy improves, our balance sheet must contract if we are to maintain price stability.

Some of the new facilities will naturally unwind gradually once they are terminated. For example, the commercial paper lending facility only purchases commercial paper of 90 days or less. Once the Fed stops new purchases, those assets will mature and begin to shrink the Fed's balance sheet.

Yet, some of the assets will not go away so quickly. For example, as 2008 ended, the Fed had begun the process of purchasing $500 billion of mortgage-backed securities, many of which will not roll off its balance sheet for years unless the Fed sells them in the marketplace. In 2009, the Fed also plans to purchase a substantial amount of asset-backed securities whose maturity will be about three years or even longer.

While the Treasury Supplementary Financing Program, which was used in 2008 and will be available in the future, gives the Fed a tool for managing its balance sheet and sterilizing the effects of its lending and securities purchases on bank reserves, the Fed is likely to still face challenges as it attempts to liquidate these longer-term assets from its portfolio.[12] Will there be pressure from various interest groups to retain certain assets? Will there be pressure to extend some of these programs by observers who feel terminating the programs might disrupt "fragile" markets or that the economy's "headwinds" are too strong? Such pressures could threaten the Fed's independence to control its balance sheet and monetary policy. We will need to have the fortitude to make some difficult decisions about when our policies must be reversed or unwound.

By setting realistic and feasible objectives, pursuing a systematic approach to its lending policies that avoids credit allocation, and communicating its objectives and actions in a clear and transparent manner, the Fed can operate independently of these types of pressures and resist them when they arise. This will help the Fed better ensure both its ability and its credibility to maintain financial stability as well as its monetary policy objectives of price stability and maximum sustainable long-term growth.

SUMMARY

To sum up, the past year has been a challenging time for the U.S. economy and for policymakers. The Fed responded to the deteriorating economic outlook and ongoing stresses in financial markets with monetary policy and extraordinary actions to ensure financial stability.

Extraordinary times are precisely when sound principles are most necessary for sound policymaking. A set of guiding principles, like a compass, can be useful to direct the course of action even in normal times. But, in the midst of a storm, a compass becomes an essential tool to ensure that we do not stray from the path consistent with our long-term objectives.

It is always tempting to take action based on short-term concerns and argue that we will worry about consequences later. Yet, as I noted in the beginning of this essay, the policy decisions we make today help shape expectations, which influence the economic decisions of households and businesses. By following a set of sound principles, we can anchor expectations and thereby reduce the inefficiencies and distortions that arise from expectations going unfulfilled.

I believe we must strive to develop sound policies that follow the four principles outlined above: clear and feasible objectives; a commitment to systematic policies; transparency; and a healthy respect for the independence of the central bank. Adherence to these principles will allow the Fed to focus its efforts on achieving its objectives in a more effective manner.

Finally, policy rules may evolve as our understanding of the economy evolves. Some future crisis may bring uncertainties and unknowns that require changes that policymakers cannot foresee. Yet, the need for such evolution or change does not negate or diminish the importance of these guiding principles. Instead, these forces of change should heighten our resolve to develop a principled, systematic approach and to clearly communicate any necessary changes, so we can continue to anchor expectations for a sound future.

ENDNOTES

[1] These four principles were outlined in a series of speeches, including Plosser (2008a), Plosser (2008b), Plosser, (2008c), and Plosser (2008d).

[2] See Plosser (2007).

[3] See the Federal Reserve Reform Act of 1977 and the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act).

[4] See Greenspan (2002).

[5] See Meltzer (1998).

[6] For more information on the Federal Reserve Act's Section 13(3), see Fettig (2008). This article, which is available on the Federal Reserve Bank of Minneapolis's website, www.minneapolisfed.org, also references a more complete history in the December 2002 issue of *The Region*.

[7] See Dotsey (2008) and Plosser (2008e).

[8] For instance, see Mishkin (2008) or Bernanke (2003).

[9] See Plosser (2008e).

[10] See Blinder (1998).

[11] Forder (2000) and Cukierman (2006) survey the more recent literature on central bank independence. Earlier analysis can be found in Alesina and Summers (1993), Cukierman (1993), and Debelle and Fischer (1994).

[12] See the joint statement issued by the Treasury and the Fed, March 23, 2009.

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SUPERVISION, REGULATION AND CREDIT DEPARTMENT

THE FINANCIAL CRISIS AND CHALLENGES FOR REGULATORS

As the financial turmoil of 2008 increased uncertainty, undermined confidence, and tightened credit conditions for households and businesses, the Federal Reserve has been a key player in providing liquidity and calming markets. And the Philadelphia Fed has done its part.

In fact, while the Third District has weathered the crisis better than other parts of the nation, many Philadelphia Fed employees have invested long hours and extra effort to help ensure that the Federal Reserve System has the resources to meet the challenges. One area with a major role in the response has been the Bank's Supervision, Regulation and Credit Department (SRC).

All of SRC's major units saw increased activity in 2008, especially those related to credit risk management, examination, surveillance, and enforcement.

"One of the consequences of any financial crisis is a heightened focus on the role of the regulator," said Michael E. Collins, executive vice president and lending officer, who leads SRC. "Our goal as financial regulators is to ensure that financial institutions operate in a safe and sound manner as they conduct their business. This includes avoiding market excesses as they manage innovations in their products and services. Our success in dealing with the current crisis will be measured largely by the restoration of public trust and confidence in financial markets and institutions." Collins notes that regulators have responded quickly and aggressively in this crisis, which has helped avoid the large-scale failures seen in the savings and loan crisis of the 1980s or the Great Depression. And while the Third District has not had many financial institution failures, SRC has responded to calls for assistance from other Federal Reserve Districts and the state of Pennsylvania's bank regulators.

He noted that, apart from the crisis, SRC also had to expand staff in 2008 to handle the increased workload associated with the relocation of a large bank holding company to the Third District.

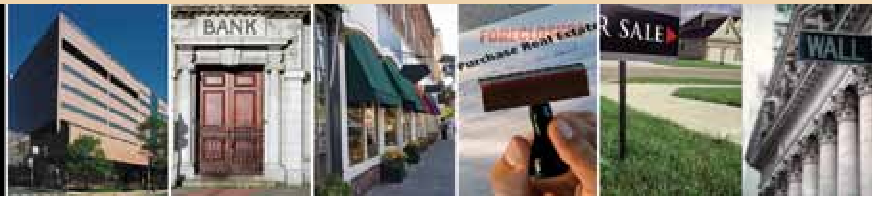
SRC's consumer compliance function also responded to the crisis, not only by heightening its focus on compliance with credit card and mortgage regulations but also by publishing a new System-wide newsletter, *Consumer Compliance Outlook*®, dedicated to consumer compliance issues in the financial industry.

Collins notes that financial crises do not happen overnight. The events that transpired over the past months have long roots – grounded in rapid growth of credit, excessive leverage, poor underwriting, and an influx of new financial products that involved complex and misunderstood risks. He said reshaping the regulatory landscape will take time, but debate and discussion about regulatory reforms are underway.

"Going forward, regulators will strive to find the right balance between regulation and market innovation. A key objective will be to close gaps in the oversight of financial institutions and markets and to update and modernize the regulatory system to keep pace with market realities and global integration," he added. "Regulators will look to improve the capacity of supervisors to identify risks while curbing excessive leverage and risk taking. Valuations of financial institutions' assets will also need to be addressed, such as how to price illiquid assets in a mark-to-market accounting framework."

Many people are aware that the core supervision area has increased its oversight and guidance of Third District financial institutions. Many are familiar with SRC's discount window operations, which have increased the flow of liquidity in the Third District. But what many people may not know is that SRC employees have played an instrumental role beyond the Third District in helping the Board of Governors and other Reserve Banks deal with numerous supervision issues.

Philadelphia's staff of experienced examiners has been a valuable resource to the System through these difficult economic times. Here's how several



employees in SRC lent their expertise to the System during the crisis.

Recently, the Board of Governors asked supervising examiner Jim Adams to help with training about how banks handle commercial real estate issues. Adams visited the Federal Reserve Bank of Richmond and the Denver Branch of the Federal Reserve Bank of Kansas City to conduct training for bank examiners. Adams also shared his expertise with the Miami Branch of the Federal Reserve Bank of Atlanta, where he helped conduct a target review of a troubled bank.

Larry Cordell, special advisor in SRC's Retail Risk Analysis unit, was invited to Washington to give a presentation on risks in the home equity market to Federal Reserve Chairman Ben Bernanke. He also worked for the Board as part of a team sent to the Federal Housing Finance Agency (FHFA), the successor agency to the Office of Federal Housing Enterprise Oversight (OFHEO), to examine the books of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac during the financial crisis. Treasury and the FHFA ultimately decided to place the GSEs into conservatorship. In addition, Cordell headed up the business group that worked with the Kansas City Fed's Research Automation Group to build a major data warehouse of mortgage loan data, with over 107 million mortgage loans (35 million active) that cover about two-thirds of the total mortgage market. His group was charged with helping create the data warehouse used by the System for research and to report on current mortgage conditions.

Assistant examiner Reginald Rountree was called on to work with the Federal Reserve Bank of Atlanta, examining the loan portfolios of a large bank in Atlanta's District. The bank was trying to assist borrowers in maintaining their large real estate development loans until the economic crisis subsides, and Rountree's job was to determine whether the borrowers were in a financial position to pay back the loans.

These are just three examples of how the Philadelphia Fed's Supervision, Regulation and Credit Department will continue to provide leadership and insight in the areas of consumer protection and mortgage markets as we continue to work through the current crisis.

"During an economic contraction, we need to oversee financial institutions more diligently and to counsel institutions in need," said Collins. "As the crisis subsides, in its wake will emerge stronger institutions — more productive and viable than before."

