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FEDERAL RESERVE BANK OF KANSAS CITY

Spring 2007

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The Federal Open Market Committee

As the central bank, the Federal Reserve has a unique set of responsibilities focused on providing a firm foundation for the nation's financial system. We are a regulator and supervisor of banks, helping to ensure consumers are able to conduct business with sound and secure financial institutions. We provide financial services to depository institutions, including the processing of cash and checks, and play a major role in operating the nation's payments system.

Our operations in these areas are crucial components of the Federal Reserve's ability to fulfill its mission. Congress created the central bank in 1913 after a series of panics caused consumers to lose trust in the nation's financial system. Well-regulated banks and a secure payments system that functions smoothly even in times of national crisis or tragedy, provide consumers and businesses with the confidence that is a necessary cornerstone for a strong economy.

Another component in providing conditions for economic stability is the most publicly watched of all the Federal Reserve's operations: the Federal Open Market Committee. The FOMC is responsible for the Federal Reserve's open market operations, which are the most often used of the Federal Reserve's monetary policy tools. The FOMC's decisions about its target for the federal funds rate, which is the interest rate depository institutions lend balances at the Federal Reserve to other depository institutions overnight, are closely followed by the markets and financial media. In recent years, changes in the fed funds rate target have received increasing attention from the mainstream media and the public.

The FOMC consists of 19 participants, 12 of whom vote on policy action. The seven members of the Board of Governors of the Federal Reserve System and the presidents of the 12 regional Reserve Banks comprise the full committee. The seven governors and the president of the Federal Reserve Bank of New York, which conducts the open market operations on behalf of the entire Federal Reserve System, are permanent voting members of the committee.

The four remaining voting seats rotate annually among the other 11 presidents of the regional Federal Reserve Banks, which are divided into four groups. In my position as the president of the Federal Reserve Bank of Kansas City, I rotate FOMC voting status with the presidents of the Federal Reserve Banks of Minneapolis and San Francisco.

The FOMC's design is reflective of the Federal Reserve's unique structure that blends aspects of government and the private sector. The seven members of the Board

of Governors, including Chairman Ben S. Bernanke, are presidential appointees who have been confirmed by the U. S. Senate. The presidents of the regional Reserve Banks, meanwhile, are selected by the Boards of Directors of their respective Banks, subject to review by the Board of Governors.

This year, for the sixth time since I became president of the Federal Reserve Bank of Kansas City in 1991, I am a voting member of the FOMC. Occasionally, media coverage of the Federal Reserve will note the voting status of a particular Reserve Bank president as either a "voter" or "non-voter." In terms of the FOMC's policy deliberations, however, the distinction between the two is less significant than you might assume, because all members are included in all discussion until the vote is actually taken.

Perhaps most significantly, the Federal Reserve Bank presidents provide the committee with information about business activity within their Federal Reserve Districts. During the first of two go-arounds that are the key elements of each FOMC meeting, the presidents each provide the full

FOMC 2007

Voting members:

- **Ben S. Bernanke,** *Chairman, Board of Governors*
- **Timothy F. Geithner,** *Vice Chairman, Federal Reserve Bank of New York*
- **Thomas M. Hoenig,** *President, Federal Reserve Bank of Kansas City*
- **Donald L. Kohn,** *Board of Governors*
- **Randall S. Kroszner,** *Board of Governors*
- **Cathy E. Minehan,** *President, Federal Reserve Bank of Boston*
- **Frederic S. Mishkin,** *Board of Governors*
- **Michael H. Moskow,** *President, Federal Reserve Bank of Chicago*
- **William Poole,** *President, Federal Reserve Bank of St. Louis*
- **Kevin M. Warsh,** *Board of Governors*

Non-voting members:

- **Richard W. Fisher,** *President, Federal Reserve Bank of Dallas*
- **Jeffrey M. Lacker,** *President, Federal Reserve Bank of Richmond*
- **Dennis P. Lockhart,** *President, Federal Reserve Bank of Atlanta*
- **Sandra Pianalto,** *President, Federal Reserve Bank of Cleveland*
- **Charles I. Plosser,** *President, Federal Reserve Bank of Philadelphia*
- **Gary H. Stern,** *President, Federal Reserve Bank of Minneapolis*
- **Janet L. Yellen,** *President, Federal Reserve Bank of San Francisco*

Two seats held by the Board of Governors are vacant.

committee with a brief but important report on regional economic conditions. These reports are based on firsthand accounts that the regional Reserve Banks receive from business and banking contacts within their Districts. When woven together, the comments provide the FOMC with an insightful picture of the total U.S. economy that is often more timely and complete than what can be determined from surveys and other reports. Because of the delays involved with gathering and processing data, the information gained through these firsthand accounts may offer the first suggestion of changing economic conditions, for example.

The regional Bank presidents, of course, offer much more to the monetary policy process than reports about their own Districts. All members, again, regardless of voting status, analyze national trends and offer comments on the national outlook. They ask questions of other Reserve Bank presidents and governors, or the Board's staff. And during a second go-around, each president discusses possible policy action and has ample opportunity to offer their insights and opinions to the full committee prior to the vote.

The deliberations of the entire committee are an exceptionally important part of the monetary policy process. Although the markets and some members of the financial press may give increased significance to comments from the FOMC's voting members, the Federal Reserve's monetary policy actions are the product of deliberations by the entire committee. Each member, regardless of voting status, is a crucial part of that process.

Thomas M. Hoenig

THOMAS M. HOENIG, PRESIDENT
FEDERAL RESERVE BANK OF KANSAS CITY

To see how the committee members work together and transcripts of all FOMC meetings posted after a five-year lag, visit www.FederalReserve.gov/fomc/transcripts/.

To learn more about the Federal Reserve's role in setting and implementing national monetary policy, visit www.FederalReserve.gov/policy.htm and www.FederalReserveEducation.org/fed101/policy/.

FOMC Meeting Dates

Jan. 30-31	March 20-21	May 9	June 27-28	Aug. 7	Sept. 18	Oct. 30-31	Dec. 11

Home lending in low- and moderate-income neighborhoods is on the rise, prompting change

As little Catalina and Anthony grew, the townhouse the Melgoza family had been renting for the past five years was starting to feel cramped. And space would be even more precious when baby Diego arrived.

So after living all their adult lives as tenants, Hugo and Sarah Melgoza bought their first house, joining a growing number of recent homebuyers on a newly revitalized block in what had been a deteriorating neighborhood in urban Kansas City, Kan.

"We were tired of wasting money (renting)," Hugo says, "and we wanted a big yard for our kids to play in."

An area nonprofit helped the Melgozas with financing as part of its efforts to increase homeownership in the low- and moderate-income neighborhoods into which it is breathing new life.

"We love it," Sarah says of their new lives as homeowners.

The Melgozas aren't alone in dreaming of homeownership—or achieving that goal. Neighborhoods, too, are reaping the benefits.

Since the early 1990s, home financing in low- and moderate-income areas within the Kansas City metro has increased notably, say Jim Harvey and Ken Spong, policy economists at the Federal Reserve Bank of Kansas City.

This heightened home financing can be attributed to many different factors, including an overall strong economy, falling interest rates, financing innovations, new regulations and special lending programs.

Harvey and Spong recently researched a variety of demographic, housing and other variables to study possible relationships between increased home lending and changes in neighborhood conditions throughout the metro, which includes 15 counties in both Kansas and Missouri.

"For homebuyers and home lenders, increased lending has several implications," Harvey says. "This stability in many lower-income neighborhoods encourages more

A home of our OWN

PHOTO BY SCOTT INDERMAUR

households to become homeowners and will provide more support for those that already are."

Their research shows there are many facets that may be affected by increased lending, such as new construction and reduced crime, but home financing appeared to be most closely related to homeownership rates and home values.

"The availability of credit," Spong says, "changes neighborhood conditions."

Overview

To measure the effects of home financing from 1990 to 2000, Harvey and Spong first assessed demographic and housing conditions at the beginning of the decade. Their research included income levels, home values, homeownership rates, new construction and vacant properties. Overall, there were a number of areas where low- and moderate-income neighborhoods lagged in 1990.

"These characteristics raised the question of whether such neighborhoods will continue to trail behind others, or will be able to show noticeable improvement," Harvey says.

In most cases, it was the latter. And results suggest housing finance played a role in supporting improvement.

During this period, home-purchase lending in low- and moderate-income neighborhoods grew at a faster pace than across the rest of the Kansas City metro area. Through the 1990s, there were significant changes in home lending trends, resulting from strong economic conditions, technological innovation, regulatory and legislative changes, and an increased role for special lending programs.

"As a result of these factors coming together," Harvey says, "home financing became more accessible for low- and moderate-income homebuyers."

Two economic trends may be particularly important: The longest period of uninterrupted economic growth took place in this country between 1991 and 2001, providing many

THE MELGOZA FAMILY purchased a home with help from City Vision Ministries, a nonprofit in Kansas City, Kan. Overall increased lending in recent years is the result of many factors, including these special finance programs, as well as declining interest rates and technological innovation.

lower-income households emploment—and optimism—to buy homes. And at this same time, mortgage interest rates declined substantially.

"The level of borrowing became associated with much lower mortgage payments, providing another incentive for homeownership," Harvey says.

Technological innovation also may have made some of the greatest contributions to lower-income home lending. Improved data collection and processing provided lenders with better information on prospective borrowers


PHOTO BY SCOTT INDERMAUR

and their neighborhoods, in turn reducing the risk of lending and lowering the cost.

Additionally, there have been a number of programs instituted during the past few years to aid first-time and lower-income buyers.

Alice Brentano, a Kansas City real estate consultant with Keller Williams Realty, has noticed an increase in a certain clientele as homeownership rates in general have grown. She's assisting more young, first-time homebuyers—something she attributes to homeownership education; employment to support ownership; buyer assistance programs; and, above all, more financing.

"Increased availability of home lending provides an opportunity for many more people to achieve the American dream of owning their own home," Brentano says.

This, Harvey and Spong say, leads to measurable benefits for families and the neighborhoods where they're buying homes.

Strengthening communities

Nearly 10 years ago, when Stephanie Jackson was finalizing her divorce, coping with the death of her twin brother and starting a new job, it was comforting to live with her parents in the house where she was raised. But Jackson knew she couldn't stay for long. She wanted more for her young daughter.

Jackson wanted Kiara to have a home of her own.

With help from City Vision Ministries, Jackson purchased a small, two-story home in a Kansas City, Kan., neighborhood nearby. Otherwise, financing the home would not have been possible, she says.

"When I moved in, I said, 'This is a dream come true,'" Jackson, now 44, remembers.

Owning a home is important to Jackson for several reasons, such as family stability and the pride that goes along with being a homeowner. But, more so, Jackson is building a secure future.

"The equity in that home—I see that as an asset," Jackson says, adding that these financial lessons will be passed on to Kiara, 16. "I'm hoping she does the same thing. It will be an asset to her."

Homeownership is highly beneficial, beyond putting a roof over a family's head, says Julie Riddle of The Family Conservancy, a Kansas City, Mo., nonprofit that administers programs to help families build assets. It can lead to increased financial knowledge as well as continued asset building, overlapping into higher education or entrepreneurship.

The positive effects also can be seen in the neighborhoods themselves. Those who own their residences are invested in their communities emotionally (garnering the status of a homeowner and planting family roots) as well as physically (vandalism, litter, theft and petty crimes are often less prevalent, as are property blight and abandonment). This makes for more desirable communities, say both Riddle and Brentano.

LIKE SO MANY HOMEOWNERS, STEPHANIE JACKSON spends much of her free time doing home improvements. She added a fence to keep in her three dogs, and now Jackson is tackling one room at a time in the 1940s house. Research shows homeownership improves neighborhood conditions, leading to more desirable communities.

PHOTO BY GARY BARBER

"Most homeowners take more pride in their homes and their neighborhoods than those who rent," Brentano says. "Homeownership contributes to people living in their homes longer and being more active in their community."

This is true for Jackson—and her neighbors. Now they're invested in their homes beyond the monthly mortgage, and as a result, they live in a desirable community, just as City Vision Ministries foresaw when it began its mortgage assistance program.

Before Jackson realized financing would be available to her, she could only drive hopefully through the neighborhood that encompasses her New Jersey Avenue residence.

"I used to say, 'I'm gonna get me a house there.'"

Now she simply says, "I love this home."

Measured progress: 1990-2000

To gauge broad changes in neighborhood conditions, like Jackson's, Harvey and Spong examined how lending varied from one census tract to another and whether lending levels may have contributed to observed changes in neighborhood conditions.

Their research shows many areas may be affected by increased lending, but home financing was associated most directly with changing homeownership rates and home values.

Among Kansas City's low- and moderate-income neighborhoods, the areas with the highest rates of lending also showed the most noticeable improvements during the last decade, suggesting a higher rate of home purchase lending may have helped to improve housing conditions and attract homebuyers.

The low- and moderate-income tracts that received the most lending typically began with more favorable demographics in terms of income levels (fewer people in poverty and more households), and they continued to maintain or extend those advantages. While these results suggest a positive influence from home lending, they also may imply that lenders are more willing to provide financing in the neighborhoods already in the best condition.

Overall, home lending grew at a faster pace in low- and moderate-income neighborhoods than across the rest of the metro area during the 1990s. This increased lending undoubtedly helped first-time homebuyers, and it may also be a sign that more active and liquid real estate markets are developing in lower-income neighborhoods.

Fannie Mae, a national organization with a mission to expand homeownership, partners with mortgage lenders to serve low- and moderate-income borrowers. Spokesperson Alfred King says recent recognition that this demographic of would-be homebuyers has long been underserved may have helped change lenders' approach to granting credit to low-income households.

"Having lenders willing to come into these areas is definitely important" to neighborhood improvement, King says, adding as lenders have expanded their markets to include low-income home loans, housing needs are being addressed. Meanwhile, lenders now view these neighborhoods as viable investments.

In the rapidly growing real estate market of the 1990s, lower-income neighborhoods in Kansas City more than held their own, and this, say Harvey and Spong, indicates neighborhood progress.

income

By definition, low- and moderate-income neighborhoods, when compared to other neighborhoods, will be made up of households with less income to meet their housing needs.

This characteristic remained true throughout the 1990s, with median income levels in Kansas City's lower-income neighborhoods staying at about 57 percent of the metrowide medium income level in both 1990 and 2000.

This income stability does indicate that median income levels in low- and moderate-income neighborhoods at least kept up with the general growth in incomes across the metropolitan area. In addition, a moderate decline occurred in the portion of the population below the poverty level in lower-income neighborhoods during the 1990s, which suggests these neighborhoods did benefit from matching the metrowide income trends.

home values

"Rising home prices also provide a positive sign that lending in lower-income neighborhoods can be undertaken with the same confidence and collateral protection as in other neighborhoods," Spong says. "It further indicates a positive influence from the lending that has taken place and offers proof that enough lenders are becoming interested in lower-income neighborhoods to support the existing stock of homes there."

Harvey and Spong's research found a significant increase (45.6 percent) in the median value of homes in low- and moderate-income neighborhoods during the 1990-2000 time span. This increase, which was similar to the metrowide average, implies low- and moderate-income neighborhoods may have reversed some previous signs of deterioration.

