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A Public Trust

As the nation’s central bank, the Federal Reserve has a unique “independent within government” structure designed by its creators to insulate monetary policy and the nation’s financial system from political pressures. Under this structure, the Board of Governors of the Federal Reserve System is a federal government agency, but the 12 regional Reserve Banks blend aspects of public and private entities. Although the Reserve Banks operate under the broad oversight of the Board of Governors, each Reserve Bank has its own local Board of Directors.

This unique structure brings with it a unique set of responsibilities. In its first annual report, issued only two months after the Reserve Banks began operations, the Board of Governors referenced the Federal Reserve’s unique position as an entity that is “invested with much of the quality of a public trust.” As such, it is important that the Federal Reserve operates in a manner that allows the public the opportunity to understand both the purpose and the process of the nation’s central bank.

Along these lines, in recent years, much has been written about the efforts of the Federal Reserve’s Federal Open Market Committee to bring more transparency into the monetary policy process. As recently as 1993, FOMC decisions about changing the federal funds rate target were not announced until at least six weeks after each FOMC meeting. Today, not only is the rate target announced immediately after each meeting, but also the FOMC comments on economic conditions and risks it sees for the economy. This move toward greater transparency has helped to reduce uncertainty in financial markets—an important aspect in maintaining stability within the financial system.

The conduct of monetary policy is the most publicly visible of the Federal Reserve’s mission areas. The importance of transparency, however, extends into all of the Federal Reserve’s operations. It is important, for example, that the public have an opportunity to understand our work in regulating and supervising financial institutions as well as the financial services we provide to those institutions. It is also important to know the individuals who direct our Bank’s work in the Tenth District.

The Board of Directors of a Federal Reserve Bank is designed to represent the banking, business, industry and public trust of each Federal Reserve District. These directors serve a unique role. In addition to the duties normally associated with a corporate board, Reserve Bank directors serve the role of providing the Bank with current information about business conditions within our District. They are, quite literally, the Federal Reserve’s most direct tie to business, industry and community, and their first-hand reports are a vital component in the FOMC’s monetary policy deliberations.

Each Federal Reserve Bank has a Board of nine directors serving a mix of appointed and elected positions designated to represent specific constituencies. You can learn more about these positions on page 28.

To learn more about the individuals currently serving on our Board of Directors, turn to page 36 of this annual report edition of TEN. There, in addition to information about our directors, you will find information about our Bank’s management committee, officers and advisory councils as well as our financial report. Those interested in learning more about our Bank also should visit our website: www.KansasCityFed.org.

THOMAS M. HOENIG, PRESIDENT
FEDERAL RESERVE BANK OF KANSAS CITY
In the government’s race to catch up with Social Security spending, there is an even bigger problem that is about to outpace it: Medicare.

Just like Social Security, the cost of Medicare benefits promised to recipients soon will exceed the program’s pool of money. However, Medicare’s financial woes will far surpass Social Security’s as healthcare costs continue to rise faster than economic growth, says Craig Hakkio, senior vice president and director of research for the Federal Reserve Bank of Kansas City. Hakkio and researcher Elisha Wiseman recently explored the challenges of the future of Medicare and Social Security.

Neither program is sustainable under its current financial arrangement. Under current law with no changes, Social Security benefits will be cut in 2041 and Medicare’s Hospital Insurance (HI) program benefits will be cut in 2020, according to the Trustees of Social Security and Medicare. And Medicare’s Supplementary Medical Insurance (SMI) program will become a larger burden—by 2080, the federal government likely will pay six times as much as it currently pays in SMI benefits.

For both Medicare and Social Security, revenue collected by the government is “woefully inadequate” to pay for benefits promised under the current law, Hakkio says. This means slashed
benefits or tax increases will be necessary to keep the programs viable in the future.

And although the spotlight of concern seems to be shining most prominently on Social Security, the total Medicare HI and SMI shortfall will be about five times that of Social Security’s by 2080. While the implications of reduced Social Security benefits are disturbing, reduced Medicare benefits could mean life or death, Hakkio says.

“Finding long-term solutions to these problems is critical,” he says. “And the problems only become larger the longer reforms are delayed.”

In the beginning

A relatively new program, Medicare came about as an amendment to Social Security in 1965. It has evolved to cover more individuals and offer new benefits, including the recent prescription drug plan, which is part of the Medicare SMI program. Medicare HI benefits are funded primarily by payroll taxes, recipient premiums and income taxes on Social Security benefits that are split with Social Security. Seventy-five percent of Medicare SMI is paid for by the government, resulting in a direct drain on the federal budget.

Social Security was created by President Franklin Roosevelt in 1935 as a post-retirement support program for those 65 and older. There are two programs: one that pays benefits to retired workers or survivors of deceased workers, and a second that pays benefits to disabled workers and their families. Benefits are funded through the payroll taxes of current workers and the income taxes on benefits that are split with Medicare. There is a trust fund that accounts for Social Security revenues and expenditures. Benefits paid by the government are debited from this account, and tax revenue paid to the government is credited to this account.

In 2004, Social Security beneficiaries received $497.1 billion, while Medicare HI and SMI benefits were $167.6 billion and $135.4 billion, respectively. Based on predicted growth and current expenditures, providing all promised benefits in the future for either program will not be possible under current law. While Medicare and Social Security are financially possible now, changes will have to be made to ensure that promised benefits can be paid in full in the future.


The Social Security challenge

Social Security is challenged because the baby boom generation will soon reach retirement age, and program spending is growing faster than both the economy and dedicated revenues. Because all spending must be paid for, the government will be challenged to find additional revenue to pay benefits. Otherwise, spending must be cut.

The number of aging baby boomers is expected to grow much faster than the number of workers. As a result, Social Security expenditures likely will jump from the current 4.3 percent to 6.1 percent of the Gross Domestic Product, or the country’s total output. This is predicted to happen in 2030, when the last baby boomer turns 65. Beyond that, the level of expenditures will rise only slightly to 6.4 percent of the Gross Domestic Product in 2080.

“Over the next decade or so, Social Security is in sound financial shape, as dedicated revenues will more than pay for promised expenditures, even as expenditures rise,” Hakkio says.
But beginning in 2017, everything changes. Projected expenditures will exceed dedicated revenues, and the Social Security Trust Fund, which is principally funded by workers’ and beneficiaries’ taxes and debited as the government pays benefits, becomes another challenge. The fund will hold a positive balance for a while, and benefits will be paid. But when revenues fall below promised benefits, the government will be forced to find other sources to pay those benefits. This means if there are no changes in other government spending or revenue, the government’s total budget deficit will grow.

Between 2017 and 2027, the Trust Fund will spend some of its interest income. But beyond that, through 2040, the fund will continue to pay benefits by selling assets. Without change, the trustees project that the fund will run out in 2041.

“In this event, new revenue sources will be needed if the government is going to continue paying promised expenditures,” Hakkio says. “Or else, under current law, promised benefits must be cut to match revenues.”

Inarguably, both Medicare and Social Security expenses will soar steadily as the baby boom generation ages. But Medicare is facing another obstacle: sharply rising healthcare costs.

**The Medicare challenge**

From now through 2023, Social Security’s projected expenditures exceed Medicare’s. Last year, Social Security’s expenditures were about 1.6 times greater than those of Medicare. However, beginning in 2024, Medicare expenditures will be larger than Social Security’s and, by 2080, are projected to more than double them.

Medicare benefits depend on the cost of healthcare, unlike Social Security’s dependence on past earnings. As a result, Medicare spending will rise much faster than Social Security’s, making its fiscal challenge pale by comparison, Hakkio says. Healthcare costs are increasing more rapidly than the economy—about 2 percentage points faster during the past 50 years. Medicare HI expenditures already exceeded dedicated revenues in 2004 and are predicted to keep doing so, depleting the Trust Fund in
2020. Once this happens, promised expenditures will have to decrease to equal revenues, just like Social Security.

**A sizable feat**

The main long-term problem is that the Social Security and Medicare programs’ spending is growing faster than the economy, while the revenue is growing at about the same rate as the economy. Combined benefits currently total about 6 percent of the Gross Domestic Product, but by 2080, that number is estimated to grow to 20 percent. Because this spending must be paid for and dedicated revenue won’t cover the cost, the government must find additional money to pay benefits. Otherwise, benefits must be cut to reduce spending.

“The dedicated sources of revenue available to the government are woefully inadequate for financing the benefits promised to current and future beneficiaries,” Hakkio says.

It is estimated that the present value of the combined programs’ future shortfall during the next 75 years is $35.6 trillion, or about $119,000 per person. Funds need to be increased by this amount (in present value), or benefits would need to be cut in order to balance revenues and expenditures during this time period.

The size of this predicted shortfall is unprecedented. In comparison, it is more than four-and-a-half times the amount of the current government debt, which was $7.9 trillion at the end of the 2005 fiscal year. And beyond 2080, the projected shortfall is even larger.

“The magnitude of the fiscal challenge facing the United States—finding the revenue to pay for these expenditures—is growing,” Hakkio says.

**The future: Don’t wait**

“With a fiscal challenge so large, there may be a tendency to postpone taking action,” Hakkio says.

Delayed action is a mistake for a couple of reasons. First, if benefits have to be cut or if taxes have to be raised, then individuals would need ample time to plan and adjust. Additionally, the problem only gets larger the longer the government waits to act.

**Federal Revenue Shortfall from Social Security and Medicare**

With the gap between benefits and dedicated revenue so large, changes must be made to the Medicare and Social Security programs. There are three options: reduce government spending on theses or other government programs; increase revenues from payroll taxes, from premium income, or from other government taxes, or run larger budget deficits and have the government borrow money from the public. Because of the massive size of the challenge, it is not likely that larger budget deficits would be feasible.

“Any viable solution is likely to involve changes in the Social Security and Medicare programs themselves, along with changes in other government spending of revenue,” Hakkio says.

**BY BRYE STEEVES, SENIOR WRITER**

**FURTHER RESOURCES**

SOcial Security and Medicare: The Impending Fiscal Challenge

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**COMMENTS/QUESTIONS** are welcome and should be sent to teneditors@kc.frb.org.
Marian Light was running errands in her hometown of Kansas City one afternoon when she made a quick stop at a 7-Eleven for a fountain drink. Her payment method: a dollar bill and some coins fished from the depths of her purse.

“I just would feel silly charging something under $2,” Light said. “And I don’t have a debit card.”

Banks and credit card issuers want to change that purchasing philosophy by converting what traditionally have been cash purchases at quick-service merchants into electronic payments—and the “contactless” payment method may be the way to make that transition happen, said Terri Bradford, a payments system research specialist for the Federal Reserve Bank of Kansas City, who recently authored an article on contactless payment.

So instead of digging for money, paying the cashier and fumbling with change, Light could complete the entire transaction with just a wave of her hand. By flashing a contactless debit or credit card in front of a small terminal at the register, Light could cut her transaction time by as much as half. And not just at the convenience store, but also at fast food restaurants, gas stations, movie theaters and other businesses with this newest fast-pay capability.

“One challenge for networks and...
issuers is to get cardholders to use their existing cards more, in particular as a replacement for cash,” Bradford said. “Toward that end, the card industry is trying to make acceptance of card products more appealing.”