Pictured seated are SRC's Reginald Rountree (left) and Jim Adams, and (standing) Larry Cordell (left) and Mike Collins.

SUPERVISION, REGULATION AND CREDIT DEPARTMENT

A WINDOW INTO THE FINANCIAL CRISIS

The term "discount window" evokes a time when a banker came to a Federal Reserve teller window to borrow funds, perhaps to ensure that the bank had sufficient reserves to complete a financial transaction or to maintain its level of required reserves. Since the Federal Reserve had long encouraged banks to seek funds from other sources first, the discount window was a quiet post at the Federal Reserve Bank of Philadelphia in most years. That is, until 2008.

Here's a quick way to picture the change. For all of 2007, the Philadelphia Fed's discount window processed almost $1 billion ($992 million) in cumulative daily total loan value. If that 2007 loan volume was a measure of what one teller window could handle, then accommodating the 2008 loan volume of $2.3 trillion would require nearly 2,300 teller windows.

Of course, rather than approaching a teller window, borrowers today simply call a toll-free number to process a loan. So don't look for any massive office renovations in the Credit and Risk Management unit in Philadelphia's Supervision, Regulation and Credit (SRC) Department. What's another way to view the change?

"Almost any way you measure it, it was an extraordinary year," said Vish P. Viswanathan, vice president and discount officer. Viswanathan explained that several factors contributed to the growth in loan activity, including a change in approach to discount window lending six years ago, the financial crisis and the resulting extraordinarily tight credit markets in 2008, and the addition of new types of Fed lending in response to the crisis.

"Before 2003, bankers had to go through a lot of hoops to get a loan from us, because if we made a loan, it was at a subsidized rate — one that was below the federal funds rate," explained Viswanathan. "Banks could not come to us unless they had exhausted all other sources." He noted that there were restrictions on the use of funds borrowed from the Fed. In addition, bankers received more supervisory oversight from bank regulators when they borrowed from the Fed and had to report to their directors about such borrowing, which added to the perceived stigma of going to the Fed's discount window.

In 2003, the Federal Reserve eased the administrative rules for discount window loans. At the same

Pictured left to right are Kim Caruso, Gail Todd, and Vish Viswanathan of the Supervision, Regulation and Credit Department. They are shown with a frame from the days when the discount window really was a window.

time, the Fed increased the discount rate to be above the federal funds target rate by a full percentage point. This approach intended to use the interest rate differential — a premium or penalty rate to keep the discount rate above the market rate — rather than administrative rules to encourage banks to find other sources of funds before coming to the Fed to borrow. “So we became, de facto, the expensive money, but with fewer restrictions. Even so, continued perceptions of stigma from borrowing at the discount window kept loan volumes low,” he said.

In the past 18 months, in response to a weakening economy and a growing financial crisis, the Fed has significantly reduced the level of short-term interest rates by lowering its target federal funds rate to near zero. It also significantly reduced the spread (premium) between the discount rate and the federal funds target to just a quarter of a point, bringing the discount rate down to a half percent. With lower rates at the Fed’s discount window and liquidity scarce as many lenders cut back their lending, more financial institutions chose to borrow at the window.

With lower rates at the Fed’s discount window and liquidity scarce as many lenders cut back their lending, more financial institutions chose to borrow at the window.

Typically, depository institutions might need a loan to bolster their reserves due to daily volatility in credit demands, unexpected withdrawals of funds, or seasonal factors. The Philadelphia Fed offers primary, secondary, and seasonal credit at its discount window, as well as 28- and 84-day Term Auction Facility (TAF) loans, one of several new lending programs that the Federal Reserve System added to meet the challenges of the financial crisis.

To qualify for primary credit and the TAF, an institution must be in sound financial condition. Institutions that do not qualify for primary credit may receive short-term secondary credit at a higher rate. In 2008, the Philadelphia Fed made very few seasonal loans, which provide smaller institutions with term loans to manage agricultural- or tourism-related seasonal swings in their normal sources of funds.

Credit and Risk Management works closely with the Bank’s regulatory units and with other regulators to gather information about all Third District financial institutions, so the staff has a good idea which credit programs each institution would be able to access. The unit also monitors the financial condition of borrowing institutions during the term of their loans, a task made all the more difficult by the volatile nature of financial markets in 2008.
To arrange a loan, depository institutions must have a borrowing agreement approved by its board of directors, naming certain individuals authorized to borrow. In addition, the institutions must pledge collateral, since all discount window loans are made only after they are “collateralized to the satisfaction of the lending Reserve Bank.“

When an institution needs a loan, a designated employee calls a Reserve Bank’s toll-free number and states how much the institution wants to borrow and for how long. Usually the loan is overnight, but primary credit loans can have terms of as long as 90 days under provisions established in 2008 to address the financial crisis.

The discount window staff then checks the level of collateral pledged by the institution using the Collateral Management System (CMS), a web-based

TRACKING $5 TRILLION IN ASSETS

John Ackley, vice president of Treasury Services, thinks of 2008 as a watershed year for the Collateral Management System (CMS), operated by Philadelphia's Treasury Services on behalf of the entire Federal Reserve System. By year-end 2008, the CMS was tracking assets with more than $5 trillion in original par value and a collateral value of $2.5 trillion.

The CMS team in Philadelphia completed a major overhaul of the system in 2006, and Ackley said that the CMS demonstrated its robustness in 2008. "We really didn't have to change the CMS at all, which was a testament to its quality and flexibility." As the Federal Reserve added new lending facilities, broadened collateral categories, and even added nonbank institutions to those with access to the window, the CMS kept up with the changes.

Ackley noted that throughout a volatile year, the CMS team maintained steady leadership and oversight to meet the requirements of the credit and risk management community. As new issues came up about collateral procedures or processes, team members, including Ackley, were taking calls and answering questions at all hours. In 2008, Ackley and his team, supported by Marie Tkaczyk and her team in Information Technology Services, introduced several improvements. One enhancement was to automate the handling of "borrower-in-custody" collateral, usually loan portfolios that a bank keeps on site so it

A WINDOW INTO THE FINANCIAL CRISIS ...*continued*

application that tracks all collateral pledged throughout the Federal Reserve System, as well as other records, to see whether the bank can borrow the amount and whether the requestor is authorized under the borrowing agreement. If so, the amount is deposited into the bank's reserve account at the Fed for the requested loan term at the current discount rate.

TAF loans are a little more complicated. The program, first introduced in December 2007, requires institutions to bid on specific auctions of either 28-day funds or 84-day funds. The interest rate paid on TAF loans is determined in the auction. It wasn't until May 2008 that a Third District institution had a winning bid for a TAF loan, and most of the TAF loans in the Philadelphia Fed's District were made in the fourth quarter of 2008. When that occurred, though, TAF loans ended up accounting for 90 percent of the Philadelphia Fed's total loan activity in 2008.

"Along with the considerable increase in cumulative daily total loan value in 2008, the actual number of loans increased four-fold from 107 to 437 loans. The real workload for Philadelphia's staff, however, came from the dramatic increase in collateral management activities, as banks added considerably to their collateral pledged at the Fed," said Viswanathan. Credit Officer Gail Todd noted that many institutions that had never borrowed at the window before pledged collateral in 2008 just in case they would later need to borrow in the midst of the financial crisis. "We have had to educate depository institutions on the various lending programs offered by the Federal Reserve," said Todd. "We walked a lot of institutions through the process of setting up borrowing agreements and pledging collateral at the window. Many institutions were looking to enhance their back-up funding sources for their own contingency planning."

When an institution pledges collateral, Todd and her team must determine if the assets are eligible, whether the Philadelphia Fed can establish a clear can service the loans. “Back in the day, a bank would show us a stack of computer paper, two inches thick, with loan information. We would determine the collateral value and enter the total for the group deposit. Now we have the ability to look at each loan, with greater granularity, so the institution can receive a more precise collateral value,” said Ackley.

The team also automated monthly reporting to depository institutions of the value of the collateral they pledged to the Fed. Collateral pricing was also improved, with more frequent updates from the National Book Entry System for Treasury securities and from the Depository Trust Company for other securities. In early 2009, the CMS began providing daily updates to pricing of other forms of collateral.

Ackley says the goal is to keep refining the system so that when intraday payment system risk (PSR) rules go into effect in two years, the CMS will be able to tell Federal Reserve Banks and their depository institutions the collateral value of the assets pledged at any given moment.

John Ackley
Vice President, Treasury Services

legal claim to the assets, and then what lendable, or collateral, value to assign to the assets, using the Collateral Management System.

Kimberly Caruso, a senior specialist in the Credit and Risk Management unit, plays a key leadership role in the Federal Reserve collateral management function by chairing the Business Steering Group (BSG) of the CMS application. As the Fed repeatedly announced new collateral requirements and additional lending programs in response to the crisis, Caruso and other members of the BSG were asked to provide feedback to the CMS team about how to use the application to track collateral for the new lending facilities. Caruso is also an active member on the Federal Reserve System’s Collateral Valuation Work Group, which helps determine the “haircuts” taken to establish the “lendable” collateral values. In September, Caruso also hosted a meeting of collateral managers and analysts, which brought together credit risk professionals from across the Federal Reserve to discuss the collateral changes.

Todd noted that all of the focus on collateral management in 2008 is a precursor to the upcoming changes in payment system risk (PSR) policies scheduled for implementation in late 2010 or early 2011. The new PSR policy will require more comprehensive and timely intraday monitoring of collateral levels that will be used to offset fees levied on financial institutions for “overdraft” protection during the day.