These increases in values also indicate housing in low- and moderate-income neighborhoods was just as good of an investment during the '90s as in other parts of the metro area—something lenders have recognized as well.

"Increased lending does stabilize and increase home values," says Brentano, the real estate consultant. "If more people are able to get loans, there is more of a demand for homes. An increase in demand most likely would increase the value."

vacant property and construction

Another indicator of neighborhood attractiveness and housing conditions is vacant property rates.

Although vacant property was more common in low- and moderate-income neighborhoods than in other Kansas City neighborhoods, the vacancy rate in these lower-income neighborhoods declined from 15.3 percent in 1990 to 13.8 percent in 2000. This suggests a successful effort had begun to clean up neighborhoods and restore or tear down deteriorated properties.

The greatest rate declines generally occurred in neighborhoods with the higher rates of home lending, which implies conditions may be improving the most in those neighborhoods with the best access to credit.

Building permits are a "vote of confidence"—a sign of new and significant investment—and provide a perspective on which neighborhoods the builders, lenders and buyers regard as attractive with favorable prospects, Harvey says.

New-home construction was rare in low- and moderate-income neighborhoods during the early 1990s. However, in later periods Harvey and Spong found a substantial increase in the number of building permits issued. This increase, consequently, implies these neighborhoods are becoming more attractive for housing investment.

City Vision Ministries has developed hundreds of new and rehabilitated homes in its 15 years of undoing absentee ownership and property deterioration that plague urban neighborhoods of Kansas City, Kan.

Capitalizing on available land, the nonprofit's mission is to improve communities at the neighborhood level while in turn benefiting the families who live there, says executive director John Harvey.

crime

Crime is another possible indicator of neighborhood conditions, Harvey and Spong say. The rate of crimes against people in low- and moderate-income neighborhoods in Kansas City, Mo., generally followed a metrowide trend, dropping by half from the 1990-1994 period to the 2001-2005 period.

Increased home lending supports neighborhood progress, area nonprofit groups say, and ownership can be linked to improved neighborhood conditions.

"Homeownership is like an inoculation from social problems," says Riddle of The Family Conservancy.

Brentano adds, "(Home)ownership is one of the best ways to stabilize a neighborhood and keep it from declining."

All these results suggest higher lending rates in low- and moderate-income neighborhoods are associated with improving neighborhood conditions in the form of rising home prices, stable or increasing homeownership rates, and a jump in new-home constructions, Harvey and Spong say.

It's difficult to conclude how much of a contribution home lending made to these positive changes in neighborhood conditions, especially when economic trends, neighborhood redevelopment efforts and other factors are considered as well.

However, Harvey and Spong say home lending contributed to or helped enable many of these favorable trends to take place by supporting homeownership and rising housing values.

These effects can be exponential—the success of low- and moderate-income neighborhoods attracts homebuyers, like the Jackson and Melgoza families. Their lives are better because of homeownership, they say.

"People see these areas as a place where they would like to live and raise a family," Brentano says.

Home sweet home

Above the chatter of little voices and the clanking of pots in the kitchen, a car pulling into the driveway can be heard.

"Daddy!" 9-year-old Catalina exclaims, running to peer through the window blinds as the car's headlights illuminate her face.

Hugo Melgoza is home from his job as

PHOTO BY GARY BARBER

During the past decade, home-purchase lending in low- and moderate-income neighborhoods grew at a faster pace than the rest of the Kansas City metro area. This Kansas City neighborhood has benefited thanks to one nonprofit's rehab efforts and lending assistance.

a technician at a local engineering company. His wife, Sarah, is in front of the stove with Diego, 1, balancing on her hip and 6-year-old Anthony looking on.

Sarah works as a secretary at the children's school just minutes from their home. It was the drive from their townhouse to the school that took her past Lloyd Street, which is now their address. The nonprofit that sold the Melgozas the house also awarded them a grant to help purchase it.

Catalina has a bright pink room covered with her artwork and filled with dolls. Even though they no longer share a bedroom like they did in the rental, her little brother, Anthony, disregards the "keep out" signs posted on Catalina's bedroom door to jump on her bed. Still, a room of her own is her favorite thing about the house, Catalina says.

Hugo and Sarah understand. They both grew up in homes their parents owned. They want the same for their children, and someday, their children's children.

In addition to the investment they are building and the contribution to the community they are making, the Melgozas have something to call their own, Sarah says.

"This is home."

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

- **HOME FINANCING IN KANSAS CITY AND ITS CONTRIBUTION TO LOW- AND MODERATE-INCOME NEIGHBORHOOD DEVELOPMENT**
- **LOW- AND MODERATE-INCOME HOME FINANCING: WHAT ARE THE TRENDS IN KANSAS CITY?**

By James Harvey and Kenneth Spong
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

A taxing way to live

PHOTO BY ROBERT ERVIN

After 25-year lows, sharp tax increases likely for middle-income households

Like the average American, Greg Paprocki—a husband, father and entrepreneur—gets a few tax breaks.

Paprocki, 34, of Omaha, Neb., considers himself middle-class, although as an illustrator he does earn more than the average household. His marriage to Beth in 2004 allows the couple to file taxes jointly, and the birth of Lydia in late 2006 offers them an additional deduction.

Effective federal tax rates for middle-income households actually are at 25-year lows as a result of changes in the tax laws beginning in the early 1980s and culminating in 2001-2003. Still, Paprocki feels like he "absolutely" pays too much in taxes.

Middle-income Americans may think this way partly because growing household incomes have kept the dollar amount of taxes paid from declining as dramatically as the percentage tax rate, say Troy Davig, senior economist, and C. Alan Garner, assistant vice president and economist, both at the Federal Reserve Bank of Kansas City. Additionally, middle-income households have not experienced comparable declines in state and local tax rates.

It's no wonder, then, that Paprocki says, "It's hard to get ahead."

For him and many other middle-income taxpayers, this situation is unlikely to improve.

Although legislation could change, under current law the effective federal tax rates on middle-income households are projected to rise sharply, say Davig and Garner, who recently researched the trends and prospects of middle-income tax rates. Much of the economic analysis and political debate about these federal tax changes focus on the impact on upper- and lower-income groups, while the impact on middle-income taxpayers is sometimes forgotten.

"Among middle-income households," Davig says, "those with children have experienced the greatest decline in effective federal tax rates. However, going forward, these households will face the largest tax increases among middle-income households and all in this bracket will likely see a rise."

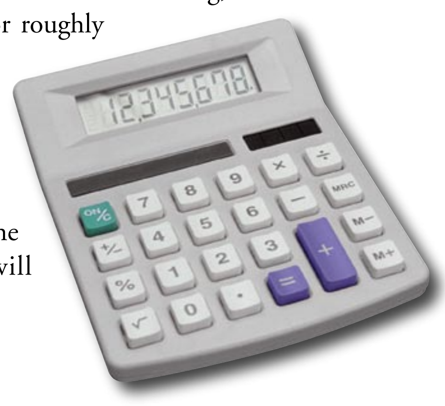
Under current law, the income tax rate for middle-income households with children is projected to double from 2004 to 2013. Elderly and non-elderly households without children face a more gradual increase until 2011, when they experience a jump in tax rates stemming from the expiration of tax provisions.

With the federal government running a substantial deficit, increases in the middle-income taxes are likely as fiscal policy makers attempt to move the budget closer to balance. Unfunded liabilities of Social Security and Medicare, in addition to state and local funding requirements such as education, Medicaid and public employee retirement, imply that middle-income households could face tax increases going forward, Garner says.

These projected changes will impact a wide spectrum of middle-income households.

For families like Fred and Judy Clark, who are nearing retirement, and Stan and Pat Hoig, who have been retired for roughly 20 years and living on a fixed income, an increase in taxes means an impact on their spending.

For families like the Paprockis, not only will



Taxes 101

Changes in tax liabilities are a result of household circumstances (such as a shift in income or birth of a child), or legislated changes in the federal tax code. As a result, federal taxes for different income groups change constantly.

These tax law changes can be "targeted" when policymakers want to alter tax treatment for a specific group, such as the child tax credit, which only benefits households with children. Tax law changes are "general" when they are broad-based, such as an increase in the amount of personal exemptions.

Since 2000, Congress has lowered individual income tax rates, increased child and dependent care credits, and reduced taxes on dividends and capital gains. Modest revisions in any given year might not be noticed, but in time these revisions could build into a large change in the middle-income tax rate.

Tax trends for middle-income taxpayers can be difficult to determine, say Troy Davig and Alan Garner, economists with the Federal Reserve Bank of Kansas City.

These households are defined as "middle-quintile taxpayers." The Congressional Budget Office divides the U.S. population into quintiles, or fifths of the income distribution, using a comprehensive income measure.

Income quintiles are not fixed groups; households can move from one group to another. Two households in the same income quintile may differ considerably in their tax liabilities. For example, two married-couple households with the same income might have different tax liabilities because they have a different number of children.

A household's taxable income is calculated based on gross income (wages, interest, pensions), less: adjustments (retirement plan contributions, moving expenses, interest on education loans), deductions (standard or itemized) and personal exemptions.

In the Tenth Federal Reserve District, where the Federal Reserve Bank of Kansas City is located, the median income for middle-income households ranges from $40,000 to $70,000. The District includes western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico.

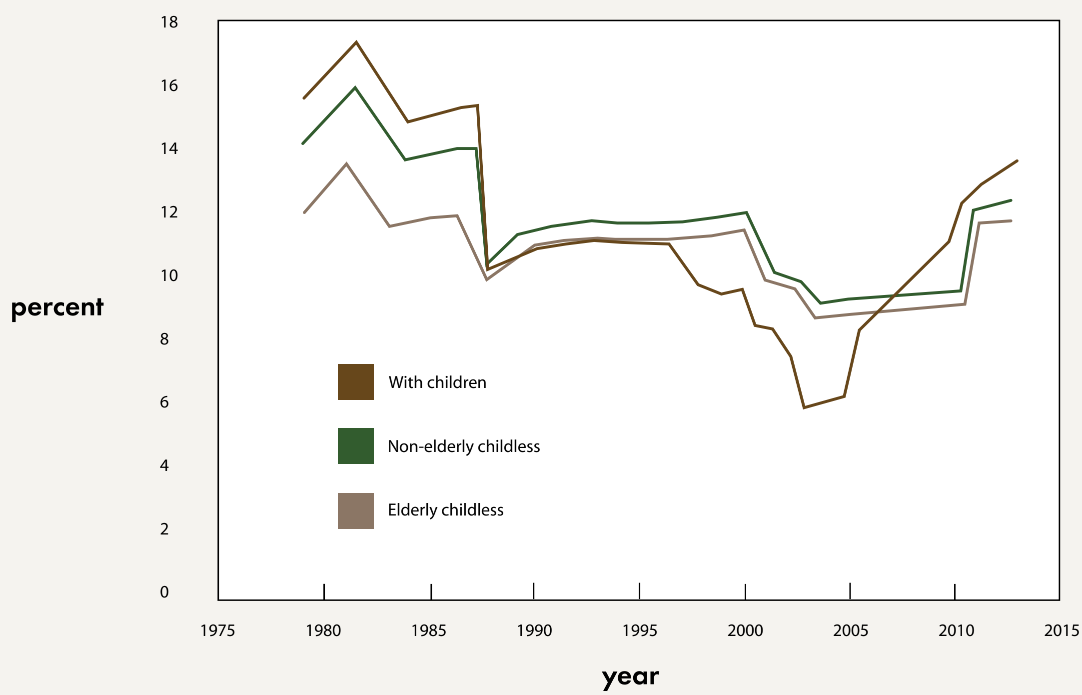
Additionally, taxes are indirectly transferred to households, such as business taxes and social insurance taxes.

Business taxes are ultimately shifted to households through complex adjustments in wages, prices and quantities traded, although the amount shifted can only be estimated. For employer-paid social insurance taxes, an analysis suggests payroll taxes paid by employers are largely reallocated to workers, mostly through lower wages.

Keith Price, a certified public accountant of 35 years in Cheyenne, Wyo., knows that the last thing middle-income households want is a tax increase, but they should be prepared for it. This means cutting back on the day-to-day frivolous expenses rather than savings funds.

"Most people in that (middle-income) group are tight on money," Price says, "so an increase is not nice."

Effective Federal Income Tax Rates for Different Middle-Income Groups



their short-term spending be impacted, but also their long-term saving for their golden years and their daughter's college education. Paying higher taxes while maintaining an adequate nest egg may affect the family's lifestyle, although Paprocki can't imagine where they could cut back.

"We live pretty modestly," Paprocki says, "watching how every dime is spent."

Going down

The total federal income tax liability has declined dramatically for middle-income households, dropping from 7.5 percent in 1979 to 2.7 percent in 2003.

"Tax policy in the United States has experienced several major changes during the past 25 years," Davig says. "Many of which were explicitly designed to benefit middle-income households."

This downward trend is a result of the ratification of various tax bills. First, in 1981, changes in the law reduced income tax liabilities. Then in 1986, changes led to a stabilization of rates. A third period of sharp declines began in 1997 and gained more momentum after the passage of three tax bills in 2001-2003.

Meanwhile, social insurance tax rates—referred to as "payroll taxes" because they are deducted directly from an employee's paycheck—have been relatively stable. By 2006, each employee paid 7.65 percent of his/her wages in payroll taxes, with an equal amount matched by employers, to finance Social Security benefits and portions of Medicare.

To assess the differences across middle-income households, the Congressional Budget Office reports rates for three groups:

- households with children,
- non-elderly childless households,
- elderly childless households.

Several trends have emerged, Garner says. First, the tax rate for elderly childless households has remained fairly stable, although there was a slight upward trend in the 1990s that was reversed by the post-2000 changes in tax law.

Second, the tax rate for both non-elderly households without children and households with children has declined, following the general trend for all middle-income households. And, non-elderly households with children have experienced sharper declines than households without children.

"The difference in the downward trends between non-elderly childless households and households with children is a consequence of changes in tax law, instead of income differences," Garner says.

Prior to 1986, the difference between these groups was modest. However, following these changes, households with children began

MIDDLE-INCOME FAMILIES WITH CHILDREN—like Greg, Beth and baby Lydia Paprocki—have seen the greatest federal tax rate benefits. But looking ahead, they will face the largest tax rate increases among middle-income households, under current law.

Stan and Pat Hoig, here with two of their seven grandchildren, have always been diligent savers but now worry they won't be able to financially help their grandkids as much as they had planned.

PHOTO BY KEITH BALL

facing less stringent tax rates than non-elderly childless households—the tax code changed to benefit those with children.

The 1986 bill increased the personal exemption amount from $1,080 to $2,000, impacting all households, but more so those with children. Changes in 1997 established a $500 child tax credit. The post-2000 tax law changes continued to widen the gap between the two groups due to increases in the child tax credit and dependent care credits.

In contrast to income taxes, federal social insurance tax rates grew, leveling off around 1990 for households with children and non-elderly households without children.