This means offering customers a method that is quicker than a cash transaction and more convenient than entering a PIN or signing a receipt. Although eliminating this verification step could mean easier access by non-authorized users, the small purchase limit on the contactless device prevents major trouble if it is lost or stolen. Plus, cardholders wouldn’t be liable for fraudulent use.

If Light’s bank issues her a contactless debit card, she will use it—contactless seems fast and easy, she said. But Light also supposed she’d be shopping more often and buying more than just a soda because she wouldn’t be limited to cash on hand.

That’s exactly what card issuers are predicting: increased small-purchase spending, and in turn, gained revenue from what would have been cash purchases. For merchants, customer loyalty and patronage likely would rise as a result of the ease of shopping. This would help offset any additional costs such as new equipment and transaction fees.

How it works

The contactless payment method works like debit and credit payments do, but doesn’t require a physical swipe to make the purchase. Instead, radio frequencies embedded in the contactless device complete the purchase when it’s flashed in front of the payment terminal. The customer sees a confirmation signal, and no additional steps are needed to complete the transaction.

The device can look like a traditional debit or credit card, or the technology can be embedded in other items such as key fobs (similar to frequent-shopper cards from grocery stores or small wands). Meanwhile, card issuers also are exploring placing the technology into other items for convenience such as cell phones, watches and money clips.

The functional goal of contactless payment for merchants and customers is speed. Because the check-out process is streamlined, less staff time at the cash register is necessary, and the time customers spend waiting in line and actually paying are both reduced.

Research from CVS—which recently implemented the method at 5,500 pharmacy stores nationwide, including in the Midwest—shows the average contactless transaction is 12.5 seconds while a traditional card transaction is 26.7 seconds and cash is 33.7 seconds.

Evolving to contactless payment

In 2005, paying with a debit card tied with cash as the most frequently used payment method for in-store purchases, according to a study from American Bankers Association and Dove Consulting. And during the last two years, 45 percent of consumers reported paying less
SPRING 2006 · TEN

often with cash. Their substitution: debit cards (53 percent), credit cards (40 percent) and checks (7 percent), according to the study.

To spur continued growth in card payments, issuers now are promoting the contactless payment method, although the technology and concept is not new. In 2003, both American Express and MasterCard launched their own versions of contactless payment cards, as did Visa in 2004. Banks also have begun to distribute contactless debit and credit cards to current and new cardholders.

However, ExxonMobil can be credited with launching contactless payment in the United States when the fuel company introduced its “Speedpass” almost 10 years ago. Speedpass is a free service that allows customers to pay for gas at the pump with a flash of a key fob.

Rolling out Speedpass when the contactless payment concept was a foreign one was based on a simple goal: customer convenience, said Don Turk, ExxonMobil spokesperson. Although the concept was unfamiliar and the technology was new at that time, Speedpass was embraced by many dealers and customers, Turk said. The payment option has grown steadily during the past decade; now more than 6 million Speedpass key fobs are active and can be used at more than 14,000 ExxonMobil stations nationwide.

For seven Exxon stations throughout Wyoming, installing contactless payment options is an investment in the future, said Brad Christiansen, chief operating officer for Red Eagle Oil, owner of the stations.

“Technology is going to be a market position,” he said, adding contactless payment will be an integral part of that. “They (customers) are after the convenience of it, and for us to be in the convenience business, we need to address that.”

Since its inception a few years ago, the percentage of customers in Wyoming who use ExxonMobil’s Speedpass is still small, but the payoff for the stores has been significant. The average number of times a customer visits the station has increased to 2.7 times a month from 1.7 times a month since Speedpass was introduced, Christiansen said. Contactless pay at the pump has not reduced inside business, such as snack and beverage purchases that also can be made with Speedpass. The average non-fuel purchase amount has jumped about $2.60 higher since Speedpass was introduced, he said.

“You can see the impact over the long term,” Christiansen said.

He predicts two factors will spur contactless payment growth in Wyoming and elsewhere: customer education and an increased variety of merchant use, such as at grocery stores, to make the payment option more mainstream. According to Bradford’s article, this is likely to happen, and now is the time.

“Momentum seems to be building for contactless payments,” she said. “And a rise in their use seems probable.”
Bradford suggests that the recent interest in contactless payment likely can be attributed to the widespread merchant acceptance of debit and credit card payments. This acceptance, coupled with the shift away from cash and checks, has created “a ripe atmosphere,” Bradford said. “And issuers, realizing the opportunity to capitalize on the revenues to be gained by converting cash transactions, have demonstrated both an interest and willingness to explore ways to differentiate their card products.”

While the concept is still being introduced in many Midwest businesses, several banks and credit card issuers have recently implemented contactless payment terminals around the region. Last year in Colorado, Chase Bank U.S.A. introduced its “blink” contactless payment card to hundreds of thousands of shoppers for use around the state, according to the company.

Nationwide participating merchants include McDonald’s, Arby’s, Walgreens, Cold Stone Creamery, Regal Entertainment Group movie theater chain, as well as several NFL stadiums such as Arrowhead Stadium, home to the Kansas City Chiefs.

Enticement
Card issuers want to make contactless payment attractive to merchants, who have the option whether to place a terminal at their registers. For example, Visa recently announced it would lower fees charged to certain retailers to accept debit and credit card purchases that total less than $15. Visa also raised the total purchase amount requiring a signature to $25, allowing lesser transactions to be completed faster.

Many merchants view this additional payment option as a plus for customers, but aren’t sure yet to what extent it will be used. Some merchants wonder if contactless payments will actually replace cash purchases, or if they would be used only by those who already pay with traditional debit and credit cards.

Marcy Burtin, a 7-Eleven store manager in Missouri, predicts contactless payment will be popular, especially with younger clientele. Since the beginning of the year, her store has accepted contactless payments, but only a few shoppers use them, she said.

Burtin is in favor of the new method because most of her customers—the majority pay with cash—are in a hurry. Plus, it would free up staff from the cash registers. Burtin supposes, just like anything new, it will take time for the word to spread, cards to be issued and customers to become comfortable with this new payment method.

As customers continue to make the transition away from checks and cash to debit and credit cards, Bradford speculates contactless payments may be the next “payment wave.” Her article suggests both merchant and consumer acceptance will be high in the next few years as the payment method becomes more familiar in the coming months. Contactless payment has made its introduction and should catch on.

“I think right now is the best time for this to happen,” Bradford said of the newest payment trend. “Just as the magnetic stripe expedited card payments as compared to the impression machines and telephone authorization, contactless technology has the potential to do the same.”

FURTHER RESOURCES
CONTACTLESS: THE NEXT PAYMENT WAVE?
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enny Schwab has spent two decades helping immigrants in southwest Kansas.

In her job as executive director of Western Kansas Mexican-American Ministries, a nonprofit operator of health clinics and provider of social services, Schwab has assisted countless immigrants. Ask her why these new Americans come to this windswept corner of the High Plains, and Schwab can answer almost without even thinking about it.

“Because there is work,” Schwab says. “The jobs are not all pleasant, but people come because there is work.”

When it comes to immigration, this question of “why” might be the only one with an easy answer. The rest of the questions are, at best, complex and, in many cases, emotionally charged.

Recently, William Keeton, an assistant vice president and economist at the Federal Reserve Bank of Kansas City, and Geoffrey Newton, a research associate, completed a research project exploring a complex question related to immigration that has received relatively little attention: Does immigration reduce or increase
CAN IMMIGRATION REDUCE IMBALANCES AMONG LABOR MARKETS?
imbalances among labor markets?

As perhaps should have been expected, they did not find a simple answer.

**The workers**

Since the 1960s, immigration has dramatically increased in the United States. This second wave of immigration, after the influx of Europeans in the late 1800s and early 1900s, has been criticized by some as having reduced job opportunities for native workers. Keeton and Newton did not explore that issue specifically, instead looking at how immigration can alter the allocation of all workers across markets.

A particular job market can experience job growth that is stronger than its peers for innumerable reasons—high consumer demand for a particular good or a production advantage that equates into lower consumer prices. As a job market grows, employers trying to attract employees from a dwindling supply of workers will tend to increase wages, creating a disparity with what is being paid in low-demand markets.

The authors write that the disparity between markets is an inefficient allocation of labor. Relocating workers into the high-demand markets can improve efficiency and thereby increase total production of goods and services. The problem, however, is that workers may be unwilling to relocate.

“According to some estimates … it would take 30 years for (native) migration to eliminate just half the difference in wages across the U.S.,” Keeton says.

Immigration, however, could help eliminate these market imbalances, Keeton says, if immigrants gravitate to markets where the demand for labor is strong.

To explore this issue, Keeton and Newton examined census data from the last half of the 1990s in considering two theories related to immigration trends:

- Immigrants moving to markets with exceptionally high labor demand could reduce differences in wages and unemployment between strong and weak cities.
- Immigrants moving to markets with an average or below-average demand for labor could create an excess supply of workers.
Both theories could have significant implications for immigrants, native workers and the economy.

The markets

Although southwest Kansas has received much attention for the arrival of Mexican and Latin American immigrants in recent years, Schwab says that immigration has played a vital role in the region for nearly a century. In the early 1900s, immigrant workers came to work the sugar beet crops and do other agricultural fieldwork. The recent flow of immigrants is also related to agriculture, starting in the mid-1980s with workers coming to the region's massive meatpacking operations.

While the meatpacking plants offer an opportunity for employment, southwest Kansas is not a booming job market. Still, immigration to the area remains strong. Bank research focusing on census data from the last half of the 1990s found that the southwest Kansas triangle of Dodge City, Garden City and Liberal all saw immigration rates far in excess of similar-sized communities with similar overall job demand.

In that period, Liberal had an immigration rate of 7.7 percent of its 1995 population—the third-highest figure for any community of a similar size. Rates for Dodge City and Garden City were also high at 6.4 percent and 5.4 percent, respectively. In comparison, the average for a community of a similar size was less than a percentage point at .8 percent.

Although these immigrants came to the United States looking for work, Keeton says that the decision to settle in rural Kansas was likely influenced by friends or relatives who had previously come to the same area.

“A number of studies have found that immigrants tend to move to markets where established immigrants of the same nationality are already living,” Keeton says.
In the 1990s, Colorado was home to some of the nation's hottest markets for job growth. In Denver, the 1990s were everything that the previous decade was not.

After watching its population slip 5 percent in the 1980s, Denver grew 19 percent in the 1990s, thanks largely to a single source.

“This growth was almost entirely attributable to an increase in the city's Hispanic population, the majority of whom are immigrants from Mexico,” reads the Brookings Institution's analysis at the Denver 2000 census data.

During the 1990s, Denver's foreign-born population jumped 178 percent compared with a 45 percent average increase for the nation's 100 largest cities, according to the Brookings analysis.

Denver's job market was also booming. According to the Bank's analysis, the Denver metropolitan area recorded employment growth of 21 percent during the last half of the 1990s. The figure is more than 5 percentage points higher than what would have been projected for the same period based on the region's industrial mix and above the 12.6 percent average employment growth for the nation's largest metropolitan areas during the same period.