“In the future we will see a lot more pressure to make timely determinations of collateral values, with more emphasis on turnaround times,” explained Todd. “Every minute that it takes you to process a collateral transaction is time that the financial institution is not getting use of the value, so we’re looking at all potential efficiencies to improve the collateral management process.”

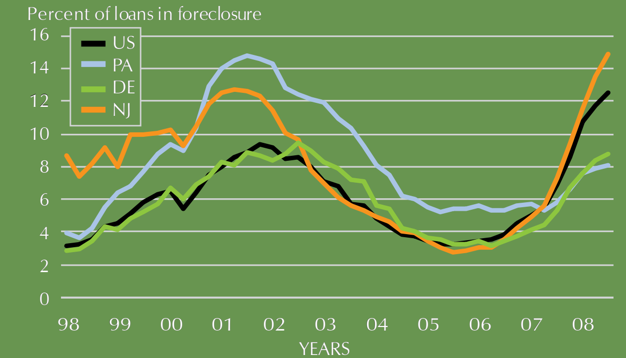
COMMUNITY AFFAIRS DEPARTMENT

HELPING THIRD DISTRICT COMMUNITIES DEAL WITH FORECLOSURES

Housing counselors in early 2008 were telling the Federal Reserve Bank of Philadelphia that homeowners in the region were in trouble. The number of foreclosed properties was increasing rapidly in Philadelphia and elsewhere in the Third District.

Bringing the District's first responders — counselors and loan servicers — together was critical to addressing the deepening subprime mortgage crisis. Dede Myers, vice president of Community Affairs, and her staff brought together more than 100 housing counselors with seven of the District's top 10 loan servicers. Her staff had been conducting foreclosure-prevention meetings to address issues in the Third District, but this program was remarkable. "Every counselor left with a lender's phone number and the confidence that they could help homeowners," Myers said.

SUBPRIME MORTGAGE FORECLOSURES



Source: Mortgage Bankers Association/Haver Analytics

One regional housing advocate who attended the meeting credits the Bank's event with prompting a vision that would lead to more opportunities to help people save their homes. In the spring of 2008, he and others launched Philadelphia's pilot program for mortgage-foreclosure diversions. This novel approach has saved homes from sheriff's sales or postponed sales because lenders may not foreclose on a property until the borrower meets with a housing counselor and lender. Essentially, the program requires lenders and their attorneys to work with housing counselors to restructure the loan before allowing foreclosure actions to proceed.

But what could the Philadelphia Fed do for borrowers to help them ward off foreclosure? Myers approached the *Philadelphia Daily News* to create a guide geared to helping troubled homeowners understand their responsibilities as well as their options. Homeowners needed to know about resources available to prevent foreclosure, whether that meant finding a housing counselor, negotiating a modification of their loan terms, or getting help to pay the legal costs to stop a sheriff's sale.

"Lenders, servicers, and consumer advocates were distressed that many people were walking away from their homes without even talking to their lender," Myers said. Sometimes they were talking to the wrong people. Homeowners, frightened by the threat of losing their homes, were falling prey to scams.

To help disseminate information, the Philadelphia Fed and the Greater Philadelphia Urban Affairs Coalition's Foreclosure Prevention Task Force worked with the *Daily News* editorial board to produce the "Foreclosure Survival Guide," published in February 2008. Community Affairs distributed 10,000 copies to agencies battling foreclosures in the Philadelphia region and shared this guide with other Federal Reserve Community Affairs offices nationwide.

Throughout 2008, the Philadelphia Fed reached out to the housing counselors serving on the frontlines of the crisis to provide more training. The Bank sponsored events with the Pennsylvania Housing Finance Agency (PHFA) and the Federal Housing Administration (FHA), which is the largest insurer of mortgages nationwide. Both the PHFA and the FHA offered training on their different loan products and helped counselors understand options available to troubled borrowers.

The Bank also hosted a two-day event that helped counselors earn certification as delinquency and default counselors. This training not only benefits borrowers buried in debt, it also positions the counseling agency to be eligible for federal funding. The national nonprofit NeighborWorks America, in conjunction with the Pennsylvania Housing Finance Agency, conducted the training. Once the training was completed, participating agencies became eligible for a portion of $360 million in federal funds that Congress asked NeighborWorks America to distribute to housing counselors helping borrowers prevent foreclosure.

The Federal Reserve's response to rising foreclosures also made the agenda during the Bank's 2008 conference on "Reinventing Older Communities: Does Place Matter?" Sandra F. Braunstein, director, Division of Consumer and Community Affairs, Federal Reserve Board of Governors, discussed the Fed's creation of new rules that provide additional protection to consumers against higher-priced mortgages under the Home Ownership and Equity Protection Act and the Truth in Lending Act. She also explained how the Federal Reserve has collaborated with regulators, community groups, and policymakers to help prevent or mitigate the effects of mortgage delinquencies and foreclosures.

One of the Federal Reserve's major undertakings was launching an online Foreclosure Resource Center on each Reserve Bank's external website. This Bank's center provides information for homeowners, prospective homebuyers, and community groups to prevent foreclosures and lessen their negative influence on neighborhoods. The center features research, regional and national resources, policy and regulation, as well as news and events. For example, the center offers a mitigation toolkit to help communities assess the foreclosures in their area, reach troubled homeowners, and provide support for displaced homeowners.

Rehabilitating and redeveloping foreclosed and abandoned properties was the purpose of the Neighborhood Stabilization Program, created by the Housing and Economic Recovery Act of 2008. It entitles states, cities, and counties to receive a total of $3.92 billion. The Philadelphia Fed asked Community Affairs' visiting scholar Alan Mallach to prepare a paper on how governments, developers, real estate agents, and others should ensure the effective use of these funds. Mallach created a blueprint outlining 11 principles communities should follow in spending the program's funds. Mallach is a nonresident senior fellow in the Metropolitan Policy Program at the Brookings Institution in Washington, D.C. His research, which is available on the Bank's website, was praised by Housing and Urban Development officials and gained widespread recognition after it was presented at the Federal Reserve's conference "Confronting the Neighborhood Impacts of Foreclosure" in Washington, D.C., in October 2008.

Community Affairs' collaborative approach to identifying, understanding, and addressing urgent problems has always been a strength, one that has helped the Third District meet its constituents' needs during this unprecedented crisis. The Philadelphia Fed will continue to respond to the ongoing effects of the subprime mortgage crisis on Third District communities through its partnerships, outreach, and research. The Bank's Community Affairs Department plans to examine the mortgage crisis and the obstacles and opportunities it presents for reinventing communities at its 2010 conference.

NO EVIDENCE OF CRA ROLE IN THE CRISIS

In looking for causes of the subprime mortgage crisis, some people have contended that the Community Reinvestment Act (CRA) pushed banking institutions to make high-risk mortgage loans in lower-income communities and that such lending led to the crisis. In a November 2008 study, Federal Reserve economists Glenn Canner and Neil Bhutta analyzed mortgage-related data to assess such arguments and found no empirical evidence to support the claim that the CRA was a major contributor to the subprime crisis.

Enacted by Congress in 1977, the CRA requires bank regulators to encourage insured depository institutions, such as banks and thrifts, to help meet the credit needs of their entire community, including low- and moderate-income areas. The CRA encourages financial institutions to extend mortgage, small business, and other types of credit to lower-income neighborhoods and households. It also encourages them to provide investments and financial services to businesses and people in low- and moderate-income areas. The law, however, does not set targets or goals for lending, investment, or services. What's more, the law states that banks and thrifts should make loans and investments consistent with safe and sound banking practices. The CRA does not cover independent nonbank lending institutions, such as mortgage and finance companies

In a December 2008 speech, then-Federal Reserve Governor Randall Kroszner specifically rebutted the claim that the CRA was a major cause of the subprime crisis, drawing on the 2008 staff analysis as well as earlier work done by Fed staff. According to Kroszner, "We have not yet seen empirical evidence to support these claims, nor has it been our experience in implementing the law over the past 30 years that the CRA has contributed to the erosion of safe and sound lending practices." He commented on two reports prepared by the Federal Reserve for Congress: the 1993 "Report to the Congress on Community Development Lending by Depository Institutions," and a 2000 report, "The Performance and Profitability of CRA-Related Lending." These reports analyzed the performance of lending to lower-income borrowers and neighborhoods under the CRA. In the speech, he stated:

> "These studies found that lending to lower-income individuals and communities has been nearly as profitable and performed similarly to other types of lending done by CRA-covered institutions. Thus, the long-term evidence shows that the CRA has not pushed banks into extending loans that perform out of line with their traditional businesses."

He went on to discuss the more recent 2008 staff analysis of the relationship of the CRA to the subprime mortgage crisis, which focused on two basic questions: What share of subprime mortgage originations

Former Federal Reserve Governor Randall Kroszner

were related to CRA? Have CRA-related subprime loans performed more poorly than other subprime loans?

PROFILE OF HIGHER-PRICED LENDING IN 2006

	Banking Institutions & Affiliates			
	Within CRA Assessment Area (percent)	Outside CRA Assessment Area (percent)	Independent Mortgage Company (percent)	Total (percent)
Non-Lower Income	7	23	27	57
Lower-Income	6	18	20	44
TOTAL	**13**	**41**	**47**	**100***

* Percentages may exceed 100 because of rounding.
Source: FFIEC, HMDA Data

With regard to the first question, the staff analysis focused on lending activity during 2005 and 2006, the period that corresponded to the height of the subprime lending boom. It found that only 6 percent of all higher-priced loans to lower-income borrowers or neighborhoods were made by CRA-covered institutions or their affiliates. In contrast, 20 percent of higher-priced loans to lower-income borrowers were made by independent nonbank institutions, such as mortgage or consumer finance companies, which are not covered by the CRA. Furthermore, nearly 60 percent of higher-priced mortgage loans were unrelated to the CRA because the loans were made to middle- and upper-income borrowers.