Elderly households without children have seen steady social insurance tax rates. This is a reflection of the small fraction of payroll taxes paid by elderly households who were also eligible for old-age Social Security benefits.

Rising share of payroll taxes

Over time, a larger fraction of middle-income households' federal tax liability has been devoted to payroll taxes. Because payroll taxes are paid only up to a certain amount of wage income, payroll taxes make up a larger share of the tax liability for low- and middle-income households versus high-income households.

"The falling trend in federal income taxes and the rising, or steady, trend in payroll taxes have a clear implication for middle-income households," Davig says. "A larger fraction of their tax liability is devoted to payroll taxes."

Research shows payroll taxes were higher than federal income taxes for 44 percent of all U.S. households in 1979, and that percentage increased to 67 percent in 1999. Current revenues from payroll and income taxes are nearly equal.

Personal federal income taxes as a share of federal taxes dropped from 40 percent in 1979 to 24 percent in 2002. At the same time, payroll taxes as a share of federal taxes rose substantially—from 46 percent to 64 percent.

"Generally, one way to view the changing composition of tax liability for middle-income households is that the total 'pie' (tax liability) has shrunk," Garner says, "while the size (share) of the 'slices' has clearly changed and shifted toward payroll taxes."

During the next few years, many features of the post-2000 legislation are set to expire, leading to a gradual rise in effective income tax rates going forward. Expiring factors contributing to the rise include the decline in the child credit and the expiration of provisions that diminish marriage penalties. In addition, the alternative minimum tax will affect a larger number of middle-income households in the future.

"The decline in income taxes for middle-income households during the past 25 years is likely to be completely reversed during the next 10 years," Garner says.

The effective federal income tax rate for households with children is forecast to rise from 5.8 percent in 2004 to 13.4 percent in 2013. Households without children will face similar, but less dramatic increases. These families, however, likely will still feel effects.

Effect on retirement

Fred Clark is at least five years from retirement, but already knows when he leaves his job his days won't be filled with fishing and golf.

"I need to remain productive from a psychological and spiritual standpoint, but more so financially," says Clark, 61.

So when he retires from his long-time position as a life and disability claims analyst in Omaha, Neb., Clark will still punch the proverbial time clock. He hopes one of his hobbies will be lucrative, such as winemaking at the small vineyard he's planning for his land in southeastern Nebraska, although he's not counting on turning a large profit. Still, he'll need a small income to supplement his and his wife Judy's retirement.

"I've resigned myself to the fact that we're going to have to cut back," Clark says. "Anyone who lives on a fixed income is going to have to cut back."

Unfortunately this is also true for retirees Pat and Stan Hoig, of Edmond, Okla.

It's not the day-to-day spending or even their long-term budget that will be most affected by increased tax rates in the coming years.

"It's going to impact us to some extent, but we won't be deprived," says Pat, 72. "We just won't be able to do as much for our grandkids."

Pat, a former elementary school music teacher, and Stan, a former journalism instructor at the University of Central Oklahoma, adamantly saved throughout their lives, always with retirement—and their grandchildren—in mind. They help two of their seven grandchildren pay for college, but worry about the children's future financial obligations.

"The burden shouldn't fall on them," Hoig says.

"The decline in income taxes for middle-income households during the past 25 years is likely to be completely reversed during the next 10 years."

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

MIDDLE-INCOME TAX RATES: TRENDS AND PROSPECTS
By Troy A. Davig and C. Alan Garner
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

It wasn't by chance that Annie Kao's parents moved to the Cherry Creek Colorado school district, where she and her twin sister would be surrounded by intensely academia-driven—and predominately white—peers.

"That's exactly what they were looking for," Kao says.

Born in Taiwan and China respectively, Kao's mother and father immigrated to America to study biochemistry at Utah State University, where they met.

"They went where the scholarship money was," Kao says. "That was their ticket to the United States. That was their way out."

And as they raised their daughters in southeast Denver, they would always emphasize the importance of education.

"It wasn't whether you were going to college, it was which one of the best colleges were you going to," Kao remembers. "You were unsuccessful if you didn't go to college. … It was a very big deal, basically since birth."

Now 30, Kao is a lawyer. Her sister is a doctor.

Career Builders

Education can help growing minority population face workforce challenges

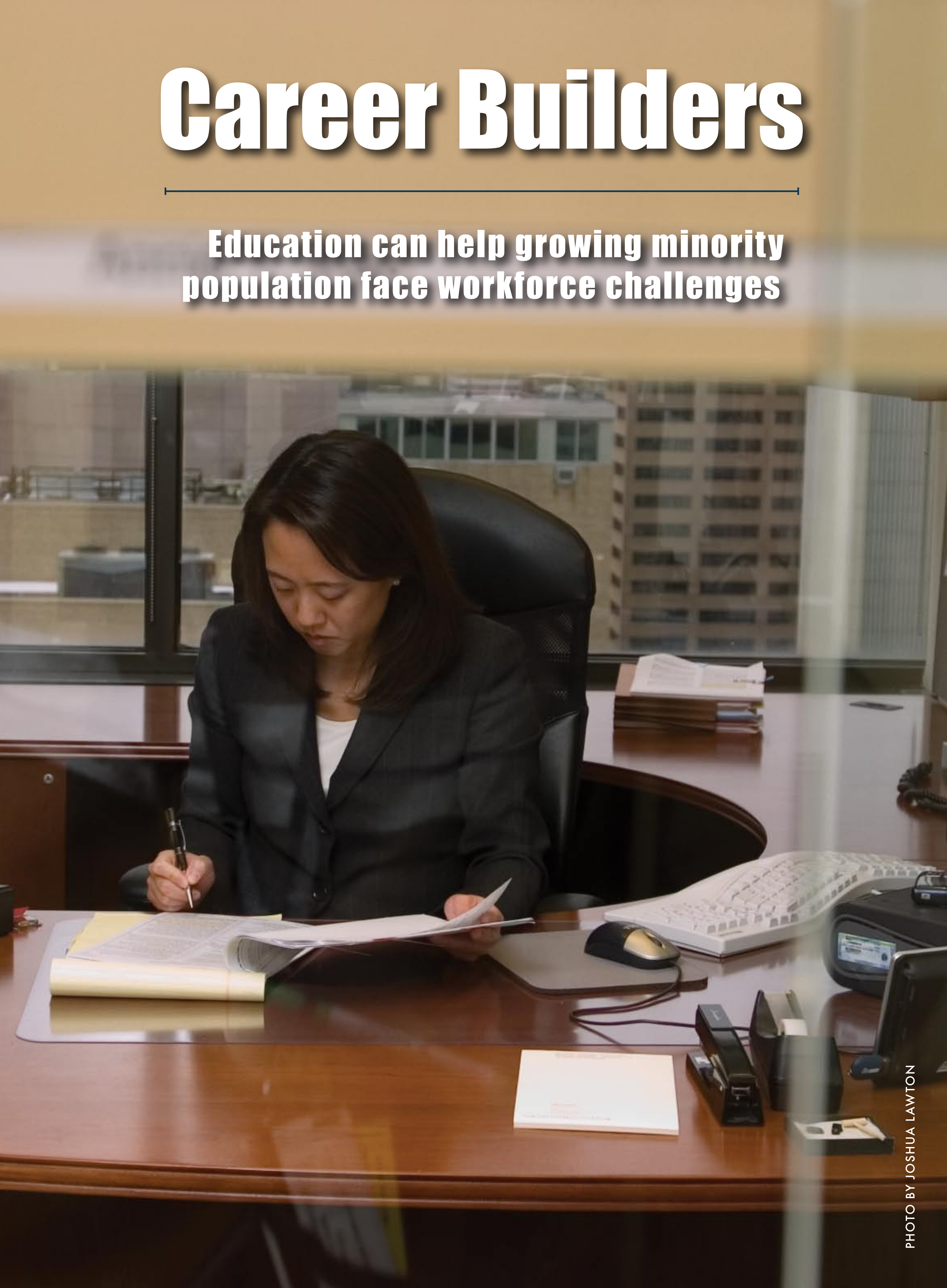


PHOTO BY JOSHUA LAWTON


PHOTO BY JOSHUA LAWTON

THE IMPORTANCE OF EDUCATION was emphasized at home. Kao's mother (right) and father immigrated to the United States to educate themselves and, years later, their daughters.

Higher skill and education levels are vital to career opportunities, but are often advantages minority groups lack. In turn, this may significantly limit the job and earning potential of rapidly growing minority populations in the region, says Chad Wilkerson, an economist and branch executive of the Federal Reserve Bank of Kansas City's Oklahoma City Branch.

Wilkerson and Megan Williams, an associate economist also at the Oklahoma City Branch, recently examined the occupational outlook and its implications for minority groups in the Tenth Federal Reserve District.

In the District, which is made up of western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico, the share of ethnic and racial minorities has almost doubled since 1970, now making up 25 percent of the area's population—and also a rapidly growing part of the labor force.

"The five- to 10-year outlook for jobs held by minorities generally is not as bright as the outlook for jobs held by non-Hispanic whites," Wilkerson says. "More education will be needed to boost both long- and short-term job prospects for minorities in the District."

It's a lesson Kao wasn't taught in the classroom, but learned by her parents and passed on to her. She is grateful for that.

"Always their No. 1 priority was education," Kao says. "It has given me so many more options."

A growing population

In 1940, minorities made up less than 10 percent of the total population of the states in the District. The average annual minority population growth through 1990 was nearly 2.5 percent—three times as fast as population growth among whites due in large part to higher birth rates—with the fastest growth occurring among Asians.

More recently, the minority population share in the District has increased even more rapidly. Meanwhile, growth for whites has eased slightly since 1990.

The District's three largest minority groups are Hispanics, blacks and Native Americans.

By state, minorities make up more than half the population in New Mexico and more than 25 percent in Colorado and Oklahoma. The minority populations in Kansas, Missouri, Nebraska and Wyoming range from 11 percent to 18 percent.

More specifically, the largest concentrations of minorities in the District are found in northern New Mexico, southern Colorado, eastern and southwestern Oklahoma, and southwest Kansas, including metropolitan areas such as Albuquerque, Denver, Oklahoma City, Tulsa and Kansas City.

The largest minority group in the District, like the nation, is Hispanics with 12 percent. The next three minority groups in the District are: blacks (6 percent), Native Americans (2.5 percent) and Asians (1.7 percent).

Although the presence of minority workers is growing, the earning levels continue to lag.

Making ends meet

After graduating from high school in New Mexico, Dave Melton did what the other young men he grew up with on the Pueblo Laguna reservation did and what their fathers before them did: looked for work.

For nearly 10 years, Melton put in long grueling days with minimal pay, first as a motorcycle mechanic and then mining for uranium.

"I could feel it," Melton remembers. "I knew I didn't want to be doing this (type of work) for the rest of my life."

So at age 27, with a wife and four children, Melton enrolled at the University of New Mexico on a scholarship from his tribe to study economics.

Now, at 53, Melton owns Sacred Power Corporation, a manufacturer of renewable energy equipment, such as solar power panels. He started his Albuquerque-based business six years ago. Much of the company's technologies are used in Indian Country to provide electricity and hot water.

"This is why I'm here," Melton says. "I've been put on this earth to help people."

This includes guiding his children, who are all currently attending college. He didn't want their career choices and, in turn, their lifestyles to be limited by a lack of education as his once were.

Research shows differences in occupational structure result in differences in salary levels. Both are tied to levels of educational attainment.

In the District, the actual median earnings for Hispanics and Native Americans are nearly 25 percent below the District average. Blacks earn about 15 percent less than the average while Asians earn less than non-Hispanic whites.

Job and salary projections for 2014 are positive for all races and ethnic groups. However, growth of high-paying jobs held by Hispanics, blacks and Native Americans isn't projected to outpace the growth of low-paying jobs to the extent it is for whites and Asians, Williams says.

DAVE MELTON AND HIS WIFE, ADA, are both entrepreneurs in Albuquerque, N.M. "If I could pin one thing on how I came to be here, it would be education," Melton says.

PHOTO BY TOBY JORRIN

RESEARCH SHOWS MINORITIES are concentrated in lower-paying, non-management jobs. This can be attributed to several factors, including immigrant assimilation, geographic mobility, cultural factors and educational attainment.

PHOTO BY TOBY JORRIN

Management positions account for about 13 percent of all jobs in the District, and as a whole, are the highest-paying major occupational group. In 2000, the share of Hispanics, blacks and Native Americans in management positions in the District was barely half that of whites. The share of Asians was moderately higher than for other minority groups, but still less than whites.

Professional jobs, such as lawyers, teachers and other non-management positions that require post-secondary training, account for nearly a fifth of all jobs in the District. Similar to management positions, these jobs are high-paying but there is a much lower minority concentration compared to whites. By contrast, Asians are highly concentrated in professional jobs.

Other occupational groups account for two-thirds of employment in the District, but pay considerably less than management and professional jobs.

"Minorities are more highly concentrated in these jobs," Williams says.

Explaining the gap

Three cultural factors have been found to influence occupational structures and economic outcomes of minorities relative to whites: labor market discrimination, immigrant assimilation and geographic mobility.

Historically, racial discrimination in the labor market accounted for some of the occupational and economic differences for minorities and whites, Wilkerson says. Some studies show this still to be a factor today while others have found little impact. Other studies have found evidence that immigrant assimilation plays an important role—immigrants' education, experience and skill levels do not transfer perfectly in the U.S. labor market.

Geographic mobility may also contribute to differences in occupational structure and wages. Cultural factors may constrain mobility, which is especially true for Native Americans, who often live on reservations in remote or rural areas where job opportunities are limited.

"Despite these cultural factors, the biggest contributing factor, by a wide margin, lies in the differences in human capital traits," Wilkerson says, "which are typically measured by education and skill attainment."

Higher education, higher pay

Education varies widely by race and ethnicity in the District. Hispanics tend to have the least education of all minority groups; only 36 percent of Hispanics ages 20 and older have attended some college and only 11 percent have a bachelor's degree or higher, according to Wilkerson and Williams' research.

Blacks and Native Americans also have below-average post-secondary education, while in contrast, more than two-thirds of Asians have at least some post-secondary education and those with master's and doctorate degrees (23 percent) greatly exceed that of all other races and ethnic groups, including whites.

Phil Birdine sees a direct link between minority workers' overall job and pay concentrations and the low level of minorities' degree attainment. For this very reason, Oklahoma State University is committed to minority students' graduation, says Birdine, OSU assistant vice president for institutional diversity.