The jobs attracted workers.

During the last half of the 1990s, the Denver metro area had an immigration rate of 3.5 percent of its approximate 1995 population—nearly twice the average of 1.8 percent for the nation's large metropolitan areas.

The Bank study also found immigration was strong in the neighboring city of Boulder, where job growth was also ahead of the national average during the same period. Boulder recorded employment growth of 18.2 percent and an immigration rate of 3.2 percent of its 1995 population.

While immigration was strong in Denver and Boulder, the two cities also experienced strong growth in the migration of U.S.-born and foreign-born individuals living in the United States, known as established immigrants.

According to the Bank study, Denver's net inflow of U.S. natives, a figure that accounts for both arriving and departing residents who were born in the United States, was 2.9 percent of the area's 1995 population—more than three times the .9 percent national average for large metropolitan areas. Meanwhile, Denver's net inflow of established immigrants was 1.4 percent, compared with an average of only .1 percent for all large metro areas. In Boulder, net inflow of U.S. natives was 2.2 percent while inflow of established immigrants was .5 percent.

The analysis

In their research, Keeton and Newton analyzed similar census data for the last half of the 1990s from numerous U.S. communities ranging from metropolitan areas to small towns. After controlling for any unrelated factors that might have influenced migration trends—the climate or favorable amenities, for example—the economists found a few clear trends:

• During the last half of the 1990s, immigrants tended to move to markets
that could be expected to experience strong job growth:
• U.S. natives tended to stay away from markets that could have been expected to receive large inflows of immigrants.

In southwest Kansas, the numbers clearly suggest a connection between inflows of immigrants and movements of native workers.

Nationwide, the average net native inflow for micropolitan areas during the period was a gain of .6 percent. However, the numbers from three southwest Kansas communities during the same period were negative, with Dodge City at -8.5 percent, Garden City at -3.9 percent and Liberal at -6.4 percent. Established immigrant inflows were mixed, with Dodge City at -9 percent and Liberal at -1.1 percent, while Garden City gained slightly at .3 percent.

Keeton and Newton currently are conducting research to determine how closely the outmigration by southwest Kansas natives relates to the arrival of immigrants.

“It is hard to tell if natives are moving out because of competition with the immigrants or if they would have moved out anyway because of rural depopulation,” Keeton says. “I suspect at least part of that outmigration is something that would have occurred anyway.”

So, looking more broadly, does immigration reduce or increase imbalances among labor markets?

The study found a little of both positions to be correct: The impact of immigration on the geographic allocation of labor is neither as adverse as opponents might suggest nor as benign as supporters sometimes claim.

“As is often the case in such controversies, the truth appears to lie somewhere in between,” the authors write.

However, Keeton says immigration could be more beneficial toward eliminating the labor market disparity if a larger percentage of immigrants living in the United States had legal status. Documented immigrants, he believes, might be more willing to relocate to stronger job markets.

Certainly the question of legal status is a major issue in the immigration debate. Census data used in the Bank’s study does, in principle, include all immigrants regardless of status. However, critics would argue that at least some undocumented workers were likely unwilling to talk to census takers.

“There’s a lot of disagreement about how many immigrants should be allowed into the U.S.,” Keeton says. “But however many immigrants do come to this country, most people agree it’s not a good situation for so many of them to be undocumented and not in the system.”

Documented workers likely also would find it easier to secure employment, which, as Schwab points out from her southwest Kansas clinic, is why the immigrants come to America.

“Anytime times get bad somewhere, people go somewhere else,” she says. “I think people would still come if the borders were closed. They need the work.”

BY TIM TODD, EDITOR

FURTHER RESOURCES

DOES IMMIGRATION REDUCE IMBALANCES AMONG LABOR MARKETS OR INCREASE THEM? EVIDENCE FROM RECENT MIGRATION FLOWS.

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COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.
For years, the Sisters of Mercy of Omaha in Nebraska saw the housing problems that plagued the disadvantaged members of the community with whom they worked. Many had difficulties with landlords, were denied loans as high-risk borrowers or lived in deteriorated housing.

The sisters decided to become part of the solution. They became landlords.

To accomplish their objective, they purchased property and they also developed a source of loan capital, establishing an organization aptly named Mercy Loan Fund. The Denver-based organization, which is a subsidiary of Mercy Housing, makes loans to developers who plan to build housing for low-income, high-risk individuals. Borrowers need not be faith-based, but they do need to be committed to providing affordable housing. Many of the investors are Catholic sisters, entrusting their retirement funds to the organization.

Mercy Loan Fund is just one type of a community development financial institution, or CDFI. This type of organization fills a void left by traditional banks, said Diane Leavesley, president of the Mercy Loan Fund.

CDFIs provide a unique range of financial products and services in economically distressed target markets, such as mortgage financing for low-income and first-time homebuyers and nonprofit developers; flexible underwriting and risk capital for needed community facilities; and technical assistance, commercial loans and investments to small startups or expanding businesses in low-income areas. CDFIs include regulated institutions such as community development banks and credit unions, and nonregulated institutions such as loan and venture capital funds.

Leavesley, a director at the Denver Branch of the Federal Reserve Bank of
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Community Development Funds Offer Financial and Social Returns
Kansas City, is careful to note that her CDFI does not compete with banks, but complements them instead.

“There are needs for gap financing that traditional banks are unable to meet,” Leavesley said. “We can provide loans with higher loan-to-value ratios and work with less-creditworthy borrowers than a banker would.”

In some cases, Mercy works with startup organizations that graduate to working with banks.

“We consider that a success,” Leavesley said.

In other cases, Mercy will be in a second position, financing a second mortgage on a property whose first mortgage is with a traditional bank, enabling the bank to remain adequately secured on the investment.

Linda Tinney, vice president and community development manager for U.S. Bank, counts Mercy Loan Fund as an important partner in their affordable-housing lending programs.

“They get projects started with their early-stage, higher-risk financing that allows us to come in behind and support,” Tinney said. In addition to their skilled management and mission-driven staff, Tinney said, CDFIs help develop the local capacity and infrastructure needed to support broader economic development.

**Filling a niche**

Because of the potential that CDFIs represent in reaching nontraditional borrowers, the Community Affairs Department of the Federal Reserve Bank of Kansas City has taken an interest.

“CDFIs set an example that financing can work in low-income and distressed communities,” said Steve Shepelwich, a senior advisor of the Community Affairs Department in the Bank’s Oklahoma City Branch. Shepelwich has been studying CDFIs in the Tenth District.

The department has taken an active role in supporting training events for CDFIs and raising awareness of the roles they can play in economic development. In Oklahoma, for example, the department co-hosted a regional training event with the Association for Enterprise Opportunity for organizations that provide support to microenterprises, as well as partnered with local CDFIs in strengthening the delivery of financial education services.

CDFIs have been around since the early 20th century, but contemporary developments helped boost their numbers. The Community Reinvestment Act of 1977 (CRA) placed the responsibility on depository institutions to lend to, invest in and serve all of the communities in which they receive deposits from customers. The mission and innovative business strategies of CDFIs have made them important partners for banks in their efforts to meet this obligation. In 1994, the federal government established the CDFI Fund within the Treasury Department with the goal of supporting CDFIs in their efforts to provide capital and financial services to underserved people and communities. CDFIs that obtain certification from the Treasury Department are eligible for various grants, loans and awards. In addition, certification indicates the CDFI has undergone a measure of due diligence into its background and operations, thereby making it
CDFIs come in many shapes and sizes, each variant seeking to fill a niche. For instance, Mercy Loan Fund is a community development loan fund; other types of CDFIs are microenterprise development loan funds, community development banks and credit unions, and community development venture capital funds. The common theme is the desire to revitalize communities and to improve the quality of life of those who live and work in these communities.

A 'double bottom line'

Shepelwich said that CDFIs present an opportunity for “social investors” who want their investments to fit their values. In industry parlance, investments that provide social as well as financial returns have a “double bottom line.” CDFIs offer individuals an opportunity to receive both a return, though often at a below-market rate (Mercy Loan Fund investors receive about 3 percent), and the assurance that their investment will be used to expand opportunities for local small businesses and community members. CDFIs offer banks and other corporations the ability to engage in new market opportunities, with reduced risk, and to contribute to corporate social responsibility goals.

CDFIs and banks frequently work as partners, with the CDFI underwriting loans while the banks provide capital. But a CDFI does much more than service the loan, depending on the niche it fills. All CDFIs offer additional services to help their clients make successful use of the financing provided. Some CDFIs offer business training and consulting services for borrowers. For people who are “unbanked,” CDFIs provide an alternative to higher-cost lenders by offering microloans and financial literacy courses.

Nationwide, CDFIs control more than $17 billion in assets, according to the CDFI Data Project, an industry database on CDFIs. The 28 certified CDFIs in the Tenth District that participated in the survey reported a total of $512 million in assets. Of this, $345 million financed housing, small business development and other development goals throughout the District. In 2004, these CDFIs financed over 900 businesses, resulting in the creation of over 750 new jobs and the creation or renovation of nearly 1,500 housing units.

While consumer loans accounted for the greatest share of the loan volume (38 percent), the survey found that 54 percent of financing dollars went to housing. Another 28 percent went to business lending with the remainder financing consumer lending and community facilities projects.

According to Shepelwich, given that only 53 of the 752 certified CDFIs in the country are located in the Tenth District, there is ample room for expansion, both in terms of the
financing offered by existing institutions as well as the number of CDFIs operating Districtwide.

A business model

The EDC Loan Corp., a subsidiary of the city-run Economic Development Corp. in Kansas City, counts a number of businesses in low-income and distressed areas as clients.

“We’ve had great success using our CDFI designation,” said Brian Standage, the director of finance for EDC Loan Corp. His organization has long used a number of products to underwrite loans to small businesses in the urban core and became CDFI-certified in late 2001. In order to receive that certification, EDC Loan Corp.’s portfolio must maintain a certain level of its investments in distressed communities.

Standage said his organization works with a handful of local and regional community banks, which receive an incentive from the Treasury Department for the loans they provide. Because banks receive that incentive, they can accept a lower rate of return from the loan, Standage said. Banks are motivated further by the potential of receiving credit toward meeting their obligations under CRA to serve the whole community.

Since becoming certified, EDC Loan Corp. has provided 29 loans totaling $1.6 million, which, in turn, have led to the creation or retention of 149 jobs and the renovation of buildings in Kansas City. Entrepreneurs need only 10 percent down for a business loan, compared with 20 percent or more required by traditional lenders.

Because of the higher risk EDC Loan Corp. takes on, underwriting is important, Standage said. A person’s creditworthiness and business plan are reviewed carefully, just as they would be at a bank.

“We want to make sure we do due diligence,” he said. “We are stringent on how we underwrite. Some lenders look at social return. We look strictly at economic return.”

One CDFI that does look mainly at social return is the First Step Fund, a microenterprise...
development loan fund in Kansas City, Mo. Though a CDFI, First Step is not certified by the Treasury Department because the program’s primary focus is not lending.