With regard to the second question, the study compared the performance of subprime and Alt-A mortgage delinquencies in lower-income neighborhoods to those in middle- and upper-income neighborhoods. Using data provided by First American Loan Performance, it found that delinquency rates of 90 days or more for subprime and Alt-A loans originated between January 2006 and April 2008 were high regardless of neighborhood income. That is, subprime or Alt-A loans made in lower-income neighborhoods (which would be the focus of CRA-related lending) did not perform worse than when such loans were made in higher-income neighborhoods.

To further explore this question, the study compared the performance of subprime mortgages with first mortgages originated and held under the affordable lending programs operated by the national nonprofit NeighborWorks America (NWA). NWA was created by the U.S. Congress to provide financial support, technical assistance, and training for community-based revitalization efforts. It works with many CRA-covered banks and thrifts to originate and hold mortgages made predominantly to lower-income borrowers and neighborhoods. The research showed that loans originated under the NWA program had a lower delinquency rate than subprime loans and a lower rate of foreclosure than prime loans.

In addition, the study examined data made available by RealtyTrac on foreclosure filings from January 2006 through August 2008. These data indicate that most foreclosure filings – about 70 percent in 2006 – have occurred in middle- or upper-income neighborhoods and that foreclosure filings have increased at a faster pace in middle- or upper-income areas than in lower-income areas, where CRA-related lending would occur.

All of this research finds no evidence that the CRA caused the spike in defaults in the subprime market. In his speech, Kroszner concluded, "The evidence does not support the view that the CRA contributed in any substantial way to the crisis in the subprime mortgage market."

RESEARCH DEPARTMENT

RESPONDING TO THE CRISIS

Given the financial crisis and the Federal Reserve's policy innovations in response to it, it is not surprising that, in 2008, demands on the Philadelphia Fed's Research Department for policy and economic analyses increased.

In addition to the usual eight meetings of the Federal Open Market Committee (FOMC), there were six unscheduled FOMC meetings as well as several unscheduled meetings of the Bank's board of directors.

The Bank's president and directors benefited from the Research Department's strong analyses of economic developments and policy issues through regular and special briefings. Topics included monetary policy at the zero bound of interest rates, interest rate spreads, the design and economic effect of the Fed's special liquidity facilities, financial regulatory reform, the TARP (Troubled Asset Relief Program), and the department's new economic forecasting model. As Director of Research Loretta Mester observed, "Policy is much more complicated in this economic environment."

The Research economists also contributed to President Charles Plosser's 11 major speeches last year, most of which addressed some aspect of the financial crisis. Topics included the limits of central banking, financial regulatory reform, and monetary policy and financial stability. Furthermore, Research staff helped Public Affairs prepare the president for interviews and questions from the media. All of these activities took on added importance because President Plosser was a voting member of the FOMC in 2008 and also because the stressed economic environment raised the public's level of interest in economic developments and what policymakers had to say about the economy. Indeed, the information specialists in the Research library worked hard to keep the public and Bank employees apprised of economic conditions. Library staff fielded an increased number of requests for information from the public and from Bank staff seeking data for studies, briefings, and presentations.

Last year, the Federal Reserve Bank of Philadelphia and its Research Department contributed to the debate on regulatory reform. Research staff organized a meeting of members of the Federal Reserve System's working group on new financial architecture with prominent banking scholars from academia to discuss proposals for regulatory reform of the financial system. This "summit meeting" was held at the Philadelphia Fed in January 2009.

The additional workload imposed by the severe economic downturn cut across all three sections of the department: regional, macroeconomics, and banking. However, the sections also maintained their normal workload, and some of that output focused on the turmoil in financial markets.

For example, the regional section compiles and publishes the monthly *Business Outlook Survey*, which polls Third District manufacturers, and the quarterly *South Jersey Business Survey*, which is sent to members of the Chamber of Commerce of Southern New Jersey. In 2008, both of these surveys kept market participants, Third District businesses, and Fed policymakers abreast of what was happening in the regional economy. In fact,

REGULAR AND ADDITIONAL FOMC MEETINGS IN 2008

The Federal Open Market Committee (FOMC) held eight regularly scheduled meetings in 2008. Research also helped prepare for six unscheduled FOMC meetings as well as several unscheduled meetings of the Bank's board of directors.

January	***9, 21***, 29-30	August	5
March	***10***, 18	September	16, ***29***
April	29-30	October	***7,*** 28-29
June	24-25	December	15-16
July	***24***		

Dates in bold italics were unscheduled meetings.

the *Business Outlook Survey* has been shown to be a good predictor of national economic conditions, so it garnered even more attention than usual in 2008. The regional section also collected specific information about how the financial crisis was affecting local businesses. For example, both surveys included special questions that asked local business leaders about problems in obtaining credit and how those problems had affected production or inventories at their firms.

The *Survey of Professional Forecasters* (SPF), conducted by the Research Department's Real-Time Data Research Center, gauged what forecasters were projecting for inflation, output, and other economic variables, as it usually does. But like the regional surveys, the SPF asked special questions related to the crisis. For instance, the SPF forecasters were unanimous in saying that the U.S. economy had entered or would soon enter a period of recession before it was declared by the National Bureau of Economic Research. The SPF also asked forecasters for their views on how a fiscal stimulus package would affect their estimates for gross domestic product in 2008, 2009, and 2010. The semi-annual *Livingston Survey* continued to collect forecasters' projections for short-term and long-term economic growth and their predictions for the movement of inflation, interest rates, and stock prices, providing valuable data on expectations about the economy.

In addition to its monetary policy work, the macroeconomics section continued its development of a new economic forecasting model that will be used to prepare the Bank's quarterly forecasts. This model has already proved useful in an environment where economic forecasting is incredibly difficult. In addition, the macro section prepared a briefing on the theoretical and empirical research on the effects of financial shocks on the economy.

The banking section also pitched in with the department's efforts. In addition to ongoing work on regulatory reform, banking staff published an issue of the quarterly *Banking Legislation and Policy* that provided information on a range of crisis-related topics, including responses to the liquidity crises at financial institutions, the government takeover of Fannie Mae and Freddie Mac, the lending facility that the Fed created for AIG, and the Fed's widening of collateral accepted for loans to banks. The quarterly *Banking Brief* kept market participants and the public up to date about conditions at banks in the Third District and nationwide.

Over the course of 2008, other output from the department reflected the economists' interest in the financial crisis and their attempts to analyze it. For example, *Business Review* articles touched on such topics as liquidity crises, the effects of bankruptcy on homeownership, and the "fresh start" provisions of the bankruptcy law. The department's Working Paper series produced studies in such areas as monetary policy, forecasting models, core measures of inflation as predictors of total inflation, the effects of monetary tightening on local banks, and central bank structure and effective central banking. In addition, department staff produced several special reports that discussed such topics as the use of real-time data to date recessions and conditions in the housing market in the Third District. Staff members also made an unusually large number of speeches, chiefly devoted to outlooks on the local economy.

In sum, besides its usual annual workload, the Research Department shouldered additional responsibilities occasioned by an unprecedented financial crisis and economic downturn. In meeting these responsibilities, not only did the department help keep Bank staff, directors, and interested parties in the Third District informed and up to date, its work also sought to lay the groundwork for improved policymaking in the future.

2008 BANK HIGHLIGHTS

AUDIT

In September, the Audit Department hosted "Best Practices and International Standards," a five-day workshop that brought together internal audit professionals from 10 Eastern European countries and the United States to discuss practical approaches to internal audits of central banks and financial sector regulatory authorities. The program was a joint undertaking of the Philadelphia Fed and the Partners for Financial Stability program, a public-private partnership of the U.S. Agency for International Development and the East-West Management Institute, a New York-based nonprofit organization.

CASH SERVICES

During the fourth quarter of 2008, the currency counting division began installing the first of eight new high-speed currency-processing machines. The units include both software and hardware updates with many technological advances for throughput and efficiency. Each upgrade will require rigorous testing and significant retraining of staff and supervisors. The upgrade project will continue throughout 2009. Also in the fall of 2008, Cash hosted a work group that is revising the custody control procedures and standards for the Federal Reserve System.

COMMUNITY AFFAIRS

In March, the Community Affairs Department hosted its third biennial conference on "Reinventing Older Communities," attended by more than 500 people from 29 states. During the year, it also supported the Federal Reserve System's Homeownership and Mortgage Initiative to help communities respond to mortgage delinquencies and foreclosures. In addition, Community Affairs staff continued efforts to broaden economic and financial education by reaching more than 500 teachers through the department's various programs.

ENTERPRISE RISK MANAGEMENT

Philadelphia's ERM officer provided System leadership by co-chairing the International Operational Risk Working Group conference and led presentations on key risk indicators and enterprise risk management. The ERM department officer also participated in a Federal Reserve System panel discussion on fraud. ERM led the effort to move the Bank's District relocation facility (DRF) to New Jersey. The new DRF opened in October.

FACILITIES MANAGEMENT

The Facilities Management Department oversaw the start of construction for the Bank's off-site screening facility. The new building on 7th Street in Philadelphia will be used for screening general delivery trucks, check courier vehicles, and armored carriers before the vehicles proceed to the main Bank building. Also, the Facilities Management staff was instrumental in getting the Bank's new District relocation facility (DRF) in New Jersey up and running.