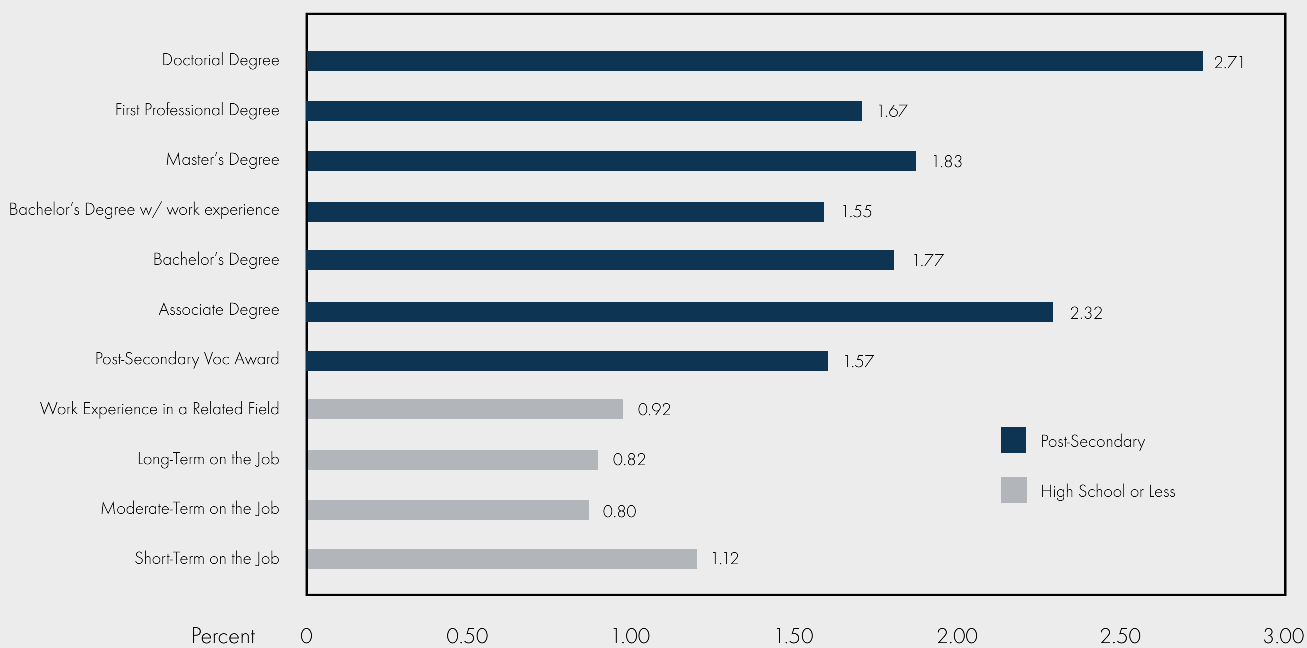
"Education is one of the main answers to closing that gap," Birdine says. "Our society is so competitive, without an education you're at a disadvantage. … The more skilled you are, the more valuable you are to an employer."

OSU has a higher share of minorities in terms of both enrollment and graduates than most major universities in the region.

However, recruiting minority students is challenging, Birdine says. Often college-age minorities have grown up in families whose members aren't highly educated and may work in lower-paying jobs.

The university has programs to not only identify and target potential minority students, but also retain them once they are enrolled. The Multicultural Student Center, for which Birdine is the director, was established nearly

Annual Projected U.S. Job Growth for 2004-2014
by Primamry Education or Training Requirements of Jobs



Source: U.S. Bureau of Labor Statistics

two decades ago to do just this. The Center offers academic, career and social advisement to help ensure the success of minority students at OSU—and beyond.

The workforce demands diversity, and it demands highly skilled workers, Birdine says.

Bill Ray, spokesperson for the Denver Metro Chamber of Commerce, agrees, saying the need for educated workers is rapidly increasing as the aerospace, bioscience, engineering and health-care industries continue to grow.

With this in mind, the Chamber is helping prepare the area's future workforce via school programs to teach children about the importance of education at an early age. These more recent efforts are in line with the Chamber's mission of economic growth.

"It's all about workforce development," Ray says. "The key is developing a talent pool."

Looking forward

Because minority groups in the region have different occupational mixes than whites, job prospects during at least the next five to 10 years are also likely to differ, Wilkerson says. Projecting the demand for occupations currently filled by minority workers helps indicate workers' prospects.

The fastest growth in the United States during the next decade is anticipated among professional and service occupations, which are generally near the top and bottom of the pay scale, respectively. These fields include healthcare, software and personal care services.

In the classroom

Crystal McClarty's college professors always know whether she's present.

"For most of my classes, I'm the only African-American," says the 23-year-old graduate student at Oklahoma State University.

This means McClarty stands out. Teachers and students remember who she is; when there's a class discussion about race issues, everyone looks to her.

She's never felt out of place on campus, though. College is where she belongs, she says.

McClarty knows she's representing her family as a member of its first generation to go to college, but also her race and ethnic minorities as a whole.

"It makes me want to work harder," McClarty says.

Research shows minority groups' representation at universities is somewhat lacking when compared to population numbers. Economists Chad Wilkerson and Megan Williams, of the Federal Reserve Bank of Kansas City, recently examined 2002-2004 enrollment and graduation data from all Title IV institutions (schools that have federal student financial assistance programs) in the Tenth Federal Reserve District. This includes western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico.

The 18- to 34-year-old minority population in the region (27 percent of the total population) is somewhat larger than minority enrollment in universities, particularly four-year schools. Minority presence was much higher in two-year and vocational or trade schools.

Wilkerson and Williams also researched graduation rates of minorities at regional universities' and found them to lag enrollment rates in most cases.

The races examined were Hispanic, black, Native American and Asian. Overall, Hispanics had the largest disparity between enrollment and degree shares and total population shares, while Asians had the smallest.

When she receives her master's degree in business administration and finance next spring, McClarty plans to pursue a career in the oil and gas industry—a field she thinks has a promising future, and one she's prepared for.

"I can't do it without an education."

Meanwhile, farming and manufacturing are anticipated to be the slowest areas of job growth in the United States through 2014, actually declining due in large part to advances in technology.

Jobs that were held by Hispanics in the District in 2000 are projected to increase slower than the average across races. The projected annual growth rate (1.08 percent) for these jobs is low because of high concentrations in occupations such as cashiers, construction laborers and telemarketers.

The prospects for jobs held by Hispanics are helped by large concentrations in health-care aide and services occupations, which are predicted to grow rapidly, although average salaries are generally low.

Jobs held by blacks in the region should rise at about the same pace (1.17 percent) as whites through 2014.

During this same time, jobs held by Native Americans in the region are projected to grow 1.12 percent annually. The outlook is hurt by high concentrations in occupations expected to experience sluggish growth or losses, such as precious-stone workers, and low concentrations in high-paying professions projected to grow rapidly, such as doctors and lawyers.

Like Hispanics, the outlook for black and Native American workers is helped by high concentrations in a number of health-care aide and services occupations, which are expected to grow rapidly but don't pay the highest wages.

In contrast, jobs held by Asians in the District are anticipated to grow at 1.31 percent—faster than the average (1.17 percent) across all races—during the next five to 10 years. Like white workers, Asian workers in the region have high concentrations in many high-paying professional occupations predicted to increase rapidly, including physicians and computer software engineers.

Projected job growth sheds light on anticipated short-term demand for minorities currently employed, and the likely increase in pay gaps between minorities and whites.

Obtaining the right kind of education is the answer for long-term job viability, quality and pay, Wilkerson and Williams say.

“ Our society is so competitive, without an education you're at a disadvantage . ”

This has been true for Annie Kao, as she strived first through Amherst College, where she graduated magna cum laude, then through George Washington University law school, and then on to the firm Brownstein Hyatt Farber Schreck, P.C., in Denver, where she specializes in commercial litigation, often from inside a courtroom winning multimillion-dollar judgments. It's a path of success not too different from her mother's and father's.

“Education is opportunity,” Kao says. “My parents had the opportunities they did because of schooling.”

And so did she.

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

- **MINORITY WORKERS IN THE TENTH DISTRICT: RISING PRESENCE, RISING CHALLENGES**
- **MINORITIES IN THE TENTH DISTRICT: ARE THEY READY FOR THE JOBS OF THE FUTURE?**

By Chad R. Wilkerson and Megan D. Williams
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

Moving mountains *(of funds and securities)*

The Wholesale Operations Site supports high-value transactions

Ever wonder how financial institutions move large amounts of money?

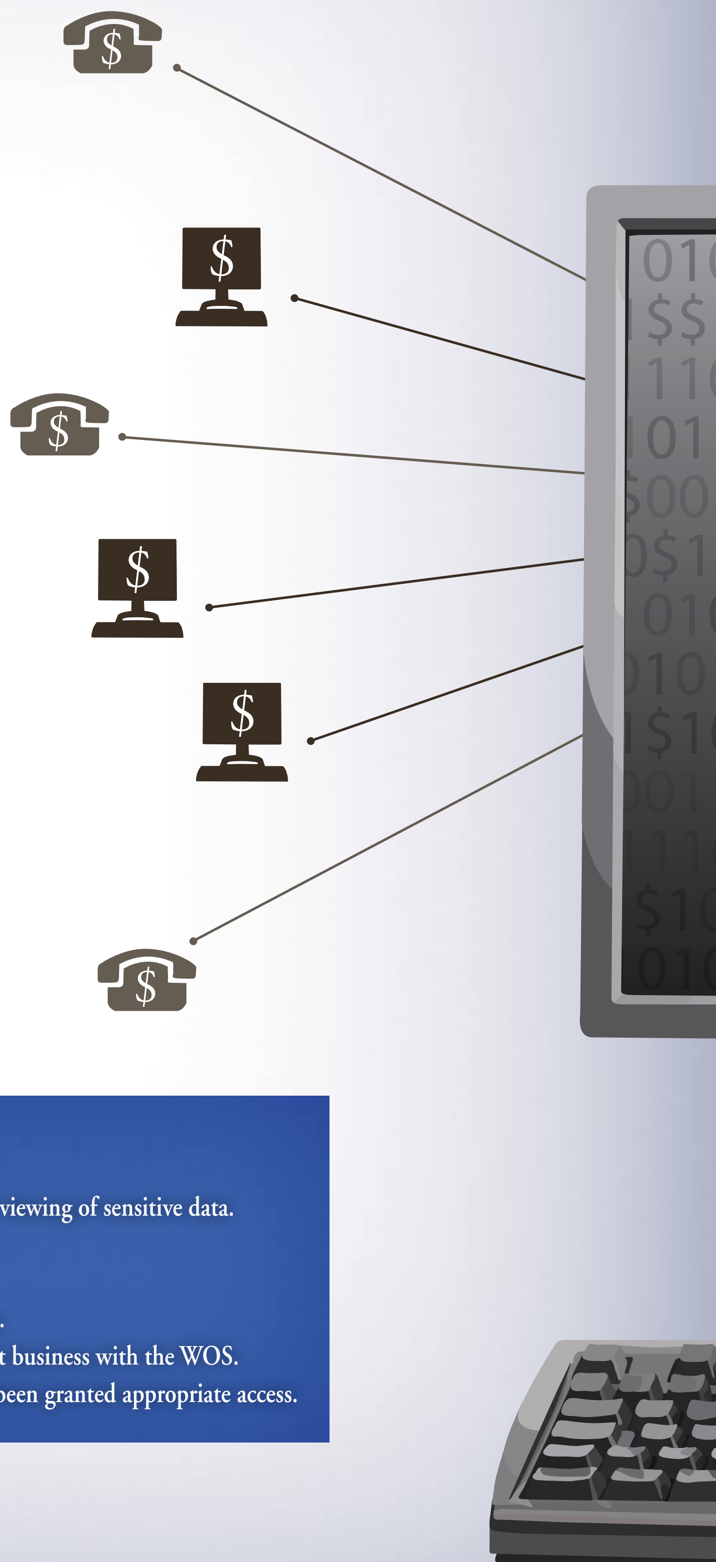
Funds and securities transactions totaling millions—and even billions—of dollars are transferred every day with the help of the Federal Reserve Bank of Kansas City's Wholesale Operations Site (WOS). As one of only two operations sites in the Federal Reserve System, the WOS supports six of the 12 Federal Reserve Districts spanning four time zones.

The WOS primarily helps ensure financial institutions can quickly and safely exchange large-value, time-critical payments. Every month, staff processes roughly 2,500 offline funds and securities transactions, each with an average value of $1.5 million and $4 million, respectively.

Operations are split between two functional units with unique duties and responsibilities. The Administrative Unit works with customers to ensure their application profile is representative of their business needs, while the Transfer Unit processes offline transfers and provides customers with transaction and other account information.

In addition to normal operations, staff exercises contingency-readiness procedures throughout the year. These tests ensure effective plans are in place to respond to network disruptions, natural disasters and terrorism. The WOS has withstood all three, including the 9/11 terrorist attacks when staff worked to help maintain liquidity for the nation's largest financial institutions.

The general daily process is outlined to the right.



RISK MITIGATION

WOS operations are tightly controlled and monitored.

- Operations are located in a secured area to prevent unauthorized viewing of sensitive data.
- All phone calls with customers are recorded.
- Unique identifiers are used to establish customer authenticity.
- Offline transactions require a strict four-party callback procedure.
- Only people authorized by the depository institution can conduct business with the WOS.
- Data security reviews are conducted regularly to ensure staff has been granted appropriate access.

TEXT BY BRYE STEEVES, SENIOR WRITER
ILLUSTRATIONS BY CASEY MCKINLEY,
SENIOR GRAPHIC DESIGNER

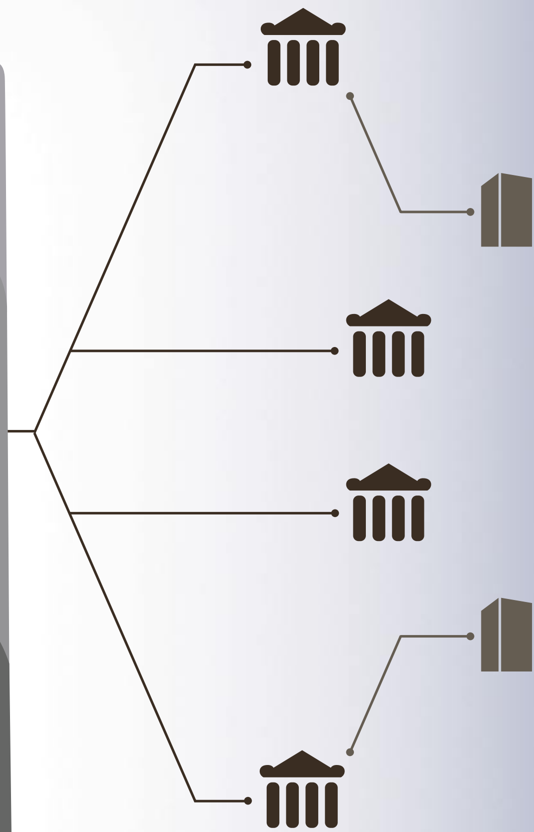
WHOLESALE OPERATIONS SITE

Funds and securities transactions are domestic and flow through Fedwire, which is the Federal Reserve's highly secure, real-time system. Transactions are immediate, final and irrevocable.

Bank to Bank

Third Party

A funds transfer can be a straight bank-to-bank transaction, or it can be destined for a named third party. Securities can be exchanged without payment, but most are "delivery versus payment" where a simultaneous payment is received for the value of the securities.



TRANSACTIONS ARE PROCESSED IN ONE OF TWO WAYS:

Online customers use an electronic connection, which is the most cost-effective and efficient method for originating transactions. The majority of Fedwire volume is processed in this manner.