First Step provides technical training to its participants during 10- and 16-week sessions. Participants all take part in reviewing loans, and graduates of the sessions can qualify for microloans of $500 to $2,500. Graduates, whose endeavors run the gamut of enterprises—janitorial services, etiquette classes, administrative support services and bakeries—receive ongoing counseling.

“Our focus as an organization is the individual and fostering economic self-sufficiency,” said Executive Director Vanessa Finley. “The tool we use is entrepreneurship.”

Finley’s organization has created its own curriculum that teaches business planning called “First Step FastTrac,” and another program for child care providers, “Developing a Family Child Care Business.” First Step has licensed both, which are sold to sites around the country, providing the main source of revenue for First Step.

Jacqueline Buycks, a program graduate who now is vice president of First Step’s Board of Directors, said that by requiring borrowers to complete a training program first, the CDFI lowers the risk associated with the loans. Buycks operates two microenterprises, a staffing service and a bakery that she co-owns with her two sisters.

“I really believe that the training I’ve had has been instrumental in helping me make intelligent business decisions,” she said. “That is key because not every business plan is feasible.”

Another recipient of First Step’s training was Simone Bennett, operator of Almost Home Child Care. She said the training helped her run a more efficient business, a child care center that takes in 12 children full-time. This, indeed, is an example of the type of social returns that CDFIs offer.

On the other end of the CDFI spectrum are venture capital funds, which take an ownership position in their investments. MetaFund, in Oklahoma City, is one such CDFI.

MetaFund Director Tom Loy ticks off the businesses his firm has invested in—everything from a sod farm to a Native American newspaper.

“Almost everything we invest in is too early-stage or too undercapitalized for a bank to consider,” he said.

Furthermore, all his investments have the potential to yield social returns.

“Everything we do we hope is either creating jobs or housing or otherwise directly benefiting low- or moderate-income people, or residents of distressed geographic areas, which is a broad definition of the Community Reinvestment Act,” Loy said. “But we are not doing this as a loss leader, as most banks would. For us, it is designed to be a self-sustaining business model.”

‘Spirit and drive’

CDFI financiers agree that finding funding for entrepreneurs is rewarding.

“We’re providing capital that’s otherwise unavailable to small business,” Standage said.

One of those businesses is Cupini’s Fresh Pasta & Panini in downtown Kansas City, Mo. Owner Robert MacFarland said the terms of the loan he received were “stellar.”

He used the funds to purchase freezers, ovens, deli counters and tables for the business that he opened in March 2005 in an area that, until then, had no delicatessens.

He credits a CDFI with making his endeavor possible and, in turn, contributing to the development of the community.

“But not only does it take an entrepreneur with a big spirit and a great drive, but it takes someone willing to finance them.”

BY TONI LAPP, SENIOR WRITER

COMMENTS/QUESTIONS are welcome and should be sent to teneitors@kc.frb.org.
Banks in which the senior managers have a significant ownership stake in the institution were top performers, researchers at the Federal Reserve Bank of Kansas City found.

Their research elicited a link between how well a firm performs with how it is governed. Similarly, they found that boards of directors were more effective at encouraging efficient bank operations when the directors had a financial stake in their bank.

Hitting on the correct management strategy is a challenge for any institution, banks included. Most businesses choose a structure that ranges from being composed of hired managers with little or no stock ownership to owner managers controlling virtually all of their company’s stock.

Federal Reserve Bank of Kansas City economists studied a group of Tenth District banks to determine which model was most effective. Senior Policy Economist Kenneth Spong and Senior Economist Richard Sullivan focused on...
banks with total assets of under $1 billion, the size of a typical community bank. However, the issues they explored were those that other small- or medium-sized businesses might face as they address issues concerning management and ownership structure, board oversight, and financial incentives.

Spong and Sullivan have been researching these issues over a period of time when corporate governance issues have taken on renewed significance, particularly with corporate scandals and the resulting passage of the Sarbanes-Oxley Act of 2002. While headlines have focused on large, publicly traded companies, these are issues that anyone in business should be thinking about, whether in the start-up phase or planning for management and ownership succession.

**Owner managers versus hired managers**

Spong and Sullivan studied two scenarios for management structure: management composed of principal owners versus hired managers. Results suggest that owning stock in a business may help ensure that the manager serves the interests of stockholders.

Motivations for hired managers will vary greatly from motivations for owner managers. The efforts of owner managers, for instance, not only will be rewarded through salary compensation, but also will be reflected in the stock returns they will receive as principal shareholders in the firm. As a result, owner managers will have an added incentive to perform well.

However, there are a variety of factors that may affect these motivations and financial incentives. Hired managers, for instance, are likely to have other incentives to perform well. They must be concerned about their reputations and value in the job market. Also, they must respond to stockholders and boards of directors, who monitor the performance of hired managers to ensure it aligns with stockholder interests.

In some instances, hiring a manager is the only option for a business. Perhaps the owner has another business to manage, or the owner wants to retire and no other family members or stockholders have an interest in running the enterprise.

“Sometimes it is better to hire a manager with skills that a member of the ownership might not have,” Spong says. “Then it becomes an issue of how to motivate this hired manager.”

While owner managers may not have to answer to others, they can still have complex motivations.

“Owner-managed banks have a number of goals, and profitability is just one,” Sullivan says. “They are free to pursue whatever goals they want. It’s difficult to say whether that’s good or bad.”

For instance, some owners in a small town might choose to place a higher priority on activities that benefit the local community than activities that maximize current profits.

For these reasons, it is difficult to directly compare the effectiveness of owner managers with hired managers. But, whatever the situation, certain steps can improve the effectiveness of management.
“Research shows that some businesses fail to match the performance of other businesses because they have shortcomings in the structure of their management, ownership and board of directors—shortcomings that the research suggests can be addressed in a number of ways,” Spong says.

“In the case of owner managers, you assume they are motivated to act in the best interest of shareholders,” Spong says, “and they will put a strong effort into generating returns.”

Spong and Sullivan find, however, that owner managers may not all have the same attitudes toward risk.

“When owner managers have most of their wealth tied up in their banks, they tend to be more conservative than owner managers that are more diversified investors,” Sullivan says.

Less straightforward is the second scenario, in which hired managers run the firm as agents of the bank’s owners. In that case, the principal compensation is salary.

“With hired managers, you have the issue of how much effort they will exert, since they will not receive the same stock returns that an owner manager would receive,” Spong says.

The possibility exists that hired managers will seek to serve their own interests rather than that of the firm. This takes on a variety of forms, according to Spong and Sullivan. A hired manager may not work as hard or may exploit the perquisites of the position. To protect their jobs, hired managers also may be averse to risk-taking, thus avoiding projects that stockholders would be willing to pursue. This behavior results in “agency” costs, and overcoming these costs is a normal part of business.

One way for businesses to address the agency costs is to have these hired managers become stockholders, thus aligning their interests more closely with that of principal shareholders. In their research Spong and Sullivan found that their sample banks performed best when hired managers had a 17 percent ownership stake. Below this level bank performance continues to improve as the hired manager’s ownership position increases. Beyond the 17 percent ownership level, Sullivan says that “there may be a balance of power issue and more serious policy conflicts between hired managers and the principal owners.” A hired manager acquiring enough stock, for instance, may be able to disregard the views of other stockholders and escape the danger of being dismissed.

As a result, additional ownership eventually may cause the manager to look more to his or her own interests, and performance could begin to suffer.
“I think it is interesting that while we did find this pattern in the data, only a few banks in the study suffered from this type of problem,” Sullivan says.

Spong and Sullivan caution that this 17 percent ownership solution should be viewed as a guide, since it is a statistical estimate based on a particular sample of banks. At any company, a desirable ownership position for hired managers also will depend on a variety of factors, including size of the business, effectiveness of board and ownership oversight, other incentives affecting a manager’s performance, and the existing ownership structure.

**Boards of directors**

Spong and Sullivan compared the effectiveness of boards of directors based on their bank’s cost efficiency and earnings.

“One surprising result pertains to the advice you hear about how it is good to have more outside directors,” Sullivan says. “By definition, an outside director has little ownership stake. What we found was that top-performing banks had directors with an ownership stake.”

The makeup of the boards at these banks did not differ significantly from the poor performers with regard to number of directors, average age or length of tenure. However, directors at the top banks had a higher median net worth, had greater ownership share in their bank and were less likely to be outside directors. These banks also tended to have more frequent board meetings, better attendance rates and higher director fees.

“That’s not to say you need to go out and get rich people for the board,” Sullivan says. “It’s more an indicator of the personal success they have had. There’s a relationship between a person’s capability and wealth, and we think that better-performing banks have been successful at recruiting motivated, capable directors.”

**Optimizing firm performance**

Spong and Sullivan say that research suggests there are a couple of steps that stockholders and directors can take to address shortcomings in their ownership/management structure. These steps reflect the role that wealth and ownership play in business ventures.

First, ensure adequate board oversight. Second, provide appropriate incentives.

“One of our key findings is that an ownership stake for hired managers can help improve firm performance and align the interests of managers more closely with that of stockholders,” Spong says.

However, he cautions against thinking of this as a magic bullet: “If you give a hired manager 17 percent stock ownership, there’s no guarantee it will be a magic solution if he or she doesn’t have skill,” Spong says. “But it does provide incentive.”

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**FURTHER RESOURCES**

“The Effect of Wealth and Ownership on Firm Performance” is a summary of five papers published by Kenneth Spong and Rick Sullivan.

“The Effect of Wealth and Ownership on Firm Performance”

“Managerial Wealth, Ownership Structure, and Risk in Commercial Banks”

“Who’s Minding the Store? Motivating and Monitoring Hired Managers at Small, Closely Held Commercial Banks”

“How Does Ownership Structure and Manager Wealth Influence Risk? A Look at Ownership Structure, Manager Wealth, and Risk in Commercial Banks”


Links to the full text of papers are available at [www.KansasCityFed.org/TEN](http://www.KansasCityFed.org/TEN)

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**COMMENTS/QUESTIONS** are welcome and should be sent to teneditors@kc.frb.org.
After President Woodrow Wilson signed the Federal Reserve Act on Dec. 23, 1913, work moved quickly to get the nation’s new central bank operational.

The Reserve Bank Organizing Committee, which was charged with dividing the country into what would become the 12 Federal Reserve Districts, would begin meeting almost immediately and complete a task that critics deemed virtually impossible in less than 100 days. (The story is detailed in the Summer 2005 edition of TEN).

Although the committee had determined which cities would be home to the Reserve Banks, the work of actually establishing those Banks would fall to local Boards of Directors. These individuals from the local business and banking community would be asked to make numerous decisions ranging from locating office space suitable for the local headquarters of the central bank to operational issues relating to how the Bank would conduct business with its District’s commercial banks.

**Creating the Boards**

The Federal Reserve has a unique public-private structure. The Board of Governors in Washington, D.C., which has broad oversight responsibilities for the entire System, is a governmental agency while the regional Banks are private corporations with their own Boards of Directors. These Boards are a unique mix. Six of the nine Board members are elected by commercial banks that are members of the Federal Reserve System in each District while the remaining three positions are appointees of the Board of Governors.

This blend of positions continues to serve the System well, but in 1914 it was a cause of some delay.