FINANCIAL MANAGEMENT SERVICES

Staff in FMS chaired several System groups, including the COSO Coordinators Group, the Cost Accounting Group, the Enterprise Risk Management Group, and the Government Entity Accounting Reporting System Management Steering Group. FMS also acted as trustee chair for the Accounting Professional Education Program. In her role as chair of the Enterprise Risk Management Group, the Bank's chief financial officer provided leadership on continuing efforts to identify, communicate, and mitigate risks, with an increased focus on cross-System interdependencies.

FINANCIAL STATISTICS

In 2008, Financial Statistics staff continued to provide superior analysis of incoming data and provided important information to policymakers as the Federal Reserve responded to credit market disruptions. The staff made important contributions to the Federal Reserve System's Statistics and Reserves Technology Modernization Project, management and enhancement of existing technology applications, and System-level training.

HUMAN RESOURCES

HR participated in WorkReady Philadelphia, a broad-based partnership dedicated to building the region's future workforce, by providing summer internships in various departments throughout the Bank. The ePEP (electronic Professional Education Program) group was involved in developing the Partnership for Progress program, which includes a website for minority-owned and de novo banking institutions. Work continues on development of the Bank's multifaceted talent management program. The Philadelphia Fed is playing a significant role in Human Resources at the Federal Reserve System level: The Bank's president chairs the Committee on Investment Performance, and its first vice president chairs the System's Committee on Plan Administration, which administers the retirement and thrift plans.

Partnership for Progress | A Program for Minority-Owned and De Novo Institutions

INFORMATION TECHNOLOGY SERVICES

IT Services managed scores of internal Bank projects, supporting most business lines, and provided significant support to the Federal Reserve System and the Treasury. Major IT leadership assignments included enhancements to collateral management and Treasury check processing systems, software quality assurance services, and a reworking of the architecture of the Federal Reserve's network infrastructure. The Bank's Groupware Leadership Center has specific responsibility for the Federal Reserve's collaboration suite of technologies, including e-mail and instant messaging, the calendar function, web conferencing, unified messaging, team workplace sites, community services, and enterprise content management. ITS also supports the Bank's video conferencing network, an enterprise-wide service for all Federal Reserve offices. A new video conferencing technology called telepresence was introduced in 2008 to provide very high-quality communications among key Federal Reserve leaders.

LAW ENFORCEMENT

Law Enforcement, in conjunction with Facilities Management and other departments, helped in the design and build-out of the District relocation facility (DRF) in New Jersey, which opened in October. The department also consulted on the build-out and integration of the security systems and operation plans for the off-site screening facility being built on 7th Street in Philadelphia. Law Enforcement staff also planned an upgrade to the Bank's security system, including a complete renovation of the Law Enforcement control center.

LEGAL

The Bank's general counsel continues to chair the System's Subcommittee of Ethics Officers, which provides information, guidance, and support to the ethics programs of all the Reserve Banks. He also arranged for ethics training for all Bank departments through online or classroom training. A Legal Department officer continues to provide legal support to Bank management regarding construction of the off-site screening facility and to the System's Groupware Leadership Center. Another Legal Department officer continues to chair the System work group reviewing legal issues related to verifying the identity of those seeking physical or electronic access to federal government sites; that officer also serves as the legal liaison to the System's Workers' Compensation Coalition.

PAYMENT CARDS CENTER

The Payment Cards Center coordinated the activities of various Bank departments related to a broader Program in Consumer Credit and Payments. This included co-sponsoring workshops related to the program and developing a communications plan to link more than 40 Bank professionals who participate in the program. The center also engaged in collaborative initiatives and events with industry trade groups, including working with the Electronic Funds Transfer Association to host a major conference on payment card fraud. The center also published discussion papers, and the center's visiting scholars contributed papers to the Research Department's Working Paper series.

PUBLIC AFFAIRS

The department completed the redesign of the Bank's external website, www.philadelphiafed.org, which now has improved navigation and new features. Department staff also worked with Bank and System colleagues to produce Partnership for Progress, a new website designed to enhance the ability of minority-owned and de novo financial institutions to thrive in a competitive banking environment. The department's media team worked with the Bank's Community Affairs Department and the *Philadelphia Daily News* to produce the "Foreclosure Survival Guide." Published as an insert to the paper, the guide was also distributed to agencies helping consumers deal with foreclosures. The media team also hosted a workshop for Third District reporters to give them a perspective on the financial crisis.

RESEARCH

The Research Department provided extensive support to the Bank's president as he dealt with policy issues surrounding the changing conditions in financial markets and the economy. The department opened the Real-Time Data Research Center, a source of knowledge and expertise about real-time macroeconomic data, surveys of macroeconomic forecasts, and macroeconomic modeling. The Research Department's regional economic staff provided technical assistance to the city of Philadelphia's Budget Office and the Pennsylvania Intergovernmental Cooperation Authority (PICA) on city budget issues. The department also sponsored several workshops and meetings last year that covered such topics as international trade, macroeconomics and monetary economics, and intellectual property in financial services.

RETAIL PAYMENTS

Philadelphia's Retail Payments Department successfully consolidated check-processing operations from the Utica, N.Y., and Windsor Locks, Conn., offices in 2008. The department implemented significant workflow changes to align operations with the increasing number of electronic check deposits and the resulting increased printing of substitute checks, which required the installation of additional high-speed printers. The Customer Relations staff worked with financial institutions to implement electronic presentment of checks (FedReceipt). At the end of 2008, almost 90 percent of the check deposits and almost 67 percent of the presentments were made electronically. In November, the Federal Reserve System announced further consolidation of check-processing operations, with Philadelphia's check operation scheduled to be moved to Cleveland by late 2009. Philadelphia also enhanced the application software needed to handle the processing of peak volumes of government checks from the early 2008 economic stimulus program.

SUPERVISION, REGULATION AND CREDIT

In July 2008, the department's retail risk officer led a group of SRC staff members in conducting a week-long math camp for more than 40 school children, grades 5 to 12 in Wilmington, Del. The participants showed improvement in their math skills through testing before and after the camp. The department made significant System contributions to monitoring retail credit markets; these markets are receiving heightened attention as credit conditions deteriorate. Philadelphia staff briefed the Board of Governors quarterly on the state of the credit card markets and prepared a quarterly profile of leading credit card issuers. Philadelphia staff continue to provide the Board of Governors and other Reserve Banks with expertise on retail credit market issues.

TREASURY SERVICES

In 2007, the U.S. Treasury selected Philadelphia to lead the development of its Collateral Management and Monitoring System. Last year, department staff defined high-level business requirements, developed high-level operational requirements, began to define user requirements, and worked with the Treasury's Financial Management Service Bureau to draft documentation for project governance. The department also effectively managed the Federal Reserve System's Collateral Management System and introduced several major system enhancements. (See page 24.)

COLLATERAL
Treasury Collateral Management and Monitoring

FEDERAL RESERVE BANK OF PHILADELPHIA

BOARD OF DIRECTORS

William F. Hecht
Chairman (1) (4)
Retired President & CEO,
PPL Corporation

Charles P. Pizzi
Deputy Chairman (1) (3) (4)
President & CEO
Tasty Baking Company

Michael F. Camardo (1) (3)
Retired Executive Vice President
Lockheed Martin ITS

Keith S. Campbell (1) (3)
Chairman
Mannington Mills, Inc.

Ted T. Cecala (1) (3)
Chairman & CEO
Wilmington Trust Corporation

John G. Gerlach (1) (2)
President
Pocono Community Bank

Aaron L. Groff, Jr. (1) (2) (4)
Chairman, President, & CEO
Ephrata National Bank

Garry L. Maddox (1) (2) 4)
President & CEO
A. Pomerantz & Company

Jeremy Nowak (1) (2)
President & CEO
The Reinvestment Fund

(1) Executive Committee
(2) Audit Committee
(3) Management and Budget Committee
(4) Nominating and Governance Committee

Standing left to right: Ted T. Cecala, Aaron L. Groff, Jr., John G. Gerlach; seated left to right: Charles P. Pizzi, Jeremy Nowak, Michael F. Camardo, Garry L. Maddox, Keith S. Campbell; front, center: William F. Hecht.

FEDERAL RESERVE BANK OF PHILADELPHIA

ECONOMIC ADVISORY COUNCIL

Renee Amoore
President & CEO
The Amoore Group
King of Prussia, PA

Daniel Blaschak
Treasurer
Blaschak Coal, Inc.
Mahanoy City, PA

Edward Coryell
Business Manager
Metropolitan Regional Council of Carpenters
Philadelphia, PA

James Hargadon
Executive Vice President & CFO
Oki Data Americas, Inc.
Mt. Laurel, NJ

Alexander Hatala
CEO
Lourdes Health System
Camden, NJ

Kelly Johnston
Vice President
Government Affairs
Campbell Soup Company
Camden, NJ

Sharmain Matlock-Turner
CEO
Greater Philadelphia Urban Affairs Coalition
Philadelphia, PA

Eric May
President & Owner
Pen-Fern Oil Co., Inc.
Dallas, PA

William W. Moore
President & CEO
Independence Visitor Center
Philadelphia, PA

Christopher Schell
President
Schell Brothers Construction
Lewes, DE

George Tsetsekos
Dean
Drexel University
Philadelphia, PA

Kenneth Tuckey
President
Tuckey Mechanical Services
Carlisle, PA

Mark Wagner
President & CEO
White Oak Mills, Inc.
Elizabethtown, PA

David Wenger
President & CEO
Transport Decisions
Churchville, PA

The Federal Reserve Bank of Philadelphia's Economic Advisory Council, which was created in 2008, includes representatives from the tourism, health-care, retail, and food industries, as well as organized labor. The council's 14 members reflect our District's diverse economic base and represent a broader geographic area than the previous council structure. The council advises Federal Reserve officials on regional business conditions and economic issues that have an impact on the marketplace.