For offline customers (those without an electronic connection to the Federal Reserve), the WOS serves as an intermediary by entering transactions into Fedwire on their behalf. This requires a highly secure authentication and verification process.

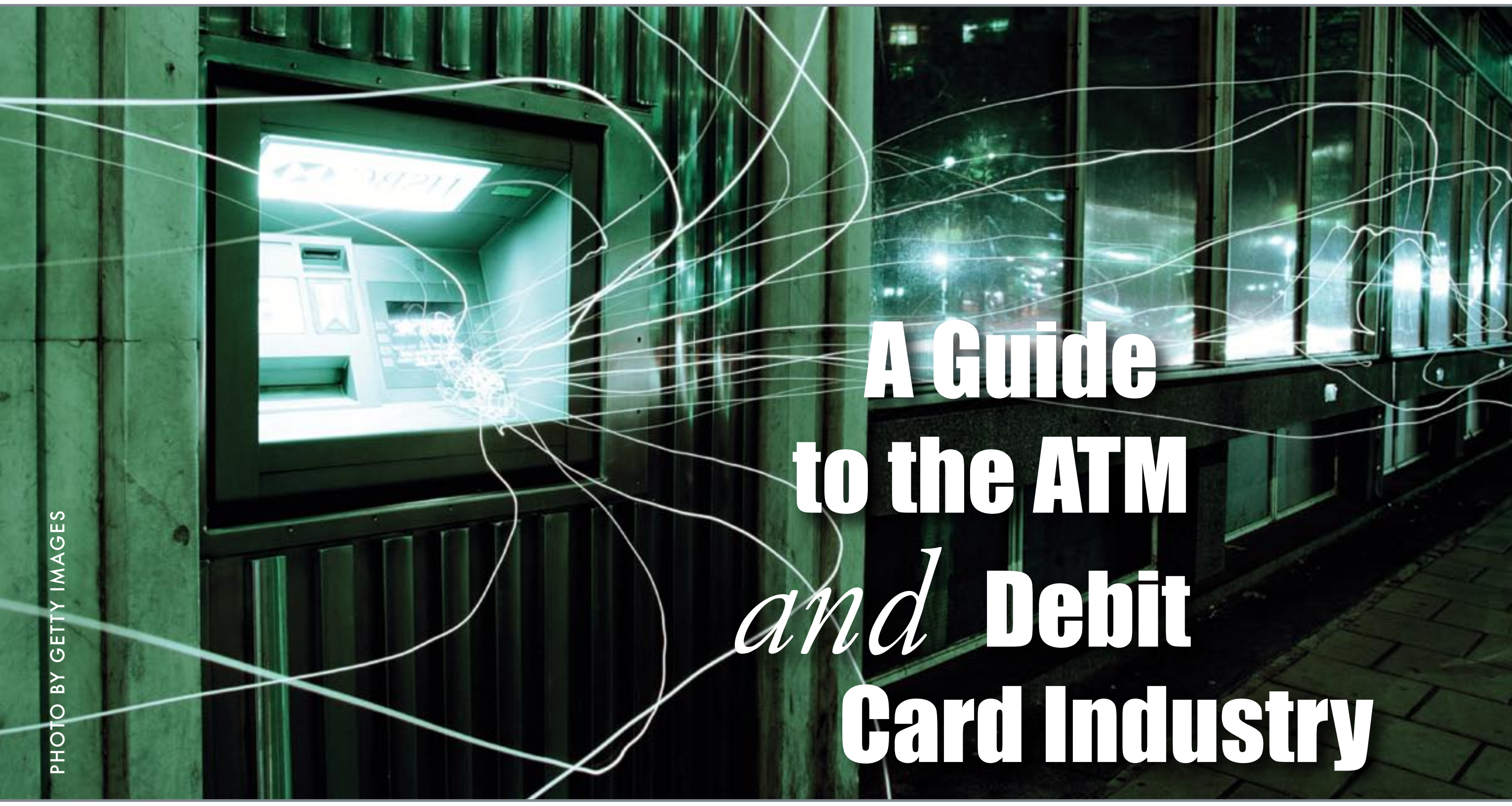


PHOTO BY GETTY IMAGES

A Guide to the ATM *and* Debit Card Industry

Three years ago, economists from the Federal Reserve Bank of Kansas City published *A Guide to the ATM and Debit Card Industry*. Since then, there have been a number of important developments in what has been a dynamic time for this industry, say Fumiko Hayashi, Rick Sullivan and Stu Weiner, authors of the *Guide* and its follow-up, *2006 Update*.

"The purpose of this new publication is to document these trends and patterns by updating the data we presented in the original book," Hayashi says. "*Update* also discusses implications for the current and future state of the industry."

The most important development is the two segments—ATM and debit—in some sense are going in opposite directions. The ATM industry has matured and stagnated. Major players are vying for market position and adopting different business strategies to adjust to the maturation of the industry. Meanwhile, the debit card industry is expanding rapidly with new players, partnerships, products and markets.

"Here the challenge is how to preserve and enhance market position—and not be left behind," Hayashi says.

Important industry changes

There are many reasons for the divergence between the ATM and debit card industries, but they are related. It's become easier to use payment alternatives, such as debit and credit cards, and as a result, consumers don't need as much cash.

The total number of ATM transactions peaked around 2000 and generally has been declining since. The number of ATM networks is also in decline, and the top three firms now process more than 55 percent of ATM transactions.

One interesting, long-run trend in the ownership structure among large regional networks is the emergence of nonbank and single bank forms of ownership at the expense of bank joint ventures. Meanwhile, the largest financial institutions continue to expand their ATM fleets, perhaps in conjunction with building branches. There have been few changes in wholesale pricing and continued increases in some retail ATM fees.

In contrast, debit is the fastest-growing retail payments type in the United States. Signature debit has a 3-to-1 lead in merchant outlets over PIN debit, but both methods have worked to develop their markets, and merchant acceptance has grown steadily.

There is a tremendous amount of network competition in the industry. The original book discussed three competitive battlegrounds within debit card networks: competition among regional PIN debit networks, competition between regional and national PIN debit networks, and competition between PIN and signature debit networks. All three remain and likely will continue, Hayashi says.

The debit card industry faces a challenge from another payment industry, the automated clearing house (ACH) system, which is developing a number of payment options that could substitute for debit.

This shift from paper-based transactions, along with the rising predominance of debit card transactions, raises a number of important policy issues related to safety, efficiency and accessibility.

Policy, fraud and data security considerations

Answers to policy questions are not easy, say the books' authors. The challenge for policymakers and industry participants alike is to stay informed and ready to make solid, sound decisions.

Amid heightened public, industry and government awareness, both data security and fraud concern spans the industries—a compromise of debit card data can enable a fraudster to exploit either the ATM or the debit function.

"Data security and fraud is a cloud that hangs over the ATM and debit industry," Sullivan says.

During 2006, two major debit card PIN breaches resulted in hundreds of thousands of dollars stolen from consumers. The year prior has been identified as the worst for data security breaches. Additionally, fraud was the primary reason for a 2005 surge in chargebacks on several networks.

However, the United States may well be able to fight fraud by improving security systems for magnetic stripe cards.

"This can help foil exploits such as card skimming and clandestine observation of ATM customers," Sullivan says.

While there are concerns that a shift from magnetic stripe to chip cards would be expensive, this is an available solution that could considerably strengthen debit card security.

Consumers are also important because their behavior ultimately determines payment methods used, based on factors such as risk of fraud, consumer protection, price, convenience and incentives.

What lies ahead

"It seems likely that there will be further shake-out in the ATM industry in light of the saturated and possibly overbuilt market," Weiner says.

To what extent depends on deployers finding a profitable mix of functionality, pricing and location. Unless significant changes are made, difficult adjustments are likely.

Banks place heavy emphasis on the ATM as a delivery channel for financial services, and because few bank customers use other functions, ATMs are mostly viewed as cash dispensers. However, they cannot be thought of as substitutes for tellers as the demand for cash declines.

"Some banks hope to change consumer perceptions of ATMs by adding new functionality, such as imaging capability for taking deposits," Weiner says.

Because check use is also declining, ATMs could be used to initiate ACH transactions for person-to-person or bill payments, as is done in other countries. Nonfinancial services dispensed through ATMs, like vending machines, is another option. This could be an opportunity to sell many items, with cash access as one of its features.

"Debit will likely become an even more important payment method in the future," Weiner says. "The conflict between merchants and card issuers, and also how the PIN and signature debit rivalry resolves, will be key."

PIN and signature debit will be affected by factors including pricing, costs, profits, security and product innovation. The authors envision four scenarios:

- Both PIN and signature continue to grow, shifting slightly into each other's market share. Customers maintain their preferred method.
- The two methods converge and become indistinguishable to consumers, such as PIN-less and signature-less debit.
- PIN networks use price, convenience and risk advantages to gain on signature debit.
- Networks enhance their signature debit products (via consumer protection and incentives) and market share over PIN debit.

A wild card for PIN and signature debit is whether ACH alternatives for retail payments become increasingly viable. There is a good deal of effort in developing these products.

"Debit will likely become an even more important payment method in the future."

"Each scenario has some plausibility," Weiner says, "but which of these scenarios is most likely is hard to predict. It would be best for the market to lead to a payments system with the most desirable set of characteristics in terms of efficiency, safety and accessibility, and combinations of payment alternatives may best serve this goal." T

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

A GUIDE TO THE ATM AND DEBIT CARD INDUSTRY: 2006 UPDATE
By Fumiko Hayashi, Richard J. Sullivan and Stuart E. Weiner
www.KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.

Economic Education

The Federal Reserve Bank of Kansas City offers resources for students, teachers and the public.

Visit us Online @

www.KansasCityFed.org

to learn more about personal finance programs, school-based programs and contests for students, such as Fed Challenge and the essay contest.

or

www.FederalReserveEducation.org

for free personal financial and economic education resources including publications and classroom-ready materials.

Notes

THE MONEY CIRCLE

Lesson plans coming soon

Newly developed economics and personal finance curriculum will be available online at www.KansasCityFed.org for use in high school classrooms April 30.

The eight lessons, called "The Money Circle," include the history of money, its functions and characteristics, budgeting, financial planning, and how the Federal Reserve affects the money supply.

The Money Circle was created by the Federal Reserve Bank of Kansas City, in partnership with the University of Missouri-Kansas City's Center for Economic Education Operation Outreach, as part of the Federal Reserve System's commitment to providing educators with classroom-ready resources to help teach economic and financial education concepts.

"The goal is to promote financial literacy at a critical time in children's lives," says Gigi Wolf, economic education specialist at the Bank, who co-developed the program. "If they are equipped with this knowledge before reaching adulthood, they are better prepared to lead financially responsible lives."

The lessons target ninth- through 12th-grade economics, personal finance, family and consumer science, history, and math classes.

For more information about this and other free teacher resources, contact Gigi Wolf at gigi.wolf@kc.frb.org or 800-333-1010 ext. 2736.

First annual event unites metro-area organizations for common cause

In an effort to raise financial awareness and benefit area residents, the Federal Reserve Bank of Kansas City is coordinating a week of events this spring for organizations dedicated to financial education.

The MoneyWi$e Week, April 23-28, includes activities that promote financial education among peers and networks through shared information. The event targets consumers, policymakers, employers, educators and social service organizations.

"The goal of this collaboration is to provide a range of quality financial-education events during National Financial Literacy Month," says Jan Huckleberry, MoneyWi$e coordinator at the Federal Reserve Bank of Kansas City.

Part of the Federal Reserve's mission is to increase understanding of economics and personal finance. Other ongoing programs sponsored by the Bank throughout the year are geared toward educators and school-aged children.

Activities are organized and implemented by partner organizations across the Kansas City metro.

For more information, visit www.KansasCityFed.org/moneywise, or contact Jan Huckleberry at jan.huckleberry@kc.frb.org or 816-881-4768.

JYM WEEK

Jumpstart Your Money

An Oklahoma Jump$tart Coalition Event • April 23 - 28, 2007

Groups merge for common cause

In an effort to increase financial literacy for all Oklahomans, organizations from around the state are combining efforts for a week of events April 23-28.

Jump$tart Your Money Week provides an opportunity for schools, universities, local organizations, corporations and others to distribute and receive vital economic and financial education.

The week of events is sponsored by the Oklahoma Jump$tart Coalition for Personal Financial Literacy. The coalition brings together more than 65 organizations—including the Federal Reserve Bank of Kansas City's branch in Oklahoma City—to strengthen financial knowledge.

"The goal of Jump$tart Your Money Week is to raise financial education awareness, provide related events across the state and show the range of services available for diverse needs," says Steven Shepelwich, Community Affairs Advisor of the Bank's Oklahoma City Branch and past president of the Oklahoma Jump$tart Coalition.

For the calendar of events, list of participants, registration information and more, visit www.KansasCityFed.org/jumpstart/index.htm.

The following banks in the Tenth District are celebrating one, five, 10, or 20 or more years as Federal Reserve members this spring.

Sundance State Bank	Sundance	Wyo.	76
First Nebraska Bank	Valley	Neb.	73
First State Bank	Ness City	Kan.	73
Bank of Hartington	Hartington	Neb.	71
Bankwest of Kansas	Goodland	Kan.	68
First State B&TC	Larned	Kan.	65
First State Bank of Hotchkiss	Hotchkiss	Colo.	65
First State Bank in Temple	Temple	Okla.	64
Citizens Farmers Bank Cole Camp	Cole Camp	Mo.	62
Jackson State Bank & Trust	Jackson	Wyo.	59
Bank of Commerce	Rawlins	Wyo.	29
Union Colony Bank	Greeley	Colo.	28
Citizens Bank of Edmond	Edmond	Okla.	26
Bank of Jackson Hole	Jackson	Wyo.	25
Bankers Bank	Oklahoma City	Okla.	21
Castle Rock Bank	Castle Rock	Colo.	21
Heritage Bank	Louisville	Colo.	20
Bank of Commerce	Chelsea	Okla.	10
Citizens Security B&TC	Bixby	Okla.	10
First American Bank	Purcell	Okla.	10
Cowboy State Bank	Ranchester	Wyo.	5
1st Bank	Evanston	Wyo.	1
Citizens Bank of Oklahoma	Pawhuska	Okla.	1
First Bankcentre	Broken Arrow	Okla.	1

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Compiled By TEN Staff

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org

About...

Jerome Thralls

Although his tenure as the first secretary and cashier of the Federal Reserve Bank of Kansas City was brief, few individuals played a more pivotal role in the Bank's history than Jerome Thralls.

The campaign to win over the Reserve Bank Organizing Committee involved many of the city's business leaders, but it was Thralls who first presented the idea to local bankers. He convinced the community it could win one of the regional banks, and he did much of the work in preparing the city's presentation, including proposing boundaries that the selection committee would nearly replicate when drawing the Tenth Federal Reserve District.

Then, little more than a year after the Bank opened, Thralls left Kansas City, taking a job on the East Coast where he became an authority on international trade with an office in the middle of New York's financial district—a long way from his humble beginnings in rural Missouri.