Each Board had its six elected directors in place thanks to some preliminary work done by the Reserve Bank Organizing Committee.
But work on filling the three appointed positions could not begin until the Board of Governors of the Federal Reserve System was sworn in on Aug. 10, 1914, almost eight months after Wilson signed the Federal Reserve Act. The Governors turned quickly to the task of filling the local Boards. The first annual report issued by the Board of Governors offers some details on the process. Specifically, it notes that the Board was especially careful because one of the appointed positions on each Board would be that Bank’s chairman of the Board and Federal Reserve agent.

“The office is undoubtedly one which calls for exceptional qualifications and is therefore difficult to fill,” the Board said in the 1914 annual report, where it goes on to write that a Reserve Bank chairman must be a person of “solidity, independence and tried character.”

To find these individuals, the Board “deemed it essential to scrutinize every name submitted for appointment or suggested from any source” through a process which “required time and necessitated visits by members of the Board to various and distant parts of the country, as well as the invitation of competent advisors to Washington for consultation.”

The Board completed its selections and announced the appointments in early October. In Kansas City, a local newspaper account of the announcement noted that it came after “a long period of anxious waiting.” Jo Zach Miller, Jr., a 51-year-old vice president of Commerce Trust Company, was selected as the Bank’s first chairman. Local newspapers praised Miller’s selection, with one noting that, with all directors in place, “nothing now remains except to start the machinery going.”

The first meeting

The Board of Directors of the Federal Reserve Bank of Kansas City met for the first time on a Friday afternoon, Oct. 16, in the board room of the Commerce Trust Company building in downtown Kansas City.

The first meeting would last a little more than three hours, during which the directors prepared for an Oct. 20 meeting in Washington, D.C., by reviewing a list of questions received from the Board of Governors relating to numerous operating issues. The directors would decide the Federal Reserve Bank of Kansas City could be open in less than one month, by Nov. 15, and could use temporary quarters, if necessary, in the Commerce Building. At this first meeting, the Board also chose Charles M. Sawyer as the
Elected and Appointed

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, a group sometimes collectively referred to as “member banks.”

These directors are bankers who are nominated and elected by member banks within the Tenth Federal Reserve District. Under the Class A category, a director will be elected by a specific group of member banks that is 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 CEO 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. A Class B director 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, CEO, Dillingham Insurance, 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. A Class C director also 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, subject to review and determination by the Federal Reserve Board.

THE BRANCHES

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 appear on pages 37-39.)
Bank’s first governor—a title that would later be eliminated by the Banking Act of 1935 and replaced by creating the position of Bank president.

An unpublished manuscript of the Bank’s history authored by Jess Worley in the early 1920s includes a partial transcript of the discussion. In it, there are comments offering insight to the hurried schedule under which the entire Federal Reserve System was operating.

Miller, who would later serve as governor after it became clear what duties each job would entail, talked about being notified of his selection while at his ranch in Texas. He told his fellow directors that, after receiving a telegram regarding his selection, he departed the ranch “within two or three hours,” on his way to Washington, D.C., to begin his new position with two days of meetings.

Preparing for opening

The Bank’s Board held its second meeting on Halloween morning, starting with a whirlwind tour of two out of the five downtown Kansas City buildings under consideration as the Bank’s headquarters. They chose the ground floor of the R.A. Long Building at the northwest corner of Tenth and Grand Avenue, directly across the street from where the Bank would begin constructing a new headquarters in 1920. For its first office, the Bank would pay $7,500 annually for 8,500 square feet.

The second meeting also included decisions about employee salaries and the Bank’s executive committee, which would include Board members. The committee would begin working continuous day-long sessions the following Monday, Nov. 2, in preparation for the planned Systemwide opening date of Nov. 16.

“This work (by the executive committee) comprised a variety of duties including innumerable conferences with business men, furniture salesmen, supply salesmen, bank officials and prospective employees; also trips of inspection and inquiry, a great amount of correspondence by letter and wire with the Federal Reserve Board and an endless amount of exhaustive discussions of letters pertaining to the opening of the Bank,” Worley writes.

“There was a great amount of urgent work to be done and temporary employees were hired to do this preliminary work.”

The Board of Directors held numerous meetings in the coming days, where they did everything from draw lots to determine terms of office, thereby staggering the terms for future elections and appointments, to determining the duties of the Bank’s officers and operating rules.

“While the officers and new employees of the Bank were busily engaged in preparing the permanent quarters and installing various systems during the first half of November, the directors were far from idle,” Worley writes.

Before the bank opened for its first business day, the work of the directors and staff was recognized in a telegram from Treasury Secretary William G. McAdoo, one of three men who served on the Reserve Bank Organizing Committee.

It reads, in part:

“Please accept my cordial congratulations upon the opening of the Federal Reserve Bank … and my sincere commendation upon the effective work you have done in preparing the Bank for business in the short time allowed for the opening.”

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.
The Community Affairs Department recently hosted in Kansas City a one-day forum, “Asset Building in the Heartland: Innovative Strategies for Rural America,” to explore the development of asset-building policies, strategies and programs for lower-income individuals and families living in rural America.

“Asset building” refers to the public policies, strategies and programs that enable people with limited financial resources to accumulate long-term and productive assets. As a development strategy, it is designed to foster economic security and opportunity that will be passed on to future generations.

Thomas M. Hoenig, president, and Alan D. Barkema, senior vice president, were among speakers at the event along with representatives from the Federal Reserve Bank of Dallas, First Nations Development Institute, the Annie E. Casey Foundation, the National Rural Funders Collaborative, and MDC, Inc.

The forum also was co-sponsored by the Federal Reserve Banks of Chicago, Dallas, Minneapolis and St. Louis along with CFED (formerly known as the Corporation for Enterprise Development), a national nonprofit dedicated to expanding economic opportunity.

The event was the third in a series titled “Innovations in Asset-Building Policy, Products and Programs.” Each is designed to explore specific challenges facing the asset-building field, highlight innovations and best practices, and create recommendations to influence future asset-building policies and programs.

The next forum, “Closing the Wealth Gap: Building Assets Among Low-Income Households,” will be held in conjunction with the CFED 2006 Assets Learning Conference, Sept. 19-21, in Phoenix.

To learn more about the Federal Reserve’s asset-building initiatives, visit www.KansasCityFed.org/TEN.

Redesigned $10 bills began circulating March 2.

The bill reflects design changes first introduced with the $20 bill in 2003, including the addition of colors beyond the traditional green. The U.S. Treasury is implementing the new designs to stay ahead of the evolving technology used by counterfeiters. Similar redesigns are anticipated every seven to 10 years.

The front of the new $10 bill features red
background images of the Statue of Liberty’s torch, the phrase “We the People” from the U.S. Constitution, a distinctive orange and yellow background color, and a borderless portrait of Alexander Hamilton.

The new $10 notes still contain enhanced security features introduced in the 1990s—a watermark, security thread and color-shifting ink. New $20 and $50 notes were introduced in 2004, and a new $100 note is next on the list for redesign. There are currently no plans to redesign the $5, $2 or $1 bills.

The Federal Reserve plays a key role in the introduction of new currency, but does not make new notes available directly to the public for circulation. Coins and currency are placed into circulation through commercial financial institutions, which obtain cash from one of the 12 regional Federal Reserve Banks.

For more information on the Federal Reserve’s role in the currency cycles, visit www.KansasCityFed.org/TEN.

Banks Marking Milestones (years) as Federal Reserve Members

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Further Resources

- Strategies for Banking the Unbanked: How Banks Are Overcoming Entrance Barriers
- “Interchange Fees in Credit and Debit Card Industries: What Role for Public Authorities?” Conference Proceedings
- Longer-Term Perspective on the Yield Curve and Monetary Policy
- Jobless Recoveries and the Wait-And-See Hypothesis
- U.S. Agricultural Credit Conditions: Rising Energy Prices Boost Farm Costs

Federal Reserve Bank of Kansas City research featured above is available at www.KansasCityFed.org/TEN

Comments/Questions are welcome and should be sent to teneditors@kc.frb.org.
Management Committee

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

Carl M. Gambs
Senior Vice President

Esther L. George
Senior Vice President

Craig S. Hakkio
Senior Vice President and Director of Research

Roberta E. Hearn
Senior Vice President

Barbara S. Pacheco
Senior Vice President

Kent M. Scott
Senior Vice President

Charles L. Bacon, Jr.
Senior Vice President,
General Counsel and Secretary
Advisor to Management Committee

(From left) Mr. Hakkio, Mr. Dubbert, Ms. George, Mr. Barkema, Mr. Hoenig, Mr. Bacon, Mr. Rasdall, Mr. Scott, Mr. Gambs, Ms. Pacheco, Ms. Hearn
Robert A. Funk, Chairman and Federal Reserve Agent
Chairman of the Board and Chief Executive Officer
Express Personnel Services International
Oklahoma City, Oklahoma (Class C)

Richard H. Bard, Deputy Chairman
Chairman and Chief Executive Officer
International Surface Preparation Corporation
Golden, Colorado (Class C)

Lu Cordova
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 Moore
President, Spearhead Ranch Company
Douglas, Wyoming (Class B, Group 3)

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
Byron G. Thompson (not pictured)
Chairman, Country Club Bank
Kansas City, Missouri

NOTE: For an explanation of class and group designations, turn to Page 28.
Appointed by the Board of Governors of the Federal Reserve System

Thomas Williams, Chairman of the Branch Board
President and Chief Executive Officer
Williams Group LLC
Golden, Colorado

Kathleen Avila
Managing Member
Avila Retail Development and Management
Albuquerque, New Mexico

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

Appointed by the Board of Directors, Federal Reserve Bank of Kansas City

Virginia K. Berkeley
President
Colorado Business Bank, N.A.
Denver, Colorado

James A. Helzer
President and Chief Executive Officer
Unicover Corporation
Cheyenne, Wyoming

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

Michael R. Stanford
President and Chief Executive Officer
First State Bancorporation
Albuquerque, New Mexico
Boards of Directors

Appointed by the Board of Governors of the Federal Reserve System

Tyree O. Minner, Chairman of the Branch Board
Plant Manager
General Motors, Oklahoma City Assembly Plant
Oklahoma City, Oklahoma

J. Larry Nichols
Chairman and Chief Executive Officer
Devon Energy Corporation
Oklahoma City, Oklahoma

Michael J. Packnett
President and Chief Executive Officer
Mercy Health Center
Oklahoma City, Oklahoma

Appointed by the Board of Directors,
Federal Reserve Bank of Kansas City

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

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

Fred M. Ramos
President
Greater Tulsa Hispanic Chamber of Commerce
Tulsa, Oklahoma

Richard K. Ratcliffe
Chairman
Ratcliffe’s Inc.
Weatherford, Oklahoma

(From left) Mr. Ramos, Mr. Ratcliffe, Mr. Nichols, Mr. Minner, Ms. Almon, Mr. Gilbert, Mr. Packnett

Oklahoma City Branch
Appointed by the Board of Governors of the Federal Reserve System