FEDERAL RESERVE BANK OF PHILADELPHIA

SENIOR STAFF

The Bank's senior staff consists of the president, first vice president, and other key senior officers. Pictured in front: William H. Stone, Jr., First Vice President (left), and Charles I. Plosser, President; second row from left: Richard W. Lang, Executive Vice President; Michael E. Collins, Executive Vice President and Lending Officer; Donna Franco, Senior Vice President and Chief Financial Officer; and Milissa Tadeo, Senior Vice President; back row from left: Blake Prichard, Executive Vice President; Arun Jain, Senior Vice President; and Loretta J. Mester, Senior Vice President and Director of Research.

FEDERAL RESERVE BANK OF PHILADELPHIA

CURRENT OFFICERS

Charles I. Plosser
President and CEO

William H. Stone, Jr.
First Vice President

Michael E. Collins
Executive Vice President
and Lending Officer
Supervision, Regulation
and Credit

Richard W. Lang
Executive Vice President

D. Blake Prichard
Executive Vice President

Donna L. Franco
Senior Vice President and
Chief Financial Officer

Mary Ann Hood
Senior Vice President
and EEO Officer
Human Resources

Arun K. Jain
Senior Vice President
Retail Payments

William W. Lang
Senior Vice President and
Chief Examination Officer
Supervision, Regulation
and Credit

Loretta J. Mester
Senior Vice President and
Director of Research

Milissa M. Tadeo
Senior Vice President
Cash Services and Treasury
Services

John D. Ackley
Vice President
Treasury Services

John G. Bell
Vice President
Financial Statistics

Mitchell S. Berlin
Vice President
and Economist
Research

Robert J. Bucco
Vice President
Wholesale Product Office

Peter P. Burns
Vice President and Director
Payment Cards Center

Michael Dotsey
Vice President and Senior
Economic Policy Advisor
Research

James S. Ely
Vice President
Public Affairs

Edward M. Mahon
Vice President and General
Counsel
Legal

Alice Kelley Menzano
Vice President
Information Technology
Services

Mary DeHaven Myers
Vice President and
Community Affairs Officer

A. Reed Raymond, III
Vice President and Chief
Administrative Officer
Supervision, Regulation
and Credit

Patrick M. Regan
Vice President
Information Technology
Services

Michelle M. Scipione
Vice President
Cash Services

Richard A. Sheaffer
Vice President and General
Auditor

Herbert E. Taylor
Vice President and
Corporate Secretary

Vish P. Viswanathan
Vice President and
Discount Officer
Supervision, Regulation
and Credit

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Law Enforcement and
Facilities Management

Kei-Mu Yi
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Research

Aileen C. Boer
Assistant Vice President
Research

Donna Brenner
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Brian Calderwood
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Information Technology
Services

Jennifer E. Cardy
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Shirley L. Coker
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and Counsel
Legal

Maryann T. Connelly
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Legal

Cynthia L. Course
Assistant Vice President
Supervision, Regulation
and Credit
and Assistant Secretary

Frank J. Doto
Assistant Vice President
Supervision, Regulation
and Credit

Michael T. Doyle
Assistant Vice President
Information Technology
Services

Gregory Fanelli
Assistant Vice President
Retail Payments

Suzanne W. Furr
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Assistant General Auditor

William L. Gaunt
Assistant Vice President
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and Credit

Stephen G. Hart
Assistant Vice President
Human Resources

Robert Hunt
Assistant Vice President
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John P. Kelly
Assistant Vice President
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Elisabeth V. Levins
Assistant Vice President
Supervision, Regulation
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Assistant Vice President
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Patrick F. Turner
Assistant Vice President
Information Technology
Services

Todd Vermilyea
Assistant Vice President
Supervision, Regulation and
Credit

Constance H. Wallgren
Assistant Vice President
Supervision, Regulation and
Credit

Christopher C. Henderson
Retail Risk Officer
Supervision, Regulation and
Credit

Thomas J. Lombardo
Financial Services Industry
Relations Officer
Customer Relations
and Assistant Secretary

Robert F. Mucerino
Treasury Services Officer
Treasury Services

Wanda Preston
Check Adjustments Officer
Retail Payments

Gail L. Todd
Credit Officer
Supervision, Regulation and
Credit

Includes promotions through March 2009

OPERATING STATISTICS

In 2008, Philadelphia's total volume of commercial checks processed decreased 44 percent, and the dollar value of transactions decreased 50 percent, as a result of the general decline in check processing in the nation's payment system. The volume of commercial checks received as Check 21 electronic images increased 106 percent, and the dollar value increased 50 percent in 2008.

During the second and third quarters, government check volumes spiked compared with recent trends because of the federal government's economic stimulus package. However, the volume and dollar value of U.S. government checks decreased 20 and 25 percent, respectively, in 2008, mostly because Philadelphia's government check operation was consolidated at the St. Louis Reserve Bank in August 2008. Additionally, this decline follows the same downward experience as commercial checks because the Treasury is increasingly using electronic payments and because depositing banks are converting government paper checks to Check 21 electronic images. The Philadelphia Reserve Bank will remain a contingency site for U.S. government check processing.

In 2008, Philadelphia continued to be a major processor of cash in the Federal Reserve System, although the volume of currency processed decreased almost 6 percent because of a Federal Reserve System policy that requires financial institutions to recirculate more currency internally or pay a fee to the Fed. Because the Bank processed a greater proportion of smaller denomination notes, the actual dollar value of currency processed decreased by a more significant margin (22 percent). In 2008, the volume of coin bags processed on-site increased 8 percent because of increased activity by two external self-service coin-counting operations and an overabundance of coin in the District resulting from the 10th year of the State Quarters program. The value of processed coin, however, decreased slightly (4 percent) because the Bank processed a smaller proportion of dollar coins.

In 2008, there was a significant increase in discount window lending activity, both in the number of loans and the value of loans advanced by the Reserve Bank. The financial turbulence and the tightening of liquidity in the economy resulted in many depository institutions relying on the discount window as a source of funds to meet their liquidity needs. In addition to the normal lending programs (i.e., primary credit), financial institutions also took advantage of the new lending programs introduced by the Federal Reserve, such as the Term Auction Facility (TAF). Discount window activity increased significantly in the Third District during the late third quarter and fourth quarter of 2008.

SERVICES TO DEPOSITORY INSTITUTIONS

	2008 Volume	2008 Dollar Value	2007 Volume	2007 Dollar Value
Check services:				
Commercial checks –				
Paper processed	554.8 million checks	$1,094.3 billion	998.3 million checks	$2,174.9 billion
Check 21 received	1.2 billion checks	$2,509.1 billion	583.7 million checks	$1,677.0 billion
U.S. government checks	40.9 million checks	$47.7 billion	51.4 million checks	$63.5 billion
Cash operations:				
Currency processed	1,793.2 million notes	$29.0 billion	1,903.9 million notes	$37.1 billion
Coin paid and received	404.9 thousand bags	$187.5 million	375.5 thousand bags	$195.8 million
Loans to depository institutions during the year	437 loans	$2,264.8 billion	107 loans	$991.9 million

STATEMENT OF AUDITOR INDEPENDENCE

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

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

FINANCIAL REPORTS CONTENTS

LETTER TO DIRECTORS

FEDERAL RESERVE BANK
OF PHILADELPHIA

April 2, 2009

To the Board of Directors

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

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

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

The management of the FRBP 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 FRBP maintained effective internal control over financial reporting as it relates to the Financial Statements.

Federal Reserve Bank of Philadelphia

by ______________________
Charles I. Plosser, President

by ______________________
William H. Stone, First Vice President

by ______________________
Donna L. Franco, Chief Financial Officer

REPORT OF INDEPENDENT AUDITORS

Deloitte.

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REPORT OF INDEPENDENT AUDITORS

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

We have audited the accompanying statements of condition of the Federal Reserve Bank of Philadelphia ("FRB Philadelphia") as of December 31, 2008 and 2007 and the related statements of income and comprehensive income and changes in capital for the years then ended, which have been prepared in conformity with accounting principles established by the Board of Governors of the Federal Reserve System. We also have audited the internal control over financial reporting of FRB Philadelphia as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB Philadelphia'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 FRB Philadelphia's internal control over financial reporting based on our audits.

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

FRB Philadelphia's internal control over financial reporting is a process designed by, or under the supervision of, FRB Philadelphia's principal executive and principal financial officers, or persons performing similar functions, and effected by FRB Philadelphia's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System. FRB Philadelphia's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of FRB Philadelphia; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial

Member of
Deloitte Touche Tohmatsu

REPORT OF INDEPENDENT AUDITORS

statements in accordance with the accounting principles established by the Board of Governors of the Federal Reserve System, and that receipts and expenditures of FRB Philadelphia are being made only in accordance with authorizations of management and directors of FRB Philadelphia; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of FRB Philadelphia's assets that could have a material effect on the financial statements.