Early years

Thralls grew up northeast of Kansas City in the small town of Chillicothe, Mo. The youngest of Henry and Margaret Thralls' nine children, he earned 50 cents a day pitching hay for a neighbor—the first in an eclectic string of early jobs and an early indicator of his work ethic and ambition.

According to a 1926 *Kansas City Star* article, Thralls built chicken coops, then took a job in a rural general merchandise store. He was later involved in small town real estate and banking, and he even earned $800 for six months as a fur trapper in the Ozarks.

He spent five years with an express company, a job he sought after reading a newspaper article that mentioned the hefty salary paid to the company's president.

"I decided that I should like nothing better than to be president of that great company and I headed at once for the job," Thralls said in the *Star* article.

He did not make it to company president, but the job took him to Kansas City, where he was offered a position with the Kansas City Clearing House Association, an organization involved in routing payments between banks. He soon became the Association's manager and still held the position when President Woodrow Wilson signed the Federal Reserve Act in December 1913. The new legislation prompted the then-32-year-old Thralls, whose job had him well-positioned to understand the relationships between the region's financial institutions, to immediately begin contacting local bankers about the idea of seeking one of the regional reserve banks for Kansas City.

Although the *Kansas City Times* later wrote "Kansas City's campaign for the Federal Reserve Bank was one of the most determined in its history," the effort did not start that way.

"At first most (Kansas City bankers) thought it was a forlorn hope," the *Kansas City Journal* wrote. "Thralls was confident and he believed differently. He insisted that there was a territory belonging to Kansas City which would supply such a bank with all needed capital and surplus."

The *Times* wrote about Thralls' initial meeting with an unidentified "president of one of the biggest banks in the city" who reportedly told Thralls, "I admire your courage, but I am afraid it would be a useless task."

It would not be the only time Thralls would find resistance to the idea.

"Other bankers were inclined to think he was too ambitious, but he said he was willing to do the work if they would get behind him," the *Times* reported.

Eventually, Thralls was able to convince the bankers to warm to his idea and the community-wide effort began to take shape.

The best-case scenario

The push eventually resulted in a Kansas City visit by the Reserve Bank Organizing Committee where Thralls presented each panel member with a leather-bound report detailing why Kansas City was an ideal location for one of the regional banks. Although the committee received similar filings from 36 other communities nationwide,

City Journal.

APRIL 3, 1914.—FRIDAY.

CITY IN U. S. SWEPT BY FLAMES

KANSAS CITY IS CHOSEN AS SITE OF RESERVE BANK

District With Capital of $5,594,916 Comprises Four States and Parts of Two Others.

TWELVE INSTITUTIONS ARE LOCATED IN U. S.

Nation Is Divided Into Sections Which Vary Little in Population, With a Pair of Exceptions.

DISAPPOINTED TOWNS MAY ENTER PROTEST

Keen Rivalry Was Feature of Contest for Selection; Decision Is Not Likely to Be Revised.

Reserve Bank Cities

KANSAS CITY. NEW YORK. PHILADELPHIA. BOSTON. CLEVELAND. RICHMOND. ATLANTA. CHICAGO. ST. LOUIS. MINNEAPOLIS. DALLAS. SAN FRANCISCO.

Clearing House Manager Who Initiated Move For Federal Reserve Bank Here

JEROME THRALLS.

the Kansas City report "was more concise, contained more real meat and was in better shape than any which had been filed with the committee," the *Journal* wrote in its April 3, 1914 story announcing the city's selection as a Reserve Bank city.

The man whom the S*tar* later described as "modest and unassuming" fit the definition of those terms with the public comments he made during a boisterous gathering of local business leaders celebrating the community's selection. At an event featuring at least one vaudeville-style performer and nearly three hours of speeches that elicited laughter and applause, Thralls was almost stoic in his brief remarks.

"We came nearer getting the territory we asked for than any other city," Thralls said. "That shows we were honest and sincere in presenting our case. We asked only for what rightfully belonged to us. I have been here 12 years and it's the greatest of Kansas City's victories in that time."

He seems to have been only slightly more emotional than he had been a day earlier when he used the words "highly gratified" to describe his feelings about the decision to a *Journal* reporter.

The Federal Reserve and beyond

The Federal Reserve Bank of Kansas City's Board of Directors chose Thralls to serve as the Bank's first cashier and secretary during its meeting on Oct. 31, 1914, about two weeks before the Bank opened for business.

"I shall support Mr. Thralls for cashier for the reason that nearly every bank in town is supporting him for that position and expects him to have it," Director and future Bank Governor Willis J. Bailey told the Bank's other directors during the meeting.

Thralls held the position for only a matter of months, however, resigning on Feb. 10, 1916 to accept a job with the American Bankers Association. According to Bank records, Thralls' resignation was accepted and "a most complimentary resolution of regret and appreciation" was adopted by the Bank's Board of Directors.

Thralls immense popularity with area bankers and his efforts to win the Reserve Bank for Kansas City were likely contributing factors to a small controversy that erupted in the weeks prior to his then-rumored departure.

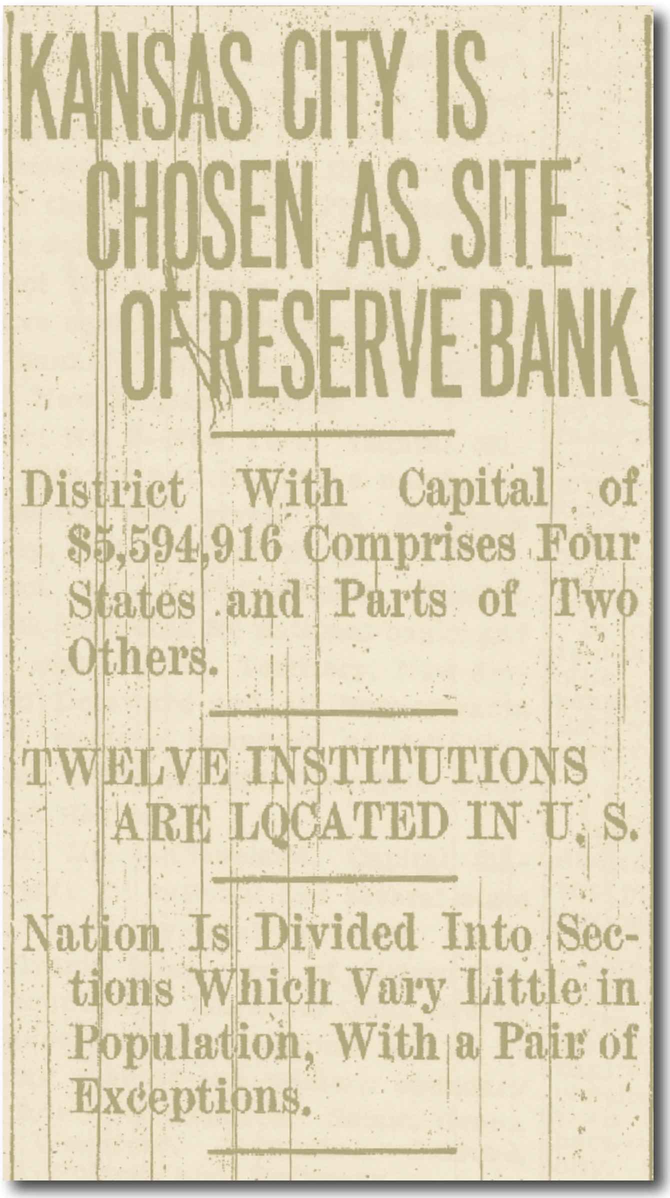
"Kansas City's campaign for the Federal Reserve Bank was one of the most determined in its history."

An article in the *Journal* suggested he was being forced out by politicians attempting to politicize the nation's new central bank. The article suggested the political pressure may have even prevented Thralls from an initial appointment to the Bank's top position.

"The bankers of Kansas City recognized

the ability of Mr. Thralls and after Kansas City had been selected as the location of one of the Federal Reserve Banks, he had many endorsements to head the institution as Federal Reserve agent and chairman of the Board of Directors," the article says. "His political affiliation is believed to have kept him out of that."

Thralls, who was out of town interviewing for the ABA position at the time the story was published, sent a letter to the newspaper refuting the article's claims and voicing support for both the Bank and the entire Federal Reserve System.



KANSAS CITY IS CHOSEN AS SITE OF RESERVE BANK

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"My connection with the Federal Reserve Bank … has no relation whatever to politics and when I leave the service of the Federal Reserve Bank of Kansas City, it will be for the purpose of engaging in a line of work which will afford a broader field of activity, and with matters of common interest to the members of the Federal Reserve System," Thralls wrote.

After leaving the Bank, Thralls went on to great success.

At the ABA, he was once again involved with clearinghouses and he served in an advisory capacity to the government's financing program for World War I. He authored a textbook, became a recognized expert on foreign trade and was involved in the formation of the American Trade Acceptance Council. He served as vice president of the Discount Corporation of New York and, later in his career, became president of the Prudence Securities Corporation.

He died on March 19, 1965 at the age of 84 in Brooklyn, N.Y.

In the *Star's* 1926 article, Thralls was asked about the various career opportunities he had pursued, with the reporter suggesting chance is a key component of any life.

"I wouldn't call it chance," Thralls said. "I'd call it opportunity. We are, in a measure, creatures of environment and opportunity. Some see and grasp every opportunity for advancement in life, while others let the opportunity slip by.

"It was opportunity to work in the neighbor's hay field that gave me my first half dollar and the inspiration to earn more."

T

BY TIM TODD, EDITOR

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.


LIGHTING

2006 Annual Report

Federal Reserve Bank of Kansas City

Officers | Directors | Advisory Councils

Federal Reserve Bank of Kansas City

Management Committee

(From left) Mr. Barkema, Ms. George, Mr. Sellon, Mr. Hoenig, Mr. Scott, Ms. Pacheco, Mr. Rasdall, Mr. Dubbert

Thomas M. Hoenig
President and
Chief Executive Officer

Richard K. Rasdall, Jr.
First Vice President and
Chief Operating Officer

Alan D. Barkema
Senior Vice President

Kelly J. Dubbert
Senior Vice President and
Chief Information Officer

Esther L. George
Senior Vice President

Barbara S. Pacheco
Senior Vice President

Kent M. Scott
Senior Vice President

Gordon H. Sellon, Jr.
Senior Vice President and
Director of Research

Kansas City

(From left) Mr. Schifferdecker, Mr. Terry Moore, Mr. Frank Moore, Ms. Córdova, Mr. Fricke, Mr. Funk, Mr. Smalley, Mr. Nunnink, Mr. Dillingham

Robert A. Funk, Board Chairman;
Chairman of the Board and Chief Executive Officer
Express Personnel Services
Oklahoma City, Oklahoma (Class C)

Lu M. Córdova, Board Deputy Chairman;
Chief Executive Officer, Corlund Industries;
Chairman, CTEK Angels
Boulder, Colorado (Class C)

Dan L. Dillingham
Chief Executive Officer
Dillingham Insurance
Enid, Oklahoma (Class B, Group 2)

Robert C. Fricke
President and Chief Executive Officer
Farmers & Merchants National Bank
Ashland, Nebraska (Class A, Group 3)

Frank N. Moore
President
Spearhead Ranch Company
Douglas, Wyoming (Class B, Group 3)

Terry L. Moore
President
Omaha Federation of Labor
Omaha, Nebraska (Class C)

Kevin K. Nunnink
Chairman
Integra Realty Resources
Westwood, Kansas (Class B, Group 1)

Mark W. Schifferdecker
President and Chief Executive Officer
Girard National Bank
Girard, Kansas (Class A, Group 2)

Rick L. Smalley
Chief Executive Officer
Dickinson Financial Corporation
Kansas City, Missouri (Class A, Group 1)

Federal Advisory Council Representative

David C. Boyles (not pictured)
Chairman, Columbine Capital Corp.;
Director, Columbine Capital Corp. &
Collegiate Peaks Bank
Buena Vista, Colorado

For an explanation of class and group designations, see Page 50.

Denver

(From left) Mr. Pearson, Ms. Leavesley, Mr. Helzer, Mr. Williams, Mr. Alexander, Ms. Schloss

Thomas Williams, Board Chairman;
President and Chief Executive Officer
Williams Group L.L.C.
Golden, Colorado

Bruce K. Alexander
President and Chief Executive Officer
Vectra Bank Colorado
Denver, Colorado

James A. Helzer
Chairman
Unicover Corporation
Cheyenne, Wyoming

Diane Leavesley
President
Mercy Loan Fund
Denver, Colorado

John D. Pearson
Real Estate Broker and Owner
Pearson Real Estate Company Inc.
Buffalo, Wyoming

Kristy A. Schloss
President and Chief Executive Officer
Schloss Engineered Equipment
Aurora, Colorado

Michael R. Stanford (not pictured)
President and Chief Executive Officer
First State Bancorporation
Albuquerque, New Mexico

Oklahoma City

(From left) Mr. Ramos, Ms. Almon, Mr. Gilbert, Mr. Ratcliffe, Mr. Cawley, Mr. Golsen, Mr. Agee

Richard K. Ratcliffe, Board Chairman;
Chairman
Ratcliffe's Inc.
Weatherford, Oklahoma

Steven C. Agee
President
Agee Energy, L.L.C.
Oklahoma City, Oklahoma

Terry M. Almon
President and Chief Executive Officer
Arkansas Valley State Bank
Broken Arrow, Oklahoma

Michael A. Cawley
President and Chief Executive Officer
Samuel Roberts Noble Foundation Inc.
Ardmore, Oklahoma

Robert R. Gilbert III
President, Chief Operating Officer and Director
F&M Bank & Trust Company
Tulsa, Oklahoma

Barry H. Golsen
Board Vice Chairman, President and Chief Operating Officer
LSB Industries Inc.
Oklahoma City, Oklahoma

Fred M. Ramos
Executive Director
State Hispanic Chamber of Commerce
Oklahoma City, Oklahoma

Omaha

(From left) Mr. Sutko, Ms. Ziegenbein, Mr. Lopez, Mr. Timmerman, Mr. Nelson, Ms. Milligan

James A. Timmerman, Board Chairman;
Chief Financial Officer
Timmerman & Sons Feeding Co.
Springfield, Nebraska

Cynthia Hardin Milligan
Dean - College of Business Administration
University of Nebraska - Lincoln
Lincoln, Nebraska

Charles R. Hermes (not pictured)
President
Dutton-Lainson Company
Hastings, Nebraska

Rodrigo Lopez
President and Chief Executive Officer
AmeriSphere Multifamily Finance, L.L.C.
Omaha, Nebraska

Michael J. Nelson
Chairman
FirsTier Bank
Kimball, Nebraska

Mark A. Sutko
President and Chief Executive Officer
Platte Valley State Bank
Kearney, Nebraska

Lyn Wallin Ziegenbein
Executive Director
Peter Kiewit Foundation
Omaha, Nebraska

Economic Advisory Council

(From left) Mr. Shaw, Ms. Johnson, Mr. Heilbrun, Mr. Stout, Mr. Perry, Ms. Herda

Jeff Heilbrun
Vice President, Project Development
Destination Club Partners
Jackson, Wyoming

Larissa Herda
Chairman, Chief Executive Officer and President
Time Warner Telecom
Littleton, Colorado