Charles R. Hermes
President
Dutton-Lainson Company
Hastings, Nebraska

Terry L. Moore
President
Omaha Federation of Labor
Omaha, Nebraska

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

Appointed by the Board of Directors, Federal Reserve Bank of Kansas City

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

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

Michael J. Nelson
Chairman
FirsTier Bank
Kimball, Nebraska

Judith A. Owen
Retired President and Chief Executive Officer
Wells Fargo Bank, N.A.
Omaha, Nebraska
Advisory Councils

(From left) Mr. King, Mr. Shaw, Mr. Stout, Ms. Johnson, Mr. Liston, Mr. Roetheli, Mr. Heilbrun, Mr. Tamba

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

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

Ralph King
Owner/Operator
King’s Management Company, Inc.
Kansas City, Kansas

Dennis Liston
Financial Secretary
International Brotherhood of Electrical Workers
Kansas City, Missouri

Russell M. Perry (not pictured)
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

Anthony F. Prinster (not pictured)
Hoskin, Farina, Aldrich & Kampf
Grand Junction, Colorado

Joe Roetheli
General Manager
S&M NuTec, LLC
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, LLC
Shawnee Mission, Kansas

Shin-ichi Tamba
President
Kawasaki Motors Manufacturing Corp., U.S.A.
Lincoln, Nebraska
Dan V. Clark  
Clark Consulting Group  
Arvada, Colorado

Patricia B. Fennell (not pictured)  
Executive Director  
Latino Community Development Agency  
Oklahoma City, Oklahoma

Carol A. Grimaldi (not pictured)  
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

Thomas G. Johnson  
Director  
Community Policy Analysis Center  
University of Missouri  
Columbia, Missouri

Tim Kenny  
Executive Director  
Nebraska Investment Finance Authority  
Lincoln, Nebraska

A. Thomas Loy  
Chairman and President  
MetaFund  
Oklahoma City, Oklahoma

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

Robin Wells (not pictured)  
Senior Vice President  
Country Club Bank  
Kansas City, Missouri

(From left) Senior Vice President Alan Barkema, Mr. Johnson, Mr. Clark, Ms. Tinney, Mr. Kenny, Mr. Loy, Assistant Vice President Paul Coquillette
Customer Advisory Council on Financial Services

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 and Trust Company
Kansas City, Missouri

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

L.D. McDonald
President and Chief Executive Officer
Midwest Independent Bank
Jefferson City, Missouri

Bruce Schriefer
President and Chief Executive Officer
Bankers’ Bank of Kansas
Wichita, Kansas

Oklahoma City
Don Abernathy
President and Chief Executive Officer
The Bankers Bank
Oklahoma City, Oklahoma

Scott Copeland
Executive Vice President
BancFirst
Oklahoma City, Oklahoma

Kerby E. Crowell
Executive Vice President
Stillwater National Bank and Trust Co.
Stillwater, 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

Timothy D. Hart
Chief Financial Officer, Secretary and Treasurer
First National Bank of Omaha
Omaha, Nebraska

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

Credit Union Customer Advisory Council

Oklahoma City Branch
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President
Halliburton Employees Federal Credit Union
Duncan, Oklahoma

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

William (Bill) 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


**Kansas City**

Thomas M. Hoenig  
President and Chief Executive Officer

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

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

Alan D. Barkema  
Senior Vice President

Kelly J. Dubbert  
Senior Vice President

Carl M. Gambis  
Senior Vice President

Esther L. George  
Senior Vice President

Craig S. Hakkio  
Senior Vice President and Director of Research

Roberta E. Hearn  
Senior Vice President

Stephen E. McBride  
Senior Vice President and General Auditor

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Senior Vice President

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Senior Vice President

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Senior Vice President and Economist

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Vice President

Anita F. Costanza  
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Vice President and Director, Center for the Study of Rural America

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Vice President and Associate Director of Research

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Vice President and Economist

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Vice President

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Vice President and Associate General Counsel

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Vice President and Economist

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Vice President and Director, Payments System Research

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Assistant Vice President

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Assistant Vice President

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Assistant Vice President

Michael R. Childs  
Assistant Vice President

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

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Assistant Vice President

Kristi A. Coy  
Assistant Vice President

Kevin J. Craig  
Assistant Vice President

Tanya L. Cvetan  
Assistant Vice President

Nigel S. Davis  
Assistant Vice President

James R. Deis  
Assistant Vice President

Linda K. Edwards  
Assistant Vice President

C. Alan Garner  
Assistant Vice President

Lori D. Haley  
Assistant Vice President

Ann L. Hoelting  
Assistant Vice President

James H. Hunter  
Assistant Vice President

William R. Keeton  
Assistant Vice President and Economist

W. Todd Mackey  
Assistant Vice President

D. Michael Manies  
Assistant Vice President

Renu A. Mehta  
Assistant Vice President

Annette K. Owens  
Assistant Vice President

Wayne M. Powell  
Assistant Vice President and Assistant Secretary

Michael R. Steckline  
Assistant Vice President

Lawrence D. Taft  
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

Stephan Weiler  
Assistant Vice President and Economist

Ginger K. Wise  
Assistant Vice President

Margaret L. Yarrington  
Assistant Vice President

Catherine A. Zeigler  
Assistant Vice President

**Denver**

Pamela L. Weinstein  
Vice President and Branch Manager

Thomas P. Bennett  
Assistant Vice President

Gary E. Darby  
Assistant Vice President

Debbie L. Meyers  
Assistant Vice President

**Oklahoma City**

Dwayne E. Boggs  
Vice President and Branch Manager

Tara B. Koenigs  
Assistant Vice President

Robert W. Toler  
Assistant Vice President

**Omaha**

Kevin A. Drusch  
Vice President and Branch Manager

Ronald M. Ryan  
Assistant Vice President and Assistant Branch Manager

D. Rick Lay  
Assistant Vice President
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, 2005 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

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

Even an effective process of internal controls, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements.

The management of the FRBKC assessed its process of internal controls over financial reporting including the safeguarding of assets reflected in the Financial Statements, based upon the criteria established in the Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, we believe that the FRBKC maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

Thomas M. Hoenig
President

Richard K. Rasdall, Jr.
First Vice President

Janel K. Frisch
Vice President, Chief Financial Officer
Report of Independent Accountants

To the Board of Directors of the Federal Reserve Bank of Kansas City

We have examined management’s assertion, included in the accompanying Management Assertion, that the Federal Reserve Bank of Kansas City (“FRB Kansas City”) maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the financial statements as of December 31, 2005, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRB Kansas City’s management is responsible for maintaining effective internal control over financial reporting and safeguarding of assets as they relate to the financial statements. Our responsibility is to express an opinion on management’s assertion based on our examination.

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

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

In our opinion, management’s assertion that FRB Kansas City maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the financial statements as of December 31, 2005 is fairly stated, in all material respects, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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

March 8, 2006
Kansas City, Missouri
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 audited the accompanying statements of condition of the Federal Reserve Bank of Kansas City (the “Bank”) as of December 31, 2005 and 2004, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Bank’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

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

March 8, 2006
Kansas City, Missouri
Federal Reserve Bank of Kansas City

**STATEMENTS OF CONDITION (in millions)**

As of December 31, 2005 and 2004

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gold certificates</td>
<td>$318</td>
<td>$302</td>
</tr>
<tr>
<td>Special drawing rights certificates</td>
<td>66</td>
<td>66</td>
</tr>
<tr>
<td>Coin</td>
<td>61</td>
<td>48</td>
</tr>
<tr>
<td>Items in process of collection</td>
<td>591</td>
<td>653</td>
</tr>
<tr>
<td>Loans to depository institutions</td>
<td>11</td>
<td>1</td>
</tr>
<tr>
<td>U.S. government securities, net</td>
<td>21,219</td>
<td>19,067</td>
</tr>
<tr>
<td>Investments denominated in foreign currencies</td>
<td>246</td>
<td>392</td>
</tr>
<tr>
<td>Accrued interest receivable</td>
<td>165</td>
<td>134</td>
</tr>
<tr>
<td>Interdistrict settlement account</td>
<td>2,422</td>
<td>1,584</td>
</tr>
<tr>
<td>Bank premises and equipment, net</td>
<td>101</td>
<td>102</td>
</tr>
<tr>
<td>Other assets</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$25,210</td>
<td>$22,364</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES AND CAPITAL</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>LIABILITIES:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Reserve notes outstanding, net</td>
<td>$22,816</td>
<td>$20,038</td>
</tr>
<tr>
<td>Securities sold under agreements to repurchase</td>
<td>863</td>
<td>809</td>
</tr>
<tr>
<td>Deposits:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depository institutions</td>
<td>655</td>
<td>721</td>
</tr>
<tr>
<td>Other deposits</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Deferred credit items</td>
<td>456</td>
<td>409</td>
</tr>
<tr>
<td>Interest on Federal Reserve notes due U.S. Treasury</td>
<td>21</td>
<td>30</td>
</tr>
<tr>
<td>Accrued benefit costs</td>
<td>39</td>
<td>41</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>24,860</td>
<td>22,058</td>
</tr>
</tbody>
</table>

| CAPITAL:                                    |       |       |
| Capital paid-in                             | 175   | 153   |
| Surplus                                     | 175   | 153   |
| **Total capital**                           | 350   | 306   |
| **Total liabilities and capital**           | $25,210| $22,364|

*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, 2005 and 2004

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INTEREST INCOME:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on U.S. government securities</td>
<td>$ 781</td>
<td>$ 581</td>
</tr>
<tr>
<td>Interest on investments denominated in foreign currencies</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>Interest on loans to depository institutions</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total interest income</strong></td>
<td>786</td>
<td>586</td>
</tr>
<tr>
<td>Interest expense:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense on securities sold under agreements to repurchase</td>
<td>23</td>
<td>8</td>
</tr>
<tr>
<td><strong>Net interest income</strong></td>
<td>763</td>
<td>578</td>
</tr>
<tr>
<td><strong>OTHER OPERATING INCOME:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from services</td>
<td>-</td>
<td>53</td>
</tr>
<tr>
<td>Compensation received for check services provided</td>
<td>56</td>
<td>-</td>
</tr>
<tr>
<td>Reimbursable services to government agencies</td>
<td>11</td>
<td>14</td>
</tr>
<tr>
<td>Foreign currency gains (losses), net</td>
<td>(38)</td>
<td>23</td>
</tr>
<tr>
<td>Other income</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total other operating income</strong></td>
<td>31</td>
<td>91</td>
</tr>
<tr>
<td><strong>OPERATING EXPENSES:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and other benefits</td>
<td>109</td>
<td>104</td>
</tr>
<tr>
<td>Occupancy expense</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>Equipment expense</td>
<td>9</td>
<td>10</td>
</tr>
<tr>
<td>Assessments by Board of Governors</td>
<td>20</td>
<td>22</td>
</tr>
<tr>
<td>Other expenses</td>
<td>43</td>
<td>37</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td>190</td>
<td>182</td>
</tr>
<tr>
<td><strong>Net income prior to distribution</strong></td>
<td>$ 604</td>
<td>$ 487</td>
</tr>
<tr>
<td><strong>DISTRIBUTION OF NET INCOME:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends paid to member banks</td>
<td>$ 10</td>
<td>$ 9</td>
</tr>
<tr>
<td>Transferred to (from) surplus</td>
<td>22</td>
<td>(9)</td>
</tr>
<tr>
<td>Payments to U.S. Treasury as interest on Federal Reserve notes</td>
<td>572</td>
<td>487</td>
</tr>
<tr>
<td><strong>Total distribution</strong></td>
<td>$ 604</td>
<td>$ 487</td>
</tr>
</tbody>
</table>