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

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

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

Deloitte + Touche LLP

April 2, 2009

STATEMENTS OF CONDITION

(in millions)

As of December 31, 2008 and December 31, 2007

	2008	2007
ASSETS		
Gold certificates	$ 453	$ 455
Special drawing rights certificates	83	83
Coin	137	88
Items in process of collection	237	317
Loans to depository institutions	38,629	-
System Open Market Account:		
Securities purchased under agreements to resell	3,493	2,057
U.S. government, Federal agency, and government-sponsored enterprise securities, net	21,926	32,987
Investments denominated in foreign currencies	2,438	2,707
Central bank liquidity swaps	54,424	2,877
Interdistrict settlement account	-	794
Bank premises and equipment, net	85	87
Accrued interest receivable	377	285
Other assets	56	55
Total assets	**$ 122,338**	**$ 42,792**
LIABILITIES AND CAPITAL		
Federal Reserve notes outstanding, net	$ 36,205	$ 34,165
System Open Market Account:		
Securities sold under agreements to repurchase	3,858	1,946
Deposits:		
Depository institutions	10,565	2,664
Other deposits	4	5
Deferred credit items	515	215
Interest on Federal Reserve notes due to U.S. Treasury	7	91
Interdistrict settlement account	66,458	-
Accrued benefit costs	79	69
Other liabilities	17	11
Total liabilities	**117,708**	**39,166**
Capital paid-in	2,315	1,813
Surplus (including accumulated other comprehensive loss of $24 and $19 at December 31, 2008 and 2007, respectively)	2,315	1,813
Total capital	**4,630**	**3,626**
Total liabilities and capital	**$ 122,338**	**$ 42,792**

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

FEDERAL RESERVE BANK OF PHILADELPHIA

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

(in millions)

For the years ended December 31, 2008 and December 31, 2007

	2008	2007
Interest income:		
Loans to depository institutions	$ 55	$ -
System Open Market Account:		
Securities purchased under agreements to resell	83	63
U.S. government, Federal agency, and government-sponsored enterprise securities	1,125	1,703
Investments denominated in foreign currencies	62	62
Central bank liquidity swaps	356	3
Total interest income	**1,681**	**1,831**
Interest expense:		
System Open Market Account:		
Securities sold under agreements to repurchase	32	74
Depository institutions deposits	9	-
Total interest expense	41	74
Net interest income	**1,640**	**1,757**
Non-interest income:		
System Open Market Account:		
U.S. government, Federal agency, and government-sponsored enterprise securities gains, net	166	-
Foreign currency gains, net	135	243
Compensation received for services provided	40	38
Reimbursable services to government agencies	32	31
Other income	37	6
Total non-interest income	**410**	**318**
Operating expenses:		
Salaries and other benefits	101	96
Occupancy expense	12	11
Equipment expense	13	12
Assessments by the Board of Governors	66	67
Other expenses	38	41
Total operating expenses	**230**	**227**
Net income prior to distribution	1,820	1,848
Change in funded status of benefit plans	(5)	5
Comprehensive income prior to distribution	**$ 1,815**	**$ 1,853**
Distribution of comprehensive income:		
Dividends paid to member banks	$ 127	$ 109
Transferred to surplus and change in accumulated other comprehensive loss	502	3
Payments to U.S. Treasury as interest on Federal Reserve notes	1,186	1,741
Total distribution	**$ 1,815**	**$ 1,853**

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

STATEMENTS OF CHANGES IN CAPITAL

(in millions, except share data)

For the years ended December 31, 2008 and December 31, 2007

		Surplus			
	Capital Paid-In	Net Income Retained	Accumulated Other Comprehensive Loss	Total Surplus	Total Capital
Balance at January 1, 2007 (36.2 million shares)	$ 1,810	$ 1,834	$ (24)	$ 1,810	$3,620
Net change in capital stock issued (0.1 million shares)	3	-	-	-	3
Transferred to surplus and change in accumulated other comprehensive loss	-	(2)	5	3	3
Balance at December 31, 2007 (36.3 million shares)	$ 1,813	$ 1,832	$ (19)	$ 1,813	$3,626
Net change in capital stock issued (10.0 million shares)	502	-	-	-	502
Transferred to surplus and change in accumulated other comprehensive loss	-	507	(5)	502	502
Balance at December 31, 2008 (46.3 million shares)	$ 2,315	$ 2,339	$ (24)	$ 2,315	$4,630

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

1. STRUCTURE

The Federal Reserve Bank of Philadelphia ("Bank") is part of the Federal Reserve System ("System") and is one of the twelve Reserve Banks ("Reserve Banks") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act"), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank serves the Third Federal Reserve District, which includes Delaware and portions of New Jersey and Pennsylvania.

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

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

2. OPERATIONS AND SERVICES

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

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

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange and securities contracts for, fourteen foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is also authorized and directed by the FOMC to maintain reciprocal currency arrangements with fourteen central banks and to "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks.

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

Major services provided by the Bank on behalf of the System and for which the costs were not reimbursed by the other Reserve Banks include Collateral Management System, Electronic Cash Letter System, Groupware Leadership Center, Treasury Check Information Services Central Business Administration Function, and Treasury Direct Central Business Administration Function.

3. RECENT FINANCIAL STABILITY ACTIVITIES

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

Expanded Open Market Operations and Support for Mortgage Related Securities

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

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

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

Central Bank Liquidity Swaps

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

Lending to Depository Institutions

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

Lending to Primary Dealers

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

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

Other Lending Facilities

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

4. SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

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

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

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

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

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

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

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

The FRBNY may engage in tri-party purchases of securities under agreements to resell ("tri-party agreements"). Tri-party agreements are conducted with two commercial custodial banks that manage the clearing and settlement of collateral. Collateral is held in excess of the contract amount. Acceptable collateral under tri-party agreements primarily includes U.S. government securities; pass-through mortgage securities of Fannie Mae, Freddie Mac, and Ginnie Mae; STRIP securities of the U.S. government; and "stripped" securities of other government agencies. The tri-party agreements are accounted for as financing transactions and the associated interest income is accrued over the life of the agreement.

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

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

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

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

Interest income on U.S. government, Federal agency, and GSE securities and investments denominated in foreign currencies comprising the SOMA is accrued on a straight-line basis. Gains and losses resulting from sales of securities are determined by specific issue based on average cost. Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency gains, net" in the Statements of Income and Comprehensive Income.

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

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

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

e. Central Bank Liquidity Swaps

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

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

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

f. Interdistrict Settlement Account

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

g. Bank Premises, Equipment, and Software

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

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

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

h. Federal Reserve Notes

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

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

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

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the Bank's currency holdings of $5,013 million and $7,564 million at December 31, 2008 and 2007, respectively.

i. Items in Process of Collection and Deferred Credit Items

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

j. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve

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

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

k. Surplus

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

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

l. Interest on Federal Reserve Notes

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

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

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

m. Interest on Depository Institution Deposits

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

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

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

The Treasury and other government agencies reimbursement process for all Reserve Banks is centralized at the Bank. Each Reserve Bank transfers its Treasury reimbursement receivable to the Bank. The reimbursement receivable is reported in "Other assets" and totaled $34 million and $33 million at December 31, 2008 and 2007, respectively. The cost of unreimbursed Treasury services is reported in "Other expense" and was immaterial at December 31, 2008 and 2007.

o. Compensation Received for Services Provided

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

p. Assessments by the Board of Governors

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

q. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property and, in some states, sales taxes on construction-related materials. The Bank's real property taxes were $2 million for each of the years ended December 31, 2008 and 2007 and are reported as a component of "Occupancy expense."

r. Restructuring Charges

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

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

s. Recently Issued Accounting Standards

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

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

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

5. LOANS

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

	2008
Primary, secondary, and seasonal credit	$ 329
TAF	38,300
Total loans to depository institutions	**$ 38,629**

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

Primary, secondary, and seasonal credit lending is collateralized to the satisfaction of the Bank to reduce credit risk. Assets eligible to collateralize these loans include consumer, business, and real estate loans, U.S.

Treasury securities, Federal agency securities, GSE obligations, foreign sovereign debt obligations, municipal or corporate obligations, state and local government obligations, asset-backed securities, corporate bonds, commercial paper, and bank-issued assets, such as certificates of deposit, bank notes, and deposit notes. Collateral is assigned a lending value deemed appropriate by the Bank, which is typically fair value or face value reduced by a margin.

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

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

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

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

	Primary, secondary, and seasonal credit	TAF
Within 15 days	$ 319	$ 7,550
16 days to 90 days	10	30,750
Total loans	**$ 329**	**$ 38,300**

Allowance for loan losses

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

6. U.S. GOVERNMENT, FEDERAL AGENCY, AND GOVERNMENT-SPONSORED ENTERPRISE SECURITIES; SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL; SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE; AND SECURITIES LENDING

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 4.366 percent and 4.424 percent at December 31, 2008 and 2007, respectively.

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

	2008	2007
U.S. government securities:		
Bills	$ 804	$ 10,080
Notes	14,617	17,775
Bonds	5,358	4,910
Federal agency and GSE securities	861	-
Total par value	21,640	32,765
Unamortized premiums	351	353
Unaccreted discounts	(65)	(131)
Total allocated to the Bank	**$ 21,926**	**$32,987**

At December 31, 2008 and 2007, the fair value of the U.S. government, Federal agency, and GSE securities allocated to the Bank, excluding accrued interest, was $24,731 million and $34,381 million, respectively, as determined by reference to quoted prices for identical securities.

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

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

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

	Securities purchased under agreements to resell		Securities sold under agreements to repurchase	
	2008	2007	2008	2007
Allocated to the Bank:				
Contract amount outstanding, end of year	$ 3,493	$ 2,057	$ 3,858	$ 1,946
Weighted average amount outstanding, during the year	4,237	1,552	2,858	1,542
Maximum month-end balance outstanding, during the year	5,196	2,278	4,303	1,946
Securities pledged, end of year			3,445	1,949
System total:				
Contract amount outstanding, end of year	$ 80,000	$ 46,500	$ 88,352	$ 43,985
Weighted average amount outstanding, during the year	97,037	35,073	65,461	34,846
Maximum month-end balance outstanding, during the year	119,000	51,500	98,559	43,985
Securities pledged, end of year			78,896	44,048

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

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

	U.S. government securities (Par value)	Federal agency and GSE securities (Par value)	Subtotal: U.S. government, Federal agency, and GSE securities (Par value)	Securities purchased under agreements to resell (Contract amount)	Securities sold under agreements to repurchase (Contract amount)
Within 15 days	$ 836	$ 20	$ 856	$ 1,747	$ 3,858
16 days to 90 days	915	143	1,058	1,746	-
91 days to 1 year	2,765	43	2,808	-	-
Over 1 year to 5 years	7,568	496	8,064	-	-
Over 5 years to 10 years	4,249	159	4,408	-	-
Over 10 years	4,446	-	4,446	-	-
Total allocated to the Bank	**$ 20,779**	**$ 861**	**$ 21,640**	**$ 3,493**	**$ 3,858**

At December 31, 2008 and 2007, U.S. government securities with par values of $180,765 million and $16,649 million, respectively, were loaned from the SOMA, of which $7,892 million and $737 million, respectively, were allocated to the Bank.

7. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

The Bank's allocated share of investments denominated in foreign currencies was approximately 9.829 percent and 11.814 percent at December 31, 2008 and 2007, respectively.

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

	2008	2007
Euro:		
Foreign currency deposits	547	848
Securities purchased under agreements to resell	401	301
Government debt instruments	453	551
Japanese yen:		
Foreign currency deposits	342	332
Government debt instruments	695	675
Total allocated to the Bank	**$ 2,438**	**$ 2,707**

At December 31, 2008 and 2007, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was $2,459 million and $2,704 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government, Federal agency, and GSE securities discussed in Note 6, unrealized gains or losses have no effect on the ability of a Reserve Bank, as central bank, to meet its financial obligations and responsibilities.

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

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

	Euro	Japanese Yen	Total
Within 15 days	$ 747	$ 342	$ 1,089
16 days to 90 days	115	62	177
91 days to 1 year	172	195	367
Over 1 year to 5 years	367	438	805
Total allocated to the Bank	**$ 1,401**	**$ 1,037**	**$ 2,438**

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

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

8. CENTRAL BANK LIQUIDITY SWAPS

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

The Bank's allocated share of central bank liquidity swaps was approximately 9.829 percent and 11.814 percent at December 31, 2008 and 2007, respectively.

At December 31, 2008 and 2007, the total System amount of foreign currency held under central bank liquidity swaps was $553,728 million and $24,353 million, respectively, of which $54,424 million and $2,877 million, respectively, was allocated to the Bank.

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

	2008			2007
	Within 15 days	16 days to 90 days	Total	16 days to 90 days
Australian dollar	$ 983	$ 1,261	$ 2,244	$ -
Danish krone	-	1,475	1,475	-
Euro	14,838	13,798	28,636	2,396
Japanese yen	4,707	7,354	12,061	-
Korean won	-	1,017	1,017	-
Norwegian krone	216	592	808	-
Swedish krona	983	1,474	2,457	-
Swiss franc	1,889	585	2,474	481
U.K. pound	12	3,240	3,252	-
Total	**$ 23,628**	**$ 30,796**	**$ 54,424**	**$ 2,877**

9. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

	2008	2007
Bank premises and equipment:		
Land	$ 7	$ 7
Buildings	92	87
Building machinery and equipment	15	14
Construction in progress	1	3
Furniture and equipment	68	68
Subtotal	183	179
Accumulated depreciation	(98)	(92)
Bank premises and equipment, net	**$ 85**	**$ 87**
Depreciation expense, for the year ended December 31	**$ 11**	**$ 10**

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

2009	$ 2
2010	2
Total	**$ 4**

The Bank has capitalized software assets, net of amortization, of $5 million and $6 million at December 31, 2008 and 2007, respectively. Amortization expense was $2 million for each of the years ended December 31, 2008 and 2007. Capitalized software assets are reported as a component of "Other assets" and the related amortization is reported as a component of "Other expenses."

10. COMMITMENTS AND CONTINGENCIES

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

At December 31, 2008, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from 1 to approximately 11 years. One equipment lease provides for increased rental payments based upon increases in operating quantity.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $1 million for each of the years ended December 31, 2008 and 2007. Certain of the Bank's leases have options to renew. The Bank has no capital leases.

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

	Operating Leases
2009	$ 483
2010	466
2011	478
2012	484
2013	434
Thereafter	2,383
Future minimum rental payments	**$ 4,728**

At December 31, 2008, there were no material unrecorded unconditional purchase commitments or long-term 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 pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio of a Reserve Bank's capital paid-in to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2008 or 2007.

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

11. RETIREMENT AND THRIFT PLANS

Retirement Plans

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

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

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

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2008 and 2007, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service. The Bank's Thrift Plan contributions totaled $3 million for each of the years ended December 31, 2008 and 2007, respectively, and are reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income. Beginning in 2009, the Bank will match 100 percent of the first 6 percent of employee contributions from the date of hire and provide an automatic employer contribution of 1 percent of eligible pay.

12. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits Other Than Pensions

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

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

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

	2008	2007
Accumulated postretirement benefit obligation at January 1	$ 62.9	$ 63.1
Service cost-benefits earned during the period	2.0	1.9
Interest cost on accumulated benefit obligation	4.2	3.6
Net actuarial loss (gain)	8.7	(3.0)
Curtailment gain	(2.4)	-
Contributions by plan participants	1.4	1.3
Benefits paid	(4.6)	(4.3)
Medicare Part D subsidies	0.3	0.3
Accumulated postretirement benefit obligation at December 31	**$ 72.5**	**$ 62.9**

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

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

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

	2008	2007
Fair value of plan assets at January 1	$ -	$ -
Contributions by the employer	2.9	2.7
Contributions by plan participants	1.4	1.3
Benefits paid	(4.6)	(4.3)
Medicare Part D subsidies	0.3	0.3
Fair value of plan assets at December 31	**$ -**	**$ -**
Unfunded obligation and accrued postretirement benefit cost	**$ 72.5**	**$ 62.9**

Amounts included in accumulated other comprehensive loss are shown below (in millions):

	2008	2007
Prior service cost	$ 2.3	$ 3.7
Net actuarial loss	(26.3)	(22.6)
Deferred curtailment gain	0.4	-
Total accumulated other comprehensive loss	**$ (23.6)**	**$ (18.9)**

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

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

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

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2008 (in millions):

	One Percentage Point Increase	One Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ -	$ (0.2)
Effect on accumulated postretirement benefit obligation	0.5	(1.7)

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

	2008	2007
Service cost-benefits earned during the period	$ 2.0	$ 1.9
Interest cost on accumulated benefit obligation	4.2	3.6
Amortization of prior service cost	(1.3)	(1.3)
Amortization of net actuarial loss	2.9	3.2
Total periodic expense	7.8	7.4
Curtailment loss	0.1	-
Net periodic postretirement benefit expense	**$ 7.9**	**$ 7.4**

Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2009 are shown below (in millions):

Prior service cost	$ (1.2)
Net actuarial loss	2.4
Total	**$ 1.2**

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

Net periodic postretirement benefit expense is reported as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income. A deferred curtailment gain was recorded in 2008 as a component of accumulated other comprehensive loss; the gain will be recognized in net income in future years when the related employees terminate employment.

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 and $0.5 million in the years ended December 31, 2008 and 2007, respectively. Expected receipts in 2009, related to benefits paid in the years ended December 31, 2008 and 2007 are $0.2 million.

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

	Without Subsidy	With Subsidy
2009	$ 4.2	$ 3.7
2010	4.6	4.1
2011	4.9	4.4
2012	5.2	4.7
2013	5.5	4.9
2014 - 2018	31.4	27.6
Total	**$ 55.8**	**$ 49.4**

Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank at December 31, 2008 and 2007 were $5 million. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2008 and 2007 operating expenses were $0.4 million and $1 million, respectively, and are recorded as a component of "Salaries and other benefits" in the Statements of Income and Comprehensive Income.

13. ACCUMULATED OTHER COMPREHENSIVE INCOME AND OTHER COMPREHENSIVE INCOME

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

	Amount Related to Postretirement Benefits Other Than Pensions
Balance at January 1, 2007	$ (24)
Change in funded status of benefit plans:	
Net actuarial gain arising during the year	3
Amortization of prior service cost	(1)
Amortization of net actuarial loss	3
Change in funded status of benefit plans - other comprehensive income	5
Balance at December 31, 2007	**$ (19)**
Change in funded status of benefit plans:	
Net actuarial loss arising during the year	(7)
Amortization of prior service cost	(1)
Amortization of net actuarial loss	3
Change in funded status of benefit plans - other comprehensive loss	(5)
Balance at December 31, 2008	**$ (24)**

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

14. BUSINESS RESTRUCTURING CHARGES

2008 Restructuring Plans
In 2008, the Reserve Banks announced the acceleration of their check restructuring initiative to align the check processing infrastructure and operations with declining check processing volumes. The new infrastructure will involve consolidation of operations into two regional Reserve Bank processing sites in Cleveland and Atlanta.

2007 Restructuring Plans
In 2007, the Bank announced a restructuring plan related to align the check processing infrastructure and operations with declining check processing volumes. The Bank's costs associated with the restructuring were not material.

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

	2008 Restructuring Plans
Information related to restructuring plans as of December 31, 2008:	
Total expected costs related to restructuring activity	$ 2.9
Estimated future costs related to restructuring activity	0.1
Expected completion date	2009
Reconciliation of liability balances:	
Balance at December 31, 2007	$ -
Employee separation costs	2.8
Other costs	0.3
Adjustments	(0.2)
Balance at December 31, 2008	**$ 2.9**

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

Other costs include retention benefits and outplacement services and are shown as components of "Salaries and other benefits" and "Other expenses", respectively, in the Statements of Income and Comprehensive Income.

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

15. SUBSEQUENT EVENTS

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

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