Deborah Johnson
Chief Executive Officer
Rick Johnson and Company Inc.
Albuquerque, New Mexico

Ralph King (not pictured)
Owner and Operator
King's Management Company Inc.
Kansas City, Kansas

Dennis Liston (not pictured)
Financial Secretary
International Brotherhood of Electrical Workers
Kansas City, Missouri

Russell M. Perry
President
Perry Publishing and Broadcasting Company
Oklahoma City, Oklahoma

Tom B. Price (not pictured)
President
UFCW District Union Local Two, AFL-CIO
Kansas City, Missouri

Joe Roetheli (not pictured)
Chief Executive Officer
Key Companies & Associates
North Kansas City, Missouri

Michael Shaw
President and Owner
Mike Shaw Chevrolet, Buick, Saab
Denver, Colorado

John Stout
Chief Executive Officer
Plaza Belmont Management Group, L.L.C.
Shawnee Mission, Kansas

Community Development Advisory Council

(From left) Ms. Capps, Ms. Fennell, Mr. Kenny, Ms. Noonan, Ms. Wells, Ms. Tinney, Mr. Jensen, Ms. Grimaldi

Linda Capps
Vice Chairman
Citizen Potawatomi Nation
Shawnee, Oklahoma

Patricia B. Fennell
Executive Director
Latino Community Development Agency
Oklahoma City, Oklahoma

Carol A. Grimaldi
Executive Director
Brush Creek Community Partners
Kansas City, Missouri

Edward F. Honesty, Jr. (not pictured)
President and Chief Operating Officer
Best Harvest Bakeries
Kansas City, Kansas

Robert Jensen
Chief Operating Officer
Wyoming Business Council
Cheyenne, Wyoming

Tim Kenny
Executive Director
Nebraska Investment Finance Authority
Lincoln, Nebraska

Linda Tinney
Vice President, Community Development
U.S. Bank
Denver, Colorado

Agnes Noonan
Executive Director
WESST Corporation
Albuquerque, New Mexico

Robin Wells
Senior Vice President
Country Club Bank
Kansas City, Missouri

Advisory Council on Payments

Kansas City

Tim Connealy
Executive Vice President and
Chief Operating Officer
Bank Midwest
Kansas City, Missouri

Lloyd Davidson
President
First Bank Kansas
Salina, Kansas

William Esry
President and
Chief Executive Officer
Blue Ridge Bank & Trust Co.
Kansas City, Missouri

Steve Hipp
Executive Vice President
INTRUST Bank, N.A.
Wichita, Kansas

Denver

Mark Frank
Senior Vice President and
Senior Operations Executive
CoBiz Bank, N.A.
Denver, Colorado

James A. Reuter
President
FirstBankData Corporation
Lakewood, Colorado

Oklahoma City

Scott Copeland
Executive Vice President
BancFirst
Oklahoma City, Oklahoma

C.H. Wyatt, Jr.
Vice Chair and
President
Interbank
Elk City, Oklahoma

Omaha

Craig E. Champion
Senior Vice President
TierOne Bank
Lincoln, Nebraska

Alan L. Fosler
Senior Vice President and
Cashier
Union Bank and Trust Company
Lincoln, Nebraska

Gerald E. Wortman
President and
Chief Executive Officer
Sherman County Bank
Loup City, Nebraska

Credit Union Customer Advisory Council Oklahoma City Branch

Kevin Bilbrey
President
Halliburton Employees
Federal Credit Union
Duncan, Oklahoma

Janice Caster
Managing Officer
El Reno RIL Credit Union
El Reno, Oklahoma

William Counts
President and
Chief Executive Officer
Communication Federal
Credit Union
Oklahoma City, Oklahoma

Terri Davis
Vice President
66 Federal Credit Union
Bartlesville, Oklahoma

Tom Eaton
Managing Officer
St. Francis Employees
Federal Credit Union
Tulsa, Oklahoma

Denise Floyd
President and
Chief Executive Officer
Fort Sill Federal
Credit Union
Fort Sill, Oklahoma

Mark W. Kelly
President and
Chief Executive Officer
Oklahoma Employees
Credit Union
Oklahoma City, Oklahoma

Mike Kloiber
President and
Chief Executive Officer
Tinker Federal
Credit Union
Oklahoma City, Oklahoma

Lynette Leonard
President
Allegiance Credit Union
Oklahoma City, Oklahoma

Steve Rasmussen
President and
Chief Executive Officer
FAA Employees
Credit Union
Oklahoma City, Oklahoma

Marsha Schmidt
President
Red Crown Federal
Credit Union
Tulsa, Oklahoma

Tenth District

Officers

Kansas City

Thomas M. Hoenig
President and
Chief Executive Officer

Richard K. Rasdall, Jr.
First Vice President and
Chief Operating Officer

Alan D. Barkema
Senior Vice President

Kelly J. Dubbert
Senior Vice President and
Chief Information Officer

Esther L. George
Senior Vice President

Barbara S. Pacheco
Senior Vice President

Kent M. Scott
Senior Vice President

Gordon H. Sellon, Jr.
Senior Vice President and
Director of Research

Charles L. Bacon, Jr.
Senior Vice President,
General Counsel and
Secretary

Craig S. Hakkio
Senior Vice President and
Special Advisor on
Economic Policy

Stephen E. McBride
Senior Vice President and
General Auditor

Todd E. Clark
Vice President and
Economist

Denise I. Connor
Vice President

Anita F. Costanza
Vice President

Steven D. Evans
Vice President

Janel K. Frisch
Vice President and
Chief Financial Officer

George A. Kahn
Vice President

Kevin L. Moore
Vice President

Dawn B. Morhaus
Vice President

Charles S. Morris
Vice President

Karen A. Pennell
Vice President

Diane M. Raley
Vice President and
Public Information
Officer

Randy M. Schartz
Vice President

Stacey L. Schreft
Vice President and
Economist

Linda S. Schroeder
Vice President

Veronica R. Sellers
Vice President and
Associate General Counsel

Stuart E. Weiner
Vice President, Economist and
Director of Payments System
Research

Susan E. Zubradt
Vice President

Josias A. Aleman
Assistant Vice President and
Assistant General Auditor

Larry D. Bailey
Assistant Vice President

Stanley R. Beatty
Assistant Vice President

Debra L. Bronston
Assistant Vice President
and Equal Employment
Opportunity Officer

Harriet I. Chern
Assistant Vice President

Michael R. Childs
Assistant Vice President

Paul S.J. Coquillette
Assistant Vice President and
Community Affairs Officer

Kelley D. Courtright
Assistant Vice President

Kristi A. Coy
Assistant Vice President

Kevin J. Craig
Assistant Vice President

Tanya L. Cvetan
Assistant Vice President

James R. Deis
Assistant Vice President

Dennis V. Denney
Assistant Vice President

Linda K. Edwards
Assistant Vice President

C. Alan Garner
Assistant Vice President and
Economist

Lori D. Haley
Assistant Vice President

Ann L. Hoelting
Assistant Vice President

Mark C. Horan
Assistant Vice President

James H. Hunter
Assistant Vice President

Lowell C. Jones
Assistant Vice President

William R. Keeton
Assistant Vice President and
Economist

W. Todd Mackey
Assistant Vice President and
Assistant Secretary

D. Michael Manies
Assistant Vice President

Renu A. Mehra
Assistant Vice President

Korie S. Miller
Assistant Vice President

Randall L. Mueller
Assistant Vice President

Annette K. Owens
Assistant Vice President

Wayne M. Powell
Assistant Vice President

Michael R. Steckline
Assistant Vice President

Leesa Guyton Thompson
Assistant Vice President

Wilmer R. Ullmann
Associate General Counsel and
Ethics Officer

Donna J. Ward
Assistant Vice President

Kathryn A. Webster
Assistant Vice President

Ginger K. Wise
Assistant Vice President

Kristina J. Young
Assistant Vice President

Catherine A. Zeigler
Assistant Vice President

Denver

Pamela L. Weinstein
Vice President

Megan L. Hruda
Assistant Vice President

Debbie L. Meyers
Assistant Vice President

Dennis J. Stansbury
Assistant Vice President

Oklahoma City

Chad R. Wilkerson
Assistant Vice President,
Branch Executive and
Economist

Robert W. Toler
Assistant Vice President

Omaha

Jason R. Henderson
Assistant Vice President,
Branch Executive and
Economist

Kevin A. Drusch
Vice President

D. Rick Lay
Assistant Vice President

Ronald M. Ryan
Assistant Vice President

Federal Reserve Bank Directors

The Board of Directors of a Federal Reserve Bank is filled through a unique blend of appointed and elected positions. The nine-member panel is divided evenly among three classifications. All directors serve staggered three-year terms.

CLASS A

The three Class A directors represent commercial banks that are members of the Federal Reserve System. These directors are bankers who are nominated and elected by member banks within the Tenth Federal Reserve District. This District includes western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico.

Under the Class A category, a director will be elected by a specific group of member banks classified as either 1, 2 or 3. This classification is based on the total amount of capital and surplus for each commercial bank, with Group 1 banks being the largest. Each group within the class elects one director.

For example, Robert C. Fricke, president and chief executive officer of the Farmers & Merchants Bank of Ashland, Neb., is a Class A director, who was elected by, and represents, Group 3 member banks.

CLASS B

The three Class B directors represent the public. Class B directors may not be an officer, director or employee of a bank or a bank holding company. However, these directors are also elected by member banks under the same categories as Class A directors. For example, Dan L. Dillingham, chief executive officer of Dillingham Insurance of Enid, Okla., is a Class B director elected by Group 2 member banks.

CLASS C

The three Class C directors also represent the public. These directors, however, are appointed by the Board of Governors of the Federal Reserve System.

Like a Class B director, a Class C director may not be an officer, director or employee of a bank or a bank holding company. These directors may not own stock in a bank or a bank holding company. From the Class C directors, the Board of Governors selects one person as chairman and another as deputy chairman.

THE BOARD OF DIRECTORS

Federal Reserve Bank of Kansas City

Reserve Bank directors meet monthly to oversee the Bank's operations and policies and to confer on economic and banking developments. The directors also provide information on economic conditions within the District as a part of the Bank president's preparation for Federal Open Market Committee meetings. Among directors' responsibilities is establishing the Bank's discount rate, which is subject to review and determination by the Federal Reserve Board. These directors and their classifications are on Page 42.

THE BRANCHES

Denver, Omaha and Oklahoma City

Each branch of the Federal Reserve Bank of Kansas City also has its own seven-member Board of Directors. Four of these directors are appointed by the Federal Reserve Bank of Kansas City while three are appointed by the Board of Governors. Branch directors serve three-year terms and provide their respective branch executives with insight on regional economic conditions as well as offer advice and counsel. Branch directors are on Pages 43-45.

Financial Report

Federal Reserve Bank of Kansas City

Federal Reserve Bank of Kansas City

925 Grand Boulevard
Kansas City, Missouri 64198-0001
(816) 881-2000

To the Board of Directors:

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

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

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

Thomas M. Hoenig
President

Richard K. Rasdall, Jr.
First Vice President

Janel K. Frisch
Vice President, Chief Financial Officer

Federal Reserve Bank of Kansas City
March 5, 2007

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
1055 Broadway, 10th Floor
Kansas City MO 64105
Telephone (816) 472 7921
Facsimile (816) 218 1890

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 Kansas City

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

Financial statements

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

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

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

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

Internal control over financial reporting

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

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

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

PricewaterhouseCoopers LLP

March 12, 2007

Federal Reserve Bank of Kansas City

STATEMENTS OF CONDITION (in millions)

As of December 31, 2006 and 2005

	2006	2005
ASSETS		
Gold certificates	$ 324	$ 318
Special drawing rights certificates	66	66
Coin	62	61
Items in process of collection	560	591
Loans to depository institutions	7	11
U.S. government securities, net	22,946	21,219
Investments denominated in foreign currencies	271	246
Accrued interest receivable	197	165
Interdistrict settlement account	4,733	2,422
Bank premises and equipment, net	174	101
Other assets	12	10
Total assets	$ 29,352	$ 25,210
LIABILITIES AND CAPITAL		
LIABILITIES		
Federal Reserve notes outstanding, net	$ 27,053	$ 22,816
Securities sold under agreements to repurchase	867	863
Deposits:		
Depository institutions	546	655
Other deposits	2	2
Deferred credit items	435	456
Interest on Federal Reserve notes due U.S. Treasury	31	21
Accrued benefit costs	46	39
Other liabilities	20	8
Total liabilities	29,000	24,860
CAPITAL		
Capital paid-in	176	175
Surplus (including accumulated other comprehensive loss of $6 million at December 31, 2006)	176	175
Total capital	352	350
Total liabilities and capital	$ 29,352	$ 25,210

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

Federal Reserve Bank of Kansas City

STATEMENTS OF INCOME (in millions)

For the years ended December 31, 2006 and 2005

	2006	2005
INTEREST INCOME		
Interest on U.S. government securities	$ 1,022	$ 781
Interest on investments denominated in foreign currencies	5	4
Interest on loans to depository institutions	1	1
Total interest income	1,028	786
Interest expense:		
Interest expense on securities sold under agreements to repurchase	39	23
Net interest income	989	763
OTHER OPERATING INCOME		
Compensation received for services provided	71	56
Reimbursable services to government agencies	10	11
Foreign currency gains (losses), net	16	(38)
Other income	3	2
Total other operating income	100	31
OPERATING EXPENSES		
Salaries and other benefits	114	109
Occupancy expense	8	9
Equipment expense	9	9
Assessments by Board of Governors	21	20
Other expenses	54	43
Total operating expenses	206	190
Net income prior to distribution	$ 883	$ 604
DISTRIBUTION OF NET INCOME		
Dividends paid to member banks	$ 11	$ 10
Transferred to surplus	7	22
Payments to U.S. Treasury as interest on Federal Reserve notes	865	572
Total distribution	$ 883	$ 604

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

Federal Reserve Bank of Kansas City

STATEMENTS OF CHANGES IN CAPITAL (in millions)

For the years ended December 31, 2006 and 2005

	Capital Paid-In	Surplus: Net Income Retained	Surplus: Accumulated Other Comprehensive Loss	Surplus: Total Surplus	Total Capital
Balance at January 1, 2005 (3.1 million shares)	$ 153	$ 153	$ -	$ 153	$ 306
Net change in capital stock issued (0.4 million shares)	22	-	-	-	22
Transferred to surplus	-	22	-	22	22
Balance at December 31, 2005 (3.5 million shares)	$ 175	$ 175	$ -	$ 175	$ 350
Net change in capital stock issued (0.0 million shares)	1	-	-	-	1
Transferred to surplus	-	7	-	7	7
Adjustment to initially apply FASB Statement No. 158	-	-	(6)	(6)	(6)
Balance at December 31, 2006 (3.5 million shares)	$ 176	$ 182	$ (6)	$ 176	$ 352

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

1. STRUCTURE

The Federal Reserve Bank of Kansas City ("Bank") is part of the Federal Reserve System ("System") and one of the twelve Reserve Banks ("Reserve Banks") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act"), which established the central bank of the United States. The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branches in Denver, Colorado; Oklahoma City, Oklahoma; and Omaha, Nebraska serve the Tenth Federal Reserve District, which includes Colorado, Kansas, Nebraska, Oklahoma, Wyoming, and portions of Missouri and New Mexico.