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, 2005 and 2004

<table>
<thead>
<tr>
<th></th>
<th>Capital Paid-in</th>
<th>Surplus</th>
<th>Total Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BALANCE AT JANUARY 1, 2004</strong></td>
<td>$162</td>
<td>$162</td>
<td>$324</td>
</tr>
<tr>
<td>Transferred from surplus</td>
<td>-</td>
<td>(9)</td>
<td>(9)</td>
</tr>
<tr>
<td>Net change in capital stock redeemed</td>
<td>(9)</td>
<td>-</td>
<td>(9)</td>
</tr>
<tr>
<td><strong>BALANCE AT DECEMBER 31, 2004</strong></td>
<td>$153</td>
<td>$153</td>
<td>$306</td>
</tr>
<tr>
<td>Transferred to surplus</td>
<td>-</td>
<td>22</td>
<td>22</td>
</tr>
<tr>
<td>Net change in capital stock issued</td>
<td>22</td>
<td>-</td>
<td>22</td>
</tr>
<tr>
<td><strong>BALANCE AT DECEMBER 31, 2005</strong></td>
<td>$175</td>
<td>$175</td>
<td>$350</td>
</tr>
</tbody>
</table>

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

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

2. OPERATIONS AND SERVICES

The System performs a variety of services and operations. Functions include formulating and conducting monetary policy; participating actively in the payments system including large-dollar transfers of funds, automated clearinghouse (“ACH”) operations, and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government’s bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies, state member banks, and U.S. offices of foreign banking organizations; and administering other regulations of the Board of Governors. The System also provides certain services to foreign central banks, governments, and international official institutions.

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

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

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

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

Beginning in 2005, the Reserve Banks adopted a new management model for providing check services to depository institutions. Under this new model, the Federal Reserve Bank of Atlanta ("FRBA") has the overall responsibility for managing the Reserve Banks’ provision of check services and recognizes total System check revenue on its Statements of Income. FRBA compensates the other eleven Banks for the costs incurred to provide check services. This compensation is reported as "Compensation received for check services provided" in the Statements of Income. If the management model had been in place in 2004, the Bank would have reported $59 million as "Compensation received for check services provided" and $53 million in "Income from services" would have been reported by FRBA rather than the Bank.

3. SIGNIFICANT ACCOUNTING POLICIES

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

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

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

The preparation of the financial statements in conformity with the Financial Accounting Manual requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. 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. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury’s account is charged, and the Reserve Banks’ gold certificate accounts are lowered. The value of gold for purposes of backing the gold certificates is set by law at $42 2⁄9 a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based on the average Federal Reserve notes outstanding in each Reserve Bank.
Special drawing rights (“SDRs”) are issued by the International Monetary Fund (“Fund”) to its members in proportion to each member’s quota in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks’ SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2005 or 2004.

b. Loans to Depository Institutions

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

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.”

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

d. U.S. Government Securities Sold Under Agreements to Repurchase and Securities Lending

Securities sold under agreements to repurchase are accounted for as financing transactions and the associated interest expense is recognized over the life of the transaction. These transactions are carried in the Statements of Condition at their contractual amounts and the related accrued interest is reported as a component of “Other liabilities.”
U.S. government securities held in the SOMA are lent to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements in order to facilitate the effective functioning of the domestic securities market. Securities-lending transactions are fully collateralized by other U.S. government securities and the collateral taken is in excess of the market value of the securities loaned. The FRBNY charges the dealer or bank a fee for borrowing securities and the fees are reported as a component of “Other Income” in the Statements of Income.

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

**e. Foreign Currency Swaps and Warehousing**

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

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

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

**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 estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations, and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs, and minor replacements are charged to operating expense in the year incurred. Capitalized assets including software, building, leasehold improvements, furniture, and equipment are impaired when it is determined that the net realizable value is significantly less than book value and is not recoverable.
Costs incurred for software, either developed internally or acquired for internal use, during the application development stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years.

**g. Interdistrict Settlement Account**

At the close of business each day, each Reserve Bank assembles the payments due to or from other Reserve Banks as a result of the day’s transactions that involve depository institution accounts held by other Districts. Such transactions may include funds settlement, check clearing, and ACH operations. The cumulative net amount due to or from the other Reserve Banks is reflected in the “Interdistrict settlement account” in the Statements of Condition.

**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) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank.

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

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

The “Federal Reserve notes outstanding, net” account represents the Bank’s Federal Reserve notes outstanding, reduced by the currency issued to the Bank but not in circulation, of $5,016 million, and $4,497 million at December 31, 2005 and 2004, respectively.

**i. Items in Process of Collection and Deferred Credit Items**

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

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

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

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

l. 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.

m. Assessments by the Board of Governors

The Board of Governors assesses the Reserve Banks to fund its operations based on each Reserve Bank’s capital and surplus balances. The Board of Governors also assesses each Reserve Bank for the expenses incurred for the U.S. Treasury to issue and retire Federal Reserve notes based on each Reserve Bank’s share of the number of notes comprising the System’s net liability for Federal Reserve notes on December 31 of the previous year.
n. 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, 2005 and 2004, and are reported as a component of “Occupancy expense.”

o. Restructuring Charges

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

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

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

The FRBNY, on behalf of the Reserve Banks, holds securities bought outright in the SOMA. The Bank’s allocated share of SOMA balances was approximately 2.828 percent and 2.628 percent at December 31, 2005 and 2004, respectively.

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

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Par value:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. government:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bills</td>
<td>$ 7,673</td>
<td>$ 6,910</td>
</tr>
<tr>
<td>Notes</td>
<td>10,751</td>
<td>9,482</td>
</tr>
<tr>
<td>Bonds</td>
<td>2,626</td>
<td>2,471</td>
</tr>
<tr>
<td>Total par value</td>
<td>21,050</td>
<td>18,863</td>
</tr>
<tr>
<td>Unamortized premiums</td>
<td>249</td>
<td>247</td>
</tr>
<tr>
<td>Unaccreted discounts</td>
<td>(80)</td>
<td>(43)</td>
</tr>
<tr>
<td>Total allocated to Bank</td>
<td>$ 21,219</td>
<td>$ 19,067</td>
</tr>
</tbody>
</table>

The total of the U.S. government securities, net held in the SOMA was $750,202 million and $725,584 million at December 31, 2005 and 2004, respectively.
At December 31, 2005 and 2004, the total contract amount of securities sold under agreements to repurchase was $30,505 million and $30,783 million, respectively, of which $863 million and $809 million, were allocated to the Bank. The total par value of the SOMA securities pledged for securities sold under agreements to repurchase at December 31, 2005 and 2004 was $30,559 million and $30,808 million, respectively, of which $864 million and $810 million was allocated to the Bank.

The maturity distribution of U.S. government securities bought outright and securities sold under agreements to repurchase, that were allocated to the Bank at December 31, 2005, was as follows (in millions):

<table>
<thead>
<tr>
<th>Maturities of Securities Held</th>
<th>U.S. Government Securities (Par value)</th>
<th>Securities Sold Under Agreements to Repurchase (Contract amount)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 15 days</td>
<td>$1,160 $</td>
<td>$863 $</td>
</tr>
<tr>
<td>16 days to 90 days</td>
<td>4,872 $</td>
<td>- $</td>
</tr>
<tr>
<td>91 days to 1 year</td>
<td>5,269 $</td>
<td>- $</td>
</tr>
<tr>
<td>Over 1 year to 5 years</td>
<td>5,961 $</td>
<td>- $</td>
</tr>
<tr>
<td>Over 5 years to 10 years</td>
<td>1,604 $</td>
<td>- $</td>
</tr>
<tr>
<td>Over 10 years</td>
<td>2,184 $</td>
<td>- $</td>
</tr>
<tr>
<td>Total</td>
<td>$21,050 $</td>
<td>$863 $</td>
</tr>
</tbody>
</table>

At December 31, 2005 and 2004, U.S. government securities with par values of $3,776 million and $6,609 million, respectively, were loaned from the SOMA, of which $107 million and $174 million, respectively, were allocated to the Bank.

5. INVESTMENTS DENOMINATED IN FOREIGN CURRENCIES

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

The Bank’s allocated share of investments denominated in foreign currencies was approximately 1.300 percent and 1.835 percent at December 31, 2005 and 2004, respectively.
The Bank's allocated share of investments denominated in foreign currencies, including accrued interest, valued at current foreign currency market exchange rates at December 31, was as follows (in millions):

<table>
<thead>
<tr>
<th>European Union Euro:</th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign currency deposits</td>
<td>$ 71</td>
<td>$ 112</td>
</tr>
<tr>
<td>Securities purchased under agreements to resell</td>
<td>25</td>
<td>39</td>
</tr>
<tr>
<td>Government debt instruments</td>
<td>46</td>
<td>72</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Japanese Yen:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign currency deposits</td>
<td>34</td>
<td>28</td>
</tr>
<tr>
<td>Government debt instruments</td>
<td>70</td>
<td>141</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$ 246</td>
<td>$ 392</td>
</tr>
</tbody>
</table>

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

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

<table>
<thead>
<tr>
<th>Maturities of Investments Denominated in Foreign Currencies</th>
<th>Euro</th>
<th>Japanese Yen</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 15 days</td>
<td>$ 44</td>
<td>$ 34</td>
<td>$ 78</td>
</tr>
<tr>
<td>16 days to 90 days</td>
<td>34</td>
<td>9</td>
<td>43</td>
</tr>
<tr>
<td>91 days to 1 year</td>
<td>27</td>
<td>13</td>
<td>40</td>
</tr>
<tr>
<td>Over 1 year to 5 years</td>
<td>37</td>
<td>48</td>
<td>85</td>
</tr>
<tr>
<td>Over 5 years to 10 years</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Over 10 years</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Total</td>
<td>$ 142</td>
<td>$ 104</td>
<td>$ 246</td>
</tr>
</tbody>
</table>

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

At December 31, 2005 and 2004, the warehousing facility was $5,000 million, with no balance outstanding.
6. BANK PREMISES, EQUIPMENT, AND SOFTWARE

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

<table>
<thead>
<tr>
<th>Useful Life Range (in years)</th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank premises and equipment:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>N/A</td>
<td>$ 40</td>
</tr>
<tr>
<td>Buildings</td>
<td>1 to 30</td>
<td>29</td>
</tr>
<tr>
<td>Building machinery and equipment</td>
<td>1 to 16</td>
<td>10</td>
</tr>
<tr>
<td>Construction in progress</td>
<td>N/A</td>
<td>27</td>
</tr>
<tr>
<td>Furniture and equipment</td>
<td>1 to 10</td>
<td>56</td>
</tr>
<tr>
<td>Subtotal</td>
<td>$ 162</td>
<td>$ 187</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(61)</td>
<td>(85)</td>
</tr>
<tr>
<td>Bank premises and equipment, net</td>
<td>$ 101</td>
<td>$ 102</td>
</tr>
</tbody>
</table>

Depreciation expense, for the years ended $ 7 $ 8

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 $27 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.