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

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

2. OPERATIONS AND SERVICES

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

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

In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. The FRBNY is authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange ("FX") and securities contracts for, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. The FRBNY is authorized and directed by the FOMC to maintain reciprocal currency arrangements ("FX swaps") with two central banks and "warehouse" foreign currencies for the U.S. Treasury and Exchange Stabilization Fund ("ESF") through the Reserve Banks. In connection with its foreign currency activities, the FRBNY may enter into transactions that contain varying degrees of off-balance-sheet market risk that results from their future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits and performing daily monitoring procedures.

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

Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include: Customer Relations and Support Office/ Customer Contact Center, People*Soft* Support Center, and Billing Operations Site.

During 2005, the Federal Reserve Bank of Atlanta ("FRBA") was assigned the overall responsibility for managing the Reserve Banks' provision of check services to depository institutions, and, as a result, recognizes total System check revenue on its Statements of Income. Because the other eleven Reserve Banks incur costs to provide check services, a policy was adopted by the Reserve Banks in 2005 that required that the FRBA compensate the other Reserve Banks for costs incurred to provide check services. In 2006, this policy was extended to ACH services, which are managed by the FRBA, as well as to Fedwire funds transfer and securities transfer services, which are managed by the FRBNY. The FRBA and the FRBNY compensate the other Reserve Banks for the costs incurred to provide these services. This compensation is reported as a component of "Compensation received for services provided," and the Bank would have reported $66 million as compensation received for services provided had this policy been in place in 2005 for ACH, Fedwire funds transfer and securities transfer services.

3. SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

a. Gold and Special Drawing Rights Certificates

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

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

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

b. Loans to Depository Institutions

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

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

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

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

d. Securities Sold Under Agreements to Repurchase and Securities Lending

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

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

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

e. FX Swap Arrangements and Warehousing Agreements

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

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

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

f. Bank Premises, Equipment and Software

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

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

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

g. Interdistrict Settlement Account

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

h. Federal Reserve Notes

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

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

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

"Federal Reserve notes outstanding, net" in the Statements of Condition represents the Bank's Federal Reserve notes outstanding, reduced by the currency issued to the Bank but not in circulation, of $3,717 million and $5,016 million at December 31, 2006 and 2005, respectively.

i. Items in Process of Collection and Deferred Credit Items

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

j. Capital Paid-in

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

k. Surplus

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

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

l. Interest on Federal Reserve Notes

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

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

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

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

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

n. Assessments by the Board of Governors

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

o. Taxes

The Reserve Banks are exempt from federal, state and local taxes, except for taxes on real property. The Bank's real property taxes were $1 million for each of the years ended December 31, 2006 and 2005, and are reported as a component of "Occupancy expense" in the Statements of Income.

p. Restructuring Charges

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

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

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

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

	Before Application of Statement 158	Adjustments	After Application of Statement 158
Accrued benefit costs	$ 40	$ 6	$ 46
Total liabilities	$ 28,994	$ 6	$ 29,000
Surplus	$ 182	$ (6)	$ 176
Total capital	$ 358	$ (6)	$ 352

4. U.S. GOVERNMENT SECURITIES, SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE AND SECURITIES LENDING

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank's allocated share of SOMA balances was approximately 2.928 percent and 2.828 percent at December 31, 2006 and 2005, respectively.

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

	2006	2005
Par value:		
U.S. government:		
Bills	$ 8,112	$ 7,673
Notes	11,782	10,751
Bonds	2,914	2,626
Total par value	22,808	21,050
Unamortized premiums	255	249
Unaccreted discounts	(117)	(80)
Total allocated to the Bank	$ 22,946	$ 21,219

At December 31, 2006 and 2005, the fair value of the U.S. government securities allocated to the Bank, excluding accrued interest, was $23,306 million and $21,707 million, respectively, as determined by reference to quoted prices for identical securities.

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

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

At December 31, 2006 and 2005, the total contract amount of securities sold under agreements to repurchase was $29,615 million and $30,505 million, respectively, of which $867 million and $863 million were allocated to the Bank. The total par value of the SOMA securities that were pledged for securities sold under agreements to repurchase at December 31, 2006 and 2005 was $29,676 million and $30,559 million, respectively, of which $869 million and $864 million was allocated to the Bank. The contract amount for securities sold under agreements to repurchase approximates fair value.

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

	U.S. Government Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	$ 1,189	$ 867
16 days to 90 days	5,297	-
91 days to 1 year	5,421	-
Over 1 year to 5 years	6,564	-
Over 5 years to 10 years	1,981	-
Over 10 years	2,356	-
Total allocated to the Bank	$ 22,808	$ 867

At December 31, 2006 and 2005, U.S. government securities with par values of $6,885 million and $3,776 million, respectively, were loaned from the SOMA, of which $201 million and $107 million, respectively, were allocated to the Bank.

5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and with the Bank for International Settlements and invests in foreign government debt instruments.

Foreign government debt instruments held include both securities bought outright and securities purchased under agreements to resell. These investments are guaranteed as to principal and interest by the issuing foreign governments.

The Bank's allocated share of investments denominated in foreign currencies was approximately 1.321 percent and 1.300 percent at December 31, 2006 and 2005, 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):

	2006	2005
European Union Euro:		
Foreign currency deposits	$ 83	$ 71
Securities purchased under agreements to resell	29	25
Government debt instruments	54	46
Japanese Yen:		
Foreign currency deposits	34	34
Government debt instruments	71	70
Total allocated to the Bank	$ 271	$ 246

At December 31, 2006 and 2005, the fair value of investments denominated in foreign currencies, including accrued interest, allocated to the Bank was $270 million and $247 million, respectively. The fair value of government debt instruments was determined by reference to quoted prices for identical securities. The cost basis of foreign currency deposits and securities purchased under agreements to resell, adjusted for accrued interest, approximates fair value. Similar to the U.S. government securities discussed in Note 4, unrealized gains or losses have no effect on the ability of a Reserve Bank, as a central bank, to meet its financial obligations and responsibilities.

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

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

	European Euro	Japanese Yen	Total
Within 15 days	$ 58	$ 34	$ 92
16 days to 90 days	32	16	48
91 days to 1 year	32	29	61
Over 1 year to 5 years	44	26	70
Over 5 years to 10 years	-	-	-
Over 10 years	-	-	-
Total allocated to the Bank	$ 166	$ 105	$ 271

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

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

6. BANK PREMISES, EQUIPMENT AND SOFTWARE

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

	2006	2005
Bank premises and equipment:		
Land	$ 36	$ 40
Buildings	17	29
Building machinery and equipment	6	10
Construction in progress	114	27
Furniture and equipment	55	56
Subtotal	$ 228	$ 162
Accumulated depreciation	(54)	(61)
Bank premises and equipment, net	$ 174	$ 101
Depreciation expense, for the years ended	$ 5	$ 7

The Bank is constructing a new building to replace the head office in Kansas City. Approximately $29 million of costs associated with the acquisition of land and site preparation for the new building are included in Land, and approximately $114 million of costs associated with the construction of the new building are included in Construction in progress.

In July 2005, the Bank completed the sale and leaseback of its head office in Kansas City. The Bank will lease the space from the purchaser until the new building is completed in 2008. In October 2006, the Bank completed the sale and leaseback of its branch office in Oklahoma City, with the current lease running through September 2011.

The Bank leases space to outside tenants with remaining lease terms ranging from one to two years. Rental income from such leases was not material for the years ended December 31, 2006 and 2005. Future minimum lease payments under noncancelable agreements in existence at December 31, 2006 were not material.

The Bank has capitalized software assets, net of amortization, of $4 million and $2 million at December 31, 2006 and 2005, respectively. Amortization expense was $1 million for each of the years ended December 31, 2006 and 2005. Capitalized software assets are reported as a component of "Other assets" in the Statements of Condition and the related amortization is reported as a component of "Other expenses" in the Statements of Income.

Due to the Bank's restructuring plan, as discussed in Note 11, the branch facilities in Omaha and Oklahoma City were impaired in 2006 and 2005, respectively. Assets impaired include land, building, building machinery and equipment, as well as furniture and equipment. Also in 2006, office furniture at the head office in Kansas City was impaired due to the decision to sell the furniture once the transition to the new building is completed. Asset impairment losses of $13 million and $5 million for the periods ending December 31, 2006 and 2005, respectively, were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses" in the Statements of Income.

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2006, the Bank was obligated under noncancelable leases for premises and equipment with remaining terms ranging from one to approximately five years. These leases provide for increased rental payments based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was $4 million and $3 million for the years ended December 31, 2006 and 2005, respectively. Certain of the Bank's leases have options to renew.

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

2007	$	2,775
2008		1,179
2009		187
2010		180
2011		133
Thereafter		-
Future minimum rental payments	$	4,454

At December 31, 2006, there were no other material 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 that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under the agreement at December 31, 2006 or 2005.

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

8. RETIREMENT AND THRIFT PLANS

Retirement Plans

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

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

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

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $4 million for each of the years ended December 31, 2006 and 2005, and are reported as a component of "Salaries and other benefits" in the Statements of Income. The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2006 and 2005, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.

9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits other than Pensions

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

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

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

	2006	2005
Accumulated postretirement benefit obligation at January 1	$ 38.8	$ 24.9
Service cost-benefits earned during the period	1.0	0.9
Interest cost of accumulated benefit obligation	1.8	1.9
Actuarial (gain) loss	(0.9)	13.6
Curtailment gain	(0.2)	-
Contributions by plan participants	1.0	0.8
Benefits paid	(2.5)	(3.3)
Plan amendments	(0.4)	-
Accumulated postretirement benefit obligation at December 31	$ 38.6	$ 38.8

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

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

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

	2006	2005
Fair value of plan assets at January 1	$ -	$ -
Contributions by the employer	1.5	2.5
Contributions by plan participants	1.0	0.8
Benefits paid	(2.5)	(3.3)
Fair value of plan assets at December 31	$ -	$ -
Unfunded postretirement benefit obligation	$ 38.6	$ 38.8
Unrecognized prior service cost		$ 7.6
Unrecognized net actuarial loss		(13.8)
Accrued postretirement benefit cost		$ 32.6
Amounts included in accumulated other comprehensive loss are shown below (in millions):		
Prior service cost	$ 5.7	
Net actuarial loss	(12.2)	
Deferred curtailment gain	0.7	
Total accumulated other comprehensive loss	$ (5.8)	

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

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

	2006	2005
Health care cost trend rate assumed for next year	9.00%	9.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	5.00%	5.00%
Year that the rate reaches the ultimate trend rate	2012	2011

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2006 (in thousands):

	One Percentage Point Increase	One Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	$ 16	$ (52)
Effect on accumulated postretirement benefit obligation	$ 233	$ (551)

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

	2006	2005
Service cost-benefits earned during the period	$ 1.0	$ 0.9
Interest cost on accumulated benefit obligation	1.8	1.9
Amortization of prior service cost	(1.6)	(1.5)
Recognized net actuarial loss	0.6	0.7
Total periodic expense	$ 1.8	$ 2.0
Curtailment gain	-	(1.0)
Net periodic postretirement benefit expense	$ 1.8	$ 1.0
Estimated amounts that will be amortized from accumulated other comprehensive loss into net periodic postretirement benefit expense in 2007 are shown below (in millions):		
Prior service cost	$ (1.4)	
Actuarial loss	0.4	
Total	$ (1.0)	

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

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

The curtailment gains associated with restructuring programs announced in 2005 and 2006 that are described in Note 11 will be used to offset unrecognized losses. As a result, an unrecognized net curtailment gain was recorded in 2005 when the affected employees terminated employment. Also, a deferred curtailment gain was recorded in 2006 as a component of accumulated other comprehensive loss; the gain will be recognized in net income in 2008 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, retroactive to January 1, 2004, are reflected in the accumulated postretirement benefit obligation as actuarial gain and actuarial loss in 2006 and 2005, respectively.

There were no receipts of federal Medicare subsidies in the year ended December 31, 2006. Expected receipts in the year ending December 31, 2007, related to payments made in the year ended December 31, 2006, are $0.2 million.

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

	Without Subsidy	With Subsidy
2007	$ 2.8	$ 2.5
2008	3.0	2.7
2009	3.2	2.9
2010	3.4	3.1
2011	3.7	3.4
2012-2016	21.2	18.8
Total	$ 37.3	$ 33.4

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 were $6 million for each of the years ended December 31, 2006 and 2005. This cost is included as a component of "Accrued benefit costs" in the Statements of Condition. Net periodic postemployment benefit expense included in 2006 and 2005 operating expenses were $1 million for both years, and are recorded as a component of "Salaries and other benefits" in the Statements of Income.

10. ACCUMULATED OTHER COMPREHENSIVE INCOME

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

	Amount Related to Postretirement Benefits other than Pensions
Balance at December 31, 2005	$ -
Adjustment to initially apply FASB Statement No. 158	(6)
Balance at December 31, 2006	$ (6)

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

11. BUSINESS RESTRUCTURING CHARGES

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

	Total Estimated Costs	Accrued Liability 12/31/2005	Year-ended 12/31/2006		Accrued Liability 12/31/2006
			Total Charges	Total Paid	
Employee separation	$ 5	$ 3	$ 3	$ 3	$ 3

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 198, including 120 and 78 staff reductions related to restructuring announced in 2006 and 2005, respectively. Costs related to staff reductions for the years ended December 31, 2006 and 2005 are reported as a component of "Salaries and other benefits" in the Statements of Income.

Restructuring costs associated with the impairment of certain Bank assets, including land, building, building machinery and equipment, as well as furniture and equipment, are discussed in Note 6. Costs associated with enhanced postretirement benefits are disclosed in Note 9.

Future costs associated with the announced plans are not material.

The Bank anticipates substantially completing its announced plans by year-end 2008.

VOLUME OF PRINCIPAL OPERATIONS (UNAUDITED)*

	2006	2005
Loans and Discounts, Daily Average	$ 22,078,000	$ 17,263,000
Number of Institutions Borrowing	78	75
Commercial Checks - Paper	$ 1,099,366,000,000	$ 1,165,527,000,000
Commercial Checks Processed	878,353,000	1,134,406,000
Commercial Checks - Check 21	$ 425,781,000,000	$ 137,114,000,000
Commercial Checks Received	177,450,000	27,612,000
Currency Receipts and Payments	$ 47,525,209,000	$ 57,636,344,000
Pieces	3,112,862,000	3,663,851,000
Coin Receipts and Payments	$ 138,556,000	$ 165,361,000
Bags	243,000	313,000
Redemption of U.S. Treasury Securities	$ 303,679,500,000	$ 314,303,266,000
Funds Transfers	$ 84,280,053,000,000	$ 83,231,378,000,000
Number of Transfers	49,626,000	50,847,000

*Numbers are not included in PricewaterhouseCoopers' audit.

Auditor Independence

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