The Bank leases space to outside tenants with lease terms ranging from one to three years. Rental income from such leases was not material for the years ended December 31, 2005 and 2004. Future minimum lease payments under noncancelable agreements in existence at December 31, 2005 were not material.

The Bank has capitalized software assets, net of amortization, of $2 million and $3 million at December 31, 2005 and 2004, respectively. Amortization expense was $1 million for each of the years ended December 31, 2005 and 2004. Capitalized software assets are reported as a component of “Other assets” and related amortization is reported as a component of “Other expenses.”

Assets impaired as a result of the Bank’s restructuring plan, as discussed in footnote 10, include software, building, leasehold improvements, furniture, and equipment. Asset impairment losses of $5 million and $1 million for the periods ended December 31, 2005 and 2004, respectively, were
determined using fair values based on quoted market values or other valuation techniques and are reported as a component of “Other expenses.”

7. COMMITMENTS AND CONTINGENCIES

At December 31, 2005, the Bank was obligated under noncancelable leases for premises and equipment with terms ranging from one to approximately three 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 $3 million and $2 million for the years ended December 31, 2005 and 2004, respectively. Certain of the Bank’s leases have options to renew.

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>$2,396</td>
</tr>
<tr>
<td>2007</td>
<td>2,346</td>
</tr>
<tr>
<td>2008</td>
<td>962</td>
</tr>
<tr>
<td>2009</td>
<td>–</td>
</tr>
<tr>
<td>2010</td>
<td>–</td>
</tr>
<tr>
<td>Thereafter</td>
<td>–</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$5,704</strong></td>
</tr>
</tbody>
</table>

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

Under the Insurance Agreement of the Federal Reserve Banks, each Reserve Bank has agreed to bear, on a per incident basis, a pro rata share of losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank’s capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 2005 or 2004.

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

Retirement Plans

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

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the System Plan and the costs associated with the Plan are not redistributed to other participating employers. The Bank's benefit obligation and net pension costs for the BEP and the SERP at December 31, 2005 and 2004, and for the years then ended, are not material.

Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled $4 million for each of the years ended December 31, 2005 and 2004, and are reported as a component of “Salaries and other benefits.” The Bank matches employee contributions based on a specified formula. For the years ended December 31, 2005 and 2004, the Bank matched 80 percent on the first 6 percent of employee contributions for employees with less than five years of service and 100 percent on the first 6 percent of employee contributions for employees with five or more years of service.
9. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS AND POSTEMPLOYMENT BENEFITS

Postretirement Benefits other than Pensions

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

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

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

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated postretirement benefit obligation at January 1</td>
<td>$24.9</td>
<td>$28.7</td>
</tr>
<tr>
<td>Service cost-benefits earned during the period</td>
<td>0.9</td>
<td>0.7</td>
</tr>
<tr>
<td>Interest cost of accumulated benefit obligation</td>
<td>1.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Actuarial loss</td>
<td>13.6</td>
<td>1.7</td>
</tr>
<tr>
<td>Curtailment gain</td>
<td>-</td>
<td>(0.1)</td>
</tr>
<tr>
<td>Contributions by plan participants</td>
<td>0.8</td>
<td>0.9</td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(3.3)</td>
<td>(3.0)</td>
</tr>
<tr>
<td>Plan amendments</td>
<td>-</td>
<td>(5.6)</td>
</tr>
<tr>
<td>Accumulated postretirement benefit obligation at December 31</td>
<td>$38.8</td>
<td>$24.9</td>
</tr>
</tbody>
</table>

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

Discount rates reflect yields available on high quality corporate bonds that would generate the cash 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):

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of plan assets at January 1</td>
<td>$ _</td>
<td>$ _</td>
</tr>
<tr>
<td>Actual return on plan assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions by the employer</td>
<td>2.5</td>
<td>2.1</td>
</tr>
<tr>
<td>Contributions by plan participants</td>
<td>0.8</td>
<td>0.9</td>
</tr>
<tr>
<td>Benefits paid</td>
<td>(3.3)</td>
<td>(3.0)</td>
</tr>
<tr>
<td>Fair value of plan assets at December 31</td>
<td>$ _</td>
<td>$ _</td>
</tr>
<tr>
<td>Unfunded postretirement benefit obligation</td>
<td>$ 38.8</td>
<td>$ 24.9</td>
</tr>
<tr>
<td>Unrecognized net curtailment gain</td>
<td></td>
<td>1.0</td>
</tr>
<tr>
<td>Unrecognized prior service cost</td>
<td>7.6</td>
<td>9.1</td>
</tr>
<tr>
<td>Unrecognized net actuarial loss</td>
<td>(13.8)</td>
<td>(0.9)</td>
</tr>
<tr>
<td>Accrued postretirement benefit costs</td>
<td>$ 32.6</td>
<td>$ 34.1</td>
</tr>
</tbody>
</table>

Accrued postretirement benefit costs are reported as a component of “Accrued benefit costs.”

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

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health care cost trend rate assumed for next year</td>
<td>9.00%</td>
<td>9.00%</td>
</tr>
<tr>
<td>Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)</td>
<td>5.00%</td>
<td>4.75%</td>
</tr>
<tr>
<td>Year that the rate reaches the ultimate trend rate</td>
<td>2011</td>
<td>2011</td>
</tr>
</tbody>
</table>
Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2005 (in thousands):

<table>
<thead>
<tr>
<th></th>
<th>One Percentage Point Increase</th>
<th>One Percentage Point Decrease</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effect on aggregate of service and</td>
<td>$ (10)</td>
<td>$ (12)</td>
</tr>
<tr>
<td>interest cost components of net</td>
<td></td>
<td></td>
</tr>
<tr>
<td>periodic postretirement benefit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effect on accumulated postretirement</td>
<td>$ (271)</td>
<td>$ 54</td>
</tr>
<tr>
<td>benefit obligation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service cost-benefits earned during</td>
<td>$ 0.9</td>
<td>$ 0.7</td>
</tr>
<tr>
<td>the period</td>
<td>1.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Interest cost of accumulated benefit</td>
<td>(1.5)</td>
<td>(2.0)</td>
</tr>
<tr>
<td>obligation</td>
<td>0.7</td>
<td>_</td>
</tr>
<tr>
<td>Recognized net actuarial loss</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total periodic expense</td>
<td>$ 2.0</td>
<td>$ 0.3</td>
</tr>
<tr>
<td>Curtailment gain</td>
<td>(1.0)</td>
<td>(9.0)</td>
</tr>
<tr>
<td>Net periodic postretirement benefit</td>
<td>$ 1.0</td>
<td>$ (8.7)</td>
</tr>
<tr>
<td>costs (credit)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Net postretirement benefit costs are actuarially determined using a January 1 measurement date. At January 1, 2005 and 2004, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 5.75 percent and 6.25 percent, respectively.

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

A plan amendment that modified the credited service period eligibility requirements created curtailment gains. The curtailment gain associated with restructuring programs announced in 2003 was recognized when employees left the Bank in 2004. The curtailment gain associated with restructuring programs announced in 2004 that are described in footnote 10 will be offset by unrecognized actuarial losses and prior service gains. As a result, an unrecognized net curtailment gain was recorded in 2005 when the affected employees terminated 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 by the Bank’s plan to certain participants are at least actuarially equivalent to the Medicare Part D prescription drug benefit. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit costs.

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

<table>
<thead>
<tr>
<th>Year</th>
<th>Without Subsidy</th>
<th>With Subsidy</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>$2.7</td>
<td>$2.4</td>
</tr>
<tr>
<td>2007</td>
<td>2.8</td>
<td>2.5</td>
</tr>
<tr>
<td>2008</td>
<td>2.9</td>
<td>2.5</td>
</tr>
<tr>
<td>2009</td>
<td>3.0</td>
<td>2.6</td>
</tr>
<tr>
<td>2010</td>
<td>3.1</td>
<td>2.7</td>
</tr>
<tr>
<td>2011-2015</td>
<td>17.1</td>
<td>14.6</td>
</tr>
<tr>
<td>Total</td>
<td>$31.6</td>
<td>$27.3</td>
</tr>
</tbody>
</table>

**Postemployment Benefits**

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2005 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. The accrued postemployment benefit costs recognized by the Bank were $6 million for each of the years ended December 31, 2005 and 2004. This cost is included as a component of “Accrued benefit costs.” Net periodic postemployment benefit costs included in 2005 and 2004 operating expenses were $1 million for both years and are recorded as a component of “Salaries and other benefits.”
10. BUSINESS RESTRUCTURING CHARGES

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

<table>
<thead>
<tr>
<th>Total Estimated Costs</th>
<th>Accrued Liability 12/31/2004</th>
<th>Total Charges</th>
<th>Total Paid</th>
<th>Accrued Liability 12/31/2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee separation</td>
<td>$5</td>
<td>$3</td>
<td>$2</td>
<td>$2</td>
</tr>
</tbody>
</table>

Employee separation costs are primarily severance costs related to staff reductions of approximately 161, including 85 and 76 staff reductions related to restructuring announced in 2005 and 2004, respectively. These costs are reported as a component of “Salaries and other benefits.”

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

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2006.

The Bank anticipates substantially completing its announced plans by 2006.
<table>
<thead>
<tr>
<th>Segment</th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans and Discounts, Daily Average</td>
<td>$17,263,000</td>
<td>$15,611,000</td>
</tr>
<tr>
<td>Number of Institutions Borrowing</td>
<td>75</td>
<td>75</td>
</tr>
<tr>
<td>Commercial Checks</td>
<td>$1,165,527,000,000</td>
<td>$1,066,725,000,000</td>
</tr>
<tr>
<td>Commercial Checks Collected</td>
<td>1,182,161,000</td>
<td>1,249,263,000</td>
</tr>
<tr>
<td>Currency Receipts and Payments</td>
<td>$57,636,344,000</td>
<td>$57,217,763,000</td>
</tr>
<tr>
<td>Pieces</td>
<td>3,663,851,000</td>
<td>3,692,199,000</td>
</tr>
<tr>
<td>Coin Receipts and Payments</td>
<td>$165,361,000</td>
<td>$112,831,000</td>
</tr>
<tr>
<td>Bags</td>
<td>313,000</td>
<td>223,000</td>
</tr>
<tr>
<td>Issues and Redemption of U.S. Government Securities</td>
<td>$314,303,266,000</td>
<td>$266,797,294,000</td>
</tr>
<tr>
<td>Funds Transfer</td>
<td>$83,231,378,000,000</td>
<td>$87,841,830,000,000</td>
</tr>
<tr>
<td>Number of Transfers</td>
<td>50,847,000</td>
<td>48,873,000</td>
</tr>
</tbody>
</table>

Volume of Principal Operations numbers were not included in PricewaterhouseCooper’s audit.

Statement of Auditor Independence

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2005 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled $4.6 million. To ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2005, the Bank did not engage PwC for any material advisory services.
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